CITIZENS RESEARCH COUNCIL OF MICHIGAN

Challenges Ahead in Balancing the State Budget

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Citizens Research Council of Michigan

RSQE

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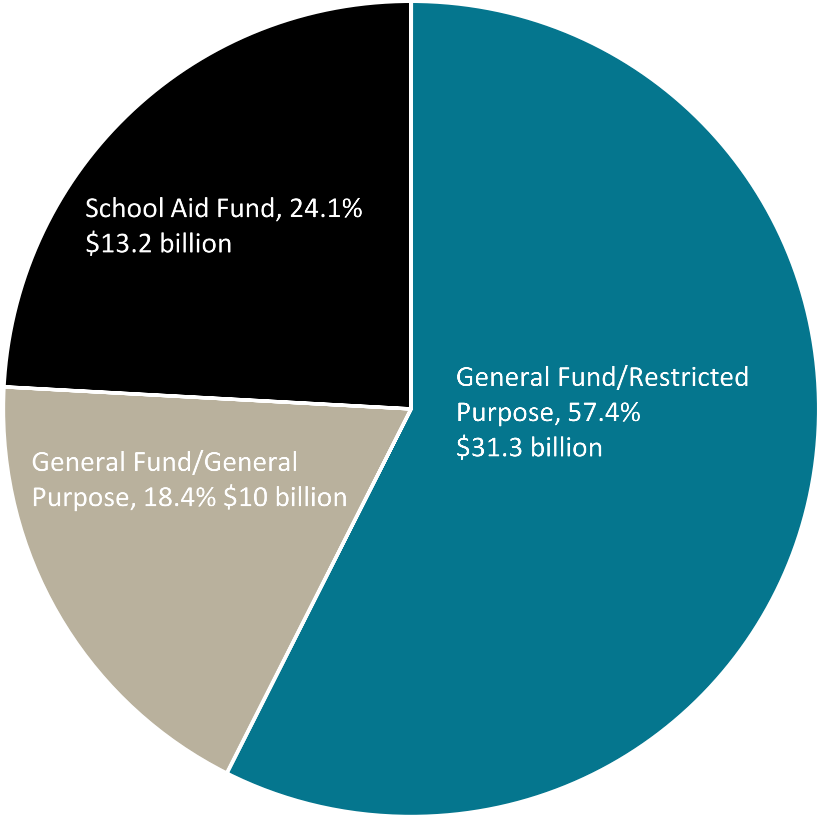
The Current State of the Budget

