CITIZENS RESEARCH COUNCIL OF MICHIGAN

"The right to criticize government is also an obligation to know what you're talking about."

Lent Upson, First Director of the Citizens Research Council

MAY 21, 2025

The Long and Winding Road to a FY2026 State Budget

In a Nutshell

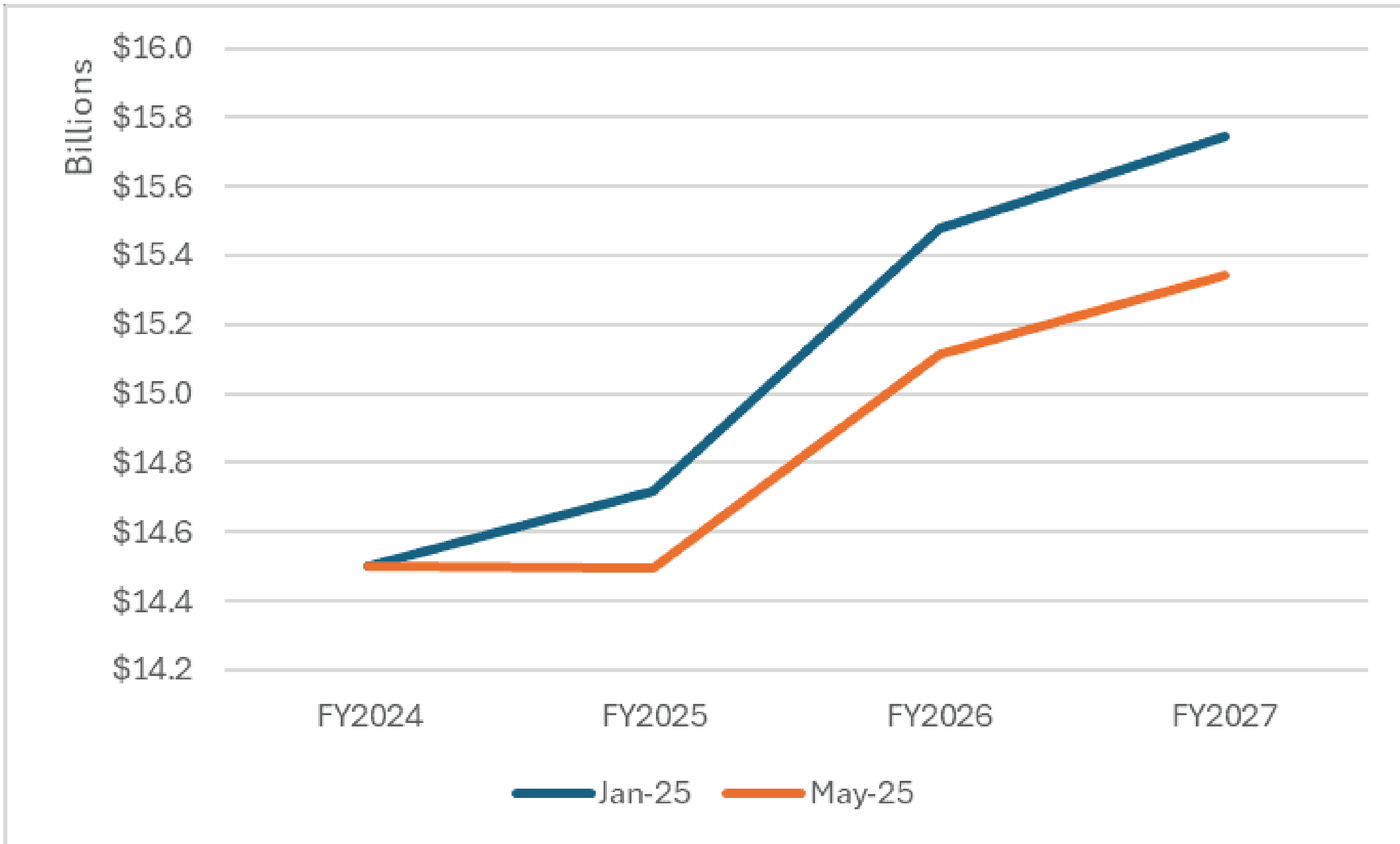
- State economists downgraded projections for state GF/GP revenue – a critical source of discretionary funding within the state budget – at last Friday's Consensus Revenue Estimating Conference.
- This comes while a number of critical budget issues are still being debated, including competing road funding proposals and federal reforms within Medicaid and safety net programs that will impact future state budgets.
- These factors mean the Governor's February budget proposal will need to be scaled back – likely by a lot depending on the outcomes of these policy debates; meaning this year's budget deliberation's will be the most challenging since the Great Recession era.

