



Governor Snyder's FY2012 Budget Proposal

Citizens Research Council of Michigan Webinar

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Outline

- Setting the Stage for FY2012 and FY2013
- Tax Reform Proposal
- Defining the Immediate Budget Problem
- Proposed Solutions
- Public Policy Issues Raised
- Progress Towards Addressing Structural Problem
- Final Thoughts

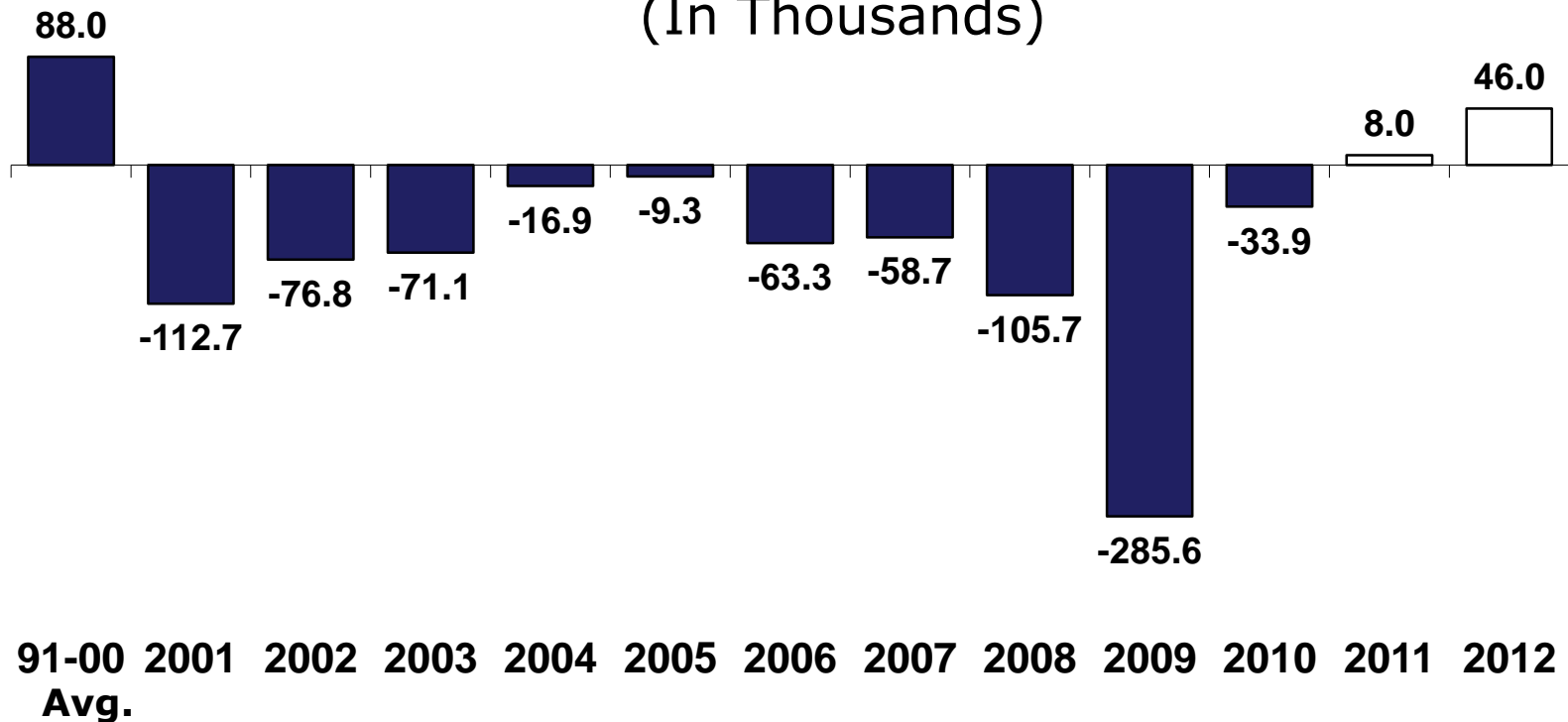


Setting the Stage for FY2012 and FY2013



Michigan Employment Starting to Grow But is Down Over 800,000 Jobs

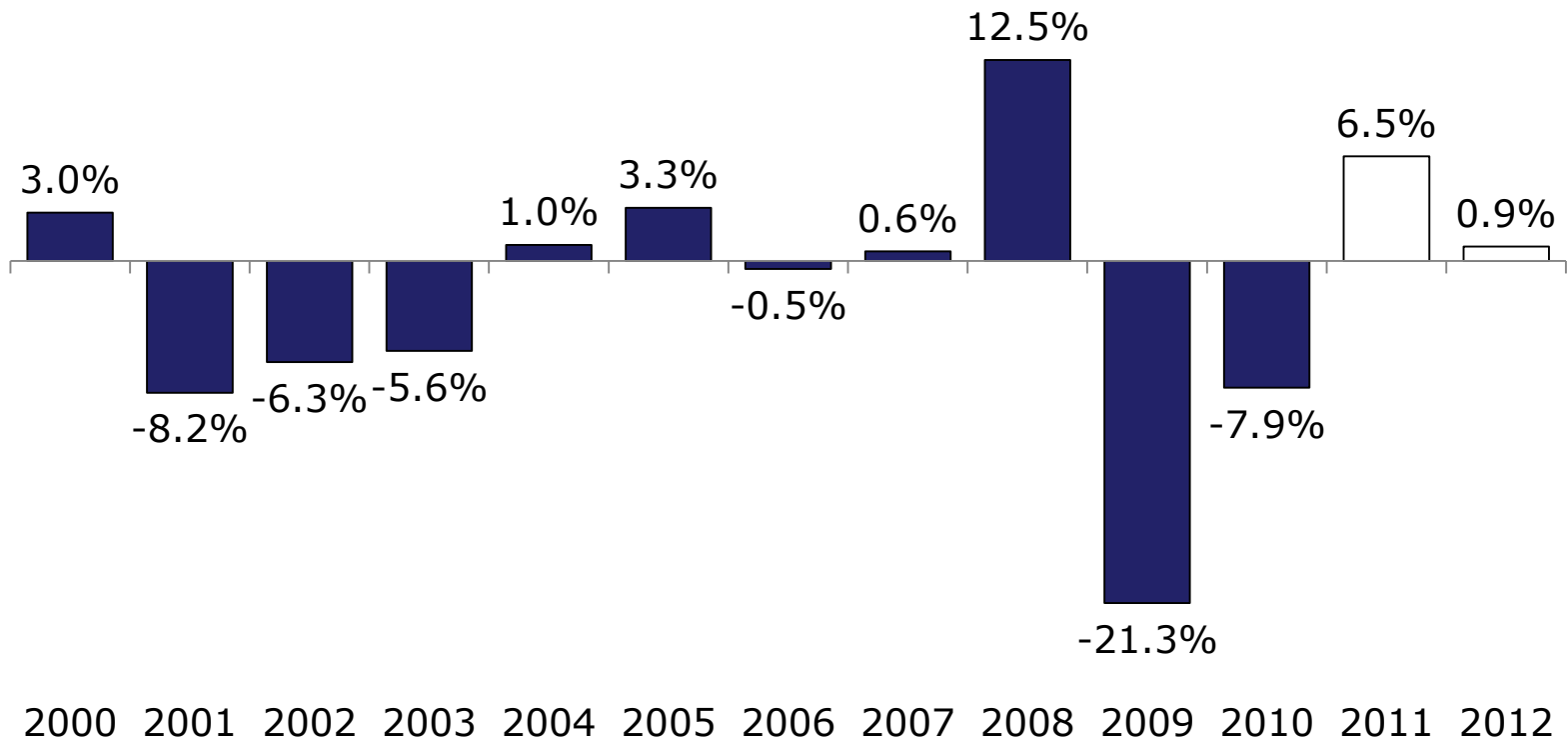
Michigan Wage and Salary Employment Y-O-Y Change
(In Thousands)





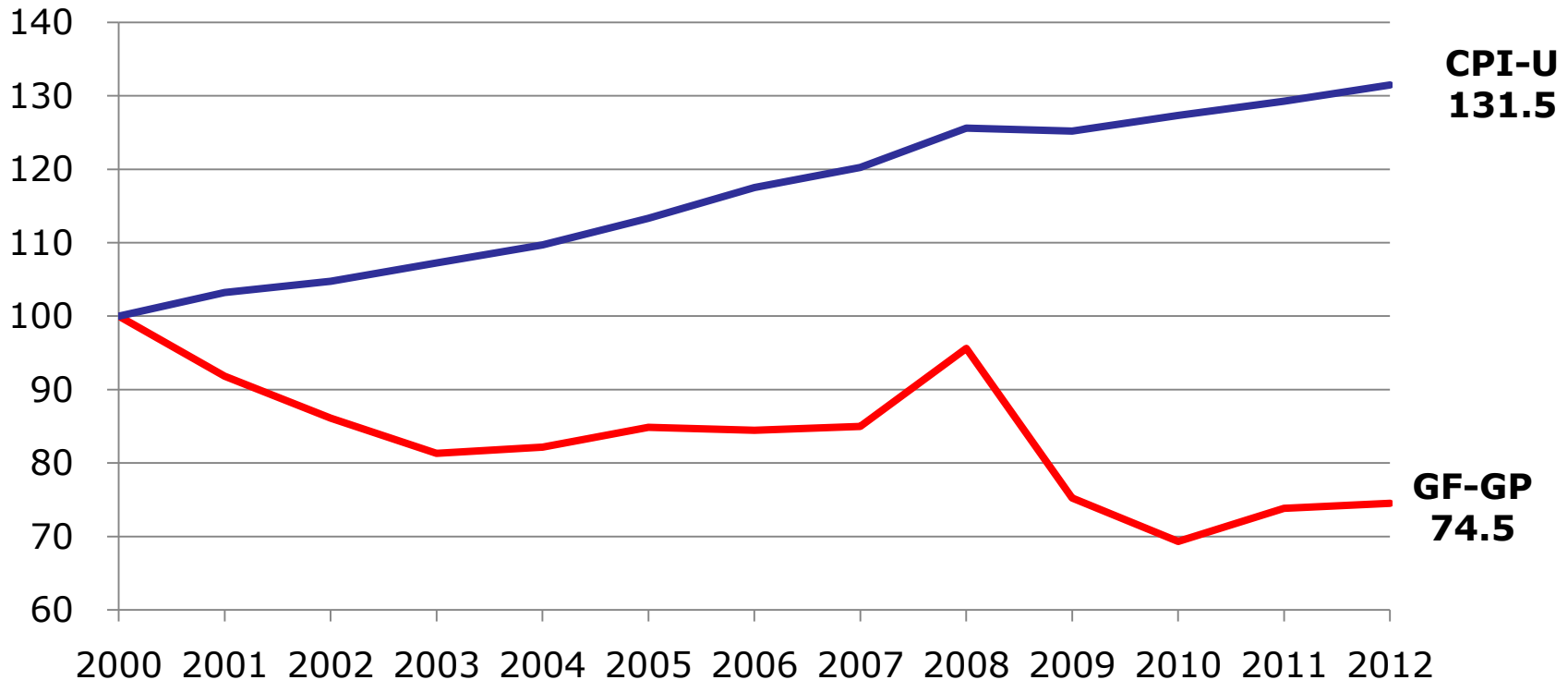
GF-GP Revenues Recovering After Drops in FY2009 and FY2010

