Gerald Faverman, Ph.D. • *Chairman of the Board*
Robert J. Kleine • *Editor*
December 7, 1990

Public Sector Reports

PUBLIC POLICY ADVISOR

Michigan's Fiscal Crisis

by Robert Kleine, Senior Economist

Democracy can last only until the citizen discovers he can vote himself public largesse and pay for it out of someone else's pocket.

De Tocqueville

INTRODUCTION

The Michigan economy is again in the grips of a recession and the state is facing its most serious budget problems since the early 1980s. Michigan also will have a new governor in January, which is sure to result in changes in Michigan's budget and tax policies. This report discusses the state's economic situation and the magnitude of the current budget shortfall, reviews how we came to such a crisis, and discusses options for dealing with the budget problems.

ECONOMIC OUTLOOK

There has been little positive economic news in recent months. Most indicators are still pointing to recession, and in fact the economy is probably already in a recession. Consumer spending appeared to improve in the third quarter, keeping GNP growth positive. But consumer spending actually was weakening all summer, and in October the Conference Board's index of consumer confidence fell to an eight-year low and recorded the largest one-month drop in its 20-year history. This drop was due partly to concern about the Middle East situation and the budget turmoil in Washington, but it also reflected more fundamental problems, such as rising unemployment and declining real incomes. Employment barely increased in the third quarter of 1990, and the unemployment rate moved up 0.3 percentage points from the second-quarter level. Housing and construction continued to be a major weak spot with housing sales 20 percent below sales a year ago and at the lowest level in eight years.

One of the few positives is that Congress and the president finally agreed on a plan to reduce the federal budget deficit. In the short run, however, the tax increases and spending cuts will dampen economic growth and budget deficits still will be well above $250 billion in the foreseeable future. At least the budget reduction plan is movement in the right direction, and the Federal Reserve Board responded by pushing the federal funds rate down by one-quarter point. Interest rates will have to drop much lower to get the economy moving again, and more easing can be expected as the economy continues to weaken.

The Michigan economy held up better than expected in the third quarter. Although employment growth was flat, the unemployment rate only increased by 0.1 percent to an average of 7.5 percent. However, car and truck sales declined almost 10 percent, and although October and early November sales were above the depressed 1989 levels, fourth-quarter sales still will be relatively weak. In response the industry has announced a number of temporary plant shutdowns and has cut fourth-quarter production schedules by 300,000 units. It is likely that the unemployment rate will jump by at least one percentage point in the fourth quarter. The Michigan economy has been in a mild recession since spring, and it will deepen in the next few months. This downturn will not be nearly as severe as in the early 1980s, however,

Public Sector Consultants, Inc.
Knapp's Centre • 300 S. Washington Square
Suite 401 • Lansing, MI 48933 • (517) 484-4954

when the unemployment rate averaged more than 15 percent from the first quarter of 1982 to the second quarter of 1983, peaking at 16.6 percent in the fourth quarter of 1982.

As can be seen in Exhibit 1, the Michigan economy has been weakening since 1987. From 1983 to 1986 it was proper to call Michigan the "comeback state," but from 1986 to 1989 real personal income increased only 5.1 percent compared with 9.7 percent nationally. The weakness in the manufacturing sector has been a major reason for the poor performance of the Michigan economy. Manufacturing employment fell by 65,000 jobs or 6.5 percent from 1986 to 1990 (estimated). As shown in Exhibit 2, this is a long-term trend that was only temporarily slowed in the 1982–86 period. In this regard, 1991 will be a watershed year for the Michigan economy as for the first time the services sector will provide more jobs than the manufacturing sector. One consequence is that Michigan has become a poorer state in the past decade. As shown in Exhibit 3, Michigan per capita personal income was about 7 percent above the national average in the late 1970s (at its peak in 1953, Michigan per capita income was about 19 percent above the national average). At the bottom of the recession in 1982 the state fell more than 3 percent below the national average. After a modest recovery in the mid-1980s, Michigan per capita income again has fallen below the national average, and the outlook for the 1990s is that our state will continue to slip behind the nation.

