Citizens Research Council of Michigan

Michigan's On-Going Budget Problems and its Fiscal Future

Presented to
Leadership Macomb

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Citizens Research Council

- Founded in 1916
- Statewide
- Non-partisan
- Private not-for-profit
- Promotes sound policy for state and local governments through factual research – accurate, independent and objective
- Relies on charitable contributions of Michigan foundations, businesses, and individuals
- *www.crcmich.org*

Agenda – Past, Present, Future

- Past
  - look back at Michigan's economy and budget from 2001 to 2008 – major shifts
- Present
  - economic forecast and budget for 2009 and 2010
- Fiscal Future Project
  - outlook for Michigan's budget

The Michigan Budget Story Has Not Changed . .

- The State of Michigan continues to face dual structural deficits affecting:
  - -Public K-12 education
  - -General Fund-financed programs
- Its causes have both spending and revenue components
- We will **not** grow out of it
- Significant spending cuts and/or tax increases will be required

But There is a New Chapter

- National recession – severe
  - Consumption
  - Business spending
  - Homebuilding
- State budget unprepared to deal with current recession
  - Exhausted reserves
  - Tax increases of 2007
- Must correct for two problems simultaneously
  - Structural deficits
  - Cyclical deficits
  - Each problem requires specific set of tools

State Budget Realities

- Budget balance is a constitutional requirement
- Budget totals over $44 billion, but
  - $1 of $4 “no strings”
  - $3 of $4 restricted
- Limited options when it comes to balancing the budget
- 80% spent outside of state government
- Only about 11% is spent on state employees
- Corrections is the largest state-run program
- Health care is largest single item – everywhere in the budget

State Revenues

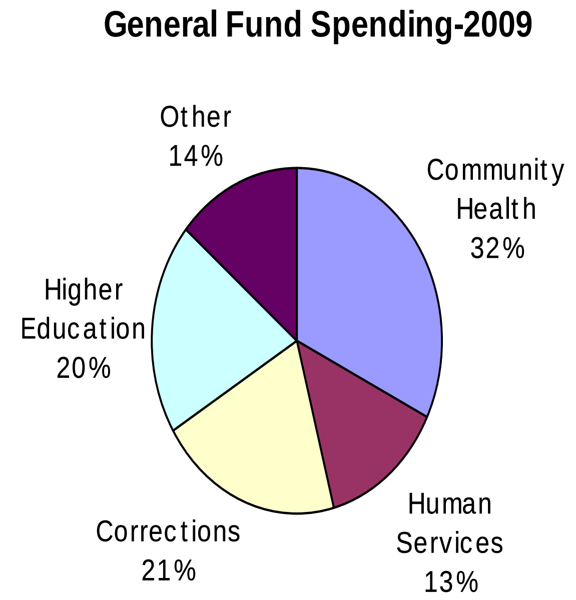
Taxes--59% of Total ($26 Billion)

- Sales & Use Taxes (31% of Total Taxes)
- Personal Income Tax (28%)
- Michigan Business Tax (10%)
- Transportation (7%)
- Alcohol and Tobacco (5%)
- Property (9%)
- Other Taxes (10%)

60% of Total is Earmarked

Discretionary Spending

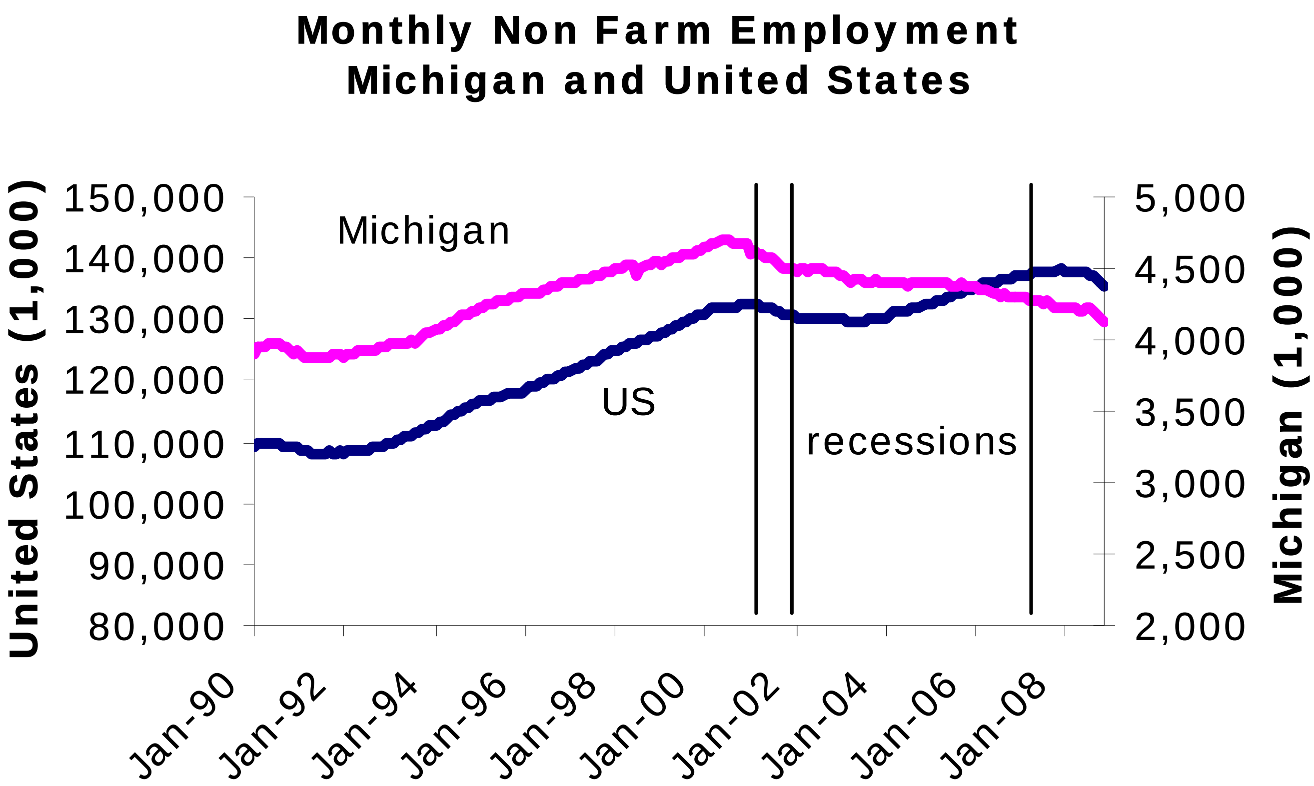
- Annual review and most attention
- $1 of $4 spent by state gov't
- 4 areas take up 86% of budget
- Corrections largest state-run program
- School Aid Fund - $12.6 billion



Total: $9.7 Billion

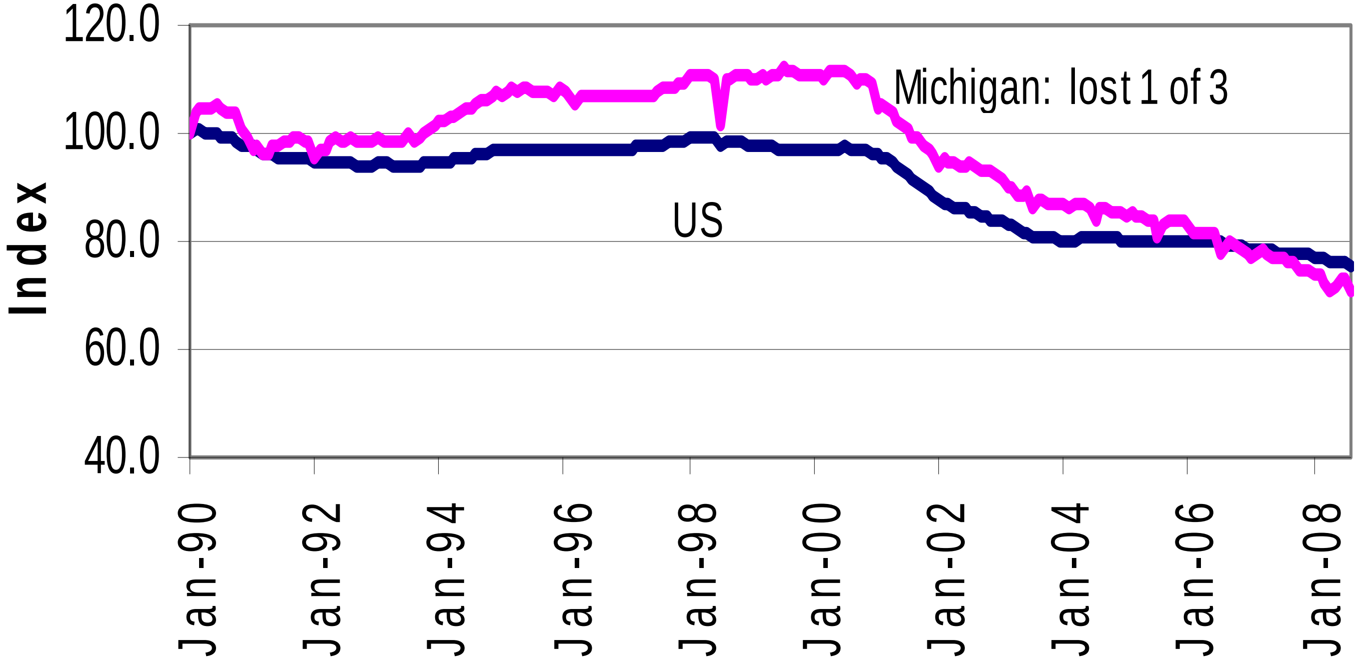
What is Going on in Michigan?