GF-GP Revenues
Year-Over-Year Pct. Change





Since 2000 GF-GP Down 25% While CPI-U Up 31%





What is the Budget Environment?

- Michigan's economy and revenues are finally starting to show growth
- But, Michigan employment fell 6.9% in 2009 and employment is down almost 18% from 2000
- While significant budget cutting has occurred, it has not matched the dramatic decline in revenues – gap has been filled with stimulus aid and other one time revenues
- FY2012 budget needs to fill gap left by end of one time revenues
- There is also great interest in making changes that could improve Michigan's economic performance



Tax Reform Proposal



Policy Objectives – Business Tax

“Michigan’s current system of business taxes, particularly the Michigan Business Tax (MBT), is highly complex, and includes an intricate web of incentives, credits, and deductions that unfairly favors some businesses or industries over others, hurts Michigan businesses and hampers growth. Replacing the MBT with a simple, fair, and efficient corporate income tax will even the playing field and enable all businesses, industries, large and small, to grow and create jobs.”

(source: Michigan Department of Treasury webpage)



Policy Objectives – Income Tax

“Further, Governor Snyder believes all taxpayers should pay the same rate regardless of their source of income.... The Governor recommends broadening the base to which the individual income tax is applied....

Consistent with his simple, fair approach to the Corporate Income Tax, the Governor also recommends that all credits and deductions related to the individual income tax, with the exception of the personal exemption, the exemption for individuals with disabilities, special provisions dealing with military personnel, the homestead property tax credit and a few other subtractions be eliminated. These changes are designed to provide equitable treatment for taxpayers.”

(source: FY2012 Executive Budget)



MBT Overview

- **Business income tax** of 4.95% & tax of 0.8% on **gross receipts** less purchases from other firms
- **Surcharge** of 21.99% before credits
- **Profits** apportioned to Michigan based on percent of sales occurring in Michigan
- Significant **credits** for compensation paid to Michigan workers (0.37%), investment in Michigan (2.9%) and Michigan R&D (1.9%); comp & investment credits capped at 52% of liability & all 3 capped at 65%
- Other significant credits include **MEGA, brownfields, personal property, film, and battery**
- Numerous other smaller credits
- **Financial institutions** and **insurance companies** have different tax bases



Corporate Tax Overview

- **6% flat rate income tax** only on corporate entities
- Apportionment still based on Michigan sales
- All credits (except small business alternate credit) are eliminated
- **Honors existing commitments** (\$500 million in FY 13) made through signed agreements (MEGA \$116M; battery \$293M; brownfield \$50M, film \$25M; other \$16M)
- Future economic development incentives awarded through appropriations process
- **Insurance** and **financial institution** taxes essentially unchanged
- **Net business tax cut of \$1.7 billion**



Income Tax Changes

- Rate fixed at **4.25%**
- **Private and public pension exemption** is eliminated
- **Personal exemption** phased-out for higher income (\$75k single; \$150k joint)
- **Special exemptions** for seniors (\$2,300), children (\$600), and unemployment comp (\$2,300) repealed
- **Credits repealed** include: EITC, city income tax, public contribution, homeless/foodbank, community foundation, college tuition
- **Homestead property tax credit** – credit lowered for seniors and raised for individuals; income phase-out lowered
- **Income tax increase of \$1.9 billion in FY 13**



