Michael Luis & Associates

MEMORANDUM

To: Nathan Gorton, Association of Realtors
From: Michael Luis
Date: 6-1-05
Re: Draft Transportation Element for Snohomish County Comp. Plan

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This memo is in response to your request to review the financing strategy component (Chapter V) of the Draft Transportation Element of the Snohomish County Comprehensive Plan (referred to below as the "plan"), and to suggest avenues to explore that would enhance Snohomish County's ability to provide transportation capacity to support anticipated growth.

The analysis is primarily qualitative. It focuses on the policy directions outlined in the plan and suggests modified and additional policies that will yield additional transportation capacity. For the most part, it does not dissect the details of methodology behind revenue or expenditure projections, although it does suggest places where the expertise of the real estate and development industry should inform those projections.

The first part of the analysis looks at the projected revenues under current policies. The second part looks at the proposed sources of additional revenue. The third part suggests policy direction that can be explored to enhance long-term access to transportation revenue needed to support growth.

I. Current Law Revenues

Of the current law revenue sources described in the plan and detailed in Table 27, most are difficult to forecast, since they are highly dependent on rates of development, individual projects, and state and federal policies over which the county has little control. Their variability is properly dealt with under new revenue. The two largest sources, however, can be projected, based on known assumptions and variables. Following are thoughts on those two.

Property Taxes (section B-1-a)
The county road levy constitutes the largest, by far, source of transportation funding for unincorporated areas, making up 54 percent of the current law projected revenue in the draft plan. Growth in the road levy, restricted by voter-approved state law, comes from two sources. First, counties are allowed to increase the total collections from all existing property by one percent per year, as part of the annual budget process. Second, the value of new residential and commercial construction is added to the tax rolls at the full levy rate.

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The plan states that the projections beyond 2006 are based on no annual increase in the levy collections (the allowable one percent increase is covered later in the plan and treated as possible new revenue). So the growth shown comes just from the new homes and commercial buildings added to the tax rolls. Table 27 shows an inflation-adjusted real annual growth rate of only about 0.35 percent. The projections, then, assume that the increase in road levy collections from new construction will be just about wiped out by inflation.

This projection is probably consistent with recent experience. The levy has grown about 3.9 percent per year for the past three years. Rapidly-climbing materials prices have pushed inflation in construction over four percent, making real growth in road levy collections flat, if not negative.

New construction, however, varies considerably from year-to-year, and since we have been coming out of a recession, new construction is likely down from past years. To see if this recent experience is the best reflection of future growth in the road levy, it would be helpful to look at longer term trends in construction, backwards and forwards at least a decade. In recent weeks the fortunes of Boeing have improved, which always signals increased economic activity in Snohomish County.

It would also be helpful to understand whether the inflation trends in construction are temporary or reflect longer term structural costs in road building. For example, strong steel demand from China has pushed up the cost of rebar, guard rails and bridge trusses. Will the steel industry catch up and relieve prices? Similarly, concrete producers have concerns about the availability and price of aggregate materials. Inflation is a very important factor in making projections about the sufficiency of transportation funding and should be well-understood.

Recommendation: Request the assumptions and methodology used to project future road levy revenue and test them against projected residential and commercial construction, and inflation trends.

Fuel Taxes (section B-1-c)
Distributions from the statewide motor fuel tax make up about 11.6 percent of the projected current law revenues. The distribution to counties comes as a percentage of total collections of the unrestricted portion of the state fuel tax. Counties currently receive 19.2287 percent of the 23 cent/gallon base fuel tax, or about 4.42 cents/gallon.

County fuel tax distributions to Snohomish County vary over time due to four main factors.

Statewide tax increase. Since this is a current-law projection, it assumes counties get the current 4.42 cents of the existing 23 cent per gallon general fuel tax. Increases in the per gallon rate are addressed under new revenue.

Relative population growth. The county portion of the state fuel tax is divided among the 39 individual counties according to some complex formulas that factor in the resource constraints of rural counties, but population within unincorporated areas plays a major role in determining how much money a county gets. The population of unincorporated Snohomish County, as a percentage of the state unincorporated area population, has been growing steadily for the past 35 years, from under nine percent to nearly 13 percent.

City-county population shifts. As population shifts to incorporated areas, but the distribution formula does not change, the relative distribution to counties increases. In 1990 unincorporated areas housed about half the state's population, and by 2004 that had fallen to 39 percent. The Growth Management Act suggests that future growth should happen in cities, so if the formula does not change, counties should receive a slight boost in their fuel tax distributions.

