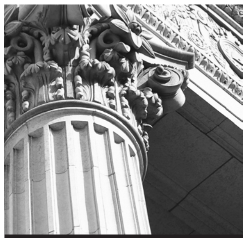

State Budget Notes

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The Michigan Budget: Back on the Roads Again

The Michigan Legislature wrapped up work on the state's $54.5 billion budget for Fiscal Year (FY)2016 back in June, but the budget was enacted without accomplishing a key goal that continues to elude both the Governor and Legislature: finding a permanent funding solution to address the state's deteriorating road infrastructure.

In May, voters resoundingly rejected Proposal 1, which would have triggered increases in both motor fuel and sales tax rates in order to generate an estimated $1.2 billion annually in additional road revenue along with $800 million for schools and local governments. With Proposal 1's failure, budget writers were forced to rely again on additional support from the state's general fund to help supplement the state's dedicated transportation revenues. As a result, the enacted budget contains a $400 million general fund/general purpose (GF/GP) appropriation for this purpose, but that increased funding falls significantly short of the annual revenue boost that road officials indicate is needed – a figure that likely now exceeds $1.2 billion and one that grows each year as road conditions further deteriorate.

The failure of the ballot measure has left lawmakers scrambling to come up with an alternative plan. So far, post-budget deliberations have produced competing plans which differ significantly in how they address a key policy question: Should new road revenue be generated from increased taxes, redirected from existing revenues currently used in other areas of the state budget, or through some combination of these options?

Any eventual solution to this policy challenge will have major implications on the future condition of the state's roadways, but the plan will have equally significant implications on the state's budget situation. A solution that relies on shifting existing GF/GP revenue to road work will require reductions to other areas of the state budget, but to what degree and how soon? The good news for policymakers is that state revenue growth is expected to be healthy for the near future according to the most recent forecasts. This growth provides a cushion that can help address road needs. However, the state faces a number of significant spending pressures as well that will require increased GF/GP support over the next several fiscal years. These budget pressures will, to some degree, negate this cushion by drawing upon at least some of this revenue growth, leaving fewer resources left over for other priorities.

In this analysis, CRC examines the long-term state budget outlook given both current revenue projections and known spending pressures and reviews the implications for the state budget of road funding plans that call for both more and less reliance on GF/GP resources to supplement traditional road dollars.

State Revenues: Growth through FY2019

Much of the state's annual budget deliberations focus on the allocation of the state's general fund/general purpose (GF/GP) revenues. Those revenues are discretionary in nature – lawmakers can allocate them between competing programs as they see fit. For the FY2016 budget, GF/GP appropriations total $9.9 billion. This is less than 20 percent of total appropriations which are otherwise composed primarily of federal revenues and state revenues which are earmarked to specific functions

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and purposes. These discretionary GF/GP revenues currently provide the majority of the state's support for a number of key functions, including higher education, the state's prison system, the Medicaid program, and a number of safety net programs. As noted above, the state has more recently drawn on GF/GP revenues to help shore up transportation funding given the degradation of the revenue base from motor fuel taxes, which make up about half of Michigan's dedicated transportation revenues.

A recovering economy has provided a boost to state revenues. For the first time in more than a decade, they are growing consistently. If the forecasts coming out of the most recent May Consensus Revenue Estimating Conference hold true, state GF/GP revenues will see consistent growth through FY2019. **Table 1** provides an overview of this forecast.

After declining sharply in FY2014, GF/GP revenues are expected to bounce back in FY2015 with annual growth of 7.8 percent. Both the FY2014 decline and the subsequent FY2015 rebound are largely attributable to swings in state income tax revenues that resulted from anticipated federal tax policy changes related to the "fiscal cliff" deliberations as well as to a spike in claims on certain state business credits. While GF/GP revenue growth is expected to slow in FY2016, projected growth rates rise again in the out years. If these projections hold true, Michigan will have experienced GF/GP revenue growth in eight of nine fiscal years since revenues bottomed out during the Great Recession in FY2010. Annualized growth from FY2010 to FY2019 would be almost 4 percent. By FY2019, the state would have almost $1.0 billion in additional GF/GP revenue than is projected to be available during the FY2016 budget year on which the June budget deal was predicated.

Michigan has not seen consistent revenue growth to this degree since the 1990s. Still, to add historical perspective, Michigan would have a little under $10.9 billion in GF/GP revenue in FY2019 under these forecasts. That would be only $200 million more than the state realized almost two decades ago in FY2000, prior to the state's economic perils during the first decade of the new millennium.

