



Michigan's Budget Crisis and the Prospects for the Future

Legislative Leadership Program

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- **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**

Michigan's Budget Situation

- Seven years of spending cuts
- FY2007 General Fund revenues lower than in FY1996
- Nearly \$7 billion in one-time resources used
- Reserves exhausted
- Weakened connection between revenue structure and the economy
- Spending pressures growing faster than revenues

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**

Deficits Defined

Cyclical — Caused by Economic Downturn

- Revenues worsen
- Some spending pressures increase
- Deficit erased when economy recovers

Structural — Caused by cost increases to maintain current policies outpacing revenue growth, *Even in Good Economic Times*



The Economic Situation

*Weak Performance
and
Lost Ground Not Likely
To Be Regained*



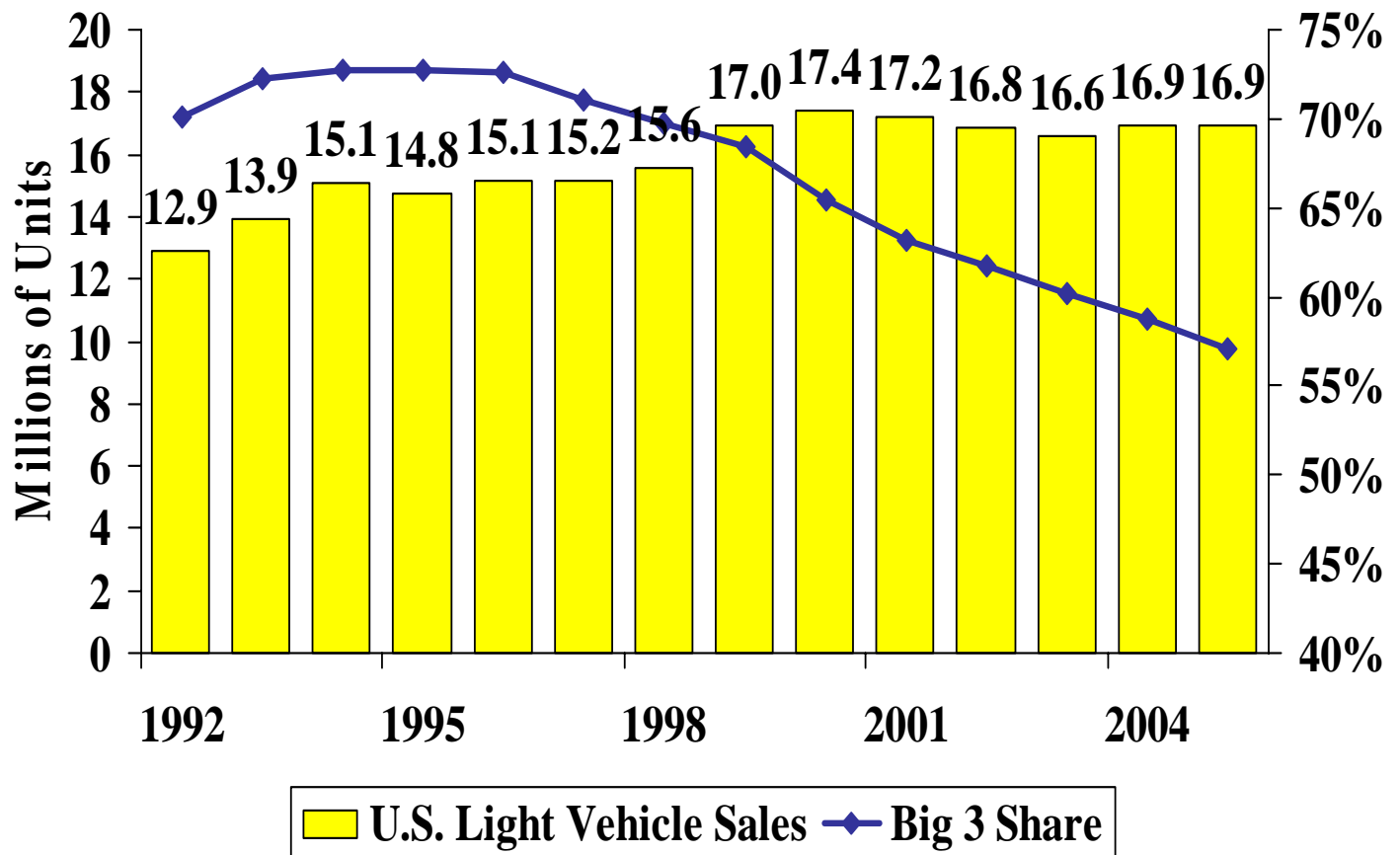
How Weak is the Economy?

