State Budget Notes

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Michigan's Weakened Financial Position and The Problem of Dual Deficits

In Brief

The incoming 95th Legislature will face the dual task of tackling a set of budget deficits brought about by the two primary forces: 1) a structural imbalance between on-going spending and revenues, and 2) the fiscal effects of the downturn in the national economy. While Michigan's structural budget problems have been apparent for some time (the CRC was the first to highlight this problem in 2001), policymakers have been reticent to take the necessary steps to bring the two sides of the budget into alignment. Failure to do so in advance of the current economic recession makes the job of addressing the cyclical budget obstacles all the more difficult.

Michigan State government finances enter calendar year 2009 ill-prepared to deal with the upheaval that the current recession is bringing. Whereas the State had amassed over $3.9 billion in major fund cash reserves to deal with the 2001 recession, today it faces an accumulated cash deficit of approximately $400 million that it must finance through internal and external borrowings. The balance sheet of the State's major funds has lost over $3 billion in fund equity since the end of FY00. Debt levels have nearly doubled during the same period, which adds to the annual interest costs of borrowing. State policymakers have three alternatives, or combinations thereof, to address the structural and cyclical budget deficits they face: Spending cuts, revenue increases, and one-time resources. It is critical that they select the appropriate method for each type of deficit.

The fiscal implications of each method must be evaluated in terms of their short- and long-term impacts on the three measures of Michigan's financial condition: the budget deficits (structural and cyclical), the balance sheet, and the cash position. Actions taken to address one of these concerns will not necessarily produce similar outcomes for the others and, in some cases there may be a completely opposite result.

Policymakers must break with past practice and avoid using budget solutions designed and intended for one set of fiscal problems to respond to the other type. Further delaying efforts to address Michigan's structural budget problems will compound these problems in future years. Strategies aimed only at achieving short-term budget balance in FY09 will add considerably to the longer-term, structural problems that will have to be confronted in FY10.

In June of this year, the Citizens Research Council of Michigan projected the size of structural deficits affecting Michigan's General and School Aid Funds (see *Michigan's Fiscal Future*, Report 349). These deficits did not occur overnight, but developed over a period of time dating back to the late 1990s. State policymakers have done very little to correct for the structural imbalances present in the two major budgets (General Fund/General Purpose and School Aid) supported by revenue from these Funds. The Citizens Research Council of Michigan estimates that, absent policy changes to address these problems, the State will face structural budget deficits averaging a total of $840 million from Fiscal Year 2009 (FY09) to Fiscal Year 2017. While policymakers have focused their attention on addressing annual budget deficits over the past eight years brought about by these structural imbalances, they have done so without regard to the overall financial condition of the State's finances. Many of the actions taken to achieve annual budget balance have contributed to ongoing deterioration of the State's financial health.

The State's structural budget problem is exacerbated by the current national recession. Recently

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revised revenue estimates for FY09 indicate that revenues will range between $420 million and $940 million below the May 2008 forecast, upon which the budget was based. While the current recession began in late 2007, five years after the end of the 2001 recession, some argue that Michigan never recovered fully from the earlier economic downturn. This provided little respite for Michigan State government finances and did not allow the State to rebuild the reserves requisite to weather the next recession. Tackling the fiscal challenges borne out of the structural and cyclical deficits will require Michigan policymakers to pay greater attention to the state's financial condition. In their efforts to craft budgetary solutions to these deficits, policymakers would be well-served by adopting the guiding principle *primum non nocere* ("first, do no harm") with respect to Michigan's fragile financial condition.

Status of Michigan's Current Financial Condition

As state policymakers embark on the dual tasks of balancing on-going revenues with expenditures and addressing the budgetary hurdles resulting from the current recession, they do so against a backdrop where Michigan's financial health is described as "failing", at best. This condition is a direct result of budget policy in recent years. Since FY01, state budget policy has focused on committing nearly all projected revenues to current or future spending and has ignored the overall financial condition of the State's major funds in doing so.[1] The financial health of Michigan's major funds can be assessed by examining three separate, but inter-related, measures: budget deficit/surplus, balance sheet, and cash position. Whereas annual budgets provide insight into the current condition of state finances, they reveal very little about the longer-term condition of government. A state's balance sheet and its cash position provide a much better picture of how a state is doing.

Year-End Balances. In evaluating the State's fiscal health, there is a tendency to focus exclusively on a single year of State operations. Most often this is done through the lens of the annual budget, which has ended each of the last eight years at or near balance. This approach fails to provide a long-term view of the State's financial position. The balance sheet provides this perspective. The balance sheet shows total state assets, liabilities, and fund balances at the close of each fiscal year.

