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121 W Allegan • Lansing, Michigan 48933
www.schoolequitycaucus.org
schoolequitycaucus@gmail.com
269.806.6159

CAUCUS INFORMATION ALERT

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Re: Consensus Revenue Estimating Conference

This morning representatives of the House and Senate Fiscal Agencies and the Michigan Department of Treasury met to arrive at official revenue estimates as part of their semi-annual Consensus Revenue Estimating Conference (CREC). This meeting provides the revenue assumptions that will provide the basis for next year's state budget by looking at of how revenues in the state's major funds are doing to this point in the fiscal year, along with providing projections for upcoming years. As had been previewed by various different sources, today's numbers were legitimately "eye-popping", continuing the remarkably positive trend from the last year or more.

However, as good as these numbers were, one of the major caveats dominating today's conference was the degree to which this level of growth is sustainable. High rates of inflation, rising interest rates, the conflict in Ukraine, and instability in a variety of commodity markets are raising caution for the long-term prognosis. Many economic indicators continue to look fine for the time being, with some retrenchment back to normal levels expected in the next couple of years. However, there are also many potential warning signs that could disrupt that forecast.

With that introduction, here's an overview of some of the key takeaways from today's meeting:

<u>The Economy</u>

Today's conference began with an in-depth look at economic projections in Michigan and beyond. In order to have the best educated guesses about where revenues might head, it is important to look at a host of factors in the economy.

In general, economists who presented today see growth continuing, but gradually slowing over the next 18-24 months. Inflation will continue to be a concern through 2022, and then is predicted to taper off. Here are some other interesting details from today's economic presentations:

- On the topic of inflation, prices for certain goods appear to have begun leveling off, but there continues to be inflationary pressure in a variety of service sectors with the tight labor market. Additionally, inflation is expected to be impacted by high fuel prices as well as looming problems in agri-business (particularly with disruptions due to the war in Ukraine on food supply, fertilizer, and the like). The CPI for Detroit is expected to be at 7.7% at the end of the year – the highest since 1981. The inflation rate is then expected to begin declining as we head into 2023.

- The stock market has been declining. At this point, it is not a measure of significant concern, but it bears watching.
- Economists are not forecasting a recession yet. However, consumer sentiment is somewhat negative, so if the economy starts to struggle at all, it could quickly tip consumers into a retrenchment in their expenditures. If that were to occur, this would contribute to recessionary pressures.
- The Federal Reserve is expected to continue raising interest rates, perhaps by as much as 2% by the end of the current year. Engineering a soft landing to our current inflationary cycle will be possible, but difficult. It is currently projected that the economy will have cooled with interest rates potentially starting to be cut again in mid-2023. Globally, most nations are dealing with the same issues, so recessions elsewhere could also impact the US economy.
- Jobs are switching back from manufacturing and selling goods (a sector that increased dramatically during the pandemic) to the service sector. The switch from spending on goods back to services may change levels in the various state revenue streams, especially in the sales tax which is more based on goods.
- The price of oil remains highly volatile, and has risen dramatically from 2020 levels. Over the next few years, the expectation is that current global supplies are sufficient to at least maintain current prices.
- Housing is already starting to feel the impact of higher interest rates, so the housing market is beginning to cool.
- Overall, employment numbers are expected to finally cross the pre-pandemic peak in the next few quarters; levels in Michigan are currently at 94.5% of where they were pre-pandemic with full recovery expected by mid-2023.
- The labor market continues to be very tight – the highest in decades. It may take years for labor participation to get back to where it had been prior to the pandemic. There are significantly more jobs available than there are unemployed workers. The unemployment rate may be somewhat artificially low because a large number of workers have decided to not seek jobs (including retired workers who had been employed in part-time positions pre-pandemic). Our current labor participation rate is at about 59.6% in Michigan, down from 61.4% in January 2020. This is also occurring naturally due to the aging of the population as baby boomers retire.
- Overall, many indices remain solid, so the most likely scenario is continued, slowing growth in the economy. However, there are many risk factors and potential problems looming that may change that forecast.

Pupil Counts

Another major factor also included in each CREC is a look at the number of pupils in Michigan schools. This obviously impacts the budget because it determines the number of pupils among whom the pot of money will be divided.

The actual audited Fall 2021 pupil count was down by 900 students over what had been projected at the January CREC. Currently there are 1,254,700 students in traditionally K-12 schools with 150,400 in charter schools. While previous trends had been seeing this number historically decline by about 10,000 students per year, the drop in the current year totaled 44,714 students, with the additional drop coming as a result of COVID-19. It remains to be seen how many of the students that left the system during the pandemic will return. Current estimates see a slow trickling back of these students to public schools over time.

With that in mind, for next year (2022-23) projections are for a further drop in enrollment (down another 6,200 students). Within that number, charter schools are expected to see a slight increase, with traditional K-12 schools down by 6,800 students. A similar drop is currently being projected for the 2023-24 school year. From a budgetary standpoint though, keep in mind that lower pupil count numbers also mean more dollars available for distribution when calculated on a per pupil basis. For instance, it is estimated that the savings realized by these lower pupil counts will amount to about $32.3 million in the current fiscal year alone, with even higher numbers in the years ahead.

Revenue Estimates

The participants in the conference next reviewed the impact of the economic factors discussed above on state revenues, both in the current year and looking forward. As compared to the time of the most recent CREC in January, revenues in both the income tax and sales tax are up significantly. In particular, big positive surprises came in April, with more money coming in through the sales tax during the month of April than for any month in history; the projected total sales tax collection by the end of the year is also currently expected to be the highest in the state's history.

