CITIZENS RESEARCH COUNCIL OF MICHIGAN

Challenges Ahead in Balancing the State Budget

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Citizens Research Council of Michigan

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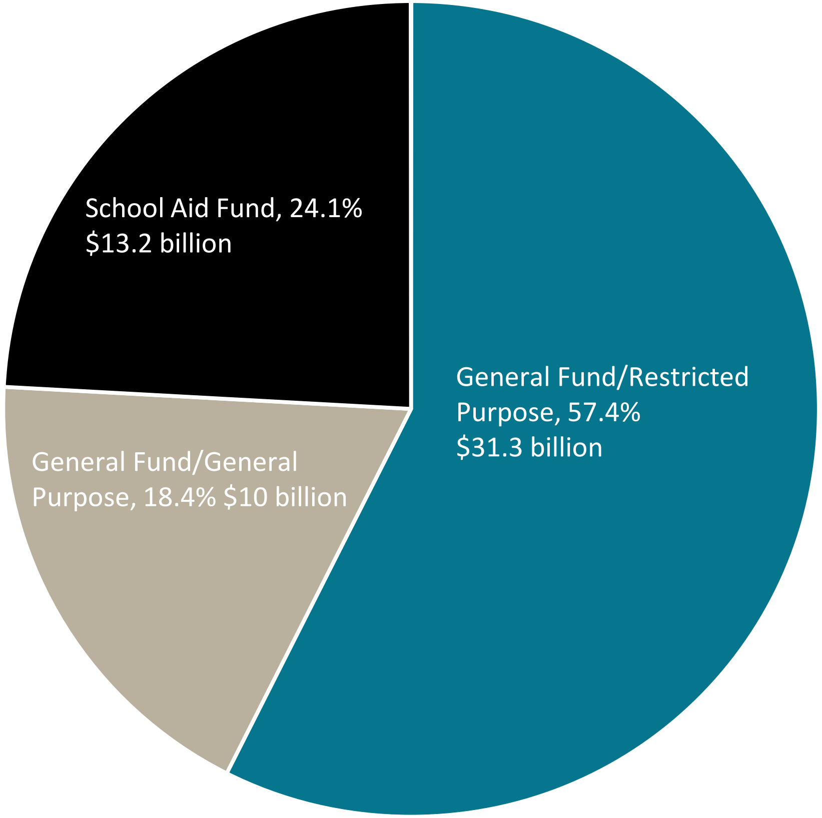
The Current State of the Budget

