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## Michigan's Fiscal Future: Long-term Analysis of Michigan's Economy and State Budget

Prepared in cooperation with  
W.E. Upjohn Institute for Employment Research

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## Citizens Research Council of Michigan

- Founded in 1916
- Statewide
- Non-partisan
- Private not-for-profit
- Promotes sound policy for state and local governments through factual research
- Relies on charitable contributions of Michigan businesses, foundations, and individuals

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## Michigan's Budgetary Morass

- 7 years of spending cuts
- FY2007 General Fund revenues lower than in FY1996
- School Aid fund annual growth since 2000: 1.4%
- \$8 billion in one-time resources used
- Reserves exhausted
- Weakened connection between revenue structure and the economy
- Spending pressures growing faster than revenues

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## The FY2008 Budget Deal

- \$1.36 billion in new revenues
  - Income Tax \$745 Million
  - Services Tax \$614 Million
- \$440 million in spending cuts to be determined
- General Fund and School Aid Fund budgets will be balanced
- Fundamental structural deficit problems remain
- Spending pressure and revenue growth paths essentially unaltered

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### Revenue Changes

- Income Tax increase phases down beginning FY2012 and eliminated by the end of FY2015
- Services tax relies heavily (74%) on taxing business-to-business services
  - Creates competitive disadvantage for firms acquiring services from other firms rather than from their own employees
- Criteria for choosing consumer services unclear
- Review and possible revision of services tax may be warranted



### The Future

- Projections seldom made beyond the current budget year
- Failure to estimate the future consequences of current actions leads to unpleasant surprises
- Knowing where we are headed helps justify actions to change the future



### Scope of the Analysis

- Ten-year scenarios of the Michigan economy with varying assumptions about:
  - Auto industry
  - Office furniture
  - Chemicals
  - Hi-tech
- WE Upjohn staff used Regional Economic Models, Inc. (REMI) to prepared economic projections
- Economic projections translated to revenue projections and projections of spending pressures



### The Economy

#### Mid-range Projections-Assumptions

- Continuous moderately growing U.S. economy (GDP 2.7% annual real growth)
- Decline in domestic name-plate market share slows
- Employment in office furniture stable
- Employment in chemicals declines
- R&D employment expands

Overall a moderately improving economy

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### Summary of Results Major Indicators

Annual rates of change

- Total Employment (-.07%)
- Labor Force (-.25%)
- Real Gross State Product (+1.2%)
- Labor productivity (+1.6%)
- Personal Income (+4.2%)
- Payrolls (+3.8%)
- Population (-.04%)

*These statistics better than last 6 years*

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### Job Gains and Losses 38,000 Overall Decline

Job Losses

- Goods producing—228,000
- Retail and wholesale trade—62,000
- Government—19,000

Job Gains

- Health care—134,000
- Business services—52,000
- Social assistance—33,000
- Recreation and amusement—27,000

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### Population in 2017 Major Changes in Demographic Composition Ahead

- Total Population—Down 41,000 (0.4%)

Specific Age Groups

- School Age (5-17)—Down 257,000 (14%)
- Higher Education (18-24)—Down 84,000 (9%)
- Labor Force (16-64)—Down 262,000 (4%)
- Seniors (65+)—Up 413,000 (31%)

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### Michigan's Changing Population 2007 to 2017

Age Group	2007 (Thousands)	2017 (Thousands)	% Change
5-17	~1,800	~1,500	-14.3%
18-24	~1,000	~900	-8.5%
16-64	~6,500	~6,200	-3.9%
65+	~1,200	~1,600	+31.5%

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### Implications for State Government Finance

#### Revenues

- Revenues from the current revenue system will grow slowly—even more slowly than the economy
- Revenue declining as share of personal income
- Official FY2008 forecasts used as the beginning point



### Revenues

- Analysis concentrates on General Fund and School Aid Fund revenues
- Local government revenue sharing also included
- Transportation revenues included
- Each revenue source is projected separately based on the economic projections
- Revenues are aggregated into total revenues available from current tax structure



### Michigan Business Tax *Fully Reflected in Analysis*

- Two new taxes replace SBT: Income and Modified Gross Receipts
- Significant personal property tax (PPT) relief (18-mill PPT exemption and PPT credit)
- Numerous new credits (compensation, investment, R&D, etc.)
- Schools held harmless from PPT loss and from declines in overall MBT revenue
- Net fiscal effect: revenue neutral (\$2.3B to GF and SAF in FY09)
- Revenue trigger for three years (limits growth)



### New Tax Increases Included

- Services Tax (Use Tax) split between General and School Aid Funds
- Income Tax increase allocated entirely to General Fund and phased out by the end of FY2015