Michigan's Recent Statistics:

- 50th in Personal Income Growth
- 49th in Unemployment Rate (Tied with Mississippi)
- 49th in Employment Growth (Decline for Michigan)---Louisiana 50th
- 49th in Index of Economic Momentum (Population, Personal Income, Employment)---Louisiana 50th

Economy in Early 1980s Much Worse

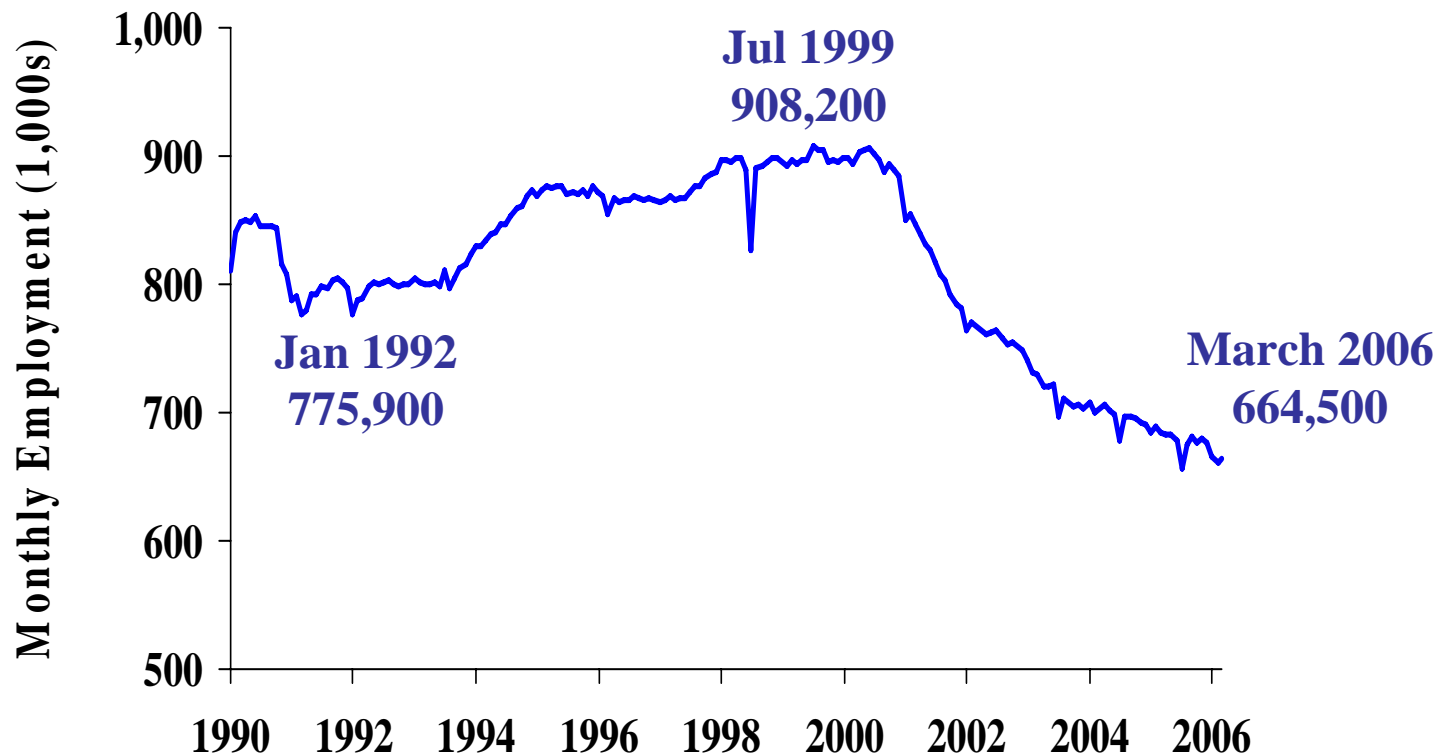
Big 3 Losing Market Share



Source: Automotive News.



Michigan Manufacturing Employment Lost 1 in 4 Manufacturing Jobs



Source: U.S. Department of Labor, Bureau of Labor Statistics.

What's Ahead?

- **Moderate economic recovery assumed**
- **Business tax cut ? (\$500 Million?)**
- **Earned Income Tax Credit (EITC)- \$300 million annual cost**
- **Continuation of cost pressures to maintain current programs**

The State Faces Tough Choices

- **Challenges exist with or without business tax cut and EITC**
- **Raise taxes?**
- **Drastically cut spending in ways not contemplated before?**
- **Combination of both?**

Examples of Major General Fund Budget Cuts

- Reduce prison sentences and inmate populations
- Eliminate selected optional Medicaid benefits
- Eliminate statutory revenue sharing aid to local governments
- Eliminate state support for selected higher education institutions
- Eliminate college student financial aid

These are examples---not proposals!

