State Budget Notes

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Stabilized State Budget and Rainy Day Fund Deposits Improve State's Cash Position

Introduction

State policymakers recently made strides to improve the state's cash position and cash flow, including reductions to state spending and deposits to the state's rainy day fund. Actions taken to address the long-standing structural budget deficit have resulted in a marked improvement in the state's cash position compared to Fiscal Year 2007 (FY2007), when the State of Michigan had to restructure its monthly payments to local school districts to avoid running out of money.

While the state has improved its year-end cash condition relative to five years ago, it still has a long way to go before the cash situation looks like it did at the end of FY2000, when state coffers were sitting on $4.8 billion in reserves. Early indicators suggest that the state has erased the accumulated year-end cash deficit in its major funds - the first time since FY2002. With the key ingredients of a structurally-balanced budget and an improving economy in place, state policymakers should maintain their focus on the underlying cash position and avoid unnecessary actions that will have negative effects on cash. The upcoming FY2013 budget represents the next opportunity to build upon the improving cash position and prepare the state budget for future economic disruptions.

Genesis of the Problem

In a May 2007 *CRC Note*, the Citizens Research Council drew attention to the state's deteriorating cash situation. From year-end FY2000 to year-end FY2003, the state exhausted over $2.9 billion in its major funds cash reserves to support spending that exceeded ongoing revenues.[1] At the end of FY2006, the major fund cash balance was negative $1.3 billion, a net change of more than $4.2 billion over six years. The depletion of reserves and the development of the accumulated major fund cash deficit were borne out of Michigan's prolonged economic downturn. However, policy choices allowed the cash deficit to persist and prevented state policymakers from replenishing reserves.

Michigan's budget, like that of many other states, was negatively affected by the national recession in the early 2000s and the terrorist attacks of September 11, 2001, when state revenue growth slowed and demand for many state services continued or increased. While other states experienced recovery and more robust revenue growth coming out of the downturn in the early- to mid-2000s, Michigan did not. Instead, Michigan's economic and attendant budget troubles continued, unabated, for a number of years. At the same time that the Michigan economy failed to recover, state policymakers failed to take the requisite steps to adjust the state budget to align ongoing spending with revenues. While state budget writers made sure to achieve the constitutionally required annual budget balance each year, state officials never attacked the underlying structural deficit. Instead they let the problem linger as they relied on a series of actions to achieve short-term goals; never embracing the reforms needed for long-term, lasting balance between spending and revenues: either significantly reducing spending or raising taxes, or some combination thereof.

The cash problems arising from Michigan's structural budget deficit were exacerbated by policy choices, including changing the timing of receipts and payments. While Michigan's deteriorating cash position became a secondary concern of the governor and legislators, it did not for Wall Street and the state's creditors, as the state's credit rating was reduced multiple times in the 2000s.

[1] Major funds include the General Fund (general and special purpose revenues), School Aid Fund, and Budget Stabilization Fund, commonly referred to as the state's rainy day fund.

CRC

CITIZENS RESEARCH COUNCIL OF MICHIGAN

MAIN OFFICE 38777 West Six Mile Road, Suite 208 · Livonia, MI 48152-3974 · 734-542-8001 · Fax 734-542-8004

LANSING OFFICE 124 West Allegan, Suite 630 · Lansing, MI 48933-1738 · 517-485-9444 · Fax 517-485-0423

CRCMICH.ORG

Reversing Course

Aided by an improving economy coming out of the Great Recession, state policymakers have made efforts in recent years to improve the cash position. Perhaps the best indicator of success on this front is the amount of "manageable" common cash on hand to satisfy state obligations (See **Table 1**).[2] Although not yet approaching the strong cash position of the early 2000s, there has been steady improvement in the major funds year-end cash deficit since the low point six years ago. The deficit stood at $1.3 billion at the end of FY2006, but it declined to $372 million at the end of FY2010 (most recent final numbers). The unaudited figures for FY2011 suggest that significant progress has been made and the major funds cash position returned to positive territory for the first time since the end of FY2002.[3]

Table 1
Year-End Balances of Manageable Common Cash, FY2000 to FY2011 (Millions of Dollars)

Fiscal Year	General and School Aid Fund	Budget Stabilization Fund	Other*	Total
2000	$1,631.6	$1,264.4	$1,966.1	$4,862.1
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
2007	(1,004.4)	2.1	2,396.9	1,394.6
2008	(616.6)	2.2	2,088.7	1,474.3
2009	(762.3)	2.2	1,843.8	1,083.7
2010	(373.7)	2.2	1,742.1	1,370.6
2011**	1,012.2	2.2	NA	NA

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

** Estimated based on unaudited state financial report for fiscal year ending September 30, 2011

Source: Michigan Department of Treasury; Michigan Department of Technology, Management and Budget

Some of the improvement is credited to the October 2007 individual income tax rate increase (from 3.9 percent to 4.35 percent), which generated an additional $745 million for the General Fund in FY2008. Also, from FY2008 to FY2010, state spending from state resources was reduced from $28.4 billion to $25.3 billion, evidence of efforts to address the structural budget problem.

