STATE BUDGET NOTES

2010-01 A publication of the Citizens Research Council of Michigan February 2010

THE FY2011 EXECUTIVE BUDGET: "DÉJÀ VU ALL OVER AGAIN"

Michigan's near decade-long economic slide provides a backdrop to the Governor's Fiscal Year 2010-11 (FY2011) budget recommendation. Both the fiscal problem and a number of the solutions offered to address it share similarities with past executive budgets. FY2011 is the second year in a row in which the two major budgets (General Fund and School Aid Fund) face a combined shortfall in excess of $1 billion (this has been the case in three of the last four years). While the specifics of the Governor's recommendations receive the most public attention, the underlying problem that affects the FY2011 budget garners much less attention. Ironically, observers of the Governor's budget recommendations are quick to point out the similarities to past proposals which are being offered anew, but largely ignore the fact that state government has failed over most of the last ten years to correct the same enduring problem: the state's structural deficit. In many respects, from the problem it attempts to address to the proposals it embodies, the Governor's FY2011 budget can be accurately described as "déjà vu all over again", to borrow a malapropism from baseball hall of famer Lawrence "Yogi" Berra.

The Governor's executive budget is the first step in the constitutionally-prescribed budget process. Some of the Governor's proposals, both old and new, grapple with aspects of the structural deficit problem, while others are instead aimed at short-term balance. Sooner or later, the Governor and the Michigan Legislature have to adopt a strategic approach to bring baseline revenues and spending back into balance and eliminate the structural deficit. For too long, state officials have relied upon a combination of one-time sources of expenditure reductions, non-recurring revenue sources, and temporary tax increases to achieve annual budget balance, while in turn largely ignoring the structural problems.

Structural Challenges Persist

Public attention to the state's long-term structural deficits affecting the General and School Aid Fund budgets declined somewhat over the past two fiscal years as a severe national recession and the near-collapse of Michigan's auto sector created near-term fiscal problems associated with massive job losses, a slowdown in consumption growth, and declines in personal income. These economic factors resulted in dramatic annual drops in combined General Fund and School Aid Fund tax revenue collections in FY2009 and FY2010, -12.4 percent and -5.1 percent, respectively. Such unprecedented revenue declines and the attendant budget shortfalls they caused, directed policymakers' focus away from the on-going structural problem. The Michigan economy appears to have stabilized somewhat, albeit at lower rates of employment, property valuation, and other key indices. This economic situation demands state policymakers again turn their attention to the structural problems impacting the General Fund and School Aid Fund budgets.

In May 2008, the Citizens Research Council of Michigan (CRC) identified the components of the state's structural deficits and projected the size of these deficits over the subsequent 10 years.[1] Despite the fact that these projections were made against an economic landscape much different than the one estimated for 2010 and 2011, the average annual General Fund and School Aid Fund budget deficits were sizeable,

[1] *Michigan's Fiscal Future*, Report 349, May 2008.

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$539 million and $308 million, respectively. The conclusion was that even in a moderately-improving economic environment, Michigan was not likely to grow its way out of these structural deficits. Given the impacts that the national recession and auto-sector restructuring have had on the state's economic base, the current-year General Fund and School Aid Fund deficit estimates are much larger.

CRC found primary drivers of long-term budget imbalance on both the spending and revenue sides. With respect to spending, the two largest and fastest growing portions of the budget are corrections and healthcare. Although the state has been successful at reducing its prison population and controlling the projected growth of the corrections portion of the budget in recent years, this program still demands over 20 percent of a much-reduced General Fund budget and the growth in on-going operating costs continues to outpace annual revenue growth rates. Healthcare, unlike corrections, is a cost component that is pervasive throughout the state budget, across all General Fund agencies and the School Aid Fund budget. Whether healthcare services are provided directly or indirectly by state government, the state budget is responsible for financing healthcare for a great many Michigan residents, e.g., state and school employees and retirees, as well as low-income children, adults, and elderly individuals.

