



MICHIGAN'S BUDGET CRISIS AND THE PROSPECTS FOR THE FUTURE

Introduction

Michigan has endured five years of a dual-deficit budget situation that has plunged state finances into the worst fiscal crisis in more than 50 years. Cyclical and structural pressures have acted together to produce both deteriorating revenue performance and escalating spending pressures. Although the State has successfully balanced budgets in each of last five fiscal years,

this has been accomplished by the use of reserves and through actions designed to prevent spending cuts from being even larger than they have been. The fundamental issue of matching revenues with desired spending remains only partially addressed. The central conclusion after close examination of spending and revenue trends is that the economy will not grow Michigan out of its deficit crisis.

Deficits Defined

A cyclical deficit is caused by a decline in the economy. Revenue performance worsens and some spending pressures increase, creating gaps between the cost of maintaining programs and the resources to pay for them. Unlike a business which is adversely affected by a recession and loses customers and experiences declining sales, the customers for state and local government programs expect the services to continue or grow, even with declining revenues. Such programs as public K-12 education can expect essentially the same levels of enrollment, whether revenues are

increasing or declining. Other programs sensitive to unemployment increases experience an actual increase in the number of citizens requesting assistance.

A structural deficit is caused when the costs of maintaining programs and policies increase faster than revenues even when the economy is performing well. Structural deficit pressures also exist when the economy is doing poorly and combined with cyclical pressures may produce an unworkable budget situation.

The Effects of Deficit Pressures

The economic downturn that started at the beginning of the decade has continued unabated in Michigan and the state government's revenue performance has paralleled the Michigan economy. In addition, some spending pressures have accelerated as the economy has declined, most noticeably programs whose clientele increases as unemployment increases – health care – and services and cash assistance for the poor. Hidden in some of the summary statistics are structural changes affecting spending pressures and revenue growth.

Structural Revenue Issues

The most obvious structural change affecting revenues was self-inflicted. The State reduced tax rates, failed to offset negative effects on state revenues created by federal tax changes, and cut other state taxes by excluding previously-taxed items from various tax bases. The current revenue structure is significantly different from that of 2000. The annual effect of these changes on the General Fund is approaching \$2 billion, nearly a fourth of the current revenue base.

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Other factors have resulted in an increasingly weaker connection between the economy and major state revenues sources. The two largest state taxes, Sales and Personal Income, have grown much more slowly than even the anemic growth in personal income since 2000. (The calculations supporting these conclusions have adjusted for changes in the income tax rate.) Current state law exempts most services from Sales or Use Tax taxation and excludes from the Income Tax sources such as retirement payments that are likely to show significant growth in the future. These revenue sources can be expected to lag behind the general economy into the foreseeable future.

State revenues overall have lost ground relative to total state personal income in recent years. Part of the slippage has resulted from tax cuts. But more importantly, the State tax system has become increasingly disconnected from the economy of today. This is partly true because many taxes are not responsive to growth in the economy. The most obvious example of this is the cigarette tax, which is levied at a constant rate of \$2.00 per pack, and is actually declining over time as cigarette consumption declines. The tax raises more than \$1.1 billion annually and portions of the revenues are earmarked to support specific programs in the budget. In FY2005, cigarette tax revenues made up around 5 percent of total tax revenues. Other taxes, although smaller than the cigarette tax, grow more slowly than the economy.

They include beer and wine, alcohol, casino, and motor fuel taxes.

Perhaps more significant overall than the taxes that do not grow with the economy, are the taxes that do grow, but at a slower rate. The largest of these is the State Sales Tax. In FY2005 revenues totaled \$6.6 billion or 28 percent of total taxes. The sales tax is levied on the purchase of goods. However, consumer spending for services is capturing an increasing share of total purchases and services now constitute more than half of all private sector economic activity. But very few services are taxed as consumption expenditures. So spending for goods, such as automobiles, clothing and appliances, is taxed but spending for recreational and personal services, such as golf greens fees or haircuts, is not. As incomes grow and consumer spending for services captures increasing shares of personal spending, the growth in revenues from this source lags behind the general economy. This factor is reflected in the relationship between changes in the Sales Tax and Michigan Personal Income. Between 1995 and 2000, personal income and Sales Tax revenues increased at about the same overall percentage rate, 24.5 percent and 23.4 percent respectively. From 2000 through 2005, the percentage changes diverged dramatically. Personal income grew 13.9 percent and sale tax revenues grew only 5.1 percent. Removing motor vehicle sales tax from the calculation increases the growth in the sales tax to 8.2 percent.

