



STATE BUDGET NOTES



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Nonrecurring Resources and the FY2011 General Fund Budget

In Brief

In July, the Citizens Research Council of Michigan examined the passage of the Fiscal Year 2011 (FY2011) state School Aid Fund budget and the major factors that contributed to its completion nearly three months earlier than last year.¹ A key to the “early” adoption of the education budget was the legislature’s decision to postpone decisions regarding the General Fund budget until a later date, presumably after the August primary election. At the time, it was estimated that the General Fund faced shortfalls of \$220 million in FY2010 and at least \$500 million in FY2011. In late August, the Michigan legislature returned to the problems facing the General Fund budget for both years. Since that time, solutions to address these budget gaps were agreed to by legislative leaders and the governor and enacted into law. The legislature passed all of the appropriations bills that make up the FY2011 General Fund budget before October 1 and the governor signed all the bills, except the one for the 15 public universities, by the start of the new fiscal year, thereby avoiding another temporary government shutdown.

Although the FY2011 General Fund budget is technically “balanced” (projected revenues exceed approved appropriations), budget balance is premised on nearly \$1 billion in one-time resources. These resources include the use of temporary federal funding, short-term savings from refinancing state general obligation debt, and advancing the collection of state revenues, including a tax amnesty program. The heavy reliance on \$1 billion in nonrecurring sources means that the FY2012 budget will face a problem at least this size, before expected spending pressures are factored in. This State Budget Note summarizes the major solutions to achieve General Fund budget balance for FY2010 and FY2011 and provides some indication of the FY2012 fiscal problems that will face the new governor and the new legislature that will be seated in January 2011.

¹ “The FY2011 School Aid Fund Budget: A Day Late and a Few Hundred Million Dollars Short,” State Budget Notes 2010-02, July 2010. www.crcmich.org

Introduction

The FY2011 budget presented yet another opportunity for the Michigan legislature and the governor to address the near decade-long structural deficit plaguing state finances. The final budget passed by the legislature and signed into the law by the governor failed again to make major inroads toward solving the state’s chronic budgetary problems. The governor’s executive budget, released in February 2010, attempted to tackle aspects of the problem through a combination of spending reforms and tax changes that would better align ongoing spending with ongoing revenues. However, the final legislative package did not include a number of the governor’s structural components, thus requiring the

legislature to identify alternatives during the appropriations process to ensure that the budget was balanced. Although the final product does include some long-term structural items that will control spending growth, the budget extensively uses a variety of one-time resources in lieu of items that would ensure longer-term balance. These one-time budget actions help the FY2011 budget, but add to the structural budget problem that will resurface in FY2012.

Michigan will continue to experience fiscal stress in the General and School Aid Fund budgets as long as the revenue structures of these major funds are mismatched with the program responsibilities the



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state underwrites in each. Over the past ten fiscal years, state revenues have fallen precipitously in response to two national recessions and major restructuring of the state's economic base. Despite the economic challenges of the past and present which have contributed to the extended decline in on-going state resources supporting the budget, a major problem going forward is that the revenue base grows less rapidly than major indices of the economy while spending responsibilities grow at rates that surpass economic growth. Only after the legislature and governor

adopt a strategic approach to bring baseline revenues and spending back into balance will the long-term prospective fiscal challenges facing the state be eliminated.

As a first step towards long-term fiscal balance, policymakers must cease, or at least reduce substantially, the use of non-recurring resources to meet annual balanced budget requirements. Throughout the last decade, the state has continued to allow on-going spending to exceed the level of ongoing resources through the use of a myriad of

one-time budget fixes. The FY2011 budget continues the practice by using nearly \$1 billion in non-recurring resources. With state reserves exhausted and the reality that significant federal stimulus funds will not be available, the FY2012 budget will not be able to depend on one-timers to achieve balance. While the expected slow recovery in the national and state economies will provide some degree of real state revenue growth in FY2012, it will not be sufficient to erase the need for long-term structural changes in the state's revenue structure and spending.

