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PAYING TO GET FROM HERE TO THERE:
Meeting North Carolina's Transportation Revenue Needs in Difficult Times

BY STEVE JACKSON, PUBLIC POLICY ANALYST

Executive Summary

- North Carolina's transportation budget is in crisis. Revenue from the state's main source of transportation revenue, the gas tax, has lagged far behind construction inflation, thanks to more fuel-efficient vehicles, fluctuating gas prices and the recession, which has prompted many people to drive less.
- The recession has also caused a decrease in vehicle sales, and as a result receipts from the Highway Use Tax, the state's sales tax on vehicles, are expected to be down over twenty percent in 2008-09 compared to the previous fiscal year.
- The third major piece of North Carolina's transportation revenue system, vehicle registration fees, fails to take into account the damage heavier passenger vehicles do to the state's roads, and as a result drivers of lighter cars are forced to help cover the costs of damage done by heavier cars.
- Changing to a system that more directly taxes road use – based on the number of miles a vehicle travels – would be beneficial to revenue collections and could be designed to more fairly distribute tax responsibility. However, creating such a system is currently unrealistic because of administrative and technology hurdles.
- Instead, North Carolina must take a close look at its current transportation revenue sources in order to make them more efficient and effective. First, it should remove the cap on the variable portion of the gas tax. North Carolina will miss out on $250 million in transportation revenue in the first six months of this year because of the cap.
- North Carolina should also abolish the Highway Use Tax's trade-in exemption, which is nothing more than a subsidy for auto retailers, and increase the rate of the HUT by a modest one percent. Together, these changes would add an additional $300 million to the state's transportation coffers.
- Revising the structure of our registration fees system to reflect the damage heavier vehicles inflict on roads would increase transportation revenues by upwards of $150 million per year.

- Dedicating one-third of the new revenue created by these proposals would be sufficient to substantially fund a new state Intermodal Fund that could provide grants to local governments and entities for capital works in public transportation, ports, rail and bike and pedestrian facilities.
- The fee increases recommended should be offset by an increase in the Earned Income Tax Credit for low-income households of 2% total, providing average relief of $32 to eligible households at a cost of around $27 million per year. This cost could be funded directly by the fee increases.

Overview

North Carolina's transportation system is straining under the combined pressure of aging infrastructure, growing demand and decades of poor administration. In her first week in office, Governor Beverly Perdue took aim at the administrative problems by committing to reform of the Department of Transportation and its board. Hopefully, changes in leadership and a restructuring of the makeup and responsibilities of the Board of Transportation will lead to a decision-making process based on needs instead of political considerations.

While these reforms should result in more efficient spending, the state still faces a considerable shortage of dollars designated for transportation because the funding sources are not keeping pace with the state's needs or rising construction costs. Revenues from the gas tax and the vehicle sales tax have declined thanks to the recession and the increase in popularity of smaller, more fuel-efficient cars. In addition, vehicle registration fees have never adequately reflected the damage larger vehicles inflict on the state's roads.

This report examines the current status of the state's three primary sources of transportation revenue and recommends changes. However, because transportation taxes tend to more heavily impact low-income people and because of the current recession, prudence and balance demand a modest approach that ensures the tax base (who gets taxed) is appropriate, does not emphasize raising tax rates, and provides a tax break for low-income families to offset any increased costs.

North Carolina's transportation needs would be best served by changing to a system that taxes drivers based on the number of in-state miles their vehicles travel. However, there are several administrative and technical hurdles that make such a switch impossible at this time. In the short term, North Carolina should remove the cap on its gas tax, rework its tag fees structure, close a major vehicle sales tax loophole and slightly increase the vehicle sales tax rate. These changes would raise substantial new revenues in a fair manner and enable North Carolina to begin to address its transportation challenges.

Troubles with the Gas Tax and the Highway Use Tax

Revenue Growth Slows Due to Changes in Driving Habits and Vehicles

North Carolina's three main sources of transportation revenue are the gas tax, the Highway Use Tax (HUT) on vehicle sales, and vehicle registration fees.

