Policy Brief

MACKINAC CENTER FOR PUBLIC POLICY

Replacing Michigan's New Taxes With Budget Reductions: Curing $1.358 Billion in Overspending With 55 Specific Recommendations

By Jack McHugh / Foreword by Lawrence W. Reed

The budget deal struck by the Michigan Legislature in the wee hours of Oct. 1, 2007, represents both bad policy and bad timing. The Legislature's limited reforms were dwarfed by tax hikes of historic dimensions — an 11.5 percent increase in the state's income tax and a new services-related 6 percent sales tax that will make Michigan a uniquely uncompetitive location for many firms.

This projected $1.358 billion tax hike for fiscal 2007-2008 would be difficult in a robust climate, but it is much worse in a state that's in the grip of a one-state recession. Michigan's tax base of people and businesses is beginning to crumble, as evidenced by these sobering facts:

- The unemployment rate, at 7.5 percent, is 60 percent higher than the national average.
- According to United Van Lines statistics, Michigan was tied with North Dakota for the highest outbound migration rate in the nation last year.
- Relative to the rest of the nation, the state's per-capita income has been in free fall since 2000. It is now an astonishing 7.8 percent below the national average.
- Home values are plummeting as foreclosures soar to their highest level in recent memory.
- Government statistics show that in 2001, Michigan's average private-sector wage was 9 percent below the average state government wage. Today, it's about 18 percent below. We're becoming a poor state with well-off public servants.
- Michigan's state and local tax burden is estimated to rise to 11th in the country under the new taxes, according to the nonprofit Tax Foundation in Washington, D.C. Add in the "taxing" effect of Michigan's high regulatory burden and the perception of an unfriendly labor climate, and you have a toxic brew that drives people and businesses away.

The extension of the sales tax to certain services is a guaranteed job-killer that will hit small businesses particularly hard. Those are the very businesses that create most of the new jobs; many of them are mobile enough to simply leave the state and escape the tax completely. For those that remain, paperwork blizzards, legal headaches and accounting nightmares await.

It should not surprise anyone that Michiganians aren't happy. By a 2-1 margin in a poll taken before the tax hikes materialized, likely Michigan voters indicated they preferred more spending cuts than tax increases to balance the state budget. Since passage of the new taxes, 10 of the legislators who voted for them — five Democrats and five Republicans — have become targets of recall election campaigns, and a broad-based coalition of business groups may put repeal of the taxes on the ballot if the Legislature doesn't reverse the damage.

Will higher taxes truly put the fiscal 2008 budget into the black? If people line up like sheep to be sheared, maybe. More likely, the dynamic disincentive effects of a bigger tax burden will accelerate the decline in Michigan's ability to produce new tax revenues. The Legislature will almost certainly be grappling with yet another shortfall soon.

Legislators and the governor can do the responsible thing and repeal the tax increases. If they don't, it is possible the people will do that for them through a ballot initiative. Either way, the issue of spending reductions and meaningful reform of state government must be revisited — the sooner the better.

The Mackinac Center for Public Policy has offered many suggestions over the years to help resolve the state's fiscal problems. With the folly of the midnight budget deal now apparent to almost everyone, the state's immediate need is for spending cuts and cost-saving reforms in the current fiscal year, thus eliminating the need for the tax hikes just passed.

This document recommends specific state spending reductions, clearing the way for urgently needed transformational reforms and government restructuring. The time for gimmicks, Band-Aids, distractions and punitive tax hikes is over. The moment for real remedies is long overdue.

Will the governor and Legislature muster the courage to do what's right by undoing what's wrong? Our state's future hangs in the balance.

Lawrence W. Reed
President
Mackinac Center for Public Policy
Oct. 17, 2007

$1.358 Billion in Spending Cuts Available Right Now

The Mackinac Center for Public Policy has regularly recommended specific state spending reductions to balance the state's budget and improve Michigan's public policy. In 2003, the Center listed more than 200 recommendations that would have produced $2 billion in savings and one-time revenue enhancements; these recommendations were updated and expanded in 2005 to produce a new total of $3.5 billion in savings and revenue enhancements.

The following list shows how the state could reduce spending immediately to help balance the state budget if policymakers chose to forgo the projected $1.358 billion in fiscal 2008 revenue from the recent state income tax hike and the new sales tax on certain services. Note that nothing in the Michigan Constitution prohibits the Legislature from shifting the savings listed below to the budget areas where they are needed.

