

Michigan's Structural Budget Deficit: Its Causes & Prospects for Resolution

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Citizens Research Council of Michigan



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- 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

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The Michigan Budget

- Total State Budget - \$39.1B
- State's Two Major Funds:
 - General Fund - \$8.7B
 - School Aid Fund - \$12.5B
- Other State Funds Restricted for Other Purposes, e.g. Transportation, Federal Revenues
- Over 80% of All Revenues Spent Outside State Government

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Five Years of Budget Problems

- Declining General Fund Revenues
- Slow Growth in School Aid Fund Revenues

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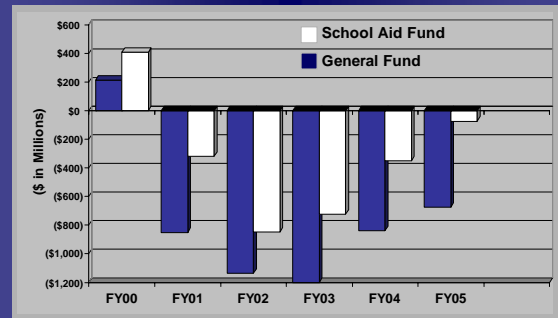
Dual Deficits at Play

- Structural and Cyclical
- General and School Aid Funds Affected

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General Fund & School Aid Operating Deficits



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Summary of One-Time Resources

(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	317
Temporary Federal Fiscal Assistance	655
Bond for Pay-as-you-go Capital Projects	211
Revenue Sharing Accounting Change	181
Refinance Bonds	209
Employee Wage Concessions	186
Other	<u>1,200</u>
	\$6,534

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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

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General and School Aid Funds Face Structural Deficits

- General Fund Somewhat More Severe
- Schools Face Retirement & Health Insurance Costs Outpacing Revenue Increases

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General Fund Budget

83% of General Fund Spending in 4 Areas:

1. Higher Education (\$1.8B)
2. Community Health — Mental Health, Public Health, Medicaid (\$2.5B)
3. Corrections (\$1.7B)
4. FIA — Family Services, Juvenile Justice, Public Assistance (\$1.1B)

All Other General Fund Programs - \$1.5B

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External Causes of Michigan's Budget Problems

- Weak Economy
- Stock Market Decline
- Michigan's Deteriorating Share of Auto and Light Truck Market

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Perspective On Revenues

- General Fund Revenues in FY03, FY04, & FY05 *Below* FY1995
- Inflation-Adjusted General Fund Revenues *Below* 1972 Level

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General Fund Spending

- Total Spending Down \$1.2B in 4 Years (12%)
- Additional Spending in Some Areas — Medicaid and Corrections — Obscures Magnitude of Cuts in Others
- Cuts Exceed \$3 Billion

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Significant Cuts

- Higher Education Cut 14% in 2 Years - \$297M
- Revenue Sharing Cut 26% in 4 Years - \$399M
- State Workforce Down 8,500 in 3 Years (14%) - *Smallest Workforce Since 1974*

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Medicaid

- Spending Up 40% in 4 Years — Nearly Double Digit Increases
- Caseload Up 27%
- Covers 1.4 Million Michigan Citizens
- Pressures on Rates Paid Providers — Could Add Significantly to Growth in Future

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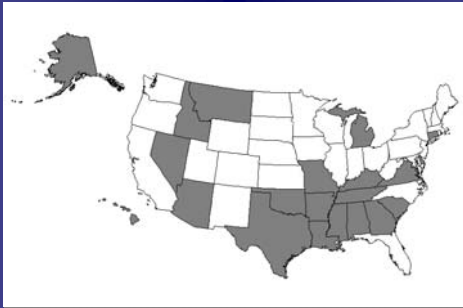
Corrections

- Largest State-Operated Program
- 50,000 Prisoners
- Over 30% of State Workers
- Over Half of Workers Paid From General Fund Revenues
- Higher Incarceration Rate Than Our Neighbors

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States With More Than 500 Prisoners Per 100,000 Residents



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The Economic and Revenue Outlook for FY2006

- Moderate Economic Recovery
- Small Employment Gains
- Improved Income Growth
- General & School Aid Fund Revenue Growth — 3.5 to 4%