BUDGET OUTLOOK

As a consequence of the recent slide in the economy, the decline in our wealth relative to other states, and our failure to adjust public spending to reflect our changed economic circumstances, Michigan is facing its most difficult budget problems since the early 1980s. As Public Sector Consultants has been projecting for several months, the budget is awash in red ink. In February the House Fiscal Agency commented: "The fiscal year 1990 and 1991 budgets will be the most controversial and painful budgets since those of the 1979–83 economic and fiscal crisis in Michigan." On November 14 the Senate Fiscal Agency reported that it expected a deficit of $373 million for FY 1989–90 and $980 million for FY 1990–91. In our budget analysis released on September 14 we said: "We are projecting a budget deficit of at least $750 million; this amount could increase substantially if the expected recession is deeper and lasts longer than expected." The problem has increased in size largely because overexpenditures have exceeded estimates and, as we said earlier, could grow well beyond our current projection of slightly over $1 billion if the economy continues to weaken. The recent budget action by the legislature, which is discussed below, will reduce the deficit by about $536 million.

How did the budget get so far out of balance? Let us begin with the FY 1989–90 budget. In February 1989 the governor recommended GF/GP spending of $6.988 billion based on a revenue estimate of $6.992 billion. The final enacted appropriation was $7.290 billion, as the legislature used a statutory revenue estimate of $7.202 and added $69 million from the Budget Stabilization Fund and $19 million in other adjustments. In February 1990 the Department of Management and Budget revised the revenue estimate upward to $7.245 million. The school aid fund (SAF) estimate also was increased by $40 million. As shown in Exhibit 4, the governor and the legislature allowed spending to run out of control in FY 1989–90. Supplementals and overexpenditures totaled about $557 million, largely in social services, corrections, and school aid. The increase in school aid is a combination of increased costs of the formula due to millage increases and lower school aid fund revenue. These additional expenditures were partially offset by negative appropriations, otherwise known as budget cuts, and lapses. Overall expenditures increased by $189 million beyond the original appropriation. At the same time GF/GP and SAF revenue fell an

EXHIBIT 1

Percentage Change in Real Michigan Personal Income, 1979–91

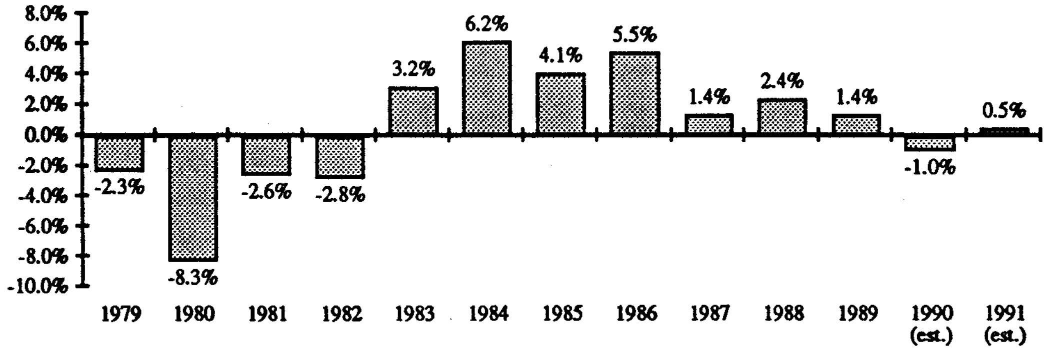


EXHIBIT 2

Michigan Manufacturing and Services Employment, as a Percentage of Total Employment, 1978–91

