CRC Notes

2007-02 A publication of the Citizens Research Council of Michigan May 2007

Michigan's Deteriorating Cash Position

Recent news that the State of Michigan restructured its monthly payments to local school districts in order to avoid a cash shortfall in May has shed new light on the severity of the State's on-going fiscal struggles in general and highlighted a growing cash deficit in the combined General and School Aid Funds. The State entered Fiscal Year 2007 (FY2007) with a sizable cash deficit, the result of over-spending available resources from FY2000 to FY2006 and the depletion of its major funds cash reserves from FY2000 to FY2003. This CRC Note highlights the size of the cash deficit, how it has come about, the methods use to finance it, and the effects of budget balancing actions on the state's cash position.

Developments in Michigan state government's deteriorating cash position:

- From Fiscal Year-end 2000 through Fiscal Year-end 2003, Michigan exhausted over $2.9 billion in its major funds cash reserves (General, School Aid, and Budget Stabilization Funds) to support spending in excess of on-going revenues. As of Fiscal Year-end 2006, major fund cash balances were negative $1.3 billion, a net change of more than $4.2 billion over six years.
- Michigan issued short-term notes each year since FY2003 to meet its bill-paying responsibilities associated with the General and School Aid Funds, after not borrowing on the open market during the prior four years. The amount of this debt and the length of time that this debt has been outstanding has increased over the last four fiscal years.
- The State is currently at its constitutional limit for short-term borrowing.
- Since FY2002, the General and School Aid Funds have increased their reliance on borrowing from other state funds to meet their daily cash needs. The amount of "manageable" common cash at Fiscal Year-end 2006 was at its lowest level, $861 million, since FY1992.
- In FY2007, the state will pay $66 million in interest on borrowing to meet its cash needs, a net change of over $200 million from FY2000 when it earned interest on its major fund cash reserves.
- In April 2007, the State changed the timing of monthly school aid payments to avoid a projected cash shortage on Friday, May 18th.
- The present cash situation limits the solutions available to policymakers confronting current-year budget deficits to those that have positive cash flow effects.

The State's action to permanently change the timing of school aid payments was necessitated by the deterioration of state revenues during the first half of the fiscal year and the lack of a full solution, to date, to balance the FY2007 General Fund/General Purpose (GF/GP) and School Aid Fund budgets. From a longer-term perspective, this move is emblematic of Michigan's structural budgetary problems. Specifically, policymakers have allowed annual operating expenditures to exceed the level of on-going revenues in the GF/GP and School Aid Fund since FY2001. The operating deficits within these portions of the budget have eroded the State's cash position and increased the reliance on assorted short-term borrowings to meet daily cash needs.

Action taken to head off the potential cash shortfall in May does nothing to permanently address the accumulated cash deficit facing the State. The accumulated cash deficit must be addressed in tandem with solutions to the overall budget deficit. Resolving these deficits can be accomplished by: 1) raising taxes, 2) reducing spending below the level of on-going revenues, or 3) some combination of these two options, with at least part of the resulting additional tax revenues or "savings" held in cash reserve to liquidate the

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cash deficit. Continuing to rely on temporary fixes without taking the steps necessary to permanently alleviate the cash deficit further jeopardizes the state's monthly bill-paying ability. Given the size of the accumulated cash deficit in the General and School Aid Funds and the available resources to finance the deficit, the current situation represents the most significant cash shortage since the adoption of the 1963 Michigan Constitution and the State's modern tax structure. The current cash deficit did not develop over night, but grew gradually over the period FY2002 through FY2007. An immediate solution to the problem is unlikely, but will require a multi-year approach consisting of a combination of additional revenues and significant spending restraint.

