



**CITIZENS RESEARCH COUNCIL
OF MICHIGAN**



**STATEWIDE BALLOT ISSUE:
PROPOSAL 15-1
SALES AND MOTOR FUEL TAX
INCREASES RELATED TO
TRANSPORTATION FUNDING**

MARCH 2015

REPORT 389

CELEBRATING 99 YEARS OF INDEPENDENT, NONPARTISAN
PUBLIC POLICY RESEARCH IN MICHIGAN

BOARD OF DIRECTORS

Chair
Terence M. Donnelly

Laura Appel
Michigan Health & Hospital Association

Michael G. Bickers
PNC Financial Services Group

Beth Chappell
Detroit Economic Club

Rick Cole
Cole Creative LLC

James Davlin
General Motors. Retired

Daniel Domenicucci
Ernst & Young LLP

Terence M. Donnelly
Dickinson Wright PLLC

Randall W. Eberts
W. E. Upjohn Institute

Sherrie L. Farrell
Dykema

Eugene A. Gargaro, Jr.
Manoogian Foundation

Vice Chair
Aleksandra A. Miziolek

John J. Gasparovic
BorgWarner Inc.

Ingrid A. Gregg
Earhart Foundation

June Summers Haas
Honigman Miller Schwartz and Cohn LLP

Marybeth S. Howe
Wells Fargo Bank

Gordon Krater
Plante Moran

William J. Lawrence III
Varnum
42 North Partners LLC

Daniel T. Lis
Attorney-At-Law

Kristen McDonald
The Skillman Foundation

Michael P. McGee
Miller, Canfield, Paddock and
Stone PLC

Treasurer
Vacant

Aleksandra A. Miziolek
Cooper-Standard Automotive Inc.

Paul R. Obermeyer
Comerica Bank

Kevin Prokop
Rockbridge Growth Equity, LLC

Jay Rising
Detroit Medical Center

Kelly Rossman-McKinney
Truscott Rossman

Candee Saferian
PVS Chemicals, Inc.

Christine Mason Soneral
ITC Holdings Corp.

Terence A. Thomas, Sr.
Thomas Group Consulting, Inc.

Theodore J. Vogel
CMS Energy Corporation

Larry Yachcik
Porter Hills

BOARD OF TRUSTEES

Chair
Eugene A. Gargaro, Jr.

Terence E. Adderley
Kelly Services, Inc.

Jeffrey D. Bergeron
Ernst & Young LLP

Stephanie W. Bergeron
Walsh College

Beth Chappell
Detroit Economic Club

Richard T. Cole
Cole Creative LLC

Brian M. Connolly
Oakwood Healthcare, Inc.

Matthew P. Cullen
Rock Ventures LLC

Stephen R. D'Arcy
Detroit Medical Center

Richard DeVore
PNC Bank

Terence M. Donnelly
Dickinson Wright PLLC

John M. Dunn
Western Michigan University

David O. Egner
Hudson-Webber Foundation
New Economy Initiative

David L. Eisler
Ferris State University

David G. Frey
Frey Foundation

Mark T. Gaffney
Eugene A. Gargaro, Jr.
Manoogian Foundation

Ralph J. Gerson
Guardian Industries Corporation

Eric R. Gilbertson
Saginaw Valley State University

Allan D. Gilmour
Wayne State University, Emeritus

Alfred R. Glancy III
Unico Investment Group LLC

Thomas J. Haas
Grand Valley State University

David S. Haynes
Northern Michigan University

James S. Hilboldt
The Connable Office, Inc.

Paul C. Hillegonds
DTE Energy Company. Retired

Daniel J. Kelly
Deloitte. Retired

David B. Kennedy
Earhart Foundation

Mary Kramer
Crain Communications, Inc.

Gordon Krater
Plante & Moran PLLC

David Leitch
Ford Motor Company

Edward C. Levy, Jr.
Edw. C. Levy Co.

Daniel Little
University of Michigan-Dearborn

Alphonse S. Lucarelli
Ernst & Young LLP. Retired

Sarah L. McClelland
JPMorgan Chase & Co.

Anne Mervenne
Mervenne & Co.

Aleksandra A. Miziolek
Cooper-Standard Automotive Inc.

Glenn D. Mroz
Michigan Technological University

Mark A. Murray
Meijer Inc.

James M. Nicholson
PVS Chemicals

Don R. Parfet
Apjohn Group LLC

Philip H. Power
The Center for Michigan

Keith A. Pretty
Northwood University

John Rakolta Jr.
Walbridge

Douglas B. Roberts
IPPSR- Michigan State University

Milton W. Rohwer
George E. Ross
Central Michigan University

Gary D. Russi
Nancy M. Schlichting
Henry Ford Health System

John M. Schreuder
First National Bank of Michigan

Amanda Van Dusen
Miller, Canfield, Paddock
and Stone PLC

Kent J. Vana
Varnum

Theodore J. Vogel
CMS Energy Corporation

Gail L. Warden
Henry Ford Health System, Emeritus

Jeffrey K. Willemain
Deloitte. Retired

Citizens Research Council of Michigan is a tax deductible 501(c)(3) organization



STATEWIDE BALLOT ISSUE: PROPOSAL 15-1

SALES AND MOTOR FUEL TAX INCREASES RELATED TO TRANSPORTATION FUNDING

MARCH 2015

REPORT 389

This full analysis of Proposal 2015-1 was amended slightly on March 23, 2015. In the first full paragraph of the second column on page 15 of the report, the original report stated that "... the act also phases in across a three year period a 36.1 percent increase in registration taxes on large trucks weighing over 26,000 pounds." In fact the increases vary depending on the gross vehicle weight of the truck. As noted later in the paragraph, a common 5-axle interstate tractor-trailer registered with an 80,000 pound gross vehicle weight will be subject to a 36.1 percent increase in registration taxes. We have replaced the underlined words in the sentence in question with "an increase" and noted that the increases will vary by gross vehicle weight.

CITIZENS RESEARCH COUNCIL OF MICHIGAN

Eric W. Luper, 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

Do you find this report useful?

The Citizens Research Council of Michigan is a non-profit organization that can only provide information to policy makers and citizens with support from people like you. You can learn more about the organization at www.crcmich.org/information/info.html. If you found the contents of this report useful and wish to provide financial support to help carry on CRC's mission, please fill out the form below and send it to:

Citizens Research Council of Michigan
38777 Six Mile Road, Suite 208
Livonia, MI 48152-3974

YES! I want to help in the support of sound public policy in Michigan!

NAME _____

ADDRESS _____

EMAIL / PHONE _____

- I wish to make a one-time, tax-deductible gift of: \$ _____
- I wish to pledge a total of \$ _____ with an initial payment of \$ _____ .
- I would like my contribution to support: Annual Fund Endowment
- Please mark my gift:

Anonymous

In Honor Of: _____

In Memory Of: _____

- Gift will be matched by: _____

Or donate online at www.crcmich.org

STATEWIDE BALLOT ISSUE: PROPOSAL 15-1

SALES AND MOTOR FUEL TAX INCREASES RELATED TO TRANSPORTATION FUNDING

Contents

| | |
|---|------------|
| Summary | iii |
| Introduction | 1 |
| Background: Financing Michigan’s Transportation Infrastructure | 2 |
| Proposed Constitutional Amendment | 5 |
| Sales Tax..... | 5 |
| One Tax, Two Rates | 5 |
| History of the Sales Tax Rate | 7 |
| Interstate Comparison..... | 7 |
| Exempting Motor Fuels from the Sales Tax..... | 7 |
| Taxing Motor Fuels..... | 7 |
| Constitutional Exemption..... | 8 |
| Other Fuels not Exempt..... | 8 |
| Sales and Use Tax Revenue Earmarks..... | 9 |
| Local Governments | 9 |
| School Aid Fund..... | 9 |
| School Aid Fund..... | 10 |
| Higher Education Appropriations | 10 |
| Permissible Uses of the School Aid Fund..... | 10 |
| Ballot Proposal Linkages: Items Tied to the Vote | 11 |
| Sales and Use Tax Increases | 11 |
| Motor Fuel Tax Increase | 12 |
| Adjustment of Future Motor Fuel Tax Rates..... | 12 |
| Interstate Comparison of Motor Fuel Taxes | 14 |
| Alternative Fuels | 14 |
| Vehicle Registration Taxes..... | 14 |
| Road Construction Process: Bidding, Warranties, and Road Design | 16 |
| Tax Credits for Low- and Moderate-Income Households | 17 |
| Analysis of Proposal 1 | 18 |
| The Proposal’s Fiscal Implications on the Public Sector..... | 18 |
| Impact on Taxes Paid at the Pump | 19 |
| The May 5 Vote: Key Issues for Voters | 21 |
| Appendix A: | 22 |
| Appendix B: | 23 |

CRC REPORT

Tables

| | | |
|---------|--|----|
| Table 1 | Impact of Registration Tax Changes | 15 |
| Table 2 | Potential Impact of Increase in State Earned Income Tax Credit | 17 |
| Table 3 | Estimated Impact of Ballot Proposal on Revenue and Spending | 18 |
| Table 4 | Initial Impact of Tax Changes at the Pump..... | 20 |

Charts

| | | |
|---------|---|----|
| Chart 1 | Revenue from Major Transportation Taxes: FY1997-FY2014 | 2 |
| Chart 2 | Percent of State Trunkline Roads with Good, Fair, and Poor Pavement Conditions..... | 3 |
| Chart 3 | Percent of Federal Aid Non-Trunkline Roads with Good, Fair, and Poor Pavement Conditions | 3 |
| Chart 4 | School Aid Fund Appropriations for Higher Education: FY2010-FY2015..... | 11 |
| Chart 5 | Looking Back: Historical Gas Tax Rates Under the Proposed Rate Adjustment Mechanism | 13 |

STATEWIDE BALLOT ISSUE: PROPOSAL 15-1

SALES AND MOTOR FUEL TAX INCREASES RELATED TO TRANSPORTATION FUNDING

Summary

On May 5, 2015, Michigan voters will be asked to vote on a single statewide ballot measure to amend the state Constitution: Proposal 15-1. Approval of Proposal 15-1 will result in increases in various state taxes, expansion of state tax credits, additional state funds for road repair and maintenance, and additional state funds for public schools and local governments. Of some confusion, perhaps, is that voters are only being asked to directly approve *some* of these changes; those amending the Constitution. The bulk of the other state tax changes are contained in laws passed last legislative session that would only take effect if Proposal 15-1 is approved.

At the end of the 2013-2014 legislative session, the governor and legislative leaders agreed to a complex plan to address the dual objective of increasing state funding for road repair and maintenance and modifying the taxation of motor fuels to guarantee that all taxes paid at the pump were directed to transportation purposes. Additionally, the plan seeks to ensure that other recipients of state funds are not financially harmed in the pursuit of these two

primary goals. By necessity, the plan consists of both constitutional and statutory components.

While the statutory law changes require only legislative and gubernatorial approval, the constitutional changes require approval by the Michigan electorate. However, because the law changes are “tie-barred” to passage of Proposal 15-1, the public vote effectively serves as a referendum on the entire transportation funding package, both the constitutional and statutory changes. Voters are being asked to *directly* approve changes to the Constitution and *indirectly* approve changes in various state laws to implement the complex transportation funding plan.

If voters approve Proposal 15-1, the state Constitution will be amended and various state laws will take effect to increase state tax revenue by nearly \$2.1 billion next fiscal year and by \$1.8 billion annually in the following two fiscal years. If voters reject Proposal 15-1, there will be no changes to the Constitution and none of the proposed tax changes contained in the state laws linked to the proposal will take effect.

Changes Impacting Road Funding and Transportation

Proposal 15-1 and the various laws tie-barred to the proposal can be divided into three main issues or categories of change. First, the proposal modifies the taxation of gasoline and diesel fuel. This is accomplished by exempting these fuels from the sales tax base and changing how the state per-gallon motor fuel tax is calculated. The combination of these tax changes will likely increase the overall taxes paid at the pump. In combination, these changes are expected to bring in \$1.3 billion per year in additional revenue for road repair and maintenance and other transportation purposes. This would be accomplished through statutory and constitutional changes that:

(Changes to the constitution, which require voter approval and are included in Proposal 15-1, are emphasized in blue)

1. Exempt gasoline and diesel fuel used to power vehicles on public roads from the sales and use tax;
2. Increase the state’s motor fuel tax rates (currently 19 cents per gallon for gasoline and 15 cents per gallon for diesel fuel) to equal 14.9 percent of the recent wholesale price of each fuel. Initial per-gallon rates would be 41.7 cents for gasoline and 46.4 cents for diesel motor fuel;
3. Establish a floor and ceiling for motor fuel tax rates that allow for annual inflationary increases to the rates and limit the volatility of future rate changes in response to future swings in wholesale fuel prices; and

4. Increase vehicle registration revenues by eliminating the depreciation discount currently given to passenger vehicles in the first few years; increase registration

taxes on large trucks; and establishing a new registration tax surcharge for electric vehicles.

