August 2020 | State Budget Note 2020-02

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The COVID-19 Recession Imperils the State's Cash Position

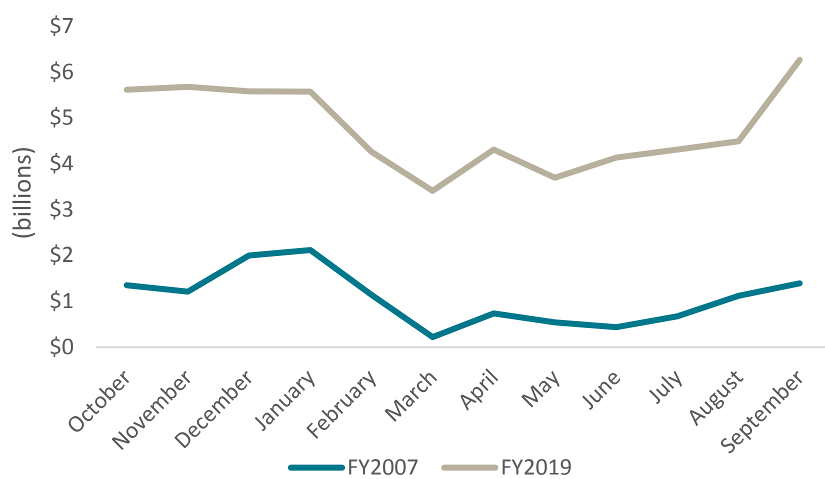
Key Takeaways

- After a decade of economic growth and policies focused on shoring up the state's fiscal health, including its cash flow, the cash position at the end of FY2019 was as strong as it had been for more than two decades.
- The state tax revenue losses arising from the current recession are creating short-term risks to the cash position.
- The approach state policymakers take to crafting FY2021 and FY2022 budgets will determine the long-term outlook for the state's cash position. Policymakers will be forced to balance the goals of maintaining a strong cash position and crafting on-going, structurally sound balanced budgets in the coming years.

The State of Michigan experienced considerable cash flow challenges, among other fiscal disruptions, throughout much of the mid-2000s. Maintaining positive monthly cash balances in its major accounts was a struggle. The state nearly ran out of cash to satisfy the monthly obligations of these accounts in 2007, before school aid payments were re-arranged to avoid a cash shortfall.[1] Over the past 10-plus years, the state's cash reserves have improved markedly.

Chart 1

Monthly Manageable Common Cash Balance, FY2007 and FY2019



Source: Michigan Treasury

This continued improvement has put the state in a stronger position to manage the monthly ebbs and flows of cash outlays (see **Chart 1**). This extra breathing room will undoubtedly prove critical in the coming months and years, as the state's fiscal picture is ravaged by the effects of the current recession. State tax receipts have plummeted while a number of state-financed programs are experiencing increased spending pressures associated with the COVID-19 pandemic. The recession is likely to affect the state's cash position immediately, but it will also have long-term implications. A pressing question facing state policymakers and budget watchers is whether Michigan made the appropriate fiscal decisions over the past decade to improve its cash position and avoid the problems experienced in mid-2000s?

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The State's Cash Position

Key indicators of a governmental unit's overall fiscal health, year- and month-end cash balances along with the timing of revenue receipts and expenditures (cash flow), often go unnoticed until a government is unable to pay its bills in a timely fashion. While much attention is given to a government's ability to maintain a balanced budget, equally important is the appropriate attention given to making sure it has sufficient cash available to meet its obligations when they come due. The credit worthiness of a government is invariably tied to its ability to manage its cash flow effectively and efficiently. Despite having a balanced budget at the end of a fiscal year, governments that struggle to meet monthly cash commitments generally have lower levels of reserves and typically have a mismatch between the timing of revenues and expenditures. Further, these entities are the most at-risk financially during economic disruptions.

