Agenda Item 4b

METROPOLITAN
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COMMISSION

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Memorandum

TO: Legislation Committee

DATE: January 7, 2011

FR: Executive Director

W. I. 1131

RE: Comprehensive Transportation Tax Swap Fix

Background on Impact of Propositions 26 and 22

In the aftermath of the November election, various transportation stakeholders, including the League of California Cities, the California State Association of Counties (CSAC), the California Transit Association and the California Alliance for Jobs, have been working to develop a strategy to address the significant uncertainty facing transportation funding in the wake of Proposition 26.

At issue is a provision in Proposition 26 that throws into jeopardy the taxes that were raised as part of the gasoline tax swap that was enacted by the Legislature in 2010 by less than a two-thirds vote. As a reminder, the swap eliminated the sales tax on gasoline and replaced it with an equivalent, and annually adjusted augmentation of the gasoline excise tax. It also reduced the diesel excise tax in exchange for raising the sales tax rate on diesel fuel by 1.75 percent in order to provide additional public transportation funding. Under a provision of Proposition 26 that is retroactive to January 1, 2010, any state tax increase enacted by a majority vote is repealed on November 2, 2011 if not reaffirmed by a two-thirds vote. Therefore, in order to retain the tax provisions of the gasoline tax swap, the Legislature would need to act by a two-thirds vote before November 2, 2011.

There is significant uncertainty regarding how Proposition 26 affects the gas tax swap that may ultimately only be clarified by a court decision. However, the worst case scenario is that the elements of the swap that lowered the sales tax would remain in effect, while the new excise tax and higher diesel sales tax would be repealed, leaving transportation accounts short by over $2.5 billion.

Further muddying the waters, Proposition 22 repealed provisions of the gas tax swap that provided for transportation bond debt service to be funded by the new excise tax. This provision results in an immediate $1 billion impact to the state's General Fund and is therefore of urgent concern to the new Brown Administration and the Legislature.

Summary of Comprehensive Strategy

The proposed strategy, summarized in Attachment A, combines legislation to reaffirm the new taxes enacted under the swap with a proposal to shift vehicle weight fees to the General Fund to help pay for transportation bond debt service. The weight fee shift proposal, originally put forth by Governor Schwarzenegger as part of the December 2010 special session, would actually shift fewer transportation funds to the General Fund than anticipated under the gas tax swap. This is because the gasoline tax swap reimbursed 100 percent of the General Fund's transportation bond debt service — estimated at roughly $1 billion per year — prior to distributing the remaining funds for various transportation improvements. By contrast, vehicle weight fees are estimated to generate roughly $850 million per year. The legislation would also revise the formulas for distribution of the excise tax and diesel sales tax to adhere as much as possible to the funding levels assumed at the time of the gas tax swap.

Without Swift Action to Validate Swap, Significant Uncertainty Could Stall Transportation Projects

There are various interpretations about what Proposition 26 means for transportation funding and what would occur if the Legislature does not reenact the tax portions of the swap by a two-thirds vote. The differences of opinion will undoubtedly give pause to the California Transportation Commission as it releases its draft fund estimate for the State Transportation Improvement Program (STIP) next March. By urging the Legislature to adopt a comprehensive fix to reaffirm the gas tax swap, the coalition is hoping to avoid delays to transportation projects that could result amidst this significant uncertainty. For instance, the Legislative Analyst's Office has stated that it believes the retroactive provision in Proposition 26 is "self-executing" and would automatically repeal the entire gas tax swap by November 2011, thereby restoring the sales tax on gasoline. Other organizations, including CSAC, disagree and believe there's a legitimate interpretation of Proposition 26 that would invalidate only the tax *increases* in AB 8X 6, not the provisions that eliminated the sales tax on gasoline. A concise legal analysis by the counsel to the California State Association of Counties is attached (Attachment B).

