

# FISCAL AWARENESS SERVICE



DR. GERALD FAVERMAN, Chairman of the Board

A LETTER OF POLITICAL AND SOCIAL COMMENTARY

December 31, 1986

TO: FISCAL AWARENESS SERVICE Subscribers  
FROM: Gerald <sup>GAF</sup>A. Faverman and Robert <sup>BK</sup>Kleine  
SUBJECT: IS THE PARTY OVER?

Governor James Blanchard was reelected to a second term by a huge margin due in large part to the strong recovery of the Michigan economy that began as he took office. Although the governor got off to a rocky start because of the necessity to increase the income tax, the robust economic recovery allowed him to put the state's finances in order, gain credit for reducing unemployment, and return the income tax rate to 4.6 percent--the rate in effect when he took office. The next four years may be less to the governor's liking.

The economic recovery has reached a mature stage and the question is when the next recession will occur (see Figure 1). A national recession in 1987 or 1988 is not likely, but the Michigan economy probably will slow significantly in the last half of 1987 due mainly to the problems in the motor vehicle industry.

The University of Michigan Research Seminar in Quantitative Economics is forecasting that real gross national product (GNP) will increase 3.3 percent in 1987 and 3.2 percent in 1988 compared with a 2.6 percent increase in 1986. However, this apparently stronger growth rate is somewhat misleading. In 1986, the foreign trade sector was a major drag on the economy as net exports decreased about \$40 billion; this sector is expected to be neutral in 1987 as the effects of the declining value of the U.S. dollar are felt. Also, nonresidential construction was a drag on the economy in 1986. It is expected to improve in 1987 after declining 12 percent in 1986 due, in part, to uncertainty about federal tax reform. The largest component of GNP, consumption, is expected to be significantly weaker in 1987 than in 1986 and to weaken further in 1988, partly because consumers are overextended. As Table 1 indicates, consumer installment debt as a share of personal income is near an all-time high.

In addition to the improved trade balance, the two most positive factors for the U.S. economy in 1987 and into 1988 will be low interest rates and inflation and the stimulus from federal tax reform. The Federal Reserve Board has been pumping out money at a fast pace, and low inflation and weak business loan demand give the Fed wide latitude to provide additional stimulus if the economy falters. On the negative side is the huge federal deficit, which could lead to a federal tax increase with the Democrats now in control of both houses of Congress.

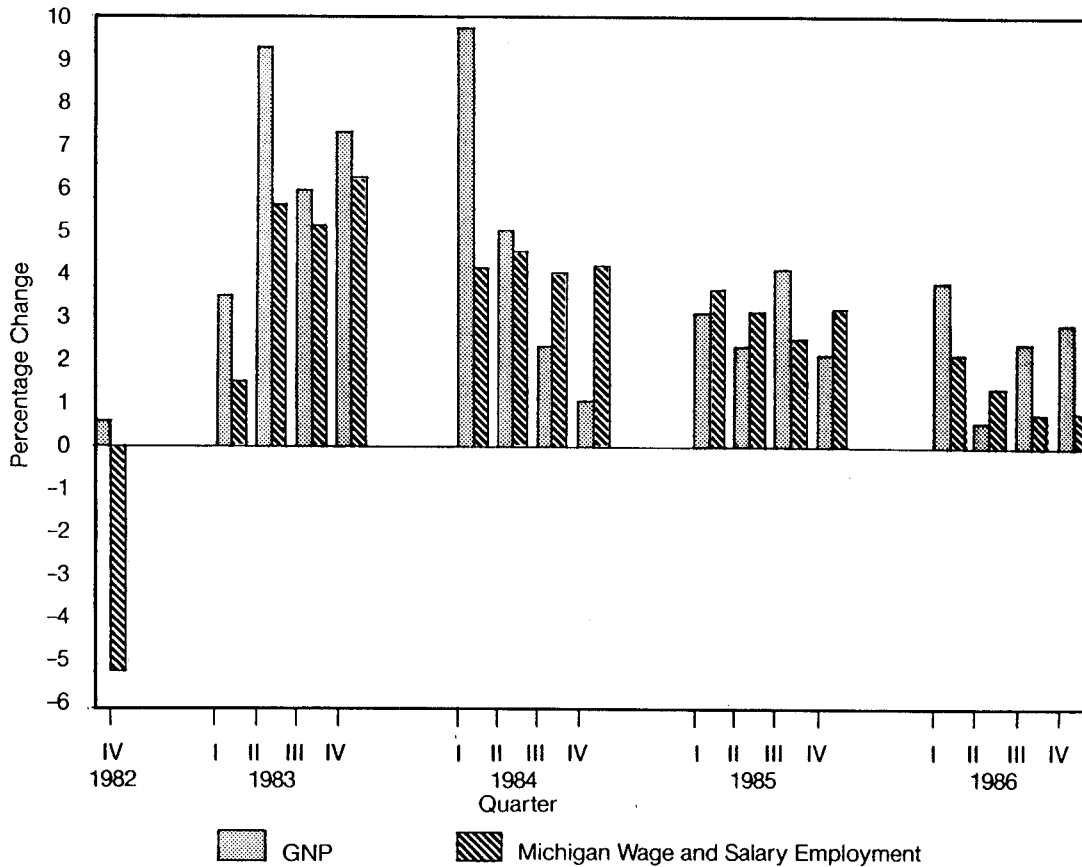
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FIGURE 1

