CALIFORNIA BUDGET PROJECT

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PROPOSITION 1A OF 2006: WHAT WOULD BE THE IMPACT OF "LOCKING IN" THE PROPOSITION 42 TRANSFER?

Proposition 1A of 2006 would impose new restrictions on the Legislature's ability to suspend the transfer of sales taxes paid on motor vehicle fuels to the Transportation Investment Fund (TIF), which supports state and local transportation programs. This transfer was originally authorized on a temporary basis in a bill passed in 2000 and subsequently made permanent by Proposition 42 of 2002.[1] Proposition 1A replaces the Legislature's current authority to suspend the transfer during a budget crisis with a provision that allows the state to borrow the funds up to twice in a 10-year period and repay amounts borrowed, with interest, no later than three years following the year in which a loan is made. Proposition 1A would also allow the Legislature, with the approval of the governor but not the voters, to issue bonds backed by vehicle fuel sales tax revenues.

The History of Proposition 42

Proposition 42 was placed on the ballot by the Legislature, and approved by the voters in March 2002, as part of an agreement to address the state's 2001-02 budget deficit.[2] Proposition 42 made permanent a five-year temporary transfer of the sales taxes paid on motor vehicle fuels originally approved by the Legislature in 2000, at the height of the boom prior to the state's recent budget crisis. Proposition 42 constitutionally dedicated these funds to transportation programs, including street and highway construction and maintenance and transit operations.[3] Proposition 42 allows the Legislature to suspend the transfer by a two-thirds vote subject to a gubernatorial declaration that the transfer would have a negative impact on the state's finances. The bill suspending the transfer could contain no unrelated provisions.[4]

Prior to 2002, sales taxes paid on motor vehicle fuels were deposited in the state's General Fund and allocated through the state budget on an annual basis. The transfer was suspended twice – partially in 2003-04 and completely in 2004-05 - due to the state's recent budget crisis. In 2006-07, Proposition 42 will shift $1.4 billion from the state's General Fund to the TIF.

What Would Proposition 1A Do?

Proposition 1A would significantly restrict the Legislature's ability to suspend Proposition 42 if the transfer would have a negative impact on the state's finances and allow the Legislature to authorize the sale of bonds that would be repaid from the proceeds of sales taxes paid on motor fuel sales. Specifically, Proposition 1A would:

- **Replace the current suspension provisions with a loan that must be repaid with interest.** Under current law, the Legislature can choose, but is not required, to treat as a loan any amounts that are kept in the General Fund when Proposition 42 is suspended. Proposition 1A would require that suspended allocations be treated as a loan that must be repaid with interest no later than the end of the third fiscal year after a suspension.
- **Limit the number of times the Proposition 42 transfer could be suspended.** Under current law, there are no limits on the number of times that the Legislature can suspend Proposition 42. Proposition 1A would limit the number of times the transfer could be suspended to no more than

twice in a 10-year period. The measure would also require any outstanding loan balances to be repaid in full before a subsequent suspension could occur.

- **Allow legislative authorization of bonds backed by Proposition 42 revenues.** Proposition 1A would allow the Legislature to authorize the sale of bonds backed by Proposition 42 revenues. The proceeds of the bonds would be allocated using the same formula as applied to the original revenue allocation.

- **Require the state to repay transportation programs for transfers that were suspended during the recent budget crisis.** Proposition 1A requires the state to pay the TIF an amount equal to the outstanding balance of Proposition 42 transfers that were suspended during the recent budget crisis on or before June 30, 2016. Annual payments could be no less than one-tenth of the balance owed.

Proposition 1A was placed on the ballot with the passage of SCA 7 (Torlakson) by a two-thirds vote of the Legislature along with four bond measures, Propositions 1B, 1C, 1D, and 1E.

What Are the Implications of "Locking In" the Proposition 42 Transfer?

Proposition 1A is intended to discourage the Legislature from using Proposition 42 revenues to help close future budget shortfalls. It would accomplish this goal by limiting the frequency that the transfer can be suspended and requiring that any amounts kept in the General Fund due to suspension be repaid, with interest, no later than the end of the third fiscal year following suspension. Under current law, the Legislature can choose whether to treat revenues kept in the General Fund due to a suspension as a loan and has the flexibility to determine when any repayment is made. Proposition 1A would require repayment over a relatively short period.

These changes would limit the Legislature's options for responding to future budget crises. To the extent suspension of Proposition 42 becomes either less attractive or unavailable for addressing a shortfall, Proposition 1A would result in cuts elsewhere in the budget, pressure on the Legislature to increase taxes, or borrowing from funds allocated to other programs and services.

