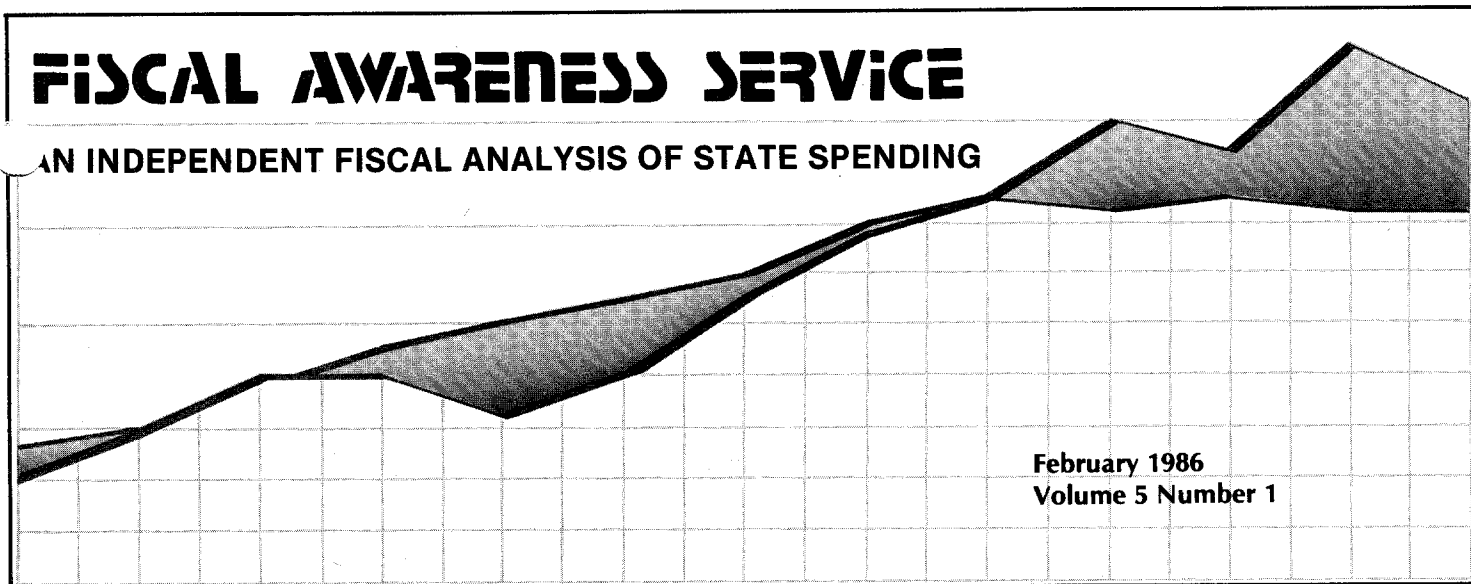


FISCAL AWARENESS SERVICE

AN INDEPENDENT FISCAL ANALYSIS OF STATE SPENDING



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Overview of Michigan Budget Appropriations Fiscal Year 1986-87

Governor Blanchard has recommended a very constrained budget for fiscal year (FY) 1986-87, with general fund-general purpose (GF-GP) expenditures recommended at \$5,991.5 million, \$11 million below FY 1985-86 appropriations (see Table 1). The reduction is \$57 million if the budget stabilization fund transfer is included. There will be actual reductions in nine departments and increases below inflation in seven others; only three departments will receive real increases — mental health, corrections, and labor. There will also be a 5.5% increase for community colleges and four-year institutions. The general fund grant to the school aid fund will be virtually unchanged, but on a per pupil basis K-12 spending will increase 6.7%.

The increases in several areas of the budget are possible because of a \$78 million reduction in capital outlay spending, a \$35 million reduction in debt service, and a \$39 million reduction in welfare expenditures. This “hold-the-line” budget is made necessary by the recommendation for a rollback in the income tax rate from 5.1% to 4.6% as of April 1. This will reduce revenues about \$200 million in the current fiscal year and \$420 million in FY 1986-87.