Cash versus Budget Deficits

The State of Michigan requires cash to pay its obligations, which are authorized pursuant to appropriation. These include employee salaries and payments to local governments, colleges/universities, school districts, medical providers and others. State government finances are not structured in such a way that there is an exact balance between the timing of the collection of receipts and the timing of state payments each month. This incongruence can result in an imbalance in the state's cash position on a daily basis. While the Michigan Constitution mandates that over the full course of a fiscal year revenues and expenditures are to be balanced, during various times throughout a year the level of obligations in a specific fund may exceed the level of cash available in that fund to liquidate the obligations, resulting in a cash shortfall. Recently, this has been a common occurrence in the General Fund (general purpose and special purpose) and the School Aid Fund, the state's primary operating funds. These two funds are considered together for cash flow purposes because portions of certain major taxes flow into both funds and school aid payments are satisfied from both.

The state's balanced budget requirement does not, by itself, prevent the accumulation of a cash deficit. "Balance," in the context of the constitutional provision, is not required in terms of the state's cash dealings, receipts and payments, but in terms of the revenues and expenditures that occur over an entire fiscal year. The distinction between these two sets of terms, receipts/payments and revenues/expenditures, is not insignificant and can be the source of some confusion, especially in light of Michigan's current "budget crisis." Although Michigan has taken the necessary steps to balance its budget each year from FY2000 to FY2006, and is fully expected to do the same in FY2007, the combined year-end cash balance in the General and School Aid Funds has gone from $1.6 billion to negative $1.3 billion over this same period, a net swing of nearly $2.9 billion (See *Table 2* on page 4). Without specific actions to address the mounting cash deficit, Michigan has been forced to carry over this deficit each of the last four fiscal years.

The apparent contradiction between the requirement to have a "balanced" budget and the presence of a cash deficit in the State's two major funds can be explained by the accounting principles under which the budget operates. Accrual accounting requires that revenues and expenditures designated to a specific fiscal period are recorded when they occur, regardless of the timing of the related cash flows. As a result, revenues and expenditures reported for a specified fiscal year can generate future cash flows. For example, some state revenues received in October and November accrue back to the previous fiscal year; however, the revenues are recorded as cash receipts in the year in which they are received, i.e., the next year.

Revenue Shortfalls

While a structural imbalance between School Aid Fund cash receipts and payments accounts for the accumulated cash deficit, the immediate cash flow problem in the Fund can be attributed to weak revenue performance in general and, specifically, the level of Sales Tax receipts. School aid spending for FY2007 was premised on the revenue projections agreed to in May 2006. As a result, the level of monthly cash disbursements are determined based on these expected revenues. By summer 2006, there were clear signs that the revenue projections for this year were falling considerably short, as Sales Tax receipts during the last quarter of FY2006 significantly underperformed. At the January 2007 revenue conference, Sales Tax estimates for the current year were adjusted downward by over $226 million in total from their original estimate, with the School Aid Fund absorbing over two-thirds of the reduction. At the May 18 revenue estimating conference, current-year school aid revenue estimates were reduced further. Total School Aid Fund resources are now expected to be $475 million below the level used to build the current-year school spending plan. The negative effects on cash resulting from the revenue shortfalls have been compounded by the level of school aid spending that occurred prior to the revised revenue estimates in May. By this time seven of the 11 monthly state school aid payments already had been made based on the May 2006 estimates.

To date, sufficient legislative action has not been taken to correct for the full extent of the projected revenue shortfall this year, either in terms of spending reductions or revenue increases. The lack of the requisite actions to balance the State's cash needs with available receipts threatens Michigan's bill-paying ability during the remaining months of the fiscal year (see *Table 1*).

Table 1
Lowest Level of Manageable Common Cash by Month: FY2006-FY2007 (millions of dollars)*

	Fiscal Year 2006	Fiscal Year 2007**	Difference
October	$ 970.9	$ 1,077.2	$ 106.3
November (1)	812.2	1,101.0	288.8
December (2)	2,268.0	1,074.2	(1,193.8)
January	2,115.2	1,248.0	(867.2)
February	1,119.2	1,185.4	66.2
March	483.0	64.2	(418.8)
April	327.0	32.4	(294.6)
May	833.9	(387.3)	(1,221.2)
June	743.1	15.1	(728.0)
July	570.7	(233.6)	(804.3)
August	357.8	(276.2)	(634.0)
September	276.2	(482.6)	(758.8)

(1) $1.3 billion in short-term notes issued in November 2005 (FY2006).

