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The New Michigan State Budget Debate: *What to Do about the Budget Surplus?*

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After a decade of heated debates in Lansing on the elimination of Michigan state budget deficits, Governor Rick Snyder and the Michigan Legislature are now faced with a new challenge: what to do about the unanticipated budget surpluses in the fiscal year (FY) 2012—the current fiscal year—General Fund/General Purpose (GF/GP) budget and School Aid Fund (SAF) budget. While dealing with an unanticipated budget surplus is not as difficult as eliminating a budget deficit, the debate over the use of the funds has generated much discussion and controversy.

The Consensus Revenue Estimating Conference (CREC) was held in Lansing on January 13, 2012. At this meeting new official GF/GP and SAF revenue estimates were agreed to for FY 2012 and FY 2013. These new revenue estimates—combined with preliminary estimates of the final year-end balances in the FY 2011 GF/GP and SAF budgets (the fiscal year that ended September 30, 2011)—lead to the unanticipated surplus in the FY 2012 GF/GP and SAF budgets. In a January 13, 2012, memorandum to the Michigan Senate,[1] Senate Fiscal Agency Director Ellen Jeffries reported that the current estimate of the FY 2012 GF/GP year-end budget balance is $627.9 million and the current estimate of the FY 2012 SAF year-end budget balance is $119.3 million. These year-end budget balance estimates significantly exceed the levels of the projected year-end surpluses that were assumed when the FY 2012 budget was originally enacted by the legislature and signed into law by the governor in late May 2011.

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The FY 2012 budget, as originally enacted, assumed a GF/GP year-end balance of $39.4 million and an SAF year-end balance of $0.2 million.[2] Therefore, the current Senate Fiscal Agency estimates of the projected FY 2012 GF/GP year-end balance are $588.5 million above the May 2011 estimates and the projected FY 2012 SFA year-end balance estimates are $119.1 million above the May 2011 estimates. This leads to a combined GF/GP and SAF unanticipated FY 2012 budget surplus of $707.6 million. The surplus results from a combination of higher- than-estimated FY 2011 year-end balances and an increase in the estimates of FY 2012 GF/GP and SAF revenues.

[1] Senate Fiscal Agency memorandum, dated January 13, 2012. [Online, accessed 2/7/12.] Available: *www.senate.michigan.gov/sfa/Publications/BudUpdates/YearEndBalance.pdf.*

[2] Senate Fiscal Agency, FY 2011–12 Appropriations Report, Part II – Initial Appropriations, August 2011. [Online, accessed 2/7/12.] Available: *www.senate.michigan.gov/sfa/Publications/Approps/Initial2012.pdf.*

Options for the Budget Surplus

The governor and the legislature have three primary options available for the use of this unanticipated year-end budget balance. The first is to increase spending in the FY 2012 state budget above the levels currently authorized by the legislature, the second is to use the year-end budget balance to reduce state tax revenues, and the third is to save the unanticipated budget surplus. This article will briefly talk about these three options and then I will provide my thoughts concerning the proper use of the unanticipated year-end budget balances.

Potential Increases in State Spending

Using all or a portion of the budget balance to increase GF/GP and SAF appropriations above the FY 2012 levels currently enacted is certain to have a major appeal among many members of the Michigan Legislature and the general public. The enacted FY 2012 state budget featured large reductions in appropriations for K–12 school districts, public universities, community colleges, and units of local government. The per-pupil foundation allowance to K–12 school districts was reduced by $300 million, or $452.5 million below the FY 2011 foundation allowance level. Total state funding for public universities was reduced by $222.4 million or 15.0 percent, and total state funding for community colleges was reduced by $12.0 million or 4.0 percent. The FY 2012 state appropriations to units of local government, through the revenue sharing program, were reduced by $129.4 million or 11.9 percent. If the projected unanticipated FY 2012 year-end budget balance was used to restore these cuts that were made to education and local units of government, the total cost would be $816.3 million. This exceeds the total projection of the unanticipated FY 2012 GF/GP and SAF year-end balance of $707.6 million.

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While the education programs and the revenue sharing payments to units of local government are likely to generate the most discussion, it is important to remember that there were other significant reductions in state appropriations in the FY 2012 budget. These include cuts to a variety of health-related programs in the Department of Community Health, a variety of programs in the Department of Human Services, and numerous other reductions, including concessions from state employee contracts.

Discussion has also occurred in the legislature about using a portion of the budget surplus to offset the cost of certain changes in the Public School Employees Retirement System. With regard to this potential use of the funds, it is important to understand that the FY 2012 SAF budget already includes a one-time appropriation of $133.0 million for this specific purpose. It is doubtful that additional funding will be needed for any potential reforms to this retirement system.

