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Fiscal Fact

March 9, 2011
No. 262

Gov. Snyder's Budget Improves Competitiveness but Costs Individuals

By
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Michigan, once the proud center of the thriving American auto industry, has been in decline for some time. In 1999, the state ranked 21st highest in the U.S. in GDP per capita; in 2009 it was ranked 41st.[1] In 2009 alone, per capita GDP fell by 5.2%,[2] and while Michigan's unemployment rate reached a two-year low of 11.1%[3] in December of 2010, it remains much higher than the national rate of 9.4%.[4]

There is strong evidence that people flee Michigan's failing economy in search of a better work environment: the state's net domestic migration rate was negative for all of the 2000s,[5] and between 2000 and 2007, an estimated 326,712 people left Michigan for another state.[6] Likewise, a 2009 study by Michigan State University found that 49 percent of the school's Michigan-native graduates leave Michigan, up from 24 percent in 2001, while the University of Michigan had 53 percent leave.[7] This "brain drain" deprives Michigan of a vital part of its workforce and contributes to the continuing decline of its economy.

On February 17, Governor Rick Snyder (R) released his proposed budget for Fiscal Years 2012 and 2013. It includes an ambitious plan to overhaul the state's business taxes. The broad outlines of the plan are to eliminate the Michigan Business Tax (MBT) and replace it with a more conventional corporate income tax. In order to make up for lost revenue from the switch, Snyder has proposed to eliminate most targeted business tax incentives, expand the individual income tax to pension income, and cancel future income tax rate reductions.

Business Taxes

Corporate Income Tax
Snyder proposes replacing the current Michigan Business Tax (MBT) with a 6 percent corporate income tax. The MBT is a combination of a corporate income tax and a gross receipts tax. Under the current system, corporate

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[1] "Gross Domestic Product By State." *Bureau of Economic Analysis*, 2011. http://www.bea.gov/regional/gsp/
[2] "Survey of Current Business, Tables." *Bureau of Economic Analysis*, Dec. 2010. http://www.bea.gov/scb/pdf/2010/12%20December/1210_gdp_state-tables.pdf
[3] "Economy at a Glance: Michigan." *Bureau of Labor Statistics*, 2011. http://www.bls.gov/eag/eag.mi.htm#eag_mi.f.2
[4] "Economy at a Glance: United States." *Bureau of Labor Statistics*, 2011. http://www.bls.gov/eag/eag.us.htm
[5] "Estimated Rate of Net Domestic Migration: Michigan." *U.S. Census Bureau*, Dec. 2009. http://www.michigan.gov/documents/cgi/Ch-DomMig0009_305586_7.pdf
[6] "State to State Migration Data," *Tax Foundation*, 2011. http://interactive.taxfoundation.org/migration/
[7] Ron French, "Half of University Grads Flee Michigan," *The Detroit News*, April 3, 2009. http://www.detnews.com/article/20090403/METRO/904030378

profit is taxed at a rate of 4.95 percent, while all transactions are taxed at a rate of 0.8 percent.[8] In addition, there is a 21.99 percent surcharge on the total tax liability from the MBT.

Many people approve of gross receipts taxes because they levy low rates, but most economists agree that gross receipts taxes can be very harmful to the business environment. The tax is applied to many intermediate business-to-business transactions and can consequently lead to hidden taxes on taxes, something economists call "tax pyramiding."[9]

Gross receipts taxes are also not ideal during economic downturns, since businesses must pay the tax even if they are losing money. The companies affected most by a gross receipts tax are ones with high volume but low profit margins, such as grocery stores and department stores. Since every intermediate transaction is taxed, those types of stores end up paying a disproportionate amount of tax relative to businesses with low volume and high profit margins.

Governor Snyder has proposed switching from the MBT to a 6 percent corporate income tax and imposing it only on "C" corporations--companies with public or private stock. While some companies, particularly those with few intermediate transactions and high profit margins, such as jewelry stores, may end up paying higher taxes under the 6 percent rate, the majority of businesses will probably see a decrease in taxes under the proposed plan. Snyder estimates the switch from the MBT to the corporate income tax will result in a loss of $1.8 billion in annual revenue, but that over 95,000 businesses will no longer have to file a corporate tax return.[10]

Incentives

In order to partially offset this revenue loss, Snyder proposes eliminating many of the targeted corporate tax credits that Michigan currently offers, projected to total over $2 billion in FY 2013. The governor's budget eliminates credits for brownfield re-development, the Michigan Economic Growth Authority (MEGA), Next Energy, film, renaissance zones and others. These programs accounted for over $400 million in expenditures in FY 2010. The elimination of tax expenditures would expand the corporate tax base and allow for a lower corporate tax rate. It would also provide a more level playing field, reducing the advantage that some companies get from the targeted economic incentives.