(2) $1.3 billion in short-term notes issued in December 2006 (FY2007).

* Manageable Common Cash includes the cash on hand in the General, School Aid, and Budget Stabilization Funds and Special Revenue, Enterprise, Internal Service, Trust and Agency Funds.

** FY2007 actual through March. Projected April through September and includes budget balancing actions through April. Does not reflect cash flow effects resulting from the change in timing of school aid payments and other cash flow adjustments beginning in May.

Source: Michigan Department of Treasury, Bureau of Bond Finance.

Loss of Cash Reserves

The State has experienced a significant and rapid depletion of its cash reserves since the end of FY2000. Reserves were built up in the General Fund, School Aid Fund and the State's rainy day fund as a result of robust tax collections during the latter half of the 1990s. Going into FY2001, the combined cash reserves in the major funds totaled $2.9 billion. As Michigan dipped into a recession in the early part of the decade, and state revenues flattened out, these reserves were relied upon to support state spending at levels to which policymakers were previously accustomed. Although some spending cuts played a role in "balancing" the budget, state government was able to sustain sizable operating deficits in the GF/GP and School Aid Fund as a result of the use of these reserves and other one-time resources. The effects of major tax cuts combined with the failure of Michigan to participate in the larger national economic recovery have prevented Michigan from replenishing the fiscal reserves used to support spending earlier in the decade. As a result, Michigan's current cash situation is ill-prepared to deal with the state revenue effects that would accompany another national economic downturn.

By the end of FY2006, the combined cash balance of the General, School Aid and Budget Stabilization Funds was a negative $1.3 billion, a net change of more than $4.2 billion over a six-year period (see *Table 2*). By the end of FY2003, the entire $1.3 billion rainy day fund balance had been used up, chiefly to support spending in the General and School Aid Funds. These rainy day fund reserves played a key role in helping to manage the State's cash flow and decreased the level of short-term borrowing needed to sustain GF/GP and School Aid Fund spending.

The combined year-end cash balance of these funds has been negative since FY2003. In FY2006, the average month-end cash deficit (excluding note proceeds) in Michigan's major fund was $1.6 billion, up substantially from $660 million in FY2003. Without access to the reserves in these key funds, state government had to turn to other tools to help smooth out the timing differences between cash receipts and payments.

Table 2
Year-End Balances of Manageable Common Cash Components:FY2000 - FY2006 (millions of dollars)

Fiscal Year-End	*Combined General Fund/ School Aid Fund*	*Budget Stabilization Fund*	*Other**	*Total*
2000	$ 1,631.6	$ 1,264.4	$ 1,996.1	$ 4,892.1
2001	1,091.5	994.2	1,782.5	3,868.2
2002	454.7	145.2	1,776.3	2,376.2
2003	(490.1)	0.0	1,915.8	1,425.7
2004	(897.6)	0.0	2,077.2	1,179.6
2005	(856.4)	2.0	1,873.3	1,018.9
2006	(1,300.5)	2.0	2,159.3	860.8

* Includes Special Revenue, Enterprise, Internal Service, Trust and Agency Funds

Source: Michigan Department of Treasury, Annual Report of the State Treasurer

Michigan's Common Cash Fund

The state maintains a Common Cash pool, under the direction of the state treasurer, to hold the cash balances of various state funds and with the objective of maximizing the earnings of the cash balances held in the pool. Investments are made mostly in prime commercial paper. The treasurer also invests some surplus funds in short-term debt instruments of the United States government and certificates of deposit issued by in-state institutions. Most state funds within the pool either receive or pay interest on their cash balances; however, the treasurer has the authority to limit the amount of interest that a fund pays or receives. For those funds that do not pay or receive interest, the General Fund pays the interest expense or receives the interest income. With the approval and guidance of the state administrative board, the treasurer is authorized to transfer cash among most of the funds in the Common Cash pool in order to best manage the cash on-hand and to offset a cash shortage within a given fund. Generally, this internal inter-fund borrowing requires repayment with interest at a rate consistent with that earned by Common Cash investments, unless the level of interest paid by a fund is capped pursuant to state policy.

