

CRC

**A GUIDE TO THE
STATE OF MICHIGAN BUDGET PROCESS**

February 1997

REPORT NO. 320

Governmental Research Since 1916

A publication of the Citizens Research Council of Michigan

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Citizens Research Council of Michigan

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A GUIDE TO THE STATE OF MICHIGAN BUDGET PROCESS

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A GUIDE TO THE STATE OF MICHIGAN BUDGET PROCESS

Foreword

Although occasional issues arise that may be of greater weight, normally the most significant activity undertaken by the executive and legislative branches of state government is the adoption of the budget. No other legislation covers such a breadth of interests or involves as much analysis. And, since money always attracts attention, the budget process is followed intently by a broad range of public officials, interest groups, the media, and members of the general public.

Unfortunately, despite the importance of the state budget, its concepts and development are understood by relatively few. Even participants in the process may comprehend only the narrow parts of the budget in which they are involved. Yet, lack of understanding of some of the basic budgetary principles can, and does, lead to counter-productive decisions.

In order to provide a basis for understanding the Budget of the State of Michigan, the Citizens Research Council of Michigan (CRC) presents this *Guide to the State of Michigan Budget Process*. It is intended to assist both participants in the process and interested observers in following the budget process, identify the principal players, comprehend the various products of the process, and appreciate the major conceptual underpinnings of both the state budget and the process from which it evolves.

Throughout the preparation of this *Guide*, CRC benefited from several individuals who assisted in the research and critique of this report. CRC is grateful to A. Thomas Clay, Deputy State Treasurer, James J. Haag, Director, House Fiscal Agency, Mark A. Murray, Director, Michigan Department of Management and Budget, and Gary S. Olson, Director, Senate Fiscal Agency for reviewing drafts of this *Guide* and offering many valuable suggestions. In particular, CRC would like to acknowledge Douglas C. Drake, Director, Office of Education, Michigan Department of Management and Budget for his many helpful comments. Finally, CRC would like to thank John J. Linderman, Director, Office of Financial Management, Michigan Department of Management and Budget and Elaine Madigan Mills and Rick Floria of the Michigan Department of Education for their assistance in the preparation of this *Guide*. Naturally, CRC accepts full responsibility for the material contained in this report.

A GUIDE TO THE STATE OF MICHIGAN BUDGET PROCESS

Introduction: What is a Budget?

In its most fundamental form, a budget is a financial plan that lays out proposed expenditures for a specific time period and the estimated revenues needed to support these expenditures. In Michigan, the state budget encompasses all revenues and expenditures, both operating and capital, of the General Fund, special revenue funds, and federal funds for the fiscal year, which runs from October 1 to September 30. A state budget, however, is much more than a comprehensive financial plan. Budgets and the process by which a governmental unit collects and appropriates its resources serve several interrelated functions.

First, all governmental budgets have as their primary function the allocation of scarce resources among a seemingly unlimited number of competing interests. In doing so, budgets determine political winners and losers. Therefore, the state budget process provides a framework for debate among elected officials, state departments, interest groups, and citizens about the priority that should be attached to government functions.

Second, the budget is the key to expenditure control. Regardless of the allocation of resources, a state must, over time, keep total expenditures within available revenues. The budget process is the vehicle by which this is accomplished and which provides a framework for deciding the size of state government.

Third, a budget is a mechanism for establishing accountability. In private firms, the budget is a plan or guide. In government, budgetary appropriations are law and the extent to which they are adhered to provides an indication of the degree to which public agencies are making appropriate use of public funds.

Fourth, since all levels of government share, in varying degree, the costs of most major domestic programs, including welfare, education, transportation, and public safety, the budget provides a legal mechanism for transferring funds from one level of government to another. Though often accompanied by numerous legal, fiscal, and programmatic guidelines, this intergovernmental funding process helps shore up the finances of state and local governmental units.

Fifth, the budget process provides the executive and legislative branches of government an opportunity to evaluate the performance of specific departments and programs. In making the case for continued or additional funding for a specific program, a department may be asked to defend the effectiveness and efficiency of the program. The state budget process, therefore, offers a tool to compel state departments and the programs and services they administer to be efficient, effective, and accountable to the public.

I. The Legal Framework for the Budget Process

In order to understand the intricacies of the state budget and the process from which it evolves, it is important to consider the broad, legal framework within which the budget process operates. In Michigan, several constitutional and statutory provisions

provide such a framework for lawmakers. These provisions work together to provide not only a legal mechanism for the state to appropriate its scarce resources, but, also, to place several restrictions on the nature and size of the state budget.

A. Constitutional Provisions

A number of provisions in the Michigan Constitution refer to either the state budget or the budget process (See **Table 1**). While each provision plays an important role in the development of the state budget, several deserve special attention, including those which fall into one of the following four categories:

- **“Power of the Purse” Provisions:** These provisions affirm the Legislature’s power to tax, appropriate, and borrow money;
- **Balanced Budget Provisions:** These provisions require the Governor to submit a balanced budget, the Legislature to adopt a balanced budget, and both the Governor and Legislature to maintain a balanced state budget;
- **“Headlee” Amendment Provisions:** These provisions limit state revenue and expenditures and define the nature of the fiscal relationship between state government and local units of government; and
- **Gubernatorial Veto Provisions:** These provisions provide the Governor the authority to veto an entire appropriation bill and any specific items in an appropriation bill (line-item veto).

1. “Power of the Purse” Provisions

The most fundamental provisions in the Michigan Constitution related to the budget process affirm the state Legislature’s authority to raise revenue through taxes, to direct the spending of such revenue through appropriations, and, in the event that revenue does not meet current obligations, to borrow on the state’s credit. Together, these three powers constitute the basic principle that the “power of the purse” rests with the legislative branch of government in Michigan.

a. Power to Tax. Through the power to tax, economic resources are transferred from individuals and private institutions to governmental units, which in turn use

these resources for financing public goods and services and transferring the purchasing power of taxpayers.

The power to tax rests solely with the state Legislature, which has the authority to levy taxes to pay the expenses of state government. According to Article IX, Section 1:

The legislature shall impose taxes sufficient with other resources to pay the expenses of state government.

The state Constitution further affirms the legislative power to tax through Article IX, Section 2, which provides:

The power of taxation shall never be surrendered, suspended or contracted away.

Given the magnitude of the Legislature’s power to tax, the state Constitution essentially prohibits the Legislature from delegating this power to any other branch of government or individual.

b. Power to appropriate. Just as significant as the power to collect taxes is the power of the Legislature to direct state revenue through appropriations. With these two powers, the Legislature has the paramount authority to both command resources, through the power to tax, and guide the use of these resources, through the power to appropriate.

The Legislature’s power to appropriate state resources is founded in Article IX, Section 17, which states:

No money shall be paid out of the state treasury except in pursuance of appropriations made by law.

Therefore, before any entity of state government takes action that commits the state to the payment of funds, an appropriation must be made by the Legislature.

Legislative Power of the Purse Provisions

Legislative Power to Tax:

- Article IX, Section 1— requires the state Legislature, through taxation and other resources, to pay the expenses of state government.
- Article IX, Section 2— prohibits the state Legislature from delegating its taxing powers.

Legislative Power to appropriate:

- Article IX, Section 17— provides that an appropriation must be made before any money is drawn from the treasury.

Legislative Power to Borrow:

- Article IX, Section 14— limits the state Legislature's power to borrow on a short-term basis.
- Article IX, Section 15— limits the state Legislature's power to borrow on a long-term basis.

Source: 1963 Michigan Constitution.

While frequently portrayed as an “expenditure” or “money,” it should be noted that an appropriation is actually neither. Rather, it is the *legal authority* granted by the state Legislature to an entity of state government to incur obligations or make expenditures. In most cases, this legal authority is limited both in the amount (total appropriation) and time (fiscal year) it may be expended. *Obligations* occur when an entity of state government employs personnel, enters into contracts, executes purchase orders, or takes any action which commits the state to pay for any goods or services. *Expenditures* or outlays, occur when obligations are paid through checks, electronic transfers, or cash.

The appropriation is the focal point of the state budget process and the means by which the Legislature controls state spending. While the Legislature does not directly control the expenditures of a state department during budget execution, it indirectly controls expenditures by providing new budget authority each year. Without this legal authority, state departments are prevented from incurring obligations or making expenditures.

c. Power to Borrow. The state Constitution places several restrictions on the short-term and long-term borrowing power of the state Legislature.

i. Short-Term Borrowing. Because the state's revenue flow is irregular and often not correlated with its disbursements, the state Constitution provides the Legislature the authority to borrow on a short-term basis to meet any cash flow problems. According to Article IX, Section 14, however, debt incurred through short-term borrowing in a fiscal year:

...shall not exceed 15 percent of undedicated revenues received by the state during the preceding fiscal year and such debts shall be repaid at the time the revenues so pledged are received, but not later than the end of the same fiscal year.

In other words, state debt incurred through short-term borrowing may not exceed 15 percent of the previous fiscal year's undedicated revenue (General Fund revenue) and must be repaid by the end of the fiscal year.

ii. Long-Term Borrowing. The state Constitution also provides the Legislature the authority to incur long-term debt. However, the state Constitution is even more restrictive with this power, requiring a two-thirds vote in each house and the approval of a majority of the electors at the next state general election before the state can enter into any long-term borrowing. As provided in Article IX, Section 15, the ballot proposal presented to voters seeking approval for long-term borrowing by the state:

...shall state the amount to be borrowed, the specific purpose to which the funds shall be devoted, and the method of repayment.

These restrictions have resulted in the creation of several authorities whose debt is not considered to be a general obligation of the state.

2. Balanced Budget Provisions

The primary function of the state budget is to allocate scarce public resources among a seemingly unlimited number of demands. The state budget process, therefore, is the means by which executive and legislative

bodies attempt to balance these resources with the public demands for goods and services. Because of the importance of keeping expenditures within available revenue, most state constitutions contain one or more of the following five balanced budget requirements:

- the governor is required to submit a balanced budget;
- the legislature is required to enact a balanced budget;
- the governor is prohibited from signing a deficit budget;
- the state is prohibited from carrying over a deficit into the next fiscal period; and
- the governor, legislature, or both is required to maintain a balanced budget over the course of the fiscal period.

In Michigan, the state Constitution satisfies three of these balanced budget requirements. First, the Governor is required to submit a balanced budget to the Legislature; second, the Legislature is required to adopt a balanced budget; and third, the Governor, with the approval of the Appropriations Committees in each house, is required to reduce expenditures over the course of the fiscal year in order to maintain a balanced budget.

While Michigan is often cited as having a constitutional provision prohibiting the Governor from signing a deficit budget, it should be noted that the state Constitution *does not* prohibit the Governor from signing a deficit budget (although the Legislature may not submit a deficit budget to the Governor). With regard to annual deficits, the state is permitted to carry deficits over into the next fiscal period. However, any deficit (or surplus) incurred in any fund during the last preceding fiscal year must be entered as an item in the budget and in one of the appropriation bills.

However, this provision does not completely take into account the timing of the state budget process. More specifically, an upcoming fiscal year state budget is adopted before a prior fiscal year deficit or surplus may be ascertained. Therefore, a projected deficit or surplus is used in the adoption of the state budget.

What is a Balanced Budget?

A state budget may be said to be in balance when the proposed or actual available financial resources for a fiscal period are equal to or greater than the proposed or actual expenditures for the same period. The financial resources may include both current revenues and available reserves, especially those that are unobligated general fund balances. Therefore, while a state may experience a budget deficit, in which current expenditures exceed current revenues, the state's budget would be considered balanced if sufficient reserves existed to cover the deficit.

a. The Governor's Role. The adoption of a balanced budget in Michigan begins with the Governor, who, according to Article V, Section 18, is required to:

...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.

At the same time the Governor submits his budget recommendations (the "executive budget"), he also is required to submit general appropriation bills to the Legislature detailing proposed appropriations and estimated revenue. In practice, only one appropriation bill details projected state revenue.

Article V, Section 18, also requires the Governor, upon the submission of the executive budget to the Legislature, to submit any necessary legislation "...to provide new or additional revenues to meet proposed expenditures." In other words, in the event that proposed expenditures exceed projected revenue in the executive budget, the Governor is required to introduce legislation which will increase revenue to at least the level of proposed expenditures.

b. The Legislature's Role. The state Constitution also requires the state Legislature to adopt a balanced budget. According to Article IV, Section 31:

One of the general appropriation bills as passed by the legislature shall contain an itemized statement of estimated revenue by major source in each operating fund for the ensuing fiscal period, the total of which shall not be less than the

Balanced Budget Provisions

The Governor's Role:

- Article V, Section 18— requires the Governor to submit a balanced budget to the state Legislature.

The Legislature's Role:

- Article IV, Section 31— requires the state Legislature to adopt a balanced budget.

The Gubernatorial-Legislative Role:

- Article V, Section 20— requires the Governor and the Appropriations Committees to maintain a balanced budget.

Source: 1963 Michigan Constitution.

total of all appropriations made from each fund in the general appropriation bills as passed.

Therefore, like the requirement for the Governor to submit a balanced budget, the requirement for the Legislature to adopt a balanced budget is only as effective as the revenue forecast on which the adopted state budget is based.

c. The Gubernatorial-Legislative Role. The third constitutional provision requiring a balanced budget in Michigan involves a joint effort of the Governor and Legislature. According to Article V, Section 20:

The governor, with the approval of the appropriating committees of the house and senate, shall reduce expenditures authorized by appropriations whenever it appears that actual revenues for a fiscal period will fall below the revenue estimates on which appropriations for that period were based.

While requiring the submission and adoption of a balanced budget are critical steps in the budget process, this provision may very well be the most significant of the three. During the preparation and adoption phases of the state budget process, many assumptions are made about the economy and its impact on the state revenue structure during the upcoming fiscal year. Consequently, the Governor's proposed budget and the budget adopted by the Legislature are based on *estimated* revenue. If, however, unforecasted economic conditions result in state revenue collections that are less than those estimated in the adopted state budget, Article V, Section 20, provides a mechanism to reduce expenditures, without giving the Governor or Legislature the exclusive authority.

3. "Headlee" Amendment Provisions

In November 1978, Michigan voters amended the state Constitution by adding 10 new sections (Sections 25 through 34) to Article IX of the state Constitution and amending one existing section (Section 6) of this same article. This constitutional amendment, often referred to as the "Headlee" Amendment, plays three roles in the state budget process by: 1) limiting state revenue; 2) limiting state expenditures; and 3) defining the fiscal relationship between state and local governmental units.¹

a. The State Revenue Limitation. Under the terms of Article IX, Section 26, total state revenue in Michigan is subject to an overall limitation each fiscal year. This limitation is based on two variables: 1) a fixed ratio of total state revenue to state personal income; and, in most cases, 2) state personal income in the prior calendar year.

According to Article IX, Section 26, the state revenue limitation in a given fiscal year:

...shall be equal to the product of the ratio of Total State Revenues in fiscal year 1978-79 divided by the Personal Income of Michigan in calendar year 1977 multiplied by the Personal Income of Michigan in either the prior calendar year or the average of Personal Income of

¹ The 1978 tax limitation amendment was placed on the statewide ballot by initiative petitions filed by an organization known as Taxpayers United for Tax Limitation. Richard Headlee, a Farmington Hills insurance executive and member of the Taxpayers United for Tax Limitation, emerged as the principal spokesman for the amendment, hence the commonly used reference, "Headlee" Amendment.

Figure 1
Calculating the State Revenue Limitation

$$\text{State Revenue Limitation} = \left(\frac{\text{Total State Revenue in Fiscal Year 1979}}{\text{State Personal Income in Calendar Year 1977}} \right) \times \text{State Personal Income in Prior Calendar Year}$$

Source: 1963 Michigan Constitution.

Michigan in the previous three calendar years, whichever is greater.

Therefore, in order to calculate the state revenue limitation in a given fiscal year, a fixed ratio is multiplied by state personal income either in the prior calendar year or the average of the three previous calendar years. In practice, state personal income from the prior calendar is used in making this calculation (See **Figure 1**). Consequently, the state revenue limitation is not a fixed dollar amount. Rather, it is a constant percentage of state personal income. As a result, the revenue limitation enables total state revenue to increase as state personal income increases. However, state revenue cannot increase at a faster rate than personal income.

As **Figure 2** illustrates, the fixed ratio or percentage of total state revenue used in calculating the state revenue limitation is 9.49 percent. Therefore, total state revenue subject to the limitation may not exceed 9.49 percent of state personal income in the prior calendar year. For example, the FY 1998 revenue limitation will be 9.49 percent of Calendar Year 1996 state personal income.

i. Exceeding the Revenue Limitation. Since the state budget is largely based on estimated state revenue and actual revenue collections may vary above or below these projections, the Headlee Amendment provides

for the disposition of any revenue collected in excess of the limitation.

According to Article IX, Section 26, if total state revenue in a fiscal year exceeds the revenue limitation by one percent or more, the total amount of the excess revenue:

...shall be refunded pro rata based on the liability reported on the Michigan income tax and single business tax annual returns filed following the close of such fiscal year.

For example, if the dollar amount of the state revenue limitation were \$20 billion and state revenue collections totaled \$20.2 billion in a given fiscal year, individual and single business taxpayers would be eligible for tax refunds on a pro rata basis. In this particular example, state revenue would exceed the revenue limitation by exactly one percent (\$20 billion x .01 = \$200 million).

On the other hand, in the event that state revenue collections exceed the revenue limitation by less than one percent, the Headlee Amendment does not specifically address the disposition of excess revenue. While Article IX, Section 26, states that excess revenue of less than one percent "may be transferred" to the state's Countercyclical Budget and Economic Stabilization Fund (See Page 10 for a description of this

Figure 2
Calculating the Fixed Ratio in the State Revenue Limitation

(dollars in millions)

$$\begin{aligned} \text{Fixed Ratio} &= \text{Total State Revenue in Fiscal Year 1979} \div \text{State Personal Income in Calendar Year 1977} \\ &= \$6,598.2 \div \$69,554.0 \\ &= .0949 \times 100 \\ &= 9.49\% \end{aligned}$$

Source: Michigan Department of Management and Budget.

