State Notes

TOPICS OF LEGISLATIVE INTEREST

Spring 2015

Sales and Use Tax Collection on Internet Purchases
By Ryan M. Bergan, Fiscal and Legislative Analyst

The rise of the internet has brought about the rise of internet commerce. This has led to ambiguity and controversy regarding sales tax collection. Generally, online retailers are not required to collect sales tax in states where they have no physical presence. That means that many large online retailers do not have to collect sales tax on most of their sales. Brick and mortar retailers say this puts them at a competitive disadvantage. They claim customers walk into the store, ask questions and try out products, and then purchase them online because there is no sales tax.

On the other hand, some retailers claim that it is unreasonable to make them collect taxes on sales from every jurisdiction. Michigan is relatively unique in that local entities are not allowed to impose their own sales taxes. Most other states with a sales tax do allow local units to impose their own, and each local unit could have its own rate as well as its own exemptions to the tax. It is difficult to determine exactly how many different sales and use tax jurisdictions exist in the country, but estimates hover around nearly 10,000.

Besides variances in the rate charged, jurisdictions may differ on their tax administration, such as due dates, the governmental entity to which the tax return must be sent, and the manner of remitting payment or claiming exemptions. They also may have different audit procedures, and vary in the manner of determining where a sale takes place, or "sourcing". When a person buys something in a brick and mortar store, there is no question about where the sale takes place. However, when a person in Michigan buys a product online from a seller headquartered in California, completes the transaction on a server located in Colorado, and has the product shipped from a warehouse in Texas, there is a question as to where the sale actually occurs.

To further complicate matters, sometimes local taxing jurisdictions do not coincide with political or geographic boundaries. For example, a sale made on the north side of a particular street in a community may be subject to the state sales tax, a county sales tax, and a special transportation district sales tax. On the south side of the street, a sale might still be subject to the state and county sales taxes, but not the special transportation tax.

Also, tax statutes often have different definitions for the same terms, which can substantively change the administration of the sales and use taxes. For example, State 1 and State 2 both exempt "food" and tax "candy". State 1 defines candy to include cookies coated with chocolate (e.g., Twix bars) and imposes tax on those cookies. State 2 does not consider cookies coated with chocolate to be candy and exempts them as food. Some states may even treat chocolate-covered cookies differently than cookies that have stripes of chocolate.

Assuming a transaction is taxable, however, if the sales tax is not collected by the retailer, the buyer is still liable to pay use tax, which is a complement to the sales tax. While sales tax is owed for purchasing an item, use tax is owed for using an item where the sales tax has not been paid. It is meant to ensure uniformity of taxation and prevent people from avoiding sales tax by purchasing items from another state with lower or no sales tax. Michigan, like every other state with a sales tax, has a use tax with the same rate as the sales tax. Michiganders who are not charged sales tax on their online purchases are required to pay this tax when they file their State income tax forms, but compliance is very low and it is difficult to enforce. The Michigan Department of Treasury has estimated that $444.0 million in sales and use tax revenue from remote sales will go uncollected in fiscal year 2014-15.[1]

Through recently enacted legislation, Michigan may be able to collect approximately $60.0 million in sales and use taxes per year that it otherwise could not. To put this in perspective, the State collected more than $7.1 billion in sales and use tax in FY 2012-13.

This article will discuss the Michigan legislation in more detail, as well as the constitutional issues involved in collecting tax on out-of-state sales, and other state and Federal legislation on the subject.

Constitutional Issues

Although the internet has led to a vast increase in out-of-state sales, the issue of collecting tax on such transactions is not new. As early as 1827, the United States Supreme Court addressed constitutional limitations on the states' ability to tax interstate commerce.

In order for a state to impose a tax collection requirement on an out-of-state seller, the law must satisfy the Due Process Clause and the "dormant" Commerce Clause.[2] Both require there to be some type of connection, or "nexus", between the state and the remote seller before the state can impose obligations on the seller. The Due Process Clause requires a sufficient nexus so that the state has provided some benefit for which it may ask something in return, and so that the seller has fair warning that its activities may be subject to the state's jurisdiction. The dormant Commerce Clause requires a nexus to ensure that the tax collection requirement does not impermissibly burden interstate commerce.

One of the first prominent decisions on the subject is *National Bellas Hess v. Department of Revenue* (386 U.S. 753), which involved sales by a mail order house. In its 1967 opinion, the U.S. Supreme Court essentially held that, under both the Due Process Clause and the Commerce Clause, a seller had to have a physical presence in a state in order to be required to collect tax on sales made in that state.

In *Quill v. North Dakota* (504 U.S. 298), the Court revisited the issue. This 1992 decision remains the controlling law on interstate taxation. In *Quill*, the Court stated, "[T]o the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings…". The Court supported a flexible approach, in which a seller may have nexus if it has directed purposeful contact at a state's residents. With respect to the Commerce Clause, however, the Court retained the requirement of physical presence in order for an activity to have substantial nexus.

---

[1] Michigan Department of Treasury - *http://www.michigan.gov/documents/treasury/Sales_Use_Tax_Report_2013_September2014_468579_7.pdf*.

[2] The Due Process Clause is found in Section 1 of the 14th Amendment, which prohibits states from denying any person life, liberty, or property without due process of law. The Commerce Clause, in Article 1, Section 8, gives Congress the power to regulate commerce among the states. The "dormant" Commerce Clause is the implicit prohibition against states' passing legislation that discriminates against or excessively burdens interstate commerce.

Determining whether physical presence exists is an issue that the Court addressed in earlier cases. In 1960, for example, the Court ruled that having in-state salespeople or agents was sufficient contact to establish a physical presence.[3] Also, physical presence is clearly established when a company has "brick and mortar" retail stores or offices in the state, even if the in-state offices are not related to the sales activity in question.[4]

Other State Actions

Some companies, such as Amazon.com, have been able to avoid the requirement to collect state sales taxes even though they have corporate offices, fulfillment and warehouse operations, customer service or other facilities in a state. They do this by creating wholly owned subsidiaries for non-sales operations so the subsidiaries' offices do not constitute a physical presence for the parent company that is making sales. This could be prevented if the U.S. Congress required sales or use tax collection for all out-of-state sellers, thus bypassing the physical presence standard. The Court pointed out in *Quill* that Congress has that power as long as the new standard complies with due process.

In the absence of Federal legislation, states have enacted their own laws to require collection from these and other companies that sell to their residents. The laws typically come in one of two types: "click-through" nexus laws and notification requirements.

Click-through nexus statutes require an online retailer to collect use taxes on sales to customers located in the state of the retailer's associates or affiliates, even if the retailer does not have a physical presence in the state. More than 15 states have enacted such laws. The term "click-through" refers to what takes place when an individual or business (called an associate or affiliate) places a link on its website directing internet users to an online retailer's website. For example, Amazon.com has the Amazon Associates program, where website owners can place links for products on their site and earn a referral fee when customers follow the link and buy from Amazon.com.

Arguably, this type of law complies with the *Quill* decision by targeting only internet retailers whose affiliate programs create some degree of physical presence in the state and whose affiliates solicit on the retailer's behalf. On the other hand, one could argue that the one-time action of placing a link on a website does not qualify as ongoing sales activity. A click-through nexus law also could be found unconstitutionally burdensome because it requires remote sellers to potentially monitor thousands of affiliates in order to determine whether the nexus requirements have been met.

The term "affiliate" also can refer to a person or organization that conducts certain activities that are significantly associated with a seller's ability to establish and maintain a market in a state, such as selling a line of products similar to the seller's, operating under the same business name as the seller or a similar name, or maintaining a place of business in the state to facilitate the sale or delivery of products for the seller. This definition is used in many of the laws enacted to prevent companies from avoiding the requirement to collect sales tax by using wholly owned subsidiaries for non-sales operations.

---

[3] *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960).
[4] *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977).

The first such law was enacted by New York in 2008. It requires collection by any entity that solicits business through employees, independent contractors, agents, or other representatives. This includes a "seller [that] enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller", if the seller does more than $10,000 in annual sales.

In 2013, the New York State Court of Appeals (the state's highest appellate court) rejected a challenge to the law.[5] According to the court, "[T]hrough this statute, the legislature has attached significance to the physical presence of a resident website owner. The decision to do so recognizes that, even in the Internet world, many websites are geared toward predominately local audiences…such that the physical presence of the website owner becomes relevant to Commerce Clause analysis…Essentially, through these types of affiliation agreements, a vendor is deemed to have established an in-state sales force." The court also found that "a brigade of affiliated websites compensated by commission" was sufficient to meet *Quill's* standard of "continuous and widespread solicitation within a state". The ruling was appealed to the United States Supreme Court, which declined to hear it.

State laws that take the "notification" approach require remote retailers to provide information to the state and customers, rather than requiring the retailers to collect the taxes themselves. Colorado enacted a notification requirement in 2010. The law imposes three duties on any retailer that does not collect Colorado sales tax, if the retailer's gross sales in Colorado exceed $100,000. The retailer must inform Colorado customers that a sales or use tax is owed on certain purchases and it is the customer's responsibility to file a tax return. The retailer also must send each Colorado customer a year-end notice of the date, amount, and category of purchases made during the year along with a reminder that the state requires taxes be paid and returns filed for certain purchases. Finally, the retailer must provide an annual statement to the Colorado department of revenue for each in-state customer showing the total amount paid for purchases during the year.

The notification law raises several constitutional questions.[6] Since any company with a physical presence in the state would already be required to collect Colorado sales tax, the law applies only to out-of-state companies. This could violate the Commerce Clause because it imposes duties on out-of-state businesses that the state does not require of Colorado businesses. Also, since the law applies to companies that do not have a physical presence in the state, the notification requirements would have to be distinguishable from the use tax collection requirements in *Quill*.

A Federal district court struck down the law in 2012, finding that the notification requirements were "inextricably related in kind and purpose to the burdens condemned in Quill", and these burdens would unconstitutionally interfere with interstate commerce.[7] In August 2013, the Tenth Circuit Court of Appeals dismissed the case, after finding that the Taxpayer Injunction Act prevented Federal courts from hearing it.[8] That law states, "The district courts shall not enjoin, suspend or

---

[5] *Overstock.com v. New York State Dept. of Taxation & Finance*, 20 NY3d 586 (2013).
[6] *"Amazon Laws" and Taxation of Internet Sales: Constitutional Analysis*, Congressional Research Service, 11-28-2014.
[7] *Direct Marketing Association v. Huber*, No. 10-cv-01546-REB-CBS (D. Colo. 3-30-2012).
[8] *Direct Marketing Association v. Brohl*, 735 F.3d 904 (10th Cir. 2013).

restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State."[9]

This decision was appealed to the United States Supreme Court. On March 3, 2015, the Supreme Court ruled that lawsuit was *not* barred by the Taxpayer Injunction Act, finding that the relief sought would not "enjoin, suspend or restrain the assessment, levy or collection of any tax under State law". The Court reversed the judgment of the Court of Appeals and expressed no view on the merits of the claims.[10]

Even if the statutes are ultimately found to be legal, there is still the concern that a retailer may end its affiliate relationships in a state in order to avoid having to comply. Amazon.com has already ended its associates program for residents of Arkansas, Colorado, Maine, Missouri, Rhode Island, and Vermont in response to their legislation. When this happens, the state loses the economic activity that is generated from the relationships, as well as the resulting tax revenue.