Michigan's major tax revenues are not growing as fast as the economy and the share of the overall economy claimed by state taxes continues to fall. Despite the fact that both individual and business taxes were increased effective for the FY2008 budget, these increases were completely eroded by the downturn in the economy that occurred soon after their enactment. Further, the changes to the individual income tax (0.45 percentage point rate increase to 4.35 percent) did not address the underlying structural challenge facing this revenue source, i.e. it fails to grow at rate consistent with the projected growth in the cost of government services it supports. The major state tax revenue source for the School Aid Fund, the sales tax, does not apply to a large and growing segment of consumption activity in the state, thus failing to respond equally to overall economic growth. The chief structural impediment reported by CRC in 2008 was that Michigan's general consumption taxes (sales/use taxes) do not capture economic activity within the services sector.

The Problem Facing the New Budget

The January 2010 Consensus Revenue Estimating Conference provided the first official estimate of FY2011 revenues and an early glimpse at the size of the shortfalls facing the General Fund and School Aid Fund budgets. Based on 1) these agreed-to revenue figures, 2) the amount of temporary federal recovery resources used in FY2010, and 3) an assumption to continue current-year spending levels with certain adjustments, the deficit facing the two major funds is estimated to be $1.5 billion in FY2011. The Governor's FY2011 executive budget recommendation provides a series of proposals to achieve budget balance in the coming fiscal year. The suggested approaches to manage the respective shortfalls in the major budgets are considerably divergent, as explained below.

School Aid Fund

The FY2011 budget deficit facing the School Aid Fund (SAF) is pegged at $410 million. This budget shortfall occurs despite the fact that the SAF is projected to see its first year of revenue growth since FY2008, although the rate is less than one-half of one percent. This shortfall comes on the heels of the FY2010 budget that

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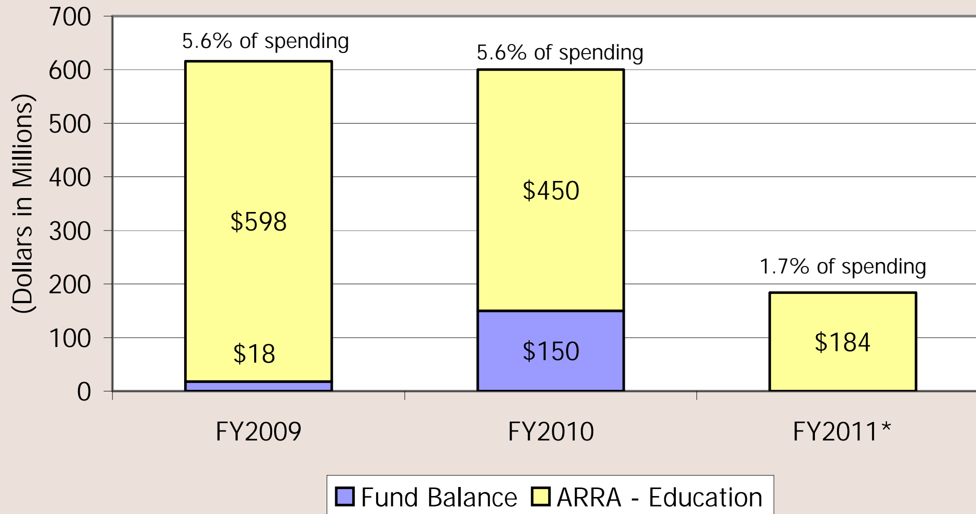
Chart 1
Non-Recurring Resources Used to Achieve SAF Budget Balance in FY2009 through FY2011



Fund Balance = $247 million at October 1, 2008. State spending excludes non-ARRA federal funds.

* Based on Governor's Executive Budget.

reduced state funding for public K-12 education significantly from the FY2009 levels. The use of $450 million in federal funds from the American Recovery and Reinvestment Act (ARRA) of 2009 was not sufficient to avoid a reduction of $165 per pupil in the FY2010 SAF budget and a gubernatorial line-item veto further reduced funding for certain high-spending districts up to an additional $324 per pupil. The projected deficit in FY2011 is almost entirely the result of the heavy reliance on non-recurring resources used to balance budgets in FY2009 and FY2010. (See **Chart 1**.)

