Information Report: An Income Tax for East Lansing?

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Abstract

The Financial Health Review Team recommended that East Lansing consider implementing a city income tax at rates of 1 percent for residents and businesses and .5 percent for nonresidents, with a $600 personal exemption. Residents would be taxed on total income (earned and capital income) excluding retirement and social security benefits, but would receive a credit for taxes paid to another Michigan city. Nonresidents would be taxed on income earned in the city. MSU students are likely to be defined as nonresidents. The Team also recommended that the city reduce the property tax rate by 5.6 mills to reduce property tax revenue equal to the income tax revenue collected from residents. In Michigan, income taxes are used by 22 cities generating about $460 million in revenue for fiscal year 2014.

The income tax/property tax substitution is expected to generate at least two transfers, a transfer of net tax liability from business to residents in aggregate and an intergenerational transfer among residents, with the old gaining at the expense of the young. The pattern of net tax change favors retired individuals especially, whereas renters and younger homeowners and families are likely to see the largest net tax increases relatively. The tax change may create an increase in demand for residences in communities close to East Lansing, including Bath, Meridian, and Williamstown Townships, with a corresponding decrease in population as well as land and housing prices in East Lansing as well as decreasing the attractiveness of living in East Lansing for families with school-age children. For MSU, economic analysis suggests the tax would cause a modest increase in before-tax wages for faculty but very small or no increase in before-tax wages for other employees. Key alternatives to a city income tax include programs to reimburse the city for foregone property tax revenue, including Public Act 289. The US Supreme Court decision in Comptroller of the Treasury of Maryland v. Wynne calls into question the constitutionality of local government income taxes as typically structured.

¹ The views expressed in this report are the result of the author’s research and do not necessarily represent the views of Michigan State University or its officials. I appreciate the comments of Michael Conlin and Soren Anderson from an earlier seminar presented to Economics Department colleagues.
I. Financial Health Review Team Proposal and Tax Characteristics

The City of East Lansing Financial Health Review Team recommended that East Lansing consider implementing a city income tax at rates of 1 percent for residents and businesses and .5 percent for nonresidents, with a $600 personal exemption. The Team also recommended that with the implementation of the income tax, the city reduce the property tax rate by 5.6 mills to reduce property tax revenue equal to the income tax revenue collected from residents.

The static analysis by consultants showed that such a policy would result in a net revenue increase of about $5 million, consisting of a $10 million increase in revenue from the income tax offset by a $5 million property tax reduction. The consultants estimated that the income tax would generate $5.3 million from resident individuals, $4.7 million from nonresidents, and $.4 million from businesses, offset by about $.4 million in administration costs.

It should be noted that city income taxes are deductible in calculating federal individual income tax for those who itemize deductions. Therefore, the effective tax rate is lower than the nominal rate for itemizers. For example, assuming a 25 percent federal marginal tax rate, a 1 percent city tax for residents becomes a .75 percent tax after deductibility. Similarly, a .5 percent nonresident city tax becomes a .375 percent tax effectively. If taxable income for a taxpayer is $100,000, the tax net of deductibility is $750 for residents and $375 for nonresidents. National data show that about one-third of federal taxpayers itemize deductions in aggregate, although the percentage who itemize is greater than 85 percent for those with adjusted gross income above $100,000. There is currently no state income tax deduction or credit for city income taxes; a prior state income tax credit was repealed in 2012.
Of course, the FHRT proposal is to reduce city property taxes by reducing the tax rate simultaneously with levying the income tax. Taxpayers who itemize deductions for the federal individual income tax would include property taxes in those deductions as well as state and local government income taxes. Therefore, although the effective city income tax rate would be reduced by deductibility for these taxpayers, they would also lose part of the itemized deduction as a result of the reduction of the city property tax.

City income taxes in Michigan do include a credit for income tax paid to another Michigan city. Thus, an individual who works in one city with an income tax and lives in a different city that also has an income tax would pay tax on earnings at the nonresident rate in the city of employment and pay tax on all taxable income in the city of residence, less the credit for tax paid to the city of employment. If both cities have 1 percent and .5 percent tax rates on residents and nonresidents respectively, such an individual effectively would (1) pay tax at a .5 percent rate on labor earnings in the city of employment, (2) pay tax at a .5 percent rate on labor earnings to the city of residence, and (3) pay tax at a 1 percent rate on all other taxable income (interest, dividends, capital gains, and so on) to the city of residence.

