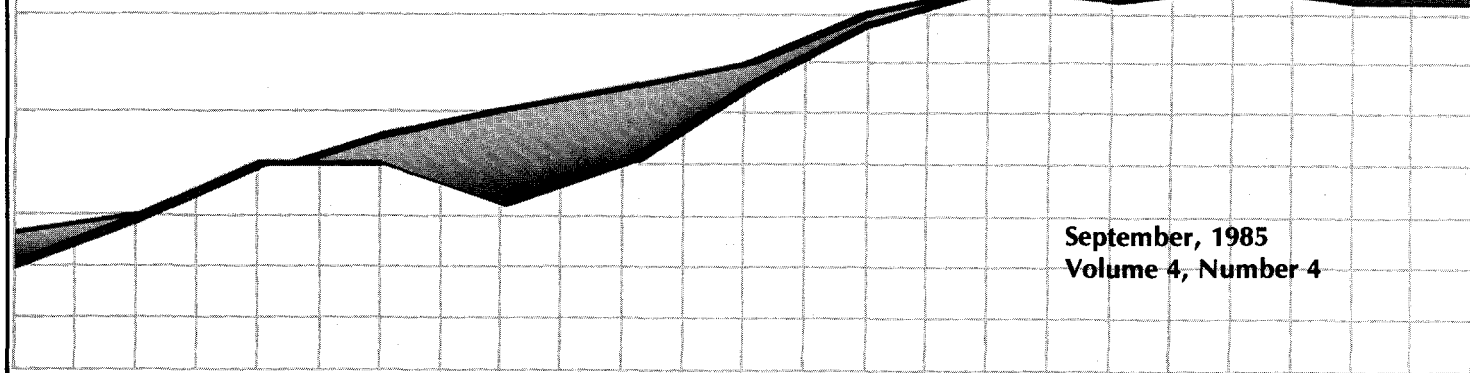


# FISCAL AWARENESS SERVICE

AN INDEPENDENT FISCAL ANALYSIS OF STATE SPENDING



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## Overview of Michigan Budget Appropriations Fiscal Year 1985-86

The fiscal year 1985-86 state budget appropriations approved by the Governor set General Fund-General Purpose (GF-GP) spending at \$5.91 billion, 2.8% more than the Governor's original budget request of \$5.75 billion.<sup>1</sup> The 2.8% essentially reflects additional funding for education, capital outlay, and corrections.

The FY 1985-86 GF-GP budget is approximately 7% greater than estimated spending levels for FY 1984-85.<sup>2</sup> Reductions from 1984-85 levels total \$125.8 million, of which \$110.1 million is a reduction in the Department of Social Services budget due primarily to a decline in caseload levels and an increase in federal matching funds. Thus, the budget contains a net increase in all other areas totaling \$516.7 million. Table 1 indicates the four areas--education, corrections, capital outlay, and economic development--that received most of the FY 1985-86 increase.

The total \$13.9 billion state budget will increase by 9.4% over the authorized 1984-85 level of \$12.7 billion. After adjustment for the estimated rate of

inflation, the purchasing power of the GF-GP budget will increase by 1.5%, while that for the total state budget will increase by 3.7%.

Since fiscal constraints were less evident than in past years, development of the 1985-86 budget went more smoothly. There were, however, the usual personality, partisan, and geographic conflicts over issues such as Detroit vs. outstate, education vs. human services, the income tax rollback, and the state's economic development policy. The end result is a budget that provides a little something for everyone but leaves a lingering sense of disappointment.

### Economic Environment

The strong economic recovery that began in the last half of 1983 has enabled the state to rebuild its fiscal strength and to provide increased funding for many key state programs. The fiscal year 1985-86 budget is based on the assumption that this recovery will continue through the budget period, albeit at a slower pace. Real Gross National Product is

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**TABLE 1**  
**Growth in FY 1985-86 State Budget General Fund-**  
**General Purpose Appropriations**  
**(millions of dollars)**

Budget Area	Dollar Increase	Percent Increase	Percent of Total Increase
Capital Outlay	\$ 59.7	54.6	11.6
Corrections	52.8	16.9	10.2
Economic Development <sup>a</sup>	19.6	15.7	3.8
Education	262.0	17.5	50.7
All Other	122.6	9.2	23.7
<b>Total Increases</b>	<b>\$516.7</b>		
Social Services	(110.1)		
Debt Service	(15.7)		
<b>Net Change</b>	<b>\$390.9</b>		

