



Is Michigan's Budget
Prepared for the Next
Recession

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Citizens Research Council of Michigan Webinar

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- Promotes sound policy for state and local governments through factual research – accurate, independent and objective
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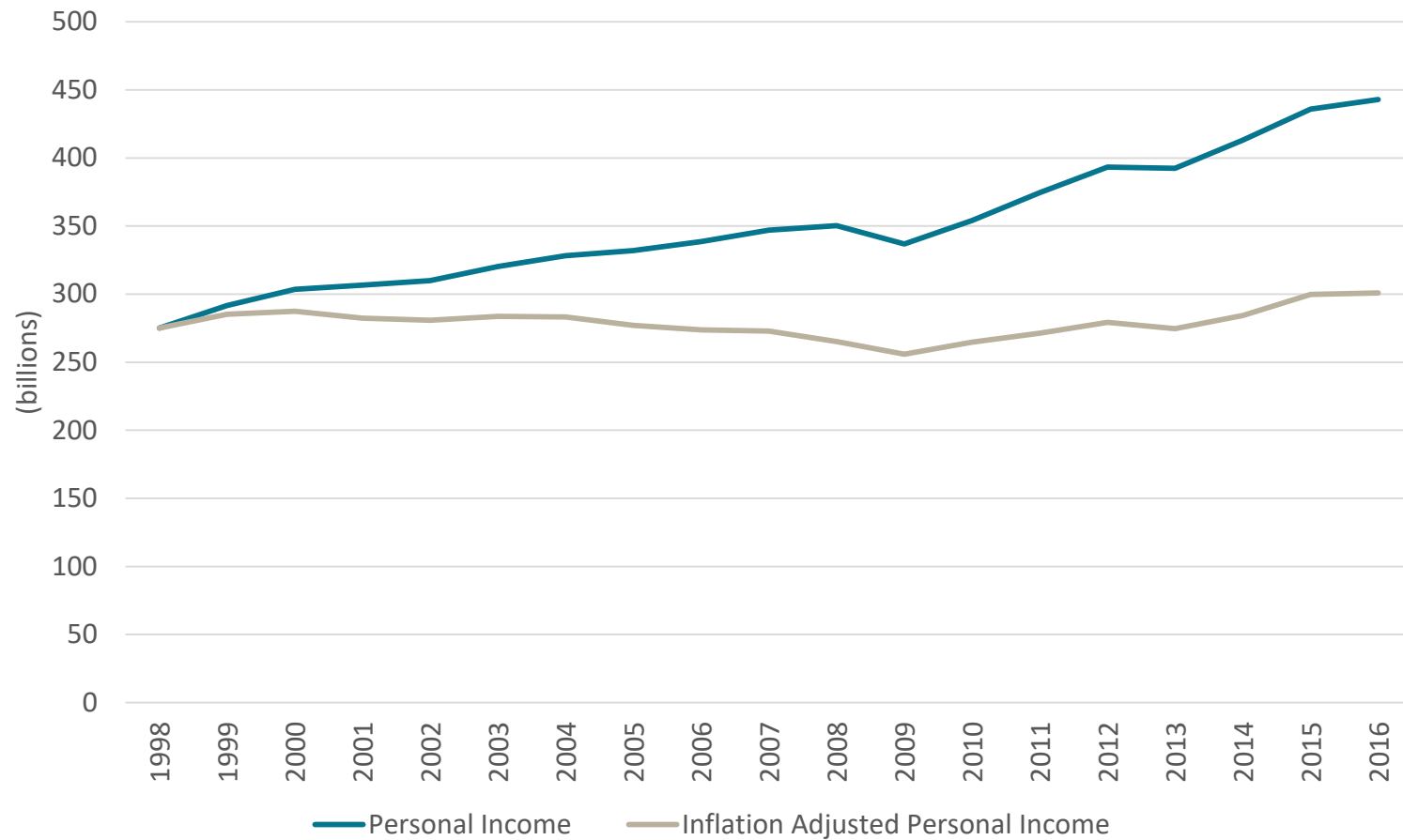
- Citizens Research Council's researcher focused on state affairs
- Recent graduate of the Michigan State University Master of Public Policy Program
- B.A. in Economics from Gonzaga University