**II. Local Government Income Taxes in Michigan**

In Michigan, income taxes are used by 22 cities currently, as shown in Table 1. According to U.S. Census Bureau data, the city income taxes in Michigan generated about $460 million in revenue for fiscal year 2014. The Citizens Research Council of Michigan reports that these taxes generated $482.7 million in 2015, as shown in Table 1.

Because so few local governments in Michigan use an income tax, it provides slightly less than 1 percent of total local government revenue, although 3.9 percent of total city government revenue. For all local governments in aggregate in the state, intergovernmental grants provide 41.9
percent of total revenue, property taxes about 23 percent, user charges about 15.4 percent, and sales tax zero percent, of course.

The City Income Tax Act of 1964 (as amended) provides authorization for city governments to levy an income tax, with approval of a vote of registered voters in the jurisdiction. The tax applies to residents, nonresidents, and businesses. For residents, the tax base is total income less some exclusions and a personal exemption between $600 and $3,000, depending on city choice. For nonresidents, the tax base is income earned in the city, with the same personal exemption. The business tax base is profits. The legislated tax rates are 1 percent for residents and businesses and .5 percent for nonresidents, although cities can adopt higher rates with state government authorization, as four cities (Detroit, Grand Rapids, Highland Park, and Saginaw) do currently (see Table 1).

Tax Base

The City Income Tax Act identifies the tax base as follows: “(1) Compensation, net profits, investments and other income of city residents; (2) Income earned in the city by nonresidents; (3) Corporate income earned in the city (allocation based on property, sales, payroll).” In practice, taxable income for residents for the city income taxes includes earned income (wages, salaries, etc.), interest and dividends, capital gains, net profit from rental property and other business activity, and some other types of income. However, excluded from taxable income are pension and retirement benefits (independent of how they are treated for the state individual income tax), unemployment insurance payments, armed forces compensation, and a few other categories.

Nonresident individuals are taxed only on income earned in the city.

The explanatory information provided by the City of Grand Rapids provides greater detail:

“A resident is subject to tax on all items included in total federal income. Taxable income includes:

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Salaries, bonuses, wages, commissions, fees, vacation pay, profit sharing plan income and other compensation regardless of where earned.
Deferred compensation distributions.
Fair market value of merchandise or services received as compensation.
Net profit from operation of a business or profession or other activity regardless of where earned.
Income from a partnership, S corporation, estate or trust, interest from bank accounts, credit unions, savings and loan associations and other income regardless of where earned.
Rental income, capital gains and dividends.

Nontaxable income includes:
Gifts, inheritances, bequests and distributions of principal from estates and trusts.
Proceeds from insurance, pensions, annuities and retirement benefits (including Social Security) even if taxable under the Internal Revenue Code.
Unemployment compensation, supplemental unemployment benefits, welfare relief payments and workers compensation.
Interest from U. S. obligations such as Savings Bonds and Treasury Notes, obligations of the states, or subordinate units of government of the states.
Compensation for service in the U. S. armed forces, including reserve components.”

The explanatory material from Grand Rapids also clarifies that for nonresidents only income derived from activities in the City is taxable. The specific instructions are:

“A nonresident is subject to tax on all items included in total federal income, which are derived from or connected with Grand Rapids sources (emphasis added). Taxable income includes:
Salaries, bonuses, wages, commissions, fees, vacation pay, profit sharing plans and other compensation for services rendered as an employee in Grand Rapids.
Fair market value of merchandise or services received as compensation.
Net profits from the operation of a business or profession or other activity conducted in Grand Rapids.
Net profits from rental of real and tangible property located in Grand Rapids.
Net profits from sale or exchange of personal property located in Grand Rapids.

The following items are nontaxable to nonresidents:
Interest, dividends and royalty income.
Income from trusts and estates.
Qualified deferred compensation properly reported on a Form 1099-R.”

There are two especially important aspects of these tax base definitions for estimating the effects of a City of East Lansing income tax. First, social security and other forms of retirement
income are excluded from taxation for residents, which has important implications for the income tax for property tax substitution proposed by the Review Team. Second, capital income (or unearned income) is not taxed for nonresidents, which has important equity implications for the tax.

Who Are Residents?
Because different tax rates apply to residents and nonresidents, the definition of a “resident” is crucial in a city such as East Lansing, which has many university students and visitors. Students presumably would prefer to be defined as nonresidents, whereas the city might prefer to count them as part-year residents or full residents. The definition in the statute is relatively standard legally:

“Resident” means an individual domiciled in the city. “Domicile” means a place where a person has his true, fixed and permanent home and principal establishment, to which, whenever absent therefrom, he intends to return, and domicile continues until another permanent establishment is established. If an individual, during the taxable year, being a resident becomes a nonresident or vice versa, taxable income shall be determined separately for income in each status.

