

**SENATE FISCAL AGENCY
MEMORANDUM**



DATE: August 26, 2020
TO: Members of the Michigan Senate
FROM: David Zin, Chief Economist
RE: Updated Information on the COVID-19 Recession's Implications for Income Tax Rate Reductions Under Public Act (PA) 180 of 2015

On April 29, 2020, the Senate Fiscal Agency provided a memo that discussed the economic slowdown associated with COVID-19 and its implications for triggering individual income tax rate reductions under PA 180 of 2015. The information in that memo was based on an April forecast issued by the Research Seminar on Quantitative Economics at the University of Michigan. This memo will update the previous memo to reflect the revenue and economic forecasts made at the Consensus Revenue Estimating Conference (CREC) held August 24, 2020.

The economic ramifications of the COVID-19 pandemic already have been significant and there is great uncertainty about both their severity and their duration. However, one consequence of those economic disruptions is that State tax revenue is likely to decline significantly in fiscal year (FY) 2019-20 and FY 2020-21. Most current forecasts predict the economy will begin a recovery later in 2020 but do not anticipate a significant recovery in State revenue until FY 2021-22. Against the backdrop of revenue recovery, PA 180 of 2015 may complicate significantly the ability of State revenue to return to pre-COVID-19 levels for years.

Public Act 180 of 2015 adopted a "trigger" to reduce the individual income tax rate whenever General Fund/General Purpose (GF/GP) revenue grows more rapidly than an adjusted inflation rate. The trigger becomes effective for tax years beginning on or after January 1, 2023, and uses FY 2020-21 revenue as the base upon which to calculate the trigger. Regardless of the path the economic recovery takes, the expected depth of the decline in both economic activity and State revenue likely will result in substantial revenue growth in FY 2021-22. Under the August 24, 2020, CREC forecast, GF/GP revenue is expected to decline 7.4% in both FY 2019-20 and FY 2020-21, before growing 9.0% in FY 2021-22. As a result, FY 2020-21 GF/GP revenue is likely to be at the lowest level since FY 2013-14 and the trigger will pin revenue growth to a nominal (not adjusted for inflation) level of revenue similar to the level of GF/GP revenue the State received almost a decade ago.

Based on the August 24, 2020, CREC forecast, the trigger will require lowering the individual income tax rate to 3.99% beginning January 1, 2023, likely lowering GF/GP by nearly \$673.9 million on a full-year basis. Under projected revenue and additional predicted triggered rate reductions, the trigger in PA 180 of 2015 will prevent GF/GP revenue from reaching the FY 2018-19 level until at least FY 2026-27, four fiscal years later than otherwise would occur. These reduced income tax rates, and the resulting reduction in tax revenue, would be in addition to revenue losses resulting from the COVID-19 pandemic.

Table 1 steps through the calculation of the rate reduction required by PA 180 using the forecasted values for FY 2020-21 and FY 2021-22. For the trigger to be applicable, three conditions must be met: 1) GF/GP revenue must have increased in the previous year, 2) the US Consumer Price Index (CPI) for the State's fiscal year must have increased in the previous year, and 3) the percentage increase in GF/GP revenue must be greater than the percentage increase in the US fiscal year CPI. When those conditions are met, the computation creates a GF/GP revenue cap at what GF/GP revenue would have been had it grown 1.425 times the growth in the CPI. Any revenue received in excess of the capped amount then is used to compute a reduction in the individual income tax rate. Year-to-year changes in economic activity prevent the rate reduction from exactly reducing individual income tax revenue by the same amount as the excess revenue, and hold-harmless provisions protect rate reductions from lowering School Aid Fund revenue. As a result, all of the impact from the rate reduction is borne by the General Fund and can be greater than the amount by which actual revenue exceeded the trigger's capped revenue.

Table 2 illustrates the estimated annual impact of PA 180 through FY 2029-30. For years beyond those forecasted by the August 24, 2020, CREC, the underlying analysis assumes that the tax base subject to individual income tax withholding grows at 4.1% per year (approximately the average annual rate between FY 2010-11 and FY 2018-19), while estimated and annual payments grow at a 6.0% rate (these revenue sources are very volatile but generally follow growth rates in equity markets) and GF/GP revenue not associated with the individual income tax increases an average of 2.5% per year. Inflation rates in later years are based on an April 2020 long-term forecast from IHS/Markit and Macroeconomic Advisors, an international forecasting company.