Changes to Restore Funding from Sales Tax Exemptions

The transportation funding package proposes to eliminate fuel from the base of the sales tax. Portions of the revenues from the sales tax flow into the state's General Fund and others are dedicated to the School Aid Fund and state revenue sharing to local governments. As a result, there would be less state funding available to these programs. The second major category of change associated with Proposal 15-1 and the linked state laws deal with modifications to the sales and use tax rates and how revenue from these taxes is distributed to hold these programs harmless. Because the state Constitution limits the maximum sales tax rate that can be levied, changes involving the tax rate require voter approval.

Overall, changes to the sales and use taxes are expected to generate an additional \$795 million per year for public schools, local governments, and the General Fund. These changes propose to:

5. Increase the maximum authorized rate of the sales tax from 6 percent to 7 percent;
6. Increase the use tax rate from 6 percent to 7 percent;
7. Dedicate 15 percent of the sales tax revenue collected at a rate of up to 5 percent (currently 4 percent) for per-capita allocations to cities, villages, and townships;
8. Dedicate 60 percent of the sales tax revenue collected at a rate of up to 5 percent (currently 4 percent) to the School Aid Fund; and
9. Dedicate 12.3 percent of the use tax revenue collected at a rate of up to 5 percent to the School Aid Fund (currently no portion of the tax levied at 4 percent is dedicated to the School Aid Fund).

Changes to Ensure Accountability of New Funding and Help those Most Impacted by Tax Increases

Finally, a number of other legislative and constitutional changes are included to address concerns regarding collateral impacts caused by tax increases and changes to revenue distributions. These proposed changes would:

10. Modify the allowable uses of the School Aid Fund to exclude higher education and include public community colleges, career and technical education programs, and certain community college or career and technical education program scholarships;
11. Introduce new road construction and

maintenance bidding, warranty, and road design guidelines to help ensure that new road funding is spent efficiently;

12. Increase the state's Earned Income Tax Credit (EITC) for low-income tax filers in an effort to help offset the regressive nature of the tax increases; and
13. Expand the state's Homestead Property Tax Credit for very low-income senior citizens and disabled homeowners in an effort to help offset the regressive nature of the tax increases.

Impact on the Public Sector

CRC estimates that Proposal 15-1 will increase sales and use tax revenues by \$795 million in Fiscal Year 2016 (FY2016), with slightly less revenue collected in FY2017 and FY2018. The revenue increase will mean additional funding for the School Aid Fund, revenue sharing to local governments, some public transit programs, and the state’s General Fund.

Net revenue gains from motor fuel tax changes designed to increase road and transportation funding are estimated to be around \$1.3 billion in FY2016, with marginally more revenue raised in FY2017 and FY2018. For the first two years, \$860 million and \$460 million, respectively, of the additional revenue is dedicated by law to pay down past state transportation borrowing and the

remaining funds will be allocated to state and local road agencies and public transit programs through the transportation distribution formula. Initial indications are that these new revenues are viewed by state policymakers as easing pressures on the state’s General Fund by allowing funds currently appropriated for transportation improvements to be redirected to other purposes. Currently, \$285 million from the state General Fund is being used to subsidize dedicated transportation funding and allow for additional road repair and maintenance. If Proposal 15-1 is approved, a portion of the \$1.3 billion revenue gain will be used to supplant the General Fund resources going to road repair, thus easing pressures on the General Fund budget and reducing the net gain in road funding.

Impact on Michigan Citizens

How Proposal 15-1 and related legislation impact the amount motorists pay at the pump will depend on the price of fuel. At current prices (roughly \$2.40 per gallon in March 2015), constitutional and legislative changes would result in a 10.2 cent increase in the per-gallon price of gasoline with the tax rates to be levied in FY2016. Perhaps counterintuitively, as the price of gasoline increases the difference between what consumers pay under the current system and what they would pay under the proposed system shrinks. For example, if per-gallon gasoline prices rise to \$3.85 during FY2016, consumers will only pay 2.1 cents per gallon more under Proposal 15-1 (See **Table A**).

Michigan’s citizens will also be obliged to pay a seven percent sales tax on goods subject to the tax; a one percentage point increase from the current rate of six percent. The impact of this will vary by individual but sales taxes tend to have a greater cost impact on lower-income individuals and families who spend proportionally more of their income on taxed goods than higher-income individuals and families. Therefore, the proposal includes an increase in the state’s Earned Income Tax Credit as well as the Homestead Property Tax Credit for very low-income seniors and disabled homeowners.

Table A
Initial Impact of Tax Changes at the Pump

| Pre-Tax Retail Price | \$1.90 | | Per-Gallon Cost | | \$3.25 | |
|-------------------------|--------------------|-----------------|------------------------|-----------------|-------------------|-----------------|
| | <i>Current</i> | <i>Proposal</i> | <i>Current</i> | <i>Proposal</i> | <i>Current</i> | <i>Proposal</i> |
| Federal gasoline tax | \$0.184 | \$0.184 | \$0.184 | \$0.184 | \$0.184 | \$0.184 |
| State sales tax | \$0.125 | \$0.000 | \$0.161 | \$0.000 | \$0.206 | \$0.000 |
| State gasoline tax | \$0.190 | \$0.417 | \$0.190 | \$0.417 | \$0.190 | \$0.417 |
| <i>Tax Subtotal</i> | <i>\$0.499</i> | <i>\$0.601</i> | <i>\$0.535</i> | <i>\$0.601</i> | <i>\$0.580</i> | <i>\$0.601</i> |
| Final Pump Price | \$2.399 | \$2.501 | \$3.035 | \$3.101 | \$3.830 | \$3.851 |
| | 10.2 cent increase | | 6.6 cent increase | | 2.1 cent increase | |

CRC REPORT

STATEWIDE BALLOT ISSUE: PROPOSAL 15-1

SALES AND MOTOR FUEL TAX INCREASES RELATED TO TRANSPORTATION FUNDING

Introduction

Increasing state funding for transportation infrastructure improvements has been a public policy issue in Michigan for a number of years. Despite broad support from a diverse coalition of groups across the state, including many in the business community, local government, and labor organizations, a comprehensive legislative solution has proved elusive. That is, until the waning days of the 2013-2014 legislative session when Governor Snyder and legislative leaders agreed to the dual goal of increasing funding for roads and simplifying the taxation of motor fuel so that revenues from all motor fuel taxes would be dedicated to transportation improvements. This required development of a complex plan to restructure various state taxes.

At the center of this transportation funding package and key to its enactment is a constitutional amendment that increases the maximum authorized sales tax rate from 6 percent to 7 percent, which can only be done by a vote of the people. The increase in the tax rate will not directly increase the amount of money for transportation purposes; instead it is

being sought to address the funding displacement that would be caused by exempting motor fuels from the sales tax base, which is part of the constitutional amendment. The proceeds from the sales tax increase would be used to offset the funding reductions to schools and local governments that would occur from the new sales tax exemptions; these entities are the primary benefactors of sales tax receipts.

The laws enacted in December 2014 as part of the transportation funding package will not take effect unless voters approve Proposal 15-1 at the special election on May 5. The fact that these laws, including those raising taxes and fees, are "tie-barred" to the statewide vote means that the May vote effectively serves as a referendum on the entire transportation funding package, both the constitutional and statutory components. If voters reject Proposal 15-1, there will be no change in the state tax landscape. This "all or nothing" proposition also means that there is no backup plan to address the transportation funding challenge should voters not approve Proposal 15-1.

THE FOLLOWING STATEWIDE BALLOT PROPOSAL WILL APPEAR ON THE MAY 5, 2015 SPECIAL ELECTION BALLOT

PROPOSAL 15-1

A proposal to amend the State Constitution to increase the sales/use tax from 6% to 7% to replace and supplement reduced revenue to the School Aid Fund and local units of government caused by the elimination of the sales/use tax on gasoline and diesel fuel for vehicles operating on public roads, and to give effect to laws that provide additional money for roads and other transportation purposes by increasing the gas tax and vehicle registration fees.

The proposed constitutional amendment would:

- Eliminate sales / use taxes on gasoline / diesel fuel for vehicles on public roads.
- Increase portion of use tax dedicated to School Aid Fund (SAF).
- Expand use of SAF to community colleges and career / technical education, and prohibit use for 4-year colleges / universities.
- Give effect to laws, including those that:
 - Increase sales / use tax to 7%, as authorized by constitutional amendment.
 - Increase gasoline / diesel fuel tax and adjust annually for inflation, increase vehicle registration fees, and dedicate revenue for roads and other transportation purposes.
 - Expand competitive bidding and warranties for road projects.
 - Increase earned income tax credit.

Should this proposal be adopted?

Background: Financing Michigan’s Transportation Infrastructure

Funding for Michigan’s state and local roads primarily originates from state taxes that are distributed through a statutory formula to the Michigan Department of Transportation, Michigan’s 83 counties, and to state’s cities and villages to care for the roads. Michigan leans heavily on two sources of state revenue to finance the maintenance of its road infrastructure: motor fuel taxes and vehicle registration taxes. However, as illustrated in **Chart 1**, revenues from these sources have been largely flat since the last increase in the gasoline tax was enacted in 1997.

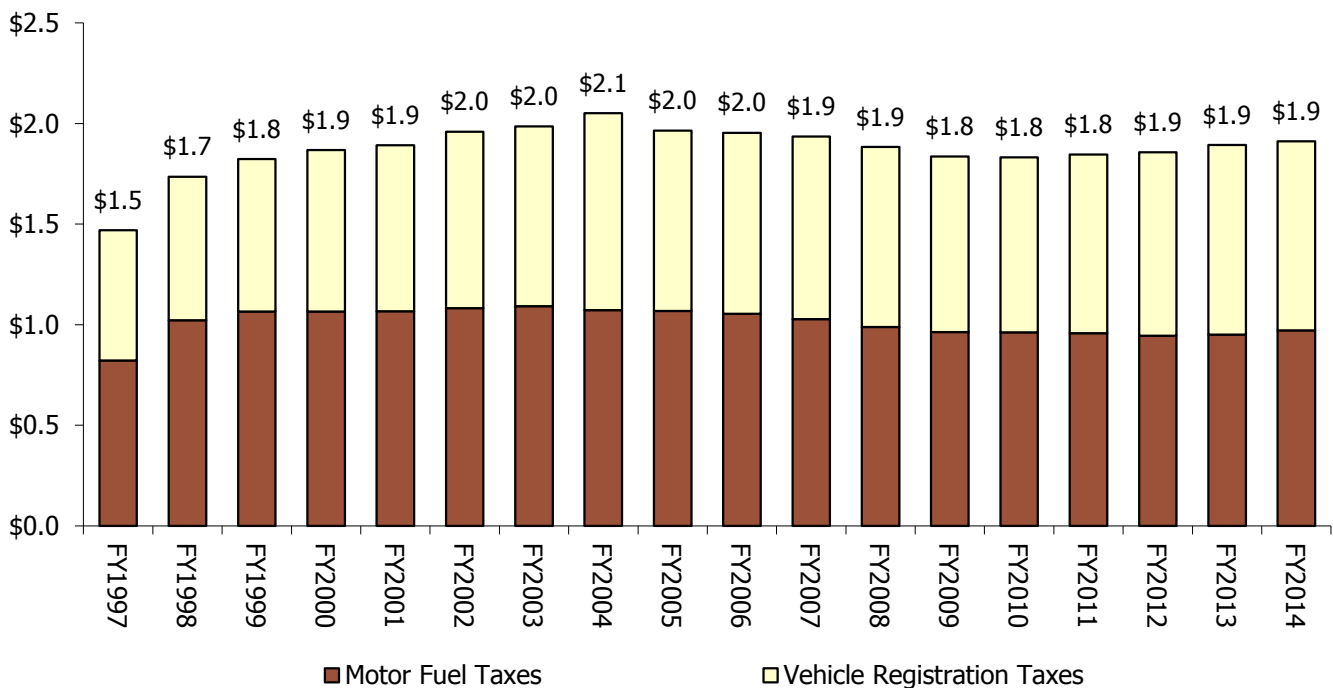
The key issue contributing to the declining revenues is that Michigan’s motor fuel taxes are set at a fixed per-gallon rate (19 cents per gallon for gasoline and 15 cents per gallon for diesel fuel). However, on average, motorists have purchased fewer gallons of fuel each year for two reasons. First, automobile fuel efficiency has improved in recent years, meaning that drivers need less gasoline to get to any given

destination. The U.S. Energy Information Administration reports that the average fuel economy of new light-duty vehicles rose from 27.1 miles per gallon in 2008 to 32.7 miles per gallon in 2012, with further increases projected through the next decade.¹ Second, motorists are driving less than in the past. In 2005, motorists drove over 104 billion miles on Michigan roadways according to Federal Highway Administration data. By 2012, that figure had dropped to 94.5 billion miles – a decline of over 9 percent.² The result: Motor fuel tax revenues have declined over time, offsetting any gains in revenue from registration taxes. Revenues from both sources in FY2014 were actually lower in nominal dollars than they were 12 years earlier in FY2002.

¹ U.S. Energy Information Administration, *Annual Energy Outlook 2014*, Figure MT-25.

² U.S. Department of Transportation, Federal Highway Administration, *Highway Statistics Series*.

