# CHAPTER 4
# *State Budget*

The state budget is the spending plan for state government; it reflects the program priorities of the governor and the legislature. The budget is a complete financial plan; it encompasses all revenue and expenditures (both operating and capital outlay) of the General Fund and special revenue funds for the 12-month period, the *fiscal year*, extending from October 1 of one calendar year through September 30 of the next.

## PROCESS

"Budget" usually refers to the amount of money spent by a person or an organization. In the case of state government, it also refers to the document submitted by the governor to the legislature. This document, formally known as the Executive Budget or, informally, as the "governor's budget message," contains the governor's spending recommendations for each department and function of state government. The requirement for state budget preparation is set out in Article V, section 18, of the Michigan Constitution.

> The governor shall submit to the legislature at a time fixed by law, a budget for the ensuing fiscal period setting forth in detail for all operating funds, the proposed expenditures and estimated revenue of the state. Proposed expenditures from any fund shall not exceed the estimated revenue thereof. On the same date, the governor shall submit to the legislature general appropriation bills to embody the proposed expenditures and any necessary bill or bills to provide new or additional revenues to meet proposed expenditures. The amount of any surplus created or deficit incurred in any fund during the last preceding fiscal period shall be entered as an item in the budget and in one of the appropriation bills. The governor may submit amendments to appropriation bills to be offered in either house during consideration of the bill by that house and shall submit bills to meet deficiencies in current appropriations.

Exhibit 1 summarizes the budget process, which begins 13–14 months prior to a new fiscal year when the various departments submit their spending requests to the Michigan Department of Management and Budget (MDMB). The requests include program descriptions, financial needs, program alternatives, and performance data. These requests are reviewed by MDMB analysts, hearings are held with the departments and the governor, and final recommendations are presented by the governor to the legislature, usually in February. By law, the governor must present the budget to the legislature within 30 days after it convenes in regular session on the second Wednesday in January (in a governor's first year in office, the presentation deadline is extended to 60

### GLOSSARY

**Executive order**
*In a budget context, a document the governor issues that will cut spending; must be approved by the appropriations committee in both legislative chambers.*

**Fiscal year (FY)**
*In Michigan, October 1 through September 30.*

**General Fund**
*Monies not "earmarked" or restricted to a specific purpose; available for annual appropriation for any purpose specified by the legislature.*

**Line-item veto**
*The governor's authority to veto individual items in budget bills.*

**Special revenue fund**
*Holds revenue "earmarked" for a special purpose; e.g., the School Aid Fund.*

**Supplemental appropriation**
*Legislation passed after the budget has been enacted that appropriates additional money to an agency or program.*

## EXHIBIT 1. State Budget Process, Step-by-Step Summary

*I. Preparation and Presentation*

Several months in advance of a new fiscal year, departments review current operations, program objectives, issues, and future plans relative to their budget. The departments submit management plans to the Office of the Budget in the Michigan Department of Management and Budget (MDMB) along with supporting material for their funding requests, analytical studies of major issues, alternatives for resolving issues, and comparisons of costs and effectiveness.

Briefings and hearings occur among department officials, budget analysts, and the governor, to prepare funding recommendations for the upcoming fiscal year.

In February the Consensus Revenue Estimating Conference (budget officials from the executive and legislative branches) meet and agree on a revenue forecast to be used for budget; the forecast is updated in May.

In February the governor presents the recommended budget to the legislature. Bills are submitted containing the governor's recommended appropriations.

*II. Consideration*

An appropriation bill is "read" (the title only, not the text) in the chamber in which it is being considered. Because there are several appropriation bills, half are introduced (originated) in the House and half in the Senate.

The bill is referred to the chambers' respective appropriations committees.

The bill is deliberated by a subcommittee.

The full appropriations committee holds a hearing on the subcommittee's recommendations.

The full appropriations committee adopts or amends the subcommittee recommendations and reports the bill with amendments or as a substitute to the floor.

Floor debate, amendment, and passage of the bill occur in the chamber of origin.

The bill is transmitted to the other chamber, where the process is repeated.

*III. Enrollment and Enactment*

If the bill passes both chambers in identical form, it is ordered enrolled by the originating chamber and printed. Upon enrollment, the bill is sent to the governor.

If the bill is passed in a different form by the second chamber, it must be returned to the originating chamber for concurrence. If that chamber accepts the amendments or the substitute bill of the other, the bill is enrolled and sent to the governor.

