Michigan's Fiscal Crisis

An Analysis of General Fund Tax Revenue and Personal Income Trends

FY 1990 - FY 2004

HIGHLIGHTS:

- Michigan was one of only a few states to reduce general fund spending during the rapid economic growth of the 1990s. The League's analysis indicates that this trend is expected to continue through FY2004, with projected general fund expenditures declining by more than 17% in real terms since FY1990.
- A relatively minor economic downturn beginning in 2001 contributed to the rapid exhaustion of Michigan's Budget Stabilization Fund and a combined general fund deficit of approximately $2 billion for Fiscal Years 2003 and 2004.
- Michigan's effective personal income tax rate (taxes supporting general fund programs as a percentage of total personal income) declined by approximately 39% since 1990-equivalent to a reduction in FY2004 general fund tax revenues of approximately $5 billion.
- Had tax reduction efforts been marginally less aggressive, (limiting reductions to 26% vs 39%), state revenues would have been sufficient to address projected FY2003 and FY2004 deficits while preserving and growing the nearly exhausted Budget Stabilization Fund in preparation for a significant economic downturn.
- Excluding Department of Corrections staffing, which rose by 25% in association with a significant increase in Michigan's prison population, total state staffing has declined by nearly 30% since FY1990. With additional staffing reductions anticipated in association with budget balancing efforts in FY2003 and FY2004, it appears that the state's ability to deliver core services related to the health and safety of its citizens and avoid significant additional federal sanctions related to rising program error rates may be compromised.

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Factors Contributing to Michigan's Current Fiscal Crisis

As Governor Granholm and the legislature begin deliberations over the FY2004 state budget in an effort to address a general fund deficit of approximately $1.7 billion, the Michigan League for Human Services has undertaken an analysis of state tax revenues and personal income trends in order to identify those factors which have contributed significantly to the current fiscal crisis. While it has generally been assumed that increased spending during the high growth and tax revenue years of the 1990s was a major contributor to the fiscal crisis now facing most states, it does not appear to be a contributing factor in Michigan. As noted in an article published by the CATO Institute on February 12, 2003, Michigan's general fund spending declined by 13.8 percent from FY1990 to FY2001. (The League's analysis of state spending suggests a projected decline of over 17 percent in real terms through FY2004.) Despite being one of only four states credited with having held the line on state spending during the economic boom of the 1990s, Michigan faces the prospect of having to reduce general fund spending and/ or increasing revenues by an additional 15 percent to 20 percent in a single year to avoid a constitutionally prohibited deficit. Had it not been for Michigan's declining expenditure trend, therefore, the worst fiscal crisis the state has seen in at least twenty years would have been significantly worse.

Another factor advanced as a contributor to the current fiscal crisis is the economic downturn beginning in 2001. While Michigan's total personal income fell by an estimated 2 percent from 2000 to 2002, the January Consensus Revenue Forecast on which the deficit projection is based assumes this relatively minor decline will be followed by an estimated 3.2 percent growth in real personal income from 2002 to 2004. As noted in Graph 1 on page three of this analysis, this anticipated return to growth would result in a 27.1 percent increase in real personal income over the period from 1990 to 2004. This significant and relatively consistent growth, like the trend toward reduced general fund expenditures cited above, would be expected to insulate Michigan from the fiscal crisis it now faces.

The other variable that could explain a major decline in general fund revenues in the face of otherwise positive income and expenditure trends is the state's effective general fund tax rate. As illustrated in Graph 1, state tax revenue supporting general fund programs is projected to decline by approximately 22.6 percent in real terms from 1990 to 2004. This reduction, together with the 27.1 percent increase in total real personal income noted above, resulted in a decline in Michigan's effective general fund tax rate of approximately 39 percent since 1990. In terms of general fund revenue, this decline reduced expected tax collections by approximately $5 billion from an estimated $12.96 billion to $7.91 billion in FY2004. Given the current deficit forecast of approximately $1.7 billion for FY2004, it appears that two-thirds of the effective general fund tax rate decline; a 26 percent reduction from 3.92 percent to 2.9 percent; could have been afforded while averting significant reductions in revenue sharing, higher education, state staffing and compensation, and a range of other initiatives and state services during what is considered by most economists to be a relatively mild recession. Limiting state general fund tax reductions to a more modest 26 percent of personal income would also have preserved the now exhausted Budget Stabilization Fund and permitted it to grow in recent years in preparation for a significant economic downturn.

