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Fitch: US States Taking on Transportation Funding Gap

Fitch Ratings-New York-16 May 2017: States will continue to increase transportation taxes and fees and seek alternative financing mechanisms to meet infrastructure challenges as federal investment remains uncertain, Fitch Ratings says. However, hurdles to realizing the full benefit of such measures include political risk, lower gas consumption, and resistance to creating and raising tolls.

Federal grants play an important role in building and maintaining highways and other transportation projects. However, federal policy inertia on transportation (and infrastructure in general) has been augmented by recent uncertainty about the current administration's funding plans.

States are likely to increase their direct investments in transportation projects by leveraging recent revenue increases. Six states (CA, MT, IN, TN, SC, WY) have raised gas taxes and fees to fund transportation projects in 2017. Six others are considering bills that would increase gas taxes to raise transportation revenues (CO, WV, MN, OR, WI, ME). Most states are only catching up as gas tax revenues have grown more slowly than inflation for decades, according to the U.S. Census Bureau Annual Survey of State Government Tax Collections. Most recently, South Carolina's House voted last week to override the governor's veto of a bill that includes a gas tax hike and some fee increases. This is the first increase in gas taxes in the state in 26 years. The state's inflation-adjusted gas tax revenues have risen by just 4.1% since 2000.

Higher gas taxes and fees could face risk from higher fuel efficiency. The Corporate Average Fuel Economy (CAFE) standards are set to raise the national fleetwide average mpg to 54.5 in 2025 from 35.5 in 2016. The current administration has called for a midterm review of the standards. However, regardless of how the regulations evolve technological advances will likely raise average MPG over the next several years.

Some states are also discussing adding tolls or raising existing tolls to meet capital demands. For example, last month Indiana approved funding to direct \$1.2 billion to state roads by 2024 from higher gas taxes and fees. The bill also requires the state to apply to the federal government for a waiver to toll currently un-tolled interstates within. Fitch expects to see other states take similar approaches as tolling the interstates is a viable option.

Tolling and other user fees could be a viable and meaningful component of highway funding if they are carefully implemented. Tolls can be adjusted with inflation with minimal adverse economic or political implications, provided the system is well operated and maintained. For example, the "first-mover disadvantage" can be limited by implementation across the system as raising tolls on one highway near an untolled road can hurt toll revenues.

In addition, PPP-enabling legislation is rising and could be another financing alternative in certain situations. In 2016 three states (KY, TN and NH) enacted PPP legislation, according to the National Conference of State Legislatures. PPPs used in the right circumstances allow governments to effectively transfer many project risks to the private sector and provide certainty in forecast costs, though they aren't a panacea for all funding shortfalls. In addition, issues of public perception, including a perceived loss of public control and a lack of understanding of potential long-term

benefits, can make implementation of PPPs challenging.

Contact:

Scott Zuchorski
Senior Director, Global Infrastructure & Project Finance
+1 212 908-0659
Fitch Ratings, Inc.
33 Whitehall Street, New York, NY

Eric Kim
Director, U.S. Public Finance
+1 212 908-0241

Robert Rowan
Senior Analyst, Fitch Wire
+1 212 908-9159

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email:
elizabeth.fogerty@fitchratings.com; Sandro Scenga, New York, Tel: +1 212-908-0278, Email:
sandro.scenga@fitchratings.com.

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