A Ten-Year Scenario

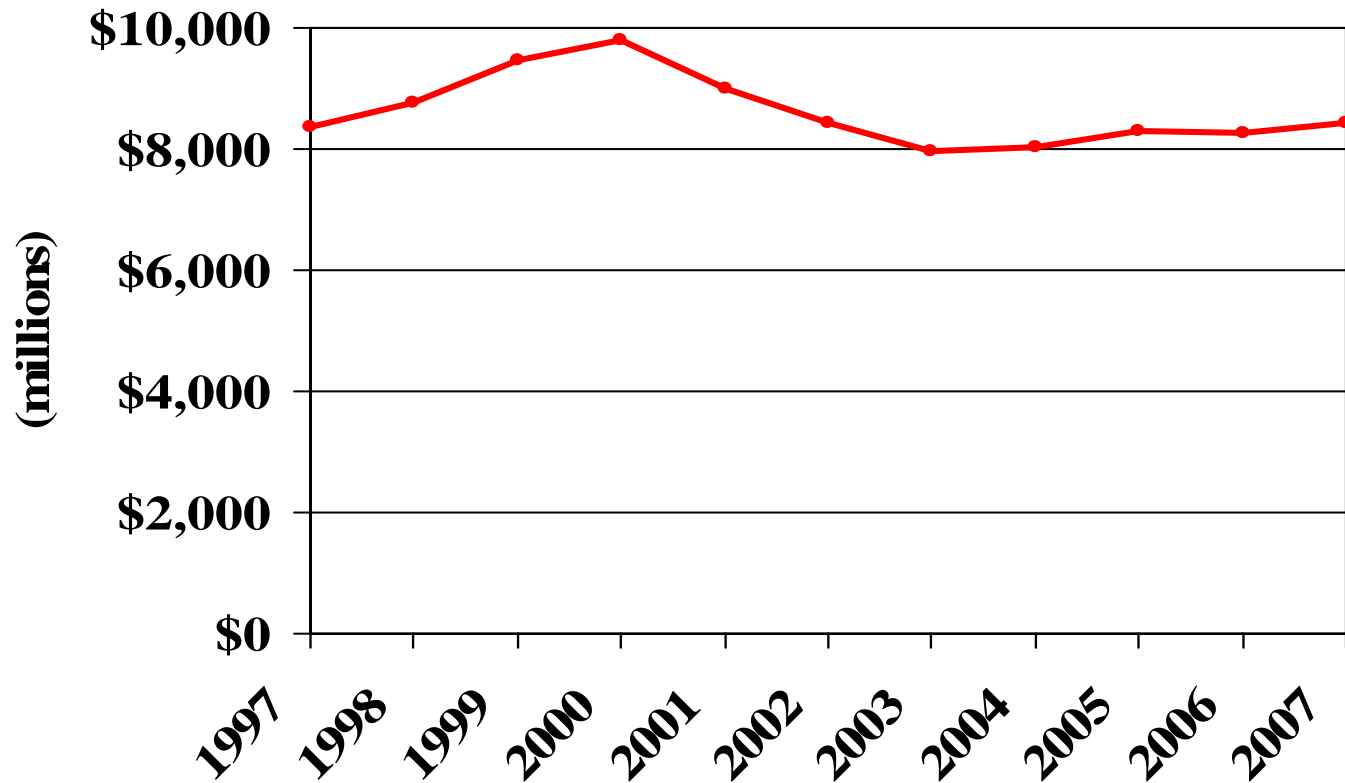
- **Spending and revenue trends extended**
- **Business tax cut assumed, EITC factored into projections**
- **Huge gaps between the cost of maintaining programs and revenues**
- **Gap is \$10 billion in General and School Aid Funds combined**
- **Gap equates to 31% of projected revenues overall—General Fund 50%**



The Michigan Budget How We Spend the Public's Money

- 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

General Fund Revenues Lower Than 10 Years Ago





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%



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 1974¹⁷



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	250
Employee Wage concessions	186
Other	<u>1,443</u>
	\$6,825

Structural Revenue Issues

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

Convergence of Fiscal Forces We Have a Train Wreck

- **Repeal of Single Business Tax**
- **Earned Income Tax Credit**
- **Exploding health care costs**
- **Prison costs outpacing revenue growth**
- **Antiquated revenue structure**
- **Slow economic growth**



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%)

SBT: The Remaining Work Ahead

- **What will replace the revenues?**
- **New taxes on business?**
- **Individuals?**
- **Full or partial replacement?**
- **\$500 Million revenue cut?**
- **Where will budget cuts occur?**
- **Nearly 30% of businesses pay no SBT (41,000)—45% below \$1000 in liability**
- **Potential for plenty of losers**

The Earned Income Tax Credit

- **Refundable tax credit for low-income individuals and families**
- **Effective for 2008 tax year initially and fully effective for tax year 2009**
- **FY2009 revenue impact \$136 million**
- **FY2010 revenue impact \$310 million**