Michigan Legislation

On January 15, 2015, Governor Snyder signed into law Public Acts 553 and 554 of 2014, commonly called the "Main Street Fairness" Acts. These laws, which will take effect on October 1, 2015, amend the General Sales Tax Act and Use Tax Act, respectively, to establish affiliate nexus standards for the purpose of requiring out-of-state sellers to collect sales and use taxes for the State.[11] In this way, the laws resemble New York's "click-through nexus" law.

Under Public Acts 553 and 554, a seller that sells to a purchaser in Michigan will be presumed to be engaged in the business of making retail sales under the General Sales Tax Act, or to have a nexus with the State under the Use Tax Act, if the seller or a person (including an affiliated person) conducts certain activities in Michigan that are significantly associated with the seller's ability to establish and maintain a market in this State. Examples include selling a line of products similar to the seller's and doing so under the same business name as the seller or a similar business name, and maintaining a place of business in Michigan to facilitate the sale or delivery of products for the seller.

In addition, a seller will be presumed to be engaged in the business of making retail sales of tangible personal property in this State, or to have a nexus with the State, if the seller enters into an agreement with one or more Michigan residents under which the residents refer potential purchasers, whether by a link on an internet website or otherwise, to the seller, as long as certain thresholds for gross sales are met.

Both presumptions may be rebutted as provided in the Acts.

The Senate Fiscal Agency estimates that this legislation may annually increase State General Fund revenue by approximately $10.0 million, School Aid Fund revenue by approximately $44.0 million, and local unit revenue by approximately $6.0 million, assuming that the legislation is applied broadly and that affiliate networks are not dissolved or restructured in response to the amendments.

---

[9] 28 U.S.C. §1341.
[10] *Direct Marketing Association v. Brohl* (575 U.S. ___).
[11] See *http://legislature.mi.gov/doc.aspx?2013-SB-0658* for a more detailed description.

Streamlined Sales and Use Tax Agreement

To encourage voluntary collection and remittance of taxes by out-of-state vendors, the National Governors Association and the National Conference of State Legislatures came together in 1999 to simplify and modernize sales and use tax collection. The product of their work is the Streamlined Sales and Use Tax Agreement (SSUTA). It is a voluntary agreement among member states designed to make it easier for sellers in the states to collect sales tax from residents of all other member states in exchange for simplifying their sales tax laws. To become a member, a state must take measures such as setting its rates at one general rate per state, with a second rate on food and drugs, and a single local rate per jurisdiction. The state also must agree to uniform definitions for categories of goods, adopt common state and local tax bases within the state, and agree to a uniform sourcing rule for goods and services and state-level administration of local sales and use taxes. There are many other features of the agreement not discussed here.

If a seller registers to collect sales tax under the agreement, the seller must collect tax from residents in all full member states, including states that become full members at a later date. The seller also may choose to collect tax for associate member states. An associate state is one that has signed on to the agreement, but is not yet in full compliance. Currently, there are 23 full member states, including Michigan, and one associate member state. In exchange for registering, the seller can receive amnesty from liability for prior sales, regardless of whether the seller had nexus with a particular state. The seller also has access to certified sales tax administration software that may be subsidized by the states, the simplicity of having one identification number to file and pay taxes in all member states, and a central location to update registration information with all the states at once.

Since SSUTA registration is voluntary, the supporters of the agreement have had only limited success signing up retailers. Federal action is necessary if collection by remote sellers is to be mandated. One of the primary goals of the SSUTA is to make sales tax collection simple enough to eliminate the argument by businesses that collection for other states is too burdensome. Eliminating that burden also could make it easier for the United States Congress to justify requiring sellers to collect and remit sales tax for customers in all states with the tax.

Federal Proposals

The United States Congress has taken up the issue of sales and use tax collection by out-of-state sellers several times since 2000. Most recently, two competing proposals have been introduced, one in the Senate and one in the House of Representatives. Each of the proposals attempts to make it feasible for businesses anywhere in the country to collect sales and use tax for any state in the union. The biggest difference between the proposals has to do with the sourcing of the sale.

There are two sourcing methods currently used with remote sales: destination sourcing (the sale is considered to take place in the location that the buyer takes possession of the merchandise) and origin sourcing (the sale is considered to take place in the location of the seller). There are philosophical reasons for each approach as well as practical concerns with implementation. Philosophically, when something is bought online, the question is whether the sale is taking place wherever the customer is using the internet, or whether he or she is virtually "traveling" to the store of the seller, much as a consumer might drive to a store in another state.

These philosophical differences as well as the practical matter of collection have led to two very different proposals. The Online Sales Simplification Act uses what it refers to as a hybrid-origin sourcing rule for sales and use tax collection. Under this proposal, remote sellers would collect sales tax at their local rate, regardless of the buyer's location. The only information they would be required to collect would be the amount of the sale, and the buyer's state and zip code. The sellers then would send the tax revenue to a clearinghouse within the state, which would determine how much tax was collected from residents of each state and send the appropriate amount of revenue to that state.

This proposal would simplify collection by requiring each seller to be familiar only with the sales tax requirements where it conducts business, and a seller could be audited only in its home state. However, several problems with this collection process have been identified. One is how to deal with sellers located in states that do not collect sales tax. If those businesses did not have to collect tax for out-of-state buyers, internet retailers would have an incentive to relocate to those states, which could lead to a "race to the bottom" among states with regard to sales tax rates. On the other hand, if a standardized collection rate were applied to sellers in those states for out-of-state buyers, the Federal government would be imposing a collection burden on the businesses that their home states decided they should not have. Arguably, the proposed law also could violate due process because if the sale takes place where the buyer is using the internet, that buyer may lack the minimum contact with the taxing state to justify being charged sales tax.

The other key proposal is called The Marketplace Fairness Act (MFA), and it passed the U.S. Senate in 2014. The proposal is different than Michigan's Main Street Fairness Act, which requires collection of sales tax from out-of-state sellers if they have sufficient nexus with Michigan. The MFA would allow any state to require sales tax collection by out-of-state sellers if the state "simplified" its sales tax system, either by becoming a member of the SSUTA or by adopting specific changes to its sales tax system. It is argued that calculation of sales tax on internet sales (particularly with the proposed simplifications) would be easily achieved with software. Mail-order retailers have complained, however, that since their customers must calculate sales tax manually, it would not be simple for them. Also, it is possible that the information that a seller would have to provide for all taxing jurisdictions could be larger than the catalogue to which it was attached. The legitimacy of this argument could depend on how successful the MFA was in reducing the number of tax rates and exemptions through its required simplification. Another major objection that has been raised is that the MFA would violate principles of federalism, imposing "regulation without representation", because retailers would be subject to burdens imposed by states in which they have no presence or political voice.

Neither of the proposals would require tax collection by firms located in other countries. They would require sellers located in one of the 50 states to collect and remit sales tax for the other states, but if a seller moved to another country, there does not seem to be a way to mandate collection. If sellers chose to relocate outside of the country to avoid collecting sales tax from buyers, even Federal legislation would be insufficient to force compliance.

Conclusion

A large amount of sales tax revenue is lost due to internet sales. While customers are required under current law to calculate and remit use taxes to their state on these sales, enforcement is difficult and compliance is very low. Many states, including Michigan, have taken action to collect a larger share of this revenue, but they are severely limited by the Constitution and judicial holdings. Action by the Federal government would overcome most legal obstacles, but there is considerable disagreement within Congress regarding the best way to organize that collection.

Overview of Governor Snyder's Special Message on Energy
By John Maxwell, Fiscal Analyst

Introduction

On March 13, 2015, Governor Rick Snyder delivered a special message on energy, "Ensuring Affordable, Reliable, and Environmentally Protective Energy for Michigan's Future", which offered a wide-ranging framework for the electricity and natural gas market in Michigan. The message covers the prices of electricity and natural gas, a discussion of the impacts of energy waste in the current system, concerns over electric and natural gas retail reliability, an outline of the energy system composition, and a section on environmental protection. The message also provides several "call to action" options for corrective behavior. This article will analyze some of the electricity and natural gas proposals in Governor Snyder's special message and examine experiences in other states. According to the U.S. Energy Information Administration (EIA), in 2012, Michigan produced 2,683 trillion British thermal units (BTU).[1] Twenty-six percent of Michigan's energy consumption is in the transportation sector, which is not a direct part of the Governor's special message. Within the special message there are four main themes with specific items in each theme. This article reviews a few of the topics in the special message including: energy waste, on-bill financing, and potential changes resulting from the Clean Power Plan.

Background

Setting energy policy and, more precisely, electricity and natural gas policy, often involves the use of key words like "affordability", "reliability", "clean", or "environmentally friendly" to demonstrate priorities and overall goals for a policy. On the surface, the following are typical statements for many energy policy initiatives in the United States:

"…Michigan's energy policy…will continue to safeguard Michigan consumers and utilities by ensuring an adequate energy supply at reasonable rates."[2]

"WHEREAS, it is critical to the public health, safety, economic welfare of the State of Michigan to have reliable, safe, clean, and affordable supplies of energy;"[3]

"We need to make sure that when we make those decisions, we have the right process to ensure the decisions focus on the pillars of a strong energy future: affordability, reliability, and protection of the environment."[4]

These priorities and goals are at times in conflict with each other. For example, if an energy system is to be reliable, it must build in excess supply that may be used only for a few hours on a few days per year. That means that the costs to keep these "peak" plants operational are charged to the ratepayer even if those plants never provide any load to the grid in a given year.