Even assuming the use of the remaining $184 million in temporary ARRA dollars available to Michigan, the level of total available state resources for K-12 education under current law will dictate larger per-pupil reductions than experienced in FY2010 to achieve balance in the SAF. To avoid an additional estimated $250 per-pupil reduction in state support and maintain the current-year spending, the Governor's SAF budget recommendation is premised on a series of tax changes to generate additional revenue for the SAF.

The key component of the Governor's SAF solution is a two-part change involving Michigan's general consumption-based taxes. First, the base of the sales tax would be expanded to include a litany of consumer services. Second, at the same time that sales tax base is expanded, the rates of the sales and use taxes would be reduced from 6 percent to 5.5 percent. The base and rate changes would be effective December 1, 2010. Notable exclusions to the expansion of the sales tax base include healthcare, social assistance, education, construction, real estate, and insurance services. To address the issue of "tax pyramiding", the proposal also would exempt service consumption that involves "business-to-business" transactions.

The $725 million in net revenue achieved from consumption tax restructuring is partially offset by a $171 million reduction in Michigan Business Tax receipts resulting from phasing-out, over a two-year period, the tax's surcharge component. The net result of the tax changes is a $554 million gain

Table 1
Governor's Proposed Tax Restructuring
FY2011 SAF Budget Impact
Dollars in millions

Sales and Use Tax	
Expand sales tax to services (5.5%)	$1,262
Reduce sales and use taxes (5.5%)	($528)
Administrative costs	($9)
Subtotal	$725
Michigan Business Tax	
Two-year phase-out of surcharge	($171)
Total Fiscal Impact	$554

Source: FY2011 Executive Budget

to the SAF for FY2011 to eliminate the budget shortfall. The General Fund would be held harmless in the tax restructuring proposal. The Governor's budget, while taking care of the projected budget gap in FY2011, also provides a level of "cushion" to the FY2012 budget to help ease the transition from the heavy reliance on non-recurring resources in the previous three fiscal years. (See **Table 1**.)

Employee benefit changes proposed by the Governor would not directly affect the SAF budget but will generate savings at the local level prospectively, helping K-12 districts manage future spending pressures arising from retirement benefit funding. The retirement portfolio's heavy investment losses in 2008 and 2009 accounts for nearly all of the 2.47 percentage point increase in the employer contribution rate for FY2011 and beyond (16.94 percent to 19.41 percent).

General Fund

The General Fund proposal is a different story. Baseline spending for FY2011, representing a continuation of current-year spending with required adjustments, is estimated at $8.9 billion and on-going revenue amounts to $7.8 billion, yielding a shortfall of just over $1 billion. The budget gap primarily results from the use of $1 billion in non-recurring ARRA resources in the FY2010 budget; those funds are largely exhausted. Welfare and Department of Corrections program increases plus previously-negotiated state employee personnel costs contribute a smaller portion to the projected FY2011 budget gap. Whereas the proposed SAF solution is revenue-centric in nature, the Governor's proposed solutions to the General Fund problem are varied.

Over one-half of the Governor's solution is tied to an assumption that the federal government will continue, for an additional six months, to pick up a larger share of Michigan's Medicaid costs. The federal government, through the ARRA legislation, has agreed to provide a higher rate of cost-sharing through the first quarter of FY2011 (until January 2011), producing an additional $208 million in federal resources to offset General Fund spending. An extension of the higher match rate for another two fiscal quarters (through June 2011) would generate another $500 million in temporary help for the budget in FY2011. The chief problem associated with this assumption is to postpone, until FY2012, crafting structural solutions totaling $700 million in one of the state's largest General Fund budget items. (Note: The FY2012 budget will face the first-year of a General Fund revenue reduction associated with the programmed rollback of the 2007 individual income tax rate increase, a $177 million revenue impact.)

