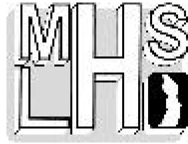
Michigan League for Human Services



September 2004

At the Fiscal Crossroad: Michigan's Current and Looming Fiscal Crises

As Michigan's decision-makers prepare to face a fifth consecutive year of significant state budget deficits, a review of recent tax policy decisions may be useful in understanding this ongoing crisis, and mapping a strategy for a less troubled fiscal future. Given the complete exhaustion of the state's fiscal reserves, and an expenditure pattern that will likely outstrip revenues by $200 to $300 million annually even if revenues grow by the currently projected 4 percent per year, action to quickly stabilize Michigan's fiscal situation is essential if significant future deficits are to be avoided.

Michigan acted aggressively to reduce taxes over the last decade, according to a recent report by the Tax Foundation entitled *Tax Burdens by State*. By 1999, the midpoint of this period, over 20 separate tax cuts had been instituted, reducing Michigan's combined state and local tax burden to approximately 10 percent of total personal income—a level roughly equivalent to the seven-state Midwest average. At this point the United States was entering the sixth year of an unprecedented economic expansion, and Michigan was continuing to enjoy budget surpluses, enabling the state to make a $244 million deposit to the existing $1 billion Budget Stabilization Fund. Michigan's fiscal outlook at that point was so positive that it enjoyed the highest state bond rating in the country. In March of that year, in its annual review of state fiscal conditions, the Center on Budget and Policy Priorities, a fiscal policy research organization based in Washington D.C., recognized Michigan as one of only seven states with sufficient revenues and reserves to permit it to weather a moderate economic downturn without having to significantly reduce state programs and/or raise state taxes.

One year later, in response to the enactment in July 1999 of a five-year phase-down of Michigan's personal income tax rate from 4.4 percent to 3.9 percent, and a 23 year phase-out of the 2.3 percent Single Business Tax, the Center revised its positive prior-year outlook, warning that ***even a minor economic downturn would quickly exhaust Michigan's fiscal reserves and plunge the state's budget into a $2 billion deficit.*** This assessment of the potential for immediate and rapidly growing fiscal deficits was, if anything, too optimistic.

As the relatively mild economic downturn of 2001-2002 began, Michigan incurred its first deficit in a decade. As the deficit quickly grew from approximately $400 million in FY 2001 to $1.4 billion in FY 2002, Michigan made significant use of its fiscal reserves and acted to freeze the phase-out of the Single Business Tax at 1.9%. These actions, however, did little to address Michigan's growing structural deficit. Further reductions in Michigan's personal income tax rate, together with a significant decline in state revenues associated with the phase-out of the federal estate tax, contributed to a deficit of at least $3.2 billion in the current fiscal year and a cumulative deficit of over $7.6 billion from FY 2001 through FY 2005.

In response to these deficits, over $2.5 billion in program reductions have been instituted since FY 2002. The state has also acted to increase fees and taxes by approximately $600 million through FY 2004. Assuming that Michigan's economy grows as projected, and that the $391 million in tax increases proposed in the FY 2005 Executive Budget (or equivalent alternatives) are adopted, it appears that Michigan's structural deficit in FY 2006 may fall below $1 billion for the first time in five years. As discussed below, however, further tax decreases and rapidly increasing program costs are likely to produce significant structural deficits for years to come.

