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RESOLVING MICHIGAN'S PAST, PRESENT, AND FUTURE FISCAL PROBLEMS THE 1983 DEBATE

Michigan's key fund[1] financial plan for fiscal year 1982-83 (FY 1983) is deficient for three reasons:

- The FY 1983 budget was based on over-optimistic revenue and spending estimates, creating a $650-$900 million current-year deficit.
- The state entered FY 1983 with a key fund cash deficit of over $800 million built mainly through accounting deviations since 1975
- The state's budget priorities do not comply with the constitutional requirement that state aid to local units be a fixed proportion of total state spending.

THE ISSUES IN BRIEF

- <u>Estimates of the size of the FY 1983 deficit vary.</u> Estimates range from $650 to $900 million depending largely on forecasts of the speed and strength of economic recovery. While the range is nearly $250 million, it equals less than 4 percent of FY 1983 key fund revenues of $6.5 billion.
- <u>How much should spending be cut or taxes increased?</u> FY 1983 spending reductions have only six months in which to take effect. An income tax increase could be made retroactive to January 1, 1983, thereby producing revenue for nine months. Given the range of deficit estimates and a range of spending reductions of $225 million to $400 million, the increase in the income tax could be as little as 0.6 percentage points ($650 million deficit, $400 million cuts) or as much as 1.5 percentage points ($900 million deficit, $225 million cuts).
- <u>Cash requirements need to be considered in solving the problem.</u> Since increased withholding cannot begin before April and collections will not begin before May, only a five-month increase in cash receipts can occur during FY 1983. In order to balance the budget and meet minimal cash requirements, it will be necessary to withhold at about 1.5 times the stated income tax rate (greater multiples if the tax increase is delayed).

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[1] Key funds finance state spending not covered by dedicated self-balancing funds. Michigan key funds are the General, School Aid, and Budget Stabilization funds. This analysis focuses on the general purpose and revenue sharing portions of the General Fund and the School Aid Fund because of the interaction among them in revenue-raising and budget-cutting proposals.

- A tax increase in FY 1984 could permit a significant incrase in spending. Without a tax increase, normal revenue growth is likely to provide an FY 1984 spending base within plus or minus two percent of the FY 1983 level. A one cent increase in the sales and use taxes effective October 1, 1983, might permit approximately an 11 percent increase in spending ($680 million). A 1.5 percentage point income tax increase to 6.1 percent effective during FY 1984 might allow nearly 14 percent more spending to occur ($930 million).

- A tax increase in FY 1984 to restore spending cuts made in FY 1983 and previous years involves significant trade-offs. Underlying the Crisis Council recommendation that the income tax increase by temporary was a concern that a permanent income tax rate of that level could not be sustained by the Michigan economy. If additional revenues are needed, the Crisis Council viewed the sales tax as more conducive to economic development. The governor's proposal of a permanent income tax increase is based on a concern that continuing state fiscal crises undermine the ability of the state to attract jobs and that a permanent tax increase is necessary to maintain essential state services and the quality of life.

- If the budget is brought into balance, existing sources of cash enhancement should minimize the state's cash problems as early as FY 1986. Cigarette tax earmarking of $115 million annually and a possible contribution of $250-$300 million to the Budget Stabilization Fund in FY 1985 could generate cash resources of about $800 million by the end of FY 1986.

- The state faces a $125 million shortfall in its required payments to local units under Section 30 of the tax limitation amendment. The 0.25 percentage point temporary income tax increase proposed by the governor could be used either to reduce the cash deficit or to supplement the required state payments to local units. If it is used for state aid, it would expend general revenues and delay the expiration of the tax. Elimination of the Section 30 deficit solely through tax increases would require $214 million in new revenue because the resulting increase in total state spending would further increase Section 30 requirements. Elimination solely through expenditure redirection would call for a $125 million reduction in "state-side" spending and a corresponding increase in "local-side" spending

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A more detailed discussion of these issues is provided in a 12-page "white paper" available on request from the Research Council.