The State Budget

Disposition of Michigan Revenues, FY2018



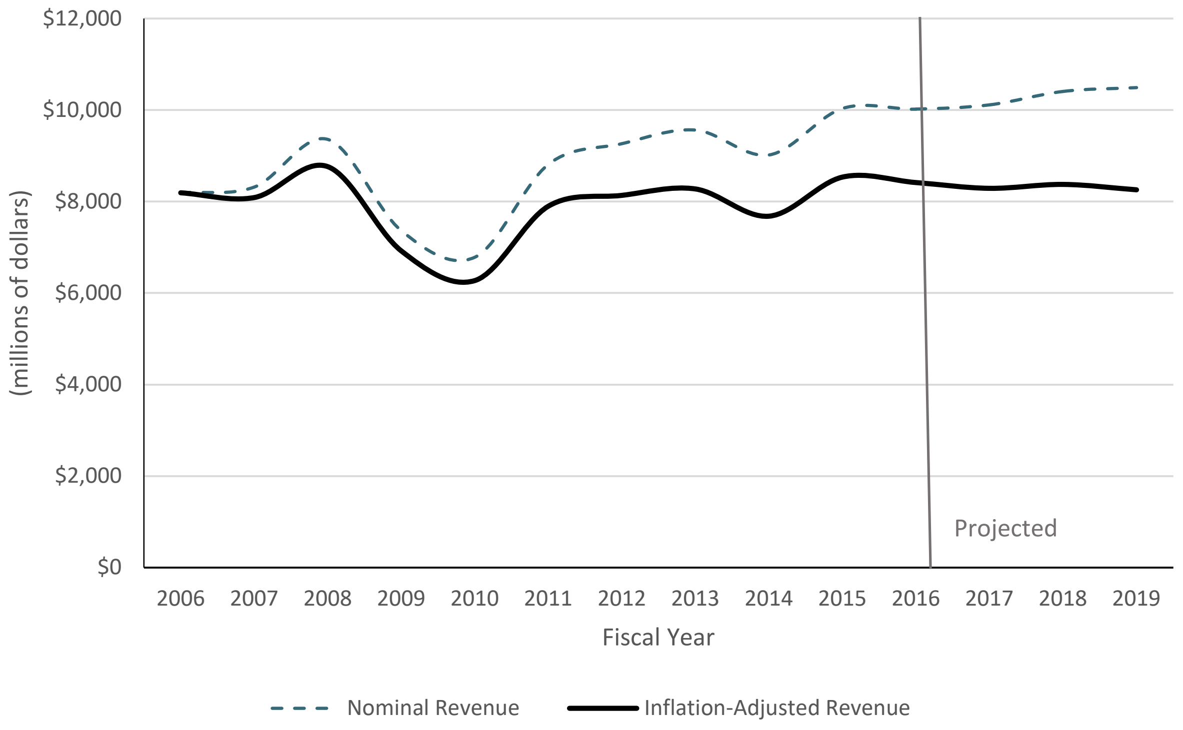
Source: House Fiscal Agency

- The state has two main accounts: the General Fund and the School Aid Fund
  - The General Fund has restricted accounts and the General Purpose fund
  - General Fund/General Purpose revenues are the state's primary discretionary account

General Fund Revenues

- $10 Billion in General Fund Revenue for FY2018
  - On a trend of slow growth
  - General Fund is declining when adjusted for inflation
- No General Fund growth is projected over the next few years

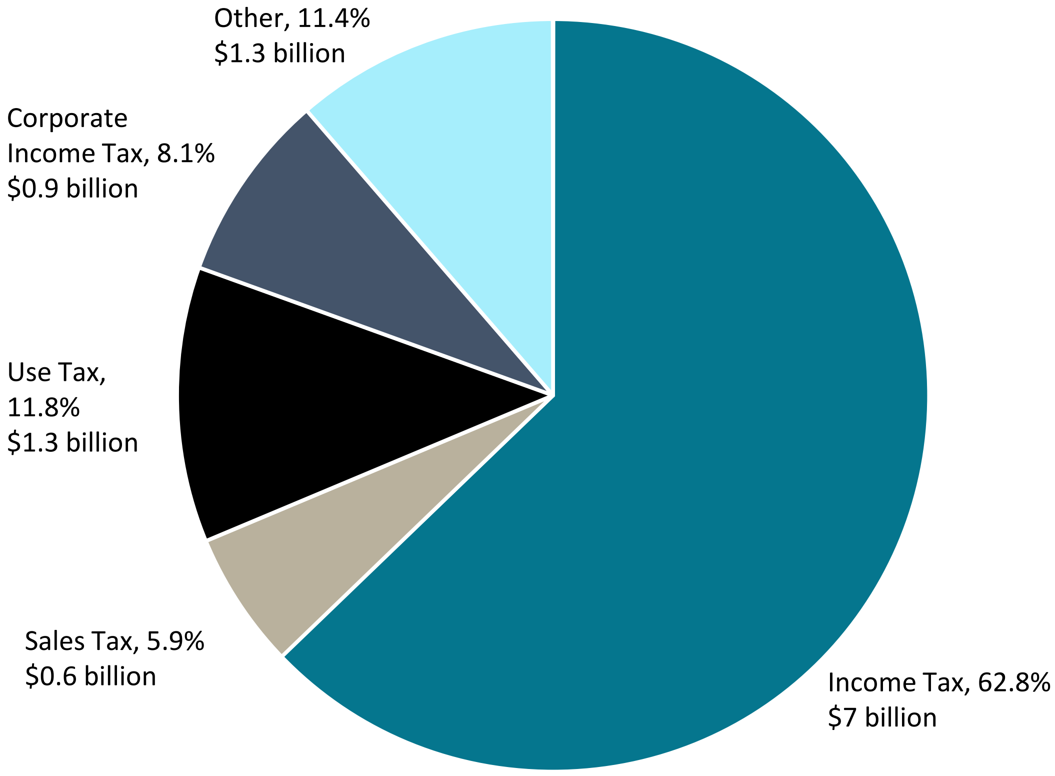
Historical and Projected General Fund Revenue, FY2006-FY2019



