

A FOUNDATION FOR THE FUTURE

Fiscal Year 2003 Executive Budget

It has been well publicized that this may be the most difficult budget year in a decade. America finds itself in the midst of an economic downturn, predicted by analysts but exacerbated by the tragedies of September 11th. The last several months have forced the nation to face the unimaginable. We have witnessed events that have not only horrified us but inspired a sense of community that our nation has not experienced in generations. Beyond the human tragedy, the September 11th attacks and subsequent related events have inflicted economic pain that contrasts sharply with the preceding decade of prosperity and growth.

Michigan has not been immune to these recent events. The impact of the recession on our great state is being widely observed. As we look forward, we face many great challenges and uncertainties. But we also have many opportunities on the horizon. Our task now is to guide Michigan through this economic downturn — protecting the gains we have made and preparing a foundation for the future.

ECONOMY COOLS DOWN

The U.S. economic slowdown that began in March 2001 ended the longest recorded U.S. economic expansion of ten years. Automakers made the most aggressive production cuts in a decade and offered zero percent financing to boost car sales beginning in October 2001. Michigan's economy also slowed, causing employment to decline. The unemployment rate averaged 5.0 percent in 2001, up from 3.6 percent a year ago.

Changes in Michigan's baseline revenues reflect the national economic condition. A year ago, when the fiscal year 2002 Executive Budget was presented, the Governor warned "there is both hard data and a growing sentiment that suggests a slowing of economic growth at the national and local levels."

At that time, the Governor proposed a budget with less than one-half of one percent general fund growth. In May 2001, it became apparent that state revenues were declining and the budgets for fiscal years 2001 and 2002 were adjusted downward to reflect the softening revenues. The terrible events of September 11th worsened an already fragile economy. By the end of fiscal year 2001, net general fund revenues had declined 8.1 percent from the prior year.

"Zero percent financing was, without a doubt, the most important stimulus package American families received. In an autumn of tragedy and grief, Michigan's companies helped 'Keep America Rolling'."

Governor John Engler, State of the State Address, January 23, 2002

Fiscal Year 2002

In October 2001, a special Consensus Revenue Estimating Conference was held at the request of the State Treasurer. At that conference, the Treasurer and the directors of the House and Senate fiscal agencies further reduced their revenue projections for fiscal year 2002, prompting the Administration and Legislature to adjust the 2002 budget accordingly. The Governor issued Executive Order 2001-9 to bring spending in balance with available revenues. The Legislature is to be commended for cooperating with the Administration to reach many difficult, yet necessary, fiscal decisions at that time.

Ultimately, Executive Order spending reductions of almost \$460 million were approved, and additional reductions of \$9.9 million were enacted by the Legislature. These Executive Order reductions were in addition to more than \$210 million in spending reductions contained within the original fiscal year 2002 budget bills. In total, we reduced general fund support to state agencies in fiscal year 2002 by over 7 percent compared to fiscal year 2001.

The final component of the fiscal year 2002 solution – the sale of state property in Northville – still awaits legislative action. The Governor urges prompt action on this bill in order to balance fiscal year 2002 and focus our collective efforts on passing the fiscal year 2003 budget.

Fiscal Year 2003 Outlook

In December 2001, economic indicators suggested the economy was turning the corner toward recovery. New claims for unemployment benefits had fallen sharply, employment declines slowed, and consumer and business confidence improved. These fundamentals indicate the underlying economy is sound and the long term outlook for our state is positive.

“The economy could see a healthy recovery by the second half of the year. Productivity remains high, fiscal and monetary policy is aggressive. As long as consumer spending stays healthy, a rebound should begin this quarter.”

