# Michigan League for Human Services

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## Michigan's Structural Deficit Requires Structural Solutions

Fiscal Year 2006 will mark the sixth consecutive year that state revenues have not been adequate to fund state programs and services. The state now faces a current year deficit of $375 million and an estimated shortfall of nearly $800 million for Fiscal Year 2006. Since the first decline in revenues in Fiscal Year 2001, Michigan has experienced cumulative deficits in excess of $7.8 billion, has exhausted nearly $3.8 billion in fiscal reserves and has instituted roughly $3 billion in spending cuts, equivalent to state program reductions of 10.4 percent. Revenue enhancements such as increases in tobacco and casino taxes and some fee increases have yielded approximately $1 billion – less than 13 percent of the total deficits since Fiscal Year 2001.

Contrary to widely held assumptions, the ongoing fiscal crisis is not solely, or even primarily, the consequence of a lagging economy. According to Michigan League for Human Services estimates, less than 25 percent of the state's General Fund deficits over the last five years can be tied to the economy. The remainder can be directly attributed to multi-year reductions in the personal income and Single Business Tax rates and the phase-out of the federal estate tax.

Despite the actions taken over the last five years to address Michigan's mounting deficits, the League estimates that state expenditures will exceed revenues by over $400 million per year, resulting in total general fund deficits approaching $5 billion over the next decade.

The impact of reductions in programs and services has been felt across Michigan. Municipalities have had to cut back on critical public safety services as a result of fewer revenue sharing dollars. Senior centers and library programs have been shut down and funding to local agencies has been reduced. Thousands of Michigan adults are without dental services and many have faced expensive surgical procedures and hospitalization that could have been avoided. Local school districts have reduced programs and services and have instituted larger class sizes as the per pupil foundation allowance remains flat. College tuition is higher at some colleges and universities; at other institutions program offerings have been reduced and students graduate at a later date. State agencies are not able to deliver timely services, and necessary oversight of state programs is in jeopardy. Across state government, there is no ability to invest in the future through expansion or enhancement of services.

The solution to Michigan's fiscal crisis is not more spending cuts that could actually make Michigan's economy worse. An analysis last year by the W. E. Upjohn Institute for Employment Research indicates that a $1 billion in reduced spending would result in the loss of another 23,000 jobs statewide, with about half of the loss occurring in the public sector and the rest in the private sector. Many public program expenditures create demand for other goods and services and result in expenditures in local communities. Health care spending, which brings $1.30 in federal matching funds into Michigan for every state dollar spent, is a particularly important contributor to local

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economies. Finally, low taxes and business incentives are not the only factors that attract businesses to a state or locality. Strong public services and infrastructure provide important support that businesses seek when determining where to locate.

**Revenue Alternatives Would Prevent Additional Harmful Reductions**

As an alternative to additional cuts in programs and services, a range of revenue solutions exist that could address the structural deficit with far less harm to essential state and local services, and most importantly, to vulnerable populations. The following options are available to Michigan's policymakers.

Michigan should take every step possible to retain revenue that we are already, or could be, collecting.

- ***Michigan should retain its share of the Federal estate tax, even as Congress is phasing it out.*** Currently 17 other states have passed legislation to "decouple" from the federal estate tax, thereby keeping state revenue needed to fund essential state services. In her FY2005 Executive Budget Governor Granholm recommended that Michigan do the same. Her proposal would have exempted estates of under $1 million from the tax, meaning that the tax would only be paid only on the amount of the estate over $1 million. In addition, family farms and businesses would have been exempt. If a similar recommendation were adopted now, Michigan could retain nearly $94 million in FY2006 and $130 million annually in the future. By not decoupling from the federal estate tax for very large estates Michigan is effectively granting a tax cut to the heirs of estates valued at over $1 million at the expense of vital programs and services.

- ***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. They generally are approved in an effort to, for example, help families afford food and prescription drugs, help seniors on fixed incomes maintain a reasonable standard of living and help Michigan businesses remain competitive. Unfortunately, because there is no annual review of tax expenditures, it has often been referred to as "silent spending." Further, since there is little, if any, overlap between the tax policy committees and the appropriations committees, policymakers tend to ignore tax expenditures during the budget process. As a result the tax expenditure budget tends to increase at a greater rate than the overall state budget. In Fiscal Year 2005 tax expenditures are expected to total $29.4 billion – over 60 percent of total potential state revenues.

  While many tax expenditures have significant merit, in the face of dramatic deficits and program reductions, a review of tax expenditures should be undertaken now, and annually in the future. A thorough annual review would encourage policymakers to rank all policy goals before making decisions about what should be funded through the tax code and which policy goals are better funded through direct appropriations.

- ***Michigan should continue its participation in the 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.*** Each year Michigan's revenue losses from mail order and internet sales increase. The losses from these consumer remote sales are estimated to be as much as $200 to $300 million annually. Michigan should reject any attempts to withdraw from the agreement and continue to be part of efforts to expand the collection of sales tax to internet and catalogue purchases. Further, while the state cannot require corporations to comply with the agreement, it can and should pursue voluntary compliance on the part of retailers. It should be noted that failure to collect these taxes gives internet businesses, many of which are located outside of the state, an unfair advantage over "main street" businesses located in Michigan.

