Michigan’s On-Going Budget Problems and its Fiscal Future

Presented to
Leadership Macomb

Craig Thiel, Director of State Affairs
September 17, 2009
Citizens Research Council

- Founded in 1916
- Statewide
- Non-partisan
- Private not-for-profit
- Promotes sound policy for state and local governments through factual research – accurate, independent and objective
- Relies on charitable contributions of Michigan foundations, businesses, and individuals
- [www.crcmich.org](http://www.crcmich.org)
Agenda – Past, Present, Future

• Past
  • look back at Michigan’s economy and budget from 2001 to 2008 – major shifts

• Present
  • economic forecast and budget for 2009 and 2010

• Fiscal Future Project
  • outlook for Michigan’s budget
The Michigan Budget Story Has Not Changed...

- The State of Michigan continues to face dual structural deficits 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
But There is a New Chapter

- National recession – severe
  - Consumption
  - Business spending
  - Homebuilding
- State budget unprepared to deal with current recession
  - Exhausted reserves
  - Tax increases of 2007
- Must correct for two problems simultaneously
  - Structural deficits
  - Cyclical deficits
  - Each problem requires specific set of tools
State Budget Realities

- Budget balance is a constitutional requirement
- Budget totals over $44 billion, but
  - $1 of $4 “no strings”
  - $3 of $4 restricted
- Limited options when it comes to balancing the budget
- 80% spent outside of state government
- Only about 11% is spent on state employees
- Corrections is the largest state-run program
- Health care is largest single item – everywhere in the budget
State Revenues

Taxes--59% of Total ($26 Billion)
- Sales & Use Taxes (31% of Total Taxes)
- Personal Income Tax (28%)
- Michigan Business Tax (10%)
- Transportation (7%)
- Alcohol and Tobacco (5%)
- Property (9%)
- Other Taxes (10%)

60% of Total is Earmarked
Discretionary Spending

- Annual review and most attention
- $1 of $4 spent by state gov’t
- 4 areas take up 86% of budget
- Corrections largest state-run program
- School Aid Fund - $12.6 billion

Total: $9.7 Billion
What is Going on in Michigan?

- Michigan economy has shown no improvement since 2001 recession – “single state recession”
- Since employment peak (June 2000), Michigan payroll employment has declined by 812,000 (21%)
  - Concentrated in manufacturing, autos specifically
- Payrolls for July 2009 281,000 below year ago levels
- Michigan Personal Income losing ground relative to US – becoming a “poorer” state
- Baseline state revenues experience anemic growth
Source: Bureau of Labor Statistics
Growth In Monthly Manufacturing Employment
Michigan and United States

Source: Bureau of Labor Statistics
Big 3 Losing Market Share

Source: Automotive News.
Michigan’s Budget Problems
FY2001 to FY2008

- 7 years of spending cuts
- Major tax cuts since late 1990s
- FY2008 General Fund revenues lower than in FY1996
- 1.4% growth in School Aid Fund since 2000
- $8 billion in one-time resources used including reserves
- Cash position improved with 2007 tax increases, but still very tenuous
- Weakened connection between revenue structure and the economy
- Spending pressures growing faster than revenues – structural *not* cyclical
State Taxes as a Percent of Michigan Personal Income

$9 billion below constitutional revenue limit in 2010
GF/GP and SAF On-Going Revenues

Fiscal Year


Millions

GF-GP

School Aid Fund

Projected

Source: Michigan Department of Treasury
FY2008 Budget – some structural changes

• Tax Increases – increased revenue by $1.3B, but did little to change revenue growth path
  • Income Tax Rate (temporary)
  • Business Tax Surcharge (temporary)
• Minimal changes made on spending side
  • State employee compensation
  • State employee/retiree health care
  • School retiree health care
  • School employee health care
• Structural problems largely remain = operating deficits going forward
GF/GP and SAF Operating Deficits

source: Senate Fiscal

Millions

FY98 FY99 FY00 FY01 FY02 FY03 FY04 FY05 FY06 FY07 FY08 FY09 FY10

$0 $500 $1,000 $1,500 $2,000

GF/GP SAF
Immediate Problem:
Current Year Budget Shortfalls

- Sizeable shortfalls in two major fund budgets—General Fund and School Aid Fund
  - Severe decline in economic activity (employment, consumption, housing)
  - Tax revenues directly affected
  - Tax policy changes play role too
- Challenge: weeks to end of start of fiscal year, schools already started
- Michigan’s structural budget problems have been overshadowed by cyclical deficits
- Must choose right tools to address deficits; however, Michigan has limited choices
2007 Recession Shaping Up To Look Like 1980 Recession

