

# State Notes

## TOPICS OF LEGISLATIVE INTEREST

Spring 2015



### A History of the Michigan Individual Income Tax Rate

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The Michigan individual income tax is now the largest source of State tax revenue, with net revenue of approximately \$8.0 billion in fiscal year (FY) 2013-14, representing 39% of combined State General Fund and School Aid Fund revenue. In FY 2013-14, the individual income tax provided 62.7% of General Fund/General Purpose revenue and 20.5% of School Aid Fund revenue.

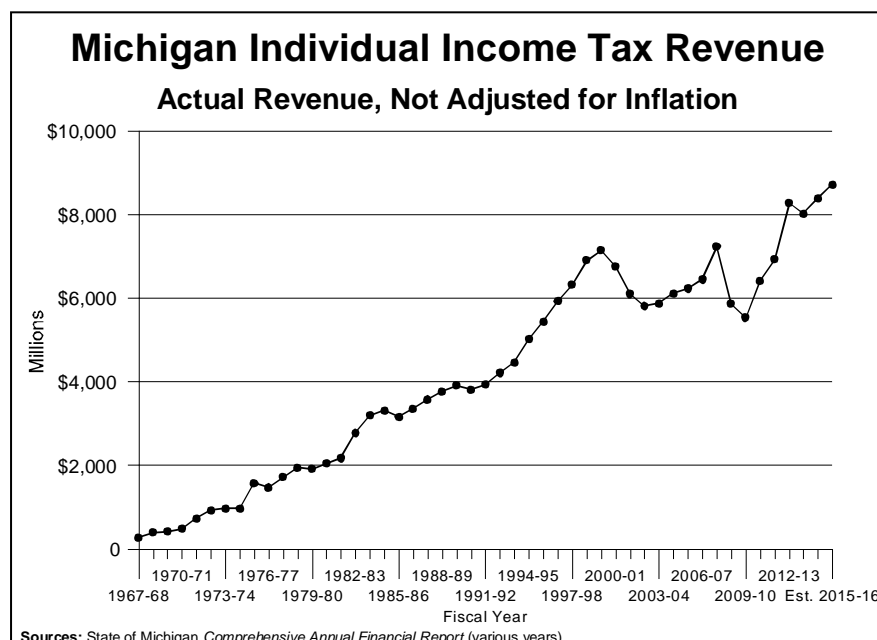
The amount of individual income tax revenue depends on the tax rate, tax base (the Federal adjusted gross income and the additions and subtractions required by Michigan), and the availability of tax exemptions and credits. The structure of the tax is limited by the Michigan Constitution of 1963, which states in Article IX, Section 7: "No income tax graduated as to rate or base shall be imposed by the state or any of its subdivisions." Thus, the Michigan individual income tax is a flat rate tax. It has been levied at a rate of 4.25% since October 1, 2012.

The individual income tax rate frequently is debated by policymakers concerned with the level of taxation and State spending. Since the advent of the tax in 1967, the tax rate has been changed frequently. This article will review the history of the income tax rate, with a focus on the changes made during the last decade.

### Individual Income Tax Revenue

The revenue from the individual income tax funds a significant portion of the State budget. In recent years it has provided well over one-third of combined General Fund/General Purpose (GF/GP) and School Aid Fund (SAF) revenue. [Figure 1](#) illustrates the full history of the individual income tax while [Table 1](#) shows the recent history of income tax revenue, with comparisons to combined GF/GP and SAF revenue. Individual income tax collections vary significantly with economic conditions, such as during the recession of 2008-2009, and changes in tax policy, such as the rate reductions implemented from 2000 through 2005. Revenue from the individual income tax has increased in its significance to the State budget over the last decade.