Total expenditures are recommended at \$14,284 million, 1.6% above FY 1985-86 projected appropriations. The increase is due mainly to growth in the restricted taxes allocated for school aid and revenue sharing and a 14.3% growth in the state lottery fund.

Because the FY 1986-87 budget is so constrained, the Governor is focusing attention on the accomplishments of the last four years. The following accomplishments are highlighted:

- The elimination of a \$1.7 billion deficit and the return to solvency. The cash flow position of the general and school aid funds has improved from a negative \$624 million in FY 1981-82 to an estimated positive balance of \$524 million in the 1986-87 budget year.
- Michigan has achieved Wall Street's highest credit rating, MIG-1, and short-term borrowing costs have been nearly eliminated — only \$3 million is recommended in FY 1986-87.
- The income tax rate will be cut to 4.6%, the lowest rate since 1981.
- The number of state employees is now 20% below the FY 1979-80 peak, despite a 45% increase in employment in corrections.
- State spending has shifted away from social services to education, law and safety, health, and revenue sharing. For example, in FY 1982-83 — when Governor Blanchard assumed office — 25% of state expenditures (from state revenue sources) was allocated to social service and 33% to education. The FY 1986-87 budget allocates 36.4% to education and only 18.2% to social services (see Figure 1 and Table 2).

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TABLE 1
General Fund-General Purpose Budget Summary,
Fiscal Years 1985-86 and 1986-87
(millions of dollars)

Department or Program	Authorized FY 1985-86 Appropriations	FY 1986-87 Executive Recommendations	Dollar Change	Percentage Change
Human Services				
Social Services	\$1,942.7	\$1,903.6	-\$39.1	-2.0%
Mental Health	663.2	704.0	40.8	6.2
Public Health	123.4	118.3	-5.1	-4.1
Education				
State Colleges and Universities	977.1	1,026.7	49.6	5.1
Operations	900.3	948.5	48.2	5.4
Financial Aid	76.8	78.2	1.4	1.8
School Aid	517.5	516.4	-1.1	-0.2
Community Colleges	175.5	185.2	9.7	5.5
Education	37.7	36.6	-1.1	-2.9
Library of Michigan	19.8	20.1	0.3	1.4
Safety and Defense				
Corrections	389.1	425.5	36.4	9.4
State Police	152.0	157.7	5.7	3.8
Military Affairs	11.6	11.6	—	-0.4
Regulatory				
Commerce	89.6	85.9	-3.7	-4.2
Labor	58.0	76.1	18.1	31.2
Licensing and Regulations	15.3	15.2	-0.1	-0.8
Natural Resources and Recreation				
Agriculture	26.0	25.3	-0.7	-2.8
Natural Resources	116.1	103.6	-12.5	-10.8
General Government				
Management and Budget	128.6	131.8	3.2	2.5
Treasury	58.5	60.9	2.4	3.9
Judiciary	79.9	85.2	5.3	6.6
Legislature	63.5	66.7	3.2	5.0
Attorney General	20.5	21.2	0.7	3.4
State	16.0	15.8	-0.2	-1.1
Civil Service	10.4	10.9	0.5	4.2
Civil Rights	9.9	10.1	0.2	2.5
Executive Office	3.5	3.6	0.1	2.5
Other				
Capital Outlay	215.5	127.4	-88.1	-40.9
Debt Service	80.5	46.0	-34.5	-42.9
Transportation	—	—	—	—
Budget Stabilization Fund	—	—	—	—
Transfer	47.1	—	-47.1	-100.0
TOTAL	\$6,048.5	\$5,991.5	-\$57.0	

TABLE 2

**State Budget Allocation from State Resources,
FY 1982-83 and FY 1986-87**

	FY 1982-83	FY 1986-87
Education	33.2%	36.4%
Social Services	25.0	18.2
Transportation	9.7	9.7
Health	8.3	8.6
Revenue Sharing	7.7	8.2
Law Enforcement and Safety	5.8	7.2
Other	10.3	11.7
TOTAL	100.0%	100.0%

ECONOMIC AND REVENUE ASSUMPTIONS

The critical factor for any state budget is the performance of the state and national economies. While Governor Milliken was bedeviled by the economy in the final years of his administration, Governor Blanchard has been blessed by a strong economy. The accomplishments of his administration would not have been possible without a strong economy.