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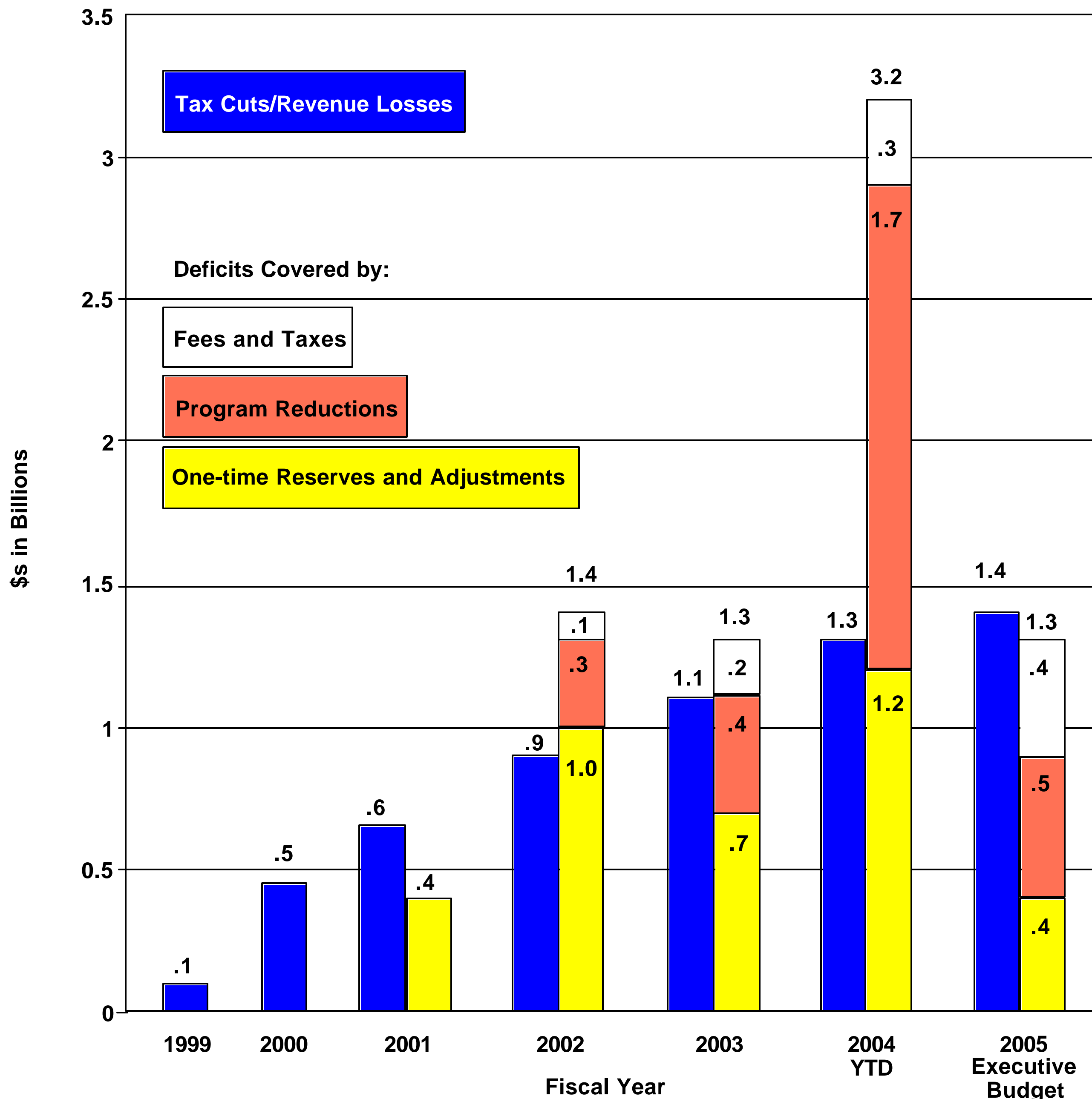
Charts I and II detail state general fund revenue losses associated with multi-year tax reductions beginning in FY 1999, actual and projected general fund deficits from FY 2001 through FY 2005, and the actions taken or proposed to date to address those deficits. As a weakening economy and multi-year tax reductions combined to produce structural deficits beginning in FY 2001, the state initially relied on fiscal reserves to minimize the need for program reductions and/or revenue enhancements. By FY 2004, however, rapidly rising deficits and dwindling reserves resulted in the institution of program reductions equivalent to approximately 10 percent of baseline state costs. Recent revenue and expenditure trends suggest that the deficit forecasts reflected below for FY 2004 and FY 2005 are probably understated by at least $200 million per year and that Medicaid, Corrections and K-12 Education costs are likely to exceed projected revenue growth by over $250 million per year for the foreseeable future.

Chart I

Revenue Reductions Associated With Multi-year Tax Cuts Compared to Michigan's Annual Deficits



Note: The columns in black reflect the loss of state revenues associated with annual tax policy changes. The second set of columns reflect the total state deficit in billions of $s and the actions taken (reserve withdrawls, program reductions and tax and fee increases) to address the identified deficits.

