

**Senate Committee on Transportation and Housing
Senate Committee on Local Government**

**Proposition 22:
Local Taxpayer, Public Safety,
and Transportation Protection Act of 2010**

A Staff Briefing Paper for the Informational Hearing

1:30 p.m., Wednesday, September 22, 2010
State Capitol, Room 112

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Proposition 22:
Local Taxpayer, Public Safety,
and Transportation Protection Act of 2010

Sponsored by the League of California Cities and the California Transit Association, the *Local Taxpayer, Public Safety, and Transportation Protection Act of 2010* has qualified for the November 2, 2010 General Election as Proposition 22.

Elections Code §9034 requires each house of the Legislature to assign qualified initiative measures to its appropriate committees. Those committees must hold joint public hearings on the subject of the measure at least 30 days before the election.

Accordingly, the Senate Committee on Transportation and Housing and the Senate Committee on Local Government will hold a joint hearing on September 22, 2010, at the State Capitol to review Proposition 22.

In accordance with the Elections Code, the Legislature has no authority to alter any initiative measure or to prevent it from appearing on the ballot.

About This Paper

This background paper prepares the members of the two committees for the September 22 public hearing. The committees will hear from the Legislative Analyst's Office, the initiative's sponsors, and its opponents. Legislators will also engage in a question and answer session. The committees will also reserve time for others to give their comments and reactions.

The paper suggests questions that legislators may want to ask the witnesses at the hearing. The suggested questions appear in *italics* and are preceded with the ► symbol.

Background and Existing Law

In the more than 30 years since voters approved Proposition 13 (1978), state and local fiscal affairs have become increasingly entangled because of decisions made

by policymakers, judges, and voters, producing conflict between the state and local governments. Proposition 22 is the most recent chapter in a decades-long struggle to achieve a balance in state-local fiscal relations.

Particularly since the property tax shifts in the early 1990s, local officials have expressed their collective irritation with the state for restricting, raiding, and refusing to repay local revenue sources. Local officials argue (and many legislators agree) that the state's budgetary behavior toward local governments has led to increasing instability and unpredictability for local budgets. They worry about the lack of legislative solutions, the continuing attempts to shift additional property taxes, the persistent uncertainty about motor vehicle fuel tax and vehicle license fee revenues, and the dysfunctional mandate reimbursement process. They argue that the convoluted state-local funding relationship has removed revenue streams further and further from the services they pay for and rendered local government financing virtually impossible for the public to understand.

Years of working groups, select committees, and blue ribbon commissions have filled legislative shelves with reports, studies, and reform proposals for fixing the state-local relationship. Few disagree with the need for reform. Affected constituencies argue about the details, but not about the need for change. The Senate Local Government Committee's 2001 report *Tension & Ambiguity: A Legislative Guide to Recent Efforts to Reform California's State-Local Fiscal Relationship*, summarizes the reform efforts. For all the long and thoughtful hours devoted to this topic, the Legislature has enacted very little real reform.

Frustrated by the Legislature's failure to enact reforms, some interest groups have placed reform proposals before the voters. In November 2004, voters approved Proposition 1A, which amended the California Constitution to limit the state's authority over revenues from property taxes, local sales taxes, and vehicle license fees. In November 2006, voters approved another Proposition 1A, which restricted the state's authority over revenues from sales taxes on gasoline. This November's Proposition 22 augments these two ballot measures by further restricting the state's authority over:

- Transportation tax revenues,
- Property tax revenues, and
- Vehicle license fee revenues.

I. Transportation tax revenues. The excise tax on motor vehicle fuels ("the gas tax") provides the primary source of state funding for transportation in California

and functions as a user-pays system for the state's highways and local streets and roads. The state first imposed an excise tax on gasoline and diesel in the 1920s and historically revenue from the state's excise tax has been allocated to both the state and local governments.

Article XIX of the California Constitution provides that the state's motor vehicle fuel excise tax 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 these gas tax revenues for most transit purposes.

A. 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 local property taxes.

In the early 1970s, the Legislature passed and Governor Ronald Reagan signed the Transit Development Act (TDA) to provide a stable local subsidy program for 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 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. These three flow into the state's Public Transportation Account (PTA), through which the state provides support to local transit districts and for intercity rail.

B. 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 this year, 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 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. In its place in 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 the California 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 Proposition 1B, but beginning in the 2010-11 Fiscal Year, gasoline excise taxes, pursuant to the gas tax swap, provide funds to repay those bonds.