Recommend MTC Support Comprehensive Fix

Despite the significant legal uncertainty regarding potential outcomes created by Proposition 22 and 26, we agree with our colleagues that the comprehensive strategy outlined above is a reasonable compromise that will help address the General Fund's $25 billion deficit, while also providing local and state transportation programs with a predictable level of funding similar to that which was assumed at the time of the gas tax swap. Additionally, thanks to Proposition 22, funding for State Transit Assistance, the STIP and local streets and roads is now more secure and predictable than ever. Given the severity of the budget deficit and the expectation that transportation funding will in some form be used to pay for debt service on general obligation bonds for transportation, staff recommends that MTC support the proposed comprehensive fix.

Steve Heminger

Attachments

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Attachment A

December 21, 2010

To: Members of the Legislature

From: Associated General Contractors
California Alliance for Jobs
California State Association of Counties
California Transit Association
League of California Cities
Regional Council of Rural Counties
Transportation California

Re: Comprehensive Fix to Address Propositions 22 & 26 and the March 2010 Transportation Tax Swap

The Problem

The passage of Proposition 22 and Proposition 26 have many implications for the Transportation Tax Swap (AB 8X 6: Tax Provisions and AB 8X 9: Allocation Formulas) enacted in March 2010. Recall, the swap made the following major changes:

1. Eliminated the sales tax on gas and replaced it with a 17.3-cent excise tax increase on gasoline, indexed to keep pace with what the sales tax on gasoline would have generated in a given fiscal year to ensure true revenue neutrality.
2. Reduced the excise tax on diesel to 13.6-cents and replaced it with an increase in the sales tax rate on diesel by 1.75 percent, and provided an exemption to hold harmless entities that would be impacted from the change (SB 70).

A primary reason for enacting the swap was to remove transportation funding from the general fund and the annual budget debate. Equally important is the state general fund savings estimated at approximately $1 billion annually from the replacement 17.3-cent excise tax or Highway User Tax Account (HUTA) dedicated to transportation bond debt service.

However, Prop 22 limits the use of HUTA funds for bond debt and general fund relief as required in the swap. Further, Proposition 26 invalidates the replacement taxes contained in AB 8X 6 within 12-months of its passage and is self-executing in November 2011.

The Solution

In order to address these issues with the Transportation Tax Swap, we urge the Legislature to enact a comprehensive solution that addresses state general fund, state and local transportation, and transit concerns. The comprehensive package should:

1. Validate the replacement tax provisions as contained in AB 8X 6 with a 2/3rds vote of the Legislature (Prop 26 fix);

2. Approve the transfer of Transportation Weight Fees from the State Highway Account (SHA) to a fund to provide the General Fund relief and backfill any losses to the SHA with a portion of the replacement 17.3-cent excise tax (Prop 22 fix); and
3. Reenact a revised AB 8X 9 (Allocations Formulas) that allows the new 17.3-cent gas excise tax and 1.75 percent sales tax rate increase on diesel to be allocated for its intended uses and achieves the same fiscal results anticipated in March (Prop 22 fix). This includes:
    a) Language to allocate the new Section 2103 Highway User Tax Account (HUTA) funds for the STIP, SHOPP, and Local Streets and Roads; and
    b) Language to achieve something closer to the originally-intended split of Public Transportation Account revenues that recognized the importance of funding local transit operations.

The Imperative

The loss of $2.5 billion in revenue jeopardizes transportation projects across California, threatens thousands of jobs, and negatively impacts the overall economic wellbeing of the State given the multiplier affects from infrastructure investment. This loss of transportation revenue would be devastating to California's transportation programs effecting state, regional and local projects across all systems and modes.

The most effective path to provide certainty and avoid the risk of losing these transportation funds and provide the State this much needed and promised general fund relief is to pass a comprehensive package to fix the issues with the transportation tax swap from Propositions 22 and 26.