The State Budget

Disposition of Michigan Revenues, FY2018



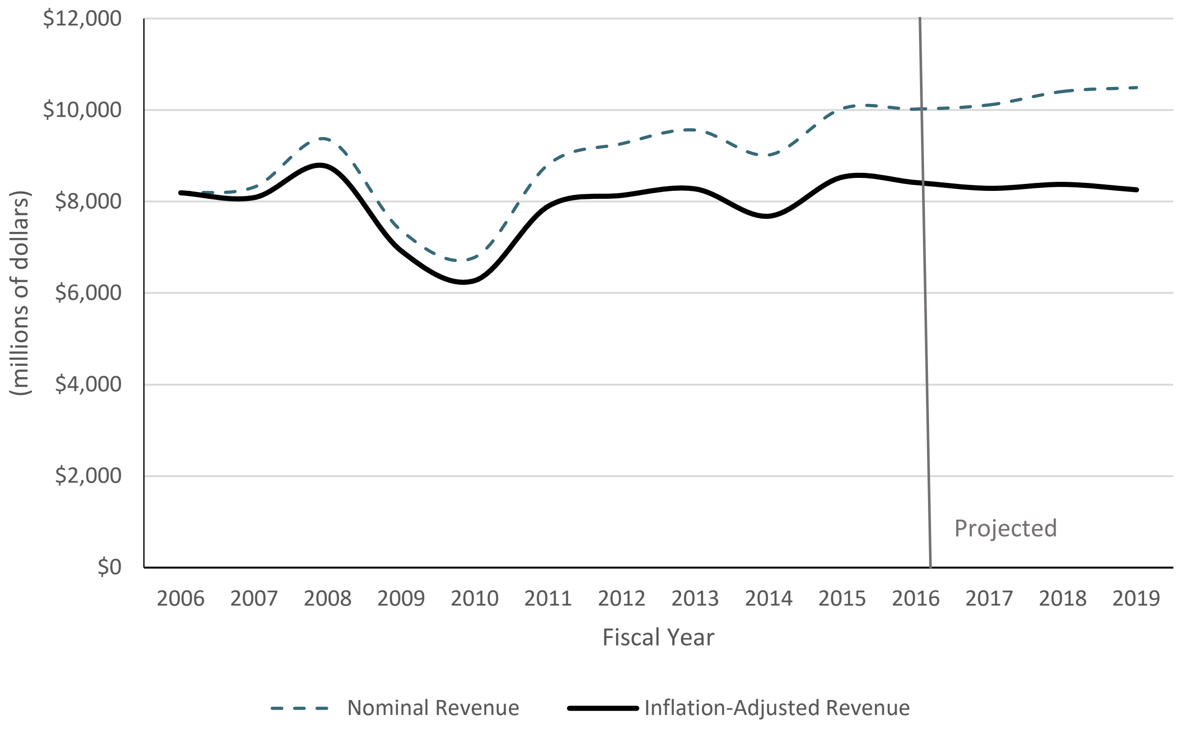
Source: House Fiscal Agency

- The state has two main accounts: the General Fund and the School Aid Fund
  - The General Fund has restricted accounts and the General Purpose fund
  - General Fund/General Purpose revenues are the state's primary discretionary account

General Fund Revenues

- $10 Billion in General Fund Revenue for FY2018
  - On a trend of slow growth
  - General Fund is declining when adjusted for inflation
- No General Fund growth is projected over the next few years

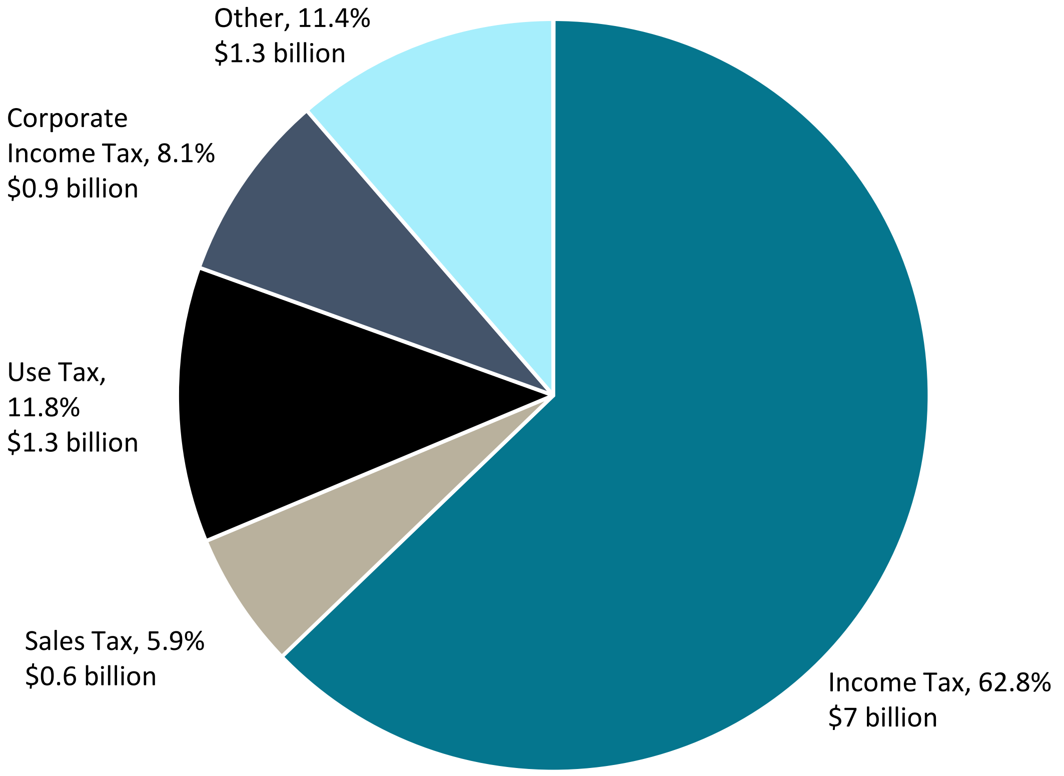
Historical and Projected General Fund Revenue, FY2006-FY2019