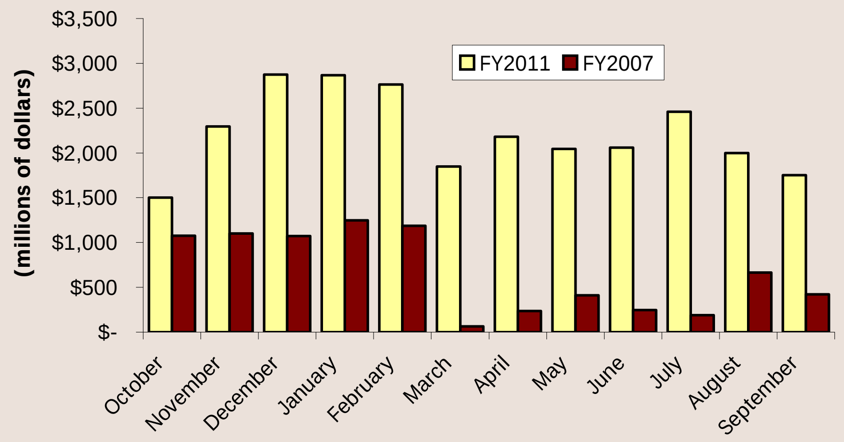
The total amount of manageable common cash on hand at the end of FY2010 was $1.4 billion, up from $861 million at the end of FY2006, when the state's cash position was the most precarious. However, the level of reserves is still far below what existed in FY2000 ($4.9 billion). At the end of FY2011, the major funds had just over $1 billion, compared to nearly $2.9 billion in FY2000.

[2] Manageable common cash consists of major fund (General, School Aid, and Budget Stabilization Funds) cash reserves and other, non-major funds. The majority of reserves from non-major funds are attributable to special revenue funds, such as transportation-specific funds. These resources are available to the state treasurer at any given point during the year to meet state obligations.

[3] As of mid February 2012, the state did not complete book closing and release its audited comprehensive annual financial report (CAFR); therefore, the final FY2011 cash figures for each grouping (General/School Aid Fund, BSF, other) are unavailable for this report.

Improvements are also apparent when monthly cash amounts on hand in FY2007 are compared to FY2011 (See **Chart 1**). On average, the monthly low averaged $660 million in FY2007 compared to $2.2 billion in FY2011. In FY2007, the monthly low ranged from just $64 million in March to $1.2 billion in January. In contrast, the monthly low in FY2011 never dipped below $1.5 billion (January). On average, the difference between the monthly lows of FY2011 and FY2007 was $1.6 billion.

Chart 1
Lowest Level of Manageable Common Cash: FY2007 and FY2011



Source: Michigan Department of Treasury.

The improvement in Michigan's manageable common cash position in FY2011 is one reason why state officials have not had to issue short-term notes in FY2012. Currently there are no plans to borrow externally to meet cash needs. Since FY2003, the state has borrowed from outside sources amounts close to the maximum permitted by the Michigan Constitution (15 percent of the previous year's undedicated revenues). In FY2011, $1.1 billion was borrowed mainly to help meet the cash needs of the School Aid Fund throughout the year (i.e., monthly payments to school districts). Each time the state borrows to meet cash flow needs, the full amount borrowed must be repaid, with interest, by the end of the fiscal year. The interest and issuance costs associated with external borrowing represent state resources that might be used elsewhere in the budget. Borrowing to meet School Aid Fund obligations throughout the year will still occur in FY2012; however, the state will be able to rely on its manageable common cash reserves rather than external creditors to satisfy payments to schools.

Major Funds Cash Deficit Erased

As noted previously, the improvement in major funds cash is largely responsible for the improvement in the state's overall cash position (See **Table 1**). While the cash deficit still existed at the end of FY2010 ($374 million), it was well below the peak of $1.3 billion at the end of FY2006. Preliminary year-end FY2011 figures indicate that the major funds deficit has been erased. The combined year-end cash balance of these funds has been negative since FY2003 and the last positive balance was FY2002.

The growing year-end balances in both the School Aid Fund budget and the general purpose portion of the General Fund budget have been a key contributor to the improvement

Table 2
Year-End Budget Balances in Major Fund Components, FY2010 to FY2014 (Millions of Dollars)

Major Fund Component	FY2010	FY2011*	FY2012**	FY2013**	FY2014**
General Fund/General Purpose	$187.2	$566.6	$541.9	$78.7	$10.4
School Aid	255.9	724.7	129.1	-	77.5
Budget Stabilization	2.2	2.2	261.1	395.8	395.8
Total	$445.3	$1,293.1	$932.1	$474.5	$483.7