Diane Swonk, Chief Economist for Bank One Corporation, January 15, 2002

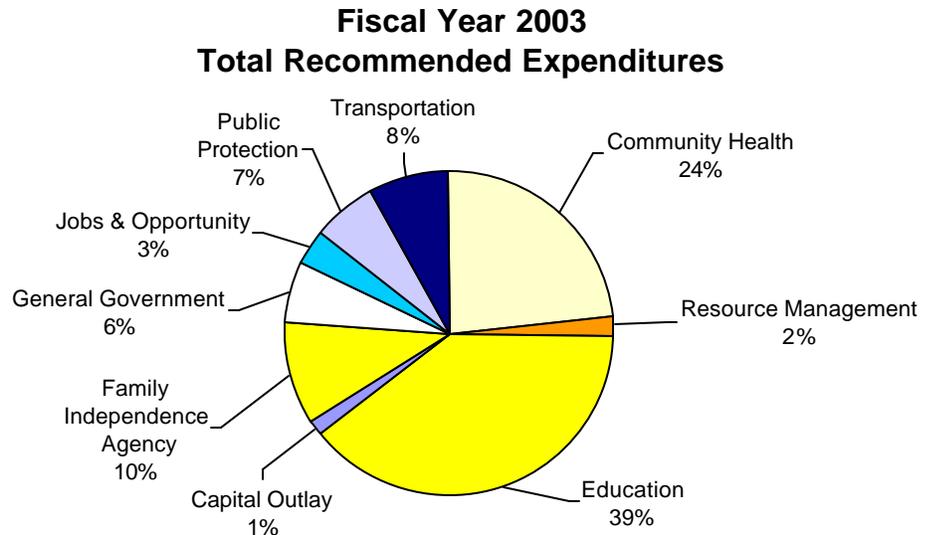
Despite early signs of an economic rebound, state revenue forecasts suggest that we not waiver from the prudent fiscal practices that gained Michigan its AAA bond rating. Nor should we waiver from those policies that spurred Michigan’s economic growth during the 1990’s: controlled spending, tax relief for the citizens of the state, and a maximum return on every tax dollar expended.

The Michigan Constitution requires the Governor to present a balanced budget to the Legislature. Proposed expenditures may not exceed available revenues. The Governor relies on the results of the Consensus Revenue Estimating Conference to set the revenues upon which the Executive Budget is based. In early January 2002, the conferees jointly determined revenue projections for fiscal year 2003. The budget presented today is based upon those revenue estimates.

HIGHLIGHTS OF THE EXECUTIVE BUDGET

The fiscal year 2003 Executive Budget reflects many difficult decisions necessary to ensure that the state lives within its means. This budget reduces spending in response to lower revenues, yet protects essential state services.

A key component of the 2003 budget is the Governor's unwavering commitment to our schools. Despite the budget shortfall, he is determined to protect the gains made in public education and honor his original commitment to boost per pupil spending to \$6,700 in 2003.



This budget also maintains a tremendous investment in Michigan's higher education system; improves health coverage for children, low-income families and disabled persons; expands drug benefits for seniors; protects critical safety-net programs for low-income residents of the state; and strengthens public safety activities.

Overall Budget

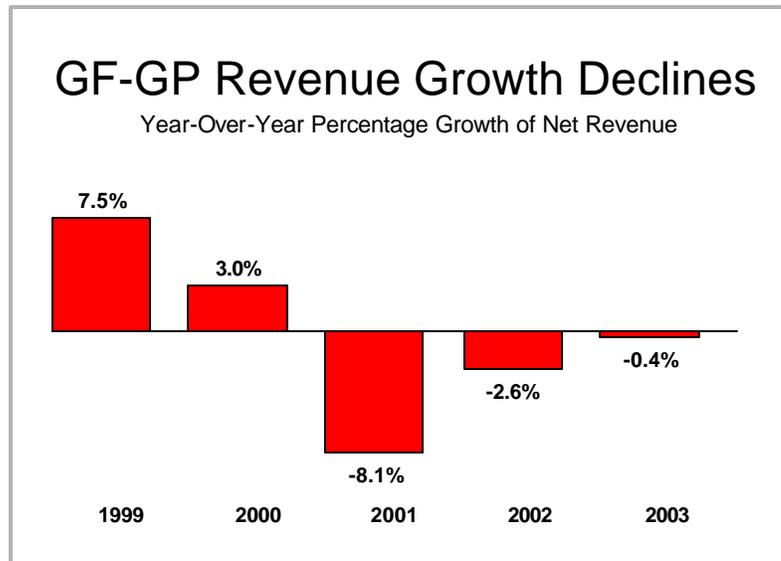
The Governor's proposed budget for fiscal year 2003 totals \$39.4 billion. This includes \$9.2 billion in general fund spending, \$11.2 billion from the School Aid Fund, \$1.5 billion in revenue sharing support for local governments, \$2.2 billion in state transportation spending, and \$11.1 billion in federal revenues.

