Council Comments

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# STATE BALLOT ISSUES – THE GRADUATED INCOME TAX

Proposition No. 1 on the November 5 ballot is a proposed amendment to the state constitution:

> "An income tax at flat rates or graduated as to rate or base may be imposed by the state or any of its subdivisions."

This amendment would replace the present Section 7 of Article IX of the state constitution, which states:

> "No income tax graduated as to rate or base shall be imposed by the state or any of its subdivisions."

## History

The present constitutional prohibition against a graduated income tax was incorporated in the constitution of 1963 as an express limitation on the power of the state legislature and political subdivisions of the state to impose a graduated income tax. There had previously been some doubt as to the constitutionality of a graduated income tax under the provisions of the constitution of 1908, although the attorney general had ruled that a graduated income tax would be constitutional.

In 1962, the city of Detroit adopted a flat rate city income tax and in 1964 the state legislature adopted a uniform city income tax act which authorized cities to enact a flat rate city income tax under terms of a uniform ordinance. In 1967, the state legislature enacted a compromise tax package which included a flat rate income tax on individuals (rate of 2.6% on taxable income), corporations (5.6%), and financial institutions (7.0%). As a part of the compromise tax package, the legislature approved the submission to the people of a constitutional amendment that would authorize state and local income taxes graduated as to rate or base.

## The Graduated Income Tax

A graduated income tax is one in which the rate varies with the amount of income (graduated rates) or one in which the rate is constant but the base against which it is imposed varies (graduated base). The examples below illustrate the two types of graduation.

The most familiar example of an income tax graduated as to rate is the federal income tax with rates (before the 1968 surtax) ranging from 14 percent on the first $500 of taxable income to 70 percent on taxable income in excess of $100,000. the rate schedule of the Georgia state income tax illustrates a state income tax with graduated rates:

| Net Income | Rate |
|---|---|
| First $1,000 | 1% |
| $1,001 - $3,000 | 2 |
| $3,001 - $5,000 | 3 |
| $5,001 - $7,000 | 4 |
| $7,001 – 10,000 | 5 |
| Over $10,000 | 6 |

An income tax graduated as to base is applied at a flat rate to a base that is graduated; e.g., the amount of federal income tax paid. The Alaska state income tax is graduated as to base. The individual taxpayer determines his Alaska state income tax liability by applying a flat rate of 16 percent to the amount of federal income tax that would be payable on his income under the federal tax rates in effect on December 31, 1963.

Since the amount of federal income tax liability is determined by applying graduated rates to taxable income, the net effect of a flat rate state income tax applied to federal income tax liability is the same as imposing a graduated state income tax at rates scaled down from the federal rates.

The rate schedule of an income tax does not, itself, determine the proportionality of progressivity of the tax. A tax is considered to be proportionate if the tax paid as a percentage of income is the same at all income levels, while a tax is considered progressive if the tax paid as a percentage of income increases as the income level increases. The progressivity of a tax is influenced by the amount allowed for personal exemptions, deductions and credits as well as by the rate schedule.

## The Income Tax in Other States

Michigan is the only state that has an explicit prohibition against graduated income taxes in its constitution, although in four other states (Massachusetts, Nevada, New Hampshire and Pennsylvania) constitutional “uniformity” provisions render doubtful the authority of the stat to impose a graduated income tax. Three other state constitutions (Florida, Tennessee and Washington) apparently prohibit any state income tax whether flat rate or graduated. The constitutions of the remaining 42 states permit graduated income taxes either explicit provisions or, in the absence of any specific restriction, adoption of a graduated income tax is within the broad powers of the legislature.

Personal Income Taxes. At the present time, a total of 35 states impose broad based personal income taxes—in 32 states the tax is graduated and in three states flat rate (Michigan, Indiana and Massachusetts).

A comparison of the effective rates (ratio of tax liability to personal income) of the 35 state personal income taxes shows that all are progressive, regardless of whether they are graduated or flat rate taxes. This results from the exemptions, deductions and credits for other taxes that are allowed in computing state income tax liability and the proportionately greater impact there have on lower income taxpayers. The Michigan state income tax, which is imposed at a 2.6 percent flat rate, is progressive because of the high personal exemption allowed ($1,200) and the sliding scale credits for property taxes and city income taxes paid. Only three states have higher personal exemptions than Michigan for a typical family (husband, wife and two children).

The effective rate of the Michigan income tax at various income levels is compared to the median effective rate at each income level of the income taxes in the 35 states that impose such taxes, and the District of Columbia. The figures show the effective tax rate for a married couple with two dependents, with all income from salaries and wages and after allowances for personal exemptions, deductions and tax credits.

| | Effective Tax Rate | |
|---|---|---|
| Adjusted Gross Income | Michigan | Median Rate In Income Tax States |
| $2,500 | 0% | 0% |
| 3,500 | 0 | 0 |
| 5,000 | 0 | .5 |
| 7,500 | .3 | 1.2 |
| 10,000 | .8 | 1.7 |
| 17,500 | 1.5 | 2.5 |
| 25,000 | 1.8 | 3.2 |

As shown in the above table, the Michigan state income tax is progressive with effective rates increasing from zero at the $5,000 and under level to 1.8 percent at the $25,000 level. The effective tax rate in Michigan is lower throughout the income scale and the median rate, which means that the total state income tax burden is lower in Michigan than the average in income tax states. The effective tax rates of the Michigan state income tax are more progressive for the income levels shown than the median rates in the income tax states.

In the seven states which are Michigan's principal competitors, two have graduated state personal income taxes (New York and Wisconsin), one (Indiana) has a flat rate state personal income tax, and the remaining four do not have state personal income taxes (Illinois, Ohio, Pennsylvania and New Jersey, although New Jersey has an income tax on commuters).

Corporate Income Taxes. A total of 40 states levy corporate income tax. In 31 states including Michigan the corporate income tax is flat rate and in nine states the corporate income tax is graduated. In the competitor states Illinois and Ohio do not tax corporate income; Indiana, Michigan New Jersey, New York and Pennsylvania impose flat rate corporate income tax with rates that vary from two percent on the first $1,000 of taxable income to seven percent on taxable income in excess of $6,000.

Local Income Taxes. The proposed amendment to the Michigan constitution states that "an income tax at flat rates or graduated as to rate or base may be imposed by the state or any of its subdivisions," (emphasis added). Thus, the proposed amendment applies not only to the state of Michigan, but also to the 2,904 units of local government in the state (83 counties, 522 cities and villages, 1,254 townships, 110 special districts, and 935 school districts).

The proposed amendment would clearly make it legally permissible for these local units to impose a flat rate or graduated income tax. There is very significant legal question, however, as to whether the proposed constitutional amendment grants these subdivisions the self-executing power to impose such taxes, or whether it simply permits the legislature to authorize political subdivisions to impose such taxes. The impact of this provision on political subdivisions such as cities which have home rule powers might be different than the impact on political subdivisions such as school districts that are "creatures" of the state with all of their powers derived from the state legislature. If interpreted very broadly, the proposed amendment could be construed to be a direct grant of power by the people to political subdivisions to levy flat rate graduated income taxes as they see fit without reference to any legislative control. A very narrow interpretation of the proposed amendment is that it simply permits the legislature to authorize local units to impose flat rate or graduated income taxes—the legislature would decide which political subdivisions would be authorized to levy what kind of income tax.

Local income taxes are currently levied in eight states (Alabama, Kentucky, Maryland, Michigan, Montana, New York, Ohio and Pennsylvania). In Maryland and New York local units impose a graduated local income tax, while in the other six states the local income taxes are flat rate.