

The Impact of Tax Expenditures on Budget Shortfalls

June 1, 2010



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Why Consider Tax Expenditures?

- Tax expenditures are an alternative to direct spending.
- They can be used to effectively continue to spend tax dollars on policy initiatives while the budget is being reduced.
- They're "off-budget" for all practical purposes.
- Transparency and government accountability demand they be reported and evaluated.



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State Budget Shortfalls Caused By

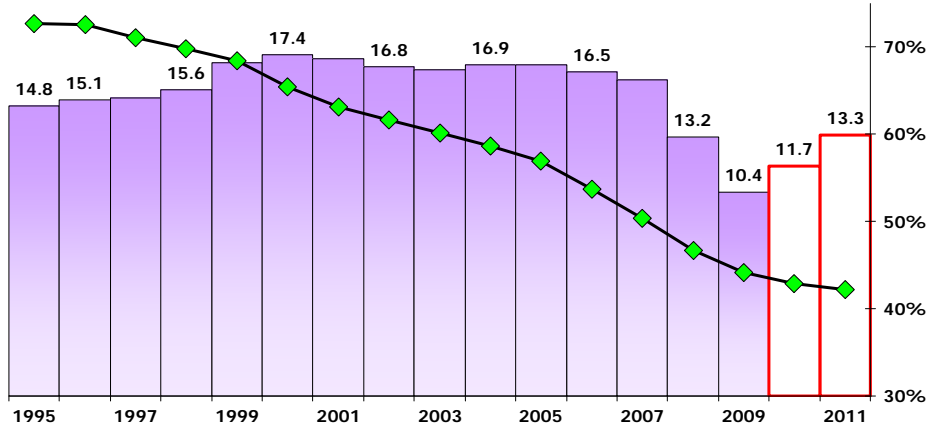
- Severe economic contraction led by domestic auto industry
- State tax policy
- Increasing cost of Medicaid care and corrections



Big 3 Losing Market Share

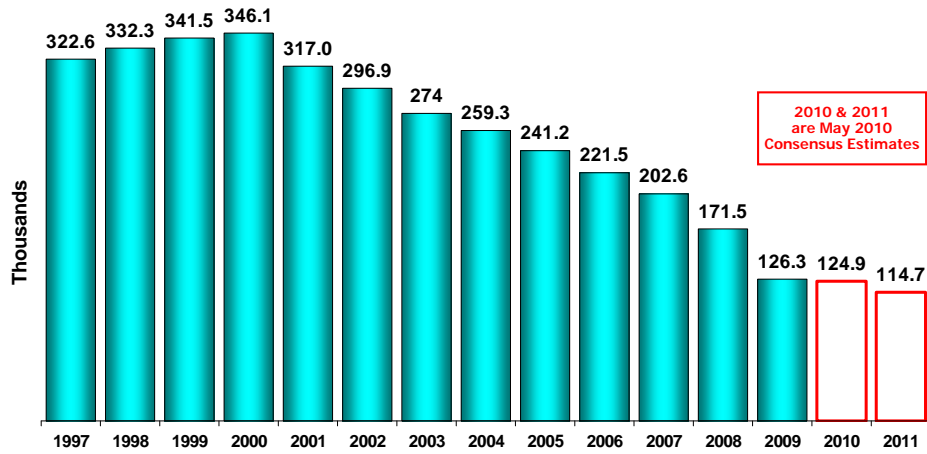
■ U.S. Light Vehicle Sales ◆ Big 3 Share

