CRC MEMORANDUM

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EARMARKING STATE TAX REVENUES: TYING POLICYMAKERS' HANDS OR PROTECTING POLICY PRIORITIES?

Michigan is among a few states that rely heavily on the practice of dedicating, or "earmarking", state tax revenue to specific purposes. While this practice safeguards funding for select public services from changing political climates, earmarking encumbers the ability of state lawmakers to carry out the task most essential to their job responsibilities.

A substantial amount of the state's financial resources are already allocated to specific purposes before Michigan lawmakers begin the annual budgeting process. Of the total $53 billion State of Michigan Fiscal Year 2015 (FY2015) spending plan, almost 42 percent is financed by federal funds that are directed to specific purposes and over which state officials have little or no discretion.[1] While the remainder of the budget is financed by state revenues, including various taxes and fees, a hefty portion is designated for specific functions or programs either by the state constitution or statute.

The Proposal A school finance reforms of the mid-1990s increased the amount of earmarking from 40 percent of state tax revenue in FY1993 to 58 percent in FY1995.[2] Since that time, additional state budget resources have been dedicated to specific functions. In FY2014, nearly 63 percent of the total $24 billion collected from major state taxes was dedicated to specific functions.[3] This means that almost two-thirds of the state tax revenue has been effectively removed from budgetary decision-making. Michigan has not seen this current level of tax earmarking since before the adoption of the 1963 Michigan Constitution.

Earmarking of some taxes, such as transportation taxes, structures the taxes as a user fee; those benefitting from the government service are responsible contributing to the financing of it. Although transportation spending is the beneficiary of earmarked fuel and motor vehicle tax revenues, the growth of these revenues has failed to keep pace with the investment levels necessary to maintain the system. At the same time, lawmakers have been hesitant to supplement the dedicated funds with discretionary funding. Until recently, lawmakers have simply adopted the earmarked level of spending without attempting to address the actual financial needs of the system. And when lawmakers have decided to supplement the earmarked funding, they have found that the pool of discretionary funding from which to draw, as a share of the total, is much smaller because of other dedications. This has made designing a fiscal plan to re-prioritize state spending to address Michigan's crumbling roads much more difficult.

For many of Michigan's general taxes (e.g., sales, income, property), no clear relationship exists between the revenue source and the dedicated purpose. Earmarking takes decision making responsibilities out of the hands of those elected to make such decisions. The legislature's "power of the purse" is effectively diminished. With proportionately fewer discretionary resources available to them, budget writers find it more difficult to reallocate funding according to shifting priorities. The current transportation funding debate illustrates many of the challenges arising from earmarking.

1 Senate Fiscal Agency, FY2014-15 Appropriations Report, August 2014. www.senate.michigan.gov/sfa/Publications/Approps/Initial2014.pdf

2 Citizens Research Council of Michigan, *The Earmarking of State Taxes in Michigan*, No. 1038, December 1995. www.crcmich.org

3 The $24 billion state tax total includes taxes reported by the Michigan Department of Treasury, 2013-14 Annual Report of the Michigan State Treasurer, and revenue collected from quality assurance assessment fees reported by the State Budget Office, State of Michigan Comprehensive Annual Financial Report.

CITIZENS RESEARCH COUNCIL OF MICHIGAN
Eric W. Lupher, President
MAIN OFFICE 38777 Six Mile Road, Suite 208 • Livonia, MI 48152-3974 • 734-542-8001 • Fax 734-542-8004
LANSING OFFICE 115 West Allegan, Suite 480 • Lansing, MI 48933-1738 • 517-485-9444
CRCMICH.ORG

Background

What is Earmarking?

Earmarking, or dedicating, refers to the practice of reserving revenues from specific sources for specific functions. It may take two forms: 1) a fixed dollar amount of the revenues generated from a given source; or 2) a fixed percentage of the revenues from a given source.

In Michigan, the common practice is to earmark a percentage of the revenues from a given source to a specific function. State government levies both fees and taxes and revenues from both sources often are earmarked. This report focuses on earmarking revenue from major state taxes and not the dedication of other state revenue, such as earmarking lottery revenue to the School Aid Fund.

Earmarking provisions are included in both the state constitution and statutory laws. Statutory provisions can be changed with the approval of the legislature and the governor, but it takes a vote of the people to alter constitutional provisions. Constitutional earmarking completely removes budget control from the legislative arena as program funding cannot be reduced below the earmarked amount. The mix of constitutionally and statutorily dedicated taxes has changed over time.

Earmarking in Michigan: Brief History

The number and amount of earmarked state taxes has increased over time. This has affected the percentage of tax revenues over which budget writers have full discretion. Over 50 years ago, the high level of earmarking and the limited legislative control over the state budget were motivations behind calling the 1961 Constitutional Convention.

The 1963 Michigan Constitution addressed some of the structural budget concerns stemming from the low proportion of discretionary revenues available to budget makers at the time. The constitutional "fix" lasted for about three decades, until Proposal A of 1994 was approved by voters. This addition of new state taxes, all of which were earmarked, to address the funding of K-12 public education, dramatically increased the amount of dedicated tax revenues and reduced the share available for discretionary spending. With the new school finance system in place, Michigan earmarked 57.7 percent of the major state taxes in FY1995.

