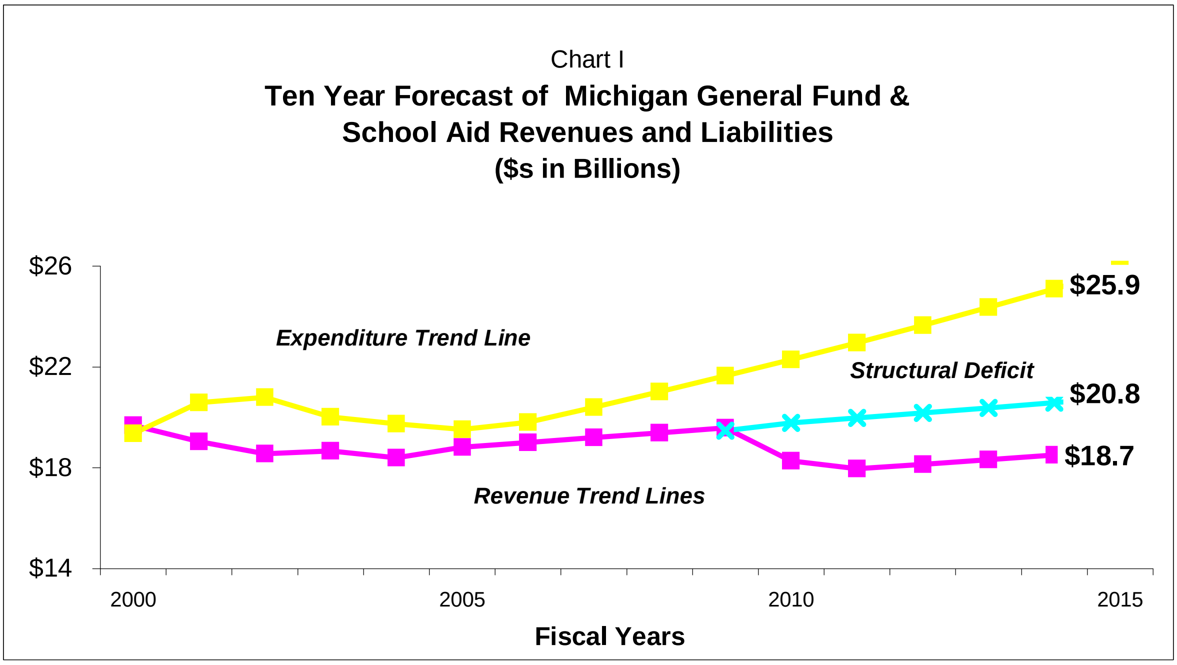
Michigan League for Human Services

Revised May 2005

Michigan s' Ongoing Fiscal Crisis

After Five Consecutive Years of Mounting Deficits, A Long Range Forecast Indicates Shortfalls Will Continue and Potentially Worsen

After incurring $7.8 billion in deficits over the last five years, resulting in the exhaustion of Michigan s' fiscal reserves and $3 billion in program reductions, a new long-term fiscal forecast indicates the state will likely incur an additional $5 billion in deficits over the next decade. As the following chart illustrates, this alarming structural deficit becomes significantly larger if revenues related to the Single Business Tax are permitted to sunset as scheduled in 2009.



Note: The spread between projected state expenditures and revenues reflected above equates to $800 million in FY2006 and is projected to increase by an additional $400 million per year through FY2015. While these "structural deficits" would have to be addressed as they materialize, it is anticipated that they would re-emerge annually, driven primarily by near double digit increases in state funded health care costs.

-o- The expenditure trend line assumes inflation adjusted average annual growth of 3 percent driven primarily by rising health care costs and projected increases in Michigan s' prison population.

-n- The revenue trend line assumes inflation adjusted average annual revenue growth of 1 percent beginning in FY2006. This growth reflects a return to more typical historic trends subsequent to estimated real declines of 1.3 percent in FY2004 and 2 percent in FY2005 per the January Consensus Revenue Conference. Beginning in 2010, however, the revenue trend line declines precipitously, resulting in the loss of approximately $2 billion related to the repeal of the Single Business Tax per existing law.

