Michigan League for Human Services

May 24, 2002

AT WHAT COST?

The Impact of Recently Enacted Tax Cuts in Michigan

At the mid-point in the current fiscal year state revenues continue well below projected levels, according to the most recent consensus revenue forecast. As a result, the administration and the legislature will be faced with difficult choices as they struggle to bring the current year's budget into balance and finalize a budget for Fiscal Year 2002-2003. The Fiscal Year 2003-2004 budget will also be a challenge as a result of a worsening structural deficit and continued spending pressures, particularly with regard to Medicaid.

After nearly a decade of revenue surpluses, Michigan's revenues began to decline in Fiscal Year 2000-2001 and continued into Fiscal Year 2001-2002. The legislature reduced some spending in the Fiscal Year 2000-2001 budget, authorized a withdrawal from the state's rainy day fund, and borrowed money for new state building construction to avoid paying cash. Just over one month into the 2001-2002 fiscal year, the governor issued an Executive Order to address a shortfall of $728 million in the general fund and School Aid Fund. The Executive Order included spending cuts, another withdrawal from the rainy day fund, transfers of restricted revenues, withdrawals from other "one-time" sources of funds, such as the Medicaid Trust Fund, and a change in the timing of collection of local property taxes targeted to schools.

Despite the measures already taken, further reductions will be necessary to keep the current year budget in balance, according to the most recent revenue figures. The current year general fund shortfall is expected to total $352.3 million, while school aid fund revenues are expected to be $79.6 million lower than January estimates. Further, the appropriations targets for budgets currently being debated by the legislature will need to be adjusted downward by as much as $320.1 million in the general fund and $62.5 million in the school aid fund. In addition, current estimates suggest that the gap between revenues and expenditures in Fiscal Year 2003-2004 could be as high as $1 billion—a structural deficit that will have to be addressed by a new administration and a new legislature.

Enacted Tax Cuts Contribute to Budget Problems

A significant factor contributing to the state's fiscal woes are the tax cuts enacted by the legislature in 1999. The state's income tax rate is being reduced by one-tenth of a percent over five years—from 4.4 percent in 1999 to 3.9 percent in 2005. In addition, the Single Business Tax (SBT)—the primary tax paid by businesses in Michigan—is being phased out over a period of 23 years. The revenue loss as a result of these tax cuts represents a substantial portion of the current gap between revenues and expenditures and each year will consume a greater portion of any revenue growth that may occur.

Had these tax cuts not been enacted, the state would have realized just over $2 billion more in income and single business tax revenues between Fiscal Year 1998-1999 and Fiscal Year 2001-2002, the current fiscal year. Instead, revenues have declined, with a substantial portion of the decline attributed to the continuation of these two tax rate reductions. While the revenue gain from suspending these tax cuts at the start of the next tax year would be less than what it would have been had the legislature acted sooner, the state could still realize an additional $211.5 million in revenue in the next fiscal year if the tax cuts were to be suspended effective January 1, 2003. The savings would increase to $524.5 million in Fiscal Year 2003-2004. (See table below).

THE COST OF ENACTED TAX CUTS AND REVENUE GAIN FROM SUSPENSION
(millions of dollars)

	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005
Income Tax						
Revenue loss due to rate cut	($247.1)	($354.2)	($463.6)	($658.8)	($875.9)	($975.5)
Revenue gain from suspension 1/1/03	$0.0	$0.0	$0.0	$124.2	$313.6	$387.9
Single Business Tax						
Revenue loss due to rate cut	($208.5)	($309.6)	($409.1)	($552.7)	($692.9)	($841.1)
Revenue gain from suspension 1/1/03	$0.0	$0.0	$0.0	$87.3	$210.9	$343.2
Total Revenue Gain from Suspension (Income tax & SBT)	**($0.0)**	**($0.0)**	**($0.0)**	**($211.5)**	**($524.5)**	**($731.1)**

Source: Senate Fiscal Agency

Who Benefits?

Following nearly a decade of tax cut measures, neither the administration nor the legislature is exhibiting much interest in suspending enacted tax cuts for individual taxpayers or for businesses. Election year politics make legislators particularly wary of suspending tax cuts that may be popular with voters. However, an analysis of the benefits of the most recently enacted tax cuts shows that the primary beneficiaries of the tax cuts have been high income households and the state's largest businesses.

