Michigan League for Human Services

April 2008
(Revised)

# Tax Avalanche Awaits Michigan Residents Under "Fair Tax" Proposal

*The following is an initial analysis of the "Fair Tax" proposal for which petitions are circulating across the state. The proposal is complex and there are outstanding questions about some elements of the proposal. This analysis is based on the most up-to-date information available.*

## Overview of the "Fair Tax" Debate

Petitions are circulating to put the so-called "Fair Tax" plan on the November ballot. The plan eliminates business taxes and the state income tax while greatly increasing the sales tax — shifting taxes from businesses and high-income individuals and onto low- and middle-income households.[i]

The "Fair Tax" proposal would:

- End business taxes in the state by repealing the new Michigan Business Tax and other business taxes;
- Eliminate Michigan's 4.35 percent income tax;
- Raise the sales tax from 6 percent to 9.75 percent and broaden the sales tax to cover all goods and services *except* those sold from one business to another; [ii]
- Apply the sales tax to groceries and prescription drugs;
- Charge sales tax on the purchase of a home;
- Levy a sales tax on certain health care expenditures;
- Give a rebate to all households, with a two-person household rebate estimated at $1,365;
- Likely eliminate the Homestead Property Tax Credit that provides households up to $1,200 per year.

The proposal is poorly written and there is confusion about some of the details of implementation. Nevertheless, one thing is clear if the "Fair Tax" is approved by voters: **Michigan's tax responsibility, now shared by business and individuals, would shift entirely to individuals**.

### *How will this affect Michigan's overall revenue picture?*

Backers of the proposal say it is designed to replace existing revenue, but in initial discussions, Department of Treasury officials indicate it may come up short by at least **$2.5 billion** compared with current year revenues. **To raise as much revenue as the taxes it is replacing, the rate would have to be approximately 11 percent — and perhaps higher.**

Additionally, the proposal has a built-in TABOR (Taxpayer Bill of Rights) that would hold revenue growth to inflation plus population growth during normal economic times and ratchet down revenues to 95 percent of the previous year's revenue during an economic downturn such as the current one. (This would be similar to the ratchet contained in the Stop OverSpending proposal that failed to qualify for the November 2006 ballot.) After adjustment for inflation, revenues could decline by approximately 8 percent or more a year for a number of years, making it impossible to maintain vital services at a time when they would be most needed.

### *The "Fair Tax" pitch is flawed and unproven*

There is no evidence that shifting virtually all taxes onto middle-income working people and creating a huge revenue gap that will prevent the state from providing quality K-12 education, higher education, roads, health programs and other essential services, will improve Michigan's business climate or economic performance. Indeed, these are the very public services businesses need for successful operation of state services. As Colorado learned following its failed TABOR initiative, the business climate suffers when revenues sink below the level needed to maintain important state services.

### *Early warning bells sounded*

While some groups are raising questions about the "Fair Tax" proposal and studying how the plan will affect their constituents, the biggest concern is whether the revenue generated will sustain current state programs and services, which are already strained by several years of cuts and flat funding.

And who will pay? Supporters indicate it's a win/win for all, creating a good business climate and protecting the neediest families through the rebate. But someone will have to pay. If the plan protects the poorest, and the very wealthy are unlikely to spend enough to replace lost revenue from the elimination of the state income tax, who is left to pay? Those in the middle are the likely candidates.

Also, there appears to be confusion in some media reports, and in conversations, about the tax on property. Some mistakenly believe it would eliminate residential property taxes. It would not. Indeed, the possible elimination of the Homestead Property Tax Credit (an income tax credit to offset property taxes) could effectively increase property taxes by ending an income tax credit worth up to $1,200 a year. That could happen because there would be no income tax under the plan, and therefore, no income tax credits.

In addition, the "Fair Tax" would impose a sales tax on home sales of about $5,000 for each $100,000 of value of the residence (not including land). This additional cost could exacerbate an already dismal housing market.

## Devil's in the Details: How Would Taxes Change Under the Proposal?

### *Tax changes would be written in Michigan's Constitution*

The ballot initiative would amend several sections of Article IX of the Michigan Constitution. Under Sections 3, 7, 8 and 43, the recently adopted Michigan Business Tax, the business Personal Property Tax, the 6 mill School Education Tax (levied on businesses only), the Michigan Income Tax, and the existing 6 percent sales tax on specified goods and services would be eliminated. Instead, it appears the intent is to replace those taxes with a 9.75 percent sales tax on all goods and services effective January 1, 2010. The "Fair Tax" proposes to replace those taxes with a 9.75 percent sales tax on all goods and services including food and prescription drugs. All business-to-business sales would be excluded from sales tax.