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fund), the disposition of this excess is technically at the discretion of the executive and legislative branches of state government. In addition to transferring an excess of less than one percent to this fund, two additional options remain, including refunding the excess to taxpayers or spending the excess.

ii. Adjusting the Revenue Limitation. The Headlee Amendment specifies three procedures by which the state revenue limitation can be adjusted. *First*, the revenue limitation can be adjusted by a vote of the people approving an amendment to the state Constitution. According to Article IX, Section 26:

This limit shall not be changed without approval of the majority of the qualified electors voting thereon, as provided for in Article 12 of the Constitution.

Therefore, as defined in Sections 1 and 2 of Article XII of the state Constitution, a constitutional amendment to increase or decrease the state revenue limitation could be proposed by either: a) the state Legislature by a two-thirds vote; or b) the citizens of the state by filing petitions containing signature of registered voters equal to at least 10 percent of the total vote cast in the last gubernatorial election. In either case, a constitutional amendment adjusting the revenue limitation

must be approved by a majority of voters in the state.

Second, the revenue limitation can also be adjusted if responsibility for funding a program is transferred from one unit of government to another as a result of a constitutional amendment. While the state revenue limitation can be adjusted under such a scenario, the state Constitution limits the amount of the adjustment from one governmental unit to another to a dollar-for-dollar transfer. According to Article IX, Section 26:

If responsibility for funding a program or programs is transferred from one level of government to another, as a consequence of constitutional amendment, the state revenue and spending limits may be adjusted to accommodate such change, provided that the total revenue authorized for collection by both state and local governments does not exceed that amount which would have been authorized without such change.

Thus, if the funding responsibility of a local program is transferred to the state by a constitutional amendment, the state revenue limitation could be increased to accommodate the need for increased revenue to support the new program. For example, by shifting a significant portion of local school funding to the state

Exceeding the State Revenue Limitation in FY 1995

Since state revenue collections tend to grow more slowly than state personal income, state revenues have tended to recede from the revenue limitation since its inception. With the adoption of Proposal A in March 1994, however, voters in Michigan approved a sweeping set of changes to the state Constitution that resulted in a large reduction in school property taxes in exchange for several increases in state taxes. The result was a \$4.4 billion increase in state tax revenue. Though this change was originally projected to leave the state below the limitation, subsequent projections of state revenue indicated that revenue collections would be stronger than expected in FY 1995 and would exceed the 9.49 percent limitation unless action was taken to reduce state revenue or adjust the revenue limitation.

In an attempt to keep the excess revenue below one percent of the limitation, thus preventing a constitutionally-required refund, several steps were taken in FY 1995 to reduce state revenue including, the enactment of three permanent tax cuts and one temporary tax credit. In FY 1995, permanent tax cuts were enacted for the single business tax, individual income tax, and intangibles tax. In addition, a one-time individual income tax credit of two percent of tax liability was enacted for 1995. This temporary tax credit appeared as a "Headlee Rebate" on 1995 individual tax returns.

While the combination of tax cuts and a one-time tax credit enabled the state to avoid a constitutionally-required refund, it did not prevent the state from exceeding the revenue limitation. In FY 1995, total state revenue exceeded the revenue limitation by \$109.6 million. However, this excess was less than one percent, most of which (\$67.4 million) was transferred to the state Countercyclical Budget and Economic Stabilization Fund at the end of FY 1995.

Figure 3 Calculating the State Expenditure Limitation

$$\text{Expenditure Limitation} = \text{State Revenue Limitation} + \text{Federal Aid} + \text{Previous Fiscal Year Surplus}$$

Source: 1963 Michigan Constitution.

through a constitutional amendment (Proposal A of 1994), the current state revenue limitation could have been increased. Conversely, if the program were to transfer from the state to local governmental units, the state revenue limitation could be decreased.

Third, Article IX, Section 27, also provides that the revenue limitation can be increased for a one-year period if: 1) the Governor requests the Legislature to declare an emergency; 2) the Governor's request specifies the nature, dollar amount, and the method of funding the emergency; and 3) the Legislature, by a two-thirds vote of the members elected to and serving in each house, declares an emergency in accordance with the specifics of the Governor's request. Theoretically, the "emergency" could be extended beyond a single fiscal year by repeating this same process.

b. The State Expenditure Limitation. In addition to subjecting state revenue to an overall limitation, the Headlee Amendment also subjects total state spending to an overall limitation. According to Article IX, Section 28:

No expenses of state government shall be incurred in any fiscal year which exceed the sum of the revenue limit established in Sections 26 and 27 of this Article plus federal aid and any surplus from a previous fiscal year.

Therefore, as **Figure 3** illustrates, the spending limitation permits the state to spend up to the amount of the revenue limitation, plus federal aid and any surplus from a prior year, which may include any accu-

mulated balances in the state's Countercyclical Budget and Economic Stabilization Fund.

c. State and Local Fiscal Relations. The Headlee Amendment also places three significant limitations on the fiscal relationship between the state and local units of government. In general, these provisions are designed to ensure that the imposition of a state revenue limitation does not result in either a reduction in state aid or shifting of state costs to local governmental units. The three limitations on state and local fiscal relations include:

- The state is prohibited from reducing the proportion of total state spending paid to all units of local government as a group below a constant proportion.
- The state is prohibited from reducing the state-financed proportion of the necessary costs of any *existing* program or service required of local governmental units by law.
- The state is required to finance the necessary increased costs incurred by local governmental units as a result of any *new* state-mandated activity or service or increase in the level of any activity or service beyond that required by existing law.

i. Proportion Limitation. According to Article IX, Section 30:

The proportion of total state spending paid to all units of Local Government, taken as a

Figure 4 Calculating the Proportion of State Aid to Local Units of Government (dollars in millions)

$$\begin{aligned} \text{Proportion} &= \text{Total State Aid to All Local Units in Fiscal Year 1979} \div \text{Total State Spending in Fiscal Year 1979} \\ &= \$3,249.6 \div \$6,635.4 \\ &= .4897 \times 100 \\ &= 48.97\% \end{aligned}$$

Source: Michigan Department of Management and Budget.

group, shall not be reduced below that proportion in effect in fiscal year 1978-79.

As **Figure 4** illustrates, based on FY 1979 figures, state spending to local governmental units must be at least 48.97 percent of total state spending. However, since Section 30 refers to "all units of Local Government, taken as a group," the state is able to determine how state spending is distributed to the various local governmental units (schools, cities, villages, townships, counties, etc.) and to various local programs and services.

ii. State-Mandated Programs and Services To further deter the state from reducing state aid to or shifting the costs to local governmental units, Article IX, Section 29: a) prohibits the state from reducing its share of *existing* state-mandated programs and services; and b) requires the state to reimburse local governmental units for any *new* state-mandated program or service.

With regard to existing state-mandated programs and services, Article IX, Section 29, provides:

The state is hereby prohibited from reducing the state financed proportion of the necessary costs of any existing activity or service required of units of Local Government by state law.

Thus, if the state is currently paying 30 percent of the costs of an existing state-mandated program, the state is required to pay at least 30 percent of the future costs of the program, as long as local governmental units continue to be mandated by state law to provide the program.

Section 29 also requires the state to fully reimburse local units the necessary costs of any new state-mandated program or service. According to Article IX, Section 29:

A new activity or service or an increase in the level of any activity or service beyond that required by existing law shall not be required by the legislature or any state agency of units of Local Government, unless a state appropriation is made and disbursed to pay the unit of Local Government for any necessary increased costs.

It should be noted that this provision in Section 29 applies to activities or programs required by the Legislature or any state agency, while the provision on

existing mandated services is limited to those required by state law.

4. Gubernatorial Veto Provisions

While the state Constitution provides the Legislature the "power of the purse," it also provides the Governor a "check" on this power through his veto authority. Like any other bill adopted by the Legislature and submitted to the Governor for consideration, appropriation bills confront the veto power of the Governor. Unlike other bills, however, appropriation bills are subject to the line-item veto power of the Governor. The extent to which the Governor utilizes the "line-item" veto largely depends on the level of cooperation between the Governor and Legislature in the preparation and adoption of the state budget.

a. Gubernatorial Veto of an Entire Bill. The state Constitution provides the Governor two mechanisms for vetoing an entire appropriation bill. First, the Governor, who has 14 days to consider an appropriation bill, may simply veto the bill and send it back to the Legislature, which in turn can override the veto with a two-thirds vote in each house.

Second, the Governor may also refuse to sign the bill, and if the Legislature has finally adjourned during the 14-day period, the appropriation bill does not become law. This type of veto is often referred to as a "pocket veto." With regard to appropriation bills, however, the pocket veto is rarely used.

The gubernatorial power to veto an entire bill rests in Article IV, Section 33, which provides that:

Every bill passed by the legislature shall be presented to the governor before it becomes law, and the governor shall have 14 days measured in hours and minutes from the time of presentation in which to consider it... If he does not approve, and the legislature has within that time finally adjourned the session at which the bill was passed, it shall not become law. If he disapproves, and the legislature continues the session at which the bill was passed, he shall return it within such 14-day period with his objections, to the house in which it originated.

b. Gubernatorial Line-Item Veto. With regard to appropriation bills, however, the line-item veto

power of the Governor is more widely utilized as a “check” on the Legislature’s power of the purse. As provided in Article V, Section 19:

The governor may disapprove any distinct item or items appropriating moneys in any appropriation bill. The part or parts approved shall become law, unless re-passed according to the method prescribed for the passage of other bills over the executive veto.

Thus, the only part of an appropriation bill subject to a

line-item veto are those items which make appropriations. All other language in an appropriation bill, particularly that language which imposes conditions on appropriations or reporting requirements (“boiler plate”), is not subject to the line-item veto authority of the Governor.

In practice, the presence of the line-item veto can be as powerful as its use. The threat of a line-item veto often deters legislators from subjecting specific items in the state budget to the gubernatorial line-item veto authority.

B. Statutory Provisions

The statutory basis of the state budget process in Michigan resides in the Management and Budget Act of 1984 (Public Act 431). The provisions of this Act, combined with the constitutional provisions previously discussed, provide the legal framework within which the state budget process operates each year in Michigan (See **Table 2**).

While several provisions in the Management and Budget Act are discussed throughout this *Guide*, two of the more significant provisions in this Act deserve special attention, including those which create and define the nature of the: 1) Countercyclical Budget and Economic Stabilization Fund and 2) Consensus Revenue Estimating Conference.

1. Countercyclical Budget and Economic Stabilization Fund

Often referred to as the state’s “budget stabilization” or “rainy day” fund, the Countercyclical Budget and Economic Stabilization Fund was established in 1977, and subsequently recodified in the Management and Budget Act of 1984. It is designed to stabilize state revenue and employment during periods of economic recession and high unemployment.

Several provisions in the Management and Budget Act define the nature of the budget stabilization fund, including specific calculations for transfers into and out of the fund, how these funds must be used, and the amount the fund may contain. Moreover, with each of these provisions, legislative action is required to make transfers, utilize funds, and maintain fund balance limitations

a. Transfers into the Budget Stabilization Fund.

The basic concept of the budget stabilization fund is that it captures any General Fund-General Purpose (GF-GP) revenue resulting from inflation-adjusted (real) growth in state personal income of more than two percent. When the adjusted annual growth rate in state personal income exceeds two percent, the percentage excess over two percent must be multiplied by total GF-GP revenue in the current fiscal year to determine the amount to be transferred into the budget stabilization fund in the ensuing fiscal year.

For example, if real state personal income in Michigan increased 2.5 percent and GF-GP revenue totaled \$8.0 billion in the current fiscal year, the amount to be transferred into the fund in the ensuing fiscal year would be the product of 0.5 percent (the percentage excess of 2.0 percent) and \$8.0 billion, or \$40.0 million.

b. Transfers out of the Budget Stabilization Fund.

Although the Management and Budget Act makes budget stabilization funds less accessible than most other funds, there are four ways in which funds may be transferred out of the fund, including:

i. Decline in State Personal Income. If real state personal income declines, the percentage below 0.0 percent must be multiplied by total GF-GP in the current fiscal year to determine the maximum amount that may be transferred from the fund to balance the current fiscal year GF-GP budget.

For example, if Michigan’s personal income decreased 0.5 percent and GF-GP revenue totaled \$8.0 billion in the current fiscal year, the amount to be transferred

out of the fund and into the GF-GP budget would be the product of 0.5 percent and \$8.0 billion, or \$40.0 million.

ii. High Unemployment Rates When the state unemployment rate is between 8.0 percent and 11.9 percent during a calendar quarter, 2.5 percent of budget stabilization funds (5.0 percent of the fund balance if the unemployment rate exceeds 11.9 percent) may be transferred out of the fund in the following calendar quarter for: (a) capital outlays; (b) public works and public service jobs; (c) refundable investments or employment tax credits against state business taxes for new outlays and hirings; and (d) any other purpose which provides employment opportunities to counter the state's economic condition.

iii. GF-GP Revenue Shortfall In a fiscal year when a deposit is made to the budget stabilization fund and actual GF-GP revenue collections are less than projected levels, an amount not to exceed the amount originally transferred into the fund may be transferred out. However, a majority vote of both houses must approve the transfer and the shortfall in GF-GP revenue cannot be attributed to statutory changes in the tax rate, tax base, fee schedules, or any other changes in the revenue system upon which the GF-GP budget is based.

iv. Emergency Transfer When a transfer based on a decrease in state adjusted personal income (item *l*) is insufficient, the Legislature may, with a two-thirds vote from both houses, make an emergency transfer out of the budget stabilization fund.

c. Limitations on the Budget Stabilization Balances As provided in the Management and Budget Act, balances in the budget stabilization fund are limited to 25.0 percent of the actual state GF-GP revenue for the fiscal year. Any balances exceeding this limitation must be returned on individual income tax returns filed following the close of the fiscal year.

2. Consensus Revenue Estimating Conference

The state budget process reflects various efforts to develop systematic plans, none of which is more important than those plans which forecast state revenue. Moreover, since the allocation of scarce resources is the primary function of each state budget, its dynamics greatly depend on state revenue forecasts, which

establish the boundaries for preparing, adopting, and executing the state budget each year.

In Michigan, this responsibility lies with the Consensus Revenue Estimating Conference (CREC), which was established in 1991 (Public Act 72) through an amendment to the Management and Budget Act. Several provisions in the Act define the nature of the CREC, including its meeting dates, principal conferees, and types of required forecasts.

a. Meeting Dates The CREC is required to meet at least twice a year, once during the second week of January and once during the last week of May. In addition, the CREC must meet if one of the three principal conferees requests a meeting of the CREC.

Both statutorily mandated meetings of the CREC are timed to play critical roles in the state budget process. The January meeting provides the initial revenue forecast for the upcoming fiscal year budget and sets the boundaries for submission of the Governor's "executive budget" to the Legislature. The May conference is timed to provide the final revenue forecast prior to the adoption of the upcoming fiscal year budget.

In addition to providing a forecast of upcoming fiscal year revenue, the January and May meetings of the CREC also update current fiscal year state revenue.

b. Principal Conferees The three principal conferees in the CREC include the State Budget Director and the directors of the House and Senate Fiscal Agencies, or their respective designees. In practice, the State Treasurer serves on behalf of the State Budget Director. In addition to these three conferees, economists from around the nation and state present their forecasts during the conference. The state's "official" forecast, however, is the consensus forecast of the three conferees.

c. Types of Forecasts Each CREC is responsible for making two forecasts for the current and upcoming fiscal year budget, including: 1) *a forecast of national and state economic variables*, which usually includes forecasts of gross domestic product, consumer price indices, state personal income, unemployment rates, and automobile sales; and 2) based on this forecast, *a state revenue forecast* which estimates the anticipated response of the state revenue structure to these economic variables.

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Pursuant to the Management and Budget Act, the state revenue forecast must include forecasts of the following:

- a) state income tax collections;
- b) state sales tax collections;
- c) single business tax collections;

d) total General Fund-General Purpose (GF-GP) revenues;

e) lottery transfers to the School Aid Fund (SAF); and

f) total SAF revenue.

Table 1
Constitutional Provisions Related to the State Budget and Budget Process in Michigan

Article/ Section	Description of Constitutional Provision
Article I, Section 4	- Prohibits the state from appropriating state property or money from the state treasury for the benefit of any religious organization.
Article III, Section 6	- Prohibits the state from being a party to any work of internal improvement, except for those public improvements provided by law.
Article IV, Section 30	- Requires two-thirds of the members in each house to approve the appropriation of public money or property for local or private purposes.
Article IV, Section 31	- Requires budget bills for the succeeding fiscal period to be passed or rejected in either house of the Legislature before that house passes any appropriation bill for items not in the budget except bills supplementing appropriations for the current fiscal year. - Provides that any bill requiring an appropriation to carry out its purpose is considered an appropriation bill. - Requires one of the appropriation bills for the ensuing fiscal period to contain a revenue estimate that shall not be less than the total of all appropriations made for the same fiscal period.
Article IV, Section 53	- Provides that the Legislature, with a two-thirds vote in each house, appoint an Auditor General. - Requires the Auditor General to conduct post financial and performance audits of the state and all branches, offices, boards, agencies, departments, commissions, authorities, and institutions established by the Constitution or law.
Article V, Section 18	- Requires the Governor to submit a balanced budget to the Legislature for the ensuing fiscal period, where proposed expenditures from any one fund shall not exceed its estimated revenue. - Requires the Governor to submit general appropriation bills to the Legislature and permits gubernatorial amendments to such bills. - Requires the Governor to submit bills to meet deficiencies in the budget. Any surplus or deficit in any fund from the previous fiscal period must be entered as an item in one of the appropriation bills for the ensuing fiscal period.
Article V, Section 19	- Provides line-item veto power to the Governor on any distinct item appropriating money in an appropriation bill and requires a three-fourths vote in each house to override the veto.
Article V, Section 20	- Provides that no appropriation of the Legislature is a mandate to spend. - Requires the Governor to reduce expenditures, with the approval of appropriating committees, when it appears that revenues will fall below the estimates for that period. - Prohibits the Governor from reducing expenditures for the legislative and judicial branches.
Article V, Section 29	- Mandates the state to provide an annual appropriation for the operation of the Civil Rights Commission.
Article VI, Section 7	- Provides that the Supreme Court controls the preparation of its budget recommendations and the expenditure of its appropriations.
Article VIII, Section 2	- Mandates the state to maintain and support a system of free public elementary and secondary education. - Prohibits the state from making an appropriation or providing any public credit to aid or maintain any private pre-elementary, elementary, or secondary school.
Article VIII, Section 3	- Provides that the boards of institutions of higher education provided in the Constitution have the authority to control and direct the expenditures of the institutions' funds
Article VIII, Section 4	- Mandates the state to make appropriations to maintain the state's 13 public universities.
Article VIII, Section 7	- Mandates the state establish and provide financial support of public community and junior colleges.
Article IX, Section 1	- Provides the state Legislature the power to impose taxes to pay the expenses of state government.
Article IX, Section 2	- Affirms the state Legislature's power to collect taxes by prohibiting any delegation of taxing powers.
Article IX, Section 7	- Prohibits the imposition of a graduated income tax.
Article IX, Section 8	- Limits the state sales tax to six percent.
Article IX, Section 9	- Provides that all taxes, except sales and use and regulatory fees, imposed on fuels sold or used to propel motor vehicles and aircraft be used for transportation purposes. Not less than 90 percent the motor-vehicle fuel and registration taxes shall be used for roads and bridges. The balance of these taxes, any aircraft fuel or registration taxes, and not more than 25 percent of sales tax levied on transportation-related items shall be used for comprehensive transportation purposes.
Article IX, Section 10	- Earmarks 15 percent of the original four percent sales tax revenues for local revenue sharing.
Article IX, Section 11	- Establishes the School Aid Fund (SAF) and dedicates portions of the sales tax to the fund. - Guarantees that total state support and local per pupil revenue for school operating purposes, beginning in the 1995-96 school year, will not be less than 1994-95 levels.
Article IX, Section 14	- Limits short-term borrowing by the state to 15 percent of the previous year's undedicated revenue and provides that the state must pay back the borrowed amount by the end of the fiscal year.

