SENATE FISCAL AGENCY
ISSUE PAPER

**STATE TRANSPORTATION INFRASTRUCTURE INVESTMENT:
PROBLEMS ON THE HORIZON?**

by

Craig Thiel
Fiscal Analyst

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A Series of Papers Examining Critical Issues Facing the Michigan Legislature

Gary S. Olson, Director
Lansing, Michigan
(517) 373-2768
TDD (517) 373-0543

Internet Address: www.senate.state.mi.us/sfa

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Gary S. Olson, Director
Senate Fiscal Agency
P.O. Box 30036
Lansing, Michigan 48909-7536
Telephone (517) 373-2767
TDD (517) 373-0543
Internet Home Page http://www.senate.state.mi.us/sfa/

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INTRODUCTION

In January 2001, the Michigan Department of Transportation issued the third volume of its annual Five-Year Road and Bridge Program covering the period 2001 to 2005, projecting an estimated average $1.5 billion annual transportation investment over the next five years. Despite the planned record amount of funding, the demand for State transportation revenues by road agencies continues to grow. This heightened demand for road and bridge funding stimulates considerable debate in Michigan, regardless of whether the topic is maintenance or building new roads and bridges to address economic development issues. Based on the fact that much of the record level of investment is the result of short- and long-term borrowing, it appears that current State transportation revenues may be insufficient to meet the increasing demand for resources by road authorities. (Note: For the purpose of this discussion, the focus is on State-generated transportation resources and excludes funding from Federal sources, which is budgeted at $659.7 million for the fiscal year (FY) 2001-02 State road and bridge program.)

Growth in the Michigan Transportation Fund since 1997 has generally kept pace with inflation; however, other factors have affected the level of State transportation revenues available to State and local road authorities. Although the State, through long-term bonding, has been able to augment current revenues, borrowing does not provide a permanent revenue source to address the elevated need for transportation resources. While long-term borrowing is primarily responsible for the projected record level of transportation spending over the next five years, it is unlikely the State will be able to sustain such a level when bond proceeds are exhausted unless another permanent revenue increase is enacted. Without such a revenue enhancement, modifications to the State's annual road and bridge program may be necessary.

STATE ROAD AND BRIDGE PROGRAM

The major resources supporting the State road and bridge program include Federal funds, State gasoline and vehicle registration tax revenues, and State bond proceeds. In addition, from time to time, these resources have been supplemented with appropriations from the Countercyclical Budget and Economic Stabilization Fund (BSF).[1] Combined, the resources dedicated to the State program are estimated at $1.5 billion in FY 2001-02. Much of this record level of transportation investment is the result of the Build Michigan III program, which relies almost entirely on long-term borrowing as a financing tool. Figure 1 illustrates the State-generated resources available for road and bridge construction/maintenance through FY 2006-07, assuming a combined annual growth rate of 2% for gasoline tax and vehicle registration tax collections and continuation of the $35 million annual transfer from the BSF to the State Trunkline Fund. These figures do not include the impact of debt service costs on transportation resources (described below).

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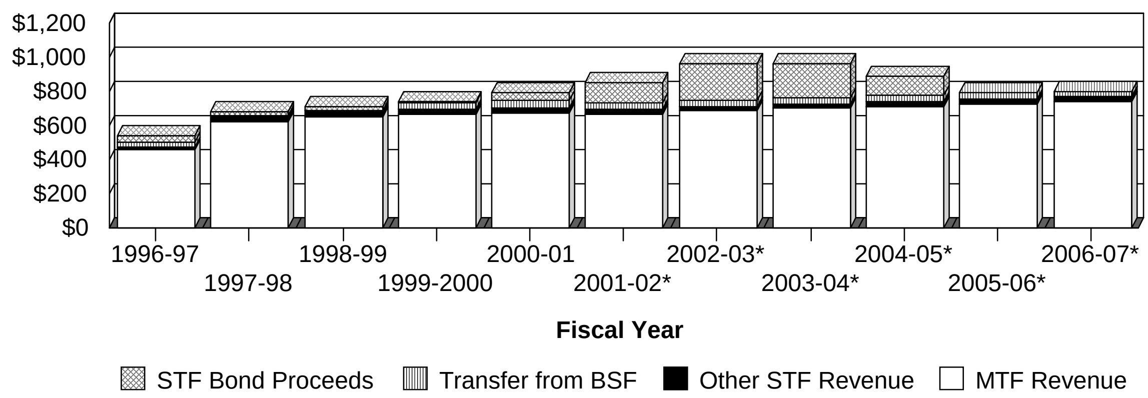
[1] In FY 1996-97 $27 million in BSF revenue was dedicated to State road and bridge projects as part of the Build Michigan II program. In FY 1999-2000, $100 million in BSF revenue was dedicated to State and local road/bridge projects as part of the Build Michigan III program. Also as part of the original Build Michigan III financing plan, from FY 2000-01 through FY 2015-16, $35 million in BSF revenue annually is transferred and appropriated to the State Trunkline Fund. The Governor's FY 2002-03 budget recommendation eliminates this annual transfer.

