Policy Brief

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Proposal 1 of 2015: An Analysis

By James Hohman

Executive Summary*

Voters will be asked to approve or reject Proposal 1 on May 5, 2015. There are many facets to this proposal — it would make four changes to the Michigan Constitution, and it is "tie-barred" to eight legislative bills that would only take effect if voters approve of the proposal. Central to these changes is increasing taxes to pay for additional investments in road building and maintenance.

The two most significant proposed changes to the state constitution are increasing the limit on the state sales tax rate from 6 percent to 7 percent and exempting fuel purchased for use by motor vehicles on public roads from the state sales tax. Tie-barred legislation would immediately hike the sales tax to the new limit of 7 percent, and this tax increase is expected to generate $1.427 billion new revenue in fiscal year 2016. Other constitutional changes include prohibiting public universities from receiving revenue out of the state's School Aid Fund and earmarking a portion of the state's use tax revenue for the School Aid Fund.

If Proposal 1 is approved, tie-barred bills would create a new and higher wholesale tax on fuel, increasing the current state excise tax of 19 cents per gallon of gasoline (15 cents for diesel) to 41.7 cents per gallon starting Oct. 1, 2015. This new tax is expected to generate $1.24 billion in new revenue in 2016.

The new wholesale fuel tax rate of 41.7 cents per gallon will increase according to a formula, which is based in part on inflation and the average wholesale price of fuel. A rate floor and rate ceiling would be established, which would limit how much this rate could increase year to year. However, the mechanics of the formula ensure that the rate floor will increase above inflation.

Although fuel purchases would be made exempt from the state sales tax, taxpayers can expect to pay more in gas taxes in the immediate future if Proposal 1 is approved. The federal Energy Information Administration projects the national average price of gasoline to be $2.39 through 2015. If this were to hold true for Michigan, the proposed new wholesale fuel tax would increase the price of gas at the pump by 4 percent, to $2.49 per gallon. Only when gas prices at the pump exceed $4.20 per gallon would taxpayers begin paying less in fuel taxes under Proposal 1.

Proposal 1 would also increase vehicle registration fees. Currently, registration fees for new cars are reduced by 10 percent each year for the first three renewals. Those discounts would be eliminated, generating $10.9 million for the state in 2016 and $150 million by 2026.

Other legislative changes that will go into effect if Proposal 1 were to be approved include adding $40 million to the state's public school "At Risk" program, creating new regulations for the Michigan Department of Transportation and boosting the state's earned income tax credit. Increasing the

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* Citations provided in the main text.

earned income tax credit will reduce state revenue by $261.1 million in 2016.

Based on data from the U.S. Census Bureau, Department of Transportation and Bureau of Labor Statistics, the typical Michigan household could expect to pay between $477 and $525 more in state taxes in 2016 as a result of Proposal 1. What taxpayers can expect to pay in increased taxes beyond that will depend on the average wholesale price of fuel, inflation and the growth in purchases of taxable goods. The average EITC recipient household may see its total state tax burden reduced by about $69, but nevertheless, some EITC recipient households may still pay more in state taxes as a result of Proposal 1.

Voting "yes" on Proposal 1 will amend the Michigan Constitution and put into effect the tie-barred legislation described above. Voting "no" will reject both the changes to the constitution and the series of tie-barred bills, and send policymakers back to negotiate over future road funding.

Introduction

On May 5, 2015, Michigan voters will be asked to approve or reject Proposal 1. The proposed amendment would change the state constitution to increase the maximum allowable sales tax rate from 6 to 7 percent, exempt fuel purchases from sales and use taxes, modify the allowed use of School Aid Fund revenues, and earmark a portion of use tax revenue for the SAF.[1]

Approval of this constitutional amendment would also trigger a series of new laws. These laws would increase the sales and use tax rates to 7 percent, create a new and higher wholesale fuel tax and earmark new revenues to road construction, increase vehicle registration fees, boost the earned income tax credit, increase public school funding and create new rules for the Michigan Department of Transportation.[2]

The impetus for Proposal 1 comes from cost projections for maintaining the condition of Michigan roads. Gov. Rick Snyder advocated for more spending on road repair and maintenance, originally calling for between $1 billion and $1.4 billion in funding.[3] Increasing the sales and use taxes rate from 6 to 7 percent would raise $1.427 billion in state revenue.[4] Altogether, Proposal 1 would increase state taxes and spending by about $2 billion in its first year.[5]

How Road Funding Works

Road construction in Michigan is primarily paid for with revenues from fuel taxes and vehicle registration fees. Since these taxes are paid by people driving vehicles on public roads, they function as a user fee.

Taxes motorists pay do not meet the strict definition of user fees, however. Vehicle registration taxes for passenger vehicles, for example, are based on their value rather than their estimated wear on the roads.[6] Further, hybrid and electric cars tend to be heavier and thus cause more wear on the roads, but owners of these vehicles buy less fuel and pay less in fuel taxes. People purchasing fuel for use in lawnmowers, snowmobiles or other recreational vehicles also pay for road maintenance.

Despite these divergences, the bulk of taxed fuel in Michigan is purchased for use by vehicles operating on government-funded roads.[*] But these taxes also can be appropriated for other purposes, which reduces their functioning as user fees. For instance, 10 percent of fuel taxes go to transit operations.[7]

* David Zin, Michigan Senate Fiscal Agency chief economist, email correspondence with James Hohman, Jan. 22, 2015. These taxes also can be diverted, breaking further from the user fee concept. For instance, 10 percent of fuel taxes go to fund public transit operations.