Figure 1





**Table 1**

<b>Individual Income Tax Revenue as a Percent of Total General Fund/General Purpose and School Aid Fund Revenue Not Adjusted for Inflation</b>			
<b>Fiscal Year</b>	<b>Income Tax Revenue</b>	<b>Total GF/GP and SAF Revenue</b>	<b>Income Tax as a Percent of Total</b>
1997-98	\$6,316.1	\$18,437.9	34.3%
1998-99	6,907.9	19,637.0	35.2%
1999-2000	7,144.2	20,569.9	34.7%
2000-01	6,749.4	19,896.5	33.9%
2001-02	6,096.0	19,483.0	31.3%
2002-03	5,811.8	19,611.3	29.6%
2003-04	5,873.4	19,584.6	30.0%
2004-05	6,108.9	20,168.3	30.3%
2005-06	6,226.3	20,313.8	30.7%
2006-07	6,442.7	20,417.4	31.6%
2007-08	7,226.0	21,849.9	33.1%
2008-09	5,856.8	19,209.4	30.5%
2009-10	5,531.3	18,495.5	29.9%
2010-11	6,417.1	20,061.2	32.0%
2011-12	6,921.0	20,125.4	34.4%
2012-13	8,271.8	20,832.2	39.7%
2013-14	8,020.1	20,539.0	39.0%
Est. 2014-15	8,393.5	21,390.5	39.2%
Est. 2015-16	8,719.7	21,976.9	39.7%

**Sources:** Michigan Comprehensive Annual Financial Reports, Senate Fiscal Agency, and Consensus Revenue Estimates as of January 16, 2015

Revenue from the individual income tax is determined by the interaction of the tax rate and base. The individual income tax base depends on the Federal definition of adjusted gross income; adjustments to income, including deductions (such as the limited exclusion of pension benefits) and additions; credits; and personal exemptions. As a result, the revenue generated by the tax will reflect a variety of economic factors, such as inflation or changes in economic growth. Individual income tax revenue also is sensitive to the tax rate. Based on current estimates, an increase of 0.1% in the individual income tax rate effective January 1, 2015, would increase State revenue by \$224.2 million in FY 2015-16. Figure 2 illustrates the history of Michigan's individual income tax revenue, adjusted for the effect of inflation. All of the major swings in revenue shown in Figure 2 reflect either changes in the tax, such as changes in the rate or base, or changes in the economy other than those associated with inflation.<sup>1</sup>

The revenue from the individual income tax primarily has been deposited in the State General Fund; however, there have been earmarks in effect since the inception of the tax. From FY 1967-68 through FY 1995-96, there were allocations made from income tax revenue to revenue sharing for counties, cities, villages, and townships. Initially, 17.0% of the net revenue was allocated to revenue sharing and the remainder to GF/GP revenue; however, the percentage and distribution of the allocation for revenue sharing were amended frequently as the revenue sharing earmark percentage was reduced in response to increases in the income tax rate and State budget difficulties resulted in payment limits, reductions, and

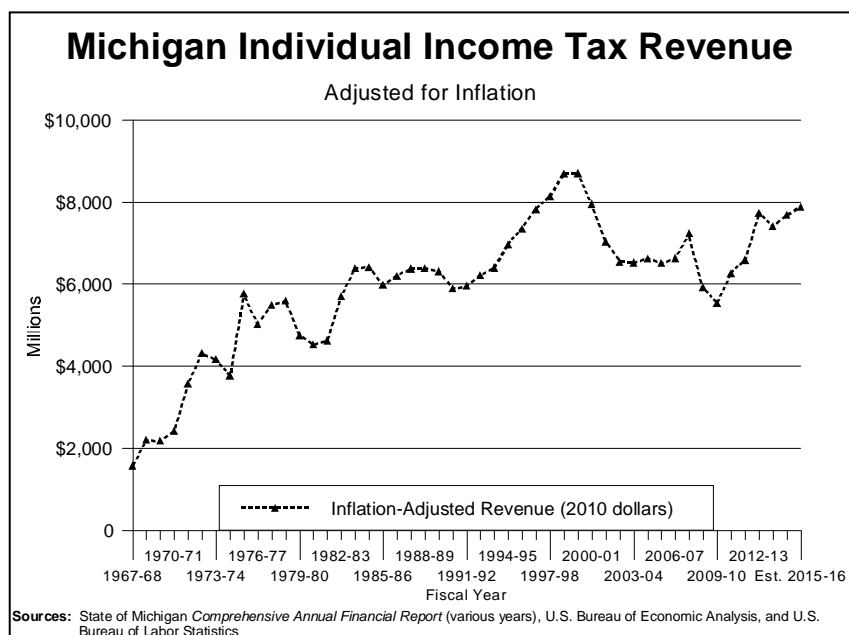
<sup>1</sup> A comprehensive review of changes to the individual income tax was published by the Michigan Department of Treasury. Please see "Michigan's Individual Income Tax 2012", Michigan Department of Treasury, Office of Revenue and Tax Analysis, Tax Analysis Division, July 2014, available as a link from [http://michigan.gov/treasury/0,1607,7-121-44402\\_44404---,00.html](http://michigan.gov/treasury/0,1607,7-121-44402_44404---,00.html) under "Tax Reports".



