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HOUSE FISCAL AGENCY

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Federal-Aid Highway Funds in the State Transportation Budget

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Executive Summary

- Federal aid provides approximately $1 billion each year for state highway programs. Federal funds support over one-half of the Michigan Department of Transportation's state trunkline road and bridge program.

- In recent years, the state's ability to access federal-aid highway funds has been at risk due to a shortfall in required state matching funds. The potential loss of federal funds, and the identification of state sources of matching funds, was the focus of both FY 2010-11 and FY 2011-12 budget deliberations. The Michigan Department of Transportation's *2012-2016 Five-Year Transportation Program* indicates that, beginning in FY 2012-13, the annual shortfall in matching funds will be between $75 million and $100 million, resulting in a potential annual loss of $440 million to $600 million in federal aid.

- Several options have been implemented, or proposed, for obtaining funds needed to match all available federal aid, including use of toll credits, use of Canadian funds related to the proposed NITC project, expanding local road agency access to federal-aid program funds, and use of state General Fund revenue for state transportation programs. While these four options may help to maintain baseline levels of transportation funding; they would not increase baseline transportation revenue or address structural problems in state transportation funding.

- A bill package intended to address larger structural transportation funding issues was introduced in both the Michigan House and Senate on January 26, 2012. House Bill 5289 would increase Motor Fuel Tax revenue; House Bill 5300 would increase Michigan Vehicle Code registration tax revenue. Together these two bills would increase dedicated transportation revenue by over $1 billion annually. While not necessarily targeted at providing matching funds, passage of these bills would provide sufficient state funds to match all available federal-aid highway funds.

Introduction

Most public funding for state transportation systems is provided through the state transportation budget.[1] While state restricted revenue (from state taxes on motor fuel and vehicle registrations) is the largest component of the annual state transportation budget, federal funds are the second largest. Federal funds typically represent one-third of the revenue appropriated in Michigan transportation budgets. Federal funds support over one-half of the Michigan Department of Transportation's state trunkline road and bridge programs.

Over the last 15 years, from FY 1997-98 through FY 2011-12, baseline federal aid appropriated in the state transportation budget ranged from $732.5 million to $1.43 billion, averaging $1.094 billion.[2] Federal aid in the current fiscal year (FY 2011-12) state transportation budget is $1.24 billion.[3]

While federal aid provides support for state transit, rail passenger, rail freight, and aviation programs, the largest share of federal aid in the state transportation budget is for state *highway programs* – $1.08 billion in the current fiscal year budget. *Highway programs* in this context means federal aid for the construction and preservation of roads, streets, and bridges under both state and local jurisdiction.

In recent years, the state's ability to access federal-aid *highway* funds has been at risk due to a shortfall in required state matching funds.[4] The potential loss of federal funds, and the identification of state sources of matching funds, were the focus of both FY 2010-11 and FY 2011-12 budget deliberations. In development of the FY 2010-11 budget, the department had indicated that it would be $84.0 million short of state funds needed to match all available federal funds. The estimated shortfall for FY 2011-12 was $147.0 million. In both fiscal years the shortfall, *as represented in the budget*, was resolved primarily through short-term or one-time savings or fund shifts, including reductions in state trunkline maintenance, deferral of capital outlay projects, and the use of toll credits.

The FY 2010-11 budget also assumed the sale of $40 million short-term notes to match federal aid. The department was able to match federal funds in FY 2010-11 without selling notes. However, in December 2011, the department sold $91.0 million in State Trunkline Fund bonds, of which $40.0 million was designated for matching federal funds in the state trunkline construction program.

The Governor's proposed FY 2012-13 transportation budget includes $96.0 million in state General Fund revenue to address the match problem with regard to federal-aid highway funds, and an additional $23.0 million General Fund appropriation to match federal transit grants. The Governor's budget designates these proposed appropriations as "one-time."

The state's ability to match all available federal-aid highway funds remains a long-term problem. The department's *2012-2016 Five-Year Transportation Program* indicates that, beginning in FY 2012-13, the annual shortfall in matching funds will be between $75 million and $100 million, resulting in a potential annual loss of $440 million to $600 million in federal aid.

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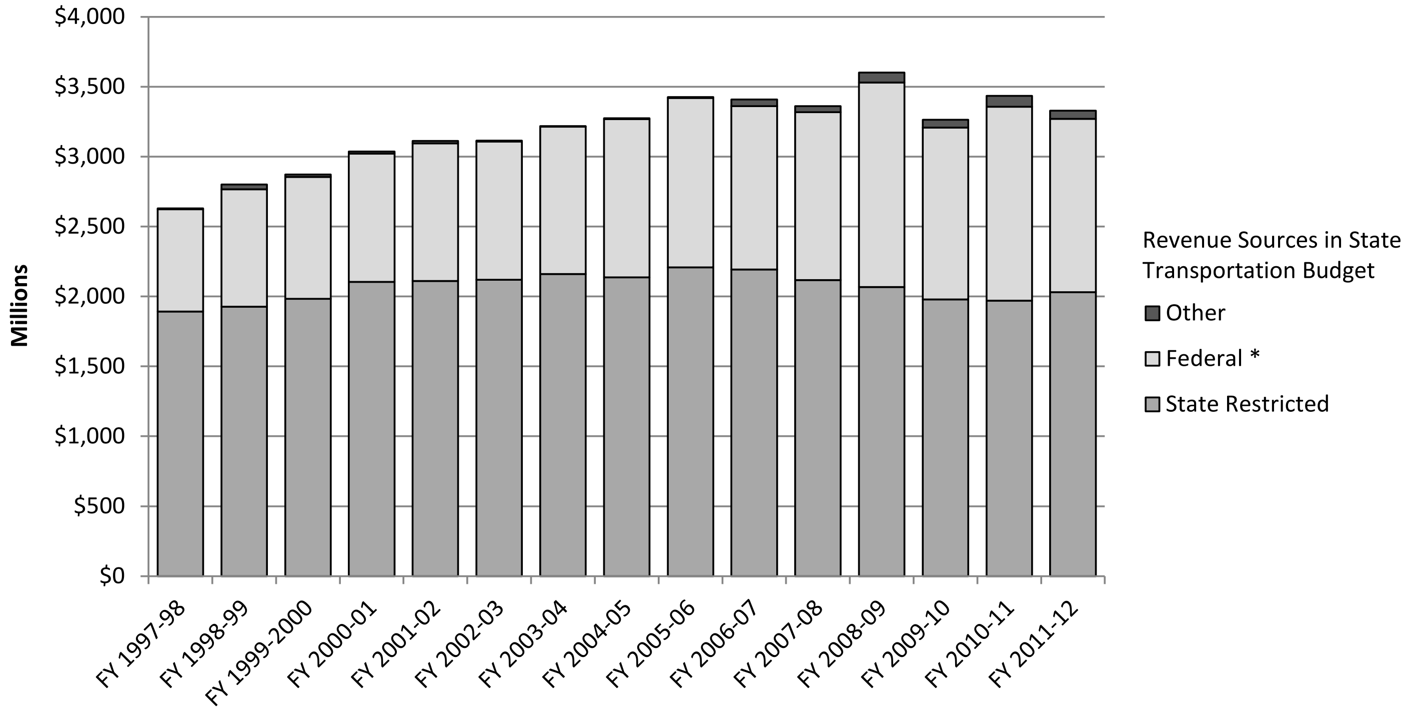
[1] There are public sources of transportation revenue that do not flow through the state transportation budget, primarily revenue generated from local transit or road millages, local general fund contributions for public transit or road programs, and federal aid to urban transit systems. Nonetheless, the largest share of public funding for state transportation programs is appropriated in the annual state transportation budget.