Table 1 shows the year-end balances of each of the major funds from FY00 to FY07. Fund equity has declined in six of the last seven fis-

[1] The State's major funds are the General, School Aid, and Budget Stabilization (Rainy Day) Funds.

Table 1: Year-End Fund Balances (Dollars in Millions)

Fiscal Year	General Fund	School Aid Fund	Budget Stabilization Fund	Total
2000	$2,101.3	$985.6	$1,264.4	$4,351.4
2001	1,908.5	704.1	994.2	3,606.8
2002	1,777.1	241.9	145.2	2,164.1
2003	1,310.8	115.1	0.0	1,425.9
2004	1,169.8	74.1	81.3	1,325.1
2005	1,453.4	98.0	2.0	1,553.3
2006	1,069.2	7.4	2.0	1,078.6
2007	982.0	94.0	2.1	1,078.1

Source: Comprehensive Annual Financial Report, various

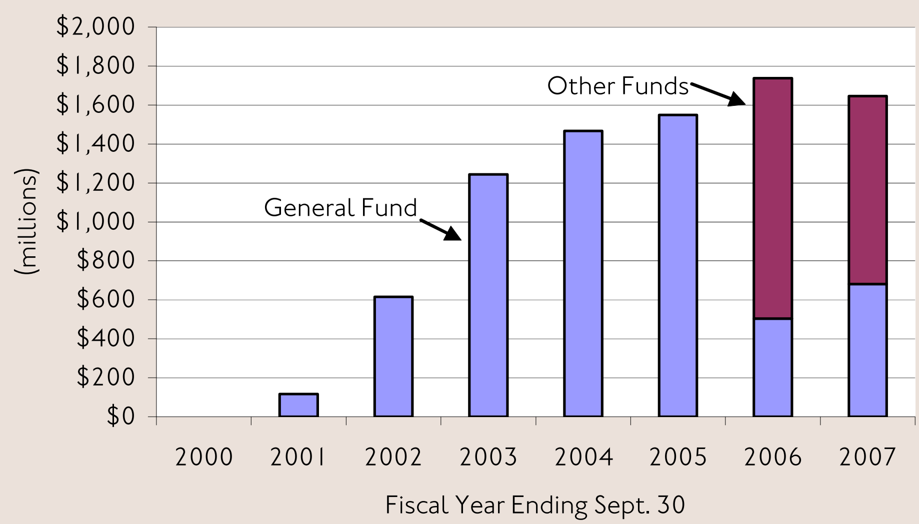
cal years (except FY05). Although state budget "balance" has been achieved in each of those years, it has occurred at a significant cost to the bottom line of the state's balance sheet. Major fund equity has declined by nearly $3.3 billion in total over this period. The General Fund's equity at year-end FY07 was less than one-half of what it was at year-end FY00. Over the same period, any measurable equity in the School Aid Fund (SAF) and Budget Stabilization Fund has been eliminated. The reserves in these major funds were used to weather the storm of the elongated 2001 recession (at least in Michigan) and were not replaced, leaving the "cupboard bare" for dealing with the current recession.

Amounts Owed to Other Funds. Many details are contained within the year-end figures that further illustrate the weakened condition of Michigan's finances. One detail that is not immediately apparent, but which is very significant to the long-term financial health of the School Aid Fund, is the degree to which the Fund "owes" other funds. **Chart 1** highlights the individual amounts due to other funds at year-end. The total amount has grown from zero to over $1.6 billion in FY07 and reflects the timing differences of SAF tax receipts and expenditures. As a result of exhausting its reserves, the SAF no longer has the cash on hand to satisfy immediate obligations and therefore must borrow from other funds. The chart does not represent appropriations to the SAF from the General Fund and others, but loans made to the SAF to provide sufficient funds to make payments to districts as scheduled.

Chart 1 also highlights a shift in the sources of SAF borrowing , specifically away from the General Fund to "other" funds. The weakened financial position of the General Fund since FY00 has required state financial managers to shift SAF year-end inter-fund borrowing to non-major funds, such as those dedicated to transportation purposes.

The amounts owed are recorded on the State's balance sheet as liabilities and represent borrowings from other funds to eliminate the negative SAF balance in the State's common cash pool. These amounts are further evidence of the growing long-term accumulated cash deficit in the combined

Chart 1
School Aid Fund Amounts Due to Other Funds



"Other" includes non-major funds, primarily transportation-related

Source: Comprehensive Annual Financial Report, various

General and School Aid Fund.[2] After the beginning of each fiscal year, the amounts due to other funds are effectively repaid with the proceeds from short-term general obligation notes, another form of borrowing. In other words, the State of Michigan exchanges one kind of IOU for another early in each fiscal year. The cash deficit highlights a growing long-term weakness in the SAF balance sheet. As the amount owed to other funds increases, so does the cost in terms of interest expenses.