Next to the Sales Tax, the largest tax

is the Personal Income Tax. That tax supports General Fund and School Aid Fund spending. Between 2000 and 2005, personal income grew 13.9 percent while net income tax receipts, adjusted to reflect a constant tax rate, dropped 7.1 percent. The failure for income tax revenues to grow when personal income was growing was caused by the growth in tax credits, nearly twice as fast as personal income and the exclusion of significant sources such as retirement and tax-deferred contributions to personal retirement savings plans. Creating additional drag on income tax revenue growth is the personal exemption which is indexed to inflation.

Structural Spending Factors

The nature of state spending is far different from that of many government units. Most of the state budget comprises payments made to other organizations or individuals that actually provide services. Less than 20 percent of the total budget is retained within state government to finance programs the State operates itself. The rest of the budget supports programs operated by non-state government organizations including K-12 education, community colleges and state universities, cities, villages, townships and counties, and organizations providing services funded by state programs such as Medicaid and community mental health.

Two areas stand out as structural spending problems relative to balancing budgets: health care and corrections. In order of magnitude,

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health care is by far the larger of the two. It affects programs throughout the budget. When state-funded share of health care spending by public school districts is added to other health spending, health care emerges as the largest expenditure items in the entire state budget.

Health insurance premiums for working employees and health benefits for retirees are together the second largest compensation item next to salaries and wages in most state department and school district budgets. The cost of health benefits has been rising at double digit rates for several years.

Each organization receiving financial support from the State faces pressures to fund health care costs for their employees and in many cases their retirees. The costs of health care have risen faster than revenues in the past five years or more, and importantly are likely to outpace revenue growth into the foreseeable future, continuing structural budget imbalances even in an improving economy. Escalating health care costs created pressures in many places in the state budget. The Medicaid program, which provides health care for the poor, has added nearly 400,000 clients since FY2000 and spending has increased by about 36 percent. One in seven Michigan citizens now receives health care paid for by Med-

icaid. Health insurance costs for state employees and state retirees have increased rapidly, despite a significant reduction in the number of state employees. Health insurance costs for public school employees and retirees have also reflected the rapid rise of health care costs. Since about 80 percent of public school financing is provided by the State, the health care cost pressures for the schools reverberated in Lansing during school aid budget deliberations.

To a smaller extent, the Department of Corrections contributes to the structural deficit pressures. It is the only state department whose General Fund spending was higher in FY2005 than it was in FY2001. Corrections is the largest program the State operates directly. It employs nearly one-third of all state employees and over one-half of employees paid from General Fund revenues. Even though crime rates in Michigan have been falling for many years, prison populations had been steadily increasing until only recently, when policy changes have helped stabilize the population. Michigan's incarceration rate (prisoners per 100,000 populations) is higher than the rates of our seven Great Lakes state neighbors who also border the Great Lakes.* Compared with the average of those states' incarceration rates, Michigan's rate is over 40 percent higher. The higher rate results from longer stays in prison for a given

crime than in neighboring states and the more extensive use of alternative forms of incarceration and supervision for some crimes in the states other than Michigan. The relationship between the higher incarceration rate and crime rates is not apparent. Our three closest neighbors: Indiana, Illinois, and Ohio, each have higher crime rates than Michigan, and the average of the seven states is 7 percent below Michigan.

Although the reasons for these differences in incarceration rates reflect different attitudes toward crime and punishment by elected Michigan officials than their counterparts in other states and may be fully justified in terms of public safety and other considerations, the fiscal consequences are significant. If Michigan had an incarceration rate equal to the average of these seven neighbors, General Fund spending for corrections programs in the Michigan budget might be reduced by as much as \$500 million—more than 5 percent of total General Fund spending.

The cyclical and structural deficit pressures have changed the shape of Michigan's budget in the last five years. Many of the pressures at play will continue to create yearly gaps between the spending required to maintain current policies and programs and the revenues to pay for them.

* Indiana, Illinois, Minnesota, New York, Ohio, Pennsylvania, and Wisconsin.