History of Proposal 1

There has been a long-standing request for more state funding for maintaining and rebuilding Michigan roads. In 2009 Gov. Jennifer Granholm called for raising the state motor fuel taxes over time, which was projected to gradually increase taxes by about $1.5 billion annually.[8]

Gov. Snyder announced his intention to improve the state of Michigan's road system in a special message he delivered on Oct. 26, 2011. He cited projections indicating deteriorating pavement conditions if the roads were not serviced and repaired. Gov. Snyder called for between $1 and $1.4 billion in additional funding for road construction.[9]

"We have invested wisely but we cannot continue to sustain the value of those investments without additional reform and additional revenues," he stated while proposing to replace the state's current fuel taxes with a new wholesale fuel tax. He also proposed allowing counties to assess vehicle registration taxes to be used to fund their local roads.[10]

Gov. Snyder's speech began a long series of negotiations with the Legislature over how to dedicate more state funding to road construction. But no plan was adopted by the end of the 2011-12 legislative session.

The state policymakers began to put some money from the state's General Fund into the transportation budget in fiscal years 2014 and 2015.[11] This was a stop-gap measure to prevent further deterioration of the roads while awaiting a longer-term road funding plan.

The governor kept pushing for more revenue for the roads in the 2013-14 legislative session. The Senate approved a plan in late 2014 that would replace the state's excise taxes on fuel with a wholesale tax, starting at 9.5 percent but ramping up to 15.5 percent in 2018.[12] Under this plan, based on a $2.80 wholesale price for a gallon of gasoline, the state fuel tax would increase from 19 cents per gallon to 27 cents per gallon. By 2018, this tax would rise to 43 cents per gallon on the wholesale price of gasoline.

The House countered with a plan that would gradually eliminate the sales tax on retail fuel sales and replace it with a wholesale fuel tax. Revenue from the replacement wholesale fuel tax would be deposited into the state's transportation funds. The state currently devotes 73 percent of its sales tax revenue, including the sales tax on fuel, to the School Aid Fund. Another 10 percent goes to local government revenue sharing. Under the House plan, therefore, the SAF and local governments would no longer benefit from the revenues generated from applying the sales tax to fuel purchases.[13] Because this plan would be gradually implemented, the state estimated that the SAF and revenue sharing would not face net reductions in revenue, merely smaller increases.[14]

The Governor and Legislature continued negotiations until they agreed on a deal on the last day of the 2013-14 session. The deal included a series of new laws and required increasing the state sales and use tax rate from 6 to 7 percent. Because the state constitution limits the sales and use tax rate to 6 percent, the Legislature needed to propose an amendment to the Michigan Constitution, an act that required a two-thirds vote in both the House and Senate. Voters then will determine if they approve these changes to the constitution on May 5, 2015.

Some of the bills passed as part of this large legislative deal are "tie-barred" to Proposal 1. In other words, they will only go into effect if voters approve the constitutional amendment. These include increasing the sales and use tax rates to 7 percent, creating a new and higher fuel tax and earmarking the resulting new revenue for roads, increasing vehicle registration taxes, appropriating more revenue to public schools, creating new rules for the Michigan Department of Transportation, and boosting the earned income tax credit.[15]

In addition to these proposed changes, several other laws were passed as part of this deal. But these other laws will go into effect regardless of whether or not voters approve Proposal 1. They include subjecting purchases made over the Internet to Michigan's sales tax, exempting certain property from taxation, creating a new tax on hydroponics and aquaculture production and requiring the state to produce a report analyzing whether or not public school districts have sufficient funds to educate students.[16]

Proposed Changes to the Michigan Constitution

The proposal makes four changes to the state constitution: exempting fuel from sales and use taxes, modifying the allowable uses of School Aid Fund revenues, increasing the sales tax rate limit and creating a new earmark for use tax revenue.

Sales Tax Exemption for Fuel

The proposal changes the constitution to exempt "the sale or use of gasoline or diesel fuel used to operate a motor vehicle on the public roads or highways of this state" from sales and use taxes.[17] This does not eliminate all sales and use taxes levied upon gasoline and diesel fuel, however. Gasoline and diesel used for industrial vehicles and fuel-powered machinery, for example, will continue to be subject to sales taxes. So will any fuel used by industries that is not otherwise tax exempt.

Further, gasoline purchased for use in lawnmowers, snowmobiles, boats or other recreational vehicles would still technically be subject to the sales tax. As a practical matter, however, it is unlikely that the state Treasury Department will be able to ensure that fuel retailers collect the tax on fuel used for purposes other than driving on public roads and highways in Michigan.[18]

Removing the sales tax on most uses of fuel while also creating a new fuel tax may make a practical difference for marine fuel stations. Gasoline sold at fuel docks will still be subject to both the sales tax and new wholesale fuel tax created by Proposal 1. While there are no estimates on how much fuel is sold for these uses, current law assumes that exactly 2 percent of all gasoline sales are intended for motor boats, off-road vehicles and snowmobiles.[19]

Only gasoline and diesel fuel would be made exempt from the sales tax under Proposal 1. Other fuels, such as liquefied natural gas that powers some vehicles, would still be subject to sales taxes. Industries would still have to pay sales tax on any other fuels they use that are not otherwise tax exempt. Finally, any fuels used in the future to power vehicles — even those used on public roads — would lack a constitutional sales tax exemption as well.