The need for the SAF to borrow from other funds to end the fiscal year in a surplus does not, necessarily, reflect a weakness of state finances in the aggregate. In each of the last eight fiscal years, Michigan has had enough money to pay its bills; however, the SAF is able to achieve "surplus" status only by way of inter-fund borrowings. Dipping into the "other funds" is akin to a parent dipping into a child's trust fund in order to make regularly scheduled payments based upon a promise to repay the borrowing when sufficient cash is available.

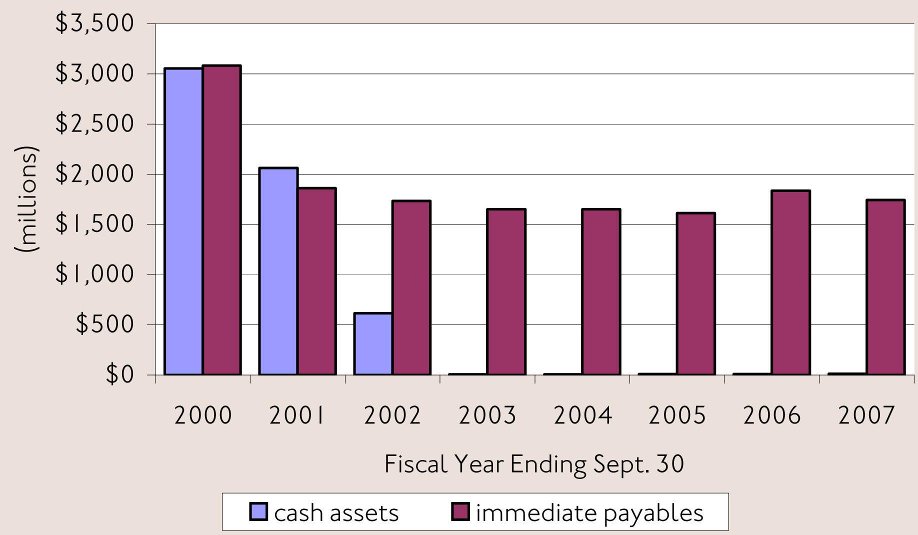
Cash Position. Cash is needed by state government to satisfy immediate obligations in the new fiscal year. If a sufficient level of cash is not available to satisfy a liability of the General/School Aid Fund, borrowing from outside sources has to occur. A single year "snapshot" of the year-end cash position provides little insight into the long-term financial condition of the State; however, examining the recent cash history does provide this perspective. In addition to providing resources to pay bills, the level of cash on-hand also indicates the degree to which the State can manage through the fiscal stresses caused by an economic downturn, such as the current one.

Chart 2 highlights the deterioration of the cash position of Michigan's major funds at fiscal year-end. The level of cash reserves in the State's major funds is measured against the level of immediate payables of these funds.

A preliminary estimate of Michigan's FY08 year-end cash

[2] These are two separate governmental funds; however, from the standpoint of the State's daily cash management responsibilities they are treated similarly. The School Aid Fund receives revenues directly from the same sources as the General Fund and school aid appropriations are satisfied by both funds

Chart 2
Year-End Cash Assets and Payables of Michigan's Major Funds



Source: Comprehensive Annual Financial Report, various

Table 2
Year-End Balances of Manageable Common Cash (millions)

Fiscal Year-End Sept. 30	Combined 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	(1,004.5)	2.1	2,396.9	1,394.5
2008**	(399.6)	2.1	1,998.7	1,601.2
2009**	(432.0)	2.3	1,876.4	1,446.7

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

** The FY08 and FY09 estimates for the combined are from the Official Statement that accompanies the 2009 general obligation notes, which contemplates $1.4 billion in short-term notes.

Source: Michigan Department of Treasury

position shows improvement over the year-end FY07 level. This is due entirely to improvements made in the combined General and School Aid Fund portion of the State's pooled or "manageable" cash resources (See **Table 2**). Despite the positive year-over-year change, the year-end position is still well below where it stood at the beginning of the decade, prior to the recession of 2001.

The total amount of manageable common cash at the end of FY08 is about $200 million above the year-ago level and $740 million above the FY06 year-end level. The combined General and School Aid Fund cash position went from negative $1.0 billion in FY07 to negative $400 million in FY08, which more than offsets the $400 million decline in the cash position of the other state funds. Although still negative, the combined funds' year-end balances have improved in each of the last two years, after declining each year since FY00.

