STATE BUDGET NOTES

2009-02 A publication of the Citizens Research Council of Michigan April 2009

DUAL DEFICITS AND FEDERAL RECOVERY ASSISTANCE: PROSPECTS FOR STATE BUDGET BALANCE

In Brief

Although the U.S. economy officially slipped into a recession in December 2007, Michigan's economy has been under significant stress since the early part of the decade, losing nearly 750,000 jobs since peak employment levels were recorded in June 2000. State and local government finances have been directly affected by Michigan's economic erosion and the state's nation-leading unemployment rate since the start of the last economic downturn in March 2001. The failure to adjust Michigan's state budget to the new economic realities has resulted in on-going structural imbalance, characterized by on-going spending exceeding on-going revenues. Annual budget balance has been achieved through the use of over $8 billion in non-recurring resources over the past eight fiscal years.

The CRC documented the sizable and growing structural budget deficits in June of 2008 (See **Michigan's Fiscal Future**, CRC Report #349, www.crcmich.org/PUBLICAT/2000s/2008/rpt349.pdf), projecting problems for the foreseeable future. As a result of the current business cycle contraction, Michigan policymakers must now address a cyclical deficit in tandem with the on-going structural problem (See **Michigan's Weakened Financial Position and The Problem of Dual Deficits**, CRC State Budget Note 2009-01, www.crcmich.org/PUBLICAT/2000s/2009/sbn200901.html).

At the national level, a massive recovery package was crafted to keep the recession from deepening and to minimize the effect the recession would have on a variety of public programs run by state and local governments. For most state governments, the stimulus package is the proper prescription for addressing the cyclical budget deficits caused by the economic downturn without raising taxes or slashing spending. In Michigan, however, the fiscal resources provided by the federal government:

- Will not be sufficient to prevent spending cuts.
- Will mask the size of the requisite cuts to deal with the structural budget problems.
- Will not be available long enough to see the state budget through the full period of reduced state tax revenues caused by the recession.
- Will cause a budgetary revenue "cliff" when the additional level of federal spending expires.

The Michigan Legislature's immediate attention is focused on the development of the Fiscal Year 2010 (FY10) budget; however, the more pressing issue and difficult task is crafting a solution for the state budget that will take effect in 18 months, the FY11 budget. While the new federal money does not provide fiscal resources for addressing the structural deficit, it does provide policymakers with additional time to tackle the very difficult task of developing a menu of structural changes required to achieve lasting harmony between annual state spending and revenue.

CITIZENS RESEARCH COUNCIL OF MICHIGAN

MAIN OFFICE 38777 West Six Mile Road, Suite 208 · Livonia, MI 48152-3974 · 734-542-8001 · Fax 734-542-8004

LANSING OFFICE 124 West Allegan, Suite 630 · Lansing, MI 48933-1738 · 517-485-9444 · Fax 517-485-0423

CRCMICH.ORG

Background

Governor Granholm's Fiscal Year 2010 (FY10) budget recommendation, released on February 12th, identified an imbalance between revenues and spending in the two major state funds, General Fund/General Purpose and the School Aid Fund, totaling $1.4 billion, although current estimates peg the deficit at closer to $2 billion. The shortfall is born from two principal causes; first, a structural imbalance between on-going spending and revenues, and second, the fiscal effects of the current economic downturn. The proposed FY10 budget was released before the enactment of the American Recovery and Reinvestment Act of 2009 (ARRA), which will provide direct fiscal relief to state and local governments.

Nearly all of this federal funding will be temporary, making the task of balancing the annual state budget easier in FY09 and FY10. Budget makers will use the federal resources to address the cyclical deficit caused by the current downturn; however, they will be unable to use the dollars to address the underlying structural problem. In the near-term, the structural deficit will be masked by efforts to address the cyclical problem in FY09 and FY10. Further, certain restrictions accompanying the new federal money (e.g., minimum spending levels) may worsen the depth and scope of the structural problem that presents itself in FY11.

