Michigan's Defining Moment:

Report of the Emergency Financial Advisory Panel

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Prepared for
The Office of the Governor

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EXECUTIVE SUMMARY

Governor Jennifer Granholm has asked this panel to "assess the current state government financial crisis and offer recommendations on how best to avoid similar crises in the years ahead."

Michigan faces a deep financial crisis. First and foremost, it must be recognized as reality that Michigan's state government confronts significant short-term and long-term financial challenges. Over the next 18 months, state policy makers must face approximately $3.5 billion of services and programs unsupported by revenues.

1. Our state has an immediate crisis in school funding (approximately $377 million shortfall, which equates to $224 per pupil or $6,000 per classroom).
2. Immediately thereafter, policy makers must resolve a nearly $500 million shortfall in the General Fund in the current fiscal year (FY 2006–07).
3. Simultaneously, policy makers face a potential shortfall of $2.6 billion in balancing the FY 2007–08 budget. Revenues to fund current programs will fall short by $1.4 billion. If policy makers fail to replace any Single Business Tax (SBT) revenue (estimated at $1.2 billion in FY 2007–08), the problem escalates to a $2.6 billion shortfall in FY 2007–08. For an entire fiscal year, the SBT generates $1.9 billion in revenue.
4. By this year's end, policy makers must lay the foundation for the long-term vitality and growth of the state.

A convergence of forces has brought about the most serious financial crisis in many years for Michigan's state and local governments. This is a structural challenge, not simply the result of an economic downturn. A persistently weak economy, tax cuts, spending pressures, and inattention to essential government reform have triggered the crisis. We will not economically grow our way out of it. We cannot solely cut or tax our way out of it. Fundamentally, Michigan must reform its spending and taxing and must reinvent the way state and local governments deliver services to be more efficient and productive. Government must demonstrate value for every dollar spent.

Our people and communities face economic hardship. That is why our state must make major investments to compete for the jobs of the 21st century and make Michigan a place where we want to live. As policy makers seek ways of handling perilous gaps between resources and demands during this and upcoming fiscal years, we urge them to tackle long-term reforms in taxing, spending, and delivering public services.

The depth and breadth of this crisis—and the fundamental need for investment—demand a comprehensive response. The state must restructure taxes in a manner that would immediately increase revenues.

The crisis demands a shared commitment to a better future for our state.

It demands that leaders lead by engaging the residents of the state in a dialogue to determine what is truly important to their futures and their families.

It demands that policy makers at all levels accept the mantle of stewardship and shed the robes of partisanship.

The way in which policy makers and residents respond to the current crisis will—in large measure—define Michigan for both this and the next generation.

After careful study and considerable discussion, this bipartisan panel believes that Michigan

- needs fundamental reform of both spending and taxes;
- must create a modern tax structure that abandons the focus on the economic system of the 20th century and looks to the developing economy of the new century;
- must end the disinvestment in education and those other assets that define the quality of life that knowledge-based workers seek—cultural offerings, natural resources, and vibrant cities; and
- must develop a fiscal plan that includes a combination of revenue increases, spending cuts, and reform of how public services are delivered.

Michigan is a special place, endowed with the magnificent Great Lakes, excellent higher education institutions, and superb cultural and natural offerings. Our state has the tools to succeed in the new global economy.

It is time for everyone in Michigan to stop blaming each other and move this state forward together.

Emergency Financial Advisory Panel members

- The Honorable James J. Blanchard, former governor
- The Honorable William G. Milliken, former governor
- Dan L. DeGrow, superintendent of St. Clair County Regional Educational Service Agency and former Republican state Senate majority leader
- Don Gilmer, Kalamazoo County administrator and former state representative and state budget director
- Paul Hillegonds, senior vice president of DTE Energy and former speaker, co-speaker, and minority leader of the state House of Representatives
- Frank J. Kelley, former Michigan attorney general
- Sr. Monica Kostielney, president and CEO of the Michigan Catholic Conference
- Dr. John W. Porter, former president of Eastern Michigan University and state superintendent for public instruction
- Douglas B. Roberts, former state treasurer

- John J.H. Schwarz, M.D., former U.S. Congressman and vice-chair of the state Senate Appropriations Committee
- Dr. Lou Anna K. Simon, president of Michigan State University
- S. Martin Taylor, former state department director, former corporate executive, and University of Michigan regent

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PREAMBLE

Michigan is a wonderful state with a history of producing great, innovative business leaders, productive workers, and products and services the world seeks. The world envies our natural and cultural resources. Michigan has been and remains a special place.

Our challenges are to rekindle an entrepreneurial vitality to create and sell highly valued goods and services, build and retain talent, and recruit the skilled and ingenious who choose places with incomparable natural resources, educational institutions, and cultural offerings.

State government can encourage innovation and invention, or it can stifle it. It can protect and build upon our natural and cultural resources, or it can let them wither. This state must make a population-wide commitment to retool Michigan for the jobs of the 21st century.

Government is designed and built around its key function as a provider of essential services for the people of Michigan. Michigan's policy makers carry out the public's bidding while seeking to inform, engage, and push visionary thinking among the public. Politics is about things as they are; with courage, it can also be about things as they should be.

