Dollars and Sense:

How State and Local Governments in Michigan Spend Your Money

2011 Citizen's Guide to
Michigan's Financial Health

Presented by
Governor Rick Snyder

KEY TERMS

There are a few key terms that may be helpful when reading this report. They include:

- **Budget deficit/surplus.** If there is less money received than paid out in a given fiscal year, there is a budget **deficit** or shortfall. If there is more money received than paid during the fiscal year, a budget **surplus** exists.
- **Debt.** Just like a homeowner takes out a mortgage, governments can borrow money to pay for certain types of projects. The state has both short-term debt (paid back within the fiscal year) and long-term debt. Debt can be either **general obligation** debt, meaning that the state pays back the debt with regular tax collections and other revenues, or **special revenue** debt, which is paid off over time with revenue from specified sources beyond the usual taxes and service fees.
- **Fiscal year (FY).** The 12-month period of time during which budgets are allocated or finances are planned. Most households have a fiscal year that runs from January 1 to December 31 (that's the period for which we pay personal income taxes in April), while state government uses an October 1 - September 30 fiscal year. Some local units of government, including public schools, use a July 1 - June 30 fiscal year, while others operate on a typical calendar year.
- **Fund balance.** Once all the bills for the year have been paid out of a certain fund, whatever is left over is called the fund balance. When a fund balance is less than zero, you'll see the number shown with parentheses around it. Deficits cause fund balances to decrease, while surpluses cause them to increase.
- **Major funds.** These are the primary sources of money from which the state pays most of its bills. They are the General Fund (which pays for a variety of government operations), the School Aid Fund (which pays for most of K-12 education), and the Budget Stabilization Fund (which is the "rainy day" fund that the state can tap into during tough economic times).
- **Public authorities.** The state can establish public, independent authorities to carry out specific tasks and issue debt tied to a specific project or type of project. For example, the Mackinac Bridge Authority was established to construct, operate, and maintain the bridge connecting the upper and lower peninsulas of Michigan.
- **Public budget gap.** A novel measure, similar to the deficit, used to measure the extent to which a government is falling short of covering its current and long-term obligations in a fiscal period. The budget gap takes into account the budget deficit, as well as any new obligations that the government has failed to cover such as **employee pensions or retiree health care.**
- **Reserved/Restricted funds.** Some funds are considered to be "reserved" or "restricted" for a specific purpose, and cannot be spent for anything else.

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Welcome

Governor Rick Snyder

Greetings,

All Michigan residents have a vested interest in the economic future of our state. We need all hands on deck as we sort out the ideas, resources and action steps necessary to get us back on course toward prosperity and growth. This report is intended to provide ALL citizens with an assessment of the financial health of Michigan's state and local governments. **For every $7 earned in Michigan, $1 is sent to state and local government in the form of taxes, fees, and charges for services.** As a taxpayer, you deserve to know what your dollars are buying, and have a voice in making sure those services and programs are going to be appropriate to righting our ship. This report provides information on:

- How taxes and fees are collected and used across our state;
- The long-term consequences of today's budget decisions—borrowing, debt levels, budget reserves; and
- The bills that are mounting for the future, such as public employee pensions and federal loans.

For this report, we have used the most recent information available. In most cases, this is for the 12-month period ending September 30, 2010. What does this report show? Largely, we find the following:

- **Michigan residents are earning less than a decade ago. Lower incomes mean less tax revenue and an increased need for government services.** The result has been an ongoing structural imbalance in the state’s finances;
- **Many governments in Michigan are spending more than they are taking in.** To support their spending, they have drained their savings, borrowed money, and failed to put money away for liabilities they know are on the horizon.
- **Michigan has been unable to invest in its future.** State government expenditures on infrastructure and higher education, among other areas, have declined over the past decade;
- **State employee compensation in Michigan has grown while private sector compensation has fallen**, inhibiting taxpayers’ ability to support the salaries and benefits of public employees, or to meet critical investment needs and assist Michigan citizens in financial distress. **The state's future has been mortgaged through extensive borrowing and accumulation of unfunded pension and retiree health care liabilities;**
- **Years of high unemployment have rendered our unemployment compensation fund insolvent** and created a greater demand for government services. Our system simply wasn’t built for this sustained level of hardship.

Once you have read this report, you are invited to make your voice heard. Bring your ideas to the table, share your opinions, contact your legislator or my office, and help us enact the change necessary to get Michigan back on track. Only by working together can we bring about the change necessary to stabilize Michigan's economy and get our citizens working again.

Thank you to the following organizations for working on this report: Business Leaders for Michigan for leading its development and Anderson Economic Group, Citizens Research Council of Michigan, the Michigan Association of Certified Public Accountants, and the Michigan Government Finance Officers Association for providing valuable input. And many thanks to you, our readers, for your interest and for being part of the historic change that will make Michigan a leader in the new economy.

Sincerely,

Governor Rick Snyder

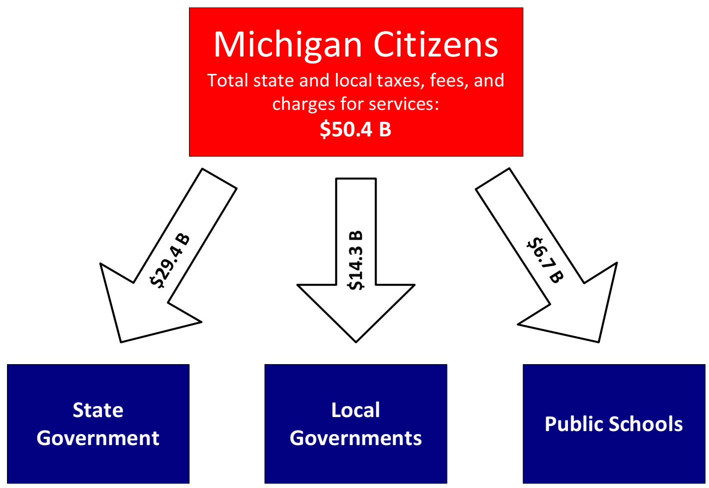
Governor Rick Snyder

How Governments Use Your Money

WHERE CITIZEN DOLLARS GO

For every $7 you earn in Michigan, you pay $1 in taxes, fees, and charges for services to state and local governments.[1] Where does that money go? What benefit do you receive in exchange for these dollars? Figure 1 shows that in FY 2010, Michigan citizens paid $50.4 billion in taxes, fees, and charges for services to state and local governments. Local governments include counties, cities, villages, townships, and some local authorities. Though schools are technically local units of government, they are often presented separately in this report.

FIGURE 1. **Where Your Money Goes, FY 2010**



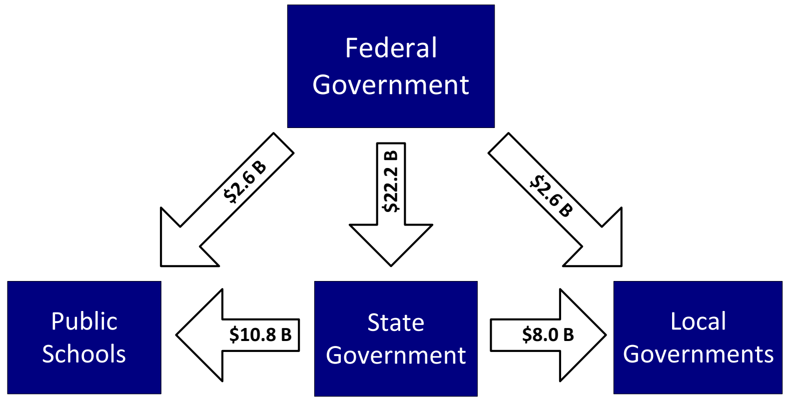
Sources: Data is for FY 2010. State data is from the unaudited FY 2010 CAFR. Local data is from AEG estimates for FY 2010, based on 2008 U.S. Census of Governments State & Local Finances Survey. Analysis: Anderson Economic Group, LLC

HOW GOVERNMENTS WORK TOGETHER

Governments often receive revenues from other government entities. Figure 2 on page 3 shows how these tax dollars and other sources of revenue flow between state, local, and federal governments. For example, most of the money provided to the state via the sales tax is sent to local school districts for K-12 public education. Local and state governments also receive money from the federal government to pay for services such as roads and health care for low-income residents. The arrows in Figure 2 on page 3 show transfers from one government entity to another in Michigan. The table immediately following the figure shows how all of these contributions add up to the total revenues of these government entities. As we discuss later in this report, state and local governments (including schools) received $82.5 billion in revenues in FY 2010.

