WHAT WOULD PROPOSITION 87 MEAN FOR CALIFORNIA?

Proposition 87 would tax oil production in California and spend $4 billion on efforts aimed at reducing gasoline and diesel consumption, including encouraging the purchase of alternative vehicles and alternative fuels, and funding renewable energy research. Proposition 87 has significant financial backing from venture capitalists Vinod Khosla and John Doerr, as well as Hollywood producer Stephen Bing.[1] The California Budget Project neither supports nor opposes Proposition 87.

What Would Proposition 87 Do?

Proposition 87 would:

- Impose a tax on oil produced in California. This tax would vary from 1.5 percent to 6.0 percent of the oil's selling price, and the tax rate would depend on the price of oil.
- Authorize $4 billion in spending over 10 years for a new California Alternative Energy Program with the goal of reducing the use of petroleum in California. The program would encourage the use alternative fuels, such as by providing financial incentives to purchase clean vehicles, and would support research on renewable energy and energy efficiency technologies. The program would also aim to bring alternative fuels and technologies to market more quickly, educate the public about energy efficiency and renewable energy, and train workers in renewable energy and alternative fuel technologies.
- Reorganize the California Alternative Energy and Advanced Transportation Financing Authority, which currently finances alternative energy and transportation technology projects. Proposition 87 would rename this body the California Energy Alternatives Program Authority and expand its mission. A nine-member board would oversee the authority and determine how Proposition 87 funds would be spent. Members would include the Secretary of the Environmental Protection Agency, the chair of the State Energy Resources Conservation and Development Commission, the state Treasurer, and six appointed individuals with expertise in specific areas, such as public health, venture capital, and renewable energy. The Governor would name two of the appointed board members, and the state Attorney General, the state Controller, the Assembly Speaker, and the Senate Rules Committee would each name one board member. The board would appoint a Chief Executive Officer and determine the number of employees needed to carry out the work supported by Proposition 87.
- Exclude revenues raised by the tax on oil producers from the State Appropriations Limit and the Proposition 98 school funding guarantee.

How Would the New Monies Be Spent?

Proposition 87 would spend $4 billion within 10 years after the adoption of a strategic plan to guide the program's work.[2] These funds could be spent at any point during the period and could come from revenues from the proposed oil tax, revenues from the sale of bonds backed by oil tax revenues, or a combination of the two.

The new funds would be spent for:

- **Reducing the Use of Gasoline and Diesel Fuels.** Over half of the funds ($2.3 billion) would subsidize the purchase of alternative fuel vehicles by public agencies and private owners and encourage the production of alternative fuels and the construction of alternative fuel filling stations. Funds would also support grants to private entities for research on alternative fuels and alternative fuel vehicles.

- **Academic Research.** Over one-quarter of the new dollars ($1.07 billion) would go to researchers at California universities for projects on renewable energy and energy efficiency.

- **Alternate Technology Start-Up Funding.** Nearly one-tenth of the funds ($390 million) would provide incentives for companies involved in commercializing alternative fuel technologies.

- **Public Education and Administration.** Proposition 87 would allocate $140 million to increase public awareness about the importance of energy efficiency and renewable energy, as well as to administer the program. No more than $100 million – 2.5 percent of total funding – could be used for administrative costs.

- **Vocational Training.** Proposition 87 would allocate $100 million to California's community colleges to train students to work with renewable energy technologies and alternative fuels.

The authority would be charged with adopting procedures and standards, including contracting procedures, to guide the work supported by the new tax. However, grants and incentives awarded by the authority would not be subject to existing state contracting laws.

In addition, most existing state conflict-of-interest laws would not apply to Proposition 87 funding. While board members could not personally apply for funding from Proposition 87, the measure would allow board members' employers to receive funding. In addition, firms in which board members have a financial interest – such as stock ownership – could receive funding under the measure, as long as the member's interest in the firm is not a controlling interest.[3]

How Are Oil Producers Currently Taxed?

