Michigan League for Human Services

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Michigan's Structural Budget Deficit: A Brief History and a Troubling Future

As Michigan begins a new fiscal year with a budget reflecting over $1 billion in significant program reductions in higher and adult education, Medicaid and numerous other programs, a newly identified $1 billion problem confirms that the state's fiscal problems have not abated. While a lagging economy contributed to the state's fiscal crisis, the following analysis indicates that the decisions of Michigan's fiscal policymakers were primarily responsible for a precipitous decline in revenues during what has been recognized as a relatively mild recession. With Michigan's reserves now fully exhausted, failure to first stabilize, and then grow the state's free falling revenues is clearly a prescription for disaster, both in the short-term, as Medicaid costs continue to rise at double digit rates and programs and staffing are repeatedly slashed, and in the long-term as the negative impact of the next inevitable business cycle downturn on state revenues becomes evident.

Recent History and Critical Decisions

As fiscal year 1999 came to a close, Michigan enjoyed the benefits of seven consecutive years of economic and state revenue growth. Over that period, in recognition that revenues were growing far faster than liabilities, the state instituted a series of over a dozen tax reductions while contributing $1.2 billion to its Budget Stabilization ("Rainy Day") Fund. Because the state's fiscal condition and future appeared so bright, it enjoyed one of the highest bond ratings in the country and was identified by the Center on Budget and Policy Priorities, a well respected Washington, D.C. fiscal policy think-tank, as one of only eight states in a position to comfortably weather a fiscal downturn of moderate proportions. It was at that point that the decision was made by Michigan policymakers to pursue tax reductions intended to continue well into the 21st century. Over the course of a few weeks the administration proposed, and the legislature adopted, two multi-year tax reduction packages that wiuldsteadily reduce state revenues as a percentage of household and business income over the next twenty-three years.

The proposal with the most immediate effect on state revenues involved the annual reduction of Michigan's personal income tax rate from 4.4 percent to 3.9 percent in .1 percent increments beginning on January 1, 2000. Subsequently it was decided to accelerate the plan by reducing the calendar 2000 rate by .2 percent, the combined value of the originally scheduled 2000 and 2001 cuts, while leaving the schedule for subsequent reductions in place. The initial .2 percent cut reduced General Fund revenues for FY2000 by $247.1 million, with the annual impact expected to increase to approximately $800 million when fully implemented in FY2005.

The second tax policy change, made retroactive to January 1, 1999 involved the phase-out of the state's 2.3 percent Single Business Tax (SBT) at the rate of .1 percent per year with the expectation that at some future unspecified date, Michigan would institute a modified business tax. Each .1 percent reduction in the SBT was expected to reduce state revenues by an amount marginally greater than $100 million per year.

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In May 2000, when the Center on Budget and Policy Priorities (CBPP) again issued its annual review of state fiscal conditions, Michigan's financial status was judged to be structurally insecure due to the significant loss of revenues over an extended period and the economic uncertainties that accompany such long-range policy planning. The Center's report also indicated that the implementation of multi-year tax reductions in the face of a moderate downturn would quickly exhaust Michigan's Budget Stabilization Fund and result in a budget deficit approaching $1 billion if the downturn lasted for three years.

Unfortunately the Center on Budget's prediction regarding the impact of a moderate recession on Michigan's state budget and operations was put to an immediate test and, if anything, proved some-what optimistic. After three years of declining revenues and significant program reductions, Michigan began the FY2004 budget development process with a revenue shortfall estimated at $1.7 billion and exhausted reserves. Michigan found itself in this fiscal crisis despite numerous actions including:

- Issuing Executive Orders in FY2002 and FY2003 reducing program expenditures and revenue sharing by $656 million;
- Expending approximately $2 billion in Budget Stabilization and Medicaid Trust Fund reserves;
- Receiving approximately $1 billion in previously unanticipated Tobacco Settlement funds;
- Increasing its reliance on the sale of bonds to finance capital projects ($211.2 million);
- Accelerating state education tax collections ($454.7 million);
- Freezing the roll-back of the Single Business Tax in FY2003 and
- Reducing state staffing by approximately 10 percent (6,000 positions at an estimated annual general fund savings of $181 million).

Further declines in revenues, exacerbated by the effects of federal tax reductions and the phase-out of the federal estate tax to which state taxes are linked, increased the projected revenue shortfall to $2.17 billion prior to the adoption of the FY2004 budget in July 2003.

