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NEWS LETTER

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THE STATE'S BALANCE SHEET

The News Letter has withheld comment on the investigation of the financial condition of the State until the complete audit made by Price, Waterhouse and Company was before it. Now that this has been published in full, and the State Auditor has issued a supplementary formal statement, it lays before its readers an analysis of the situation, based on the facts shown in these reports, covering the following questions:

(1) Did the State, on December 31, 1922 (the date of the audit) have sufficient cash on hand to meet the expenses it had incurred up to that date? Has it sufficient cash on hand today to meet the expenses incurred since that date? In other words is the State being operated on a pay-as-you-go basis?

(2) What is the underlying principle of the cash or pay-as-you-go policy of financing, and of the accrual policy?

(3) If the State is not running at present on a pay-as-you-go or cash basis, when and how was the change effected?

(4) Is the accrual basis sound?

(5) On the basis of financing adopted by the State did the State, up to December 31, 1922, live within its resources?

(6) Is the State during the present period, that is, since December 31, 1922, living within its resources?

Report of the Auditors

The balance sheet submitted by Price, Waterhouse and Company shows the condition of the current general fund of the State on December 31, 1922, as follows:

Resources

Cash (overdraft, per contra)		$
Uncollected revenues (partly estimated)		4,730,915.54
Advanced to counties, recoverable: Principal	$243,070.00	
Accrued interest receivable	$11,382.87	254,452.87
Lapsed appropriations recoverable from other funds		211,532.50
Expenditures applicable to the half year ending June 30, 1923, prepaid		58,070.03
Total resources at Dec. 31, 1922		$5,254,970.94
Excess of obligations over resources at Dec. 31, 1922		477,194.75
		$5,732,165.69

Obligations

Cash overdraft	$2,189,970.49
Notes payable	2,764,744.00
Warrants payable	131,692.51
Miscellaneous accounts payable	112,133.75
Matured bonds unpaid	28,600.00
Matured bond interest unpaid	80,108.00
Provision for institutional deficits	51,000.00
Revenues applicable to the half-year ending June 30, 1923, prepaid	373,916.94
	$5,732,165.69

What the Audit Shows

This balance sheet shows that the State's obligations on December 31, 1922, amounted to $5,732,165.69 and that its resources on the same date amounted to $5,254,970.94. The excess, therefore, of obligations over resources constituted, on Dec. 31, 1922, a deficit of $477,194.75, say the auditors. Furthermore, under obligations against the general fund there was included by the auditors a note of $710,000 issued by the extra session of the legislature of 1921 to care for an accumulated deficit in the special school funds of the State when the method of financing the public schools was changed. It seems not to have been intended by the legislature that the note should be charged against the general fund, but the auditors have so treated it. If this note is not included, the State on December 31, 1923, had according to the auditor's report a surplus of resources over obligations amounting to $232,805.25.

Why, then, has there been such confusion in the public mind concerning the financial condition of the state? Simply because this statement of the auditors', like any similar statement of the condition of any corporation, can be interpreted from two different points of view, which again go back to two different policies as to how a state should be financed, namely the pay-as-you-go policy and the accrual policy.

It is very important, in understanding the State's financial condition, to keep clearly in mind these two different policies.

The Cash Basis

The theory underlying the pay-as-you-go policy holds that the State should operate on a cash basis; that it should conduct its finances as does a man who never buys anything until he has the actual cash in his pocket to pay for it. Naturally, no state can operate one hundred percent on that basis, as its revenues come in irregularly and its expenditures from its operating funds are continuous. But, under its former system of taxation, the State of North Carolina tried to approximate such a basis. That is, its main source of revenue was from taxes levied on property, which were listed in May and due in October of the same year. The cash to meet the year's expenditures under this system was for the most part supposed to be in hand before the end of the year, if not when the expenditures were incurred.