Further, it has now been more than six years since the end of the Great Recession. The revenue growth projections assume continued growth in the state and national economy. An economic downturn over this time horizon would bring significant downward adjustments to these figures.

Table 1
Estimated GF/GP Revenues Through FY2019 (in millions of dollars)

	Actual FY2014	Estimate FY2015	Estimate FY2016	Estimate FY2017	Estimate FY2018	Estimate FY2019
GF/GP Revenue	$9,018.6	$9,724.9	$9,881.9	$10,121.5	$10,486.8	$10,862.6
Annual Growth Rate		7.8%	1.6%	2.4%	3.6%	3.6%

Source: May 2015 Consensus Revenue Estimating Conference

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State Spending: Four Key GF/GP Budget Pressures

While the state revenue picture looks as strong as it has in more than 15 years, imminent spending pressures on the expenditure side of the budget will offset some of the impact of this revenue growth. This analysis will focus on the most significant of these spending pressures, which include:

1. Additional state match requirements under the recent Medicaid expansion;
2. Federal requirements that will eliminate the state's ability to assess the use tax on certain Medicaid managed care organizations;
3. The loss of one-time savings built into the FY2016 budget related to hospital provider taxes; and
4. General inflationary pressure related to employee compensation and Medicaid/public assistance caseload costs.

Healthy Michigan Plan

The federal Affordable Care Act (ACA) was enacted in 2010 with the goal of expanding the availability of affordable health care coverage and reducing the number of uninsured Americans. A key component of the act was allowing states to expand their Medicaid programs to provide health coverage for adults with incomes up to 138 percent of the federal poverty level. After months of debate and political wrangling, the Michigan Legislature enacted legislation in 2013 to authorize this expansion of health coverage under Michigan's Medicaid program to eligible low-income adults.

As of August 2015, Michigan's Medicaid expansion program – known as the Healthy Michigan Plan – covered over 591,000 eligible adults.[1] From a state budget perspective, the expansion creates upfront savings for the state. Through calendar year 2016, the federal government covers 100 percent of the coverage-related costs for the newly eligible adult population. At the same time, the state achieves savings as adults who previously received care under state-funded programs (e.g. behavioral health services, some forms of prisoner health care) are shifted to federally-funded Medicaid coverage. Current state savings from the expansion are estimated to be just over $250 million per year.

However, under the ACA, states will begin to share in the Medicaid expansion costs starting in calendar year 2017 when Michigan will have to cover 5 percent of the coverage-related costs of the expansion. That state share will increase to 6 percent in 2018, 7 percent in 2019, and finally 10 percent in 2020 and thereafter. With total Medicaid expansion costs topping $4.0 billion in the FY2016 budget, CRC estimates the future state match requirements will add $160 million to state GF/GP costs in FY2017, with costs growing to $250 million in FY2018 and $310 million in FY2019 as the match requirements escalate and overall costs continue to grow.[2]

Use Tax on Medicaid Managed Care Organizations

Michigan's $54 billion FY2015 budget includes almost $16 billion in federal and state funding to cover the Medicaid program, which provides both physical and behavioral health coverage to eligible low-income residents. As part of the state's financing strategy to cover its share of Medicaid costs, revenue from two state tax sources are used to support the Medicaid program.

First, Michigan includes medical services provided through Medicaid managed care organization in the base of the state's 6 percent use tax. The inclusion of these services in the tax base was reinstated in 2014 after being suspended in 2012. This component of the use tax will generate an estimated $375 million in GF/GP revenue in FY2015 and $407 million in FY2016.[3] However, the imposition of this tax also generates some offsetting costs. Federal

[1] Michigan Department of Health and Human Services, Healthy Michigan Plan Progress Report, August 17, 2015.

[2] The CRC calculations assume annual growth in total Healthy Michigan Plan costs of 4 percent across this period.

regulations require that Medicaid managed care organizations receive "actuarially-sound" reimbursement rates from state Medicaid programs. That essentially means that legitimate cost increases must be met with increased reimbursement to cover those costs, and the use tax is an added expense for these entities. Thus, to provide actuarially-sound rates, Michigan must appropriate an additional $150 million in GF/GP support, which – when combined with matching federal dollars – allows the Medicaid managed care organizations to recover the added cost of the tax. In the end, the state is expected to close FY2015 with a net revenue gain of around $225 million, equal to the $375 million in new use tax revenue minus this $150 million in required spending.

