



*Analysis of state policy choices with particular attention to their impacts on low- and moderate-income Marylanders*

# MARYLAND POLICY REPORTS

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Adequacy - *Fails to fully meet overall needs. \$550 million in budget cuts are required to achieve balance. \$213 million of that amount is to be determined by the Governor when he submits his proposed budget in January.*

Equity - *Overall, larger burden on low-income families. Income tax changes do improve progressivity, but not enough to offset sales tax increase.*

Efficiency - *Mostly uses existing tax mechanisms. Minimal new administrative and compliance costs. Possible economic distortion from arbitrary choice of one service to add to sales tax.*

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## ***Director's Corner***

*By Neil Bergsman*

*These are exciting times. I started as director of the Maryland Budget and Tax Policy Institute in the midst of a special session of the legislature to resolve a shortfall in the State's finances. The legislature's package did some things to soften the effects on low-income and working families. But they left a lot of serious unmet needs, and significant amount of unspecified budget cuts to be determined. These cuts may harm our most vulnerable citizens, service providers and local governments. In our lead article this month, we assess the special session's work.*

*We also feature an article outlining the dimensions of poverty in Maryland. Maryland has the highest median income and the lowest poverty rate in the nation (or at least tied for first, when you account for the statistical margin of error). But 428,000 poor Marylander's is still more than the entire population of the Eastern Shore.*

*We plan to issue "Maryland Policy Reports" every month. We'll include two or three brief articles on subjects relevant to Maryland state and local finances, and their effects on low-income and disadvantaged populations.*

*We are inaugurating an occasional feature called "State Scope" that will provide information on trends and emerging issues from around the nation.*

*In addition, we will be issuing "Special Reports" as needed to provide timely information on fast-moving developments.*

*I would like to hear from you with comments, suggestions, or ideas for topics we should address in future issues.*

*See 'ya next month.*

## **B&T Policy Institute Rates the Special Session**

As the legislature completed its work last April, the state budget was balanced through June 30, 2008. But the state continued to spend more in each year than it took in: a "structural deficit." Governor O'Malley implemented about \$200 million in budget reductions in July to provide a "down-payment" on the structural deficit.

In the fall, he developed a multi-faceted fiscal plan affecting most major sources of state revenue, as well as slowing the planned growth of public school aid. The Governor called a special session to consider the proposals, beginning on October 29.

The projected budget gap for fiscal year 2009 (July 2008 through June 2009) was \$1.7 billion, according to the Department of Legislative Services. The total package approved by the special session includes provisions which increase and decrease revenues, increase and decrease expenditures, and re-allocate revenues among different funds – some of them newly established (see the box on page 3). To close the gap, the package relies on an array of spending cutbacks, some of them specified, some to be determined.

In this issue, we have rated the special session according to three of the customary criteria for tax policy: Adequacy, Equity and Efficiency.<sup>1</sup>

### **Adequacy**

Adequacy means a tax raises enough revenue to support necessary expenditures. The estimated shortfall was \$1.7 billion dollars.<sup>2</sup> The special session's actions only raised a net \$1.3 billion: 76%.

## ***Major Budget & Tax Actions of the Special Session:***

### *Sales Tax:*

- *Increase sales tax rate from 5% to 6%*
- *Expand base to include computer services*
- *Share of increase to transportation*

### *Income Tax*

- *Increase rates on incomes over \$200,000 (\$150,000 for singles)*
- *Expand earned income tax credit*
- *Reform personal exemption*

### *Cigarette Tax*

- *Increase from \$1 per pack to \$2*

### *Corporation Tax*

- *Rate increase from 7% to 8.25%*
- *\$56 million share of revenue to new Higher Education Investment Fund*

### *Transportation*

- *Vehicle titling tax rate increase from 5% to 6%*
- *Credit for value of trade-in*

### *Transfer and Recordation Taxes*

- *Apply to transfers of "controlling interest"*

### *Slot Machines*

- *Referendum in November, 2008 for 5 sites.*

### *Budget*

- *Public schools \$154 million cut*
- *Other local aid \$61 million cut*
- *Unspecified cuts \$213 million*
- *Health insurance expansion – phases up to \$283 million in fiscal 2012*
- *\$405 million increase for transportation*

*SOURCE: Department of Legislative Services*

As a result, \$550 million remains to be cut from the budget in the regular session in January. More than 1/3 of these cuts are unspecified. Governor O'Malley will need to identify \$213 million in unspecified cuts when he presents his budget in January.