One-Time ARRA Funds and State Budget Impacts

The State of Michigan budget is supported by a variety of revenue sources, including funding that is received from the federal government. The enacted FY09 spending plan relies upon $15 billion in federal funds, one-third of the $44 billion total state budget. Whereas these federal dollars are on-going and long-term in nature, ARRA funding will be quite different in scope and longevity.

Two-thirds ($500 billion) of the total $787 billion package will be in the form of increased governmental spending, the majority of which will be carried out by state and local governments. Of the spending provisions, state budgets will directly benefit in various ways, including $87 billion for a temporary increase in the federal share of Medicaid costs; $54 billion in a State Fiscal Stabilization Fund to mitigate cuts in public education and other programs; and various other funding streams including educational, human services, workforce training, and general state assistance programs. State budgets will also see an infusion of dollars for capital projects, including roads, bridges, and buildings. The Senate Fiscal Agency estimates that $7 billion of the federal funding available under the ARRA legislation will flow through the state budget for state government and/or local government programs in Michigan.[1]

Objectives of ARRA

The nature of the $500 billion in increased governmental spending is different than current federal resources flowing through Michigan's budget. Whereas nearly all current sources of federal spending continue from year-to-year for established programs, the new ARRA funds are designed to be temporary and serve specific purposes. The temporary spending endeavors to achieve three objectives. First, it is intended to help states avoid cuts to public programs that may be sensitive to economic conditions (e.g., health care and income/food support programs for the poor). Similarly, the funding is being provided to avoid programmatic cuts that may be required as a result of declines in state tax revenues. Nearly all state governments, unlike the federal government, are legally required constitutionally or statutorily to maintain balanced budgets and cannot engage in deficit financing to pay for on-going programs. State actions to constrict spending in the face of the recession would undermine the federal government's attempt to use its fiscal resources to "jump start" the economy.

Second, the federal funds are intended to be stimulative and help "jump start" an economic expan-

[1] Senate Fiscal Agency, Overview of Governor Granholm's FY10 Budget, February 2009. www.senate.michigan.gov/sfa/Publications/BudUpdates/OverviewGovsRecFY10.pdf

sion. The funding will be provided through various state-administered programs to get money into the hands of consumers, through both public and private employers. The "pump priming" aspect of the ARRA spending is intentionally temporary. Specifically, most of the funding must be spent by the states within specific time periods in order to capitalize on their potential to stimulate economic activity.

Finally, some of the new federal spending is designed to strengthen long-term economic competitiveness through spending on university research, teacher preparation, and emerging technologies.

Achieving Budget Balance

The enhanced level of federal funding received in FY09 and FY10 can be used both directly and indirectly to achieve annual budget balance. In terms of direct methods, budget writers will use the limited discretionary resources to fill holes in the state budget resulting from lower-than-expected state revenues. Of the $500 billion in new governmental spending, only $8.8 billion contains "no strings" and is completely discretionary. The Michigan state budget will receive a one-time infusion of $300 million from this provision of the ARRA legislation.[2] This amounts to 3 percent of the planned FY09 General Fund spending and less than 1.5 percent of total General Fund spending for FY09 and FY10 combined. Based on the relatively small amount of discretionary resources available in total and to Michigan specifically, it is clear that the ARRA is not designed to provide general, untargeted fiscal relief to the states. Instead, state budget support is much more focused.

Nearly all of the ARRA funding that will flow through the state budget will be restricted as to its use, either because it will be provided via an existing federal program (e.g., Medicaid, Federal-Aid Highway, Food Stamps) or because the dollars not tied to an existing program are earmarked to support specific services (e.g., education). These restrictions effectively limit the potential for the approximately $7 billion in new federal aid to directly help maintain overall state budget balance.