To resolve this shortfall in the FY2004 budget Michigan's decision-makers:

- Approved $1.05 billion in program reductions;
- Reduced payments to local units of government by $245.4 million;
- Utilized $337 million in one-time federal fiscal relief;
- Increased a variety of fees and fines by approximately $97 million;
- Closed tax "loopholes" related to casino winnings and homestead property tax credits worth approximately $25 million;
- Instituted a new lottery game expected to net $50 million per year;
- Instituted state contract reductions expected to save approximately $11 million;
- Adopted a series of refinancing and reserve adjustments intended to provide one-time revenues totaling $149.1 million and
- Assumed $214.4 million in prior year carry-forward funds would be available to for use in FY2004.

Since the adoption of the FY2004 budget in July, revenue collections have fallen significantly below forecast levels, resulting in the convening of a special Consensus Revenue Forecasting Conference on October 14, 2003. At that meeting, representatives from the House and Senate Fiscal Agencies and the Michigan Department of Treasury agreed to a revised revenue forecast that identified a combined General Fund and School Aid Fund deficit of over $800 million. This revenue shortfall, together with recent indications that Medicaid costs will exceed budgeted levels by approximately $200 million, suggests a current deficit of approximately $1 billion.

Together with the $2.17 billion shortfall addressed in the budget adopted in July, the total FY2004 deficit represents over 15 percent of the combined General and School Aid budget. This massive shortfall materialized over a year after the end of the relatively mild recession of 2001 - 2002. Having just cut state programming by $1 billion in July and by approximately $2 billion since FY2002, the legislature and the governor must confront yet another fiscal crisis with few easy options and no fiscal reserves at their disposal.

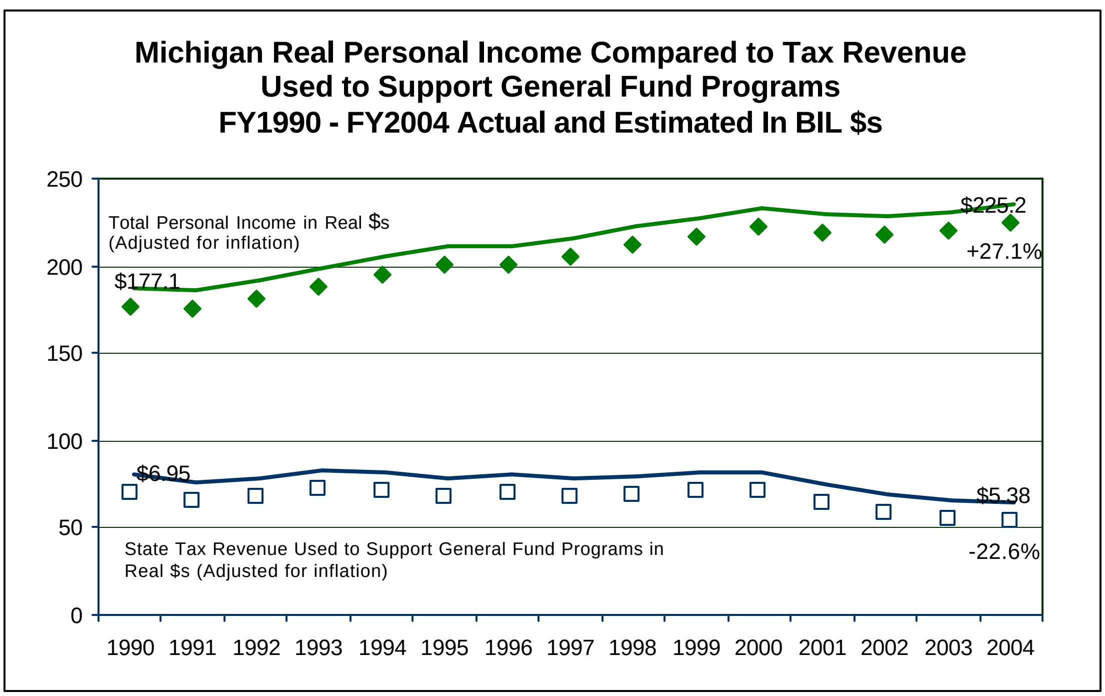
Where Has All The Money Gone?

The following table reflects actual (nominal) and inflation adjusted (real) General Fund tax revenues for the period 1999 (base year) through 2002 with current estimates for 2003 and 2004 in billions of dollars.

