State Budget Notes

2011-02 A publication of the Citizens Research Council of Michigan July 2011

The State of Michigan's New Fiscal Plan

In Brief

The recently enacted Fiscal Year 2012 (FY2012) state budget provides a marked change from the fiscal plans of recent years. The FY2012 budget does not rely on non-recurring revenue sources or delaying expenditures to achieve balance. Instead, it enacts significant appropriation reductions to bring ongoing expenditures in line with ongoing revenues. It begins to rebuild the state's long-depleted cash reserves. The state's new fiscal plan takes aim at growing long-term obligations by putting funding aside to pay for state retiree liabilities. The plan makes significant tax changes by lowering and simplifying business taxes and increasing individual income taxes. Finally, with the concentration of political power across the executive and legislative branches of state government, the budget was adopted in May, much earlier than in recent years. Entities that rely on state appropriations were given more time to plan for enactment of their own budgets.

Introduction

State policymakers began work on the FY2012 state budget in February. At that time, the General Fund portion of the budget faced an estimated $1.4 billion deficit largely created by the exhaustion of significant amounts of temporary budget resources. In addition to the budget problem, the state faced a sizeable major funds cash deficit created by years of over-spending available resources. Furthermore, the state had amassed significant long-term obligations, primarily unfunded retirement liabilities, because it failed to set aside the necessary resources when the obligations were incurred.

Against a backdrop of an improving state economy, the Governor and legislative leaders enacted a financial plan for the State of Michigan consisting of: 1) a revamped state tax structure, 2) a state budget that balances ongoing expenditures and resources mainly through appropriation reductions; 3) a down payment on future long-term obligations; and 4) a deposit in the state's rainy day fund. The plan contains significant elements of the Governor's proposed budget and tax proposals, but also incorporates features of legislative priorities. An improving outlook for state revenues released in May helped address the projected General Fund deficit identified in January and partially finance the net tax cut of the restructured tax plan.

Tax Changes Establish a Smaller Financial Base

The combination of business tax restructuring and individual income tax changes will create a new financial base for the state budget; one which will generate less revenue compared to current tax policy and one which shifts a greater portion of the overall state tax burden from those paying business taxes onto those paying the individual income tax. The budget will have to accommodate net tax cuts in FY2012 and FY2013, although an improving economic climate and the attendant state revenue growth will partially finance the tax cuts. The tax changes affect the General and School Aid Funds differently, which creates the need to make other budgetary adjustments to balance spending from these funds with the available earmarked revenues.

CITIZENS RESEARCH COUNCIL OF MICHIGAN

MAIN OFFICE 38777 West Six Mile Road, Suite 208 · Livonia, MI 48152-3974 · 734-542-8001 · Fax 734-542-8004

LANSING OFFICE 124 West Allegan, Suite 630 · Lansing, MI 48933-1738 · 517-485-9444 · Fax 517-485-0423

CRCMICH.ORG

A New Business Tax, But a Much Smaller Burden

The cornerstone of the business tax restructuring is the elimination of the Michigan Business Tax (MBT), a $2.0 billion revenue source to the General Fund and School Aid Fund budgets. The nascent MBT and its tax surcharge were enacted in 2007 to replace, dollar for dollar, the revenues generated by the Single Business Tax, certain personal property taxes, and the short-lived tax on services. Unlike in 2007, however, the 2011 iteration of business tax reform did not endeavor to be revenue-neutral, but instead provides a substantial net business tax cut.

To replace some of the lost MBT revenue, a new six percent corporate income tax is established that will take effect on January 1, 2012; however, a good portion of the revenue from this tax will be eaten up by the provisions to honor existing, firm-specific tax credits issued before the effective date of the new corporate tax under the MBT. These credits are estimated to total nearly $300 million in FY2012 and grow to $500 million in FY2013. The new corporate income tax is void of the myriad credits that populated the MBT, with the exception of a single small business credit.

The net business tax cut will reduce state revenues by $1.1 billion in FY2012 and $1.7 billion in FY2013 when all pieces are fully phased-in. **Table 1** provides a summary of the individual pieces by major fund for each year. The School Aid Fund shoulders most of the net tax cut burden over the combined two-year period, and it must finance 70 percent ($758 million) of the net tax cut in FY2012.

Rate Freeze and Expanding the Base of the Income Tax

A complex and varied mix of changes to Michigan's personal income tax offsets some of the fiscal effects to the state of direct business tax cuts. The income tax changes will increase tax collections primarily by modifying, limiting, and eliminating certain tax exemptions and credits. Also, the planned 0.1 percentage point reduction in the tax rate is postponed 15 months from October 1, 2011, to January 1, 2013, and all other future planned rate reductions are eliminated by freezing the rate at 4.25 percent.

