SENATE FISCAL AGENCY

NOTES ON THE BUDGET AND ECONOMY

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STATE APPROPRIATION GROWTH
by Gary S. Olson, Director

During the past eight years the performance of the Michigan economy outpaced the expectations of all economic forecasters. Increases in State employment levels, record levels of automobile sales, and modest increases in inflation all combined to move the State's economy forward since 1992. This robust economic growth also translated into very good news for the State budget. The economic growth resulted in increased levels of State tax collections, which provided the Governor and the Legislature with many opportunities regarding State budget policies. The path chosen by the Governor and the Legislature for the State budget, in recent years, has involved a combination of reductions in State taxes and increases in State appropriations. This article reviews the recent trends in State appropriations from an overall budget perspective and from trends in specific appropriation areas.

While the State's economy has grown for the past eight years, the appropriation data that are reviewed in this article only cover the past six years. During fiscal year (FY) 1993-94 the State, through a constitutional amendment approved by the voters, reformed the method of financing the operation of K-12 public schools in the State. This constitutional amendment increased the level of State appropriations to K-12 school districts while reducing the use of local property taxes to fund schools. This change provided a large increase in the level of State appropriations beginning in FY 1994-95. As a result, any comparison of State appropriations before FY 1994-95 with State appropriations after FY 1994-95 leads to misleading conclusions. Therefore, the appropriation data reviewed in this article are for the period FY 1994-95 through FY 1999-2000.

Table 1 provides a summary of State appropriations for the period FY 1994-95 through FY 1999-2000. The table presents appropriation data in terms of Adjusted Gross appropriations, State Spending from State Resources appropriations, and General Fund/General Purpose (GF/GP) appropriations. Over this five-year period Adjusted Gross appropriations increased by 28.5%, State Spending from State Resources appropriations increased by 25.5%, and GF/GP appropriations increased by 17.5%. The fact that Adjusted Gross and State Spending from State Resources appropriations increased faster than GF/GP appropriations over the time period results from the impact of the substantial growth in Federal revenues on Adjusted Gross appropriations, and the impact of the growth in State Restricted revenue sources, such as tobacco settlement funds, on State Spending from State Resources appropriations. In addition, the State tax reductions enacted over this time period have been structured to affect State GF/GP revenues almost exclusively.

In order to bring some context to the growth in State appropriations, Figure 1 provides a graphic summary of the growth in State appropriations versus the growth in Federal government expenditures, Michigan personal income, and the rate of inflation, as measured by the United States consumer price index over the same five-year period. Over this period Federal government

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Table 1
State Appropriations by Fiscal Year
(millions of dollars)

Fiscal Year	Adjusted Gross	Percent Change	SSSR*	Percent Change	GF/GP	Percent Change
1994-95	$27,523.5	---	$19,593.2	---	$8,176.4	---
1995-96	28,493.9	3.5%	20,521.9	4.7%	8,449.4	3.3%
1996-97	29,656.5	4.1%	21,552.2	5.0%	8,369.1	(1.0)%
1997-98	31,470.0	6.1%	22,493.6	4.4%	8,735.1	4.4%
1998-99	33,160.3	5.4%	23,276.8	3.5%	9,415.0	7.8%
1999-2000	35,401.4	6.8%	24,579.0	5.6%	9,607.7	2.0%
Five-Year Growth		28.5%		25.5%		17.5%

Source: Senate Fiscal Agency *SSSR = State Spending from State Resources

expenditures increased by 16.3%, Michigan personal income increased by 24.8%, and inflation increased by 12.7%. Therefore, while the growth in State appropriations exceeded the growth in inflation and the growth of the Federal budget, State appropriations over this time period increased at roughly the same level as the growth in Michigan personal income.

While overall State appropriations, as measured by the growth in State Spending from State Resources, grew by 25.5% over the five-year time period, the growth in appropriations within specific areas of the budget over this period varied significantly. Table 2 provides a summary of the growth in State Spending from State Resources appropriations for the period FY 1994-95 through FY 1999-2000 by major program area. The growth in appropriations by program area ranges from a high of 130.4% for capital outlay programs to a low of 5.9% for resource management programs. Areas of the budget that exhibited above-average growth in appropriations over this time period included economic development and job training and transportation. The large appropriation categories of K-12 education, higher education, corrections, and revenue sharing all grew at a rate approximately equal to the 25.5% overall growth in appropriations. The major area of the State budget that exhibited growth considerably below the average was the human services area. This slower growth in human services spending over the time period is explained by a large drop in welfare caseloads that directly affected State appropriations in such programs as Medicaid and the Family Independence Program. This drop in caseloads offset the spending increases in these programs resulting from higher medical costs.

