MICHIGAN'S DUAL CHALLENGES: RECESSION AND NEW FEDERALISM

Douglas B. Roberts
Michigan Department of Management and Budget
Lansing

As so often in our history, our nation today finds itself in the midst of change, change at every level of our society, whether it be in the kinds of cars we drive or don't drive, in the expectations we hold for the future, or in the patterns of family living. Coping with these changes is what government is all about, and the thrust of my remarks today will be to develop the implications of two of these changes, the major adjustments taking place in Michigan as a result of the national recession and the changing federal philosophy of public policy often referred to as "New Federalism."

The nation entered an economic downturn during 1980. While some national recovery occurred during 1981 before a deeper recession set in towards the end of 1981, Michigan never recovered. A major factor was and is interest rates. It seems like another century, as recently as 1977 that the prime rate averaged only 6.8 percent. By 1981 it had more than doubled to 15.3 percent on average and hit a record 21.5 percent in December 1980. The one bright spot in the picture has appeared this year with the prime rate most recently dropping to 13.5 percent.

It is important to put Michigan's economic difficulty in some perspective. Michigan currently produces approximately 1/3 of the domestic automobiles. As Table A indicates, this percentage declined dramatically during 1980 to 26 percent. It is now clear that Michigan's automobile industry collapsed in 1980, declining by 40 percent. The question naturally arises, why did Michigan's production of automobiles fall by 40 percent when domestic car sales for 1980 fell by only 21 percent? The answer concerns the mix of production of small and large cars. Table B indicates that during 1979 Michigan was heavily dependent upon the production of full-size automobiles.

Michigan has recovered its share of domestic production but, unfortunately, it is a share of a very weak total market. To illustrate, total domestic automobile production for June and July of this year averaged 5 million units based on Seasonally Adjusted Annual Rate (SAAR). The peak month in 1978 was 10 million units. The domestic automo-

Table A

MICHIGAN MOTOR VEHICLE PRODUCTION
(Percent of U.S. Prod.)

Model Year	Mich/U.S.
1970	34.2%
1975	33.2
1976	33.9
1977	32.4
1978	30.2
1979	29.1
1980	26.2
1981	30.4
1982*	34.4

*First three quarters only.

Table B

MICHIGAN MOTOR VEHICLE PRODUCTION
MIX, FY 79 - FY 82

	FY '79	FY '80	FY '81	FY '82
Passenger Cars:				(3 qtrs.)
Subcompact	0.0%	0.0%	13.2%	11.9%
Compact	35.7	40.4	34.2	25.1
Intermediate	18.7	24.9	23.2	26.5
Full-Size	45.6	34.7	29.3	36.5
Total Cars	100.0%	100.0%	100.0%	100.0%
Motor Vehicles:				
Passenger Cars	69.6%	78.2%	78.2%	76.2%
Trucks	30.4	21.8	21.8	23.8
Total Motor Vehicles	100.0%	100.0%	100.0%	100.0%

bile industry is running at 50 percent of the peak reached in 1978. In any given month, Michigan's domestic automobile sales are running at a 20-24 year low.

Michigan's construction industry has suffered even more than the automobile industry. Residential construction permits on a monthly basis are currently running at about 20 percent of the peak month reached in 1977. Specifically, residential construction permits for November, 1977 were 6,700, while in June, 1982, the permits equalled only 1,300. Michigan's unemployment statistics are equally as bleak. Since the start of 1980, Michigan has experienced double digit unemployment for 32 consecutive months. The peak unemployment rate was reached in March, 1982 at 17 percent (unadjusted). We do not expect Michigan's unemployment rate to dip below 10 percent until late 1984, the fifth straight year of double digit unemployment problems.

The economic statistics translate directly into budget difficulties. Table C indicates actual General Fund-General Purpose budget numbers as well as real GF-GP spending. It is interesting to note that the 1982 budget, which will be concluded September 30, 1982, is actually below the 1980 spending level. The proposed 1983 budget is 1/2 of 1 percent above the 1980 budget level. I know of no other state that can claim its actual total spending for 1983 is almost equal to its FY'80 spending.