Source: Consensus Revenue Estimating Conference Summaries

Sources of General Fund Revenue

Sources of General Fund Tax Revenues, FY2016



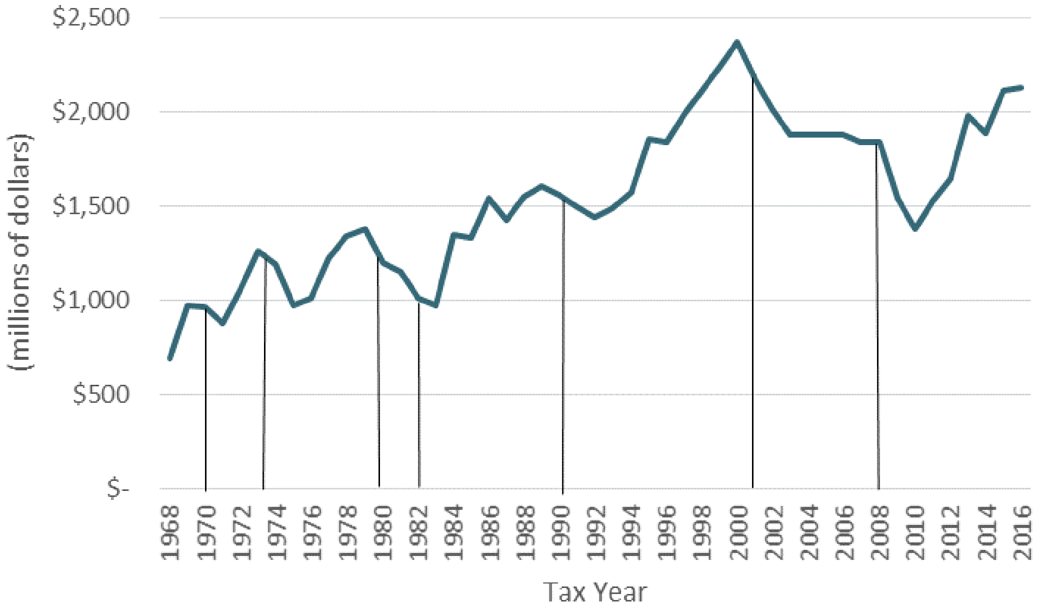
Source: Michigan Annual Report of the Treasurer

- The Personal Income Tax is responsible for nearly two-thirds of General Fund revenue
- Despite rivaling the PIT in total collections, the Sales Tax only contributes about 6% to the General Fund

Reliance on the Income Tax

- The Income Tax is responsible for about two-thirds of the General Fund
  - Because Income Tax revenue shifts with economic conditions, this means the General Fund is strongly tied to the economy
- Small economic contractions reduced Income Tax Revenues 5%, large declines by 25%
  - A decline could cut General Fund revenues anywhere from 4.5% to 20%

Inflation-Adjusted Income Tax Revenues Per Unit and National Recessions



Source: Michigan CAFRs and Federal Reserve Economic Data; calculations by CRC

Revenue Diversions

Tax Credits

- Michigan Business Tax replaced by the Corporate Income Tax in 2011
- Tax credit agreements negotiated while the MBT was in effect continue to divert large amounts of revenue from the General Fund

MEGA Tax Credits

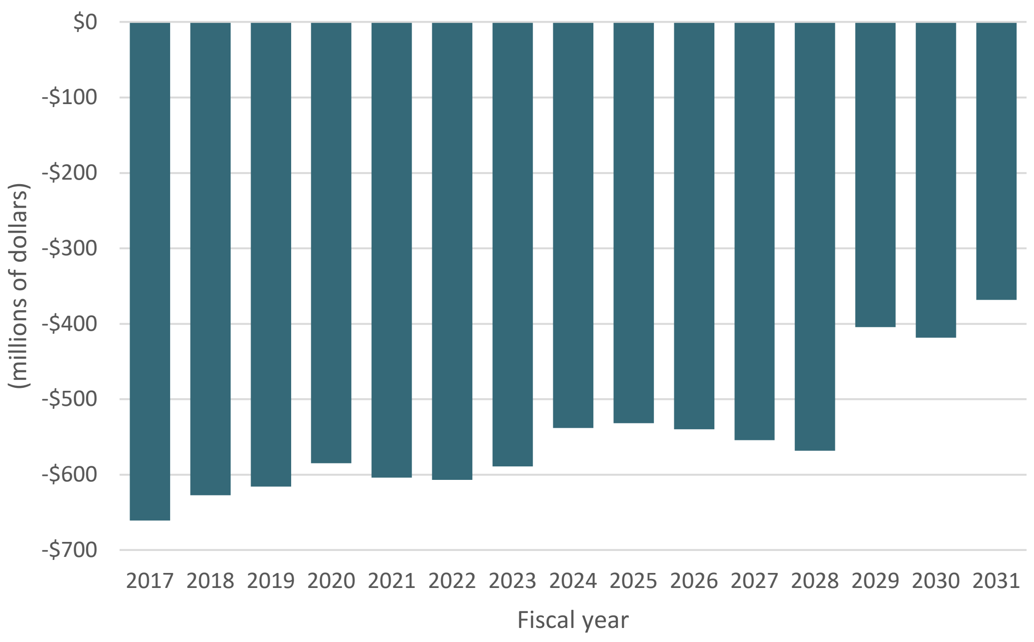
- Negotiated with businesses, active for up to 20 years
  - Last agreement will be in effect through 2032
- Projected liability between $5 and $9 billion over next 15 years
  - The cost of credits could increase depending on the type of credit; job retention credits are the most expensive
- Will reduce revenue by more than $500 million annually until 2029
  - Exact amounts for individual years are hard to project
  - Compliance verification takes time, and credits are not always claimed immediately