Source: Consensus Revenue Estimating Conference Summaries

Sources of General Fund Revenue

Sources of General Fund Tax Revenues, FY2016



Source: Michigan Annual Report of the Treasurer

- The Personal Income Tax is responsible for nearly two-thirds of General Fund revenue
- Despite rivaling the PIT in total collections, the Sales Tax only contributes about 6% to the General Fund

Revenue Diversions

Tax Credits

- Michigan Business Tax replaced by the Corporate Income Tax in 2011
- Tax credit agreements negotiated while the MBT was in effect continue to divert large amounts of revenue from the General Fund

MEGA Tax Credits

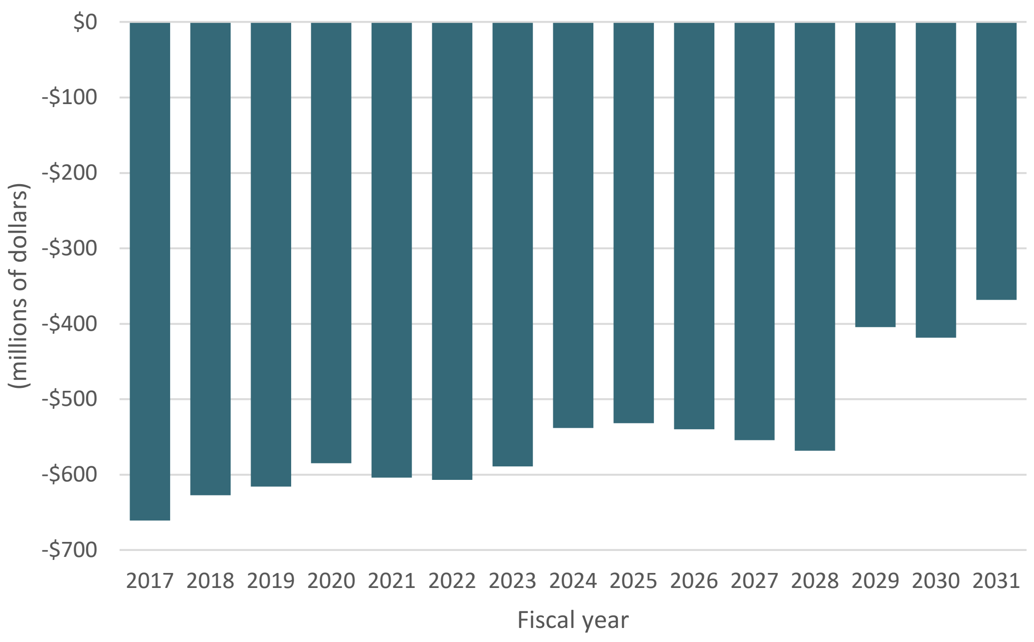
- Negotiated with businesses, active for up to 20 years
  - Last agreement will be in effect through 2032
- Projected liability between $5 and $9 billion over next 15 years
  - The cost of credits could increase depending on the type of credit; job retention credits are the most expensive
- Will reduce revenue by more than $500 million annually until 2029
  - Exact amounts for individual years are hard to project
  - Compliance verification takes time, and credits are not always claimed immediately

