State Notes

TOPICS OF LEGISLATIVE INTEREST

Winter 2015

North American Indian Tuition Waiver Program
By Bill Bowerman, Associate Director

Introduction

Public Act 174 of 1976 provides for free tuition for North American Indians who are residents of Michigan and attend Michigan public community colleges, public universities, and certain Federal tribally controlled community colleges. (The language of the Act is contained in the Appendix to this article.) Since 1981, there have been sporadic efforts to eliminate the program, as well as efforts to fully reimburse institutions for costs incurred pursuant to Public Act 174. In the fiscal year (FY) 2014-15 higher education budget, an additional $500,000 was appropriated to partially offset the difference between State appropriations and actual costs of the tuition waiver. This was the first appropriation of additional funds for the tuition waiver since FY 2007-08. This article provides an update to the winter 2012 *State Notes* article on the North American Indian Tuition Waiver Program. It gives an overview of the program and describes how the difference between appropriations and actual costs developed over time.

Background

The Waiver of Tuition for North American Indians Act, as enacted in 1976, provided for free tuition for full-time students who were legal residents of Michigan for at least 18 months, and were certified by the Michigan Commission on Indian Affairs as one-half quantum blood Native American. The Act did not provide for State reimbursement to public universities and community colleges. In 1978, the Act was amended to require the State, upon application, to reimburse each institution for the total amount of tuition waived during the prior fiscal year. The 1978 amendments also reduced the quantum blood requirement to one-quarter from one-half, reduced the residency requirement from 18 months to 12 months, and extended waivers to part-time students. In 1993, an amendment extended the tuition waiver program to Federal tribally controlled community colleges. This change affected Bay Mills Community College and Saginaw Chippewa Tribal College.

Before FY 1996-97, there was a separate line-item appropriation in the higher education appropriation bill to fund tuition waiver costs incurred by community colleges and universities. In FY 1996-97, the separate line item was eliminated and amounts were rolled into the base appropriations of individual universities and community colleges in order to continue funding costs of the program. The amounts rolled into base appropriations were calculated using a three-year average cost of waivers by institution. This change was made due to indications that then-Governor Engler would veto funding for the North American Indian tuition waivers. Since that time, until FY 2014-15, there was no specific earmarking of funds for Indian tuition waiver reimbursements, with the exception of pass-through appropriations in the higher education appropriation for the Saginaw Chippewa Tribal College and Bay Mills Community College.[1] While Public Act 174 of 1976, as amended, still requires the State to "reimburse each institution for the total amount of tuition waived during the prior fiscal year", that process has not been in effect since FY 1996-97 when the separate line-item appropriation for reimbursement was eliminated.

[1] Article III, Sec. 269 and Sec. 270 of Public Act 196 of 2014. This Act amended the State School Aid Act, which is where annual appropriations for higher education have been made since FY 2011-12.

Funding Disparity

Reductions in State funding for higher education and community colleges, the level of participation in the tuition waiver program, and increases in tuition have contributed over time to the disparity between the actual cost of the program and the amounts built into the base appropriations of individual community colleges and universities. From FY 1996-97 through FY 2013-14, the total cost of waivers for public community colleges increased from $617,391 to $2,065,276 (234.5%). During the same time period, the total cost for public universities increased from $2,026,581 to $8,512,217 (320.0%). Figure 1 and Figure 2 illustrate the difference between State funding and actual waiver costs for community colleges and universities, respectively. The State funding amounts are estimated based on the amounts originally rolled into university and community college operation line items in FY 1996-97, specific adjustments in FY 2007-08 and FY 2014-15, and the impact of across-the-board increases and decreases on amounts in base appropriations.[2]

Educational institutions have absorbed the difference between the amount included in base appropriations and the actual cost of the tuition waivers. While previous higher education budgets, and the FY 2014-15 higher education budget, have included language of intent that funds be allocated for unfunded North American Indian tuition waiver costs, community colleges and universities continue to absorb a large share of actual waiver costs.[3]

Table 1 provides a summary of the FY 2014-15 shortfall in State funding for the Indian Tuition Waiver Program, based on FY 2013-14 actual costs. The first column reflects amounts originally rolled into operating budgets in FY 1996-97. The second column reflects amounts remaining in the base appropriation based on across-the-board adjustments to university and community college operations line items (increases and decreases) and specific appropriations for the Indian tuition waiver since FY 1996-97.[4] The amount necessary to fund the entire cost of tuition waivers issued by community colleges and universities totals approximately $10.6 million, almost $5.8 million more than the estimated amounts remaining in the base budget of educational institutions.

The shortfall in State funding for the North American Indian tuition waiver costs has a varying impact on institutions, as shown in Table 2. The shortfall represented as a percentage of FY 2014-15 State appropriations for community colleges' operations equates to less than three-tenths of a percent for 16 colleges. However, the shortfall in State reimbursements for North American Indian tuition waivers equates to 5.4% of State funding for North Central, 3.4% for Mid Michigan, 2.3% for Northwestern, and 1.8% for West Shore. For nine universities, the shortfall represents less than five-tenths of a percent of their State appropriations for operations. However, the shortfall represents 2.5% of State appropriations for Lake Superior State University, 1.0% for Central and Grand Valley, and just under 1.0% for Northern, Ferris, and University of Michigan-Flint.

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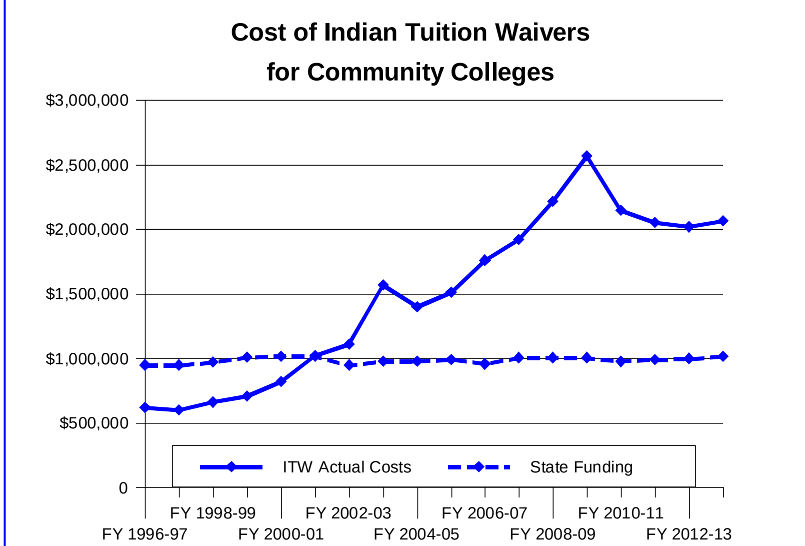
[2] Across-the-board increases and decreases to operations line items do not include funding adjustments based on performance measures.

[3] Article III, Section 268 of Public Act 196 of 2012.

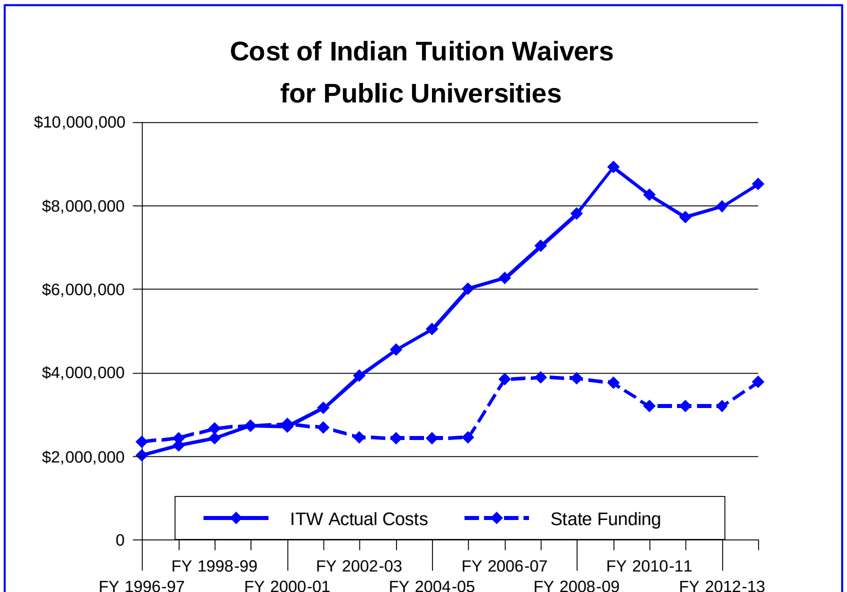
[4] In FY 2007-08, university operation line items were increased by $1.4 million in recognition of increasing costs of the tuition waivers. In FY 2014-15, a separate $500,000 appropriation was included to partially offset the disparity between actual costs and appropriations.

Figure 1



Source: Workforce Development Agency and annual appropriations

Figure 2



Source: Higher Education Institutional Data Inventory and annual appropriations

Michigan Constitution, Article I, Section 26

On November 7, 2006, the electors approved an amendment to the Michigan Constitution that prohibits the State, public universities, community colleges, school districts, and other political subdivisions and governmental instrumentalities from discriminating against, or granting preferential treatment to, any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public employment, public education, or public contracting. (The language of the amendment is contained in the Appendix.) There is a legal argument that the North American Indian Tuition Waiver fulfills the State's trust responsibility that is upheld in the Comstock Agreement[5], and therefore is excluded under the provisions of Article I, Section 26 (i.e., the preference is based not upon an individual's race or national origin, but instead upon his or her political status, or affiliation with his or her tribe, and in turn, the tribe's government-to-government relationship or sovereign status). Based on this interpretation, beginning on July 15, 2010, the Michigan Department of Civil Rights has granted waivers only to individuals who are enrolled members of federally recognized tribes and are not less than one-quarter Native American blood quantum.[6] Since that time, 174 applications for tuition waivers have been denied because the tribe of the applicant was not federally recognized. In 2007, the Michigan Attorney General was asked whether Public Act 174 of 1976 was constitutional, specifically in relation to Article I, Section 26. The Attorney General advised that in a situation in which legal questions involve potentially disputed factual issues, resolution by the judicial branch is the appropriate course.[7]

Conclusion

Efforts to eliminate the North American Indian tuition waiver date back to the early 1980s. In FY 1996-97, the threat of a gubernatorial veto resulted in the elimination of the separate line-item appropriation for the program. Because the costs of the program have been rolled into the base appropriation for each institution, community colleges and universities have absorbed a substantial portion of the cost of the North American Indian tuition waiver. The 2006 amendment to the Michigan Constitution has generated questions regarding the waiver program. While resolution of the funding issue is the prerogative of the Legislature, resolution of legal issues surrounding the waiver program will in all likelihood, as stated by the Department of Attorney General, require a judicial determination.

Sources

Indian Tuition Waiver Program, Michigan Legislative Service Bureau Legislative Research Division Research Report Volume 20, Number 3, May 2000

Michigan Department of Civil Rights

Michigan Workforce Development Agency

Fiscal Year 2014-15 Higher Education Appropriations Report

[5] The Comstock Agreement refers to a 1934 letter from then-Governor Comstock to the U.S. Secretary of the Interior, in which the State accepted property known as the Mount Pleasant Indian School on the condition that "the State of Michigan will receive and care for in State institutions Indians resident within the state on entire equality with persons of other races…".

[6] The Michigan Commission on Indian Affairs was abolished by Executive Reorganization Order No. 1991-20. Its powers and duties were transferred to the Director of the Department of Civil Rights.

[7] July 9, 2007, letter from Attorney General Mike Cox to State Representative Michael Sak. In January 2015 the Department of Attorney General reported that its position on this issue has not changed since the 2007 letter.

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Winter 2015

Table 1

NORTH AMERICAN INDIAN TUITION WAIVER FY 2014-15 Appropriations Compared to FY 2013-14 Actual Costs[1)]				
Community Colleges	**Amount Included in FY 1996-97**	**Adjusted ITW Funding in Base**	**FY 2013-14 Actual Cost**	**Difference**
Alpena	$9,800	$10,606	$26,727	$16,121
Bay de Noc	69,000	74,677	124,347	49,670
Delta	41,400	44,806	21,587	(23,219)
Glen Oaks	3,100	3,355	0	(3,355)
Gogebic	14,100	15,260	45,536	30,276
Grand Rapids	73,000	79,006	286,744	207,738
Henry Ford	73,900	79,981	38,110	(41,871)
Jackson	16,700	18,074	86,381	68,307
Kalamazoo Valley	33,600	36,365	48,647	12,282
Kellogg	13,400	14,503	21,889	7,386
Kirtland	9,100	9,849	16,246	6,397
Lake Michigan	8,000	8,658	29,674	21,016
Lansing	66,600	72,080	137,446	65,366
Macomb	73,300	79,331	26,150	(53,181)
Mid Michigan	10,900	11,797	169,139	157,342
Monroe	1,900	2,056	5,686	3,630
Montcalm	1,400	1,515	13,592	12,077
Mott	50,600	54,763	42,930	(11,833)
Muskegon	31,000	33,551	95,684	62,133
North Central	40,300	43,616	214,602	170,986
Northwestern	110,500	119,592	326,532	206,940
Oakland	54,300	58,768	40,592	(18,176)
St. Clair	26,400	28,572	32,254	3,682
Schoolcraft	29,300	31,711	46,246	14,535
Southwestern	12,900	13,961	53,782	39,821
Washtenaw	30,500	33,010	32,359	(651)
Wayne County	24,900	26,949	30,863	3,914
West Shore	6,600	7,143	51,531	44,388
Subtotal	**$936,500**	**$1,013,555**	**$2,065,276**	**$1,051,721**
Universities				
Central	$144,117	$343,799	$1,159,337	815,538
Eastern	103,478	152,835	218,473	65,638
Ferris	156,380	222,620	636,275	413,655
Grand Valley	114,121	310,372	915,137	604,765
Lake Superior	276,146	434,723	750,512	315,789
Michigan State	313,968	508,060	1,109,472	601,412
Michigan Tech	58,509	111,554	262,492	150,938
Northern	264,054	386,803	765,402	378,599
Oakland	50,610	107,793	293,848	186,055
Saginaw Valley	37,266	66,145	146,817	80,672
U of M-Ann Arbor	432,567	530,220	774,564	244,344
U of M-Dearborn	58,541	79,265	160,123	80,858
U of M-Flint	54,531	85,396	263,138	177,742
Wayne State	169,537	250,149	422,514	172,365
Western	111,851	196,265	634,113	437,848
Subtotal	**$2,345,676**	**$3,786,000**	**$8,512,217**	**$4,726,217**
TOTAL	**$3,282,176**	**$4,799,555**	**$10,577,493**	**$5,777,938**

[1)] Does not include pass-through appropriations for Bay Mills Community College ($100,000) and Saginaw Chippewa Tribal College ($29,700).

Sources: Fiscal Year 2014-15 Higher Education Appropriations Report (Senate Fiscal Agency and House Fiscal Agency), Workforce Development Agency, Higher Education Institutional Data Inventory, and annual appropriation bills.

