Challenges Ahead in Balancing the State Budget

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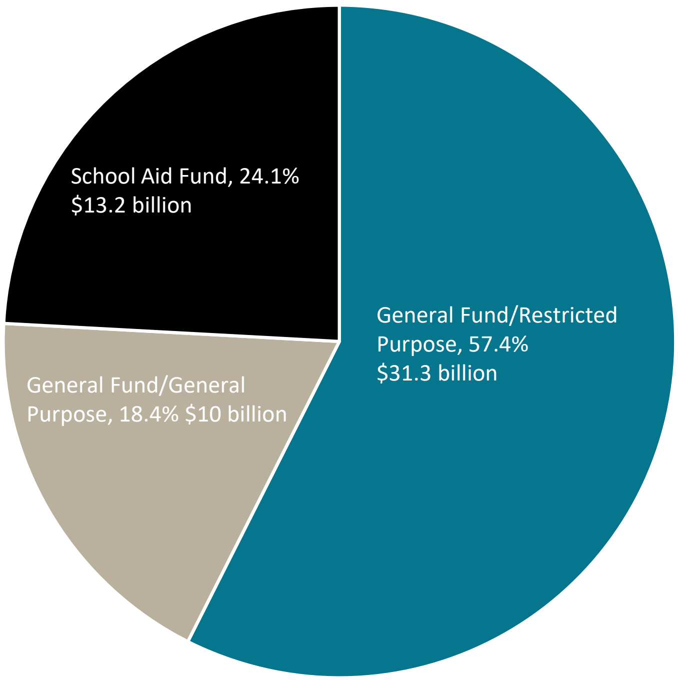
Revenue Status – Current and Projected

The State Budget

Disposition of Michigan Revenues, FY2018



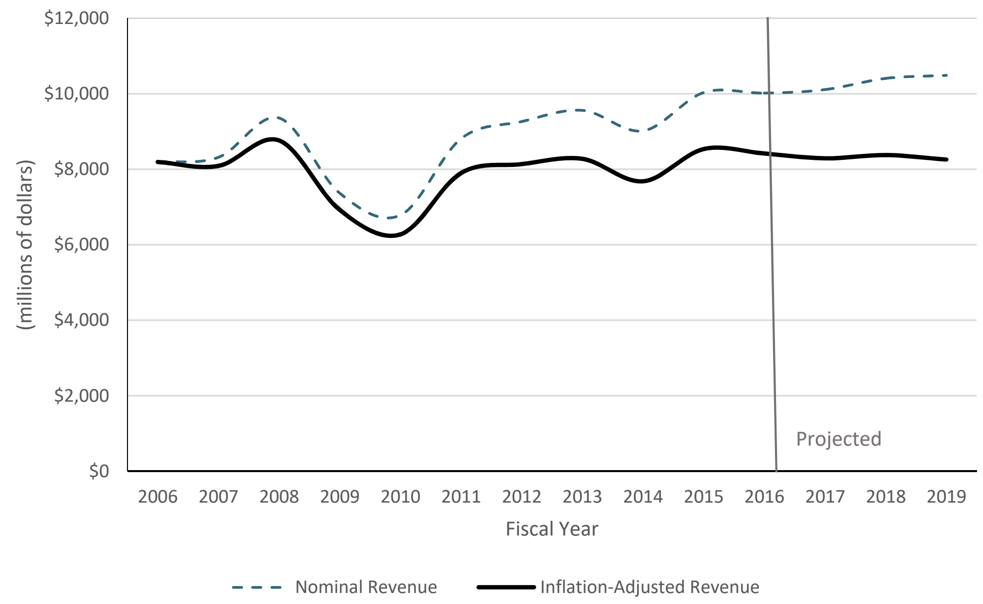
Source: House Fiscal Agency

- 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.