Other Tax Credits

- The Brownfield Tax Credit will average $35 million annually over the next 6 years
- Farmland Preservation Credits will divert $1.5 million annually with no sunset date
- The Polycrystalline Energy Credit is expected to lower revenues $20 million annually over the next six years
- The Renaissance Zone Tax Credit will drain an average of $3 million a year for the next six years

Total Effect of MBT Credits

Expected MBT Tax Credit Revenue Effect



Source: Department of Treasury and Michigan Strategic Fund

- The state is liable for more than $9 billion in tax credits between now and 2032
- Year to year variation on compliance verification and when companies claim credits adds pressure to the budget
- Tax credits will divert more than $500 million in revenue annually for the next decade

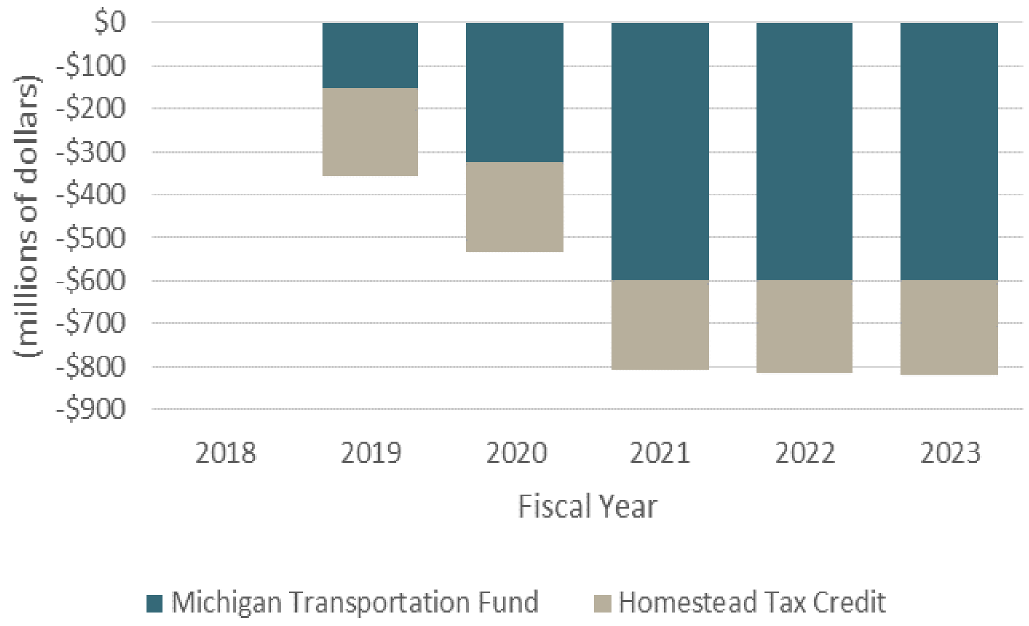
Transportation Funding Package

- The 2015 transportation package will divert $600 million annually from the General Fund to the Michigan Transportation Fund
  - The diversion begins in FY2019 with $150 million, increases to $325 in FY2020, and increases to $600 million in FY2021
- The transportation package included an increase in the Homestead Property Tax Credit which will reduce Income Tax revenue by about $200 million annually
  - The legislation broadened eligibility up to households with an annual income of $60,000 and below
  - This was designed to offset the increased tax burden on low-income families due to the increase in fuel taxes and registration fees

Transportation Funding Package

- In total, the transportation package will lower General Fund revenues by $800 million a year once fully implemented
- The bill did not provide a funding mechanism – it was assumed that continued economic growth would increase tax revenues to pay for the diversion

Transportation Funding and Homestead Tax Credit Diversion Projections, FY2018-FY2023