2010 & 2011 are May 2010 Consensus Estimates





Michigan Vehicle Employment

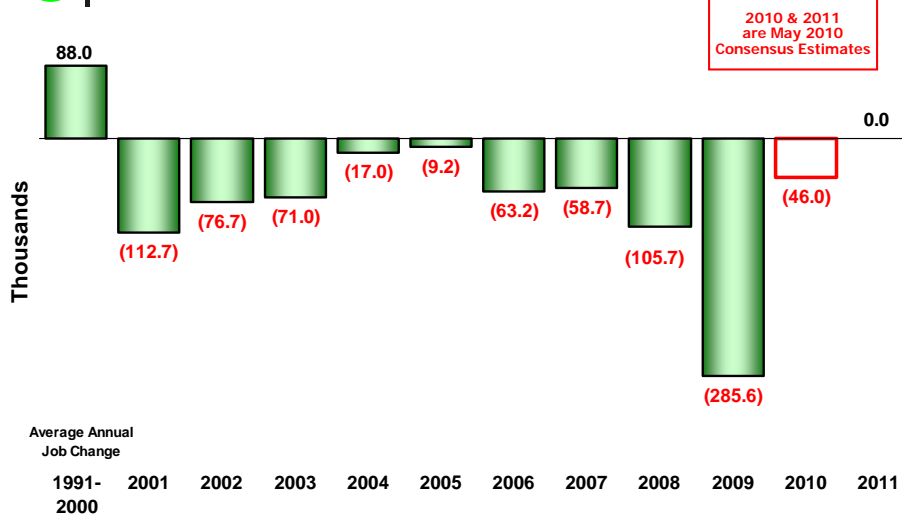


Source: U.S. Bureau of Labor Statistics and May 2010 Consensus Estimates

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Job Change in Michigan

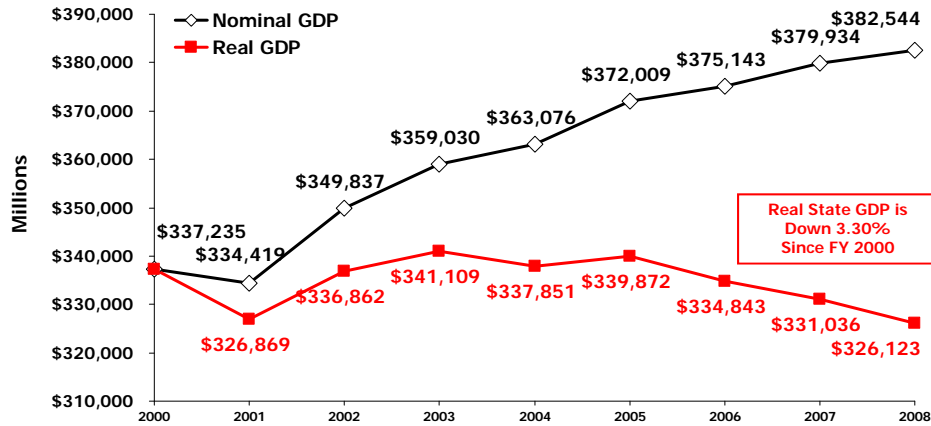


Source: U.S. Bureau of Labor Statistics and May 2010 Consensus Estimates

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Real and Nominal State GDP

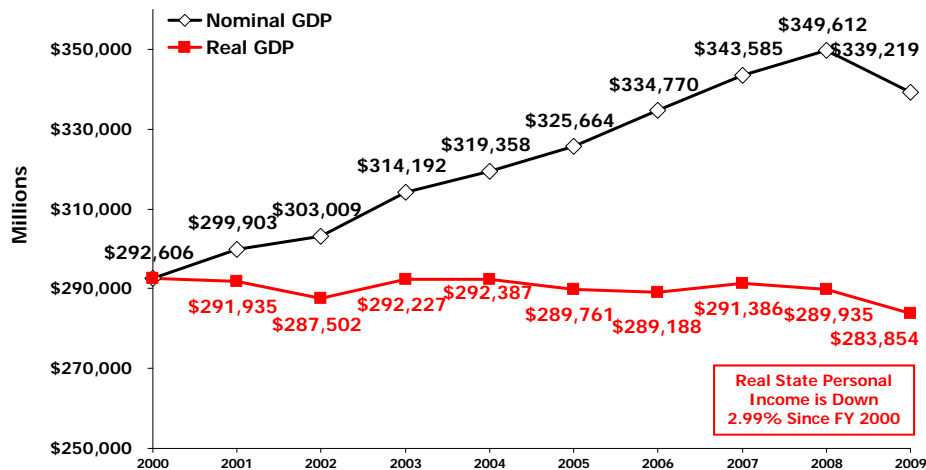


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Real and Nominal State Personal Income