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The Current Situation

Michigan's economy and state and local government programs and finance have been deteriorating for more than a half a decade. Dramatic changes in virtually every measure of our economy have occurred and these forces have created great stress on public services citizens receive from their governments. A description of where we have come will help us gain an understanding of where we are likely to go, absent significant changes in public policies affecting the economy, the revenue structure, and the array of programs state government operates.

The Economy

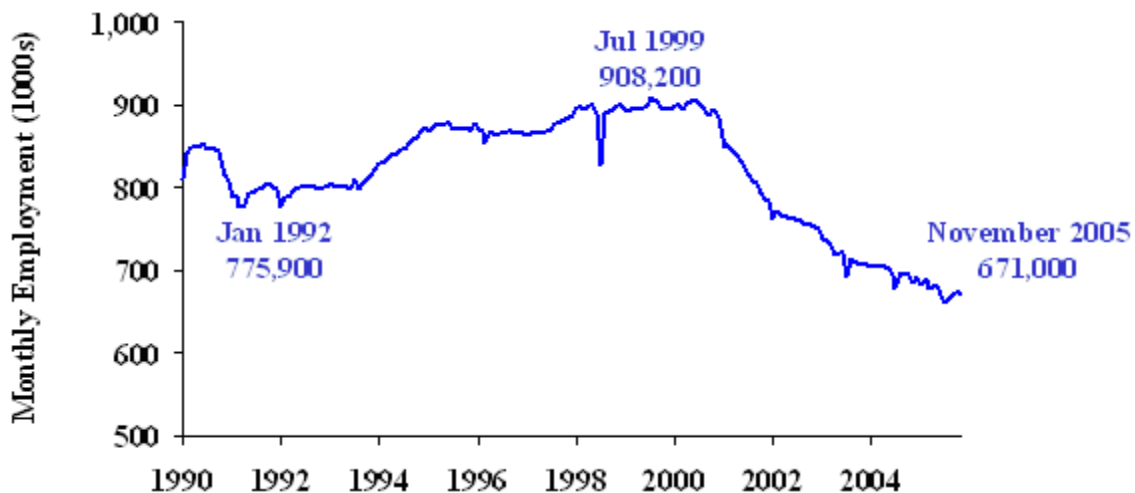
Since 2000, Michigan's economy has been in a downward spiral. The losses recorded in the five-year period have canceled the gains of the last half of the 1990s. Several key variables highlight the profound changes that have taken place:

- Total employment declined by 325,000 (6.9 percent). Fewer people were employed in December 2005 than in December 1996.
- Manufacturing employment dropped 236,000 (26.0 percent) (See **Chart 1**).

- Non-manufacturing employment fell 89,000 (2.4 percent).
- Manufacturing accounted for 73 percent of the job losses.
- The unemployment rate more than doubled from 3.2 percent to 6.7 percent.
- Personal income increased 13.9 percent, when adjusted for inflation amounts to only 1.5 percent.
- Auto and light truck sales by the Big Three dropped 15.8 percent (1.8 million units).
- Auto and light truck production in Michigan declined 20.5 percent (657,000 units).

Chart 1
Michigan Manufacturing Employment

Lost 1 in 4 Manufacturing Jobs



Source: U.S. Department of Labor, Bureau of Labor Statistics, as used by Michigan Department of Treasury in the January 2006 Consensus Revenue Forecasting Conference

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State Revenues

Revenue performance paralleled the economic decline. But aggressive cuts in the Personal Income and Single Business tax rates, enacted in the good times of the late 1990s, exacerbated the dismal revenue performance. And other taxes have been cut or eliminated. The Estate Tax is nearly gone as a result of the phasing out of the federal estate tax. The revenue loss to the General fund in FY2006 will be approximately