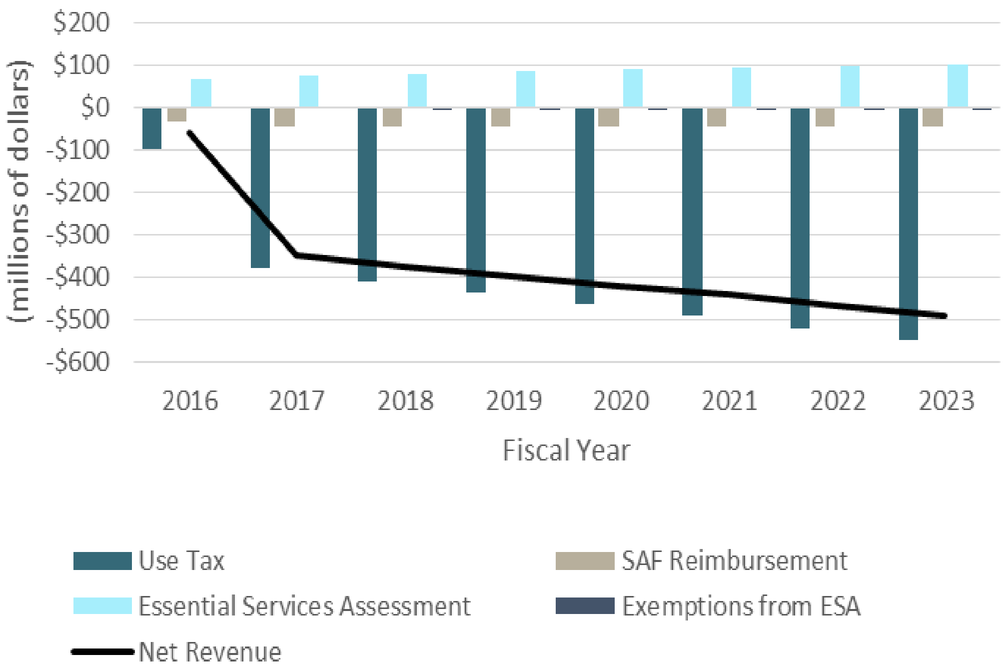
Source: Senate Fiscal Agency

Personal Property Tax Reform

- To make new exemptions for certain industrial equipment to the Personal Property Tax palatable, the state included a planned reimbursement to localities for revenues that would be lost by paying out of the General Fund share of the Use Tax
- The legislation also reimbursed the School Aid Fund for lost revenues
- To recoup some of the revenues, the reform also created the Essential Services Assessment

Personal Property Tax Reform

Projected PPT Revenue Effects, FY2016-FY2023



Source: Senate Fiscal Agency

- The ESA revenue does not come close to offsetting the net diversions
- In FY2017, the net reduction due to the reform will be $350 million
- The costs are expected to increase, reaching nearly $500 million in FY2023, when the phase-in is complete

Health Insurance Claims Assessment and the Medicaid Managed Care Organization Use Tax