Ballot Box Budgeting Continues

Many analysts cite earmarking – the dedication of state tax revenues to specific programs and services at the ballot box – as a major factor contributing to California's fiscal problems. Proposition 42 constitutionally restricted the use of funds that previously had been deposited in the state's General Fund, where they could be allocated based on annual needs and priorities through the budget process. In essence, Proposition 42 created a constitutional spending obligation, without providing new or additional revenues to pay for the additional spending.

Over time, a number of ballot measures have earmarked specific revenue sources – some new and some existing – for specific programs. Other ballot measures have established minimum funding levels or "locked in" the allocation of specific revenues among the state and local governments (see below). To the extent an increasing share of the budget becomes "locked in" by these measures, lawmakers have fewer options for reducing spending during a budget shortfall. Moreover, ballot measures passed recently have included more stringent restrictions than those passed previously. Proposition 98 of 1988, which established a minimum funding level for schools and community colleges, for example, can be suspended by a two-thirds vote of the Legislature. Proposition 98 does not require repayment of amounts lost due to a suspension and, instead, simply restores the guarantee over time to the level where it would have been absent a suspension.[5]

Critics of ballot box budgeting note that granting constitutional protection from budget cuts to one type of spending may encourage advocates for other types of spending to seek similar protection. To the extent this trend continues, the Legislature would be left with limited discretion to address budget deficits and/or discretion that may be limited to the core operations of government, such as tax collection and the court system, that are critical to the functioning of government, but which lack the political support to generate constitutional protection.

The Next Budget Crisis Will Be More Difficult to Address

As noted above, a number of recent ballot measures have locked in spending or revenues or imposed limits on the Legislature's ability to respond to future budget shortfalls. These measures include:

- Proposition 1A of 2004, which severely limits the state's ability to reallocate property tax revenues to reduce the state's school funding obligations. A temporary $1.3 billion shift of property tax revenues was used to help close budget gaps in 2004-05 and 2005-06.

- Proposition 1A of 2004 also requires the state to reimburse local governments for the cost of state-mandated programs and services and suspends the mandated program or service if the state budget fails to provide adequate funding.

- Proposition 1A of 2004 replaced the state's appropriation of funds to counties and cities as reimbursement for revenues lost due to the Vehicle License Fee (VLF) reductions enacted during the late 1990s with an increased share of local property taxes.[6] The restrictions on the Legislature's ability to reallocate local property tax revenues essentially "lock in" the cost of the VLF backfill, which now exceeds $4.6 billion.
- Proposition 58 of 2004, which requires the state to seek voter approval in order to issue debt to finance future budget shortfalls.

Most Transportation Funds Are Already "Locked In"

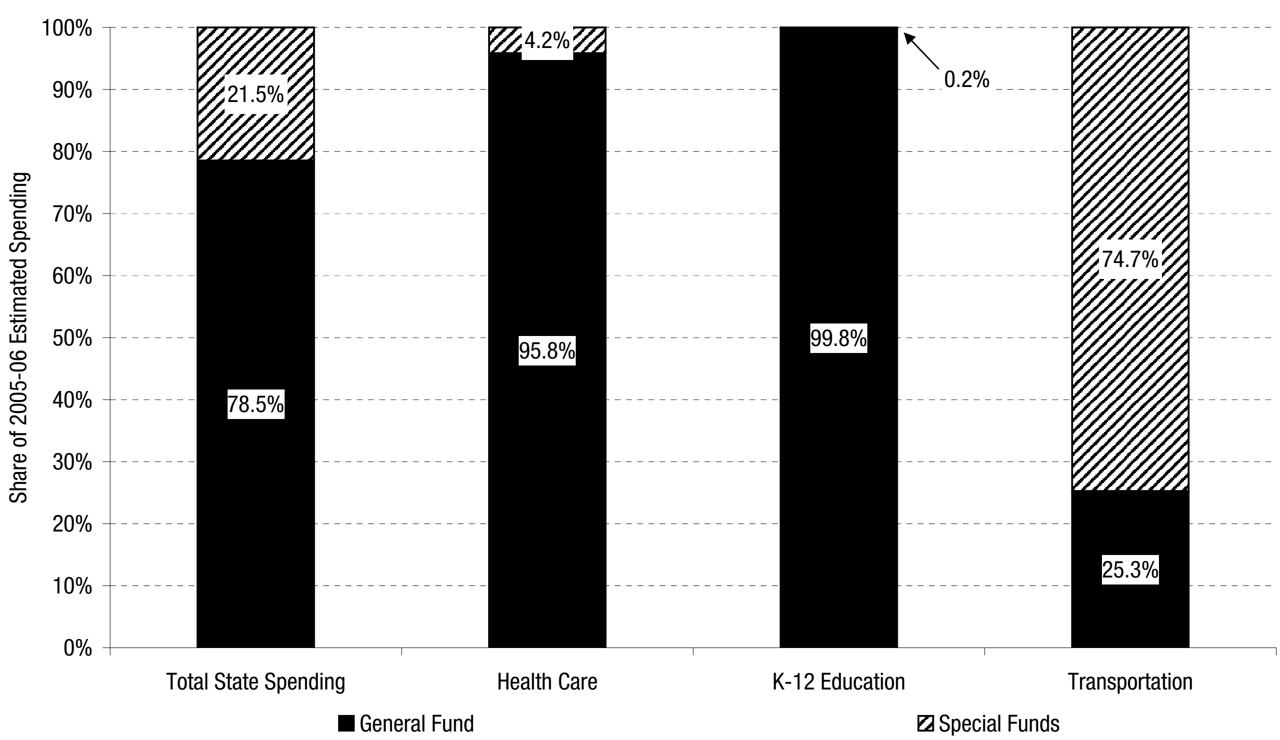
Approximately three-quarters of the funds that support transportation programs are already "locked in" (Figure 1). In 2005-06, special funds – funds that are restricted to a particular purpose – provided 74.7 percent of the dollars for transportation. The remaining 25.3 percent, including $1.4 billion in Proposition 42 funds, came from the state's General Fund.[7] In contrast, just 21.5 percent of total state spending came from special funds. Only 4.2 percent of the support for health programs came from special funds and only 0.2 percent of education spending came from special funds.[8]

