Senate Committee on Transportation and Housing
Assembly Committee on Transportation

February 28, 2011

Transportation Funding Overview

BACKGROUND PAPER

INTRODUCTION

Today's hearing is to brief the members of both the Senate Transportation and Housing Committee and the Assembly Transportation Committee on the structure of transportation funding in California. To this end, representatives of the Legislative Analyst Office, the California Transportation Commission, and the Department of Transportation will testify.

This background report begins with a broad overview of the evolution of transportation finance in California. This will be followed by a more detailed discussion of specific transportation funding mechanism with special attention being given to recent changes in the financing scheme as a result of the gas tax swap enacted last year.

OVERVIEW OF TRANSPORTATION FUNDING IN CALIFORNIA

California's transportation funding policy has evolved over the last century in response to the political requirements of particular periods in the state's history. With the rising popularity of the automobile, the first efforts to finance road construction was a series of bonds between 1911and 1919. Because the state did not have a coherent taxing system, the bond debt was overwhelming state finances, but the demand for roads continued. The response was the imposition of a two-cent per gallon state gas tax in 1922.

By the onset of World War II, some basic policies had been established: the gas tax is to be shared between the state and cities and counties, some state gas tax must be geographically allocated to ensure equity in the expenditures of funds on the highway system, and Article XIX was added to the state constitution to ensure that state gas tax revenue must only fund state highways and local streets and roads. This was to curtail the use of gas tax revenues for general fund purposes, which occurred during the 1930s. Article XIX essentially makes the gas tax a user pays system of funding. After several amendments, Article XIX today provides that gas tax revenue may only be used for the "research, planning, construction, improvement, maintenance, and operations of public streets and highways (and their related public facilities for nonmotorized traffic)" and the "research, planning, construction, and improvement of exclusive public mass transit guideways (and their related fixed facilities)… ." Article XIX, therefore, prohibits using gas tax revenues for most transit purposes, such as the purchase of buses, rail transit vehicles, and all operating costs.

Between 1940 and 1970, California's population increased from seven to twenty million persons. The demand for new highways continued to grow and in 1956, congress enacted the Federal Interstate Highway Act, which paid for 90 percent of the cost of constructing specific highway routes in each state, thus accelerating the development of the state's highway system. By 1970, major freeway construction had nearly run its course and the first transit funding program was enacted, the Transportation Development Act of 1971 (TDA). This act established a statewide local transit funding program that was created when the state surrendered a ¼ percent of its sales tax, shifting it to local government. (TDA generated $1.9 billion for transit in 2009.) The revenue loss to the state was offset by extending the sales tax to gasoline. The 1971 decision set the stage for much of the debate over the use of the gasoline sales taxes during the last ten years.

The last major feature of transportation finance in the state has been the emergence of the local, voter-approved sales taxes for transportation that came to prominence in the 1980s. The nineteen counties that have transportation sales tax are referred to as the self-help counties. Collectively, the self-help counties generated approximately $2.6 billion in 2009.

SUMMARY OF SPECIFIC TRANSPORTATION FUNDING MECHANISMS

TRANSIT FUNDING

In the post-World War II era, transit transitioned from privately provided to a local public service that was locally funded, largely from property taxes.

The Transportation Development Act (TDA), signed by Governor Ronald Reagan, created a stable source of local funding statewide for public transit. This was the state's first foray into using the sales tax, rather than an excise tax, to fund transportation.

With the passage of the TDA, the state dropped its statewide sales tax rate by a quarter percent and made up for the loss in the state's General Fund by broadening the sales tax base to include gasoline. Whenever the sales tax on gasoline produced more than enough revenue to fill that revenue hole, the state agreed to use the excess, or what was called the "spillover," to support public transportation. At the same time, the state required counties to impose a quarter-cent sales tax to be used to fund transit in urban areas and transit and roads in rural areas. Later the sales tax on diesel was also dedicated to transit.

These three sources – the local sales tax, the spillover, and the sales tax on diesel – became the primary sources of state support for transit funding. The local sales tax is returned to the county of origin where the money is allocated by transportation planning agencies to eligible transit operators. The spillover and the sales tax on diesel flow into the state's Public Transportation Account (PTA), through which the state provides support to local transit districts and for intercity rail.

THE GAS TAX

In 1990, the voters approved Proposition 111, which the Legislature placed on the ballot and which increased the excise tax on motor vehicle fuels from 9 cents to 18 cents over a period of five years. The last of the Proposition 111 increases occurred on January 1, 1994 when the tax went up one cent to 18 cents per gallon. (This amount stood until 2010, when the Legislature enacted the "gas tax swap," which is described below.)

Through Proposition 111 the state also dedicated the increment of sales tax on the new 9 cents of gasoline excise tax to transit, a new revenue source for the PTA.

