Date: September 11, 2009

To: Commissioner Gerry Parsky, Chair, COTCE

From: Commissioner Fred Keeley

Re: Your request for ideas to fix Prop. 42 transportation funding problem resulting from the proposed Business Net Receipts Tax

Current Transportation Funding

Overview

State public transportation funding in California is challenged both by complicated spending formulae and years of diversions. This has led to chronic and significant underfunding which, without a solution, will be significantly exacerbated by the proposed Business Net Receipts Tax. Currently, most of the state's transportation funding comes from the current $0.18 per gallon excise tax and the state and local retail sales tax. The Article XIX-restricted excise tax is not at risk from the proposed elimination of the state portion of the retail sales tax, but virtually all funding for public transit operations and other transportation expenditures that fall outside of Article XIX will disappear as well as some Article XIX-type expenditures funded by the retail sales tax.

Current Spending Formula

Retail sales tax revenue on gasoline and diesel fuel is the core source of funding for transportation and public transit. Each year, retail sales tax revenues on gasoline is allocated into three pots: 80% is split evenly between state and locals for the STIP and highway allocations, respectively, and the remaining 20% is allocated to transit. In addition to the 20% of the sales tax that transit receives (Proposition 42); transit receives 100% of the sales tax on diesel fuel; and, 100% of the portion of the sales tax on the gasoline tax (the 9 cents that was added in 1990). Traditionally, transit has also received 100% of the spillover revenue that is generated. Spillover is the difference between the state sales tax rate (5.25%) applied to all taxable goods except gasoline and a state sales tax rate (5.0%) apllied to all taxable including gasoline. Essentially, spillover is generated when the price of gasoline increases at a faster rate than all other taxable items.

Half of the funds generated from the above mentioned sources (with the exception of transit's share of Prop 42) flow into the State Transit Assistance program. This is a subaccount of the PTA, and can be used for operations as well as capital expenditures. The other half of the funds that are generated are used for a variety of expenditures including funding the PTA STIP, which is for new capacity, the intercity rail program, as well as providing the CTC, Caltrans, and CPUC, with funding to operate.

Current Transportation Spending Deficits

The transportation sector is already starved for funds. In the last three budget cycles, billions of dollars have been diverted away from public transportation in order to plug the state's chronic General Fund deficits. Approximately $2.443 billion should have been made available to the STA program over FY 07-08, 08-09, and 09-10. The STA program however was funded at $315 million for FY 2007-08 and $150 million for FY 2008-09, while funding for the program was eliminated for 2009-10 and beyond, until FY

2012-13. Consequently, the loss in STA revenue for 07-08 is approximately $455.5 million ($770.5 - $315); $825 million for 08-09 ($975 - $150); and $697 million for 09-10. Therefore, the total loss of STA over the three-year period is approximately $1.978 billion. The amount of PTA—STIP/ITIP lost over the three-year period is $1.37 billion ($587 million in 2007-08, $570 million in 2008-09, and $213 million in 2009-10). There have been zero dollars available for PTA-STIP over the past three years. In fact, the $2.162 billion figure referenced in the chart was spent on Home-to-School transportation, G.O. Bond debt service, and regional occupation centers, in addition to traditional purposes such as the intercity rail program, and administrative costs for the CPUC, CTC, and HSRA, among other things. The total loss of PTA revenues is approximately $3.348 billion ($1.978 + $1.37 = $3.348) over the three-year period.

Effect of Proposed Tax Reforms on Transportation Spending

Elimination of the retail sales tax on gasoline and diesel fuel would zero-out state funding for public transportation operations and capital expenditures. Transit operations is the key concern. Since 2007-2008, the state has diverted over $4.6 billion in funding from the PTA, of which $2 billion represented funding for operations. Between the existing huge shortfall in funding highway maintenance and public transit, the basic transportation infrastructure of the state of California is already at grave risk. This would likely push the State into collapse. Envision the combined disasters of bridge and/or major highway lane closures and bus and transit stoppages and the resulting economic chaos for the Los Angeles, San Francisco and San Jose metropolitan regions. These are not exactly the vision the Governor had in mind when he created the Commission on the 21st Century Economy.

Recommended Actions: Two Alternatives

In conversations with transit and transportation leaders, the two main methods of avoiding the further deterioration in transportation and transit funding which would result from the elimination of the retail sales tax are as follows:

1/ Retain the existing state and local sales tax on gasoline and diesel fuel. While this would result in differing tax rates being imposed by a given retailer on different products (i.e. a local sales tax on cans of oil sold and a state and local sales tax on gas and diesel sold), retailers currently are able to differentiate between taxable and non-taxable items sold, so this hopefully should not pose a huge challenge.

2/ Assuming the passage of the proposed Petroleum Fuel Pollution Tax, funding to replace the existing retail sales tax funding for public transit could be achieved using Proposition 1B bonds. Specifically, the issuance of Prop. 1B bonds would be accelerated such that the remaining amount of Prop. 1B bonds are issued, resulting in an estimated total bond service of slightly in excess of $1 billion. The debt service for the Prop. 1B bonds, normally paid out of the General Fund, would instead be paid by the proceeds from the proposed Petroleum Fuel Pollution Tax, since debt service on these bonds are Article XIX compliant expenditures. The approximately $1 billion in General Fund monies that would thereby be 'released' would be directed to Proposition 42-type expenditures.

Assistance in preparing this memo was provided by Arianna Van Meurs, Josh Shaw, and Mark Watts. Their participation in preparing this memo does not imply their support or opposition of any element of the COTCE package, nor the support or opposition of their clients.