The spending plan for 2003 continues the Executive Order reductions implemented last November with the exception of veterans service organizations and critical public transit and transportation economic development fund programs, which will be restored to their original fiscal year 2002 levels.

The fiscal year 2003 budget also recommends that fee increases included in Executive Order 2001-9, totaling over \$3.5 million, be permanently enacted into law. This includes a number of fee increases in the departments of State Police and Corrections, to support fingerprint and criminal records checks, parole and probation oversight fees, and security guard licensure fees.

General Fund Budget

The Consensus Revenue Conference estimates fiscal year 2003 general fund revenues at \$8.72 billion. This is a decline of 0.4 percent from the fiscal year 2002 revenues. In fact, general fund revenues for 2003 are below 1998 levels. When compared to the enacted fiscal year 2002 budget – including Executive Order 2001-9 reductions – *the revenues for next year are \$540 million less than this year's budget!* The pending 2002 supplemental for acknowledged Medicaid and public assistance caseload growth will boost the funding gap to \$580 million.



It is important to note that the pending supplemental recognizes a Medicaid caseload increase that is the result of a Fall 2001 consensus agreement with the legislative fiscal agencies. However, the Administration remains concerned that Medicaid needs are understated. As a result, the Administration will be carefully monitoring the Medicaid caseloads and expenditure patterns throughout the year.

Fiscal Year 2003 Funding Gap (GF/GP \$ in millions)	
FY 2003 Consensus Revenue Estimate	\$8,724.2
+ Diesel Equity and Simplification	<u>\$3.0</u>
Total Available FY 2003 Revenues	\$8,727.2
FY 2002 Enacted Appropriations	\$9,265.4
+ Medicaid & Welfare Caseload Increases	<u>\$41.8</u>
Anticipated FY 2002 Spending	\$9,307.2
Funding Gap	\$580.0
+ Unavoidable Spending Increases	<u>\$388.2</u>
Total FY 2003 Funding Gap	\$968.2

In addition to the base funding shortfall of \$580 million, fiscal year 2003 has known and unavoidable general fund spending pressures of over \$388 million. These spending pressures most significantly affect human service programs, including \$247 million for Medicaid costs and \$43 million for Family Independence Agency public assistance caseload growth. An additional \$43 million is required for non-discretionary economic increases, \$30 million for the Department of Corrections operational costs, \$16 million for State Building Authority rent, and \$10 million for other agency cost increases.

When these unavoidable spending pressures are combined with current year spending, the state faces a general fund gap of just under \$970 million. The fiscal year 2003 budget closes this funding gap with a variety of solutions including expenditure reductions, use of available state restricted revenues, and a withdrawal from the Budget Stabilization Fund. Many of these solutions are painful and they will not be easy. However, the fiscal year 2003 Executive Budget provides a reasonable, balanced response to the effects of the economic downturn while maintaining tax cuts we have collectively supported.

The solutions to the funding gap do not pause the personal income tax rate cut scheduled for next year, nor the Single Business Tax rate cut in January 2003. With disciplined spending decisions, we will be able to preserve the tax relief that is so vital to individual taxpayers and businesses in the state.

BALANCING THE GENERAL FUND BUDGET

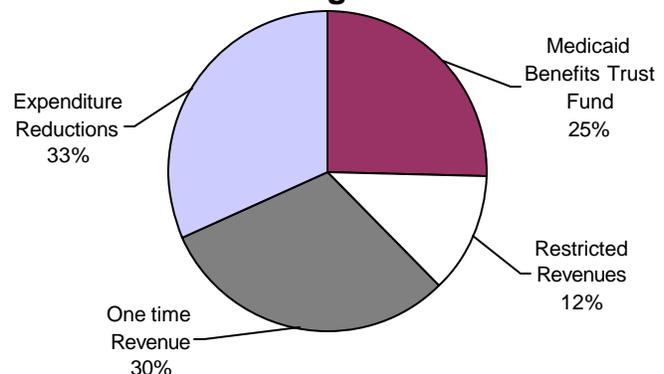
The unpleasant reality is that, in fiscal year 2003, the general fund revenue available for spending is less than it was five years ago. It will not be enough to simply 'tighten the belt' once more. The solutions to this spending shortfall lie in difficult decisions, and major cost-cutting actions. Now is the time to influence the future, recognizing that there is a clear difference between those programs we would like to fund, and those essential programs we must fund.

