

The Corrections Budget in Context

Remarks of Tom Clay

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I'm going to run through a slide show here. I've got lots of bad news. You have a hard copy of this presentation in the materials that have been given to you [[click here](#)].

Michigan is not alone in its budget crisis. This is a national problem brought on by some longer term trends which are, unfortunately, not going to go away. The state budgets and state governments have program responsibilities that do not match up in terms of their growth rates with the revenue structures.

The two most obvious examples in Michigan are Medicaid and Corrections. Medicaid is a national problem. Corrections is a problem in some states and not so much in others. But spending growth is occurring at a greater rate than revenues even in good years.

To give you a sense of the Michigan budget, it's about a \$40-billion enterprise and the problems and crisis with the budget have been concentrated in two major funds of the state, which combined, raise about \$20 billion from state citizens. These are all state-raised revenues -- the general fund, and that's the place where most of the Corrections budget resides, and the school aid fund, which is where most of public K-12 education is financed following Proposal A in 1994.

Most other state revenues, revenues in other funds, are earmarked for specific purposes and are not available to help cushion the problems that are occurring in the general and school aid funds. Both funds exhibit the situation that this chart attempts to portray, and that is, in the last few years of the 1990s, the state was spending less than it was taking in. It was salting away revenues and various reserves, the rainy day fund being the most obvious one that affects the general and school aid funds, but building up surpluses in the general fund and the school aid fund, as well.

Beginning in fiscal year 2001, the state began spending more than it was taking in. And that trend has continued. It's occurring this year. Part of the spending is supported by one-time revenues that will not renew themselves next year or in following years. So the state has been basically spending more than it had and sustaining expenditures at a level that could not be sustained in the future with the current revenue structure. The school aid fund is the same situation.

The causes for the decline in revenues include a weak economy, but our economy is not weak by comparison with previous recessions. In the early 1990s, we had an

unemployment rate of almost 10 percent. In the early 1980s, in December of 1982, the unemployment was over 16 percent.

In that year we had double digit inflation. We had interest rates on mortgages of 15 percent. You only have to go back about 20 years and find an economy that was 10 times as bad as the economy we are in now, and yet the state budget is in greater stress.

Part of it has been caused by decisions to cut the revenue base, to cut taxes, that were made in the late 1990s when the revenues were increasing rapidly but continued in the face of a declining economy and a clear indication that spending could not be sustained and that current programs could not be operated with the revenue base that was unfolding. And finally, there has been a failure on the part of the state to implement permanent solutions to this problem, either by stopping tax cuts, raising revenues, cutting spending in some specific way.

In 1998, the Legislature and the governor, the previous governor, decided to eliminate the single business tax, albeit over a 23-year period by reducing the rate by a tenth of a point a year, but to eliminate the only significant tax that business pays to state government. It represented 26 percent of the general fund revenue base before the cuts began. And at the same time, the Legislature and governor decided to reduce the state income tax rate from 4.4 percent to 3.9 percent by reducing its rate by a tenth of a point a year over a five-year period. The calculation in terms of the allocation of revenues between school aid general fund was made so the entire effect of the tax cut fell on the general fund, and the percentage for the school aid fund was raised just enough to offset the reduction of the rates.

So the decision that was made in the late 90s was to take away eventually a third of the general fund revenue base, but yet there were no formal discussions, no hearings held on what was to be done on the spending side of the budget to track this future decline in revenues. The implication then was that the state could somehow operate with one-third less revenue and continue to do pretty much what it was doing with the higher revenue base.

Looking at the one-time revenues, the state has used \$4.5 billion of one-time resources in fiscal years 2001, 2002 and 2003. It propped spending up above what the regular revenue that was coming in could support.

The state has used up \$1.25 billion of rainy day funds that have accumulated; it used close to a billion dollars worth of the school aid fund surplus that had accumulated, used up the general fund surplus and a whole bunch of other items. Those monies are all gone now, and they are not available in 2004 and beyond to support spending.

Looking at the current year, we had already \$750 million in round figures, three quarters of a billion in cuts in the budget enacted last summer. We had an executive order in December as Gov. Engler left office; we've had an executive order in February by Gov. Granholm and reductions of school aid. Most of that three quarters of a billion has been in the general fund, and the revenue forecast which will be reviewed next Tuesday (May 13th) at least the Senate Fiscal Agency forecast, would indicate that their figures are lower than the January forecasts. A small executive order could be necessary in the general fund and some more cuts in school aid could be necessary this year.