1. The amount of dollars earned in Michigan per dollar sent to governments is derived by dividing total personal income in the state ($342.3 billion) in the year 2009 by the amount of money state and local governments collected in taxes, fees, and charges for service ($50.1 billion) for FY 2009.

FIGURE 2. **Cash Flow Between Governments**



Sources: FY 2010 Michigan CAFR; U.S. Census Bureau Survey of State & Local Finances; AEG estimates
Analysis: Anderson Economic Group, LLC
Note: Money provided by the federal government to the state government for public schools is shown as a transfer from the federal government to public schools.

Who Funds Michigan's State and Local Governments?, FY 2010

	State Government	Local Governments	Public Schools (K-12)	Total Funds Provided
Michigan Citizens	$29.4 billion	$14.3 billion	$6.7 billion	$50.4 billion
Federal Government	$22.2 billion	$2.6 billion	$2.6 billion	$27.4 billion
Other	$0.8 billion	$3.2 billion	$0.6 billion	$4.4 billion
				$82.5 billion
Transfers from State Government:		*$8.0 billion*	*$10.8 billion*	
TOTAL REVENUES	**$52.5 billion**	**$26.0 billion**	**$20.7 billion**	

Sources: Michigan CAFR, U.S. Census Bureau Survey of State & Local Finances, AEG estimates
Analysis: Anderson Economic Group, LLC

SERVICES THAT GOVERNMENTS PROVIDE

Where does this money go? In general, state and local governments collect money in the form of taxes and fees and use it to coordinate delivery of public services, including, but not limited to:

- Community health (Medicaid, local public health, and mental health services)
- Human services (cash assistance, food stamps, child foster care, disability insurance)
- Corrections and law enforcement
- Infrastructure (roads and bridges)
- Resource protection
- Elementary and high school education
- Higher education (community colleges and universities)
- Planning, zoning, and economic development

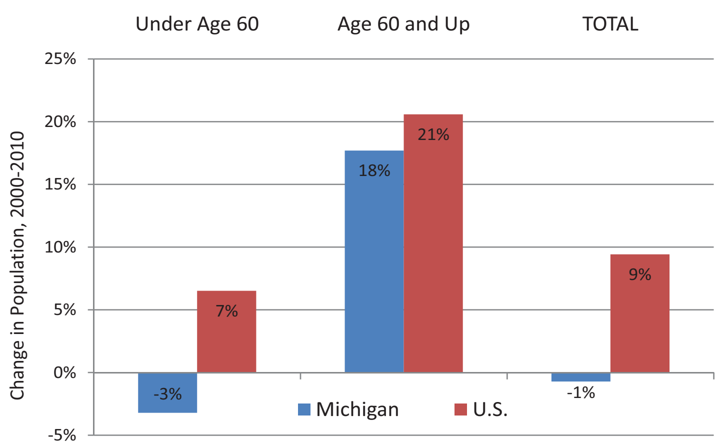
Where We're Headed: Michigan's Economic and Demographic Trends

It is no secret that Michigan's economy has been flagging for some time. People need government services more than ever as they struggle with unemployment and economic hardship. But fewer jobs also mean fewer dollars in tax revenue to support these services. This fundamental tension is, in a nutshell, the current challenge facing our state. Long-term trends in our population and our economy compound this challenge.

OUR PEOPLE

Michigan's population is aging. As shown in Figure 3, the number of Michigan residents below the age of 60 declined between 2000 and 2010 while the number over 60 increased. Aging is a national phenomenon due to the size of the baby-boomer generation, but the situation is more acute in Michigan where there is also a reduction in the number of young people. People over the age of 60 provide less tax revenue on average because pension income is exempt from the state income tax, while they tend to require as many or more public services (e.g. health care). They also consume less, yielding lower sales tax revenue.

FIGURE 3. **Michigan Population Aging—Fewer Younger Workers**



Source: U.S. Census Bureau, Population Estimates, 2000-2009; 2010 Census data
Analysis: Anderson Economic Group, LLC

OUR JOBS

Michigan's unemployment is high. Employment in Michigan has been affected by the poor economy. Between 2000 and 2010, the unemployment rate in Michigan increased from 3% to over 14%—well above the national rate of 10%. **Michigan private sector job losses were equivalent to two-thirds of all jobs lost in the U.S. between January 2000 and January 2010.**[2] This has lowered tax revenue and

2. Nonfarm employment data is from the U.S. Bureau of Labor Statistics, State and Area Employment, Hour and Earnings, and the Current Employment Statistics survey (national).

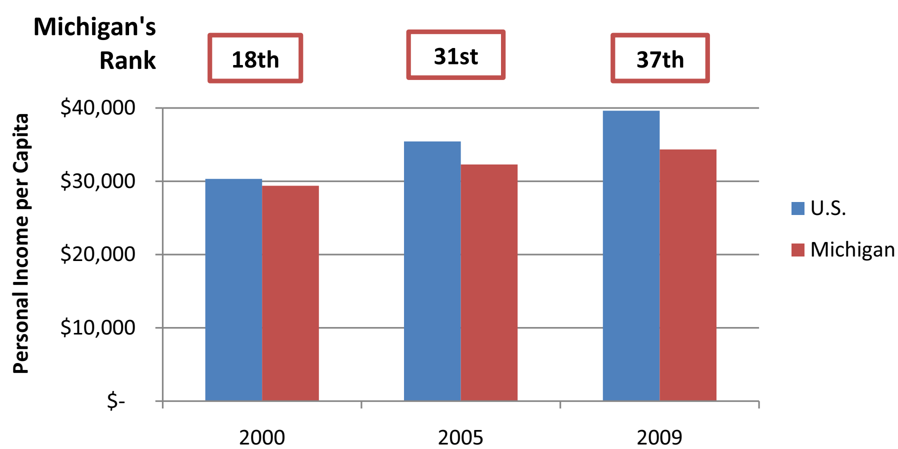
increased demand for unemployment benefits from the state, which we discuss in more detail in "Unemployment Insurance Benefits" on page 18.

OUR INCOME

Michigan's families are among the poorest in the nation. Michigan's income levels have grown slowly during the past fifteen years, largely due to high unemployment and an aging population. Personal income grew by only 7% between 1995 and 2009, compared with U.S. growth of 35% during the same period. In 2000, per capita income in Michigan (in 2009 dollars) was $37,195. By 2009, this had fallen to $34,812. This is lower than the national average of $39,626. **Michigan now ranks 37th in per capita income among all 50 states—and our families are among the poorest in the nation.** See Figure 4.

Michigan now ranks 37th in per capita income among all 50 states—and our families are among the poorest in the nation.

FIGURE 4. **Michigan Has Lagged Behind the Nation in Income Growth**



Source: Bureau of Economic Analysis Regional Information Systems
Analysis: Anderson Economic Group, LLC

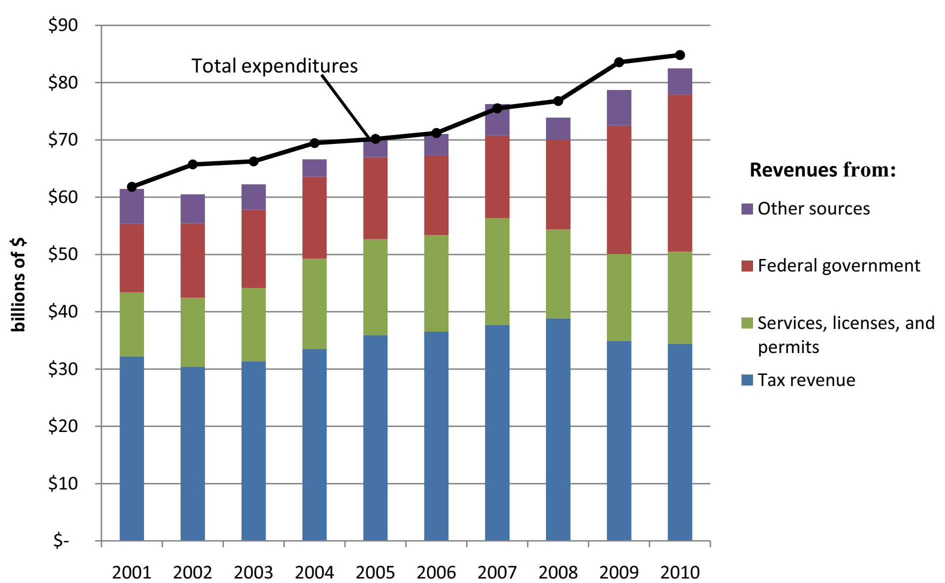
How Taxpayer Money Is Spent: Government Revenues and Expenditures

PUBLIC BUDGET DEFICITS

Many governments in Michigan are spending more than they take in. In total, state and local governments (including public schools) received $82.5 billion in revenue and spent $84.8 billion in FY 2010. This accounts for revenues from all sources, including taxes, service and permit fees, and federal dollars. It includes all primary government spending, not just the major funds such as the General Fund and School Aid Fund. Here's the budget equation for Michigan governments in 2010, in plain and simple terms:

State & Local Government Spending in Michigan, FY 2010	
Government took in:	$82.5 billion
Government spent:	$84.8 billion
Difference:	**($2.3 billion)**

FIGURE 5. **Spending Levels Often Exceed Revenues, FY 2001-FY 2010**



Source: State data from the Statement of Activities, Michigan CAFR. Local data is from the U.S. Census of Governments, State and Local Finance Survey with AEG Projections for FY 2010
Analysis: Anderson Economic Group, LLC
Note: Local government data (which includes public schools) is unaudited survey data compiled by the U.S. Census Bureau. This was the best data available.

