GOVERNOR'S WORKING GROUP
ON
HIGHWAY FUNDING

Short-Term Recommendation

December 15, 2015

Presented to:

The Honorable Asa Hutchinson, Governor

INTRODUCTION

The Governor's Working Group on Highway Funding was created by Executive Order 15-08 on April 23, 2015. The Working Group serves as an investigative and advisory body of the Governor. The Group is composed of the following Governor appointees:

Duncan Baird, Chair	Philip Taldo
Scott Bennett	Dr. Brett Powell
Alec Farmer	Larry Walther
Rep. Dan Douglas	Guy Washburn
Sen. Bill Sample	Shannon Newton
Rep. Andy Davis	Charles Weaver
Rep. Prissy Hickerson	Craig Douglass
County Judge Jerry Holmes	Jackson Williams
Mayor Harold Perrin	Frank Scott, Jr.
Randy Zook	Dr. Robin Bowen

Executive Order 15-08 states that "[t]he Working Group shall provide recommendations to the Governor for the state to create a more reliable, modern, and effective system of highway funding by December 15, 2015."

The Working Group is composed of members of the Arkansas House and Senate transportation committees, designees from integral state agencies and commissions, and individuals that have knowledge of the transportation and finance industries. This group of stakeholders first met in June 2015 and began meeting monthly in August 2015 to begin developing strategies to increase highway funding in the state. The Working Group discussed highway-user revenues, testimony from state agencies, previous proposed Arkansas legislation, and the funding approaches of other states. The Working Group relied heavily on data gathered by highway needs studies that have been conducted by the Arkansas Highway and Transportation Department ("AHTD" or "Highway Department") in the past and the more recent Blue Ribbon Committee Final Report, which was published in 2010, in developing its recommendations. The data contained in the December 2010 Blue Ribbon Committee Final Report, with appropriate updates, is hereby incorporated into this Final Recommendation.

The Working Group concluded that its focus should be on finding immediate sources of funding to meet the short-term needs of the Highway Department. The Working Group determined that it needs to develop a strategy to net $110 million in additional revenue annually to the Highway Department over the next one to three years. Assuming a continuation of the current 70-30% revenue split with cities and counties, the short-term target is approximately $160 million annually.

The proposals contained in this Recommendation are for short-term funding. The Working Group intends to extend its efforts beyond December 15, 2015 to address the state's long-term transportation funding needs. While the Working Group has begun to explore long-term funding options, such as public-private partnerships and a more sustainable formula for highway revenue not tied directly to gas consumption, it would like to continue these efforts, as needed, until the Governor announces completion of the Working Group's purpose, as articulated in the Executive Order.

FUNDING OBJECTIVES

The Working Group heard testimony from the Arkansas Highway and Transportation Department on potential funding targets and needs that could be addressed with different levels of funding for highways. The Highway Department submitted the following needs analysis for the Working Group's consideration:

Short-Term Target (within two years) – $110 million net to the AHTD

This is the amount of new revenue needed annually to help address AHTD's most critical needs. This amount of new revenue would allow the Highway Department to match federal aid apportionments for the foreseeable future based on scenarios currently being debated by Congress. The amount needed for matching is estimated to be **$45 million annually** based on the federal transportation bills currently in conference committee. The balance, an estimated **$65 million**, would be used by the Highway Department for **overlays**, **sealing projects**, and other **non-federally funded projects**.

Mid-Term Target (three to five years in the future) – $140 million net to the AHTD

This amount of new revenue, when combined with the short-term target discussed above, would provide the Highway Department a total of approximately **$250 million annually** in new revenue in three to five years. Achieving the mid-term target would allow AHTD to match federal aid plus implement an **Enhanced Maintenance Program** for existing highways. Approximately half of the total amount, or about $125 million per year, would fund a **resurfacing program**. At this funding level, the Highway Department could overlay/seal/rehabilitate approximately 50% of the highway system every 15-20 years. The Enhanced Maintenance Program would also include:

- At least doubling AHTD's annual striping program;
- Increasing the frequency of sign replacements;
- Adjusting the timetable/frequency of roadside mowing;
- Increasing the equipment investment to reduce the fleet's average age;
- Establishment of a Motorist Assistance Patrol to aid stranded motorists;
- Safety and functional upgrades to Rest Areas; and
- Other facility upgrades aimed at increasing efficiency.