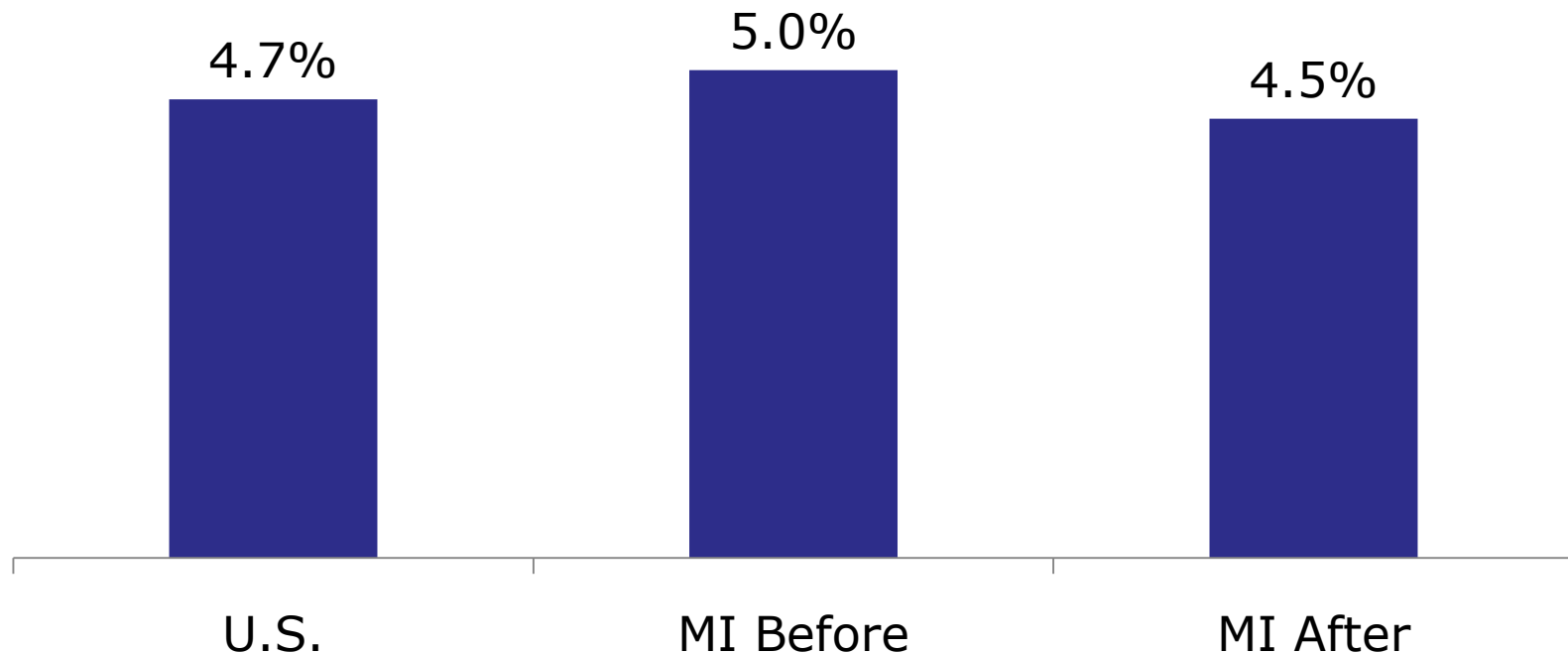
Summary of Tax Changes

	<u>FY 2012</u>	<u>FY 2013</u>
MBT Current Law	\$2,170.0	\$2,024.0
Revenues from Proposed Reforms		
MBT (4th quarter 2011 and annual pymts)	\$900.2	\$0.0
New Corp Tax	\$194.8	\$292.7
Bus. Tax Under Budget Proposal	<u>\$1,095.0</u>	<u>\$292.7</u>
Net Business Tax Cut	(\$1,075.0)	(\$1,731.3)
Income Tax Increases	<u>\$820.9</u>	<u>\$1,863.8</u>
Net Impact Proposed Changes	(\$254.1)	\$132.5 *

* Budget Indicates \$100 million of FY 2013 revenues will be reserved for tax cuts