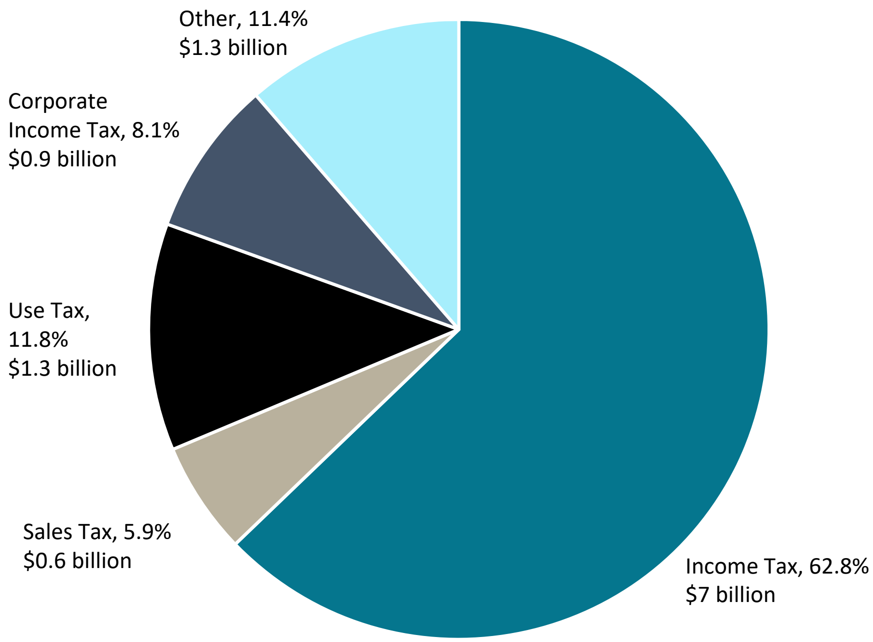
Historical and Projected General Fund Revenue, FY2006-FY2019



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 accounts for about 6 percent in contribution 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 percent, large declines by 25 percent.
  - A decline could cut General Fund revenues anywhere from 4.5 to 20 percent.

Inflation-Adjusted Income Tax Revenues Per Unit and National Recessions

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

Revenue Diversions

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Tax Credits Under the Michigan Business Tax

- Numerous tax credit agreements negotiated while the MBT was in effect divert a large amount of revenue from the General Fund.
  - Michigan Economic Growth Authority credits designed to incentivize job growth and retention.
  - Brownfield credits designed to incentivize development on previously contaminated sites.
  - Farmland preservation credits.
  - Polycrystalline Energy credits.
  - Renaissance Zone credits.

MEGA Tax Credits

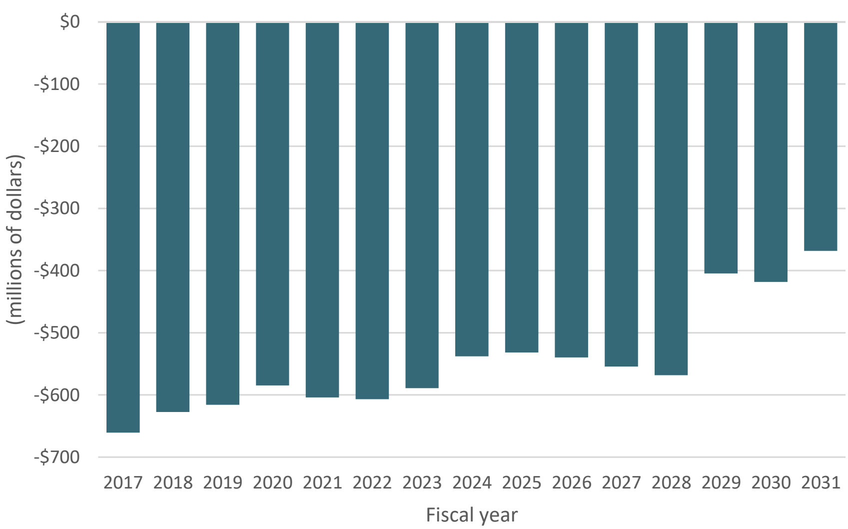
- Negotiated with businesses, active for up to 20 years.
  - Last agreement will be in effect through 2032.
- Projected liability between $5 and $9 billion over next 15 years.
  - The cost of credits could increase depending on the type of credit; job retention credits are the most expensive.
- Will reduce revenue by more than $500 million annually until 2029.
  - 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.

