State Government Debt

BACKGROUND

To raise the funds necessary to finance expenditures, the state government of Michigan, like most large organizations, occasionally issues (incurs) debt. In some cases the state borrows directly from commercial banks, but the more common practice is to issue bonds and notes that are sold directly to investors. Although there are many ways to classify state debt, there are four general categories.

- *Short-term* In many years it is necessary for the state to finance the mismatch between the timing in expenditures and revenue by issuing short-term debt (usually called notes). For example, the state's payments to K–12 schools traditionally have been made in the first nine months of the state fiscal year, while the revenue that the state uses to pay for K–12 schools is collected over 12 months. This timing problem requires the state to borrow money that it repays as the balance of the revenue comes in. The state constitution limits short-term borrowing to 15 percent of undedicated state revenues (those not specifically "earmarked" for a given purpose) and specifies that the notes must be repaid within the same fiscal year. In recent years, the state has borrowed nearly $1 billion annually for cash-flow purposes.
- *General-obligation* The Michigan Constitution allows the state to issue long-term general-obligation debt, which is backed by a pledge of the full faith and credit of the state; i.e., the debt is the first obligation that the state must pay, and its repayment is guaranteed by the state's full taxing power. To issue state general-obligation debt, the constitution requires a two-thirds vote by the legislature and approval by the voters in a general election.
- *Revenue-backed* Sometimes the state issues debt without its general-obligation pledge but with the backing of a specific revenue source. For example, the Michigan Department of Transportation issues debt backed by gasoline tax and vehicle registration revenue. Another example is the State Building Authority, which issues debt to fund construction of state buildings; in this case the backing is the promise of annual state appropriations. Revenue-backed debt does not require a vote of the electorate.
- *Indirect* It is in this category that most outstanding state debt falls. Indirect debt is issued by a state authority in behalf of an entity other than state government. For example, the Michigan Municipal Bond Authority issues debt on behalf of local governments; the bonds do not have the backing of the state—they pledge only the revenue of the local government. The Michi-

GLOSSARY

General-obligation debt
Backed by the full faith and credit of the state and, in Michigan, must be approved by a vote of the people.

Indirect debt
Issued by the state in behalf of another entity (e.g., Michigan Municipal Bond Authority) and backed by that entity.

Revenue-backed debt
State-issued debt backed by a specific state revenue source (e.g., gasoline tax revenue) but not the full faith and credit of the state; need not be approved by the electorate.

Short-term debt (notes)
Used to cover cash-flow timing problems and repaid in the fiscal year in which is borrowed.

State of Michigan fiscal year
October 1–September 30.

gan Strategic Fund issues debt on behalf of private corporations, and the Michigan Hospital Finance Authority issues debt backed solely by nonprofit hospitals.

As the exhibit shows, all categories of state debt have grown during the 1990s (short-term debt is not included because the constitution requires it to be zero by the end of the fiscal year in which it is incurred).

- General-obligation debt rarely is issued because of the constitutional requirement for voter approval; thus, at year end FY 1995–96, outstanding Michigan generation-obligation debt totaled just $685 million. This category has grown fastest—264 percent from 1990 to 1996—but it started at a level much lower than revenue-backed and indirect debt.
- In contrast, revenue-backed debt totals $2.6 billion, and indirect debt issued by independent state authorities totals $8.9 billion.
- Of the outstanding indirect debt, the largest share has been issued by the Michigan State Hospital Authority—$2.8 billion at the end of 1996. Next are the Michigan Strategic Fund and the Michigan State Housing Development Authority, issuing $2.0 billion and $1.9 billion, respectively.

In total, direct and indirect state debt has grown by 56 percent since the start of the decade. In comparison, Michigan personal income grew 33 percent, and the state population grew 2 percent.

EXHIBIT 1. Outstanding Debt, State of Michigan (fiscal year end, millions)

	FY 1990	*FY 1996*	*Pecentage Change*
General-obligation debt	$188	$685	264%
Revenue-backed debt	1,600	2,558	60
Indirect debt	6,020	8,930	48
TOTAL	$7,808	$12,173	56%

SOURCE: Michigan Department of Treasury.

