FISCAL AWARENESS SERVICE

Volume 3, Number 2
January 31, 1984

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Prudence and Caution Urged for Fiscal '85 Budget

In 1983 Michigan began to reverse many of its unacceptable accounting practices. A rebounding economy and resultant higher revenue levels have enabled Michigan to move quickly to restore its financial flexibility and credit standing and to help close its fiscal gap by effecting $141.1 million of accounting reforms. This reduced the FY 1983 General Fund budget overage from $165.7 million to $24.6 million. The economy expanded rapidly in 1983 but is now growing at a slower pace. This, in combination with the phaseout of the income tax increase and statutory spending obligations, requires stringent fiscal restraint during FY 1984 and 1985. The potential for a $325 million deficit exists for FY 1985. Prudence and caution must be exercised to avoid repeating the fiscal difficulties and destruction of government services which occurred in FY 1982.

Michigan's 1982-83 General Fund Budget Surplus Revisited

Since April 1983 Michigan's fiscal position has steadily improved. Revenues from the temporary income tax increase and higher levels of business activity have generated more dollars than anticipated, leading to estimates of a General Fund budget surplus ranging from $24.5 million to $200 million. There has been a storm of controversy as to how best to deal with this "windfall," losing sight of the fact that since the recession began in 1979 the state had accumulated a debt in excess of $1 billion. This deterioration in Michigan's fiscal position was reversed in 1983. For the first time since 1978 the state concluded its fiscal year in a stronger financial position than it started.

The different General Fund surplus estimates have generated considerable confusion, but these various reports are not in substantial conflict. The income tax increase was enacted in April 1983 but made retroactive to January of that year. Not all employers complied with the higher withholding rates until almost two months after the tax increase was approved. The slowness in withholding at the higher rate and the retroactivity provisions will prevent Michigan from receiving the full benefit of the income tax increase until individual income tax returns are received in April 1984.

Few disputed that the increase in the state's income tax rate would increase revenues and eliminate the projected 1982-83 budget deficit. It was not thought that these revenues would flow into the state treasury soon enough nor accumulate quickly enough to permit reversal of myriad unorthodox accounting practices until the 1983-84 fiscal year. However, a rebounding economy and associated improvements in both income and sales tax collections provided almost immediate relief for the state's financial problems. This permitted the government to accumulate revenues more quickly and reverse some of the unacceptable accounting practices previously used.

The restorations and accounting practice reversals achieved in the 1982-83 fiscal year are detailed in the following table. As shown here, if previous budget practices had been continued, Michigan's General Fund budget would have shown a purported surplus of $165.7 million. Such a surplus would have been more a fiction than a reality since the debt which the state repaid would have remained a liability to be dealt with in either the 1983-84 or 1984-85 fiscal year.

Table 1. Detail of Accounting Reforms/Restorations Achieved in Fiscal Year 1982-83 (in millions of dollars)

Item	Amount
Write-off of uncollectible revenues from previous fiscal years	$28.2
Repayment of FY 1981-82 Section 30 shortfall	19.4
Restoration of reserve account for payment of employee leave and longevity	18.8
Restoration of reserve account for capital outlay expenditures	36.8
Recognition of delay in collection of advances to local units	32.0
Other	5.9
Subtotal	$141.1
Official General Fund surplus	24.6
Total	$165.7

Two other major accounting reforms were accomplished through expenditure of revenues reserved for that purpose. When the Michigan personal income tax rate was increased from 4.6% to 6.35%, 0.25 percentage points of the increase were dedicated to the State Accounting and Fiscal Responsibility Account (SAFRA). At the close of the 1982-83 fiscal year this account contained over $111 million. Part of this balance was used to restore disbursements for the voluntary home heating assistance program ($22.5 million) and the General Assistance medical program ($6.3 million) to accrual accounting from cash accounting. Other programs still awaiting such reform include the Medicaid program ($172.0 million) and payment of state income tax refunds ($185.0 million).

The temporary income tax measure was coupled with a resolve to correct quickly unsound accounting practices previously employed. Despite the potential negative political consequences of these actions, this resolve enabled Michigan to reap significant advantages in its credit standing and fiscal stability. It is important that the success of these past ten months not be interpreted as eliminating the need for continued resolve and fiscal restraint. As we stated in our newsletter of February 10, 1983,

> "The challenge to Michigan can best be understood as four related but separable components: (1) eliminating a fiscal 1982-83 budget shortfall which is officially placed at $900 million; (2) paying off $800 million of accrued debt; (3) creating a $600 million cash cushion to eliminate the need for borrowing to cover short-term cash flow problems; and (4) preparing a foundation for economic renewal and improved employment opportunities."