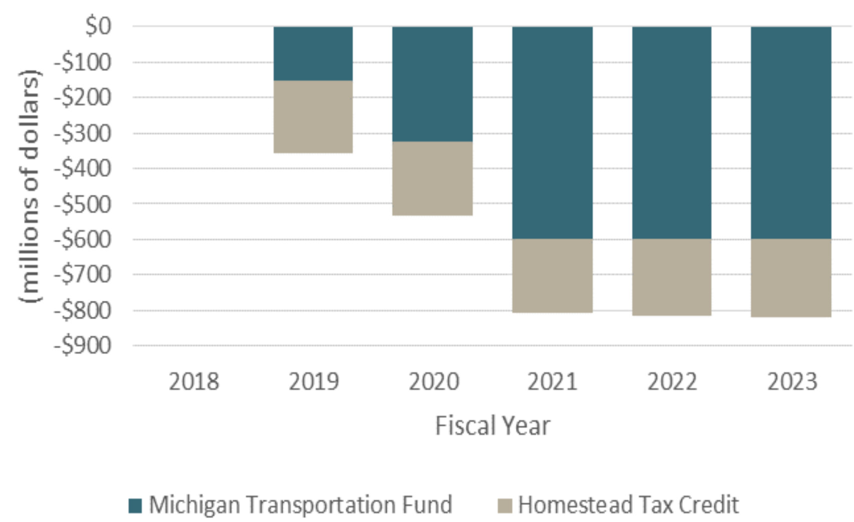
Transportation Funding Package

- 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



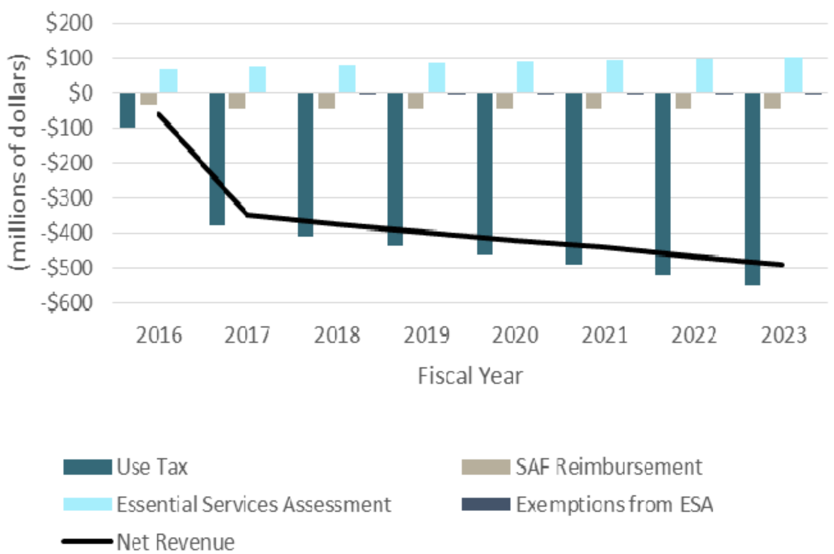
Source: Senate Fiscal Agency

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



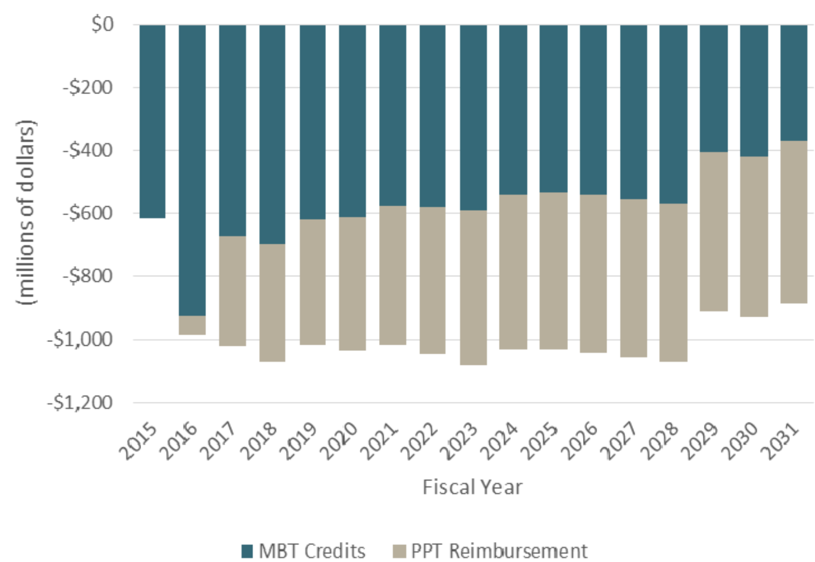
Source: Senate Fiscal Agency

- 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

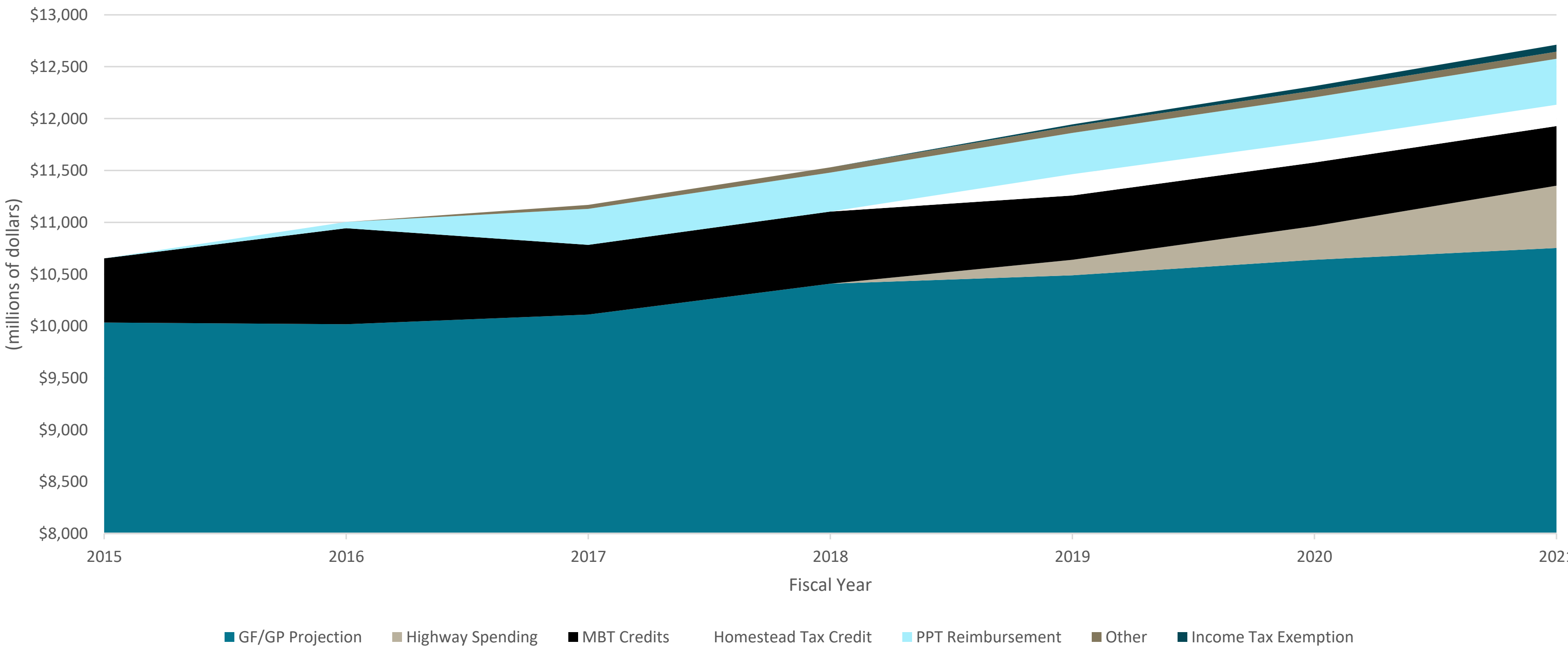
- In 2015, the federal government told the state to end its Use Tax on Medicaid Managed Care Organizations by the end of 2016.
- The Use Tax was used to exploit a loophole in federal Medicaid spending, which allowed MCOs to bring in more money than was taxed.
- It raised $253 million annually, and brought 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 percent to 1 percent 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