The Senate Fiscal Agency forecast reported in this morning's Gongwer for next year are around, I think, \$150 million lower for the two funds combined, so some adjustments in the governor's proposals for 2004 would be needed if those forecasts turn out to be roughly in

line with the consensus that the House and Senate Fiscal Agencies and the treasurer are required to reach next Tuesday. March and April revenues were up from a year ago in line with forecasts. I think, and many people think, though, that the revenue risk is on the downside.

Last summer, the Legislature passed the school aid budget. Now, using January numbers, it's short almost \$400 million of being able to be paid for in 2004, the year that begins this coming October. And, as I said, I think the risk is on the downside, and Gary Olson who does the forecast for the Senate Fiscal Agency apparently agrees, because his numbers are lower than the January numbers.

In the general fund, I won't go through the details, but it's well published that a gap of \$1.7 billion existed between the official revenue forecast in the state for 2004 and an extension of the 2003 appropriations plus adjustments that were not discretionary, such as losses of federal money and Medicaid, a contract that already been approved for state employees, increases in bed space requirements in Corrections that current policies implied. So when the Governor set about presenting the budget, she had over \$2 billion worth of gap to deal with, close to \$400 million in the school aid fund and \$1.7 billion in the general fund and had made the decision that tax increases would not be part of her solution. That included a decision that stopping the income tax cuts, and we have one more of those scheduled for January, 2004, were also not a part of her solution. So she was faced with coming up with essentially program expenditure cuts and other types of adjustments in a general fund budget that was approximately 20 percent short (that's what the arithmetic is) and spends over 80 percent of this money for Corrections, higher education, health, and Family Independence Agency, aka the old Department of Social Services. All the rest of general fund spending in the state budget this year adds up to \$1.7 billion, which coincidentally is the size of the problem. So it was clear that those four big areas were going to have to take some hits.

While looking at her budget proposal, she did reflect her priorities. She did not recommend across-the-board cuts. She protected programs in health and human services for the poor. Higher education is recommended to be cut significantly. She proposed policy changes in Corrections that I am sure that were everyone in this room knows more about than I do, but that would have the effect of having fewer people in prison than current policies apply. She continued cuts and expanded cuts in revenue sharing to local units of government and proposed to close some loop holes in the tax system. That's also been described as tax policy changes or tax increases by others that aren't as supportive of those proposals.

Looking at the \$1.7 billion, more than half is covered by reductions in the budget, a small amount of fee increases and tax policy changes, changes in corrections policies that save over \$100 million, eliminating the subsidy from the general fund to the school aid fund, and continuing and expanding revenue-sharing cuts. This table provides the numbers in another form.

Looking at the school aid, over half of the school aid problem is covered by cutting spending, and the remainder by a variety of either one-time or permanent revenue changes -- new lottery games, some tax policy changes (small amounts) and refinancing school bonds, which will be a one time revenue source.

2004 will be the first year, interestingly, where state spending for public K-12 education has declined on a year-to-year basis. So, in the face of this awful revenue situation, school aid has inched up at the same time the general fund was going down some, and would have gone down a lot more had it been based entirely on current revenues. It's a small decline, but as we look at the 2004 recommendation, the one-time revenues used in her overall

budget proposal are concentrated in school aid, which means that the potential for school aid increases in 2004 is very small.

In the higher education area, the combination of cuts made this year plus the cuts in the budget proposed for 2004 add up to about 10 percent for public community colleges and state universities. The 10 percent cut in state universities implies that we will see double-digit tuition increases this fall and perhaps into the winter. Certainly the effect of these cuts will translate to large increases in tuition. Some of the schools, like Wayne State, which gets close to 70 percent of its operating budget from state appropriations, may have to increase their tuitions by more than 20 percent to stay even close to even with the loss of state appropriations and higher costs.

The merit scholarship program is recommended to be cut by 80 percent, down from \$2,500 to \$500.

Looking at higher education from a little longer perspective, if the Governor's proposal is approved, look back in 1979, roughly a quarter of a century ago, the ratio of appropriations to tuition was 70 to 30. Appropriations was 70 percent, tuition 30 percent. In 2002, the last year in which actual data is available, it's roughly 50/50. Actually, tuition comprises a little larger amount of the total in public universities than appropriations. And if the recommendation is approved and the universities act as they have in the past to recoup those lost dollars by raising tuitions and to cover cost increases of relatively modest magnitudes, we can see the share then getting close to 60/40. It's been described by some as the privatization of public higher education in Michigan.