No matter what we do, the decisions Michigan makes this year will begin to define our future.

MICHIGAN'S FISCAL CRISIS

The state faces a fiscal train wreck.

Tom Clay, Director of State Affairs, Citizens Research Council of Michigan

Michigan faces both a cyclical and structural dilemma. Over the next 18 months, state policy makers are looking at approximately $3.5 billion of services and programs unsupported by revenues.

1. Our state has an immediate crisis in school funding (approximately $377 million shortfall which equates to $224 per pupil cuts, or $6,000 per classroom) that must be solved in the month of February.
2. Immediately thereafter, policy makers must resolve a nearly $500 million shortfall in General Funds in the current fiscal year (FY 2006–07).
3. Simultaneously, policy makers face a potential shortfall of $2.6 billion in balancing the fiscal year (FY 2007–08) budget. Revenues to fund current programs will fall short by $1.4 billion. If policy makers fail to replace any Single Business Tax (SBT) revenue (estimated at $1.2 billion in FY 2007–08), the problem escalates to a $2.6

billion shortfall in FY 2007–08. For an entire fiscal year, the SBT generates $1.9 billion in revenue.

4. By this year's end, policy makers must lay the foundation for the long-term vitality and growth of the state.

A convergence of forces imperils Michigan's state and local governments. The combination of tax cuts without corresponding spending cuts, failure to confront overdue government policy and structural reforms, a pattern of using one-time money to handle real structural deficits, and the extreme stress placed on the state's manufacturers has produced the crisis. It has been developing for a long period of time and will take uncommon courage, vision, and actions hewn from facts to resolve.

This crisis does not—and should not—call for a Republican or Democratic nor liberal or conservative solution. Rather, it requires a fact-based Michigan solution that repositions Michigan for growth, opportunity, and success. Policy makers and other leaders owe the public an honest explanation regarding the undeniable direct relationship between levels and quality of public services and taxes, neither of which can be raised or lowered without impacting the other.

Michigan faces a "structural deficit," which means that the cost of maintaining programs is increasing relative to revenues, even when the economy is expanding.

Michigan's Economic Future *by Charles Ballard, PhD, Professor of Economics, Michigan State University*

Pragmatically, policy makers have too often resorted to short-term fixes to lessen threats to some essential public services. It is critical now that they should construct long-term reforms of taxing, spending, and the delivery of public services.

Michigan's Economy[1]

- The state has weathered six consecutive years of net job losses, the longest stretch at least since the Great Depression of the 1930s.
- Michigan has lost 246,000, or one in four, manufacturing jobs since 2000 (Bureau of Labor Statistics).[2]
- The Big Three's share of domestic auto sales plummeted from 73.7 percent in 1993 to 53.7 percent in 2006. By 2011, domestic share is predicted to drop to 45.2 percent.
- Our state's per capita income is now 5 percent below the national average. That is the lowest point it has been since 1933.
- In the latest index of economic momentum (quarterly changes in personal income,

[1] See the following reports for economic and fiscal outlook: "Administration Estimates Michigan Economic and Revenue Outlook FY 2006–07 and FY 2007–08," by the Senate Fiscal Agency, January 2007, available at http://www.michigan.gov/documents/treasury/AdminTreasHandout_184003_7.pdf, and "Revenue Estimates for Michigan FY 2006–07 and FY 2007–08," by the House Fiscal Agency, January 2007, available at http://house.michigan.gov/hfa/PDFs/rev_1-07.pdf.

[2] *Current Employment Statistics*, Office of the Michigan Labor Market Information, Michigan Department of Labor & Economic Growth.

employment, and population), Michigan ranks dead last among states.[3]

In just the past six years, production of vehicles in Michigan has dropped 27 percent, nearly 900,000 units. The impact is the equivalent of closing five assembly plants and losing 120,000 jobs throughout the state. If market share drops as predicted to 45.2 percent, it could cost Michigan another 50,000 jobs.

Manufacturers of autos, office furniture, and household goods are concentrated in our state. For decades they have given us one of the world's highest standards of living. Working with business and labor, state government should examine ways to help in key areas, such as reducing legacy costs associated with health care benefits and retirement plans. While agriculture and agribusiness have been stable and are growing, policy makers must also assure that the state's historical competitive advantage is enhanced in the new bio-economy.

We understand the global forces and technological innovation that move all economies toward knowledge-based services. While embracing the New Economy and its new growth engines, we also must lend help to manufacturing industries. Michigan has the assets to remain a world leader in advanced manufacturing while also being a leader in the bio-economy.