Real Per Capita Baseline Revenue Growth
Combined GF/GP and SAF

Source: Senate Fiscal Agency; CRC calculations
The Dual Deficit Problem

- National recession – cyclical deficit
- Michigan is ill-prepared to deal with
  - State’s combined fund equity down $3.3 billion since FY00
  - Reserves completely exhausted by end of FY03
  - Negative cash balance at beginning of fiscal year, financed by borrowing
  - Increased use of debt-financing, in some cases to support on-going services
- Balancing FY09 and FY10 budgets may come at expense of the state’s underlying financial condition
### 2009 General Fund Budget (millions)

<table>
<thead>
<tr>
<th></th>
<th>Jan</th>
<th>May</th>
<th>Diff</th>
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</thead>
<tbody>
<tr>
<td><strong>Beginning Balance</strong></td>
<td>$458</td>
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<tr>
<td><strong>Revenues</strong></td>
<td>$8,945</td>
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<td><strong>Spending</strong></td>
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<td><strong>Shortfall</strong></td>
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<td><strong>Solutions</strong></td>
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<td>Exec Order Cuts</td>
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<tr>
<td>ARRA - discretionary</td>
<td>$290</td>
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<tr>
<td>ARRA - Medicaid</td>
<td>$940</td>
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<tr>
<td><strong>Balance</strong></td>
<td>$(144)</td>
<td>$354</td>
<td>21</td>
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General Fund FY09 Solutions

- One-quarter (~$300 M): spending reductions
  - Employee layoffs and furloughs
  - Medicaid reimbursement rate reduction/eliminate optional services
  - Revenue sharing
  - Some areas protected per ARRA
  - Some address structural problems, others?
- Three-quarters (~$900 M): federal recovery funding (ARRA)
  - $300M completely discretionary
  - Remainder from Medicaid match rate increase - states have a significant amount of flexibility
<table>
<thead>
<tr>
<th></th>
<th>Jan</th>
<th>May</th>
<th>Diff</th>
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</thead>
<tbody>
<tr>
<td><strong>Beginning Balance</strong></td>
<td>$247</td>
<td>$247</td>
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<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
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<tr>
<td>Dedicated SAF</td>
<td>$11,369</td>
<td>$10,944</td>
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<td>GF Grant</td>
<td>$41</td>
<td>$78</td>
<td>37</td>
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<td>Federal</td>
<td>$1,562</td>
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<td><strong>Total</strong></td>
<td>$13,219</td>
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<td><strong>Proj. Spending</strong></td>
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<td><strong>Shortfall</strong></td>
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<td><strong>Solutions</strong></td>
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<td>Exec Order Cuts</td>
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<tr>
<td>ARRA - Education</td>
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<td>$1,302</td>
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<td><strong>Balance</strong></td>
<td>$(38)</td>
<td>$873</td>
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SAF FY09 Solutions

- Problem not nearly as large as General Fund
- Much less time to effect spending cuts, schools end fiscal year on June 30
- Foundation grant can NOT be cut, per ARRA
- Almost entirely reliant on federal recovery funding (education) to maintain balance
- Remainder of federal funding ($870M) available for FY10
FY09 Budget: Non-Recurring Resources Used

<table>
<thead>
<tr>
<th>GF/GP</th>
<th>SAF</th>
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<td>$800</td>
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<td>$400</td>
<td>$200</td>
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<td>$600</td>
<td>$200</td>
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<tr>
<td>$1,200</td>
<td>$200</td>
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<tr>
<td>$1,600</td>
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15% of total spending

5% of total spending

Legend:
- '08 Reserves
- ARRA - discretionary
- ARRA - Medicaid
- ARRA - Education
- Other
Governor’s FY10 Budget

- Projected baseline deficit of $1.8B for GF
  - No new programs and caseload adjustments
- Proposed solutions: Mix of cuts, revenues, and reforms
- Revenues:
  - primarily tax expenditures (e.g., personal exemption), but some increases (e.g., tobacco)
  - Federal stimulus funding through Medicaid
- Cuts: 3% higher education (except 2-years), corrections-closing facilities (net $120M)
- Reforms: parole policy changes
- By May Revenue Conference: Problem was much worse, but federal intervention much larger
## 2010 General Fund Budget
(millions)

<table>
<thead>
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<th></th>
<th>Jan</th>
<th>May</th>
<th>Diff</th>
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<tbody>
<tr>
<td><strong>Revenues</strong></td>
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<tr>
<td><strong>Spending</strong></td>
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<tr>
<td>Gov. Rec.</td>
<td>$9,460</td>
<td>$9,460</td>
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<tr>
<td>Medicaid Caseload Adj.</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Human Srvcs. Adj.</td>
<td></td>
<td></td>
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<tr>
<td>Proj. Spending</td>
<td>$9,460</td>
<td>$9,548</td>
<td>$88</td>
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<tr>
<td><strong>Shortfall</strong></td>
<td>$(687)</td>
<td>$(1,789)</td>
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<tr>
<td><strong>Solutions</strong></td>
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<tr>
<td>Tax changes</td>
<td>$166</td>
<td>$166</td>
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<tr>
<td>ARRA - Medicaid '09</td>
<td></td>
<td></td>
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<tr>
<td>ARRA - Medicaid '10</td>
<td>$521</td>
<td>$950</td>
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<tr>
<td><strong>Balance</strong></td>
<td>$-</td>
<td>$(319)</td>
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</table>
FY10 Budget: Non-Recurring Resources Used