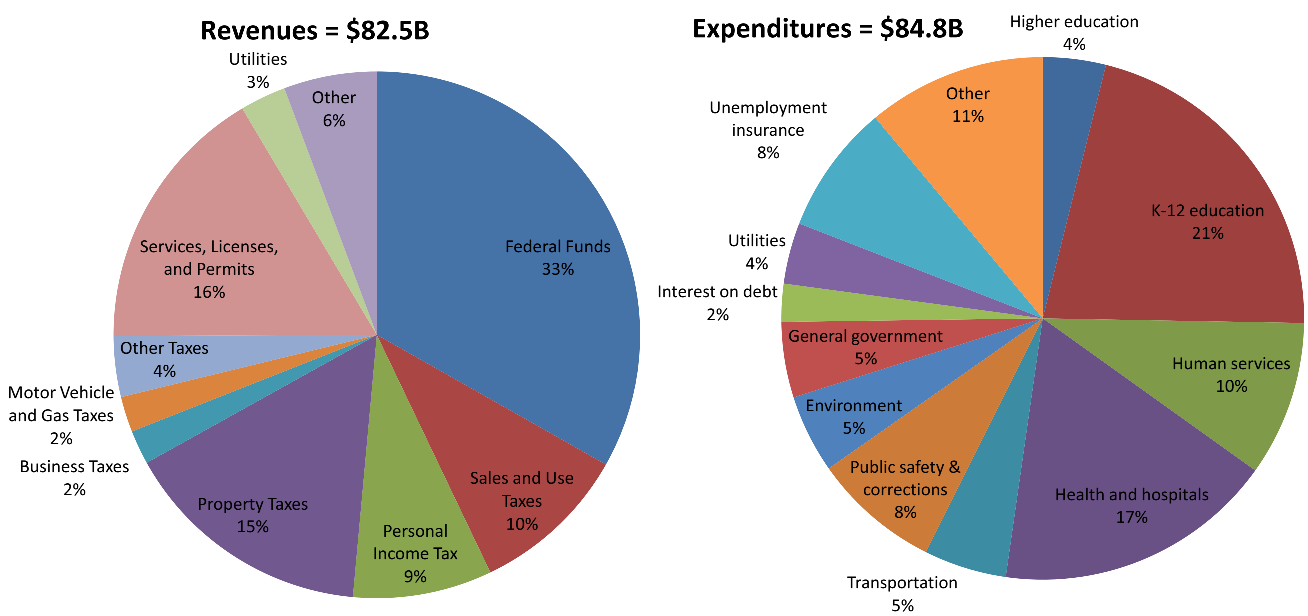
Michigan governments spent more than they received in 2010. *This is not a rare or new thing*. As shown in Figure 5 above, **Michigan's state and local units of government have regularly spent more money than they have taken in since 2001.** In

2010, state government had a primary government deficit of almost $1 billion while local governments, taken together, had a deficit of about $1.2 billion. The state government covered its shortfall in 2010 with $1.2 billion in loans from the federal government for unemployment insurance, which will be repaid by Michigan employers later on.

Public Revenues. Figure 6 shows a breakdown of the dollars moving in and out of state and local governments during 2010. On the revenue side, taxes make up approximately 42% of total revenue, with property taxes at 15% of total revenue, followed by sales and use taxes, and personal income taxes. In 2010, federal funds provided a third of the revenue to Michigan's state and local governments, while charges for services and permit fees accounted for 16% of revenue. Revenues from the federal government have been elevated over the last two years due to temporary federal programs, like the American Reinvestment and Recovery Act (the stimulus package) and extensions of unemployment benefits.

Public Expenditures. Elementary and high school education; health services and hospitals; and human services (including welfare, disability insurance, and the food stamp program) account for almost half of all public expenditures.

FIGURE 6. **Public Revenues and Expenditures by Category, FY 2010**



Source: State data is from the Michigan CAFR. Local data is from the FY 2008 U.S. Census of Governments State and Local Finance Survey, with AEG Projections for FY 2010
Analysis: Anderson Economic Group, LLC

MICHIGAN'S STATE SPENDING PRIORITIES

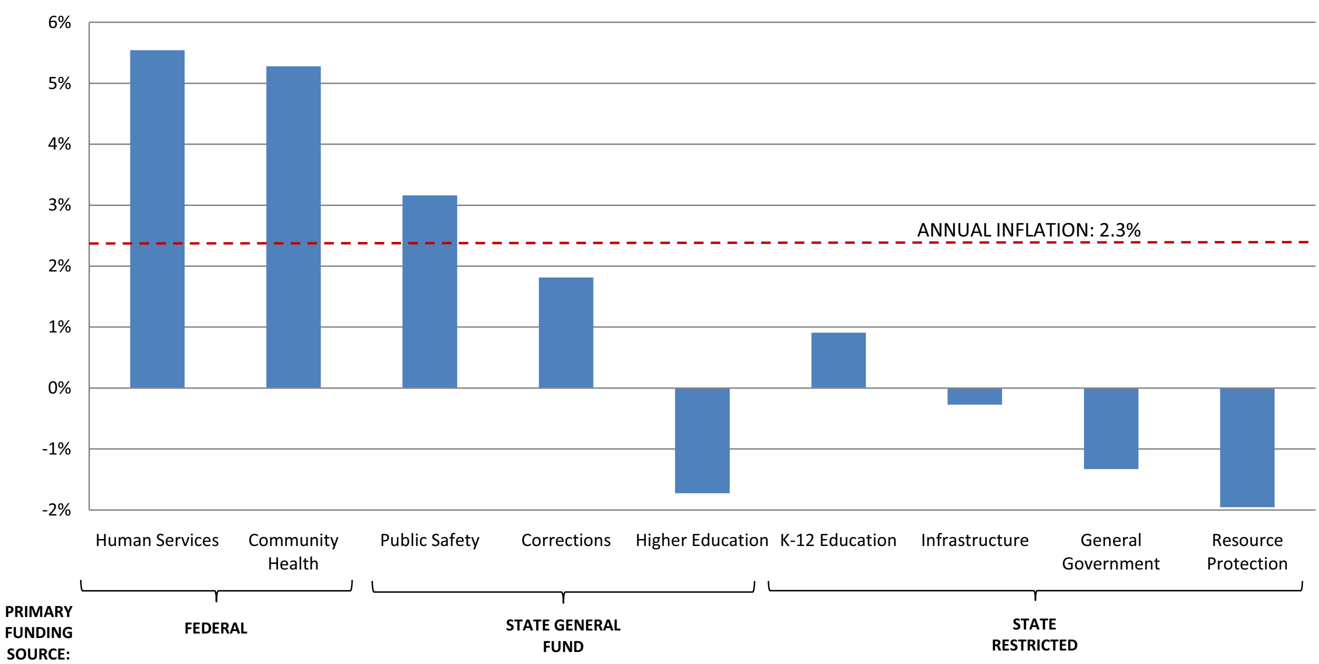
Michigan's state government has not been able to make investments that might spur economic growth, but rather has had to meet heightened demand for community health and human services. The largest expenditure category for the *state* government alone (the previous section included local government and schools, as well) is community health (Medicaid and mental health services, for example), followed by K-12 education, and human services (e.g. disability insurance, cash assistance, the food stamp program, child foster care programs). These three categories accounted for 75% of total appropriations by the state government this past fiscal year. *Appropriations* are funds allotted to state departments by the legislature.

State Government Appropriations, FY 2010		
Community health	$13.6 billion	*29.8%*
K-12 education	$12.8 billion	*28.1%*
Human services	$7.8 billion	*17.1%*
Other	$11.4 billion	*25.0%*
TOTAL	**$45.6 billion**	

Source: Michigan House Fiscal Agency
Note: Total appropriations do not match up exactly with total expenditures because accounting methods for the two are different and not all state government expenditures are appropriations.