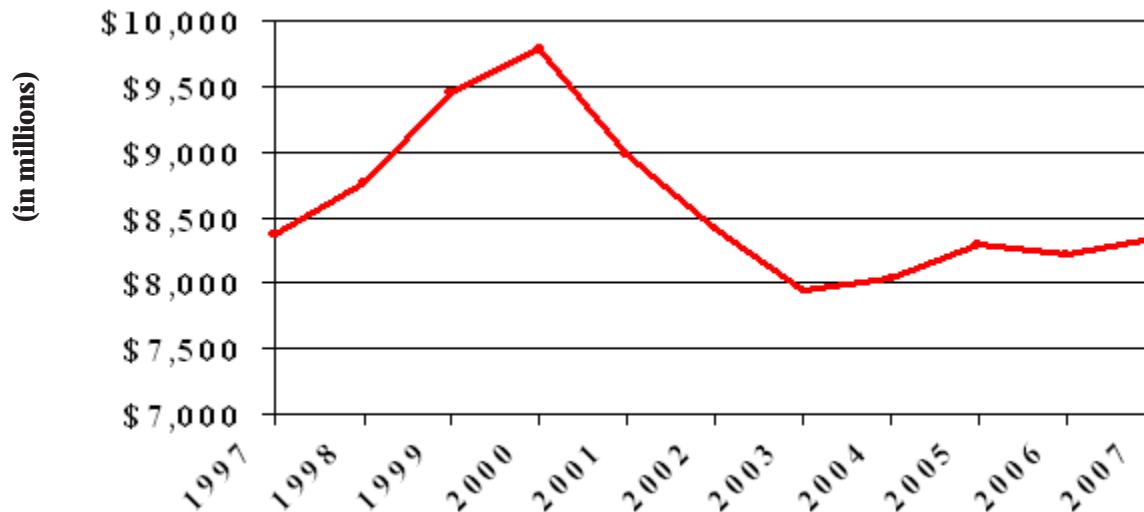
\$200 million. Other actions at the State level, such as indexed Personal Income tax exemptions, reductions in the Single Business Tax base, and exemptions affecting the Sales and Use taxes have whittled away pieces of the General and School Aid funds revenue bases. From a general perspective, revenue performance has failed to deliver the resources needed to keep pace with spending pressures associated with continuing programs and policies on a year-to-year basis.

Since FY2000:

- General Fund revenues dropped \$1.5 billion (15.6 percent).
- Income Tax revenues to the General Fund declined \$1 billion (19.7 percent) (See **Chart 2**).
- Single Business Tax revenues to the General Fund fell \$410 million (17.6 percent).
- School Aid Fund revenue grew \$900 million (9.1 percent), an annual rate of 2.2 percent.
- Sales Tax, the largest School Aid revenue source, increased only 5.1 percent.

Chart 2
Michigan General Fund Revenue

FY2005 and FY2006 Revenue Below 1998 Level



Source: Michigan Department of Treasury as used in January 2006 Consensus Revenue Forecasting Conference.

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Expenditures and Programs

Faced with significant revenue constraints and escalating cost pressures, state policy-makers relied primarily on two basic approaches to keep the budgets in balance: onetime revenue resources and spending reductions. Over the five-year period FY2001 through FY2005, onetime revenues and other budget actions totaling \$6.6 billion were used to support spending in the General and School Aid Funds at levels above the annual revenues flowing into these funds. The General Fund claimed benefit from \$4.2 billion of these resources and the School Aid Fund benefited from the remaining \$2.4 billion. The sources of these resources varied widely, from the \$1.4 billion rainy day fund to changing the collection date for the State Education property tax to temporary employee compensation concessions.

The willingness of elected state officials to use these resources validates, at least for the time they were used, the elevated level of spending and the policies and programs receiving support. But the unwillingness to secure permanent revenues, through tax increases or tax restructuring, indicates that the programs protected by the use of one-time resources may not survive in the longer term. And the use of the reserves and other actions places the State in a particularly vulnerable position when the next economic downturn occurs.

During this FY2001-FY2005 period, General Fund-General Purpose (GF-GP) spending dropped \$1.1 billion or 11 percent. All major categories of GF-GP spending declined except the Department of Corrections. Even the

Department of Community Health, where the Medicaid and community mental health programs are provided funding, saw its GF-GP funding decline \$137 million. Including all financing resources, spending increased \$1.5 billion or 16 percent. Replacement of General Fund financing in the Medicaid program with increased restricted state funding and growth in Federal support made growth in the Community Health budget possible.