Figure 1
State Road/Bridge Program Resources
(millions)



* Estimate
SOURCE: Michigan Department of Transportation

As Figure 1 shows, bonding proceeds from the Build Michigan III program (estimated average of $140 million annually) increase substantially the level of resources available for State transportation investment between FY 2000-01 and FY 2004-05. However, the total level of funding available falls significantly in FY 2005-06 after the bond proceeds are exhausted, as borrowing does not address permanent, long-term resource needs. In fact, after the bond proceeds are spent, annual debt service payments must continue to be made, effectively reducing the level of available resources for actual road and bridge construction/maintenance projects. Required debt service payments on Build Michigan III bonds begin in FY 2001-02. Table 1 lists annual State road and bridge debt service costs associated with existing State Trunkline Fund bonds (excluding Critical Bridge, Blue Water Bridge, and Economic Development Fund bonds) and the remaining Build Michigan III bonds ($460 million). Debt service requirements will have increased from 4.7% of dedicated revenue in FY 2000-01 to 11.1% of dedicated revenue in FY 2005-06. If one assumes that long-term borrowing is required to meet the State's annual transportation needs in FY 2000-01 through FY 2004-05, then it could be argued that the annual needs will not be met beginning in FY 2005-06, unless additional resources are identified.[2]

[2] The Federal highway program authorization legislation, the Transportation Equity Act for the 21st Century (TEA-21), is scheduled for reauthorization in FY 2002-03; however, it is unlikely that Michigan will realize the significant increase in Federal funding under the new law that occurred when TEA-21 was enacted.

Table 1

Total State-Generated Resources and Related Debt Service Costs (millions)							
	Fiscal Year						
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
State Resources (after debt costs)	$762.1	$807.2	$899.1	$890.1	$816.3	$713.3	$727.1
Debt Service	35.9	45.3	67.4	78.9	78.9	79.4	79.4
Debt service as % of resources	4.7%	5.6%	7.5%	8.9%	9.7%	11.1%	10.9%

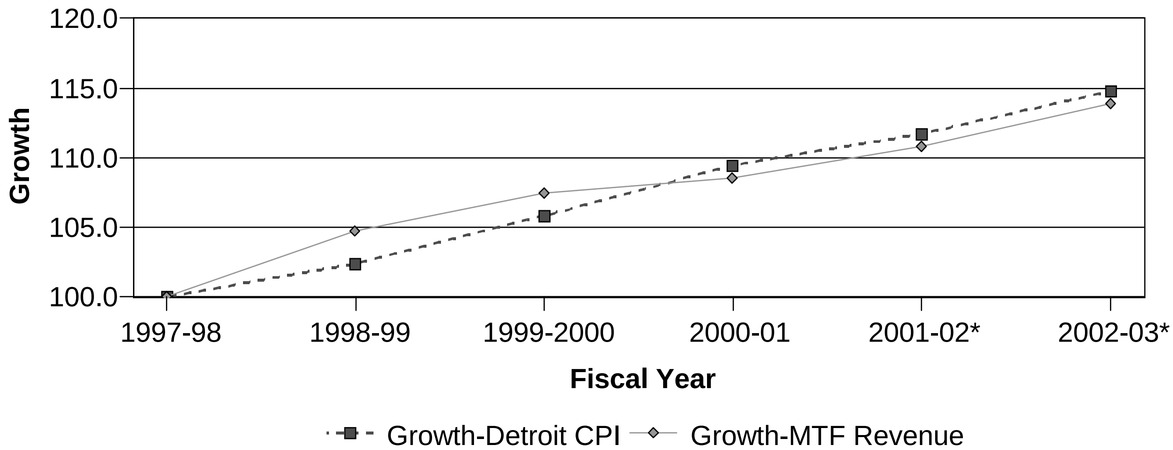
Source: Michigan Department of Transportation, SFA calculations