	Nominal Revenues (Actual Dollars)	Real Revenues (Inflation Adjusted)	Real Revenue Change From 1999 Base
1999	$9.50	$9.50	Base Year
2000	$9.79	$9.48	-$.02
2001	$8.99	$8.44	-$1.06
2002	$8.43	$7.80	-$1.70
2003	$7.89 (est.)	$7.14 (est.)	-$2.36 (est.)
2004	$7.79 (est.)	$6.88 (est.)	-$2.62 (est.)
Cumulative Loss of General Fund Revenue from 1999 Base			**-$7.76 Billion**

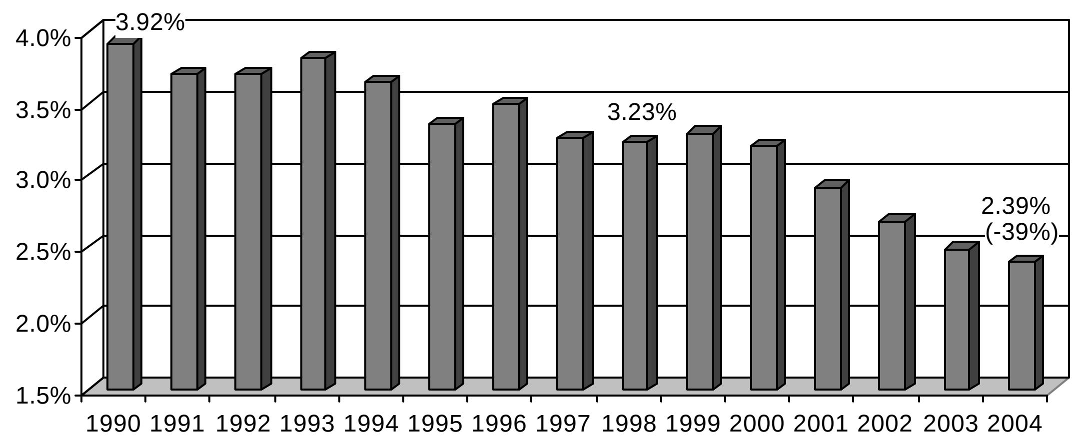
While a portion of the decline cited above was attributable to the 2001-2002 recession, it should be noted that revenues have continued to fall well after the recession's official end and the exhaustion of the state's fiscal reserves. While revenues are currently forecast to grow at an annual rate of approximately 4 percent beginning in the spring of 2004, growth will continue to be suppressed by the effects of phased-in state and federal tax reductions over the next several years.

The following tables, taken from a recently published League analysis entitled *Michigan's Fiscal Crisis: An Analysis of General Fund Tax Revenue and Personal Income Trends*, (the full report is available on the League's website at www.mlhs.org) provide useful perspective regarding tax revenue and rate trends in Michigan. The first table indicates that over a fifteen year period from 1990 through 2004, Michigan's total personal income adjusted for inflation is projected to rise by over 27 percent, while general fund revenue adjusted for inflation is expected to decline by more than 22 percent.



Looking at general fund revenues as a percentage of personal income, the second table indicates that the tax rate over the same period is projected to decline by a relatively dramatic 39 percent from 3.92 percent to 2.39 percent. Had tax rates remained unchanged over this period, state general fund revenues for FY2004 would have been approximately $13 billion, over $5 billion more than currently forecast.

Michigan Tax Revenues Used to Support General Fund Programs as a Percentage of Total State 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.

This suggests that, had tax reduction efforts over the period been marginally less aggressive, reducing taxes as a percentage of income by 26 percent versus the 39 percent actually implemented, the deficits of FY2001 - 2003 which drained Michigan's Budget Stabilization Fund would instead have been surpluses, permitting the Budget Stabilization Fund to grow in preparation for a significant downturn. It would also have significantly reduced the size of the FY2004 and FY2005 deficits currently estimated at over $4.6 billion.

Fiscal Year 2005 and Beyond

While the administration has begun its review of the Current Services Baseline documents submitted by the various departments in an effort to determine the size of the structural deficit for FY2005, official numbers will not be agreed upon until the next Consensus Revenue Forecasting Conference in January. It appears evident, however, that many of the one-time revenues used to close the $2.17 billion deficit identified in May will have to be replaced by revenue enhancements and/or program reductions in FY2005. The following table reflects the League's current estimate of the FY2005 structural deficit.

