FISCAL AWARENESS SERVICE

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NATIONAL OVERVIEW, FISCAL YEAR 1983

The 27-month national recession which ended in November 1982 seriously impaired the budget-balancing efforts of all 50 states. Declining business activity and employment levels reduced tax revenues while simultaneously increasing the demand for public assistance programs. As a result, states faced greater human service needs at a time when their ability merely to maintain existing service levels was rapidly deteriorating.

In an effort to provide funding to meet the most urgent demands with their dwindling resources, most states reordered their original 1983 spending priorities; 27 states implemented general program cuts and 37 states implemented selective cuts. Fifteen states delayed expenditures, 19 attempted to improve their cash flow position by accelerating their due dates for major taxes, 6 shifted capital outlay financing from the general fund to bond issues, 27 proposed or enacted permanent tax increases, and 24 initiated temporary tax increases. In addition, 22 states laid off personnel, 42 mandated hiring freezes, 9 imposed unpaid leave days for government employees, and 32 restricted either in-state or out-of-state travel, or both. Despite these measures, the 1983 combined budget balances for the 50 states totalled only $291 million, down from $4.5 billion in fiscal year 1982. Texas showed a fiscal year 1983 ending balance of $630 million; if it had been excluded, the remaining 49 states would have shown an aggregate deficit of $339 million.

MICHIGAN'S EXPERIENCE

Even though federal record keepers agreed that the last national recession extended from July 1980 to November 1982, Michigan's recession lasted considerably longer. Michigan had not yet recovered from the 1979-80 recession when the national economy took another nosedive in July 1980. Most of this difference in economic resiliency can be traced to Michigan's dependence on credit-sensitive, highly cyclical heavy manufacturing industries whose market shares have been eroded by a strong dollar and by import competition.

Partly because of this extraordinarily long period of recession, Michigan was forced to resort to austerity measures well in advance of many other states. In fiscal year 1983 Michigan state government was able to use only four of the austerity measures listed above -- employee layoffs, a hiring freeze, selected reductions in general fund outlays ("executive order reductions"), and an income tax increase. Most of the other measures had been adopted in previous fiscal years and remained in effect. Table 1 provides a chronological listing of the principal actions taken between fiscal years 1975 and 1983 to produce a budget which at least appeared balanced.

Michigan's constitution requires that the state budget be kept in balance throughout the October 1 to September 30 fiscal year. Each of the preceding actions was taken in order to meet that requirement. However, despite creation and use of a countercyclical "rainy day" fund in the state budget, Michigan's faltering economy made compliance, first with the intent of the law and later with the letter of the law, increasingly difficult. By fiscal year 1980, revenue from the major state taxes was automatically accrued to the previous fiscal year but liabilities funded by these revenues were not. One consequence of this practice was a chronic insufficiency of cash on hand to pay outstanding bills.

Short-Term Borrowings

The timing of school aid payments intensified the state's cash shortfall problems. Even though school aid payments are made every other month throughout the fiscal year, the largest payment (20% of the year's total) is made on the first day of the state's fiscal year. This is approximately three weeks before the treasury receives any significant amounts of tax revenue with which to make school aid payments. In order to provide these payments on a timely basis, the state borrows funds in anticipation of tax receipts.

As Michigan's economy deteriorated and tax revenues declined below projected levels, the state's dependency on short-term borrowings extended for longer and longer periods of time. By 1979, short-term borrowings were relied upon to finance continuing operations rather than just to bridge the gap in timing between the dates expenditures were made and supporting tax revenues were received. Table 2 shows the amount of short-term borrowing and the number of days it was outstanding in each of the state