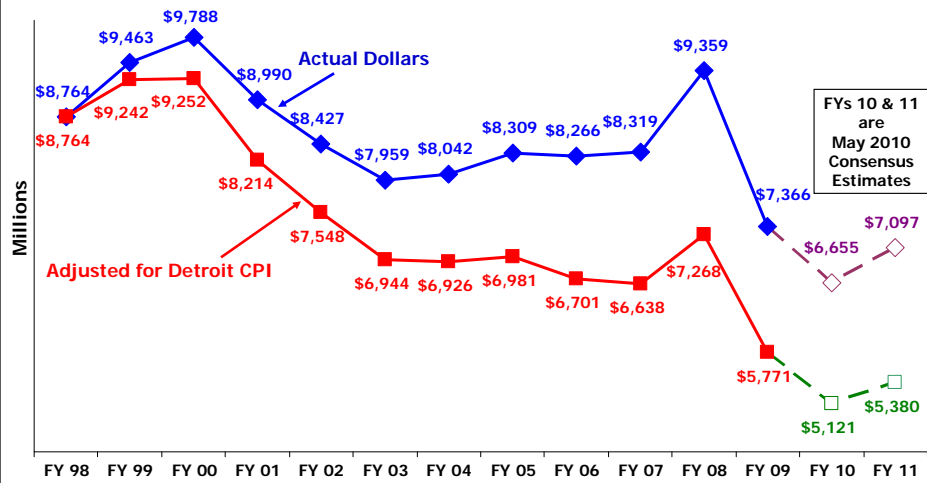
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Source: U.S. Bureau of Economic Analysis. 2009 personal income numbers are from the May 2010 Consensus Revenue Estimating Conference.

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Inflation Adjusted GF/GP Revenue Down 42% Since FY 2000

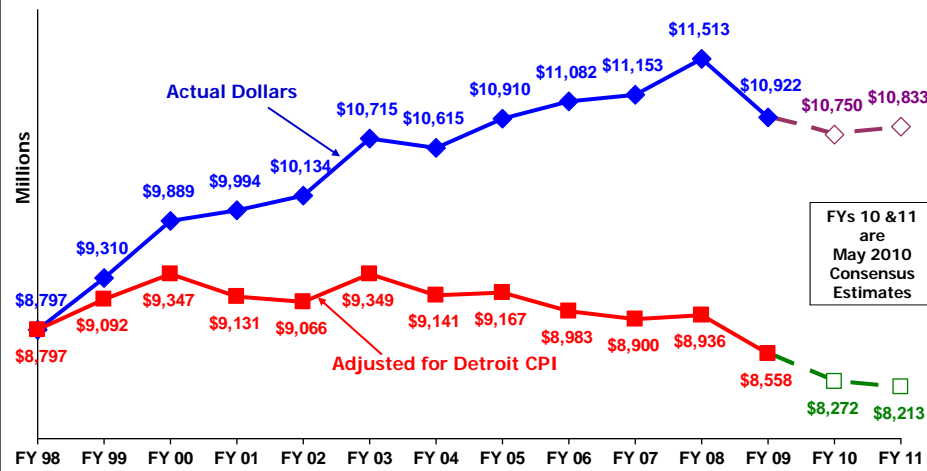


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Inflation Adjusted SAF Net Revenue Down 12% Since FY 2000