Not only are human services and community health two of the largest spending categories, they have been growing at the fastest rate over the past ten years. While human services and community health increased at twice the rate of inflation, almost all other categories remained flat or lost funding over the same period.

FIGURE 7. **Average Annual Change in State Appropriations, FY 2001-2010**



Source: Michigan Senate Fiscal Agency; House Fiscal Agency for FY 2010; U.S. Bureau of Labor Statistics for inflation
Analysis: Anderson Economic Group, LLC

Spending growth on public safety outpaced inflation, but spending on public safety only represents 2% of state government spending. Spending on K-12 education has gone up less than 1% per year, on average, over the past decade, while expenditures on infrastructure, general government, higher education (including community colleges and public universities), and resource protection (including agriculture) have all declined. Much of the appropriations in the "general government" category go to revenue sharing, which is the allocation of a share of state sales tax revenue to local governments. (The Constitution requires a given amount of revenue sharing, but there is also a discretionary component.) State appropriations for revenue sharing decreased one-third from $1.5 billion in 2002 to $1.0 billion in 2010, accounting for all of the decline in this category.

GOVERNMENT EMPLOYEES

In Michigan, the public sector (including all state, local, federal, military, and public school employees) made up 15% of the state's workforce in 2010. In that year, the state government employed 50,615 classified and almost 3,000 unclassified (e.g. judges, elected officials) workers. In addition, there are approximately 400,000 local government employees in the state.[3] Between 1990 and 2010 the number of classified state employees fell by almost a quarter. Meanwhile, the number of local government employees peaked in 2003 and has since nearly returned to 1995 levels.

Public Sector Employment in Michigan, 1990-2009

	1990	1995	2000	2005	2009	*% Change Since 1990:*
Local Government (including public school employees)	388,144	400,634	443,061	446,807	407,693	*5%*
State Government	66,791	62,672	61,493	52,614	51,699	*-23%*

Sources: Michigan Civil Service Commission, Annual Workforce Reports; Bureau of Economic Analysis, Regional Economic Information System
Analysis: Anderson Economic Group, LLC

DIFFERENCE IN PUBLIC AND PRIVATE SECTOR COMPENSATION

Real (inflation-adjusted) compensation of state and local government employees (including salary, wages, and benefits) has increased during the last 10 years while real private sector compensation has declined. Between 2000 and 2009, compensation of the average private sector worker fell 4% while it increased 19% for state government employees and 13% for local government employees (local government employees includes teachers and other employees of school districts).

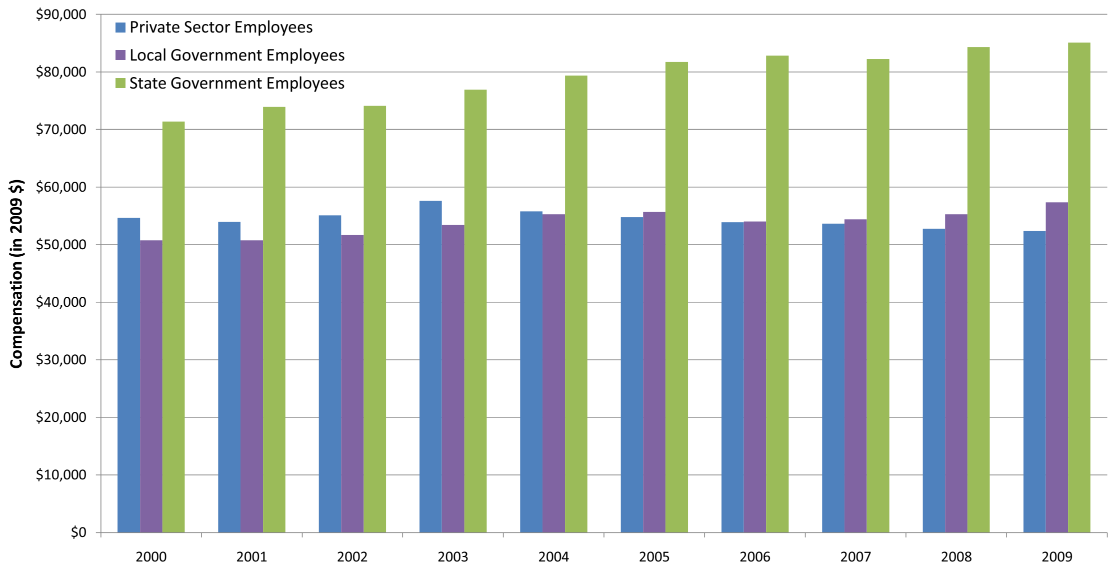
Average annual compensation of state employees (including salary, wages, and benefits) was over 60% higher than average annual compensation of private sector workers in 2009.

Figure 8 on the following page shows the average compensation of private sector workers, state government employees, and local government employ-

3. Local government employees and compensation are from the U.S. Bureau of Economic Analysis Regional Economic Information System data for 2009.

ees. While average compensation for local and state government workers has grown, there has not been a corresponding increase in private sector compensation to support this growth.

FIGURE 8. State Employee Average Compensation Exceeds That of the Private Sector



2009 Avg. Comp.

State: $85,076
Local: $57,333
Private: $52,365

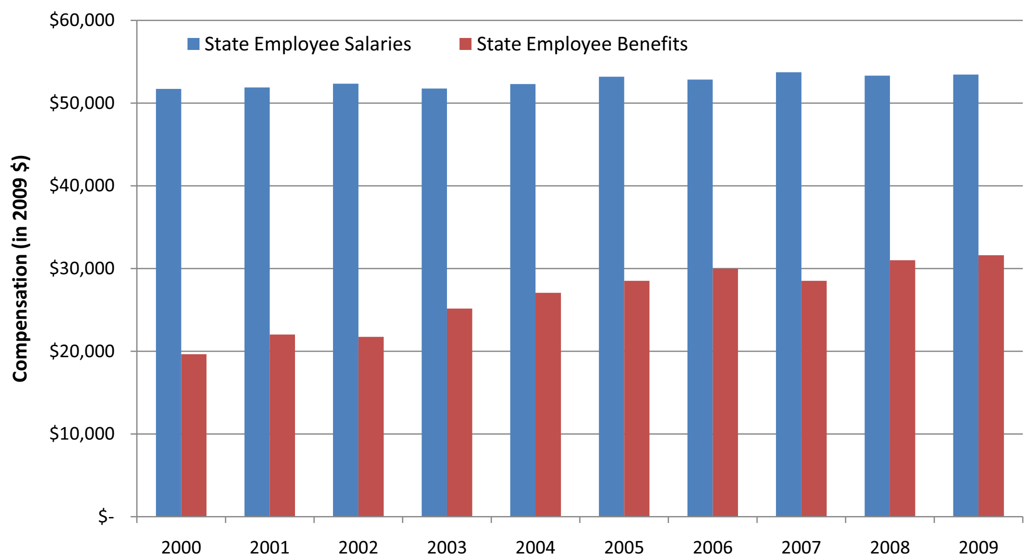
Note: Employee compensation includes salary, wages, pension benefits, and health insurance benefits.
Source: Local government data and private sector data are from the Regional Economic Information Systems, Bureau of Economic Analysis. State government data is from the Michigan Civil Service Commission Annual Workforce Report, 1990-2009. Inflation as determined using the Consumer Price Index for All Urban Consumers, All Items reported by the Bureau of Labor Statistics.
Analysis: Anderson Economic Group, LLC
Revised: See the "Revisions" section at the end of this report for further information.

The averages presented above show the growing disparity in private and public sector compensation. In 2000, average public sector compensation was 31% higher than average private sector compensation. In 2009, state classified employee compensation was 63% higher, on average, than the private sector. This analysis only compares average compensation and does not compare private and public sector employees with similar jobs, years of experience, or education.

We are using total wage employment for both sectors, which includes both part-time and full-time workers. The data shown here for private sector compensation is average compensation for all non-farm wage employment in the private sector in Michigan. State employee compensation includes only compensation for classified workers. The state has nearly 3,000 unclassified workers (people who are elected or appointed to their position) who make more than classified state employees, on average, so including these workers would result in a higher amount for average state employee compensation. For example, unclassified workers include the governor (salary of $159,300), Michigan Supreme Court justices (salary of $164,610) and state legislators (salary of $71,685 and higher).[4]

Real growth in state employee compensation over the past decade has occurred almost exclusively through growth in the cost of employee benefits, including active employee health care, retiree health care, and pensions. In 2009, the average annual state employee salary was $53,453 and average benefits were $31,623. Figure 9 shows that average salaries for state employees have stayed fairly constant at just over $50,000 (in real terms) since 2000. In that same time period, benefit costs have grown from almost $20,000 to almost $32,000 per employee.