- Michigan economy has shown no improvement since 2001 recession – “single state recession”
- Since employment peak (June 2000), Michigan payroll employment has declined by 812,000 (21%)
  - Concentrated in manufacturing, autos specifically
- Payrolls for July 2009 281,000 below year ago levels
- Michigan Personal Income losing ground relative to US – becoming a “poorer” state
- Baseline state revenues experience anemic growth



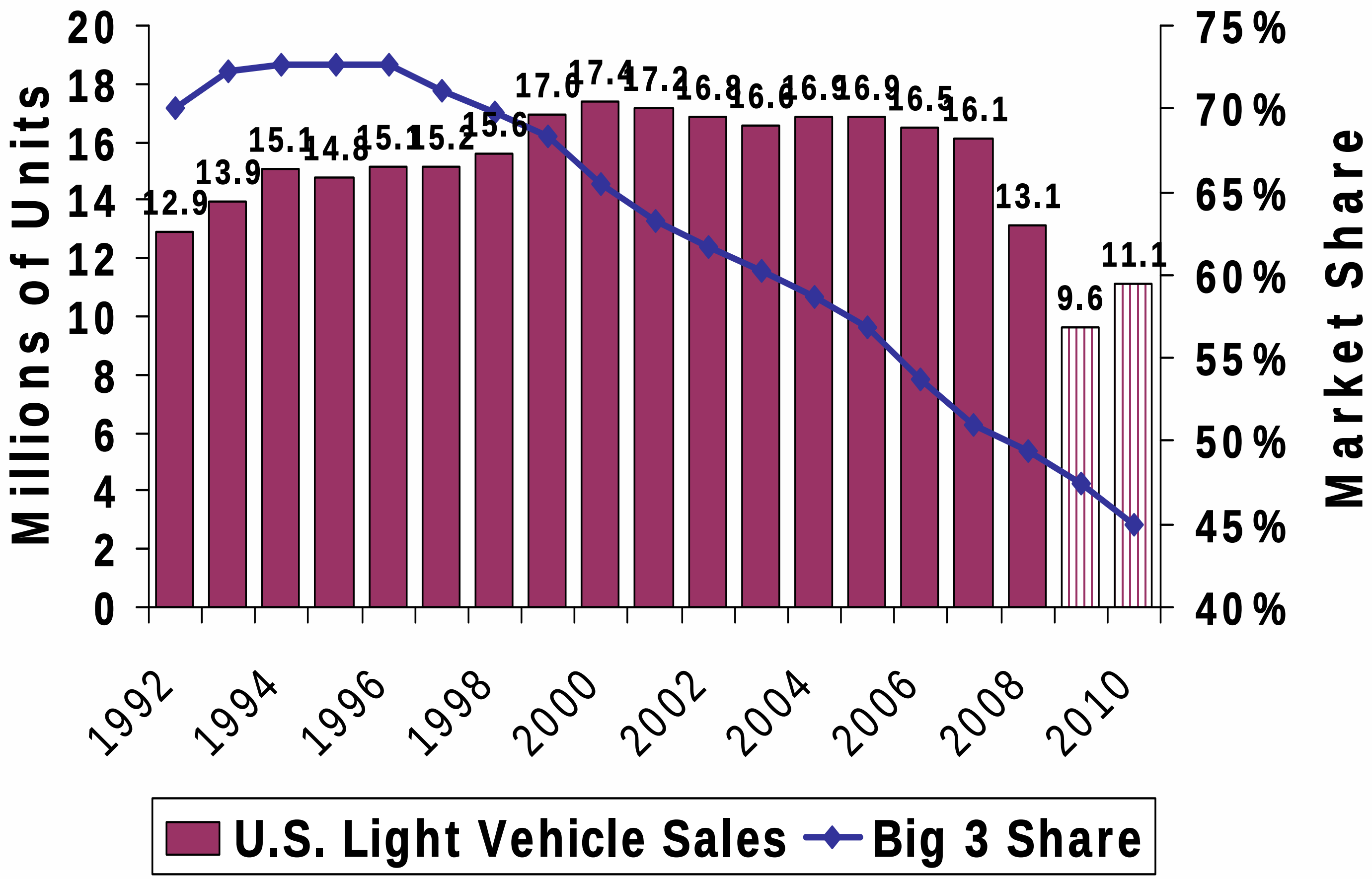
Source: Bureau of Labor Statistics

Growth In Monthly Manufacturing Employment
Michigan and United States



Source: Bureau of Labor Statistics

Big 3 Losing Market Share

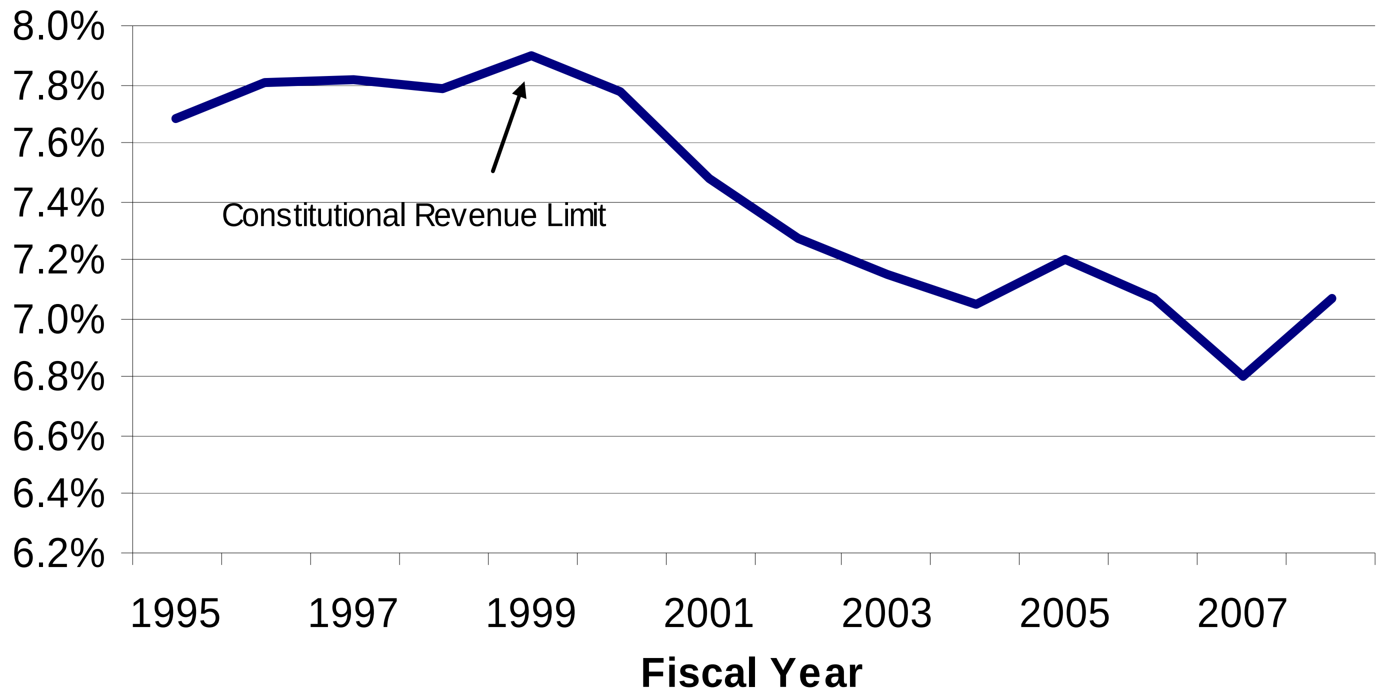


Source: Automotive News.

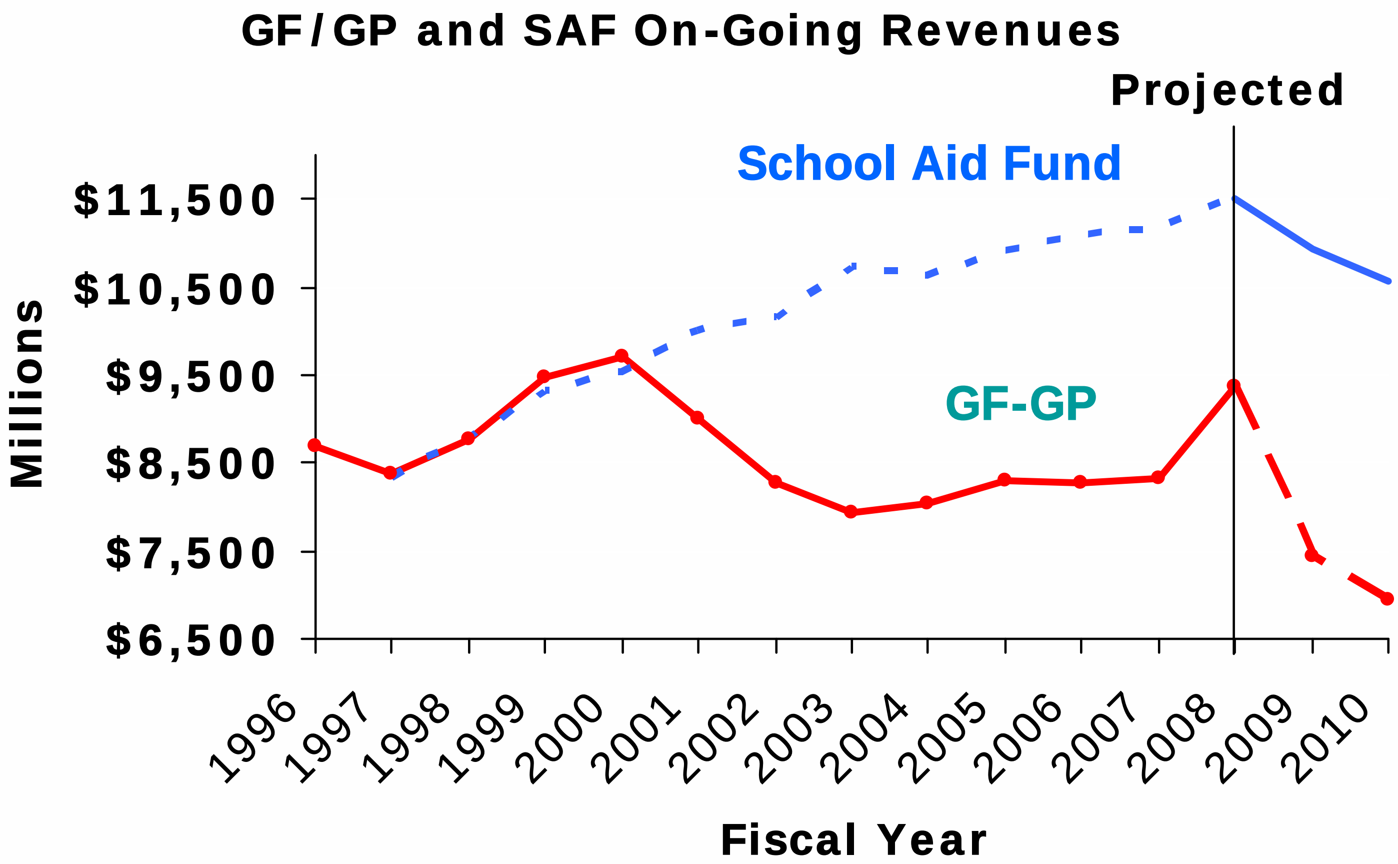
Michigan's Budget Problems FY2001 to FY2008