Michigan's Economic Trajectory

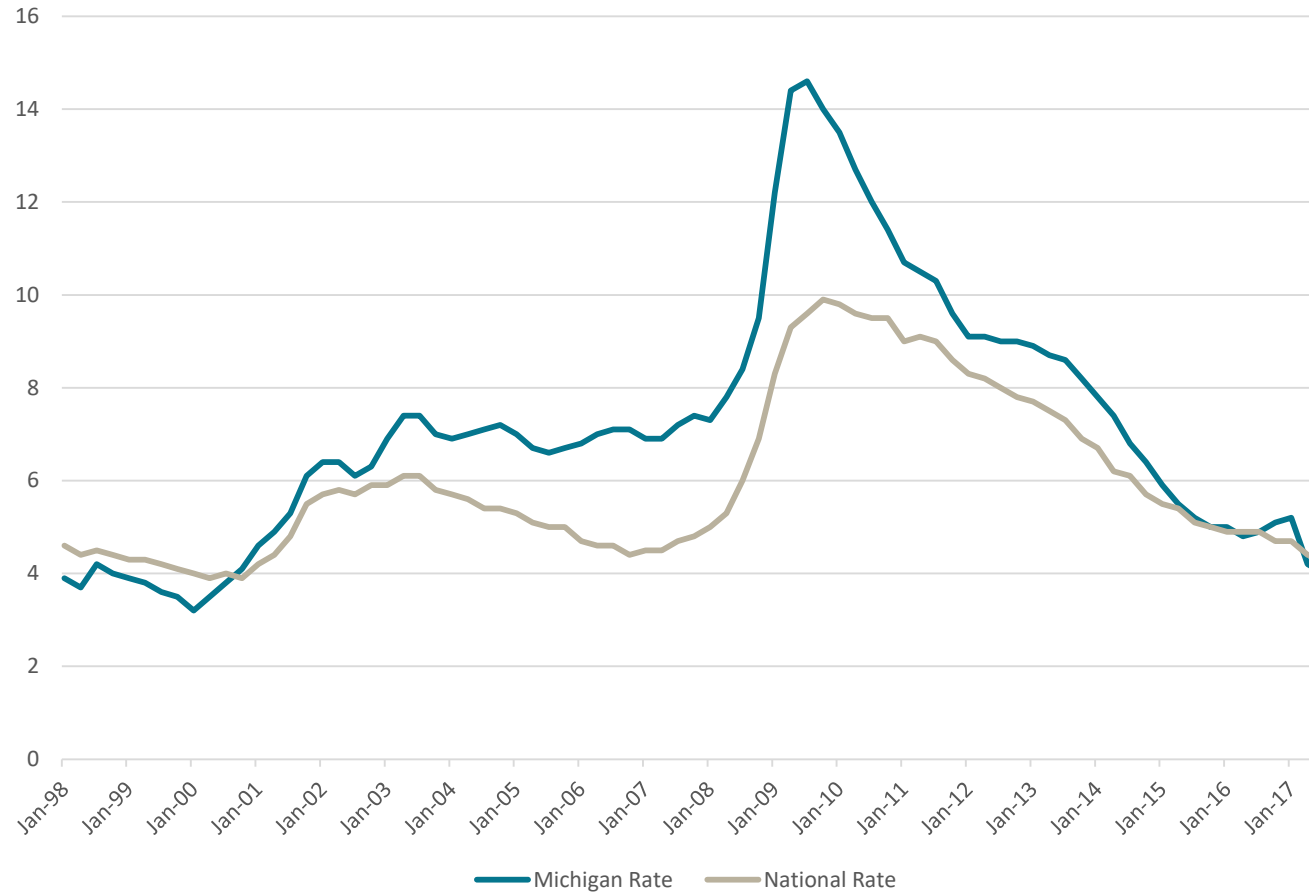
Recovering from a Rough Decade

- The turn of the 21st century was very rough for Michigan's economy:
 - Back to back recessions left little room for recovery.
 - The economy faced a decade with near-continuous declines
- Since 2009, the economy has seen a slow but steady turnaround.
 - Personal income is growing relative to inflation.
 - Unemployment reached pre-recession levels.