* Preliminary based on unaudited FY2011 comprehensive annual financial report

** Estimates based on Executive Budget for FY2013 and FY2014

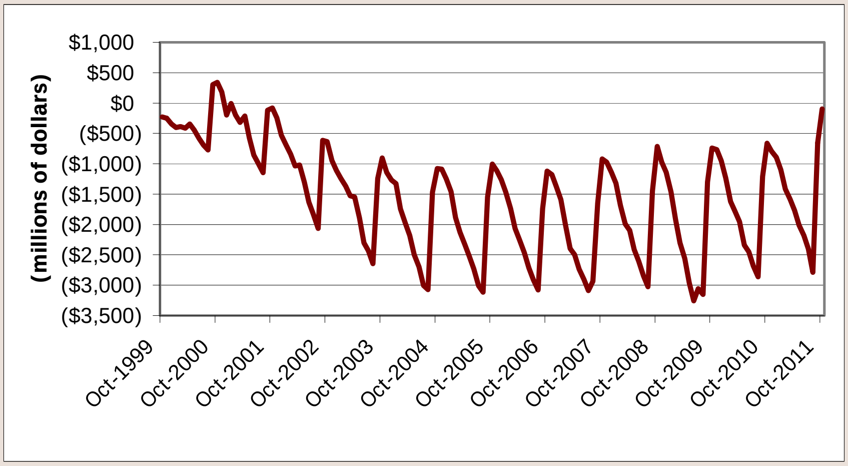
source: Governor Rick Snyder, Executive Budget for FY2013 and FY2014

in the major fund cash deficit through FY2011 (See **Table 2**). In both cases, year-end balances increased substantially from FY2010 to FY2011. In FY2012, a substantial portion of the School Aid Fund balance is designated to finance $456 million in one-time spending items. This one-time spending reduces the estimated year-end balance in the School Aid Fund significantly in FY2012, which will likely affect the combined year-end cash position of the major funds for the year. Similarly, nearly all of the General Fund's projected FY2012 year-end balance is committed to spending under Governor Snyder's FY2013 Executive Budget proposal.

On average, monthly school aid payments (eleven made from October to August) represent about one-third of the state's total monthly cash outlay. These payments are a major contributor to the major fund cash deficit in any year. The problem arises because the 11 monthly payments are fairly uniform, but the revenue does not flow into the treasury evenly on a month-to-month basis. Much of the dedicated revenues to support the school payments are received at the end of the fiscal year and there is no school aid payment made in September resulting in a sharp improvement in cash balances at the end of each fiscal year. The cumulative annual cash shortfall in the School Aid Fund resulting from these timing issues is presented in **Chart 2**. In each year, the cash shortage grows as the year progresses before improving (although still negative) right at the end of the year when there is no monthly payment and a major portion of the revenues are received.

The improving School Aid Fund cash flow picture is reflected in recent monthly lows (in August) in FY2010 and FY2011 that are smaller negative numbers than previous years. Also, the figures for the beginning of the year (October) are not as grim as in the past; the

Chart 2
Cumulative School Aid Fund Monthly Cash Deficits: FY2000 to FY2011



Source: Michigan Department of Treasury

negative $96 million in 2011 compared to a negative $662 million for 2010.

The FY2012 budget begins to rebuild previously depleted cash reserves in the state's rainy day fund; it contains a scheduled $256 million General Fund appropriation to the Budget Stabilization Fund. Assuming these funds remain in reserve through the end of FY2012 and are not diverted to finance state spending, the deposit will improve the major funds' year-end cash position. Governor Snyder's FY2013 budget recommendation calls for another deposit to the Budget Stabilization Fund ($133 million), which will increase cash reserves to nearly $400 million going into FY2014.

Summary

Often the "forgotten stepchild" of the state's financial picture, cash and cash flow are very important indicators of fiscal health. Throughout the annual budget debates of the 2000s, little attention was paid to the consequences (intentional or otherwise) that fiscal decisions had on the underlying cash position and the state's ability to meet its monthly obligations. Instead, policymakers and others mainly focused their attention on achieving annual budget balance, sometimes to the detriment of the state's cash position. Rarely did decisions positively influence the state's immediate cash position and often decisions did more harm than good to the state's overall fiscal health. As a result, substantial reserves were depleted and the cash position weakened throughout the last decade.

State policymakers are currently drafting a spending plan for FY2013. Improving national and state economies, along with sizeable estimated surpluses in the major funds going into FY2013, will create pressure to increase spending in areas of the budget that have experienced reductions over the years. While critical state and local priorities should and must be met, budget writers should exercise caution when committing budget surpluses. They should avoid designating these one-time resources for ongoing commitments, or risk jeopardizing the state's structural budget balance. The executive budget for FY2013 spends down the projected FY2012 School Aid Fund and General Fund surpluses mainly on one-time items, including a deposit to the rainy day fund.

Furthermore, state officials would be wise to ensure that financial decisions are not made that jeopardize the improving health of the state's cash position, such as tapping into the rainy day fund reserves. A strong case can be made that building up reserves to prepare Michigan for the next economic downturn would be a wise policy objective during the FY2013 budget development. The FY2013 executive budget includes a $133 million deposit to the Budget Stabilization Fund, which, if approved by the legislature, would bring the estimated balance to nearly $400 million at the end of FY2013. Clearly this is an improvement over recent experience and provides a positive signal to Michigan's creditors, but it represents less than one-quarter of the cash on hand that the rainy day fund had at the end of FY2000.