-Ú- An alternative revenue trend line assumes action is taken to reform or replace the SBT in a manner that preserves current tax receipts as assumed in the administration s' restructuring proposal.

Prepared by the Michigan League for Human Services

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Consistent with the League's long-term projection, the January Consensus Revenue Estimating Conference identified forecast shortfalls of approximately $400 million in the current year and $800 million for FY2006, marking the sixth consecutive year that state spending is expected to exceed available revenues. As illustrated by Chart I on the previous page, these structural deficits appear likely to continue to materialize for years to come despite the reduction of state program spending by over 10 percent since 2001.

On the revenue side of the ledger, the League's forecast assumes state receipts rebound from estimated real declines of 1.3 percent in FY2004 and 2 percent in FY2005 per the January Consensus Revenue Forecast, and grow by an inflation adjusted annual rate of 1 percent over the ten year forecast horizon.

Expenditures, driven by a continuation of near double digit health care costs for public employees, retirees and Medicaid beneficiaries, together with an expected 3 percent annual increase in Michigan's prison population, are forecast to increase by 3 percent annually when adjusted for inflation. The resulting 2 percent spread between projected real revenues and expenditures would result in an estimated average annual deficit of approximately $400 million over the balance of the ten year forecast period.

While this projected shortfall may seem manageable compared to the $1.5 billion in average annual deficits incurred since FY 2001, it will likely not materialize in such manageable installments. Even if periods of strong economic growth over the forecast period result in smaller deficits, or produce surpluses permitting a deposit of up to $250 million in the Budget Stabilization Fund (the BSF balance at which the Single Business Tax phase-out would be triggered, resulting in a 5 percent reduction in business taxes worth approximately $100 million), the onset of an economic downturn would quickly exhaust any accumulated reserves. In the downturn of 2001, for example, had state revenues not been reduced by the ongoing implementation of multi-year Personal Income, Single Business and Federal Estate tax reductions, the League estimates that $1.9 billion of the $7.8 billion in deficits recognized over this period would still have materialized.

The Impact of Recent Multi-year Tax Cuts on State Revenues and the Actions Taken to Address Recognized Deficits

