# "Michigan at the Crossroads"
## A "State of the State" Address

by Lawrence W. Reed
President of the Mackinac Center for Public Policy
January 31, 2005

MACKINAC CENTER FOR PUBLIC POLICY

Thank you, Chris. Hello, everyone. It's terrific to be here today and to get to talk to people I haven't seen for a while.

I can't attend these Issues and Ideas luncheons as often as I'd like, and looking at everyone here, I'm reminded of just what I enjoy about these events: the palpable sense of energy and the interest in the affairs of our state — and always that sense that we can change them for the better. There may be differences in our views, of course — though I'll be delighted if there aren't any! — but this is the perfect venue for discussing new directions, which is the subject of my discussion this afternoon.

Michigan needs to strike out in a new direction, and in describing why, I will mention some findings that may sound discouraging. But my message today is optimistic: We can head in a new direction. We only need to honestly assess where we are; where we need to go; and what we should do to get there.

---

Make no mistake: Michigan really is at a crossroads. In 2005, we can no longer evade difficult decisions in the hope that we can muddle through, or that a miraculous change in our economic environment will save us.

This has been the approach in Lansing for the past few years, despite many good intentions and even a few successes. State leaders have become increasingly adept at accounting gimmicks and cosmetic fixes that optimize revenues but minimize spending discipline. They are treating the symptoms, rather than the disease.

It's time for Michigan's political leaders to pass a comprehensive package of fundamental reforms that address the root of our economic crisis. Given this, I will try, in the next few minutes, to answer three basic questions about the nature of these reforms.

First, is our economic situation really bad enough to require a dramatic change in course? Second, why have we arrived at the point where Michigan feels threatened by a global economy it used to lead? And third, what should we do to make Michigan, once again, a state with a surging economy that provides good opportunities for our children and attracts the best and brightest?

Most people recognize that Michigan is not the economic powerhouse it once was. But many aren't aware just how serious the problem is becoming.

Consider the following five jobs, output and income figures, based on recent federal statistics.

1. From December 1995 through December 2004 — years in which the state invested most aggressively in what it calls "economic development initiatives" — Michigan finished 50th out of 50 states in percentage employment growth.

2. Even when you focus only on private-sector employment growth and broaden the time frame to December 1994 to December 2004, Michigan placed 50th in the nation.

3. Michigan was one of just two states to lose jobs in 2004, and the only one to lose a significant number. Our 7.3 percent unemployment rate is now worst in the nation.

4. From 1993 to 1997, Michigan's percentage increase in per-capita gross state product was 18th in the nation, but from 1998 to 2003, it had fallen to 44th, suggesting a shift from somewhat respectable at best to dismal at worst.

5. Michigan is traditionally a wealthy state, but by 2003, our per-capita personal income had dropped to 19th in the nation. Our per-capita personal income growth was an anemic 43rd in the United States from 1995 to 2003.

This is why I say that Michigan is at a crossroads. The state's output and wealth measures have fallen to no better than middle-of-the-pack — but the trends are pointed straight in the wrong direction at the very same time that most of the nation has been experiencing three years of recovery and economic growth. That is a sobering, if not frightening, thought.

Why are we underachieving? In part, global and technological trends are bringing new pressures to bear on our state. Ongoing technology gains are driving down manufacturing employment. Heightened global competition is putting new stress on the state's businesses, especially in manufacturing, which is the route to economic success for scores of developing nations. Auto production is suffering from chronic overcapacity that squeezes profits and closes auto plants and parts manufacturers.

But global pressures push both ways. Technology gains, free trade and even outsourcing tend to liberate investment capital, open new markets for our businesses and reduce costs for consumers and employers. These trends have the potential to produce more wealth and more jobs for Michigan than they destroy.

This potential will only be realized, however, if Michigan's workers, entrepreneurs and financiers are free to employ their abilities and resources to their fullest. They must be able to receive good investment returns, exploit new technologies and expand production and jobs without undue obstructions.

This is where public policy comes in. I'll focus on state policy, since Michigan can't do as much about federal policy, and since Michigan can achieve a lot by managing its own affairs better.

Indeed, the state has real room for improvement. The Pacific Research Institute in San Francisco recently ranked Michigan 34th of the 50 states on a highly detailed economic liberty index that included regulatory, judicial and government spending policies. Economic liberty, the study found, had a statistically significant and "substantial impact on income levels across the U.S. states."

Part of Michigan's problem continues to be its tax policies. Despite the tax cuts in the 1990s, Michigan's state and local tax burden as a percentage of personal income is still above the national average, according to the widely respected Tax Foundation in Washington, D.C. The Foundation places us 36th out of the 50 states on its overall business climate index.