Chart 1
Revenue from Major Transportation Taxes: FY1997 - FY2014 (in billions)



Source: Michigan House Fiscal Agency

During the same time, the costs of maintaining and repairing the state’s road system have risen. A commonly cited measure of road construction costs is the National Highway Construction Cost Index.³ Between March 2003 (when the index was first established) and September 2014, the index suggests construction costs nationally have risen by about 13.5 percent.⁴ With stagnant revenues unable to keep up with the increasing needs and costs of road maintenance, road quality has deteriorated. **Chart 2** and **Chart 3** highlight trends in the percentage of state trunkline (interstate and state “M-route” and “US-route” highways) and non-trunkline (other federal aid-eligible non-highway roads) roadways classified as being in “good,” “fair,” and “poor” condition according to data from the Michigan Transportation Asset Management Council.

The charts show that road conditions have deteriorated within both road classifications. The percentage of state trunkline lane miles in good condition (brown segment of **Chart 2**) fell from 35 percent in 2007 to 25 percent in 2013, while lane miles in poor condition (blue lined segment of **Chart 2**) rose from 10 percent to 15 percent over the same period. Conditions worsened to an even greater extent for the non-trunkline roadways with the percentage of lane miles in poor condition (brown segment of **Chart 3**) rising from around 15 percent in 2005 to just over 43 percent by 2013.

In a larger sense, the ballot proposal is essentially a referendum on a larger package of legislation aimed at addressing the state’s transportation infrastructure needs.

Chart 2
Percent of State Trunkline Roads with Good, Fair, and Poor Pavement Conditions

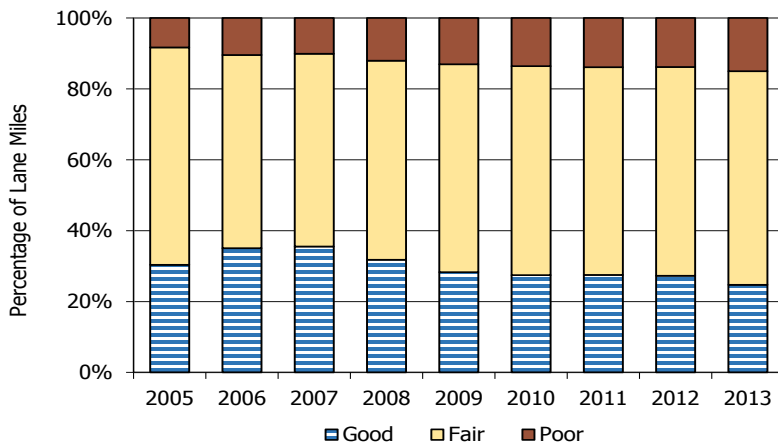
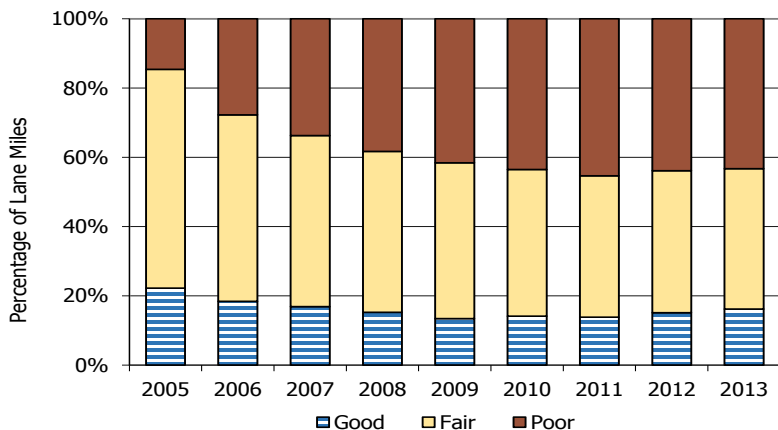


Chart 3
Percent of Federal Aid Non-Trunkline Roads with Good, Fair, and Poor Pavement Conditions



Source: Michigan Transportation Asset Management Council, Pavement Condition and Forecasting Dashboard, <http://tamc.mcgi.state.mi.us/MITRP/Data/PaserDashboard.aspx>

³ Data from the index is available at www.fhwa.dot.gov/policy-information/nhcci/pt1.pdf

⁴ The index shows national construction costs actually peaked in September 2006 and September 2008, reaching levels that were 35 to 40 percent higher than in the March 2003 base period. However, the impact of the Great Recession pushed costs down significantly between the end of 2008 and the beginning of 2010.

The Need for a Public Vote

State lawmakers encountered a policy issue somewhat unique to Michigan in attempting to craft a solution to the state's chronically deteriorating roads. As public attention about the condition of the roads increased and consensus formed around the need to increase transportation spending, many voiced a policy preference that all taxes levied on motor fuels should be used exclusively for road care. Michigan is one of a few states that levy a sales tax on motor fuels. Sales tax revenues do not go towards roads, but portions of the revenues are primarily dedicated to schools and local governments through the constitution.

The 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. In developing the plan, policymakers were confronted with the fact that simplifying the tax structure by exempting motor fuels from the sales tax would financially harm schools and local governments unless there was offsetting action to increase funding to these programs another way.

In most other states, actions to keep schools and local governments whole through such a tax simplification effort would not require a vote of the people. It is only because the Michigan Constitution limits the sales tax rate and dedicates funding from the sales tax to these specific purposes that a constitutional amendment is necessary to achieve this end. While a vote of the people is required to amend the state constitution in almost every other state, few other states have included such prescriptive provisions in their constitutions. All states set tax rates statutorily. If other states do dedicate revenues to specific purposes, most include such detailed material more appropriately within state laws.

An ideal situation would have the state levy taxes needed to fund the services and functions necessary for the operation of state government and the ancillary programs. State policymakers would then prioritize the services with the greatest needs and direct available funding to meet those needs. However, the citizens of Michigan have moved away from the ideal situation by creating a number of constitutional limits on the policy actions of their elected officials, most notably by:

- Limiting the sales tax rate that may be levied by the state and excluding local governments from levying local-option sales taxes;
- Dedicating revenues from specific taxes and other sources to favored purposes; and
- Limiting the rate of taxation that may be applied to property.

The Citizens Research Council of Michigan has long admonished the drafters of constitutional amendments who placed these provisions into the Constitution. Such provisions go beyond serving their immediate purposes and often hamstring elected officials down the road from responding to changing circumstances. As a result, any subsequent revisions to these provisions that might become necessary involve the cumbersome and expensive steps of requesting voter approval for constitutional amendments.

Proposal 15-1 is an example of these onerous public policies coming to fruition. More than one commentator has chided the legislature for passing responsibility for crafting a solution for Michigan's road funding problems on to the voters. Given the limitations Michigan residents have placed in the state Constitution over the years, achieving the dual goals of increasing transportation funding and simplifying the tax structure on motor fuels could not be achieved without involving the voters. In short, this is a problem of our own creation largely caused by the nature of the material we have chosen to populate our fundamental governing document. Unfortunately, the proposed solution does not fix the problem for future policymakers. Instead, the solution makes it worse by adding another restriction to the Constitution that exempts motor fuel from the sales tax and expands the earmarking of sales and use tax receipts. This could require Michigan voters to repeat this process in the future.

Proposed Constitutional Amendment

Proposal 15-1 is a proposed constitutional amendment that was placed on the ballot by the Michigan Legislature and will be submitted to voters at a special election on May 5, 2015. If approved by the voters, the proposal will substantively amend three sections (Sections 8, 10, and 11) of Article IX (Finance and Taxation) of the 1963 Michigan Constitution.

As a constitutional amendment, the proposal must be distinguished from the various laws adopted by the legislature associated with the complex transportation funding package. These laws are described later in the paper. The constitutional amendment, if approved, will:

- Increase the maximum rate of the sales tax from 6 percent to 7 percent;
- Exempt gasoline and diesel fuel used to power vehicles on public roads from sales and use taxes;

- Dedicate 15 percent of the sales tax revenue collected at a rate of up to 5 percent (currently 4 percent) for assistance to townships, cities, and villages;
- Dedicate 60 percent of the sales tax revenue collected at a rate of up to 5 percent (currently 4 percent) to the School Aid Fund;
- Dedicate 12.3 percent of the use tax revenue collected at a rate of up to 5 percent to the School Aid Fund (currently none of the tax at the 4 percent rate is dedicated to the School Aid Fund); and
- Modify the allowable uses of the School Aid Fund to exclude higher education and include public community colleges, career and technical education programs, and certain community college or career and technical education program scholarships.

Sales Tax

Michigan has levied a state sales tax since 1933, initially at a rate of 3 percent. The tax rate was increased to 4 percent in 1961 and to 6 percent in 1994. The tax is levied on retailers based on their gross sales (i.e., the retail price) of tangible personal property. Article IX, Section 8 of the Michigan Constitution caps the maximum sales tax rate that the legislature can impose at a rate of 6 percent. Currently, the legislature has authorized the tax to be levied at the maximum 6 percent rate.

One Tax, Two Rates

For consumers paying the sales tax, the tax appears as a single tax levied at a 6 percent rate. However, the current 6 percent rate has two distinct parts; a 4 percent rate and a 2 percent rate. Each component has its own language in the Michigan Constitution and the revenues generated by each are allocated differently. Proposal 15-1 would modify the language dealing with the 4 percent rate; the 2 percent rate language is unaffected.

The current 4 percent rate is established within the

constitutional limitation found in Article IX, Section 8, which states “. . . the Legislature shall not impose a sales tax on retailers at a rate of more than 4%...” This provision grants the legislature the power to levy a tax at a rate of up to 4 percent, but it does not require the legislature to do so.

Section 8 was amended in 1994 to require that an additional 2 percent tax rate be imposed. Unlike the permissive language pertaining to the 4 percent tax rate limit, the 2 percent tax rate is mandated. Because the Constitution states that the additional 2 percent rate “shall be imposed,” the 2 percent rate is the minimum that the legislature must levy. Thus, the legislature can authorize a sales tax rate ranging from 2 percent to 6 percent. The General Sales Tax Act (Public Act 167 of 1933) currently sets the tax rate at the 6 percent maximum.

Proposal 15-1 allows the legislature to increase the 4 percent rate up to 5 percent. The proposed change, combined with the required 2 percent rate, has the effect of increasing the maximum total sales tax rate that the legislature can impose from the current 6

Giving Effect to State Laws via a Constitutional Amendment

Proposal 15-1 is rather unique as a ballot measure in that it directly asks voters to approve a constitutional amendment, but that direct vote also indirectly triggers the enactment of an entire package of laws. While each law embraces an appropriate subject, passed the legislature with the necessary support, and was signed by the governor, it is unclear whether the public vote triggering mechanism passes muster with the state Constitution.

The laws necessary to increase motor fuel taxes are not part of the constitutional amendment voters are being asked to approve at the May election. However, in order for those laws to take effect, voters must approve Proposal 15-1. This is because each of the laws is "tie-barred" to the public vote. A "tie bar" is a device to condition the effectiveness of legislation on the enactment or passage of other specified legislation.

Michigan's Constitution is clear that the legislative power of the state is vested in a senate and a house of representatives (Article IV, Section 1). Being so vested, the legislature is without power to delegate any part of it, except as authorized to do so by the constitution.

In two provisions of the 1963 Constitution the people have retained direct roles in the lawmaking process. Both require gaining the approval of a majority of voters at a statewide election. The **statutory initiative** is defined by Article II, Section 9 as the power which the people reserve to themselves "to propose laws and to enact and reject laws." The power of initiative extends to the people the power to enact any law that the legislature may enact and is invoked by filing petitions. The legislature is required to enact, without modification, or reject any laws proposed by initiative within 40 session days. An initiative not enacted by the legislature is placed on the statewide ballot at the next general election. A total of 13 statutory initiatives have appeared on the ballot since the adoption of the current constitution; seven initiatives were approved and six proposals were rejected.

Article IV, Section 34 allows any bill approved by the legislature and signed by the governor (except bills appropriating money) to provide that it will not become law unless approved by the voters. This is called a **legislative referendum**. Since 1963, voters have faced 13 legislative referenda; they approved nine and rejected four.

The laws that are "tie-barred" to Proposal 15-1 are neither statutory initiatives (i.e., filed by petition) nor legislative referenda (i.e., directly referred to the voters for approval by the legislature), although they are functioning much like the latter. However, instead of voters being asked to approve each individual law separately at the May election, they are being asked to approve the entire package of legislation *en masse*. The vote on the constitutional amendment effectively serves as a referendum on the entire complex package of laws.

Giving effect to a single law, let alone a host of laws, via a public vote on a constitutional amendment is not a common occurrence. In fact, the only other instance when this occurred was under Proposal A of 1994. While the legislature frequently uses the "tie-bar" mechanism to condition the effectiveness of legislation on the approval of other specified legislation, Proposal 15-1 uses this tool to link the enactment of a number of laws to a constitutional amendment proposed by the legislature. In this sense, it does not meet the requirements of either a statutory initiative or a legislative referendum. From a constitutional perspective, it calls into question whether Proposal 15-1 represents a proper delegation of legislative powers.

percent to 7 percent.

The constitutional language that voters are being asked to approve is permissive, not mandatory. While the Constitution sets out limitations on the sales tax rate, the actual rate itself is established through state law. To effect an increase in the tax rate, the legislature needed to enact amendments to the General Sales Tax Act, which it did with the package of laws “tie-barred” to Proposal 15-1 (discussed below).