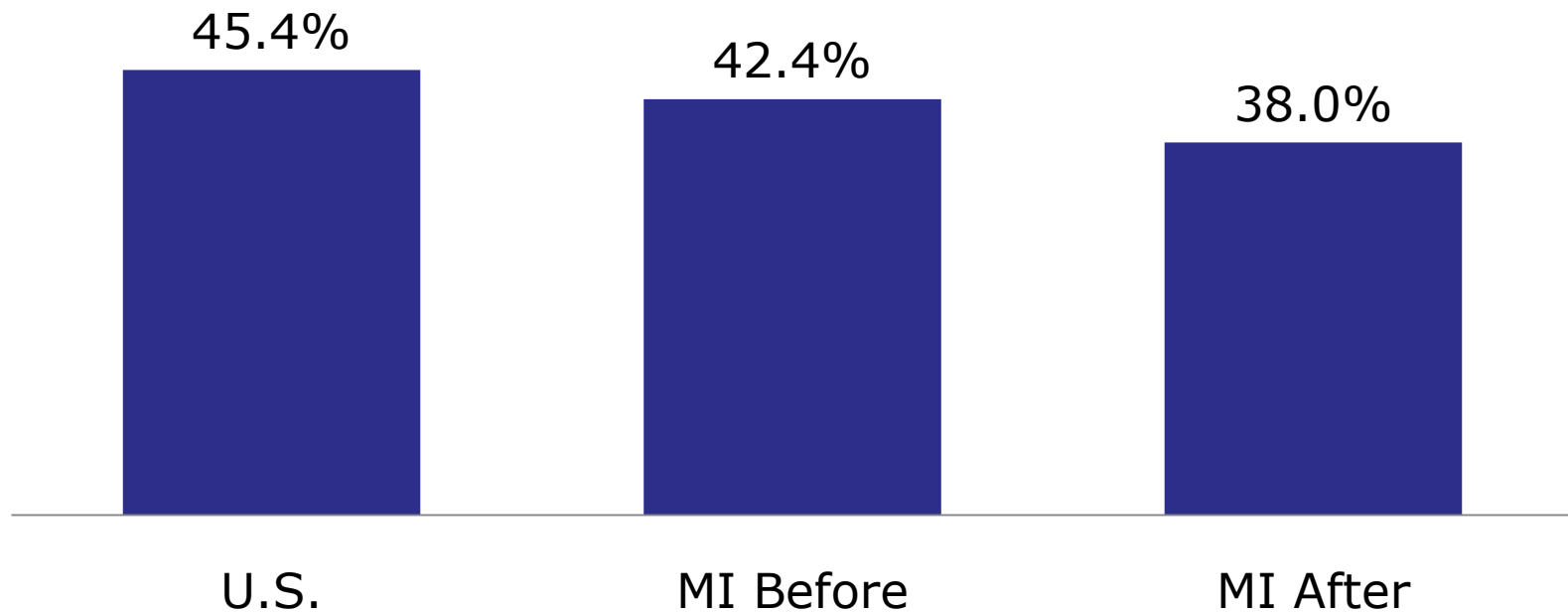


Michigan's S&L Business Taxes as % of GSP Would fall from 19th to 35th Highest





S&L Business Taxes as % of All State and Local Taxes from 35th to 45th Highest





Who Pays the MBT?

- Statutory incidence of the MBT is on corporate and non-corporate entities
- Ultimately, burden of any tax is borne by individuals
- Possible ways MBT burden is borne by individuals:
 - Lower rate of return on capital for shareholders and other capital owners
 - Reduced wages received by workers
 - Higher prices paid by consumers
- While it is reasonable to assume that most of the MBT burden is borne through a reduced rate of return on capital for those doing business in Michigan, this has not been established empirically, so while a reasonable conjecture, it is an assumption



How Would the Statutory Burden on Business Change?

- **MBT to corporate tax represents an 86% cut** in FY 13. Looking at all state and local taxes paid by businesses (using COST estimates) roughly a 10% cut.
- **Non-corporate entities** currently subject to MBT and individual income tax; they now would only be subject to individual income tax (**go from tax disadvantaged to tax advantaged**)



How Would the Statutory Burden on Business Change (cont)?

- Large cut means that most businesses should pay less – however, **loss of personal property tax credit means that some firms will pay more**, especially multistate manufacturing firms based in Michigan
- **MBT** has significant credits for Michigan based activity in **an attempt to export the tax**; rescinding these credits means the share of tax cut received by out-of-state firms likely greater than share of MBT they pay



How Does the Burden Change on Individuals?

- Income tax increases concentrated among **seniors** (loss of pension exemption, reduction in HPTC) and **low-income individuals with wage income**
- EITC approx. \$350M claimed by over 700,000 Michigan taxpayers; MI credit started in 2008



How Does the Burden Change on Individuals (cont)?

- While repealing the pension exemption is a move towards treating taxpayers with similar income similarly, the repeal of exemption represents a **significant tax increase on seniors** (\$800M)
- Repeal of non-refundable credits raises individual taxes by \$85 million with increase concentrated among those paying city income taxes (\$32M) and those making contributions to certain charities (\$45M)



Will the Tax Changes Improve Economic Growth?

Positive Impacts

- The new lower tax should increase the return on capital invested in Michigan leading to greater investment and economic growth (assuming MBT is a tax on capital)
- Money appropriated for economic development will work to offset the effect of removing investment credits
- Simpler and lower business tax should improve Michigan's reputation among businesses, encouraging firms to invest here



Economic Impact Continued

Negative Impacts

- Overall tax change is revenue neutral: tax increase on seniors and low income workers will reduce their consumption which has a negative impact on Michigan's economy
- Repeal of EITC reduces return to low wage workers for participating in the labor market
- Tax relief will be spread across new investment and existing capital, while this improves fairness, tax relief for existing capital does not improve growth



Economic Impact Continued

Negative Impacts (continued)

- Repeal of personal property tax credit means that taxes for some types of investment may be higher than under the MBT
- Repeal of brownfield credit and loss of personal property tax credit will reduce the incentive to invest in urban areas

Economic Impact Bottom Line

- Overall impact is unclear: tax change will improve Michigan's reputation in the business community and increase the rate of return for investing in Michigan
- If this effect is greater than the drag on consumption from the higher income taxes, overall changes should have a net positive impact on growth



Other Factors To Consider

- New tax does not tax favor new investment like the MBT. This improves the “fairness” of the business tax, a stated policy goal, but uses some tax relief for items besides encouraging growth (however, some question the efficacy of the investment incentives in the MBT)
- The new business tax will be easier to administer for both taxpayers and the state
- There is merit in moving economic development from tax expenditures to the appropriations process
- Non-corporate entity tax rate would be 4.25% compared to 6% for corporate entities. Is there a policy rationale for the difference?