Dedicated funds for transportation include gas and diesel fuel taxes and weight fees paid by operators of commercial vehicles. The special fund status of these taxes and fees limits and, in some cases, prohibits their diversion for other budget priorities. The state constitution dedicates the proceeds of vehicle fuel taxes to transportation. These taxes are anticipated to raise $3.5 billion for transportation in 2006-07. In addition, the vehicle registration fees are earmarked for transportation-related public safety and regulatory activities. Vehicle registration and weight fees will raise an estimated $2.9 billion in 2006-07.

Transportation programs, specifically the Public Transportation Account (PTA), also receive a portion of sales tax collections referred to as "spillover."[9] Spillover revenues are estimated at $668 million in 2006-07.[10]

Finally, state law earmarks the proceeds of a ¼ cent sales tax rate for county transportation programs. This rate will provide an estimated $1.5 billion for local transportation programs in 2006-07. In addition, a number of counties and at least two cities have enacted local-option sales tax rates that fund transportation

Figure 1: Most State Transportation Spending Is "Locked In" Through Special Funds



Note: Proposition 42 funds are counted under General Fund.
Source: CBP analysis of Legislative Analyst's Office data

programs. These taxes raised $3.1 billion in 2004-05, the most recent year for which data are available.

Should the Legislature Have the Authority to Issue Bonds Backed by Proposition 42 Revenues?

Proposition 1A would allow the Legislature to issue revenue bonds – bonds backed by a specific revenue, in this case Proposition 42 revenues – and use the proceeds to support transportation programs based on the same formula used for annual revenue allocations.[11] This would allow the Legislature to issue bonds without seeking voter approval. Currently, the state could not issue bonds backed by Proposition 42 funds without approval by the voters.

Proponents argue that this authority would allow the state to spend more sooner to address identified transportation needs. However, bonds would reduce the total amount of funding available over time since bonds must be repaid with interest. The Legislative Analyst's Office (LAO) estimates that, "Assuming that a bond issue carries a tax-exempt interest rate of 5 percent, the cost of paying it off with level payments over 30 years is close to $2 for each dollar borrowed—$1 for the amount borrowed and close to $1 for interest. This cost, however, is spread over the entire 30-year period, so the cost after adjusting for inflation is considerably less—about $1.30 for each $1 borrowed."[12]

How Would Proposition 1A Affect the Budget?

The direct impact of Proposition 1A would be attributable to the provision that requires the state to pay the TIF for amounts that it did not receive during the years when Proposition 42 was suspended. The measure requires that full repayment occur no later than June 30, 2016 and states that the annual payments must be no less than one-tenth of the balance owed at the time the measure is enacted. The Legislative Analyst estimates the current balance to be $754 million, translating into annual payments of no less than $75.4 million.[13]

More significantly, as noted above, Proposition 1A would limit the options available to future Legislatures to address budget shortfalls. To the extent suspending Proposition 42 became either a less attractive or unavailable option, lawmakers would be forced to cut spending elsewhere in the budget, borrow from other programs or funds, or raise taxes.