Table 2

NORTH AMERICAN INDIAN TUITION WAIVER Funding Shortfall as a Percent of State Appropriations for Operations			
Community Colleges	**Tuition Waiver State Funding Shortfall**	**FY 2014-15 State Appropriations**	**Shortfall % of State Appropriation**
Alpena	$16,121	$5,390,700	0.3%
Bay de Noc	49,670	5,419,500	0.9%
Delta	(23,219)	14,498,900	(0.2%)
Glen Oaks	(3,355)	2,516,100	(0.1%)
Gogebic	30,276	4,451,400	0.7%
Grand Rapids	207,738	17,947,500	1.2%
Henry Ford	(41,871)	21,623,800	(0.2%)
Jackson	68,307	12,087,300	0.6%
Kalamazoo Valley	12,282	12,503,100	0.1%
Kellogg	7,386	9,813,500	0.1%
Kirtland	6,397	3,167,700	0.2%
Lake Michigan	21,016	5,342,900	0.4%
Lansing	65,366	30,877,600	0.2%
Macomb	(53,181)	32,816,600	(0.2%)
Mid Michigan	157,342	4,682,000	3.4%
Monroe	3,630	4,492,900	0.1%
Montcalm	12,077	3,226,700	0.4%
Mott	(11,833)	15,686,100	(0.1%)
Muskegon	62,133	8,901,000	0.7%
North Central	170,986	3,172,400	5.4%
Northwestern	206,940	9,078,800	2.3%
Oakland	(18,176)	21,123,300	(0.1%)
St. Clair	3,682	7,061,600	0.1%
Schoolcraft	14,535	12,513,700	0.1%
Southwestern	39,821	6,576,400	0.6%
Washtenaw	(651)	13,077,300	0.0%
Wayne County	3,914	16,727,600	0.0%
West Shore	44,388	2,414,900	1.8%
Subtotal	**$1,051,721**	**$307,191,300**	**0.3%**
Universities			
Central	$815,538	$79,115,000	1.0%
Eastern	65,638	71,771,100	0.1%
Ferris	413,655	49,087,000	0.8%
Grand Valley	604,765	63,136,000	1.0%
Lake Superior	315,789	12,782,500	2.5%
Michigan State	601,412	264,429,100	0.2%
Michigan Tech	150,938	45,923,100	0.3%
Northern	378,599	44,277,200	0.9%
Oakland	186,055	48,364,100	0.4%
Saginaw Valley	80,672	27,610,200	0.3%
U of M-Ann Arbor	244,344	295,174,100	0.1%
U of M-Dearborn	80,858	23,689,300	0.3%
U of M-Flint	177,742	21,337,700	0.8%
Wayne State	172,365	190,519,800	0.1%
Western	437,848	102,742,000	0.4%
Subtotal	**$4,726,217**	**$1,339,958,200**	**0.4%**
TOTAL	**$5,777,938**	**$1,647,149,500**	**0.4%**

Sources: Fiscal Year 2014-15 Higher Education Appropriations Report (Senate Fiscal Agency and House Fiscal Agency), Workforce Development Agency, Higher Education Institutional Data Inventory, and annual appropriation bills.

Appendix

WAIVER OF TUITION FOR NORTH AMERICAN INDIANS Act 174 of 1976

An act to provide free tuition for state resident North American Indians in Michigan public community colleges, public universities, and certain federal tribally controlled community colleges; and to prescribe certain powers and duties of certain state departments, commissions, and agencies.
History: 1976, Act 174, Eff. Aug. 1, 1976; -- Am. 1993, Act 106, Imd. Eff. July 15, 1993.

The People of the State of Michigan enact:
390.1251 Waiver of tuition for North American Indians; qualifications; participation of federal tribally controlled community college; eligibility for reimbursement.

Sec. 1. (1) A Michigan public community college or public university or a federal tribally controlled community college described in subsection (2) shall waive tuition for any North American Indian who qualifies for admission as a full-time, part-time, or summer school student, and is a legal resident of the state for not less than 12 consecutive months.

(2) A federal tribally controlled community college may participate in the tuition waiver program under this act and be eligible for reimbursement under section 2a if it meets all of the following:

(a) Is recognized under the tribally controlled community college assistance act of 1978, Public Law 95-471, 92 Stat. 1325.
(b) Is determined by the department of education to meet the requirements for accreditation by a recognized regional accrediting body.

History: 1976, Act 174, Eff. Aug. 1, 1976; -- Am. 1978, Act 505, Imd. Eff. Dec. 13, 1978; -- Am. 1993, Act 106, Imd. Eff. July 15, 1993.

390.1252 "North American Indian" defined.
Sec. 2. For the purposes of this act, "North American Indian" means a person who is not less than ¼ quantum blood Indian as certified by the person's tribal association and verified by the Michigan commission on Indian Affairs.
History: 1976, Act 174, Eff. Aug. 1, 1976; -- Am. 1978, Act 505, Imd. Eff. Dec. 13, 1978.

390.1252a Reimbursement of tuition waived; report.
Sec. 2a. The Michigan commission on Indian Affairs shall annually, upon application therefore, reimburse each institution for the total amount of tuition waived during the prior fiscal year under section 1 of this act. The commission shall report to the legislature annually the number of American Indians for whom tuition has been waived at each institution and the total amounts to be paid under this act.
History: Add. 1978, Act 505, Imd. Eff. Dec. 13, 1978.

390.1253 Effective date.
Sec. 3. This act shall take effect on August 1, 1976.
History: 1976, Act 174, Eff. Aug. 1, 1976.

Appendix

Michigan Constitution, Article I, § 26.

Sec. 26. (1) The University of Michigan, Michigan State University, Wayne State University, and any other public college or university, community college, or school district shall not discriminate against, or grant preferential treatment to, any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public employment, public education, or public contracting.

(2) The state shall not discriminate against, or grant preferential treatment to, any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public employment, public education, or public contracting.

(3) For the purposes of this section "state" includes, but is not necessarily limited to, the state itself, any city, county, any public college, university, or community college, school district, or other political subdivision or governmental instrumentality of or within the State of Michigan not included in sub-section 1.

(4) This section does not prohibit action that must be taken to establish or maintain eligibility for any federal program, if ineligibility would result in a loss of federal funds to the state.

(5) Nothing in this section shall be interpreted as prohibiting bona fide qualifications based on sex that are reasonably necessary to the normal operation of public employment, public education, or public contracting.

(6) The remedies available for violations of this section shall be the same, regardless of the injured party's race, sex, color, ethnicity, or national origin, as are otherwise available for violations of Michigan anti-discrimination law.

(7) This section shall be self-executing. If any part or parts of this section are found to be in conflict with the United States Constitution or federal law, the section shall be implemented to the maximum extent that the United States Constitution and federal law permit. Any provision held invalid shall be severable from the remaining portions of this section.

(8) This section applies only to action taken after the effective date of this section.

(9) This section does not invalidate any court order or consent decree that is in force as of the effective date of this section.

History: Add. Init., approved Nov. 7, 2006, Eff. Dec. 23, 2006.

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Winter 2015

A Primer on Certificated Credits under the Michigan Business Tax

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

Introduction

State General Fund/General Purpose (GF/GP) revenue estimates for fiscal year (FY) 2013-14, FY 2014-15, and FY 2015-16 were revised downward at the January 2015 Consensus Revenue Estimating Conference. The revenue decrease was due primarily to the larger-than-expected amount of refunds issued for the Michigan Business Tax (MBT). Although the Michigan Business Tax Act was repealed on January 1, 2012 for most business tax filers, some businesses continue to file MBT returns in order to claim refundable tax credits. While new MBT tax credits have not been issued since the MBT Act was repealed, previous tax credit agreements are still in place and have been amended, and the improving economy has made it more likely that eligible businesses can complete the investments and job increases required to claim credits; thus, the amount of credits claimed by eligible businesses has continued to grow. This article reviews the tax credits that are now being claimed, summarizes the recent history of business taxes in Michigan that led to the award and continuation of these tax credits, discusses reasons for the volatility in the amounts being claimed, and describes possible options for limiting the impact of these tax credits on GF/GP revenue.

Background

Public Act 24 of 1995 created the Michigan Economic Growth Authority (MEGA) tax credit program to attract, retain, create, and increase job and capital investment in Michigan. The Michigan Economic Growth Authority tax credits are refundable tax credits, which means that if the credit amount is greater than the tax owed, the State will pay the cash difference to the company as a refund, whether or not the company has any tax liability. At its inception, the program authorized the award of credits against the Single Business Tax (SBT) to approved companies in targeted industries that met criteria for job creation and investment.

The business tax structure in Michigan has changed dramatically since the MEGA credit program was first enacted. The Single Business Tax was replaced effective January 1, 2008, by the MBT. The Michigan Business Tax raised an amount of revenue similar to the SBT revenue and allowed previously issued tax credits to continue to be claimed. Under the MBT, new MEGA credits also continued to be approved by the MEGA board through the end of 2011.

Effective January 1, 2012, the MBT was repealed (for most taxpayers) and replaced with the Corporate Income Tax (CIT). The Corporate Income Tax generates substantially less revenue from business taxpayers than either the SBT or MBT raised. Under the MBT, businesses (including corporations, partnerships, S-Corporations, sole proprietorships and limited liability companies) were taxed at a rate of 4.95% on business income and 0.8% on gross receipts, although a 21.99% surcharge effectively made the rates 6.04% on business income and 0.98% on gross receipts. Under the CIT, only corporations are taxed and the rate is 6.0% of corporate income. The Corporate Income Tax legislation permitted MEGA credit holders to choose to switch to the CIT and forego the MEGA credits or to continue to file under the MBT Act and claim credits, giving companies the option to continue to benefit from refundable credits for which they were eligible. Approximately 200 taxpayers continue to file MBT returns in order to claim MEGA credits and other certificated credits. Because of the value of these credits, it is likely that these businesses will continue to do so until they have redeemed all of the MEGA tax credit certificates for which they are eligible.

The 2011 legislation that effectively eliminated the MBT for most taxpayers also prohibited the issuance of new tax credit awards after January 1, 2012. Additional legislation created a new incentive program beginning in FY 2011-12 that functioned by issuing grants and loans instead of tax credits. However, because some MEGA awards may be claimed for as long as 20 years, companies are expected to continue to be eligible for credits through 2032. Furthermore, FY 2031-32 will not be the last fiscal year that payments on these credits will be made and the MBT Act will not officially be repealed until all credits have been redeemed.

Credits were issued by the MEGA board from 1996 through 2011. Claims of credits by companies started in 1996. Based on the potential credits that have been awarded, claims of credits can continue through 2032. Even though new credits cannot be issued, the Michigan Strategic Fund board can amend previously issued credits, which can either increase or decrease the refund amount.

Michigan Business Tax Credits

The 2011 legislation preserved a variety of different types of credits under the MBT. In addition to credits issued in the MEGA program, certificated credits that may be claimed include the Early Stage Venture Capital credit, brownfield redevelopment credits, credits for photovoltaic technology, anchor company payroll credits, Federal government employment credits, anchor company taxable value credits, polycrystalline silicon manufacturing credits, credits for high-power energy batteries, hybrid technology research and development credits, media production credits, media infrastructure credits, historic preservation credits, renaissance zone credits, NASCAR Speedway credits, and farmland preservation credits. For most of these credits, the credit awards were approved by the Michigan Economic Growth Authority board, which was located within the Michigan Strategic Fund, and staffed by the Michigan Economic Development Corporation since Executive Order 1999-1. The MEGA board was dissolved by Executive Order 2012-9, which moved all of the responsibilities of the MEGA board to the MSF board. No new credits have been issued by the MSF board since the end of 2011, although credit agreements have been amended.

Generally, MEGA credits involve some sort of *quid pro quo* arrangement in which the taxpayer is required to accomplish certain goals in exchange for the credits. While awards can be for as long as 20 years, distinct criteria generally are specified for each individual year during that period and the first year of the award period may be several years after the formal award agreement is approved. The criteria vary by the nature of the credit or program, but often include provisions regarding creating or maintaining a certain number of jobs and/or making investments in plants and equipment of at least a specified level, whether in terms of developing new facilities or rehabilitating old facilities. Taxpayers may fail to qualify for a credit in one year but then later qualify for the credit, while others may never qualify for the credit. The nature of the agreements, in which the taxpayer is promised some sort of tax compensation in exchange for pursuing specified economic activities, has resulted in the development of policies to preserve the credits even as the tax structure has changed.

In the debate over the value of economic development incentives, an issue that often arises is whether an incentive is generating new economic activity or merely subsidizing activities that otherwise would have occurred. Evaluating this aspect of incentives is very difficult for even a single year, let alone when done for awards that may have been made almost two decades ago. An incentive may make no difference or all of the difference in a project, by raising the return on a project to a level at which the project can proceed. The following example illustrates this point: Assume a taxpayer is considering a business investment and requires a 5.0% return on the investment to pursue it. Also assume that the State offers an incentive that will improve the rate of return on the project by 2.0%. Three scenarios can be considered based on three different states of the economy. Assuming the taxpayer's forecast of the market is correct, the following three cases describe the potential outcome if, absent the incentive, the taxpayer will receive a return of:

a) 1.0%
b) 7.0%
c) 4.0%

In scenario a), the economy will return 1.0% on the investment and the tax incentive will improve that return to 3.0%. The taxpayer will not pursue the investment because even with the incentive, the project will fail to generate sufficient returns. In this case, the incentive made no difference to the business decision and ultimately would not cost the State any revenue.

In scenario b), the economy will return 7.0% to the taxpayer and the incentive will boost that return to 9.0%. The taxpayer will pursue the investment and, because of the incentive, will receive a return of 9.0% rather than 7.0%. In this case, the incentive did not change taxpayer activity but did cost the State revenue, which simply made the firm's activities more profitable than they otherwise would have been.

In scenario c), the economy will return 4.0% on the investment and the taxpayer would not pursue the investment without the incentive. However, the incentive raises the return on the project to 6.0%, now making it profitable for the taxpayer to proceed. In this case, the incentive will reduce State revenue, but will also generate economic activity that would not otherwise occur.

An important caveat to mention with economic development incentives is that there also may be cases in which the incentive does not affect *whether or not* the taxpayer pursues the investment but affects *where* the taxpayer pursues the investment. It is not difficult to locate media articles describing states or local units that effectively bid against each other in order to attract a business investment, or to find businesses that attempt to pit governments against each other in such bidding. In these circumstances, a condition such as scenario b) might exist, but if one state is offering an incentive that improves the rate of return by 2.0% and another state offers an incentive that improves the return by 4.0%, the business is going to pursue the activity regardless of whether an incentive is offered by any state, but will more than likely pursue the investment in the second state in order to maximize its return.