Fiscal Year 2010 Review

The condition of the enacted FY2010 state budget (which ended on September 30, 2010) changed dramatically following the May revenue estimating conference; however, the nature of change was different for each of the two major pieces of the budget, the General Fund and the School Aid Fund (SAF). The conference revised downward substantially the FY2010 General Fund revenue estimate (from \$6,898 million to \$6,655 million, a \$243 million decline) and the SAF revenue estimate was revised upward significantly (from \$10,458 million to \$10,750 million, a \$292 million increase).

Combining the new revenue estimates with revised expense projections caused a deficit in the General Fund budget of \$303 million and a SAF surplus of \$397 million. Lower than anticipated business tax revenue contributed heavily to the General Fund revenue shortfall, while an improved sales tax estimate (coming out of the recession) accounted for the SAF surplus.

Placing the Current-Year Problem on the Backburner

The welcomed news regarding SAF revenues was sufficient to allay public fears about another

mid-year state aid cut to public schools and provided the legislature with the financial resources to pass a FY2011 SAF budget without a per-pupil funding cut. Furthermore, the revenue increase effectively allowed budget writers to pass the SAF budget on July 1, about three months earlier than in the prior year and in time for the start of the schools' new fiscal year. Under state law, the revenue shortfall in the General Fund should have triggered the constitutional executive order spending reduction process; however, executive proposals to address the General Fund budget deficit did not come

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until September.² Meanwhile, legislative attention was directed away from the current-year problem and focused on the development of the FY2011 budget, which also faced a significant deficit.

Although the budget gap was identified in May, nothing substantive was done until four months later. When policy makers finally decided in September to address the problem, there was less than one month remaining in the fiscal year. The delay in acting limited the options available to achieve budget balance for the fiscal year, effectively ruling out expenditure reductions or revenue increases.

² Executive order spending reductions are required by Article V, Section 20 of the 1963 Constitution, which states, "The governor, with the approval of the appropriating committees of the house and senate, shall reduce expenditures authorized by appropriations whenever it appears that actual revenues for a fiscal period will fall below the revenue estimates on which appropriations for that period were based." The Management and Budget Act (PA 431 of 1984) provides for the statutory implementation of this provision.

Options Limited: One-Time Fixes Rule the Day

With so little time left in the fiscal year, actions to eliminate the FY2010 General Fund shortfall were limited to those of a one-time nature; spending reductions or revenue enhancements were not part of the overall plan. A key one-time component was the available surplus in the SAF. The state used \$208 million in SAF surplus revenue to offset a cut in the General Fund allocation to the community college budget, a solution that addressed two-thirds of the \$303 million budget hole. The state used \$94 million in unanticipated federal Medicaid funding to offset state spending in that program, which accounted for the remainder of the solution. The lack of permanent reductions to the spending base or increases to ongoing General Fund revenues in FY2010 pushed the entirety of the budget problem to the next fiscal year and did nothing to address the General Fund's ongoing structural budget shortfall.

Both budget balancing measures represent one-time fixes to long-term problems. The increased Medicaid funding is only available for a finite period. Likewise, the use of SAF fund balance will not be available in future years. Fu-

ture use of SAF revenue to finance community college expenditures would require reductions in K-12 expenditures. If continued into future years, the use of the SAF to support non-K-12 education programs would represent a partial solution to the General Fund's structural budget deficit, prospectively. While the 1963 Constitution permits the funds to be used for such purposes, SAF revenues have not been used to finance higher education spending in the past. Such a solution would merely shift a portion of the General Fund's longstanding problem to the SAF budget and do little to address the overall budget situation facing the state's finances.

The one-time solutions have near-term consequences for the SAF and its ability to support education spending in FY2011 and FY2012. The community college funding shift reduces the projected FY2010 year-end balance of the SAF from \$397 million to \$163 million. While the SAF will carry forward this ending balance, this amount will not be sufficient to make up for the difference between the amounts of federal stimulus funding used to support appropriations in FY2010 (\$450 million) and FY2011 (\$184 million).