Table 1. History of Budget Balancing Measures, Fiscal Years 1975-1983

Fiscal Year	Principal Actions
1975	Increased income tax rate to 4.6% from 3.9% to compensate for repeal of sales tax on food and prescription drugs Issued two executive order reductions totaling $109.5 million Accrued sales, use, and personal income tax receipts to gain $190 million for the general fund Used $51 million of unencumbered capital outlay revenues to balance general fund budget
1976	Issued executive order reduction of $123.7 million Borrowed $200 million in short-term notes Extended fiscal year by three months to gain $207 million Adopted SBT and realized one-time cash flow increase of $240 million Accrued utility property tax collections to gain $60 million Lapsed $55.3 million from DSS budget Used $34.6 million in contingency fund reserves from the public school employees' retirement system fund
1977	No major fiscal actions or borrowings
1978	Borrowed $200 million in short-term notes
1979	Borrowed $450 million in short-term notes
1980	Issued executive order and mandated lapses totaling $158.4 million Borrowed $26 million from Kammer Recreational Land Acquisition Fund Withdrew $263.6 million from Budget Stabilization Fund Accrued SBT revenues to gain $159 million Accrued Insurance Premium Tax payments of $31 million Borrowed $500 million in short-term notes

fiscal years from 1975 to 1983; Table 3 details year-end and month-end cash balances for the same period.

Other processes were occurring simultaneously. The balance in the Budget Stabilization Fund (BSF), popularly known as the "rainy day" fund, had been drawn down in 1980 and in 1981 and was virtually depleted by the start of fiscal year 1982. Special purpose funds were then tapped to finance general fund expenditures; unencumbered capital outlay revenues were captured to finance ongoing operations; and state contributions to state employees' and public school employees' retirement systems were reduced by inflating the present value of system reserves.

Section 30 Requirements

One additional factor complicated state efforts to balance outlays with revenues. The 1978 tax limitation amendment to the Michigan constitution (commonly known as the "Headlee Amendment" after its sponsor) required 41.6% of total state spending to be

Fiscal Year	Principal Actions
1981	Issued executive order and mandated lapses totaling $148.7 million Borrowed $46.2 million from Kammer Recreational Land Acquisition Fund Withdrew $16.9 million from Budget Stabilization Fund Used $46.7 million from unencumbered capital outlays for other general fund purposes Transferred $20.1 million from Railroad Delinquent Tax Fund to general fund Shifted Medicaid outlays to a cash accounting basis to gain $87.4 million Borrowed $500 million in short-term notes
1982	Issued four executive orders totaling $778 million Accrued oil and gas severance tax collections of $6.9 million Accrued beer and wine tax collections of $2.4 million Increased income tax rate to 5.6% for six months to gain $286 million Retained Medicaid/GA Medical accounting on a cash basis to save $120 million Used $13.4 million in unencumbered capital outlay revenues for other general fund purposes Borrowed $500 million in short-term notes Increased cigarette tax by 10¢ per pack and dedicated revenue to a new Working Capital Reserve Account
1983	Issued executive order reduction of $225 million Borrowed $500 million in short-term notes Increased personal income tax rate from 4.6% to 6.35% retroactive to January 1 and dedicated .25 percentage points of the increase to a new State Accounting and Financial Responsibility Account Retained Medicaid accounting on a cash basis to save $172 million

returned to local governmental units. In order to comply with this provision, state government was required to increase total state spending by $1.71 when it chose to increase spending by $1 on a state-funded program such as General Assistance. Yet recession-induced job losses increased requirements for just such entitlement programs, and caseloads continued to grow despite repeated tightening of program eligibility standards.

By the time Michigan entered fiscal year 1983 it had already exhausted virtually all the means at its disposal for managing its fiscal affairs. Even though the national economy showed some signs of finally pulling out of recession, the immediate prospects for Michigan's economy remained grim. Although impressed with its recent efforts to resolve long-simmering fiscal problems, Wall Street reduced Michigan's credit rating to the lowest of all the 50 states. Until a consortium of five Japanese banks submitted letters of credit to guarantee Michigan's general obligation notes, the state was effectively locked out of the credit market.

The Vise Tightens

While many continue to debate the wisdom of permitting Michigan's fiscal health to decline to such a condition, such debates are largely academic and contribute little to resolution of the problem. Although estimates of the general fund revenue shortfall for fiscal 1983 ranged from a low of $650 million to a high of $900 million, by January 1983 no one seriously disputed the fact that Michigan's financial condition had reached a state of crisis and immediate action was required if further damage was to be avoided.

