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CITIZENS RESEARCH COUNCIL OF MICHIGAN

101 YEARS OF UNCOMPROMISING POLICY RESEARCH

Challenges Ahead in Balancing the State Budget

38777 Six Mile Road, Suite 208 | Livonia, MI 48152 | 734.542.8001
115 West Allegan, Suite 480 | Lansing, MI 48933 | 517.485.9444
P.O. Box 1612 | Holland, MI 49422 | 616-294-8359 | crcmich.org

Challenges Ahead in Balancing the State Budget

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Challenges Ahead in Balancing the State Budget

Summary

In a Nutshell

1. The State of Michigan is facing a new turbulent period despite several years of economic rebound. Tax credits and promises by previous legislatures and the governor to fund roads and personal property tax reimbursement are starting to come due to the tune of $2 billion a year and possible federal cuts are on the horizon.
2. Budget pressures will force the legislature to make tough choices with no future significant unrestricted General Fund revenue sources, and minimal growth of current revenues.
3. Michigan could see $2 to $5 billion in diversions by FY2022, equal to 20 to 45 percent of the current General Fund budget. Moving into the next decade, this means that Michigan has the potential for a very challenging budget environment.

Although Michigan is rebounding from two major recessions to start the millennium, policy actions that affected future revenues and created new spending obligations are pushing the state budget into a new turbulent period. Many spending decisions that have been kicked down the line by previous legislatures are starting to become due, leading to revenue diversions that total $2 billion, and will be compounded by a lack of legislative flexibility over revenue sources, potential federal action, and the risk of a recession in the state.

Recent revenue projections show that General Fund growth has plateaued; while nominal revenues are likely to increase slightly in the near term, projected and recent trends in inflation-adjusted revenue show that General Fund/General Purpose (GF/GP) revenue has reached a peak. Revenue reached about $10 billion in Fiscal Year (FY)2016, and is expected to remain at about that level over the next three years according to the Consensus Revenue Estimating Conference (CREC).

The CREC projects that the economy will continue to grow at its current pace; if the state were to enter a recession, Personal Income Tax revenues could fall anywhere from 5 to 25 percent, which would lower General Fund revenue. With no new significant unrestricted General Fund revenue sources on the horizon, and minimal growth of current revenue sources under strong economic forecasts, the state budget is about to enter a period that will require policymakers to make tough choices.

The diversions include tax credits associated with the repealed Michigan Business Tax (MBT). These tax credits have tied the state to agreements that lower General Fund revenue by more than half a billion dollars each year, virtually offsetting revenue generated from the main MBT-replacement tax, the Corporate Income Tax. Tax credits from the Michigan Economic Growth Authority (MEGA) and the Brownfield MBT Credit program will have a lasting effect on General Fund revenue beyond 2032, when the last of the MEGA credits expire.

Funds also will be diverted from the General Fund account to the Michigan Transportation Fund for highway spending as part of the recent transportation spending package. Money for infrastructure spending alone will siphon $600 million per year without any new revenue sources. The transportation package also increased the eligibility for the Homestead Property Tax Credit as a means of lowering the impact of the increase in fuel taxes and registration fees for lower income households, which will lower collections by an additional $200 million annually.

Recent exemption of certain personal property from the property tax is another significant loss of resources. While local governments lost revenue from these exemptions, the state made the exemption more palatable for local governments by including a provision to reimburse localities for the lost revenue. The School Aid Fund also lost revenue with the exemptions, and that revenue is scheduled to be replaced with General Fund dollars. The net effect of this reform will be a decline in General Fund revenue by nearly $500 million a year by FY2023.

Some tax changes will have relatively small revenue effects individually, but are significant when considered as a whole. The state was required by federal law to stop collecting the Use Tax on Medicaid Managed Care Organizations, which will lower General Fund revenue nearly $200 million in FY2018. The phase-out of the "tax on the difference", a provision where the state taxed the trade-in value of automobiles, will reduce revenue more than $15 million a year once fully implemented. Exempting data center equipment and over-the-counter drugs from taxation, and diverting taxes on aviation fuel to the State Aeronautics Fund will reduce General Fund revenue by tens of millions when combined.

The sum of all revenue losses and diversions will total more than $2 billion by FY2023, as **Chart A** shows. This is equivalent to 20 percent of today's General Fund revenue.

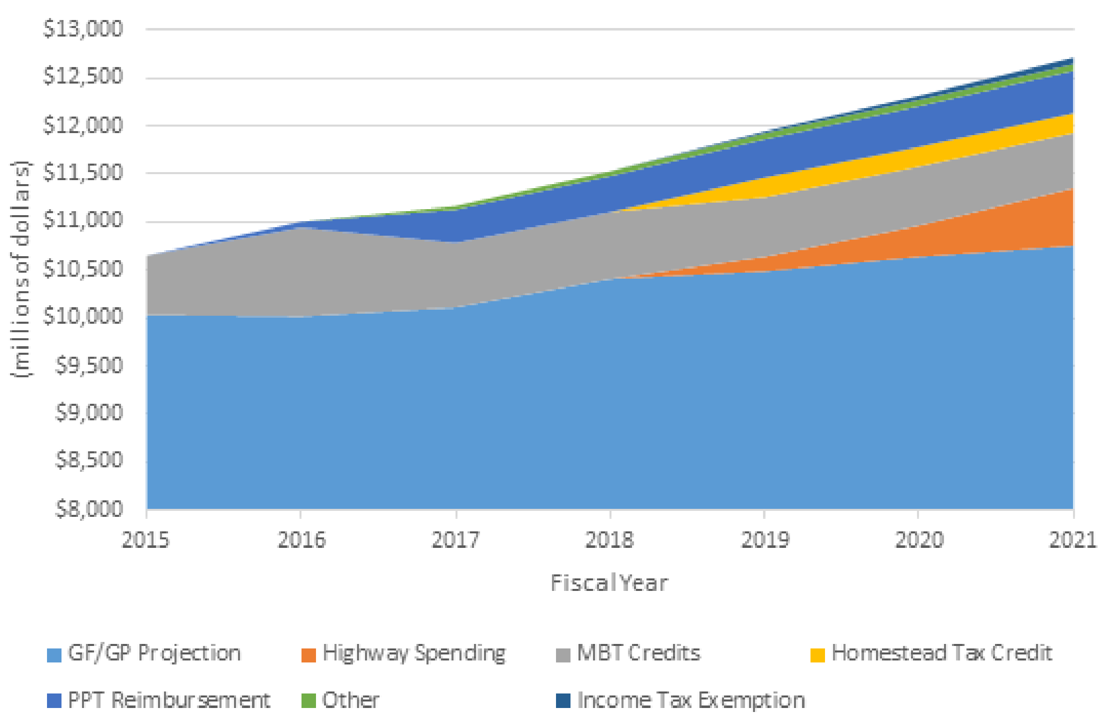
With pressure building from new spending and revenue diversions, many state fiscal constraints will limit the decisions legislators can make in the budget process. The state's heavy use of earmarking limits options for managing revenue streams, and legislated reductions in the Personal Income Tax rate and increases in exemptions for the Personal Income Tax could lower revenue even further.

Federal spending cuts could also be on the horizon, including a potential multi-billion dollar change in the funding structure of Medicaid and a Supplemental Nutrition Assistance Program (SNAP, formerly known as the food stamps program) reduction that could increase the cost of the program to the state by more than $3 billion over the next decade, along with cuts to other programs that provide funding for a wide variety of state services. While these cuts have not been decided on yet, they add another significant level of uncertainty that state policymakers need to consider when making decisions that affect the budget.

When viewed as a whole, the possibility of a decline in General Fund revenue, increase in costs to the system, and decline in federal funding approaches $5 billion, close to half of the current General Fund budget. Moving in to the next decade, the state has the potential to see a budget environment with a higher demand for funding with a lower level of funding relative to inflation.

Chart A

Projected General Fund Revenue and Diversions, FY2015-FY2021



Sources: House Fiscal Agency, Senate Fiscal Agency, CREC

Challenges Ahead in Balancing the State Budget

While the State of Michigan's budget situation is not under any immediate pressure, underlying issues have the potential to lead to a significant increase in stressors on the system over the next five years. The recent past shows how quickly the budget situation can change; despite having nearly $1.3 billion in the Counter Cyclical and Budget Stabilization Fund (BSF) to start the millennium, from Fiscal Year (FY)2001 to FY2003[1] the state quickly exhausted the BSF to support spending through the beginnings of what became Michigan's prolonged single-state recession.[2]

While the Great Recession (December 2007 through June 2009) is over, the economic outlook shows slow revenue growth on the horizon. Current projections will likely force tradeoffs between long-term program needs and future policy priorities. Even with a growing economy, General Fund revenue declined 1.4 percent from FY2015 to FY2016 when adjusted for inflation, demonstrating the current budgetary vulnerabilities. Even a small decline in revenue growth could drastically change the state's ability to pay for core services, which would exert pressure on a budget already facing long-term questions. With significant amounts of money earmarked for increases in transportation funding, upcoming changes to the healthcare system, and the lingering impact of tax credits and exemptions, the possibility exists for the state's budget outlook to deteriorate rather quickly.