FIGURE 9. Benefits Are the Primary Source of Growth in Average State Employee Compensation



Note: Data is for classified state employees only.
Source: Michigan Civil Service Commission Annual Workforce Reports, Bureau of Labor Statistics Seasonally-Adjusted Consumer Price Index for All Urban Consumers, All Items to adjust for inflation.
Analysis: Anderson Economic Group, LLC
Revised: See the "Revisions" section at the end of this report for further information.

4. "Salaries and Expense Allowances for Positions Subject to SOCC Recommendations, 2011," Michigan Civil Service Commission, State Officers Compensation Commission.

Michigan's Fiscal Health

In order to spend at current levels, Michigan governments have:

1. Drawn down reserves
2. Borrowed money
3. Increased unfunded pension and other retirement liabilities

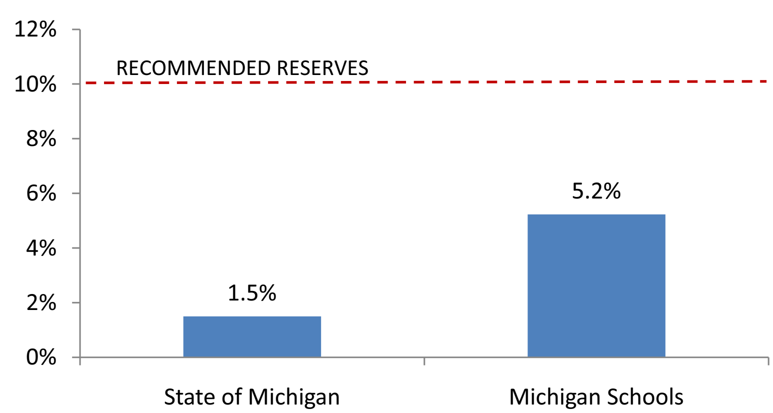
RESERVES AND MAJOR FUND BALANCES

In recent years, governments and schools have drawn down their financial reserves or depleted their savings to support current spending levels. State and school reserve levels are presented in Figure 10 below. Aggregate local government reserve information is not available on a statewide basis.

State Government Reserves. It is considered good practice to keep around 10% of annual operating expenditures in unrestricted fund balances to cover new, unexpected expenses or an unanticipated drop in revenue.[5] This is the state's equivalent of a cookie jar on the counter, or money in a savings account for unexpected needs. The State of Michigan had almost $720 million in unrestricted fund balances in its major funds in FY 2010. That is 1.5% of total expenditures from those funds—well below the recommended 10%.

School Reserves. In FY 2004, public school districts had unrestricted reserves equivalent to over 10% of operating expenditures. Over the past few years, they have drawn down these reserves, bringing the reserve level to 5% last year.

FIGURE 10. **Government Savings Depleted, FY 2010**



Source: Michigan CAFR; Department of Education Michigan Bulletin 1011
Analysis: Anderson Economic Group, LLC

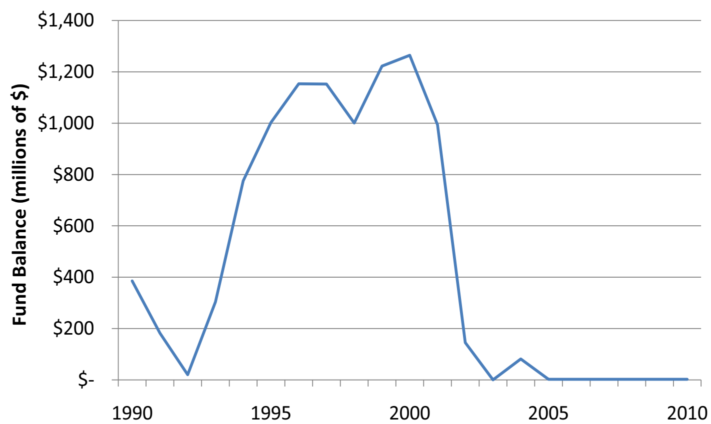
5. There is some disagreement as to the best level of reserves for government funds. The Government Finance Officers Association (GFOA) recommends 2 months 'worth (or about 17%) of reserves, while the National Association of State Budget Officers (NASBO) recommends a level of 5%. For the analysis shown here, we have chosen a level of 10%.

MICHIGAN'S "RAINY DAY FUND"

At the current level of $2.2 million, the balance in the state's "Rainy Day Fund" is not enough to cover the cost of state government operations for 30 minutes.

The state's "Rainy Day Fund" (officially, the Budget Stabilization Fund), is designed to help the state weather challenging economic periods or unforeseen emergencies. During good economic times money is put into the fund and during poor times, money is drawn out to fund government expenditures. The Budget Stabilization Fund had $1.2 *billion* in it in FY 2000, but just $2.2 *million* by FY 2005. The fund remains at that level today. **At $2.2 million, the balance in the "Rainy Day Fund" is not enough to cover the cost of state government operations for 30 minutes.** See Figure 11 below.

FIGURE 11. **Michigan Rainy Day Fund Balance Has Dropped Significantly**



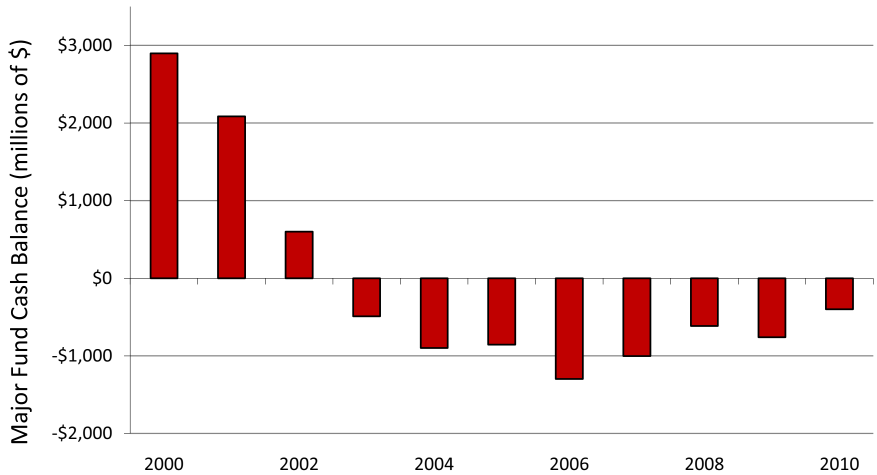
Source: Michigan Senate Fiscal Agency; Michigan Department of Treasury Annual Report, FY 2008-09
Analysis: Anderson Economic Group, LLC

CASH ON HAND AND INTERNAL BORROWING

The General Fund and the School Aid Fund do not have cash on hand. The state takes out short-term loans to pay current bills. In order to make scheduled payments for services, the state government has begun borrowing through short-term general obligation loans that have to be paid back within the fiscal year. In eight of the last nine years, the State of Michigan borrowed over $1.2 billion at the beginning of the fiscal year that it paid back *with interest* at the end of the fiscal year. **The Constitution requires that short-term state borrowing in any given year must not exceed 15% of unrestricted state revenues from the previous year.**

As shown in Figure 12 on page 14, the State had a positive cash balance in major funds until 2002, but has borrowed to make payments each year since 2004, resulting in a negative cash balance. A negative cash balance occurs when a fund currently owes more money to other funds and entities than it has in cash on-hand.

FIGURE 12. **The State's Negative Year-End Cash Balances, FY 2000-FY 2010**



Source: Michigan Department of Treasury, Annual Report, FY 2008-09
Analysis: Anderson Economic Group, LLC
Note: Major funds are the General Fund, School Aid Fund, and Budget Stabilization Fund

> ***Each year, school operations continue only because money that had originally been designated for other purposes is temporarily re-routed into the School Aid Fund.***

The School Aid Fund has ended the fiscal year with no cash on hand each year for the past ten years. In order to continue funding schools in Michigan, cash is diverted from other state funds into the School Aid Fund. In other words, **each year school operations continue only because money that had originally been designated for other purposes is temporarily re-routed into the School Aid Fund.** The State's General Fund has had similar problems. A the end of 2001, the General Fund had over $1 billion in cash. By 2003, that amount had dropped to $7 million and has stayed roughly the same ever since.