The single largest component of the change involves modifying the income tax exemptions for pub-

Table 1
Michigan Business Tax Changes
(Dollars in Millions)

	FY2012			FY2013		
	General Fund	School Aid Fund	Total	General Fund	School Aid Fund	Total
MBT changes (net)	($504)	($758)	($1,262)	($1,215)	($777)	($1,991)
Corporate income tax	433	0	433	799	0	799
Financial institutions tax	28	0	28	44	0	44
Outstanding credits	(293)	0	(293)	(500)	0	(500)
Total	**($337)**	**($758)**	**($1,094)**	**($871)**	**($777)**	**($1,648)**

Source: House and Senate Fiscal Agencies

CRC Board of Directors
EUGENE A. GARGARO, Jr., Chair
JEFFREY D. BERGERON, Vice Chair
NICK A. KHOURI, Treasurer
JOSEPH R. ANGILERI
MICHAEL G. BICKERS
BETH CHAPPELL
RICK DIBARTOLOMEO
TERENCE M. DONNELLY
RANDALL W. EBERTS
DAVID O. EGNER
LAURA FOURNIER
JOHN J. GASPAROVIC
INGRID A. GREGG
MARYBETH S. HOWE
DANIEL T. LIS
SARAH L. MCCLELLAND
ALEKSANDRA A. MIZIOLEK
CATHLEEN H. NASH
PAUL OBERMEYER
KEVIN PROKOP
LYNDA ROSSI
JERRY E. RUSH
MICHAEL A. SEMANCO
TERENCE A. THOMAS, Sr.
AMANDA VAN DUSEN
KENT J. VANA
JEFFREY P. GUILFOYLE, President

Will the Tax Plan Improve Economic Growth?

Michigan enacted significant tax changes as part of its fiscal plan. The tax changes involved an overall net tax cut, and a significant shift in the overall tax burden from businesses towards individuals. While policymakers cited a number of goals as part of these reforms, the overriding goal of the tax changes was to improve economic growth, and with it, employment.

Some elements of the tax changes will improve economic growth and some will hurt economic growth. These elements are briefly summarized below:

Positive Impacts

Net business tax cut: The tax plan replaces the Michigan Business Tax with a corporate income tax. When fully phased-in, the corporate tax will raise approximately $2 billion less than the MBT. The reduction in business taxes will increase the rate of return on investment which will created incentives for more investments, a positive for economic growth.

Reputation Effects: The new corporate tax places a significantly lower burden on businesses. In addition, the tax is significantly simpler. These changes should improve Michigan's reputation in the business community, a positive for economic growth.

Negative Impacts

Income Tax Increases: The higher income tax collections (totaling $1.4 billion) will reduce disposable income for Michigan taxpayers. Lower disposable income will result in reduced consumption, a net negative for economic growth.

Budget Cuts: On net, the combined business and income tax changes represent a $224 million tax cut. Lower revenues will reduce government spending. Lower government spending will result in lower income for Michigan residents, either through less being paid to public employees, or less income earned by the owners and employees of firms that do business with the government, a negative for economic growth.

Loss of Personal Property Tax Credits: The business tax cuts will result in lower taxes for most Michigan firms. However, some firms will pay more under the new tax. In particular, due to the repeal of the personal property credits that were part of the MBT, large multi-state companies that have a significant amount of personal property in Michigan, but a relatively small share of sales occurring in the state, will likely pay more. These higher taxes reduce the incentive for these firms to invest in Michigan, a negative for economic growth.

Other: Some of the business tax relief will go to out-of-state firms that sell in Michigan but have very little production here. The tax relief provided to out-of-state firms is unlikely to spur Michigan economic growth. By contrast, almost all of the negative impact of the individual income tax increases will be concentrated among Michigan residents. Therefore, even if the positive impact of lower business tax is greater than the negative impact of higher income taxes, this positive will be offset in part by the fact that the income tax increases are concentrated in Michigan while the business tax relief is more dispersed.

Net Impact of Changes

The tax reforms enacted in 2011 have positives and negatives for economic growth. Because these positives and negatives cannot be easily quantified, it is difficult to determine whether the changes will be a net positive or negative for economic growth. However, because of the offsetting nature of these effects, any overall effect on growth, positive or negative, is likely to be small.

lic and private pensions by creating a three-tiered exemption based on a taxpayer's age. Currently, all public pension/retirement income and significant portions of private pension/retirement income are exempt from the income tax. Another major tax base change is the phase-out of the personal exemption for higher income taxpayers. Other noteworthy changes to existing tax credits involve reductions in the Earned Income Tax Credit and Homestead Property Tax Credit.

Overall, the income tax changes will increase revenues by an estimated $559 million in FY2012 and $1.4 billion in FY2013, resulting in a net tax cut of $535 million in FY2012 and $224 million in FY2013 after accounting for the business tax changes (**Table 2** on page 4). Again, because of statutory earmarking provisions, the effects on the two major funds are different. At the fund level, the combination of the business and income tax changes add resources to the General Fund but decrease School Aid Fund revenues. The state spending plan had to accommodate these changes.