Snyder also proposes removing all economic development incentives from the tax system and evaluating them through the appropriations process instead. Despite Snyder's proposed cuts, numerous tax expenditures would remain in the Michigan tax code. Many of these programs serve a legitimate purpose; however, they should be treated as government expenditures rather than tax policy. Tax expenditures are no different than any other government spending and should be made transparent through the appropriations process rather than hidden in the tax code.

Snyder will honor existing commitments to economic development incentives, including over $600 million in both FY 2014 and 2015. The Governor does not completely end targeted incentives to businesses, proposing a $25 million fund for business retention, a $25 million fund for film incentives, and a $5 million fund for a Quality of Place partnership dedicated to art and cultural initiatives. This is in addition to the $75 million 21st Century Jobs Fund which is used to attract companies to Michigan through marketing and business incentives.

Individual Income Taxes

Cutting targeted business tax incentives will make up only part of the revenue lost in the transition to a corporate income tax. Snyder's budget calls for an additional $1.7 billion in revenue to be raised from the individual income

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[8] "Michigan Business Tax Details." *Michigan Department of Treasury, 2011.* http://www.michigan.gov/taxes/0,1607,7-238-46621-169398--,00.html

[9] Andrew Chamberlain and Patrick Fleenor, *Tax Foundation Special Report,* No. 147, "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes," Dec. 2006. http://www.taxfoundation.org/files/sr147.pdf

[10] "Michigan Executive Budget Fiscal Years 2012 and 2013." http://michigan.gov/documents/budget/1_345974_7.pdf

tax by suspending scheduled rate reductions and broadening the income tax base to include pension income and eliminate many targeted credits and deductions.

Scheduled Rate Reduction
In October 2007, Michigan increased its income tax rate from 3.9% to 4.35%.[11] This change was designed to stay in effect until October 2011, after which it would decrease by .1 percent each year for the next four years. Snyder's proposal to suspend the rate reductions is not surprising, as temporary tax increases have a tendency to become permanent. California's new governor, Jerry Brown (D), for example, recently proposed extending the state's temporary income and sales tax increase.[12] Other states, however, let temporary taxes expire on schedule: Maryland Governor Martin O'Malley (D) allowed his state's temporary income tax increase to expire, while New Jersey Governor Chris Christie (R) vetoed a bill to extend the expiring income tax on high-income individuals. While Snyder is not alone in making permanent a "temporary" tax increase, this still represents a failure to follow through with what was sold to taxpayers and voters by his predecessor.

Credits and Deductions
Snyder has also proposed removing most income tax credits and deductions currently offered to Michigan taxpayers. Remaining will be "the personal exemption, the exemption for individuals with disabilities, special provisions dealing with military personnel and veterans, the homestead property tax credit and a few other subtractions." However, the personal exemption and the homestead property tax credit will face phase-outs at higher levels of income.

Pension Income
The most dramatic change, in terms of additional revenue for the state, is the taxation of pensions. Both private and public pension income are currently exempt from tax in the state, one of only three states not to tax either form of pension income. However, a number of states exempt at least some form of pension income.

There is little economic rationale for taxing pension income differently from other types of income. However, employers made contracts with workers with the understanding that pension income was exempt from state taxes. This means workers likely accepted lower wages and pension benefits based on their understanding of the tax code.

Analysis

Overall, Snyder's proposal will likely improve Michigan's competitiveness. The 2011 *State Business Tax Climate Index* ranked Michigan 48th in the Corporate Tax Index and 17th overall.[13] If Snyder's proposals had been in

effect in 2010, Michigan would have ranked 22nd in the Corporate Tax Index and 13th overall. The switch from the problematic Michigan Business Tax to a more standard corporate income tax could serve to make Michigan more appealing to business.

While Michigan policymakers will certainly debate Snyder's corporate and individual income tax proposals, his plan deserves praise for the way it raises revenue within the individual income tax. While some states have targeted income tax increases on high-income individuals, Snyder's approach broadens the base of the tax. By eliminating tax credits and closing loopholes in both the corporate and individual income taxes, Snyder seeks to bring more people into the tax base while eliminating unjustifiable distortions. The result would be a more level playing field for both businesses and individuals.

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[11] "Michigan Public Act 97 of 2007." http://www.legislature.mi.gov/documents/2007-2008/billanalysis/Senate/pdf/2007-SFA-5194-N.pdf
[12] Joseph Henchman, "New California Governor Proposes Initiative to Extend Tax Increases," *Tax Foundation Tax Policy Blog* (Jan. 3, 2011). http://www.taxfoundation.org/blog/show/26938.html
[13] Kail. M. Padgitt, *Tax Foundation Background Paper,* No. 60, "2011 State Business Tax Climate Index," Oct. 2010. http://taxfoundation.org/files/bp60.pdf

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