Personal Income in Michigan



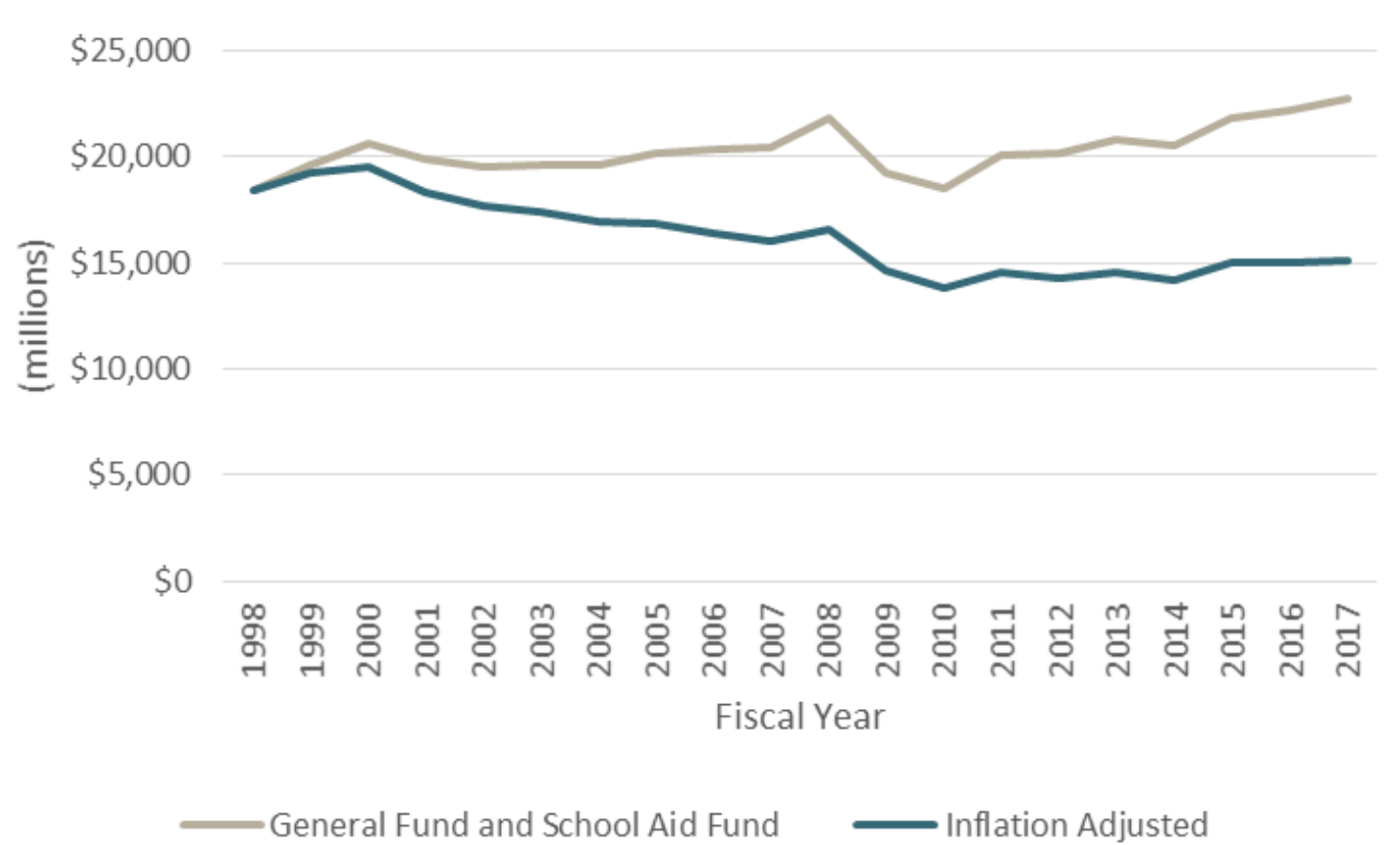
Michigan Unemployment Rate



2000s Budget Problems

- During the beginning of the Single State Recession, a structural deficit was magnified by:
 - Winding down the Single Business Tax;
 - Declining revenues from the recession;
 - Untaxed services grew faster than goods;
 - Increased Medicaid spending; and
 - Increased demand for programs for the poor.
- This caused the state to spend the entirety of the \$1.3 billion rainy day fund in 3 years.

