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**MICHIGAN'S FISCAL FUTURE**

**MAY 2008**

**REPORT 349**

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# MICHIGAN'S FISCAL FUTURE

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REPORT 349

The Report was prepared with assistance from the **W.E. Upjohn Institute for Employment Research**, the **Detroit Renaissance**, the **Herbert H. and Grace A. Dow Foundation**, the **W. K. Kellogg Foundation**, and the **Frey Foundation** financially contributed to this study.

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## MICHIGAN'S FISCAL FUTURE IN BRIEF

For seven years, Michigan has endured its worst financial crisis in more than 50 years. Cyclical and structural pressures have combined to produce both deteriorating revenue performance and escalating spending pressures. Although the State has successfully balanced budgets in each fiscal year, this has been accomplished by the use of reserves and through actions designed to minimize spending cuts. The fundamental issue of matching available on-going revenues with spending remains only partly addressed.

The task facing policy makers over the next several years will be to bring the growth of spending pressures in both the General Fund and the School Aid Fund into line with the growth of revenues. The projected gaps are significant. If current spending and taxing policies are unchanged, a gap of \$6 billion will develop by Fiscal Year 2017 in the General Fund and \$3.6 billion in the School Aid Fund. The Michigan Constitution prohibits budget deficits, so these gaps will not materialize. But, these projections provide an indication of the magnitude of policy changes that will be necessary in order to restore long-term balance to the State budget.

Budget deficits can be classified as either *cyclical* or *structural* to reflect their causes. *Cyclical* deficits are caused by a decline in the economy. Revenue performance worsens and some spending pressures increase, creating gaps between the cost of maintaining programs and the resources available to pay for them. Unlike a business, which is adversely affected by a recession through lost customers and declining sales, the customers for state and local government programs expect the services to continue, even with declining revenues. Programs such as K-12 education expect essentially the same levels of enrollment, whether

revenues are increasing or declining. Other programs sensitive to unemployment levels may experience an increase in the number of citizens requesting assistance at the same time governmental revenues are decreasing. When the economy improves, cyclical deficits tend to be self-correcting.

*Structural* deficits are created when the costs of maintaining programs and policies increase faster than revenues even when the economy is performing well. Structural deficit pressures may also exist when the economy is doing poorly and, combined with cyclical pressures make balancing the budget even more difficult.

### Economic Review and Short Term Outlook

The Michigan economy and state and local government programs and finance have been under significant stress since Fiscal Year 2001 (FY01). State government revenue performance paralleled the economic decline. Aggressive cuts in Personal Income Tax and Single Business Tax rates, enacted in the good times of the late-1990s, exacerbated the dismal performance of the tax base. Revenue performance has failed to keep pace with spending pressures associated with continuing programs and policies on a year-to-year basis. From FY00 through FY07:

- General Fund revenues dropped by \$1.5 billion (15.4 percent)
- Income Tax revenues to the General Fund declined by \$802 million (15.6 percent)
- Single Business Tax revenues to the General Fund fell by \$507 million (21.6 percent)
- State-raised School Aid Fund revenue grew \$829 million (8.0 percent), an annual rate of only 1.1 percent.
- Sales Tax revenues, the largest School Aid Fund revenue source, increased by only 4.2 percent.

*Michigan's Fiscal Future* was prepared by the Citizens Research Council of Michigan and the W. E. Upjohn Institute for Employment Research. Both organizations recognized the need to assess the future dynamics of the interaction of the Michigan economy with the governmental programs supported by the tax revenues dependent on the performance of that economy.

The report was generously supported by the Herbert H. and Grace A. Dow Foundation, the Frey Foundation, the W. K. Kellogg Foundation, and Detroit Renaissance.

Because the deterioration in the economy and revenue performance began occurring as the FY01 budget was being completed, spending in FY01 was supported by nearly \$1.2 billion in one-time resources and no significant cuts in spending were made. Significant changes occurred in subsequent years, however:

- General Fund spending dropped by \$673 million (6.5 percent)
- Higher education spending dropped by \$184 million (8.8 percent)
- Department of Human Services lost \$56 million in General Fund support (4.5 percent)
- Statutory revenue sharing for cities, villages, townships, and counties was cut by \$558 million (58.3 percent)
- School Aid spending from state-raised revenues increased by \$529 million (4.9 percent or 0.8 percent per year). K-12 program reductions were required to accommodate increases for school personnel retirement, health insurance, and salaries.
- State government work force dropped by 9,500 employees (15.2 percent), bringing the number of State employees below the level of FY74
- Corrections spending increased by \$253 million (15.8 percent)
- General Fund Community Health spending (largely Medicaid and public and mental health programs) increased by \$251 million (9.3 percent)

The financial condition of the State has deteriorated to the point that reserves are exhausted and cash-flow problems threaten the ability to make payments on a timely basis.

## Economic Projections

The budgetary projections in this report are based on a series of assumptions about the performance of the Michigan economy from 2007 to 2017. Projections of State spending are based upon a moderately growing state economy, an improvement over the experience of the last seven years.

The Michigan economy will be driven by the national economy, which is projected to experience the following rates of change:

- Real Gross Domestic Product up by 2.7 percent per year

- Employment up by 0.9 percent per year (slightly below population growth of 1.0 percent per year)
- Manufacturing employment down by 1.3 percent per year (2.8 percent decline in auto employment)

Employment growth will be concentrated in the service sector, specifically, health care, business administrative, leisure and hospitality, and educational services.

Rates of change for Michigan include:

- Personal income up by 4.2 percent per year (real personal income, 2.3 percent)
- Share of U. S. personal income down by 9 percent from 3.3 percent to 3.0 percent
- Employment basically unchanged, with declines in manufacturing (3.5 percent per year) and increases in health care (2.4 percent per year) and leisure and hospitality (0.5 percent per year)

## Population Projections

The Michigan demographic landscape will undergo a marked transformation during the period of the projections. While total population will remain unchanged, its composition will change:

- The over-65 cohort increases 2.8 percent per year; other cohorts decline
- School age (5-17) population declines by 1.5 percent per year
- The decline in Michigan's share of the U. S. population will accelerate from 0.7 percent per year (1997-2007) to 1.1 percent per year (2007-17), dropping the share from 3.3 percent to 3.0 percent

## Michigan Revenue Structure and Projections

This report covers budgets supported by three major state funds: General Fund (GF), School Aid Fund (SAF), and Transportation Fund. Each of these funds depends heavily on state taxes for its revenues and is reliant upon the Michigan economy to produce the activity to generate the tax revenues. The connection between the Michigan economy and the state tax structure has weakened since the late-1990s leading to a lag between the growth of the economy and growth in tax revenues.

Major changes in the tax structure made during FY07 will affect the revenues for FY08 and beyond. Substi-

tution of the Michigan Business Tax (MBT), a tax on business income and gross receipts, for the Single Business Tax (SBT) in 2007 is projected to result in essentially no change in revenue. Also in 2007, the rate of the Personal Income Tax was increased by 0.45 percentage points, from 3.9 percent to 4.35 percent. That increase, plus a surcharge on the MBT, are projected to yield approximately \$1.2 billion in FY08 (partial year) and \$1.5 billion in FY09.

Six major taxes (Personal Income, Sales, Use, MBT, State Education, and Tobacco Products) provide the bulk of the revenues to the GF and SAF and the projections in this report focus on those taxes. The overall growth paths of the revenues to the GF and SAF are the same (3.0 percent), before adjustments for future changes already in law are factored in. Two series of tax cuts are in state law for FY09 and beyond (Earned Income Tax Credit and phase-out of the 2007 Personal Income Tax increase) and will have the effect of reducing the already anemic annual growth rates in GF revenues to less than 1.0 percent in several years beyond FY10. Overall, the cuts reduce the average annual growth rate from 3.0 percent to 1.4 percent, with GF revenues rising from \$10.0 billion in FY09 to \$11.1 billion in FY17. Funds available to finance K-12 education (state, federal, local) are projected to grow from \$18.1 billion to \$23.0 billion in that period (3.0 percent annually).

## Michigan Budget and Spending Pressure Projections

General Fund spending pressures are projected to grow from \$10.1 billion in FY09 to \$17.1 billion in FY17, an annual rate of growth of 6.8 percent. This growth is not uniform across GF programs, nor is it consistent each year during the projection period. Average annual growth rates range from 10.7 percent for Medicaid to 4.1 percent for most general government programs. School aid spending pressures are projected to grow from \$18.4 billion in FY09 to \$26.6 billion in FY17, or an annualized rate of 4.7 percent.

Medicaid and corrections are the main drivers of GF spending pressure growth, while health care coverage for both active and retired employees is the principal factor in the growth of K-12 spending pressures.

## Employee Compensation

Employee compensation expenditures by the State and, especially, by K-12 school districts will continue to contribute to the structural deficit. Spending on salaries and fringe benefits represents nearly 80 percent of total annual K-12 spending, whereas compensation accounts for only about 11 percent of total State spending. The growth in compensation spending pressures will be driven heavily by health care benefits provided to both current and retired employees.

With respect to GF compensation:

- Spending pressures are projected to rise 4.8 percent annually from nearly \$2.9 billion in FY09 to over \$4.3 billion in FY17.
- Nearly one of every three dollars (31 percent) in FY17 will be spent on health care for current and retired employees; up from 22 percent in FY09
- Total compensation spending pressures will increase by an average of \$159 million per year

With respect to K-12 compensation:

- Spending pressures are projected to rise 5.1 percent annually from \$14.4 billion in FY09 to \$21.4 billion in FY17
- Total compensation spending pressures will increase by an average of \$875 million per year, or \$700 per pupil per year
- Declining enrollments will lead to teacher attrition and help to moderate overall salary spending growth; however, health care spending pressures will continue to grow

## K-12 School Aid

In FY07, Michigan public elementary and secondary schools provided education to 1.7 million pupils through 552 school districts, 229 public school academies, and 57 intermediate school districts operating in about 4,000 facilities.

State aid to K-12 schools is supported by the School Aid Fund (SAF), which is composed primarily of revenues from the Sales Tax, Use Tax, State Education Property Tax, the State Lottery, Casino Gaming Tax, liquor and tobacco taxes, and the Real Estate Transfer

Tax. These sources are supplemented at the local level by local property taxes levied largely on business property.

Consonant with the decline in school age population, K-12 enrollment is projected to decline from 1.65 million in FY08 to 1.45 million in FY 17, an average annual decline of 1.4 percent. Spending pressures do not, however, decline in concert with enrollment declines because pupil loss is typically spread out in a way that hinders concurrent reduction in expenditures.

K-12 revenues are projected to grow at a rate of 3.0 percent per year from \$17.7 billion in FY08 to \$23.0 billion in FY 17, while spending pressures are projected to grow at a rate of 4.7 percent per year from \$17.7 billion in FY08 to \$26.6 billion in FY 17, creating a gap of \$3.6 billion.

The gap is largely attributable to spending pressures for health care both for current employees, which is projected to grow at an annual rate of 9.3 percent, and for retired employees, which is projected to grow at an annual rate of 11.9 percent.

**Table 1**  
**Projected Growth in K-12 Spending Pressures, FY09 to FY 17**

<u>Spending Pressures</u>	<u>Annual Rate of Change, FY09-FY 17</u>
Payroll	3.3%
Pension Benefits	3.3%
Retiree Health Care	11.9%
Other Benefits (Employee Health Care)	9.3%
Other Spending	3.3%
<b>Total</b>	<b>4.7%</b>

Source: CRC calculations.

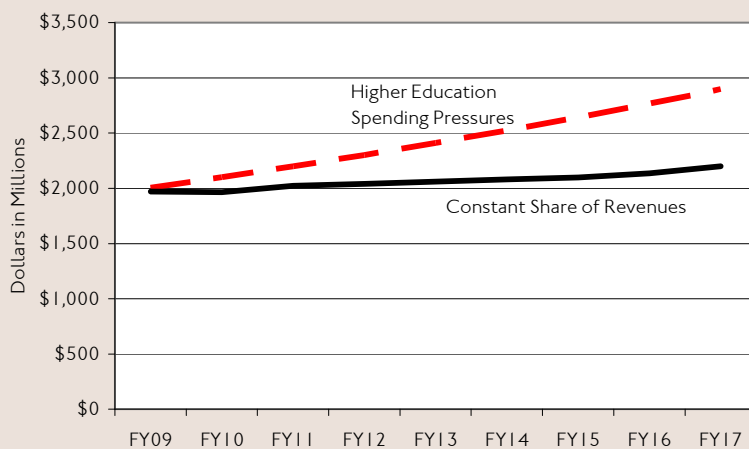
### Higher Education

State appropriations support the operations of 15 state universities and 28 community colleges in Michigan. In FY07, General Fund support was \$1,625 million for universities and \$290 million for community colleges.

Reduced support for higher education has been a key part of the State response to declining GF revenues. From FY00 to FY07:

- State appropriations to state universities declined by 0.6 percent per year, while tuition and fees grew by 9.4 percent annually.
- State appropriations to community colleges declined 0.5 percent per year, while tuition and fees grew by 9.2 percent and local property tax support grew by 7.3 percent per year.

**Chart 1**  
**Projected Higher Education Spending Pressures and Revenue Growth, FY09 to FY 17**



Despite, or perhaps owing to, declining economic conditions in Michigan, enrollments increased significantly from FY00 to FY07 and are projected to continue to increase (by 1.2 percent per year), even though the college age population is projected to decline.

While GF revenues are projected to rise by 1.4 percent per year, higher education spending pressures are projected to grow by 4.7 percent per year. Even if higher education maintains its current share of GF revenues (19.8 percent), a gap of approximately \$700 million would open up by FY 17.



## Medicaid and Related Health Programs

Medicaid is a state-federal health insurance program for low-income recipients. Nationally, Medicaid accounts for about one-sixth of health care spending and nearly half of all spending on long-term care. MIChild is the Michigan version of the state-federal State Children's Health Insurance Program (SCHIP). Michigan also has responsibility for 90 percent of the funding of Medicaid Part D drug program for Medicaid recipients. Medicaid, MIChild, and the state obligation for Medicare Part D prescription drugs total \$10.4 billion from all sources and absorb \$2.4 billion, or 25.6 percent of FY08 GF appropriations.

Medicaid services are either mandatory or optional and Michigan has expanded both the services covered and the categories of low income families and individuals eligible for the services beyond federal minimum requirements. Optional services, however, include pharmaceuticals, emergency care, and nursing home care, services not easily eliminated.

Medicaid and related health programs have been, and will continue to be the most rapidly growing portion of both GF and total State spending. The projected annual growth rate of these programs (GF portion) is 10.1 percent through FY17, far greater than the projected GF revenue growth rate of 1.4 percent. Total spending pressures are projected to rise from \$10,417 million in FY08 to \$20,227 million in FY17, with the GF portion rising from \$2,412 million to \$5,732 million during that period.

## Mental Health

Since the mid-1960s, the delivery of mental health services to Michigan residents has shifted from state-run hospitals to the community level. The advent of psychotropic drugs and changes in state law aided this transition and resulted in the closure of 26 state inpatient facilities since 1978. Despite this marked change in the mode of service delivery, the State budget still plays a major role in financing behavioral health care services. In FY08, the State will support \$2 billion in mental health services for Medicaid and non-Medicaid eligible individuals. From FY09 to FY17:

- Total mental health spending pressures will double to over \$4 billion
- General Fund spending pressures for Medicaid mental health services will increase by 8.6 percent

per year, nearly six times faster than the projected GF annual revenue growth rate

- Non-Medicaid GF mental health spending pressures will increase by 2.9 percent per year (approximately twice as fast as projected GF revenues), rising from \$449 million in FY09 to \$564 million in FY17
- The rising cost and use of prescription drugs, together with caseload increases, and the aging Michigan population, will contribute to mental health spending demands during the projection period.

## Human Services

Human services programs, including income support, day care, foster care, adoption, and family preservation, have undergone major transformations since the passage of federal welfare reforms in the mid-1990s. Spending on traditional public assistance programs has been replaced by spending on services designed to assist individuals in securing employment. The Michigan Family Independence Program (FIP) caseload reached a low in FY01 before beginning a rise through FY07.

Future human services spending pressures will be determined by economic factors as well as by state policies, including state employee compensation. State economic performance will influence the number of individuals served by human services programs, while state policies will determine benefit levels, eligibility criteria, and benefit time limits.

Whereas FIP caseloads have slowly increased since FY01, benefit levels have remained virtually untouched for almost 20 years. Despite infrequent benefit increases, the projection of spending pressures includes an annual inflationary increase in benefit levels in order to maintain the current purchasing power of grants.

Overall, human services GF spending pressures are projected to increase by 3.2 percent per year from \$1.3 billion in FY09 to slightly more than \$1.7 billion in FY17. Michigan's share of federal Temporary Assistance to Needy Families is fixed at \$775 million per year, meaning that any increase in the spending pressures resulting from caseloads or benefits will have to be supported by state resources alone.

# CRC REPORT

## Corrections

Corrections constitutes the largest program operated directly by state employees, has grown by an annual rate of nearly 4 percent since FY00, and will be second only to health care as a contributor to the State General Fund structural deficit through FY17. The Department of Corrections now employs over 17,000 persons, nearly one-third of the classified State workforce.

Growth in Corrections spending will be fueled by a projected 2.2 percent annual growth rate in the number of prisoners, or nearly 1,300 per year. While Michigan does not sentence an extraordinarily large number of felons compared to other Great Lakes states, the average length of stay is nearly 60 percent longer, resulting in substantially higher incarceration rates (489/100,000 population vs. 338/100,000 in 2006). Under present policies, the Michigan incarceration rate is projected to rise to 623/100,000 by FY17.

## Highway Finance

Although not funded by the General Fund and therefore not part of the gap between GF spending and revenues, highway construction is a large part of the total State budget and is subject to many of the same forces that condition other State programs.

Michigan highway revenue sources (Motor Fuel and Vehicle Registration taxes) have failed to fund the planned construction and maintenance of the State highway system, resulting in unmet system condition goals. Moreover, the current funding structure will not result in revenue growth sufficient to keep pace with the projected spending pressures facing the system.

The Gasoline Tax was last increased in 1997 (\$0.04/gallon). However, slow growth in motor fuel consumption coupled with the effects of inflation has eroded the purchasing power of the increase. While another increase in the tax rate would provide addi-

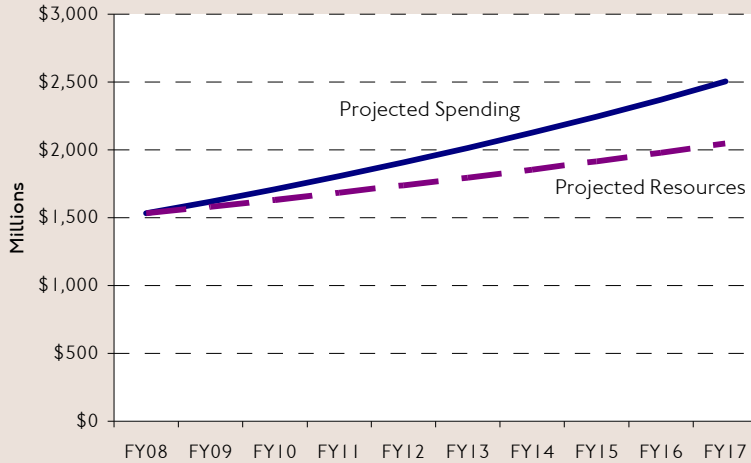
**Table 2**  
**Corrections Projections, FY08 to FY17**

<u>Fiscal Year</u>	<u>Prisoners</u>	<u>Incarceration Rate</u>	<u>Total Spending (millions)</u>	<u>Spending per Capita</u>	<u>Facility Debt Service (millions)</u>
2007-actual	50,203	497.4	\$1,866.4	\$185	
2008-estimate	51,394	509.7	1,996.1	198	
2009	52,100	517.2	2,118.5	211	\$2.1
2010	53,598	532.5	2,250.9	224	8.5
2011	55,124	548.3	2,415.7	240	10.9
2012	56,094	558.6	2,593.8	258	13.8
2013	57,335	571.2	2,786.3	278	17.4
2014	58,603	584.0	2,994.4	298	21.1
2015	59,899	596.8	3,219.4	321	24.8
2016	61,224	609.6	3,462.8	345	20.8
2017	62,578	622.5	3,726.2	371	41.2
Average Annual Increase FY09 to FY17	2.3%	2.3%	7.3%	7.3%	

\* 2008 to 2012 figures from Michigan Department of Corrections Prison Population Projection Report, January 2008; 2013 to 2017 figures based on CRC projections.

# MICHIGAN'S FISCAL FUTURE

**Chart 2**  
**MDOT Road and Bridge Program Projected State and Federal Resources and Spending, FY08 to FY17**



Sources: MDOT; U.S. Department of Labor; CRC calculations.

## Unrestricted State Revenue Sharing for Local Governments

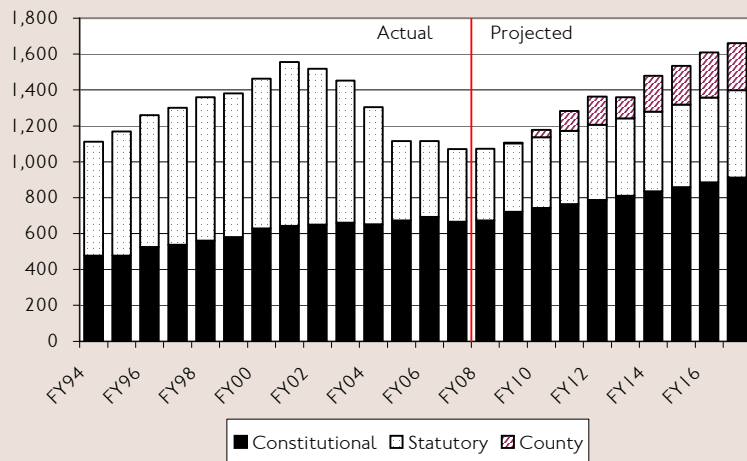
The Michigan state revenue sharing program distributes Sales Tax revenues in two ways: The first carries out a constitutional provision to distribute 15 percent of revenues from the Sales Tax collected at the 4 percent rate to cities, villages, and townships on a per capita basis. In addition, a statutory program distributes another 21.3 percent of the Sales Tax revenues to cities, villages, townships (16 percent) and counties (5.3 percent). A 1998 law created a formula that weights the population of cities, villages, and townships by measures of need and tax capacity for distributing these funds. Counties are funded on a per capita basis.

Efforts to deal with the State structural deficit led State policy makers to retain funds that would have been allocated to statutory state revenue sharing in order to make funds available for other programs. From FY02 to FY08, over \$2.1 billion has been retained in the General Fund. Revenue sharing payments to counties were paused completely in 2004,

tional revenue in the short-run, it would do nothing to affect the underlying growth path of this revenue source. Vehicle Registration taxes have accounted for nearly all the annual growth in state highway funding in the past and will continue to do so. Highway revenues (state and federal) are projected to grow at an annual rate of 3.5 percent between FY09 and FY17 with state revenues growing at only 2 percent. State revenue for state roads and bridges (not including revenues directed to local units) is projected to grow from \$776 million in FY08 to \$928 million in FY17.

Projected spending pressures will increase by 5.6 percent per year, not including costs associated with unmet needs prior to the projection period. Adding those costs would dramatically increase the projected spread between spending and revenues. The gap between spending pressures and projected state-federal revenues will be approximately \$412 million by FY17.

**Chart 3**  
**Spending Pressures for Statutory State Revenue Sharing: FY 94 to FY07 Actual and FY08 to FY17 Projected**



offset temporarily by the extra funds collected through a shift in the collection of county taxes from winter to summer.

Funds distributed through the constitutional per capita formula are projected to grow at an annual rate of 3 percent—equal to the projected growth rate of the Sales Tax. It is assumed that all cuts in statutory revenue sharing for cities, villages, and townships will continue. It is further assumed that no further cuts will occur for cities, villages, or townships and that counties will recoup their lost payments, with inflationary adjustments. Starting in FY 10, the State will have to make a decision regarding the source of funds to finance revenue sharing for counties, which will amount to more than \$100 million in FY 11 and over \$200 million by FY 15.

### Summary of Structural Deficit Projections

When the projections of spending pressures and revenues are combined, an increasing gap appears. Spending pressures in two areas stand out as major causes of the structural deficit: corrections and health care. Both areas are projected to grow at more than twice the rate of increase in revenues unless policies are implemented that substantially reduce the rates of growth in the two areas. Major tax revenues are not growing as fast as the economy and the share of the overall economy claimed by State taxes will continue to fall. The largest tax sources (Personal Income and Sales and Use) are projected to increase about 3 percent per year.

Spending pressures in public K-12 education are projected to grow about 4.7 percent annually, while revenues are projected to grow at 3.0 percent per year. The gap of about 1.7 percentage points amounts to an annual shortfall of about \$300 million.

In the General Fund, revenue growth averages 1.4 percent per year—lower than the School Aid Fund growth rate because of tax cuts already in State law that will pare the growth from a baseline rate of 3.0 percent. GF spending pressures are projected to grow 6.8 percent annually, leaving an average shortfall of 5.4 percentage points, or more than \$500 million annually.

### The Challenge Ahead

The Michigan Constitution mandates a balanced budget. The State has accomplished this task each fiscal year during the current period of weak economic performance, usually with the use of non-recurring financial resources. It has, however, seen its reserves depleted to the point at which it can no longer avoid the difficult process of bringing its recurring revenues and its spending commitments into long-term balance.

The State budget process contains nothing that forces consideration of the long-term consequences of current policies. As a consequence, policies are often adopted, which, although affordable at the time of adoption, may contain elements of growth that result in budgetary pressure in subsequent fiscal periods. This report is aimed at assisting policy makers in developing strategies that address the structural deficit that continues to plague the Michigan State budget.

**Table 3**  
**Summary Calculations of the Structural Deficits, FY09-FY 17**

<u>Spending Area</u>	<u>Average Annual Revenue Growth</u>	<u>Average Annual Spending Pressure Growth</u>	<u>Annual Gap (Revenues Minus Spending Pressures)</u>	<u>Annual Structural Deficit in Millions of FY09 Dollars</u>
GF-GP	1.4%	6.8%	-5.4%	\$539
School Aid	3.0%	4.7%	-1.7%	\$308
Transportation	3.5%	5.6%	-2.1%	\$33

# MICHIGAN'S FISCAL FUTURE

## I. Introduction

It has been apparent for several years that Michigan State government and its constituent governmental units are faced with a structural deficit that requires significant changes in revenue and spending policies. This report is intended to measure the size of the challenge that will face policymakers in the future and to define the magnitude of actions that might be taken to mitigate some of the structural deficit pressures. To do so, the Michigan economy and state budget for the past decade are reviewed and projections are made of economic and budgetary scenarios through 2017. The projections of government finances are based on a range of projections of the future performance of the economy.

Michigan State government has not, as a regular practice, measured the future consequences of fiscal current decisions. Generally, the analyses of proposed changes in tax and program spending policies do not include projections that would help identify problems with sustaining the policy changes in the long run. Michigan's fiscal history is littered with examples of policy changes, such as the aggressive tax cuts implemented in the late 1990s, that were believed to be affordable without significant changes in programs.

This analysis accepts the changes that have occurred in the State's expenditure and revenue structure and incorporates those changes into the spending and revenue bases. It then makes calculations to determine where spending pressures from existing programs would take the budget if sufficient resources were available. Similarly, it calculates the rate of growth for the revenues that pay for the programs. The January 2008 consensus revenue projections of the State are used as the starting point. The revenue and spending pressure projections in this analysis go to 2017, nearly a decade into the future.

Major revenue sources are examined separately and aggregated into a set of projections of available resources consistent with the underlying economic projections. Major areas of state government spending are likewise examined separately and projections of spending pressures are developed based on economic and demographic assumptions. The areas of spending receiving specific treatment are:

- Employee Compensation and Other Costs
- School Aid
- Higher Education (State Universities and Community Colleges)
- Medicaid and Related Programs
- Mental Health
- Human Services
- Corrections
- Highway Finance
- State Revenue Sharing
- Other State Programs

### The Balance of This Report

Michigan has been struggling with structural budget deficits since 2000. The balance of this report explores the revenue and expenditure changes made to keep annual budgets balanced and projects structural budget problems for the next decade. Chapters II through IV describe actions that have been taken to deal with structural budget deficits and lay out economic and demographic assumptions about Michigan's future. Chapter V describes what those assumptions will mean for state revenues and Chapter VI depicts what those assumptions will mean for the state budget and spending pressure projections. Chapter VII explores state and school employee compensation costs and projects how pressures for compensation and health care for current and retired employees will drive costs. Chapters VIII through XVI explore the projected mismatch between revenues and expenditure pressures for the State's largest programs. Finally, Chapters XVII and XVIII identify the cumulative size of the projected annual deficits that can be expected absent any policy changes and alternatives to address the revenue structure and spending pressures.

This report was prepared by the Citizens Research Council of Michigan and the W.E. Upjohn Institute for Employment Research. Both organizations recognized the need to assess the future dynamics of the interaction of the Michigan economy with the governmental programs supported by tax revenues dependent on the economy's performance. Detroit Renaissance, the Herbert H. and Grace A. Dow Foundation, the W. K. Kellogg Foundation, and the Frey Foundation contributed financially to this study.

## II. Economic Review and Short-Term Outlook

Michigan's economy and state and local government programs and finance have been under significant stress since Fiscal Year 2001 (FY01)<sup>1</sup>. Changes in our economy have created pressure on the public services our citizens receive from their governments. A description of where we have come from will help us gain an understanding of where we are likely to go, absent significant changes in public policies affecting the economy, the State revenue structure, and the array of programs State government funds.

Compared with the other states, Michigan has ranked at or near the bottom in three important measures of economic performance for the last seven years: employment growth, unemployment rate, and personal income growth. Recently, Michigan has been one of only two states (the other being Ohio) experiencing recent year to year declines in total employment.

### The Economy

Since 2000, Michigan's economy has been in a downward spiral. The losses recorded in the seven-year period have canceled the gains of the last half of the 1990s. Fewer people were employed in December 2007 than in April 1995. Several key variables highlight the profound changes that have taken place since 2000:

- Total employment declined by 445,300 (9.5 percent).
- Manufacturing employment dropped by 298,400 (33.0 percent).
- Non-manufacturing employment fell by 146,900 (3.9 percent).
- Manufacturing employment accounted for 67 percent of the job losses.
- The unemployment rate more than doubled from 3.2 percent to 7.2 percent.
- Personal income increased 20.2 percent; when adjusted for inflation, the increase amounts to only 1.0 percent.
- Auto and light truck sales by the Detroit Three (General Motors, Ford, and Chrysler) dropped 21.3 percent (2.4 million units).
- Auto and light truck production in Michigan declined 26.4 percent (817,000 units).

### State Revenues

State government's revenue performance paralleled the economic decline. Aggressive cuts in the Personal Income and Single Business Tax rates, enacted in the good times of the late 1990s, exacerbated the dismal performance of the tax base. Michigan's Estate Tax was eliminated as a result of the phasing out of the federal estate tax, with revenue loss to the General Fund in FY07 of more than \$200 million. Other actions at the State level, such as indexed Personal Income Tax exemptions, reductions in the Single Business Tax base, and exemptions affecting the Sales and Use taxes, have diminished the General and School Aid Funds' revenue bases. Revenue performance has failed to keep pace with spending pressures associated with continuing programs and policies on a year-to-year basis. From FY00 through FY07:

- General Fund revenues dropped \$1.5 billion (15.4 percent).
- Income Tax revenues to the General Fund declined \$802 million (15.6 percent).
- Single Business Tax revenues to the General Fund fell \$507 million (21.8 percent).
- School Aid Fund state-raised revenue grew \$829 million (8.0 percent), an annual rate of only 1.1 percent.
- Sales Tax revenues, the largest School Aid Fund revenue source, increased only 4.2 percent.

These figures are not adjusted for inflation; this would make the declines in purchasing power even larger.

### Expenditures and Programs

Because the deterioration in the economy and revenue performance began occurring as the FY01 budget was being completed, that budget was based on overly robust economic and revenue growth forecasts. As has been the practice in the past when a recession begins to affect the budget adversely, one-time resources were used as the primary means for keeping the budget in balance. As a consequence, spending in FY01 was supported with nearly \$1.2 billion of one-time resources in the General and School Aid Funds combined and no significant cuts in spending were made. Because of the lag in action to begin permanent expenditure reduc-



# MICHIGAN'S FISCAL FUTURE

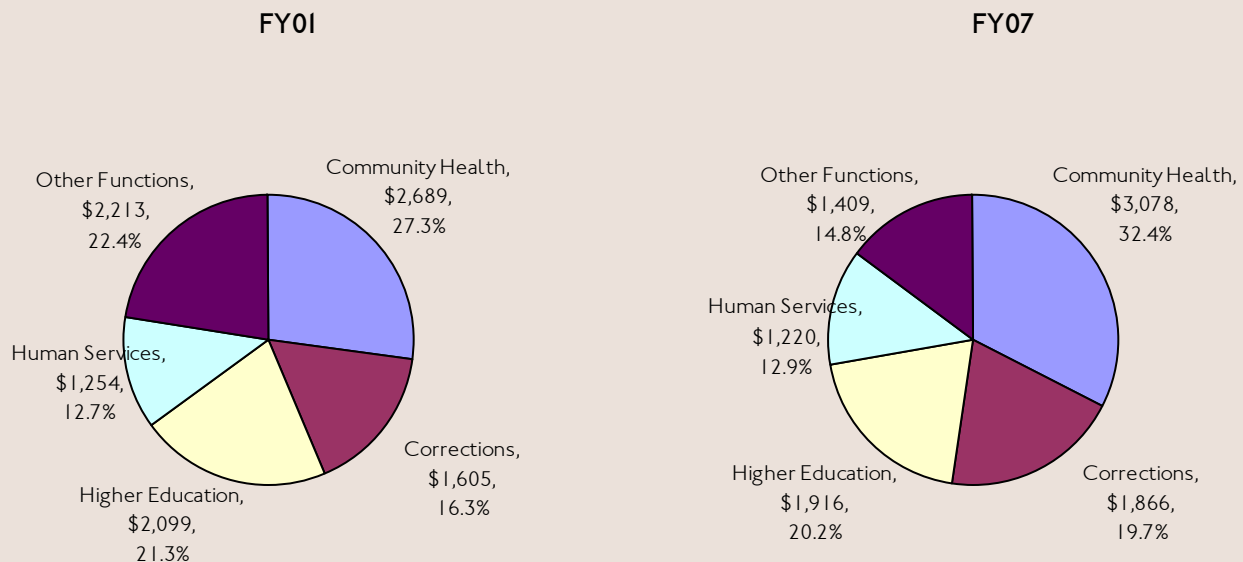
tions, the following spending changes are measured from the FY01 level and span the FY01 to FY07 period. The figures are not adjusted for inflation:

- General Fund spending dropped \$673 million (6.5 percent).
- Corrections spending increased \$253 million (15.8 percent).
- Community health spending, which includes the Medicaid program and public and mental health programs, increased \$251 million (9.3 percent).
- Higher education support dropped \$184 million (8.8 percent).
- Department of Human Services lost \$56 million of General Fund support (4.5 percent).
- Statutory revenue sharing for cities, villages, townships and counties was cut \$558 million (58.3 percent). The cuts in revenue sharing were a significant means to reduce the cuts in other state programs that depend on General Fund revenues.

- School Aid spending from state-raised revenues increased \$529 million (4.9 percent or 0.8 percent per year). School districts had to make program reductions to accommodate cost increases for retirement contributions, health insurance and pay raises that in the aggregate substantially exceeded the increased School Aid grants from the State.
- The State government workforce dropped by 9,500 employees (15.2 percent). The number of State employees in September 2007 was lower than in FY74.

From FY01 to FY07 the allocation of General Fund appropriations changed dramatically (see **Charts II-1** and **II-2**). By FY07, approximately 86 percent of General Fund dollars were spent in four large areas: Community Health, Corrections, Higher Education, and Human Services. During the period, Community Health and Corrections combined grew from about 44 percent to 52 percent of spending.

**Charts II-1 and II-2**  
**Shares of General Fund-General Purpose Spending, FY01 and FY07**  
**(Dollars in Millions)**



Higher education and the group of smaller agencies lost \$1.0 billion in appropriations while budgets for Community Health and Corrections together increased by \$650 million during the same period.

State support for public K-12 education grew at varying rates from FY01 to FY07. In the 14 years since the approval of Proposal A, School Aid support increased, albeit at declining rates in the last four years. The robust economic growth of the late 1990s made it possible to narrow the differences between higher and lower spending school districts significantly, a stated goal of Proposal A. Between 1994 and 2002, the minimum foundation allowance increased from \$2,762 to \$6,500 per pupil. During that same period, the highest foundation allowance increased from \$10,294 to \$11,754. The ratio of highest to lowest foundation allowance dropped from nearly 4 to 1 to less than 2 to 1 in eight years.

Since FY02, the minimum foundation allowance has increased slowly, growing from \$6,500 in FY02 to \$7,204 in FY08, an increase of 10.8 percent in six years. This growth was not sufficient to cover the increased combined costs in employee health insurance, retirement contributions and general pay increases, forcing most districts to cut programs to achieve the savings needed to fund these costs or to use fund balances to augment revenues.

## The Outlook for FY08 and Beyond

Spending reductions, especially in General Fund programs, have been dramatic. Generally, these changes can be regarded as permanent reductions in the spending base, as relentless cyclical and structural forces continue to exert pressure on the budget. The consensus economic forecasts being used by state policymakers for FY08 and FY09 reflect declining em-

ployment and rising unemployment. On a calendar year to calendar year basis, employment is expected to drop 1.9 percent in 2008 and 0.8 percent in 2009. Employment levels are expected to begin improving slightly toward the end of 2009. The average unemployment rate is forecast to increase from 7.2 percent in calendar 2007 to 8.2 percent in 2008 and 8.7 percent in 2009. This economic outlook is the state version of a recession, at least for 2008. Employment declines and declining real disposable personal income will result in shrinking the Michigan economy at least through the first half of 2009. If the national economy slips into a recession, the outlook for Michigan would be even worse.

Structurally, the budgets for both the General and School Aid Funds continue to reflect expenditure pressures exceeding revenue growth. General Fund revenues in FY09, including resources resulting from diversions of statutory revenue sharing, are projected to decline \$53 million, partly as a result of the Earned Income Tax Credit income tax cut. The projected increase in School Aid Fund revenues in FY09 is \$504 million, but about two-thirds of the increase is committed to offset the loss of property tax revenues associated with personal property tax relief enacted as part of the new Michigan Business Tax. The resulting per pupil revenue increase is not sufficient to cover the increased cost pressures in a typical district.

The financial condition of the State has deteriorated to the point that reserves are exhausted and cash-flow problems threaten the State's ability to make payments on a timely basis. The scenarios presented in this analysis essentially would maintain the current weak position only if the actions taken to balance budgets in future years avoid reliance on one-time revenues and creative accounting changes that would further weaken the State's cash position.

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## Endnotes

<sup>1</sup> Michigan State government fiscal years begin on October 1 and extend through the following September.



## III. Economic Projections

Three alternative long-term illustrations of the state's economy were prepared for this report using the Regional Economic Models Incorporated (REMI) Michigan model maintained by the W.E. Upjohn Institute for Employment Research. The model generates long-run trend projections of future economic performance in the Michigan based on specific assumptions regarding key economic variables. Because of the longer time horizon of the projections, it is not a suitable vehicle to estimate the impacts of short-range business cycle movements. Specific short-term adverse economic impacts resulting from business cycle variations are not explicitly factored into the projections generated by the model. Therefore, the current national economic slowdown caused by housing market disruptions and the tightening of credit markets – lower consumption and residential construction – is assumed to be short-term in nature and will be offset by subsequent expansionary periods during the 10-year projection period.

The model's projections provide the economic foundations necessary to estimate future State revenue growth. These revenue projections also depend on certain underlying assumptions with respect to Michigan's two major state tax categories, personal income and consumption. Both personal income tax and consumption tax receipts will be determined, to a large extent, by components of these projections, such as Michigan's future population growth and personal income growth. Other measures from the economic projections that will be useful in projecting revenue growth include disposable personal income and pay-

rolls. The projections also highlight, indirectly, some of the spending pressures facing the State's budget in the future. For example, the projections provide the means to estimate changes in federal cost-sharing under the Medicaid program, which will affect future General Fund requirements.

All three scenarios are long-term in nature. Whereas the State of Michigan currently relies on economic projections to predict short-term state economic activity and tax revenue receipts (i.e., usually for the next 18- to 24-month period), the REMI model takes a longer view of the State's economic landscape with a general "smoothing" of business cycle ups and downs. The model begins with certain assumptions regarding the performance of the national economy. From there, varying assumptions are made regarding large sectors of Michigan's economy to produce three separate economic projections.

While the REMI model was employed to produce three separate projections (both economic and population) for this analysis, the moderate growth scenario is being used to illustrate the future fiscal challenges facing Michigan policymakers. It is important to note, at the outset, that the projections do not account for the impacts that a prolonged national economic downturn would have on the health of Michigan's economy. All three scenarios have to be viewed in light of the absence of such an occurrence through FY 17. Should one occur, the three illustrations would likely change significantly.

### Employment Statistics

It is important to point out the definition of employment used in this analysis and the data source, as there are significant differences between the major state employment metrics developed by the federal government. REMI uses the annual data series developed by the U.S. Department of Commerce, Bureau of Economic Analysis (BEA) as opposed to the more commonly used figures generated by the U.S. Department of Labor, Bureau of Labor Statistics (BLS). Neither data set can be viewed as "better" than the other. The major difference between the two is one of definition, specifically the treatment of military jobs and the self-employed. The BEA data includes federal military jobs, whereas the BLS data does not, and BEA data incorporate a much higher estimate of the self employed. To illustrate the magnitude of these differences, consider the Michigan employment estimates for 2006. BEA reports 5,549,900, and BLS shows 4,341,100, a difference of 1,208,800.

## National Projections

All three statewide projections are based on the same national projections, which calls for the national Gross Domestic Product (GDP) to grow at an average 2.7 percent annual rate during the projection period 2007 to 2017. During this period:

- Employment is projected to increase by 0.9 percent per year, which is slightly below the nation's population growth of 1.0 percent per year, due to the aging baby boomers retiring and living longer. Overall productivity is projected to increase by 1.8 percent annually.
- Manufacturing employment is projected to decline by 1.3 percent per year. Moreover, employment nationwide in motor vehicle production is projected to drop by 2.8 percent annually because of increased productivity gains in the sector. In other words, even if Michigan automakers were successful in maintaining market share, employment in the auto industry would decline during the period.
- Employment growth is concentrated in the following service sectors: health care, which will account for 29 percent of net employment growth and result from the aging baby boomer cohort; business administrative services, 14 percent; leisure and hospitality, 11 percent; government, 11 percent; and, private educational services, 8 percent. Most of these activities are population-driven, which suggests that the nation's employment growth will continue to follow demographic shifts to the nation's southern and western states.
- Finally, the national projections call for the nation's growth to be more and more service-based. Much of this growth will be population driven, based on consumer expenditures and health care expenditures. Nevertheless, the services portion of the nation's exports is expected

**Table III-I**

**Summary of National Projections, 2007 to 2017**

	<b>Annual Growth</b>
Total Employment	0.9%
Total GDP (real dollars)	2.7%
Total Labor Productivity - Non Farm	1.8%
Personal Income (nominal dollars)	5.1%
Population	1.0%
<b><u>Components of GDP</u></b>	
Total Consumption	2.9%
Total Fixed Investment	4.5%
Residential	1.6%
Non-Residential	2.2%
Producers Durable Equipment	6.7%
Total Exports	5.0%
Total Imports	5.6%
Total Government	1.2%
<b><u>Employment</u></b>	
Construction	0.6%
Manufacturing	-1.3%
Motor Vehicle Manufacturing	-2.8%
Retail Trade	0.6%
Professional, Technical Services	1.0%
Management of Companies, Enterprises	-0.4%
Administrative, Support Services	2.1%
Educational Services	3.2%
Health Care	2.8%
Social Assistance	2.9%
Leisure and Hospitality	1.3%
Government	0.7%

to continue to grow as well.

This national projections (the details of which are summarized in **Table III-I**) were used as the basis for the alternative projections for the State's economy.

# MICHIGAN'S FISCAL FUTURE

## 2007 UAW Labor Agreement

The future effects of the 2007 United Auto Workers (UAW) contracts with the Detroit automakers are not included in the economic projections presented here. Details about how these contracts will affect wages and employment levels in Michigan's automotive manufacturing sector specifically, and other manufacturing sectors generally, are unknown at this time; however, they are likely to have noticeable and measurable impacts. The historic contracts, which, among other things, created two-tiered wage schedules, will substantially lower wages in the auto industry. The new wage schedules will impact the projections of Michigan personal income presented in each scenario, in effect lowering the growth rates. CRC is unable to quantify the effects that these contracts will have on personal income growth in the future.

The new contracts also shift responsibility for retiree health care from the auto manufacturers to the unions through the establishment of Voluntary Employee Beneficiary Associations (VEBAs). Combined with the financial effects of changing to a two-tiered wage schedule, the VEBA's will make the Detroit car companies much more competitive by reducing their cost disadvantage with foreign automakers. The improvement in the domestic automakers' competitive position vis-à-vis overseas car makers' could stem the loss of jobs projected in this report, specifically those in auto manufacturing. All three economic projections reflect significant yearly job losses in the sector (3.0 percent, 7.3 percent, and 13.2 percent, respectively). It is unlikely that the new UAW contracts will change fundamentally the direction of future employment levels; however, they may moderate the losses through 2017. The three scenarios do not take into consideration the effects that new UAW agreements will have on key components of Michigan's economy prospectively.

## Michigan Projections

Three separate projection scenarios were prepared for Michigan's economy using alternative assumptions about the performance of the state's auto industry and other major export-based industries, including chemicals and office furniture. Assumptions are also made regarding Michigan's employment in research and development.

Tables III-2 and III-3 present the assumptions used in each of the scenarios. In the high growth scenario, the state's auto industry retains its 2007 share of the U.S. auto market, estimated at 53.4 percent. In addition, employment in the State's office furniture industry is assumed to increase by 1.0 percent a year. Employment in the chemical industry, including pharmaceuticals, would hold steady, and there would be a 0.5

**Table III-2**  
Annual Market Share Assumptions, 2007 to 2017

	<u>Low Growth</u>	<u>Moderate Growth</u>	<u>High Growth</u>
Michigan Auto Manufacturers	-2.8%	-1.4%	0

**Table III-3**  
Selected Employment Annual Growth Assumptions (Non-Automotive), 2007 to 2017

<u>Industry</u>	<u>Low Growth</u>	<u>Moderate Growth</u>	<u>High Growth</u>
Office Furniture	-1.0%	0.0%	1.0%
Chemicals	-3.0%	-1.5%	0.0%
Research & Development	-0.5%	0.0%	0.5%

## The REMI and RSQE Models

The State of Michigan relies, in large measure, on the economic forecasts produced by the University of Michigan's Research Seminar in Qualitative Economics (RSQE) to estimate state economic activity and tax revenue generation. The RSQE annually produces seven forecasts of the US economy and four specific to the Michigan economy. Michigan state government fiscal experts use these forecasts, specifically those from November and March, to predict short-term performance of the national and state economies. These predictions then drive the official State General Fund and School Aid Fund revenue projections for the current fiscal year and the succeeding fiscal year. Through a revenue estimating consensus process, these projections become the bases for both the Governor's budget recommendation (February) and the final budget negotiations (May), in advance of the beginning of the next fiscal year.

The REMI model, on the other hand, generates long-range economic trend forecasts. For the purposes of this report, the model was employed to test the hypothesis of whether the structural budget problems facing Michigan over the past seven years would be alleviated over the next 10-year period given certain assumptions about the national economy (e.g., 2.7 percent annual growth in GDP) and state economic activity. The three long-term state forecasts developed have to be viewed in light of the major assumptions underlying each economic scenario. Furthermore, short-term volatility in the business cycle is assumed to be offset by subsequent expansionary periods over the forecast period under the REMI model, whereas in the RSQE model these business cycle movements are fully incorporated into the economic forecasts generated by state fiscal analysts.

With respect to future state revenue collections, this report relies upon the official State of Michigan revenue forecasts for FY08, past trend analysis, and the REMI economic forecasts to illustrate possible future revenue performance. All current tax policy is reflected in the analysis, such as the planned phase-out of the recent Personal Income Tax increase and the implementation of the Earned Income Tax Credit, but the report does not make any assumptions about future tax policy.

The revenue and spending scenarios presented here are designed to provide the reader with a sense of the nature and size of the future fiscal challenges facing Michigan policymakers. These scenarios are not to be interpreted as predictions of future state budgets, as the Michigan Constitution requires the Legislature to pass a balanced budget each year and it is assumed that this provision will be met during the forecast period.

percent annual increase in research and development employment.

Under the moderate growth scenario, the state's automakers' market share drops by 1.4 percentage points a year, falling to 39.4 percent in 2017. Employment in the office furniture industry and research and development remain unchanged, while employment in chemicals declines by 1.5 percent per year.

In the low growth scenario, the state's automakers' market share falls by 2.8 percent a year to 25.4 percent in 2017, and employment falls in the state's other major base industries by the factors listed in **Table III-3**.

**Appendices A through C** contain the full results for all three economic projections produced by the REMI model.

## High Growth Scenario

In the high growth scenario, employment in Michigan is projected to grow at only 0.5 percent each year, nearly half of the national rate. Although the state's auto producers retain market share in this scenario, the sector's employment still falls by 3.0 percent annually as a result of steady gains in productivity over the period. The decline pulls manufacturing employment down by 1.9 percent on an annual basis, despite a growing office furniture industry. The decline in manufacturing, in combination with stagnant population growth, contributes to a lack of employment growth in the state's retail sector.

Other major sectors of the state's service-providing industries gain employment during the decade, including a 2.5 percent annual increase in health care employment. Jobs in the leisure and hospitality sectors grow, albeit at a very slow rate.