The budget relies on spending reductions tied to major policy changes affecting the Department of Corrections budget and with employee benefit costs throughout General Fund agency operations. Net savings of $129 million in the Corrections budget result from sentencing policy changes that would reduce the amount of time served in prison through the application of "good time credits". A reduction of the prison population to 1992 levels (35,500 inmates) and a number of facility closures would follow according to the State Budget Office. The reductions represent long-term and growing cost avoidance.

Another $116 million in General Fund savings is predicated on changes to current employee and retiree compensation and benefit levels. One component is an early retirement program. Included in the program are both an incentive for eligible employees to leave the state workforce and a disincentive for those eligible to retire to stay in the state workforce. State savings accrue in FY2011 largely from reducing the workforce and decreasing compensation costs for new employees. Under the plan, new employees would receive lower salaries than those retiring and would participate in a less-costly health plan, resulting in $98 million in General Fund savings. Prospectively, the elimination of the state subsidy for retiree dental and vision coverage, included as the disincentive, would reduce state financial obligations. Another change affecting current employees yields savings by rescinding the three percent salary increase for 15,000 non-unionized employees ($18 million).

The policy changes affecting the Department of Corrections and state employee benefits, and attendant General Fund savings, are contingent on legislative enactment of statutory changes. In both cases, timing and the scope of the final legislative product, if any, will be key factors to affecting the savings that can be achieved. The contemplated savings in the executive budget are premised on fairly speedy legislative action.

The Governor's General Fund budget also relies on a new tax in the Medicaid program. In many ways similar to a proposal passed by the Michigan House of Representative last year, but defeated by the Senate, the budget is based on extending the Medicaid provider tax to physicians at a rate of three percent. (Note: Similar provider taxes apply to health maintenance organizations, hospitals, and nursing home services.) The tax proposal allows for the capture of additional federal funding to support higher physician service Medicaid reimbursement rates (a net increase of $715 million) in addition to a $133 million General Fund spending offset within the program.

Prospects for Long-Term Balance

As the April 2009 CRC *State Budget Note* pointed out, "Michigan is not going to grow its way out of the structural deficits affecting the General Fund and School Aid Fund budgets; therefore, state officials must direct policy changes at specific components of the state revenue and spending structure that contribute most to the deficits."[2] Coming out of the "Great Recession", the Michigan economy, as a whole, is not expected to exhibit much growth in 2011. Rather, the economic forecast predicts more of a "bottoming out" than a recovery over the next 24 months. Given this fact, economic growth as a solution to the state's structural problems in 2010 and 2011 barely fits into the equation. In this light, spending and revenue restructuring must take center stage as the Michigan Legislature begins to craft a FY2011 state spending plan. The Governor's planned budget contains elements aimed at both short- and long-term balance.

Short-Term Budget Fixes

Some aspects of the Governor's FY2011 budget proposal are designed to do little more than achieve one-year budget balance and fail to address the fundamental structural problem. Use of such measures, although limited, can exacerbate the current problem because the program costs in FY2012 likely will be higher

[2] *Dual Deficits and Federal Recovery Assistance: Prospects for State Budget Balance*, State Budget Note 2009-2, April 2009.

than they are in FY2011 when use of the one-time budget solution is no longer available. Fortunately, these pieces do not represent a majority of the aggregate solution proffered.

The clearest example of a short-term budget fix is the assumption that the enhanced Medicaid matching rate will continue. Such a solution assumes that the higher rate is temporary and expires mid-way through the next fiscal year. Ignoring the question of whether or not such federal assistance will materialize, if the money is made available to the state during the fiscal period then turning it down would not be a prudent approach, especially given the sizable federal cost-share (nearly 75 percent of total program costs). However, policymakers must acknowledge the short-term nature of such a solution and plan accordingly for the out-years.