[2] These baseline figures do not include over $1.2 billion in temporary federal "Stimulus" funds made available for state transportation programs in FYs 2008-09 through 2010-11 under the American Recovery and Reinvestment Act of 2009 (ARRA).

[3] The appropriated amounts represent the best estimates of available federal funds at the time budgets were enacted. Actual federal-aid revenue earned and expended by the state is different than the appropriated amounts. See **Graph 1** for appropriations history; see **Graph 2** for actual federal-aid highway revenue.

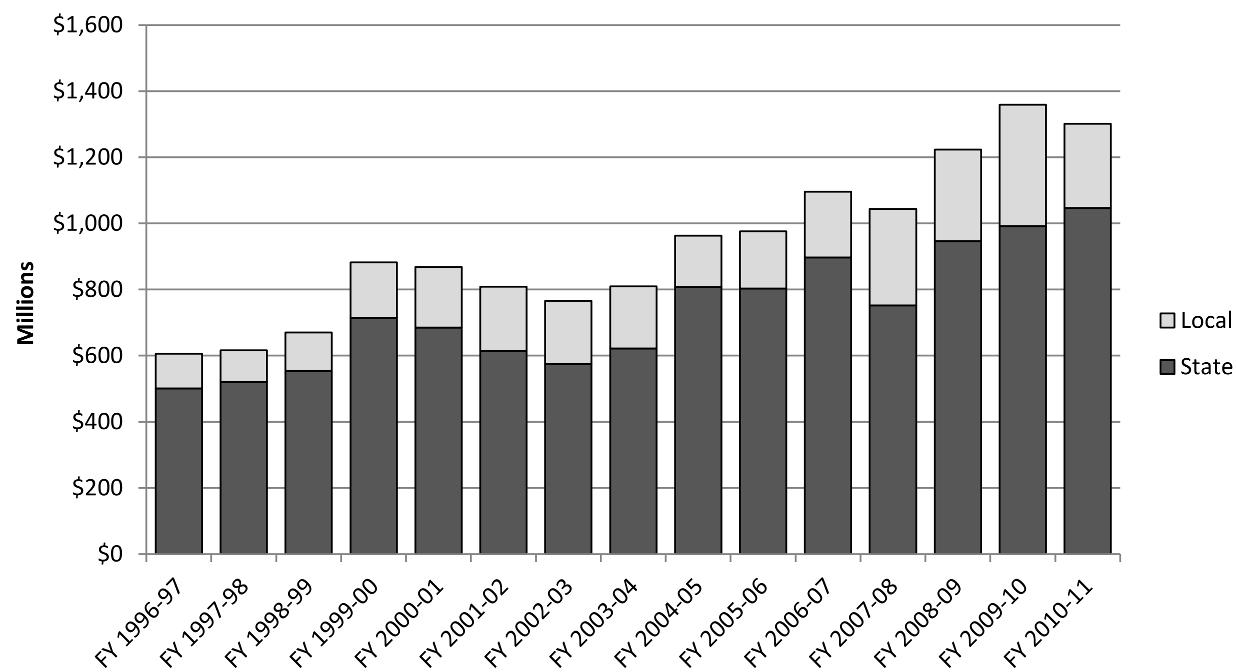
[4] Michigan's ability to match all available federal transit and aviation program funds is also in jeopardy. However, the focus of budget discussion and the focus of this memo is the state's ability to match federal-aid *highway* funds.

Graph 1
Michigan Federal-Aid Transportation Funds
As Appropriated
FY 1997-98 through FY 2011-12



* = Baseline federal-aid transportation funds, not included ARRA funding.

Graph 2
Michigan Federal-Aid Highway Funds
Actual Expenditures/Revenue Earned
FY 1996-97 through FY 2010-11



The balance of this memo will describe federal-aid transportation programs, and more specifically, federal-aid *highway* programs, and the relationship of those federal programs to the state transportation budget. The memo will also discuss in more detail the potential loss of federal funds due to an anticipated shortfall in state matching funds, options for providing matching funds, and the larger issue of the state's structural transportation funding problem.