Notably, the Foundation ranked our Single Business Tax 50th among the various state corporate taxes — that is, the absolute worst. This finding dovetails with another extensive study that showed Michigan's corporate taxes as a percentage of gross state product to be 50 percent above other U.S. states on average between 1977 and 1995.

Our taxes are a problem, but Michigan's regulatory policies likewise burden our economy. They are unnecessarily bureaucratic, unpredictable and costly, particularly in the areas of telecommunications and the environment. I'll return to these later.

Another critical policy area that affects our competitiveness in the world market is education. Too often, Michigan's public schools are not providing our children with the skills they need to compete successfully. This forces them to learn those skills on the job – if they can – and it makes Michigan's employers and universities spend a minimum of $600 million or more annually on remediation. That's a kind of tax, and an especially onerous one.

The fiscal, regulatory and education concerns I've just outlined are causing real trouble for Michigan. But I want to emphasize that state officials have done some things right in response to them. Gov. Granholm and the Legislature have avoided major general tax hikes in response to significant state budget deficits, thus avoiding the big mistake state officials made just 21 years ago when the income tax was hiked by 38 percent. The governor and the Legislature have also proceeded — although with some delay — with personal income tax cuts that were scheduled during the Engler administration, making our income tax rates reasonably competitive.

And despite heated political rhetoric, no one is seriously proposing to reinstitute general assistance welfare, cancel privatized health care for Michigan prisoners or return to a defined-benefit pension system for new state employees. These reforms of the 1990s lightened the load for Michigan's taxpayers and created new choices and better lives for many people. I would also point out that in 2000, the state partially deregulated its electricity markets, providing a number of customers with new choices and lower rates, while increasing the state's generating capacity.

At this point, I'd love to tell you that these successes have done the trick and say there is nothing but smooth sailing ahead. After all, it would give me a shorter speech — and just think of the unusual headline we'd be handing tomorrow's newspapers: "Mackinac Center praises state government, recommends nothing further."

But in fact, there is much more to do. Some might say that some of our proposals may be beyond the politically possible. But the Mackinac Center's job is not to tell policymakers what they will do — we leave that to Miss Cleo and the clairvoyants among us. Our job is to suggest to policymakers what they ought to do.

We must start by recognizing that our deteriorating economic position is due to mistakes on the fundamentals, and that we must correct these mistakes. Let me focus on three areas I previously mentioned: state spending and taxing; regulation of economic activity; and education.

When it comes to state fiscal policy, the discussion in Lansing has turned to analyzing the "price of government" and using the principles of zero-based budgeting. These tools may prove helpful, but possibly the greatest benefit of this approach is encouraging citizens and legislators to answer a fundamental question: What is the appropriate scope and size of government's role in our society?

The Mackinac Center has often argued that state government attempts too much and crowds out private initiative. Michigan's waning competitiveness is a sign that this view was correct. Accordingly, the Legislature should focus first on the economy, which affects all of Michigan's citizens, and then change the state budget to match.

Improving our economic climate means reducing state taxes decisively. We must, therefore, reduce state spending. This is simple, mathematical logic. It's also what fiscal responsibility is all about.

The Mackinac Center has identified a host of specific state spending cuts that would generate hundreds of millions of dollars in budget savings. Today, I will touch on a few of the most important examples.

One is Medicaid. Medicaid expenditures continue to run amok. A reform that would give Medicaid recipients more control over their health care dollars is an insurance voucher system, so that they can choose services and insurers that most closely match their needs. A one-size-fits-all Medicaid plan is simply wasteful, and it doesn't serve patients well, either. Florida is considering a Medicaid voucher plan, and Michigan should look into one, too.

Another important budget area is corrections. The state should multiply its success with privatization here. Since 1997, the state has competitively contracted with a private firm for medical services in its corrections system. The state recently extended that contract, which is, by all signs, a quality and cost-saving success.

This should encourage state officials to outsource management of larger portions of the corrections system to private firms. In 1998, Tennessee considered this option, and it estimated the state's potential cost savings at 22 percent. Similar reductions in Michigan would cut more than $350 million annually from the state's general fund appropriation for state prisons.

This brings me to one other spending area that desperately needs discipline: so-called "economic development." These programs, which are overseen by the Michigan Economic Development Corporation, typically provide subsidies, tax credits, tax abatements and other special breaks to specific businesses or industries in hopes of facilitating economic growth.