Financing the Cash Deficit

The Michigan Constitution (Article IX, Section 14) limits the amount of external borrowing to meet operating requirements to 15 percent of the previous year's undedicated revenues and requires repayment within the same fiscal year. This debt is backed by the full faith and credit of the State. The State has a long history of issuing short-term notes to meet its cash needs and has increased its reliance on this method in recent years, having issued notes in each of the last five years. The amount of notes issued and the number of the days that the debt has been outstanding has increased from FY2003 to FY2007. Prior to FY2003, Michigan last issued short-term notes in FY1998. The State is currently at its constitutional limit for short-term borrowing.

The State has four tools at its disposal to cover a cash shortfall in the General and School Aid Funds;

1) borrow from other state funds within the Common Cash pool (see Box),
2) borrow on the open market,
3) change the timing of payments, or
4) change the timing of receipts.

The State is limited in the amount of borrowing it can do for cash flow purposes and when it reaches these limits, it has the option to change the timing of payments or receipts.

Although the State has intensified its use of external borrowing in recent years, this fact alone does not indicate a negative financial position of state government. When extraordinary sources of cash are needed to meet obligations, the use of this tool instead of internal borrowing can be financially advantageous to the State. Borrowing externally can be less costly to the State than borrowing from internal sources because the State is able to issue tax-exempt debt which typically carries lower interest cost than borrowing from other state funds. State cash reserves are largely invested in higher rate taxable securities (on which the State pays no tax). Also, the State can earn a return on those note proceeds not immediately needed for cash flow by investing in short-term taxable commercial paper (arbitrage). Furthermore, by issuing short-term notes to meet its cash needs, the State is able to invest its other Common Cash pool assets in higher-return securities rather than "investing" these resources in the State's General and School Aid Funds.

The treasurer employs two types of internal borrowing to meet the cash needs of the General and School Aid Funds. First, borrowing occurs between the State's major funds themselves, General, School Aid, and Budget Stabilization Funds. Prior to FY2003, the State relied upon the cash reserves of the Budget Stabilization Fund to help offset negative cash balances in the General and School Aid Funds. However, since the depletion of its rainy day fund, the State has relied more heavily on borrowing from other sources in the Common Cash pool.

The second source of internal borrowing is from other earmarked "special revenue" funds. Collectively, these funds have sizable year-end cash balances (see *Table*

2 on page 4), due largely to transportation-specific funds. Combined with the cash balances in the General, School Aid, and Budget Stabilization Funds, the cash resources in these special revenue accounts represent the total "manageable" common cash available to the state treasurer at any given point during the year. While other fund types also maintain balances in the Common Cash pool, the State has been hesitant to borrow from these reserves because of their fiduciary nature, e.g., retirement funds. Bond funds also maintain cash reserves; however, these resources are dedicated to finance specific capital projects and borrowing against them might not be viewed favorably by Michigan's creditors or Wall Street.

While the State has avoided borrowing from retirement and bond funds, it should be noted that state law directs the Treasurer to manage the dollars that are not immediately needed in a manner consistent with other cash reserves and there is no legal prohibition against borrowing from these sources. Faced with the prospect of further cash shortages, the State will have to consider borrowing from these funds in the future unless other solutions to Michigan's cash needs are implemented. To date, Michigan's inter-fund borrowing has been limited to the "manageable" portion of the Common Cash pool, a share that has been declining significantly due to the negative year-end balances of the combined General and School Aid Funds. At the end of FY2000, "manageable" cash represented 93 percent ($4.9 billion) of the total Common Cash balance whereas at the end of FY2006 it comprised just 62 percent ($861 million), due entirely to a cash deficit of $1.3 billion in major funds.