While reviewing the growth in State appropriations by major budget area provides an interesting picture of the recent trends in the State budget, it is also important to note that in some budget areas the amount of the appropriations made by the Legislature in each year is significantly influenced by the number of people served by the appropriation. This is especially true for the appropriations that support the

Figure 1

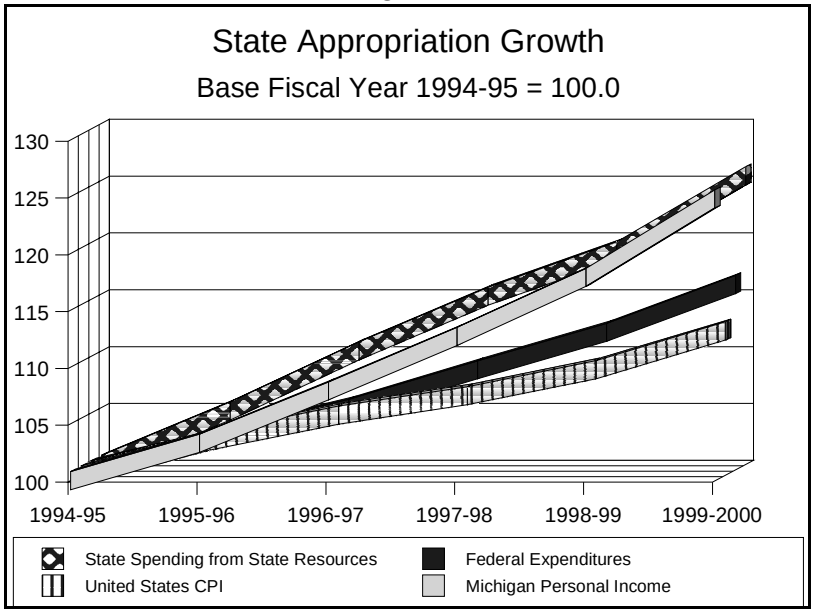

Table 2
Categories of State Appropriation Growth - State Spending from State Resources
(millions of dollars)

Spending Category	FY 1994-95	FY 1999-2000	Difference	Pct. Change
K-12 Education[1)]	$7,966.6	$10,025.4	$2,058.8	25.8%
Human Services[2)]	3,870.8	4,276.8	406.0	10.5%
Higher Education[3)]	1,629.8	2,079.3	449.5	27.6%
Transportation	1,429.2	1,984.0	554.8	38.8%
Corrections	1,208.2	1,531.3	323.1	26.7%
Revenue Sharing	1,170.0	1,470.5	300.5	25.7%
Resource Management[4)]	690.5	731.0	40.5	5.9%
Econ. Dev. & Job Training[5)]	327.9	562.9	235.0	71.7%
Capital Outlay	204.3	470.7	266.4	130.4%
Public Protection[6)]	314.5	385.2	70.7	22.5%
Judicial Branch	173.3	221.8	48.5	28.0%
Legislative Branch[7)]	126.3	151.3	25.0	19.8%
All Other	481.8	688.8	207.0	43.0%
Total Appropriations	$19,593.2	$24,579.0	$4,985.8	25.5%

[1)] Includes K-12 Education and Department of Education. 2) Includes Community Health and Family Independence Agency. 3) Includes Higher Education and Community Colleges. 4) Includes Agriculture, Natural Resources, Environmental Quality, and Environmental and Natural Resources Bond. 5) Includes Career Development, Consumer and Industry Services, and Strategic Fund Agency. 6) Includes State Police and Military Affairs. 7) Includes Legislature, Auditor General, and Library of Michigan.

Source: Senate Fiscal Agency

Department of Corrections, K-12 School Aid, community colleges, and universities. In all of these budget areas, a review of State appropriations per person provides another method of viewing budget priorities. Table 3 provides a summary of these data for the FY 1994-95 through FY 1999-2000 period. The data show several interesting trends. First, in spite of the overall recent growth in appropriations for the Department of Corrections, the appropriation per prisoner grew by a very modest 3.7% over this time period. This appropriation growth has forced the Department of Corrections to develop cost saving initiatives. These initiatives include the extensive use of double bunking of State prison inmates and the recent trend toward the privatization of certain services including health care in the prisons. The second trend apparent from Table 3 is that State appropriations per full-time student for the K-12 schools, community colleges, and universities all increased at levels near or in excess of the 12.7% increase in inflation over the same time period. Community colleges have seen their State appropriation per full-time student increase by 23.7%, universities by 11.5%, and the K-12 schools by 16.0%.