Background

There is a long history of cooperation between the federal government and the states in the development of a national highway system. According to a Federal Highway Administration (FHWA) history of the federal highway construction program, the Federal-Aid Road Act of 1916 "*established the basis for the Federal-aid highway program in cooperation with the States*." The subsequent Federal-Aid Highway Act of 1921 "*defined the Federal Aid Road Program*" and helped create a national network of U.S. highways. Starting with these 1916 and 1921 acts, the federal government has provided funding for highway construction on a shared basis with the states.[5]

Federal support for highway programs increased significantly in 1956 with the passage of the Federal-Aid Highway Act of 1956, which authorized the construction of the interstate highway system. In recent years, federal aid for surface transportation programs have been authorized and defined by multi-year authorization acts including the *Intermodal Surface Transportation Efficiency Act of 1991* (ISTEA), the *Transportation Equity Act for the 21st Century* (TEA-21) enacted in June of 1998, and the *Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users* (SAFETEA-LU), signed into law August 10, 2005.[6]

SAFETEA-LU authorized $244.1 billion in guaranteed federal surface transportation program funding, including over $193.2 billion authorized for federal-aid highway programs, for the five-year authorization period ending September 2009. Since SAFETEA-LU expired in September 2009, Congress has been unable to enact a long-term reauthorization. On September 15, 2011, Congress passed an extension of the program through March 31, 2012, the seventh short-term extension since September 2009.

Apportionment/Allocation of Federal-Aid Highway Funds to States by Program Category

The federal-aid highway program is primarily a shared federal-state program. Funding is provided by the federal government to states for certain eligible activities and programs. States administer the programs in accordance with federal requirements.

Most federal-aid highway funds are *apportioned* to states within specific program categories based on formulas in federal law, specifically 23 USC, as amended by SAFETEA-LU. The six *core* federal program categories are Interstate Maintenance (IM), National Highway System (NHS), Surface Transportation Program (STP), and Highway Bridge Replacement and Rehabilitation (HBRR), Congestion Mitigation and Air Quality (CMAQ), and Highway Safety Improvement Program (HSIP).

[5] The description of the development of the federal-aid highway program is based on: *The Trailblazers*, a history of the federal highway construction program on the FHWA website; Wikipedia entries for *Federal Air Road Act of 1916*, and *Federal Aid Highway Act of 1921 (Phipps Act)*; and a September 2, 2011 transcript of a National Public Radio interview with Earl Swift, author of *The Big Roads, The Untold Story of the Engineers, Visionaries, and Trailblazers Who Created the American Superhighways*.

[6] The term "surface transportation programs" refers primarily to highway, transit, and rail passenger programs. These surface transportation authorizing acts amend various sections of federal law dealing with transportation, primarily Title 23 of the U. S. Code (Highways), and Title 49 of the U. S. Code (Transportation). Federal aid for aviation programs is authorized under separate authorizing legislation.

In addition to these six core apportioned programs, SAFETEA-LU provides additional funds to some states based on equity considerations. This additional funding, intended to bring "donor states" up to an established minimum rate of return on imputed contributions to the Federal Highway Trust Fund, is called the "Equity Bonus." The six core apportioned programs, plus the Equity Bonus, represent approximately 85% of total highway authorizations in SAFETEA-LU, $164.5 billion over the original five-year SAFETEA-LU authorization period.

A number of smaller programs and subprograms are also authorized in SAFETEA-LU. Smaller apportioned programs include the *National Corridor Infrastructure Improvement Program*, and *Safe Routes to Schools.* Certain required state planning activities are funded through "takedowns" from the larger core programs: *Statewide Planning and Research* (SPR) is funded from a 2% takedown from funding apportioned to the six core programs; *Metropolitan Planning* is funded from a 1.25% takedown from core programs, as well as an authorization in the *Transit* title of SAFETEA-LU. The *Transportation Enhancements Program* is funded from a set-aside from the larger STP core program.

In addition to these *apportioned* programs, which are distributed by formulas established in SAFTEA-LU, some federal aid programs are *allocated* based on criteria established in the authorizing legislation or in appropriations acts. Many of these program funds are subject to Congressional earmarking. Under SAFETEA-LU, one of the largest of these allocated or discretionary programs, *High Priority Projects*, had been effectively a program of Congressional earmarks.

Federal law (23 USC) defines how categorical program funding can be used, i.e. the specific activities and projects that are eligible for program funding. Federal law also directs the sub-allocation of some program funds within the state based on population or other criteria. For example, 23 USC 133 directs that a portion of STP program funds be sub-allocated geographically within the state based on population – in part to urbanized areas over 200,000 population and in part to other areas. Other examples of these programmatic or distribution requirements include: the requirement that not less than 15% of federal bridge funds must be spent on "off-system" bridges; and the apportionment of CMAQ funds based on regional air quality measures, typically within urban areas of the state.

The requirements of federal law effectively create two "templates" which guide the distribution of federal-aid highway funds within the state: a programmatic template reflecting categorical program requirements, and a template reflecting geographic/population distribution requirements. In addition to these two federal "templates," state law also provides for a third guidance template – the distribution of federal funds by *jurisdiction*.

Allocation of Federal Highway Funds Between the State and Local Road Agencies

Generally speaking, the federal-aid highway program provides funding only for capital projects, and related planning activities. Federal funds cannot be used for routine or reactive maintenance, or for general administrative functions. In addition, federal funds are generally only available for roads and streets of a certain "functional classification." Broadly speaking, the program supports major roads and streets but not subdivision streets or local rural roads. Roads meeting these federal requirements are referred to as "federal-aid eligible" or "on the federal-aid system."

Federal-aid highway funds are made available to *states*, and state highway agencies are responsible for administering the programs in accordance with federal requirements. However, not all federal-aid eligible roads in Michigan are under state jurisdiction; a large number of federal-aid eligible roads are under the jurisdiction of local road agencies – county road commissions, cities, and villages.

Of 119,570 total road miles in Michigan, 33,504 are on the federal-aid system. Of these 33,504 federal-aid system miles, 9,681 are under state jurisdiction (state trunkline highways), and 23,823 are under the jurisdiction of local road agencies. The share of federal-aid eligible roads under state jurisdiction in Michigan, 29%, is quite low compared to other states.