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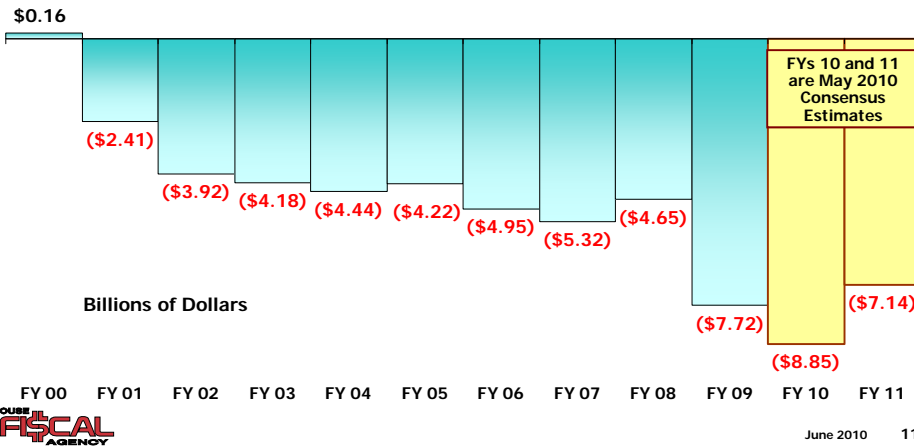
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Constitutional Revenue Limit

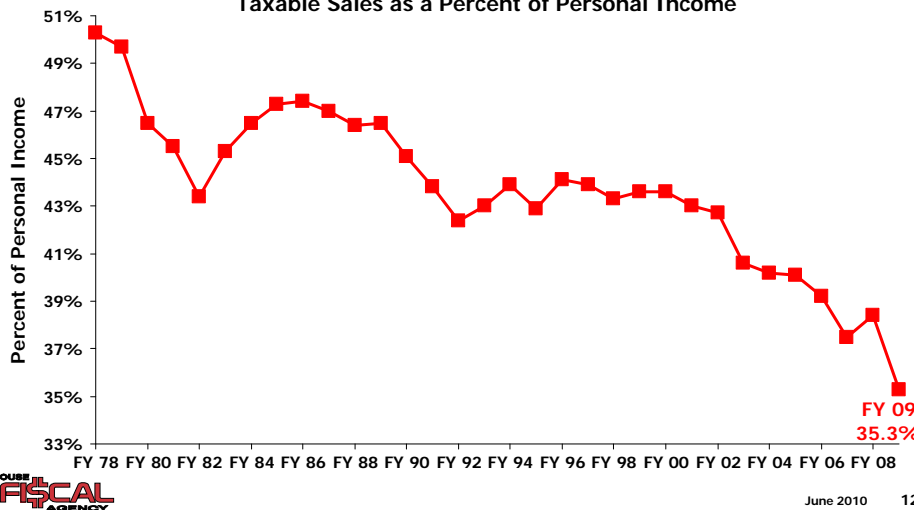
Average growth of Michigan personal income = 1.7% per year from 2000 through 2011