14% of total spending

6% of total spending

(millions)

GF/GP

ARRA - Medicaid '09

ARRA - Medicaid '10

ARRA - Education

SAF
Achieving Balance for FY10

- Despite significant federal funding, still major hurdles
- Proposed tax changes – some old and some new – little discussion thus far
  - Some DOA in past
- Major portions of budget “off the table” per ARRA (Medicaid, education)
- Corrections reforms – little consensus thus far
- After using all available federal $, still short $319M in GF
ARRA and State Budget Balance

- Michigan state and local governments: $7.2B
  - MI share 3% of total (equal to share of US pop)
  - MI leads nation in unemployment @ 12.9%
- $3.7B – provide ready fiscal relief
  1) SFSF - Education Block Grant ($1.3B)
  2) SFSF - Flexible Grant ($300M)
  3) Federal Medicaid match increase ($1.9B)
- Available in FY09 and FY10 – GF and SAF budgets
- Remaining $3.6B – targeted and unable to be used for general budget balance
  - Categoricals: education (formula programs – special and disadvantaged), transportation, workforce development, unemployment, weatherization, pollution control
  - Little state discretion – use existing programs
  - Some of same problems when funds expire
BEWARE: Cliff Ahead

Chart 1
Federal Funding Appropriated in State Budget
On-going and Recovery Funds

On-going Funding  ARRA - other  ARRA - fiscal relief
Michigan’s Fiscal Future: A Long-Term Analysis of Michigan’s Economy and Budget

Prepared in cooperation with W.E. Upjohn Institute for Employment Research
Scope of the Analysis

- Ten-year scenarios of the Michigan economy with varying assumptions about:
  - Auto industry
  - Office furniture
  - Chemicals
  - R & D
- W.E. Upjohn staff used Regional Economic Models, Inc. (REMI) to prepare economic projections
- Economic projections translated to revenue projections and projections of spending pressures
- Not predictions but projections
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
Employment Projection

**Job Losses**
- Goods producing—228,000
  - Auto manufacturing -- 117,000
- 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

**Total: 38,000 Decline**
Major Changes in State’s Demographic Composition Ahead

-14.3%  -8.5%  -3.9%  +31.5%

5-17 18-24 16-64 65+

Age Groups
Projecting Future Revenues

- Analysis concentrates on GF/GP 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
Implications for State Government Finance

Revenues in General

- Revenues from the current revenue system will grow slowly—even more slowly than the economy
- Revenue (and taxes) declining as share of personal income
- FY2009 forecasts (Jan. ‘08) used as the beginning point

Taxes

- Account for 87% of General and School Aid Funds revenues
- Aggregate growth rate about 2.4%
- Remaining sources grow less than 2%
- Higher growth rate will be needed to keep up with spending pressure increases
Annual Growth Rates—General and School Aid Revenues (FY09-FY17)

- Income—3.25% (1.4% after tax changes)
- Business—3.1%
- Sales—3%
- Use—3%
- Tobacco—Minus 2.5%
- State Education (Property)—4.25%
- Other Sources—1.9%

**Overall**

General Fund: 1.4%
School Aid Fund: 3%
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
- Tax Policy –
  - Earned Income Tax Credit
  - Phase-out of Income Tax increase
Structural Deficit

Spending Pressures Outpace Revenue Growth

- Over 85% of GF/GP budget concentrated in four areas:
  - Community Health ($3.1B)
  - Corrections ($2 B)
  - Higher Education ($2 B)
  - Human Services ($1.3 B)
- Most significant spending pressures:
  - Health care
  - Corrections – personnel costs
  - Employee compensation – pay and fringes
Health Care Costs

Single largest component in state budget
- Medicaid
- Mental health services
- Health insurance for school and state employees
- Health insurance for school and state retirees
- Health care provided to prisoners
Medicaid

- Medical care for 1 in 7 Michigan citizens
- Future spending growth pressures nearly 8% annually
- Some state revenues dedicated to Medicaid do not grow—Tobacco Settlement revenues, Cigarette Tax
- Others lag behind the overall growth in program
- General Fund requirements grow nearly 11% annually
- General Fund spending pressures outpace revenue growth eight-fold
Corrections