Since that time, changes to the state tax landscape have gradually increased the amount of earmarked taxes. State lawmakers have dedicated greater portions of existing tax revenues and enacted new taxes with earmarked revenues. In FY2014, 62.7 percent of tax revenue ($15.3 billion) was dedicated to a specific function. Compared to the FY1995 level, the difference of five percentage points on today's total state tax revenue basis of $24.2 billion is equal to $1.3 billion in earmarked tax revenue. Stated differently, if Michigan had maintained the share of earmarked taxes from 20 years ago, it would have an additional $1.3 billion in discretionary resources to allocate among spending priorities.

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Good Public Policy?

Justifications

States justify the use of earmarking in three ways. The most common justification for dedicating revenues from certain taxes is the benefit principle. The argument is that those who benefit from a public service financed by taxes should pay that particular tax. Based on this perspective, the specific tax effectively serves as a user fee for consuming a certain government service. This might be similar to fees charged for entrance into a park or for a hunting permit. In both cases, the users of a public good (e.g., public land and natural resources) are, at least partially, paying for the associated costs. The benefit concept introduces a level of market orientation in to government service provision and funding decisions. If users of a service can be identified, equity and efficiency will be promoted by taxing them in accordance with their use of the service.[4]

The most common application of the benefit principle in taxation involves transportation taxes. In many states, motor fuel and vehicle registration taxes collected from highway users are dedicated to the maintenance and construction of roadways and bridges. A high correlation exists between the direct use of these facilities and the tax revenues generated. Of course, with roads and bridges, highway users are not the only beneficiaries. The non-motoring public also benefits from the trade and commerce that is made easier by highway infrastructure. The corollary to the benefit principle is that revenues generated by users should not be used to subsidize other services.

Earmarking is also justified on the basis of providing a minimum level of support and funding continuity for government functions. Programs with dedicated funding do not have to compete with other budget priorities for limited revenues. Dedicating revenues to a certain function may be the result of the political process; those programs with popular support get earmarked funds. At other times, earmarking is done for more pragmatic reasons. This is the case with certain capital investment programs and long-term projects, which might be more difficult to or more costly to fund without secured sources of financing. Dedicated revenues for projects provide governments with higher bond ratings, which generally translate into lower interest costs.

A final justification for the use of earmarking is to gain political support for new or increased taxes. Elected officials are more likely to garner the political support needed to raise taxes by guaranteeing the disposition of some, or all, of the revenue to certain functions that are important to voters.

Criticisms

Three principal criticisms are directed at earmarking. First, it introduces inflexibility and rigidity in the state budget process. Earmarking renders certain funding decisions as automatic; effectively inhibiting or preventing the governor and legislature from comprehensively examining the state budget. Funding levels are determined by the amount of earmarked revenues, rather than program needs or benefits relative to other competing priorities. The inflexibility created by dedicating revenues can result in less program oversight or scrutiny relative to those programs that must go through a more deliberative budget review.

Michigan highway spending has been rendered automatic for many years, bringing to light many of the criticisms of tax earmarking. Transportation tax earmarking provisions not only govern the total financial resources available for highway construction and maintenance each year, but also the allocation of these resources to state and local road agencies. Distribution is guided by state law Public Act 51 of 1951. The law is highly prescriptive as to the distribution of earmarked state transportation tax revenues among state government, county road agencies, and cities/villages. The combination of dedicating state transportation taxes and Public Act 51 means that highway spending at all levels of government has occurred without serious and continual consideration

[4] The benefit principle of taxation is juxtaposed to the ability-to-pay principle. The theory behind the latter is that taxes that support services consumed by nearly every citizen (e.g., public safety) or for which user charges are inappropriate (e.g., welfare), should be levied according to taxpayers' ability-to-pay, rather than based on the benefit received. In general, these services should be financed by general taxes that take into account the economic means of individual taxpayers.

of actual system needs, but instead has been determined by earmarking provisions in state law (Note: Public Act 51 distributions account for the majority of local government highway resources.) The allocation of these resources within the system has been governed by formulas contained in a 60-year-old law.

A second criticism is that while earmarking may be implemented to guarantee a minimum level of support from a specific tax, it is does guarantee that other revenue for a function will be maintained. This is because all money is fungible; state financial resources are perfectly substitutable. The use of earmarking simply allows program funding at a level that would have been provided in any event, while freeing money previously spent on that function for other purposes. A popular example of this criticism is the dedication of lottery revenues to the School Aid Fund in the early 1980s.[5] The dedication of lottery revenues did not proportionally increase the total money available for schools, but instead it allowed general fund money previously used for school aid to be spent elsewhere.

Third, whether providing a minimum level of support or additional funding, earmarking causes distortions in tax and funding levels when revenue growth is not consistent with changes in a function's needs. While a function might have required the full allotment of the dedicated funds when earmarking began, there is no guarantee that the relationship will remain going forward. In some cases, revenues grow faster than needs, typically resulting in expenditures growing to meet revenues. This can result in wasteful government spending as program managers are expected to exhaust the full amount of resources available to them, while those programs with greater needs are ignored. Or, taxes are levied at higher rates to meet the needs of discretionary programs. In other cases, dedicated revenues may not grow at a rate sufficient to fund the needs of a function. The dedication of tobacco taxes to support K-12 education is a prime example where revenue growth (steady decline) has not kept pace with school funding needs.

Another distortion within the budgetary arena occurs when the amount of earmarking increases, which has been Michigan's experience over the past 20 years. As a result, those programs dependent on non-dedicated revenues compete for a smaller share of the state budget. If the needs of these functions are greater than available funds, the result is either underfunding or increases in non-earmarked taxes. During the economic challenges of the 2000s when state revenues declined or stagnated, state funding for discretionary programs like aid to higher education and statutory revenue sharing was disproportionately reduced.