Table 2
Overall Tax Changes
(Dollars in Millions)

	FY2012			FY2013		
	General Fund	School Aid Fund	Total	General Fund	School Aid Fund	Total
Business tax changes	($337)	($758)	($1,094)	($871)	($777)	($1,648)
Income tax changes	492	68	559	1,309	115	1,424
Total	**$155**	**($690)**	**($535)**	**$438**	**($662)**	**($224)**

Source: House and Senate Fiscal Agencies

Constitutionality of Certain Income Tax Changes

The taxation of public pension income has been long thought to violate Article IX, Section 24 of the 1963 Constitution. This section prohibits the "accrued financial benefits of each pension plan and retirement system of the state" from being "diminished or impaired." The Constitution does not provide the same protection to private pension income. Private pension/retirement income has been subject to various degrees of income taxation over the years and currently enjoys substantial exemptions.

Because of the financial significance of various pension-related income tax changes included in Public Act 38 of 2011, Governor Snyder has asked the Supreme Court to opine on the constitutionality of these provisions under the authority granted to him by the Constitution.[1] Specifically, the Governor has asked whether the taxation of public pension income violates Article IX, Section 24. He also asked whether the exemptions for all pension incomes (public and private) violate the contract protection language of Article I, Section 10. The income tax changes involving the treatment of pension/retirement income are expected to generate $225 million for the FY2012 budget and about 25 percent ($56 million) of the total amount is attributable to public pension/retirement income.

It is noteworthy that the question involving Article IX, Section 24 was partially addressed in a 1991 Attorney General opinion (OAG #6697). The Attorney General found that the state could limit or repeal the tax exemption of public pension income if it provided equal or greater benefits in exchange for the taxation of benefits; however, the opinion left unanswered the question of whether the taxation could occur without replacement benefits. This question was still being researched at the time of the opinion and the Attorney General has not answered the question to date.

Similarly, Governor Snyder has asked for a ruling on the changes involving the personal exemption and whether the provisions that use age and/or income criterion to phase-out the exemption violate the constitutional prohibition against graduated income taxes (Article IX, Section 7). It is thought that such exemptions have the practical effect of graduating the base of the personal income tax. The personal exemption changes are estimated to generate $55 million.

The Michigan Supreme Court will hear arguments on the questions raised by Governor Snyder on September 7, 2011. The resolution of the legal questions surrounding the income tax changes could have a significant revenue impact on the state's fiscal plan and could require policymakers to find alternative revenues or enact further appropriation reductions to maintain budget balance.

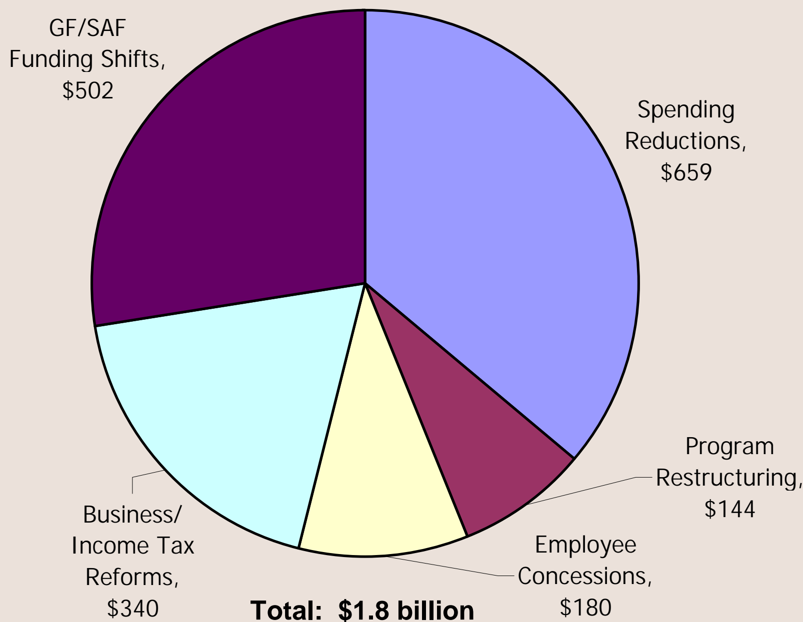
[1] Article III, Section 8 of the Michigan Constitution allows either chamber of the legislature or the governor to request the Supreme Court to issue an opinion about the constitutionality of legislation after it has been enacted, but before it takes effect.

The FY2012 Spending Plan

Governor Snyder presented his FY2012 spending proposal to the legislature in February. His recommendation relied on a host of solutions to close the estimated $1.4 billion General Fund budget gap. His plan overshot the gap by nearly $400 million by proposing solutions totaling $1.8 billion (**Chart 1**). Of the excess, $260 million was designated for newly-identified appropriations, the largest piece being a $200 million down payment on state retiree health care costs. In terms of major solutions, the largest piece involved state expenditure cuts – including a 15 percent reduction to university funding. Another major component involved using the School Aid Fund to finance appropriations traditionally financed by the General Fund. Because of the statutory earmarking provisions associated with some tax revenues, the proposed tax restructuring plan also helped with the General Fund deficit (described above). A number of these solutions, while helping balance the General Fund budget, had the opposite effect on the School Aid Fund budget.

