Council Comments:

Citizens Research Council of Michigan

1666 CITY NATIONAL BUILDING, DETROIT 48226
(313) 961-5377
909 MICHIGAN NAITONAL TOWER, LANSING 48933
(517) 485-9444

No. 941 June 15, 1983

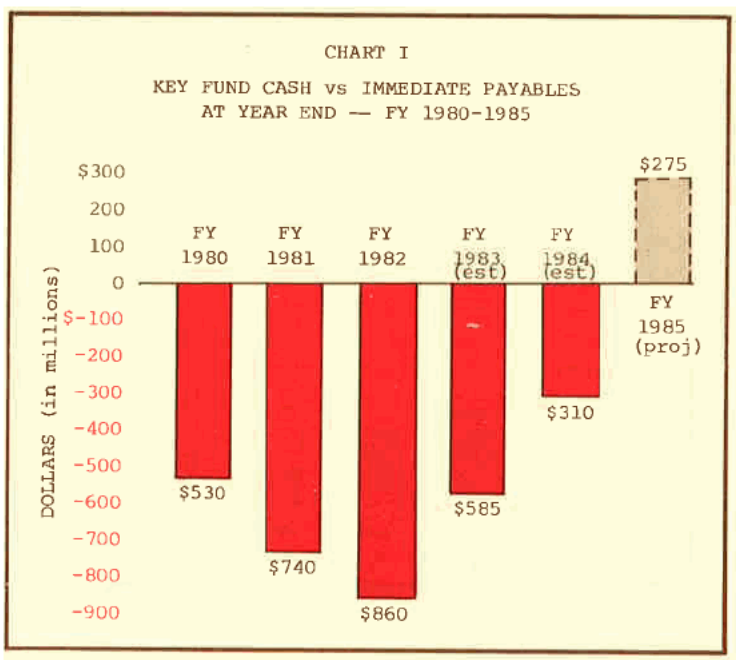
THE STATE FISCAL PLAN

The State of Michigan entered 1983 with a sizable cash deficit created by over-spending available resources from 1975 to 1982, an impending budget deficit for fiscal 1983, and the prospect of continuing fiscal problems for the foreseeable future. State policymakers could have moved in one of three directions – raise new revenues, check the growth of spending, or some combination thereof. In March they put into place a plan that will raise $3.2 billion in revenue over the 1983-1986 period and that cut 1983 spending by $225 million.

I. TAX INCREASES TO ESTABLISH A FINANCIAL BASE

- <u>$800 million in additional cigarette and income taxes to restore cash balances depleted by past overspending.</u> The legislature in May 1982 had adopted a cigarette tax increase of 10 cents per pack and in March 1983 added an income tax levy of 0.25 percent to eliminate the key fund cash deficit and to permit compliance with generally accepted accounting principles. Although the 0.25 percentage point income tax is authorized until September 30, 1986, these taxes should yield over $800 million by the end of fiscal 1985 and accomplish their purpose. The income tax would then expire, while revenue from the cigarette tax increase ($113 million annually) would become available for general purposes.

  Chart I indicates the projected improvement in the cash position of the state key fund balance sheets through 1985. the 1985 year-end cash position could be positive for the first time since 1974 with the prospect that substantial growth in personal income (adjusted to remove the effects of inflation and transfer payments) will trigger a general fund contribution to the budget stabilization fund of perhaps $275 million. The temporary cash cushion provided by such a contribution would last until the next recession. The improved cash position and conformance with generally accepted accounting principles should improve the credit rating of the state.