Earmarking in Michigan: Trends, Analysis, and Challenges

Michigan has a long history with tax earmarking. The 1850 Michigan Constitution dedicated state tax proceeds to the Primary School Interest Fund. Additional state tax revenues were dedicated in the 1930s and 1940s through constitutional amendments that earmarked motor fuel and vehicle weight tax revenues to highway construction and maintenance and a portion of the Sales Tax to local governments. The increased use of earmarking continued into the 1950s, primarily through statutory allocations of new and existing taxes. By 1960, 12 state taxes and over 60 percent of the total tax yield were constitutionally dedicated, primarily to finance highway, public education, and state revenue sharing functions. Additional statutory allocations reserved more of the state tax base for other purposes. The heavy reliance on earmarked taxes was one motivation for calling a constitutional convention in 1961. The 1963 Michigan Constitution eliminated the Primary School Interest Fund and directed the previously dedicated revenue to the state General Fund.

Trends

Following the adoption of the 1963 state constitution, two seemingly contradictory trends occurred with the disposition of state tax revenues. First, after the framers reduced the amount of constitutional earmarking, many of the new taxes enacted during the subsequent three decades included earmarking provisions. For example, the individual income tax

[5] Voters approved a constitutional amendment in 1972 to authorize a lottery. The revenues were deposited in the General Fund until 1981, when state law was changed to dedicate the funds to the school Aid Fund.

was authorized in 1967 with some of the proceeds going to the School Aid Fund and state revenue sharing. Similarly, the Single Business Tax adopted in 1975 allocated some of the revenues to local governments.

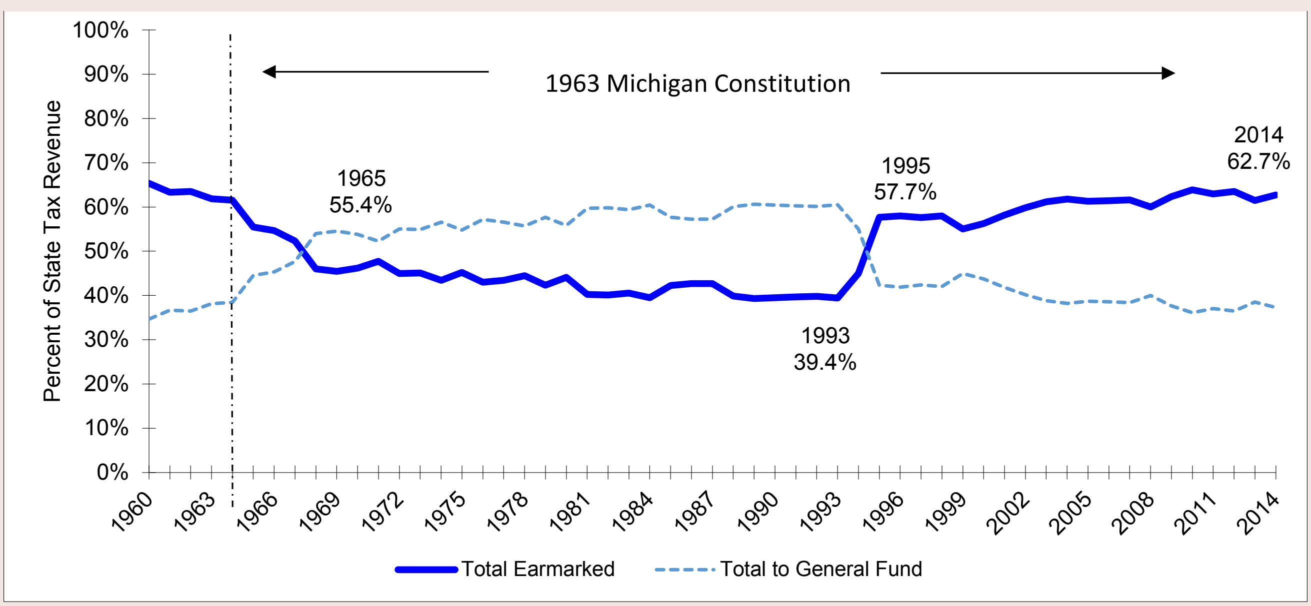
The second trend was that earmarked revenues did not grow as a percent of total state tax revenues (**Chart 1**). In 1965, approximately 55 percent of the total tax yield was earmarked to specific functions. As a share of the total, earmarked revenues fell gradually over the next 15 years to about 40 percent of the total in 1980. The amount of dedicated revenue remained at this level for next 15 years until the adoption of the Proposal A school finance reforms in 1994. These two trends suggest that during the three decades immediately following the adoption of the new constitution the amount of dedicated taxes did not grow as a share of the total tax generated, but this was not the result of lawmakers' deciding to earmark fewer taxes.

Proposal A changed the earmarking landscape immediately and dramatically. The changes involved a major shift from local to state school financing of public education. This was accomplished by reducing local property taxes and replacing the lost revenue with state taxes; specifically, the adoption of two new taxes and increases to a number of existing ones. Additionally, the new state revenue generated was completely dedicated to the School Aid Fund. In the first full year that the tax changes took effect (FY1995), earmarked revenues constituted 58 percent of the total state tax collection, up from 40 percent just prior to Proposal A.