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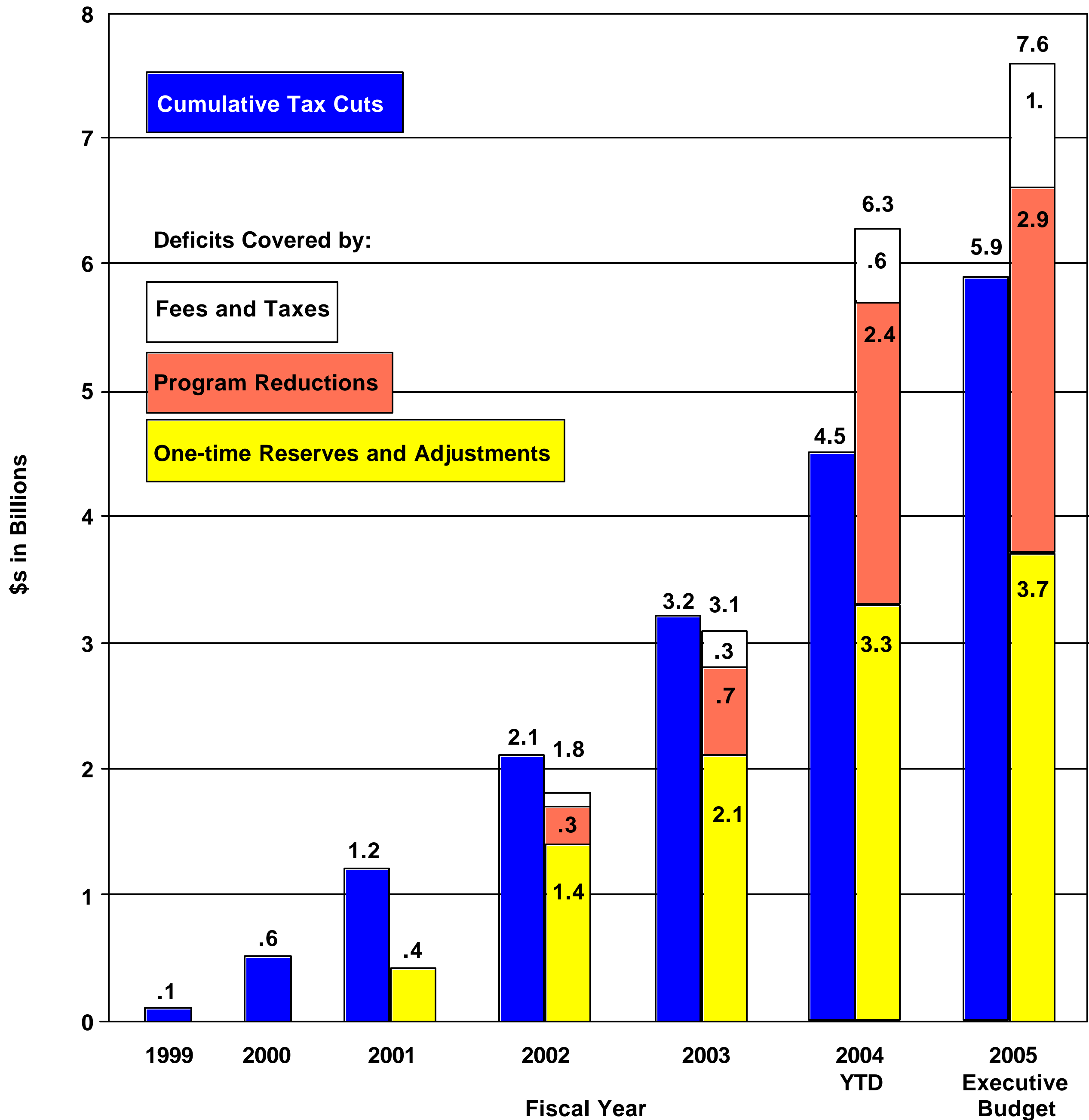
As the following chart indicates, there is a strong correlation between the cumulative loss of revenues associated with multi-year reductions in Michigan's personal income, single business and estate taxes, and the cumulative value of the state's deficits over this period. While the economic downturn and subsequent jobless recovery exacerbated the problem, revenue reductions associated with these multi-year initiatives equate to over 77 percent ($5.9 billion) of the combined $7.6 billion General Fund and School Aid deficits incurred or projected through FY 2005.