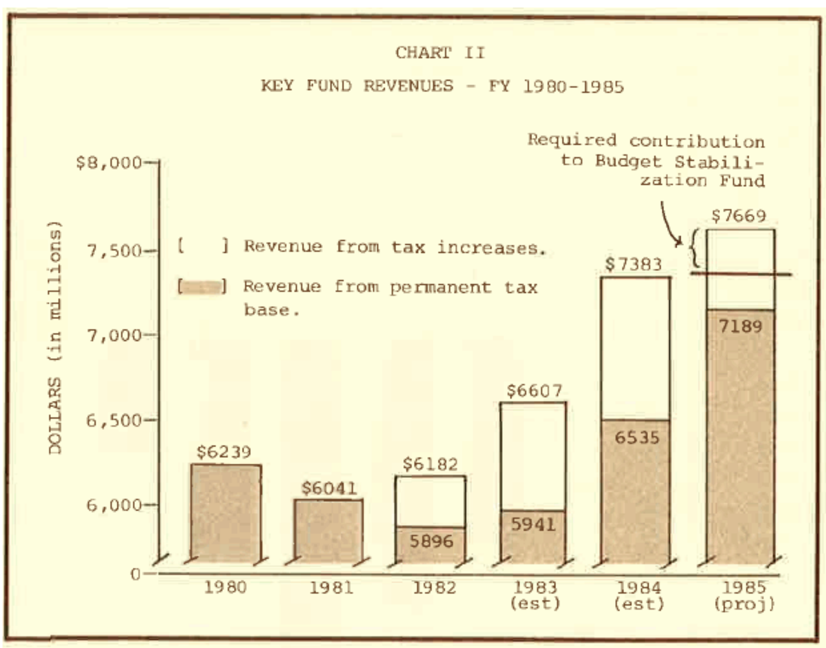
- <u>$675 million in additional income taxes and $225 million in spending reductions to bring the fiscal 1983 budget into balance.</u> The legislature in March adopted an income tax increase of 1.5 percentage points in addition to the 0.25 percentage point increase (bringing the total rate from 4.6 to 6.35 percent), effective for all of calendar 1983. Shortly thereafter, legislative appropriation committees approved an executive order eliminating or delaying $225 million in budgeted spending. These steps should eliminate a projected $900 million imbalance in the fiscal 1983 budget plan.

$1.7 billion in additional income taxes to augment fiscal 1984-1986 revenues. The 1.5 percent income tax levy for 1983 will be reduced to 1.25 percent in calendar 1984 and 0.5 percent thereafter. Should unemployment drop below 9 percent, the 0.5 percent levy would end. The Senate Fiscal Agency estimates out-year revenue from this tax will total $845 million in fiscal 1984, $480 million in fiscal 1985, and $370 million in fiscal 1986, with the income tax rate returning to 4.6 percent in 1987. despite the increase in the income tax (as well as increases in transportation taxes), the state has a projected $756 million margin in FY 1984 under the overall state revenue limit established by the 1978 tax limitation amendment.

With this financial base in place, submission of the Executive Budget has initiated debate on a spending plan.

II. SUBSTANTIAL INCREASES IN KEY FUND[1] SPENDING

With the income tax increase and the prospect of economic recovery, the fiscal 1984 key fund budget can be based on substantially higher revenues. The Department of Management and Budget expects that, after three years of stagnation, key fund revenues will rise by 6.4 percent in fiscal 1983 and then by 11.7 percent in fiscal 1984 (see Chart II). The Executive Budget for 1984 takes full advantage of this turnaround in revenue trends, calling for an 11.4 percent growth in key fund spending over estimated fiscal 1983 levels. While the budget does not project spending requirements for 1985 and 1986, it is reasonable to assume the 1984 spending level will become a base for further increases in later years. The fiscal plan for the 1983-1986 period thus far appears to be based on higher revenues, fully committed to current spending.



The first question to ask about such a fiscal policy is whether it has a reasonable chance of succeeding as it has been laid out. The Governor's Budget Message contains no discussion of the factors that are critical to success of the plan, but there are two that will work against it:

[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, the School Aid Fund and the Budget Stabilization Fund because of the interaction among them in revenue-raising and budget-cutting proposals.

- The tax increase will be phased out beginning January 1, 1984. Thus it will produce fewer dollars each year to augment underlying revenue growth.