In real terms, the situation is even more dramatic. Michigan's real General Fund-General Purpose expenditures in Fiscal Year 1982 are approximately equal to the amount spent in Fiscal Year 1972, and real expenditures for Fiscal Year 1983, as projected, are even below the amount spent during Fiscal Year 1972. In real terms, Michigan is spending $350 million less in its current Fiscal Year 1982 than it spent during Fiscal Year 1978.

Table C

MICHIGAN GENERAL FUND AND GENERAL PURPOSE EXPENDITURES
1963-83

Fiscal Year	General Fund/ General Purpose Expenditures	Constant Dollars[1]
	(Billions)	(Billions)
1963	.492	.548
1964	.524	.579
1965	.650	.702
1966	.794	.821
1967	1.049	1.049
1968	1.152	1.104
1969	1.339	1.211
1970	1.564	1.332
1971	1.799	1.478
1972	1.999	1.584
1973	2.316	1.722
1974	2.572	1.725
1975	2.827	1.766
1976[2]	3.649	1.728 (4/5 of 2.160)
1977	3.313	1.836
1978	3.791	1.953
1979	4.201	1.920
1980	4.772	1.882
1981[3]	4.478	1.616
1982[3]	4.663	1.607
1983[3]	4.813	1.558

1. Deflated by the Detroit Consumer Price Index.
2. Fiscal Year 1976 included 15 months in order to bring the state's fiscal year in line with the Federal Government's.
3. Includes lottery revenue. Lottery revenues have been removed from General Fund-General Purpose totals but are included here in order to provide consistent comparisons.

I think it is instructive to detail ways in which Michigan has coped with this "worst case" situation. There are obviously only two major methods in which to solve a budget problem: more revenue or fewer expenditures. Michigan used both methods with most of the emphasis on expenditure reductions rather than revenue enhancements. The obvious, however, does not preclude creativity or special nuances.

Although Michigan has had problems for several years, most of my remarks will be limited to the current fiscal year 1982 since it has been our most difficult. During Fiscal Year 1982, it was necessary to put Michigan's budget-cutting apparatus into motion four times.

Under the constitutionally prescribed procedure, the governor issues an executive order which in effect unappropriates funds from specific programs and departments. Before it can take effect, however, the approval of each of the House and Senate Appropriations Committees is required. This process was invoked four times in the course of the year, first for $270 million at the start of the fiscal year in October, then another for $308 million in April, yet another $50 million more in May, and finally, $150 million last week. These four spending reductions totaled $778 million or 17 percent of the current GF spending level.

It is important to emphasize supplemental needs were required in social services. Therefore, the reductions in one area of the budget were, in some cases, used to pay for spending elsewhere. The important point is that real reductions had to be found. Some of these reductions were straightforward and some involved special twists. That is, we were looking for the most cuts with the smallest amount of pain. The actions taken include the following:

• State employment is down from a peak of 72,300 in mid-1980 to less than 60,000 and dropping. We have had to lay off 8,100 state employees in the process.

• A series of employee concessions, some voluntary, some not, have been employed to achieve additional reductions. Last year, six one-day layoffs saved about $20 million, affecting two-thirds of the employees. In effect, we closed down all but critical areas of state government for one day on six occasions without pay. However, a wave of resentment among state workers resulted from this policy. The resentment centered on the fact that some state workers, for example, mental health, corrections, and state police employees did not share in the pain and thus the policy was deemed by many to be unfair.

In the current year the emphasis was shifted to a different policy, one of reduced hours or deferred pay. Specifically, each employee not subject to a contract which prohibited it was required to contribute 55 hours in pay reductions. The employee could choose to work less than 80 hours per pay period and receive less pay or the employee could choose to work 80 hours and receive annual leave in exchange for less pay. An employee could volunteer to contribute even more than the requirement. In either event, wage and salary requirements were reduced. Unfortunately, some employee unions did not participate. This resulted in additional employee layoffs.

As we move into Fiscal Year 1983, most state employees will not receive any pay raise. This fact involves a first in our state's history since all employees were scheduled to receive a 5 percent pay raise beginning October 1, 1982. The raise was renegotiated by some unions and eliminated for the unrepresented.