Gov. Snyder has pledged to support legislation that would create tax exemptions for any gasoline or diesel fuel sales that might still subject to sales taxes if Proposal 1 is approved by voters. At the time of this writing, no such legislation exists.[20]

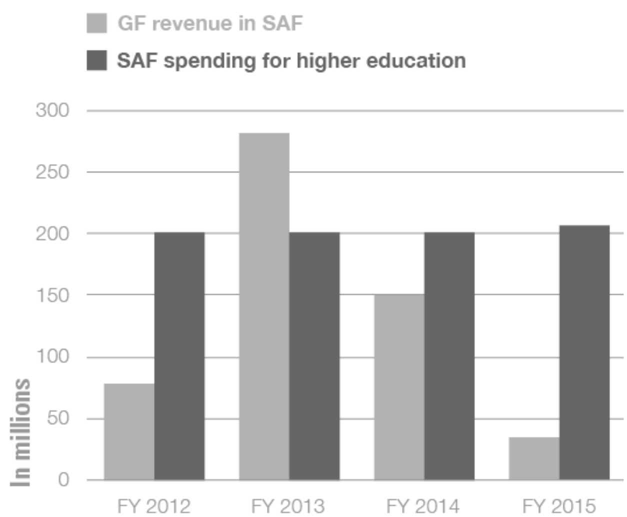
Allowable Uses of the School Aid Fund

If approved, Proposal 1 would modify the allowable uses of the School Aid Fund. Currently, the constitution allows the SAF to support "school districts, higher education and school employees' retirement systems[.]"[21] Proposal 1 would eliminate the provision allowing for payments to higher education, but add new language that would authorize SAF revenue to support "public community colleges, public career and technical education programs, scholarships for students attending either public community colleges or public career and technical education programs."[22]

This provision may have practical effects for the state budget. The majority of state payments to institutions of higher education — public universities — comes from the state's General Fund, while only a small portion comes from the SAF. Since fiscal year 2012, state universities have received about $200 million annually from the SAF, roughly 13 percent of their total appropriations.[23]

The overall impact on the state budget may be minimal, however, because General Fund revenue also partially funds the SAF. There has been an increase in General Fund support for the SAF in recent years. In fiscal year 2013, $282 million was appropriated to the SAF from the General Fund, but this appropriation has decreased since.[24] See Graphic 1 for details.

Graphic 1: General Fund Support of School Aid Fund and Higher Education Funding, 2012-2015



Source: “School Aid Funding History” (Michigan Senate Fiscal Agency, March 13, 2015), http://perma.cc/CB9F-KSS2 (accessed March 16, 2015); Marilyn Peterson, Michigan House Fiscal Agency Analyst, email correspondence with James Hohman, Feb. 2, 2015.

As shown in the graphic above, with a constitutional prohibition against spending SAF revenue on public universities, the state budget could replace a portion of the $204.5 million SAF dollars in its budget with the $33.7 million from the General Fund that ends up in the SAF.*

But as a constitutional change, the state would no longer have the option of spending school aid revenue on public universities. During the 2012 election, Gov. Snyder was criticized for spending SAF revenue for purposes other than supporting public school districts.[25] Gov. Granholm also used the same revenue to subsidize community colleges in 2010.[26]

Indeed, Proposal 1 would still allow community colleges to receive SAF revenue. They received $364.7 million from this fund in fiscal year 2015.[27] Proposal 1 would also allow the SAF to support a series of programs that it currently does not fund directly. These include “public and career technical education programs, scholarships for students attending either public community colleges or public career and technical education programs.”[28] It is unclear whether a public university could operate one of these programs or accept scholarship money for one of these programs, and thus still receive funding from the SAF.

Tax Rate Increases and New Earmarks

The Michigan Constitution earmarks portions of state tax revenues for specific funds. Proposal 1 would change which state revenues go into the School Aid Fund.

Sales tax revenue is currently split into two categories, according to constitutional requirements. Two percent of the sales tax is a mandatory levy devoted exclusively to school aid. This provision was put into effect via a voter-approved constitutional amendment in 1994.[29] The other category is an optional levy of up to 4 percent, of which 60 percent goes into the SAF, 15 percent to cities, villages and townships (“revenue sharing”), and the rest to the state’s General Fund.[30]

Proposal 1 would increase the maximum rate of the optional portion of the sales tax from 4 to 5 percent. As mentioned earlier, new laws will automatically go into effect that will result in a new total sales tax rate of 7 percent. The use tax rate would also increase to 7 percent from 6 percent, although the state’s constitution does not limit its maximum rate.[31] A fiscal

* For fiscal year 2015, the Michigan Legislature substantially reduced General Fund support for the SAF in an attempt to fill a budget hole resulting from a business tax credit program. Kyle Feldscher, “Bill Taking Money from School Aid Fund to Balance Budget Deficit Passes Michigan House,” *MLive.com*, Feb. 18, 2015, http://perma.cc/3SWD-A58R (accessed March 16, 2015).

analysis estimates that these rate increases will add $708.6 million to the SAF and provide $177.1 million for revenue sharing in fiscal year 2016.[32]

The amendment also adds a new constitutional earmark on the state use tax. While the full 2 percent portion of the use tax is earmarked to the SAF, none of the other 4 percent portion goes to it. If Proposal 1 is approved by voters, 12.3 percent of the revenue generated by the 4 percent portion (to be increased to 5 percent) of the use tax would be earmarked for the SAF. This is expected to add $151.1 million to that fund in fiscal year 2016.[33]

Tie-Barred Legislation

Proposal 1 is "tie-barred" to other legislative bills. These laws, which would only go into effect if the Proposal 1 is approved by voters, include changes to:

- Sales and use taxes
- Fuel taxes
- Vehicle registration fees
- Earned income tax credits
- Public school funding
- MDOT regulations

The sections below describe these changes in more detail.