In the 20 years since the school finance reforms, the state tax landscape has remained fairly stable. The majority of the tax policy changes enacted since Proposal A have dealt with the state's main business tax. Most of this has occurred within the last 10 years. Over a fairly short period of time, the state abandoned the 1975 Single Business Tax (SBT) in 2006; enacted the Michigan Business Tax (MBT) in 2007 to replace the SBT; and then scrapped the MBT in 2011 in favor of the Corporate Income Tax.

Each of these tax changes had different effects on the amount of total state revenue generated and how much of the revenue was earmarked to specific functions. At the time the SBT was eliminated in 2006, 100 percent of the generated revenue went to the state General Fund. The replacement MBT allocated some of the tax proceeds to the School Aid Fund with the remainder flowing to the General Fund. This setup increased the share of total state

Chart 1
Percent of State Tax Revenue Earmarked Compared to General Fund Contribution



taxes earmarked for specific purposes beginning in 2007.[6] When the MBT was eliminated in 2011 and replaced with the new Corporate Income Tax, all of the business tax proceeds were again directed to the General Fund. The switch from the MBT to the Corporate Income Tax involved a sizeable reduction in the amount of business taxes paid and therefore the overall amount of state taxes collected.

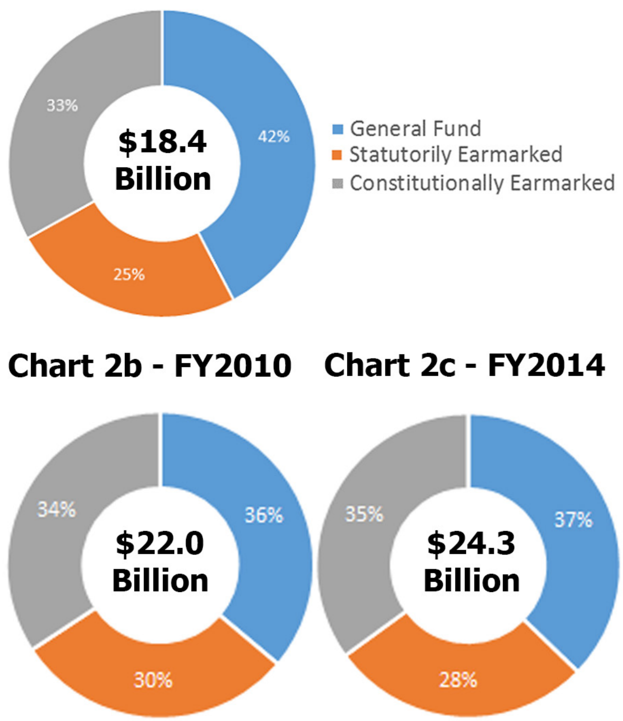
Because of the business tax changes along with the adoption of a handful of new taxes, all of which earmark some of the revenue generated, the share of the total state tax yield dedicated for specific functions has increased gradually since Proposal A.[7] **Charts 2a-2c** show the distribution of total state tax revenues between the General Fund and earmarked funds in FY1995, FY2010, and FY2014.In FY2014, nearly 63 percent of the total is earmarked ($15.3 billion). This is a change of more than five percentage points compared to the amount of earmarking in FY1995. On a total state tax basis of $24.3 billion in FY2014, this represents an additional $1.3 billion in earmarked revenues.

Analysis

CRC's Outline of the Michigan Tax System identifies 38 taxes imposed by the state and 22 taxes imposed by or for local government.[8] For the purposes of the report, taxes are grouped into five categories: 1) income, 2) business privilege, 3) sales-related, 4) property, and 5) transportation. The analysis that follows is based on the same categorization.[9] For each tax grouping, the amount of earmarked revenue generated is examined in FY1995, FY2010, and FY2014, as well as notable changes over time.

Charts 2a-2c
Dedication of Total State Taxes: FY1995, FY2010, and FY2014

Chart 2a - FY1995



Income Tax

Michigan has levied a flat-rate individual income tax since 1968. In FY2014, the tax raised nearly $8.2 billion, of which about 24 percent of the revenue was earmarked to the School Aid Fund. The amount going to the School Aid Fund is designed to shield schools from reductions to the income tax rate. Under current law, the formula in state law sets the earmark equal to the percentage share 1.012 is of the current income tax rate (e.g., 1.012/4.25 equals 23.8 percent). This effectively increases the

[6] The allocation of a portion of the MBT revenue to the School Aid Fund was designed to offset the loss of local personal property taxes that were used to fund public education. The personal property tax changes, in combination with the MBT changes, resulted in a further shift in school funding responsibility from the local level to the state. Schools were held harmless with the MBT earmarking provisions.