# MICHIGAN'S FISCAL FUTURE

**Table III-4**

**Summary of Economic Growth in the High Growth Scenario, 2007 to 2017**

	<u>2007</u>	<u>2017</u>	<u>Annual Growth</u>
<b><u>Employment (1,000s)</u></b>			
Total Employment	5,491.5	5,758.7	0.5%
Manufacturing	673.4	553.3	-1.9%
Motor Vehicle Manufacturing	221.1	162.5	-3.0%
Retail Trade	631.4	640.3	0.1%
Health Care	495.6	637.4	2.5%
Finance, Insurance, Real Estate	405.0	426.7	0.5%
Leisure and Hospitality	492.8	545.8	1.0%
State and Local Government	601.7	599.6	0.0%
Personal Income (Dollars in Millions)	\$381.7	\$603.5	4.7%
Salaries and Wages (Dollars in Millions)	\$210.4	\$328.4	4.6%
Total Gross Regional Product (Billion 2000\$)	\$366.8	\$448.7	2.0%
Population (1,000s)	10,093.7	10,324.7	0.2%

## Moderate Growth Scenario

Under the moderate growth scenario, state employment declines at the modest rate of 0.1 percent annually during the 10-year period. Manufacturing employment is dragged down by a large 7.3 percent annualized loss in the state's auto industry. Manufacturing's large multiplier effect ensures that retail employment in the state also dips into negative territory.

Employment in the health care industry remains positive, growing at a 2.4 percent annualized rate. Although Michigan's population remains flat during the period, the 65 year and older cohort grows substantially, adding to employment gains in health care. Michigan also will realize very small employment gains in the leisure and hospitality industries.

Personal income in the state grows at a moderate rate,

**Table III-5**

**Summary of Economic Growth in the Moderate Growth Scenario, 2007 to 2017**

	<u>2007</u>	<u>2017</u>	<u>Annual Growth</u>
<b><u>Employment (1,000s)</u></b>			
Total Employment	5,491.5	5,453.8	-0.1%
Manufacturing	673.4	469.4	-3.5%
Motor Vehicle Manufacturing	221.1	104.1	-7.3%
Retail Trade	631.4	604.2	-0.4%
Health Care	495.6	629.7	2.4%
Finance, Insurance, Real Estate	405.0	411.3	0.2%
Leisure and Hospitality	492.8	519.3	0.5%
State and Local Government	601.7	582.8	-0.3%
Personal Income (Dollars in Millions)	\$381.7	\$574.0	4.2%
Salaries and Wages (Dollars in Millions)	\$210.4	\$305.2	3.8%
Total Gross Regional Product (Billion 2000\$)	\$366.8	\$413.9	1.2%
Population (1,000s)	10,093.7	10,052.5	0.0%

4.2 percent annually (real personal income grows 2.3 percent), which is lower than the 5.1 percent annual rate experienced by the nation as a whole. As a result, Michigan will lose ground relative to the rest of the country as its proportion of total U.S. personal income declines almost 9 percent over the 10-year period, from 3.3 percent to 3.0 percent. The wage and salary component of personal income increases 3.1 percent annually under this scenario.

On a per capita basis, however, Michigan residents' personal income increases relative to the national average per capita figure, rising from 93.1 percent of the national per capita amount in 2007 to 94.6 percent in 2017. This occurs solely as a result of Michigan's slight population loss over the time period, whereas the U.S. population experiences continuous, annualized growth of 1 percent.

## Low Growth Scenario

In this scenario, total employment declines at a 0.6 percent annual rate, due in large measure to a 5.1 percent annualized decline in manufacturing (auto manufacturing employment falls 13.2 percent annually). In terms of the number of jobs, employment in the state's auto industry in 2017 is projected to be less than one-fourth (53,519) of the 2007 base (221,056).

Retail employment is dragged down by the loss of manufacturing jobs, a 0.3 percent annual decline in population, and sluggish personal income growth. Health care employment increases at a rate similar to the other two scenarios (2.3 percent per year) resulting primarily from the aging of Michigan's population and the increased demand for services provided by this industry.

**Table III-6**  
**Summary of Economic Growth in the Low Growth Scenario, 2007 to 2017**

	<u>2007</u>	<u>2017</u>	<u>Annual Growth</u>
<b><u>Employment (1,000s)</u></b>			
Total Employment	5,491.5	5,191.6	-0.6%
Manufacturing	673.4	398.2	-5.1%
Motor Vehicle Manufacturing	221.1	53.5	-13.2%
Retail Trade	631.4	582.7	-0.8%
Health Care	495.6	622.9	2.3%
Finance, Insurance, Real Estate	405.0	398.2	-0.2%
Leisure and Hospitality	492.8	496.9	0.1%
State and Local Government	601.7	566.7	-0.6%
Personal Income (Dollars in Millions)	\$381.7	\$548.5	3.7%
Salaries and Wages (Dollars in Millions)	\$210.4	\$285.4	3.1%
Total Gross Regional Product (Billion 2000\$)	\$366.8	\$384.7	0.5%
Population (1,000s)	10,093.7	9,793.4	-0.3%

## IV. Population Projections

In addition to the economic scenarios, the W.E. Upjohn Institute for Employment Research also generated demographic projections through its REMI model to assure that this report's economic and demographic long-term projections are internally consistent. Chapter III provides a description of the assumptions used to generate the national projection and the differences between the inputs used for the three alternative economic illustrations for Michigan. The Michigan population projections under each scenario are driven, in large measure, by the economic projection used for each scenario and Michigan's economic situation relative to that of other Great Lakes states.

A number of State programs are sensitive to population changes, especially in certain age groups. For example, State spending for education programs, such as K-12, is primarily population-driven. The amount of State dollars provided to K-12 school districts annually is based

on the total tax yield of specific taxes and the number of students enrolled in each district. Health care programs, such as Medicaid, will be directly affected by the aging of Michigan residents. Demographic projections also aid in estimating revenue yields for certain taxes, most notably personal income and consumption taxes. Consumer spending levels move in concert with a state's population, which in turn drive sales and use tax collections. Personal income tax receipts are dictated, in large measure, by the size of the traditional working-age population (16- to 64-year-old cohort). Also, an increase in Michigan's senior population (65 and older group) relative to the working-age population will affect income tax revenues, as the State does not tax a large portion of retirement income, particularly pensions.

**Appendices D through F** contain the full results for all three population projections produced by the REMI model.

### Census Projections Compared to REMI Projections

In 2004, the U.S. Census Bureau issued population projections through 2030 based on the 2000 Census. The Census Bureau's projections, and any series of population projections for that matter, are based on estimated survival rates and net migration in and out of the state, with the latter being the most difficult to predict. The volatility associated with the level of net migration can significantly alter population projections across the various sources.

Whereas both the Census and the REMI models are based on specific assumptions for survival rates and migration patterns, the REMI model introduces another dynamic, as it allows for different statewide economic variables. Changing these variables will further affect estimates of future migration patterns. Census figures consider only recent state-specific trends in domestic and international migration. REMI takes into account the effects that various economic assumptions will have on these migration patterns. Specifically, changes in Michigan's relative position in terms of labor and production costs will affect employment opportunity in the state. For example, a lowering of Michigan wage rates relative to other states will make the state less attractive to economic migrants. However, at the same time, if these lower wage rates attract new employers, the resulting increase in employment opportunities will have a positive impact on economic migrants. The REMI model forecasts these economic effects by occupation group, e.g. professional workers, health care workers, manufacturing workers, etc. The three sets of population projections presented correspond with the three economic forecasts for Michigan over the next 10 years.

Annually, the Census Bureau produces state population estimates for the current year and revises previous estimates. Working from the 2007 Michigan population estimate as the base year, the CRC applied the annual growth rates associated with the Census Bureau's 2004 projections (2007-2017) to arrive at an updated Census data set for the period 2007 through 2017. As can be seen in the table below, these projections are most similar to the REMI model's high growth scenario, but differ substantially from those generated under the middle and lower growth scenarios, with the key difference being the lack of growth in the REMI scenarios. Again, the major difference between the Census and REMI figures lies in the methodologies employed. REMI incorporates economic variables and their effects on net migration, whereas Census does not.



**Table IV-1**

**Michigan Population Projections - U.S. Census Bureau compared to REMI, 2007 to 2017**  
(Populations in Thousands)

	<u>2007</u>	<u>2017</u>	<u>Change</u>	<u>Percentage Change</u>	<u>Annual Growth</u>
U.S. Census	10,071.8	10,411.2	339.4	3.4%	0.3%
REMI-High	10,093.7	10,324.7	231.0	2.3%	0.2%
REMI-Middle	10,093.7	10,052.5	-41.2	-0.4%	0.0%
REMI-Lower	10,093.7	9,793.4	-300.3	-3.0%	-0.3%

Source: U.S. Department of Commerce, Census Bureau, 2007 State Population Estimates. [www.census.gov/popest/states/tables/NST-EST2007-01.xls](http://www.census.gov/popest/states/tables/NST-EST2007-01.xls).

## High Growth Scenario

Under the high growth scenario, Michigan is projected to gain 231,000 residents, or 2.3 percent, over the 10-year period (see **Chart IV-1**). This growth occurs steadily over the projection timeframe. The 65 and older population cohort grows substantially between 2007 and 2017, as this group increases by almost 32 percent, or 416,500 individuals. The school-age population (5- to 17-year-olds) experiences the largest percentage loss (11.4 percent). As a result of these projected changes, the composition of Michigan's population will look markedly different in 2017 than it does today. The 65 and older population group will be larger than the school-age population group in 10 years. The ratio between the two groups will go from 1.4 school-agers to 1 senior in 2007 to 0.9 to 1 in 2017. The population group that makes up the vast majority of the

labor force (16- to 64-year-olds) will decline by 69,000 (see **Table IV-2**).

Under this scenario Michigan will continue to lose a portion of its share of the national population over the 10-year period at about the same annual rate that it lost population share during the past 10-year period. Michigan's share of the U.S. population fell 0.7 percentage points each year between 1996 and 2006 according to U.S. Census Bureau figures, for a total of 6.7 percent points. Michigan's proportion of the U.S. population will decline from 3.3 percent in 2007 to 3.1 percent in 2017, or a total of 7.6 percent over the 10-year period. This loss will affect the amount of federal funding distributed to the State of Michigan for programs based on states' relative populations (e.g., transportation, economic development).

**Table IV-2**

**Summary of Population Projections in the High Growth Scenario, 2007 to 2017**  
(Populations in Thousands)

<u>Selected Age Groupings</u>	<u>2007</u>	<u>2017</u>	<u>Change</u>	<u>Percentage Change</u>	<u>Annual Growth</u>
5 to 17	1,794.3	1,589.2	-205.1	-11.4%	-1.2%
18 to 24	977.7	924.9	-52.8	-5.4%	-0.6%
16 to 64	6,683.7	6,614.7	-69.0	-1.0%	-0.1%
65 and older	<u>1,310.8</u>	<u>1,727.3</u>	416.5	31.8%	2.8%
Total Population*	10,093.7	10,324.7	231.0	2.3%	0.2%

\* Groupings do not sum to Total because some age groups are not included here.



## Moderate Growth Scenario

The moderate growth projection produced by the REMI model shows Michigan's population declining slightly to 10,052,500 residents by 2017. However, between 2007 and 2014, the population steadily declines to about 10,035,000 residents before rising each year thereafter through 2017 (see **Chart IV-1**). The rebound from the previous years' population losses beginning in 2015 is attributable to improvements in Michigan's economic situation that began two years earlier in 2013. By 2013, total employment in the state under the corresponding economic projection begins a reversal of the previous years' downward direction and starts rising. As a result, Michigan is expected to gain population, however at very low levels.

The REMI model assumes that Michigan's wage and production costs, relative to those of other states, will fall during the years preceding the rebound in population. As these costs fall, Michigan will become a more attractive place for firms to locate and/or expand and hire more workers, causing an increase in employment levels. Despite the turn around in employment, Michigan's total employment in 2017 is still 38,000 jobs below the level of 2007.

Similar to the high growth scenario, the largest percentage decline in population occurs in the school-age cohort, which falls 1.5 percentage points annually. As a percentage of total Michigan residents, the school-age group (5- to 17-year-olds) will decrease from 18 percent in 2007 to 15 percent in 2017 (see **Table IV-3**).

The 65 and over age group grows substantially, by almost 3 percent annually. By 2017, the percentage of Michigan residents age 65 and older will increase from its present 13 percent to 17 percent. As a result of the shifts at both ends of the population spectrum, the 65 and older age group will be larger than the school-age cohort at the end of the 10-year period. The ratio between the school-age group and the 65 and older group goes from 1.4 to 1 in 2007 to 0.9 to 1 in 2017 (the same as the high growth scenario).

Under this scenario, the traditional higher education student population group (18- to 24-year-olds) will decline almost 1 percent annually, or about 9 percent between 2007 and 2017.

The 16- to 64-year-old cohort (traditional working-age group) is projected to decline by 4 percentage points, losing 261,900 individuals. The annual decline mirrors the corresponding economic scenario that projects a decline in total employment (-0.7 percent), primarily in the manufacturing sector (autos specifically). This change is significant to Michigan's fiscal future because the two groups at the opposite ends of the population spectrum, under-16 and 65 and older, are primarily non-working and will pay less in terms of state taxes over the period. As the working age population declines (from 66 percent to 64 percent of the total), fewer workers (and therefore State income taxpayers) will be available to fund government programs and services provided to residents in the two "non-working" cohorts (under-16 and over-64). At the same time, seniors tend to cut their con-

**Table IV-3**  
**Summary of Population Projections in the Middle Growth Scenario, 2007 to 2017**  
**(Populations in Thousands)**

<u>Selected Age Groupings</u>	<u>2007</u>	<u>2017</u>	<u>Change</u>	<u>Percentage Change</u>	<u>Annual Growth</u>
5 to 17	1,794.3	1,537.5	-256.8	-14.3%	-1.5%
18 to 24	977.7	894.1	-83.6	-8.5%	-0.9%
16 to 64	6,683.7	6,421.8	-261.9	-3.9%	-0.4%
65 and older	<u>1,310.8</u>	<u>1,723.2</u>	412.5	31.5%	2.8%
Total Population*	10,093.7	10,052.5	-41.2	-0.4%	0.0%

\* Groupings do not sum to Total because some age groups are not included here.

sumption of taxable goods and services in retirement, further driving down sales and use tax receipts. With respect to spending, this shift in population will exacerbate the spending pressures in Medicaid, certain human services programs, and other programs directed at the aging population.

The state's share of the projected United States population also continues to fall under this scenario, but at a moderately faster annual rate (-1.05 percent) than the experience over the preceding 10 years (-0.7 percent). Michigan's share of the country's total population will decline from 3.3 percent to 3 percent in 2017.

### Low Growth Scenario

Under this assumption, Michigan's population declines steadily during the 10-year period at an annual rate of

0.3 percent. This projection is consistent with Michigan's economic performance during the projection timeframe. Unlike the moderate growth scenario, total employment falls each year during the low growth scenario. The shift in the composition of the state's population is the same as the two cases described above, with the 65 and older age group growing and the school-age population leading the population loss, at least in percentage terms. Overall, there are 300,000 fewer residents in Michigan in 2017 under this scenario.

Not surprisingly, Michigan's share of the national population falls the fastest under this scenario, declining 0.4 percentage points, from 3.3 percent in 2007 to 2.9 percent in 2017. This represents a total change of -12.4 percent or -1.3 percent annually on average (nearly double the annual rate of decline during the previous 10 years, -0.7 percent).

**Table IV-4**  
**Summary of Population Projections in the Lower Growth Scenario, 2007 to 2017**  
**(Populations in Thousands)**

<u>Selected Age Groupings</u>	<u>2007</u>	<u>2017</u>	<u>Change</u>	<u>Percentage Change</u>	<u>Annual Growth</u>
5 to 17	1,794.3	1,487.9	-306.4	-17.1%	-1.9%
18 to 24	977.7	865.9	-111.7	-11.4%	-1.2%
16 to 64	6,683.7	6,238.8	-444.9	-6.7%	-0.7%
65 and older	<u>1,310.8</u>	<u>1,719.1</u>	408.3	31.2%	2.7%
Total Population*	10,093.7	9,793.4	-300.3	-3.0%	-0.3%

\* Groupings do not sum to Total because some age groups are not included here.

# MICHIGAN'S FISCAL FUTURE

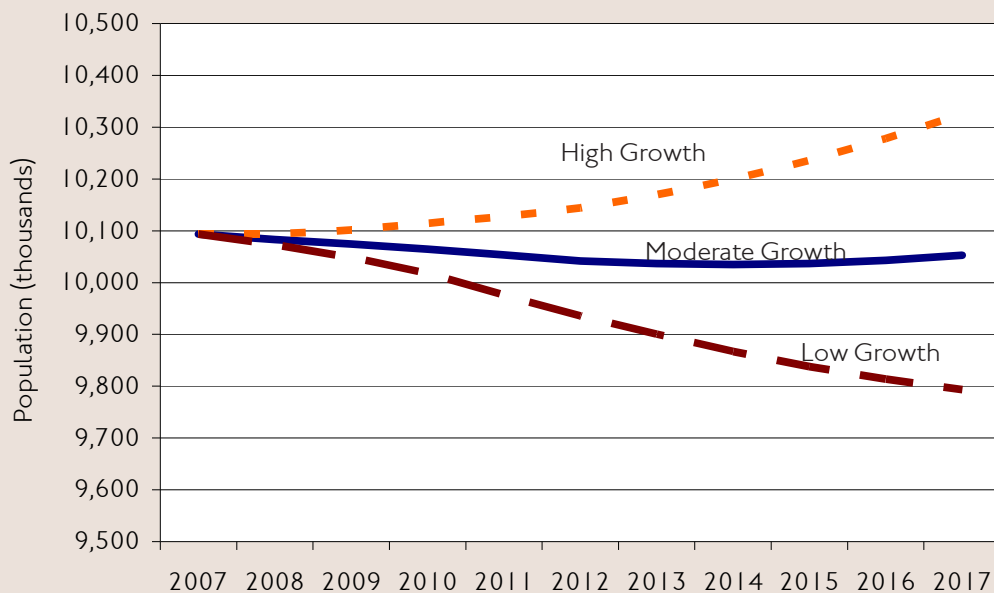
## Scenarios Used to Analyze Michigan's Fiscal Future

The estimates of Michigan's fiscal future are based on the moderate growth scenarios, both economic and population. The performance of key economic variables under these scenarios shows a marked improvement over their performance during the past seven years. Similarly, the projections of future revenue growth show improvement over the experience since Fiscal Year 2001 (FY01). The difference between the

The estimates of Michigan's fiscal future are based on the moderate growth scenarios, both economic and population.

State government revenue performance under the moderate growth scenario and that of the other two scenarios, is equivalent to about 1 percentage point annually, positive or negative. The population projections presented here differ from those of the U.S. Census in one significant way. The REMI model captures the effects that Michigan's economic performance will have on migration patterns, whereas Census relies on historical patterns. The moderate growth scenario estimates that Michigan's population will remain basically flat.

Chart IV-1  
Summary of Population Projections, 2007 to 2017



## V. Michigan's Revenue Structure and Projections

In Fiscal Year 2008 (FY08), the State of Michigan budget is predicated on receipt of about \$43 billion. Approximately 30 percent of this revenue will come from the federal government and the remainder from state and local sources, mostly state taxes and fees.

Most revenues are restricted for specific uses either by the federal government, Michigan Constitution, or Michigan statute. Revenues with no restriction as to their use are deposited into the General Fund for general purpose uses. General Fund-General Purpose (GF-GP)<sup>1</sup> revenues may be used for any state governmental purpose and represent a little over one-fifth of projected FY08 revenues. It is the GF-GP portion of the state budget that has experienced the greatest stress during Michigan's budget crisis over the last seven years. To a similar but lesser degree, K-12 programs supported by School Aid Fund revenues have had to be cut to deal with spending pressures that outpaced revenues.

This report concentrates on the budgets supported by three major state funds: the General Fund, School Aid Fund, and Michigan Transportation Fund. Each of these funds depends heavily on state taxes for their revenues and is reliant on the Michigan economy to produce the activity to generate the tax revenues.

The General and School Aid Funds share revenues from some major taxes, while transportation programs receive earmarked revenues related to transportation activity. Transportation revenues are covered in the Chapter XIV.

The revenues supporting the General Fund and School Aid Fund spending come predominately from state taxes. In FY07, taxes totaled \$18.9 billion, 88 percent of total revenues to these funds. Of the total tax revenues, 96 percent were accounted for by six major taxes: four of which were shared by the two funds. Those six taxes include the Personal Income, Sales, Use, Single Business (now Michigan Business), Tobacco, and State Education taxes.

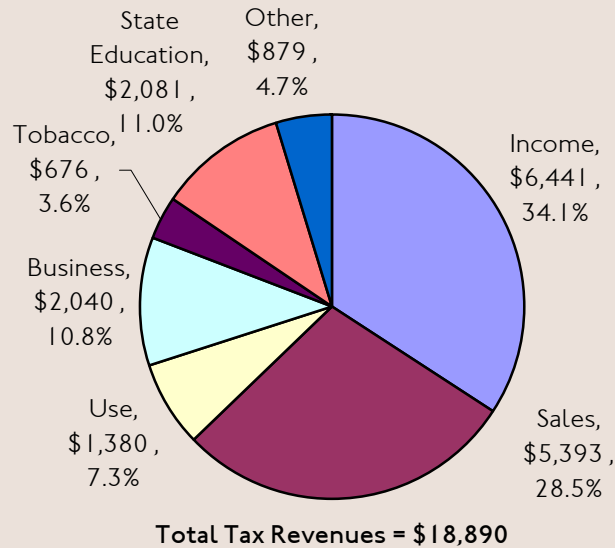
The performance of the major taxes has been dismal since FY00. Revenues from the Personal Income and business taxes (Single Business Tax [SBT] and Insurance) declined over the seven-year period (2001 to 2008), largely as a result of cuts in the Personal Income Tax and SBT rates (see **Table V-1**). Tobacco tax revenues increased only because of tax rate increases, and revenues from the Sales and Use Taxes increased very slowly. Significant Sales Tax revenues earmarked by state statute for unrestricted state revenue sharing were diverted to augment overall GF-GP revenues.

**Table V-1**  
**Changes in General Fund-General Purpose and School Aid Fund Tax Revenues, FY00 to FY07**  
**(Dollars in Millions)**

	<u>FY00</u>	<u>FY07</u>	<u>Total</u> <u>Percent</u> <u>Change</u>	<u>Annual</u> <u>Rate of</u> <u>Change</u>
Personal Income	\$ 7,101	\$ 6,441	-9.3	-1.4%
Sales	4,726	5,393	14.1	1.9%
Use	1,349	1,380	2.3	0.3%
Single Business	2,515	2,040	-18.9	-2.9%
Tobacco	536	676	26.0	3.4%
State Education	1,381	2,081	50.6	6.0%
Other	<u>1,085</u>	<u>879</u>	-19.0	-3.0%
Total	\$18,693	\$18,890	1.0	0.1%

# MICHIGAN'S FISCAL FUTURE

**Chart V-1**  
**General Fund-General Purpose and School Aid Fund Tax Revenue, FY07**  
 (Dollars in Millions)



Other taxes in the aggregate declined by \$206 million, largely as a result of the elimination of the Estate Tax, which was piggybacked on the Federal Estate Tax eliminated by the U.S. Congress. Only the State Education Tax (6-mill state property tax), dedicated to the School Aid Fund, kept pace with spending pressures, growing 6 percent per year.

The connection between Michigan's economy and the State government's tax structure has weakened since the late 1990s. As a consequence, the growth in revenues from the major taxes has lagged behind general measures of the Michigan economy. Three measures of the economy often used to help predict tax revenues are total personal income, disposable personal income, and total payrolls. Total personal income is the total of all sources of income for all individuals in the state. Disposable personal income is personal income minus taxes. Total payrolls are the wages and salaries before taxes paid to individuals in the state. All three indicators have their limitations in measuring the overall performance of the economy, but one would expect the performance of taxes on income and consumption spending to exhibit similar rates of

change to the income measures, unless other factors are at play.

From FY00 through FY06, all three broad measures of Michigan income outpaced the growth in Personal Income Tax revenues (adjusted for rate reductions) and Sales and Use Tax revenues. Factors contributing to this situation include:

- Faster increases in the amount of the income tax personal exemption than in payrolls (because of indexing the exemptions to the Consumer Price Index [CPI]).
- Faster growth in income tax credits (e.g., homestead property tax credits) than income.
- Tax exempt pensions and retirement savings.
- Growth in Internet and catalog sales not subject to collection of use tax by sellers.
- Sluggish growth in goods purchases accompanied by faster growth in services purchases, which are largely not taxed.

Some of these factors will affect the growth in income and consumption taxes in the future. Pensions, which are mostly exempt from Michigan's Personal Income

**Table V-2**  
**Changes in Broad Income Measures and Consumption and Income Tax Revenues, FY00 to FY07**  
**(Dollars in Millions)**

	<u>FY00</u>	<u>FY07</u>	<u>Change</u>	<u>Percent Change</u>	<u>Annual Rate</u>
Personal Income	\$294,227	\$352,672	\$58,445	19.9%	2.6%
Disposable Personal Income	253,237	313,996	60,759	24.0%	3.1%
Payrolls	175,327	189,062	13,735	7.8%	1.1%
Personal Income Tax	6,556	6,441	-115	-1.8%	-0.3%
Sales Tax (GF-GP and School Aid only)	4,726	4,852	126	2.7%	0.4%
Use Tax	1,349	1,380	31	2.3%	0.3%

Tax, will likely grow at least 50 percent faster than sources of taxable income, due to the rapid projected increase in the senior citizen population. Pensions are not included in Personal Income in the income accounts of the economy when they are paid to individuals. Rather, they are reflected at the time the employer contributions are made to the pension fund. Because of this timing difference, the outlook for consumption taxes is somewhat stronger than that for personal income growth alone. The largest component of personal income is salaries and wages, projected to grow at an annual rate of 3.8 percent. By comparison, pensions are likely to grow about 6 percent.

The services sector of the Michigan economy has increased more rapidly than other areas for more than two decades. This is expected to continue as individuals spend an increasing share of their income on services and a lower share on goods. Since most services consumed by individuals are not taxed, the growth path for the Sales and Use Taxes will likely fall significantly below the growth in major income measures in the future.

Efforts have been going on for many years to capture Use Tax revenues from remote sellers of goods to Michigan taxpayers. Purchases on the Internet or from catalogs when the business does not have physical presence in Michigan are taxable, but the sellers are not required to collect the tax and Michigan taxpayers, although liable for the tax, seldom pay it. Currently, the likelihood of substantially increasing revenues from these remote sales is low without further action by the U.S. Congress.

Property Tax credits have had a significant negative effect on Personal Income Tax revenue performance since FY00. After increasing by less than \$100 million from FY95 through FY00 (to \$514 million), credits jumped by more than \$300 million from FY00 through FY05 (to \$840 million). The credits increased 10 percent per year on average, with about half of the increase accounted for by growth in the number of credits and the other half related to growth in the average credit per Income Tax return. The projection assumes that incomes will rise more rapidly than in the period since 2000, and this should reduce the adverse effect of credits on revenues in the projections.

Major changes in the tax structure made during FY07 will affect the revenues for FY08 and beyond. In August 2006, the SBT was repealed effective December 31, 2007. Replacement of the lost revenues was approved in June 2007 in a comprehensive business tax package resulting in the Michigan Business Tax (MBT). The package included a tax on business income, a tax on business gross receipts, the elimination of education taxes on personal property and credits for remaining personal property taxes, and an increase in taxes paid by insurance companies. The package approximately replaces the revenues lost by the SBT repeal.

In September 2007, two tax increases intended to cover most of a projected deficit for FY08 were approved. The increases included a 0.45 percentage point hike in the Personal Income Tax rate from 3.9 percent to 4.35 percent and new taxes at a 6.0 percent rate on selected services. The services tax was repealed in December

# MICHIGAN'S FISCAL FUTURE

2007 and replaced by a surcharge on the new MBT designed to raise nearly the same amount of revenue as the services tax.

Together the tax increases are projected to yield about \$1.2 billion in FY08 (partial year yield) and \$1.5 billion in FY09. All of the increased Personal Income Tax revenues are allocated to the General Fund. The MBT surcharge is divided between the General and School Aid Funds. The School Aid Fund's earmarked revenues from the MBT were increased by \$205 million and \$250 million for FY08 and FY09 respectively.

## The Revenue Outlook

The three economic scenarios each have different revenue outlook implications. The scenarios are not pre-

dictions of the performance of the Michigan economy, but rather illustrations of how the state economy would perform under a set of assumptions about the national economy and industries especially important to Michigan. The economic projections assume an uninterrupted period of national economic growth for the 10-year period. The revenue projections included in this report are based on the revenue structure defined by current law for FY08 and beyond.

Although the report concentrates on the moderate growth economic projections, the scenarios on either side of the moderate scenario convert to projected annual revenue increases that vary by about one percentage point. Three broad income measures for the moderate growth projections and recent years are included in **Table V-3**.

**Table V-3**  
Annual Rates of Change in Broad Michigan Income Measures, FY00 to FY06 and FY07 to FY17

	<u>FY00 to FY06</u>	<u>FY07 to FY17</u>		
	<u>Actual</u>	<u>Low Growth</u>	<u>Moderate Growth</u>	<u>High Growth</u>
Personal Income	2.6%	3.7%	4.2%	4.7%
Disposable Personal Income	3.1%	3.7%	4.2%	4.7%
Payrolls	1.1%	3.1%	3.8%	4.6%

**Table V-4**  
**Growth Rates in Major Taxes Used in Projections, FY09 to FY 17**

<u>Tax</u>	<u>Annual Growth Rate</u>
Personal Income	3.25%
Business	3.0%
Sales	3.0%
Use	3.0%
Tobacco	-2.5%
State Education	4.25%

To determine the projected growth rates for each revenue source, CRC compared the relationship between past changes in major economic indicators, including personal income and salaries and wages, and the performance of individual taxes and other revenue sources. Because such a high percentage of revenues is derived from six major taxes, most of the analysis of the relationships between the economy and the revenues focused on these taxes. **Table V-4** provides the projected annual growth rates for each major tax associated with the moderate growth economic forecast scenario.

The GF-GP and School Aid Fund revenue estimates for FY09 agreed to at the January 2008 Consensus Revenue Estimating Conference are used as the base for the revenue projections. The growth factors in **Table V-4** and growth factors contained in Appendices H and I for smaller revenue sources are applied to the FY09 revenues to generate the projections. The overall growth paths of General Fund and School Aid Fund revenues in the moderate growth scenario are equal (3.0 percent), before adjustments for future law

changes are factored into the calculations.

Two series of tax cuts are already in state law for FY09 and beyond. The first is a state Earned Income Tax Credit that will reduce revenues by \$134 million in FY09 and by \$300 million annually in FY10 and beyond. The second is the phase-out of the Personal Income Tax rate increase that begins in FY12 and is completed by FY16.

The phase-out of the 0.45 percentage point rate increase occurs in 0.1 percentage point increments with the final reduction of 0.05 percent occurring in FY16, returning the tax rate to 3.9 percent. The combined annual effect of the cuts, when fully implemented (FY16), is nearly \$1.4 billion or 10 percent of the GF-GP revenue base.

The tax cuts have the effect of reducing the already anemic annual growth rates in GF-GP revenues to below one percent in several years beyond FY10. Overall, the cuts reduce the average annual growth rate from 3.0 percent to 1.4 percent. With the tax cuts in place in state law, a relatively minor negative deviation in the perfor-

The overall growth paths of General Fund and School Aid Fund revenues in the moderate growth scenario equal (3.0 percent), before adjustments for future law changes are factored into the calculations.



# MICHIGAN'S FISCAL FUTURE

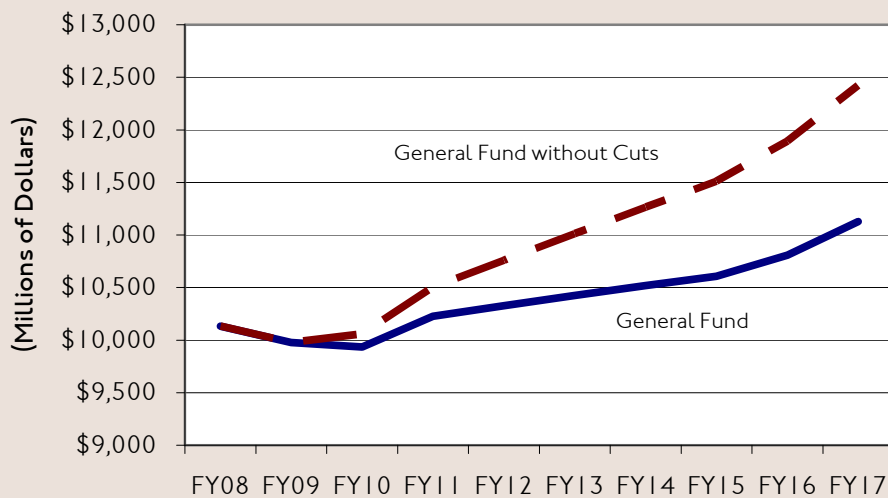
mance of the economy would cause year-to-year declines in GF-GP revenues (see **Chart V-2**).

The two largest areas of tax revenues for the General and School Aid Funds are the Personal Income Tax and the major consumption taxes (Sales and Use Taxes). Together they are expected to generate 71 percent of total tax rev-

enues to these two major funds. The performance of these major taxes will determine how well the revenue structure will be able to fund the spending pressures confronting the state budget. Further, these major taxes represent the best opportunities to restructure the tax system to increase the growth in revenues in the future.

The tax cuts have the effect of reducing the already anemic growth rates in GF-GP revenues to below one percent in several years beyond FY10.

**Chart V-2**  
Effects of Future Tax Cuts on General Fund Revenues, FY08 to FY17



## Endnotes

<sup>1</sup> The State of Michigan's principal operating fund is the **General Fund**, which is financed by *general purpose* and *special purpose* revenue. The difference between **General Fund-General Purpose** (GF-GP) and **General Fund-Special Purpose** (GF-SP) revenue is the degree to which the state Legislature has discretion in making appropriations. With GF-GP revenue, the Legislature may make appropriations for any government program or service from year to year, thus providing the Legislature the needed flexibility to meet the changing public demands and needs of the state. Most of this report deals with GF-GP programs for which the projected amount of available revenues are not sufficient to fund projected spending pressures.

On the other hand, because GF-SP appropriations are restricted by constitutional, statutory, or contractual provisions, the Legislature must appropriate GF-SP revenue for specific government programs or activities. Unlike special revenue funds (described below), separate funds are not established for GF-SP revenue. For example, Article IX, Section 10, of the Michigan Constitution requires a portion of the sales tax (15 percent of the original four percent sales tax revenue) to be used for state revenue sharing. However, all sales tax revenues restricted for revenue sharing are deposited in the state's General Fund. Two major non-General Fund programs are discussed in this report: school aid and transportation.

The State also has **Special Revenue Funds**. These funds include operating fund activities financed by special revenue sources that are legally dedicated or "earmarked" to a specific fund and activity. Therefore, unlike GF-SP revenue, special revenue funds are created for each government activity. Special revenue funds are not discussed in this report.

## VI. Michigan's Budget and Spending Pressure Projections

The State of Michigan budget totals \$42.8 billion in Fiscal Year 2008 (FY08). Projected spending is funded by a mix of resources, including federal revenues, state revenues, and to a small extent, local and private revenues (see **Chart VI-1**). This report focuses primarily on spending supported by two major funds within the budget, the general purpose portion of the General Fund and the School Aid Fund. Spending for unrestricted state revenue sharing payments to local government (cities, townships, villages, and counties) financed by the special purpose portion of the General Fund and for highways (Michigan Transportation Fund), are also covered in the report.

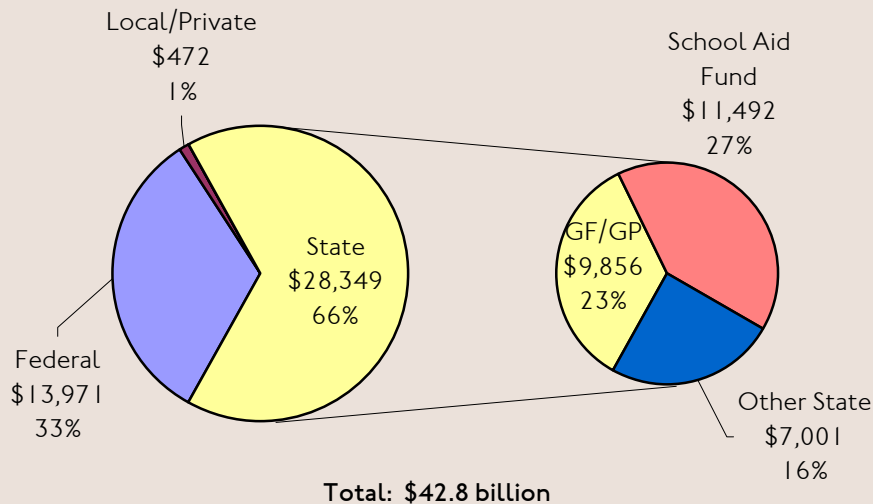
State payments from the School Aid Fund account for nearly two-thirds of all K-12 education spending in Michigan. In addition to its focus on the School Aid Fund, this report examines K-12 spending supported by local operating revenues and federal education grants as well (see **Chart VI-2**). Because local and state funds are used interchangeably to finance K-12 education operational costs, a broader perspective on spending provides a more complete picture of the ag-

gregate spending pressures facing K-12 education service providers.<sup>1</sup>

State spending differs from that of other governmental units (e.g. school districts, municipal governments) in that less than 20 percent of annual expenditures finance programs that the State operates itself and only approximately 11 percent of the total budget each year supports the compensation of state employees (this is a much lower percentage than in any other governmental sector in Michigan). The rest of the state budget (about 80 percent) supports programs operated by non-state government organizations including local public schools; community colleges and state universities; cities, villages, townships and counties; and for-profit and non-profit organizations providing services to clients of state programs (e.g., hospitals and community mental health boards).

Two areas of state spending stand out as structural problems: health care expenses and the Department of Corrections. In order of magnitude, health care is by far the larger of the two. It affects programs

**Chart VI-1**  
**State of Michigan Budget by Source and Fund, FY08**  
 (Dollars in Millions)



## Deficits Defined

Financial deficits can be classified either as cyclical or structural to reflect their causes.

**Cyclical deficits** are caused by a decline in the economy. Revenue performance worsens and some spending pressures increase, creating gaps between the cost of maintaining programs and the resources to pay for those programs. Unlike a business, which is adversely affected by a recession through lost customers and declining sales, the customers for state and local government programs expect the services to continue, even with declining revenues. Programs such as public K-12 education can expect essentially the same levels of enrollment, whether revenues are increasing or declining. Other programs sensitive to unemployment increases may experience an increase in the number of citizens requesting assistance at the same time governmental revenues are decreasing. When the economy improves, cyclical deficits tend to be self-correcting.

**Structural deficits** are caused when the inherent costs of maintaining programs and policies increase faster than revenues. Structural deficits persist even when the economy is performing well. Structural deficit pressures also exist when the economy is doing poorly and combined with cyclical pressures make balancing the budget even more difficult.

throughout the budget. When the state-funded share of health care spending by public school districts is added to other health spending, health care emerges as the largest cost area in the entire state budget. One of the challenges that confronted CRC in developing projections of future health care spending is that these expenditures are not budgeted for separately. Health care spending does not appear as a separate program area within the State budget, like Corrections or Medicaid. For this reason, approximations of health care spending had to be derived. In order to do so, this report partitions health spending from other expenditure centers, both in terms of state programs financed by the General Fund and K-12 education programs.

Health insurance premiums for working employees and health benefits for retirees together are the second largest compensation item next to salaries and wages in most state department and school district budgets. All of the recipients of state payments face pressures to fund health care costs for their employ-

ees and, in many cases, their retirees. The costs of health care have risen faster than revenues in the past seven years and are likely to outpace revenue growth into the foreseeable future, continuing structural budget imbalances even in an improving economy.

To a smaller extent, the Department of Corrections contributes to the fiscal challenges that the State will face during the projection period. It is the only state department, other than the Department of Community Health, which includes Medicaid, where General Fund spending was higher in FY07 than it was in FY01.

The Department of Corrections is the largest program the State operates directly. It employs nearly one-third of all state employees and over one-half of all state employees paid from General Fund revenues. Even though crime rates in Michigan have been falling for many years, prison populations have steadily increased until only recently, when policy changes helped stabilize the population.

## Spending Pressure Projections

The spending projections are structured into the major policy sections of the state budget. Specific treatment is given to those programs that have contributed significantly to budget increases over time, such as Medicaid and Corrections. Other, smaller programs are covered in a single section of the report. Also, funding for local schools is examined separately. For each area of the budget, current-law spending policy is projected, taking into account the effect that caseloads, school enrollments, prices, federal and state revenue limitations and match requirements, and other factors will have on total program costs.

This report projects that General Fund spending pressures will grow from \$10.1 billion in FY09 to \$17.1

billion FY17, an increase of 69 percent or 6.8 percent annually. This annual growth rate is not uniform across General Fund-financed programs, nor is it consistent each year during the projection period. Average annual growth rates range from 10.7 percent for Michigan's Medicaid program to 4.1 percent for most general government programs. This variation among programs results from the relative size and mix of the different cost components that make up each program.

Also, year-over-year changes in the General Fund spending pressures differ during the projection period, growing from 4.4 percent in FY09 to 7.6 percent in FY12 before declining to 7.0 percent in FY17. These different annual rates occur because of the different growth

rates applied to each program, and, to a lesser extent, because of the state employee salary increases scheduled for FY09 (0 percent), FY10 (1.5 percent), and FY11 (3.0 percent). From FY09 to FY17, the 6.8 percent average annual rate of growth is greater than the projected annual growth in state personal income over the period (4.2 percent) and well above estimated General Fund revenue growth per year under current-law tax policy (1.4 percent).

Separate analyses of specific K-12 spending projections are presented in Chapter VIII. For the purposes of this

report, K-12 education programs include services delivered by local public schools (traditional and charter) and intermediate school districts. Because compensation costs play a significant role in K-12 education spending each year (nearly

80 percent), they are, and will continue to be, the single largest contributor to the K-12 fiscal challenges facing public policymakers. Within the grouping of compensation costs, health care stands out as the major driver of future spending pressures, with annual growth rates ranging from 9.3 percent to 11.9 percent. These rates are more than three times the rate of expected revenue growth during the projection period (3.0 percent).

To arrive at annual growth rates for non-K-12 programs, spending pressures were calculated separately for major state General Fund programs, including Corrections, Medicaid, Department of Human Services, mental health services, and universities and community colleges, using FY08 appropriation levels as the base

This report projects that General Fund spending pressures will grow from \$10.1 billion in FY09 to \$17.1 billion FY17, an increase of 69 percent or 6.8 percent annually.

### Projections not Predictions

The estimated spending amounts contained in this report do not purport to be predictions of what the Legislature and Governor will agree to as funding levels of future state budgets or the final amount of funds to be allocated to specific program areas. This report makes very few assumptions about policy decisions regarding future discretionary spending. The figures presented here are intended to be reasonable projections of what current-law spending policies will look like if allowed to continue, unmodified, during the projection period FY09 to FY17. In this regard, the projections reflect a baseline or starting point for future spending policy decisions. The spending pressures are designed to illustrate the size of the challenges facing policymakers given the current mix of services and programs supported in the budget.

# MICHIGAN'S FISCAL FUTURE

## \$8 Billion in Stop-Gap Adjustments to Balance Michigan's Budgets

As has been noted earlier, the State of Michigan's budget has been lumbering under structural deficit pressures since FY01. While these deficits remained each year, policymakers have been able to meet their constitutional mandates of adopting (Article IV, Section 31) and maintaining (Article V, Section 20) balanced budgets each of the last seven fiscal years. Structural solutions, either on the revenue or spending side of the budget ledger, have been scarce. Instead, budget writers have relied almost exclusively on non-recurring adjustments to revenues and/or spending to maintain annual balance. On a yearly basis, budget-balancing efforts have avoided the requisite steps to bring on-going revenues into alignment with on-going spending, a hallmark of a structurally-balanced budget.

CRC estimates that a total of \$8 billion of non-recurring measures has been employed to achieve balance in the GF-GP and School Aid Fund budgets between FY01 and FY07. The FY08 budget, unlike those immediately before it, is void of such stop-gap measures as a result of the major tax increases enacted in 2007. The breadth and amount of these non-recurring adjustments varied considerably, as can be seen from the following examples:

- Rainy Day Fund surplus - \$1,400 million
- Combined FY00 General and School Aid Fund surplus - \$1,200 million
- Tobacco settlement securitization - \$800 million
- Temporary Federal financial assistance - \$650 million
- Medicaid Benefits Trust Fund - \$560 million
- Advance State Education Tax collection date - \$450 million
- County revenue sharing accounting change - \$180 million
- Delay August 2007 higher education payment - \$165 million
- Reduce required retirement system contributions - \$130 million

to develop future spending demands. The major drivers of future General Fund spending are identified in each of the major programs and addressed individually. Discussions of these programs are included in Chapters IX through XIII. This report uses a standard growth factor to project General Fund spending in other programs of the budget (Chapter XIV). This factor relies heavily on CRC's estimates of future employee compensation costs (Chapter VII), which are applied consistently across all state programs that employ state workers.

The final cost pressures for each area of the budget are compared to the revenue estimates of the funds that support each area. In each case, the disparity between projected spending in that area of the budget and available revenues is identified. To arrive at the annual structural deficit projections, CRC aggregates all spending pressures by funding source (e.g., General Fund, School Aid Fund, and transportation revenues) and compares these figures with total revenue estimates included in Chapter V.

**Table VI-1**  
**Summary of K-12 Education Structural Deficit: FY09 to FY17**  
**(Dollars in Billions)**

	<u>FY09</u>	<u>FY17</u>	<u>Dollar Change</u>	<u>Percent Change</u>	<u>Annual Growth</u>
Revenue	\$18.1	\$23.0	\$4.9	27.1%	3.0%
Spending Pressures	\$18.4	\$26.6	\$8.2	44.4%	4.7%
Structural Deficit	\$0.3	\$3.6			1.7%

**Table VI-2**  
**Summary of General Fund Structural Deficit: FY09 to FY17**  
**(Dollars in Billions)**

	<u>FY09</u>	<u>FY17</u>	<u>Dollar Change</u>	<u>Percent Change</u>	<u>Annual Growth</u>
Revenue	\$10.0	\$11.1	\$1.1	11.5%	1.4%
Spending Pressures	\$10.1	\$17.1	\$7.0	69.3%	6.8%
Structural Deficit	\$0.1	\$6.0			5.4%

## Structural Deficits Persist

Michigan has endured seven years of a dual deficit budget situation that plunged state finances into the worst crisis in more than 50 years. Cyclical and structural pressures have acted together to produce both deteriorating revenue performance and escalating spending pressures. Although the State has successfully balanced budgets in each of the last seven fiscal years, this has been accomplished by the use of reserves and through actions designed to minimize spending cuts. The fundamental issue of matching available on-going revenues with spending remains only partially addressed.

When the projections of spending pressures and revenues are combined, an increasing gap appears. Spending pressures in public K-12 education are projected to grow about 4.7 percent annually while revenues are projected to grow 3.0 percent per year. The gap of 1.7 percentage points amounts to about a \$300 million shortfall in system-wide resources in FY09 and a \$3.6 billion shortfall by FY17, when all revenues and spend-

ing are factored into the calculations (See **Table VI-1**). In the General Fund, revenue growth averages 1.4 percent per year. General Fund revenue growth is lower than School Aid Fund revenue growth because of tax cuts already in state law that pare the growth from a baseline rate of 2.8 percent. General Fund spending pressures are projected to grow 6.8 percent annually, leaving an average shortfall of 5.4 percentage points or about \$500 million in General Fund dollars annually (See **Table VI-2**).

Spending pressures in public K-12 education are projected to grow about 4.7 percent annually while revenues are projected to grow 3.0 percent per year. In the General Fund, revenue growth averages 1.4 percent per year. General Fund spending pressures are projected to grow 6.8 percent annually, leaving an average shortfall of 5.4 percentage points.

The magnitude of the structural deficits facing Michigan's policymakers is daunting. The calculations are made against an assumption of a continuously improving national economy. Departures from an environment of steady improvement in the

national economy will likely cause significant fluctuations for Michigan. Our state is ill-equipped to deal with downturns in the national economy: the combination of cyclical and structural deficits have taken a huge toll on Michigan's financial health and eliminated the reserves needed to weather another economic storm.

## Endnotes

<sup>1</sup> Currently, a single, complete, and consistent data set of total (state and local) K-12 spending and revenue does not exist, either at the state or the local level. CRC collected data from a number of sources to create a comprehensive set of fiscal information for all K-12 education programs statewide (e.g., traditional and charter public school districts, intermediate school districts). This collection relied on data from the Michigan Department of Education, the National Public Education Financial Survey, the Michigan Public Schools Employees Retirement System, and the Michigan Department of Treasury.



## VII. State Government and K-12 Employee Compensation

Employee compensation spending, unlike spending for programmatic areas such as Corrections, Medicaid, or education, is not a separate program supported by the State of Michigan budget. Instead, state spending for employee compensation cuts across all areas of the budget, including those distinctly identified in this report. Whereas multiple factors contribute to the future spending pressures in many areas of the State budget, compensation costs are the main driver for spending pressures in what is herein categorized as the “other” areas of the budget (as described in Chapter XVI). Because of the significance that personnel costs will have on Michigan’s future structural budget challenges, this topic is treated collectively in a single discussion rather than individually in the separate programmatic sections of the report. Further, employee compensation spending factors are very consistent across state programs because of the high degree of similarity among the various collective bargaining agreements between the State of Michigan and state employee unions.

### Background

Employee compensation plays a major role in budgets at nearly all levels of government. In the case of Michigan, the annual State budget directly supports employee compensation for the State government workforce as well as for K-12 education programs (local public school districts, public school academies, and intermediate school districts). The current fiscal relationship between the State and local education providers is largely the result of school finance reform in the mid-1990s, which transferred the financing responsibility of Michigan’s public K-12 education system from the local level to the state level. Since 1995, state tax revenues have provided the majority of support for K-12 spending (see Chapter VIII). Today, the State budget supports both current and retired state employees as well as current and retired local school employees.

In the aggregate, general purpose local governments are less dependent than local schools on direct state funding. Local governments generally rely less on direct state support and more on local property taxes to fund employee-related costs, but state policies and

laws significantly affect the structure of local government finances. Given the relatively minor role played by the State budget in local government compensation costs, this section focuses on employee compensation costs at the state and K-12 education levels only.

Employee compensation costs consist of wages and salaries, employer-paid taxes, and employer-financed fringe benefits. At the state level, these costs accounted for \$4.5 billion, or 11 percent, of total State of Michigan expenditures in Fiscal Year 2007 (FY07). Compared to other levels of government, this is a fairly small proportion. In the case of State government, close to 80 percent of the services supported by Michigan’s budget are actually delivered by organizations other than the State. The 11 percent figure is about average for the past 10 fiscal years.