Mechanics of the MEGA Credit Process

To qualify for and receive a MEGA credit, businesses are required to go through a number of steps, listed in Figure 1. First, a business must undergo an application process and receive approval of a credit agreement by the MEGA board. Second, an approved company must complete the required investment and job creation. Third, in order to receive the financial benefit of the credit, the business must apply for a credit certificate. Fourth, after review of the application, the MSF/MEDC issues a credit certificate. Fifth, the company then submits the certificate, with an MBT return, to the Department of Treasury. If the company has already submitted a return for that tax year, the company will submit an amended return. The Department of Treasury may have audit issues that must be resolved before it issues any refund. Finally, once approved by Treasury, the business receives the credit. Businesses have flexibility on when they can redeem the credit certificates. In some cases, the tax returns are due before credit certificates have been received and the business must file an amended tax return. Businesses also can amend multiple tax returns in the same year. With reviews and audits possible at each stage, the time frame can be several years from when a business first applies for the credit to when it receives the payment, explaining why payments for redeemed tax credits could continue well beyond FY 2031-32.

As of November 2014, the MEDC estimate of the amount of MEGA credits that were awarded for the years 2015 through 2032 but not yet redeemed totaled $6.5 billion, up $1.6 billion from an estimated $4.9 billion in March 2011, as shown in Figure 2. The increased value of awards reflects new awards made during 2011 and amendments to agreements that were made before 2011. Additionally, the MEDC has made changes in certain calculations used to estimate future credit amounts.

According to the MEDC, the $1.6 billion change in the estimated value of MEGA awards from March 2011 to November 2014 represents approximately $73.0 million in new awards made during 2011, approximately $391.0 million in increased awards attributable to amendments to previous awards, and approximately $1.1 billion from the revised calculations made to estimate the value of the awards. The majority of these revisions affect job retention credits, and the value of those credits depends heavily on the compensation (wages, health care costs, etc.) paid to retained employees. Apparently, earlier estimates not only assumed an average compensation rate on retained jobs that was too low, but also assumed no growth in compensation rates over the 20-year period of the awards. While the MEDC has updated the projected costs to reflect compensation costs submitted under recent claims, the projections continue to assume no growth in future years from those revised levels.

As a result, the data illustrated in Table 1 and Figure 2 likely understate the future value of both the awards and the projected claims. It is unknown what portion of the award amounts reflect these job retention credits, but if 50% of the amounts shown represent job retention credits and compensation costs rise 5.0% per year, the total value of the awards is approximately $1.7 billion more than shown in Table 1, and the projected cost of the credits is approximately $1.4 billion higher. If the retention credits are 70% of the total and compensation costs average 8.0% growth, the value of the awards is approximately $4.2 billion higher than shown in the table, and the value of projected claims is approximately $3.5 billion higher.

Furthermore, predicting the number and amount of credits that will be redeemed is difficult, and generally depends much more on economic factors specific to the taxpayer than on general economic conditions forecasted by the Consensus Revenue Estimating Conference. Previously, estimates assumed that approximately 35.0% of awards would ultimately be claimed, while more recent estimates have been adjusted to reflect taxpayer claims over the last few years and predict that, on average, approximately 75.0% of the award amounts will be redeemed. The combination of timing issues in the credit process, amendments to credit agreements and calculations, and changes in redemption rates makes it difficult to predict the amount of redeemed tax credits that will be paid in a single budget year.

Figure 1

MEGA Credit Process

Business applies for a credit award
(only available before January 1, 2012)

An agreement is reached regarding terms of the incentive
(only available before January 1, 2012)

MSF board approves the award, which may be for as many as 20 years
(only available prior to January 1, 2012)

Business pursues the required investments

Business applies for a credit certificate, which verifies compliance with the agreement

MEDC verifies compliance with the award

MEDC issues a credit certificate that the taxpayer may submit with its tax return

Business submits a tax return claiming the credit. If the taxpayer has previously submitted a return, an amended return is submitted

Treasury reviews the tax return

Treasury issues any refunds due as a result of the credit

Figure 2

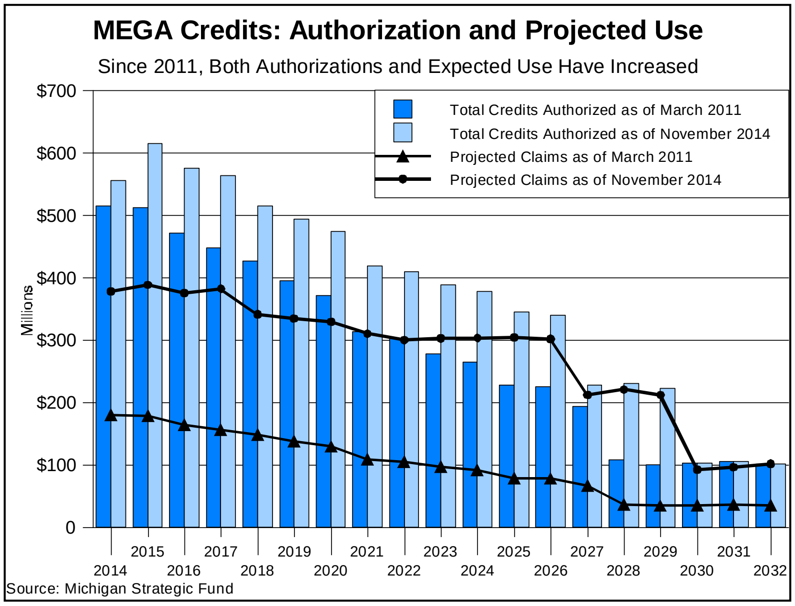


Table 1

Approved MEGA Awards and Projected Credit Values - 2015-2032 (Dollar Amounts in Millions)		
Year	**Amount**	**Credit Value**
2015	$615.1	$388.2
2016	575.6	375.2
2017	563.4	382.4
2018	514.3	341.5
2019	493.1	334.6
2020	474.1	329.0
2021	418.8	310.3
2022	409.0	300.0
2023	388.1	302.5
2024	377.6	303.5
2025	344.4	304.3
2026	340.3	302.2
2027	227.6	212.2
2028	230.0	220.8
2029	222.2	212.3
2030	102.9	92.4
2031	105.4	96.2
2032	102.1	102.1
Total	**$6,504.0**	**$4,909.7**

Note: Projected credit values represent MSF/MEDC projections and differ in both magnitude and content from MBT estimates made as part of the Consensus Revenue Estimating process. See text for details.

Source: Michigan Strategic Fund/Michigan Economic Development Corporation, November 2014.

Michigan Business Tax Credits and the Impact on State Revenue

The January 2015 Consensus Revenue Estimating Conference (CREC) adopted a revenue forecast for the General Fund in FY 2015-16 that was $532.1 million less than forecasted in May 2014. Net MBT revenue for FY 2015-16 was estimated at a negative $807.4 million, which is $350.9 million lower than what was predicted during the May 2014 CREC. While the estimated impact of MEGA awards is expected to decline in the future as credits continue to be redeemed, net negative MBT is expected to be a significant drain on General Fund revenue for at least another decade.

Table 1 displays approved credits and projected redemptions for 2015 through 2032. These figures represent award amounts and the associated projected use for each year based on estimates of when and by how much a business meets the specified criteria. As indicated earlier, timing issues significantly affect when the credits will actually be paid and it is likely that credits will continue to be claimed well past the 2032 horizon shown in the table. Beyond the timing issues, net MBT revenue is likely to differ substantially from the projected credit amounts because some businesses will exhibit tax liabilities that offset the projected credit amounts, firms may file tax returns that are later amended, and there are MBT revenue issues not related to MEGA credits. (For example, despite the repeal of the SBT Act after tax year 2007, the State still processes millions of dollars in payments, refunds, and penalties from the SBT.)

Table 2 illustrates the magnitude of the timing issues that can affect the differences between a given year's projected award amounts and when revenue is affected. The majority of refunds paid during FY 2013-14 reflected credits claimed for return years that began in either 2011 or 2012, although almost 5.0% of the refunds were paid for return year 2008. Return year 2013, the most recently completed full year for returns that would have been received during FY 2013-14, represented approximately 12.0% of the refunds paid during FY 2013-14. If the comparison includes the portion of refunds received but not yet paid that are attributable to return year 2013, the share actually declines to 9.0%. As a result, while Table 1 illustrates awards for future years, not only is there a delay between the award year and the year in which the refunds are paid, but multiple years of awards can occur within a single fiscal year.

Table 2

FY 2013-14 Michigan Business Tax Refunds by Return Year
(Dollar Amounts in Millions)

	Dollar Amount	Share of Total
Refunds Paid During FY 2013-14, by Return Year		
2008	$34.1	4.7%
2009	65.5	9.0
2010	89.9	12.3
2011	213.4	29.3
2012	186.8	25.6
2013	88.5	12.1
2014	50.5	6.9
Total Refunds Paid	$728.8	100.0%
Accrual for Claims Received by Treasury But Not Yet Paid	$341.5	N/A
Refunds Already Booked to Prior Years	($267.2)	N/A
Net MBT Refunds with Accruals	**$803.1**	

Note: Return year means all returns beginning in that calendar year. A firm with a tax year running from August 2009 to July 2010 would be included in return year 2009. N/A = Not Applicable.

Source: Michigan Department of Treasury

As discussed earlier, the SBT and the MBT generated similar revenue totals and the CIT generates substantially less than either the SBT or the MBT. The reasoning behind keeping certificated credit holders under the MBT concerned the magnitude of the credits a business would receive relative to its tax liability. For example, if a taxpayer usually experienced an MBT liability of $10.0 million and received a credit award of approximately $5.0 million, the perception was that it would not be in the State's interest to allow the taxpayer to continue to claim the $5.0 million credit if the taxpayer were now filing under a new law under which the tax liability would be something lower, for example, $4.0 million. Although the State would be forgoing $5.0 million in both cases, under the MBT the State would still receive $5.0 million while under the CIT the State would issue a $1.0 million refund.

The problem for State revenue is that the logic used to justify keeping taxpayers with certificated credits under the MBT is difficult to extrapolate to the State when taxpayers are viewed as an aggregate. In FY 2010-11, the State paid $334.7 million in MBT refunds, a portion of which was refunds for what would later become certificated credits. However, those refunds were offset by more than $2.4 billion in MBT revenue, leaving the State with net positive MBT revenue of just under $2.1 billion. In comparison, in FY 2013-14, the State paid $803.1 million in MBT refunds that was offset by $79.8 million of MBT revenue and $906.4 million in CIT revenue. When combined with refunds paid under the SBT, net business tax revenue under the CIT, MBT, and SBT totaled $137.6 million in FY 2013-14. The decline in net business tax revenue since the $2.1 billion generated in FY 2010-11, the last full year of MBT revenue, reflects the approximately $1.6 billion tax cut from moving to the CIT as well as increases in MBT credits.

Not only have MBT refunds increased due to changes in the State's incentives but the credits are offset by a much smaller revenue stream. In FY 2015-16, the net business tax revenue from the CIT, MBT, and SBT is projected to total $159.3 million, with $976.7 million in CIT revenue largely being offset by $807.4 million in negative net MBT revenue. These credits reduce General Fund revenue and represent a significant portion of the General Fund available in any given year. Based on FY 2013-14 revenue, MBT credits reduced General Fund revenue by $807.3 million, or approximately 9.0%.

Under the current forecast, certificated credits under the MBT are predicted to equal 7.7% of General Fund revenue in FY 2014-15, and 8.8% in FY 2015-16, as shown in Figure 3. As a result, significant swings in the value of MBT credits claimed in any given year can have a significant impact on General Fund revenue. As indicated above, certificated credits include both MEGA credits and a number of other credits; however, the Michigan Strategic Fund's estimate of MEGA credit claims indicates that MEGA credits represent a significant component of the credits that will reduce General Fund revenue, as Figure 4 illustrates.

Figure 3

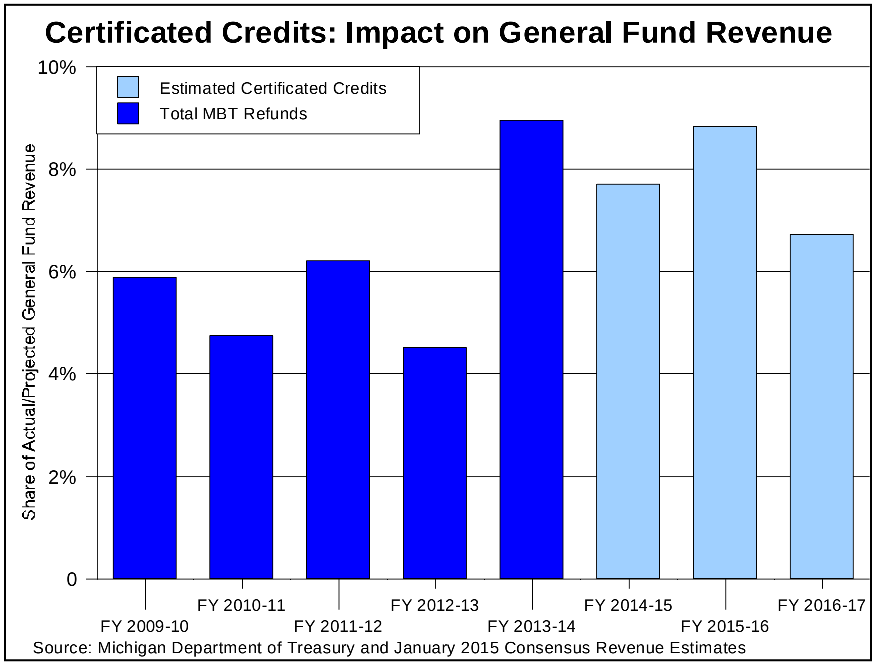
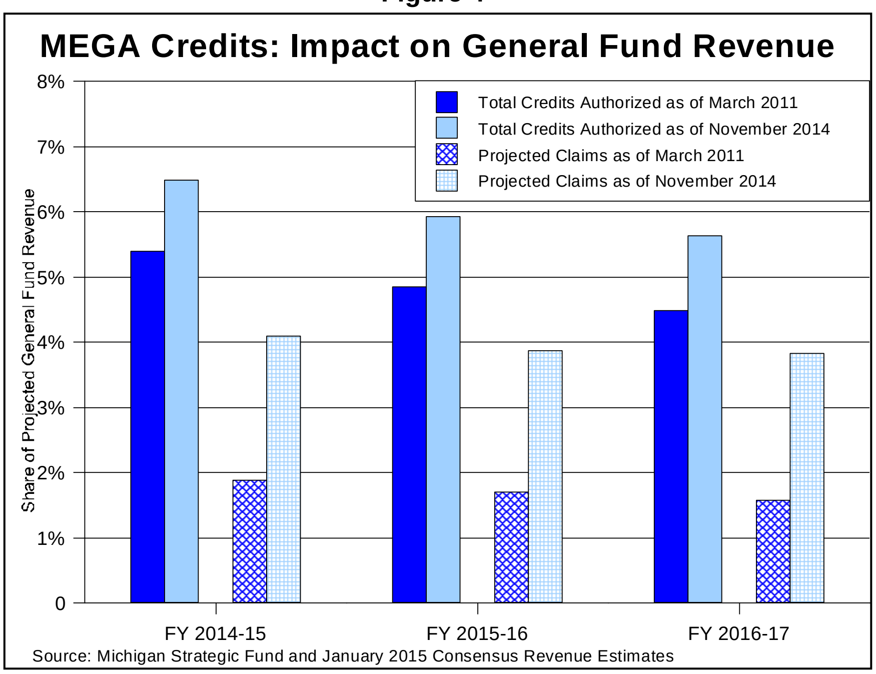


Figure 4



Making Revenue and Credits More Predictable

There are written agreements between the Michigan Strategic Fund and businesses regarding the payment of credits. However, there may be ways to limit both the volatility and magnitude of certificated credits in a given year, as well as ways to prevent the State's total exposure to revenue losses from increasing. The following discussion is not meant to represent a comprehensive list of options, or to suggest that any of these options has been investigated with respect to its economic, legal, or political ramifications. The options mentioned in the following paragraphs are provided as a reference point for the types of actions that could accomplish specific goals related to State revenue.