- The state likely will be required to set aside revenues under the budget stabilization law in fiscal 1985 and possibly in 1986.

The state will receive an estimated $365 million less in revenue augmentation during fiscal 1985 than in fiscal 1984 because of the income tax rate reduction scheduled for January 1, 1985, and economic recovery may require the set-aside of $275 million into the budget stabilization fund in 1985 as well – effectively cutting the potential growth of spending by $640 million. Even if underlying key fund revenues were to rise by 10 percent, the result would be a "no-growth" fiscal 1985 budget (as illustrated in Chart II). Unless they establish control over spending growth in 1984, state policymakers may well need to adopt abrupt spending constraints in 1985 – or enact further tax increases.

The situation in 1986 and beyond is more complicated. The phase-out of the tax increase and possible set-asides for budget stabilization are likely to be offset in some degree by new general-purpose revenues from the 1982 cigarette tax (which will have completed the purpose for its earmarking) and by reduced interest payments on borrowing for cash needs. On the other hand, the likelihood of an economic downturn will increase.

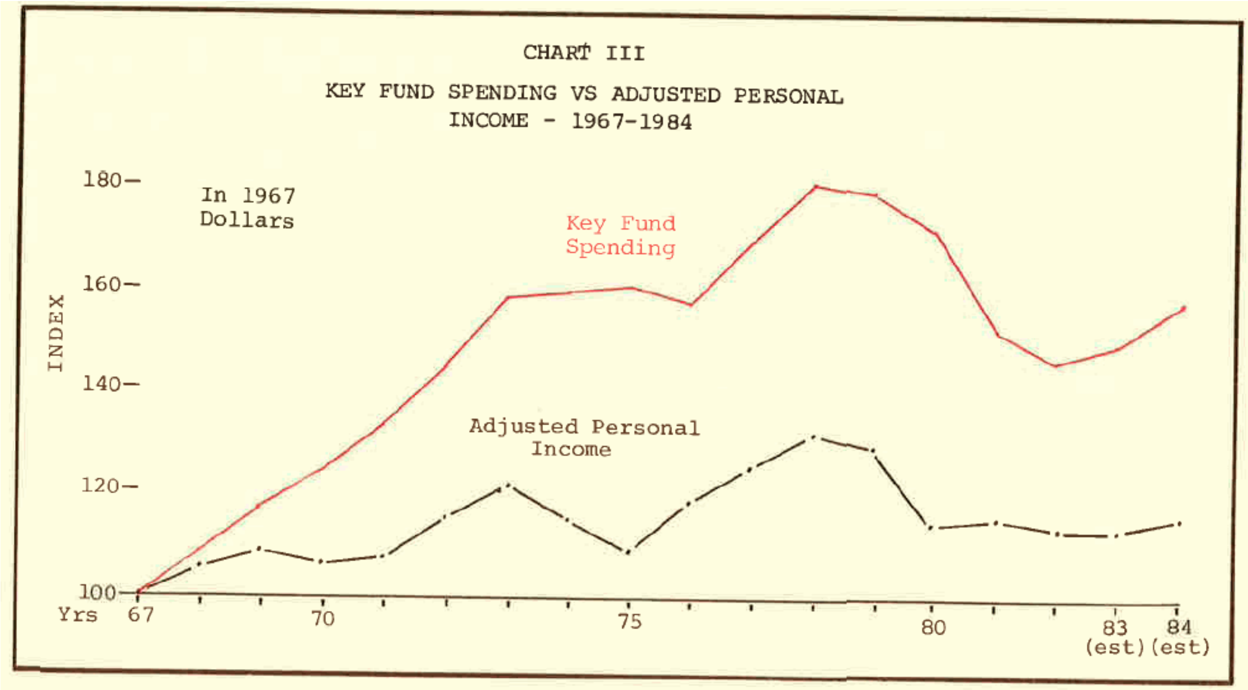
The state has been in this position before. Perceiving that the boom-and-bust cycle of Michigan economic growth created tax-and-spend cycles in state government, policymakers adopted the budget stabilization law in 1977 to smooth the trend of state spending potential, setting aside revenue from "boom" years to support spending in "bust" periods. The fund provided a cash cushion during 1978 and 1979 and supported spending levels in 1980 when revenue growth ceased. But in retrospect it seems clear that, even with the budget stabilization fund, the spending base expanded beyond the capacity of the revenue system to support it. For instance, state employment rose by 12,000 after 1976 – and has had to be reduced by 11,000 since 1980. It would be prudent for state policymakers to look beyond 1984 in setting a spending policy this time around.