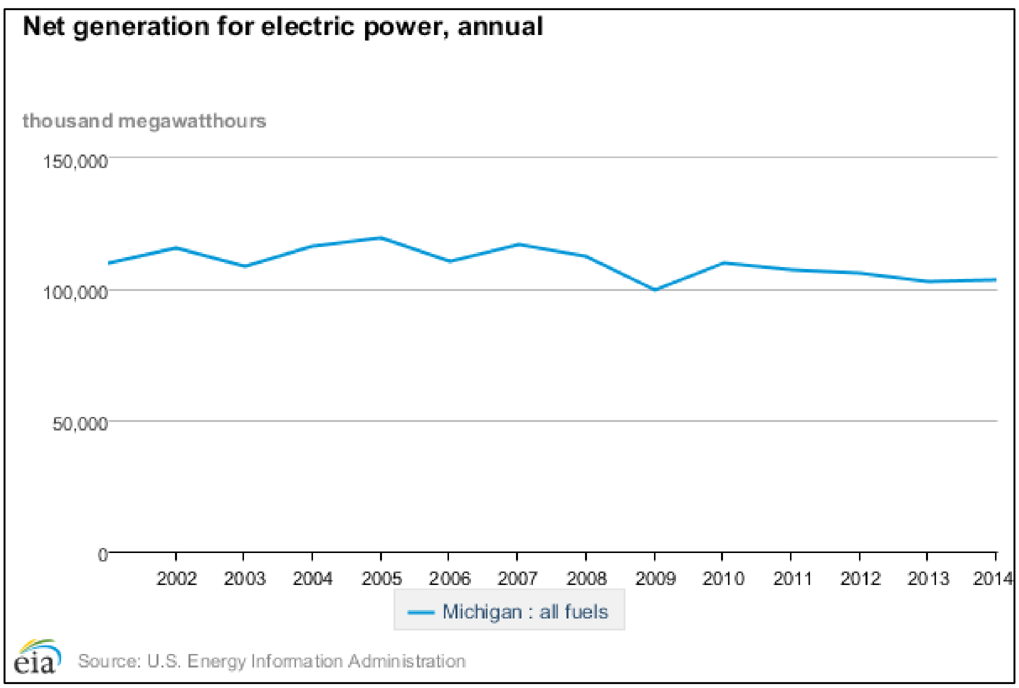
---

[1] U.S. Energy Information Administration, Michigan, State Energy Data Systems (SEDS)
[2] Governor John Engler, *South Bend Tribune* Michigan Briefs (Indiana), January 11, 2001
[3] Governor Jennifer Granholm, 21st Century Energy Plan - Executive Directive No. 2006-2, April 6, 2006
[4] Governor Rick Snyder, "Ensuring Affordable, Reliable and Environmentally Protective Energy for Michigan's Future"

Any electricity or natural gas policy will involve trade-offs to optimize the "values" and "norms" for a given system. Constraints are imposed by a fixed infrastructure delivering commodities, necessitating a required profitable rate of return for the utility. This ensures that supply is available when it is needed. Under this type of market, in Michigan from 1960 through 2000[5], total energy used in the electric power sector increased by 270%, but from 2000 to 2012 the increase was only 2.9%. (See Appendix 1.)

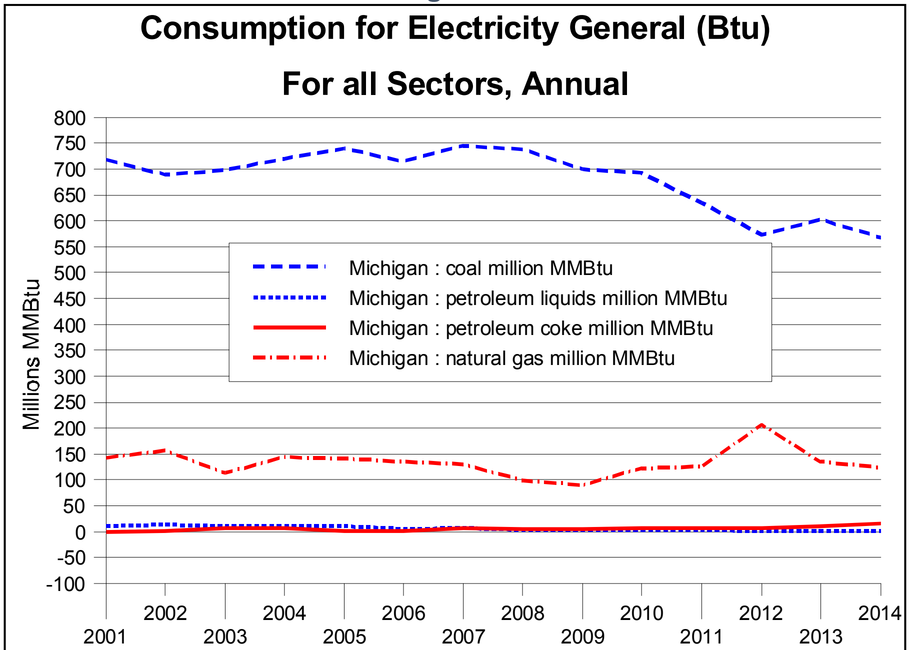
While this slow growth corresponds to recessionary pressures in Michigan, the growth in electricity demand has slowed nationwide. As stated in the 2014 U.S. Energy Information Administration's Annual Energy Report: "Growth of electricity demand (including retail sales and direct use) has slowed in each decade since the 1950s, from 9.8%/year from 1949 to 1959 to only 0.7%/year since 2000."[6] (See Figures 1 and 2.) As electricity demand has stagnated, the ability to spread capital cost across a growing ratepayer base has been diminished; this means that any new generation asset is paid for by a fixed pool of ratepayers. Both net electricity generation and natural gas consumption have seemingly hit a plateau in Michigan. (See Appendix 2.) To replace aging generation assets required to meet minimum base load requirements as well as Federal standards, utilities nationwide must determine the proper allocation of capital and the resulting cost recovery plans. Optimizing the utility business and impacts on society under several constraints creates trade-offs under which priorities of stakeholders will be debated and ultimately lead to a policy framework.

Figure 1



[5] See Note 1
[6] http://www.eia.gov/forecasts/aeo/MT_electric.cfm

Figure 2



Source: U.S. Energy Information Administration

Waste Elimination

Elimination of energy waste, otherwise known as energy efficiency, is projected by the Governor to replace 15% of the State's electricity generation portfolio. The assumption underlying this claim is that there are static energy efficiency savings. In other words, energy saved through efficiency will not be used elsewhere. This assumption is missing a factor, often cited in discussions of increased energy efficiency, known as "the rebound effect". As stated in an editorial in the journal *Energy Policy*: "In its broadest sense, the rebound effect is simply the interaction of energy use with the efficiency of energy use: lower the energy required to do something, and you will do a bit more of that thing."[7]

In practice, the "rebound effect" occurs as an individual operates more energy-efficient products, the per-unit cost of energy declines and, because the marginal cost to operate the product declines, the individual may use more of that product, thus negating some of the energy savings. Though the overall magnitude of the "backfire" or the increased energy use from productivity gains is in dispute[8], the underlying principle that reduction in the implicit energy price will lead to increased demand is fairly well accepted in the literature. Policymakers should keep the "rebound effect" in mind if there is an assumption of large energy savings in any electricity policy framework.

If the goal is 15% reduction from the elimination of energy waste, building in a minor direct and indirect rebound effect of 20% means that a 15% goal from efficiency savings would need a total of 18.75%

[7] Schipper, L., "On the rebound: the interaction of energy efficiency, energy use and economic activity. An introduction." *Energy Policy*, Volume 28, 2000 p. 351-353.

[8] Khazzoom , J. Daniel, "Economic Implications of Mandated Efficiency in Standards for Household Appliances", *Energy Journal*, Volume 1, issue Number 4, p. 21-40 (1980).

savings from the base. If the 15% is the baseline target, the overall energy savings will likely be in the neighborhood of 12% due to the increased demand resulting from an effective lower price. As the assumed savings from waste reduction increase and the implicit price of energy declines, the direct and indirect financial impact from increased energy productivity becomes more uncertain. Static analysis of energy savings requires an effort to estimate the baseline or an expectation that the overall savings will be lower than the baseline goal. At a high level, if legislators rely on a reduction in energy due to more efficiency, building in an assumption of a "rebound effect" is reasonable to estimate the probable impact of that policy.

On-Bill Financing (OBF)

Innovations in energy efficiency financing have led several states, such as California, Georgia, Kentucky, and Minnesota, to create OBF regimes with utilities, public finance entities, and nonprofit groups.[9] In Michigan, Public Act 408 of 2014 updated the mechanism for municipalities to establish energy efficiency programs for residential consumers in municipally owned electric service areas. Previously, this program had been available only to commercial and industrial customers.[10] Additionally, Cherryland Electric Cooperative had participated in an OBF program administered through Members First Credit Union.[11]

The basic idea entails an investment that will deliver energy savings. The debt for the new asset is serviced from the difference between the existing energy cost and the new energy costs from the more efficient asset. The reduction of the energy use becomes realized when energy efficiency improvements are made to the property. In the short run, there is no net reduction in the monthly bill for a ratepayer though there is a reduction of the overall consumption of electricity. Over the long run, with all other things equal, once the note is paid in full the monthly bill would decline. The amount of energy savings likely has an inverse relationship to the total upfront cost of the improvements. As the cost of the improvements increases, the length of the loan increases and the risk to the lender increases as well.

In some states, the utility acts as the lender and, in other states, nonprofit and other quasi-governmental organizations operate as the loan administrator.[12] Some of the advantages for the utilities to provide the OBF programs are obtaining data on the effects of upgrades for energy efficiency and using that information to assist in load planning. Additionally, if the utility is broadening business units into an energy services area, the knowledge gained from an OBF program may allow the utility to operate in a wider consumer space.

One issue that has been raised with the expansion of OBF into multifamily dwelling segments is the practicality of tying the debt to the meter. If a tenant participates in an OBF program without the consent of or advanced notice to the landlord, there may be difficulties with the liability for the obligation if the tenant surrenders the dwelling before the debt is completely serviced. At the outset, if the landlord takes depreciation associated with that asset, it may be difficult for the tenant to install a new furnace.

---

9 http://www.ncsl.org/research/energy/on-bill-financing-cost-free-energy-efficiency-improvements.aspx

10 Public Act 408 of 2014 enacted the Michigan Utility Residential Clean Energy Program Act (MCL 460.961-460.971). A description of the legislation is available on the Michigan Legislature website: http://www.legislature.mi.gov/documents/2013-2014/billanalysis/Senate/pdf/2013-SFA-5397-L.pdf

11 http://www.michigan.gov/documents/dleg/tidbitsmay_319906_7.pdf

12 Ibid.

In a sub-metered apartment where electricity and natural gas charges are added to the rent, this problem is mitigated if the landlord participates in the program. Designing a policy that defines property rights and aligns incentives is critical to the success of an OBF program.

A related area of energy waste elimination financing is known as Property Assessed Clean Energy (PACE)[13]. This method is similar to the on-bill finance regime, but the upfront loan is specific to the property itself rather than to the owner[14]. In Michigan, there are currently two PACE programs operating: one in Ann Arbor and the other in Eaton, Genesee, Grand Traverse, Huron, Ingham, Macomb, Saginaw, Washtenaw, and Wayne Counties.[15] This method has a better track record with commercial properties compared to residential property.

With respect to single-family residential properties, the Federal Housing Finance Agency (FHFA) has issued statements concerning the priority of lienholders. "While FHFA supports energy retrofit financing programs to allow homeowners to improve energy efficiency, these programs must be structured to ensure protection of the core financing for the home and, therefore, cannot undermine the first lien-status of Fannie Mae and Freddie Mac mortgages...In issuing this statement, FHFA wants to make clear…that Fannie Mae and Freddie Mac's policies prohibit the purchase of a mortgage where the property has first-lien PACE loan attached to it."[16] This clarification statement makes participation in the PACE program very difficult for any single-family owner-occupied residential dwelling that has a mortgage. The more likely participants are industrial and commercial building owners that have larger returns from any energy efficiency investment and are not subject to FHFA rules.