First, the State could alter the manner in which credits are paid. For example, the State could convert the credits from refundable to nonrefundable and/or allow them to be carried forward to offset liabilities in future tax years. Several certificated credits were originally nonrefundable credits. If the credits were no longer refundable but carried forward, their dollar value would be eroded by inflation and most affected taxpayers would need to continue filing the MBT well past FY 2031-32. However, eliminating refundability would reduce both the magnitude of any changes in net MBT revenue and the degree to which total net MBT revenue would be negative. Based on limited data from tax year 2012, it appears that such a change would reduce the impact of the credits by roughly 75.0% each tax year, although it would significantly increase the number of fiscal years that would be affected by the credits.

Another option to alter the manner in which credits are paid could be to limit total payments in a given year. Many of the credits included in the list of certificated credits have at various times been subject to annual limits when claimed while other credits were subject to annual limits when awarded. Credits during a year paid could be limited to a specific sum, such as $300.0 million, and once the State had paid credits totaling that amount, any additional refunds would earn interest and be paid in future fiscal years and/or carried forward to offset future tax liabilities. Similarly, the State could limit a taxpayer to receiving payment for only one tax year's worth of credits during any one fiscal year.

Second, the State could exert greater control over the credit process, specifically with respect to changes in agreements or other administrative calculations. Much as the State has gained greater control and discretion over economic incentives by shifting the programs from ones based on tax credits to ones based on appropriated expenditures, the State could limit the authority for altering agreements or require the incremental costs of such changes to be paid from current appropriations used for current incentives. The Legislature could even require that outstanding agreements be frozen under their current terms and prohibit amendments.

Third, the State could use or build a reserve to mitigate the impact of swings in credits. Historically, transfers have been made from the Budget Stabilization Fund to provide revenue for a variety of purposes, such as making court-mandated payments and offsetting declining revenue from recessions. Large swings in MBT credits simply represent a specific way in which the budget can be subjected to unpredictable circumstances and stabilization funds generally exist to insulate the budget from such swings. Similarly, just as the Legislature has exhibited concerns about unfunded liabilities in State-sponsored retirement systems, the State could embark on a project to "prefund" outstanding MBT credits.

Conclusion

The Michigan Business Tax continues to have a significant impact on State revenue despite being "repealed" more than three years ago. Furthermore, credits authorized under the MBT are likely to have a significant effect on State revenue for at least another two decades. Despite knowing the number of outstanding credits that have been awarded through 2032, the total value of these awards, the magnitude of payments, and when the credits will be paid are relatively unknown and incapable of being forecasted with any meaningful accuracy. Not only have MBT refunds increased due to changes in the State's incentives but the credits are offset by a much smaller revenue stream. Under the current forecast, certificated credits under the MBT are predicted to equal 7.7% of General Fund revenue in FY 2014-15, and 8.8% in FY 2015-16. As a result, large swings in the value of MBT credits claimed in any given year can have a significant impact on General Fund revenue. Until steps are taken to limit the impact of outstanding economic incentive awards, or until the credits have been exhausted, MBT credits will continue to both reduce General Fund revenue and increase its volatility.

State Notes

TOPICS OF LEGISLATIVE INTEREST

Winter 2015

The Long and Winding Road: Proposal 1 and Road Funding Reform
By Glenn Steffens, Fiscal Analyst

On May 5, 2015, Michigan voters will have the choice to approve or reject Proposal 1, which would increase the sales tax ceiling from 6.0% to 7.0%. However, the voters' decision will affect much more than the sales tax – there are a number of other measures in a recently passed transportation funding reform package that will take effect only upon voter approval of Proposal 1. These bills cover a variety of reforms that would affect fuel taxation, road construction warranty requirements, the earned income tax credit, State trunkline debt service, the School Aid Fund, and vehicle registration fees, among other items.

The purpose of this article is to provide background on the road funding situation, details on the key provisions of the reform package, and a look at the comparative tax burden at the gas pump under current law as well as the reform package, and address some common questions regarding the transportation funding package.

Background: Road Funding Situation

Recently, it has become generally accepted that Michigan's road and bridge infrastructure is suffering from funding shortfalls. Roads and bridges at the State and local levels have been deteriorating, are receiving proportionately less funding than in the past, and will become exponentially more expensive to repair as crucial maintenance is delayed. The Michigan Department of Transportation (MDOT) has indicated that an immediate increase of over $1.1 billion is needed to bring most State roads and bridges up to good or fair condition by 2025.[1] The amount of additional funding that local road agencies may need is a difficult question and the focus of much debate.

State revenue for transportation is primarily driven by vehicle registration fees and motor fuel taxes. Table 1 compares select State revenue in transportation for fiscal year (FY) 1997-98 (adjusted for inflation based on the Consumer Price Index) and FY 2013-14. Since the last fuel tax increase took effect in FY 1997-98, that year serves as a good basis of comparison.

Table 1
State Revenue Comparison: Fuel Taxes & Registration Fees, FY 1997-98 & FY 2013-14

State Revenue Source	FY 1997-98 (adjusted for inflation)	FY 2013-14	% Change
Fuel Taxes	$1.5 billion	$938.0 million	37.4% decrease
Vehicle Registration Fees...............	$978.1 million	$939.5 million	4.0% decrease
Total	**$2.5 billion**	**$1.9 billion**	**24.0% decrease**

Although Table 1 shows a 24.0% decrease in fuel tax and vehicle registration fee revenue from FY 1997-98 to FY 2013-14, this is not to say that there has been a 24.0% decrease in State revenue altogether. When General Fund dollars are considered ($0 in FY 1997-98 and $336.6 million in FY 2013-14), the funding decrease from FY 1997-98 to FY 2013-14 is 12.0%. Historically, it was extremely unusual for General Fund dollars to fund transportation. However, since transportation revenue in

[1] According to an MDOT presentation on the state of road funding that was given at the State Transportation Commission hearing in July 2014.

recent years has been insufficient to maximize Federal match dollars, the State has been forced to rely on General Fund dollars to make up the difference.

As Table 1 illustrates, the primary reason for decreased revenue lies within diminishing fuel tax receipts. This is caused by increases in vehicle fuel economy, which result in lower consumption, and inflation. The gasoline tax rate of 19 cents per gallon was set in 1997. Accounting for inflation, 19 cents in 1997 would equal roughly 28 cents today. Looked at another way, today's 19-cent gas tax would equal 13.5 cents in 1997 – meaning that the gas tax burden has effectively decreased since the last rate increase 18 years ago. As to fuel economy, the average fuel economy for a model 1997 vehicle was 24.6 miles per gallon, while the average fuel economy for a model 2014 vehicle was 31.6 miles per gallon. This increase in fuel economy affects the amount of fuel consumed, and fewer gallons of gasoline consumed directly translate to less revenue for roads. The combination of inflation and decreasing fuel consumption has resulted in a significant drop in fuel tax revenue and buying power.

Proposal 1 and the Transportation Reform Package: What It Would Do

Simply put, the transportation reform package effectively would draw a bright line between taxing fuels and all other goods. In the process, it would alter sales tax and fuel tax provisions, and raise revenue for transportation, schools, and local governments. Central to the transportation reform package is House Joint Resolution UU (Proposal 1).

House Joint Resolution (HJR) UU would amend the State Constitution to raise the sales tax ceiling from 6.0% to 7.0%, and requires a vote of the people. This amendment is at the center of the proposal due to various tie-bars throughout the reform package (meaning that other legislation will not take effect unless the voters approve HJR UU). At its core, the package would do the following:

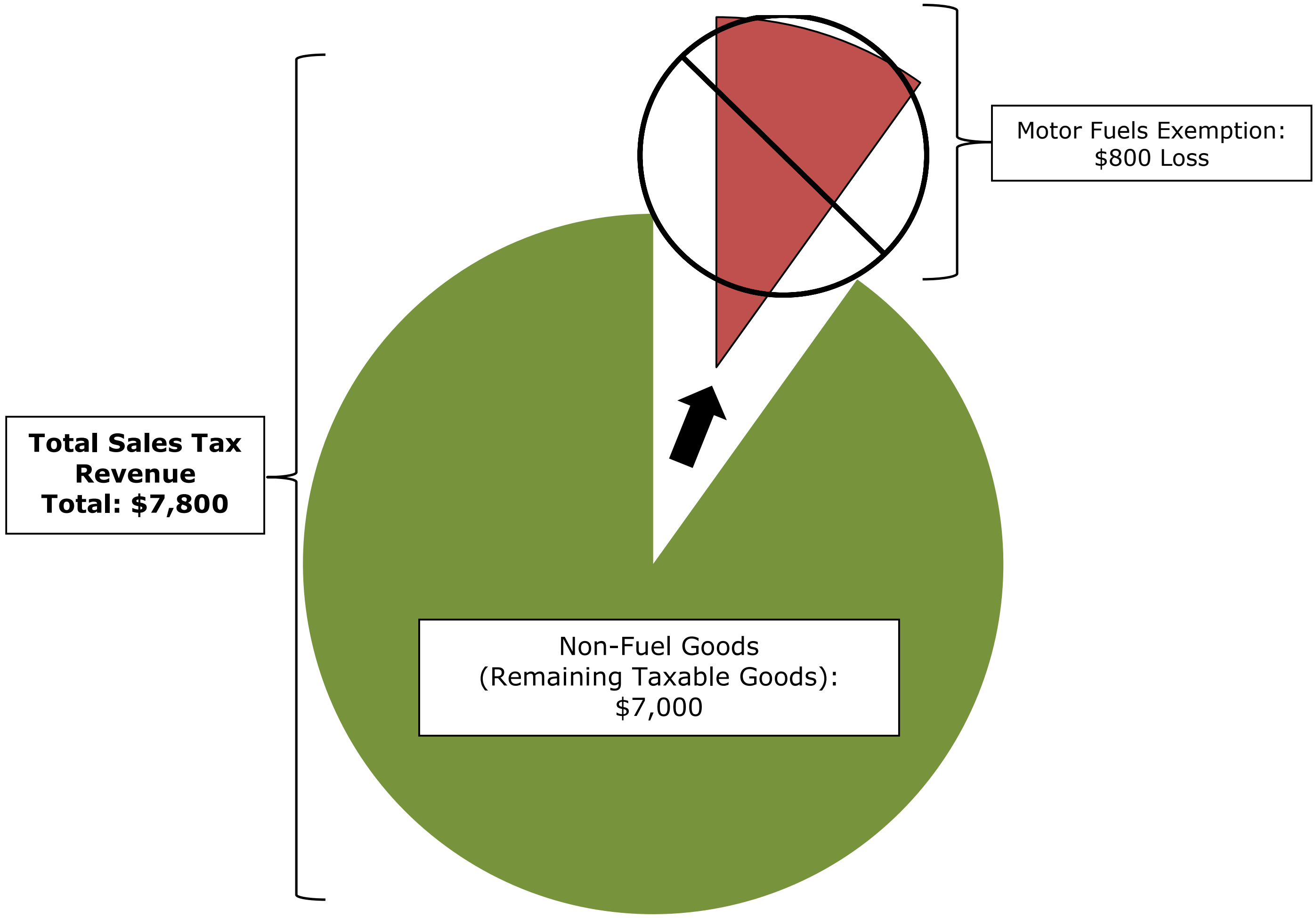
- Eliminate the sales tax on motor fuels.
- Increase the sales tax on non-fuel goods from 6.0% to 7.0%.
- Direct a portion of the use tax revenue to the School Aid Fund.
- Increase the Earned Income Tax Credit (EITC) from 6.0% to 20.0% of the Federal EITC.
- Change the current 19-cents-per-gallon gasoline tax to an annually adjusted rate that would be based on 14.9% of the average wholesale price of gasoline.
- Direct a portion of new transportation revenue to pay down MDOT debt service by approximately $1.2 billion out of $2.0 billion total over the next two years.

Figures 1-4 offer illustrations and explanations of the dynamics of the points discussed above. A comprehensive table (Table 3) at the end of this article details the estimated fiscal impact of the entire package. For a more comprehensive look at the provisions of the package, please see the Senate Fiscal Agency's analysis of House Joint Resolution UU (Proposal 1) and the related legislation.[2]

The exemption of motor fuels from the sales tax would result in a revenue loss of about $800.0 million to public transit, the School Aid Fund, revenue sharing, and the General Fund. However, the sales tax increase on remaining goods would generate roughly $1.4 billion, resulting in a net increase in State revenue for these areas of about $600.0 million. Figures 1 and 2 illustrate this in more detail.

[2] http://www.legislature.mi.gov/documents/2013-2014/billanalysis/Senate/pdf/2013-SFA-HJRUU-N.pdf

Figure 1
Exempting Motor Fuel Purchases from Sales Tax
(Dollars in Millions)



Step 1: Motor Fuels Exempted from the Sales Tax

This would reduce sales tax revenue by approximately $800 million.

