

THE FISCAL 1983 STATE BUDGET SHORTFALL**History of the Budget Problem**

A major portion of Michigan's current budget problem can be attributed to three years of economic recession. Reduced business activity eroded business tax revenues and increased unemployment. Growing unemployment reduced consumer spending, eroding both income and consumption tax revenues. As unemployment climbed, the demands on Michigan's medical and mental health programs, correctional facilities, and welfare support services increased substantially. This chain of events has created a 1982-83 budget shortfall, estimates of which range from \$664 million to \$927.2 million.

Failure to anticipate correctly either the depth or duration of the recession compounded this budget problem by encouraging use of short-term solutions such as deferrals, borrowing and unorthodox accounting procedures to maintain state services without seeking a tax increase. When the true nature of the problem became painfully obvious in the spring of 1982, conflicting deficit estimates and profound opposition to new taxes prevented the state from resolving the issue. In his 1983 State of the State message Governor Blanchard outlined a \$1.7 billion state fiscal problem.

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 state has insufficient financial resources to manage all these challenges simultaneously. In order to keep the other problems from growing, the state's first priority must be to resolve this year's budget shortfall.

The Executive's Budget Assumptions

The assumptions upon which the revenue and expenditure estimates are based are critical in assessing the 1983 budget shortfall. The administration has assumed the following:

- Michigan will not experience an economic recovery in fiscal 1983. Total state economic activity will increase less than 1% over fiscal 1982.
- Unemployment will average 16.5%, up from 14.6% in fiscal 1982.
- Total U.S. auto sales will increase to 8.0 million units from 7.7 million last fiscal year.
- State tax revenues will fall 1.8% below revenues for 1982.
- High unemployment will cause a steady increase in the use of state entitlement programs. Specifically, AFDC caseloads will rise 3.6% this fiscal year, averaging 240,000 compared to 231,600 in fiscal 1982. General Assistance caseloads are projected to average 135,000 a month throughout the fiscal year, 27,550 cases (25.6%) above the monthly average for 1982.

TABLE 1

Summary of Revised Executive Estimate of the
1982-83 General Fund Budget (in millions of dollars)

<u>Anticipated Supplemental Expenditures</u>		<u>Revenue Estimate Shortfall</u>	
School Aid Formula	\$ 45.5	Income Tax	\$292.7
School Aid sales tax shortfall	81.7	Sales Tax	28.0
Medicaid	102.0	Use Tax	18.0
Aid to Families with Dependent Children	37.0	Single Business Tax	55.0
General Assistance	78.0	Other Tax Revenue	22.2
Emergency Needs Program	5.0	Non-tax Revenue	<u>82.1</u>
Heating Program	13.0		
AFDC Foster Care	13.0		
Other State Programs	<u>54.0</u>		
Subtotal	\$429.2	Subtotal	\$498.0
Total (column 1 plus column 2)	<u>\$927.2</u>		

SOURCE: Department of Management and Budget.

As additional economic data become available, it is our opinion that the economy stopped contracting in late November and has commenced the long road to recovery. Declining interest rates have increased consumer confidence and helped stimulate activity in housing, auto sales and retail sales. Inflation is down, real personal income up. The stock market has made huge advances since July. Finally, the index of leading economic indicators rose 1.5% in December, the eighth consecutive increase in the past nine months. December's increase was the largest since September 1980 when the economy was last recovering from recession.

A few economists expect a much stronger recovery than that outlined in consensus forecasts. The true trend of the economy should become more certain by spring. Recent economic developments have buoyed our optimism and led us to believe that a more vigorous recovery is likely.

Because Michigan's economy is so heavily dependent upon the automotive industry, gains in auto sales are particularly beneficial for Michigan. Total auto sales showed year-to-year increases of 2% in October, 21% in December, and 11% in January. Auto production is 46% above production for the same period in 1982. The industry believes the sales improvement is permanent and is recalling workers. If the sales increase were viewed as temporary, the industry would manage the higher production requirements through greater use of overtime hours rather than through additions to its workforce.

This increased auto employment will have only a slight impact upon Michigan because most of the recalls are slated for other states. Conversely, if the anticipated increase in auto sales fails to materialize, Michigan auto workers will also be relatively insulated from additional work force reductions. This suggests that Michigan's unemployment rate is stabilizing and should start to show a sustained decline over the next few months.

