Michigan League for Human Services

March 12, 2003

The Governor's Budget Addresses Current Year Crisis But Longer Term Solutions Are Needed

The release of Governor Jennifer Granholm's much-awaited budget on March 6th marked yet another milestone in a continuing saga of fiscal decline in Michigan. The proposed budget for Fiscal Year 2003-2004 came after more than three years of revenue decline in Michigan and was expected to address what has been termed the state's worst fiscal crisis since World War II.

Michigan is not alone in facing daunting shortfalls. Across the country, state budget deficits total between $70 billion to $85 billion for the coming fiscal year, an average of 14.5 percent to 18 percent of state general fund spending. In most states, the national economic decline has clearly affected state economies and state budgets. In addition, rising health care costs, growing Medicaid caseloads, and reduced federal Medicaid funding are putting severe pressures on state Medicaid budgets. Michigan shares these problems but in addition, multi-year tax cuts enacted in 1999 have drained revenues. Since Fiscal Year 2001, rate reductions in the Single Business Tax (SBT) and the personal income tax alone total $2.6 billion in foregone revenue.

Over a period of three years a number of actions have been taken to address the continuing budget shortfalls. In Fiscal Year 2000-2001 and again in Fiscal Year 2001-2002, modest reductions and withdrawals from the rainy day fund and Medicaid trust fund helped to balance the budget. The Fiscal Year 2002-2003 budget was balanced by initial reductions of nearly $1 billion, an increase in the cigarette tax and a pause in the SBT rate reduction, and Executive Order reductions of $460 million in December of 2002. Almost immediately after taking office Governor Granholm issued an Executive Order to address the latest current year shortfall. The Executive Order contained large reductions in higher education, and savings were also achieved throughout state departments by not filling current vacancies and reducing program expenditures. Prior to the Executive Order, school districts were also notified of required reductions due to a current year shortfall in the School Aid Fund.

Although budget reductions over the last three years have been significant, they have been accomplished largely through one-time measures such as rainy day and Medicaid trust fund withdrawals, use of restricted revenues, sale of state land and a change in the timing of summer property tax collections. These one-time measures have produced only temporary solutions to the worsening budget problems and have largely been exhausted. The rainy day fund, which had a balance of nearly $1.3 billion in Fiscal Year 1999-2000, is expected to be depleted at the end of the current fiscal year. And, the Medicaid trust fund, which totaled $421 million at the end of Fiscal Year 2000-2001, will have a balance of only $44 million at the end of the current fiscal year. The result is a structural deficit that must be addressed through permanent solutions. According to the Senate Fiscal Agency, GF revenues declined by 17.5 percent between Fiscal Year 1999-2000 and Fiscal Year 2002-2003, yet appropriations declined by only 7.1 percent.

1115 South Pennsylvania Avenue, Suite 202, Lansing, MI 48912-1658 • (517) 487-5436
Fax: (517) 371-4546 • Web site: http://www.MiLHS.org

The Governor's Budget Makes Significant Spending Cuts and Proposes Some Revenue Enhancements

In order to address a projected General Fund deficit of $1.7 billion and a School Aid Fund shortfall of $365 million, Governor Granholm's budget proposes a combination of spending reductions and revenue enhancements.

The recommended budget includes $937 million in spending reductions, with the largest amount falling in the category of Administrative Savings ($217 million), including a significant amount in hoped-for employee concessions. Other major spending reductions include a 6.5 percent cut in spending for higher education, a 3 percent reduction in revenue sharing on top of already frozen payments, and a 50 percent reduction in arts funding.

In addition, the budget assumes $174 million in Medicaid savings, achieved largely through a federal waiver that would restructure the state's Medicaid program coverage for adults. Michigan Merit Award Scholarships funded through the state's tobacco settlement revenues are recommended to be reduced, with significant funding redirected to Michigan's Medicaid program.

Revenue enhancements totaling $403 million are also included in the Governor's budget. New revenue includes a series of tax loophole closures primarily affecting out-of state residents and businesses, increases in various fees and fines and a 4 cents per gallon increase in the diesel fuel tax.