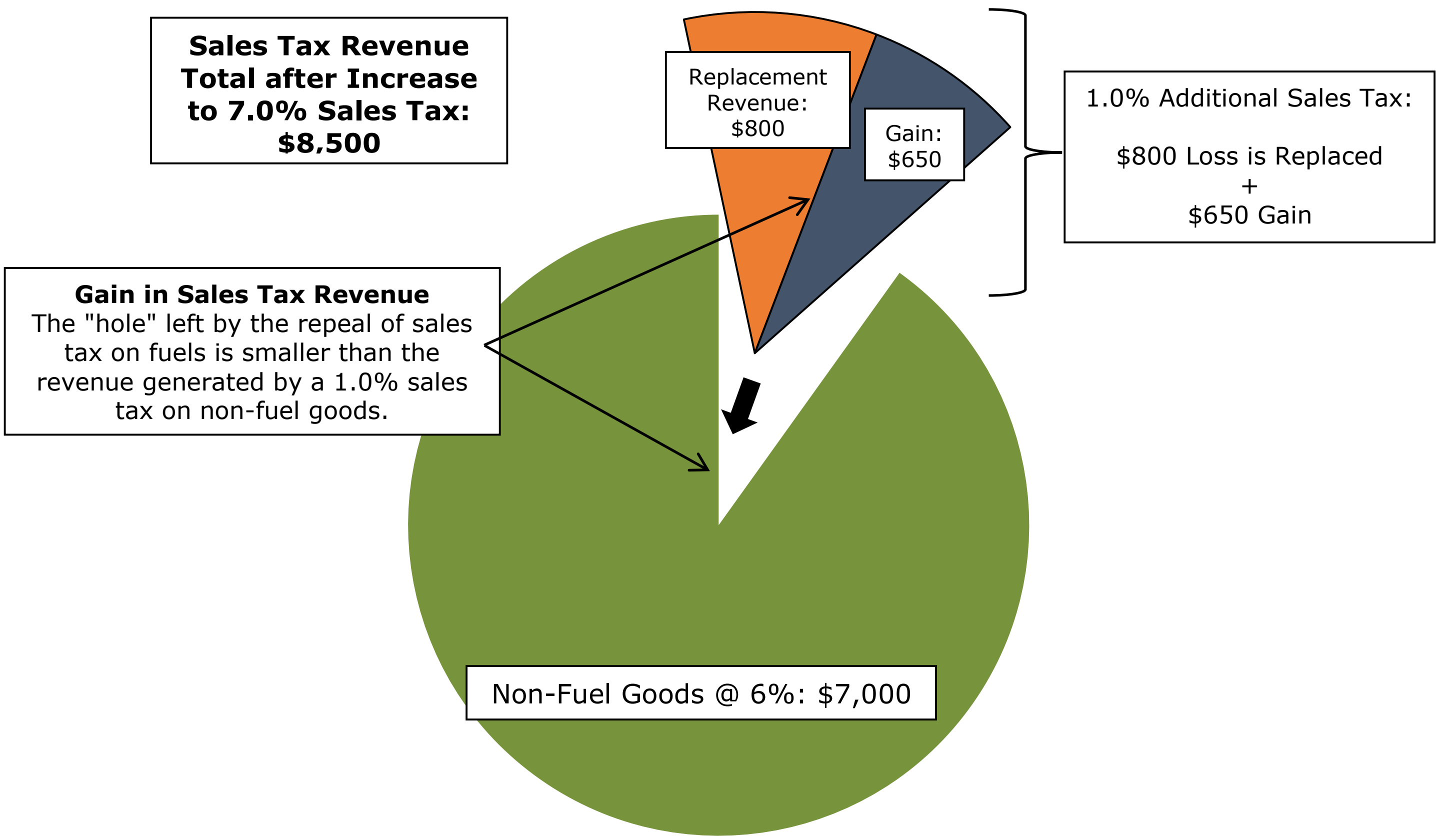
This would result in the following losses (in millions):

- School Aid Fund	($570)
- Revenue Sharing	($100)
- General Fund	($100)
- Comprehensive Transportation Fund (CTF)	($30)

Some of these losses would be replaced. See Figure 2.

This step would not have any effect on road funding.

Figure 2
Sales Tax Increase from 6.0% to 7.0% on Non-Fuel Goods:
Replacing & Increasing Sales Tax Revenue for Schools, Revenue Sharing, & General Fund
(Dollars in Millions)



Step 2: Sales Tax Increased to 7%; Use Tax Redirection; EITC Increase

This would increase sales tax revenue by approximately $1.4 billion for a net gain of $650.0 million. It also would redirect $150.0 million of the use tax from the General Fund to the School Aid Fund, and $260.0 million General Fund toward the Earned Income Tax Credit.*

This would replace the losses in Step 1 & result in the following net gains (in millions):

- School Aid Fund	$300
- Revenue Sharing	$100
- General Fund	$16

CTF (Public Transit) would see a net loss of $20.0 million, but would see further increases under the fuel tax increase. See Figure 3C for net CTF gains under the reform package.

This step would not have any effect on road funding.

**These estimates reflect only key provisions of the entire reform package. See Table 3 for a comprehensive fiscal analysis.*

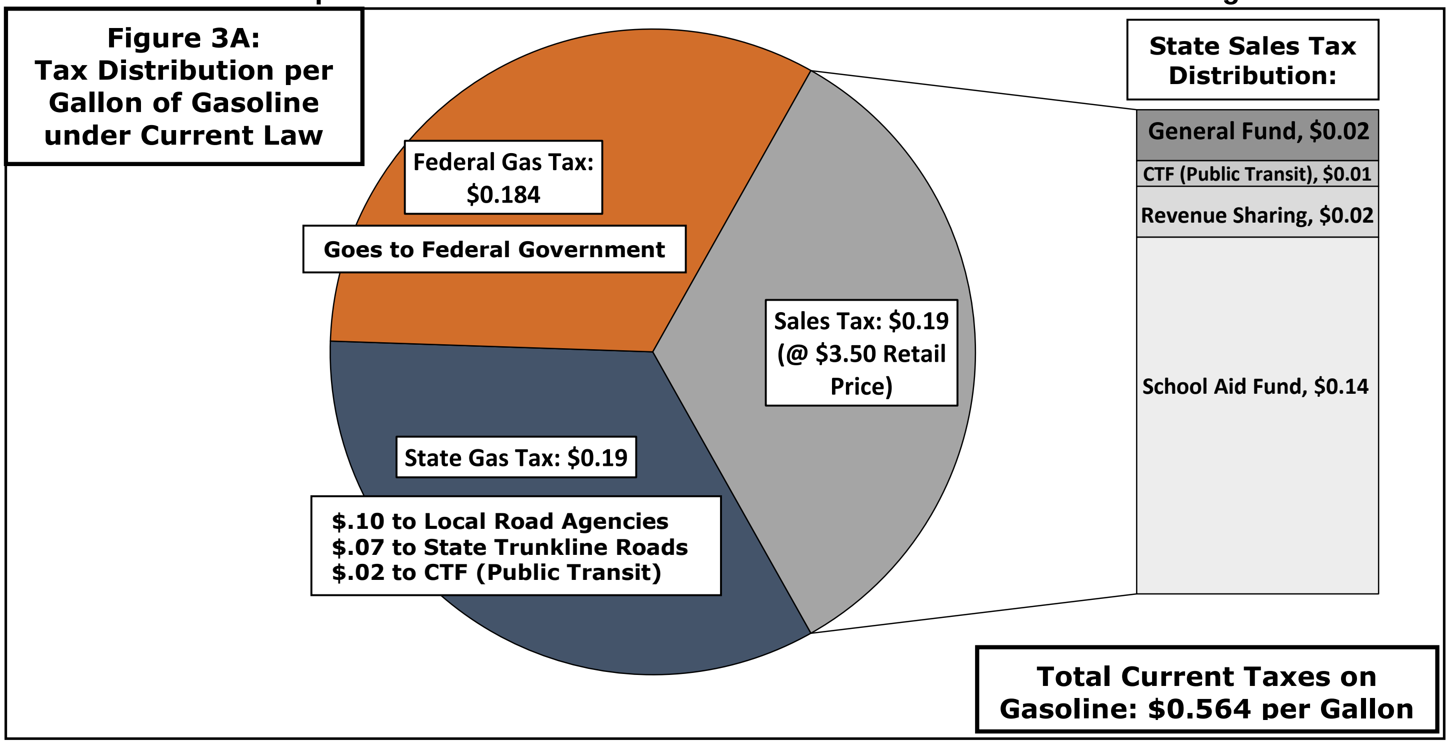
As noted above, the reform package includes fuel tax changes. The State taxes levied on gasoline include $0.19 per gallon in fuel tax and $0.19 per gallon in sales tax (based on a $3.50 per gallon retail price). The fuel tax revenue is directed to transportation and distributed according to statute, but revenue from the sales tax on fuels is directed to schools, local governments via revenue sharing, public transit, and the General Fund.

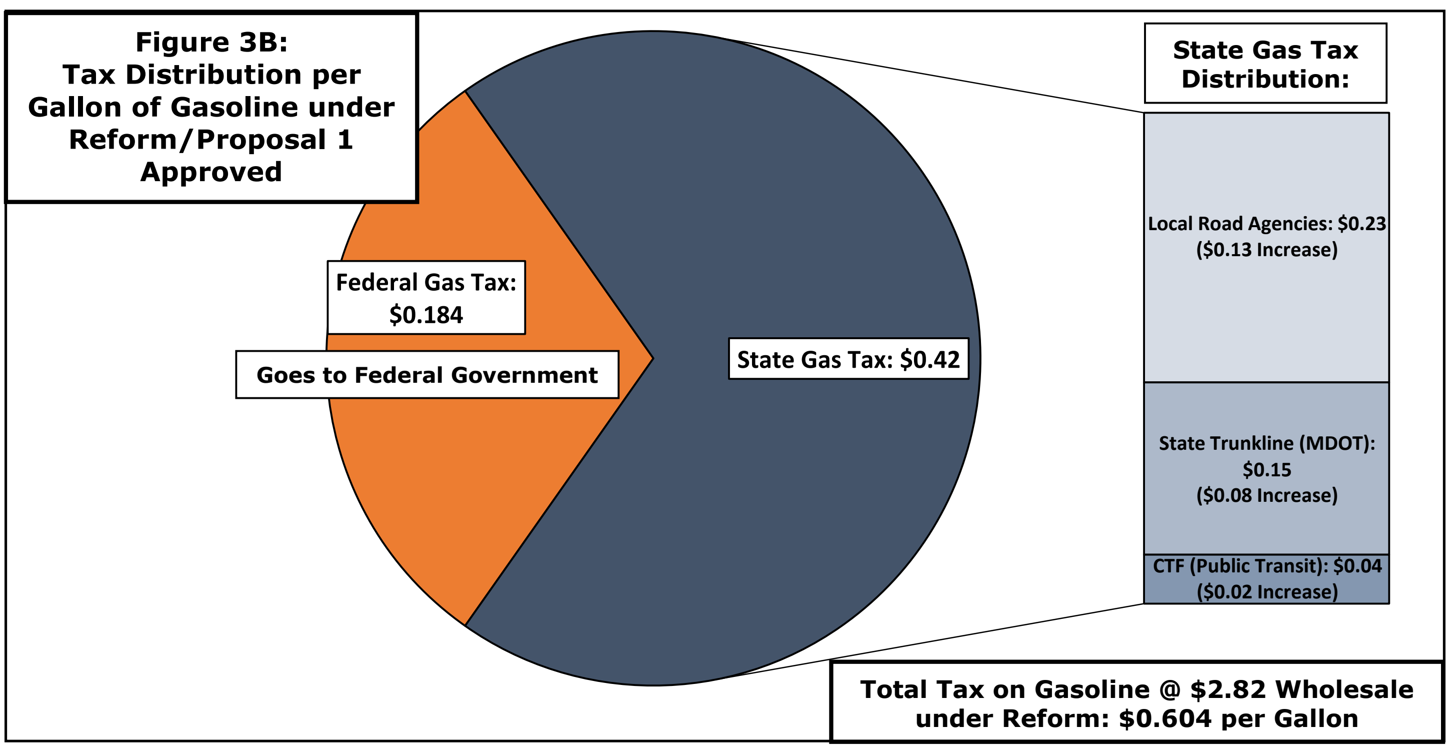
While the provisions described in Figures 1 and 2 above would repeal the sales tax on fuels, Figures 3A and 3B illustrate the gas tax increase. At a retail price of $3.50 per gallon, the $0.19 per gallon sales tax effectively would be replaced by an additional $0.23 per gallon in "new" gas tax. The end result would have all State taxes paid at the pump directed to transportation.

If the voters were to approve Proposal 1 and the reform package took effect, the gas tax would be 42 cents per gallon beginning October 1, 2015, and would be adjusted every October based on the rolling 12-month average wholesale price. The initial tax of 42 cents is based on an average wholesale price of $2.82 per gallon. Large year-to-year fluctuations in gas prices would not have a significant impact on the gas tax, however, since annual adjustments would be capped at the lesser of a 5.0% change in fuel price or inflation. The diesel fuel tax would be revised from $0.15 per gallon to 14.9% of diesel fuel average wholesale prices as well. Under the new fuel tax rates, Michigan Transportation Fund (MTF) would see an increase of approximately $1.2 billion in FY 2015-16.[3] The reform package includes various other revenue increases for transportation as well, for a grand total of approximately $1.3 billion in additional transportation revenue in FY 2015-16.

[3] This calculation is based on MTF revenue prior to appropriations to the CTF and other earmarks under the MTF law, Public Act 51 of 1951 (MCL 247.660).

Figures 3A-3B
Increasing the Fuel Tax: Where Taxes on Fuels Go
Comparison of Gas Taxation under Current Law vs. the Reform Package





It is important to note that under the reform package, any new revenue in excess of $800.0 million in FY 2015-16 and $400.0 million in FY 2016-17 would be directed to pay down existing transportation debt.[4] This means that road agencies would not realize the "total" revenue increases under the reform package until FY 2017-18. Table 2 presents the approximate distribution of "new" transportation revenue that would be generated under the reform package.

Table 2

Transportation Funding under Reform/Proposal 1:
Net Estimated Additional Revenue Distributions
(in Millions)

	FY 2015-16	FY 2016-17	FY 2017-18
State Trunkline (MDOT)	$180	$350	$575
Local Road Agencies	280	540	900
CTF (Public Transit)	25	70	125
Debt Service Payment	815	440	0
Total Increase	**$1,300**	**$1,400**	**$1,600**

Common Questions about Proposal 1 and the Reform Package

Question #1:
Is Proposal 1 a sales tax increase to pay for roads?

The increase for road funding would stem from a fuel tax increase, ***not*** *the sales tax increase. The sales tax on fuels would be eliminated.*

The State sales tax does not currently fund roads, and would not fund roads under the reform package. The sales tax on motor fuels would be repealed under the plan. This tax currently funds schools, local units of government, the General Fund, and public transit – but not roads.

The revenue generated from raising the sales tax to 7.0% would not be dedicated to roads. It would replace the revenue losses to schools, local units, the General Fund, and public transit, while increasing funding for these areas (with the exception of the CTF).

Effectively, the proposal would shift the sales tax burden from motor fuels to other goods, and also would provide an overall increase in sales tax revenue. The sales tax components of the reform package would not have any bearing on road funding. Under Proposal 1, all State taxes paid at the pump would go to transportation funding. Under current law, at a pump price of $3.80 per gallon, one-half of State taxes (the fuel tax) goes to transportation funding, and the other half (the sales tax) goes to schools, local governments, and the general fund.

Question #2:
Would Proposal 1 result in higher taxes at the gas pump?

The comparative tax burden per gallon of gasoline would depend on the retail price of gas at the time of purchase and the 12-month average wholesale price of gas for the fiscal year.

[4] According to MDOT, current transportation indebtedness is roughly $2.0 billion.

Estimates throughout governmental agencies as well as the press regarding the tax burden difference for FY 2015-16 have varied between $0.03 and $0.12 per gallon – but this is attributable to the use of different fuel prices for each calculation.

The current sales tax on gasoline is based on 6.0% of the *retail* price *at the time of purchase*. This means that the sales tax on gas can change from purchase to purchase, depending on the where and when gas is purchased. However, the motor fuel tax under the reform package would change only every 12 months, and would be based on the *12-month average wholesale* price of gasoline. The adjustment limitation of 5.0% or the level of inflation also would mitigate changes in the fuel tax relative to price shifts. As a result, if there were a spike in the retail price of gas, the tax burden under the reform package likely would be less than under current law.