Demand Response

One area mentioned in the affordability section of the Governor's special message is demand response or "peak shaving". These strategies are also known as management of the demand side of the electricity market. The main feature of any demand response program is to "…modify [reduce or shift] electricity customer electricity demand".[17] Demand response can be used as a resource planning tool to address electricity or natural gas prices by giving mainly large base load consumers an incentive to shift demand to an off-peak time. These types of programs have the ability to address the issue of resource adequacy without building new generation sources. There are two paths that the demand response programs can follow[18]:

- Direct cost recovery: a regulator-approved structure to facilitate the direct program operation of any demand side management program.
- Performance-based incentive: an allowance for a utility to realize a return for any avoided cost from demand management activities.

---

13 http://energy.gov/eere/slsc/property-assessed-clean-energy-programs
14 http://www.nrel.gov/docs/fy10osti/47097.pdf
15 http://www.pacenow.org/resources/all-programs/#Michigan
16 http://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-the-Federal-Housing-Finance-Agency-on-Certain-Super-Priority-Liens.aspx
17 http://www.dleg.state.mi.us/mpsc/electric/workgroups/demandresponse/aug3_07dte_dr_whitepaper.pdf
18 https://www.michigan.gov/documents/energy/Energy_Efficiency_Question_19_response_from_DTE_418741_7.pdf

One example of a demand response program is for thermostats to "speak" with grid administration and change air conditioner cycle frequencies on days in which the demand peaks are the highest, and thus manage the highest part of the peak in order to maintain grid integrity.

Another idea is that, with the deployment of smart-grid technologies, there is a capability for both real-time pricing and time-of-use pricing for consumers. Both of these pricing mechanisms can create incentives for consumers to shift their demand to off-peak hours when prices are lower. The result of increased demand in off-peak hours is a higher use of base-load generation and thus a greater return than otherwise would be realized. The more the demand is shifted in the intra-day time period, the less the need exists for construction of peak plants. Therefore, in theory, a lower rate for consumers will result. Demand-side management programs and deployment of "smart" home devices enable consumers to receive a more accurate cost of service electricity or natural gas tariff. Policymakers could evaluate the attractiveness of these types of programs and determine whether they fit into Michigan's policy choices.

Potential Responses to Clean Power Plan

On June 2, 2014, President Obama proposed a draft rule seeking to reduce carbon dioxide (CO_2) emissions by 30% below 2005 levels. This rule is known as the Clean Power Plan (CPP). The regulation, which is scheduled to be completed sometime in 2015, uses the Clean Air Act (CAA) as the legal mechanism to regulate carbon dioxide emissions from existing power plants. In 2007, the U.S. Supreme Court ruled, in *Massachusetts v. Environmental Protection Agency* (549 U.S. 497), that the Environmental Protection Agency (EPA) has the ability under Section 202(a)(1) of the CAA to regulate carbon dioxide. According to the decision, the EPA has the ability to regulate CO_2 if, in the EPA administrator's judgment, "air pollution may reasonably be anticipated to endanger public health or welfare". In December 2009, the EPA administrator found that current and projected future concentrations of CO_2 would endanger the public health and welfare of current and future generations. The ruling in *Massachusetts v. Environmental Protection Agency* has led the EPA to issue further restrictions on carbon dioxide emissions. Before the rule was proposed in June 2014, the most recent carbon dioxide regulation was an EPA proposal that would have placed emission restrictions of 1,100 pounds of CO_2 per megawatt hour on new coal-based power plants. The June 2014 proposed rule would expand the September 2013 CO_2 regulation for new plants and additionally regulate existing power plants.

Since the rule is primarily targeted at reducing the amount of carbon dioxide produced per megawatt hour of electricity generated, there are different approaches that the State of Michigan could take to meet the statewide threshold set under the draft rule. In order to allow states to determine their own path to reach the proposed CO_2 standards, the EPA has identified four "building blocks". These building blocks are formulated with the CAA in mind. The CAA provides for the EPA administrator to determine whether "…the best system of emission reduction…has been adequately demonstrated", to ensure that states will reduce pollution that has been identified.

The four building blocks that the EPA outlines are:

1) Making fossil fuel power plants more efficient.
   The EPA's example is making coal plants produce less CO_2 per unit of electricity generated.
2) Using more of low-CO_2 emitting sources.
   The example the EPA gives is using more natural gas in the fuel mix of the electricity generating portfolio.

3) Dispatching a greater number of zero- and/or low-emitting power sources.
   The EPA states that the use of nuclear, wind, solar, and hydroelectric power are ways to achieve this building block.
4) Increasing the efficiency of existing electricity generation.
   The EPA states that a 1.5% annual increase in efficiency would meet this pollution reduction strategy.

Additionally, the EPA allows states to choose whether the reduction is measured in percentage terms or in total amount of carbon dioxide. If a state chooses to reduce total emissions, it can set targets with other states and develop a regional regime to achieve the CPP standard that has been set by the EPA.

Given revisions of previous EPA rules on CO_2 and the CAA, there is a high likelihood that the draft rule will be revised and updated. Under the current draft rule though, the anticipated decision dates for submission of State Plans are as follows:

1. June 30, 2016 – Initial plan or complete plan due
2. June 30, 2017 – Complete individual plan due if state is eligible for a one-year extension
3. June 30, 2018 – Complete multistate plan due if state is eligible for two-year extension (with progress report due June 30, 2017)

The CPP Rule and Michigan

Under the proposed rule, each state will receive a state-specific goal that it must reach by 2030 with "meaningful progress" toward reductions by 2020. Each state will receive a targeted number of pounds of CO_2 per megawatt hour of electricity generated. In 2012, Michigan had 1,690 pounds per megawatt hour. Under the proposed rule, the State will have to meet a standard of 1,161 pounds per megawatt hour of electricity generated. This is a reduction of 31.3% in the CO_2 produced on a per-megawatt-hour basis. In the context of surrounding midwestern states, this is near the average in terms of the reduction required to meet the draft rule.

With the flexibility granted to the states under the draft rule, Michigan has the ability to craft policy and standards that are based on the recommendations of stakeholders and ultimately approved by the Legislature. The states have been issued different sets of reductions according to a formula (which bases the emissions rate on a total amount of CO_2 emissions divided by the amount of electricity generated in that state), as well as how well the states could meet a reasonably set emissions target.

With the target emission in place, the states have the opportunity to determine the policy that will achieve the emissions reduction outcome. If a state refuses to comply with the rule, the EPA will likely mandate a plan independently and, since a Federal agency will be operating within a state, the plan will have a lower degree of flexibility, and achieving the compliance standard could be more costly if it is set by EPA. If the rule survives the legal challenges that are expected, without a Michigan-specific plan, the State risks Federal oversight and an uncertain outcome for coal-fired electric-generating plants in the State.

Depending on the final outcome of the EPA/CPP rule-making process, there might be restrictions on the operational ability of existing coal generation, which could affect coal generation assets in Michigan. One proposed solution to avoid the potential Federal decrees of the CPP is through a multistate compact. The framework created by EPA allows states to partner with each other and with the various stakeholders in the states to develop and administer feasible programs to meet the CO_2 emissions standards set by the EPA for existing power plants. This regime could safeguard a state's rights in the policy architecture and authority.

One advantage to a multistate compact is that many states may find it advisable to participate because "electric systems and electrical resources are commonly shared across state boundaries".[19] One analysis has pegged the cost of the 2030 marginal CO_2 abatement costs without regional cooperation for Michigan at $36 (in 2011 dollars per ton).[20] With Pennsylvania at $39 (in 2011 dollars per ton), Michigan ranks second-highest in abatement costs (without cooperation) compared with other geographically and economically similar states (Wisconsin $33, Minnesota $32, Indiana $13, Ohio $11, Illinois $6, and Iowa $0, all 2011 dollars per ton).[21] Depending on how the regional compacts are structured, the generation assets may have incentives to be located in states with the lowest estimated abatement costs. This is an area in which legislators and policymakers will need to stay well-informed in order to mitigate the risks of any policy action.

Table 1

Selected States Clean Power Plan Compliance Plan			
State	**2012 Rate (lbs/MWh)[22]**	**2030 Estimated Goal (lbs/MWh)[23]**	**Potential % Change**
Minnesota	1,470	873	(40.6)
Wisconsin	1,827	1,203	(34.2)
Illinois	1,894	1,271	(32.9)
Michigan	1,690	1,161	(31.3)
Pennsylvania	1,531	1,052	(31.3)
Ohio	1,850	1,338	(27.7)
Indiana	1,924	1,531	(20.4)

Source: EPA, Clean Power Plan, technical support data file

Conclusion

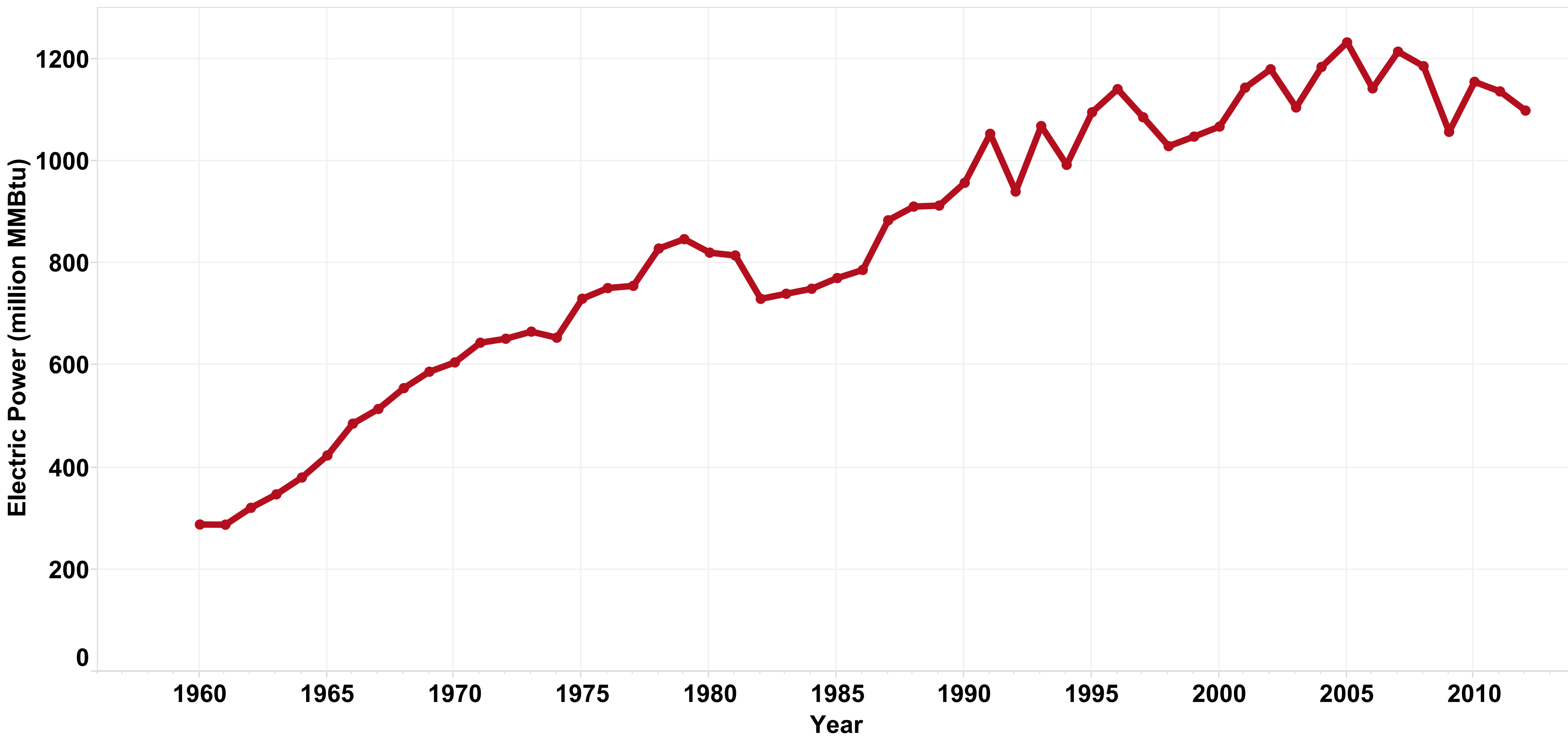
Governor Snyder's special message on energy mentions many strategies and goals. As the topics discussed in this paper demonstrate, there are a number of issues that legislators and policymakers will need to be aware of in the next few years. Depending on how the special message is translated into specific legislation, there are many different impacts that the overall plan may have on Michigan.

