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THE 1981-82 STATE BUDGET

In September 1981 we estimated the 1981-82 state budget would be $650 million short of requirements. Due to the continued deterioration of the economy and increased welfare caseloads, in February we revised our estimate of the 1981-82 fiscal year revenue shortfall to $854 million. On the basis of our most current projections, we are increasing our estimate of the budget shortfall to $950 million.

As of April 1982 the state had acknowledged a 1981-82 deficit of $863 million. The state has proposed spending cuts and tax increases to eliminate this deficit. October's executive order reduced state spending by $252 million. The April executive order authorized a $308 million reduction comprised of deferrals, lapses, reduced contributions to the retirement systems, and expenditure reductions. The remaining $303 million is to be covered through income and use tax increases (Table A).

TABLE A. 1981-82 Budget Shortfall (in millions).

	DMB ESTIMATE	FAS ESTIMATE
Projected Deficit, including supplements	$863	$950
Less:		
October Executive Order	252	252
April Executive Order	308	308
1.0% Increase in Income Tax	295	245
Use Tax on Amusements	15	15
PROJECTED BALANCE ON 9-30-82	$ 7	($130)

Senate Bill 190 proposes a 6-month one percentage point increase in the income tax, raising it to 5.6%. Officials anticipate this will increase income tax revenues by $295 million. Proponents expect to generate an additional $15 million this year by including in the use tax base amusements such as video games, cable television services, and tickets for movies, concerts, and sporting events. The cigarette tax has also been increased from 11¢ to 21¢ per pack with the additional revenue dedicated toward reduction of the state's anticipated $1.2 billion cash deficit.

We do not concur in these yield estimates. Utilizing the Indiana experience as a model, we anticipate net revenue from the cigarette tax increase to be $18.3 million, 48% below state estimates. We project annual net revenue per one percentage point increase in the income tax at $490 million, thus yielding $245 million over the next 6 months, $50 million less than official estimates. The use tax on amusements is estimated by the state at $15 million in FY 1982 and $40 million annually thereafter. The reliability of these estimates, fashioned in the fray of battle, is open to question.

High interest rates, increasing unemployment, declining tax receipts, and poor economic performance have reduced state income by $87 million. This shortfall, in combination with overestimates of new revenue, lead us to believe the 1981-82 budget will be $130 million short of requirements. A brief discussion of the factors pertinent to this assessment follows.

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Unemployment

The unemployment rate has continued to climb, indicating the nation's economy is still bottoming out. March's nationwide unemployment rate rose to 9%, up from February's rate of 8.8% and January's rate of 8.5%. The 9% rate matched the post World War II unemployment record of May 1975. While jobs will increase during the summer, their number and rate of increase will be less than in previous years because fewer than normal warm weather jobs will be available. We believe unemployment will continue to rise during the next two months to just under 10% nationwide. This contrasts with Management and Budget's projected unemployment rate of 8.0% to 8.5% for the remainder of this year.

Michigan's difficulties lead the nation; our March unemployment rate exceeded the national rate, increasing to 17% from 16.1% in February. Michigan's unemployment rate could increase to 18% or more before it begins to decline. Plant closings in the automobile industry alone have eliminated 600,000 jobs, approximately 200,000 of them in Michigan. Technological change and foreign competition continue to erode the employment base in this industry.

Layoffs among the automakers total 200,000; suppliers have lost 400,000 jobs. MESC estimates 55% of Michigan's employment is directly tied to the auto industry. As a result, unemployment rates in Michigan will decline slowly even as the projected recovery gains momentum.

Interest Rates

Conflict over the federal budget, uncertainty about the size of the federal deficit, and erratic growth in the nation's money supply have kept interest rates at their current high levels. Interest rates remain too high (16.5% prime) to encourage consumer purchases or rebuilding of business inventories. Recovery in Michigan will not occur until interest rates moderate to below 15%. Interest rates must gradually decline to about 12% in order to sustain a strong recovery. We expect lower interest rates by August or September.

Auto Sales

Auto sales have continued to show marked declines even relative to last year's unusually poor performance. March 1982 sales of domestic and imported automobiles were 22.4% below March 1981 sales. Ward's Automotive Reports anticipates domestic auto sales for the 1982 calendar year will total 5.7 million units compared to 1981 sales of 6.2 million units. State forecasters retain their estimate of 6.8 million units despite mounting evidence to the contrary. Our estimate, which may be unduly optimistic, projects an increase for calendar 1982 of 100,000 units, 300,000 units above the March rate. We expect domestic sales of 6.3 million units, 500,000 units below DMB estimates.

Revenues

The four largest sources of revenue to the state are the sales tax, use tax, personal income tax, and the single business tax. The yields of each of these taxes have declined during the year.

February sales tax collections were 6.6% below February 1981 collections. Auto sales generate a major portion of the sales tax revenues; motor vehicle collections were down 15.5%, and collections from all other sources were down 5.8%. Moreover, prices of goods have remained relatively constant over the last several months, depriving the state of the "inflation tax" on goods and services. Use taxes in February were 2.8% higher than in February 1981, but collections on used cars were down 15.5% for the same period. The single business tax generated $8.95 million less in the first quarter of this fiscal year than in the first quarter of FY 1981.