Since over 80% of Maryland's budget is devoted to education, health, social services and public safety, some of the cuts are nearly certain to harm these services.

The legislature prescribed another \$337 million in cuts, mostly to public school funding and other local government aid. As local government's study their finances, these cuts will cascade into the services that make up most of their budgets: local schools and libraries, community colleges, police and fire protection.<sup>3</sup>

### **Equity**

When we look at equity, we look at two aspects: Are similar taxpayers treated alike? Does the tax burden reflect the ability to pay? As you can guess, these considerations often work in different directions.

Most of the revenue in the special session's package comes from increasing the sales tax. This affects all consumers alike if their buying patterns are the same. But they aren't. Lower-income taxpayers expend more of their income on purchases than higher income taxpayers do (they save less). And they spend more of their income on goods, which are generally subject to the sales tax, compared with services, which are generally not taxed. The Department of Legislative Services estimates that a poverty-level taxpayer pays almost twice the share of her income in sales tax as a household making \$100,000.

Maryland and the nation are shifting our consumption from goods to services, especially among high-income earners. Broadly including consumer services in the sales tax would have helped make the sales tax fairer. Unfortunately,

the special session was not able to accomplish this. The only service added to the sales tax was “computer services.”

Compared with the other states, Maryland already had one of the better income tax structures for its treatment of low income taxpayers (see *Poverty in a Rich State* in this issue). The special session improved it in a number of ways.

The Refundable Earned Income Tax Credit is expanded. This program rewards low-income, working taxpayers. The special session increased the amount of the credit by 25% and made low-income earners without children eligible for the credit. Previously, the credit was only available to earners with dependents. This increase would be worth about \$200 to a family of four with poverty-level income<sup>4</sup>

Personal exemptions are increased by \$800 for all but upper-level taxpayers, meaning a middle-income family of four saves as much as \$152.

The tax package does very little for the non-working poor.

To increase the progressivity of the tax, the special session added new brackets for high-income earners. The existing rate tops out at 4.75% for anyone with taxable income over \$3000. The legislative package increases the tax for high-income earners, with new marginal rates for tax year 2008. Income over \$200,000 (or \$150,000 for single filers without children) will be subject to a 5% tax. A 5.25% rate will apply from \$350,000 (300,000 for single filers), and income over \$500,000 will be taxed at 5.5%.

The special session eliminated a serious loophole that allows some businesses to avoid transfer and recordation taxes when they buy and sell property. But the legislature failed to eliminate the ability of multi-state corporations to shelter income from the Maryland corporation tax. The legislature did establish a study commission to

examine the issue. The Governor had proposed a “combined reporting” system to require multi-state corporations to pay income tax on their real profits. By eliminating this provision from the package, big multi-state corporations can effectively hide millions of dollars from state taxes.