Sales and Use Tax Rate Increase

The sales tax covers goods purchased by consumers in the state and is collected by retailers. The use tax applies to certain purchases for which a sales tax is not collected. These include goods purchased outside the state of Michigan, and used automobiles, snowmobiles, boats and other used recreational vehicles. It also applies to some specified services. Both taxes are assessed as a percentage of the value of the purchased product.

If voters approve Proposal 1, laws will go into effect that will increase the sales and use tax rate to a new, maximum allowable rate of 7 percent. These taxes are the largest combined sources of revenue for the state. In fiscal year 2015 they are estimated to bring in almost $9 billion, 31 percent of total state tax revenue. The next largest source is the individual income tax, which collects $8.5 billion. After these taxes, the revenue raised by a single tax drops off substantially: the State Education Tax — a statewide six-mill assessment on property — collects just $1.8 billion.[34]

Increasing the sales tax is expected to raise an additional $1.427 billion in the first year of adoption.[35] This amount accounts for the decrease in revenue resulting from exempting gasoline and diesel fuel from the state sales and use taxes.

New and Higher Wholesale Fuel Tax

Currently, the state assesses both an excise tax (19 cents for gasoline, 15 cents for diesel) and a 6-percent sales tax on the purchase of fuel.[36] Proposal 1 would repeal and replace these fuel taxes with a new "wholesale" tax levied at 41.7 cents per gallon initially.[37] This new tax is estimated to bring in $463 million more than the current taxes assessed on fuel would in fiscal year 2016. The actual amount this new tax will raise, however, varies depending on the price of fuel.[38]

Taxpayers would pay the same in fuel taxes if the pump price of gasoline increases to $4.20 per gallon. The federal Energy Information Administration estimates the national average gasoline price to be $2.39 in 2015.[39] At this price, taxpayers would pay 10 cents more per gallon in taxes, a 4 percent increase. This tax would go into effect on Oct. 1, 2015.

The new wholesale tax would increase over time based on a formula. The rate is set by multiplying 14.9 percent by the average wholesale price of fuel.* The rate, however, must fall between the minimum "rate floor" and the maximum "rate ceiling." The rate floor would start at 41.7 cents per gallon and then adjust annually based on inflation, limited to a maximum inflation-based increase of 5 percent.[40] In the event of negative inflation rates, or deflation, the rate floor would not change.[41] The rate ceiling would always be five cents more than the rate floor.[42] Based on this design, the maximum amount this wholesale tax could increase annually is five cents more than a rate floor that increased by 5 percent.†

However, the increase to the rate floor will be higher than inflation based on the way that it was legislated. The first increase will occur on Oct. 1, 2016, and will be based on the change in the inflation rate from the period of July 2013 to June 2014 through July 2015 to June 2016.[43] The initial rate adjustment, then, will be based on two years' worth of inflation. Subsequent increases are based on one-year changes to the inflation index. However, changes build upon each other, ensuring that the tax rate will increase above inflation. For more details about the rate floor, rate ceiling and allowable tax rates, please see Appendix B: Allowable Wholesale Fuel Tax Rate Projections.

The initial rates set by the tie-barred legislation are set based on the average wholesale price of fuel of $2.80 per gallon.‡ To illustrate how the formula would work, consider the following scenarios for fiscal year 2017, assuming a 2 percent average annual inflation rate:

- The average wholesale price of fuel drops to $2.50 per gallon, making the new rate 37.3 cents per gallon. This is below the rate floor, however, so the effective rate that would be applied is the inflation-adjusted rate floor of 43.4 cents per gallon (a 4 percent increase to the initial rate of 41.7 cents).
- The average wholesale price of fuel increases to $3.00 per gallon, making the new rate 44.7 cents per gallon. This rate falls between the inflation-adjusted rate floor of 43.4 cents and the new rate ceiling of 48.4 cents, so it would become the effective rate. (This represents a 7 percent increase to the initial rate of 41.7 cents.)
- The average wholesale price of fuel increases to $3.50 per gallon, making the implied rate 52.2 cents per gallon. This is above the rate ceiling, however, so the effective rate that would be applied is the rate ceiling of 48.4 cents per gallon (a 16 percent increase to the initial rate of 41.7 cents).

Earmarks for New Fuel Taxes

Proposal 1 would earmark the revenue generated by the new wholesale fuel tax. Of the $1.24 billion in expected revenue in fiscal year 2016, $400 million would go to the Michigan Transportation Fund, the state's primary road building and maintenance fund.[44] The fund also provides money to other transportation uses. The remaining $815 million — about two-thirds of the new revenue — would be used to pay down a portion of the $1.96 billion in debt the state has accumulated from previous road construction projects.[45]

The following year, about $800 million of the expected $1.28 billion in revenue from this new tax would go to the transportation fund and $456 million would be

* The average wholesale price of fuel would be determined based on a 12-month average from the period July 1 to June 30 each year. "Public Act 468 of 2014" (State of Michigan, Jan. 12, 2015), sec. 2(b)–(c), http://perma.cc/95VH-H3UH (accessed March 17, 2015).

† For example, based on the initial rate of 41.7 cents per gallon beginning in October 2015 and running through fiscal year 2016, this new tax rate could not be more than 48.8 cents per gallon in fiscal year 2017, no matter how much the average wholesale price of fuel increases.