Table 1 (continued)	
Article/ Section	Description of Constitutional Provision
Article IX, Section 15	- Provides that long-term borrowing by the state is permitted if adopted by a two-thirds vote in each house and approved by the majority of voters at any general election.
Article IX, Section 16	- Provides that the state may borrow and pledge its full faith and credit for the purpose of making loans to local schools. - Provides that the Legislature, subject to other constitutional provisions, has the power to prescribe and limit the procedures for obtaining and making state loans and for the repayment of such loans. - Provides that the power to tax for the payment of bonds issued for schools is without limitation as to rate or amount.
Article IX, Section 17	- Provides that no money shall be paid out of the treasury except in pursuance of appropriations made by law.
Article IX, Section 18	- Prohibits the state from granting its credit to any person, association, or corporation except as authorized by the Constitution.
Article IX, Section 21	- Requires the Legislature to provide for the annual accounting for all public moneys, both state and local.
Article IX, Section 23	- Requires all financial records, accountings, and audit reports of the state to be open to the public for inspection and requires the annual publication of all state revenues and expenditures.
Article IX, Section 24	- Requires that the retirement benefits arising from service each year be funded in that year and prohibits such funding to be used for financing unfunded accrued liabilities.
Article IX, Section 25 ("Headlee" Amendment)	- Provides that state taxation and spending may not be increased above the limitations set forth in the "Headlee" Amendment without a direct vote of the people.
Article IX, Section 26 ("Headlee" Amendment)	- Limits total state revenue to a fixed proportion (9.49 percent) of total state personal income in the prior calendar year. - Provides that if total state revenue exceeds this limit by one percent or more, the state is required to refund the excess to taxpayers on a pro rata basis, as reported on income and single business tax returns. - Provides that if total state revenue exceeds this limit by less than one percent, the excess may be transferred to the rainy day fund. - Provides two ways to increase the 9.49 percent limit: a) by a vote of the people approving an amendment to the Constitution; and b) if the responsibility for funding a program is transferred from one level of government to another due to a constitutional amendment. - Provides that the revenue limit does not apply to taxes imposed for voter approved state debt and loans to local school districts.
Article IX, Section 27 ("Headlee" Amendment)	- Provides that the revenue limit may be exceeded if the Governor and Legislature, by a two-thirds vote in each house, declare an emergency and specify the nature, cost, and method of financing the emergency.
Article IX, Section 28 ("Headlee" Amendment)	- Limits state spending to the amount of the revenue limit plus federal funds, any surplus from a previous fiscal year (including accumulated surpluses in the rainy day fund), and payments on voter approved state debt or school bond debt or school bond loans.
Article IX, Section 29 ("Headlee" Amendment)	- Prohibits the state from reducing the state financed proportion of the necessary costs of any existing activity or service required of local governmental units by state law.
Article IX, Section 30 ("Headlee" Amendment)	- Prohibits the state from reducing the proportion of total state support to local governmental units, as a group, to less than that proportion in effect in FY 1978-79 (48.97 percent).
Article IX, Section 35	- Establishes the Natural Resources Trust Fund which is to be used for acquiring land or the rights of land for recreation uses or protection of such land. - Provides that the fund shall consist of revenue derived from leases for the extraction of nonrenewable resources from most state owned land and limits the accumulation of principal in the fund to \$200 million.
Article IX, Section 36	- Earmarks six percent of the proceeds of the tax on tobacco products to improving the quality of health care in the state.
Article IX, Section 36(1)	- Establishes the State Parks Endowment Fund and provides that the fund be used for state park operations and maintenance. - Provides that the accumulated principal in the fund not exceed \$800 million, at which point the fund limit shall be annually adjusted to inflation. - Provides that until the fund reaches \$800 million, the Legislature may not appropriate more than \$5 million from the fund. - Provides that once the fund reaches \$800 million, only the interest and earnings of the fund in excess of the amount necessary to maintain the fund's accumulated principal limit may be made available for expenditure.
Article IX, Section 37	- Establishes the Michigan Veterans' Trust Fund and provides that any expenditure or transfer of fund assets, interest, or earnings must be made by the fund's board.
Article XI, Section 5	- Mandates an appropriation to the Civil Service Commission in the ensuing fiscal year a sum not less than one percent of the total payroll of the prior fiscal year.

Source: 1963 Michigan Constitution.

**Table 2
Principal Statutory Provisions Related to the State Budget and Budget Process in Michigan
Management and Budget Act of 1984 (Public Act 431)**

Section	Description of Section
242	<ul style="list-style-type: none"> - Provides that the Joint Capital Outlay Subcommittee (JCOS) and the State Budget Director determine the priority of capital projects to be studied and planned. - Prohibits a professional services contract from being awarded until a program statement is approved by the Department of Management and Budget (DMB) and notice of approval is given to JCOS. - Provides that funds cannot be expended for a schematic plan until the release is authorized by DMB and JCOS. - Provides that an appropriation will not be released for preparation of a preliminary planning document until the schematic plan for the capital project is approved by DMB and JCOS. - Provides that appropriations will not be released for capital project construction until preliminary plans are approved by DMB and JCOS. - Provides that appropriations made for studies and preliminary plans of capital projects are not considered a commitment on the part of the state Legislature to appropriate funds for the completion of plans or construction of any capital project.
248	<ul style="list-style-type: none"> - Provides that appropriations made in any budget bill for the planning of a capital project not lapse at the end of the fiscal year to the fund from which the appropriation was made, but shall continue until the purposes for which the sum was appropriated are completed. - Provides that capital projects that have been authorized for planning for five years or more which has not been authorized for construction, will be terminated, unless the project is reauthorized in a budget act.
321	- Creates the office of the State Budget Director and provides that the Director be appointed by and serve at the pleasure of the Governor.
323	- Requires the Governor to establish and maintain an executive budget function through the State Budget Director.
341	- Requires the State Budget Director to plan and prepare the executive budget and execute, manage, and control the enacted state budget.
342	- Requires the State Budget Director to establish and maintain an economic analysis, revenue estimating, and monitoring activity.
344	<ul style="list-style-type: none"> - Requires the State Budget Director to develop annual proposals for department program activities and the estimated costs and sources of financing of such activities and to review any findings of the Auditor General as a basis for recommended department expenditures. - Requires the State Budget Director to determine interest and principal payments for state debt each year and review the capital outlay needs and priorities for the succeeding five years.
348	- Requires the executive budget to include the financing for all state agency programs provided by the resources of state operating funds and that the recommendations for expenditures from each fund not to exceed the estimated beginning balance and revenue of each fund.
349	- Implements the calculation for the proportion of state spending to local government (Article IX, Section 30, of the Michigan Constitution).
350	- Provides that if the state assumes the financing and administration of a function after December 22, 1978, the state payments for the function will be counted as state spending paid to local units of government (Article IX, Section 30, of the Michigan Constitution).
350(b)	- Implements the calculation of the state revenue limitation (Article IX, Section 26, of the Michigan Constitution).
350(c)	- Implements the calculation for the state expenditure limitation (Article IX, Section 28, of the Michigan Constitution).
350(d)	- Implements the Headlee refund for exceeding the state revenue limitation (Article IX, Section 26, of the Michigan Constitution).
350(e)	- Requires DMB to prepare an annual compliance report for the state revenue limitation and provides that the report be submitted to the state Auditor General no later than May 31 each year and submitted to the Legislature no later than June 30 each year.
351	- Establishes the state Countercyclical Budget and Economic Stabilization Fund (the state's "budget stabilization" or "rainy day" fund).
352	<ul style="list-style-type: none"> - Provides that when the inflation-adjusted growth in state personal income increases by two percent or more, the percentage in excess of two percent shall be multiplied by the total state general fund-general purpose revenue for the fiscal year ending in the current calendar year to determine the amount to be transferred into the budget stabilization fund. - Provides that when state personal income declines, the percentage below zero percent must be multiplied by the total state General Fund-General Purpose revenue for the fiscal year ending in the current calendar year to determine the amount eligible to be transferred out of the budget stabilization fund and into the state General Fund.

Table 2 (continued)

Section	Description of Section
353	<ul style="list-style-type: none"> - Provides that when the state unemployment rate is between 8.0 and 11.9 percent during a calendar quarter, 2.5 percent of the budget stabilization funds (5.0 percent if the unemployment rate exceeds 11.9 percent) may be transferred out of the fund in the following quarter. - Provides that these funds may be used for (a) capital outlays; (b) public works and public service jobs; (c) refundable investments or employment tax credits against state business taxes for new outlays and hirings; and (d) any other purpose which provides job opportunities to counter the state's economic condition.
354	<ul style="list-style-type: none"> - Requires the executive budget and an appropriation bill to have an estimate of the transfers into and out of the budget stabilization fund.
355	<ul style="list-style-type: none"> - Provides that a transfer into or out of the budget stabilization fund may be adjusted in light of revision in the annual growth rate for the calendar year upon which the transfer was made.
356	<ul style="list-style-type: none"> - Limits the balance in the budget stabilization fund at the end of the fiscal year to 25 percent of General Fund-General Purpose revenue and requires a rebate on the individual income tax returns of any fund excess.
357	<ul style="list-style-type: none"> - Provides that a transfer may be made from the budget stabilization fund in a year in which a deposit was made to the fund, but actual General Fund-General Purpose revenue are less than projected levels.
358	<ul style="list-style-type: none"> - Provides that the Legislature may make emergency appropriations from the budget stabilization fund with a two-thirds vote in each house.
359	<ul style="list-style-type: none"> - Allows the Treasurer to combine balances in the budget stabilization fund with other amounts in the treasury for cash management purposes.
360	<ul style="list-style-type: none"> - Requires the Governor to include a tax expenditure report with the submission of the executive budget to the Legislature.
363	<ul style="list-style-type: none"> - Requires the Governor to submit a budget to the Legislature within 30 days after the Legislature convenes (or within 60 days for a newly elected Governor) and a line-item appropriation detail of this budget to the House and Senate Fiscal Agencies.
367(b)	<ul style="list-style-type: none"> - Establishes the Consensus Revenue Estimating Conference (CREC) and requires a meeting of the conference in January and May. - Provides that the Budget Director and the directors of the House and Senate Fiscal Agencies (or their designees) are the principal conferees. - Requires the conference to forecast the major national and state economic variables and a revenue forecast for the income, sales, and single business taxes, total General Fund-General Purpose revenue, lottery transfers to the School Aid Fund (SAF), and total SAF revenues.
367(d)	<ul style="list-style-type: none"> - Provides that the official state revenue forecast must result from a unanimous decision of the principal conferees in the CREC.
367(e)	<ul style="list-style-type: none"> - Requires the CREC to publish a report detailing the economic and revenue forecasts established by the conference.
371	<ul style="list-style-type: none"> - Prohibits an employee of a state agency from making or authorizing an expenditure or incur an obligation which will exceed their appropriation. - Requires state departments and agencies to establish an allotment schedule to represent a spending plan. - Provides that when it appears that this spending plan or related financing sources do not provide the level of program service assumed in the appropriation bill, the State Budget Director must require departments to reduce their spending plans.
372	<ul style="list-style-type: none"> - Provides that allotments may be adjusted by the State Budget Director as requested by a department and allotments may be adjusted or reduced by the State Budget Director in implementing measures of administrative efficiency.
381	<ul style="list-style-type: none"> - Prohibits departments from establishing a new program or expanding a current program, from any source of funds, above the level approved in the enacted budget.
382	<ul style="list-style-type: none"> - Requires the State Budget Director to certify in writing to the chairs of the Appropriations Committees in each house that a recommendation for supplemental appropriations is within the financial resources of the state.
386	<ul style="list-style-type: none"> - Requires the State Budget Director to prepare monthly financial reports within 30 days after the end of each month.
388	<ul style="list-style-type: none"> - Requires the State Budget Director to monitor state spending to local units of government on a continuous basis.
391	<ul style="list-style-type: none"> - Implements the constitutional requirement for maintaining a balanced budget (Article IV, Section 31, of the Michigan Constitution).
393	<ul style="list-style-type: none"> - Provides that the budget director may make transfers of appropriations within departments to adjust for current cost and price variations. - Provides that these transfers must not include adjustments that have policy implications or that have the effect of creating, expanding, or reducing programs within that department. - Provides that any such transfers may be disapproved by either Appropriations Committee within 30 days. - Prohibits the State Budget Director from transferring appropriations within a department for reasons other than cost and price variances, unless approved by both Appropriations Committees, and prohibits a transfer from creating a new line. - Provides that the State Budget Director may make transfers between departments for federal and other restricted flow-through funds when funds are appropriated in the budgets of both departments.

Table 2 (continued)

Section	Description of Section
396	<ul style="list-style-type: none"> - Requires the state Attorney General to notify the House and Senate Appropriations Committees, the House Speaker, and the Senate Majority Leader within 14 days after entering into a settlement or consent judgment which results in a state obligation of more than \$200,000. - Provides the Budget Director may make transfers from appropriations into separate accounts to pay for settlements and judgments.
451	<ul style="list-style-type: none"> - Requires the unencumbered balance of each appropriation to lapse to the state fund from which it was appropriated. - Provides that work order and work project appropriations are available until completion of the work or 12 months after the last expenditure, whichever comes first, then the remaining balance lapses to the state fund from which it was appropriated.
461	<ul style="list-style-type: none"> - Requires the Auditor General, an independent accounting firm selected by the Auditor General, or an auditor approved by the federal government to perform an audit of all federal awards granted to the state.
462	<ul style="list-style-type: none"> - Requires state agencies, within 60 days after an audit is released, to submit a plan to comply with the audit recommendations to DMB.
486	<ul style="list-style-type: none"> - Requires each state department to employ an internal auditor, who is responsible for conducting and supervising audits relating to the financial activities of the department, oversee internal financial controls and accounting policies, and promote efficiency.
491	<ul style="list-style-type: none"> - Requires the state fiscal year to run from October 1 through September 30.
493	<ul style="list-style-type: none"> - Requires the State Budget Director to submit a preliminary, unaudited financial statements, including notes of the General Fund and the School Aid Fund to the Legislature within 120 days after the end of the fiscal year.
494	<ul style="list-style-type: none"> - Requires the State Budget Director to publish a comprehensive annual financial report within 6 months after the end of the fiscal year.
497	<ul style="list-style-type: none"> - Requires the State Budget Director to submit an itemized statement of state spending to local governmental units to the state's Auditor General by May 31 each year and publish this same statement by June 30 each year.
<p>Source: Management and Budget Act of 1984 (Public Act 431).</p>	

II. Fund Accounting and the State Budget

One of the principal differences between public and private sector accounting is the “accounting entity.” In the typical private sector organization, the accounting entity is the organization itself, since accounts are designed to illustrate the resource position of the entire organization. The public sector, on the other hand, separates financial resources into distinct accounting entities called *funds*, which are established to record and account for the use of specific groups of assets or sources of revenue. Moreover, funds are established by the public sector to assure that the resources devoted to a specific purpose are not mixed in with resources devoted to other purposes.

According to the Government Finance Officers Association (GFOA), a fund is defined as:

A fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or

attaining certain objectives in accordance with special regulations, restrictions, or limitations.

While a governmental unit may utilize any number of funds in executing a wide range of operations and services, it is generally accepted that a governmental unit use the minimum number of funds possible. This “minimum number of funds” principle is set forth by the Governmental Accounting Standards Board (GASB):

Governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established, however, because unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration.

In Michigan, government operations are carried out by approximately 100 funds, which can be divided into two broad categories, primary government funds and component unit funds.

A. Primary Government Funds

As the name suggests, these funds are the principal funds utilized by state government in carrying out government operations. The primary government funds in Michigan include: 1) governmental funds; 2) proprietary funds; 3) fiduciary funds; and 4) account groups (See **Table 3**).