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**

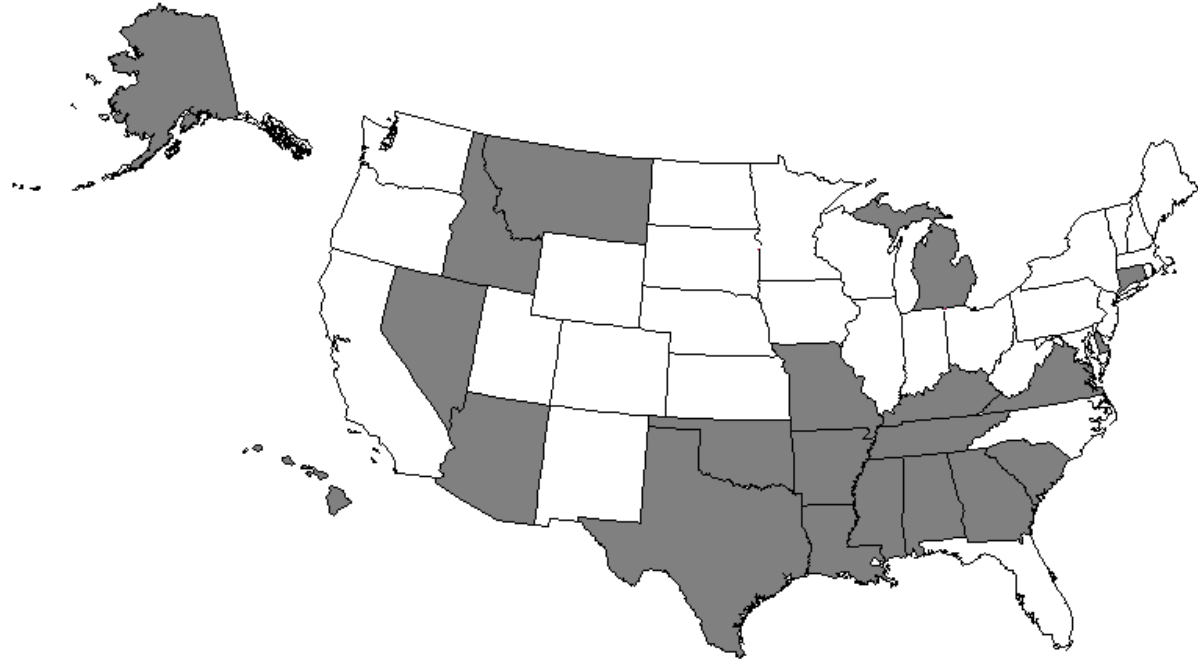
Medicaid

- **Medical care for one in seven Michigan citizens**
- **Future spending growth pressures 8 to 9 percent 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 percent of state employees
- Nearly 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

States With More Than 500 Prisoners Per 100,000 Residents



Corrections Projections

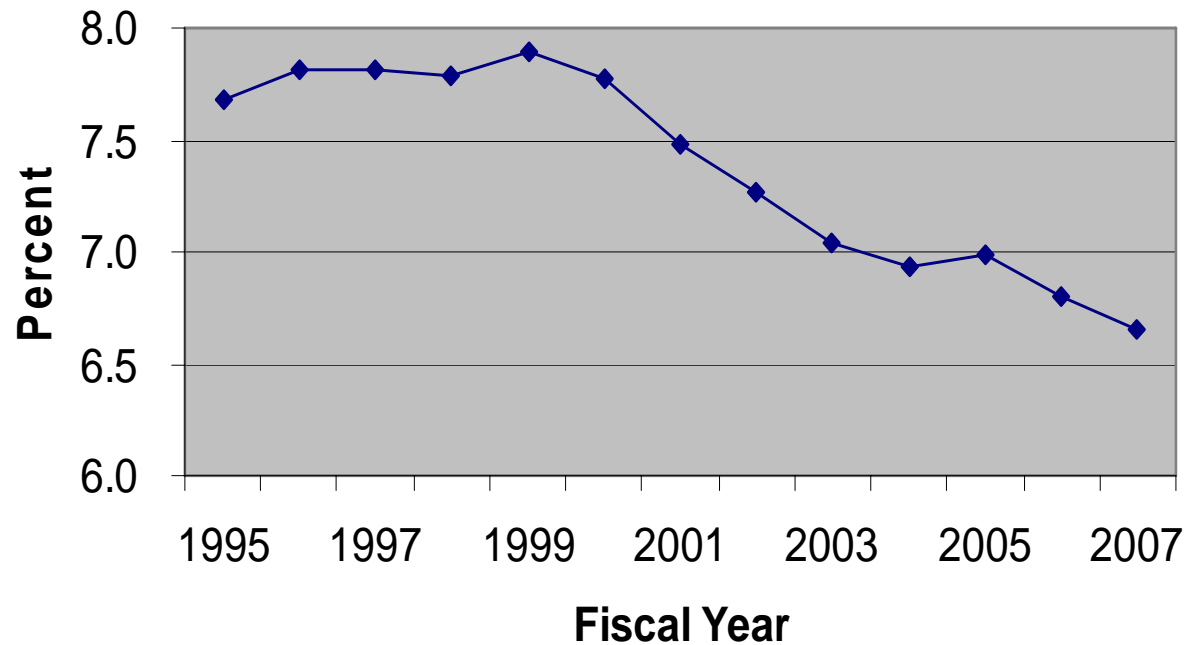
- **Crime rates falling but prison population pressures continue to increase**
- **Populations projected to increase 1,000/ year until 2010 (if current policies continue)**
- **Annual cost increases about \$80M**
- **Annual increases about 7%
—Twice as fast as revenues will grow**

