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CRC Memorandum

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The Problematic Fiscal Year 2003-04 State Budget

Introduction

The presentation of the Governor's Fiscal Year 2003-04 (FY04) Executive Budget on March 6 signaled the beginning of a period of intense debate over the future shape of Michigan's budget. In particular, the General Fund and School Aid Fund, which together constitute over half of the total state budget, have been under significant pressure since FY00, the last year of relatively strong economic and revenue performance in Michigan. Although balancing the General Fund and School Aid Fund budgets will likely be substantially more difficult in FY04, the FY05 budgets will also be extremely tight. Looking beyond FY05, the state is likely to face continuing structural problems with the budget that only structural changes in the programs and/or the revenue base will solve.

Revenues

The January 14 consensus revenue estimates for FY03 and FY04 established one side of the budget equation and helped to clarify measurement of the gaps for those two years that must be closed to balance the budgets. The revenue forecasts continue to reflect the past deterioration in the economy, which has yet to begin a sustained recovery. The economic forecast has the Michigan economy beginning recovery in the first calendar quarter of 2003 and, by the end of 2003, increasing at a moderate rate through the third quarter of 2004, the remainder of the forecast period.

After factoring in the remaining 0.1 percentage point cut in the Individual Income Tax scheduled for January 1, 2004, and the continuing reduction in Estate Tax revenues caused by the federal tax reform program approved in 2001, General Fund revenues will barely grow at all on a year-to-year basis. The projected increase after these adjustments is $108 million or 1.3 percent. Revenues, before tax changes are factored in (baseline revenues), are projected to increase $355 million or 4.3 percent.

Baseline School Aid Fund revenues in FY04 are projected to grow 4.2 percent from FY03 forecasts. After adjusting for $692 million of one-time revenues and resources used in FY03, available resources are projected to fall $365 million short of FY04 School Aid Appropriations, which were approved in 2002.

In addition, General Fund and School Aid Fund revenues will be further adversely affected if the President's proposal to exempt dividends from taxation is adopted, since federal adjusted gross income (AGI) would be reduced for taxpayers and AGI is the starting point in calculating Michigan income tax liability. The potential total revenue losses for FY03 and FY04 are about $40 million and $125 million respectively. Approximately one-fourth of the impact would fall on the School Aid Fund and the remainder on the General Fund. By some estimates, the additional stimulus to the Michigan economy of the President's total proposal could produce enough additional revenue to offset the loss of dividends from the tax base. However, the revenue increases would not likely occur in the same fund mix as the losses.

The Executive Budget is only the beginning of a public process that culminates in the adoption of legislative appropriations to authorize state expenditures for FY04. Much debate will occur before those appropriations are made. CRC will stay abreast of the developing budget and issue updates on the CRC website, www.crcmich.org. To receive e-mail announcements of these updates, contact CRC by phone, fax, or e-mail.

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The Path of Least Resistance

Past use of one-time fixes has allowed the structural budget deficit problem to linger and has left few fixes of this type to address current needs. For three fiscal years (FY01-FY03) state decision-makers continued cutting tax rates and used one-time revenue resources to avoid corresponding reductions in General Fund spending. In the School Aid Fund, a surplus of nearly $1 billion and other one-time revenues were used to permit school aid spending to increase at a faster rate than the tax revenues earmarked for the fund did as the economy slowed. The two funds combined will have used $4.5 billion of one-time resources over three fiscal years, as itemized in **Table 1**.

Table 1
Summary of One-time Resources
Fiscal Years Ending 2001-2003
(In Millions)

Rainy Day Fund	$1,264.4
FY00 School Aid Fund Surplus	983.9
FY00 General Fund Surplus	211.8
Medicaid Benefits Trust Fund	561.1
Tobacco Settlement Revenues	259.0
Advance State Education Tax Collection Date	454.7
Bond for Pay-as-you-go Capital Projects	211.2
Employment Contingent Fund	89.5
Sale of Properties	72.3
Executive Order 2002-22 One-time Spending Adjustments*	204.4
Other	168.0
Total	$4,479.3

Source: Senate Fiscal Agency and State Budget Office

*If actions to balance the enacted budget are needed to avoid a deficit, the Governor presents an Executive Order reducing spending, which requires the approval of the majority of members of each appropriations committee to be implemented.