Fiscal Year 2011 Budget

Executive Budget

When Governor Granholm presented the executive budget for the fiscal year starting October 1, 2010 (FY2011) to the legislature, the gap between the projected General Fund spending and the January revenue forecast was just over \$1 billion.³ This estimate was based on four major assumptions: 1) January consensus revenue estimates; 2) the remaining amount of temporary federal stimulus funding available to support General and School Aid Fund expenditures; 3) an assumed six-month extension (until June 30) of enhanced federal matching funds in the Medicaid program; and 4) spending to maintain programs and policies with expected caseload increases. Using the same fundamental assumptions applied to the General Fund, the executive budget projected a \$410 million shortfall for the SAF budget in FY2011. The combined gap, nearly \$1.5 billion, equated to seven percent of projected FY2010 spending levels for the two funds.

The governor's budget proposal relied on different approaches to close the gaps in the two funds. The proposed General Fund solution represented a mix of spending cuts, policy changes, new taxes, and the assumption that additional federal revenues

would be forthcoming. One-time revenue resources associated with the Medicaid program, which permit postponing a portion of the problem to future years, totaled \$514 million and represented one-half of the solution. Expenditure reductions include major policy changes affecting the Department of Corrections that would further reduce the prison population and reforms to the state employee pension plan. These reforms contained both near-term and long-term cost savings for the State of Michigan. Approval of the executive budget as proposed would have eliminated a portion of the state's ongoing structural deficit, primarily by concentrating on the spending side of the budget ledger.

The proposed executive budget addressed the projected School Aid Fund gap entirely through a series of tax policy changes that would raise an additional \$554 million in FY2011, but would become revenue-neutral beginning in FY2014. The new revenue would cover the projected \$410 million deficit, negating the need for a \$250-per-pupil funding reduction and providing a cushion for the SAF in FY2012. In addition to raising additional revenue in the first year of implementation, the approval of the tax restructuring proposal also would have increased the growth potential of the School Aid Fund by aligning the revenue stream with the changes in the state's economy. This attribute of the tax restructuring proposal was designed to address a component

of the long-term (structural) problem facing the School Aid Fund budget.

Legislative Response

The governor's proposed budget included several structural reforms that were unacceptable to the legislature. These items were designed to address part of the state's ongoing deficits in the General Fund and School Aid Fund. The legislature's rejection of these items required alternatives to be identified and enacted. The primary question facing the legislature was whether to enact alternatives that merely would provide balance in the FY2011 budget, or whether it would adopt budget elements to help ensure budget balance over the long run. Alternatives focused on short-term budget balance have the effect of perpetuating the state's structural deficit problems without narrowing the gap between ongoing revenues and spending. Going into the legislative appropriations process, proposals to address the state's long-term fiscal problems were offered by groups in both chambers.

Of the structural proposals advanced by the governor, the most contentious pieces included:

- *Reinstatement of "good time credits" to reduce the prison population and close facilities.* The proposal called for amending the truth-in-sentencing laws to allow prisoners to reduce the amount of time incarcerated in a secure

³ "The FY2011 Executive Budget: Déjà vu All Over Again," State Budget Notes 2010-01, February 2010. www.crcmich.org

facility while remaining under state supervision through other means. The changes would have permitted the closure of four to five secured correctional facilities and net budgetary savings of \$129 million to the General Fund.

- *Adoption of a new physician tax.* The state would implement a three percent assessment on gross revenues from all physician services (Quality Assurance Assessment Program - QAAP) to generate \$300 million in new revenue. The QAAP would be modeled after similar taxes currently applied to hospitals and nursing homes. The additional state revenue would allow the state to draw down additional federal dollars while simultaneously allowing higher Medicaid physician reimbursement rates and generating General Fund savings of \$133 million.
- *Restructure state taxes to fund education.* The major components of the taxing change were the expansion of the sales tax base to a host of consumer services, a reduction in the sales tax rate from 6 to 5.5 percent, a two-year phase-out of the Michigan Business Tax surcharge, and a reduction in the Michigan Business Tax's gross receipts tax rate. Rejection meant that \$554 million in new School Aid Fund revenue would not be available in FY2011. In addition to the net revenue increase, the tax restructure would have increased the future growth of the SAF due to the expand-

ing service sector, a longer term issue.