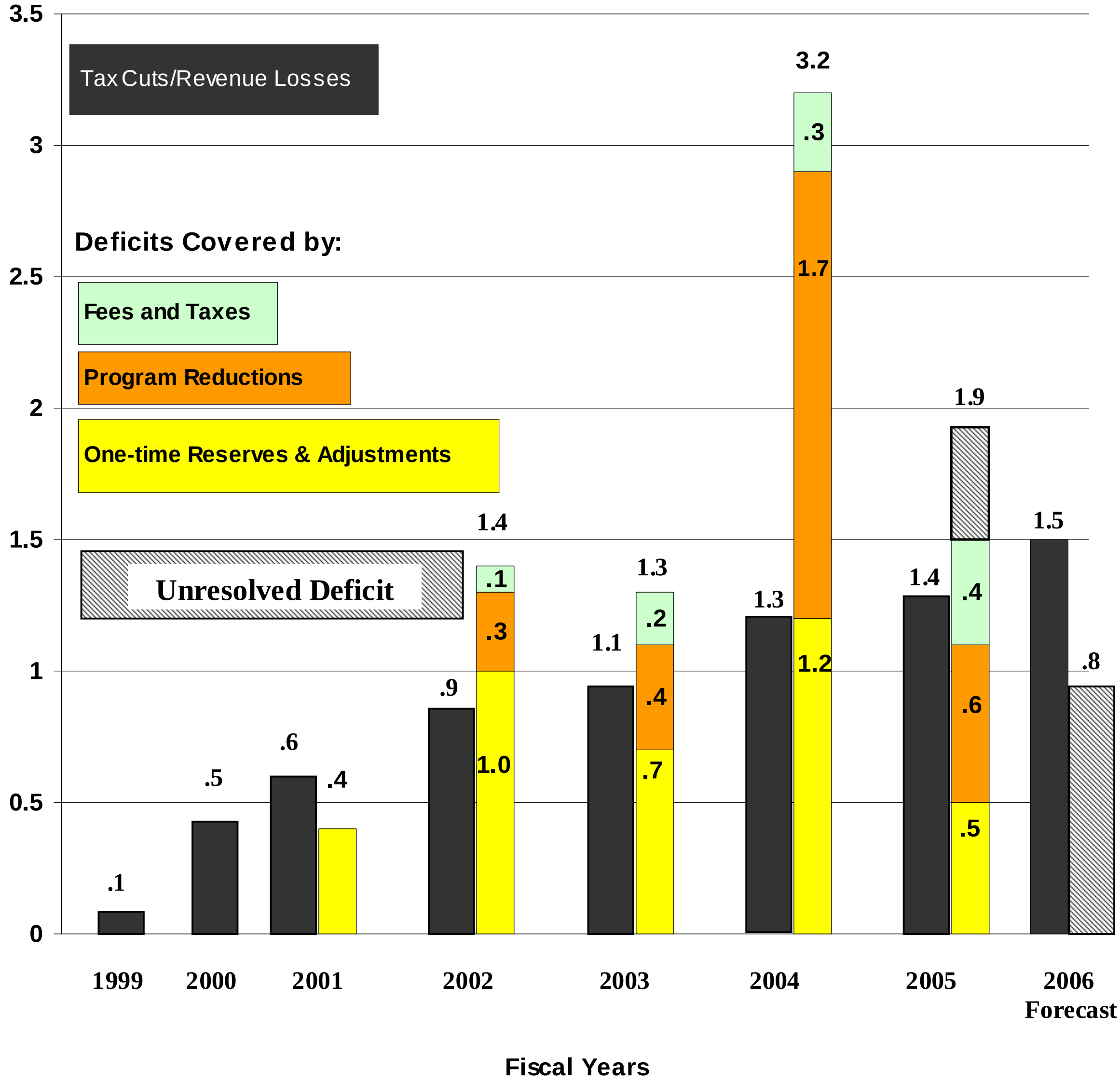
Charts II and III on the following pages detail state general fund revenue losses associated with multi-year tax reductions beginning in FY1999, actual and projected general fund deficits from FY2001 through FY2006, and the actions taken to date to address those deficits. As a weakening economy and multi-year tax reductions combined to produce structural deficits beginning in FY2001, the state initially relied on fiscal reserves to minimize the need for program reductions and/or revenue enhancements. By FY2005, however, rapidly rising deficits and dwindling reserves resulted in cumulative program reductions equivalent to approximately 10.4 percent of baseline state costs.

As Chart III illustrates, there is a strong correlation between the loss of revenues associated with multi-year reductions in Michigan's Personal Income, Single Business and Federal Estate taxes, and the cumulative value of the state's deficits over this period. While the economic downturn and subsequent jobless recovery exacerbated the problem, revenue reductions associated with these multi-year tax cuts equate to over 75 percent ($5.9 billion) of the combined $7.8 billion General Fund and School Aid deficits incurred or projected through FY2005.

Chart II

Revenue Reductions Associated With Multi-year Tax Cuts Compared to Michigan's Annual Deficits

$s in Billions



Note: The columns in black reflect the loss of state revenues associated with annual tax policy changes. The second set of columns reflect the total state deficit in billions of $s and the actions taken (reserve withdrawls, program reductions and tax and fee increases) to address the identified deficits. No specific solutions are assumed relative to projected FY2006 deficits.