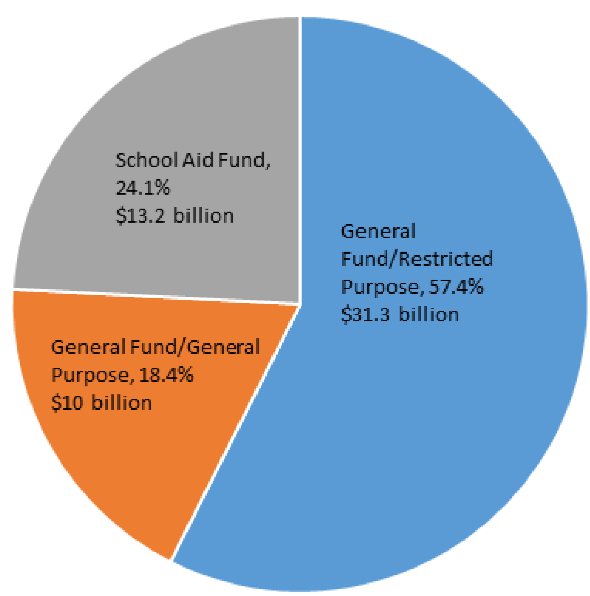
There is even more reason to worry; the Consensus Revenue Estimating Conference (CREC), a meeting between the House Fiscal Agency (HFA), Senate Fiscal Agency (SFA), and Michigan Department of Treasury, lowered the revenue projections for the General Fund over the next three years at the May 2017 conference. Given that future revenue diversions were already building pressure for the General Fund budget, further tightened expectations could increase the magnitude of those pressures. These factors could, when magnified by an inflexible budget environment and a less than predictable federal budget battle that might reduce the amount of federal funds used to finance state services and programs, create budgetary issues down the road.

State of the Budget

The total state budget was set at $56.5 billion for FY2018. Of that, $13.2 billion was dedicated to the School Aid Fund, $41.4 billion to the General Fund. Of the money sent to the General Fund, about $31.3 billion (76 percent) was earmarked (directed to a specific purpose; for example, portions of the Gasoline Tax and Vehicle Registration Fees go to the Michigan Transportation Fund, which is constitutionally required to be spent on road and transit spending). This only left $10 billion in the General Fund/General Purpose (hereafter referred to as the General Fund) budget in FY2018 (see **Chart 1**). Thus, a relatively small part of the budget is responsible for a majority of discretionary funding decisions.

Chart 1

Disposition of Michigan Revenues, FY2018



Source: *FY2017-18 Education Omnibus Budget Summary: Conference Report* and *FY2017-18 General Omnibus Budget Summary: Conference Report*, House Fiscal Agency

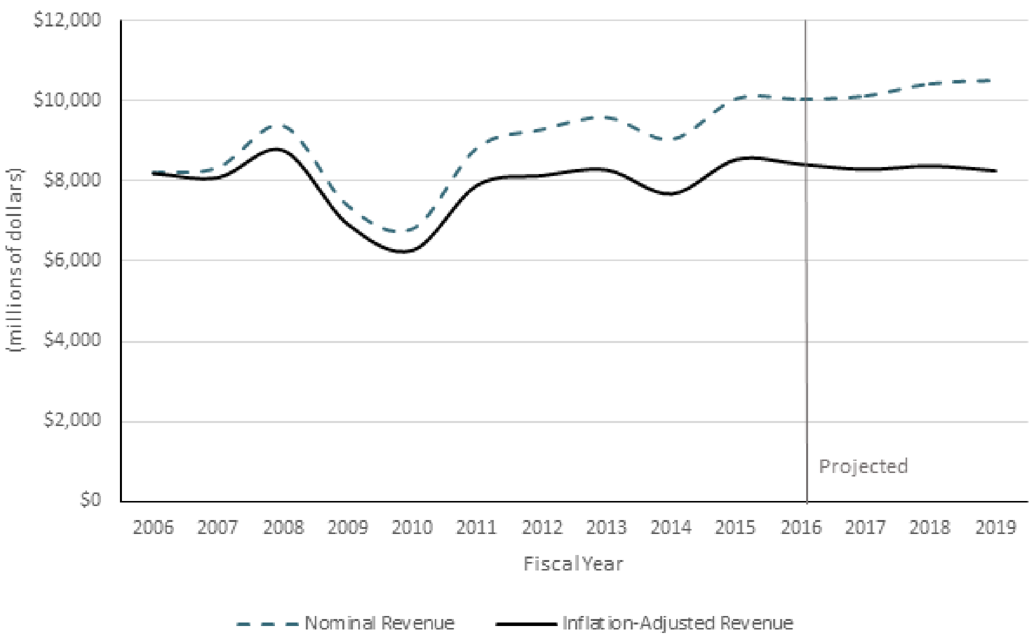
1 The state fiscal year runs from October 1 of one year through September 30 of the next year, and is referred to by the calendar year in which the fiscal year ends.

2 *Economic Outlook and Revenue Estimates for Michigan FY2016-17 Through FY2018-19*, House Fiscal Agency, www.house.mi.gov/hfa/PDF/Revenue_Forecast/Economic_Outlook_and_Revenue_Estimates_May17.pdf

Revenue History

Since the Great Recession, General Fund revenue has seen slow, but mostly stable, nominal growth. After an initial drop of nearly $2 billion in nominal revenue due to the recession, General Fund revenues rebounded by FY2012 and have grown at a rate of about 3.9 percent per year, reaching a peak of $10.8 billion in FY2015. **Chart 2** shows the growth of General Fund revenues since FY2006 in both inflation-adjusted and nominal terms. While nominal revenue shows a long-term upward trajectory, when indexed to 2006 inflation levels, revenue growth has yet to fully recover from the recession, and is not expected to reach pre-recession levels over the next few years. A slight decrease in FY2016 revenue has the budget below the pre-recession peak. So while the state has seen an increase in nominal collections for General Fund programs, inflation-adjusted revenue has actually declined overall since FY2008.

Chart 2
Historical and Projected General Fund Revenue, FY2006-2019



Source: Consensus Revenue Estimating Conference Summaries

This trend is likely to continue into the next few years as the state fiscal agencies expect revenues to increase very slowly in nominal terms. The May 2017 CREC, projected that revenue was likely to increase less than 1.0 percent in FY2017, 2.9 percent in FY2018 and 0.8 percent in in FY2019. These changes represent an even lower revenue forecast than the previous CREC estimates from January, lowering expected General Fund revenue by $100 million for FY2019.

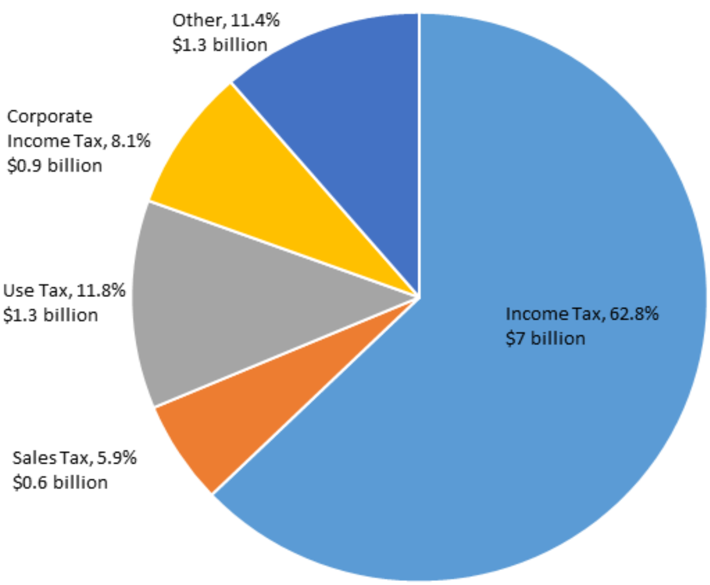
Revenue Structure

General Fund collections overwhelmingly come from the Personal Income Tax (PIT)[3]; in FY2016, 62.8 percent of collections were from the PIT. This is mostly because the PIT is one of the few major revenue sources for which a majority of the revenues are not earmarked; 76.192 percent of its collections flow to General Fund programs. The Use Tax is the second largest collection source, responsible for 11.8 percent of General Fund collections; 65.06 percent of Use Tax collections are deposited in the General Fund. The Corporate Income Tax (CIT) is the third largest source of revenue, responsible for 8.1 percent of total General Fund collections. The Sales Tax is the last of the major contributors. Only 8.9 percent of Sales Tax collections went to the General Fund budget in FY2016, which means even though more money was collected in total from the Sales Tax than all sources of General Fund revenues except the PIT, it was responsible for 5.9 percent of General Fund collections. **Chart 3** shows the full distribution of General Fund revenue sources.

Because the PIT is responsible for nearly two-thirds of General Fund collections, the General Fund budget is strongly tied to PIT revenue. This makes General Fund revenue particularly vulnerable to changes in the PIT. As PIT revenues are expected to be responsible for the majority of increases in the budget, lower than

3 This section uses collections, rather than net revenue, because the Michigan Business Tax and Single Business Tax count against General Fund net collections; their inclusion would result in the sum of positive revenue sources totaling more than 100 percent.

Chart 3
Sources of General Fund Tax Revenues, FY2016



Source: State of Michigan Annual Report of the Treasurer FY2016

projected PIT revenues in FY2017 will add pressure to the budget moving forward. The Use Tax is also expected to decline for FY2017, while all other sources are expected to increase nominally over last year's figures.