The gas tax provides more than half of the state's transportation revenue. Three-quarters of that money goes into the Highway Fund for road maintenance, public transportation and ports and airports, while the remaining quarter goes to the Highway Trust Fund to help fund the building of new roads.

As cars have become more fuel-efficient over the decades, the rate of the gas tax has failed to adjust. In 1963, the average driver paid three times more in gas taxes to drive one mile than he does today. Recent data illustrate the accelerating trend to more fuel-

The Commitments Required before New Revenue is Raised

1. **REFORM THE DEPARTMENT OF TRANSPORTATION AND THE BOARD OF TRANSPORTATION**

   North Carolina needs an improved and more efficient transportation bureaucracy. The problems at the Department of Transportation are well-documented: ragged internal coordination, poor leadership and low morale. The Board of Transportation has been dominated by large political campaign contributors, and transportation professionals have been too few and far between. The board should be staffed by transportation and public sector management experts and focus on crafting strategy, long-term plans, and oversight of DOT operations. There are promising signs of change at the department and board levels, but recent transportation administrative history makes observers wary.

2. **REFORM HOW TRANSPORTATION DOLLARS ARE ALLOCATED**

   North Carolina can no longer afford the waste scarce budget dollars building and maintaining high-volume highways in areas that do not use them. Currently, money from the Highway Trust Fund for new roads is allocated based on a statutory formula rather than the population's needs. This process must be reformed. New prioritization policies - in the form of a set of analytic principles that allow decision-makers within the Board and Department of Transportation to set a budget-allocation strategy based on need and cost/benefit trade-offs - are required. Sustainable traffic management and balanced transportation solutions to combat congestion, including public transportation, must be made priorities.

3. **MORE PUBLIC TRANSPORTATION FUNDING**

   One-third of any new revenues or of a bond mostly funded by new revenues should be placed in a new state Public Transportation, Bike, Pedestrian, Rail and Ports Fund. The NC General Assembly's 21st Century Transportation Study Committee recommended the creation of such a fund.[1] The money could be used as state matching money for public transportation capital projects, to help cover operating expenses, or as competitive project grants.

4. **USE THE EARNED INCOME TAX CREDIT TO OFFSET IMPACTS OF FEE AND TAX INCREASES**

   All existing state transportation taxes and fees are regressive to some extent; that is, low-income people tend to pay a higher proportion of their incomes on them than higher-income people do. In difficult economic times, fee and tax increases hit these families hard. North Carolina should increase the state Earned Income Tax Credit (EITC) to offset any tax or fee increases. A small portion of the new revenue generated could fund an EITC increase.

efficient vehicles: the number of taxable gallons sold between 2003-04 and 2006-07 increased less than 2 percent,[2] while North Carolina's population increased more than 6 percent.[3] In addition, the spike in gas prices in 2008 led to a historic decline in vehicle-miles traveled - down 7.1 percent in August 2008 from one year before in North Carolina.[4] Gas tax receipts will be down over 5 percent for 2008-2009.[5] The uncertain economic outlook does not bode well for gas tax revenues over the next two or three years.

The crisis of the gas tax has been building for many years, but it has now been joined by a downturn in receipts from the Highway Use Tax, the state's sales tax on vehicles. The HUT makes up about one-fifth of state transportation revenue and is used to fund road construction. HUT receipts are expected to be down more than twenty percent, in 2008-09 compared to 2007-08.[6] The recent economic downturn and higher gas prices have pushed overall demand for vehicles down and switched some remaining demand toward lower-priced vehicles.

As these major revenue sources run into trouble, the price of transportation infrastructure construction and maintenance has rapidly increased. The cost of highway and street construction materials increased 43 percent between July 2003 and July 2007.[7] Construction material costs rose by more than 20 percent in the first nine months of 2008 alone.[8]

Transportation Taxation is Regressive

State transportation taxation is broadly based on user-fee principles. The system is regressive because the taxation or fee rates do not vary with income and as a result low-income people pay greater shares of their incomes toward these taxes than upper-income people do.

