Spending Cuts Would Eviscerate Critical Services; Tax Reduction Delay, Sales Tax Expansion Hurt Less

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One month into the new fiscal year revenue projections indicate that Michigan's fiscal crisis is far from over. The latest revenue shortfall of over $800 million, plus at least $200 million in unanticipated Medicaid costs, suggest that the FY2004 deficit is actually closer to $1 billion. Further, the structural deficit will reach approximately $1.3 billion in FY2005 when the state loses federal fiscal relief and special Medicaid funding that have shored up the budget.

The new projections follow three years of lagging revenues and cuts totaling nearly $2 billion. Now, the state must quickly cut an additional $1 billion or raise revenues to balance the budget. Solving the problem through cuts alone would require a 16 percent reduction in all state programs effective January 1st, and would eviscerate critical services, including those to the poor, elderly and disabled, as well as local fire and police protection. Revenue strategies, however, would prevent deep spending cuts and provide structural solutions to the state's fiscal problem.

One has only to look at the major cause of the state's revenue loss to understand and solve the problem. Despite the impacts of the recent recession and jobless recovery, Michigan's deficits stem primarily from multi-year reductions in Michigan's income and Single Business Tax (SBT) rates, further exacerbated by the phase-out of the federal Estate Tax. While a robust economy may have financed these tax cuts without precipitating a fiscal crisis, basing long-term policy on the assumption that unprecedented economic growth will continue indefinitely is shortsighted at best and fiscally irresponsible at worst. The continuation of these tax cuts, culminating in the elimination of the SBT in 2009, will only make one of the worst fiscal crises in Michigan history significantly worse.

Immediate steps must be taken to preserve every dollar of revenue possible. That means halting the next reduction in the income tax rate, worth approximately $120 million in FY2004 and $160 million annually thereafter. This would not be a tax increase since taxpayers would pay what they are currently paying. Yes, some would argue that not receiving a promised cut is an increase. But, reductions in government spending may be *more* damaging to the economy than tax increases. Much of state spending is matched with federal funds. When the ripple effect of reductions throughout the state's economy is considered, total business activity in Michigan will decline significantly, as will related sales, business, and income tax revenues.

Michigan must also join eighteen other states in retaining the state share of the federal Estate Tax. In 2002 Congress began a repeal of the tax, costing Michigan approximately $140 million annually by FY2007. In Michigan, repeal of the tax would benefit about 1,300 of the state's wealthiest households—a benefit averaging over $100,000 per household.

Finally, policymakers must examine Michigan's overall tax structure. The sales tax, funding about half of the school aid budget, was instituted in 1933 and is based on a manufacturing economy. Michigan must modernize its

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sales tax by expanding it to services and internet sales—the growing sector of today's economy. The income tax should also be examined. It will yield far less revenue when baby boomers retire and pay no income tax on state and federal pensions *and* claim a double exemption at age 65. Further, one of the country's most regressive tax systems should be made more progressive.

Michigan needs a revenue base for the future that is adequate, stable and fair. A tax base that cannot generate growth is not adequate. A tax base that fluctuates wildly and is not dependable is not stable. And, a tax base that places the largest burden on those least able to pay is not fair.

There is a way out of this fiscal morass, short of slashing spending. But it will take courage, leadership, and a vision of Michigan that promises a future for its youngest citizens while protecting its most vulnerable.

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