Options for dealing with the problem were extremely limited because the most commonly used methods had already been implemented. Prohibitions on diversion of dedicated funds to finance general fund requirements meant that any potential benefits the state might realize by reducing outlays for dedicated purposes such as highway construction could not be used to bolster the general fund. Another possibility, wholesale layoffs of state government employees, would have saved relatively little once unemployment compensation benefits had been paid and would not have accomplished the objective even if such an action had been desirable and feasible. The remaining option -- taking large amounts of dollars from the major general fund budget areas of school aid, higher education, mental health, social services, and local revenue sharing -- would have essentially dismantled those programs and seriously jeopardized Michigan's prospects for future economic viability. Major reductions in aid to schools, colleges, and universities would have required massive program reductions and impaired the quality of education. This would have diminished Michigan's ability to attract new industry and to build the economic diversity it needs to weather future business recessions. Voters would not have tolerated releasing inmates and mothballing most of the state's correctional facilities. Finally, virtual elimination of all human service programs at a time when need was especially acute would not only have lowered the quality of life in Michigan but could easily have led to civil unrest. In addition, federal hearing requirements on social service cuts would have delayed implementation of these cuts, forcing eventual grant reductions to be larger and concentrated into a shorter period of time than otherwise necessary just to achieve the targeted savings. Exercise of any of these options could have damaged Michigan's attractiveness to business and commerce for decades to come.

Given the magnitude of the budget imbalance, the service areas which would have had to be cut, and the relatively short time in which to implement any action, state officials had little choice but to impose some kind of tax. Of the existing state taxes, only three could potentially generate sufficient revenue to cover the budget shortfall -- the Single Business Tax (SBT), the sales tax, and the state income tax. Raising the SBT would have tended to validate Michigan's antibusiness reputation. Prospects for increasing the sales tax were considered slim because the sales tax rate is set in the state constitution at 4% of retailers' gross taxable proceeds and would require a majority vote of the electorate and a 2/3 majority vote of the legislature to increase it. Timing also would have been a major constraint even assuming the legislature and voters approved a sales tax increase. It would have taken a minimum of 135 days before receipts from this higher tax rate started to trickle in and would have provided less than one full month of collections before the fiscal year ended. Rates could not have been raised enough to eliminate the entire shortfall within the time remaining. The remaining alternative was to increase the income tax.

1983 Actions

In April, the Michigan legislature approved a $225 million general fund spending reduction, raised the state's income tax rate from 4.6% to 6.35% (effective retroactively to January 1, 1983), and dedicated a portion of the income tax increase to a separate account for use in correcting deviations from generally accepted accounting practices.

Although these measures closed the budget gap, there is general dispute, both by the public and in the legislature, as to whether or not the 38% increase in the state income tax rate was a case of overkill. This discussion, however, ignores several relevant facts:

1. The conditions creating Michigan's fiscal crisis did not occur overnight. The temporary measures the state employed from 1976 to 1983 to achieve a budget which was at least balanced on paper were extraordinary and could not be

Table 2. Short-Term Borrowings, Fiscal Years 1975-1983

Fiscal Year	Face Value of Notes Issued	Calendar Days Outstanding
1975	-0-	-0-
1976	$200 million	223
1977	-0-	-0-
1978	$200 million	163
1979	$450 million	257
1980	$500 million	331
1981	$100 million	13[a]
	$350 million	208
	$150 million	223
1982	$350 million	349
	$150 million	364
1983	$100 million	15[b]
	$350 million	329
	$150 million	344

SOURCE: Department of Treasury.

[a]The fiscal year budget was not enacted until January 1981, consequently delaying short-term borrowing until February. Michigan banks arranged a loan of $100 million in the interim, and this borrowing took place on October 1, 1980.