timing shifts. The use of income tax revenue for revenue sharing payments for local units of government ended with the repeal of former MCL 206.481 by Public Act 342 of 1996.

The allocation for revenue sharing was the only earmark from the income tax until the implementation of the Proposal A school finance reforms in 1994. Beginning October 1, 1994, 14.4% of gross income tax collections before refunds were allocated to the School Aid Fund. As of September 30, 1996, the share of income tax allocated to the School Aid Fund increased to 23.0%. That allocation remained in effect until January 1, 2000, when a calculation was implemented to hold the School Aid Fund harmless from changes in the individual income tax rate. The earmark to the SAF is contained in MCL 206.51(2).

**Figure 2**



### History of the Individual Income Tax Rate

The Michigan individual income tax was enacted by Public Act 281 of 1967 after years of debate on the need for and merits of an individual income tax. The initial rate was 2.6% effective October 1, 1967. The rate remained at that level until January 1, 1972, when it increased to 3.9% pursuant to Public Act 76 of 1971, which also called for the Act to expire August 1, 1972, unless certain ballot questions were submitted to the voters. However, Public Act 181 of 1972 kept the Act effective with the tax rate at 3.9%.

Public Act 19 of 1975 increased the individual income tax rate from 3.9% to 4.6% from May 17, 1975, through June 30, 1977, after which the rate was to decline to 4.4%. Public Act 44 of 1977 eliminated the sunset on the 4.6% rate, which then remained in effect until mid-1982.

The significant State fiscal pressures of the early 1980s resulted in a period of turbulence in the individual income tax rate, which had ramifications for the Michigan Senate. Public Act 155 of 1982 increased the income tax rate from 4.6% to 5.6% for the period from April 1, 1982, to September 30, 1982, after which the rate returned to 4.6%. Public Act 15 of 1983, however, increased the income tax rate to 6.35% beginning January 1, 1983. The Act included a complicated set of surcharges, adjustments, and economic triggers that would reduce the rate according to a formula over a period of years. This was met with opposition by voters in some areas. Two State Senators were recalled over the issue at separate elections held in late November 1983 in Oakland County and Macomb County. Public Act 221 of 1984 then reduced the tax rate

from 6.35% to 5.35% as of September 1, 1984, with a further reduction to 4.6% scheduled for October 1, 1987. However, Public Act 16 of 1986 accelerated the rate reduction by 18 months, resulting in a 4.6% rate as of April 1, 1986.

For the next 15 years, the income tax rate was relatively stable. The income tax rate remained at 4.6% for eight years until Public Act 328 of 1993 reduced the rate to 4.4% as of May 1, 1994. The 4.4% rate endured until 1999.