If the originating chamber rejects the amendments or substitute bill of the other, the bill is sent to a special conference committee composed of legislators from both bodies who attempt to make compromises between the two versions. The conference committee does not consider any matters other than the differences between the two versions. If the agreement reached affects other parts of the bill, the conferees may recommend amendments to conform with the agreement. They also may recommend correction of any errors in the bill or in the title. When the conference committee reaches a compromise, it submits a report to both chambers. If the report is approved by both, the bill is enrolled and sent to the governor. If the conference committee cannot reach a compromise, or if the legislature does not accept the conference report, a second conference committee may be appointed.

When the governor receives the bill, s/he may sign it into law, veto the entire bill, or veto only specific "line items." To override a veto, a two-thirds vote by the full membership of each chamber is required.

*IV. Implementation and Adjustments*

During the fiscal year each department may request allotment revisions, transfers, or supplemental appropriations. The MDMB submits revised allotments to the State Administrative Board for approval. Transfers of funds within a department are submitted by the MDMB to the House and Senate appropriations committees for approval before being sent on to the State Administrative Board. Action by the legislature and the governor on supplemental appropriation bills is similar to that taken on an appropriation bill.

The MDMB reviews appropriations, prepares allocations, and estimates revenue (in cooperation with legislature and Consensus Revenue Estimating Conference). If there is insufficient revenue, the MDMB prepares an executive order by which the governor makes recommendations to reduce the budget.

The governor transmits the executive order to the legislature. It is not necessary that the full legislature act, but the approval of both appropriations committees is required within 10 days after the recommendation is made.

days). Because there are several appropriation bills, half are *originated* (introduced first) in the House and half in the Senate.

The governor's budget recommendations are considered first by the appropriations committees of the respective chambers. These each have subcommittees that specialize in various sections of the budget; for example, the higher education subcommittee reviews the recommendations made for public colleges and universities. The governor's proposals may be accepted as presented, changed by a committee, or changed by either chamber of the legislature. The budget bills must be approved by both chambers (differences between the two are resolved by conference committees consisting of three members from each chamber) and signed by the governor before becoming law.

Although not required, legislative passage of the budget bills usually is accomplished prior to the beginning of the new fiscal year (October 1). After the governor submits the budget recommendations in February, the appropriation bills usually are considered and passed in April by one house and in early June by the other; conference reports or final action usually is completed around July 4. As mentioned, the legislature may change the budget in any way it wishes, and the governor may veto any item in the budget (this is called a *line-item* veto). The legislature may override a veto by a two-thirds vote of the full membership in each house.

The process is not complete with the budget's final enactment. At any time during the year *supplemental* spending bills may be enacted, or the governor may submit an *executive order* cutting spending; the latter must be approved by both appropriations committees but not by the full legislative bodies. Since 1974 there have been 15 executive orders to reduce expenditures, but on five occasions they were not approved by the appropriations committees (in each instance the governor issued a subsequent executive order that was).

## SIZE AND COMPOSITION

State government (including public colleges and universities) is a major industry in Michigan, employing 164,000 workers and spending more than $29 billion in FY 1996–97. In Michigan, only durable goods manufacturing, services, retail trade, and local government employ more workers. If higher education and other nondepartment employees are excluded from the number of state employees, the current figure is about 64,000.

In FY 1959–60 the state budget was just over $1 billion, and there were about 73,000 state workers (includes employees of public colleges and universities and their hospitals). From 1960 to 1997, total state spending (adjusted for inflation) increased 284 percent, and state government employment increased from 2.6 percent of total Michigan employment to 3.7 percent.

Exhibit 2 displays total FY 1996–97 state spending by major category. The largest are school aid and community health, accounting for 29.1 percent and 23.2 percent, respectively, of total state spending.