The set of students at a place such as Michigan State University is quite diverse, but many typical undergraduates are claimed as dependents by parents or others for federal and state income tax purposes, many may file their own federal/state income tax returns from a home address (their parents’), many (and likely most) retain a home (parents’) address on a driver’s license or passport, and although some are registered to vote locally many register at the home location. Thus, it seems likely that many students would not meet the domicile rule in East Lansing.

Grand Rapids is a city with both an income tax and a public university (Grand Valley State University) that has both student residences and academic facilities in the city. Communication with tax authorities for Grand Rapids revealed that students are treated as nonresidents for income tax purposes unless they have changed the driver’s license and voter registration to the Grand
Rapids address, i.e. have become domiciled in the city. Although perhaps a matter for litigation, it seems reasonable that most MSU students would be nonresidents for purposes of an East Lansing city income tax.

**III. Local Government Income Taxes in the U.S.**

To put the East Lansing proposal in context, it seems helpful to note the application of local government income taxes nationally. About 5,000 local governments – including counties, municipalities, and school districts – spread over 15 states levy individual income taxes. For context, there are more than 90,000 local governments in the U.S., including about 36,000 municipalities. Local government income taxes are most important in 5 states (Maryland, Kentucky, New York, Ohio, Pennsylvania), with more than 2,900 of these local governments in the state of Pennsylvania alone. Local income taxes also are authorized but not currently used in two other states, Arkansas and Georgia. However, local government sales taxes are more common, being used in 37 states.

Local governments, in aggregate, generated only about 1.7 percent of revenue from income taxes in 2014, which reflects the fact that only a small fraction of local governments use this tax. However, municipalities in aggregate rely on income taxes for about 4 to 5 percent of revenue. Again in contrast, intergovernmental grants provide about 31.2 percent of total local government revenue in aggregate, property taxes about 25.5 percent, general sales taxes about 4.3 percent, and user charges about 14.8 percent.

The structure of local income taxes varies substantially, especially concerning the tax base and how tax bases are distributed among different localities. Some local income taxes exclude property income and apply only to earned income and are typically referred to as wage taxes. In two states (California and New Jersey), the local government taxes are payroll taxes.
collected from businesses. In some cases local income taxes are residence-based (sometimes applying only to residents). In other cases, the jurisdiction where the income is earned has preference.

The practice in Pennsylvania is particularly complicated because different rules apply to Philadelphia and other jurisdictions. Philadelphia has first right to tax the income earned by nonresidents in the city. Because the tax rate in Philadelphia is greater than the permitted rate in neighboring jurisdictions, these jurisdictions have not adopted income taxes because they could collect no tax on income earned in Philadelphia by their residents. Other than Philadelphia, the jurisdiction of residence has first claim to residents' income earned in other jurisdictions in Pennsylvania. As a result, jurisdictions surrounding Pittsburgh adopted local income taxes following Pittsburgh in order to retain that income tax base.

IV. Effects of a City Income Tax on the City

The proposal by the Financial Health Review Team to levy an income tax offset partly by a property tax reduction equal to the amount of income tax collected from residents is revenue neutral for the set of residents in aggregate, but not individually. First, part of the benefit from reducing the property tax rate will accrue to owners of business property or land, who will receive a tax decrease. Second, only for some residents will the property tax reduction be large enough to offset the new income tax.

2 The Financial Health Review Team recognizes this, as the Revenue Options report states “The millage reduction applies to all who pay property tax. As Attachment 1 indicates, 46% of the $5 million of millage reduction would apply to residential (homestead) property, and the remainder is spread among other taxpayer categories. Persons and entities who own real property and do not end up paying or owing City income tax will also have the same millage reduction.”
Effects for Taxpayers

Taxpayers for whom property value is high relative to taxable income are those most likely to have no tax change or see a net tax decrease. Because social security and retirement income is not taxed by the city income tax, older or retired residents are most likely to be in this group. However, for most residents, and certainly those for whom property value is low relative to taxable income, a net tax increase is expected. Residents who are younger, those with families, and renters are expected to be in this group.

Therefore the income tax/property tax substitution proposal would be expected to generate at least two transfers (not counting an adjustment of behavior by residents and business). Clearly there would be a transfer of net tax liability from business to residents in aggregate. In addition, there would be an intergenerational transfer among residents, with the old gaining at the expense of the young.