The increase in the State's year-end cash position is due, in large measure, to the income tax rate increase (from 3.9 percent to 4.35 percent effective October 1, 2007) and the new Michigan Business Tax surcharge enacted as part of the FY08 budget deal. These increases helped shrink the structural gap between on-going revenues and on-going expenditures in the General Fund/General Purpose and School Aid Fund budgets. The income tax rate increase is expected to bring in an additional $744 million of income tax revenue to the General Fund in FY08 and $819 million in FY09. The MBT surcharge revenue, which will be shared between the General Fund and School Aid Fund, is expected to bring in $479 million in FY08 and $722 million in FY09. The tax increases (in the absence of a corresponding spending increase) have served a dual purpose by addressing both the structural deficits facing the General Fund/General Purpose and School Aid Fund budgets and the accumulated cash deficit in the major funds. While two tax changes increased the aggregate level of tax receipts in the current and future years, the particular combination did nothing to address the future growth path of state revenues, which remained below the projected growth in spending pressures.

Debt. The financial strains of the recent years prompted policymakers to increase the use of long-term financing to fund government services and projects. In some cases, debt was issued to provide needed resources to support on-going operations, such as the sale of future tobacco settlement revenues in 2006 and 2007. The amount of debt outstanding devoted to primary governmental operations at the end of FY07 was $8.2 billion, of which $1.5 billion was "full faith and credit" and $6.67 billion revenue-dedicated debt, such as transportation. This figure represents an 82 percent increase above the level of outstanding debt at the end of FY01 ($4.5 billion). Incurring additional debt requires greater annual debt service obligations, which can add to the State's cash flow problem.

Tackling the Structural and Cyclical Deficits

Three alternatives exist to deal with the budget problems presently facing Michigan's GF/GP and SAF budgets. These options can be effective for dealing with the structural problems, the cyclical problems, or both sets of problems.

- reduce expenditures
- raise revenues
- use one-time fixes (reserves, sale/lease of assets, accounting changes, etc.)

The fiscal implications of each method must be evaluated in terms of their short- and long-term impacts on the three measures of Michigan's financial condition: the budget deficits (structural and cyclical), the balance sheet, and the cash position. Although these issues are interrelated, they are not identical. Actions taken by policymakers to address one of these concerns will not necessarily produce similar outcomes for the others and, in some cases there may be a completely opposite result. Thus, any actions must be weighed against their effects on all of these issues.

Spending Cuts. Permanent expenditure reductions would meet all three fiscal criteria by reducing the budget deficits, improving the balance sheet, and improving the cash position. Governor Granholm recently issued and the legislative budget committees approved an Executive Order to reduce FY09 GF/GP appropriations by $134 million. The EO contained a series of programmatic spending reductions totaling $39 million, which, if continued in future years, would address the structural budget deficit in addition to helping to balance the FY09 budget. The permanent spending reductions included the closing of two prisons

Spending cuts that are the result of temporary conditions, although helping with short-run budget balance brought about by cyclical budget pressures, do little to solve structural deficits. The recent EO contained such short-term spending reductions premised on projected caseload declines in certain human service programs. If the caseload numbers rebound in future years, the underlying structural deficit is not addressed. Of course, if these caseload decreases become permanent because of policy or programmatic changes designed to control growth, then they will help with long-term budget balance.

Raising Revenue. General revenue increases are not being proposed at this time to deal with the budget imbalance. While general tax increases may be extremely unlikely, non-tax revenue increases might be considered. New or increased fee revenue was used frequently and to varying degrees over the past six fiscal years to support GF/GP appropriations in the State budget. Recent budgets have relied much less on these non-tax sources of revenue, presumably because of the 2007 tax increases. Also, revenue increases might be realized by way of broadening tax bases through the elimination of tax credits or exemptions.

Permanent revenue increases, whether in the form of tax or non-tax increases, also meet all three criteria: reducing the budget deficit, improving the balance sheet, and improving the cash position. The 2007 income tax rate increase is the most recent example of a revenue response to Michigan's budget deficits. The rate increase partially addresses the structural budget deficit; however, because of its structure, Michigan's income tax will not grow at a rate sufficient to keep up with the growth in future state spending pressures. Further, the planned phase-out of the rate increase will add to the long-term deficit.

One-Time Resources. The menu of one-time resources available to meet Michigan's budgetary problems is not nearly as expansive as it once was. The past use of $8 billion in non-recurring resources to maintain budget balance effectively reduced the options available to state policymakers to deal with today's challenges (See **Table 3**). Whereas the FY07 budget was based in good measure (over $1 billion) on the use of such resources, the revenue from the 2007 tax increases largely replaced these resources in the FY08 and FY09 budgets; however, some one-time fund transfers were included in those budgets.