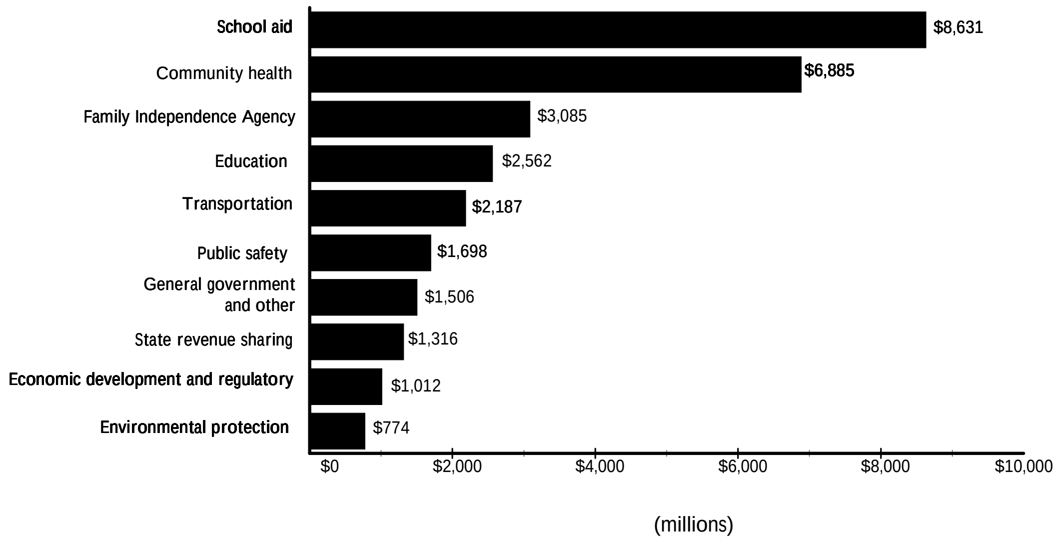
A major share of the budget is allocated to local units of government; spending on local programs has been increasing faster than spending on state programs for several years. The largest local-program categories are school aid, revenue sharing, transportation, community mental health, and community colleges. As a result of the so-called Headlee amendment (1978), the constitution (Article IX, section 30) requires that no less than 41.6 percent of the state budget (not including federal aid) be allocated to local units of government. If this percentage is not met, make-up payments must be made in the following fiscal year; this has occurred twice. Because of school finance reform (1994), which shifted most K–12 funding to the state level and therefore increased state payments to local school districts, the share of state spending allocated to local units of government now is about 60 percent, effectively eliminating the relevance of this provision.

The state budget is divided into three major fund categories (see Exhibit 3):

- General Fund/General Purpose (GF/GP) (commonly referred to simply as the *General Fund*),
- General Fund/Special Purpose (GF/SP) (commonly referred to simply as *special purpose funds*), and
- special revenue.

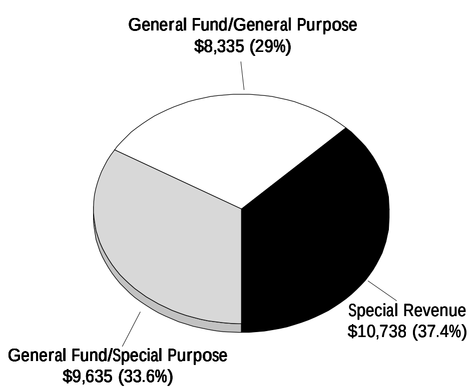
The accounts of GF/GP reflect the major share of transactions. The budget process is concerned mainly with the general purpose portion, as only these monies are subject to the complete control of the governor and the legislature (special purpose funds may be expended only for designated programs).

## EXHIBIT 2. Total State Spending by Major Category, FY 1996–97 (millions)




*SOURCE: Senate Fiscal Agency,* 1997 Statistical Report.
[a]*Higher education and Department of Education.*
[b]*Departments of Corrections and State Police.*
[c]*Michigan Jobs Commission and Department of Consumer and Industry Services.*
[d]*Departments of Agriculture, Environmental Quality, and Natural Resources.*

## EXHIBIT 3. Major State Funds, FY 1996–97 (millions)




*SOURCE: State of Michigan,* Executive Budget, 1997–98 Fiscal Year.
*NOTE: Figures are adjusted to reflect interfund transfers.*
[a]*School Aid Fund revenue accounts for $8,344 million of this total.*

- In FY 1996–97 the GF/GP budget totaled $8.34 billion.
- For FY 1997–98 the final figure is projected at $8.60 billion.
- For FY 1998–99 the governor's recommendation is $8.77 billion.

As mentioned, the uses to which special purpose revenue may be put are restricted. By constitution, statute, contract, or agreement, such revenue is reserved for specific purposes, and its expenditure is limited by the amount of revenue realized. The major categories—which account for about 83 percent of special purpose revenue and spending—are

- tax revenue that is allocated to local governments ($1.5 billion in FY 1996–97), and
- federal aid ($6.5 billion in FY 1996–97).