Although most federal-aid eligible road mileage in Michigan is under local jurisdiction, the state trunkline highway system, almost all of which is on the federal-aid system, has the highest traffic volume, as measured by Average Daily Traffic, and carries the largest share of commercial truck traffic. The state trunkline system includes all the Interstate, "US", and "M" numbered highways.

Because a large share of federal-aid eligible roads in Michigan are under the jurisdiction of local road agencies, Section 10o of 1951 PA 51, the statute governing state transportation funding, requires that 23% to 27% of federal-aid highway funds, with certain exceptions, be allocated to programs administered by local jurisdictions.[7] Act 51 does not establish a specific amount or percentage for any particular local road agency – not all local road agencies have roads on the federal-aid system.[8]

As described above, the federal authorizing acts, like SAFETEA-LU, establish *authorization* limits, by program category, over the life of the act. Each year, the federal government announces to the states how much of that authority can actually be programmed for expenditure in the upcoming fiscal year. The amount of actual spending authority is called *obligation authority* or *obligation limit*. This obligation limit is established in annual federal appropriations bills.

After the Michigan Department of Transportation is notified by the FHWA of actual obligation authority by program category, the department develops, in cooperation with representatives of local road agencies, an allocation of that authority, by program category, between the state and local agencies. It should be noted that some programs, such as Interstate Maintenance, are only available for use by the state, i.e. the Michigan Department of Transportation. All the Interstate highways in the state are state trunkline highways, under department jurisdiction. For the Michigan Department of Transportation report showing the allocation of federal funds between state and local programs see http://www.michigan.gov/documents/mdot/MDOTsec401_365841_7.pdf.

After agreeing on the overall state/local allocation of federal funds by program category, STP funds are further sub-allocated geographically across the state by population.[9] See flowchart on page 7 showing the distribution of federal aid by program category and geographic sub-allocation.

In summary, the allocation of federal funds between the state and local agencies is based on a number of factors: the amount of federal aid available for obligation by program category; federal requirements regarding how those program categories can be spent, including geographic sub-allocation by population; and the state statutory requirement that 23% to 27% of major federal-aid highway funds be allocated to programs under local jurisdiction.

Federal Aid Planning Process/Project Development

As described above, federal funds are apportioned to the state and then allocated between the state trunkline system and local jurisdictions by program category. However, this allocation process is really simply an allocation of *authority* to spend federal funds. The allocation of spending authority does not of itself earn actual federal dollars. The state does not receive federal-aid highway revenue until money is expended on eligible projects or programs.

The federal-aid highway program is a reimbursement program. The state and local road agencies are reimbursed with federal funds for qualified expenditures on authorized projects and programs as those expenditures are made.

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[7] Section 10o of Act 51 indicates that it is the intent of the Legislature that an average of 25% of applicable federal funds be allocated to programs for local jurisdictions.

[8] All 83 county road commissions have roads on the federal-aid system and many cities have federal-aid eligible streets. However, a number of smaller cities and villages either do not have federal-aid eligible streets, or have very limited street mileage on the federal-aid system, and do not routinely develop federal-aid projects.

[9] The geographic distribution is prescribed in part by the requirements of the STP program (23 USC 133), and in part in by agreement between the department and local road agencies.

In effect, the state and local agencies earn federal aid over the course of each year as eligible costs, such as contractor payments, or related engineering labor, benefits, and equipment, are incurred and billed to federal participating project accounts through the department's federal-aid billing system.

In order to be eligible for federal aid, projects must be developed through a federally-mandated planning process. The broad statewide planning requirements are defined in 23 CFR Subchapter E, "Planning and Research." Project-specific planning requirements are contained in 23 CFR Subchapter H "Right of Way and Environment."

In order for specific projects to be eligible for federal funding, they must first be included in the Statewide Transportation Improvement Program (STIP) or the Transportation Improvement Programs (TIPs).

In urbanized areas, the TIPs, which include both state trunkline and local federal aid projects, are prepared under the guidance of the applicable Metropolitan Planning Organization (MPO). In non-urban areas, the Michigan Department of Transportation develops state trunkline projects for inclusion in the STIP. *Rural task forces* select local federal-aid projects outside of MPO boundaries. Rural task forces are ad-hoc committees comprised of local road and transit agencies within certain designated regions. There are 22 rural task force regions in Michigan.

The STIP/TIP development process *requires* the participation of local public officials.