An examination of the auditors' report shows that, on this pay-as-you-go basis, the State was approximately five million dollars behind on December 31, 1922. There appears not only a deficit of $477,194.75, but, under the item of resources, a sum of $4,730,915.54 which is not cash in hand but an estimate of taxes levied but collectible later. A condition in general similar to this would be shown were the State's books to be audited today, or on any date that might be chosen. The State, in other words, is in the position of having to borrow large sums against anticipated revenues. It has been in this position since 1921, and will be in this position as long as the present method of state financing obtains.

The Accrual Basis

The second policy, that now is in force in the State is that of operation on what is known as the accrual basis. The State adopted this policy in 1921 when it put in effect its new taxation system. The essential thing about the accrual basis is the use of anticipated, that is of accruing income through the machinery of credit. To take a simple illustration, this is the basis which is adopted by a man who is living, say, on a monthly salary, and who buys during the month on credit and pays for what he buys when his salary check for the month comes in on the first of the succeeding month. His salary is accruing all during the month, but is not collectible until the month is up. Most corporations adopt the same system. They constantly borrow large sums against resources which they cannot at once turn into cash, but which are later collectible—that is, are potential but not actual cash. Very few business houses of any size fail to make large use of credit in this way. Modern business is too complex as a rule to be conducted on the pay-as-you-go plan. Thus the resources of a large business consist, as a rule, on any date, not only of cash on hand, but of assets collectible within a reasonable period, of assets that are known, and are well secured, that are accruing, but not necessarily due until a later time.

How the Change Came About

The State went on such an accrual basis when, instead of raising its main revenues from property, it began to raise them from incomes. A tax on property can be collected during the same year that it is levied; the policy in North Carolina was to levy in May and collect in October of the same year. But an income tax cannot be collected until after the end of the year for which it is levied. The reason is a simple one. It is because few individuals or corporations who pay income taxes are in a position to compute how much these will amount to until the year's operations on which they are levied have ended, and they know how much their incomes for the year have been.

When the State in 1921 discontinued its property tax for state purposes and began to rely heavily on income taxes, it levied an income tax on the new basis for 1921. But this tax, though levied on incomes of 1921, was not due and collectible until March 15, 1922, for reasons just stated.

At the same time the State discontinued its property tax, which, on the old basis, would have been due in October of that year. This tax is now, and has been since 1921, utilized altogether for county and local purposes. The State government derives no support from property taxes. Therefore, during 1921, the State received neither a property tax nor the newly authorized income tax. The income tax, however, which was levied on incomes of 1921 (though not collectible until 1922) was a potential, an accruing, asset of the State, and, once collected, it could be applied to the expenses of the State incurred during 1921. The State, therefore, in order to operate during 1921, borrowed money against the income tax (and other minor sources of revenue) accruing during that year, but collectible later. This is how the change of basis came about.

Is the Accrual Basis Sound?

Plainly enough, an individual, a business, or a government living on the accrual basis may or may not be in a sound financial position. Credit may be used legitimately, or it may not. The tests of sound financing on this basis are simple. They are, first, that the amount of credit used shall not exceed a legitimate estimate of the resources from which credit operations must be covered at the proper time, and, second, that the credit used must be obtainable at a reasonable rate of interest. These tests apply to individuals, to business operations, and to governments alike. The man on salary who is paid monthly, who uses credit at the stores because his salary, though accruing, is not collectible until the first of the succeeding month, is employing sound finance only when he does not buy more than his accruing income warrants, when the prices he is charged for the use of credit are not too high. The farmer who meets his living expenses by mortgaging a crop is not in a sound position, as his crop may not turn out well and the rates he must pay for the accomodations are high. A corporation that is constantly borrowing large sums at low rates of interest against adequate accruing assets that are well secured and collectible within reasonable periods is, on the other hand, sound.

The accrual basis, in other words, may be either sound or unsound, according as it makes proper or improper use of credit. In the case of the State government, we must ask, first, whether its borrowings against anticipated revenues exceed the amounts of those revenues once they are collected; in other words, whether the State is living within its resources, and, second, whether the State can borrow against anticipated revenues at advantageous rates.