Chart II

Michigan's Cumulative Multi-year Tax Cuts Compared to Cumulative State Deficits



Note: The columns in black reflect the cumulative loss of state revenues associated with tax policy changes for FY 1999 through projected FY 2005. The second set of columns reflect cumulative state defcits beginning in FY 2002 and the actions instituted (reserve withdrawls, program reductions and tax and fee increases) to address these deficits.

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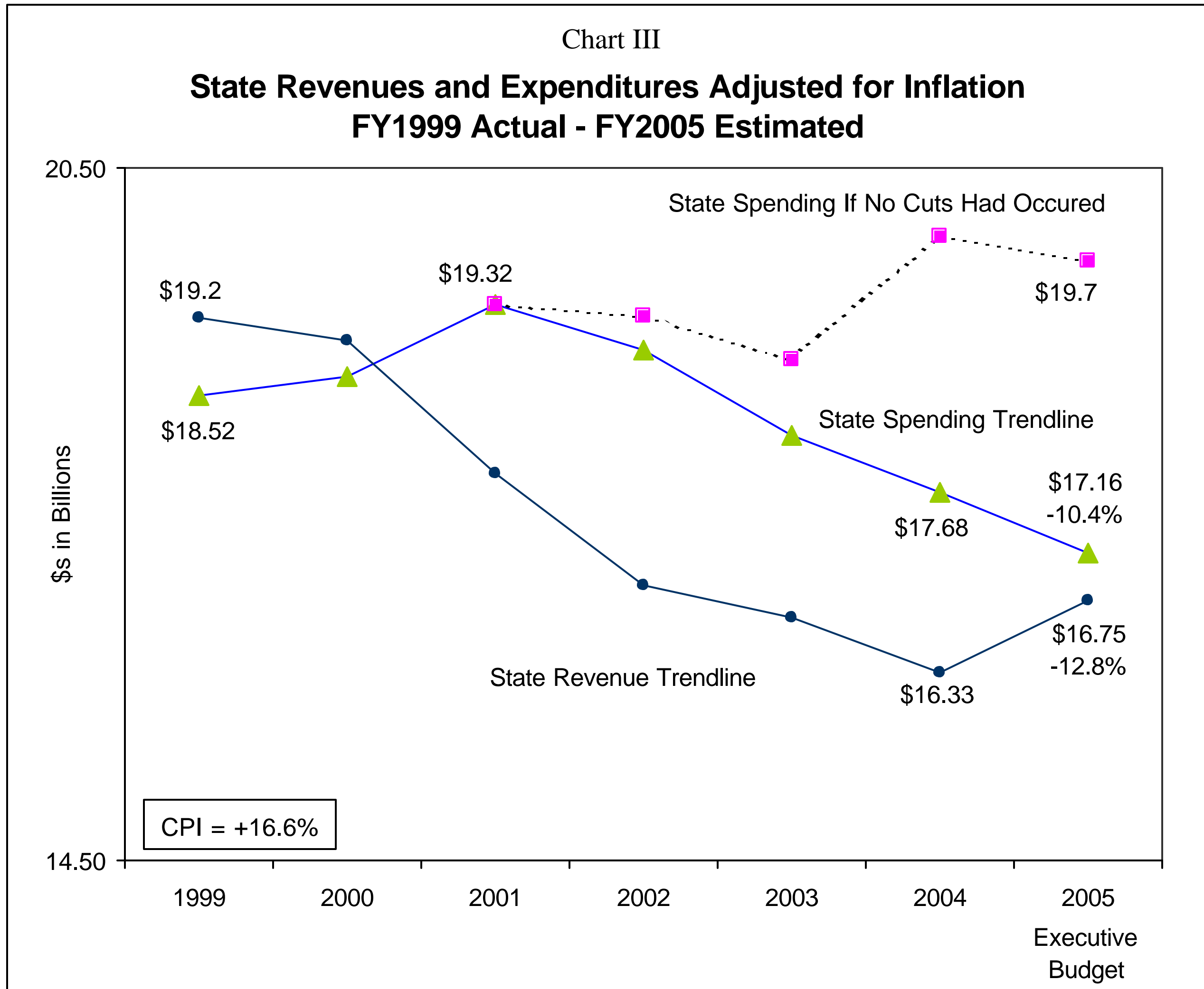