1. Governmental Funds

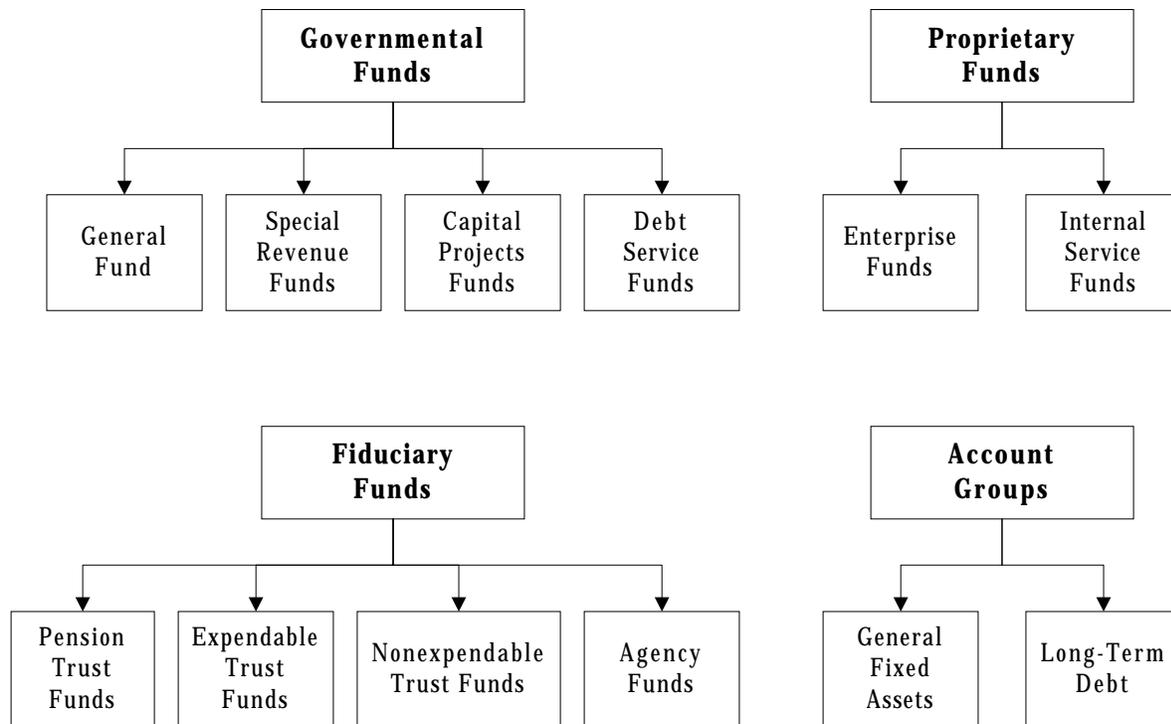
Most government functions are financed through four types of governmental funds, including the general fund, special revenue funds, capital projects funds, and debt service funds.

a. General Fund. The principal operating fund in Michigan is the General Fund, which is financed by *general purpose* and *special purpose* revenue. The difference between General Fund-General Purpose (GF-GP) and General Fund-Special Purpose (GF-SP) revenue is the degree to which the state Legislature has discretion in making appropriations. With GF-GP revenue, the Legislature may make appropriations for

any government program or service from year to year, thus providing the Legislature the needed flexibility to meet the changing public demands and needs of the state.

On the other hand, because GF-SP appropriations are restricted by constitutional, statutory, or contractual provisions, the Legislature must appropriate GF-SP revenue for specific government programs or activities. Unlike special revenue funds (described below), separate funds are not established for GF-SP revenue. For example, Article IX, Section 10, of the Michigan Constitution requires a portion of the sales tax (15 percent of the original four percent sales tax revenue) to be used for state revenue sharing. However, all sales tax revenues restricted for revenue sharing are deposited in the state’s General Fund. Likewise, many federal funds are deposited in the state’s General Fund. However, use of these funds are restricted for specific government programs or activities. The most notable example of this would be federal matching funds for the state Medicaid program.

**Figure 5
Primary Government Funds**



Source: Government Finance Officers Association.

b. Special Revenue Funds. These funds include operating fund activities financed by special revenue sources that are legally dedicated or “earmarked” to a specific fund *and* activity. Therefore, unlike GF-SP revenue, special revenue funds are created for each government activity. In general, state revenue may be earmarked either by constitutional or statutory law. After special revenue funds are created, they usually continue year after year until discontinued or revised by the constitutional or statutory authority which created the fund.

c. Capital Projects Funds. Capital projects funds are used to account for most major capital acquisitions and construction projects.

d. Debt Service Funds. These funds are used to account for the accumulation of resources for, and the payment of,

general long-term debt principal and interest.

2. Proprietary Funds

Proprietary funds are used to account for government activities that receive a significant portion of their funding through user charges. With these funds, governments attempt to recover, in whole or in part, the cost of providing goods and services to beneficiaries. Proprietary funds include two types of funds, *enterprise funds and internal service funds*

The principal difference between enterprise and internal service funds is the beneficiary of the government good or service. Enterprise funds account for government goods and services provided to and financed by the general public, while internal service funds account for goods and services provided to and financed by another government department or agency.

How and Why is State Revenue Earmarked?

State revenue may be earmarked for one of three reasons. *First*, the revenues may be viewed by the state as “user fees” that should be limited to financing whatever program is being used by those paying for it and not used to subsidize other government functions. For example, Section 10.134 of Public Act 327 of 1945 provides that all revenue generated by the aviation fuel tax in Michigan is to be deposited into the State Aeronautics Fund and used for local airport improvement projects and administration.

Second, the revenues may come from the federal government and be legally limited to the financing of a specific government program or agency. For example, federal funds for the school lunch program may not be used for any other program.

Third, revenues may be placed in a dedicated fund in order to place a “floor” under the financing of a particular program. For example, Section 9.1097(11b) of Public Act 51 of 1951 provides that \$5.0 million from the Michigan Transportation Fund is annually earmarked to the Critical Bridge Fund and is to be used for bridge improvements and construction (See Council Comments #1038, *The Earmarking of State Taxes in Michigan*).

3. Fiduciary Funds

This fund category is used to account for assets held by the state in a trustee capacity or as an agent for individuals, private organizations, other governments, or on behalf of other state funds. This category consists of *pension trust funds nonexpendable trust funds expendable trust funds and agency funds*

a. Pension Trust Funds. These funds are used to account for public employee retirement systems. The state of Michigan oversees retirement funds for the Legislature, state police, state employees, public school employees, judges, and municipal employees.

b. Expendable Trust Funds. These funds are designed to provide stewardship over expendable assets and investment earnings held in trust by government and functions much like a governmental fund.

c. Nonexpendable Trust Funds. These funds are similar to expendable trust funds, except that only the investment earnings on the assets held in trust may be spent. Hence, the assets held in this fund are nonexpendable. Essentially, these trust funds function like endowments.

d. Agency Funds. Expendable and nonexpendable trust funds involve some degree of financial management (investment, utilization, etc.) by a governmental unit. Agency funds, on the other hand, are used in situations where the governmental unit plays a much more limited role. For example, the governmental unit may simply collect or temporarily hold assets on behalf of a third party. These funds are often used to account for taxes collected by one governmental unit on behalf of another.

4. Account Groups

Governmental funds are used for the short-term (fiscal year) budgetary needs of the governmental unit and do not comprise a unit’s general long-term obligations or fixed assets. Such information is provided apart from governmental funds in two separate account groups, the general fixed assets account group and the general long-term debt account group. These two account groups are unique in that they are not funds and do not report “operations.” Rather, account groups simply list the governmental unit’s general fixed assets (land, buildings, and equipment) and long-term obligations, except for those accounted for directly in another fund.

B. Component Unit Funds

In addition to the state’s primary funds, there are certain legally separate governmental organizations, or *component units*, for which the state is financially accountable. Financial accountability to these component units is evidenced largely by the Governor having

the legal authority to appoint a voting majority of the component unit’s governing board (See **Table 4**).

From an accounting perspective, component units of state government are treated separately from primary

government funds and are divided into three unit categories: governmental, proprietary, and public university. While the governmental and proprietary component units function in a similar fashion to primary governmental funds, they are legally separate from other governmental units.

Ten public universities in the state whose governing boards are appointed by the Governor also are considered component units of state government. These

universities include Central Michigan University, Eastern Michigan University, Ferris State University, Grand Valley State University, Lake Superior State University, Michigan Technological University, Northern Michigan University, Oakland University, Saginaw Valley State University, and Western Michigan University. Since their governing boards are elected and legally separate from the state, Michigan State University, University of Michigan, and Wayne State University are not reported as component units.

C. Michigan's "Key" Funds

In Michigan, the three funds with the most budgetary relevance are the: 1) General Fund-General Purpose; 2) School Aid Fund; and 3) Countercyclical Budget and Economic Stabilization Fund. Year-end balances in these "key" funds provide the most insight into the state's fiscal position. For example, the General Fund-General Purpose and School Aid Fund are the focus of the state "surplus" or "deficit," technically the working balance of the state, while the Countercyclical Budget and Economic Stabilization Fund reflects accumulated contributions by the General Fund-General Purpose. Together, these fund balances are a good indicator of available state resources, outside of current revenues, to finance the general operations of state government in Michigan.

1. General Fund-General Purpose

The principal operating fund is the General Fund-General Purpose (GF-GP). Unlike most other funds, revenues deposited into the General Fund-General Purpose are not legally dedicated to any specific government agency or program. As a result, legislators

have more discretion appropriating GF-GP revenue than any other revenue, which enables legislators to reallocate funding priorities from one budget session to the next. Due to the flexibility provided to legislators in appropriating its revenue, the GF-GP budget is the focal point of the state budget process.

2. School Aid Fund

The School Aid Fund (SAF), which was originally created by a 1955 amendment to the 1908 Michigan Constitution, is the vehicle through which state aid is provided to local school districts and the school employees' retirement system. The SAF is primarily supported by dedicated portions of the sales, use, income, cigarette, and non-cigarette tobacco taxes and all of the liquor excise, real estate transfer, and state education property taxes, which are distributed to local schools through a statutory formula. Net revenue from the state lottery is also deposited into the SAF. Since SAF revenues have historically fallen short of the amount necessary to finance the state's share of school aid, the SAF is supplemented by GF-GP reve-

The State Treasurer's Common Cash Fund

Governments often combine cash balances not needed to pay immediate obligations from different funds into a separate cash fund. While primarily utilized as a mechanism for managing cash flow among the various participating funds, cash funds also are used by governments to maximize investment earnings on short-term investments. In Michigan, cash balances from most primary government funds, including the General Fund, School Aid Fund, and Budget Stabilization Fund, are collectively pooled in the Treasurer's Common Cash Fund. Though not reported as a separate fund in the state's Comprehensive Annual Financial Report, the Treasurer's Common Cash Fund plays a critical role in the day-to-day operations of state government. Once state departments incur *obligations* or actions that commit the state to pay for goods or services, the state's Common Cash Fund is used for the payment of outstanding liabilities. Therefore, because the flow of revenue into the state's numerous funds varies from fund to fund, the Common Cash Fund enables funds to draw on the available balances of other funds to meet their obligations. Therefore, the Common Cash Fund is often used as a mechanism for short-term interfund borrowing among participating funds.

nue. Therefore, in practice, the SAF is an adjunct to the GF-GP and has the same effect on the state's working balance as do GF-GP expenditures

3. Countercyclical Budget and Economic Stabilization Fund

Established in 1977, the Countercyclical Budget and Economic Stabilization Fund stabilizes state revenue and employment during periods of economic recession and high unemployment. In addition to stabiliz-

ing revenue and employment, this fund stabilizes state expenditures during periods of economic expansion by artificially depressing the resources available to the GF-GP budget. The Countercyclical Budget and Economic Stabilization Fund is not a typical special revenue fund in the sense of having its own dedicated revenue source and specific agency or program use. Rather, it is a temporary segregation of GF-GP revenue that, when released, may be used for the same purposes as other GF-GP resources.

Table 3
Michigan Primary Government Funds

Fund Category/ Type	Fund Description/ Use	Legal Basis
Governmental/ General Fund: 1) General Fund-General Purpose 2) General Fund-Special Purpose	- any government program or activity, as provided by the Legislature - restricted by constitutional, statutory, or contractual provisions and must be appropriated for specific government programs or activities	
Governmental/ Special Revenue Funds: 3) State Aeronautics Fund 4) State Trunkline Fund 5) Michigan Transportation Fund 6) Comprehensive Transportation Fund 7) Combined State Trunkline Fund Bond Proceeds Fund	- administration of and improvements to local airport projects - highway administration, maintenance, construction, and debt service - allocates money for state and local transportation needs - planning and development of public transportation systems - construction and maintenance of the state trunkline system and provide loans to local governments	P.A. 327 of 1945 P.A. 51 of 1951 P.A. 51 of 1951 P.A. 327 of 1972 P.A. 51 of 1951
8) Combined Comprehensive Transportation Bond Proceeds Fund 9) Game and Fish Protection Fund 10) Michigan State Waterways Fund 11) Marine Safety Fund 12) Game & Fish Protection Trust Fund	- construction and acquisition of comprehensive transportation projects - support the conservation program for preservation and control of fish and wildlife - improvement of lake harbors, docking facilities, and inland waterways - educational programs, law enforcement, and regulations for watercraft operation - restrict certain assets for transfer to the Game & Fish Protection Fund	P.A. 51 of 1951 P.A. 17 of 1921 P.A. 320 of 1947 P.A. 303 of 1967 P.A. 73 of 1986
13) State Park Improvement Fund 14) Recreation Bond Fund (Local Projects) 15) Environmental Protection Bond Fund 16) Michigan Natural Resources Trust Fund 17) Michigan State Parks Endowment Fund	- acquisition of land, construction, development, and improvement of state parks - various state and local public recreation projects - various clean-up programs, including toxic and solid waste sites, sewage treatment, etc. - recreational land use purchases, administration, and any taxes owed by the state on the land - operation, maintenance, and capital improvements at state parks	P.A. 149 of 1960 P.A. 329 of 1988 P.A. 328 of 1988 P.A. 101 of 1985 P.A. 354 of 1994
18) Michigan Nongame Fish & Wildlife Fund 19) Forest Development Fund 20) MI Civilian Conservation Corps Endowment Fund 21) Michigan Underground Storage Tank Financial Assurance Fund 22) Safety Education & Training Fund	- research and management of nongame fish and wildlife, endangered species, and plants - reforestation, forest protection, and timber stand improvement - conserve, improve, and develop the state's natural resources, public lands, and waters - assist tank owners in meeting provisions set forth in the Solid Waste Disposal Act - workplace safety education and training	P.A. 189 of 1983 P.A. 351 of 1993 P.A. 394 of 1994 P.A. 518 of 1988 P.A. 24 of 1977
23) Uninsured Employers' Security Fund 24) State Construction Code Fund 25) Homeowner Construction Lien Recovery Fund 26) MI Employment Security Act-Admin. Fund 27) Michigan Veterans' Trust Fund	- workers' compensation benefits where employers failed to provide coverage - administration and operation of construction codes - allows contractors and others to collect payments for uncompensated work - operation and administration of unemployment compensation program - various programs to assist veterans and their beneficiaries	P.A. 198 of 1993 P.A. 371 of 1980 P.A. 497 of 1980 P.A. 1 of 1936 P.A. 9 of 1946

Table 3 (continued)

Fund Category/ Type	Fund Description/ Use	Legal Basis
<p>Governmental/ Special Revenue (cont'd): 28) Children's Trust Fund 29) School Bond Loan Fund 30) School Aid Fund 31) Countercyclical Budget and Economic Stabilization Fund</p>	<p>- child abuse and neglect prevention programs - issuance of state general obligation bonds on behalf of local school districts - public school aid and financing for public school employees' retirement - stabilize revenue and employment during periods of recession and high unemployment</p>	<p>P.A. 249 of 1982 P.A. 74 of 1955 Art. 9, Sec. 11 P.A. 76 of 1977</p>
<p>Governmental/ Debt Service Funds 32) Combined State Trunkline Bond & Interest Redemption Fund 33) Water Pollution Control Bond & Interest Redemption Fund 34) Combined Comprehensive Transportation Bond & Interest Redemption Fund 35) Recreation & Environmental Protection Bond Redemption Fund 36) State Building Authority</p>	<p>- debt service on all State Trunkline Funds related bond issues - retire bond issues of the Water Pollution Control Bond Fund - debt service on all Comprehensive Transportation Fund related bond issues - debt service on Recreation (State & Local Projects) & Environmental Protection Bond Funds - debt service on bonds to finance the construction, acquisition, or renovation of buildings</p>	<p>P.A. 51 of 1951 P.A. 329 of 1966 P.A. 51 of 1951 P.A. 326-327 of 1988 P.A. 183 of 1964</p>
<p>Governmental/ Capital Project Funds 37) Recreation Bond Fund (State Projects) 38) State Building Authority 39) State Building Authority Advance Financing Fund</p>	<p>- various state public recreation projects - construction of state projects, equipment, and higher education related projects - expenditures incurred for equipment, higher education, and state projects prior to the issuance of State Building Authority bonds</p>	<p>P.A. 183 of 1964 P.A. 329 of 1988 P.A. 183 of 1964</p>
<p>Proprietary/ Enterprise Funds 40) Liquor Purchase Revolving Fund 41) State Lottery Fund 42) Michigan State Fair Revolving Fund 43) Natural Resources Magazine Fund 44) Accident Fund of Michigan*</p>	<p>- sales of, replenishing of, and transportation of liquor stock of the state liquor stores - net income derived from the state lottery operations - administration of the Michigan State Fair and fairgrounds - administration of the publication of the department's publications - provides worker's compensation insurance for Michigan employers</p>	<p>P.A. 259 of 1941 P.A. 239 of 1972 P.A. 224 of 1962 P.A. 107 of 1979 P.A. 157 of 1990</p>
<p>Proprietary/ Internal Service Funds 45) Correctional Industries Revolving Fund 46) Motor Transport Fund 47) Office Services Revolving Fund 48) Information Technology Revolving Fund 49) Risk Management Fund 50) State Sponsored Group Insurance Fund</p>	<p>- accounts for financial transactions involving inmates of the state correctional facilities - provides automobiles to state agencies on a permanent or short-term basis - provides various office services to state agencies including, photocopying and mailing - provides telecommunication and information technology services to state agencies - provides liability coverage for automobile use, state fair and employee bonding - provides health, long-term disability, life, vision, and dental coverage for state employees</p>	<p>P.A. 15 of 1968 P.A. 431 of 1984 P.A. 262 of 1952 Administrative Administrative Administrative</p>