Table 3
Growth in State Appropriations Per Prisoner and Student

Department of Corrections				Community Colleges			
Fiscal Year	Approps. (Millions)	Prison and Camp Population	Approps. Per Prisoner[1)]	Fiscal Year	Approps. (Millions)	Full-Time Students	Approps. Per Student
1994-95	$1,208.2	38,854	$31,095.9	1994-95	$251.6	117,187	$2,147.0
1995-96	1,302.1	40,182	32,405.1	1995-96	253.0	110,949	2,280.3
1996-97	1,336.0	41,356	32,304.9	1996-97	262.2	107,970	2,428.5
1997-98	1,374.1	43,821	31,357.1	1997-98	275.0	107,501	2,558.1
1998-99	1,417.6	44,500	31,856.2	1998-99	282.0	109,700	2,570.6
1999-2000	1,531.3	47,484	32,248.8	1999-2000	297.2	111,894	2,656.1
Percentage Growth			3.7%	Percentage Growth			23.7%

Table 3
Growth in State Appropriations Per Prisoner and Student

K-12 School Aid				Higher Education			
Fiscal Year	Approps. (millions)	Student Mmbship.	Approps. Per Student	Fiscal Year	Approps. (millions)[2]	Full-Time Students	Approps. Per Student
1994-95	$7,911.8	1,564,729	$5,056.3	1994-95	$1,268.1	206,321	$6,146.2
1995-96	8,221.9	1,615,586	5,089.1	1995-96	1,308.1	207,704	6,297.9
1996-97	8,558.3	1,646,747	5,197.1	1996-97	1,379.2	209,417	6,585.9
1997-98	9,307.4	1,671,015	5,569.9	1997-98	1,443.0	214,167	6,737.7
1998-99	9,495.1	1,688,814	5,622.3	1998-99	1,482.7	223,724	6,627.4
1999-2000	9,957.6	1,698,419	5,862.9	1999-2000	1,562.0	227,993	6,851.1
Percentage Growth 16.0%				Percentage Growth 11.5%			

1) Appropriations per prisoner is a measure of total departmental appropriations divided by prisoners in State facilities. The Department of Corrections is also responsible for the funding and supervision of approximately 60,000 additional individuals on probation or parole.
2) Reflects appropriations for university operations only.

Source: Senate Fiscal Agency

Conclusion

The robust economic growth in Michigan over the past eight years had a significant impact on the overall State budget. The economic growth fueled State revenue collections, which resulted in the opportunity for the Governor and the Legislature to enact a series of State tax reductions at the same time as providing for growth in overall State appropriations. State appropriation growth over the period FY 1994-95 through FY 1999-2000 roughly equaled the growth in the income of Michigan residents. The fact that the State implemented significant State tax reductions at the same time that State appropriations have continued to grow speaks volumes as to the strength of the recent economic expansion in the State.

AN UPDATE ON PRISON CONSTRUCTION
by Karen Firestone and Mike Hansen, Fiscal Analysts

It has been nearly three years since the Legislature last authorized funding for new prison bed construction. While most of the construction is now complete, the State's prison population continues to grow, and eventually more bed space will be needed. Given that the time-line for site acquisition and construction could be two to three years, the discussion of how to address the bed space needs must begin soon.

This article provides an update on the recent construction projects, the impact of the new capacity on prison operational costs, an estimate of future bed space needs, and a discussion of options and alternatives to new prison bed construction.

Where We Are Now

The last major round of prison construction culminated in Public Act (PA) 273 of 1998, which authorized $197.0 million to construct 5,856 new beds at 11 different locations ranging from new multilevel prisons to minimum security "drop-in"[1] housing units at existing prisons. While the construction of most of the facilities is now complete, some facilities have not opened as the prison population has not increased as quickly as expected. Table 1 provides the status of each of the PA 273 projects.

1) A "drop-in" unit is a prisoner housing unit or block of cells that is added at an existing prison site.

Table 1
STATUS OF PRISON BED CONSTRUCTION

Project	Cost	Beds	Status	Occupancy Date
"Bellamy Creek" - New Multilevel prison at Ionia	$80,500,000	1,500	Under construction	Oct. 2002
"Pine River" - New Level I prison at St. Louis	$25,000,000	960	Complete and open	Jan. 2000
Level I housing unit at Baraga Maximum prison	$3,500,000	240	Complete and open	Feb. 2000
Level I housing unit at Cooper Street Facility	$6,100,000	480	Complete and open	Jan. 2000
Level I housing unit at Crane	$6,000,000	240	Complete and open	Apr. 2000
Level I housing units at Camp Ojibway	$19,900,000	480	Conversion complete	July 2000
Level I housing units at Camp Pugsley	$28,000,000	800	Conversion complete	Jan. 2001
Level IV housing unit at Macomb Prison	$8,400,000	240	Complete pending certification-delayed opening	June 2001
Level IV housing unit at Saginaw Prison	$9,300,000	240	Complete pending certification-delayed opening	May 2001
Level IV housing unit at Thumb prison	$8,800,000	240	Complete pending certification-delayed opening	May 2001
Other Level I bed expansion	$1,500,000	436	Complete	Fall 1998

