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# State Budget Notes

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## The Prospects for a Long-Term Solution to Michigan's General Fund Structural Deficit

As the Michigan Legislature nears completion of its deliberations on the FY2003 budget, it is appropriate to look beyond 2003 to assess the longer-term outlook for Michigan's General Fund budget.

CRC's March 2002 Budget Note analyzed the outlook for the state's School Aid program and concluded that it is unlikely that any year-to-year declines in school aid spending will be necessary to balance expenditures with revenues unless there is a significant downward revision in School Aid Fund revenue estimates. However, the same cannot be said for programs financed by the General Fund.

The proposed FY2003 General Fund budget already reflects some permanent cuts in program spending initiated in FY2002 and carried forward into FY2003 as well as new reductions proposed in the Executive Budget for FY2003 ($308 million). However, the magnitude of the cuts is small in comparison with the remaining imbalance between base revenues and the current level of program spending, which is now being supported by one-time revenues.

The proposed level of General Fund spending exceeds base revenues by $660 million and it is likely the Medicaid program is roughly $100 to $150 million short of financing the level of services proposed in the budget. As the outlook for FY2004 and beyond is analyzed, the beginning imbalance is about $770 million, over 8 percent of recommended FY2003 spending. That figure could expand unless revenue growth resumes soon. Revenues during January, February, and March have fallen short of that projected in the consensus revenue forecast agreement of January 2002. Another consensus conference is scheduled for May 16 and downward revisions for both FY2002 and FY2003 may be in the offing. If so, with little time left in the current fiscal year, reliance on one-time revenue sources such as the Rainy Day Fund will be appealing to policymakers despite the expanding gap between revenues and spending.

This analysis is based on the January Consensus Revenue agreement. It seeks to determine how soon, or indeed if ever, growth from currently authorized revenues will permit eliminating the structural deficit without very large cuts in program spending. Thus far, the overall level of programs and services in place before the economic downturn has been validated as desirable and appropriate as demonstrated by the actions taken to provide temporary resources to fill in the revenue shortfalls. In past periods of budget duress the approach of using one-time revenues to buy time for revenue growth to resume was effective. However, in the current budget environment the prospect of revenues growing to catch up with current spending in the foreseeable future is nil. Moreover, additional budget demands loom on the horizon and, combined with routine demands arising from higher costs and prices, portend very difficult times ahead.

### Tax Policy

The difference separating this period from the budget problems of the mid-70s, early-80s, and early-90s is that the state has already committed a significant portion of future revenue growth to tax rate reductions in the state's two largest sources of General Fund revenue. Under current law the Single Business Tax (SBT) is scheduled for eventual elimination by reducing the tax rate in one-tenth percentage point increments over a period of more than 20 years. The current rate is 1.9 percent, down from the 2.3 percent rate of 1998. The Personal Income Tax rate is being phased down from 4.4 percent to 3.9 percent, with the rate already reduced to 4.1 percent. The rate will drop to 4.0 percent on January 1, 2003, and the final income tax rate cut is scheduled for January 1, 2004. When fully implemented, the SBT and Income Tax cuts combined will eventually eliminate more than one-third of the General Fund revenue base as it existed in 1998. Implications for the programs they support are not yet clear.

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## Revenues

**Table 1** summarizes revenue projections for FY2002 through FY2009. The projections for FY2002 and FY2003 are the current state consensus projections. Beyond FY2003, base revenues are assumed to grow at 4.5 percent per year under this scenario, consistent with moderate, steady economic growth.

Reductions are then made for SBT and Income Tax rate cuts that have not yet occurred (i.e. after January 1, 2002). In addition, federal tax law changes approved in 2001and 2002 are having a negative effect on state revenues, principally on the Estate Tax, which will be eliminated by the end of 2004. These federal tax reform effects are also factored explicitly into the calculations as the reductions are scheduled to occur.

Two conclusions derived from these projections are noteworthy:

- Available revenues do not return to their pre-downturn FY2000 peak of $9,831 million until FY2009.

- Available revenues do not reach the enacted FY2002 level of expenditures of $9,266 million until FY2007.