State Revenues[4]

- There has been a recent, steady decline in General Fund revenue: It is currently lower in absolute dollars (i.e., with no adjustment for inflation) than in 1996.
- Since the beginning of the economic downturn in 2000, General Fund revenue has declined by 15.8 percent in absolute dollars.
  - During the same period, there has been only a modest increase (6.4 percent) in sales tax revenue with no adjustment for inflation.
  - During the same period, without adjusting for inflation, there has been a decline in proceeds from the
    - income tax of 12.9 percent ($921 million), and
    - SBT of 20.8 percent ($483 million).[5]
- The sales tax does not reflect the economy's transformation.
  - In 1977–78, taxable sales represented slightly more than 50 percent of personal income. Today, those sales represent 39 percent. The state sales tax covers 20 percent less of the economy than it did 30 years ago.[6]

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[3] "*State Policy Reports*," Federal Funds Information for States, December 2006, Vol. 24, Issue 23–24.
[4] Both of the state's two major funds rely on a handful of taxes for most of their revenues. The General Fund receives 84 percent or $6.9 billion of its revenues from the personal income tax, the single business tax, and the use tax. The School Aid Fund receives 84 percent or $9.3 billion of its revenues from the sales and use taxes, personal income tax, and state education property tax. Approximately 6 percent comes from state lottery revenues, and the remainder from a variety of sources.
[5] Tom Clay, Citizens Research Council.
[6] "Michigan's Changing Economy: The Impact on State Sales Tax Collections," by Gary S. Olson, the Senate Fiscal Agency, in *State Notes*, July/August 2004, available at http://www.senate.michigan.gov/sfa/Publications/Notes/2004Notes/NotesJulAug04gso.PDF.

- Services represent a steadily increasing share of the economy, and they are not subject to sales tax.[7]
- Internet sales have mushroomed and, for the most part, have not been captured by the sales tax.[8]

- There is a reliance on taxing products such as cigarettes, the sales of which are not growing.
- Changes in federal tax law, such as elimination of the federal estate tax and changes related to retirement plans, have also reduced state revenues.

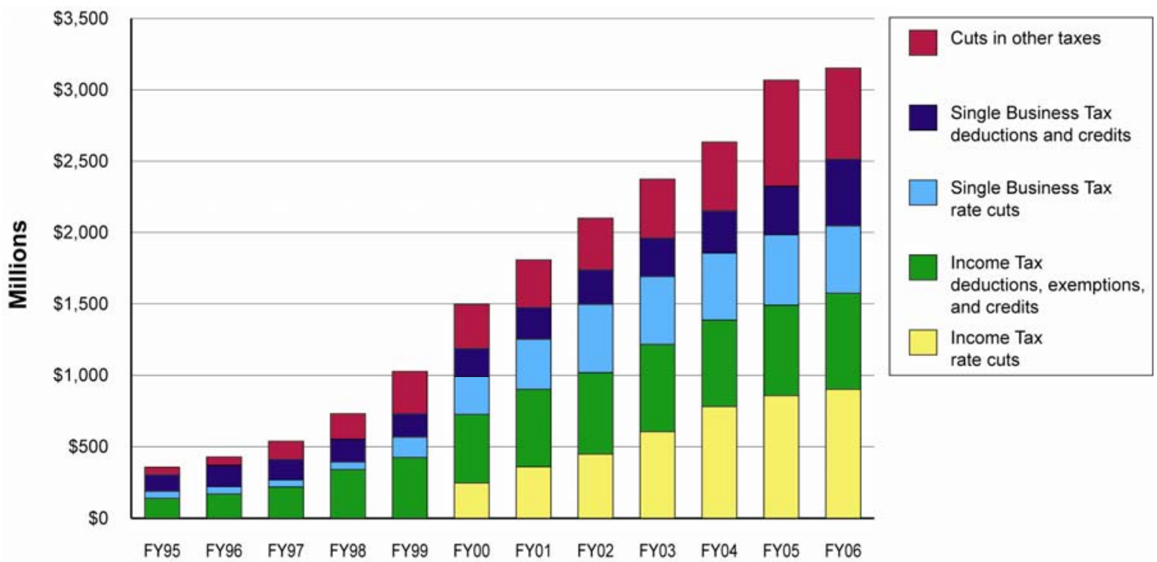
The current fiscal year will be the seventh consecutive year in which state revenues have fallen short in funding state programs and services. Since the first decline in FY 2000–01, Michigan has faced projected shortfalls totaling nearly $10 billion and avoided them by using up its reserves (including $1.4 billion in rainy day funds), tapping one-time resources ($5.4 billion), and cutting more than $3 billion in spending. For this fiscal year, analysts are anticipating a budget shortfall of $819 million—$442 million in the General Fund and $377 million in the School Aid Fund.[9] To this panel's knowledge, there are few rabbits left in the hat.

[7] Based on the data from the U.S. Bureau of Economic Analysis, the service sector generated almost 48 percent of Michigan's gross state product in 2005.
[8] Michigan is a participant in the Streamlined Sales Tax Project, which develops measures to design, test, and implement a sales and use tax system that simplifies sales and use taxes across states.
[9] Calculations by the Citizen Research Council. See the following link for further information: *http://www.crcmich.org/PUBLICAT/2000s/2006/budget11-13-06.pdf*.

Tax Cuts

Since the passage of Proposal A in 1994, Michigan has enacted tax cuts which reduce current state revenue by $3.2 billion a year (see chart).[10] In addition, local property taxes have been cut by $5.4 billion.