In total, the Senate Fiscal Agency estimated that $1 billion in K-12 resources were either eliminated as part of the Governor's tax plan or used in his $1.8 billion General Fund budget solution. The Governor recommended substantial K-12 funding cuts to accommodate the $1 billion reduction, including a $470 per-pupil reduction to each district's foundation grant, which equated to a 6.4 percent reduction to the lowest foundation grant. The total effect of the Governor's School Aid Fund budget proposal on districts varied as many also lost categorical funding (reduced by $86 million in total) in addition to the $470 per-pupil cut.

Chart 1
Executive Budget: General Fund Deficit Solutions
(Dollars in Millions)



Source: Senate Fiscal Agency

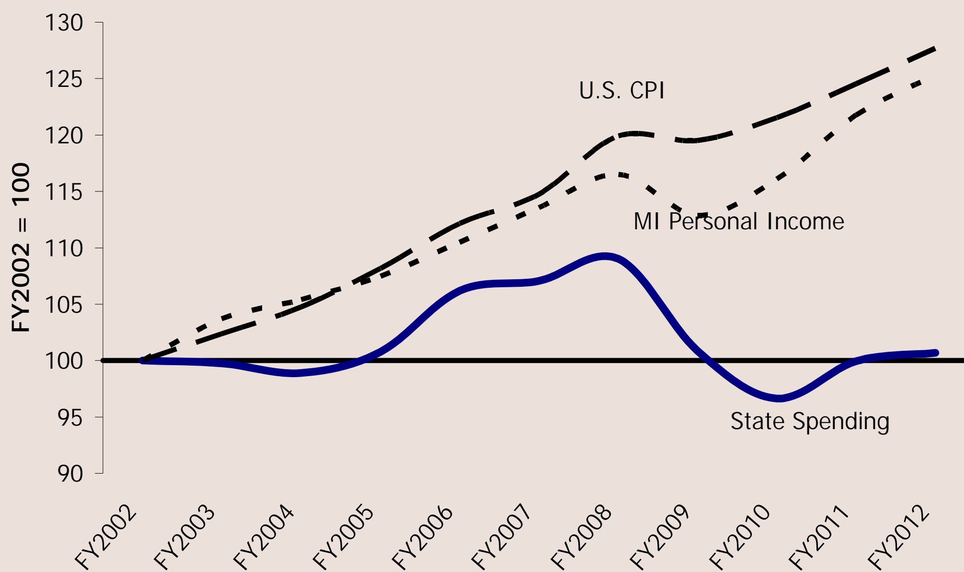
The Executive Budget contained specific elements unacceptable to one or both legislative chambers of the legislature. However, in terms of the major avenues to achieve balance in the General and School Aid Fund budgets, the final FY2012 spending plan is fundamentally the same document presented by the Governor in February and achieves balance through spending cuts and program restructurings. Significant among the modifications made to the Governor's plan are:

- *Tax restructuring.* Changes to the Governor's original tax plan resulted in a larger net tax cut, which reduced the net revenue gain to the General Fund (from $340 million to $155 million) and increased the net revenue loss to the School Aid Fund (from $594 million to $690 million). While the business tax components remained largely intact through the legislative process, some of the original income tax pieces were not enacted. The negative revenue effects of the compromise (approximately $280 million in

total) were offset by improving (relative to January estimates) state revenues coming out of the May consensus revenue estimate (almost $500 million). Without these additional resources, further appropriation reductions would have been necessary to finance the larger tax cut.

- *Higher education funding shift*. The Executive Budget originally planned to use almost $900 million from the School Aid Fund to fund universities and community colleges. The final budget reduced this amount to only $400 million (with the balance coming from the General Fund) and directed more School Aid Fund resources to K-12 spending; however, it retained the aggregate university spending cut of 15 percent originally proposed by the Governor and reduced appropriations to community colleges by 4.1 percent.
- *K-12 per-pupil cut*. The Senate proposed to reduce the across-the-board per-pupil cut to $340, while the House recommendation looked very similar to the Governor's. The final deal maintained the $470 per-pupil cut for all districts with the possibility that districts could reduce this cut by about $200 per-pupil; however, these additional funds are available only in FY2012 and only if districts meet state-mandated criteria intended to reduce spending pressures (discussed later).
- *Department of Corrections*. The Executive Budget basically held the line on the $1.9 billion General Fund corrections budget compared to the current-year. In contrast, the legislature called for substantial reductions in this major area. The final plan included a compromise reduction of $43 million from the FY2011 appropriation and $55 million below the Governor's proposal.
- *State employee concessions*. Under the Governor's proposal, $180 million in ongoing General Fund spending would have been pared from the compensation paid to state workers. This figure, while still significant, was reduced to $145 million in the final budget.