**Table 1**

**General Fund-General Purpose Revenue Projections**
**Fiscal Year 2001-02 through 2008-09**
(Dollars in Millions)

| Fiscal Year | Baseline GF-GP Revenues* | Percent Change | Cumulative Revenue Reductions: Income Tax | SBT | Federal Tax Reform | Available GF-GP Revenues | Percent Change |
|---|---|---|---|---|---|---|---|
| 2002 | $ 8,758.3 | (3.2) | | | | $ 8,758.3 | (3.2) |
| 2003 | 9,029.1 | 3.1 | $144.5 | $ 88.5 | $ 68.8 | 8,727.2 | (0.4) |
| 2004 | 9,435.4 | 4.5 | 352.3 | 215.8 | 128.3 | 8,739.0 | 0.1 |
| 2005 | 9,860.0 | 4.5 | 420.8 | 354.4 | 170.9 | 8,913.9 | 2.0 |
| 2006 | 10,303.7 | 4.5 | 439.7 | 505.0 | 178.9 | 9,180.1 | 3.0 |
| 2007 | 10,767.4 | 4.5 | 459.5 | 668.4 | 188.9 | 9,450.5 | 2.9 |
| 2008 | 11,251.9 | 4.5 | 480.2 | 845.5 | 200.9 | 9,725.3 | 2.9 |
| 2009 | 11,758.2 | 4.5 | 501.8 | 1,037.3 | 212.9 | 10,006.3 | 2.9 |

* Baseline revenues are the total estimated total revenues from tax rates in effect at the beginning of FY2003.

Source: FY2003 Executive Budget and CRC Calculations.

## Expenditures

On the expenditure side of the budget, proposed appropriations for FY2003 were adjusted to reflect known additional spending requirements in the Medicaid program over and above the executive recommendations and then extended into FY2004 and beyond. Growth in state funding requirements in Medicaid alone surpass projected revenue growth in FY2004 and FY2005.

The projections beyond FY2003 are intended to measure the future cost of current policy—frequently called the current policy baseline. They include incremental increases for the following items:

- The cost of state employee pay raises already negotiated with unions representing most state employees. The increases are 3 percent for FY2004 and 4 percent for FY2005. In years beyond FY2005, 2 percent was used for employee pay raises.

- Medicaid spending was adjusted to reflect the need to replace $247 million of Medicaid Benefits Trust Fund revenues, which will likely be exhausted after FY2003, and increases in the reimbursement rates paid by the state for medical services it purchases for clients (5 percent). In addition, federal participation in Medicaid "special benefits", a mechanism used by Michigan and several other states to increase federal matching funds, is being phased down by a cumulative total of $376 million by FY2006.

- The cost of increasing higher education appropriations by 3 percent each year, an amount approximating the expected rate of inflation. Failure to increase appropriations would increase pressure on tuition paid by students and their families to cover the entire effect of inflation on community college and university costs.

- Amounts to cover general inflation (3 percent) were added to the calculations to cover services and commodities purchased by the state, such as fuel and food, group insurance premium increases for state employees and general inflation for programs supported by state funds, such as community mental health and services purchased for Family Independence Agency clients.

**Table 2**

**Projected Current Policy Baseline Increases in Spending**
**Fiscal Years 2002-03 through 2008-09**
(Dollars in Millions)

| | FY2003 | FY2004 | FY2005 | FY2006 | FY2007 | FY2008 | FY2009 |
|---|---|---|---|---|---|---|---|
| Medicaid Shortfall | $100 | | | | | | |
| Prior Year Requirements | | $100 | $ 729 | $1,130 | $1,500 | $1,754 | $2,018 |
| Medicaid Rates | | 70 | 74 | 77 | 81 | 85 | 89 |
| Medicaid Trust Fund Replacement | | 247 | | | | | |
| Reduction in Medicaid Special Financing | | 125 | 125 | 125 | | | |
| Employee Compensation | | 60 | 80 | 42 | 43 | 44 | 45 |
| Higher Education (3%) | | 64 | 66 | 68 | 70 | 72 | 74 |
| General Inflation | —— | 54 | 56 | 58 | 60 | 63 | 65 |
| Cumulative Total Additional Needs | $100 | $729 | $1,130 | $1,500 | $1,754 | $2,018 | $2,291 |

Source: Calculations made by CRC from data in FY2003 Executive Budget.