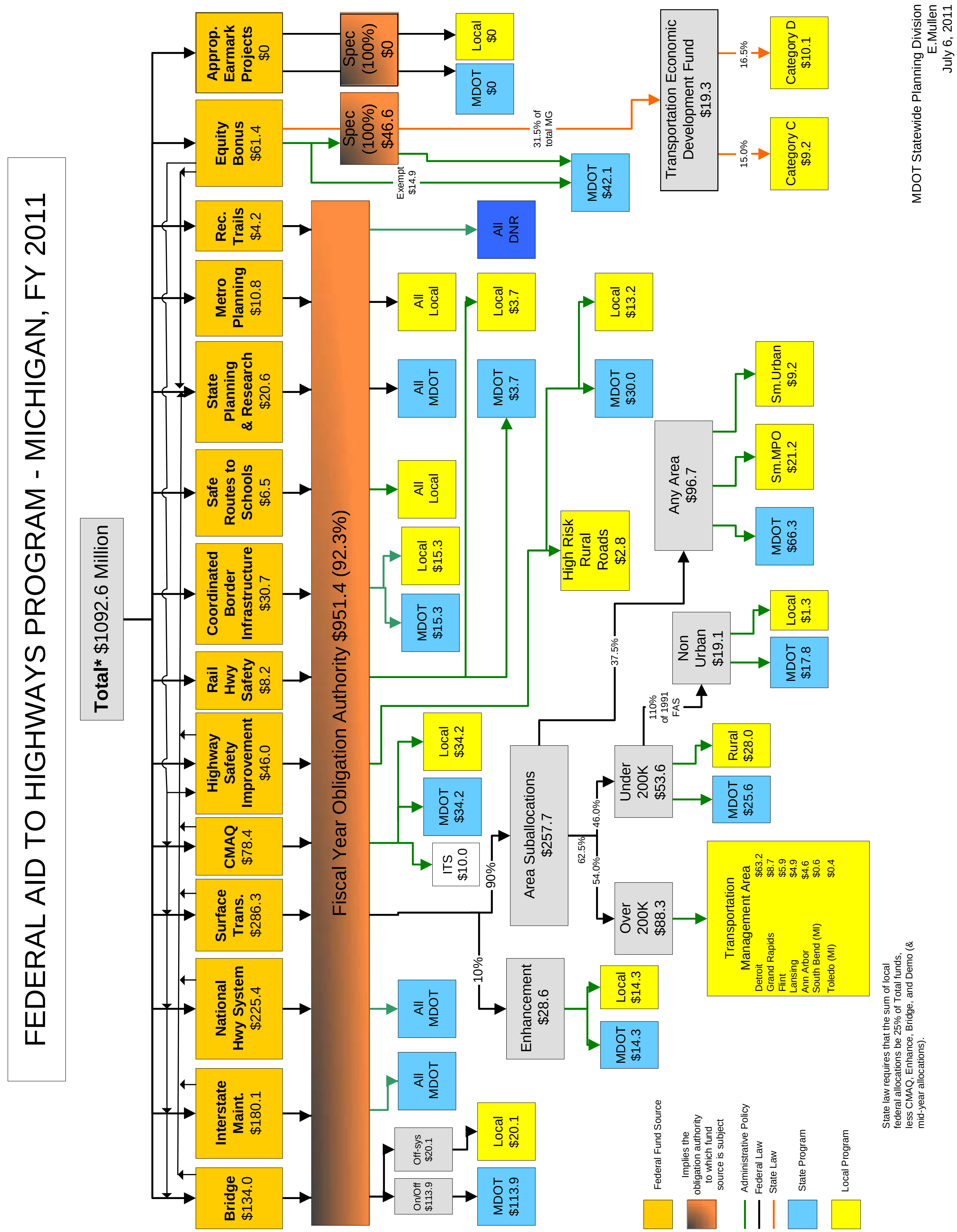
The STIPs and TIPs are *fiscally constrained*; they are not a wish list of projects. The TIPs and STPs are developed from *estimated* available federal program revenue (based on SAFETEA-LU authorization limits), and *estimated* non-federal matching revenue, available for the four-year planning horizon. The amount of actual federal revenue available for the state and local agencies for an upcoming fiscal year is based on the amount of federal aid *obligation authority* made available to states. Once a project is on the TIP or STIP, it can proceed to design and construction, subject to *actual* available federal revenue, *actual* available state or local matching revenue, and project-specific planning considerations.

The Michigan Department of Transportation provides administrative support and guidance to local agencies to ensure that the development of local federal-aid projects follows federal requirements. In addition, the department advertises and awards local federal-aid project construction contracts on behalf of local road agencies; local federal-aid projects follow the same competitive bidding process as state trunkline projects. Contractor payments and other local project costs are processed through the department's contractor payment and federal-aid billing systems.

Federal Aid Highway Funds Relation to the State Budget

The activities related to the allocation federal aid and the planning of federal-aid projects are generally independent of the state appropriations process. Federal-aid highway funds shown in the annual state transportation budget are based on Michigan Department of Transportation estimates of available federal obligation authority; the actual amount is often not known during budget development – it may not be known until well into the state fiscal year.

Article IX, Section 17 of the Michigan Constitution indicates that no funds may be spent from the state treasury except by appropriation. The annual state budget simply provides to the Michigan Department of Transportation the authority to spend federal funds. The budget does not determine the amount of federal funds available to spend or the allocation by program category. Similarly, the state budget recognizes the federal funds available to local road agencies through an appropriations placeholder, *Local federal aid construction*. This appropriation does not determine the actual amount available to local agencies or direct the suballocation to particular local agencies.


FEDERAL AID TO HIGHWAYS PROGRAM - MICHIGAN, FY 2011
Total* $1092.6 Million
Bridge $134.0
Interstate Maint. $180.1
National Hwy System $225.4
Surface Trans. $286.3
CMAQ $78.4
Highway Safety Improvement $46.0
Rail Hwy Safety $8.2
Coordinated Border Infrastructure $30.7
Safe Routes to Schools $6.5
State Planning & Research $20.6
Metro Planning $10.8
Rec. Trails $4.2
Equity Bonus $61.4
Approp. Earmark Projects $0
Fiscal Year Obligation Authority $951.4 (92.3%)
Spec (100%) $46.6
Spec (100%) $0
Local $0
MDOT $0
Exempt $14.9
31.5% of total MG
MDOT $42.1
Transportation Economic Development Fund $19.3
16.5%
15.0%
Category D $10.1
Category C $9.2
All DNR
All Local
Local $3.7
Local $13.2
All MDOT
MDOT $3.7
MDOT $30.0
Sm.Urban $9.2
Sm.MPO $21.2
MDOT $66.3
Any Area $96.7
All Local
Local $15.3
MDOT $15.3
High Risk Rural Roads $2.8
Local $1.3
MDOT $17.8
Non Urban $19.1
37.5%
110% of 1991 FAS
Local $34.2
MDOT $34.2
ITS $10.0
90%
Area Suballocations $257.7
62.5%
46.0%
54.0%
Under 200K $53.6
Rural $28.0
MDOT $25.6
Over 200K $88.3
Transportation Management Area
Detroit $63.2
Grand Rapids $8.7
Flint $5.9
Lansing $4.9
Ann Arbor $4.6
South Bend (MI) $0.6
Toledo (MI) $0.4
10%
Enhancement $28.6
Local $14.3
MDOT $14.3
All MDOT
All MDOT
Off-sys $20.1
On/Off $113.9
Local $20.1
MDOT $113.9
Federal Fund Source
Implies the obligation authority to which fund source is subject
Administrative Policy
Federal Law
State Law
State Program
Local Program
State law requires that the sum of local federal allocations be 25% of Total funds, less CMAQ, Enhance, Bridge, and Demo (& mid-year allocations).
MDOT Statewide Planning Division
E.Mullen
July 6, 2011

