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CITIZENS RESEARCH COUNCIL OF MICHIGAN

Evaluating Michigan's Options to Increase Road Funding

This paper accompanies a longer paper, *Evaluating Michigan's Options to Increase Road Funding*. That paper is available at https://crcmich.org/evaluating-michigans-options-to-increase-road-funding.

Key Takeaways

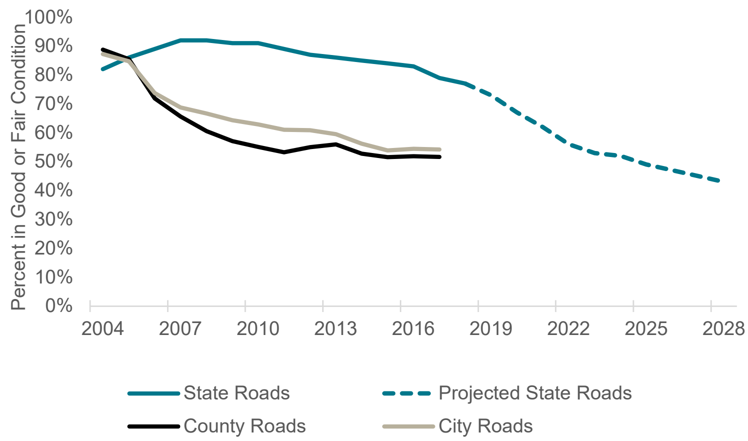
1. In 2015, Michigan enacted a funding package that will eventually generate $1.2 billion annually for state and local road projects. Even after it is fully implemented, the state will continue to be plagued with poor road conditions.
2. Resources to address our current road needs can come from three main sources: increasing dedicated taxes, diverting existing state revenues, and/or borrowing. Each choice presents its own set of advantages and obstacles.
3. Michigan taxpayers will be well served if reforms: disentangle motor fuels from the Sales Tax, prudently use all available resources for this funding priority, use bonding authority judiciously, and address how revenues are distributed and employed.

Summary

Michigan's roads are in relatively bad shape and without an infusion of new resources they are destined to deteriorate further. In 2018, only 77 percent of state operated roads were graded in "good" or "fair" condition. By 2025, that number is expected to drop below 50 percent (see **Chart A**). Facing worsening conditions, a $1.2 billion road funding package was enacted in 2015, with half the money coming from increased taxes and the other half diverted from the General Fund. While the state began collecting an additional $600 million in fuel taxes and registration fees in Fiscal Year (FY)2017, the full $600 million diversion from the General Fund will not be realized until FY2021.

In the interim, road funding needs have grown. The 21st Century Infrastructure Commission estimated that road infrastructure needs $2.2 billion annual funding beyond the 2015 package to bring most roads up to at least fair condition. The Senate Fiscal Agency recently released a report that says even that might be an underestimate, as the state has continued to underinvest in roads since that report.

Chart A
Past and Projected Michigan Road Conditions 2004-2028



Note: This chart combines Charts 1 and 13 from the body of the report.

Source: House Fiscal Agency and the Michigan Transportation Asset Management Council.

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The vacuum created by the lack of road funding is being filled by other costs. The Road Improvement Project estimates that Michigan's poor roads cost drivers $562 a year on vehicle maintenance, as well as the costs of lost time in congestion and road-related accidents. Michigan needs to "fix the damn roads."

Additional road funding can come from three main sources: new taxes, diverting existing state revenues, and/or borrowing. Each track presents its own set of advantages and obstacles.

