



# State Budget Notes

## THE FY2003 EXECUTIVE BUDGET: SHORT-TERM BALANCE, LONG-TERM GAPS

Deterioration in the economy and attendant declines in state revenues have caused a series of state budget adjustments now spanning three fiscal years. Throughout that period, the State has relied heavily on one-time sources of expenditure reductions and one-time revenue resource augmentations. The need still exists for the State to adopt a strategic approach to bringing base revenues and spending back into balance and eliminating the structural deficits in the General and School Aid funds. This Note examines the Governor's Fiscal Year (FY) 2003 State of Michigan Executive Budget to assess the progress made in bringing spending back into balance with revenues.

### School Aid Fund

In the January CRC State Budget Note the structural budget problem for the 2 major funds was estimated at \$1.65 billion, although it was concluded that the School Aid budget had the potential of eliminating its structural deficit by using one-time revenue sources to buy time for revenue growth to catch up with spending. The Governor's budget proposal reflects that approach by using one-time revenues from advancing the due date of the State Education Tax in 2003 to the Summer for all taxpayers (many already pay the tax in the Summer) and using the Rainy Day fund to augment revenues resources.

The Rainy Day Fund will provide \$350 million to the School Aid Fund in FY2002, with \$272 million carrying over into FY2003 to help support spending. The State Education Tax change is accomplished in 2 steps.

The State Education Tax will be due in the Summer of 2003, but for that year only, the tax rate will be reduced from 6 to 5 mills for all taxpayers, producing a one-time gain to the School Aid Fund of \$494 million. In 2004, the tax rate will be restored to 6 mills producing a one-time gain of more than \$270 million. By adopting this

approach, it becomes possible to fund the increase in the per-pupil foundation allowance from \$6,500 in FY2002 to \$6,700 in FY2003, as originally promised in the 3-year School Aid bill approved in July 2000. In FY2004, with a continuation of the economic recovery forecasted by the state, school aid spending should be able to grow by about 2 percent from FY2003 levels. This proposed plan successfully manages through the economic downturn without cutting school spending in any year.

### General Fund

The General Fund proposal is a different story. Proposed FY2003 spending is approximately level with FY2002 spending, with program reductions in General Fund operations a relatively small piece of the total fiscal puzzle. Of an overall problem of \$968 million, as stated by the State Budget Director, only \$308 million is met by expenditure reductions and more than half of those reductions have no effect on General Fund agency operations.

General revenue sharing to local units of government is reduced by \$122 million by reducing the formula amount of sales tax revenues allocated to the program. In effect, this is a revenue increase to the General Fund, although it is a budget cut to local government. Unaffected is the City of Detroit's allocation, frozen at \$333.9 million, which is consistent with the new revenue sharing act that was approved in 1998.

General Fund savings of \$41 million are also included in the expenditure reductions by restructuring state debt to take advantage of lower interest rates. The remaining reductions of \$145 million are achieved through an early retirement program (\$50 million), which will reduce the number of state employees and create unpredictable effects on state programs, and other reductions spread throughout the budget.

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Citizens Research Council of Michigan  
38777 Six Mile Road, Suite 201A  
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The remaining gap of \$660 million is covered by one-time actions to fill in the difference between proposed spending and revenues. The components are:

Rainy Day Fund (\$255 million will remain in the fund)	\$207 million
Medicaid Benefits Trust Fund Revenue (\$280 million will remain in the fund)	247 million
Merit Award Trust Fund (Tobacco Settlement revenues)	100 million
Michigan Employment Security Contingent Fund	80 million
Environmental Response Fund	8 million
Other miscellaneous sources	<u>18 million</u>
Total	\$660 million

The January CRC State Budget Note measured the structural gap between General Fund revenues and spending for FY2002 at \$628 million. The new budget essentially maintains that gap for FY2003 and provides no solution to the fundamental problem facing the General Fund budget. Because of scheduled tax cuts already in State law and federal tax reform measures already passed by the Congress, General Fund revenues will not grow appreciably in FY2004 and only modestly in FY2005. If new revenue is not found for the General Fund, cuts in spending of significant magnitudes are inevitable. The difference between proposed FY2003 spending and FY2004 revenues is likely to be \$650 to \$700 million, without any adjustment for increases due to the effects of increased program costs.

The General Fund budget proposal, in effect, exhibits an internal contradiction. By continuing to support current spending levels in most programs, the budget validates those spending levels as appropriate from a public policy perspective. But because insufficient permanent funding sources exist to pay for those programs, their continuation in the future is open to question. The issue of balancing program costs with the price citizens and

businesses pay for those programs through the tax system remains unresolved.

Four areas account for more than 80 percent of General Fund spending. They are as proposed in the FY2003 budget:

Higher Education	\$2,132 million
Community Health	2,563 million
Family Independence Agency	1,208 million
Corrections	<u>1,628 million</u>
Total	\$7,531 million

Budget reductions in these areas carry with them implications such as higher student tuition at colleges and universities, potential reductions in medical care for the poor, reduced mental health services, diminished income assistance for the poor, and overcrowding in the prisons.

In subsequent State Budget Notes CRC will examine the longer-term issue of balancing spending with revenues in more detail, provide School Aid revenue and spending scenarios through FY 2006, and project Medicaid spending requirements taking into account the eventual elimination of the Medicaid Benefits Trust Fund as a source of revenue.