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Senate Bill 8 (Substitute H-4)
Senate Bill 98 (Substitute H-1)
First Analysis (6-23-87)

Sponsor: Sen. Norman D. Shinkle
Senate Committee: Finance
House Committee: Taxation

THE APPARENT PROBLEM:

Unless Michigan changes its tax system, many of its taxpayers will face higher state income taxes as a result of changes in federal tax law made by the Tax Reform Act of 1986. This is because state taxpayers figure their state income tax liability based on their federal adjusted gross income, and adjusted gross incomes will go up under the new federal tax law (although tax rates generally will go down). The generally accepted estimate for the amount of the "windfall" to the state from the fully phased-in tax law is $170 million annually. (It should be noted that this estimate is based in part on "behavioral assumptions"; that is, on assumptions about how people's economic behavior will change in response to tax law changes.) Some people believe that failing to return the windfall to the taxpayers is equivalent to raising taxes. Governor Blanchard proposed returning the taxes by cutting the income tax rate from 4.6 percent to 4.4 percent, and the State Senate has passed a measure to do that. An alternative method, which would distribute the windfall differently, some say more progressively, would be to raise the personal exemption.

THE CONTENT OF THE BILL:

Senate Bill 8 (H-4) would amend the Income Tax Act to raise the personal exemption from $1,500 to $1,800 for the 1987 tax year, to $1,950 for the 1988 tax year, and to $2,000 after that. Further, the bill would allow a single additional exemption of $1,200 for 1987, $1,050 for 1988, and $1,000 after that for a paraplegic, quadraplegic, or hemiplegic; a deaf person; a person 65 years of age or older; a blind person; and for a tax return for which unemployment compensation amounted to 50 percent or more of adjusted gross income. (The two exemptions would total $3,000 in each year, equivalent to the two $1,500 exemptions currently allowed for these categories of taxpayers.) Senate Bill 8 is tie-barred to Senate Bill 98, and to House Bills 4606 through 4613 (constituting the 10/20 property tax plan package).

MCL 206.30

Senate Bill 98 (H-1) would amend the Income Tax Act to update the reference to the federal Internal Revenue Code. "Internal Revenue Code" would be defined as "the United States internal revenue code in effect on January 1, 1987, or at the option of the taxpayer, in effect for the taxable year." Senate Bill 98 is tie-barred to Senate Bill 8.

MCI 206.12

FISCAL IMPLICATIONS:

The bills are intended to be revenue neutral. According to the House Taxation Committee, Senate Bill 8 would cost the state $92 million in 1987, $167 million in 1988, and $182 million in 1989. Senate Bill 98 captures the "windfall" from federal tax reform, which the Senate Fiscal Agency has estimated will produce $110 million in fiscal year 1986-1987, $164 million in fiscal year 1987-1988, $177 million in fiscal year 1988-1989, and $184 million in fiscal year 1989-1990.

Below is a chart produced by House Taxation Committee staff comparing the annual benefits to taxpayers, by income and family size, of the Senate-passed tax rate rollback proposal and the personal exemption proposals contained in the House substitute. (Figures in parentheses represent tax increases.)

TAXPAYERS		$10,000		$25,000		$40,000		$50,000		$100,000	
		S	H	S	H	S	H	S	H	S	H
General											
Family Size 2	1987	11	28	33	28	56	28	71	28	146	28
	1988	14	41	44	41	74	41	94	41	194	41
	1989	14	46	44	46	74	46	94	46	194	46
Family Size 3	1987	8	41	31	41	53	41	68	41	143	41
	1988	11	62	41	62	71	62	91	62	191	62
	1989	11	69	41	69	71	69	91	69	191	69
Family Size 4	1987	6	55	29	55	51	55	66	55	141	55
	1988	8	83	38	83	68	83	88	83	188	83
	1989	8	92	38	92	68	92	88	92	188	92
Family Size 5	1987	4	69	26	69	49	69	64	69	139	69
	1988	5	104	35	104	65	104	85	104	185	104
	1989	5	115	35	115	65	115	85	115	185	115
Seniors											
Family Size 1											
	1987-1989	14	0	(22)	0	8	0	28	0	128	0
Family Size 2											
	1987-1989	8	0	(94)	0	(64)	0	(44)	0	56	0

OVER

ARGUMENTS:

For:

The state stands to gain an estimated $170 million per year extra from taxpayers as a result of changes to the federal income tax code. This "windfall" should be returned to taxpayers. For the state to keep the unanticipated revenues would be a back door tax increase. There are several ways to offset the federal changes that produce the windfall, the most popular proposals being a lowering of the tax rate and a raising of the personal exemption. The House Taxation Committee proposal would provide for a three-step increase in the personal exemption (similar to the phased-in personal exemption increase for federal taxes) and would produce a better-targeted, more progressive distribution of the windfall than a simple rate cut.

