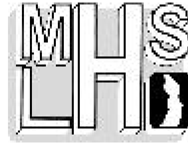
Michigan League for Human Services



February 2004

TAX CUTS AND VANISHING REVENUE: GOING, GOING, GONE

One month after the January Consensus Revenue Forecasting Conference identified a revenue shortfall for FY 2004 of over $800 million, the Granholm administration has pegged the total FY2005 structural deficit at $1.3 billion due in part to Medicaid caseload and cost increases and in part to a plan to restore cuts made in FY2004 to K-12 and higher education

As the attached table notes, the newly recognized FY2005 deficit, together with program reductions, Budget Stabilization and Trust Fund withdrawals, and variety of accounting adjustments instituted since FY 2001, total approximately $7.62 billion through FY2005. As this comparison of estimated deficits and tax revenue declines also notes, these very large and growing deficits materialized as multi-year reductions to the Personal Income, Single Business and Estate Taxes were being phased in.

Despite the negative effects of the 2001 through 2002 recession and the subsequent jobless recovery on state revenues, there is a strong correlation between the size of projected state deficits and state revenue reductions resulting from these multi-year tax cuts. The related loss of revenues equates to over 77 percent of the $7.62 billion in estimated deficits incurred since their enactment. Much of the difference can be attributed to the effect state program reductions have on subsequent state revenue collections. To date, for example, in addition to exhausting virtually all of its various fiscal reserves, Michigan has instituted approximately $2.5 billion in program reductions. When considering the loss of matching federal funds and the multiplier effect of program reductions throughout the state's economy, total business activity in Michigan could be expected to decrease by significantly more than the value of the initial cuts. Sales, business, income, use and local tax revenues would, in turn, decline by approximately 10 percent of the resulting decrease in economic activity, potentially resulting in additional program reductions and revenue losses.

In conclusion, it appears that most of the revenue shortfalls experienced by Michigan since FY 2001 can be linked directly or indirectly to the multi-year tax reductions implemented at the state and federal levels since 1999. While a robust economy could potentially have financed these tax reductions without precipitating a fiscal crisis, basing long-term policy decisions on the assumption that unprecedented economic growth will continue unabated into the future appears short-sighted at best and fiscally irresponsible at worst. As a consequence of these tax policies, it appears that a relatively modest economic downturn resulted in the rapid exhaustion of the state's Budget Stabilization and Medicaid Trust Funds and contributed significantly to revenue deficits of $7.62 billion since FY2001. The continued implementation of these tax reduction policies, culminating in the elimination of the Single Business Tax in FY 2009, would only make what has been repeatedly characterized as one of the worst fiscal crises in Michigan history significantly worse.

What can be done to resolve the current revenue crisis? First, do no harm. As noted above, significant additional state program reductions would likely exacerbate the state's fiscal woes by further reducing the flow of federal funds into the state and further reducing economic activity and related state tax revenues. Maintaining state spending while preserving state revenues

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by further delaying or repealing the last .1 percent Personal Income Tax rate reduction and at least partially decoupling from the federal Estate Tax phase-out, as seventeen other states have done, appears a rational first step. Together, these actions would preserve between $300 million and $350 million in annual General Fund revenues currently used to fund state programs. While these revenues represent a small share of the newly identified $1.3 billion dollar structural deficit for FY2005, their preservation would avoid a worsening of the fiscal situation while state leaders consider options for addressing a shortfall equivalent to nearly 15 percent of the projected General Fund revenues for FY2005.

Tax Code Revenue Reductions Compared to Michigan's General Fund and School Aids Deficits

(FY1999 to FY2009 In MIL $s)

