COVID-19 HIGHLIGHTS THE NEED FOR MORE STATE REVENUE

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Executive Summary

As Michigan grapples with the worldwide COVID-19 pandemic, it is also sliding into a severe economic and fiscal crisis that has delayed work on the state's 2021 budget and it has forced Gov. Gretchen Whitmer and lawmakers to address what is now expected to be a decline in state revenues of $3.2 billion in 2020, and $3 billion in 2021.[1] Without additional flexible federal funding, lawmakers will need to make deep cuts in public services, including potentially early childhood education and care, K-12 education, public health, human services and postsecondary education. Because of inequities embedded in the state's economy and workforce, cuts in public services will inevitably have a disparate impact on families and children within communities of color, as well families with lower incomes and fewer savings or assets.

This brief describes Michigan's current fiscal crisis and includes a range of options for addressing the crisis, with a focus on progressive tax policy changes that could help Michigan recover quickly and weather future economic downturns in ways that keep the state's economy stable and robust. Among the options for policymakers are:

- Advocate for additional federal relief that is flexible and tied to state economic conditions and COVID-related revenue shortfalls.
- Take maximum advantage of the state's Countercyclical Budget and Economic Stabilization Fund, also known as the rainy day fund.
- Ensure that corporations are paying their fair share for the services that support their businesses.
- Modernize the state sales tax to reflect the current economy and the growth of the services sector.
- Reform the state's estate tax by decoupling it from the federal estate tax.
- Reform Michigan's personal income tax to make it more progressive and based on the ability to pay.
- Reevaluate the effectiveness of tax expenditures.

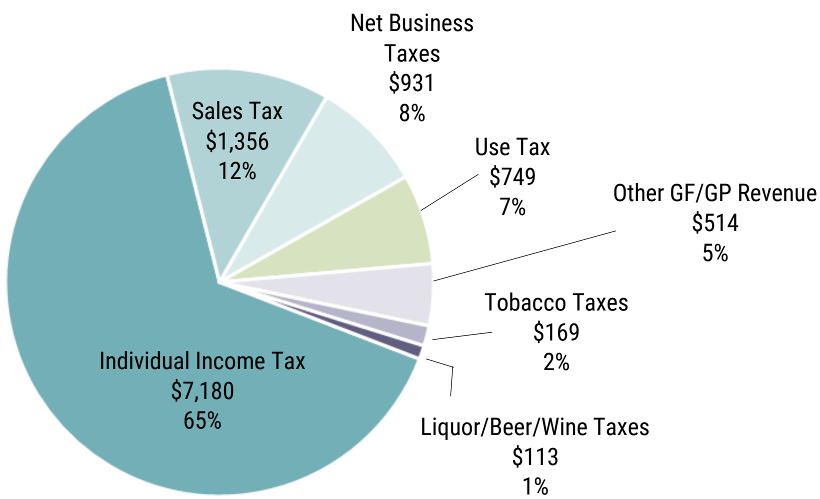
Context

A Rapidly Emerging Fiscal Crisis

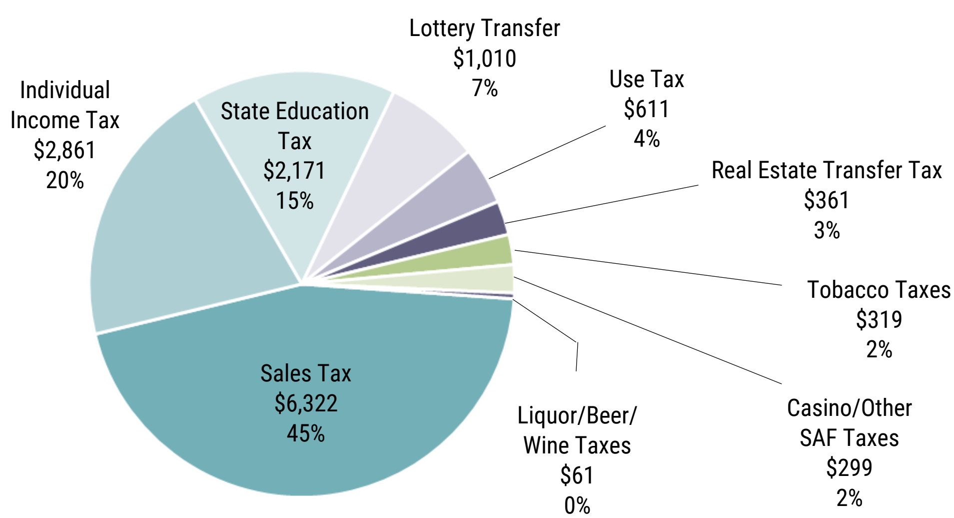
Gov. Gretchen Whitmer, like many of her peers in other states, responded quickly and forcefully to the worldwide COVID-19 pandemic, with an eye on protecting the health and safety of Michiganders. She issued executive orders to keep residents and K-12 students safely at home, to flatten the curve so Michigan hospitals are able to respond to the rapid spread of COVID-19, to help prevent evictions and utility shutoffs, and to ensure child care services for essential workers. While absolutely necessary to protect human life, the inevitable result was a temporary halt to much of the state's economic activity as Michiganders left their workplaces, and businesses were temporarily shuttered.