In summary, while the current economic downturn contributed to the general fund deficit now facing Michigan, it appears that a less aggressive tax reduction strategy would have allowed the state to weather the current slowdown with little or no impact on services or the Budget Stabilization Fund. It would also have better positioned the state to address anticipated double digit increases in Medicaid and employee/retiree medical benefit costs expected to add significantly to general fund costs over the foreseeable future. Given that tax policy decisions appear to have significantly contributed to the current fiscal crisis, it appears incumbent upon policymakers to acknowledge this problem and to act to mitigate its impact on critical services. In an effort to limit the most harmful of resulting reductions, lawmakers could act to freeze or eliminate the last scheduled reduction in the Personal Income Tax. This action, while restoring less than 7 percent of revenue reductions linked to rate cuts, would help to address a problem that a more conservative approach to tax policy might have avoided.

Summary and Implications of General Fund Tax Revenue and Personal Income Trends

- Total personal income in Michigan grew by 22.9 percent in real (inflation adjusted) dollars over the period from 1990 to 2002. While there has been a marginal decline in total personal income in Michigan during calendar years 2001 and 2002, the current Consensus Revenue Forecast assumes resumption of growth in calendar years 2003 and 2004, bringing projected total growth over the fifteen year period covered in this analysis to **27.1 percent**. (See Graph 1)

- Total General Fund tax revenue over the period from FY1990 to FY2004 is projected to decline from $6.95 billion to $5.38 billion in real (inflation adjusted) dollars. This represents a decline of **22.6 percent**. (See Graph 1).

- In FY 1990, the base year for this analysis, tax revenues used to support general fund programming represented approximately 3.92 percent of total personal income in Michigan. As illustrated in the following bar chart, this value is projected to decline by **39 percent** to 2.39 percent of total personal income by FY2004. (See Graph 2).

- Had Michigan's effective general fund tax burden remained at the 3.92 percent levied in FY1990 without affecting economic growth over the period, the state could have expected to collect approximately $12.96 billion in total General Fund revenues. ($330.85 billion in projected personal income x 3.92 percent). This is approximately $5.0 billion or 64 percent above the tax revenues projected in the January Consensus Revenue Forecast. If it is assumed that increased personal income resulting from general fund related tax decreases since 1990 drove as much as 20 percent of the personal income growth over the period, a relatively generous assumption given that it represents approximately 5.3 percent of the personal income growth over that period; the additional revenues associated with holding the effective tax rate at 3.92 percent would decline to approximately **$4 billion.**

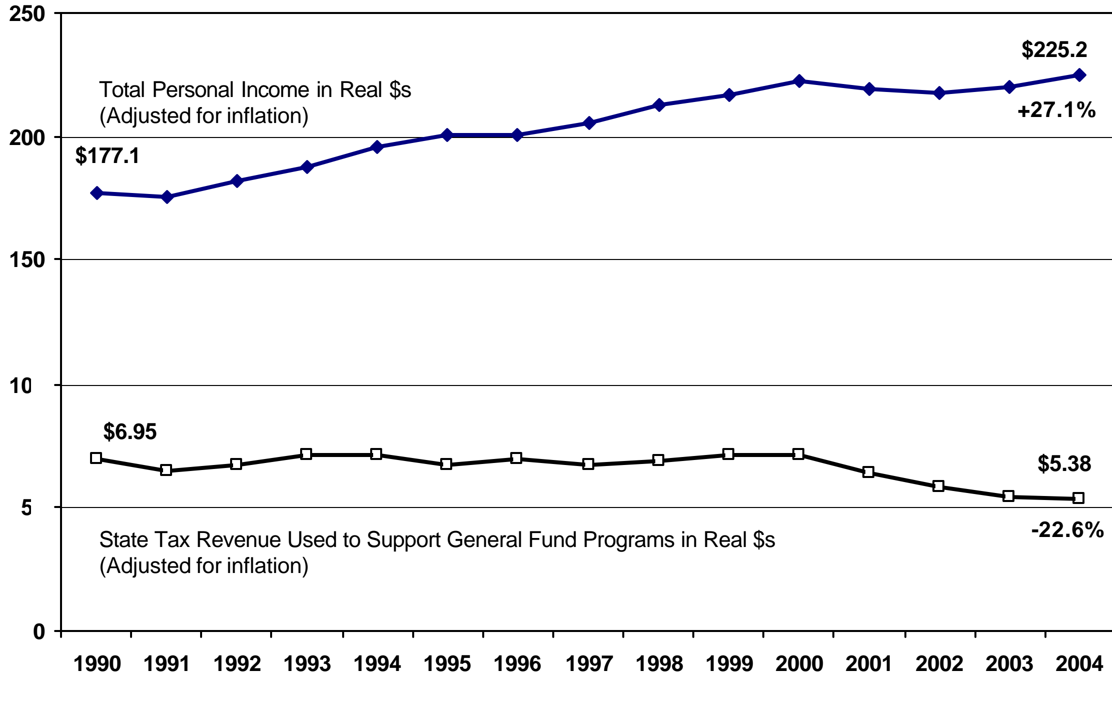
- Had policymakers anticipated the impact of the current, relatively mild recession on state revenues and reduced the effective general fund tax rate from 3.92 percent to 2.9 percent (a 26 percent reduction equivalent to two-thirds of the reductions actually instituted), the above assumptions suggest that Michigan would have collected approximately **$1.7 billion** more in General Fund tax revenues than the $8.19 billion currently assumed in Consensus Revenue Forecast. A marginally less aggressive tax reduction strategy would also have resulted in the preservation of the state's Budget Stabilization Fund in anticipation of a more significant recession, such as those experienced in 1982-83 and 1991-92.