Source: Senate Fiscal Agency

In addition to the costs of new construction, the new facilities require additional operating funds as well. The operating costs include the salaries of administrators and guards, consumables such as food and supplies, utilities, and medical care. The cost of operating the new facilities authorized in PA 273 has added a total of $128.5 million or an average $23,712 per bed per year to the appropriations for the Department of Corrections (DOC). Operating costs vary based on the type and security level of the facility, and in most cases also are affected by the type and seniority level of staff required at the facility.

Projection of Future Bed Needs

In order to predict the future need for prison bed capacity, a projection of prison population must be made. At this time, however, there is no reliable population projection that accounts for changes in sentencing guidelines and truth-in-sentencing statutes. As seen in Table 2, in accordance with the boilerplate language of the annual appropriations act, the DOC provided a five-year prison population projection based on trend analysis that is not adjusted for changes to sentencing guidelines or the enactment of truth-in-sentencing. Nonetheless, the projection shown in Table 2 indicates that additional capacity will be needed by the end of calendar year 2003.

Information developed for the Sentencing Commission more than two years ago indicated that sentencing guidelines would result in a net decrease in the number of admissions to prison as offenders score out of prison sentences, while truth-in-sentencing statutes would result in a net increase in prison population as prisoners serve a longer period of time. The problem with using this information to adjust the prison population projection is that it is out of date and fails to analyze the sentencing statutes as enacted and subsequently amended. Also, one assumption that underlay the projection was that the trends in probation and parole violations would remain constant, while all indications are that these categories of admission to prison are on the increase.

Further complications in estimating the need for additional capacity include the fact that in the past, the DOC's estimates have proven to be higher or lower than actual prison population by about 1,000 prisoners, because prison population trends are not consistent year over year. Although the error rate of 1,000 prisoners over a

five-year projection period is not high, it is significant because it represents an entire prison worth of prisoners. Also, probation and parole violators are becoming a larger part of prison intake. Given that there is less information about these offenders than about prisoners, attempts at predicting their population trends are harder to make. Even if sentencing guidelines applied for the original sentence, judges are under no obligation to apply the guidelines when sentencing for a technical probation violation.

Alternatives to New Construction

As described above, the reliability of prison population projections is influenced by a number of factors, including changes in sentencing guidelines, the enactment of truth-in-sentencing, and concerns about changing prison admission and parole patterns. Given these concerns, it appears that 2003 is the best target date estimate for needed prison capacity expansion. Capacity expansion, however, does not necessarily need to come in the form of new construction. One alternative to constructing new prison beds is prison bed leasing. Currently, Michigan law prohibits leasing beds from private vendors, but does allow for prisoner placement at other state or Federal facilities. For example, last year when the prison population exceeded the prison capacity, Michigan placed prisoners in a Commonwealth of Virginia facility. However, the availability of out-of-state, government-operated leased prison beds is very limited. In order for Michigan to lease beds from private vendors, a change in statute would be required.

There are also a variety of other nonprison alternatives for probationers, parolees, and new offenders that could be explored. These options include expanded use of community programs, changes in laws setting mandatory minimum sentences, and changes in departmental policy regarding the sanctioning of probation and parole violators. Barring the implementation of prison alternatives, and assuming that the population projections hold true, the State will need to begin planning for new prison construction this year.

In the past, the State has financed the construction of new prison beds by selling bonds through the State Building Authority (SBA). If the Legislature chooses to embark on another round of prison construction to address capacity needs, it is very likely that the SBA's bond capacity debt limit will need to be raised. The statutory limit on the amount of principal debt issued by the SBA that may be outstanding at any one time is set at

Table 2
PRISON POPULATION AND CAPACITY COMPARISON

Year	Month	Capacity [a)]	Population [b)]	Capacity Surplus (Deficit)
2001	January [c)]	47,873	45,870	2,003
	March	47,873	46,279	1,594
	June	48,593	46,650	1,943
	September	48,593	46,874	1,719
	December	48,593	47,303	1,290
2002	March	48,593	47,789	804
	June	48,593	48,219	374
	September	48,593	48,438	155
	December	50,093	48,978	1,115
	March	50,093	49,354	739
2003	June	50,093	49,817	276
	September	50,093	50,258	(165)
	December	50,093	50,709	(616)

a) The actual net capacity from January 2001 increased by the capacity in new facility openings requested in the FY 2001-02 Executive Recommendation. b) Population projection from the Department of Corrections 1/31/01. c) Actual capacity and population.