Average decline of Michigan revenue = 0.5% per year from 2000 through 2011



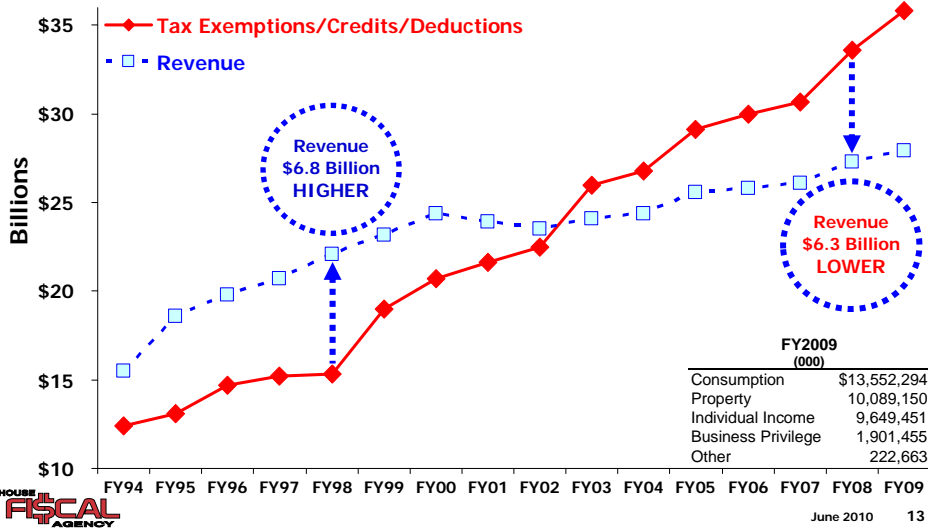
Sales/Use Tax Share Declining

Taxable Sales as a Percent of Personal Income





Impact of Tax Exemptions/Credits/Deductions



Impact of Recent Tax Cuts on Future Revenues

	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Reducing Michigan Income Tax Rate	\$0.0	\$0.0	\$0.0	(\$150.0)	(\$329.0)	(\$522.5)
Alternative Energy Credits - Income Tax	(\$16.0)	(\$46.0)	(\$47.0)	(\$42.0)	\$0.0	\$0.0
Michigan EITC	(\$140.0)	(\$325.0)	(\$338.0)	(\$358.3)	(\$379.8)	(\$402.6)
Eliminating MBT Surcharge			Eliminated in Tax Year 2017			
MBT Battery Credits (Assumes Maximum Used)	\$0.0	\$0.0	\$0.0	(\$40.0)	(\$268.0)	(\$278.0)
MBT Film Production Credit	(\$37.5)	(\$100.0)	(\$125.0)	(\$125.0)	(\$125.0)	(\$125.0)
Photovoltaic Technology - Facility & Manufacturing	\$0.0	(\$0.8)	(\$9.8)	(\$12.5)	(\$12.5)	(\$15.0)
Polycrystalline Manufacturing Credit	\$0.0	\$0.0	\$0.0	\$0.0	(\$25.0)	(\$25.0)
MBT Gross Receipt Changes	(\$115.8)	(\$80.5)	(\$93.4)	(\$117.8)	(\$129.9)	(\$132.7)
Decouple Bonus Depreciation/Production Activities	\$172.5	\$23.4	\$19.2	\$45.3	\$52.3	\$60.0
Historic Preservation Credits	\$0.0	\$0.0	(\$5.0)	(\$8.6)	(\$9.6)	(\$10.6)
Promise Zones - SET	\$0.0	(\$1.0)	(\$4.0)	(\$10.0)	(\$15.0)	(\$20.0)
IFT Exemption for Commercial Real Land	\$0.0	(\$2.0)	(\$2.0)	(\$2.0)	(\$2.0)	(\$2.0)
Use Tax Bad Debt Deduction Change (Court Case)	(\$2.0)	(\$25.5)	(\$16.6)	(\$17.1)	(\$17.7)	(\$18.4)
Exempt Supplies for Cobo Center	\$0.0	\$0.0	(\$2.5)	(\$2.5)	(\$3.5)	(\$1.5)
Totals in Millions	(\$138.8)	(\$557.4)	(\$624.1)	(\$840.5)	(\$1,264.7)	(\$1,493.3)



Potential GF/GP Revenue Growth (millions)

	Consensus FY 2011	FY 2012	FY 2013	FY 2014
Baseline Revenue				
* Assume 3% Growth	\$6,968.4	\$7,177.5	\$7,392.8	\$7,614.6
Adjust for Tax Change Not Built Into FY 2011	N/A	(\$194.4)	(\$591.5)	(\$789.1)
Net GF/GP Revenue	N/A	\$6,983.1	\$6,801.3	\$6,825.5
Percent Change from Prior Year	N/A	0.2%	(2.6%)	0.4%

* Note: 3% baseline growth has not been achieved since 2000.