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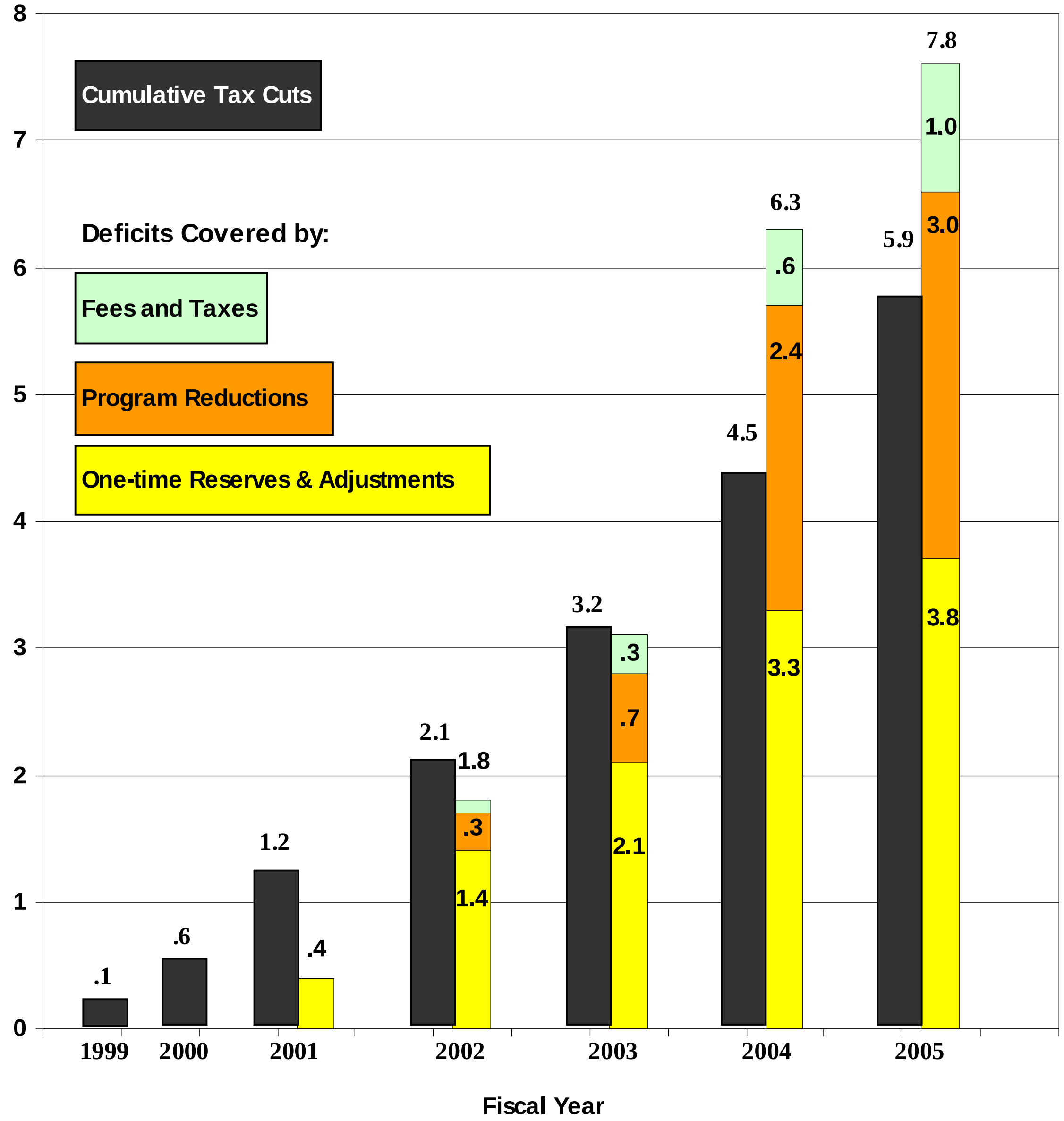
Chart III

Michigan's Cumulative Multi-year Tax Cuts Compared to Cumulative State Funds Deficits

$s in Billions



Note: The columns in black reflect cumulative loss of state revenues associated with tax policy changes for FY 1999 through projected FY 2005. The second set of columns reflect cumulative state deficits beginning in FY 2002 and the actions instituted (reserve withdrawls, program reductions and tax and fee increases) to address these deficits.

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Michigan's Fiscal Outlook

Given the depletion of over $3.8 billion in fiscal reserves and one-time accounting adjustments since FY2001, coupled with the likelihood that these fiscal reserves will not be restored in preparation for the next economic downturn, the projected $400 million average annual deficit reflected in Chart I would likely translate into periodic multi-billion dollar budget deficits, the impact of which could greatly exceed that of the most recent downturn.