Revenues

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

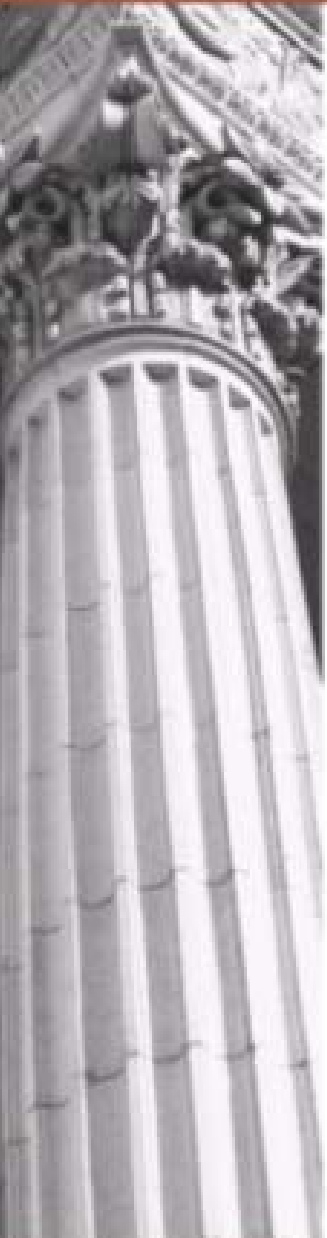


State Taxes as a Percent of Michigan Personal Income

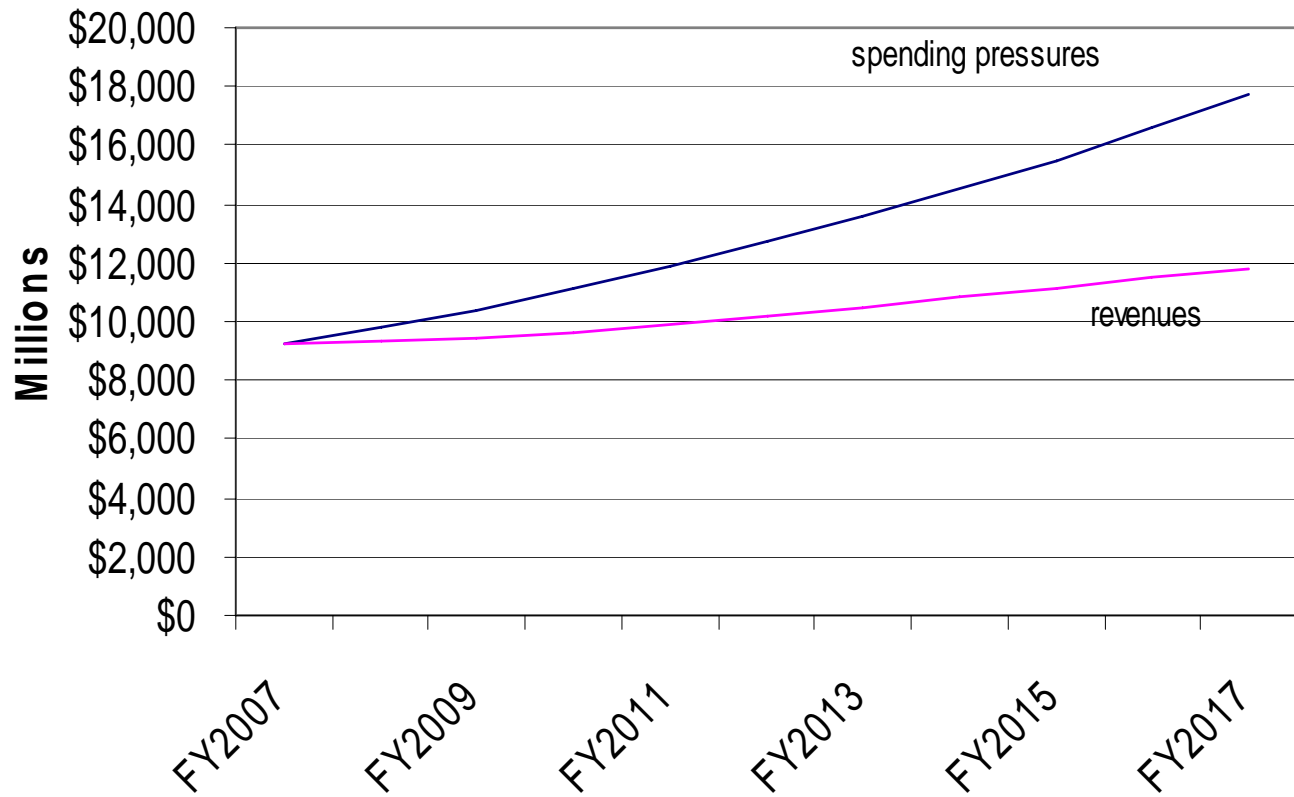


Constitutional Revenue Limit

- **FY1995—State revenues at the limit (9.49% of Personal Income)**
- **FY2007---State revenues 15% below the limit (8.09% of Personal Income)**
- **Difference equals \$4.7 billion**



