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DUST CLEARS, BUT NOT THE FUROR: SOME THOUGHTS ONE WEEK LATER

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Exactly one week ago the Michigan Legislature passed and the Governor signed into law a \$1.48 billion tax increase that stopped a state governmental shutdown, but jump-started a raging controversy.

While most observers had expected a substantial boost in the state income tax, they were not prepared for a 6% sales/use tax on a large list of services selected for inclusion virtually out of public sight. As predicted in the Capitol Report we issued just after the Legislature's action, the service tax ignited a firestorm far exceeding the public outcry over the income tax and pumped fresh air into recall efforts. Within 24 hours of its enactment, those legislators who voted for the service tax, (and even those who didn't) were reeling under a negative public backlash. Not a few talked privately about trying to repeal the tax even before it's scheduled to take effect on December 1, 2007.

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With one week's hindsight, let's look at where we are:

In its initial reports to the public, the media gave the service tax issue superficial analysis, apparently buying the line peddled by its proponents that the tax was only on "luxuries" or "unnecessary" or "unessential" services. After all, the tax would be on singing telegrams, escort services, balloon-o-grams, bronzed baby shoe producers, etc. Har, har, har. A good laugh was had by all.

And for 24 hours the diversion worked. When the media and the public woke up, what they found was that in reality the tax hits a whole host of major mainline activities, and that it falls heavily on businesses. In the catch-all phrase "consulting services" alone, a whole host of taxed activities were swept up, including most out-sourced services such as technology, human resources, and payroll.

In addition, the services subject to the tax were a crazy-quilt of inconsistencies. Ski tow tickets in, greens fees out; wedding planners in, wedding singers out; personal

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trainers in, fitness centers out; investment advisers licensed as stock brokers out, investment advisers not licensed as stock brokers in; architects and engineers out (unless performing certain environmental services, in which case they are in at least to those services); interior designers and public relations firms in, lawyers, lobbyists and accountants out. In the judgment of one analyst, “This is potential the largest tax increase in state history and it represents a radical change in business tax policy.”

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So how much revenue will the new tax actually raise? Good question. Some observers think it will bring in much less than predicted (\$740 million annually). (Will the shoe shine boy remit his 6% to the state?) Others think it will raise far more than originally projected. (How can Treasury resist applying the tax to every service remotely connected to the applicable NAICS codes?)

What is clear is that many businesses which had just gotten relief from the repeal of the hated SBT will now be paying out millions for the new service tax. One major auto manufacturer projects its liability at \$70 million a year.

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Against this backdrop, what will happen to the tax going forward? Repeal by a petition-driven referendum is probably impossible because the Legislature carries an appropriation which inoculates it against a public vote. Repeal by the Legislature will be difficult, too, despite the strong temptation. For one thing, it would mean colossal political embarrassment. More importantly, what would replace it? Talk of re-visiting the income tax to enact an increase to the increase seems to most of us at Kelley Cawthorne as highly improbable. Besides, why would legislative Dems want to bail out businesses at the expense of individual taxpayers and why would legislative Republicans want to free Dems from the onus of having been mainly responsible for passing the political albatross in the first place.

Further budget cuts? The Legislature is already staggering under the task of cutting \$443 million required by the package as passed. More likely: attempts to delete selected services (making the crazy quilt even crazier) and perhaps adding some services in exchange for lowering the 6% rate (a deal that could have been had last February). Late Friday, joining the scurry for cover, Speaker Andy Dillon proposed putting on the January ballot a one cent sales tax increase and altering or repealing the very service tax the Legislature OK'd just a days before. We think the legislative battle could drag on for a very long time.

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Despite the grass roots uproar, prospects of anyone actually being recalled are not especially bright. The Governor certainly will not be, and even carefully targeted lawmakers have a good chance of dodging the bullet because of tough petition signature requirements and a tight timeline. Recalls will certainly be attempted but at this point don't count on many...if any...actually succeeding.

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One of the big losers in the whole budget outcome was certainly the Michigan Education Association (MEA) and its insurance affiliate MESSA. Even during the

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Engler years, the MEA successfully beat back pension and health care reform efforts. Not this time around, even with a Democratic Governor and House. The huge teacher group believes it was stabbed in the back by politicians they had loyally supported and their wrath will certainly play itself out in the 2008-2010 primaries and general elections. Newly allowed insurance pooling and pension reforms will provide school boards and administrators with new flexibility that many hope will not end up being lost at the bargaining table.

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Speaking of reforms, aside from teacher pension and health care, few specific reforms were actually written into the new budget agreement. Instead, a new commission will “study” the possibility of new reforms and cost cutting (haven’t been around this block a hundred times before?).

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As pointed out in our last Capitol Report, the Legislature will take the next three weeks to actually write the 2007-2008 state budget. The school aid foundation grant will probably receive a 1% (or \$71 per pupil) increase. \$20 million or more in “equity payments” will probably provide another small boost to low revenue districts. Higher education faces the prospect of no boost at all (this after a \$1.3 billion tax increase!).

Most state departments will see “cuts” of 2.5%, but Community Health (\$52.5 million), Human Services (\$80 million), and Corrections (\$55.6 million) will see specific dollar cuts. But it should also be noted that these “cuts” are from the original proposed 2007-2008 budget and not reductions from last year’s numbers. Exactly how the various departments spread these cuts internally will be the focus of the next three weeks.

All in all, the past few weeks in the Legislature have seen unprecedented drama and action. What lies ahead is a great unknown. Whatever comes, we at Kelley Cawthorne will be ready.

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