<sup>a</sup>Includes Commerce, Labor, and \$7.4 million for job training in Management and Budget.

projected to advance about 3.5% in fiscal years 1985 and 1986 compared with a 7% increase in 1984. U.S. auto sales are expected to stabilize at the 1984 sales rate of 10½ to 10½ million units throughout the budget period. In Michigan, employment is expected to increase about 2 to 2.5%, and personal income is expected to increase about 7% in 1986. The major negative for the economic outlook is the large federal budget deficit, which continues to threaten the recovery but has yet to have a significant impact. On the positive side, continued low inflation, stable or falling interest rates, and the weakening U.S. dollar hold the promise of continued economic progress.

Because of the strong economy, the Governor's fiscal recovery plan is slightly ahead of schedule. In the 1980 to 1983 period the cash balances in the state's key funds averaged a negative \$509 million, peaking at minus \$621 million in FY 1982. To eliminate this cash deficit and to bring the state into conformity with generally accepted accounting principles, the state has been accumulating funds from a 10-cent increase in the cigarette tax (May 1982) and a temporary 0.25% surcharge on the income tax (March 1983) in a Working Capital Reserve Account. By

January 1985, Michigan had either repaid or reserved funds to repay \$535 million of the accumulated debt, and the cash balances in the key funds had improved dramatically. The Department of Treasury is estimating a cash balance of \$415 million as of September 30, 1985, and \$519 million as of September 30, 1986.

The only remaining piece of the fiscal recovery plan is the recording of state income tax refunds on an accrual rather than a cash basis. This will entail a one-time accounting adjustment of about \$765 million. Sufficient funds to make this adjustment will be available before January 1, 1986. The 0.25% income tax surcharge will expire, reducing the current 5.35% tax rate to 5.1%, when the state treasurer certifies that sufficient funds are available to meet the accounting adjustments specified in the State Accounting and Fiscal Responsibility Account (SAFRA) Act of 1983. The 10-cent cigarette tax will then be diverted to the state's General Fund.

The completion of the fiscal recovery plan combined with an upgraded credit rating, a reduction of 12,400 classified employees from the peak 1980 level, declining welfare caseloads, and continued

economic growth solidifies the optimism for fiscal stability that has existed in Lansing for the past year.<sup>3</sup>

## Budget and Economic Stabilization Fund

The state's "rainy day" or Budget Stabilization Fund (BSF) was depleted quickly during the fiscal crisis of the early 1980s but is now being replenished. In fiscal year 1984-85, \$338.3 million was transferred from the General Fund to the BSF, and an estimated \$87.5 million will be transferred in FY 1985-86.

This replenishment, however, has been slowed by the use of BSF monies to finance prison construction. The BSF act allows 2.5% of the fund to be appropriated for economic stabilization purposes in periods when the Michigan unemployment rate exceeds 8%. This provision was used, for the first time, to withdraw \$34.2 million in FY 1984-85 and will be used to withdraw an estimated \$45.3 million in FY 1985-86. In something of an unusual move, the Legislature amended the BSF act to allow the withdrawal of an additional \$60 million in FY 1985-86 and \$30 million in FY 1986-87. These funds, as well as the economic stabilization fund withdrawals, will be used to finance prison construction in lieu of bond financing.

The balance of the BSF, including interest earnings, is estimated at \$340 million as of September 30, 1985 and \$425 million as of September 30, 1986.

## Tax Issues

The continuing debate of this session centers on the rollback of the personal income tax rate from 5.1% to 4.6%.<sup>4</sup> Under Public Act 221 of 1984, the rate will drop to 4.6% on October 1, 1987. The Republican-controlled State Senate has passed and sent to the House proposed legislation that would return the rate to 4.6% on January 1, 1986. The Administration has proposed a tax fairness plan that would return the rate to 4.6% on May 15, 1986. This proposal is now before the Senate.