Inflation. As a per gallon tax, the fuel tax grows with fuel use, but not with inflation. Although per-capita vehicle miles were increasing substantially during the 1980s, that has leveled off, so fuel use, and taxes collected, should roughly track overall population and household growth. Fuel efficiency of cars affects the taxes collected per mile, but fuel efficiency trends have proven very hard to predict.

The plan assumes a very low rate of real growth in fuel tax distribution to Snohomish county. Over the past decade, statewide collections of the base 23 cent per gallon fuel tax have been relatively flat, in real terms, so the plan seems to assume that Snohomish County will not increase its share of the overall county distribution. The plan does not indicate how either of the two population factors noted above will affect fuel tax distribution, so the projections may miss a shift of fuel tax revenues to Snohomish County.

Recommendation: Request the assumptions and methodology used to project fuel tax distributions to Snohomish County, and test those against anticipated population growth in unincorporated Snohomish County and in the remainder of the state.

It is assumed that future drafts of the plan will include fuel tax revenues from the new, one-half-cent per gallon county distribution adopted by the Legislature in 2005. This new revenue, which will be phased in over two years, constitutes an 11.3 percent increase over current distributions, adding $8.4 million to the short-range projection, and $14 million to the long-range projection.

II. New Revenues

The plan shows a shortfall of $225 million over 20 years under the current law revenue assumptions, or $203 million including the new fuel tax for counties adopted in 2005. Even if current law projections are adjusted upward to account for higher population growth and higher rates of commercial and residential development, there will still be a substantial shortfall in revenues needed for capacity-enhancing capital projects. The plan proposes new revenue sources that could, if fully implemented, more than cover the shortfall.

These potential funding sources require affirmative votes by legislative bodies and/or voters, and in the present political climate, they would seem to have varying degrees of likelihood of being adopted. Following are thoughts on those proposed revenue sources.

One percent property tax increase (C-2-a)
State law, as approved by voter initiative, restricts all jurisdictions to increases of one percent or less in the total property tax collections from existing property. The plan projects that if the one percent increase were adopted each year, up to $102 million in revenues would be added to the 25-year total. This move alone would erase half the projected shortfall, or more, if growth projections are found to be unrealistically low. Since the one percent increase is considerably below the rate of inflation, it would seem logical for the county to adopt it, but that is a policy decision that must be made by the Council.

Recommendation: Urge that the one percent annual increase be included in revenue projections of the plan, since it is highly probable the Council will adopt it with proper support.

Extend REET (C-2-b)
The recent reallocation of REET funds from other infrastructure to transportation signals an important shift in policy toward greater support for transportation. It is reasonable to assume that transportation will continue to be a top priority for the council five years from now, and that constituencies for other non-transportation uses of REET will be unable to reclaim the allocation. The Council can make clear that infrastructure funding is a priority by continuing the REET allocation to transportation.

Recommendation: Urge that the extension of the REET allocation be included in revenue projections of the plan, since it is highly probable the Council will adopt it with proper support.

Increase impact fees (C-2-c)
Table 29 shows that impact fees, if pushed to their limits, have the potential to raise a substantial amount of money. Per-unit impact fees, however, raise a number of issues. At a time of increasing land and development costs, impact fees worsen the affordability problem for building lots, and, consequently, finished homes. The per-lot fee gets multiplied by a factor of between three and four before it is passed from the land developer to the homebuilder and ultimately to the homebuyer. Second, since impact fees must be used in a reasonable timeframe to mitigate impacts clearly associated with the development, it may be difficult to target the money to truly high priority projects.

Recommendation: Consider changes to impact fees within the larger discussion of value capture and sub-area transportation strategies.(see page 6)

Regional Transportation Improvement District (C-2-d)
In spite of its struggles, the RTID remains the central vehicle through which major transportation funding increases will become available in the coming decade. Not only does it have its own taxing authority, but its regionally-generated funds provide the match for state

funds through the new Transportation Partners program approved by the Legislature in 2005. So although it is impossible to predict with certainty that RTID funding will eventually be adopted, the stakes are very high for vital projects throughout the region. It is difficult to imagine that regional leaders will abandon RTID or use it only to fund high profile projects like SR-520 or the Alaskan Way Viaduct. The array of funding and projects that might be acceptable to voters, however, remains a mystery.

Recommendation: Monitor RTID negotiations and project lists to ensure that proposed projects will improve key arterials or have the potential to reverse spillover traffic from state highways.