Transportation taxes are particularly concerning because they are largely unavoidable for working families. Access to mobility is vital for work and social connectivity. There is only a small degree to which households can avoid the gas tax and HUT beyond which lies effective exclusion and diminished economic and social opportunities.

Studies from the last twenty years have found the gas tax is among the most regressive forms of transportation funding,[9] and the emergence of hybrid vehicles and more fuel-efficient vehicles has exacerbated that situation. Households that can afford these vehicles effectively shift some of the costs caused by their driving to households that drive older and/or less fuel-efficient vehicles. Every new hybrid vehicle on the road -- until cheaper models or a large second-hand market emerges -- further shifts those costs.

The gas tax is a finance mechanism that is unable to adjust for this shift, and therefore at some point in the future, an alternative must be found.

Is a Vehicle-Miles-Traveled Tax a Fairer and More Adequate Alternative?

Since progressive forms of taxation, such as income taxes, are extremely unlikely to be used to fund transportation, selecting the best revenue source must be based on minimizing regressitivity and ensuring the tax base includes all users. Taxing road use more directly -- i.e. by taxing vehicle-miles traveled (VMT) -- looks like the best long-term candidate, if commercial trucking is included. VMT taxes are certainly regressive and unavoidable, yet they are more equitable than most non-use taxation forms dedicated to transportation, such as sales taxes.[10]

The practical question arises as to whether it is possible to adopt a VMT tax approach now, and to do so while the gas tax remains the major revenue source. This seems unlikely because of two considerable obstacles.

First, the state must find a reliable way to measure vehicle-miles traveled. VMT measurement systems using global positioning systems are still experimental, and using simple annual odometer readings to measure miles traveled creates the problem of how to deal with out-of-state travel of residents and in-state travel of non-residents.

Second, the question arises as to how to phase in a VMT system while phasing out the gas tax. Simply adding it to the existing gas tax undermines whatever equity credibility it may have – it becomes a second user charge.

Moving to a VMT approach will probably require either federal, multi-state or large state (i.e., California) initiative to introduce the technology and solve in-state and out-of-state issues. It is a matter of judgment, but if the choice is either raising the gas tax or adding a VMT tax, then, at present at least, staying with the gas tax is more attractive.

Registration Fees Issues

Vehicle registration fees (tag or plate fees) in North Carolina are predominantly a flat rate, although larger non-commercial light trucks (over 4000 pounds) do have higher tag fees.

The flat-rate fee structure means drivers of non-commercial lighter vehicles (small sedans and compacts) are subsidizing the repair of road damage caused by non-commercial light-truck vehicles (SUVs and pick-ups). The structure of tag fees should be changed to better reflect the relative degree of damage each vehicle does to the road, which is an issue of weight.

Fees for commercial trucks, especially those towing large trailers, do not reflect the damage they do to roads. The commercial trucking business is transferring the cost of the damage caused by their trucks to non-commercial drivers. This will need addressing in future years.

Recommended Reforms

Some politically feasible tweaking of rates, closing of loopholes and restructuring of vehicle registration fees could have a profound effect on transportation revenue, raising new revenue in excess of $400 million per year.

Remove the Cap on the Gas Tax

A recent Brookings report concluded that, despite its growing problems, raising the gas tax may be a better bet right now than introducing a VMT tax.[11] This conclusion is based on the fact that the country is currently seeing an historic decline in vehicle-miles traveled; gas prices and a bad economy are reducing driving.

The cap on the gas tax has cost and will cost the transportation budget hundreds of millions of dollars. For instance, absent a cap, the tax would be at 40 cents per gallon from January 1 to June 30 of this year (a rate based on wholesale prices from April through September 2008, before gas prices tumbled). Instead it will remain at the cap of 29.9 cents, a loss of at least $250 million in just six months.