State Matching Funds and the Potential Loss of Federal Aid

Most federal-aid transportation programs require a non-federal match. The amount of required matching funds varies by program. The Interstate Maintenance program requires only a 10% non-federal match; federal funds support 90% of eligible Interstate Maintenance costs. Most federal-aid highway programs, including the largest programs (STP, NHS, HBRRP) require a 20% non-federal match. For projects under the jurisdiction of the Michigan Department of Transportation, the non-federal matching funds are typically provided from the state-restricted State Trunkline Fund (STF). For projects on roads under local jurisdiction, the non-federal match is typically provided from the local agency's distribution of Michigan Transportation Fund (MTF) revenue.

In its *2008-2012 Five-Year Transportation Program*, the department first publically identified a shortfall in state funds needed match all available estimated federal aid. The department indicated that starting in FY 2009-10 it would not be able to match all available federal aid.

The potential loss of federal funds, and the identification of state sources of matching funds, were the focus of both FY 2010-11 and FY 2011-12 state transportation budget deliberations. In development of the FY 2010-11 budget, the department had indicated that it would be $84.0 million short of state funds needed to match all available federal funds. The identified shortfall in FY 2011-12 was $147.0 million. In both fiscal years the shortfall, *as a budgetary issue*, was resolved – primarily through short-term or one-time savings or fund shifts, including reductions in state trunkline maintenance, deferral of capital outlay projects, and use of toll credits.

The FY 2010-11 budget also assumed the sale of $40 million short-term notes to match federal aid. The department was able to match federal funds in FY 2010-11 without selling notes. However, in December 2011, the department sold $91.0 million in State Trunkline Fund bonds, of which $40.0 million was designated for matching federal funds in the state trunkline construction program.

The department's *2012-2016 Five-Year Transportation Program* indicates that beginning in FY 2012-13, the annual shortfall in STF matching funds needed for the state trunkline highway program will be between $75 million and $100 million, resulting in a potential annual loss of $440 million to $600 million in federal aid.

The reduction in state funds available to match federal funds is primarily the result of two factors: the reduction in STF revenue, and the increase in STF-related debt service. Both these factors date from 2004.

The STF receives most of its revenue from a distribution from the Michigan Transportation Fund (MTF) – the state's primary collection and distribution fund for state restricted motor fuel tax and vehicle registration tax revenue. MTF revenue peaked in 2004 at $2.065 billion and declined each year through FY 2009-10. FY 2009-10 MTF revenue of $1.840 billion was $225 million less than the FY 2003-04 peak. The STF share of MTF revenue correspondingly declined, from $747.8 million in FY 2003-04 to $630.4 million in FY 2009-10, a decline of $117.4 million.[10]

The second factor affecting STF revenue available for matching federal aid-highway funds was the increase in STF-related debt service. In FY 2003-04 STF supported debt service was $43.8 million. By FY 2010-11 STF supported debt service had increased to $145.5 million. The increase in debt service reduces the amount available for current year programs. [11]

The shortfall figures used in the department's *Five Year Transportation Program* documents represent the department's best estimates of both federal program funding and available state matching funds at a point in time.

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[10] See House Fiscal Agency website for a rolling analysis of MTF revenue and distribution.
[11] See HFA memo State Transportation Borrowing and Debt Service [54K], April 22, 2010.

The discussion of matching funds and the potential loss of federal-aid highway funds, in budget development and in the department's *Five-Year Transportation Program*, relate only to the *state trunkline* road and bridge program. Representatives of local road agencies and regional planning organizations have indicated that many local road agencies are also having trouble providing matching funds for *local* federal-aid projects. The MTF is the primary source of funds for local road agencies and the decline in MTF revenue has limited the ability of those agencies to provide matching funds for local federal-aid projects. Because there are a large number of local road agencies with potential federal-aid projects, it is hard to quantify the total amount of the shortfall related to local agency federal-aid highway programs.

Several options have been used, or proposed, for obtaining funds needed to match all available federal aid. Those options are discussed in detail below.

Options for Matching Federal-Aid Highway Funds – Toll Credits

As noted above, most federal aid highway programs require a non-federal match – most commonly 20% of project cost. To recognize states with a high reliance on toll facilities, federal law allows use of capital expenditures made by toll facilities, such as toll bridges and toll roads, to count as a "soft match" for federal funds.[12] Toll credits allow states to access federal funds in situations when they do not have sufficient non-federal matching funds.

Toll credits can be used for both highway programs established under 23 USC and transit programs established under 49 USC. When toll credits are used as the "soft match" for a project, the project is effectively a 100% federally funded.

According to the American Association of State Highway and Transportation Officials' "Innovative Finance" website, "*Toll credits are earned when the state, a toll authority, or a private entity funds a capital transportation investment with toll revenues earned on existing toll facilities (excluding revenues needed for debt service, returns to investors, or the operation and maintenance of toll facilities). The amount of credit earned equals the amount of excess toll revenues spent on nonfederal highway capital improvement projects.*" [13]

To be eligible to use toll credits, a state must also meet federal maintenance of effort (MOE) requirements. The MOE requirements help ensure that states do not simply use federal funds to replace state or local transportation funds. According to a FHWA guidance document dated February 8, 2007, "*To be able to earn a toll credit, a state must satisfy the MOE determination of 23 U.S.C. 120(j)(2). The MOE determination is an assessment of a state's non-federal transportation capital expenditures over a four year period.*"

The department established a toll facility credit program in 1994 in accordance with Section 1044 of ISTEA, and began computing toll credits based on toll-financed capital expenditures at three publically-owned toll facilities, the Mackinac Bridge, the Blue Water Bridge, and the International Bridge. However, because the department had adequate revenue to match all available federal funds, toll credits were not used as a financing tool until 2005. In 2005, because of a shortfall in available Comprehensive Transportation Fund revenue, the Michigan Department of Transportation began using toll credits to provide the non-federal share of federal *transit* grants for local transit agencies.[14]

Through 2010, the department has requested, and the FHWA approved, $99.4 million in toll credits related to the three publically-owned toll facilities. Those toll credits recognize toll-financed capital expenditures made in years

[12] Use of toll credits was first authorized in 1992 under provisions of Section 1044 of ISTEA. The toll credit provisions were codified in Section 120(j) of 23 USC.