As to the second point, that of the rates which the State must pay for its borrowings against anticipated revenues, the general answer may be given that the State borrows at less than the legal rate of interest. The News Letter lacks information as to the exact rate of interest paid on each occasion, and the question as to how these compare with the rates paid by other States during similar conditions of the money market. It should be recalled, however, that the individual taxpayer gains through the use of his money for the year more than the State loses through its payment of interest, as his money is worth the legal rate to him, and the State can borrow for less.

As to the first point, that of whether the State is living within its resources, the data in hand give the following answer.

Resources and Expenditures

The report of Price, Waterhouse and Company was made for a period of twenty-five months ending December 31, 1922. As the State's fiscal year, until 1921, ended on November 30 (it now ends on June 30), it was necessary for the auditors to go back to December 1, 1920, that is, to the beginning of the first fiscal year of the biennial period under discussion. The following table, presented in a form different from, but checking with, the auditors' report, shows the facts for these twenty-five months.

Cash on hand December 1, 1920	$673,098.38	
Resources accrued but uncollected on December 1, 1920, net	1,372,134.36	$2,045,232.74
Revenue collected from December 1, 1920, to December 31, 1922, in addition to the above	$8,945,962.83	
Revenue accrued but uncollected on December 31, 1922. (The State Auditor reports that on September 1, $5,178,965.67 of taxes due the State on December 31, 1922, had been collected)	4,730,915.54	13,676,878.37
Total revenue to December 31, 1922		$15,722,111.11
Expenditures for the same period		16,199,305.86
Net deficit on December 31, 1922, including school note of $710.000		477,194.75
Note: If school note be excluded, deduct		710,000.00
Leaving net surplus on December 31, 1922		$232,805.25

The table shows the revenues collected for the twenty-five months, and the revenues accrued but uncollected, and applicable to the expenditures of the same period. The State, it will be noted, expended from its general fund during these twenty-five months the sum of $16,199,305.86. To apply to these expenditures it had, during the period, cash in hand amounting to $10,991,195.51 including the surplus at the beginning of the period. It had, to apply on these same expenditures, a sum estimated at $4,730,915.54 in revenues levied but uncollectible until after the period ended, leaving a deficit of $477,194.75. It is very important, then, to know whether the estimate of $4,730,915.54 was a true estimate. This is answered by the State Auditor's report published in the state press on September 21, which in condensed form is as follows:

Resources

Cash (overdraft per Contra).		
Uncollected revenues: Collected and turned in to the State treasurer since December 31, 1923, but applicable to the estimate of $4,730,915.54 uncollected revenues, made by the Joint Legislature Committee		$5,078,619.95
Collected and in hands of Commissioner of Revenue September 1, 1923, also applicable to the above estimate		100,345.72
		$5,178,965.67
Advances to Counties recoverable: Principal	$ 243,070.00	
Accrued interest receivable	11,382.87	
	$ 254,452.87	
Lapsed appropriations recoverable from other funds	211,532.50	
Expenditures applicable to the half-year ending June 30, 1923	58,070.03	
	$5,703,021.07	

Obligations

Cash overdraft	$2,189,970.49
Notes payable	2,054,744.00
Warrants payable	131,692.51
Miscellaneous accounts payable	112,133.75
Matured bonds unpaid	28,600.00
Matured bond interest unpaid	80,108.00
Provision for institutional deficit	51,000.00
Revenues applicable to the half-year ending June 30, 1923	373,916.94
	$5,022,165.69
Surplus	680,855.38
	$5,703,021.07

Surplus or Deficit

Excess of collections over estimate:		
Estimate of tax to be collected	$4,730,915.54	
Actually collected	$5,178,965.67	
		448,050.13
Surplus shown by Legislative Committee Report by omitting the school note of $710,000		232,805.25
Surplus		$ 680,855.38

What the Report Shows

This statement shows that the estimate made on December 31st as to the amount of revenue accrued but uncollected was a conservative estimate. Instead of $4,730,915.54, as estimated on that date, the State actually collected $5,178,965.67, or $448,050.13 more than was anticipated. This means that on December 31, 1922, instead of a deficit of $477,194.69, as estimated at that time, the State had, if the school note be included, a deficit of $29,144.62, or, if the school note be excluded, a surplus of $680,855.38.