The increased federal support, in many cases, requires states to maintain spending at current levels and is intended to avert state spending cuts for targeted services that otherwise would be necessary owing to the economic downturn. Two areas, education and Medicaid, stand out as examples in this regard. First, Title XIV of the legislation provides $54 billion in a new State Fiscal Stabilization Fund, primarily for baseline education services at the K-12 and post secondary levels. Michigan will receive $1.3 billion from this Fund to ensure that state formulaic education funding in FY09, FY10, and FY11 is at least equal to FY08 levels. Second, Michigan will receive an additional $2 billion over the next three years in additional Medicaid dollars through a temporary 6.2 percentage point increase in the matching rate.

Michigan will be able to use ARRA funding indirectly to achieve short-term budget balance. Assuming all federal requirements are attended to, the ARRA funds can replace discretionary state funds in those programs scheduled to benefit from the new federal dollars. This is most likely to occur in the Medicaid program. A portion of the discretionary General Fund resources budgeted for this program can be re-directed to address budget imbalance elsewhere in the budget. The resultant gap can be filled, at least temporarily, by the increased federal matching dollars without reducing service levels. The proposed FY10 budget includes $500 million in additional federal Medicaid matching funds to replace an equal amount of General Fund resources.

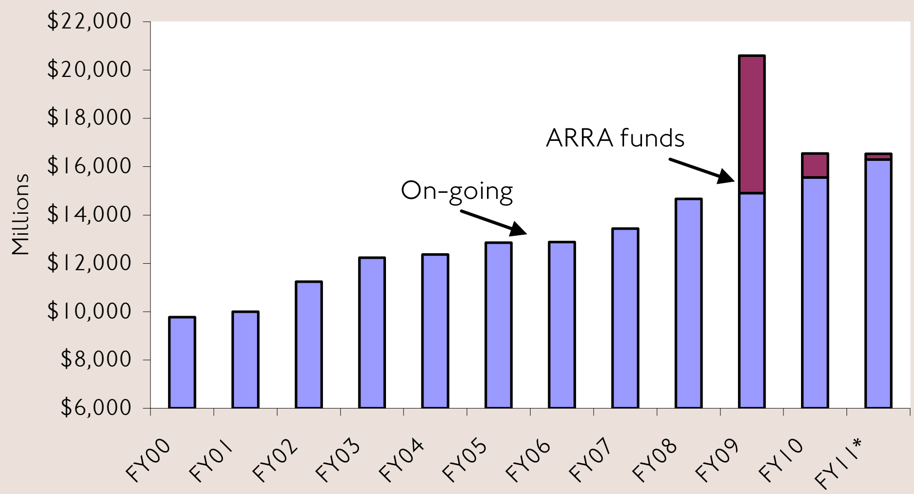
Such budget adjustments are prudent tools for maintaining service levels in specific programs such as Medicaid and achieving short-term balance in the broader state budget. However, such adjustments will have to be reversed relatively soon thereafter to avoid service cuts when the ARRA funds are exhausted. It is unlikely that state tax revenue performance will have improved sufficiently to make up for the loss of the temporary fiscal relief available, directly or indirectly, from the federal government.

Budget Revenue Cliff

A direct objective of the ARRA funding is to help states meet their balanced budget requirements

[2] Senate Fiscal Agency, American Recovery and Reinvestment Act of 2009, March 2009. www.senate.michigan.gov/sfa/main/ARRAct2009.pdf

Chart 1
Federal Funding Appropriated in Michigan State Budget
On-going and ARRA Funds



* Projected

Source: Senate Fiscal Agency, www.senate.michigan.gov/sfa/StateBudget/AppropriatedFedFunds.pdf. CRC calculations.

without having to slash spending or raise taxes in the midst of the recession; however, a potential indirect consequence of the new money is the creation of a revenue "cliff" for state budgets. Such a "cliff" is the result of the temporary nature of the federal money and the fact that the money is intended to be integrated into the economy in a relatively short time period. The ARRA spending provisions are "front-loaded" as nearly all of the federal spending will have to be appropriated in FY09, with a much smaller amount in FY10. When the federal funding is no longer available for budgetary purposes, Michigan will have to decide what to do about the "void" that remains. This is likely to occur in FY10.