Lowering the tax rate by and large favors the well-off. Raising the personal exemption in a system with a flat tax rate, generally, is of greater benefit to moderate and lower income taxpayers and to families. It will also relieve, say tax specialists, some 100,000 Michigan residents with no federal tax liability from having to pay state income tax. This is congruent with the federal emphasis on reducing tax burdens for lower-income people. (It has the added benefit of eliminating potential compliance problems for the state, which uses information from federal returns in checking to see if people have filed state returns or paid the right amounts.) Further, the House Taxation proposal would hold harmless senior citizens, whereas the Senate's rate cut proposal would raise taxes on moderate income seniors. The bill would restore to seniors and the blind the double personal exemption that would otherwise be lost due to federal changes. (The loss of the extra personal exemption is offset at the federal level by lower rates, the increase in the personal exemption and, for non-itemizers, an extra standard deduction.) It would also restore the special treatment for people whose income is largely derived from unemployment benefits.

Response: Some people find the rate rollback more attractive. For one thing, it is easy to understand, a feature that should not be underestimated considering the public cynicism about taxes and government spending. Determining who benefits most from federal tax reform and who should benefit the most from the state's return of the windfall are complicated subjects. Rather than attempt to make reparations for the effects of the new federal tax law, the state should cut its rate and accept the broadening of the tax base resulting from the law.

Against:

A good case can be made for retaining the so-called windfall. Consider the following:

- Economic forecasters have warned the legislature of the potential for difficult times ahead, with the prospect of revenues falling far short of expectations and producing budget deficits in the very near future. By one estimate, the 1988 budget is already $150 million in deficit. No one should need to be reminded of the pain caused a few years ago by a serious decline in revenues or of the trauma involved in raising taxes temporarily. Consideration should be given to crediting the windfall to the budget stabilization fund or applying it to essential programs.
- There are already so many unmet needs and such severe restraints on state and local government budgets that it seems senseless to return what will amount to less than a dollar a week for many families. The people would be better served by applying the unanticipated revenue to current endeavors, such as controlling crime, providing job training and improving education. Many government and private human service agencies have suffered from enormous federal cutbacks in this decade and many, furthermore, have never fully recovered from state budget cuts made during the recession. If Congress takes its deficit reduction mandates from Gramm-Rudman seriously, more debilitating cuts are in store. Representatives of the state's cities, for example, have testified that their loss in federal revenue sharing is, coincidentally, equal to the amount of the so-called windfall. (The state has lost an additional $100 million in revenue sharing.) School districts believe that they are owed nearly $90 million taken from them by executive orders in 1982 and 1983. To ignore the needs of local units and the schools in dealing with the windfall is simply to shift the burden to local property taxes, widely considered a more unpopular tax than the income tax.
- The estimates of the effects of federal tax reform may prove faulty. The estimates are based on assumptions that may be wrongheaded. If the windfall is not forthcoming, the state will simply have cut income tax revenues without any great demand for income tax reductions and will be forced to eliminate programs that are in demand. (It is likely the actual effect of federal tax changes will never accurately be known since the changes will alter the nature of information available in a way that makes the accounting impossible.)
- If the federal changes had resulted in a reduction in revenue on the same scale, would there be a similar outcry to make things even by raising tax rates or reducing personal exemptions? Indeed, some tax specialists have said that the windfall simply gives back to the state some of the revenue lost in recent years by a narrowing of the tax base by Congress (e.g. the advent of IRAs).
- If there is to be tax relief, it ought to be significant and ought to focus on the property tax, which is coming under increasing scrutiny as the discussions proceed on how to restructure the way the state pays for its schools.

Against:

There is no good reason to tie-bar the windfall bill to the governor's 10/20 property tax proposal. The two issues are separate and each should be evaluated on its own merits.

Response: Tax equity is all of a piece. If it is fairness that dictates that the federal windfall be returned to taxpayers then other tax fairness issues should be addressed as well, for example the comparative tax burdens of homeowners with moderate incomes and financial institutions.

POSITIONS:

There are no positions at present.