• We have virtually eliminated capital outlay projects and reluctantly turned to bonding to carry them out, unfortunately, at a time when long-term, tax-exempt bonds find little interest, or high interest, if you will, in the market place.

• We have had to reduce subsidies to education, especially our colleges and universities, to the point that tuition is now among the highest in the nation.

• Programs have been cut back throughout state government. Few have been eliminated, but our state parks are not as clean, our beaches are not as well watched by lifeguards, some treasury and secretary of state field offices have been closed. We have instituted such ideas as having employees empty their own wastebaskets. We are installing hot air blowers to eliminate the need for paper hand towels. State employees who take state cars home are being charged for the home-to-office mileage and that includes department directors.

• We have had to reduce the number of attendants in our mental health institutions.

• Grant levels for our welfare recipients have been cut 8.5 percent in two years.

• The state saved over $100 million in the current fiscal year by adjusting the interest assumption for the various state pension systems. Although this was an actuarily sound assumption, it provided an important budget savings when it was most needed.

• Finally, I would like to explain the last executive order reductions for this year. Just last week $150 million was cut out of the budget. The order cut $112 million from the education community and $38 million from local units. Reductions in departmental operations were not possible with only two weeks left in the fiscal year. As a way of assisting the educational community, the payment schedule for the 1983 budget was adjusted so that payments normally paid in August of 1983 will be paid on June 30, 1983.

This change is important to schools since almost all school districts, plus colleges and universities, are on a July 1 to June 30 fiscal year. This means that, for the school budget year 1982-83, the dollars are returned. Clearly, the schools lose but only the interest on the delay.

Future state budgets will be required to maintain the same new payment schedule.

Michigan made the effort to ride out the recession without a tax increase, but the recession lasted too long. The legislature adopted a unique budget stabilization plan in 1977, setting aside funds in prosperous years. It provide $282 million toward resolving our budget problems in 1980 and 1981, but that source has now run dry.

The legislature joined the governor in another unique move earlier this year, approving a 10-cent-a-pack increase in the cigarette tax — to 21 cents a pack — with the proceeds earmarked for the sole purpose of easing the state's cash flow shortage. Because of a number of different budget decisions in recent years, the treasury's cash flow had been seriously depleted and the tax was designed to reverse that problem, a problem that has required us to borrow $500 million annually on a short-term basis to smooth out our payments during the year, especially to schools, institutions, and local units of government. It is a testimony to the willingness of the legislators to make tough decisions that they approved this tax increase in an election year, especially when it was a tax that provided no direct program benefit to the taxpayers.

It was an even greater tribute that the legislature also approved a temporary increase in the state's flat rate income tax, from 4.6 to 5.6 percent for six months. In addition to all the budget cuts, this revenue increase of $295 million was vital to achieving a balanced budget. To reiterate an earlier statement, despite the temporary income tax increase, Michigan's general fund for FY'82 will be actually below the FY'80 level.

One factor has been increasingly apparent. The federal government at this point is not in a position or a frame of mind to initiate spending programs, as has been its habit in the past. A new approach to relationships between states and the federal government, the so-called new Federalism, has developed.

As in so many things, the federal search for a new relationship with the states receives additional motivation from the need to reduce federal spending. For years, the federal initiatives have assumed larger and larger roles in expanding services and the states have followed suit, a trend that clearly is no longer acceptable. The bulk of federal spending is concentrated in three areas: defense, Social Security and related programs, and funding of the national debt. I do not believe that these areas are going to be subject to any major reductions in the near future. Therefore, the squeeze is clearly on other programs, including payments to state and local governments.

The present New Federalism plan calls for the federal government to take over full control of medicaid in exchange for the states taking over Aid to Families with Dependent Children. In addition, more than

35 federal education, transportation, community development, and social service programs would be turned back to the states with a federal trust fund set up to finance them. The fund, initially, would hold the states harmless in the massive transfer. But the fund also phases out of existence by 1991.