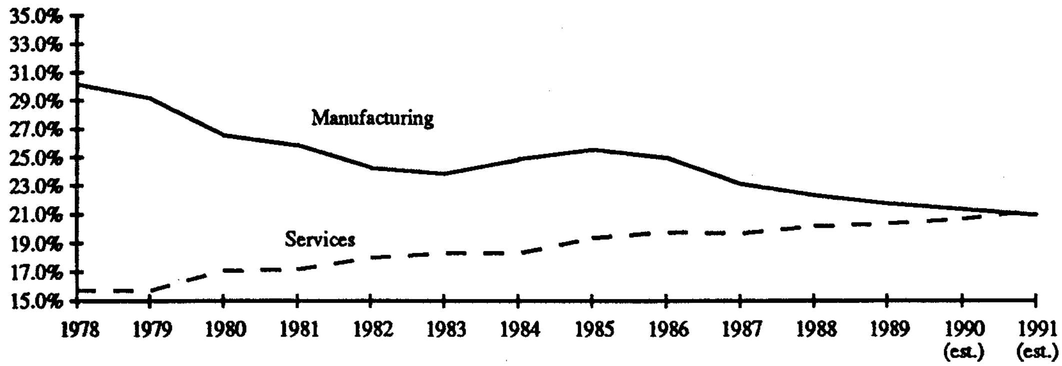


EXHIBIT 3

Michigan Per Capita Income as a Percentage of U.S. Per Capita Income, 1977–91

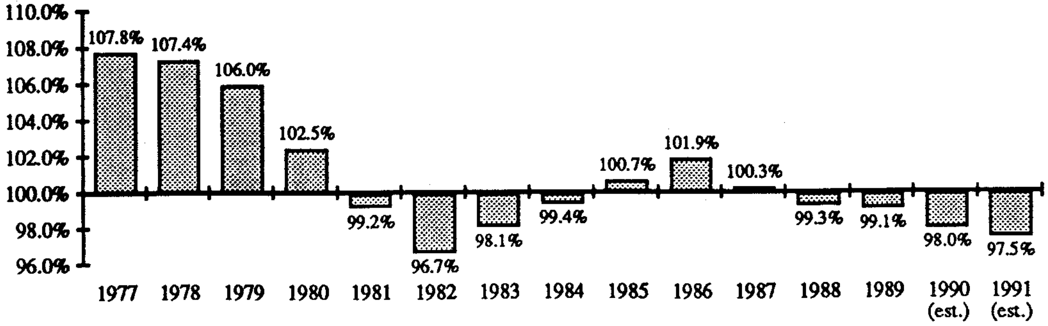


EXHIBIT 4

Adjustments to FY 1989–90 General Fund/General Purpose and School Aid Fund Budgets (dollars in millions)

	Negative Appropriations	Supplementals	Overexpenditures	Lapses	BSF Withdrawal	Total
Social Services	–$57.8	$128.7	$177.9	–$36.8	—	$212.0
Corrections	–17.1	63.2	12.1	–7.2	—	51.0
Mental Health	-0-	-0-	39.4	–24.0	—	15.4
Capital Outlay	–83.6	-0-	-0-	–28.1	—	–111.7
Other	–34.9	19.6	2.9	–9.3	—	–21.7
School Aid Fund			113.0		–$69.0	44.0
TOTAL	–$193.4	$211.5	$345.3	–$105.4	–$69.0	$189.0

SOURCE: Calculated by PSC from data provided by Senate Fiscal Agency and House Fiscal Agency.

estimated $175 million below the statutory estimate and $230 million below the February 1990 budget estimate. The result is a large budget deficit for FY 1989–90.

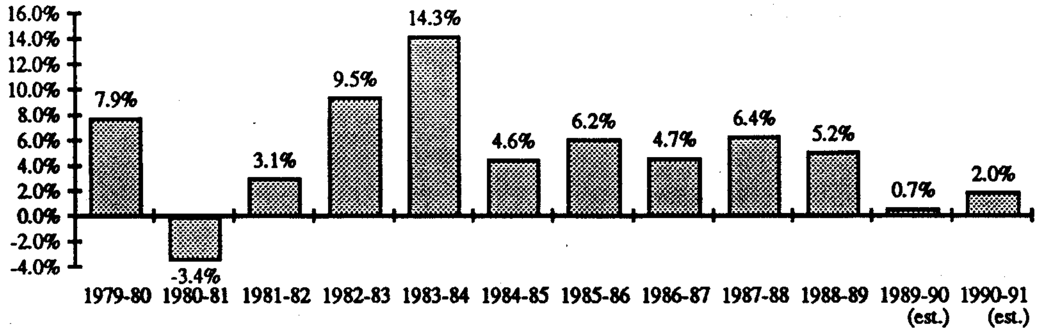
The FY 1990–91 budget problem is the result of a continuation of overspending, a lower revenue base for FY 1989–90, and slower than expected revenue growth in the current fiscal year. As shown in Exhibit 5, revenues increased less than one percent in FY 1989–90 and are expected to increase only 2 percent in FY 1990–91, compared with the budget forecast of a 5 percent increase. Moreover, revenues are more likely to grow less than 3 percent than more. The Senate Fiscal Agency is estimating overexpenditures of about $450 million in FY 1990–91, with $419 million in human services. Also, $114 million in additional spending for school aid will be required due to a shortfall in restricted taxes. A major reason for the overspending in human services is an increase in welfare caseloads above projections. October caseloads were about 5 percent above the year-ago level, and as the economy slows caseload growth could accelerate and add to the deficit problem. A balance sheet for fiscal years 1989–90 and 1990–91 is shown in Exhibit 6. As mentioned above, we believe that there is a strong possibility that the FY 1990–91 deficit could be higher than our current estimates.