Combined General Fund and School Aid Fund Revenues, FY1998-FY2017



The Next Recession

- Economic cycles make the question of the next recession one of when, not if, but the timing is uncertain.
 - The current economic expansion is the 3rd longest in U.S. history.
- Despite growing since 2010, there are concerns about the strength of the recovery.
- State revenues have yet to recover; when adjusted for inflation, they are more than \$2 billion below FY2000 levels.
- Other budget issues are beginning to boil to the surface.

Options to Maintain Budget Balance During a Recession

Options During a Recession

- During a recession, tax revenue tends to decrease while some spending needs tend to increase.
- This leaves 3 options for Michigan if a recession were to hit:
 - Increase revenues (particularly through tax increases);
 - Reduce spending levels;
 - Rely on existing reserves.
- Michigan must maintain a balanced budget.
- Coming out of a recession, revenue growth speeds up initially.

Difficulties with Spending Cuts

- During economic downturns, poverty relief programs like Medicaid and Welfare see increases in demand.
 - This creates upward pressures on spending, while also magnifying the effects of cuts to government services.
- Cuts for programs can have long-term ramifications.
 - Infrastructure cuts cause the state to fall behind reducing growth down the road.
 - Education has long-term multiplier effects.

Difficulties with Revenue Increases

- While reducing spending can be tricky, finding ways to make up for declining revenue sources during a recession can be difficult.
- Increasing taxes to have more money to spend runs the risk of making a recession worse.
 - Increased taxes on individuals or goods and services could lower consumer spending, creating a more stagnant economy.
 - Increasing taxes on businesses could magnify impacts of a downturn on investment and employment, causing the recession to hit harder.

Rainy Day Savings – A Third Alternative

- While increasing revenues and reducing spending both can be problematic, state savings can limit the need to resort to either.
- Rainy day fund reserves can move excess funds from strong economic climates to weak ones.
- The problem is they require state policymakers to plan ahead and actually save money for a recession during good times.

Rainy Day Savings – Why Not Save?

- Political competition between returning excess funds to taxpayers and increasing spending for programs that could use more money leave savings without a constituency group.
- Saving takes dollars out of the economy; funds sitting in the state's bank account don't help facilitate economic growth.
 - Money spent on a number of programs could produce positive economic effects.
 - Money returned to taxpayers can increase consumer spending and reduce tax burdens, which can continue economic expansions.

Rainy Day Savings – Short Term Benefits

- While savings might not fuel the economy the same way tax cuts and spending increases could, they still have some economic benefit that is usually ignored.
- Rainy day funds are part of the state's Manageable Common Cash fund, which means it can smooth out volatile revenue cycles in the General Fund and School Aid Fund without the need for state borrowing.
- It helps improve the state's credit with rating agencies, reducing the interest rates the state must pay for capital expenditure projects.

Michigan's Rainy Day Fund

- The Counter-Cyclical Budget and Economic Stabilization Fund was created in 1977 after a series of economic challenges.
- It was recodified into the Management and Budget Act in 1984.
- There are three conditions that allow Michigan to add or withdraw funds:
 - Changes in personal income in the state;
 - Revenue and employment factors; and
 - Legislative discretion.

Historical Rainy Day Fund Balances

- At the end of FY2017 the rainy day fund balance was \$711 million.
 - \$167 million is projected to be deposited in FY2018.
 - The projected year-end balance of \$890 million would be the second highest peak.
- The late 1990s saw the largest growth in the rainy day fund balance.
 - The rainy day fund reached more than \$1.2 billion by FY2000.
 - The balance was depleted almost entirely during the first 2 years of Michigan's Single State Recession.