As chart III notes, adoption of the proposed FY 2005 Executive Budget recommendation would authorize state spending at a level 10.4 percent below the $19.32 billion expended in FY 2001 and 12.2 percent below the $19.7 billion (see dotted line) required to fund state programs at a continuation level, had program cuts not been instituted beginning in FY 2002. Unfortunately, as this table also notes, state revenues through FY 2004 continued to decline at roughly the same rate. As a result, Michigan's current state spending will exceed projected state revenues by approximately $1.35 billion on an annual basis.

In an effort to resolve this deficit, the Governor has recommended a 2.9 percent reduction in real (inflation adjusted) spending and a 2.5 percent real increase in revenues for FY 2005, together with a variety of accounting adjustments and one-time measures. If adopted as proposed, however, these recommendations would result in a residual structural deficit of at least $400 million. ***Alternatively, if the entire FY 2005 structural deficit were addressed through program reductions, it would require the equivalent of a 9 percent cut in all state funded programs effective 10/1/2005, bringing the total value of cuts instituted since FY 2002 to approximately 20 percent.*** Given that a large share of state spending is mandated in association with such federal programs as Medicaid and Transitional Assistance to Needy Families (TANF), it appears likely that funding for optional services and revenue sharing payments to local units of government would have to be severely cut or eliminated altogether to reduce state spending by such a significant percentage.

Table I

Change in State Spending From FY2001 Actual Through FY2005 Executive Budget Proposed

	$ Change in Billions (Adjusted for Inflation)	**Percentage Change**
Community Health/Medicaid	*$0.28*	*11%*
Corrections	*-0.03*	*-2%*
K-12 Education	*-$0.88*	*-8%*
FIA (Social Services)	*-$0.21*	*-17%*
All Other Departments	*-$1.14*	*-28%*
Revenue Sharing/Local Units	*-$0.35*	*-22%*
Total	***-2.33***	***-10.4%***

Note: Reductions currently under consideration to address a recently identified $263 million deficit for FY2004 have not been reflected in the spending cuts noted above.

Table I reflects the real (inflation adjusted) change in spending by department since FY 2001 assuming adoption of the FY 2005 Executive Budget. While program spending over this period is projected to decline by over 10 percent, general fund revenue available to support state programs has declined by over 22 percent since its peak in the early 1990s (by over 38 percent when measured as a share of Michigan's total personal income), with additional personal income and estate tax reductions yet to be implemented. This very dramatic revenue decline, together with continuing double digit growth in health care costs for Michigan's low-income families and employees, suggests that the budget deficits and program cuts of recent years will continue well into the future. This relatively bleak forecast will worsen significantly if Michigan's Single Business Tax, which currently provides approximately 25 percent of Michigan's projected $8 billion annual general fund revenue, is permitted to sunset as scheduled in FY 2009. This prospect, together with the increasing likelihood that Michigan will face the next economic downturn with a zero cash balance in its Budget Stabilization Fund, suggests that budget deficits and program cuts to date may be a modest preview of the state's fiscal future.

Michigan is clearly at a fiscal crossroad. Decision makers can choose to modernize the state's tax code to provide adequate and stable revenues to fund the programs and services that have contributed greatly to Michigan's reputation as a quality place to live and work, or they can choose the path taken by other states whose citizens clearly have a lower quality of life, thereby assuring significant additional cuts to higher education, medical and social services for Michigan's most vulnerable children and adults, and dramatic cuts in revenue sharing payments to local units of government having primary responsibility for fire and police protection as well as other essential public services. Ignoring the history of the last five years, and the clear indicators of fiscal distress ahead, would be an unfortunate choice to forego needed fiscal reform in favor of reductions in critical programs and services.

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