Michigan League FOR Human Services

November 13, 2008

Legislature Considering Phase-out of Michigan Business Tax Surcharge Despite Looming Deficits

During last October's budget impasse, with the state preparing to close parks and discontinue other non-essential services, the legislature adopted a 6 percent sales tax on selected services. Within weeks, however, negative public reaction convinced policy makers to replace the ill-fated services tax with a 21.99 percent surcharge on tax liabilities associated with the recently adopted Michigan Business Tax (MBT). The surcharge, which was viewed by many in the business community as less cumbersome to administer than a sales tax on services, was estimated to yield approximately $660 million annually prior to its phase-out beginning in 2017.

On October 2nd, less than one year after its adoption, the Michigan Senate approved a measure (SB 1242) intended to eliminate the MBT surcharge over a four year period beginning in the current fiscal year. The Senate also adopted SB 1038, a measure estimated to reduce MBT tax revenues by approximately $140 million annually in association with amendments governing the treatment of real estate and security trader commissions and taxes paid by companies with annual gross receipts less than $6 million. If implemented as adopted the Michigan League for Human Services estimates that these measures would reduce current year revenues by $260 million and cumulative state revenues through FY2012 by approximately $2.23 billion.

As the following table illustrates, the resulting revenue losses would exacerbate a forecast $500 million annual structural deficit and growing cyclical deficits associated with a rapidly deteriorating economy.

Forecast Deficits Assuming Adoption of Michigan Business Tax Changes FY2009-FY2012

($ in billions)

	FY 2009	FY2010	FY2011	FY 2012
MBT Surcharge Phase-out (SB1242)	–$.12	–$.33	–$.56	–$.66
MBT Taxable Income Changes (SB1038)	–$.14	–$.14	–$.14	–$.14
Forecast Ongoing Structural Deficit		–$.50	–$.50	–$.50
Forecast Revenue Loss Due to Recession	–$.56	–$.73	–$.38	–$.00
Total Projected Deficits	**–$.82 BIL**	**–$1.70 BIL**	**–$1.58 BIL**	**–$1.3 BIL**

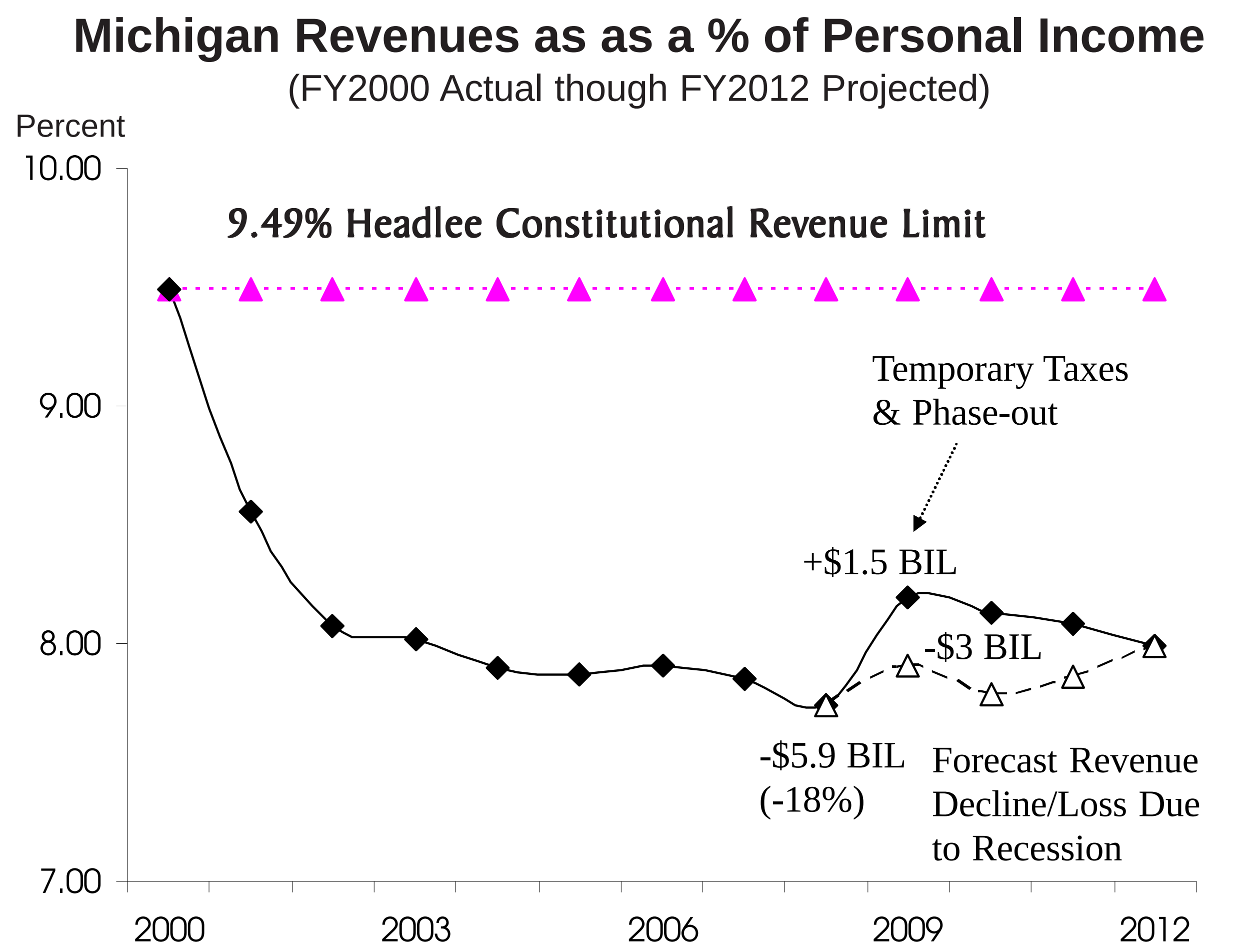
Data Sources: SB1242 revenue loss estimate prepared by the Senate Fiscal Agency, SB1038 revenue loss estimate prepared by the Michigan Department of Treasury, structural and cyclical deficit forecasts prepared by the Michigan League for Human Services.