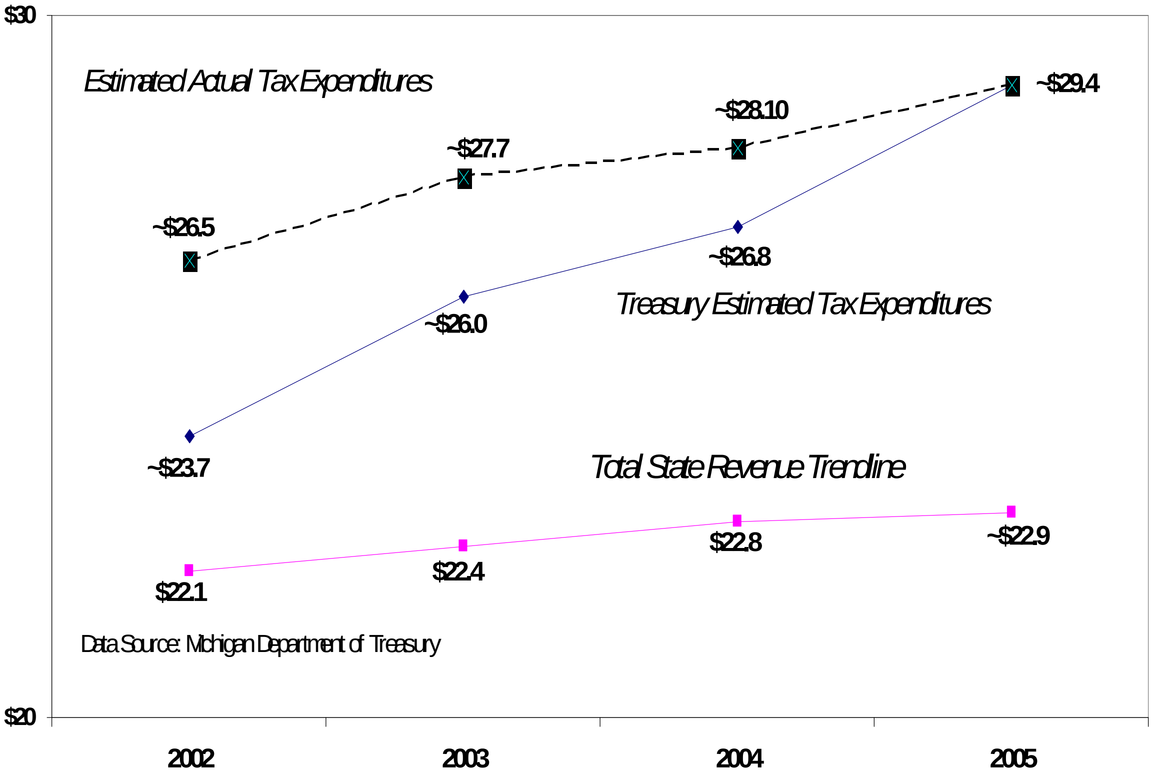
Despite the magnitude and intractability of the fiscal problems outlined above, Michigan's fiscal circumstances could get significantly worse. The projected $400 million average annual deficit assumes state revenues remain relatively stable and actually grow over time to cover a portion of expected cost increases. As the lower revenue trend-line on Chart I illustrates, however, approximately $2.0 billion in revenues, equivalent to roughly 10 percent of total state revenues and 25 percent of the remaining General Fund, are associated with the Single Business Tax, which is currently scheduled to sunset at the end of calendar year 2009. Given this looming deadline, if the administration's recent SBT reform proposal or a revenue neutral alternative is not adopted, existing state revenues could decline dramatically.