Chart 2
Growth in State Spending from State Sources



Source: Senate and House Fiscal Agencies

Table 3
State Spending from State Sources
(Dollars in Millions)

	FY2002	FY2011	FY2012	2002 to 2012 Dollar Change	2002 to 2012 Percent Change
Community Health	$3,066	$4,273	$4,901	$1,835	60%
Corrections	1,653	1,998	1,927	274	17%
Human Services	1,230	985	1,155	(75)	(6%)
K-12 Education	11,221	10,956	10,550	(671)	(6%)
Universities	1,941	1,574	1,264	(677)	(35%)
Community Colleges	320	296	284	(36)	(11%)
State Revenue Sharing	1,517	1,059	959	(558)	(37%)
All Other	5,139	4,934	5,219	80	2%
Total	**$26,087**	**$26,075**	**$26,259**	**172**	**1%**
US CPI (fiscal year basis)	178.9	222.8	228.4		28%

Source: Senate and House Fiscal Agencies

The final FY2012 General Fund appropriations total $8,274 million, which is $37 million less than FY2011 appropriations but $144 million more than the Governor's recommendation. These ongoing appropriations are supplemented with $457 million in one-time appropriations for FY2012, including a $256 million deposit in the state's rainy day fund (discussed later). The combination of ongoing and one-time appropriations brings the total FY2012 General Fund outlay to $8,731 million, $420 million more than the current year amount.

Spending Priorities

The new budget does not contain any major shifts in state spending priorities, although it does reflect a couple of minor changes.[2] Aggregate spending growth continues its post-recession upward trend, but at a slightly lower rate in FY2012. The new fiscal plan continues the long-term trends of increased spending for the Department of Community Health (including the Medicaid program) and decreased spending for education programs, both elementary and post-secondary, and local government revenue sharing. The budget reverses the long-term growth trend in the Department of Corrections spending by reducing year-over-year General Fund appropriations by 2.2 percent.

Since FY2002, growth in aggregate spending from state sources has trailed growth in state personal income and inflation (U.S. CPI) (**Chart 2** on page 6). Coming out of the national recession when spending dropped in FY2009 and FY2010, the new fiscal plan builds upon the modest FY2011 increase (3.4 percent). State spending rises very slightly (0.7 percent in FY2012), well below the estimated annual growth in personal income and inflation for the coming period of 2.9 percent and 2.5 percent, respectively.

Table 3 provides a picture of the recent spending patterns by major area and compares the experience of the past ten years with the FY2012 plan. Again, few major changes are detected when amounts for FY2002 are compared with current-year appropriations. Many long-term spending trends are continued in FY2012. Funding for the Department of Community Health con-

[2] State spending includes spending from both the general purpose and the special purpose accounts of the General Fund. Including both accounts provides a comprehensive picture of state spending from own-source revenues (all taxes, fees, and charges).

tinues to demand greater amounts of state resources, while spending for education programs (K-12 and all levels of higher education) has experienced reductions. Since FY2002, the share of spending devoted to the Department of Community Health has increased from 12 percent to 19 percent, while the share allocated to K-12 spending (largest category by far) decreased from 43 percent to 40 percent. Combined state spending for universities and community colleges decreased from 9 percent of the total in FY2002 to 6 percent of the total in FY2012.

Michigan policymakers continue to divert state resources previously shared with local governments to meet other state budget needs. The FY2012 spending plan will reduce ongoing general revenue sharing to local governments by $100 million from FY2011 amounts. Whereas this component accounted for 6 percent of state spending in FY2002, in FY2012 it will be less than 4 percent.

Corrections spending, which accounted for 6 percent of all spending in FY2002, rose to 8 percent of the total in FY2011. The share allocated to corrections will fall to just over 7 percent in FY2012 as a result of the modest funding reductions adopted. Spending growth on corrections, driven largely by incarceration policy decisions, has been a key contributor to Michigan's structural deficit problems throughout the 2000s. The savings identified for FY2012 are not the result of a change in incarceration policy, but rather they are borne out of changes in prison operations and programming.

Michigan's New Fiscal Focus

When it comes to the state's fiscal health over the past ten years, state policymakers have been singularly focused on achieving and maintaining annual budget balance in the General and School Aid Funds. As Michigan endured a prolonged single-state recession, the challenges associated with meeting constitutionally-required balanced budget provisions seemed to escalate each year. Considerable time and effort was devoted to this single objective. During this period, very little attention was given to addressing the long-term structural problems plaguing the budget. Even after enacting the individual and business tax increases of 2007, structural problems remained. In recent years, the fundamental problems received little attention as sizeable amounts of temporary federal funding effectively papered over the underlying mismatch between ongoing state spending and ongoing revenues. Making matters worse, many of the budget actions employed over the last decade came at the expense of the state's basic financial well-being, including its cash position.

