

 CITIZENS RESEARCH COUNCIL OF MICHIGAN

**Michigan's Fiscal Future:
Long-term Analysis of Michigan's
Economy and State Budget**

Prepared in cooperation with
W.E. Upjohn Institute for Employment Research

September 2007

www.crcmich.org

 CITIZENS RESEARCH COUNCIL OF MICHIGAN

**Citizens Research Council
of Michigan**

- 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

2

 CITIZENS RESEARCH COUNCIL OF MICHIGAN

Michigan's Budgetary Morass

- 7 years of spending cuts
- FY2007 General Fund revenues lower than in FY1996
- School Aid fund annual growth since 2000: 1.4%
- \$8 billion in one-time resources used
- Reserves exhausted
- Weakened connection between revenue structure and the economy
- Spending pressures growing faster than revenues

3

 CITIZENS RESEARCH COUNCIL OF MICHIGAN

The Future

- Projections seldom made beyond the current budget year
- Failure to estimate the future consequences of current actions leads to unpleasant surprises
- Knowing where we are headed helps justify actions to change the future

4



Scope of the Analysis

- Ten-year scenarios of the Michigan economy with varying assumptions about:
 - Auto industry
 - Office furniture
 - Chemicals
 - Hi-tech
- WE Upjohn staff used Regional Economic Models, Inc. (REMI) to prepared economic projections
- Economic projections translated to revenue projections and projections of spending pressures



The Economy

Mid-range Projections-Assumptions

- Continuous moderately growing U.S. economy (GDP 2.7% annual real growth)
- Decline in domestic name-plate market share slows
- Employment in office furniture stable
- Employment in chemicals declines
- R&D employment expands

Overall a moderately improving economy



Summary of Results Major Indicators

Annual rates of change

- Total Employment (-.07%)
- Labor Force (-.25%)
- Real Gross State Product (+1.2%)
- Labor productivity (+1.6%)
- Personal Income (+4.2%)
- Payrolls (+3.8%)
- Population (-.04%)

These statistics better than last 6 years



Job Gains and Losses 38,000 Overall Decline

Job Losses

- Goods producing—228,000
- Retail and wholesale trade—62,000
- Government—19,000

Job Gains

- Health care—134,000
- Business services—52,000
- Social assistance—33,000
- Recreation and amusement—27,000

CITIZENS RESEARCH COUNCIL OF MICHIGAN

Population in 2017 Major Changes in Demographic Composition Ahead

- Total Population—Down 41,000 (0.4%)
- School Age (5-17)—Down 257,000 (14%)
- Higher Education (18-24)—Down 84,000 (9%)
- Labor Force (16-64)—Down 262,000 (4%)
- Seniors (65+)—Up 413,000 (31%)

9

CITIZENS RESEARCH COUNCIL OF MICHIGAN

Michigan's Changing Population 2007 to 2017

Age Group	2007 (Thousands)	2017 (Thousands)	% Change
5-17	~1,800	~1,550	-14.3%
18-24	~1,000	~920	-8.5%
16-64	~6,500	~6,250	-3.9%
65+	~1,200	~1,580	+31.5%

10

CITIZENS RESEARCH COUNCIL OF MICHIGAN

Implications for State Government Finance

Revenues

- Revenues from the current revenue system will grow slowly—even more slowly than the economy
- Revenue declining as share of personal income
- Official FY2008 forecasts used as the beginning point

11

CITIZENS RESEARCH COUNCIL OF MICHIGAN

Revenues

- Analysis concentrates on General Fund and School Aid Fund revenues
- Local government revenue sharing also included
- Transportation revenues included
- Each revenue source is projected separately based on the economic projections
- Revenues are aggregated into total revenues available from current tax structure

12



Michigan Business Tax *Fully Reflected in Analysis*

- Two new taxes replace SBT: Income and Modified Gross Receipts
- Significant personal property tax (PPT) relief (18-mill PPT exemption and PPT credit)
- Numerous new credits (compensation, investment, R&D, etc.)
- Schools held harmless from PPT loss and from declines in overall MBT revenue
- Net fiscal effect: revenue neutral (\$2.3B to GF and SAF in FY09)
- Revenue trigger for three years (limits growth)