There are several considerations to be made and the acknowledgement of trade-offs is a first step in ranking priorities and goals for any policy. Though many ideas have been offered as a solution in the past, most if not all have been unachievable. Though a simplification, the basic question becomes, for any electric or natural gas market, is the market designed to service the marginal peak demand or to cover only the baseline energy needs? If the desire for reliability becomes the priority of the system, will customers accept a higher cost than if the priority of the market were to deliver the lowest rates?

[19] http://www.analysisgroup.com/uploadedFiles/Publishing/Articles/Analysis_Group_EPA_Clean_Power_Plan_Report.pdf
[20] http://www.brattle.com/system/publications/pdfs/000/005/025/original/EPA%27s_Proposed_Clean_Power_Plan_-_Implications_for_States_and_the_Electric_Industry.pdf
[21] Ibid.
[22] http://www2.epa.gov/sites/production/files/2014-06/documents/20140602tsd-goal-computation.pdf
[23] Ibid.

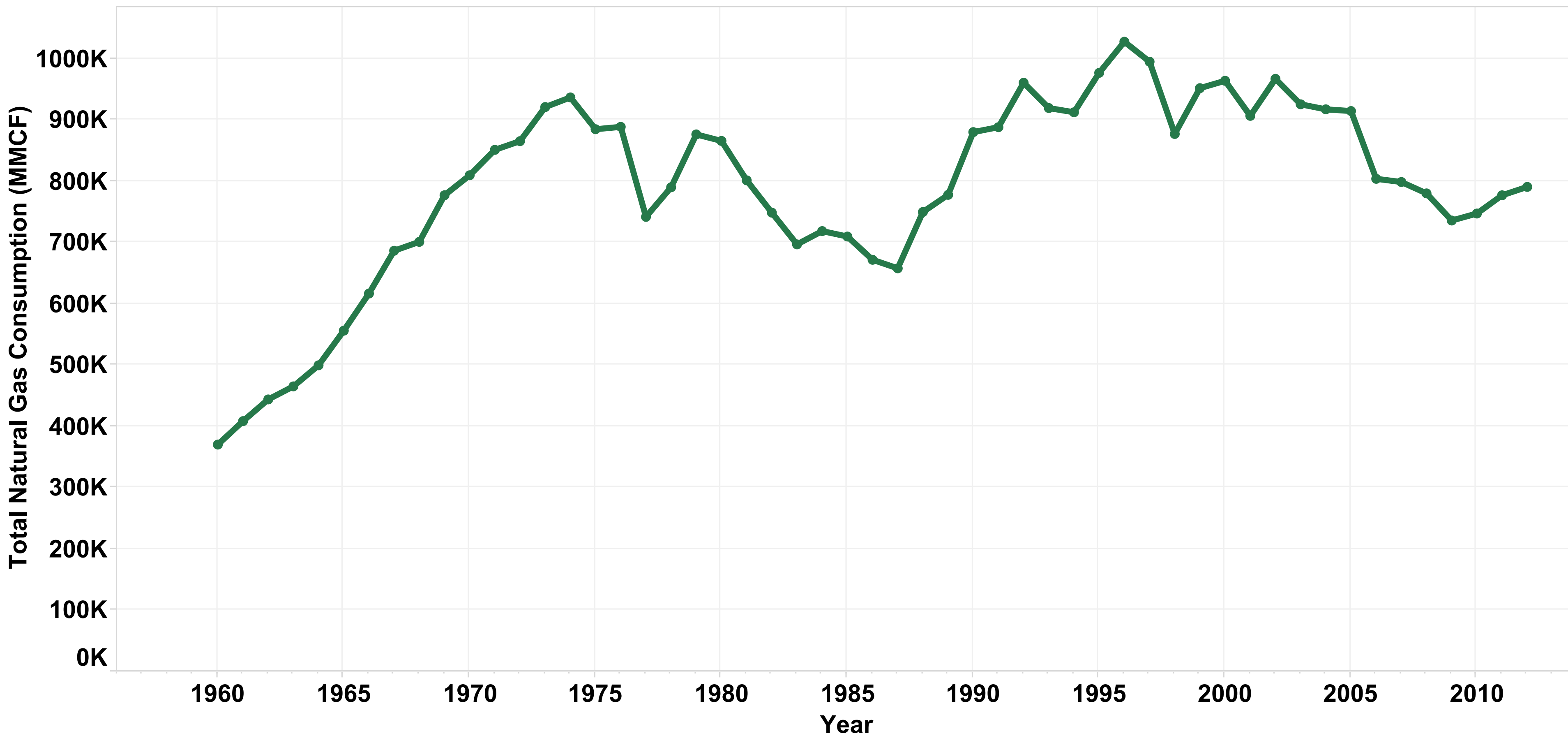
If the system is designed to create the lowest possible rates for consumers, will ratepayers accept the risk that all of their needs might not be met on the days with the highest demand? These are difficult questions for legislators and policymakers, but a recognition of the trade-offs between priorities should frame any debate involving complex decisions and outcomes.

Total Michigan Electric Power Consumption 1960-2012



Appendix 1

Total Michigan Natural Gas Consumption (1960-2012)



Appendix 2

State Notes

TOPICS OF LEGISLATIVE INTEREST

Spring 2015

A History of the Michigan Individual Income Tax Rate

By Elizabeth Pratt, Fiscal Analyst, and David Zin, Chief Economist

The Michigan individual income tax is now the largest source of State tax revenue, with net revenue of approximately $8.0 billion in fiscal year (FY) 2013-14, representing 39% of combined State General Fund and School Aid Fund revenue. In FY 2013-14, the individual income tax provided 62.7% of General Fund/General Purpose revenue and 20.5% of School Aid Fund revenue.

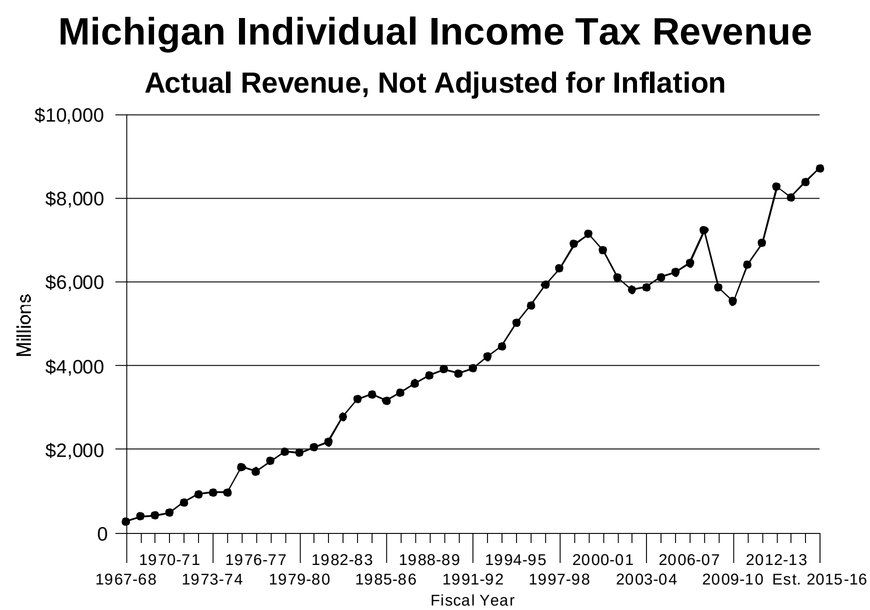
The amount of individual income tax revenue depends on the tax rate, tax base (the Federal adjusted gross income and the additions and subtractions required by Michigan), and the availability of tax exemptions and credits. The structure of the tax is limited by the Michigan Constitution of 1963, which states in Article IX, Section 7: "No income tax graduated as to rate or base shall be imposed by the state or any of its subdivisions." Thus, the Michigan individual income tax is a flat rate tax. It has been levied at a rate of 4.25% since October 1, 2012.

The individual income tax rate frequently is debated by policymakers concerned with the level of taxation and State spending. Since the advent of the tax in 1967, the tax rate has been changed frequently. This article will review the history of the income tax rate, with a focus on the changes made during the last decade.

Individual Income Tax Revenue

The revenue from the individual income tax funds a significant portion of the State budget. In recent years it has provided well over one-third of combined General Fund/General Purpose (GF/GP) and School Aid Fund (SAF) revenue. Figure 1 illustrates the full history of the individual income tax while Table 1 shows the recent history of income tax revenue, with comparisons to combined GF/GP and SAF revenue. Individual income tax collections vary significantly with economic conditions, such as during the recession of 2008-2009, and changes in tax policy, such as the rate reductions implemented from 2000 through 2005. Revenue from the individual income tax has increased in its significance to the State budget over the last decade.

