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DR. GERALD FAVERMAN, Chairman GERRIT VAN COEVERING, Senior Consultant CHERYL PARISH, Editor

Michigan's Cash Flow Position:

An Update

From 1974 to 1982 Michigan state government chronically overspent its income. Cash outlays exceeded cash receipts in the state's key funds, requiring reliance on internal and external borrowing, use of questionable accounting practices, and budget cuts. A fiscal recovery plan has arrested or reversed many of these practices, but continued fiscal progress is threatened by demands for immediate phaseout of the income tax increase and plans to divert the additional 10¢ per pack levy on cigarettes. Until Michigan fully corrects past practices and establishes a sufficient cash balance to eliminate its annual refinancing of notes, it must remain vigilant in its effort to fend off demands that jeopardize the state's long-term interests.

I. Background

A major share of Michigan's overspending took place during recessionary periods when outlays rose for social support programs such as Aid to Families with Dependent Children, General Assistance, and Medicaid. These expenditures were necessary to help maintain income levels and offset additional damage to Michigan's economy. However, Michigan's constitution requires state government to maintain a balanced budget, to reduce expenditures whenever revenues are insufficient to cover spending commitments, and to repay any budget deficit in the succeeding years. As noted in earlier reports, this was circumvented by modifying government accounting practices to credit tax revenues prior to their receipt and to delay recording obligations until payment was made. These tactics nominally complied with constitutional requirements by creating the illusion of a balanced budget, but did nothing to halt a growing deficit. Bills cannot be paid from funds not yet

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KNAPP'S CENTRE • 300 S. WASHINGTON SQUARE • SUITE 401 • LANSING, MI 48933 • (517) 484-4954

TABLE 1

Available Cash Balances as of September 30 for General Fund, School Aid Fund, and Budget Stabilization Fund

($ in millions)

Year	General Fund	School Aid Fund	Budget Stabilization Fund	Total	Cash Balances as % of General Fund
1976	-$ 1.2	-$144.9	—	-$146.1	- 3.9
1977	+ 241.0	- 311.0	—	- 70.0	- 2.0
1978	+ 175.3	- 303.9	+$112.8	- 15.8	- 0.4
1979	+ 107.7	- 187.3	+ 235.1	+ 155.5	+ 3.6
1980	- 451.3	- 193.6	+ 266.8	- 378.1	- 7.8
1981	- 580.2	+ 4.1	+ 17.7	- 558.4	- 12.4
1982	- 418.6	- 205.0	+ 2.9	- 620.7	- 12.5
1983	- 257.1	- 225.9	+ 3.2	- 479.8	- 9.7
1984	+ 428.3	- 112.3	+ 3.5	+ 319.4	+ 5.9

SOURCES: **Annual Report of the State Treasurer**, various years, and **Budget Message of the Governor**, various years.

received, and spending obligations are payable even if they are not recognized.

To finance the cash deficit created by these accounting practices Michigan government relied on a combination of external and internal borrowing. The extent of this deficit may be gauged by examining the state's "key" funds -- the General Fund (GF), School Aid Fund (SA), and Budget Stabilization Fund (BSF). The General Fund supports state programs that do not have separate, dedicated sources of funding. The balance in the General Fund is influenced by spending requirements of the School Aid and Budget Stabilization Funds. By statute, the School Aid Fund receives net proceeds from the lottery and portions of the liquor, cigarette, and sales taxes. If these sources are insufficient to finance school funding commitments, the balance is taken from the General Fund. The BSF or "rainy day fund" draws from and contributes to the GF on a formula basis. Table 1 shows the cash balance in each of these three funds on the last day of each fiscal year going back to 1975-76.

In addition to using interfund borrowing to cover the cash deficiencies in the state's key funds, Michigan state government also relied on short-term external borrowing. Table 2 details, from fiscal years 1975-76 through 1984-85, the extent of the state's reliance on short-term debt.

II. Remedies

In May 1982 Michigan raised the state tax on cigarettes from 11¢ per pack to 21¢. The proceeds from the increase were deposited in the Working Capital Reserve Account (WCRA) and earmarked to eliminate accumulated state debts. It was also intended that proceeds from the increase be used to provide a sufficient cash reserve to eliminate the need for future short-term external borrowing. Less than one year later a temporary income tax increase was imposed to close an estimated $900 million budget deficit. The income tax increase also included a 0.25 percent surcharge dedicated to bring the state into conformity with generally accepted accounting practices and to help erase the accumulated debt.