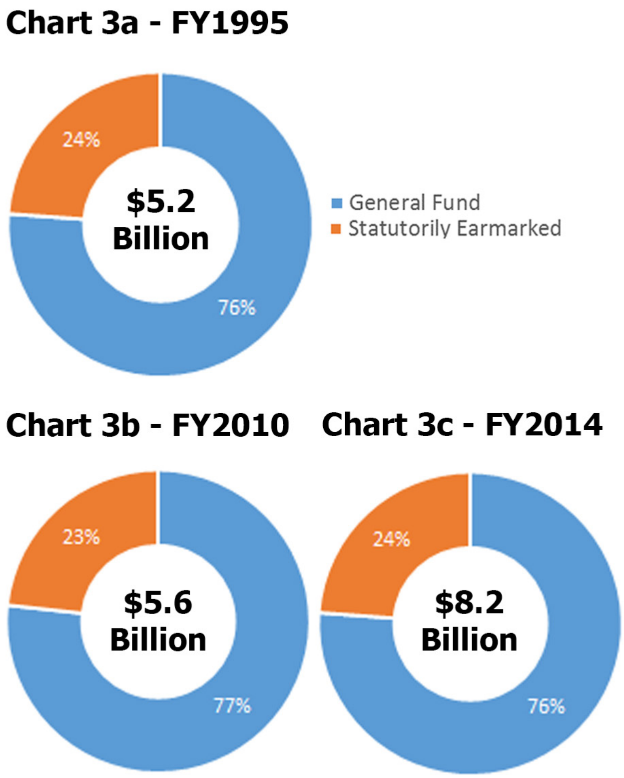
[7] In addition to the business tax changes discussed here, the state enacted four new taxes since the adoption of Proposal A; Casino Wagering Tax (1999), Commercial Mobile Radio Services Tax (1999), Quality Assurance Assessment Program (2002), and Health Insurance Claims Assessment (2012). In each case, all or some of the revenue generated is dedicated to a specific function.

[8] Citizens Research Council of Michigan, *Outline of the Michigan Tax System*, May 2015. www.crcmich.org/PUBLICAT/2010s/2015/Tax%20Outline_ALL.pdf

[9] The one exception is the new Corporate Income Tax, which is identified as an income tax in the Tax Outline, but is included as a business privilege tax for this report. As the primary business tax for corporations, treating the Corporate Income Tax similar to its predecessors (e.g., MBT and SBT) better illustrates the amount of earmarking across years.

earmarking percentage when the income tax rate is reduced. From 1999 to 2004, the tax rate fell from 4.4 percent to 3.9 percent and the share of the revenue to the School Aid Fund rose from 23 percent to almost 26 percent. However, when the tax rate was raised to 4.35 percent in 2007, the share of the revenues dedicated to the School Aid Fund fell to approximately 23 percent.

Charts 3a-3c
Dedication of Income Taxes: FY1995, FY2010, and FY2014

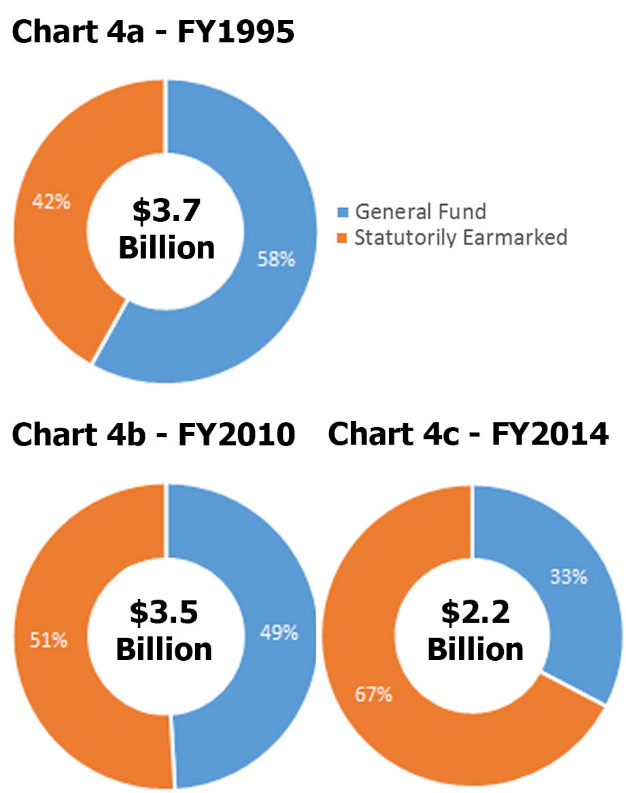


Business Privilege Taxes

These taxes are levied on firms that do business in Michigan, or engage in a specific line of business. A 6 percent corporate income tax replaced the Michigan Business Tax for most firms in 2012. In addition to this main business tax, state government levies another 11 taxes in this category, ranging in nature from a tax on health insurance claims to a tax on horse race wagering. In total, these taxes generated $2.2 billion in FY2014, down from $3.5 billion in FY2010.

In terms of revenue dedication, only 42 percent of the revenue went to specific functions in FY1995 compared to 51 percent in FY2010 and 67 percent in FY2014. The rise in earmarking has resulted from the addition of a handful of taxes in which all the revenue generated is dedicated. For example, quality assurance assessment fees were created in 2002 and 2005 to generate additional revenue for the state Medicaid program as was the health insurance claims tax in 2012. At the same time that these new taxes added to the amount of state revenue dedicated to specific functions, the yield from the state's main business tax fell substantially from $2.1 billion in FY2010 under the MBT to $942 million under the corporate income tax. Because all the revenue from the corporate income tax goes to the General Fund, the net tax cut increased the earmarked proportion of state revenues from this category. In addition to shrinking the overall business tax yield with the shift to the corporate income tax, tax refunds owed to businesses filing under the MBT are paid from the General Fund. These refunds reduced net tax

Charts 4a-4c
Dedication of Business Privilege Taxes: FY1995, FY2010, and FY2014



receipts (General Fund) in this category by $610 million in FY2014.