Local K-12 educational service providers in Michigan, like those across the country, spend much of their budgets on employee compensation. In FY07, compensation costs for employees of 552 local school districts, 57 intermediate school districts, and 229 public school academies statewide accounted for almost 80 percent of total operating expenditures on K-12 education. Compensation costs exert the most pressure on local school budgets; greater than for State government.

Although K-12 programs and State government differ in terms of the significance that compensation costs play in total spending, both face many of the same spending pressures, currently and prospectively. At the state level in recent years, the growth in total spending on salaries and wages has risen, more or less, in concert with the growth in resources; however, much of this is attributable to declines in workforce levels. At the school level, total salary spending has declined in each of the last three years, FY05 to FY07. In contrast to salary and wage spending, the growth in spending on employer-paid benefits, particularly health insurance for current employees and retirement benefits (pension and health), has outpaced revenue growth substantially over the period FY01 to FY07. These benefit costs will continue to stress the budgets of local schools and State government between FY09 and FY17.



## State Government Employee Compensation

Today, the number of state employees is at its lowest level since the early 1970s. While this number has fluctuated over the last 35 years, it reached its peak in FY80 at just under 70,000 employees. The size of the state workforce declined in each of the last five fiscal years and was about 52,000 at the end of FY07. Despite the decline in employees, total classified employee compensation costs increased by 13 percent since FY01. On a per employee basis, however, total compensation (salaries and fringes) increased 30 percent over the same time. The reduction in the size of the state workforce has moderated the growth in total compensation costs statewide.

**Salaries and Wages.** Salaries and wages are the largest portion of state government's total compensation spending, \$2.9 billion in FY07. These costs are directly paid from various funding sources within the State budget. The General Fund supports about 60 percent of total compensation spending statewide (note: General Fund spending represented only 22 percent of the total spending by state government in FY07). Since FY01 the average classified salary increased by 21 percent, or 3.3 percent annually. This growth has out-

paced inflation, as measured by the Detroit Consumer Price Index (CPI), which rose 15 percent, or 2.3 percent annually over the same period.

Adjustments to the pay level for classified employees within the civil service system are set by the constitutionally-established Civil Service Commission. In December 2004, the Commission established pay adjustments for a three-year period, FY06 through FY08. Under the collective bargaining agreements negotiated between the Commission and the employee unions, classified employees receive pay increases every six months, beginning in October 2005 (the first month of FY06) under the schedule in **Figure VII-I**.

In December 2004, the Commission established pay adjustments for a three-year period, FY06 through FY08. Under the collective bargaining agreements negotiated between the Commission and the employee unions, classified employees receive pay increases every six months, beginning in October 2005 (the first month of FY06) under the schedule in **Figure VII-I**.

increases every six months, beginning in October 2005 (the first month of FY06) under the schedule in **Figure VII-I**.

The phased-in salary adjustments under the current agreements will result in a cumulative increase of 10.4 percent by the end of FY08, higher than the expected change in inflation over this period (7.8 percent). The salary adjustments equate to a 3.5 percent annual increase, again, substantially above the recent annual change in inflation.

Collective bargaining agreements covering the majority of state employees for the three-year period FY09

Today, the number of state employees is at its lowest level since the early 1970s. On a per employee basis, total compensation (salaries and fringes) increased 30 percent since FY01.

**Figure VII-I**  
**Pay Increases for State Classified Employees, FY06 through FY08**

<u>Date of Pay Increase</u>	<u>Fiscal Year Affected</u>	<u>Pay Increase</u>
October 2005	2006	1 percent
April 2006	2006	1 percent
October 2006	2007	2 percent
April 2007	2007	2 percent
October 2007	2008	2 percent
April 2008	2008	2 percent
<b>Cumulative 3-year Increase</b>		<b>10.4 percent</b>

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through FY II recognize the significance that employee compensation costs have on overall state spending. As a result, state employees will not receive a pay raise in FY09, but will receive a 1 percent increase in FY10 (October 1, 2009), and a 3 percent increase in FY11 (October 1, 2010). These adjustments have been factored into the spending projections contained in this report.

Article XI, Section 5 of the 1963 Michigan Constitution allows the Legislature, by a two-thirds vote, to reject or reduce the salary increases approved by the Civil Service Commission. Legislative action to reject or reduce the negotiated pay raises must occur within 60 days of the Governor's presentation of the State budget, which occurs in early February most years. The Legislature has avoided using this mechanism as a tool to balance the budget in recent years. The Legislature will be able to exercise this authority following the Governor's submission of the FY10 bud-

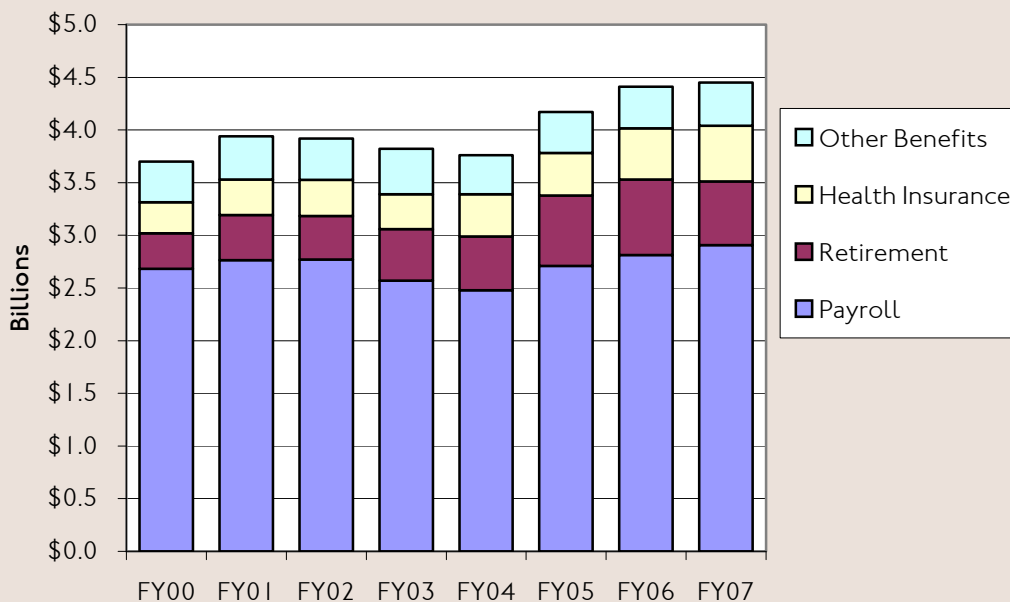
get, the next year in which a scheduled pay raise is to occur.

**Fringe Benefits.** Of the \$4.5 billion in total compensation costs (salaries and fringes) in FY07, the State of Michigan spent about \$1.5 billion on fringe benefits for its current and retired employees. This included payments for various group insurances (health, dental, vision, life), retirement contributions (defined benefit and defined contribution plans), and retiree health benefits.

Of the \$4.5 billion in total compensation costs in FY07, the State of Michigan spent about \$1.5 billion on fringe benefits for its current and retired employees.

During the period from FY01 to FY07, total classified compensation grew at an annual rate of 2 percent (See **Chart VII-1**). This growth was driven almost exclusively by the rise in spending on fringe benefits, as total spending on salaries grew at a very low annual rate (0.8 percent). Total spending on fringe benefits grew at a

**Chart VII-1**  
State of Michigan Classified Employee Compensation, FY00 to FY07



Source: Department of Civil Service, various Annual Workforce Reports.

## Constitutional Provisions Regarding Retiree Health Care Benefits

Article IX, Section 24 of the Michigan Constitution establishes the “accrued financial benefits” of each public pension and retirement system in the State as a contractual obligation thereof and prohibits state and local governments from diminishing or impairing these benefits. Further, Section 24 requires public pension and retirement systems to fund the financial benefits earned on account of services rendered in the fiscal year in which they were earned. Section 24 has been interpreted by the Michigan Court to apply only to pension benefits, and not to other retirement benefits, such as health care, that might be earned by employees during their time working for the State or local governments.

In *Musselman v. Governor*, 448 Mich 503; NW2d 237 (1995), the Michigan Supreme Court ruled that health care benefits do not constitute “accrued financial benefits” as the term is used in Section 24. The issue in *Musselman* was whether the Governor (Engler) had the budget-cutting authority to reduce state contributions intended to prefund retiree health care benefits. The Court affirmed the executive power to effect cuts related to funding health care benefits. In effect, the Supreme Court ruled that health care benefits are not protected by the Constitution from diminishment or impairment in the way that pension benefits are protected.

Section 24 does not prevent the State or local governments from modifying or diminishing pension benefits prospectively. It applies only to “accrued financial benefits,” or, in other words, benefits earned for services already rendered. Therefore, governments in Michigan are able to change pension plans and retirement systems to affect benefits earned in the future or by future employees; however, the State and local governments are unable to diminish or impair those benefits already earned.

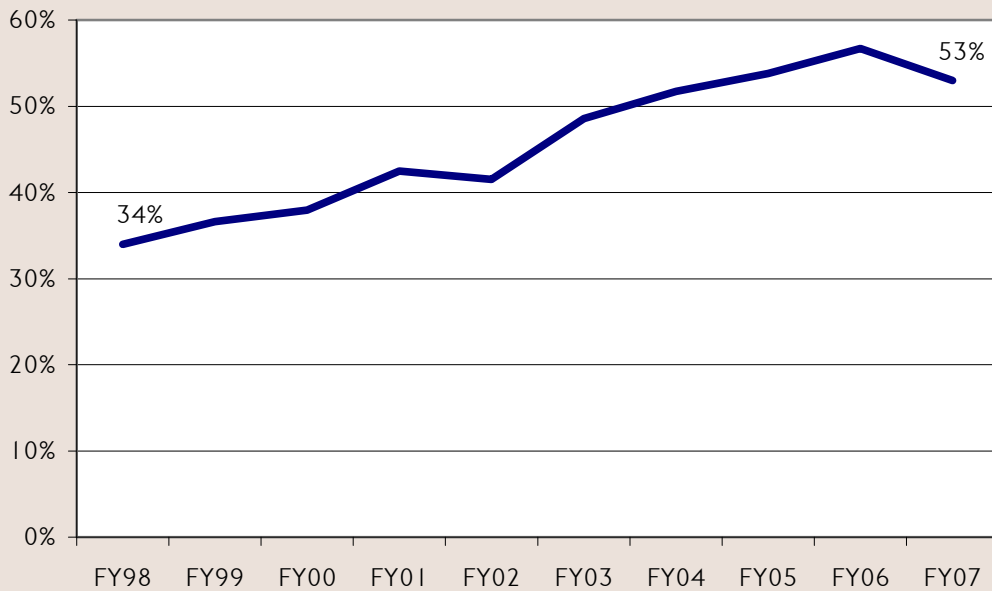
rate of 4.7 percent annually. The modest growth rate for total fringe benefit spending occurred despite a 15 percent (over 9,200 employees) reduction in the size of the state workforce over this period. Much of this reduction is attributable to an early retirement program offered to employees in 2002. Fewer state workers helped absorb the escalating spending pressures associated with the salary increases previously mentioned. Growth rates on a per employee level were much greater.

Per employee fringe benefit costs have risen 52 percent since FY01. Average employer-paid benefits rose from \$18,180 in FY01 to \$27,559 in FY07 according to data from the Department of Civil Service. Combined

with an average salary figure of \$51,929, the average total compensation package for classified employees in Michigan State government was nearly \$80,000 in FY07, compared with \$61,000 in FY01, a 30 percent increase. Whereas the significant reduction in the size of the state workforce helped to moderate the growth rate of total benefit spending, per employee rates do not reflect the impacts associated with a shrinking state workforce. Total fringe benefit spending is expected to grow more rapidly during the projection period because this report assumes a flat, rather than a contracting, state workforce.

Since FY98, fringe benefit costs, measured as a percent of base payroll (total payroll less fringe ben-

**Chart VII-2**  
Employee Benefits as Percentage of Base Payroll, FY98 to FY07



Source: Department of Civil Service, various Annual Workforce Reports.

efits), have risen steadily (See **Chart VII-2**). Total fringe benefit costs represented 53 percent of base payroll statewide in FY07, up from 34 percent in FY98. Growth in these costs reflects increases in health insurance premium costs for current and retired employees and higher retirement contribution rates, resulting from stock market declines in the early part of the decade and the rising number of retirees.

By far, health and retirement benefits are the largest portion of the employee benefit costs paid by state

By far, health and retirement benefits are the largest portion of the employee benefit costs paid by state government, accounting for 73 percent of the total in FY07 (\$1.1 billion).

government, accounting for 73 percent of the total in FY07 (\$1.1 billion). These costs have risen rapidly in the past six years, with health insurance expenditures increasing 56 percent from FY01 to FY07, or 7.7 percent annually. As a percentage of base payroll, employer-paid health insurance rose from 12 percent to 18 percent. In aggregate, the State spent nearly \$530 million for health benefits for its current employees in FY07.

On a per employee basis, employer-paid health insurance has nearly doubled over the six-year period, from \$5,500 to \$10,200.

## Reporting and Accounting for OPEBs

Many employees of the State and local governments in Michigan (including local schools) earn, as part of their compensation, benefits that will not be received until after their employment with government ends. The most common of these benefits is a pension. In addition, many governments allow employees to earn other postemployment benefits (OPEBs) during their working years. These benefits generally take the form of health insurance and other healthcare benefits (e.g., vision, dental, prescription). In most cases, the benefits are available to both the retiree and beneficiaries of the retiree.

Pension benefits and OPEBs are financed in one of two ways. *Actuarial financing* requires that the employer set aside a sufficient amount of money as these benefits are earned to finance benefits during retirement. Money set aside is invested so that earnings can contribute to the ultimate cost of the benefits. Pension benefits are financed on an actuarial basis. Conversely, most governments use a *pay-as-you-go* approach to finance OPEBs. Under this method, retiree benefits are financed with resources allocated through current budgets.

Governmental accounting standards established in 1994 provided guidance as to how pension benefits should be accounted for and reported in governmental financial statements. The standards did not address OPEBs. For the most part, governments have traditionally reported the cash outlays for OPEBs each year, but not the total employer costs associated with the future benefits earned by employees. The difference between these numbers can be quite large. In the case of the State Employees Retirement System, the State spent \$364 million on retiree health benefits in FY07, but the total long-term obligation of these benefits was valued at \$8.2 billion at the end of the fiscal year. The State had only \$60 million in assets to satisfy these obligations. Although these benefits represent long-term financial obligations of government, accounting standards have not required their inclusion in financial reports, making it difficult for readers of such reports to ascertain the true long-run financial health of government.

In 2004, governmental accounting standards were developed to address financial reporting and accounting for OPEBs, effectively requiring governments to treat the annual costs of these benefits in the same manner as for pensions. It is important to note that the standards will not require Michigan governments to finance these benefits. The OPEB plans covering State employees and local school employees have reported this information for some time. The

In addition to paying for health benefits for current state employees, the State budget finances health benefits for retired employees. These costs are financed on a cash or pay-as-you-go basis and, unlike the pension benefit, are not advance-funded. Thus, these retiree health benefits must be paid from current State budget resources rather than from a pool of funds that was accumulated while an employee was working for the

State. As health care costs and the number of state retirees have risen, so has spending for retiree health benefits. In FY07, the State spent \$364 million to pay for the health benefits promised to its former employees and their beneficiaries, nearly 50 percent more than it did in FY01 (\$248 million). The State spent \$8,000 per retiree/beneficiary in FY07 for health care benefits.

In FY07, the State spent \$364 million to pay for the health benefits promised to its former employees and their beneficiaries, nearly 50 percentage points more than it did in FY01 (\$248 million).

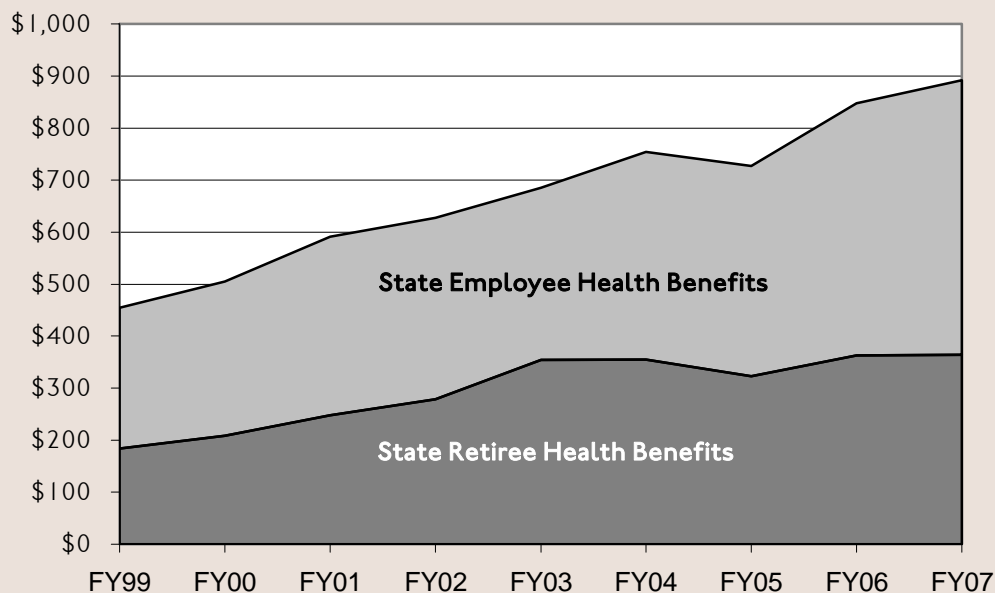
# MICHIGAN'S FISCAL FUTURE

Because the State does not pre-fund retiree health care, the unfunded liability associated with these future benefits has risen 22 percent from \$6.7 billion in FY00 to \$8.2 billion in FY06. Data from the 2006 actuarial report for the State Employees Retirement System revealed that in order to pre-fund this liability over 30 years and to finance the cost of current benefits, the employer contribution in FY06 should have been 22.0 percent of payroll, rather than the 12.2 percent

rate that was included in the budget.

Total spending for current and retired state government employee health benefits approached \$900 million in FY07, nearly twice the amount spent in FY99 (\$454 million). Spending for retiree health benefits grew at a similar annualized rate as expenditures for health insurance for current employees (8.9 percent and 8.7 percent, respectively) since FY99 (See **Chart VII-3**).

**Chart VII-3**  
**Costs for Active and Retired Employee Health Care, FY99 to FY07**  
**(Dollars in Millions)**



## School Employee Compensation

Whereas compensation costs for Michigan state government represent about 11 percent of total spending, these costs accounted for nearly 80 percent of total K-12 education (local public districts, intermediate districts, and public charters) spending in FY07.

**Salaries and Wages.** Salaries, about \$9.1 billion statewide in FY07, represent the largest portion of local K-12 expenditures. FY07 was the third straight year that the aggregate wages paid by Michigan schools declined, after peaking in FY04 at \$9.4 billion.<sup>1</sup> The decline was the result of retirements, combined with fiscal constraints that prevented schools from adding

staff. The number of teachers in Michigan public K-12 schools declined by almost 4,200 between FY03 and FY06. As a result of these recent declines in personnel, total wages paid by Michigan public K-12 programs from FY01 to FY07 increased only 4.5 percent, or less than 1 percent annually.

**Fringe Benefits.** In FY07, total employee fringe benefit costs for all public schools in Michigan were nearly \$4.6 billion. Similar to Michigan state government, costs for group insurances (mainly health insurance) and retirement benefits account for the largest portion of the total employer-paid benefits in K-12 education, about 85 percent or \$4 billion in FY07. In contrast to the slow growth in payroll expenditures, fringe

## The Switch to a Defined Contribution Plan for State Employees

In 1997, the State of Michigan established a new 401(k) defined contribution plan to replace its defined benefit pension plan for all new employees hired after March 31, 1997. This plan was also made available, for a limited time, to current State employees covered under the pension plan who wished to switch over to the new 401(k) plan. Under a defined benefit plan, the employer is required to set aside an actuarially-determined amount of money for current employees (reflected as a percent of covered payroll) and invest these funds in a manner that provides sufficient future resources to finance the pension benefits promised to these employees. Under a defined contribution plan, the employer establishes individual retirement accounts for eligible employees and may provide a contribution (either directly, in the form of a match, or both) to these accounts. Accounts are managed by the employees, with the level of retirement benefits determined, in large part, by the mix of investment instruments selected and the performance of the investment portfolio.

One goal of the State of Michigan in making the switch from the pension plan to the 401(k)-type plan was to stabilize contribution rates. The new defined contribution plan for State employees limits the maximum employer contribution to 7 percent of each employee's salary, regardless of market performance.

The shift to the new system also moved the investment risk associated with retirement benefits from the State to individual employees. By doing so, the State budget was effectively disconnected from the year-to-year fluctuations in investment returns. Investment returns that do not meet actuarial assumptions often can result in increased future employer contribution rates, i.e., a larger percentage of covered payroll, in order to meet funding requirements. Michigan's defined benefit system confronted this reality in the early part of the decade when actual annual investment returns were negative, as opposed to an assumed positive 8 percent.

Concurrent with the switch to the 401(k) defined contribution plan, the State of Michigan made changes to the way in which State employees earn OPEBs. Similar to the retirement plan switch, these changes applied only to new employees hired after March 31, 1997. For employees covered under the old defined benefit plan, the State subsidizes a specific portion of the premium costs for retiree group insurances (e.g., health at 95 percent, dental and vision at 90 percent) after 10 years of service. For those employees covered under the new defined contribution plan, the level of State subsidy for OPEBs is contingent on the number of years of service. After ten years of State employment, the State subsidy for health, dental and vision insurance is 30 percent of the premium cost. Each year thereafter, the State picks up another 3 percent of the insurance cost, up to a maximum of 90 percent after 30 years of service. As a result of the OPEB switch, State employees will have to work 30 years to earn approximately the same State subsidy that those employees under the defined benefit plan earn with just 10 years of service with the State of Michigan. Over the long term, the State budget will realize savings as a result of the switch in the way OPEBs are earned by State employees.



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benefit spending increased 50 percent from FY01 to FY07, or 7 percent annually. This annual growth surpassed the growth rate of total operating spending (2.5 percent) over the six-year period. Group insurance benefits, again primarily health insurance for current employees, increased by over 65 percent, or 8.7 percent annually, during the FY01 to FY07 period.

Fringe benefit spending increased 50 percent from FY01 to FY07, or 7 percent annually.

Spending to satisfy retirement contributions (pension and health) rose significantly from FY01 to FY07 (60 percent) and contributed to the rise in total fringe benefit costs at the K-12 school level. Contributions for pension benefits rose more rapidly than those for retiree health, 11.4 percent compared to 3.6 percent annually. The marked increase in pension contributions was fueled primarily by poor investment returns in the state-administered pension funds in 2001 and 2002. The

retirement investment portfolios in each of these years failed to achieve the returns originally assumed, thereby requiring higher contributions in subsequent years to ensure that actuarial requirements were met. Total pension contributions rose from \$532 million in FY01 to just over \$1 billion in FY07.

The growth in annual spending for retiree health was moderated through the use of reserves, which resulted in the contribution rate (as a percent of payroll) for local school districts rising from 5.55 percent in FY01 to 6.55 percent in FY07. Reserves were used to augment contributions each year from FY04 to FY06, which aided in efforts to control the growth of the contribution rate. Total retiree health care spending for K-12 education programs increased from \$483 million to \$595 million between FY01 to FY07. The retiree health contribution rate in FY09 will rise to 6.81

## Michigan's Public School Pension Program

The State of Michigan administers 5 public pension plans, including one that covers public school teachers. The Michigan Public School Employees Retirement System (MPSERS) is the largest public employee retirement system in the state, providing pension and health care benefits to retired employees and their eligible dependents.<sup>1</sup> Pension benefits are financed on an advance funding basis while the health benefits are on a cash disbursement basis. In both cases, these benefits are funded by employer contributions expressed as a percentage of active employee payrolls. The Office of Retirement Services, Department of Management and Budget annually determines these rates.

Prior to the implementation of Proposal A in 1995, the State of Michigan and public school districts shared in the financing of the employers' shares of contributions to MPSERS. After Proposal A was approved, full responsibility for financing the employers' contributions passed to the school districts. Under the new finance system, the level of financial support provided to local schools was intended to provide sufficient resources for local school districts to pay for MPSERS contributions.

As of September 30, 2007, the number of participants in the health plan was 121,804. As of year-end FY06, the unfunded actuarial accrued liability associated with the accrued health care benefits earned by current and retired employees totaled \$24.8 billion. The health plan was funded 2.5 percent at the end of FY06.

In contrast to the funding status of future health benefits provided to MPSERS members, future pension benefits were funded 81.2 percent at the end of FY06, an improvement over the FY05 level (79.3 percent). The unfunded actuarial liability associated with the pension benefits totaled \$9.2 billion in FY06 (total assets of \$39.9 billion), down from \$10 billion in FY05 (\$38.2 billion in assets). Since FY97, pension benefits have been funded at a level of 80 percent or greater, with the sole exception of FY05. On the other hand, the health care benefits have been funded at a level less than 10 percent each year since FY90, and was funded 1.1 percent in FY01.

MPSERS provides benefits to employees in all local school districts, intermediate school districts, public community colleges, 7 state universities, 57 public school academies, and 11 public library organizations. As of September 30, 2007, the system had 473,827 members (active and retired).

percent and grow each year thereafter until FY 17 when it is expected to reach 12.91 percent of payroll, based on calculations made by CRC.

To date, there has been no pre-funding of retiree health care benefits. K-12 education providers are responsible for paying for current retiree health care benefits with current budget resources, much the same way that the State of Michigan does for its former employees. For the most part, retiree health costs are satisfied by state dollars provided via the annual foundation allowance. In FY07 these costs were roughly \$595 million, up 23 percent from FY01 levels. On a per student basis, these costs equated to over \$350. On a per retiree/beneficiary level, K-12 schools spent, on average, \$4,400 in FY07 for these health benefits.

While K-12 education service providers are required to support retiree health care costs from their current operating revenues, they have little control over these costs. Benefit levels and eligibility criteria are set by the State, not local school officials. Schools have little recourse when presented with the requirement to finance these benefits. One popular response by schools has been the use of early retirement programs. These programs allow schools to reduce payroll by replacing more senior employees with less experienced, lower paid employees. As a result, the employer's "out of pocket" expenses are reduced with the retirement of employees because the retirees' health benefits are now spread across the system as a whole (i.e., all employers in the retirement system).

## Future Outlook

State and public school employee compensation costs will increase each year during the projection period. These spending pressures will be driven largely by employer-paid fringe benefits, especially health care. While governments can influence the annual increases in salaries and wages through collective bargaining, they have less control over the spending pressures associated with employer-paid fringe benefits, such as health benefits (for current and retired employees) and pension benefits. The costs of providing promised

benefits is contingent on factors such as stock market performance, the number of eligible retirees, the amount of health care consumed by current and retired public employees, and the cost of health care in general. These factors can be influenced only marginally by elected officials in Lansing. Given the significance of these costs, health insurance and retirement costs will continue to be major drivers of the structural deficit problems facing schools and the State of Michigan during the projection period.

State and public school employee compensation spending pressures will be driven largely by employer-paid fringe benefits, especially health care.

## Policy Provisions that May Affect Projections

Implementation of a defined contribution plan in lieu of the current defined benefit plan for local school employees could influence the spending projections included here. Presumably, this would apply only to new hires as of a specific date, as opposed to retroactively to all school employees. Such a change would likely mirror the change made to the state defined benefit plan in 1997. In the long-term, such a switch could result in savings to the State School Aid Fund through reduced pension contributions. However, initially, the switch would result in additional costs to the State of Michigan in order to ensure sound, actuarial funding of the defined benefit system.

Public Act 110 of 2007 changed the way new local school employees earn other post employment benefits (OPEBs). Now they receive future benefits contingent on the number of years worked (graded benefit), similar to the way new state employees earn benefits. Implementation of the graded retiree health care benefit will result in savings when these new employees retire; however, the changes do not affect savings in the near-term. This is especially true because the State does not pre-fund the school retiree health care benefit (see Chapter VIII for more information on these recent modifications).

## Spending Pressure Projections

**Table VII-1** (on page 37) lists the compensation cost factors used in the development of future spending pressures for both the State of Michigan's General Fund-General Purpose budget and local schools'

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**Table VII-1**  
Average Annual Compensation Growth Factors, FY09 to FY 17

<u>Component</u>	<u>State of Michigan</u>	<u>K-12 Schools</u>
Salaries and Wages	3.2%	3.3%
Employee Health Care	9.0%	9.3%
Pension Benefit	3.2%	3.3%
Retiree Health Care	10.0%	11.9%
Other Group Insurances	3.0%	3.3%
Total	4.8%	5.1%

budgets. These factors were applied to the spending bases for FY07 to project spending pressures, by year, for the period FY09 to FY 17. Calculations were then made to arrive at an annual growth rate for compensation spending for both state government and K-12 education programs.

### State Employee Compensation

To project future spending demands, this analysis takes into account the collective bargaining agreements for state employees approved for FY09 through FY 11. For the remainder of the projection period (FY 12 to FY 17), state classified payroll is assumed to rise 3.5 percent annually, a figure that takes into account pay increases, longevity and step improvements, and the effects of employee turnover. Over the FY09 to FY 17 period, the average annual growth rate in salaries is assumed to be 3.2 percent, or \$63 million each

Annual health care costs, for both current and retired employees, are projected to increase 9 percent and 10 percent, respectively.

year. After the cumulative effect of these increases, total General Fund spending for salaries will be \$541 million higher in FY 17 than it was in FY09 (\$1.9 billion). **Table VII-2** lists the projected General Fund spending pressures related to each compensation component for FY09 and FY 17. One important assumption in this

analysis is a constant state workforce level and the absence of early out retirement programs that would result in a net reduction of state workers.

Annual health care costs, for both current and retired employees, are projected to increase 9 percent and 10 percent, respectively. These rates of increase are consistent with past trends and reflective of general inflationary pressures. Further, the factor applied to current employee health care costs (9 percent) takes into account the effects that recent state em-

**Table VII-2**  
State General Fund Compensation Spending Pressures, FY09 to FY 17  
(Dollars in Millions)

<u>Component</u>	<u>FY09</u>	<u>FY17</u>	<u>Total Change</u>
Salaries and Wages	\$1,858	\$2,400	\$541
Employee Health Care	383	764	381
Pension Benefit	160	206	47
Retiree Health Care	263	563	300
Other Group Insurances/Fringes	263	336	73
<b>Total</b>	<b>\$2,927</b>	<b>\$4,351</b>	<b>\$1,342</b>

ployee collective bargaining agreements will have on state spending pressures. Under these agreements, the employee share of the annual health care premium will increase from 5 percent to 10 percent for those enrolled in the state health plan and from 0 percent to 5 percent for employees covered by the state's HMO. Changes in health programs offered to both current and retired employees by the state could affect these rates of increase substantially.

In the aggregate, General Fund retiree health spending will more than double from \$263 million in FY09 to \$563 million in FY17. This projection reflects current policy and does not assume future expenditures to amortize existing or potential unfunded liabilities for retiree health care benefits, estimated at \$7.5 billion as of the end of FY06. Efforts to begin funding these liabilities would add substantially to the spending pressures facing the State's General Fund budget.

This report assumes stable pension contribution rates during the projection period. Total annual retirement contributions covered by the State (both defined benefit and defined contribution programs) will rise in concert with total annual salary spending (3.2 percent). Various factors, almost all of which are outside of the Legislature's control, could increase or decrease retirement costs by hundreds of millions of dollars in any given year. Strength or weakness in the equity mar-

kets could cause General Fund costs to be higher or lower in the future. In total, this analysis estimates that the General Fund spending pressures associated with pension contributions will rise from \$160 million in FY09 to \$206 million in FY17.

In FY07, 60 percent (\$2.7 billion) of the total compensation costs (\$4.5 billion) for Michigan state government

employees was funded by the General Fund, with the remainder funded through restricted State and Federal dollars. The total General Fund spending pressures associated with compensation for current and retired state employees will rise to \$4.3 billion in FY17, based on the component increases described above and the cur-

rent distribution of costs among the various funding sources. Overall, this increase represents a 4.8 percent average annual growth rate, which will be over three times as large as projected annual General Fund revenue growth (1.4 percent).

**School Employee Compensation.** At the local school level, salary costs rise as a result of negotiated raises and step improvements. Unlike the projection for the state workforce, this analysis assumes that the overall increase in K-12 payroll levels will be moderated to some extent by employee attrition caused by declining student enrollments (1.4 percent annually). One half of the annual decline in student population (0.7 percent) is assumed to result in decreased compensation

Overall, spending pressures associated with compensation for current and retired state employees represents a 4.8 percent average annual growth rate, which will be over three times as large as the projected annual General Fund revenue growth (1.4 percent).

# MICHIGAN'S FISCAL FUTURE

spending pressures, i.e., fewer employees. Taken together, these factors will result in salaries and wages rising 3.3 percent annually during the FY09 to FY17 period. **Table VII-3** lists the projected compensation spending pressures for FY09 and FY17.

Health care spending will drive the overall rise in compensation spending, with retiree health care spending growth (11.9 percent) outpacing current employee health care expenditure growth (9.3 percent). School retiree health projections, like those made for the State, assume that current policy will continue with regards to funding the unfunded liabilities associated with these future benefits. The growth rate for retiree health contributions increases due to the ever-increasing cost of health care, as well as the assumed increase

in the number of individuals becoming eligible for the benefits (3 percent annually). The increase in school retirees is consistent with the REMI model's population projections for the over-65 age cohort (2.8 annualized growth).

In the aggregate, local schools spent \$13.7 billion on compensation (salaries and fringes) in FY07. Using the assumed growth factors described above, it is estimated that K-12 programs statewide will spend \$14.4 billion in FY09 and that this figure will grow to \$21.4 billion by FY17, representing an annualized growth rate of 5.1 percent. Because of the significant role compensation costs play in local school budgets, they will be the main cause for continued structural budget imbalance during the projection period.

**Table VII-3**  
**K-12 Compensation Spending Pressures, FY09 to FY17**  
**(Dollars in Millions)**

<u>Component</u>	<u>FY09</u>	<u>FY17</u>	<u>Change</u>
Salaries and Wages	\$9,454	\$12,258	\$2,804
Group Insurances	2,667	5,432	2,765
Pension Benefit	920	1,193	273
Retiree Health Care	644	1,583	939
Other	<u>723</u>	<u>938</u>	<u>215</u>
Total	\$14,408	\$21,403	\$6,995

**Options to Control Future Cost Pressures.** Future compensation spending pressures will be driven primarily by health benefits for current and retired employees. Efforts to pre-fund a portion of promised health benefits for retirees, at both the State and local school level, will relieve some of the long-term upward pressures on future budgets associated with unfunded liabilities. Recent changes in government accounting standards require units to measure and report the unfunded liabilities associated with promised retiree health benefits, something that the State of Michigan has been doing for its major retirement systems for some time. The changes do not require funding of these benefits, but they do require governments to reflect these long-term liabilities on their financial books, if left unfunded.

A number of tools are available to address future retiree health care cost pressures facing the State budget. One way is to begin pre-funding these benefits on an actuarial basis. At least one local unit of government, Oakland County, has been pre-funding retiree health benefits since 1984. The State of Michigan attempted to start pre-funding benefits in the late 1990s, but fiscal stress resulted in the set-aside reserves being diverted to help contain the annual increases in contribution rates and to balance annual operating budgets. Pre-funding will require the allocation of additional current resources, with the promise of relieving future budgets from a portion of the cost pressures associated with the requirement to fund retiree health on a pay-as-you-go basis.

Another method to pre-fund benefits and address the growth in costs for these benefits is through the use of OPEB obligation bonds, the proceeds of which could be dedicated to covering all or a portion of the unfunded liabilities associated with future health benefits. By using these bonds, it is possible for the State to receive an interest rate from the investment of the bond proceeds that is higher than the rate paid to service the bonds, producing annual interest earnings (legal arbitrage). These earnings can result in savings if the debt service on the bonds is less than the cost to fund all or a portion of the unfunded liability each year.

Recent changes to state law (Public Acts 110 and 111 of 2007) require new school employees to work longer before they are entitled to life-time health care benefits in retirement. This switch was similar to the changes made to the state system, which resulted in employees earning benefits based on their years of service. This switch will not generate substantial fiscal savings for the State or local schools through FY 17; however, beyond the projection period, this change should help moderate the spending demands associated with retiree health care, assuming everything else equal.

Other options to control future cost increases for retiree health could include requiring retirees to pick up a larger share of annual premiums, increasing co-pays for services received, and/or limiting the level of benefits provided. Again, these are changes that would require state-level action and are not options available to local school administrators to mitigate future spending demands.

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## Endnotes

<sup>1</sup> The data sources used include Bulletin 1011 and the National Public Education Financial Survey, 1997-2006, Michigan Department of Education (MDE); information gathered on retirement contributions to the Michigan Public School Employees Retirement System (MPERS) from the annual financial reports of the system, Office of Retirement Services, Michigan Department of Management and Budget; January 2008 Consensus Revenues Forecasts; and data on taxable values and revenues from the Michigan Department of Treasury.

## VIII. School Aid

In Fiscal Year 2007 (FY07), Michigan's public elementary and secondary schools provided education for 1.7 million students. Programs were delivered by 552 local school districts, 57 intermediate school districts, and 229 public school academies, operating in about 4,000 buildings. Approximately 140,000 students received education in non-public school settings, the majority in private schools.

### Background: Proposal A and School Finance

School funding in Michigan changed significantly in the 1990s. Proposal A of 1994 and its implementing legislation greatly reduced local property taxes supporting K-12 education and replaced them with several State-levied taxes. Prior to this, local school districts raised two-thirds of their operating revenue through property taxes and received one-third of their revenue from the State through a guaranteed tax base formula that attempted to provide a more equitable tax base yield among the districts. However, by the early 1990s, the gap in per pupil spending between high revenue and low revenue districts had risen substantially and local property tax rates had increased to very high levels in many districts. These two factors led to dissatisfaction with the school finance system. Since the enactment of school finance reforms in 1994, the State's role in financing the operations of public K-12 districts has been dominant. The new system of finance essentially eliminated the ability of individual districts to raise local tax revenues to supplement the total operating revenues determined by the State.

The Michigan Constitution of 1963 states that the State School Aid Fund is "...to be used exclusively for aid to school districts, higher education and school employees' retirement systems, as provided by law." The School Aid Fund consists of all State revenue sources dedicated to K-12 education. Revenues are dedicated to the fund by the Constitution and State statute. The General Fund also makes transfers to the School Aid Fund to supplement dedicated revenues, although the amounts have been insignificant since FY06. Over 40 percent of School Aid Fund revenues come from two constitutionally dedicated sources: 4.4 percentage points of the 6.0 percent Sales Tax and 2.0 percentage points of the 6.0 percent Use Tax. Part or all of several other State taxes are allocated to the School Aid Fund:

- Personal Income Tax (25.9 percent),
- Liquor Excise Tax (100.0 percent)<sup>1</sup>,
- Tobacco Products Tax (41.6 percent of proceeds from cigarette taxes),
- State Casino Gaming Tax (45.0 percent),
- State Real Estate Transfer Tax (100.0 percent), and
- State Education Tax (100.0 percent of the proceeds from the 6-mill state property tax).

In addition to the dedicated taxes, the profits from the Michigan State Lottery are allocated to the fund.

In FY07, over 80 percent of School Aid Fund revenues came from four State taxes: Sales Tax, Use Tax, Personal Income Tax, and State Education Tax. School Aid Fund



revenues make up approximately two-thirds of the revenues supporting K-12 education. They are supplemented by federal education grants and local operating property taxes, which are levied largely on business property.

## Revenue Performance

The funding system created by adoption of Proposal A of 1994 worked well from FY97 to FY00 as State tax revenues supporting K-12 education grew at a 6.2 percent annual rate. After FY01, however, State tax revenues grew at a rate of only 1.7 percent per year (see **Table VIII-I**). Revenues from the Sales, Use, and

Income Taxes all stagnated after FY01 with annual rates of growth between 0.5 and 1.3 percent, while the State Education Tax grew 5.7 percent annually. In FY09, the State Education Tax is projected to overtake the Personal Income Tax as the second largest source of State-raised school aid revenues.

Tobacco Products Tax revenues grew because of increases in the cigarette tax rate in 2002 and 2004. Lottery funds experienced fairly slow growth of 1.7 percent initially, but they grew at a greater rate of 4.1 percent per year from FY01 to FY07 because of the introduction of new games. Funds transferred from the General Fund increased from FY97 to FY00, but they

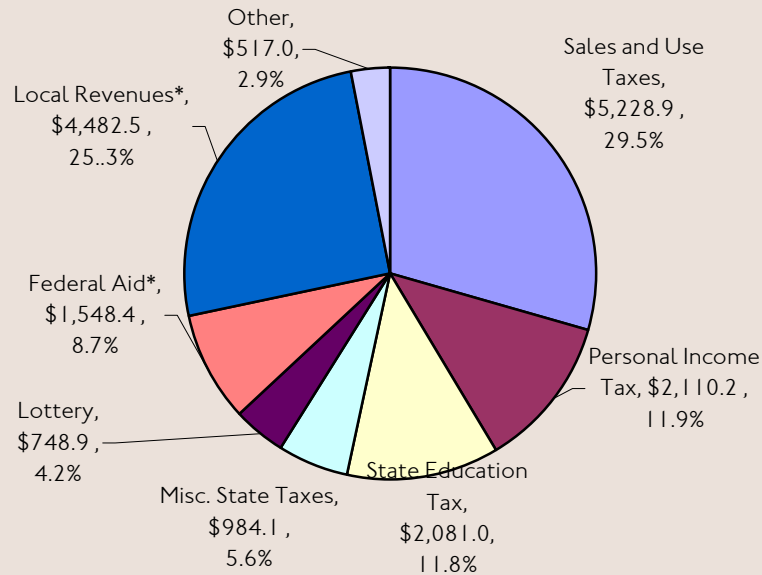
**Table VIII-I**  
**Growth in Revenues Supporting K-12 Education, FY97 to FY07**

<u>Revenues</u>	<u>Annual Rate of Change, FY97-FY00*</u>	<u>Annual Rate of Change, FY01-FY07</u>
Sales Tax	5.2%	0.5%
Personal Income Tax	7.5%	1.3%
Use Tax	7.8%	0.6%
State Education Tax	6.1%	5.7%
Real Estate Transfer Tax	10.1%	-1.0%
Tobacco Products Tax	3.4%	2.7%
Other Taxes	17.0%	2.9%
Total State Taxes	6.2%	1.7%
Lottery Funds	1.7%	4.1%
Federal Aid	6.0%	5.6%
Local Property Taxes	3.3%	5.0%
General Fund Grant	16.3%	-33.0%
Total	5.6%	2.8%

\* The annual rate of growth in school aid revenues is measured from FY97 (rather than from immediately after passage of Proposal A in FY95) because FY97 represents the first full year of tax collections for all the major revenue sources supporting K-12 education.

Source: Bulletin 1011 and National Public Education Financial Survey data, 1997-2006, Michigan Department of Education (MDE); revenues tracked by CRC as reported by the Michigan Department of Treasury.

**Chart VIII-I**  
**Revenues Supporting K-12 Education, FY07**  
 (Dollars in Millions)



\* Local revenues and federal aid are projected from background data provided by the MDE (National Public Education Financial Survey) because FY07 data was not available at the time of publication.

Source: CRC calculations based on data provided by the Michigan Departments of Education and Treasury.

declined by \$386 million from FY00 to FY07 (in FY07, the General Fund grant totaled less than \$35 million).

**Chart VIII-I** illustrates the composition of funds supporting K-12 education in Michigan in FY07.

As noted, in addition to revenues raised directly by the State, Federal aid and local operating property taxes are important components of school revenues. The annual increases in both sources exceeded State-

raised revenue growth, with local operating property taxes increasing 5.0 percent annually and Federal aid growth averaging 5.6 percent per year from FY01 to FY07. It is important to note that while Federal funds have experienced strong growth over the last few years, Federal mandates have also been rising with the No Child Left Behind (NCLB) legislation through increased testing, assessment, reporting, and other program requirements.

## Programmatic Funding

Since the passage of Proposal A, State funding for many specific programs (i.e. categorical grants) has fluctuated significantly with some programs being eliminated as new ones have been created. **Table VIII-2** details funding for some larger programs and all other categorical programs. As the table shows, funding for at-risk students and special education has increased since the passage of Proposal A in 1994 while funding for adult education has declined significantly since Proposal A took effect. Funding for all other categorical programs, which include bilingual education, vocational education, and school lunch, as well as programs other than those detailed in **Table VIII-2**, increased considerably from FY95 to FY00 and has continued to increase at a lower, but still significant, annual rate from FY00 to FY07. At the same time, total State funding appropriated for the basic foundation allowance increased 3.1 percent per year from FY95 to FY00, but since FY00 has increased only 2.2 percent annually. However, as the student population declines, the per pupil foundation allowance will increase at a faster rate than the total funding appropriated for the foundation grant.

The increase in special education funding is largely the result of the Michigan State Supreme Court *Durant*<sup>2</sup>

ruling, which found that special education and special education transportation are State-mandated activities. Under provisions of the Headlee Amendment of 1978 (specifically, Article IX, Section 29 of the Michigan Constitution), the State is prohibited from reducing its portion of the necessary costs of special education programs or from requiring any new or expanded programs without the requisite funding. The ruling led to State appropriations for special education increasing from \$201 million in FY97 to \$723 million in FY98 – a 260 percent increase. As a result of the ruling, the only way that the State’s share of special education funding can decline is if the total costs for special education decline. Subsequent *Durant* cases (II, III, IV) have not yet led to more monetary relief for school districts.

Special education programs represent a cost pressure that is not expected to moderate. It remains an obligation of the State that is appropriated separately from the basic foundation allowance. In FY07, special education programs represented the largest line item of State funding outside of the per pupil grant and almost one-third of all Federal education grants received by the State. The Federal grants for special education are accompanied by Federal rules and mandates in addition to the State regulations regarding special education.

**Table VIII-2**  
**State Funding for Education Programs, FY94 to FY07**  
**(Dollars in Millions)**

<u>Specific Education Programs</u>	<u>FY94</u>	<u>FY95</u>	<u>FY00</u>	<u>FY07</u>	<u>Annual Rate of Change, FY95-FY00</u>	<u>Annual Rate of Change, FY00-FY07</u>
At-Risk Students	\$ 23.5	\$ 230.0	\$ 270.9	\$ 310.5	3.3 %	2.0 %
Special Education	121.4	121.4	777.6	970.3	45.0 %	3.2 %
Adult Education	285.0	185.0	80.0	24.0	-15.4%	-15.8%
All Other Categorical Programs	94.8	130.8	350.2	521.5	21.8 %	5.9 %
Basic Foundation Allowance	n/a	7,245.0	8,418.6	9,770.7	3.1 %	2.2 %

Source: State appropriations as reported by the Senate Fiscal Agency.

## Future Outlook

### Policy Provisions that May Influence the Projections

#### Property Tax Limitations

Policy provisions that may influence the projections for revenue and spending pressure growth in K-12 education include the property tax limitations created by Proposal A of 1994 and the Headlee Amendment. Proposal A limits growth in the tax base by requiring that annual increases in the taxable value of each parcel of existing property be limited to the lesser of five percent or the rate of inflation and that property only be increased to state equalized value (cash value) upon a transfer in ownership.

The Headlee Amendment limits growth in the tax rate by requiring that, if the existing property tax base in a unit of government increases faster than the rate of inflation, the maximum authorized rate must be reduced or "rolled back" by a commensurate amount so as to produce the same real property tax levy as would have been obtained from the old base.<sup>3</sup>

Both of these property tax limitations will affect the growth of local property tax revenues, which remain a large source of revenue for K-12 districts and intermediate school districts. While the State Education Tax is not subject to the rollback provision, revenues are constrained by the taxable value growth limits.

#### FY08 Reforms to School Employees' Benefits

Recent reforms to school employees' benefits may lead to some cost savings in the future, but substantial savings are not expected in the next 10 years. One reform, requiring current insurance providers and third-party administrators (e.g., Michigan Education Special Services Association) to release health claims utilization and cost information data for groups of over 100 employees in order to allow for pooling and competitive bidding of school district health care benefits, will likely lead to more competitive bidding for health care coverage and may lead to savings in the future.<sup>4</sup> Potential savings will depend on whether other insurance companies can offer rates below those currently offered. The legislation also allows for employer pooled plans to provide medical insurance to groups of at least 250 employees on a self-insured basis.

The other major reform involves basing retiree health care benefits on years of service with a maximum benefit of 90 percent of health care premiums covered after 25 years of service and placing an age requirement on the receipt of health care benefits.<sup>5</sup> Retirees with less than 25 years, but more than 10 years of service, will receive a percentage of their health insurance premiums equal to 30 percent for the first 10 years plus 4 percent for each additional year of service once they reach 60 years of age (retirees with 25 years of service or more may receive benefits before they are 60).

The savings from this reform may be substantial, but they are prospective. This provision affects only new employees hired after June 30, 2008. As long as the State continues its current pay-as-you-go method of financing retiree healthcare, the change will not have any effect on the State's retiree health care costs until these new hires retire. The Senate Fiscal Agency's analysis of the fiscal impact of this change estimates that savings will increase gradually over 30 to 40 years at which point all retirees will fall under the new plan. At that point, the Office of Retirement Services estimates that the savings will total 45 percent of retiree health care costs. This level of savings in FY05 would have decreased public school employee retiree health care costs by \$342 million from \$760 million to \$418 million.<sup>6</sup> However, this reform is not expected to lead to any savings in the next 10 years.

Other reforms enacted include requiring new school employees to contribute a larger percentage to the Member Investment Plan for their pension benefit and new restrictions on the way school employees may purchase years of service.<sup>7</sup> These are not expected to result in substantial savings in the near-term.

During the FY08 budget negotiations, consideration was given to changing the school employees' retirement plan from a defined benefit to a defined contribution system. This change has been heralded as one that may save school districts money in the long-run; however, since public school employees already do contribute to their current retirement plans, there is no guarantee that changing to a defined contribution system will bring savings. It would guarantee stability in contributions to the retirement system, but no definite savings. In fact, in the short-

run, it would cost employers additional money to close the defined benefit system.