Fiscal Year 2003. The January 2003 forecasts of General Fund and School Aid Fund revenues triggered action to eliminate projected deficits in both funds. An executive order and other related actions reducing General Fund spending by $158 million were approved in February and reductions in School Aid spending totaling $127 million were implemented during that same time period. Those actions coupled with General Fund adjustments of $460 million in December 2002 brought the budget reduction actions to about $750 million since the beginning of the fiscal year. **Table 2** itemizes the one-time resources used for both funds this fiscal year.

Fiscal Year 2004. The reliance on one-time revenues to sustain FY03 spending levels in both funds created very large gaps between spending and baseline revenues carrying into FY04. Since the one-time revenues used in FY03 are not available in FY04 to support spending, a combination of revenue growth, spending reductions and revenue enhancements are needed to balance the budgets for FY04. The total one-time revenues, $1.5 billion for the two funds combined, far exceeds the annual revenue growth associated with even a healthy, expanding economy, let alone a struggling economy such as the current one. As a consequence, a combination of spending cuts and revenue enhancements will have to carry the majority of the load in balancing the budget in the two funds.

Table 2
Fiscal Year 2003 One-time Resources Used to Balance the Budget
General Fund and School Aid Fund
(In Millions)

General Fund		
Beginning Balance	$114.5	
Merit Award Withdrawal	150.0	
Waterways Transfer	7.8	
Pre-funded Health Reserve	58.2	
Unemployment Agency Fund	10.0	
Property Sales	66.1	
Rainy Day Fund	116.9	
Medicaid Benefits Trust Fund	284.0	
General Fund Total		$807.5
School Aid Fund		
Beginning Balance	$237.0	
Rainy Day Fund (Durant Court Settlement)	32.0	
State Education Tax Date Shift	454.7	
School Aid Fund Total		723.7
Total One-time Revenues		$1,531.2

Source: Senate Fiscal Agency and State Budget Office

The Size of the Fiscal Year 2004 Gap

The General Fund. Adding to the General Fund budget problem for FY04 is additional spending requirements that combined with the FY03 one-time revenue gap to produce a projected shortfall of $1.7 billion which are itemized in **Table 3**.

Table 3
The Projected Fiscal Year 2004 General Fund Gap
(In Millions)

FY04 Consensus Revenue Estimate		$8,191.5
FY03 Appropriations	$8,925.9	
Employee Compensation Cost Increases	140.0	
Medicaid	535.0	
Debt Service	111.0	
Corrections Bed Space and Health Care	150.0	
Other	30.0	
Projected Spending Requirements		9,891.9
Projected Shortfall		($1,700.4)

Source: Fiscal Year 2004 Executive Budget

The School Aid Fund. By comparison with the General Fund, the FY04 School Aid situation is more manageable. In the summer of 2002, the legislature passed a school aid budget that essentially continued spending the levels reflected in the FY03 appropriations. Baseline revenues are projected to grow $452 million in FY04. But one-time revenues of $724 million are used in FY03 and even with that temporary infusion of resources; revenues in FY03 are $127 million short of supporting the FY03 appropriations. Overall, after taking other adjustments into account, the projected revenues needed to cover the FY04 appropriations are $365 million short of balancing with the appropriations. **Table 4** summarizes the School Aid Fund gap calculation.