**Table 2** summarizes the projections for the FY2003 through FY2009 period. The largest incremental increases in spending occur in FY2004, when replacement revenues are needed for the Medicaid Benefits Trust Fund revenues, $125 million of Medicaid special funding benefits are lost, and other temporary resources used to support spending in FY2003 are no longer available.

In terms of pressures on the budget for spending increases, the rates of increase reflected in **Table 2** are very moderate by historical experience. Each constituency for specific programs can and will build a case for larger increases. The yearly increments run in the range of 3 percent per year after FY2004, approximately the rate of change in available revenues displayed in **Table 1**.

**Table 3** combines revenues and projected spending demands. The size of the gaps for FY2004 and beyond is determined primarily by one-time actions proposed for FY2003 to balance the budget ($660 million) and projected Medicaid requirements ($442 million).

The resulting gaps between revenues and projected spending demands are not a prediction that the state will incur a deficit. Rather, they indicate the size of the challenge state leaders must address. They also assume no downward revisions in FY2002 and FY2003 revenue forecasts and no recession before 2009.

The State Constitution contains very strong strictures against running budget deficits. The gaps measure the approximate amount of combined spending reductions and revenue increases needed to achieve that required budget balance.

**Table 3**

**Projections of General Fund-General Purpose Budget Gaps**
**Fiscal Years 2002-03 to 2008-09**
(Dollars in Millions)

| Fiscal Year | Projected Revenues | Appropriations/ Proposed Spending | Additional Spending Demands | Projected Spending Demands | Spending/ Revenue Gap |
|---|---|---|---|---|---|
| 2002 | $9,290* | $9,290 | $100 | $9,390 | ($100)* |
| 2003 | 9,239* | 9,235** | 100 | 9,335 | (99)* |
| 2004 | 8,865 | 9,235** | 729 | 9,964 | (1,099) |
| 2005 | 9,046 | 9,235** | 1,130 | 10,365 | (1,319) |
| 2006 | 9,318 | 9,235** | 1,500 | 10,735 | (1,417) |
| 2007 | 9,594 | 9,235** | 1,754 | 10,989 | (1,394) |
| 2008 | 9,876 | 9,235** | 2,018 | 11,253 | (1,377) |
| 2009 | 10,163 | 9,235** | 2,291 | 11,526 | (1,362) |

* Revenue projections and gaps for Fiscal Years 2002 and 2003 are calculated to include the one-time revenues already proposed for use.

** FY2003 Executive Budget Proposal

Source: FY2003 Executive Budget and CRC calculations

## Alternatives for Balancing the Budget

A plan that uses a combination of spending reductions and revenue enhancements will likely receive consideration by the new policymakers elected in November. On the spending side, the composition of General Fund spending will make spending cuts difficult to implement. More than 80 percent of General Fund spending falls into four broad categories: higher education, health, corrections and Family Independence programs. **Table 4** summarizes the proposed FY2003 General Fund appropriations, with an adjustment made for the funding shortfall in the Medicaid budget.

**Table 4**

**Projected General Fund-General Purpose Appropriations**
**FY2003**
(Dollars in Millions)

| Program Area | Amount | Percent of Total |
|---|---|---|
| Higher Education | $2,132 | 22.8 |
| Community Health | 2,633* | 28.5 |
| Family Independence Agency | 1,208 | 12.9 |
| Corrections | 1,628 | 17.4 |
| Other General Fund Programs | 1,704 | 18.3 |
| Total | $9,335 | 100.0 |

*Includes $100 million for expected additional Medicaid requirements.

Source: FY2003 Executive Budget. Calculations by CRC

Since the gap in FY2004 is more than 10 percent of projected spending demands, it appears that traditional retrenchment methods such as hiring restrictions and other expenditure controls will not solve the problem. Less than 25 percent of General Fund spending is for employee compensation. The majority of spending occurs outside state government for services provided by non-state agencies and organizations. The heavy emphasis on human services and higher education creates the potential need for using major changes in state policy as the device to achieve savings rather than across-the-board reductions.

- It is probably not feasible to reduce the rates paid to providers of service to Medicaid clients, for example, since those reimbursement rates are already below the costs incurred by some providers for the services they deliver and below routine charges for many others. Elimination of optional medical services, those not required by the federal government of a state to provide in order to participate in the program, may be the only means to achieve substantial savings in the program.