Other Tax Credits

- The Brownfield Tax Credit will average $35 million annually over the next 6 years
- Farmland Preservation Credits will divert $1.5 million annually with no sunset date
- The Polycrystalline Energy Credit is expected to lower revenues $20 million annually over the next six years
- The Renaissance Zone Tax Credit will drain an average of $3 million a year for the next six years

Total Effect of MBT Credits

Expected MBT Tax Credit Revenue Effect



Source: Department of Treasury and Michigan Strategic Fund

- The state is liable for more than $9 billion in tax credits between now and 2032
- Year to year variation on compliance verification and when companies claim credits adds pressure to the budget
- Tax credits will divert more than $500 million in revenue annually for the next decade

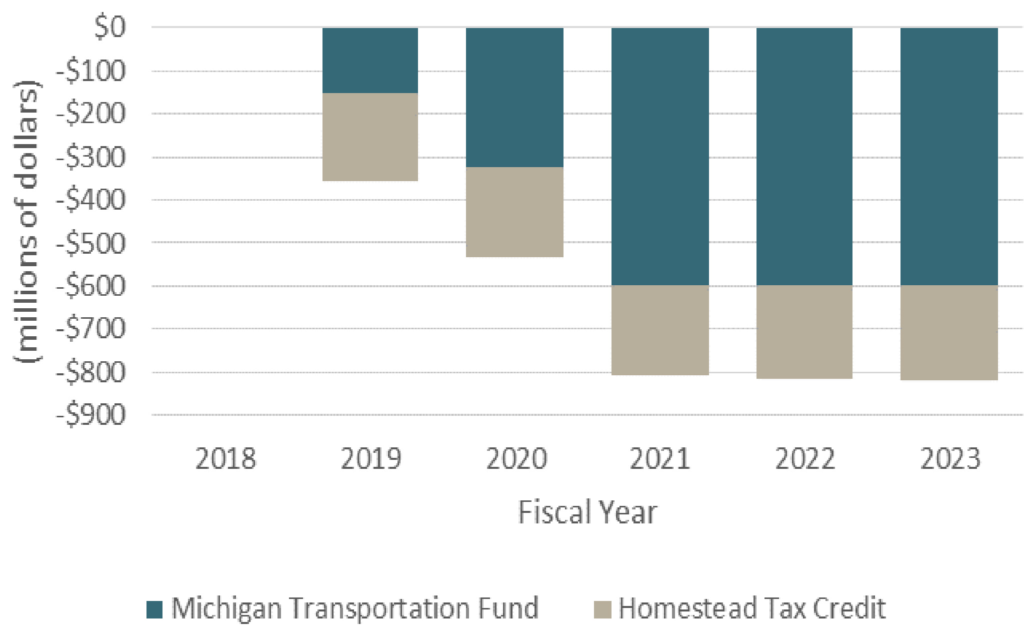
Transportation Funding Package

- The 2015 transportation package will divert $600 million annually from the General Fund to the Michigan Transportation Fund
  - The diversion begins in FY2019 with $150 million, increases to $325 in FY2020, and increases to $600 million in FY2021
- The transportation package included an increase in the Homestead Property Tax Credit which will reduce Income Tax revenue by about $200 million annually
  - The legislation broadened eligibility up to households with an annual income of $60,000 and below
  - This was designed to offset the increased tax burden on low-income families due to the increase in fuel taxes and registration fees

Transportation Funding Package

- In total, the transportation package will lower General Fund revenues by $800 million a year once fully implemented
- The bill did not provide a funding mechanism – it was assumed that continued economic growth would increase tax revenues to pay for the diversion

Transportation Funding and Homestead Tax Credit Diversion Projections, FY2018-FY2023