Sales-Related Taxes

General sales and use taxes are levied by the state government in addition to a number of excise and selective sales taxes. In total, these taxes generated $9.9 billion in FY2014, with nearly 90 percent raised by the 6 percent sales tax ($7.2 billion) and the 6 percent use tax ($1.6 billion). Both taxes are heavily earmarked. Nearly 90 percent of sales tax revenue goes to specific functions, mainly the School Aid Fund and local government revenue sharing. Currently, one-third of the use tax revenue is deposited to the School Aid Fund with the remainder going to the General Fund. Earmarking of the Use Tax will increase over the coming years as a result of the personal property tax changes enacted in 2014 (discussed later). The majority of the revenue from many of the selective excise taxes (e.g., alcohol, tobacco) is earmarked. For the category in total, approximately two-thirds of the revenue is dedicated. This amount of earmarking has remained constant for some time.

Property Taxes

The state levies a handful of property taxes, but the vast majority of property taxation occurs at the local government level. The major source of state revenue for this category is the 6-mill State Education Tax, created as part of the Proposal A school funding system. The tax accounted for nearly 90 percent ($1.8 billion) of the total $2.1 billion generated by this category of taxes in FY2014 with the Real Estate Transfer Tax bringing in $220 million. All of revenue from both of these state taxes is dedicated to the School Aid Fund. This earmarking is responsible for the fact that almost 97 percent of all state property taxes are reserved for specific functions.

In FY1995, a smaller portion of the total revenue raised by state property taxes was earmarked because the proceeds from two taxes (intangibles tax and estate tax) were deposited in the General Fund. Both taxes were eliminated since that time, resulting

Charts 5a-5c
Dedication of Sales Related Taxes: FY1995, FY2010, and FY2014

Chart 5a - FY1995

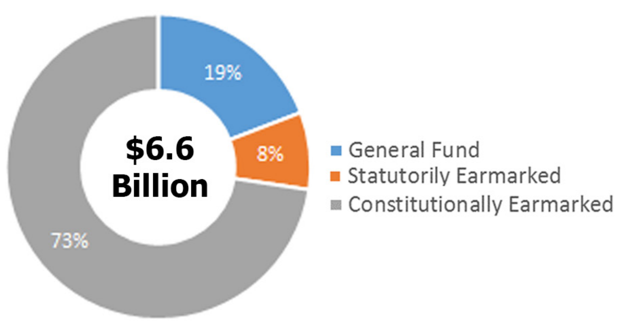
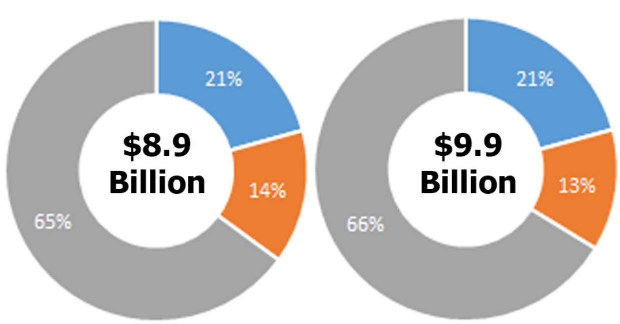


Chart 5b - FY2010 **Chart 5c - FY2014**



Charts 6a-6c
Dedication of Property Taxes: FY1995, FY2010, and FY2014

Chart 6a - FY1995

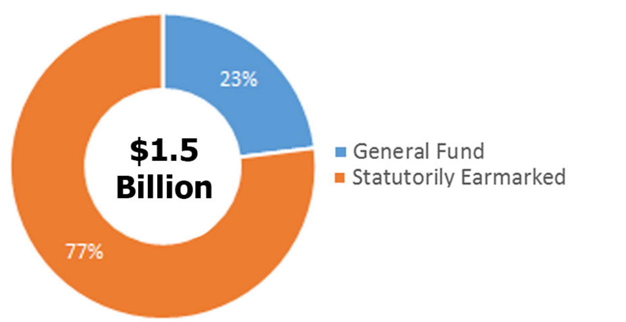
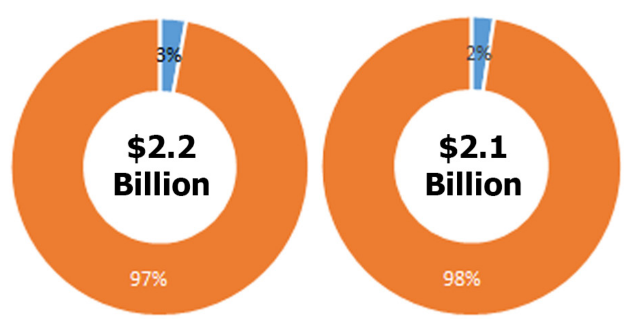


Chart 6b - FY2010 **Chart 6c - FY2014**



in a larger share of the total being dedicated revenue.

Transportation Taxes

These are sales-related and property taxes levied on items used for transportation purposes. A total of $1.9 billion was raised in FY2014 by this grouping of taxes with the two largest sources being motor vehicle registration taxes ($944 million) and gasoline tax ($824 million). Each of these taxes is earmarked specifically to transportation purposes by the state constitution, Article IX, Section 9. The earmarking provisions have not changed in the last 20 years.