Transportation Taxes

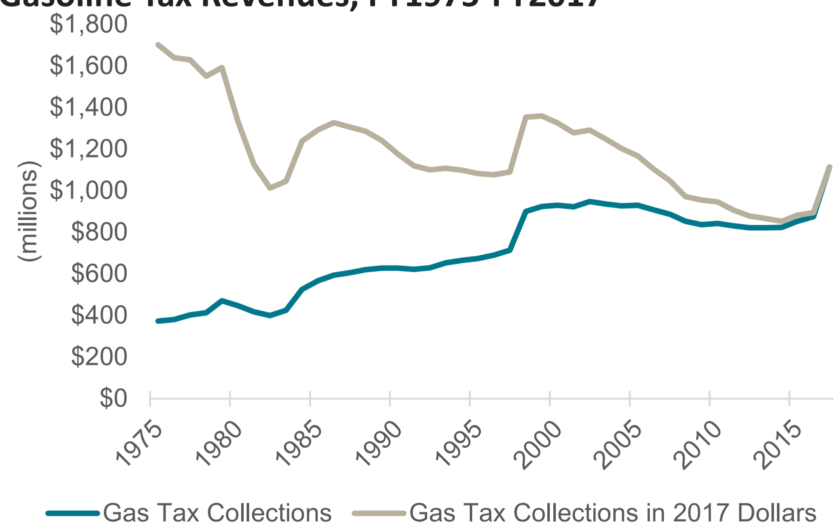
Road-related tax revenues – primarily motor fuel taxes ($1.4 billion in FY2018) and motor registration fees ($1.3 billion) – are deposited into the Michigan Transportation Fund (MTF) and distributed based on Public Act 51 of 1951 (Act 51). The Michigan Department of Transportation (technically the State Trunkline Fund, or STF) receives 39.1 percent, county road commissions receive 39.1 percent, and city and village road commissions receive the remaining 21.8 percent.

Despite being the state's largest source for road funding, the fuel tax has a long-term structural problem. Cars are becoming more fuel efficient; new vehicles averaged 13.1 miles per gallon in 1975, while new cars in 2017 averaged 25.2 miles per gallon. Fuel tax collections will decline long-term without continuous rate increases. From FY1997, when the state raised the Gas Tax from 15 to 19 cents per gallon, to FY2016, the year before the fuel tax was raised from 19 to 26.3 cents per gallon, collections per 10,000 miles traveled declined 12 percent (see **Chart B**). Over the long term, the fuel tax rate would have to be raised faster than inflation to maintain funding levels.

Motor vehicle registration fees have fared much better. Revenues nearly quadrupled from FY1983 when the fee structure changed to their peak amount in FY2004, from $237.7 million to $935 million. During the same period, fees only increased 30 percent.

As a result of the 2015 tax law changes, Michigan has one of the highest fuel tax rates, and one of the highest registration fees. Yet state road spending is towards the bottom of the national rankings. Michigan motor vehicle registration fee revenues per capita ranked 14th highest in the nation prior to the 20 percent increase scheduled by the 2015 road funding package. While the state's motor fuel tax rate ranks 19th highest in the nation, the total of all taxes paid at the pump raises Michigan to 5th highest. Part of the issue is that motor fuel is included in the base of the Sales Tax. Revenue from that tax does not go to roads. A small portion of the tax goes to public transit projects, but the lion's share goes to schools and revenue sharing.

Chart B
Gasoline Tax Revenues, FY1975-FY2017



Source: Annual Report of Michigan's Treasurer; Citizens Research Council calculations.

Diverting Revenues

Rather than raise new revenues to fund roads, policy-makers could opt to divert existing revenues. The 2015 road funding package diverts resources that had been destined for the General Fund, the state's main discretionary account. However, funding diversions will reduce funding available for other state functions. The Senate Fiscal Agency estimates that only $5.25 billion of the $11 billion General Fund is truly discretionary; this includes the current allocation for roads. When the 2015 road package is in full effect in FY2021, this will represent more than five percent of the General Fund.

Over the short term, General Fund growth will be limited. In fact, the General Fund is not projected to exceed FY2018 levels until FY2022 (see **Chart C**). One way to free up General Fund resources without making drastic cuts is to increase the proportion of higher education spending coming from the School Aid Fund. Currently, about 62 percent of the $1.6 billion higher education budget comes from the General Fund.

