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The Looming Danger of Tax Cut Triggers in Michigan

INTRODUCTION

Three years ago, policymakers in Lansing passed a package of bills that promised to address Michigan's crumbling roads. One of the most significant yet largely overlooked changes included in the package was a personal income tax cut set to trigger almost a decade later in 2023. Under the law, if General Fund revenues grow by more than the rate of inflation in a given year, the rate of the income tax will be reduced. The tax rate cut will also be eligible to trigger every year thereafter until the personal income tax rate is reduced to zero.[1] A 0.1% rate cut eliminates roughly $250 million in tax revenue on a full year basis. As Michigan's economy enters its tenth year of recovery from the Great Recession, one thing is clear: our economy is not prepared to weather another round of tax cuts. **Incremental cuts to the state income tax would eventually eliminate a funding stream worth about $10 billion and put a significant strain on the state's ability to fund schools, roads, safety net programs and public safety.**[2] It is not too late for policymakers to reverse their decision; it is the morally and fiscally responsible thing to do.

This brief explains why income tax cut triggers are the wrong choice for Michigan for four primary reasons:[3]

- Policymakers do not have enough information to know if they are affordable.
- They can trigger during economic downturns or other times when revenues are badly needed.
- They primarily benefit the top 1% of taxpayers.
- They enable policymakers to claim credit for cutting taxes while avoiding accountability for the consequences.

BACKGROUND

Put simply, income tax revenue is a vital lifeline for the state's General Fund. It is estimated to contribute 69.1% of the total revenue for General Fund/General Purpose funding in FY 2017-18, and 22% of the total revenue for the School Aid Fund in the same period.[4] Making up the majority of General Fund/General Purpose funding, income tax revenue helps pay for important services like healthcare, higher education, public safety, preschool and other vital human services. Despite its important role, General Fund growth rates have not kept up with the rate of inflation. Between budget year 2000 and anticipated budget year 2019, inflation increased by 73% while General Fund revenues are actually down about 1%.[5] By 2020, the General Fund will be below 1968 levels when adjusted for inflation; 1968 was the year the income tax was enacted.[6] During this time, the cost of services will continue to grow due to growth in the overall population and in groups, such as students and the elderly, who tend to use more state services.

A consistently flat state budget has been partially a result of tax cuts and earmarked tax revenues that state legislators have made in recent years. Among these are the Personal Property Tax reform passed in 2014 and the road funding package passed in 2015, both of which will squeeze hundreds

2015 Income Tax Trigger

Under the law, an annual General Fund (GF) revenue cap would be calculated by inflating Fiscal Year 2020-21 revenue by 1.425 times cumulative inflation after that year. If GF revenues exceed the GF cap, the rate of the income tax will be reduced. The first year the tax cut could trigger is 2023, and it would be able to trigger indefinitely on an annual basis until the income tax rate is reduced to zero. Over time, even with cumulative adjustments for inflation to GF revenues, significant revenue growth may be hindered given the possibility of triggering another tax cut.

Source: *Legislative Analysis: Road Funding Package – Enacted Analysis*, House Fiscal Agency, November 2015.

of millions in funding from the General Fund. Overall, the state has spent more in state and local tax credits, deductions and exemptions than it has in total budget spending from state and general restricted funds over the past several years. **These commitments cost state and local governments approximately $39.87 billion in FY 2018, and they will further constrain General Fund revenue growth in the years to come.**[7] The consequence of these tax cuts is that the State has less money to expend on important state services that Michiganders depend on.

Despite the strains that our state budget is enduring, there are legislators who continue to champion new tax cuts as an economic development strategy that will transform our economy. But the evidence of tax cuts in Michigan tell a different story. Business tax cuts passed in 2011, for example, did not serve as a catalyst for job creation. In fact, job growth actually slowed in the years immediately following the tax cuts.[8] Meanwhile, legislators tried to make up for lost revenue from the tax cuts by cutting K-12 per-pupil funding and funding to higher education institutions, among other services.[9]

Michigan has also grown more reliant on federal funds to support services like early childhood education, health care and safety net programs like the Supplemental Nutrition Assistance Program (SNAP) over the past several years. Over the past decade, our total budget grew by 29.8%, federal funds appropriated in our state budget grew by 57.8% during the same period, while state spending from state resources only grew by 13.3%.[10] **Today, federal revenues contribute about $23 billion, or over 40%, of our state budget.**[11] The Trump administration's determination to cut funding for important public programs, is a warning to state legislators who hope to erode tax revenue through income tax cuts. Michigan would lose millions in federal funding if President Trump makes good on his promises, and without additional state revenue, this would likely lead to devastating cuts to important programs.