The FY 1986-87 budget assumes a continuation of steady economic growth (see Table 3). Real gross

national product (GNP) is expected to increase 3.4% compared with an estimated 2.6% increase in FY 1985-86 and a 3.4% increase in FY 1984-85. Total U.S. passenger car sales in 1986-87 are estimated at 10.2 million units, a small improvement following a drop from 11.1 million units in FY 1984-85 to an estimated 10.1 million units in FY 1985-86. Michigan employment growth is expected to be only 1.4% compared with growth of 2.7% in FY 1984-85 and an estimated 1.7% in FY 1985-86.

Underlying the Governor's economic forecast are assumptions that there will be moderate cuts in federal aid, no negative impacts on Michigan business from federal tax reform, and a moderate improvement in the U.S. trade deficit.

The FY 1986-87 budget is also based on the assumption that revenues will decline about 1% due to the rollback of the income tax rate, after an estimated increase of 5.1% in FY 1985-86. The FY 1986-87 budget includes three unusual revenue adjustments.

1. The Governor established by executive order a citizen's escrow fund to set aside 0.5% of the income tax after March 31, 1986. The purpose is to ensure that funds will be available for return to the taxpayers if the Legislature has not reached final agreement on the date for the tax rollback prior to that time. An estimated \$191 million will be escrowed.

