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# State Budget Notes

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## A Recap of the FY04 Budget and a Look Ahead to FY05 and Beyond

### Introduction

Substantial completion of the Fiscal Year 2003-04 (FY04) budget by the Legislature in mid-July defied predictions that the budget debate would run until September or beyond. The budget contains significant elements of the Governor's original budget proposal and major features of legislative priorities. It made substantial progress in closing the gap between baseline revenues and spending, but still uses one-time resources of over $700 million. A revision in the consensus revenue estimates on October 14 throws the General Fund and School Aid Fund budget into deficit and budget balancing actions will be needed in the few weeks following the revisions. The FY05 revenue growth in the General Fund will not be sufficient to replace the one-time resources used in the FY04, let alone restore the gap between FY04 revenues and appropriations. The resulting spending constraints will be severe. The School Aid situation is relatively less serious than the General Fund, but revenue growth, after covering the loss of one-time resources, will not likely be sufficient to permit FY05 appropriations to exceed the FY04 appropriations, before any spending cuts are made to balance the budget.

(At this writing the Capital Outlay appropriations have not been passed by the Legislature.)

### Fiscal Year 2004 Budget

#### Executive Budget

In March, the FY04 Executive Budget was presented to the Legislature. The General Fund faced a $1.7 billion revenue shortfall, while School Aid revenues were $365 million short. The combined gaps, over $2 billion, were nearly 10 percent of the projected FY03 spending levels for the two funds combined. These gaps had resulted from three years of spending in excess of baseline revenues and the exhaustion of approximately $4.5 billion in reserves and one-time revenues.

The Governor's budget proposal relied primarily on spending reductions to close these gaps. Revenue enhancements derived from recommended fee increases and tax policy changes (described as closing tax loopholes) provided additional resources to help balance revenues and spending. These proposed changes accounted for about one-eighth of the overall solution. One-time revenue resources, which permit postponing a portion of the problem to future fiscal years, totaled $340 million, temporarily covering about one-sixth of the problem. Approval of the Executive Budget as proposed would have eliminated most of the state's structural deficit and left FY05 as an austere budget year with essentially no additional revenues available to cover higher costs and increases in numbers of people served by various programs.

#### Legislative Response

The original General Fund Executive Budget proposal contained several elements that were unacceptable to the Legislature. Significant among these were:

- *Reduction in the Merit Scholarship Award amounts from $2,500 to $500 per student*. The budgetary savings, about $65 million, were to be allocated to the Medicaid to mitigate reductions in health-care programs for the poor. The federal financial assistance program described on page 3 permitted the FY04 budget to adopt the Governor's recommended Medicaid program and retain the Merit Award program.

- *Tax policy changes referred to as "Closing Tax Loopholes*." The proposed changes would have produced about $109 million for the General Fund and $20 million for School Aid. The legislature approved changes producing about $19 million in total ($15 million General Fund and $4 million School Aid Fund).

- *Elimination of the General Fund grant to the School Aid Fund and replacement with one-time revenues resulting from an accounting change in the revenue sharing program for local units of government*. By eliminating a reserve established each year as the books were closed and placing


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the program on a pay as you go basis, $196 million of one-time revenues are made available in FY03 to carry forward to FY04.

• *Elimination of funding for new road construction projects in order to concentrate on maintenance of existing roads*. (While the Transportation budget does not rely on the General or School Aid Funds, the issue became an important area of difference requiring resolution.)

Although General Fund appropriations exceeded the Executive Budget proposal by $296 million, most of the difference was accounted for by the Legislature not accepting the Governor's proposal to eliminate the General Fund grant to School Aid. The prospect of having to find a General Fund replacement in FY05 probably influenced many legislators to maintain current practice. The final appropriations are $86 million above the original FY03 General Fund grant, presumably to cover most of the $106 million decline in the School Aid Fund revenue estimate determined at the May Consensus Revenue Estimating Conference. In the School Aid appropriations, the Legislature also added $51 million to the FY03 General Fund grant to avoid pro rata spending reductions that would have been triggered by the consensus revenue reductions for FY03.