$2.7 billion. The current estimate of available bond capacity left under the limit is projected to be about $250 million. Given that a new prison will likely cost nearly $100 million, a $250 million financing capacity is, in practical terms, not sufficient. Furthermore, while the $250 million estimate reflects all projects currently being planned or under construction, it does not account for any new building projects at State agencies, colleges, or universities that the Legislature may choose to authorize in the future.

DURANT: PAST AND PRESENT
by Kathryn Summers-Coty and Joe Carrasco, Fiscal Analysts

Note: This article reviews a series of lawsuits brought by school districts against the State, commonly known as *Durant I*, Durant *II*, and *Durant III*. Begun in 1980 and continuing to the present, this litigation involves the State's alleged failure to fund special education and other programs at constitutionally mandated levels. It should be noted that this is not a legal document intended for use in a court of law. This document is not to be construed to constitute an admission of liability to the districts and intermediate school districts (ISDs) in this State in any litigation or future litigation with a district or ISD. This document is intended as a summary of important and relevant events and as a reference tool encapsulating the *Durant* lawsuits.

DURANT I

The Case: The case commonly referred to as *Durant I* was initially filed in 1980 and alleged a violation of Article 9, Section 29 of the State Constitution of 1963, the so-called mandated cost provision of the Tax Limitation Amendment of 1978, also often named the Headlee Amendment. Specifically, the lawsuit alleged that the State had violated the Headlee Amendment by failing to provide adequate funding for the costs of those activities that the State mandated the plaintiff school districts to perform. A total of 83 school districts and one ISD were plaintiffs in the suit, and an opinion was issued by the Michigan Supreme Court in 1997.

The Decision: The opinion stated that special education, special education transportation, and the school lunch program are required by State law. The Court further opined that the State had violated the Headlee Amendment as it pertains to maintaining proportional funding levels required by law for programs mandated by the State. In other words, the Court found that the State had been funding these programs at lower percentages than those appropriated in 1978, when the Headlee Amendment was adopted. The Court determined the constitutional funding level percentages for special education and special education transportation to be 28.6138% and 70.4165% of necessary costs, respectively, meaning that the State must meet these funding percentages. The Court also issued a monetary "remedy" that was calculated on the amount of "underfunding" in 1991-92, 1992-93, and 1993-94 totaling $212 million for the original 84 plaintiffs.

Resulting Changes Made in the School Aid Act: Public Act (P.A.) 142 of 1997 provided the first funding changes to the State School Aid Act in response to the Supreme Court's ruling in *Durant I*. This Act appropriated the $212 million for the plaintiffs, and another $636 million for nonplaintiff districts, to be awarded in two payments: yearly cash payments over 10 years, and bonding options or annual cash payments over 15 years. The Act also was restructured with respect to how the State paid for special education pupils and special education costs. Briefly, districts report special education costs to the State. Then, a calculation is made to determine roughly 28% of the approved costs of special education and 70% of the approved costs of special education transportation. This is the State's constitutional obligation according to the Supreme Court. Districts were paid foundation allowances for special education pupils. If the special education foundation allowance total met or exceeded the State's cost obligation, no further payment was made. If not, a payment was made to ensure that districts received at least 28% and 70% of the costs of special education.

DURANT II

The Case: A total of 250 districts and ISDs brought the lawsuit commonly referred to as *Durant II* against the State in May of 1998, making three claims. These plaintiffs alleged that the State was continuing to underfund special education in violation of the Headlee Amendment. The plaintiffs filed an additional claim that the State violated Article 9, Section 11 of the State Constitution of 1963, often called the Proposal A guarantee, a per-pupil school funding guarantee of at least the fiscal year (FY) 1994-95 level, by using foundation allowance payments to satisfy special education funding obligations. The third claim asserted that the State also violated the Headlee Amendment by underfunding school lunch programs.

