LEAGUE OF CALIFORNIA CITIES

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Pending Budget Proposals on Local Highway User's Taxes and Redevelopment Funds

The following two items in the proposed budget seek to take a combined $2.7 billion from local governments over the next few years. Both of these items will have major consequences at the local level. The League believes they are also both unconstitutional.

Two-Year Grab of Local Highway User's Taxes: The proposed budget includes a Department of Finance (DOF) proposal to seize $986.3 million of city and county shares of the Highway User's Tax Account (HUTA), or gas tax, for FY 2009-10, and an additional $750 million for FY 2010-11 to pay for transportation debt services. This provision would devastate local street and road maintenance programs, cost thousands of local jobs, create public safety hazards, and expose communities to fines for not sufficiently sweeping streets and maintaining storm drains.

The League is strongly convinced this proposal is unconstitutional. Cities are taking action to protest the proposed HUTA grab. As of Thursday, June 18, more than 67 cities had passed a resolution agreeing that the proposal is unconstitutional and authorizing their city attorney to cooperate with the League and other cities that may engage in litigation on the matter. The League's legal opinion on this matter was prepared by Nielsen, Merksamer, Parrinello, Mueller & Naylor, LLP and released on Friday, June 12. The opinion is available on the League's Web site at www.cacities.org/HUTAopinion. (See "A")

City-by-City estimated impacts are also available online.
www.californiacityfinance.com/HUTAprojFY10.pdf.

Background on HUTA has been posted online.
http://www.californiacityfinance.com/HUTAfacts.pdf (See "B")

Earlier in the budget process, the Legislative Analyst Office (LAO) had a counter-proposal to "borrow" 100 percent of these funds ($1.03 billion) from cities and counties, and repay them with interest within three years. Borrowing is permitted under Section 6, Article XIX of the California Constitution and League attorneys are reviewing potential legalities. This "borrowing" option is not currently on the table, but could re-emerge as legislators become informed on the effects of this proposal.

Redevelopment Funds at Risk for Three-Year Hit: Even though the Sacramento Superior Court declared unconstitutional the seizure of $350 million in redevelopment funds for the FY 2008-09 budget, the Conference Committee adopted trailer bill language from DOF that attempts to work around the decision. The committee also approved taking an additional $350 million in both FY 2009-10 and FY 2010-11 from redevelopment agencies.

This massive hit on local redevelopment agencies totals $1.050 billion and would mothball many planned local redevelopment projects that provide economic development and jobs that are desperately needed in this economy. Given that the courts have already deemed this action unconstitutional, if approved, it will trigger additional litigation.

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June 12, 2009

PRIVILEGED AND CONFIDENTIAL
ATTORNEY-CLIENT COMMUNICATION

TO: Chris McKenzie, Executive Director
League of California Cities

FROM: Richard D. Martland

RE: Highway Users Tax Account

You have asked that we review the Governor's proposal to allocate 25% of the revenues in the Highway Users Tax Account (HUTA) to the state for payment of current debt service and reimbursement of the State for the payment of prior debt service on voter approved transportation-related state issued bonds. The entire 25% is to come from HUTA funds allocable to cities and counties. While one cannot predict how the courts might rule, for the reasons stated below, it is our opinion that the most reasonable interpretation of the relevant constitutional provisions is that reallocation to the state of the cities' and counties' allocation under HUTA would violate Article XIX, sections 3, 5 and 6 of the California Constitution.

Proposition 5, placed on the June Primary 1974 election ballot by the Legislature, amended then Article XXVI of the California Constitution (since renumbered Article XIX) to provide cities and counties greater control over their allocation of funds from the Highway Users Tax Account (HUTA). For the first time, authorization was granted to use HUTA funds for the payment of debt service on voter approved transportation-related bonds. (*City of Costa Mesa v. Connell* (1999) 74 Cal.App.4th 188, 195.) Section

5 of Article XIX provides that the state and cities and counties may use up to 25% of their respective allocations of HUTA funds for the payment of debt service on voter-approved bonds for research, construction, improvement, maintenance and operation of public streets and highways. Specifically:

> The Legislature may authorize up to 25% of the revenue available for expenditure by any city or county, or by the State, for the purposes specified in subdivision (a) of Section 1 of this article to be pledged or used for the payment of principal and interest on voter approved bonds issued for such purpose.