The second tax utilized in Medicaid financing is the Health Insurance Claims Assessment (HICA). When the use tax on Medicaid managed care organizations was initially suspended in 2012, the HICA was established as a replacement tax imposed at a 1 percent tax rate on paid claims in this state on behalf of Michigan residents by health insurers in general. When revenues from HICA fell below projections, the use tax on Medicaid managed care organizations was reinstated to help cover the revenue shortfall, and the HICA tax rate was lowered to 0.75 percent. The revised HICA tax is expected to generate around $233 million in revenue in FY2015 for the Medicaid program.

This current two-pronged approach, however, will need to be revisited beginning in 2017. The federal government has informed states that it will begin to strictly enforce regulations that essentially prohibit financing mechanisms such as Michigan's use tax on Medicaid managed care organizations.[4] Those regulations, modified by recent changes in federal law, effectively require that these taxes be broad-based – covering all health care providers within a given category (i.e. all managed care organizations, not just those that exclusively serve Medicaid patients). The federal government will require the elimination of mechanisms that don't comply with these regulations by the end of the current legislative session – which for Michigan is the end of calendar year 2016.

As a result, Michigan will need to once again eliminate its use tax on Medicaid-only managed care organizations. **Table 2** illustrates the net long-term impact of this change. Since the tax can be maintained only through December 2016, it can be in place (at the latest) for only the first quarter of FY2017 (Michigan's fiscal year runs from October 1 to September 30 of the following year). This will re-

Table 2
General Fund Impact of Eliminating Medicaid Use Tax (in millions of dollars)

	FY2016	FY2017	FY2018	FY2018
Direct revenue from Use Tax	$407	$102	$0	$0
Revenue Loss from FY2016 Base		($305)	($407)	($407)
Expenditure Savings:				
Actuarial Soundness Costs	($163)	($41)	$0	$0
HICA-Related Savings	$236	$295	$320	$325
Subtotal - Savings	$73	$254	$320	$325
Savings Gain from FY2016 Base		**$181**	**$247**	**$252**

[3] This reflects only the GF/GP impact of this component of the use tax. Roughly one-third of this revenue benefits the School Aid Fund. Additional SAF revenues are estimated to be $187 million in FY2015 and $203 million in FY2016 due to the tax on top of the GF/GP revenues noted here.

[4] SHO# 14-001, Letter to State Health Officials from Cindy Mann, Director of the Center for Medicaid and CHIP Services, July 25, 2014.

duce projected revenue from this component of the use tax from $407 million in FY2016 to only $102 million in FY2017 – a decline of $305 million. By FY2018, the state will lose the entire $407 million in revenue that currently supports the FY2016 budget.

Conversely, on the expenditure side of the budget, the state will actually see savings from the change. First, the state will avoid the added actuarial soundness costs noted above. The FY2016 budget includes $163 million to cover these costs. With the elimination of the use tax on Medicaid managed care entities, those costs will fall to an estimated $41 million in FY2017 and will be eliminated altogether in subsequent years. In addition, the HICA tax rate will revert back to 1 percent again as a result of statutory provisions triggered by the federal government's disallowance of the Medicaid use tax. This is expected to boost HICA revenue from $236 million in FY2016 to $295 million in FY2017, $320 million in FY2018, and $325 million in FY2019.[5] The additional HICA revenue will help offset GF/GP needs within the Medicaid program. Still, **Table 2** demonstrates that the negative revenue impact will exceed these additional expenditure savings over time.

State Savings from Hospital Provider Tax

Michigan has a long history of utilizing various types of provider taxes to finance state Medicaid expenditures. The state's Quality Assurance Assessment Program (QAAP) imposes a tax on hospitals and long-term care organizations such as nursing homes in order to generate restricted state revenue to support the Medicaid program. Most of that state-generated revenue is then used to draw additional federal matching funds (roughly two federal dollars for every state QAAP tax dollar) in order to allow for increases in Medicaid provider rates to these same entities. So, in the end, hospitals and long-term care facilities pay the QAAP tax but receive even greater revenue in return from the resulting increases in state reimbursement rates, largely financed with federal dollars. At the same time, a smaller portion of the QAAP revenue – commonly referred to as the "state retainer" – is used to offset the need for state GF/GP revenue within the Medicaid program as a whole, thus creating state GF/GP savings.

The FY2016 budget includes a one-time only $92.9 million increase in the state retainer under the QAAP tax imposed on hospitals. This increase in the state retainer resulted in direct GF/GP savings that will no longer be available in FY2017 and beyond. As a result, state GF/GP spending will need to increase accordingly to offset the lost retainer savings.