It is important to note that the $5,178,965.67 collected since December 31, last, is not applicable to expenditures incurred since December 31, but to those incurred prior to that date. It represented on December 31 a potential asset, already utilized, that is, borrowed against, by the State, an asset then accruing but not collected, and not applicable to the State's expenditures during the first eight months of 1923.

But, of course, the State's expenditures have continued since December 31. The main source from which these can be met is the income tax for 1923, which is not collectible until March 15, 1924, and must then be applied to meet the State's 1923 expenses, which the State is presumably in the meantime covering by borrowing against this anticipated revenue, which is now accruing. As already explained, the use of credit against anticipated income is an essential feature of the accrual system, with governments as with business.

One further point should be made clear. This is that, on December 31, 1920, the State had a surplus on hand, in cash and accrued revenues, of $2,045,232.74. This surplus was absorbed during the operations of the twenty-five months period, if the school note be included, or materially lessened, if it be excluded; in other words, the revenues of the State during the twenty-five months would not, without the surplus, have sufficed fully to meet its expenditures to December 31, 1922.

Present Condition

Is the State since December 31, 1922, living within its resources? The State Auditor's statement deals only with the conditions affecting the State's financial position on December 31, 1922, and gives no information as to the condition at any later date.

As for the six months covering the balance of the State's fiscal year from December 31, 1922 to June 30, 1923, Price Waterhouse and Company estimated that the expenditures would exceed the revenues by $319,273.38. The News Letter has no data available as to how this prediction has squared with the facts. As for the two year period beginning July 1, 1923, on which date the State went on its new appropriation basis, too short a time has since elapsed to make successful forecasts possible.

By Way of Conclusion

The News Letter has attempted in the foregoing to set forth the facts as to the State's financial condition. The following facts stand out from such an examination:

(1) The State, in terms of actual cash in hand, lacked on December 31, 1922, by about five million dollars an amount sufficient to wipe out its expenses incurred up to that time. It is presumably in about the same position today, and will be as long as it operates on its present financial system.

(2) The accrual basis involves the use of credit as against anticipated revenues, which accrue during a given period but are collectible later.

(3) The State shifted to the accrual basis in 1921, when it changed its system of taxation, discontinuing the use of taxation on property for State purposes, and beginning systematically to tax incomes. As the income tax for 1921 was not collectible until 1922, and as the property tax for State purposes had been abandoned, the State borrowed against the accruing, but later collectible, income taxes.

(4) On the accrual basis the tests of soundness for the State are whether its expenditures for a given period do or do not exceed the revenues which accrue for that period and may later, when collected, be used to pay the expenses of that period, and whether the State can borrow advantageously.

(5) For the twenty-five months ending December 31, 1922, the State's accruing revenues, once they were collected, plus its surplus of $2,045,232.74 on Decemner 1, 1920, were sufficient to meet its expenditures and leave a surplus of $680,855.38, if the school note be excluded. If the school note be included this surplus becomes a deficit of $29,144.62. Without the initial surplus on December 1, 1920, its revenues would not have sufficed to meet its expenditures.

(6) Information as to whether the State during the present two-year period is living within its resources is not yet available.

A Question of Policy

The question of whether the state should operate on the cash or on the accrual basis is a question of public policy, altogether apart from an analysis of the facts such as the News Letter has tried to give. But the question of the proper basis for financial operation should not be confused with the question of the soundness of the State's financial condition on the basis which it has adopted. It is very important that these two issues should be kept separate in the public mind.