California does not currently tax the production of oil, but oil producers pay a small regulatory fee and oil producers pay income, property, sales, and other taxes on the same basis as other California businesses.[4] The fee is 6.2 cents per barrel and is anticipated to raise $14 million in 2006-07.[5] Revenues from the fee support the Department of Conservation's oversight of oil drilling and production.

California is the only major oil producing state without an oil production tax (Table 1). Proposition 87's highest tax rate of 6.0 percent would be lower than that of most other major producing states.

Table 1: Oil Taxes in Top Producing States

	Barrels Produced, 2005 (Millions)	Top Tax Rate
Texas	385.1	4.6%
Alaska	315.4	15.0%
California*	**230.0**	**0.0%**
Louisiana	72.8	12.5%
Oklahoma	61.5	7.0%
New Mexico	60.6	3.75%
Wyoming	50.9	6.0%
North Dakota	34.7	6.5%
Kansas	33.6	8.0%
Montana	33.0	14.8%

* California oil producers pay a regulatory fee of 6.2 cents per barrel.
Source: US Department of Energy and state revenue departments

How Much Would the Oil Tax Raise?

The Legislative Analyst's Office (LAO) estimates that the tax imposed by Proposition 87 would raise between $225 million and $485 million per year.[6] This wide range is due to two areas of uncertainty: how the tax rate structure would apply and whether oil production on state and federal lands would be taxed.

Proposition 87 would tax oil production based on the price of oil produced beginning January 1, 2007. The measure states that the tax "shall be applied to all portions of the gross value of each barrel of oil severed as follows:"[7]

- 1.5 percent of the price of oil from $10 to $25 per barrel;
- 3.0 percent of the price of oil from $25.01 to $40 per barrel;
- 4.5 percent of the price of oil from $40.01 to $60 per barrel; and
- 6.0 percent of the price of oil from $60.01 per barrel and higher.

Proposition 87 appears to impose a graduated tax rate structure on each barrel of oil produced. However, the LAO notes that the measure could also be read to impose a single tax rate that would vary, depending on the price of oil.[8] Under a single tax rate, the tax per barrel would be $4.20 at a price of $70 per barrel. Under a graduated rate structure, the tax would be $2.175 on a $70 barrel of oil.

According to the LAO, it is also unclear whether the new tax would apply to oil produced on state lands, including offshore production within three miles of the coast, and to oil produced on federal lands. However, the tax would not apply to federal production more than three miles off the coast.[9]

The oil tax would end after $4 billion has been spent and any bonds issued by the authority have been repaid. The tax could remain in effect from approximately eight years to several decades, depending on the amount of revenues raised and the extent to which bonds are used to finance Proposition 87-related spending.[10]

Who Would Pay the Oil Tax?

Proposition 87 would impose the new oil tax on oil producers.[11] In addition, Proposition 87 would prohibit oil companies from passing on the tax to consumers by raising the price of oil or gasoline and charges the Board of Equalization (BOE) with enforcing this provision. However, it is unclear how the BOE would prevent companies from passing on the tax to consumers, since it could be difficult to determine whether oil companies raised prices due to the tax or for other reasons.

Even if the BOE could not prevent companies from raising the price of oil or gasoline to pay for the tax, economists generally agree that oil prices are set in the global market and that individual producers have little influence on the price of oil.[12] Since the tax would be imposed on oil produced in California, it would raise production costs only in California. Oil producers would likely find it difficult to pass on the added cost to refineries or other purchasers because the purchasers could choose to buy oil from outside California for a lower price. One study of a prior proposal to enact an oil production tax found such a tax "would affect final consumers very little."[13]

To the extent that the tax would make production at certain California oil wells less profitable, oil production could decline. Most of the oil produced in California is heavy or intermediate crude, which is of relatively low quality. Independent analysts suggest that an oil production tax would have a minimal impact on current oil production, but could lead to a decline in production over the long term if investment in additional oil wells becomes less profitable.[14]

What Would Proposition 87 Mean for the Budget?

Proposition 87 would create new programs and a revenue source to pay for those programs. While these programs are generally "self-financing," the measure would affect the state's budget, as well as local property tax revenues.