### Major Revenue Sources-Six Taxes

- **Personal Income Tax**—divided between General and School Aid Funds
- **Sales Tax**—principally allocated to School Aid and Revenue Sharing
- **Use Tax**—Divided between General and School Aid Funds
- **Michigan Business Tax**—General and School Aid Funds
- **Tobacco Taxes**—Divided between General and School Aid Funds and Medicaid program
- **State Education Property Tax**—School Aid Fund

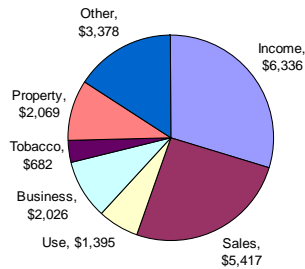


### Six Taxes

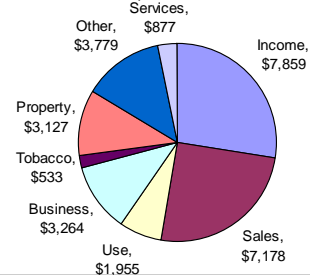
- Account for 85% of General and School Aid Funds revenues
- Aggregate growth rate about 3%
- Higher growth rate will be needed to keep up with spending pressures increases
- Remaining sources trend growth less than 2%



#### FY2007 Sources of General and School Aid Fund Revenue \$21,303 Million



#### FY2017 Sources of General and School Aid Fund Revenue \$28,572 Million





### Growth Rates—General and School Aid Revenues (FY2008-FY2017)

- Income—3%
- Business—3%
- Sales—3%
- Use—3.5%
- Services—2%
- Tobacco—Minus 2.5%
- State Education (Property)—4.5%
- Other Sources—1.8%



### Reasons for Sluggish Revenue Growth

- Increasing Senior Citizen Population—Retirement income not taxed and spend less on goods
- Consumption taxes goods oriented—economic growth is in service sector
- Slow or no growth revenues drag down overall growth (e.g. tobacco, gambling, alcohol)
- Flat rate income tax



### Spending Pressures

Analysis covers nine major areas

- School Aid
- Higher education
- Medical care
- Corrections
- Human services
- Mental health
- Revenue sharing with local governments
- Employee compensation and benefits
- Transportation



### School Aid Structural Deficit

*Spending Pressures Outpace Revenue Growth*

- Retirement Contributions—rapid growth
- Employee Health Insurance—rapid growth
- General Pay Raises
- Other—Fuel, Utilities, Supplies
- Revenues Growing Slowly



### School Aid Revenues & Spending Pressures

- Spending pressures grow 5% per year
- Revenues grow 3% per year
- Shortfall of 2% each and every year without spending and revenue policy changes



### Higher Education

- Enrollments at all-time high
- Increased participation needed to make Michigan competitive
- State support has lagged behind costs placing pressure on tuition
- Increased state support required to produce more college graduates
- Revenues will not grow fast enough to maintain state share of costs without cuts elsewhere



### Medical Care

Health care everywhere in budget  
Growing faster than revenues

Largest component in state budget

- Medicaid
- Health insurance for school and state employees
- Health insurance for school and state retirees
- Prisoners



### Medicaid

- Medical care for 1 in 7 Michigan citizens
- Future spending growth pressures 8% to 9% annually
- Some state revenues dedicated to Medicaid do not grow—Tobacco Settlement revenues, Cigarette Tax
- General Fund requirements grow faster than total Medicaid spending
- General Fund spending pressures outpace revenue growth by 3 to 4 times



### Corrections

- Largest state-operated program
- 30% of state employees
- More than 50,000 prisoners
- 58 prisons and camps
- \$30,000 per prisoner cost per year
- \$1.9 billion budget
- Incarceration rate 40% higher than Great Lakes neighbors-the result: \$500 million higher costs
- Spending pressures increasing twice as fast as revenues in an improving economy



### Corrections

#### Background

- Since 2000: population growth 1.3%/yr
  - 2 years of declines ('03 and '04)
  - Recent increases ('05 and '06)
- Workforce more than tripled since 1980, today 1 in 3 work for corrections

#### Spending Trends

- Growth since 1980: 9.2%/yr
- Per capita spending: '80 – \$18  
Today – \$177
- 1 in 5 General Fund dollars (\$1.8 B)
- Fueled by Michigan's disproportionate incarceration rate – 40% higher than neighbors