The Decision: In October 1999, the Michigan Court of Appeals issued a ruling in favor of the State in two of the three claims listed above. First, the Court held that the State did not violate the Headlee Amendment in regard to funding the necessary costs associated with State-mandated special education programs, services, and transportation. In other words, the funding method adopted in P.A. 142 of 1997 did meet the special education funding obligations required by *Durant I*. Second, the Court found that the State did in fact violate the funding guarantee outlined in Article 9, Section 11 of the State Constitution. This guarantee was added when Proposal A was adopted by the voters in 1994, and guarantees that school districts will not receive less unrestricted operational per-pupil funding than they received in FY 1994-95. In other words, the foundation allowance payments that were restricted for special education purposes beginning with P.A. 142 of 1997 cannot also be counted toward meeting the Proposal A guarantee. Finally, the Court found that the State did not violate the Headlee Amendment in regard to funding school lunch programs. A monetary judgment was not issued; however, the plaintiffs were awarded legal fees as settlement.

Resulting Changes Made in the School Aid Act: Public Act 297 of 2000 includes several changes in which school districts receive payments, for both general education and special education pupils. Three payments are now made: 1) a payment equivalent to the amount reached by multiplying a district's total pupil membership (including special education pupils) by the district's FY 1994-95 foundation allowance; 2) a payment equivalent to roughly 28% of the approved costs of the district's special education programs plus roughly 70% of the approved costs of the district's special education transportation costs; and 3) a "discretionary" payment to ensure that districts receive what they otherwise would have received under certain sections of prior versions of the State School Aid Act, if the first two payments are not sufficient. (A hypothetical district example illustrating this process is attached.) By making the first two payments, the State believes that it is meeting the two Constitutional obligations facing the State: Proposal A and Headlee. Essentially, several sections of the School Aid Act in place after *Durant I* and before P.A. 297 of 2000 are retained and used for calculation purposes only. These sections include the calculation of general education memberships and resulting foundation allowance allocations; special education memberships and resulting foundation allowance calculations; special education program and transportation cost calculations; and miscellaneous special education sections. In P.A. 297 of 2000, these sections are used to calculate how much a district *would have received* if no change in the law occurred.

DURANT III AND *ADAIR*

The Cases: A total of 443 districts and ISDs filed two cases, which are often lumped together as *Durant III*. It is important to separate the two suits into *Durant III*, a continuation along the lines of the previous two actions, and *Adair*, a new suit alleging that various items of the Revised School Code are new mandates or increases in the levels of existing services or activities, that are underfunded or unfunded, thereby violating the Headlee Amendment. In *Durant III*, the plaintiffs allege that the State, via P.A. 297 of 2000, is continuing to allocate the per-pupil revenue guaranteed by Proposal A for the restricted purpose of paying the costs of special education programs and services. Further, the suit alleges that the State, in violation of the Headlee Amendment, is not meeting its constitutional funding obligations with respect to special education and special education transportation.

In *Adair*, several Headlee Amendment issues are raised. Count I of the suit alleges that the State has mandated an increased level of special education activities without providing increased revenues to support them. Examples of these mandates include teacher-to-student ratios, teacher aides in certain classes, and caseload requirements. Count II of the suit claims that the State requires an increased level of minimum days and hours of pupil instruction without adequate funding. Finally, Count III alleges that the State requires the following items in certain situations without providing funding: annual financial audits; instruction about dangerous communicable diseases; development of school improvement plans; provision of a core academic curriculum; administration of State assessments; accreditation; provision of teacher professional development; and, creation and maintenance of data on essential student data elements.

The Decision: No decision has yet been rendered in either of these cases.

SFA Interpretation of *Durant III*: It is the interpretation of the Senate Fiscal Agency that the plaintiffs' claims of underfunding in *Durant III* essentially rest on guaranteeing a current-year foundation allowance payment for all pupils, plus roughly 28% of the costs of special education and roughly 70% of the costs of special education transportation. The current School Aid Act guarantees the FY 1994-95 foundation allowance payment for all pupils, plus roughly 28% of the costs of special education and roughly 70% of the costs of special education transportation, and also makes a discretionary payment. The “value” of the discretionary payment differs among districts based upon their current-year calculated foundation allowances, their pupil memberships (both general education and special education), and special education costs.

Hypothetical District Monetary Example
Illustrating Change in Funding Allocation in P.A. 297 of 2000

District Data
A -- 400 General Education Pupils
B -- 50 Special Education Pupils
C -- Current-Year Foundation Allowance = $6,000 Per Pupil
D -- Special Education Costs = $1,500,000 [*Durant*/Headlee percentage = 28.6138%]
E -- Special Education Transportation Costs = $250,000 [*Durant*/Headlee percentage = 70.4165%]
F -- Local Revenue Portion (deduct) = $500,000
G -- FY 1994-95 Foundation Allowance = $4,800 Per Pupil