Table 3 (continued)

Fund Category/ Type	Fund Description/ Use	Legal Basis
Fiduciary/ Pension Trust Funds 51) Legislative Retirement Fund 52) State Police Retirement Fund 53) State Employees' Retirement Fund 54) Public School Employees' Retirement Fund 55) Judges' Retirement Fund 56) Municipal Employees' Retirement Fund	- retirement benefits for members of the Legislature, presiding officers, and beneficiaries - retirement benefits for state police officers - retirement benefits for state employees - retirement benefits for employees of local schools, community colleges, and state universities - retirement benefits for state judges - retirement benefits for municipal employees	P.A. 261 of 1957 P.A. 182 of 1986 P.A. 240 of 1943 P.A. 300 of 1980 P.A. 234 of 1992 P.A. 234 of 1992
Fiduciary/ Expendable Trust Funds**: 57) Michigan Unemployment Compensation Fund 58) MI Employment Security Act Contingent Fund 59) Second Injury Fund 60) State Employees' Deferred Compensation Fund II (401k)	- payment of benefits to eligible unemployed workers - solvency tax, interest on contributions, penalties, and damages collected under Michigan Employment Security Act - insure carriers and self-insured employers against certain workers' compensation losses - deferred compensation plan which allows state employee participation	P.A. 1 of 1936 P.A. 535 of 1982 P.A. 317 of 1969 Administrative
Fiduciary/ Agency Funds 61) Metropolitan Planning Fund 62) Financial Institutions Deposits Fund 63) Dept. of Natural Resources Deposits Fund 64) Insurance Carrier Deposits Fund 65) Treasurer's Escrow & Paying Agent Fund 66) State Employees' Deferred Compensation Fund I (457)	- accounts for federal funds that reimburse local regional planning agencies - accounts for security deposits held by the State Treasurer on behalf of bank trust departments - accounts for various deposits of the Department of Natural Resources - accounts for deposits held by the State Treasurer on behalf of insurance carriers in the state - accounts for investments held in escrow by the Treasurer as fiscal agents for hospitals - deferred compensation plan which allows state employee participation	Fed. Highway Act Administrative Administrative Administrative Administrative Administrative
<p>*The Accident Fund of Michigan was sold by the state in FY 1995. **In addition to these four funds, there are four transportation related sub-funds and various miscellaneous trust accounts in which the state holds funds in a fiduciary manner. Source: Department of Management and Budget, <i>State of Michigan Comprehensive Annual Financial Report, FY Ended September 30, 1995.</i></p>		

**Table 4
Michigan Component Unit Funds***

Fund Category/ Type	Fund Description/ Use	Legal Basis
Governmental Component Units 1) Mackinac Bridge Authority 2) Michigan Higher Education Facilities Authority	- construction and operation of a bridge between the Upper and Lower Peninsulas of the state - assist private nonprofit institutions of higher education in financing their facilities	P.A. 21 of 1950 P.A. 295 of 1969
Proprietary Component Units 3) Michigan State Hospital Finance Authority 4) Michigan Education Trust 5) Michigan Higher Education Student Loan Authority 6) Michigan Higher Education Assistance Authority 7) Mackinac Island State Park Commission 8) Michigan Strategic Fund** 9) Michigan State Housing Development Authority 10) Michigan Municipal Bond Authority	- lend money to nonprofit, nonpublic hospitals and health care corporations for capital improvements or debt refinancing - operates a prepaid tuition program for public universities and community colleges in the state - make loans to qualified students attending participating institutions of higher education - guarantees 100 percent of principal and interest on loans to persons attending eligible institutions of higher education in the state - manages Mackinac Island and the Michilimackinac State Parks - diversify the economy of the state and provide for economic development, by assisting businesses obtain additional sources of financing - issues notes and bonds to finance housing for sale or rent to families with low or moderate incomes and to finance home improvements - assist local units of government in reducing their financing costs for public improvements, deficit reduction, and various other purposes	P.A. 38 of 1969 P.A. 316 of 1986 P.A. 222 of 1975 P.A. 77 of 1960 P.A. 355 of 1927 P.A. 270 of 1984 P.A. 346 of 1966 P.A. 227 of 1985

* In addition to these funds, there are component unit funds for the 10 public universities whose boards are appointed by the Governor.

**Subsequently renamed the Michigan Renaissance Fund.

Source: Department of Management and Budget, *State of Michigan Comprehensive Annual Financial Report, FY Ended September 30, 1995.*

III. An Overview of the State Budget Process

A. Phases in the State Budget Process

The state budget process is best understood as a continuous cycle with five distinct phases, including preparation, adoption, execution, year-end book closing, and audit (See **Figure 6**). While both the executive and legislative branches of government share responsibilities throughout the state budget process, each phase, as a general rule, focuses on one of these two branches. Moreover, the product of each phase in this process initiates the work in the ensuing phase.

1. Preparation Phase

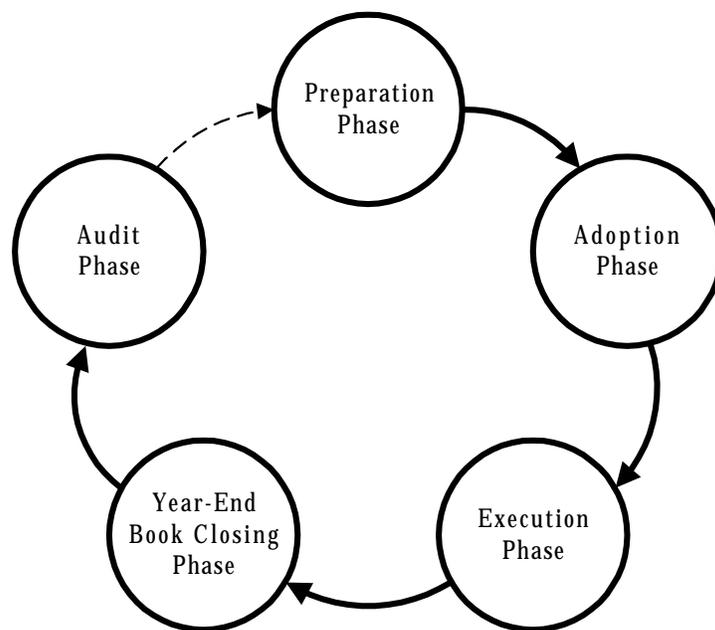
The first phase in the state budget process is largely a function of the executive branch. More specifically, the State Budget Director and the directors of all other state departments are responsible for preparing the state budget in readiness for consideration and adoption by the state Legislature. The final product of this phase is the Governor's budget, or *executive*

budget, which reflects the Governor's priorities for the upcoming fiscal year state budget.

2. Adoption Phase

During the second phase, the legislative branch assumes control over the state budget process as the Legislature begins deliberating and modifying the recommendations of the Governor. The products of these legislative deliberations are *enrolled appropriation bills* which are sent to the Governor for consideration. The adoption phase is complete once the Governor has signed these bills, or the Legislature has acted upon any gubernatorial vetoes. The final products of this phase are *enacted appropriation bills* which grant state departments and other entities of the state (local schools, universities, community colleges) the legal authority to incur obligations or make expenditures.

Figure 6
Phases in the State Budget Process



3. Execution Phase

In the third phase, the executive branch resumes control of the state budget process as state departments implement the legislative intent of appropriations. In many cases, however, revisions are made to enacted appropriations during this phase, at which point the Legislature plays a critical role. Due to these revisions, the final products of this phase, *actual expenditures* may differ significantly from enacted appropriations.

4. Year-End Book Closing Phase

The executive branch retains control of the state budget process in the fourth phase, as state departments demonstrate legal compliance to enacted or revised appropriations. The final product of this phase

is the publication of the state's *Comprehensive Annual Financial Report*, which summarizes department compliance on a fund-by-fund basis.

5. Audit Phase

The state budget process concludes with the audit of department budgets and programs. Like the year-end book closing phase, legal compliance is demonstrated in this phase. However, this compliance is demonstrated to the legislative branch in this phase. During the audit phase, the state's legislative Auditor General conducts post financial and performance audits of state governmental operations. The final products of this phase are various *audit reports* detailing the findings of the Auditor General.

B. The Budget Calendar

Though the fiscal year runs from October 1 to September 30, the budget process extends well beyond this 12-month period. As **Figure 7** illustrates, the budget process begins at least 14 months prior to the start of the fiscal year with the preparation and adoption of the executive budget. Following the first two phases in the state budget process, the start of the fiscal year (October 1) marks the beginning of the execution

phase as state departments and other state entities implement their approved budgets. Following budget execution, the state's books are not closed until the following March, or six months after the end of the fiscal year. Thus, prior to the audit of department programs and budgets, which may not begin until the following year, the state budget process for a single fiscal year has taken nearly three years (32 months).

C. Overlapping Nature of the State Budget Process

Because the state budget process extends well beyond the fiscal year, it should be noted that at any given point in the year, several different phases in this process and several different state budgets will be taking place at the same time. In fact, it is possible that all five phases and five different state budgets will simultaneously be in effect. As **Figure 8** illustrates, this is likely to occur in the month of

March each year. For example, in March 1997, a few state departments may be making initial preparations for the FY 1999 budget, the Legislature may be in the process of adopting the FY 1998 budget, the FY 1997 budget is being executed, the state is closing out the books from the FY 1996 budget, and the legislative Auditor General may be auditing a state department's FY 1995 operations.

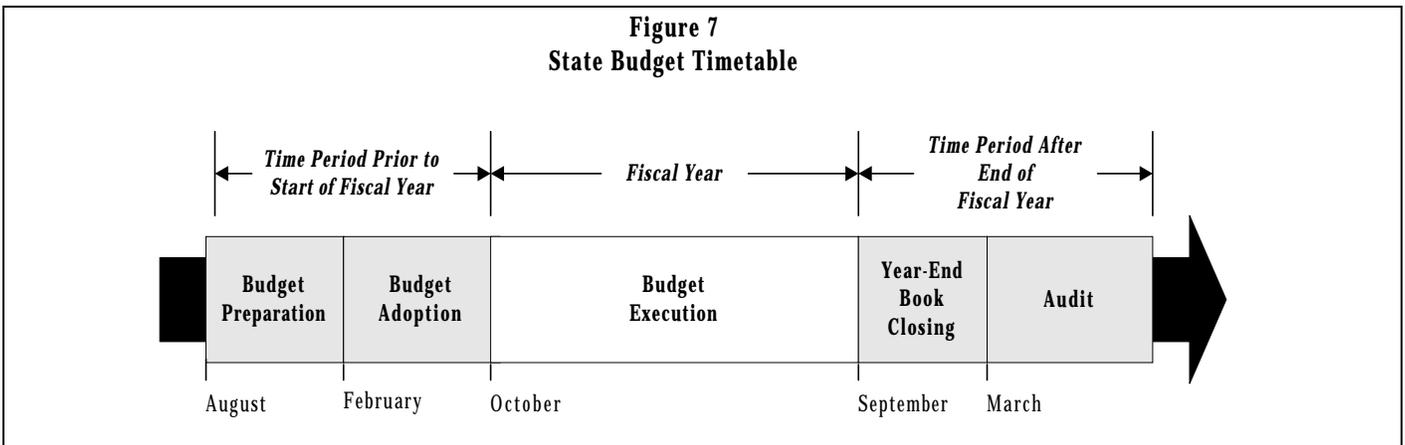
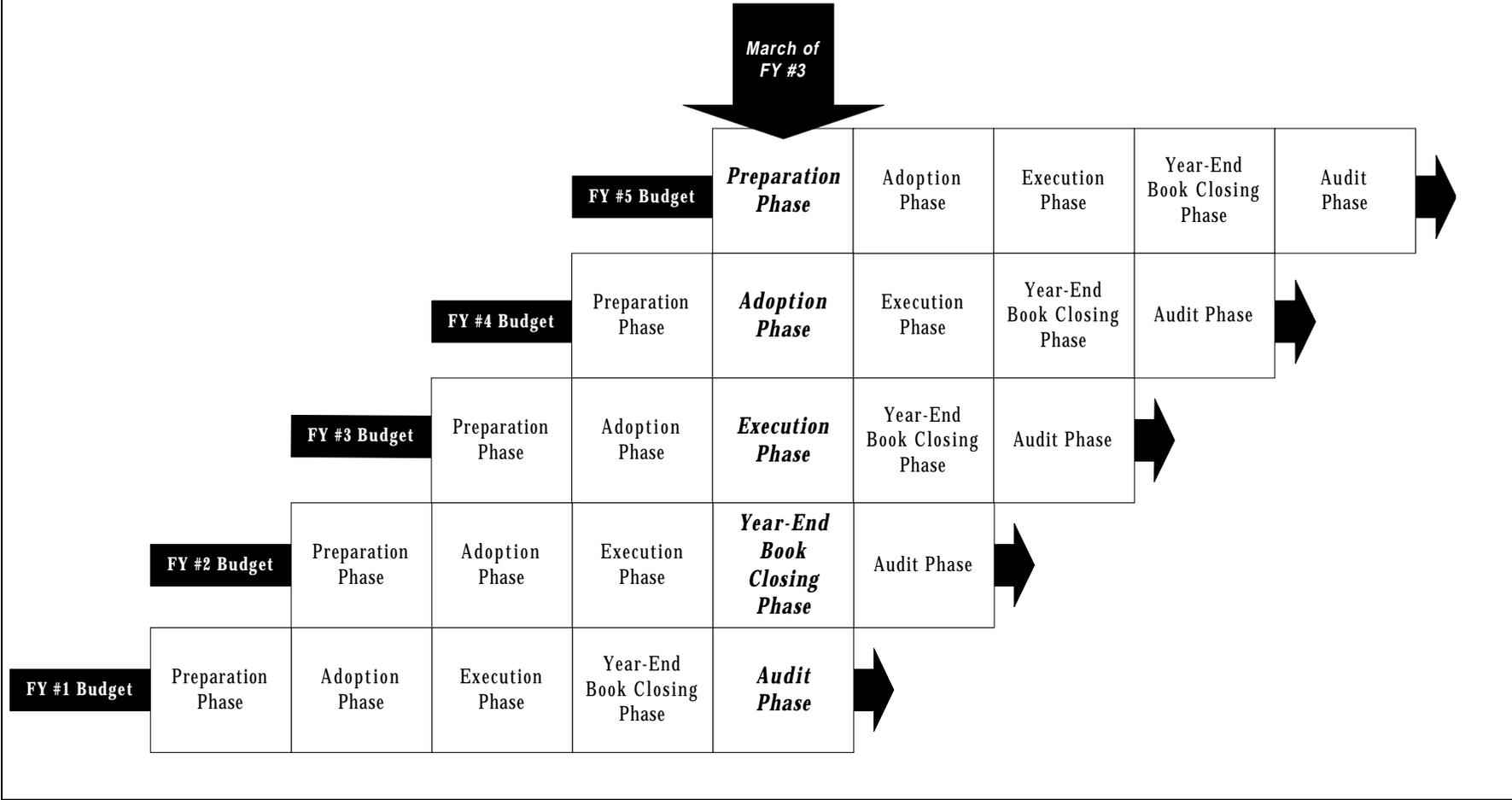


Figure 8
Overlapping Nature of the State Budget Process



IV. Budget Preparation

The initial phase of the state budget process is the preparation of the Governor's budget (the "executive budget") in readiness for consideration and adoption by the state Legislature. While the start of the preparation phase may vary due to department size or change in administration, most state departments in

Michigan begin preparing for an upcoming fiscal year budget as early as August each year. In other words, departments begin preparing at least six months prior to the submission of the executive budget to the Legislature in February and 14 months before the start of the fiscal year in October.

A. Principal Players in the Preparation Phase

The preparation phase of the state budget process is largely a function of the executive branch and involves these principal players:

1) The *Governor* is responsible for appointing the State Budget Director and State Treasurer and other department directors and submitting a balanced budget to the Legislature each year.

2) The Director of the Department of Management and Budget, or *State Budget Director*, serves as the Governor's primary budget policy advisor and is responsible for issuing budget and program guidelines, reviewing department budget requests, and preparing the Governor's budget.

3) The *State Treasurer* serves as the Governor's

primary tax policy advisor and is responsible for advising the Governor on the impact of state and federal tax policies and monitoring state revenue collections.

4) *Department directors*, including the State Budget Director and State Treasurer, are responsible for overseeing the preparation of and response to departmental budget requests and monitoring changes in federal and state law that may affect department funding and program operations.

5) The *Consensus Revenue Estimating Conference*, a joint executive-legislative conference, is responsible for establishing the fiscal boundaries for budget deliberation for the upcoming fiscal year through the January state revenue forecast.