[b]The fiscal year budget was not enacted until October 1982, delaying short-term borrowing. Michigan banks arranged an interim loan of $100 million, and this amount was outstanding from October 5 to October 21, 1982.

permitted to become the norm. Failure to reverse these practices and restore the state's financial integrity will merely perpetuate the crisis and impair Michigan's ability to deal effectively with future business recessions.

2. Inflation-adjusted spending for education has declined almost continuously over the past five years. If Michigan is to attract the growth jobs of the future, revitalize and diversify its economy, it must provide the research facilities, capital and human resources necessary to achieve that goal. This cannot be achieved without greatly expanding public support of educational and economic development programs.

Until and unless both of these objectives are realized, any reported surplus in the state's general fund budget will remain primarily an accounting artifact unrelated to the economic health of the state.

Summary and Conclusions

Michigan is starting to emerge from a long and very difficult period of economic contraction. As the economy recovers, revenue prospects will improve and demand for social support programs decline. Both factors will ease the stresses on the state's budget. Moreover, mechanisms are now in place to resolve and reverse the unorthodox fiscal management practices of the past. However, if Michigan is to diversify its economy and build a stronger base for the future, it must move beyond fiscal management concerns and begin now to develop the human and man-made resources essential to achieving this goal.

Table 3. Year-End Cash Balances of Key Funds and Average Month-End Cash Balances, Fiscal Years 1975-1983

Fiscal Year	Ending Fiscal Year Balance[a]	Average Month-End Balance[b]
1975	-$123.4 million	N. A.[c]
1976	-$146.1 million	-$324.7 million
1977	-$ 70.0 million	-$228.6 million
1978	-$ 15.8 million	-$198.3 million
1979	-$150.6 million	-$143.1 million
1980	-$382.1 million	-$344.5 million
1981	-$558.4 million	-$739.2 million
1982	-$620.7 million	-$997.2 million
1983	-$520.2 million	-$760.8 million[d]

SOURCE: Based on information from the Department of Treasury.

[a]Includes General Fund, School Aid Fund, and Budget Stabilization Fund from 1977 on. Budget Stabilization Fund did not exist in fiscal 1975 or 1976.
[b]Excludes proceeds of short-term borrowings.
[c]Information not compiled on a monthly basis until fiscal 1976.
[d]Preliminary.

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EXCERPTS FROM FISCAL AWARENESS SERVICE DOCUMENTS

FISCAL AWARENESS SERVICE Newsletter, Sept. 25, 1981, Vol. 1, No. 1

Squeezed by the Headlee requirement of a 41.6% return of state spending to local units and the 19.6% cut in federal funds, state programming in the general fund will have to undergo significant reductions. We estimate that the legislative and executive branches in fiscal '82 will have to cope with general fund cuts on the order of $650 million. Those programs of the general fund component of the budget not sheltered by other considerations will face cuts on the order of 30%. The degree to which local units, school districts, colleges and universities, and state agencies will share the burden is not yet clear. The competition between state agencies and other recipients will be most intense, as cuts occur throughout the year ahead.

Restoration of retricted funds borrowed plus the costs of any property tax, single business tax and worker's compensation reforms will have to be addressed outside of the $650 million shortfall. Readers should note that the 1982 budget will have to accommodate more than $685 million in federal fund cuts and $650 million of cuts in the general fund. In the next twelve months, rescissions and program changes will, in our opinion, be unavoidable.

FISCAL AWARENESS SERVICE Newsletter, Dec. 21, 1981, Vol. 1, No. 2

Our judgment continues to be that the general fund shortfall will be on the order of $650 million. We believe this deficit could result in additional school aid cuts from the general fund of $30 million.

The restricted funds of the state were estimated to generate $1.2 billion in fiscal 1982, for an increase of 16.9% over 1980-81 actual collections. We believe this anticipated restricted fund revenue for schools will not be realized, and will be short $125 million. This will create additional funding problems for schools. With our projected general fund loss for schools of $30 million and our projected $125 million loss of restricted funds, school districts may face a shortfall of $155 million, for an average per pupil reduction of $85 in this current fiscal year. These cuts may well occur in February and September of 1982, and fall into two separate school district fiscal years. All districts will suffer from these cuts, but those districts already confronting financial difficulties will suffer the most.