Illustrations of the potential net tax effects from a 1 percent income tax collected from residents coupled with a reduction in the city property tax rate of 5.6 mills are shown in Table 2. The illustrations suggest that most city residents would experience a direct net tax increase from such a tax substitution, absent any changes in behavior or prices. For example, a household with taxable income of $100,000 residing in a house with taxable value of $100,000 (implying a market value of at least $200,000) would have about a $440 net tax increase. In contrast, consider a household (with a retiree) with $20,000 of income from interest, dividends, and part-time work and $80,000 of income from social security and pension benefits. If that household lived in a home with taxable value of $100,000 (implying a market value of at least $200,000), it would have a net tax decrease of about $360. The net effect is a tax decrease because the social security and pension income are not taxed.
The effect for nonresident landlords and landowners also may be of interest. The case for nonresident landowners seems clear. If the land were vacant, the landowner would receive a property tax reduction and owe no income tax. If the land is leased, then the landowner would receive the property tax reduction and owe income tax on the net lease income, so the overall effect is not known. Nonresident landlords would be taxed on net rental (business) income from properties owned in the City and would receive a property tax reduction as a result of the reduction in the tax rate. A rough estimate for the property tax reduction would be the 5.6 mills times the taxable value of the property, which is a maximum of 50 percent of the market value. Thus,

\[ \text{Property tax reduction} = \left(\frac{\text{Property value}}{2}\right) \times \left[\frac{5.6}{1000}\right] \]

The income tax would be .5 percent of net rental income or

\[ .005[r \times \text{Property value}], \text{ where } r = \text{rate of return (profit rate) from rental activity} \]

The net rental rate of return would have to be very high (above 56 percent) for the income tax to exceed the property tax reduction.

**Effects on City Development**

The net increases in tax liability suggest the possibility for changes in residential and business location. Individuals and families have substantial choice of residential localities within the Lansing-East Lansing metropolitan area (which the Census Bureau categorizes as being composed of the three county region encompassing Clinton, Eaton, and Ingham counties). It seems reasonable to anticipate an increase in demand for residences in communities close to East Lansing, including Bath, Meridian, and Williamstown Townships. Indeed, a substantial amount of residential development and population increase has occurred already in those areas in recent years. Such changes in residential locations would be expected to increase land and housing prices in those surrounding jurisdictions, with a possible corresponding decrease in population as well as
land and housing prices in East Lansing. Decreases in the price of housing or land in East Lansing would cause part of the revenue increase from the income tax to be offset by an unanticipated decrease in property tax.

The pattern of net tax change from the combination of an income tax increase and property tax reduction favors older and especially retired individuals, as this is a group with potential net tax reductions (or at least the smallest increases). Conversely, renters and younger homeowners and families are likely to see the largest net tax increases relatively, as shown in Table 2. A potential irony, therefore, is that the income tax for property tax substitution may have the effect of especially decreasing the attractiveness of living in East Lansing for families with school-age children who are likely to have relatively high income relative to property value. Such a change could affect enrollment in the East Lansing School District.

As an illustration, a young faculty member at MSU might have taxable income of $125,000 and live in a $200,000 house with a taxable value of $100,000. Such a household residing in East Lansing would have a net tax increase (sum of property and income tax) of $690 compared to the current tax structure as a result of the proposal (as shown in Table 2). If such a household currently resides in East Lansing, it would have an incentive to move to a nearby local jurisdiction without an income tax. If such a household represents the situation for a family newly joining MSU, there clearly is an incentive not to select the City of East Lansing for residence. In contrast, retired individuals might find East Lansing more attractive than currently because the property tax rate would be lower and much of the individual’s income would not be taxed by the City.

East Lansing and Lansing

If East Lansing adopts an income tax (1%/0.5%) and Lansing retains its current tax at those rates, a combination of interactions would result. A resident of Lansing who works in East Lansing
currently pays a 1 percent tax to Lansing on all taxable income. With the adoption of an East Lansing tax, such a person would pay a .5 percent to East Lansing on income earned in the city (nonresident), a .5 percent tax to Lansing (after the tax credit) on income earned in East Lansing, and a 1 percent tax to Lansing on all other taxable income. Although there would be no change in tax paid overall, there would be a decrease in tax revenue to Lansing.

In contrast, a resident of East Lansing who works in Lansing currently pays a .5 percent tax to Lansing on income earned in that city. Such an individual would now pay a .5 percent to Lansing on income earned in that city, a .5 percent tax to East Lansing (after the tax credit) on income earned in Lansing, and a 1 percent tax on all other taxable income. Clearly such a person has a tax increase. What is interesting, however, is that such a person could move to Lansing with no income tax change. The incentive for someone who works in Lansing to live in East Lansing to reduce the Lansing tax is eliminated. Similarly, a resident of East Lansing who works in East Lansing could move to Lansing and have the same income tax liability.