Another significant challenge to the stability of state revenues is reflected in the Michigan Tax Expenditure and Revenue Trends chart on page 6. Tax expenditures are those credits, disregards, deductions and exemptions added to the tax code in an effort to, for example, help families afford child care, help seniors on fixed incomes maintain a reasonable standard of living and help Michigan businesses remain competitive. While many of these decisions to forego tax revenues have significant merit, in the face of dramatic deficits and program reductions, a review of tax expenditures should arguably be included in the list of options available to decision makers as they struggle to resolve the state's fiscal crisis. It is noteworthy that the Michigan Department of Treasury states in its annual tax expenditure report that "…tax expenditures are very similar to direct appropriations." "…Annual review of tax expenditures would encourage policymakers to rank all policy goals before deciding which should be funded, by how much, and by what means." Currently, there is no annual review of tax expenditures, and no direct link between House Tax Policy and Senate Finance Committee decisions regarding tax expenditures and the various Appropriations Subcommittees working to adopt budgets based on an assumed level of revenue.

As Chart IV on the next page illustrates, tax expenditures have grown significantly since FY2002, a period during which the state struggled to address $7.8 billion in budget shortfalls, and now represent over 60 percent of total potential state revenues. If the upward trend in tax expenditures continues, the one percent real revenue growth assumed in the League's ten year forecast of state revenues and liabilities could be difficult to realize, resulting in correspondingly larger deficits.

Chart IV also indicates that state revenues over this period remained virtually unchanged, declining in real (inflation adjusted) terms by approximately 7 percent since 2002 to their lowest value since 1970, a point in time when the state was providing services for 1.3 million (approximately 15 percent) fewer citizens.

Chart IV
Michigan Tax Expenditure & Revenue Trends
(Actual $s in Billions)



Note: In the introduction of its annual report, the Michigan Department of Treasury notes that "tax expenditures are very similar to direct appropriations."..."Annual review of tax expenditures would encourage policymakers to rank all policy goals before deciding which should be funded, by how much, and by what means."

The Executive Summary of the annual tax expenditure report issued by Treasury cautions that "comparisons between the estimates for consumption tax expenditures contained in this report and those in prior (years) are not valid due to a change in the methodology used to calculate tax expenditures related to services." Of the $5.7 billion in increased tax expenditures reflected in this report from 2002 to 2005, $4 billion falls into the services category referenced in the Department of Treasury's caution. Assuming that the value of non-taxed services over this three-year period grew by 5 percent annually, it is estimated that approximately 50 percent of the $5.7 billion in increased tax expenditures relates to methodology changes and 50 percent relates to tax policy changes, inflation, and other income and consumption trends. (The dotted line reflects the resulting estimated actual tax expenditures.) Regardless of methodology changes, however, Treasury indicates that $29.4 billion, which represents over 55 percent of potential state revenues, is their current best estimate of total tax expenditures.

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Difficult Choices Ahead

In early 1999, just prior to enactment of multi-year tax reductions, the Department of Management and Budget indicated that approximately $6.82 billion in state revenues supported discretionary state spending. Taking into consideration subsequent program reductions, and assuming K-12 School Aid revenue is held harmless, the League estimates that discretionary state spending will fall below $5 billion in 2005. This implies, even if action is taken to retain or replace $2 billion in current Single Business Tax revenues, Michigan would be forced to eliminate all remaining discretionary spending over the next 10 years in order to address forecast structural deficits. Resulting reductions would include elimination of the remaining $1.86 billion in state support for higher education and the $444 million in discretionary revenue sharing payments to local units of government.

In addition, assuming that secondary education is protected from funding reductions, all other departments would have to absorb program cuts averaging 38 percent. Given the 10.4 percent in program reductions instituted since FY2002, and the significant growth expected in Medicaid and Corrections over the next decade, such reductions appear unrealistic.

Conclusion

The above analysis suggests that without additional revenues the state will likely have to make significant program reductions on an annual basis for years to come. If decision-makers fail to implement fiscal policies designed to resolve the existing structural problem and replenish the exhausted Budget Stabilization Fund, the next economic downturn will likely force the state to both raise revenues and cut remaining programming significantly, precisely the reverse of the stimulative economic policies typically pursued to mitigate the impact of a recession. As a consequence, the loss of public and private sector jobs, and of matching federal funds, could further reduce state revenues and delay Michigan's economic recovery.