The Governor's budget closes the general fund shortfall with a mix of solutions. It covers the \$247 million Medicaid spending increase with a withdrawal from the Medicaid Benefits Trust Fund of an equal amount. The Medicaid Benefits Trust Fund was created from special financing revenues that have been earned in this, and previous, fiscal years. In Michigan, special financing has always been dedicated to support the Medicaid program.

While the Trust Fund was originally intended to cover changes in the level of federal financial support for the Medicaid program, spending it for unavoidable caseload growth during this economic downturn is an appropriate use of the money. Even after this withdrawal, the Fund will have a balance of \$280 million at the end of next year.

Appropriations reductions of nearly \$310 million account for another 33 percent of the fiscal year 2003 budget solution. A freeze on revenue sharing to local units of government will save \$112.4 million. By taking advantage of the state's strong

**Fiscal Year 2003
GF/GP Budget Solutions**



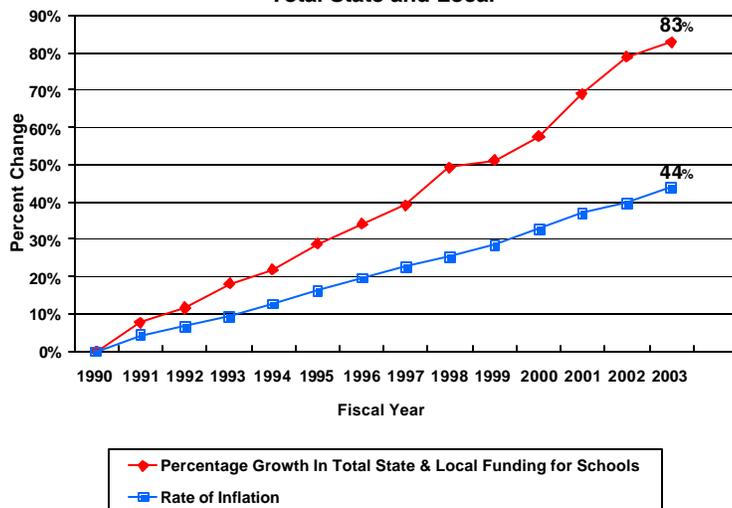
credit rating and current low interest rates, debt restructuring will save \$41 million. Collectively, state agencies will reduce staff in order to fund employee-related economic adjustments. Additional agency cuts of over \$60 million will be achieved by reducing capital outlay spending, pausing economic development job training grants during the summer months, consolidating long-term care spending to ensure that seniors receive services in the least restrictive setting, streamlining substance abuse administration and other smaller savings throughout state government. In addition, \$50 million in savings from the special initiative announced this week will be allocated to individual agency budgets as more information becomes available.

In the current year, almost \$160 million of tobacco settlement revenues are being used to help balance the general fund. For fiscal year 2003, the Governor reduces the reliance on this fund source; the Merit Award Trust Fund withdrawal is reduced to \$100 million and the Governor recommends no withdrawal from the Tobacco Settlement Trust Fund, as it is fully committed for valued health programs.

The Governor also recommends the use of \$27.6 million in available state restricted and federal funds to replace general fund spending. In addition, the Governor recommends that the available fund balance in the Michigan Employment Security Act Contingent Fund be used to maintain the general fund contribution to the School Aid Fund at the current year level of just under \$200 million.

The Governor is also recommending a withdrawal of \$207 million from the Budget Stabilization Fund. The Governor proposes to transfer any unreserved general fund balance to the Budget Stabilization Fund at the end of fiscal years 2002 and 2003 to begin to re-build the Fund for future economic downturns. These actions leave the Fund balance very close to \$250 million at the end of 2003.