MICHIGAN TRANSPORTATION FUND GROWTH

The Michigan Transportation Fund (MTF) is the principal recipient of State transportation-related revenues. Article IX, Section 9 of the Michigan Constitution provides that all specific taxes, except the general sales tax and regulatory fees, imposed directly or indirectly on motor fuels and registered motor vehicles must be used exclusively for transportation purposes. Combined, revenue from the State gas tax and vehicle registration taxes accounts for 87% of annual MTF revenue. Pursuant to Public Act (PA) 51 of 1951, as amended, revenues dedicated to the MTF, after the deduction of certain statutory allocations and administrative costs, are distributed among road agencies (State and local) according to a formula. It is estimated that MTF revenue accounts for 55% of the budgets of local road authorities (counties, cities, and villages) and 87% of the total State funds available for the State's road program. The amount of MTF revenue available to road authorities in any given year is a function of MTF revenue growth, statutory allocations, and State appropriation decisions. Statutory allocations from the MTF have not changed since passage of the four-cent per gallon gasoline tax increase in FY 1996-97.

Figure 2 compares the growth in the Detroit Consumer Price Index with the growth in the MTF. Using FY 1997-98 as the base year, the first full fiscal year following the four- cent increase in the State gasoline tax, revenue growth in the MTF outpaced inflation through FY 1999-2000. Beginning in FY 2000-01, however, the growth in the Detroit Consumer Price Index surpassed MTF revenue growth. This trend is projected to continue through FY 2002-03.

Figure 2
MTF Revenue Growth Compared With Detroit CPI Growth
FY 1997-98 = 100



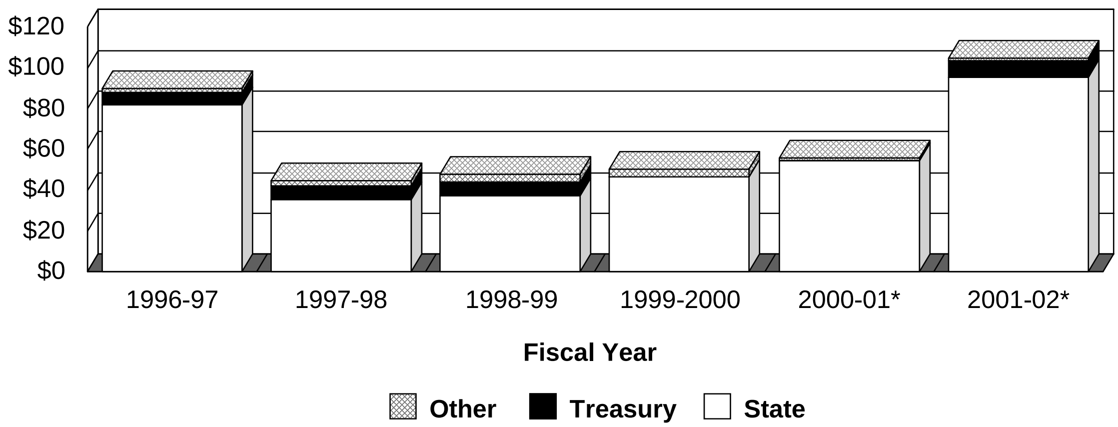
* Estimate

MTF-RELATED ADMINISTRATIVE COSTS

In addition to revenue growth, the amount of MTF dollars available to State and local road authorities is affected also by appropriation decisions, specifically appropriations made for MTF-related administrative costs. Deductions to cover MTF-related administrative costs are distributed before other statutory allocations are made, thereby affecting the total amount of the Fund available for distribution to road agencies. Under the formula contained in PA 51 of 1951, any "off-the-top" deductions for MTF-related administrative costs are borne by public transportation programs, the State road and bridge program, counties, and cities and villages.