A key General Fund assumption contained in the executive budget and adopted in both legislative proposals was the continuation of the enhanced Medicaid matching rate. The enhanced matching rate that was enacted as part of the Federal American Recovery and Reinvestment Act (ARRA) was due to expire on December 31, 2010. The governor's budget proposal assumed the enhanced rate would be extended through June of 2011, three quarters of FY2011.⁴ Inclusion of this item by all parties was premised on President Obama's federal budget proposal released in February. The final congressional product was completed in late summer and the amount of aid provided and the distribution to the states varied from the President's proposal. Because of this, the final state budget had to be adjusted to reflect the reduced amount (discussed below).

May Revenue Revisions

The budget picture changed following the May revenue estimating conference. Better-than-expected revenue performance during the first part of the current fiscal year (FY2010), along with an improved economic fore-

⁴ The enhanced matching rate was in place for the entirety of FY2010 and effectively reduced General Fund expenditures in the Medicaid program by \$1.1 billion in total compared to what would have been the case without the federal stimulus legislation.

cast nationally and in Michigan, increased the revenue estimates for FY2011. The FY2011 General Fund revenue estimate was increased by \$128 million due to a stronger economic forecast (compared to January's forecast) and estimates for FY2011 School Aid Fund revenue were increased by \$352 million.

The improvement in the School Aid Fund, combined with minor reductions to required spending to maintain current levels, completely eliminated the projected FY2011 shortfall in the executive SAF budget (\$410 million). Perhaps, most significantly, the improved revenue picture terminated any further discussion regarding the governor's proposed tax restructuring plan to help balance the education budget. Moreover, in late summer, the U.S. Congress approved a new education funding bill to provide states with \$10 billion in the current school year to save or create education-related jobs. Michigan stands to receive \$316 million to be used in the FY2011 SAF budget for distribution to local schools. This new, temporary federal aid diverted legislative attention away from the long-term revenue issues facing Michigan education finances.

Unlike the School Aid Fund budget, the revised General Fund revenue estimates only marginally reduced the projected budget gap, from slightly over \$1 billion to just under \$1 billion. Final legislative agreement on a budget solution would not come until early September.

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Table 1
General Fund Appropriations: FY2010 and FY2011
(Dollars in Millions)

	FY2010	FY2011	Change	
			Amount	Percent
Agriculture	\$ 29.8	\$ 30.3	\$ 0.5	1.7%
Attorney General	28.6	28.6	-	0.0%
Civil Rights	11.6	11.0	(0.6)	-5.2%
Community Colleges*	299.4	295.9	(3.5)	-1.2%
Community Health	2,179.0	2,421.5	242.5	11.1%
Corrections	1,919.7	1,917.9	(1.8)	-0.1%
Education	19.9	21.9	2.0	10.1%
Energy, Labor & Economic Growth	54.6	47.6	(7.0)	-12.8%
Executive Office	4.8	4.6	(0.2)	-4.2%
Higher Education	1,460.2	1,543.4	83.2	5.7%
Human Services	896.9	924.0	27.1	3.0%
Judiciary	153.1	152.1	(1.0)	-0.7%
Legislature	117.1	111.8	(5.3)	-4.5%
Military & Veteran Affairs	36.2	36.4	0.2	0.6%
Natural Resources & Environment	44.1	41.3	(2.8)	-6.3%
School Aid	30.2	27.8	(2.4)	-7.9%
State	18.1	13.9	(4.2)	-23.2%
State Police	268.1	260.4	(7.7)	-2.9%
Technology, Management and Budget	293.1	299.8	6.7	2.3%
Treasury	131.2	120.9	(10.3)	-7.9%
undesignated pension savings	_____	<u>(80.0)</u>		
Total	\$7,995.7	\$8,231.1	235.4	2.9%

* FY2010 Community College appropriation adjusted to exclude the one-time \$208 million appropriation financed by School Aid Fund.

Source: Senate Fiscal Agency, appropriation report as of October 12, 2010.

