**Michigan League for Human Services**

April 18, 2007

# Michigan's Ongoing Fiscal Crisis: Falling Tax Rates Drive Ballooning Deficits

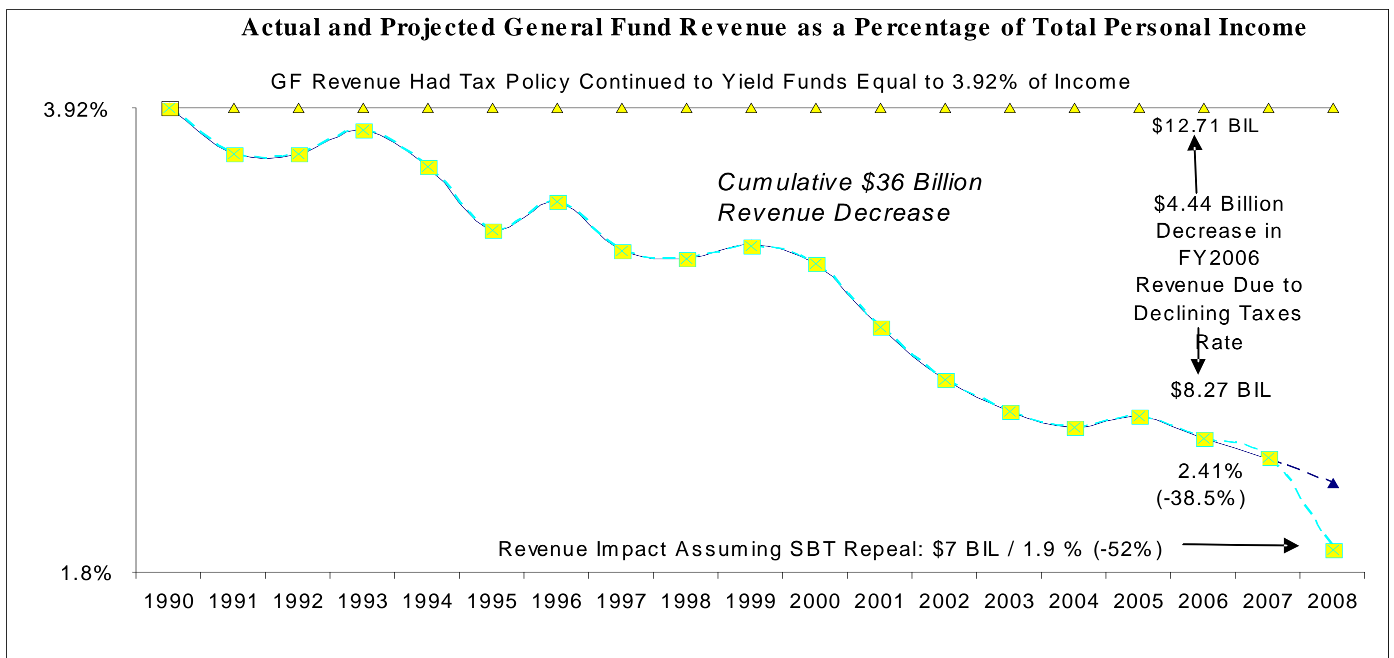
As lawmakers consider various options for addressing a dramatically worsening state fiscal outlook, a review of revenue trends reveals a clear link between tax policy decisions and ongoing state budget deficits.

The chart below illustrates that tax reductions, together with an antiquated tax structure, have permitted General Fund revenues as a share of personal income to decline by over 38 percent since 1990. The chart, which removes the impact of economic fluctuations, indicates that state General Fund revenues declined by a cumulative $36 billion over this period, including $4.4 billion in FY2006 alone, due to a reduction in taxes as a share of personal income from 3.92 percent to 2.41 percent.