Table 4
The Projected Fiscal Year 2004 School Aid Fund Gap
(In Millions)

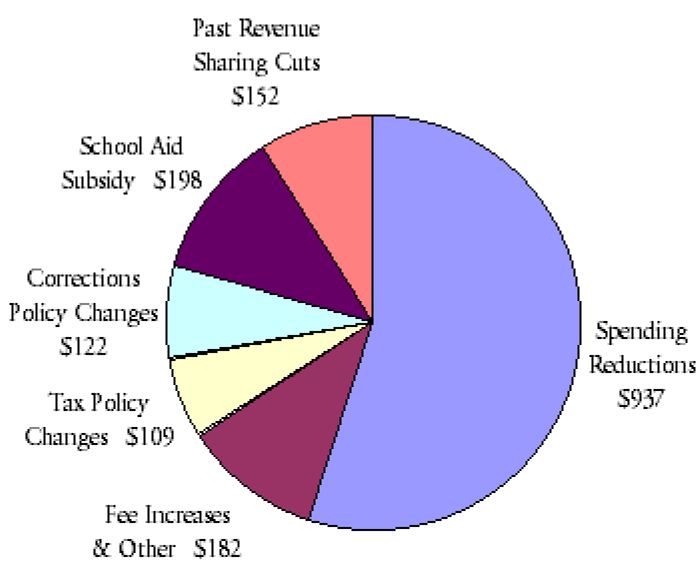
FY04 Consensus Revenue Estimate	$10,854.7	
General Fund Grant	198.4	
Federal Funds	1,219.8	
Total Revenue Resources		$12,272.9
Appropriations	$12,696.9	
Adjustments: Taxable Value and Enrollments	(59.0)	
Projected Spending Requirements		12,637.9
Projected Shortfall		($365.0)

Source: Fiscal Year 2004 Executive Budget

The Proposed Fiscal Year 2004 General Fund Budget

Faced with a $1.7 billion gap between revenues and projected spending requirements, the proposed budget for FY04 advocates a combination of spending reductions, revenue enhancements, and policy changes. **Chart 1** summarizes the general methods proposed to close the gap.

Chart 1
Closing the $1.7 Billion Fiscal Year 2004 General Fund Gap
(In Millions)



Structural Changes

The result, if approved as proposed, will represent significant structural change in the General Fund budget. Principal among the changes are:

(1) A significant reduction in the percentage of state-shared sales tax revenues paid to local units of government: cities, villages, townships, and counties. The budget proposal represents the third year that statutory payments will fall below the percentage of the Sales Tax revenues specified in statute. In FY04 cities, villages, townships, and counties will receive 73 percent of the amount specified in statute, or $269 million less than if state revenue sharing were fully funded.

(2) Large reductions in state appropriations for higher education that will likely change the student tuition/state appropriations funding shares. The mix of state appropriations and tuition varies among the 15 state universities, but on average each contributes approximately equal shares to overall university funding. The gap between these sources could grow to as much as 15 percentage points if tuitions are increased to recoup lost appropriations and cost increases.

(3) Elimination of the direct General Fund subsidy to school aid;

(4) Redirection of tobacco settlement revenues away from higher education student financial aid to health care programs;

(5) Policy changes that slow growth in prison bed needs;

(6) Increased reliance on fees to pay certain program costs.

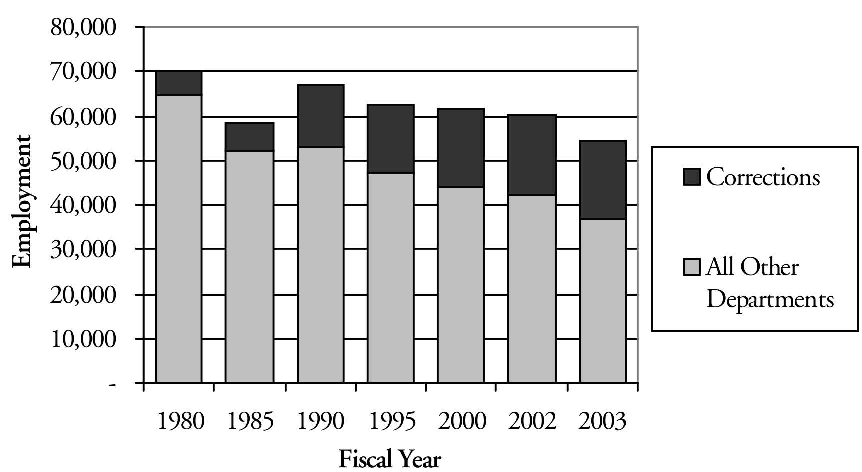
Employee Compensation—Concessions versus Jobs