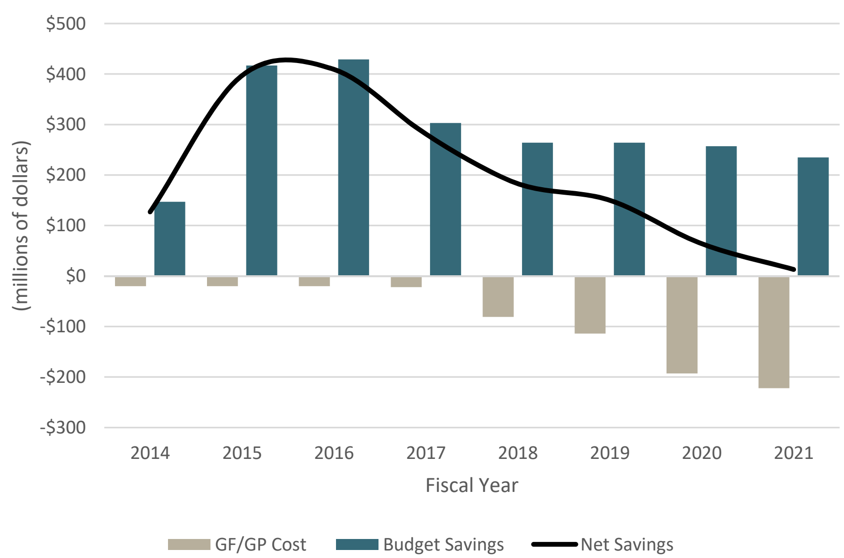


Sources: Senate Fiscal Agency, House Fiscal Agency, and the CREC

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.

Future Challenges – Pensions

- The state's school pension system has an unfunded liability of $26.7 billion.
- The recent pension bill will increase costs on the School Aid Fund for the increases in employer match costs.
- While the General Fund is not the account typically responsible for pensions, recent history shows that General Fund revenues are occasionally used to deal with the deficit.
  - $255 million was directed to the pension system in the FY2018 General Fund budget.

Future Challenges – Education Spending

- Michigan's schools are falling behind nationally – Michigan is in the bottom half of the nation in math and reading scores, and is not advancing at the same pace as other states.
- The 21st Century Michigan Education Commission outlined a series of recommendations to improve educational achievements and prepare our state's students for the modern economy.
- These recommendations, in sum, will likely cost more than $1 billion to implement.

Future Challenges – Infrastructure Spending

- The 21st Century Infrastructure Commission outlined the condition of Michigan's infrastructure. Thousands of roads and bridges need repair, significant water systems are out of date.
- The Infrastructure Commission recommended a $4 billion increase in spending to improve water, road, and telecommunication infrastructure.
- The $1.2 billion in transportation funding, while a good start, is seen as insufficient based on the committees recommendation.

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.

Potential Federal Changes

Federal Changes Could Pose a Challenge

- The executive budget and federal budgeting climate seem to indicate handing over more of a spending role from the federal government to state governments.
- While these changes are not certain to occur, they are reflective of both the executive budget and other changes proposed by Congress.
- Given the pressures in Michigan's current budget environment, even small changes could have ramifications for the state down the line.