Estimated FY2005 Budget Base Shortfall

	$s in Millions
• Phase-out of Medicaid Special Financing	$135
• Projected Medicaid Inflation/Utilization Costs In Excess of Revenue Growth	$250
• FY2005 Impact of the Scheduled 1/2004 .1% Personal Income Tax Reduction	$40
• Decline in State Revenues Related to the Phase-out of the Federal Estate Tax	$27
• Reduction TANF Balances Available to Fund Rising FIP & Day Care Caseload	$50
• Loss of Reed Act Funding for the Department of Labor and Economic Growth	$50
• *Loss of Federal Fiscal Relief Used in the FY2004 Medicaid Budget Base**	*$168*
• *Projected Department of Corrections Population Increase*	*$60*
• *Projected Higher Education Inflation*	*$58*
• *Estimated Structural Deficit in the School Aid Fund*	*$17*
• *Estimated Additional General Fund Structural Deficit*	*$591*
• *Scheduled State Employee Pay Raise*	*$80*
• *Offset Due to Expected Increase In Medicaid Federal Match to 56.71%*	*-$60*
Total Projected FY2005 Budget Base Shortfall	**$1,466**

*Figures in italics reflect estimates taken from the Citizen's Research Council's *State Budget Notes*, October 2003.

A variable that could significantly affect the FY2005 projected structural deficit is the Medicaid inflation and utilization rate. If FY2004 Medicaid policy changes and an improving economy do not serve to reduce the double digit Medicaid cost increases experienced in recent years, Michigan's structural deficit could increase further. Similarly, rising public assistance caseloads and/or a reduced TANF block grant could push deficits upward. These variables, together with the possibility that the School Aid Fund structural deficit may increase if the projected 4 percent growth does not materialize, suggest that the risks related to the current FY2005 deficit forecast are probably on the up side.

An analysis just completed by the League entitled *Tax Cuts and Vanishing Revenue: Going, Going, Gone* (available on the League's website at www.MLHS.org), indicates that approximately $4.3 billion, 68 percent, of the $6.32 billion in revenue shortfalls experienced by Michigan in the period from FY2001 to FY2004 - can be directly attributed to the implementation of the Personal Income and Single Business tax reductions adopted by the legislature and approved by the Governor in 1999. The analysis also indicates that a third multi-year tax reduction, the phase-out of the federal Estate Tax by FY2009, reduced revenues through FY2004 by an additional $247 million, or 3.9 percent. ***The League's analysis also notes that virtually the entire $1.46 billion deficit projected for FY2005 is attributable to revenue losses directly related to these three multi-year tax reductions.***

Pending federal and state legislation could exacerbate Michigan's mounting revenue problems. Currently before Congress is a bill that would eliminate taxes on telecommunications services. Also under consideration at the state level is the exclusion of health insurance premiums from the taxable income of businesses under the Single Business Tax. The League estimates that the adoption of these measures would reduce Michigan's annual revenues by $315 million and $126 million respectively. The already scheduled phase-out of the state credit related to the federal estate tax is estimated to reduce annual state revenues by an additional $106 million by FY2007. The elimination of Michigan's Single Business Tax, currently scheduled for FY2009, is estimated to further reduce state General Fund revenue by $1.9 billion or 24.4 percent of the $7.78 billion currently forecast for FY2004.

On the other side of the equation, state economists currently project revenue growth in the near term of approximately 4 percent. While this is slightly above their projections related to growth in the over-all Consumer Price Index (cost of living measure), it is well below the anticipated inflation rate for services currently provided by the state. The inflation rate for medical services and health insurance, for example, has exceeded 10 percent for the last several years. Currently over one-third of the state's General Fund is expended in relation to these exploding costs. Taken together, the trend in state revenues and costs suggests that Michigan's current fiscal crisis will continue and potentially worsen.

In conclusion, it appears that the state's decision-makers either did not anticipate, or were willing to risk, the cumulative effects of multi-year tax reductions and an economic downturn. Now, however, a different set of decision makers must face a dramatically different fiscal reality. Spending reductions of the magnitude necessary to balance the budget in the near term would severely curtail the delivery of services throughout Michigan, and potentially compromise the health and safety of its citizens. The revenue loss stemming from enacted multi-year cuts, and the choices confronting current policymakers as a result, suggest that adopting measures that preserve revenue and avoid future revenue losses would begin to correct the current structural problem and provide the best protection against the adverse impacts of a serious recession in the future.