Revenue Burdens and Spending Levels

It is also important for state policymakers to consider the relationship between revenue burdens and spending levels in setting fiscal policy. More than 80 percent of the $3.4 billion involved in the plan to cure the state's fiscal problems will come from increasing the levy on those who pay the state income tax during the 1983-1986 period. That taxpayers will bear chief responsibility for correcting the post-1974 imbalance between revenue and spending reflects the belief of some state policymakers that preserving existing public services is a key to Michigan's economic future, that erosion in those services has occurred in recent years, and that the income tax is the most equitable method to provide additional financing.

In short, it is argued that state spending has not kept pace with inflation and that increases are justified to restore state government purchasing power to its former level. In order to assess such an argument, it is also necessary to look at the base from which state revenues are derived – personal income.

Chart III compares the growth of adjusted personal income in Michigan (total personal income less transfer payments) with the rise in state key fund spending since adoption of the state income tax in 1967. Adjusted to remove inflation, key fund spending rose rapidly through 1973 and then again after 1976, peaking in 1978. It fell substantially thereafter, but even in the trough year of 1982 stood 48 percent above the 1967 level in real terms. Adjusted real personal income grew much more modestly after 1967, also peaking in 1978 and falling thereafter. The 1982 level was less than 14 percent above that of 1967 as compared to a 48 percent increase in real key fund spending.



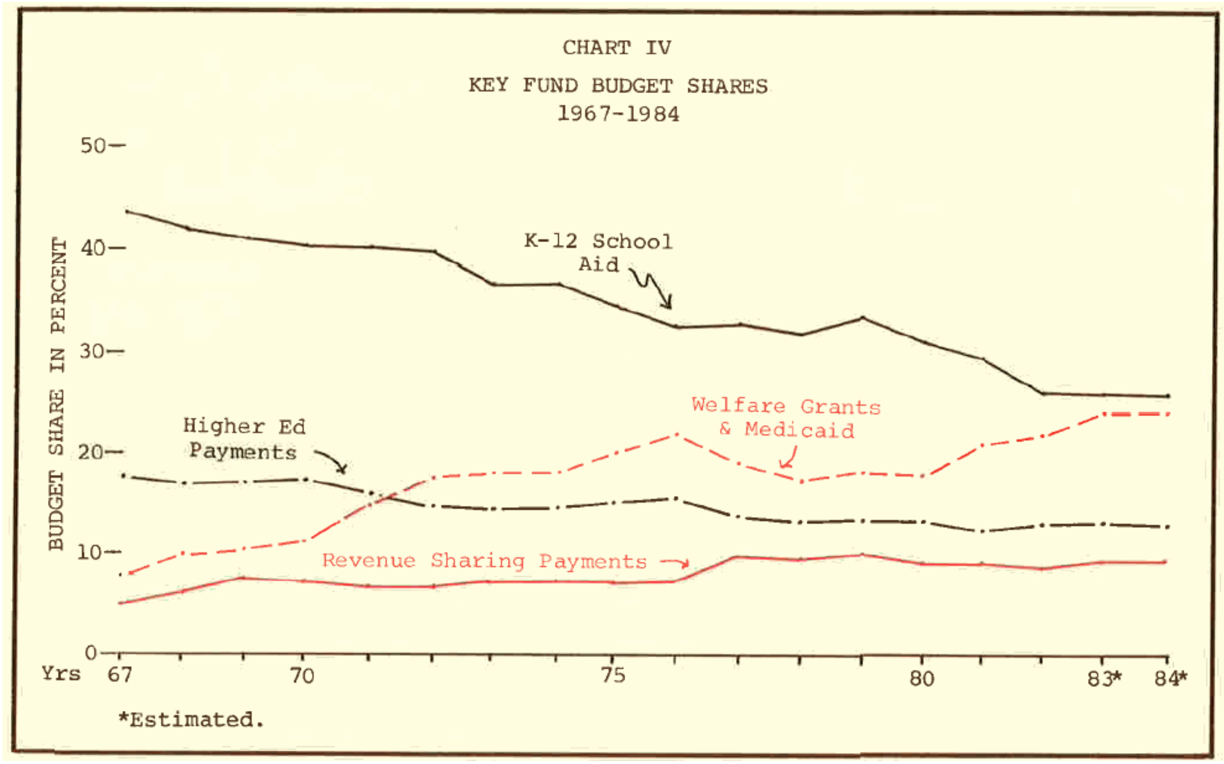
Spending projected for 1983 and 1984 could inaugurate another period of significant growth. While adjusted personal income is expected to grow by 2 percent, 1982 to 1984, the Executive Budget for 1984 programs is a real key fund spending level 7.8 percent above that of 1982. It is widely recognized that the Michigan economy is undergoing a basic structural change. A key question for the governor and the legislature to consider is whether the economic base of the state can continue to support the levels of and increases in state spending that it did in the past. In the long run, economic growth is the only sure route to increasing key fund spending power.