TABLE 3

Economic Assumptions, FY 1986-87 Budget

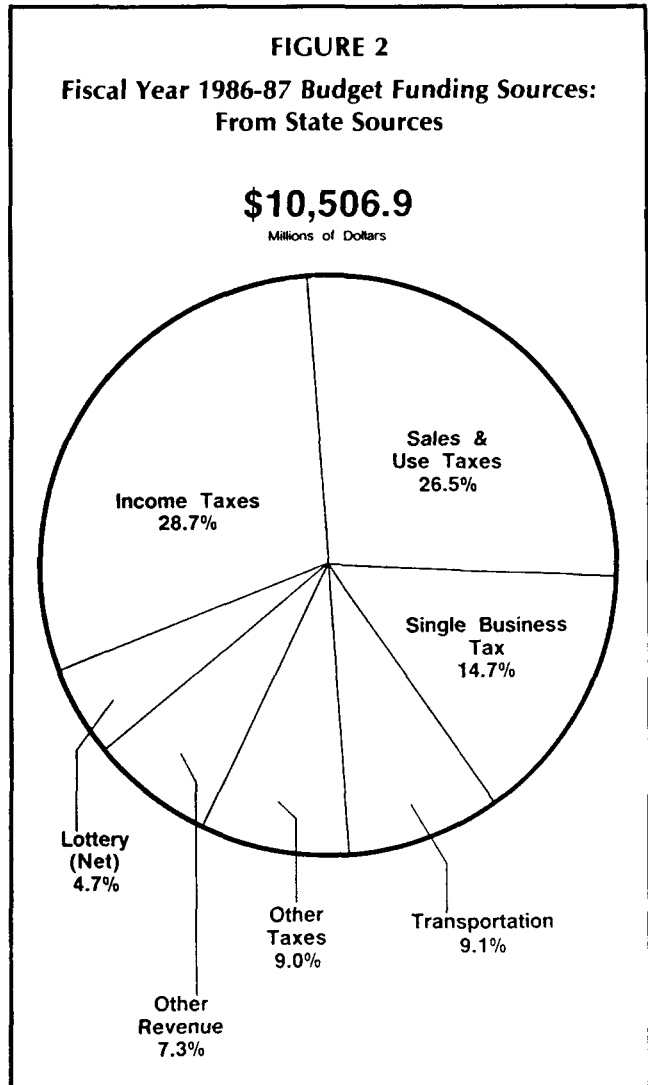
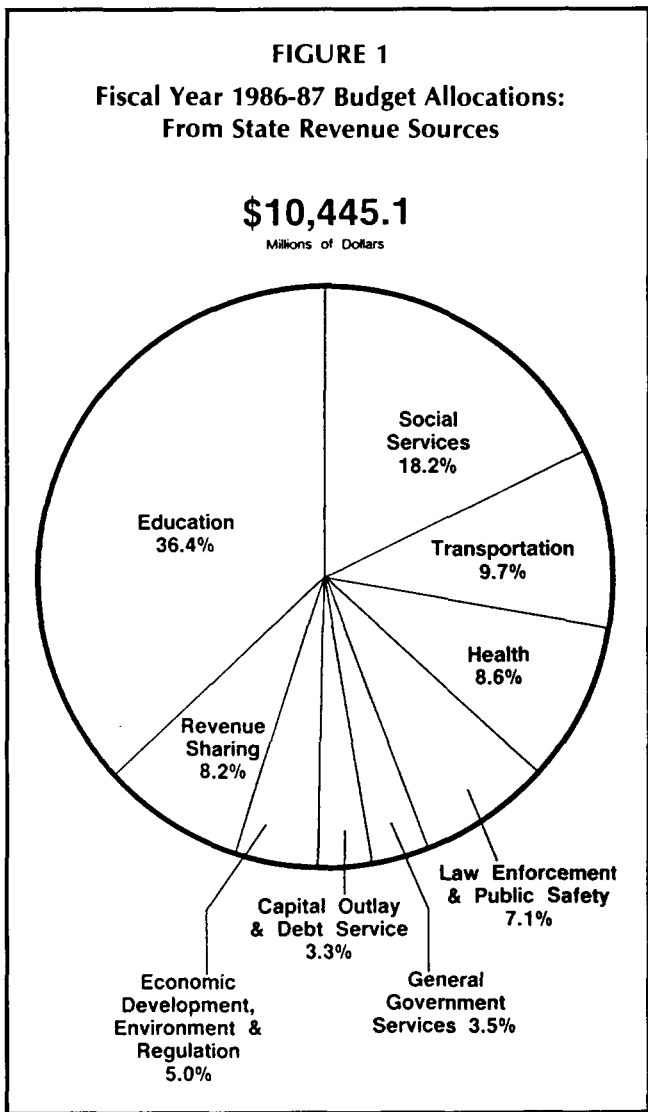
	FY 1984-85 (actual)	FY 1985-86 (estimate)	FY 1986-87 (estimate)
United States			
GNP (% change)	3.4%	2.6%	3.4%
Passenger Car Sales (millions of units)	11.1	10.1	10.2
Import Share (%)	24.2%	30.2%	30.7%
Federal Budget Deficit	\$211.3	\$185.8	\$173.1
Michigan			
Motor Vehicle Production (millions of units)	3.3	3.1	3.18
Wages and Salary Employment (% change)	2.7%	1.7%	1.4%
Unemployment Rate (%)	10.4%	9.9%	9.7%
Real Personal Income (% change in millions of 1967 dollars)	4.2%	2.0%	1.5%
Detroit CPI (1967 = 100) (% change)	3.4%	2.7%	4.3%

2. The tax amnesty plan is expected to generate \$50 million in revenues on a one-time basis.
3. The working capital reserve account is expected to have an available balance of \$48 million, after accrual of the liability for income tax refunds to be paid in the spring of 1987.

Adjusted for the special factors described above, GF-GP revenues are estimated to increase 6.7% in FY 1985-86 and 5.9% in FY 1986-87.

FY 1986-87 SPENDING POLICIES

Figures 1 and 2 illustrate the allocations and funding sources of the recommended 1986-87 budget. Figure 1 shows state expenditures from state revenue sources, which exclude federal aid and local and pri-



vate revenue sources. This is the best way to look at state spending because it includes the school aid fund but excludes federal aid, which is largely outside the influence of the Governor and the Legislature.

Figure 2 shows that about 70% of state revenue is generated by just four of the state's taxes — individual income, single business, sales, and use. (Federal aid is the state's largest revenue source — an estimated \$3.65 billion in FY 1986-87.)

Figure 1 shows how state own-source revenues are distributed among major state program areas. Social services, health, education, transportation, and revenue sharing together use 81 cents of every budget dollar from state revenue sources.