Conceptually, I support New Federalism. I like the placement of responsibility at the state level for the most part. Because of the divided responsibility for many of the present programs, citizens believe they are on a merry-go-round. The states must be willing to accept and defend their actions once they have assumed full responsibility.

The swap of AFDC for medicaid programs could make a state a winner or loser depending on how the details are worked out. For instance, will optional programs be included? Still to be determined is the disposition of programs for the medically needy, those persons with marginal incomes who cannot afford to pay for their own medical care. Another difficult issue is the disposition of long-term care programs.

Only when these issues are decided can we make an accurate determination of the consequences of this massive shift. Michigan is especially concerned, I might say, because of past experience. First, Michigan's experience with block grants was less than satisfactory.

You remember block grants, don't you? It was a concept endorsed by many of the states fully recognizing its stick-and-carrot aspects. The idea was simple and appealing. Several categorical grants would be combined into blocks. The new blocks would receive fewer total dollars, the stick aspect, and, in return, states would be given greater flexibility, the carrot aspect. The initial concept and the final result were not exactly the same. Quoting from the Omnibus Budget Reconciliation Act of 1981 concerning the spending on alcohol and drug abuse activites:

> "(7) In any fiscal year, the state agrees to use funds for the alcohol and drug abuse activities prescribed by section 1914(a) as follows:
>
> "(A) Not less than 35 percent of the amount to be made available for such activities shall be used for programs and activities relating to alcoholism and alcohol abuse.
>
> "(B) Not less than 35 percent of the amount to be made available for such activities shall be used for programs and activities relating to drug abuse.
>
> "(8) Of the amount to be used in any fiscal year for alcohol or drug abuse activities, the State agrees to use not less than 20 percent of such amount for prevention and early intervention programs designed to discourage the abuse of alcohol or drugs, or both."

The above language is not what I had in mind when I talk about greater flexibility. I believe the states received the stick aspect all right but I am not convinced we received the carrot portion.

Another reason that past experience has made us skeptical concerns Michigan's unique position relative to our return on dollars sent to Washington. Michigan is last among the 50 states, receiving only 66 cents on the dollar, according to latest estimates. Very clearly, Michigan cannot afford any more redistribution of funds that exacerbates this situation. We do not need, and we cannot afford, any proposal which costs Michigan any more dollars.

On the other hand, there is another reason, beside a philosophical one, why New Federalism has some appeal. This reason specifically concerns the possible takeover of medicaid by the federal government. The medicaid program is seemingly uncontrollable. While the total Michigan General Fund budget from 1980 to 1983 will be up by approximately $20 million, medicaid expenditures during the same period will be up approximately $140 million. This increase is in spite of $40 million in cost containment and cost avoidance programs. One more statistic: in the past 15 years, the hospital account alone has increased in gross dollars from $50 million to $500 million, or 10 times. Total medicaid expenditures currently equal 76 percent of the total state dollars provided to the state's kindergarten through 12th grade education system. Clearly, given Michigan's constrained growth in revenue, coupled with the increases in medicaid, it is obvious that taken as a group, everything else in the budget is receiving actually fewer dollars. The overall conclusion is equally clear: medicaid is one of Michigan's biggest budget problems because of its relentness growth, and a federal takeover would be a plus.

For the reasons cited above, the National Association of Governors and the National Association of State Budget Officers have joined forces to assist Congress in working out a formula that is as equitable as possible for all concerned.

Most states are feeling the pinch of the recession. They are having to deal with faltering revenues and sharply restrained budgets. There are a hundred ways of dealing with these problems, but none is painless. The federal government is both cutting back in domestic spending and formulating major policy changes in domestic programs. Very clearly the end result will not be increased help for troubled state budgets.

In conclusion, Michigan has gone through several very difficult years. Reduced economic activity has resulted in serious budget problems. Michigan is providing fewer real governmental services today than we provided a decade ago. Given this background, I am hopeful but also skeptical about New Federalism. New Federalism provides government, in general, with an opportunity to define responsibility, an objective which I believe to be a worthy one. However, this opportunity cannot be at the expense of needed federal dollars.

FOOD POLICY