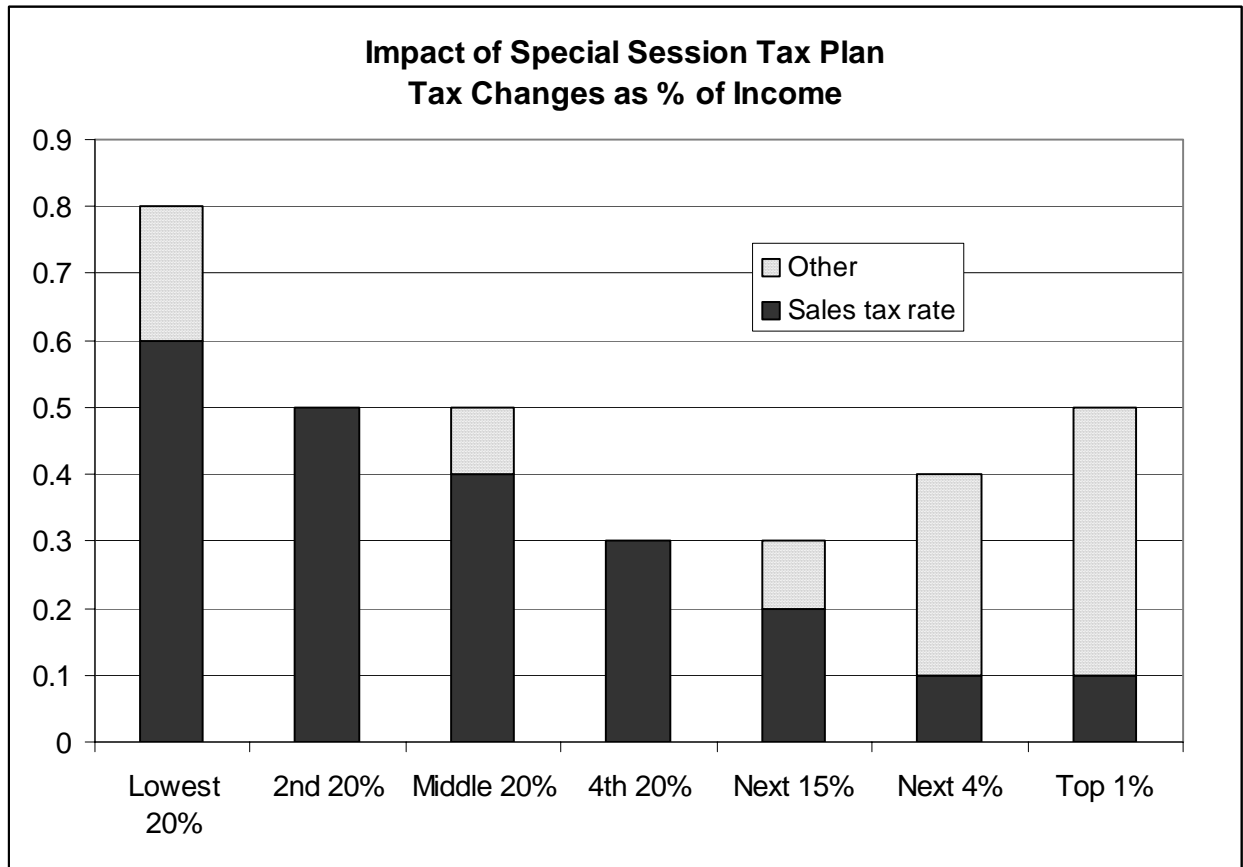
The Institute on Taxation and Economic Policy estimates that the overall effect of the tax package is regressive.<sup>5</sup> The poorest 1/5 of taxpayers will pay nearly 0.8% more of their income in taxes. The middle 1/5 will pay half that percentage: just over 0.4%. The wealthiest 1/5 will pay between 0.3% and 0.5% of their incomes in increased taxes. This overall regressive distribution occurs because the regressive nature of the sales tax rate increase overwhelms the progressive features of the income tax changes.

The Department of Legislative Services has prepared tax burden scenarios for four example taxpayers as different income levels. That analysis shows that a family with \$40,000 of income essentially breaks even on the package, and that better-off families pay progressively more up to \$75,000. Legislative Services’ analysis did not consider families with income under \$40,000 that make up the lower 40% of households, and did not take into account the cigarette tax increase or the sales tax on computer services.<sup>6</sup>

### **Efficiency**

There are three aspects to consider for efficiency. One is the cost to the government of collecting and enforcing the tax. The lower these administrative costs, the more of the money collected can go to fund public services. Most of the changes involve existing taxes and processes, so the administrative costs to the government are minimal.

The exception is the slot machine program. Of course, the November, 2008 referendum will



SOURCE: Institute on Taxation and Economic Policy, 11/20/07

determine if slot machine revenue becomes part of the final package. If it does, 33% of revenues would go to the operators and 2% would go to the State Lottery Agency for administration, regulation and oversight. Many people, however, would consider it inappropriate to compare the administrative costs of gambling revenue with those of taxes.

A second aspect is the cost for taxpayers to comply with the tax. In this respect, the special session's actions mostly involve people and companies that are already subject to taxes, so there are not a lot of extra compliance costs. Computer services companies may have some time and expense getting set up to collect and remit sales taxes.