## Enacted Budget

**General Fund.** The enacted FY04 General Fund appropriations total $8.9 billion, about $80 million, or nearly one percent, higher than the projected FY03 spending. Baseline revenues total less than $8.2 billion, up $75 million, or about one percent, higher than projected FY03 revenues.

**Table 1** summarizes the FY04 proposed solutions to closing the gap between spending needs and revenues compared with the methods used in the final enacted budget.

**School Aid.** The enacted FY04 School Aid appropriations total $12.6 billion, about $50 million, or one-half percent, higher than the projected FY03 spending. Baseline revenues total less than $12.4 billion, up nearly $400 million, or about 3 percent, higher than projected FY03 baseline revenues. The total increase in resources is only $33 million, owing to about $700 of one-time revenues supporting the FY03 appropriations versus $137 million in FY04.

The Governor's original School Aid proposal relied more heavily than the General Fund on one-time resources. The use of $196 million in one-time revenues from a change in an accounting procedure plus $100 million in one-time savings from refinancing School Bond Loans permitted the Executive Budget to cover a shortfall, projected at the time, of $365 million while cutting specific spending items by $195 million and funding some relatively small required increases.

**Table 1**
**Closing the Fiscal Year 2004 General Fund Gap**
**(in millions)**

| | Executive Budget | Enacted Budget |
|---|---|---|
| Projected Spending Requirements | $9,892 | $10,072 |
| Projected Revenues | 8,192 | 8,159 |
| Total Gap | ($1,700) | ($1,913) |
| **Measures to Close Gap** | | |
| Spending Reductions | $937 | $904 |
| Fee Increases & Other | 182 | 226 |
| Tax Policy Changes | 109 | 15 |
| Corrections Policy Changes | 122 | 122 |
| Eliminate School Aid Subsidy | 198 | |
| Revenue Sharing Accounting Change | | 196 |
| Continue Past Revenue Sharing Cuts | 152 | 146 |
| Federal Revenues | | 305 |

**Table 2**
**Closing the Fiscal Year 2004 School Aid Fund Gap**
**(in millions)**

| | Executive Budget | Enacted Budget |
|---|---|---|
| Projected Spending Requirements | $12,638 | $12,703 |
| Projected Revenues | 12,273 | 12,264 |
| Total Gap | ($365) | ($439) |
| **Measures to Close Gap** | | |
| Spending Reductions (net) | $195 | $187 |
| Tax Policy Changes | 20 | 4 |
| New Lottery Games | 50 | 50 |
| School Bond Loan Refinance | 100 | 128 |
| Additional General Fund Grant | | 33 |
| Additional Other Revenue | | 37 |

The appropriations exceeded the executive proposal by $118 million. The differences between the Executive Budget and the legislative School Aid Fund appropriations were less significant than in the General Fund. Perhaps the most significant issue was whether the General Fund grant to School Aid would continue. While the Governor's proposal provided one-time replacement funding for FY04, it did not address the issue of where FY05 funding would be found. That vulnerability turned out to be unacceptable to the Legislature. **Table 2** lists the FY04 proposed solutions to closing the gap between spending and revenues compared with the actions included in the final enacted budget.

## Midcourse Adjustments

Complicating matters was a downward revision in May of projected FY04 revenues for both the General and School Aid Funds. The reductions totaled $139 million making the process of compromise and accommodation all the more difficult. Then a federal *deus ex machina* provided a temporary means to resolve the differences without additional difficult compromise. The rescue came in the form of a two-year fiscal relief package for the states totaling $20 billion. The money is divided approximately equally between Medicaid and unrestricted aid, and Michigan stands to receive $655 million over the two-year period FY03 and FY04.

In addition, a package of fees affecting drivers in various ways provided $87 million to the General Fund, an amount roughly comparable to the proposed tax policy changes not approved by the legislature ($94 million). The additional resources accommodated some of the major differences and provided for higher caseloads in the Family Independence Agency and the Medicaid program, with enough left over to permit a modest reserve to be set up in the School Aid Fund and a small deposit to be made to the Rainy Day Fund.