Research Regarding City Income Taxes

Research regarding local government income taxes generally generates several observations (see Sjoquist and Stoycheva, Wassmer, Wildasin, and Wink in the references). First, local government income taxes tend typically to be slightly regressive both because a flat rate is common and because not all income (especially capital income) is taxed. Second, revenue is generated directly from nonresident workers (commuters) but not directly from visitors (in contrast to a local sales tax). Third, local income taxes may lead to a more dispersed urban area as a result of relocation of residences and other economic activity.

On the last point, the case of Philadelphia has been studied in detail more than any other locality. The local income tax in Philadelphia is a wage tax collected through employers, and
Philadelphia has legal preference to tax the wages of nonresidents who work in the city over neighboring jurisdictions where workers live. And the tax rate in Philadelphia is substantially higher than that allowed in neighboring localities. Research shows that the result has been a decrease in employment in Philadelphia. The research shows that the elasticity of employment in Philadelphia with respect to the wage tax rate (or tax rate differential between Philadelphia and other localities) is between -.1 to -.6, so a 10 percent increase in the tax rate differential for Philadelphia results in a 1 to 6 percent decrease in employment in the city.

**V. Effects of a City Income Tax for MSU**

What are the potential effects of an East Lansing income tax for MSU directly? One is obvious, as employers are required to do withholding for the city income tax. However, the University already does tax withholding against both the federal and state income taxes for employees, so the additional withholding requirement would seem to impose little additional administrative cost after an initial adjustment to records.

Another issue of interest is whether the creation of a city income tax would increase labor costs for the University (and other employers) by causing wage increases to at least partly offset the new tax, what economists refer to as incidence or burden of the tax falling on employers. The standard economic analysis of this issue is clear. The more that economic agents, whether employers or employees, are willing to change behavior, the less of the tax burden that will fall on them. In the terminology of economics, the more price elastic is supply or demand, the less the ultimate tax burden.

To apply this concept, one might think of two types of University employees. For faculty, it seems reasonable to assume that faculty members have more flexibility to change behavior than the University (price elasticity of demand is less than price elasticity of supply or relatively elastic
supply and inelastic demand). The market for faculty is international, and the University has to meet the market price in order to hire quality faculty and researchers. In that case, one expects the tax to impose a relatively larger burden on employers than employees, which would cause a modest increase in before-tax wages for faculty.

For other, non-faculty University employees, however, just the opposite seems most likely. For these employees, it seems reasonable to think that workers do not have as much flexibility as does the University, that is the price elasticity of demand is greater than price elasticity of supply or inelastic supply and elastic demand. Many University employees, and especially student employees, are tied to the local labor market and thus have limited employment opportunities beyond the University. For these workers, the expectation is that the tax would impose a relatively larger burden on employees than employers, leading to a very small or even no increase in before-tax wages for these employees. As a result, many such workers (including students) would experience a decrease in after-tax income (without adjusting their behavior).

VI. Legality of Local Income Taxes

State government income taxes are origin-based, so tax responsibility arises in the state where income is earned. To avoid multiple jurisdictions taxing the same income, state income taxes include either a deduction for income earned in another state or a tax credit for income tax paid to another state. However, local income taxes typically do not include such adjustments.

County governments collect broad-based income taxes in Maryland that are administered by the state government, and although the Maryland state income tax includes an allowance for income tax in other states, the local county income taxes do not. As a result, a taxpayer filed suit claiming that the county tax is unconstitutional via violation of the Commerce Clause. For example, a Maryland resident who works in the District of Columbia or Virginia is liable for three
income taxes – the Maryland state tax, the income tax in DC or Virginia where the taxpayer earns income, and the local county income tax where the taxpayer resides in Maryland. The taxpayer would not be taxed under the Maryland state income tax for income earned outside the state, but would owe county income tax on the taxpayer’s full income wherever earned. Essentially, income earned in DC would be taxed both by the DC income tax and the Maryland county income tax.

Initially, courts agreed with the allegation in Comptroller of the Treasury of Maryland v. Wynne. On May 18, 2015, the U.S. Supreme Court upheld the decision of the Maryland Court of Appeals that a Maryland resident may apply a tax credit for income taxes paid to other states against both Maryland state-level and state-administered county-level personal income taxes. This decision, although limited in some ways, potentially could make nearly all local government income taxes as currently structured unconstitutional because there is no allowance for income tax paid to another state. Such an issue could arise for East Lansing residents, including faculty members, who earn income in states other than Michigan that have state government income taxes.