History of the Sales Tax Rate

Although the state sales tax was first levied in 1933, a rate ceiling was not established until 20 years later. In 1954, voters approved the first constitutional sales tax rate limitation (3 percent). As is the case today, the language added to the Constitution was permissive, stating “At no time shall the legislature levy a sales tax of more than three percent.” Again, in 1960, voters approved an increase in the rate ceiling from 3 percent to 4 percent.

Since 1960, there have been five attempts to increase the maximum sales tax rate – four unsuccessful and one successful. In 1980, 1981, and twice in 1989, voters rejected proposals to increase the sales tax from 4 percent to 5.5 percent, 5.5 percent, 6 percent and 4.5 percent, respectively. In each instance, the proposed sales tax rate increase was part of a larger plan designed to provide taxpayers with some degree of property tax relief. In addition to lowering the property tax burden, both proposed rate increases in 1989 involved efforts to reform the state’s K-12 education finance system. Property taxes played a key role in financing education and the sales tax increases were pursued as a way to hold schools harmless from the tax reductions.

Following the four unsuccessful attempts, voters approved an increase in the rate ceiling by two percentage points in 1994. Similar to the previous attempts to increase the sales tax rate, this amendment was part of a larger fiscal plan to reduce local property taxes and reform the financing of public schools. However, unlike the previous endeavors, Proposal A

did not allow voters to maintain the status quo taxing scheme. Instead, they were forced to choose between the sales tax rate increase that was part of Proposal A and a personal income tax rate increase that was enacted in state law as a “plan B” in providing a trade-off for the property tax relief. Voters chose an increase in the sales tax over an increase in the personal income tax.

Interstate Comparison. Forty-five states and the District of Columbia levy state sales taxes. Many of these states also allow local-option sales taxes, which increase the overall sales tax burden in some locations within these states. The Michigan Attorney General has ruled that local sales taxes are not permitted under the Michigan Constitution.⁵

Of the states levying statewide sales taxes, the highest rate is 7.5 percent in California with five states tied for the second highest at 7 percent.⁶ The state with the lowest rate is Colorado at 2.9 percent. A total of 10 states (including Michigan) have a 6 percent sales tax rate. Michigan’s neighbors levy their sales taxes at various levels: 5 percent (Wisconsin), 5.75 percent (Ohio), 6.25 percent (Illinois), and 7 percent (Indiana).

At 6 percent, Michigan is tied for the 16th highest rate nationally. If approved, Proposal 15-1 would move Michigan to a tie for the second highest state levied sales tax rate in the nation at 7 percent. (See **Appendix A**.)

Exempting Motor Fuels from the Sales Tax

Taxing Motor Fuels. The State of Michigan levies several different taxes on the sale of motor fuels (e.g., gasoline and diesel). Currently, gasoline sold in Michigan is taxed at 19 cents per gallon and diesel fuel is taxed at 15 cents per gallon. In addition to these fixed per-gallon excise taxes, the state also imposes the 6 percent sales tax on motor fuels. The sales tax is levied on the retail price of motor fuels, including the federal motor fuel excise tax (18 cents per gallon), but not the state excise taxes.

⁵ OAG 1969-70, No. 4694.

⁶ Tax rates current as of January 1, 2015. Source: Federation of Tax Administrators. www.taxadmin.org

The constitutional language that voters are being asked to approve is permissive, not mandatory. While the Constitution sets out limitations on the sales tax rate, the actual rate itself is established through state law.

Use Tax as Complement to Sales Tax

The state use tax was enacted in 1937 as a complement to the sales tax. The use tax is levied on items that are purchased from out-of-state, or that are rented and leased and then used in Michigan. The use tax effectively prevents Michigan residents from avoiding taxation through these transactions. Since its inception, the use tax rate has mirrored the sales tax rate.

If approved, Proposal 15-1 would trigger changes to the Use Tax Act to increase the tax rate from 6 percent to 7 percent to match the increase in the sales tax rate, effective October 1, 2015.

Currently, to the taxpayer, the use tax is a single tax levied at 6 percent. However, the use tax, similar to the sales tax, has different components. Just like the sales tax, language added to the Constitution by Proposal A of 1994 requires the legislature to impose a 2 percent use tax and dedicates this funding to the School Aid Fund: this represents a rate floor. The rate ceiling is a key difference between the sales and use taxes. As noted, since 1954 there has been a rate cap on the sales tax; however, no such cap exists for the use tax. Because of this, the legislature has complete discretion to set the rate.

There are two additional components making up the remaining 4 percent tax; these are contained in state law. The current 4 percent levy is divided between a state share that flows into the state's General Fund and a local share that is used to reimburse local governments for foregone property tax revenues. These statutory components were created as a result of personal property tax reforms enacted in 2014. The rate of the local share is determined annually to generate a specified amount of money needed to reimburse local governments. The rate of the state share is the residual amount; the difference between 4 percent and the local share tax rate.

The state has levied the sales tax on motor fuels since the adoption of the tax in 1933. A number of other states also levy a sales tax on motor fuel as well as allow local governments to levy separate sales taxes on motor fuels.

Constitutional Exemption. If approved, Proposal 15-1 will exempt certain motor fuels from the state sales tax. The specific language that will be added to Article IX, Section 8 states, "No sales or use tax shall be charged or collected from and after October 1, 2015 on the sale or use of gasoline or diesel fuel used to operate a motor vehicle on the public roads or highways of this state."

Other Fuels and Uses not Exempt. The language of the proposed constitutional amendment and implementing statute are specific as to the *type of fuel* to be exempted from taxation – gasoline and diesel. Also, they specify the *use of fuel* eligible for the tax exemption – that used to operate motor vehicles on public roads. Because of the language's specificity, Proposal 15-1 does not exempt *all* gasoline and diesel fuel from the sales tax.

Fuel sold to power boats, off-road vehicles, landscaping equipment (e.g., lawnmowers, blowers,

etc.), and fuel used for other non-motor vehicle use would still be subject to the sales tax. Similarly, fuel sold to operate motor vehicles that are *not* used on public roadways could continue to be taxed under the General Sales Tax Act. Also, the sales tax would continue to be assessed on other fuels used to power motor vehicles, such as fleet vehicles that run on compressed natural gas (CNG).

These other fuels and uses would be subject to the higher motor fuel taxes contemplated in the laws tied to the passage of Proposal 15-1 (discussed later). Therefore, the higher motor fuel taxes applied to purchases of these fuels would not be offset by the elimination of the sales tax on these fuels. As a result, the pump price of these fuels would increase substantially and would be higher than other fuel. Also, it should be noted that the vast majority of gasoline and diesel fuel is sold by gas stations without regard to the intended use. The creation of the sales tax exemption for some fuel sales and not others may create compliance challenges for taxpayers.

It should be noted that while Proposal 15-1 creates a sales tax exemption for certain motor fuels in the Michigan Constitution, nothing in the proposal would prevent the legislature, at a future date and by

separate legislation, from expanding statutory sales tax exemptions for fuel sold for other uses (e.g., landscaping, marine, etc.) or exempting from the sales tax other fuels used to power motor vehicles on public roads (e.g., CNG). However, if Proposal 15-1 is approved, the legislature would not be able to undo the constitutional sales tax exemption for motor fuel used to operate vehicles on the roadways by amending statutory law; it would take another constitutional amendment to undo or modify the exemption. In this way, the exemption would be more permanent than a statutory exemption.

Sales and Use Tax Revenue Earmarks

Proposal 15-1 modifies two existing constitutional sales tax revenue earmarking provisions and creates a new use tax revenue earmark.

Local Governments. Currently, Article IX, Section 10 provides that 15 percent of the sales tax imposed at the 4 percent rate be used exclusively for assistance to cities, villages, and townships on per-capita basis. The funding local governments receive under this provision is commonly referred to as constitutional state revenue sharing, which is different from the state funds shared through various statutory provisions. Constitutional state revenue sharing dollars are unrestricted, meaning that local governments are free to use them as they wish.

Dedicating a portion of the state sales tax revenues to local governments for their unrestricted use first occurred in 1946 as a result of the “sales tax diversion” amendment approved by voters. The current allocation was established in 1974, when voters increased the percentage of the sales tax directed to local governments from 12.5 percent to 15 percent as a tradeoff for exempting food and prescription drugs from the sales tax base. In 1994, voters amended this section again, primarily to specify that the local government allocation applied only to the sales tax at the 4 percent rate; the additional 2 percent rate added at the time is dedicated to the School Aid Fund.

If approved, Proposal 15-1 will make one change in Section 10; replace “4.0%” with “5.0%” to reflect the

proposed increase in the maximum sales tax rate. This change will increase the amount of sales tax revenue going to local governments in the aggregate and increase the amount that each governmental unit receives under the per-capita formula.

School Aid Fund. Currently, Article IX, Section 11 of the Michigan Constitution directs 60 percent of the sales tax imposed at a rate of 4 percent to the state School Aid Fund (SAF). In addition, 100 percent of both the sales and use taxes imposed at the 2 percent rate is dedicated to the SAF. The SAF provides the bulk of support for public school operations.

If approved, Proposal 15-1 will replace “4%” with “not more than 5%” to reflect the proposed increase in the sales tax rate under Public Act 467 of 2014. This change has the potential to increase the amount of sales tax earmarked to the SAF.

The language opens the possibility for the legislature to provide 60 percent of the sales tax revenue at a rate *less than* 5 percent to the School Aid Fund.

The intent of this wording change is fairly clear – allow the SAF earmark to reflect the increase in the sales tax rate. Generally speaking, the addition of the words “not more than” is used in statutory construction to convey a ceiling,

as opposed to a specific amount. Whereas the current constitutional language states that 60 percent of the sales tax at the 4 percent rate shall go to the SAF, the proposed language could limit the revenue allocation to the SAF.

The language opens the possibility for the legislature to provide 60 percent of the sales tax revenue at a rate *less than* 5 percent. For example, if Proposal 15-1 is approved and the legislature sets the sales tax rate at the new constitutional maximum 7 percent, it could decide to allocate 60 percent of the revenue from the tax levied at 4 percent (current allocation) and direct 60 percent of the revenue from the remaining one percent tax to the state General Fund. (Note: Of the total 7 percent tax, 100 percent of the revenue from the tax levied at 2 percent is earmarked to the SAF.)

The addition of the “not more than” wording would match the current sales tax earmark language to local governments (discussed above). While this wording change may open up an opportunity for the

legislature to allocate something less than the full amount of the increased sales tax revenue to the SAF, the legislature has not used similar language to reduce the constitutional sales tax earmark to local governments.

In addition to modifying the existing sales tax earmarks to reflect the increase in the sales tax rate, Proposal 15-1 creates a new use tax earmark in the Michigan Constitution. Currently, the use tax is levied at 6 percent: revenue from 2 percent of the use tax is constitutionally dedicated to the SAF and the other 4 percent is shared, by local governments and the state's General Fund. Under one of the laws linked to the May public vote, the use tax would rise to 7 percent to match the increase in the sales tax rate.

If approved, Proposal 15-1 will allocate additional funds to the SAF from the use tax. Specifically, the Michigan Constitution would dedicate "an amount equal to 12.3% of the use tax imposed at a rate of not more than 5%. . ." to the SAF. This language effectively creates an "off-the-top" allocation of use tax revenues that are not currently constitutionally dedicated (i.e., revenue from the 2 percent tax going to SAF). The net effect of the new earmark will be to reduce the amount of use tax revenue going to the General Fund and increase the amount going to the SAF. Because of the mechanics of the earmark, along with the existing statutory provisions, the amount of the use tax levied to reimburse local governments for lost personal property tax revenue will be unaffected.

School Aid Fund

The School Aid Fund (SAF) is one of the state's major funds, the other being the General Fund. The fund was originally created in 1954 to receive revenue from 66 percent of the state sales tax. Article X, Section 23 of the Constitution limited the uses of the fund to provide "aid to the school districts and school employees' retirement purposes." The framers of the 1963 Constitution reauthorized the fund and expanded the permissible uses of the fund, specifically adding the words "higher education." Article IX, Section 11 currently states that the fund shall be used "exclusively for aid to school districts, higher education, and school employees' retirement systems, as provided by law."

Until recently, the SAF was used almost exclusively to finance state appropriations for K-12 education, including the per-pupil foundation grant for each school district. Proposal 15-1, if approved, will amend the permissible uses of the SAF in a material way.