The Legislature has provided such authority to cities and counties in Streets and Highway Code section 2107.4 and to the State in Government Code section 16965. Neither sections 2107.4 and 16965, nor Article XIX section 5, provide that the State may use the cities' and counties' allocation of HUTA funds to fund the State's debt service on voter approved transportation-related state issued bonds. The Governor's proposal, in essence, reallocates HUTA funds otherwise allocable to cities and counties to the State to meet the State's General Fund obligations for current debt service and to reimburse the General Fund for payments of prior debt service on voter approved transportation-related state issued bonds.

The manner in which HUTA funds are allocated to cities and counties is governed by statute (See Streets and Highways Code sections 2100 to 2128.1). Proposition 5 restricted the power of the Legislature to amend these provisions, as they existed when Proposition 5 was adopted. Article XIX, section 3 provides:

> "The Legislature shall provide for the allocation of the revenues to be used for the purposes specified in Section 1 of this Article in a manner which ensures the continuance of existing statutory allocation formulas for cities, counties, and areas of the State, until it determines that another basis for an equitable, geographical, and jurisdictional

> distribution exists; provided that, until such determination is made, any use of such revenues for purposes specified in subdivision (b) of Section 1 of this article by or in a city, county, or area of the State shall be included within the existing statutory allocations to, or for expenditure in, that city, county, or area. *Any future statutory revisions shall provide for the allocation of these revenues, together with similar revenues, in a manner which gives equal consideration to the transportation needs of all areas of the State and all segments of the population consistent with the orderly achievement of the adopted local, regional, and statewide goals for ground transportation in local general plans, regional transportation plans, and the California Transportation Plan.*" (Emphasis added.)

Reallocation to the State of 25% of the cities' and counties' total allocation from HUTA is inconsistent with the italicized language, above, and section 5. In effect, the Governor is treating HUTA as a general revenue source which the State may tap to meet its own debt service obligations. The Governor's proposal is not only inconsistent with sections 3 and 5, but with section 6, added by the Legislature to Article XIX in 1998 as part of Proposition 2 on the November election ballot. Section 6 permits the State to borrow funds from HUTA for one fiscal year, three if the Governor proclaims a fiscal emergency or the estimated revenues for the current fiscal year are less than the aggregate revenues of the preceding year, adjusted for changes in cost of living and population.

In the official ballot pamphlet for the November 1998 General Election, the Legislative Analyst, in describing Proposition 2, set forth the general background of transportation funding, stating in part:

> Currently, revenues derived from the gas tax on motor vehicle fuel used in vehicles on public roads and revenues from fees and taxes on motor vehicles are restricted to specified transportation purposes by the California Constitution. The State Constitution, however, permits these revenues to be loaned temporarily to the

> state General Fund with the condition that the loaned amount must be repaid. The state General Fund supports non-transportation activities such as education, corrections, and health and social services programs.

The Analyst then described the changes that would be made by Proposition 2 by stating in part:

> This measure amends the California Constitution to restrict the conditions under which state transportation funds, including gas tax revenues, revenues from fees and taxes of motor vehicles and their use, and funds in the Public Transportation Account, can be loaned to the state General Fund. Specifically, loans to the state General Fund in any fiscal year must be repaid within that fiscal year, except the repayment may be delayed up to 30 days after a state budget is enacted for the subsequent fiscal year. Loans extending over the fiscal year may be made only if the Governor declares a state of emergency which would result in a significant negative impact to the General Fund, or if there is a decrease in General Fund revenues from the previous year's level. Loans extending over the fiscal year must be repaid in full within three fiscal years.

The Attorney General's title and summary for Proposition 2 stated in part:

> Requires loans of transportation related revenues to the General Fund be repaid the same fiscal year, or within three fiscal years if the Governor declares an emergency significantly impacting the General Fund or General Fund revenues are less than the previous fiscal year's adjusted revenues.

There was no argument in the ballot pamphlet opposing Proposition 2. The argument in support of Proposition 2 stated in part:

> Proposition 2 will prevent the Governor and the Legislature from borrowing transportation funds for other purposes except in specified economic emergencies. And it requires a prompt payback when they borrow. PROPOSITION 2 WILL RESTORE CALIFORNIA'S TRANSPORTATION TRUST FUNDS.