B. Five Steps in the Preparation Phase

The preparation phase of the state budget process is best understood when divided into five steps (See **Figure 9**):

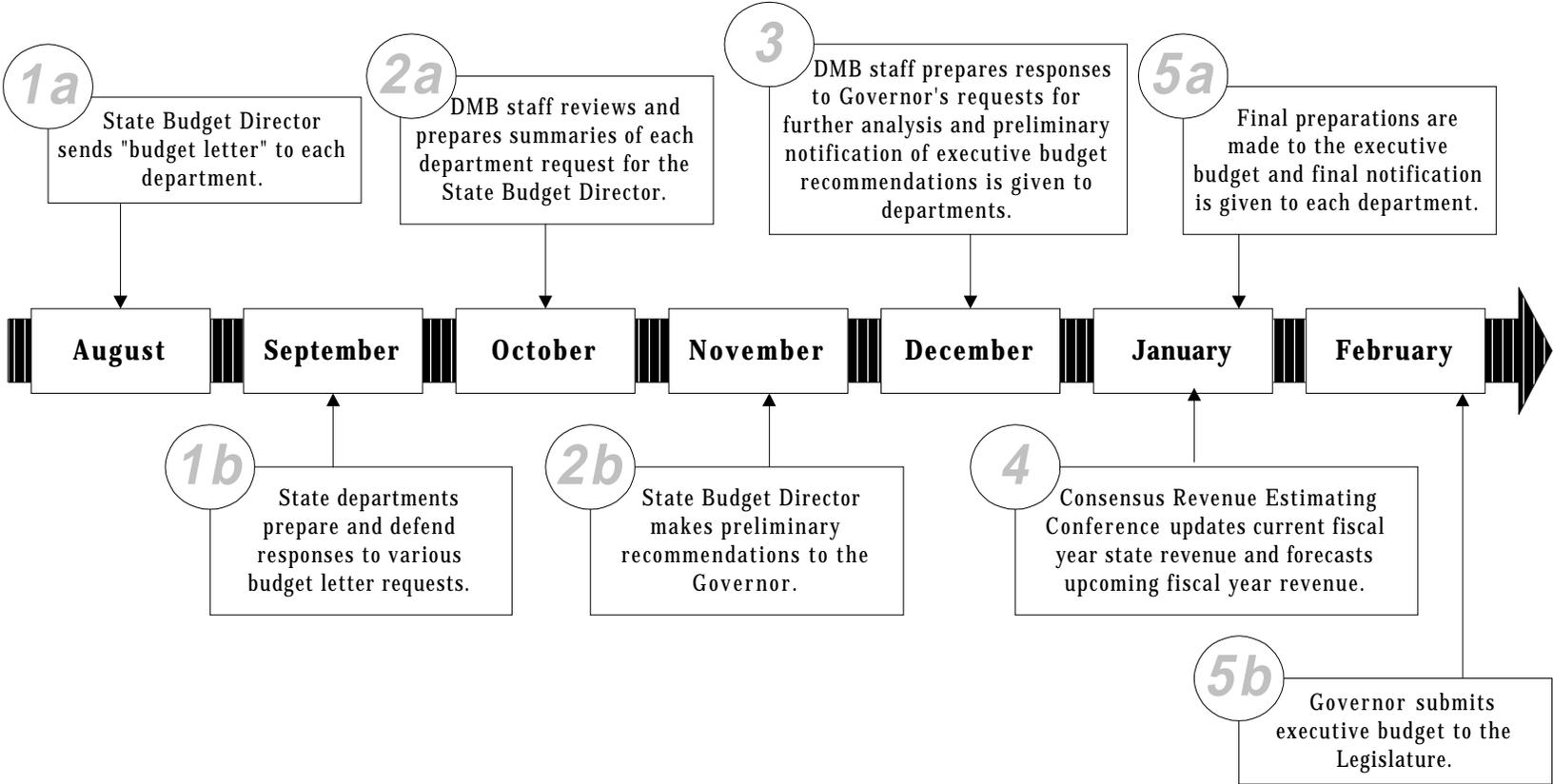
Step 1: The "Budget Letter"

The state budget process typically begins in August each year with a letter, often referred to as the "budget letter," from the State Budget Director to each state department. However, since the Department of Management and Budget (DMB) is not legally bound to any specific deadline, the budget letter may be sent earlier or later than August. In addition to identifying the Governor's priorities and budget and program guidelines for the upcoming fiscal year budget, the budget letter contains several requests, each with its own deadline, which lay the groundwork for the preparation of the executive budget. Upon receipt of the budget letter, state departments typically have four to eight weeks to respond to each request.

These requests fall into four broad categories, three of which are required of each department (current services baseline, budget reduction, and final operating budget requests) and one which is optional (a capital budget request).

a. Current Services Baseline Request. With this request, DMB requires each state department to identify what their operating costs will be in the upcoming fiscal year for the same level of services being supported by the current fiscal year budget. Allowable adjustments to a department's cost projections are specified in the budget letter and may include: 1) mandated spending increases resulting from federal law, court orders, and consent decrees; 2) full-year funding costs for programs that received partial funding in the current fiscal year; 3) funding costs of programs transferred into the department from another department; and 4) savings resulting from operational efficiencies in the department. Projected increased

Figure 9
Preparation Phase of the State Budget Process



costs due to changes in department policy, economic factors (inflation), and new department programs usually are not included in the current services base-line request.

b. Expenditure Reduction Plans. In order to force a continuing re-evaluation of the merits of lower priority programs, and to be prepared for the possible need to make operating budget cuts in the upcoming fiscal year, the budget letter also contains a request for two operating expenditure reduction plans, the sizes of which are largely dependent on the strength of the economy. As a general rule, a stronger economy results in smaller expenditure reduction plans and a weaker economy results in much larger expenditure plans. For example, following the 1990-91 recession, the two expenditure reduction plans requested 10 percent and 20 percent operating reductions in department-wide General Fund-General Purpose (GF-GP) appropriations and administrative operations funded from dedicated funding sources, including federal funds and General Fund-Special Purpose (GF-SP). On the other hand, expenditure reduction plans for FY 1997 were relatively modest, requesting operating reductions of only two and five percent.

As requested in the budget letter, each operating expenditure reduction plan must identify which programs are targeted for funding reductions, the amount of the funding reduction, employee vacancies that may not be filled, the effects of the funding reductions on the department's ability to meet its goals and objectives, and the consumers of the department affected by the reduction plan.

c. Final Operating Budget Request. The third and final required request in the budget letter is for each department's final operating budget. This request, which generates the most paperwork for a department, may require each department to submit to DMB:

- a) a description of each state department and program, including organizational charts and the legal basis of each program;
- b) a description of major program outcomes;
- c) budget revision requests;
- d) legislative Auditor General findings and recommendations;

- e) federal funding information;
- f) revenue source descriptions; and
- g) budget detail for the upcoming fiscal year.

Of these various requests, the most significant is the budget revision request, which, in most cases, seeks additional funding for existing programs or funding for new department programs. However, budget revision requests also may seek reductions in funding levels for state programs.

d. Capital Improvement Request. State departments also may submit a capital improvement request to DMB for the upcoming fiscal year. In this request, departments prioritize their maintenance and construction needs and provide a detailed summary of the nature and cost of the capital project.

Step 2: Executive Review of Requests

As department budget requests for the upcoming fiscal year budget begin arriving to DMB in mid-October, DMB staff reviews and prepares summaries of the requests and, in most cases, discusses the details of each request with the submitting departments. Based on these discussions, DMB staff then makes recommendations to the State Budget Director, who in turn makes preliminary budget decisions and briefs the Governor on these decisions in late November or early December. In addition to making adjustments to these recommendations, the Governor typically requests further analysis or review of specific budget items, resulting in continued discussions between DMB staff and state departments through December.

Step 3: Preliminary Notification and Appeals

With the vast majority of the executive budget in its final form by late December or early January, preliminary notices of executive budget recommendations are given to each department at this time by the State Budget Director. Based on these recommendations, department directors often appeal directly to the State Budget Director regarding proposed budget cuts in the department, denials of increased funding for the department, or proposed policy changes within the department. The State Budget Director and Governor then review any department appeals and, in most cases, await the results of the state revenue forecast before responding to such appeals.

Capital Budgeting in Michigan

Capital budgets are markedly different from operating budgets. Capital budgets result in the creation of public capital assets (roads, bridges, buildings, etc.) whose benefits, presumably, are utilized over many years. Moreover, once started, capital projects become long-term financial commitments, and cannot easily be turned on and off without serious delays and irretrievable costs. Operating budgets, on the other hand, result in public programs and services whose benefits are consumed on an annual basis. Consequently, the budget authority granted to and funding structure of operating and capital budgets reflect this fundamental difference. With operating budgets, current revenues, or a “pay as you go” funding approach, are used to pay for current programs and services and the budget authority granted to such programs and services terminates, in most instances, at the end of the fiscal year. With capital budgets, however, this “pay as you go” approach is less likely, since current revenues are not sufficient to pay the high cost of most capital projects. As a result, long-term financing structures, typically in the form of a bond issue, are used to pay for capital projects.

Because the financing structure and financial commitment of capital projects are quite distinct from recurring government operations, the two are divided into separate budgets in Michigan, an operating and capital budget. Moreover, just as capital budgets differ from operating budgets, so too does the capital budget process differ from the operating budget process. Though most differences between these two processes are subtle, two of the most significant differences should be noted. *First*, whereas operating budgets are primarily reviewed and amended by Appropriations Committees and subcommittees in each house, the capital budget process tends to be more of a cooperative effort among the requesting department or state entity, the Department of Management and Budget (DMB), and the Joint Capital Outlay Subcommittee (JCOS), a 16-member joint subcommittee consisting of 8 members from both the House and Senate Appropriations Committees. JCOS is chaired on a two-year rotational basis and, unlike any other subcommittee, has specific responsibilities defined in the Management and Budget Act of 1984.

Second, given the long-term financial commitment of capital projects, several “safety valves” are added to the adoption and execution phases of the capital budget process which enable lawmakers to terminate projects before the state is fully committed to the payment of long-term debt. For example, the Legislature must grant planning authorization to a state department before any preliminary plans are drawn for the project, DMB and JCOS must approve a program statement for each capital project before funds are released to pay an architect for schematic plans, and the Legislature must approve final project plans before construction begins on any capital project.

Step 4: Revenue Estimating Conference

Established in 1991 (Public Act 72 of 1991), the Consensus Revenue Estimating Conference is responsible for making at least two state forecasts each year in Michigan, one in the second week of January and the other in the last week of May. In addition to revising the revenue estimate of the current fiscal year budget, the January conference also provides the initial revenue forecast for the upcoming fiscal year budget, from which the Governor makes final adjustments to the executive budget. The January forecast, therefore, establishes the boundaries for final budget preparation and initiates budget deliberation and adoption by the Legislature.

The principal participants in the conference include one member of the executive branch (the State Budget Director), two members of the legislative branch (the directors of the House and Senate Fiscal Agencies), or

their respective designees. Since 1991, the State Treasurer has served on the CREC on behalf of the State Budget Director. In addition to these three players, several economists also present their forecasts during the conference. The state’s official forecast, however, is the consensus forecast of the conferences’ principal players.

Each conference is responsible for making two forecasts for the current and upcoming fiscal year, including: 1) *a forecast of national and state economic variables* including gross domestic product, consumer price index, state personal income, unemployment rates, and automobile sales; and 2) based on this economic forecast, *a state revenue forecast* which estimates the anticipated response of the state revenue structure to these variables. In other words, various economic variables are used to forecast revenue of the state’s

primary taxes, including the income, sales, and single business taxes.

Step 5: Submission of the Executive Budget

Approximately two weeks prior to the submission of the executive budget to the Legislature in February, final notifications of executive budget decisions are presented to state departments. In the two weeks leading up to the submission of the executive budget, final review, analysis, and negotiations of executive budget decisions take place between the State Budget Director and state departments. In addition, the State Budget Director and DMB staff begin briefing legislative leaders on the executive budget.

While nothing precludes the Governor from submit-

ting the executive budget on the first day of a regular legislative session (second Wednesday in January), the Management and Budget Act (Public Act 431 of 1984) requires the Governor to submit the executive budget within 30 days after this day or, in a year in which a newly elected Governor is inaugurated into office, 60 days after this day. In other words, the state budget is submitted to the Legislature no later than the beginning of February or March, depending on whether the Governor has been re-elected or newly elected.

In addition to requiring submission of the executive budget to the Legislature, the Management and Budget Act also requires the State Budget Director to present a line-item appropriation detail of the state budget to the House and Senate Fiscal Agencies.

The Executive Budget

The “executive budget” summarizes the Governor’s budget recommendations for each government operation in the upcoming fiscal year. It is largely a narrative which highlights the outputs of government operations, namely appropriations, expenditures, and program outcomes. Though supplemented by numerous tables summarizing proposed appropriations, the executive budget provides limited line-item detail, both historically and prospectively, by government operation and program. Furthermore, while less emphasis is placed on the inputs of state government (revenues), summary tables do show the relationship between estimated revenues and proposed appropriations.

The executive budget is further characterized by heavy emphasis on only one state fund, the General Fund-General Purpose (GF-GP). Though estimates for all revenue sources, including federal funds, are provided in the executive budget, GF-GP revenue is the only funding source specified for each state government operation. As a result, detail is not provided for appropriation items using dedicated funds.

While its structure varies somewhat by administration, the current executive budget is divided into seven sections:

- 1) A letter from the Governor highlighting the most significant budget priorities for the upcoming fiscal year;
- 2) An overview of the Governor’s budget recommendations for the upcoming fiscal year, including summary tables of executive appropriation recommendations for the principal operations of state government;
- 3) A department-by-department summary of executive budget recommendations for the upcoming fiscal year detailing funding history, proposed department and program changes, and program outcome measures;
- 4) An estimate of year-end balances for the upcoming fiscal year for all state funds;
- 5) A four-year summary of revenue collections, including estimated collections for the upcoming, current, and previous fiscal years and actual collections for the most recent fiscal year for which the state’s books are closed;
- 6) A line-item summary of executive budget bill recommendations for the principal operations of government; and
- 7) A listing of additional legislation needed to implement the executive budget (i.e., tax increases or decreases).

V. Budget Adoption

Whereas the preparation of the state budget is largely a function of the executive branch, the second phase in the state budget process, adoption, is largely a function of the legislative branch. Furthermore, the adoption of the state budget is the focus of the state budget process, as attested by Article IX, Section 17, of the Michigan Constitution, which states:

No money shall be paid from the treasury except in pursuance to appropriations made by law.

The adoption phase, therefore, results in legislative sanction of a total level of spending and specific spending amounts for each department and program.

A. Principal Players in the Adoption Phase

The adoption phase of the state budget process is controlled by the legislative branch and involves these principal players:

1) The *House and Senate Appropriations Committees* are responsible for reviewing the executive budget, referring each appropriation bill to the appropriate subcommittee, adopting or amending the appropriation bill recommendations of each subcommittee, and reporting the state budget to the floors of the House and Senate.

2) The *House and Senate Appropriations Subcommittees* are responsible for holding separate budget hearings on each appropriation bill, reviewing department budget requests and justifications, adopting or amend-

ing the recommendations set forth in the executive budget, and reporting the specific appropriation bill to the full House or Senate Appropriations Committees.

3) The *House and Senate Fiscal Agencies* are responsible for fiscal analysis and responding to legislative requests to develop alternatives to the executive budget.

4) The *Governor* is responsible for signing into law or vetoing enrolled appropriation bills.

5) The *Consensus Revenue Estimating Conference* is responsible for establishing the final boundaries for the adoption of the upcoming fiscal year budget through the May state revenue forecast.

B. Six Steps in the Adoption Phase

The process of adopting the state budget involves the same steps as the adoption of most other bills into law, including: 1) the introduction and referral of a bill to committee; 2) committee and subcommittee review of the bill; 3) floor action on the bill; 4) second house action on the bill; 5) conference committee action on the bill; and 6) gubernatorial action on the bill (See **Figure 10**).

Step 1: Introduction and Referral of Bills

While the executive budget is presented to the public and Legislature as a single document, the state budget actually is a collection of individual appropriation bills (See **Table 5**). By custom, all of the appropriation bills are introduced in both houses simultaneously. However, appropriation bills are divided between each house on a rotating basis for consideration each year. In other words, a specific

appropriation bill may first be considered in the House of Representatives one year and in the Senate the next year. In mid to late January, a bill schedule is produced by the chairs of the House and Senate Appropriations Committees identifying the origin of each appropriation bill.

Though all of the appropriation bills typically are introduced by the chairs of the Appropriations Committees, Subcommittee chairs also may introduce appropriation bills. Once introduced, appropriation bills receive a first readings in the House of Representatives and a first and second readings in the Senate. In practice, only the titles of the bills are read. Appropriation bills are then referred to the House Appropriations Committee by the Speaker of the House and the Senate Appropriations Committee by the Majority Leader of the Senate.