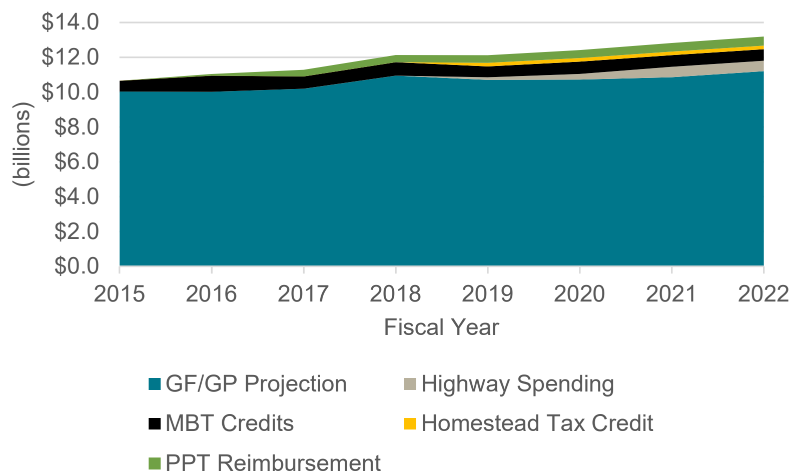
Alternatively, some of the funds could come from disentangling fuel purchases from the Sales Tax. If fuels were exempted from the Sales Tax, the legislature could increase the fuel tax an equivalent amount without increasing prices at the pump. The total revenue this could generate fluctuates depending on the rate set; but based on a $.154 Sales Tax on gasoline and a $.164 Sales Tax on diesel, a fuel tax increase to replace the Sales Tax could raise nearly $900 million annually. Policymakers would likely seek to backfill the reduced Sales Tax revenues to hold schools and local governments harmless.

What about Borrowing?

The state could borrow to finance road improvements through general obligation bonds or through State Trunkline Fund (STF) bonds.

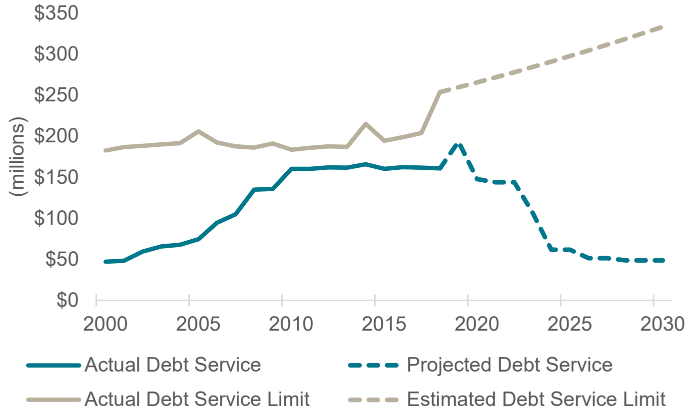
STF bonds are revenue bonds; they are backed by transportation-dedicated revenues. The Michigan Constitution of 1963 allows the legislature to authorize transportation bonds. Through Act 51, the legislature has delegated this authority to the State Transportation Commission (STC). The STF must maintain a 2-to-1 coverage ratio by state law; however, current STC policy requires at least a 4-to-1 coverage ratio. While STF borrowing has been limited in recent years, the Michigan Department of Transportation (MDOT) is still making $160 million in debt service payments annually from borrowing incurred almost 20 years ago (see **Chart D** on page 4). Based on current revenues and state restrictions, the state could not sell more than $1 billion STF bonds at the current time.

Chart C
General Fund Revenue Growth and Projections FY2015-FY2022



Sources: House Fiscal Agency, Senate Fiscal Agency, and Michigan Treasury

Chart D
Actual and Projected STF Debt Service Payments, FY2000-FY2030



Note: Projected debt service includes debt service payments owed on Strategic Fund bonds for the I-75 Improvement Project (see **Box** on page 15).

Source: Michigan Department of Transportation, Michigan Comprehensive Annual Financial Report, and Citizens Research Council calculations.

This option could be used to fix only a small portion of the road system, albeit a significant portion. STF bonds only benefit state roads; new bond issuances would not go towards county or city/village roads.

General obligation bonds function quite differently. They are authorized separately, and are backed by the full faith and credit of the state, meaning payments are constitutionally required to be appropriated before other programs are funded. General obligation bonds also require a vote of the people to be approved, limiting the legislature's ability to issue bonds. The state does not have any specific limitations to the amount that can be borrowed this way, though debt service payments will directly compete with General Fund obligations. General obligation bond proceeds would be distributed at the legislature's discretion.

Borrowing can finance a rebuild of state roads, or other large-scale reconstruction that would otherwise take several years. This can quicken the timeframe of projects, and bring the economic benefits of road reconstruction sooner. It also serves as an economic stimulus, by increasing the demand for construction work in the state. While there are benefits, borrowing can hamstring the state long term. Without new revenues, increased borrowing will reduce the state's ability to maintain road conditions in the long term. It also would export the costs of road improvement to future generations; while road conditions improve immediately, the construction costs are paid over two to three decades.