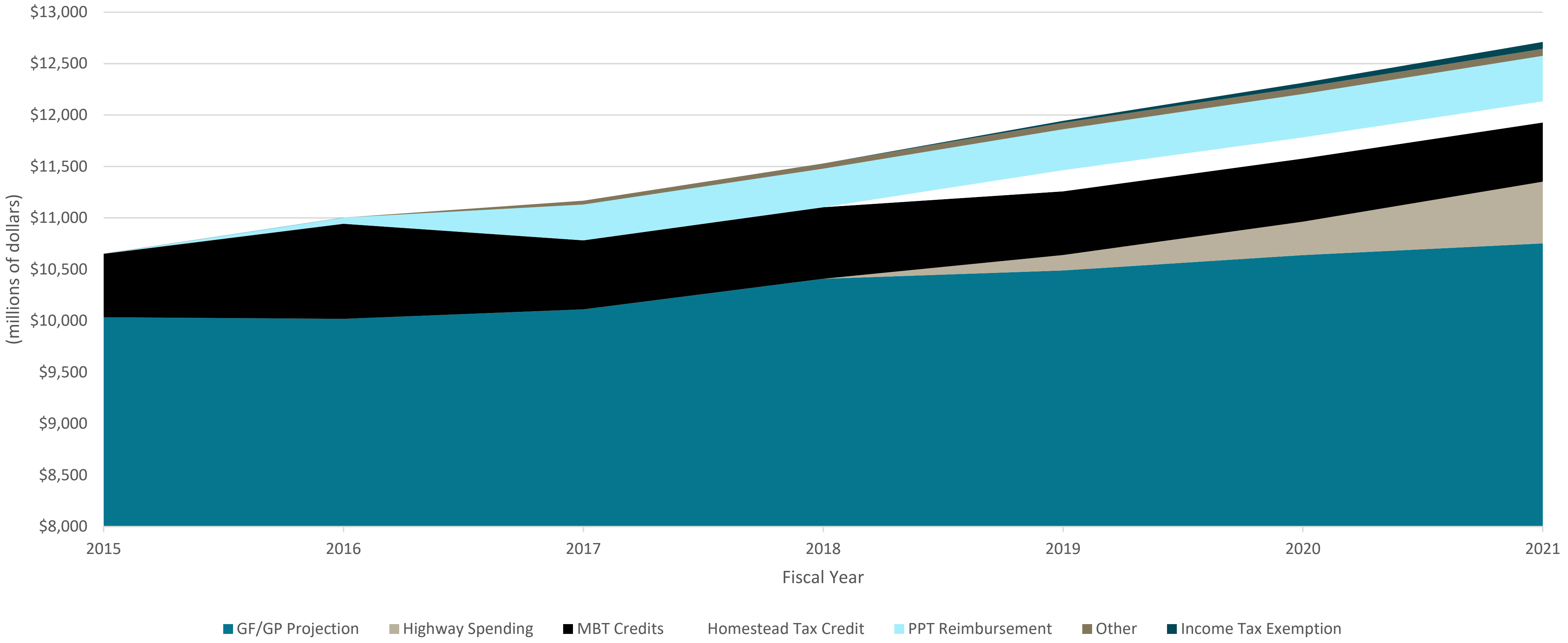
- In 2015, the federal government told the state to end its Use Tax on Medicaid Managed Care Organizations by the end of 2016
- The Use Tax was used to exploit a loophole in federal Medicaid spending, which allowed MCOs to bring in more money than was taxed
- It raised $253 million annually, and brought in additional federal dollars
- The Health Insurance Claims Assessment rate, a tax on paid health service claims, included a clause which triggered an increase in the rate from .75% to 1% if the Use Tax was repealed, but is set to expire in 2020
- The combined loss of General Fund revenue would be close to $500 million

Other Revenue Losses

- The removal of Driver Responsibility fees will reduce revenues $48 million annually once fully phased out
- The state's new limits on Corporate Officer Liabilities will lower collections by more than $60 million annually.
- The phase-out of the "tax-on-the-difference" provision will lower revenues by nearly $12 million a year by 2023.
- The exemption of over-the-counter medications and data center equipment from the Sales and Use Tax lower collections another $10 million each year.
- Collections of the Sales and Use Tax from aviation fuel will be diverted to the State Aeronautic Fund, diverting an additional $15 million annually by FY2023.