The state's cash position reflects the balance of state funds at given points in time (it is usually measured monthly) throughout a fiscal year. It effectively shows the amount of "cash on hand" available to liquidate financial obligations arising from state appropriations. This is a core indicator of a state's fiscal health.

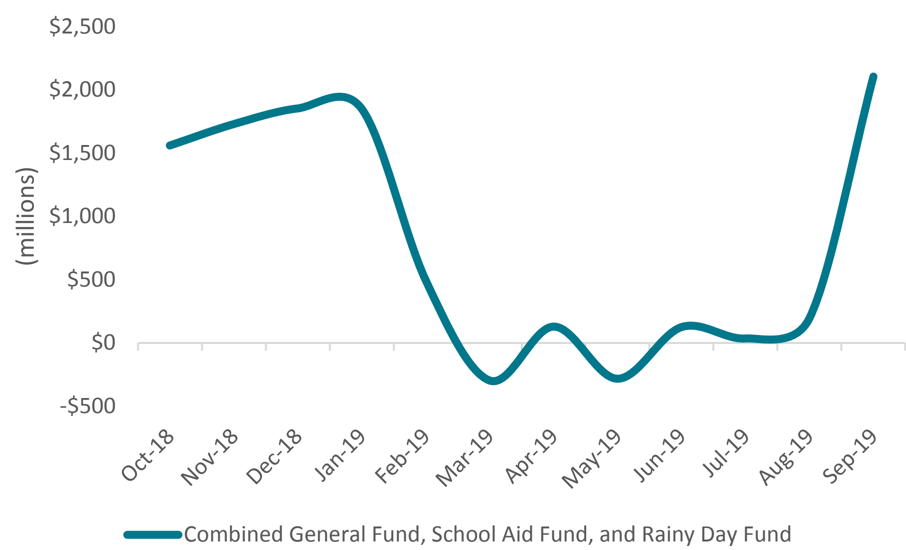
The timing of revenue receipts and expenditures does not always align to where the state has collected enough revenue in a given fund, or collectively across all funds, to cover all expenditures at a particular point in time. As a result, some state funds operate cash negative at times, requiring them to borrow from other state funds or from outside creditors to cover expenditures. This is another reason why maintaining a strong cash position is important; it allows the state to have money to pay the bills when a specific fund might be waiting on tax collections. In addition to inter-fund borrowing, the state can address a cash deficit through external borrowing: issuing short-term cash flow notes. The Michigan Constitution (Article IX, Section 14) allows the legislature to authorize the state to issue full faith and credit notes. This borrowing must be repaid within the same fiscal year and the amount is limited to 15 percent of prior-year General Fund revenue. [2]

The state has not borrowed money for cash flow purposes since FY2011. Generally speaking, this is positive and one sign that the state's overall fiscal condition has improved.

The state's major funds can operate with a negative cash balance and it is not uncommon for this to

Chart 2

General Fund, School Aid Fund, and Rainy Day Fund Combined Balance, FY2019



Source: Michigan Treasury

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happen, particularly for the School Aid Fund. In fact, in recent years the combined common cash position of the General Fund, School Aid Fund, and Rainy Day Fund were in the negative for portions of the year (see **Chart 2**).

In addition to the General Fund and School Aid Fund, other funds contribute to cash reserves. The State Treasurer manages the common cash pool and invests monies not needed to pay immediate obligations. The common cash pool includes reserves of most state funds, including special revenue funds such as the State Trunkline Fund, Lottery Fund, and many others.

By pooling cash balances, the state can reduce the need for short-term notes. The Treasurer manages a single account with significant funds rather than a multitude of accounts with limited balances. The performance of the funds that are invested to maximize investment earnings are tracked and credited to those funds eligible to earn interest (called participating funds).

While these accounts are separate, generally speaking, the Treasurer is able to use the balance of the cash pool to cover cash needs in each specific fund. The fund running a deficit is required to reimburse the money borrowed, as well as any interest that would have been credited to the participating funds accounts. This inter-fund borrowing can save the state money by limiting the costs arising from having to do external short-term borrowing to meet cash needs.