Tax Cuts Since Proposal A Build to Significant Levels; Revenue Loss in FY 2006 Totals $3.2 Billion



SOURCE: Michigan Department of Treasury; calculations by Citizens Research Council

- In FY 2005–06 (the last full year for which data are available), these tax cuts reduced income tax revenue by $1.6 billion, a cut of 20 percent. The income tax rate has been cut by 11 percent (from 4.4 to 3.9 percent), personal exemptions have been increased, special exemptions and credits have been added, and most private pension income has been exempted. If the personal income tax were at the 4.4 percent level of the 1990s rather than the current 3.9 percent level, the state would be receiving $850 million more—or about the level of the estimated shortfall in General Fund and School Aid Fund revenue this year.
- The tax cuts reduced FY 2005–06 SBT revenue by nearly $1 billion (from $2.8 billion to $1.8 billion), a cut of 34 percent. The SBT rate was cut by 19 percent (from 2.35 to 1.9 percent); small business relief has been increased; and many credits have been added.
- The repeal of the intangibles tax in the mid-90s reduced FY 2005–06 taxes by $245 million.
- In addition, there have been numerous recent tax cuts representing $186 million in annual revenue. For example, Michigan has eliminated the sales tax on soft drinks

[10] Calculations by the Citizens Research Council. Also see *Proposal A: Are We Better Off? A Ten-year Analysis 1993–94 Through 2003–04,* by Kathryn Summers-Coty, the Senate Fiscal Agency, available at http://www.senate.michigan.gov/sfa/Publications/Issues/PropA/ProposalATenYears.pdf.

and snack foods sold from vending machines. Telephone companies and railroads have received cuts in their state property tax.

- The federal government's decision to stop sharing a portion of the federal estate tax with states cost Michigan $200 million in FY 2005–06.[11]

The income and SBT rate cuts passed in 1999 stayed in force even after Michigan went into a recession in 2000. In response to temporary good economic times, Michigan enacted permanent tax cuts. Those lost revenues took a toll on public services as the economy slowed down. In addition, the state often cut taxes without an equivalent cut in services. Instead, it paid for those cuts through the use of one-time resources.

Benchmarking Michigan's Tax Burden

It is a common misconception that Michigan is a high-tax state. According to the U.S. Census Bureau, Michigan ranked 25th in the nation in state and local tax revenue as a share of personal income for FY 2003–04. This is the single best measure of the total tax burden borne by individuals and businesses.

With the repeal of the SBT, policy makers wrestle with questions about the appropriate share of taxes that should be borne by businesses and how Michigan's business taxes compare to those of other states.

Since 1990, the share of all taxes (including property and income) borne by Michigan businesses has declined from 43 percent to 37.9 percent.

According to the Council on State Taxation, in a study produced annually by Ernst and Young, Michigan ranks 36th lowest in state and local business taxes as a share of Gross State Product.[12] If Michigan does not replace the SBT with other business taxes, the ranking would likely drop to the lowest in the country. If the SBT is removed from data for 2005, Michigan would tie for the lowest with three other states. Michigan's rankings in its other major state taxes are also below the middle of all the states. In 2004, revenues from the personal income and sales taxes as a share of personal income ranked 36th and 29th respectively.[13]

Many states tax residents at higher levels than Michigan *and* have enjoyed greater job growth and personal income gains than Michigan. They have high percentages of high school and college graduates, vibrant cultural offerings, excellent roads, and more venture capital.

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[11] Tom Clay, Citizens Research Council.
[12] "Total State and Local Business Taxes," by Robert Cline, Tom Neubig, and Andrew Phillips, Ernst & Young LLP, March 2006.
[13] Tom Clay, Citizens Research Council.

Our future is directly tied to our ability to develop, attract, and retain concentrations of skilled people.

Mark Murray, president of Meijer, Inc.,
and former president of Grand Valley State University, state treasurer, and state budget director

Prosperous states rely on high-pay, knowledge-based industries far more than does Michigan. Those industries account for 19 percent of Michigan's economy, compared to 45 percent in Delaware, 31 percent in Connecticut, 25 percent in Illinois, and 24 percent in Minnesota.[14]

- Of the 12 states with the highest per capita personal income, only Colorado imposes state and local taxes per capita lower than Michigan. In 2002, Michigan's per capita total state and local taxes were $90 lower than the national average ($3,052 compared to $3,142). States with the highest per capita income and greatest economic growth since 1993 include Connecticut (with state/local taxes $2,574 higher per capita than the national average), Massachusetts ($1,231 higher), New York ($1,495 higher), New Jersey ($895 higher), Minnesota ($532 higher), and Illinois ($160 higher).[15]

- Of the states with the lowest state/local tax burdens (Tennessee, Alabama, South Dakota, Montana, Oregon, and South Carolina), not one ranks at or above the national average in per capita personal income.

Michigan's constitution imposes a metric for determining when state taxes are too high and a trigger for automatically rolling them back. In 1978, Michigan voters adopted stringent limits on the taxing and spending powers of state and local government. The constitution prohibits the state legislature from adopting any tax that, along with other state revenue, would exceed 9.49 percent of state personal income. We are nowhere near that level.[16] Today, Michigan's total taxes fall $5.2 billion below that limitation.