QUARTERLY CHANGE IN REAL GROSS NATIONAL PRODUCT AND  
MICHIGAN WAGE AND SALARY EMPLOYMENT, 1982-1986  
(SEASONALLY ADJUSTED ANNUAL RATES)



SOURCES: Council of Economic Advisers, Economic Indicators, Washington, D.C.: October 1986, and Saul H. Hymans, Joan P. Crary, and Janet C. Wolfe, The U.S. Economic Outlook for 1987, Ann Arbor: The University of Michigan Research Seminar in Quantitative Economics, November 1986.

TABLE 1

## CONSUMER INSTALLMENT CREDIT, U.S., 1960-1985

<u>Calendar Year</u>	<u>Consumer Installment Credit (billions)</u>	<u>% Change at Annual Rate<sup>a</sup></u>	<u>Consumer Installment Credit as % of Disposable Personal Income</u>	<u>Automobile Installment Credit (billions)</u>	<u>% Change at Annual Rate<sup>a</sup></u>	<u>Automobile Installment Credit as % of Disposable Personal Income</u>
1960	\$ 43.0	0.0	12.2	\$ 17.7	0.0	5.0
1965	71.3	10.6	14.4	28.6	10.0	5.8
1970	105.5	8.1	14.8	36.3	4.9	5.1
1975	172.0	10.2	15.2	57.2	9.5	5.0
1980	296.3	11.5	15.5	112.1	14.5	5.9
1981	312.9	5.6	14.7	119.8	6.9	5.6
1982	328.3	4.9	14.2	124.9	4.3	5.4
1983	376.0	14.5	14.9	142.5	14.1	5.7
1984	452.4	20.3	16.6	172.5	21.0	6.3
1985	541.4	19.7	19.0	210.0	21.7	7.4
1986 <sup>b</sup>	577.0	14.0	19.3	228.7	18.6	7.6

SOURCE: Council of Economic Advisers, Economic Indicators, February 1986, and Board of Governors Federal Reserve System, Federal Reserve Bulletin, various issues.

<sup>a</sup>Percentage change listed for 1965, 1970, 1975, and 1980 is compounded annual rate for previous five years.

<sup>b</sup>The latest annualized data available are for August.

The outlook for the Michigan economy is not quite as rosy. Economic growth in Michigan in 1987 and particularly in 1988 is likely to be significantly weaker than national growth due to declining auto sales and General Motors' financial difficulties, which involve plant closings. Manufacturing, the mainstay of the Michigan economy for sixty years, has shown increasing signs of weakness. Manufacturing employment reached a peak of about 1.2 million jobs in 1978 and fell to about 875,000 jobs in 1982; approximately 150,000 or half of the lost jobs were regained by the fourth quarter of 1984. However, since then Michigan has lost about 28,000 manufacturing jobs, 22,000 of which were auto related. The outlook is for a further loss of manufacturing jobs during the next two years. Private nonmanufacturing jobs, particularly in services and trade, have more than made up for the lost manufacturing jobs, but if the manufacturing sector continues to erode, fewer nonmanufacturing jobs will be created. Fortunately, unemployment will not rise as much as this scenario suggests as the labor force is expected to exhibit little growth. The University of Michigan, which is slightly more optimistic than is Public Sector Consultants, Inc., forecasts an unemployment rate of 8.8 percent in 1987 and 9.5 percent in 1988, compared with 8.9 percent in 1986.

A weak economy means slower growth in revenues, higher welfare caseloads,<sup>1</sup> and a tighter state budget. To illustrate, the welfare caseload increased 49 percent between fiscal year 1979<sup>2</sup> and fiscal year 1983, putting an immense strain on state resources (see Table 2 for a history of welfare caseloads). (Each 1,000 increase in the welfare caseload costs the general fund \$2.4 million.) After generous budget increases in fiscal years 1983 to 1985, the last two budgets have been tight due to the phased reduction of the income tax rate (see Table 3). Tight budgets will become a way of life for the next few years as general fund and school aid fund revenue growth is expected to be no more than 5 percent and likely lower.