Process in Place **Prior** to P.A. 297 of 2000			
Section 20 Foundation Allowance Revenue:	$2,400,000[1]	**=**	**A x C**
Local Revenue Portion (deduct)	($500,000)	=	**(F)**
PLUS			
Section 51a(2) and (3) Special Ed. Payment:	$605,248[2]	=	**(.286138 x D) + (.704165 x E)**
H -- District A's Total State Payment:	**$2,505,248**	=	**Sum of Above**

Process Enacted in P.A. 297 of 2000			
I -- Proposal A Obligation Payment:	$2,160,000[3]	=	**(A + B) x G**
Local Revenue Portion (deduct):	($500,000)	=	**(F)**
PLUS			
J -- *Durant* - Headlee Obligation:	$605,248[4]	=	**(.286138 x D) + (.704165 x E)**
PLUS			
Discretionary Payment:	$240,000[5]	=	**H - I - J**
District A's Total State Payment:	**$2,505,248**	**=**	**Sum of Above**

[1]The Sec. 20 Foundation Allowance Revenue is determined by multiplying the general education pupils (400) by the current-year foundation allowance ($6,000).

[2]The Sec. 51a(2) and (3) Revenue is determined by first calculating the special education foundation allowance revenue (50 special education pupils X $6,000 = $300,000), and determining if that amount satisfies the *Durant* - Headlee special education funding percentage obligations (28.6138% times $1,500,000 plus 70.4165% times $250,000 = $605,248). Since it does not, the district would receive $300,000 in special education foundation allowance payments plus $305,248 in Headlee obligation payments.

[3]The Proposal A Obligation Payment is calculated by multiplying District A's general education PLUS special education pupils by the district's FY 1994-95 foundation allowance.

[4]The *Durant* - Headlee Obligation Payment is calculated by applying the court-mandated percentages to costs (28.6138% times $1,500,000 plus 70.4165% times $250,000 = $605,248).

[5]The Discretionary Payment is calculated by subtracting the Proposal A Obligation Payment, the Local Revenue Portion, and the *Durant* - Headlee Obligation Payment from the district's Total State Payment calculated under the process in place prior to P.A. 297 of 2000.

Source: Senate Fiscal Agency

PRESIDENT BUSH'S TAX CUT PROPOSAL
by Jay Wortley, Senior Economist and David Zin, Economist

Although tax bills must originate in the U.S. House of Representatives, Senators Phil Gramm of Texas and Zel Miller of Georgia have introduced S.35, a bill reflecting President Bush's campaign promise to change Federal tax laws. The bill proposes numerous changes in the Federal individual income tax, including changes in marginal tax rates for all taxpayers, an additional deduction for married couples in which both spouses work, an expansion of education individual retirement accounts (IRAs), a phased-in increase in the child tax credit, and certain incentives designed to increase charitable contributions. The bill also proposes a phase-out of Federal estate and gift taxes and recommends eliminating the 2004 expiration of the current research tax credit. Some of these provisions would affect Michigan tax revenues. A brief summary of those impacts is provided below and a detailed Senate Fiscal Agency analysis of the impact is scheduled to be released later in March 2001.

Proposed Changes

Income Tax. The current Federal individual income tax employs five tax brackets to define the levels of taxable income subject to different marginal tax rates. President Bush's tax cut proposal would change both the taxable income levels where brackets begin and the marginal tax rates for each bracket. Currently, the marginal tax rates range from 15% to 39.6%, with higher levels of taxable income facing higher marginal tax rates. President Bush's proposal, once fully phased-in for 2006, would reduce the number of brackets from five to four, and the marginal tax rates would range from 10% to 33%. Currently, the levels of taxable income that define each bracket are adjusted each year for inflation. President Bush's proposal would eliminate these adjustments until after 2006.

"Marriage Tax". Under current law, married couples in which both spouses work face a "marriage tax". The "marriage tax" results from the combined income of the couple facing a higher marginal tax rate than would occur if each spouse were able to file as an unmarried individual. President Bush's tax cut proposal would provide an additional deduction to married couples in this situation. The deduction would be limited to the lesser of 10% of the earned income of the spouse with the lower earned income or 10% of an applicable limit. The applicable limit would rise from $6,000 in 2002 to $30,000 in 2006. As a result of this deduction, married couples in which both spouses work would be able to deduct up to $3,000 ($600 in taxes for a married couple in the proposed 20% marginal tax bracket) from their taxable income once the change was fully phased-in. The deduction would be available to all married individuals filing joint returns, not just those taxpayers who are able to itemize deductions. The proposal would not adjust the applicable limit amount each year for inflation.