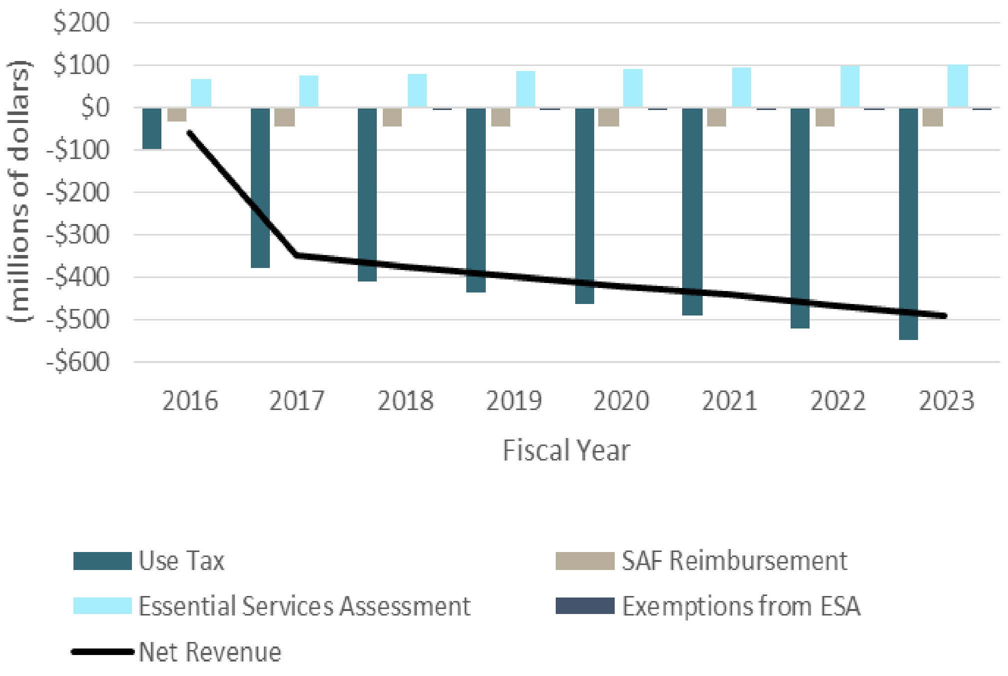
Source: Senate Fiscal Agency

Personal Property Tax Reform

- To make new exemptions for certain industrial equipment to the Personal Property Tax palatable, the state included a planned reimbursement to localities for revenues that would be lost by paying out of the General Fund share of the Use Tax
- The legislation also reimbursed the School Aid Fund for lost revenues
- To recoup some of the revenues, the reform also created the Essential Services Assessment

Personal Property Tax Reform

Projected PPT Revenue Effects, FY2016-FY2023



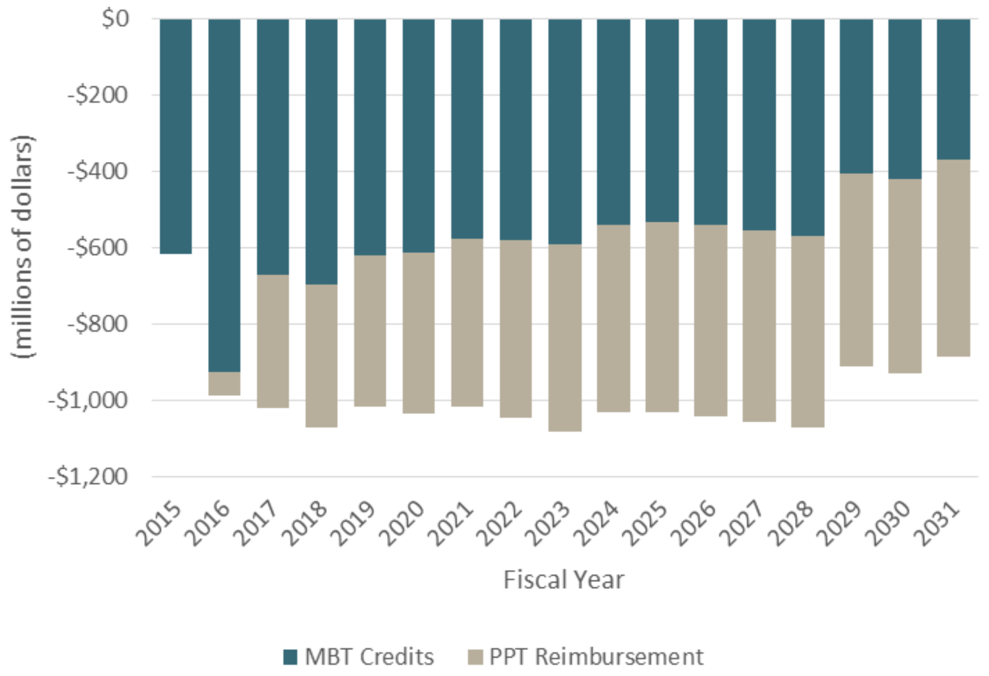
Source: Senate Fiscal Agency

- The ESA revenue does not come close to offsetting the net diversions
- In FY2017, the net reduction due to the reform will be $350 million
- The costs are expected to increase, reaching nearly $500 million in FY2023, when the phase-in is complete