The third aspect of tax efficiency is a little more subtle. When one item is taxed a lot compared to another, the difference can affect the decisions of people and businesses to spend less on the item with the higher tax. The best example is the increase in the cigarette tax from \$1 a pack to \$2. However, we do not downgrade the special session for this aspect, because the state wants to discourage tobacco use as well as to raise revenue.

The expansion of the sales tax to just one service – computer services – could cause some real economic distortion as people and businesses shift spending from computer services to other services. As indicated above, the best move

would be to apply the sales tax evenly to a broad range of services.

### Overall

Overall, the special session showed significant progress, but also left significant room for improvement. It raised enough revenue to avoid a calamity, but not enough to maintain and improve education, health, and other human services. As the state allocates \$550 million in cuts, local governments and non-governmental service providers may be particularly vulnerable.

The special session affected several tax sources. The special session improved the fairness of Maryland's income tax, but it missed opportunities to improve the sales tax by including a broad array of services, and the corporate income tax by requiring combined reporting. By relying so much on the sales tax, the overall effect hit low-income taxpayers hardest as a percentage of income.

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## Poverty in a Rich State

It's easy to get caught up in all the problems in our state and to forget to count our blessings. According to the US Census Bureau 2006 American Community Survey, Maryland has the highest median family income in the nation and the lowest poverty rate.<sup>7</sup> Our revenue system protects the poor more than many other states. However, poverty in Maryland is concentrated in certain jurisdictions and segments of the population. For those families, it is all the more tragic to be poor in a rich state.

### High Incomes and Low Poverty Rates

Maryland's median household income for 2006 was \$65,144, edging out second-place New Jersey by \$674 (the difference between the two states is actually well within the Census bureau's statistical margin of error, so you could consider it a

statistical "tie). The "median" is the income level right in the middle: half of Maryland households made more than \$63,144 and half made less. The US median is \$48,451.

The figures show that under the official federal definition of poverty, there were 428,345 poor Marylanders in 2006: 7.8% of the population. The overall poverty rate for the US is 13.3%.

### Troubles Hidden in the Numbers

Although Maryland has one of the lowest poverty rates among the states,<sup>8</sup> a few points ought to draw our concern.

- 428,000 is still a lot of people. For example, it's about equal to total number of people living in the nine Eastern Shore counties.<sup>9</sup>
- The state's child poverty rate is 9.7%, while the poverty rate among the elderly (65 and over) is 8.2%.
- The poverty is concentrated in Baltimore City and a few rural areas. Baltimore City's poverty rate is 19.5%. Allegany and Wicomico counties have poverty rates exceeding 10%. The child poverty rate in Baltimore City is 27.5%. Child poverty also

*The poverty rates for children and the elderly exceed the rate for the overall population.*

exceeds 10% in Wicomico, Allegany, Baltimore and Washington counties. The survey reports only jurisdictions with total populations over 65,000, so we do not have comparable figures for the eight smallest jurisdictions.

- The official definition of poverty understates the number of people who lack the means

for a decent living. The official definition of poverty has not changed materially since the 1960's except to adjust for inflation.<sup>10</sup> For example, the poverty threshold for a single, non-elderly adult living alone is 10,488 in 2006. For a family with two adults and 2 children it's 20,444.<sup>11</sup> In one survey, 59% of respondents thought it would take at least \$40,000 to support a family of four at a decent level.<sup>12</sup>

### Poor Families Are Somewhat Protected from State Taxes

Maryland's tax system does more than most states to spare citizens living in poverty. The very poor are protected from paying state income tax. For example, for a two-parent family of four, no tax is due in incomes below \$31,000.<sup>13</sup> Only six states have higher tax thresholds. For working families, Maryland provides a refundable earned income tax credit (EITC). As a result, a family of four with wage earnings and the poverty level of income would actually receive a \$423 tax refund to supplement their earnings.

Maryland relies more on income tax revenue than most states: 42% versus the national average of 35%. The flip side of this fact is that Maryland relies less on the general sales tax: 23% versus the national average of 32%.<sup>14</sup> Since the sales tax is less responsive to incomes, it hits lower-income families harder. Maryland's revenue system draws less from this regressive tax than most other states.

