

# ***Tax Reform in Michigan***

Testimony of

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I thank the Committee for the opportunity to present some thoughts on Michigan tax reform. You are to be commended for taking on this very difficult issue.

My thoughts are presented from my own perspective as an economist who has specialized in state and local economic development policies. I emphasize that my employer, the Upjohn Institute, is a non-partisan research institution that does not endorse legislation. My comments should not be taken as reflecting any official position of the Upjohn Institute.

My presentation is in three parts. First, what goals should be emphasized in Michigan tax reform? Second, what are the main problems with the Michigan tax system? Third, what most needs to be done to correct these problems?

## **GOALS OF TAX REFORM**

What goals should tax reform emphasize? And, just as important, what is the relative weight that should be placed on these goals? No tax system is perfect. There are always tradeoffs between different possible goals.

I would list four goals of tax reform as being most important. First, there is long-run revenue adequacy. The tax system should be designed so that absent policy changes, state and local tax revenue should comprise about the same share of personal income 10 years from now as it does today. As I will elaborate on in a minute, such a system is fair to both sides in the debate over the appropriate size of government, in tune with the public's demand for public services, and more likely to lead to well-considered legislative decisions about tax and spending policy. In contrast, today's Michigan tax system is designed so that the tax share of personal income tends to significantly decline over time, absent policy changes.

A second goal that should guide tax reform is incentivizing expanded employment. The tax system should be designed to reduce the tax burden on businesses that expand employment relative to those that do not do so. In contrast, in much of the policy debate, little distinction is made between average business tax rates versus the tax rates on businesses that are expanding.

A third goal that should guide tax reform is moderately increasing progressivity. State and local tax systems tend to be regressive, that is overall tax burdens tend to be a higher percentage of income for lower income households than for upper income households. Michigan has a regressive state and local tax system. We should try to modify that system modestly so that it is closer to being proportional to household income.

A fourth goal that should guide tax reform is horizontal equity. By “horizontal equity” I simply mean that absent some strong reason to the contrary, all income should be taxed the same regardless of source, and all spending should be taxed the same regardless of its object. This rule of horizontal equity should only be overridden if there are strong reasons to do so because of the goals of revenue adequacy, expanded employment, or progressivity.

Of these four goals, long-run revenue adequacy should be viewed as by far the most important. If I were going to choose weights to place on these three goals, I would put 50% of the weight on long-run revenue adequacy, 25% on promoting employment expansion, 15% on increasing progressivity, and 10% on horizontal equity.

Why is long-run revenue adequacy such an important goal? First, such a system is fair to both sides of the debate over the appropriate size of government in the economy. If the tax system simply grows proportionately with personal income, then government’s share of the economy will not grow or shrink over time without explicit policy changes. Those who favor an expanded role for the government can advocate for tax policy changes to pay for expanded

government services. Those who favor a smaller role for government can advocate for tax policy changes to shrink the role of government, with accompanying reforms to reduce public spending. Neither liberals nor conservatives will gain an unfair advantage by taxes automatically changing to reflect their policy views.

Second, the empirical evidence suggests that demand for public services tends to grow proportionately with personal income. Changes in population bring proportional changes in demand for public services. Changes in per capita income also tend to bring proportional changes in demand for public services.

Third, a tax system that does not accommodate the public's demand for public services tends to lead to poor decision-making. A poorly designed tax system that does not match this demand—that either raises too little revenue or too much revenue relative to the economy—periodically experiences crises. These crises lead to poorly designed quick-fix tax changes or spending policy changes. These crises undermine public confidence in government leaders and the institutions of government.

With respect to the goal of enhancing employment, it might be thought, given Michigan's economic problems, that this should be the number one goal. However, empirical research suggests that although business taxes have some effect on economic development, the size of the effect is modest. Therefore the cost of creating a job through across-the-board business tax cuts is considerable. Empirical estimates based on my research and the research of others suggest that to create one job through business tax cuts requires forgoing business tax revenue whose present value is about \$200,000.

Furthermore, public services also affect business location decisions. The quality of a state's roads and education system are at least as important as the state's business tax system in determining long-run economic development.

Therefore, we need to think of business tax reforms that encourage employment while promoting adequate revenue for public services. This can be done if we focus more attention on business tax reforms that reduce the burden on businesses that invest in Michigan or expand employment more in Michigan.

The average tax rate on business or the total amount of business tax revenue collected is NOT a good measure of the tax burden associated with expanding employment or business investment. The aspect of taxes that determines business decisions about expanding employment or business investment decisions is the ADDITIONAL business taxes incurred because of that decision. In economics jargon, this would be called the marginal business tax rate. This marginal business tax rate may not have much to do with the average taxes businesses pay. The two are disconnected because frequently business investment or employment decisions receive various types of tax credits and tax deductions. These credits and deductions may reduce the additional tax burden due to an expansion to be zero, or even reduce the tax burden, even if the average business tax rate is high.

It would be a significant advance in Michigan tax policy if state policymakers regularly examined the effects of business tax reforms on the marginal business taxes associated with business investment or business employment expansions. A business tax system may collect the same or more business tax revenue, yet be friendlier to business investment and expansion, depending upon the details of what investment or employment tax credits are provided. For

example, higher basic business tax rates with higher investment tax credits may encourage business investment.

Therefore, the goal of creating a Michigan business tax environment that is friendly to business investment and employment expansion is quite compatible with the goal of long-run revenue adequacy. A business friendly Michigan requires long-run tax adequacy.

With respect to the goal of progressivity, there are significant limits to what state and local tax policy can do about the distribution of income. The empirical evidence suggests that state and local governments do far more to help lower-income households through the expenditure side of government than through the revenue side. Whether adequate government can be financed is far more important than exactly how it is financed.