Table 4 illustrates the discretionary portion of the budget relative to total appropriations for selected program categories. (Discretionary funds are those subject to the direct control of the Governor and the

Legislature.) In FY 1986-87, only 42% of the budget will be discretionary. Restricted funds totally finance transportation and revenue sharing and finance more than one-half of education, social services, and regulatory programs. As recently as FY 1979-80, about 50% of the budget was discretionary. (See "The Proposed Executive Budget, Fiscal Year 1985-86," March 25, 1985, vol. 4, no. 2, Public Sector Consultants, Inc., for a discussion of this issue.)

Education

The largest dollar increases in the budget recommendations are in education programs. A \$48.1 million, or 5.5%, increase in operating support is recommended for *four-year colleges and universities*. Unlike previous budgets, the same increase applies for each institution. The only exception is that \$3.1 million is recommended for the operating costs for new facilities opening in FY 1986-87 at five institutions. The budget also includes a continuation of \$25 million for the research excellence and economic development fund and \$5 million for instructional equipment needs.

The funding increases for higher education in the FY 1986-87 budget and the three previous budgets have two major purposes: to improve the quality of

higher education and to slow tuition increases. From FY 1978-79 to FY 1983-84 there was an 85% increase in average undergraduate tuition and fee rates. However, tuition increases were only 2.7% in FY 1984-85, an estimated 2.7% in FY 1985-86, and are estimated at 4% in FY 1986-87. For the past two years, tuition rates for undergraduate students who are Michigan residents have been frozen; for FY 1986-87 the intention is that tuition increases be no greater than the rate of inflation.

The budget recommends an additional \$9.7 million for *community colleges*, also a 5.5% increase. Again, each college receives approximately the same increase. The recommendations continue the phase-in of the formula funding process for distributing state resources, which began in FY 1984-85. There are several small adjustments in the formula to eliminate inconsistencies and to recognize differences in the ability of the colleges to raise local revenues.

The general fund contribution to the *school aid fund* is basically unchanged, but the total funding increase for direct operating aid and school employee retirement is recommended at \$144.4 million, a per pupil increase of about 7%. This increase is due to an estimated \$145 million increase in restricted taxes, mainly sales tax and lottery. The basic membership

TABLE 4
Comparison of Discretionary and Restricted Funding,
Budget Recommendations by Category, FY 1986-87 Budget
(millions of dollars)

Program Category	General Fund- General Purpose (Discretionary)	Total All Funds	GF-GP Expenditures as Percentage of Total Funds
Education	\$1,785.0	\$4,304.1	41.5%
Social Services	1,903.6	4,173.2	45.6
Health	822.3	1,264.4	65.0
Law Enforcement and Safety	594.8	632.2	94.1
Regulatory (Commerce, Labor, Licensing and Regulation)	177.2	514.8	34.4
Environmental Protection (Natural Resources and Agriculture)	128.9	307.9	62.0
Revenue Sharing	—0—	860.1	—0—
Transportation	—0—	1,306.1	—0—
General Government	406.3	761.6	86.6
Capital Outlay and Debt Service	173.4	316.3	53.4
TOTAL	\$5,991.5	\$14,284.0^a	42.0%

^aComponents do not add to total because of \$156.7 million in interdepartment appropriations.

formula is recommended at a level of \$300 per pupil plus \$72 per levied mill. In addition, \$28 per pupil is recommended for districts offering a minimum curriculum or mandating a minimum set of graduation requirements and \$12 per pupil is available to districts achieving class size reductions in K-3 grades.

Also recommended are a \$6.4 million increase in school transportation aid to begin the implementation of a new formula and \$9.3 million more for vocational education. A \$43 million or 7.2% increase is recommended for the school employee retirement fund.

Safety and Defense

Corrections has been a major growth industry in Michigan in recent years. The FY 1986-87 budget continues this trend, recommending a 9.4% increase above the FY 1985-86 appropriation. The budget also includes \$544 million (\$34.8 million from the budget stabilization fund) for construction and renovation of prison facilities. The number of available prison cells is expected to increase from 15,770 in December 1985 to 19,471 in July 1988.