Under these assumptions, PA 180's rate reduction provisions would be triggered in every fiscal year except FY 2024-25. (Although actual revenue still would exceed the revenue cap under the computation for that fiscal year, GF/GP revenue would have declined from the previous year—meaning that the three criteria that must be satisfied before the trigger provisions are applicable would not have been met.) The cap on GF/GP revenue under the computation formula would not exceed the FY 2018-19 level until FY 2026-27, the same year that actual revenue is forecast to finally exceed the FY 2018-19 level and four years after revenue would have otherwise recovered to the FY 2018-19 level. Because the income tax rate reductions under PA 180 begin on January 1 and the State's fiscal year runs from October 1 through September 30, the first fiscal year in which a rate reduction occurs does not reflect the full-year impact of the change. Table 2 indicates that the rate reduction effective January 1, 2023, will lower GF/GP revenue by \$573.6 million in FY 2022-23 and, combined with an additional rate reduction for tax year 2024, that amount will increase to more than \$1.5 billion in FY 2023-24.

Table 1
Income Tax Trigger Example
Using the August 24, 2020 Consensus Revenue Estimates
(dollars in millions)

<u>Variable</u>	<u>FY 2020-21</u>	<u>FY 2021-22</u>	<u>Percent Change</u>
U.S. CPI	260.710	265.813	2.0%
GF/GP Forecast Revenue	\$9,536.7	\$10,392.5	9.0%
Trigger Formula Test:			
GF Revenue Increased?			Yes
FY CPI Increased?			Yes
Revenue Increase Exceeds CPI Increase			Yes
Trigger Formula:			
U.S. CPI in FY 2021-22		265.813	
U.S. CPI in FY 2020-21		<u>260.710</u>	
Ratio		1.0196	
Minus 1		0.0196	
Multiplied by 1.425		0.0279	
Plus 1		<u>1.0279</u>	
Equals Capped Revenue Multiplier		1.0279	
FY 2020-21 GF Forecast Revenue			\$9,536.7
Times Capped Revenue Multiplier			<u>1.0279</u>
Equals Capped GF Revenue			\$9,802.8
GF Revenue Exceeding Capped Revenue		\$589.7	
Divided by FY 2020-21 GF Revenue		<u>0.0618</u>	
Multiplied by Tax Year 2022 Rate of 4.25%		0.2628	
Subtract Prior Line from Tax Year 2022 Rate to Produce:			
New Income Tax Rate for Tax Year 2023			3.99%

Table 2
Estimated Revenue Impact of Public Act 180 of 2015
Using the August 24, 2020 Consensus Revenue Estimates
(dollars in millions)

Fiscal Year	General Fund Revenue		Difference	GF/GP Revenue Cap Under PA 180	Estimated Individual Income Tax Rate Tax Years Beginning Jan. 1 of Fiscal Year
	Absent PA 180	With PA 180			
2020-21	\$9,536.7	\$9,536.7	\$0.0	Not applicable	4.25%
2021-22	10,392.5	10,392.5	0.0	\$9,802.8	4.25%
2022-23	11,515.3	10,941.7	(573.6)	10,020.2	3.99%
2023-24	11,988.9	10,447.9	(1,541.0)	10,262.4	3.64%
2024-25	12,483.8	10,788.1	(1,695.6)	10,552.4	3.64%
2025-26	13,000.9	11,002.7	(1,998.2)	10,888.1	3.56%
2026-27	13,541.3	11,431.3	(2,110.0)	11,249.5	3.56%
2027-28	14,106.1	11,714.7	(2,391.4)	11,622.4	3.50%
2028-29	14,696.6	12,080.9	(2,615.7)	11,988.6	3.47%
2029-30	15,313.8	12,467.8	(2,846.0)	12,351.0	3.44%

In January 2021, the Senate Fiscal Agency, House Fiscal Agency and the Michigan Department of Treasury will convene a CREC, as required by law. That CREC will produce preliminary final revenue estimates for FY 2019-20 and updated revenue estimates for FY 2020-21 and FY 2021-22. The January 2021 CREC also will be the first time official estimates are made for FY 2022-23, and those estimates will reflect the first official forecasts of the impact of any anticipated income tax rate reductions required by PA 180 of 2015.

Please contact me at 3-2768 if you have any questions or need additional information.

/lms

c: Christopher Harkins, Director
 Kathryn Summers, Associate Director
 Ryan Bergan, Fiscal Analyst