Major Revenue Sources-Six Taxes

- Personal Income Tax-divided between General and School Aid Funds
- Sales Tax-principally allocated to School Aid and Revenue Sharing
- Use Tax-Divided between General and School Aid Funds
- Michigan Business Tax-General and School Aid Funds
- Tobacco Taxes-Divided between General and School Aid Funds and Medicaid program
- State Education Property Tax-School Aid Fund

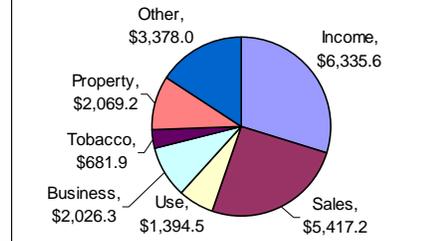


Six Taxes

- Account for 85% of General and School Aid Funds revenues
- Aggregate growth rate about 3%
- Higher growth rate will be needed to keep up with spending pressures increases
- Remaining sources trend growth less than 2%

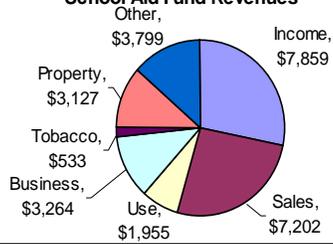


FY2007 Sources of General and School Aid Fund Revenues





FY2017 Sources of General and School Aid Fund Revenues



Growth Rates—General and School Aid Revenues (FY2008-FY2017)

- Income—3%
- Business—3%
- Sales—3%
- Use—3.5%
- Tobacco—Minus 2.5%
- State Education (Property)—4.5%
- Other Sources—1.8%



Reasons for Sluggish Revenue Growth

- Increasing Senior Citizen Population—Retirement income not taxed and spend less on goods
- Consumption taxes goods oriented—economic growth is in service sector
- Slow or no growth revenues drag down overall growth (e.g. tobacco, gambling, alcohol)
- Flat rate income tax



Spending Pressures

Analysis covers nine major areas

- School Aid
- Higher education
- Medical care
- Corrections
- Human services
- Mental health
- Revenue sharing with local governments
- Employee compensation and benefits
- Transportation

 CITIZENS RESEARCH COUNCIL OF MICHIGAN



School Aid Structural Deficit

Spending Pressures Outpace Revenue Growth

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

21

 CITIZENS RESEARCH COUNCIL OF MICHIGAN



School Aid Revenues & Spending Pressures

- Spending pressures grow 5% per year
- Revenues grow 3% per year
- Shortfall of 2% each and every year without spending and revenue policy changes

22

 CITIZENS RESEARCH COUNCIL OF MICHIGAN



Higher Education

- Enrollments at all-time high
- Increased participation needed to make Michigan competitive
- State support has lagged behind costs placing pressure on tuition
- Increased state support required to produce more college graduates
- Revenues will not grow fast enough to maintain state share of costs without cuts elsewhere

23

 CITIZENS RESEARCH COUNCIL OF MICHIGAN



Medical 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

24



Medicaid

- Medical care for 1 in 7 Michigan citizens
- Future spending growth pressures 8% to 9% 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% of state employees
- More than 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
- Spending pressures increasing twice as fast as revenues in an improving economy



Corrections

Background

- Since 2000: population growth 1.3%/yr
 - 2 years of declines ('03 and '04)
 - Recent increases in '05 and '06
- Workforce more than tripled since 1980, today 1 in 3 work for corrections

Spending Trends

- Growth since 1980: 9.2%/yr
- Per capita spending: '80 – \$18
Today – \$177
- 1 in 5 General Fund dollars (\$1.8 B)
- Fueled by Michigan's disproportionate incarceration rate – 40% higher than neighbors



States With More Than 500 Prisoners Per 100,000 Residents





Corrections

Spending Pressures

- Population growth '07 to '11: 2.2%/yr or about 1,200 prisoners/yr
 - \$37M additional per year
- Health care for prisoners (\$5,400/prisoner per year)
- Aging prisoner population
- Wage and salary increases for employees
- New construction?
- Overall: corrections spending pressures will be more than double (7 to 8%) General Fund revenue growth of 2.8% during forecast

29



Human Services

- About 13% of General Fund (\$1.2 B)
- General shift from cash assistance to services as a result of welfare reform
- Primarily caseload driven – continue to rise in future
- No adjustment to cash grant since 1993
 - Recipients becoming “poorer”
 - Some increase expected in forecast
- Future: spending pressures rise faster (3.5%) than revenue growth (2.8%)