According to the Washington, D.C.-based Institute on Taxation and Economic Policy:

- Nearly one-third of the benefits of the income tax rate cut have gone to households with average annual incomes of $317,000—the top 5 percent of income. Their average tax savings in 2002 will be $275.
- Within that group, the households in the top 1 percent of income realized 18 percent of the total tax cut benefit. Households in this group have an average annual income of $827,000; their average tax savings will be $722.
- Only 1.4 percent of the benefit from the income tax rate cut will be realized by households in the bottom 20 percent of incomes—those with annual incomes below $16,000 and average incomes of $9,500. Their average annual saving will be $3.

Income Tax Savings from Planned Rate Reductions

	Income Group				
	Lowest 20%	Lowest 40%	Lowest 60%	Top 5%	Top 1%
Average Income in Group	$9,500	$15,900	$23,400	$317,000	$827,400
Average Tax Savings Per Taxpayer	$3	$8	$13	$275	$722
Tax Savings as Percent of Average Income	0.03%	0.05%	0.06%	0.09%	0.09%
Share of Total Tax Savings	**1.1%**	**6.5%**	**16.9%**	**34.2%**	**18.7%**

	Lowest 40%	Middle 20%	Middle High 20%	Next to Top 15%	Top 5%
Share of Total Tax Savings	**7.2%**	**11%**	**20.4%**	**29%**	**32.4%**

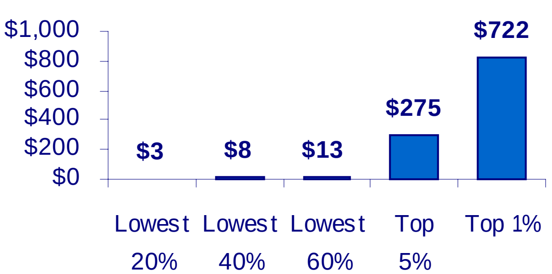
Source: Institute on Taxation and Economic Plolicy

Further, according to the most recent report from the Michigan Department of Treasury, Office of Revenue and Tax Analysis:

- Businesses with gross receipts of less than $250,000 do not owe an SBT tax and are not required to file (45 percent of Michigan businesses).
- Only 36 percent of Michigan businesses had a SBT liability in 1997-1998.
- Of the total 136,723 firms that filed an SBT return, 175 paid 34 percent of the SBT.
- Of all firms with a SBT liability, 2 percent paid 65 percent of the tax.

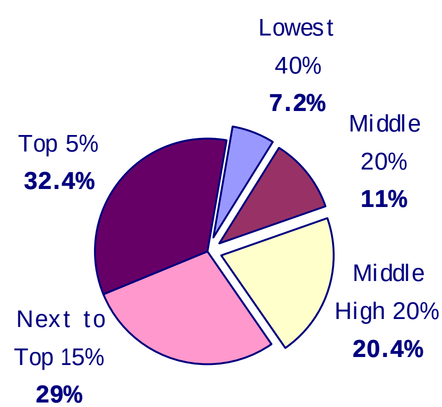
The distributional impact of the income tax rate cut underscores the fact that the state's recent tax policy is tilted largely in favor of higher income households even though low-income households in Michigan continue to bear a heavy tax burden. According to the Center on Budget and Policy Priorities, Michigan is one of 19 states that in tax year 2001 imposed an income tax on two-parent families of four with incomes below the federal poverty line, and is one of 17 in which poor single-parent families of three also paid a state income tax. Michigan's income tax for a family of four at the poverty level is

Average Tax Savings Per Taxpayer



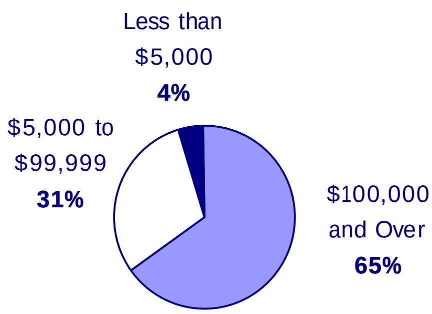
Source: Institute on Taxation and Economic Plolicy

Share of Total Tax Savings by Income Group

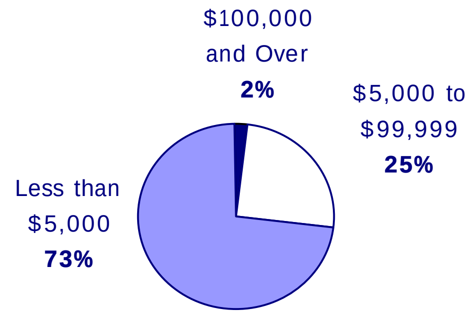


Source: Institute on Taxation and Economic Plolicy

Percent of SBT Paid by Tax Liability Class



Percent of Firms in SBT Liability Class



Source: Michigan Department of Treasury

$223; a family of three owed $178. Despite this high tax burden, these households will realize little benefit from the income tax rate cut.