The cost of short-term borrowing to manage Michigan's cash flow has grown significantly since FY2000 (see *Table 3*). This growth reflects the increased reliance on borrowing, both external and internal, over the period. The State will pay an estimated $66 million in interest this year to finance its short-term borrowing, a cost that must be covered along with other budget obligations. This cost is in marked contrast to the earnings received when the state's major funds had sizable cash balances and received common cash interest earnings.

Another option available to manage the cash shortage is to modify the timing of cash receipts and payments into and out of these funds

Table 3
General Fund and Budget Stabilization Fund Interest Income /(Expense): FY2000 - 07 (millions of dollars)

Fiscal Year-End	Short-Term Notes Issued	External Borrowing (Expense)	Internal Borrowing Interest Income / (Expense)	Budget Stabilization Fund Interest Income	Total Interest Income/ (Expense)
2000	-	-	$ 63.3	$ 74.0	$ 137.3
2001	-	-	48.3	66.7	115.0
2002	-	-	(15.1)	20.8	5.7
2003	$1,248.0	$ (5.3)	(13.8)	1.8	(17.3)
2004	1,300.0	(9.2)	(14.3)	-	(23.5)
2005	1,275.0	(22.4)	(32.0)	2.0	(52.4)
2006	1,299.5	(36.7)	(21.8)	0.1	(58.4)
2007* est	1,306.9	(36.8)	(28.8)	0.1	(65.5)

* School Aid Fund will cover $22.8 million of the $28.8 million interest expense associated with interfund borrowing. Previously, the General Fund absorbed all borrowing costs associated with the School Aid Fund's cash needs.

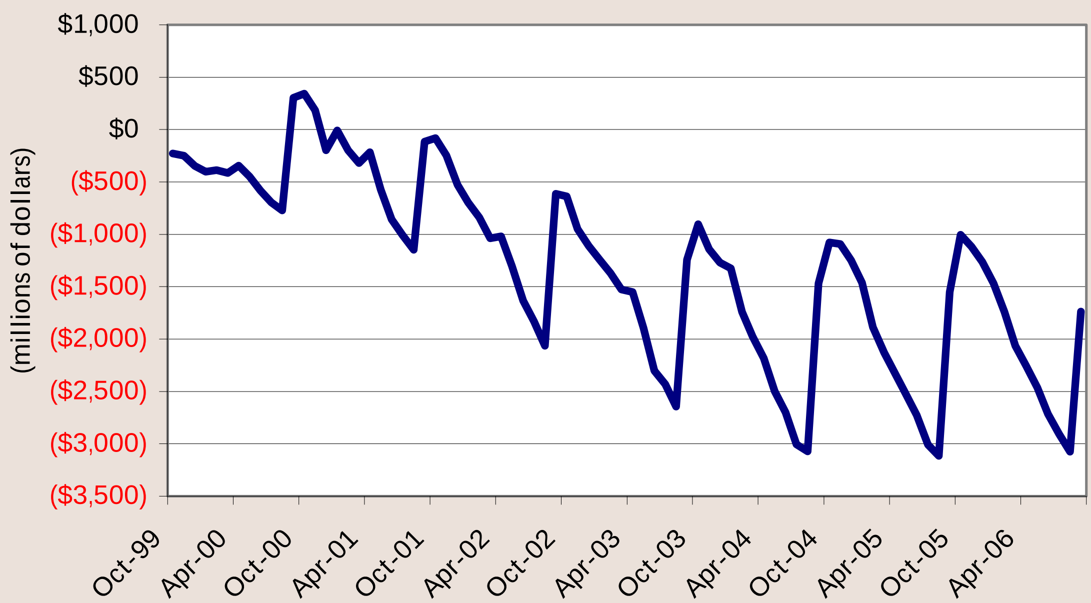
Source: Michigan Department of Treasury, Bureau of Bond Finance until there is sufficient cash on-hand to cover required obligations. This can involve advancing the collection of revenues or delaying the disbursement of payments, or some combination thereof. In April 2007, the State took action to avoid a potential cash shortage in May resulting from the timing of school aid payments by permanently changing the disbursement date of these payments when they are scheduled to occur on a weekend (from May 18 to May 21). Moving the disbursement from the previous Friday to the following Monday, will provide state government with revenues receipted on Monday to help cover the school aid payments that went out that same day.