General GF/GP Budget Pressures

Finally, on top of the specific budget pressures mentioned above, state GF/GP spending is always subject to general inflationary budget pressures tied to personnel costs and caseload spending in areas such as Medicaid and other public assistance programs. Personnel costs include the costs of pay raises, for which lawmakers have at least some level of oversight and control.[6] Other cost increases, however, are related to items such as health care coverage and pension liabilities that are driven by both policy decisions as well as outside factors such as inflation or market conditions. Similarly, the state's safety net programs may experience caseload changes that generate increased program costs related to economic conditions and demographic trends rather than changes in program guidelines. In general, these general budget pressures represent cost increases needed to maintain current staffing levels and program standards.

Table 3 displays the GF/GP component of these cost increases included in the last five enacted budgets to cover these kinds of personnel and caseload costs. As the table shows, these cost pressures can

[5] State law authorizing the HICA tax is scheduled to sunset on January 1, 2018. This analysis assumes that the Michigan Legislature extends that sunset before this date.

[6] Article IX, Section 5 of the Michigan Constitution give the Michigan Civil Service Commission the authority to determine appropriate increases in rates of compensation for state civil service employees. The Michigan Legislature may, by two-thirds vote of the members elected and serving in each chamber, reject or reduce the these increases, but may not reduce rates of compensation below those in effect at the time of the commission's determination.

Table 3
Added GF/GP Costs of Employee Compensation and Social Service Caseloads

	FY2012	FY2013	FY2014	FY2015	FY2016
Employee Compensation	$104.7	$104.7	$71.4	$54.9	-$5.8
Medicaid/Public Assistance Caseloads	$134.8	$81.1	$66.2	$23.0	$71.2
Total Appropriation Increase	**$239.5**	**$182.6**	**$137.6**	**$77.9**	**$65.4**

Source: Senate Fiscal Agency, annual Appropriations Reports

vary dramatically from year to year. The FY2012 enacted budget contained $239.5 million in extra general fund appropriations to cover added costs in these two areas. Conversely, this added cost totaled only $65.4 million in the recently enacted FY2016 budget, due primarily to savings generated from reduced retirement contribution rates for state employees. Total appropriations related to employee compensation costs actually declined due to these savings.

Given their variability, it is difficult to predict the magnitude of these cost pressures in future years. The state and employee labor unions are in the midst of contract negotiations that will set parameters for some of these future costs. The analysis below assumes annual GF/GP increases of $100 million each year will be needed to cover these costs – slightly more than in the last two years, but less than the long-run average over the period.

Combined Spending Pressures

Table 4 aggregates the four categories of additional GF/GP spending across the next three fiscal years. Total additional spending required to meet these pressures is estimated to be around $171 million in FY2017 and rise to $451 million by FY2019. CRC utilizes these calculations in the long-term analysis that follows.

Table 4
Cumulative GF/GP Spending Increases through FY2019
(in millions of dollars)

	FY2017	FY2018	FY2019
State Match for Medicaid Expansion	$160	$250	$310
Net Savings: Medicaid Use Tax and HICA	($182)	($247)	($252)
Loss of One-Time Hospital QAAP Retainer	$93	$93	$93
Other Budget Pressures	$100	$200	$300
TOTAL GF/GP SPENDING INCREASE	**$171**	**$296**	**$451**

Road Funding: Legislative Deliberations Continue

Long-term assessments of road conditions suggest that anywhere between $1.2 billion and $2.0 billion in additional annual revenue will be needed to ensure that Michigan's road infrastructure can be returned to an acceptable condition over the next 10 years.[7] Both the Michigan House and Senate have passed legislative packages this summer to address the road situation, but neither funding plan includes new revenue approaching the $1.2 billion minimum threshold immediately.