**Table 3** summarizes the components of General Fund revenues supporting General Fund appropriations.

**Table 3**
**Fiscal Year 2004 General Fund-General Purpose Revenue Components**
**(in millions)**

| | Original Proposed Budget | Appropriated Budget |
|---|---|---|
| Beginning Balance | $ 0.0 | $ 360.6 |
| Consensus Revenues (May Consensus)* | 8,158.7 | 8,158.7 |
| Revenue Sharing Reductions* | 245.4 | 245.4 |
| Tax Policy Changes ("Loopholes") | 108.6 | 12.1 |
| Unrestricted Federal Aid | | 169.0 |
| Federal Tax Reform | | (34.5) |
| Federal Unemployment Insurance Change | | 8.0 |
| Bad Driver Fees | | 65.0 |
| Drivers License Fees | | 25.9 |
| Other Misc. | 22.6 | 22.8 |
| **Total Revenues** | $8,535.3 | $9,033.0 |
| Recommended Spending/Appropriations | $8,591.2 | $8,886.8 |
| **Ending Balance** | ($ 55.9)* | $ 146.2 |

* The deficit projected in this table reflects the downward revision in the revenues occurring at the May consensus conference. The Executive Budget proposal was in balance with the consensus revenues at the time of presentation.

## Summary of the Enacted Budget

As passed by the Legislature, both the School Aid and General Fund budgets spend more than the Executive Budget proposal and together make less progress in closing the state's structural deficit than the Executive Budget would have accomplished. General Fund spending for FY04 exceeds the baseline revenues by $405 million and the Medicaid budget contains $168 million of the temporary federal support. The School Aid appropriations spend $150 million more than baseline revenues and are supported in part by a $282 million grant from the General Fund, an increase of $84 million from the FY04 grant. The two funds together will spend more than $700 million or about 3.5 percent in excess of baseline revenues. The percentages are quite different for the individual funds with the General Fund nearly 7 percent out of structural balance and the School Aid Fund just over one percent short.

Several of the significant features of the proposed solutions to the structural gaps were incorporated by the Legislature into the appropriations:

- *Higher education* appropriations were cut an average of 6.7 percent, bringing the two-year reduction in funding to 10 percent. In total, higher education appropriations were cut $127 million, bringing the two-year total to $211 million.

- *Unrestricted revenue sharing* to cities, villages, townships, and counties retained previous cuts and reflect an additional cut of 3.5 percent from FY03. Since about half of revenue sharing funds are constitutionally protected, all of these reductions fell on the statutory portion of the program. Payments for the statutory program in FY04 will be about $245 million, or 25 percent, less than the amounts state statute allocate to that program from the sales tax.

- Projected increases in the *Corrections* budget were controlled and policy changes achieving the $122 million savings included in the Executive Budget are reflected in the appropriations. A new conditional reintegration program that places selected parole-eligible prisoners in non-prison setting immediately prior to parole reduces needs for new prison beds by 750. Also generating savings are two new community-based programs to provide lower cost options to prison for low-level felons.

- Appropriations for *employee compensation* generally reflect the amounts in the Executive Budget. Those calculations assumed concessions would be negotiated with the employees to offset:

  - Costs of a pay raise negotiated by the prior administration;

- Higher retirement contributions rate necessitated by weak investment returns, medical insurance costs for retirees, and the 2002 early retirement program; and

- Higher group insurance premium costs for current employees.

The amounts involved, $250 million in total, $140 million from the General Fund have not yet been covered by concessions and layoffs seem likely. The total number of jobs at stake could reach 3,000. Only a little over a third of the amount is directly related to the pay raise alone with increased retirement contributions and insurance premiums accounting for the other two-thirds.

- The budget proposed $119 million from increases in *fines and fees* intended to replace General Fund financing for use in other programs and the Legislature approved virtually all of the proposals.