Special revenue funds are used to finance particular activities from the receipts of specific taxes or other revenue. Such funds are created by the constitution or statute to provide certain activities with definite and continuing revenue. The largest special revenue funds—which together account for more than 95 percent of total special fund revenue ($10.74 billion in FY 1996–97)—are the School Aid and Transportation funds. Another large fund is the Lottery Fund.

- The *School Aid Fund* is financed by restricted taxes, lottery revenue, and a grant from the General Fund.
- The *Transportation Fund* is financed mainly by gasoline and weight taxes and federal aid.
- The *Lottery Fund* receives all revenue from lottery ticket sales; after deductions for prizes and administrative expenses, the remainder is transferred to the School Aid Fund.

The *Budget and Economic Stabilization Fund* (usually referred to as the budget stabilization fund or BSF) is among the most important budget tools available to state government. Also known as the "rainy-day fund," it was established in 1977 to smooth out the peaks and valleys in state spending. During years of economic health or malaise, monies are deposited or withdrawn according to a formula: Deposits are made when real Michigan personal income increases more than 2 percent, and withdrawals are made when that income declines from the previous year. The law also provides for withdrawals when the Michigan unemployment rate averages more than 8 percent for a quarter; these monies are to be used for economic stabilization purposes, such as job retraining or summer youth employment. Major withdrawals from the BSF, to cover budget shortfalls, occurred in FY 1979–80 ($263.7 million), FY 1990–91 ($230 million), and in FY 1991–92 ($170.1 million). Smaller withdrawals have been made several times to fund such programs as school aid, prison construction, road construction, and court judgements. Large payments were made from the General Fund to the BSF in FYs 1992–93, 1993–94, 1994–95 and 1995–96. The balance in the BSF as of September 30, 1997, was about $1.2 billion. Settling the *Durant* court case against the state will require a payout to school districts of $212 million on April 1, 1998, and another $74 million on October 1, 1998.

## CHANGES IN STATE SPENDING

Spending priorities change over time because economic, social, and political conditions change. This certainly has been the case in Michigan during the last 25 years. Tracking these changes has been complicated by school finance reform and government reorganization.

As may be seen in Exhibit 4, school aid (and two smaller programs) increased from about 20 percent of the state budget in FY 1990–91 to nearly 32 percent in FY 1996–97. This resulted from the transfer of most K–12 funding from the local to the state level and the accompanying increase—from about $3.5 billion to more than $8 billion—in state payments to school districts. School finance reform vastly increased total state spending, which means that the share of the total attributed to other programs has diminished.

In the last five years there have been several major changes in state government organization.

## EXHIBIT 4. Selected Expenditure Categories as a Share of the Total State Budget

| *Category* | *FY 1967–68* | *FY 1982–83* | *FY 1990–91* | *FY 1996–97* |
|---|---|---|---|---|
| School aid (K–12), Dept. of Education, and State Library | 32.9% | 19.4% | 20.1% | 31.9% |
| Family Independence Agency | 16.9 | 33.5 | 30.5 | 10.4 |
| Transportation | 16.1 | 9.4 | 8.5 | 7.4 |
| Higher education | 10.9 | 8.1 | 8.4 | 5.9 |
| Community Health | 7.2 | 7.9 | 9.1 | 23.2 |
| Grants to locals (revenue sharing) | 4.4 | 6.1 | 5.6 | 4.4 |
| Safety and Corrections | 2.3 | 3.9 | 5.7 | 6.0 |
| General government and other | 10.3 | 15.6 | 12.1 | 10.8 |

*SOURCES: Senate Fiscal Agency,* 1997 Statistical Report; State of Michigan Executive Budget, 1997–98 Fiscal Year. *Calculations by Public Sector Consultants, Inc.*

- First, the departments of Mental Health and Public Health were merged and the large Medicaid program transferred from the former Department of Social Services (DSS), creating the new Department of Community Health. The DSS was renamed the Family Independence Agency (FIA).
- Second, the departments of Commerce and Labor were merged and renamed the Department of Consumer and Industry Services. Some of their programs were transferred to the newly created Michigan Jobs Commission.
- Third, the Department of Natural Resources was split into two departments, Natural Resources and Environmental Quality.

The many program shifts have resulted in budget shifts. For example,

- in FY 1990–91 the DSS was allocated more than 30 percent of the state budget; in FY 1996–97 the FIA was allocated only 10 percent;
- in FY 1990–91 Public and Mental Health were allocated only 9 percent of the state budget; in FY 1996–97 Community Health was allocated 23 percent.