General Fund Structural Deficit Projections

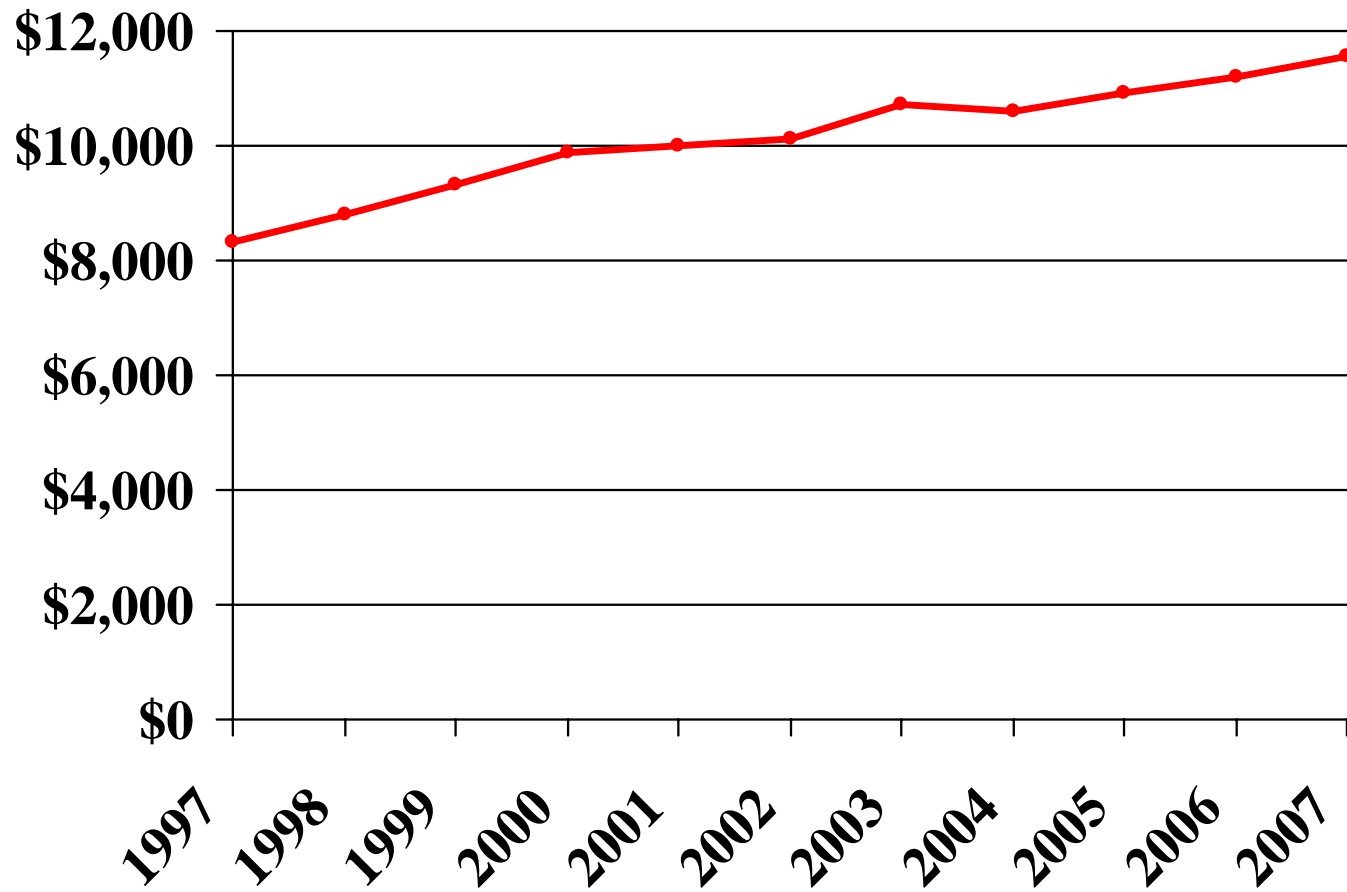


School Aid Fund

- Revenues earmarked exclusively for public schools
- FY2007 forecast \$13.0 billion
- Slow growth in revenues since FY2000
- Main Sources of Revenue:
 - Sale and Use Taxes- \$5.6 Billion (43%)
 - Income Tax- \$2.1 Billion (16%)
 - State Education Property Tax- \$2.1 Billion (16%)
 - Other Revenues Include Lottery, Cigarette, Federal

School Aid Fund Revenues

(in millions)



State-Local School Finance Relationship

- Amounts of total revenue for each district determined by the State pursuant to State law and appropriations
- School Aid revenues and total local operating property taxes determine the amount the State can “Afford”
- Local school operating property taxes subtracted from the total to determine State payments to district
- School Districts cannot levy operating taxes
- Districts pay retirement contributions as a flat percentage of payrolls

FY2007 Spending Pressures

- Retirement—Increases 16.34% to 17.74% —about \$80 per pupil on average
- Employee Health Insurance averages about \$1200 per student likely will rise by more than \$50 per student
- Pay and Step Raises cost nearly \$60 per student on average—4% = \$240 per student
- Other—Fuel, Utilities, Supplies—\$50 per student
- Total could exceed \$400 per student
- Not enough growth in total School Aid resources (\$230) to cover all cost pressures

General Fund Spending Pressures Spill Over to School Aid

- **General Fund support down \$357 million since FY2000**
- **FY2007 reduces grant to “Irreducible Minimum”**
- **Shifts of spending to School Aid Fund in FY2007 Appropriations- \$63 Million**
- **Total Effect- \$420 million (\$250 per pupil)**
- **Will Higher Education be next?**