‡ This would be gasoline that sells at the pump for $3.35 per gallon, with 18.4 cents in federal excise taxes, 19 cents in state excise taxes and 18 cents in state sales taxes.

used to pay down state road debt.[46] Starting in fiscal year 2018, nearly all of the projected $1.38 billion in wholesale fuel tax revenue would go into the transportation fund.[47]

However, it should be noted that the actual language of the bill dedicates $400 million of the *total state revenue* from fuel taxes to the MTF, not just the additional revenue from the new proposed wholesale tax. According to the Senate Fiscal Agency, this would mean a $522.2 million *decrease* in the amount of revenue going into the transportation fund and much higher revenue going toward debt payments in 2016.[48]

Similar to the issue regarding the sales tax being levied on gasoline purchased at marine fuel stations and for lawnmowers, snowmobiles and other recreational vehicles, legislation may needed to earmark only the new revenue generated from the proposed fuel tax.

The MTF supports more than just servicing the state's road infrastructure. It provide funds to counties, cities and villages for road construction and maintenance. It also funds the Comprehensive Transportation Fund, which grants money to bus services and other transit operations.[*] Additionally, 2 percent of fuel tax revenue is constitutionally earmarked for the state's Recreation Improvement Account, which funds recreational boating facilities and snowmobile trails.[49]

Vehicle Registration Fee Increases

Proposal 1 would make changes to three different types of vehicle registration fees. The tax structure for these fees is complex, with assessment based on, according to the House Fiscal Agency, "vehicle model year, the list price of the vehicle, the weight of the vehicle, the use of the vehicle, and, in some cases, some characteristic of the vehicle owner."[50]

The proposed change that will affect the most taxpayers concerns registration fees for passenger vehicles.[†] Currently, fees are assessed based on the initial list price of a vehicle. Fees are then reduced for the first, second and third renewals, loosely mimicking a depreciation-based fee structure. Fees are then frozen at the third renewal level over the life of the vehicle.

Proposal 1 would phase out discounts on passenger vehicles starting Jan. 1, 2016. Passenger vehicles with model years of 2013 and older would be allowed to keep any discounts applied to their annual registration taxes. It is unclear what would happen to 2014 and 2015 model year vehicles based on the language in the proposal. They may be eligible for a discounted rate for the life of the vehicle, but may also later revert to their initial registration rates. All 2016 model passenger vehicles and newer would receive no discounts.[‡]

Because this would only affect owners of newer vehicles, this provision is only expected to raise $10.9 million in fiscal year 2016. The state estimates that this will increase to $150 million by 2026.[51]

Patrick Anderson of the Anderson Economic Group observes that this loss of discounting could eliminate taxpayers' ability to deduct these fees from their federal taxes. He estimates that this could cost Michigan residents an extra $102 million in federal taxes.[52]

The second change to vehicle registration fees would be an increase for heavy commercial trucks. For trucks that weigh more than 26,000 pounds, fees would be increased based on a sliding scale. Vehicles are tiered by weight and each weight class above 26,000 pounds

* The CTF also receives earmarks from the state sales tax that will be affected by the sales tax exemption on fuel and the increase in the sales tax rate. Even though the CTF would lose revenue from exempting the sales tax from fuel purchases, it would still receive a net increase in revenue under Proposal 1."Transportation Funding Analysis" (Michigan Senate Fiscal Agency, Jan. 16, 2015), 23, http://perma.cc/JX4C-HQ62 (accessed March 9, 2015).

† Although vehicles that are older than 1984 will be unchanged by this proposal.

‡ Vehicles with model years 2014 and 2015 do not get locked into their current rates as do older vehicles. There are special rules for discounted registration for these two model years in the proposed statute, but it is unknown whether these discounts would actually apply or remain in effect for the life of the vehicle. "Public Act 470 of 2014" (State of Michigan, Jan. 12, 2015), sec. 801(1)(p), http://perma.cc/QK7W-XD55 (accessed March 17, 2015).

would face registration fee hikes between 9 percent and 12.1 percent.[53]

The third change to registration fees offered by Proposal 1 would create higher registration fees for electric vehicles and electric-powered hybrids. Owners of these vehicles would pay an additional $75 on their annual registration fees for vehicles under 8,000 pounds and $200 more for vehicles over 8,000 pounds. This applies to vehicles that are "of a brand or has been modified to be powered solely or predominately by electricity under normal average class operating conditions."[54]

Earned Income Tax Credit Increase

The federal government offers a refundable tax credit program for low-income taxpayers called the earned income tax credit. The tax credit depends on the household's reportable income and the number of dependent children living in the home. Households can earn larger benefits with higher income, but only up to a point. Benefits then taper off for households that earn income above a certain level.[55]

Half the states offer their own supplements to the federal EITC, though four of them do not make their state benefits refundable.[56] Eligibility for these state EITC credits is identical to federal requirements, and they offer a percentage of the federal credit amount to be used against the state income tax.

Michigan's program offers qualifying households a credit worth 6 percent of their federal credit.[57] The proposal would increase this to 20 percent after Dec. 31, 2015.[58]

The maximum credit for the federal EITC range from $503 for low-income, childless adults to $6,242 for low-income households with more than two children.[59] If Proposal 1 were approved, the maximum that the state would provide to a household in refundable credits would be $1,248, up from $375.