Given the importance of the gas tax to the budgets for maintenance, public transportation, ports and bike and pedestrian projects, there is a reasonably compelling argument that the cap be lifted. Of course, lower gas prices in the first half of 2009 will mean lifting the cap will have no effect on collections in the short term, but there will be the promise of future greater revenue collections once gas prices again reach the four dollar per gallon mark.

Raise Highway Use Tax One Percent

For all the problems with sales taxes, the Highway Use Tax is nevertheless a critical contributor to transportation revenue and is the major state funding source for highway construction. The danger lies in the urge to significantly increase the rate and fall into over-reliance, which would potentially depress vehicle sales and hurt low-income people.

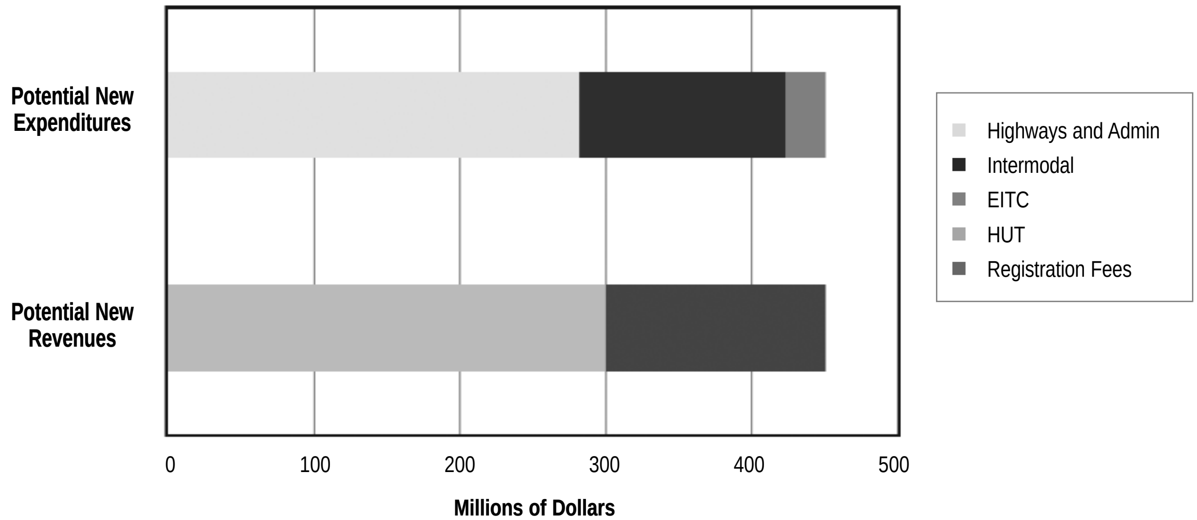
The HUT is presently set at 3 percent, compared to the standard rate on goods of 6.75 percent. North Carolina's HUT is lower than surrounding states, save South Carolina. A one-percent increase would be modest and would yield around $170 million, a sum that would increase as the economy improves.

Close the Trade-in Loophole in the Highway Use Tax

The trade-in exemption to the HUT is a subsidy to auto retailers that North Carolina can no longer afford. That exemption means a buyer trading in a vehicle to an auto retailer pays 3 percent on the new vehicle price less the trade-in value. While many states in the

FIGURE 1

PROPOSED NEW REVENUE AND EXPENDITURE SUMMARY, 2009-2010



Southeast have this "net of trade" loophole, their HUT rates are higher: Georgia's varies from 4 percent to 7 percent depending on the county. Tennessee's is 7 percent. Virginia has a 3 percent vehicle sales tax but no trade-in exemption. Florida has a 6 percent tax with no trade-in exemption.

Abolishing the trade-in exemption would generate around $100 million per year with the HUT at 3 percent, upwards of $130 million per year if the HUT moves to 4 percent. Again, that sum will increase as the economy improves.

Restructure and Raise Vehicle Registration Fees

Since registration fees fund road maintenance, it is logical that the structure of the registration fee schedule reflect the relative wear-and-tear a vehicle imposes on roads. Heavier vehicles inflict more wear-and-tear on roads, and therefore it would be reasonable for fees to increase proportionate to the weight of the vehicle, as they do in Florida, Virginia, Maryland and Texas. Furthermore, larger light trucks and SUVs should be charged more than cars of similar weight because they are built to carry greater loads.