Figure 3 shows budgeted MTF grants to State agencies, other than the Michigan Department of Transportation (MDOT), for administrative costs from FY 1996-97 to FY 2001-02. These grants totaled $90.3 million in FY 1996-97. Public Act 79 of 1997, part of the Build Michigan II program, provided for the phase-out of MTF grants to all State agencies except the State Transportation Commission and the Departments of Transportation, Environmental Quality, State, and Attorney General, by the end of FY 1999-2000. In addition, PA 111 of 1997 provided a $43 million fund shift, replacing MTF revenue in the Department of State budget with an equal amount of General Fund/General Purpose (GF/GP) revenue to cover MTF-related costs. This fund shift continued in the annual Department of State budget until FY 2001-02. Together, these pieces of legislation, which were intended to provide more State transportation revenue to road agencies, reduced the amount of MTF allocated to other State agencies for MTF-related administrative costs to $44.6 million in FY 1997-98. Through FY 2000-01, MTF grants to other State agencies had grown to $55.9 million, an increase of 25% from the FY 1997-98 level.

Figure 3
MTF-Related Administrative Grants to State Agencies
(millions)



"Other" includes Attorney General, Auditor General, Environmental Quality, Management and Budget, and State Police
* Budgeted

EXECUTIVE ORDER 2001-9

As part of the solution to balance the FY 2001-02 GF/GP budget, Executive Order (EO) 2001-9 provided an additional $48 million in MTF charges above the enacted FY 2001-02 level for MTF-related administrative costs in the Department of State ($40 million) and the Department of Treasury ($8 million). The increase in MTF funding to the Department of State budget effectively eliminated the $43 million fund shift initiated in the FY 1997-98 budget. These MTF charges will offset GF/GP reductions of equal amounts in the Departments of State and Treasury. The additional charges to the MTF contained in EO 2001-9 increase the total budgeted MTF grants to other agencies to $104.8 million in FY 2001-02, an increase of 135% from the FY 1997-98 level. This increase will reduce, from the FY 2001-02 enacted level, funding to the State and county road commissions by $16.9 million each, cities and villages by $9.4 million, and the Comprehensive Transportation Fund by $4.8 million. These reductions to road agencies and public transportation programs are assumed to be permanent for the foreseeable future. (Note: Public Act 79 of 1997 did not include the Department of Treasury in the list of State agencies eligible to receive MTF grants after FY 1999-2000.)

While the growth of the MTF has generally kept pace with inflation over the past four fiscal years, the growth in MTF grants to other State agencies for administrative costs over the same period has skyrocketed. The majority of the increase is attributable to EO 2001-9. This increase in MTF grants has reduced the amount of State-generated transportation revenue available to road agencies. At the same time that there have been fewer State transportation resources available, there has been an increased demand for such resources at the State and local levels. It appears that the transportation needs of the State and local governments are not being met by current permanent revenue.

TRANSPORTATION BONDING

The State of Michigan, from time to time, has used long-term borrowing to augment transportation funding provided by the MTF. The use of bonding as a financing tool allows the State to generate a significant increase in transportation revenue in the near term without having to raise taxes. Bonding has been used to finance new projects and/or accelerate existing projects. Regardless of its use, bonding suggests that current taxes are insufficient to meet annual transportation needs. Furthermore, bonding does not address the issue of increased, permanent funding for the State's transportation system.

Table 2 lists State Trunkline Fund (STF) bond issues (excluding refunding bonds) since 1989. These issues represent revenues available for road and bridge projects, whereas refinancing bonds are issued to take advantage of lower interest rates in order to retire previous, higher-interest bonds. The amount of STF debt outstanding has more than doubled over the period FY 1990-91 to FY 1999-2000, from $276.4 million to $633.2 million, demonstrating an increase in the use of bonding to finance State transportation projects. During the same period of time, the amount of dedicated revenue to service STF debt has grown by 87.3%, indicating an increased ability to support additional debt.

Table 2

State Trunkline Fund Bond Issues
(exclusive of refunding bonds)

Year Issued	Bond Purpose(s)	Amount
1989	State road and bridge projects; Economic Development Fund	$135,780,000
1992	Build Michigan; Critical Bridge Program	253,618,000
1994	Capital preventive maintenance	150,000,000
1996	Right-of-way purchases; Blue Water Bridge	54,500,000
2001	Build Michigan III (phase 1) *	308,200,000

* This includes approximately $70 million in Economic Development Fund (EDF) bonds issued as part of the program and represents the first of three planned issuances. The State Transportation Commission has authorized the Department of Transportation to issue up to a total of $900 million in STF bonds (traditional and EDF) for the Build Michigan III program.