Conclusion:

While a large share of the tax reductions implemented since 1990 may have been affordable, the fact that a relatively mild recession quickly exhausted the Budget Stabilization Fund and produced the largest deficit in Michigan in at least twenty years, suggests that the series of decisions which together reduced taxes supporting general fund programs by approximately 39 percent relative to personal income, did not anticipate the effects of an economic slowdown. The opportunity exists to address this oversight by amending prior fiscal decisions and pausing or eliminating the last scheduled income tax rate reduction. Such action would represent an important step in recognizing and addressing what has been identified as a significant structural deficit.

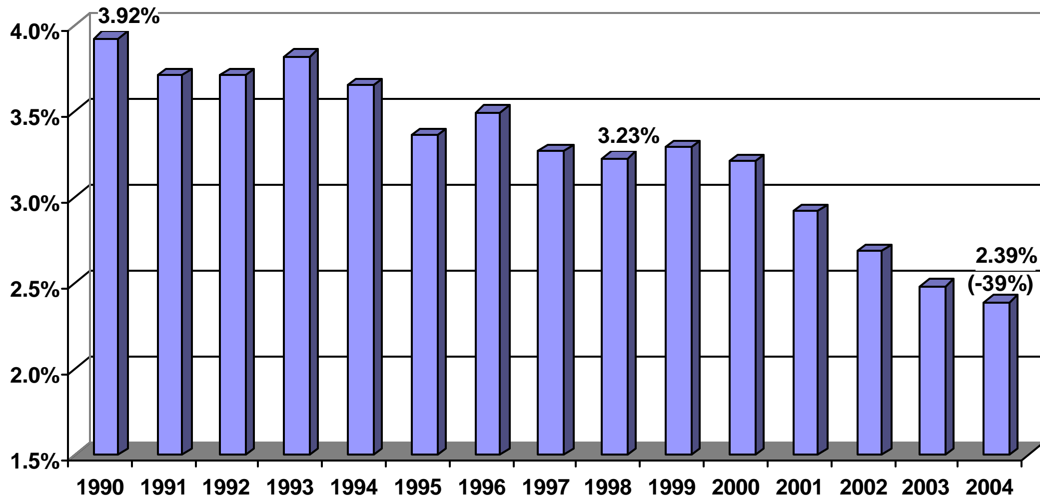
Graph 1

Michigan Real Personal Income Compared to Tax Revenue Used to Support General Fund Programs FY1990 - FY2004 Actual and Estimated In BIL $s