Distributive Considerations

Act 51 plays a significant role in the efficiency of state road funding. MDOT is only responsible for about 10,000 miles of road; county road agencies are responsible for about 90,000 miles, while city and village road agencies are responsible for about 21,000 miles. Despite being a small fraction of the total system, state roads are responsible for more than 50 percent of all travel.

While state, county, and city/village road systems are all in poor shape, the local road agencies are largely beholden to the state for resources to care for their roads. Beyond distributions from Act 51, counties and cities can only raise money through property taxes or a city income tax.

In addition to a general lack of resources being made available for road care, the revenue distribution in Act 51 is rather inefficient. It does not consider road usage or condition. Although all three types of road agencies clearly have needs, it has been years since the formula dividing the funds among them has been revised. Nor have the methods for dividing county or municipal funds been revised. Division of the funds among the local road agencies is primarily based on road miles, population, and vehicle registrations. These rudimentary measures do not begin to address funding to the highest levels of need. Rural areas contain 69 percent of roads, yet represent 29.8 percent of road usage.

Grounding Principles When Considering Road Funding Options

Despite an enhancement of road funding in 2015, the systems needs are quickly outpacing current resources. The cause of the problem is relatively simple: the state has underinvested in road maintenance, and a significant portion of state roads are on the cusp of deteriorating beyond fair condition. Even as the 2015 road funding package improves Michigan's resources, the phase-in of revenues delays the investment in roads and the overall funding is still not adequate.

The unfortunate truth is that finding additional dollars to fund the state's roads is not an easy problem to solve. Michigan has one of the highest fuel tax levies and the most expensive registration fees in the nation; but state road spending per mile traveled is towards the bottom. Additional use of the state's limited General Fund dollars will not improve the roads without new revenues or steep cuts elsewhere. Fixing the roads will require choices that reflect policy priorities and political realities.

Here are some principles that should be reflected in any broad funding package.

* Taxes collected at the pump are distributed differently in Michigan than in other states. While most people intuitively tie taxes levied at the pump to road funding, fuels are subject to the Sales Tax and those collections are used to fund schools and make revenue sharing payments. The disentanglement of motor fuels and the Sales Tax should be a priority. Exempting motor fuels from the Sales Tax and increasing fuel tax rates an equal amount would make taxation on motor fuels more transparent and promote the user fee approach engrained in road funding in Michigan.

* If policymakers decide improving the state's road infrastructure is indeed a high priority, policy should reflect that reality. The identification of resources to direct at this issue should not be restrained by past use. However, funding for priorities is zero-sum. Let's not solve this problem by creating new problems.

* Bonds can be an effective tool when making road improvements, but are not a panacea. In the past, the state issued bonds without providing sufficient revenue to repay the debt and maintain road conditions. When looking for funds to fix the roads, policymakers should treat bonds for what they are: an instrument to finance large-scale projects, rather than as a way to increase funding for short-term maintenance. If used improperly, debt service payments can limit the ability to maintain road conditions, and Michigan roads will revert back to current conditions.

* The distribution of tax revenues should better reflect road condition and usage. The current Act 51 allocation ignores road capacity, which is a true indicator of costs, and road usage, which is a key driver of degradation. It does not direct funds to the roads in the poorest condition. If funding does not reflect the realities on the ground, increases will have less of an effect on road condition, while some road agencies will be over-funded. Reform of Act 51 should accompany efforts to raise new revenues.

* Raising revenue to actually fix the roads, whether through cutting spending in other state programs or increasing road user fees, will require a significant investment from the state. Boosting funding in small amounts, or for short periods of time, will mean new construction and maintenance will not be maintained as efficiently. If the legislature chooses to increase funding, those increases should be sufficient to reconstruct roads to high standards and maintain them throughout their life cycles. Partial measures and kicking the can down the road will not create a lasting improvement in Michigan's road conditions.

Road infrastructure becomes more expensive to fix as it degrades, and a significant portion of Michigan's roads are close to falling into 'poor' condition. Making a decision on how to finance roads will not be easy, but is a decision that cannot be put off any longer.

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