Although some spending reductions were recommended for the state's human services departments, health and social services programs were largely spared in the Governor's budget, reflecting her priority on services for children, the disabled and the elderly. Nevertheless, the spending reductions recommended in her budget are significant and, when combined with reductions over the decade, will have a detrimental impact on service delivery as well as the quality of life in Michigan.

Eighty percent of the General Fund Budget is spent in just four areas: Higher Education, Community Health, Corrections and the Family Independence Agency. The School Aid Fund budget funds Kindergarten through 12th grade education across the state.

- In human services programs, the state already cut services to the bone during much of the early 1990s. Michigan stands out as one of two states that made the broadest and deepest cuts in overall safety net programs in 1991. Those cuts and programs were never restored, and additional reductions continued through the decade as a series of mental health facilities were closed across the state, creating strains on community mental health resources and leaving a large void in the availability of suitable placements for persons with serious emotional disorders. Although the current budget does not propose significant reductions in those areas, neither does it provide for any expansion of desperately needed services and benefits such as cash assistance grants, day care assistance, or Medicaid coverage for adults.
- While spared reductions during much of the decade, recent cuts in higher education are substantial. The General Fund pays half of university operating costs and one-third of the operating costs of community colleges. The December 2002 Executive Order included a reduction in higher education spending of 2 percent—larger than some other departments and the first reduction in 12 years. Governor Granholm's Executive Order in February

reduced higher education by another 1.5 percent and her proposed budget would reduce spending in that area by another 6.5 percent in Fiscal Year 2003-2004. Significant tuition increases, layoffs and reductions in course offerings are anticipated at some of the state's colleges and universities.

- Revenue sharing payments to local governments have also been reduced. The reductions represent an overall cut of 27 percent. Revenue sharing funds are a critical source of funding for local governments, in some municipalities totaling as much as 20 percent of their general fund revenues. The impact of these reductions is likely to result in cutbacks in essential services such as police and fire protection, as well as the loss of important services such as health services and services to seniors.
- As a result of shortfalls in the School Aid Fund, as well as declining enrollments, K-12 education is also experiencing reductions. Many local school districts are closing schools, particularly elementary schools, and laying off staff. The result will be larger classroom size and fewer services for students. Funding for adult education—a critical resource for low-income adults who have not graduated from high school—is proposed to be reduced by 75 percent and could significantly affect the ability of these individuals to achieve economic self-sufficiency.
- Finally, the loss of nearly 8,000 state employees through early retirement has had a significant impact on the ability of some departments of state government to provide services at adequate levels. In some departments, staffing losses could actually contribute to federal financial penalties. The problems created by the loss of direct service staff, as well as the loss of experienced managerial and policy staff, will be exacerbated by the hiring freeze reflected in the Governor's February Executive Order and if state employees do not agree to wage and benefit concessions, layoffs are likely.

Additional Revenue Solutions Must Be Explored If Services and Quality of Life Are To Be Preserved In The Future

The revenue shortfalls for Michigan are based on January 2003 estimates and reflect projections of only moderate growth, without considerations of larger events that could impact the economy, such as war with Iraq. Unfortunately, economic growth is not yet evident at the national or state level. Typically, economic growth at the state level lags a federal recovery by approximately 18 months. Thus, every month that an improvement in the economy is delayed makes the state's fiscal situation more precarious, without even taking into consideration the uncertainties of national events. The proposed budget, which was balanced when presented, may be in jeopardy by the time of the May 2003 or January 2004 Consensus Revenue Estimating Conference.

Federal tax and spending decisions will also impact Michigan's budget and some of these decisions are not reflected in the Governor's proposed budget. Michigan will lose approximately $99 million in Fiscal Year 2003-2004 as a result of the phase-out of the federal estate tax, according to the Washington, D.C. based Center on Budget and Policy Priorities. The loss will grow to $565 million by Fiscal Year 2006-2007. Although this revenue loss is reflected in the revenue estimates upon which the Governor's budget is based, the impact of the federal stimulus package proposed by the Bush Administration is not. If the exclusion of stock dividends from taxation is approved, the cost to Michigan will be between $100 and $175 million. In view of the budget pressures created by defense and national security policies, domestic spending could be reduced significantly and would affect programs throughout state government that rely on federal funding.