Summary of Enacted Budget

The enacted FY2011 General Fund appropriations total \$8.2 billion, about \$235 million or 2.9 percent higher than the projected FY2010 adjusted spending (disregarding the one-time funding shift in the community colleges budget) (See **Table 1**). The final level of spending also exceeds that proposed by the governor in

her budget by \$300 million, due in large part to the rejected corrections spending reductions.

On the revenue side of the budget, ongoing resources total just over \$8.0 billion for FY2011, which is \$458 million or about 6.1 percent higher than projected FY2010 revenues, before one-time budgetary adjustments.

Governor's Proposal Versus Final Legislative Product

By early September, the major components of a final budget agreement between legislative leaders and the governor had taken shape. Some of the pieces originally recommended by the governor were incorporated into the final consensus agreement on

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the budget, but other major pieces either were rejected during the appropriations process or made moot by federal action. While both chambers of the legislature agreed with the governor's assumption regarding a continuation of the enhanced Medicaid funding through June 2011, the final version of the extension reduced the aggregate amount available to the states and modified the distribution formulae. The practical effect of the federal changes was to reduce Michigan's share by almost \$200 million from what was assumed by all parties within state government in the development of the General Fund budget. Additionally, the legislature did not accept the governor's proposals relating

to reforms in the Department of Corrections (\$129 million projected net savings) or the new physician tax (\$133 million projected revenues), which meant that the legislature had to identify alternatives. Finally, the legislature modified the state employee pension reforms recommended by the governor, reducing the projected FY2011 savings from \$98 million to \$80 million.

Based on 1) the enhanced federal Medicaid funding, 2) modifications to state employee pension reforms, and 3) the components of the executive budget agreed to by the legislature, the projected FY2011 budget gap was reduced from just under \$1 billion to

slightly less than \$500 million. Consensus on solutions to address this reduced shortfall consisted of state tax policy changes and departmental appropriation reductions beyond those proposed by the governor. The final solution also relied on debt refinancing to lower FY2011 debt service payments and on advancing the collection of unclaimed property.

As passed by the legislature, the General Fund budget spends marginally more than the budget proposal of the governor, largely because of the reduction in temporary Medicaid funding (\$200 million) originally assumed by the governor and legislature's rejection of the proposed sentencing reforms and the new tax on phy-

Table 2
FY2011 General Fund Budget Gap and Measures
(Dollars in Millions)

	<u>Executive Budget</u>	<u>Enacted Budget</u>
Projected On-going Revenues	\$7,829	\$8,012
Projected Baseline Spending	\$8,916	\$8,916
Gap	\$(1,087)	\$ (904)
Measures to Close Gap		
Corrections "truth-in-sentencing" reforms	\$129	\$ -
State employee pension reforms	98	80
Other spending cuts	206	179
Debt refinancing		77
Total spending reductions	433	336
Additional federal funding	514	320
Physician QAAP	133	-
Tax policy changes/Tax amnesty	12	62
Unclaimed property reforms		166
Liquor reforms		9
Misc. transfers to General Fund		11

sician services (which collectively would have reduced General Fund spending by \$262 million). Perhaps most important from a longer-term perspective, the final budget makes less progress in closing the state's structural deficit than the executive budget would have accomplished.

Table 2 summarizes the FY2011 proposed solutions to closing the gap between spending needs and revenues compared with the methods used in the final enacted budget.

Because of the structuring of a number of the spending and revenue items included in the final budget agreement, many of the items are one-time in nature and designed to address the FY2011 budget problem and nothing further. As such, the fundamental imbalance between ongoing revenues and required spending in the General Fund are not ad-

dressed in the recently-approved budget.