In June, the House approved a plan that relies primarily on diverting existing state revenues to road improvements. The plan calls for redirecting current GF/GP revenue generated from the state sales tax on motor fuel as well as a portion of the state income tax for road work. In addition, the plan increases the tax rate on diesel fuel from 15 cents per gallon to 19 cents per gallon (equal to the current gasoline tax rate) and creates a new annual surcharge on the registration of electric-powered vehicles. The House package also eliminates the state's Earned Income Tax Credit for low-income wage earners. In total, the combined package is expected to generate $555.1 million in additional funding for road purposes in FY2016, increasing to just under $1.2 billion by FY2019. This boost in funding relies partially on new revenue, but primarily on shifting existing GF/GP revenues to roads through the redirection of sales and income tax revenues. By FY2019, the net impact on GF/GP revenues would grow to $782 million under the House plan according to House Fiscal Agency estimates.[8]

The Senate-passed plan relies to a greater extent on adding new revenues for road work through increases in the state's motor fuel taxes on both gasoline and diesel fuel. The rate increases would generate $347 million in new road revenue in FY2016 and $424 million by FY 2018 according to Senate Fiscal Agency projections.[9] However, like the House plan, the plan also calls for new earmarks for roads from the state income tax, starting at $350 million in FY2017 and increasing to $700 million in FY2018 and thereafter. Combined road funding generated from the tax rate increases and new revenue earmarks would reach just under $1.2 billion by FY2018. Thus, both plans would call for the eventual shifting of additional current GF/GP revenue to roads beyond the $400 million currently appropriated for FY2016.

While hopes rose for a legislative compromise in late August, discussions between the House, Senate, and Administration continue.

[7] Recent analyses have suggested the total need has grown in recent years with the continuous decline in road conditions. See, for instance, www.mlive.com/lansing-news/index.ssf/2014/03/michigan_road_funding_new_repo.html

[8] www.house.michigan.gov/hfa/PDF/Summaries/15h4605_4616_Fiscal_Summary_House_Road_Pkg.pdf

[9] www.senate.michigan.gov/sfa/Publications/Memos/mem070815.pdf

Long-Term Outlook: Funding Roads with General Fund Resources

Lawmakers on both sides of the aisle appear to agree now that Michigan needs to find at least $1.2 billion in additional annual funding to address the condition of the state's roadways. However, considerable disagreement still exists as to how to reach that goal. The FY2016 budget already includes $400 million in temporary GF/GP resources for roads, and legislative proposals this summer have generally called for some mix of tax increases and the redirection of existing revenues to meet the $1.2 billion threshold. Thus, it seems likely that any eventual plan will include continued GF/GP support for roads in some form, either through direct appropriations or the earmarking of current GF/GP tax revenues to roads.

The details of the final plan will have significant implications for the state's budget. To what degree would the continued reliance on GF/GP support for roads necessitate reductions to other areas of the budget? Conversely, how would the situation change under a plan that relied on new tax revenue rather than the redirection of current general fund resources? Below, CRC analyzes underlying revenue projections and the spending pressures detailed earlier through FY2019 to address these key questions.

Key Assumptions

Both the House Fiscal Agency and Senate Fiscal Agency currently estimate a beginning GF/GP balance of $170 million for FY2016.[10] CRC utilizes revenue figures from the May 2015 Consensus Revenue Estimating Conference; revenue estimates for the Medicaid managed care use tax discussed above which assume the tax will be eliminated

[10] See GF/GP balance sheets within House Fiscal Agency, FY15-16 Appropriations Summary and Analysis, July 2015 and Senate Fiscal Agency, State Budget Overview, August 15, 2015.

in January 2017; and other revenue adjustments primarily related to revenue allocated to statutory revenue sharing[11] to arrive at total adjusted revenues for FY2016 through FY2019. It is assumed that future revenue sharing appropriations will remain at FY2016 levels after the elimination of a small one-time allocation in FY2016.

On the expenditure side, the analysis assumes a continuation of non-transportation related GF/GP appropriations at FY2016 baseline levels of just under $9.5 billion. It also assumes that no further contributions are made to the state's Budget Stabilization Fund (BSF) following a planned deposit of $95 million in FY2016. The only GF/GP spending growth included in the analysis is the spending growth tied to the four budget spending pressures identified earlier in the report.

Outlook

Given these assumptions, CRC analyzes the long-term budget outlook under two alternative scenarios in which policymakers enact road plans that provide $1.2 billion in new permanent annual funding for roads beginning in FY2016. The two scenarios examine road plans that:

- Generate $1.2 billion in new annual revenues from tax increases and allow for the elimination of the current GF/GP appropriation for roads
- Rely on a 50-50 mix of $600 million in new annual revenues generated from tax increases and an increase in permanent GF/GP support for roads to $600 million

A plan that allows for the elimination of current GF/GP support by raising new revenues for road work would allow for some baseline GF/GP spending growth beyond that needed to cover the specified spending pressures in future years. **Table 5** suggests that annual GF/GP increases of around $200 million per year would be supportable over this budget horizon by projected revenue growth.