30



Mental Health

Background

- Little discretion in program, Art. VIII, Sec. 8
- Shift from state- to locally-delivered services
- Result: little relief to state budget
- Medicaid assuming larger role
- Managed care provided some relief
- Over \$2 billion spent annually

Spending Trends

- Since FY90: below total state spending - 4.2% compared to 5.1%
- Since FY00: slowed to 3%, but equals total
 - Greater than GF spending (-0.6%)

31



Mental Health

Spending Pressures

- General health care increases, specifically prescription drug costs
- Aging population – more users
- Medicaid as an entitlement
- Overall: growth of at least 3% annually compared to General Fund revenue growth of 2.8% during forecast

32



Employee Benefits

- Benefits significant portion of public budgets
 - State: from 34% to 57% of base payroll between FY98 and FY06
- Major driver is health care for current and retired employees
 - State employees: over \$9,000/yr
 - School employees: over \$8,000/yr
- Failure to “pre-fund” retiree health = stresses budgets
 - School retiree health more than double from FY07 to FY17, from 6.6% to 14% of payroll
- Future growth of 7% to 9% annually



Transportation

- Over \$2.0 billion in state revenue raised annually, about 50/50 between fuel taxes and vehicle registrations

Problem

- Fuel tax revenues, flat in *nominal* terms, but negative 4.2% annually in *real* terms
- Registration revenues rising, but not enough

Why

- Fixed per-gallon tax (19 cents, last raised in 1997)
- Decreased consumption due to fuel efficiency, alternative fuels, and cost of fuel



Transportation

Spending Pressures

- System deterioration, unable to sustain condition goals (90% “good”)
- Significant “backlog” needs (primarily expansion of highway system)
- Overall: Spending pressures of 5% annually (compared to 3% revenue growth)
 - “gap” of \$3 billion over 10 years
 - excludes “backlog” (\$5.4 billion over next 25 years)



Michigan Local Governments

- Counties, cities, villages, townships facing structural deficits as well
- Health care cost driving expenses
- Individual units not experiencing full property tax revenue growth due to:
 - Cap on assessment increases
 - Headlee tax rate reductions



Michigan Local Governments

- 5 years of State Revenue Sharing funds diverted to General Fund for other needs
- Assume current funding will serve as base for future growth
 - State keeps what has been diverted
 - Locals experience growth on current base
 - Counties re-enter program

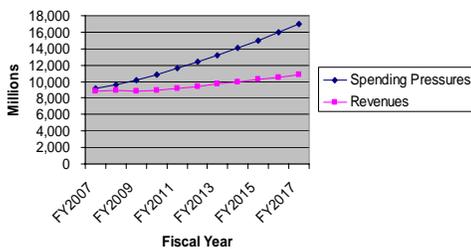


General Fund Revenues and Spending Pressures

- Spending pressures grow 6.5% per year
- Revenues grow 2.8% per year
- Shortfall of 3.7% each and every year without spending and revenue
- Policy changes required



General Fund Structural Deficit Projections Fiscal Years 2007-2017



Policy Options

- Reduce rate of spending pressure growth
- Increase revenue growth
- Bend the two curves so they meet

 CITIZENS RESEARCH COUNCIL OF MICHIGAN



Spending Pressures

- Corrections incarceration policies
- Health care costs—reduce rate of increase and overall costs
 - Medicaid
 - Employee health insurance
 - Retiree health care

41

 CITIZENS RESEARCH COUNCIL OF MICHIGAN



Revenues

- Change system so revenues grow in line with economy and personal income
- Consider taxing services
- Modify personal income tax by changing rate and exemptions—or—implement graduated income tax (Constitutional amendment required)
- Consider taxing pensions and other retirement income (area of greatest income growth in future)
- Reduce reliance on “sin” taxes

42

 CITIZENS RESEARCH COUNCIL OF MICHIGAN



Achieving Structural Balance

- Revenue system changes alone will not be sufficient
- Policy changes reducing spending pressure growth will be required
- Health care is the principal target
- National action may be required

43

 CITIZENS RESEARCH COUNCIL OF MICHIGAN



Citizens Research Council of Michigan

CRC Publications available at
www.crcmich.org

Providing Independent, Nonpartisan Public Policy Research Since 1916

44