## School Funding Equity

When the State overhauled school operating funding in 1994, it did not alter the funding of school infrastructure, leaving it a local responsibility. This has been referred to as “The Unfinished Business of Proposal A,” because local tax base disparities and local voters’ willingness to approve bond issues lead to great disparities in school infrastructure among school districts. Districts with high property values can raise large sums of money with relatively low property tax rates while districts with low property values raise smaller amounts of revenue with much higher tax rates. This causes inequities in the quality of school infrastructure across the state that can be solved only with some level of State funding of school infrastructure.<sup>8</sup>

Equity remains a critical issue in both operating and capital funding of school districts. While the issue is more pronounced in capital funding, which is raised through local property taxes, inequity persists in school operating funding as well. The goals of Proposal A included lowering local property taxes and leveling the resources of high spending and low spending school districts. Fourteen years after Proposal A, the gap between high and low spending districts has been reduced by over 30 percent from approximately \$7,500 in FY94 to approximately \$5,200 in FY08. It should be noted that the highest spending districts do contribute more to their foundation allowance through their local property taxes. While the gap has not been closed, progress has been made in increasing the resources for low spending districts.

In the FY08 budget, the State Legislature did address the lingering inequity in school district operating funding. The FY08 foundation allowance reintroduces equity payments into the formula, with districts receiving an increase between \$48 and \$96 per pupil depending on their current foundation allowance. Districts with lower foundation allowances receive a larger increase in funding, thereby reducing the funding gap by a small amount.

## Potential Policy Changes

**Raise Drop-Out Age.** Currently, Michigan students can drop out of high school at the age of 16. There has been discussion by Michigan policymakers of increasing the drop-out age to 18. If the legal drop-out age is raised, total enrollment numbers will likely increase to include those 16- and 17-year-olds who would have otherwise dropped out of high school. This could add 25,000 to 50,000 students per year to the total K-12 enrollments, as much as a 3 percent increase.<sup>9</sup>

**Preschool Education.** Mandatory preschool education is another program under discussion that would affect enrollment data and cost pressures. Some studies have shown that early childhood education (pre-kindergarten) is critical to closing the gap between disadvantaged, low-achieving students and their higher-achieving peers. Many states are considering investing more money in preschool education, some through programs that are available to all preschoolers, others through programs that are available only to students from low-income homes. The Governor’s proposed FY08 school aid budget included a \$194.6 million program that would have paid foundation allowances to all districts that provided a full-day preschool program for educationally at-risk four-year-olds. This proposal was eliminated in the negotiations to balance the FY08 budget. Mandating full-day kindergarten is a related issue that would lead to additional costs for the State and school districts.

**Consolidation of School Districts.** Michigan has 552 local school districts and 229 public school academies. At 552 local districts (excluding charter schools), Michigan has approximately one school district per every 18,300 residents. The national average is approximately one district for every 70,500 residents. For states with populations over 10 million<sup>10</sup>, the average is around 54,000 residents per district. For Great Lakes states<sup>11</sup>, the average is 19,000 residents per district.<sup>12</sup> The number of residents per school district in Michigan is comparable with its Great Lakes neighbor states, but much lower than the national average and the average of states with a population over 10 million. Michigan has more public school districts than the average state and more than its fellow large states.

# MICHIGAN'S FISCAL FUTURE

Michigan school districts may be able to save money and reduce costs through consolidation of services or reorganization. While consolidation of districts can be politically difficult, there may be opportunities for greater coordination and collaboration among school districts that can lead to cost savings. Alternatively, it may be possible to enhance collaboration and service delivery through more use of intermediate school districts.

## Projections: FY09 to FY17

To estimate the growth in total revenues and total spending pressures for K-12 districts and intermediate school districts through FY 17, CRC used multiple data

sources to estimate State, Federal, and local revenues and total spending for recent years. These estimates were used as the base on which to apply different growth factors and assumptions about the major components of growth in the future.<sup>13</sup>

K-12 enrollment numbers decline by approximately 200,000 students from 1.65 million students in FY08 to 1.45 million students in FY 17.

## Enrollment

Based on projections generated by the REMI model, K-12 enrollment numbers will decline by

approximately 200,000 students from 1.65 million students in FY08 to 1.45 million students in FY 17 (see **Table VIII-3**). The 1.4 percent per year decline in public education students is due to a projected decline in the population of school-age children (5- to 17-year-olds) in Michigan. This enrollment decline supposes the moderate growth scenario from the REMI model (see

**Table VIII-3**  
**K-12 Enrollment, FY97 to FY 17**

<u>Fiscal Year</u>	<u>Enrollment</u>	<u>Annual Rate of Change</u>
FY97	1,645,594	
FY98	1,670,213	1.5%
FY99	1,687,295	1.0%
FY00	1,696,590	0.6%
FY01	1,704,157	0.4%
FY02	1,709,572	0.3%
FY03	1,714,867	0.3%
FY04	1,714,402	0.0%
FY05	1,707,780	-0.4%
FY06	1,697,534	-0.6%
FY07	1,681,062	-1.0%
FY08	1,653,408	-1.6%
FY09 (projected)	1,615,577	-2.3%
FY10 (projected)	1,580,654	-2.2%
FY11 (projected)	1,550,007	-1.9%
FY12 (projected)	1,522,848	-1.8%
FY13 (projected)	1,499,128	-1.6%
FY14 (projected)	1,481,494	-1.2%
FY15 (projected)	1,468,480	-0.9%
FY16 (projected)	1,458,292	-0.7%
FY17 (projected)	1,451,616	-0.5%

Source: Pupil Membership Data provided by the Senate Fiscal Agency, FY97-FY08; CRC calculations based upon REMI model population projections.

Chapter IV) and maintenance of the current ratio of the number of public school students to the number of student-age persons in Michigan.

A declining student population for individual school districts leads to less State revenue for those districts. However, a declining student population statewide will permit larger increases in the per pupil grant because there will be fewer pupils overall to share the revenues for K-12 education. A declining student population also should theoretically lead to lower costs for school districts in the form of reduced personnel and building expenses.

However, in reality, it can be quite difficult for districts to transform declining student populations that are spread across many schools and classrooms into the elimination of specific teachers, classrooms, and buildings. It can take years and many painful decisions to translate a declining student population into real savings, especially in small districts, where managing enrollment declines is very challenging.

Of Michigan's 551 traditional public school districts in FY06, only 28 percent (152) had enrollment of at least 3,000 students.<sup>14</sup> A district of 3,000 students experiencing an enrollment decline of 1.4 percent in one year would lose 42 students. If it is presumed that the loss would be spread over 13 grades, the district would lose an average of three or four students per grade. Such a district would likely have one high school, one middle school, and at least four elementary schools. The classroom teacher represents the most important unit of cost. While 42 students would represent the approximate teaching load of nearly two teachers, the enrollment reductions could not be easily consolidated to allow eliminating even one teacher. The enrollment reduction would be spread over 13 grades and approximately 120 teachers. It would take almost eight years for

enrollment reductions of 1.4 percent annually to build up to the equivalent of one 25-student classroom per grade. So enrollment declines cannot, as a rule, be translated immediately into staff reductions and commensurate savings, even in relatively large districts. In the remaining 399 traditional districts with enrollments below 3,000 students, capturing the savings to offset the lost revenues associated with

declining enrollments would take much longer, especially in the smallest 82 districts with enrollments below 500. During that time, districts that have fund balances may use their reserves to prevent deficits.

This analysis assumes that districts would be able to translate one-half of the average 1.4 percent per year decline in enrollment into reduced cost pressures.

Public school academies (i.e., charter schools) face challenges with declining enrollments as well because they all represent fairly small school districts. In FY06, one charter school had over 2,000 students with the remaining all having enrollments of less than 1,500 students. The majority of charter schools (69 percent) had enrollments of less than 500 students. However, the enrollment challenges faced by charter schools differ from traditional K-12 districts because charter schools are not as limited by geographic boundaries and their survival from their start depends on their ability to recruit students from other districts. In fact, charter schools, with their recent growth in both numbers and enrollments, have contributed to the enrollment declines in many traditional K-12 districts.

When adjusting to declining enrollment, the first programs to be cut are usually those on the periphery of the classroom (e.g., sports, art, and music programs). As districts' budgets are stretched thinner, there may be more cuts to instructional and classroom expenditures. This analysis assumes that districts would be able to translate one-half of the average 1.4 percent per year decline in enrollment into reduced cost pressures (i.e., 0.7 percent decline in the growth of cost pressures).



# MICHIGAN'S FISCAL FUTURE

## Revenues

Revenues are projected to grow at a rate above that experienced from FY01 through FY07, but below the high rate of growth from FY97 to FY00 (see **Table VIII-4**). Chapter V provides more detail about revenue projections, and the assumptions used to make those projections.

Total State taxes for School Aid are projected to grow approximately 3.1 percent per year. This projected growth is driven by a 4.25 percent annual increase in State Education Tax revenues and the introduction of a portion of the Michigan Business Tax (MBT) into the School Aid Fund. After the first year of full collections (FY09), the MBT is projected to grow 2.5 percent annually. The other major State taxes (Sales, Use and Income) are projected to grow at annual rates around 3 percent. The projected slowed growth in lottery funds is due

to the passage of Proposal 2004-01, which requires a statewide vote on any State actions to expand gambling opportunities. Federal aid growth has been robust since FY97 and while it is projected to continue to grow at a fairly high annual rate (4.0 percent), it is

Total state taxes for School Aid are projected to grow approximately 3.1 percent per year.

lower than the 5.6 percent yearly growth from FY01 to FY07. The 4.0 percent rate reflects recent trends in Federal aid growth (from FY04 to FY08). Local school operating property tax

revenues are projected to grow 3.0 percent per year, which is lower than the projected 4.25 percent growth in the state property tax. This is because local revenues largely exclude the taxation of homestead property, which is projected to grow more robustly than non-homestead property through FY17. However, if the current credit crisis continues and the housing market deteriorates even further, these assumptions of property tax growth may prove to be too optimistic.

**Table VIII-4**  
**Growth in Revenues Supporting K-12 Education, FY97 to FY17**

<u>Revenues</u>	<u>Annual Rate of Change, FY97-FY00</u>	<u>Annual Rate of Change, FY01-FY07</u>	<u>Projected Annual Rate of Change, FY09-FY17</u>
Sales Tax	5.2%	0.5%	3.0%
Personal Income Tax	7.5%	1.3%	3.3%
Michigan Business Tax (MBT)	—	—	2.5%
MBT Surcharge	—	—	2.5%
Use Tax	7.8%	0.6%	3.0%
State Education Tax	6.1%	5.7%	4.3%
Real Estate Transfer Tax	10.1%	-1.0%	2.5%
Tobacco Products Tax	3.4%	2.7%	-2.5%
Other State Taxes	17.0%	2.9%	1.7%
Total State Taxes	6.2%	1.7%	3.1%
Lottery Funds	1.7%	4.1%	2.0%
Federal Aid	6.0%	5.6%	4.0%
Local Property Taxes	3.3%	5.0%	3.0%
Total	5.6%	2.8%	3.0%

Source: Bulletin 1011 and National Public Education Financial Survey data, 1997-2006, MDE; revenues tracked by CRC as reported by the Michigan Department of Treasury; CRC calculations.

## Spending Pressures

By far the largest component of K-12 spending is employee compensation, accounting for almost 80 percent of school district operating expenses. Compensation includes salaries and wages, employer taxes, and employer-paid fringe benefits. Salaries and wages (including employer-paid taxes) paid to employees account for approximately 56 percent of operating costs in FY07. The two largest fringe benefits, health insurance and retirement, have grown at relatively rapid rates since FY00. It is estimated that in FY07, the typical district spent about \$960 per pupil for employer contributions for retirement (\$355 per pupil for retiree health care and \$605 per pupil for pension benefits) and \$1,360 per pupil for health insurance and other benefits for employees and their families.

**Table VIII-5** shows the projected annual growth in spending pressures over the coming decade. The growth in payroll expense reflects the effects of consumer inflation (2.5 percent), salary increases through longevity and educational step improvements (2.0 percent), and some real improvement in salaries and the standard of living for employees (0.5 percent). It also reflects decreases for expected employee turnover (-1.0 percent) and for one-half of the projected decline in enrollment (-0.7 percent: only one-half of the decline is assumed to result in decreased cost pressures; it is assumed that the rest of the decline would result in program cuts). Pension

contributions are projected to increase at the same annual rate as payroll (3.3 percent) because pension benefits are pre-funded and their percentage of payroll each year should stabilize at 9.73 percent after FY08.

The major cost driver is health care, both for retirees and current employees. Health care for retirees is determined by the State and is funded as a percentage of payroll for active employees. It is projected to increase 11.9 percent per year. Unlike pension benefits, retiree health care is not pre-funded and health care's percentage of payroll is projected to increase rapidly in the coming years, mirroring projected cost increases. Other benefits, which mainly consist of health care for current employees, are projected to increase 9.3 percent annually. This growth reflects past trends in health care spending (10.0 percent), but is adjusted downward to account for the projected decline in enrollment (-0.7 percent). Other spending includes cost pressures not related to employee salaries and benefits, such as spending on classroom supplies and motor fuels for transportation. The growth in other spending reflects inflationary increases (4.0 percent), but is also adjusted downward to account for the projected decline in enrollment (-0.7 percent). A declining student enrollment should theoretically lead to the need for fewer employees and to less demand for supplies and materials. Chapter VII discusses the cost pressures of local school employee compensation in more detail.

# MICHIGAN'S FISCAL FUTURE

## Gap between Revenues and Spending Pressures

Projections for school funding over the next decade show a growing gap between projected revenues and spending pressures. **Table VIII-5** illustrates this gap that grows to \$3.6 billion in FY 17 as projected

The gap between revenues and spending pressures grows to \$3.6 billion in FY 17 as projected revenues grow at 3.0 percent per year while spending pressures grow at a higher annual rate of 4.7 percent. The gap, measured as a percentage of projected revenues, is 16 percent.

revenues grow at 3.0 percent per year while spending pressures grow at a higher annual rate of 4.7 percent. The gap, measured as a percentage of projected revenues, is 16 percent.

**Table VIII-5**  
**Projected Growth in Total K-12 Revenues and Cost Pressures, FY08 to FY 17**  
 (Dollars in Millions)

	<u>Total Revenues</u>	<u>Total Spending Pressures</u>	<u>Gap</u>
FY08*	\$17,729	\$17,729	\$ 0
FY09	18,095	18,444	-349
FY 10	18,584	19,281	-697
FY 11	19,153	20,152	-1,000
FY 12	19,741	21,092	-1,351
FY 13	20,349	22,083	-1,734
FY 14	20,977	23,129	-2,152
FY 15	21,627	24,234	-2,606
FY 16	22,300	25,401	-3,101
FY 17	22,995	26,636	-3,641
Average Annual Increase, FY09-FY 17	3.0%	4.7%	

\* The projections are made from a FY08 revenue and spending base that is assumed to be balanced, in the aggregate. A balanced starting point was used so that projections of the gap beyond FY08 would be entirely caused by the differences in spending pressure and revenue growth rates.

Source: CRC calculations based on data provided by the MDE (National Public Education Financial Survey data, 1997-2006); Michigan Department of Treasury; January 2008 Consensus Revenue Forecasts; and the Office of Retirement Services, Michigan Department of Management and Budget.

**Tables VIII-6 and VIII-7** (page 53) show a breakdown of the major components of K-12 operating revenue and spending pressures and their projected growth through FY 17. The major components of operating revenue are all projected to grow approximately 3 to 4 percent on a yearly basis. While cost pressures for payroll, pension benefits, and other benefits are all projected to grow 3.3 percent annually, health care costs for retirees and for current employees are

projected to grow at high annual rates of 11.9 percent and 9.3 percent respectively. This illustrates that the main driver in school spending pressure growth is health care costs, which is a major cause of the gap between the projected growth in revenues and spending pressures. As mentioned earlier, recent reforms may help to slow the rate of increase in health care costs, but health care costs remain a problem throughout the budget.

**Table VIII-6**  
**Actual and Projected Growth in Major Components of K-12 Operating Revenue, FY06 to FY 17**  
**(Dollars in Millions)**

	<u>Local Operating Revenue</u>	<u>Personal Property Tax Reduction</u>	<u>State- Raised Revenue</u>	<u>Federal Revenue</u>	<u>Other Revenue</u>	<u>Total Operating Revenue</u>
FY06	\$4,261	\$ –	\$11,260	\$1,560	\$11	\$17,092
FY07(est.)	4,483	–	11,643	1,548	11	17,685
FY08	4,617	–	11,444	1,658	11	17,729
FY09	4,756	-342	11,946	1,724	11	18,095
FY10	4,898	-352	12,234	1,793	11	18,584
FY11	5,045	-363	12,595	1,865	11	19,153
FY12	5,196	-374	12,968	1,939	11	19,741
FY13	5,352	-385	13,354	2,017	11	20,349
FY14	5,513	-396	13,753	2,097	11	20,977
FY15	5,678	-408	14,165	2,181	11	21,627
FY16	5,849	-421	14,592	2,269	11	22,300
FY17	6,024	-433	15,034	2,359	11	22,995
Average Annual Increase, FY09-FY 17	3.0%		2.9%	4.0%	0.0%	3.0%

Source: CRC calculations based on data provided by the MDE (National Public Education Financial Survey data, 1997-2006), Michigan Department of Treasury, and January 2008 Consensus Revenue Forecasts.

# MICHIGAN'S FISCAL FUTURE

The fact that health care is the major driver in the projected growth in K-12 spending pressures is also evident when looking at revenues and cost pressures per pupil (see **Table VIII-8** on page 54). Unlike **Tables VIII-5** through **VIII-7**, which illustrate *total* projected revenues and spending pressures, **Table VIII-8** reflects revenues and spending pressures *per pupil* in actual

dollars. The annual rates of growth in both revenues and spending pressures are greater when measured per pupil because of the projected decline in the number of pupils through FY 17. The projected gap between total cost pressures and total revenues per pupil grows to \$2,500 by FY 17.

**Table VIII-7**  
**Actual and Projected Growth in Major Components of K-12 Operating Expenditures and Spending Pressures, FY06 to FY 17**  
**(Dollars in Millions)**

	<u>Payroll</u>	<u>Employer Social Security Contribution</u>	<u>Employer Pension Contribution</u>	<u>Employer Retiree Health Contribution</u>	<u>Other Benefits (Health Insurance)</u>	<u>Other Spending</u>	<u>Total</u>
FY06	\$ 9,297	\$711	\$ 910	\$ 609	\$2,095	\$3,756	\$17,379
FY07(est.)	9,090	695	1,017	595	2,290	3,880	17,568
FY08	9,152	700	931	599	2,440	3,907	17,729
FY09	9,454	723	920	644	2,667	4,036	18,444
FY10	9,766	747	950	733	2,915	4,169	19,281
FY11	10,088	772	982	818	3,186	4,306	20,152
FY12	10,421	797	1,014	929	3,482	4,449	21,092
FY13	10,765	824	1,047	1,045	3,806	4,595	22,083
FY14	11,120	851	1,082	1,169	4,160	4,747	23,129
FY15	11,487	879	1,118	1,299	4,547	4,904	24,234
FY16	11,866	908	1,155	1,437	4,970	5,066	25,401
FY17	12,258	938	1,193	1,583	5,432	5,233	26,636
Average Annual Increase, FY09-FY 17	3.3%	3.3%	3.3%	11.9%	9.3%	3.3%	4.7%

Source: CRC calculations based on data provided by the MDE (National Public Education Financial Survey data, 1997-2006) and the Office of Retirement Services, Michigan Department of Management and Budget.

# CRC REPORT

**Table VIII-8**

**Projected Growth in K-12 Revenues and Cost Pressures PER PUPIL, FY08 to FY 17**

	<u>Salaries and Wages</u>	<u>Health Care</u>	<u>Retirement Benefits</u>	<u>Other Spending</u>	<u>Total Cost Pressures</u>	<u>Total Revenues</u>	<u>Gap</u>
FY08	\$5,959	\$1,476	\$ 925	\$2,363	\$10,723	\$10,723	\$ 0
FY09	6,300	1,651	968	2,498	11,416	11,200	-216
FY 10	6,651	1,844	1,065	2,637	12,198	11,757	-441
FY 11	7,006	2,055	1,161	2,778	13,001	12,356	-645
FY 12	7,367	2,287	1,276	2,921	13,850	12,963	-887
FY 13	7,730	2,539	1,396	3,065	14,731	13,574	-1,157
FY 14	8,080	2,808	1,519	3,204	15,612	14,160	-1,452
FY 15	8,421	3,096	1,646	3,339	16,503	14,728	-1,775
FY 16	8,760	3,408	1,777	3,474	17,418	15,292	-2,127
FY 17	9,090	3,742	1,912	3,605	18,349	15,841	-2,508
Average Annual Increase, FY09-FY 17	4.7%	10.8%	8.9%	4.7%	6.1%	4.4%	

Source: CRC calculations based on data provided by the MDE (National Public Education Financial Survey data, 1997-2006); Michigan Department of Treasury; January 2008 Consensus Revenue Forecasts; and the Office of Retirement Services, Michigan Department of Management and Budget.

## Endnotes

<sup>1</sup> Michigan levies four taxes on liquor sales. One of those taxes, levied at a rate of 4 percent, is completely dedicated to the School Aid Fund. The total tax levy on liquor is 13.85 percent.

<sup>2</sup> *Donald Durant, et al. v. State of Michigan, et al.*, Nos. 104458-104492 (1997).

<sup>3</sup> The Citizens Research Council of Michigan. "Headlee Rollbacks" and the Constitutionality of Public Act 415 of 1994. Council Comments: No. 1039, January 1996.

<sup>4</sup> Public Act 106 of 2007.

<sup>5</sup> Public Act 110 of 2007.

<sup>6</sup> Senate Fiscal Agency, Bill Analysis: Public Acts 110 and 111 of 2007 (5-October-2007).

<sup>7</sup> Public Act 111 of 2007.

<sup>8</sup> The Citizens Research Council of Michigan and The Education Policy Center at Michigan State University. *Adequacy, Equity and Capital Spending in Michigan Schools: The Unfinished Business of Proposal A*. May 2005.

<sup>9</sup> This rough estimate was derived from discussions with the House Fiscal Agency and CRC calculations.

<sup>10</sup> States with a population over 10 million in 2006 include: California, Florida, Illinois, Michigan, New York, Ohio, Pennsylvania, and Texas ([www.census.gov](http://www.census.gov)).

<sup>11</sup> States touching one of the Great Lakes include: Illinois, Indiana, Michigan, Minnesota, New York, Ohio, Pennsylvania, and Wisconsin.

<sup>12</sup> School district data from School Data Direct, Standard and Poor's ([www.schooldata.org](http://www.schooldata.org)).

<sup>13</sup> The data sources used include Bulletin 1011 and the National Public Education Financial Survey, 1997-2006, Michigan Department of Education (MDE); information gathered on retirement contributions to the Michigan Public School Employees Retirement System (MPERS) from the annual financial reports of the system, Office of Retirement Services, Michigan Department of Management and Budget; January 2008 Consensus Revenues Forecasts; and data on taxable values and revenues from the Michigan Department of Treasury.<sup>14</sup> Bulletin 1014, 2006, MDE (MDE reports 551 school districts in 2006; the Center for Educational Performance & Information [CEPI] reports 552 in 2007).

## IX. Higher Education

State appropriations support the operation of 28 public community colleges and 15 state universities in Michigan. The State General Fund provides most of this support: all of the \$290 million appropriated for Fiscal Year 2007 (FY07) in the community college appropriations act and \$1.625 billion of the \$1.787 billion in the appropriations act for state universities and financial aid programs. In the seven years of the State's current budget crisis, the State has routinely cut spending to higher education; FY07 appropriations were \$196 million (8.6 percent) lower than the peak level of appropriations in FY02. State appropriations for higher education were decreased even further to balance the FY07 budget by delaying August 2007 payments of \$164.5 million (\$138.7 million to universities and \$25.8 million to community colleges), which were repaid in October 2007 (the beginning of FY08).

FY07 appropriations were \$196 million (8.6 percent) lower than the peak level of appropriations in FY02.

### Higher Education in Michigan: FY77 to FY07

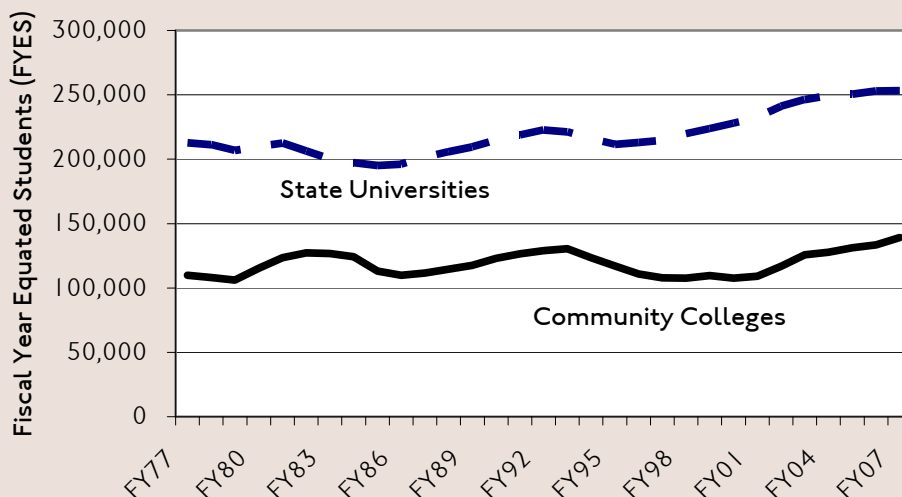
#### Enrollment Trends

In FY07, approximately 253,000 fiscal year equated students (FYES), which represents the calculated equivalent of full-time students, attended public universities, and 139,000 attended public community colleges. Total public higher education enrollments are at an all-time high notwithstanding the rapid increases in tuition that have occurred as State appropriations were cut in recent years.

Enrollments have not exhibited steady, uninterrupted growth over the past three decades (see **Chart IX-1**). Community college enrollments reflect a 0.8 percent annual rate of growth over the 30-year period, but the path to the 2007 level was anything but steady. In fact, enrollments in FY00 were lower than FY77 by 2,000 FYES, or 2 percent. Since FY00, community college enrollments have grown by 31,500 FYES or 29 percent. Community college enrollments have generally in-

Community college enrollments have generally in-

**Chart IX-1**  
Public Higher Education Enrollments, FY77 to FY07



Source: Higher Education Institutional Data Inventory (HEIDI) database, Michigan State Budget Office (SBO); Activity Classification Structure (ACS) Data Book, Michigan Department of Labor & Economic Growth (DLEG).



creased during recessionary periods and declined during economic recoveries. Weakness in labor markets presumably causes more people to enroll in community colleges to upgrade job skills.

State university enrollments have exhibited similar cyclical changes, but the changes are not as pronounced. Over the 30-year period, university enrollments increased at an average annual rate of 0.6 percent. From FY00 to FY07, universities added approximately 25,400 FYES, an increase of 11 percent.

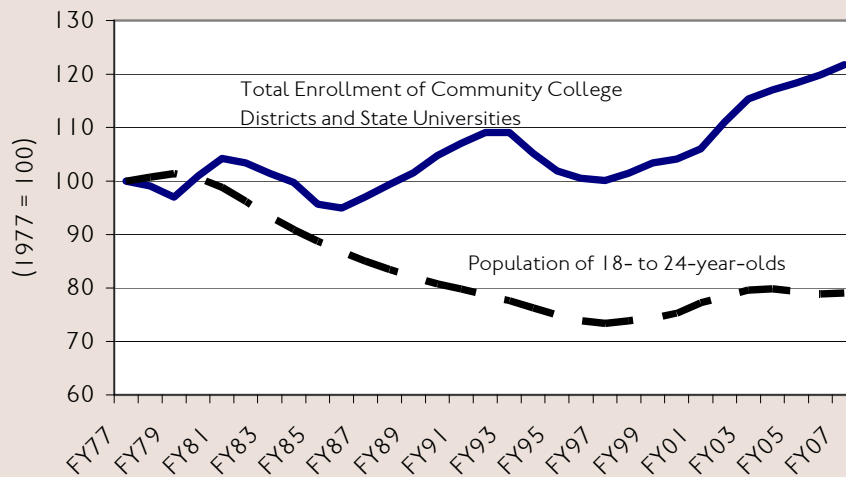
The effect of non-resident student enrollment growth (out-state and international students) since FY00 has been small. With the exception of the University of Michigan-Ann Arbor and Michigan State University, few of Michigan's public universities have a substantial non-resident student population at the undergraduate or graduate levels. The annual rate of growth in total non-resident FYES for all public universities in Michigan was 0.4 percent from FY00 to FY06. This compares to 1.9 percent yearly growth in total in-state FYES at public universities.<sup>1</sup>

The enrollment changes over the past 30 years have no obvious connection to demographic changes. The

traditional student population age group (18- to 24-year-olds) is often used to help predict higher education enrollment changes. The numbers in this age group declined by 27 percent from FY77 through FY97, and then grew by 8 percent from FY97 to FY07. **Chart IX-2** illustrates the population of 18- to 24-year-olds and public higher education enrollments over the last 30 years using their FY77 levels as a base. It shows the growth in enrollments, which has fluctuated throughout the years, and the decline in the traditional college-age population in real terms since FY77 (in reality, the traditional college-age population is much higher than total enrollments even though it has been declining while enrollments have been increasing). Increased participation, of both traditional and non-traditional age groups rather than growth in the core age group, clearly has been significant.

Even though there has been an increase in the number of students pursuing higher education in recent years, Michigan still falls below the national average in the percentage of residents who have higher education degrees. Many researchers have concluded that there is a strong positive relationship between higher education attainment rates and income and employment growth differences among the states.

**Chart IX-2**  
**Index of Traditional College Age Population and Public Higher Education Enrollment, FY77 to FY07**



Source: U.S. Census Bureau; ACS Data Book, Michigan DLEG; HEIDI database, Michigan SBO.

# MICHIGAN'S FISCAL FUTURE

## Revenue Trends

### State Universities

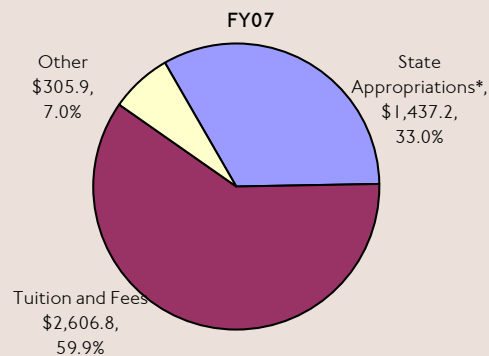
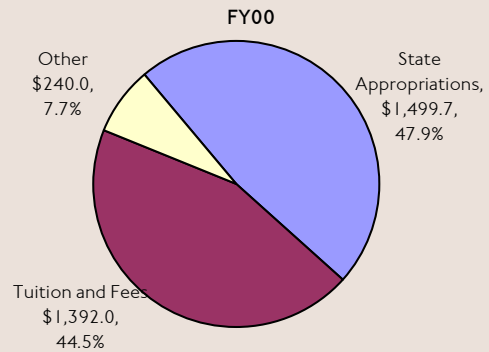
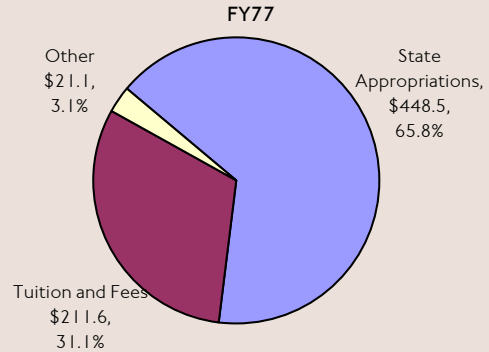
The share of total public university operating costs funded by State appropriations has dropped steadily and significantly over the last three decades. In FY77 State appropriations for universities were more than twice total tuition and fees and provided almost two-thirds of total university operating support. In the past three decades that relationship has changed dramatically (see **Charts IX-3 through IX-5**). Over the 30-year period, State appropriations grew at an annual rate of 4.0 percent while revenue from tuition and fees grew by 8.7 percent per year. Enrollments increased by 0.6 percent per year.

From FY00 to FY07, State appropriations for public universities declined in actual dollars from \$1.5 billion to \$1.4 billion, while tuition and fees increased from \$1.4 billion to \$2.6 billion. The annual rates of change in State appropriations (-0.6 percent) and tuition and fees (9.4 percent) from FY00 to FY07 can be compared to an annual increase of 2.4 percent in inflation (Detroit-area Consumer Price Index) and a 4.8 percent annualized increase in personal income over the same time period. It should be noted that Michigan is not the only state to experience significant increases in tuition and fees at public colleges and universities in recent years.

State appropriations have been declining as a percentage of total university operating funding (and as a dollar amount in some years) at the same time as student enrollments have been increasing. State appropriations to public universities per FYES peaked in FY01 at \$6,853; in FY07, State appropriations per FYES were \$5,673. That reflects an actual dollar loss, not adjusted for inflation, of almost \$1,200 per student. Tuition and fees at state universities per FYES averaged \$10,829 in FY07. These numbers include revenues for all students, both in-state and out-of-state.

Charts IX-3, IX-4, IX-5

State University Operating Funding: FY77, FY00, and FY07  
(Dollars in Millions)



\* FY07 state appropriations as reported by the State Budget Office (HEIDI database) include the August 2007 delayed payment of \$138.7 million (some universities accrued the payment to FY07, others to FY08).

Source: HEIDI database, Michigan SBO.

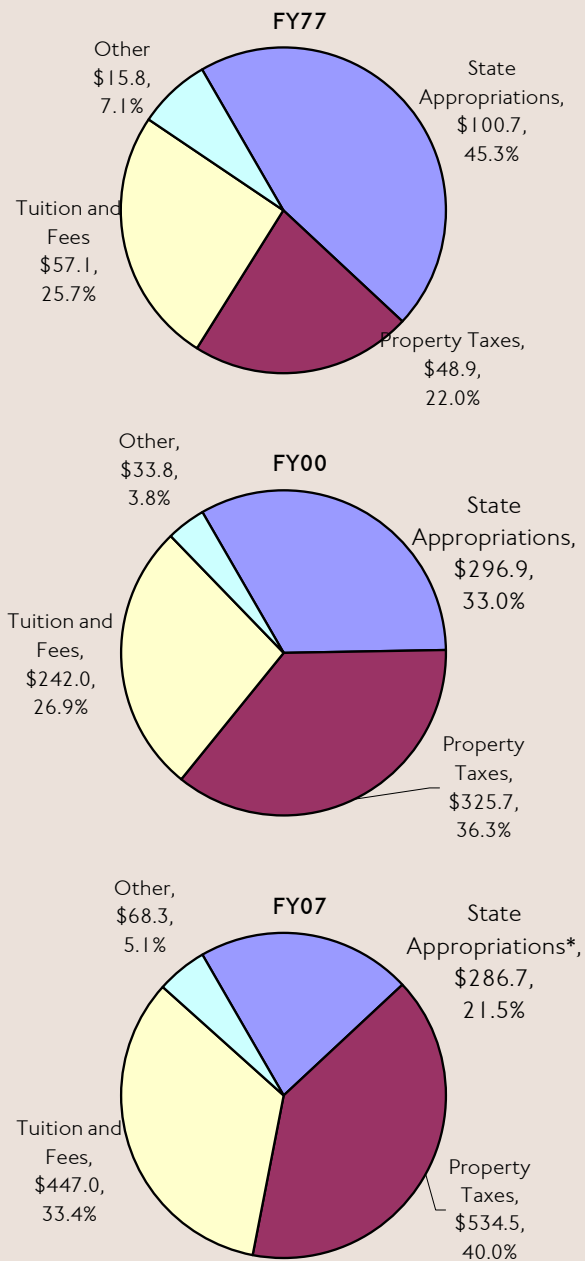
## Community Colleges

Community college operating costs are financed primarily by three major revenue sources: tuition and fees, property taxes, and State appropriations. Since FY77, the State appropriations share of community college operating funding has declined significantly while the shares funded by property taxes and tuition and fees have increased correspondingly (see **Charts IX-6 through IX-8**). The average annual rate of growth in State appropriations over the 30-year period was 3.5 percent, whereas property taxes increased 8.3 percent annually and tuition and fees increased 7.1 percent per year over the same time period.

From FY00 to FY07, State appropriations to community colleges decreased in actual dollars while property taxes and tuition and fees increased substantially. During this time period, the average annual rate of change in State appropriations was negative (-0.5 percent) while the average annual rates of growth in property taxes and tuition and fees were 7.3 percent and 9.2 percent respectively.

At community colleges, State appropriations have been declining as a percentage of total operating funding and as a dollar amount at the same time as student enrollments have been increasing. State appropriations per FYES at community colleges peaked in FY01 at \$2,883; in FY07, State appropriations per FYES were \$2,059.<sup>2</sup> In FY07, tuition and fees at community colleges averaged \$3,211 per FYES and property tax revenues averaged \$3,839 per FYES.

**Charts IX-6, IX-7, IX-8**  
**Community College Operating Funding: FY77, FY00, and FY07**  
**(Dollars in Millions)**



\* CRC includes the August 2007 delayed payment of \$25.8 million (which was repaid in October 2007) in the FY07 state appropriation number for more accurate comparison purposes across the years. The FY07 state appropriations as reported by the Michigan Department of Labor & Economic Growth (ACS Data Book) does not include the delayed payment because it was accrued to FY08 to comply with Generally Accepted Accounting Principles (GAAP) requirements.

Source: ACS Data Book, Michigan DLEG.

## Future Outlook

### Policy Provisions that May Influence the Projections

#### Property Tax Limitations

Policy provisions that may influence the projections for revenue and spending pressure growth in higher education include the property tax limitations created by Proposal A of 1994 and the Headlee Amendment of 1978. These property tax limitations will have an effect on the growth of local property taxes, which help to support community colleges (see Chapter VIII for more information on Proposal A and the Headlee Amendment).<sup>3</sup>

#### Policy Shift to State-Funded Scholarships

Michigan has recently implemented a program that funds students directly. In FY99, the State established the Michigan Merit Award program, which provided State scholarships to eligible students, i.e., Michigan residents or graduates of Michigan high schools with qualifying Michigan Educational Assessment Program (MEAP) scores.<sup>4</sup> The first Merit scholarships were awarded to high school graduates of the class of 2000 and provided up to \$2,500 in aid. For the classes of 2005 and 2006, the award was increased to \$3,000. A portion of the award (\$1,000) was made available for use at institutions outside of Michigan. In FY06, the Michigan Merit Award was replaced with the Michigan Promise Scholarship.<sup>5</sup> Beginning with the class of 2007, the Michigan Promise Scholarship provides qualifying

high school graduates with up to \$4,000 in student aid. Eligibility requirements include Michigan residency, qualifying scores on the state assessment test, enrollment at an approved Michigan postsecondary institution (includes public and private institutions) or a military service academy, and completion of postsecondary requirements with a minimum college grade point average of 2.5.

The total amount appropriated for the Michigan Merit Award in FY00 was \$86.3 million and this helped increase total State-provided financial aid from \$121.6 million in FY99 to \$212.7 million in FY00 (see **Table IX-1**). The Michigan Merit Award appropriation increased throughout the years until the Michigan Promise Scholarship was instituted in FY08. While FY08 appropriations for the Michigan Promise Scholarship are only \$43.5 million, the total potential award liability for the class of 2007 is estimated as high as \$477.6 million.<sup>6</sup> Total appropriations are much lower than total potential liability because Michigan Promise scholarship payments are made to students in installments (i.e., the full \$4,000 does not go to each student at the time of high school graduation and enrollment in college). The State is also still making Michigan Merit Award payments in FY08 to those students who graduated in 2006 and earlier. Total State financial aid decreased slightly in FY08 due to the change from the Merit Award to the Promise Scholarship and the fact that some of the costs associated with the Promise Scholarship are prospective.

**Table IX-1**  
**State Financial Aid Programs, FY99 to FY08**  
**(Dollars in Millions)**

<u>Fiscal Year</u>	<u>Michigan Merit Award</u>	<u>Michigan Promise Scholarship</u>	<u>Total Financial Aid</u>
FY99	n/a	n/a	\$121.6
FY00	\$ 86.3	n/a	212.7
FY07	127.7	n/a	259.3
FY08	60.0	\$43.5	241.6

Source: Higher Education Appropriations Report, House and Senate Fiscal Agencies, FY99-00 through FY07-FY08.

These programs are significant because they signal a shift in State funding from the institutions directly to the students themselves. Total State appropriations for universities and community colleges still dwarf total State financial aid to students, but financial aid to students appears to be growing as programs are being instituted to allow more money to follow students to the postsecondary institution of their choice. Neither the Michigan Merit Award nor the Promise Scholarship is linked to the financial needs of the students. They are both based upon Michigan residency or Michigan secondary school attendance and student merit and achievement, so they are open to all Michigan students prepared to be successful in postsecondary education.

### Potential Policy Changes

*The Final Report of The Lt. Governor's Commission on Higher Education & Economic Growth* ("Cherry Commission Report"), recommends some major policy changes that would require an increased State investment in higher education with the goals of: 1) doubling the percentage of Michigan residents who attain postsecondary degrees or certificates, 2) improving the alignment of Michigan's higher education institutions with emerging employment opportunities, and 3) building a dynamic workforce of employees who have the talents and skills needed for success in a changing economy. The policy changes discussed to help meet these goals include removing the barriers (both financial and social) to higher education and making postsecondary education universal in Michigan, setting high expectations for high school students and equipping educators and administrators to support those high expectations, expanding access to colleges and universities, and improving institutional completion measures.

State policymakers have taken steps to improve high school achievement by implementing a rigorous curriculum requirement and passing legislation for a new high school student achievement assessment. The State has also taken steps to reduce the financial burden on students and to expand access to college by in-

stituting the Michigan Promise program to encourage more students to pursue postsecondary education. As stated earlier, the State is likely to face significant future costs associated with the Michigan Promise program.

While State policymakers continue to espouse a policy of increasing higher education attainment and have

taken some steps to meet the Cherry Commission Report's goals, removing barriers to college and expanding access are costly initiatives. In recent years, Michigan has witnessed increasing financial burdens for college students as State appropriations have been

cut and colleges and universities have responded by raising tuition and fees. The policy changes discussed in the Cherry Commission Report would likely lead to expanded access to higher education for Michigan high school students. However, many of these policy changes would affect cost pressures and enrollment growth in higher education and it is unlikely that funding for community colleges and universities could be increased by the amounts implied in the Cherry Commission Report without significant structural changes elsewhere in the budget.

### Projections: FY08 to FY17

#### Enrollment

The number of traditional college-age Michigan residents (18- to 24-year-olds) is projected to decline in the next 10 years. While this could lead to declining enrollments in Michigan community colleges and state universities, enrollment grew from FY77 to FY07 even though the population of 18- to 24-year-olds declined by 260,000. Although a declining student-age population is expected in the next 10 years, state universities and community colleges could continue to increase student population as Michigan transitions into a knowledge economy and more people of all ages realize the benefit of a college degree, especially if a higher percentage of young people enroll in college after completing high school and if more displaced workers and other non-traditional students (i.e., older students) enroll in college to improve their job skills.

The Michigan Merit Award and Michigan Promise Scholarship are significant because they signal a shift in state funding from the institutions directly to the students themselves..

# MICHIGAN'S FISCAL FUTURE

**Table IX-2**  
**Population and Enrollment Growth, FY00 to FY17**

<u>Fiscal Year</u>	<u>18 to 24 Population</u>	<u>Community Colleges FYES</u>	<u>State Universities FYES</u>	<u>Total FYES</u>	<u>FYES Percent of Student-Age Population</u>
FY00	938,359	107,660	227,972	335,632	35.8%
FY07	985,844	139,219	253,346	392,565	39.8%
Annual Rate of Change, FY00-FY07	0.7%	3.7%	1.5%	2.3%	
FY08 (projected)	987,110	142,839	254,359	397,198	40.2%
FY17 (projected)	894,075	179,958	263,664	443,623	49.6%
Projected Annual Rate of Change, FY08-FY17	-1.1%	2.6%	0.4%	1.2%	

Source: U.S. Census Bureau; ACS Data Book, Michigan DLEG; HEIDI database, Michigan SBO; CRC Calculations.

Community college enrollment data from fall 2001 to fall 2006 show that overall enrollment grew 3.6 percent annually. This increase can be attributed to growth in both the traditional student population (under age 25) and the non-traditional student population (25 and older). While the number of traditional students grew at a higher rate of 4.4 percent per year, the number of non-traditional students also grew 2.7 percent annually during this time period.<sup>7</sup> The same trend, however, is not evident at the university level. Enrollment data from 2002 to 2006 show a 4.8 percent decline in the number of students over age 24, while the number of students under age 25 grew by 9.5 percent.<sup>8</sup> With the population of traditional college-age residents projected to decline, it is possible that future growth will depend more on increasing numbers of non-traditional students attending community colleges.

**Table IX-2** details population and enrollment growth from FY00 to FY07 and the projected population and enrollment growth from FY08 to FY17 if enrollment patterns remain the same. This calculation projects continued increasing enrollment in higher education,

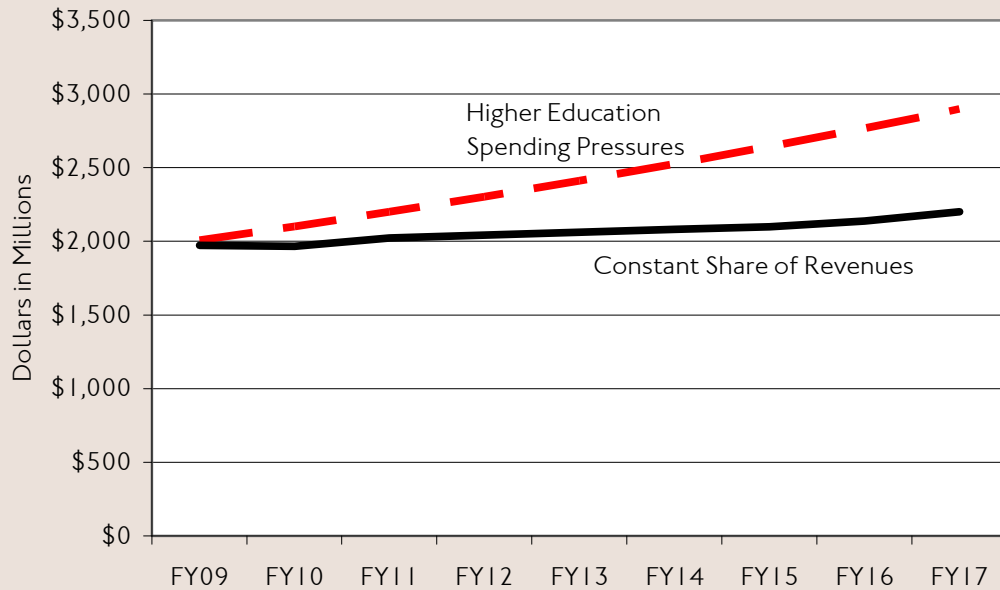
but not at the same rates as in the recent past owing to a declining student-age population.

### Spending Pressures

Higher education spending pressures will depend on enrollment growth, increases in employee compensation (which will be driven by health care and retirement benefits as well as national competition for high-caliber faculty and researchers), and inflationary increases for non-compensation items. This analysis assumes that enrollment and cost pressures will continue to grow as higher education becomes more important for the State's and individuals' economic success. Producing more college graduates will likely require Michigan colleges and universities to make a greater investment in increasing students and expanding access, which would require increased State support. However, General Fund revenues are not projected to grow fast enough to maintain the State's share of funding higher education. Higher education spending pressures, for both community colleges and state universities, are projected to grow 4.7 percent annually, well above the projected average annual growth

Higher education spending pressures, for both community colleges and state universities, are projected to grow 4.7 percent annually, well above the projected average annual growth in revenues in the General Fund (1.4 percent).

**Chart IX-9**  
**Projected Higher Education Spending Pressures and Revenue Growth, FY09 to FY17**



in revenues in the General Fund (1.4 percent). The projected increase in higher education spending pressures is based on a projected 3.5 percent annual increase in the general operations of postsecondary institutions (i.e., increases in salaries and benefits, administrative functions, supplies, etc.) and an approximately 1.2 percent yearly increase in enrollments.

**Revenues**

If the State can maintain its current share of operating funding for higher education (approximately one-third of university operating funding and 21.5 percent of community college operating funding), then tuition and fees (and property taxes for community colleges) would increase about 3.5 percent annually to meet growing cost pressures (the remaining 1.2 percent yearly increase would be met through growing enrollments). If the State cannot maintain its share of the increases, tuition and fees (and possibly property taxes) would likely increase at a faster rate.

**Chart IX-9** illustrates higher education spending pressures growing 4.7 percent per year through FY17 compared with General Fund appropriations for higher education growing approximately 1.4 percent per year, the average projected rate of growth in General Fund revenues (see Chapter V for more detail about revenue projections). This projected revenue growth assumes that higher education would maintain its share of General Fund revenues (19.8 percent). However, this assumption may be optimistic considering higher education appropriations made up nearly 23 percent of General Fund revenues in FY02 and less than 20 percent in FY08. As the chart shows, even if higher education does receive 19.8 percent of General Fund revenues, there would still be a significant gap between that level of support and the projected growth in spending pressures, approximately \$700 million by FY17. Without structural spending and revenue reforms in the General Fund, higher education appropriations would have to grow at the expense of other areas of the budget to meet growing spending pressures.



# MICHIGAN'S FISCAL FUTURE

Higher education is one area of the budget where legislators have discretion over spending and which has recourse to financing sources outside of the General Fund, so it is an area that can be cut more easily when the State is facing budget shortfalls. Without structural changes in revenue and spending, the State may be forced to make continued cuts or to provide smaller funding increases than would be needed to cover the

State's share of costs in areas where it has discretion – including higher education. This could lead to continued high growth in tuition and fees and property taxes for community colleges. However, if Michigan needs a more educated workforce and wants to keep more educated adults living and working in the state, then Michigan will need more residents of all ages pursuing postsecondary education.

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## Endnotes

<sup>1</sup> Higher Education Institutional Data Inventory (HEIDI) database, Michigan State Budget Office (SBO).

<sup>2</sup> FY07 state appropriations include the August 2007 delayed payment of \$25.8 million.

<sup>3</sup> The Citizens Research Council of Michigan. *"Headlee Rollbacks" and the Constitutionality of Public Act 415 of 1994*. Council Comments: No. 1039, January 1996.

<sup>4</sup> Public Act 94 of 1999.

<sup>5</sup> Public Act 479 of 2006.

<sup>6</sup> Office of Scholarship and Grants, Michigan Department of Treasury. Michigan Promise: Snapshot of High School Class 2007. [www.michigan.gov/documents/mistudentaid/snapshot-class-of-2007\\_212479\\_7.pdf](http://www.michigan.gov/documents/mistudentaid/snapshot-class-of-2007_212479_7.pdf) (18.December.2007).