While the state has the option to borrow from other state funds to cover a cash deficit in a fund, it is not required to do so. In some cases, it can be cheaper for the state to borrow from external sources than engage in inter-fund borrowing to smooth out its cash needs because of the interest one fund must pay another fund.

Building Cash Reserves

Michigan's fiscal challenges throughout much of the 2000s and its responses to those challenges are well-documented. Annual state budget deficits in both major funds led to structural imbalances between on-going state revenues and approved expenditures in the General and School Aid Funds. Policymakers, faced with reduced tax receipts from a struggling economy, were unwilling to adopt long-term solutions to the structural imbalance between state revenues and spending, often relying on short-term, one-time budget patches to address more permanent fiscal problems.[3] In some years, this led to state budgets being passed after the start of the fiscal year only to be adjusted downwards months later. These budgetary problems were left unaddressed over a number of years and directly caused cash flow problems.

The state's deteriorating cash position, especially in the combined General and School Aid Funds, came to a head in 2007 when the state was forced to restructure monthly payments to local school districts to avoid a cash shortfall in the common cash pool.

Michigan's cash position has improved dramatically over the past 10 years. The state accumulated more than $5 billion in Common Cash reserves by the end of FY2016. Monthly cash balance never dropped below $3 billion in FY2019 (see **Chart 1** on page 1). Since FY2012, the state has been able to maintain year-end cash reserves of at least $4 billion, averaging approximately 23 percent of combined General Fund and School Aid Fund revenue.

Revitalization of the Rainy Day Fund contributed greatly to improvements in state cash position. The Rainy Day Fund, the state's savings account, is statutorily protected from use outside of economic downturns.

While the state maintained a balance of more than $1 billion in the Rainy Day Fund in the late 1990s, it exhausted that account quickly. From FY2000 to FY2002, the fund's year-end balance was reduced from $1.3 billion to $145.2 million, with the account reaching a $0 balance in FY2003. As a result of the state's financial woes, the state was unable to build the Rainy Day Fund over the next several years. When the state experienced cash flow issues in FY2007, the Rainy Day Fund balance was only $2.2 million.

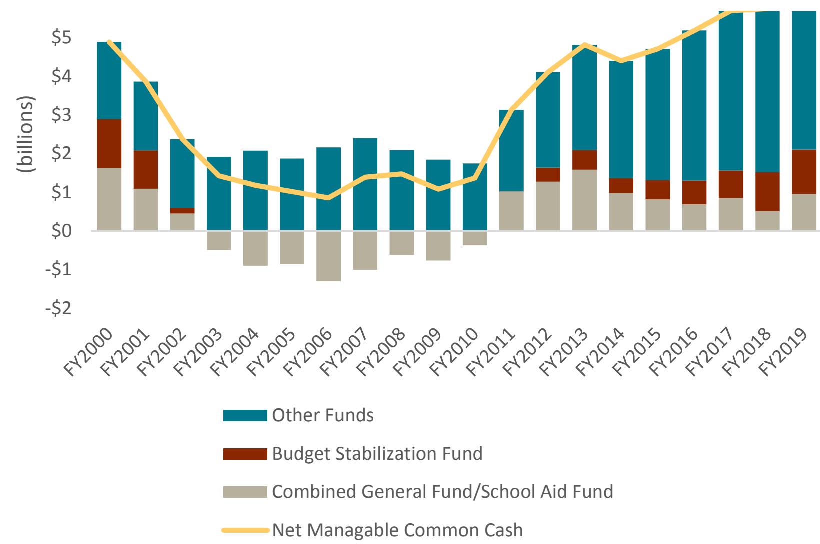
During the Snyder Administration, a concerted effort was made to bolster the state's savings, increasing the account from $2.2 million to $1.2 billion as of FY2019. The improved condition provided a buffer for managing cash flow, especially to meet General and School Aid Fund needs.