The reasonable interpretation of Proposition 2 is that it permits funds from HUTA to be used for General Fund purposes *only* if borrowed and repaid within the specified periods. To suggest that because Proposition 2 does not expressly prevent an outright diversion of HUTA funds for General Fund purposes, such diversion is authorized, would ascribe to the Legislature and the Legislative Analyst an intent to deceive the voters. In *Giles v. Horn* (2002) 100 Cal.App.4th 206, 220 the court stated: "We must select the construction that comports most with the apparent intent of the Legislature, with a view to promoting rather than defeating the general purpose of the statute, and avoid an interpretation that would lead to absurd consequences."

The potential ramifications of the Governor's action on the cities' and counties' allocation of HUTA funds is significant. Reimbursement of the State for payment of prior debt service is merely a means of placing revenues in the General Fund for General Fund purposes not for the payment of existing debt. Thus, under the guise of reimbursing the state for prior payment of debt service, the Governor could determine the aggregate amount paid over time for debt service on transportation-related state-issued bonds, and each year reallocate a portion of the cities and counties allocation of HUTA funds to the General Fund until all prior debt service has been reimbursed.

For the reasons stated above, it is our opinion that the most reasonable interpretation of Propositions 5 and 2 is that they do not permit reallocation to the State of the cities' and counties' allocation of HUTA funds through any mechanism other than borrowing in accordance with Article XIX section 6.

RDM/mc

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Highway User Tax Facts

(aka "Motor Vehicle Fuel Tax," "Gasoline Excise Tax," "Article XIX Revenues")

Rev June 1, 2009

The State of California imposes excise taxes on various transportation fuels. California motor vehicle fuel taxes include the gasoline tax, diesel fuel tax, and the use fuel tax. Taxes on aircraft jet fuel are transferred to the state Aeronautics Account. Taxes on fuel used for other motor vehicles are transferred to the state Highway Users Tax Account. These include:

- The "gasoline tax" and "diesel fuel tax" imposed on the use of vehicle fuels at the rate of $0.18 per gallon including the $0.09 rate imposed by Proposition 111 (1994).
- The "use fuel tax" is imposed on vendors and users of motor vehicle fuels that are not taxed under either the gasoline or diesel fuel tax, such as liquefied petroleum gas, ethanol, methanol and natural gas (both liquid and gaseous) for use on state highways. Use Fuel Tax rates vary depending on the type of fuel.

The allocation of highway user tax revenues is complex, with differing allocations of the $0.09 Proposition 111 rate versus the $0.09 original gasoline tax rate, as well as differences in the allocation of gasoline tax revenues from diesel and fuel use tax revenues. Chart One illustrates the allocation of Highway User Tax revenues.

Revenue Allocations

City Allocations.

Cities receive Gasoline Tax revenue under the following three formulas outlined in the Streets and Highways code.

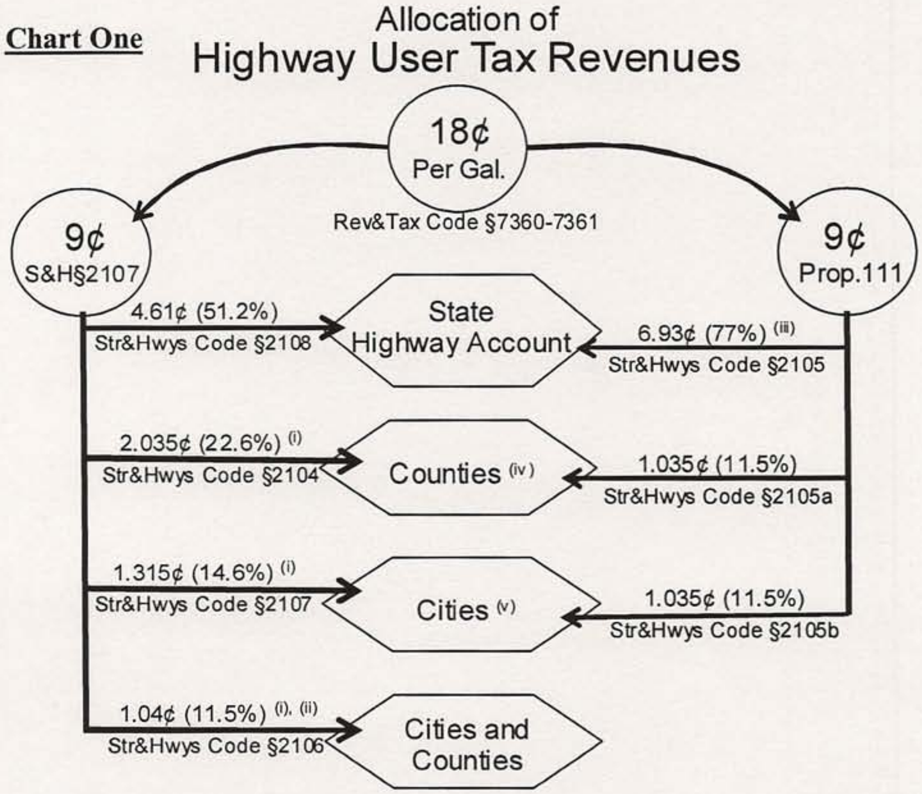
Section 2105. Section 2105(b) allocates 11.5 percent of the tax revenues in excess of 9 cents per gallon (i.e. the Proposition 111 rate) monthly among cities based on population (about $190 million per year).