Major Federal Programs

- The Supplemental Nutrition Assistance Program:
  - The President's budget has included a 25 percent cut in federal spending on SNAP, also known as the Food Stamps program.
  - Michigan receives $2 billion annually for the SNAP program.
  - Cuts could cost in the realm of $380 million annually.
- Medicaid:
  - The state receives $13 billion annually from the federal government for Medicaid spending.
  - Uncertainty surrounding Medicaid and Healthcare funding could put significant risks on the state.

Other Federal Funding

- Environmental programs such as:
  - The Great Lakes Restoration Initiative; a $300 million program to prevent algal blooms and clean pollution in and around the Great Lakes.
  - Department of Environmental Quality Funding, which receives a large portion of its $120 million from the federal government.
- Education programs that provide more than $100 million to the state including:
  - The Supporting Effective Instruction grant program that provides teacher training.
  - The 21st Century Community Learning Centers program, which provides after school programs for low-income students.

Other Federal Funding

- Cuts to the Department of Housing and Urban Development, including the Community Development Block Grant that provides funding for homeless shelters, senior transportation, and aims to stop blight in Detroit.
- Low-Income Home Energy Assistance Program heating credits that the state receives more than $175 million annually for.

Cumulative Federal Impact

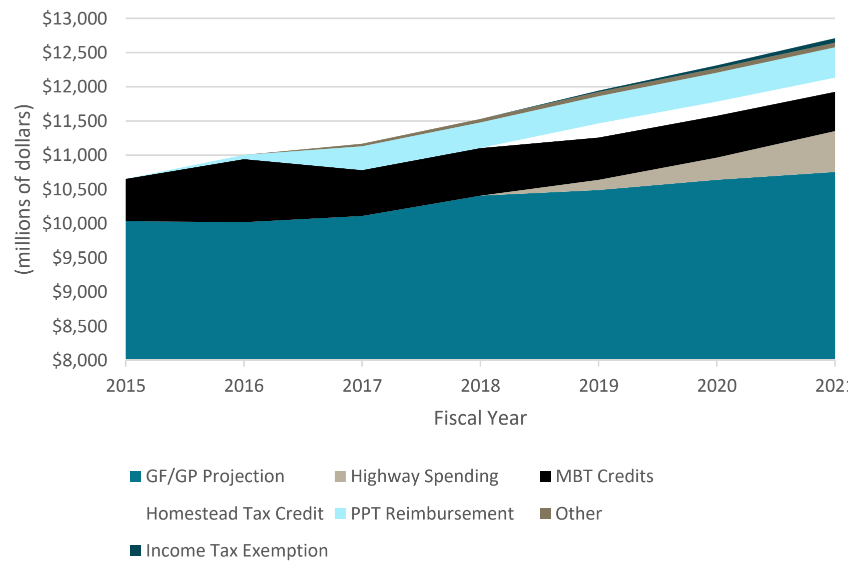
- Along with the programs mentioned previously, there are dozens of state programs that receive millions each.
- If all proposed federal cuts go through, the state could expect to lose $2-3 billion in federal assistance.
- This leaves the state with tough choices:
  - Pay some or all of the federal decreases.
  - Leave programs at current state-funded levels.
  - Reduce or eliminate state funding for those programs.

The Overall Outlook

Cumulative Effect on the General Fund

- Revenue Diversions:
  - Combine to more than $1.5 billion before including the uncertain nature of HICA and the Use Tax; would bring the total to $2 billion.
- Spending Pressures:
  - Planned spending increases are near $500 million; additional pressure could come from Pension Reform, Infrastructure improvement and Education reform.
- Federal Cuts:
  - Cuts to federal funding of state programs could be as high as $2-3 billion, though spending in many areas could stay constant.

Projected General Fund Revenue and Diversions, FY2015-FY2021



Source: Senate Fiscal Agency, House Fiscal Agency, and CREC

Questions?