The Rainy Day Fund's steady recovery has helped improve the cash position; however, growth in combined General Fund and School Aid Fund cash reserves has not been nearly as steady. Year-end balances were higher immediately following the Great Recession (from 2008 to 2009), reaching a combined peak of $1.6 billion in FY2013. The two accounts have maintained smaller account balances than they had prior to the state's economic problems in the early 2000s. Rather than having a fairly balanced mix of funds supporting the state's cash reserves, as the state did in FY2000 (see **Chart 3**), the majority of the state's cash reserves are in restricted funds. The lack of cash reserves in the General and School Aid Funds accounts mean they are more vulnerable to economic crises and potential cash flow issues.

While some special revenue funds maintain a significantly larger balance than they did in the 2000s, the School Loan Revolving Fund is mostly responsible for the growth in year-end cash reserves. In FY2008, the School Loan Revolving Fund carried a year-end balance of $83.7 million; in FY2019, it was $1.1 billion.

Chart 3

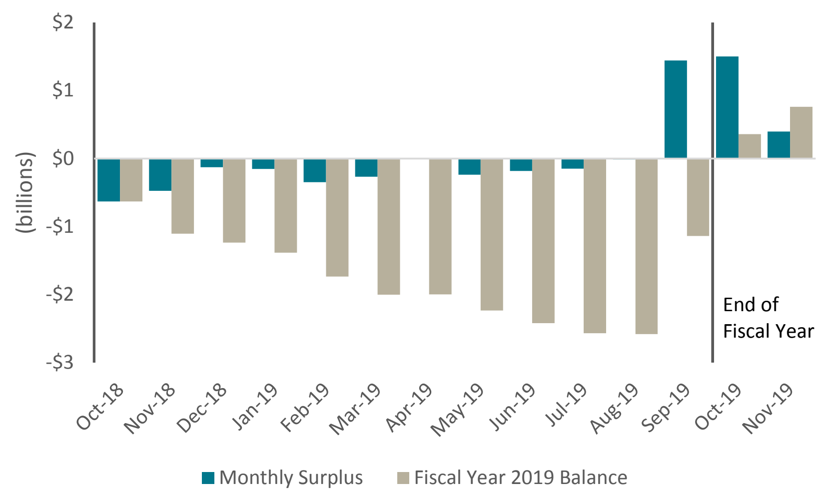
Common Cash Balances, FY2000-FY2019



Source: Michigan Treasury

Chart 4

School Aid Fund FY2019 Monthly Surplus and Cumulative Balance



Source: Senate Fiscal Agency

The timing of School Aid Fund receipts and payments is an important issue with the state's current cash flow schedule. The School Aid Fund makes monthly payments to local and charter school districts, except in September (the last month of the state fiscal year). A significant portion of School Aid Fund revenue in the first two months of each fiscal year is accrued back to the year prior; much of the revenue collected in these months is from taxes paid in the previous year.[a,4] Because of the School

a There is a natural lag in collection of sales, use, and income tax revenues and remittance to the state, but of more significance is the summer property tax levy. It is due September 15 and revenues are remitted to the state in October, but with accrual accounting those revenues are attributed to the previous fiscal year.

Aid Fund's unique cash flow schedule, the Fund has a negative cash balance for a significant portion of each fiscal year (see **Chart 4**). The School Aid Fund must do a considerable amount of borrowing from other funds to meet its cash needs beginning early in the fiscal year.

Risks

Coming into 2020, the state was in a much healthier position than during the previous two decades. At the same time, some risk factors remain, particularly with the relatively low year-end balances of the General Fund and School Aid Fund. The COVID-19 induced recession will put the improvements (and vulnerabilities) of the state's cash position to the test.