Revenue Outlook

Projected General Fund Revenue and Diversions, FY2015-FY2021

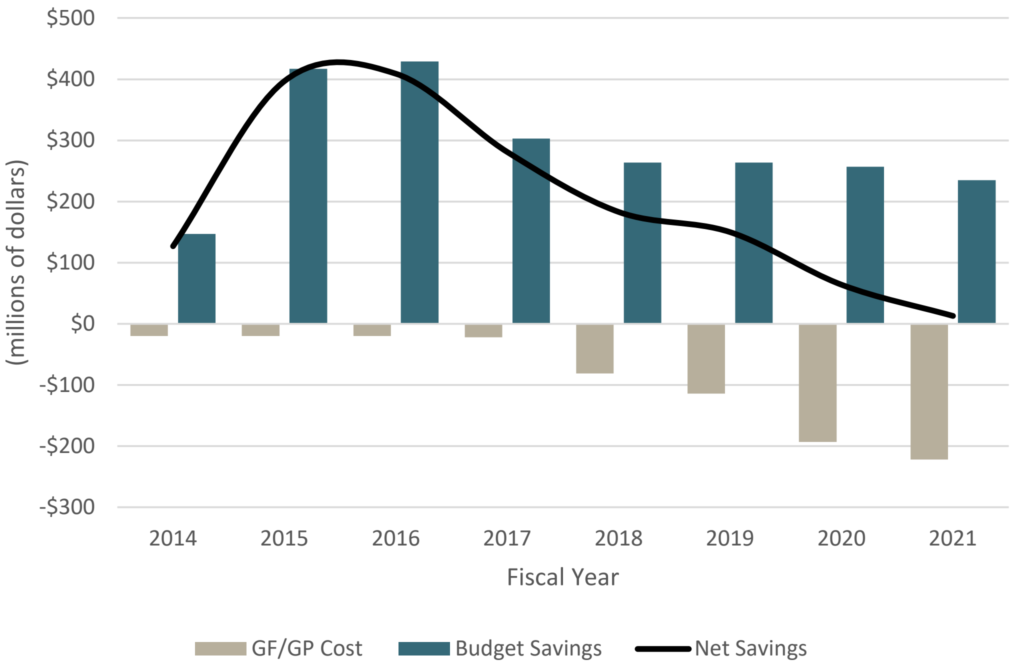


Sources: Senate Fiscal Agency, House Fiscal Agency, and the CREC

Spending Pressures

The Healthy Michigan Plan

Projected Healthy Michigan Plan Net Savings, FY2014-FY2021



Source: House Fiscal Agency

- In addition to the benefits of increased insurance coverage, the Healthy Michigan Plan, Michigan's component of the Medicaid Expansion, saves the state money on prisoner health services and mental health care
- The state is required to start paying on the HMP in 2017, while savings are beginning to decline
- The state can continue or terminate the HMP – either way, state costs will increase

Michigan Indigent Defense Commission

- In an effort to overhaul its indigent defense system, the state created the MIDC to set new standards for public defense
- To meet Headlee Amendment requirements, the state will have to pay a portion of local government changes
- Under current recommendations, this is estimated to be a $50 million cost to the state
- Future changes in standards could increase compliance costs, and the amount the state is required to pay