It is possible, even likely, that the fuel tax burden in future years could be lower than under current law. This is because, while the retail price of gas tends to increase over time, despite the occasional dip, the basis for the fuel tax (the average wholesale price) would be locked in for 12 months and subject to caps on adjustments.

Figures 4A and 4B illustrate the comparative tax burden at the pump at different retail prices. The first scenario shows that in FY 2015-16, at a retail price of $2.00 per gallon, the reform package would result in a higher tax rate at the pump of $0.13 per gallon. The second scenario shows the reform package burden at $0.04 less than current law at $5.00 per gallon.

The lower the average wholesale price of fuel is in proportion to the retail price at the time of purchase, the lower the comparative tax burden would be under the reform package. For example, at $4.00 per gallon, the reform package would be tax-burden neutral as to gasoline – the sales tax would be $0.19 per gallon under current law, while the gas tax would be $0.19 more per gallon under the reform package. Given that the current 2014 average retail price of gasoline was $3.80, it is likely that the reform package would not have a substantial impact on pump prices in the aggregate.

Figure 4A: Tax Burden at $2.00 per Gallon
Current Law vs. Reform Package (FY 2015-16)
Gasoline Price: $2.00/Gallon Retail, $2.82 Avg Wholesale

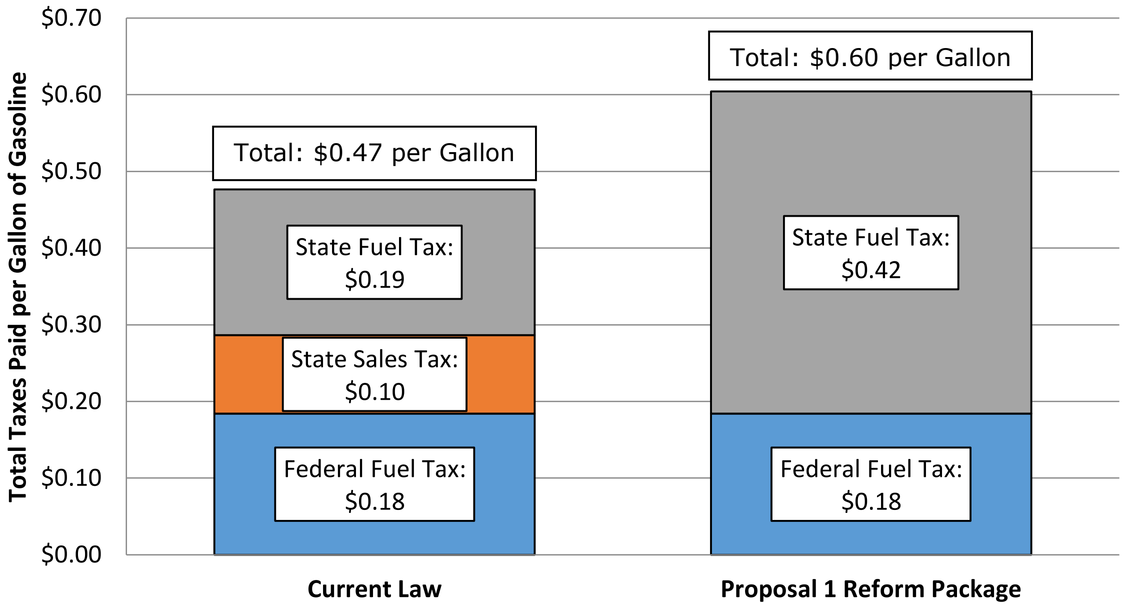
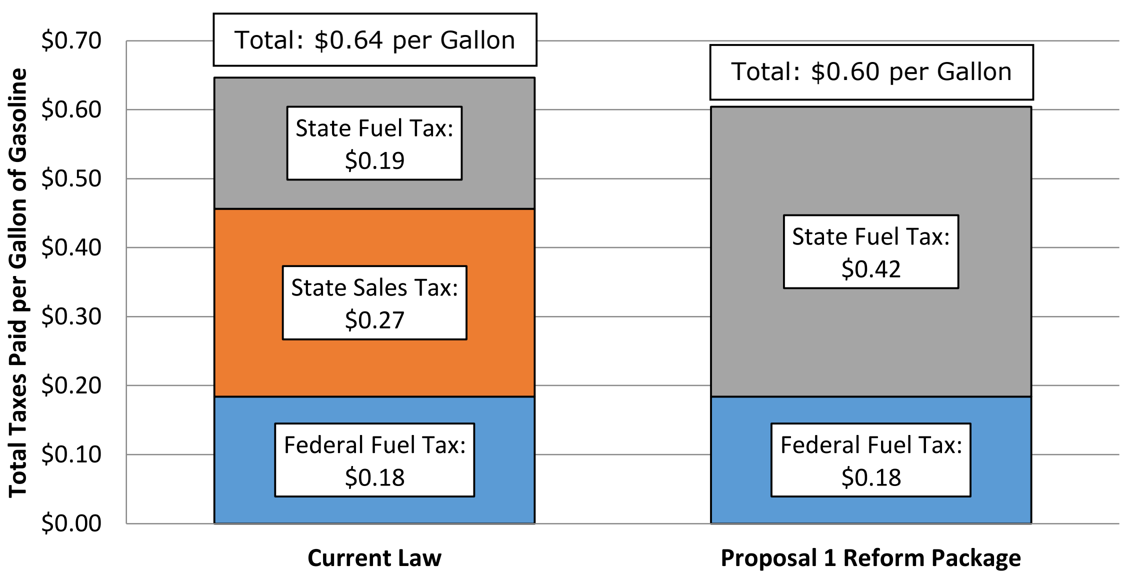


Figure 4B: Tax Burden at $5.00 per Gallon
Current Law vs. Reform Package (FY 2015-16)
Gasoline Price: $5.00/Gallon Retail, $2.82 Avg Wholesale



Question #3:
Could the revenue raised by the fuel tax increase be directed to areas other than transportation and road funding, or go to fund projects that are unrelated to roads?

Under the State Constitution, all fuel and registration taxes must be used for transportation purposes – and at least 90% must be used specifically for roads. Additionally, road funding is distributed according to a statutory formula, which offers little opportunity for direction to unrelated projects.

Article 9, Section 9 of the State Constitution states the following (emphasis added):

"*All specific taxes* … *on fuels* sold or used to propel motor vehicles … shall… be used *exclusively for transportation purposes*…

"Not less than *90 percent* … shall… be used *exclusively* for the transportation purposes of planning, administering, constructing, reconstructing, financing, and maintaining state, county, city, and village *roads, streets, and bridges*…

"*The balance*, if any … shall be used *exclusively for* the transportation purposes of *comprehensive transportation*…".

Simply put, it would be unconstitutional for less than 90% of the revenue generated from the fuel tax increase, or vehicle registration fee increases, to be used for roads. Further, it would be unconstitutional for any remainder to be used for anything other than comprehensive transportation purposes (public transit, aeronautics, and rail).

With regard to the unrelated projects, Public Act 51 of 1951 (PA 51) contains the statutory formula that determines where transportation funding goes. Generally speaking, 10.0% of the revenue goes to the CTF. Of the remainder, 39.1% goes to MDOT, 39.1% goes to county road agencies, and 21.8% goes to cities and villages. The formula calculates disbursements to individual local road agencies based on readily quantifiable data such as population, vehicle registrations, and urban and primary lane miles. Absent amendments to PA 51, new transportation revenue under the plan would have to follow the existing PA 51 formula.

While the Legislature may include budget provisions to allocate funds to specific road projects, those funds still must be directed and used according to the terms of the Constitution and statute. The Michigan Department of Transportation and local road agencies must abide by the rules when spending the fuel tax and vehicle registration tax revenue. The same rules that now apply to road funding would continue to apply to the new revenue generated under the reform package. The reform package would have no substantive change on distribution or spending rules.

Conclusion

From a budgetary standpoint, the transportation reform package would result in increases in transportation funding, the School Aid Fund, constitutional revenue sharing, and the General Fund. The plan would result in an increase in motor fuel tax revenue that would more than account for inflation since the last gas tax increase to 19 cents per gallon in 1997. As gasoline consumption continues to decline in future years, revenue from gasoline taxes will continue to decrease accordingly. However, these negative effects would be somewhat mitigated since the tax would be based on the average wholesale price of gasoline, which has tended to increase over time.

Additionally, the reform package could indirectly affect a number of other budgets. If Proposal 1 fails, and if the past several years are any indication, roughly $150.0 million in additional transportation funding will be needed to maximize Federal match dollars. Typically, Federal match funding in recent years has been maximized through the appropriation of General Fund dollars to transportation. These General Fund appropriations to transportation come at the expense of various other budget areas. If Proposal 1 is approved, the increase to State trunkline funding likely should be sufficient to maximize Federal match dollars in FY 2016-17 – even when considering the earmark of a portion of new revenue to paying down debt service. In FY 2015-16, General Fund appropriations will be required to maximize Federal match dollars, regardless of the outcome of Proposal 1.

From the standpoint of infrastructure demands, it is unclear what effects the reform package would have. With regard to the State trunkline, which does not include roads under local control, MDOT has indicated that it needs an additional $1.1 billion in immediate funding to meet infrastructure goals by 2025. Under the reform plan, due to the debt repayment mandate, the additional revenue gained by MDOT would be approximately $180.0 million in FY 2015-16 and $348.0 million in FY 2016-17, and would stabilize around $573.0 million in FY 2017-18. As a result, this likely would push back the 2025 goal date, and perhaps MDOT would adjust its road condition goals due to funding restraints. The tradeoff for delaying funding increases would not necessarily be year-for-year – a year of maintenance delay on the front end would result in a longer delay on the back end. Local road agencies would see an increase, but since their funding needs are less clear, it is difficult to predict whether Proposal 1 would generate enough funds to satisfy local road needs.

From the consumer and taxpayer standpoint, the provision of the reform package that would have the most impact is the sales tax increase. The sales tax increase on nonfuel goods from 6.0% to 7.0% would increase the cost of purchasing these goods. On the other hand, the fuel tax increase combined with the repeal of sales tax on fuels would result in a nominal difference for those buying fuel at the pump.

From a policy standpoint, the reform package would represent a shift for the State in drawing a line between motor fuels and other commodities. All taxes on fuel would go to transportation and roads, whereas taxes paid at the pump currently go to roads, schools, local governments, and the General Fund.

Table 3
Estimated Impact of Transportation Package as Passed by Legislature
Tax and Vehicle Registration Changes
(dollars in millions)

Tax/Registration Change	FY 2015-16	FY 2016-17	FY 2017-18
Increase Tax Credits (SB 847)			
Increase Earned Income Tax Credit	$0.0	($260.8)	($267.4)
Increase Homestead Prop. Tax Credit for Low Income Seniors	$0.0	($0.3)	($0.3)
Total	$0.0	($261.1)	($267.7)
General Fund	$0.0	($261.1)	($267.7)
Exempt Gas from Sales/Use Tax (HB 4539/HB 5492)			
School Aid Fund	($567.1)	($557.5)	($568.0)
Comprehensive Transportation Fund	($35.7)	($35.1)	($35.7)
Constitutional Revenue Sharing	($76.7)	($75.4)	($76.8)
General Fund	($96.7)	($95.2)	($97.1)
Total	($776.2)	($763.2)	($777.7)
Increase Sales Tax (Sales other than gasoline/diesel fuel) (HJR UU)			
School Aid Fund	$708.6	$732.6	$754.7
Comprehensive Transportation Fund	$16.5	$17.0	$17.5
Constitutional Revenue Sharing	$177.1	$183.2	$188.7
General Fund	$524.4	$541.2	$557.5
Total	$1,426.6	$1,474.1	$1,518.4
Use Tax Earmark to School Aid Fund (HB 5492/HJR UU)	$151.1	$155.6	$160.3
General Fund	($151.1)	($155.6)	($160.3)
Establish Affiliate Nexus (SB 658/SB 659)			
School Aid Fund	$44.0	$45.5	$46.8
Constitutional Revenue Sharing	$6.0	$6.2	$6.4
General Fund	$10.0	$10.3	$10.6
Total	$60.0	$62.0	$63.9
Restructure Motor Fuel Tax (HB 5477/HB 5493)			
Michigan Transportation Fund	$400.0	$800.0	$1,352.3
Comprehensive Transportation Fund	$40.0	$80.0	$135.2
MDOT Debt Service	$814.7	$456.2	$0.0
Recreation Account (Legacy Fund)	$24.8	$25.6	$27.6
Total	$1,239.5	$1,281.8	$1,379.9
Vehicle Registration (HB 4630)			
Truck Registrations	$50.0	$50.0	$50.0
Depreciation/Discount Elimination	$10.9	$41.0	$62.0
Total	$60.9	$91.0	$112.0
Michigan Transportation Fund	$60.9	$91.0	$112.0
Comprehensive Transportation Fund	$6.1	$9.1	$11.2
Net Impact of Changes			
Michigan Transportation Fund	$460.9	$891.0	$1,464.3
Comprehensive Transportation Fund	$26.9	$71.1	$128.3
MDOT Debt Service	$814.7	$456.2	$0.0
Recreation Account (Legacy Fund)	$24.8	$25.6	$27.6
School Aid Fund	$336.5	$376.2	$393.8
Constitutional Revenue Sharing	$106.4	$114.0	$118.3
General Fund	$286.6	$39.6	$43.1
Total	$2,029.9	$1,902.6	$2,047.0

Prepared by: Michigan Senate Fiscal Agency, April 15, 2015

State Notes

TOPICS OF LEGISLATIVE INTEREST

Winter 2015

Michigan Early Stage Venture Capital Tax Vouchers
By David Zin, Chief Economist

The Senate Fiscal Agency's December 2014 *Economic Outlook and Budget Review* presented projected balance sheets for the General Fund and School Aid Fund for the current 2014-15 fiscal year (FY) as well as FY 2015-16. Both balance sheets contained a new entry, not included in the balance sheets published after the May 2014 Consensus Revenue Estimating Conference, lowering both General Fund and School Aid Fund revenue. This new entry reflects the likely redemption of tax vouchers issued under the Michigan Early Stage Venture Capital program.

The Michigan Early Stage Venture Investment Act was enacted in 2003 in order to, as the legislation states, "promote the economic health" of Michigan by "assisting in the creation of new jobs, new businesses, and new industries". Venture capital is a term that describes money invested in startup firms and small businesses that are perceived to have long-term growth potential but do not have access, or sufficient access, to capital markets. Venture capital investments are often regarded as risky but have the potential to generate above-average returns, at least over a long period of time. As a result, such investments are made only by firms and individuals who have the resources to weather substantial losses or can afford to wait sometimes decades for a return on their money.

Access to capital also can affect location decisions and it is not uncommon for firms that would be likely to attract the attention of venture capital investors to relocate to places where such capital is more readily available. By increasing the amount of venture capital available to Michigan businesses, the Michigan Early Stage Venture Investment Act intended not only to expand Michigan's economy but also to prevent the relocation of promising startup companies already located in the State.