There is hereby established a limit on the total amount of taxes which may be imposed by the legislature in any fiscal year on the taxpayers of this state.

Article IX, Sec. 26 of the Michigan State Constitution

Michigan Has Exhausted its Use of One-Time Resources from 2001–2006

Policy makers have tapped one-time resources totaling $6.8 billion to balance budgets over the past several years.

- The state has depleted the entire rainy day fund ($1.363 billion).

[14] See "A New Agenda for a New Michigan," by Michigan Future Inc., June 2006, available at *http://www.michiganfuture.org/Reports/NewAgendaFinalReportComplete.pdf*.
[15] Ibid.
[16] See "History of State Revenue Limit," by Gary S. Olson, the Senate Fiscal Agency, in *State Notes*, July/August 2006, available at *http://www.senate.michigan.gov/sfa/publications/notes/2006notes/notesjulaug06gso.pdf*.

- It exhausted FY 1999–2000 surpluses in the School Aid Fund and General Fund ($1.196 billion).
- It has advanced the state education tax collection date ($455 million).
- The state has captured some $3.8 billion from myriad one-time resources, including refinancing bonds, raiding various trust funds, adopting accounting changes, and negotiating state employees' wage concessions.

One-time solutions are no longer acceptable.

Low Return on Federal Taxes

In FY 2003–04 (the last year for which data are available), Michigan paid $6,044 per capita in taxes to the federal government. That ranks us as the 20th highest taxed population in the nation. The same year, federal spending that came back to Michigan amounted to $6,006 per capita. We rank 46th in receiving federal spending.[17] While we would like to see Michigan receive a fairer share of federal spending, that is unlikely to happen in the near future.

THE URGENCY OF THE CRISIS

Budgetary woes do not begin to describe the depth of the governmental crisis facing Michigan. Leaders have only weeks, at most four months, to solve this crisis or face the rightful wrath of Wall Street, students, retirees, workers, and employers thinking of staying in or moving to Michigan. Employers, above all else, seek reliability and dependability in governmental transactions, services, and regulation. The uncertainty surrounding future taxes contributes to the problems of retaining and recruiting job providers.

State government's financial problems flow directly into financial plights for cities, counties, townships, villages, and schools, all of which depend on revenue from state government. For individuals and families, this means reduced access to important local public services such as police and fire protection and schools.

It is imperative that policy makers act quickly.

FINDINGS

Michigan must see the fiscal crisis for what it is—fundamental and (if we do too little) long term. We base our findings on the following: (a) Michigan taxes and spending priorities have not changed with the times, for which we are paying a high price; (b) the current crisis has been years in the making; and (c) the avenues out of the current crisis must reposition the state for *growth*, *opportunity*, and *success*.

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[17] *Federal Tax Burdens and Expenditures,* by Curtis S. Dubay, State Tax Foundation, March 2006, available at *http://www.taxfoundation.org/research/show/62.html*.

This panel reaches four key findings:

- **Michigan cannot economically grow its way out of the current financial crisis facing state and local government.**
- **Michigan should not rely solely on budget cuts to balance state budgets this year and next.**
- **The state must restructure taxes in a manner that would immediately increase revenues, but Michigan should not solely tax its way to balanced state budgets.**
- **Michigan must fundamentally reform government and the delivery of public services.**

Michigan cannot economically grow its way out of the current financial crisis facing state and local government.

State revenues now grow more slowly than the economy even when it performs well, because of the weakening connection between the tax structure and the modern economy. Even the rosiest of economic forecasts fails to provide sufficient revenues under the current tax structure to meet projected budget shortfalls.

A sluggish economy takes an even bigger toll on revenues. Economists tell us that the state's economy will be anemic through 2008 and likely longer. They expect a net loss of 33,000 manufacturing jobs this year and another 27,000 next year. The Big Three market share likely will decline from 53.7 percent in 2006 to 45.2 percent by 2011. Each one percentage point drop in the Big Three market share translates to the equivalent annual production of one assembly plant. Dropping by 8.5 percentage points in a market of 16.5 million units would cost the Big Three about 1,400,000 units of sales and production. If the losses were spread evenly among automobile-producing states, Michigan's job losses across the total state economy would be about 50,000.

Nationally, forecasters see only moderate growth over the next two years. Any economic downturn or recession (inevitable at some future date) will extract an even greater toll on the state's economy. Most expect that it will take at least 10 years for total employment in Michigan to return to pre-2000 levels.[18] Michigan will not grow its way out of this fiscal crisis.

Michigan should not rely solely on budget cuts to balance state budgets this year and next.

Relying exclusively on budget cuts to balance the current and FY 2007–08 budget would mean devastating disinvestment in important programs and services supported by the General Fund and significant cuts in school aid. Without replacing the revenue lost from the elimination of the SBT combined with other revenue shortfalls and spending pressures, the equivalent cuts needed to achieve balanced budgets in the current and

[18] In addition to the cited reports by the House Fiscal Agency and the Senate Fiscal Agency, the Research Seminar for Quantitative Economics at the University of Michigan provides periodic forecasts on various aspects of the Michigan economy.

upcoming fiscal years equate to $3.5 billion, or about one in seven dollars in the School Aid Fund and General Fund combined.