Figure 10
Adoption Phase of the State Budget Process

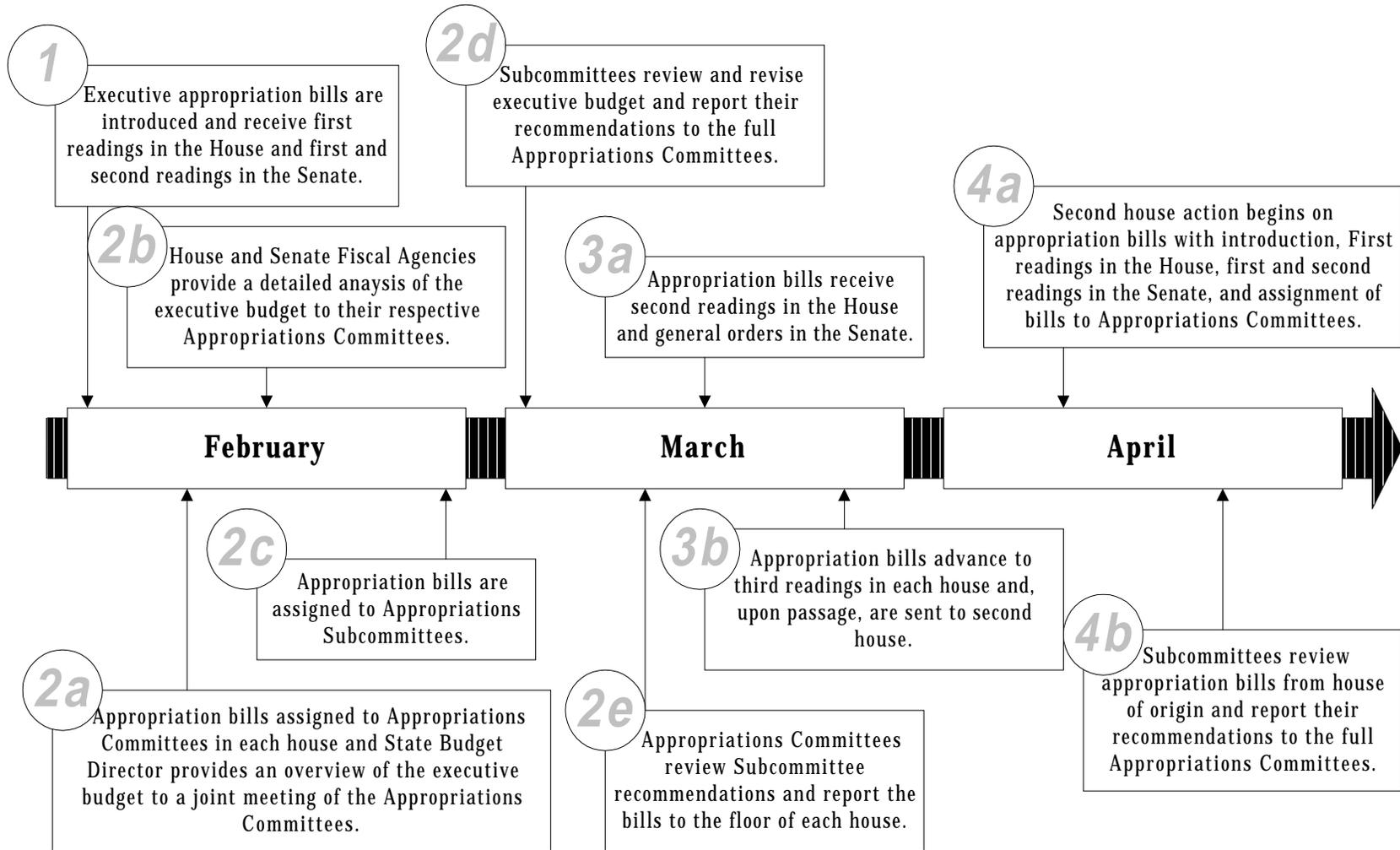
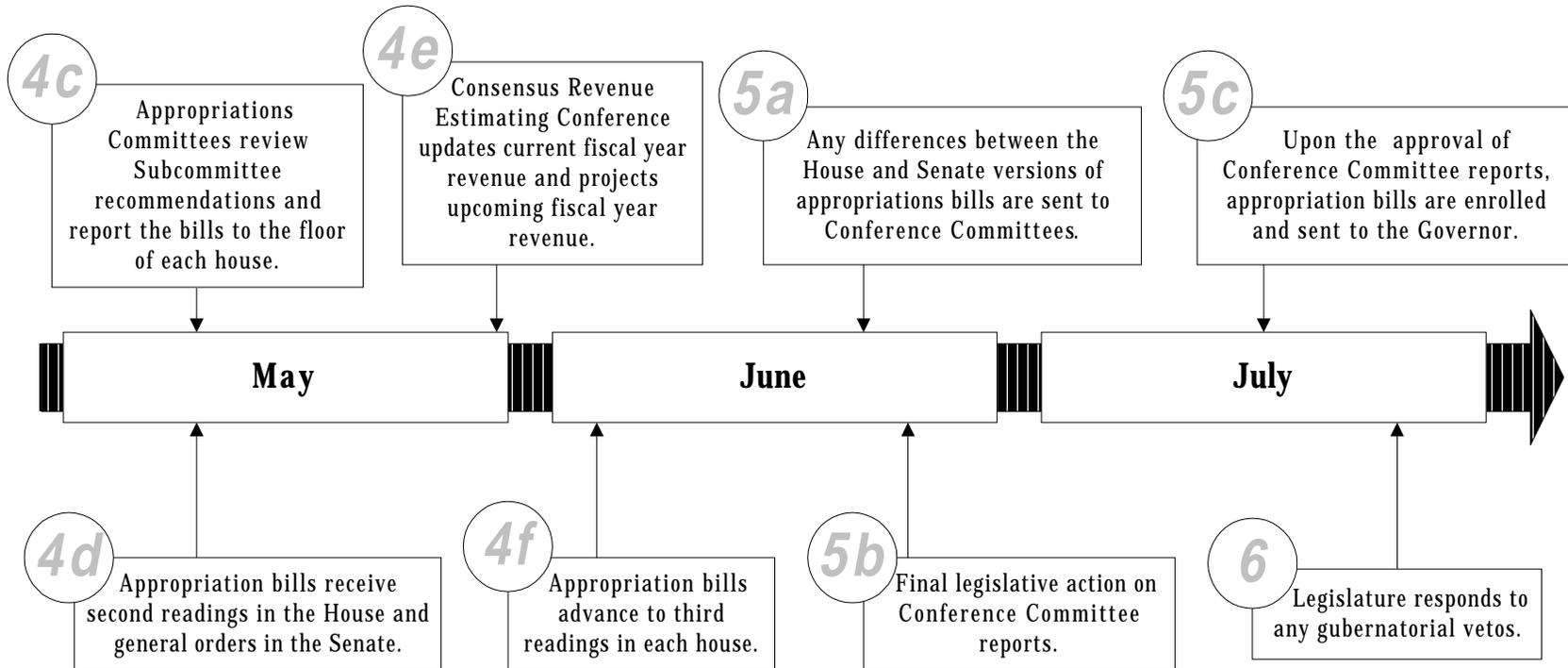


Figure 10 (continued)



**Table 5
FY 1998 Appropriation Bills, State of Michigan**

1) Department of Agriculture	10) Department of State Police
2) Department of Community Health	11) Department of Transportation
3) Departments of Consumer & Industry Services and Michigan Jobs Commission	12) Capital Outlay
4) Department of Corrections	13) Community Colleges
5) Department of Education	14) General Government*
6) Department of Environmental Quality	15) Higher Education (Universities)
7) Department of Family Independence Agency	16) Judiciary
8) Department of Military Affairs	17) Local School Aid
9) Department of Natural Resources	18) Supplemental Appropriations**

*Includes the Depts. of Attorney General, Civil Rights, Civil Service, Management and Budget, State, and Treasury, executive office, and legislative branch.

**May be made for any of the above appropriation bills.

Step 2: Committee and Subcommittee Review

Legislative analysis, debate, and deliberation over the state budget begins in mid-February with the referral of appropriation bills to the full Appropriations Committees in each house. Once an appropriation bill arrives to the full committee, a series of public hearings begins. First, the State Budget Director presents a broad overview of the executive budget recommendations to the full committee, highlighting the Governor's budget priorities in the upcoming fiscal year. The House and Senate Fiscal Agencies then follow with a more thorough analysis of the executive budget, detailing any differences between the Governor's proposed budget and current fiscal year appropriations.

Following initial hearings on the executive budget, each full Appropriations Committee assigns appropriation bills to various Appropriations Subcommittees, which continue holding public hearings on the appropriation bills through mid-March. During these hearings, department directors and staff defend their

budget requests, describe specific programs, and respond to any inquiries from legislators. In addition, public testimony is also taken during these public hearings. As **Table 6** illustrates, Appropriations Subcommittees in each house vary somewhat in number and subject matter.

Based on these hearings, a subcommittee then reports its recommendations to the full Appropriations Committee, which in turn reports the bill, in most cases, to the House or Senate floor without changes or with amendments by the third week of March. In some cases, however, the full Appropriations Committee may send the bill back to the appropriate subcommittee for further review and analysis or completely disregard the recommendations of the subcommittee and report a substitute appropriation bill in place of the original bill.

Step 3: Floor Action on Appropriation Bills

By the third week of March, most appropriation bills have been reported to the House and Senate floors. Like any other bill, an appropriation bill receives its

**Table 6
FY 1998 House and Senate Appropriations Subcommittees, State of Michigan**

<u>House</u>		<u>Senate</u>	
1) Agriculture	10) Judiciary	1) Agriculture	9) Natural Resources & Environment Quality
2) Capital Outlay*	11) Natural Resources & Environmental Quality	2) Capital Outlay*	10) Regulatory
3) Community Colleges	12) Retirement	3) Community Colleges	11) Retirement
4) Community Health	13) School Aid & Department of Education	4) Community Health	12) School Aid & Department of Education
5) Consumer & Industry Services	14) State Police & Military Affairs	5) Corrections	13) State Police & Military Affairs
6) Corrections	15) Supplementals	6) Family Independence Agency	14) Transportation
7) Family Independence Agency	16) Transportation	7) General Government	
8) General Government		8) Higher Education	
9) Higher Education			

*The Capital Outlay Subcommittee is actually a joint committee of the House and Senate.

Source: House and Senate Appropriations Committees.

second reading in the House and receives a General Orders status in the Senate. At this time, Appropriations Committee recommendations are considered by the full membership of each house and amendments to appropriation bills may be offered and adopted. In practice, few amendments are adopted by the Legislature once appropriation bills reach the floor since legislators typically offer any amendments to the Appropriations Committees or subcommittees prior to floor action.

Following second reading in the House and General Orders in the Senate, appropriation bills then advance to third reading in each house. Though again subject to debate and amendment by the full house membership, few amendments are adopted during this step in the adoption phase. At times, however, a delay of the final vote is necessary to assure the passage of a specific appropriation bill. This delay may take the form of sending the appropriation bill back to the Appropriations Committee for further consideration or delaying the final vote on the bill until a majority of legislators support the appropriation bill. At the conclusion of third reading, appropriation bills are passed and sent to the other house by the end of March. Generally, the target is to complete first house action (house of origin) on appropriation bills prior to the April recess, although some bills may not move out of their house of origin until after this recess.

Step 4: Second House Action

Once passed in the house of origin, appropriation bills are sent to the second house, where this same procedure is followed. Following an early April recess, Appropriations Committee and subcommittee review begins in the second houses and appropriation bills are sent to the floor of each house by the end of May. During the last week in May, the Consensus Revenue Estimating Conference convenes for an update of current fiscal year revenue and the final state revenue consensus forecast for the upcoming fiscal year. Based on this forecast and the recommendations of the Appropriations Committees, final actions in the second houses are taken.

If appropriation bills are passed in the same form by both houses, they are ordered “enrolled” in their house of origin and sent directly to the Governor for consideration. With the vast majority of appropria-

tion bills, however, changes are made to bills in the second house, at which point, they are sent back to the house of origin for consideration. If the house of origin accepts the changes made by the second house, the bill is enrolled and sent to the Governor. More often, however, the house of origin rejects at least some changes made by the second house and the appropriation bill is sent to a conference committee.

Step 5: Conference Committee Action

Conference committees are temporary committees created to work out any differences between House and Senate versions of a specific bill. In Michigan, three members from each house are typically appointed from their respective house’s Appropriations Committee or subcommittee. However, the Speaker of the House or Senate Majority Leader may appoint other conference committee members. Conference committee work usually is limited to the differences between the two houses and any errors in the bill.

Since the appropriation bill must be passed out of conference committee by a majority (4) of the conferees, two of whom must come from each house, compromise between the two houses is inevitable at this point in the adoption phase. Moreover, conference committee negotiations can be particularly intense, especially when the two houses are controlled by different political parties or when the extent of the differences between the houses is seemingly irreconcilable.

Once a majority of conferees has resolved any differences between the two houses, a conference committee report is first sent to the house of origin and then to the second house for approval or rejection, both of which are prohibited from amending the conference committee report. If both houses approve the conference committee report, the bill is enrolled and sent to the Governor. If either house rejects the report or if the conference committee fails to reach a compromise, the bill is sent to a second conference committee.

Step 6: Gubernatorial Action

Upon receipt of an enrolled appropriation bill, the Governor has 14 days to take action on the bill. Prior to any action, however, the Department of Management and Budget (DMB) prepares a gubernatorial signing package for each appropriation bill. In-

cluded in this package is a summary of changes made by the Legislature to the executive budget and DMB recommendations of gubernatorial action for each appropriation bill and line-item in the bill

Upon the review of these recommendations, the Governor may: 1) sign the bill; 2) veto the entire bill; 3) sign the bill but veto specific line-items in the bill; or 4) refuse to sign or veto the appropriation bill.

a. Gubernatorial Signature. If the Governor signs the appropriation bill, it is filed with the Secretary of State, who in turn “enacts” the bill through the assignment of a public act number. In most cases, appropriation bills are given “immediate effect” by a two-thirds vote of each house, which simply means that the bills become law upon the Governor’s signature.

b. Gubernatorial Veto. If the Governor vetoes the entire appropriation bill, often referred to as a “package veto,” the bill is returned to its house of origin for consideration with a message stating the Governor’s objections. In response to a package veto, the

Legislature may override the veto with a two-thirds vote in each house and the bill becomes law or refer the bill to its Appropriations Committee, thus starting the adoption process over again.

c. Gubernatorial Line-Item Veto. More common than the veto of an entire appropriation bill, however, is the line-item veto. If the Governor signs the appropriation bill, but vetoes specific line-items in the bill, those sections of the bill approved become law and any items vetoed do not become law unless the Legislature overrides the veto with a two-thirds vote in each house. In practice, vetoes and line-item vetoes have rarely been overridden by the Legislature.

d. Gubernatorial Refusal to Sign or Veto. If the Governor refuses to sign or veto the appropriation bill by the end of the 14-day period, it becomes law if the Legislature is still in session. If, however, the Legislature has adjourned, the bill does not become law. In practice, this rarely occurs, since appropriation bills are usually submitted to the Governor by early July and the Legislature does not adjourn until December.

VI. Budget Execution

The third phase of the state budget process is the execution or implementation of the enacted state budget. Unlike the preparation and adoption phases, the execution phase of the state budget process has a defined beginning (October 1) and end (September 30), or the state's fiscal year. While a number of activities during the execution phase are directed at implementing the legislative intent of

appropriations, several activities also occur throughout the fiscal year which alter the intent of the Legislature. As unforeseen problems and new conditions arise, the approved spending levels of state departments may change, often drastically. Consequently, at the end of the fiscal year, a state department's executed budget may differ significantly from its enacted budget.

A. Principal Players in the Execution Phase

The execution phase of the state budget process is primarily controlled by the executive branch and involves these players:

- 1) The *State Budget Director* is responsible for allotting appropriations to state departments and monitoring department expenditures.
- 2) The *State Treasurer* is responsible for processing payments on behalf of state departments and monitoring state revenue.

3) Each *department director* is responsible for overseeing the execution of the department budget and monitoring department expenditures.

4) The *Consensus Revenue Estimating Conference* is responsible for updating the current fiscal year revenue forecast in January and May.

5) The *Appropriations Committees* in each house are responsible for approving most revisions to enacted appropriation bills.

B. An Overview of the Budget Execution Phase

The execution phase is a shorthand term for a number of activities directed at implementing the legislative intent of enacted appropriation bills and, at times, revising the intent of such bills. With regard to implementing the state budget, four significant activities occur during budget execution, including the establishment of department accounts, establishment of allotment schedules, issuance of warrants, and monitoring state revenue and expenditures.

Though a critical step in the execution phase, establishing accounts is a relatively straightforward activity because the state's accounting system is structured to mirror enacted appropriations, with each line-item having a corresponding account. Furthermore, given the fact that few new line-items are added to the state budget each year, most of the same line-items and accounts carry over from year to year. As a result, most accounts are established well before the start of the execution phase.

1. Implementing Enacted Appropriations

a. Establishing Department Accounts. Immediately following the enactment of appropriation bills, state departments and other entities of the state, under the supervision of the Department of Management and Budget (DMB), are responsible for establishing *accounts* to manage financial resources (appropriations) and transactions (outlays and expenditures). Though at times a fund and an account may be one and the same, funds generally consist of several accounts. For example, the state School Aid Fund (SAF) has separate accounts for basic foundation grants, special education, gifted and talented pupil programs, adult education, and vocational education.

b. Establishing Allotment Schedules. Budgetary control is integrated into the state's accounting system, with appropriations entered as overall spending limits by account for each line-item in a department's budget. A device used by the executive branch to control department spending and assure that a department's appropriations are not exhausted before the end of the fiscal year is the *allotment*, which is the part of an appropriation that may be expended or encumbered during a specific period.

Pursuant to the Management and Budget Act, DMB is required to establish an allotment schedule for appro-

priations within 15 days of the date a department's appropriation bill has been enacted into law. During this 15-day period, the State Budget Director notifies each department of the general guidelines for upcoming fiscal year allotments, each department proposes an allotment schedule based on these guidelines, and the State Budget Director approves each department's allotment schedule for the upcoming fiscal year.²

Although appropriations usually are allotted on a quarterly basis, allotments typically are not apportioned in equal installments. For example, the fourth allotment to a department often is larger than the second and third allotments, and may even be larger than the first allotment as well. The rationale for this is quite simple: if there are more funds available at the end of the fiscal year, it is much easier to balance the state budget and, if possible, prevent a budget deficit. Allotments between quarters may also vary due to the number of paydays in the quarter, seasonal employment variations, or statutorily mandated payment schedules.

c. Issuing Warrants. Once funds have been allotted, a state department can incur *obligations* or take actions that commit the state to pay for goods or services. For example, when a department hires an employee or enters into a contract for services, it is incurring an obligation. Once the goods or services for which funds were obligated have been provided, most expenditures or outlays are made by means of *warrants*, which are orders drawn on the State Treasurer's Common Cash Fund to pay a specified amount to the person or organization named (See **The Treasurer's Common Cash Fund**, page 21). In some areas such as school aid, electronic fund transfers may be used in lieu of warrants.

Though similar to bank checks, warrants are not drawn on banks. Each quarter, departments use their allotment authority to request warrants from the State Treasurer, who prepares and issues warrants and ensures that sufficient funds are on deposit to cover them. As departments spend their warrants to pay for goods and services, the warrants clear through local banks.

² To the extent that the Management and Budget Act proposes to give the state budget director or any other member of the executive branch, alone, the authority to reduce appropriations or eliminate programs, the State Attorney General ruled this section of the act unconstitutional.

c. Monitoring of Revenue and Expenditures. Throughout the course of the fiscal year, department budgets are monitored by several members of the executive and legislative branches, producing daily, weekly, monthly, quarterly, and year-to-date expenditure reports. The most significant of these reports is the state's *monthly financial report*. As provided in the Management and Budget Act, the State Budget Director is required to prepare monthly financial reports within 30 days after the end of each month. This section further requires each monthly report to include:

- a statement of actual monthly and year-to-date revenue collections for each operating fund;
- a statement of estimated year-end lapsed appropriations and overexpenditures for the state General Fund by department;
- a statement projecting the ending state General Fund balance for the fiscal year in progress;
- a summary of current economic activity in the state economy and, based on this summary, an update of the state's revenue forecast; and
- statements demonstrating the state's compliance with two Headlee Amendment requirements in the state Constitution: the revenue limitation (Article IX, Section 26) and state payments to local units of government (Article IX, Section 30).