The average Michigan recipient of the state EITC received a $140 credit in 2013, and the average recipient reported having between one and two children and an income of $17,725.[60] The proposal would mean the average recipient would receive a $482 credit, adjusted for the increases to the federal EITC since 2013.[61] At these rates, the state EITC would fully cover any tax liability that the average recipient household would have and provide a small refund, if the household claimed only standard exemptions with no other credits or exemptions.*

This tax credit program is expected to reduce state revenue by $261.1 million in fiscal year 2016.[62]

The proposal also would increase a tax credit available to low-income seniors who pay property taxes. This is expected to reduce state revenue by $300,000 in fiscal year 2016.[63]

Funding Increase for a Public School Program

Under Proposal 1, the state would appropriate an additional $40 million from the School Aid Fund to school districts through the "At Risk" school program.[64] This program provides additional funding to school districts based on their enrollment of students at risk of failing to meet state-determined academic proficiency standards.[65] This would represent an increase of about 13 percent of what the state spent on the At Risk program in fiscal year 2015.[66]

* A single filer with one child and average EITC income would pay $413 in state income tax liability with no other credits or deductions. Author's calculations based on "Michigan Earned Income Tax Credit: Tax Year 2013" (Michigan Department of Treasury, Feb. 2015), http://perma.cc/3WVJ-2NKD (accessed March 18, 2015); "2014 Michigan Individual Income Tax Return" (Michigan Department of Treasury, 2014), http://perma.cc/5XG8-T987 (accessed March 19, 2015); "Form 1040: U.S. Individual Income Tax Return" (Internal Revenue Service, 2014), http://perma.cc/73V2-69FW (accessed March 19, 2015).

New MDOT Regulations

Also tie-barred to Proposal 1 are bills that would create new regulations for the Michigan Department of Transportation and local road agencies — county road commissions, cities and villages. Specifically, MDOT and these road construction agencies would have to develop "performance based maintenance systems" and "performance rating systems."[67] For all projects with costs exceeding $1 million, warranties for the pavement work performed would have to be secured. Finally, local road agencies would also now have to competitive bid for projects that cost more than $100,000.[68]

Net Impact of Proposal 1

Graphic 2 below shows the estimated revenue from the proposed increase tax changes under Proposal 1 and the distribution of that revenue to different government funds and programs.

Graphic 2: Proposed New Taxes and Revenue Distribution, 2016

Tax Increase	Estimated Revenue
Sales and Use Tax	$1,426,600,000
Wholesale Fuel Tax	$463,300,000
Commercial Truck Fees	$50,000,000
Passenger Vehicle Fee Discounts	$10,900,000
Total	**$1,950,800,000**
Proposed Allocation	**Amount**
MDOT Debt Service	$814,700,000
Michigan Transportation Fund*	$414,800,000
School Aid Fund	$292,600,000
Earned Income Tax Credit	$261,100,000
Local Government Revenue Sharing	$100,400,000
Comprehensive Transportation Fund	$26,900,000
Recreation Improvement Account	$24,800,000
General Fund	$15,400,000
Total	**$1,950,700,000**

Source: Author's calculations based on "Transportation Funding Analysis" (Michigan Senate Fiscal Agency, Jan. 16, 2015), 23, http://perma.cc/JX4C-HQ62 (accessed March 9, 2015). *Totals do not match due to rounding.*

The table above shows the impact these changes will have on funding for the state's government, but how will the measure impact Michigan residents and taxpayers?

Most Michigan residents will likely face an overall larger tax burden as a result of Proposal 1, largely resulting from hiking the sales and use tax and imposing a new and higher wholesale fuel tax. Households that plan to purchase new vehicles would also pay higher registration fees. Further, residents may see higher prices for goods and services, if businesses pass on their increased costs for paying higher registration fees and fuel taxes.

How much more a typical household would pay in sales taxes depends on the makeup and composition of the household. The state expects increasing the sales tax rate to 7 percent to generate $1.4 billion. According to the Census Bureau, there are about 3.8 million households in Michigan.[69] Assuming that the total cost of the increase in the sales tax will be borne by state taxpayers and not by businesses or visitors from out of state, the average Michigan household would pay $389 more in sales taxes in fiscal year 2016.†

Costs from the new wholesale fuel tax are more complex. As illustrated in a previous section, the proposed fuel tax rate would depend on inflation and the wholesale price of fuel. Projecting what consumers would eventually pay at the pump under Proposal 1 is thus contingent on unknown variables. Similarly, what consumers will pay at the pump under the current system is also affected by the future price of fuel. These facts complicate the question of how much taxpayers would actually pay in increased fuel taxes if the proposal were approved.

But generally, if Proposal 1 were approved by voters, taxpayers would pay more at the pump if the price of gasoline remains low. The federal Energy Information

* This amount does not include MFT revenue transferred to the Comprehensive Transportation Fund.

† The tax burden from hiking the sales and use tax rate will increase based on the growth of taxable sales made in Michigan.

Administration predicts a national average pump price of $2.39 for 2015.[70] If this held true for Michigan, the proposed changes would increase the price at the pump by 10 cents per gallon (a 4 percent increase). Only when the price of gasoline at the pump exceeds $4.20 per gallon would taxpayers start to pay less in state gas taxes under Proposal 1 than they would under the current gas tax.*

According to the Bureau of Labor Statistics' Consumer Expenditures Survey, the typical household in the Detroit metropolitan statistical area spent an average of $3,067 on motor fuel and motor oil in both 2012 and 2013.[71] Using the EIA 2012 and 2013 average motor fuel prices implies average fuel consumption of 860 gallons. Based on this figure and the projected national average price of fuel from the EIA for 2015, a typical Michigan household might pay an additional $88 in fuel taxes in 2016.

A similar finding results from using different data from the U.S. Census Bureau and U.S. Department of Transportation. According to the Census Bureau, the median household in Michigan owned two vehicles in 2013, and, according to the Department of Transportation, the average vehicle consumed 664 gallons of gas in 2012.[72] Using these data with the projected EIA average gasoline prices, the median Michigan household would pay an extra $136 per year in additional fuel taxes if Proposal 1 were approved. As mentioned above, this figure would decrease with higher fuel prices and increase with lower fuel prices.