- 7 years of spending cuts
- Major tax cuts since late 1990s
- FY2008 General Fund revenues lower than in FY1996
- 1.4 % growth in School Aid Fund since 2000
- $8 billion in one-time resources used including reserves
- Cash position improved with 2007 tax increases, but still very tenuous
- Weakened connection between revenue structure and the economy
- Spending pressures growing faster than revenues – structural ***not*** cyclical

State Taxes as a Percent of Michigan Personal Income



$9 billion below constitutional revenue limit in 2010

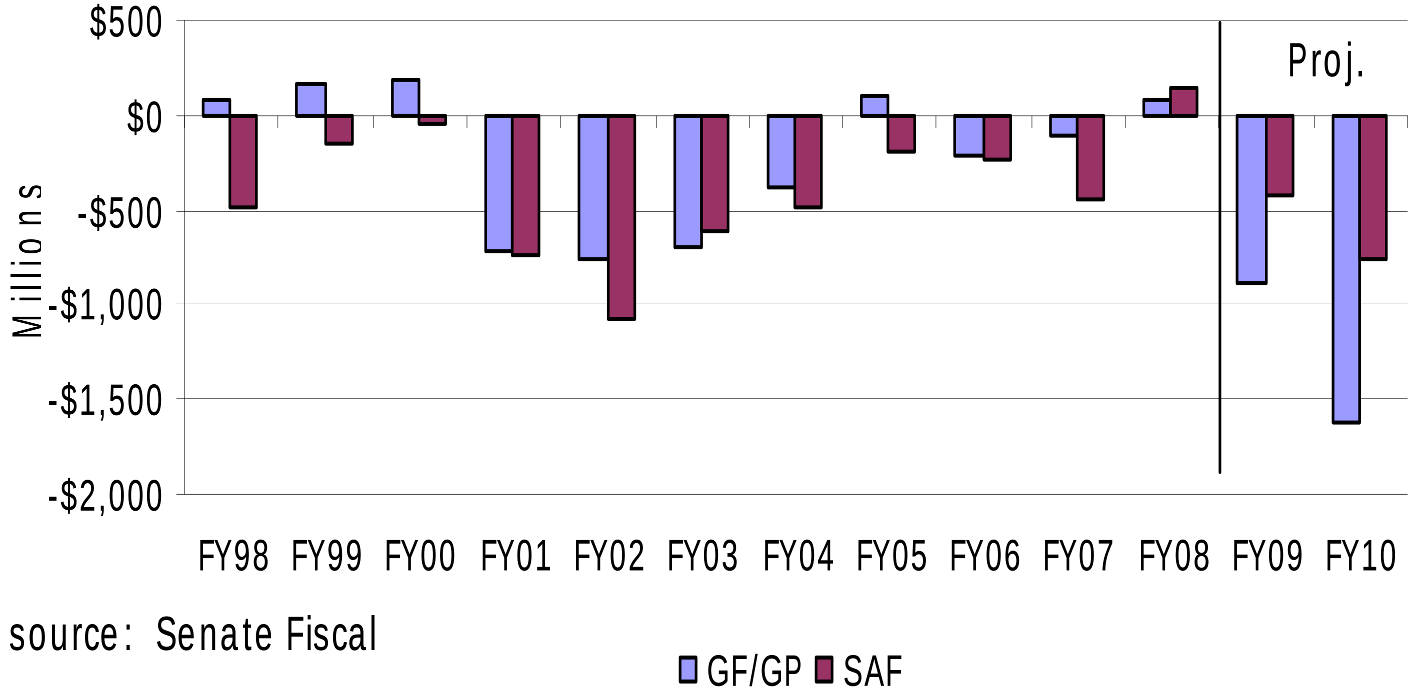


Source: Michigan Department of Treasury

FY2008 Budget – some structural changes

- Tax Increases – increased revenue by $1.3B, but did little to change revenue growth path
  - Income Tax Rate (temporary)
  - Business Tax Surcharge (temporary)
- Minimal changes made on spending side
  - State employee compensation
  - State employee/retiree health care
  - School retiree health care
  - School employee health care
- Structural problems largely remain = operating deficits going forward

GF/GP and SAF Operating Deficits

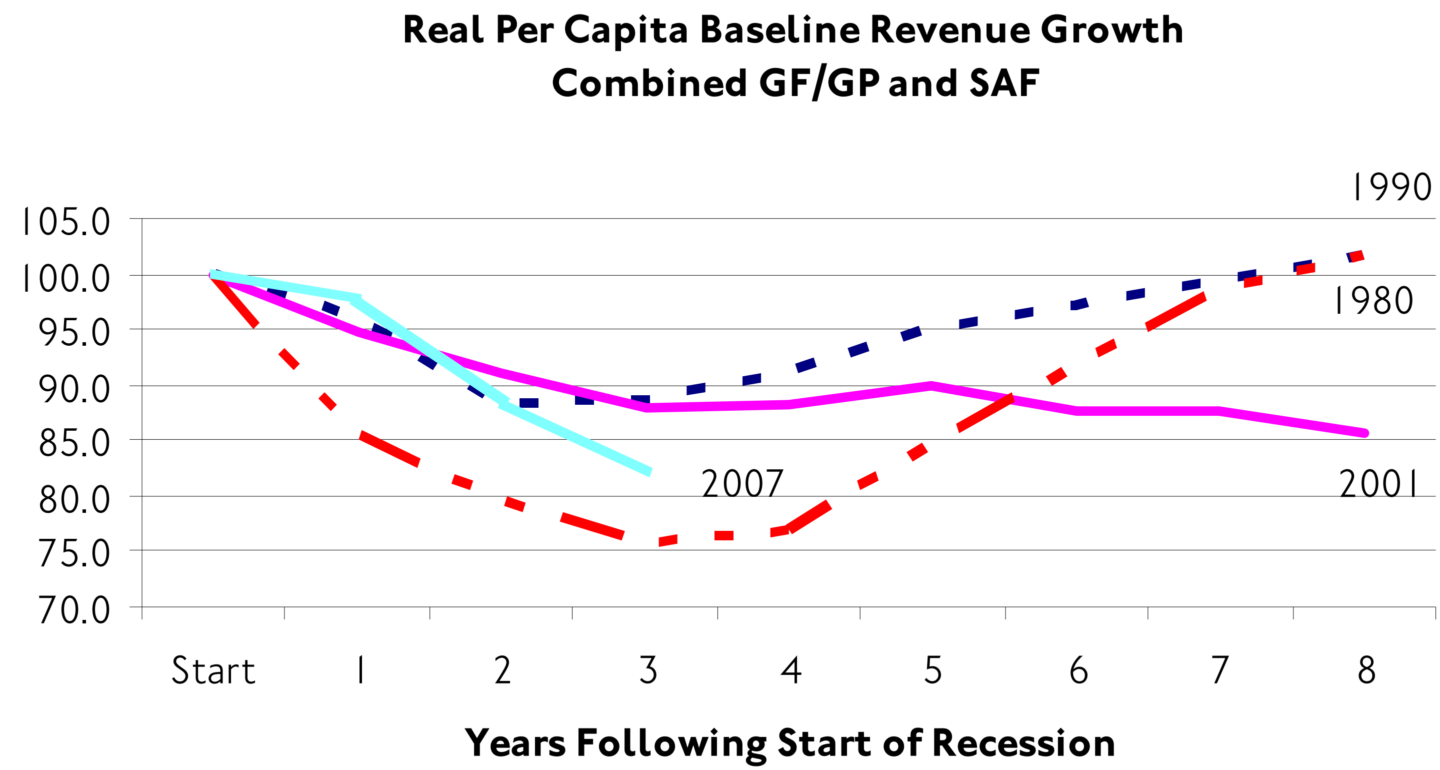


source: Senate Fiscal

Immediate Problem: Current Year Budget Shortfalls

- Sizeable shortfalls in two major fund budgets–General Fund and School Aid Fund
  - Severe decline in economic activity (employment, consumption, housing)
  - Tax revenues directly affected
  - Tax policy changes play role too
- Challenge: weeks to end of start of fiscal year, schools already started
- Michigan's structural budget problems have been overshadowed by cyclical deficits
- Must choose right tools to address deficits; however, Michigan has limited choices