Short-Term Risks

The reduced economic activity in response to the pandemic disrupted many state revenue sources. As the state shut down much of economic activity, and businesses temporarily shuttered, many revenue sources slowed or disappeared, potentially lowering the state's cash on hand. In addition, the deadlines for a few major revenue sources were delayed, causing short-term reductions in cash flows. Some of the larger potential disruptions include:

Reduced Tax Collections. The short-term revenue picture due to COVID-19 looks fairly bleak. With significant reductions in sales due to retail closures, reduced income tax revenue with increased furloughs and unemployment, and declines in a litany of other tax revenues, COVID-19 hit the state budget hard and fast. The May 2020 Consensus Revenue Estimating Conference (CREC) projected deficits larger than $2 billion in FY2020 and FY2021.

Tax collections for April and May show how short-term revenue declines can impact the overall state cash position. Michigan collections for the General Fund and School Aid Fund were $1.48 billion, down 44 percent from the previous year.[5] That represents a $1 billion reduction in revenue compared to the previous year, some temporary in the form of delayed income tax payments (as discussed in the next section) and some permanent due to decreased economic activity. While the state did limit some spending as the crisis ensued but, by and large, annual expenditures have not decreased. This revenue reduction is significant from a cash perspective.

While revenues collected in May track closer with prior year collections, overall combined General Fund and School Aid Fund year-to-date revenue is down 15.9 percent ($300 million) from the prior year. This includes a 20 percent decline in sales tax receipts. These declines are only a teaser for what the state is expected to experience over the next several months, particularly if a second wave of the virus does hit the state.

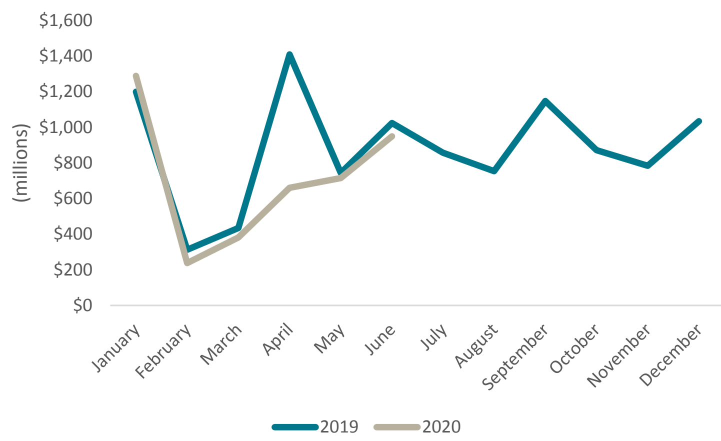
Until the state plan to balance the budget has been finalized and takes effect, these revenue declines will likely reduce the combined General Fund and School Aid Fund operating balance. Those budgetary changes could turn short-term challenges into long-term problems if:

- The plan reduces the year-end balance of these funds. If a budget agreement reduces the year-end balance, that will weaken the state's cash position and essentially serve as a utilization of one-time dollars.
- The plan uses Rainy Day Fund savings. Such a plan would lower one of the larger sources of the state's cash reserves, in an account that would be unlikely to recover quickly (more on this below). Or,
- State policymakers' efforts do not fully balance the budget. If spending reductions and revenue increases are not sufficient, and the state does not receive sufficient additional federal aid to bring the budget into balance, the General Fund and School Aid Fund could run deficits in one of the next few fiscal years, lowering the state's cash position.

Delayed Income Tax Deadline. The nascent recession and the policy decision to move the state income tax filing deadline to July 15 posed a short-term cash flow threat. The federal government took the lead in this space, delaying the filing date for annual income taxes from April 15 to July 15. Most states, including Michigan, followed suit and moved their tax filing deadlines.[6] Combined with a reduction in revenue due to decreased economic activity, state cash receipts for April were significantly lower than in previous years.