Revenue Performance Since May

- **Most Major School Aid Fund Taxes Performing Below Forecasts**
- **Surplus Originally Projected for FY2006 (\$95 Million--\$55 Per Pupil)**
- **Surplus to be Used to Pay For Part of FY2007 School Aid**
- **FY2006 School Aid Fund Deficit Likely**

Effects on FY2007 School Aid Budget—Action Required Soon

- Lower FY2006 base to grow from in FY2007
- Delay in beginning of growth and acceleration projected
- No FY2006 surplus
- Midland property tax appeal cases--\$61 million
- Total problem for FY2007 could be more than \$200 per pupil

Possible Actions to Deal With Revenue Shortfall

- Pro-rata reductions
- Revenue increase as part of business tax restructuring?
- Is there another rabbit in the hat? (e.g. collect all or some of the 18 mills in summer)

School Aid Outlook Beyond FY2007

- **Moderate Revenue growth (\$340 Per Pupil)**
- **Revenue growth rate below general economy**
- **Annual State revenue increases about 3%**
- **Not enough growth to match spending pressures**

School Aid Structural Deficit

Spending Pressures Outpace Revenue Growth

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

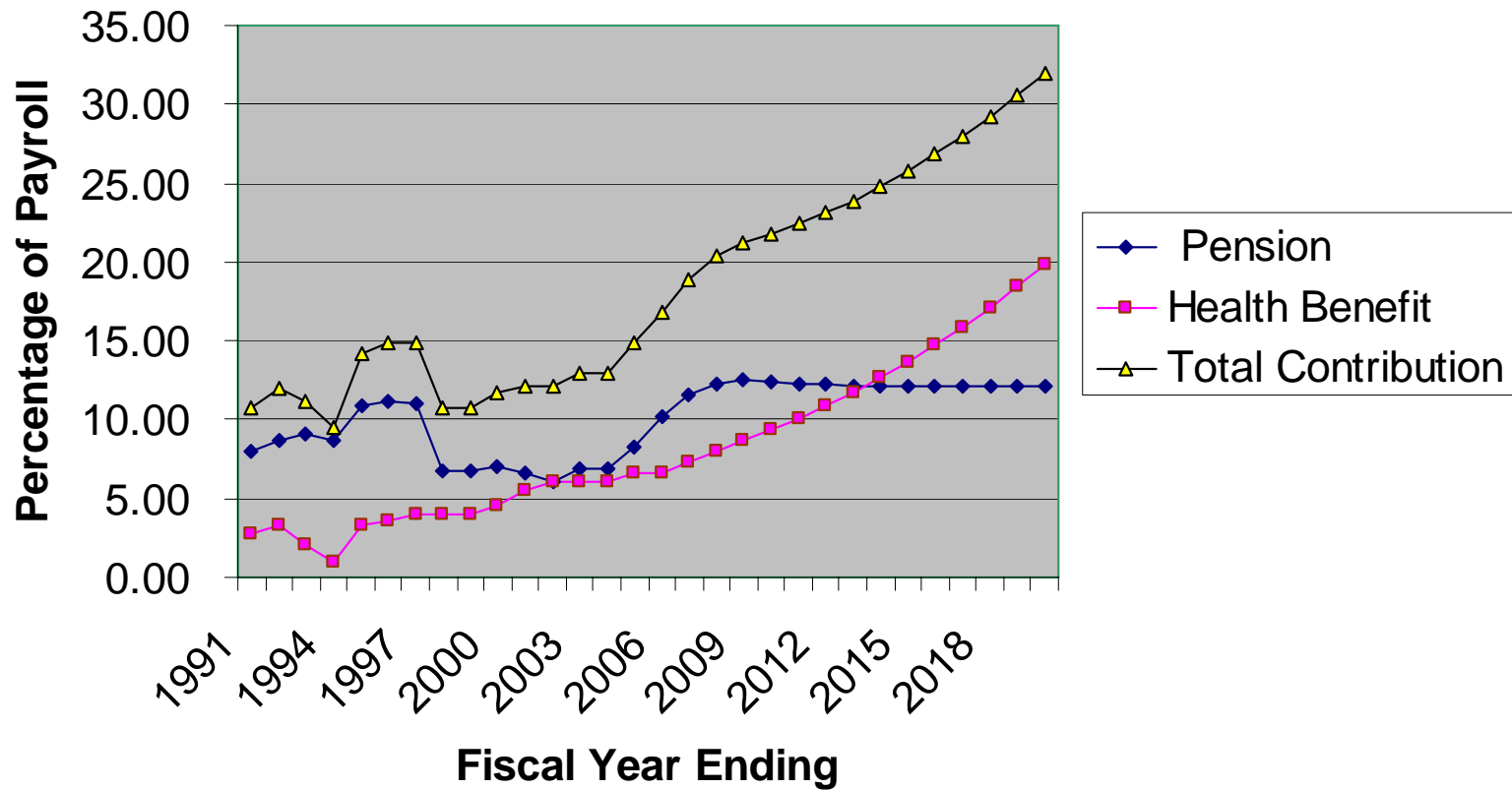
School Retirement Funding

- School Districts pay contributions for employees
- Rate for FY2007 17.74% of Payrolls
- Proposal 05 would cap school district payments
- Contribution rate composed of two parts
 - Regular Pension Benefit
 - Health Care Benefits
- Both parts will continue to increase in the future