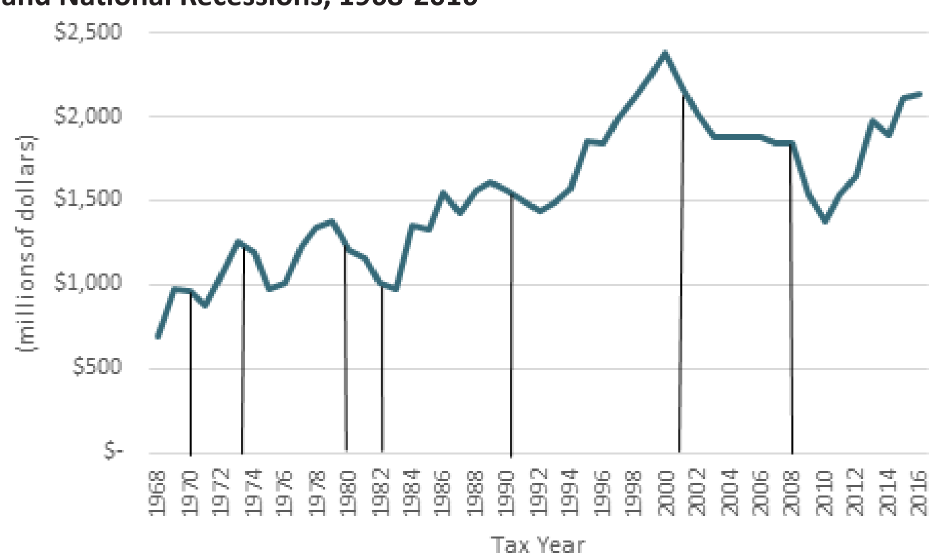
Even though the majority of revenue sources are projected to increase, the projected levels of growth are lower than the expected rate of inflation. Once adjusted for projected inflation, revenue will fall from FY2016 values, and remain around FY2006 levels. Based on the CREC projections and recent historical trends, inflation-adjusted General Fund revenues seem to have plateaued.

The close relationship between General Fund revenues and PIT collections also means that recessions can have a large impact on General Fund collections. Since the state's PIT was first adopted in 1968, PIT revenue trends have closely followed economic conditions. **Chart 4** outlines inflation-adjusted historical collections from the PIT for each percentage point levied, and also shows the start of national recessions.

As **Chart 4** shows, a few recessions had a significant impact on the amount of revenue collected under the PIT. The Great Recession and Michigan's single state recession both demonstrate that a downturn can reduce PIT revenues significantly; from 2008 to 2010, inflation-adjusted per-unit collections fell 25 percent; from 2001 to 2004, after more than a decade of consistent growth in PIT collections, inflation-adjusted per-unit collections fell 19 percent. Declines due to the 1979 energy crisis also caused a significant downturn; from 1979 to 1982, revenues fell 16 percent. Today, a decline of the magnitude of the Great Recession would result in a $1.7 billion (17 percent) decline in General Fund revenue; one the size of the 1979 energy crisis would equate to a $1.1 billion (11 percent) General Fund decline today.

Even a more modest economic downturn would still have a sizable effect; adjusted collections after the 1973 oil embargo dropped 13 percent, while adjusted collections from the recession in the early 1990's fell

Chart 4
Michigan Inflation-Adjusted Personal Income Tax Collections Per-Unit and National Recessions, 1968-2016



Note: The vertical lines indicate the years national recessions began.

Source: State of Michigan CAFRs, Various Years, Federal Reserve Economic Data, and calculations by Citizens Research Council to adjust for inflation and PIT rate using CPI-U data from the Department of Commerce

6.6 percent. A decline equivalent to that of the early 1990's recession would roughly equate to a $460 million decline in revenue, or a 4.6 percent decline in total General Fund revenue.

Current projections for General Fund revenue assume continued economic growth. If the state were to enter a recession, these projections would likely overestimate collections in the range of hundreds of millions of dollars.

Building Budget Pressures

While the state appears to be headed towards a period of economic growth, the lack of expected increases in General Fund revenue could lead to tough choices for the state. Because revenue projections show no growth in inflation-adjusted revenues, budgetary decisions are going to be made in an even tighter budget environment.

Compounding this is a series of revenue diversions that will lower long-term projections for General Fund revenue. As diversions to pre-authorized programs like the PPT reform reimbursement and the transportation funding package ramp up, a revenue situation that is already somewhat restricted could become much more difficult to manage.

Revenue Diversions

Michigan Business Tax Credits

Despite enactment of the Corporate Income Tax (CIT) in 2012 as the primary business tax, many companies continue to file their taxes with the state through the Michigan Business Tax (MBT), the tax that the CIT replaced. Companies with existing tax credit agreements may continue filing through the MBT, rather than filing under the new CIT, until all credits are either used or the agreement expires. The existence of these tax credits exerts significant pressure on the budget, as they are refundable credits, meaning if they exceed a corporation's tax liability, the corporation can collect money from the state for the remaining value of that credit.

Michigan Economic Growth Authority Credits The Michigan Economic Growth Authority (MEGA) tax credit program is the tax credit program with the largest impact on General Fund revenue. Prior to January 1, 2012, companies were able to enter into agreements with the state, where the state would provide a refundable tax credit in exchange for that company increasing its investment or job creation efforts in the state. Because these agreements were negotiated with individual businesses, the exact number of jobs or amount of investment varies from agreement to agreement. These agreements are optional for businesses; they can choose whether or not to meet the conditions and apply for the credits. The length of the agreements cannot exceed 20 years; thus, some agreements the state entered into will run through 2032. Because of the time consuming nature of verifying compliance, payments from the program will be made beyond that timeframe.

The amount of credits owed under these agreements is significant. The Michigan Economic Development Corporation reported that over the remaining life of the MEGA tax credit agreements, the state has roughly $6.4 billion in potential liabilities, and they estimate that roughly $5 billion of those credits will be claimed by 2032 (in addition to around $1.3 billion in credits that have not yet been submitted for past years), with the entirety counting against General Fund revenue.[4] These estimates may be on the low side; if job retention credits make a higher portion of the agreements, the projected revenue diversion from MEGA credits claimed could rise by as much as $3 billion over the lifetime of the agreement, as the compensation costs increase for those particular credits, according to the SFA.[5]

Other Credits Beyond the MEGA tax credits, a few other MBT tax credits will continue to reduce General Fund

4 *MEGA and other Certified Credits 2016 Annual Report*, Michigan Department of Treasury and Michigan Strategic Fund, www.michigan.gov/documents/treasury/Section_941_FY_17_MEGA_and_Other_Credits_Report_545698_7.pdf

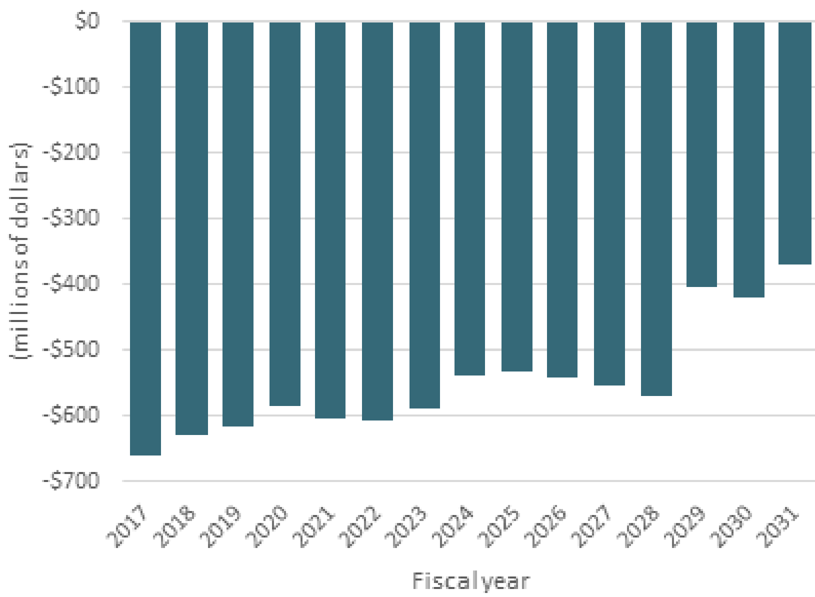
5 *A Primer on Certified Credits under the Michigan Business Tax*, Senate Fiscal Agency www.senate.michigan.gov/sfa/Publications/Notes/2015Notes/NotesWin15lpcsdz.pdf

revenue over the long-term. The Brownfield MBT Credit allows businesses to claim up to 12.5 percent of expenses in eligible brownfield[6] development investments (or 20 percent for Urban Development Area Projects) against their tax liability. These credits can either be used, sold to other companies to use against the purchasing companies' liabilities, or redeemed for 85 percent of their value if a company exhausts its tax liability and opts not to sell it to a third party. These credits are expected to be worth $210 million over the course of the next six years.

Other tax credits that remain in the MBT framework that will lower revenue include the Farmland Preservation Credit, which is estimated at about $1.5 million annually;[7] the Polycrystalline Energy Credit, which is expected to average around $20 million a year for the next six years; and the Renaissance Zone tax credit, which is declining but will average more than $3 million a year until about 2023.

Chart 5

Expected MBT Tax Credit Revenue Effect, FY2017-FY2031



Source: Michigan Strategic Fund

Net General Fund Impact Under the various MBT agreements, the State of Michigan is expected to have a tax credit liability of roughly $9.2 billion between now and the expiration of all agreements, including credits that may have already been earned but have yet to be submitted. **Chart 5** shows the total liability the Department of Treasury expects each year until all remaining agreements expire. The net impact on the General Fund budget is expected to be around $600 million per year between now and FY2022, and then will slowly decline until all MEGA tax credits have been claimed after the phase-out in FY2032. The lost revenue due to payments under the MBT will lay a sizable claim to General Fund resources for the foreseeable future.

Compounding the decline of tax revenue related to MBT credits is a large decline in revenue collection under the CIT. When designing the CIT, the state made a choice to lower revenue collections to improve the business climate in the state and offset those declines by eliminating the scheduled reduction of the PIT rate, expanding the PIT base to include pension and other retirement income, and reducing the Earned Income Tax Credit (a refundable tax credit provided to low-earning households that incentivizes work) and the Homestead Property Tax Credit (a credit against the PIT for property taxes paid by lower-income property owners and renters that use the property as a primary residence).[8]

The MBT raised an average of more than $2 billion annually in the four years it was levied including the revenue declines from credits paid out; the Single Business Tax (the MBT's immediate predecessor) collected more than $1.8 billion annually for more than a decade prior. To date, the Corporate Income Tax has averaged a collection of $927 million per year, less than half the average income under the taxes that it replaced (and this difference does not include the net payout from credits during those years). Thus, most of these tax credits are designed around a timeframe when the

6 A Brownfield is a previous industrial or commercial site that has its future use limited due to actual or perceived environmental contamination from that previous use.