C. The 2010 Gas Tax Swap. The gas tax swap enacted in March 2010 eliminated, effective July 1 2010, the sales tax on gasoline and replaced it with an 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. The gas tax swap legislation also provided that about \$1 billion annually of PTA and gas tax revenues would be used to repay existing general obligation transportation bonds, including those authorized under Proposition 1B of 2006.

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 transit operations funding.

D. 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, 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. Loans extending over a fiscal year may be during times of significant negative impacts on the General Fund. Loans extending over a fiscal year 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.

II. Property tax revenues. Before voters' approval of Proposition 13 (1978), local governments set their own property tax rates. Proposition 13 capped the rate of ad valorem taxes on real property at 1%, cutting statewide property tax revenues by 57%, and gave the Legislature the power to allocate the remaining property tax revenues.

The Legislature responded by allocating property tax revenues to counties, cities, special districts, and school districts based on each agency's pro rata share of the property taxes collected within a county in the three fiscal years prior to 1978-79 (SB 154, Rodda, 1978). The Rodda bill also bailed out local governments with \$858 million in block grants. In 1979, the Legislature permanently restructured the allocation of property taxes (AB 8, L. Greene, 1979). AB 8 used SB 154's property tax allocations as a base and then, in place of block grants, shifted some of the schools' property tax revenues to local agencies and replaced the schools' losses with increased subventions from the state General Fund.

To balance the State Budget in 1992-93, and then again in 1993-94, the Legislature permanently shifted property tax revenues from local governments to each county's Educational Revenue Augmentation Fund (ERAF) to benefit schools --- and offset State General Fund spending. During the late 1990s, efforts to reverse or mitigate the ERAF property tax shifts and to reform the state-local fiscal relationship failed to produce results.

Following these failed legislative reform efforts, and in response to the threat of more local revenues being shifted to the state, a coalition of local governments qualified the *Local Taxpayers and Public Safety Protection Act* for the November 2, 2004 ballot as Proposition 65. Proposition 65 reduced the state's control over some local funding sources by requiring majority-voter approval of legislation to reduce, suspend, or delay local governments' property tax, sales tax, and Vehicle License Fee (VLF) revenues.

Alarmed by Proposition 65's potential fiscal consequences for the state, Governor Schwarzenegger proposed an alternative approach. The governor's package proposed reforming the state-local fiscal relationship in exchange for a two-year local government property tax contribution toward the State Budget. On a separate track, the Legislature re-engaged in conversations with local governments on how best to reform the system. These two efforts came together and a proposal emerged as part of the 2004-05 State Budget package, leading to voter approval of Proposition 1A in November 2004.

Proposition 1A of 2004 amended the California Constitution to prohibit the state from shifting to schools or community colleges any share of property tax revenues allocated to local governments for any fiscal year under the laws in effect as of November 3, 2004. Proposition 1A allowed the state to shift to schools and community colleges a limited amount of local government property tax revenues if: the Governor proclaims that the shift is needed due to a severe state financial hardship, the Legislature approves the shift with a two-thirds vote of both houses, and certain other conditions are met. The state must repay local governments for their property tax losses, with interest, within three years.

The 2009-10 State Budget used this constitutionally-permitted exception to borrow \$1.9 billion of property taxes from cities, counties, and special districts. That budget redirected revenues equal to 8% of each local agency's 2008-09 property tax apportionment (excluding debt levies) into a new fund in each county – the Supplemental Revenue Augmentation Fund (SRAF) – to offset State General Fund

spending for trial court, correctional, and other state-funded services. The funds must be repaid by June 30, 2013.

State law lets redevelopment agencies divert other local governments' property tax increment revenues so that they can fight physical and economic blight. In 2007-08, redevelopment agencies diverted about \$5.4 billion in property tax increment revenues annually from counties, cities, special districts, and school districts. The state General Fund must backfill the schools' losses, about \$2.7 billion a year. Proposition 1A's restrictions do not apply to redevelopment agencies. The 2009-10 State Budget took advantage of this exception by requiring redevelopment agencies to shift nearly \$2 billion of revenues to schools over two years.