The rollback is a controversial issue because of the differing views as to its impact on the State's fiscal situation. A rollback date of May 15, 1986 would reduce FY 1985-86 revenues an estimated \$150 million. If the rate were rolled back on January 1, 1986, this revenue loss would more than double to about \$325 million. On September 18, the Senate Fiscal Agency projected a surplus of \$343 million for fiscal year 1986, an amount sufficient to allow for an early rollback. The Department of Management and Budget projections imply a year-end surplus of about \$75 million provided there are no tax law changes. This surplus would not even cover the Administration's proposed May 15 rollback. Given the current direction of the Michigan economy and state revenue collections, Public Sector Consultants, Inc. believes the FY 1985-86 surplus could be as high as \$200 million.

## 1985-86 Spending Policy

The General Fund-General Purpose budget is that portion of the total state budget which is not constitutionally or statutorily mandated for use on specifically designated programs. Table 2 details anticipated FY 1984-85 GF-GP expenditures, FY 1985-86 executive budget recommendations, and FY 1985-86 legislative appropriations.

## Local Government

The State of Michigan pays a significant share of the cost of essential services provided by local governments. Article IX, Section 30, of the Michigan Constitution (Headlee Amendment) attempts to provide a dependable flow of funding by requiring that 41.6% of all state spending from state funds be returned to local governments. Michigan has been able to meet this requirement in both fiscal years 1984 and 1985. The FY 1986 budget will not only meet the Section 30 requirement but exceed it by \$174.6 million.

The largest component of the state's financial assistance to local governments,

**TABLE 2**  
**General Fund-General Purpose Budget Summary,**  
**Fiscal Years 1984-85 and 1985-86**  
**(millions of dollars)**

Department or Program	Projected FY 1984-85 Expenditures	FY 1985-86 Executive Recommendation	FY 1985-86 Legislative Appropriation	Increase/Decrease Over FY 1984-85	Percent Change
Social Services	\$2,052.8	\$1,950.3	\$1,942.7	\$ - 110.1	- 5.4
Mental Health	603.0	649.9	656.5	53.5	8.9
Public Health	111.8	123.6	123.0	11.2	10.0
Corrections	312.3	315.3	365.1	52.8	16.9
Education	29.7	38.2	36.6	6.9	23.2
School Aid	440.3	440.1	554.9	114.6	26.0
Community Colleges	159.3	171.2	174.1	14.8	9.3
State Colleges and Universities	846.5	951.4	970.4	123.9	14.6
Library of Michigan	18.0	18.8	19.8	1.8	10.0
Executive Office	3.0	3.5	3.5	0.5	16.7
Legislature	56.5	60.2	63.5	7.0	12.4
Judiciary	70.8	78.9	79.9	9.1	12.8
Attorney General	18.0	20.2	20.5	2.5	13.9
State Management and Budget	9.8	15.5	15.9	6.1	62.2 <sup>a</sup>
Treasury	98.3	121.3	123.7	25.4	25.8 <sup>b</sup>
Civil Rights	55.7	59.1	58.5	2.8	5.0
Civil Service	9.6	9.8	9.9	0.3	3.1
Commerce	8.4	10.4	10.4	2.0	23.8 <sup>c</sup>
Labor	78.8	82.0	88.4	9.6	12.2
Licensing and Regulation	45.4	31.5	47.9	2.5	5.5
State Police	13.8	15.3	15.3	1.5	10.9
Military Affairs	145.4	149.0	148.8	3.4	2.3
Agriculture	10.6	11.3	11.6	1.0	9.4
Natural Resources	24.0	25.8	26.0	2.0	8.3
Transportation <sup>d</sup>	102.2	110.8	104.1 <sup>e</sup>	1.9	1.9
Capital Outlay	0.0	0.0	0.0	0.0	0.0
Debt Service	109.3	107.5	169.0	59.7	54.6
Section 30	89.0	80.2	73.3	-15.7	-17.6
Budget Stabilization Fund	0.0	0.0	0.0	0.0	0.0
Transfer	<u>338.3</u>	<u>176.0</u>	<u>87.5</u>		
<b>TOTAL GF-GP</b>	<b>\$5,860.6</b>	<b>\$5,827.1</b>	<b>\$6,000.8</b>	<b>\$ 391.0</b>	

<sup>a</sup>The FY 1985-86 legislative appropriation increase over FY 1984-85 includes additional funding for implementation of the Emissions Inspection and Maintenance Program in southeastern Michigan.

<sup>b</sup>The FY 1985-86 legislative appropriation increase over FY 1984-85 includes additional funding for further development and maintenance of lottery game operations including Lotto, an increase for grant funding in support of the Office for Job Training — Michigan Skills Partnership programs, and an increase in State Building Authority rent.