<sup>7</sup> Enrollment Data 2000–2001 to 2005–2006, Community College Services Unit, Michigan DLEG, [www.michigancc.net/data/ea/enrollments.aspx](http://www.michigancc.net/data/ea/enrollments.aspx) (25.February.2008).

<sup>8</sup> Enrollment data from the Federal Integrated Postsecondary Education Data System (IPEDS).

## X. Medicaid and Related Programs

### Background

The Department of Community Health budget includes appropriations and revenues for medical benefits funded by the state and federal governments under a number of Medicaid programs authorized by Title XIX of the Social Security Act, as well as MIChild and the Medicaid Adult Benefits Waiver that are authorized by the federal State Children’s Health Insurance Program (SCHIP is authorized in Title XXI of the Social Security Act). Also included is the Federal Medicare pharmaceutical reimbursement program that is completely funded by the State. Administrative costs associated with these programs are included in Chapter VI. This section focuses on the health services delivery portions of these medical programs.

There were 1.7 million individuals eligible for Michigan Medicaid and related health services programs, including MIChild, in August of 2007. The expenses and revenues associated with these mental and physical health programs will have a major impact on the state budget in the coming years.

### Current Status

**Medicaid.** Medicaid, which was created by the federal government in 1965, is a state and federally funded health program for individuals and families with low income and resources. Each state administers its own program and may bundle Medicaid with other programs such as the State Children’s Health Insurance Program. States set eligibility, services, and payment criteria within the federal requirements. Nationally, Medicaid is the largest source of funding for medical and health related services for people with limited incomes, financing acute and long-term care services for more than 55 million individuals. Medicaid accounts for about one-sixth of the nation’s health care spending and almost half of all spending on long-term care.

More than 30 percent of Michigan children are enrolled in Medicaid; over one-third of births and two-thirds of long-term care patients are paid for by Medicaid. Although low income children and parents comprise three-fourths of Medicaid beneficiaries, 70 percent of spending is for care for the elderly and people with disabilities.

**Table X-1**  
**Michigan Medicaid Expenditures, FY00 to FY08**  
**(Dollars in Millions)**

<u>Fiscal Year</u>	<u>Total Medicaid Expenditures</u>	<u>General Fund Support</u>	<u>Total General Fund</u>	<u>GF Support as a Percent of GF</u>
FY00	\$7,486.3	\$2,226.6	\$9,788.2	22.7%
FY01	7,924.3	2,183.6	9,044.1	24.1
FY02	7,424.2	2,195.8	8,165.5	25.9
FY03	8,453.6	1,889.9	8,514.2	22.2
FY04	8,622.3	2,120.4	8,522.8	24.9
FY05	9,076.6	2,068.2	8,717.7	23.7
FY06	8,849.9	2,424.2	8,816.5	27.5
FY07	9,639.5	2,504.8	9,244.7	27.1
FY08**	10,450.3	2,533.5	9,911.9	25.6

\*\* Appropriation

Source: State Budget Office

# MICHIGAN'S FISCAL FUTURE

In Fiscal Year 2008 (FY08), 25.6 percent of Michigan's General Fund/General Purpose (GF/GP) appropriations are allocated to Medicaid; this percentage is up from 8.3 in FY80, 17.8 in FY90, and 22.7 in FY00.

Because the federal government provides at least half of Medicaid eligible program expenses, states including Michigan have developed a number of strategies for maximizing federal matching dollars. Some of these strategies do not involve the provision of medical services, but rather are transfers of funds to and from service providers designed for the sole purpose of generating federal matching dollars, part of which is used to generate General Fund savings and to relieve pressure on other areas of the budget, and part of which may be used to generate even more federal dollars. In addition, Michigan has created various restricted funds that are used to support Medicaid and related programs.

Medicaid has been, and, absent significant federal action, will remain the most significant program causing upward pressure on the State's General Fund expenditures.

Eligibility. Individuals are eligible for Medicaid if they belong to any of 25 different categories. Broad coverage categories include the following:

- Children
- Pregnant women
- Adults in families with dependent children
- Individuals with disabilities
- The elderly

Individuals must also meet income and assets requirements as well as immigration and residency requirements. Aged, blind, and disabled persons who receive Supplemental Security Income automatically qualify. Low income families that qualify for Michigan's wel-

fare program (Family Independence Program) also automatically qualify. The origin of these "mandatory" coverage groups derives from Medicaid's history as a health care program for individuals on welfare.

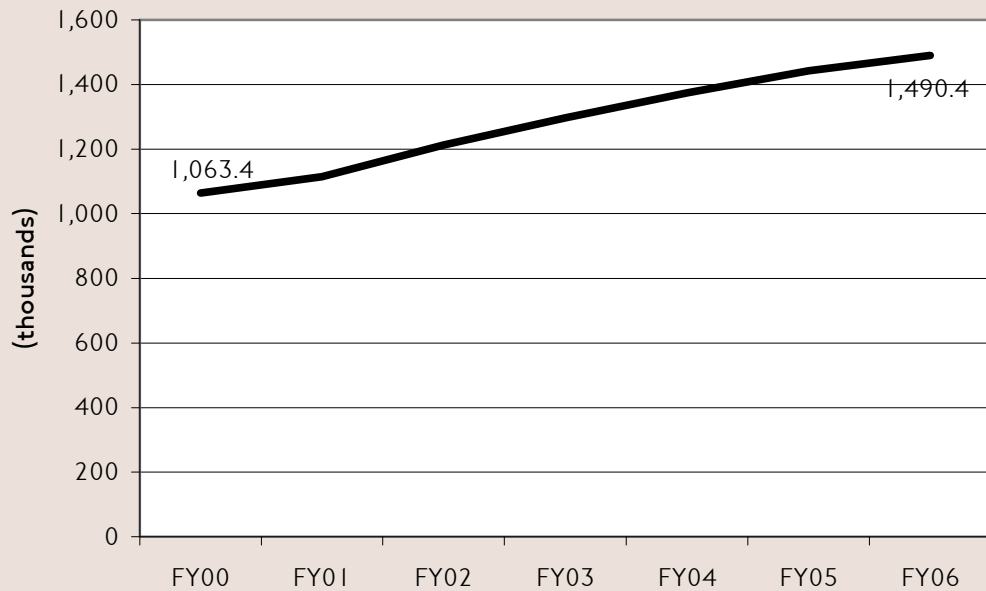
Michigan has expanded coverage to pregnant women, children, and elderly and disabled persons at higher income levels than is mandated. Pregnant women and children under age one in families with incomes up to 185 percent of the federal poverty level<sup>1</sup> are covered. Children aged 7 to 19 with family income up to 150 percent of the federal poverty level qualify for Michigan Medicaid. Youth aged 19 to 20 and caretaker relatives with income up to 50 percent of the federal poverty level qualify for Michigan Medicaid, as do elderly and disabled with incomes up to 100 percent of the federal poverty level. When states choose to extend eligibility to optional groups, the individuals in those groups are entitled to the same benefits offered to mandatory groups. "Optional" services often provide care coordination and essential services such as prescription drugs.

Michigan also covers the "medically needy" category in which, if income exceeds the limit, individuals who meet the non-financial eligibility requirements may incur medical expenses that equal or exceed the excess income and still qualify for Medicaid services. In states where the medically needy are included in the state's plan, prenatal and delivery services, postpartum pregnancy services for those under 18, and home health services to beneficiaries who are entitled to receive nursing facility services must be included, although states are not required to provide all mandated services to the medically needy.

Between FY00 and FY06, the number of Michigan Medicaid clients increased by 40 percent, from less than 1.1 million to almost 1.5 million (See **Chart X-1** on page 66).

Medicaid has been, and, absent significant federal action, will remain the most significant program causing upward pressure on the state's general fund expenditures.

**Chart X-1**  
Michigan Medicaid Clients, FY00 to FY06



\* The Department of Community Health estimates that 1,705,464 individuals were eligible for Medicaid in FY07. The chart represents actual Medicaid clients for FY00 through FY06.

The Michigan Department of Community Health estimates that in FY07, 1.7 million individuals were eligible for Medicaid and related programs.

Services. Federal Medicaid regulations specify mandatory services for mandatory (categorically needy) groups, optional services for mandatory groups, mandatory services for optional groups, and optional services for optional groups.

Mandatory coverage categories are those in which an individual who belongs to the category and meets financial and other requirements must be covered. Mandatory state services include the following:

- Inpatient hospital (excluding mental health)
- Outpatient hospital
- Laboratory and X-ray
- Pediatric services
- Early and periodic screening, diagnosis, and treatment for children under 21
- Family planning services and supplies
- Physicians services
- Medical and surgical services of a dentist

- Home health services for beneficiaries who are entitled to nursing facility services
- Nurse midwife services
- Pregnancy and 60 day postpartum related services
- Emergency services for non-citizens
- Federally qualified health center and rural health clinic services

All states provide some optional services, which generally must be offered to all enrollees. In Michigan, optional services include the following:

- Prescribed drugs
- Emergency hospital
- Hospice services
- Most mental health services including psychologists
- Transportation
- Personal care services
- Respiratory care
- Physical and occupational therapy
- Chiropractic services
- Private duty nursing services
- Eye glasses and eye exams

**Figure X-1**  
**Matrix of Mandated and Optional Services and Eligibles**

	<b>Mandated Services</b>	<b>Optional Services</b>
<b>Mandated Eligibles</b>	States <u>must</u> provide mandated services to mandated eligible persons	States <u>may</u> provide optional services to mandated eligible persons
<b>Optional Eligibles</b>	States <u>must</u> provide mandated services if they choose to include optionally eligible persons	States <u>may</u> provide optional services to persons they choose to include as optionally eligible

- Hearing aids
- Durable medical equipment
- Clinic services
- Nursing home services for individuals under 21
- Nursing home care for the elderly
- Intermediate care facility services for the mentally retarded
- Home and community based services
- Dental
- Optometry
- Prosthetic devices
- Tuberculosis services

States may apply for waivers from the federal government to cover services that would not otherwise be covered. For example, Michigan obtained a waiver to provide family planning services to women of child bearing age at up to 185 percent of poverty.

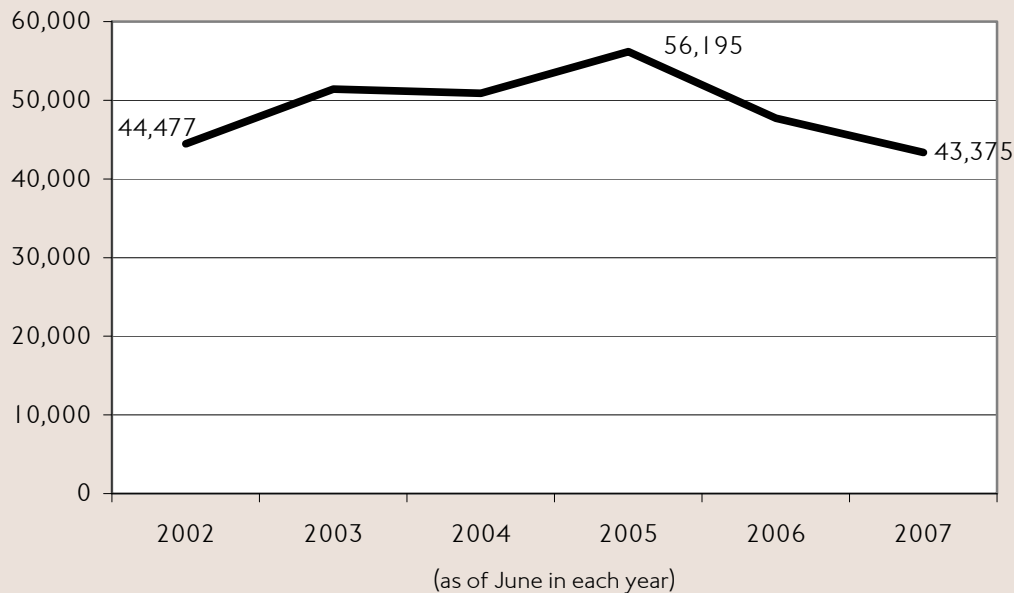
Maternal and child health block grants are provided to local agencies to enable them to address the needs of low income women, infants, and children in their jurisdiction based on a needs assessment. Other community based plans include a low income uninsured program targeted at non-elderly adults with incomes less than 150 percent of the poverty level, and third share programs aimed at the working poor in which the employer pays one third, the employee pays one third, and county government pays one third.

**SCHIP.** The State Children's Health Insurance Program (SCHIP) was enacted as Title XXI of the Social Secu-

rity Act by the U.S. government in 1997 to provide a capped amount of federal matching funds to states for coverage of children up to age 19 and some parents with incomes up to 200 percent of the federal poverty level (too high for Medicaid), but for whom private health insurance was not available. SCHIP is jointly financed by the federal and state governments and is administered by the states, which determine program design, eligibility groups, benefit packages, payment levels, and operating procedures, within broad federal guidelines. Unlike Medicaid, SCHIP is a block grant program, financed through a fixed federal appropriation. States may use SCHIP funds to extend Medicaid eligibility to children who did not previously qualify for that coverage; if they do, the coverage must mirror the Medicaid coverage provided by that state. Ineligible children include those covered under a group health plan or other health insurance, those who are members of a family that is eligible for state employee insurance, those residing in a institution for mental diseases, and those who are eligible for Medicaid. MICHild, Michigan's SCHIP program, is budgeted at \$38.7 million in FY08.

State allotments of federal funding are based on a statutory formula that includes two factors: the number of children (50 percent of the low income uninsured children in the state and 50 percent of the low income children in the state) and the state cost (based on annual wages in the health care industry in the state). For qualifying expenditures, states receive an enhanced federal matching rate equal to 70 percent of their Medicaid Federal Medical Assistance Percent-

**Chart X-2**  
**Michigan Children Enrolled in MICHild, June 2002 to June 2007**



Source: *SCHIP Enrollment in June 2007: An Update on Current Enrollment and SCHIP Policy Directions*, prepared by Vernon Smith et al, January 2008, the Henry J. Kaiser Family Foundation

age plus 30 percentage points, not to exceed 85 percent of total costs. Certain funding limits are also imposed.

Michigan has received an adult benefits waiver to use unspent SCHIP money, as well as GF/GP funds, to extend health insurance coverage to 62,000 uninsured childless adults with countable incomes at or below 35 percent of the federal poverty level. This waiver expires in 2009. In FY08, \$129.3 million is appropriated for the medical portion of the adults benefit waiver and \$40 million is appropriated for the mental health/substance abuse portion.

**Medicare Pharmaceutical Program.** The implementation of the federal Medicare Part D program resulted in a major shift in spending for prescription drugs from Medicaid to Medicare. “Dual eligible” individuals who qualify for both Medicaid and Medicare started receiving their pharmacy benefits from Medicare in 2006. States are required to return 90 percent of pharmacy costs to Medicare to compensate it for assuming the cost for these patients. The “claw back” is based on 2003 costs and growth rates, and is estimated at \$186.0 million, all state GF/GP, in Michigan’s FY08 budget.

# MICHIGAN'S FISCAL FUTURE

## The 2008 Budgetary Base

### Policy Provisions that Influence Projections.

Michigan's Medicaid, SCHIP, and Medicare Pharmaceutical Programs are the products of both federal and state policies that are subject to change. Federal policies regarding coverage and cost sharing have affected, and will continue to affect, Michigan's programs. Both Democratic and Republican federal administrations have pursued the goal of restricting state strategies that are designed purely to generate additional federal revenues. It is assumed that the State will continue efforts to maximize federal revenues and contain state costs.

**Managed Care.** Providers of Medicaid managed care services are paid on either a capitation basis, in which a uniform payment is made per client, or on a fee for service basis. In risk-based capitation plans, the provider is paid primarily through capitation; in non-risk capitation, the provider is paid for enrollees through

capitation, but payments are settled at the end of the year at amounts that do not exceed the fee for service cost for services actually provided, plus an amount for administration. In fee for service arrangements, the managed care entity is paid for each service provided, plus a case management fee. In 2006, 84.9 percent of Michigan Medicaid enrollees were in managed care plans of all kinds.

In 2006, 84.9 percent of Michigan Medicaid enrollees were in managed care plans of all kinds.

The Michigan Department of Community Health contracts with 15 health plans (both commercial and Medicaid-only managed care organizations) to provide managed care services to Michigan Medicaid enrollees. The state pays HMOs a monthly fee for each patient and the HMOs pay the physicians and other care-givers. Managed care plans win Medicaid contracts based on how robust their networks of doctors and hospitals are. Although they may be in managed care, Medicaid recipients may not enroll in a risk based capitation health plan if they are receiving Medicare, live in a nursing

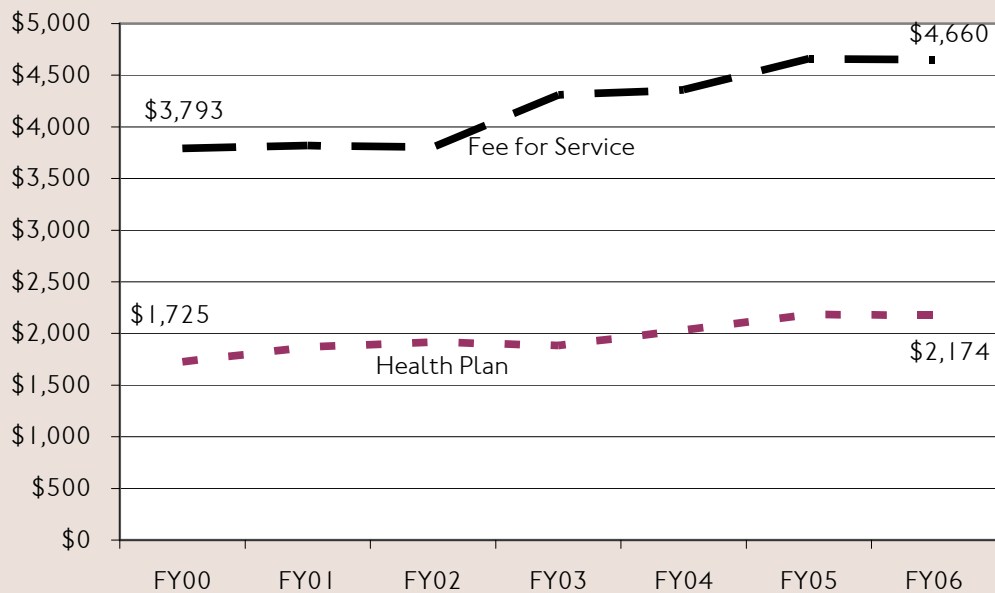
**Table X-2**  
Michigan Medicaid Caseload and Cost, FY00 to FY06

<u>Fiscal Year</u>	<u>Fee for Service Caseload</u>	<u>Cost in 1,000s</u>	<u>Health Plan Caseload</u>	<u>Cost in 1,000s</u>
FY00	341,500	\$1,295,372.7	721,900	\$1,244,935.9
FY01	432,500	1,652,789.2	682,200	1,273,442.7
FY02	451,300	1,717,313.1	761,000	1,458,748.9
FY03	489,547	2,110,913.0	806,547	1,520,609.9
FY04	514,274	2,241,235.2	859,926	1,747,937.8
FY05	543,900	2,534,658.3	898,600	1,963,844.3
FY06	569,400	2,647,115.9	921,000	2,002,403.1

Source: Michigan Department of Community Health



**Chart X-3**  
**Per Person Expenditures for Enrollees in Michigan Medicaid, FY00 to FY06**



home, have a monthly spend-down amount, or are receiving home and community based services for the elderly and disabled.

In FY06, the cost per person for individuals enrolled in health care plans was less than half of that for individuals for whom care was compensated on a fee for service basis: \$4,649 for those paid on a fee for service basis and \$2,174 for those enrolled in health plans. (See **Chart X-3.**) Individuals for whom care was provided on a fee for service basis include those in long-term care, and a large proportion of disabled and elderly. Individuals enrolled in health care plans were generally children and families.

In FY08, Michigan appropriated \$2.8 billion for health plan services.

Historically, one of the ways the State controlled costs was to freeze or reduce payments to providers. The federal government now requires that payments to managed care providers be on an actuarially sound basis. This requirement was cited as the reason for a 4.2 percent adjustment in managed care capitation rates and a 2.5 percent increase in Medicaid mental health and substance abuse services for FY08.

In FY06, the cost per person for individuals enrolled in health care plans was less than half of that for individuals for whom care was compensated on a fee for service basis.

**Long-Term Care.** Long-term services include assistance with routine activities such as dressing, bathing, preparing meals, taking medication, and managing money, as well as case management and adult and respite care. In FY08, Michigan appropriated almost \$1.6 billion for long-term care and nearly \$245.8 million for adult home help services. The FY08 budget for long-term care services was reduced by \$10.1 million (\$4.2 million from the General Fund) to reflect a statutory change that created a Medicaid long-term care estate recovery program.

**Acute Care.** Medicaid also provides acute care services, which includes hospital and physician services. The 2008 budget includes \$1.4 billion for hospital services and therapy, \$198.9 million for state hospital care at the five state-run hospitals, and \$500.2 million for physician services and children's medical care and treatment.

**Dual Eligibles.** On December 31, 2006, Michigan's Medicaid program included 194,120 "dual eligibles," who are low income seniors and people with disabilities who are enrolled in both Medicare and Medicaid. Most of these individuals receive full Medicaid coverage, but some receive Medicaid assistance only to help pay their Medicare premium and/or cost sharing obligations. These enrollees are among the poorest, sickest, and heaviest users of health care. Of the \$346.5 million appropriated for Medicare premiums in FY08, the State General Fund will pay \$145.2 million and the federal government will pay \$201.3 million.

As previously noted, dual eligible individuals started receiving their pharmacy benefits from Medicare in 2006, with states reimbursing the federal government for 90 percent of costs (\$186.0 million in FY08). Further shifts in responsibility between Medicaid and Medicare (particularly those that shift more of the cost of nursing home care to the federal government), programs that allow the elderly to remain in their homes, or that promote private long-term care insurance, can have a major impact on Medicaid costs paid by Michigan.

**Optional Eligibles and Services.** In FY07, the estimated spending for optional Medicaid services for beneficiaries over age 21 was \$2.6 billion. The state's FY08 Medicaid program includes coverage for a number of optional groups including childless adults, youths aged 19 to 20, and caretaker relatives, as well as optional services such as dental (\$117.5 million), podiatric, chiropractic, hearing services, pharmaceutical (\$285.2 million), hospice (\$85.3 million), and transportation (\$10.7 million). Mental health (\$1.7 billion) and substance abuse (\$36.4 million) services are also optional.

Expansion or reduction of the optional categories of recipients and the optional services would have a major impact on program costs and on the health status

of the state's poor and elderly residents. Elimination of some optional services would be expected to result in increased need for more expensive services.

**Disproportionate Share (DSH) Payments.** Michigan makes payments to hospitals that provide disproportionate amounts of care to indigent patients in order to support hospitals that are critical to the health care safety net and to preserve access to financially vulnerable hospitals for Medicaid and related program enrollees. These payments may not exceed a hospital's uncompensated care for providing inpatient and outpatient services to Medicaid and uninsured patients. For FY08, total DSH spending is expected to be \$474.9 million, including \$52.5 million carried forward from FY06 and FY07.

**SCHIP.** In FY08, MICHild is budgeted at \$38.7 million, of which \$11.3 million is state GF/GP. Program costs grew at an average annual rate of 9.7 percent in the last five years for which there is expenditure data. The federal authorization for SCHIP expired in October 2007, and two efforts by Congress to reauthorize and expand the program were vetoed by the President based on concerns about the substitution of government health care for private insurance. In December, the President approved the continuation of the present program through March 2009. The federal government is reportedly imposing restrictions on expanded eligibility to requests by states for expanded coverage under both SCHIP and Medicaid. Further, SCHIP was designed to provide coverage to low income children; the waiver that allows use of \$91.4 million of federal SCHIP funds for childless adults (the adults benefit waiver program totals \$129.3 million in FY08) may not be reauthorized.

**Michigan First Healthcare Plan.** The state entered into negotiations with the federal Department of Health and Human Services to secure approval of the Michigan First Healthcare Plan, which would extend coverage to more than 550,000 uninsured individuals in households with income up to 200 percent of the poverty level. That plan, which would be fully funded by the federal government at a cost of \$100 million, has not been approved and this projection assumes that it will not be approved.

## Projections

**Expenditure Projection.** Medicaid and related program costs are the result of enrollment, coverage, utilization, and health care inflation. Increasing enrollment is attributable to demographic trends; increasing survival rates of individuals with severe, chronic health conditions; unemployment and poverty rates; continuing declines in employer sponsored health insurance; and state decisions on extending coverage. Utilization reflects health status (affected by birth rates, an aging population, and unhealthy lifestyles) and coverage. Health care cost increases are driven by technological advances, fears of malpractice suits, lack of attention to medical best practices, and a failure to make health care costs transparent to consumers.

The Michigan House Fiscal Agency, in a January 2007 report titled “Managing Medicaid Costs in Michigan,”<sup>2</sup> noted that the state’s Medicaid expenditures are expected to grow at an average annual rate of 8 percent over the next 10 years, and that this is more than twice the typical average rate of growth in general fund/general purpose revenues in non-recessionary years.

For the purposes of this projection, growth rates are assigned to each of the various components of the Michigan Medicaid and SCHIP programs based on national health expenditure projections for state and local payments for Medicaid made by the Centers for Medicare and Medicaid Services, Office of the Actuary, (OA) for 2009 through 2016.<sup>3</sup> The OA growth rate for 2016 is also used for 2017. Medicare Pharmaceutical Program clawbacks are based on the OA projections for Medicare payments for prescription drug expenditures.

According to OA, overall health expenditures nationally will grow at annual rates ranging from 6.6 to 7.3 percent over the projection period ending in 2016.

6.6 to 7.3 percent over the projection period ending in 2016, assuming an average annual U.S. population growth rate of 0.8 percent. The Office of the Actuary projects that the proportion of Gross Domestic Product attributable to health will increase from 16.0 percent in 2006 to 19.6 percent in 2016 and that nationally, per capita spending for health will increase from \$7,092 in 2006 to \$12,782 in 2016.

A major difference in assumptions between the Centers for Medicare and Medicaid Services, Office of the

**Table X-3  
National Health Expenditure Projections for Medicaid; Annual Percent Change from Previous Year, 2009 to 2016**

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
Aggregate	7.8	7.9	8.1	8.2	8.3	8.3	8.3	8.3
Health Services and Supplies	7.8	7.9	8.1	8.2	8.3	8.3	8.3	8.3
Personal Health Care Expenditures	7.8	7.9	8.1	8.2	8.2	8.2	8.3	8.3
Hospital Care Expenditures	6.9	6.8	7.0	7.1	7.1	7.1	7.2	7.1
Physician and Clinical Services	7.7	7.4	7.6	7.7	7.7	7.6	7.6	7.7
Dental Services Expenditures	9.0	8.8	9.0	9.3	9.3	9.3	9.4	9.3
Other Professional Services	10.3	10.1	10.3	10.5	10.5	10.5	10.5	10.4
Home Health Care	10.1	9.8	9.9	9.7	9.6	9.5	9.4	9.3
Prescription Drugs	5.9	7.6	7.9	8.0	8.0	8.0	8.1	8.0
Nursing Home Care	5.6	5.8	6.0	6.2	6.4	6.6	6.8	6.8
Other Personal Health Care	11.9	11.9	11.8	11.7	11.7	11.6	11.5	11.4
Durable Medical Equipment	1.0	0.3	-3.6	0.2	-0.3	-0.2	0.2	0.0

Source: Centers for Medicare and Medicaid Services, Office of the Actuary

**Table X-4**

**Total Medicaid and Related Services Cost Projection, FY08 and FY17  
(Dollars in Millions)**

	<u>FY08 Budget</u>	<u>FY17 Projected</u>	<u>Increase</u>	<u>Annual Rate of Change</u>
Health Plan Services	\$2,762.1	\$5,598.5	\$2,836.4	8.2%
Mental Health & Substance Abuse	1,754.3	3,555.8	1,801.5	8.2
Long Term Care Services	1,554.1	2,700.8	1,146.7	6.3
Hospital Services and Therapy	1,376.1	2,539.4	1,163.3	7.0
Physician and Clinical Services	500.2	969.7	469.5	7.6
Pharmaceutical	471.2	1,094.6	623.4	9.8
Home Health Care	394.7	902.3	507.6	9.6
Medicare Premiums Payments	346.5	674.3	327.8	7.7
State Hospital Care Expense	198.9	367.1	168.2	7.1
SCHIP Programs	167.9	340.4	172.5	8.2
Dental Services	117.5	259.2	141.7	9.2
Other Professional Services	99.3	241.7	142.4	10.4
All Other	<u>674.1</u>	<u>983.1</u>	<u>309.0</u>	4.3
Total*	\$10,416.9	\$20,226.9	\$9,810.0	7.7

\*Total is for service delivery programs and excludes administration.

Source: State Budget for FY08; CRC Calculations

Actuary projections and those generated by this Michigan projection is the growth rate and the age composition of the population. This projection incorporates the effects of economic restructuring in Michigan, which is expected to result in population losses from 2006 through 2014 and a relatively rapid increase in the proportion of the population over age 65. Thus, the increase in Medicaid enrollment in Michigan may be disproportionately larger for categories of enrollees that have higher per capita costs. Economic restructuring may also result in higher rates of unemployment and fewer people with employer paid health insurance, thereby raising the number of income based Medicaid recipients.

The U.S. Department of Health and Human Services, Centers for Medicare and Medicaid Services' expected annual rate increases for categories of health care expenditures are reflected in **Table X-3**.

Michigan Medicaid and related medical services spending through FY17 is projected in **Table X-4**. These projections are based on total amounts budgeted by the State of Michigan in FY08 for Medicaid

services, SCHIP funded programs, and the Medicare drug clawback, using information from the Michigan Office of the State Budget on characteristics of specific programs and funding sources, and using projected rates of growth for categories of expenditures from the Centers for Medicare and Medicaid Services.

**Spending Pressures Projection.** For purposes of this projection, the key issue is the projected change in general fund/general purpose expenditure pressures for Medicaid and related medical services programs. Calculations of the General Fund spending pressures assume that total costs will grow at rates projected by the Office of the Actuary, that federal contributions including Title XIX and XXI will vary as noted below, that non-general fund sources will also vary as noted below, and that the General Fund would absorb the remainder of program costs after federal, state restricted, local, and other sources of revenues have been exhausted.

In Michigan, the state share of Medicaid and related program funding is derived from the General Fund, Merit Award Trust Fund, Medicaid Benefits Trust Fund,

provider taxes, special financing, other state restricted funds, and local funds. The projected increases in the non-general fund sources of support are well below the projected increases in the spending pressures, leaving an increasing proportion of total spending to be financed by General Fund revenues. This unfavorable leveraging of the General Fund exacerbates General Fund structural deficit problems.

Increases in enrollment and utilization, as well as in medical costs, have resulted in increasingly expensive programs. The Federal Deficit Reduction Act, which became effective in early 2006, revised certain Medicaid eligibility criteria and benefits in an effort to reduce program costs. The state has also implemented various program savings and reductions.

This projection assumes that federal Medicaid, SCHIP, and related programs remain intact and that state efforts to leverage federal funding, including the Quality Assurance Assessment Program, remain robust and effective.

**Federal Medical Assistance Percentage.** Michigan's Medicaid program, like that of all other states, is supported by federal funds, the annual amount of which is determined by a formula that compares a state's economic situation with the nation's. Specifically, the formula compares each state's three-year average per capita personal income with the national three-year

average. The formula is designed to provide a state with a per-capita figure that mirrors the national average with a federal share equal to 55 percent, leaving the state to contribute the remaining 45 percent of program costs. In general, the federal share cannot be less than 50 percent and the maximum cannot be more than 83 percent. The federal matching rate is called the Federal Medical Assistance Percentage or FMAP.

Criticism has been leveled against the FMAP calculation methodology, focusing on the time lag associated with the data used. (Michigan's 2009 FMAP is based on personal income data from 2004 through 2006.) Critics contend that the formula tends to be "pro cyclical" because the time delay results in a state receiving a higher rate when its economy is performing relatively better and a lower rate when its economy is performing less well. When states are struggling economically relative to the nation, the federal share of the Medicaid program, as measured by the FMAP, may actually decline, despite the fact that this is the time when the demand for services is greater and the state's resources are more limited.

In FY08, Michigan's FMAP is 58.1 percent. It will increase to 60.3 percent in FY09, according to the U.S. Department of Health and Human Services. For the remainder of the projection period, the FMAP will increase through FY 11, reaching 61.1 percent before falling steadily through FY 17. The decline does not result from

**Table X-5**  
**Michigan Medicaid Program: FMAP, FY08 to FY 17**

<u>Fiscal Year</u>	<u>Upjohn/CRC Projected FMAP</u>
FY08	58.1
FY09	60.3
FY 10	60.9
FY 11	61.1
FY 12	60.8
FY 13	60.6
FY 14	60.4
FY 15	60.2
FY 16	60.1
FY 17	59.9

Source: State Budget for FY08; CRC Calculations

**Table X-6**  
**Federal Participation in Michigan Medicaid and Related Programs, FY08 to FY17**  
 (Dollars in Millions)

<u>Fiscal Year</u>	<u>Federal Share</u>	<u>Total Spending Pressures</u>	<u>Federal Share as a Percent of Total</u>
FY08	\$5,953.0	\$10,416.9	57.1%
FY09	6,274.0	11,168.4	56.1
FY10	6,770.0	11,985.1	56.5
FY11	7,283.1	12,888.0	56.5
FY12	7,797.3	13,879.5	56.2
FY13	8,366.2	14,952.6	56.0
FY14	8,980.3	16,114.7	55.7
FY15	9,646.5	17,379.9	55.5
FY16	10,376.7	18,747.3	55.4
FY17	11,150.2	20,226.9	55.1

Source: State Budget for FY08; CRC Calculations

an improvement in Michigan's economic condition relative to the nation, but rather is a function of the population projection. Michigan's annual personal income growth rate (4.2 percent on average) consistently lags the national average annual rate of 5.1 percent during the projection period, but because of population loss in Michigan, the per capita personal income figure improves relative to the national average. This, in turn, causes the FMAP to decline from FY 12 through FY 17.

In addition to the FMAP contribution, the federal government participates in the SCHIP programs at the rate of 70.7 percent, pays 100 percent of some programs, pays varying proportions of other programs, and pays none of the costs of certain programs. Federal payments for Medicaid and related service delivery programs are projected in **Table X-6**.

**Quality Assurance Assessment Payments.** Michigan has been aggressive in finding ways to maximize the federal funding for Medicaid, including complex systems of provider taxes, payments, and intergovernmental transfers designed specifically to generate federal matching funds. These include the quality assurance assessment tax, disproportionate share payments to public hospitals, long-term care adjustor payments to county medical care facilities, outpatient adjustor payments to public hospitals, and school based services payments to local school districts. A

2007 legislative briefing prepared by the Senate Fiscal Agency<sup>4</sup> describes "special financing" Quality Assurance Assessment Payments:

- The state imposes a tax on a class of medical providers and collects the revenue.
- A portion of the revenue collected by the state replaces General Fund dollars as the non-federal share of Medicaid funding. The General Fund saving achieved by the state through QAAP is called gainsharing.
- Remaining revenue generated through the tax is used to increase the reimbursement rates paid to the taxed provider group for services to Medicaid recipients. When the funding is used to increase provider rates it generates Federal matching funds, about \$1.39 for every \$1 in state expenditure. With a Federal match included in the rate increase, a provider group (as a whole) will receive more revenue in Medicaid reimbursement than it paid in taxes.

As states have increasingly used these and similar special financing strategies, the federal government has initiated rules to regulate their use.

The basic provider tax of 5.5 percent imposed on hospitals and Medicaid HMOs is used to gain federal matching funds for the state Medicaid program. According to federal law, the provider tax must be im-

**Table X-7**  
**QAAP Financing as a Portion of Michigan Medicaid and Related Programs, FY08 to FY17**  
**(Dollars in Millions)**

<u>Fiscal Year</u>	<u>Special Financing-QAAP</u>	<u>Total Appropriations</u>	<u>QAAP as a Percent of the Total</u>
FY08	\$1,166.8	\$10,416.9	11.2%
FY09	1,204.4	11,168.4	10.8
FY10	1,260.2	11,985.1	10.5
FY11	1,320.9	12,888.0	10.2
FY12	1,388.6	13,879.5	10.0
FY13	1,460.7	14,952.6	9.8
FY14	1,537.1	16,114.7	9.5
FY15	1,620.4	17,379.9	9.3
FY16	1,711.1	18,747.3	9.1
FY17	1,808.8	20,226.9	8.9

Source: State Budget for FY08; CRC Calculations

posed on all members of a provider type (i.e. all hospitals, all HMOs); the rate must be uniform and may not exceed 5.5 percent for all providers of the same type; and the tax cannot be structured in a way that guarantees that a provider receives exactly the amount it was assessed (no hold harmless). The QAAP formula for long-term care providers is more complicated and is applied in different ways to various facilities. In FY08, QAAP is expected to provide \$1,166.8 million for the following:

- Mental health and substance abuse services,
- Hospital services and therapy,
- Long-term care services, and
- Health plan services.

This projection assumes that the provider tax will remain at 5.5 percent.

**Tobacco Revenues.** A portion of the revenues from the state tax on tobacco products is dedicated to fund Medicaid. Increases in tobacco tax rates and changes to the distribution of those tax revenues passed in 2004 resulted in significantly increased revenues being distributed to the Medicaid Benefits Trust Fund. In FY08, the MBTF is expected to contribute \$380.0 million to fund Medicaid programs; those funds are expected to decline by 2.5 percent annually.

Revenues from the tobacco tax that support the SCHIP adult benefits waiver are projected to remain stable.

In 1998, 46 states and the District of Columbia agreed to settle a lawsuit against tobacco manufacturers for Medicaid and other costs resulting from tobacco related illnesses. Tobacco settlement funds have been used by the state as a revenue source to support Medicaid. All assets and liabilities of the Tobacco Settlement Trust Fund, which was repealed as part of the tobacco securitization legislation passed in November 2005, were transferred to the Michigan Merit Award Trust Fund in FY06. In FY08 Merit and/or Tobacco Settlement revenue is expected to provide \$139.0 million to fund Medicaid programs: this revenue is expected to remain stable.

**Miscellaneous Revenues.** A number of minor revenue sources that are classified as restricted or local are projected to produce stable contributions to various Medicaid programs over the period of the projection.

**General Fund/General Purpose.** In FY08 the State's General Fund will contribute \$2.4 billion to Medicaid service delivery programs, SCHIP programs, and the Medicare pharmaceutical clawback. Adding revenues from the tobacco tax and tobacco settlement revenues to the General Fund contribution results in a state contribution of over \$3 billion.



**Table X-8**

**Total General Fund-General Purpose Projected Costs for Medicaid and Related Services, FY08 and FY17  
(Dollars in Millions)**

	<u>FY08 Budget</u>	<u>FY17 Projected</u>	<u>Increase</u>	<u>Annual Rate of Change*</u>
Mental Health & Substance Abuse	\$604.0	\$1,204.2	\$600.2	797%
Health Plan Services	331.1	1,377.2	1,046.1	1716
Pharmaceutical	303.5	761.0	457.5	10.75
Long Term Care Services	282.9	656.8	373.9	9.81
Physician and Clinical Services	223.5	428.8	205.3	7.51
Home Health Care	164.3	359.5	195.2	9.09
Medicare Premiums Payments	145.2	270.4	125.2	7.15
Hospital Services and Therapy	139.6	233.2	93.6	5.87
Dental Services	51.0	112.5	61.5	9.19
Other Professional Services	42.4	102.7	60.3	10.33
SCHIP Programs	36.5	87.0	50.5	10.13
State Hospital Care Expense	28.1	49.6	21.5	6.52
All Other Programs	<u>59.9</u>	<u>88.9</u>	<u>29.0</u>	4.48
<b>Total</b>	<b>\$2,411.9</b>	<b>\$5,731.8</b>	<b>\$3,319.9</b>	<b>10.10%</b>

Generally, Medicaid programs have a combination of revenue sources, although a few are funded completely by either the federal government or by the State's General Fund. In the current fiscal year, the General Fund provides varying proportions of funding for Medicaid and related programs, from 0 percent to 100 percent. In a very few programs, costs are shared equally between the federal and state governments. SCHIP programs are funded 70.7 percent by the federal government and 29.3 percent by the State. This projection assumes that programs that receive 0 percent, 29.3 percent, 50 percent, and 100 percent from the General Fund will continue at those payment ratios.

In some programs, (e.g. physician services, Medicare premium payments, personal care services) the General Fund portion of funding is the 41.9 percent that would be predicted with the current year FMAP of 58.1. This projection assumes that the FMAP percentage will vary as noted previously and that the state will continue to pay the remainder after the FMAP contribution in each year.

In other programs, (e.g. hospital services and therapy, long-term care services, health plan services) the use

of state restricted funds, local appropriations, and/or special financing generated match also reduces the General Fund portion of program costs. In those cases, Citizens Research Council has relied on information from the Office of State Budget to project the growth of various funding sources. Further, some programs (e.g. hospital disproportionate share payments, county indigent and third share programs, maternal and child health) are stable, with no growth in total appropriations expected over the projection period. Where current payments from external sources are scheduled to end before FY17, that has been factored into the projection (the last year the state will receive payment from the Omnicare Pharmacy Settlement is FY10). An evaluation of each Medicaid service program, both SCHIP programs, and the Medicare Part D pharmaceutical payment results in the conclusion that General Fund costs will increase from \$2.4 billion in FY08 to \$5.7 billion in FY17.

The extraordinary growth projected in General Fund costs for health plan services is a result of non-general fund revenues that are stable (\$73.7 million in special financing- state psychiatric DSH, \$180 million of QAAP, \$3.7 million of local school health financ-

**Table X-9**  
**General Fund-General Purpose Support of Michigan’s Medicaid and Related Service Delivery Programs, FY08 to FY17**  
 (Dollars in Millions)

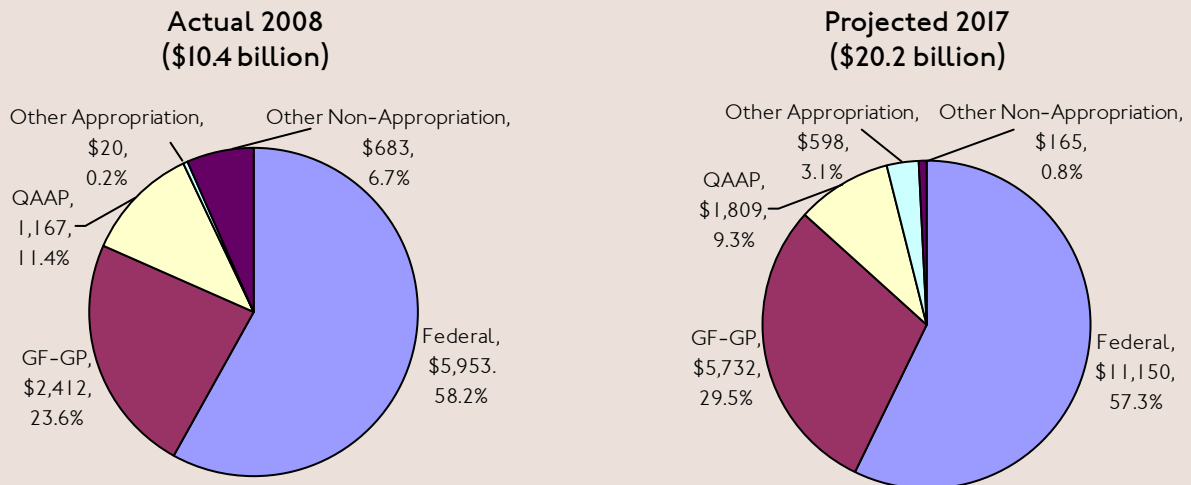
<u>Fiscal Year</u>	<u>GF/GP Support</u>	<u>Total Appropriations</u>	<u>GF/GP Support as a Percent of the Total</u>
FY08	\$2,411.9	\$10,416.9	23.2%
FY09	2,545.3	11,168.4	22.8
FY10	2,776.0	11,985.1	23.2
FY11	3,068.7	12,888.0	23.8
FY12	3,437.2	13,879.5	24.8
FY13	3,823.5	14,952.6	25.6
FY14	4,244.6	16,114.7	26.3
FY15	4,704.7	17,379.9	27.1
FY16	5,190.1	18,747.3	27.7
FY17	5,731.8	20,226.9	28.3

ing) or declining (revenues from the cigarette tax are projected to decline by 2.5 percent annually). As noted, the General Fund is treated as the funder of last resort.

Because this section of the projection excludes administrative functions that are included in State of Michigan reports on Medicaid and related programs,

the proportion of General Fund support in FY08, and consequently in subsequent years, reflected in **Table X-9** varies from published state reports. Based only on appropriations that fund service delivery programs and excluding administrative functions, this analysis projects an increasing portion of total Medicaid and related service delivery costs will be borne by the State’s General Fund.

**Chart X-4 and X-5**  
**Actual 2008 and Projected 2017 Revenues**



# MICHIGAN'S FISCAL FUTURE

Total expenditures for Medicaid and related health programs are expected to roughly double from \$10.4 billion dollars in FY08 to \$20.2 billion in FY17. Because of variations in federal funding and restrictions on the growth of restricted and other non-general funding sources, the General Fund

The average annual rate of increase in GF-GP spending pressures from Medicaid and related programs projected over the FY2008 to FY 2017 period is 10.1 percent, well above the projected average annual growth in revenues in the General Fund (1.4 percent).

costs of continuing current programs are projected to increase by \$3.3 billion, or 137.6 percent. The average annual rate of increase in General Fund spending pressures from Medicaid and related programs projected over the FY08 to FY17 period is 10.1 percent.

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## Endnotes

<sup>1</sup> The U.S. Department of Health and Human Services annually publishes poverty guidelines for determining eligibility for certain federal programs. For 2006, the guidelines for the 48 contiguous states provide that a family of four with a maximum of \$21,200 of income is in poverty.

<sup>2</sup> [www.house.mi.gov/hfa/PDFs/manage%20medicaid%20costs.pdf](http://www.house.mi.gov/hfa/PDFs/manage%20medicaid%20costs.pdf).

<sup>3</sup> [www.cms.hhs.gov/NationalHealthExpendData/Downloads/proj2007.pdf](http://www.cms.hhs.gov/NationalHealthExpendData/Downloads/proj2007.pdf).

<sup>4</sup> [www.senate.michigan.gov/sfa/publications/notes/2007notes/notesjulaug07df.pdf](http://www.senate.michigan.gov/sfa/publications/notes/2007notes/notesjulaug07df.pdf).

## XI. Mental Health

The Michigan Constitution of 1963 enumerates very few specific government programs, but it does mandate programs for the care, treatment, education, and rehabilitation of residents with mental illness (Article VIII, Section 8). Michigan constitutions dating to 1850 have contained language dealing with the care of individuals with serious mental and physical disabilities. Until about 1970, these constitutional provisions resulted in an expanding network of state institutions for the care of seriously disabled people. Since that time, however, the delivery of mental health services and services for those with developmental disabilities has undergone significant changes, with institutional care becoming much less prevalent and community care becoming the dominant mode of service delivery.

### Background

Prior to the 1960s and the national movement towards “deinstitutionalization” for the provision of mental health services, nearly all acute mental health care in Michigan was provided in state-run institutions. The advent of psychotropic drugs and changes in state law in the mid-1960s shifted the locus of this care from centralized state-run psychiatric facilities to community-based programs. In fact, it was the 1961 Michigan Constitutional Convention that added the words “programs, and services” to “institutions” in the Constitution in order to recognize the evolving nature of mental health care in Michigan. The changes in state law brought about the creation of county-organized Com-

munity Mental Health Services Programs (CMHSPs).

**Coverage.** Today, a network of 46 CMHSPs, covering all 83 counties, is responsible for planning, monitoring, and implementing mental health programs for Michigan residents with severe mental illness and developmental disabilities. Pursuant to the Mental Health Code<sup>1</sup>, these entities enter into contracts with the State of Michigan for the provision of mental health services to residents within their geographic boundaries. CMHSPs are organized in one of three ways: 1) as an arm of county government; 2) as a separate government entity formed by two cooperating counties under state law; or 3) as an independent authority created by at least one county by means of a resolution of the county board of commissioners.

Mental health services are delivered to both Medicaid-eligible as well as non-Medicaid eligible (low-income) residents. Medicaid mental health services are provided through Specialty Prepaid Health Plans (i.e., managed care entities) under contract with the State on the basis of prepaid capitation fees. Today, 18 qualified CMHSPs operate the plans, which, combined, cover the entire state. In Fiscal Year 2006 (FY06), the CMH system served nearly 207,000 adults and children with mental illness, substance abuse, developmental disabilities, or some combination thereof, which is approximately the same number of clients served in FY99. Services to these individuals include those funded through the Medicaid program as well as non-Medicaid services.

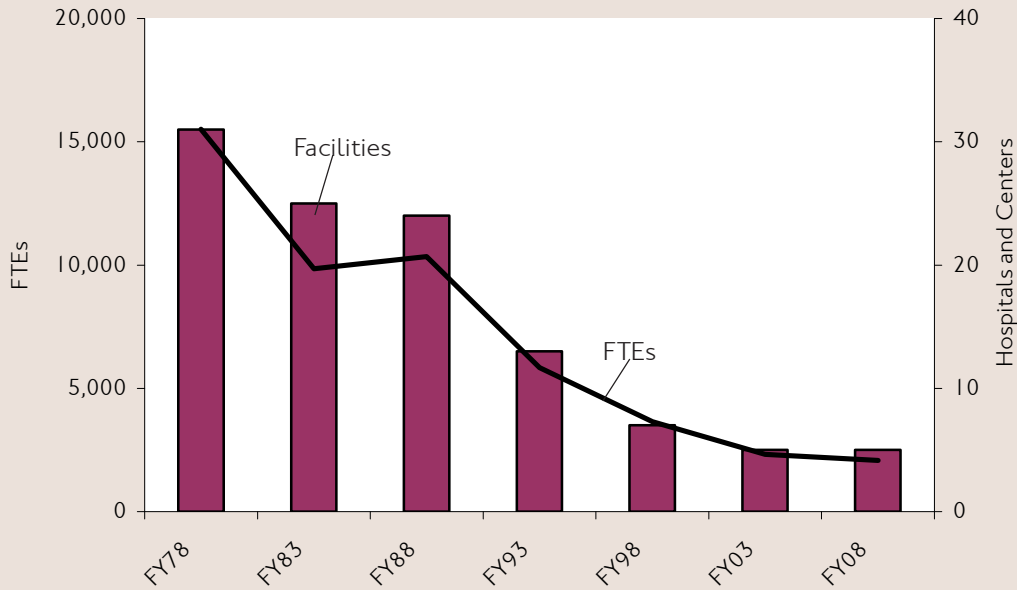
### Article VIII, Section 8 of the 1963 Michigan Constitution: Services for Disabled Persons

Institutions, programs, and services for the care, treatment, education, or rehabilitation of those inhabitants who are physically, mentally, or otherwise seriously disabled shall always be fostered and supported.