2. Revising Enacted Appropriations

Since the state budget is largely based on predictions made prior to the start of the fiscal year, variations in the state budget are all but assured during its execution. While most budget variations are minor and are handled throughout the fiscal year in the ordinary course of business by departments, more significant budget variations may require adjustments of appropriation authority. There are three principal ways in which appropriation authority may be altered during budget execution, including transfers, supplemental appropriations, and budget reductions.

a. Transfers. The most common method for revising enacted appropriations is through the transfer of line-item appropriations *within* or *between* departments. Transfers must be made between existing line-

Appropriations: Mandates to Spend or Authorizations to Spend?

In theory, an appropriation may be viewed either as a legislative mandate to spend, an authorization to spend, or, to some extent, both. As a legislative mandate to spend, an appropriation represents the amount a department or other entity of the state must spend. Failing to do so violates the statutory law which provided the department the legal authority to make expenditures. With this view, however, at least two questions arise. First, is the department obligated to spend all or most of an appropriation regardless of whether the expenditures are necessary and beneficial? Second, if a department refuses to make unnecessary expenditures, does the legislature have a means of enforcing such a mandate?

An appropriation, however, also may be viewed as an authorization to spend. With this view, an appropriation represents a limitation on the amount a department may commit for a specific purpose during a specific time period, which in most cases is the fiscal year. In other words, departments may not spend more than the amount appropriated to it, and the department must use this authority to incur obligation for the purposes of and according to the terms established by the legislature. Furthermore, once expenditures equal the authority granted by an appropriation act, no more obligations may be incurred by a state department without an "appropriation made by law."

In Michigan, there is little question that an appropriation is first and foremost an authorization to spend. As provided in Article V, Section 20, of the Michigan Constitution, "No appropriation shall be a mandate to spend."

items in appropriation bills and may not create a new line expenditure item.

i. Intradepartmental Transfers The vast majority of line-item appropriation transfers are made within departments and may be made by: 1) the State Budget Director; 2) the State Budget Director, with the approval of the Appropriations Committees in each house; and 3) the State Administrative Board.

The Management and Budget Act identifies two circumstances where the State Budget Director, alone, has the authority to transfer line-item appropriations.

- Section 393 provides the State Budget Director the authority to make intradepartmental transfers "...to adjust for any cost and price variations from the enacted budget items, or to adjust amounts between federal sources of financing..." not less than 30 days after notifying the Appropriations Committees in each house. For example, if the Legislature enacted and the Governor signed a bill increasing the salaries of state employees, the State Budget Director has the authority to make intradepartmental transfers in order to cover the resulting cost variations.
- Section 396 provides the State Budget Director the authority to make intradepartmental transfers to pay court judgments, including

court approved consent judgments, and record expenditures for write-offs of accounts receivable recorded in a prior year. Furthermore, within 14 days after entering into a settlement or consent judgment which results in a state obligation of more than \$200,000, the Attorney General must notify the Appropriations Committees in each house, the Speaker of the House, and the Majority Leader in the Senate.

However, the Management and Budget Act further provides that any such intradepartmental transfers made by the State Budget Director which have "...policy implications or that have the effect of creating, expanding, or reducing programs..." must be approved by the Appropriations Committees in each house. For example, if a department wanted to transfer a portion of a line-item appropriation from one office within the department to another, the State Budget Director and the House and Senate Appropriations Committees would have to approve such a transfer.

Finally, intradepartmental transfers also may be made by the State Administrative Board, a six-member board consisting of the Governor, Lieutenant Governor, Secretary of State, Attorney General, Superintendent of Public Instruction, and State Treasurer. In this case, six members of the executive branch have the authority to revise enacted appropriations with-

out the consent of the Legislature. Though challenged by the Legislature on the grounds that the 1921 statute granting the Board the authority to make transfers was repealed by the Management and Budget Act of 1984, the State Supreme Court ruled in 1993 that the Management and Budget Act failed to repeal this authority, thus upholding the Board's authority to make intradepartmental transfers. *House Speaker v State Administrative Board*, 441 Mich 547 (1993).

ii. Interdepartmental Transfers Line-item appropriation transfers also may be made between departments and are made by either the State Budget Director, alone, or the state Legislature. First, according to the Management and Budget Act, the State Budget Director has the authority to make interdepartmental transfers for federal and other restricted flow-through funds when funds are appropriated in the budgets of both departments. This simply means that the State Budget Director has the authority to transfer federal and restricted funds from the principal receiving department to any other state department to which was appropriated such funds.

Second, while the Management and Budget Act does not specifically address any interdepartmental transfers outside of federal and restricted flow-through funds, all other interdepartmental transfers are made

by the Legislature.

b. Supplemental Appropriations. Another method of revising enacted appropriations is through supplemental appropriations, which provide additional budget authority to state departments. Supplemental appropriation bills, which are adopted in the same manner as any other appropriation bill, typically are adopted in two situations. First, supplemental appropriations are adopted to cover needs deemed too urgent to be postponed until the next fiscal year budget. For example, when enacted appropriations are insufficient or when specific activities have not been provided for in enacted appropriation bills, supplemental appropriations may be made. Second, they also are made upon the receipt of revenue not anticipated when appropriation bills were enacted.

c. Budget Reductions. A third method of revising enacted appropriations during the execution phase is through budget reductions. Budget reductions may result in one of two ways. First, the state Legislature may adopt and the Governor approve legislation which reduces appropriations over the course of the fiscal year. This approach is often referred to as a "negative" or "deficiency" supplemental appropriation.

Second, as provided in Article V, Section 20, of the

A Word About Lapsed Appropriations

Operating appropriations typically are made for a finite period, the state's fiscal year. At the end of the fiscal year, unless otherwise specified, a department's authority to incur obligations or make expenditures for operating purposes expires and any unused authority *lapses*. As provided in the Management and Budget Act, the lapsed appropriation then reverts "...to the fund from which it was appropriated." Thus, lapsed appropriations become available to provide authority for future fund expenditures on any item, not just the account in which the lapse occurred.

At times, however, state departments and other entities of the state are authorized to retain lapsed appropriations, in full or in part, for use beyond the fiscal year in which the appropriation was made. The most common method for a state department to retain a lapsed operating appropriation is through a "work project," which is a special project undertaken by a department which utilizes funds for a specific, non-recurring good or service. For example, lapsed appropriations may be used by a department to purchase a new computer or pay for an employee training seminar. As provided in the Management and Budget Act, however, all work projects require the approval of the Appropriations Committee in each house.

In addition to work projects, enacted legislation may provide state departments or other entities of the state the authority to retain lapsed appropriations. For example, the revised Mental Health Code (Public Act 290 of 1995) grants community mental health services programs the authority to carry forward up to five percent of the excess of state revenue over state expenditures for a three-year period.

A GUIDE TO THE STATE OF MICHIGAN BUDGET PROCESS

Michigan Constitution, the Governor, with the approval of the Appropriations Committees in each house:

...shall reduce expenditures authorized by appropriations whenever it appears that actual revenues for a fiscal period will fall below the

revenue estimates on which appropriations for that period were based.

As discussed in **The Legal Framework for the Budget Process**, this method is used to avoid a budget deficit and balance the state budget in Michigan.

VII. Year-End Book Closing Phase

Often overlooked in any discussion of the state budget process in Michigan is the phase which immediately follows the execution phase, year-end book closing. Though largely an accounting function, the significance of the year-end book closing phase should not be overlooked. The overall objec-

tive of this phase is for state departments and other entities of the state to demonstrate to the executive branch that expenditures comply with legally enacted appropriations. In order to do so, departments must balance appropriations and expenditures in each department account.

A. Principal Players in the Year-End Book Closing Phase

The fiscal year-end book closing phase is controlled by the executive branch and involves these principal players, including:

1) The *chief financial officer of each state department* is responsible for overseeing the year-end book closing of each department, paying any outstanding liabilities, and collecting any outstanding revenues and receivables.

2) The *Office of Financial Management*, which is located in the Department of Management and Budget, is responsible for coordinating and monitoring each department's book closing.

3) The *legislative Auditor General* is responsible for reviewing year-end book closings for each department and providing an independent audit of the state's financial statements each year.

B. An Overview of the Year-End Book Closing Phase

Year-end book closing is best understood as the phase which terminates the state budget each year. As **Figure 11** illustrates, four significant activities occur in this six-month period following budget execution, including the payment of all outstanding liabilities and collection of all outstanding revenues, preliminary book closing meetings, and the publication of two reports, the "120 Day Report," and the Comprehensive Annual Financial Report (CAFR).

1. Payment of Outstanding Liabilities & Collection of Outstanding Revenues

The first step following the end of the fiscal year is to pay all outstanding liabilities incurred in the fiscal year. Since state departments and other entities of the state incur obligations near the end of the fiscal year, expenditures or outlays for these liabilities may not occur until after the fiscal year. In other words, liabilities incurred on September 30, the last day of the fiscal year, may not be paid until October, or even later in certain instances. When this occurs, the state's accounting system reports these expenditures as

previous fiscal year expenditures. As a general rule, most obligations are paid by the second week in November, or six weeks after the end of the fiscal year.

Likewise, outstanding revenue must also be collected by state departments and other entities of the state before their books are officially closed. While taxes or user fees collected on or near the end of the fiscal year account for most of these revenues, many federal funds are not disbursed until after the end of the fiscal year. In practice, most revenues are collected by the end of November.

2. Preliminary Book Closing Meetings

Once most outstanding liabilities have been paid and revenues collected, preliminary book closing meetings occur throughout the month of December between state departments and the Office of Financial Management. During these meetings, departments demonstrate legal compliance to enacted appropriations by reviewing the liabilities and assets of each department account, or line-item.

3. The “120 Day Report”

In January, as provided in the Management and Budget Act, the Department of Management and Budget is required to publish unaudited financial statements for two of the state’s “key funds,” the General Fund-General Purpose (GF-GP) and School Aid Fund (SAF), as well as the General Fund-Special Purpose (GF-SP). Based on the preliminary book closing meetings, these unaudited financial statements, which must be issued 120 days after the end of the fiscal year (thus the “120 Day Report”), project year-end balances and liabilities in each of these funds.

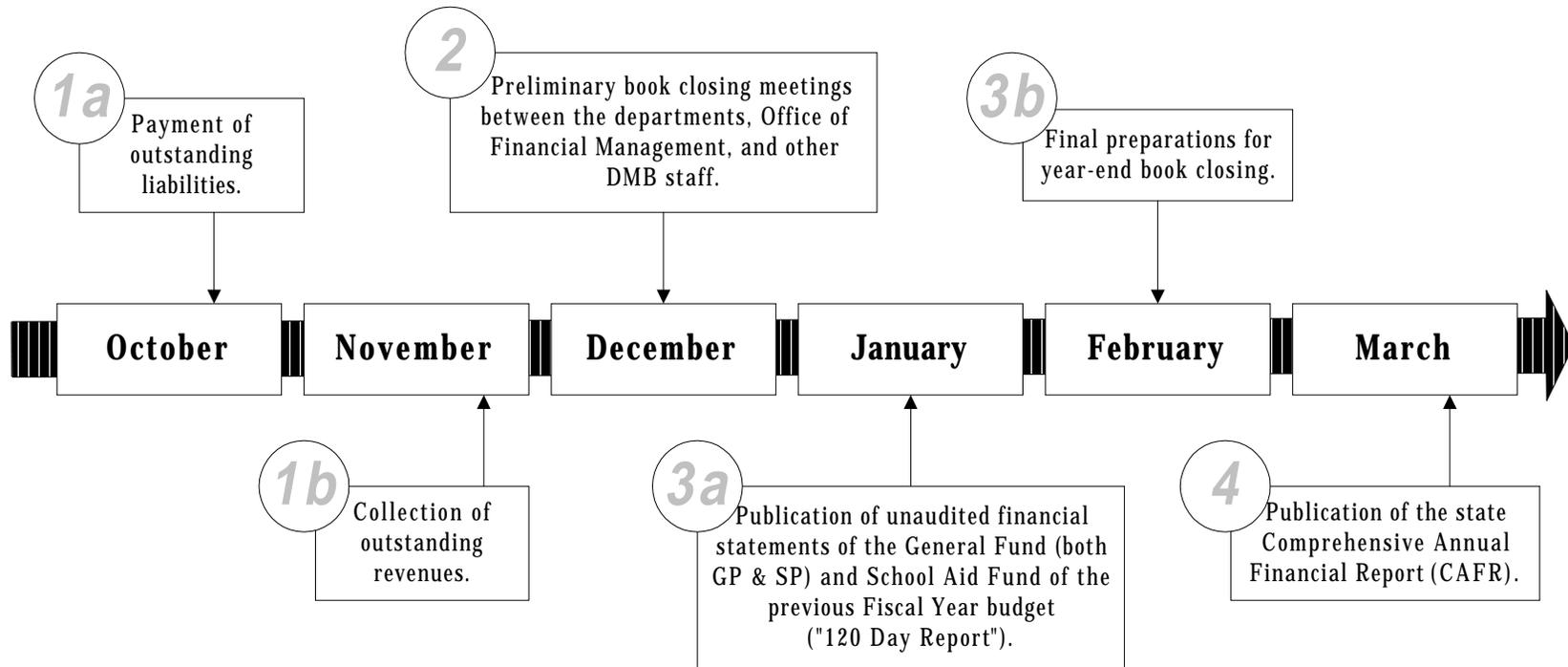
4. Comprehensive Annual Financial Report

The year-end book closing phase concludes with the publication of the state’s most significant financial

document, the Comprehensive Annual Financial Report (CAFR). As required in the Management and Budget Act, the State Budget Director is required to publish the state’s CAFR within six months after the end of the fiscal year, or by the end of March each year.

Simply put, the CAFR is a compilation of financial statements for each state fund, both primary and component unit (See **Fund Accounting and the State Budget** on page 18), which detail final revenue collections and expenditures on a fund-by-fund basis for the fiscal year. While these financial statements demonstrate legal compliance of expenditures with enacted appropriations for each state department and entity of the state, it should be noted that the CAFR is not an independent audit of such operations.

Figure 11
Year-End Book Closing Phase of the State Budget Process



VIII. Audit

The fifth and final phase in the state budget process is the audit of government operations, programs, and activities. Unlike any other phase in the state budget process, it is extremely difficult to identify the start and conclusion of the audit phase for a specific fiscal year budget because of the number of government operations, both state and local, that receive appropriations and the various types of audits performed on these operations. For example, a financial audit of a specific department program may not occur for as many as two years after the end of the fiscal year.

Like the year-end book closing phase, the audit phase is largely an accounting function demonstrating a department's legal compliance with enacted appropriations. Unlike the year-end book closing phase, however, this compliance is demonstrated to the legislative branch. Furthermore, whereas the year-end book closing phase refers more to the procedures associated with the termination of the fiscal year budget, the audit phase refers to the legal verification of department transactions and accuracy of accounts. In other words, the resulting audits of this phase provide a legislative "check" on executive branch expenditures.

A. Principal Players in the Audit Phase

The audit phase of the state budget process is controlled by the legislative branch and involves these principal players:

- 1) The *Legislature* is responsible for appointing the legislative Auditor General and reviewing the findings of the Auditor General.
- 2) The *legislative Auditor General* is responsible for conducting post financial and performance audits of state governmental operations and responding to any legislative requests for any further review of state governmental operations.

- 3) The *internal auditor* of each department is responsible for conducting and supervising audits related to the financial activities of their respective departments and ensuring that their department's financial controls comply with executive guidelines.

- 4) Within 60 days after an audit, each *state department* is responsible for submitting a compliance plan to the Department of Management and Budget which details the methods by which the department will comply with any audit recommendations of the legislative Auditor General.

B. Overview of the Audit Phase

General responsibility for compliance to legally enacted appropriations is in the hands of state departments and other entities of the state to whom appropriations are made. The state Legislature, however, has an independent check on this compliance through the legislative Auditor General.

As provided in Article IV, Section 53, of the state Constitution, the legislative Auditor General is required to:

...conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the

state established by this Constitution or by law, and performance post audits thereof.

Given the magnitude of this responsibility, this section of the state Constitution further provides that the Auditor General may, "...employ independent accounting firms or legal counsel..." to conduct such audits.

Two types of audits are performed by the legislative Auditor General, including financial audits and performance audits.

- 1. Financial Audits.** Financial audits, which include financial statement and financial related audits, are designed to assure that the financial statements of

audited entities are fairly presented in conformity with generally accepted accounting principles.

The legislative Auditor General conducts three types of financial audits, including:

- an annual audit of the financial statements appearing in the state's *Comprehensive Annual Financial Report*;
- a biennial audit of all government operations (state and local) which receive \$100,000 or more in federal funds; and
- periodic financial audits of funds, state departments, programs, and other state entities

which are performed at the discretion of the Auditor General or upon request by the Legislature.

2. Performance Audits. Performance audits are designed to improve the effectiveness and efficiency of a governmental entity, program, or activity. Moreover, performance audits attempt to assess whether these entities, programs, and activities produce those services mandated by the Legislature and whether the results are useful and delivered in the most cost-efficient manner. Unless mandated by the Legislature, performance audits are performed at the discretion of the legislative Auditor General.

Conclusion

Nationally-recognized expert on governmental budgeting, Allen Schick, has commented that “it is no exaggeration to state that the capacity to govern depends on the capacity to budget.” A government that is unsuccessful in carrying out the basic functions of budgeting—keeping spending within available revenues and allocating that spending in a fashion that comports to the extent possible with the demands of its constituents—will sooner or later find itself unable to manage its affairs. Clearly, more than good budgeting is necessary for successful governance, but no governmental unit can claim to be well-managed if its budgetary process does not work.

Because of the significance of budgeting, it is easy to

assume that all manner of governmental ills, real and imagined, can be cured by tinkering with the budget process. Frequently, those seeking to influence the level of government spending will seize on the budget process as a means of doing so. Somehow, it is felt, if only a few adjustments in the process could be made, spending levels would respond accordingly.

In fact, budgeting tends to be neutral as it relates to the actual amount of money spent. The same budget process that results in relatively high spending in one state will produce relatively low spending in another. Far more important are the underlying political culture and demographic, social, and economic context within which spending decisions are made.