Spending cuts in other areas of the budget provided revenue to the General Fund that was being used to prevent even deeper cuts. The largest area is the State Revenue Sharing program. This program allocates constitutionally and statutorily earmarked sales tax revenues to cities, villages, and townships and until FY2005 to counties. In FY2001, the last year before reductions in revenue sharing began, \$1.56 billion was paid to local units of government. In FY2002, cuts in the statutory part of the program began. By FY2005, annual statutory payments had been reduced \$440 million or 53 percent. Of this total \$182 million was accomplished by eliminating county revenue sharing payments altogether. In addition to actual reductions from FY2001 payment levels, the growth in the Sales Tax would have produced an additional \$66 million, which the State also captured to augment GF-GP revenues. In FY2005 \$506 million of Revenue Sharing allocations were diverted to supplement GF-GP revenues. It is unlikely that the State will be able to restore allocations to their former percentages of Sales Tax collections in the foreseeable future. It is more likely that the reductions in revenue sharing will be made permanent at some time in the future, thereby in-

creasing the General Fund-General Purpose revenue base by a half a billion dollars or more.

Because the deterioration in the economy and revenue performance began occurring as the FY2001 budget was being completed, that budget was based on robust economic and revenue growth forecasts that did not materialize. As has been the practice in the past when a recession begins to affect the budget adversely, one-time resources were used as the primary means for keeping the budget in balance. As a consequence, spending in FY2001 was supported with nearly \$1.2 billion of one-time resources in the General and School Aid Funds combined and no significant cuts in spending were made. Because of the lag in action to begin permanent expenditure reductions, the spending changes are measured from the FY2001 level.

- General Fund spending dropped nearly \$1.1 billion (10.8 percent).
- Corrections spending increased \$93 million (6.3 percent).
- For the Department of Community Health, which supports the Medicaid program and public mental health programs, General Fund spending dropped \$137 million (5.3 percent).
- Higher education support dropped \$226 million (11.5 percent).
- Department of Human Services lost \$145 million of general fund support (12.4 percent).
- Statutory revenue sharing for cities, villages, townships and counties was cut \$469 million (56.3 percent). The cuts in revenue sharing had the effect of increasing General Fund revenues and

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were a significant means to lessen the cuts in programs depending on General Fund revenues.

- School Aid spending increased \$338 million (3.4 percent or less than 1 percent per year). School districts had to make program reductions to accommodate cost increases for retirement contributions, health insurance and pay raises that in the aggregate exceeded substantially the increased School Aid grants from the State.
- The State government workforce dropped by 7,900 employees (12.7 percent). The number of State employees in January 2006 was lower than in FY1974, more than 30 years ago.

In the FY2001 through FY2006 period, the shape of the General Fund budget has changed dramatically. In FY2006 approximately six out of every seven General Fund dollars will be

spent in four large areas—Community Health, Corrections, Higher Education, and Human Services. **Table 1** summarizes the shares in the two respective fiscal years. During the five year period, Community Health and Corrections combined have grown from about 44 percent to nearly 53 percent of spending. All other areas have declined in share. The three categories losing share lost \$1.3 billion in appropriations while those gaining share increased more than \$400 million during the same period.

Support for public K-12 education through the School Aid Fund has fared differently than the General Fund during the period of budget stress. In the slightly more than a decade since the approval of Proposal A, School Aid support has increased, albeit at declining rates in the last four years. The increase made possible by the robust economic growth of the late 1990s made it possible to

narrow the differences between higher and lower spending school districts significantly. Between 1994 and 2002, the minimum foundation allowance increased from \$2,762 to \$6,500. During that same period, the highest foundation allowance increased from \$10,294 to \$11,754. The ratio of highest to lowest foundation allowance dropped from nearly 4 to 1 to less than 2 to 1 in eight years.

Since FY2002, the minimum foundation allowance has increased slowly, going from \$6,500 in FY2002 to \$6,875 in FY2006, an increase of less than 6 percent in four years. The increase has not been sufficient to cover increased combined costs in employee health insurance, retirement contributions and general pay increases, leaving most districts with the need to cut programs to achieve the savings needed to fund these cost pressures.

Table 1
Shares of General Fund-General Purpose Spending
Fiscal Years 2001 and 2006

	<u>FY2001</u>	<u>FY2006</u>	<u>Change in Percentage Point Share</u>
Community Health	27.3%	32.9%	5.6
Corrections	16.3	19.8	3.5
Higher Education	21.3	20.7	(0.6)
Human Services	12.7	12.0	(0.7)
Other	22.4	14.5	(7.9)

“Other” includes items such as court funding, state police, natural resources, environmental quality, and capital outlay.

Numbers may not add to 100.0% due to rounding.

