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State Budget Notes

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Michigan's Budget Problems – Time for Permanent Solutions?

As the presentation of the Governor's Fiscal Year 2003 budget proposal nears, it is appropriate to examine some of the financial challenges confronting the state. The combination of a weakening economy, the significant use of one-time budget balancing measures in both FY2001 and FY2002, and future reductions in major taxes already enacted into state law has created FY2003 revenue shortfalls in the State's two largest funds: the General Fund and the School Aid Fund. In order to bring those funds back into operating balance, difficult actions will have to be considered including reducing spending, reallocating revenues presently used for other purposes to help support ongoing programs, using additional one-time actions to help manage the problem over a 2- or 3-year period or longer, and possibly postponing or eliminating future tax cuts already in state law.

Of all the taxes, fees, and other state-raised revenues, about ¾ are allocated to the General and School Aid Funds. These funds receive most of the major taxes and are the most vulnerable to the business cycle. The weakening economy and the shock of the September 11 tragedy have driven state revenues significantly below the levels initially predicted when the FY2002 budget was approved. Most of the budget-balancing actions taken to date are not available to use year after year. Consequently, very large gaps between the spending base in each fund and the revenue stream have opened up. Eventually, revenue growth should bring revenues to the level of current spending, but it could take 2 years or more for the School Aid Fund and potentially many more years for the General Fund.

General Fund

Table 1 summarizes the FY2002 budget and revenue situation and provides summary information for FY2003. The revenue projection for FY2003 is the forecasted rate of increase in General Fund revenue made by the University of Michigan's Research Seminar in Quantitative Economics (RSQE) applied to the State's consensus FY2002 fore-

Table 1

General Fund-General Purpose Budget Summary
Fiscal Years 2002 and 2003
(In millions)

	FY2002	FY2003	
Estimated Revenues	$8,808	$9,092	
Incremental FY03 Cost of Enacted Tax Cuts		(303)	
Incremental FY03 Cost of Federal Tax Reform		(86)	
Available Revenues	$8,808	$8,704	
Estimated FY02 Appropriations	$9,615	$9,615	
Executive Order Reductions-Permanent	(250)	(250)	carry over gaps
Increased Bond Interest		45	
Required State Match for Medicaid		75	
One-time Budget Adjustments	(402)		
Rainy Day Fund	(155)		
Adjusted Budget	$8,808	$9,484	
Projected Budget Balance	(0)	(781)	
Operating Budget Gap	(557)	(781)	

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cast. RSQE is predicting a gradual economic recovery beginning early in 2002. This translates to a revenue increase of only about 3 percent before the effects of scheduled tax cuts and federal tax reform are factored into the estimates. After allowing for these impacts, revenues decline by about $100 million on a year-to-year basis to a level lower than even the FY1998 revenues….4 years previous.

The spending figures used for FY2003 are the projected FY2002 appropriations adjusted to reflect FY2002 Executive Order reductions that can be made permanent in FY2003. Two additional budget requirements are added: (1) bond interest and principal resulting from converting some major capital projects from pay as you go to bonding to help close the FY2001 budget gap and (2) additional state match for the Medicaid program required to maintain the program at its FY2002 spending level.

The FY2003 gap is very large, especially since no allowance is made in these figures for general inflation, increases in appropriations for colleges and universities, higher costs for Medicaid and public assistance programs, and population increases in Corrections facilities. Spending reductions will likely close a portion of the gap. The challenge will be considerable since about 80 percent of General Purpose spending occurs in the following areas: Higher Education, Corrections, Family Independence Agency (public assistance, juvenile justice services, and family services), and Community Health (public/mental health and Medicaid).

Revenue adjustments may also become part of the solution. Possibilities include reallocation of tobacco settlement funds to general spending, postponement of scheduled tax cuts, use of Medicaid special reimbursement revenues to temporarily support the Medicaid program, and other revenues such as increases in General Purpose revenues resulting from continuing FY2002 General Revenue Sharing reductions into FY2003 and possibly beyond. The Rainy Day Fund will have about $500 million in it at the end of FY2002. However, long term commitments from the fund for the state's settlement of a court case and for Transportation bond debt service will require that significant funds remain in the fund for these and cash-flow needs. Table 2 lists some of these actions with ranges of potential impact on the gap.