Unfortunately, they do not work. If they did, Michigan would be an economic leader — not the only state to lose a significant number of jobs in 2004. Note that during the same years of poor economic growth that I cited earlier, Michigan was shifting its emphasis from across-the-board tax relief for the many to discriminatory tax abatements for the well-connected few. We've spent hundreds of millions of dollars on such relief, and in the past two years, we've piled on with a new list of programs. The fact is that the MEDC produces more self-serving press releases than it does jobs.

I don't usually like to make partisan references. I am convinced the Mackinac Center's proposals are in the enlightened self-interest of both major political parties. But now I would suggest that when it comes to corporate welfare, it's time for the Republicans, like Richard Nixon, "to go to China." They gave these programs the legitimacy and scope of departmental status, and they may be the only ones who can end them.

If general assistance and adult education can be cut, as they were under the previous governor and the current one, the MEDC and its programs can be trimmed to focusing on streamlining the rest of state government. Playing one-upmanship with other states through selective favors is, at the very best, a wash in the long run. Worse, it distracts the state from fundamental, broad-based tax cuts and other needed reforms.

What should such tax cuts look like? Michigan's personal income tax burden could certainly go lower, but it's actually now about average. This suggests "Job One" is reforming the worst corporate tax in America — the Single Business Tax.

By "reforming," I don't quite mean what the Granholm administration is suggesting, though there are elements of it that deserve applause. Do we want to turn around Michigan's economic decline in a heartbeat? Here's how: If the Mackinac Center's budget cut recommendations were adopted, or if equivalent "reprioritization" and restructuring were accomplished through the "Price of Government" process, we could eliminate the SBT and replace it with — nothing. This single step would move us from 50th in the Tax Foundation's ranking of corporate taxes to a tie for first with four other states. The ranking of our general business climate would climb from 36th to 12th.

Just visualize it for a moment. Freed of that burden, Michigan's economy would rapidly blossom and offer greater opportunity. Even state budget revenue forecasts would be more reliable. We wouldn't be simply jimmying the system for the umpteenth time, cutting taxes on some and raising them on others.

Of course, we recognize that there is a state budget deficit already predicted for fiscal 2006, so that even with the cuts we've recommended, it might take two or three years to eliminate the SBT completely. But the effects would be felt quickly: If we simply cut the SBT in half in the first year, Michigan would move from dead last on the Tax Foundation's corporate tax ranking to approximately 20th place, and our general business climate ranking would go from 36th to around 27th place.

We also recognize that some legislators may fear that they will be criticized by their colleagues for supporting a bold tax cut. To them, I'd make the following, simple suggestion, applying the lessons of an important vote last September: Just say you're voting for a shift in the collection date for the Single Business Tax — a postponement of, say, a hundred years. Really, it's not a tax cut!

We're less enthusiastic about the Granholm administration's proposed tax reform. Granted, it appears that the plan would provide some helpful SBT tax simplification and rationalization, and that might be a net plus. Still, for three reasons, we believe it's a pale thing compared to what the state of Michigan needs, and compared to eliminating the SBT.

First, the Granholm plan is purportedly revenue-neutral and thus forgoes most of the benefit a genuine tax cut would have. Second, it takes one of the few areas where we reportedly have a relatively low tax rate — state taxes on in-state insurance and financial services companies — and hikes it hard. Third, it has a huge differential tax impact, forcing largely one industry to shoulder the tax burden that would be removed from manufacturers and others who are "winners" under the reform. If the plan ends up taxing faster-growing service firms to help slower-growing manufacturing firms, it could fall into a trap that the Chinese call "whipping the faster ox."

This brings me to the state's regulation of commerce — and to my second, and last, reference to political party. Gov. Granholm and Democrats in the state Legislature should recall the Democratic Party's great and often unappreciated initiatives in the late 1970s on airline and trucking deregulation. President Jimmy Carter and other Democrats recognized that the existing federal regulations in transportation were outmoded, and that deregulation would spur business growth and bring new choices to less wealthy consumers.

Similarly outmoded state regulations now hinder telecommunications, which are as much a part of our commercial infrastructure as the planes and trucks that carry our goods. The deployment of advanced wireless and broadband technologies is much lower in Michigan than in the Asian and European frontrunners with whom we compete.

Fortunately, Michigan's Telecommunications Act is slated to sunset at the end of this year, providing the Legislature and the Granholm administration with an opportunity to eliminate price controls, service mandates and a tangle of subsidies that keep competitors from entering the market. The Center has detailed a range of valuable steps in its recently published "Telecommunications Primer," which is posted on our Web site.