Use of Nonrecurring Budget Resources

The General and School Aid Fund structural imbalances since FY2001 were able to linger because sufficient permanent spending reductions and/or revenue increases were not enacted. In the absence of these permanent fixes, state budget writers employed various temporary or nonrecurring resources to achieve balance in the General and School Aid Fund budgets. Through FY2007, CRC estimates that the state had used nearly $8 billion in nonrecurring budget fixes; the majority of this total was used in the early 2000s. More recently, the General Fund and School Aid Fund budgets benefited from $4.4 billion in temporary federal stimulus funding spread over a three-year period (FY2009 through FY2011). While the use of these temporary budget fixes did not create the structural deficits in the two budgets, their use perpetuated the deficits and delayed permanent solutions.

The FY2012 budget does not use temporary measures to achieve ongoing balance in the General or School Aid Funds. Although the budget includes appropriations financed by nonrecurring resources, the appropriations are identified as being for FY2012 only (although some of the one-time K-12 appropriations support ongoing costs at the district level). The FY2012 budget treats nonrecurring resources fundamentally differently than the budgets of the past.

According to the Senate Fiscal Agency, both the General and School Aid Funds are projected to end the current year (FY2011) with sizeable positive balances. The FY2011 budget was originally based on revenue projections agreed to in May, 2010. Because of improvements in the U.S. and Michigan economies, state tax receipts are expected to exceed original projections. Based on these revenue estimates and after accounting for supplemental appropriations since the budget was enacted, the General and School Aid Funds are expected to end FY2011 with surpluses of $255 million and $646 million, respectively. These resources will carry forward into FY2012.

The entirety of the FY2011 General Fund surplus and over two-thirds of the School Aid Fund surplus is appropriated in the FY2012 budget to finance appropriations identified specifically as one-time in nature. For the General Fund, a total of $256 million is designated for deposit in the state's rainy day fund to help rebuild cash reserves (see below).

A total of $456 million of the projected FY2011 School Aid Fund surplus (70 percent of total) is appropriated in the FY2012 budget. Two-thirds ($299 million) is intended to0 provide temporary relief for the operating cost increases facing school districts and help absorb a portion of the $470 per-pupil foundation reduction included in the budget. While the total figure amounts to $200 per pupil statewide, the amount that each district will receive will vary based on the "strings" tied to each pot of funding. Of the $299 million, $155 million will be distributed to districts to help them meet the required ongoing increase in employer contributions to the state-administered retirement system covering school personnel. The retirment contribution rate is scheduled to increase from 20.7 percent of payroll this year to 24.5 percent of payroll in FY2012, an average of $245 per pupil. Districts will share in this appropriation based on their share of the total statewide payroll base of the retirement system. On a per-pupil basis, amounts will vary widely among traditional public school districts, while most charter schools will not benefit because they do not participate in the retirement system. The contribution rate will rise again to 27.4 percent of payroll in FY2013, but this one-time money will not be available to help districts finance the added costs.

Table 4
Common Cash Fund
Year-End Balance
(Dollars in Millions)

Fiscal Year	Combined General Fund/ School Aid Fund	Budget Stabilization Fund	Other*	Total
2000	$1,631.6	$1,264.4	$1,966.1	$4,862.1
2001	1,091.5	994.2	1,782.5	3,868.2
2002	454.7	145.2	1,776.3	2,376.2
2003	(490.1)	0.0	1,915.8	1,425.7
2004	(897.6)	0.0	2,077.2	1,179.6
2005	(856.4)	2.0	1,873.3	1,018.9
2006	(1,300.5)	2.0	2,159.3	860.8
2007	(1,004.4)	2.1	2,396.9	1,394.6
2008	(616.6)	2.2	2,088.7	1,474.3
2009	(762.3)	2.2	1,843.8	1,083.7
2010	(373.7)	2.2	1,742.1	1,370.6

* Includes Special Revenue, Enterprise, Internal Service, Trust and Agency Funds

Source: Annual Report of the State Treasurer; Official Statements of the State of Michigan

Another $154 million will be distributed to districts (traditional public and charter schools), on a per-pupil basis, but only if they meet certain state-mandated criteria. Districts are eligible to receive a one-time payment of $100 per pupil if they meet four of five "financial best practices" by June 2012. The $299 million in one-time appropriations effectively allow schools to postpone, for one year only, the full impact of the ongoing $470 per-pupil operational cut built into the budget.

Finally, the budget sets aside in reserve $133 million to begin the process of transitioning from a defined benefit pension plan to a defined contribution plan for public school personnel. Few details accompanied this appropriation.