III. CONTINUATION OF ESTABLISHED SPENDING PATTERNS

The proposed budget for fiscal 1984 gives little indication of any major shift in state spending priorities.

Historical Trends in State Spending Priorities

Although state key fund spending growth has exceeded that of Michigan's adjusted personal income base, not all components of key fund spending have risen equally. Four large payments – K-12 school aid, welfare assistance, higher education payments, and revenue shared with local governments – constituted about 70 percent of state key fund spending, with outlays for state departmental administration and other purposes making up the remaining 30 percent. Since 1967 the share of key fund spending devoted to K-12 school aid and higher education payments has fallen steadily, while welfare assistance (Aid to Families with Dependent Children, Supplemental Security Income, General Assistance, Medical Assistance) has gained a much larger share of the total and the shares of departmental and revenue sharing outlays have risen marginally (see Chart IV). From 1967 to 1983 key fund support for the educational components grew less than the increase in the personal income base, while for the other major components key fund spending grew more. The trend in educational funding has been accomplished by shifts to property tax and tuition support which have grown rapidly.



Spending Priorities in the 1984 Budget

The Governor's Budget Message includes in clear terms a policy preference for reversing the trends in educational funding. But the prospects for fiscal 1984 also include continuing high welfare caseloads, a civil service pay raise, increased prices for most goods and services bought by the state, and pressures to undo the impact of departmental budget reductions from the 1980-1983 period. Education must compete with these factors for a place in the fiscal 1984 spending plan.

The Executive Budget for 1984 proposes to increase key fund expenditures by 11.4 percent, or $756 million, over estimated fiscal 1983 levels. The announced priorities are education, jobs and economic development, and selected human services programs. The key fund figures (shown in Table 1) indicate that:

- K-12 school aid and welfare assistance both would receive 12.4 percent increases.

- Higher education actually would receive less in 1984 than in 1983. The 1983 total includes $80 million to cover a 1982 deferral, so it can be argued that the budget provides an effective annual increase of 8.1 percent; but even with a sizable tax increase the budget allocates fewer dollars to higher education than were made available the year before.