A DECADE AFTER THE GREAT RECESSION, MICHIGAN'S ECONOMY IS STILL RECOVERING

Looming income tax cuts also come at a time when Michigan is in its tenth year of recovery from the Great Recession. While the state has made great strides, Michigan's GDP is growing at a slower rate than it did in previous recoveries (inflation-adjusted GDP is growing at a 2.2%, whereas historically the economy has grown at a 4.4% rate).[12] Furthermore, while in previous recoveries government spending increased to meet needs, spending has declined in the current economic recovery.[13] This hasn't been good for important services like K-12 schools, safety net programs and higher education institutions, which experienced significant funding cuts in the years after the recession. In the workforce, though Michigan's unemployment rate has declined since its peak during the recession, part of the decline has been due to the number of workers leaving the labor force.[14]

In fact, labor force participation tells the long-term story of Michigan's economy. For a number of years, labor force participation rates have stagnated, meaning that a smaller number of Michiganders are working or looking for work.[15] Overall, Michigan has lost 326,000 workers since 2000, which still exceeds the number of currently unemployed individuals who are looking for work (227,000).[16] When it comes to wages, low- and middle-income workers have seen declining real hourly wages since 1979.[17] Inflation-adjusted hourly earnings increased a mere 1.2% in 2016, down from a 2.1% increase in 2015.[18] Stagnating wages for workers mean that more families have a harder time meeting basic needs as the costs of goods and services continue to rise, and can more easily slip into poverty, hurting our economy overall. **It's clear that though our state has made strides since the recession, the economy is still recovering and legislators will do more harm than good if they allow income tax cuts to trigger in the coming years.**

Overview of Michigan's Tax Commitments

Tax Cut	FY 2019 Estimate	FY 2020 Estimate
Michigan Business Tax Credits	$619 million	$614 million
Personal Property Tax Reimbursement	$437.7 million	$465.9 million
Homestead Property Tax Credit Expansion	$205.8 million	$205.8 million
Road Funding Diversion	$150 million	$325 million
Personal Exemption Increase	$75 million	$146.3 million
Additional Tax Cuts	COUNTLESS	COUNTLESS
Potential Loss of Federal Funds	COUNTLESS	COUNTLESS
Total Cost	**$1.47 billion+**	**$1.74 billion+**

Sources: Senate and House Fiscal Agencies[19]

INCOME TAX TRIGGERS ARE THE WRONG CHOICE FOR MICHIGAN

We don't know if the tax rate reductions are affordable. When tax cuts are enacted several years before they take place, it is virtually impossible to determine whether the state can afford to make such cuts. We do not know if we will be facing another economic recession in the next couple of years, or if a crisis will arise in the state that will require significant investments from the government. Even though the trigger requires that revenues rise above inflation before the cuts are considered affordable for the state, this mechanism does not take into account the additional revenue needed to maintain current level funding for services. Absent multi-year projected revenues, legislators simply do not have enough information to responsibly implement the tax cut.

Triggered Income Tax cuts are not good for Michigan's economy. Some individuals argue that triggered tax cuts serve as an economic development strategy because they give businesses and individuals time to make investment decisions based on tax cuts set to take place in the near future. Evidence, however, shows that taxes do not actually play a significant role in driving decisions by households about where to settle down. Individuals are more likely to make living decisions based on factors like family, job opportunities, cost of housing and weather.[20] Furthermore, only a small fraction of the general population are actual business owners who would be the ones making significant capital investment decisions based on state taxes.

Triggered tax cuts are simply not an economic development strategy, and in fact, have shown to be quite the opposite because they can trigger during times of economic downturns when revenues are needed the most. This is what happened in Oklahoma, where legislators stubbornly held onto triggered tax cuts even after the first rate cut was suspended due to low levels of revenue in 2010. The tax cut eventually took place in 2012, even though state revenues had not yet recovered from the recession. In 2016, another triggered tax cut went into effect (this time lowering the top tax rate) amid an economic downturn caused by falling oil prices. The result? State legislators were left with a budget hole of nearly $900 billion.[21] Since then, state legislators have been trying to repeal the tax cuts. Oklahoma should serve a cautionary tale for Michigan legislators who continue to believe that this flawed approach will spur economic development.