Income tax collections also continue to be up significantly (at the January CREC income tax growth had been projected to fall back). In 2021 income tax collections set a record at $11.8 billion (by about $1 billion over the previous high). The forecast for 2022 income tax revenue is now thought to be well over $13 billion – another record! While wages are up due to inflation, productivity is also up significantly, driving business profits higher and meaning that business tax revenue is also up.

The bottom line is that we are currently seeing the largest growth ever for both the state's General Fund (GF/GP) and for the School Aid Fund (SAF). With this news, here is how it plays out in actual numbers:

For the current year, total revenues are expected to be up by more than $2.4 billion over FY 2021 (8.5%). About $1.17 billion of that increase is expected in the state's General Fund (GF/GP), with the School Aid Fund (SAF) seeing an increase of $1.28 billion. This represents a growth of 9.0% for the GF/GP and 8.0% for the SAF. (Total dollar amounts are contained in the tables on the next page.) In January, at the time of the previous CREC, it was thought that state revenues would be down by 1.6% over the year before, so this is a positive swing of nearly $3 billion from where things were thought to be at that time!

Looking to next year, revenues in both the SAF and GF/GP are being projected to decline from these tremendous numbers (by -0.8% and -1.5% respectively), but they are expected to still remain at levels more than $2.5 billion above what was projected in January. And in 2024, moderate growth is expected to return, with the SAF increasing by 1.5% and the GF/GP by 1.8%. Therefore, after this year's massive increases in revenue, things look to hold fairly flat for the two years beyond that as the economy returns to a more "normal" growth pattern.

The Balance Sheet

When we look at what the tremendous numbers could mean for the budget, the bottom line is that there is much more money available to spend. The Senate Fiscal Agency has released their version of the state's balance sheet moving forward ***using the 2022-23 budget version currently passed by the Senate***. For schools, the Senate SAF budget represents a carry-forward budget in many areas, but it did incorporate a $450 per pupil foundation allowance increase. Here is the estimate of what the SAF that would look like ***including the budget as passed by the Senate***:

School Aid Fund (SAF)	FY 2021-22	FY 2022-23	FY 2023-24
Beginning Balance	**$2,922.3**	**$5,028.9**	**$5,047.0**
Total Revenues	$19,896.5	$19,557.2	$19,806.8
Total Expenditures	$17,789.9	$19,539.2	$18,409.9
End-of-Year Balance	**$5,028.9**	**$5,047.0**	**$6,443.9**

Source: Senate Fiscal Agency. Amounts in millions. Calculation errors due to rounding.

On the General Fund side, things look very similar, ***again incorporating the current version of the 2022-23 budget as passed by the Senate***:

General Fund (GF/GP)	FY 2021-22	FY 2022-23	FY 2023-24
Beginning Balance	**$4,362.8**	**$5,278.2**	**$4,486.5**
Total Revenues	$13,676.8	$13,421.0	$13,703.9
Total Expenditures	$12,761.4	$14,212.7	$12,666.9
End-of-Year Balance	**$5,278.2**	**$4,486.5**	**$5,523.4**

Source: Senate Fiscal Agency. Amounts in millions. Calculation errors due to rounding.

As discussed in our last newsletter, both Governor Whitmer's budget proposal and the 2022-23 budget passed by the House contained significantly more spending than the Senate's version, but it is clear that the State has plenty of money available! Indeed, if one were to just carry forward the current rates of spending (with no increases), the fund balance would grow to some $10 billion by the end of the 2023-24 budget year.

<u>What Does This All Mean?</u>

There is certain to be much "spin" coming out of today's numbers as all sorts of different interest groups express their viewpoints on spending priorities. From the perspective of Michigan's K-12 schools, here are a few initial thoughts:

- <u>Foundation Allowance</u> – There is certainly more than enough money to provide all districts with a larger per pupil foundation allowance increase than has been proposed to date. Keep in mind that with inflation projected to finish the year at an annual rate of 7.7%, a corresponding increase on the current target foundation allowance ($8,700) would amount to approximately $670 per student. The highest amount proposed to date is $450. With our current number of students, each $100 of foundation allowance increase costs approximately $140 million.
- <u>SAF Funding of Higher Education</u> – There is no better time than the present to return higher education expenditures to the GF/GP. When SAF funds were first used for this purpose, it was cast as a "loan". Suffice it to say that the loan has never been repaid and (depending on the budget proposal) the SAF could be carrying up to $1.38 billion (House version), $1.76 billion (Senate version), or a reduced $818 million in Governor Whitmer's budget. We have the funds available to return these expenses – no matter which budget is chosen – to the GF/GP.

- Tax Cuts – Today's numbers will certainly add fuel to the tax cut fire. As these discussions progress, it is crucial that we protect the state's revenue sources so that as the economy levels off, we are still able to provide the levels of funding our students need. We are still well below the levels of funding identified as adequate in the School Finance Research Collaborative (SFRC) study from January 2018 – and costs have escalated dramatically since that time. Let's be sure not to sacrifice long-term stability for short-term electoral politics.

Looking Ahead

Now the House and Senate, in conjunction with Governor Whitmer, will move into the final phase of their budget negotiations for next year. There will certainly be politics at work as we head toward the November elections, and that could be helpful to schools. As politicians face the voters, they certainly prefer to campaign on strong support of our schools. We need to encourage them in that vein!

Legislative leadership has expressed their desire to have the budget completed by early to mid-July. As always, we will continue to be engaged in the budget negotiations in Lansing as they move forward, and will keep you updated as things develop. If you have questions on any of the above, please do not hesitate to ask!

Have a great weekend!

Dirk Weeldreyer
Executive Director
(269) 806-6159
schoolequitycaucus@gmail.com