In addition, there are serious limits to the degree of progressivity that is possible for state and local tax systems. Mobility of households and businesses significantly limits the degree of possible progressivity.

Finally, horizontal equity is an important default rule. We should tax all income and spending the same absent some strong reason not to do so. This broader taxation is fairer. Broader taxation also allows lower rates, which along with more equal rates promotes economic efficiency. A strong reason for deviating from horizontal equity might be that this special tax exemption or deduction clearly is an efficient way of promoting some other goal. The public and legislators should always ask whether exemptions or deductions have a strong case for existing. If there is no strong case, these exemptions or deductions should be eliminated.

## PROBLEMS IN MICHIGAN'S TAX SYSTEM

What are the main problems in Michigan's current tax system in terms of achieving these goals? These problems include the following:

- Michigan's sales tax system has limited coverage; especially of services. This means the sales tax base does not grow proportionately with personal income. As a result, over the long-run, the revenue raised by the sales tax does not grow at the same rate as the economy. Furthermore, many of the exemptions for services lack a good rationale.
- Michigan's income tax system is less progressive than that of the typical state. Most states have some higher rate on upper income households. A more progressive income tax system would also tend to grow faster with personal income. This would help offset other Michigan taxes that grow slower than personal income.
- The exemption of most pension income from the income tax slows down the rate of tax collections relative to the economy. Over time, as the population ages, this will become an increasing problem for Michigan's tax system. Michigan is quite unusual in how generous a tax break is given to pension income. It is hard to justify such a generous pension exemption in terms of horizontal equity.
- Tax expenditures in Michigan have tended to grow over time faster than state taxes and faster than the economy. By "tax expenditures," I mean exemptions and deductions that depart from a hypothetical neutral tax system. Growth in tax expenditures is likely to continue to erode long-run revenue adequacy. Tax expenditures grow faster in part because some of the growing sectors of the economy receive exemptions, and in part because there is a natural political tendency to add tax breaks over time to the tax system.
- The debate over business taxes has tended to focus on the amount of business revenue collected from the main state business tax. The debate should instead focus on the additional business taxes of all types, state and local, that are imposed on businesses that invest in Michigan or expand employment in Michigan.

## REFORMING MICHIGAN'S TAX SYSTEM

How can these problems be dealt with? The ideal solution is implicit in my description of the problems. A better Michigan tax system would include the following components:

- **A broader sales tax including services.** This would be fairer and grow more proportionately with the growing sectors of the economy. Such a broader sales tax

would resemble the so-called “Fair Tax.” However, I don’t think that the rates or broad design proposed by the Fair Tax are feasible, and I believe that the revenues projected are overstated. Therefore, I do not think that the Fair Tax should be seen as a tax that can feasibly substitute for most other state taxes.

- **A more progressive income tax system.** More progressivity in the income tax system would help long-run revenue adequacy, and would move the overall Michigan tax system towards being less regressive. A progressive income tax would seem to require a constitutional amendment. However, it may be possible to increase the progressivity of Michigan’s income tax system by increasing the tax rate and introducing additional broader earned income credits and sales tax credits.
- **Elimination of the pension exemption.** If this cannot be done, at least the exemption level should be frozen in nominal dollars; that is, not indexing the exemption level to consumer prices. This would reduce the long-run threat of the pension exemption to revenue adequacy. It also is fairer in taxing all incomes regardless of source.
- **A regular review of tax expenditures** to keep them within a budget constraint.
- Focusing on making the business tax system more business friendly by **focusing business tax relief on businesses making investments or businesses expanding employment.**

How might some of these reforms be achieved? We need to think of policymaking mechanisms that focus everyone’s attention on the big picture. Consider the following options:

- A bipartisan commission that would consider all tax expenditures, and recommend which tax expenditures should be eliminated. The recommendation of this commission should be subject to an up or down legislative vote without amendment. This is similar to what the U.S. Congress has done with base closings. The Cato Institute has frequently proposed a similar mechanism for restraining corporate welfare programs.
- Enact a tax reform process that would start out with a much broader system, and then procedurally require that all modifications be revenue neutral 10 years from now. In other words, I suggest that bills be introduced to have a sales tax and income tax system with absolutely zero exemptions and deductions, no tax exemptions whatsoever. The tax rates would be calculated on the sales tax and income tax to be revenue neutral today. These tax rates would then be much lower than today’s sales and income tax rates. I emphasize that these broad income and sales taxes would simply be the starting point for a disciplined legislative process that would lead to a more carefully considered final tax system.

These tax reform proposals would be considered by the Michigan House and Senate under legislative procedures that would require that any exemptions or deductions that are added be offset by a corresponding rate increase that is projected to be revenue neutral 10 years from now. This would impose a real cost on adding exemptions. The final enacted tax reform bills would no doubt still have considerable exemptions and deductions. However, I believe this procedure would lead to more limited exemptions and deductions than prevail today. This procedure would also focus everyone's attention on the long-run revenue consequences of different proposals.

- Require that all business tax proposals must calculate how they affect the additional business taxes paid by typical businesses making business investments or employment expansions in Michigan.

In all of these proposals, I am essentially proposing that the Michigan Legislature agree to bind itself with certain procedural rules. As far as I know, even with such rules, the Legislature could always override the procedural rules through majority vote. However, if there is a broad agreement ahead-of-time on these rules, and broad public and media understanding of the purpose of these rules, then there would be significant political costs of overriding the rules.

## **CONCLUSION**

Michigan's tax system is badly in need of reform. If we revise the system from the ground up, we can achieve a system that provides adequate long-term revenue while promoting employment expansion. To do so requires a legislative process that will encourage everyone to focus on the big goals of tax reform, and less on particular interests.