Funding for Schools Outpaces Inflation
Total State and Local



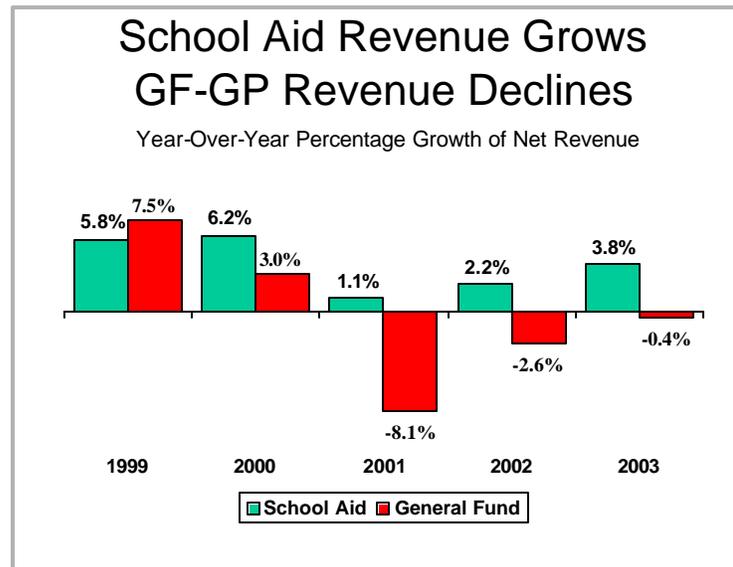
EDUCATION REMAINS TOP PRIORITY

Education has been and continues to be critically important to the state. More than \$15.1 billion, or 39 percent, of the state's overall budget is devoted to education. This includes funding for the K-12 system, universities, community colleges and student financial aid.

Funding for K-12 public schools continues to be Governor Engler's top priority. School Aid Fund revenues, like general fund revenues, have been affected by the recent economic downturn.

However, unlike general fund revenues which have declined, the School Aid Fund has seen a slowing in the rate of year-to-year growth. In the late 1990's, School Aid Fund revenues grew around 6 percent per year. In 2002, that rate of growth slowed to approximately 2 percent. The January Consensus Revenue Conference projected that, as the economy rebounds, School Aid revenues will increase by 3.8 percent in fiscal year 2003.

Those revenue projections are the basis for the Governor's State School Aid budget.



In fiscal year 2003, for the sixth year in a row, the state will spend more state dollars on K-12 education than it spends for the entire general fund budget. State spending in the fiscal year 2003 School Aid budget is almost \$11.5 billion, including \$198.4 million general fund, an amazing commitment given the state's current fiscal situation. In addition, over \$1.3 billion of federal funds are appropriated, for total appropriations of nearly \$12.8 billion. When local school operating property taxes are combined with state appropriations, support for schools jumps to nearly \$14.5 billion in fiscal year 2003.

Although faced with declining state revenues, the Governor is committed to boosting the minimum foundation allowance to \$6,700 per pupil in fiscal year 2003. This \$200 or 3.1 percent per pupil funding increase will cost \$337 million. To pay for this important enhancement, the Governor proposes modifying the state education tax collection structure in fiscal year 2003. Currently, the six mill state education property tax is collected in July and December each year. The Governor recommends that, beginning in July 2003, all of the state education tax be collected in the summer.

An earlier due date may cause financial hardship for some taxpayers. Therefore, the Governor proposes a one-time tax cut of \$266 million for all taxpayers in 2003, by reducing the millage rate from the current six mills to five mills for one year only. The estimated additional fiscal year 2003 revenue generated by changing the tax collection schedule is just under \$500 million, providing enough revenue to support an increase in the foundation allowance to \$6,700 per pupil.

All federal grant programs that support school district operations have been transferred to the State School Aid budget to allow greater coordination with state school aid dollars. Federal implementation of the “No Child Left Behind Act of 2001” results in significant new resources for school districts. Federal formula-allocated funds received by Michigan from the U.S. Department of Education total more than \$1.3 billion, an increase of over \$172 million from the prior federal fiscal year.

