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TAX POLICY AND ECONOMIC PERFORMANCE: CAN TAX REFORM HELP THE MICHIGAN ECONOMY?

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Can Tax Reform Help the Michigan Economy?

The November ballot will contain three alternative proposals for changing the tax system in Michigan. Two of the proposals would reduce property taxes at the local level, substituting in one case a higher income tax and in the other a higher sales tax, both to be collected at the state level. The third proposal would cut property taxes in half, compel the state to partially replace the lost revenue, and limit the possibility for raising new taxes in the future. All of the proposals include some arrangements for limiting the inflationary growth of tax revenues in the future.

Meanwhile, the Michigan economy is experiencing the brunt of a sharp downturn in employment and income. Being highly dependent upon the automobile industry, the Michigan economy usually does decline in a recession more than does the national economy. This time, though, there are two factors that generate more concern than usual about the longer run outlook for the automobile industry and the Michigan economy: a major, abrupt change in consumer buying patterns and the availability of highly competitive foreign products. Instead of the usual expectation of a nine-to-fifteen-month recession, there is reason to believe that the period of poor economic performance may be considerably more prolonged. It is against this backdrop of pessimism and concern about future economic conditions in Michigan that the relationship between the proposed tax changes and state economic growth is examined.

Proponents of the tax cut proposal claim that a tax cut at this time could stimulate the Michigan economy to a speedier, more vigorous recovery. As evidence that the tax cut proposal could result in such stimulation, the effects of previous federal income tax cuts and the results of the Proposition 13 tax cut in California are cited. These situations, however, as discussed below, are not analogous to the current Michigan situation. Unlike the national government and the state of California at the time of the Proposition 13 implementation, the state of Michigan cannot duplicate the fiscal process that could lead to economic growth; nor could either of the tax shift proposals stimulate the economy. Each of the three proposed tax plans would, however, have subtle effects that are important to the Michigan business climate and are discussed below.

Taxes and Economic Growth

The relationship between tax cuts and economic growth has been an issue in this country for fifty years. During this period the federal government has reduced income taxes from time to time, but when it has done so, it has not reduced expenditures to match. When taxes are reduced and government expenditures remain unchanged, the effect is to stimulate economic activity. If the economy is operating at less than full capacity, reduction in taxes increases the purchasing power of taxpayers and leads to increases in purchases of goods and services by the private sector of the economy.

In addition, when the federal government maintains the level of expenditures, it continues to give purchasing power to those from whom it purchases goods and services. In the early 1960s the Kennedy administration initiated a federal income tax cut, coupled with no reduction in expenditures. The subsequent strong performance of the U.S. economy is considered evidence of the success of this type of policy.[1]

In recent years it has been asserted by some individuals that a reduction in taxes that is matched by a reduction in government expenditures would also be stimulative. With lower taxes, individuals would work harder, and with a decrease in the overall presence of government in the economy in the form of regulation and intervention, private initiatives would become stronger. This type of reasoning has been offered as a major explanation for the poor U.S. productivity growth record of recent years. While there has been considerable discussion of this idea, there have been no episodes or experiments that would lend evidence either in support of or in opposition to this conjecture. Proposition 13, as it was initially proposed, was to provide just this kind of economic experiment by cutting both taxes and the level of government expenditures. As it turned out, however, while Proposition 13 produced a tax cut, expenditures were not cut appreciably. Thus, the Proposition 13 experience cannot be used as evidence that a tax cut/expenditure cut would encourage economic growth.

The California Experience: Proposition 13

Much has been written about the political and economic setting in which Proposition 13 emerged.[2] For the purpose of this analysis, the facts are that in California during the mid-1970s residential real estate prices, and thus property taxes, were rising at rates considerably higher than the rate of increase in personal income, and the rate of housing inflation was accelerating.[3] State income and sales tax revenues were rising rapidly, primarily because of a highly progressive state income tax and inflation-induced consumer spending patterns. It was estimated that during the mid-1970s, for every 1 percent increase in personal income, state tax revenues increased 1.6 percent.