A significant piece of the budget puzzle is employee compensation. Approximately $250 million ($140 million General Fund) of compensation cost increases are not specifically funded in the budget. The cost increases include a pay raise of 3 percent negotiated with employee unions by the previous administration, the employer's share of retirement contributions and social security taxes, and group insurance premium increases. Roughly 3,000 jobs are at stake, with concessions offering the mechanism to lessen the need to reduce employment across state government. Failure to achieve the compensation savings could result in a state workforce of 50,000, approximately 20,000 lower than the peak level in 1980. **Chart 2** depicts employment over the last 23 years and the large shift to Corrections and away from other agencies. During that period, Corrections employment has increased from 5,000 to 17,400 (248 percent) while employment in all other state departments declined from 65,000 to 36,900 (43 percent).

Human Services

Little change is recommended in the Family Independence Agency (FIA) and the Medicaid program emerges virtually unscathed from budget cutting, although savings from projected reductions in pharmaceuticals prices and increased federal funding match in some areas are reflected. Reduced

Chart 2
State Government Employment Trends



Source: Michigan Department of Civil Service, Workforce Reports caseloads are projected for the Temporary Assistance for Needy Families (TANF) program in FIA and Medicaid, both at the hopeful end of the range of possibilities. Staffing may be the major issue in both programs, with service levels for FIA clients threatened by the employee concession issue.

Fragile Elements

In a budget proposing such major reshaping, many elements of the overall proposal generate negative reactions. These components constitute a significant portion of the overall solution, and failure to achieve legislative approval will necessitate other offsetting adjustments in the plan to achieve balance between spending and revenue. The following areas appear among the most fragile large elements of the proposal:

Tax Policy Changes. The General Fund budget proposes "closing $109 million in tax loopholes, …" Changes totaling $20 million are proposed for the School Aid Fund. The reaction from the business community has essentially been negative with arguments made that the proposal to close loopholes is instead a set of tax increases. Clearly, if the changes are approved by the Legislature some taxpayers will pay more taxes although tax rates would remain unchanged. This issue will be dealt with by legislative committees different than those dealing with the spending side of the budget, and legislative leadership will need to coordinate the efforts of the committees responsible for spending and revenues to achieve a balanced outcome.

Merit Scholarships. The proposal to reduce the Merit Scholarship awards from $2500 to $500 has elicited significant opposition in the legislature. Reallocation of the uses of Tobacco Settlement revenues away from some past uses to help fund the Medicaid program presents a dilemma to legislators who support both programs, since reductions in Medicaid services might be required if the Merit Scholarship program is kept intact.

Higher Education. The reductions proposed for higher education in FY04 come on top of reductions in FY03. Overall, proposed appropriations for FY04 are 10 percent below the actual FY02 appropriations. Historically, colleges and universities have used their other major funding source, tuition and fees, to cover shortfalls in state funding. FY04 will likely be no different and if the 15 public universities are to recoup lost appropriations plus cover cost increases for salaries, group insurance, employer taxes and other items such as utilities, they would have to institute double digit increases in tuition and fees in the fall of this year, and many universities would have to increase tuition and fees by more than 20 percent.