As a result, the state's public health crisis has become an unavoidable fiscal challenge. Stay-at-home orders and business closures have put many people out of work, so fewer are paying income taxes. And, with unemployment high and many stores and businesses closed, sales tax revenues are also dropping. The two largest contributors to Michigan's General Fund (GF) and School Aid Fund (SAF) are income and sales taxes—both of which are deeply affected by the COVID-19 crisis; roughly 20% of the School Aid Fund revenues come from the personal income tax, with 45% through the sales tax.

General Fund/General Purpose (GF/GP) Revenue Sources



School Aid Fund (SAF) Revenue Sources



Percentages may not add up due to rounding.
Source: House Fiscal Agency

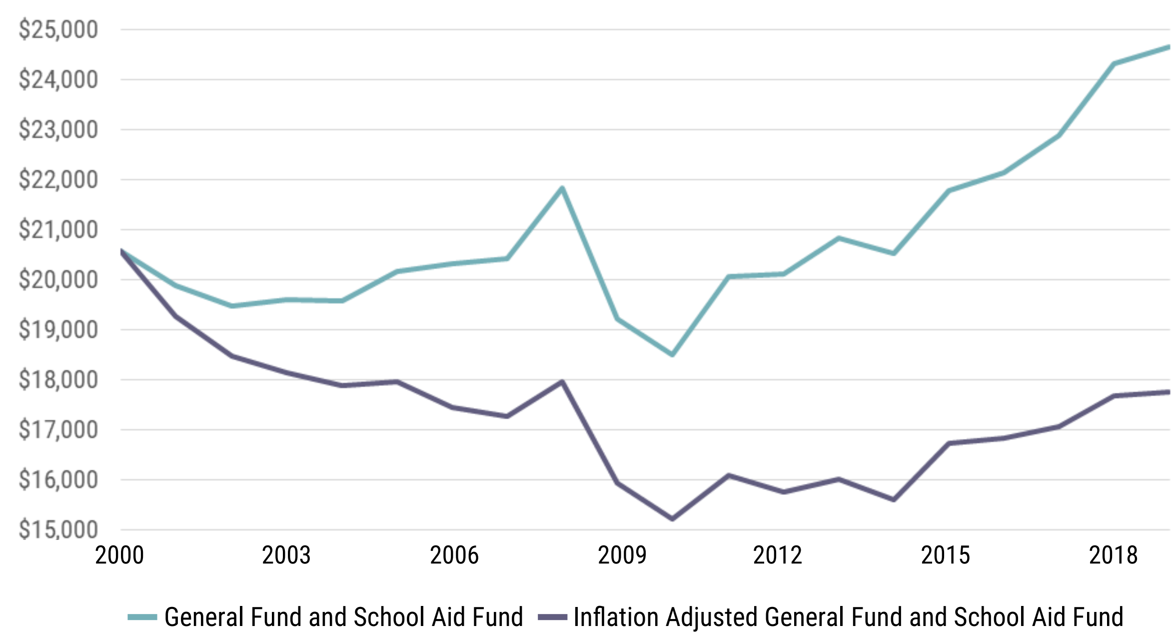
A State Unprepared for an Economic Downturn

Economists estimate that the current crisis will have a substantially larger impact on Michigan's economy and fiscal health than the Great Recession. During the worst budget year of the Great Recession, Michigan's net General Fund and School Aid Fund revenues fell $2 billion and $0.6 billion, respectively.[2] Michigan's Consensus Revenue Agreement states that net General Fund and School Aid Fund revenues are projected to decline $6.2 billion in the next two budget years and are not expected to return to 2018-19 levels until after 2022.