Other Factors To Consider

- A corporate income tax will be much more volatile than the MBT, which is more volatile than the SBT; however this volatility will be mitigated by the fact that the corporate tax is estimated to only generate \$290 million in FY13 compared to \$2 billion for the MBT
- The constitutionality of taxing public pensions and phasing-out the personal exemption for high income taxpayers will likely be challenged in court
- Shifting \$1.8B in taxes from businesses to individuals will make Michigan's tax system more regressive



Other Factors To Consider

- Removal of the pension exemption will improve growth rate of the income tax and will increase equity among income taxpayers, but it represents a large tax increase on seniors
- The income tax will grow faster under the proposed changes because Michigan's population is aging and pension income will represent an increasing share of Michigan personal income.
- In the long run, low-income households could come out ahead if the tax changes lead to significantly higher economic growth
- Seniors will not directly benefit from improved growth in Michigan's economy



Defining the Immediate Budget Problem

Deficits Defined

Cyclical — Caused by economic downturn

- Revenues worsen
- Some spending pressures increase
- Deficit erased when economy recovers (self-correcting)

Structural — Caused by year-over-year spending pressures outpacing annual revenue growth and continued use of non-recurring resources

- Spending to maintain current policies and programs
- Revenue insufficient, even in good economic times
- Unable to grow out of this type of deficit

Defining the FY2012 GF Problem

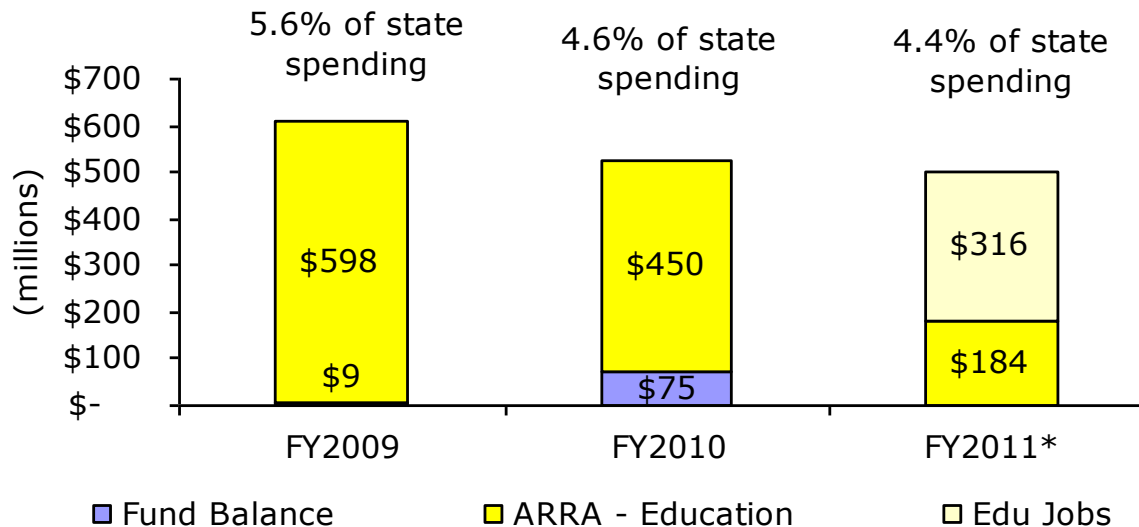
Loss of Federal \$ and Cost Increases Contribute

- FY2012 on-going revenues: \$8.2B
- Current-year spending with adjustments: \$9.6B
- Major adjustments include:
 - \$900M in temp. federal (mostly stimulus)
 - \$193M caseload increase in Human Services and Community Health
 - \$98M increase in debt service payments
 - \$105M increase in employee costs/early out
- Bottom line: \$1.4B structural imbalance in GF

FY2012 SAF Budget in Much Better Shape

Despite Use of Non-Recurring Resources

Non-Recurring Resources Used for SAF Budget



Fund Balance = \$247 million at 10/1/08. State spending excludes federal.

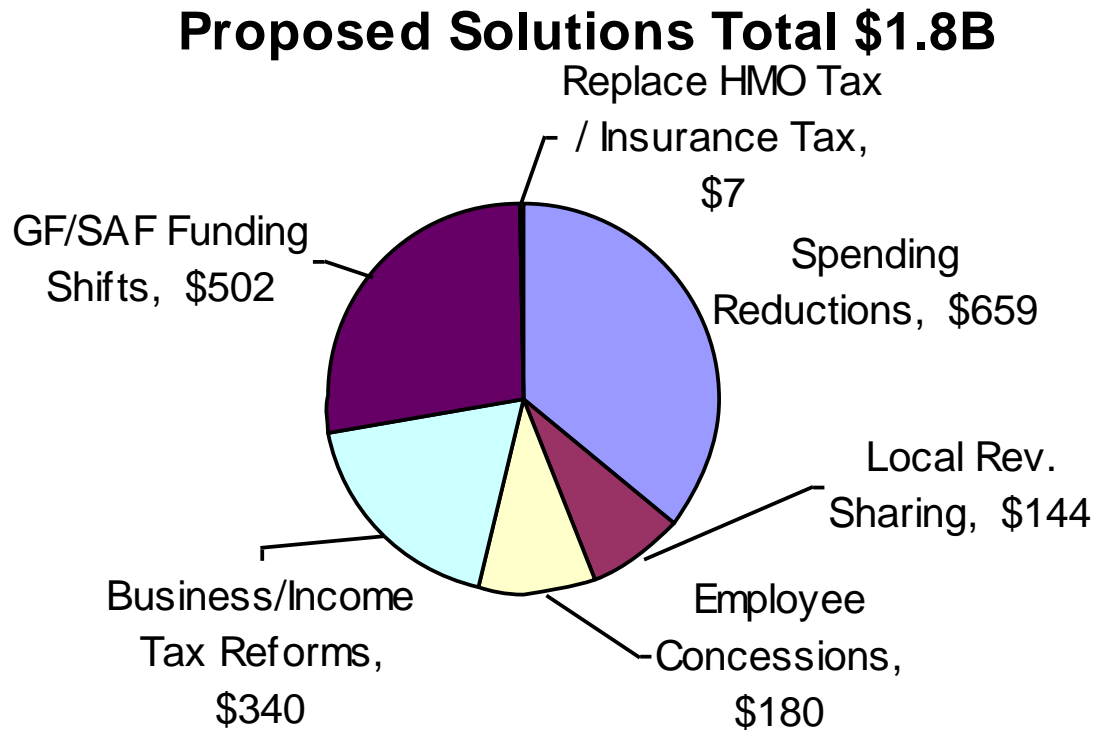
* Based on enacted budget as of 7/10 and projected Edu Jobs funding.