2007 Recession Shaping Up To Look Like 1980 Recession



Source: Senate Fiscal Agency; CRC calculations

The Dual Deficit Problem

- National recession – cyclical deficit
- Michigan is ill-prepared to deal with
  - State's combined fund equity down $3.3 billion since FY00
  - Reserves completely exhausted by end of FY03
  - Negative cash balance at beginning of fiscal year, financed by borrowing
  - Increased use of debt-financing, in some cases to support on-going services
- Balancing FY09 and FY10 budgets may come at expense of the state's underlying financial condition

2009 General Fund Budget
(millions)

		Jan		May		Diff
Beginning Balance	$	458	$	458		
Revenues	$	8,945	$	8,196	$	(749)
Spending						
Initial Approps.	$	9,701	$	9,701		
Supplemental Approps.	$	(20)	$	268		
Exec Order Cuts	$	(134)	$	(134)		
Proj. Spending	$	9,547	$	9,835	$	288
Shortfall	**$**	**(144)**	**$**	**(1,181)**		
Solutions						
Exec Order Cuts			$	(305)		
ARRA - discretionary			$	290		
ARRA - Medicaid			$	940		
Balance	$	(144)	$	354		

General Fund FY09 Solutions

- One-quarter (~$300 M): spending reductions
  - Employee layoffs and furloughs
  - Medicaid reimbursement rate reduction/eliminate optional services
  - Revenue sharing
  - Some areas protected per ARRA
  - Some address structural problems, others?
- Three-quarters (~$900 M): federal recovery funding (ARRA)
  - $300M completely discretionary
  - Remainder from Medicaid match rate increase - states have a significant amount of flexibility

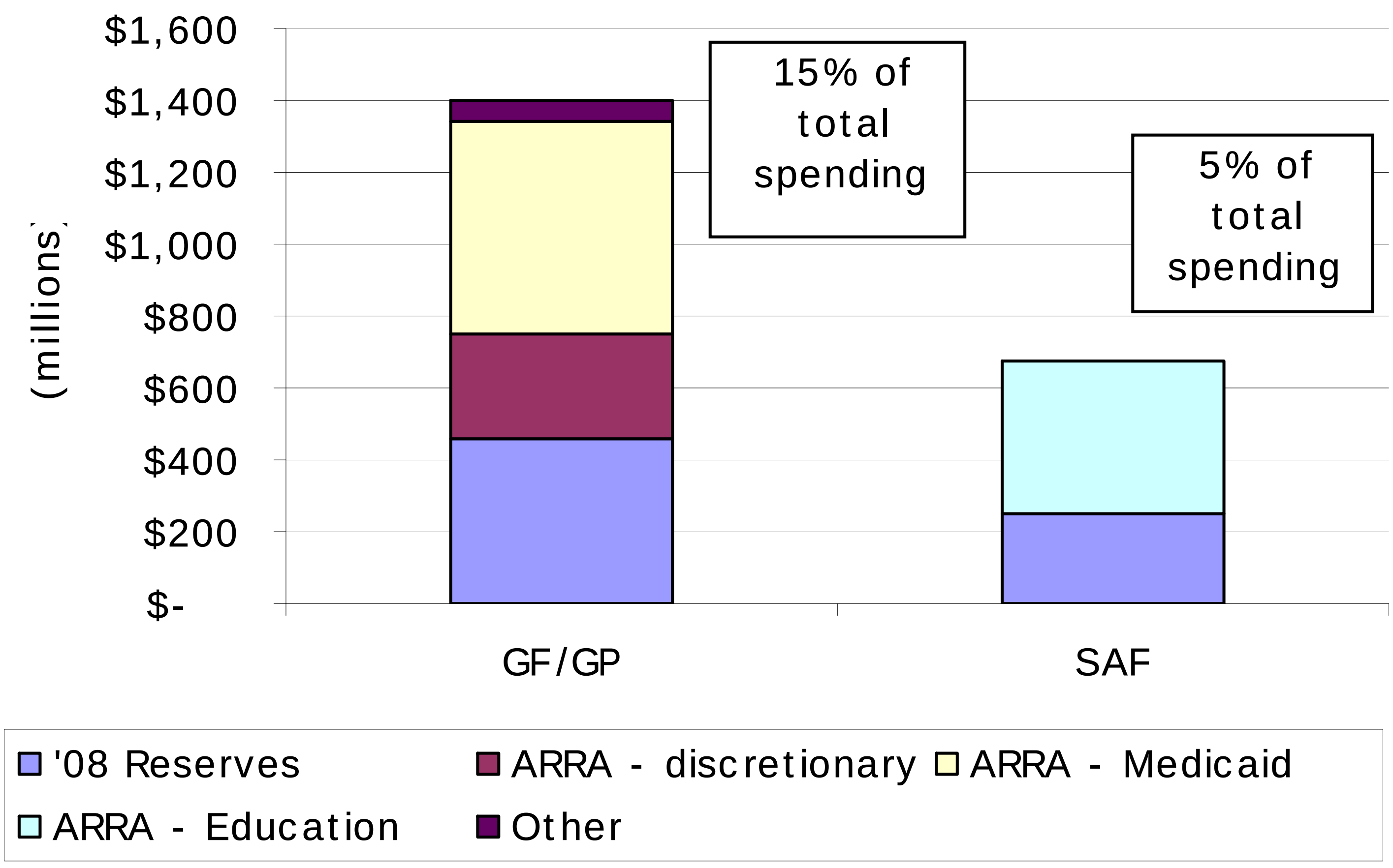
2009 SAF Budget (millions)

	Jan	May	Diff
Beginning Balance	$ 247	$ 247	
Revenues			
Dedicated SAF	$ 11,369	$ 10,944	$ (425)
GF Grant	$ 41	$ 78	$ 37
Federal	$ 1,562	$ 1,562	
Total	$ 13,219	$ 12,831	$ (388)
Proj. Spending	$ 13,257	$ 13,267	$ 10
Shortfall	**$ (38)**	**$ (436)**	
Solutions			
Exec Order Cuts		$ (7)	
ARRA - Education		$ 1,302	
Balance	$ (38)	$ 873	

SAF FY09 Solutions

- Problem not nearly as large as General Fund
- Much less time to effect spending cuts, schools end fiscal year on June 30
- Foundation grant can NOT be cut, per ARRA
- Almost entirely reliant on federal recovery funding (education) to maintain balance
- Remainder of federal funding ($870M) available for FY10

FY09 Budget: Non-Recurring Resources Used



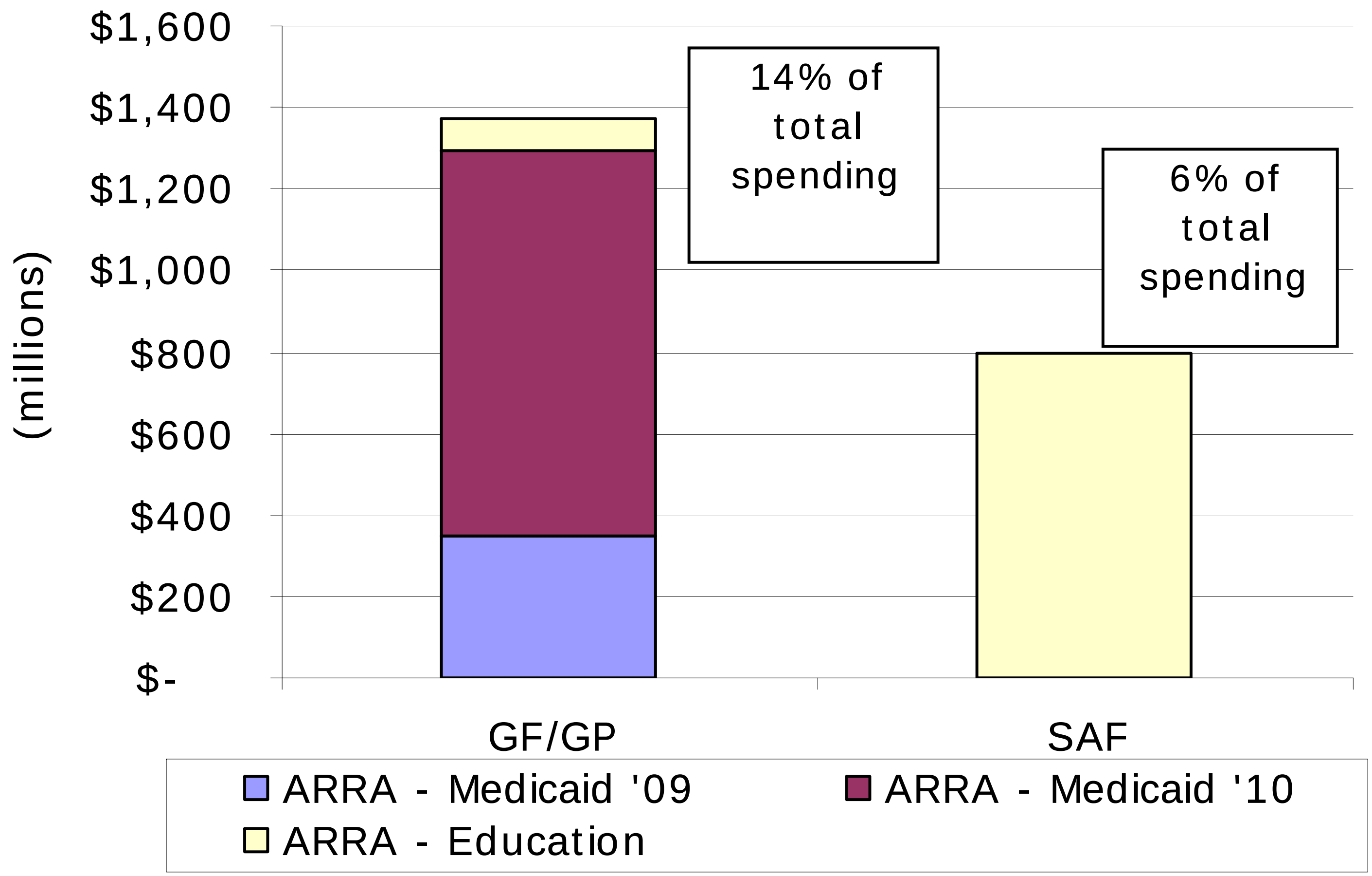
Governor's FY10 Budget

- Projected baseline deficit of $1.8B for GF
  - No new programs and caseload adjustments
- Proposed solutions: Mix of cuts, revenues, and reforms
- Revenues:
  - primarily tax expenditures (e.g., personal exemption), but some increases (e.g., tobacco)
  - Federal stimulus funding through Medicaid
- Cuts: 3% higher education (except 2-years), corrections-closing facilities (net $120M)
- Reforms: parole policy changes
- By May Revenue Conference: Problem was much worse, but federal intervention much larger