Following the economic expansion of the 1990s, a phased-in rate reduction was enacted in 1999 (Public Acts 2, 3, 4, 5, and 6 of 1999) to decrease the income tax rate from 4.4% to 3.9% over five years. Public Act 40 of 2000 accelerated the decline by reducing the rate from 4.3% to 4.2% for 2000. The income tax rate declined as planned from 4.4% in 1999 to 4.2% in 2000 and 2001, 4.1% in 2002, 4.0% in 2003, and 3.9% in 2004. The individual income tax rate of 3.9% as of January 1, 2004, was the lowest rate since 1975.

A temporary income tax increase of one-tenth of one percent applied for six months in 2004. Public Act 239 of 2003 increased the rate from 3.9% to 4.0% from January 1, 2004, to June 30, 2004, after which the rate returned to 3.9%

Difficulties in developing the FY 2007-08 budget resulted in a debate between the Governor and the Legislature on increasing tax revenue, and the annual budget bills for FY 2007-08 were not signed into law until November 8, 2007. The tax debate was settled on the last day of FY 2006-07 upon adoption of the conference report on House Bill 5194 (Public Act 94 of 2007) which increased the individual income tax rate from 3.9% to 4.35% as of October 1, 2007. (An expansion of the use tax to certain services also was approved; however, the use tax expansion was repealed two months later, on the day that it was to take effect, and replaced with a Michigan Business Tax surcharge.) The income tax rate was to remain at 4.35% for four years, then decline over six years back to 3.9%.

The rate reductions enacted in 2007 did not occur as planned, however. In 2011, tax reforms enacted under Governor Snyder resulted in a shift in the State tax burden from businesses to individuals. These changes included replacing the Michigan Business Tax with the Corporate Income Tax and making substantial changes to the individual income tax. The individual income tax changes included provisions that reduced the pension income deduction, reduced the earned income credit and the homestead property tax credit, and eliminated most remaining income tax credits such as those for charitable donations or city income taxes. The changes to the individual income tax also scaled back the gradual reduction in the income tax rate. Instead of the reduction from 4.35% to 3.9% over five years, Public Act 38 of 2011 made a single reduction from 4.35% to 4.25% as of January 1, 2013, although Public Act 223 of 2012 subsequently accelerated the rate reduction by three months, to October 1, 2012. [Table 2](#) compares the schedule for future individual income tax rates under the provisions of Public Act 94 of 2007 and the subsequent legislation that has amended that schedule.

Although higher than the rate in effect between January 1, 2000, and October 1, 2007, the current tax rate of 4.25% is lower than the rate levied during most of the history of the individual income tax, including the 25 years between 1975 and 2000. Over the 48-year life of the individual income tax, the median average tax rate levied was 4.4%.



