

January 18, 2007

BUDGETS – TAXES – POLITICS

Undoubtedly state government currently faces the most severe financial crisis it has experienced in decades. While the national economic situation has shown improvement, Michigan continues to develop discouraging numbers reflecting the problems of the big three automakers. The resulting revenue loss presents the administration and the Legislature with a major fiscal problem that has many ramifications including: the substantial revenue shortfall for the fiscal year; replacing the Single Business Tax (SBT) due to expire at the end of 2007; a decision as to whether to design a complete restructuring of state taxation or a patchwork of existing programs; and, school aid financing, to mention but a few of the major issues.

By many estimates the state is facing a budget deficit approaching \$3 billion by the end of 2007. This figure includes the \$1.9 billion loss with the repeal of the state's SBT (if nothing were done to replace it) and a \$1.2 billion hole expected in the current fiscal year 2007 and fiscal year 2008. The revenue loss caused by the repeal of the SBT will be replaced in some form.

What are the solutions being discussed? The Governor outlined suggested changes in the fall of 2006 such as a loophole closing for business and she has also mentioned that this may well be the time to consider all state taxes with the objective of a major restructuring of the system. A key question is whether she will ask for a tax increase or a tax shift. The bi-partisan emergency financial panel, appointed by the Governor on January 10, has been meeting and will be reporting to her in advance of the February 6 State-of-the-State speech. We may see some of their recommendations incorporated into her presentation to the Legislature.

One tax proposal – a sales tax on services – appears to be primed for serious legislative consideration beginning this month. As of this writing, no legislative leader or the Governor has dismissed the idea of expanding the sales tax to certain services. In exchange for broadening the sales tax to services, the sales tax rate would likely decrease from the current 6 percent to 5 percent. This is purely speculative at this point and any such plan may have to go to the Michigan voters for approval. In a recent interview, newly appointed Senate Appropriations Chairman Ron Jelinek suggested that the proposal "deserves some scrutiny" and that it could be "very appetizing to lower the tax and broaden the scope." Senator Jelinek further states that a mandatory tax increase (such as an income tax increase) will not be popular, but a sales tax on services might work because it is more of a voluntary tax. A sales tax on services would likely include such items as dry-cleaning, movie theater tickets, attorney fees, beauty salons, and obviously pest control/lawn maintenance services. Items excluded would likely include business-to-business transactions, prescription drugs, healthcare, and food.

Another suggestion being offered to assist with the fiscal crisis is to consolidate local government services and school systems. Senate Majority Leader Mike Bishop has stated that the public expects government to operate efficiently and that "consolidation of government really deserves a spot in our priorities."

Public schools could be faced with a pro-rata cut this year which may ease the \$210 amount lawmakers gave as a per pupil increase in the current fiscal year budget. The sales tax revenue mostly goes to fund the School Aid Fund (SAF) which has been significantly impacted due to the economy. School officials and education groups are expecting to see discussions of consolidation as a way to cut costs.

The Governor has recently stated that more cuts to government services may be unavoidable but that revenue proposals must protect our vital programs. Republican leaders and some state business groups have raised immediate objections to even broaching the subject of higher taxes saying more can be done to cut state spending. House Minority Leader Craig DeRoche (R-Novi) has stated that he will continue to oppose raising taxes to balance the budget. Senate Majority Leader Mike Bishop (R-Rochester) recently stated that he would rule out no proposals to get the state's budget back in shape, but that tax increases "have been the remedy of the past and they have failed." The new House Speaker Andy Dillon (D-Redford Twp.) has said he would like to see personal property tax relief to be part of any tax package proposed. He has said the \$1.8 billion tax puts Michigan at a competitive disadvantage.

Obviously it will be a very active next six months in Lansing as the Legislature wrestles with various "revenue enhancement" (means tax increase) proposals and suggestions for a balanced budget via reduced government spending. Karoub Associates will keep you posted as the budget challenge unfolds.