2010 General Fund Budget (millions)

	Jan	May	Diff
Revenues	$ 8,773	$ 7,759	$ (1,014)
Spending			
Gov. Rec.	$ 9,460	$ 9,460	
Medicaid Caseload Adj.		$ 151	
Human Srvcs. Adj.		$ (63)	
Proj. Spending	$ 9,460	$ 9,548	$ 88
Shortfall	**$ (687)**	**$ (1,789)**	
Solutions			
Tax changes	$ 166	$ 166	
ARRA - Medicaid '09		$ 354	
ARRA - Medicaid '10	$ 521	$ 950	
Balance	$ -	$ (319)	

FY10 Budget: Non-Recurring Resources Used



Achieving Balance for FY10

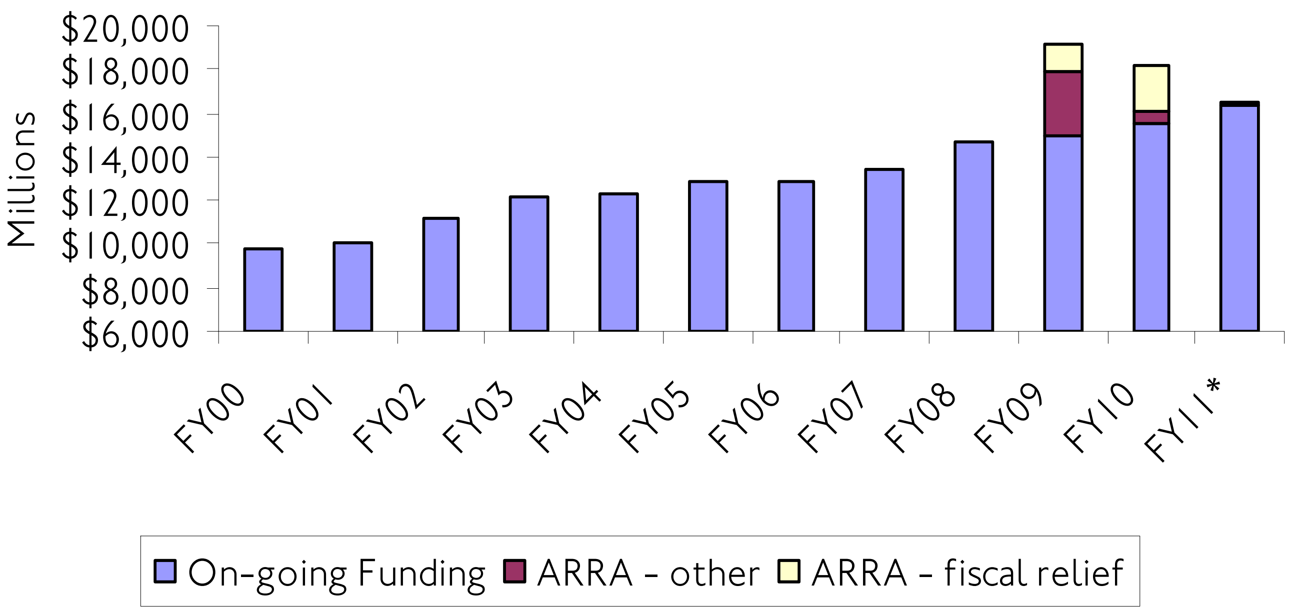
- Despite significant federal funding, still major hurdles
- Proposed tax changes – some old and some new – little discussion thus far
  - Some DOA in past
- Major portions of budget “off the table” per ARRA (Medicaid, education)
- Corrections reforms – little consensus thus far
- After using all available federal $, still short $319M in GF

ARRA and State Budget Balance

- Michigan state and local governments: $7.2B
  - MI share 3% of total (equal to share of US pop)
  - MI leads nation in unemployment @ 12.9%
- $3.7B – provide ready fiscal relief
  1) SFSF - Education Block Grant ($1.3B)
  2) SFSF - Flexible Grant ($300M)
  3) Federal Medicaid match increase ($1.9B)
- Available in FY09 and FY10 – GF and SAF budgets
- Remaining $3.6B – targeted and unable to be used for general budget balance
  - Categoricals: education (formula programs – special and disadvantaged), transportation, workforce development, unemployment, weatherization, pollution control
  - Little state discretion – use existing programs
  - Some of same problems when funds expire

BEWARE: Cliff Ahead

Chart 1
Federal Funding Appropriated in State Budget
On-going and Recovery Funds



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Michigan’s Fiscal Future:
A Long-Term Analysis of Michigan’s Economy and Budget

Prepared in cooperation with
W.E. Upjohn Institute for Employment Research

Scope of the Analysis

- Ten-year scenarios of the Michigan economy with varying assumptions about:
  - -Auto industry
  - -Office furniture
  - -Chemicals
  - -R & D
- W.E. Upjohn staff used Regional Economic Models, Inc. (REMI) to prepare economic projections
- Economic projections translated to revenue projections and projections of spending pressures
- Not predictions but projections

Summary of Results
Major Indicators

Annual rates of change

- Total Employment (-.07%)
- Labor Force (-.25%)
- Real Gross State Product (+1.2%)
- Labor productivity (+1.6%)
- Personal Income (+4.2%)
- Payrolls (+3.8%)
- Population (-.04%)

These statistics better than last 6 years

Employment Projection

Job Losses

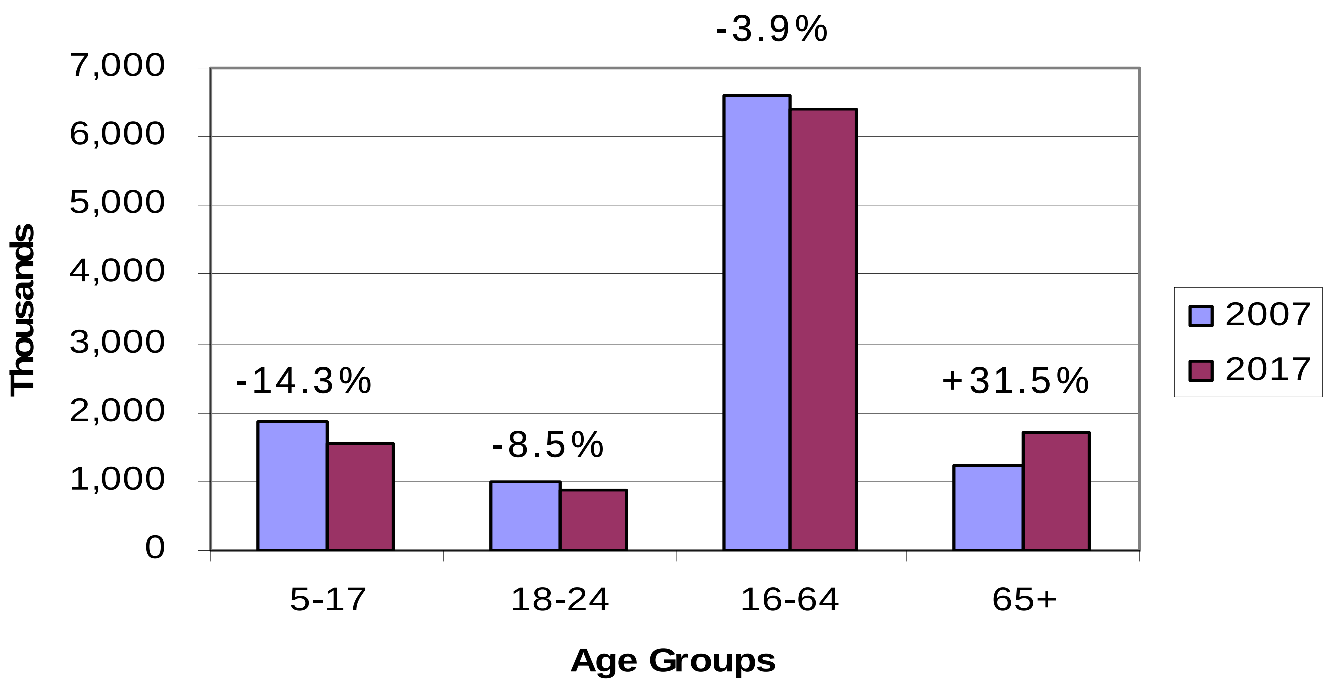
- Goods producing—228,000
  - Auto manufacturing -- 117,000
- Retail and wholesale trade—62,000
- Government—19,000

Job Gains

- Health care—134,000
- Business services—52,000
- Social assistance—33,000
- Recreation and amusement—27,000

Total: 38,000 Decline

Major Changes in State's Demographic Composition Ahead



Projecting Future Revenues

- Analysis concentrates on GF/GP and School Aid Fund revenues
- Local government revenue sharing also included
- Transportation revenues included
- Each revenue source is projected separately based on the economic projections
- Revenues are aggregated into total revenues available from current tax structure

Implications for State Government Finance

<u>Revenues in General</u>

- Revenues from the current revenue system will grow slowly—even more slowly than the economy
- Revenue (and taxes) declining as share of personal income
- FY2009 forecasts (Jan. ‘08) used as the beginning point