Selected Tax Expenditures Estimated FY2009-10 Amounts (in \$000s)

<u>Consumption</u>		\$14,041,051	
Services	\$10,096,211		
Food	\$1,141,588		
Industrial Processing	\$847,626		
Prescription Drugs	\$537,390		
Horticultural and Agricultural Products	\$252,880		
Residential Utilities	\$152,500	\$13,028,195	92.8%



Selected Tax Expenditures

Estimated FY2009-10 Amounts (in \$000s)

<u>Property</u>			\$10,018,200	
18-mill Homestead Exemption	\$3,520,000			
Taxable Value Cap	\$3,400,000			
Tax Exempt Property	\$1,542,000			
Personal Property Tax Exemptions	\$383,100			
Industrial Facilities Development	\$256,000			
Homestead Exemption for Farm Property	\$150,000	\$9,251,100	92.3%	



Selected Tax Expenditures

Estimated FY2009-10 Amounts (in \$000s)

<u>Individual Income</u>			\$10,156,055	
Adjustments to Income	\$4,603,497			
Personal Exemption	\$1,165,221			
Employer Contributions to Insurance (Federal)	\$1,049,355			
Homestead Property Tax Credit	\$987,477			
Earned Income Tax Credit	\$333,000			
Social Security Deduction (Federal)	\$252,472	\$8,391,022	82.6%	



Selected Tax Expenditures

Estimated FY2009-10 Amounts (in \$000s)

<u>Business Privilege</u>			\$1,921,480	
Small Business Alternate Credit	\$308,100			
Compensation Credit	\$185,000			
Film Credits	\$155,100			
Personal Property Tax Credit	\$152,600			
Investment Tax Credit	\$107,400			
MEGA Credits	\$105,600	\$1,013,800	52.8%	



Senior Tax Preferences

- **Income Tax**
 - Fully exempts social security, military, federal, state and local government pension/retirement income
 - Exempts private pensions up to \$45,120 single/\$90,240 joint (TY 2009); indexed to inflation
 - Annual cost all pension income exemption = \$725 million
 - Deduction for senior investment income \$10,058 single/\$20,115 joint; indexed to inflation
 - Annual cost = \$40 - \$50 million



Senior Tax Preferences

- **Income Tax**
 - Additional Personal Exemption \$2,300 single/\$4,600 joint (TY 2009)
 - Annual cost = \$55 million

- **Property Tax**
 - **Homestead Property Tax Credit**
 - Under age 65 – credit is 60% of the amount by which property taxes exceed 3.5% of household income, up to a maximum of \$1,200
 - 65 and older – credit is 100% of the difference
Annual cost = \$320 million



Demographics

- **Michigan's population is aging**
 - 2000 – 12.3% pop age 65+
 - 2010 – 12.8% pop age 65+
 - 2020 – 16.0% pop age 65+
 - 2030 – 19.5% pop age 65+

- **Senior tax preferences will get more expensive**



Impact of Shrinking Tax Base

	<u>Income Tax Rate</u>	<u>Collections as Percent of State Personal Income</u>
FY 2000	4.0%	2.6%
FY 2010	4.35%	1.5%
Revenue Impact of Declining Base (In Millions of Dollars)		\$3,653.50

	<u>Sales and Use Tax Rate</u>	<u>Collections as Percent of State Personal Income</u>
FY 2000	6.0%	2.8%
FY 2010	6.0%	2.1%
Revenue Impact of Declining Base (In Millions of Dollars)		\$2,511.60



Fewer People Pay Income Tax

	<u>2000</u>	<u>2008</u>
Tax Liability < \$0	19.5%	25.6%
Tax Liability = \$0	8.0%	8.0%
Tax Liability < \$100	33.6%	38.6%



