


CITIZENS RESEARCH COUNCIL OF MICHIGAN



## Michigan's Budget Crisis and Options for the Future

Citizens Research Council of Michigan  
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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

- Seven years of spending cuts
- FY2007 General Fund revenues lower than in FY1996
- School Aid fund annual growth since 2000: 1.4%
- Nearly \$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 Central Message Is:

- The State of Michigan has a structural deficit affecting:
  - Public K-12 education
  - General Fund financed programs
- Its causes have both spending and revenue components
- We will not grow out of it
- Significant spending cuts and/or tax increases will be required

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### Deficits Defined

- Cyclical** — Caused by Economic Downturn
  - Revenues worsen
  - Some spending pressures increase
  - Deficit erased when economy recovers
- Structural** — Costs to maintain current policies increase faster than revenue growth, *Even in Good Economic Times*



### The Michigan Budget: How the Public's Money is Spent

- Total state budget — \$41.7B
- State's two major funds:
  - General Fund — \$9.2B
  - School Aid Fund — \$13.1B
- Other state funds restricted for other purposes, e.g. transportation, federal revenues
- Over 80% of all revenues spent locally—schools, hospitals, universities, roads

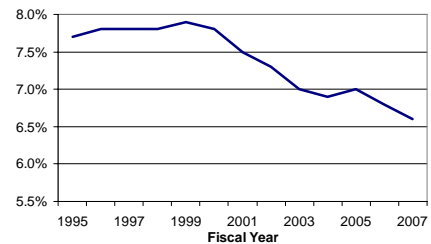


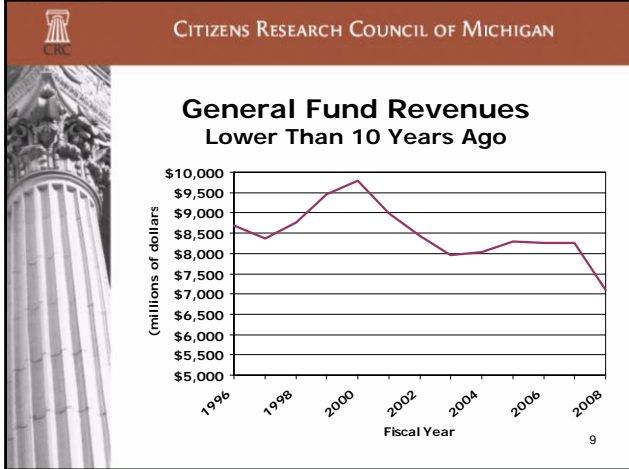
### Revenues

- Self-inflicted changes in revenue structure
  - Tax rate cuts
  - Federal changes in tax law
  - Increased use of slow or no-growth revenue sources (e.g. tobacco taxes)
- Weakening connection of economy with revenues
  - Sales Tax
  - Income Tax



### State Taxes as a Percent of Michigan Personal Income





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### Summary of One-Time Resources

FY2001-FY2006  
(in Millions)

Rainy Day Fund	\$1,363
FY2000 School Aid Fund surplus	984
FY2000 General Fund surplus	212
Medicaid Benefits Trust Fund	561
Advance State Education Tax collection date	455
Tobacco Settlement/Merit Award Revenues	324
Temporary Federal Fiscal Assistance	655
Bond for pay-as-you-go capital projects	211
Revenue Sharing accounting change	181
Refinance bonds	295
Employee wage concessions	186
Other	<u>1,383</u>
<b>Total</b>	<b>\$6,810</b>

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### The FY2007 Budget Solution Adds \$1 Billion to One-time Resource List

Tobacco Settlement Securitization	\$ 406.8
Higher Education Loan Authority Transfer to General Fund	90.0
University and Community College Payment Delays	164.6
Convention Facilities Fund	35.0
21st Century Jobs Fund	30.0
Conservation Corps Endowment Fund	20.0
Refined Petroleum Fund	70.0
Other Restricted Funds	67.4
One-time Reductions in Required Retirement Funding	<u>131.2</u>
<b>Total</b>	<b>\$ 1,015.0</b>

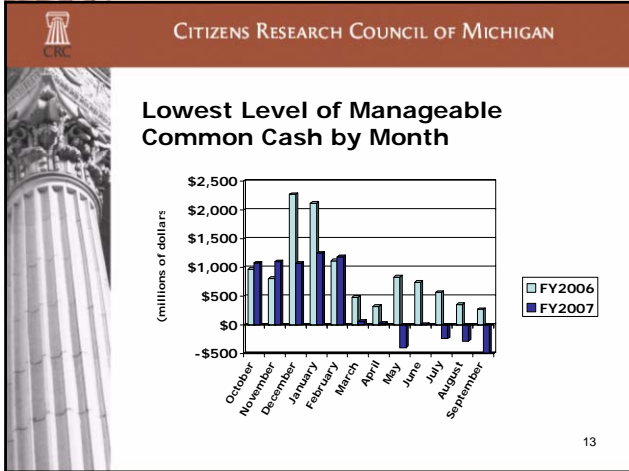
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### Use of One-time Resources Nearing \$8 Billion in 7 Years

- Reserves exhausted
- Minimal gains so far in solving structural deficit
- State vulnerable to next national recession
- Cash situation precarious