Likewise, analysis of SBT liability dispels the notion that small businesses in Michigan would be harmed by a suspension of the SBT phase-out. In this instance, the very largest firms do pay the largest share of the SBT, with 175 firms paying $1 million or more in 1997-1998. Seventy-three percent of firms (99,488) paid less than $5,000. The average tax savings in the current fiscal year for a firm paying $5,000 in taxes is $119.

The Budgetary Pressures Are Severe

The deterioration in Michigan's overall fiscal condition, which has occurred over a period of approximately three years, is not likely to abate in the near future. Because of constitutional mandates the state's budget must be brought into balance. But spending pressures, coupled with declining revenues, will present significant challenges. Future revenue growth that would normally be expected to help address spending pressures is largely committed to the enacted tax cuts. According to the Senate Fiscal Agency, while the baseline general fund growth rate in Fiscal Year 2002-2003 is expected to be 5.2 percent above Fiscal Year 2000-2001, the actual growth rate after tax changes will only be .4 percent. House Fiscal Agency projections indicate that 6 percent growth is necessary to maintain a flat budget without any inflationary increases, and another 4 percent in growth is needed to fund enacted tax cuts. With the growth rate estimated well below necessary levels, net general fund revenues for Fiscal Year 2002-2003 are expected to be lower than Fiscal Year 1997-1998, according to consensus revenue forecasting conference estimates.

While Michigan is already feeling the impact of federal funding changes, the impact will be felt to an even greater extent as Medicaid special financing mechanisms continue to be phased out. The state is expected to lose as much as $350 million in federal matching funds over the next three years, adding significantly to the state cost of this entitlement program. Further, as Congress reauthorizes the Temporary Assistance to Needy Families (TANF) block grant that was enacted as part of welfare reform in 1996, it is likely that the block grant funding will be frozen at the current level. If that is the case, the purchasing power of the TANF block grant will have been reduced by 23 percent by Fiscal Year 2006-2007, which will cause the state to gradually reduce the services it funds through this source. That process has already begun with the approval by legislative committees of reductions in TANF spending for Fiscal Year 2002-2003. The children's clothing allowance for children of cash assistance recipients is affected, as are before and after school programs in eight counties.

As the administration and the legislature look for ways to reduce current spending they are likely to be seriously constrained as a result of prior budget cuts. Michigan has already cut to the bone in many of its human services programs in particular. Michigan stands out as one of two states that made the broadest and deepest cuts in overall safety net programs in 1991 and the state that cut welfare benefits more deeply than any other state—13 percent. The maximum grant for a family of three has remained at $459 per month, only 37 percent of the federal poverty level, for over a decade. At that time Michigan's General Assistance (GA) program was terminated, ending both cash and medical assistance for nearly 83,000 single adults and couples without children, and saving the state $240 million. There is no single program in today's Family Independence Agency budget that would yield the same savings. The Emergency Needs Program was also eliminated and replaced with a far more restrictive program—the State Emergency Relief (SER) program. Expenditures for emergency assistance plummeted from $59 million in Fiscal Year 1991 to $20 million in Fiscal Year 1991-1992, with only 3,841 families being helped, compared to 15,299 the prior year. The Fiscal Year 2001-2002 appropriation for SER is still 36 percent below the Fiscal Year 1991-1992 level, even though emergency services providers throughout Michigan have experienced a steady increase in requests for services over the decade. Finally, mental health facilities have been closed across the state, creating strains on community mental health resources and leaving a large void in the availability of suitable placements for persons with serious emotional disorders.