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The Outlook for FY2006, FY2007

The spending reductions, especially in General Fund programs, have been dramatic and for the most part can be regarded as permanent reductions in the spending base. But the relentless cyclical and structural forces continue to exert pressure on the budget. The economic forecasts for FY2006 and FY2007 project declining employment and rising unemployment through most of the period with a very gradual upturn beginning after the end of calendar year 2006. On a fiscal year to fiscal year basis, employment is expected to be unchanged and the unemployment is forecasted to average above 7 percent for both fiscal years. While this economic outlook would likely not meet the technical definition of the state-version of a recession, it is a very sluggish economy with revenue growth below rates consistent with moderate rates of expansion. The economy of 2006 and 2007 in Michigan will likely continue to be adversely affected by cyclical forces.

Structurally, the budgets for both the General and School Aid funds continue to reflect cost increase pressures exceeding revenue growth. General Fund revenues, including revenues resulting from additional reductions in statutory revenue sharing, are projected to grow only \$172 million (2 percent) over the two-year period. The increase in School Aid Fund revenues of \$681 million (7.3 percent) over the two years is substantially greater than the General Fund change. However, the resulting per pupil allocations are not sufficient to cover the increased costs alone of retirement and health insurance for school employees for the typical district.

Other resources, in addition to revenues from existing sources, are proposed to help pay for the Governor's FY2007 budget. They are concentrated in the General Fund, but the School Aid recommendation relies on some added resources as well. Both funds rely on surpluses carrying over from FY2006. The General Fund amount is \$77.5 million; the School Aid budget depends on \$80.2 million of prior year surplus. In order for those amounts to be available, revenues and spending in FY2006 will have to meet current projections.

Other General Fund revenue sources total \$188 million, including some one-time resources totaling \$53.8 million and tax increases resulting from the elimination of several tax exemptions yielding \$88.4 million. The proposed budget includes Liquor License Fee increases totaling \$23 million and shifting short-term borrowing costs of \$22.8 to the School Aid Fund. The School Aid Fund would benefit from eliminating tax exemptions totaling \$22.8 million.

The use of one-time resources in the FY2007 budget, if approved as proposed, will be the smallest amount since the budget slide began in FY2001.

On the spending side of the budget, some areas of General Fund spending fall short of the amounts that would fund the costs of continuing FY2006 policies and programs. In some cases structural changes are proposed that lessen costs. The corrections budget continues a five-year program to control prison growth

and projections reflecting this effort call for stable prison bed capacity through 2010. This is in sharp contrast to projections made before the program was instituted calling for increases of about three percent per year in prison populations until 2010. Although corrections costs in Michigan still are very high compared with other states, the stabilization in prison populations will lessen some of the pressure on the budget if the program continues.

The FY2007 budget proposal involves some restructuring of state support for higher education. The budget proposes phasing out tuition grants that benefit students attending private colleges in Michigan and using about half of the resulting savings to increase competitive scholarships. Support for community colleges and state universities is increased by 2 percent, which will likely continue the reduction in the share that state support provides of the operating budgets of public higher education institutions.

The State provides around 80 percent of public school funding. While the State exercises some oversight and control over many programs operated by the school districts, the districts are left to themselves to balance their budgets when confronted with a shortfall in the revenues needed to maintain programs on a year-to-year basis. In the three years beginning in FY2003, the level of support from the State was essentially unchanged and the K-12 system had to absorb cost increases by reducing programs. Rising costs for employee health insurance and retirement contributions displaced other spending categories and caused some districts

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to use reserves to help close budget gaps. The \$175 increase in per-pupil aid in FY2006 was the first in three years, but health insurance and retirement cost increases exceeded that gain in overall support. The proposed increase of \$200 in per-pupil support proposed for FY2007 will likely be absorbed by health insurance and retirement contribution increases as well.