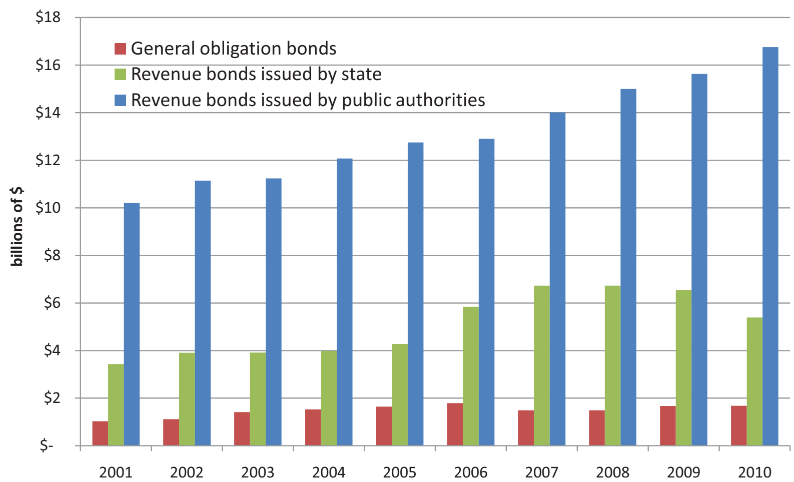
PUBLIC BORROWING

State Government Debt

Governments and schools do not always have the cash on hand to pay for large projects like new buildings or even to make scheduled payments. Like households, governments borrow to pay for larger expenditures, or to deal with cash-flow problems.

In FY 2010, the State of Michigan had over $1.6 billion in outstanding general obligation debt, borrowed mostly for loans to school districts and environmental protection projects. In addition, the State had $5.5 billion in outstanding special revenue bond debt, and public authorities created by the State had $16.6 billion in outstanding special revenue bond debt in FY 2010. (Public authorities are independent government entities with designated revenue streams, so if they fail to repay their debts, the state taxpayers are technically not on the hook for the shortfall.) Figure 13 on page 15 shows these three types of state debt.

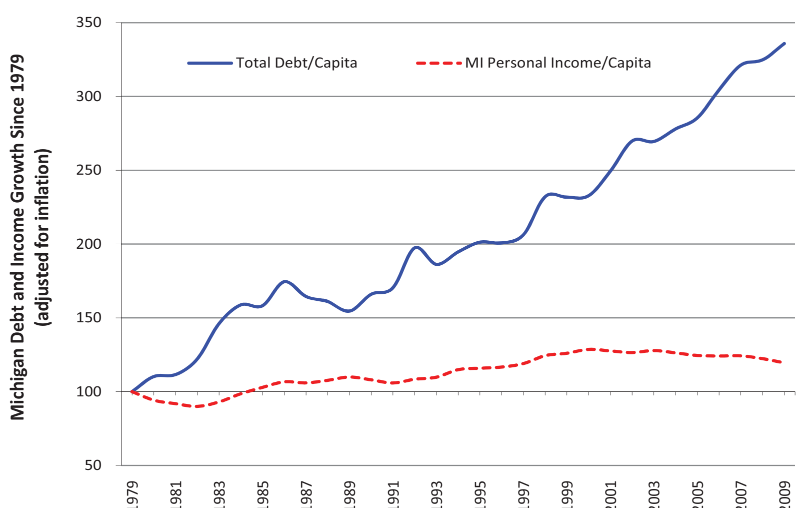
FIGURE 13. Debt Owed by State Government Grew, FY 2001-FY 2010



Source: Michigan CAFR
Analysis: Anderson Economic Group, LLC
Note: The shift from state revenue bonds to public authority bonds in 2010 was due to the re-categorization of the Tobacco Settlement Finance Authority, which carries approximately $1.1 billion in debt, as part of an independent public authority.

The state has borrowed money at a faster pace than personal incomes have grown over the past 20 years. The level of state debt per person has increased from $724 per person in 1979 (in 2010 dollars) to over $2,430 per Michigan resident in 2009 (in 2010 dollars), as Figure 14 shows.

FIGURE 14. Debt Far Outpaces Income, FY 1979-FY 2009

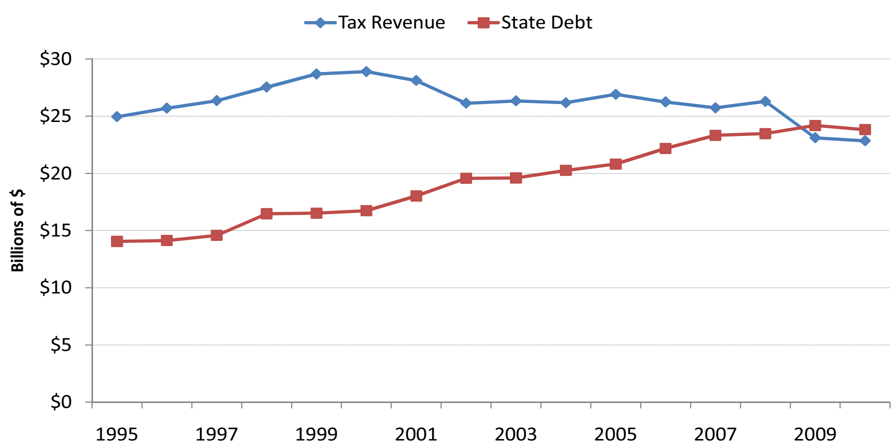


Source: State of Michigan, Michigan Department of Treasury, Annual Reports
Analysis: Anderson Economic Group, LLC
Note: Total debt includes state general obligation debt, state-backed revenue dedicated debt, and debt issued by state-created public authorities.

The level of state debt per person has increased from $724 per person in 1979 to over $2,431 per Michigan resident in 2009.

State public debt (including debt issued by state-created public authorities) compared to annual state tax revenue is shown in Figure 15, adjusted for inflation. State revenue from taxes used to be almost twice as much as the state's outstanding debt, but debt has grown while tax revenue has fallen. **Today, outstanding state debt levels are greater than annual state tax revenue.**

FIGURE 15. **State Tax Revenue Compared to Total State Government Debt, FY 1995-FY 2010**



Source: Michigan Department of Treasury, Annual Reports; Michigan Senate Fiscal Agency
Analysis: Anderson Economic Group, LLC

Local Government and School Debt

Local governments and school districts also take on short- and long-term debt. They take on short-term debt primarily for cash-flow reasons, and long-term debt in order to fund schools, utilities, and larger projects. **Similar to the State, local government debt has increased considerably over the past decade.** Combining school districts, municipalities, and local special districts (such as waste management districts, special assessment districts, etc.), total debt outstanding at the end of 2008 was $46.7 billion (in 2010 dollars), up from $35.1 billion in FY 2000 (in 2010 dollars).

Total Government Debt

Total government debt (local governments + school districts + state) has grown from $52 billion in FY 2000 to almost $70 billion in FY 2008 (in 2010 dollars). Adjusting for inflation, this is almost a 35% increase over eight years. As shown in the following table, local government and schools increased their debt by a third during this time period, while state debt increased by 40%.

Total Government Debt Grew, FY 2000-FY 2008 (in 2010 $)	**2000**	**2008**	**Average Annual Increase, 2000-2008**
State Government	$16.7 billion	$23.5 billion	*4.4%*
Local Governments and Public Schools	$35.1 billion	$46.7 billion	*3.6%*
TOTAL	**$51.8 billion**	**$70.2 billion**	***3.9%***

Source: State Treasurer Report, U.S. Census of Governments State and Local Finance Survey
Analysis: Anderson Economic Group, LLC
Note: Total debt includes state GO debt, state-backed revenue dedicated debt, debt issued by public authorities, and local governments and public school-debt.

PENSION AND RETIREE HEALTH CARE OBLIGATIONS FOR PUBLIC EMPLOYEES

Michigan has not adequately funded its future retirement obligations for public employees. Public employees who meet certain requirements, such as years of service and age, receive a pension when they retire. Many also have the option to enroll in a retiree health care program.