Notes: The projected revenue decreases associated with the current economic downturn assume a percentage impact roughly equivalent to the revenue losses experience during the 1981-1983 recession.

The table above does not reflect an estimate for the potential increase in demand for services such as Medicaid and public assistance that typically increase during periods of economic distress. To the extent that demand for these counter-cyclical programs increase during what is expected to be a protracted recession, Michigan's deficit picture could be expected to worsen.

Assuming that repeal of the MBT surcharge and reductions to taxable business income as proposed in SB1038 are not adopted, or if implemented that resulting revenue losses are replaced on a dollar for dollar basis, the preceding forecast suggests that Michigan would likely still face revenue shortfalls of approximately $3 billion through FY2012. These deficits would follow over $11 billion in budget shortfalls addressed by the state since FY2001 through a combination of program reductions, one-time accounting adjustments, temporary tax increases and the depletion of virtually all state fiscal reserves.

As the following chart illustrates, state revenues as a share of Michigan's economy fell by approximately 18 percent, equivalent to $5.9 billion in the last fiscal year alone, since FY2000. In an effort to address forecast out-year deficits exacerbated by this revenue decline, the legislature adopted temporary income and business tax increases intended to restore approximately one-fourth of identified revenue losses. Unfortunately, as the forecast revenue line on the chart below illustrates, most of those anticipated revenue gains appear likely to be offset by the impact of a recession whose dimensions may prove historic. Given the current economic uncertainties, and $3 billion in forecast revenue shortfalls through FY2012, the adoption of business tax cuts projected to reduce revenues by an additional $2.23 billion without a replacement revenue source would appear to be a prescription for massive cuts to public services already strained as the result of a significant disinvestment of resources in recent decades.



Data Sources: Annual CAFR, Consensus Revenue Conference Reports
Note: Forecast assumes the Michigan Business Tax and Surcharge are not significantly modified from their original form.

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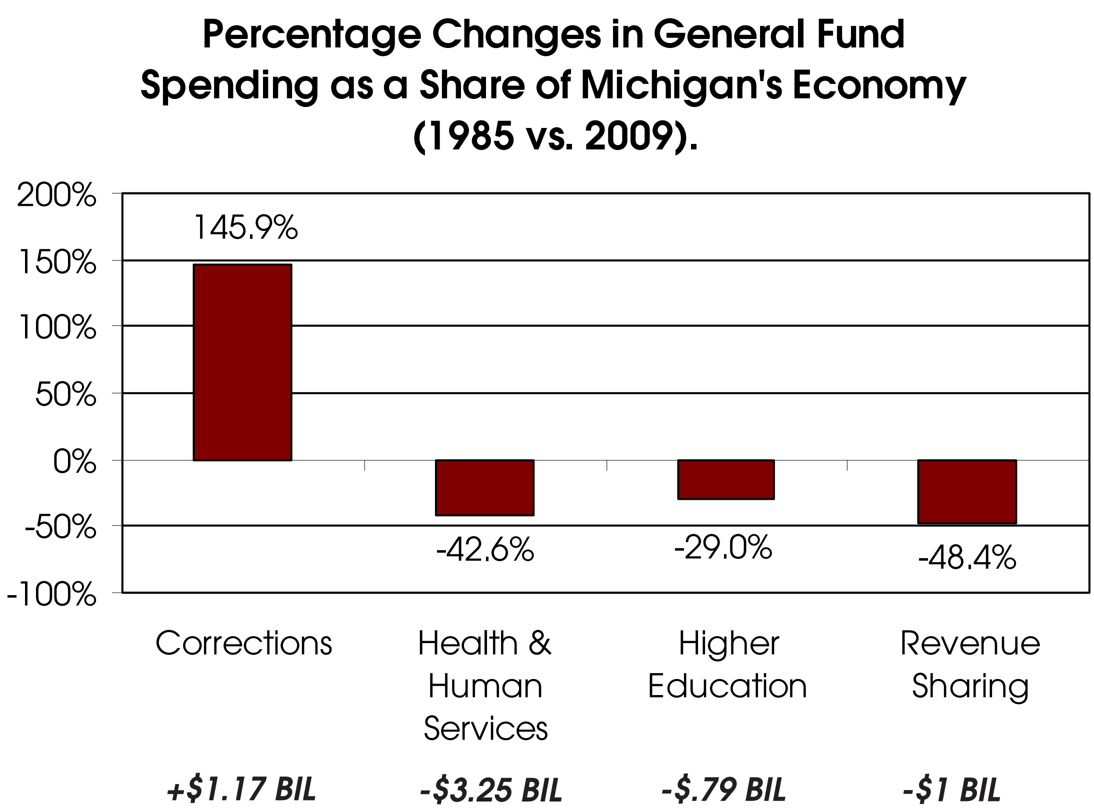
As the following charts illustrate, over the last twenty-five years Michigan has significantly reduced state funding as a share of personal income for health and human services programs, higher education and revenue sharing payments to local units of government primarily in support of community fire and police protection. On average over this period state spending as a share of Michigan's economy declined by 40 percent in these categories, a disinvestment equivalent to approximately $5 billion. Over the same period state spending as a share of personal income increased by approximately 145 percent, equivalent to nearly $1.2 billion, for the Department of Corrections in conjunction with a rapidly growing prison population.