Corrections Policy Changes. In order to largely avoid a projected increase of $150 million for added bed space in prisons and increased health care costs for prisoners, changes in policy are reflected in the proposed budget that increase the reliance on community alternatives to prison. The savings from the policy changes total $122 million and face opposition from members of the legislature who oppose changes that might be regarded as more lenient than current policies.

Employee Concessions. The State faces about $250 million of added costs for various elements of employee compensation. The General Fund share is $140 million. While the budget acknowledges the costs, funding is not included in the recommendation to pay for them. Instead, the budget assumes that concessions and reductions in the number of employees through attrition and layoffs will combine to cover the requirements.

Caseloads. The number of individuals served by the Medicaid program and receiving benefits from the Temporary Assistance for Needy Families program is assumed to decline from current levels in FY04. If the economy fails to improve, as projected, this component of the proposed budget is at risk. There are no obvious places to turn to find adjustments to offset higher costs in these two programs.

Federal Medicaid Support. Part of the Medicaid budget depends on changes that will leverage increased federal support and waivers to permit program changes. Increased federal earnings are reflected in some areas through higher matching rates. The Federal government's approval of proposed changes is assumed in the budget, but may not be forthcoming in every instance and or at least in time to result in the desired budgetary impact.

Federal Tax Law Changes. The budget makes no provision for potential changes in federal tax law. The President has proposed a package of tax cuts intended to stimulate the economy. Among the recommended cuts is the elimination of dividends from taxation under the federal income tax. Since Michigan starts with federal adjusted gross income (AGI) in computing taxable income under state law, the elimination of dividends from AGI would reduce Michigan income tax revenues unless state law explicitly adds dividends back into Michigan AGI. At risk is about $125 million in FY04, about three-fourths from General Fund and the remainder from the School Aid Fund. The President's proposal is still under consideration by the Congress and it is possible that the Michigan budget could be finalized before this uncertainty is resolved.

The Economic Outlook and Projected Revenues. Repeatedly in the past two years the State has been forced to lower the economic and revenue forecasts to reflect the realities of a sluggish economy and declines in tax revenues. In order for the new budget proposal to hold together, the economy will have to cooperate. Failure to see improvement in revenue collections and economic statistics before the May Revenue Consensus Conference will likely mean a downward adjustment in revenues and the need for more spending or revenue adjustments. Reopening the budget to add more balancing actions risks the whole thing unraveling.

Summary

In sum, the FY04 budget proposal for the General Fund is fragile. It seems likely that some important elements will change in size and composition. However, modifying the proposal is a zero-sum game. The formidable task of finalizing the FY04 budget has the potential of extending well beyond the traditional end-of-June timeframe.

The Proposed Fiscal Year 2004 School Aid Budget

Faced with a gap of roughly 3 percent, the Governor's budget proposes to modify the spending and revenues in several ways. **Chart 3** displays the general means used to rebalance the budget.

Unlike the General Fund proposal which relies on only $42 million of one-time revenues, the FY04 School Aid recommendation depends on approximately $328 million of one-time revenues. In addition to one-time savings of $100 million derived from refinancing School Bond Loan Authority bonds, the General Fund grant to the School Aid Fund of $198 million is eliminated and replaced by one-time revenue of $199 million from an accounting change in the State Revenue Sharing program and $29 million of one-time revenues from advancing the collection date of the State Education Tax to the summer of 2003 spill over into FY04.

The budget proposes to cut funding by $69 million in eight categorical programs, most notably adult education, which is reduced $57.5 million (74 percent). Ten categorical programs listed in **Table 5** are recommended for elimination, saving a to-

Chart 3
Closing the $365 Million Fiscal Year 2004 School Aid Fund Gap
(In Millions)