"Balanced" Budget by Using \$500M of SAF Reserves



Proposed Solutions

Mix of Proposed Solutions to Address \$1.4B Gap



Savings Offset By \$260M in New Investments



State Education Funding Act

Funding for K-12 through Higher Ed

- Education appropriations contained in single budget
- K-12 no longer has exclusive claim to School Aid Fund resources – shifts \$896M to colleges and universities
- Overall reduction of \$1B (6.7%)
- After removal of temporary federal funding, cuts \$566M (4.4%) in spending from state resources (GF and SAF)

Total Education Funding (millions)

	K-12	Community Colleges	Higher Education	Total
FY2011	\$ 12,954	\$ 296	\$ 1,578	\$ 14,829
FY2012	\$ 12,174	\$ 296	\$ 1,362	\$ 13,832
<i>Change</i>	\$ (781)	\$ -	\$ (216)	\$ (997)

Source: Executive Budget for Fiscal Years 2012 and 2013



K-12 Education

No Federal \$ and After Funding Shifts - \$470 Hard Cut

- Expiration of one-time federal funds: \$170 per pupil (\$267M)
- Foundation reduction: \$300 per pupil (\$453M)
- Elimination/reduction of various categoricals (\$86M)
- Retirement rate – 20.7% to 24.5% (add'l \$245 per pupil)

	FY2011	FY2012	Change
Min. Grant	\$ 7,316	\$ 6,846	\$ (470)
Basic Grant	\$ 8,489	\$ 8,019	\$ (470)
Max. Grant	\$ 8,489	\$ 8,019	\$ (470)

Effective Per-Pupil Reduction: \$715 (10%)



Higher Education/Community Colleges

- Public universities – uniform 15% cut (\$213M), plus cut of 5% to 10% (\$83M) - varies by school
 - Restoration of \$83M based on tuition restraint (less than 7.1% in FY2012)
- Consolidates all need-based financial aid
 - New “Pathways” scholarship – up to \$875/yr
- Community college funding held constant (\$296M)
- Total of \$896M in SAF revenue (\$567 per-pupil cut in K-12 funding)

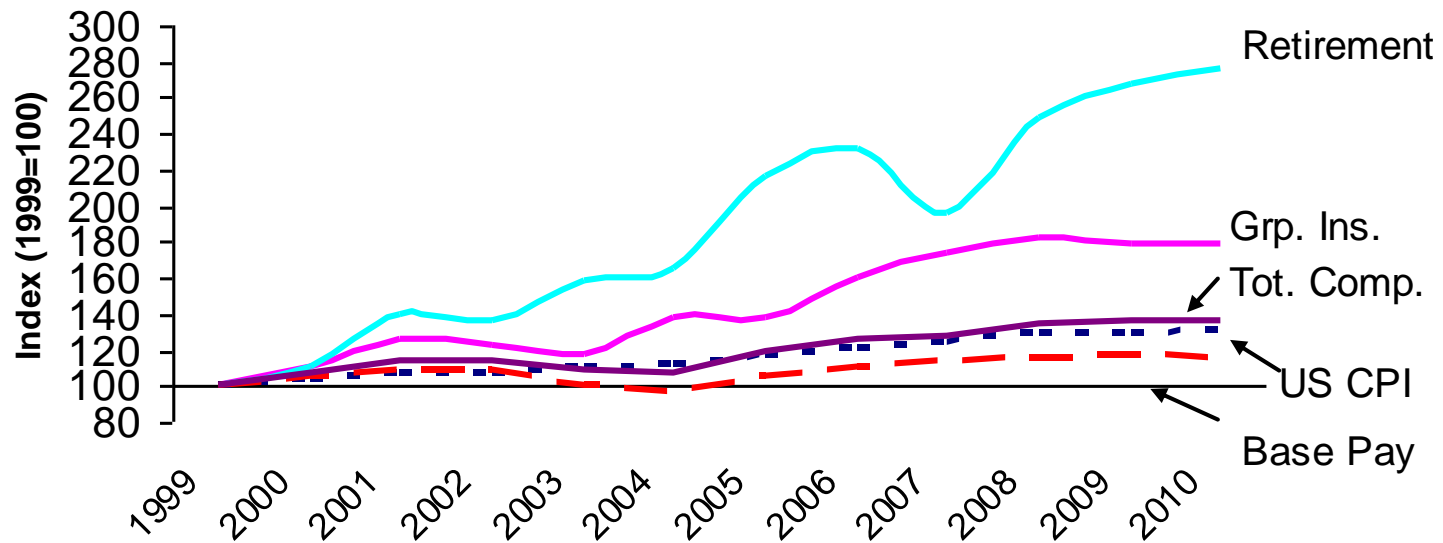


State Employee Compensation

- Net increase of \$105M to fund employee costs, primarily related to retirement (pension and OPEB)
 - Retirement contributions increase from 37.4% to 50.9% of payroll for defined benefit employees
- After adjusting for required employee costs (above), \$180M GF savings reflected in budget – to be negotiated later
- Budget includes \$200M to address future unfunded health care liabilities for state retirees, which are currently funded with current dollars