<sup>c</sup>The FY 1985-86 legislative appropriation increase includes additional funding for workload increases caused by a leveling of the state workforce and reopening exams to nonemployee candidates.

<sup>d</sup>The Department of Transportation relies on transportation taxes and federal funds for its budget and hence receives no General Fund appropriations.

<sup>e</sup>Expected restoration of vetoed items will increase this number to \$110.4.

other than school aid, is state revenue sharing. The revenue sharing program allows local governments flexibility to meet varying local needs. State revenue sharing in fiscal year 1986 will increase 7.2% to \$812.9 million.

The Michigan equity program provides funding to the City of Detroit and out-state cities for cultural activities and a new resource recovery program linked to economic development and energy conservation. A total of \$44.2 million has been appropriated for this program in FY 1986. Of the total appropriation, \$34.1 million is earmarked for the City of Detroit, \$6 million to outstate cities, and \$4 million for resource recovery.

## Education

Total support for all levels of education in FY 1985-86 will be \$3.57 billion, an increase of 12.2%. This large increase will help relieve pressure on local property tax levies.

After receiving assurances that all 15 Michigan four-year public colleges and universities would freeze tuition next fiscal year, the Governor approved a higher education budget totaling \$970.4 million, an increase of 14.6%. Of this amount, \$76.8 million is allocated for student financial assistance, a 39% increase over the current year. Controversy surrounded the establishment of a \$25 million Research Excellence Fund designed to encourage research in areas related to economic development. The Governor supported language that would have enabled the state to review research proposals and closely monitor use of the funds. Looser language was adopted, however, which gave the state less control over the funds. After indicating he might veto the entire appropriation, the Governor finally approved the funding when he was assured by the universities that they would target research programs to meet specific economic development goals.

Michigan's 29 community and junior colleges also received funding increases ranging from 7% to 12.1%. To emphasize

government's increasing reliance on two-year institutions' role in adult job training, an additional \$270,000 was appropriated to the Job Training and Retraining Investment Fund. The Governor line-item vetoed \$1.45 million for repair and deferred maintenance based on the view that such funding should be dispensed through the colleges' operational funding formula.

Total school aid funding was increased 11.6%, which will mean an increase of about 12.7% per pupil. The GF-GP share increased 26%. Categorical grant programs, such as special education and student transportation programs, received significant increases, and a new professional development program to enable teachers to upgrade and update their skills was funded at \$1.8 million. In addition, the School Employees' Retirement Fund was increased \$45.7 million over the current year.

## Human Services

The Department of Social Services (DSS) budget, which accounts for 32% of state GF-GP spending, was reduced by \$110 million as a result of the continuing decline in caseload levels and an increase in federal matching funds.<sup>5</sup> The higher education budget was held up until agreement was reached that welfare recipients would receive a 4.5% increase in grants, their first since 1979. Medicaid providers will receive a 5% increase in reimbursement.

The Administration's goals of increasing cost-efficiency in the administration of social services programs and self-sufficiency for welfare recipients are reflected in the DSS budget. Funding will continue for a program of computer matches of welfare recipients with specific state agencies and financial institutions, a program of enforcing child support payments, a job placement and training program for welfare recipients, and a program providing subsidized employment for recipients who forego public assistance (Project Self-Reliance). For

the third time, the Governor vetoed a line item that would have banned Medicaid funding for abortions.

GF-GP funding for mental health totaled \$656.5 million, an increase of 9%. Emphasis continues to be placed on strengthening community mental health programs and improving conditions in state institutions. Community mental health services will receive \$616.1 million; Northville Regional Psychiatric Hospital, \$11.1 million; and the Family Support Subsidy Program, which assists families in caring for autistic or developmentally disabled children in their homes, \$6.7 million.

Spending for public health programs will increase by 10%, with \$3.3 million directed at health promotion programs; \$2.7 million for special initiatives to reduce infant mortality; and \$26.2 million for substance abuse programs. The total GF-GP appropriation for the department is \$123 million.

## Economic Development

The increased investment in Michigan's education system discussed earlier will enhance Michigan's ability to compete for new businesses. Other economic development initiatives in next year's budget will provide funds to assist business, encourage job training, and promote Michigan products.