Michigan's sluggish recovery from the Great Recession and current projections indicate that the state is not poised to recover quickly from this current crisis. Michigan experienced a slow recovery in labor force participation in the years after the recession, marking a large increase in those that are not seeking employment or working. The labor force participation rate in Michigan fell from 64.2% in 2007 to a low of 60% in 2012 and has only recovered to 61.4% in 2018.[3] Wages have also not kept pace with inflation; real wage growth has been stagnant for the last two decades, rising only 0.1% between 2000 and 2018.[4] While Michigan's General Fund and School Aid Fund have climbed since the depths of the recession, real General Fund revenues are far below levels in the 1960s and the School Aid Fund is below 2000 levels when adjusted for inflation.

With the state's slow recovery from economic recessions, along with tax decisions that limited state revenues, Michigan has underinvested in critical services and infrastructure and placed itself in a vulnerable position during this crisis. Funding for essential public health services has remained essentially flat with losses against inflation, statutory

Michigan's Fund Contributions Have not Kept Up With Inflation



Source: Consensus Revenue Estimating Agreements

MICHIGAN LEAGUE FOR PUBLIC POLICY | WWW.MLPP.ORG revenue sharing to local units of government has been deeply cut (making a local response to COVID-19 more difficult), and the state's human services capacity has continued to weaken.[5]

Current Policy Response

State Response

The state and federal government have moved aggressively to respond to the COVID-19 crisis, but their actions to date will not be adequate to correct Michigan's economy and state finances. Michigan has taken a number of steps to respond to the crisis and protect Michigan's finances:

- The Legislature appropriated $150 million earmarked to supplement the public health response to the virus.
- Gov. Whitmer vetoed current-year supplemental funding to free up additional revenues.
- Gov. Whitmer issued a range of Executive Orders intended to protect public health and to provide some basic services for essential workers and those who are unemployed and facing financial hardship.
- The Legislature and governor temporarily delayed action on the state's 2021 budget, with an expected initial assessment of the budget gap having been reported at the May Consensus Revenue Estimating Conference.

Federal Response

The federal CARES Act allocated funds to states, earmarked for necessary expenditures incurred from the COVID-19 crisis. Michigan is poised to receive nearly $3.9 billion in federal relief, with $3.1 billion apportioned to the state government and $792.8 million apportioned to local units of government with more than 500,000 people. The CARES Act funds for states are specifically earmarked for necessary expenditures incurred because of the COVID-19 crisis. These funds cannot be used to address state budget deficits and have to be spent before December 30, 2020. This means that the federal relief to states will not cover revenue losses resulting from the public health crisis, even though the fiscal crisis is going to extend far beyond the COVID-19 health crisis.