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- ### General Fund Budget FY2007
- 86% of General Fund spending in 4 areas:
    - Higher Education (\$1.9B)—21%
    - Community Health-Mental Health, Public Health, Medicaid (\$2.9B)—32%
    - Corrections (\$1.8B)—20%
    - Human Services-family services, juvenile justice, cash assistance (\$1.2B)—13%
    - All other General Fund programs (\$1.3B)—14%
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- ### Looking Back: Reshaping the General Fund Budget
- Reductions
- Higher Education—\$275M in 4 years (13%)
  - Human Services—\$172M in 5 years (14%)
  - School Aid—\$323M in 5 years (84%)
  - Revenue Sharing—\$447M in 5 years (29%)
  - State employees—7,400 in 4 years (12%)  
—smallest workforce since 1974
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- ### The Current Situation FY2007
- Michigan is still in a recession
  - Revenue performance continues to lag
  - General Fund and School Aid revenues now projected to be \$723 million below forecasts original budget assumed
  - Solution to projected deficit relies almost entirely on one-time fixes
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### Much Work Remains

- Business tax replacement
- FY2008 budget
- Most governmental units' fiscal years begin July 1



### Single Business Tax Eliminated

(Effective December 31, 2007)

- Law change initiated by petition
- Legislature enacted the law
- Impervious to gubernatorial veto
- SBT is gone and with it \$1.9 billion of General Fund revenue (22%)
- Will all lost revenue be replaced?



### Fiscal Year 2008 Budget Situation

- General Fund shortfall about \$1 billion, even without net business tax cut
- Shortfall over 10%
- School Aid Fund \$450 million short
- Total problem about \$1.5 billion
- Failure to replace any SBT revenues would add \$1.2 billion to FY2008 problem



### FY2008 Budget Outlook Governor's School Aid Proposal

- \$178 per pupil foundation increase net of enrollment declines—\$190 million
- Reduced retirement costs (relative to 17.74% rate)—\$100 million
- Other specific increases—Great Start, Declining Enrollment, Special Education, Cost Sharing, etc. —\$287 million
- Total revenue increases and cost reductions \$577 million



### FY2008 Budget Outlook Governor's General Fund Proposal

- In general, Governor is proposing a continuation budget with few program expansions
- Most increases associated with caseloads (corrections, human services, Medicaid)
- Some program reductions - \$310 million
  - Corrections
  - Tuition grant program
  - Human services – day care policy changes
- Revenue increases total \$2.1 billion (includes business tax replacement)



### What is Required for FY07 and FY08 Proposals to be Implemented?

- Legislative approval of tax changes—increases and decreases
- Legislative approval of retirement change—value portfolio at 9/30/06 market value



### What Happens if Legislature Does Not Approve Governor's Proposal?

#### FY2008 General Fund Programs

- Average cuts in FY2008 would have to exceed 10%
- Higher Education, Revenue Sharing especially vulnerable
- Health care and services for the poor at risk
- Other areas include corrections, public safety, mental health, judiciary



### What Happens if Legislature Does Not Approve Governor's Proposal?

#### FY2008 School Aid

- Not enough state funding in FY2008 to match FY2007 appropriations
- Revenue increase proposed for FY2008 \$453 million—\$268 per pupil
- Significant program cuts from current levels will be necessary



### Elements of Structural Deficit

- Exploding health care costs
- Prison costs outpacing revenue growth
- Antiquated revenue structure



### Structural Revenue Issues

- Revenue system reflects economy of the 50s, 60s, and 70s
- Revenues grow more slowly than economy
- Income tax growing slowly
- Consumption taxes goods-oriented
- Relatively few services are taxed
- Services are over half of private sector economic activity



### Health 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



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



### School Aid Structural Deficit

*Spending Pressures Outpace Revenue Growth*

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



### Summary Numbers 10 Years Out

- “Gap” equals spending pressures minus revenues
- General Fund gap \$5.9 billion (50%)
- School Aid Fund gap \$4.5 billion (21%)
- Total gap exceeds \$10 billion
- Gap = 31% of projected revenues
- Combination of spending cuts and revenue increases required to balance budgets



### What if Economy is Stronger? Can We Grow Out of Problem?

- General Fund revenues would have to grow more than twice as fast
- School Aid Fund revenues would need to grow 2 percentage points (60%) faster
- Growing out problem through accelerated revenue growth not likely without changing the revenue structure



### Some Revenue Options

- Improve the tax system:
  - Growth
  - Equity
- And possibly increase revenues



### Broadening the Sales and Use Taxes Base

- Most services not taxed
- Services constitute more than 1/2 private economic activity
- Starting point—\$8.8 Billion
- Revenues would grow faster than current Sales & Use Taxes
- Would socially valuable services such as medical care and education be exempt? — \$2.9 billion
- Business to business services (Pyramiding could create multiple taxation problem) — \$3.6 billion



### Income Tax: Increase or Restructure?

- Raise tax rate and personal exemption amount—each 1/10<sup>th</sup> percentage point yields \$170 million
- Eliminate some income exclusions
- Graduated income tax—Constitutional amendment required
- Restructuring would cause revenues to grow faster—even if starting point is revenue-neutral



## And on the Spending Side

- Health care
  - Medicaid
  - Retired teacher health care
- Corrections
- Local government reform

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