Governor Rick Snyder's Fiscal Year 2011–12 State Budget Recommendation:
Charting a New Fiscal Future for Michigan

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On Thursday, February 17, 2011, Governor Rick Snyder presented his fiscal year (FY) 2011–12 Michigan State Budget recommendations to the Michigan legislature. The budget recommendation contained three major themes, which were emphasized in the governor's budget presentation to a meeting of the Senate and House of Representatives Appropriations and Tax Policy Committees:

- State budget process reforms
- Tax policy reforms
- State spending cuts

This paper provides a discussion and analysis of these three major budget themes.

State Budget Process Reforms

During his campaign for governor, Rick Snyder emphasized the need to make significant reforms in the process used to enact the Michigan State Budget. These proposed reforms include a longer-range outlook for the State budget, elimination of one-time fixes to help balance the budget, and basing future budget decisions on measured outcomes of program success. All of these reforms are in the governor's budget message.

During his campaign for office, Governor Snyder had recommended that Michigan shift from an annual to a **biannual budget process**. Using a biannual budget process, the legislature would enact a budget covering a 24-month period instead of the traditional 12-month period. While the governor did provide a budget recommendation for both FY 2011–12 and FY 2012–13, the recommendation for FY 2012–13 is not binding due to State constitutional issues. It is unclear at this point if the legislature will attempt to include any FY 2012–13 language in the enacted budget.

In his budget presentation, the governor emphasized the **elimination of one-time fixes** to balance the budget. During the past three State fiscal years, the State's General Fund/General Purpose (GF/GP) and School Aid Fund (SAF) budgets were balanced through the use of one-time revenue sources. These one-time revenue sources consisted primarily of $4.7 billion of temporary federal funds provided to the State under the American Recovery and Reinvestment Act of 2009 (ARRA). The State also used other one-time revenue sources to balance the budget, such as prior year budget balances, revenue from a tax amnesty program, and revenue from the changes in the treatment of abandoned

bank accounts and other such property that is eventually transferred to the State. The governor's budget recommendation almost entirely eliminates these one-time revenue sources and creates a structural balance between ongoing revenues and appropriations. The only exception involves the FY 2011–12 SAF budget, which features $411.5 million of one-time revenue associated with a carry-forward balance from FY 2010–11.

The governor's budget recommendation begins the practice of **measuring outcomes** of State programs and expenditures. The budget recommendation for each department and agency has performance measures designed to assess the success of programs. A big question in the future will be how these measures influence upcoming budget decisions.

An example is the performance measure in the Michigan Department of Community Health budget under the substance abuse services program. The measure captures the reduction in substance abuse among clients in State programs. Will funding for substance abuse programs be increased or decreased as a result of changes in the number of clients dealing with substance abuse? An argument can be made that if the number of clients with substance abuse problems increases, then additional funding is needed. Conversely, some may contend that funding should be reduced because the program is not achieving its stated goal of reducing substance abuse. This type of issue will need to be resolved before performance measures are likely to have any substantial impact on future budget decisions.

The governor's budget recommendation also includes a proposal to the legislature to **change the structure and content of the enacted appropriation bills**. The governor has proposed that the legislature enact only two appropriation bills: a bill for education programs and a bill for all other State programs. The governor is also suggesting that the level of detail in the appropriation bills be reduced by the legislature. Taken together, these budget process proposals will significantly shift power and authority regarding the budget from the legislature to the executive. The number of appropriation bills is less important from a public policy view than the contents of the appropriation bills. It will be up to the legislature to determine the fate of these two budget process reforms. As the former chief fiscal advisor to the Michigan Senate, this author has major doubts as to whether the legislature will agree to these process reforms.

Tax Policy Reforms

Governor Snyder's budget recommendation includes major proposed changes in State tax policy, most prominently a reduction in business taxes to be paid by increases in individual income taxes. The tax reform proposal calls for the elimination of the Michigan Business Tax, the implementation of a 6 percent corporate income tax, and the elimination of numerous exemptions and credits under the State income tax. When fully phased in, the governor's tax reform proposal is close to revenue neutral. According to data in the governor's budget message, during FY 2012–13, when the tax reform proposals are fully implemented, total GF/GP and SAF revenues will increase by $132.1 million, or 0.7 percent of total estimated GF/GP and SAF revenues.

The policy debate on the governor's tax reform proposal is likely to center on the very **significant shift of the tax burden in Michigan from business to individuals**. A look at the numbers associated with this tax burden shift will help frame this debate. Under current law, during FY 2012–13, individual income taxes will account for 31 percent of total GF/GP and SAF revenues. Under the governor's tax reform proposal, individual income taxes will account for 41 percent of total GF/GP and SAF revenues. This is a 32 percent increase in individual income taxes under the tax reform proposal. On the other hand, during FY 2012–13, revenue from the Michigan Business Tax will account for 11 percent of GF/GP and SAF revenue under current law. If the governor's tax reform proposal is enacted, the net revenue from the proposed corporate income tax and the continuation of previously granted tax breaks under the Michigan Business Tax will equal only 1.6 percent of GF/GP and SAF revenue. This equates to an overall 86 percent drop in business taxes under the tax reform proposal.