The revenue enhancements that the Governor included in her proposed budget represent a good start toward ensuring adequate revenues for the future. However, according to the Citizens Research Council of Michigan, even with modest growth, Michigan will not be able to fund programs and services at even Fiscal Year 2001-2002 levels until at least 2006. During those intervening years, budgets are likely to remain flat, causing programs and services to be reduced further due to the inability to provide even inflationary increases. If Michigan is to have adequate revenue to both balance budgets and expand services and programs to reflect current and future needs, additional revenue solutions must be explored.

Many of the nation's governors have submitted budget proposals for fiscal year 2002 that include tax increases in order to balance budgets. Sixteen of the 34 governors who have submitted budget proposals, have included increases in income taxes, sales taxes, corporate taxes and/or excise taxes. Further, their proposals include both raising rates and broadening tax bases. The governors proposing tax increases include both Republicans and Democrats in all regions of the country. States whose governors have proposed tax increases include Arkansas, California, Delaware, Georgia, Idaho, Iowa, Kentucky, Missouri, Nebraska, New Jersey, Nevada, New York, North Dakota, Ohio, South Dakota, and West Virginia.

In Michigan a range of revenue solutions exist that could reduce the need for spending reductions in order to achieve a balanced budget:

- *The scheduled reduction in the income tax rate should be suspended.* According to the Washington, D.C. based Institute on Taxation on Economic Policy, nearly one-third of the benefits of the income tax rate cuts have gone to households with average annual incomes in the top 5 pecent of income ($317,000) and only 1.1 percent of the benefit has been realized by households at the bottom 20 percent—those with average annual incomes of $9,500.
- An average family with income of $50,000 is saving only $50 as a result of the rate cut. If the rate reduction from 4 percent to 3.9 percent did not take effect on January 1, 2004 the state would save $118 million.
- *Michigan should follow the lead of 17 other states by passing legislation that would make it possible to continue to collect revenue from the federal estate tax, even as Congress is phasing it out.* It is estimated that approximately 1,400 estates—those of the wealthiest taxpayers in the state—would benefit from eliminating the tax. However, between Fiscal Years 2003 and 2007, Michigan could retain $565 million if it kept the tax by decoupling the state estate tax from the federal provisions.
- *Michigan should examine its Tax Expenditure Budget and eliminate those that have outlived their public purposes or provide unfair advantage to certain groups of taxpayers.* A tax expenditure is revenue foregone as a result of preferential provisions in the tax code such as exclusions, deductions, exemptions, credits, deferrals or lower tax rates. Tax expenditures are a way of allocating state resources, but through the tax system rather than through the appropriations process. Unfortunately, policymakers tend to ignore tax expenditures during the budget process

and therefore the tax expenditure budget tends to increase at a greater rate than the overall state budget. Tax expenditures in Fiscal Year 2003-2003 are estimated to total $24.6 billion. Governor Granholm's budget recommends closing $109 million in such loopholes and is a step in the right direction. However, more should be done in this area and minimally, consideration of any additional tax expenditures should be suspended until the structural deficit is resolved.

- *Michigan should modernize its sales tax structure to reflect changes in technology and the change from a manufacturing to a service economy.* Each year Michigan's losses from mail order and internet sales increase. The revenue losses from these consumer remote sales are estimated to be $210 million in Fiscal Year 2001 and $349 million by Fiscal Year 2005. Michigan has passed legislation that will allow the state to participate in a multi-state Streamlined Sales and Use Tax Agreement by which sales tax will be collected from companies that have remote sales transactions with Michigan customers.

  Just as rapidly expanding technology has implications for sales tax collections, so does the growth in the service sector of the economy. Services are the largest single exclusion from the state's sales tax base, yet Michigan continues to tax very few services relative to other states. The estimated loss of revenue due to the exemption of services was $4.6 billion in Fiscal Year 2001. As the service sector continues to grow in economic importance, however, this figure will increase. Many services were never specifically exempted from the sales tax because they represented such a small segment of economic activity and generated very little revenue. That has changed. For example, it may no longer make sense to exempt admissions to entertainment and amusements from taxation. Most states do tax admissions to events and Michigan could generate an additional $175 million if it did so as well.