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FY2006 General Fund Spending Pressures Exceed Revenues by \$1 Billion

- Medicaid \$500 - \$600M
- Debt Service - \$55M
- Restore FY05 Employee Concessions - \$76M
- Employee Retirement and Health Insurance - \$50M
- Employee Pay Package - \$28M
- Family Independence Agency - \$60M
- Corrections Population Increases - \$60M
- Replace One-time Revenues - \$95M
- Other Pressures for Increases Calculated at 3 Percent (e.g. Higher Education) - \$115M
- FY2006 Revenues Less Than FY2005 Appropriations

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Beyond FY2006 The Structural Problem Continues

- Expenditure Causes
 - Medicaid
 - Corrections
- Revenue Causes
 - Antiquated Revenue Structure
 - Revenue Sources Unresponsive to Economic Growth

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Medicaid

- Projected Spending Pressures of Medicaid Exceed General Fund Revenue Growth
- Significant State Revenue Sources Will Not Grow — e.g. Tobacco Revenues
- General Fund Requirements Grow at 150% of Total Spending Growth
- Near Term General Fund Increases at 12%

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Corrections

- Crime Rates Falling but Prison Populations Continue to Increase
- Populations Projected to Increase 1,800/Year until 2010 (if Current Policies Continue)
- Annual Increase in Costs About \$100M
- Annual Increases About 7% — Twice the Rate General Fund Revenue Increase

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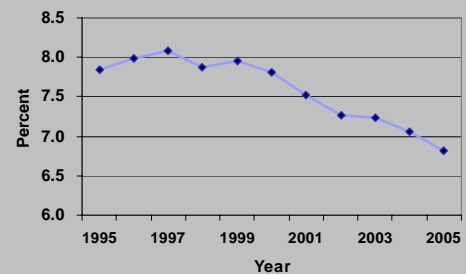
Structural Revenue Issues

- 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

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State Taxes as a Percent of Michigan Personal Income



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A Medium-Range General Fund Budget Scenario

- Medicaid & Corrections Projections Incorporated
- Other Areas of General Fund Spending Assumed to Increase at 3%/Yr
- Revenues Grow about 3%/Yr
- Major Revenue Sources w/No Growth — Retard Overall Growth
- SBT Eliminated at End of Calendar 2009 — 23% of General Fund Revenue

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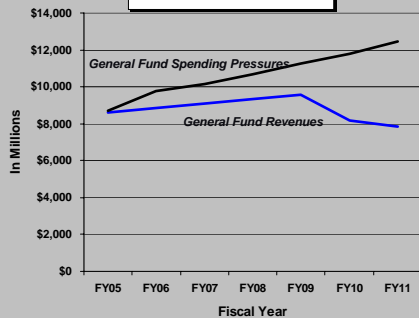
Combining Revenues and Spending Pressures

- State *Will* Have Balanced Budgets — Constitutionally Required
- Incremental Problem Each Year Will Exceed \$300M (Over 3% of Spending Base) After FY2006

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General Fund Structural Deficit



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Implications

- Balancing Budget W/Spending Cuts Will Require Structural Changes Likely Affecting Medicaid & Corrections
- Significant Changes in State Financial Support for Local Government & Higher Education Would Likely Continue

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Revenue Changes

- Replace the “Lost” SBT Before 2010 Governor’s Proposal “Revenue-Neutral”
- Broaden the Base of the Sales & Uses Taxes to Include More Services

Broadening the Sales and Use Taxes Base

- Most Services Not Taxed
- Services Constitute More Than 1/2 Private Economic Activity
- If Starting Point is Revenue-Neutral, Significant Rate Reduction Could Occur
- Revenues Would Grow Faster Than Current Sales & Use Taxes

Issues With Services Taxation

- Would Socially Valuable Services Such as Medical Care and Education be Exempt?
- Business to Business Services — Pyramiding Could Create Multiple Taxation Problem

Importance of Restoring Fiscal Balance

- Fiscal Problems Crowd Out Consideration of Other Important Issues
- Michigan’s Budget Situation Affects Credit Rating
 - Recent Downgrade
 - Reflects on Schools & Local Government Units
 - Increases Borrowing Costs



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