DISCUSSION

For state governments, debt is neither good nor bad; what is important is how the money is used. As a general rule, if the money is spent on long-term investment in the state's infrastructure (e.g., transportation systems), issuing debt is a sound way to equate for each generation of taxpayers the benefits and costs of a project. For long-term investments, taxes generated to pay for a project should match the useful life of the asset. For example, it is unfair to require current taxpayers to pay the full cost for constructing a building that will be used for many years. Issuing debt rarely reduces a government project's overall cost, but it is an efficient way to spread the cost across generations. Most economists believe it is sound public policy for government to issue debt to fund large infrastructure projects.

The problem is when a state issues debt to pay for current expenditures. If debt is financing an imbalance in a government's operating budget, to cover for revenue shortfalls (rather than simply to resolve timing problems, as described above), then to issue debt is to put an unfair financial burden on future generations.

Since the start of the decade, Michigan's general-obligation and revenue-backed debt has grown by $156 for every state resident. Some analysts believe that this growth is excessive. (They also point out that in just a decade, annual state short-term borrowing to fund the mid-year cash flow deficit has grown from zero to nearly $1 billion.) They assert that the several tax cuts enacted during the 1990s are being funded in part by issuing debt. Finally, some observers contend that any debt, regardless of the projects being financed, is inappropriate; they believe that current taxpayers never should leave unpaid bills for the future.

Many analysts argue a more subtle point against Michigan's current debt policy. The Michigan Constitution's drafters clearly were worried about excessive state debt, and they set out very strict restrictions on the state's issuance of general-obligation bonds. They hoped that requiring a popular vote before bonds may be issued would be an effective check on state debt. And, as the exhibit shows, Michigan's general-obligation debt remains very low, both in absolute terms and relative to other states. The exhibit also shows, however, an explosion in other debt, both direct and indirect. Some analysts believe that all debt bearing the state's name should require voter approval.

There is, of course, other opinion on each point. Some believe that the nearly 60 percent long-term debt increase since 1990 is justified if one examines it closely. First, the debt is being used for good purpose. Nearly one-third of the increase in general-obligation and revenue-backed debt has fulfilled the 1988 voter-approved environmental protection/recreation program. Because the state issues these bonds only after specific projects have been identified and are ready to be undertaken, of the $546 million in debt issued under this program, nearly all has been since 1990.

The next largest debt increase since 1990 has been for road and bridge construction. From 1990 to 1996, Michigan Department of Transportation debt rose from $482 million to $854 million. Some proponents of the state's debt policy argue that there are sound reasons for this and, in fact, the department has issued too little debt. They point out that Michigan's transportation- infrastructure needs are great, and the department's debt-service ratio (the proportion of future debt-service requirements to available revenue) stands at over ten times coverage, better than twice the national average.

Second, even with the increase in the 1990s, Michigan remains an overall low-debt state. According to Moody's Investors Service, Michigan's 1997 debt-to-personal-income relationship is 1.5 percent, ranking us 35th among the 50 states. Due in part to the state's conservative use of debt, in 1995 and again in 1998 Michigan received an upgrade in its bond rating to the highest in more than 15 years.

Many among the supporters of Michigan's current debt policy, however, concede that the state's cash-flow situation—resulting in the need to borrow nearly $1 billion each year to make mid-year payments—was unsustainable. However, legislation enacted late in 1997, as part of the settlement of the *Durant* special education lawsuit against the state, will eliminate most of the state's cash flow problem: Michigan traditionally has "front-loaded" its payments to school districts—that is, it disburses funds to the districts in the first nine months of the year but collects the revenue to pay for it equally over the full year, and this payment schedule was the major reason for the state's cash-flow deficits. The new legislation moves the payment schedule from 9 to 11 months, and specifies that the 11 payments will be roughly equal. As a result, it is possible that starting in 1999, the state no longer may need to borrow for cash-flow financing.

FOR ADDITIONAL INFORMATION

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