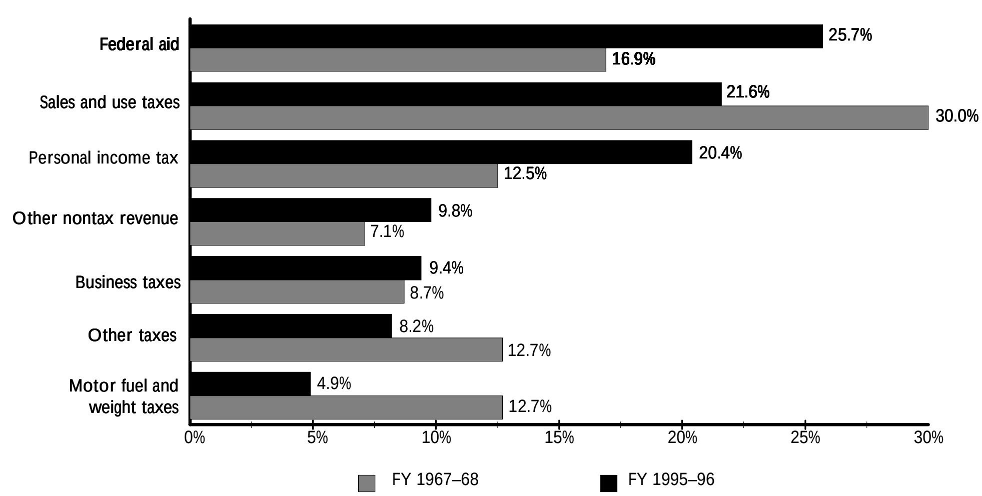
One other significant change has been the declining share of funds allocated to transportation. Transportation spending comes from restricted funds, mainly gasoline and weight taxes. The dip in transportation spending can be traced to (1) the gasoline consumption drop due to price hikes after the 1973 Arab oil embargo and (2) improved vehicle fuel economy over the last several years (made possible in part by reducing vehicle weight). In FY 1996–97 transportation spending accounted for just over 7 percent of total state spending, down from 16 percent in FY 1967–68 (this decline has been exaggerated by the large increase in school aid expenditures).

## REVENUE SOURCES

Exhibit 5 compares revenue sources over almost 20 years: FY 1967–68 and FY 1995–96.

- In FY 1967–68 the state's largest revenue source was the consumption taxes (sales and use), accounting for 30 percent of the total. By FY 1995–96 these tax contributions had dropped to about 22 percent, despite an increase in the rate from 4 percent to 6 percent in 1994 (as part of school finance reform).

## EXHIBIT 5. State Government Revenue Sources, FY 1967–68 and FY 1995–96




SOURCE: *Senate Fiscal Agency,* 1997 Statistical Report. *Calculations by Public Sector Consultants, Inc.*

- Michigan did not enact a personal income tax until 1967, at which time the rate was set at 2.6 percent, and in FY 1967–68 the levy accounted for less than 13 percent of state revenue. By FY 1995–96 the personal income tax was providing more than 20 percent of all revenue.
- Currently, the state's largest revenue source is federal aid, which accounted for about 17 percent of total revenue in FY 1967–68 but nearly 26 percent in FY 1995–96.

The increase in the share provided by business taxes is somewhat misleading, as the property tax on business inventory—a local levy—was one of those replaced when the single business tax was enacted (1976). This resulted in an increase in state business taxes and a reduction in local business taxes.

As stated earlier, the share of revenue from motor fuel and weight taxes has declined because gasoline consumption has dropped and so has vehicle weight. The decline in the share of revenue provided by other taxes is caused by their slow growth rate (particularly cigarette and alcohol taxes) relative to the growth of other revenue sources.

The increase in the federal aid share reflects the increase in federal categorical (specific purpose) and block grants, principally for Medicaid, during the late 1960s and the first half of the 1970s. Federal aid as a share of total annual Michigan revenue peaked at 27 percent in FY 1975–76, before declining to almost 24 percent by the late 1980s. The share has grown in the last several years due to large increases in federal payments for Medicaid.

## SPENDING TRENDS

### State Government Spending Growth

As indicated in Exhibit 6, the rate of state government spending growth has slowed markedly in recent years. In the 1960s and 1970s, when state government spending increased faster than the national average, Michigan established a reputation for high spending, but since 1975 Michigan spending growth has been below the national average.