Also in the area of law enforcement, the *State Police* budget includes \$2.3 million to cover full-year cost of 100 additional police officers, to be hired late this fiscal year.

Human Services

The *Department of Mental Health* has been targeted for a \$40.8 million increase. Mental health is a high priority for the Governor; the FY 1986-87 recommendation (all funds) is 53% above the spending level for FY 1982-83. About 50% of the increase in the FY 1986-87 mental health budget is for the continuation of the patient reduction at Northville Regional Psychiatric Hospital. Substantial funds are also recommended to maintain accreditation standards for the twelve state institutions for the mentally ill, which currently meet the national accreditation standards, and for the eight centers for the developmentally disabled, which meet federal care standards; efforts to achieve accreditation at the remaining three unaccredited facilities for the mentally ill will continue.

The budget also contains funds to continue the transfer of authority and responsibility for mental health services to the county community mental health boards.

The reduction in the *Public Health* budget reflects a recommendation for a \$7.6 million increase in fees and collections to replace GF-GP financing (see Table

1). Included in the budget recommendations are a \$250,000 grant for adolescent health services and \$470,000 for implementation of a program aimed at preventing the spread of AIDS, educating citizens about it, and providing additional laboratory testing.

Natural Resources and Recreation

The *Department of Natural Resources* recommendation is for a \$12.5 million reduction, second only to the Department of Social Services. However, the reduction is not as severe as it appears. The budget reflects a \$7.2 million reduction due to elimination of the following two one-time payments made in FY 1986:

- \$5.3 million for a court judgment
- \$1.9 million for the Indian fishing settlement.

In addition, \$6.5 million for the superfund cleanup program required to match federal revenue is carried over from the FY 1985-86 budget, creating a general fund savings of a like amount.

The budget recommends department-wide reductions of \$7.6 million. The reductions allow for a \$4.2 million increase to replace the loss of restricted funds in environmental programs and \$4.1 million for a number of other programs.

Regulatory

In contrast to previous Blanchard budgets, there are few new initiatives in economic development. The reduction in the *Department of Commerce* budget is due to the elimination of the \$4 million grant to the cities for resource recovery (recycling waste).

The large increase in the *Department of Labor* budget is mainly the result of the transfer of the Office of Job Training from the Department of Management and Budget (\$7.6 million) and a \$8.8 million allocation for Project Self-Reliance, a program to provide job training and placement for persons eligible for general assistance grants.

General Government

There are few significant changes in this area of the budget. The largest recommended increase, \$5.3 million, is for the *Judiciary*. These funds are to be used for full-year funding of judicial salary standardization, pay raises for trial court employees, and a January 1, 1986, judicial pay raise, as well as additional staffing to improve court operations.

The budget includes a recommended increase of only 2.5% for the *Department of Management and Budget*. However, there are some significant increases in this department: \$9.8 million for building authority rent and \$3 million for services to the aging. These increases are partially offset by a \$7.6 million savings from the transfer of the Office of Job Training to the Department of Labor.

Other

Although the *Capital Outlay* budget recommendation is \$88.1 million below the FY 1985-86 appropriation, the recommendation of \$127.4 million is among the highest ever appropriated for capital outlay. It reflects the strong policy priorities of the Governor toward public safety and educational projects. Over \$60 million is allocated for maintenance, remodeling, and completion of construction at higher education institutions and about \$24 million is allocated for the Department of Corrections. In addition, corrections will receive \$34.8 million from the budget stabilization fund. Other state agencies will receive about \$42 million for maintenance and construction. Included is \$5 million to complete construction of the state library/museum complex.

Expenditures for *debt service* in FY 1986-87 will be \$34.5 million below the previous year. This is due mainly to the state's improved fiscal position, which will sharply reduce the need to issue general obligation notes, and a reduction of \$11.4 million in Vietnam veteran's bond and interest redemption obligations.

There is little new money for *local government* in the budget although tax revenue restricted for revenue sharing will increase an estimated 6.2%. Section 30 of the Michigan constitution requires that 41.6% of state spending be allocated to local governments. The State fell short of this obligation in two earlier budgets, but in FY 1986-87, the requirement will be exceeded by more than \$250 million.