Proponents Argue

Proponents argue that the state needs significant investments in transportation spending in order to keep pace with population growth and to make up for a lack of spending during the recent budget crisis. Proposition 1A, they argue, will discourage lawmakers from diverting these funds during future budget crises, thus maintaining an important source of funding for state and local transportation improvements. The ability to issue bonds back by these revenues, moreover, will increase the amount of funds available now to help finance critical investments.

Opponents Argue

Opponents argue that Proposition 1A will make it more difficult for lawmakers to balance the budget during future budget crises. They note that Proposition 42 included a provision allowing suspension precisely for this reason. To the extent lawmakers are limited in their ability to suspend the transfer of sales taxes paid on vehicle fuels to transportation and required to repay these amounts over a short time period – a protection not provided to other important programs and services – lawmakers will be forced to cut spending for health, education, environmental, or other public priorities. Finally, opponents note that California has historically used a "pay-as-you-go" approach to finance spending on transportation. Bonds, they add, reduce the resources available for spending over time, since a portion of future revenues must be used for interest payments on outstanding debt.

Conclusion

California's transportation infrastructure is in need of substantial public investment. However, a constitutional amendment would restrict options available to future Legislatures in the event of a budget shortfall, limit the ability of the Legislature to respond to changing transportation priorities, and force reductions in other essential services in the event of an economic downturn.

Jean Ross prepared this Budget Brief. The California Budget Project (CBP) neither supports nor opposes Proposition 1A. This Budget Brief is designed to help voters reach an informed decision based on the merits of the issues. The CBP was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

[1] This paper refers to these revenues interchangeably as sales taxes paid on motor vehicle fuels or Proposition 42 revenues. Proposition 111 allocated the portion of the sales tax paid on the 9 cent per gallon gas tax increase authorized by Proposition 111 of 1990 to the Public Transportation Account.

[2] ACA 4 of 2001 (Resolution Chapter 87, Dutra and Longville).

[3] This transfer is typically referred to as the Proposition 42 transfer. Proposition 42 allocated 20 percent of the annual revenues to public transit and mass transit; 40 percent to transportation projects contained in the State Transportation Improvement Program; 20 percent to cities for street and road maintenance; and 20 percent to counties for street and road maintenance.

[4] This provision is designed to require the Legislature to have a straight "up or down" vote on the issue of suspension and to prevent suspension from being tied to other provisions that might allow lawmakers to claim that they voted in favor of the bill due to its other contents.

[5] For a detailed explanation of Proposition 98, see California Budget Project, *School Finance in California and the Proposition 98 Guarantee* (April 2006).

[6] The property taxes now allocated to counties and cities came from a reduction in the share allocated to schools and community colleges. Schools and community colleges received a dollar-for-dollar increase in state funding in order to fulfill the requirements of the Proposition 98 guarantee. For a more detailed discussion of this transaction and other provisions of Proposition 1A of 2004, see California Budget Project, *What Would Proposition 1A Mean for State and Local Government Finance?* (September 2004).

[7] Proposition 42 funds are treated as General Fund monies, since they are first deposited into the General Fund and then transferred to the TIF.

[8] Health care spending includes dollars appropriated to the Department of Health Services, California Medical Assistance Commission, and Managed Risk Medical Insurance Board.

[9] Spillover occurs when sales tax revenues at 4.75 percent on all sales exceed revenues at 5 percent from all sales excluding gasoline. See Legislative Analyst's Office, *Public Transportation Account: Options to Address Projected Shortfall* (January 4, 2000), p. 4.

[10] The rising price of gasoline has increased the amount of revenues raised by this provision. The 2006-07 Budget Agreement allocated these revenues to partially repay Proposition 42 loans ($200 million), seismic retrofit of Bay Area bridges ($125 million), farmworker transportation ($20 million), high speed rail development ($13 million), and transit-related programs ($310 million). See Legislative Analyst's Office, *Major Features of the 2006 California Budget* (July 2006), p. 25.

[11] For more information on revenue bonds and their use, see California Budget Project, *A Mini-Primer on Bonds* (February 2006).

[12] Legislative Analyst's Office, *An Overview of State Bond Debt* (February 2006) downloaded from http://www.lao.ca.gov/ballot/2006/bond_6_2006.htm on July 19, 2006. This estimate is for general obligation debt, which typically carries a somewhat lower interest rate than revenue bonds. The debt service costs on bonds backed by Proposition 42 revenues could be higher. The distribution of funds among the various purposes would remain the same.

[13] Legislative Analyst's Office, *Major Features of the 2006 California Budget* (July 2006), p.26.