- Proposals in the *Medicaid* program to leverage additional federal funds and reduce costs by constraining benefits to healthy adults were largely followed. Also included were savings in pharmaceutical purchases achieved through multi-state purchasing collaborations.

## Further Adjustments Needed in the FY04 Budget

As has been the case since FY00, the timing and strength of the projected economic recovery might make all other issues pale by comparison. Michigan's economy and revenues continue to exhibit no significant bright spots. While there are signs of improvement in the national economy, manufacturing remains weak nationally and remains a critical factor for the state economy.

On October 14, the state held a special consensus revenue estimating conference and the principals agreed on new revenue estimates for FY03 and FY04. The reductions in both years put the General and School Aid Funds out of balance for FY04 and actions to deal with the revenue shortfall will be required.

The reductions in the estimates for FY03, which ended two weeks before the conference, create a deficit in the School Aid Fund that either will carry over into FY04 and absorb revenues from that year or possibly be covered by a supplemental appropriation from the General Fund if a sufficient fund balance is available at year-end. Regardless of how the School Aid revenue shortfall is handled, the revenue revisions have the effect of absorbing the projected $360 million FY03 General Fund surplus, which was to be used to help pay for FY04 appropriations and fund modest contributions to the Rainy Day Fund and a new School Aid Rainy Day Fund. Instead of a balanced budget for FY04 in both funds, a combined shortfall of $925 million results from the revisions. **Tables 4 and 5** summarize the effects of the October consensus estimates compared with the May figures.

Spending reductions after a fiscal year has already begun are especially difficult, since they must be achieved over a shorter period of time. In the case of state programs, it is likely that reduction actions could not be in place and fully working any sooner than December and possibly beyond. Public schools operate on a July-June fiscal year, so they are already more than three months into their fiscal year and probably will have to achieve the necessary budget adjustments, in some cases including the expenditure of available fund balances, in the second semester of the school year.

The revenue shortfall in the General Fund triggers the Executive Order spending reduction process, a constitutionally defined mechanism for reducing spending. In the case of School Aid, the appropriations act specifies that spending reductions necessitated by a revenue shortfall are made by equal per-pupil reductions in state aid. It is likely that attempts will be made to spare the foundation allowance from any reductions. However, if School Aid is actually cut by $342 million in FY04, categorical programs other than Special Education total only a little over $600 million and would have to be decimated to avoid cutting the foundation allowance.

Although revenue increases offer another way of handling the shortfalls, including a supplemental to School Aid from the General Fund, recent history indicates that this alternative has not received much support. The most obvious possibility is the final 0.1 percentage point reduction in the Personal Income Tax scheduled to occur January 1, 2004. Although postponing or eliminating the rate reduction produces about $110 million, it would represent a relatively

**Table 4**
**The Effects of the October Consensus Revisions on the General Fund**
**(in millions)**

| Fiscal Year 2003 | May Consensus | October Consensus |
|---|---|---|
| Beginning Balance | $114.5 | $114.5 |
| Baseline Revenues | 8,083.8 | 7,885.2 |
| Revenue Sharing Reductions | 146.2 | 146.2 |
| Other One-time Sources | 823.1 | 753.0 |
| Estimated Revenues | $9,167.6 | $8,898.9 |
| Estimated Spending | 8,807.0 | 8,807.0 |
| Estimated Year-end Balance | $360.6 | $91.9 |
| **Fiscal Year 2004** | | |
| Beginning Balance | $360.6 | $91.9 |
| Baseline Revenues | 8,158.7 | 7,785.4 |
| Revenue Sharing Reductions | 245.4 | 213.3 |
| Bad Driver and Driver License Fees | 90.9 | 90.9 |
| Other Sources | 191.8 | 246.9 |
| Projected Revenues | $9,047.4 | $8,428.4 |
| Projected Spending | 8,886.8 | 9,011.8 |
| Projected Year-end Balance | $160.6 | ($583.4) |