Beyond FY2007

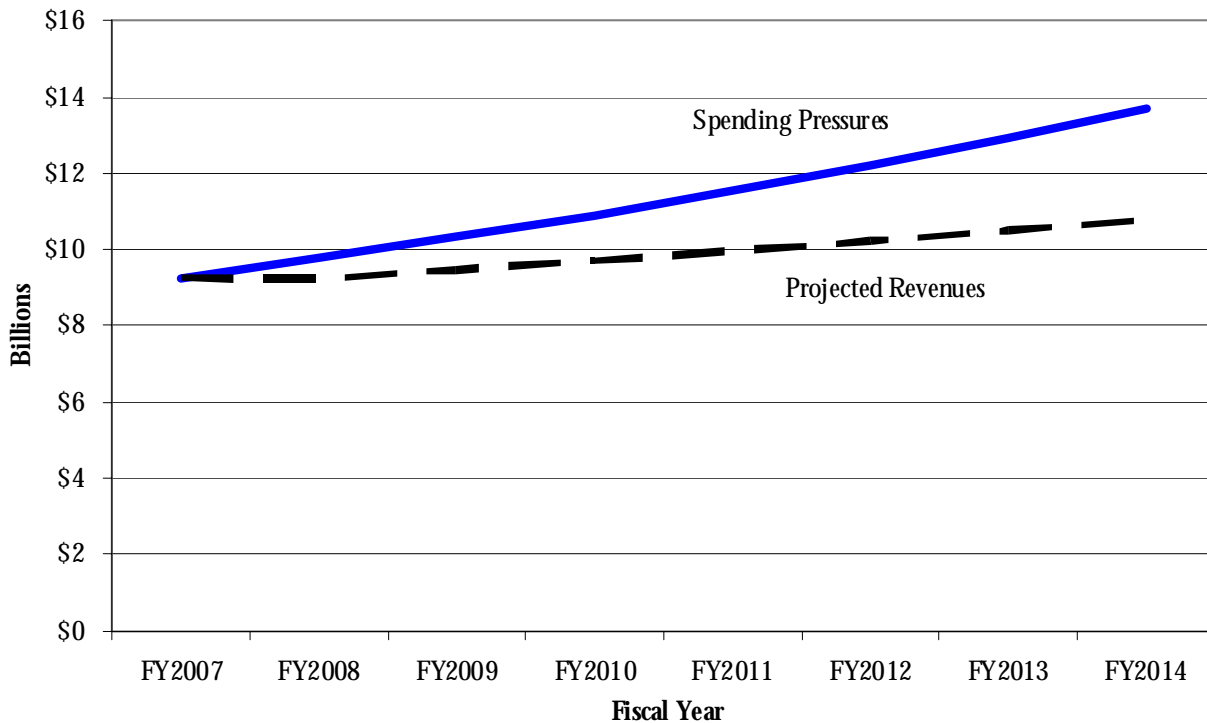
Today we find we have a state government that has depleted its reserves, reduced its taxes, cut its workforce, and significantly reduced spending in most areas of the budget. As we look to the future, that

government is ill-prepared to deal with a continuation of trends on the spending and revenue sides of the budget and at great risk if a recession hits the economy at any time in the near future.

Detailed projections of General Fund spending pressure trends and revenues yield a widening gap for FY2008 and beyond, unless structural changes are made in programs and policies and/or the revenue system. In a moderately improving economy, General Fund revenues will likely grow around 3 percent per year on average. Spending pressures, boosted by health care costs and the state's corrections programs will

