2011-12 under the Proposition 98 minimum funding guarantee. We encourage the Legislature to begin working now to give school districts early signals about the budgetary and programmatic framework they will be operating under in the coming fiscal year and beyond. In particular, districts would benefit from the earliest-possible notice of changes to their budgeted state funding. In November, we suggested that the Legislature consider eliminating the $1.8 billion in K-14 payments deferred in the 2010-11 budget package until July 2011. If it were to do so now, districts would have the greatest possible time to react and avoid committing those funds to additional spending. Acting now also would help minimize the magnitude of the programmatic cuts that districts could be required to make in 2011-12. In addition, a significant way to assist districts would be to retain existing flexibility provisions (most notably, continuing to make certain categorical funding flexible), extend some of those provisions (for example, to apply to the K-3 Class Size Reduction and Home-to-School Transportation programs), and explore new types of flexibility (such as removing restrictions on contracting out and priority and pay for substitute teaching positions).

WEIGHT FEE PROPOSAL

The administration's December special session package proposes to use vehicle weight fees to pay $1.6 billion of General Fund transportation debt-service costs over 2010-11 and 2011-12 combined. Below, we provide background information about recent changes in state transportation financing, then outline and comment on how the Legislature could respond to these latest proposed changes.

Background

Transportation revenues come mainly from taxes on fuels and vehicle weight fees and are generally used for transportation purposes. Transportation programs also benefit by receiving funds from the sale of general obligation bonds. The debt service on these bonds has historically been paid by the state's General Fund. Recently, however, transportation funds have been used to reimburse the General Fund for some of the debt-service costs on certain transportation bonds. In addition, transportation funds have been loaned to the General Fund to help alleviate the state's fiscal problems.

Fuel Tax Swap Increased Funds Available to Pay Debt Service. In March 2010, the Legislature enacted a "fuel tax swap" to provide the state with greater flexibility over the long run in how it uses taxes on fuels for the state's spending priorities. The fuel tax swap changed the way the state taxes fuels in order to provide ongoing reimbursements to the General Fund for the payment of debt service on transportation bonds. Prior to passage of this legislation, the state charged an 18 cents per gallon excise tax on gasoline and diesel fuel. The state also charged a 6 percent sales tax on the purchase of these fuels. A major provision of the fuel tax swap was for the state to stop charging a sales tax on gasoline, and instead impose an additional excise tax (17.3 cents per gallon in 2010-11) on gasoline to generate an amount equivalent to what would have been collected from the sales tax. This is because the state has more flexibility to use excise tax revenues to help the General Fund condition. The legislation did not change the total amount of transportation revenues collected by the state.

The fuel tax swap along with other actions adopted in the *2010-11 Budget Act* would have provided the state with $1.6 billion in General Fund relief in the current year. Specifically, in the budget plan, $491 million was to be used to reimburse the General Fund for highway and road debt service, and $762 million was to be loaned to the General Fund. In addition, the budget plan included reimbursements for transit debt service amounting to $287 million. Various transportation funds amounting to $109 million were also to be loaned to the General Fund.

Proposition 22 Increases the Current-Year Deficit. On November 2, 2010, the voters approved Proposition 22, a complex measure that made numerous changes to the state Constitution and to the way transportation funds are allocated. This measure has an immediate impact on the state's fiscal situation. Specifically, the state is no longer allowed under Proposition 22 to use fuel tax revenues to reimburse the General Fund for transportation debt service. Similarly, borrowing of fuel tax funds is also prohibited. This has the immediate impact of increasing the current-year budget deficit by roughly $900 million.

Proposition 26 Reduces State Flexibility. At the November 2010 election, voters also passed Proposition 26. Among other things, this measure could be interpreted—as we assumed in our recent fiscal forecast—to repeal the fuel tax swap effective November 3, 2011, and return the state to taxing fuels as it did prior to the passage of the swap. While the full impact of Proposition 26 is still unclear, it is likely that the state will lose flexibility in how it uses transportation funds and that the allocation of transportation funds for various purposes would change significantly.

Governor's Special Session Proposal

Use Vehicle Weight Fees for General Fund Relief. The Governor's December special session package proposes to transfer vehicle weight fee revenues to the General Fund. This would achieve an estimated $850 million in budget solutions in 2010-11 and $727 million in 2011-12 by reimbursing the General Fund with weight fee revenues for certain transportation bond debt service costs, and also loaning a portion of the weight fee revenues to the General Fund. Under the proposal, the fuel tax revenues that would have helped the General Fund prior to Proposition 22 would now be available for transportation programs.

LAO Recommendations

Overall, we think the Governor's proposal is reasonable and could achieve the level of savings proposed. Because of the complexity of the state's system for funding transportation, we propose that the Legislature take a two-step approach regarding the use of transportation funds to help the state's fiscal condition. First, we recommend the Legislature adopt during the special session the Governor's proposal and an additional General Fund solution we describe below to achieve total estimated General Fund savings of $900 million. Second, we recommend that the Legislature develop and enact comprehensive legislation to address the use of transportation funding in the future.

Maximize General Fund Benefit in the Short Term. Changes made to the Constitution by Proposition 22 do not explicitly prohibit the use of weight fees for the payment of debt service or General Fund loans. While Proposition 22 will likely be subject to judicial interpretation, we think the Governor's approach is reasonable. The amount of General Fund benefit of the Governor's proposal could be increased by about $50 million. That is because the state will collect an estimated total of $900 million from weight fees in 2010-11. Given the state's severe budget problem, we recommend adopting the Governor's proposal and borrowing the remaining $50 million in weight fees to help address the state's current General Fund deficit.

More Comprehensive Fix Needed for the Future. The Governor's weight fee proposal is only a short-term benefit to the state General Fund. Assuming the fuel tax legislation is repealed by Proposition 26 in November 2011, there would no longer be sufficient fuel excise tax revenues to backfill for the weight fee revenue sent to the General Fund under the Governor's proposal without major programmatic impacts on transportation. A long-term solution to benefit the General Fund beyond this date would likely require the Legislature to reenact fuel tax swap legislation or other actions. We are continuing to analyze the components of a more comprehensive solution to these problems.

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