Another potential use for the budget surplus is for one-time expenditures. Over the past 20 years the State of Michigan has used one-time budget balances for the appropriation of projects such as infrastructure needs in state buildings, to pay down existing bonded debt of the state, and for one-time capital funding for local units of government. The FY 2012 enacted budget already includes one-time funding to begin the payment of unfunded accrued health care liabilities under the State Employees Retirement System. The appropriation for this purpose is $140.0 million.

Potential State Tax Reductions

In May 2011, the legislature approved and the governor signed into law major changes in the tax structure of Michigan. These changes centered on a large reduction in the level of taxes paid by Michigan businesses, to be offset in large part by increases in the level of taxes paid by Michigan's individual income taxpayers. Some members of the legislature and the general public will advocate using the surplus to lessen these increases in individual income taxes. Most of this debate is likely to center on the taxation of pension income, a significant reduction in the earned income tax credit, and the elimination of numerous income tax credits, including tax credits for certain charitable contributions. The Michigan Legislature is also currently debating the elimination of property taxes on personal property. The unanticipated year-end budget balance could be used to offset the revenue loss from this property tax change.

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The danger of using the surplus to offset changes in the state tax structure is that long-term budget problems could result. Unanticipated year-end budget balances are temporary in nature and using them to fund permanent changes in tax policy could create long-term structural problems in the state budget.

Saving the Unanticipated Year-End Budget Balances

The fact that a $707.6 million budget surplus exists does not mean that Governor Snyder and the legislature should use these funds to either increase spending or reduce taxes. Another option is to save all or a portion of the unanticipated year-end balance. These savings could be accomplished by depositing the revenue into the Budget Stabilization Fund or leaving the surplus funds in the FY 2012 budget and using the funds to bolster the FY 2013 state budget. If the governor and the legislature elect to leave the FY 2012 surplus funds untouched during the fiscal year, statutory requirements dictate that the amount of the surplus in both the GF/GP and SAF budgets would carry forward into FY 2013 and become additional revenue in that fiscal year.

At the close of FY 2012, the Budget Stabilization Fund will have a projected year-end balance of $258.0 million.[3] This balance is equal to 1.4 percent of combined GF/GP and SAF revenues. When bond rating agencies evaluate the credit worthiness of a state, they would like to see a minimum of 5.0 percent of revenues in a reserve account, and Michigan is significantly short of this amount.

The idea of carrying forward the FY 2012 surplus to bolster the FY 2013 state budget is likely to be advanced by some legislators. This approach,

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[3] Senate Fiscal Agency, FY 2011–12 Appropriations Report.

based on the FY 2013 consensus revenue estimates, would ensure modest growth in both the GF/GP and SAF budgets during the next fiscal year. The potential long-term problem with this approach is that the use of unanticipated year-end budget balances in FY 2013 might create problems in the FY 2014 state budget unless other revenues are available to support the appropriations funded with one-time revenues.

Comment on the Use of the Unanticipated Year-End Balance

There is little doubt that the major pressure on the legislature will be to use the surplus to offset some or all or the enacted FY 2012 budget reductions to K–12 school districts, universities, community colleges, and units of local government. While this approach clearly has political appeal, it is important to understand that K–12 school districts, universities, community colleges, and units of local government have already adjusted their budgets to deal with these significant reductions. Simply providing additional funding to a local K–12 school district, for example, in the middle of the school year is not likely to produce any policy changes in the district. The vast majority of school districts would likely place the additional funding into their funding reserves. The same holds true for funding increases to universities, community colleges, and units of local government. If these institutions receive additional funding in the middle of their fiscal years, they would likely save the funds unless they had some guarantee that the expenditure of the surplus funds could be continued into the next fiscal year. Although using the surplus to offset budget reductions might be attractive, I do not believe the State of Michigan should pursue this option at present.

Likewise, I do not believe that using the unanticipated year-end balance to offset some of the enacted increases in the state income tax is a sound public policy option. This approach will lead to long-term structural funding issues in the state budget.

It is my strong belief that all or a significant portion of the unanticipated year-end budget balance of $707.6 million should be deposited into the Budget Stabilization Fund. If all of these monies were deposited into the fund, the FY 2012 year-end balance would total $965.6 million. This would move the Budget Stabilization Fund balance from its current projected level of 1.4 percent of combined GF/GP and SAF revenues to 4.9 percent. This approach is based on sound fiscal policy. First, it is certainly prudent to have reserve funds of a sufficient nature available for use. These reserve funds could be used in the coming fiscal years to offset or partially offset unanticipated drops in state revenues that lead to budget deficits. In addition, this policy decision would offer some stability and predictability in the future funding of K–12 school districts, universities, community colleges, and units of local government, whose budgets have historically been reduced in order to eliminate a budget deficit.

The key to understanding the proper use of an unanticipated budget surplus is to remember that the surplus is temporary. Spending a temporary source of revenue to support ongoing expenditures or revenue policy changes will almost certainly lead to future budget problems. The pressure will be on the members of the Michigan Legislature to spend this surplus revenue, but the best policy decision would be to save all or a large portion of it.