To the extent that policymakers add to the amount of non-recurring resources used to maintain balance in the FY09 budget, the cyclical deficit is addressed but the structural deficit is ignored. Upon passage, the FY09 GF/GP budget was based on $139 million of FY08 reserves. Better-than-expected revenue performance in the last half of the year combined with a lower level of spending effectively increased the level of FY08 reserves to $440 million. To the extent that the additional $300 million is used to support FY09 spending, the current-year deficit is addressed but the structural deficit becomes larger. Use of these reserves does not affect the State's FY09 cash position, but it does worsen the long-term cash position.

Other nonrecurring resources frequently used in the past include one-time revenue transfers from the restricted portion of the General Fund to the general purpose portion of the General Fund in order to support current GF/GP spending. The FY09 budget does not rely much on such transfers, which help to balance only the current-year budget, but add to the structural problem. These transfers do not adversely impact current cash flows, but can pose challenges in the future if spending is not adjusted accordingly.

Table 3: One-Time Resources Used FY01 to FY08 (Dollars in Millions)

Rainy Day Fund	$1,363
FY00 School Aid Fund Surplus	984
FY00 General Fund Surplus	212
Medicaid Benefits Trust Fund	561
Advance State Education Tax Collection Date	455
Tobacco Settlement/Merit Award Revenues	324
FY03 and FY04 Temporary Federal Fiscal Assistance	655
Bond for Pay-as-you-go Capital Projects	211
Revenue Sharing Accounting Change	181
Refinance Bonds	295
Employee Wage Concessions	186
Tobacco Settlement Securitization	407
August 2007 Higher Ed Payment Delay	165
Retirement Fund Contributions	131
Other	$1,937
Total	$8,067

Federal Stimulus. Money from a federal stimulus package for state government is one type of non-recurring resource that undoubtedly will be employed for purposes of the FY09 budget. The incoming Obama administration has made clear that it will be proposing such a package for 2009. It is unclear in what form the package will come and how much it will mean to state finances.

Timing is also an issue. The 2003 stimulus package totaled $50 billion nationally and included two broad types of aid to help states manage budget shortfalls, unrestricted aid and Medicaid. Of the total, Michigan received $655 million over two years; however, the aid was received well after the conclusion of the national economic contraction and after actions already had been taken to maintain budget balance.

The fiscal stimulus contemplated for 2009 could affect Michigan finances on both sides of the budget ledger. Direct federal grants will add to other state revenues, while increased federal matching funds will decrease spending requirements from state sources. Similarly, federal fiscal stimulus in the form of tax rebates or cuts would generate additional economic activity in the state and thus enhance state tax revenues. The use of one-time federal resources to support on-going state expenditures can pose problems in out years, but the use of these resources to respond to temporary spikes in the demand for services (e.g., Medicaid, unemployment) is appropriate.

Other. Because of the vast differences in the type and form that non-recurring budgetary adjustments can take, it is impossible to state definitively what effects such actions will have on the three fiscal criteria. Generally speaking, the past use of non-recurring resources and/or accounting changes helped achieve temporary budget balance but did nothing to address the underlying imbalance between on-going revenues and on-going spending. Payment delays and accounting changes worsen the cash position and the condition of the balance sheet; however, the sale of assets (e.g., tobacco settlement revenue securitization) generally has a neutral to positive effect on state cash flow and balance sheet conditions.

Conclusion

Michigan policymakers enter calendar 2009 facing both structural and cyclical deficits. Ideally, they would work on these deficits independently of one another and employ those tools and budgetary responses appropriate to the challenges posed by the specific problem. However, given the immediacy of the problems they face and the constitutional requirement to maintain a balanced budget, they will have to tackle the deficits simultaneously. It is likely that solutions appropriate to deal with cyclical deficits will be relied upon to temporarily address the structural budget problem. Whereas extraordinary steps are usually reserved for dealing with the fiscal constraints resulting from an economic contraction, it is very likely that legislators will rely on such steps to address both structural as well as cyclical problems facing Michigan State government finances in FY09.

Policymakers must break with past practice and avoid using budget solutions designed and intended for one set of fiscal problems to respond to the other type. Further delaying efforts to address Michigan's structural budget problems will compound these problems in future years. Strategies aimed at achieving only short-term budget balance in FY09 will add considerably to the longer-term, structural problems that will have to be confronted in FY10. Further, budget solutions in the current year that, at a minimum, do little or no harm to Michigan's already fragile financial condition will make solving the structural problems less difficult.