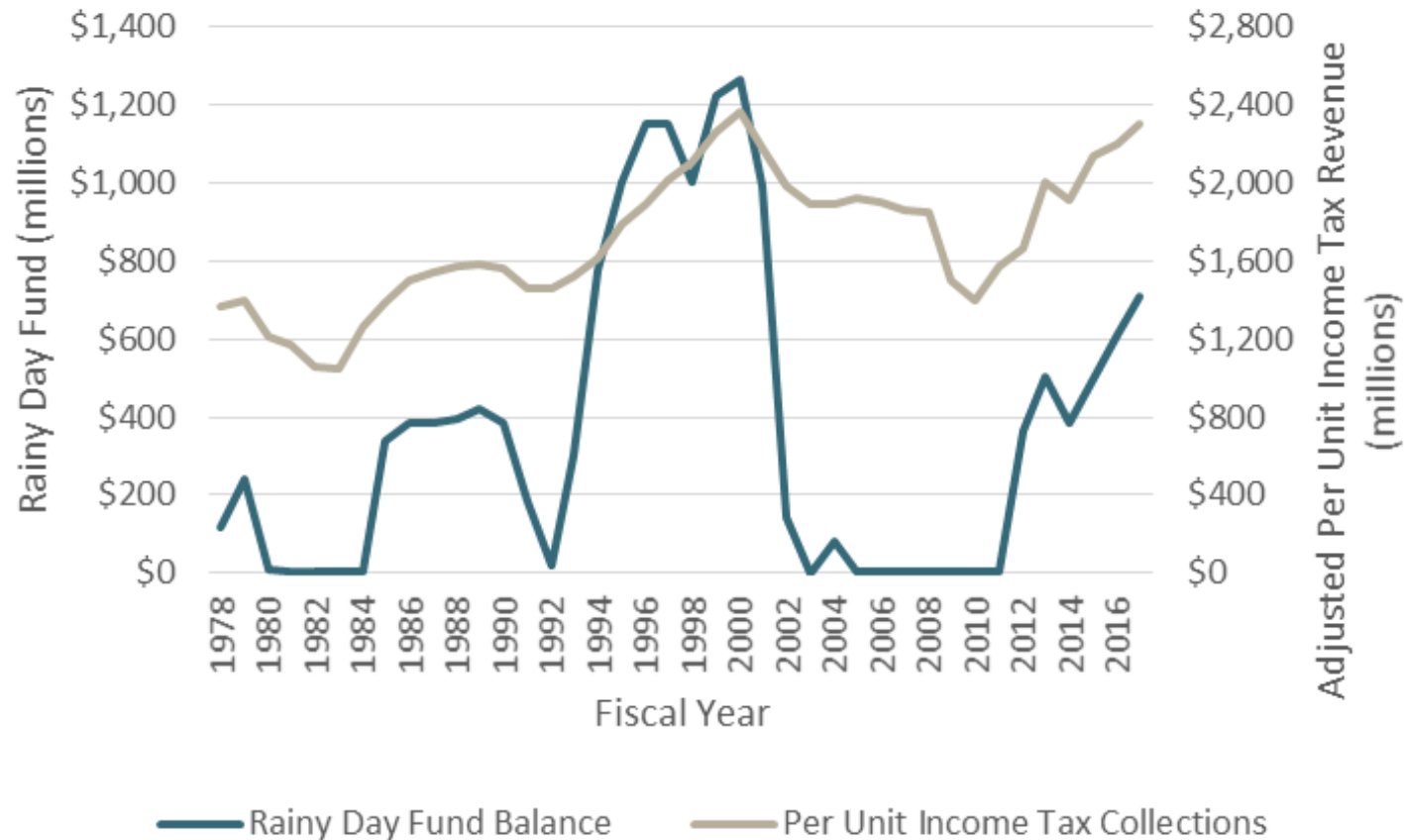
Rainy Day Fund Year-End Balance, FY1978 to FY2017



Relationship to Economic Conditions

- Because the rainy day fund's goal is to save money for rough times, it is important to track its use with economic conditions.
 - If revenues are used during high growth periods, or periods with low unemployment, the fund is not being used effectively.
 - If rainy day fund use tracks with recessions, it would indicate that current rules are effective at safeguarding revenue during periods of economic expansion but allow their use during recessions.