As noted in *Be&T Policy Institute Rates the Special Session*, the special session's legislative action disproportionately burdened Maryland's poorest households. It generates the lion's share of its revenue by raising the sales tax rate – one of the taxes that hits low income earners harder than upper income households. The regressive sales tax effect was blunted only in part by expanding the Refundable Earned income Tax Credit and increasing the personal exemption.

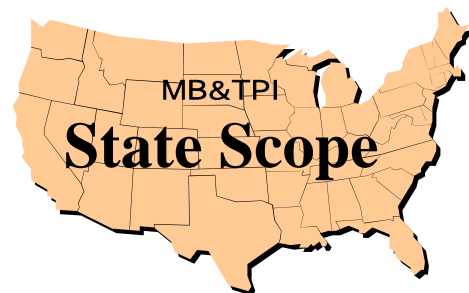
### Protect Our Safeguards – Increase Investments

We can be proud of our state's wealth, our low poverty rate, and a tax structure that is kinder to the poor than those of many states. As the Governor and legislature complete their work to close the state's budget gap, they will need to identify another \$550 million in budget cuts. They should remember the 428,000 citizens who face the distress of being poor in a rich state. They need to preserve and enhance the progressive features of our revenue system. At the same time, they need to promote effective public investments needed to help Marylanders lift themselves out of poverty. Education, health, workforce development, child care and substance abuse treatment are some of the investments with the highest returns. We will look more closely at some of these investments in future issues.

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## State-Scope Michigan and the \$75-Million Donuts

This month, we will look at a state whose legislators have been working late into the autumn nights to correct a \$1.7 billion projected shortfall. The Governor proposed a comprehensive proposal, involving over \$1 billion in tax increases and over \$400 million in budget cuts. The legislature greatly modified the proposal, making it friendlier to businesses and high-income taxpayers. The state is Michigan.



While Maryland's financial picture is unique to Maryland, we also face many of the same trends and pressures as other states. State-Scope is a new feature in our monthly reports. In it, we will bring you brief accounts of state budget and tax developments from around the nation.

#### Production Cuts in Detroit--Tax Cuts in Lansing

While there are many similarities between Maryland's and Michigan's budget situations, Michigan's are even more dismal. Michigan's problems are driven in large part by the decline of the domestic auto industry, but also by a large and sustained program of irresponsible tax cuts. From 1995 to 2007, Michigan cut state taxes by over \$3 billion. John Engler, Michigan's Governor from 1991 to 2002, signed a total of 32 tax cuts.<sup>15</sup> The state cut the income tax, business taxes, and other taxes. Increased taxes on gasoline, casino gambling and tobacco offset about 1/4 of the reduction.<sup>16</sup>

From 2001 through 2007, Michigan's revenues did not cover its expenditures. Budgets were funded with transfers from dedicated funds, borrowing from future tobacco settlement revenues and accounting gimmicks. The state budget was cut by a total of 40%.

#### Paralysis in the Legislature

Back in February, 2007, Michigan's current Governor, Jennifer Granholm, proposed a budget solution with tax increases and budget cuts<sup>17</sup>. The revenue proposals included restructuring Michigan's business taxes, placing a 2% sales tax on specified services, and increased taxes on tobacco, and liquor.

The legislature, all of whose members had served fewer than eight years due to term limits, was paralyzed. As the months passed and the state's budget year drew to a close, the legislators could not agree on either further cuts or on tax increases.

The State was poised to literally run out of cash by the end of January, 2008.<sup>18</sup> Advocates for a financial solution actually staged a bake sale on

the Capitol grounds in Lansing to highlight the desperate situation, with donuts priced at \$75 million each. The organizers would have needed to sell two dozen to solve the budget gap.<sup>19</sup>

#### Two Steps Forward and One Step Back

As the legislature debated into the wee hours of the morning October 1, Michigan State government actually shut down for a few hours. The Senate and House finally agreed on an income tax rate increase, a 6<sup>0</sup>% sales tax on some two-dozen services (including tanning, carpet cleaning, ski lifts and landscaping).<sup>20</sup> Michigan's Treasurer explained the process for selecting services to be taxed as, "We had to look for a certain amount of money and we looked for services we thought we could get votes for."<sup>21</sup> The legislature could not agree on a package of cuts, and passed a 30-day continuation budget.