Department of Corrections:
$136.0 MILLION IN SAVINGS

On Sept. 23, the Michigan Senate passed Senate Bill 511, a budget that included many "hard cuts" — that is, real reductions, not gimmicks, fund shifts and so on. Gov. Granholm has also recommended sentencing guidelines revisions that would move Michigan closer to the Midwest average in prisoner population; we're currently 40 percent above it. Both proposals should be adopted.

- Adopt at least three-quarters of Gov. Granholm's sentencing reforms: $69.0 MILLION
- Close three prisons (net savings): $37.6 MILLION
- Cut employee nonholiday overtime pay: $10.0 MILLION
- Other staffing efficiencies: $8.8 MILLION
- Centralize prison store operations: $3.7 MILLION
- Privatize certain prison food services: $6.9 MILLION

"Economic Development" Subsidies:
$90.0 MILLION IN SAVINGS

For 60 years, Michigan has been targeting particular firms or industries to be the beneficiaries of special favors in the hope that those businesses will prosper and ultimately help our economy. But extensive research has shown that these subsidies are not improving Michigan's economy, and that such state subsidies typically do not stimulate economic growth in other states either.

- Eliminate the new "21st Century Jobs Fund" spending: $75.0 MILLION
- Reduce so-called "job creation services" funding; shift off-budget Michigan Economic Development Corporation revenue, such as casino revenue, to the general fund: $15.0 MILLION

Department of Human Services:
$135.7 MILLION IN SAVINGS

Michigan offers a variety of optional welfare benefits to groups not covered in neighboring states. Once again, the Senate-passed version of Senate Bill 511 identified immediate savings opportunities.

- Reduce welfare day care subsidy reimbursement rates: $47.2 MILLION
- Increase welfare day care subsidy case reviews: $6.1 MILLION
- Strengthen welfare-to-work sanctions: $57.1 MILLION
- Close Maxey Boys Training School: $11.8 MILLION
- Make changes to child welfare programs: $13.5 MILLION

Department of Community Health:
$82.2 MILLION IN SAVINGS

The Medicaid low-income health care program is the state's second-largest spending item. Financed by both state and federal money, this is a command-and-control program hindered by counterproductive incentives and in need of major reform. In the short term, Michigan's economic situation requires that we tighten eligibility and stop offering nonmandatory services.

- Eliminate Medicaid coverage for caretaker relatives: $25.6 MILLION
- Eliminate Medicaid coverage for 19- and 20-year-olds: $12.7 MILLION
- Eliminate most "Healthy Michigan Fund" grants: $18.9 MILLION
- Impose mandatory citizenship verification for Medicaid recipients: $10.0 MILLION
- Require the Detroit-Wayne County community mental health services program to become a mental health authority: $15.0 MILLION

Higher Education, Including Community Colleges: $82.7 MILLION IN SAVINGS

When times are tough, the state's universities should tighten their belts. Given decades of increases greatly exceeding the inflation rate, universities are well-situated to manage without a state funding hike.

- Cut the proposed 1 percent increase in grants to state colleges and universities: $27.5 MILLION
- Cut scholarships to students at independent colleges by one-third: $18.6 MILLION
- Cut "Cooperative Extension and Agricultural Experiment Stations" by 50 percent: $31.5 MILLION
- Cut the "Tuition Incentive Program" by 25 percent: $3.5 MILLION
- Cut community college "at risk" student funding subsidies by 50 percent: $1.6 MILLION
- Impose a moratorium on new construction: current year savings indeterminate (and not included in total savings)

Primary and Secondary Schools:
$286.3 MILLION IN SAVINGS

Given the state's troubled economy and the $11.5 billion education budget, which is the state's largest spending area, school districts must tighten their belts along with everyone else. Proposed funding increases in school operating money should be eliminated, and millions for optional "nice-to-have" items should be cut.

- Eliminate a proposed 1 percent increase in per-pupil foundation grants: $115.9 MILLION
- Eliminate extra money to school districts with declining enrollment: $20.0 MILLION
- Cut state preschool "readiness" and related programs by 50 percent: $49.0 MILLION
- Reduce by 9 percent extra "at risk" funding to certain school districts: $28.0 MILLION
- Cut intermediate school district operations funding by 10 percent: $8.0 MILLION
- Cut middle school math grants to districts by 50 percent: $10.0 MILLION
- Cut adult education by 60 percent: $14.4 MILLION
- Eliminate "20j" payments to wealthy districts: approximately $36.0 MILLION
- Cut "school equity" payments by 25 percent: $5.0 MILLION
- Impose a moratorium on new School Bond Loan Fund commitments: current year savings indeterminate (and not included in total savings)

Department of History, Arts and Libraries:
$29.9 MILLION IN SAVINGS

This department is clearly not a core function of state government. A state whose per-capita income is now 7.8 percent below the national average can't afford to maintain the department's current funding levels.