III. Vehicle license fee revenues. The motor vehicle license fee (VLF) is a state excise tax on the ownership of a registered vehicle, in lieu of a personal property tax on vehicles. Motor vehicles were originally part of the local property tax rolls, subject to local property taxes. In 1935, the legislature removed vehicles from local property taxation and instead substituted a state-imposed vehicle license fee. The state returned the revenues from the VLF, minus administrative costs, to counties and cities as a replacement for the revenues they would have received if vehicles had remained on property tax rolls. Voters approved Proposition 47 (1986) to constitutionally guarantee that VLF revenues go to counties and cities.

The VLF rate was constant for more than 50 years until 1998, when the Legislature began cutting the VLF rate from 2% to 0.65% of a vehicle's value. The state General Fund backfilled the lost VLF revenues to cities and counties.

As part of the 2004-05 budget agreement, the Legislature enacted the "VLF-property tax swap." Instead of a backfill subsidy from the State General Fund, cities and counties get more of the property tax revenues that otherwise would have gone to schools through the Educational Revenue Augmentation Fund (ERAF). In turn, the state General Fund backfills schools for their lost ERAF money. As a result of these changes, the net VLF revenues available for per capita allocation to local governments were reduced by nearly 90%, from approximately \$1.86 billion to \$196.7 million in 2004-05.

Proposition 1A (2004) amended the California Constitution to require that the Legislature must allocate to local governments a minimum amount of funding that is equal to what they would have received from a 0.65% VLF rate, even if the Legislature lowers the VLF rate below 0.65%. Under Proposition 1A of 2004, the

Legislature retained the authority to allocate VLF revenues among cities and counties.

Proposed Initiative

Proposition 22 restricts the Legislature's authority over revenues from transportation taxes, property taxes, and vehicle license fees.

I. Transportation taxes. Proposition 22 prohibits state borrowing of transportation funds, repealing the provisions of the California Constitution that Proposition 2 of 1998 and Proposition 1A of 2006 added. It would also embed in the California 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 of the Legislature. Also, the proposition provides that the Legislature may not direct gas tax funds to pay previously issued bonds, thus undoing a major provision of the gas tax swap at General Fund cost of about \$1 billion per year.

- ▶ *To the extent that Proposition 22 embeds in the state's constitution statutory transportation funding formulas, does it lock in a financing system that is not responsive to meeting California's transportation needs?*
- ▶ *For transportation bond repayment purposes, why does Proposition 22 treat local government use of gas tax revenues differently than state use of these revenues (i.e., why does it require a vote of the people and permit prospective use only for the state)?*
- ▶ *By further restricting the state's authority to borrow gas tax revenues and PTA revues, what impact does Proposition 22 have on the state's cash flow?*

II. Property taxes. Proposition 22 repeals the Legislature's authority to shift a limited amount of local government property tax revenues to schools and community colleges during a time of severe state financial hardship.

Proposition 22 prohibits the Legislature from requiring a community redevelopment agency to either:

- Pay, remit, loan, or otherwise transfer, directly or indirectly, taxes on ad valorem real property and tangible personal property allocated to the agency for the benefit of the state, any agency of the state, or any jurisdiction; or
 - Use, restrict, or assign a particular purpose for such taxes for the benefit of the state, any agency of the state, or any jurisdiction, other than for making payments to affected taxing agencies pursuant to specified statutes or for increasing, improving, and preserving the supply of low and moderate income housing available at affordable housing cost.
- ▶ *By further restricting the state's authority to borrow or reallocate property tax revenues, does Proposition 22 advance the goal of local government finance reform or does it reinforce an existing flawed revenue structure?*
 - ▶ *To the extent that Proposition 22 locks in funding for local governments, does it make it harder for the state to pay for other programs such as education, social services, corrections, and transportation? Does it increase the likelihood of future tax increases?*

III. Vehicle License Fees. Proposition 22 prohibits the Legislature from changing vehicle license fee allocations to reimburse a local government when the Legislature or any state agency mandates a new program or higher level of service on that local government.

- ▶ *By prohibiting the Legislature from reallocating VLF revenues to reimburse local governments for mandate costs, does Proposition 22 make it more likely that legislators will suspend state mandates because they lack funding?*

IV. Other provisions. Proposition 22 automatically repeals any statute passed by the Legislature between October 21, 2009 and November 2, 2010 that would have been prohibited if Proposition 22 were in effect on the date it was enacted.

- ▶ *What measures have been enacted into law since October 20, 2009 that will be retroactively repealed by Proposition 22? Specifically, beyond undoing the paying of transportation bond debt with gas tax revenues, what impact does Proposition 22 have on the March 2010 gas tax swap?*