HIGHER EDUCATION

Higher education is clearly one of the Governor’s top priorities. For fiscal year 2003, the Governor proposes maintaining funding for colleges and universities at current year funding levels in order to protect students and their families from the effects of sky-rocketing tuition increases. This significant investment of resources should ensure that our higher education institutions remain affordable.

“Education, more than any other single factor, will assure Michigan’s quality of life and economic future.”

Governor John Engler, State of the State Address, January 23, 2002

In recognition of the impact of the economy on state revenues and on the pocketbooks of students, the university presidents have agreed to constrain tuition increases for next year to a maximum 8.5 percent, or \$425. A freeze on state appropriations, while difficult, is a fair response to the decline in state revenues. Our higher education

leaders are to be applauded for their commitment to control tuition costs, and the Governor urges the Legislature to swiftly enact the higher education budgets to bring certainty to college tuition costs for next year.

SUPPORT FOR LOW INCOME FAMILIES & CHILDREN

Last year, when dealing with budget shortfalls, the Governor made it clear that he considers health and safety-net services a priority. This budget reasserts the Governor’s commitment to Michigan’s most vulnerable residents. Despite the state of the economy, and despite budget shortfalls, critical services for low-income individuals and families will remain in place.

As the lagging effects of the recession continue, more and more Michigan residents may turn to the state for assistance. Now, during these challenging

times, this budget devotes an increasing amount of federal and state funds to public assistance programs to support the growing number of families who need temporary income.

The Executive Budget recommends an additional \$60.2 million in federal funding to cover cash assistance for 92,100 families, a 20 percent increase over the current welfare caseload of 75,800. Although this increase appears to be sizeable, the number of families receiving cash assistance will remain below caseload levels experienced in the early 1990's. These relatively modest caseload increases demonstrate the success of welfare reforms made during the Engler Administration, which help families move from welfare to work.

"Why would you want to keep someone on welfare instead of helping them get a job?"

Governor John Engler, 1991

In addition, 70,000 low-income families will continue to rely on the state for day care assistance in fiscal year 2003. To cover these costs, the Governor includes \$23 million in new state funds to match available federal day care revenues.

A \$7.7 million increase for the State Emergency Relief program will provide additional funding for energy-related home repairs, rent assistance, and other forms of emergency assistance.

Michigan is expecting to receive a substantial increase in its federal Low Income Home Energy Assistance award. The additional \$18.9 million that is recommended in fiscal year 2003 represents an increase of nearly 30 percent from the current year. These funds will support the home heating credit, energy-related crisis intervention payments, and weatherization activities that make homes more energy efficient.

HEALTH CARE & MEDICAID

Medicaid, which provides comprehensive physical and mental health coverage for the state's most vulnerable residents, is currently one of the state's largest expenditures — and the caseloads for these services are expected to rise. The Executive Budget is built on the assumption that the number of Medicaid recipients will continue to grow steadily through the third quarter of fiscal year 2002, stabilize as the economy recovers and then begin to slowly decline as the economy rebounds. Medicaid spending on physical health services for fiscal year 2003 totals \$4.3 billion, an increase of 5 percent over current year levels.

The Governor's spending plan also includes an additional \$112.9 million to finance a new initiative, the MIFamily Plan, which will expand Medicaid benefits and improve health care access for more than 200,000 Michigan residents.

The MIFamily Plan will utilize the flexibility given to states by the Bush Administration's Health Insurance Flexibility and Accountability federal waiver process. This flexibility will allow the state to maximize unspent federal dollars from the MICHild program and expand health care coverage to more individuals. Michigan will also seek to increase federal funding as a match for state mental health funds, thereby increasing overall mental health appropriations by \$50 million.

"When Washington gives the states the flexibility to design programs that meet our needs, we stretch the dollars and help more people."

Governor John Engler, announcing the MIFamily health plan, January 23, 2002

In his State of the Union address, President Bush renewed his commitment to provide prescription drug coverage to seniors. Two of his proposals, Medicare Low-Income Drug Assistance and the Medicaid Pharmacy Plus Waiver, are built into the fiscal year 2003 Executive Budget. These initiatives will almost triple the funding for Michigan's Elder Prescription Insurance Coverage (EPIC) program from \$50 million this year to \$145 million in fiscal year 2003. It is anticipated this enhanced funding will allow EPIC to provide prescription drug benefits to an additional 50,000 senior citizens with household incomes at or below 200 percent of poverty.