By the end of the 30 days, the legislature finally enacted a budget for the month-old fiscal year. Budget cuts of about \$400 million included reductions to the rate of increase in public school, higher education and community college funding, the closure of three prisons, and reductions in community health and social services programs<sup>22</sup>

The services tax, however, was quickly under siege from business groups. By November 8, the House and Senate had voted to repeal the tax on services. The revenue is to be replaced by business surtax. The surtax is designed to spare large, in-state businesses and to capture revenue from out-of-state businesses.<sup>23</sup>

#### Once More Up to the Brink

The legislature remained deadlocked about the details of the new business surtax, right up to the last minute. On the day the service tax went into effect, the legislature hammered out the surtax deal, with a \$6 million cap for any one business. Because of the timing of the decision, service businesses including nail salons and ski resorts were unsure of whether to collect the tax on December 1.<sup>24</sup>

### Lessons for Maryland

There are important differences between Maryland's and Michigan's situations. Still, there are several lessons we can learn.

First, when states cut their budgets significantly, they have to cut where the money is. That means education, health, public safety and social services.

Next, state officials need to pay attention to the projections of state revenues and expenditures, and to think a few years ahead.

Third is to resist the temptation of popular but irrational tax cutting. Stable taxes at reasonable rates will not drive business away from our state. Poorly performing, cash-starved education, health, and public safety programs will.

Finally, Maryland, Michigan and other states need to bring the service economy into the tax base. Both the demands of fairness and the need to fund vital services require it. It won't work to have some politicians propose taxing a few arbitrary services. Maryland and Michigan should each set up long-term study commissions to propose a rational and fair plan for updating their sales tax systems for the economy of the 21<sup>st</sup> century.

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***HAPPY HOLIDAYS FROM THE  
MARYLAND BUDGET & TAX POLICY  
INSTITUTE***

### **About the Maryland Budget & Tax Policy Institute**

The Maryland Budget & Tax Policy Institute is a nonpartisan research organization that provides timely, accurate, and accessible analysis of state budget and tax issues. In addition to general budget and tax research and analysis, the Institute examines issues affecting vulnerable populations and the important community programs that serve them. For additional information on the Institute, to be added to our e-mail list, or to make a tax-deductible donation, please visit our website at [www.marylandpolicy.org](http://www.marylandpolicy.org).

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## Endnotes

<sup>1</sup> There are many specific schemes for evaluating tax systems. See for example, Snell, Ronald, *New Realities in State Finance*, National Conference of State legislatures, Denver: 2004, p. 13. Under adequacy, "...provide appropriate and timely revenues. Under equity, "...distribute burdens equitably," and under efficiency "...promote economic efficiency and growth," and "be easy to comply with and administer." Snell also includes "Ensure accountability," which we are not assessing in this report.

<sup>2</sup> Fiscal estimates on the special session legislative package are from Department of Legislative Services, *Administration Proposals as Amended by the General Assembly*. Department of Legislative Services, Annapolis, MD: November 27, 2007.

<sup>3</sup> See for example, Sedan, Sean R. and Janel Davis, *Tax Changes Roil County Budgets*, The Gazette of Politics and Business, Gaithersburg, MD, November 23, 2007, p. A-1.

<sup>4</sup> Based on a federal credit of \$3650 for a married family of 4 with \$21,000 in income. See Center for Budget and Policy Priorities, 2007 Earned Income Tax Credit Estimator, <http://www.cbpp.org/eic2007/calculator/eitcchoose.htm>, November 27, 2007.

<sup>5</sup> Institute on Taxation and Economic Policy, *Maryland Assembly's Tax Plan: More Revenue, Less Fairness*, [Hhttp://www.itepnet.org/mdgataxplan.pdf](http://www.itepnet.org/mdgataxplan.pdf)H, November 20, 2007.

<sup>6</sup> Department of Legislative Services, *Tax Burden Scenario – Governor's proposal as Amended by the General Assembly*, December, 2007, p. 5.