Long-Term Target (six to nine years in the future) – $150 million net to the AHTD

This amount of revenue, on top of the short- and mid-term targets, would provide the Highway Department a total of approximately **$400 million** annually in new revenue in six to nine years. Achieving the long-term target would allow AHTD to match federal aid, better maintain the existing system, and undertake an **Economic Development Improvement Program**. The new money could be combined with existing federal funds to implement the following:

- A focused construction program designed to reduce the number of deficient and/or weight restricted bridges and highways;
- Projects to address localized congestion/capacity needs;
- Additional work on the Four-Lane Grid System of highways;
- Additional work on providing four-lane economic development connectors to cities of 5,000 population or greater; and
- Projects to better integrate bicycle/pedestrian facilities where needed.

Ultimate Needs (ten years in the future) – $16.8 billion net to the AHTD

$1.68 billion in new revenue annually for ten years would yield the following:

- Completion of I-49 and I-69;
- Completion of the entire Four-Lane Grid System, including all Economic Development Connectors;
- No deficient or weight-restricted bridges or highways;
- Pavement condition of "Good" on all highways
- No major capacity or congestion issues in the state;
- Average age of the AHTD fleet at 8 years; and
- Updated Department facilities statewide.

Upon hearing these targets, as presented by AHTD, the Working Group reached a consensus that it should focus on providing a menu of options to address the Highway Department's most critical needs, or short-term goals, to the Governor by the December 15, 2015 deadline contained in the Executive Order. It is important to also note that both cities and counties, while not providing a quantified need, expressed the need for local road, bridge, and safety improvements. Accordingly, taking the targets articulated by AHTD, the need to be able to match federal funding, and the timing of lawmaking sessions all into consideration, and assuming continuation of the current 70-

30% split with cities and counties, the Working Group determined that its recommendations to the Governor would consist of strategies to generate a total of **$160 million in additional revenue annually over the next 1-3 years**.

FUNDING RECOMMENDATIONS

As directed, the Working Group is presenting a menu of options that can potentially reach the $160 million annual target within three years. While four specific proposals are outlined in detail, the Working Group would like to make clear that there may be some overlap of individual elements across various proposals and that the proposals are not necessarily mutually exclusive. It is the Working Group's intent that the Governor will use these recommendations as an advisory tool to ultimately develop a strategy that addresses the state's most critical transportation needs, is politically feasible, maintains adequate funding for other key areas (e.g., prisons, education), and fits within the administration's balanced budget. With those concerns in mind, the Working Group would like to submit the following recommendations for the Governor's consideration:

<u>Proposal #1</u>: Increase motor fuel taxes; Transfer road-user revenue from General Revenue

A. **Index motor fuel tax with any increase limited to 2¢ per gallon per year.** The gasoline tax could be indexed on an agreed-to annual measurement with a 2¢ per gallon cap. A 2¢ increase in the tax would yield an additional $28.5 million gross ($20 million net to AHTD). A 2¢ per gallon increase in diesel fuel tax would yield an additional $12.6 million gross ($8.8 million net to AHTD). Combined, this could generate up to approximately $41 million in additional revenue, with $28.8 million going to AHTD.

   Indexing the motor fuel tax is not a guaranteed increase; rather, it is a hedge against inflation. The tax rate only goes up if costs increase and buying power decreases. The increase in the tax rate (and consequently in revenue) would offset or minimize the increased costs and help maintain buying power. Indexing will help maintain the purchasing power of the primary revenue source for highways. This measure would require legislative action either during a Special Session or the 2017 General Session, but could be implemented quickly upon a change in the law.

B. **Increase the diesel fuel tax by 5¢ per gallon**. This would generate $31.5 million gross, with $22 million going to the Highway Department.