Table 5
Long-Run Budget Outlook: Elimination of GF/GP for Transportation

	FY2016	FY2017	FY2018	FY2019
Beginning Balance	**$170.1**	**$423.0**	**$340.3**	**$196.2**
Revenues				
May 2015 Consensus Revenue Estimates	$9,881.9	$10,121.5	$10,486.8	$10,862.6
Medicaid Managed Care Use Tax	$406.7	$101.7	$0.0	$0.0
Statutory Revenue Sharing and Adjustments	($466.5)	($460.7)	($460.7)	($460.7)
Total Adjusted Revenues	**$9,822.1**	**$9,762.5**	**$10,026.1**	**$10,401.9**
Expenditures				
Baseline GF/GP Appropriations (non-MDOT)	$9,474.2	$9,474.2	$9,474.2	$9,474.2
Transportation Support	**$0.0**	**$0.0**	**$0.0**	**$0.0**
BSF Contributions	$95.0	$0.0	$0.0	$0.0
Other Budget Pressures		$171.0	$296.0	$451.0
GF/GP Growth/(Reductions)		**$200.0**	**$400.0**	**$600.0**
Total Expenditures	**$9,569.2**	**$9,845.2**	**$10,170.2**	**$10,525.2**
Ending Balance	**$423.0**	**$340.3**	**$196.2**	**$72.9**

[11] Within the budget, statutory revenue sharing is technically appropriated from restricted sales tax revenue rather than GF/GP revenue. However, this restricted revenue is initially a component of the GF/GP consensus revenue estimates and is subtracted out to reflect its status as a restricted fund.

That means that discretionary GF/GP spending for functions outside of transportation could grow by about 2.0 percent annually over this period while still maintaining a small GF/GP balance at the close of FY2019.

Conversely, if annual GF/GP support for roads (either through direct GF/GP appropriations or the redirection of existing GF/GP revenue) is increased to $600 million per year beginning in FY2016, **Table 6** shows that GF/GP reductions equivalent to $177 million would immediately be necessary in the FY2016 budget given the redirection of GF/GP resources. Further, the cumulative reduction would increase in FY2017 to $483 million unless new revenues from the School Aid Fund, the Budget Stabilization Fund, or elsewhere were tapped to fill the hole. This is equivalent to 5.1 percent of the FY2016 GF/GP baseline appropriations for non-transportation purposes. Revenue growth would provide room to partially restore these reductions over the next two fiscal years, but GF/GP spending would otherwise have to been held in check beyond funding to finance the four areas of spending pressure. In FY2019, non-transportation GF/GP baseline spending would have to remain 1.3 percent lower than FY2016 baseline levels under this scenario.

Table 6
Long-Run Budget Outlook: Expanded GF/GP Support for Transportation

	FY2016	FY2017	FY2018	FY2019
Beginning Balance	**$170.1**	**$0.0**	**$0.0**	**$0.0**
Revenues				
May 2015 Consensus Revenue Estimates	$9,881.9	$10,121.5	$10,486.8	$10,862.6
Medicaid Managed Care Use Tax	$406.7	$101.7	$0.0	$0.0
Statutory Revenue Sharing and Adjustments	($466.5)	($460.7)	($460.7)	($460.7)
Total Adjusted Revenues	**$9,822.1**	**$9,762.5**	**$10,026.1**	**$10,401.9**
Expenditures				
Baseline GF/GP Appropriations (non-MDOT)	$9,474.2	$9,474.2	$9,474.2	$9,474.2
Transportation Support	**$600.0**	**$600.0**	**$600.0**	**$600.0**
BSF Contributions	$95.0	$0.0	$0.0	$0.0
Other Budget Pressures		$171.0	$296.0	$451.0
GF/GP Growth/(Reductions)	**($177.0)**	**($482.7)**	**($344.1)**	**($123.3)**
Total Expenditures	**$9,992.2**	**$9,762.5**	**$10,026.1**	**$10,401.9**
Ending Balance	**$0.0**	**$0.0**	**$0.0**	**$0.0**

The School Aid Fund: Budget Safety Valve?

The budget factors noted above have focused exclusively on the general fund side of the state budget. What about the state's other primary budgetary fund – the School Aid Fund (SAF)? The SAF is expected to take in almost $12 billion in state revenue in FY2015, and, like the General Fund, continued revenue growth is forecast through FY2019. How does this growth impact the long-run budget outlook?

