CALIFORNIA BUDGET PROJECT

budget brief

MAY 2006

WHAT WOULD BE THE IMPACT OF "LOCKING IN" THE PROPOSITION 42 TRANSFER?

Proposition 42 of 2002 constitutionally dedicated sales taxes paid on motor fuel sales to transportation. The measure was placed on the ballot by the Legislature (ACA 4 of 2001) as part of the 2001-02 budget agreement. A previous bill (AB 2928 of 2000), passed at the height of the boom prior to the state's recent budget crisis, temporarily transferred these funds to transportation. Proposition 42 was placed on the March 2002 ballot as part of an agreement to defer the 2001-02 transfer to help close an emerging budget gap. Proposition 42 included a provision that would allow future legislatures to suspend the transfer by a two-thirds vote in the event of a fiscal emergency subsequent to a gubernatorial declaration that the transfer would have a negative impact on the state's finances. In 2006-07, Proposition 42 will shift $1.4 billion from the state's General Fund to transportation. Prior to 2000, sales taxes collected on fuel sales – the funds covered by Proposition 42 – were deposited in the state's General Fund.

The Current Proposal

Reports suggest that negotiated agreements around a package of bonds include a measure that would limit the Legislature's ability to suspend future Proposition 42 transfers. Reports suggest that these agreements would limit how often Proposition 42 could be suspended and require repayment of funds that are not transferred due to a suspension.

What Would This Mean?

During the recent budget crisis, Proposition 42 transfers were partially suspended in 2003-04 and fully suspended in 2004-05 in order to avert deeper cuts elsewhere and/or a tax increase. The 2005-06 budget agreement fully funded Proposition 42. If limits on the suspension of Proposition 42 had been in effect during the recent budget crisis, the Legislature would have been forced to:

- Make deeper cuts in areas of the budget which lack constitutional protection, such as health care, environmental programs, higher education, and human services;
- Rely more heavily on the deficit financing bonds authorized by Proposition 57 of 2004 (during future budget crises, this option would not be available without voter approval); or
- Increase taxes.

The Next Budget Crisis Will Be More Difficult to Address

The current proposal would take away one of the tools used to minimize the impact of the recent budget crisis. In the future, legislators will have fewer options to address budget shortfalls as a result of:

- Proposition 1A of 2004, which severely limits the state's ability to reallocate property tax revenues to generate savings in the state's school funding obligation. In 2004-05 and 2005-06, a temporary $1.3 billion shift of property tax revenues helped to close budget gaps. Proposition 1A also limits the state's ability to defer reimbursement of local governments' costs for state-mandated programs and services.

- Proposition 1A's elimination of the appropriation that reimbursed local governments for revenues lost due to the Vehicle License Fee (VLF) reductions enacted during the late 1990s. As a result of the restrictions on property tax shifts discussed above, this cost is now essentially "locked in."

- Debt service costs on the general obligation (GO) bonds currently under consideration by the Legislature. Debt service costs would boost state spending by approximately $650 million each year for each $10 billion of borrowing.

- Proposition 58 of 2004, which limits future deficit borrowing without voter approval.

What Would Happen During the Next Budget Crisis?

- **Schools will fall behind transportation and local governments with respect to constitutional spending protection.** School funding would have weaker protection than that provided to transportation programs authorized by Proposition 42 or to local governments under Proposition 1A. This could increase the likelihood that school funding would be cut to address future budget shortfalls.

- **Programs without any constitutional protection would be most vulnerable to budget cuts.** Programs that lack constitutional or other protection, such as higher education, many human service programs, health care, parks, and other environmental programs, would be most vulnerable during future budget crises.

How Much Is $1.4 Billion?