POLITICAL LETTER, Oct. 25, 1982

In our last letter we speculated about the possibility that Headlee might refine his campaign rhetoric to attract independent voters and moderates from both parties, a move designed to make the bid for governor a close and more spirited contest. Despite modest attempts to placate the concerns of these constituencies, Headlee has achieved relatively little success in attracting their allegiance. Our reading of voter sentiment suggests Blanchard will win the governorship by a margin of 8 to 10 percentage points, capturing 53 percent of the vote in comparison to 44 percent for Headlee; Tisch will draw about 3 percent of the total vote. This voter division would constitute a huge Democratic landslide by Michigan standards...

A Blanchard victory with anything in excess of a 6 percentage point lead would have ripple effects on other state races. Depending on the point at which voters start splitting their ballot, a Blanchard victory could provide an additional 2 or 3 percentage points for the Democrats, certainly enough to determine the outcome in a number of close state district races.

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FISCAL AWARENESS SERVICE Newsletter, Jan. 10, 1983, Vol. 2, No. 2.

Increases in health care costs reflect both inflation and improved technology. Average annual medical care cost increases outpaced the general rate of inflation and the rate of growth of personal income for the period 1969-1981. This increased the proportion of public and private resources expended on health care and contributed appreciably to the cost of employer-paid health insurance plans. Slower economic growth, squeezed profit margins, and shrinking tax revenues have magnified the impact and heightened awareness of health care cost increases. In the public arena, this has generated a plethora of rules and regulations which focus on symptoms rather than on the underlying causes of cost increases and has contributed little toward understanding of the industry or resolution of the dilemma inherent in public provision of health care services.

MICHIGAN POPULATION TRENDS, Mar. 22, 1983

An Update to the Monograph "Michigan's Emerging Work Force."

...We do not believe that this population loss will continue if appropriate initiatives are taken. Michigan has a unique combination of ingredients including its central location, a wide variety of natural resources and a large renewable source of water, excellent educational institutions, and a highly skilled work force, all of which offer the potential for significant industrial diversification and expansion. With a national economic recovery, Michigan's large industrial base, in conjunction with a rapid expansion in tourism as well as growth in the service sector, offers the potential for substantial employment growth. We anticipate a state unemployment rate under 10 percent by 1985. Full employment (an unemployment rate of 6.5 percent or less) is possible by the latter part of the 1980s. Expanding employment opportunities in Michigan should result in greatly reduced out-migration of younger people and a renewal of population growth. We project Michigan's 1990 census count to be approximately 9,500,000. We continue to anticipate pronounced growth in the southwestern part of the state and in the northern counties of the lower peninsula.

THIRD QUARTERLY ECONOMIC FORECAST 1983, JUNE 1983

Economic Overview

The economic recovery which started late last year has gradually spread from housing and auto sales to other sectors of the economy. Gains in employment and more moderate rates of inflation will provide consumers with the financial means to demonstrate their growing confidence in the economy... Consumers show more optimism about economic prospects than they have in over six years...We look for continued economic growth extending through 1984.

* Interest rates will continue to moderate, although heavy federal borrowing demands will prevent major reductions in short- and long-term interest rates.
* Auto sales will show improvement in calendar 1983, rising to 8.9 million units. Auto sales in 1984 will increase to 9.9 million units.
* Lower mortgage rates will stimulate housing starts to 1.7 million units nationwide this year.
* Pulled down by lower energy prices, the Consumer Price Index will register increases of 4.6% in 1983 and 5.5% in 1984.
* Unemployment nationwide will average 9.7% in 1983 and 8.8% in 1984. Michigan's unemployment rate will average 14.6% this year and decline to 12.8% in 1984.
* Inflation-adjusted personal income will increase by 2% in 1983 and 3% in 1984.