The courts noted the potential for income tax credits against city income taxes to resolve the issue. Indeed, the local income taxes in Michigan do provide a credit against taxes paid to another city in Michigan, so East Lansing residents who work in Lansing would not pay both the full East Lansing tax at the resident rate and the Lansing tax at the nonresident rate. It is worth mentioning that prior to the 2012 Michigan income tax changes, Michigan had a state government income tax credit for city income taxes. But the city income taxes in Michigan on city residents do not adjust for income tax paid to other state governments.

VII. Alternatives

The Financial Health Review Team also considered a number of options to improve the city’s financial position. Because the income tax proposal is motivated in part by the fact that
government property, including that owned by Michigan State University, is exempt from
property taxation, other alternatives to dealing with tax-exempt property seem important to note.

One well-known option is referred to as payments in lieu of taxes (PILOTs), which refers
to informal or negotiated agreements between a local government with property tax authority and
institutions that own tax-exempt property, especially private, nonprofit (charitable)
organizations. Research by Daphne Kenyon and Adam Langley for the Lincoln Institute of Land
Policy shows that such agreements are used in at least 18 states, with PILOTs most common in
Massachusetts where they are utilized in 82 of the 351 municipalities in the state.

Michigan has three state government programs to replace lost property tax revenue for
local governments. The first is Public Act 78 of 2016 (which replaced Public Act 66 of 2012)
that allows local municipalities to be reimbursed for real and personal property taxes lost due to
the property tax exemption for eligible senior citizen and disabled housing facilities provided by
state law. Municipalities receive a payment in lieu of taxes from the state government to offset
property tax revenue foregone because of an explicit state government exemption. Second, the
state government also makes payments to local units of government in lieu of property taxes for
public lands owned by the State and administered by the Department of Natural Resources. In
each of these cases, the state government is reimbursing local governments for foregone property
tax revenue caused by explicit state government action.

Third, since 1977, state law (Act 289 of 1977) has provided for the state government to
distribute grants to municipalities to assist in paying for fire protection in jurisdictions with state
government owned facilities. The legislature appropriates an amount each year that is allocated
to this program. Each municipality’s intended grant is the percentage of property value in the
jurisdiction that is owned by the state multiplied times that jurisdiction’s fire protection
expenditure. Thus, if state-owned tax exempt property is 20 percent of total property value in a city, the grant could cover 20 percent of the city’s fire protection spending. However, if the appropriated total amount is not sufficient to cover the total intended grants, then each municipality’s amount is reduced proportionately.

This program is especially interesting because it is tied to a specific local government service that might be affected by the location of state-owned facilities. Clearly this might be the case for a public university such as Michigan State, for which local governments would have fire protection responsibility for university property but not collect property taxes from that property to assist in covering the public service cost. The Ann Arbor Chronicle reported in 2014 that since 1996 the annual appropriation for this program has varied from 23 percent to 68 percent of the amount required to fully fund the grants based on the legislated formula. In the case of East Lansing and Michigan State University, the state government grant from this program is about $1.1 million annually. However, a report by Great Lakes Economic Consulting shows that the grant to East Lansing under this program is “underfunded” by about $1.6 million based on the legislated formula. One substantial alternative for East Lansing, therefore, would be to encourage the state government to fully fund this fire-protection grant program.

It is worth noting that in addition to the state government fire protection grants, there is an agreement between East Lansing and Michigan State University through which the University pays $326,000 annually to the City for costs associated with fire protection and rescue services to MSU property outside the City boundary.

The state fire protection grant program suggests the possibility of establishing a similar program targeted to public colleges. One might think of a distinction between students who live on the campus of a public university as opposed to students who live in private sector housing.
Students who live on campus have some similarity to traditional commuters (the reason Detroit was granted authority for an income tax initially). Students who live off campus are in apartments or houses that generate property tax revenue. However, on-campus students do not generate similar property tax revenue. Both groups of students generate property tax revenue indirectly through consumption at retail and commercial business located in the jurisdiction, but a difference in property taxes from the residential circumstances remains.