Public Pension Benefits

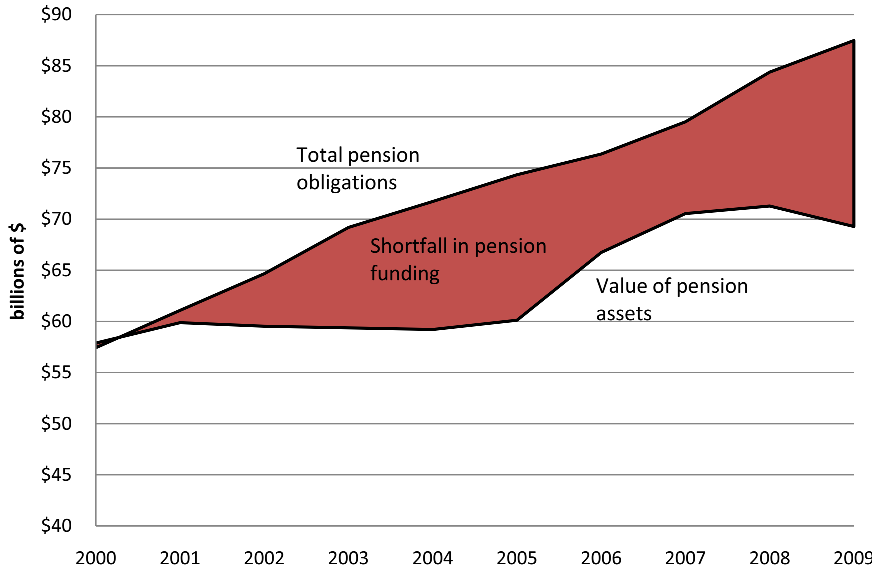
Pension benefits are pre-funded by contributions from employers (governments or school districts) and employees, who often need to contribute a certain percentage of their salary. There are three principal statewide pension systems: the Michigan Public School Employees Retirement System (MPSERS), the Michigan State Employees Retirement System (MSERS), and the Municipal Employees Retirement System (MERS). MPSERS and MSERS are managed by the State of Michigan, while MERS is an independent public corporation, overseeing a retirement fund for local governments across the state. The largest pension system in Michigan, by far, is MPSERS (for public school employees) which has over $30 billion in net assets and serves 440,000 active and retired employees.

Quickly rising benefits, poor market conditions, and insufficient contributions have resulted in a total state and local pension fund shortfall of at least $18.2 billion.

Investment returns for these systems have been very poor the past few years. In 2008 and 2009, state and local retirement systems lost a combined $15 billion in net investments before gaining about $5 billion in 2010. Benefits paid to retirees, on the other hand, have continued to rise from year to year. Total pension benefits paid by the state have risen by 4.8% per year while local government pension benefits have risen by 4.3% per year since 2000, after adjusting for inflation.

Each of these funds remains solvent, but pension funds are only properly funded when current contributions are enough to meet expected future payments for today's employees. **The combination of quickly rising benefits, poor market conditions, and stagnant or slowly rising contributions have made for a considerable shortfall in funding for future public sector pension obligations.**

FIGURE 16. Shortfall in Funding of Public Pension Systems in Michigan



Unfunded Pension Liabilities (at end of FY 2009)

State Government: $3.1 billion
Local Government: $3.1 billion
School Districts: $12.0 billion

Source: Comprehensive Annual Financial Statements for MSERS, MPSERS, MERS, DGRS, and DPFRS
Analysis: Anderson Economic Group, LLC

Figure 16 shows the present value of total future obligations for the largest public retirement funds in Michigan compared to the appraised value of the funds' assets. When future obligations exceed the value of the funds' assets, the fund has a shortfall. Worsening market conditions and insufficient contributions have combined to result in a total state and local pension fund shortfall of at least $18.2 billion.

Retiree Health Care Benefits

Each of the retirement systems mentioned in the previous section also funds retiree health care. These benefits are pay-as-you-go, meaning they are not pre-funded. *Unlike state pensions, these benefits are not guaranteed by the State Constitution.*

MERS, which serves local governments across Michigan, just started its retiree health benefits programs in 2004. The MERS health care fund now has $217 million in net assets, but only paid out $6.6 million in benefits in 2009 since only a few enrollees have retired. In 2010, MSERS and MPSERS paid out $330.5 million and $650.7 million, respectively, in retiree health benefits. **Since MSERS and MPSERS health care benefits are not pre-funded, their unfunded future obligations are significant, at $12.6 billion and $27.6 billion, respectively.** Detroit paid $300 million in retiree health care benefits in 2010, but maintained a fund balance of only $6 million for retiree health care. All future liabilities for retiree health care in Detroit, an estimated $5 billion, are unfunded.

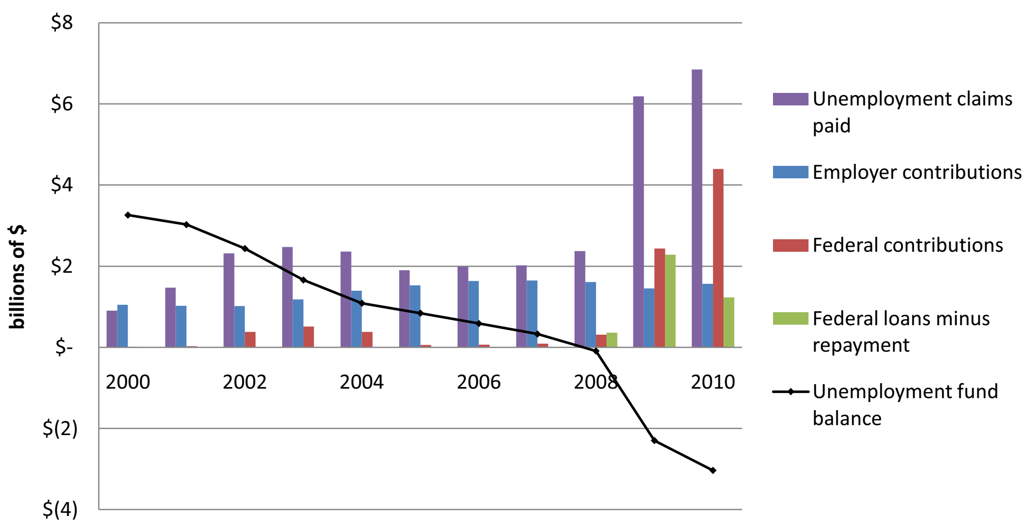
UNEMPLOYMENT INSURANCE BENEFITS

After years of high unemployment, Michigan's Unemployment Compensation Fund is broke. Unemployment compensation funds are funded through Michigan employer taxes and federal dollars. The federal government currently pays for all extended unemployment benefits (all benefits beyond 26 weeks, and up to 99 weeks). When states are no longer able to fund their own unemployment insurance, the federal government offers loans. Ideally, the funds increase during good times so that they are large enough to handle the drain from high unemployment during recessions. However, these funds are not intended to handle an entire decade of high unemployment, which the state of Michigan has recently experienced.

In 2009 and 2010, Michigan borrowed a combined $3.5 billion from the federal government in order to continue making payments on unemployment insurance claims.

As shown in Figure 17, the last time that Michigan's Unemployment Compensation Fund received more payments from employers and the federal government than it paid out to the unemployed was in 2000. At the end of that fiscal year, the fund had a surplus of $3.3 billion. In 2008, after 7 consecutive years of an unemployment rate in Michigan at or above 7%, the fund became insolvent, *surviving since then only due to loans from the federal government*.

FIGURE 17. **Michigan Unemployment Trust Fund Insolvent**



Sources: Michigan Comprehensive Annual Financial Reports
Analysis: Anderson Economic Group, LLC

In 2009 and 2010, as the statewide unemployment rate rose to over 14%, Michigan borrowed $3.5 billion from the federal government in order to continue making payments on unemployment insurance claims. **By the end of 2010, Michigan's unemployment trust fund was in the red by $3 billion.**

Until now, the state government has not had to pay interest on these loans, but interest will be charged this year, barring Congressional action. Also, the state enforces a special tax on some businesses whenever its unemployment insurance fund is insolvent. This tax had been postponed due to the poor economy, but will begin this year.

MICHIGAN'S CREDIT RATING

Michigan maintains a sound credit rating despite its challenges. The credit-worthiness of the State of Michigan is assessed by three rating agencies: Standard and Poor's, Moody's, and Fitch. The market assesses the budget practices of the State and determines whether it believes Michigan has the ability to re-pay its debts. A ranking of AA or AAA is considered a secure, or high-quality investment. The State of Michigan had a AAA rating in 2000. Since then its ratings have slipped a bit to AA-, according to Standard & Poor's, but Michigan is still considered a high-quality investment. This is critical, as the state's credit rating affects the cost of borrowing, and local units of government rely on the state's credit rating when securing financing.

A WIDENING PUBLIC BUDGET GAP

A *deficit* is the extent to which expenses exceed revenues in a given year. However, state and local governments have unfunded obligations that are not recognized in their deficits—namely, unfunded pensions and retirement health benefits are not recognized as liabilities and therefore not included in the budget surplus or deficit figure. Though governments have not fully funded these obligations, they will eventually have to pay for them since the Michigan Constitution guarantees pensions (but not retiree health benefits) for public employees. We present an alternative measure to the budget deficit called the *public budget gap*.