7 The Farmland Preservation Credit as of writing has no sunset date, and agreements can last anywhere from 10 to 90 years.

8 *The State of Michigan's New Fiscal Plan*, The Citizens Research Council, www.crcmich.org/PUBLICAT/2010s/2011/sbn2011-02.pdf

state was collecting more than double in business taxes than what it is currently collecting. In FY2011, the state netted $2.1 billion in revenue from the MBT and SBT. In FY2017, the SFA predicts the combined CIT and MBT net revenue to be $160.7 million.

Because of the variable nature of tax credits (companies can elect to claim or not claim credits at any time over the life of the agreement), changes that can increase the value of the credits, and the long timeframe it can take to actually distribute payments for tax credits, there can be large year-to-year variations in the revenue losses. That variation will likely increase pressure on the budget. This is best demonstrated by the 2015 CREC, where the agencies lowered their previous revenue estimates for FY2015-16 by half a billion dollars due largely to larger losses than projected under the MBT. The combination of the MBT credits and the decline in revenue when moving from the MBT to the CIT puts significant, long-term pressure on General Fund revenue.

While these credits are accounted for in the General Fund revenue estimates (because they are tax credits, they are subtracted from collections to form the net budget), increases in the use rate of the credits could potentially lower revenue projections further than they already have. And while the number of credits outstanding will decline, the General Fund will forgo over half a billion dollars in revenue each year for more than a decade, significantly limiting the flexibility that legislators have when putting together future budgets.

Transportation Funding Package

On November 10, 2015, Governor Snyder signed a package of bills that will add $1.2 billion to the Michigan Transportation Fund (MTF) for transportation funding when fully phased in in FY2021; $600 million by increasing the fuel tax to 26.3 cents per gallon and increasing registration fees 20 percent, and $600 million by diverting money from the Personal Income Tax (PIT) to the MTF. Starting in FY2019, $150 million will be diverted from General Fund revenue to the MTF, with that amount increasing to $325 million in FY2020, and finally reaching $600 million annually in FY2021 and thereafter.[9]

9 Public Acts 176-180 of 2015

The transportation bill did not provide a mechanism to replace diverted PIT revenue for the General Fund. When the legislation was initially passed, the underlying assumption was that, as the economy continued to improve, the General Fund would expand with economic growth driving increases in PIT and other tax revenue. There are reasons to be skeptical of this assumption. Between 2005 and 2015, General Fund revenue decreased when adjusted to inflation and the CREC projects General Fund revenue will stay flat once adjusted for inflation over the next few years. This assumption also requires that no other needs for spending arise, whether for new programs or needed expansions of existing programs.

Additionally, the transportation bill was packaged with a tax relief effort in the form of an expansion of the Homestead Property Tax Credit. This was included to offset the increase in tax burden on lower income individuals caused by increases in fuel taxes and vehicle registration fees.

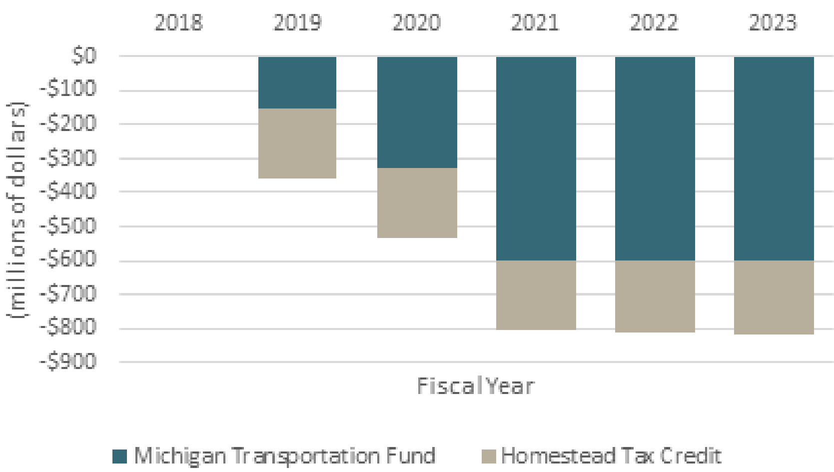
In expanding the credit, Public Act (PA) 179 of 2015 made a number of changes that served to increase the projected amount of credits that will be earned. The act expanded eligibility by increasing the income limit to apply for the credit from $50,000 to $60,000 and indexed that number to inflation starting in 2021. The credit calculation was also changed, lowering the contribution amount where a homeowner started earning credits from 3.5 percent to 3.2 percent of total income. Finally, it also indexed the cap on property value to inflation.

The expansion of the Homestead Property Tax Credit takes effect in the 2018 tax year. When credits are claimed, the SFA expects the program to lower revenue by $205.8 million in the first year, and slowly increase after it becomes indexed to the rate of inflation in 2021.

The combination of the diversion of funds to the Michigan Transportation Fund for transportation improvements and the Homestead Property Tax Credit will continue to stress the budget. **Chart 6** shows how diversion of General Fund revenue is expected to ramp up over the next few years.

While increases in revenue from the fuel tax and registration fees have already begun to phase in, diversion of PIT revenue from the General Fund budget to

Chart 6
Projected Transportation Package Revenue Effect, FY2018-FY2023



Source: General Fund/General Purpose Revenue Growth, Senate Fiscal Agency, www.senate.michigan.gov/sfa/Publications/Notes/2017Notes/NotesSpr17lpdz.pdf

the MTF and revenue losses due to the Homestead Property Tax Credit will not start until FY2019. In the first year of revenue generation $356 million in General Fund revenues will be used for these purposes, increasing to $531 million in FY2020, and then the it ratchets up to $805.8 million in FY2021, where the MTF transportation funding diversion reaches its peak. In subsequent years, the revenue loss will increase with inflationary adjustments to the Homestead Property Tax Credit, causing the total revenue diversion to slowly increase after FY2021. The combination will add pressure to the General Fund budget in the form of more than $800 million a year in revenue diversions once fully implemented.

Personal Property Tax Reimbursement

In 2014, the Legislature finalized a long negotiated plan to phase out the Personal Property Tax (PPT) on industrial and some commercial property in an attempt to improve the business climate of the state. Businesses with commercial and industrial personal property with a true cash value less than $80,000 were made exempt from the PPT starting in 2014, and businesses with more valuable holdings would see the PPT phased out between the years 2016 and 2023. **Figure 1** shows the timeline of PPT exemptions; starting in 2016, all eligible personal property purchased before 2006, and all eligible property purchased after 2013, was made exempt from the PPT. For all remaining personal property, once the property reached 10 years of age, it becomes exempt from the PPT.

With local governments losing the majority of the revenue forgone due to the PPT exemption, reform became more palatable when it included a funding package to replace the more than half a billion dollars in local government revenue. The legislation provided two mechanisms to replace local revenue. First, the state created the Essential Services Assessment (ESA), authorizing the state to levy a tax on certain industrial and/or commercial personal property. Second, the state re-directed portions of the Use Tax from the General Fund to localities to compensate for the missing funding.[10]

As the ESA was a new revenue source for the General Fund, it limited the impact the PPT reforms had on General Fund revenues; the amount of revenue generated is small relative to the Use Tax diversion. Reimbursement payments from PPT reform began in FY2016, starting at $96.1 million. The payments will escalate

Figure 1
Phase-In Schedule for Existing Eligible Personal Property under PPT Reform

	Tax Year							
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
2005	X	X	X	X	X	X	X	X
2006		X	X	X	X	X	X	X
2007			X	X	X	X	X	X
2008				X	X	X	X	X
2009					X	X	X	X
2010						X	X	X
2011							X	X
2012								X
2013	X	X	X	X	X	X	X	X

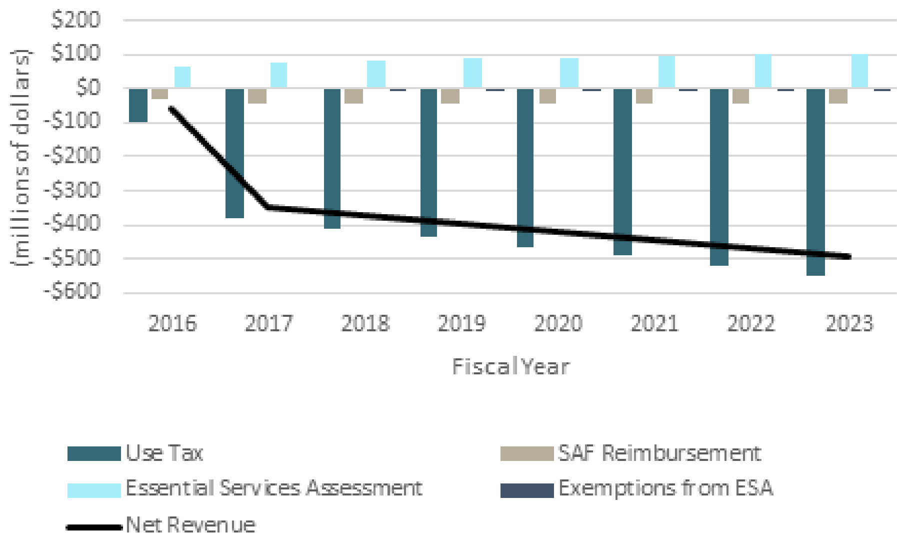
Year placed in service
X = exempt from personal property taxation

10 Public Act 80 of 2014.

to $380.9 million for FY2017, and then reach their full effect at $572.6 million in FY2028, where the reimbursement will increase by one percent per year after. The revenue from this component of the tax does not affect the two percent portion of the Use Tax directed to the School Aid Fund; this means that the entirety of the funding will come from the General Fund component of the tax. Compounding these factors, the PPT reform created new property tax exemptions, meaning the state also lost State Education Tax revenue, which will also be replaced by General Fund dollars.[11]

Chart 7

Projected Personal Property Tax Reform Revenue Effect, FY2016-FY2023



Source: Senate Fiscal Agency

Chart 7 shows the individual tax and net effect of revenue from the ESA and the cost of replacing lost revenue from the PPT phase out and the State Education Tax. As shown, Essential Services Assessment revenue covers a relatively small portion of the overall cost of the program; the ESA tax raised only $67.6 million in FY2016, relative to the more than $420 million in forgone revenue expected in FY2017, the first full year of implementation. This means that even with the ESA revenue, PPT reform will reduce General Fund revenue by $350 million in FY2017, and will escalate to about $500 million by FY2025.