**EXHIBIT 6. Growth in Total State General Fund Spending, FY 1959–60 to FY 1990–91 (average annual rates)**

| *Time Period* | *Growth, Michigan* | *Growth, All States* |
|---|---|---|
| FY 1960–70 | 11.1% | 10.5% |
| FY 1970–75 | 13.4 | 12.4 |
| FY 1975–80 | 10.6 | 10.7 |
| FY 1980–89 | 5.9 | 8.7 |
| FY 1990–96 | 2.9 | 4.6 |
| FY 1996–97 | –1.4 | 5.0 |
| FY 1997–98 (projected) | 5.3 | 5.5 |

*SOURCE: National Association of State Budget Officers, Washington, D.C.*

### Limits on State Spending

Partly in response to large increases in spending and taxes, in 1978 the voters approved a constitutional limit on state spending—the so-called Headlee amendment, which requires that

- total state spending (excluding federal aid) not exceed 9.49 percent of Michigan personal income (the ratio in the fiscal year in which the amendment was approved) and
- any excess revenue be refunded to the taxpayers.

As a result of the 1994 school finance reform, which replaced local property taxes with state taxes (mainly on sales, use, and property), revenue approached the limit in FY 1994–95 and would have exceeded it except for enacted tax cuts—one of which was a 2 percent income tax credit enacted specifically to keep revenue below the Headlee limit. Revenue is expected to be about $900 million below the limit in FY 1997–98 and $1.4 billion below in FY 1998–99.

## COMPARISONS WITH OTHER STATES

### Expenditures

State-local spending (direct general-government expenditures) in Michigan is $4,146 per capita—almost exactly the U.S. average and ranking Michigan 20th (FY 1993–94 data, the latest available). As recently as ten years ago, in FY 1987–88, Michigan was 9 percent above the national average and ranked 11th. As a share of personal income, state-local spending is 20 percent, ranking Michigan 24th; ten years ago Michigan ranked 17th.

Exhibit 7 shows state-local spending in various categories for all states. Michigan ranks high in education, corrections, and health and hospitals but low in highways, interest payments, and parks and recreation. The low ranking in highway spending is somewhat misleading because that category is largely a function of population density: States with a small population and many miles of highways (e.g., Alaska, Wyoming) have high per capita spending, and states with a large population and few miles of highway (e.g., Massachusetts, Rhode Island) have low expenditures. Michigan's low rank on interest payments reflects its "pay-as-you-go" philosophy for financing capital projects.

## EXHIBIT 7. Per Capita State-Local Direct General Spending by Category, FY 1993–94

| *Category* | *Michigan* | *United States* | *Michigan as Percentage of U.S. Average* |
|---|---|---|---|
| Education | $1,582 | $1,357 | 116.6% |
| K-12 | 1,071 | 949 | 112.9 |
| Higher education | 471 | 349 | 135.0 |
| Public welfare | 732 | 691 | 105.9 |
| Health and hospitals | 417 | 386 | 108.0 |
| Highways | 227 | 277 | 81.9 |
| Police and fire | 191 | 210 | 91.0 |
| Corrections | 134 | 124 | 108.1 |
| Parks and recreation | 42 | 64 | 65.6 |
| Sanitation and sewerage | 140 | 137 | 102.2 |
| Interest on general debt | 151 | 211 | 71.6 |
| Other | 530 | 668 | 79.3 |
| TOTAL | $4,146 | $4,125 | 100.5% |

*SOURCE: U.S. Department of Commerce, Bureau of the Census,* Government *Finances: 1993–94.*

### Revenue

One criterion for a good state-local tax system is the balanced use of the major revenue sources—income, sales, and property taxes. A rule of thumb is that each should contribute 20–30 percent of total state-local taxes. Prior to school finance reform in 1994, it could be said that for many years the Michigan tax system was unbalanced because it relied too much on property taxes and too little on the sales tax. The 1994 reforms corrected this imbalance by reducing property taxes by about one-third and increasing the sales tax rate by 50 percent.

Michigan's total tax burden is slightly above average. Total state-local own-source revenue is 17.3 percent of personal income, or $3,550 per capita; this compares with the U.S. average of 16.5 percent and $3,399 per capita. Michigan ranks 13th and 14th, respectively, in these categories (FY 1993–94 data).