As noted in our January 17, 1983 forecast, unemployment rates in Michigan and the United States will remain relatively high for all of 1983, averaging 10.3% for the nation and 15.2% for Michigan. A slowly expanding economy will only gradually improve employment opportunities, keeping the unemployment rate high. As job prospects improve, the people who were too discouraged to seek employment during the recession will again resume their job search, also helping to maintain the unemployment rate. The decline in unemployment, from a revised seasonally adjusted 17.1% in December to 15.5% in January in Michigan and from 10.4% to 10.2% for the nation, was good news and could indicate a more vigorous recovery than generally anticipated. Most of the improvement in Michigan was attributable to the mild weather and to gains in the automotive sector.

TABLE 2

Comparison of Gross Tax Receipts in Millions (Preliminary)

	October-January Fiscal 1982	October-January Fiscal 1983	Percent Increase (Decrease)
Gross Sales Tax	\$ 545.4	\$ 528.9	(-3.0)
Auto Sales Tax	58.3	66.5	14.1
Gross Use Tax	84.2	87.4	3.8 ^b
Income Tax	938.0	1,004.2	7.1 ^b
Single Business Tax	278.8	303.1	8.7
Cigarette Tax ^a	46.2	45.6	(-1.3)
Other Taxes	431.8	461.9	7.0
TOTAL	\$2,382.7	\$2,497.6	4.8

SOURCE: Department of Treasury, January 31, 1983.

^aExcludes the 10¢ per pack tax dedicated to the Cash Restoration Account.

^bThese figures are not strictly comparable as the October 1982 figure includes the 5.6% income tax rate on September salaries and wages. The adjusted year-to-date percentage increase is 3.7.

PSC Budget Assumptions

A high unemployment economy will net the state approximately \$400 million less in revenues than the statutory estimate contained in the budget. Concurrent increases in expenditures for school aid and human service programs will cost the state roughly \$290 million, creating a fiscal 1983 budget shortfall of \$745 million. Total resolution of the state's budget crisis will require an additional \$676 million to eliminate the accrued debt, \$600 million for a cash reserve account, and \$200 million for economic redevelopment. The sum of these short and long term elements is therefore \$2.221 billion. To provide these funds, state lawmakers and leaders of the executive branch must agree on an agenda of program cuts, new revenue for fiscal 1982-83, and additional revenues for another two or three fiscal years.

Encouraging news on the economy is beginning to translate into increased tax revenue. Preliminary information on tax collections for the first four months of

fiscal 1983 show a modest 4.8% increase over tax collections for 1982 (Table 2). The largest year-to-year gains came from sales tax collections on new motor vehicles. Despite Michigan's record high unemployment rate, gross income tax collections are running approximately 3.7% above 1982 collections.

The expenditure portion of the state budget has deteriorated. Welfare caseloads have risen this year rather than remained constant or fallen. Monthly AFDC caseloads for October through December averaged 231,607, virtually unchanged from the average monthly caseload of 231,643 during fiscal 1982. If previous trends hold, AFDC caseloads will rise through April, decline from May through August, and increase again in September. Although PSC anticipates that monthly AFDC caseloads will average just over 234,000 for all of fiscal 1983, preliminary January DSS statistics indicate the caseload is highly volatile. A large number of people are exhausting their unemployment benefits. If these people obtain welfare assistance, total AFDC and GA caseloads could increase dramatically. This could raise expenditure requirements by as much as \$75 million.

The General Assistance (GA) caseload has increased by about 4,100 each month this year and will probably continue to rise during the next 3 to 4 months. As GA shows a seasonal trend much like that for AFDC, the caseload should start to decline in late April or May and continue to decline during the summer months. We project the monthly caseload will average 118,000 this year, up from 107,500 last year.

Table 3

PSC Summary of Anticipated Budget Adjustments
for Fiscal 1982-83 (in millions)

Supplemental Appropriations

School Aid Formula	\$ 46
School Aid Sales Tax Shortfall	65
Medicaid	100
AFDC	17
GA	32
Other Programs	85
Subtotal	<u>\$345</u>
Revenue Shortfall	<u>\$400</u>
 TOTAL	 \$745

This \$745 million projection assumes the Michigan economy neither expands nor contracts for the remainder of the fiscal year. A recovering economy would improve the revenue receipts but have relatively minor effect on state expenditures. The total deficit would decline to \$695 million if economic activity starts to increase in April as anticipated.

Once this year's budget problem is resolved, the state must focus its attention on other budgetary requirements. Funds are required for liquidating the state debt and establishing a cash reserve account to eliminate the need for borrowing in anticipation of tax receipts. The recession and associated spending reductions of the past three years have exacted a heavy toll on schools, colleges and universities, and local governmental units. Additional funding is required to reverse this decay, to attract new businesses, and to provide for new jobs. None of these goals will be achieved quickly, but a billion-dollar-per-year solvency and recovery tax program would provide significant progress toward ultimate resolution of the state's budgetary and economic worries.