- *Michigan should adjust alcohol taxes for inflation.* Although the state's liquor taxes are adjusted for inflation, beer and wine taxes are not. Michigan's beer tax has not been raised since 1966 and the wine tax was last adjusted in 1981. A doubling of the beer tax from $6.30 per barrel (approximately 2 cents per can) to $12.60 would yield an additional $43 million in revenues and recoup one-third of the inflationary loss over the last 37 years. If both beer and wine taxes were doubled an additional $51 million would be generated. If the taxes were also tied to inflation, revenue growth would be ensured in future years.

- *Michigan should retain its Single Business Tax, or replace it with a tax of similar revenue-generating capacity and stability.* Other states' corporate income taxes have proven elusive since many mechanisms exist that permit corporations to avoid them (i.e. shift to other states or other subsidiaries, etc.) The SBT currently provides approximately one-fourth of General Fund revenues, and provided an even higher share prior to enactment of legislation to gradually phase out the tax.

- *Michigan could consider raising additional revenues by selling bonds backed by the state's future tobacco settlement funds if the state's fiscal situation continues to worsen.* As part of a major legal settlement with tobacco companies in 1998, Michigan and 45 other states will receive annual payments from the tobacco companies in perpetuity. The annual payments to states would rise or fall depending on tobacco product sales volumes and would be adjusted to reflect inflation or 3 percent, whichever is higher. Michigan has received a total of $941.4 million in association with this settlement, including $328.1 million in calendar year 2002. The Michigan Department of Treasury has estimated that the state can expect to receive an additional $7.55 billion from this agreement through 2025.

At least nine states and local governments have sold over $13 billion in bonds backed by future revenues from the tobacco settlement monies as a means of addressing state budget problems. California will soon join the list of states with a bond offering of $3 billion. Securitization would allow the state to convert a long-term stream of revenue into current revenue. Much of the risk of future reductions in settlement payments, which could occur if a tobacco company went bankrupt or tobacco sales declined, would thereby be transferred from the state to the bond-holders.

Michigan could sell a flat amount of its settlement payments over a 22-year period (e.g. $10 million per year) and net approximately $125 million. Or, the state could choose to sell all of its tobacco settlement proceeds over the same period, setting up a trust fund for the proceeds. The latter option, which would yield approximately $3 billion, may pose fewer risks, as the full amount of Michigan's settlement funds would be secured. While the state would be giving up a portion of its settlement monies, it could reduce the out-year risks of participating tobacco company insolvency and at the same time stem a worsening state budget deficit. If the state's fiscal condition continues to worsen this could be an option that would provide short-term relief.

Summary

It is clear that the state's budget crisis will not be resolved without incurring some pain. While the Governor's budget attempts to target spending reductions where the least harm will occur, there will nevertheless be a disruption in certain services and increased costs on the part of the public. Further, the budget is dependent on agreement by the legislature to potentially controversial policy changes. And some measures, such as employee concessions, cannot be realistically looked to in subsequent years as a solution to a budget deficit.

Longer term considerations are important as well. While every effort is being made through this budget to minimize the harm to citizens and the damage to state services and institutions and the quality of life throughout Michigan, there is no guarantee that larger economic forces may cause the economy to continue to lag. In that case, additional revenues will surely be necessary in order to continue vital programs. For that reason it is important to continue to explore revenue solutions that provide opportunity for future growth in order that critical services can be maintained now and in the future. Exploration of revenue solutions also provides an opportunity for a comprehensive review of the state's tax system through which issues of revenue adequacy and stability can be addressed, as well as the fairness of the state's tax system with respect to the burden borne by various classes of taxpayers.

Sources:

Center on Budget and Policy Priorities, Washington, D.C.
Citizens Research Council of Michigan
Institute on Taxation and Economic Policy, Washington, D.C.
Michigan Department of Treasury
Michigan Senate Fiscal Agency
University of Michigan Research Seminar in Quantitative Economics