These dramatic tax rate and revenue reductions suggest that the $9 billion in deficits addressed by the state since FY2001, and the recently acknowledged $900 million shortfall for FY2007, could have been avoided had revenue reduction policies been marginally less aggressive. Conversely, it suggests that the current budget crisis, and the $500 million in annual deficits forecast to materialize over the next decade, could be addressed with relatively modest increases in revenues as a share of personal income.

Unfortunately, the attention of state policymakers has been diverted by the scheduled elimination of the Single Business Tax by the end of 2007, with no consensus plan for its replacement. Consequently, as Michigan faces an imminent $2.1 billion deficit ($900 million in FY2007 and an additional $1.2 billion in FY2008), the legislature and the administration are considering proposals that, if adopted in isolation, would add approximately $400 million to out-year deficits.

As the chart below illustrates, failing to replace the Single Business Tax would reduce revenue as a share of personal income to less than half its value in 1990, resulting in an additional $1.2 billion deficit in FY2008 alone. Given the devastating impacts existing deficits could have on public health, public safety and the financial viability of state and local government, the SBT debate will hopefully be brief, allowing policymakers to turn their full attention to reversing revenue trends that otherwise will necessitate massive disinvestment in public services of all kinds.

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While the impact of declining tax rates on state revenues was mitigated by a rapidly growing economy during the 1990s, the decision by policymakers to implement additional multi-year personal income and Single Business Tax reductions in 1999, just as the economy began to slip into recession, quickly resulted in large structural deficits. As the following chart illustrates, from FY1999 through FY2006, total inflation adjusted School Aid and General Fund revenue declined by approximately 15 percent from $22.9 billion to $19.3 billion. The trend in inflation adjusted state program spending, while lagging behind the precipitous decline in revenues, fell by approximately 14 percent from a peak of $23 billion in FY2001 to $19.8 in FY2006.

As a result of the lag between revenue declines and state program spending reductions, which typically take significant lead time to implement, the state identified approximately $9 billion in deficits over the last six years, which it addressed by implementing approximately $4 billion in program and staffing reductions while using approximately $5 billion in reserves, one-time accounting adjustments and property sales to balance the state's annual budgets.

With the state's fiscal reserves now fully exhausted, and Wall Street bond rating companies taking action to either downgrade (Fitch Bond Rating Service) or place a watch on Michigan's credit worthiness (Standard and Poor's), the state faces a cumulative FY2007 - FY2008 deficit estimated by the Michigan League for Human Services to total at least $2.1 billion. This estimate assumes:

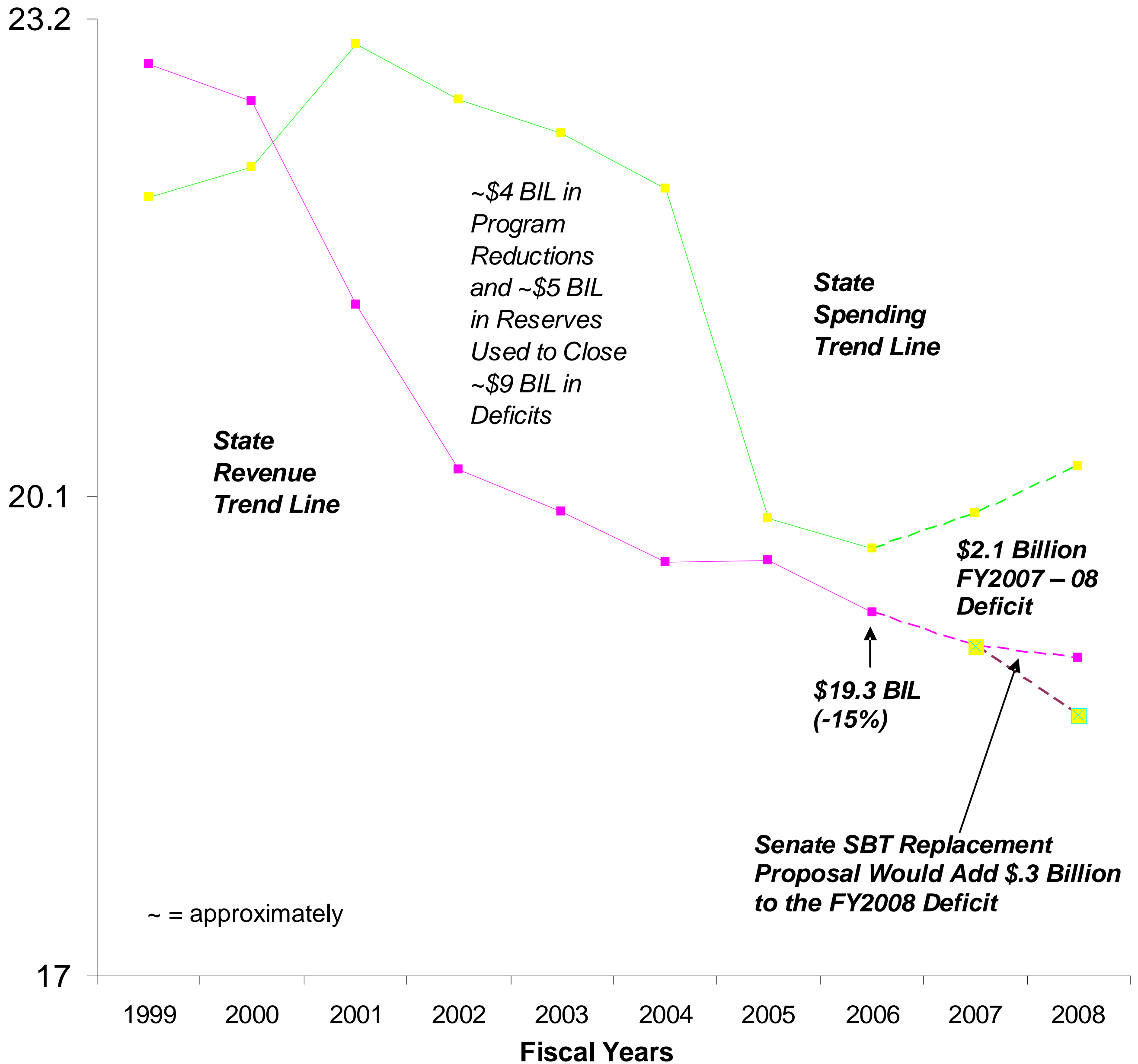
1) Single Business Tax revenues equivalent to approximately $1.9 billion annually are fully replaced by alternative revenues when the SBT is removed from the tax code on January 1, 2008;

2) the FY2007 and FY2008 state revenues forecast by the January Consensus Revenue Conference fully materialize; and

3) state program costs grow by an inflation adjusted 3 percent for FY2007 and FY2008 prior to the implementation of program reductions and modifications.

As the following chart illustrates, if the Single Business Tax replacement package under consideration by the Michigan Senate is adopted, related revenues would decline by approximately $300 million in FY2008 and by approximately $400 million when fully annualized in FY2009. If an agreement regarding an acceptable replacement for the Single Business Tax fails to materialize, the cumulative FY2007 and FY2008 deficit would increase by approximately $1.2 billion to a total of $3.3 billion, equivalent to approximately 11 percent of the cost of continuing existing School Aid and General Fund programs through the end of FY2008. In FY2009, the annualized impact of eliminating the Single Business Tax would equal approximately $1.6 billion, equivalent to about 20 percent of the state's current annual General Fund budget.