The only thing that has made life tolerable since 1979 for budget officials and those who rely on state funds has been tax increases. Without these increases, an additional \$1.8 billion in cuts in general fund-general purpose and school aid fund expenditures would have been required in fiscal years 1980 to 1983. From fiscal year 1979 to fiscal year 1987, tax increases and revenue adjustments financed an additional \$1 billion in spending. Yet, adjusted for inflation, expenditures actually declined 11.3 percent during this period. (Expenditures for fiscal year 1987 are based on current appropriations.) Figure 2 shows, in current and constant dollars, what would have occurred if the fiscal years 1971-1979 spending trend had continued through fiscal year 1987. Note that in current dollars, spending would have been \$3.2 billion higher.

The legislature has been talking about further tax reductions, but the reality is that tight budgets will become the norm without tax increases. For the near term, there are several resources available to cushion the budget impact. First, the surplus for fiscal year 1986 is estimated at about \$160 million. Second, federal tax reform is expected to generate a \$150 million

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<sup>1</sup>Current budget projections assume that welfare caseloads will decline.

<sup>2</sup>The state government fiscal year runs from October 1 of one calendar year through September 30 of the next year. For purposes of reference, the year in which the fiscal year ends is the identifying year.

TABLE 2

## MICHIGAN WELFARE CARELOADS

<u>Fiscal Year</u>	<u>Aid to Families With Dependent Children (AFDC)</u>	<u>General Assistance<sup>a</sup> (GA)</u>
1970	70,609	NA
1971	108,978	NA
1972	148,978	NA
1973	169,049	NA
1974	180,594	NA
1975	192,555	NA
1976	203,985	NA
1977	199,629	NA
1978	194,699	NA
1979	200,097	49,733
1980	219,814	77,111
1981	241,157	107,673
1982	231,643	107,450
1983	239,848	132,411
1984	240,066	148,720
1985	224,991	131,668
1986	220,100	117,100
1987	206,000 <sup>b</sup>	105,000

SOURCE: Senate Fiscal Agency, 1986 Statistical Report, Lansing: October 1986, p. 50.

<sup>a</sup>Statewide general assistance began in April 1979.

<sup>b</sup>Appropriated caseload.

NA = Not applicable.

## STATE BUDGET EXPENDITURES, FISCAL YEARS 1971 TO 1987

<u>Fiscal Year</u>	<u>General Fund- General Purpose and School Aid Fund Expenditures (millions)</u>	<u>Dollar Change</u>	<u>% Change</u>	<u>% Change Adjusted for Inflation<sup>a</sup></u>	<u>Revenue and Accounting<sup>b</sup> Adjustments</u>	<u>Addendum: GF-GP Year-end Balances</u>
1971	\$2,727.4	-			84.8	0.7
1972	3,018.3	\$290.0	10.6	4.6	161.5	31.3
1973	3,443.8	425.5	14.0	6.4	41.3	184.7
1974	3,794.6	350.8	10.1	0.1	-130.4	207.2
1975	4,108.6	314.0	8.2	-1.7	55.1	1.5
1976 <sup>c</sup>	4,496.6	388.0	9.4	2.2	651.7	28.3
1977	4,809.7	313.1	6.9	0.1	5.0	67.9
1978	5,445.0	635.3	13.2	5.2	-58.1	63.6
1979	6,100.3	655.3	12.0	2.6	-3.4	29.2
1980	6,705.5	605.2	9.9	-1.0	505.7	0.0
1981	6,211.1	-494.4	-7.4	-14.7	257.9	0.0
1982	6,106.7	-104.4	-1.7	-8.1	364.1	6.2
1983	6,616.7	510.0	8.3	3.5	681.0	19.7
1984	7,300.2	683.5	10.3	4.9	72.8	283.2
1985	8,077.8	797.6	10.6	5.0	-576.0	139.2
1986	8,515.0 (prel.)	437.2	5.4	1.0	-62.0	160.0 (est.)
1987	8,736.5 (est.)	221.5	2.6	-2.1	-256.0 (est.)	NA

SOURCE: Senate Fiscal Agency, 1986 Statistical Report, Lansing: October 1986, and Department of Management and Budget, Lansing.