- Largest state-operated program
- 30% of state employees
- More than 50,000 prisoners and growth of 1,200 annually
- 45 prisons and camps
- $30,000 per prisoner cost per year
- Incarceration rate 47% higher than Great Lakes neighbors-the result: $500 million higher costs
- Spending pressures will increase 7%, five times as fast as GF growth
Employee Compensation

- Benefits significant portion of public budgets
  - State: from 34% to 54% of base payroll between FY98 and FY07
- Major driver is health care for current and retired employees
- 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
- Spending pressures grow 4.9% annually, twice as fast as GF revenues and one and a half times faster than School Aid revenues
FY17 General Fund Spending Pressures (millions $)

- Human Services: $1,730, 10%
- All Others: $2,105, 12%
- Corrections: $3,726, 22%
- Higher Education: $2,897, 17%
- DCH: $6,687, 39%

Total: $17.1 Billion
General Fund Structural Deficit Projections
FY09 to FY17

- Spending grows 6.8% annually
- Deficit=$6 B in FY17
- Revenues grow 1.4% annually
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
Retirement Funding

- School districts make contributions for employees
- School districts also pay for health care for retirees
- Rate for FY2009 is 16.54% of payrolls
- Contribution rate composed of two parts
  - Regular pension benefit (9.73%)
  - Health care benefits (6.81%)
- Both parts will continue to increase in the future
  - Pension because of market in 2008
  - Health because of increase in retirees and cost of health care
MPSERS Projected Rates

- **% of payroll**
  - 0.0
  - 5.0
  - 10.0
  - 15.0
  - 20.0
  - 25.0
  - 30.0

- **Fiscal year**
  - 2008*
  - 2010
  - 2012
  - 2014
  - 2016
  - 2018
  - 2020

- **Actual Rates**

- **Pension**
- **Health**
- **Total**

* Actual Rates

---

50
School Aid Revenues & Spending Pressures

- Spending pressures grow 4.7% per year
- Revenues (state and local) grow 3% per year
- Shortfall of 1.7 percentage points each and every year without spending and revenue policy changes
- By FY17, revenues will cover only 86% of spending
## Declining Enrollments

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<th>Year</th>
<th>Projected</th>
<th>Change</th>
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<td>1,615,577</td>
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<td>2010</td>
<td>1,580,654</td>
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<td>2011</td>
<td>1,550,007</td>
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<td>2012</td>
<td>1,522,848</td>
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<td>2013</td>
<td>1,499,128</td>
<td>(23,720)</td>
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<td>2014</td>
<td>1,481,494</td>
<td>(17,634)</td>
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<td>2015</td>
<td>1,468,480</td>
<td>(13,013)</td>
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<tr>
<td>2016</td>
<td>1,458,292</td>
<td>(10,188)</td>
</tr>
<tr>
<td>2017</td>
<td>1,451,616</td>
<td>(6,676)</td>
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</table>

Average Rate - 1.4%
How does this translate at the classroom level?

• Ave. per pupil revenue growth of 4.4% or $570
• Spending pressures and “requirements” of 6.1%:
  • Salaries - $350
  • Retirement - $110
  • Group insurances (health) - $250
  • Other (fuel, utilities, etc.) - $130
• Structural deficit of $270 per pupil
School Aid Structural Deficit Projections
FY2009 – FY2017

Revenues grow 3%
Spending grows 4.7%
Deficit = $4 B
Policy Options
Achieving Long-Term Structural Balance

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

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

- Expanding Sales and Use Taxes
  - Exempt business-to-business
  - Reducing rate to 3.6% (neutral)
  - Adds about 0.8% to growth rate
- Graduated Income Tax
  - Revenue-neutral starting point
  - Nearly doubles growth rate
- Combined effects
  - Adds 0.8% to School Aid Fund growth
  - Adds 1.5% to General Fund growth
  - Still work to do – spending solutions
Spending Scenario

- **Corrections**
  - Reducing prison incarceration rate to the average of our neighbors (1,200/yr)
  - Ten-year phase-in
  - Eliminates growth pressure in Corrections (from plus 7% to negative 1%)
  - Reduces overall General Fund spending pressure growth by 1.1%

- **Health care**
  - Holding health care cost increases to 5% per year
  - Reduces General Fund annual spending pressure growth by 1.6%
  - Reduces School Aid annual spending pressure growth by 1.1%
Effects of Alternative Policies to Close $5.4 Billion of $6 Billion General Fund FY17 Deficit ($ in Millions)

- Services Tax, $151
- Income Tax, $1,559
- Health Spending, $2,203
- Corrections Spending, $1,487
Effects of Alternative Policies to Close $3.7 Billion of $4.0 Billion School Aid FY17 Deficit ($ in Millions)

- Services Tax, $501
- Income Tax, $777
- Health Spending, $2,384
Questions?

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