**Anatomy of Budget
"Balance" for FY2011**

With projected ongoing revenues of \$8.012 billion and appropriations totaling \$8.258 billion, the "structural" gap between base revenues and spending is \$246 million in FY2011. However, the total General Fund appropriation level is understated by at least \$600 million because of the availability and use of one-time federal money that otherwise would be the responsibility of the General Fund. Furthermore, a number of nonrecurring state revenue changes including a tax amnesty program and accelerated collections of unclaimed property to provide \$250 million to support the approved General Fund spending level. Thus, while on paper the FY2011 General Fund is "balanced", a structural gap of at least \$850 million exists and is

unattended in the final budget adopted by the legislature (See **Table 3**). This gap will have to be addressed in FY2012 in addition to accommodating the spending pressures of the out-year effects of the one-time budget solutions used in FY2011.

**Nearly \$1 Billion in
Nonrecurring Sources**

The single largest item contributing to the structural imbalance in the General Fund budget is the use of temporary or one-time federal funding. The FY2009, FY2010, and FY2011 budgets have benefited from 33 months worth of enhanced matching funds in the Medicaid program that will be exhausted effective June 2011. For the next fiscal year, this amounts to a \$460 million hole. Added to this total is a one-time, Michigan-specific adjustment in the federal match rate related to a previous year miscalculation. This item reduces General Fund spending by \$160 million in FY2011, but it must

**Table 3
Use of One-time Resources in the FY2011 General Fund Budget
(Dollars in Millions)**

Temporary Funding Shifts to Offset General Fund Spending	
Enhanced Medicaid Match from Federal Stimulus	\$460
One-time Medicaid Match Increase	160
Accelerate Receipt of State Revenues	
2011 Tax Amnesty Program	63
Unclaimed Property Changes	166
Temporary Reductions in State Spending	
General Obligation Debt Short-term Refinancing	77
Other	
Liquor Industry Changes	9
Misc. Transfers to General Fund	<u>11</u>
Total	\$945

be restored in the next fiscal period. While the \$620 million in enhanced federal assistance is welcome, its prolonged use postpones a portion of needed permanent solutions to future budgets.

To a lesser extent but still significant, the FY2011 budget relies on changes that will increase current-year state revenues at the expense of future collections. Such solutions, while addressing the budget needs, create future cash flow problems for the state. Specifically, modifications to the treatment of unclaimed property have been enacted to both increase the number of collection periods, from one to two, and reduce the "dormancy period" (i.e., time after which property is transferred to the State of Michigan) effective for FY2011. Collectively, it is projected that the statutory changes will net the state General Fund \$168 million in FY2011 and \$61 million in FY2012, above what would have occurred under the previous process. Pulling future revenue forward to address the current budget shortfall creates problems beginning in FY2012, when there will be \$100 million less in revenue. Current estimates of the enacted legislative changes to the escheats programs suggest that the net revenue gains will be exhausted in FY2013. From FY2013 to FY2015 General Fund revenues will be reduced because the value of the claims made by individuals and firms to unclaimed property is expected to exceed the balances held by the state in each year to satisfy the claims, creating a drain on the General Fund.

Similarly, the state will implement a 45-day tax amnesty program in spring 2011, akin to one used in 1986, designed to incent delinquent taxpayers to pay their liabilities without penalty. The budgetary effect of such a program is to accelerate collections and to get some individuals and firms that might not otherwise settle with the state to honor their delinquent tax bill. Accelerating collections is expected to net the General Fund \$62 million for FY2011, but by doing so it will reduce FY2012 collections. Again, a portion of the budget gap is addressed at the expense of the state's ability to meet future cash flow needs. It appears the amnesty program was developed with the primary intention to address the current budget problem, as opposed to a well-defined tax policy objective.

In addition to the various nonrecurring resources used to achieve balance in FY2011, the final budget assumes general obligation debt refinancing to reduce projected General Fund and School Aid Fund spending in FY2011 only. The total savings for the fiscal year are \$119.7 million (\$77 million accruing to the General Fund and the remainder to the School Aid Fund). This generates immediate net savings in projected debt financing costs in FY2011, but over the five-year life of the refinancing proposal it will cost the state an additional \$14 million in interest payments. Furthermore, because of the relatively short time period for refunding (presumably to take advantage of the lowest possible interest rates) and the repayment

schedule, the total annual debt service obligation increases from \$60 million in FY2011 to \$222 million in FY2012, an increase of \$162 million. A "balloon" payment of this magnitude is likely to require further debt refinancing, perhaps at much less favorable rates, in the future.