ASSURING PUBLIC SAFETY

The events of September 11th have created needs for new emergency response capabilities and protective measures to ensure the safety of Michigan residents. In the aftermath of these tragic events, the Governor acted quickly to ensure Michigan's vital infrastructure was secure, our drinking water safe, and our health officials prepared. In his State of the State address, the Governor recently reconstituted the existing anti-terrorism task force as the Michigan Homeland Security Task Force headed by the Michigan State Police.

"Michigan has always met its challenges -- our state has always been a leader -- when confronting crises at home or abroad."

Governor John Engler, State of the State Address, January 23, 2002

The fiscal year 2003 Executive Budget marshals state resources to meet potential threats. The Governor's recommendation includes an innovative Airport Security and Protection (ASAP) plan that will invest over \$1 billion in airport security and capital improvements over the next five years. As the past few months have painfully demonstrated, airport security

and safety are more important than ever. The Airport Security and Protection (ASAP) plan will help ensure that new security measures, including controlled airport access, passenger and baggage screening, terminal modifications, and

airport employee screening are put in place as quickly as possible. This proposal will redirect \$6 million annually from the airport parking tax and combine it with existing state aeronautics fund revenues, bond proceeds, federal funds, and local revenues to pay for needed improvements to the statewide aviation system. The Governor urges adoption of this package expeditiously, to avoid delaying these key projects, several of which could begin immediately. Supplemental appropriations of \$55 million will allow many of these projects to start during the summer of 2002.

A few days ago, the Bush Administration announced that Michigan will be receiving a one-time grant of \$30 million to build a stronger and more responsive public health infrastructure. This funding will be used to improve labs, upgrade infectious disease surveillance, and improve communications between local, state and federal officials. The new federal funds will also support the education of medical and emergency workers to assist in the early recognition of infectious disease outbreaks, including a bioterrorist attack, involving the release of anthrax or smallpox germs. The Governor advocates quick action to strengthen our state's ability to detect, prevent and respond to possible acts of terrorism. The fiscal year 2003 budget includes \$9.5 million for this program and the Governor will be recommending supplemental appropriations in the current year as funds become available.

The Governor proposes supplemental appropriations of \$15.5 million for the construction of two new armories to serve the needs of the Michigan National Guard. The Jackson Armory was built in 1850, and is the oldest armory in the country. The Calumet Armory was constructed in 1915 and currently operates as a joint-use facility. The existing facilities are outdated and cannot meet the Guard's current needs. The new facilities will provide adequate space for training, allow the posts to operate as command control centers in the event of an emergency, and meet federal security requirements. Most importantly, the new facilities will be able to handle the needs of a more sophisticated, technology-oriented military.

"In Michigan some special citizen-soldiers are keeping us safe at our border, in our airports, and on duty overseas. They make us proud – they are the Michigan National Guard."

**Governor John Engler, State of the State
Address, January 23, 2002**

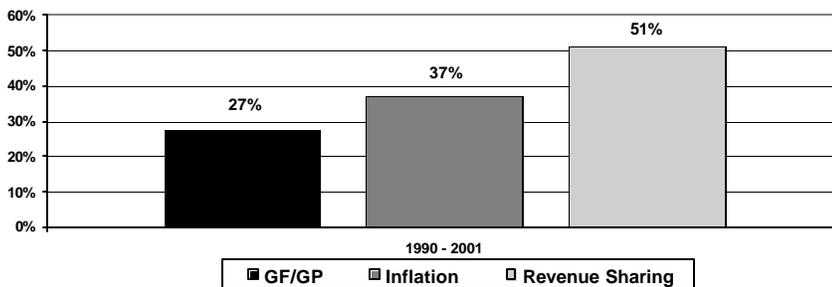
To ensure quality care for our veterans receiving services at the Grand Rapids Veterans' Home, the Governor recommends augmenting staffing and services with funds made available through certification of the home as a Medicaid-eligible long-term care facility. The fiscal year 2003 recommendation provides additional spending authorization of \$3.6 million to support the effort to obtain and maintain Medicaid certification. A fiscal year 2002 supplemental of \$300,000 is also recommended to cover partial year costs associated with acquiring Medicaid certification.