Charts 7a-7c
Dedication of Transportation Taxes: FY1995, FY2010, and FY2014

Chart 7a - FY1995

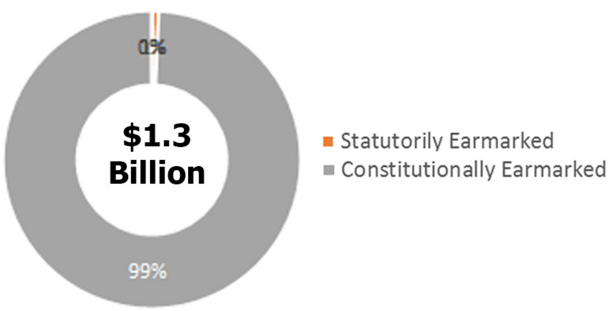


Chart 7b - FY2010

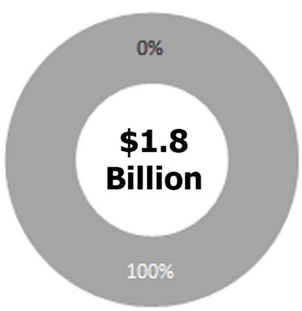
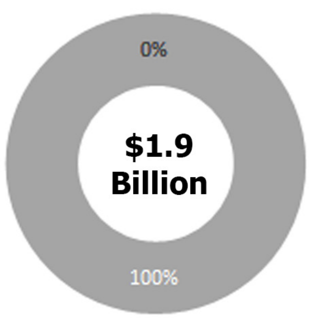


Chart 7c - FY2014



Challenges

Relationships: Tax to Specific Function

In Michigan, as in many other states, some taxes are earmarked to specific functions because it is easy to identify the direct users and beneficiaries of the government service being consumed. Dedication of benefit taxes can be justified on the grounds that taxation introduces a degree of market orientation into government service provision. As previously noted, the most common example is motor fuel and vehicle registration taxes, which are dedicated to highway maintenance and construction. However, these taxes comprise only a minor share of the total state budget and are not responsible for the expansion of earmarking over time. For the past 20 years, transportation taxes have accounted for just between 7 and 9 percent of the total tax revenue generated (8 percent in FY2014) and just 13 percent of the total earmarked taxes in FY2014 ($15.3 billion).

Generally, criticisms of earmarking rest predominately with the dedication of revenues from general, broad-based taxes (e.g., income, sales, and property). This type of earmarking is especially problematic when there is no relationship between the tax and the function benefiting from the revenue generated. Michigan has a long history of forcing relationships between the tax being levied and the public service provided. One example is the dedication of a portion of sales tax revenue to local governments. Part of the thinking behind the linkage here is that Michigan law prohibits local governments from levying general sales taxes and sharing a portion of the state sales tax yield is one way to address this tax limitation.

For the vast majority of Michigan's earmarking provisions, a relationship does not exist between the tax and the government function. Primary among these is the dedication of several taxes to the School Aid Fund. Dedicating specific state revenues to this fund dates back to a 1946 constitutional amendment in which a portion of the Sales Tax was earmarked. The intention at the time was to remove state funding for public education from the budget process, safeguarding the function from potential future cuts. Since that time, more sales tax revenue, some of the use tax revenue, and the proceeds from various new taxes (e.g., tobacco, state property) have been designated to the fund, either in the state constitution or in state law. As discussed earlier, the majority of this earmarking was the result of Proposal A.

Since the adoption of Proposal A, the amount of earmarked tax revenue to the School Aid Fund has grown substantially in relation to the share of taxes deposited in the General Fund. In FY1995, the General Fund received $7.8 billion while the School Aid Fund received $7.0 billion of the total tax yield.

Sales Taxation of Fuel

It must be noted that in addition to the 19-cent per-gallon motor fuel tax levied on gasoline, the State of Michigan also levies its 6 percent general sales tax on the purchase of motor fuels. Whereas 100 percent of the transportation taxes levied (motor fuel and vehicle registration) are constitutionally earmarked for transportation purposes, no portion of the sales tax collected on fuel sales goes to roads. Taxpayers are not responsible for two separate tax bills when they purchase motor fuel, instead both taxes are combined in the total per-gallon price paid at the pump. From the taxpayer's perspective, the general sales tax on fuel is just as much a user fee as the motor fuel excise tax. However, the government treats the disposition of the revenue from transportation taxes and the general sales tax very differently. Thus, because of Michigan's current tax structure and the various earmarking provisions, the total tax levy on motor fuel purchases deviates from a pure user fee.

Twenty years later, in FY2014, the School Aid Fund's take was $11.5 billion compared to the General Fund that received $8.4 billion. One practical effect is that resources available for education purposes have grown substantially, largely without any recognition of the actual funding needs. Another result is that, over the years, budget writers' have seen their control over the entire budget process dwindle as the General Fund's relative role has shrunk.

Catch 22

It is widely accepted that the condition of the state's road and bridge infrastructure has deteriorated significantly over the last decade and that the system is in need of substantial additional investment. Although transportation spending is the beneficiary of earmarked motor fuel and vehicle registration tax revenues, the growth of these revenues has failed to keep pace with the investment levels needed to maintain the system. At the same time, lawmakers have been hesitant to supplement the dedicated funds with discretionary funding. Until recently, lawmakers have simply appropriated the revenue generated from earmarked taxes and ignored the actual needs of the system. And when it has decided to supplement the earmarked funding, it has found that the pool of discretionary funding, as a share of the total, is much smaller because of other dedications. This has made re-prioritizing state spending to a critical state function much more difficult.