- Departmental administration and other outlays would show the largest percentage increases, even though some departments would be held to little growth. Major increases would go to the departments of Mental Health, for both more aid to community programs and staffing improvements at state facilities; Corrections, for program improvements and construction of facilities; Social Services, for welfare administration and state payments of all AFDC foster care payments; and Commerce, for a "Strategic Investment Fund" and other economic initiatives. A Senate Fiscal Agency analysis indicates these involve significant personnel growth only in Corrections, with overall state employment dropping by 3 percent. But payroll growth is a factor, since about 60 percent of state classified employees agreed to defer fiscal 1983 pay increases and thus will receive an effective raise of 7.1 percent in 1984.

Table 1
Key Fund Budget Plans – 1983 vs. 1984
(Amounts in Millions)

	Amended 1983 Budget Plan	Proposed 1984 Budget Plan	Increase Amount	Increase Percent
Major Payments				
K-12 School Aid	$1,675	$1,882	$207	12.4%
Welfare	1,564	1,758	194	12.4%
Higher Education	916	904	(12)	-1.3%
Revenue Sharing	605	661	56	9.2%
Departmental & Other Outlays				
Mental Health	$ 522	$ 596	$ 74	14.2%
Social Services	311	357	46	14.8%
Corrections	226	261	35	15.5%
Public Health	88	100	12	13.6%
Commerce	62	80	18	29.0%
All Other	698	783	85	12.2%
Unallocated (lapses)	(40)	—	40	
TOTALS	$6,627	$7,383	$756	11.4%

The Section 30 Problem

The 1978 tax limitation amendment to the constitution requires that 41.6 percent of total state spending by paid to local governments. The implementing legislation requires this proportion to be observed in the Executive Budget and in legislative appropriations, and it requires any shortfall in the local share of spending to be redressed by additional appropriations in the following year. The state is likely to owe over $100 million in spending share to local units at the end of fiscal 1983, and it will owe up to $200 million when spending accounts are accrued to remove the distortions caused by “gimmicks” used to balance the 1981 and 1982 budgets. While the Executive Budget for fiscal 1984 is apparently “balanced” between state and local spending for fiscal 1984, it does not address the carryover problem from fiscal 1983. Attempts are underway to change the basis for allocating certain payments, moving them into the local share without affecting the actual distribution of spending.

CONCLUSION

To some extent, the fiscal 1984 Executive Budget can be viewed as a watershed in recent state financial history. It is widely believed that Michigan is at last emerging from the prolonged recession that has precipitated a seemingly endless series of budgetary adjustments and fiscal crises. The financial position of the state, although still deep in deficit, is improving and should be positive by the end of fiscal 1985. The March tax increase expanded the available revenues of the state so that, with some prudence, state officials should find ample resources in fiscal 1984 to support state programs. And, although welfare caseloads are projected to continue their rise into 1984, the outlook is for stabilization and perhaps an opportunity for state policymakers to order spending priorities in accordance with long-term goals for economic development. In short, the stage is set for a fresh start.

- The fiscal 1984 Executive Budget provides these indications of the future direction of state spending:

- The state will allocate all of the available key fund revenue in fiscal 1984. This will establish a spending base that may not be sustainable in fiscal 1985 given revenues projected for that year.

Spending priorities are essentially unchanged. The proportions of key fund spending accorded to welfare, education, and revenue sharing simply extend existing trends.

The seeds of the 1980-1983 state fiscal problems were planted in 1977-1979 when the state failed to act to repair the fiscal damage done during the 1975-1976 recession. Instead, all available revenues were committed to current or future spending and, when the economy faltered, revenues were inadequate to support the greatly expanded spending base that had been built up during recovery. Assuming that 1983 and 1984 will be recovery years, Michigan enters the period in a financial position substantially weaker than in 1977. In formulating financial plans for 1984 and beyond, policymakers should review carefully the 1977 to 1983 experience in order to insure that it is not repeated.

* * *