Higher Education Appropriations

Although the 1963 Michigan Constitution has allowed the SAF to be used to finance appropriations for higher education since its adoption, the use of the SAF for this purpose is relatively recent. It was not until Fiscal Year 2009-10 (FY2010) that the legislature appropriated SAF funds for state support of higher education institutions (public universities and community colleges). In FY2010, \$208 million of the

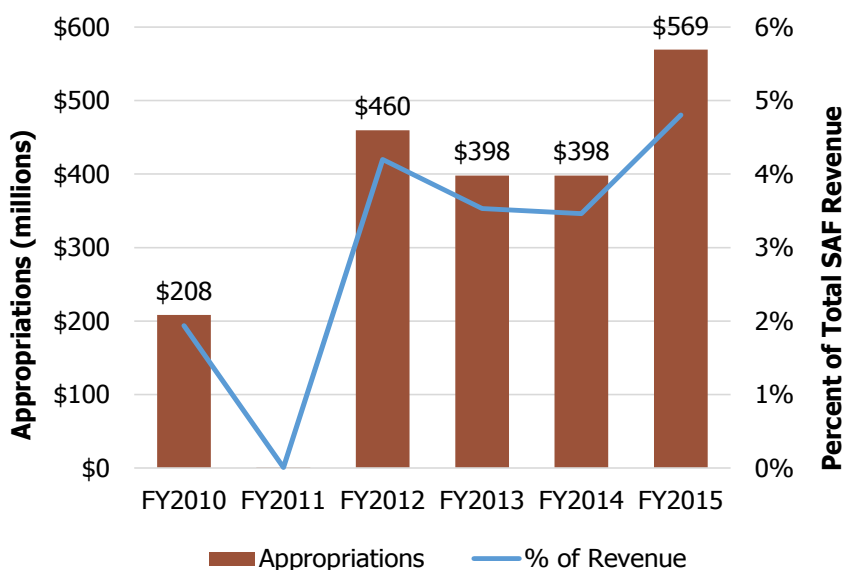
\$300 million total appropriation for community colleges was financed with the SAF. The FY2011 state budget did not appropriate SAF dollars for higher education purposes.

Since FY2012, higher education appropriations (both community colleges and universities) have been financed with at least \$400 million from the SAF (See **Chart 4**). For the current state fiscal year (FY2015), the SAF is responsible for financing approximately \$204 million of the total higher education appropriation and \$365 million of the total community colleges appropriation. The recent trend to appropriate SAF funds for higher education has been driven by challenges in the General Fund portion of the state budget. The use of SAF revenue in this way reduced General Fund appropriations without reducing overall funding levels, effectively a funding shift. However, by using the SAF for higher education purposes, the resources are not available for other purposes, such as aid to K-12 school districts.

Permissible Uses of the School Aid Fund

Proposal 15-1, if approved, will make two major changes to the language concerning the use of the SAF. First, by replacing the term "higher education" with "public community colleges," it will effectively narrow the current meaning of "higher education" as understood for the purposes of Article IX, Section 11. Currently, the term includes both Michigan's 15 public

Chart 4
School Aid Fund Appropriations for Higher Education: FY2010 - FY2015



Source: House Fiscal Agency reports

While the language eliminates the potential for the SAF to finance any or all of the total appropriation to universities, it maintains the SAF's exposure to fund state appropriations for public community colleges (currently \$365 million).

Second, in addition to narrowing the working definition of "higher education," new language would expand the permissible uses of the SAF to include an added set of programs, specifically, "public career and technical education programs, scholarships for students attending either public community colleges or public career technical education programs." Because these programs are not currently defined in the constitution or law, it is impossible to know the future application of this section for making appropriations from the SAF for the new purposes.

four-year universities and the 28 public community colleges. This will have the effect of prohibiting the legislature from appropriating SAF funds for public four-year universities (currently \$204 million of a total \$1.5 billion appropriation for the universities).

Because these programs are not currently defined in the constitution or law, it is impossible to know the future application of this section for making appropriations from the SAF for the new purposes.

Ballot Proposal Linkages: Items Tied to the Vote

While the ballot question deals directly with constitutional changes related to the sales and use taxes, an assortment of legislation is tied to the outcome of the May vote. A total of 9 public acts are "tie-barred" to voter approval, meaning that if voters reject the

ballot question, the changes implemented in these acts go away as well. Much of this legislation is related to addressing Michigan's long-standing pursuit of additional road funding.

Sales and Use Tax Increases

As noted above, the constitutional amendment before voters raises the maximum sales tax rate authorized in the Constitution from 6 percent to 7 percent. The amendment itself, however, does not actually implement an increase in the sale tax. Separate legislation changing the General Sales Tax Act was needed to accomplish the sales tax rate increase. Likewise, legislation was needed to effectuate the rate increase to the companion use tax.

That legislation was enacted as Public Acts 467 and 474 of 2014. The acts increase the actual sales and use tax rates from 6 percent to 7 percent. Thus, the public vote in May has the dual effect of: 1) increasing the maximum sales tax rate the legislature is *authorized* to impose under the Constitution, and 2) increasing the actual sales and use tax *levied* by the legislature from 6 percent to 7 percent.

The public acts also make other changes to the state

statutes to conform to the constitutional amendment – for instance, by exempting motor fuel from the sales and use taxes and revising the distribution provisions for both taxes in accordance with the new constitutional provisions. These changes are reviewed more fully in the previous section on the constitutional amendment.

Nothing in Proposal 15-1 would prevent the legislature at a future date from amending either the General Sales Tax Act or the Use Tax Act to reduce either tax rate to something less than 7 percent. However, the legislature is prevented from reducing either rate below 2 percent.

Motor Fuel Tax Increase

Public Acts 468 and 475 of 2014 implement an increase in the state's motor fuel tax rates on both gasoline and diesel fuel. Under current law, Michigan drivers pay a tax of 19 cents per gallon on gasoline and 15 cents per gallon on diesel fuel. The new acts establish tax rates that – at least initially – are tied to the wholesale price of motor fuel. The rates would equal 14.9 percent of the average monthly wholesale prices of each fuel between July 2013 and June 2014, which equaled \$2.80 per gallon for gasoline and \$3.11 per gallon for diesel fuel. If the ballot proposal is approved by voters, these calculations will increase the gasoline tax rate to 41.7 cents per gallon and the diesel fuel tax rate to 46.4 cents per gallon. These rates will become effective on October 1, 2015 and remain in effect through September 30, 2016.

These rates do not remain fixed over time. To address the funding challenges posed by today's fixed per-gallon motor fuel tax rates, Public Act 468 sets up an annual adjustment process for future rates. Effectively, the proposal calls for an increase in the traditional per-gallon tax rates for gasoline and diesel fuel and indexes these new rates to inflation. Public dialogue on the new tax structure has commonly focused on the tying of motor fuel tax rates to wholesale fuel prices. However, as is explained in the next section, this adjustment process will likely break the link between tax rates and wholesale prices in the long run.

Adjustment of Future Motor Fuel Tax Rates

Once the initial tax rates are established at 14.9 percent of recent wholesale fuel prices, Public Act 468 establishes both a rate floor and a rate ceiling to control future changes in gasoline and diesel fuel tax rates. An initial tax rate floor for both taxes is set at 41.7 cents per gallon – which equals the initial

gasoline tax rate. Likewise, the act sets a tax rate ceiling equal to the tax rate floor plus 5 cents per gallon. So, the initial tax rate ceiling will be 46.7 cents per gallon ($41.7\text{¢} + 5.0\text{¢} = 46.7\text{¢}$).

Furthermore, the tax rate floor and tax rate ceiling themselves will be adjusted over time. The tax rate floor is adjusted annually based on the inflation rate as measured by the Detroit-area Consumer Price Index (CPI). The floor will rise each year to reflect changes in the CPI with two limitations. First, the floor will never go down from one year to the next, and second, growth in the tax rate floor will be capped at 5 percent, which limits growth should the economy return to a period of higher inflation. The tax rate ceiling will continue to be the tax rate floor plus 5 cents per gallon. In short, the floor and ceiling rates should gradually increase over time at a rate consistent with growth in the CPI. If current CPI inflation projections hold, the tax rate floor should adjust to around 42.7 cents per gallon when it is first adjusted for FY2016. That would also increase the tax rate ceiling to 47.7 cent per gallon.

The first annual adjustment in the actual tax rates will occur on October 1, 2016. As with the initial tax rates, the Department of Treasury will calculate a rate for both gasoline and diesel fuel that equals 14.9 percent of recent wholesale prices; this time, the calculation will be based on average monthly fuel prices between August 2015 and July 2016. However, the actual rate will be constrained to fall within the tax rate floor and tax rate ceiling.

To illustrate, if the average wholesale price of gasoline equals \$2.00 per gallon between August 2015 and July 2016 (roughly equal to the prevailing wholesale price at the time of publication), the calculated rate would be 29.8 cents per gallon (14.9% of $\$2.00 = \0.298). This, however, falls below the newly

adjusted tax rate floor. So, the actual rate put into effect on October 1, 2016 would revert to the floor of 42.7 cents per gallon. In the same way, if wholesale prices were dramatically higher and the calculated rate exceeded the tax rate ceiling, the new rate would be set at the ceiling of 47.7 cents per gallon. Only when the calculated rate falls somewhere between the tax rate floor and the tax rate ceiling will it become the effective rate without modification.

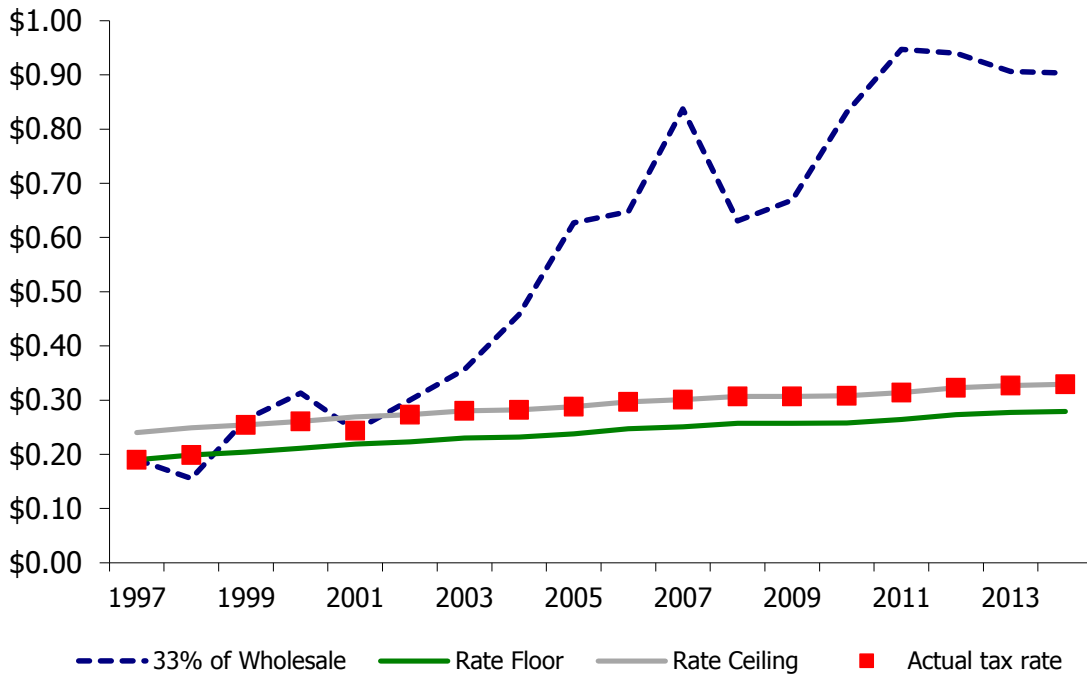
Clearly, this process is complex. Further, no one can know with certainty where actual gasoline and diesel fuel tax rates will move in the future since those movements are tied to unknown future changes in wholesale fuel prices and consumer price levels. Perhaps the most effective way to demonstrate how the process might work is to look backward. CRC looked back to 1997, the last time the state raised the gasoline tax, and considered how gasoline tax rates would have changed between then and now had the legislature adopted this same adjustment

process at that time.

In 1997, wholesale gasoline prices were significantly lower than today’s levels. Energy Information Administration data show that wholesale gasoline prices in the Midwest were under 58 cents per gallon. Thus, the initial 19-cent per gallon rate would have been equivalent to 33 percent of prevailing wholesale prices. **Chart 5** models how the gasoline tax rate would have changed over time had the legislature adopted the proposed rate mechanism – setting the rate equal to 33 percent of prevailing wholesale prices with changes limited by the same inflation-adjusted floor and ceiling.

The exercise demonstrates two key points. First, given the volatility of wholesale gasoline prices, the actual tax rate (shown by the red squares) quickly deviates from the rate calculated based on the wholesale prices (shown by the dashed dark blue line). By 2005, for instance, the calculated rate

Chart 5
Looking Back: Historical Gas Tax Rates Under the Proposed Rate Adjustment Mechanism



Source: CRC calculations based on historical data on rack prices of regular unleaded conventional gasoline (U.S. Energy Information Administration) and the Detroit-area Consumer Price Index for all urban consumers (U.S. Bureau of Labor Statistics)

based on wholesale prices would have equaled 62.7 cents per gallon. However, that would have greatly exceeded the established rate ceiling, which would limit the actual rate to 28.8 cents per gallon given the trends in the CPI during that time period. Thus, in the end, the enacted rate increase is probably better described as an increase in the per-gallon tax rate indexed to inflation. The impact of wholesale fuel price level changes will likely become much less important in calculating the actual rate in the long run if future motor fuel price volatility is consistent with historical patterns.

Second, the modeling exercise illustrates how the new motor fuel tax rates will adjust over time with continued moderate inflation. Had the legislature adopted this approach in 1997, the gasoline tax would have increased from 19 cents per gallon in 1997 to 26.1 cents per gallon in 2000. After 2002, it would have tracked along with the established rate ceiling, reaching 30.1 cents per gallon by 2007. As of October 1, 2014, CRC estimates the rate would have been set at 32.9 cents per gallon.