As shown in Exhibit 7, the overspending in the current and the past fiscal years is a continuation of a long-running problem. In every year since 1980 there have been large supplementals and overexpenditures. This problem has been covered up by revenues from the 1983 tax increase, a relatively strong economy, and the use of loans from other funds, carryover surpluses, and other adjustments. The only year in the past decade in which current expenditures and current revenues balanced was FY 1988–89. See Appendix A for list of the various budget balancing measures used from 1980 to 1988.

Michigan is not alone in its budget problems, more than half the states are facing the need for budget cuts and revenue increases according to the National Association of State Budget Officers. Twenty-six states already have raised $10.3 billion in revenue for FY 1990–91, the largest single-year increase ever recorded. Although Michigan has not controlled spending as well as it should have, we are not among the highest spending states in the nation. Based on FY 1987–88 data, we rank 16th in state-local expenditures

EXHIBIT 5

Percentage Change in Growth of General Fund/General Purpose and School Aid Fund Revenue (annual percentage change)



as a percentage of personal income, 8.4 percent above the national average. In terms of state spending, we rank 24th, 10.9 percent above the national average. Michigan state-local spending (per $1,000 of income) ranks high for welfare (8), education (13), and health (13) and low for highways (47) and debt (43). For a detailed comparison of Michigan's expenditures and revenues with other states see our March 30, 1990, *Public Policy Advisor*.

EXHIBIT 6

GF/GP Revenues, Expenditures, and Year-end Balance, FY 1989–90 and 1990–91 (millions of dollars)

	FY 1989–90	FY 1990–91
Revenues:		
Beginning Balance	$61.1	–0–[a]
Current Revenues	7,105.0	$7,220.0
School Aid Fund Shortfall	–0–	–120.0
Subtotal	$7,166.1	$7,100.0
Expenditures:		
Initial Appropriations	$7,290.0	$7,672.0
Additional Spending (Net Supplementals)	463.0	340.0
Recutions	–193.0	–536.0
Projected Overexpeditures	–0–	110.0
BSF Withdrawal	–68.8	–0–
Subtotal	$7,491.2	$7,586.0
Year-end Balance	–$324.9	–$486.0

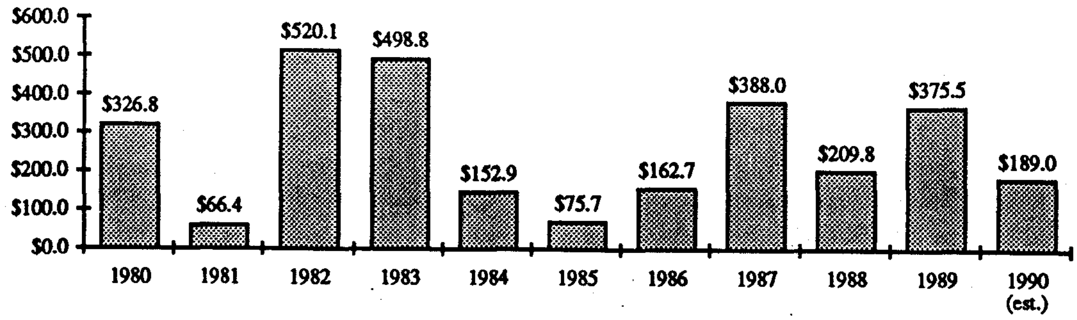
[a]FY 1989–90 deficit will be covered by bookkeeping adjustments.