Chart 5

Net Income Tax Collections, 2019 and 2020



Source: Senate Fiscal Agency

Income tax withholdings are due to the state quarterly, but the annual filing deadline for individuals typically makes April the strongest month for collections. In April 2019, net income tax collections were $1.4 billion compared to just $661 million this past April (see **Chart 5**). Some of the decline relative to April 2019 could be due to a reduction in withholdings arising from the pandemic, but May 2020 collections show that income tax collections stayed relatively consistent with 2019. The majority of the reduction is likely due to the delayed income tax deadline and will result in a temporary cash flow disruption through July.

Transportation-Related Revenue and Cash Flow Problems. Delays in motor vehicle registration deadlines and loss of significant fuel tax revenue could create a reduction in the state's available cash-on-hand. Vehicle registration and fuel tax revenue is deposited into the Michigan Transportation Fund (MTF), a special revenue fund that represents a sizable component ($765 million) of the common cash pool. With the shutdown of Secretary of State locations, the state delayed registration requirements for many drivers for months, thereby pushing back the date of revenue collection. This delay could pose a cash flow issue by limiting dollars in the MTF.

Fuel tax collections also dropped considerably with the crisis; in March, when the state issued the stay at home order, fuel tax collections were down 20 percent from the previous year.[7] Unlike the cash flow issue relating to registration, this revenue is permanently lost; with less money than projected, the MTF could carry a lower balance moving forward.

Short-Term Outlook. The state is set up relatively well to survive the short-term cash flow issues caused by changes in tax deadlines. The last decade-plus of fiscal improvements has put it in a position where delays in income tax and vehicle registration payments were unlikely to create a larger problem.

In addition, the state received significant dollars from the federal Coronavirus Relief Fund. While the significant funding allocated to Michigan could not be used to address budgetary woes, the funds provided an influx of cash into the state's common cash pool.[8]

The larger concern lies with the short-term revenue losses. The stark state revenue declines projected for FY2020 and FY2021 increase the prospect for cash flow problems in these funds. As the state pieces together a balanced FY2021 budget, the decisions made could set the stage for longer term cash flow issues. These decisions can directly affect the state's ability to meet monthly cash obligations.

Long-Term Risks

Some long-term effects of the recession could begin to chip away at the state's cash position but are likely to be relatively minor.

Decline in Major Fund Balances. A sharp decline in year-end fund balances is the most apparent long-term effect to Michigan's cash flow due to COVID-19. In January 2020, prior to the COVID-19 crisis, the Senate Fiscal Agency estimated that the combined General Fund and School Aid Fund balance at the end of FY2020 would be $975 million, and was projected to reach $1.3 billion at the end of FY2021.[9]

Those would have represented the highest year-end balances since FY2013.

After the May 2020 CREC, the estimated year-end balance was negative $2 billion for FY2020, and negative $3.4 billion for FY2021.[10] While those deficits must be addressed because of Michigan's constitutional balanced-budget provisions, the solution will focus primarily on bringing balance back to the state rather than restoring the previously projected balances. As a result, the General Fund and School Aid Fund will likely have little to no year-end balance over the next few years. That means no reserves to rely on to meet monthly cash demands when revenues do not align with spending.

The Rainy Day Fund balance also is expected to decline over the immediate term. The initial budget agreement from June included the use of $350 million in Rainy Day Fund savings. While there is currently no projected automatic pay-out for FY2021, and there is a projected pay-in for FY2022, the legislature has the ability to change the conditions for pay-outs and must authorize pay-ins. Policymakers could look towards the Rainy Day Fund to help balance the budget beyond what current statute allows.

Over the long-term, the decline in the Rainy Day Fund will be one of the more important questions for overall state liquidity. Much of the state's improved cash position was due to an increased state savings account. If that account is exhausted like it was in the early 2000s, it could weaken the state's cash position more seriously than most other choices.