The annual rate of inflation during this period averaged just over 2 percent, which is consistent with current economic projections. Thus, the new mechanism should generate proportionate rate increases in the near future. Assuming continued moderate general inflation and a return to retail pump prices in the range of \$3.50 to \$4.00 per gallon, CRC projects that the gasoline tax rate would adjust to around 45 cents per gallon by October 1, 2019 and to about 50 cents per gallon by October 1, 2024. Under these assumptions, actual future tax rates will be most significantly influenced by the tax rate floor.

Vehicle Registration Taxes

A smaller element of the transportation funding package is an increase in vehicle registration taxes for both passenger cars and trucks as well as larger commercial trucks. Current law bases registration taxes for passenger vehicles on the manufacturer's list price of the vehicle. The tax amount is reduced over the subsequent three registration periods to reflect depreciation in the vehicle's value, so that the tax payable for the second, third, and fourth registration period is 90 percent, 81 percent, and 73 percent, respectively, of the initial tax. Public Act

Interstate Comparison of Motor Fuel Taxes

If the ballot proposal is approved by voters, the net increase in taxes paid at the pump would give Michigan the sixth highest rate of combined state and local taxes and fees assessed on gasoline among the fifty states and the District of Columbia. The American Petroleum Institute compiles data annually on state and local levies on motor fuels. Had the provisions of Proposal 15-1 been in place on January 1, 2015, Michigan's combined rate would have been 42.58 cents per gallon (see **Appendix B** for state-by-state details).⁷ In fact, on January 1, 2015, Michigan ranked 17th in terms of combined state and local tax rates, having a total rate of 30.26 cents per gallon. That includes the gasoline excise tax, the sales tax, and a small environmental protection fee. As noted, the proposal would eliminate the sales tax on gasoline, but the increase in gasoline excise tax would more than offset the sales tax reduction.

Alternative Fuels

Currently, the Motor Fuel Tax Act imposes a tax on gasoline and diesel fuel as discussed above, and on one other fuel: liquefied petroleum gas (propane) which is currently taxed at 15 cents per gallon when used for transportation purposes. Public Act 468 adds a new definition for "alternative fuels" which would now include other fuels used to propel motor vehicles including fuels such as natural gas, liquefied natural gas, compressed natural gas, hydrogen, and hydrogen compressed natural gas. These fuels – including propane – would now be subject to the same tax rate as diesel fuel under the new system.

470 of 2014 effectively eliminates this depreciation discount for new vehicles and freezes the discount for recently purchased vehicles.

A vehicle's treatment under the new act is tied to its model year. Vehicles produced in model year 2012 or earlier will be unaffected by these changes and will continue to receive the full depreciation discount.

⁷ American Petroleum Institute, State Motor Fuel Taxes: Rates Effective 1/01/2015, accessible at www.api.org/~media/files/statistics/statemotorfuel-onepaggers-jan-2015.pdf

Table 1
Impact of Registration Tax Changes on Vehicle
with a \$30,500 List Price

| | | 2012 Model Year | | | | |
|-------------|-------------------------|-------------------|-------|-------|-------|-------|
| | | Registration Year | | | | |
| | | 2015 | 2016 | 2017 | 2018 | 2019 |
| Current Law | | \$112 | \$112 | \$112 | \$112 | \$112 |
| | <i>% of Initial Tax</i> | 73% | 73% | 73% | 73% | 73% |
| Proposal | | \$112 | \$112 | \$112 | \$112 | \$112 |
| | <i>% of Initial Tax</i> | 73% | 73% | 73% | 73% | 73% |

| | | 2014 Model Year | | | | |
|-------------|-------------------------|-------------------|-------|-------|-------|-------|
| | | Registration Year | | | | |
| | | 2015 | 2016 | 2017 | 2018 | 2019 |
| Current Law | | \$138 | \$124 | \$112 | \$112 | \$112 |
| | <i>% of Initial Tax</i> | 90% | 81% | 73% | 73% | 73% |
| Proposal | | \$138 | \$138 | \$138 | \$138 | \$138 |
| | <i>% of Initial Tax</i> | 90% | 90% | 90% | 90% | 90% |

| | | 2016 Model Year | | | | |
|-------------|-------------------------|-------------------|-------|-------|-------|--|
| | | Registration Year | | | | |
| | | 2016 | 2017 | 2018 | 2019 | |
| Current Law | | \$153 | \$138 | \$124 | \$112 | |
| | <i>% of Initial Tax</i> | 100% | 90% | 81% | 73% | |
| Proposal | | \$153 | \$153 | \$153 | \$153 | |
| | <i>% of Initial Tax</i> | 100% | 100% | 100% | 100% | |

first-year discount of 90 percent of the initial registration tax, but foregoing the future discounts the owner would receive under current law. Finally, the owner of a 2016 model year vehicle, like owners of all new vehicles in the future, would be charged the full initial tax in each subsequent year and forego all of the current law's discounts.

In addition to the increase in registration taxes on passenger vehicles, the act also phases in across a three year period an increase in registration taxes on large trucks weighing over 26,000 pounds (variable by gross vehicle weight). Currently, the annual registration tax for these trucks varies, based on gross vehicle weight (GVW), between \$558 (GVW between 26,001 and 28,000 pounds) and \$3,117 (GVW over 160,000 pounds). To illustrate the potential impact, a common 5-axle interstate tractor-trailer registered with an 80,000 pound GVW currently pays an annual registration tax of \$1,660. That tax would increase by 12 percent to \$1,860 on March 1, 2016; by a cumulative 24.1 percent to \$2,060 on March 1, 2017; and by a cumulative 36.1 percent to \$2,260 on March 1, 2018.

Newer existing vehicles will have their registration taxes frozen at a partially-discounted level, and newly sold vehicles (model 2016 and thereafter) will no longer receive any discount in future years.

Table 1 illustrates the impact of the proposal on new and existing vehicles. The chart looks at three hypothetical vehicles: one from model year 2012, one from model year 2014, and one from model year 2016. All three are assumed to have a list price of \$30,500. For any vehicle with this list price, the initial registration tax is \$153. The owner of the 2012 model year vehicle is already receiving the full depreciation discount, paying an annual tax of \$112 (73 percent of \$153). The new law would have no impact on this owner who would continue to pay the fully discounted rate for the life of the vehicle. A model year 2014 vehicle, like other newer existing vehicles, would have its registration tax frozen as of January 1, 2016. The owner of the 2014 model year vehicle would continue to pay \$138, maintaining the

Lastly, the act establishes a new annual registration tax surcharge effective no later than January 1, 2016 for electric-powered vehicles. The rationale for the surcharge is that owners of these vehicles pay significantly less in motor fuel taxes than the owner of a traditional gasoline-powered vehicle who drives the same number of miles on state roadways. For vehicles powered "solely or predominantly by electricity" with an empty weight of 8,000 pounds or less, the surcharge would be \$75 on top of the regular registration tax. For heavier vehicles in this category, the surcharge would be \$200. For vehicles "partially powered, but not predominantly powered" by electricity with an empty weight of 8,000 pounds or less, the surcharge would be \$25 on top of the regular registration tax.⁸ For heavier vehicles in this category, the surcharge would be \$100.

⁸ The Secretary of State is given the authority in statute to determine what vehicle models meet the "solely or predominantly" versus "partially-powered, but not predominantly powered" standards.

Road Construction Process: Bidding, Warranties, and Road Design

The tie-barred package also includes three new public acts that change current law requirements related to the road construction projects. Public Act 471 of 2014 requires the Michigan Department of Transportation and larger local road agencies⁹ to develop and implement a “performance-based maintenance system” to improve maintenance efficiencies and outcomes and to implement a “performance rating system” that would collect data on maintenance activities and costs. Beginning October 1, 2016, at least 20 percent of all funds spent by these agencies on specified maintenance services would have to be based on outputs and outcomes associated with

⁹ The bill imposes these requirements on local road agencies that received at least \$20 million in funding from the Michigan Transportation Fund in FY2013. According to a legislative analysis from the House Fiscal Agency, six local road agencies - those representing Wayne, Oakland, Macomb, Kent, and Genesee Counties as well as the City of Detroit - met this criterion.

this rating system. The act also clarifies competitive bidding requirements for road contracts in excess of \$100,000 and adds new reporting requirements for agencies that determine that a method other than competitive bidding is in the public interest.

Public Act 473 of 2014 includes revisions to current law intended to strengthen current road warranty requirements for specified road projects. The act includes new reporting requirements for the Michigan Department of Transportation (MDOT) and local road agencies on the warranty status of all road projects, including projects costing more than \$1 million where a warranty was not secured. Local road agencies would have to submit a proposed warranty program to MDOT by February 1, 2016.

Finally, Public Act 472 of 2014 provides townships with greater latitude to require competitive bidding

Drafting Error: Distribution of Revenue for State Road Indebtedness

The laws that were enacted as part of the transportation package were enacted during the waning hours of the 2013-2014 legislative session and were the result of lengthy year-end deliberations between the legislature and administration. As has occurred in the past with complex legislative packages enacted at the end of legislative sessions, at least one significant drafting error appears to have been made in putting the final agreement into bill form. It is very likely the Legislature will move to fix the error during the current session if the May proposal is approved. Still, the issue is significant in nature and should be understood by voters.

As part of the final agreement, the Legislature intended to earmark a portion of the new revenues generated in FY2016 and FY2017 from the motor fuel tax increases towards paying down current State Trunkline Fund debt tied to past state road building initiatives. The package is estimated to generate just over \$1.2 billion during these first two fiscal years from the motor fuel tax increases. Legislative intent was to allocate \$400 million in FY2016 and \$800 million in FY2017 of the new tax revenue for distribution through the state’s transportation funding formula, most of which would go to state and local road agencies. The remainder (roughly \$860 million in FY2016 and \$460 million in FY2017) would go to pay down state road debt.

However, the language included in Public Act 468 of 2014 to effectuate this earmark appears to be flawed. The language specifies that “the first \$400,000,000.00 received and collected under this act” in FY2016 and “the first \$800,000,000.00 received and collected under this act” in FY2017 would be distributed through the state funding formula. But, revenue “received and collected under this act” includes not only the new revenue from the recent legislative changes, but all existing revenue as well. As such, a literal reading of the language would suggest, for instance, that around \$1.7 billion (the \$800 million intended earmark plus current baseline fuel tax revenue of around \$900 million) would be earmarked for debt reduction in FY2016.^a Under that reading, FY2016 funding available for formula distribution would actually go down by around \$500 million from current levels.

^a Since vehicle registration taxes are collected under a separate act – the Michigan Vehicle Code – they are not a factor in this distribution issue.

by county road commissions on road projects for which the townships contribute 50 percent or more to the project cost. The act would also give townships greater oversight over construction and design

standards imposed by county road commissions on projects that meet the definition of “very low-volume local road projects.”

Tax Credits for Low- and Moderate-Income Households

Outside of the transportation-related legislation, another piece of legislation tied to the ballot proposal boosts two existing tax credits for low-income and moderate-income households. Some have argued that such legislation was needed to counteract the impact of the sales tax rate hike. Economists generally agree that the sales tax is a more regressive tax in that its burden is proportionately heavier on lower income households. Their rationale is that these lower income households tend to spend more of their disposable income and spend a greater share of that income on clothing, household goods, and other items of necessity that are subject to the sales tax. Conversely, higher income households tend to save a larger share of their income as well as spend a larger share of that income on services that are not subject to the sales tax.

Public Act 469 of 2014 first expands the state’s Earned Income Tax Credit (EITC) against the personal income tax. To qualify, a household must have earned income below certain thresholds. For tax year 2014, those thresholds range from \$52,427 for a married couple filing jointly and having three or more qualifying children down to \$14,590 for single taxpayer with no children.¹⁰ The current state EITC is pegged to the federal Earned Income Tax Credit. Michigan filers can currently claim a

state income tax credit equal to 6 percent of any federal EITC they can claim. The act would expand the state credit to 20 percent of the federal EITC. The impact of the change will depend on the composition and income levels of lower income households.

Table 2 highlights the impact of the change on a number of hypothetical Michigan households.

Second, the act also expands the state’s Homestead Property Tax Credit for very low-income senior citizens and disabled taxpayers. Currently, most Michigan taxpayers can claim this credit against their state income tax liability for a specified percentage of their property tax payments on their homestead residence that exceed 3.5 percent of their household income. For senior citizens and disabled individuals, more generous provisions apply that allow for a larger credit. Public Act 469 further expands these provisions for seniors and disabled individuals, resulting in somewhat larger credits for senior or disabled filers with household incomes between \$3,000 and \$6,000.

**Table 2
Potential Impact of Increase in State Earned Income Tax Credit**

| <u>Household Type</u> | <u>Children</u> | <u>Earned Income</u> | <u>State EITC</u> | |
|-----------------------|-----------------|----------------------|-------------------|-----------------|
| | | | <u>Current</u> | <u>Proposal</u> |
| Married couple | 3 | \$45,000 | \$94 | \$312 |
| Married couple | 1 | \$35,000 | \$86 | \$285 |
| Single individual | 0 | \$10,000 | \$21 | \$70 |
| Single parent | 2 | \$20,000 | \$300 | \$1,000 |

Note: Calculations are based on federal eligibility criteria for the 2014 tax year.