Taking a longer view of the state's structural deficit, the Michigan League for Human Services estimates that without a significant reduction in the rate of growth of state funded health care costs, together with Department of Corrections reforms leading to a reversal of inmate population trends, the state is likely to see re-emerging structural deficits of at least $500 million annually over the next decade. This suggests that the ballooning deficits of FY2001 – FY2006 may be replicated over the next five or six years. This second deficit balloon, however, could be far more devastating to critical public services, given that the fiscal reserves and "low hanging" program reductions used to address the shortfalls of recent years are no longer available to mitigate the impact of Michigan's massive and growing fiscal crisis. The crisis, as the charts in this analysis illustrate, has been precipitated in large measure by declining revenues associated with the implementation of a series of significant tax reductions and an antiquated tax code that is unable to yield revenues that grow with the general economy.


Michigan Revenue and Expenditure Trend Lines
FY1999 Through Projected FY2008
(GF & SAF $s in Billions Adjusted for Inflation)
23.2
20.1
17
~$4 BIL in Program Reductions and ~$5 BIL in Reserves Used to Close ~$9 BIL in Deficits
State Spending Trend Line
State Revenue Trend Line
$2.1 Billion FY2007 – 08 Deficit
$19.3 BIL (-15%)
Senate SBT Replacement Proposal Would Add $.3 Billion to the FY2008 Deficit
~ = approximately
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
Fiscal Years
Note: FY2006 used as base year for purposes of adjusting for inflation
Prepared by MLHS

**Report of Governor Granholm's Emergency Financial Advisory Panel**

In January Governor Granholm created the bi-partisan Emergency Fiscal Advisory Panel co-chaired by former Governors William Milliken and James Blanchard. The mission of the twelve member panel was to develop a report identifying the causes and magnitude of the fiscal crisis confronting Michigan, and to outline in general terms the actions required for its successful resolution. On February 2, 2007 the panel issued a unanimous report indicating that the state faces a long-term fiscal crisis driven by "a persistently weak economy, tax cuts, spending pressures, and inattention to essential government reform."

The Executive Summary of the panel's report indicates that the state faces a deficit of at least $2.3 billion over the next 18 months, a deficit that could grow to as much as $3.5 billion if policy makers fail to replace all or a portion of the Single Business Tax scheduled for elimination by the end of this calendar year.

To address the acknowledged fiscal crisis the advisory panel indicated that "the state must restructure taxes in a manner that would immediately increase revenues," and policy makers "must develop a fiscal plan that includes a combination of revenue increases, spending cuts, and reform of how public services are delivered."

Regarding the impact state tax cuts have had on recent and projected deficits, the advisory panel report indicated that a series of personal income, business, estate and other tax reductions instituted since 1995 reduced cumulative state revenues by approximately $20 billion, including the loss of approximately $3.2 billion in FY2006 alone.

**Emergency Financial Advisory Panel Findings**

**The advisory panel report cited the following four key findings:**

1. **Michigan cannot economically grow its way out of the current fiscal crisis facing state and local government.**
2. **Michigan should not rely solely on budget cuts to balance state budgets this year and next.**
3. **The state must restructure taxes in a manner that would immediately increase revenues, but Michigan should not solely tax its way to balanced state budgets.**
4. **Michigan must fundamentally reform government and the delivery of public services.**

In the report's concluding remarks it noted that "Members of this panel have advocated tax increases from time to time, and we opposed them at other times. We have voted in different ways on many tax and spending issues. We differ among ourselves on what size of government is ideal. One thing upon which we agree today is that somewhere between today's state revenues (estimated by the Michigan League for Human Services at approximately 7.2 percent of total state personal income) and the state constitution's limitation (specified as 9.49 percent of total state personal income by the Headlee constitutional amendment of 1978) lays the appropriate level of taxes and public spending."

**Conclusion**

Michigan's fiscal crisis is attributable to several factors, including the dramatic reduction in state revenues outlined above. Immediate action must be taken to increase state revenues to avoid the devastating impacts that a "cuts only" solution to the deficit would have on essential public services. In keeping with the panel's recommendations, a comprehensive solution, which must include carefully considered revenue increases as well as administrative reforms and prioritized program reductions, is essential if Michigan's quality of life is to be preserved.