Figure 1



Sources: State of Michigan *Comprehensive Annual Financial Report* (various years)

Table 1

Individual Income Tax Revenue as a Percent of Total General Fund/General Purpose and School Aid Fund Revenue Not Adjusted for Inflation			
Fiscal Year	**Income Tax Revenue**	**Total GF/GP and SAF Revenue**	**Income Tax as a Percent of Total**
1997-98	$6,316.1	$18,437.9	34.3%
1998-99	6,907.9	19,637.0	35.2%
1999-2000	7,144.2	20,569.9	34.7%
2000-01	6,749.4	19,896.5	33.9%
2001-02	6,096.0	19,483.0	31.3%
2002-03	5,811.8	19,611.3	29.6%
2003-04	5,873.4	19,584.6	30.0%
2004-05	6,108.9	20,168.3	30.3%
2005-06	6,226.3	20,313.8	30.7%
2006-07	6,442.7	20,417.4	31.6%
2007-08	7,226.0	21,849.9	33.1%
2008-09	5,856.8	19,209.4	30.5%
2009-10	5,531.3	18,495.5	29.9%
2010-11	6,417.1	20,061.2	32.0%
2011-12	6,921.0	20,125.4	34.4%
2012-13	8,271.8	20,832.2	39.7%
2013-14	8,020.1	20,539.0	39.0%
Est. 2014-15	8,393.5	21,390.5	39.2%
Est. 2015-16	8,719.7	21,976.9	39.7%

Sources: Michigan Comprehensive Annual Financial Reports, Senate Fiscal Agency, and Consensus Revenue Estimates as of January 16, 2015

Revenue from the individual income tax is determined by the interaction of the tax rate and base. The individual income tax base depends on the Federal definition of adjusted gross income; adjustments to income, including deductions (such as the limited exclusion of pension benefits) and additions; credits; and personal exemptions. As a result, the revenue generated by the tax will reflect a variety of economic factors, such as inflation or changes in economic growth. Individual income tax revenue also is sensitive to the tax rate. Based on current estimates, an increase of 0.1% in the individual income tax rate effective January 1, 2015, would increase State revenue by $224.2 million in FY 2015-16. Figure 2 illustrates the history of Michigan's individual income tax revenue, adjusted for the effect of inflation. All of the major swings in revenue shown in Figure 2 reflect either changes in the tax, such as changes in the rate or base, or changes in the economy other than those associated with inflation.[1]

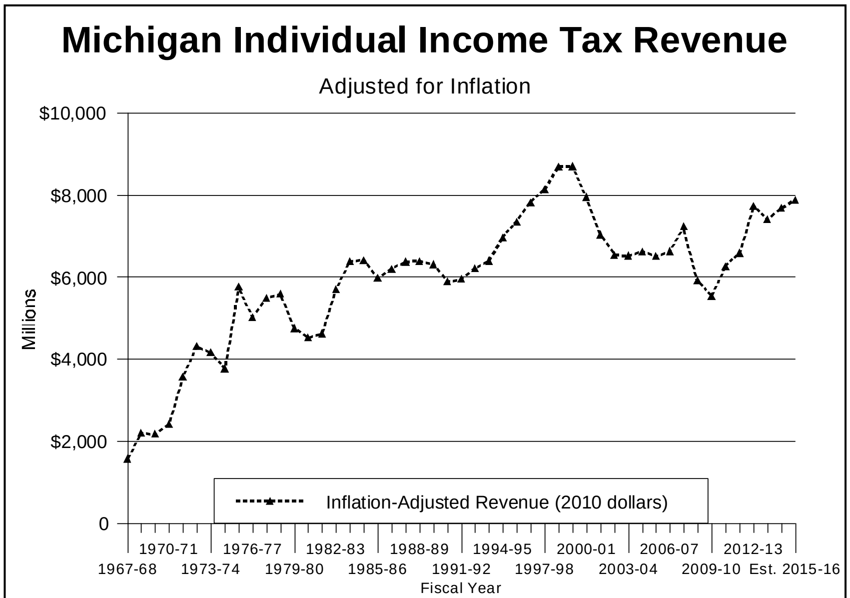
The revenue from the individual income tax primarily has been deposited in the State General Fund; however, there have been earmarks in effect since the inception of the tax. From FY 1967-68 through FY 1995-96, there were allocations made from income tax revenue to revenue sharing for counties, cities, villages, and townships. Initially, 17.0% of the net revenue was allocated to revenue sharing and the remainder to GF/GP revenue; however, the percentage and distribution of the allocation for revenue sharing were amended frequently as the revenue sharing earmark percentage was reduced in response to increases in the income tax rate and State budget difficulties resulted in payment limits, reductions, and

[1] A comprehensive review of changes to the individual income tax was published by the Michigan Department of Treasury. Please see "Michigan's Individual Income Tax 2012", Michigan Department of Treasury, Office of Revenue and Tax Analysis, Tax Analysis Division, July 2014, available as a link from http://michigan.gov/treasury/0,1607,7-121-44402_44404---,00.html under "Tax Reports".

timing shifts. The use of income tax revenue for revenue sharing payments for local units of government ended with the repeal of former MCL 206.481 by Public Act 342 of 1996.

The allocation for revenue sharing was the only earmark from the income tax until the implementation of the Proposal A school finance reforms in 1994. Beginning October 1, 1994, 14.4% of gross income tax collections before refunds were allocated to the School Aid Fund. As of September 30, 1996, the share of income tax allocated to the School Aid Fund increased to 23.0%. That allocation remained in effect until January 1, 2000, when a calculation was implemented to hold the School Aid Fund harmless from changes in the individual income tax rate. The earmark to the SAF is contained in MCL 206.51(2).

Figure 2



Sources: State of Michigan *Comprehensive Annual Financial Report* (various years), U.S. Bureau of Economic Analysis, and U.S. Bureau of Labor Statistics

History of the Individual Income Tax Rate

The Michigan individual income tax was enacted by Public Act 281 of 1967 after years of debate on the need for and merits of an individual income tax. The initial rate was 2.6% effective October 1, 1967. The rate remained at that level until January 1, 1972, when it increased to 3.9% pursuant to Public Act 76 of 1971, which also called for the Act to expire August 1, 1972, unless certain ballot questions were submitted to the voters. However, Public Act 181 of 1972 kept the Act effective with the tax rate at 3.9%.

Public Act 19 of 1975 increased the individual income tax rate from 3.9% to 4.6% from May 17, 1975, through June 30, 1977, after which the rate was to decline to 4.4%. Public Act 44 of 1977 eliminated the sunset on the 4.6% rate, which then remained in effect until mid-1982.

The significant State fiscal pressures of the early 1980s resulted in a period of turbulence in the individual income tax rate, which had ramifications for the Michigan Senate. Public Act 155 of 1982 increased the income tax rate from 4.6% to 5.6% for the period from April 1, 1982, to September 30, 1982, after which the rate returned to 4.6%. Public Act 15 of 1983, however, increased the income tax rate to 6.35% beginning January 1, 1983. The Act included a complicated set of surcharges, adjustments, and economic triggers that would reduce the rate according to a formula over a period of years. This was met with opposition by voters in some areas. Two State Senators were recalled over the issue at separate elections held in late November 1983 in Oakland County and Macomb County. Public Act 221 of 1984 then reduced the tax rate from 6.35% to 5.35% as of September 1, 1984, with a further reduction to 4.6% scheduled for October 1, 1987. However, Public Act 16 of 1986 accelerated the rate reduction by 18 months, resulting in a 4.6% rate as of April 1, 1986.

For the next 15 years, the income tax rate was relatively stable. The income tax rate remained at 4.6% for eight years until Public Act 328 of 1993 reduced the rate to 4.4% as of May 1, 1994. The 4.4% rate endured until 1999.

Following the economic expansion of the 1990s, a phased-in rate reduction was enacted in 1999 (Public Acts 2, 3, 4, 5, and 6 of 1999) to decrease the income tax rate from 4.4% to 3.9% over five years. Public Act 40 of 2000 accelerated the decline by reducing the rate from 4.3% to 4.2% for 2000. The income tax rate declined as planned from 4.4% in 1999 to 4.2% in 2000 and 2001, 4.1% in 2002, 4.0% in 2003, and 3.9% in 2004. The individual income tax rate of 3.9% as of January 1, 2004, was the lowest rate since 1975.

A temporary income tax increase of one-tenth of one percent applied for six months in 2004. Public Act 239 of 2003 increased the rate from 3.9% to 4.0% from January 1, 2004, to June 30, 2004, after which the rate returned to 3.9%

Difficulties in developing the FY 2007-08 budget resulted in a debate between the Governor and the Legislature on increasing tax revenue, and the annual budget bills for FY 2007-08 were not signed into law until November 8, 2007. The tax debate was settled on the last day of FY 2006-07 upon adoption of the conference report on House Bill 5194 (Public Act 94 of 2007) which increased the individual income tax rate from 3.9% to 4.35% as of October 1, 2007. (An expansion of the use tax to certain services also was approved; however, the use tax expansion was repealed two months later, on the day that it was to take effect, and replaced with a Michigan Business Tax surcharge.) The income tax rate was to remain at 4.35% for four years, then decline over six years back to 3.9%.

The rate reductions enacted in 2007 did not occur as planned, however. In 2011, tax reforms enacted under Governor Snyder resulted in a shift in the State tax burden from businesses to individuals. These changes included replacing the Michigan Business Tax with the Corporate Income Tax and making substantial changes to the individual income tax. The individual income tax changes included provisions that reduced the pension income deduction, reduced the earned income credit and the homestead property tax credit, and eliminated most remaining income tax credits such as those for charitable donations or city income taxes. The changes to the individual income tax also scaled back the gradual reduction in the income tax rate. Instead of the reduction from 4.35% to 3.9% over five years, Public Act 38 of 2011 made a single reduction from 4.35% to 4.25% as of January 1, 2013, although Public Act 223 of 2012 subsequently accelerated the rate reduction by three months, to October 1, 2012. Table 2 compares the schedule for future individual income tax rates under the provisions of Public Act 94 of 2007 and the subsequent legislation that has amended that schedule.

Although higher than the rate in effect between January 1, 2000, and October 1, 2007, the current tax rate of 4.25% is lower than the rate levied during most of the history of the individual income tax, including the 25 years between 1975 and 2000. Over the 48-year life of the individual income tax, the median average tax rate levied was 4.4%.

Table 2

Scheduled Individual Income Tax Rates, 2007-2016			
	Individual Income Tax Rates		
Tax Year	**2007 PA 94 In Effect 10/1/2007 to 9/30/2011**	**2011 PA 38 In Effect 10/1/2011 to 9/30/2012**	**2012 PA 223 In Effect 10/1/2012 to Present**
2007	3.90% 1/1 to 9/30 4.35% 10/1 to 12/31	--	
2008	4.35%	--	
2009	4.35%	--	
2010	4.35%	--	
2011	4.35% 1/1 to 9/30 *The rates below did not take effect due to 2011 PA 38.* 4.25% 10/1 to 12/31	4.35%	--
2012	4.25% 1/1 to 9/30 4.15% 10/1 to 12/31	4.35% *This rate ended 10/1/12 due to 2012 PA 223.*	4.35% 1/1 to 9/30 4.25% 10/1 to 12/31
2013	4.15% 1/1 to 9/30 4.05% 10/1 to 12/31	4.25%	4.25%
2014	4.05% 1/1 to 9/30 3.95% 10/1 to 12/31	4.25%	4.25%
2015	3.95% 1/1 to 9/30 3.90% 10/1 to 12/31	4.25%	4.25%
2016	3.90%	4.25%	4.25%

Source: Senate Fiscal Agency

Figure 3 and Table 3 present the history of the average income tax rate levied since the inception of the tax. The annual average rate differs from the statutory number when more than one rate is in effect during a tax year. The average rate is weighted to reflect the time that each rate was in effect. The current tax rate of 4.25% is lower than the rate levied in more than half of the years that the individual income tax has been in effect.