Source: Michigan Department of Transportation

Table 2 does not include $400 million in short-term Grant Anticipation Notes (backed by future Federal highway revenues) issued in August 2001 to accelerate the Build Michigan II program. These notes, combined with the Build Michigan III bond proceeds, account for a significant portion of MDOT's planned $1.5 billion annual transportation program.

Most recently, the Build Michigan III program was enacted to address, in part, the heightened demand for additional transportation resources.[3] This program relies on bonding and a $100 million BSF appropriation rather than a permanent tax increase to meet current transportation needs (State and local). Under the Build Michigan III program schedule, an estimated annual average of $140 million in STF bond proceeds will be available each year from FY 2000-01 through FY 2004-05 to augment current revenues for the State's road and bridge program. While the estimated $700 million in bonds will provide an influx of short-term revenue, Build Michigan III does not address the long-term resource needs of the State's transportation system. After the bond proceeds are exhausted in FY 2004-05, the State will continue to pay debt service on the outstanding bonds of approximately $47 million annually until FY 2030-31[4]. Debt service payments effectively reduce the amount of State-generated transportation revenue available for the annual road and bridge program (Table 1).

MOTOR FUEL TAXES

Public Act 83 of 1997, part of the Build Michigan II program, increased the State gasoline tax by four cents from 15 cents per gallon to 19 cents per gallon, effective August 1, 1997. The four-cent increase provided an additional $189 million for transportation purposes. Despite considerable pressure to do so, the Legislature did not increase the diesel motor fuel tax when it passed the gasoline tax hike in 1997. Today, the diesel motor fuel tax remains at 15 cents per gallon. Recently, there has been renewed discussion about increasing the diesel motor fuel tax to 19 cents per gallon in order to match the gasoline tax levy and provide additional revenues for transportation investment in the State.

The yield per penny of gasoline and diesel motor fuel tax is displayed in Table 3. Based on FY 1999-2000 data, an increase in the diesel motor fuel tax to 19 cents per gallon would generate an additional $38 million in permanent revenue to the Michigan Transportation Fund. Under current law provisions, the increase in diesel fuel tax revenue would be distributed to the Comprehensive Transportation Fund ($3.8 million), the State Trunkline Fund ($13.4 million), county road commissions ($13.4 million), and cities and villages ($7.4 million).

Each penny of State gasoline tax generates nearly $49 million in revenue for the Michigan Transportation Fund. The tax revenue resulting from a gas tax hike would be distributed in the same proportions as a diesel motor fuel tax increase (described above).

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[3] For a more detailed discussion of the Build Michigan III program, refer to the Senate Fiscal Agency issue paper "State Transportation Bonding And Build Michigan III" at www.senate.state.mi.us/sfa/.

[4] The financing plan for Build Michigan III enacted by the Legislature includes a $35 million annual transfer from the BSF to the STF from FY 2000-01 through FY 2014-15 to cover, in part, the debt financing costs.

Table 3

Michigan Motor Fuel Tax Yields FY 1999-2000			
Fuel	**Revenue**	**Tax Rate (cents)**	**Yield Per Penny**
Gasoline	$921,991,065	19	$48,525,846
Diesel	143,436,547	15	9,562,436

Source: Michigan Department of Treasury.

CONCLUSION

Since passage of the gas tax increase in 1997, growth in the MTF has mirrored inflation; however, the rise in administrative charges to the MTF over the past four fiscal years has seriously cut into the amount of State-generated revenue available for road authorities. In an attempt to provide sufficient resources for transportation investment in Michigan, the State has used long-term borrowing to augment current revenues, which will result in a projected total annual State road and bridge program of $1.5 billion. While borrowing provides significant amounts of funding for road and bridge projects in the short-term, this financing strategy does not address long-term transportation resource needs. Also, after all the bond proceeds are spent, the level of resources available for State projects decreases substantially, while continued debt service payments further reduce the amount of resources available for actual road and bridge construction/maintenance projects. It is unknown whether the Michigan Department of Transportation will be able to sustain, beyond FY 2004-05, its planned $1.5 billion annual investment in the State's transportation infrastructure based on the current level of ongoing State resources. Without a revenue enhancement, modifications to the State's annual road and bridge program may be necessary, possibly before FY 2004-05.