Section 2107. This section provides monthly allocations of 1.315 cents per gallon of gasoline, 1.8 cents per gallon of diesel, and 2.59 cents per liquefied petroleum gas (LPG), as follows.

a. Each city with snow removal costs in excess of $5,000 is allocated 50 percent of the cost exceeding $5,000. (about $3.7 million per year).

b. The remainder is allocated to cities based on population (about $250 million per year).

Chart One



(i) The 4.39¢ local share of diesel fuel tax is allocated 1.8¢ to counties and 2.59¢ to cities.
(ii) Str&Hwy Code §2106 funds are distributed based on registered vehicles, assessed property valuation, and population.
(iii) A portion of funds in State Highway Account is allocated among counties and cities for Regional Transportation Improvement Programs.
(iv) County apportionments are based on numbers of registered vehicles and county road mileage.
(v) City apportionments are based on population.
Source: California Department of Transportation

Section 2107.5. These funds (about $2.6 million per year) are allocated annually in July to cities in fixed amounts based on population as follows:

City Population	Annual Allocation
over 500,000	$ 20,000
100,000 to 500,000	$ 10,000
50,000 to 99,999	$ 7,500
25,000 to 49,999	$ 6,000
20,000 to 24,999	$ 5,000
15,000 to 19,999	$ 4,000
10,000 to 14,999	$ 3,000
5,000 to 9,999	$ 2,000
less than 5,000	$ 1,000

Section 2107.5 funds must be used for engineering costs and administrative expenses related to city streets. Cities with populations under 10,000 may also expend the moneys for street construction or acquisition of street rights-of-way.

City and County Allocations.

Section 2106. Revenues equal to 1.04 cents per gallon are allocated as follows:

a. $7.2 million per year to the State Bicycle Transportation Account.

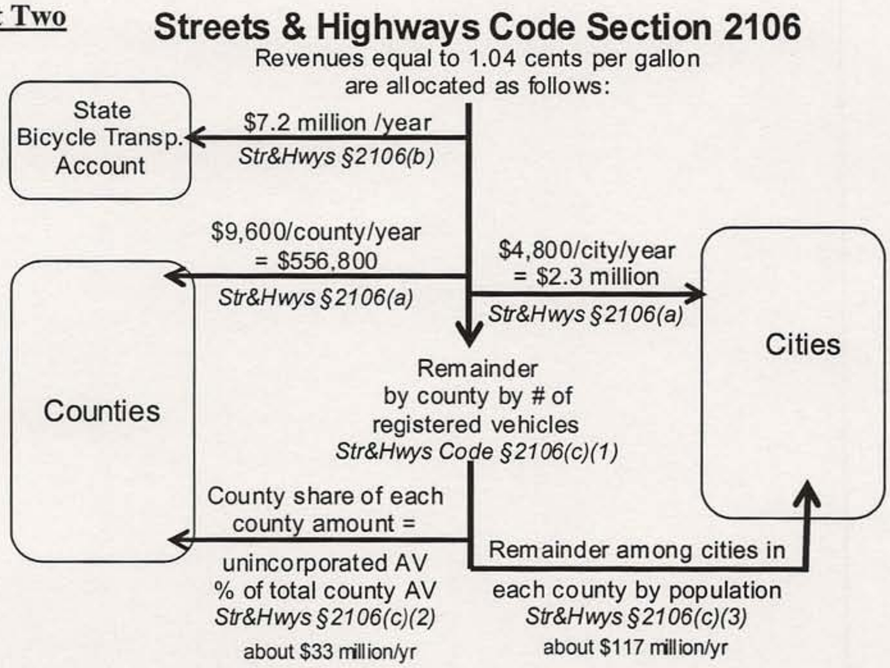
b. $400 per month to each city (about $2.3 million per year)