In what has generally been the starting gun for the final stage of budget deliberations, state economists last week finalized state revenue estimates that will establish guardrails for deliberations on the size of Fiscal Year (FY)2026 state budget appropriations. The bad news for state appropriators: for only the second time in the last eleven revenue conferences dating back to August 2020 state revenues were adjusted down, rather than up, from the previous set of estimates. Importantly, the Governor's budget proposal released in February is based on these older and rosier estimates from January.

As background, the Consensus Revenue Estimating Conference (CREC) establishes forecasts for the state's two major revenue pots: General Fund/General Purpose (GF/GP) revenue and the School Aid Fund (SAF). While these two funds make up only about 40 percent of the total state budget, almost all of the critical appropriations decisions made within the budget process are tied to these revenues because this is the money over which appropriators have the most discretion.

As we discussed in our recent podcast recorded after the Friday conference, the downgraded revenue projections were tied to GF/GP revenue. Forecasters projected GF/GP revenue will be $222 million lower in FY2025, $363 million lower in FY2026, and $399 million lower in FY2027 than they expected back in January; a drop of between 1.5 and 2.5 percent in each year (chart). Since the Governor's budget proposal can no longer be supported with these reduced revenues and Michigan's constitution requires a balanced budget, lawmakers will need to cut GF/GP appropriations within the Governor's budget to account for the new forecast.

GF/GP Revenue Estimates: January 2025 and May 2025



Source: May 2025 CREC Executive Summary

To be sure, these adjustments are not dramatic in size. But added to a plethora of other issues like competing road funding plans and uncertainty regarding federal reforms of major social welfare programs including Medicaid and food assistance, finalizing the FY2026 budget may look more like a marathon than a sprint this year. Here are three other hurdles that will need to be cleared before lawmakers will be in position to enact a new budget for FY2026.

Road Funding: What's the Deal?

As we have previously discussed, the most critical factor shaping the conclusion of FY2026 budget deliberations is whether state lawmakers can come to a deal on road funding, and what that deal looks like.

Both House Speaker Matt Hall and Governor Whitmer have put forward frameworks for road funding legislation that would generate more than $3 billion in additional annual revenue for transportation infrastructure. Both plans also rely – although to differing degrees – on redirecting current state revenue. Since most of that redirected revenue is already used elsewhere in the budget, both plans have significant budget implications to meet Michigan's balanced budget requirement.

The Governor's February budget proposal included about $500 million of program increases and other new public investments. If we assume all of this gets zeroed out in the final budget, implementing the House road plan would likely necessitate an additional $2 billion in offsetting GF/GP budget reductions. The Governor's proposal would require approximately $500 to $700 million in additional GF/GP spending cuts. As of today, no one within the executive or legislative branch has outlined a plan to fully achieve those reductions.

So, to start, the three most critical questions affecting the FY2026 budget outlook are:

- Will there be a roads deal at all?
- How much current state revenue will be reallocated to roads under any deal?
- And, perhaps most importantly, where will the offsetting budget cuts come from?

Michigan's Insurance Provider Assessment: Is the End Near?

Adding to this budget challenge, a new proposed rule from the federal Centers for Medicare and Medicaid Services may be the death-knell for Michigan's Insurance Provider Assessment (IPA). The tax, established in 2018, is assessed on a broad group of health care insurers, including both Medicaid contracted health plans and specialty pre-paid health plans that administer Medicaid behavioral health services.