What's Wrong with Using One-Timers?

A case can be made for the limited use of one-time actions to achieve budget balance. These resources can be prudent fiscal tools for riding out the short-term revenue fluctuations that accompany an economic contraction. One-timers also can be warranted when paired with structural reforms designed to better align ongoing spending and revenues. Unfortunately, the FY2011 budget is not premised, to any great extent, on either of these uses. Instead, they have been employed because of their political expediency.

The FY2011 fiscal plan does not represent the first time that Michigan budget writers have relied so heavily on nonrecurring sources to support ongoing state government expenses. The FY2007 General and School Aid Fund budgets were largely balanced with the use of nearly \$1 billion in nonrecurring resources.⁵ Thus, the FY2011 budget represents more of the same as opposed to a singular occurrence. Over the years,

⁵ "State Budget "Balance" Achieved with \$1 Billion in Additional Non-recurring Resources," State Budget Notes 2007-01, June 2007. www.crcmich.org

Michigan budget writers have employed various methods to achieve budget "balance" in the short-term, including delaying payments, borrowing, use of restricted funds to support General Fund appropriations, and advancing state revenue collections. Because the state constitution requires only that the budget be balanced and the state uses a one-year budget, policymakers can take a myopic view of the state's future finances.

From a fiscal management perspective, there are a number of problems associated with a continued, heavy dependence on nonrecurring budget actions. The biggest problem is that these resources, once exhausted, cannot be used again. By their very definition these budgetary resources only can be used once, despite the fact that the services are ongoing and must be funded in the next fiscal period. A corollary here is the fact that such solutions often create funding "cliffs" when moving from one fiscal period to the next.

Over a longer period, use of these resources perpetuate and add to existing structural deficits. Structural deficits are defined by an imbalance between ongoing resources and revenues.

In those states and localities that use multi-year budgeting, it is very difficult to utilize one-time resources for a prolonged period or to any great extent. Faced with strict balanced budget requirements, the use of nonrecurring resources makes keeping both years of a multi-year budget in balance very challenging. While Michigan state government uses a formal process to forecast future revenues, it does not engage in multi-year budgeting or provide projections of future spending requirements. Doing so might mitigate the degree to which nonrecurring revenues are employed to balance the budget.

Another important issue involves intergenerational equity. The use of one-time resources to finance current services benefits taxpayers today at the direct expense of future taxpayers. This occurs

because financial resources amassed in prior years, or alternatively, resources that will be collected in future years, are used to support spending on services received by today's taxpayers. In short, today's taxpayers enjoy a "free ride" and future taxpayers must forgo the opportunity to use the resources for services that would benefit them. Another way that future generations can be negatively impacted by the use of one-time budget fixes is by being saddled with higher costs in the future, such as increased debt service associated with borrowing for current operations.

The \$1 billion in nonrecurring resources identified above represents about 11 percent of the total planned General Fund spending. Such heavy reliance on nonrecurring solutions to piece together a "balanced" budget will make the task of achieving a fiscally sound budget very difficult for the new governor and legislature without enacting significant spending reductions or increasing revenues.

Fiscal Year 2012 Budget Outlook

While an official picture of the FY2012 budget will not come until the January 2011 revenue estimating conference, projections can be made based on the decisions made to balance the FY2011 budget and on assumptions about revenue growth. Combining these factors, and before considering pressures for increased spending, the FY2012 budget development process starts with a deficit of at least \$1 billion.