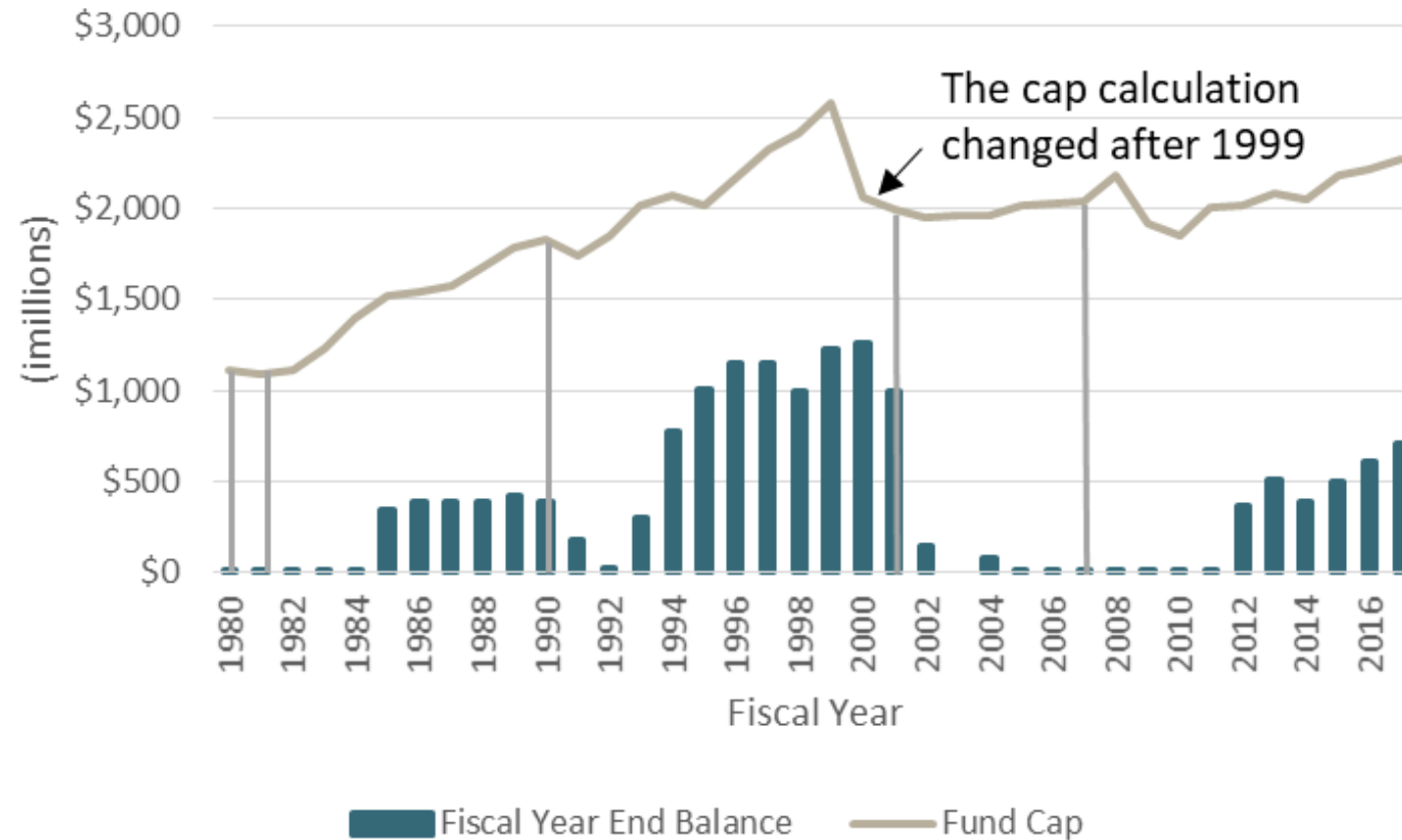
Rainy Day Fund Balance and Income Tax Collections



Rainy Day Fund Balance Cap

- Michigan law caps the amount of money that can be saved in the rainy day fund.
 - Originally, the cap was set at 25% of General Fund revenue.
 - This ignored the potential for the School Aid Fund to grow relative to the General Fund; after Prop A, the cap was changed to 10% of combined School Aid Fund and General Fund revenue.
 - For some programs, the School Aid Fund and General Fund were used interchangeably.