The IPA is one of three major Medicaid provider taxes assessed; the others are taxes on hospitals and nursing homes. At their core, provider taxes are designed to help leverage additional federal funding to support Medicaid. The state imposes a tax on a health care provider group. Then, those tax revenues are used to boost Medicaid reimbursement to those same providers by drawing down federal matching funds (note: within the traditional Medicaid program, Michigan gets roughly two dollars in federal funding for every dollar of state funds). Finally, some of the additional funding is used to offset GF/GP appropriations that would otherwise be spent on Medicaid.

Federal law and regulations establish guidelines for Medicaid provider taxes. These include requirements that taxes must be imposed broadly on all providers within a tax group. If a state taxes doctors, for instance, the tax needs to be imposed on all doctors, not just those who accept Medicaid patients. The taxes also must be assessed at uniform rates across all these health care providers. These requirements are designed to ensure that states don't establish taxes that shift tax burden to providers with heavy Medicaid utilization (who stand to gain from the resulting enhanced reimbursement) and away from those with low utilization (who would pay the tax without significant reimbursement gain). Why is this important? Because taxes that do this would shift more and more of the states' share of Medicaid costs to the federal government by leveraging even greater amounts of federal dollars from high-utilization providers.

Importantly, however, the federal government also allows states to apply for a waiver of these requirements. To gain approval, states must demonstrate that their tax structure passes a statistical test set out in federal rules that is intended to measure the degree to which the tax burden is more heavily distributed to providers with high Medicaid utilization. The problem for the federal government is that this statistical test is not an effective one. Over the years, states have realized it is possible to create a tax structure that passes the statistical test in a mathematical sense but that also pushes tax burden to heavier Medicaid users, enhancing the gains to both providers and the state, which runs counter to the spirit of the federal limitations.

The proposed rule makes it clear that the federal government intends to put a stop to previously approved taxes of this nature. Unfortunately for Michigan, it appears the IPA is one of those taxes targeted by the new rule.

The proposed rule was issued on May 15 and is currently in a public comment period that runs until July 14. While the rules promulgation process can vary in time length, it would not be surprising to see final rule approved early in FY2026, if not even before the new fiscal year begins on October 1. For Michigan, that would mean the loss of roughly $630 million in annual IPA revenue. Some of that revenue is simply used to reimburse Medicaid health plans for the cost of the tax, but importantly, the loss of the IPA also creates the need to backfill the rest of that revenue loss with roughly $450 million in GF/GP revenue.

What Else Happens at the Federal Level?

While much is still undetermined, federal reforms under consideration in Washington, D.C., could also have significant impacts on the state's costs related to key safety net programs.

The largest state budget impacts could come from changes to the Supplemental Nutrition Assistance Program (SNAP), formerly the "Food Stamps" program. Currently, SNAP benefits are funded 100 percent by the federal government, but the U.S. House budget reconciliation bill contains provisions that would require minimum cost sharing of five percent by states and up to 25 percent based on state payment error rate percentages. Based on Michigan Department of Health and Human Services (HHS) data, Michigan residents received nearly $3 billion in assistance during FY2024; therefore, the minimum five percent cost sharing could result in $150 million in new annual GF/GP costs to Michigan that would be needed to maintain current enrollment and benefit levels.

Another provision would increase state-federal cost sharing for SNAP administrative expenses, from 50-50 generally to 75-25. Based on the most recent reporting from the U.S. Department of Health and Human Services, Michigan incurred around $400 million in total SNAP-related administrative costs. So, raising the state's share of these expenses would increase Michigan's costs by an estimated $100 million annually.