Refundable Credits on the Michigan Income Tax

- Homestead Property Tax Credit (\$987.5 million in FY2009-10)
- Earned Income tax Credit (\$333.0 million in FY2009-10)
- Alternative Energy/Qualified Home Improvement Credit (\$46.0 million in FY2009-10)
- Adoption Credit (\$1.0 million in FY2009-10)
- Stillbirth Credit (\$41,000 in FY2009-10)



Indexed Provisions of the Michigan Income Tax

- Personal Exemption
- Special Exemptions for Seniors and/or Disabled Individuals
- Special Exemption for Qualified Disabled Veterans
- Income Threshold for Pension Income Deduction
- Income Threshold for Deduction of Interest and Capital Gains Earned by Seniors
- Home Heating Credit
- Stillbirth Credit

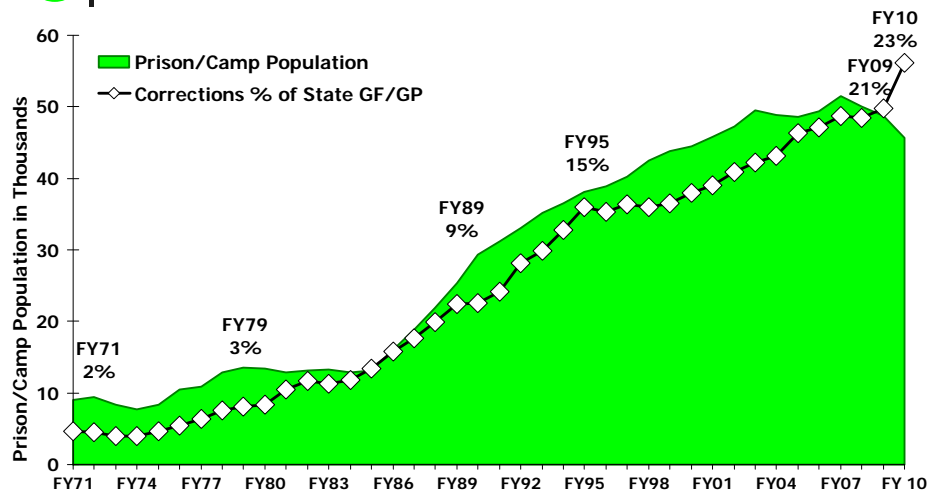


Medicaid Impact on Michigan Budget

- For FY 10, approximately 17.7% of Michigan GF/GP revenue is appropriated for Medicaid
- 1 of 6 Michigan residents were eligible for Medicaid in April 2009
- 42% of births and 70% of nursing home expenditures in Michigan are financed through Medicaid
- Total state and federal Medicaid appropriation is over \$10.7 billion in FY 10
- Since FY 1999-2000
 - 109.8% increase in Medicaid funding
 - 52.6% growth in Medicaid caseload (559,400 cases)



Corrections Budget Increases



*Fiscal Year 2008-09 includes GF/GP reductions due to appropriation of federal ARRA funds.
Fiscal Year 2009-10 includes the impact of gubernatorial vetoes of negative line items in the MDOC budget.*



PROBLEM: The State tax base is not stable and will not support any level of service for long.

SOLUTION: Stabilize the tax base at some level – higher, lower, or revenue neutral by doing the following.

- Reduce or eliminate as many tax expenditures as possible and lower marginal rates as much as possible.
- Institute a Sunset Commission that officially reviews economic development incentives on a regular basis.
- Institute a Peer Review process using M.S.U., U of M, and the Upjohn Institute to verify the expected impact of economic development incentives.
- Institute a Pay-As-You-Go system to identify spending cuts or revenue increases to fund program expansions and new tax expenditures.

The same principles apply to a flat tax and a graduated tax. The "Best" tax system is a diverse set of taxes that are stable, simple to understand, and easy to comply with. The tax base would be as broad as possible, and marginal rates as low as possible.