The current fee schedule charges more for heavier light trucks but makes no differentiation among cars. The current fee for all cars and light trucks (i.e. SUVs and pick-ups) weighing less than 4000 pounds (curb weight plus driver) is $28, except in the Triangle counties, where it is $33. This flat fee is about average for the region, except for in Virginia, where fees are 35 percent higher for vehicles less than 4000 pounds.

Given that North Carolina maintains more lane miles than every other state save Texas, and that its roads and bridges are generally acknowledged to be in a poor state of repair, the argument that registration fees are too low and that the maintenance budget is suffering as a result is compelling. The bottom passenger-vehicle rate should be at least equal to Virginia's ($38.75), and rates for heavier vehicles should be adjusted accordingly. Based on a fee increase of $10 for compact vehicles, a hypothetical new schedule could be structured as follows:

FIGURE 2

SUGGESTED NEW RATE FEE STRUCTURE			
WEIGHT	CURRENT FEE	NEW FEE	TYPES OF VEHICLES
All vehicles up to 3000 lbs	$28	$40	Compacts, sub-compacts
Passenger vehicles 3001-4000 lbs	$28	$48	Mid-size car
Light trucks 3001-4000 lbs	$28	$48	Compact SUV
Passenger vehicles 4001-5000 lbs	$28	$54	Large luxury sedans
Light trucks 4001-5000 lbs	$43.50	$70	Mid-size SUV
Light trucks & cars 5001+ lbs	$51.60	$80	Large SUVs

These fee increases in the $20 to $25 range on vehicles over 3000 pounds would increase registration fee revenues by upwards of $150 million in the first year.

Create a New State Fund for Non-Highway Transportation Needs

State road construction is largely funded via the Highway Trust Fund. A parallel state fund specifically for intermodal projects (public transportation, bike and pedestrian improvements, rail freight and ports) has been recommended by the 21st Century Transportation Committee, the study commission of legislators and citizens that reports to the NC General Assembly. This fund would make grants to local governments and transportation entities.

Filling this new state fund would probably cost around $160 million (in 2007 dollars) per year through 2020, based on assessments of needs by the Intermodal Committee of the 21st Century Transportation Committee.[12] The immediate needs would be less, starting at $100 million per year in 2009-10. Dedicating one-third of the new revenues proposed above could be the revenue basis of this new fund.

The justification for using road-based charges and taxes for non-road transportation improvements is simple and obvious: road users benefit from the development of transportation alternatives because they reduce traffic on roads by providing a viable alternative to driving.

Reduce the Impact of Regressive Taxes and Fees by Increasing the Earned Income Tax Credit

Any fee increases should be offset by an increase in the state Earned Income Tax Credit (EITC) to hold harmless low-income households. Assuming an average increase of around $25 for each vehicle registration, the required EITC increase would be around 1.5 percent for an average benefit of $24, which would cost the state approximately $20 million annually.

The Highway Use Tax increase could also be offset by a 0.5 percent increase in the EITC, costing a little under $7 million annually. The average benefit of $8 per household would go some way to offset the HUT increase on purchases of inexpensive vehicles, assuming that such vehicles are driven by purchasers for multiple years.

Conclusion

The tax and fee increases recommended in this report are relatively modest, reflecting the difficult economic times and the pressing need to stretch our transportation tax dollar further by introducing a more stringent project selection and prioritization process that better considers the effect of projects on future transportation demand and land use patterns. But more money is needed at the state level, not the least for non-highway projects, in particular for public transportation.

The changes are contingent on the allocation of a third of the new revenue to a new state Intermodal Fund, and to an EITC offset to ease the burden these fee increases would impose on low-income people. From a practical perspective, a more balanced approach to transportation requires increased revenue streams. The package recommended here is a starting point for that goal.

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