SENATE FISCAL AGENCY

REDUCTION OF MICHIGAN'S TAXES DUE TO FEDERAL 2001 TAX CUTS

by Jay Wortley, Senior Economist

In June 2001, President Bush and the Congress enacted the largest cut in Federal taxes since 1982. These tax cuts, which were contained in the Economic Growth and Tax Relief Reconciliation Act of 2001, primarily affect the Federal individual income and estate taxes. Because Michigan's income and estate taxes are directly linked to their Federal counterparts, these Federal tax changes also will reduce Michigan's tax revenue. This article summarizes the Federal tax cuts, and explains why, and by how much, these cuts will have an impact on Michigan's taxes.

Federal Tax Cuts

The Economic Growth and Tax Relief Reconciliation Act of 2001 contains many tax changes that are phased-in and -out over the next 10 years. The major components of the tax cuts contained in this Act include:

- A reduction in the marginal tax rates of the individual income tax, plus the addition of a new low tax bracket with a 10% tax rate.
- Payment of a tax rebate to taxpayers in the summer of 2001, which equaled the tax cut resulting from the new 10% tax bracket.
- A phased-in increase in the income tax child exemption from $500 per child to $1,000 per child.
- An increase in the standard deduction for married couples to help reduce the "marriage tax penalty".
- A gradual reduction of the estate tax beginning in 2002, and the complete elimination of this tax in 2010.
- Delayed realization of almost 60% of the tax cuts until the period from 2007 to 2011, while the enacted tax cuts will reduce Federal government revenue from FY 2001 to FY 2011.
- The expiration at the end of 2010 of all of the tax cuts enacted in this Act, to the levels in place before the Act was enacted.

All of the tax changes contained in this 2001 Federal tax law will reduce Federal taxes an estimated $1.35 billion over the next 10 years. The largest share of this overall tax reduction is generated by the reduction in the income tax marginal tax rates, which will cut taxes an estimated $842 billion. The other changes that will generate the largest tax reductions include the increase in the child exemption ($172 billion), the repeal of the estate tax ($138 billion), and the reduction in the "marriage tax penalty" ($63 billion).

Impact on Michigan Taxes

In addition to cutting Federal taxes, the tax cuts included in the Economic Growth and Tax Relief Reconciliation Act of 2001 will have an impact on Michigan's State government taxes. In general, the bases of Michigan's individual income and estate taxes are both directly tied to key components of the Federal income and estate taxes, including key definitions, measures of income, and tax credits, among others. To the extent that the new Federal tax cuts change these key Federal tax components on which Michigan's taxes are based, Michigan's taxes also will be affected by the Federal tax cuts. For example, the starting point for Michigan's individual income tax is Federal adjusted gross income (AGI). Therefore, any change to Federal AGI also will affect Michigan's income tax. On the other hand, the cut in the Federal income tax rates will have no direct impact on Michigan's income tax because Michigan's tax rate is in no way linked to the Federal tax rates.

As shown in Table 1, it is estimated that the Federal tax reductions will reduce Michigan's taxes an estimated $34 million in fiscal year (FY) 2001-02, $120 million in FY 2002-03, and $179 million in FY 2003-04. Almost all of this loss in revenue will affect the General Fund/General Purpose budget. While estimates of the revenue loss have not yet been made for later years, Michigan will continue to experience a loss in revenue through FY 2010-11, after which there will be no revenue loss because the Federal taxes will revert to their previous levels. The key ways in which Michigan's tax will be reduced are summarized below.

Table 1
ESTIMATED IMPACT OF THE 2001 FEDERAL TAX CHANGES ON MICHIGAN'S TAX REVENUE
(dollars in millions)

Federal Tax Changes	FY 2001-02	FY 2002-03	FY 2003-04
Income Tax			
Education Provisions:			
New Deduction for Higher Ed Expenses	($10.2)	($13.1)	($16.6)
Expansion of Education IRAs	(1.2)	(2.1)	(2.5)
Other	(1.5)	(2.1)	(2.4)
Subtotal Education Provisions	($12.9)	($17.3)	($21.5)
Adoption Credit Increase	1.1	1.1	1.1
Pensions and IRA Increases	(4.5)	(9.7)	(12.1)
Total Income Tax Loss	($16.3)	($25.9)	($32.5)
Single Business Tax Loss	(0.5)	(0.9)	(1.0)
Estate Tax Loss	(17.0)	(93.0)	(145.0)
Total Michigan Tax Loss	**($33.8)**	**($119.8)**	**($178.5)**

Source: Senate Fiscal Agency estimates

Income Tax. Income tax revenue will be reduced an estimated $16 million in FY 2001-02 and $33 million by FY 2003-04. This loss in revenue will be due primarily to changes in special tax provisions related to education expenses as well as individual retirement arrangements (IRAs) and pensions. A credit for adoptions will offset a small portion of this revenue loss.

- **Education-Related.** The largest single negative impact on Michigan's income tax revenue will result from the new Federal deduction for certain higher education expenses. Under this deduction, which will be in effect for tax years 2002 to 2005, taxpayers will be able to deduct from AGI higher education expenses for such items as tuition, fees, books, and required equipment, and some taxpayers will be able to deduct room and board expenses. In addition, education IRAs and the deduction for interest paid on student loans were increased. These education-related income tax changes will reduce Michigan's income tax revenue an estimated $12.9 million in FY 2001-02 and $21.9 million by FY 2003-04.

- **Pensions and IRAs.** A number of changes to the Federal tax code increase the amount taxpayers may contribute to tax-deductible retirement accounts or other tax-deferred retirement and pension plans. These IRA and pension-plan changes will reduce Michigan's income tax revenue an estimated $4.5 million in FY 2001-02 and $12.1 million by FY 2003-04.

- **Adoption Tax Credit.** Michigan's income tax includes a special credit for certain adoption expenses that exceed the Federal adoption credit. The recent changes to the Federal income tax included increasing the Federal adoption credit. As a result, less adoption expense will now be eligible for the Michigan credit and the cost of Michigan's credit will decline an estimated $1.1 million a year.

Estate Tax. The Federal estate tax allows a credit, up to a certain maximum, for any death-related tax an estate has to pay to a state government. Most states, including Michigan, levy an estate tax equal to the maximum credit allowed under the Federal estate tax. As a result, Michigan's estate tax does not increase the tax burden on an estate, but simply captures some of the tax revenue that otherwise would go to the Federal government. A number of changes were made to the Federal estate tax in the Economic Growth and Tax Relief Reconciliation Act of 2001, including phasing in the repeal of the estate tax over the next 10 years and phasing out the state death tax credit over the next four years. As a result of these changes, the revenue from Michigan's estate tax will decline an estimated $17 million in FY 2001-02, $93 million in FY 2002-03, and $145 million in FY 2003-04. Because the Federal state death tax credit will be eliminated in 2005, Michigan's estate tax, which generated about $155 million in FY 2000-01, will be completely eliminated in FY 2004-05.

More detailed information on the Federal tax cuts and the impact they will have on Michigan's taxes, is available in a Senate Fiscal Agency report entitled, "The Economic Growth and Tax Relief Reconciliation Act of 2001". This report is available on the Senate Fiscal Agency web site @ www.senate.state.mi.us/sfa/, or from the Senate Fiscal Agency at (517-373–5300).