Potential Reduction in Other Fund Balances. Large reductions in major fund balances are likely, but a significant portion of the state's cash reserves belong to special revenue funds. These funds account for $3.3 billion, including the School Loan Revolving Fund ($1.2 billion), the State Trunkline Fund ($765 million), the 21st Century Jobs Trust Fund ($333 million), the Comprehensive Transportation Fund ($205 million), and the Michigan Transportation Fund ($102 million).

During previous recessions, these funds' cash positions declined. In the early 2000s, cash declined by 11 percent and a similar decline occurred during the Great Recession, when the year-end balance declined 23 percent from FY2007 to FY2009.

The revenue sources for some of those funds (particularly the transportation funds) have been hit relatively hard with the closing of portions of the economy. Fuel tax revenue, which makes up a sizable portion of revenue for the State Trunkline Fund, dropped by more than 20 percent in March alone. While the reopening of the economy will likely help stabilize collections, fuel tax collections for April and May experienced declines. With lower-than-projected revenue, transportation-related funds could carry smaller balances in the common cash pool until (or for a short while after) revenue recovers.

Second Wave and Other COVID-19 Risks. The uncertainty surrounding how the economy will recover from the current COVID-19 recession poses another risk. While it certainly is possible that the worst is behind us, and the state and country will continue to reopen and recover, other scenarios remain. The potential for a second outbreak, or elongated stay-at-home style protections, could extend the effects of many of the short-term revenue issues.

Potential Budget Woes. A major contributing factor to the FY2007 cash position crisis was due to poor management of the state's budget woes. Over the first decade of the millennium, Michigan struggled with structural deficits and falling state revenue. As a result, the health of the state's cash position took a backseat to other budget concerns, and threats were ultimately ignored until the cash position was at risk of going negative.

The current fiscal crisis has the potential to create a similar budget focus for policymakers. It would be a myopic approach to maintaining budget balance through a series of one-time or non-recurring fiscal interventions. With projected deficits in the billions for FY2020 through FY2022, divided government, and a General Fund budget that was already facing a number of challenges in the next few years[11], a lot of attention will be paid to how the state balances the budget. Finding the right mix between spending cuts, revenue increases, Rainy Day Fund dollars, and federal assistance will be necessary to maintain structural balance over the long-term; otherwise, the state risks falling into the same trap it did in the early 2000s.[12]

Long-Term Outlook. There is significant uncertainty when projecting the economics of the current recession. The state is set up to possibly maintain a strong cash position through the recession, but policy choices made in the coming years will play an important role in maintaining the state's cash reserves.

A reduction of the overall common cash pool balance is likely; many funds will experience short-term declines and limit the available cash on hand. These changes are not an immediate concern in creating a cash flow problem. A second wave of the virus, and the economic effects that come along with it, could create other short-term issues, but the changes in revenue are unlikely to create a cash flow crisis.

Problems are more likely to lie in how the state approaches budget challenges associated with the recession. The use of the Rainy Day Fund poses a longer-term issue; if the state exhausts those resources, it could weaken the state's cash position over the long term. Additionally, policymakers must tread carefully to not balance the state budget using one-time gimmicks as they did in the early 2000s. Those decisions directly led to the state's cash position crisis in 2007; current leaders should use that as a lesson when determining how to resolve today's budget imbalance.

Conclusion

The emergence of the COVID-19 induced recession demonstrates the importance of the state's improvements in cash position. Had the state not stabilized its cash position over the last decade, Michigan may, like other states, be facing an overall cash deficit as well as a budgetary deficit. Instead, considerations of the state's cash position have been put on the back burner relative to balancing the FY2020 and FY2021 budgets.

The state may not be at risk of an immediate cash shortfall; yet that does not mean policymakers should ignore considering how their actions could impact cash flow. COVID-19 will weaken the state's cash position temporarily as any recession would; and significant uncertainty remains. The resiliency built in the state's cash reserves over the last decade should be sufficient to last through the recession. As long as policymakers make responsible choices in response to the current economic downturn, Michigan should not be at risk of a cash deficit due to the recession.

Endnotes

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