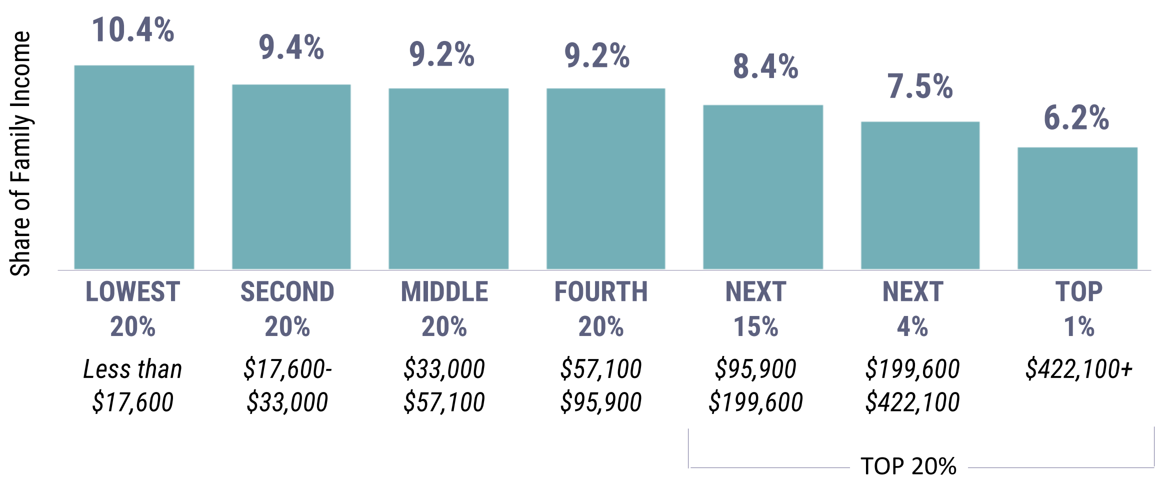
It is critical that the CARES Act funding is used to protect the health of Michiganders with a focus on the residents with the greatest needs. The funds should be focused on providing food and nutrition assistance, housing and energy assistance, among other public services. The funds should also protect the services most needed when the economy restarts, including child care.

The State of Current Policy

Michigan's current tax system cannot generate the revenues needed for the COVID-19 crisis and cannot adequately produce the resources needed to rebuild the state's economy, fund vital services and infrastructure, and prepare for future downturns. Without additional and more flexible federal aid or proactive tax changes, Michigan will have to revert to deep cuts in services that will affect all residents, with a particularly disparate impact on families of color and residents with lower incomes and wealth. If nothing is done to generate more revenue, the Legislature and governor will be unable to invest in the initiatives needed to bolster the state's economy. This will have a profound effect on our economy and has implications for many important measures of Michigan's residents' well-being, including unemployment, personal income and spending throughout the economy.[6]

Michigan's state and local tax system is regressive overall, meaning that families with relatively less income pay a greater share of their total household income in taxes. In Michigan, those families with incomes less than $17,600 pay an average of 10.4% of their personal income in taxes, while the top 1% pay an average of 6.2% of their incomes in taxes. This is because of fundamental design flaws in our system, including a heavy reliance on Michigan's flat income tax and narrow sales.

Total State and Local Taxes in Michigan 2018



Source: *Michigan: Who Pays? 6th Edition.* ITEP, itep.org/whopays/michigan/

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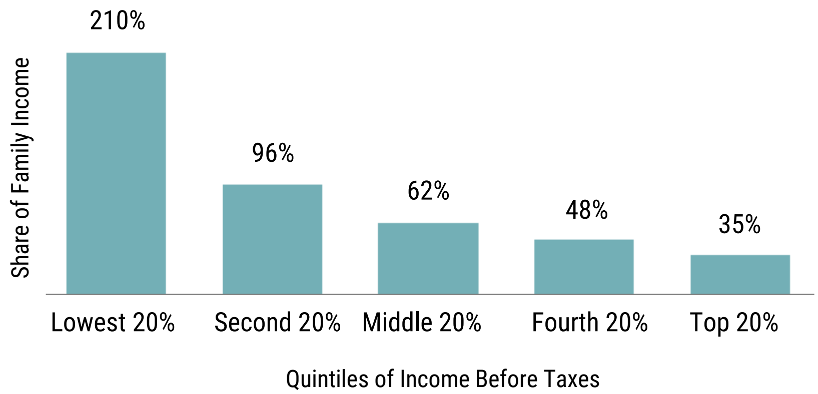
Michigan has a flat income tax. This means that the same tax rate is applied to every dollar of a taxpayer's income, regardless of income level. Michigan is one of nine states with a flat income tax, which contributes to the state having the 22nd most unfair tax system in the nation.[7]

Data from the Bureau of Labor Statistics shows that households with lower incomes spend a greater share of their income to purchase necessities, such as housing, food, utilities and transportation. This means that the regressivity of the tax system has direct implications on the well-being of the majority of Michigan residents through their relative ability to purchase goods and services. Changes to the currently flat personal income tax, including credits and exemptions for taxpayers with low and moderate incomes, combined with an increase in the overall income tax rate, would achieve dual goals of repairing inequities in the tax system and raising revenue to fund state programs.