Of the approximately $7 billion in direct budgetary resources from the ARRA legislation, the Senate Fiscal Agency estimates that almost $5.7 billion will be available for appropriation in FY09, $1 billion (almost all of it tied to the increased federal share of Medicaid) in FY10, and the remaining $300 million for the Medicaid program in FY11.[3] **Chart 1** illustrates the fiscal effect of the revenue cliff in FY10 by comparing the historical level of on-going federal funding appropriated with the projected level of ARRA resources that will flow through the state budget for state and local government programs over the next three years.

It is hoped that the economic recovery will have taken root by the time that the revenue cliff appears. The recovery will aid state revenue growth to some degree and will help mitigate the size of such a "void". However, it is unlikely that the full rebound will have been realized by the time the federal dollars are no longer available, as evidenced by Michigan's experience coming out of the last two recessions (1990 and 2001). Thus, it is unlikely that state revenue will have grown sufficient enough to make up for the "lost" federal dollars.

When the federal dollars are no longer available to support current programs and policies, Michigan will have to take steps to ensure budget balance. The prescription for this problem is exquisitely simple in terms of its scope; cut spending and/or raise taxes.

[3] Senate Fiscal Agency, February 2009.

State Revenue Recovery

Michigan's experiences in recent national recessions suggest that state tax revenues will continue their decline for two or more years before beginning a very modest and gradual ascent. State revenue growth performed differently coming out of the three most recent economic downturns. Applying the growth patterns from these scenarios to the current economic period reveals that adjusted baseline revenues will not approach their pre-recessionary levels until FY13 at the earliest, even under the most robust growth assumptions.

Past Recessions

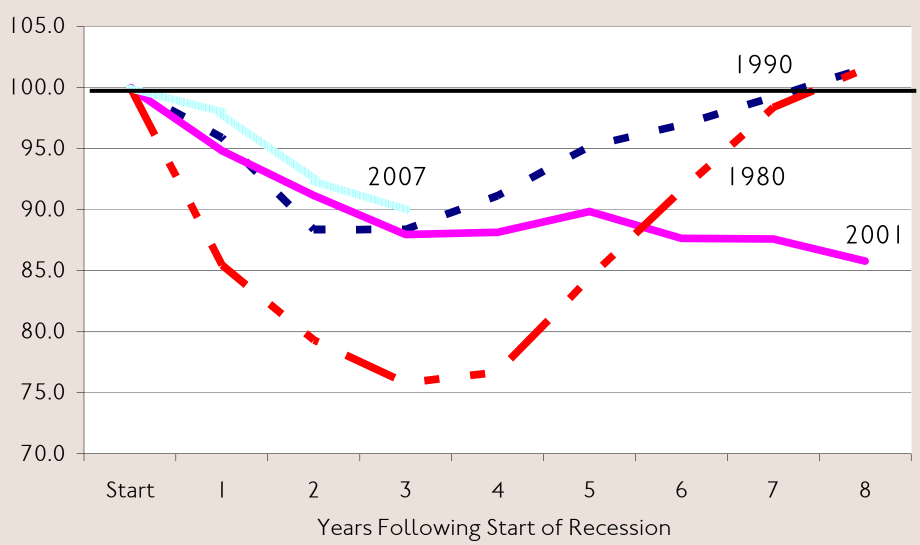
State government tax revenue is directly affected by economic slowdowns. **Chart 2** compares Michigan baseline revenue growth in the three most recent recessions (1980, 1990, and 2001), adjusted for population and inflation.[4] Baseline revenue, tracked by the Senate Fiscal Agency since FY80, isolates the effects of economic factors on revenue performance and filters out non-economic factors (e.g., tax policy and balance sheet adjustments such as transfers) on tax collections. The adjusted tax revenue data is indexed to equal 100 at the approximate start of each economic contraction. **Chart 2** highlights baseline revenue changes over an eight-year period for each recession.