Ideally, the General Fund gap would close during an economic recovery. However, with the scheduled tax cuts and the negative impact of Federal tax reform on State revenues, base revenues[1] need to grow about four percent before net revenues increase at all. This situation will continue until after FY2004, when the last reduction in the individual income tax rate is scheduled to occur (January 1, 2004). Therefore, it will take a fairly robust recovery before growing out of the gap is a significant consideration.

School Aid Fund

Table 3 summarizes the FY2002 School Aid budget and provides information for FY2003. The methodology used for the revenue projections is the same as for the General Fund, using the RSQE forecasted rate of growth for FY2003. Unlike the General Fund, School Aid was spared reductions in spending in the Executive Order (except for the Golden Apple Award which was cut $7.2 million (90 percent)). One-time resources covered the revenue shortfall and the operating gap exceeds $800 million.

Table 2

Potential General Fund Budget Balancing Actions
(In millions)

Tobacco Settlement Revenues	$100-200
Medicaid Special Reimbursement Revenues	60-100
Continue FY2002 General Revenue Sharing Reductions	68
Postpone January I, 2003 Income Tax Cut	135
Postpone January I, 2003 Single Business Tax Cut	93
Rainy Day Fund Withdrawal	0-200
Expenditure Reductions	??

[1] Base revenues are the revenues before any changes in the rates or defined bases of the state's taxes.

Since there are no significant tax cuts scheduled for School Aid Fund taxes, the prospect of growing revenues to eventually close the gap is more promising than for the General Fund. However, the RSQE forecast for School Aid revenue growth is only about 3 percent in FY2003 and a commitment made before the budget difficulties began, to increase the per-pupil foundation allowance from $6,500 to $6,700, must be considered.

The use of one-time budget balancers to permit revenues to "catch up" with spending will likely receive attention. Some of the potential actions identified for the General Fund could be considered for the School Aid Fund creating competition between these two key areas of the budget. Tobacco settlement revenues are currently allocated, in part, to Merit Scholarships and advocates for School Aid might argue that any reallocation affecting these scholarships should benefit education. Also, there is a limit as to how much Rainy Day Fund money can be used in total, so competition between the two funds is likely.

Other significant one-time resources could be derived by moving the collection date from winter to summer for local school operating taxes and/or the State Education Tax in districts not already collecting 100 percent of these taxes in the summer. These revenues could cross from FY2004 to FY 2003 creating one-time revenue gains to help manage closing the gap. The impact of the potential change in the timing of the State Education Tax collection is roughly $700 million. Another timing action that could create significant one-time budget benefits is delaying part or all of the August State School Aid payment until after October 1, into the beginning of the state's next fiscal year but still in the same fiscal year for all school districts. This potential change could yield a one-time budget benefit of roughly $1 billion.

Summary

It is clear that a multi-year approach will be needed to manage baseline revenues and get spending back into balance. It seems appropriate that the participants in the process—those allocating the resources and those dependent on those resources to operate public programs—should work cooperatively to devise and implement the solutions to the problem.

Table 3

School Aid Fund Budget Summary
Fiscal Years 2002 and 2003
(In millions)

	FY2002	FY2003
Estimated Base Revenues	$10,189	$10,505
Federal Revenue	205	205
GF-GP Grant	206	206
Rainy Day Fund-Durant Settlement	32	32
Prior Year Fund Balance	493	
Rainy Day Fund Withdrawal	327	
Available Revenues	$11,451	$10,948
Estimated FY02 Appropriations	$11,458	$11,458
Executive Order Reductions-Permanent	(7)	(7)
Foundation Allowance Increase to $6,700		253
Adjusted Budget	$11,451	$11,704
Projected Budget Balance	0	(756)
Operating Budget Gap	(820)	(756)

carry over gaps

This State Budget Notes accompanies a PowerPoint presentation. To view that presentation, go to www.crcmich.org/publicat/2000s/2001/FiscalUpdate/index.htm