<u>Taxes</u>

- Account for 87% of General and School Aid Funds revenues
- Aggregate growth rate about 2.4%
- Remaining sources grow less than 2%
- Higher growth rate will be needed to keep up with spending pressure increases

Annual Growth Rates—General and School Aid Revenues (FY09-FY17)

- Income—3.25% (1.4% after tax changes)
- Business—3.1%
- Sales—3%
- Use—3%
- Tobacco—Minus 2.5%
- State Education (Property)—4.25%
- Other Sources—1.9%

Overall

General Fund: 1.4%

School Aid Fund: 3 %

Reasons for Sluggish Revenue Growth

- Increasing senior citizen population—retirement income not taxed and spend less on goods
- Consumption taxes goods oriented—economic growth is in service sector
- Slow or no growth revenues drag down overall growth (e.g. tobacco, gambling, alcohol)
- Flat rate income tax
- Tax Policy –
  - Earned Income Tax Credit
  - Phase-out of Income Tax increase

Structural Deficit

Spending Pressures Outpace Revenue Growth

- Over 85% of GF/GP budget concentrated in four areas:
  - Community Health ($3.1B)
  - Corrections ($2 B)
  - Higher Education ($2 B)
  - Human Services ($1.3 B)
- Most significant spending pressures:
  - Health care
  - Corrections – personnel costs
  - Employee compensation – pay and fringes

Health Care Costs

Single largest component in state budget

- Medicaid
- Mental health services
- Health insurance for school and state employees
- Health insurance for school and state retirees
- Health care provided to prisoners

Medicaid

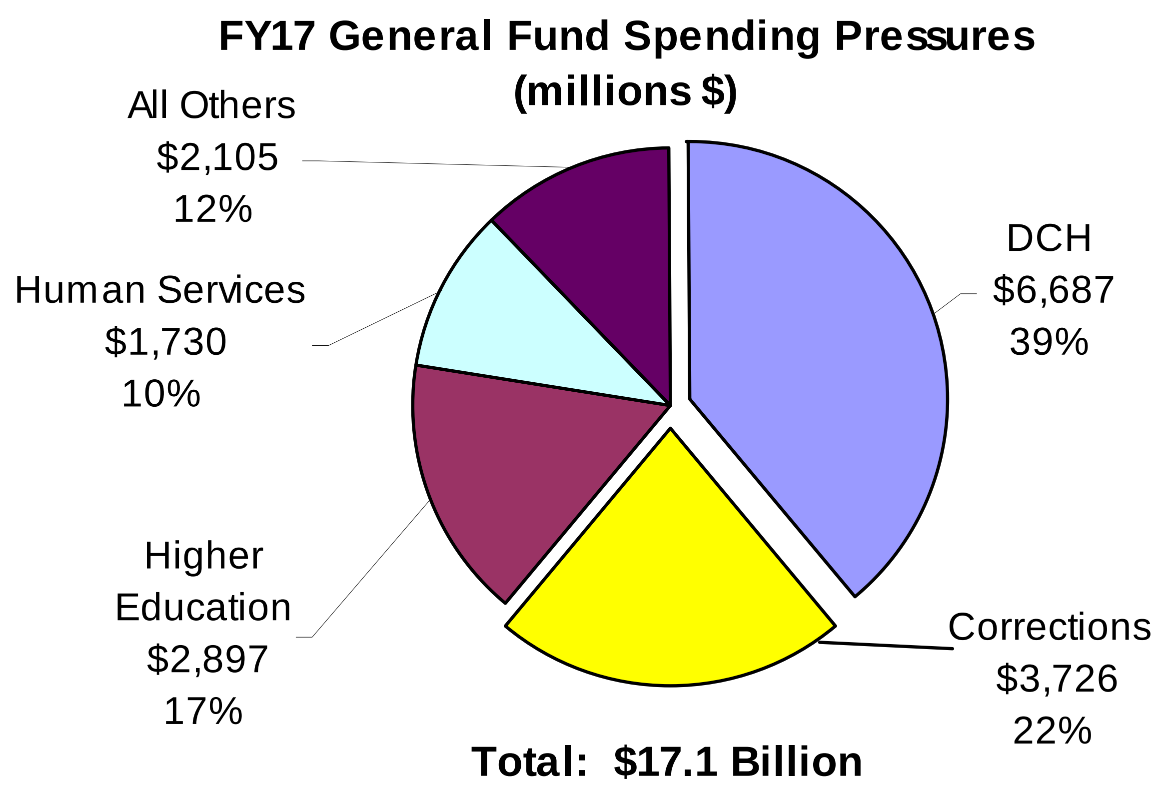
- Medical care for 1 in 7 Michigan citizens
- Future spending growth pressures nearly 8% annually
- Some state revenues dedicated to Medicaid do not grow—Tobacco Settlement revenues, Cigarette Tax
- Others lag behind the overall growth in program
- General Fund requirements grow nearly 11% annually
- General Fund spending pressures outpace revenue growth eight-fold

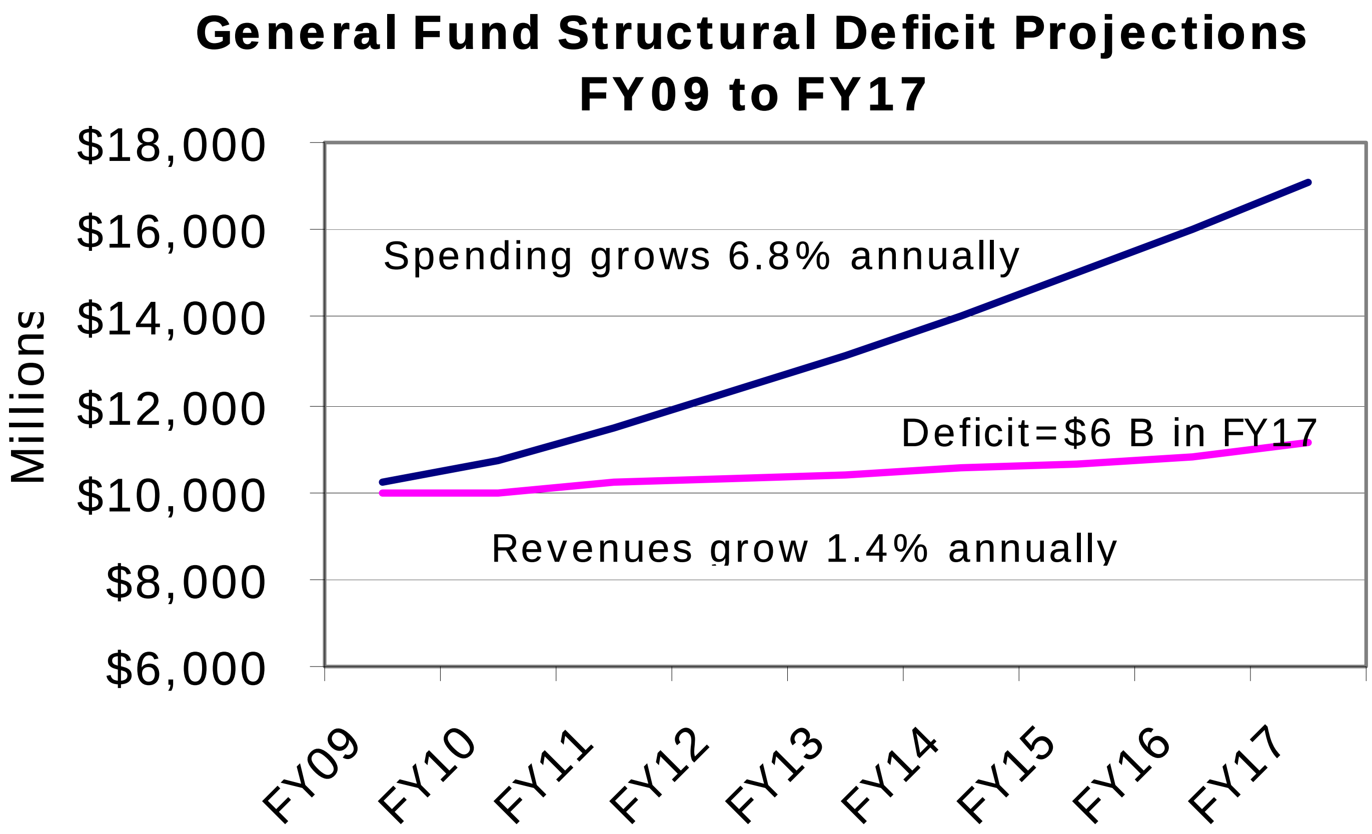
Corrections

- Largest state-operated program
- 30% of state employees
- More than 50,000 prisoners and growth of 1,200 annually
- 45 prisons and camps
- $30,000 per prisoner cost per year
- Incarceration rate 47% higher than Great Lakes neighbors-the result: $500 million higher costs
- Spending pressures will increase 7%, five times as fast as GF growth

Employee Compensation

- Benefits significant portion of public budgets
  - State: from 34% to 54% of base payroll between FY98 and FY07
- Major driver is health care for current and retired employees
- Failure to “pre-fund” retiree health = stresses budgets
  - School retiree health more than double from FY07 to FY17, from 6.6% to 14% of payroll
- Spending pressures grow 4.9% annually, twice as fast as GF revenues and one and a half times faster than School Aid revenues


FY17 General Fund Spending Pressures
(millions $)
All Others
$2,105
12%
DCH
$6,687
39%
Human Services
$1,730
10%
Higher Education
$2,897
17%
Corrections
$3,726
22%
Total: $17.1 Billion