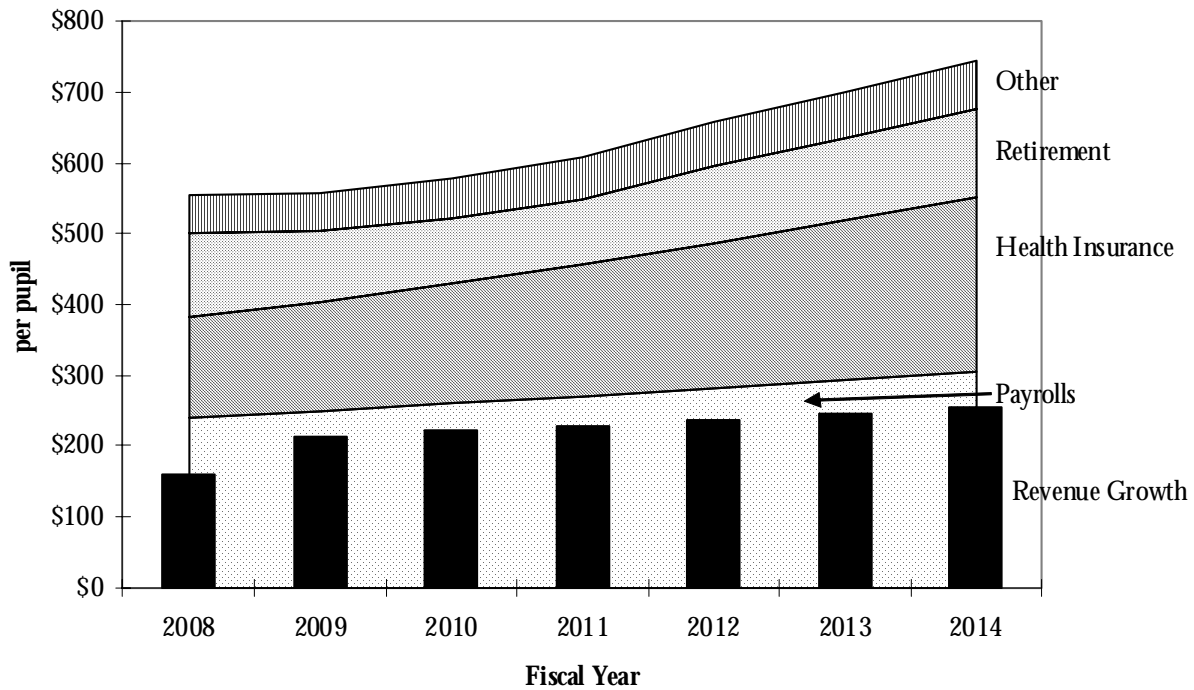
likely grow more than twice that fast overall, unless policies change to reduce the spending growth trajectory (See **Chart 3**). Projecting Department of Community Health and Department of Corrections General Fund spending at 7 percent and 8 percent annual growth rates respectively, higher education at a 4 percent growth rate, and all other areas at 3 percent yields an annual gap between revenues and spending pressures and revenues exceeding 3 percent initially and expanding quickly beyond 4 percent into the future. This measures the size of the gap that would have to be closed unless structural changes are made. It is not a prediction of budget defi-

Chart 3
General Fund Structural Deficit Projections



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Chart 4
Cumulative Per Pupil Components of Projected
School Aid Spending Pressures
Compared With Projected Revenue Growth



cits. The State Constitution and State statutes require that the State balance the budget and it has done so in the past and can be expected to do so in the future.

School Aid revenue projections were projected by individual revenue source and the resulting overall annual growth rate is around 3 percent. That works out to a little over \$200 per pupil rising gradually as the economy and revenues grow. Spending pressures in public K-12 education are inflated by health care costs. Areas directly affected are health in-

surance premiums for employees and the portion of retirement contributions funding health care costs for retirees. Both are expected to increase faster than revenues in the future. Health benefits are funded on a pay-as-you-go basis and the contribution rate can be expected to rise for the current contribution rate of 6.55 percent of payroll to double that rate by FY2015, if current trends continue. Combined with the contribution rate for cash pensions, the annual per pupil increment in retirement contributions will likely be about \$100. Health

insurance costs for current school employees now average more than \$1200 per pupil and annual increases of around 10 percent in premiums would produce annual increases of more than \$100 per pupil in the future.

The largest component of school budgets is salaries and wages. General pay raises covering cost of living (inflation) in the range of 3 percent per year would require annual increases of more than \$150 per pupil. Other factors, including increases resulting from employee

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longevity and additional educational attainment by teachers and administrators, would add more than \$50 per student per year on average system-wide. Other expenses in school budgets including fuel, utilities, maintenance and supplies could add \$50 per student each year. These calculations sum-

marized in **Chart 4** are not predictions of the spending increases that will occur, since the current revenue system will not support them. They do, however, illustrate the rough dimensions of the budget-balancing challenge facing school administrators in the future. If the incremental cost pressures are ag-

gregated, they total more than twice the incremental per pupil revenue increases of a little over \$200, suggesting that a combination of structural changes affecting pension benefits, health insurance and revenues may be necessary to achieve balanced school budgets in the future.

Conclusion

Permanent solutions to Michigan's structural budget crisis will require structural changes. The economy and state revenues in a period of continuing expansion will not grow enough to keep up with the growth in costs associated with maintaining current policies and programs. Structural changes in programs and policies affecting such factors as the

eligibility for program services, length of stay in prisons, and the investments in public education, and reductions in support for local governments all represent options that may have to be pursued. Structural changes in the revenue system to make revenues more responsive to growth in the economy offer another approach. In all likelihood, struc-

tural changes on both sides of the budget equation will be necessary. It remains to be seen if State government will be up to the task. It may be that the most significant problem on the spending side of the problem – health care – will only be solved by national intervention.