Federal matching requirements will also make expenditure reductions more difficult since a significant portion of the budgets for both the Family Independence Agency and the Department of Community Health are needed to garner federal matching funds. While Michigan has in the past forfeited federal matching funds in order to save general fund dollars, the budgetary choices that remain could put a significantly higher amount of federal funds at risk. For example, Michigan must spend its entire Maintenance of Effort amount of $468 million in state funds in order to receive its annual $775 million federal TANF allocation.

Given the current constraints, there is no question that expenditure reductions of the magnitude necessary to address current and future revenue shortfalls will deliver a severe blow to core human services. The state's budget debacle has progressed beyond the point where simply "whittling around the edges" of programs will provide sufficient fiscal relief. Program eliminations and changes in eligibility that restrict access to services are both more likely to yield greater general fund savings, yet would seriously jeopardize a significant number of the state's most vulnerable residents.

Solutions Must Maintain Programs and Ensure Adequate Future Revenues

At the end of a sustained period of unprecedented economic growth, followed by the most mild recession in recent history, the state is now facing its worst fiscal crisis in nearly 40 years, according to the Citizens Research Council of Michigan. As discussions proceed over how to resolve the state's budget problems the focus must be on short-range as well as long-range solutions. The budget must be balanced in the short run, but there must also be provision for adequate revenues in the future with which to fund vital services. The continued use of "one-time" measures to balance the budget will not correct the serious structural deficit that the state now faces. The Budget Stabilization Fund, which stood at $1.3 billion just a short time ago, is nearly depleted. The Senate Fiscal Agency estimates that by the end of Fiscal Year 2002-2003 the state's rainy day fund balance will have dropped to $225 million.

Suspension of the income and single business tax rate reductions should be an obvious solution in both the short and long term. The escalating cost to the state of these two tax changes simply cannot be sustained. While the income tax rate reduction will stop at 3.9 percent in Fiscal Year

2005, the state will continue to lose revenue as a result of the permanent reduction from 4.4 percent to 3.9 percent. The single business tax, which is being entirely eliminated over a period of 20 more years, currently provides 22 percent of general fund revenues. There has been no discussion of replacement revenue for the single business tax in years to come. It should be noted that the single business tax rate cut will automatically stop if the rainy day fund balance drops below $250 million. Policymakers should not wait, however, for a trigger to do what they have been unwilling to do. The tax cuts should be suspended as soon as possible.

Suspension of the tax cuts, in addition to yielding a portion of needed revenue, also affords an opportunity to review the tax cuts in terms of the state's overall tax policy and what makes the best sense for taxpayers, as well as for the state's ability to fund essential programs and services in the future. For example, the reduction in the individual income tax rate fails to target relief where it is needed most—to low and moderate-income taxpayers. If Michigan had enacted a state Earned Income Credit based on 25 percent of the federal credit, the family receiving the $2 savings from the income tax rate cut would instead receive a credit of over $500 if they were working and raising one child, and over $750 if they were working and raising two or more children.

As a long-term strategy Michigan could also gain additional revenues by retaining its portion of the federal estate tax. Although the federal estate tax is being phased out, state governments also receive revenue through the federal estate tax and the federal phase-out therefore has the effect of repealing state estate laws, draining revenue from the states at a time when it is needed to balance budgets. Ten states and the District of Columbia have passed legislation, or have begun to take legislative or administrative action, to retain these revenues. The amount of revenue that Michigan would gain by "decoupling" from the federal estate tax is substantial. According to the Senate Fiscal Agency, Michigan will lose $67 million in federal estate taxes in Fiscal Year 2002-2003 and that loss has already been factored into the current revenue estimates. The Center on Budget and Policy Priorities estimates that Michigan could retain as much as $689 million between Fiscal Years 2003-2007. Retention of Michigan's estate law would affect only about 1,389 estates—those of the wealthiest taxpayers in the state and only 2 percent of the people who die each year.

While cuts in programs and services will undoubtedly be part of the mix as the budget is brought into balance, cuts in programs should not come at the expense of the most vulnerable and least vocal segments of Michigan's population. The administration and the legislature must maintain a viable safety net for children, low-income families and individuals, disabled populations and the elderly. The long-term fiscal health of the state must also be ensured by providing for a stable, fair and adequate revenue base. The most responsible action now is to suspend the tax cuts to address a portion of future revenue shortfalls; the least responsible action now is to make cuts in critical programs and fail to provide sufficient revenues for current and future needs.

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