¹⁰ Numerous other restrictions related to filing status, citizenship, and investment income also apply. For details, see the Internal Revenue Service’s Publication 596 accessible at <http://www.irs.gov/pub/irs-pdf/p596.pdf>.

Analysis of Proposal 1

The Proposal's Fiscal Implications on the Public Sector

If approved by voters, the ballot proposal and the laws associated with the proposal are expected to generate just over \$2.0 billion in new revenue during FY2016. That amount will fall to around \$1.8 billion during the subsequent two fiscal years as the impact of the expanded tax credits is realized. **Table 3** below outlines the implications of the proposal on both state tax revenue and future state spending. These figures assume that motor fuel prices will gradually rise across the next three fiscal years, with retail unleaded gasoline prices starting at around \$2.45 per gallon for FY2016 and rising to \$3.00 per gallon by FY2018. The actual path of gasoline prices will have a significant impact on the negative adjustment to

sales and use tax revenue in the table. Higher prices mean a greater revenue loss due to the exemption of motor fuels from the sales tax, while lower prices would mean a smaller loss.

Assuming CRC's assumptions hold, the proposal should increase sales and use tax revenue by around \$795 million in FY2016, with the one percent rate increase generating almost \$1.5 billion in new revenue to offset the \$690 million lost from exempting gasoline and diesel fuel from the tax base. This net gain will decrease slightly in FY2017 and FY2018 as motor fuel prices are expected to rise, which will increase the revenue loss tied to their exemption from

the sales tax. The increased revenue will mean additional earmarked funding to the School Aid Fund and to local governments through constitutional revenue sharing. Conversely, the state's Comprehensive Transportation Fund, which supports public transit programs, will see its sales tax revenue earmark from the sale of automotive-related products (including motor fuel) decline over this period with the exemption of motor fuel from the tax. Remaining undedicated revenue will flow into the state's general fund, increasing discretionary state revenue by around

Table 3
Estimated Impact of Ballot Proposal on Revenue and Spending
(in millions of dollars)

| | FY2016 | FY2017 | FY2018 |
|-----------------------------------|----------------|----------------|----------------|
| Sales and Use Taxes | | | |
| Increase Sales Tax from 6% to 7% | \$1,485 | \$1,520 | \$1,560 |
| Exempt Motor Fuel from Sales Tax | (\$690) | (\$775) | (\$850) |
| TOTAL SALES AND USE TAXES | \$795 | \$745 | \$710 |
| <i>Distribution:</i> | | | |
| School Aid Fund | \$389 | \$349 | \$320 |
| Local Governments | \$116 | \$112 | \$109 |
| Public Transit | (\$15) | (\$19) | (\$22) |
| GF/GP | \$306 | \$303 | \$303 |
| Transportation Taxes | | | |
| Increase Motor Fuel Tax Rate | \$1,260 | \$1,260 | \$1,290 |
| Increase Registration Taxes | \$28 | \$68 | \$102 |
| TOTAL TRANSPORTATION TAXES | \$1,288 | \$1,328 | \$1,392 |
| <i>Distribution:</i> | | | |
| Road Funding | \$385 | \$781 | \$1,253 |
| Public Transit | \$43 | \$87 | \$139 |
| State Trunkline Debt | \$860 | \$460 | |
| Tax Credit Adjustments | | (\$260) | (\$270) |
| TOTAL NEW REVENUE | \$2,083 | \$1,813 | \$1,832 |

Source: CRC calculations based on legislative analyses of the proposal by the House Fiscal Agency and Senate Fiscal Agency and motor fuel tax revenue estimates from the Michigan Department of Treasury.

\$300 million in each year.

The proposal is also expected to generate close to \$1.3 billion of new transportation revenues in FY2016, with revenue growth slowing over the subsequent two fiscal years, primarily due to increases in registration taxes that are phased in during those years. The dedication of revenue to pay off state trunkline debt (see the related box) will limit the revenue available for distribution through the state's transportation funding formula during FY2016 and FY2017.

The funding formula allocates 90 percent of the remaining revenue for road repair and maintenance, while 10 percent is deposited in the state's Comprehensive Transportation Fund to benefit public transit programs. The allocation for road repair and maintenance is further distributed by formula (for use only on road work) to the Michigan Department of Transportation (39.1 percent), county road commissions (39.1 percent), and cities and villages (21.8 percent).

An additional \$428 million should flow through the formula in FY2016, which means an additional \$385 million in revenue for roads and \$43 million for public

transit for the year. That figure increases to over \$1.2 billion by FY2018 once the debt allocations are fulfilled. Likewise, revenue for public transit programs increases initially by \$43 million in FY2016 before increasing to around \$136 million in FY2018. However, these increases will be offset by the losses to the Comprehensive Transportation Fund from the elimination of the sales tax on motor fuel outlined in the sales tax portion of the table.

Finally, it should be noted that state general fund revenues have been used in recent years to help supplement dedicated transportation funding and allow for additional road repair and maintenance work. For FY2014, this general fund subsidy amounted to over \$450 million with another \$285 million currently appropriated in FY2015 for transportation purposes. Governor Snyder's recent budget proposal called for the phase-out of this general fund subsidy, eliminating general fund support for transportation in FY2017. Assuming the phase-out is implemented, the actual net increase in new revenue for transportation over today's levels will be smaller than **Table 3** suggests as the revenue gains triggered by the ballot proposal would be partially offset by the loss of the existing general fund subsidy.

Impact on Taxes Paid at the Pump

If Proposal 15-1 is approved by voters, the driving public will likely pay more in taxes when they purchase motor fuel. However, the amount of additional taxes owed will vary depending on prevailing pump prices. This arises because the proposal implements two changes to fuel-based taxes that counteract one another. Motorists will pay more in gasoline and diesel fuel taxes with the increase in these per-gallon tax rates from current levels. However, the added cost of the motor fuel taxes will be offset to some degree by removing motor fuel from the base of the sales tax, and unlike the motor fuel taxes which are assessed at a fixed per-gallon basis, the sales tax charged at the pump depends upon the retail price of motor fuel. The 6 percent sales tax rate is currently imposed on the underlying per-gallon retail price of motor fuel plus the 18.4-cents per gallon federal motor fuel tax. So, when fuel prices rise, so does the amount of sales tax paid at the pump. Likewise, drivers pay less in sales tax when fuel prices fall.

To help gauge the impact of the tax adjustments, **Table 4** illustrates the impact of the proposal on the final cost of one gallon of gasoline across a range of gasoline prices. At the time of publication in March 2015, retail gasoline prices for regular conventional gasoline in Michigan averaged around \$2.40 to \$2.45 per gallon, after bottoming out at less than \$2.00 per gallon in January – the lowest prices Michigan had experienced since 2009. If gasoline prices stay near their current levels (see the first column of **Table 4**), motorists would pay just over 10 cents more per gallon in taxes at the pump, which is the net impact of the additional 22.7 cents paid toward the gasoline tax minus the 12.5 cents that consumers would no longer pay toward the sales tax.

As gasoline prices rise, however, this net impact is reduced. Retail regular gasoline prices exceeded \$3.80 per gallon during portions of 2012. At prices in this range (see the last column of **Table 4**), consumers

**Table 4
Initial Impact of Tax Changes at the Pump**

| Pre-Tax Retail Price | \$1.90 | | Per-Gallon Cost | | \$2.50 | | \$3.25 | |
|-------------------------|--------------------|-----------------|------------------------|-----------------|-------------------|-----------------|----------------|-----------------|
| | <i>Current</i> | <i>Proposal</i> | <i>Current</i> | <i>Proposal</i> | <i>Current</i> | <i>Proposal</i> | <i>Current</i> | <i>Proposal</i> |
| Federal gasoline tax | \$0.184 | \$0.184 | \$0.184 | \$0.184 | \$0.184 | \$0.184 | \$0.184 | \$0.184 |
| State sales tax | \$0.125 | \$0.000 | \$0.161 | \$0.000 | \$0.206 | \$0.000 | \$0.206 | \$0.000 |
| State gasoline tax | \$0.190 | \$0.417 | \$0.190 | \$0.417 | \$0.190 | \$0.417 | \$0.190 | \$0.417 |
| <i>Tax Subtotal</i> | <i>\$0.499</i> | <i>\$0.601</i> | <i>\$0.535</i> | <i>\$0.601</i> | <i>\$0.580</i> | <i>\$0.601</i> | <i>\$0.580</i> | <i>\$0.601</i> |
| Final Pump Price | \$2.399 | \$2.501 | \$3.035 | \$3.101 | \$3.830 | \$3.851 | \$3.830 | \$3.851 |
| | 10.2 cent increase | | 6.6 cent increase | | 2.1 cent increase | | | |

would continue to pay an additional 22.7 cents per gallon in gasoline tax, but the sales tax savings would be magnified, increasing to around 20.6 cents per gallon. The net impact at these higher price levels would be closer to 2.1 cents per gallon.

Finally, if gasoline prices were to rise above roughly \$4.20 per gallon, the tax impact on motorists would actually reverse. At those levels, motorists

would actually save more money from the proposal's sales tax exemption than they would pay due to the heightened motor fuel tax rates. Thus, motorists would pay less in taxes at the pump under the proposal than they would under current law under these conditions. This breakeven price, however, would continue to rise each year as the motor fuel tax rates increase due to the inflationary adjustments discussed earlier.

Wise Use of Road Funds

Road funding has been a perennial issue that has been the subject of debate in prior legislative sessions. Some of the discussions in earlier sessions have ended without policy solutions to the road funding needs not because of an inability to agree on tax increases, but because of disagreements about what to do with the funds once the tax increases are levied. The policy solutions tied to Proposal 15-1 have largely ignored this aspect.

Motor fuel tax and vehicle registration fee revenues are deposited into the Michigan Transportation Fund and distributed to various road funding needs according to a formula spelled out in Public Act 51 of 1951, as amended.

CRC identified the need to address provisions of Public Act 51 nearly 20 years ago and in subsequent reports. By not addressing Act 51, the funds will continue to be distributed to the state, counties, and municipalities in the same manner. Evolving travel patterns and an increase in the number of local jurisdictions levying local taxes to contribute to road funding suggests this is a subject that can be considered for amendment.

The proposed solutions will not address how funds are distributed among the counties or among the cities and villages of the state. The current formula treats a two-lane rural road the same as a five-lane urban road carrying much more traffic on a regular basis. As a result, taxes have to be levied at artificially high levels to get needed funding to the roads that most benefit the state's economy.

The proposed solutions also do not address road construction standards. Michigan's geography, northern location, and susceptibility to the freeze-thaw cycle suggests that its roads cannot be built to the same standards as is used in southern states. Constructing roads to higher standards will cost more in the short term, but should be more durable and require less remedial attention over the long-term.

The May 5 Vote: Key Issues for Voters

On May 5, Michigan voters will be asked to approve the Legislature's plan to raise over \$1.3 billion in additional annual tax revenue for transportation purposes and over \$700 million in new annual sales tax revenue that will benefit schools, local governments, and other areas of the state budget. The plan represents a compromise reached during the final days of the 2013-2014 legislative session and marks the first successful effort in nearly two decades to enact an increase in transportation taxes to generate revenues for road repairs.

As they head to the ballot box, voters will need to understand the big picture of the complex package of legislation that is in play on May 5. As noted above, the constitutional amendment that is the direct subject of the May 5 vote does not raise revenue for roads; it authorizes an increase in the sales tax rate to generate revenue for other purposes. So, why are Michigan voters being asked to approve a sales tax increase as part of a road funding package?

The answer to that question revolves around both political necessities and the current earmarking of state revenues. One of the most popular complaints by citizens about raising motor fuel taxes is that not all of the current taxes paid at the pump are used for road repair and maintenance. As noted, Michigan's sales tax has traditionally been applied to motor fuel sales in addition to the motor fuel excise taxes, and the vast majority of that sales tax revenue does not go toward road and transportation needs. The complexity of the plan put before voters arises out of both the policy and political challenges of addressing this common criticism.

The proposal would trigger an increase in gasoline and diesel fuel taxes, but also would eliminate the sales tax imposed on motor fuel purchases. Thus, the proposal means that all taxes collected at the pump will go to transportation purposes (meaning roads and public transit), with revenue distributed through the state's statutory transportation formula. That addresses the common concern regarding the use of taxes paid at the pump.

However, the elimination of the sales tax on motor fuel

has ripple effects on other areas of the state budget. The state Constitution currently earmarks just over 83 percent of current sales tax revenue to the School Aid Fund, which primarily supports K-12 schools, and for revenue sharing payments to local municipalities. If the state were to stop assessing sales tax on motor fuel, these stakeholders lose part of their current revenue. The proposed increase in the sales tax ensures that this won't happen: the revenue loss from exempting motor fuel from the sales tax is more than offset by the revenue gain from the extra one percent added to the rate. However, given the current rate limitations and revenue earmarks in Michigan's Constitution, these revisions require a constitutional amendment and thus a vote of the people.

Then, there are political realities to the package. As demonstrated by the failures of previous transportation funding plans, it is difficult to build a coalition of legislators willing to vote to raise taxes. The package contains provisions aimed at garnering that political support. Schools and local governments are not only prevented from incurring a loss, but gain some revenue under the plan. The state Earned Income Tax Credit is raised to appease those who are worried about the disproportionate impact of the increased sales tax on lower-income households. New provisions encouraging competitive bidding and road warranties are included to address desires that any new road funding come with assurances that it will be used effectively.