The proposed tax restructuring plan to eliminate the FY2011 SAF budget shortfall represents both a short- and long-term solution. The net tax revenue increase would address the immediate challenge and avoid a significant per-pupil funding reduction, which was tempered by receipt of temporary ARRA funding in FY2009 and FY2010. From a long-term perspective, the adjustments to the sales tax base have the potential to increase the future growth rate in consumption tax receipts. Another aspect of the Governor's plan affecting out-years entails a reduction in the Michigan Business Tax gross receipts tax rate beginning in FY2012. Taken together, the Governor's suggested tax changes become "revenue neutral" in FY2014.

The proposed early-out programs for state and school employees would result in the replacement of senior, higher-paid employees with lower-paid employees. At a replacement rate of one-for-one, early retirement programs are generally used to effect budget savings over the short-run; however, if such programs are designed to reduce the size of the overall workforce, which is being proposed for state employees, they can be part of a strategy to achieve long-term budget balance by eliminating future personnel costs.

Structural Deficit Components

The executive recommendation for the General Fund and School Aid Fund budgets include expenditure and revenue components that take aim at the structural challenges facing Michigan. The recommendation to address the School Aid Fund budget shortfall depends entirely on increasing state revenues for K-12 schools through an expansion of the sales tax base to that segment of the economy which is growing the fastest: services. The service tax base expansion excludes the rapidly growing healthcare sector. Increasing healthcare costs are driving much of the spending pressures facing the state, in both the General Fund and School Aid Fund budgets. While adding services to the tax base will increase the growth rate of Michigan's sales tax, the resultant rate likely will continue to trail the growth in state healthcare costs.

The proposed changes directed at financing pension benefits for school employees have the potential to provide fiscal relief to local school budgets in the future by shifting more of the annual benefit costs from the employer to the employee. Further savings are achieved by capping service credit for current employees and requiring newly-hired employees to be part of a proposed "hybrid" retirement program, consisting of elements of both defined benefit and defined contribution plans.

In contrast to the K-12 budget, the General Fund solutions focus more immediately on the spending side of the ledger to address structural budget problems in FY2011 and into the future. Policy changes in the Department of Corrections, which in recent budgets accounted for $1 out of every $5 in General Fund spending, would target the state's prison population with the goal of reducing prison population levels by 20 percent to levels not seen in 10 years.

Similarly, the reductions recommended for on-going General Fund personnel-related savings are sought through pay freezes in FY2011 and by shifting more of the cost of retirement benefits (pension and insurance) to the employee. Smaller aggregate dollar reductions are contained in the higher education, community health, and human services budgets, representing long-term savings resulting from program and service elimination.

Conclusion

Over the next 24 months, the Michigan economy will struggle to regain its footing after "The Great Recession". During this time, state tax revenues are expected to grow minimally, but well-below the rate needed to meet expected spending demands. Simultaneously, the FY2011 state budgets for the General Fund and School Aid Fund reveal the "revenue cliff" that was predicted following the exhaustion of the temporary federal stimulus funds in the FY2009 and FY2010 budgets. These funds were used to meet state and school budget challenges over the economic downturn, but not intended to provide long-term fiscal relief. However, now that they are gone state policymakers are faced with the same long-term problem that plagued the state budget for years preceding FY2009. Even when economic growth and state revenue growth return in the coming years, Michigan's budget will face a fundamental imbalance between on-going revenue and projected spending.

The FY2011 budget presents yet another opportunity for the state's elected officials to begin the process of correcting the near-decade long problem. The Governor's fiscal plan for FY2011 contains elements that address the causes of the problem on both the spending and revenue side. In a number of cases, these proposals have been offered before, albeit in a slightly different form. While some are meritorious from the vantage point of providing long-term fiscal stability to the state budget, many have experienced strong opposition because they entail increasing taxes and cutting services. However, absent further extraordinary sources of budget resources akin to the federal ARRA dollars, the solutions available to policymakers to achieve long-term, lasting balance in FY2011 are limited to cutting and eliminating programs or raising taxes.