PPT Reform and MBT Revenue Effects

- Initially, the PPT reform diversion was intended to be offset by declines in MBT tax credit claims
- More recent projections show that the decline in MBT credits will only partially offset the reimbursements for the SAF and local governments

Cumulative Effect of PPT Reform and MBT Credits, FY2015-FY2031



Source: Senate Fiscal Agency and Michigan Strategic Fund

Health Insurance Claims Assessment and the Medicaid Managed Care Organization Use Tax

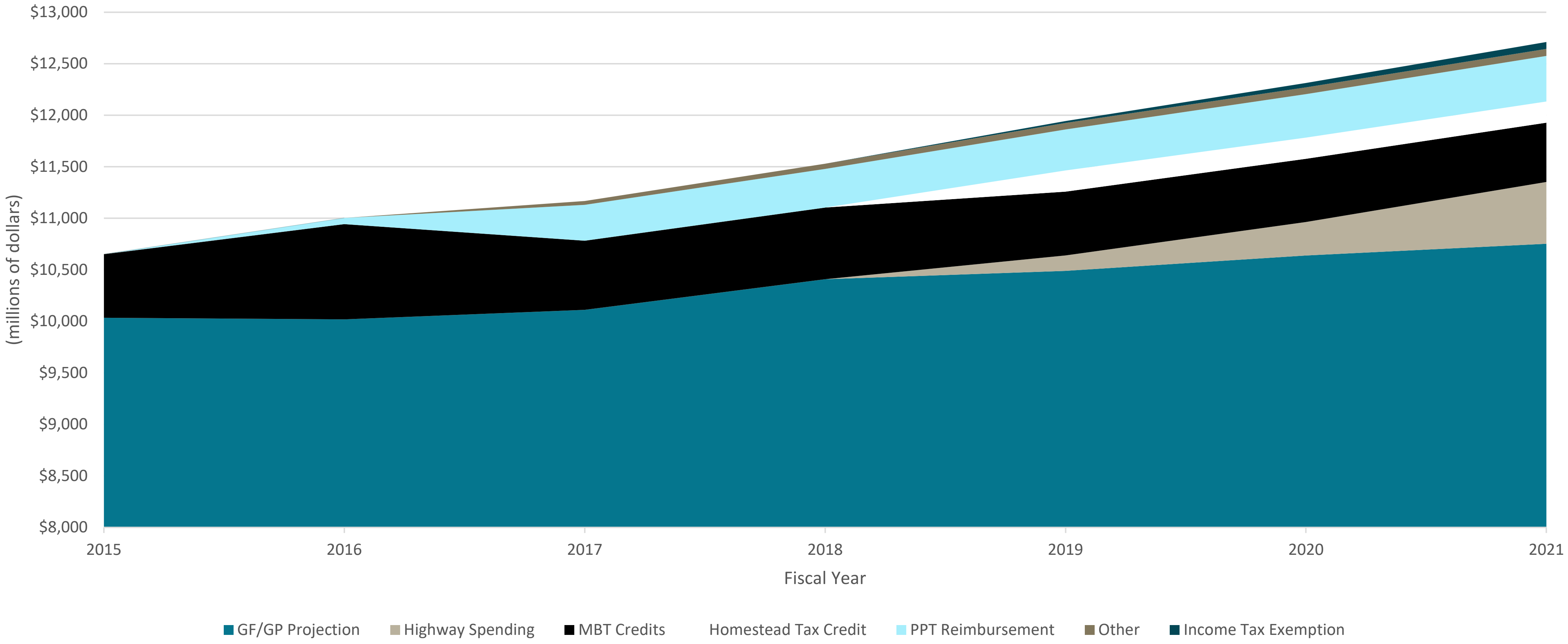
- In 2015, the federal government told the state to end its Use Tax on Medicaid Managed Care Organizations by the end of 2016
- The Use Tax was used to exploit a loophole in federal Medicaid spending, which allowed MCOs to bring in more money than was taxed
- It raised $253 million annually, and brought in additional federal dollars
- The Health Insurance Claims Assessment rate, a tax on paid health service claims, included a clause which triggered an increase in the rate from .75% to 1% if the Use Tax was repealed, but is set to expire in 2020
- The combined loss of General Fund revenue would be close to $500 million

Other Revenue Losses

- The removal of Driver Responsibility fees will reduce revenues $48 million annually once fully phased out
- The state's new limits on Corporate Officer Liabilities will lower collections by more than $60 million annually.
- The phase-out of the "tax-on-the-difference" provision will lower revenues by nearly $12 million a year by 2023.
- The exemption of over-the-counter medications and data center equipment from the Sales and Use Tax lower collections another $10 million each year.
- Collections of the Sales and Use Tax from aviation fuel will be diverted to the State Aeronautic Fund, diverting an additional $15 million annually by FY2023.