Based on these calculations, the typical Michigan household could expect an increase in state tax burdens of between $477 and $525 in 2016. This would depend, of course, on a household's actual purchases of taxable goods.

Low-income taxpayers would see their earned income tax credits increase in this proposal. Whether EITC recipients will end up with a larger tax liability depends on their spending and income levels. According to the BLS, consumers in the lowest quintile spend 47 percent less annually than those in the middle quintile.[73] If EITC recipient households purchase the same proportion of taxable goods as the average household, they would see their sales and use tax payments increase by $205. If they own a single vehicle and consume a typical amount of fuel, they would pay $68 in increased fuel taxes.

This $273 increased burden would be less than the $342 increase to the average EITC credit. With below-average tax credits or above-average taxable spending, some EITC recipients may pay higher taxes under the proposal.

Conclusion

Proposal 1 would make major changes to state tax policy. It would increase the sales and use tax rates, replace the current fuel tax with a new and higher one and increase some vehicle registration fees. All told, this would increase state taxes by $2 billion in 2016.

That increased revenue would largely go to pay for road construction and maintenance. In fiscal year 2016, taxpayers and motorists would devote $1.24 billion to paying down debt owed by the Michigan Department of Transportation and putting more money into the Michigan Transportation Fund. The other 37 percent of new revenue in 2016 would go to public schools, local governments, the state's General Fund and for boosting the earned income tax credit.

Proposal 1 would make several changes to the Michigan Constitution. It would create a new earmark for use tax revenue to be deposited into the School Aid Fund. It would prohibit the use of SAF revenue to

* This would also mean that fuel would sell at wholesale for $3.60 per gallon and increase to the tax's price ceiling the following year. The break-even point would increase annually based on the adjustments in the tax rate.

support public universities, but also add several new allowable uses of the same fund. Additionally, Proposal 1 would create a constitutional exemption from the sales tax for fuel purchased for vehicles that operate on the state's roads and highways. Finally, Proposal 1 would increase the constitutionally allowable sales tax rate from 6 to 7 percent.

With so many moving pieces, it is hard to estimate the impact of this constitutional amendment and series of bills on the typical Michigan resident. A rough cost estimate suggests that a typical household could expect to pay between $477 and $525 more in state taxes in 2016 if voters were to approve Proposal.

It should also be pointed out that the proposed new wholesale tax on fuel is designed to increase at a rate that will exceed inflation. To the extent that the price of road maintenance increases at the same rate as inflation for the Detroit metropolitan area, this feature of the wholesale tax will ensure that road funding will outpace the inflationary increase in road construction costs.

Voting "yes" on Proposal 1 approves these changes to the Michigan Constitution and would put into effect the series of bills that are tie-barred to its passage. Voting "no" would reject these proposed changes and the tie-barred legislation. Based on the projections of future road conditions in Michigan, the state would still need more funding to maintain public roads, so policymakers would probably negotiate new legislative reforms to fund roads if voters reject Proposal 1.

Appendix A: Ballot Language of Proposal 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.

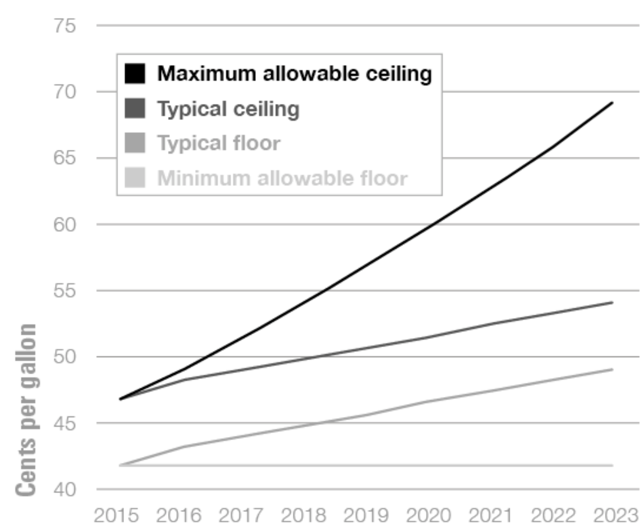
Should this proposal be adopted?

Appendix B: Allowable Wholesale Fuel Tax Rate Projections

Proposal 1 would create a new wholesale fuel tax whose rate would increase based on a formula. The rate is 14.9 percent of the average wholesale price of fuel, but this rate must fall within a specified range. This range is established by the rate floor and rate ceiling, with initial rates of 41.7 cents and 46.7 cents, respectively. The rate floor would increase based on an inflation index (but only between zero and 5 percent), and the rate ceiling would always be 5 cents more than the rate floor.

Graphic 3 shows a projection over time of the minimum allowable rate floor and the maximum allowable rate ceiling. Also included are lines for what might be the typical rate floor and typical rate ceiling based on the past decade's inflation.