The difficult fiscal problems facing Michigan are compounded by Governor-elect John Engler's pledge to reduce property taxes by 20 percent and not to raise taxes. A 20-percent reduction in property taxes, spread over two years, would cost about $800 million each year (the cost could be less depending upon whether changes are made to the current state property tax relief program). As a consequence, large cuts will be required in the state budget in the current fiscal year and in FY 1991–92 as well, in addition to those recently enacted. In fact, the only solution may be to spread cuts and the property tax cut over several years. This will be discussed in the next section. What this means is that even if the economy recovers next year the FY 1991–92 budget also will be very tight—how tight depends on how the current year problem is solved.

To summarize, Michigan is faced with a budget problem that could approach $2 billion, or 20 percent of expenditures, if the economy weakens a little more than expected and property taxes are reduced.

EXHIBIT 7

General Fund/General Purpose and School Aid Fund Net Supplemental and Overexpenditures, FY 1980–FY 1990 (dollars in millions)



DEFICIT REDUCTION OPTIONS

The governor and the legislature have several options available to bring the budget into balance: (1) cut spending, (2) use the Budget Stabilization Fund (BSF), (3) raise taxes, and (4) use accounting and other fiscal adjustments.

The first option is to cut spending. In early December the legislature passed legislation (SB 827) that reduces spending by 9.2 percent for most budget areas. The exemptions are

- school aid, school employees retirement, debt service, state building authority rent, and unclassified state employees salaries;
- spending on higher education and community colleges, which would be cut by only one percent;
- revenue sharing payments to locals, which would be cut by one percent overall (2 percent from nonconstitutionally mandated revenue sharing), resulting in a $10.7 million revenue gain.

The bill also includes supplemental appropriations totaling $340 million for human services agencies (Social Services, Mental Health, and Public Health). These departments will be subject to the 9.2 percent cut in other areas of their budgets.

The budget reductions total about $536 million and are to take effect immediately. However, the decisions on where to cut the department budgets are likely to be made by Governor-elect Engler and his department heads after January 1. If the cuts take effect in January, about a 12 percent spending reduction for the remainder of the year would be required to achieve the targeted goal. Additional cuts will be necessary, and these will be doubly painful. The available base for spending cuts is about $11 billion, as shown in Exhibit 8. (The total state budget is about $17.5 billion, but federal aid and restricted taxes other than revenue sharing, which are not subject to legislative discretion, are excluded.[1]) A reduction of about

1 There are some restricted taxes that could be diverted to the general fund, and the programs financed by these taxes could be reduced. However, the amounts are not large enough to alter this analysis significantly.

EXHIBIT 8

State Budget Allocations, FY 1990–91[a]

Category	Amount (millions)	Percent of Total
Human Services	$4,184.5	38.4%
Education	4,438.0	40.7
-School Aid	3,070.0	28.1
-Higher Education	1,261.2	11.6
-Community Colleges	225.5	1.0
General Government	442.2	4.0
Regulatory	202.1	1.9
Safety and Defense	213.4	2.0
Natural Resources and Agriculture	152.7	1.4
Capital Outlay	203.0	1.8
Revenue Sharing	1,075.0	9.8
TOTAL	$10,910.9	100.0%

[a]Prior to passage of SB 827.

9 percent would be required to reduce spending by $1 billion. Because school aid was exempted and higher education and revenue sharing were reduced by only one percent, the 9.2 percent reduction saves only about half that amount. Another similar reduction will be required to eliminate the estimated $1 billion deficit completely.

An $800 million property tax reduction would increase the additional required reductions to about 12 percent, or about 20 percent excluding education. These calculations assume that the cuts are made at the beginning of the year—the longer they are delayed the larger the percentage reductions required. Clearly cuts of this magnitude on top of the reductions already taken are not achievable without permanently damaging public services, which could be as harmful to the state's economy as high taxes. There are almost certain to be layoffs as a result of the first round of cuts, and additional cuts likely would result in very large layoffs. The state classified payroll is a little over $2 billion, therefore a 10 percent reduction in work force, about 6,500 (or 4,000 GF/GP funded positions), would save less than $150 million (GF/GP), after deducting the cost of unemployment insurance and payouts for accrued sick and annual leave.