The total state budget is $41.7 billion. A total of $32.5 billion is restricted by federal law, the state constitution, or state statute. Those funds are dedicated to specific programs and services. This means that the governor and the legislature have discretion over only $9.2 billion in spending (the General Fund). Discretionary funding supports higher education, corrections, Medicaid, local revenue sharing, community and mental health, cash assistance and other human services, and many operations of state government, including the courts, state police, agricultural and health inspections, and environmental protection.

Bringing the issue down to reality, in order to save on the order of $3.5 billion,[19] the disinvestment would be the equivalent of

- cutting ALL funding for the state's universities and community colleges and eliminating ALL mental health services, or
- eliminating ALL health care programs for seniors and children living in poverty and releasing ALL 51,000 prisoners, or
- cutting $2,000 in per pupil aid to public schools (a reduction of one-fourth or more in school support).

Our state has an immediate crisis in school funding (approximately $377 million shortfall, which equates to $224 per pupil or $6,000 per classroom) that must be resolved.

Even assuming complete replacement of the revenues lost from eliminating the SBT ($1.9 billion), General Fund cuts required to resolve the immediate crisis of this year and next would still be significant and dramatic. They would fall on (a) nursing home residents who rely on Medicaid funding; (b) Medicaid-eligible children whose health coverage would be eliminated or slashed; (c) families with students at community colleges and public and private colleges and universities who would receive tuition bills significantly higher than current levels; (d) residents of communities who would see layoffs of police and fire personnel as local units of government take another $400 million in cuts in revenue sharing; and (e) residents who would see prisoners released hurriedly without plans for their return to communities. In Medicaid, slashes in spending only shift burdens and higher costs onto employers and individuals as health care providers and insurers tap other pockets. If state government prunes revenue sharing to local units of government, the public will face ballot proposals to levy additional local taxes to offset losses in state support.

Cuts in the higher education budget over the past few years roughly equate to the sum total of state investment in the seven smallest public universities in Michigan.[20] The disinvestment has caused increases in tuition, increased class sizes, the elimination of some courses, and cutbacks in research.

[19] The $3.5 billion is comprised of an $877 million shortfall in FY 2006–07; the reduction of $1.2 billion in FY 2007–08 revenues associated with the repeal of the Single Business Tax; $490 million of additional costs to maintain school programs at FY 2006–07 levels in FY 2007–08; and a $900 million shortfall of FY 2007–08 revenues from the cost of maintaining General Fund programs in FY 2007–08.
[20] Citizens Research Council.

Michigan can meet this challenge [the global economic transformation] only if it has the courage to set and achieve within the next ten years a new expectation for learning: postsecondary education for all.
The Lt. Governor's Commission on Higher Education and Economic Growth, December 2004

The core of economic growth rests in knowledge-based talent. States with the greatest number of college-degreed and technically-skilled talent will win the race for 21st century jobs and economic growth. Michigan must return to its tradition of investing in higher education, including vocational programs, community colleges, and public and private colleges and universities.

Michigan's economic future similarly depends on the capacity of our research universities to nurture new and growing industries. These include research and development in advanced manufacturing, biotechnology, alternative energy, homeland security, plant sciences, and the life sciences. The state cannot afford to continue to lose talent and technological resources to other states and nations. To encourage innovation, Michigan must provide research universities funds to match and win federal grants and expand private venture capital to commercialize research.

There's an almost perfect correlation between the number of jobs in a region and the strength of the universities.
Bill Gates, Jr., Microsoft founder and philanthropist

In tough times, the selling of assets tempts decision makers. For example, people have offered ideas about privatizing public universities and selling state parks. Policy makers must weigh such decisions against the fundamental purposes and benefits of the public good. Also, selling assets today only postpones difficult financial decisions.

The state must restructure taxes in a manner that would immediately increase revenues, but Michigan should not solely tax its way to balanced state budgets.

The Citizens Research Council and the Upjohn Institute project that state revenues over the next 10 years—assuming no change in tax structure and full replacement of SBT revenues—will fall short of current programs and spending policies by $10 billion. Relying solely on tax increases to balance future budgets will create an instability that will drive Michigan out of competitiveness for jobs and greatly dampen economic investment. Since the connection between Michigan's revenue structure and the modern economy is weakening, growth in revenue will not keep pace with growth in spending pressures and will lead to an endless series of political battles over tax increases and spending cuts.

Revenue growth in FY 2007–08 is projected to be quite slight (flat in the General Fund and less than a 3 percent increase in the School Aid Fund). The Upjohn Institute and Citizens Research Council project 3 to 4 percent growth in both General Fund and School Aid Fund revenues over the next few years, assuming a return to normal economic growth. To meet current program and service levels, the state needs 7 percent growth in the General Fund and 5 percent growth in the School Aid Fund. To keep up with spending pressures, state revenues would have to grow nearly twice as fast as projected, and that is not in the realm of possibility with the current revenue system.

