Michigan League FOR Human Services

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Clock Is Ticking to Resolve Budget Deficits:

It's Time for a Long-Term Solution

Once again, Michigan finds itself with less than a month left in the fiscal year and no budget in place for the next fiscal year which begins Oct. 1. The last time this happened, in 2007, state government was shut down for four hours before a budget agreement was reached between Gov. Jennifer Granholm and the Legislature. In 2007, state policymakers were wrestling with a $1.7 billion budget deficit. This time, they are faced with a deficit that almost reaches $3 billion for fiscal year 2010.

While state leaders have huddled behind closed doors to negotiate on the budget throughout the summer, state revenues have continued to drop. Revenues are down $150 million since the May Revenue Estimating Conference. According to the Senate Fiscal Agency, July revenues are 10.4 percent less than July 2008 revenues and the amount of revenue collected in this fiscal year through July is 13 percent less than it was last year at this time. July marked the seventh time in the first nine months of this fiscal year that revenues have fallen 10 percent below the previous year's level.

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These revenue declines, together with shortfalls anticipated by the governor's original Executive Budget and $1.7 billion in additional revenue declines recognized at the May Revenue Estimating Conference, suggest that fiscal year 2010 General and School Aid revenues will be approximately $4 billion (20%) below the $21 billion anticipated for fiscal year 2010 as recently as 18 months ago.

Legislative action

Prior to the summer legislative recess, both chambers of the Legislature had taken action on almost all of Michigan's 17 department budgets, sending them to conference committee for final agreement. Unfortunately, those budgets contain some very deep and painful cuts, especially for low- and middle-income families and children in the state. These proposed cuts come on top of cuts that were enacted mid-year by the governor's Executive Order, in response to shrinking revenues.

The budgets passed by the Senate propose $1.3 billion in cuts. In the Department of Community Health budget, the Senate-passed version reduces General Fund spending for low-income households by 24.5 percent, about $500 million below the governor's revised budget recommendation and about $400 million below the DCH budget adopted by the House. Similarly, the

Department of Human Services budget passed by the Senate would reduce General Fund support by $330 million (29.4%). The cuts include reductions in cash assistance grants, the annual children's clothing allowance and child day care programs.

As the clock is ticking, it becomes increasingly difficult for the governor and the Legislature to pass meaningful, comprehensive tax reform to modernize the state's tax structure, as recommended by the League. Without this reform, state policymakers will likely again be reduced to a piecemeal approach to dealing with the looming budget crisis and deficit without addressing the state's structural deficit.

This is not a new problem. Fiscal year 2009 marks the ninth consecutive year that state revenues have not been adequate to fund state services and programs. Since the first decline in revenues in fiscal year 2001, Michigan has experienced cumulative deficits well in excess of $10 billion, has exhausted over $6 billion in fiscal reserves and has instituted over $4 billion in spending cuts.

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Over the years, in response to the ongoing deficit, the Legislature has cut the budget, raised the income tax temporarily and used other one-time measures. None of these represent an acceptable long-term solution. Spending cuts to public safety, health care, human services and education are being felt all across the state. Not only do spending cuts cripple services, but they are also bad for the economy, as they lead to further loss of jobs. Given the size of the current deficit and the implications, it is virtually impossible to address the deficit solely through cuts.

Unlike past years, there are federal stimulus dollars available to help plug holes in the state budget. Overall, the state will receive about $3.7 billion that can be used to balance the General Fund and School Aid budgets. Some of that money is being used to address the budget shortfall in this year's budget. According to the House Fiscal Agency, even if all of the remaining stimulus dollars are used in fiscal year 2010, the state would still have a $1.2 billion budget hole. Nevertheless, state policymakers should use stimulus dollars to provide essential services to those most affected by this recession, while recognizing this is another one-time fix.

How did we get here?

Senate Fiscal Agency Director Gary Olson recently pointed out that Michigan citizens are paying a smaller part of their personal income to fund government. According to Olson, in 2000, citizens paid about 9.49 cents of $1 of personal income to state government. Today that amount has shrunk to 7.3 cents, a 23 percent decrease. State revenues would now be $7.5 billion higher if the state's tax burden were the same as it was in 2000.

Michigan's state tax burden has fallen over the last decade because of decisions made by state policymakers over that time. Tax credits and exemptions (reducing what individuals and businesses pay in taxes) have climbed dramatically as state revenues have plummeted. The state's income tax, which was 4.4 percent in 1999, was reduced to 3.9 percent in 2003. Although it was raised to 4.35 percent in 2007, the increase is only temporary and does nothing to solve the long-term revenue problem. The Single Business Tax rate was also cut, from 2.35 percent to 1.95 percent in 2001 and was replaced by the Michigan Business Tax in 2007. All of these policy decisions have contributed to a dramatically shrinking revenue base for the state.

Furthermore, Michigan policymakers have failed to modernize the state's antiquated tax structure, which has not changed as the economy has changed. The sales tax is one example. Michigan residents are buying fewer goods, which are taxed, and more services, which are for the most part not taxed in this state. In fact, Michigan taxes only 26 services out of a possible 168 services identified by the Federation of Tax Administrators. The current tax structure has a particularly adverse affect on the School Aid Fund, which has relied heavily on sales tax revenues since the passage of Proposal A in 1994.

In 2007, as the governor and Legislature made last-minute decisions to resolve the fiscal year 2008 budget, a proposal extending the sales tax to some services was passed. However, it was quickly repealed after pressure from affected special interests.

The state is long overdue in extending the sales tax to some services. Doing so has great potential for stabilizing and ultimately expanding state revenues long-term.

Michigan's flat income tax structure is another example of a tax in need of modernization. Currently the state taxes all personal income at a rate of 4.35 percent. However, this rate is scheduled to be reduced in October 2011 and each year after until it returns to 3.9 percent on Oct. 1, 2015. Under its flat tax system, the state has not been capturing the growth in income that has been occurring among the state's higher-income taxpayers.

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Michigan is one of only seven states that have a flat tax. Thirty-four states, the District of Columbia and the federal government all have graduated income tax structures. Under a graduated system, those with higher levels of personal income are in a higher tax bracket and are taxed at a higher rate and those with lower incomes pay a lower rate.

One of the benefits of a graduated income tax system is that revenue growth occurs at a higher rate as income growth has been concentrated among groups earning higher incomes. This creates a more stable and adequate source of revenue for the state, helping to address the structural deficit.

A more modern state tax structure should also include a process to evaluate tax expenditures. These expenditures, which are also known as loopholes, credits, exemptions and tax giveaways, total over $35 billion annually. Broadly speaking, they reduce or eliminate taxes that would have been otherwise paid by businesses, individuals and other entities, thereby reducing revenues.

Like spending on specific programs, tax expenditures impact the state budget, but they do so in a more silent way. Although they reduce state revenues available for spending, there is no formal evaluation process in place to evaluate the effectiveness and public benefit of the expenditure. Generally speaking, tax expenditures continue on year after year without review.

As Michigan wrestles with declining state revenues and painful budget cuts, the Legislature should take action to require that every tax expenditure be reviewed by the appropriate appropriations committee as part of the budget process. Only then can there be some assurance that there is a benefit to the lost state revenue.

Conclusion

As time runs out, the temptation to balance the 2010 budget with deep cuts and one-time fixes surely increases. Not only does that add to the poor budget decisions that have already been made, but it also creates even greater problems for the following fiscal year—2011. Without structural changes to stabilize and expand the state revenue, with stimulus dollars drying up and with continued demand for essential services, the state will again be facing a budget crisis, perhaps of an even greater magnitude.