Chart XI-I

State of Michigan-Administered Hospitals and Centers

Employment Levels (FTEs) and Number of Facilities, FY70 to FY06, Selected Years



Source: Department of Community Health

**Chart XI-I** shows the number of state-administered facilities and associated employment levels, and demonstrates the general shift in responsibility from the state to the CMH system. In 1995, the State Department of Mental Health was combined with other State health functions and merged into the newly-created Department of Community Health.

**Spending.** In Michigan, annual mental health spending growth rates have been lower than total State spending growth rates over the period FY90 to FY07 (4.2 percent compared to 5.1 percent). Over a shorter period of time, FY00 to FY07, annual mental health spending growth rates in Michigan have kept pace with total state spending (3 percent compared to 3.1 percent). Over the same period, however, General Fund participation by the State de-

creased at an annual rate of 0.6 percent compared with the increase in mental health spending. The use of various Medicaid special financing techniques by Michigan helped to fuel the overall spending growth, while, at the same time, containing the growth in General Fund spending.

The State of Michigan will spend over \$2 billion (Medicaid and non-Medicaid) on services for mentally ill adults and children and for persons with developmental disabilities in FY08. This amount is twice the level of expenditures in FY90, when mental health spending totaled \$1.05 billion.

The State of Michigan will spend over \$2 billion (Medicaid and non-Medicaid) on services for mentally ill adults and children and for persons with developmental disabilities in FY08. This amount is twice the level of expenditures in FY90, when mental health spending to-

taled \$1.05 billion. This increase in spending provides some sense of the cost pressures facing mental health service providers over the past 18 years; however, what the growth rate does not reflect is the change in spending composition that has occurred over this time.

Generally speaking, State funding followed the shift in service provision down to the CMH system. The movement of services to the local level did provide some relief to State finances as 26 state institutions, some of them very antiquated and expensive to operate, have been closed since 1978. Of this total, 19 have been closed since FY88, the most recent being Northville Psychiatric Hospital in 2003. Plans for future closures have not been articulated at this time. Today, the State operates five hospitals/centers serving residents with mental illness and/or developmental disabilities.

State spending in direct support of CMH increased five-fold between FY90 and FY07, from \$386 million to over \$1.9 billion (see **Table XI-1**). During the time that spending in this area increased, expenditures for state-run programs dropped dramatically. This shift in spending reflects the transfer of increasing levels of responsibility to the CMH system, most notably the spending on state institutions and state-run group homes (Community Residential Services). Spending at the local level comprised 37 percent of total men-

tal health expenditures in FY90, whereas in FY07, CMH spending accounted for 91 percent of the total.

Spending growth since FY90 is attributed to two inter-related factors: a rise in the number of people being treated for mental disorders (i.e., at the community level), and more significantly, an increase in the amount and mix of services provided to people with mental illness. The most rapidly growing form of treatment during this period was psychotropic medication, as evidenced by an increase in prescription drug spending from 7 percent to 21 percent of total mental health spending. Some of this increase in drug treatment spending was mitigated by decreased in-patient psychiatric hospital lengths-of-stay. State in-patient hospitals provided mental health care to nearly 5,000 individuals (adults and children) in 1990, whereas today state-run institutions house fewer than 1,000 people. Hospital census reductions allowed for the closure of a number of in-patient hospitals/clinics since 1991, which has reduced the growth in spending on mental health services.

Spending at the local level comprised 37 percent of total mental health expenditures in FY90, whereas in FY07, CMH spending accounted for 91 percent of the total.

**Table XI-1**  
**Mental Health Spending (Medicaid and Non-Medicaid), FY90 to FY07**  
**(Dollars in Millions)**

	<u>FY90</u>	<u>FY95</u>	<u>FY00</u>	<u>FY05</u>	<u>FY06</u>	<u>FY07</u>
CMH - Medicaid Services	\$93.7	\$433.7	\$1,175.0	\$1,416.7	\$1,480.6	\$1,537.7
CMH - Non-Medicaid Services	287.8	306.7	301.9	311.8	312.6	317.8
CMH - Other	4.5	43.8	6.9	59.0	61.3	61.5
Subtotal CMH	386.0	784.2	1,438.8	1,787.5	1,854.5	1,917.0
Institutions and Community Residential Services	<u>655.2</u>	<u>517.2</u>	<u>219.6</u>	<u>167.1</u>	<u>180.7</u>	<u>185.2</u>
Total	\$1,051.2	\$1,301.4	\$1,703.4	\$1,954.6	\$2,035.2	\$2,102.2
Average Annual Rate of Change Since FY90		4.4%	4.9%	4.2%	4.2%	4.2%
Average Annual Rate of Change Since FY00				2.8%	3.0%	3.1%

Source: Senate Fiscal Agency; CRC calculations.

# MICHIGAN'S FISCAL FUTURE

Historically, for those mental health services delivered to non-Medicaid individuals, funds were distributed to individual CMHSPs via a formula based upon each CMHSP's history of key factors. Today, allocations are based on incremental budgeting – what each CMHSP receives tends to be a percentage increase (or decrease) from the previous year. Over the years, there have been a number of reallocation efforts to narrow the spread between higher- and lower-funded CMHSPs. As a general rule, counties are responsible for 10 percent of net costs for persons within their geographic area, with “net” being defined as total costs less those paid by federal, private and/or insurance funds. In the past, the failure of counties to generate the requisite local match resulted in those counties being required to return state funds. The FY08 budget will provide about \$320 million from the General Fund to the CMH system to deliver non-Medicaid mental health services to residents of the state.

**National Expenditures.** The Substance Abuse and Mental Health Services Administration (SAMHSA) estimates that \$100.3 billion was spent on mental health services nationally in 2003, up from \$55.2 billion in 1993, an increase of nearly 82 percent. Michigan's recent increase in spending on mental health services was less than the national rate of increase in mental health spending and less than the rate of increase for all health care spending nationally. Over the 10-year period (1993 to 2003), national mental health care spending grew at an annual rate of 6.2 percent while total health care

spending experienced an average annual growth rate of 6.6 percent (see **Table XI-2**). These figures compare with Michigan's 10-year average annual growth rate of 4.2 percent over a comparable period (FY90 to FY00). Annual growth in mental health prescription drug spending (18.8 percent) outpaced all health prescription drug spending (13.3 percent) over the 10-year period, evidence of the increased reliance on prescription drugs and the related advances in the effectiveness of those pharmaceuticals.

**Medicaid.** By the end of the 1980s, Michigan had begun to rely increasingly on Medicaid for the financing of mental health services, a transition experienced in many other states during the same time. Nationally, Medicaid covered 21 percent of total mental health spending in 1993, this increased to 26 percent by 2003 (see **Table XI-2**). Medicaid financed only 17 percent of all health spending nationally in 2003. A more complete discussion of Michigan's Medicaid program, along with projected revenue and spending is included in Chapter X of this report.

The growth in Medicaid financing for mental health services helped Michigan and other states transition from state-run institutional care to community-based care. The growth in Medicaid was the result of the establishment and expansion of optional enrollment categories and services and not necessarily an increase in the number of people with mental illness. Further, Medicaid was seen in states as a means to pay for men-

**Table XI-2**  
**National Spending Growth for Mental Health (MH) and All Health, 1993 to 2003**

<u>By Selected Service Types</u>	<u>Annual Growth Rate</u>		<u>Percent of Total MH Spending</u>		<u>Annual Growth Rate</u>
	<u>1993 to 2003 – MH</u>	<u>1993</u>	<u>2003</u>	<u>1993 to 2003</u>	<u>All Health</u>
Inpatient	1.9%	36.4%	24.0%		Na
Outpatient	6.1%	31.2%	31.0%		Na
Residential	6.1%	19.2%	14.7%		Na
Prescription drugs	18.8%	7.5%	23.2%		13.3%
Total	6.2%				6.6%
<b><u>By Selected Payer Type</u></b>					
Medicaid	8.5%	21.3%	26.3%		16.6%

Source: Substance Abuse and Mental Health Administration; CRC calculations. [www.samhsa.gov/spendingestimates/toc.aspx](http://www.samhsa.gov/spendingestimates/toc.aspx).



tal health services previously funded by state dollars. The change from state-only funding for mental health services to a joint federal-state responsibility helped shift some of the cost burden from the state budgets to the federal government and provided some stability to CMH finances. The shift to Medicaid, which is an entitlement program, for mental health services also meant that states had less ability to control annual mental health spending.

**Managed Care.** Mental health spending in Michigan has been stabilized by the implementation of managed care for the mentally ill and developmentally disabled Medicaid population. The State of Michigan completed its transition to a mandatory managed care model for Medicaid recipients in 1998, following federal approval of the program. Today, over 90 percent of Michigan Medicaid recipients are enrolled in managed care. Just as managed care has helped mitigate the cost increases for physical health services, implementation of managed care has helped control the growth in costs for behavioral health services. Managed care also has provided health care beneficiaries, and to some extent public budgets, with a degree of predictability, resulting from the use of capitated reimbursements.

Medicaid services at the CMH level are provided through managed care plans operated by qualified CMHSPs. Funds are distributed to individual plans based on a risk-based capitation formula.

**Revenue.** Mental health services spending in Michigan, at both the State and CMH level, is supported by a complex mix of sources, including federal Title XIX (Medicaid), State General Fund, State restricted, and local revenues. Revenues supporting the Medicaid-financed portion of mental health programs within the budget are covered in Chapter X.

As noted in the chapter on Michigan's Medicaid program, CMH financing has benefited from the use of provider taxes. Since 2004, CMHSPs have been subject to a Quality Assurance Assessment Program (QAAP) tax. The use of this special financing arrangement for Medicaid effectively allows the State to receive additional federal Medicaid funds, increase provider reimbursement rates, and offset General Fund spending. The Senate Fiscal Agency recently estimated that as of the end of FY07, the CMHSP provider

tax has resulted in cumulative General Fund savings of \$96.4 million.<sup>2</sup>

## Future Outlook

**Policy Provisions that Influence Projections.** Mental health services in Michigan are a function of policies at both the federal and state levels. Given Medicaid's substantial role in the financing of these services, federal policies governing cost-sharing, services, and eligibility will directly affect Michigan's future General Fund spending. At the same time, the cost of non-Medicaid mental health services will be determined by state policies regarding eligibility, services, and cost-sharing.

Public payers, such as Medicaid, reimburse a disproportionate share of mental health care costs compared to costs for treatment of other health problems. This will add to the fiscal stress facing Michigan's Medicaid budget during the out years of the projection period. Within the Medicaid budget, Michigan's Federal Medical Assistance Percentage (FMAP), i.e., the federal-state cost-sharing rate, will adjust with the economic conditions in the state.

Under the economic projection presented here, Michigan's FMAP will increase marginally between FY09 (60.3 percent) and FY11 (61.1 percent) as the state's economy continues to struggle relative to the national economy. Therefore, the State's percentage share of total program costs will decrease over this time, providing some relief to General Fund spending pressures. However, due primarily to Michigan's projected population losses, its per capita personal income ranking will rise relative to the national average from FY12 to the end of the projection period, driving its FMAP down to 59.9 percent by FY17. During this period, Michigan's economic performance will continue to under perform the national economy, but the State will have to absorb a larger portion of the cost of its Medicaid program.

The State has been able to use provider taxes to address the escalating costs associated with the Medicaid program. Changes to the federal legislation that authorize provider taxes can affect General Fund spending on mental health services. The maximum provider tax rate for FY08 was reduced to 5.5 percent (from 6 percent) for the CMHSPs, requiring Michigan

to increase its General Fund spending by \$8.8 million to compensate for the loss of the special financing revenue. Federal action to curb states' use of these Medicaid financing arrangements may result in additional pressure on the State's General Fund budget to continue to provide the same level of mental health services. This report assumes federal policy will not further curtail states' use of provider taxes.

**Spending Projections.** Future spending pressures will be a product of a number of factors, including caseload growth, rising health care costs in general (specifically prescription drugs), and coverage. Caseloads will be driven in large part by demographic trends, such as the aging of Michigan's population; economic variables (e.g., poverty and unemployment); trends in private health insurance coverage; and utilization. Given the significance of drug treatment for a variety of behavioral health disorders, factors that affect the costs of prescription drugs, psychotropic drugs in particular, will determine future spending pressures. Finally, the mix of Medicaid state plan services (mandatory and optional) will determine future spending pressures in that program. Mental health services are an optional service under Michigan's plan.

Along with advances in medical technology and procedures, new pharmaceutical technology is enabling people with mental illness to lead more productive lives. These advances do come at a price to public budgets. According to the SAMHSA, drug spending increased nearly 19 percent annually between 1993 and 2003, nearly three times faster than spending for other services (in-patient, outpatient, residential). While this

growth rate is unlikely to continue in the future, pharmaceutical treatments will continue to be a major component of mental health spending. Medicaid's coverage of new drug technology will continue to add to the spending pressures in this area of Michigan's budget.

As Michigan's population ages, which is reflected in this report's demographic projection (See Chapter IV), mental health spending will exert additional pressure on the State budget. Much of the treatment for mental illness for the aged population will not be provided in a community-based setting, but instead will have to be provided in a nursing home. Such in-patient care generally will be more expensive.

To project future non-Medicaid mental health spending supported by the State General Fund, this report uses CMH appropriations for FY08. Growth rates were applied to the FY08 appropriated amounts to arrive at spending projections for FY09 through FY17 (see **Table XI-3**). Spending projections associated with Medicaid services delivered at the CMH level are included in Chapter X.

Community Mental Health boards receive State General Fund support to deliver services through a number of appropriations, most notably the CMH non-Medicaid line item, the Purchase of State Services (POSS) line item, and the Community Residential Services (CRS) or "group homes" line item. As state-paid group home leases expire, this funding is projected to be transferred to the CMH line item; therefore, spending for this program is expected to remain constant

**Table XI-3**  
**Community Mental Health Non-Medicaid General Fund Spending Projections, FY09 to FY17**  
**(Dollars in Millions)**

<u>Non-Medicaid Programs</u>	<u>FY09</u>	<u>FY17</u>	<u>Percent Change</u>	<u>Annual Growth Rate</u>
Purchase of State Services (POSS)	\$112.6	\$155.3	37.9%	4.1%
CMH "formula" grant	327.6	399.1	21.8%	2.5%
Other line items	9.1	9.1	0.0%	0.0%
Total	\$449.3	\$563.5	25.4%	2.9%

during the projection period. Spending in the other two major state-supported CMH programs is projected to grow as result of increases in caseloads, service levels, medication costs, and employee compensation costs. The future spending pressures for the POSS line item are projected to increase consistent with the annual growth rates applied to the "other" areas of the General Fund budget, 4.1 percent on average, to reflect that these services are carried out by state employees in state facilities. To reflect the inflationary pressures facing the provision of health services to the non-Medicaid eligible population, this report grows the CMH "formula" line item by the assumed rate of inflation, 2.5 percent per year.

In light of the General Fund revenue projection presented here (average annual growth rate of 1.4 percent), it is expected that annual mental health spending pressures of 2.9 percent will be greater than the annual growth in the state's discretionary resources.

Since the beginning of the state's fiscal problems in the early part of the decade, the growth in spending on mental health services (Medicaid and non-Medicaid) by state and local agencies has outpaced the annual rate of change in Michigan's discretionary resources. A continuation of this trend will add to the spending pressures facing Michigan's General Fund budget during the projection period. In light of the General Fund revenue projection presented here (average annual growth rate of 1.4 percent), it is expected that annual mental health spending pressures of 2.9 percent will be greater than the annual growth in the state's discretionary resources.

## Endnotes

<sup>1</sup> PA 258 of 1974.

<sup>2</sup> "The Role of Medicaid Special Financing in Changes in State Expenditures", Senate Fiscal Agency, January 2008. [www.senate.michigan.gov/sfa/Publications/Issues/MedicaidSpecialFinancing/MedicaidSpecialFinancing.pdf](http://www.senate.michigan.gov/sfa/Publications/Issues/MedicaidSpecialFinancing/MedicaidSpecialFinancing.pdf).

## XII. Human Services

### Background

The Department of Human Services operates a number of programs designed to help needy Michigan children, families and vulnerable adults. These programs cover a wide spectrum of services, ranging from cash assistance (welfare) paid to families meeting income and eligibility requirements to programs designed to care for youth that have violated the law and have been committed to the Department by the court. The programs can be divided into the following broad categories (with examples):

- Public Assistance: Family Independence Program (welfare), Food Assistance, State Disability Assistance, Child Day Care, State Emergency Relief
- Adult and Child Services: Adoption Services, Child Abuse Prevention, Foster Care
- Licensing: Child Day Care, Foster Care
- Child Support Enforcement
- Juvenile Justice

The Department of Human Services is primarily funded by the General Fund, Federal dollars that Michigan receives as part of its Temporary Assistance for Needy Families (TANF) block grant, and, to a lesser extent, Medicaid. The amount of General Fund resources spent on Human Services programs is significant, approximately 13 percent (\$1.3 billion) of Michigan's total

The amount of General Fund resources spent on Human Services programs is significant, approximately 13 percent (\$1.3 billion) of Michigan's total General Fund resources in FY08.

General Fund resources in Fiscal Year 2008 (FY08). While future annual spending pressures in this area may not be as severe as those associated with other large General Fund-financed programs (e.g., Medicaid and Department of Corrections), Human Services programs will continue to demand a sizeable share of the State's discretionary General Fund resources.

Given the significant share of discretionary budget resources allocated to Human Services programs, spending decisions that involve the re-allocation of State budget resources to any sizable degree will have to take into account the funding provided to Human Services programs.

### Welfare Reform

Federal welfare reform in 1996 (Personal Responsibility and Work Opportunity Reconciliation Act) significantly changed the system of public assistance provided by states, and Michigan was no exception. The over-arching goal of the changes to federal welfare law was to move those people that were dependent on cash assistance into the workforce, establish time limits for most benefits, and end the "entitlement" nature of welfare benefits. The Act devolved power from the federal government to state governments, most notably in the nature of the new federal funding provided to states. The Temporary Assistance to Needy Families (TANF) block grant replaced the more rigidly-structured Aid to Families with Dependent Children (AFDC).

Nationally, federal welfare reform has been successful in attaining its goal of reduced cash assistance caseloads. Michigan's experience with cash assistance caseloads is consistent with the national trends as caseloads have declined by two-thirds since enactment of the reforms, from an annual average of nearly 225,000 in FY94 to around 87,500 in FY07.

At the same time that welfare reform reduced cash assistance caseloads, caseloads in other support services provided by the states increased because of the flexibility provided under the TANF block grant. States were allowed to craft programs and services necessary to meet the needs of those individuals leaving cash assistance and entering the workforce, such as transportation, day care, and job training services. The composition of state spending under TANF programs has changed dramatically, shifting away from direct cash assistance towards other services. Michigan's experience has been no different than other states as spending on cash assistance has plummeted while spending on other services has grown following welfare reform.

Over one-half (\$657 million) of the total FY08 General Fund spending by the Department will be in two broad areas: public assistance programs and adult and child services. It is expected that these two areas will continue to be the drivers of future Human Services spending pressures during the projection period: therefore, they are the primary focus of this analysis. Historically, the largest and most significant determinant of spending in these areas has been the number of people served by each program, i.e. caseloads. The long-term factors affecting caseloads, especially as they relate to CRC's economic projections, will be examined here. In addition, it is also instructive to analyze other factors that might affect future state spending, such as benefit levels, the level of Federal resources available, and changes in state policies outside of the Human Services arena.

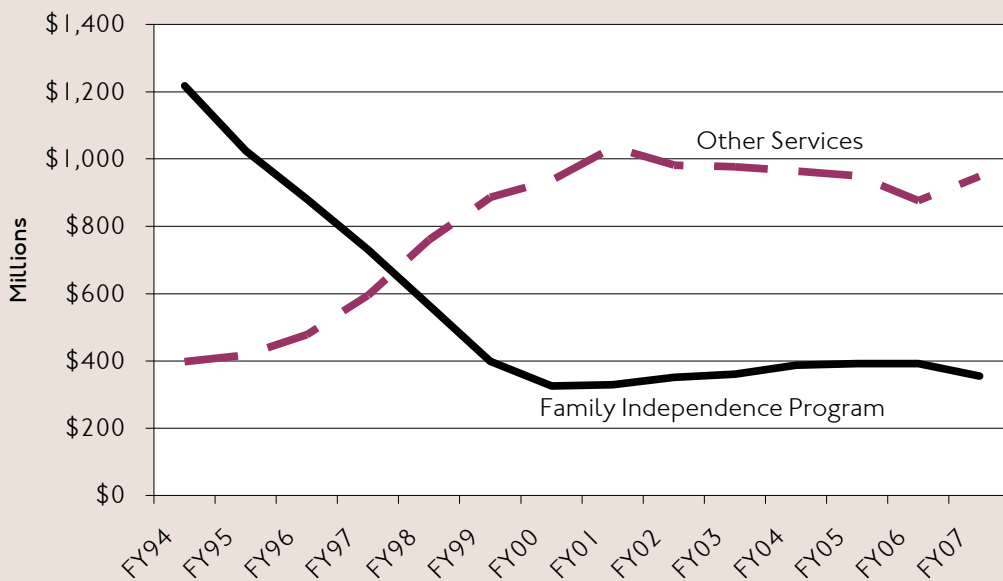
## Current Status

**Shifts in the Human Services Spending Mix.** Before the enactment of federal welfare reforms in the mid-1990s, Michigan's mix of Human Services spending was

undergoing a significant change. Michigan was one of the first states to obtain relief from federal welfare rules and condition benefits on increased work requirements with the stated aim of directly reducing caseloads. Michigan was also one of the early states to increase penalties for failing to meet work participation or training requirements. The federal reforms in 1996 hastened the trend in declining caseloads that began in the early 1990s in Michigan.

It is widely accepted that state and Federal welfare reform policies were the primary factors in caseload reductions during the 1990s, however, it is important to recognize that welfare reform occurred during a historically high-growth economic cycle, both nationally and in Michigan. Therefore, two factors were in play that help to explain the sharp drop in cash assistance caseloads in Michigan. While there is some debate regarding how strongly welfare caseload trends are linked to the economy, it is acknowledged that economic factors do influence caseloads. Unemployment is considered one of the most predictive "short-term" variables of cash assistance caseloads.

**Chart XII-1**  
**Family Independence Program and Other Services\* Spending, FY94 to FY07**



\* Other Services include day care, foster care, adoption, and family preservation.

Source: House Fiscal Agency.

# MICHIGAN'S FISCAL FUTURE

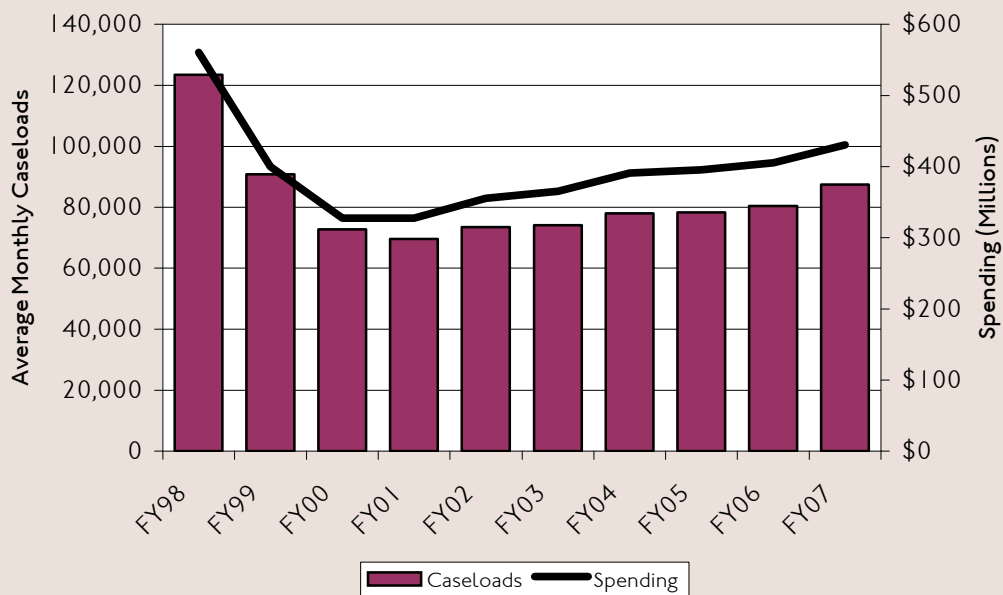
Michigan's budget did not realize the full fiscal effects associated with welfare caseload reductions that occurred in the 1990s. Budgetary savings associated with decreases in welfare spending were partially consumed by spending in other Human Services areas. Welfare reform effectively shifted spending away from cash assistance to spending on other Human Services program areas, mainly those that enabled individuals to find and maintain employment (e.g., day care, job training). The shift in spending was aided by the flexibility provided in the new federal funding, Temporary Assistance to Needy Families (TANF). **Chart XII-1** depicts the shift in spending away from cash assistance to other services in Michigan following welfare reform. A reversal of this shift is not expected during the projection period.

**Recent Caseload Growth.** Michigan's welfare program, the Family Independence Program (FIP), provides cash grants to low-income families who need help in meeting basic needs (e.g., housing, clothing, utilities). After falling precipitously to a historic low in FY01, the

average monthly FIP caseload has been gradually increasing. The monthly caseload has grown from 69,543 in FY01 to 87,450 in FY07, representing a 3.9 percent annual growth rate. During the same time, total annual FIP payments followed a similar trend. After welfare reform in the 1990s, the amount of total payments fell until FY01. In FY02 this trend reversed course, and since that time total payments have increased each year. Payments have grown at an average annual rate of 4.7 percent, rising from \$327.3 million in FY01 to \$430.6 million in FY07 (see **Chart XII-2**).

At the same time that FIP participation and spending were growing at moderate annual rates, participation in other assistance programs delivered by the Department of Human Services grew much faster. Because FIP recipients automatically qualify for food stamps, growth rates for the cohort receiving both FIP and food stamp benefits are nearly identical, about 4 percent annually. However, the number of non-FIP recipients receiving food stamps increased 14 percent annually between FY01 and FY07. Although the food program

**Chart XII-2**  
Family Independence Program Spending and Caseloads, FY98 to FY07



Source: Department of Human Services, various monthly statistical reports. [www.michigan.gov/dhs/0,1607,7-124-5458\\_7696\\_10831-,00.html](http://www.michigan.gov/dhs/0,1607,7-124-5458_7696_10831-,00.html).



is funded by federal dollars and does not directly affect the State General Fund, the recent growth pattern demonstrates that an increasing number of Michigan residents require public assistance to meet basic needs. Undoubtedly, economic factors, including Michigan's chronically high unemployment rate, contribute to the food assistance caseload increase. Other factors also at work include changes in eligibility and increased outreach efforts in recent years.

The recent growth in caseloads and spending has accompanied Michigan's economic downturn. Michigan's economy, as measured by employment, began a steady slide in 2001, which continues today. Michigan wage and salary employment has fallen since its peak in July 2000, with the Bureau of Labor Statistics reporting the loss of nearly 450,000 jobs. The struggles in the manufacturing sector explain much of the loss. During this period, Michigan's once-enviable unemployment rate skyrocketed and remains the highest in the nation.

Similar trends are seen in the recent caseload figures for Medicaid (non-FIP participants). Overall, caseload growth in Human Services programs is not projected to abate enough to relieve the spending pressures in this area of the State budget. A continuation of caseload growth, albeit at lower levels, portend rising spending pressures on Michigan's General Fund budget.

### Future Outlook

**Policy Provisions that Influence Projections.** Both state and federal policies can affect the spending outlook in this area of the State's budget. Federal policies regarding cost-sharing have, and will continue to, influence Michigan's public assistance programs. Historically, Federal funds distributed to the states have been capped, which places additional spending pressures on state funds when policymakers consider improvements in benefit levels. Similarly, state policies covering eligibility, time limits, and sanctions are key determinants of future spending pressures facing the Department of Human Services.

Federal welfare changes did not specify how states should determine families' eligibility for cash assistance and thus, states have the flexibility to establish the income eligibility rules that best meet their resi-

dents' needs. Prior to a very small increase in 2006, Michigan had not adjusted its income threshold since 1993. The maximum monthly income level (which is calculated as earned income plus the FIP grant) to qualify for the FIP grant remained at \$774 per month until it was raised to \$810 per month in 2006. By holding the threshold constant in nominal dollars, recipients have seen a significant reduction in the real purchasing power of the FIP grant over the past 15 years. The annual income threshold of \$9,288 in 1993 is equivalent to purchasing power of \$6,774 (70 percent) in 2007 dollars due to inflation as measured by the Consumer Price Index.

Unlike eligibility for food assistance, income eligibility for cash assistance is not indexed to inflation each year. This projection does not make explicit assumptions about the impacts on caseload levels associated with future changes to income thresholds; however, it is likely that changes designed to assist individuals who are below the federal poverty level will add to the caseload.

A primary tenet of federal welfare reform was the establishment of time limits. Federal law established a five-year lifetime limit on benefits for most cases, but allowed states to set lower time limits, which a number have done. While Michigan is prohibited from providing cash assistance to recipients beyond the five-year period using Federal funds, the State can provide benefits beyond the Federal limit using state funds, which it currently does. Recent efforts to shorten time limits, which would reduce the number of individuals served in Michigan, have failed. Maintaining the current policy with respect to time limits for state-paid benefits will continue to add to Michigan's annual welfare bill.

A new state policy requiring proof of citizenship, such as a birth certificate, may contribute to a caseload reduction if this requirement makes it more difficult for individuals to receive public assistance.

Caseloads also can be affected by the State's use of sanctions. Sanctions are applied to benefit recipients when they fail to meet work or other requirements and can result in the termination of benefits for periods of time. While Federal law establishes certain minimum sanctions that states must apply, the states have con-



siderable latitude to design and use more stringent sanctions. Compared with other states, Michigan is recognized for its relatively strict sanctions. Policies that further expand sanctions could result in a reduction in future caseload levels.

**Caseload Projections.** While Michigan remains plagued by very slow economic growth, the projections presented here envision only marginal growth in caseloads. Of particular relevance to Human Services caseloads, the economic projection shows total employment in the state remaining flat. Also, real disposable personal income is expected to rise only 2.3 percent on an annual basis (See Chapter III). Further, the proportion of the state's population over 65 is expected to rise substantially during the projection, which may add to the growth in caseloads as individuals leave the workforce (See Chapter IV). These economic and demographic factors are not expected to provide any relief from recent caseload growth rates or a reversal of the past six-year trend. At the same time, the projections do not include the effects of a national economic downturn. Should one occur, it is extremely unlikely that the recent growth in Michigan's caseload figures will abate.

CRC is projecting that assistance caseloads will continue to increase, but not at the same rate seen between FY06 and FY07 (e.g., growth in FIP at nearly 9 percent). Spending projections assume caseload annual growth rates slightly lower than the rates experienced over the last seven years.

**Benefit Levels.** While the level of total Human Services spending during the projection period will be driven primarily by caseload levels, other factors will be at play, including benefit levels and the level of federal resources available. All other things being equal, an increase in the level of benefits, either in the form of cash grants or the subsidy provided by the State for a specific service, will add to overall Human Services spending. To the extent that Federal resources are unavailable to absorb such increases, State budget resources will have to assume these marginal increases.

The decision to increase welfare benefits, such as the cash assistance grant, rests entirely with the State government. Michigan can increase the FIP cash grant in two ways. First, it can directly change the size of the

cash grant paid to eligible recipients. This straightforward approach involves increasing the maximum size of the monthly grant. The second approach does not involve increasing the size of the grant, but entails adjustments to the earned income disregard to allow recipients to retain more of their earnings before the size of their cash grant is reduced. In 2007, the disregard was increased, allowing FIP recipients to retain the first \$200 plus 50 percent, as opposed to 20 percent, of the remaining earned income. Legislation passed in 2006 requires the Department to incrementally raise the threshold to 67 percent by FY II.<sup>1</sup>

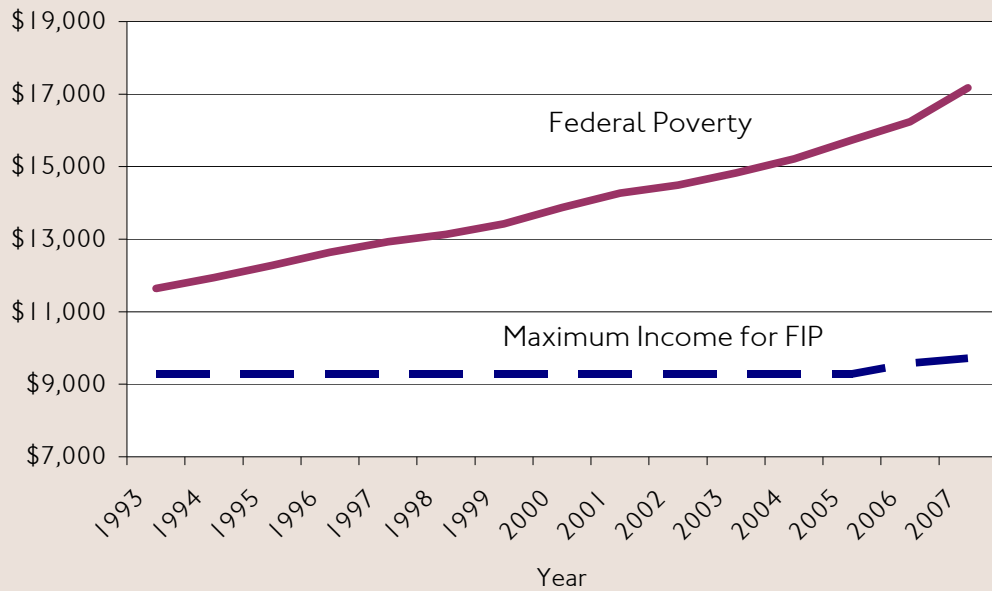
Without major adjustments to the level of benefits provided since 1990, FIP recipients have seen the purchasing power of their cash grants eroded by inflation.<sup>2</sup> At the same time, due to the annual adjustments made to the poverty level, individuals must be relatively poorer each year to qualify for the FIP benefit. (See **Chart XII-3.**)

Given the paucity of benefit increases during the past 15 years, it is likely that some adjustments will have to be made during the projection period to ensure that the basic needs of FIP recipients are minimally addressed. While policy is in place to increase the income disregard during the projection period, increasing the FIP grant itself will result in further growth in welfare spending. The Human Services spending projections in this report include a funding increase of 2.5 percent annually to the base welfare spending level in FY08. This increase reflects the impact that inflation has on the purchasing power of the FIP grant annually.

**Federal Resources and TANF Reserves.** Michigan, like many other states, was able to amass significant TANF surpluses during the beginning years of the program when caseloads were falling. In the early years following welfare reform, states received more TANF authorization than they spent each year. As states became more familiar with the federal program and began to tailor their own programs, this trend was reversed and spending outpaced receipts on an annual basis. In Michigan's case, reserves were used to support program expansions with little additional pressure on state funds.

TANF reserves were also used to address state General Fund budget shortfalls. General Fund spending

**Chart XII-3**  
**Difference between Federal Poverty Level and Income Threshold for FIP Grant, 1993 to 2007**



Source: Department of Human Services; U.S. Census Bureau.

on Human Services programs, in the aggregate, was cut by 10 percent between FY01 and FY06. In some cases, Michigan was able to supplement state resources with available federal funds, as long as minimum matching requirements were maintained, which they were. By the time the TANF program was reauthorized in 2006, however, all of the built-up reserves had been exhausted. In the future, state resources will have to play a larger role in funding the additional costs resulting from caseload, policy or program expansions.

Federal funding provided to Michigan during the projection period will affect both total spending and spending from state sources. Under the 2006 law, Michigan will continue to receive the same level of federal funding each year, \$775 million, through FY II, so the real value of those grants will continue to decline in the future. The fixed amount of this grant will increase the pressure on state funding sources in order to maintain current policies and programs, especially when faced with the prospect of rising caseloads. A constant level of federal resources also means that

future adjustments in benefit levels by Michigan will have to be financed entirely by State dollars. Furthermore, any reduction to the TANF block grant during the current federal program will require an offsetting increase in State funding to avoid program cuts.

A significant aspect of the TANF reauthorization that relates to Michigan's fiscal future is work participation rates. Michigan was highly successful at meeting its previous work participation standards, due in large measure to the application of caseload reduction credits. However, the new law recalibrates how these credits are calculated, effectively requiring Michigan to double its current work participation rate. Failure to meet the new mandates will result in penalties, beginning in FY08, in the form of a reduced TANF grant and increased maintenance of effort requirement. Reduction in the TANF grant would have to be offset by increased State spending. This projection does not include penalty costs because Michigan has the potential of avoiding payment through a corrective action plan.

**Earned Income Tax Credit.** Certain tax policy changes can directly affect the number of individuals receiving welfare benefits. The Federal Earned Income Tax Credit (EITC), originally enacted in 1975, provides significant financial incentive to welfare recipients to find and maintain work. Also, it has been found to be a major factor in reducing poverty among working families. At the national level, the creation and subsequent expansions of the EITC has contributed to caseload reductions by increasing the proportion of single parents participating in the labor force. Michigan tax law was amended in 2006 to create a state tax credit (payable to the filer regardless of the state tax liability) tied to the federal credit (equal to 20 percent of the federal credit when fully phased-in). It is likely that the Michigan EITC will increase employment for low-income families and reduce welfare caseloads to some degree; however, CRC is unable to quantify the effect that the credit will have on employment and caseload levels.

**Changes in Other State Policies.** As state policymakers grapple with the fiscal challenges associated with growing prison populations, decisions that move individuals out of state-run facilities into community-based settings may increase the number of individuals eligible to receive certain welfare benefits. This may be especially true for specific populations of people (e.g., single mothers) released from prison into alternative settings. For a variety of reasons, it may be difficult for some to obtain and maintain employment upon their release from prison, giving rise to increased Human Services caseloads. Decisions by policymakers to relieve the spending pressures in the corrections budget may result in savings; however, the effect of such decisions may increase spending in Human Ser-

vices programs and reduce the net fiscal impact on a budget-wide basis.

**Spending Projections.** The future General Fund spending pressures facing the Department of Human Services will be a function of three primary factors. First, employee compensation costs will increase at the same rate as those experienced in other State departments and agencies (4.8 percent annually) between FY09 and FY17. Given the large number of Human Services employees, this factor will be a major contributor to the overall General Fund structural budget challenges. The Department has the second largest number of state employees (10,500 full-time equated (FTE) positions), exceeded only by the Department of Corrections with 17,600 FTE positions. The Department of Human Services' FY08 compensation base (salaries plus fringe benefits) alone is over \$600 million GF/GP.

The second factor that will drive future spending is caseloads. Projecting state expenditures associated with caseloads is difficult given the uncertainty surrounding long-term projections of this variable. Caseload levels are dependent on economic conditions as well as policy decisions made by state elected officials and program administrators. There is very little reliable data to help quantify the long-term direction of these factors. However, as noted throughout this report, estimates of future spending are predicated on the underlying economic projections of the national and Michigan economies. Given the moderately improving national economy and a trailing Michigan economy, this report assumes moderately increasing caseload levels on a year-over-year basis.

A final factor is the level of benefits provided under Michigan's mix of Human Service programs. As noted earlier, the benefit level of many services have not been substantially increased since the early 1990s, resulting in recipients "losing ground" relative to the poverty threshold. The spending projections presented assume increases in annual benefit levels consistent with annual cost of living adjustments (2.5 percent per year. Given the fixed nature of federal TANF funds, the General Fund share of these benefit increases would have to increase at a higher annual rate than 2.5 percent.

Overall, spending pressures for the Department of Human Services are expected to increase by 3.2 percent annually based on caseload trends, cost-of-living ben-

efit increases, and employee compensation factors consistent with other departmental spending. This annual growth rate is over twice as large as the projected annual growth in General Fund resources (1.4 percent). Given the size of the Department of Human Services' General Fund budget (13 percent in FY08) relative to the entire state General Fund budget, this Department will continue to contribute significantly to future structural budget challenges. In total, Human Services General Fund spending pressures are projected to grow from \$1.3 billion in FY09 to slightly

more than \$1.7 billion in FY 17, an increase of 29 percent. The fiscal challenges facing policymakers resulting from these spending requirements will become even more acute given the fixed nature of the other major revenue source available to finance these programs, namely the TANF grant.

Overall, spending pressures for the Department of Human Services are expected to increase by 3.2 percent annually based on caseload trends, cost-of-living benefit increases, and employee compensation factors; over twice as large as the projected annual growth in General Fund resources (1.4 percent).

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## Endnotes

<sup>1</sup> PA 468 of 2006.

<sup>2</sup> At the time of writing this report, the Governor

's FY09 budget proposal included increased General Fund appropriations to support a 2 percent increase in the FIP grant, from \$489 to \$492 per month for a family of three with no other income.

## XIII. Corrections

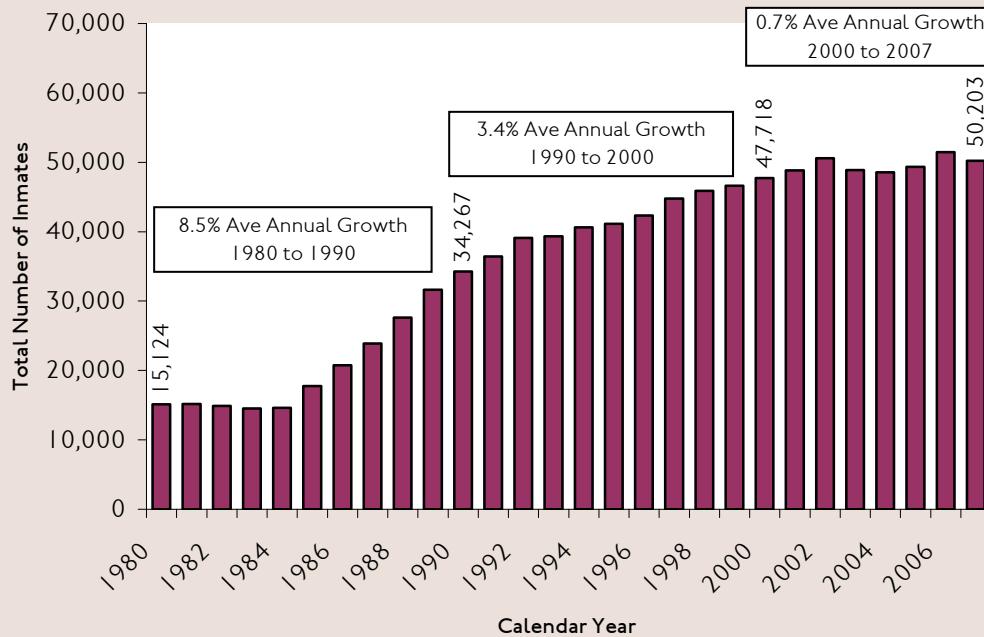
### Background

Michigan's prison population grew to a new high by the end of 2006 (51,454 inmates) and continued to climb during the first few months of 2007 (51,554 inmates). Over the last nine months of 2007, the State was able to reduce the prison population to 50,203 inmates. Inmate numbers are expected to increase each year for the next five years: the Department of Corrections projects that the prison population will increase from 50,203 at the end of 2007 to 56,094 by the end of 2012. At the current cost of almost \$30,000 per prisoner per year, spending for additional inmates will place escalating demands on the State's General Fund, upon which the Department of Corrections is almost entirely dependent. Rising health care expenditures, driven by the general cost pressures associ-

ated with health care for inmates combined with the increased number of prisoners, will exacerbate funding requirements. The expected increase in Department of Corrections spending pressures arising from these forces will outpace General Fund revenue growth by a factor of more than four during the projection period. Annual spending pressure increases in Corrections will be outpaced only by spending growth for health care in the State budget.

**Prison Populations.** Two basic factors determine the size of a state's prison population: 1) the number of convicted felons who enter the system and 2) the length of time those prisoners remain incarcerated. A host of variables affect these two factors, including state policies, decisions at various levels of the justice system, and demographics.

Chart XIII-I  
Michigan Prison Population, 1980 to 2006



Source: Michigan Department of Corrections; CRC calculations

Michigan's prison population has grown at an average rate of 4.5 percent annually over the period 1980 to 2007, compared with growth of 0.3 percent annually in the general population. At the end of 1980, the Department of Corrections had about 15,000 prisoners under state supervision in 26 prisons and camps. By the end of 2007, Michigan's prison population had more than tripled to 51,454 inmates in 45 prisons and camps (See **Chart XIII-I**).

The most significant period of prison population growth in Michigan history occurred between 1985 and 1990, when the prison population exploded, increasing by 17,176 inmates over five years, or 16.8 percent annually. This period was characterized by public policies aimed at being "tough on crime," some of which were enacted in response to specific high-profile crimes that occurred in Michigan. The number of drug-related prison commitments increased 303 percent, from 504 in 1985 to 2,030 in 1990.

While recent annual growth rates are well below those of the late 1980s, the period between 1990 and 2000 was characterized by a steady annual increase in inmates, which exerted substantial pressure on Michigan's limited discretionary General Fund budget resources. Parole policies changed during this time, coinciding with the 1992 switch in the composition of the Parole Board, from civil servants to appointees. From 1990 to 2003, the percentage of inmates serving beyond their parole eligibility date rose from 17 percent (5,869 inmates) to 32 percent (16,036 inmates).

More recently, prison populations grew in 2005 and 2006. These increases followed two years of declines (2003 and 2004), which had provided some relief to the spending pressures affecting the state budget. The short-lived decline in the number of prisoners under state supervision was attributable to explicit policies aimed at constraining prison population growth. Specifically, the Department of Corrections implemented

its *Five Year Plan to Control Prison Growth* in January 2003. This plan effectively pushed Michigan's "run-out-of-bed" date from December 2003 to June 2005.

The prison population grew at a rate of 4.2 percent in 2006, due in large part to one high-profile crime. The criminal justice system responded with more arrests and more prison sentences. At the same time, fewer paroles were granted. Explicit efforts to help address the State's fiscal crisis in 2007 explain the recent reduction in the inmate population: 1,200 fewer from 2006 to 2007. These efforts resulted in more paroles and fewer parole failures in 2007. Unfortunately, the effects of these policies may be only temporary. (As noted, recent population projections released by the Michigan Department of Corrections reveal a return to steady annual increases in the number of inmates.)

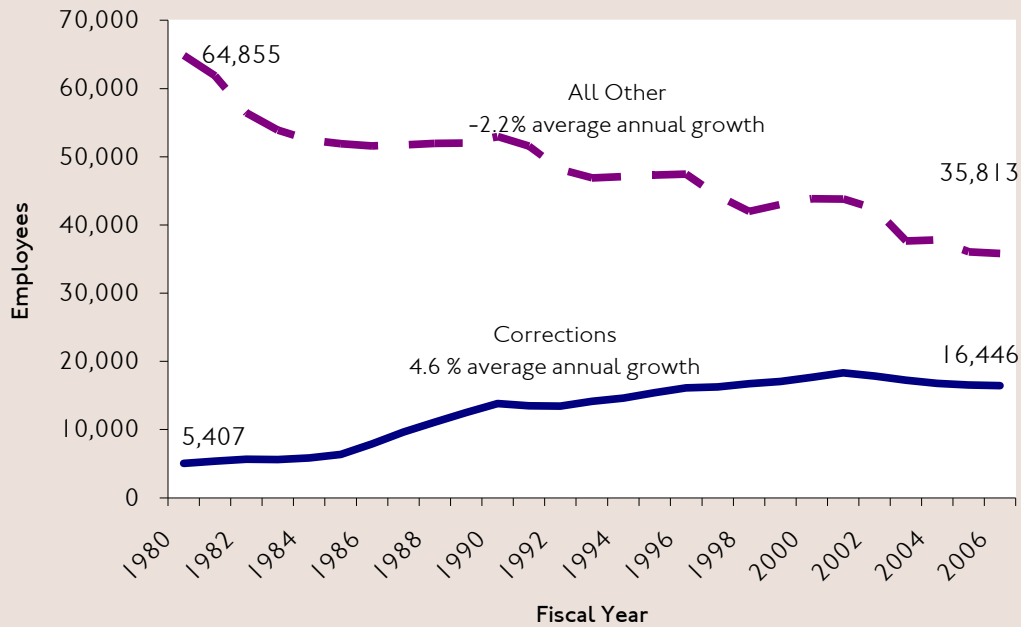
Michigan's prison population has grown at an average rate of 4.5 percent annually over the period 1980 to 2007, compared with growth of 0.3 percent annually in the general population.

In Michigan's case, the massive increase in prisoners over the last two decades is largely attributable to changes in sentencing laws and release policies and practices. Generally, Michigan uses prison more intensively for some offenses than its neighbor states and keeps people in prison longer for the same offenses. Michigan's "truth-in-sentencing" law is more punitive than the national norm, resulting in more convicted felons going to prison for longer stays. Similarly, changes in Michigan parole policies have contributed to longer stays for those committed to prison.

**Department of Corrections Workforce.** Growth in the number of the Department of Corrections employees mirrored the increase in the number of prisoners under state supervision. In Fiscal Year 1980 (FY80), the number of state employees totaled nearly 70,000, with Corrections accounting for 7 percent of the total state workforce. In FY06, state employees numbered 52,259 and nearly one-third (31 percent) worked for the Department of Corrections. Over that quarter of a century, the number of Corrections employees more than tripled, while the remainder of the

# MICHIGAN'S FISCAL FUTURE

**Chart XIII-2**  
**State Classified Workforce: FY80-FY06**



Source: Department of Civil Service; CRC calculations

state government workforce declined by 45 percent (See **Chart XIII-2**). Measured by the number of employees, the Department of Corrections is, by far, the largest program the State operates directly.

**Spending.** The steady increase in the number of inmates in Michigan prisons, coupled with the rise in the Department of Corrections workforce, have resulted in a dramatic shift in the allocation of state resources. In FY80, the Department of Corrections portion of the State budget claimed 3.6 percent of General Fund spending. During the FY03 and FY04 period of budget stress, annual growth in Corrections spending was moderated, to some extent, by the State's explicit policies aimed at controlling prison populations, as expressed in the Department's *Five Year Plan to Control Prison Growth*.