To balance the state budget this year and next with no spending reductions, policy makers would have to hike taxes in ways that would compound the financial struggles and anxieties of Michigan families and employers. Using quick-fix tax increases to solve only the two-year crisis and dodging overall reform of state taxes simply postpone the day of reckoning and leave Michigan without a long-term cure for its financial instability.

It is imperative that policy makers look now at opportunities to control the spending side of government. In particular, we must pay attention to rising costs in corrections and public employee benefits.

Corrections costs must be reduced through more sensible sentencing and alternative methods of protecting public safety (e.g., tethering). Michigan's prison population of more than 50,000 carries a yearly cost of $30,000 per inmate.[21] What the state pays for corrections now exceeds what it pays for higher education, and currently at $1.9 billion, the Department of Corrections' budget will grow by about $80 million a year. Michigan's incarceration rate is 40 percent higher than that of its Great Lakes neighbors, resulting in $500 million annually in higher costs. Michigan is adding 1,000 new prisoners annually, and its crime rate is no lower than that of its neighbors.

We continue to incarcerate a larger share of our population than surrounding states, at great cost to families and to the taxpayer. The system needs to be fixed for both financial and human reasons.

Patrick L. Anderson, CEO of Anderson Economic Group

All public agencies must benchmark employees' (including school employees') pension, health care, and other benefits to the private sector. Some have benchmarked, but others have not. Spiraling costs are particularly acute for local government and school districts.

We value greatly the men and women who dedicate their lives to public service. The public will rely upon them in molding constructive ways to reform government. The scale of long-term benefit costs, however, tests the public purse just as it does the competitiveness of the Big Three and other large companies with many retirees and many others heading into retirement. There is nearly a $35 billion unfunded liability for state workers' and school district employees' pensions and retiree health care benefits. Schools spend over $1,200 per pupil yearly on health insurance premiums—about one in six dollars spent on public education—and annual increases could exceed $100 per pupil.[22] Unless checked, fully one in every three dollars of School Aid Funds will go to pensions and health care by 2018. Unlike employees in the private sector, public employees sometimes vest pensions or earn lifetime health care benefits in short periods of time (as few as five years in some instances).

[21] The Michigan Department of Corrections.

[22] See "Revenue Changes and Retirement Costs in the Public School Employees' Retirement System," by Kirk Sanderson, Senate Fiscal Agency, in *State Notes*, July/August 2006, available at *http://www.senate.michigan.gov/sfa/Publications/Notes/2006Notes/notesjulaug06ks.pdf*.

Michigan must fundamentally reform government and the delivery of public services.

Just as government must create a 21^{st} century tax structure to finance essential public services such as education, roads, and the social safety net, so too must government create a 21^{st} century system for delivering these services. Using only tax increases to solve the crisis allows state and local government and school districts to dodge the retooling and restructuring that are overdue. Best practices must be employed throughout public institutions. Government must find better, less expensive ways to deliver public services.

Government cannot insulate itself from the forces that are challenging the private sector. Who in the private sector can afford to carry excess capacity, not consolidate where appropriate, fail to add value at every stage of production, not subject major expenses to competitive bidding, not measure benefits against costs?

Government can do better. Reforms that should be considered include:

- Requiring specific measurements of performance, value, and benchmarking from all public agencies, including K-12 and higher education. Research universities need to significantly improve technology transfer that leads to job creation.
- Undertaking comprehensive health care reform. With a national health care policy years away from construction, states must act individually. Michigan must take full advantage of mechanisms already available (such as federally qualified health centers) to provide primary and preventive care. All of our residents, especially our children, must have access to health care. Costs for the uninsured fall upon individual payers and employers who offer health care benefits. With specific measurement of value to drive payment for health care services, a well regulated system of universal access to health care will decrease, not increase, health care expenditures and costs.
- Encouraging, and if need be requiring, local units of government and school districts to share or consolidate administrative services and deliver them more cost effectively. Michigan has more than 1,800 local units of government and 553 school districts, another 230 charters, and 57 intermediate school districts.
- Reforming Public Act 312, which requires binding arbitration.
- Providing taxpayers annually with an understandable report card on state and local spending and taxing.
- Continuing to explore and apply best practices from other states and information technology to more efficiently enforce business regulations and lessen the time and costs to business of meeting regulatory requirements. The state should inventory all statutory regulations and apply a rigorous risk assessment to each.

With regard to taxes, investment, and structural reforms, Michigan should set benchmarks drawn from best practices in Great Lakes and comparable states. Michigan needs to identify the best models in such critical areas as business taxation and regulation, roads, venture capital, and higher education. Michigan then needs to move toward and surpass the most successful states.

PRINCIPLES FOR MOVING MICHIGAN FORWARD

Institutions—even those as sacred as police and fire stations and elementary schools—are not the only components that matter in this financial crisis. Public values matter: feeling safe; giving everyone a chance to learn; attracting new job providers; keeping our children and grandchildren nearby; and having pride of place and pride in our natural and cultural heritage. These values matter to people today, and they will matter to people in Michigan's future.

Policy makers have an immediate challenge and a long-term challenge. There are no quick fixes anymore.