### *Low-Income Households would have large new sales tax burden, but may have trouble getting the rebate*

Under Section 46, the plan would attempt to mitigate the impact of the new sales tax on low-income households. All Michigan households would receive this rebate, equal to 9.75 percent of the federal poverty level. The Michigan Fair Tax Association's Web site has information on a monthly payment to households, but the ballot language only requires an annual payment with no mention of the exact timing, or of the fact that payments would only be made electronically.

To receive a sales tax rebate on a pro-rated monthly basis beginning in February 2010, households would have to provide the Michigan Department of Treasury with a verifiable Michigan address, a list of household members, their Social Security numbers and the household's electronic bank routing information.

Treasury officials say they have the necessary information to electronically distribute rebates to a significant share of Michigan households with state tax liabilities, but they do not have that information for households not required to file a state tax return, including very low-income households. It appears that while needy households would qualify for rebates to offset increased sales taxes, they would also be the least likely to have the personal and electronic banking information necessary to receive those rebates.

### *Rainy day fund withdrawals and deposits would be mandated*

Section 47 concerns deposits and withdrawals from the state's rainy day fund. If total state revenues raised by the sales tax fall below 95 percent of the sales tax revenues rose in the prior fiscal year, withdrawals from the state's Budget Stabilization Fund (BSF) would be triggered to raise revenue to 95 percent of prior year revenues. If the BSF fund balance is insufficient, the "Fair Tax" requires the sales tax rate to be increased by enough to reach 95 percent of prior year revenues for not more than one year.

The "Fair Tax" ballot language does not specify that withdrawals from the BSF would be included in the revenue base used to determine the value of the mandated 95-percent-of-prior-year-revenue threshold. This suggests that required minimum revenues could fall by the specified 5 percent per year plus any BSF withdrawal used to comply with the minimum revenue threshold in the prior year.

Also under Section 47, if the "Fair Tax" revenues, adjusted for inflation plus population growth, cause sales tax revenues in 2010 to exceed revenues collected in 2009, any surplus would be deposited in the state's BSF. (This implies that revenue equivalent to prior year revenue plus inflation and population growth would be available in FY2010 to support state spending.) In 2011 and subsequent years, sales tax revenues (accounting for inflation and population growth) that exceed prior year sales tax revenues would be deposited in the BSF up to a limit of 10 percent of sales tax revenues. For revenues beyond that, the 9.75 percent sales tax would be reduced for not longer than one year in order to eliminate excess state revenues.

### *Businesses and wealthy individuals shielded; nonprofit insurance companies would be taxed*

Section 43 would prohibit the state from imposing a general business tax other than that established by the "Fair Tax" initiative and also stipulates that the rate of a general business tax shall only be increased with the approval of a majority of the qualified electors of the state. A rate increase would require the vote of a majority of qualified voters, not a majority of voters participating in an election.

Section 44 would constitutionally prohibit the state from imposing an estate or other tax on accumulated wealth.

Under Section 45, each insurance company doing business in the state of Michigan would be subject to a tax equal to 1.1 percent of gross direct premiums, down from the 1.25 percent under the Michigan Business Tax. A report coauthored by "Fair Tax" supporter Gary Wolfram—a Hillsdale College professor of economics and a former deputy state treasurer—also indicates that this would include nonprofit insurance companies, which are not currently taxed.

### *Impact on local units of government*

Under Section 10, the "Fair Tax" initiative language specifies that, effective January 1, 2010, funds equivalent to current constitutional and statutory revenue sharing payments to counties, townships, cities and villages would be constitutionally mandated and distributed as specified by law.

The ballot proposal language would mandate statutory revenue sharing payments, thus shifting approximately $200 million annually from the state budget base to local units of government. While this sounds like a positive for local governments, it may not be. They may be receiving a portion of an ever-shrinking pool of revenue. Moreover, if state revenues are indeed short by at least $2.5 billion a year, and if state revenues are ratcheted down periodically and cannot recover when the economy recovers, localities may find themselves making up for very sizable cuts in state expenditures for education and other services. This issue needs further study.