The PPT reform reimbursement is another significant diversion of revenue away from the General Fund. While the legislation specifies that the intent is that funding will be offset by the phase out of the MBT credits (particularly the MEGA credits discussed earlier), there is a window where the PPT reform reimbursement is much larger than the anticipated decline in MBT tax credits, causing a significant reduction in General Fund revenue until around FY2028. **Chart 8** shows the expected total reduction in revenue due to these two programs until the MBT credits are set to expire. If you exclude the extreme level of credits redeemed in FY2016 as an outlier (where nearly $1 billion in credits were claimed, by far the largest total disbursement in the program's short history), declines in MBT credits are not projected to offset increases in PPT reform reimbursements. In fact, the net revenue loss from the two policies remains at a billion dollars through FY2028, when the MBT credits start to taper off as the majority of agreements begin to expire.

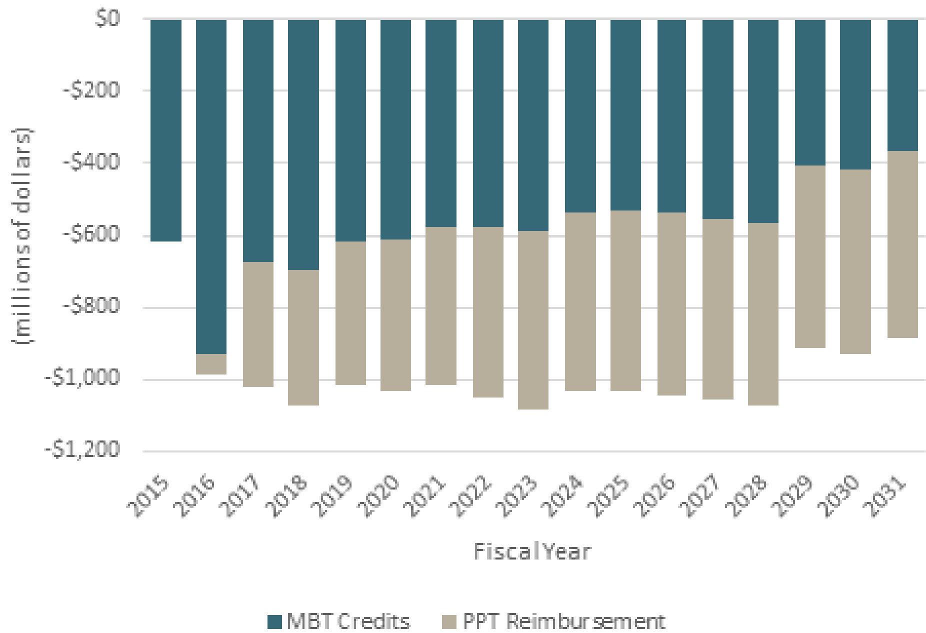
11 *General Fund/General Purpose Revenue Growth*, Senate Fiscal Agency, www.senate.michigan.gov/sfa/Publications/Notes/2017Notes/NotesSpr17lpdz.pdf

Medicaid Managed Care Use Tax Repeal and HICA Sunsets

The Use Tax on Medicaid Managed Care Organizations (MCOs) originated in 2009, when the state added Medicaid Health Maintenance Organizations (HMOs) and pre-paid inpatient health plans (PIHPs) to the list of entities subject to the Use Tax. This process was used to exploit a loophole in federal law that allowed the state to tax only Medicaid organizations, which would likely see that money and more replaced due to increases in federal matching. The federal government later determined that this process would be barred, and closed the loophole in 2011. However, California received permission to enact a similar tax, which the federal government then extended to Michigan for a limited amount of time. In 2015, the federal government alerted the state that the application of the Use Tax to Medicaid HMOs and PIHPs must be phased out by the end of 2016. The Medicaid MCO Use Tax

Chart 8

Net Effect of Personal Property Tax Reform and MEGA Credits, FY2015-FY2031



Source: Senate Fiscal Agency and Michigan Strategic Fund

generated approximately $253 million a year for the General Fund, which was also used to earn federal matching dollars.[12]

The federal removal of the state's application of the Use Tax to Medicaid HMOs and PIHPs triggered an increase in the Health Insurance Claims Assessment (HICA) rate, a tax on paid health service claims, from 0.75 percent to 1.0 percent. This will replace about $60 million of lost revenue from the repeal of the Medicaid MCO Use Tax each year, but it leaves a secondary problem. The HICA tax is scheduled to sunset in 2020. While that date has already been extended once, it leaves open the possibility of an even greater decline in revenue. Prior to the recent extension, the SFA estimated that the General Fund would lose $465 million in revenue in FY2019, what would have been the first full year without the HICA charge, if both the HICA and the MCO Use Tax were to expire. Some of the lost savings do overlap with the projected savings from the Healthy Michigan Plan; about $29 million would be generated each year by HICA using funding for the Healthy Michigan Plan, so the combined numbers would over-estimate revenue loss slightly.

Currently, the state only has a couple of ways to respond to the lost Use Tax revenue, as well as HICA revenue if HICA sunsets. It could replace Use Tax and HICA spending with General Fund dollars, which would increase Medicaid spending by the full amount of the decline. Alternatively, the state could opt to end that spending—but this solution is not that simple. Because spending from the MCO Use Tax and HICA bring in federal matching dollars, if the state chose to reduce that spending, the state would have to reduce Medicaid spending at more than a dollar-for-dollar rate. Any decline in revenue from the Use Tax and HICA will exert more pressure than just the revenue lost, which would be in the magnitude of hundreds of millions of dollars.

Other Revenue Reductions

In addition to the major changes listed above, several smaller adjustments that the state made will have individually minimal effect on the General Fund budget, collectively add up to create an additional burden on the budget.

Driver Responsibility Fee In 2014, state law scheduled the phase-out of driver responsibility fees, a punishment for individuals convicted of reckless driving, drunken driving, or driving without a license. While the phase out began in 2016, effects on General Fund revenue did not begin until FY2017. Once fully eliminated, the SFA predicts the phase-out will lower General Fund revenue by $48 million a year.[13]

12 *Health Insurance Claims Assessment (HICA) Primer*, Senate Fiscal Agency, www.senate.michigan.gov/sfa/publications/notes/2015notes/notesfal15sa.pdf

13 Public Act 250 of 2014.

Corporate Officer Liability Also in 2014, the state limited the personal liability that could be imposed on officers of corporations that owed taxes when the organization either defaulted or went out of business. These regulations are expected to reduce revenue by over $60 million each year starting in FY2016, with the magnitude of the revenue loss expected to increase yearly, reaching $77 million by FY2023.[14]

Other Tax Changes A couple of changes in tax provisions will reduce General Fund revenues. In 2015, data center equipment were exempted from the Sale and Use Taxes, which reduced General Fund revenue by just over $5 million in FY2016, and is expected to reduce General Fund revenue more than $7 million a year starting in FY2017. That year, another bill was passed redirecting a portion of Use and Sales Tax revenue from the sale of aviation fuel towards the State Aeronautics Fund, which will lower General Fund revenue by $8 million in FY2017, and the revenue loss will increase to $14.6 million by FY2023. In 2013, the Sales Tax was amended in two material ways that will reduce the amount of revenue collected. While the majority of the revenue forgone from these changes will affect the School Aid Fund, they will have noticeable impacts on General Fund collections. The first change removed the "tax on the difference", a provision that included the value of a vehicle trade-in in the calculation of the taxable value of a vehicle purchase. This will reduce annual General Fund revenue by $11.8 million from FY2016 levels in FY2023, and will continue to reduce revenue until fully phased out in FY2039.

The second change to the Sales Tax was a provision to exempt prescribed over-the-counter medications from taxation; this is expected to reduce General Fund collections by $1.5 million per year starting in FY2016.[15]

Summary—Revenue Diversions

Given the slow nominal growth in General Fund revenues over the last few years, Michigan's General Fund revenue has declined when indexed for inflation. State policymakers should know that a recession would likely have significant effect on PIT collections, and thus overall General Fund revenue. History shows us that even a small economic slowdown could cause as much as a 5 percent drop in PIT collections, and a more severe contraction could reduce General Fund revenues by billions of dollars.

On top of the threat of diminished revenues due to an economic downturn, several tax credits, earmarks, and tax reductions are beginning to reduce General Fund revenues in a significant amount. While these diversions are small relative to the General Fund budget today, by 2023 they will represent more than $2 billion in lost revenue, or 20 percent of current General Fund revenue. These past policies will significantly limit discretionary revenues policymakers will have at their disposal for the next 15 years, when the last of the MEGA tax credit agreements expire, but will continue to have a large impact as long as the PPT reform reimbursement and transportation funding are extended.

Spending Pressures

Along with the diversions that will lower General Fund revenue, a few programs have mandated spending increases that will further complicate future budget decisions.