Fiscal Year	Revenue* Impact of Single Business Tax Phase-out	Revenue* Impact of Personal Income Tax Rate Phase-down	Revenue* Impact of Federal Estate Tax Phase-out	Total Revenue Reductions Related to Tax Cuts	Actual and Estimated** General Fund & School Aid Deficits
1999	(87.6)			**(87.6)**	
2000	(208.6)	(247.1)		**(455.7)**	
2001	(309.7)	(354.2)		**(663.9)**	**(384)**
2002	(409.7)	(448.3)	(17.0)	**(875.0)**	**(1,417)**
2003 (est.)	(409.3)	(605.7)	(100.0)	**(1,115.0)**	**(1,350)**
2004 (est.)	(425.0)	(708.5)****	(130.0)	**(1,263.5)**	**(3,172)*** **
2005 (est.)	(425.0)	(839.0)	(177.0)	**(1,441.0)**	**(1,300)**
FY99-FY05 Totals	**(1,849.9)**	**(2,363.8)**	**(247.0)**	**(5,901.7)**	**(7,623)**
2006 (est.)	(425)	(839)	(225)	(1,489)	TBD
2007 (est.)	(425)	(839)	(236)	(1,500)	TBD
2008 (est.)	(425)	(839)	(245)	(1,509)	TBD
2009 (est.)	(2,300)	(839)	(255)	(3,394)	TBD
FY99-FY09 Totals	**(5,849.9)**	**(6,647.3)**	**(1,385.0)**	**(13,882.2)**	**TBD**

Notes:

* Actual values through FY2002 and estimated values for FY2003 and FY2004 were provided by the Senate Fiscal Agency and reflect figures agreed to at the Consensus Revenue Conference.

** The deficit values cited in this column reflect the total of withdrawals from the Budget Stabilization and Medicaid Trust Funds, FY2002, FY2003 and FY2004 Executive Order Reductions, deficits covered by various accounting adjustments, $2.172 billion in deficits addressed in the intitial FY2004 budget and $1.3 billion in additional revenue shortfalls and increased expenditures projected for the current fiscal year.

*** Reflects an initial $2.172 billion shortfall addressed in the FY2004 enacted budget plus the $1.0 billion revenue and expenditure deficit addressed by Executive Order 2003-23 and the related supplemental appropriation act.

**** Reflects a six month pause in the last .1 percent decrease in the Personal Income Tax rate from 4 percent to 3.9 percent.

Notes continued:

Public Act 115 of 1999 specified the phase-out of the Single Business Tax in .1% increments over a period of twenty-three years beginning in FY1999. With the deterioration of Michigan's fiscal condition and the resulting decline in the Budget Stabilization Fund in FY2003 to a level below the $250 million trigger built into the original SBT phase-out language, the SBT rate was frozen at 1.9%. The twenty-three year phase-out period was, however, ammended to permit the SBT to sunset in FY2009 regardless of the status of the Budget Stabilization Fund. The figures in the table above assume that the SBT phase-out remains frozen at the current 1.9% through FY2008 and that the Single Business tax is permitted to sunset per current statute in FY2009.

Public Acts 1-6 and 40 of 1999 instituted a reduction in the Michigan Personal Income Tax rate of .1% per year for five years beginning in calendar 2000. Subsequently, it was decided to advance the calendar 2001 reduction to 2000. The last .1 percent reduction is currently scheduled for implementation on July 1, 2004.

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) signed into law in June, 2001 specified the phase-out of the federal Estate Tax by 2010 with a full restoration in 2011 if no legislation specifying its permanent repeal is approved in the interim. Phase-out of the state tax credit, which is directly linked to the federal Estate Tax in most states including Michigan, however, was scheduled for repeal on an accelerated basis at 25% per year beginning with estates settled in FY2003 related to deaths in FY2002 (Estate Taxes are due within nine months of the date of death). This accelerated phase-out implies that states that do not decouple from the federal phase-out of the state tax credit will lose all related revenues by the end of calendar year 2006.

It was assumed for purposes of this analysis that real personal income and real taxable business income will remain flat through FY2009. While recent Consensus Revenue Forecasts have assumed some moderate growth in these catagories, actual growth adjusted for inflation has been either negative or only marginally positive through FY2003. While a return to moderate growth would increase the impact of tax policy changes being considered here, the value of these increases are relatively minor relative to the baseline values reflected above.

The deficits reflected for FY2004 and FY2005 are based on revenue figures from the Consensus Revenue Forecasting Conference and upon expenditure forecasts by the Michigan League for Human Services. For FY2005 the League estimates a structural deficit of approximately $1.30 billion related primarily to the loss of Medicaid special financing and Medicaid caseload growth.

FY2001, FY2002 and FY2003 deficits covered by Executive Order reductions and withdrawls from the Budget Stabilization Fund would have been significantly lower had revenues related to the noted tax reductions remained available. This would also have permitted Budget Stabilization Fund balances to be preserved and possibly increased in preparation for a significant economic downturn. In FY2005, revenue reductions related to the itemized multi-year tax reductions exceed the projected strctural deficit.

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