One aspect of road funding debate has focused on the current taxation of motor fuels, specifically the Sales Tax levied on fuel. It is widely accepted that the earmarking of sales tax revenues to non-road purposes has been one factor contributing to the stalemate over finding a long-term funding strategy for the state's ailing road and bridge infrastructure system. As mentioned, none of the Sales Tax revenue goes to highway purposes. One preferred public policy response to address the poor road conditions involves the dual objective of garnering more funding for roads and simplifying the tax structure so that only motor fuel excise taxes are levied on motor fuels. Pursuing both policy objectives has presented lawmakers with a Catch 22.

Proposal 15-1 on the May 2015 special election ballot attempted to address both policy objectives.[10] The proposal involved exempting motor fuels from the Sales Tax and replacing the tax with an increase in the motor fuel excise tax. The tax switch guaranteed more money for roads without dramatically raising the price that motorists pay at the pump. However, because of the existing sales tax earmarking, this component of the plan financially harmed schools and local governments. To avoid the cuts to schools and locals, the proposal included an increase in the Sales Tax rate (a public vote was required because the Michigan Constitution caps the tax rate), which would have provided these entities with additional state funds to offset the losses. The complexity of the proposal, combined with the $2.0 state tax increase involved, prompted voters to overwhelmingly reject it at the polls.

More Earmarking on the Horizon

The share of Michigan state taxes dedicated to specific functions is expected to grow next fiscal year (FY2016). This will result from a series of personal

[10] Citizens Research Council of Michigan, *Statewide Ballot Issue: Proposal 15-1, March 2015*. http://www.crcmich.org/PUBLICAT/2010s/2015/transportation_funding_proposal-2015.pdf

property tax reforms which were approved as part of a statewide vote in August 2014.[11] The expansion of earmarked taxes will further reduce the share of the state budget that lawmakers exercise control over, making it more difficult to re-prioritize state spending in the future.

One major obstacle to past efforts to reduce the personal property tax (i.e., tax levied on business equipment, furniture, moveable objects) burden on Michigan firms was the fiscal impact to local governments. The tax generates substantial financial resources for local governments to deliver public services and some units are extremely dependent on the tax because of the presence of large commercial and industrial property operations in their communities. The key to the success of the 2014 reforms hinges on the various local government reimbursement mechanisms guaranteed in the reforms.

Specifically, full replacement revenues are guaranteed by a newly created tax, Local Community Stabilization Share Tax. This tax, which will take effect on October 1, 2015, was carved out of the state's existing Use Tax by splitting it into two distinct new taxes: (1) Local Community Stabilization Share Tax to be levied by the Local Community Stabilization Authority; and (2) State Share Tax which would continue to be levied by the state, with revenues used for state purposes. The combined tax rate of the two components is capped at 6 percent (the same rate as the existing 6 percent state Use Tax).

The division of the Use Tax to reimburse local governments comes at the expense of the General Fund's share (i.e., existing 4 percentage point tax); the portion of the tax dedicated to the School Aid Fund (i.e., 2 percentage points) was not changed with the reforms. Because the personal property tax exemptions are phased-in, the need for local government reimbursement ramps up over time. The reduction to the General Fund portion of the tax in the first year (FY2016) is estimated at $96 million, but grows to nearly $500 million within five years (FY2021). When fully implemented (i.e., existing personal property fully exempt by FY2023), approximately two-thirds of the Use Tax revenue will be earmarked for local government reimbursement and schools, double the amount currently earmarked.

Reversing Course

Reversing course to undo the current level of earmarking will not be an easy task for state lawmakers. Doing so will require decision makers to face both legal and practical considerations. In terms of legal matters, constitutional dedications cannot be changed without a vote of the people, while changing statutory earmarking provisions require the consent of the legislature and the governor. Changes to state law, whether constitutional or statutory, may be the easy part. Getting the political support to reduce tax dedications will be much more difficult. Those that currently benefit from earmarking are unlikely to support efforts that would subject their policy interests to annual budgetary scrutiny. These interests have no financial incentive to assume such a risk.

If undoing current earmarks is a heavy political lift, another option for lawmakers could be to stop the current trend towards more tax earmarking. The prospects here also seem dim as evidenced by the recent personal property tax reforms as well as the means of addressing road funding in Proposal 15-1. Both policy responses suggest an increased trend towards the earmarking of state taxes, not the opposite. Even though the statewide vote on Proposal 15-1 failed, it is highly unlikely that the plan would have made it to the ballot if the replacement funding for schools and local governments was not guaranteed. In the case of the personal property tax reforms, local governments and schools would only agree to the personal property tax exemptions (and loss of tax revenue) if replacement revenues were guaranteed by the state. As discussions continue about finding a road funding solution, it is unlikely that any plan that involves an increase in state tax revenue will not be accompanied by an earmarking provision of such revenue.

Michigan's high dependence on earmarking, coupled with recent trends, should serve as a caution to

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[11] Citizens Research Council of Michigan, *Statewide Ballot Issues: Proposal 2014-1, July 2014*. www.crcmich.org/PUBLICAT/2010s/2014/personal_property_tax_reform_question-2014.pdf

lawmakers. As the current road funding dilemma clearly shows, the ability, and willingness, to tap into a shrinking pot of discretionary funding over the years has resulted in underinvestment in this critical state function. Priority setting will be made even more difficult if the economy slips into a recessionary period and state tax revenue growth stagnates or declines. Should this occur, and the amount of total tax revenue decreases, budget writers will have little alternative to budget cuts for non-earmarked state functions, regardless of their priority. It is true that earmarked programs would have to endure cuts also, but only to the degree dictated by state law unless lawmakers are willing to amend statutory earmarking provisions.

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