Another misguided proposal is the Water Legacy Act, which would impose water-use permit requirements on industrial and commercial users. This would be a major, unnecessary expansion of regulatory power and the "the worst possible job-killing environmental regulation," according to Russ Harding, senior environmental policy analyst with the Mackinac Center and former director of the Department of Environmental Quality. In fact, as Harding notes, Michigan already has generous statutory powers to protect its water supply. We do not need to turn Michigan's citizens into squatters when it comes to their own water supplies.

At the same time, we can make existing state environmental policies more effective by establishing regulatory priorities based on what sound science — not ideology or bureaucratic politics — tells us are the greatest threats. For instance, we should adopt a law that prohibits the DEQ from issuing regulations more stringent than federal standards without presenting scientific evidence that can convince a majority of the Legislature. This proposal and four other specific environmental regulatory reforms can be found on our site in commentaries by Russ Harding.

This brings me to my final area of discussion: education. I would love to talk about educational quality — the Mackinac Center has published a great deal on the subject, and it's the main reason we have long championed greater choice, flexibility, accountability and innovations like our universal tax credit for contributions to scholarship funds.

But all the education talk in Michigan these days is about money. This focus might be easier to take if a bit of spending reform were thrown in, but public education officials don't seem permitted to suggest that money isn't enough.

So I'll take up the job, and I'll limit myself to two very modest proposals about "money" that should be a prerequisite before we paste more cash with chewing gum and bailing wire onto a rickety system that needs an overhaul.

First, exempt public schools from Michigan's archaic Prevailing Wage Act. Mackinac Center research has estimated that forcing schools to subsidize construction unions inflates renovation and construction costs by $150 million per year. Ohio exempted its public schools from a similar state law, and the savings there confirm our estimates.

This lost money reduces the value of every school bond that Michigan's generous taxpayers have agreed to in recent years. It even kills jobs in the construction industry.

There is simply no good reason to keep this dinosaur alive. You can't be in support of doing things for kids if you're not willing to euthanize this pointless law.

Second, we must tackle MESSA, the health insurance provider affiliated with the Michigan Education Association. Public school districts are awash in soaring health care costs, and this is happening in part because many of the districts buy MESSA insurance, whose Cadillac plans carry Rolls-Royce premiums.

But MESSA is often unwilling to provide general claims data that would allow districts to seek competitive health insurance bids. State legislators should challenge this by requiring district contracts to stipulate that data generated by these taxpayer-paid policies is owned by the public. Freeing districts to shop around for insurance would save significant sums statewide.

It is critical for state officials to recognize that their own policies are fueling the perceived need for more money. They must also recognize that districts are not always being conscientious with their money. An extensive Mackinac Center survey in 2003 suggested that only about one-third of Michigan school districts privatize food, busing or janitorial services, meaning that many millions of dollars are being wasted. In the schools, we don't have a funding crisis so much as we have a management crisis.  And it's not Proposal A that needs to be tweaked.  What needs to be changed are tired, old ways of business as usual, and union roadblocks that stand in the way of progress such as a 200 million dollar private sector offer to help inner city Detroit schools.

Keeping some cost control in Michigan's education system is ultimately a matter of common sense and real courage. The same is true for reforming Michigan's fiscal and regulatory policies along the lines I've outlined today.

Granted, defenders of the status quo will complain that Michigan can't afford spending cuts, tax cuts, deregulation, or education spending discipline. Let me offer this response: If the state does not get its economic house in order by improving the economic freedoms of citizens and the competitiveness of our business climate, much greater cuts will have to come in the not-too-distant future. Just as Detroit Mayor Kwame Kilpatrick recently pointed out in a televised address, the Mackinac Center identified the need for the city of Detroit to get its fiscal house in order years ago, and Detroit is now paying a steep price today for not having done that then.

This price may get a lot steeper before it eases. If the state wants to avoid a similar fate, it needs to do more than the same old things. We need the courage to focus on the fundamentals, and to fight the all-too-human tendency to define our possibilities down when we're confronted with persistent difficulty. Otherwise, we soon reach the point where simply shifting taxes around becomes "bold leadership." Serious tax cuts, serious spending cuts and serious reforms suddenly seem out of reach, and the state misses its crossroad, convinced that it must plow straight ahead into a bleak dead-end.

We don't need to make this mistake. If we do all rise to the occasion, I'm confident we will re-establish the vitality and prosperity in Michigan that are such integral parts of our history.

MACKINAC CENTER
FOR PUBLIC POLICY

140 West Main Street • P. O. Box 568 • Midland, Michigan 48640
(989) 631-0900 • Fax (989) 631-0964
www.mackinac.org • info@mackinac.org