FISCAL AWARENESS SERVICE

SPECIAL REPORT
April 2, 1984
Volume 3, Number 4

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Special Advisory

Revenue Policy: A Return to Jeopardy?

Senate Bill 660 would accelerate the rollback of the income tax increase, and was approved by the Michigan Senate on March 27, 1984. If approved by the full legislature, this rollback would reduce state revenues by $897 million over the next three fiscal years. This would set the stage once more for executive order reductions, program cuts, and fiscal instability. It could undermine the credit of the State of Michigan, exacerbate political problems, and make the political uproar resulting from approval of the 1983 income tax increase seem miniscule by comparison.

Michigan's individual income tax rate was increased from 4.6% to 6.35% on March 29, 1983. Since the tax was made retroactive to January 1, 1983, it was necessary to implement a higher withholding rate (6.92%) so that the average rate during 1983 was the stipulated 6.35%. A special state accounting and fiscal responsibility account (SAFRA) was established to bring the State of Michigan back into conformity with generally accepted accounting principles. Revenue from 0.25 percentage points of the tax increase is earmarked for this account and amounts to about $16.3 million per month.

Passage of the income tax increase enabled the state to take substantial steps toward fiscal solvency. Higher revenue, combined with spending restraint, signaled to the national credit markets that Michigan was serious about confronting and resolving its financial problems. Satisfaction with Michigan's fiscal progress resulted in an improved credit rating, thus reducing interest charges on new and outstanding debt. In fiscal year 1983 Michigan effected two accounting changes at a cost of $48.8 million. The two programs affected were the home heating assistance program and the medical assistance program for general assistance recipients. Remaining accounts still requiring such action are Michigan's Medicaid account and the income tax refund account. The cost to the state of restoring these accounts to accepted standards is estimated at $892.4 million and will be completed no later than fiscal year 1986. Thus, while Michigan has made significant progress in regaining its financial health and reputation, much remains to be done yet.

Tax increases are never popular. When economic conditions are poor, opponents argue that the economy cannot afford a heavier tax burden. When economic conditions are good, opponents argue that an increase is not necessary because tax revenues will rise automatically. Since December 1983 political events have favored an accelerated rollback of the tax increase and ultimately resulted on March 27, 1984, in Senate passage of Senate Bill 660. Various government agencies have estimated revenue loss from reducing the rate to 5.35% on July 1, 1984, at $120 to $130 million for fiscal year 1984. Under Senate Bill 660, rolling back the rate to 4.6% on July 1, 1985, would, by government agency estimates, produce a total revenue loss of $220 to $250 million for the next fiscal year.

Historically, there has been a seasonal improvement in income tax receipts starting in late spring. Improvement is due to the higher levels of employment usually realized during the warmer months. If the tax rate is reduced during the early summer, the state will be deprived of the extra revenue from the higher rate and of the extra revenue provided by higher employment levels. The table shows our projection of revenue loss if Senate Bill 660 becomes law.

The total impact of a July 1, 1984 rollback to a 5.35% rate would be approximately $120 million in fiscal year 1984. Existing law would not reduce the rate to 5.35% until January 1, 1985. This first early rollback, combined with elimination of SAFRA and a further rate reduction to 4.6% on July 1, 1985, would produce a total revenue loss of roughly $267 million in the 1985 fiscal year and $510 million in the 1986 fiscal year. These estimates of revenue loss are based upon seasonal fluctuations in employment levels. If hiring patterns are stronger than usual during particular months of the year, income tax revenues should be correspondingly stronger. Conversely, if hiring patterns are weaker than normal, the yield per percentage point of the income tax will decline, causing an even larger revenue loss than shown in this table.

One of the disturbing features of the present economic expansion has been its remarkably weak impact on reducing unemployment levels. In 1981, employers were confident that the economy was recovering and hired back many of their laid-off employees in anticipation of the greater volume of business activity that recovery would bring. When the recovery fizzled, the drain that additional salaries and wages made on these employers compounded their financial problems and made the 1981-82 recession even more difficult. Now that the economy is expanding again, employers are understandably wary of repeating their 1981 mistake and have been reluctant to rehire until business has shown a sustained increase. For this reason, employment and income tax receipts have not shown as much improvement as would historically be expected.

As the economy has improved, employers have been slow to increase employment. Our projections show that unusually low employment gains have deprived the state of approximately $100 million in income tax revenue this fiscal year, a situation only partially compensated for by the higher income tax rate. If this employment pattern continues to hold for the remainder of the calendar year, Michigan could experience considerable fiscal problems even without a rollback of the income tax increase.

Impact of July 1, 1984 Rollback to 5.35% and July 1, 1985 Rollback to 4.6%

Fiscal Year	Loss To General Fund	Loss to SAFRA	Total Loss Per Fiscal Year
1984	$120 million	-0-	$120 million
1985	$215 million	$ 52 million	$267 million
1986	$390 million	$120 million	$510 million

SOURCE: Public Sector Consultants, Inc.

Conclusion

Considerable progress has been made toward restoring Michigan's fiscal health, but other tasks remain to be accomplished before the state can boast of full recovery from its recent problems. Until these tasks are accomplished, any lessening of fiscal discipline is ill-advised. A revenue reduction which is not matched by a corresponding reduction in state spending is guaranteed to destroy the tenuous achievements of the past fiscal year.