Historical Rainy Day Fund Balance vs Cap

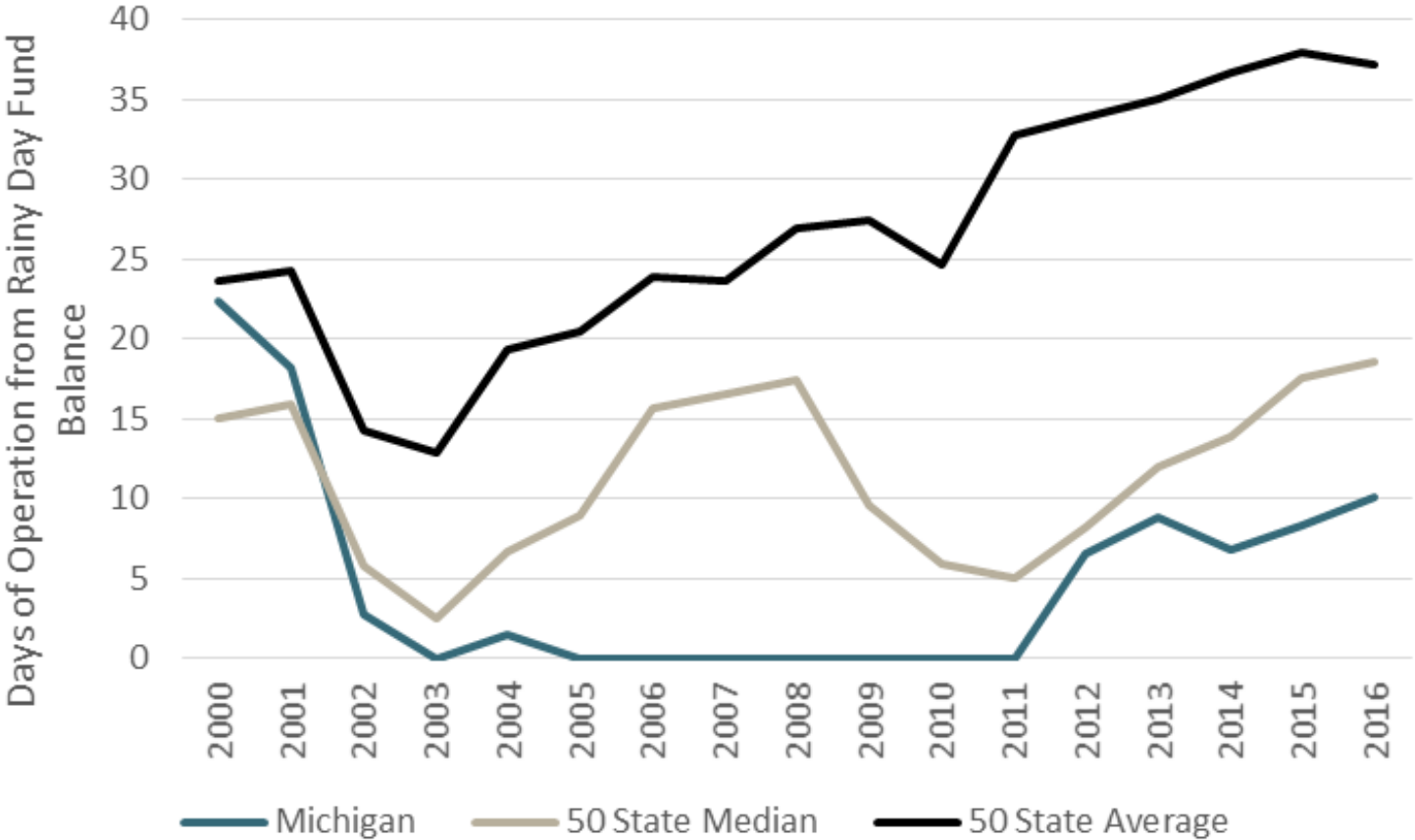


Adequacy of Current Reserves

Is Michigan Saving Enough?

- By the end of FY2018, Michigan will have \$890 million saved in the rainy day fund.
 - That is equivalent to about 4% of combine General Fund and School Aid Fund revenues.
- There is no exact amount that Michigan needs to save.
 - Expert organizations disagree on the ideal level; some recommend anywhere from 5 to 15% of revenues.
- Experts have estimated Michigan's General Fund would need about \$1.5 billion to weather an average recession.

Days of Operation Using Rainy Day Funds



Conclusions

Better Preparing for the Next Recession

- After a decade of economic troubles and the tepid growth that followed, Michigan's rainy day fund is finally refueling.
- While the \$890 million expected to be saved by the end of the fiscal year is a stronger start than the state has seen for most of the fund's history, Michigan should continue efforts to build up reserves.
- Michigan's rainy day fund is well designed to save money for an economic downturn, but the savings cap could limit its effectiveness. Once Michigan reaches the savings cap, lawmakers should consider raising the amount that is allowed to be saved.

Questions?