Revenue Outlook

Projected General Fund Revenue and Diversions, FY2015-FY2021

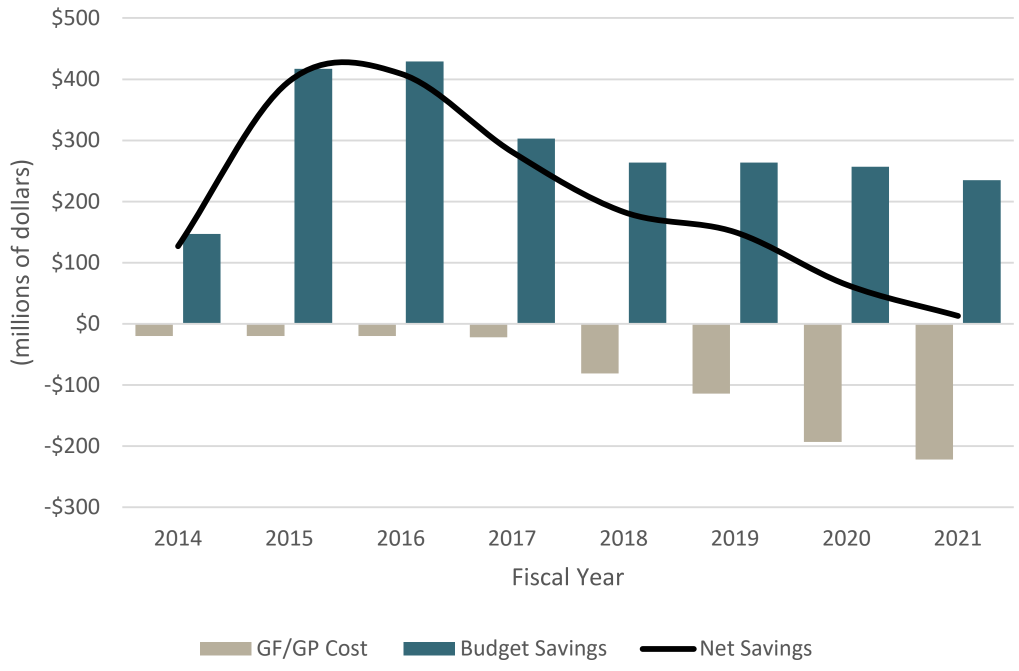


Sources: Senate Fiscal Agency, House Fiscal Agency, and the CREC

Spending Pressures

The Healthy Michigan Plan

Projected Healthy Michigan Plan Net Savings, FY2014-FY2021



Source: House Fiscal Agency

- In addition to the benefits of increased insurance coverage, the Healthy Michigan Plan, Michigan's component of the Medicaid Expansion, saves the state money on prisoner health services and mental health care
- The state is required to start paying on the HMP in 2017, while savings are beginning to decline
- The state can continue or terminate the HMP – either way, state costs will increase

Michigan Indigent Defense Commission

- In an effort to overhaul its indigent defense system, the state created the MIDC to set new standards for public defense
- To meet Headlee Amendment requirements, the state will have to pay a portion of local government changes
- Under current recommendations, this is estimated to be a $50 million cost to the state
- Future changes in standards could increase compliance costs, and the amount the state is required to pay

Other Budget Hurdles

Revenue Earmarking

- While the state budget is $56 billion, certain restrictions limit where money can go and how it can be used; 63% of tax revenues were earmarked
  - Constitutional restrictions: 2 cents per dollar of the sales tax are constitutionally directed to the School Aid Fund as an example
  - Legislative restrictions: these include changes like the PPT reimbursements.
  - Federal spending: federal grant money is generally tied to a specific purpose
- While some of these rules are changeable (particularly legislative restrictions), fights over changing revenue disbursement are more difficult because they require changing statutes and deciding new funding levels
- This also means that increases in revenue might not mean proportional increases in General Fund revenue

Income Tax Changes

- As part of the transportation package, the Income Tax is scheduled to change in two material ways:
  - The tax rate will decrease when revenue growth is larger than 1.425 times the rate of inflation, beginning in 2023
    - This might lower the Income Tax rate in the long term
    - There is no equivalent provision to increase the Income Tax rate
    - The cost will depend on future increases beyond the inflation rate
  - The size of the personal exemption also was indexed to inflation, and will increase once the indexed value ($3,700 in 2012 dollars) surpasses $4,000.
    - Will reduce revenues on the Income Tax by millions