The first challenge has been met and Michigan is working steadily at the second and fourth. No action has yet been taken on the third. Whether the state successfully achieves all four of these tasks will depend in large part on the commitment of its leadership to adhere to a financial recovery plan by placing the public interest above parochial political considerations. The citizenry must not be lured into acceding to proposals which would prematurely terminate fiscal recovery by building in new tax credits, rebates, or program expenditures. The recovery plan is of limited duration, but expanded tax credits and increased program outlays continue indefinitely and could seriously erode Michigan's ability to deal effectively with future recession-induced fiscal problems.

Budget Prospects for Fiscal Years 1983-84 and 1984-85

Table 2 shows our projection of the state's General Fund budget balance in fiscal years 1983-84 and 1984-85. The projection is based on the assumption that state expenditures will keep pace with inflation and that economic growth will continue throughout each of these fiscal years, albeit at a lower rate of increase than that realized in 1982-83.

Table 2. Projected General Fund Receipts and Expenditures of a Zero-Growth Budget in Fiscal Years 1983-84 and 1984-85 (in millions of dollars)

Item	FY 1983-1984	FY 1984-85
Total General Fund revenues, all sources	$5,420	$5,665
General Fund expenditures	-5,159	-5,520
Single Business Tax Refund	- 43	--
Welfare Caseload Adjustment	+ 37	+ 20
Section 30 Repayment	--	- 140
Transfer to Budget Stabilization Fund	- 35	- 350
Surplus (deficit)	+ 220	(- 325)

This ending budget balance is contingent both on the amount of revenue the state receives and the expenditures it makes during the course of any fiscal year. Revenues depend on economic performance and state-imposed rates of taxation. Accelerated phaseout of the income tax increase would alter revenue receipts; the strength of economic activity will influence expenditure levels and tax receipts. Changes in either expenditures or revenues materially alter projections of the ending fiscal year budget balance, as demonstrated in the 1981-82 fiscal year.

Three items deserving close scrutiny are the welfare caseload adjustment, the Section 30 repayment, and the transfer to the Budget Stabilization Fund. Caseload levels typically rise to new highs during recession but never decline to prerecession levels after the economy has fully recovered. Given the large number of individuals who have exhausted their unemployment benefits and withdrawn from the labor force, caseload levels may decline even more slowly than usual during this recovery. If welfare caseloads fail to register their expected rate of decline, state spending for income maintenance could remain at its lofty level instead of decreasing.

The second item of concern is the Section 30 reimbursement requirement stemming from inadequate outlays for local spending during the 1982-83 fiscal year. A final tally of the dollar amount by which local spending fell short of the mandated share of 41.6% has not been made, but our estimate places it at $140 million. The constitution is unclear whether this shortfall is a liability against the current fiscal year or the following one. This ambiguity will probably be resolved by court decision, but since no local unit of government has yet sued the state to force compliance with Section 30 requirements, payment timing is still open to interpretation. Most state officials believe the shortfall would not have to be reimbursed until the fiscal year following the year in which the magnitude of the shortfall was officially determined. This would argue for repayment of the fiscal 1982-83 shortfall in the 1984-85 fiscal year. However, with revenues barely increasing in 1984-85 over 1983-84 due to phaseout of the income tax increase, the 1984-85 fiscal year will be difficult even with continued fiscal restraint. In view of this difficulty, it may be more expedient to repay the 1982-83 shortfall in the current 1983-84 fiscal year instead of waiting until next fiscal year.

Moreover, if the budget becomes too severely squeezed by revenue declines and increased expenditures for selected state programs during 1984-85, the legislature might amend or repeal the statute creating Michigan's Budget Stabilization Fund, the "rainy day account." With establishment of SAFRA and a working capital reserve account, the state has eliminated several of the uses (but not the purpose) for the Budget Stabilization Fund. Reduction in or elimination of this statutory obligation would eliminate the 1984-85 budget gap but would make fiscal management during future times of hardship just that much more difficult. Obviously there are inherent advantages to using the savings in a special reserve account such as the Budget Stabilization Fund instead of raising taxes.

Some have speculated that the Section 30 repayment may never be made. There is considerable interest in redefining certain state expenditures as local expenditures, to maintain these payments but to credit this spending toward the local rather than state side of the expenditure equation. If this change is effected, the repayment requirement might be eliminated, helping to transform the projected deficit into a $165 million surplus.

Summary and Conclusion

A rebounding economy and resultant higher revenue levels have enabled Michigan to move quickly to restore its financial flexibility and credit standing and to help close its fiscal gap by effecting $141.1 million of accounting reforms. Despite these improvements, there is little room for expanding program commitments, repealing the temporary income tax increase, or increasing tax credits and exemptions. True fiscal health will be attained only when Michigan has paid off the balance of its accumulated debt, established a cash cushion to avoid the costs of continuing short-term borrowings, and devoted more effort and resources toward rebuilding the social and economic infrastucture vital to the state's future.