The Healthy Michigan Plan

Notwithstanding changes to the Medicaid Expansion at the federal level, the current design of the Healthy Michigan Plan will increase Michigan's expenditures over the next five years. Under its effort to expand healthcare coverage nationwide, the federal government offered to fully fund the cost of Medicaid expansions (like the Healthy Michigan Plan) through 2016, and then would require states to pay for a portion of the expansion; the state share started at five percent of the expansion cost in 2017, increasing each year until the state contribution reaches ten percent in 2020. Once fully phased in, the HFA estimates the cost of the total state contribution to be around $400 million per year. Because Medicaid costs are partially funded through provider assessments and state retainers, the

14 *General Fund/General Purpose Revenue Growth*, Senate Fiscal Agency, www.senate.michigan.gov/sfa/Publications/Notes/2017Notes/NotesSpr17lpdz.pdf

15 Senate Fiscal Agency

Pension Funding

In addition to internal General Fund pressures, financial needs from the Michigan Public School Employees' Retirement System (MPSERS) could lead to calls to divert even more resources. In 2015, MPSERS had an unfunded liability of $26.7 billion,[1] and that number is estimated to be more than $29 billion in 2017.[2]

No single cause is responsible; a decade of assumptions that did not hold including investment returns and retirement periods coalesced to create the liability. This has lead the state to significantly increase spending to reduce the unfunded liability as of late.

In June of 2017, the Legislature came to an agreement on MPSERS reform with the Governor to reduce risk to the system. This closed the existing hybrid pension system, opening a new one with measures to reduce the state's long-term risk of unfunded liabilities. Along with the reform, there is an increased cost associated with the increase in defined contribution matching and the change in the defined benefit structure. The Senate Fiscal Agency anticipates the increased cost of total employer contributions under the new system will increase $23.1 million in the first year, increasing to $168.2 million by year 10, and $810.7 million by year 30 of the new system.

The new agreement still leaves the issue of remaining unfunded liabilities. Employers in the MPSERS system are limited to paying at most 20.96 percent of payroll costs towards that liability each year, while the School Aid Fund (SAF) adds additional funding towards the unfunded liability. The SAF contribution has increased significantly, from $155 million in FY2012 to $984 million in FY2016.[3]

While the SAF is the account primarily responsible for these payments and increased retirement contributions, there has been a trend to utilize money from General Fund revenue to help defray some of the costs from the SAF. The FY2018 budget demonstrates this; $200 million was allocated from the General Fund budget to pay down MPSERS liability, while an additional $55 million was allocated to cover costs associated with the transition from the old retirement system to the new system.[4] It is unknown what role the General Fund will play moving forward.

1 *Total Accumulated Pension Unfunded Liabilities*, Senate Fiscal Agency, www.senate.michigan.gov/sfa/Departments/DataCharts/DCret_Pension&HealthLiabilities.pdf

2 *Pension Dispute Derails Michigan Budget Talks*, Detroit News, www.detroitnews.com/story/news/politics/2017/05/19/pension-dispute-derails-mich-budget-talks/101868344/

3 *Michigan Public School Employees' Retirement System*, House Fiscal Agency, www.house.mi.gov/hfa/PDF/Retirement/MPSERS_Briefing_October2016.pdf

4 *$56.6B budget headed to Gov. Rick Snyder's desk*, MLive, www.mlive.com/news/index.ssf/2017/06/566b_budget_headed_to_gov_rick.html

HFA estimates that about $220 million per year would need to come from the General Fund in FY2021.[16]

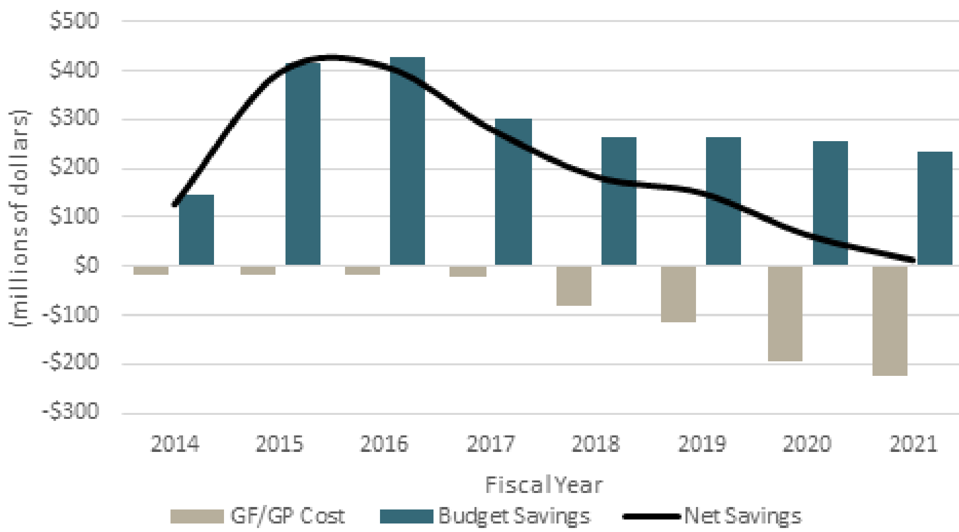
The Healthy Michigan Plan is scheduled to expire when calculated costs of the program exceed the state's savings. Unfortunately, that does not mean that there is not a negative budgetary impact from the program's expiration. Over the last two years, the HFA estimates that the program has saved the General Fund about $400 million per year in costs elsewhere. If the program were to be eliminated today, it would create a significant need to increase spending for other programs in the General Fund budget (these include programs that overlap with Healthy Michigan Plan spending, particularly Non-Medicaid Mental Health spending and health care for prisoners housed in state facilities).

16 *Memorandum: Healthy Michigan Plan Saving and Cost Estimates*, House Fiscal Agency, www.house.mi.gov/hfa/PDF/HealthandHumanServices/HMP_Savings_and_Cost_Estimates.pdf.

As it stands, even with the required increase in spending, the HFA projects that the Healthy Michigan Plan will still save the state more money than it costs through at least FY2021. **Chart 9** outlines the projected costs and savings of the program. Despite an increase of General Fund costs of about $200 million yearly by FY2021, it is projected that the Healthy Michigan Plan will still save the state $13 million in the first year the state pays its maximum contribution. This, however, would result in a net increase in General Fund spending. So regardless of how the state chooses to handle the Healthy Michigan Plan over the long-term, the state will need to increase spending by $400 million from FY2015 levels.

Chart 9

Projected Healthy Michigan Plan Net Savings, FY2014-FY2021



Source: *Memorandum: Healthy Michigan Plan Saving and Cost Estimates*, House Fiscal Agency, www.house.mi.gov/hfa/PDF/HealthandHumanServices/HMP_Savings_and_Cost_Estimates.pdf

The Michigan Indigent Defense Commission

In response to a public defense system that many saw as underwhelming, the Michigan Indigent Defense Commission Act (MIDCA) created a state-run commission to improve criminal defense services for individuals who are unable to afford an attorney. To improve these services, the MIDCA set up a board of 16 members to set standards for local indigent defense efforts.

Because of the Headlee Amendment to the Michigan Constitution provisions prohibiting new unfunded mandates, the MIDCA includes provisions that allow the Commission to provide grants and outlines legislative funding requirements to ensure that the state share of system funding is not reduced. While the net effect of these provisions is not yet known, it could result in a significant increase in spending.[17] As the Michigan Indigent Defense Commission is proposing its first set of standards, local governments are bracing for significant financial costs. Each county has until November 20, 2017, to submit their compliance plan and cost assessment to the Michigan Indigent Defense Commission (MIDC), and once those analyses have been completed more information on the state's overall costs will be known.[18] Early estimates have the state share of costs for the standards at $50 million a year, though no official estimates or appropriations have been made.[19]

Oakland County recently published an analysis evaluating what will be required of the county based on some assumptions of what the final standards might include. Oakland County estimates that their annual costs will increase by more than $18 million annually, along with fixed costs expected to reach more than $25 million.[20] Oakland County is one of the larger counties and more urban than most of the other 82 counties, so most other counties are likely to face increases of lesser

17 *Legislative Analysis: Michigan Indigent Defense Commission Act*, Senate Fiscal Agency, www.legislature.mi.gov/documents/2013-2014/billanalysis/House/pdf/2013-HLA-4529-4569088C.pdf.

18 Michigan Indigent Defense Commission, michiganidc.gov/standards/

19 *State will soon be asked to pay more for indigent defense*, Lansing State Journal, www.lansingstatejournal.com/story/news/local/capitol/2017/05/03/state-soon-asked-pay-more-indigent-defense/101021178/

20 *Oakland County Long-Range Fiscal Plan*, Oakland County, www.oakgov.com/investors/Documents/Oakland_Fiscal_Plan_FY_2017_through_FY_2022.pdf

Moving Forward: The Costs of Competitiveness

As the state continues to reestablish itself after the single-state recession and the Great Recession, much discussion has taken place over what the state still needs to do to improve its economic standing in the 21st century. In an attempt to build on the momentum of Michigan's recovery, Governor Snyder established commissions on the state's infrastructure, education, and economy to determine what investments the state can make to improve its long-term standing.

While there are currently no plans to implement the majority of the various commissions' recommendations, and the recommendations are not based on a consensus of opinion of what the state needs, these recommendations do provide a starting point for a discussion of issues that the state legislature will need to examine, whether investment starts now or some time down the road.