Figure 3

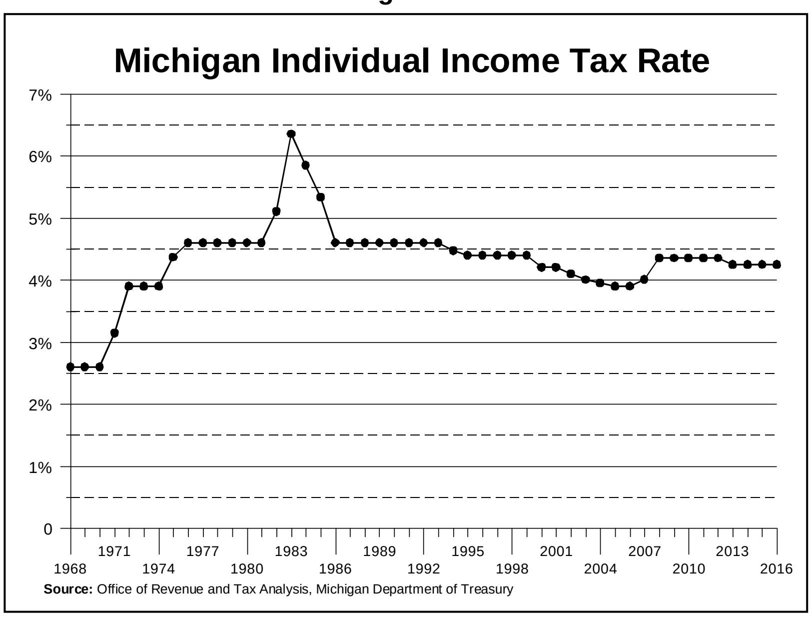


Table 3

Average Annual Individual Income Tax Rate			
Tax Year	**Average Annual Rate**	**Tax Year**	**Average Annual Rate**
1968	2.6%	1992	4.6%
1969	2.6	1993	4.6
1970	2.6	1994	4.47
1971	3.14	1995	4.4
1972	3.9	1996	4.4
1973	3.9	1997	4.4
1974	3.9	1998	4.4
1975	4.37	1999	4.4
1976	4.6	2000	4.2
1977	4.6	2001	4.2
1978	4.6	2002	4.1
1979	4.6	2003	4.0
1980	4.6	2004	3.95
1981	4.6	2005	3.9
1982	5.1	2006	3.9
1983	6.35	2007	4.01
1984	5.85	2008	4.35
1985	5.33	2009	4.35
1986	4.6	2010	4.35
1987	4.6	2011	4.35
1988	4.6	2012	4.33
1989	4.6	2013	4.25
1990	4.6	2014	4.25
1991	4.6		

Sources: Michigan Department of Treasury, Office of Revenue and Tax Analysis, Tax Analysis Division, "Michigan's Individual Income Tax 2012", July 2014 and Senate Fiscal Agency

Comparing the Tax Rate to the Tax Burden

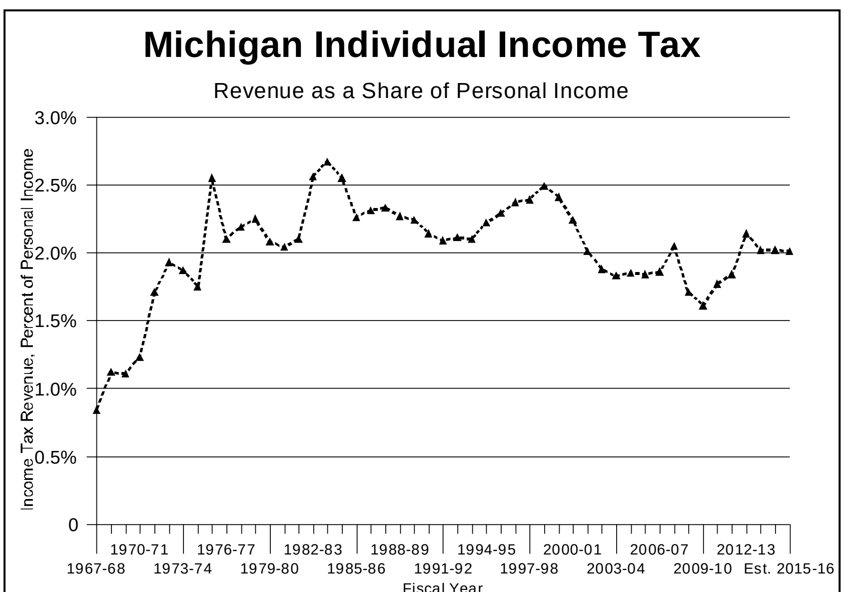
While the individual income tax rate has ranged from 3.9% to 4.4% during the last 17 years, the effective tax rate (the amount of tax collections after refunds divided by taxable income) has been much lower. The existence of personal exemptions and tax credits such as the homestead property tax credit make the effective rate of the tax lower than the nominal rate. Another way to measure the taxpayer impact of the individual income tax is to compare net tax revenue with State personal income. These figures show the tax burden as lower than the effective rate due to the exclusion of various types of income from taxation. The effective rate of the individual income tax, the average rate levied, and the estimated share of State personal income paid in State individual income tax are listed in Table 4. Figure 4 illustrates Michigan individual income tax revenue as a percentage of Michigan personal income.

Table 4

Michigan Individual Income Tax The Average Tax Rate, Effective Tax Rate, and Income Tax as a Percentage of State Personal Income			
	Average Tax Rate	**Effective Tax Rate**	**Income Tax Paid as a % of State Personal Income (Fiscal Year)**
1998	4.4%	2.88%	2.39%
1999	4.4	2.86	2.50
2000	4.2	2.68	2.41
2001	4.2	2.59	2.24
2002	4.1	2.49	2.01
2003	4.0	2.35	1.88
2004	3.95	2.20	1.83
2005	3.9	2.05	1.85
2006	3.9	2.03	1.84
2007	4.01	1.99	1.86
2008	4.35	2.24	2.04
2009	4.35	2.03	1.71
2010	4.35	2.07	1.61
2011	4.35	2.11	1.77
2012	4.33	2.42	1.84
2013	4.25	N/A	2.14
2014	4.25	N/A	2.01

Sources: Michigan Department of Treasury, Office of Revenue and Tax Analysis, Tax Analysis Division, "Michigan's Individual Income Tax 2012", July 2014 and Senate Fiscal Agency

Figure 4



Sources: State of Michigan *Comprehensive Annual Financial Report* (various years), U.S. Bureau of Economic Analysis, and January 2015 Consensus Revenue Estimates

Conclusion

The current individual income tax rate of 4.25% is lower than the median rate of 4.4% that was levied over the nearly five decades that the individual income tax has been in effect. The revenue from the income tax is determined by the tax base, the tax rate, and the availability of targeted tax relief in the form of credits and exemptions. As a result of these provisions, the effective rate of the tax is less than the statutory rate. Over the last decade, the effective rate has been approximately half of the statutory rate.

During the last 15 years, the revenue generated by the tax has represented approximately 2.0% of personal income. However, throughout much of its history, the individual income tax has raised a larger share of State revenue than any other tax. In FY 2013-14, the individual income tax provided 39.0% of General Fund and School Aid Fund revenue. As a result, marginal reductions in the tax tend to have a small impact on taxpayers, relative to their incomes, but a large impact on State revenue. The history of the individual income tax demonstrates that it is frequently changed, suggesting it will continue to be a focal point when issues arise regarding either the budget or tax burdens.

State Notes

TOPICS OF LEGISLATIVE INTEREST

Spring 2015

Allocation of Penal and Civil Fine Revenue
By Suzanne Lowe, Associate Director

Introduction

The Michigan Compiled Laws establish fines for criminal offenses (misdemeanors and felonies) and noncriminal violations that are labeled by statute as "civil infractions" or "state civil infractions". The statutes also establish "civil fines" for other noncriminal violations that are not called civil infractions or State civil infractions. In the case of a criminal offense, a fine may be ordered by the court as part of the sentence after the defendant is convicted. In the case of a violation that is a civil infraction under the Michigan Vehicle Code, or a violation that is designated a State civil infraction, a judge or magistrate may order the defendant to pay a fine either after he or she admits responsibility without a hearing, or after the defendant is found responsible for the violation after a formal or informal hearing has been conducted. For other civil infractions or violations that are subject to civil fines, a court may order a defendant to pay a fine after a hearing or trial. This article addresses what happens to the revenue from the fines after they have been paid.

Nearly two decades ago, the Senate Fiscal Agency published an article on the same subject, "Allocation of Fine Revenue" (*Notes on the Budget and Economy*, May/June 1996). It appears that, since then, there have been few substantive changes in the law pertaining to the disposition of fines imposed for violations of State law that are criminal offenses, civil infractions, and other civil violations. The current article serves as a refresher on the subject, providing background and an updated review of how fine revenue is allocated.

Except as mentioned with respect to municipal civil infractions, this article does not address fines imposed for violations of local codes and ordinances. In addition, the article does not discuss administrative fines (which are often referred to as "civil" but are imposed by an agency after an administrative hearing). The article also does not address costs or other assessments that may be imposed along with fines. Specifically, the focus is on fines ordered by the courts for violations of State statutes.

Overview

The State Constitution, statutory law, and judicial decisions govern the allocation of fine revenue. All penal fine revenue is constitutionally dedicated to public libraries. Fines imposed for State civil infractions and civil infractions, including those under the Michigan Vehicle Code, are statutorily dedicated to public libraries. In many cases, fines imposed for other civil violations are allocated by statute to a specific fund, which may include the State General Fund. If these fines are not specifically designated, they may be credited to the General Fund; the allocation of these fines is not directly addressed by State statute, however, and the potential for inconsistent treatment exists. Table 1 provides a snapshot of fine allocations.

Table 1

Allocation of Fines Imposed for Violations of State Law	
Type of Violation	**Allocation of Fine**
Criminal offense	Public libraries
Civil infraction & State civil infraction	Public libraries
Other civil violations	• Fund specified by statute • General Fund • Other

Criminal Offenses

Beginning with the State Constitution of 1835 (Article 10, Section 4), revenue collected from the violation of penal laws has been dedicated to public libraries. Presently, the State Constitution of 1963 (Article 8, Section 9) states: "The legislature shall provide by law for the establishment and support of public libraries which shall be available to all residents of the state…All fines assessed and collected in the several counties, townships and cities for any breach of the penal laws shall be exclusively applied to the support of such public libraries, and county law libraries as provided by law."

This constitutional requirement is reflected in Section 8379 of the Revised Judicature Act, which states, "(1) Fines and costs assessed in the district court shall be paid to the clerk of the court who shall appropriate them as follows: (a) A fine imposed for the violation of a penal law of this state and a civil fine ordered in a civil infraction action for a violation of a law of this state shall be paid to the county treasurer and applied for library purposes as provided by law" (MCL 600.8379).