Education IRA. Under current law, taxpayers may contribute up to $500 per year per beneficiary to an education IRA to reimburse certain postsecondary education expenses. With an education IRA, the income is taxed in the year the contribution is made while taxes on the interest earnings are deferred until withdrawals are made. Withdrawals are taxed at the beneficiary level, where the income usually faces a lower marginal tax rate. President Bush's proposal significantly would expand the provisions of education IRAs. The contribution limit would be increased to $5,000 by 2006, and eligible expenses would be expanded from postsecondary expenses to include also elementary and secondary education expenses, whether incurred at a public, private or religious institution, as well as expenses associated with home schooling.

Child Tax Credit. Currently, many taxpayers with children are eligible for a nonrefundable credit of up to $500 per child. For certain taxpayers with higher incomes the credit is reduced or

eliminated. President Bush's proposal would phase-in an increase in the credit to $1,000 by 2006, as well as changes that would preserve more of the credit for higher income taxpayers. The proposal also would eliminate a provision that reduces or eliminates the credit for certain taxpayers who must pay taxes under the alternative minimum tax.

Charitable Contributions. Under the current Federal individual income tax, taxpayers who are eligible to itemize deductions may subtract a portion of charitable contributions from taxable income. President Bush's proposal would change the deduction so taxpayers who do not itemize also could claim it. For nonitemizers, the percentage of allowable deductions that may be claimed would increase from 20% in 2002 to 100% in 2006. The plan also would eliminate certain penalties on IRA withdrawals if those withdrawals were used for qualified charitable contributions.

Estate Tax. President Bush's tax cut plan would begin a phase-out of Federal estate and gift taxes. Under current law, estates are effectively exempted from the tax if the taxable value of the estate is below $675,000. Current law will increase that limit to $1,000,000 by 2006, although certain estates are already exempt up to a value of $1.3 million. The President's proposal would retain these exemptions, but would apply lower tax rates to all brackets. Initially, all tax rates in all brackets would be reduced by five percentage points in 2002 and 2003, but the reduction would increase to 40 percentage points by 2008. After 2008, the proposal would repeal the Federal estate and gift tax. The Senate Fiscal Agency has a forthcoming report estimating the effect of the Federal estate tax changes on Michigan tax revenues.

Corporations. President Bush's tax cut plan would increase the amount that corporations may deduct for contributions for charitable giving from 10% to 15% of taxable income, and eliminate the sunset on a credit for certain research activities. Under current law, the credit for increasing research activities is to expire in 2004.

Impact on Michigan

Michigan's income and estate taxes are linked, by varying degrees, to the Federal income and estate taxes. As a result, the changes proposed by President Bush would affect the amount of revenue these Michigan taxes generate. Following are brief descriptions of the linkages between the Federal and Michigan income and estate taxes, including the components of the Bush plan that would affect Michigan's taxes.

Income Tax. Michigan's income tax uses Federal adjusted gross income (AGI) as its starting point for calculating taxable income. Therefore, any of President Bush's proposed changes to the Federal income tax that would change AGI would have an impact on Michigan's income tax. Under S. 35, the only component that would change AGI is the deduction designed to reduce the so-called "marriage tax". Therefore, if a working married couple would qualify for a marriage penalty deduction on their Federal return, they also would automatically realize this deduction on their Michigan income tax calculation because the deduction would be included in their AGI. If this component of the Bush plan were to become law, Michigan lawmakers would face a policy issue. Unlike the Federal income tax, Michigan's income tax does not currently create a marriage penalty on married couples who both work. The marriage penalty at the Federal level results from the progressive rate schedule, under which taxpayers face a higher average tax rate as their taxable income increases. Michigan's income tax rate is not progressive, but is a single flat rate, currently at 4.2%. All Michigan taxpayers, no matter what their taxable income, are taxed at the same rate. As a result, while this proposed marriage penalty deduction would help create a more equitable tax structure for the Federal income tax, it would create a less equitable tax structure for Michigan's income tax by creating a "marriage subsidy". To address this equity issue, the Legislature could enact a law to exclude the Federal marriage penalty deduction from AGI when the Michigan income tax is calculated.

Estate Tax. Michigan's estate tax is directly linked to the Federal estate tax. The Federal estate tax allows a credit for State death tax liabilities, up to some maximum level. As in most other states, Michigan's estate tax liability is equal to whatever maximum allowable Federal credit can be claimed by the decedent's estate. Therefore, any changes in the Federal estate tax that altered the credit for state death taxes would affect the amount of revenue Michigan collects from its estate tax. As described above, President Bush's plan would phase out the Federal estate tax from 2002 to 2008, and as a result, Michigan's estate tax also would be eliminated over this time period. In FY 2000-01, the estate tax is expected to generate $190 million, and all of it is earmarked to the General Fund/General Purpose budget.