The reductions that would be needed elsewhere in the budget to make up for an inability to suspend the Proposition 42 transfer would be sizeable. For example, $1.4 billion equals:

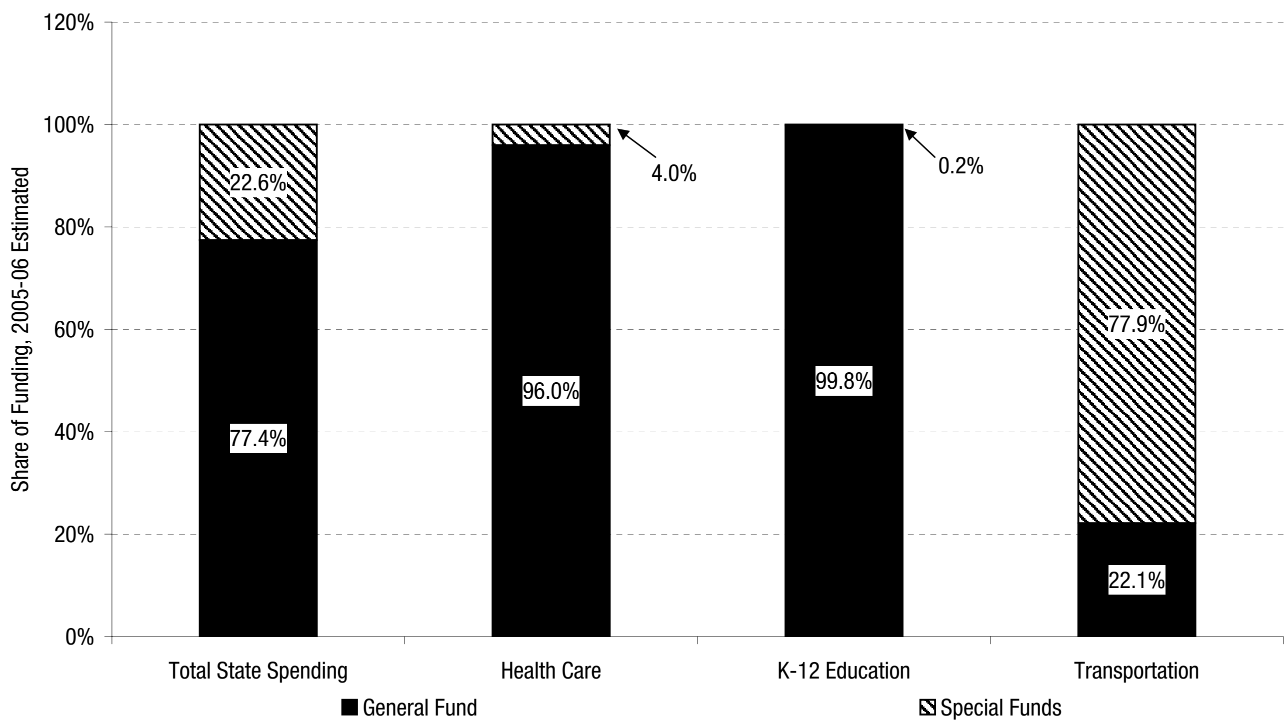
- Combined state spending for foster care, child welfare services, and the Healthy Families Program ($1.4 billion);

- More than the state spends from the General Fund and special funds for environmental protection ($1.1 billion);

- Almost as much as it spends on reducing class sizes in public education ($1.8 billion); or

- Approximately half of what the state spends toward general support of local community colleges ($2.9 billion).

Figure 1: Most Transportation Spending Is Attributable to Special Funds



Note: General Fund amount for transportation represents $1.3 billion in Proposition 42 funding.
Source: CBP analysis of Legislative Analyst's Office data

Most Transportation Funds Are Already "Locked In"

Over three-quarters of the funds that support transportation program are already "locked in" (Figure 1). In 2005-06, special funds – funds that are designated for a particular purpose – provided 77.9 percent of the dollars for transportation. The remaining 22.1 percent, including $1.3 billion in Proposition 42 funds, came from the state's General Fund. In contrast, just 22.6 percent of total state spending comes from special funds. Only 4.0 percent of the support for health programs comes from special funds and only 0.2 percent of education spending comes from special funds.

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. Thus, transportation programs already enjoy more significant protection than other areas of the budget.

Jean Ross prepared this Budget Brief. The California Budget Project (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.