REVENUE SHARING

Over 1,800 units of local government receive a portion of sales tax revenue through the state revenue sharing program. The Governor's budget for fiscal year 2003 includes \$1.53 billion for revenue sharing payments to local communities. Each county, city, village and township retains the discretion to determine which local services will be financed through state revenue sharing funds. In 2003, total state spending as payments to local units of government will exceed \$16.1 billion; state revenue sharing payments represent 9.5 percent of this total.

The source of revenue for the state revenue sharing program - sales tax revenue - has reflected both the booming economy of the 1990's and the recent economic downturn. Revenue sharing payments to local communities increased from \$1.03 billion to \$1.56 billion from fiscal year 1990 through 2001 – an increase of over 51 percent, compared to the 37 percent increase in inflation during that

**Revenue Sharing,
Inflation and General Fund Revenues**



period. However, in the current year, revenue sharing payments were reduced to \$1.53 billion, a 1.7 percent reduction from the prior year. The Governor's budget for fiscal year 2003 recommends that aggregate revenue sharing payments remain unchanged at \$1.53 billion.

With continuation funding of \$1.53 billion and a larger allocation required for the constitutionally-guaranteed portion of revenue sharing, certain communities are expected to receive reduced revenue sharing in fiscal year 2003. In order to minimize the financial difficulties that this might pose for those communities, the Governor's budget establishes one-time grants to local governmental units with \$10 million in general fund resources.

TRANSPORTATION

To accelerate the improvement of our state roads and bridges, in particular the commercial routes, and to ensure that the costs of the preservation and critical maintenance are shared fairly by all motorists, the fiscal year 2003 budget includes a comprehensive package of diesel tax and collection simplification reforms. Michigan's current diesel taxation system is one of the most complicated and burdensome in the nation. The proposed reforms simplify and modernize the collection process for diesel fuel users and distributors, and accelerate the

investment on Michigan's most heavily traveled roads and bridges. The package addresses fairness for motorists by rectifying the inequity between motor fuel tax rates – standardizing all motor fuel taxes, including gasoline, diesel, and liquefied petroleum gas, to an effective tax rate of 19 cents per gallon. Revenues from a four cent diesel increase will be distributed as follows: 85 percent for use on National Highway System routes, and 15 percent to the Critical Bridge Fund for use on local “on-system” bridges. The reform package provides a long-term revenue stream, generating additional support of \$46.3 million in fiscal year 2003, \$66 million in 2004, and over \$90 million in 2005. Dedicating the revenues for these purposes ensures that the diesel fuel tax increase is used on the commercial system which is critical to the state's trucking, manufacturing, and commercial interests.

“This is a matter of simple equity, of truck owners paying at least as much as other motorists for the privilege of using Michigan roads.”

The Grand Rapids Press, May 15, 2001

CONCLUSION

The budget that is presented today leaves a balance of approximately \$250 million in the Budget Stabilization Fund. It is the Governor's recommendation that any unreserved fund balance at the end of fiscal years 2002 and 2003 be deposited into the Budget Stabilization Fund. He also recommends that, if revenues improve from current estimates, a portion of the increase be earmarked for deposit into the Fund. Setting aside a reserve is more than just sound economic policy; it's an obligation to Michigan's citizens. As the current economic downturn has demonstrated, adequate reserves in the Budget Stabilization Fund can help protect critical programs when the economy weakens. We need to rebuild the Fund as quickly as possible.

The creation of this budget has not been easy. There will be vigorous debate on some of the recommendations. Together we face the challenge of enacting a balanced budget. The politics of balancing the budget are difficult, and there is a temptation to delay. But decisions that are difficult today will be even more difficult tomorrow. As term limits bring many to bid farewell, let us have the courage to address the issues head-on, and the conviction to look beyond election-year politics. To lay a firm fiscal foundation in these times of economic turmoil is not only the best option, it's also the only option.