[13] http://www.innovativefinance.org

[14] The Comprehensive Transportation Fund is a state restricted transportation fund dedicated to public transportation programs. It receives most of its funding from a distribution of MTF revenue.

1995 through 2003, and 2008. However, because the state did not meet MOE requirements, toll-financed expenditures made in FY 2003-04 through FY 2006-07, and FY 2008-09, could not be recognized for use as toll credits.

The department initially used toll credits primarily to match federal transit grants for local transit agencies. However, as part of the FY 2010-11 budget agreement, $11 million in toll credits were designated for matching federal-aid highway funds in state trunkline construction program.

Federal law allows the recognition of capital investments made at private toll facilities in calculating a state's toll credits. However, the state, (not the toll facility) still has to meet the federal MOE requirements. In addition, the private toll facility has to identify toll-financed capital expenditures. Prior to 2011, neither the Ambassador Bridge, a private toll facility owned by the Detroit International Bridge Company (DIBC), nor the Detroit-Windsor Tunnel, were included in the state's toll credit calculation.[15]

In 2011, the department and DIBC came to an agreement which allowed the third party review of DIBC records in order to include DIBC capital expenditures in the department's toll credit calculation. The review identified $50.6 million in toll credits related to DIBC 1998, 2001, 2002, 2003, and 2008 toll-financed capital expenditures. On May 18, 2011 the FHWA approved the department's request to use these private facility toll credits for non-federal match for either federal-aid highway programs or federal transit programs. These toll credits were recognized in the FY 2011-12 budget agreement as a source of matching funds for federal-aid highway funds appropriated in the FY 2011-12 state transportation budget.

Also in 2011, the department and the Detroit-Windsor Tunnel Company came to an agreement which allowed the recognition of that company's toll-financed capital expenditures for years 1994, 1996, 1997, 1999, and 2008 in the department's toll credit calculation. In December 2011, the FHWA approved $5.8 million in toll credits related to the Detroit-Windsor Tunnel.

Toll credits are a soft match and not real money. Construction contractors on projects cannot be paid in toll credits. In addition, toll credits do not increase total federal funds available to a state. The amounts apportioned to the state according to federal program requirements remain the same. To illustrate: If total federal aid apportioned to the state was $800 million, the state could fund ten $100 million projects using 80% federal aid and 20% non-federal matching funds. If non-federal matching funds were not available, and the state generated enough in toll credits, the state could fund eight $100 million projects with federal funds providing 100% of project cost. In both cases, the total federal aid to the state is $800 million. However, in the first instance, the state would have a $1.0 billion construction program; in the second, only an $800 million program.

Toll credits should be considered a short-term or one-time financing mechanism, and not a solution to the state's structural transportation funding problems. Because there is no assurance that the state will continue to meet MOE requirements, there is no assurance that the state will continue to earn toll credits for matching future federal aid.

In addition, the amount of toll credits earned over the last ten years have been substantially less than the $75 million to $100 million annual shortfall in matching funds identified in the *2012-2016 Five Year Transportation Program*.

Options for Matching Federal-Aid Highway Funds – Canadian Contribution to NITC Project

In his 2011 State of the State message, Governor Rick Snyder announced that the Canadian government had agreed to provide up to $550 million (U.S.) to cover costs that would otherwise be borne by the state of Michigan in relation

[15] In a January 27, 1994 letter, the Michigan Department of Transportation requested information from the DIBC on toll-financed capital expenditures in order to include that information in its toll credit calculation. The department and the DIBC did not come to an agreement on sharing this information until 2011.

to the proposed North American International Trade Crossing (NITC) project.[16] In addition, the Governor indicated that the FHWA had agreed to allow the state to use this Canadian contribution to the NITC as a match for federal-aid program funds.

Historically, the state has provided non-federal matching funds on a project-by-project basis. For example, the department develops and awards approximately 400 federal-aid participating state trunkline construction projects each year. Each project is typically developed using a combination of federal aid and non-federal STF matching funds. The total federal aid earned by the state would be the sum of all the federal aid earned on all 400 projects, and the related matching funds needed would be the sum of all the non-federal matching funds applied to all 400 projects.

The agreement with the FHWA announced by the Governor would allow the state to demonstrate that it met federal matching requirements for the STP program, the largest of the federal-aid highway categorical programs, on a *total program basis*, and not necessarily on a project-by-project basis. This would allow the funding of some projects in outstate Michigan with 100% federal funds with no non-federal match required.

The ability to provide matching funds on a program basis, rather than project-by-project basis, has always been authorized in 23 USC 133 for the STP program. It has never been used in Michigan and it is not clear if this method of matching federal aid has been used in other states.

The department's *2012-2016 Five Year Transportation Program* indicated that in FY 2012-13, the annual shortfall in matching funds will be between $75 million and $100 million, resulting in a potential annual loss of $440 million to $600 million in federal aid. The $550 million Canadian contribution to the NITC project could provide most of the shortfall amount identified in the *Five Year Transportation Program* for the four fiscal years FY 2012-13 through 2015-16, depending on the approval of the NITC project and the timing of expenditures. The Canadian contribution could not provide the entire match shortfall because the contribution is only recognized as a match for STP program funds.