Budget Proposal Takes Aim at Cost Drivers

Retirement Contributions and Insurance Costs Drive Total State Personnel Expenses



Source: State of Michigan Workforce Reports



Getting \$180M GF in Employee Compensation Savings

- Total compensation (FY2010): \$4.8B
 - For every dollar cut, \$.50 in GF savings
 - Salaries/wages (63% of total), insurance (14%), and retirement contributions (18%)
- New contract for state unions in FY2012
- Possible solutions:
 - Equivalent to 12% cut in salary (\$6,700 per employee)
 - Change insurance cost-share (80/20): \$39M
 - 5% wage cut: \$76M
 - 18 unpaid furlough days: \$66M



State Revenue Sharing

Eliminates Statutory Payments

- Since 2001, statutory revenue diverted to help balance GF budget
 - ~ 1,200 units (cities, villages, twps.) no longer receive statutory payments
- Eliminates \$292M to remaining 600 units
 - \$200M to all units (1,800) based on new formula
 - Governor to deliver specifics in March
 - Overall cut, \$101M (34%)

State Revenue Sharing

Eliminates Statutory Payments

- County payments reduced by 34% (\$52M) from statutory formula
 - Affects 50 counties receiving payments (prorated)
 - Others still drawing “revenue sharing” from escrowed funds resulting from shift in timing of tax collections
- Meanwhile, taxable values (statewide) expected to decline for the fourth year (1.3% in 2012)



Public Policy Issues Raised

Public Policy Issues Raised

Budget Process Changes

- Two-year budget
 - Two, one-year budgets as opposed to true biennial budget
 - First year is “legal” budget, while second year is more of a plan
 - FY2013 reflects full implementation of tax reform changes
 - Continuation of spending in FY2013, with adjustments (caseload, healthcare reform, employee economics)



Public Policy Issues Raised

Budget Process Changes

- Omnibus budget and line item “roll ups”
 - Trade-off: transparency vs. flexibility
 - Shifts authority to executive branch
- Use of performance measures for state programs
 - How do specific items relate to funding and which direction?
 - At this point, not clear how appropriation levels will be impacted by performance metrics

Public Policy Issues Raised

Other Changes

- Legislative oversight of state spending
 - Constitutional “power of the purse” diminished with line item “roll ups”
 - Legislative branch to make laws and set direction
 - Executive branch to carry out laws
 - Monitoring state spending becomes more difficult

Public Policy Issues Raised

Other Changes

- Earmarking of state revenue – tax restructuring
 - Reduces amount of tax receipts dedicated to School Aid Fund (SAF)
 - Shifts \$500M in tax revenue to GF/GP
 - Provides executive and legislative branch with more discretionary resources
 - Related change - proposal breaks with past practice of reserving SAF resources for K-12 education

Public Policy Issues Raised

Other Changes

- Incentive-based funding for revenue sharing programs (schools and general)
 - Little details provided in proposal, but general theme is to encourage service sharing and cost sharing with others
- Some questions to consider:
 - Timing - Creating incentive program in “cuts” budget creates funding losses to local governments immediately
 - Alternative is to implement incentive program in future growth budget using “new” revenue for incentives
 - Fairness – how will entities that already embraced changes be treated?



Progress Towards Addressing Structural Problem

Assessing the Structural Integrity

Progress Towards Solving the Structural Deficit

Evidence

- Lack of non-recurring resources to achieve balance
- Cuts spending significantly – “right-sizes” budget after years of neglect
 - K-12 education
 - Higher education
 - Employee compensation
- New tax structure likely to grow faster than existing one
- Provides look into future (FY2013) – balanced budget



Assessing the Structural Integrity

Progress Towards Solving the Structural Deficit

Concerns

- Does not directly address costs/growth in Dept. of Corrections spending – continuation budget without any major policy recommendations
- Does not directly address escalating health care costs that appear throughout the budget, but it does:
 - Contemplate higher employee health care cost sharing
 - Begins pre-funding state retiree health
- After making significant cuts in revenues, does not directly address cost pressures at K-12 level (retirement, health, general salary increases)
- Will growth of re-vamped taxes keep pace with spending pressures?



Final Thoughts



Final Thoughts

- FY2012 budget is balanced without using one-time revenues or other budget gimmicks
- Combination of tax reform, spending reductions, and funding shifts used to achieve structural balance
- Business tax would be simpler and dramatically lower; economic development incentives moved from tax expenditures to appropriations process
- Income tax would also be simpler with removal of senior tax preferences, refundable credits, and EITC
- Individual income tax increase is significant. Revenues from tax increase used to restructure business tax as opposed to mitigating budget cuts



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