California voters soundly approved the adoption of Proposition 13 in June 1978. It went into effect in July 1978 cutting property taxes by 57 percent ($6.9B), and imposing strict limitations on the growth of such taxes thereafter. Local units of government, the collectors of these taxes, would have had to cut services severely if the state government had not come to their rescue. As it was, the state was accumulating a large surplus (considerably larger than was generally expected or known), and was able to make up much of the shortfall for local governments. The state's so-called bail-out amounted to $4.4B during the first year following passage (ending July 1979) and $4.9B during the second year (ending July 1980). New local fee systems and the exhaustion of local budget surpluses offset most of the rest of the lost revenue. A few services were cut (free summer school, some library services) and some reduction in employment at the local government level (about 2 percent) occurred in the two years following passage. Overall, total state and local government expenditures were reduced very little, and the level of government services remained relatively constant.[4]

From an economic standpoint, Proposition 13 had a stimulating effect on the California economy. The impact on economic activity arose from the fact that taxes were cut more than were government expenditures. The real stimulus came from increased purchasing power in the hands of California residents, which indirectly arose from the expenditures of previously idle state and local surpluses. Whereas these funds, prior to passage of Proposition 13, may have been invested in financial instruments and thus been accessible to the national economy, once the funds flowed out purchasing power was concentrated in California households and businesses. Almost any form of mobilization of these funds would have had the same stimuating effect in the California economy.

Proponents of Proposition 13 argued that lower property taxes would attract new investment, generate higher profits and income, and thus create more jobs. Economic indicators suggest that the California economy has generally outperformed the U.S. economy since the passage of Proposition 13; but economic growth was stronger in California than for the nation as a whole before passage as well.[5] During the two years prior to Proposition 13 implementation, personal income in California grew more rapidly than in the U.S. as a whole (see Table 1). After Proposition 13, the gap increased. Some of the difference may be attributed

TABLE 1

SELECTED ECONOMIC INDICATORS FOR
CALIFORNIA AND THE UNITED STATES
(Percent Change from Year Earlier)

	2nd Quarter 1977		2nd Quarter 1978		2nd Quarter 1979		2nd Quarter 1980	
	Calif.	U.S.	Calif.	U.S.	Calif.	U.S.	Calif.	U.S.
Personal Income (S.A. Billion $)	12.4	10.7	12.4	11.9	15.1	11.6	15.3[1]	10.3
Retail Sales (Billion $)	10.6	10.3	10.4	10.4	17.6	12.7	8.1	3.5
Consumer Price Index	7.7	7.0	6.5	8.9	9.9	11.2	16.2	14.1
Private Employment	5.1	3.7	10.1	4.9	6.4	4.6	1.9[2]	1.6
Unemployment Rate (Actual)	8.3%	6.9%	7.1%	5.8%	6.0%	5.7%	7.2%	7.5%

[1]Preliminary figures through April 1980.

[2]Preliminary figures through May 1980.

Sources: U.S. Department of Labor, U.S. Department of Commerce.

to a higher rate of inflation in California than in the rest of the country. Similarly, retail sales in 1978-80 surged compared to the rest of the country. In the two years previous, the difference had been negligible.

Employment figures show a somewhat different pattern. Private employment grew more rapidly in California than in the rest of the country for the two years prior to passage. During the two years following passage employment continued to grow though the California figures did not maintain as large an advantage over the national figures as they had been before passage. Unemployment figures reflect the strong growth trend (both before and after passage) in California and, particularly, a greater resiliency to recession than the U.S. as a whole. Most analysts acknowledge that the California economy has been stronger than the economy of the rest of the country for several years. Proposition 13 certainly did not detract from that trend, though it is not apparent just how much additional stimulation occurred. Indeed, the strong growth of the aerospace and electronics industries in California probably enhanced the adjustment to the change in taxation.

The overall effect of Proposition 13 has been a tax shift--a reduction in property-based local taxation and an increase in income-based state tax collection. Though the major intent of Proposition 13 proponents was to cut the level of government expenditures, the actual effect was a relatively smooth transition to another system of taxation, with little, if any, reduction in total expenditures. Certainly there have been many adjustments on the part of local governmental units to the shift in tax base, but from a fiscal standpoint, total taxes and expenditures have remained relatively balanced.

Although much of the initial impetus and eventual impact of Proposition 13 was to control the inflation-distorted growth in property taxes, the proposition did not affect the impact of inflation on other types of taxes. It was not until November 1979 that voters took the opportunity to impose limitations on the inflationary growth in state income taxes. More recently, California votes turned down a proposal that would have cut both state income taxes and state expenditures. One interpretation of this series of votes on tax reform in California is that all along voters were seeking to control the impacts of inflation on tax revenues. They did not want to cut the size of government; rather, they wanted to limit its growth.