**Table 5**
**The Effects of the October Consensus Revisions on the School Aid Fund**
**(in millions)**

| Fiscal Year 2003 | May Consensus | October Consensus |
|---|---|---|
| Beginning Balance | $237.0 | $237.0 |
| Baseline Revenues | 10,311.0 | 10,232.0 |
| General Fund Grants | 249.4 | 249.4 |
| Federal Aid | 1,219.8 | 1,219.8 |
| Other One-time Revenues and Adjustments | 487.2 | 462.2 |
| Estimated Revenues | $12,504.4 | $12,400.4 |
| Estimated Spending | 12,503.1 | 12,503.1 |
| Projected Year-end Balance | $1.3 | ($102.7) |
| **Fiscal Year 2004** | | |
| Projected Beginning Balance | $1.3 | ($102.7) |
| Baseline Revenues | 10,749.0 | 10,527.3 |
| General Fund Grant | 282.1 | 282.1 |
| State Lottery Changes | 50.0 | 50.0 |
| Federal Aid | 1,316.7 | 1,316.7 |
| Other One-time Revenues and Adjustments | 137.9 | 137.9 |
| Projected Revenues | $12,537.0 | $12,211.3 |
| Projected Spending | 12,553.4 | 12,553.4 |
| Projected Year-end Balance | ($16.4) | ($342.1) |

small part of the solution to a very large problem.

As the Governor and Legislature approach the budget cutting exercise, they face a far more difficult challenge than forming the FY04 appropriations. The enacted budget already reflects more than $900 million in spending cuts and the use of significant one-time resources, including the federal fiscal relief revenues. **Table 6** summarizes the basic shape of the General Fund appropriations, with over 80 percent of spending falling into four major areas where further reductions will be particularly difficult.

**Table 6**
**Major Components of the General Fund, Fiscal Year 2004**
**(in billions)**

| | | |
|---|---|---|
| Community Health—Mental Health, Public Health, Medicaid | $2.6 | 28.8% |
| Corrections | 1.6 | 18.4 |
| Family Independence Agency—Family Services, Juvenile Justice, Public Assistance | 1.1 | 12.8 |
| Higher Education | 1.9 | 21.6 |
| All Other Programs | 1.6 | 18.5 |
| Total | $8.9 | |

* Numbers do not add due to rounding.

Other concerns in the FY04 budget include caseloads in the Medicaid program and financial assistance programs in the Family Independence Agency. A continuing weak economy lays open to question the caseload estimates upon which the appropriations are based. The $925 million budget gap includes $125 million for a Medicaid supplemental appropriation to finance the higher caseloads. Also, to the extent that employee concessions do not offset scheduled compensation cost increases, a smaller workforce will be the result, likely weakening the effectiveness of program operations. In some areas the State would be forced to provide additional resources to prevent layoffs, the most obvious area being Corrections guards.

## Fiscal Year 2005 Outlook*

Reliance on one-time revenues to support about $700 million of expenditures in FY04 means that the nearly all of revenue growth associated with an expanding economy in FY05 will be needed just to offset the loss of the one-time revenues. The main component of one-time revenues is the federal financial assistance for the states. While the assistance is welcome, its use postpones a portion of needed permanent solutions to future budgets. **Table 7** summarizes the one-time resources supporting FY04 spending. The General Fund, which is significantly smaller than the School Aid Fund, relies on more one-time revenues.

* Using data from the October consensus revenues for FY04, CRC has projected FY05 revenues and has extended into FY2005 the enacted appropriations for FY2004. To the extent permanent that actions are taken to close portions or all of the FY04 deficits, the gaps for FY05 in the following scenarios will be less.