Share of Family Income Before Taxes Spent on Food, Housing and Transportation in the U.S., 2018



Source: Bureau of Labor Statistics 2018 Consumer Expenditure Survey

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Under the Income Tax Act, Michigan's personal income tax is slated to be reduced starting in the 2023-24 budget year. The formulaic cap on the income tax rate will be evaluated every year based on 2020-21 general fund revenues. Since 2020-21 revenues will be significantly impacted by the COVID-19 pandemic, these reductions will be severe.[8]

Michigan does not tax services, despite the now well-established shift from an economy based on manufacturing to a growing service sector. By not updating Michigan's sales tax to apply to services, the state is not collecting taxes on what is increasingly purchased by Michiganders. As consumption patterns continue to shift toward services, the current tax base will not support long-run revenue growth.[9]

Michigan reduced corporate taxes in 2011, while increasing reliance on personal income taxes. In 2011, the Michigan Legislature eliminated the 4.95% Michigan Business Tax (MBT), replacing it with the current Corporate Income Tax (CIT), a move that lowered the tax rate for most businesses to the 4.25% personal income tax rate and created a 6% tax on C corporations.[10] Since that time, the amount of revenue generated through business taxes dropped from $2.6 billion to $914 million between 2011 and 2020. As a share of tax collections, business taxes have dropped from 5.5% to 2.6%.[11]

Pass-through corporations pay taxes through the owner's distributive share. In other words, an owner of an S-corporation receives their share of the corporation's income and pays taxes on it through their personal income tax.[12] As part of the 2012 business tax legislation, S-corporations are no longer required to pay a 4.95% business tax on business profits in addition to the personal income tax on household earnings derived from business activity. Those earnings, instead, are now taxed at the 4.25% personal income tax rate only.

Policy Recommendations

The League has made a number of policy recommendations that would ensure that Michigan can recover quickly from the fiscal crisis and weather the long-term impacts of COVID-19 on the economy. Michigan lawmakers need to be bold in implementing many of these recommendations so that the state's economy can remain stable and robust. These recommendations put the interests of the vast majority of residents first, in protecting our vital infrastructure, responding to the crisis effectively, and making sure that our government continues to serve the people. The alternative to these revenue generating policies is the sure decimation of the service structure of the State. Michiganders living paycheck-to-paycheck need publicly funded services more than ever and the funds provided to the most economically vulnerable residents are cycled back into the Michigan economy.

Michigan is required to balance its budget, and research has shown that spending cuts could hurt the economy more than tax increases.[13] This means that lawmakers, who must choose cuts to vital public investments or increasing taxes, are making a decision between not providing services to those that need it most and asking those who can contribute to do so. State tax policy should reflect the realities of the state economy, where some households and businesses continue to thrive with high profits and incomes, while the rest of the economy suffers. As recommended by the Institute on Taxation and Economic Policy, "For states facing catastrophic revenue declines, asking more of taxpayers with a clear ability to pay is far preferable to cutting state budgets, which would lead to mass layoffs, steep cuts in public services, and a downward spiral in the economy."[14]

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> *— Institute on Taxation and Economic Policy*

Advocate for Additional Federal Relief

The first round of federal stimulus through the CARES Act cannot be used to backfill lost revenues. This means that lawmakers will have to cut programs and services across the board. State lawmakers and advocates alike need to put pressure on the federal lawmakers to pass additional, unrestricted, direct relief to states and local units of government. Ideally, relief funds would be sustained and tied to economic and fiscal conditions in the state.

On May 18, 2020, the U.S. House passed the HEROES Act, which includes $3 trillion in additional stimulus. Nearly $500 billion of these appropriations will be fiscal aid for states, cities, counties and tribes. Though this bill is not expected to pass the U.S. Senate in its current form, it will be used as a basis for negotiations between the House and Senate.