Under Section 7, the petition language indicates that, despite a prohibition on a state income tax after January 1, 2010, political subdivisions of the state could levy such a tax. This language appears to trump existing statutory language granting 20-plus Michigan communities the right to levy an income tax, thus opening the option up to all political subdivisions.

## Analysis of the "Fair Tax" – How Fair Is It?

### *Big shift to families with a potential loss of state services*

Adoption of the "Fair Tax" ballot initiative would eliminate the recently reformed Michigan Business Tax and shift the related $2.2 billion annual liability to Michigan's families. In addition, the personal property tax and sales and use tax on business purchases would be dropped, creating a massive shift in taxes from businesses to consumers.

The "Fair Tax" would ostensibly increase the current sales tax rate from 6 percent to 9.75 percent and expand its application to the sale of all non-business-to-business goods and services, including food and prescription drugs. However, state officials have raised questions about the wording of the petition and whether it would instead establish a smaller tax on services and food and drugs.

Despite claims by the "Fair Tax" group that their proposal is intended to be revenue neutral, the Michigan Department of Treasury, in initial discussions, estimates that it would reduce annual state revenues by at least $2.5 billion (approximately 13 percent) in the first full year of implementation.

The Wolfram analysis, upon which the "Fair Tax" is based, fails to take into account $1.6 billion in new revenue associated with the income tax rate increase and the Michigan Business Tax surcharge enacted last year. Further, the analysis does not recognize nearly $900 million in revenues that the state would need if the Homestead Property Tax Credit remains in effect.

The Michigan League for Human Services estimates that the 9.75 percent sales tax proposed by the "Fair Tax" coalition would have to be increased to approximately 11 percent to secure the revenue neutrality claimed by the measure's proponents.

The revenue gap created by the "Fair Tax," if not closed through a higher sales tax, would result in significant cuts to programs and services.

### *No counter-cyclical help to shore up the economy*

During a period of economic decline such as Michigan has experienced over the last seven years, the proposed "Fair Tax" constitutional amendment would permit state revenues used to support K-12 and higher education, health care, law enforcement and most other functions of state government to decline by up to 5 percent per year in actual dollars. When adjusted for inflation, this decrease could be expected to equate to a potential annual decline in the state's purchasing power of roughly 8 percent with no provision for restoring resulting program cuts when the state's economic climate improved. Furthermore, because prior year revenues serve as the basis for determining permissible current year revenues under the "Fair Tax," a prolonged economic downturn could result in a dramatic downward spiral in revenues available to support critical public services.

Revenues produced by the proposed "Fair Tax" could be expected to fluctuate, rising and falling with the economy rather than providing a stable flow of revenues throughout the business cycle. The result would be the inability of government to fund counter-cyclical programs to respond to and mitigate the impacts of a declining economy. The likelihood that revenues would decline dramatically during a downturn under the "Fair Tax" suggests that it could exacerbate the state's worsening fiscal outlook.

### *Take a second look at the impact on seniors and homeowners*

The proposed shift from income and business taxes to a 9.75 percent sales tax on all non-business-to-business goods and services would be particularly burdensome for Michigan's senior citizens, who currently benefit from significant income tax credits and disregards.

About 93 percent of senior households have no liability under the state income tax so they would not benefit from the elimination of the income tax. A broad-based sales tax on goods, including food and prescription drugs, and services, including out-of-pocket health care costs, would have a disproportionately harsh impact on seniors. At a time when the health care crisis is affecting an increasing numbers of households, a sales tax on health care could serve to further reduce access to health care.

Seniors and other homeowners also would be hurt by the loss of the Homestead Property Tax Credit. Since the tax credit is tied to the income tax, which would be abolished by the "Fair Tax" proposal, households could lose a tax credit worth up to $1,200 per year if the tax is implemented.

In addition, adoption of the "Fair Tax" proposal would add significantly to the cost of a new home. While no sales tax would be levied on the land used as a building site for a new home, the "Fair Tax" would add 3.75 percent to the cost of building materials currently taxed at 6 percent, and 9.75 percent to the balance of the purchase price related to labor and profit. In total, the Michigan League for Human Services estimates that the "Fair Tax" would add approximately $5,000 to the cost of a new home for every $100,000 of appraised value. The "Fair Tax" would also apply to the sale of used homes but the formula is less clear. The sales tax would be due at closing. This could greatly increase a home-buyer's upfront costs.