Until recently, any cross-support between the state's General Fund and SAF flowed in one direction – from the General Fund to the SAF. However, first in FY2010 and then from FY2012 until the present, SAF revenue has been utilized to finance a portion of appropriations for the state's univer-

sities and community colleges, which traditionally had relied on GF/GP appropriations. The recently enacted FY2016 budget appropriates $257 million in SAF revenue for community colleges (about two-thirds of the total appropriations for the colleges) and another $205 million for the state's universities (just over 13 percent of total appropriations for the universities). Thus, the GF/GP pressures discussed above could also be alleviated without additional GF/GP budgetary reductions if lawmakers agreed to expand this SAF support for higher education, freeing GF/GP revenues for other purposes. Effectively, this would shift some portion of the burden of the GF/GP reductions to School Aid budget, which supports K-12 schools and other education-related programs. To some degree, this would likely curtail growth in per-pupil grants to K-12 school districts, which account for a large majority of School Aid appropriations.[12]

Healthy projected revenue growth for the SAF could make this easier to do. Looking at core SAF revenues as agreed to in the May Consensus Revenue Estimating Conference, SAF revenue growth is expected to average around 2.9 percent over the next three years, increasing by over $1.0 billion to $13.3 billion by FY2019.

However, as with the General Fund, this revenue growth is offset to a degree by other budget pressures. In particular, the revenue loss attributable to ending the imposition of the state's use tax on Medicaid managed care organizations will have sizable impacts on the SAF side of the budget as well. **Table 7** outlines both projected SAF revenue growth from the May revenue conference combined with the impact of this loss of use tax revenue which is not included within the consensus estimates. Adjusting for the loss in use tax revenue reduces the cumulative revenue gain to the SAF, but even under this scenario, FY2019 revenue is expected to be over $878 million higher than FY2016 levels.

Table 7
Projected Revenue Growth in the School Aid Fund through FY2019 (in millions)

	FY2016	FY2017	FY2018	FY2019
Consenus Revenue Estimates	$12,242.9	$12,598.8	$12,948.3	$13,322.9
Medicaid Managed Care Use Tax	$203.3	$50.8	$0.0	$0.0
Total Combined Revenue	$12,446.2	$12,649.6	$12,948.3	$13,322.9
Cumulative Revenue Growth from FY2016		$203.4	$502.1	$876.7

Source: Consensus estimates from May 2015 Consensus Revenue Estimating Conference; Use tax estimates from Senate Fiscal Agency, State Budget Overview, August 14, 2015.

The Budget Trade-Offs Going Forward

For years now, state policymakers have grappled with the state's road infrastructure needs. However, a permanent solution to the state's road funding challenges has remained elusive. As road funding needs have outpaced available dedicated revenues, lawmakers have authorized the use of state GF/GP dollars to supplement existing base revenues. However, that redirection of discretionary GF/GP resources means less funding is available for other state budget priorities.

A conservative analysis of both long-run revenue projections and spending trends suggests that eliminating the use of GF/GP resources for roads would allow for about 2 percent annualized growth in total GF/GP appropriations for these other state programs between FY2016 and FY2019 – slightly out-

[12] While per-pupil allocations to school districts have risen in recent years, a large portion of these increases have specifically covered increased retirement system liabilities as opposed to other discretionary spending areas. For a discussion, see CRC's webinar on the Governor's FY2016 budget proposal available at www.youtube.com/watch?v=_AOZFfLZCd0.

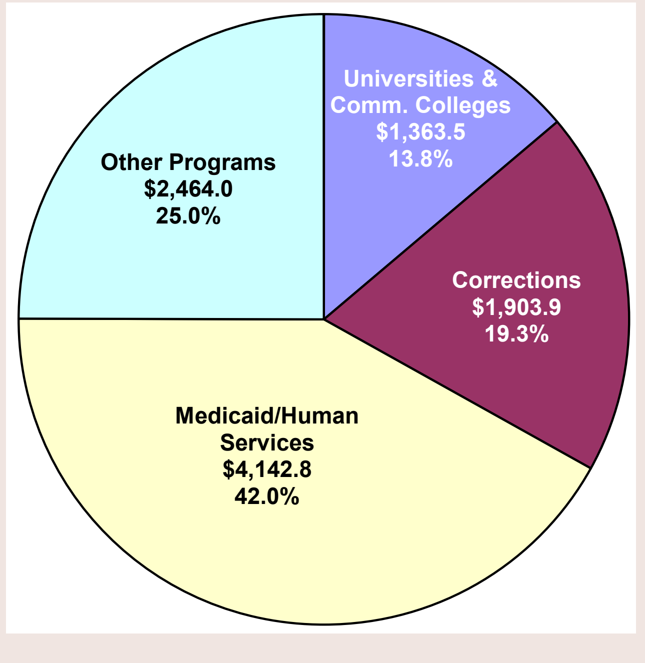
pacing anticipated inflation over the same period. However, this would likely also require a substantial tax increase in some form for Michigan taxpayers; one that would generate a minimum of around $1.2 billion annually to address projected road needs. To date, political support for such an increase has not been forthcoming.