Through a dramatic and historic reform of government spending, taxing, and delivering public services, the leadership of Michigan can rebuild public confidence shattered by the greatest economic transformation since the invention of the automobile. Job providers and global economic forces sometimes trump what any one state or local government can do to promote good-paying employment. Yet reinventing the way government pays for and delivers public services must be part and parcel of the fight to regain mastery of this state's fate and to solve short-term budgetary woes. The public sector must reform just as the private sector reinvents.

We subscribe to common sense and not ideological purity, and we ask policy makers to align proposed solutions with the following principles:

1. Michigan needs fundamental reform of both spending and taxes.
2. Michigan must create a modern tax structure that abandons the focus on the economic system of the 20th century and looks to the developing economy of the new century. As a first step, the state must end the uncertainty over business taxation as soon as possible by replacing the revenues from the repeal of the SBT. Generally, the state should consider broadening the tax base to more closely reflect economic realities. It is not fair that some activities and businesses currently enjoy lower taxes, such as the insurance industry, or exemption from taxes, while individuals and other businesses bear a disproportionate share of the tax burden.
3. Investment is what matters. No one can be expected to invest in a state that does not invest in itself. Investment has helped make Michigan a global leader. The new economy based on information, knowledge, and rapid response to changing demands requires a highly skilled workforce. If it truly wants to reposition itself for growth, opportunity, and success, Michigan cannot afford to disinvest in those services and initiatives that will develop this skilled workforce. In other words, an investment strategy means support for education—one that produces results. It also means reinvestment in those elements that create the quality of life that knowledge-based workers seek—the state's natural resources, educational institutions, cultural assets, infrastructure, and urban centers.

A major key to a robust 21st century economy will depend on policy and physical infrastructure that enhances innovation.

National Innovation Initiative, The Council on Competitiveness 2004
(more than 400 leading thinkers from top industry CEOs, universities, and unions)

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4. Solving the state's budget crisis requires a combination of revenue increases, spending cuts, and reform of how public services are delivered. No single silver bullet incorporating only tax increases, only spending cuts, or only government reform will work in either the short term or the long term to solve the state's fiscal challenge.

Public investment and public opinion should not be adversaries, and public needs, public policies, and public budgets are not static. Taxes pay for essential services that people seek and need. When economic times are good (as in the 1990s), fewer people rely on many public services and it may be understandable public policy to cut taxes. When the economy is in the doldrums (as it is now), regrettably, public policy may require increased taxes to meet the growing demands of residents for essential assistance; maintain our critical infrastructure; and lay the foundation for investment in a growth economy.

CONCLUSION

Leaders of all groups (faith, philanthropy, business, labor, public policy, health care, education, civic endeavors, and others) owe the public complete candor. People will not always agree on solutions. Observers undoubtedly will concur that, in this year, in this state, the defining moment is here. Leaders must give the public the facts and help the public weigh the consequences of spending, tax, and structural reforms. Nobody in Michigan can ignore the reality that we face a crisis that must be solved now. The public must understand the huge gaps between state income and expenses and the need for compromise to resolve them.

A cultural and economic change of historic magnitude is well under way. We live in a global marketplace. People produce, distribute, and buy goods and services oblivious to ancient customs and geographical boundaries. A largely unforeseen evolution of a global economy and a manufacturing transformation hit Michigan, hit it hard, and transcended our ability to control it.

We cannot turn back the clock on technology, nor begrudge other nations' drive to compete and improve living standards. We can, however, make choices about how to help…U.S. workers prepare for and adapt to changes in technology or competition that adversely affect them.

National Innovation Initiative, The Council on Competitiveness 2004
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Michigan can remold itself, in part through tax, spending, and structural reforms, as the "go-to" place in the world for entrepreneurs, for those with dreams of capitalizing on a New Economy. Solving the state's budget crisis demands that we invest wisely in those things that lead to overall and shared prosperity and that some sacrifice toward that end is borne by all.

Michigan is a special place, endowed with the magnificent Great Lakes, excellent higher education institutions, and superb cultural and natural offerings. While they have been tarnished by neglect, our cities are poised for rebound. During the last century, our cities were the envy of the nation as we put a nation on wheels, built a middle class, and became the engine that drove American economic development. For 170 years, Michigan's natural heritage and its entrepreneurial spirit have helped fuel the growth of a nation. Our state has the tools to succeed in the new global economy.

It is time for everyone in Michigan to stop blaming each other and move this state forward together.

Members of this panel have advocated tax increases from time to time, and we opposed them at other times. We have voted in different ways on many tax and spending issues. We differ among ourselves on what size of government is ideal. One thing upon which we agree today is that somewhere between today's state revenues and the state constitution's limitation lays the appropriate level of taxes and public spending.

We need massive citizen involvement to help our state be the kind of place our children and our grandchildren want to live and to make a bright future for us all.

It's YOUR state.

And its future is too important to leave to others.

Philip H. Power, chairman and founder, The Center for Michigan, Grand Valley Metro Council speech, June 8, 2006

We know that today's decision makers feel a sense of urgency as they assume responsibility to cure matters that largely they did not create.

The simple truth is that the government we have formed and reinvented over time needs reinvention once again.