It should be noted that because of their variable nature, closing costs such as title search, loan origination, property survey, attorney and mortgage processing fees, most of which could be expected to increase under the "Fair Tax" proposal, have been excluded from the upfront cost comparison.

Further, the estimated impact of the proposed "Fair Tax" on the upfront cost of a new home assumes that 25 percent of the total cost relates to excludable land costs and that 50 percent of the actual building costs are materials currently taxed at 6 percent.

Given the big increase in upfront costs illustrated above, it appears reasonable to assume that implementation of the "Fair Tax" would have a significant chilling effect on a housing market already reeling from the sub-prime mortgage crisis and the continuing loss of high-wage manufacturing jobs in Michigan.

The proposal puts a new burden on owner-occupied housing, but it would be helpful to landlords who would benefit from the repeal of the state education tax (SET) on real property that is business property by exempting most residential rental property from the SET.

### *Unintended consequences? More Internet, out-of-state sales; drop in charitable giving*

Establishing a sales tax that is much higher than that of the surrounding states would likely result in a significant loss of economic activity, especially in those border communities where individuals have easy access to markets in other states. Indiana's sales tax, for example, is now 7 percent.

Further, implementation of a 9.75 percent sales tax would accelerate the already growing shift to out-of-state Internet sales, thus disadvantaging in-state merchants and services providers and further reducing state revenues.

As designed, the "Fair Tax" would shift a large share of Michigan's existing tax burden from businesses and high-income individuals currently subject to the state income tax, to middle-income households who spend a much larger share of their incomes on taxable goods and services. Despite claims by "Fair Tax" proponents to the contrary, this shift from for-profit companies and affluent households to moderate-income households appears extremely regressive in nature.

While local governments may welcome the "Fair Tax" provision that would guarantee revenue sharing payments in the constitution, the estimated $200 million funding increase could be quickly offset by reduced K-12 education payments from the $12 billion School Aid Fund during an economic downturn. The "Fair Tax" language would permit a decline in supporting revenues of 5 percent per year during economic downturns with no provision for a catch-up of lost revenues during an economic recovery. The loss of local K-12 purchasing power could in fact be even greater since the minimum revenue requirements of the "Fair Tax" proposal do not include an adjustment for inflation. In a year in which inflation is 3 percent, for example, the 5 percent year-to-year revenue loss permissible under the "Fair Tax" would result in a decline in real purchasing power of 8 percent.

The “Fair Tax” also would eliminate the itemized income deductions for contributions to such organizations as food banks, public radio and television stations and various other public service and assistance programs dependent on charitable giving.

An analysis of the impact of eliminating the Estate Tax on charitable giving suggested that this change in tax policy could have a major chilling effect on contributions.

The apparent ability of all local units of government to impose an income tax on households residing in their jurisdiction under the auspices of the “Fair Tax” language may be viewed as a significant issue by the electorate. Because this issue is not raised in the summary of what the “Fair Tax” is intended to do, however, signers may feel they were not fully or properly informed regarding the potential impacts of the proposal.

## Conclusion

One of the talking points of the “Fair Tax” coalition is the suggestion that the proposal would eliminate “tax day,” a reference to eliminating the state personal income tax due on April 15. It seems cold comfort, however, to realize that their proposal would make every day “tax day” in Michigan.

“Fair Tax” supporters say their plan would make life simple. In reality, the plan is anything but simple.

If passed, Michigan will be less protected in economic downturns, home sales may suffer and businesses near the borders may lose out. Vulnerable families may not have the wherewithal to participate in the rebate process. It’s likely the middle class would shoulder much greater tax responsibility, and more local income tax levies could be allowed.

At the same time, state revenues are at risk of shrinking, requiring more cuts into a budget that’s already down to muscle and bone, if the “Fair Tax” fails to yield needed revenues.

mar/all/Fair Tax Avalanche

[i] The petition drive is led by Rep. Fulton Sheen, R-Plainwell, a third-term lawmaker. Sheen and 35 GOP cosponsors last year introduced a legislative resolution to move the issue onto the ballot. That resolution remains in committee, and Sheen and others have turned to a petition drive instead to place the constitutional amendment in front of voters.

[ii] The petition wording is not entirely clear on rate and coverage.