TABLE B. Income Tax Yield Per 1%, Fiscal Years 1977-82. Based on data from the Office of Revenue and Tax Analysis.

Fiscal Year	Gross	Net to General Fund[1]
1976-77	$427 million	$318 million
1977-78	490 million	372 million
1978-79	556 million	372 million
1979-80	520 million	416 million
1980-81	473 million	443 million
1981-82[2]	485 million	334 million

[1] Net after refunds, contributions to the State Campaign Finance Fund, and disbursements to local governmental units.
[2] Yield at annualized rate through February 1982.

Continuing high unemployment rates erode the yield from personal income tax revenues to the state (Table B). The yield is variable and closely tied to the employment rate. Although the net income tax yield to the state general fund was $443 million last year for each percentage point, this year's yield has averaged $334 million. The state has at no time in its history grossed $590 million per percentage point from the income tax, and only grossed $556 million in FY 1978-79, the most prosperous year in recent history.

Income tax refunds and deductions for the campaign finance fund have already been subtracted from this year's gross income tax receipts, and disbursements to local governments are based on a fixed formula unaffected by increases in the income tax rate. Consequently, for the remaining 6 months of the fiscal year, the net will closely approximate the gross yield. If the economy turns around quickly, income tax yields could range as high as $540 million (a 10% increase over the current $485 million yield) per percentage point. We estimate the yield from the increase will be $245 million, $50 million below government estimates (Table A).

The 10¢ per pack increase (91%), from 11¢ to 21¢ per pack in the cigarette tax is estimated by the state to net $35 million for the remainder of this fiscal year. We believe this expectation is unwarranted. The higher tax will reduce demand and encourage smuggling so that the state will not realize the full 10¢ increase on the current volume of cigarette sales.

No state has ever increased its cigarette tax by 10¢. Connecticut came closest in 1969, increasing its tax from 8¢ to 16¢; it experienced a 20% decline in sales. Based on information from the Tobacco Tax Council, the reduction in cigarette sales due to an increase in the tax does not appear to be directly proportional to the tax; i.e., sales may decline 1% for a 1¢ increase in the tax, but 5.5% for a 3¢ increase. Indiana is the only state contiguous to Michigan to substantially increase its cigarette tax in recent years. In 1977 Indiana raised its cigarette tax 4.5¢, to 10.5¢ per pack (Table C). Based on its experience, we estimate sales will decline 27.3%, generating a far lower revenue increase to the state ($18.7 million over the next 5 months). Moreover, loss of sales tax revenue due to the decline in sales volume will cost the state approximately $375,000, netting $18.3 million instead of $35 million. These dollars are dedicated toward reducing the cash shortfall and will have no impact on the budget deficit.

TABLE C. Cigarette Tax Rate Changes and Effect on Sales, Selected States. Based on data from the Tobacco Tax Council.

State	Current Tax	Previous Tax	% Increase or Decrease in Sales per 1¢ Increase in Tax
Florida	21¢	17¢	+0.80
Massachusetts	21	16	-1.38
Connecticut	21	16	-1.16
Wisconsin	16	14	-2.17
Illinois	12	9	-1.43
Indiana	10.5	6	-2.73
Ohio	15	10	-0.66
New York	15	12	-1.06
Pennsylvania	18	13	-1.32
Minnesota	18	13	-3.11

THE 1982-83 STATE BUDGET

The state is faced with two distinct fiscal challenges: (1) the 1981-82 budget deficit and the constitutional mandate for a balanced budget; and (2) the requirement to enact a 1982-83 budget whose expenditure levels are consonant with projected revenue. Inadequate funding for required road repair, postponed highway construction, and major financial reform of the retirement systems must be dealt with soon. Underfunding and increased drawing of benefits will severely threaten the solvency of the retirement systems in the decade ahead. Minimum unfunded accrued liabilities are currently estimated at $1.3 billion. These issues, not addressed in the proposed 1982-83 budget, will become part of the fiscal agenda this year or next.

State economic forecasters have projected that the current and proposed 1982-83 budgets will enjoy earlier recovery and at a more rapid rate than we project. We believe we are approaching the bottom of this recession. There are tentative and preliminary signs of improved economic activity. That, in tandem with the seasonal improvement in employment and the decelerating growth rate of welfare caseload and our assessment that federal action to reduce interest rates will occur in late summer to give impetus to a slow recovery, leads us to believe revenue collections will be $300 million below that projected by framers of the 1982-83 budget. This $300 million shortfall, in conjunction with $80 million of deferred payments to colleges and universities, our estimate of a minimum 15% reduction in federal aid to the state which will require $135 million of additional program dollars from the state general fund, and a $75 million liability in human service areas due to underestimation of the welfare caseload presents the state with a $590 million problem for the 1982-83 fiscal year.