State of California
DEPARTMENT OF TRANSPORTATION

Business, Transportation and Housing Agency

Memorandum

ITEM 13

To: CHAIR AND COMMISSIONERS
CALIFORNIA TRANSPORTATION COMMISSION

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Subject: **<u>DISCUSSION OF PROPOSITION 22</u>**

SUMMARY

On November 2, 2010, Californians will decide whether to vote the “Local Taxpayer, Public Safety, and Transportation Protection Act of 2010” (Proposition 22) into law, effective November 3, 2010. Among other property tax proposals not addressed in this report, Proposition 22 seeks to restrict the ability to borrow, loan, and divert revenues that are dedicated to funding transportation improvement projects and services.

Proposition 22 is an initiative constitutional amendment with significant funding impacts to transportation and the General Fund. It is clear that there are many unresolved and alarming uncertainties surrounding Proposition 22, and a variety of possible implications are discussed below. Should this proposition pass in November, it will change the way that the programs within the Department of Transportation (Department) are operated and funded. It is also clear that transportation funds, the General Fund, or both will be negatively affected depending on the interpretation of this proposition.

On the surface, Proposition 22:

- Prohibits borrowing and diversions from the fuel excise and sales taxes deposited in the Highway Users Tax Account (HUTA), the Public Transportation Account (PTA), and the Transportation Investment Fund (TIF), eliminating over $900 million in various diversions and loans planned for the 2010-11 fiscal year.
- Appears to repeal ABX8 6 and ABX8 9, collectively referred to as the “fuel tax swap.” This would likely negate the $603 million debt service payment of highway proceeds in 2010-11 and eliminate the dedicated funding for future debt service payments on highway bonds.
- Protects and increases local transit funding significantly by preventing the suspension of sales tax transfers and more than doubles annual funding for State Transit Assistance (STA).
- Restricts the Department’s ability to manage transportation resources through short-term loans, which could cause transportation accounts to reach insolvency levels.

However, depending on the implementation of Proposition 22, additional issues related to State and transportation funding could include:

- Creates additional General Fund liability of $4.7 billion or more
- Significantly impacts State Highway System Maintenance and State Highway Operation and Protection Program (SHOPP) Programs
- Prohibits borrowing of most transportation resources for General Fund relief, but eliminates protection for weight fees
- Creates significant increase in transit funding
- Loopholes may lead to significant transportation impacts
- Eliminates interfund loans from the PTA, which will impact transportation cash management
- May not result in an expected revenue change
- Eliminates interest earnings for the PTA
- Creates appropriation problems

BACKGROUND:

On March 22, 2010, Governor Schwarzenegger initiated the "Fuel Tax Swap" by signing ABX8 6 and ABX8 9 into statute. The fuel tax swap is complicated, but it serves to stabilize transportation funding and to provide a dedicated source of revenue to fund debt service on transportation related bonds, such as the Proposition 1B program approved by voters in November 2006.

In recent years, transportation resources have been borrowed, loaned, and diverted accordingly:

- $603 million payment from the HUTA for debt service on voter approved bonds scheduled for 2010-11, and funded from the tax swap revenues. In 2014-15, the debt service payment is projected to increase to $1.1 billion.
- $700 million in delayed excise tax allocations to local agencies for local street and road programs.
- $650 million loan from the HUTA to the General Fund planned for 2010-11, funded from the tax swap revenues.
- $396 million from the PTA for debt service payments on voter approved bonds, including $254 million planned for 2010-11
- $335 million in long term loans from the State Highway Account (SHA) to the General Fund.

While the intent of Proposition 22 appears to be to protect transportation funding from loans and diversions, there are many other issues that may impact the General Fund and transportation funding as follows:

- **Creates additional General Fund liability of $4.7 billion or more –** The fuel tax swap provided a stable dedicated funding source for the payment of General Obligation bond debt service on transportation bonds from the excise taxes on fuel. Proposition 22 would eliminate that fund source, meaning that the General Fund would incur additional liability of at least $4.7 billion in debt service payments from 2011-12 through 2014-15. Proposition 22 also proposes to eliminate the ability to make transfers from the PTA to any other fund in the State Treasury including the General Fund and the Transportation Debt Service Fund, which could eliminate the ability to make transit-related debt service payments from the PTA. For

2010-11, debt service payments from the PTA were planned at $254 million. While the exact impact is not measurable at this time, the potential liability for the General Fund is enormous.

- **Significantly impacts the State Highway System Maintenance Program and State Highway Operation and Protection Program (SHOPP) –** Proposition 22 restricts the use of excise taxes for the payment of debt service on voter approved bonds issued after November 2, 2010 to 25 percent of revenues. Currently Article XIX allows for the use of up to 25 percent of both excise taxes (estimated at up to $5.6 billion per year including local apportionments) and weight fees (estimated at about $1 billion per year). The omission of the 25 percent limit on weight fees could mean that all weight fee revenue could be used for debt service, which would effectively eliminate state funding for the SHOPP, and very significantly reduce funding for maintenance and operation of the State Highway System.

- **Prohibits borrowing of most transportation resources for General Fund relief, but eliminates protection for weight fees** – Proposition 22 would expressly prohibit loans from fuel excise and sales taxes, but the proposed language eliminates protections for weight fee revenue. The result would eliminate the planned $650 million loan from the HUTA to the General Fund in 2010-11 funded by the tax swap, and bar the suspension of Proposition 42 revenues, while leaving about $1 billion in weight fees unprotected. Proposition 42 was partially suspended in 2003-04 and fully suspended in 2004-05 in order to avoid a General Fund shortfall. To date, the General Fund must still repay $1.4 billion to various transportation funds as a result of the suspensions. However, the re-write of Article XIX contained in Proposition 22 would not prohibit or limit loans from weight fee revenue, which are currently limited to three years.