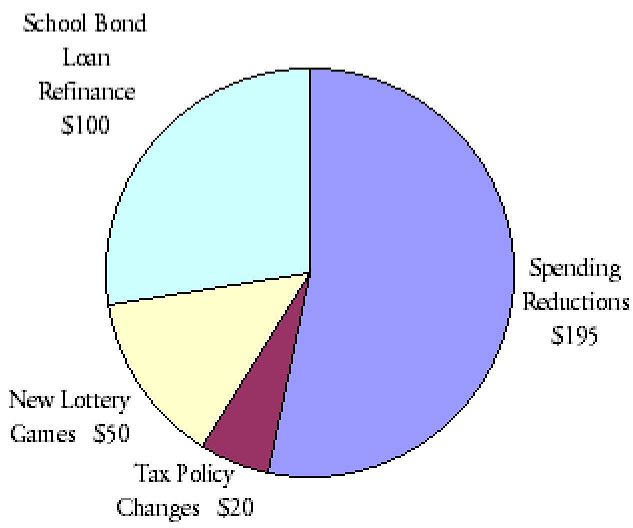


Table 5
School Aid Categorical Programs
Recommended for Elimination in Fiscal Year 2004
(In Millions)

Career Preparation Programs	$22.2
Partnership for Adult Learning	20.0
Math and Science Centers	10.2
Gifted and Talented Programs	5.0
Standard & Poors' Contract for Data Reporting & Analysis	2.5
School Health Curriculum Grants	3.1
Grants to Interagency Collaborative Bodies	2.0
Accreditation Assistance Grant to Dept. of Education	2.0
Golden Apple Awards	1.3
Autism Program Grant to Grand Valley State University	0.5
Total	$68.8

Source: Fiscal Year 2004 Executive Budget

tal of $68.8 million. Changing the method for counting students from 80 percent fall count and 20 percent the previous February count to a 50/50 blend is proposed. The change benefits districts with declining enrollment and reduces overall funding by $40 million. Savings from refinancing Durant Settlement bonds ($40 million) are partially offset by budgetary increases totaling $23 million.

In recognition of the already tight budgets faced by local school districts resulting from declining support and increasing costs, notably in health insurance premiums, the budget proposes to temporarily hold the employer-paid retirement contribution rate at 12.99 percent of payroll. The actuarially calculated rate for FY04 is 14.37 percent. The temporary savings are $133 million. The use of reserves accumulated in the retirement system make this proposal possible. Further, the proposal is tied to the cooperation of directly affected school districts, who must join with the state in the school bond loan refinancing proposal.

Comparing the FY04 School Aid proposal with the FY03 budget after reductions implemented to cover the revenue shortfall, FY04 will be the first year since Proposal A was implemented in 1994 that overall State School Aid will decline on a year-to-year basis. The net amount of the reduction is $78 million, 0.6 percent.

The Outlook Beyond Fiscal Year 2004

FY05 General Fund. Even with an expanding economy, the FY05 General Fund will be extremely tight. Net revenue growth will be constrained by the effect of the 2004 reduction in the Income Tax rate, the elimination of the Estate Tax by the federal government, one-time revenues supporting FY04 spending, and possibly the exclusion of dividends from taxation. On the spending side, the former administration negotiated a pay increase for state employees of four percent effective in FY05, which will add significantly to costs. Reductions in federal support for special Medicaid financing will add to General Fund requirements. These factors alone will more than absorb the net revenue growth consistent with a four percent increase in baseline revenues. Pressures for spending increases for higher education, increased medical care costs, and increases for providers of other services for clients of state-financed programs and many other demands for financial support will not be possible to meet without spending cuts elsewhere in the budget or revenue enhancements. **Table 6** displays a scenario including these factors.