On average, school aid payments represent about one-third ($1.0 billion) of the state's monthly cash obligations (October through August) and are a major contributor to the state's cash deficit in any year. This occurs because payments to school districts are made October through August; however, the dedicated revenues to support these disbursements do not flow into the treasury evenly on a month-to-month basis. By the end of August, the entire amount of school aid payments have been made, but revenues to entirely support these cash outflows have not been fully received. Major portions of earmarked taxes for K-12 education are not received until the end of the fiscal year, or in some cases during the early months of the following fiscal year.

Chart 1 shows the growing significance of the cash flow problem associated with the School Aid Fund. During each fiscal year, the monthly cash deficit of the Fund steadily increases from October to August, with an improvement in September, resulting from the lack of a state school aid payment. The year-end cash deficit in the Fund becomes the beginning cash balance for the following year, which must be financed through borrowing.

Postponing the scheduled May 18 school aid payment to May 21 avoided the State's immediate short-term cash problem, but did nothing to deal with the underlying cash problem. Furthermore, changing the timing of state payments is not a painless endeavor, especially for the recipients affected. In the case of school aid payments, the delay may not be as disruptive to districts that do not have an immediate cash need (pri-

Chart 1
Cumulative School Aid Fund Monthly Cash Deficits: FY2000 to FY2006



Source: Michigan Department of Treasury, Bureau of Bond Finance

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marily payroll) as it will be to those districts that have a scheduled payday. These districts will have to rely on their reserves (if available), borrow funds, and/or delay paying employees in order to absorb the fiscal effects resulting from the delay in their State payments.

Budget Actions and the Cash Deficit

State budget balancing actions have had mixed effects on the cash deficit caused by the timing of school aid payments and receipts. Michigan policymakers restructured monthly education payments (K-12 and higher education) in FY1999, increasing the number of payments from nine to 11 per fiscal year, which helped reduce the disconnect between monthly outflows and inflows in the School Aid Fund and mitigated the need for short-term borrowing.

Other actions have had negative effects on cash. The State's decision to advance the collection of the State Education Tax to the summer tax levy, effective 2003, contributed to an immediate cash problem in FY2003. This change, driven primarily by a desire to maintain previously-promised per-pupil funding levels, provided the budget with an additional $450 million in FY2003 revenues that, absent the change, would not have been available until FY2004. The modification further added to the structural imbalance between school aid payments and receipts that already existed. As a result, almost all of the tax (a little more than $2.0 billion) is received by the State late in the fiscal year (August and September) or in the first few months of the next fiscal year with accruals back to the previous year.

The State's chronic budget problems over the past six fiscal years have prompted policymakers to take extraordinary steps to bring both the General Fund/General Purpose and School Aid Fund budgets into "balance" on a regular basis. In some cases, the objective was to avoid fundamental changes to spending and revenue that are required to achieve long-term balance in both funds. The use of certain nonrucurring budget adjustments, while effective at attaining budget balance have had no corresponding positive effect on the state's cash position. In fact, by way of allowing policymakers to avoid aligning on-going expenditures with on-going revenues, certain budget adjustments have contributed to the State's weakened cash position.

As state policymakers face the challenge of fully resolving the current-year General Fund/General Purpose and School Aid Fund budget deficits and confronting further deficits in FY2008, solutions will require strict attention to Michigan's current cash needs. Responses that do not positively influence the State's immediate cash position will be difficult, if not impossible, to employ given the lows level of "manageable" common cash resources available to satisfy General and School Aid Fund obligations. Absent corresponding payment delays and/or changes that would advance the collection of receipts, both of which would have a positive effect on cash, the State will have to rule out those budget-balancing items that cause further deterioration in the cash position.