**Table 7**
**Use of One-time Revenues in Fiscal Year 2004 Budget**
**(in millions)**

| | | |
|---|---|---|
| **General Fund** | | |
| Prior Year Fund Balance* | $360.6 | |
| Temporary Federal Unrestricted Aid | 169.0 | |
| Temporary Federal Medicaid Matching Assistance | 168.0 | |
| Other Miscellaneous Sources | 22.8 | |
| Subtotal General Fund | | $720.4 |
| **School Aid Fund** | | |
| Prior Year Fund Balance | 1.3 | |
| School Bond Loan Fund Refinancing | 128.3 | |
| Subtotal School Aid Fund | | 129.6 |
| **Total** | | $850.0 |
| Less: Ending Reserve Balances | | 146.2 |
| **Net Use of One-time Revenues** | | $703.8 |

* The prior year balance is essentially composed of the revenues derived from an accounting change in the revenue sharing program ($196 million) and the unrestricted temporary federal assistance for FY03 ($169 million).

Other items will add and subtract from baseline revenues in FY05. The final 0.1 percentage point reduction in the Personal Income tax rate will reduce revenues in the beginning quarter of the fiscal year by about $43 million (The Personal Income tax rate was reduced over the period January 2000 through January 2003 from the previous rate of 4.4 percent to 4.0 percent in 0.1 percentage point increments and is scheduled to be reduced to 3.9 percent January 1, 2004). Federal tax reform changes will cost the state $55 million as the final installment in the elimination of the Estate tax, which is coupled with the federal Estate tax. On the positive side, since the "Bad Driver Fees" create two-year obligations for the drivers, the second year revenues will be roughly double the first, an increase of $65 million. Finally, although not a General Fund revenue source per se, the federal matching percentage for Medicaid will increase in FY05, netting the state about $60 million at current spending levels, thus lessening the pressure for additional state funds. This is the silver lining in a very dark economic cloud because the increased federal match is a result of Michigan per capita personal income increasing at a rate below the national average, a far more significant factor in the overall fiscal scheme of things.

**Table 8**
**Fiscal Year 2005 General Fund Scenario**
**(in Millions)**

| | | |
|---|---|---|
| FY04 Baseline Revenues | $7,785 | |
| 4 Percent Growth | 311 | |
| Continue Prior Revenue Sharing Reductions | 213 | |
| Tax Policy and Other FY04 Changes | (14) | |
| Bad Driver Fees and Driver License Fees | 156 | |
| Income Tax Rate Reduction | (43) | |
| Federal Estate Tax Elimination | (55) | |
| Net Available Revenues | | $8,354 |
| Projected FY04 Appropriations | | 9,012 |
| Revenue Gap | | ($658) |

## General Fund

Even with an expanding economy, both the General Fund and School Aid budgets will be extremely tight in FY05. **Table 8** displays a scenario that assumes 4 percent growth in baseline revenues over the current consensus revenue estimate for FY04 and factors in other adjustments described above. Under this scenario, revenue growth is insufficient to offset the loss of one-time revenues. Under this scenario revenues fall short of FY04 projected appropriations by $658 million.

Other factors to consider include increased federal match for the Medicaid program ($60 million) and the loss of $135 million of Medicaid special financing revenues. On the expenditure side, reductions may be required in some programs to accommodate growth in others. Examples include the 4 percent pay raise negotiated for state employees in 2001 ($80 million); health care cost increases affecting broad areas in the budget including such areas as employee group insurance premiums, prison inmate health care costs, and the Medicaid program; and increases in prison populations. **Table 9** itemizes several significant pressures on the budget for FY05.

**Table 9**
**Other Non-Revenue General Fund Considerations, Fiscal Year 2005**
**(in millions)**

| | | |
|---|---|---|
| Contracted FY05 Employee Pay Raise | ($80) | |
| Medicaid—Federal Temporary Fiscal Relief Elimination | (168) | |
| Medicaid—Federal Funding Match Increase | 60 | |
| Medicaid—Special Financing Revenue Loss | (135) | |
| Corrections Population Increase | (60) | |
| Medicaid Cost Increases | (80) | |
| Higher Education Inflation | (58) | |
| Subtotal | | ($521) |
| Revenue Gap | | (658) |
| Total | | ($1,179) |

## School Aid

A School Aid scenario with the same baseline revenue growth assumption (4 percent) from the FY04 consensus estimate produces revenues slightly below the FY04 appropriations before any spending reductions occurring to balance the FY04 School Aid budget. **Table 10** depicts such a scenario. Without any additional resources, schools will have to cover a combination of higher employer-paid health insurance premiums and an increase in the retirement contribution rate that was postponed in FY04. Other increases such as employee pay raises will add to the financial pressures facing the public school sector making FY05 another year of budget retrenchment.