Overall, during the past six fiscal years, Department of Corrections spending has increased concurrent with

overall General Fund spending reductions. From FY01 to FY06, General Fund spending declined 9 percent while Corrections spending increased 11 percent, resulting in Corrections' share of the General Fund budget rising from 16.3 percent to 19.6 percent. The Department's spending plan for FY08 will consume over one in every five dollars of General Fund appropriations and eclipse the \$2.0 billion mark.

On a per capita basis, Michigan's General Fund spending on Corrections has increased nearly ten-fold over the period FY80 to FY07.

On a per capita basis, Michigan's General Fund spending on Corrections has increased ten-fold over the period FY80 to FY07. In FY80, the State spent \$18 per Michigan resident on the programs administered by the Department of Corrections, whereas in FY07 the State spent \$185 per resident. Overall, spending on Department of Corrections programs has grown at an annual rate of 9.2 percent since FY80. Between FY80 and FY07, nominal spending increased from \$170 million to nearly \$1.9 billion, almost an eleven-fold increase.



**Table XIII-I**  
**2006 Prison Populations, Incarceration Rates, Crime Rates**  
**Great Lakes States**

	<u>Prison Population</u>	<u>Incarceration Rate</u> (per 100,000 residents)	<u>Incarceration Rate as a Percentage of Michigan's Rate</u>	<u>Crime Rate Index</u> (per 100,000 residents)
Michigan	51,577	511		3,775.2
Illinois	45,106	350	68.5%	3,561.2
Indiana	26,091	411	80.4%	3,817.2
Minnesota	9,108	176	34.4%	3,391.5
New York	63,315	326	63.8%	2,487.6
Ohio	49,166	428	83.8%	4,028.9
Pennsylvania	44,397	353	69.0%	2,878.4
Wisconsin	23,431	393	76.9%	3,101.8
Average (excluding MI)		348		3,323.8

Sources: U.S. Department of Justice, Bureau of Justice Statistics; U.S. Department of Justice, Federal Bureau of Investigation, Uniform Crime Reporting (UCR) Program; CRC calculations. [www.disastercenter.com/crime](http://www.disastercenter.com/crime); [www.ojp.usdoj.gov/bjs/pub/pdf/p06.pdf](http://www.ojp.usdoj.gov/bjs/pub/pdf/p06.pdf)

In 2005, the most recent year data is available, Michigan's incarceration cost per prisoner per year was \$28,740. This figure places Michigan above three of its Midwestern neighbors (Indiana, Illinois, and Ohio), but slightly below Minnesota and Wisconsin. The average annual cost per prisoner ranges from \$21,531 (Indiana) to \$28,932 (Wisconsin).<sup>1</sup> Some of the differences between the states can be explained by differences in employee costs. Michigan's base hourly rate for entry-level correctional officers is higher than its Midwestern neighbors as well as above the national average. A number of factors can account for the differences between the states, such as the existence of collective bargaining, regional economic factors, and issues related to job duties.<sup>2</sup>

**Incarceration Rate.** Michigan's incarceration rate (prisoners per 100,000 residents) in 2006 was approximately 47 percent above the average of the other seven states bordering the Great Lakes.<sup>3</sup> Michigan's higher incarceration rate cannot be explained by a higher crime rate (crime per 100,000 residents). Al-

though Michigan's crime rate fluctuated somewhat in the 1980s, overall, it has been trending downward since its peak in 1981. According to the Federal Bureau of Investigation's Uniform Crime Reporting (UCR) Program, Michigan's crime rate index per 100,000 residents was cut by 45 percent from 1981 to 2006. The index fell from 6,854 crimes per 100,000 Michigan residents in 1981 to 3,775.2 crimes per 100,000 residents in 2006. Crime rates (both violent and property) have risen each of the last two years, 2005 and 2006. It is unclear whether this represents a change in the direction of the long-term trend experienced over the last 25 years, or is a short-term phenomenon (See **Table XIII-I**).

If Michigan's incarceration rate were to mirror the average of other Great Lakes states, the reduction in costs could reach \$500 million annually. Of course, a reduction of this magnitude would not be achievable in the short-run, but is illustrative of the potential long-term cost avoidance associated with reducing the number of inmates under state supervision.

## Future Outlook

**Prison Populations.** Projections of prison populations are dependent on many factors, only one of which is the incidence of crime. Projecting prison populations based on current policies and practices provides a rough benchmark to help gauge spending pressures that will confront policymakers in the future and to assess the potential to lower cost pressures by adopting different practices.

The Department of Corrections annually projects prison populations for the next five years. In February 2008, the Department released its figures through 2012, indicating that populations will rise by almost 5,900 inmates or 12 percent (2.2 percent annually) between the beginning of 2008 and the end of 2012. The population totals jump from 50,203 to 56,094.

Given the importance of prison populations to projecting spending pressures, it was necessary to make

The 2.2 percent annual population growth rate estimated for the 2008 through 2012 period will add an average of nearly 1,300 new prisoners to the system each year during the projection period.

assumptions about population growth beyond 2012. CRC expanded on the Department of Correction's most recent projections to estimate future population growth through 2017. Because the analysis assumes a continuation of current spending policies, this report carries forward the 2.2 percent annual population growth rate estimated for the 2008 through 2012 period. This rate will add an average of nearly 1,300 new prisoners to the system each year during the projection period. A 2.2 percent rate is higher than the average growth rate since 2000, slightly lower than the average growth rate from 1990 to 2000, and substantially lower than the average growth rate from 1980 to 1990.

The FY08 budget for the Department of Corrections was based upon a reduction in prisoner population that occurred during 2007 as a result of efforts to increase paroles and decrease parole failures. While these actions will result in immediate savings in the current fis-

## Michigan Prison Capacity and Population Growth

Prison capacity is the space available to house prisoners and is measured by the number of beds available. Comparing year-end prison populations (institutions and camps) with net operating capacity from 2000 to 2006 shows that the Department of Corrections had additional capacity in each year, averaging about 700 beds at year-end. Based on the Department's projections for 2008 and beyond, the prison population is expected to reach capacity early in 2009, absent approaches to address the population growth path. Looking beyond 2008, the Department estimates virtually no growth in operating capacity, resulting in year-end population estimates exceeding bed space by almost 1,000 by the end of 2009 and nearly 5,500 by the end of 2012.

This report assumes a 2.2 percent annual increase in the number of prisoners, thus begging the question "How will the State of Michigan house these additional prisoners?" In the very near-term, methods for accommodating these prisoners will include double-bunking, bed leasing, re-opening shuttered facilities, and other capacity management techniques. Following the exhaustion of these methods and absent policy interventions to address escalating populations, demands for bed space will require the construction of additional facilities.

The assumed annual population growth rate will result in the addition of nearly 1,300 prisoners, on average, to the system over the next 8 years. Prison facility construction costs vary depending on type and security level with a reasonable range of \$40,000 to \$50,000 per new bed constructed based on recent experience. While facility capacities vary, ranging from around 120 prisoners to 1,800 prisoners, a traditional regional prison houses about 1,000 inmates. Our expected growth rate necessitates, on average, the construction of one new facility each year. The estimated operating costs of new facilities have been incorporated into the spending projections included in this chapter. The debt financing costs are included in the projections addressed in Chapter XVI (Other General Fund Programs).

cal year (estimated \$52 million), they did little to address the growth in future spending pressures facing the Department because they do not address the spending demands resulting from future commitments to the system and the length of stay of those remaining in the system. The number of paroles increased, but the approval rate was unchanged in 2007. These savings can be viewed only as a reduction to the “base” funding level for the Department, and not as a fundamental change to the future spending growth path. This analysis assumes that the practice of increasing the number of parolees can not be repeated on an annual basis consistently and views the budgetary savings as “one-time” in nature.

**Aging Population.** National statistics show the average age of prisoners to be increasing, from 31 in 1990 to 34 in 1999. In Michigan, the average age grew from 31 in 1985 to 36 in 2007. With longer sentences and fewer prisoners being granted parole, this aging trend can be expected to increase. The Michigan Department of Corrections reports that the percentage of new prisoners age 40 and older has increased substantially, from 18.6 percent of the total in 1988 to 24.3 percent of the total in 2004. This increase has occurred as the percentage of prisoners 19 and under has declined. An aging prison population portends additional spending pressures as health care costs rise commensurate with prisoner age. Generally speaking, older prisoners will require additional and more expensive kinds of medical care.

**Incarceration Rate.** Based on CRC’s projected 2.2 percent annual growth rate, Michigan’s incarceration rate will increase 31 percent, from 511 inmates per 100,000 residents in 2006 to 623 inmates per 100,000 residents in 2017. As noted in Chapter IV the state’s population is projected to remain virtually unchanged through 2017, declining by about 40,000 residents. Given the projected growth in the number of inmates and the slight fall in population in the moderate growth scenario, the incarceration rate will rise slightly faster (2.3 percent each year) than the annual percentage in-

crease in inmate population from 2008 to 2017 (2.2 percent each year).

**Health Care.** In addition to higher spending resulting from growth in the number of prisoners, the Department of Corrections budget will confront cost increases associated with prisoner health care. In 1976, the United States Supreme Court ruled that prison inmates have a constitutional right to health care and withholding such care constitutes cruel and unusual punishment under the Eighth Amendment of the U.S. Constitution.<sup>4</sup> Therefore, the State of Michigan is mandated to provide health care services to those individuals under its supervision. Prisoner health care costs are largely unavoidable and will have to be addressed through additional general fund allocations. Increases in these costs will follow, generally, the health care spending trends projected for the general population.

Despite the implementation of the managed care model, the average annual per prisoner health care cost (physical and mental) jumped from \$4,227 in FY97 to \$5,492 in FY06, a 30 percent change.

The Department of Corrections spent over \$274 million on prisoner health care in FY06, the latest year for which data is available. The Department implemented managed care for the provision of health services in 1997, helping to moderate the growth in health care costs. Despite the implementation of the managed care model, the average annual per prisoner health care cost (physical and mental) jumped from \$4,227 in FY97 to \$5,492 in FY06, a 30 percent change. This rise is attributable to a number of factors, including increased referrals to specialists outside the prison setting and more hospital stays for prisoners. The State’s prisoner health care bill is also directly affected by the health status of individuals entering prison. Chronic diseases (e.g., diabetes, high blood pressure), substance abuse, and mental illness, that afflict prisoners when they enter the system, subsequently become the responsibility of the State. As the cost of treating these ailments rises and the number of prisoners afflicted with these conditions increases, the spending pressures facing the Department of Corrections can be expected to escalate concomitantly. The increased use of pharmaceuticals will add to overall health care spending in the Department.

# MICHIGAN'S FISCAL FUTURE

Total inmate health expenditures rose from \$189 million in 1997 to \$274 million in FY06, an annualized growth rate of 4.2 percent. Projecting future spending based on this growth rate suggests that annual health care spending will rise by an increment of \$15 million per year, on average through FY17, during the projection period. As a result, in FY17, the State's annual prisoner health care bill will total \$448 million, more than double the amount 20 years previously. As the average age of the prison population rises, these costs could go even higher.

The State will shoulder the entire burden of these health care cost increases in the future. The inmate population is not eligible for either the Medicare or Medicaid programs. As a result, health care costs for individuals who would be covered by these programs outside of the prison setting and subject to federal/state cost-sharing (Medicaid) or covered by Federal dollars (Medicare) will have to be paid entirely with State of Michigan resources.

**Spending Pressure Projections.** Overall, the spending pressures facing Michigan policymakers in the Department of Corrections during the projection period will be the result of a growing prisoner population, increased health care costs for prisoners, inflation on operating expenses and equipment, employee compensation costs, and support costs to operate new prison facilities. Without policy interventions to address these cost factors, the projected increase in spending will be largely unavoidable.

The base operating costs for the Department of Corrections can be expected to rise 5 percent annually, a figure that includes employee compensation increases (salaries and fringes) consistent with other departments (Chapter VII). Added to these cost pressures will be rising prisoner health care spending and operational cost increases. Factoring in year-over-year operational cost increases for additional prisoners will

add another 2 percent annually to the spending pressures facing the Department. As a result, absent any changes to programs or policies, the General Fund spending pressures on the State budget arising from the Department of Corrections increase 7.0 percent annually, nearly three times faster than projected baseline General Fund revenue growth (2.8 percent) and more than four times as fast as the net growth rate of 1.4 percent (See **Table XIII-2** on page 102).

These projections include only operating spending and do not factor in capital outlay expenditures facing the Department of Corrections. Capital outlay expenditures for new prisons during the projection

period are estimated to be about \$500 million. In keeping with past practice, new prison construction will be financed via state-issued debt (State Building Authority), which will require annual General Fund repayment. These additional debt service payments have been incorporated into future spending pressures facing the State Building Authority. The cumulative estimated annual debt service to repay the bonds will increase from \$2 million in FY09 to \$41 million in FY17. Because of the long-term nature of the debt, these payments will remain an obligation of the General Fund beyond the projection period.

Total FY08 General Fund spending in the Department is expected to be \$2.0 billion (See **Table XIII-2**). Based on the assumptions used in this analysis, Corrections spending pressures will increase to \$3.7 billion by FY17. On a per capita basis, spending will increase from \$185 per Michigan resident in FY07 to \$371 per capita in FY17. Department of Corrections spending will continue to be a major force in future structural budget challenges facing Michigan policymakers. This level of required spending will effectively "crowd out" other General Fund programs in the State budget, as elected officials must meet these requirements while, at the same time, annually balancing the overall budget.

The General Fund spending pressures on the State budget arising from the Department of Corrections rise 7.3 percent annually, nearly three times faster than projected baseline General Fund revenue growth (2.8 percent) and more than four times as fast as the net growth rate of 1.4 percent.

**Table XIII-2  
Corrections Projections, FY08 to FY 17**

<u>Fiscal Year</u>	<u>Prisoners</u>	<u>Incarceration Rate</u>	<u>Total Spending (millions)</u>	<u>Spending per Capita</u>	<u>Facility Debt Service (millions)</u>
2007-actual	50,203	497.4	\$1,866.4	\$185	
2008-estimate	51,394	509.7	1,996.1	198	
2009	52,100	517.2	2,118.5	211	\$2.1
2010	53,598	532.5	2,250.9	224	8.5
2011	55,124	548.3	2,415.7	240	10.9
2012	56,094	558.6	2,593.8	258	13.8
2013	57,335	571.2	2,786.3	278	17.4
2014	58,603	584.0	2,994.4	298	21.1
2015	59,899	596.8	3,219.4	321	24.8
2016	61,224	609.6	3,462.8	345	20.8
2017	62,578	622.5	3,726.2	371	41.2
Average Annual Increase FY09 to FY 17	2.3%	2.3%	7.3%	7.3%	

\* 2008 to 2012 figures from Michigan Department of Corrections Prison Population Projection Report, January 2008; 2013 to 2017 figures based on CRC projections.

## Future Considerations

State policymakers will be unable to avoid the spending pressures arising from current Corrections policy. A continuation of current policies will require a significant shift of resources away from other areas of the General Fund budget to the Department of Corrections, or additional General Fund resources through a tax increase. On the other hand, should policymakers decide to take action to control future Corrections spending, they will have to focus on reducing prison populations. Those policies that determine who is committed to prison and how long those individuals are required to stay incarcerated will have the greatest effects on future spending. Regardless of the direction(s) taken by lawmakers, there will be tradeoffs

that have substantial long-term fiscal effects. Fiscal benefits resulting from policies aimed at controlling population growth will have to be weighed against the risks to public safety.

While alternatives to incarceration may reduce state Corrections spending, these strategies may result in shifting costs to other service providers, such as local government or human services agencies. The cost savings to the State budget resulting from employing such alternatives will have to be measured against the possible additional spending elsewhere to determine the net fiscal impact of such strategies. It is very likely that the overall net savings will be less than the savings in Corrections spending resulting from the reduction in the number of prisoners under state supervision.

## Endnotes

<sup>1</sup> Pew Charitable Trusts, *Public Safety, Public Spending, Forecasting America's Prison Population 2007 – 2011*, February 2007, [www.pewcenteronthestates.org/uploadedFiles/Public%20Safety%20Public%20Spending.pdf](http://www.pewcenteronthestates.org/uploadedFiles/Public%20Safety%20Public%20Spending.pdf)

<sup>2</sup> Senate Fiscal Agency, *Incarceration and its Costs in Michigan*, May 2007, [www.senate.michigan.gov/sfa/Publications/Issues/IncarcerationCosts/IncarcerationCosts.pdf](http://www.senate.michigan.gov/sfa/Publications/Issues/IncarcerationCosts/IncarcerationCosts.pdf).

<sup>3</sup> States touching one of the Great Lakes include: Illinois, Indiana, Michigan, Minnesota, New York, Ohio, Pennsylvania, and Wisconsin.

<sup>4</sup> *Estelle v. Gamble*, 429 U.S. 97 (1976), [caselaw.lp.findlaw.com/scripts/getcase.pl?court=US&vol=429&invol=97](http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=US&vol=429&invol=97).

## XIV. Highway Finance

Thus far, the discussion has focused on State-supported services principally funded through the discretionary portion of the budget, namely the General Fund/General Purpose budget. CRC has included this chapter, which focuses on state highway finance, to illustrate how the mismatch between spending and revenues extends beyond the General Fund budget to programs that are supported by dedicated revenue streams. Highway finance was selected over environmental/natural resources and other state programs that have earmarked revenue sources, many of which face similar structural financing problems during the forecast period, because of the overall size of the highway finance program and its importance to the Michigan economy. Similarly, the road networks managed by local governments face the same fiscal challenges as the State program; however, because the focus of this report is concentrated on state finances, a discussion of the disconnect between local road needs and resources is not included.

### Background

Responsibility for the construction, rehabilitation, maintenance, and operation of Michigan's highway system belongs to state government as well as cities, villages, and counties. The responsibility for financing the system falls primarily to the federal and state governments. Federal, and most state, highway financing methods primarily rely upon users of the system to pay for the privilege. In Michigan, fuel taxes are the primary user charges employed to finance the highway system. In addition to fuel taxes, Michigan also levies vehicle registration taxes, a revenue source that is growing much faster than fuel tax receipts. State revenues from fuel and registration taxes in Michigan are shared with cities, villages, and county road commissions.

Michigan's mix of highway revenue sources does not adequately fund the needs of the State's highway system, resulting in unmet system condition goals. The current funding mechanism will not result in revenue growth sufficient to keep up with the mounting needs of the system.

Transportation taxes are disconnected from the broader economy and generally unresponsive to economic growth. Unlike other major state tax receipts that move in concert with the economy, such as personal income and consumption taxes (e.g., Sales and Use), fuel tax revenues are driven almost entirely by

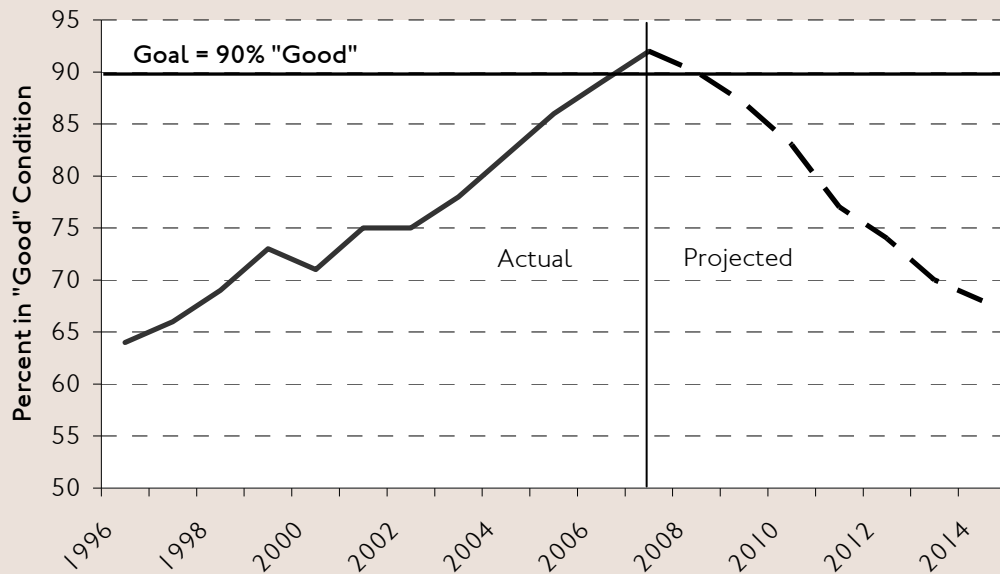
fuel consumption and the tax rate applied to motor fuels. Slow growth in future consumption, due to increased fuel-efficiency, greater use of alternative fuel vehicles, and Michigan's fixed per-gallon tax rates, will continue to constrain fuel tax revenue growth through Fiscal Year 2017 (FY 17).

Failure to align future revenue growth with future spending pressures will contribute to further highway system deterioration in Michigan. The challenge is to develop a system of user charges that generates the requisite resources to meet the mounting spending pressures facing Michigan's highway system.

**Unmet Needs and System Deterioration.** Two common measures of the health of Michigan's highway system are 1) road and bridge condition and 2) congestion. Nearly 10 years ago, the Michigan Department of Transportation (MDOT) established highway and bridge condition goals for the state trunkline system, with the intent of meeting those goals by the end of 2007 and 2008. According to annual reports, significant progress has been made towards reaching the various goals, and some have been attained in advance of the original timeline. These reports also highlight that other goals will not be met within the planned period. Furthermore, projections reveal that these unmet goals will continue to go unattained beyond 2007 and 2008, given the current financing system and level of planned future investment.



Chart XIV-1  
State Trunkline Combined (Freeway and Non-Freeway) Pavement Condition, 1996 to 2014



Source: Michigan Department of Transportation.

Even more troubling than the failure to meet established goals is the projection that goals previously achieved will not be maintained and road and bridge conditions will begin to deteriorate. In some cases, the deterioration is quite substantial and rapid as it appears that future infrastructure conditions will fall below levels of 10 years ago. Long-range projections by the Michigan Department of Transportation clearly show that in order to adequately preserve Michigan's road and bridge infrastructure and to avoid losing ground, added investment will be required.

System deterioration can be explained, in part, by increased use of the system, which results in congestion. Congestion occurs when traffic demands exceed the available capacity of the system, causing travel delays, accidents, and pollution. Congestion on Michigan's highways is expected to increase, especially on urban and suburban roads. Rural roadways, which previously

experienced little, if any, congestion, will begin to see more and more congestion during the projection period. Congestion places further pressures on the state's highway infrastructure. Solutions to mitigate

congestion, such as capacity improvements, require additional investment. The Michigan Department of Transportation calculates that current and projected congestion could be alleviated by increasing highway capacity by 15 percent or 4,300 lane miles. Increasing

capacity to this extent would be cost prohibitive given the current funding streams. Furthermore, addressing congestion through expansion of the system also results in future preservation costs, thereby adding considerably to the long-run costs of system expansion.

**Recent Funding Trends.** Highway funding in Michigan is derived from all levels of government, from the federal government down to cities, villages, and townships, but federal and state taxes contribute the most.

Even more troubling than the failure to meet established goals is the projection that goals previously achieved will not be maintained and road and bridge conditions will begin to deteriorate.



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Local governments support, to varying degrees, transportation programs within their communities. Whereas federal and state transportation dollars are generated almost exclusively through user charges, locally-raised transportation revenues come from non-transportation taxes, such as property taxes. It is important to recognize that, because of intergovernmental fiscal relationships, local highway projects are primarily financed by state funds and federal funds to the extent they are eligible for federal assistance. This does not mean that local governments cannot play a larger role in financing transportation projects in the future, especially with respect to those projects that primarily serve the needs of local residents. Future policy options might consider requiring increased locally-raised revenue for local roads and bridges.

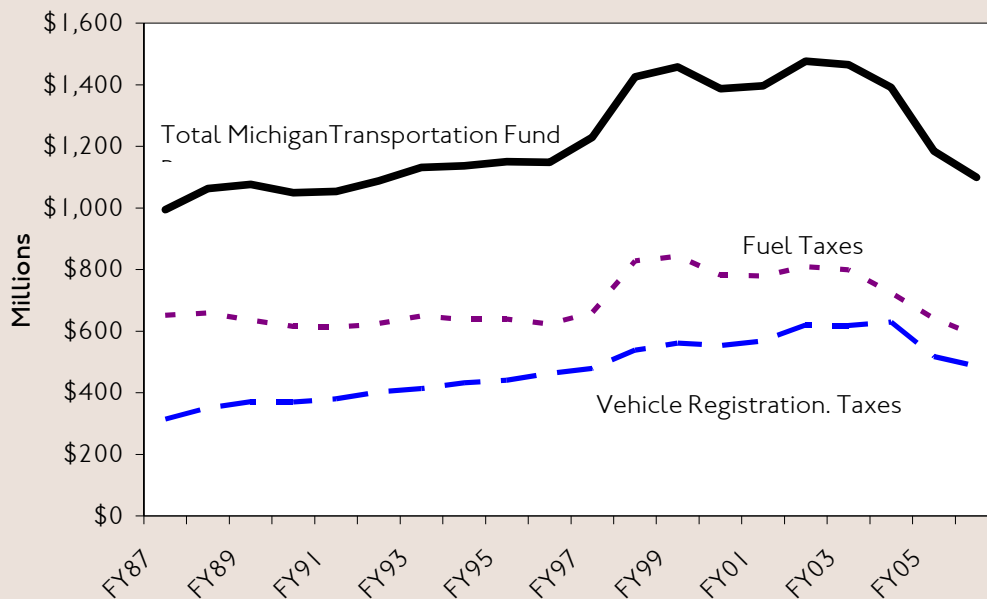
The two largest on-going state sources of highway revenue,

motor fuel taxes and vehicle registration taxes, generated \$1.9 billion combined in FY08. These taxes are the primary resources used to support all highway programs in Michigan, regardless of the level of government responsible for service delivery. These dollars are constitutionally earmarked to the Michigan Transportation Fund (MTF), making up 97 percent of the total, and are restricted as to their use.<sup>1</sup>

Because of its significant role in financing highway construction and maintenance at all levels of government, growth in the MTF is important when examining future spending requirements. Over the 20-year period following FY87, MTF revenue grew 3.4 percent annually. Factoring out the 1997 gasoline tax increase, the annual rate of change over this period was 2.6 percent. More recently, from FY99 to FY07, the annual growth rate was 0.6 percent. Factoring in inflation (measured by the Producer Price Index for Highways

Inflation has totally eroded the increase in purchasing power associated with the 4-cent-per-gallon tax increase in 1997.

**Chart XIV-2**  
Inflation-Adjusted Major Transportation Revenues\*, FY87 to FY07



\* Based on Producer Price Index for Highways and Streets, 1987 = 100

Source: Michigan Department of Transportation; U.S. Department of Labor; CRC calculations

and Streets), MTF revenue has decreased, on average, 4.7 percent per year between FY99 and FY07. Inflation has totally eroded the increase in purchasing power associated with the 4-cent-per-gallon tax increase in 1997; total real (inflation adjusted) MTF revenue in FY07 was \$234 million less than it was in FY97.

The primary reason for the lack of growth in the MTF is reliance on Michigan fuel tax receipts, which make up 53 percent of total MTF revenue. Since passage of the gas tax in 1997, fuel tax revenues have remained flat in nominal terms (decreasing 0.5 percent annually) and have decreased significantly in real terms, 5.7 percent on average annually. As a result of this decline, fuel tax receipts have accounted for a declining share of the total MTF revenue each year.

Increased fuel efficiency, coupled with the fixed per-gallon tax rates, has resulted in minimal fuel tax receipt growth. Recent spikes in fuel prices do nothing to increase fuel tax receipts because these taxes are not based on the price of the fuel consumed, but instead on the number of gallons consumed. Rising fuel prices further exacerbate the already anemic tax revenue growth as consumption falls when prices increase. Higher fuel prices do result in additional State Sales Tax revenue collections on fuel purchases; however, current state law does not designate any of this revenue to highway finance.

It is clear that any growth in overall transportation revenues over the last 20 years has been driven by the Motor Vehicle Registration Tax, which makes up about 44 percent of total MTF revenues. These taxes are levied on an ad-valorem basis and tied to vehicle values, which tend to rise year-over-year. Between FY99 and FY07, these taxes grew 2.6 percent annually, on average. Unfortunately, growth in vehicle registration taxes has not been enough to make up for the lack of growth in fuel tax collections.

In recent years, Michigan has increased its reliance on debt financing to address slow growing user fee revenues. The amount of transportation debt outstanding nearly tripled from FY00 (\$633 million) to FY06 (\$1.6 billion), and additional debt is planned in FY08.

Over the next two years, 20 percent of the total State road and bridge program will be financed with bond revenue. The annual principal and interest payments associated with this increased borrowing will draw resources away from future programs. Over time, given the fiscal effects of additional borrowing and no growth in user fee revenue, a larger portion of annual tax receipts will be devoted to debt requirements.

## Future Outlook

The challenge facing policymakers during the projection period is to ensure that reasonable infrastructure goals are achieved and maintained. Projected revenues will not provide the means to meet all road and bridge goals.

The amount of transportation debt outstanding nearly tripled from FY00 (\$633 million) to FY06 (\$1.6 billion), and additional debt is planned in FY08.

Perhaps more troubling than the failure to achieve specific goals is the fact that some of the goals, once met, cannot be maintained under the current funding methods used in Michigan. The lack of adequate future resources to maintain goals will cause assets to deteriorate. In some cases this deterioration may be quite rapid and widespread. As a result of the deterioration, condition levels may be reduced to the levels of 10 years ago. This suggests a need to increase future investment in the system. If future system condition projections indicate a need for additional investment, policymakers must confront the question, "Exactly how much?" While an absolute answer to this question is beyond the scope of this analysis, it is possible to identify future spending pressures that Michigan's highway system will have to confront.

**Revenue Growth.** Table XIV-1 and Chart XIV-3 (on page 107) show the growth patterns of broad measures that will determine future MTF receipts. The number of registrations (i.e., the tax base for which total vehicle registration taxes are determined) is projected to grow over the next 10 years at an annual rate (1.0 percent) lower than the annual rate between FY85 and FY07 (1.4 percent). At the same time, the annual growth in the average registration tax (i.e., the tax rate) will increase 2.5 percent annually, a lower rate than the previous period, when it was 3.5 percent. Both the average tax base and the average effective tax rate are projected to increase, but at lower rates than the pre-

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**Table XIV-1**  
Factors Affecting MTF Receipts, FY08 to FY17

	<u>2008</u>	<u>2017</u>	<u>1985 – 2006</u>	<u>2008-2017</u>	
			<u>Annual Growth Rate</u>	<u>Percent Growth</u>	<u>Annual Growth Rate</u>
Passenger Registrations (thousands)	6,898.2	7,530.9	1.4%	9.2%	1.0%
Average Registration Tax	\$93.38	\$116.74	3.5%	25.0%	2.5%
Annual Vehicle Miles Traveled (billions)	102.9	110.2	1.9%	7.0%	0.8%

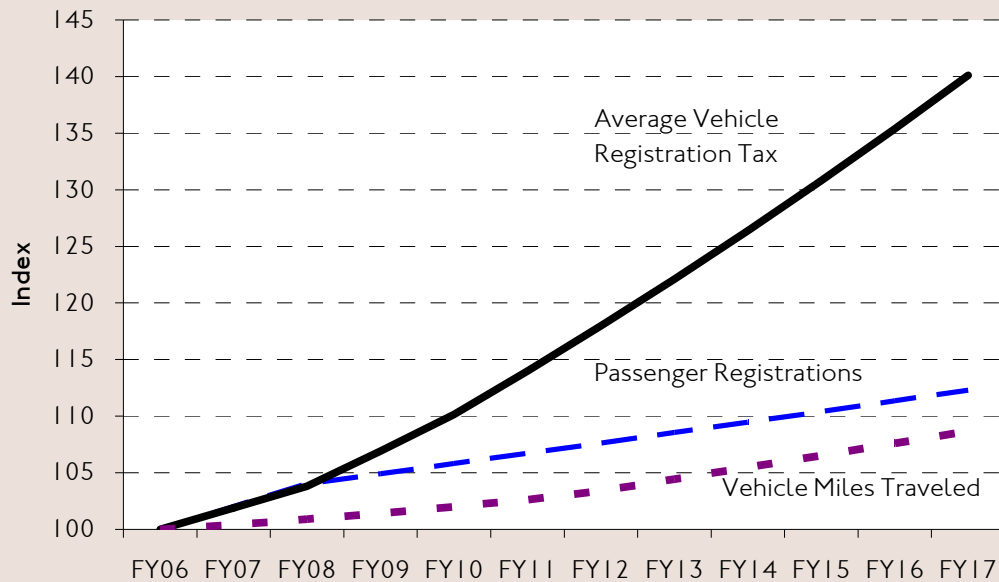
Source: Michigan Department of Transportation, Bureau of Statewide Planning Long-Range Forecast Model; CRC calculations.

vious period. Under current tax policy, CRC projects that registration tax receipts will grow at an annual rate of 3.5 percent during the projection period.

While increasing the fuel tax rate will generate addi-

tional fuel tax receipts per gallon of gasoline sold, it may not positively affect the expected growth rate for this highway funding source. It is possible that raising the fuel tax rate will reduce consumption, thereby reducing the expected growth rate associated with this

**Chart XIV-3**  
Projected Growth of Vehicle Registrations, Average Registration Tax, and Vehicle Miles Traveled, FY06 to FY17



Source: Michigan Department of Transportation, Bureau of Statewide Planning Long-Range Forecast Model.

revenue stream. As shown in **Chart XIV-3**, the number of miles traveled during the next three years is expected to be stable, thus constraining fuel consumption and tax receipts. Increases in vehicle miles traveled will be offset by advances in the fuel efficiency of vehicles. The combination of these factors is projected to result in flat, if not declining, fuel consumption.

Given the broad factors presented here, any future MTF revenue growth will be driven primarily by the increases in the value of new vehicles, and to a lesser extent by the number of vehicle registrations. Fuel consumption, assuming a constant fixed per-gallon tax rate, will not contribute to future MTF growth.

In the aggregate, on-going revenues from registration taxes and fuel taxes to finance the state highway finance are expected to increase 2 percent annually.

**Chart XIV-4** presents the expected combined state and federal revenue available for the state road and bridge program during the projection period. Baseline state revenue is expected to grow from \$776 million in FY08 to \$928 million in FY17.<sup>2</sup> Federal revenues for FY08 are estimated at \$765 million and are expected to grow 4.9 annually. The federal funding growth rate is based on MDOT's long range projection which is based on Michigan federal highway obligations from 1985 to 2004. Overall, total transportation revenues are expected to increase by 3.5 percent annually from FY09 to FY17.

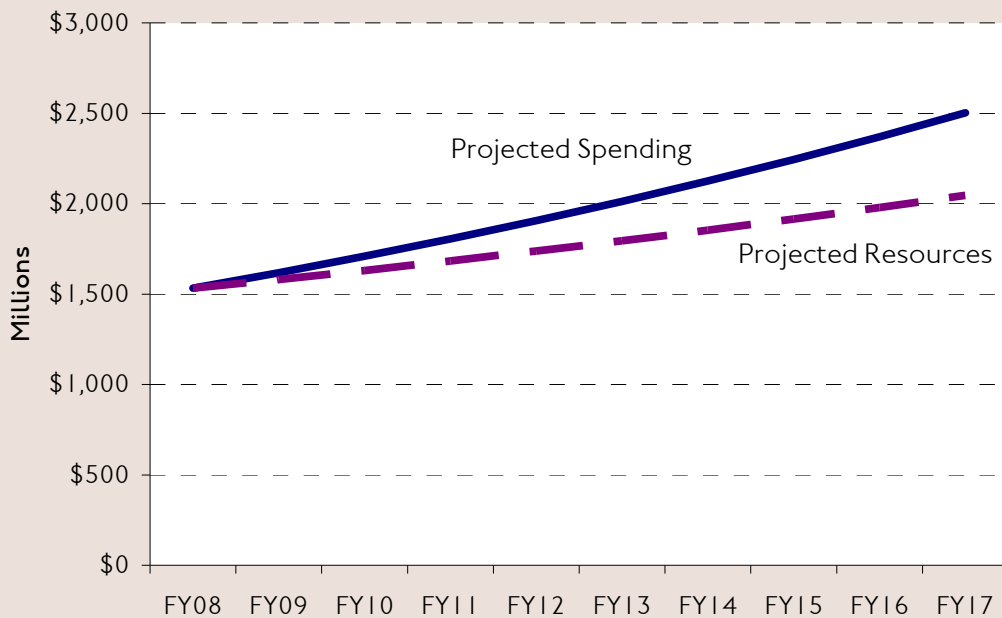
Overall, total transportation revenues are expected to increase by 3.5 percent annually from FY09 to FY17. highway and street construction costs can be expected to increase at 5.6 percent per year.

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**Spending Pressures.** Growth in future spending pressures facing state road and bridge construction can be estimated using two data sets, the Federal Highway Administration's construction index and the U.S. Department of Labor's Producer Price Index for Road and

Overall, total transportation revenues are expected to increase by 3.5 percent annually from FY09 to FY17. highway and street construction costs can be expected to increase at 5.6 percent per year.

**Chart XIV-4**  
MDOT Road and Bridge Program Projected State and Federal Resources and Spending, FY08 to FY17



Sources: MDOT; U.S. Department of Labor; CRC calculations.

Bridge Construction. Based on changes in both indices from 1999 to 2007, highway and street construction costs can be expected to increase at 5.6 percent per year. **Chart XIV-4** applies this annual growth rate to the baseline FY08 revenues to illustrate the spending pressures that the program will face during the projection period. Spending and revenue are set at the same level for the initial period, FY08, to recognize the balanced budget requirement.

**Funding Shortfalls.** The annual “gap” between the estimated revenues and the projected spending pressures facing the state-administered highway program is 2.0 percent. From FY08 to FY 12, the annual revenue shortfall grows to over \$150 million and the total for all five years is \$360 million. By FY 17, the annual “gap” between the available revenue and estimated spending expands to \$412 million and the aggregate difference between

on-going revenues and spending over the entire nine-year period, FY08 to FY 17, will be \$1.9 billion.

The projection is an estimate using a relatively straightforward linear projection of spending pressures and projected revenues, based on the current mix of state spending. These estimates do not reflect any resources required to address unmet highway needs that existed prior to the projection period. The state’s Long-Range Transportation Plan (2006 to 2030) estimates these costs to total approximately \$8.7 billion (FY05 dollars) over the next 25 years, with the largest component of this figure being the backlog related to highway expansion (\$5.4 billion). Inclusion of these backlog costs in the spending pressure projections lie beyond the scope of this analysis. The state’s projection estimates that only 13 percent of the expansion needs would be met under the current funding model.

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## Endnotes

<sup>1</sup> See Article IX, Section 9 of the 1963 Michigan Constitution.

<sup>2</sup> This analysis examines MTF revenue growth since the 1997 gas tax increase. Such a methodology looks at the growth in tax receipts in the absence of fuel tax increases. Furthermore, by using this time period, the analysis relies on recent fuel consumption patterns, as opposed to looking at fuel consumption over a longer timeframe. Recent patterns are more consistent with expected future consumption behavior.

## XV. Unrestricted State Revenue Sharing for Local Government

### Background

Michigan has a long history of the State collecting revenues for distribution to local governments for their provision of services. In some of these revenue sharing programs, the distributions are restricted for specific purposes such as schools, highways, courts, and police services. The State also distributes to local governments state-collected tax dollars that can be used for any purpose: that is, their use is unrestricted (hereafter referred to as state revenue sharing).

Originally created to compensate local governments for local taxes that were replaced or pre-empted by state taxes, the role of state revenue sharing and the amounts shared have grown as the State has replaced more local taxes with state taxes and preempted local governments from levying certain taxes. State revenue sharing evolved as a series of state pledges to share with local governments revenues from several taxes.

Revenue sharing was initiated by a 1939 state law that exempted intangible property, which includes items such as stocks, bonds, and monies on deposit, from local taxation and that levied a state tax in lieu of the local tax.

In 1946, a petition-initiated constitutional amendment was adopted requiring that the State share Sales Tax revenues with schools and local governments. The “Sales Tax Diversion Amendment” required that one-sixth of the revenues from the then three-cent Sales Tax be distributed among cities, villages and townships on a per capita basis. The 1963 Michigan Constitution, which had a four-percent limit on the Sales Tax rate, provides in Section 10 of Article IX that:

One-eighth of all taxes imposed on retailers on taxable sales at retail of tangible personal property shall be used exclusively for assistance to townships, cities and villages, on a population basis....

The required distribution remained at one-eighth of the Sales Tax revenues (12.5 percent) until a 1974 con-

stitutional amendment exempted food and prescription drugs from the Sales Tax base. The allocation of Sales Tax revenues to local governments was increased to 15 percent of collections to compensate for the loss of revenues resulting from the exemptions.

The Income Tax was enacted in 1967 to increase state revenues. Six years earlier, in 1961, the City of Detroit had initiated the levy of a local income tax. A short time after, in 1964, the State adopted the Uniform City Income Tax act to authorize local-option income taxes for other cities. Thus, there was concern at the time of enactment of the State tax that it might preempt cities from levying local income taxes. In order to win approval for the tax package, the State agreed to share Income Tax revenues with local governments.

The Single Business Tax was enacted in 1975 to replace eight state and local taxes on business. The State, in replacing the local taxes, agreed to reimburse cities, villages, townships, counties and authorities for the loss of revenue.

These individual revenue sharing programs continued until 1998, when the authorization of revenue sharing from each of these taxes were consolidated into a single program of statutory state sharing revenues from the Sales Tax. The statute provides that 21.3 percent of the revenues from the Sales Tax collected at a four percent rate<sup>1</sup> is allocated to cities, villages, and townships (16 percentage points) and counties (5.3 percentage points). The 1998 law created a formula that weights the population of cities, villages, and townships by measures of need and tax capacity for distributing these funds. Counties receive these funds on a per capita basis.

Funds received through state revenue sharing played an important role in local government budgets. Prior to the prolonged economic downturn of the past seven years, state shared revenues contributed more to the funding of local government services than locally-collected property taxes for approximately half

**Table XV-1**

**Local Units of Government with Revenue Sharing Payments Exceeding Property, Resident City Income, and Utility Excise Tax Collections, 1998**

	<u>Number of Units in Michigan</u>	<u>Revenue Sharing Exceeded Resident Local Taxes</u>	<u>Percent of Total Units</u>
Cities	284	10	3.5
Villages	271	74	27.3
Townships	<u>1,242</u>	<u>800</u>	<u>64.4</u>
Total	1,797	884	49.2

Source: Michigan Department of Treasury.

of all municipal governments (cities, villages, and townships) (See **Table XIV-1**). Townships were the most dependent on state revenue sharing as a percent of their total revenues. While fewer cities and villages received state revenue sharing payments in excess of their own-source revenues, the formulae used for distributing revenue sharing resulted in larger per capita amounts going to these types of local governments.

## Current Situation

### Revenue Sharing for Cities, Villages and Townships

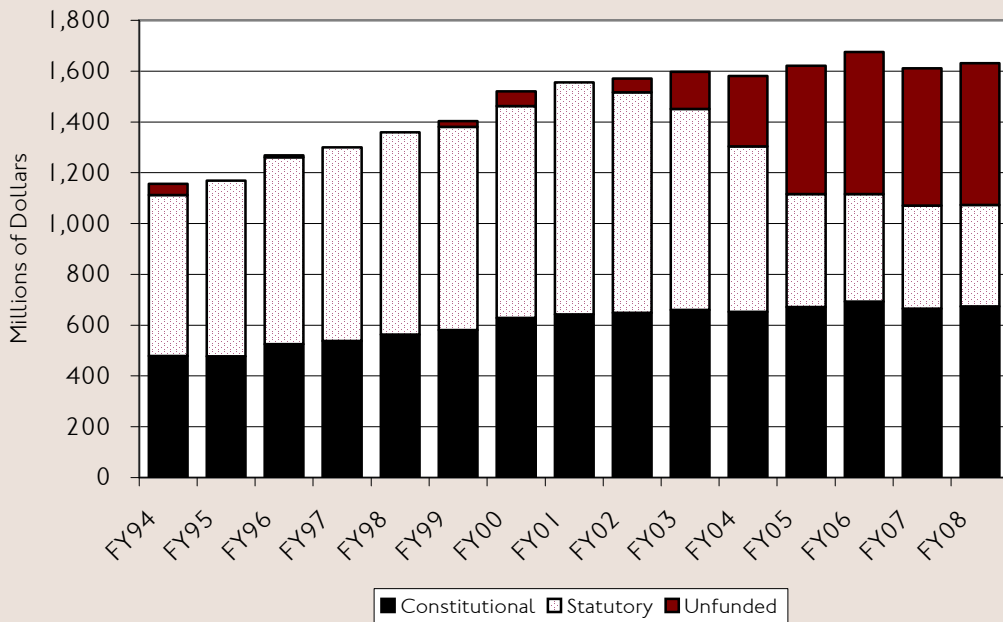
To comply with the constitutional provisions, cities, villages, and townships receive an amount equal to their population according to the most recent decennial census multiplied by a per capita amount that changes each year as Sales Tax revenues change. The per capita amount in Fiscal Year 2007 (FY07) was approximately \$71. Counties do not share in the constitutionally allocated revenue sharing payments.

The 1998 revenue sharing legislation created a new formula for distributing the statutory allotment to cities, villages, and townships. This formula was to be phased in over time to reduce the amount of change for individual local governments that rely on these funds, but that phase in lasted for only a few years before the State's fiscal problems began and the State began retaining funds for other State spending needs. Phase in of the 1998 formula has been all but abandoned and current distributions of statutory revenue sharing are based on the amount of funds available and the funding each municipality received in the prior year.

Efforts to deal with the State's structural budget deficit led state policymakers to retain funds that previously would have been allocated to statutory state revenue sharing in order to make funds available for other State General Fund programs. Since the State began cutting statutory revenue sharing payments in 2002, over \$2.1 billion has been retained in the State General Fund (See



**Chart XV-1**  
**State Revenue Sharing, Actual and Statutory Reduction, FY94 to FY08**



Source: Michigan Department of Treasury.

**Chart XV-1).** If fully funded, about \$1 billion would be paid to local governments through statutory state revenue sharing program in FY08. Because of diversions, only \$399.0 million will actually be shared with local governments.

Attempts were made to spread the cuts to revenue sharing proportionally among the cities, villages, and townships, but those cuts and the decisions to hold constant the amount of funds available for revenue sharing (the total amount for the constitutional and statutory programs) have not affected all local governments equally. With Constitutional payments on autopilot, the State is required to distribute a fixed percentage of Sales Tax revenues – 15 percent – on a per capita basis. Thus, in every year that Sales Tax revenues increase, the amount to be distributed on a per capita basis has to

increase. That increase for the past six years has come from the balance of funds appropriated for state revenue sharing – those that would have been used for statutory payments.

If fully funded, about \$1 billion would be paid to local governments through statutory state revenue sharing program in FY08. Because of diversions, only \$399.1 million will actually be shared with local governments.

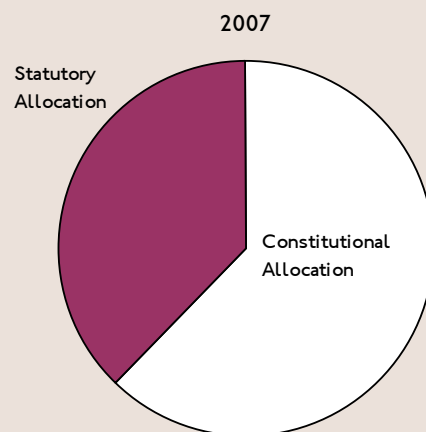
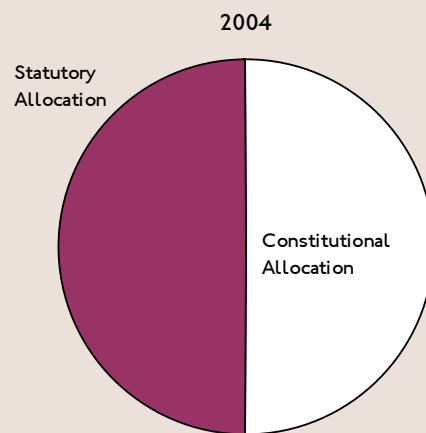
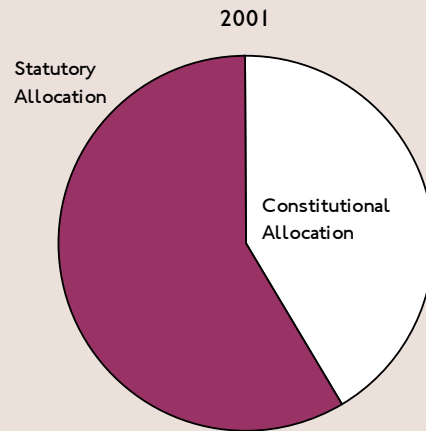
After the initial cuts eliminated statutory revenue sharing payments to the smallest local governments, each year that the amounts available for state revenue sharing are further cut or held to the previous year's amount it causes a

shift of funding from the statutory program to the constitutional program. In FY01, when state revenue sharing was at its peak, 58.7 percent of the funds were distributed as statutory payments. By FY04, revenue sharing funds were split evenly between constitutional and statutory payments. By FY07, 62.2 percent of the funds were distributed as constitutional payments (See **Charts XV-2, XV-3, and XV-4**). The result of this shift

has been an erosion of funds distributed to the larger cities and charter townships to the benefit of smaller cities, villages, and townships. As funds have shifted away from the statutory program, additional local governments were cut out of statutory payments, with those funds distributed evenly among all local governments. For those local governments that lost statutory revenue sharing, the amounts lost in statutory payments were greater than what was gained in constitutional payments. The net gains came to those that no longer receive statutory payments, but get increased constitutional payments each year: the less populated governments. These shifts have eliminated statutory payments for over 900 of Michigan's least populated cities, villages and townships. In FY08, fewer than half of the local units of government will receive any statutory revenue sharing payments, and 37 cities and townships cumulatively will receive 80 percent of the funds. The City of Detroit is expected to receive 52 percent of the total.

The diversion of revenue sharing funds to other state purposes has not been offset with funding from other sources. While property taxes are the primary funding source for local governments, many of the local governments most dependent on revenue sharing have little capacity in their available millage to levy new taxes to replace lost revenue sharing.