On the other side of the coin, a key component of the budget reconciliation bill is the implementation of work requirements on non-disabled adults who receive either Medicaid or SNAP benefits. Here, costs savings to the state from Medicaid disenrollments are likely to offset any administrative costs tied to implementing the work requirements. Notably, Michigan enacted legislation to implement similar work requirements on Healthy Michigan Plan (HMP) – Michigan's Medicaid expansion program – recipients in 2018. While the implementation of these changes was eventually blocked by a federal court, a House Fiscal Agency analysis had projected net state cost savings of between $5 million and $20 million annually with HMP enrollment declining by 5 to 10 percent (around 50,000 to 100,000 people were projected to be disqualified from Medicaid eligibility).

While deliberations are still ongoing on each issue, it appears most likely that any implementation of these proposals would occur after the conclusion of FY2026. However, while these aren't immediate concerns, they would have significant effect on future budgets perhaps as soon as FY2027.

How Much Will Need to be Cut?

Put together, all these factors are likely to result in some of the most difficult budget decision-making that the state has faced since the Great Recession years, and the budget process is already behind its traditional timeline. The Michigan House of Representatives has yet to report any FY2026 budget bills from appropriations subcommittees. And while the Senate has passed a full set of bills, those bills are based on the earlier and rosier projections and do not make any of the GF/GP budget reductions that will be needed to effectuate either of the two road plans offered by the Governor and Michigan House Republicans.

The Governor's February budget proposal included ongoing GF/GP appropriations (i.e., those intended to carry into FY2027 and beyond) of $14.6 billion. It also included one-time appropriations that would largely eliminate a one-time GF/GP fund balance of $721 million.

Even if lawmakers fail to reach any road funding deal, the impact of the downward revisions in GF/GP revenue estimates along with the likely loss of IPA revenue mean an estimated $800 million in ongoing reductions to the GF/GP appropriations contained in the Governor's budget proposal will be necessary to bring appropriations in line with ongoing revenue; that amounts to about 5.5 percent of total ongoing GF/GP appropriations.

Add on some form of compromise roads deal that redirects another $1 billion in GF/GP to transportation, and the size of budget cutting grows to $1.8 billion (just over 12 percent of ongoing GF/GP appropriations). Either scenario calls for significant budget cuts from GF/GP resources that are highly concentrated in just three areas of the state budget: health and human services (48 percent of total), corrections (14 percent), and public universities (12 percent).

Further, this initial round budget cutting will need to extend further once the magnitude and timeline of the federal measures related to Medicaid and SNAP are finalized, perhaps as soon as FY2027.

Finally, all of this assumes no other major tax policy changes are enacted that would further impact future GF/

GP revenue. That would include both Republican-sponsored legislation to permanently cut the state income tax rate from 4.25 to 4.05 percent (which is expected to reduce GF/GP revenue by more than $700 million annually) and Democratic-sponsored legislation creating a new $5,500 per child tax credit for lower-income taxpayers with pre-school aged dependent children (similar 2024 legislation was estimated to reduce GF/GP revenue around $1 billion annually).

After years of revenue growth that helped drive both new public investments and significant tax relief, lawmakers need to be prepared for a new budget reality this summer – one that may make reaching the finish line on the FY2026 state budget extra difficult.

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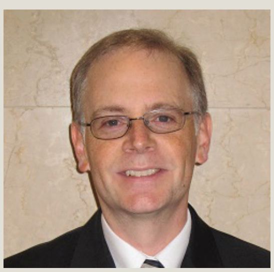

Bob is in his second stint with the Citizens Research Council, having worked for the organization from 2013 to 2015. He has spent most of his time in state government, having worked in the Office of Health and Human Services – State Budget Office and as Associate Director for the non-partisan Michigan House Fiscal Agency (HFA). He has extensive expertise and has provided non-partisan advice and analysis on state policy and budget matters in areas including corrections, human services, and transportation. Prior to joining HFA, he was a research assistant and project manager from 1994 to 1996 for Public Policy Associates, a Lansing-based policy research and consulting firm. He also served for two years within the Michigan Department of State working on department budget and financial issues.

Bob received his B.S. in Economics from Central Michigan University and his M.A. in Economics from Michigan State University.