Rebuilding Cash Reserves

Cash is needed by state government to satisfy immediate obligations for the purchase of goods and services during the fiscal year. If a sufficient level of cash is not available to satisfy a liability of the General and School Aid Funds, borrowing from outside sources has to occur. As a result of a series of budget decisions, Michigan policymakers exhausted nearly $3 billion in built-up cash reserves within the state's major funds in the early years of the last decade.[3] Between FY2000 and FY2003, the state used $1.6 billion in combined General and School Aid Fund balances and $1.3 billion in Budget Stabilization Fund (BSF) reserves to finance ongoing operating expenses of the General and School Aid Funds and delay raising taxes or cutting expenses. Since FY2003 the combined year-end cash balance of the major funds has been negative, sinking to negative $1.3 billion in FY2006 (see **Table 4**). While the cash deficit picture has improved over the past seven years, it remained negative at the end of FY2010 ($370 million). The daily cash balances of these funds throughout each year, as well as the balances of other state funds with deposits in the Common Cash Fund, can vary substantially.

Without access to the reserves in these key funds, state government had to turn to other tools to help smooth out the timing differences between cash receipts and payments required from the General and School Aid Funds. A variety of approaches were used to cover these cash shortfalls, including borrowing from other state funds deposited in the state's Common Cash Fund, borrowing on the open market, changing the timing of payments, and changing the timing of receipts. The individual and business tax increases of 2007 helped to manage the major fund cash flow problems and partially explain some of the observed improvement. More recently, the availability of substantial amounts of temporary federal assistance (e.g., stimulus funding) helped ease the cash pinch and reduced the use of these other techniques to meet the monthly cash demands of the General and School Aid Funds.

The state incurs external and internal borrowing costs to manage the annual cash needs of the General and School Aid Funds; however, these costs have come down in recent years (see **Table 5**). When the state has access to major fund cash reserves, less borrowing (internal and/or external) is required, thereby reducing financing costs. Also, BSF reserves parked in the state's Common Cash Fund earn interest.

The FY2012 budget begins to rebuild previously-depleted cash reserves. The budget contains a scheduled $256 million General Fund appropriation to the BSF. Assuming these funds remain in reserve through the end of FY2012 and are not diverted to finance state spending, the deposit will improve the major funds' year-end cash position; however, the balance may still be negative.

The deposit of FY2012 General Fund revenue into the BSF is triggered by provisions in state law tied to changes in inflation-adjusted state personal income growth. As a result of moderate real income growth (5.4 percent) coming out of the recessionary period, a portion of the FY2012 General Fund projected revenue (3.4 percent or $256 million) is earmarked for the BSF, subject to appropriation. The FY2012 budget contains the full amount of the statutory transfer, which amounts to 1.3 percent of total General and School Aid Fund revenue in FY2012. In FY2000, cash reserves amounted to 15 percent of total annual revenues collected in the two funds. Although relatively small in amount, the

[3] The state's major funds are the General Fund, School Aid Fund, and Countercyclical Budget and Economic Stabilization Fund or rainy day fund.

Table 5
State of Michigan Major Fund
Interest Income / (Expense)
(Dollars in millions)

	General/School Aid Fund				
Fiscal Year	General Obligation Notes Issued	External Borrowing Cost	Interest Income / (Internal Expenses)	Budget Stabilization Fund Interest Income	Total
2000	-	-	$63.3	$74.0	$137.3
2001	-	-	$48.3	$66.7	$115.0
2002	-	-	($15.1)	$20.8	$5.7
2003	$1,248.0	($5.5)	($13.8)	$1.8	($17.5)
2004	$1,300.0	($9.4)	($14.3)	-	($23.7)
2005	$1,275.0	($22.6)	($32.0)	$2.0	($52.6)
2006	$1,299.5	($36.9)	($21.8)	$0.1	($58.6)
2007	$1,306.9	($38.7)	($26.4)	$0.1	($65.0)
2008	$1,360.4	($33.4)	($22.5)	$0.1	($55.8)
2009	$1,411.3	($24.6)	($4.5)	$0.0	($29.1)
2010(1)	$1,268.8	($6.8)	($4.6)	$0.0	($11.4)
2011(1)	$1,100.0	($5.4)	($4.6)	$0.0	($10.0)

(1) preliminary

Source: Michigan Department of Treasury, Bureau of Bond Finance

FY2012 BSF transfer is the first since FY2000.

The state will be able to reduce or eliminate inter-fund borrowing (major fund borrowing from other state funds) in FY2012. However, the state will likely continue to issue short-term notes for cash-flow because of the structural imbalance between cash in-flows and out-flows in the School Aid Fund. Furthermore, borrowing externally can be less costly to the state than borrowing from internal sources because the state is able to issue tax exempt debt which typically carries lower interest cost than borrowing from other state funds. The BSF deposit also has symbolic significance as the state endeavors to improve its credit-worthiness and raise its bond ratings, which can result in reduced borrowing costs.

Taking Aim at Long-Term Obligations

The budget directs a substantial amount of current-year funding to begin addressing future financial obligations; specifically obligations accumulated in the largest state-managed retirement system covering state employees, the State Employees' Retirement System (SERS). The budget allocates $200 million from the General Fund to begin the process of prefunding health care for retirees and their eligible beneficiaries (commonly referred to as "other post-employment benefits" (OPEBs)). Of this total, two different General Fund contributions are made; an ongoing payment of $140 million and a one-time payment of $60 million. Additional federal and other resources are expected to match these resources and increase the total to $280 million. Addressing this cost today will reduce the state's exposure in the future, assuming other changes (e.g., benefit levels, scope of benefits) are not made to state OPEB liabilities.