TABLE 2

Comparison of Interest Payments on General Obligation Notes and Revenue to WCRA

($ in millions)

Fiscal Year	General Obligations Notes	Cost of Credit	WCRA	Interest Payments as % of WCRA Revenue
1975-76	$200	$ 5.227	—	—
1976-77	—	—	—	—
1977-78	200	3.026	—	—
1978-79	450	20.351	—	—
1979-80	500	32.122	—	—
1980-81	500	31.022	—	—
1981-82	500	69.495	$ 53.784	129.211%
1982-83	500	33.300[a]	115.292	28.883
1983-84	500	32.500[b]	114.742	28.324
1984-85	450	34.360[c]	115.900[d]	28.646

SOURCES: **Annual Report of the State Treasurer,** various years, and **State of Michigan: Executive Budget, Fiscal Year 1985-86.**

[a]Interest cost of $27.375 million plus 3.955 million for a letter of credit and $1.970 million in finders fees.

[b]Interest cost of $29.400 million plus $3.100 million for a line of credit.

[c]Interest cost of $32.700 million plus $1.660 million for a line of credit.

[d]Projected.

III. Results

By January 1985 Michigan had either repaid or reserved funds to repay $535 million of its accumulated debt.[1] Only one major accounting correction remains to be made, the recording of state income tax refunds as the liability is incurred rather than when refund checks are issued. This would be recorded on the state's accounting ledgers as a one-time cost of $764 million. With the additional 10¢ per pack cigarette tax generating an average of $9.7 million per month and the income tax surcharge producing $14.7 million per month, under current economic conditions Michigan will be able to make this accounting adjustment by December 1985. If the economy continues to expand, more people will be employed and subject to the 0.25 percent income tax surcharge. This will increase the revenue yield of the surcharge, boosting it to between $16.5 million to $17 million per month, and permit the adjustment to occur by November 1985 rather than December.

Complete correction of Michigan's accounting practices, however, does nothing to eliminate state government's dependency on external borrowing -- the approximately $500 million of general obligation notes refinanced every September. Refinancing occurs because article IX, section 14 of Michigan's constitution requires that short-term debts be repaid by September 30, the end of the state's fiscal year. Approximately $300 million of the $500 million obtained from the sale of general obligation notes is used to make the October school aid payment to local districts. The rest is used for other governmental programs. Although this amount was reduced to $450 million during the current fiscal year, to free

[1] Budget Message of the Governor, 1985-86 Fiscal Year, p.6.

the state completely from the need to borrow on a short-term basis, continuation of both the income tax surcharge and the 10¢ increase in the cigarette tax would be necessary for an additional 16-17 months. If the surcharge were eliminated and the cigarette tax increase left to do the job alone, it would take just under four years to raise sufficient funds.

The legislature is strongly inclined to eliminate immediately both the income tax surcharge and the income tax increase. Moreover, as the extra 10¢ per pack cigarette tax strengthens the state's cash flow position, a variety of special interests are already lining up in anticipation of the day this revenue will revert to the General Fund. Several strategies are being prepared to capture these proceeds for favorite programs and projects. None could be funded unless the increased cigarette tax revenue becomes available to the General Fund, which in turn is possible only if state government decides to perpetuate the short-term borrowing. Elimination of the short-term borrowing, consequently, would be met with strong vocal resistance.

IV. Future Considerations

Since the state has almost continuously relied on external funds to finance its cash flow needs over the past ten years, few are likely to notice or be concerned about the drain the associated interest charges place on Michigan's General Fund (see Table 2). This is a very shortsighted perspective, since the annual interest on these short-term borrowings amount to approximately $30 million, or about 29 percent of the receipts generated by the 10¢ per pack tax. Having to spend money for debt service means it cannot be used to fund services for Michigan's taxpayers or to reduce the cost of providing current levels of services. If state government had sufficient resources to meet its cash requirements without borrowing, not only would it save finance charges on borrowing, but it would also be able to invest these funds for weeks or months at a time and earn additional investment income to further offset government cost or finance expanded services.

V. Conclusion

Michigan's fiscal recovery plan has enabled it to make extraordinary strides in eliminating accumulated debt and restructuring its accounting techniques to conform to generally accepted practices. The very success of the plan, however, has made its architects sensitive to charges of overkill and to demands for early phaseout. While this is understandable in a political context, acquiescence to such demands is ill advised.

Even when the accounting revisions are completed early next year, Michigan must still provide sufficient cash reserves to obviate its need for annual short-term borrowing. This would provide a double benefit. In addition to eliminating a demand on the General Fund that conveys no benefit to taxpayers, a cash reserve could provide investment and income opportunities to reduce the cost of government or to finance additional services in targeted programs.