To measure the public budget gap in any given year, one adds any new unfunded obligations for pensions or retiree health benefits accrued during the year to current expenses.[6] This gives the total amount needed to fully fund state and local governments' obligations for the fiscal year. Subtracting these new "expenses" from revenues gives the public budget gap for that year. For FY 2009, the deficit for the State of Michigan (derived by subtracting expenses from revenues) was $3.8 billion and for local governments was an estimated $1.0 billion. Accounting for unfunded pensions and unfunded retiree health benefits, the *public budget gap* was $8.3 billion in 2009 for the state and $1.9 billion for local governments. This is the amount of new unfunded liabilities and uncovered expenses accrued during that year, as shown in the table below.

Michigan's Public Budget Gap in FY 2009 (millions of $)

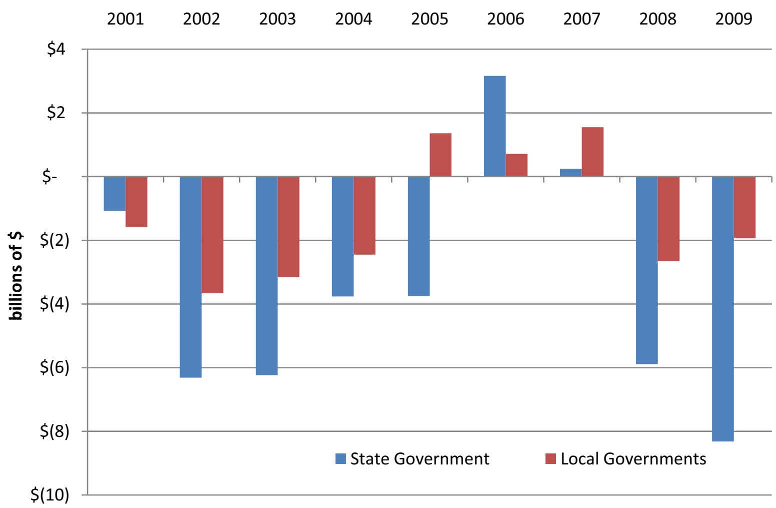
	State Government	Local Governments	TOTAL
Surplus / (Deficit)	($3,826)	($1,024)	($4,850)
- New Unfunded Pension Obligations	($3,893)	($912)	($4,805)
- New Unfunded Health Care Obligations	($602)	n/a	($602)
PUBLIC BUDGET GAP	**($8,320)**	**($1,936)**	**($10,256)**

Sources: See Figure 17 notes

6. In deriving the public budget gaps presented here, for local governments, unfunded retiree health care obligations are not included due to data limitations. Pre-2006, state retiree health care obligations are estimates.

Public budget gaps for each year between 2001-2009 are shown in Figure 18 for state and local governments. The large negative public budget gaps in years 2002 through 2005 were mainly due to the state under-funding its pensions. In each of these years, state pensions added $2 to $4 billion in unfunded obligations. In 2006 and 2007, the state actually had a surplus using the public budget gap measure because the state lowered its unfunded pension obligations by a combined $5 billion in those two years.

FIGURE 18. **The Public Budget Gap Widens for State & Local Governments**



Sources: State of Michigan CAFR, CAFRs for state and local pension plans, U.S. Census Bureau State and Local Finance Survey, AEG estimates
Analysis: Anderson Economic Group, LLC
Note: Unfunded obligations for local government retiree health care are not included due to data limitations. Pre-2006 retiree health care obligations for the state are estimated due to data limitations. Unfunded public school teacher pensions and retiree health care are included in "State Government" because the state government is constitutionally or contractually obligated to provide these benefits.

Cumulative Public Budget Gap

The State government had a cumulative public budget gap at the end of FY 2009 of $43.3 billion.

Public budget gaps are like deficits in that, over time, they accumulate. For example, if the state has two consecutive years with a public budget gap of $5 billion in each year, that means that state government has underfunded its obligations and expenses by a total of $10 billion over those 2 years. The state's *cumulative public budget gap,* accrued over its history, can be estimated by subtracting all of the state's unfunded pension and retiree health care obligations from the state's net equity. By the end of 2009, the net equity of the state government stood at $11.7 billion. **If the state government were to recognize appraised pension obligations and contractually-promised retiree health care obligations on its balance sheet, the State would need to subtract $55 billion from its net equity to arrive at the State's *cumulative public budget gap* of $43.3 billion at the end of 2009.**

How This Report Was Developed

The goal of this report was to provide the public with as much information as possible on the revenues, expenditures, and other financial activities of state and local governments. On behalf of Governor Rick Snyder, Business Leaders for Michigan commissioned this report from Anderson Economic Group. A special note of appreciation is extended to the following organizations, who also contributed to the design and content of this report:

- Citizens Research Council of Michigan
- Michigan Association of Certified Public Accountants
- Michigan Government Finance Officers Association

DATA SOURCES AND NOTES

State government data is from the Michigan Comprehensive Annual Financial Report (CAFR), the FY 2009 Annual Report of the Michigan State Treasurer, and the CAFRs of the public pension systems (MERS, MPSERS, and MSERS). Historical state appropriations data is from the Michigan Senate Fiscal Agency. The Michigan Department of Treasury provided FY 2010 unaudited Michigan Comprehensive Annual Financial Report (CAFR) information on state revenues, expenditures, reserves, and debt.

Local government data is from U.S. Census of Governments State and Local Finance survey. We reviewed local government data provided to the Michigan Department of Treasury, but found it to be inconsistent year-to-year, and thus relied on the U.S. Census data. This too has its problems as it is unaudited survey data compiled by the Census. We used the Department of Education Bulletin 1011 data for local schools.

The information presented is the most recent data available by fiscal year. For most indicators, this is FY 2010. For the state government, the fiscal year runs October 1 to September 30 while local governments vary. While the goal is to present the same information for all public entities, local data limitations prevented us being able to do this for all measures.

OTHER SOURCES AND LINKS

This report, along with a detailed supplemental data and methodology appendix, can be found at www.michigan.gov/budget. For other information about state government funding, please refer to the following resources:

- Michigan Comprehensive Financial Report
(http://www.michigan.gov/documents/budget/cafr2009_313817_7.pdf)
- Annual Report of the Michigan State Treasurer
(http://www.michigan.gov/documents/treasury/STAR08-09_322948_7.pdf)
- Michigan House Fiscal Agency
(http://www.house.mi.gov/hfa/)
- Senate Fiscal Agency
(www.http://www.senate.michigan.gov/sfa/)
- Citizens Research Council of Michigan
(www.crcmich.org)

REVISIONS

The following revisions have been made to this document since its release on January 31, 2011.

Date	Section	Page	Revision
1/31/2011	How Governments Use Your Money	p. 4	In figure 2 and the accompanying table, federal government payments to local governments previously included some public school payments totalling $400 million. Since we show federal government payments to public schools as a separate item, we revised the federal government payments to local governments from $3.0 to $2.6 billion in order to avoid double-counting these payments.
3/28/2011	Government Employees; Difference in Public and Private Sector Compensation	pp. 9-11	The analysis on public sector compensation has been clarified and expanded: **1.** The value for average private sector compensation shown in this revision is derived by dividing the total salary and benefits of private sector, salaried workers in Michigan by total private sector salaried employment, *excluding sole proprietors*. "Sole proprietors," under the tax code, are contract workers or people who are self-employed. Many employees, working in both the government and private sector, are also "sole proprietors" when they earn outside income. This income could come from contract work, consulting, or from ownership of a small business. There is no unambiguous, direct method to compare the earnings of public and private sector workers without more comprehensive data on self-employed earnings. Previously, we included sole proprietors when estimating average private sector compensation. The difference between our previous estimate of private sector average compensation and our revised estimate is shown in the table below for the year 2009. Note that the number we now use for average private sector compensation is likely to be an overestimate since some sole proprietors also have salaried positions in the private sector, whereas the value obtained using the previous method was an underestimate. **2.** The local government employees category was erroneously described in the original report as not including public school teachers. Public school teachers are included in local government data reported by the Bureau of Economic Analysis (BEA). Similarly, private school teachers are included in the private sector employment data. **3.** Salaries for some unclassified employees are now described in the text. **4.** A graph has been added, with some related text, showing salary and benefits separately for state employees.

Comparison of Methods for Estimating Average Private Sector Compensation in Michigan, 2009

	Total Compensation (thousands)	Total Employment	Average Compensation
Total private employment (with sole proprietors)	$171,914,760	4,299,412	$39,986
Private wage employment only (without sole proprietors)	$171,914,760	3,283,005	$52,365

Source: Regional Economic Information Systems, Bureau of Economic Analysis
Note: Employee compensation includes salary, wages, pension benefits, and health insurance benefits