Increase in state fuel tax (C-2-e)

Until 2003, increases in the state fuel tax sent additional money to counties through the allocation formula. The 2003 "nickel" package and the 2005 increase both allocate the new money differently. The nickel package provides no money to local governments, and the allocation to counties in the 2005 package is outside of the traditional formula. So, the plan's suggestion that allocation to counties could continue to increase through the general statewide fuel tax seems unlikely. It is encouraging that the 2005 Legislature clearly saw the needs of counties and cities, but strategies for gaining increases in state fuel tax allocations to counties will likely need to be different from past strategies.

Recommendation: Urge that the plan include a periodic increase in the fuel tax allocation to counties since the Legislature has historically recognized the road needs of counties and the lack of inflation sensitivity in the fuel tax.

Local option vehicle license fee (C-2-f)

This would appear to be an unlikely source of funds. Voters explicitly lowered their car tab fees, and courts ruled that the local option portion fell under the initiative. Reversing the sentiment behind that vote would be a challenge. Moreover, the Legislature has provided ample new local option taxing authority through the RTID and would not likely authorize a new tax that would compete at the county level with the RTID's multi-county approach. Although this is an unlikely source of revenue it has the potential to raise up to $80 million over the life of the plan.

Recommendation: Do not assume this will happen.

Other sources (C-3-a through C-3-g)

Only one of these items, the local option fuel tax, is a defined new revenues source, and it would be precluded by the RTID. The others involve strategies for sharing costs, these will be discussed below.

III. Future Transportation Funding Strategies

As has become clear in the past few years, meeting the growth-related transportation needs of the region cannot be accomplished through traditional means. With key parts of the region's infrastructure reaching the end of their life cycles, renovation and replacement of existing facilities will absorb much of the new revenue over the next decade. As Table 25 shows, the plan calls for more spending on non-capacity capital as on capacity-related capital in the near term, and nearly as much over the 20 year timeframe. Since the current policy of agencies throughout the state is to fund maintenance and replacement before new capacity, creativity will be required to ensure growth-related capital needs are met.

Following are three area to explore.

Interaction of state and county road systems
The spine of the regional road network is operated by the state, in the form of interstate freeways and state highways. In most of the Puget Sound region, sections of the state system experience severe congestion, especially during commute hours. In response to this congestion, motorists often shift to arterials, causing them to become congested. It would be safe to say that many arterials in Snohomish County experience congestion due to spillover traffic from congested parts of the state system.

To determine the ability of the county arterial system to handle additional growth, then, it is necessary to look at future expansion of the state system to see if state investments will free up arterial capacity.

It is assumed that the plan takes into account projects that will be completed as part of the 2003 "nickel" package. More state projects, however, are in store and are not likely factored into the plan. In the closing days of the 2005 Legislative session, the state adopted a phased, nine-and-a-half cent per gallon increase in the fuel tax, all but a penny of which will be directed to state highway improvement and capacity projects.

Some of these projects, although listed as safety or freight-related, will add incrementally to capacity. Others are aimed squarely at congestion and choke point relief, promising significant new capacity. 2005 projects for Snohomish County include $123 million for improvements to SR-9, and $121 million for a series of interchange improvements to I-5. These, and future projects planned under the new program, should be examined for potential to free up arterial capacity and push needed arterial projects further into the future, thereby freeing up funding.

Value capture
A number of revenue raising and financing techniques can be used to capture part of the value created by new infrastructure in order to pay for that infrastructure. Over time growth does pay for itself, but conventional capital improvement programs and budget processes do not usually create direct links between new revenues generated by new development and the cost of providing infrastructure to that development.

Unlike impact fees or SEPA mitigation payments, which are one-time charges against the development that are passed on to the buyer, value capture recognizes that new development adds to the tax base and creates an ongoing stream of revenue that would not exist without the development. Since new development also brings added service demands to government, much of the new revenue stream is needed for operating budgets. But since new development generally has higher value per unit than older development, some new revenue could be diverted for infrastructure while still meeting the service needs of the new development.

Following are three common ways to capture value of new development to finance infrastructure:

> <u>Tax increment financing (TIF)</u>. Under TIF, the new property taxes generated by development are set aside to pay debt service on bonds sold to pay for infrastructure supporting that development. Taxes being collected on the property prior to the TIF program continue to go where they went historically, and when the bonds are paid, the new increment can go to general government. TIF has a problematic legal history in Washington State, and the structure currently authorized has proved unattractive.
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> <u>Local improvement districts (LIDs) and Road improvement districts (RIDs)</u>. RIDs are mentioned in the plan (C-3-d) as a possible way to generate new revenue. Any type of special assessment district faces the challenge of gaining approval from property owners who feel they will not benefit. So while a few major property owners may want to institute an RID to make their property developable, property owners with no development plans may balk.
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> <u>Latecomer fees.</u> The complexity of LIDs and RIDs can be overcome to some extent by using latecomer processes. Rather than charging all property owners who connect to the new facility up front, as in an assessment district, latecomer processes require the first developer or group of developers to pay the entire privately-funded cost, with future developers reimbursing the original funders as their developments come on-line. Snohomish County has a latecomer process on the books.