Graph 2

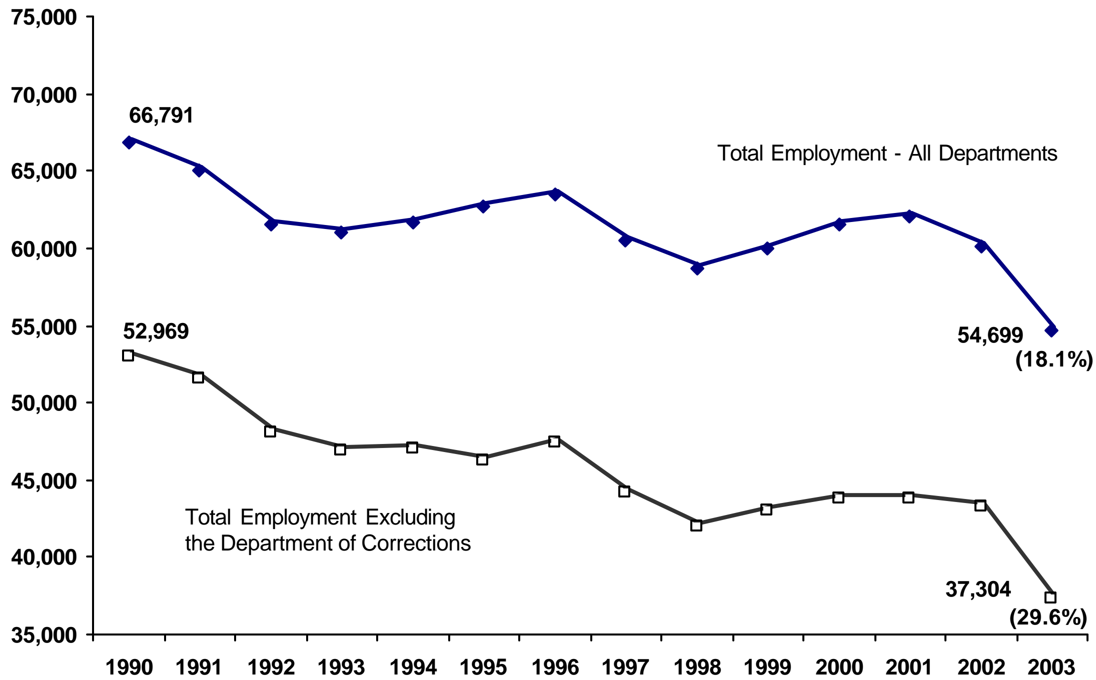
Michigan Tax Revenues Used to Support General Fund Programs as a Percentage of Total Personal Income



1990 - 2001 Personal Income data source: Bureau of Economic Analysis, U.S. Department of Commerce
2002 - 2004 Personal Income estimates: January Consensus Revenue Forecast adjusted for inflation.
FY1990 - FY2002 Tax Revenue data source: Michigan's Comprehensive Annual Financial Reports, Schedule of Revenue and Other Financing Sources - General Fund (Taxes section)
FY2003 - FY2004 Tax Revenue data source: Consensus Revenue Forecast adjusted to remove minor non-tax items.
All figures are adjusted for inflation per the actual and estimated Detroit Consumer Price Index and assume 1990 as the base year.

Graph 3

Michigan State Employment
Average FY1990 - FY2003 YTD



The figure cited for FY2003 reflects staffing averages through 1/18/2003 and does not reflect the full impact of Executive Order 2003-3 or a related hiring freeze. No impacts related to anticipated budget reductions in FY2004 have been assumed. Data was provided by the House Fiscal Agency and by Civil Service.

The above chart illustrates the impact of early retirements and other staffing related trends through January 2003. The nearly 30 percent decline in non-Corrections staff since 1990 will likely increase as staffing related savings associated with Executive Order 2003-3 and the proposed Executive Budget for FY2004 are considered and implemented. Given these likely reductions, issues of service delivery and cost/benefit must be considered when making decisions regarding appropriate staffing levels.

In FIA, for example, it appears that the length of time required to process an application for assistance has significantly increased since approximately 2,800 experienced staff left the department in relation to the latest early retirement program. Another example of the likely consequences of recent staffing trends relates to fiscal penalties associated with Food Stamp program error rates. To date Michigan has been required to spend $28 million in unmatched general fund dollars to address error rates significantly higher than the national average. The FY2003 and recommended FY2004 FIA budgets indicate that the department will need an additional $24.12 million in unmatched general fund dollars to address current and anticipated federal corrective action and penalty requirements. While FIA has made progress in reducing Food Stamp error rates, the recent loss of experienced staff seems likely to aversely affect this effort – resulting in still more sanctions. This probable consequence of the early retirement program is compounded when it is noted that staffing costs incurred in an effort to avoid future sanctions would have been eligible for federal match on a dollar for dollar basis. The department will now be required to dedicate increasingly scarce staffing resources to this issue and will be unable to claim related federal match. Comparable examples of the unintended effects of staffing reductions on service delivery and fiscal stability in many of Michigan's departments should be of great concern to the state's program managers and elected officials.