21st Century Infrastructure Commission

Governor Snyder created the 21st Century Infrastructure Commission (Infrastructure Commission) to evaluate the state's infrastructure needs. Many of the state's infrastructure issues have been apparent for some time; Snyder's Executive Order mentions that nearly 3,000 bridges were graded as structurally deficient or obsolete and that water systems are out of date.[1] Even beyond those problems, the Commission found that 39 percent of roads are in poor condition and that ten percent of the state's septic systems are failing. The Executive Order underscores the importance of infrastructure in the state given the reliance of our manufacturing sector on roads, as well as the need for high-quality infrastructure for the state's population, and a need to improve investments in cyberspace to adapt to the modern economy's reliance on internet usage.

Based on these challenges, the Infrastructure Commission came to the conclusion that Michigan has an annual investment gap of nearly $4 billion dollars a year to repair roads, rebuild sewage and water infrastructure, and improve the state's telecommunication systems.[2] While the transportation funding package provides a starting point for infrastructure investments, it falls short of the Commission's recommended levels of spending for Michigan's roads, and leaves other core pieces of the state's infrastructure in their current condition. The Infrastructure Commission did outline some sources of revenue that could fund such an undertaking but, as the highway funding package demonstrated, increased spending could end up being financed by the General Fund.

21st Century Education Commission

The 21st Century Education Commission (Education Commission) was created to determine what steps the state should take to better prepare students to compete in the modern economy. Studies have found that students in the state are falling behind compared to the rest of the United States; according to the Education Commission, Michigan was one of three states that saw 4th grade reading scores drop since 2003, where the state now ranks 42nd nationally. This trend is reflected in other scores across subjects and grade levels.[3]

The Education Commission outlined nine core strategies to improve the state's education system. These key strategies vary in cost, and some have an uncertain effect, but the Commission's minimum cost estimation was over $800 million annually. These include programs to improve teacher training, enhance classroom practices, and expand college and career training opportunities. While many of these costs would come from the School Aid Fund, hundred-million dollar increases in spending would require additional resources, and could lead to pressure on the General Fund.

Building the 21st Century Economy Commission

The Building the 21st Century Economy Commission (Economy Commission) was established to evaluate ways to change state policies to improve economic prosperity and job growth in Michigan. Many of the recommendations echoed those of the Infrastructure and Education Commissions, as the Commission found that the talent pool and available infrastructure in the state were two of the biggest driving factors for improving the state's economic outlook over the long term.[4] While few of the other priorities the Commission outlined required changes in revenue or spending patterns in the state, the fact that the Economy Commission emphasized the findings of both the Infrastructure and Education Commissions gives more credibility to the argument that investment needs to be increased in both sectors.

1 Executive Order No. 2016-5

2 *21st Century Infrastructure Commission Report*, 21st Century Infrastructure Commission, www.michigan.gov/documents/snyder/21st_Century_Infrastructure_Commission_Final_Report_1_544276_7.pdf

3 *The Best Education System for Michigan's Success,* 21st Century Education Commission, mieducationcommission.com/document/final-report-best-education-system-michigans-success#overlay-context=document/investment-our-future

4 *Building the 21st Century Economy Commission Report to the Governor*, Building the 21st Century Economy Commission, www.mi21stcenturyeconomy.com/2017/05/31/building-the-21st-century-economy-commission-report-to-the-governor/

amounts. The state would not be responsible for the entirety of the costs, but these estimates will provide a better baseline of what the state should expect to be required to pay. In addition, as the MIDC sets more standards, compliance costs will increase, as well as the state's share of those costs.

Earmarking and Potential Rate Cuts

The design of the current tax system has a few features that make crafting the budget even more difficult to navigate. Earmarking, automatic rate cuts, and constitutional caps on the Sales Tax rate each limit the flexibility of policymakers in their ability to respond to impending budget pressures.

Earmarking

One characteristic of Michigan's tax code less common in other states is the heavy use of earmarking, or the process of dedicating specific revenue streams to specific purposes. Earmarking can either occur in specific dollar amounts, or on a percentage of revenue basis. While earmarking is used to protect specific revenue streams from changing political climates, high rates of earmarking severely limit the flexibility that the legislature has to change spending distributions in response to budget shortages.

After the passage of Proposal A in 1994, the rate of earmarking in the budget process has remained around 60 percent of the state budget, showing a trend of increasing slightly over the last two decades. As of FY2014, about 63 percent of state tax revenues were earmarked; leaving only 37 percent for General Fund expenditures. This creates a couple of problems if shortfalls arise.

First, it limits the number of state programs open to cuts. Because revenues are statutorily or constitutionally directed, making cuts to programs outside of the General Fund scope would require amending their respective statutes or the state constitution; processes that could prove to be very difficult. Even if some rates are able to be changed statutorily, the lion's share of decreases will come from General Fund spending, and the percentage of cuts in the General Fund budget will likely be greater than the percentage of overall spending that the General Fund budget represents.

Second, it means that potential increases in certain tax revenues might not be distributed to the General Fund as needed. Where earmarks mandate a specific percentage of revenue is distributed to specific locations, revenue increases will be less malleable than non-earmarked funds would be. If the Sales Tax, for example, saw a spike in revenue, only about 9.2 percent of that increase would show up in the General Fund budget. Because the majority of General Fund revenue comes from the PIT, and the majority of other sources are earmarked, increases in revenue from other sources will not aid the General Fund to the same extent.

Pending Income Tax Changes

Beyond the built in constraints through earmarks, the balanced budget process, and impending revenue diversions, rate cuts in the Personal Income Tax could place a further bind on the General Fund budget. As part of the 2015 transportation package, the PIT rate is scheduled to be reduced in any fiscal year for which cumulative General Fund revenue growth exceeds 1.425 times the cumulative rate of inflation starting in tax year 2023. These reductions specifically target the General Fund component of revenue, meaning all declines in revenue would show up as decreases in General Fund revenues. It also does not have a provision to return the tax rate to previously authorized levels if General Fund revenues subsequently grow by less than the rate of inflation; thus, if there is a one year spike in revenues, and they were to rebound the next year, a cut would be permanent.

The size of the PIT personal exemption is also indexed to inflation. As a byproduct of the 2011 tax reform, the amount of income an individual is allowed to claim as an exemption is due to increase. Since enactment, the exemption has remained flat at $4,000 per person, but once the indexed value ($3,700 in 2012 dollars) passes the nominal figure, the indexed number will take effect. The SFA expects the exemption to start increasing in FY2019, lowering revenue by millions of dollars each year after as it lowers the effective tax rate on all taxpayers.

Given that the PIT was responsible for 62.8 percent of the General Fund budget in FY2016, these potential changes to the tax rate and tax base create the possibility for even further decreases in the state's discretionary revenue, leaving the state with fewer options to deal with upcoming budget pressures.

Federal Cuts Cast a Shadow

Along with localized decisions that will put the state budget under pressure, Michigan is particularly vulnerable to changes in federal spending. For each dollar of federal taxes collected in the state, the federal government spends $1.32 on Michigan programs, according to State Policy Review.[21] As the Trump administration has made reigning in spending on federal programs a top priority within its budget decisions, these cuts will force states across the country to make tough choices. Programs benefiting from federal funding can be:

- maintained solely with state resources with the state making up for lost federal funding (which will require an increase in spending);
- maintained with state resources at the amounts the state was spending (which is funding neutral, but lowers service quantity and/or quality); or
- eliminated (which frees up state resources for other programs).

While the recently agreed upon continuing resolution (a federal appropriations package that continues the previous appropriation with slight modifications for a limited time, usually utilized when a budget has not been agreed upon) does not implement the deep cuts President Trump's budget called for, the administration is continuing to focus on cutting programs that supplant local spending for future budget battles, intending to let an increased burden fall on state governments. Under those guidelines, Michigan programs would likely see some of the biggest cuts; 12.1 percent of discretionary grant funding in the state is on the chopping block based on President Trump's most recent budget (the fourth most of any state in the country). To get a better idea of what that might mean for the state, a few of the programs more specifically targeted by the looming cuts are discussed below.

21 *Another Round of Fend-For-Yourself Federalism*, State Policy Review, Volume 35 Issue 8 April 2017.

Medicaid Cuts

While the federal government is still attempting to figure out what exactly it is trying to do on healthcare, many of the proposals would put the state in a fiscal bind. Michigan currently spends $17.6 billion a year on Medicaid. Of that, $13 billion is paid by the federal government. A one percent decrease in federal commitment would lower the amount the state receives by $130 million. Any cuts will put pressure on the budget. Cuts as severe as under the American Health Care Plan, the House of Representatives replacement for the Affordable Care Act, would cut federal funding 25 percent, or roughly $4.25 billion, nearly the amount the state currently spends on Medicaid. The most recent version of the White House budget would cut the program by $800 billion over 10 years. Such drastic cuts would significantly reduce federal Medicaid funding, forcing either massive cuts to health coverage and benefits in the state, draw significant amounts of funding away from other programs, or (most likely) a combination of the two, with reduced eligibility and service coverage.

Environmental Cuts

Proposed cuts to the Environmental Protection Agency targeted a few specific programs that impact Michigan directly, including a proposed cut to the Great Lakes Restoration Initiative, a $300 million program which includes services that clean up pollution and prevent algal blooms in the Great Lakes, and works within the eight states bordering the Great Lakes.[22]

Furthermore, the Michigan Department of Environmental Quality (DEQ) is at risk of losing much of its $120 million per year in federal funding. While the exact total at risk is uncertain, proposed cuts include 45 percent of state assistance grants, Superfund cuts of 30 percent,

22 *Trump EPA cuts could hobble Michigan pollution monitoring, cleanup*, MLive, www.mlive.com/news/index.ssf/2017/03/mdeq_epa_trump_cuts.html

and enforcement cuts of 25 percent, which threaten a sizable portion of DEQ's federal funding.