In the end, voters will need to decide whether the costs of the complete package – including both higher transportation taxes and a higher sales tax – are worth the benefits of this shifting of all taxes paid at the pump towards generating new revenues for road repairs in an effort to reverse the deterioration of Michigan's road infrastructure. They should recognize that there is no "back-up plan" in place should the measure fail. A "yes" vote will provide the first significant hike in transportation revenues since 1997 and provide a fix to the long-standing debate on how to fund Michigan's road infrastructure needs. A "no" vote will signal to the legislature that voters want them to go back to the drawing board and come up with another plan.

CRC REPORT

Appendix A Inter-State Comparison: Sales Tax Rates

| Current Law (as of January 1, 2015) | | | Michigan Under Ballot Proposal | | |
|-------------------------------------|----------------------|----------------|--------------------------------|----------------------|----------------|
| | | Sales Tax Rate | | | Sales Tax Rate |
| 1 | California | 7.50 | 1 | California | 7.50 |
| 2t | Indiana | 7.00 | 2t | Indiana | 7.00 |
| 2t | Mississippi | 7.00 | 2t | Michigan | 7.00 |
| 2t | New Jersey | 7.00 | 2t | Mississippi | 7.00 |
| 2t | Rhode Island | 7.00 | 2t | New Jersey | 7.00 |
| 2t | Tennessee | 7.00 | 2t | Rhode Island | 7.00 |
| 7 | Minnesota | 6.88 | 2t | Tennessee | 7.00 |
| 8 | Nevada | 6.85 | 8 | Minnesota | 6.88 |
| 9t | Arkansas | 6.50 | 9 | Nevada | 6.85 |
| 9t | Washington | 6.50 | 10t | Arkansas | 6.50 |
| 11 | Connecticut | 6.35 | 10t | Washington | 6.50 |
| 12t | Illinois | 6.25 | 12 | Connecticut | 6.35 |
| 12t | Massachusetts | 6.25 | 13t | Illinois | 6.25 |
| 12t | Texas | 6.25 | 13t | Massachusetts | 6.25 |
| 15 | Kansas | 6.15 | 13t | Texas | 6.25 |
| 16t | Florida | 6.00 | 16 | Kansas | 6.15 |
| 16t | Idaho | 6.00 | 17t | Florida | 6.00 |
| 16t | Iowa | 6.00 | 17t | Idaho | 6.00 |
| 16t | Kentucky | 6.00 | 17t | Iowa | 6.00 |
| 16t | Maryland | 6.00 | 17t | Kentucky | 6.00 |
| 16t | Michigan | 6.00 | 17t | Maryland | 6.00 |
| 16t | Pennsylvania | 6.00 | 17t | Pennsylvania | 6.00 |
| 16t | South Carolina | 6.00 | 17t | South Carolina | 6.00 |
| 16t | Vermont | 6.00 | 17t | Vermont | 6.00 |
| 16t | West Virginia | 6.00 | 17t | West Virginia | 6.00 |
| 26 | Utah | 5.95 | 26 | Utah | 5.95 |
| 27t | Ohio | 5.75 | 27t | Ohio | 5.75 |
| 27t | District of Columbia | 5.75 | 27t | District of Columbia | 5.75 |
| 29 | Arizona | 5.60 | 29 | Arizona | 5.60 |
| 30t | Maine | 5.50 | 30t | Maine | 5.50 |
| 30t | Nebraska | 5.50 | 30t | Nebraska | 5.50 |
| 32 | Virginia | 5.30 | 32 | Virginia | 5.30 |
| 33 | New Mexico | 5.13 | 33 | New Mexico | 5.13 |
| 34t | North Dakota | 5.00 | 34t | North Dakota | 5.00 |
| 34t | Wisconsin | 5.00 | 34t | Wisconsin | 5.00 |
| 36 | North Carolina | 4.75 | 36 | North Carolina | 4.75 |
| 37 | Oklahoma | 4.50 | 37 | Oklahoma | 4.50 |
| 38 | Missouri | 4.23 | 38 | Missouri | 4.23 |
| 39t | Alabama | 4.00 | 39t | Alabama | 4.00 |
| 39t | Georgia | 4.00 | 39t | Georgia | 4.00 |
| 39t | Hawaii | 4.00 | 39t | Hawaii | 4.00 |
| 39t | Louisiana | 4.00 | 39t | Louisiana | 4.00 |
| 39t | New York | 4.00 | 39t | New York | 4.00 |
| 39t | South Dakota | 4.00 | 39t | South Dakota | 4.00 |
| 39t | Wyoming | 4.00 | 39t | Wyoming | 4.00 |
| 46 | Colorado | 2.90 | 46 | Colorado | 2.90 |
| 47t | Alaska | none | 47t | Alaska | none |
| 47t | Delaware | none | 47t | Delaware | none |
| 47t | Montana | none | 47t | Montana | none |
| 47t | New Hampshire | none | 47t | New Hampshire | none |
| 47t | Oregon | none | 47t | Oregon | none |

Source Data: *Federation of Tax Administrators, State Sales Tax Rates & Food and Drug Exemptions*, accessible at <http://www.taxadmin.org/fta/rate/sales.pdf>. Table includes sales tax rates levied on a statewide basis. Three states (California, Utah, and Virginia) have local sales taxes levied statewide, and these are included.

Appendix B

Inter-State Comparison: Total State and Local Taxes Imposed on Gasoline

| Current Law (as of January 1, 2015) | | | | Michigan Under Ballot Proposal | | | | | |
|-------------------------------------|----------------------|--------------|--------------|--------------------------------|----------|----------------------|--------------|-------------|--------------|
| | | Gasoline | Other | | | Gasoline | Other | | |
| | | Excise Tax | Taxes/Fees | Total | | Excise Tax | Taxes/Fees | Total | |
| 1 | Pennsylvania | 0.00 | 50.50 | 50.50 | 1 | Pennsylvania | 0.00 | 50.50 | 50.50 |
| 2 | California | 36.00 | 9.39 | 45.39 | 2 | California | 36.00 | 9.39 | 45.39 |
| 3 | New York | 8.05 | 37.04 | 45.09 | 3 | New York | 8.05 | 37.04 | 45.09 |
| 4 | Hawaii | 17.00 | 28.00 | 45.00 | 4 | Hawaii | 17.00 | 28.00 | 45.00 |
| 5 | Connecticut | 25.00 | 18.22 | 43.22 | 5 | Connecticut | 25.00 | 18.22 | 43.22 |
| 6 | North Carolina | 37.50 | 0.25 | 37.75 | 6 | Michigan | 41.70 | 0.88 | 42.58 |
| 7 | Washington | 37.50 | 0.00 | 37.50 | 7 | North Carolina | 37.50 | 0.25 | 37.75 |
| 8 | Florida | 4.00 | 32.42 | 36.42 | 8 | Washington | 37.50 | 0.00 | 37.50 |
| 9 | West Virginia | 20.50 | 14.10 | 34.60 | 9 | Florida | 4.00 | 32.42 | 36.42 |
| 10 | Nevada | 23.00 | 10.15 | 33.15 | 10 | West Virginia | 20.50 | 14.10 | 34.60 |
| 11 | Rhode Island | 32.00 | 1.00 | 33.00 | 11 | Nevada | 23.00 | 10.15 | 33.15 |
| 12 | Wisconsin | 30.90 | 2.00 | 32.90 | 12 | Rhode Island | 32.00 | 1.00 | 33.00 |
| 13 | Vermont | 12.10 | 19.87 | 31.97 | 13 | Wisconsin | 30.90 | 2.00 | 32.90 |
| 14 | Oregon | 30.00 | 1.07 | 31.07 | 14 | Vermont | 12.10 | 19.87 | 31.97 |
| 15 | Illinois | 19.00 | 11.72 | 30.72 | 15 | Oregon | 30.00 | 1.07 | 31.07 |
| 16 | Maryland | 23.90 | 6.40 | 30.30 | 16 | Illinois | 19.00 | 11.72 | 30.72 |
| 17 | Michigan | 19.00 | 11.26 | 30.26 | 17 | Maryland | 23.90 | 6.40 | 30.30 |
| 18 | Maine | 30.00 | 0.01 | 30.01 | 18 | Maine | 30.00 | 0.01 | 30.01 |
| 19 | Indiana | 18.00 | 11.85 | 29.85 | 19 | Indiana | 18.00 | 11.85 | 29.85 |
| 20 | Minnesota | 28.50 | 0.10 | 28.60 | 20 | Minnesota | 28.50 | 0.10 | 28.60 |
| 21 | Ohio | 28.00 | 0.00 | 28.00 | 21 | Ohio | 28.00 | 0.00 | 28.00 |
| 22 | Montana | 27.00 | 0.75 | 27.75 | 22 | Montana | 27.00 | 0.75 | 27.75 |
| 23 | Kentucky | 26.20 | 1.40 | 27.60 | 23 | Kentucky | 26.20 | 1.40 | 27.60 |
| 24 | Massachusetts | 24.00 | 2.54 | 26.54 | 24 | Massachusetts | 24.00 | 2.54 | 26.54 |
| 25 | Georgia | 7.50 | 19.03 | 26.53 | 25 | Georgia | 7.50 | 19.03 | 26.53 |
| 26 | Nebraska | 25.60 | 0.90 | 26.50 | 26 | Nebraska | 25.60 | 0.90 | 26.50 |
| 27 | Idaho | 25.00 | 0.00 | 25.00 | 27 | Idaho | 25.00 | 0.00 | 25.00 |
| 28 | Utah | 24.50 | 0.00 | 24.50 | 28 | Utah | 24.50 | 0.00 | 24.50 |
| 29 | Kansas | 24.00 | 0.03 | 24.03 | 29 | Kansas | 24.00 | 0.03 | 24.03 |
| 30 | Wyoming | 23.00 | 1.00 | 24.00 | 30 | Wyoming | 23.00 | 1.00 | 24.00 |
| 31 | New Hampshire | 22.20 | 1.63 | 23.83 | 31 | New Hampshire | 22.20 | 1.63 | 23.83 |
| 32 | District of Columbia | 23.50 | 0.00 | 23.50 | 32 | District of Columbia | 23.50 | 0.00 | 23.50 |
| 33t | Delaware | 23.00 | 0.00 | 23.00 | 33t | Delaware | 23.00 | 0.00 | 23.00 |
| 33t | North Dakota | 23.00 | 0.00 | 23.00 | 33t | North Dakota | 23.00 | 0.00 | 23.00 |
| 35 | Virginia | 19.88 | 2.50 | 22.38 | 35 | Virginia | 19.88 | 2.50 | 22.38 |
| 36t | Colorado | 22.00 | 0.00 | 22.00 | 36t | Colorado | 22.00 | 0.00 | 22.00 |
| 36t | Iowa | 21.00 | 1.00 | 22.00 | 36t | Iowa | 21.00 | 1.00 | 22.00 |
| 36t | South Dakota | 22.00 | 0.00 | 22.00 | 36t | South Dakota | 22.00 | 0.00 | 22.00 |
| 39 | Arkansas | 21.50 | 0.30 | 21.80 | 39 | Arkansas | 21.50 | 0.30 | 21.80 |
| 40 | Tennessee | 20.00 | 1.40 | 21.40 | 40 | Tennessee | 20.00 | 1.40 | 21.40 |
| 41 | Alabama | 16.00 | 4.87 | 20.87 | 41 | Alabama | 16.00 | 4.87 | 20.87 |
| 42 | Louisiana | 20.00 | 0.01 | 20.01 | 42 | Louisiana | 20.00 | 0.01 | 20.01 |
| 43 | Texas | 20.00 | 0.00 | 20.00 | 43 | Texas | 20.00 | 0.00 | 20.00 |
| 44 | Arizona | 18.00 | 1.00 | 19.00 | 44 | Arizona | 18.00 | 1.00 | 19.00 |
| 45 | New Mexico | 17.00 | 1.88 | 18.88 | 45 | New Mexico | 17.00 | 1.88 | 18.88 |
| 46 | Mississippi | 18.00 | 0.78 | 18.78 | 46 | Mississippi | 18.00 | 0.78 | 18.78 |
| 47 | Missouri | 17.00 | 0.30 | 17.30 | 47 | Missouri | 17.00 | 0.30 | 17.30 |
| 48 | Oklahoma | 16.00 | 1.00 | 17.00 | 48 | Oklahoma | 16.00 | 1.00 | 17.00 |
| 49 | South Carolina | 16.00 | 0.75 | 16.75 | 49 | South Carolina | 16.00 | 0.75 | 16.75 |
| 50 | New Jersey | 10.50 | 4.00 | 14.50 | 50 | New Jersey | 10.50 | 4.00 | 14.50 |
| 51 | Alaska | 8.00 | 3.30 | 11.30 | 51 | Alaska | 8.00 | 3.30 | 11.30 |

Source Data: American Petroleum Institute, State Motor Fuel Taxes: Rates Effective 1/01/2015, accessible at www.api.org/~media/files/statistics/statemotorfuel-onepaggers-jan-2015.pdf

Note: API employs a methodology using weighted averages of local tax rates in calculating state-level rates.