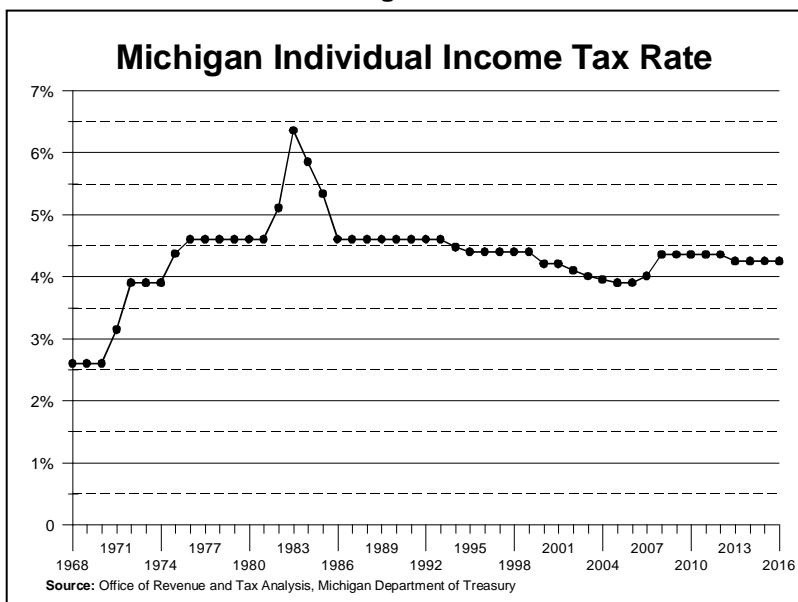
**Table 2**

<b>Scheduled Individual Income Tax Rates, 2007-2016</b>			
<b>Individual Income Tax Rates</b>			
<b>Tax Year</b>	<b>2007 PA 94 In Effect 10/1/2007 to 9/30/2011</b>	<b>2011 PA 38 In Effect 10/1/2011 to 9/30/2012</b>	<b>2012 PA 223 In Effect 10/1/2012 to Present</b>
2007	3.90% 1/1 to 9/30 4.35% 10/1 to 12/31	--	
2008	4.35%	--	
2009	4.35%	--	
2010	4.35%	--	
2011	4.35% 1/1 to 9/30 <i>The rates below did not take effect due to 2011 PA 38.</i> 4.25% 10/1 to 12/31	4.35%	--
2012	4.25% 1/1 to 9/30 4.15% 10/1 to 12/31	4.35% <i>This rate ended 10/1/12 due to 2012 PA 223.</i>	4.35% 1/1 to 9/30 4.25% 10/1 to 12/31
2013	4.15% 1/1 to 9/30 4.05% 10/1 to 12/31	4.25%	4.25%
2014	4.05% 1/1 to 9/30 3.95% 10/1 to 12/31	4.25%	4.25%
2015	3.95% 1/1 to 9/30 3.90% 10/1 to 12/31	4.25%	4.25%
2016	3.90%	4.25%	4.25%

**Source:** Senate Fiscal Agency

Figure 3 and Table 3 present the history of the average income tax rate levied since the inception of the tax. The annual average rate differs from the statutory number when more than one rate is in effect during a tax year. The average rate is weighted to reflect the time that each rate was in effect. The current tax rate of 4.25% is lower than the rate levied in more than half of the years that the individual income tax has been in effect.

**Figure 3**





**Table 3**  
**Average Annual Individual Income Tax Rate**

Tax Year	Average Annual Rate	Tax Year	Average Annual Rate
1968	2.6%	1992	4.6%
1969	2.6	1993	4.6
1970	2.6	1994	4.47
1971	3.14	1995	4.4
1972	3.9	1996	4.4
1973	3.9	1997	4.4
1974	3.9	1998	4.4
1975	4.37	1999	4.4
1976	4.6	2000	4.2
1977	4.6	2001	4.2
1978	4.6	2002	4.1
1979	4.6	2003	4.0
1980	4.6	2004	3.95
1981	4.6	2005	3.9
1982	5.1	2006	3.9
1983	6.35	2007	4.01
1984	5.85	2008	4.35
1985	5.33	2009	4.35
1986	4.6	2010	4.35
1987	4.6	2011	4.35
1988	4.6	2012	4.33
1989	4.6	2013	4.25
1990	4.6	2014	4.25
1991	4.6		

**Sources:** Michigan Department of Treasury, Office of Revenue and Tax Analysis, Tax Analysis Division, "Michigan's Individual Income Tax 2012", July 2014 and Senate Fiscal Agency

### Comparing the Tax Rate to the Tax Burden

While the individual income tax rate has ranged from 3.9% to 4.4% during the last 17 years, the effective tax rate (the amount of tax collections after refunds divided by taxable income) has been much lower. The existence of personal exemptions and tax credits such as the homestead property tax credit make the effective rate of the tax lower than the nominal rate. Another way to measure the taxpayer impact of the individual income tax is to compare net tax revenue with State personal income. These figures show the tax burden as lower than the effective rate due to the exclusion of various types of income from taxation. The effective rate of the individual income tax, the average rate levied, and the estimated share of State personal income paid in State individual income tax are listed in [Table 4](#). [Figure 4](#) illustrates Michigan individual income tax revenue as a percentage of Michigan personal income.