Historically, financing these benefits has been on a pay-as-you-go (pay-go) basis. Some prefunding had occurred before, but these reserves were diverted to relieve state budgetary pressures in the 1990s and 2000s.

Because of the current lack of prefunding, current-year dollars are required to cover the benefits paid each year. According to the most recent SERS valuation, employer contributions for retiree health care costs totaled $387 million in FY2010, which only represented the pay-go amount to cover the benefits paid on behalf of about 45,000 individuals. This amount is expected to grow to $420 million in the FY2012 budget. The state budget annually must shoulder the entire retiree health care pay-as-you-go bill. (Note: Public Act 185 of 2010 requires current state employees to contribute three percent of their salary to OPEB prefunding, but this is currently held up in litigation and is not being used to cover retiree health care.)

To meet the "prefunding" accounting standards for OPEBs, the state must meet the actuarially-determined annual required contribution (i.e., the amount needed to cover one year's payment on the unfunded liability and the normal costs of OPEBs). The FY2012 amount is $736 million, $316 million above the pay-go amount in FY2012. Thus, the $280 million appropriation included in the budget (plus the $420 million the state is expected to spend to cover the pay-go OPEB bill in FY2012) will nearly allow the state to make the full annual required contribution payment and meet the accounting standards required for prefunding OPEB costs (similar to pension costs).

The state's long-term exposure to OPEB obligations has been steadily growing. At the end of FY2010 the unfunded liability was $14.7 billion, up from $13.0 billion in FY2007. If the state is able to muster all the resources to meet the OPEB prefunding requirements in FY2012 ($736 million), the actuarial-determined unfunded liability will fall considerably (from $14.7 billion to $9.1 billion according to the state's actuary).

Beginning the process of prefunding OPEB liabilities represents a major change in budget policy for the state compared to recent years when the focus was almost entirely on meeting near-term state obligations. There is a tradeoff with this change in policy; setting aside resources today for these future costs diverts the resources from being available for financing ongoing appropriations and necessitates greater spending cuts. Over the long-run and as reserves accumulate with continued prefunding beyond FY2012, the state budget will be able to move away from financing OPEBs entirely on a pay-as-you-go basis and use investment earnings to meet the annual financial obligations, while continued commitment to prefunding will relieve the state from a growing future fiscal pressure.

Time to Plan

Completing the state budget by the end of May, and nearly four months before the start of the state fiscal year, provided many other entities with additional time to make decisions concerning their 2012 budgets. This contrasts with recent experiences when state policymakers ran state budget completion right up to the deadline, sometimes enacting the budget after the start of the fiscal year. For those entities that rely on state appropriations and have fiscal periods that begin on July 1, the late May completion provides a clearer picture of the amount of state aid they can expect before their fiscal years begin. In some cases (e.g., school districts) the state appropriation represents the vast majority of operating resources. Similarly, state agencies will have four months to prepare for the FY2012 budget as opposed to mere days.

The budget's two-year perspective (FY2012 and FY2013) also provides entities with some planning guidance for the future. While not technically binding, the FY2013 spending plan allows fiscal managers to look at the next two years, with some degree of confidence of what state support might look like. While things may change on a number of fronts, which could influence the actual FY2013 appropriations, the longer-term perspective is a welcomed change from past budget policy.

Conclusion

In contrast to the fiscal maneuvers employed since the early 2000s, the FY2012 budget addresses, head on, a number of the state's fundamental financial problems. In many respects, the new budget and the enacted tax changes articulate a new fiscal plan for the state. This plan ends the long-standing practice of using temporary, nonrecurring financial resources to achieve annual balance. It takes steps to improve the state's weakened cash position and it also takes aim at long-term ballooning financial obligations by setting aside resources today to honor bills that will come due in the future. This change in focus, from the short-term to the long-term, comes with a price. Specifically, significant funding cuts to state-financed programs at the state and local government level. Budgetary resources that might be used to finance ongoing programs and services are instead redirected to shore up reserves, address long-term obligations, and finance one-time spending.

The plan also entails a fairly significant shift in the state tax burden, reducing the taxes paid by business and increasing the taxes paid by individuals. Direct business taxes are reduced by $1.7 billion from the current-law tax landscape, while individual income taxes are raised by $1.4 billion, thereby resulting in a net tax cut that the budget must accommodate. Although difficult to quantify, reduced business taxation on its own is likely to yield positive economic growth; however, this will be offset, at least in part, by the negative economic growth that accompany higher income taxes through reductions in disposable income. Any net effect, positive or negative, is likely to be small. The state's new income tax base (including pension income) is likely to grow at a faster rate than the current tax base. Increasing the growth potential of this major tax source addresses one aspect of the state's structural budget problem.