You all know about Corrections. It's the largest program the State of Michigan actually operates. I did a set of figures the other day and over 80 percent of the total money in the state budget is sent somewhere else to be spent for programs that are delivered by other entities -- hospitals, the public schools, universities and the like. So less than 20 percent of that total state budget of nearly \$40 billion is sent somewhere else to be spent by some other organization to provide services for people that are dependent on the state budget for those services. But in Corrections the state is actually operating a very big program, as you know. Over 30 percent of the state work force is in Corrections. The budget this year avoids what was projected to be a \$150 million increase, which would have been more prisons in all likelihood. Instead, the budget recommends an increase of \$33 million and community-based alternatives are emphasized.

This chart is kind of hard to see. A colleague sent it to me just a few days ago, and it shows which states in the United States have higher incarceration rates than in Michigan. It surprised me because as you can see the Bible Belt is where the higher rates are. The only northern state I believe is Delaware; it's a little higher than Michigan. None of the states in the upper Midwest, none of the states in the far west with the exception, I guess, of New Mexico and Arizona, if you call those far west. Essentially, the north has lower rates of incarceration than the south, with Michigan as the large exception. And it does say something about the difficulties that we have in our budget.

Another chart which I think says an awful lot, too, is one that separates state classified employment into two parts and looks over roughly a 2½-decade period. In 1980, which was the highest year for state classified employment, the state had 75,000 employees on average and 5,000 of them worked for Corrections and 65,000 of them worked for all other departments combined. A couple of weeks ago, the state had 54,000 employees, so employment has dropped by 16,000. But during that same period, Corrections had gone up by 5,000 to 17,000, up by 12,000, so all other departments combined had gone down by 28,000, which was over 40 percent over that period. Part of that has been forced by budget

constraints. Part of it is the deinstitutionalization of mental health clients. So it has not all been forced by the budget. But the bottom line is that the composition of state employment is very different now than it was a little over 20 years ago.

I'm not going to spend much time on the two big human services agencies except to say that I was amazed that the Governor's budget for Community Health and Family Independence Agency was able to continue programs pretty much unaffected. I don't want to minimize. There are some reductions there. But for the most part, the programs the state is operating in those two departments were minimally affected by the budget problems. Probably the biggest issue in the Family Independence Agency is staffing and we will talk about that in a minute.

Local revenue sharing has been taking the largest cuts in the last couple of years, far larger than internal state departments. The Governor's budget proposal for 2004, when added to cuts that have been made in previous years and are in the base, will result in 27 percent less of the statutory revenue sharing money that is allocated through the state's sales tax being paid to cities, villages, townships and counties than current state law provides. This is all entirely legal because the act also indicates that the amount that the Legislature appropriates for statutory revenue sharing controls. If it appropriates less than that percentage, which is 21 percent than that controls.

This chart shows the path of revenue sharing and actual reductions that are occurring on a year-to-year basis. These are larger reductions than you are seeing in other areas, for sure, with the possible exception of higher education. Revenue sharing is the second largest revenue source for cities, villages, townships and counties next to the property tax. For cities and villages, it's over 20 percent of the revenue base on average; for townships it's over 30 percent.

The final big piece of the budget puzzle is employee compensation. The Governor acknowledged \$250 million of additional costs of compensation, \$140 million in the general fund. They arise from a pay raise that was negotiated by the previous administration and calls for a 3 percent increase for all state employees in 2004 and, incidentally, 4 percent in 2005. Higher contribution rates for retirement caused by the lousy performance of the stock market created actuarial losses, and higher health insurance costs for retired state employees which are paid for on a pay as you go basis, and higher fringe benefit costs, most notably health insurance. So add it all together. It is a \$250 million price tag, \$140 general fund, and unless the employee unions agree to concessions to fully cover this gap, if you will in the budget, as many as 3,000 jobs could be at stake. And recall that Corrections is over 30 percent of the state workforce so that sounds like close to 1,000 jobs in Corrections.

While there are a lot of areas of risk in the budget, the revenue outlook, employee compensations, the Legislature has picked away at the so-called tax loopholes so not many of those are likely to get through. There has been a lot of adverse reactions to fee increases. The case loads that the FIA and Medicaid budgets are based on, I think, are at the hopeful end of the spectrum of possibilities. They are entirely possible but maybe slightly risky.