The majority of the increases in **individual income taxes** will fall on two groups of taxpayers. First are retirees and senior citizens, many of whom will see significant tax increases from the proposed elimination of the tax treatment of pension incomes and the elimination of other special exemptions for senior citizens. Certain senior citizens will also see a tax increase as a result of the governor's proposal to reduce the level of the homestead property tax credit that the elderly are eligible to claim. The other group most affected is the working poor. The proposal includes the elimination of the earned income tax credit for this group of taxpayers. The public policy debate will center on the business tax reductions to be paid by tax increases on retirees, senior citizens, and the working poor.

The governor's tax reform proposal is developed using the macro-economic assumption that a reduction in State business taxes will increase business activity in the state. While the budget recommendation does not include any economic estimate of additional economic activity that will result from the business tax reduction, it is important to understand that the State tax burden on business in Michigan has significantly declined over the past decade. At the same time that the Michigan business tax burden has declined, the State has seen a drop in payroll employment of approximately 850,000, a 17 percent decline over the past decade. During FY 1999–2000, major State business taxes equaled 0.99 percent of Michigan personal income. During FY 2009–10, these same State business taxes equaled 0.68 percent of Michigan personal income. In spite of this significant decline in the business tax burden in the state, the economic realities of the past decade suggest that—while the business tax burden does play a role in economic decision making—the link between business tax relief and Michigan's economic activity is tenuous.

The other factor that will have to be considered in the governor's tax reform proposal is the **economic impact of increasing the individual income tax burden** by 32 percent. While businesses will benefit economically from the business tax reductions, certain individuals will see a significant drop in their level of disposable income under the governor's tax reform proposal. This debate in the legislature will be very interesting to follow.

State Spending Cuts

The governor's budget recommendation features significant proposed changes in State appropriations. The budget recommendation includes major funding reductions for the following: public universities, aid to local governments through the revenue sharing program, aid to K–12 local school districts, and State employee compensation.

The governor's budget includes a 15 percent reduction ($222.1 million) in operational appropriations to the state's 15 **public universities**. While operational funding for universities has been reduced during several fiscal years in the past decade, this recommendation represents the largest percentage reduction in higher education operational funding in recent history. The budget recommendation also includes the appropriation of $83 million in funding that will be released to universities if the governing boards of the universities agree to restrain FY 2011–12 tuition increases to 7.1 percent or less. While a 7.1 percent increase in tuition for Michigan students may seem relatively modest in light of a 15 percent reduction in State appropriations for universities, the parents paying tuition bills will not likely call a 7.1 percent increase in tuition a restrained increase.

The governor's budget includes a proposal to eliminate **statutory revenue sharing payments** to cities, villages, and townships and a 34 percent reduction in the level of statutory revenue sharing payments to counties. These proposed appropriation reductions will total $344 million. The budget recommendation includes the appropriation of $200 million of incentive-based revenue sharing payments to cities, villages, and townships that meet best practices as outlined by the governor. The content of these best practices will be outlined during Governor Snyder's March 2011 special message to the legislature on government reform.

Two major issues become apparent when reviewing the governor's proposed revenue sharing changes. The first issue is the impact of the elimination of statutory revenue sharing payments to cities. Several municipalities in Michigan, including, but not limited to, the City of Detroit, are currently facing large financial pressures. The proposed elimination of statutory revenue sharing payments will most severely impact the large cities in the state. More than 50 percent of these payments go to Detroit, whose $145 million equates to almost 12 percent of its general fund revenue base. The elimination of these payments has the potential to put Detroit and other large cities closer to the brink of bankruptcy. The second issue involves the distribution of the $200 million of proposed incentive-based revenue sharing payments. It will be very difficult to develop a formula for the distribution of these incentive payments which can be accurately measured.

The governor's budget recommendation proposes significant reduction in the **funding of local K–12 school districts**. The proposal calls for a $470 reduction in the minimum per-student State funding to local school districts and also recommends that $896 million of restricted SAF revenue to fund local school districts in FY 2010–11 be shifted to fund community colleges and universities beginning in FY 2011–12. The $470 per-student reduction is a 6.4 percent cut. This reduction will have to be absorbed by local school districts during the fiscal year in which the required local school district contribution to the Public School Employees Retirement System (PSERS) will increase from 20.7 percent to 24.5 percent of payroll, adding $380 million or $245 per student to local school district obligations. It is very likely that the legislative debate over the governor's proposed K–12 School Aid budget will be the most spirited of any budget discussions.

During his campaign for governor, Rick Snyder promised to reduce overall **compensation for State employees**. The governor's budget recommendation delivers on this promise by including $180 million of proposed but unspecified cuts to State employee wages and benefits. These savings will be realized by negotiations between the State and represented employee organizations. During the budget presentation, State Budget Director John Nixon suggested that a significant amount of the employee concessions would materialize by increasing the health care costs borne by State employees from the current level of 10 percent of total health care costs to 20 percent. If this change is negotiated, the FY 2011–12 GF/GP budget savings will be approximately $39 million. This leaves an additional $141 million of employee concessions coming from either wages or retirement contribution costs. If the additional $141 million of employee concessions came from wage reductions, this would equate to an 8.2 percent reduction in total State employee salaries.

In summary, the debate in the legislature over the governor's FY 2011–12 budget recommendation will involve a discussion of the fundamental changes in State tax policy and appropriation reductions to universities, local units of government, local K–12 school districts, and State employee compensation. The outcome of this debate in the legislature will certainly set the stage for significant changes in the State budget for the years to come.

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