<sup>7</sup> Webster Bruce H., Jr., and Alemayehu Bishaw, US Census Bureau, American Community Survey reports, ACS-08, *Income, Earnings, and Poverty Data from the 2006 American Community Survey*, US Government printing Office, Washington DC, 2007.

<sup>8</sup> Maryland has the lowest rate, but new Hampshire and Connecticut are within the statistical margin of error.

<sup>9</sup> Maryland Department of Planning, Planning Data Services, *U.S. Census Bureau's 2006 Population Estimates for Maryland's Jurisdictions, Table 1a. Total Resident Population for Maryland's Jurisdictions, 2000-2006*. [Hhttp://www.mdp.state.md.us/msdc/Pop\\_estimate/Estimate\\_06/county/dw\\_popest\\_cnty06.htm](http://www.mdp.state.md.us/msdc/Pop_estimate/Estimate_06/county/dw_popest_cnty06.htm)H. March, 2007.

<sup>10</sup> Greenberg, Mark, Indivar Dutta-Gupta and Elisa Minhoff, *From Poverty to Prosperity, A National Strategy to Cut Poverty in Half*, Center for American Progress, Washington, DC, 2007, P. 17. Note that the official definition has other limitations. For example, it does not adjust for taxes, government benefits, or costs of employment. That's an interesting subject for another issue.

<sup>11</sup> US Census Bureau, Housing and Household Economic Statistics Division, *Poverty Thresholds 2006*. [Hwww.census.gov/hhes/www/poverty/threshld/thresh06.html](http://www.census.gov/hhes/www/poverty/threshld/thresh06.html)H. August 28, 2007.

<sup>12</sup> Corporate Voices for Working Families survey (July-

August 2004). Cited in Greenberg 2007.

<sup>13</sup> Center on Budget and Policy Priorities, *The Impact of State Income Taxes on Low-income Families in 2006*, [Hhttp://www.cbpp.org/3-27-07sfp.htm](http://www.cbpp.org/3-27-07sfp.htm)H, 2006.

<sup>14</sup> Federation of Tax Administrators, 2006 *State Tax Collections by Source*, [Hhttp://www.taxadmin.org/fta/rate/06taxdis.html](http://www.taxadmin.org/fta/rate/06taxdis.html)H,

<sup>15</sup> State of Michigan, "Governor John Engler Biography," [Hhttp://www.michigan.gov/formergovernors/0,1607,7-212-31303-2273--,00.html](http://www.michigan.gov/formergovernors/0,1607,7-212-31303-2273--,00.html)H, November 26, 2007.

<sup>16</sup> Bean, Mitchell, E., House Fiscal Agency, *Michigan's Fiscal Crisis, Presentation for Fifteenth Annual State Fiscal Conference*, Washington, DC, November 13, 2007.

<sup>17</sup> Department of Management and Budget, *Budget Overview*, [Hhttp://www.michigan.gov/documents/A1-12\\_115962\\_7.pdf](http://www.michigan.gov/documents/A1-12_115962_7.pdf)H, February, 2007.

<sup>18</sup> Bean.

<sup>19</sup> Mutavdzija, Andrew F. [www.countdowntochaos.org](http://www.countdowntochaos.org). September 7, 2007.

<sup>20</sup> Hornbeck, Mark and Charlie Cain, *Granholm, Legislature Have 30 Days to Hammer Out Cuts*. The Detroit News, October 1, 2007.

<sup>21</sup> Cain, Charlie and Mark Hornbeck, *Michigan Wakes up to Tax Increases*. The Detroit News, October 2, 2007.

<sup>22</sup> Luke, Peter, *Michigan Budget Dealing Easier This Round*. M.Live.com, October 30, 2007. And Personal interview with Mark Hornbeck, The Detroit News by Neil Bergsman, November 23, 2007.

<sup>23</sup> Christoff, Chris. *Services Tax Dying: What next?* Detroit Free Press, November 8, 2007.

<sup>24</sup> Bell, Dawson and Kathleen Gray, *Services tax goes in and out of effect*, Detroit Free Press, December 2, 2007.