General Fund Structural Deficit Projections
FY09 to FY17
$18,000
$16,000
$14,000
$12,000
$10,000
$8,000
$6,000
Millions
Spending grows 6.8% annually
Deficit=$6 B in FY17
Revenues grow 1.4% annually
FY09
FY10
FY11
FY12
FY13
FY14
FY15
FY16
FY17

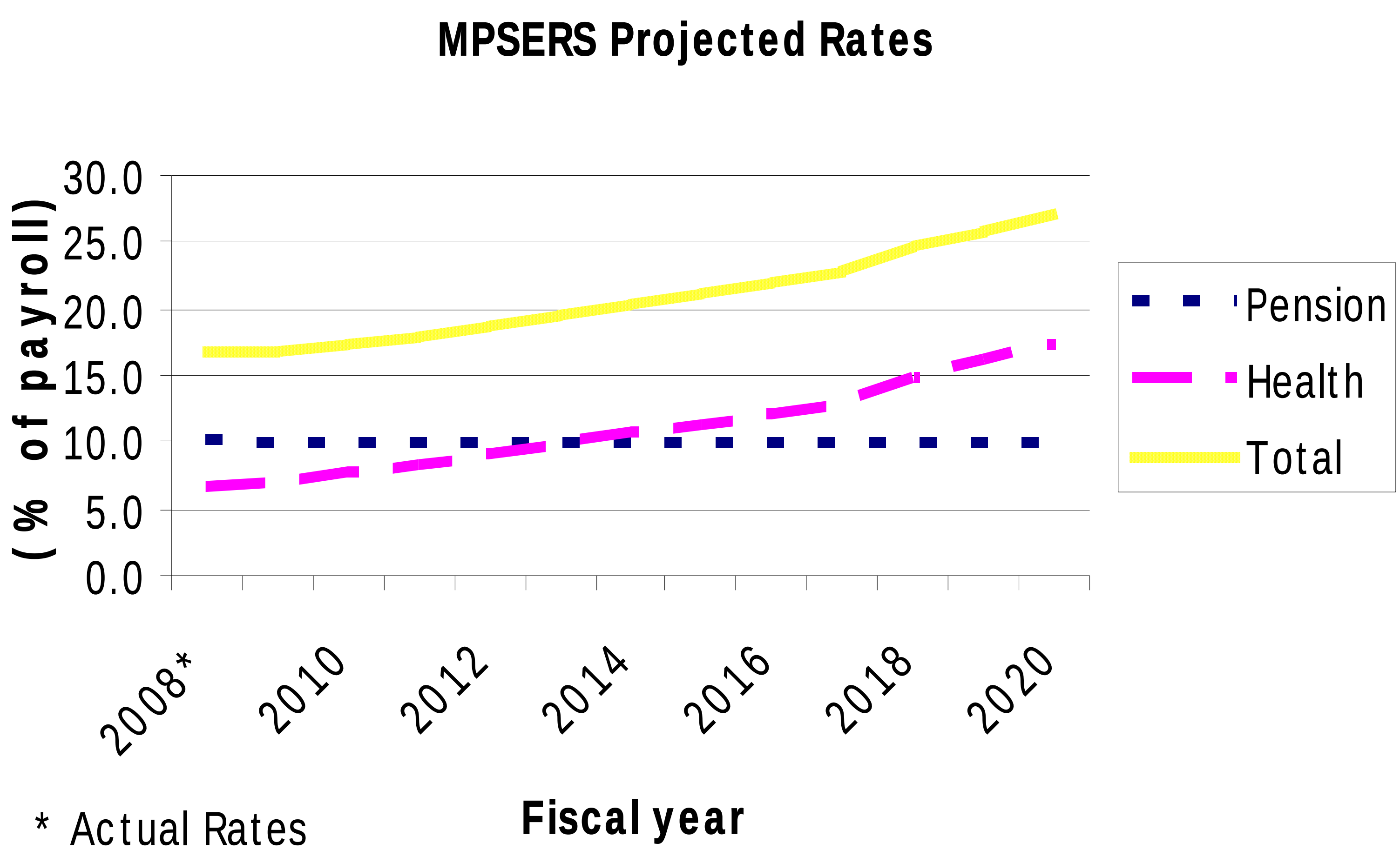
School Aid Structural Deficit

Spending Pressures Outpace Revenue Growth

- Retirement Contributions—rapid growth
- Employee Health Insurance—rapid growth
- General Pay Raises
- Other—Fuel, Utilities, Supplies
- Revenues Growing Slowly

Retirement Funding

- School districts make contributions for employees
- School districts also pay for health care for retirees
- Rate for FY2009 is 16.54% of payrolls
- Contribution rate composed of two parts
  - -Regular pension benefit (9.73%)
  - -Health care benefits (6.81%)
- Both parts will continue to increase in the future
  - Pension because of market in 2008
  - Health because of increase in retirees and cost of health care


MPSERS Projected Rates
30.0
25.0
20.0
15.0
10.0
5.0
0.0
(% of payroll)
2008*
2010
2012
2014
2016
2018
2020
Pension
Health
Total
* Actual Rates
Fiscal year

School Aid Revenues & Spending Pressures

- Spending pressures grow 4.7% per year
- Revenues (state and local) grow 3% per year
- Shortfall of 1.7 percentage points each and every year without spending and revenue policy changes
- By FY17, revenues will cover only 86% of spending

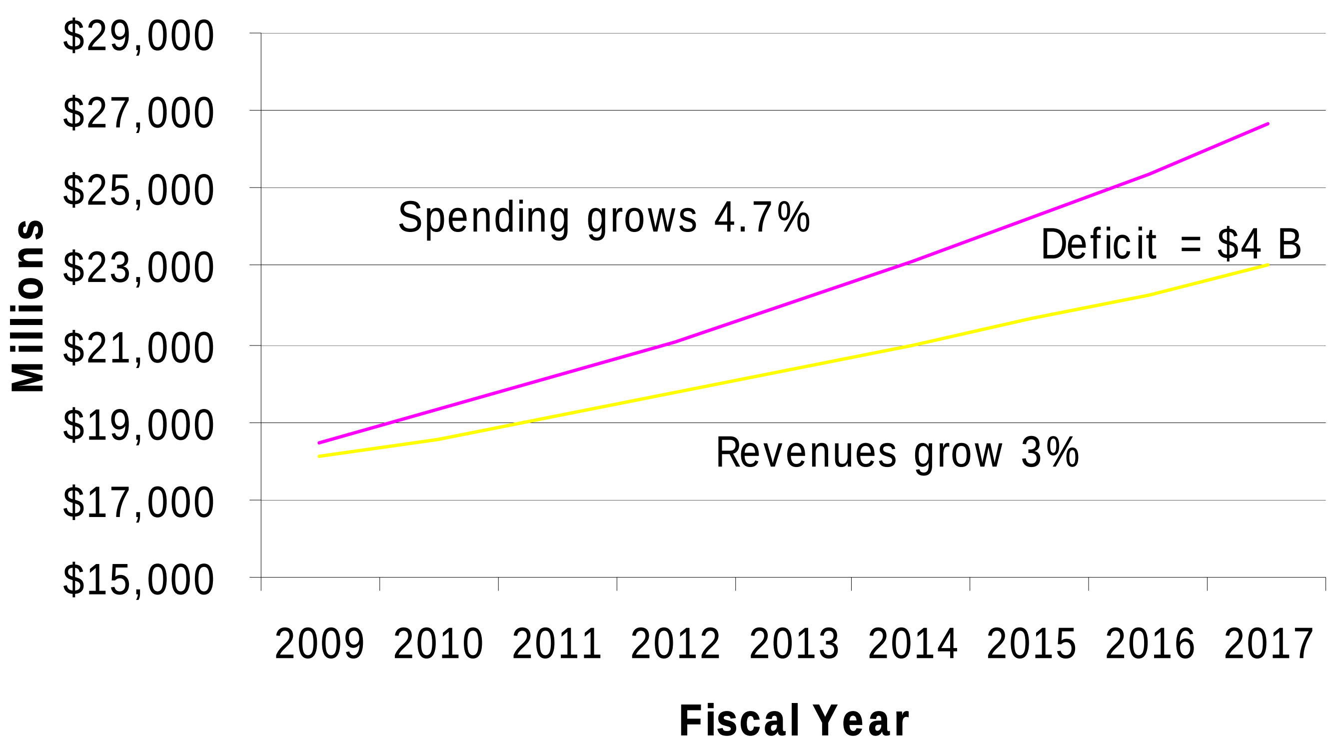
Declining Enrollments

Year	Projected	Change
2009	1,615,577	(37,831)
2010	1,580,654	(34,922)
2011	1,550,007	(30,647)
2012	1,522,848	(27,160)
2013	1,499,128	(23,720)
2014	1,481,494	(17,634)
2015	1,468,480	(13,013)
2016	1,458,292	(10,188)
2017	1,451,616	(6,676)
Average Rate		- 1.4%

How does this translate at the classroom level?