To assist businesses, the Department of Commerce budget included \$1.3 million to establish the Michigan Industrial Technology Deployment Services (MITDS) and the Office of New Enterprise Services (ONES). The MITDS will assist smaller manufacturing firms in meeting their computer-based needs and ONES will encourage the growth of technology-intensive new enterprise. The Community Growth Alliance program, which encourages greater coordination of local economic development efforts and the expansion of local assistance provided to small businesses, will be expanded by \$750,000, bringing its total funding to \$2.1 million next year. A cooperative technology transfer network

involving businesses, higher education institutions, and state economic development programs will receive a \$450,000 increase. The network provides access to expertise and assistance to businesses interested in modernizing, expanding, or using new technologies.

The general government budget contained \$7.4 million for a new job training program called Michigan Skills Partnership. It will offer retraining scholarships to dislocated workers and skills upgrading grants to employers who must retrain their workers in new technologies. The Michigan Youth Corps, which provides summer jobs for young people, received \$15 million through the Department of Labor.

Forest product development, part of the state's target industry program, received additional funding of \$1.3 million. One of the more innovative programs in the Department of Agriculture's budget is the development of a model dairy farm in Sichuan Province in China.

## Law Enforcement

State spending for corrections will increase by \$52.8 million to \$365.1 million. The corrections budget includes \$31.9 million in state operating funds for prison expansion and \$12 million for a training program for new corrections officers. As mentioned earlier, money to finance prison construction also will come from the Budget Stabilization Fund.

The Department of State Police was appropriated \$148.8 million, \$2.3 million of which will be used to hire and train 100 new officers, bringing the total number of uniformed troopers to 1,216 by the end of FY 1985-86. Also included were increases of \$900,000 for the State Police Crime Lab, \$1 million for the development of an automated fingerprint identification system, and \$665,000 for six-months funding of 21 positions to expand law enforcement efforts against auto theft, narcotics trafficking, wanted felons, and major crimes in metropolitan Detroit.

## Environment

A major new initiative in the Department of Natural Resources budget is the establishment of a \$10 million Clean Michigan Fund to promote alternatives to land disposal of solid wastes, begin closing unsafe landfills, provide temporary alternatives to disposal, and establish pilot projects in recycling and composting. State funds of \$8.1 million will be used for toxic waste cleanup at the nine most contaminated and dangerous sites in Michigan. This appropriation will earn the maximum federal superfund support of \$36.4 million, bringing the total funds for cleanup to \$44.5 million. Environmental protection programs were allocated \$50.8 million, an overall increase of 39%. The Department of Agriculture budget included \$2 million to continue cleanup of PCB-contaminated farm silos. The Governor vetoed three line items in the DNR budget, claiming they reflected unnecessary expenditures. One item was a \$13.5 million appropriation for state park operations, all but \$600,000 of which is expected to be returned in supplemental appropriations.

## General Government and Other

The remaining areas of the budget account for less than 12% of total GF-GP spending and generally comprise the housekeeping and support functions of government, such as budgeting, accounting, tax collection, building maintenance, debt service, and capital outlay, as well as monies for the judicial and legislative branches of government.

When budgets are tight, the area that generally suffers the most is capital outlay, and this has certainly been the case in Michigan since 1979. From fiscal year 1973-74 to fiscal year 1977-78, capital outlay expenditures averaged 2.4% of total GF-GP expenditures. During the fiscal year 1978-79 to fiscal year 1983-84 period, capital outlay expenditures fell to only 1.2% of total GF-GP expenditures. However, this trend has been reversed in the last two enacted budgets. Capital

outlay expenditures for fiscal year 1984-85 are estimated at \$109.3 million, an 88.8% increase over the previous year. As of this writing, the capital outlay budget for fiscal year 1985-86 has not received final approval, but the agreed upon target is \$169 million, almost triple the FY 1983-84 level. This represents 2.9% of the GF-GP budget, the highest level since FY 1974-75.

Fifty percent of the capital outlay budget, or \$84.5 million, is allocated for prison construction. An additional \$105.3 million is to be appropriated from the BSF. Other major areas of expenditure are \$16 million for maintenance and improvement of state facilities, \$22 million for maintenance and improvement of university facilities, \$25 million for new construction projects at universities, and \$5.9 million for maintenance and new construction at community colleges. The capital outlay bill includes new language that requires the Department of Management and Budget to develop a building renewal model for allocation of lump-sum special maintenance and lump-sum remodeling and additions appropriations for state agencies, universities, and community colleges. The formula must be approved by the Joint Capital Outlay Committee before funds can be distributed.