- ***Michigan should enact a Medicaid Estate Recovery program as required by federal law.*** Since passage of the Omnibus Budget Reconciliation Act of 1993, Congress has required states to try to recover the cost of Medicaid benefits from the estates of certain nursing home residents and older persons receiving home-and community-based services. This law applies to individuals who were age 55 or older when they received Medicaid. Recovery cannot take place before the death of a surviving spouse or if the individual has a surviving child who is under age 21 or who is blind or permanently disabled. States have wide latitude in determining what assets are subject to recovery and the level at which recovery will be pursued. Annual savings of approximately $17 million from estate recovery were assumed in the Fiscal Year 2004 and 2005 budgets; Governor Granholm's Fiscal Year 2006 budget again includes an estate recovery provision with savings of $10 million assumed. Michigan is the only state that has not implemented a Medicaid estate recovery program.

In addition to taking steps to retain as much revenue as possible, policymakers must begin to restructure Michigan's tax code to ensure growth and fairness in the future.

- ***Michigan should modernize its sales tax structure to reflect the change from a manufacturing to a service economy.*** The sales tax, instituted in 1933, was based on a manufacturing economy, in which the production and sale of goods were the dominant features. However, Michigan's' economy, like those of most states, is increasingly a service economy. Despite this shift, Michigan continues to tax very few services relative to other states. And, while the sales tax funds over 40 percent of the School Aid Fund, services are the largest single exclusion from the state's sales tax base. This exemption currently results in the loss of an estimated $8.6 billion in state revenues, and as the service sector continues to grow in economic importance this figure will increase significantly.

  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. A particularly good example is the category of Arts, Entertainment and Recreation, which would include admissions to performing arts, spectator sports, race tracks, college sports, bowling, museums, amusement parks, gambling, golf and country clubs, ski resorts, marinas and fitness facilities. This is a service category that is entirely discretionary and one that most other states do tax. If this category of services were taxed, Michigan could expect to generate an additional $212 million in revenue.

  A concern often raised during discussions about expanding the sales tax to services relates to the regressive nature of the sales tax and its impact on low and moderate-income households. Lower income households disproportionately purchase more goods than services. One way to mitigate the impact of the regressivity of the sales tax would be to lower the sales tax while expanding the base. This alternative, while revenue neutral at the outset, would provide more growth in sales tax revenues over time.

- ***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 these taxes were also indexed to inflation, the purchasing power of the revenues generated by these taxes would be preserved.

- ***Michigan should retain its Single Business Tax, or replace it with a tax of similar revenue-generating capacity and stability.*** Michigan's Single Business Tax (SBT) dates back to 1975. It replaced seven existing taxes and came about largely through a desire to simplify a multi-tax system and to stabilize resulting revenues by moving away from a profits based tax that fluctuated significantly with changes in the business cycle. Since its enactment, according to a 2003 study by the Multi-State Tax Commission, Michigan's business tax revenues have remained relatively stable while those of other states have declined dramatically, due in large part to their susceptibility to shifts in taxable profits to out-of-state or offshore entities.

  Legislation to phase-out the SBT was enacted in 1999 but the gradual rate reduction was paused as a result of a "trigger" provision in the legislation stipulating that the rate reduction be paused when the state's rainy day fund dropped below $250 million. Regardless of the size of the state's' reserves, however, the SBT is scheduled to expire at the end of 2009. If this is permitted to occur, Michigan could expect to lose approximately one-fourth of remaining General Fund revenues.

  In late January Governor Granholm announced her proposed Michigan Jobs and Investment Act, which would restructure the SBT. Under this plan, tax rates would, in general, be lowered for large manufacturers and raised for insurers and some financial institutions. The revised tax would be weighted more toward profits and a greater portion of the tax burden would be shifted to out-of-state businesses. An important feature of the plan is its revenue neutrality; while it is not intended to generate additional revenue, it preserves the level of revenue currently being collected. However, should the final agreement on reforming or replacing the SBT not preserve this revenue neutrality, Michigan's projected long-term structural deficit will be exacerbated.

## Summary

Since FY2001 Michigan has undertaken a combination of one-time measures, spending reductions and modest revenue enhancements to balance each year's budget. In coming years, while economic growth is assumed, projected program costs are expected to significantly exceed revenues due to annual increases in the Corrections population, and near double digit increases in health care costs for state employees, public school teachers and retirees, and Medicaid recipients.

Michigan's revenues have eroded primarily as a result of past state tax policy decisions. Revenues are at their lowest levels since 1970 – a time when the state was providing services to 1.3 million fewer citizens. $3 billion has been stripped from state programs and services in five years, resulting in harm to local communities, schools, and vulnerable populations across Michigan.

Future state tax policy decisions, rather than further diminishing critical services, must address the deficiencies in the state's tax structure. Revenue options are available to policymakers as alternatives to additional spending reductions. Further, revenue solutions provide an opportunity for the needed 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 taxpayers across the income spectrum.

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