- Changes in state law regarding prison sentences may be the only way to achieve substantial savings in corrections programs, and such changes might have to be retroactive in order for savings to be immediate.

- Changes in policies reducing services provided to Family Independence Agency clients may be required, as might eligibility restrictions for community mental health programs.

- Reductions in higher education appropriations would likely translate into significant tuition increases to offset the revenues lost to public universities and community colleges.

Revenue enhancements represent the other side of the fiscal equation. One obvious alternative is to forgo future rate reductions in the SBT and Personal Income Tax. Although not part of the FY2003 Executive Budget proposal, delaying or terminating the tax cuts scheduled for January 1, 2003 and beyond would produce substantial revenues to address a portion of the projected future gaps. **Table 5** displays the projected gaps from **Table 3** and shows the positive impact that foregoing the future rate cuts can provide. It also indicates that 5 more years of budget constraint will be necessary even if the tax cuts are stopped.

**Table 5**

**Projected General Fund-General Purpose Gaps With No Further Tax Cuts**
**Fiscal Years 2003-04 to 2008-09**
(Dollar in Millions)

| Fiscal Year | Projected Gap | Revenues from Postponing Future Tax Cuts | Remaining Gap |
|---|---|---|---|
| 2004 | ($1,099) | $568* | ($531) |
| 2005 | (1,319) | 775 | (544) |
| 2006 | (1,417) | 945 | (472) |
| 2007 | (1,394) | 1,128 | (267) |
| 2008 | (1,377) | 1,326 | (52) |
| 2009 | (1,362) | 1,539 | 177 |

* Includes only the revenues lost in FY2004 from tax cuts effective January 1, 2003 and 2004.

Source: Calculations by CRC

Even with the additional revenues made possible by delaying or terminating the tax cuts, the remaining gap in Fiscal Years 2004-2006 is daunting. If the goal is to hold the spending reductions to a predetermined minimum, then additional temporary resources would need to be identified. The heavy reliance on such resources in Fiscal Years 2002 and 2003 has left the cupboard relatively bare. At the end of FY2003, $255 million is projected to remain in the State's rainy Day Fund, down from $1,264 million in FY2000.

Several states have considered securitizing some portion of their tobacco settlement revenues and at least 3 have done so. Although the mechanism can take different form, the simplest approach would be for the state to sell bonds pledging future tobacco settlement revenues to repay the bondholders. The annual stream of future revenues is more than $300 million. If committed entirely to a securitization program, a very large amount could be derived to provide time for revenues to approach projected spending levels. Committing less than the full amount could contribute substantially as a component of an overall plan to achieve balance. Diverting tobacco settlement revenues for gen-

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eral use would require reducing current uses such as the Merit Scholarship program.

Other relatively permanent resources are also potentially available. They include further reductions in the statutory allocation of Sales Tax dollars to the state's revenue sharing program for local units of government—cities, villages, townships, and counties. These units have already seen their allocations for FY2003 targeted for reductions totaling $122 million, and this proposal is assumed to be permanent for purposes of this analysis. Further reductions could be made in the future with the effect of adding additional revenues to the General Fund. The statutory allocation for revenue sharing in the proposed FY2003 budget is $846 millions. Further reductions would have significant adverse effects on local units depending on revenue sharing as a principal source of revenue.

Other actions might include:

- Some current tobacco settlement revenues could be reallocated from current uses to become a General Fund revenue resource.

- Another potential reallocation of resources is the relatively small grant from the General Fund to the School Aid Fund ($198.4 million in FY2002 and FY2003). This grant represents only 0.16 percent of proposed school aid spending for FY2003.

- Increasing one or more state taxes would derive additional resources. Such action would fly in the face of several years of cutting state taxes and legislative approval would be difficult to obtain, even if a governor were to propose it. The most likely candidates would be the SBT and Personal Income Tax, the object of prior rate reductions. Backtracking part of the way toward the pre-1999 rates would yield substantial added revenues. And some officials have suggested a Cigarette Tax increase would be appropriate, although the idea is usually connected with specific program spending plans and the tax holds little potential for growth.

Alternative solutions to the problem are relatively easy to identify, but will be difficult to implement. The likelihood appears to be greater that the problem will prove larger following the May Consensus Conference than that good news will prevail. An updated analysis will be released following the revisions of revenue projections in May and the approval of appropriations for FY2003 in May or June.