Make Use of the Rainy Day Fund

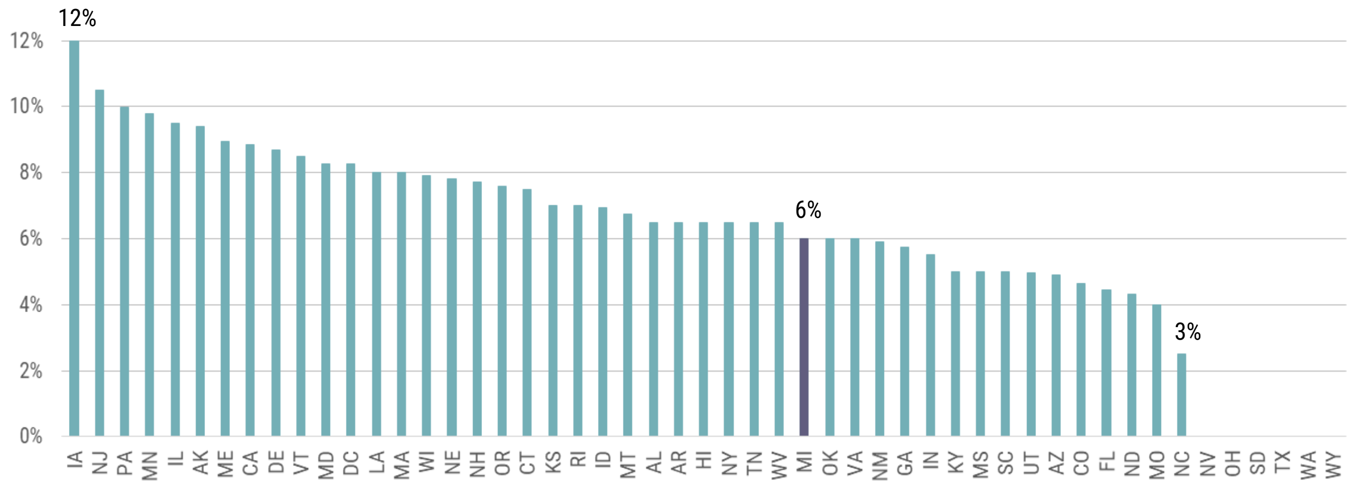
Michigan's Countercyclical Budget and Economic Stabilization Fund was last depleted during the Great Recession. The fund has received contributions since 2012 and reached a balance of $1.2 billion in the 2019-20 budget year. Because Michigan's personal income growth is projected to be negative for the 2019-20 budget year, 25% of the fund—$287.2 million—will automatically be withdrawn for appropriation by the legislature. However, this means that a remaining balance of nearly $913 million will remain in the fund.[15]

This fund was created under the state's Management and Budget Act specifically for fiscal crises like the one that Michigan is facing. The remaining funds could be used to partially fill gaps in the 2019-20 budget while the governor and Legislature focus on medium- to long-term solutions, such as the ones listed above. To appropriate the balance of the fund, the Michigan Legislature will have to make a two-thirds majority vote.[16]

Reform Michigan's Corporate Tax System

Corporate taxes automatically adjust to economic conditions because they only apply to businesses that turn a profit in any given year. Ultimately, corporate taxes are paid by higher-earning businesses and shareholders.[17] To raise revenue to supplement general fund expenditures, Michigan lawmakers should increase the corporate income tax rate. Michigan has the 30th highest corporate tax rate amongst the states.[18]

Top Corporate Tax Rates by State, 2020



Source: MLPP Analysis of Tax Foundation Data

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In addition to a general rate increase, it is important to create parity between business types. C corporation profits are taxed at a higher rate than S corporations, which means that a business can avoid taxes by forming as an S corporation or by having subsidiaries that are formed as S corporations.

Combined, the creation of the Corporate Income Tax and repeal of the Michigan Business Tax on S corporations reduced state revenues by $1.6 billion in 2012. These losses were exacerbated every year as the economy and corporations recovered from the Great Recession and means that Michigan is not collecting billions in revenue that could otherwise be used to address the state's public health and fiscal crises, as well as support its aging infrastructure and other services that attract new businesses. Restoring parity between C and S corporations and increasing the corporate tax rate would increase and stabilize state tax revenue at negligible cost to the households and families that make up the Michigan economy.