**Table 10**
**Fiscal Year 2005 School Aid Fund Scenario**
**(in Millions)**

| | | |
|---|---|---|
| FY04 Baseline Revenues | $10,527 | |
| 4 Percent Growth | 421 | |
| Adjustment for One-time State Education Tax Revenues | (29) | |
| Other Adjustments | (3) | |
| Tax Policy Changes and New Lottery Games—FY04 | 54 | |
| FY04 General Fund Grant | 282 | |
| Federal Revenue | 1,317 | |
| Net Available Revenues | | $12,569 |
| Projected FY04 Appropriations | | 12,586 |
| Potential Spending Change | | ($17) |
| Percent Change | | (0.1) |

## Prospects beyond Fiscal Year 2005

Michigan will continue to experience fiscal stress in its two major funds as long as the revenue structure continues to be mismatched with the program responsibilities the state underwrites.

- Health care costs for employees, prison inmates, and over one million Medicaid clients can be expected to grow faster than revenues.

- The state corrections system, the largest program the State operates directly, accounting for more than 30 percent of all state employees, is projected to encounter increasing populations under current state policies.

- Public schools spend about 85 percent of their resources on personnel. Health insurance costs for active employees are paid through group insurance plans and the contribution rate for the Public School Employees Retirement System (PSERS) reflects the recent weak performance of the stock market and the health insurance costs for retired PSERS members. Since there is no pre-funding for retiree health care costs, premium increases feed directly through to the contribution rate paid by the employers.

On the revenue side of the budget equation, the State excludes or misses important areas of economic activity and potential tax base with its two largest areas of taxation: 1) the Sales and Use taxes and 2) Personal Income tax. Perhaps the most significant examples are associated with Sales and Use taxes. Out-of-state sellers, without physical presence in Michigan, are not required to collect Use taxes on purchases by Michigan residents. Although Michigan residents are legally liable for the tax, it is seldom paid and roughly $300 million in state revenues are foregone. A national solution to this situation is underway, but it will likely take several years to eliminate the disparate treatment.

An even larger area is the issue of taxation of services. Few services are taxed directly in Michigan and the services sector is the area of fastest growth in the economy. Thus, the rate of increase in Sales tax revenues is largely dependent on tangible goods purchases from businesses located in Michigan.

If services and remote sales were brought under the Sales and Use tax umbrella and the rates were reduced to make the change revenue-neutral at the point of change, the revenue structure would likely grow more in line with the overall economy in the future and some of the structural pressure would be relieved, while at the same time removing some of the inequity between purchasers of goods and purchasers of services.

Although less significant than the exemption of most services from the Sales and Use taxes, the Personal Income tax exempts most pension benefits taxed by the federal government and the federally-taxable portion of Social Security benefits. These exemptions are estimated to reduce Income tax receipts by roughly $700 million. With the aging of the population, these exclusions from the tax base will likely become relatively more important in the future.

Michigan will likely experience structural pressures in its budget for many years. A revenue base that grows less rapidly than major indices of the economy coupled with spending responsibilities so heavily weighted in areas growing at rates faster than the economy, such as health care and corrections, is a recipe for continuing budget problems. Areas in which the State has some discretion, such as higher education and local revenue sharing, offer a way for the State to relieve some of the pressures by shifting more of the financial responsibilities to the purchasers of higher education – students and parents – and to local taxpayers through cuts in services or higher taxes. Without structural changes in the revenue system, the inescapable alternative involves continued significant reductions in state-funded programs.