The interest on the general obligation borrowing of the State is expected to be \$11 million lower in fiscal year 1985-86 than in the previous year. This reflects lower market interest rates and the state's improved fiscal condition.

## Comment

The fiscal year 1985-86 budget can be viewed as a restoration budget. After several years of fiscal austerity, it provides funds for critical state programs that have been underfunded in recent years. We are particularly pleased to see increased funding for education, economic development, and capital outlay, as these areas are important to Michigan's economic future. We also applaud the long overdue funding for prison construction and

increased support for welfare recipients, whose benefits have been seriously eroded by inflation in recent years; from 1978 to 1984 the average AFDC payment declined by 28.3%, adjusted for inflation.

However, we disagree with the decision to raid the BSF to finance prison construction. If one lesson is to be learned from the recent fiscal crisis, it is that Michigan, with its highly cyclical economy, must maintain a large budget reserve. In our view a reserve of about 10% of the General and School Aid Funds would be adequate. This would amount to an estimated \$780 million in FY 1985-86. The balance in the BSF is expected to be only \$425 million by the end of FY 1985-86. (At the height of the fiscal crisis the potential budget shortfall approached \$1 billion.) We are also concerned that this action could set a precedent for future raids on the fund for so-called critical budget needs. The creation of the BSF in 1977 was an innovative and wise action, and the fund should not become a cookie jar for pet spending programs. Funds for prison construction are a top priority, and rightly so, but these funds should be taken from the projected surplus or raised through bond financing.

We do not understand the aversion to bond financing. First, the proposed projects will benefit future as well as present generations, and the costs should not be fully borne by current taxpayers. Second, the cost of borrowing these funds will likely be less than the return that could be earned by investing the money. Third, we believe the current period of relative economic prosperity and fiscal stability is the time to develop bonding programs for needed projects such as prison construction, waste management, and rebuilding infrastructure. Winning voter approval for general obligation bonding would also be much easier now than during a period of economic decline.

A closely related issue is the question of the rollback of the personal income tax rate from 5.1% to 4.6%. Under current legislation the rate will drop to

4.6% on October 1, 1987. The Administration has proposed a May 15, 1986 rollback, and the State Senate has passed legislation that would advance the rollback to January 1, 1986. An early rollback would use all or most of the projected surplus, depending on the rollback date, and sharply reduce the resources available for the FY 1986-87 budget. The Governor's fiscal recovery plan will be completed in fiscal year 1985-86, but many state and local programs have not fully recovered from the cutbacks of the early 1980s. We strongly oppose the early rollback of the income tax rate. However, if the rollback is to occur, we advise that its implementation be phased in over the next two fiscal years to build the greatest possible reserve in the BSF and allow a more rational budget planning process.

We commend the Administration on its fiscal recovery programs and are supportive of many of its budget initiatives. Governor Blanchard's and the Legislature's support of the large income tax increase in March 1983 was an act of political courage. As a result, the state's fiscal condition is better than at any time in the last decade. Now is the time to move forward not backward. The state's elected officials have a responsibility to the people they represent to ensure that adequate reserves are available to withstand another serious recession without resorting to tax increases or draconian budget cuts. Shortsighted political expediency can only lead us down the road to financial ruin. With responsible leadership and careful planning, the painful experiences of the last few years will never have to be relived.

## NOTES

<sup>1</sup>Adjusted to reflect change in the Governor's recommendation for transfer of cigarette tax revenue (\$98 million) from SAFRA to School Aid Fund. The Legislature allocated these monies to the General Fund.

<sup>2</sup>Excludes Budget Stabilization Fund transfer.

<sup>3</sup>Michigan recently received the top credit rating from Moody's Investor Service and Standard and Poor's on its \$350 million note sale, the first time since 1978 that the rating has been given to Michigan without insurance from a commercial institution.

<sup>4</sup>The current rate is 5.35%, but .25% is allocated to SAFRA and will expire later this year.

<sup>5</sup>The increase in federal matching funds is due to a decline in Michigan per capita personal income relative to national per capita income.