Modernize the State Sales Tax

Broadening the sales tax base to include services makes the sales tax sustainable as the Michigan economy shifts toward the consumption of services over tangible goods. Nearly 73% of Michigan's sales tax is distributed to the School Aid Fund; as such, broadening the sales tax base to include services will ensure the long-term sustainability of K-12 education in the state.

Although sales taxes are regressive, expanding the sales tax to services can increase fairness in the tax system. Applying the sales tax broadly to services can improve "horizontal equity," meaning that households will be taxed the same regardless of their consumption preferences. Taxing services can also improve "vertical equity," as some services are consumed disproportionately by wealthier households. The expansion of the sales tax to services should be broad across services primarily purchased by households.

Expanding the sales tax base to include services for personal consumption would raise approximately $4 billion in revenues.[19] An alternative option would be to expand the sales tax base with a reduction in the overall sales tax rate. Reducing the sales tax rate to 5.32% and expanding the sales tax base to services would raise approximately $2.7 billion.[20]

Create a Michigan-specific Estate Tax

Michigan's estate tax is tied to the federal tax code. The estate tax is equal to the maximum federal tax credit that an estate receives through the federal tax code to offset estate taxes paid to the state. The credit was eliminated in 2005, which makes the Michigan estate tax defunct.

The estate tax is highly progressive because it only applies to estates valued above a certain threshold. If lawmakers were to decouple the Michigan estate tax and make an exemption for estates with less than $1 million in assets, the state would bring in an average of $360 million a year.[21]

Redesign Michigan's Personal Income Tax

Michigan's constitution includes a provision banning the state from instituting a graduated income tax. Though this is a significant barrier to reforming Michigan's income tax, there are ways to increase revenues from this source while building more progressivity into the tax system. Namely, Michigan should adopt a higher personal income tax rate and include tax credits or deductions that reduce the tax liability for households with low to moderate incomes.

Tax credits like the Earned Income Tax Credit (EITC) have already been implemented in the state and could be adjusted to offset tax increases by restoring the EITC rate to 20% of the federal EITC and expanding the EITC to households in the middle income brackets and to adults between the age of 19 and 24. It is also possible to create an entirely new credit, modeled on Utah's Taxpayer Tax Credit or Pennsylvania's Tax Forgiveness Credit. These credits mimic a lower income tax bracket by providing a credit for taxes paid for incomes less than a set threshold. Michigan could also increase the standard deduction or personal and dependent exemptions to insulate lower-income families from a rate increase. In any case, it is very possible to increase the personal income tax rate to capture more taxes from households in upper income brackets while providing more-than-adequate relief for the average household.

Reevaluate the Effectiveness of Tax Expenditures

Tax expenditures are special carve-outs in the tax code that are designated as a preferential tax treatment in the form of credits, deductions, and exemptions. The state generally divides them into five main categories: business privilege, consumption, personal income, transportation and local/property. These tax expenditures are often called silent spending because, like appropriations, they allocate resources for public purposes but do so through the tax code rather than through the annual state budget process. They have a significant impact on the annual budget process as they reduce or eliminate revenue that would have otherwise been collected, but are not regularly reviewed and evaluated.

Some of these have a particularly positive impact, such as the Earned Income Tax Credit and food sales tax exemptions. However, many tax expenditures have either outlived their useful life or have proven to be ineffective at achieving their desired goals. In the 2019 budget year, tax expenditures were estimated to be $42 billion.[22]

Other Taxes to Consider

In 2018, the people of Michigan passed Proposition 18-1, which legalized recreational marijuana sales and set an excise tax rate of 10% on top of the 6% sales tax charged on purchases. The cannabis industry is countercyclical, meaning that demand for cannabis continues even during economic downturns. This means that cannabis taxes have the potential to provide revenues to the state during the COVID-19 crisis. Michigan's taxes on cannabis sales are the some of the lowest in the country.[23] Legislators could increase the tax on cannabis consumption to bring in stable revenues.

Alcohol taxes are also a possible target for increase. The excise tax on alcohol are set through the Michigan Liquor Control Code of 1998, and those rates have not been reevaluated since. Because liquor, beer, and wine taxes are based on quantity and not price, these rates have not kept up with inflation.

Endnotes

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10. A C corporation is any corporation that is taxed separately from its owners.
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