- Ave. per pupil revenue growth of 4.4% or $570
- Spending pressures and “requirements” of 6.1%:
    - Salaries - $350
    - Retirement - $110
    - Group insurances (health) - $250
    - Other (fuel, utilities, etc.) - $130
- Structural deficit of $270 per pupil

School Aid Structural Deficit Projections FY2009 – FY2017



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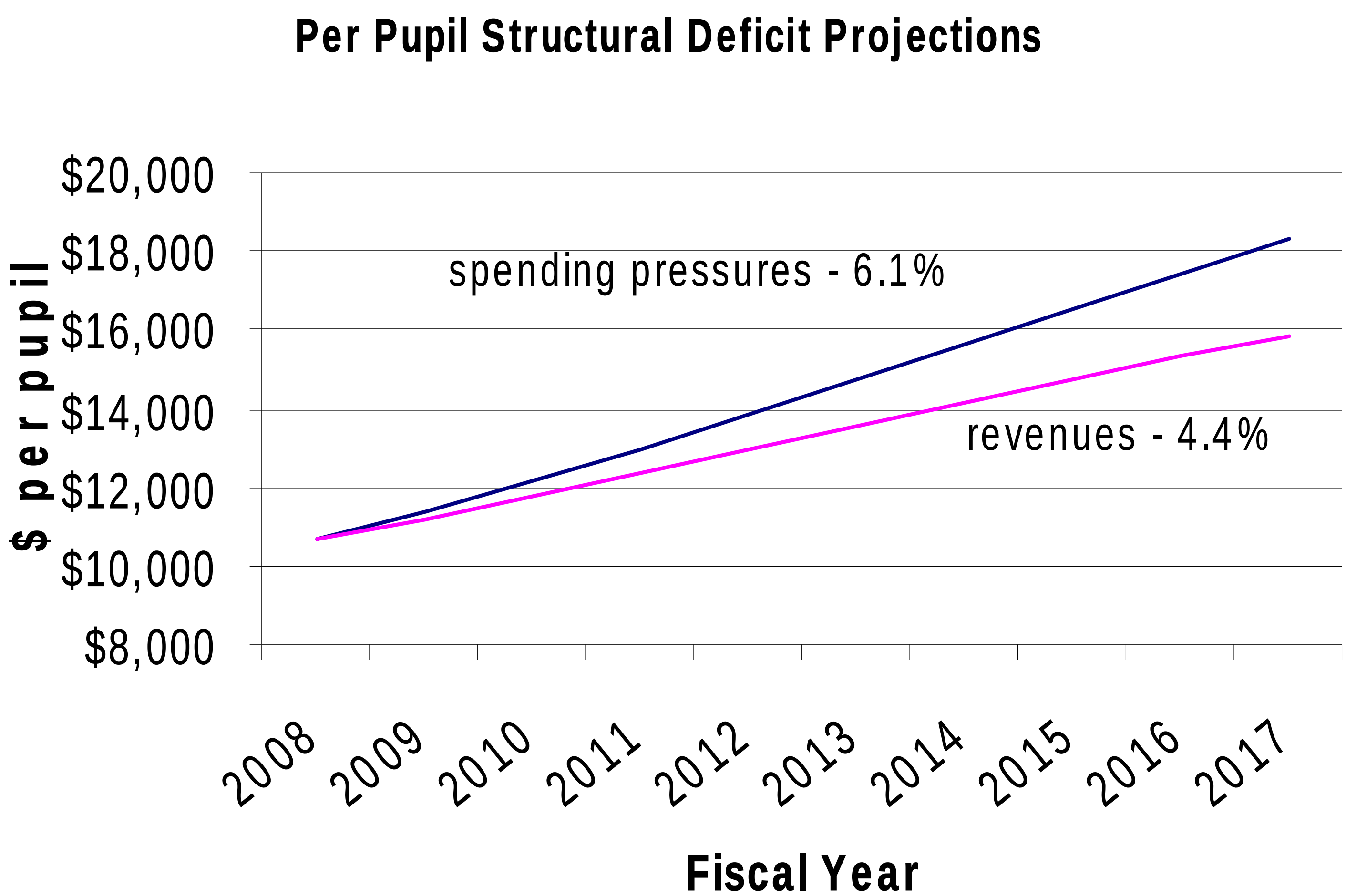


Policy Options

Achieving Long-Term Structural Balance

- Increase revenue growth
- Reduce rate of spending pressure growth
- Bend the two curves so they meet

Revenues

- Change system so revenues grow in line with economy and personal income
- Consider taxing services broadly
- Modify personal income tax by changing rate and exemptions—or—implement graduated income tax (Constitutional amendment required)
- Reduce reliance on “sin” taxes
- Consider taxing pensions and other retirement income (area of income growth in future)

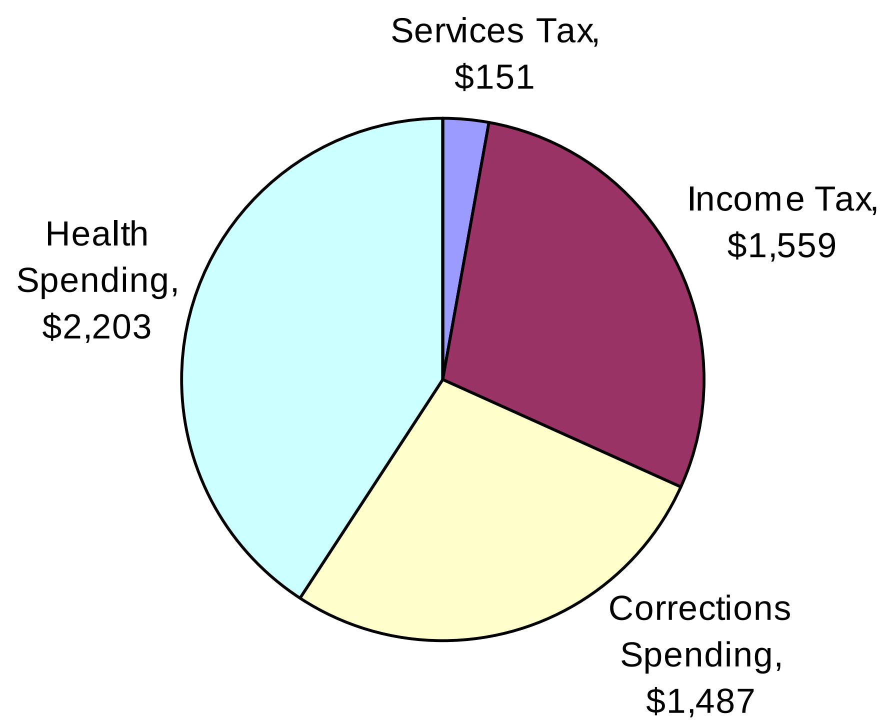
Tax Scenario

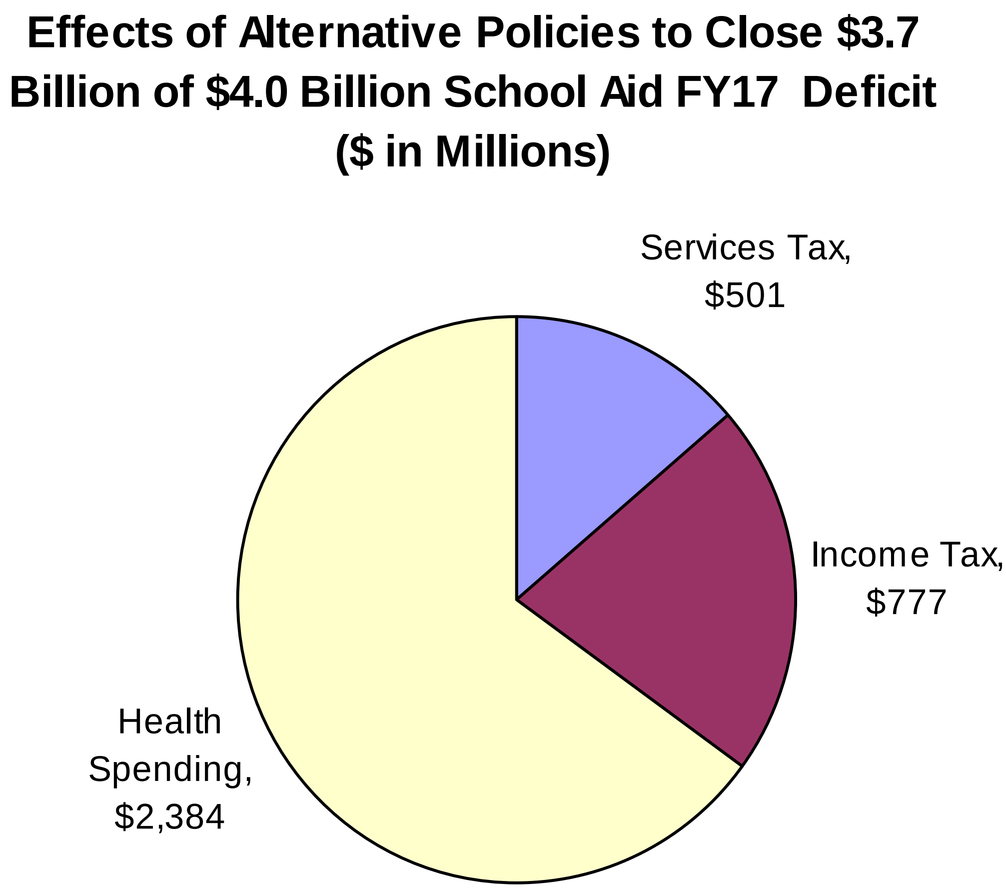
- Expanding Sales and Use Taxes
  - Exempt business-to-business
  - Reducing rate to 3.6% (neutral)
  - Adds about 0.8% to growth rate
- Graduated Income Tax
  - Revenue-neutral starting point
  - Nearly doubles growth rate
- Combined effects
  - Adds 0.8% to School Aid Fund growth
  - Adds 1.5% to General Fund growth
  - Still work to do – spending solutions

Spending Scenario

- Corrections
  - Reducing prison incarceration rate to the average of our neighbors (1,200/yr)
  - Ten-year phase-in
  - Eliminates growth pressure in Corrections (from plus 7% to negative 1%)
  - Reduces overall General Fund spending pressure growth by 1.1%
- Health care
  - Holding health care cost increases to 5% per year
  - Reduces General Fund annual spending pressure growth by 1.6%
  - Reduces School Aid annual spending pressure growth by 1.1%

Effects of Alternative Policies to Close $5.4 Billion of $6 Billion General Fund FY17 Deficit ($ in Millions)




Effects of Alternative Policies to Close $3.7 Billion of $4.0 Billion School Aid FY17 Deficit ($ in Millions)
Services Tax, $501
Income Tax, $777
Health Spending, $2,384

Questions?

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