Because real Michigan personal income is projected to increase less than 2% in 1986, no transfer to the *budget stabilization fund* will be required; an estimated \$34.8 million will be withdrawn for prison construction under the economic stabilization provisions of the budget stabilization fund. In the current fiscal year, the estimated pay-in to the budget stabilization fund, based on the formula, should be \$107.1 million, but this will be reduced by \$60 million to help finance prison construction (in effect, this is GF-GP money); an additional \$34.8 million will be withdrawn under the economic stabilization provisions, also to finance prison construction.

COMMENT

The most interesting aspect of the Governor's recommended FY 1986-87 budget is the case it makes for his reelection. The budget is presented as the final piece in a four-year plan to restore the state's fiscal integrity, stabilize the Michigan economy, and redirect spending priorities to areas where there is a long-term economic payoff, such as education and economic development. Now that the fiscal recovery is essentially complete the Governor can, as promised, roll the income tax rate back to 4.6%. The timing is excellent, as the rollback on April 1 (recommended in the budget) will be fresh in the voter's minds as the election campaign begins. The Governor's success has been the result of good planning and good luck. Interest rates, inflation, and the automobile industry have contributed to the latter.

To the victors belong the spoils, and rightly so. However, one wonders whether any other course of action was available. The Michigan constitution requires a balanced budget; there were only a few crumbs left in the cookie jars and the budget had been cut to the bone in the last years of the Milliken administration. There was little choice but to raise taxes. The contrast with the federal budget process is striking. The president has been able to resist tax increases because the federal government can print money and run large deficits. The deficit for the last five federal budgets (including 1985-86) totals about \$875 billion. The Blanchard administration should be given kudos for setting money aside to put the state's books in order, although the process had begun under Governor Milliken with the earmarking of the 10-cent per pack cigarette tax increase.

In view of the size of the tax increase one might ask if it was too large. The answer largely depends on one's point of view. State spending has certainly not been running wild. Between FY 1982-83 and FY 1986-87, state spending will decline almost 1%, adjusted for inflation.¹ Certainly there could have been greater real reductions in the budget, but given Michigan's economic and fiscal condition when Governor Blanchard took office this likely would have caused long-term damage to Michigan's economic vitality. Also, there are those who feel that the Governor has spent too little on human services.

The Governor and the Legislature are to be commended for their commitment to roll back the income tax rate to 4.6% as promised. However, as we have pointed out before, a rollback before the legislated

¹The GNP deflator for state and local government purchases is used to measure inflation.

date of October 1, 1987, leaves little fiscal flexibility to deal with an economic downturn or the more than \$200 million reductions in federal aid to Michigan expected to result from the Gramm-Rudman Act in FY 1986-87. There will be a balance of about \$400 million in the budget stabilization fund, but this is less than 4% of state expenditures (from state revenue sources.) In our view, a reserve of about 10% of the general and school aid funds would be adequate. We understand the lust for budget and tax reductions, particularly in an election year, but the dangers are quite sobering.

Tempering this concern is our belief that the budget is built on conservative economic assumptions, particularly for FY 1985-86. It is likely that revenues in the current fiscal year will be \$100-150 million higher than estimated by the Department of Management and Budget. However, there will be considerable pressure in this election year to spend these funds on education, a welfare grant update, or additional tax relief — for property taxes or a higher personal income tax exemption. This additional money may be

the oil needed to make the budget work. Certainly a case can be made for more spending for economic development, education, and infrastructure. We prefer, however, to see some of this money used to build up the balance in the budget stabilization fund, as no contribution is recommended (or required by the formula) in the 1986-87 budget.

As for the recommended FY 1986-87 budget itself, little can be said. It is a maintenance budget that provides little for anyone, but also imposes little pain on anyone. It undoubtedly was tough to put together, but would have been much more difficult without the reductions in interest, welfare, and capital outlay. Also, the recipients of State largesse have been well nourished in the last three budgets, and much of the damage caused by the reductions in the last recessionary cycle has been repaired. With the rollback of the income tax rate, federal aid cuts, and a recession quite possible in the next two years, it may be some time before we see any significant increases in state spending.

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