One factor that could complicate the process of reducing the budget is Article IX, Section 30 of the state constitution, which requires that a minimum of 41.6 percent of spending from state sources be allocated to local units of government. Prior to any adjustments in the budget, spending on local governments in FY 1990–91 will exceed the requirement by an estimated $225 million. The court of appeals, however, ruled in *County of Oakland* v. *Michigan Department of Mental Health* that payments to county mental health boards cannot be counted as payments to local governments. The state has appealed the decision to the Michigan Supreme Court, but if it stands, this will reduce local spending by about $450 million a year and require offsetting spending increases in other local programs. In effect, this will limit severely the state's ability to cut expenditures for school aid, community colleges, and revenue sharing and force the majority of cuts to be made in "state programs" such as social services, corrections, state police, and higher education (if it is not placed off limits).

The second option is to use funds from the BSF, which currently has a balance of more than $400 million. Withdrawals from the BSF are triggered by changes in real Michigan income, and to a smaller degree by the unemployment rate. PSC and the Senate Fiscal Agency are projecting about a one percent decline in real income in 1991, which would trigger a payout to the general fund of about $80 million. However, the legislature with a two-thirds vote can declare an emergency and withdraw all the money from the BSF or with a simple majority can simply change the law and take all the money. Given the magnitude of the problem it would be prudent to use all the money in the fund over the next two fiscal years. However, this only delays finding a solution, as this is a one-time revenue source and the expenditure base is not reduced or the revenue stream permanently raised.

The third option is to raise taxes. This is a responsible approach and is expected to be used by about half the states in 1991. However, John Engler has largely ruled out tax increases, although the door has been left open to raise revenue by eliminating tax expenditures such as industrial property tax abatements. Also, there may be some willingness to use some of the $400 million in revenue that would be available, without legislative action, if the Michigan Supreme Court upholds the lower court and rules the capital acquisition deduction portion of the single business tax unconstitutional. However, a Republican governor is not likely to raise taxes on business and take away an important economic development incentive. Another possibility is to raise gas, cigarette, and alcohol taxes. This, however, has already been done by the federal government, making such action more difficult for the states. Moreover, these taxes do not generate a great deal of revenue. What we must conclude is that there will be no major tax increases, but there may be politically acceptable ways to raise $150–250 million. This fiscal crisis presents a good opportunity to change our policies on tax expenditures. We would like to see expenditures classified as to importance or validity and reviewed on a regular basis (those of least importance would be reviewed most often) by the appropriations committees.

The fourth option is to use accounting changes or other fiscal adjustments. This was done in the early 1980s when there was no willingness to raise taxes or cut expenditures sharply enough to balance the budget. However, these adjustments are temporary measures and only delay the problem. They also do not help the state's cash flow, which has been deteriorating sharply in recent months. The GF/GP and school aid fund cash balance at the end of October was a negative $463.6 million, down from a negative $170.2 million in October 1989. This also has a negative effect on the budget, as the general fund paid about a $22 million in interest to other funds in FY 1988–89 and this amount will increase substantially in the current fiscal year. There is a strong possibility that the state will have to borrow short-term funds for the first time since FY 1985–86. Fiscal adjustments can be helpful as part of a multiyear program, which attempts to protect essential programs from cuts until the economic recovery produces higher revenues. Several adjustments already have been mentioned. Among them are: accruing annual income tax payments; extending the fiscal year; and delaying fourth-quarter payments to universities until October 1. (Appendix A includes a number of other adjustments that have been made in the past.) We strongly advise against this option, however, as its earlier use has helped bring us to our present situation. It was wrong then and it is wrong now. Unfortunately, accounting adjustments will be required to balance the FY 1989–90 budget because of an unwillingness to face up to the problem earlier in the year. Although an option is not to cover up the deficit and to deal with it for both years in one package.