The tax cuts are not equitable. In addition to being a fiscally dangerous move for our state, triggered tax rate cuts will not be felt equally among all of Michigan's residents. **The tax cuts are set to primarily benefit the top 1% of taxpayers. Meanwhile, Michigan's middle- and lower-income families will be left to deal with worsening roads, underfunded schools and fewer services.** New analysis by the Institute on Taxation and Economic Policy (ITEP) uses current year and

Analysis of Michigan's Personal Income Tax Trigger Rate Cuts
All Michigan Residents, 2018 Incomes

2018 Income	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less than $22,000	$22,000 - $39,000	$39,000 - $63,000	$63,000 - $103,000	$103,000 - $208,000	$208,000 - $463,000	$463,000 or more
Average Income in Group	$13,000	$30,000	$50,000	$81,000	$139,000	$294,000	$1,490,000
Impact of Personal Income Tax Rate Cut From 4.25% to 4.15%							
Tax Change as Percent of Income	-0.04%	-0.05%	-0.05%	-0.06%	-0.07%	-0.08%	-0.07%
Average Tax Change	-$5	-$14	-$24	-$49	-$100	-$237	-$1,104
Percent With Income Tax Cut	58%	71%	79%	89%	96%	99%	99%
Average Tax Cut for Those With Cut	-$8	-$20	-$31	-$55	-$104	-$239	-$1,111
Share of Tax Cut	2%	5%	9%	18%	28%	18%	20%
Impact of Personal Income Tax Rate Cut From 4.25% to 4.0%							
Tax Change as Percent of Income	-0.10%	-0.12%	-0.12%	-0.15%	-0.18%	-0.20%	-0.19%
Average Tax Change	-$12	-$36	-$61	-$123	-$249	-$593	-$2,761
Percent With Income Tax Cut	59%	71%	79%	89%	96%	99%	99%
Average Tax Cut for Those With Cut	-$20	-$51	-$77	-$138	-$259	-$597	-$2,778
Share of Tax Cut	2%	5%	9%	18%	28%	18%	20%

Source: Special Data Request from the Institute on Taxation and Economic Policy, May 2, 2018.

two-year forecasts to calculate the impact that a 0.1 or 0.25 rate reduction in the Personal Income Tax (PIT) could have on taxpayers and state revenue. The data shows that any reduction in the PIT actually shifts the tax load further to low-income Michiganders. Under a 0.1 rate reduction in the PIT, 99% of the top 1% of taxpayers would receive a tax cut while only 58% of those in the lowest 20% of taxpayers would see their tax contributions reduced. Additionally, Michigan's taxpayers would receive only a small annual benefit, which for many would be barely noticeable as it is spread over paychecks.

Triggered tax cuts enable policymakers to claim credit for cutting taxes while avoiding accountability for consequences. There are no practical benefits for scheduling income tax cuts so far in advance. There were also no logistical issues that would have prevented legislators from implementing the tax cut right away. So why did legislators choose to wait? **The reality is, legislators who championed triggered tax cuts several years ago when the law was passed did so because they knew they were unaffordable at the time**. Implementing then in 2015 would have likely forced cuts to state services in order to balance the budget—a politically unpopular move. Legislators chose this route because they knew they wouldn't have to deal with the consequences when cuts did take effect. **By 2023, when the first income tax rate cut will be eligible to trigger, many of the legislators who passed the legislation will be long gone.** This should set off alarm bells for Michigan taxpayers who will be left to deal with the aftermath.

POLICY RECOMMENDATIONS

- **Repeal triggered tax cuts.** Legislators must now do the fiscally responsible thing and repeal the triggered income tax cuts that were passed into law in 2015. If triggered in 2023, these tax cuts will only hold Michigan's economy and its residents back. If left in place, the cuts will significantly erode revenue available to fund important programs and services. Moreover, state revenues will never be able to return to previous levels because any minimal rise in revenue will only trigger another rate cut. Essentially, we will be digging ourselves into a deeper and deeper fiscal hole.

- **Adopt a fair income tax structure.** If our legislators truly want to help all Michiganders thrive, one of the things they can do is implement a graduated income tax structure that would ensure that low- and middle-income taxpayers don't pay a greater share of their incomes in taxes than the wealthiest taxpayers. Currently, Michigan is only one of eight states in the country that still relies on a flat income tax structure. A graduated tax structure would also help generate additional revenue needed for investing in our schools, our communities and our roads.

- **Restore tax credits that support low- and middle-income Michiganders, and help our economy grow.** In 2011, legislators reduced the Michigan Earned Income Tax Credit (EITC) by 70%. In doing so, they virtually eliminated one of the most effective strategies for supporting working families struggling to make ends meet. Research shows that cutting low-income tax credits is not good for our economy because it makes it more difficult to develop a highly skilled workforce. Unlike an inequitable tax cut that delivers only a token benefit to low- and middle-income taxpayers, a fully restored EITC would deliver real and significant benefits to help Michiganders thrive.

ENDNOTES

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