c. $800 per month to each county ($556,800 per year)

d. The residual amount (about $150 million per year) to each county and the cities in that county based on registered vehicles. In each county, from this amount, the county receives an allotment based on the share of assessed value of the county which is in the unincorporated area. The remainder is allocated to the cities within the county based on population.

Section 2106 allocations are illustrated in Chart Two on the following page.

<u>**Chart Two**</u>



County Allocations.

In addition to receiving a portion of the funds allocated under Streets and Highways Code Section 2106 (above), counties receive Gasoline Tax revenue under the following to sections.

Section 2104. Section 2104 allocates funds to counties with designated allotments for engineering and administration, snow removal, heavy rainfall / storm damage as well as county streets, roads and public mass transit guideways and facilities (about $360 million per year).

Section 2105. Section 2105(a) allocates 11.5 percent of the tax revenues in excess of 9 cents per gallon (i.e. the Proposition 111 rate) monthly among counties based on population (about $190 million per year).

Use of Funds

The use of these funds is restricted by Article XIX of the California State Constitution and by Streets and Highways Code Section 2101. All Motor Vehicle Fuel Tax funds allocated from the Highway Users Tax Account must be expended for the following:

(a) The research, planning, construction, improvement, maintenance, and operation of public streets and highways (and their related public facilities for nonmotorized traffic), including the mitigation of their environmental effects, the payment for property taken or damaged for such purposes, and the administrative costs necessarily incurred in the foregoing purposes.

(b) The research and planning for exclusive public mass transit guideways (and their related fixed facilities), the payment for property taken or damaged for such purposes, and the administrative costs necessarily incurred in the foregoing purposes.

(c) The construction and improvement of exclusive public mass transit guideways (and their related fixed facilities), including the mitigation of their environmental effects, the payment for property taken or damaged for such purposes, the administrative costs necessarily incurred in the foregoing purposes, and the maintenance of the structures and the immediate right-of-way for the public mass transit guideways….

(d) The payment of principal and interest on voter-approved bonds issued for the purposes specified above.

Payment Delays

In FY2008-09, the Legislature passed and the Governor signed, legislation delaying local gasoline tax revenue payments in order to manage state cash flow troubles. These delays in payment did not affect local budgets because they were paid within the fiscal year. Local Highway Users Tax payments totaling approximately $500 million over five months were delayed beginning in April 2008. The funds were paid in full without interest in September 2008. Subsequent legislation again delayed the scheduled payments of local Highway User Tax funds in February, March and April 2009 until May 2009.

The authority for such a delay in the payment of gas tax revenues is found in Section 6 Article XIX of the California Constitution, which permits borrowing of these funds under certain conditions but requires repayment either within 30 days of the adoption of the budget bill for the subsequent fiscal year or – under specific conditions - within three years.

Borrowing Provisions

Section 6 of Article XIX of the State Constitution provides that the state may borrow Highway Users Tax revenues into the state General Fund (i.e. for cash flow purposes) if the amount is repaid within the same fiscal year or within 30 days after the adoption of a state budget for the following fiscal year. Alternatively, the state may borrow these funds for up to three years if one of the following conditions is met:

(1) The Governor has proclaimed a state of emergency and declares that the emergency will result in a significant negative fiscal impact to the General Fund.

(2) The aggregate amount of General Fund revenues for the current fiscal year, as projected by the Governor in a report to the Legislature in May of the current fiscal year, is less than the aggregate amount of General Fund revenues for the previous fiscal year, adjusted for the change in the cost of living and the change in population.

Article XIX includes no provision for the payment of interest on such borrowing.

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