On the other side of the equation, a boost to GF/GP support would negate at least some of the need for additional revenue through higher taxes. However, the same analysis suggests GF/GP budget reductions on the order of 5.1 percent could be necessary in FY2017 in order to increase total GF/GP support for roads to $600 million beginning in that fiscal year – which represents only about one-half of the $1.2 billion minimum threshold that has been the target for new road resources. This initial reduction could be partially restored over the next two fiscal years, but GF/GP funding levels for non-road functions would remain below FY2016 levels at least through FY2019 if the underlying assumptions hold up.

In short, this latter approach would call for difficult budget decisions down the road in terms of reductions to GF/GP-financed programs, the use of limited one-time Budget Stabilization Fund resources, or expanded use of the School Aid Fund safety valve discussed above that would shift this budget burden to K-12 schools. Adding to the budget challenge, **Chart 1** shows that 75 percent of state GF/GP appropriations are concentrated on three large functions: Medicaid and social services, corrections, and higher education. Another big-ticket budget item is the discretionary component of state revenue sharing, which effectively draws from the state's General Fund as well. That means that these politically-sensitive programs will need to be part of any GF/GP reductions plan, or much larger cuts will need to be imposed on other program areas to make up the difference.

Further, to differing degrees, each of these functions has already seen funding constrained due to stagnant revenues during Michigan's pronounced economic slide experienced during the previous decade. **Table 8** outlines state-source appropriations (which include GF/GP appropriations along with

Chart 1
FY2016 GF/GP Appropriations (in millions)



those from other state restricted revenue sources) for these large budget areas in both FY2000 and in the initial FY2016 budget. Funding for statutory revenue sharing as well as state universities has fallen by 44 percent and 19 percent, respectively from FY2000 – even before adjusting for inflation. In constant dollars, only appropriations for health and human services have outpaced inflation, growing by almost 12 percent during the period. All four of the other large budget areas have seen negative growth over the period after adjusting for general inflation.

Whether further reductions to state GF/GP spending are warranted depends largely on subjective opinion. Is state government too big, too small, or just the right size? Even well-informed citizens may disagree depending upon their perspective. Further, some citizens may agree that reductions are warranted, but disagree on the program areas that should be reduced. A final challenge in evaluating potential GF/GP reductions is that it's not always clear how these reductions will be absorbed by affected entities. For instance, would cuts to the state universities be met with sharp increases in

tuition rates; or can universities scale back costs to absorb the lost revenue? The public's support for such a reduction may depend upon the answer to this question, yet the answer cannot be known with certainty at the time the reduction is implemented.

Regardless, it is important to note that every budgetary decision involves tradeoffs, and the eventual solution to the state's road funding troubles will as well. Motor fuel and registration tax increases will redirect disposable income of Michigan citizens to the roads. Likewise, redirecting existing GF/GP revenues for road use will require reductions in other areas of the state budget. Lawmakers – and the public at large – should be cognizant of those tradeoffs as any road funding plan is finalized.

Table 8
Appropriations from State Resources, FY2000 - FY2016 (in millions)

Budget	FY2000	FY2016 Year-to-Date	Percent Change	FY2016 Inflation-adjusted	Percent Change
Universities	$1,782.1	$1,437.7	-19.3%	$1,080.7	-39.4%
Community Colleges	$297.2	$387.8	30.5%	$291.5	-1.9%
Statutory Revenue Sharing	$833.7	$463.5	-44.4%	$348.4	-58.2%
Corrections	$1,531.3	$1,947.9	27.2%	$1,464.2	-4.4%
Health/Human Services	$4,277.1	$6,357.1	48.6%	$4,778.5	11.7%

Sources: Revenue sharing: House Fiscal Agency, Background Briefing: Revenue Sharing, October 2014; Other areas: Senate Fiscal Agency budget memoranda. Inflation adjustment based on CRC calculations using Detroit CPI data.

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