In the years between full implementation of Proposition 111 and 2010, the gasoline excise tax lost over 30 percent of its purchasing power due to inflation. In its place the state provided primarily General Fund revenues, and local governments contributed funds from local, voter-approved, transportation sales tax revenues.

One of the most significant shifts of General Fund revenues to transportation occurred in 2000, when the Legislature dedicated the state sales tax on gasoline to transportation. California included this dedication in its constitution when the people approved Proposition 42 in 2002. Twenty percent of those revenues were dedicated to transit, 40 percent to the state highway system, and 40 percent to local streets and roads.

Then in 2006, Proposition 1B, which the Legislature placed on the ballot, authorized a $19 billion general obligation bond for transportation. Originally, the state General Fund repaid bonds issued under Prop 1B, but beginning in the 2010-11 Fiscal Year, gasoline excise taxes, pursuant to the gas tax swap, provide funds to repay those bonds. (Because of the passage of Proposition 22 in November 2010, the state may have to use a revenue source other than gasoline excise taxes to repay these bonds. The Governor's Budget proposes paying this debt service out of commercial vehicle weight fees.)

THE 2010 GAS TAX SWAP

Enacted in March 2010, the gas tax swap eliminated, effective July 1, 2010, the sales tax on gasoline and replaced it with an increase in the gasoline excise tax designed to generate an equivalent amount of revenue. To ensure continuing revenue neutrality in the swap, each year the Board of Equalization must adjust the gasoline excise tax such that over time the new excise tax generates the same revenue as the old sales tax on gasoline would have generated.

By eliminating the sales tax on gasoline, the gas tax swap ended the spillover and the Prop 42 revenue stream. It thus decreased the amount of revenue dedicated to transit. The increase in the gasoline excise tax maintained Prop 42-levels of funding for local street and roads and expanded funding for state highways. The swap also created a new, non-General Fund revenue stream of about $1 billion annually from the new gas tax revenues to repay existing general obligation transportation[1] bonds, including those authorized under Proposition 1B of 2006.

To partially make up for this loss in transit funding, the gas tax swap legislation also provided for a revenue-neutral swap of (increased) sales tax on diesel and (reduced) diesel excise tax in order to increase PTA funds available for funding transit operations.

CONSTITUTIONAL LIMITS ON BORROWING TRANSPORTATION FUNDS

As the state moved away from the user-pay concept in transportation and embedded transportation in the state's General Fund, it subjected transportation to the same revenue vagaries that other General Fund programs face. During booming economic times,

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[1] Because of the requirements of Article XIX the gas tax revenue service that portion of the transportation bonds cannot pay debt service for bond revenue used to acquire buses or rail transit vehicles. The debt service on bond revenue used to investments in rail transit construction—track, stations and other related infrastructure—may be paid with gas tax revenues, as this is not inconsistent with the provisions of Article XIX.

transportation received extra funding, but during more austere economic times the state borrowed transportation revenues or, in the case of PTA funds, used them without a plan to repay. In response, to restrict borrowing of these transportation funds, the people amended the California Constitution through:

- Proposition 2 of 1998, which limited state General Fund borrowing of state transportation funds, including gas tax revenues and funds in the Public Transportation Account. Specifically, loans to the state General Fund in any fiscal year must be repaid within that fiscal year, except that repayment may be delayed up to 30 days after a state budget is enacted for the subsequent fiscal year. Funds may be borrowed over a fiscal year during times of significant negative impacts on the General Fund, but these loans must be repaid in full within three fiscal years.
- Proposition 1A of 2006, which restricts the borrowing of gasoline sales tax (*i.e.*, Proposition 42) funds. It limits such borrowings to twice in a ten-year period, but it requires full repayment of the first loan before a second could commence and requires that any loan be fully repaid within three years.

PROPOSITION 22 OF 2010

In November 2010, the voters passed Proposition 22, which:

- Prohibits state borrowing of transportation funds, repealing the provisions of the California Constitution that Proposition 2 of 1998 and Proposition 1A of 2006 added.

- Embeds in the constitution statutory transportation funding formulas, generally providing that these could only be changed after a California Transportation Commission public hearing and reporting process and a two-thirds vote of each house.

- Precludes the Legislature from directing gas excise tax funds to pay previously issued bonds, thus undoing a major provision of the gas tax swap.

PROPOSITION 26 OF 2010

Also, in November 2010, the voters passed Proposition 26, which requires that any "change in state statute which results in any taxpayer paying a higher tax" must be enacted by a two-thirds vote of both houses and applied this requirement to any tax adopted after January 1, 2010. Any tax increase enacted after January 1 of last year that the Legislature enacted by majority vote is void in November 2011. Thus, Prop 26 will void the increase in the gasoline excise tax within the gas tax swap later this year. It is unclear, but very possible, that Prop 26 will not, however, void the elimination of the sales tax on gasoline that was also included in the gas tax swap. Therefore, transportation advocates and the Brown Administration have proposed re-enacting the gas tax swap with a two-thirds vote.