The Michigan Experience

As has been true in California, Michigan voters have also sought ways of dealing with inflation-induced increases in taxes in the past few years. In November 1978 Michigan voters approved a system whereby state revenues would be limited and property taxes would be rolled back whenever property tax revenues increase more rapidly than general price levels. The system has not proven to be as effective as has been hoped in limiting property taxes for homeowners.[6] All three proposals on the upcoming ballot attempt to index property taxes to a greater degree than is now occurring. In addition to the indexing issue, however, each of the three proposals offers another modification to the tax system, in the form of tax cuts coupled with expenditure cuts, and/or tax shifts.

Proposal D: Tax Cut/Expenditures Cut

This proposal would cut property taxes by more than 50 percent (about $2.5B) and require that the state make up most of the difference (about $2B) on a matching basis. Although this proposal is patterned after Proposition 13, in that it calls for a reduction of property taxes and reimbursement to local units by the state government, there is no question that the fiscal impacts would be quite different in Michigan.

The state of Michigan (like most other states, including California) is prevented by law from spending more than its current income and accumulated surplus. With current revenues declining sharply in the state due to the recession, and with no surplus at this time, implementation of Proposal D would require the state of Michigan to reduce its expenditures further to accommodate the local bail-out. The combination of property tax reductions at the local level and expenditures reductions at the state level would cause a decrease in state government services. The tax reduction would, of course, increase the spendable income of Michigan taxpayers, who would no doubt spend a good part of that increase. The reduction in state expenditures, however, would reduce the incomes of those from whom the state has been purchasing goods and services and to whom it has been making transfer payments. These recipients, having experienced a reduction in income, would reduce their expenditures on goods and services.

Furthermore, a matched tax and expenditures cut would, if anything, reduce tax receipts even further. If the state reduced its expenditures, tax receipts from that source would fall. If individuals experienced a reduction in taxes, and therefore an increase in spendable income, this increase in income would be taxed by the state and be subject to federal income tax as well. Any effect of a reduction in property taxes would be offset in part by an increase in federal taxes.

Proposal D supporters argue that the private economy in Michigan would be stimulated by the matched cuts in taxes and expenditures. They say that private incentives would increase as a result of lower taxes and that government would necessarily become more efficient as its resources were decreased while demand for services was not. The debate on these issues continues because there is no evidence either to support or to refute these arguments. Certainly the Proposition 13 experience cannot be held up as an example of such a tax cut. Implementation of Proposal D in Michigan would not repeat the California experience with Proposition 13.

Assertions that the economy would benefit from Proposal D conceal the real issue underlying the plan, which has to do with size of government. Michigan voters must decide whether they want to substantially and permanently reduce the level of state government services.

Proposals A and C: Tax Shifts

Neither Proposals A nor C would cause a direct tax cut. Instead, each contains provisions for cutting and indexing property taxes and replacing the lost revenues with other taxes. From a purely fiscal standpoint, expenditures would not be affected. As long as both total tax revenues and expenditures remained at about the same level, no stimulating effect on the economy would be expected. There are, however, some differences in impact with respect to saving and with respect to the cyclicality of revenues.

Comparing the income-based Proposal A to the sales-based Proposal C, there could be some differences in impact on the incentive to save. (Proposal A would tax all income; Proposal C would tax only that portion of income that is spent.) To the extent that Proposal C would encourage greater saving, this would increase the funds available for investment and tend to lower interest rates. However, since savings flow into financial markets that operate on a national level, the advantage of encouraging savings out of current income would be spread across the nation. The impact on investment in Michigan would be minimal.

The proposals that shift some taxes from a property base to an income or sales base would result in more variability in revenues over the business cycle. Personal income, sales, and corporate activity all vary over the business cycle, and the amount of variability is greater in Michigan than in any other state.[7] Thus, tax systems that are based on these economic flows generate cyclical revenue patterns. A property-based tax is usually less cyclical, because property values do not generally vary over the business cycle. Proposals A and C would both partially shift the tax system from the relatively steady property base to a more cyclical sales- or income-based system. From the viewpoint of the taxpayer, an income tax system offers the advantage that the tax burden lightens in times of economic disadvantage (no income, no income tax); property taxes, however, continue to be imposed whether there is income or not. The sales tax burden is less cyclical than the income tax but more cyclical than the property tax. To some extent, then, the income and the sales taxes automatically vary contracyclically to the benefit of taxpayers.