The administration's FY 2011-12 budget proposal had recognized $50 million from the Canadian NITC contribution as one of the elements in matching all federal aid shown in the budget. The Legislature rejected the recognition of the Canadian funds and instead assumed $50 million in toll credits as the means of matching federal funds.

The proposed use of Canadian NITC funds as the match for federal funds is similar to the use of toll credits in some regards. Both financing methods allow capital expenditures on certain facilities to be recognized for matching purposes on the state's total trunkline federal-aid construction program. Both financing methods would allow some projects to be programmed with 100% federal funding. However, neither toll credits nor recognition of the Canadian contribution would increase total federal funds available to a state. The amounts apportioned to the state according to federal program requirements remain the same. In addition, both should be considered short-term or one-time financing mechanisms, and not a solution to the state's structural transportation funding problems.

The proposed Canadian contribution differs from toll credits in that the Canadian funds represent real money, money that could be expended for engineering, construction contractor payments, and other NITC project-related work in Michigan. Toll credits are a soft match and not real money. In addition, the amount of funds identified in the Canadian proposal, up to $550 million, is substantially more than any anticipated toll credits over the next five years.

[16] The department has indicated that the proposed Canadian contribution would cover certain state costs associated with the NITC project. Such work could include utility relocation, right of way acquisition, realignment of surface streets, and connections to interstate freeways. As described in an administration briefing paper (September 2011) the Canadian contribution would not be a loan to the state of Michigan. There would be no liability created or reported on the state's financial statements. The Canadian government would be repaid from tolls under the public private partnership agreement to the extent that tolls supported repayment.

Options for Matching Federal-Aid Highway Funds – Increased Local Federal Aid Program

The discussion of the shortfall in matching funds and the potential loss of federal-aid highway funds has been focused on the state trunkline road and bridge construction program. Some have suggested that if the state is unable to identify matching funds for its program, rather than lose federal aid, local agencies should be given access to additional federal-aid highway funds. This appears to be the intent of House Bill 4739 (Rep. Knollenberg) which would allow local jurisdictions an increased share of federal-aid highway funds beyond the 23% to 27% currently mandated by 1951 PA 51.

Increasing local road agency access to the state's federal aid program would shift limited transportation funds from the state trunkline system to the local road system. However, it is not clear that local agencies could access additional federal aid. Many local road agencies have indicated that they are having trouble providing the non-federal match for the current local federal aid program, and it appears unlikely that local road agencies could provide the additional $75 million to $100 million shortfall identified in the department's *Five Year Transportation Program*. In addition, some federal-aid funds are available only to the Michigan Department of Transportation; local road agencies do not have the ability to access Interstate Maintenance program funds.

Options for Matching Federal-Aid Highway Funds – Use of General Fund Revenue

Some have suggested the use of state General Fund revenue to provide the matching funds needed to access all available federal-aid highway funds. Two bills introduced in the 2011-2012 Legislative Session, House Bill 4521 (Rep. Agema), and Senate Bill 351 (Sen. Proos) would redirect the General Fund portion of the sales tax applicable to motor fuel sales to transportation funds. House Bill 4521 would redirect an estimated $83.1 million to $112.7 million from the state General Fund to transportation funds.

If the General Fund portion of the sales tax applicable to motor fuel sales were targeted for the state trunkline road and bridge program, it could provide roughly the amount of the shortfall identified in the department's *Five Year Transportation Program* – $75 million to $100 million. However, if the funds were allocated between the state trunkline system and local road agencies in accordance with the current distribution formulas of 1951 PA 51, the amount credited to the STF would range from $29 million to $39 million – well short of the needed matching funds identified by the department.

The Governor's proposed FY 2012-13 transportation budget includes $96.0 million in state General Fund revenue to address the match problem with regard to federal-aid highway funds, and an additional $23.0 million General Fund appropriation to match federal transit grants. The Governor's budget designates these proposed appropriations as "one-time."

Historically, state General Fund revenue has not been routinely appropriated for state transportation programs. To the extent that revenue from fuel taxes and vehicle registration taxes is constitutionally restricted for transportation, there has been a "firewall" between transportation funds and the state General Fund – a firewall recognized in Section 10 of 1951 PA 51 which prohibits the credit of state General Fund revenue to the MTF. In addition, use of General Fund revenue would have to be offset with reductions in baseline General Fund programs.

Other Transportation Funding Options – Transportation Fuel and Registration Taxes

The four options discussed may help the state to match all available federal-aid highway funds, and in doing so, to maintain baseline levels of transportation funding. None of the four proposals would increase baseline transportation revenue or address structural problems in state transportation funding.

In September 2011, a bi-partisan workgroup of the House Transportation Committee issued a report that concluded that the state needed $1.4 billion in additional annual infrastructure investment to preserve the current road system. In an October 2011 Special Message on Michigan's Infrastructure, Governor Rick Snyder indicated support for increasing investment in the state's transportation infrastructure. The Governor cited a 2008 Transportation Funding Task Force (TF2) report which advocated increasing annual state transportation funding.

On January 26, 2012, bills reflecting the Governor's proposals for transportation funding were introduced in both the Michigan House and Senate. One of the House Bills in the package, House Bill 5289, would increase motor fuel taxes, increasing transportation revenue by over $525 million in the first year of the bills' effect. House Bill 5300 would increase vehicle registrations by an estimated $500 million.[17]

The bill package was not necessarily targeted at providing matching funds for the federal-aid highway program. The bills were intended to address larger structural transportation funding issues. Nonetheless, if passed, the bills to increase transportation revenue would provide more than enough state funds to match all available federal-aid highway funds.

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NOTE: This report was written by William E. Hamilton, Senior Fiscal Analyst. Kathryn Bateson, Administrative Assistant, prepared the report for publication.

[17] The revenue impact of House Bill 5889 is based on a House Fiscal Agency bill analysis. The impact of House Bill 5300 is based on administration estimates.