- **Creates significant increase in transit funding –** Between 2010-11 and 2014-15, STA revenues are projected to increase from $1.6 billion to $4.1 billion if Proposition 22 passes. Proposition 22 proposes for the STA to receive 50 percent of the diesel sales tax, Proposition 111, Proposition 42, and spillover revenues deposited in the PTA. While this is consistent with the historical split, funding for the PTA is significantly increased under Proposition 22, primarily because of the proposed change to the treatment of spillover revenue. Proposition 22 permanently directs to the PTA all "spillover" funds generated by high fuel prices. Spillover funds were commonly used for General Fund relief and debt service on transit related bonds until a recent court decision limited the use for General Fund relief to current-year debt service. The fuel tax swap had eliminated the spillover issue by abolishing the sales tax on gasoline, and replacing it with an equivalent excise tax. This excise tax is a significant source of General Fund relief in the form of a stable revenue source for debt service on transportation related bonds.

- **Loopholes may lead to significant transportation impacts –** Proposition 22 appears to contain some loopholes that, if exploited, may result in future lawsuits and uncertainty of funding. Proposition 22 does not appear to expressly prohibit the use of PTA funds for debt service on bonds, if those bonds are for mass transportation purposes. Although Proposition 22 proposes to restrict the transfer of PTA resources to other funds in the State Treasury, it does not prohibit the creation of a debt service account outside of the State Treasury. Also, it is at least theoretically possible to make direct expenditures from the PTA for debt service on transit-related bonds.

- **Eliminates interfund loans from the PTA, which will impact transportation cash management** – Proposition 22 proposes to eliminate the transfer of PTA resources to any fund in the State Treasury. As a result, the Department would be prohibited from conducting interfund loans to or from the PTA for cash management as currently allowed by statute. Historically, long-term loans have been made to the PTA for cash management, and some short-term loans have been made from the PTA to the SHA for cash management. Elimination of the ability to make transfers would impact the Department's ability to manage transportation funds on a cash basis. With over $1.7 billion of outstanding loans from transportation accounts to the General Fund, interfund loans are often required to maintain the solvency of transportation funds.

- **May not result in an expected revenue change** – It is unclear how provisions in Proposition 22 will affect the taxes on motor vehicle fuels. Proposition 22 does not appear to contain specific language regarding each of the methods of taxation contemplated. As a result, legal interpretation could result in a variety of tax collection issues, including any of the following:
    1. The fuel tax swap could be completely repealed; reinstating the historical sales taxes, and eliminating the increased excise taxes. Legal interpretation would need to conclude the two bills that enacted the fuel tax swap are in direct conflict with the provisions of Proposition 22, and subject to repeal per the section titled "Conflicting Statutes." Given that there does not appear to be clear language in Proposition 22 regarding tax rates, this may not be the case. An independent analysis by the California Budget Project states, in part, "it is unclear whether the measure would override the rate and allocation changes established by the Legislature, particularly since those changes were legal when they were enacted."
    2. Because there does not appear to be specific language regarding the actual fuel sales tax rates, or specific language requiring the imposition of sales tax on fuel, the fuel tax swap may not be found to be in direct conflict with the provisions of Proposition 22. This could result in a situation wherein both the existing excise tax (including the recent increase), and some or all of the sales tax (if reinstated by Proposition 22) would exist concurrently. While this would greatly increase transportation funding, voters may not have approved Proposition 22 with the understanding that both forms of revenue would remain in place.
    3. An unintended combination of taxes could result from unclear language. As discussed, the Proposition 22 language regarding fuel tax rates is not clear or decisive, so a combination of some sales taxes and some excise taxes could result, depending on interpretation and implementation.

- **Eliminates interest earnings for the PTA** – Because Proposition 22 proposes to eliminate any transfers from the PTA to any other fund in the State Treasury, this would also prohibit deposits into the Surplus Money Investment Fund (SMIF), which is the sole means of earning interest on deposits in the State Treasury. In 2010-11, SMIF income interest is projected to account for $10 million in revenue, and this number is expected to increase as PTA cash balances rise and interest rates recover from historic lows.

- **Creates appropriation problems –** The proposed constitutional language in Proposition 22 specifically appropriates all PTA and TIF funds to the State Controller, including funds that had previously been appropriated to the Department, the Commission, and other State Agencies. Potentially, this could put many traditional expenditures from the PTA and TIF at risk. These include a significant portion of the Commission's operating budget; the Department's operating budget for transportation planning, mass transportation, and rail (including the State Amtrak contract); and funding for the STIP. Because the appropriation changes would be constitutional, budgetary fixes to this problem may not be tenable.

CONCLUSION:

Regardless of which of these eventualities are implemented should Proposition 22 pass in November, it will change the way that the programs within the Department are operated and funded. It is also clear that either transportation funding or the General Fund will be affected depending on the interpretation of this proposition. Given the number of unknowns, it is difficult to provide a single scenario, however any scenario will have a significant impact on the operations of the state. In the worst case, Proposition 22 will significantly add to the budget shortfall already faced by the state.