Table 6
Fiscal Year 2005 General Fund Scenario
(In Millions)

FY04 Baseline Revenues	$8,192	
4 Percent Growth	328	
Continue Prior Revenue Sharing Reductions	269	
Tax Policy and Other FY04 Changes	119	
Income Tax Rate Reduction	(43)	
Federal Estate Tax Elimination	(55)	
Federal Dividend Elimination	(95)	
Net Available Revenues		$8,714
Proposed FY04 Spending	$8,592	
Contracted FY05 Employee Pay Raise	80	
Medicaid—Federal Funding Reductions (net)	96	
Net Expenses		$8,768
Shortfall		($54)

FY05 School Aid. The School Aid Fund depends more heavily on one-time revenues in FY04 than does the General Fund. If baseline revenues grow four percent in FY05, all but $74 million will be needed to offset the loss of one-time FY04 revenues. **Table 7** summarizes the fiscal arithmetic of this possible scenario. Public schools will face another year of absorbing higher costs essentially without increased state support.

The public school employee retirement contribution rate is headed up significantly in FY05 and almost certainly beyond, reflecting investment losses and higher health insurance costs for retirees. Local districts will need to anticipate increases and plan for them in budgets beyond FY04. The State may be in a position to phase-in these increases over two or three years using the remainder of accumulated reserves not used for FY04. If the State announces a multi-year plan well before districts begin their budget planning for FY05 and beyond, orderly consideration of this financial requirement will be facilitated.

Table 7
Fiscal Year 2005 School Aid Fund Scenario
(In Millions)

FY04 Baseline Revenues	$10,855	
4 Percent Growth	434	
Adjustment for One-time State Education Tax Revenues	(29)	
Tax Loopholes and New Lottery Games—FY04	70	
Federal Revenue	1,244	
Federal Dividend Elimination	(32)	
Net Available Revenues		$12,543
Proposed FY04 Spending		12,469
Potential Spending Increase		$74*
Percent Increase		0.6

* Local districts will have to cover increases in areas such as health insurance, employee pay, energy, and retirement contributions.

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Conclusion

Much has been said about the structural deficit in Michigan's General Fund budget. Yet the factors that led to the budget crisis include some important non-structural causes such as a sluggish economy and the false sense of revenue plenty resulting from unsustainable rates of appreciation in the stock market. Adding to the crisis were deliberate changes in the tax structure: rate reductions and other tax cuts that reduced the general fund revenue base. But in the background of these changes there were and still are pressing expenditure demands in corrections and medical care programs that grow faster than the revenue base even in a good year. These pressures will not be relieved in the future without policy changes. The FY04 budget proposal recalibrates the revenue and spending sides of the budget and reflects structural changes that solve the deficit for the time being. But without policy or financial changes that bring the growth rates in spending demands and revenues into line, we can expect significant problems in balancing the budget in years to come. Changing spending growth rates would require changes in corrections policies aimed at reducing prison populations. In Medicaid, fundamental changes in federal/state financial sharing to take advantage of the more robust growth in the federal revenue system will likely be needed unless significant changes are made in system of financing health care.

On the revenue side, the economy and Michigan's tax structure are increasingly becoming mismatched. This is especially evident when analyzing Michigan's Sales and Use taxes. Few services are taxed directly in Michigan and the services sector is the area of fastest growth in the economy. Thus, the rate of increase in Sales Tax revenues is largely dependent on tangible goods purchases from businesses located in Michigan, because the State lacks an effective way to collect Use Tax on tangible goods purchased from sellers outside the state. Remote sales of goods to Michigan customers by businesses located outside the state place instate businesses at a competitive disadvantage. Remote sales through catalogs and the Internet are expanding more rapidly than traditional store sales and the lost revenues to the state are estimated to be about $300 million. A national solution to this situation is underway, but it will likely take several years to eliminate the disparate treatment. If services and remote sales were brought under the sales and use tax umbrella and the rates were reduced to make the change revenue-neutral at the point of change, the revenue structure would likely grow more in line with the overall economy in the future and some of the structural pressure would be relieved.

CRC notes with sadness the passing of Robert F. Magill, who died on April 9, 2003, at the age of 85. Bob was a member of the CRC Board of Directors for 25 years and was president of the Board from 1982 to 1988. He was always active and engaged in CRC efforts to achieve excellence. He was a friend to board and staff members alike and will be sorely missed.