[4] Adjusting for the effects of population changes and inflation allows us to further isolate the economic effects on baseline revenues during the business cycle, specifically from the beginning of a downturn and over the next eight years.

The strength and depth of the 1980 recession is clearly illustrated in a decline of almost 25 percent by the end of the third year, before beginning a recovery in the fourth year. By the end of the eighth year (FY87) revenue had clawed its way back to pre-recessionary levels and surpassed the initial level by 1.5 percent. The "U"-shaped pattern of the 1980 recession is emblematic of the traditional state revenue response to a recession.

The reaction of state revenues to the 1990 recession was typical of most economic slowdowns that

Chart 2
Real Per Capita Baseline Revenue Growth
Combined General Fund/General Purpose and School Aid Fund



Source: Senate Fiscal Agency; CRC calculations preceded it, but on a milder scale. Adjusted revenue dipped initially, falling for two years by a total of 11 percent, followed by a no growth year. During the next five years, adjusted revenue levels increased each year, forming a shallow "U"-shaped pattern for the period. It took seven years for real per capita tax revenue to return to the level it was at during the beginning of the mild recession of 1990.

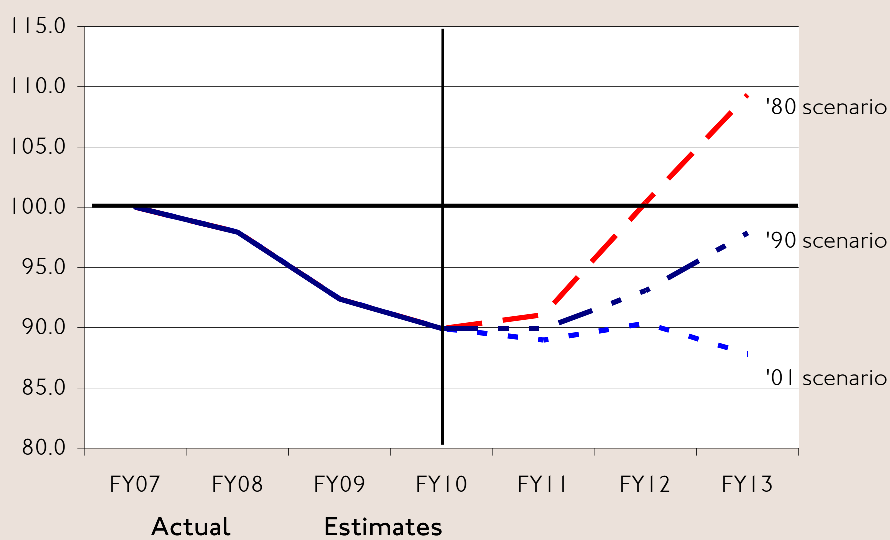
State revenue behaved quite differently under the 2001 recession, breaking with the experience of the previous downturns. The effects of the 2001 recession on adjusted baseline revenues can be seen in three straight years of declines, totaling 12 percent. Whereas the depth of the revenue decline was similar to that of the 1990 recession, it took three years to reach this level. In short, the revenue decline was more gradual, but more prolonged. Revenue remained basically flat during the fourth year, before experiencing a minor uptick in the fifth year. A traditional revenue rebound did not follow the decline. Adjusted revenue levels saw a very small (less than 2 percentage points) increase in the fifth year before stagnating. The atypical state revenue response to the 2001 recession can be explained, in part, by the continued erosion of Michigan's economic base during the beginning of the decade.