**Charts XV-2, XV-3 and XV-4**  
**Allocation of State Revenue Sharing between Constitutional and Statutory Payments, FY01, FY04 and FY07**



## Local Government Finances

Chapter V focuses on the major tax sources for the State of Michigan. The chapter discusses the factors that cause revenues from those sources to increase at slow rates relative to personal income or the programs funded by those revenues. The revenue side of Michigan's structural budget problems relate to the State's inability to adapt to a changing economy and create tax structures that capture that growth.

Michigan's general purpose local governments are facing structural fiscal problems of their own, but those problems are not directly related to the economy, the services provided, or policies adopted by local governments. Property tax revenues, the primary revenue source for most of Michigan's general purpose local governments, tend not to vary with economic cycles. General purpose local governments purchase the same basket of goods they did 20 years ago. And the number and variety of local governments means that a variety of policies are adopted.

### Revenues

A primary cause of Michigan's general purpose local governments' structural fiscal problems is the change in rate of increase for revenues those governments rely on. General purpose local governments rely on three revenue sources: property taxes, state revenue sharing, and local income taxes for 22 Michigan cities.

Since 1978, voters have twice amended the Michigan Constitution to create property tax limitations. The 1978 ("Headlee") amendment was designed to adjust the tax rate governments can levy to offset growth in the tax base (exclusive of new developments), so the net levy results in inflationary increases from one year to the next. The 1994 amendment (Proposal A) was designed to limit the rate of growth in the tax base for individual parcels of property to the rate of inflation from year to year. While both were designed to hold the growth of local government property tax revenues to the rate of inflation, the interaction of the two limitations results in growth at rates slower than inflation for some governments in some years.

This round of cuts to the statutory state revenue sharing occurred at the same time as the 1994 property tax limitations were taking full effect and the price of some goods common to local governments were increasing.

Finally, for those 22 cities levying a local income tax, the State's problems with the Income Tax tends to be mirrored at the local level. Like the state tax, local income taxes must be levied at a flat rate. As jobs have left Michigan's urban core cities and the state, the revenues of these taxes have suffered.

### Expenditures

At the same time local governments struggle with limitations tying growth of property tax revenues to the rate of inflation they have had to purchase many goods for which the price has increased at rates faster than the rate of inflation. Important commodities like motor fuel and road construction material have risen in price at rates faster than the rate of inflation. The cost of health care for current and retired municipal workers has increased at rates equal to those of state or school employees. In general, the goods purchased by local governments to provide services bear little relationship to the rate of inflation as measured by the U.S. Consumer Price Index.

Local governments have employed three approaches to dealing with their fiscal problems. Because local governments have balanced budget requirements similar to the State's, the changes have occurred gradually. 1) Some local governments have reduced services. Municipalities are operating with fewer police officers and fire fighters to provide public safety. Public facilities, such as libraries, have cut back on operating hours. Quality of life services, such as parks and recreation programs, have been eliminated or scaled back in major ways. 2) Some local governments have attempted to increase revenues. In the last three general elections, there have been 658 local ballot questions seeking tax increases or the override of Headlee tax rate rollbacks. Only 38.6 percent of these questions have been approved. A number of cities have contemplated a local-option income tax to supplement existing revenues. On November 6, 2007, voters in the City of Ypsilanti rejected a proposal for a city income tax on residents and workers within the city. 3) Across Michigan, local governments have placed a priority on finding alternative methods of providing services. Intergovernmental collaboration and private providers offer economies of scale by expanding the geographic areas served.

# MICHIGAN'S FISCAL FUTURE

## State Revenue Sharing for Counties

At the same time the State was cutting revenue sharing payments to cities, villages, and townships, a deal was struck to pause state revenue sharing payments to counties. The loss of those revenue sharing payments was temporarily offset by funds established by a one-time collection of county taxes in the summer rather than the winter. By shifting from winter to summer tax collections, counties collected taxes twice in their fiscal years. For most counties, this substitute funding source was equal to several times the annual revenue sharing payment. This process provided for each county a pool of money that could be tapped into to replace state revenue sharing for several years, until that county's pool was exhausted. As long as a county's pool of money contains funds, that county is required to draw its "revenue sharing" payments from that pool in an amount that increases each year by the rate of increase in the U.S. Consumer Price Index.

This one-time shift in the collection of county taxes created a benefit to the State's General Fund budget that exceeded the adverse effect on local governments caused by diverting state revenue sharing. In

2004, the year before the change, county taxes totaled \$1.9 billion statewide. Revenue sharing distributions to counties were less than a tenth of that amount. The benefit to the State General Fund was \$182 million in FY05 when the change occurred.

When the change was implemented, State policymakers expressed the intention to restore the lost revenue sharing to each county as its pool of one-time revenues is exhausted. **Table XV-2** provides estimates of future restoration payments. The restoration of revenue sharing payments to counties in FY08 and FY09 will not create significant General Fund financial burdens. However, starting in FY10 the State will have to make significant policy decisions concerning the source of funds to finance revenue sharing for counties, which amounts to more than \$100 million by FY11 and over \$200 million by FY15. The use of Sales Tax revenues as provided for in state law would take funding from the purposes for which these funds were diverted. The use of funds currently dedicated to state revenue sharing would be at the expense of those cities, villages, and townships still receiving statutory revenue sharing payments.

**Table XV-2**  
**Estimates of Future Restoration Payments for County Revenue Sharing, FY07 to FY17**  
**(Dollars in Millions)**

<u>Fiscal Year</u>	<u>Number of Counties Rejoining Revenue Sharing Program</u>	<u>Payments</u>
FY07	1	\$ 0.2
FY08	1	0.3
FY09	5	2.0
FY10	12	40.0
FY11	19	112.6
FY12	12	156.8
FY13	8	177.1
FY14	9	198.5
FY15	7	216.0
FY16	5	251.4
FY17	1	262.7

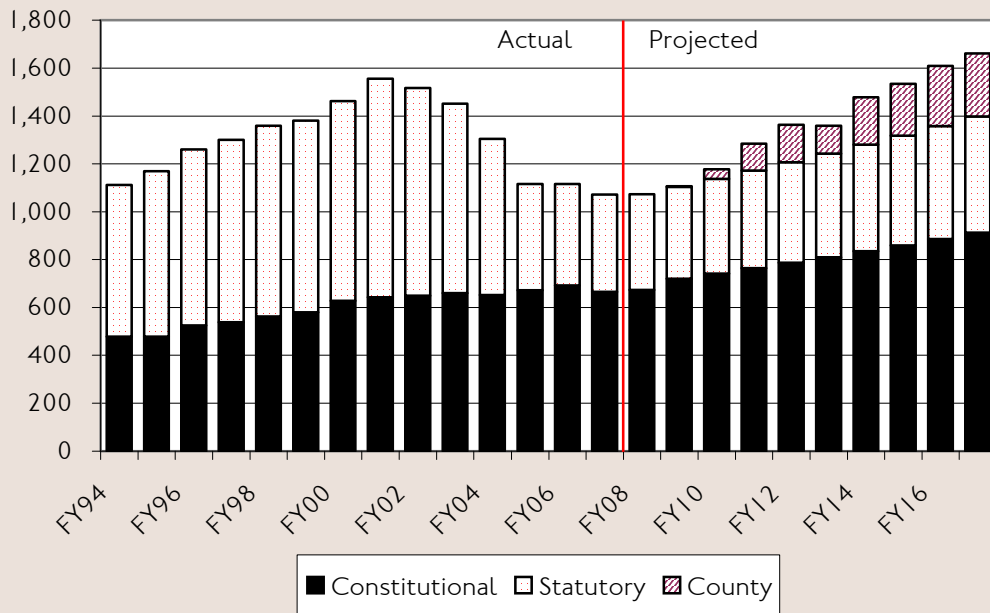
## The Impact on Local Governments

The retention of State Sales Tax revenues that would otherwise have been paid as state revenue sharing has contributed more to balancing the General Fund budget than any other budget-balancing actions. Comparing the projected FY08 statutory revenue sharing payments with the 21.3 percent statutory allocation of the Sales Tax yields a difference of almost \$600 million, or nearly 60 percent. From FY01 to FY07, total revenue sharing payments, including constitu-

The retention of state Sales Tax revenues that would otherwise have been paid as state revenue sharing has contributed more to balancing the General Fund budget than any other budget-balancing actions.

tional allocations that have increased, are down nearly 34 percent and statutory payments have dropped nearly 58 percent. Adjusting for the use of one-time revenues to prevent spending cuts in the counties results in a reduction of 24 percent for cities, villages, and townships. By contrast, cuts in General Fund support for state universities and student aid were 16 percent, community college support dropped 13 percent, and school aid appropriations from state sources increased 9 percent.

**Chart XV-5**  
**Spending Pressures for Statutory State Revenue Sharing:**  
**FY 94 to FY07 Actual and FY08 to FY17 Projected**



## Future Outlook

This is not the first time that the State has addressed its fiscal problems by diverting revenue sharing funds for other purposes. Because local governments generate their own revenue sources, cuts to state revenue sharing were seen to create less of a burden than potential cuts to other State programs. State revenue sharing always returned to full funding following earlier diversions as revenues grew to meet spending pressures. This time the State has not grown its way out of its chronic deficits. Growth of a magnitude sufficient to restore statutory revenue sharing is not projected through 2017 (see Chapter V).

Although legislative actions to balance the State budget have resulted in continual reductions in the funds available for state revenue sharing, the projections in this report assume that the funds distributed through this program will grow at an annual rate of about 3 percent – equal to the projected rate of growth of Sales Tax revenues. The projections assume that all cuts in revenue sharing for cities, villages and townships that have occurred through FY08 will continue. It is further assumed that no further cuts will occur for cities, villages, and townships and that the counties will recoup their lost payments, with inflationary adjustments, as the projections in **Table XV-5** show. The State will not have sufficient Sales Tax revenues to fund the statutory program at the levels set out in the 1998 statute. Any years in which state revenue sharing funding increases at rates below the rate of growth of Sales Tax revenues will further in-

crease the overall share of payments to the constitutional program at the expense of the statutory program. Clearly the spending pressures of other General Fund programs will continue to place state revenue sharing before policymakers as a source of funds to draw upon to fund those programs.

A weaker economic scenario could bring a more dour fate for statutory revenue sharing. The overall spending pressures of other General Fund programs and

sluggish revenue growth suggest that the remainder of statutory revenue sharing for cities, villages, and townships is at great risk of elimination and the restoration of county revenue sharing is equally vulnerable. In the context of the projected FY17 General Fund gap between spending pressures and projected revenues, the complete elimination of statutory revenue sharing for all units of local government closes \$777 million, or 13 percent, of the overall \$6.0 billion gap.

Unlike the other programs discussed in this report, it is not possible to quantify the spending pressures for state revenue sharing. Revenue sharing is distributed, or slated for distribution, to more than 1,800 counties, cities, villages, and townships based on deals, or promises, that were made over a number of years. Those local governments provide varying amounts and levels of services and have varying abilities to raise funds locally. Some have taken actions to accommodate the reduced levels of funding, others have limited ability to do so.

The projections in this report assume that the funds distributed through this program will grow at an annual rate of about 3 percent – equal to the projected rate of growth of Sales Tax revenues.

## Policy Questions

Predicting the future of statutory revenue sharing is a tenuous exercise. Only about 40 percent of the statutory program remains and the units still receiving payments are generally experiencing more fiscal stress than the units that have lost their statutory payments altogether. The assumption that the system will continue is based on a fulfillment of current state law, but the ultimate fate of state revenue sharing is a policy issue to be weighed against other State needs.

If statutory revenue sharing survives, it will be necessary to consider how to divide the remaining dollars between cities, villages, townships and counties. Dividing the dollars on the basis of the Sales Tax allocation percentages contained in the revenue sharing statute would seem to avoid favoring one group of units versus another. Before cuts began, approximately one-fourth of the statutory dollars went to counties and three-fourths were paid to cities, villages, and town-

ships. However, to resume county revenue sharing as spelled out in statute, without the influx of additional funds, would require the diversion of additional funds from the statutory payments to cities, villages, and townships, pitting those local governments against the counties.

Finally, policymakers will need to consider how the population shifts measured by the 2010 Census are to be incorporated into the distribution of statutory revenue sharing. Every ten years, the payments to local governments are subject to abrupt shifts as new populations are inserted into distribution formulas. Such will be the case following the 2010 Census. A significant difference this time is that statutory payments since 2002 have been based on the amount, or a portion of the amount, distributed to the remaining eligible units in the prior year. The State is without a formula to determine how population changes should be incorporated into distribution of statutory revenue sharing.

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## Endnotes

<sup>1</sup> The six percent Sales Tax rate consists of a four percent rate, which took effect in 1960, and an additional rate of two percent, which took effect in 1994. Sixty percent of the revenue from the four percent rate, together with 100 percent of the revenue from the additional rate of 2 percent (60 percent of four percent plus 100 percent of two percent equals 73.3 percent) is constitutionally dedicated to the School Aid Fund. Another 35.6 percent (15 percent constitutionally, 20.6 percent statutorily (21.3 percent when lag in payment schedule is accounted for)) of the revenue from the 4 percent rate only (35.6 percent of four percent plus zero percent of two percent equal 23.7 percent) is dedicated to counties, cities, villages, and townships for revenue sharing.



## XVI. Spending in Other Areas of the General Fund Budget

In addition to projecting specific spending pressures in the major General Fund-financed programs, this report also estimates spending in other areas of the budget in order to provide a complete picture of the structural budget challenges facing Michigan policymakers. In Fiscal Year 2008 (FY08), this spending accounts for about \$1.4 billion, or about 14 percent, of total General Fund appropriations. Of this amount, about one-half, \$670 million, is attributable to employee compensation costs (salary and fringe benefits) for state employees in the various state departments and agencies not individually discussed in this report.

**Other Departmental Spending.** In order to project future General Fund obligations under current programs and policies in the “other” areas of the state budget, a standard growth factor was developed. This standard factor was based primarily on employee compensation. As noted in Chapter VII on employee compensation, the General Fund’s exposure to future state employee salary and fringe benefit costs was projected. Compensation costs account for more than 80 percent of total spending by certain departments. Annual growth in these costs (4.8 percent on average) will dominate future spending in a number of departments and therefore compensation costs became the basis for developing the standard “other” growth factor.

In addition to compensation, departments will face spending pressures associated with rents, utilities, transportation, and information technology. To reflect the reality that these other cost centers will have their own pressures, a general inflationary growth factor (2.5 percent annually) was applied to the FY08 appropriation base of these expenditure categories. This report recognizes that different areas of the budget have different rates of spending increase among the various expenditure categories (e.g., technology, utilities, rent). For example, future spending by the Department of State Police will be dominated more by fuel prices than will spending in the Department of Attorney General. Similarly, those departments that are more reliant on information technology will experience proportionately more spending on computer hardware, programming, and software than departments that do not have such a technology focus. CRC did not provide individual projections for each department based on that

department’s unique mix of spending categories. Instead, a standard growth factor was developed to apply to all “other” areas of the budget that are not distinctly covered in other sections of the report.

The standard factor varies by fiscal year, due to the mix of compensation cost components and the growth rates assigned to each in a given fiscal year. Overall, however, the factor averaged 4.1 percent annually during the projection period, ranging from 3 percent in FY09 to 4.5 percent in FY17. This factor was applied to the FY08 General Fund appropriations in the following areas:

- General government programs (e.g., Attorney General, Secretary of State, Legislature, Executive Office)
- Economic development programs (e.g., Strategic Fund, Labor and Economic Growth.)
- Environmental protection/natural resource conservation programs (e.g., Agriculture, Environmental Quality, Natural Resources)
- Public safety programs (e.g., State Police, Military and Veteran Affairs)

Areas of the General Fund budget not covered above, or elsewhere in this report, are given specific treatment based on projected spending during the projection period. In some cases, such as debt service for long-term general obligation debt, future spending requirements are established in bond covenants. In other areas, such as the General Fund grant to the School Aid Fund, current spending is held constant throughout the projection period. A discussion of these areas follows.

**Service on Existing Debt.** This report includes the future annual debt service payments (principal and interest) on existing general obligation debt currently financed with General Fund dollars (i.e., environmental and recreation related). It is assumed that general obligation debt issued for the purpose of making qualified loans to local school districts will continue to be satisfied by the School Aid Fund, as has been the practice since FY04. Further, the report does not assume the issuance of new debt or the fiscal effects of future refinancing of existing bond issues. In FY09, the General Fund will be responsible for debt service of \$83 million. The annual amount averages \$107 million

## Environmental and Natural Resource Programs

**Departmental Spending.** Michigan's fiscal crisis has disproportionately affected environmental and natural resources program in terms of General Fund support appropriated to the Departments of Agriculture, Environmental Quality, and Natural Resources. Combined support from the General Fund for these three departments declined by half between FY01 to FY07, while total General Fund spending declined 7 percent. As a result, environmental/natural resource programs' share of total General Fund spending declined from 2.1 percent to 1 percent during this seven-year period. For the most part, the decline in General Fund appropriations to these departments helped to support increases in other areas of the budget, namely Corrections and Community Health, driven by caseload demands in the programs administered.

Some of the lost General Fund support was substituted with user fee revenues, thereby making the overall spending reduction in these departments less stark. Whereas statewide spending from all sources increased 12.5 percent from FY01 to FY07, all-funds spending for environmental programs declined 6 percent over the same period.

A continuation of recent trends regarding General Fund support of environmental programs is not included in our spending projections. Annual General Fund support for the Departments of Agriculture, Environmental Quality, and Natural Resources is projected to increase at the same rate as for other state departments, 4.1 percent on average during the projection period. Future spending pressures reflect the current mix of funding in the FY08 budgets of the departments and do not assume future substitutions of user fees for General Fund dollars.

**Clean Michigan Initiative.** The \$675 million in bond proceeds for the Clean Michigan Initiative approved by the voters in 1998 will be exhausted in FY08. While the existing debt service payments are included in the General Fund spending projections, this report does not contemplate additional borrowing to continue the program during the forecast period. The program spends up to \$100 million a year on environmental clean-up projects across the state. Should the program continue, it is unclear where the funding will come from, i.e., either direct General Fund support or through general obligation debt. Historically, major environmental clean-up programs have been financed through long-term borrowing.

during the projection period, with the maximum payment (\$130 million) occurring in FY 12.

**Cash Flow Borrowing.** Michigan's continual struggles with structural budget deficits have adversely affected the state's cash flow position of its major funds (i.e., General and School Aid), resulting in the most significant cash shortage in over 40 years at the end of FY06.<sup>1</sup> The State began FY08 with a combined major fund cash deficit of \$1 billion, down markedly from \$1.3 billion at the beginning of FY07. The average cash shortfall at the beginning of the year since FY03 has been \$910 million. These annual deficits have required the State to borrow short-term (\$1.3 billion each in FY07 and FY08) in order to ensure sufficient cash on-hand to satisfy obligations throughout the years. Whereas the General and School Aid Funds were previously used to help manage the cash needs of other state funds, since FY03 these two major funds are now paying interest to borrow from other state funds as well as to borrow from outside creditors. These interest costs totaled nearly \$65 million in FY07.

CRC's General Fund spending projections assume the continuation of cash flow borrowing, both internally and externally, and include the costs associated with such actions. The level of external borrowing is limited by the Michigan Constitution (Article IX, Section 14) to 15 percent of undedicated revenues and must be repaid within the fiscal year in which the borrowing occurs. This analysis assumes that Michigan will continue to borrow the maximum amount allowed by the Constitution, something which it has done for each of the last two fiscal years. The future interest costs are factored into our projections at \$79 million each year during the forecast period.

Nearly all annual budget-balancing efforts of the last seven years either had a neutral or negative effect on Michigan's cash position because of the lack of structural reforms. Future efforts to address the state's structural budget problems, either on the revenue or spending side or both, will likely have complementary positive effects on the state's cash flow position. Such effects would likely decrease the level of short-term

borrowing, and therefore interest payments, required in the future.

**State Building Authority.** The General Fund spending projections include the annual debt service payments associated with capital projects financed through the State Building Authority (SBA), i.e., state agencies and universities. This report does not contemplate further borrowing to finance additional projects, other than correctional facilities. The debt service schedule for long-term obligations, which was current as of the end of FY07, has been incorporated into the spending projections along with the projected debt service associated with the SBA's short-term commercial paper program, which is used to cover certain project costs before long-term debt is issued by the Authority.

As noted in Chapter XIII, this report reflects the 2 percent annual growth in the number of prisoners that is projected by the Department of Corrections for the period 2008 through 2012. This growth rate would necessitate the opening of currently shuttered facilities and/or the construction of new facilities. Spending

projections included in the Department of Corrections section of this report do not include these capital costs, but only the additional operating costs associated with the assumed population growth. New facilities would be financed through SBA debt financing, with annual payments satisfied by the General Fund. Facilities are added as they are needed, thereby increasing the amount of outstanding debt each year and the total annual debt service payments. These payments increase from \$2 million in FY09 to a cumulative \$41 million by FY17.

**School Aid Fund.** The General Fund provides approximately \$35 million of K-12 program costs in FY08. This amount compares to \$378 million in FY04. Nothing in state law would prevent the General Fund from being used to increase future K-12 budgets; however, this report does not assume that such a transfer will occur during the projection period. Revenue projections for the School Aid Fund and the future General Fund spending figures in this report are based on the current fiscal policy that allocates \$35 million from the General Fund to K-12 education.

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## Endnotes

<sup>1</sup> For a detailed discussion of Michigan's cash flow problems, see CRC Note 2007-02, *Michigan's Deteriorating Cash Position*, May 2007. [www.crcmich.org/PUBLICAT/2000s/2007/note2007-02.pdf](http://www.crcmich.org/PUBLICAT/2000s/2007/note2007-02.pdf)

## XVII. Projections of the Structural Deficits

Deficit projections are the difference between projected revenues and projected spending pressures.

General Fund-General Purpose spending pressures were computed by compiling specific projections for these major areas of spending:

- Higher Education
- Medicaid and Related Programs
- Mental Health
- Human Services
- Corrections

Together, these areas account for 79 percent of General Fund appropriations for Fiscal Year 2008 (FY08).

Projections for other GF-GP expenditure areas were derived by using average rates of increase that were determined by a combination of detailed projections of employee compensation spending pressures and general cost increases in other areas of spending. The overall increase for spending areas not subject to detailed analysis in this report averages 4.1 percent per year.

Spending pressures for K-12 programs were derived by projecting major areas of total system spending, including spending supported by local and federal revenues. These areas include:

- Salaries and wages
- Group insurance benefits (principally health insurance)
- Employer contributions for social security and Medicare
- Employer contributions for pensions
- Employer contributions for retiree health care
- Other areas of general spending including energy, classroom supplies, equipment, food service and transportation

The projections were then aggregated into total spending pressures for the entire system, not the state-funded part alone. The calculations took into account total projections of K-12 enrollment declines during the period after FY08.

Spending pressures in transportation programs were derived using general factors representing construc-

tion cost increases and estimates of the maintenance costs associated with the depreciation of the existing transportation infrastructure.

Over the projection period, the average annual percentage increases in spending pressures by major area are as follows:

- General Fund (GF-GP) Programs – 6.8 percent
- K-12 Programs – 4.7 percent
- Transportation Programs – 5.6 percent

Each of these spending areas has a revenue counterpart. The GF-GP revenues are the discretionary revenues which are not earmarked. During the projection period, these revenues will be subject to tax cuts based on current law—a phase-out of the temporary Income Tax rate increase and the phase in of the state Earned Income Tax Credit (EITC). From FY09 through FY17, in only two fiscal years (FY11 and FY17) do tax cuts already in state law not diminish the year to year growth rate in General Fund revenues. From FY09 through FY17, the average annual growth rate is 1.3 percentage points lower than baseline annual growth rate without tax cuts of 3.0 percent.

Operating revenues for the K-12 system include state-raised revenue, which accounts for about two-thirds of total system revenue, federal revenues, which provide 9 percent, and local property taxes, which provide the remainder. There are no provisions in state law that will cause reductions in School Aid Fund or local school revenues during the projection period. The average annual growth in School Aid Fund revenues is determined by the major tax revenue sources: Sales, Use, Personal Income, State Education, and Michigan Business. Together, these taxes are projected to account for 86 percent of the state-raised School Aid Fund revenue in FY09 and are projected to grow 3.3 percent annually, a little above the 3.0 percent projected growth in School Aid Fund revenues overall.

Transportation revenues are projected individually and aggregated into the total amount available for the State's highway program.

# MICHIGAN'S FISCAL FUTURE

**Table XVII-I**  
Summary Calculations of the Structural Deficits, FY09-FY 17

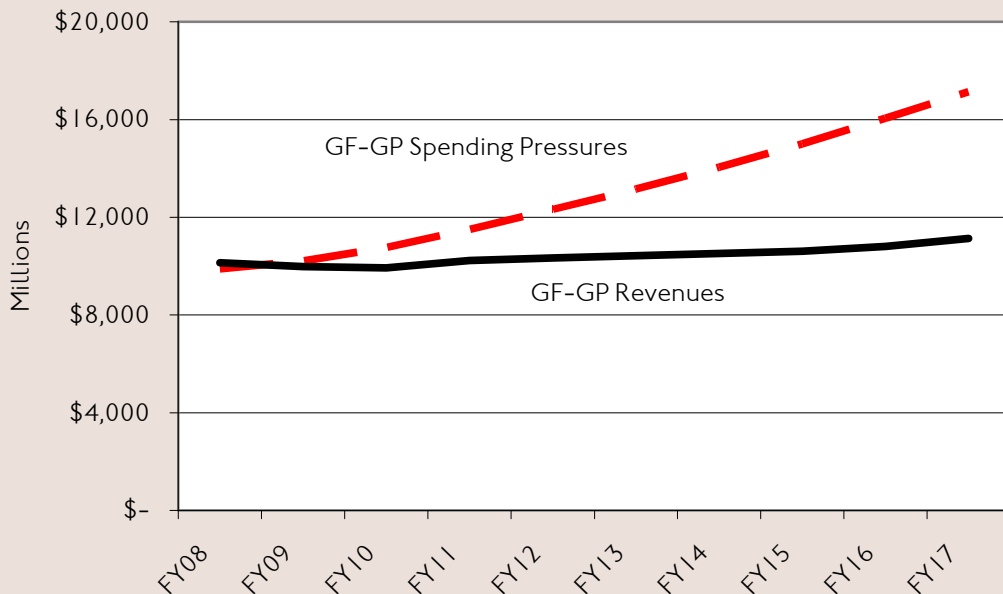
<u>Spending Area</u>	<u>Average Annual Revenue Growth</u>	<u>Average Annual Spending Pressure Growth</u>	<u>Annual Gap (Revenues Minus Spending Pressures)</u>	<u>Annual Structural Deficit in Millions of FY09 Dollars</u>
GF-GP	1.4%	6.8%	-5.4%	\$539
School Aid	3.0%	4.7%	-1.7%	\$308
Transportation	3.5%	5.6%	-2.1%	\$33

The annual deficits are derived by computing the difference between the growth rates in revenues and spending pressures for each broad spending area. **Table XVII-I** presents the calculations.

The figures presented in **Table XVII-I** represent the approximate annual differences between the revenues available from the current revenue system and the costs of continuing existing programs and policies at their

prior year level. They are annual estimates that would recur unless structural changes are made in the revenue and/or program policies of the state that would change the slope of the spending or revenue curves. The multi-year nature of the structural deficit is shown in **Chart XVII-I**. It portrays the growing gap between program costs and revenues over time. Such deficits would not be allowed to occur since state law prohibits deficit spending. However, the chart does underscore the size

**Chart XVII-I**  
General Fund-General Purpose Revenues and Spending Pressures, FY08 to FY 17

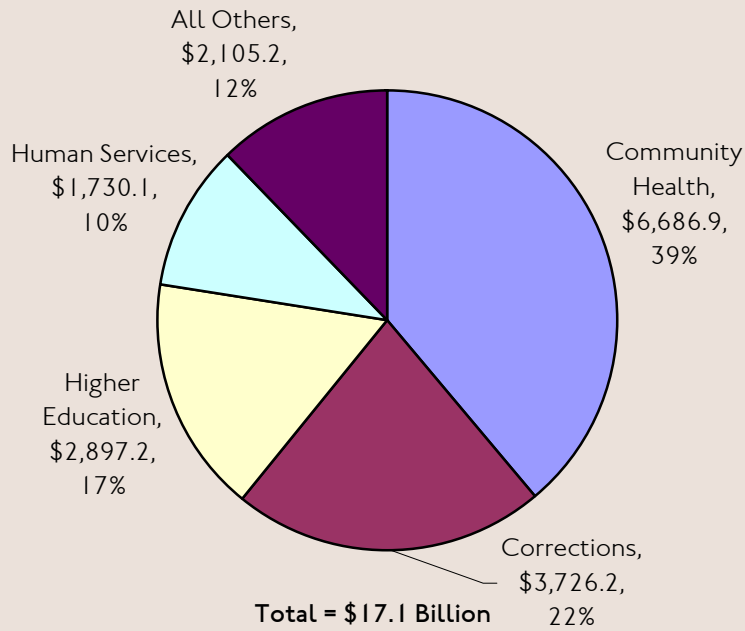


of the challenge facing policymakers in the future. The capacity of the GF-GP revenue structure falls about \$6 billion, or 54 percent, short of the projected costs of current programs in FY17. The shortfall is so large that if programs operated by the

departments of Community Health and Corrections were permitted to increase at the rates calculated in this analysis, only about \$700 million of revenue would remain to fund all other GF-GP programs.

The capacity of the GF-GP revenue structure falls about \$6 billion, or 54 percent, short of the projected costs of current programs in FY17.

**Chart XVII-2**  
**General Fund-General Purpose Spending Pressures, FY17**  
**(Dollars in Millions)**



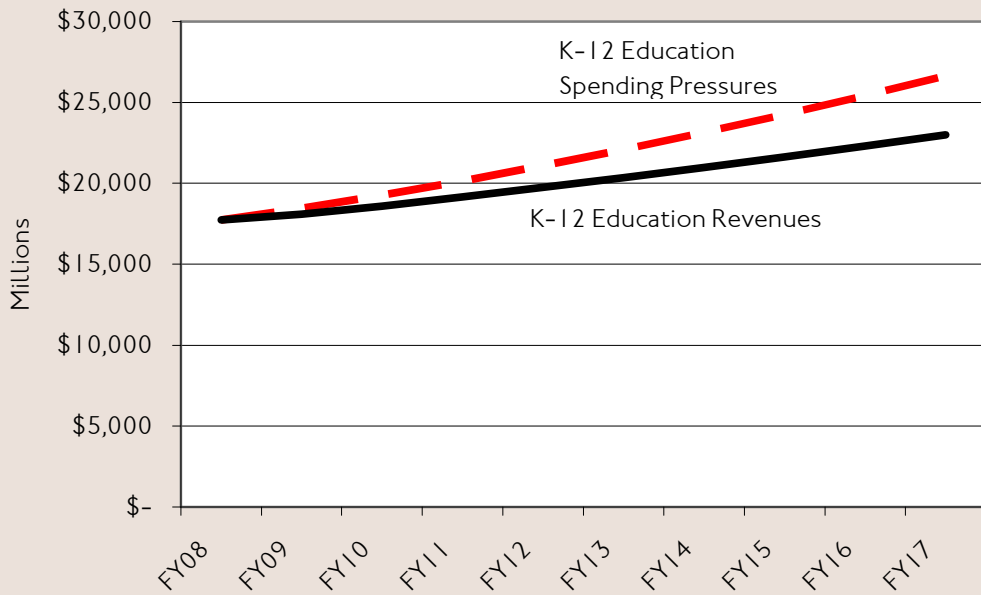
# MICHIGAN'S FISCAL FUTURE

The K-12 structural deficit is not as large in total dollars or percentage terms. An average annual difference of 1.7 percent between revenues and spending pressures nonetheless will present local school decision-makers with difficulties balancing their annual bud-

gets. Since local school districts and public school academies are prohibited from increasing local property taxes to support their operations, the State will have to either adjust the tax structure or provide districts with authority to raise revenues to eliminate the structural imbalance.

An average annual difference of 1.7 percent between revenues and spending pressures will present local school decision-makers with difficulties balancing their annual budgets.

**Chart XVII-3**  
K-12 Education Revenues and Spending Pressures, FY08 to FY17





## Appendix A. Alternative Policies to Reduce Structural Deficit

Michigan has a structural budget deficit. The cost drivers for many of the functions paid for by the State's major funds are growing faster than the revenues that flow into these funds. Reductions in the structural deficit would occur as a result of some combination of increased revenue growth and decreased spending pressure growth. External factors such as accelerated growth in the economy and declining growth in the numbers of persons participating in various programs could cause a reduction of the structural deficit in the future, but the Upjohn economic and population projections (see Chapters III and IV) leave little hope that Michigan will solve its chronic structural deficit problems through improved economic conditions.

If Michigan is not likely to grow its way out of the structural deficits, State officials must consider policy changes aimed at the specific components of the state revenue and spending structure that contribute most to the deficit.

As discussed in Chapter V, the Personal Income and Sales taxes are the two largest contributors to the General Fund and School Aid Fund budgets. Changes in the tax structure, such as adding services to the base of the Sales Tax and applying graduated rates to the Personal Income Tax, would increase the growth rates in revenue.

The two largest and fastest growing portions of the General Fund and School Aid Fund budgets are Corrections and health care. Changes in Corrections and health care spending policies could reduce the rate of increase in spending pressures.

In this chapter, calculations of potential changes in revenue and spending policies are provided to determine how effective changes to these revenue sources and major spending programs might be in closing the structural imbalance between revenues and spending pressures. Clearly, dealing with the State's structural deficit will require policy changes to a number of programs beyond these reforms.

### Structural Changes in Revenues

Michigan is utilizing the same revenue sources as are levied in most other states. Therefore, opportunities to improve Michigan's revenue performance generally involve restructuring the current tax system to make it more responsive to the economy. Other than the Michigan Business Tax, which was enacted in 2007 to replace the Single Business Tax (which was enacted in 1975), Michigan's tax structure is generally the same now as it was 40 years ago. Michigan's economy has evolved over those 40 years and it likely to experience further changes as policymakers strive to bring businesses and job opportunities to the state.

The present tax system produces revenue growth below the rate of growth in the state's economy (revenues are declining as a share of such overall measures as personal income). Section 26 of Article IX of the State Constitution limits State revenues to no more than 9.49 percent of personal income. Since FY00, when State revenues slightly exceeded that limit, the gap between the limit and actual revenues grew to about \$5.4 billion in FY07.

A combination of factors contributed to the growth in this gap, including tax cuts and weakening connections between the economy and many significant state taxes. Policies enacted in the late 1990s reduced tax rates, permitted federal policies to diminish State revenues by failing to offset negative effects on State revenues with changes in State law, and cut other State taxes by excluding previously taxed items from various tax bases. Changes in the revenue structure also have resulted in an increasingly weaker connection between the economy and major state revenues sources. The two largest State taxes, Personal Income and Sales, have grown much more slowly than even the anemic growth in personal income since 2000. (The calculations supporting these conclusions have adjusted for changes in the Income Tax rate.) Current state law exempts most services from Sales or Use taxes and excludes from the base of the Income Tax some sources, such as

retirement payments, that are likely to show significant growth in the future. The growth in these revenue sources can be expected to lag behind the general economy into at least the near future.

Many taxes perform sluggishly whether in good or bad economic times. In order for the overall growth in revenue to keep pace with the economy, other taxes have to grow faster than the economy. Since such a large share of current tax revenues comes from Sales and Personal Income Taxes, restructuring of these taxes offers the greatest potential impact.

**Sales and Use Taxes.** Michigan's major consumption taxes on the sale and use of tangible property and a limited number of services do not connect effectively with our service-oriented economy. Services have grown faster and are likely to continue to grow faster than other areas of the economy. The Bureau of Economic Analysis in the U.S. Department of Commerce reports that services constituted 11 percent of gross state product in Michigan in 1977 and had grown to over 20 percent by the turn of the century. Without recognizing growth of the service sector in today's economy, the State faces an increasing disconnect between the economy and revenues.

A survey of the states by the Federation of Tax Administrators reveals Michigan to be in the bottom quarter of all states in the number of services subject to taxation.<sup>1</sup> Services that could be subject to taxation include a broad array of activities purchased by consumers and businesses. They include medical services, such as visits to a physician; recreational and entertainment activities, such as movies and sports events; personal services, such as hair care; repair services, such as automobile repairs; professional services, such as tax preparation and legal services; and services for the home, such as lawn care. The failed attempt to include services in the Sales and Use Tax bases in 2007, demonstrated that the selection of services to be included in the tax base is very important and very sensitive.

The effect on the tax base of including all services would be substantial, since the dollar value of services not taxed exceeds the dollar value of the goods and services currently taxed. A reconstituted tax base with a significant services component would grow faster than the current Sales and Use Tax bases, since

expenditures for services are expected to continue to grow faster than spending for goods. Adding services to the goods-dominated consumption tax base could be combined with a reduction in the 6 percent tax rate to make the starting point revenue-neutral.

**Personal Income Tax.** Michigan's Personal Income Tax has also proven to be less responsive to economic changes than the income taxes levied in some other states. Creating a responsive income tax is a complex exercise because of the interaction of tax deductions, exemptions, credits, and the tax rate. A major difference between Michigan's Income Tax and those levied by other states is Michigan's constitutional prohibition on graduated tax rates. Like the federal government, 35 of the 41 states that have an income tax levy the tax at graduated tax rates. Six states have flat rate taxes.

The concept of a graduated income tax rate structure is straightforward – as taxable income rises for a taxpayer, the rate of tax on successively higher increments of income rises. For instance, the Ohio income tax is graduated, with taxable income below \$5,000 subject to a 0.612 percent rate and the rates building up to a 6.24 percent tax rate for amounts of income exceeding \$200,000.<sup>2</sup> With the same level of income growth, revenues from graduated income taxes grow faster than the revenues from flat rate taxes. If Michigan were to substitute a graduated income tax for its current flat rate tax, considerable additional growth in revenues could be produced, even after making the starting point revenue-neutral.

Because Section 7, Article IX, of the Michigan Constitution prohibits a graduated income tax, a constitutional amendment would have to be adopted for a graduated income tax to be permitted. (Three times in the past, Michigan voters have defeated proposed constitutional amendments to permit graduated income taxes.) Absent a constitutional amendment, modifications could be made in the flat-rate tax to make it more responsive to growth in personal income by simultaneously raising the tax rate and the personal exemption. This could be done in a way that would make the starting point revenue-neutral.

**A Tax-Restructuring Scenario.** Having identified potential reforms that would improve revenue performance, CRC set out to test the effects on overall

revenue growth of modifying the Sales, Use, and Personal Income taxes. CRC created models of revenue growth from FY08 to FY17 that include services in the Sales and Use Tax base and apply a graduated tax rate to the Income Tax, consistent with the following assumptions:

- The alternative forms of the taxes were revenue-neutral in the beginning year.
- The services added to the Sales and Use Tax base exclude only business-to-business services. The dollar value of the remaining services is about two-thirds of the existing Sales and Use tax base, making a rate reduction of 2.4 percentage points (to 3.6 percent from 6 percent) necessary to achieve beginning revenue neutrality. It is assumed that statutory and constitutional earmarking of the Sales and Use taxes would be adjusted to protect revenues going to the School Aid Fund, State Revenue Sharing, and Comprehensive Transportation Fund and produce a distribution of the restructured taxes to the General and School Aid funds identical to the present distribution.
- The services component of the Sales and Use Tax base grows 2 percentage points faster than the existing tax base, raising the overall revenue growth of Sales and Uses taxes by 0.8 percentage points.
- The assumed revenue elasticity relative to personal income of the hypothetical alternative income tax is 1.4. Elasticity in this case is the ratio of revenue percent change to personal income percent change. Personal income is projected to grow 4.2 percent annually, so revenues from the alternative tax would grow 5.9 percent annually (1.4 x 4.2).

The assumptions are relatively aggressive since they imply an alternative income tax for which revenues grow 40 percent faster than personal income, and alternative Sales and Use Tax bases that include almost all services, including medical services. The reason for beginning with an aggressive calculation is to test the

plausibility of improved revenue growth to close the structural deficit.

The results of the restructuring scenario are 1) an increase in the growth rate of School Aid Fund revenues from about 3 percent per year to nearly 3.8

The results of the restructuring scenario are 1) an increase in the growth rate of School Aid Fund revenues from about 3 percent per year to nearly 3.8 percent per year and 2) an increase in the General Fund growth rate from 1.4 percent per year to about 3.0 percent per year.

percent per year and 2) an increase in the General Fund growth rate from 1.4 percent per year to about 3.0 percent per year. Even with the hypothetical revenue restructuring, the revenue growth rates are not as great as the growth rates in spending pressures, leaving a gap that would have to be filled by

spending reductions or other tax increases.

## Structural Changes in Spending

Some of the costs of government are growing faster than the general economy. The two areas of greatest spending pressures are health care and Corrections. Health care is by far the most expensive category and the projected rate of growth in spending pressures is larger than for corrections. Without reform, the cost of these items threatens to diminish the State's ability to provide other services, such as education, environmental, or recreation programs. Again, dealing with the State's structural deficit will require policy changes to a number of programs beyond these reforms.

**Corrections.** Corrections policies in Michigan produce a significantly higher incarceration rate than in neighboring states. The Michigan incarceration rate is 47 percent above the average of the seven other states bordering the Great Lakes. The baseline spending pressures in the Department of Corrections exceed 7 percent per year. They are composed of growth in prisoner populations of about 2 percent per year and costs of employee compensation, prisoner health care, and other operating costs averaging about 5 percent per year (See Chapter XIII for more information).

The cost of operating the Corrections system is determined primarily by the number of prisoners. Two basic factors determine the size of a state's prison

population: 1) the number of convicted felons who enter the system and 2) the length of time those prisoners remain incarcerated. CRC created a model of changes in the corrections population from FY08 to FY17 to measure the way in which changing prison populations could reduce the cost of operations. Such policy changes could include sentencing reform, greater use of alternative corrections systems, and changes in the amount of prison time serviced for many felony convictions. If some or all of those reforms could be enacted, CRC assumed that instead of the prisoner population growing two percent per year, populations would decline over a 10-year period to bring the incarceration rate down to the current average of Michigan's neighbors. Over a period of 10 years, the prison population would decline by about 20,000 instead of increasing by 11,000.

If policies were implemented to produce such changes, the growth in Corrections spending pressures would be about one percent per year and Corrections would become an area of budget relief rather than an area of budget stress. The rate of growth in overall General Fund spending pressures would be reduced by a little over one percentage point annually.

It should be noted that Corrections reform does not come without potential risks. While Corrections offers a huge opportunity for budgetary savings, shorter sentences and non-prison punishment alternatives come with the risk that some people who would otherwise be incarcerated would commit crimes. Alternative sentencing policies might also increase spending in other areas of the budget, such as Mental Health.

**Health Care.** Health care is the single largest contributor to the structural deficit on the spending side of the budget. It is not only the largest area of spending, but health care growth rates exceed those in any other spending area.

Significant health care spending occurs in the following areas:

- Medicaid

- Mental Health
- Corrections
- State and school employee health insurance
- State and school retiree health insurance

The spending pressure projections reflected for health care in the baseline projections range from almost 11 percent in Medicaid to 9 percent annually for health insurance for current state employees. Potential savings in health care could be realized by increasing cost-sharing with current and retired state and school employees, eliminating optional benefits, and enrollee categories from Medicaid coverage, and other politically challenging approaches. Nonetheless, it is instructive to know about how much of the

structural deficit might be eliminated by reducing the increase in health care costs to a rate more like those in other areas of the budget.

In order to illustrate the effect a significant reduction in health cost increases would have on the structural deficit, a rate of 5 percent is used for each area of basic health care costs, adjusted to reflect changes in the numbers receiving the benefits. The General Fund spending pressures in these calculations are in the Medicaid program, prisoner health care, and the health insurance payments and retirement health care contributions made by state departments for their employees. Using 5 percent as the health care cost increase factor reduces the General Fund spending growth by nearly 2 percentage points per year.

In the area of school spending, the effect of controlling health care cost increases to 5 percent per year on spending pressure growth is a reduction of about one percentage point, more than half the structural deficit gap in K-12 programs.

State and local governments may not be capable of reducing the rate of increase in health care spending. A national approach to health care finance may be the *dues ex machine* that eventually resolves the problem facing the public and private sectors nationwide.

If policies were implemented to produce such changes, the growth in corrections spending pressures would be about one percent per year and corrections would become an area of budget relief rather than an area of budget stress.

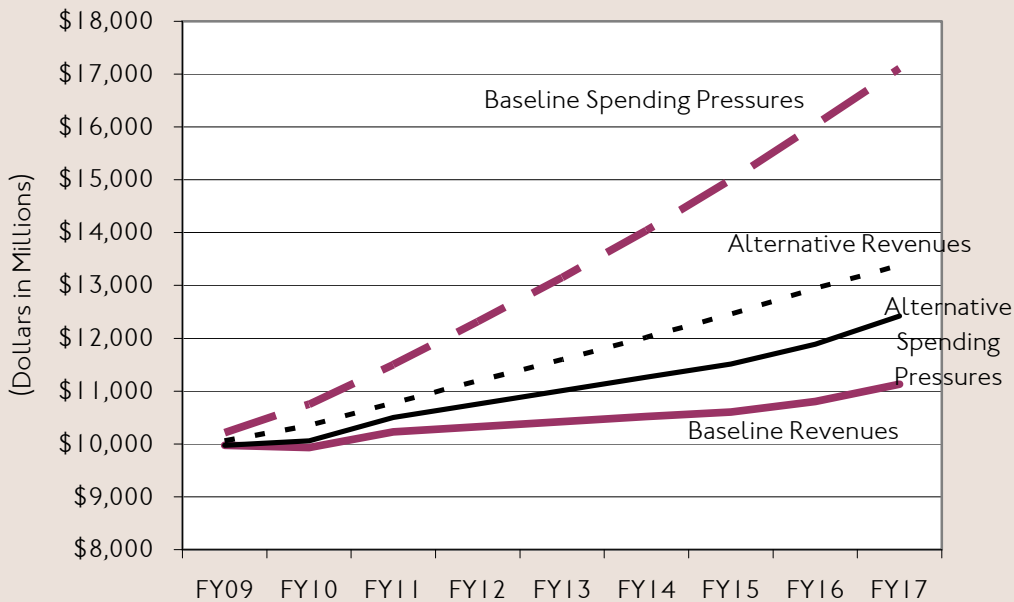
## Combining Revenue and Spending Calculations

If the four major changes discussed in this section were combined, revenues would grow faster from the same starting point and spending pressures would grow more slowly than baseline spending pressures.

If the four major changes discussed in this section were combined, revenues would grow faster from the same starting point and spending pressures would grow more slowly than baseline spending pressures.

**General Fund.** The annual rate of increase in General Fund spending pressures would drop to an average of 3.8 percent from 6.8 percent. The average annual revenue growth rates, including the effects of future tax cuts already in state law, would increase from 0.8 percent to 2.2 percent. Overall, the revenues and spending pressures would be relatively close to one another 10 years from now and the gap would be only about one-tenth as large.

**Chart A-1**  
**General Fund Structural Deficit Projections**  
**Current and Alternative Policy Scenarios, FY09 to FY17**



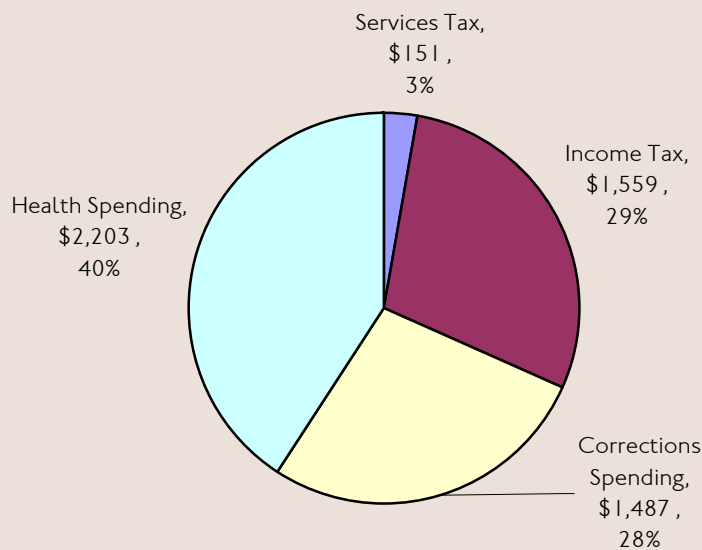
# MICHIGAN'S FISCAL FUTURE

The contributions of the four policy actions to reducing the structural gap are significantly different: revenue changes account for roughly one-fourth of the gap reduction and spending changes account for about three-fourths. The effect of expanding the Sales and Use Taxes for the General Fund into services is relatively small since the revenues affected total only about one-sixth of the General Fund revenues. Amending the Income Tax to incorporate graduated rates, by contrast, provides about one-half of General

Fund revenues, and the effect on the growth rate is significantly larger.

**School Aid Fund.** Combining the revenue and spending changes as they affect K-12 education programs would likely be sufficient to eliminate the structural deficit entirely. The annual gap, measured as the difference between spending pressures and revenues, is 1.7 percent. Reduced health care costs cover about one percentage point of the gap and the two revenue alternatives would reduce the annual gap by about eight tenths of a percentage point.

**Chart A-2**  
**Effects of Alternative Policies to Close \$5.4 Billion General Fund FY 17 Structural Deficit Gap**  
(Dollars in Millions)



## Endnotes

<sup>1</sup> [www.taxadmin.org/fta/pub/services/services.html](http://www.taxadmin.org/fta/pub/services/services.html).

<sup>2</sup> [www.taxadmin.org/fta/rate/ind\\_inc.html](http://www.taxadmin.org/fta/rate/ind_inc.html)

## Appendices

The other appendices for this document are available as a separate document. The appendices include the data produced by the economic model for employment, personal income, output, and gross regional product; population projections for each economic scenario; the revenues that would be produced under the moderate growth scenario for the General Fund and School Aid Fund, and General Fund-General Purpose spending pressures that would be produced under current law.

- B. Economic Projections (high growth)
- C. Economic Projections (moderate growth)
- D. Economic Projections (low growth)
- E. Population Projections (high growth)
- F. Population Projections (moderate growth)
- G. Population Projections (low growth)
- H. General Fund Revenue Projections 2007 to 2017
- I. School Aid Fund Revenue Projections 2007 to 2017
- J. General Fund-General Purpose Spending Pressure Projections 2007 to 2017

To access these appendices, go to: [www.crcmich.org/PUBLICAT/2000s/2008/rpt349\\_appendices.xls](http://www.crcmich.org/PUBLICAT/2000s/2008/rpt349_appendices.xls).