However, in 2003 the State faced serious budgetary constraints because of the weak recovery following the 2001 recession, making it difficult to find funding for a new program that would require significant State revenue. As a result, the Michigan Early Stage Venture Investment Act was designed to commit future State revenue, through the use of tax incentives that would be redeemed in future years when the economy (and presumably State revenue) would be better, to guarantee loans that could invest in venture funds in the near term. Further, the operations of the program were structured to require the involvement of outside venture capital funds, thus allowing the State's near-term investments to leverage additional venture capital from private investors.

This article will provide background information regarding the program established by the Michigan Early Stage Venture Investment Act of 2003, discuss how the program works, describe the impact the program is expected to have on the budget over the next few fiscal years, and suggest options to alter that impact.

Background

In the early 2000s, the Michigan Treasury, the Michigan Legislature, the newly formed Michigan Venture Capital Association, and various individuals began working to create a vehicle to support the emerging venture community and foster greater early stage technology investment. In a bipartisan effort led by legislators and supported by the State Treasurer, the Michigan Early Stage Venture Investment Act of 2003 was enacted. The initial legislation consisted of three measures: Public Acts 295, 296, and 297 of 2003. Public Act (P.A.) 295 and P.A. 297 provided tax credits against the income tax and Single Business Tax (SBT), respectively, for investments made pursuant to P.A. 296. Public Act 296, the Michigan Early Stage Venture Investment Act of 2003, established the corporate and administrative framework for the investments.

As part of the package implementing the Michigan Early Stage Venture Investment Act of 2003, P.A. 297 of 2003 amended the Single Business Tax Act to provide $150.0 million of refundable SBT credits to collateralize (secure loans to) the Venture Michigan Fund (VMF or the Program). The Venture Michigan Fund is a nonprofit corporation created under the Michigan Early Stage Venture Investment Act (the Michigan Early Stage Venture Investment Corporation) and overseen by a seven-member board that includes the State Treasurer and the chief executive officer of the Michigan Economic Development Corporation (MEDC), or their designees, and five other individuals appointed by the Governor, including one from recommendations made by the House, the Senate, and a statewide nonprofit organization representing more than 50% of Michigan venture capital companies (currently the Michigan Venture Capital Association). The loan proceeds were to be used by the VMF to fund investments in venture capital funds operating in Michigan. The legislation indicates that the tax credits would cover any difference between an agreed-upon rate of return for, or negotiated payment to, lenders and the actual return or payment made under the loan agreements. The credits could be redeemed for tax liabilities generated in tax years after 2008 and before 2020. As originally enacted, not more than $30.0 million of credits could be authorized in any calendar year. Public Act 295 of 2003, which amended the Income Tax Act, provided that for tax years after 2009, if a credit could not be claimed against the SBT, it could be applied against income tax withholding requirements and/or transferred to another taxpayer.

In 2005, the program created by the Michigan Early Stage Venture Investment Act of 2003 was revised and expanded. A package of bills was enacted to obtain funds for economic development programs, in relation to the securitization of a portion of tobacco settlement revenue. One of those measures, P.A. 233 of 2005, amended the SBT Act to convert the refundable credits into nonrefundable, but transferable, vouchers, and increase the maximum amount of vouchers that could be issued from $150.0 million to $600.0 million if securitization occurred, as it did. The conversion to vouchers took place because it had been determined that the credits were equivalent to a guarantee and thus deemed unconstitutional.

Under the 2005 legislation, a tax voucher would be a certificate that a taxpayer could remit in lieu of a tax payment or portion of a tax payment, and the voucher would satisfy the taxpayer's associated liability. Vouchers were not to be approved after December 31, 2015, and the amount approved for any tax year was limited to 25.0% of the value of all approved vouchers. The Act retained the requirement that vouchers not be applied before 2009, but further limited the vouchers to be the least of: 1) the amount stated on the voucher, 2) the amount authorized to be used, or 3) the taxpayer's liability. Excess voucher amounts could be carried forward indefinitely. In 2007, with the adoption of the Michigan Business Tax (MBT), the existing legislative provisions were adapted to allow vouchers to be applied against the MBT or income tax withholding.

The Venture Michigan Fund is authorized to promote Michigan's economic health by assisting in the creation of new jobs, new businesses, and new industries in Michigan through the creation of a fund-of-funds that would invest with venture capital managers (private venture capital funds) that, in turn, would invest in Michigan-based early stage companies. Two fund-of-funds were created: the Venture Michigan Fund I, Limited Partnership (VMF I) and the Venture Michigan Fund II, Limited Partnership (VMF II). Both VMF I and VMF II were funded with money borrowed by the Venture Michigan Fund.

The Venture Michigan Fund and Tax Vouchers

As permitted by the Michigan Early Stage Venture Investment Act, the State Treasurer has approved $450.0 million in vouchers that may be issued by the VMF, with $200.0 million in vouchers allocated to VMF I and the remaining $250.0 million to VMF II. For both VMF I and VMF II, the Venture Michigan Fund borrowed money to invest with venture capital funds. The loan agreements specified the amount of the loan, the timing over which funds from the loan could be drawn down, the timing and amounts for repayment of principal and interest, and the establishment of reserve funds to pay debt service, operate the funds, and allow required capital contributions to venture capital funds. Both the reserve funds and the tax vouchers serve as collateral for the lenders that provided the loans. According to the Administration, the tax vouchers were designed to serve as collateral for the loans and at least a portion of the vouchers was always intended to be used to repay some portion of the loans. Although copies of the agreements are submitted to the Department of Treasury, the VMF's activities, including any borrowing terms and investment plans, are overseen by the VMF's board of directors.

The amount and timing of tax voucher use are affected by several factors, including the performance of the venture capital funds, the timing of cash flows to and from the venture capital funds, and the discount to face value at which the vouchers are sold. The vouchers represent the primary source of collateral for the lenders' loan underwriting and were considered critical because the VMF possessed no assets of its own to collateralize any debt.

The legislation places no restrictions or other requirements on the agreements, and a limited number of restrictions on any investments made by the VMF. However, investments were supposed to be made in venture capital funds that would, in turn, invest in companies that would be the most successful at generating above-average returns in the context of pursuing a variety of economic development priorities. Investments from VMF I and VMF II in a venture capital fund were not to exceed 25.0% of a recipient's capital, and recipients were to have a substantial Michigan presence.

Section 27 of the Early Stage Venture Investment Act of 2003 requires the VMF to publish annual reports that include information regarding all activities, an analysis of the economic impact of its investment plan, the number of jobs represented by investments, and a variety of detail on the return on any investments. However, the law does not require these annual reports to be submitted to any specified entity. While both the audited annual financial reports and the annual reports required under Section 27 have been produced, and provided to the Department of Treasury and the Michigan Economic Development Corporation, the Senate Fiscal Agency (SFA) has been unable to obtain copies.

VMF I and VMF II

As noted earlier, the Venture Michigan Fund currently has two main investment programs operating: VMF I and VMF II. Both operate in substantively the same manner but represent two discrete investment operations. The first major activities under VMF I began in 2006, when VMF I secured $200.0 million in loans from special purpose entities formed by Deutsche Bank and Credit Suisse. The loans were drawn down in five equal annual installments and were collateralized by $200.0 million in tax vouchers, with portions of the loan proceeds allocated to reserves required under the loan agreements. The loans bear a fixed interest rate of 6.875% and repayment of principal will occur over a 50-month period scheduled to begin in June 2015. After the deductions for the required reserves, the VMF committed $95.0 million to the VMF I program.

Operational activities for VMF I and VMF II are handled by a fund manager that the Venture Michigan Fund contracts with to manage the programs. The fund manager uses VMF's capital commitments to make capital commitments to venture capital funds. These venture capital funds then use the VMF commitments, and commitments from other investors, to make investments in early-stage Michigan companies meeting the criteria identified in the Early Stage Venture Investment Act. As a result, venture capital firms essentially pool money from a variety of investors, not just from VMF I, and then select what they perceive as promising investments in early-stage Michigan businesses. Therefore, the funds from VMF I generally will represent only a portion of both the money invested in a venture capital firm and the venture capital firm's underlying portfolio of investments in firms. VMF I has committed to invest $95.0 million with 11 venture capital funds, some based and/or located in Michigan and some based/located in other states.

Figure 1 illustrates the cash flows involved in the process when VMF I began operations. The process began with the State authorizing the VMF and the tax vouchers. After the lenders became involved, there are actually two "circles" of money flowing, joined by the link between the lenders and the VMF. One circle is the tax vouchers, which are discussed in more detail later. These vouchers flow from the State to the lender to various taxpayers and are ultimately redeemed by the State. The second circle involves the proceeds from the loan. This circle, discussed in more detail below, involves the VMF investing the loan proceeds in venture capital funds, which in turn invested in Michigan early stage businesses. As illustrated by Figure 1, both circles of money flow are rather complex.

If the cash flow details created by the VMF obtaining the loan proceeds over a five-year period are ignored, the loan proceeds of $200.0 million were initially directed to three accounts: an interest reserve, a shortfall reserve, and an operating account. After a 2014 amendment to the financing structure, a capital contribution reserve account also was created.

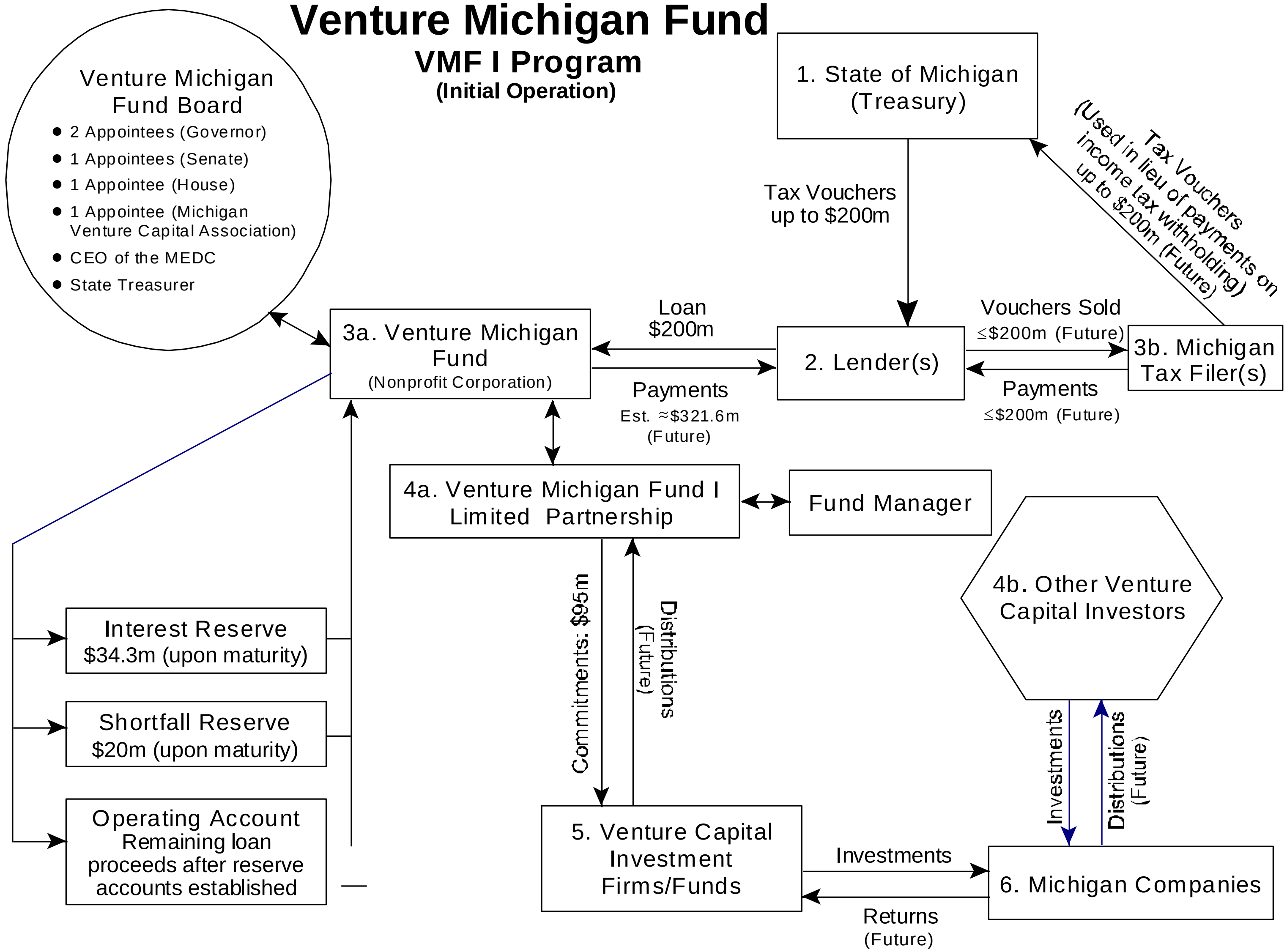
Figure 1 attempts to illustrate two things: 1) the flow of money from various entities and funds, and 2) the magnitude of the various money flows. While the structure of the relationships is relatively straightforward, specific numbers in the figure can be misleading. For example, it is estimated that the shortfall reserve will eventually need to provide $20.0 million in proceeds. However, the demands for money from this account will occur over a period of years and the money in the reserve was invested so that, upon maturity, the account would provide the full $20.0 million, even if at any specific time the account does not exhibit a balance of $20.0 million. Similarly, money was initially deposited in the interest reserve account and invested so that, upon maturity, the account would provide $34.3 million, even if at any specific time the account does not exhibit a balance of $34.3 million. Over the last several years, the operating account has been depleted as capital contributions to the venture capital funds and expenses, particularly interest expenses, were paid from the account's balance. As a result, any monetary amounts shown in Figure 1 represent the value as of a specific point in time.

Figure 1

Venture Michigan Fund

VMF I Program

(Initial Operation)



The interest reserve was initially dedicated to making the interest payments on the loan during the time the loan was expected to be repaid, beginning in June 2015. The money in the account was invested and the securities are configured to have maturity dates and amounts adequate to cover all of the interest due on the loans. The reserve initially invested in securities that would yield $34.0 million upon maturity. However, these securities were offered by AIG and during the 2008-2009 financial crisis the securities were downgraded and deemed insufficient to qualify as a valid reserve investment. As a result, and in order to avoid a default on the loans that would have triggered the use of the tax vouchers, VMF I invested an additional $28.1 million (with a face value at maturity of $34.3 million) as a new interest reserve. The shortfall reserve also held securities issued by AIG. The AIG securities for both the interest reserve and the shortfall reserve were retained until they had appreciated and were sold in December 2012 and January 2013 for approximately $46.2 million, which represented a gain of $3.7 million relative to the value the investments had accumulated as of the sale date. The proceeds from these sales were deposited into the operating account to replace the additional amounts that had been deposited into the interest and shortfall reserves as a result of the downgrade.