Thus, an argument might be made for state government grants to local governments that have property owned by state public universities, with allocation based on the number of public college students who live on campus. One might envision a local jurisdiction with a public college for which all students live in private housing on which property tax is collected. Although the local government does not generate property tax revenue from the college property per se, it does generate revenue from the residential expenditure of students who are attracted to the community by the college. That revenue might not exist but for the location of the college. In contrast, suppose another local jurisdiction is the location of a public college for which all students live in residences owned by the college and located on college property. In that case, no property tax revenue is generated by the residential expenditure of the students.

Similarly to the fire protection grant program, suppose an annual state government grant allocation, A, is appropriated for a Public University PILOT. A local government’s grant share of the total allocation would be that community’s share of the total number of students residing on public university campuses in the state. Thus,

\[ \text{PUPILOT}_i = \left[ \frac{R_i}{\text{Sum of } R} \right] \times A \]

\[ \text{PUPILOT}_i = \text{public university PILOT grant to community } i \]

\[ R_i = \text{number of on-campus public university resident students in community } i \]
Sum of R = total number of on-campus public university resident students statewide

A = annual state grant appropriation

In this way, a jurisdiction where 10 percent of on-campus residing students are located would receive 10 percent of the state allocated funds for this program. Another way to think of such a program is that the state government is compensating each local government with a fixed amount for each student residing in university-owned housing. That is,

\[ PUPILoi = Ri \times \left( \frac{A}{\text{Sum of } R} \right) \]

Such a grant program might apply to each local government where public university owned or on-campus housing is located. Obviously this would include East Lansing as well as such localities as Ann Arbor, Auburn Hills, Dearborn, Detroit, Flint, Grand Rapids, Houghton, Kalamazoo, Marquette, Mt. Pleasant, Sault Ste Marie, Ypsilanti, and others.

**VIII. Conclusions**

The East Lansing Financial Health Review Team recommended that East Lansing consider implementing a city income tax at rates of 1 percent for residents and businesses and .5 percent for nonresidents, with a $600 personal exemption. The Team also recommended that with the implementation of the income tax, the city reduce the property tax rate by 5.6 mills to reduce property tax revenue equal to the income tax revenue collected from residents. An economic and legal analysis suggests the following likely outcomes:

1. Revenue for the City would increase by a maximum of $5 million;
2. Residents would be taxed on total income (earned and capital income) excluding retirement and social security benefits, but would receive a credit for taxes paid to another Michigan city. Nonresidents would be taxed on income earned in the city at half the resident rate. MSU students are likely to be defined as nonresidents;
(3) The amount of income tax collected from residents is revenue neutral for the set of residents in aggregate, but not individually. Older and retired individuals are those expected to have potential net tax reductions or at least the smallest increases. Conversely, renters and younger homeowners and families are likely to see the largest net tax increases relatively. Business owners would have a net tax decrease;

(4) The tax change may create an increase in demand for residences in communities close to East Lansing, with a corresponding decrease in population as well as land and housing prices in East Lansing as well as decreasing the attractiveness of living in East Lansing for families with school-age children;

(5) For MSU, economic analysis suggests the tax would cause a modest increase in before-tax wages for faculty but very small or no increase in before-tax wages for other employees;

(6) Important alternatives to a city income tax include programs to reimburse the city for foregone property tax revenue, including Public Act 289;

(7) The US Supreme Court decision in Comptroller of the Treasury of Maryland v. Wynne calls into question the constitutionality of local government income taxes as typically structured.
References