None of these processes is perfect, and some creativity is often needed. For instance, although TIF is difficult to implement, a less formal version might work, in which the county uses limited tax general obligation debt to fund road improvements in a newly developing area, knowing that the new development will throw off substantial new property tax revenue to help retire the bonds.

The key to making any value capture program work is identifying specific geographic areas that are ready for new development, and working closely with property owners to craft a plan for financing needed transportation improvements. This can be a departure from typical arms-length relationships between transportation agencies and property owners, but a detailed subarea transportation and financing plan goes a long way toward building trust on all sides. The public agency needs to know that the development, and subsequent new revenues, will happen on schedule, and the developers need to know that private contributions are fair and that the projects will be completed.

Two good examples of public-private cooperation in transportation are the interchanges built in Issaquah to serve Issaquah Highlands, and in Dupont, to serve Northwest Landing. In both cases the new interchanges were necessary for the success of the masterplanned community, and the developer made major financial contributions. The state, in turn, did its best to accelerate construction to meet the timelines for the development. This type of cooperation can work at a smaller scale to unlock land for development that is currently served poorly by roads.

Dedicated fund for arterial expansion

As noted, the approach taken by most transportation agencies is to place the highest priority on maintenance of the existing system. With the deterioration of the existing road and bridge network, maintenance and non-capacity capital improvements (e.g. replacement of a bridge with one of the same capacity) can soak up most of the available money, leaving little for new capacity.

The state began to recognize this problem, and created the "nickel" account in 2003 that dedicates the entire fuel tax increase to a specific list of projects. The 2005 Partners program similarly dedicates funds to a specific project list. While not all of these projects add new capacity, the process does signal a willingness to insulate those funds from the growing needs of the maintenance and operation budgets.

Snohomish County could take a similar approach. Since the critical unfunded part of the plan involves arterial capacity improvements needed to support growth, a new dedicated "arterial growth fund" could be set up to collect growth-related revenues that now go to general government. This fund would target one-time revenues coming in under existing taxes that are a direct result of new housing and commercial development.

In other words, this fund would consist of revenues that would not exist if growth never happened, and that are not needed for the new development to pay for its ongoing service costs. This approach is based on two principles. First, since growth varies from year to year, it is not wise for governments to depend on one-time growth-related revenues for their general fund budgets. Second, if growth is to pay for itself, some mechanism is needed to make that happen in identifiable ways.

The main source of revenue to make up such a fund would be the sales tax charged on construction. Counties collect one percent sales tax on all contracting activities, so most of the value of a new structure gets taxed at the point of land development or building construction. A home selling for $300,000 would, therefore, yield somewhere between $2,000 and $2,500, depending on the part of the selling price taken up by the non-taxable components of raw land, sales commissions and profits. Similarly, construction of a new $1 million retail building might yield $8,000 to $10,000.

The amounts of money yielded by the sales tax on construction will not likely be huge, and it will take some time and dedication to divert it from the general fund. But such an approach moves in the important direction of capturing the revenues generated by growth to pay for growth. And once an arterial growth fund is established, other growth-related revenues could be moved into it, such as property taxes on unsold lots or homes, or sales tax on commercial fixtures and equipment for new businesses.

Conclusion

The draft transportation element discusses all revenue sources that could reasonably be expected to be included in a county road budget during a time when county governments are feeling extreme budget pressures. The plan does seems fairly conservative in its projections of revenue growth, from both an economic and political perspective. This is an appropriate approach for a draft of a staff document: overconfident revenue projections can cause later difficulties, and staff should not be speculating on future policy decisions.

As indicated above, however, there are a number of areas in which the experience and expertise of the real estate and development industries could bring new information and help refine revenue projections. The industry has unique information on the direction of future growth, and, as politically active groups, should have a point of view on the likelihood of future policy decisions.

This planning process is also an ideal time to discuss ways to craft a more creative approach to transportation financing over the 20-year life of the plan. The state has shifted its financing strategies toward cooperative approaches aimed at specific priority projects, and the same type of strategy could be adopted at the county level to fund priority projects in growth areas.