Other Budget Hurdles

Revenue Earmarking

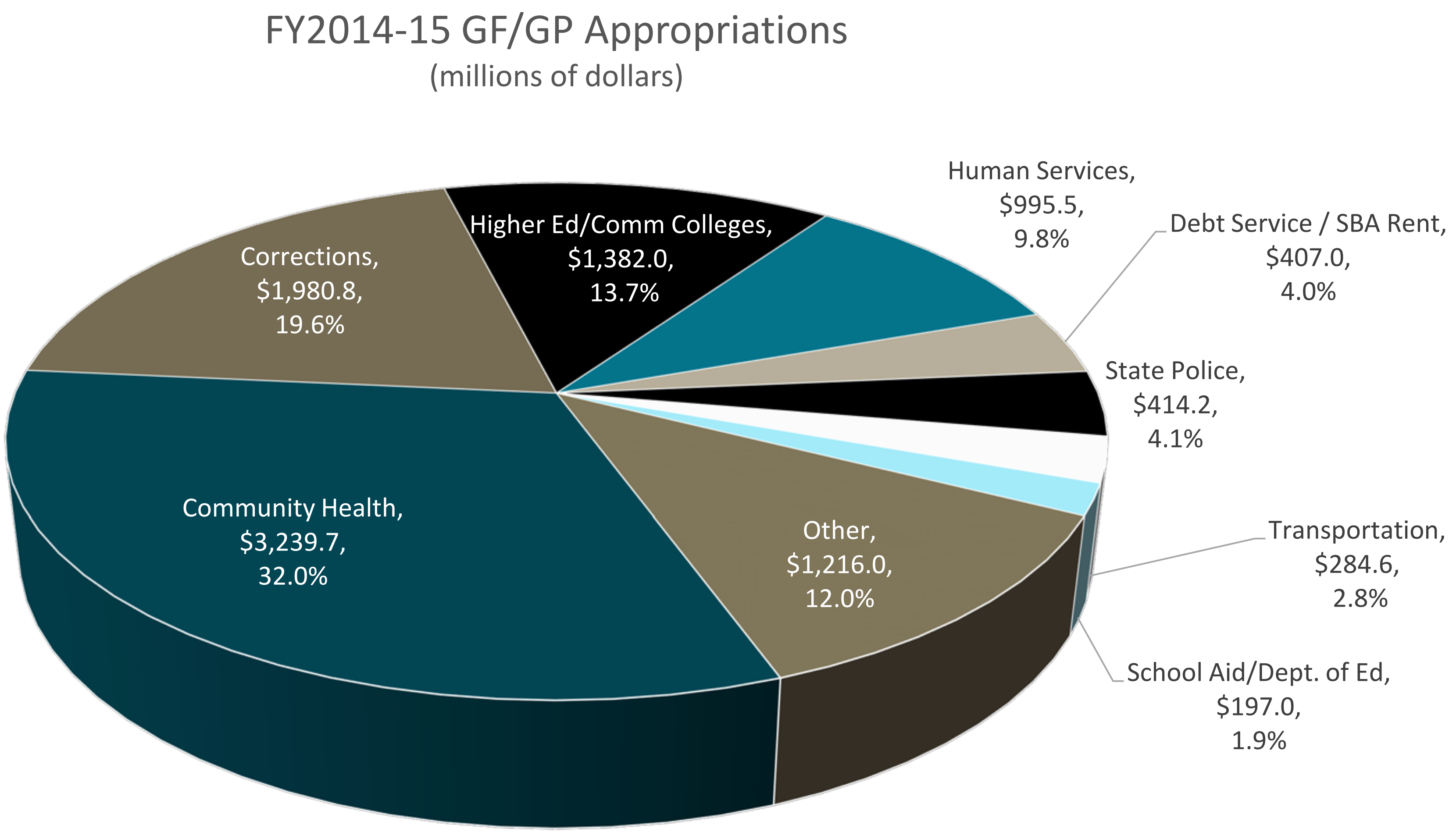
- While the state budget is $56 billion, certain restrictions limit where money can go and how it can be used; 63% of tax revenues were earmarked
  - Constitutional restrictions: 2 cents per dollar of the sales tax are constitutionally directed to the School Aid Fund as an example
  - Legislative restrictions: these include changes like the PPT reimbursements.
  - Federal spending: federal grant money is generally tied to a specific purpose
- While some of these rules are changeable (particularly legislative restrictions), fights over changing revenue disbursement are more difficult because they require changing statutes and deciding new funding levels
- This also means that increases in revenue might not mean proportional increases in General Fund revenue

Income Tax Changes

- As part of the transportation package, the Income Tax is scheduled to change in two material ways:
  - The tax rate will decrease when revenue growth is larger than 1.425 times the rate of inflation, beginning in 2023
    - This might lower the Income Tax rate in the long term
    - There is no equivalent provision to increase the Income Tax rate
    - The cost will depend on future increases beyond the inflation rate
  - The size of the personal exemption also was indexed to inflation, and will increase once the indexed value ($3,700 in 2012 dollars) surpasses $4,000.
    - Will reduce revenues on the Income Tax by millions

What spending categories are at risk?

What is funded through the General Fund?



Questions?

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