The other side of this effect, though, is that state revenues contract sharply in recessions. In the absence of surpluses, governmental expenditures must contract also, forcing governmental services to decline. Tax revenues at the state level already vary considerably, causing periodic contractions in state budgets (as anyone concerned with state spending is well aware!). The question of whether more cyclicality ought to be imposed is a consideration to be addressed. It comes down to which sector ought to bear the burden of a recession--taxpayers' spending or government spending on services to the taxpayers.

The important issue with respect to either of the tax shift proposals, in comparison to the existing system, involves the question of appropriate tax base. And the issue of tax base (income, spending, or real wealth) eventually leads to the ultimate question: who should bear the tax burden?

Summary and Conclusion

Michigan voters will be asked in November to choose among three tax reform proposals, each of which seeks to counteract some inflationary distortions in the property tax, as well as to accomplish either a cut in government services or a shift of the tax burden. Supporters of the Proposal D tax cut in Michigan have cited Proposition 13 and the subsequent economic performance of the California economy as evidence that substantial cuts in property taxes can stimulate economic growth. However, the two situations are not analagous. Proposition 13 effectively resulted in a partial tax shift, from property taxes to income taxes. Any economic stimulation that resulted from Proposition 13 was the result of spending previously accumulated governmental surpluses. Little reduction in government expenditures occurred.

To cite the California experience as evidence that a tax cut similar to Proposition 13 would benefit the economy of Michigan is therefore in error. Economic conditions in Michigan do not exhibit the same positive momentum as was the case in California. More important, however, is the fact that the highly progressive income tax system of California generated enough revenues to replace the cut in property tax revenues. If Proposal D was implemented in Michigan, the tax cut would necessarily force cuts in government expenditures. Michigan has no budget surpluses on which to draw, and the state income tax system is considerably less progressive than that in California. With no available supplementary funds and a legal requirement that the state budget be balanced, tax cuts would force expenditure cuts. Whether this would help or harm the Michigan economy is not known, though the thought of experimenting on the Michigan economy when it is already in such fragile condition does indeed seem unwise. The uncertainty and disruption that could be expected as a result of cuts in government services would not be conducive to economic recovery.

The implementation of Proposition 13 resulted in a situation similar to the tax shift that would occur with the implementation of Proposals A or C. The replacement of one tax system by another does not substantially affect economic activity if government revenues and expenditures remain constant. The subtle effects of taxing consumer spending (sales) rather than consumer income would be of minimal advantage to the Michigan economy. The more cyclical nature of income and sales taxes does not directly affect economic activity either, though it does affect government services periodically.

The conclusion to be drawn, then, is that the economy of Michigan will not directly benefit from cutting or shifting taxes as proposed. Instead, the three tax reform proposals ought to be debated in terms of the following broad issues:

1. How much inflation indexing do Michigan taxpayers want to build into their tax system, and which taxes do they want to index?
2. Do the voters of Michigan wish to substantially cut the level of governmental services?
3. If not, do Michigan voters wish to change the system of taxation from one based on property tax to one based more on either income or sales?

These are important issues that rest, to some degree, on value judgments rather than scientific information. The question of economic impact is not one of them.

FOOTNOTES

1. The policy of maintaining budget deficits over a period of many years has contributed to the inflation problem.

2. For an excellent historical description, see Frank Levy, "On Understanding Proposition 13," The Public Interest 56 (Summer 1979): 66-89.

3. In 1976 the average assessed value of single-family homes increased 12.8 percent; in 1978 the average assessed value increased 20 percent.

4. A recent study by California's legislative analyst concluded that essentially no local services have been cut.

5. David Levin, "Proposition 13: One Year Later," Survey of Current Business (November 1979): 14-17.

6. The tax limitation amendment approved in November 1978 establishes a method of tax rate rollbacks when the increase in total assessed property values of a community exceeds the rate of inflation. Because slowly rising prices of commercial property have offset the more rapidly increasing prices of residential property, the overall rollbacks have been small.

7. Howard Friedenberg and Robert Breitzfelder, "Sensitivity of Regional and State Nonfarm Wages and Salaries to National Business Cycles, 1948-1979," Survey of Current Business (May 1980): 21.

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