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Proposition 26 and the Impact on the Transportation Tax Swap
November 24, 2010

Pursuant to County Counsel review, below is a brief outline of the impacts of Proposition 26 on the transportation tax swap adopted pursuant to AB 8X 6 (Chapter 11, Statutes of 2010), which eliminated the sales tax on gas and replaced it with an increased excise tax on gas and sales tax on diesel, and AB 8X 9 (Chapter 12, Statutes of 2010), which codified the allocation formula and other transit funding provisions. In summary, they are concerned that both the 17.3 cent gas tax or Highway User Tax Account (HUTA) funds and 1.75 percent rate increase of the sales tax on diesel for transit adopted to replace the sales tax on gas will be in jeopardy in November of 2011, within twelve months of enactment of Proposition 26, without a re-enactment of the replacement taxes by a two-thirds vote of the Legislature.

Counsel thinks there is a substantial risk that a court will disagree with the Legislative Analyst Office's (LAO) assumption that the sales tax is reinstated when the highway user tax and rate increase of the sales tax on diesel are voided. Although the LAO has articulated an equitable argument to reinstate the sales tax, counsel can not say with any certainty of success how the court might rule on this issue.

Their conclusion is to seek re-enactment of the taxes (AB 8X 6 provisions) by a two-thirds vote of the Legislature recognizing that Proposition 22 now precludes a simple re-enactment of the two bill package adopted in March of 2010. Any re-enactment of the provisions that includes allocation of these funds for General Fund relief (AB 8X 9 provisions) is now complicated by the fact that this is precluded by Proposition 22, which prohibits the use of transportation funds for General Fund relief or any other purpose other than for transportation whether through temporary borrowing or a permanent taking.

Real Life Implications
Without re-enactment of the replacement tax provisions of the swap, $2.5 billion generated annually from these revenue sources will be in jeopardy beginning in November 2011. This revenue would otherwise be distributed annually as follows:

- Approximately $1 billion for General Fund Relief (although Proposition 22 prohibits this expenditure into the future)
- 12% for the State Highway Maintenance, Safety and Protection or SHOPP
- 44% for the State Transportation Improvement Program or STIP
- 44% for local streets and roads allocated equally to counties and cities
- $120 million for transit from the sales tax on diesel increase.

This loss to transportation would equate to job losses estimated at 27,000 based on a $1.5 billion allocation for transportation and 45,000 jobs should the entire $2.5 billion be available for transportation purposes.

Below is a more detailed summary of the relevant provisions and counsel conclusions:

Summary of Relevant Provisions of Proposition 26
New Article XIII A § 3 (a) provides "Any change in state statute which results in any taxpayer paying a higher tax" must be imposed by a 2/3 vote of the Legislature. Notice that the language applies to "change in state statute" not to "any statute."

New XIII A § 3 (c) provides "any tax adopted after 1/1/2010, but prior to the effective dates of this Act, that was not adopted in compliance with the requirements of this section is void 12 months after the date of this Act unless the tax is reenacted by the Legislature and signed into law by the Governor in compliance with the requirements of this section."

Summary of Conclusions Regarding Impact of Proposition 26 on the Swap
The tax increase is not void until 12 months after the effective date of Proposition 26. Counsel believes this is self executing. In other words, it will not require someone to sue to have non-complying taxes repealed. However, since the tax increase went into effect immediately and the initiative does not specifically provide for return of monies collected under a tax declared to be void at a future date, they conclude local governments can continue to receive these funds for the 12 month period following the effective date of Proposition 26, and that local governments can not be compelled to return those funds it properly receives.

Assuming the Legislature does not re-enact the provisions of the tax swap by a 2/3 vote, what is voided by § 3 (c) is a tax that does not comply with § 3 (a) – that is, any part of AB x8 6 that results in any taxpayer paying a higher tax – the increases, not the decreases. The tax decreases do not have to be approved by a 2/3 vote. As such, counsel thinks it is very likely that a court will disagree with the LAO's assumption that the sales tax is reinstated when the highway user tax and sales tax on diesel are voided.

Counsel concluded that a legislative, rather than legal, solution to this problem should be the main focus. This would involve re-enactment of the replacement tax provisions using a 2/3 vote. This is the most expeditious and certain means of securing the funds for transportation into the future. However, there will be complications with re-enacting the entire two-bill package, given the new restrictions of Proposition 22 that prohibit the allocation of these funds for General Fund relief as provided for in AB 8X 9.