Although the Constitution does not clarify what is meant by "penal laws", and whether the term could apply to all provisions imposing a *penalty*, Michigan statutes clearly distinguish between fines imposed for criminal offenses (felonies and misdemeanors) and those imposed for noncriminal, or civil, violations.[1]

Civil Infractions

The term "civil infraction" was first introduced into Michigan statutes, and definitions of the term were added to the Michigan Vehicle Code and the Revised Judicature Act (RJA), when traffic and parking offenses were decriminalized in 1978. Legislation enacted in 1995 added Chapter 88 to the RJA to establish procedures under which a violation of State law may be treated as a "state civil infraction", and an increasing number of violations are designated civil infractions or State civil infractions.[2]

As originally enacted, the term "civil infraction" in the Vehicle Code means, "an act or omission prohibited by law which is not a crime as defined in section 5 of…[the Michigan Penal Code], and for which civil sanctions may be ordered" (MCL 257.6a).[3]

The current definition of "civil infraction" in the RJA is, "an act or omission that is prohibited by law and is not a crime under that law or that is prohibited by an ordinance and is not a crime under that ordinance, and for which civil sanctions may be ordered" (MCL 600.113). This definition includes, but is not limited to, the following:

- A violation of the Michigan Vehicle Code designated as a civil infraction.

---

[1] Also, after legislation providing for civil infractions was enacted, the Michigan Court of Appeals stated in a 1982 opinion, "Civil infractions are not crimes and are not punishable by imprisonment or by 'penal fines'" (*Board of Library Commissioners of the Saginaw Public Libraries v. Judges of the 70th District Court*, 188 Mich App 379).

[2] A list prepared by the State Court Administrative Office identified 82 sections of statute that create State civil infractions, as of May 2014. Subsequently enacted legislation established an additional six State civil infractions; changed an existing misdemeanor to a State civil infraction; and identified one existing civil violation as a State civil infraction.

[3] Section 5 of the Penal Code defines "crime" as "an act or omission forbidden by law which is not designated as a civil infraction, and which is punishable upon conviction by any 1 or more of the following: (a) Imprisonment. (b) Fine not designated a civil fine…" (MCL 750.5).

- A violation of a city, township, or village ordinance substantially corresponding to the Vehicle Code, if the ordinance designates the violation as a civil infraction.
- A municipal civil infraction.
- A State civil infraction.
- A violation of the Pupil Transportation Act designated as a civil infraction.
- A violation of a parking, traffic, or pedestrian ordinance adopted by the governing board of a State university or college, if the ordinance designates the violation a civil infraction.
- A violation of a city, township, or village ordinance adopting the Uniform Traffic Code, if the code designates the violation as a civil infraction.
- A violation of parking regulations adopted by a county board of commissioners.
- A violation of an ordinance adopted under Public Act 235 of 1969 (which governs the control of traffic in parking areas).

It is clear that the term "civil infraction" includes many violations that are not violations of State law. As discussed below, however, the statutes that allocate fines for civil infractions apply only to violations of State law, except with respect to local violations that involve commercial vehicles.

The 1978 legislation also added a section to the Michigan Vehicle Code providing that a civil fine ordered under Section 907 of the Vehicle Code for a violation of the Code or other State statute "shall be exclusively applied to the support of public libraries and county law libraries in the same manner as is provided by law for penal fines assessed and collected for violation of a penal law of the state" (MCL 257.909). (Section 907 governs the imposition of civil fines and costs for civil infractions adjudicated under the Code.)

As noted above, legislation amended the RJA in 1995 to provide for the disposition of State civil infractions. Originally, the RJA defined "state civil infraction" as a civil infraction involving a violation of State law that is designated by statute as a State civil infraction (MCL 600.113). The current definition also refers to a violation of a city, township, village, or county ordinance that is designated by statute as a State civil infraction.[4] Chapter 88 of the RJA, governing State civil infractions, which does not contain a separate definition of the term.

As provided in the Vehicle Code for civil infractions under the Code, Chapter 88 states, "A civil fine which is ordered under Section 8827 for a violation of state statute shall be exclusively applied to the support of public libraries and county law libraries in the same manner as is provided by law for penal fines assessed and collected for a violation of a penal law of the state" (MCL 600.8831).[5] (Section 8827 provides for the imposition of civil fines and costs for State civil infractions under Chapter 88.)

While that language is specific to State civil infractions, Section 8379 of the RJA, as noted above, also dedicates to public libraries "a civil fine ordered in a civil infraction action for a violation of a law of this state". Thus, whether a statute labels a violation a "state civil infraction" or a "civil infraction", the fine revenue is allocated to public libraries if the infraction involves a violation of State law.

---

[4] Although such a violation may be labeled a "state civil infraction" under this definition, it remains a violation of a *local* ordinance. Thus, the fine revenue would not be subject to Section 8831 of the RJA, which directs to public libraries State civil infraction fines for violation of a *State* law.

[5] The statutes contain at least one exception to this requirement. The Playground Equipment Safety Act specifies that a person who violates the Act in the manufacture or assembly of public playground equipment is responsible for a State civil infraction; sets maximum civil fines for violations; and requires the money collected to be deposited in the Children's Trust Fund (MCL 408.685).

In addition, the Vehicle Code states that the provision directing civil fines to public libraries "is intended to maintain a source of revenue for public libraries which previously received penal fines for misdemeanor violations of this act which are now civil infractions". Chapter 88 of the RJA contains language that is identical except that it refers to "misdemeanor violations of state statute which are now designated state civil infractions".

Municipal Civil Infractions

Legislation enacted in 1994 amended the Revised Judicature Act and a number of other statutes governing local ordinances, to provide for municipal civil infractions. This legislation authorizes political subdivisions of the State to treat local violations as "municipal civil infractions", rather than criminal offenses. As a rule, State statutes do not address the disposition of fines collected for local violations, but this revenue traditionally has not been considered penal fine revenue for purposes of the constitutional dedication of penal fines to libraries. According to a 1943 opinion of the Michigan Supreme Court, the issue was settled by an 1877 decision in which the Court held, "[F]ines collected for violations of a city ordinance were not received under the 'penal laws' of the State within the meaning of that phrase as used in the constitutional provision then in effect" (*Delta County v. City of Gladstone*, 305 Mich 50).[6]

Legislation enacted in 2000, however, amended various statutes pertaining to the operation of commercial motor vehicles, to allocate civil fines imposed on commercial vehicle operators for violations of local ordinances governing vehicle operation and equipment. Under the Michigan Vehicle Code, if a civil fine is ordered for the violation of such an ordinance that substantially corresponds to a provision of the Code, the fine must be paid to the county treasurer and allocated as follows: 70% to the local authority in which the citation is issued, and 30% for library purposes as provided by law (MCL 257.909).[7]

Other Civil Violations

Many statutes impose civil fines for violations but do not designate the violations as civil infractions. In some cases, a statute requires the fine to be credited to a particular fund. This occurs, for example, in various sections of the Natural Resources and Environmental Protection Act (NREPA). These sections include Section 21112, which imposes a civil fine for submitting false information when registering an underground storage tank system, and allocates the fine to the Underground Storage Tank Regulatory Enforcement Act; Section 32612, which imposes a civil fine for violations of Part 326 (Great Lakes Submerged Logs Recovery) and dedicates civil fine revenue to the Submerged Log Recovery Fund; and Section 20108, which creates the Cleanup and Redevelopment Fund and requires the Fund to receive money collected by the Attorney General in actions filed under Part 201 (Environmental Remediation). Another example is the Worker's Disability Compensation Act, which allocates to the Worker's Compensation Administrative Revolving Fund civil fines collected from employers who fail to comply with the Act's insurance coverage requirements.

---

[6] The ordinances that the Court addressed in *Delta County* "authorized generally the imposition of a fine or jail sentence and dealt with offenses also punishable under State statutes".

[7] According to the Senate Fiscal Analysis of this legislation (House Bills 4927 through 4932 of the 1999-2000 session), some local units of government reportedly were overzealously enforcing motor carrier laws in order to generate funding for the local governments, since the fines collected for violations of local ordinances were not dedicated to public library purposes.

Other statutes specify that civil fines are to be deposited in the General Fund. These include the Michigan BIDCO Act (MCL 487.1719) and some sections of NREPA. In at least one instance, the law requires a civil fine to be paid to the Attorney General or the prosecuting attorney bringing the action.[8]

In other cases, a statute that imposes civil fines requires money collected or income received under the act to be deposited in a particular fund. Examples of this approach include the State Construction Code Act and the Electrical Administrative Act; both of those laws dedicate the money to the State Construction Code Fund (MCL 125.1522 and 338.889, respectively).

If a statute provides for civil fines but does not dedicate the fine revenue to a specific fund, however, it is possible that a "default" provision of the Management and Budget Act applies.[9] The Act states, "Except as provided by law, all money received by the various state agencies for whom appropriations are made by a budget act shall be forwarded to the state treasurer and credited to the state general fund" (MCL 18.1443). Whether a civil fine constitutes "money received" is unclear; it is possible that the language refers only to fees, administrative fines, other assessments, and other sources of revenue. If a State law establishes a civil fine for a violation but does not allocate the fine revenue, and if an action is brought to enforce the law and a fine is ordered, where that money goes might be subject to the discretion of the court imposing the fine, in the absence of statutory direction.

Conclusion

Statutory provisions that impose civil fines but do not allocate the revenue might be, or might be becoming, an exception to the rule. Increasingly, contemporary statutes either dedicate civil fine revenue to a particular fund or identify civil violations as civil infractions or State civil infractions. In any case, it might be necessary to review an entire statute to determine whether civil fine revenue is, in fact, dedicated to a particular fund, as one or more sections of the statute might set a fine, while another section allocates it. Often, however, the law simply does not indicate where the money is to go.

A related issue is the absence of statutory provisions governing the enforcement of laws that impose civil fines for violations. The Michigan Vehicle Code prescribes procedures for the issuance of citations, admissions of responsibility, informal and formal hearings, and appeals with respect to civil infractions under the Code, and Chapter 88 of the RJA does the same concerning State civil infractions. The Michigan Compiled Laws, however, do not contain similar provisions concerning other civil infractions or civil violations. Thus, it is not clear what procedures (such as discovery) or rights (such as a jury trial) apply. In addition, the party who would bring the action is unclear, as a rule. While it might be reasonable to assume that the department or agency responsible for enforcing an act would be the party bringing an action for a violation, that is not always explicit in the statutes. Also, as discussed above, if an agency does bring an action and the court orders the violator to pay a civil fine, it is not certain whether that fine revenue defaults to the State's General Fund.

It has been suggested that Michigan law would be improved if legislation established an overall enforcement mechanism concerning civil violations, as well as language directing the disposition of fine revenue that is not otherwise allocated.

---

[8] This occurs in the Occupational Code, which provides for an action against someone engaging in a regulated occupation without a license or registration, or operating a barber college, school of cosmetology, or real estate school without being licensed or approved (MCL 339.2412).

[9] For example, the Workforce Opportunity Wage Act (which replaced the former Minimum Wage Law in 2014) prescribes various civil fines but does not indicate where the revenue is to be deposited.