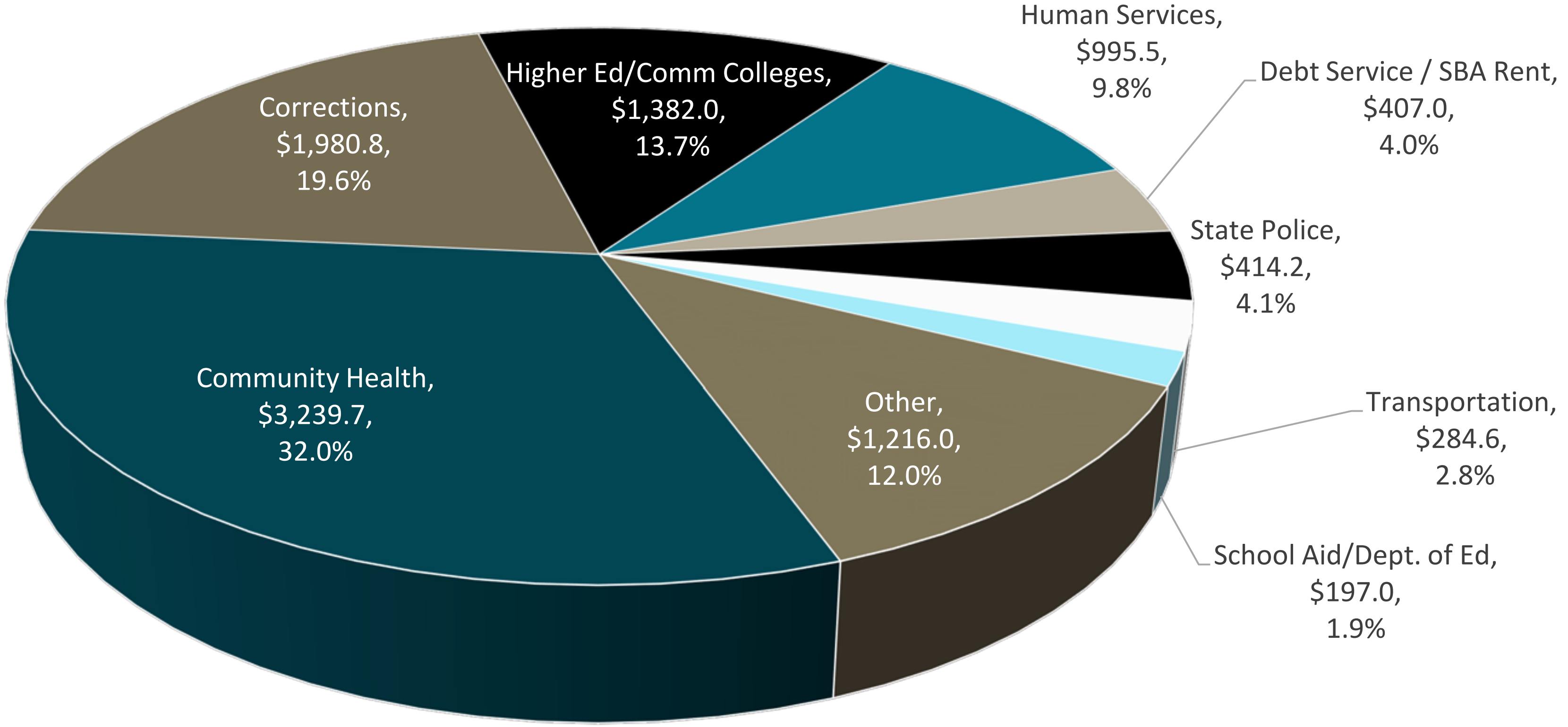
What are the options?

Cut Services

- Nearly 80% of taxes sent to Lansing are distributed to other service providers
  - Medicaid
  - Higher education and community colleges
  - State revenue sharing to counties, cities, villages, and townships
  - Human service providers
- Cuts would come on top of cuts made from 2002 – 2012
  - Many entities that benefit from state funding feel like they're still in recovery

Services funded through the General Fund

FY2014-15 GF/GP Appropriations
(millions of dollars)



Increase Taxes

- $2 billion is a big hole to fill
- Would have to focus on taxes not constitutionally dedicated
  - i.e., not sales or use taxes
- Action should come soon so not introducing a new tax or increasing rate of existing tax in a recession

Undo Statutory Commitments

- Do not provide road funding from General Fund that 2015 package would require
- Do not reimburse local governments for foregone personal property tax revenues
- End Medicaid expansion
  - Not because it is failing, but because the state cannot afford it
- Undo Income Tax provisions that would increase personal exemption or scale back tax rate

Questions?

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