   This is a proven revenue source for highways. This would be paid mostly by commercial and industrial road users, as it is supported by the Arkansas Trucking Association. The

International Fuel Tax Agreement results in fuel taxes being distributed based on the number of miles driven in a state, not on the number of gallons purchased in a state. This measure would require legislative action, but could be implemented quickly upon a change in the law.

C. **Phase-in a transfer of revenue from the sales and use tax on new and used vehicles from General Revenue to the highway fund**. Over seven years, this would shift:

1. 2017-2018: $43.4 million gross/$30.4 million net to AHTD
2. 2018-2019: $89.5 million gross/$62.6 million net
3. 2019-2020: $138.2 million gross/$96.7 million net
4. 2020-2021: $189.8 million gross/$132.8 million net
5. 2021-2022: $244.4 million gross/$171 million net
6. 2022-2023: $302.1 million gross/$211.4 million net
7. 2023-2024: $363 million gross/$254 million net

This would use existing tax revenue to fund highways. Critical state programs and services are funded from General Revenue so this transfer could negatively affect the funding of other services. For instance, education makes up around 65% of General Revenue funded items. This proposition could be addressed during a Special Session or the 2017 General Session. However, it most likely could not be implemented immediately due to budget constraints and a full phase-in would take many years.

D. **Reduce the temporary ½ ¢ sales tax by 1/8¢ and permanently dedicate 3/8¢ of the remaining general sales tax revenue to the highway fund**. This would gross approximately $244 million with $171 million going to AHTD.

The ½¢ sales tax is a temporary tax created by a constitutional amendment. A new amendment would be required to be put on the ballot and adopted by the voters to enact this option.

<u>Proposal #2</u>: Implement Revenue-Neutral Strategies

A. **Redirect that portion of the diesel tax currently going to General Revenue to the highway fund to make up for lost revenue from the truck trailer sales tax**

exemption passed in 2011. This represents approximately $4 million gross revenue to AHTD, cities, and counties. The Department would receive $2.8 million.

Due to its relatively small size, this could possibly be incorporated into the next budget, with offsetting budget cuts or revenue growth.

B. **Rebate an amount equivalent to the temporary ½¢ sales tax revenue that is currently directed to Constitutional and Fiscal Agencies ("Central Services"), back to the highway fund**. The Department of Finance and Administration ("DF&A") can certify the amount collected by Central Services annually and then transfer that amount in July 2016, the beginning of the new fiscal year. DF&A should calculate the amount collected to date since the passage of the sales tax and refund those amounts in equal payments over the remaining life, based on the original terms, of the sales tax. This revenue was approved by popular vote to be used on highways, not administrative costs. This refund is estimated to be $5.4 million gross, with $3.8 million going to AHTD.

The off-the-top deduction for State Central Services is currently 3.2%, which is 2/10% higher than the normal rate, due to additional funding needs of those agencies. This revenue is generated by a temporary sales tax, meaning it will eventually not be available to this fund. This proposition would require legislation action either during a Special Session or the 2017 General Session.

C. **Rebate the sales and use taxes paid on construction materials used for state highways**. AHTD, in conjunction with DF&A, should promulgate rules that allow AHTD to request a rebate of sales and use taxes collected on materials used on highway projects. This rebate is currently estimated at $17 million gross, with $11.9 million going to AHTD based on the state sales tax of 6.5%. These are highway user fees that are currently transferred to General Revenue that should be refunded for use on highways.

The $17 million figure is an estimate from industry groups. It would be difficult for the state to calculate the actual number. As a result, an estimate would be used to shift these funds. This would require legislative action.

D. **Offset planned school desegregation tax reduction with a user fee increase dedicated to the highway fund**. Currently, there is a sales tax reduction planned to occur in 2017 when triggered by resolution of the Central Arkansas schools desegregation case and elimination of those payments by the state. This tax cut is estimated to be between $60 and $70 million annually.

This offset could take various forms which would generate revenue for highways while remaining "net neutral" to taxpayers. This would likely take 3-5 years to implement.

<u>Proposal #3</u>: Phased-In Motor Fuel & Diesel Tax Increase

A. **Adjust the existing gasoline and diesel taxes to recoup the amount lost in recent years to inflation and index in the future.** This represents an approximate $160 million in new funds to AHTD, cities and counties. The Highway Department would net approximately $112 million.