The sobering revenue trends outlined above suggest that Michigan faces enormous challenges as it attempts to resolve a long-term fiscal crisis that could devastate the programs that are critical to future economic growth and the maintenance of Michigan's quality of life. In this context, further reducing state revenues by adopting SB1242 and SB1038 would make the preservation of these critical programs significantly more difficult.

Michigan's Shifting Spending Priorities



Note: The total personal income value used to represent the size of Michigan's economy in 1985 ($134.08 billion) was taken from the revised state by state personal income report prepared by the U.S. Department of Labor, Bureau of Economic Analysis. The 2009 estimate of total personal income in Michigan ($365.13 billion) was taken from the May 2008 Consensus Revenue Estimating Conference report.

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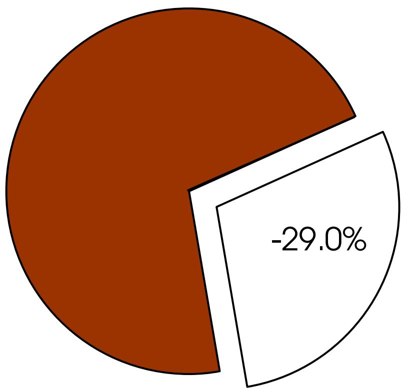
Michigan's Shifting Spending Priorities

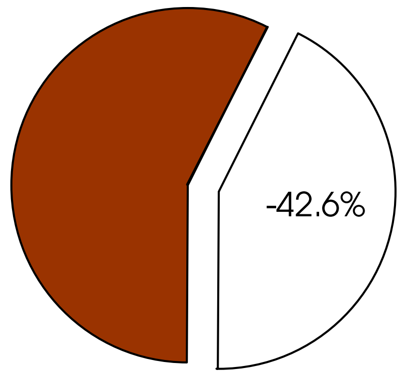
Percentage Changes In General Fund Spending as a Share of Michigan's Economy (FY1985 vs. FY2009)

Higher Education



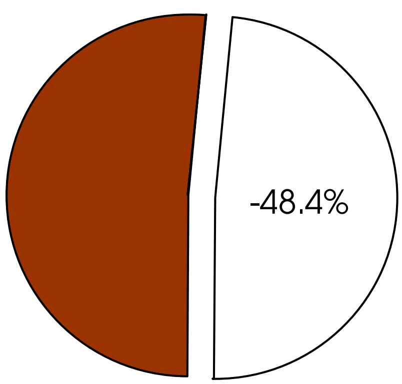
Represents $.79 BIL in reduced spending

Health & Human Services



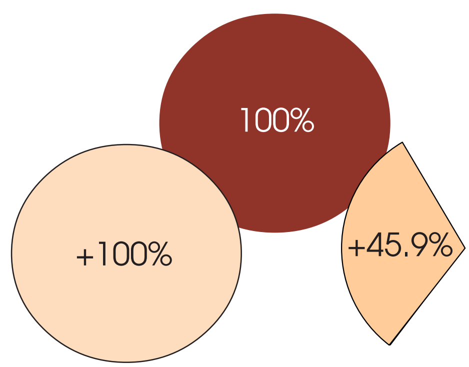
Represents $3.25 BIL in reduced spending

Local Revenue Sharing



Represents $1 BIL in reduced spending

Corrections



Represents $1.17 BIL in increased spending

Note: The total personal income value used to represent the size of Michigan's economy in 1985 ($134.08 billion) was taken from the revised state by state personal income report prepared by the U.S. Department of Labor, Bureau of Economic Analysis. The 2009 estimate of total personal income in Michigan ($365.13 billion) was taken from the May 2008 Consensus Revenue Estimating Conference report.

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