The solution to this fiscal crisis must be a combination of the options discussed above. One workable package would include the following components: (1) cover the 1989–90 deficit with accounting adjustments (a given), (2) raise $200 million in revenue, (3) transfer $200 million from the BSF, (4) cut spending by about $600 million, adding about $65 million to the first round of cuts, (5) enact a 20-percent property tax cut spread over four years to take effect in 1992. This package will solve the budget problem in FY 1990–91, but additional reductions will be required in FY 1991–92 even if the economy improves. If revenue increases by $500 million in FY 1991–92 (about an average increase), this would cover all but $150 million of the loss of the one-time BSF transfer and the $450 million property tax cut, requiring an additional $150 million cut in the state budget. This would be a reduction of only 1.5 percent or about 5.5 percent adjusted for inflation—not easy, but manageable.

An even more difficult question is where to make the cuts. The first round of reductions were across the board, with few exceptions, rather than selective. The former are easier politically and purport to treat everyone equally. Actually, across-the-board cuts penalize those who have run efficient programs and reward those who have been wasteful. They also assume that all programs are of equal priority, which obviously is not true. We believe that every department should be required to rank its programs on a priority basis, and those at the bottom should be cut or eliminated first. No area, such as education, should be completely exempt from budget reductions. Neither should the cuts all be targeted to certain program areas, such as human services, simply because the spending pressures have been greatest in these programs. Michigan always has been a progressive, compassionate state, and we hope that this fiscal crisis is not used as an excuse to curtail sharply support for the less fortunate, because of philosophical differences.

CONCLUSION

Michigan state government will be faced with very constrained budgets for at least the next three years. The combination of weak economic growth and a new administration with new priorities will force a downsizing of state government. This will be a painful process for those who depend on public services and support from state government, including local governments. We strongly urge the governor and the legislature to develop a multiyear plan for bringing expenditures in line with revenues and revise the budget process to insure that all public programs, including tax expenditures are carefully evaluated and prioritized. Policy again needs to take precedence over politics if we are to work through this crisis with minimal damage to public services and the state economy.

APPENDIX A

Summary of Adjustments and One-time Revenues Used to Balance the State's GF/GP and School Aid Fund Budget: FY 1980–FY 1988 (dollars in millions)

FY 1980

Accrue Single Business Tax	$159.0
Accrue Insurance Company Premiums Tax	31.1
Budget Stabilization Fund Transfer	263.7
Recreational Trust Fund Borrowing	26.0
Revenue Sharing Reductions	19.5
Beginning Balance	29.2
TOTAL	$528.5

FY 1981

Budget Stabilization Fund Transfer	$16.3
Cigarette Tax Accrual	11.7
Recreational Trust Fund Borrowing	46.2
Railroad Delinquent Tax Transfer	20.1
Medicaid Accounting Change	82.5
Revenue Sharing Reduction	43.5
Unencumbered Capital Outlay Reserve	46.7
TOTAL	$267.0

FY 1982

Income Tax Increase	$285.8
Accrual of Oil and Gas Severance Revenues	9.3
Medicaid Accounting Change	120.0
Revenue Sharing Reductions	60.5
TOTAL	$475.6

FY 1983

Utilize Beginning Balance	$6.3
Income Tax Increase	666.7
Revenue Sharing Reduction	15.0
TOTAL	$688.0

FY 1984

Utilize Beginning Balance	$19.7
Income Tax Increase	890.0
TOTAL	$909.7

FY 1985

Utilize Beginning Balance	$283.2
Income Tax Increase	430.8
TOTAL	$714.0

FY 1986

Utilize Beginning Balance	$117.0
Income Tax Increase	112.2
Working Capital Reserve Transfer	83.4
Tax Amnesty	95.5
TOTAL	$408.1

FY 1987

Utilize Beginning Balance	$152.6
Pension Valuation Adjustments	95.1
Capital Outlay Bonding Recapture	47.2
Federal Tax Reform Revenue	80.0
TOTAL	$374.9

FY 1988

Utilize Beginning Balance	$11.0
Capital Outlay Bonding Recapture	13.5
Spending Adjustments	63.6
School Aid Adjustment	62.6
TOTAL	$150.7
9-YEAR AVERAGE	$501.8

SOURCE: House Fiscal Agency, *Economic and Fiscal Outlook for 1990 and 1991*, February 12, 1990, p. 57.