Coastal and marine management grants, which provides funding for the state's universities to conduct Great Lakes research, could be eliminated under the proposed budget. Cuts in funding for the National Vehicle and Fuel Emissions Laboratory would threaten facilities located in Ann Arbor, and cuts to the Army Corps of Engineers will severely limit the effectiveness of efforts to deal with invasive species in the Great Lakes (e.g., the Asian Carp).

Education Cuts

The President's budget proposed a $9 billion cut to the Department of Education, particularly targeting the Supporting Effective Instruction State Grant program and the 21st Century Community Learning Centers program. The state received $121 million for those two programs for the current fiscal year, to provide teacher training and after school programs for low income students, respectively.[23]

Housing and Urban Development Cuts

President Trump's budget eliminates significant amounts of funding for the Department of Housing and Urban Development, including $111 million the state receives each year for the Community Development Block Grant program that provides for homeless shelters, transportation for seniors, and costs to fight blight issues in Detroit, Flint, and other communities. Other HUD cuts would remove $29 million more recently provided to communities in an attempt to "devolve activities to the state and local level".

Low-Income Energy Incentives

The state received $175 million in FY2017 from the Low-Income Home Energy Assistance Program for heating credits, weatherization, and crisis intervention programs, and was previously anticipating an increase in funds into the future. This program was absent from the President's first budget, indicating a removal of federal support.[24]

Supplemental Nutrition Assistance Program

The most recent version of the President's FY2018 budget looks to reduce food stamp funding more than 25 percent. Each year, Michigan receives $2 billion in aid for food benefits through the Supplemental Nutrition Assistance Program (SNAP), formerly known as the food stamps program, as well as millions more each year in other SNAP services. The Executive Budget explicitly plans to reduce funding to increase state contributions into the program. Cuts of this magnitude would leave thousands of Michiganders worse off or require the state to make up hundreds of millions of dollars in reduced federal assistance each year.[25] The Center on Budget and Policy Priorities estimates that over ten years, Michigan would be required to contribute $3.78 billion in additional resources to maintain current program levels.[26]

Other Cuts

Beyond the significant proposed cuts listed above, potentially dozens of programs that could lose funding from the federal government that would either require the state to make up the funding or to stop providing services. These include $10 million in cuts to the Legal Services Corp., an organization that provides legal aid to those who cannot afford it; cuts to the National Institutes of Health, which provides significant grants to the University of Michigan and Michigan State University; an elimination of Department of Transportation grants that have helped the state fund programs like the M-1 line in Detroit and a bridge replacement in Ann Arbor; cuts to Department of Agriculture county offices; and millions from the National Endowment of

23 *Trump's budget would scrap $120M for Michigan teacher training, after-school programs*, MLive www.mlive.com/news/index.ssf/2017/03/trumps_budget_would_scrap_120m.html.

24 *Here's how the new federal budget will affect Michigan, the Detroit Free Press*, www.freep.com/story/news/politics/2017/03/16/heres-how-new-federal-budget-affect-michigan-2017/99241350/.

25 *Trump budget plan adds costs, cuts for Michigan*, The Detroit News, www.detroitnews.com/story/news/politics/2017/05/22/budget-trump-michigan-medicaid-welfare-farm/102034412/

26 *President's Budget Would Shift Substantial Costs to States and Cut Food Assistance for Millions*, Center on Budget and Policy Priorities, www.cbpp.org/research/food-assistance/presidents-budget-would-shift-substantial-costs-to-states-and-cut-food

the Arts; National Endowment for the Humanities; the Corporation for Public Broadcasting; Meals on Wheels; and the Institute of Museum and Library Sciences.[27]

The Cumulative Federal Impact

The potential for widespread cuts to federal programs and funding in the state should be a cause of concern for state policymakers. The new healthcare legislation, whatever form it ends up taking, will have an impact on the budget in billions of dollars. If the full range of recommended reductions occurs, billions of dollars per year in funding for programs operating in Michigan will be cut. While the state would not be required to replace each program, or even fund them at their current rate, these cuts would drastically alter service provision in the state, forcing the legislature to make very important and possibly difficult decisions about what programs are worth keeping, and how much the state can afford to appropriate to each.

Net Outlook

Over the next several years, the combined effect of these budget pressures will force the legislature to make many difficult decisions. Scheduled cost increases and revenue diversions result in a net revenue reduction for the General Fund of more than $2 billion dollars annually by FY2022, compared to a net diversion of $220.8 million in FY2015. This has quite a significant impact on overall General Fund revenue; these costs and revenues would represent a 20 percent increase in General Fund revenue. **Chart 10** compares the magnitude of the expected revenue diversions with projected net revenue. This chart shows that the majority of potential increases in General Fund revenues are diverted to other funds, leaving General Fund revenue close to its current levels into the foreseeable future.

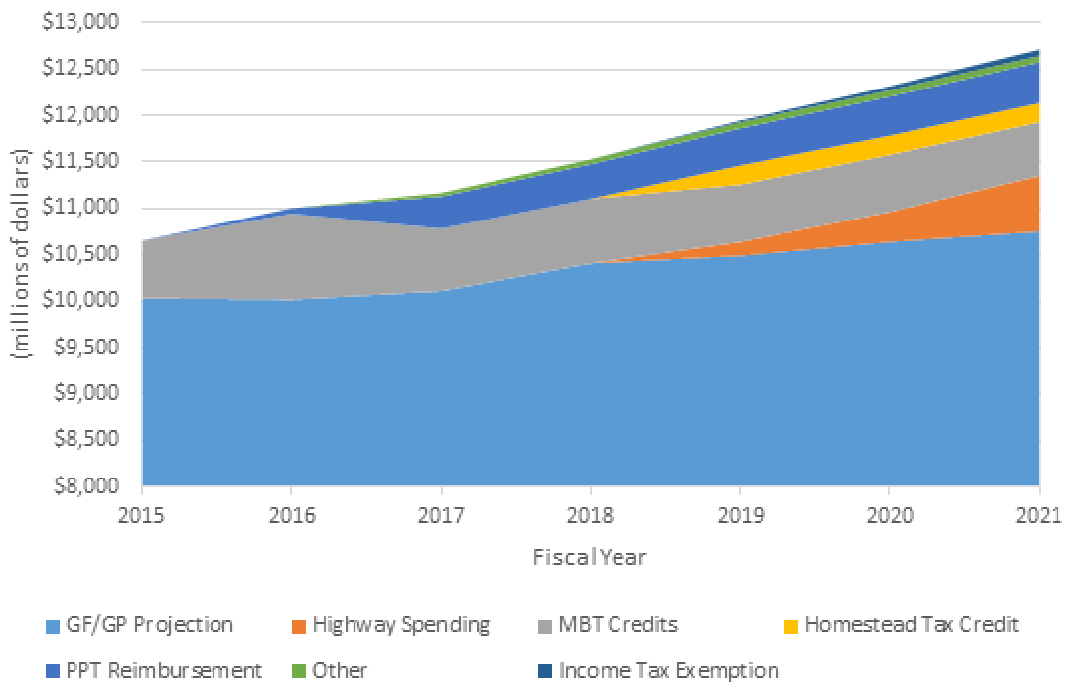
In addition to the more than $2 billion increase in definitive diversions and costs, potential revenue losses from HICA expiring and the removal of the Medicaid MCO Use Tax, and an increase in indigent defense spending through MIDCA grants will add anywhere from an additional $50 million to more than $500 million per year by FY2023 (an extension of the HICA sunset would reduce the majority of these costs). Beyond that, the possibility of federal cuts could see billions of dollars in losses to various programs in the state that will put significant pressure on the state either through increases in costs or the effects of the loss of these programs. The additional possibility of losing federal matching dollars on spending for many of the discretionary programs will amplify the impact of many of the cuts the state could make.

When all possible pieces are accounted for, the total impact could be a diversion of General Fund revenue, increase in spending for existing programs, and decline in federal spending in the state of more than $5 billion, and these numbers do not account for increases in program spending due to inflationary causes or the rise of other state needs. This leaves a rather large range: from $2 to $5 billion in revenue diversions by FY2022, amounts that would equal anywhere between 20 and 45 percent of projected General Fund revenue. Even at the lower values using legislated state changes, this is a significant siphon on General Fund revenue that state policymakers need to keep an eye out for when making new appropriation decisions.

27 *Trump budget cuts would hit Michigan cultural groups hard*, Crain's Detroit www.crainsdetroit.com/article/20170316/NEWS/170319882/trump-budget-cuts-would-hit-michigan-cultural-groups-hard

Chart 10

Projected General Fund Revenue and Diversions, FY2015-FY2021



Sources: House Fiscal Agency, Senate Fiscal Agency, CREC

Appendix A

Cumulative Effect of Revenue Diversions and Healthy Michigan Plan, FY2015-2023

(in millions of dollars)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
MBT Credits	$ -617.8	$ -924.8	$ -671.3	$ -695.6	$ -619.1	$ -613.5	$ -575.2	$ -78.1	$ -589.2
Transportation Package	-	-	-	-	-150.0	-325.0	-600.0	-600.0	-600.0
Homestead Tax Credit	-	-	-	-	-205.8	-205.8	-205.8	-214.0	-218.3
PPT Reimbursement	-	-59.7	-347.9	-374.9	-397.9	-421.9	-442.4	-469.7	-492.8
Income Tax Exemption	-	-	-	-	-18.3	-42.7	-67.1	-91.5	-115.9
Healthy Michigan Plan	397.0	409.0	281.0	183.0	150.0)	64.0	13.0	13.0	13.0
Other Costs	-	-	-37.3	-50.7	-63.4	-65.7	-68.1	-70.7	-73.3
Total	$ -220.8	$ -575.5	$ -775.5	$ -938.2	$ -1,304.5	$ -1,610.6	$ -1,945.6	$ -2,011.0	$ -2,076.5

Sources: House Fiscal Agency, Senate Fiscal Agency, CREC

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