Graphic 3: Projected Allowable and Average Wholesale Fuel Tax Rates, 2015-2023

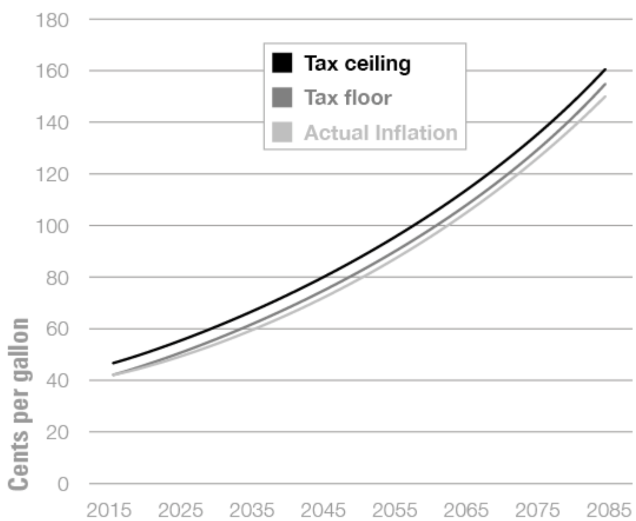


Source: Author's calculations based on Public Act 468 of 2014 and Bureau of Labor Statistics Detroit Metropolitan Statistical Area Consumer Price Index.

The mechanism created by Proposal 1 to adjust the new wholesale fuel tax rate to inflation would ensure adjustments that will exceed inflation. The process subtracts the difference between the index values for the most recent year and the cumulative changes to the rate floor, and yields a percentage increase in the tax rate that would outpace inflation.

Graphic 4 below depicts how the rate floor and rate ceiling would increase if inflation increases at a steady 1.83 percent — the average rate for the past decade. The formula would result in 1.86 percent annual increases in the rate floor for fiscal year 2017. Over time, these small increases in the rate add up to noticeable differences whereby the increases to the rates are higher than average inflation.

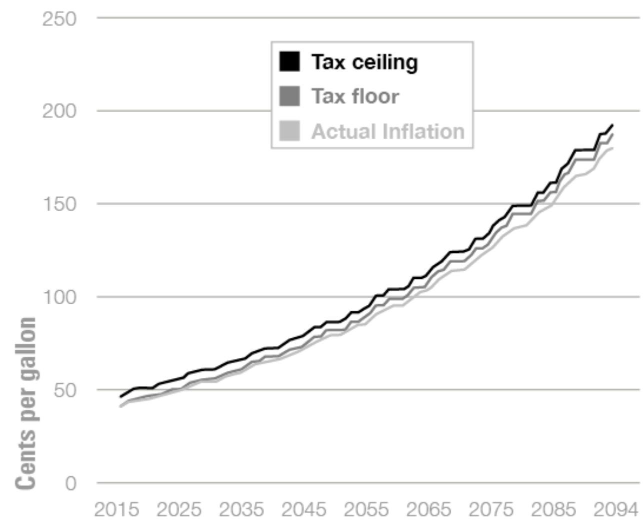
Graphic 4: Projected Wholesale Fuel Tax Rates Based on Average Inflation Rates, 2015-2085



Source: Author's calculations based on Public Act 468 of 2014 and Bureau of Labor Statistics Detroit Metropolitan Statistical Area Consumer Price Index.

But steady increases in inflation are unlikely. Graphic 5 applies the past decade's trends of inflation into the future. In the latter years, the formula commonly produces results that will increase the wholesale fuel tax rate by the minimum and maximum amounts — no change or 5 percent — even though inflation over this period was never lower than 0.38 percent or higher than 3.69 percent.

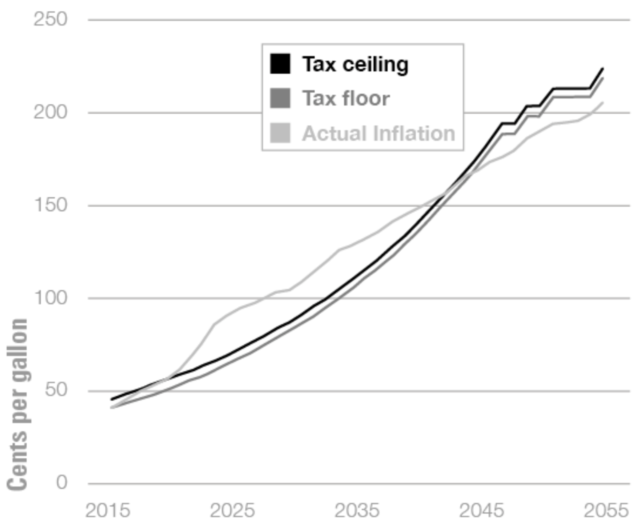
Graphic 5: Projected Wholesale Fuel Tax Rates Based on Recurring 2005-2014 Inflation Rates, 2015-2094



Source: Author's calculations based on Public Act 468 of 2014 and Bureau of Labor Statistics Detroit Metropolitan Statistical Area Consumer Price Index.

Inflation has increased by more than 5 percent in a single year. The rate floor would be limited to a 5 percent increase per year, but the formula meant to track the rate to inflation allows it to "catch up" to cumulative inflation over time. Applying the increases in inflation from 1973 to 2012 — where there was high inflation followed by low inflation — shows that the "brake" performs its function. But the difference between the statutory adjustments to inflation and actual record of inflation remain noticeable. At the end of this period, the rate floor would still be 6.7 percent higher than inflation.

Graphic 6: Projected Wholesale Fuel Tax Rates Based on 1973-2012 Inflation Rates, 2015-2055



Source: Author's calculations based on Public Act 468 of 2014 and Bureau of Labor Statistics Detroit Metropolitan Statistical Area Consumer Price Index.

The inflation-based adjustments to the floor tax rate are permanent. It will increase based on inflation, but will never decrease in the event of a negative inflation rate, or deflation. If wholesale fuel prices drop to an incredibly low price of 50 cents per gallon, for example, the fuel tax would still increase according to the inflation rate. Likewise, if the price of fuel increases, the tax could ratchet up only to the rate ceiling. Thus, while this tax is billed as a "wholesale tax," the price of fuel may not have a large influence on the level of taxation.

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