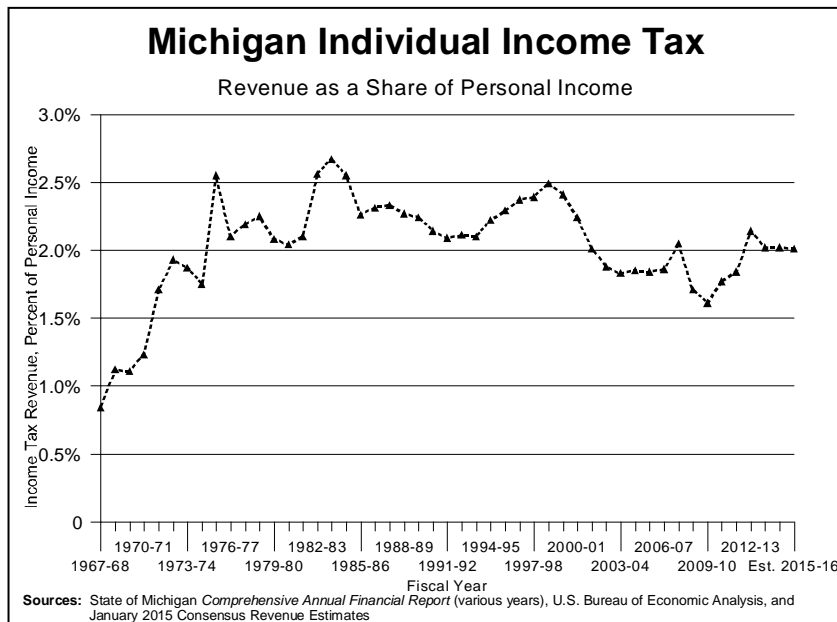


**Table 4**

<b>Michigan Individual Income Tax The Average Tax Rate, Effective Tax Rate, and Income Tax as a Percentage of State Personal Income</b>			
	<b>Average Tax Rate</b>	<b>Effective Tax Rate</b>	<b>Income Tax Paid as a % of State Personal Income (Fiscal Year)</b>
1998	4.4%	2.88%	2.39%
1999	4.4	2.86	2.50
2000	4.2	2.68	2.41
2001	4.2	2.59	2.24
2002	4.1	2.49	2.01
2003	4.0	2.35	1.88
2004	3.95	2.20	1.83
2005	3.9	2.05	1.85
2006	3.9	2.03	1.84
2007	4.01	1.99	1.86
2008	4.35	2.24	2.04
2009	4.35	2.03	1.71
2010	4.35	2.07	1.61
2011	4.35	2.11	1.77
2012	4.33	2.42	1.84
2013	4.25	N/A	2.14
2014	4.25	N/A	2.01

**Sources:** Michigan Department of Treasury, Office of Revenue and Tax Analysis, Tax Analysis Division, "Michigan's Individual Income Tax 2012", July 2014 and Senate Fiscal Agency

**Figure 4**





## **Conclusion**

The current individual income tax rate of 4.25% is lower than the median rate of 4.4% that was levied over the nearly five decades that the individual income tax has been in effect. The revenue from the income tax is determined by the tax base, the tax rate, and the availability of targeted tax relief in the form of credits and exemptions. As a result of these provisions, the effective rate of the tax is less than the statutory rate. Over the last decade, the effective rate has been approximately half of the statutory rate.

During the last 15 years, the revenue generated by the tax has represented approximately 2.0% of personal income. However, throughout much of its history, the individual income tax has raised a larger share of State revenue than any other tax. In FY 2013-14, the individual income tax provided 39.0% of General Fund and School Aid Fund revenue. As a result, marginal reductions in the tax tend to have a small impact on taxpayers, relative to their incomes, but a large impact on State revenue. The history of the individual income tax demonstrates that it is frequently changed, suggesting it will continue to be a focal point when issues arise regarding either the budget or tax burdens.