B. **Increase gasoline and diesel taxes by 15¢ per gallon, phased-in over three years (5¢ per gallon per year**). This represents an approximate $300 million in new funds to AHTD, cities, and counties.

C. **To begin in 2017, the state should consider transitioning to a Reportable Miles Traveled funding strategy where drivers will report their annual mileage at their annual car tags renewal date and pay a fee to AHTD, cities and counties**.

This strategy is different from Vehicles Miles Traveled (VMT) where devices are attached to vehicles. Drivers would still maintain their privacy therefore this strategy would not encounter many of the privacy objections that have been expressed in states like Oregon and in the Arkansas legislature when a pilot VMT program was proposed in the 2015 General Session.

<u>Proposal #4</u>: Eliminate the Sales Tax Exemption for Motor Fuel and Diesel

A. **Apply the excise tax to motor fuel, i.e., remove the exemption**. DF&A could convert the sales tax of 4.5% at retail to a per-gallon tax collected at the wholesale level. Because of the volatility in retail pricing, the conversion and the application could be done by DF&A periodically, such as quarterly or every six months. At the weekly price of gasoline on October 26, 2015, this could gross approximately $200 million, with $140 million going to the AHTD.

This proposition could be implemented quickly with legislative action. This method does present some concerns over predictability. Fuel prices are volatile, which could lead to great swings in the amounts of revenue generated.

The Working Group recognizes that elements of some of these proposals do not generate new revenue for highways but, instead, shift existing funding away from other state priorities. As such, we suggest that these proposals only be considered in conjunction with more comprehensive state budgeting deliberations. A comprehensive approach would ensure that the funding shortfall contemplated by these recommendations is not simply transferred from one state agency to others.

The Working Group additionally recognizes that while the fuel tax is a proven revenue source for highways, any proposal dependent solely on the consumption of gasoline is not a long-term or sustainable source of highway funding. As fuel economy has improved and vehicles have become more fuel efficient, the number of gallons used continues to decline. Further, traditional fuels are being replaced by alternatives that are not currently subject to the fuel tax. While many states have made this a key component of their highway funding packages, the Working Group appreciates that the fuel tax cannot be the primary strategy for mid- and long-term funding targets.

In addition to the above proposals, the Working Group endorses some of the remaining Blue Ribbon Committee funding recommendations and often-cited suggestions. The Working Group maintains that many of the following propositions could be appended to the aforementioned proposals:

A. Initiate a $300 registration fee for hybrid and electric vehicles. This is expected to gross $200,000-$300,000 in the immediate future but will grow as consumers' choices shift toward these types of vehicles.

B. Implement fuel taxes on fuels other than diesel and gasoline, such as Compressed Natural Gas. This could possibly include enacting legislation that redefines "fuel."

C. Modify funding to cities and counties – any new funds to cities and counties would be injected into the City and County Aid programs.

D. Require annual reporting on the use of City and County turn-back funds.

E. Increase registration fees $12.50 on Class 1, 2 and 3 passenger cars, and Class 1 trucks equaling the approximate average of similar registration fees in Arkansas' surrounding states. This would generate approximately $24 million gross annually, with $16.8 million going to the Highway Department.

F. Transfer of revenue from the sales and use tax on car-related items (e.g., batteries, windshield wipers) from General Revenue to the highway fund.

G. Require county minimum road tax of 3-mills before it can share in growth of highway turn-back funds.

CONCLUSION

As previously discussed, the above recommendations address short-term funding goals suggested for the Arkansas Highway and Transportation Department. Upon submission of these Short-Term Recommendations, the Working Group will solicit feedback from the public and additional guidance from the Governor. The Working Group will continue to explore feasible short-term strategies in greater depth but will shift its focus to long-term targets and strategies. Long-term strategies worthy of greater examination include tolling and various project delivery models such as public private partnerships - on a case-by-case basis. Further, the Working Group will look at various policy reforms that have the potential to create greater accountability, transparency, and increased efficiencies in order to obtain more sustainable, reliable, and effective approaches to meet the long-term needs of Arkansas' highway system.