### Table 1

#### City Income Taxes in Michigan

<table>
<thead>
<tr>
<th>City</th>
<th>Resident &amp; Business</th>
<th>Nonresident</th>
<th>2015 Revenue</th>
<th>2010 Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Detroit</td>
<td>2.4</td>
<td>1.2</td>
<td>$264,412,154</td>
<td>713,777</td>
</tr>
<tr>
<td>Grand Rapids</td>
<td>1.5</td>
<td>0.8</td>
<td>$81,970,412</td>
<td>188,040</td>
</tr>
<tr>
<td>Lansing</td>
<td>1.0</td>
<td>0.5</td>
<td>$31,660,923</td>
<td>114,297</td>
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<tr>
<td>Flint</td>
<td>1.0</td>
<td>0.5</td>
<td>$14,012,171</td>
<td>102,434</td>
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<tr>
<td>Pontiac</td>
<td>1.0</td>
<td>0.5</td>
<td>$11,385,266</td>
<td>59,515</td>
</tr>
<tr>
<td>Battle Creek</td>
<td>1.0</td>
<td>0.5</td>
<td>$16,475,837</td>
<td>52,347</td>
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<tr>
<td>Saginaw</td>
<td>1.5</td>
<td>0.8</td>
<td>$12,252,323</td>
<td>51,508</td>
</tr>
<tr>
<td>East Lansing</td>
<td></td>
<td></td>
<td></td>
<td>48,579</td>
</tr>
<tr>
<td>Muskegon</td>
<td>1.0</td>
<td>0.5</td>
<td>$8,274,666</td>
<td>38,401</td>
</tr>
<tr>
<td>Jackson</td>
<td>1.0</td>
<td>0.5</td>
<td>$8,806,662</td>
<td>33,534</td>
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<tr>
<td>Port Huron</td>
<td>1.0</td>
<td>0.5</td>
<td>$6,431,121</td>
<td>30,184</td>
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<tr>
<td>Walker</td>
<td>1.0</td>
<td>0.5</td>
<td>$10,446,592</td>
<td>23,537</td>
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<tr>
<td>Hamtramck</td>
<td>1.0</td>
<td>0.5</td>
<td>$1,988,096</td>
<td>22,423</td>
</tr>
<tr>
<td>Highland Park</td>
<td>2.0</td>
<td>1.0</td>
<td>$2,917,943</td>
<td>11,776</td>
</tr>
<tr>
<td>Ionia</td>
<td>1.0</td>
<td>0.5</td>
<td>$2,075,833</td>
<td>11,394</td>
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<tr>
<td>Muskegon Heights</td>
<td>1.0</td>
<td>0.5</td>
<td>$894,380</td>
<td>10,856</td>
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<tr>
<td>Big Rapids</td>
<td>1.0</td>
<td>0.5</td>
<td>$2,063,600</td>
<td>10,601</td>
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<tr>
<td>Lapeer</td>
<td>1.0</td>
<td>0.5</td>
<td>$2,895,494</td>
<td>8,841</td>
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<tr>
<td>Albion</td>
<td>1.0</td>
<td>0.5</td>
<td>$979,477</td>
<td>8,616</td>
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<tr>
<td>Springfield</td>
<td>1.0</td>
<td>0.5</td>
<td>$934,368</td>
<td>5,257</td>
</tr>
<tr>
<td>Portland</td>
<td>1.0</td>
<td>0.5</td>
<td>$784,192</td>
<td>3,883</td>
</tr>
<tr>
<td>Hudson</td>
<td>1.0</td>
<td>0.5</td>
<td>$548,239</td>
<td>2,302</td>
</tr>
<tr>
<td>Grayling</td>
<td>1.0</td>
<td>0.5</td>
<td>$475,735</td>
<td>1,881</td>
</tr>
</tbody>
</table>

*The tax rate for business is 2.0

Table 2

Net Tax Change, City Income Tax Adoption with Property Tax Reduction
(1% income tax rate; Decrease of 5.6 mills property tax rate)

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Taxable Property Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20,000</td>
<td>$88 $-24 $-136 $-248 $-360 $-640 $-920</td>
</tr>
<tr>
<td>$25,000</td>
<td>$138 $26 $-86 $-198 $-310 $-590 $-870</td>
</tr>
<tr>
<td>$50,000</td>
<td>$388 $276 $164 $52 $-60 $-340 $-620</td>
</tr>
<tr>
<td>$75,000</td>
<td>$638 $526 $414 $302 $190 $-90 $-370</td>
</tr>
<tr>
<td>$100,000</td>
<td>$888 $776 $664 $552 $440 $160 $-120</td>
</tr>
<tr>
<td>$125,000</td>
<td>$1,138 $1,026 $914 $802 $690 $410 $130</td>
</tr>
<tr>
<td>$150,000</td>
<td>$1,388 $1,276 $1,164 $1,052 $940 $660 $380</td>
</tr>
<tr>
<td>$175,000</td>
<td>$1,638 $1,526 $1,414 $1,302 $1,190 $910 $630</td>
</tr>
<tr>
<td>$200,000</td>
<td>$1,888 $1,776 $1,664 $1,552 $1,440 $1,160 $880</td>
</tr>
<tr>
<td>$225,000</td>
<td>$2,138 $2,026 $1,914 $1,802 $1,690 $1,410 $1,130</td>
</tr>
<tr>
<td>$250,000</td>
<td>$2,388 $2,276 $2,164 $2,052 $1,940 $1,660 $1,380</td>
</tr>
<tr>
<td>$300,000</td>
<td>$2,888 $2,776 $2,664 $2,552 $2,440 $2,160 $1,880</td>
</tr>
</tbody>
</table>

Note: Taxable Property Value <= 50% Property Market Value

Note: Taxable Income is after exemptions and income not taxed (such as retirement benefits, social security payments, and