In recognition of the bottoming out of the national and state economies, net General Fund revenues are projected to grow 6.6 percent in FY2011, after declining by 21 percent in FY2009 and by 10 percent in FY2010. Despite the change in course, a slow, drawn out recovery from the recent recession will constrain revenue growth going forward. Based on such an economic scenario and

assuming an increase of 5 percent or \$400 million, ongoing General Fund revenues will total \$8.4 billion in FY2012, less than half of the amount needed to address the projected budget shortfall. Overall, the assumed \$400 million in revenue growth is completely offset by the current tax law changes on the books and the second-year impacts of the FY2011 budget solutions, most notably:

Table 4
FY2012 General Fund Scenario
(Dollars in Millions)

Revenues	
FY2011 Ongoing Revenue	\$8,012
5 Percent Growth	401
Income Tax Rate Reduction	(150)
Other Tax Policy Changes	(58)
Effects of FY2011 Tax Amnesty Program	(109)
Effects of Unclaimed Property Changes	<u>(107)</u>
Net Available Revenue	\$7,989
Expenditures	
FY2011 Appropriations	\$8,231
Non-Revenue GF Considerations	
GF Replacement for Enhanced Medicaid Matching Rate	\$ 460
GF Replacement for One-time Federal Medicaid Funds	160
General Obligation Debt Service Increase	162
Early Retirement Program	<u>15</u>
Projected Expenditures (before spending pressures)	\$9,028
Gap	\$ (1,039)

- The personal income tax rate was increased from 3.9 percent to 4.35 percent on October 1, 2007, and a phased-in reduction of the increase begins on October 1, 2011. The first 0.1 percentage point reduction in the individual income tax rate will reduce revenues by \$150 million.
- Other scheduled tax policy changes, including changes involving the Michigan Business Tax, will reduce net revenue to the General Fund by \$58 million.
- The 2011 tax amnesty program, because it pulls forward into FY2011 revenue that otherwise would be collected in

FY2012, results in a net \$109 million loss to the budget.

- Changes made to the treatment of unclaimed property provide an additional \$61 million in FY2012; however, this is down from the \$166 million received in FY2011 and results in a net \$107 million reduction year-over-year.

Even with an expanding economy, the General Fund budget will be extremely tight in FY2012. **Table 4** presents a scenario based on the assumed growth in ongoing revenues and other factors described above. Adding to the revenue challenges will be the requirement to back fill the lost

temporary federal resources with state funds. While the reduction from four quarters (FY2010) to three quarters (FY2011) of enhanced Medicaid matching funds provides some transition for state budget writers, it is not sufficient to avoid the inevitable “cliff” associated with the receipt of these resources. Furthermore, the decision to refinance state general obligation debt to effect substantial one-year savings will cause a balloon in the debt service payments effective FY2012.

Adding to known aspects confronting the FY2012 budget will be the built-in spending pressures (i.e., caseloads) that come with various human service and health

care programs funded through the state budget. Also, employee compensation and health care increases will further stress the budget for the next fiscal year.

FY2011 was the last year of the three-year contracts between the State of Michigan and various employee unions and the upcoming contract negotiations will de-

termine the amount of pressure on the budget resulting from salary and fringe benefits.

Conclusion

While the enacted FY2011 General Fund budget is technically “in balance” — projected revenues exceed planned spending — the legislature’s recent actions do little to solve the state’s long-term fiscal problems. In fact, a number of the legislature’s solutions will exacerbate the immediate budget problems. Specifically, the heavy use of one-time revenues and actions to permit greater spending levels effectively delays today’s problems, making the FY2012 budget problems even worse. Furthermore, and perhaps most troubling, very little progress was made to address the state’s near decade-long structural budget deficit through the FY2011 budget.

The FY2011 General and School Aid Fund budgets represented another opportunity for policymakers to tackle a critical problem in the state’s finances: the long-term mismatch between ongoing revenue and spending. While aspects of structural reform, most notably employee pension reforms, have been adopted and reflected in the budget, other previously recommended pieces (e.g., corrections reforms, tax revenue modernization, permanent spending reductions, changes to employee compensation) were left on the “cutting floor” as the FY2011 budget was pieced together.

Michigan will continue to experience structural pressures in its budget for many years. A revenue base that grows slower than the economy, coupled with spending responsibilities concentrated in areas growing at rates faster than the economy, notably health care, is a recipe for persistent budget problems. Until policymakers embrace the inevitable conclusion that a fundamental mismatch exists, structural budget balance will remain elusive. In the broadest terms, actions must be taken to align the growth rates of both spending pressures and state revenues with the Michigan economy.