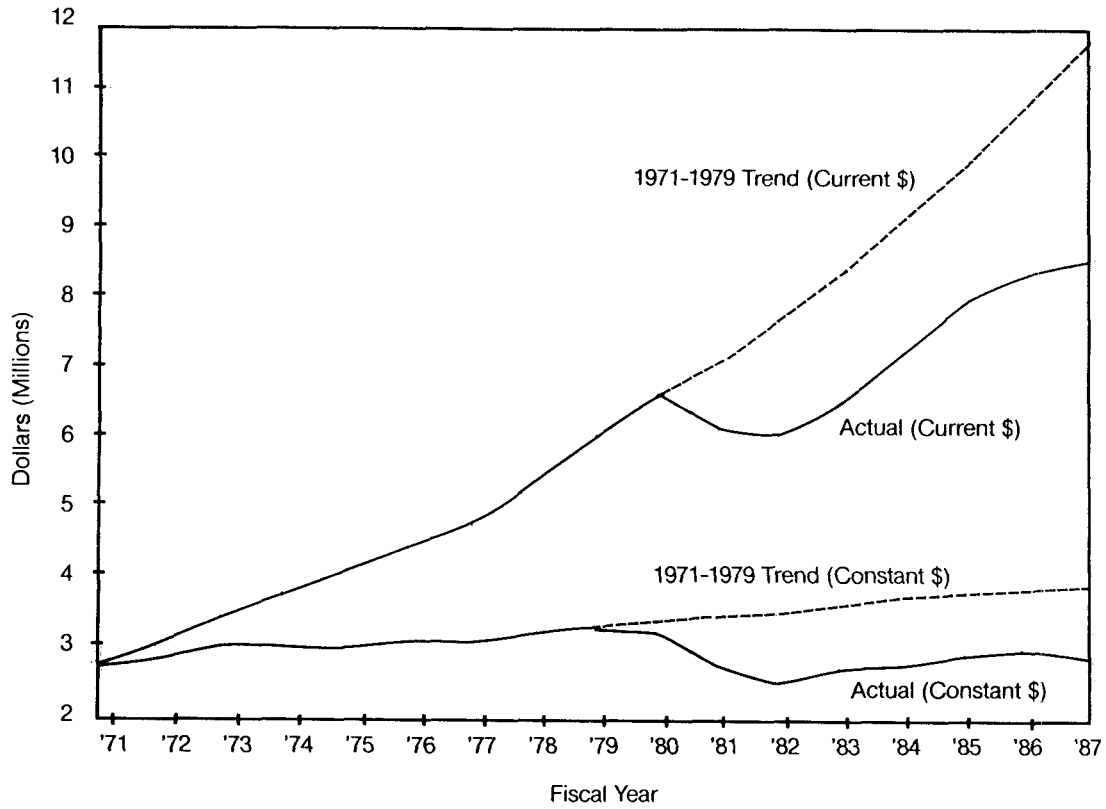
<sup>a</sup>GNP price deflator for state-local spending is used to remove effects of inflation; 1971=100.

<sup>b</sup>This number represents the marginal change from the previous year rather than the absolute amount raised by the tax change.

<sup>c</sup>Fifteen-month fiscal year.

FIGURE 2

GENERAL FUND-GENERAL PURPOSE AND SCHOOL AID FUND BUDGET EXPENDITURES,  
FISCAL YEARS 1971-1987, CURRENT AND CONSTANT DOLLARS



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revenue windfall for Michigan. (The governor has made a commitment to return this revenue to the taxpayers.) Third, there is about \$360 million in the Budget Stabilization Fund (BSF) that can be used to prop up state spending as the economy weakens. These funds may be sufficient to keep things running if the economy is merely stagnant. However, if Michigan experiences a recession that even approaches the magnitude of the last one, at least \$1 billion will be needed to prevent deep budget cuts.

Fortunately, the state is in a better position to weather a downturn than it was in 1980. There is no hidden deficit, all liabilities are on the books, and the cash flow is excellent. In addition, the 17 percent reduction in the number of state government employees between fiscal years 1979-1980 and 1983-1984 has been maintained despite large employment increases in the Department of Corrections. The prudent spending policies of the last two budgets will make it easier to deal with a budget crunch.

The message is that the world is going to get a lot tougher and the governor, the legislature, and those who rely on state spending should begin to plan for a rainy day. People in this state seem to believe that recessions last forever and that recoveries never end. We know better, but we somehow become caught up in the despair or the euphoria of the moment. The Budget Stabilization Fund was intended to provide a partial solution to this problem, but politicians in this state have never taken the fund's purpose seriously, as evidenced by the raid on the fund to finance prison construction.

We are not saying the sky is falling. We are saying that the Michigan economy is going to be weaker in the next two or three years than most people expect. We are also saying that the state budget is going to be very tight and everyone is going to have to live with less. If we begin to make adjustments now, such as putting the fiscal year 1986 surplus in the BSF, leaving the income tax rate at 4.6 percent, avoiding all but the most critical supplementals, and lowering our expectations, the budget chaos experienced during the last recession can be avoided.

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