And the federal government keeps making changes in its policy that has the affect of taking money away from Michigan. A couple of years ago, they decided to eliminate the federal estate tax and in so doing, they created a situation with virtually every state in the country that had an estate tax piggy-backed on federal. So they took away our estate tax at the same time. It will be all gone by 2005. It is a \$200 million loss in state revenue.

The President, a few weeks ago in his stimulus package, recommended eliminating dividends from federal income tax taxation. We start with federal adjusted gross income, which is computed with dividends in now and would be with the dividends out, if this thing passes, and if it passes, that is \$125 million in 2004, which is not required in the Governor's budget because it hasn't passed yet. But roughly three-fourths of that would be a hit in the general funds and one-fourth in the school aid fund. So there are plenty of risks in this budget.

Looking at 2005, if this budget, which is a balanced budget, is approved as presented, then 2005 will be a tough year, but it will be a year that will permit a slight nominal growth in spending. Probably not enough to cover inflation, but would represent the first time that the state would have a little more resources to work with than previous years. That assumes a 4 percent increase in revenues, which would be consistent with a moderate economic performance.

I wonder whether the general fund structural deficit would be eliminated as a result of the acceptance of the Governor's budget proposal, and I think the answer to that, unfortunately, is "no". The two main causes on the spending side for the structural deficit are Medicaid and Corrections. It will take some significant changes in federal-state relations in the Medicaid program to change the situation that virtually every state in the country finds itself in. That is, Medicaid is trying to grow at 10 percent and state revenues are going at four or five. Corrections policy changes could cause the growth path to slow down, but that remains to be seen whether legislative support can be found for changes that would reduce the number of individuals in prison.

On the revenue side, we have a revenue structure that basically misses services almost altogether. Services is where economic growth is occurring in this country and Western Europe; that's the big growth area. We hardly tax any services at all. We tax winter clothing for poor children who are going back to school, but we don't tax golf greens for use when I go to play golf. It's ironic that we are missing the opportunity to tap into revenue sources. We could change our tax structure and reduce the rate to make the change initially revenue neutral and our revenue structure would be more suitable to deal with program responsibilities in the future if we were to make that change. Our sales tax is now 6 percent. If we were to add services we could probably reduce it to maybe 5 percent or even less and have a broader base and a better growth path for the future. So until those kind of those things are considered, we can expect to have tough budgets year after year in good times and crisis when the economy goes south.

Looking at school aid, it faces the same sort of problem for 2004, but has a better longer term outlook than the general fund. Most of the Governor's one-time resources in her budget were in school aid, over \$300 million, so if we get a 4 percent increase in school aid revenues, that is \$440 million, that would turn around or result in the potential to increase school spending by a little over 1 percent in 2005. Another very austere year of the schools essentially having to absorb virtually all the higher costs that they face.

Harry Gast, the 18-year chair of Senate Appropriations, used to say every year at the budget presentation, "the Governor proposes and the Legislature disposes", and so the Governor has proposed and the Legislature is in the process of disposing. Those of you who are following the legislative activity will notice that there are lots of shaky pieces, places where the Legislature has indicated they are not ready to approve and unlike previous Legislatures, legislative leadership has said things like "Well, we don't like this. It's the Governor's problem to come back with another alternative." Well, of course that could go on forever. We never would have heard Harry Gast or Dominic Jacobetti or Don Gilmer, you just would not have heard legislative leadership say those kind of things in the past. It may

be a reflection of term limits. We are finally running out of experienced legislators. But our constitution requires that Legislature to pass a balanced budget. They have to enact a budget that has revenue estimates in it that are high enough to cover the spending that they appropriate, and I think the law is very much on the side of the Governor's saying, "I've given you a proposal. It is now your turn to come up with a balanced budget and it's your constitutional responsibility to do so."

I think the makings are there for the budget going through the summer before it's approved. In the early '80s, we had one situation where the appropriations weren't finally made until December, almost three months into the fiscal year, and I think that is an outside possibility. But we will see next Tuesday whether the recommendations have to be revised. I hope they don't have to be revised downward, but at least the Senate Fiscal Agency numbers would suggest that they would be. And we'll see whether we have this process to watch all summer long.

That's the extent of the bad news, at least the amount that I can share with you in a half an hour.

Thank you very much.