MPSERS Contribution Rates

Fiscal Years Ending 1991 Through 2020



Financial Significance

- School District contributions exceeded \$1.35 billion in FY2005
- Costs will likely average \$1000 per student in FY2007
- Incremental increases exceed \$90 per pupil after FY2008
- Rising contribution rates will continue to claim significant share of future revenue increases

Employee Health Insurance

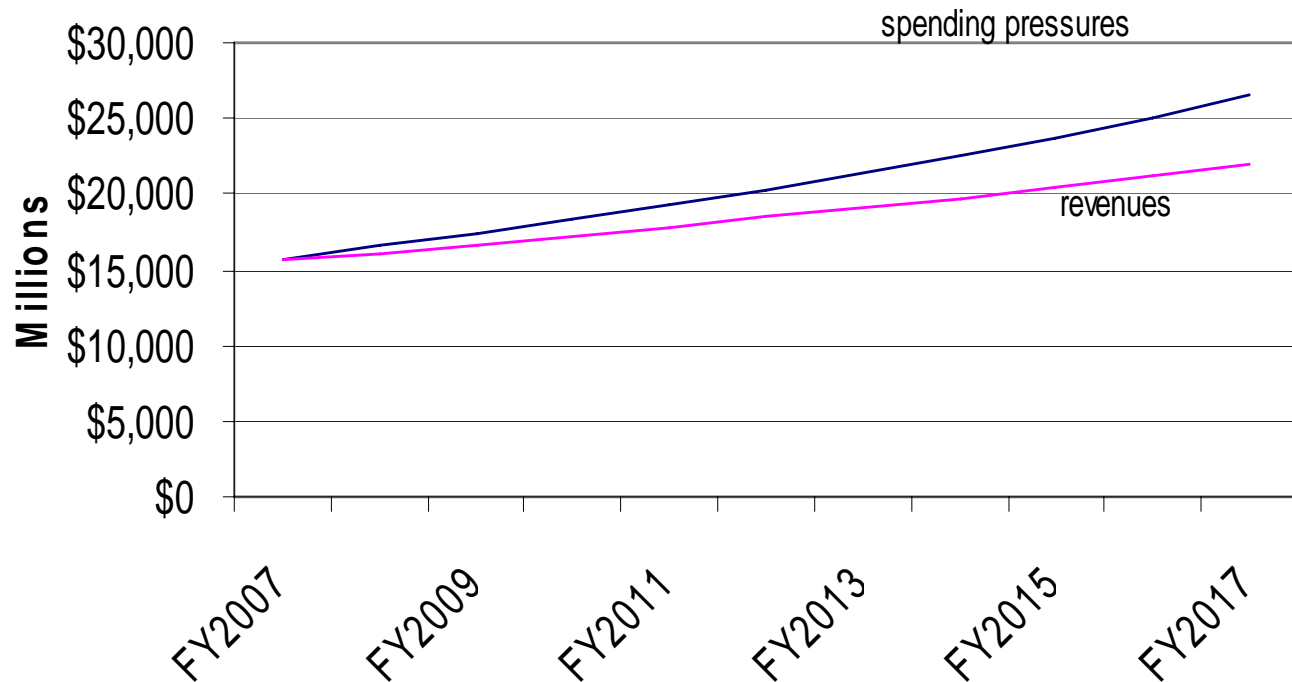
- Double-digit premium increases recently
- FY2007 increases moderated
- Schools spend over \$1200 per pupil on Health Insurance Premiums
- Annual increases could exceed \$100 per pupil

School Aid Numbers —FY2008 and Beyond

- Revenues grow about \$340 per pupil per year
- Spending Pressures and “Requirements”
 - Retirement- \$90+
 - Health Insurance- \$100+
 - Salaries and Wages (4%)- \$240+
 - Fuel, Utilities, Etc.- \$50+
- Structural Deficit Nearly \$150 per pupil (about 2%)
- Recession Widens Gap to 4% or More



School Aid Structural Deficit



Structural Deficits Require Structural Changes

- Expenditures
 - Retirement Costs—Retiree Health Care
 - Health Insurance
 - Change Programs
- Revenues
 - Broaden Base of Sales and Use Taxes
 - Eliminate Some Tax Expenditures

Retirement Changes Being Considered in Lansing

- Earn retiree Health Benefits based on years of service
- Defined Contribution program for pension benefits
- Both changes would likely only affect new employees
- Financial effects would be negligible at first

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 percent) faster**
- **Growing out problem through accelerated revenue growth not likely without changing the revenue structure**

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

How to Fix It: Possible Big Changes

Spending

- Reduce prison populations
- Reduce number of higher education institutions
- Eliminate selected health benefits and eligibility
- Eliminate remaining state aid to local government

Revenues

- Sales Tax on services
- Modify Personal Income Tax—increase exemption and raise rate



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