Three Scenarios

To illustrate potential revenue performance under different scenarios and the prospects for a recovery to pre-recessionary levels, the CRC adjusted baseline revenues for the effects of population and inflationary changes. Again, revenues are indexed to 100 to show growth under various scenarios, based on the experiences from the last three recessions. Baseline state revenue estimates for FY09 and FY10 from the January consensus revenue conference are reflected in **Chart 3**, along with actual figures for FY07 and FY08.[5] **Chart 3** builds upon current revenue estimates and projects revenue performance, based upon growth rates in the three years that followed the "bottom" of each of the last three recessions.

[5] The FY09 and FY10 estimates will be reviewed in May and could be adjusted downward further based on the performance of the U.S. and Michigan economies since January and the outlook over the next 18 months.

Chart 3
Real Per Capita Baseline Revenue Growth
Combined General Fund/General Purpose and School Aid Fund: FY07 to FY13



Source: Consensus Revenue Estimates; CRC calculations

The chart shows the very robust economic expansion that Michigan experienced following the 1980 recession. Revenue growth is small in FY11 (1 percent) and very robust in FY12 (10 percent) and FY13 (9 percent). By the end of FY13, adjusted baseline revenue is nearly 10 percent above the pre-recessionary level.

Under the 1990 scenario, adjusted baseline revenue growth stagnates in FY11, before increasing moderately FY12 (4 percent) and FY13 (5 percent). However, baseline revenues do not return to their pre-recessionary level at the end of FY13.

Under a 2001-like recovery scenario, adjusted baseline revenue growth is negligible to non-existent. Baseline revenues do not approach the pre-recessionary level even after six years, the end of FY13. The recovery from the 2001 recession coincided with a major restructuring of Michigan's economic base, which certainly contributed to state tax revenue performance during the six-year period. Continued or further economic erosion over the next three years will constrain revenue growth through FY13, similar to the experience under the 2001 scenario.

Writing the FY10 Budget with an Eye on the Structural Deficit in FY11

The Michigan Legislature currently is tasked with developing an FY10 budget that takes effect on October 1, 2009, which is estimated to face nearly a $2 billion shortfall. The job of achieving balance will be made easier because of the availability of nearly $7 billion in federal funds. These funds should be used for their intended purpose, to balance the cyclical deficits in Michigan's major budgets that will develop in FY09 and FY10. These funds will not directly help legislators craft solutions to the longer-term structural deficits that have plagued Michigan since FY01. An enhanced level of federal resources can assist in the transition towards achieving structural balance by providing policymakers with additional time to craft solutions and prepare for the revenue cliff that appears in the FY10 budget. Addressing the structural deficit will be made easier the more time policymakers have to develop, analyze, and ultimately decide upon the necessary fiscal steps to address Michigan's structural budget deficits that resurface for FY11. Waiting until February 2010, after the Governor presents her FY11 budget recommendation will make this task very difficult, if not impossible to accomplish.

Michigan is not going to grow its way out of the structural deficits affecting the General and School Aid Fund budgets; therefore, state officials must direct policy changes at specific components of the state revenue and spending structure that contribute most to the deficits. Changes in the tax structure to permit baseline revenues to grow in concert with the broader economy should be an objective of any tax reform efforts. Modifications can be made from a "revenue neutral" starting point with the intent that collections from Michigan's two largest taxes (Personal Income and Sales/Use) grow more at increased rates. Graduating income tax rates and adding services to the base of consumption taxes would increase the growth rates.

On the spending side, the two largest and fastest growing portions of the General and School Aid Fund budgets are Corrections and health care. Containing the future growth in these two areas offer the greatest potential for reducing the overall spending pressures facing the two budgets. Significant structural reforms impacting corrections spending have been put forward by both the governor and various outside organizations and await review in the legislative arena. The immediate savings in some cases (e.g., $120 million under Governor Granholm's proposal) are small relative to the overall size of the corrections budget ($2 billion); however, such policy interventions have long-lasting effects on spending pressure growth rates in the out years.