### States With More Than 500 Prisoners Per 100,000 Residents



### Corrections

#### Spending Pressures

- Population growth '07 to '11: 2.2%/yr or about 1,200 prisoners/yr
  - \$37M additional per year
- Health care for prisoners (\$5,400/prisoner per year)
- Aging prisoner population
- Wage and salary increases for employees
- New construction?
- Overall: corrections spending pressures will be more than double (7%) General Fund baseline revenue growth during forecast



### Human Services

- About 13% of General Fund (\$1.2 B)
- General shift from cash assistance to services as a result of welfare reform
- Primarily caseload driven – continue to rise in future
- No adjustment to cash grant since 1993
  - Recipients becoming “poorer”
  - Some increase expected in forecast
- Future: spending pressures rise faster (3.5%) than revenue growth



### Mental Health

#### Background

- Little discretion in program, Art. VIII, Sec. 8
- Shift from state- to locally-delivered services
- Result: little relief to state budget
- Medicaid assuming larger role
- Managed care provided some relief
- Over \$2 billion spent annually

#### Spending Trends

- Since FY90: below total state spending - 4.2% compared to 5.1%
- Since FY00: slowed to 3%, but equals total
  - Greater than GF spending (-0.6%)



### Mental Health

#### Spending Pressures


- General health care increases, specifically prescription drug costs
- Aging population – more users
- Medicaid as an entitlement
- Overall: growth of at least 3% annually will exceed General Fund baseline revenue growth during forecast period



### Employee Benefits

- Benefits significant portion of public budgets
  - State: from 34% to 57% of base payroll between FY98 and FY06
- Major driver is health care for current and retired employees
  - Current state employees: over \$9,000/year
  - Current school employees: over \$8,000/year
- Failure to “pre-fund” retiree health = stresses budgets
  - School retiree health more than double from FY07 to FY17, from 6.6% to 14% of payroll
- Future growth of 7% to 9% annually

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## Transportation

- Over \$2.0 billion in state revenue raised annually, about 50/50 between fuel taxes and vehicle registrations

**Problem**


- Fuel tax revenues, flat in *nominal* terms, but negative 4.2% annually in *real* terms
- Registration revenues rising, but not enough

**Why**

- Fixed per-gallon tax (19 cents, last raised in 1997)
- Decreased consumption due to fuel efficiency, alternative fuels, and cost of fuel

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## Transportation

**Spending Pressures**

- System deterioration, unable to sustain condition goals (90% "good")
- Significant "backlog" needs (primarily expansion of highway system)
- Overall: Spending pressures of 5% annually (compared to 3% revenue growth)
  - "gap" of \$3 billion over 10 years
  - excludes "backlog" (\$5.4 billion over next 25 years)

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## Michigan Local Governments

- Counties, cities, villages, townships facing structural deficits as well
- Health care cost driving expenses
- Individual units not experiencing full property tax revenue growth due to:
  - Cap on assessment increases
  - Headlee tax rate reductions

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## Michigan Local Governments

- 5 years of State Revenue Sharing funds diverted to General Fund for other needs
- Assume current funding will serve as base for future growth
  - State keeps what has been diverted
  - Locals experience growth on current base
  - Counties re-enter program

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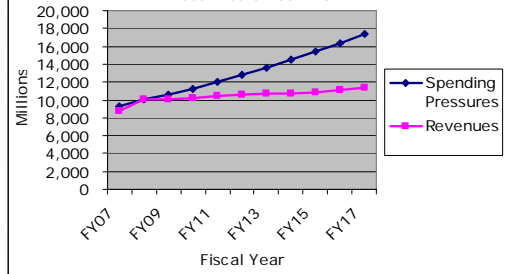


### General Fund Revenues and Spending Pressures

- Spending pressures grow 6.5% per year
- Baseline revenues grow 2.8% per year
- Revenues grow unevenly due to EITC and Income Tax increase phase-out
- Average revenue growth reduced to 1.5% per year
- Shortfall averages 5% per year
- Policy changes required



General Fund Structural Deficit Projections  
Fiscal Years 2007-2017



### Policy Options

- Reduce rate of spending pressure growth
- Increase revenue growth
- Bend the two curves so they meet



### Spending Pressures

- Corrections incarceration policies
- Health care costs—reduce rate of increase and overall costs
  - Medicaid
  - Employee health insurance
  - Retiree health care



## Revenues

- Change system so revenues grow in line with economy and personal income
- Consider taxing services broadly
- Modify personal income tax by changing rate and exemptions—or—implement graduated income tax (Constitutional amendment required)
- Consider taxing pensions and other retirement income (area of greatest income growth in future)
- Reduce reliance on “sin” taxes

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## Achieving Structural Balance

- Revenue system changes alone will not be sufficient
- Policy changes reducing spending pressure growth will be required
- Health care is the principal target
- National action may be required

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