The $20.0 million directed to the VMF I shortfall reserve was intended to cover discounts that were expected to occur when the tax vouchers are sold. The vouchers have a face value of $200.0 million. However, because the lenders are not located in Michigan, they are not likely to be able to use the vouchers. (Although the vouchers could be applied to MBT payments, it is expected that the vouchers will likely be applied against individual income tax withholding payments required by the State, and without any employees in Michigan, the lenders would not be subject to any withholding requirements.) Therefore, in order for the vouchers to generate money for the lenders, the lenders will need to sell the vouchers to taxpayers who will have the ability to use them. As a result, the lenders are likely to realize less in proceeds from the sale than the $200.0 million face value of the vouchers. The shortfall reserve is an account intended to cover the difference between the face value of the vouchers and what the lenders ultimately receive when the vouchers are sold. As the size of the reserve suggests, the vouchers were predicted to be purchased at a 10.0% discount, meaning that $50.0 million of vouchers would sell for $45.0 million. However, although the sale would generate only $45.0 million in proceeds for payment to the lender, the full $50.0 million must still be repaid and the purchaser would be able to redeem the vouchers for the full $50.0 million face value, thereby reducing State withholding revenue by $50.0 million.

Proceeds not directed to these reserve accounts were placed into the operating account. As a result, the operating account held proceeds both to fund the VMF I's commitments to venture capital funds and to address virtually all of the other fees and expenses associated with operating VMF I. While $95.0 million of the loan proceeds was committed for investment in venture capital funds, the commitments do not immediately translate into actual investments. The venture capital funds draw on the capital commitments over time as suitable investments are determined and/or need additional capital; until the venture capital funds make such capital calls, the money remains in the operating account. As a result, the operating account's balance has varied, as venture capital funds have drawn down the capital VMF I has committed. Aside from funding VMF I's commitments to the venture capital funds, the greatest expense the operating account has covered has been the roughly $14.0 million in annual interest the loan has generated. Like the other accounts, the operating account also has generated interest income from its balances.

In 2014, the VMF also established a $10.0 million capital contribution reserve account for VMF I to cover capital calls made on the VMF by the venture capital funds in which VMF I had made commitments, as well as to cover operating expenses. This reserve balance is measured and reassessed on a monthly basis, and can have a maximum balance of the lesser of $10.0 million or 90% of VMF I's remaining capital commitments to the venture capital funds. This account was created as a result of amendments to the original loan, which also required any remaining cash in the operating account to be used to repay the loan. Since the 2014 amendment, approximately $4.0 million of the loan principal has been repaid.

Figure 2 illustrates the cash flows and financing structure of VMF I as of December 31, 2014. As a result of both returns from investments and capital freed up by various restructuring in the financing arrangements, approximately $4.0 million of loan principal has been repaid. VMF I has received approximately $14.0 million in distributions from the venture capital funds, which has helped cover ongoing interest and operating costs. VMF I also has paid approximately $84.5 million in interest to the lenders. Once the scheduled repayment process begins in 2015, the voucher sale process will begin, ultimately leading to repayment of the loan principal, and the declining loan principal will result in lower interest payments from VMF I.

VMF II operates functionally the same way as VMF I. The initial loan from an affiliate of Credit Suisse was for $250.0 million, and is being drawn down in six equal annual installments that began in December 2010. The last draw on the loan is scheduled to occur in January 2016. The VMF II program has committed $120.0 million for investment with 10 venture capital investment firms. Some of the funds receiving VMF II are the same funds (or affiliate funds) as those invested in by VMF I.

As of November 2014, the two VMF programs had invested $155.0 million in 42 Michigan early-stage companies. Because the venture capital funds pool these investments with money from other investors, these companies have actually received a total of $879.5 million of investments, suggesting that the Michigan portion of these investments leveraged an additional $724.5 million of investment capital. According to the data received by the SFA, these 42 Michigan companies currently have more than 1,000 employees and employment at these firms has increased by approximately 59.5% since the firms began receiving capital from the VMF program.

In addition to resulting in capital investments in early-stage Michigan companies, the Michigan Early Stage Venture Investment Act of 2003 has affected the venture capital industry in Michigan. The number of venture capital firms headquartered in Michigan has increased from just a few in 2003 to 16 in 2009 and 23 in 2013; the number of venture capital professionals employed at these firms almost doubled in the last five years, rising from 44 in 2009 to 81 in 2013, according to the Michigan Venture Capital Association.

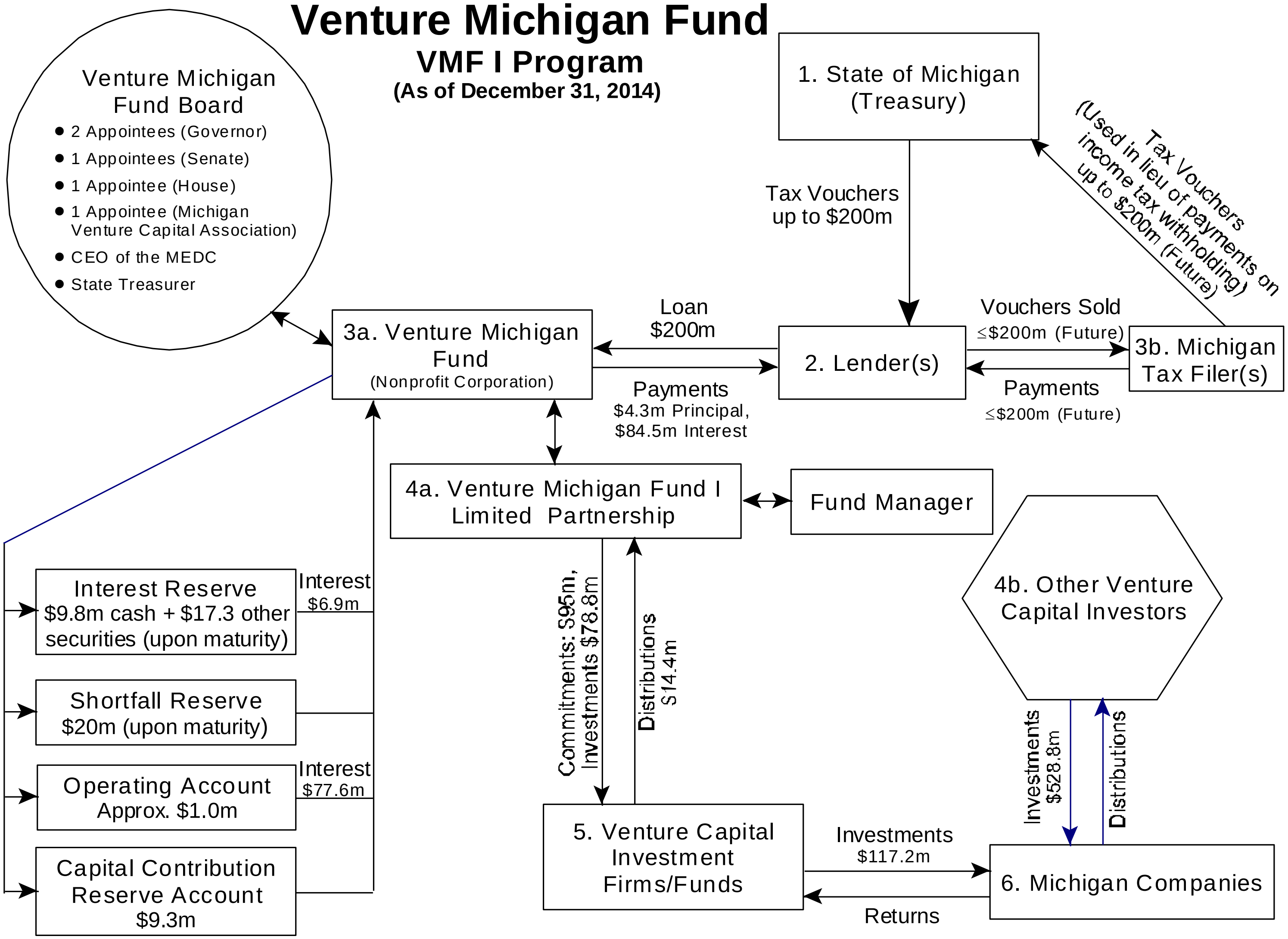
The growth of early-stage companies is often constrained by limited available capital and the business activity is often very capital-intensive. Furthermore, early-stage companies are often characterized by long lead times to product development, resulting in long time horizons for potential investment returns. Realization of these aspects of the investments is illustrated by the enacting legislation, which does not call for the Venture Michigan Fund to expire until January 1, 2054, roughly 50 years after the initial legislation took effect.

Figure 2

Venture Michigan Fund

VMF I Program

(As of December 31, 2014)



Impact of the Vouchers on State Revenue

As indicated earlier, the tax vouchers are forecasted to be applied against a taxpayer's withholding liabilities under the Michigan individual income tax. Taxpayers will essentially remit a voucher in lieu of a payment or portion of a payment. The redemption amount will reflect the face value of the voucher, not the price a taxpayer may have paid when the taxpayer purchased it from the lender. Withholding revenue is directed to both the General Fund and the School Aid Fund, with the School Aid Fund receiving approximately 23.8% of the revenue. Any portion of the vouchers applied against MBT liabilities would reduce only General Fund revenue.

The loan agreements provide a schedule for both interest payments and principal repayment. The necessity and timing of selling tax vouchers to meet the terms of the repayment schedule depends on the timing and amount of any returns generated by the investments in the venture capital funds. Based on current information, vouchers worth $140.0 million are currently scheduled to be sold, and will be presented to the lenders as follows:

1) $25.0 million in June 2015.
2) $25.0 million in October 2015.
3) $50.0 million later in FY 2015-16.
4) $40.0 million in FY 2016-17.

While this schedule indicates when the lenders will receive the vouchers, it does not indicate when the vouchers will be sold by the lenders, what proceeds the lenders will ultimately receive for the vouchers, or when a buyer will use the voucher to satisfy a tax obligation. As a result, the fiscal impact of the vouchers may or may not occur during the fiscal year in which the vouchers are presented to the lenders.

Assuming the first two redemptions post against FY 2014-15 individual income tax withholding revenue and the rest post in the fiscal year in which they are presented to the lenders, the vouchers will reduce General Fund revenue by $38.1 million in both FY 2014-15 and FY 2015-16, and by $30.5 million in FY 2016-17. Over the life of the vouchers, assuming all $450.0 million in vouchers is ultimately used, the entire General Fund reduction could total as much as $342.8 million. Similarly, based on the same assumptions, the redemptions will reduce School Aid Fund revenue by $11.9 million in both FY 2014-15 and FY 2015-16, by $9.5 million in FY 2016-17, and over the life of the vouchers by as much as $107.2 million.

Options to Alter the Fiscal Impact of the Vouchers

The State has limited options available to alter the fiscal impact of the vouchers on State revenue, primarily because the money for the VMF programs has largely already been borrowed. As a result, the State's maximum liabilities related to the program are essentially fixed at $450.0 million. However, the Legislature could make changes to the Program that could alter the timing and/or magnitude of the impact, as well as the distribution of the impact between the General Fund and the School Aid Fund.

The most extreme option the State could pursue would be to terminate the Venture Michigan Fund Program. Such a termination would result in a default under the loan documents for both VMF I and VMF II, with the potential of affecting the State's reputation in capital markets. Furthermore, the interest rate on the loans would increase until both loans were repaid and would allow the lenders to accelerate their sale of all tax vouchers. Not only would the vouchers be sold more rapidly, accelerating the impact of revenue losses to the State, but the volume of vouchers would likely increase for two reasons. First, because the investments for VMF I and VMF II are also collateral for the lenders, the lenders would liquidate those investments in the venture capital funds, and these sales would likely face steep discounts because these investments have not yet matured to their maximum value. Second, the sale of such a large volume of vouchers might increase the discount applied to the voucher sales and thus increase the number of vouchers that would need to be sold in order to generate sufficient proceeds to repay the loans. The most significant drawback to this approach is that the State's liabilities would be relatively unchanged: the $450.0 million in loans still would need to be repaid and the $450.0 million in vouchers would still need to be honored. The only potential savings would occur if the losses on the current investments were less than the net interest paid on the loans; and, if the calculation includes the net return on the investments that would be generated if the programs were not terminated, the likelihood of savings is further reduced. Furthermore, unlike VMF I, the VMF II program is sufficiently new that the prepayment penalties on the loan used to fund VMF II have not yet expired, meaning that an early payoff of the loan would have additional costs beyond the outstanding balance.

Another option involves limiting the amount of vouchers that can be redeemed each fiscal year. The timing of when the vouchers need to be sold is largely driven by when returns are received from the investments and the repayment schedule for the principal. Assuming the returns in the short term are unlikely to generate sufficient revenue for repayment, the repayment schedule is essentially the same as the one for voucher sales. However, while voucher sales generate proceeds for the lenders according to the repayment schedule, no similar requirement exists for the taxpayers that purchase the vouchers. As a result, the State could limit the total amount of vouchers that can be redeemed each fiscal year, either on a per-taxpayer basis or in total for all taxpayers, or both. Such limitations could reduce the amount of revenue the State would lose each year and would be somewhat consistent with the original tax credit legislation that limited the credits to not more than $30.0 million per year. However, limiting the potential ability of taxpayers to redeem vouchers would likely increase the discount associated with their sale, thus increasing the use of vouchers over time and resulting in a greater loss of revenue to the State. Depending on the degree to which discounts were affected, such changes also would have the potential to raise default issues under the loan agreements.

A third option, one that would not require any legislation other than an appropriation, or raise issues of default under the loan agreements, would be for the State to purchase the vouchers from the lenders at face value. Under such an arrangement, the State could save money because no discount would need to be built into the voucher sale and greater proceeds would be available to repay the loans. As indicated above, the agreement structure assumes a 10.0% discount on the sale of the vouchers, so a $50.0 million voucher sale would reduce State revenue by $50.0 million but generate only $45.0 million for the lender. In this example, the State's purchase of $50.0 million in vouchers from the lender would reduce State revenue by $50.0 million but generate $50.0 million in proceeds for the lender, rather than only $45.0 million. Given that the sale of vouchers would generate higher proceeds, fewer vouchers would likely need to be sold in aggregate. Furthermore, this option could reduce the costs to the State because the VMF could attempt to negotiate more favorable terms with the lenders. One additional facet of this approach is that it would eliminate the impact of the vouchers on the School Aid Fund, and all of the impact would fall on the General Fund because General Fund revenue would be used to purchase the vouchers.

Conclusion

Because of the risks associated with early-stage businesses, venture capital finance is complicated and requires investors to accept long time horizons in order to maximize returns. The Michigan Early Stage Venture Investment Act of 2003 not only had to contend with the complexities of venture capital markets but needed to address the problem of how the State, during a recession and accompanying budget difficulties, could encourage such businesses in an effort to create, as described in the Act, "new jobs, new businesses and new industries within" Michigan. More than a decade later, the costs associated with that endeavor are coming due. How those costs will be addressed is something that will likely be determined during the 2015-2016 legislative session.