- Eliminate state government arts grants: $10.1 MILLION
- Cut state aid to libraries by 50 percent: $6.1 MILLION
- Replace the state subsidy to Mackinac Island tourism with user fees: $3.4 MILLION
- Cut department operations by 50 percent: $2.8 MILLION
- Reduce "historical administration and services" general fund support by 80 percent: $4.2 MILLION
- Replace 50 percent of Library of Michigan subsidies with user fees and cuts: $3.3 MILLION

Other Departments and Programs:
$211.3 MILLION IN SAVINGS

Over time, state departmental budgets have accumulated luxury items, noncore spending programs, and direct and indirect subsidies to local governments and other entities. For example, Mackinac Center research shows that repealing the state's prevailing wage law, which prohibits awarding state construction and repair projects to the lowest bidder unless the company pays union wages, would very conservatively save the state at least $90 million this year on government infrastructure projects. (Repealing the law would also save local governments and school districts money that is not included here in the total savings, which involve the state budget only.)

If the state is indeed in a budget "crisis," then policymakers should be willing to give up or reduce a wide variety of business-as-usual spending items.

- Cut funding for agriculture "development" programs: $2.3 MILLION
- Cut State Police "secondary road patrol" spending by 50 percent: $7.0 MILLION
- Cut statutory revenue sharing to local governments by 10 percent: $40.7 MILLION
- Adopt Michigan Supreme Court recommendations for reducing low-caseload judges: $3.7 MILLION
- Reduce spending on the Legislature: $8.9 MILLION
- Reduce so-called "workforce training grants": $4.4 MILLION
- Eliminate state Amtrak subsidy: $7.2 MILLION
- Reduce local transit operating subsidies by 20 percent: $32.4 MILLION
- Reduce lottery advertising: $10.0 MILLION
- Close nine Secretary of State offices: an estimated $4.7 MILLION

- Repeal state prevailing wage law: $90 MILLION
- Impose a moratorium on all new state construction (including the new state police headquarters): current year savings indeterminate (and not included in total savings)

Achievable Government-Wide Economies:
$303.9 MILLION IN SAVINGS

A large portion of the budget "deficit" is actually a gap between spending increases the state would like to enact and the amount of revenue it expects to collect. For example, included in departmental budgets are employee pay hikes and other automatic "economic" increases in base spending. These should be eliminated, and state employees, like private-sector workers, should pick up a greater portion of their health insurance costs. Such changes would require the governor and state workers to engage in some tough negotiations, but there is no reason state employees should escape the burden of balancing the budget.

- Eliminate state employee pay increases: $150.7 MILLION
- Shift 10 percent of current state employee health insurance costs to employees: $59.0 MILLION
- Eliminate "economic adjustments" and impose administrative savings identified in Senate Bill 511: $94.2 MILLION

Total Savings: $1.358 BILLION

The static analysis by the state Senate Fiscal Agency estimates that the 11.5 percent income tax increase (from 3.9 percent to 4.35 percent) will extract $744.8 million from state taxpayers in fiscal 2007-2008, and that the 6 percent service tax will take $613.8 million (of which $453.3 million is from businesses). This adds up to $1.358 billion, assuming the unlikely outcome that taxpayers do not change their behavior or leave the state.

The prudent, immediately achievable budget savings listed above add up to the same $1.358 billion and make the repeal of these tax increases a matter of common sense and good public policy.

Conclusion

The $1.358 billion in savings identified would replace the recent tax increases, but obviously would not close the projected $1.749 billion gap between desired spending and expected revenue in the fiscal year now underway. It is entirely possible, however, to find $391 million in additional spending reductions, as past Mackinac Center publications have shown.

Ultimately, current spending levels are the product of past failures to embrace genuinely transformational government restructuring, including public employee benefit changes, competitive contracting for government services and reforms of harmful incentives in social welfare programs. The current tax increases, which will further burden the private economy, are likely to establish a cycle of ever-lower revenues and successive budget crises.

Therefore, after the tax hikes are repealed and the cuts outlined here are implemented, creative responses are called for to close the remaining gap. For example, Mackinac Center research has shown that the state could realize many tens of millions of dollars from selling assets, such as the state fairgrounds, the McMullan hotel-conference center on Higgins Lake, the Porcupine Mountains ski hill, and state parks that do not represent significant natural or historic resources. Another idea is to save $192 million by reducing the state work force along lines proposed by the Michigan Senate last month.

Given the serious economic challenges facing this state, residents deserve bold leadership on transformational change and restructuring.

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