Proposition 87 would modestly reduce state revenues, although the magnitude of the reduction is likely to be small. The oil tax would reduce state income tax revenues, since oil producers can deduct the oil tax from their income taxes as a cost of doing business. In addition, fuel tax revenues – which provide dedicated support for transportation programs – could decline to the extent the measure succeeds at reducing the use of traditional fuels. Revenues attributable to oil production on state lands could also decrease. The LAO estimates that annual income tax revenues could decline by up to $10 million and that revenues from oil production on state lands could fall by between $7 million and $15 million annually.[15] The reduction in revenues from production on state lands would occur only if the tax applied to production on state lands.

Revenues raised by the new tax on oil producers would not count toward the Proposition 98 school funding guarantee. To the extent Proposition 87 reduces state General Fund revenues, it may reduce the state's school funding obligation under Proposition 98 under some circumstances.[16] Proposition 87 would modestly reduce local property tax revenues by several million dollars per year. Property taxes are allocated among cities, counties, special districts, schools, and community colleges. The measure would reduce revenues allocated to cities, counties, and special districts. Most school districts and community colleges would receive additional funds from the state to make up for any reduction in local property tax revenues. However, some so-called "basic aid" districts that receive property tax revenues from oil producers could experience a revenue loss under Proposition 87.[17]

Policy Issues Raised by Proposition 87

Is an Oil Production Tax Good Public Policy?

Proposition 87 would impose a severance tax on private entities for the "privilege" of extracting a non-renewable natural resource of the state. Severance taxes are typically imposed on the severance – or extraction – of natural resources, such as timber, oil, and gas. Analysts argue that it is fair for producers to pay for using natural resources and that an oil tax would capture a portion of the value of oil for the state's residents.

Should Voters Set Budget Priorities at the Ballot Box?

Proposition 87 would establish an oil production tax and dedicate the revenues to specified uses. Opponents of so-called "ballot box budgeting" argue that the initiative process limits voters to an up-or-down choice in isolation from other potential uses of funds. They further argue that earmarking the proceeds from a revenue source that is relatively popular among voters limits the ability of legislators to use the same source for other spending priorities or to fill a gap in the state budget. Moreover, initiatives such as Proposition 87 "lock in" spending by limiting the ability of the Legislature to make programmatic changes or to modify spending in response to economic, budget, and demographic shifts.[18]

Finally, opponents argue that California faces ongoing budget shortfalls and that any new revenues should be used to ensure that current programs are adequately funded prior to taking on additional responsibilities.

Proponents of initiative-based spending argue that the two-thirds vote requirement for legislative approval of tax increases makes it difficult, if not impossible, to raise revenues to support important programs. Given this difficulty, they maintain, it is appropriate to offer voters the ability to raise taxes to fund programs supported by a majority of the voters.

Would Proposition 87 Allow Sufficient Flexibility?

Proposition 87 would allocate a fixed percentage of spending to five basic program areas. The distribution formula is fixed and dollars could not be moved between categories if, for example, experience suggests that the measure's goals might be better met by a different allocation of funds. Moreover, in some categories the types of technology that would be eligible for support are defined in the measure. Funds could not be shifted if, for example, research identified a new technology that would more effectively reduce petroleum use but that technology does not meet the specifications contained in the measure.

Supporters' Arguments

Supporters argue that Proposition 87 would:

- Reduce California's dependence on foreign oil by increasing consumption of alternative fuels;
- Reduce pollution that causes global warming, asthma, lung disease, and cancer; and
- Require oil companies to pay their "fair share."

Opponents' Arguments

Opponents argue that Proposition 87 would:

- Reduce oil production in California due to higher production costs and result in higher dependence on foreign oil;
- Reduce funding to schools by lowering local property and state tax revenues;
- Raise the price of gasoline at the pump; and
- Circumvent conflict-of-interest rules for individuals who decide how Proposition 87 funds are spent.

Conclusion

Proposition 87 would impose a tax on oil producers in California and direct the proceeds to efforts aimed at reducing the use of gasoline and diesel fuels. In assessing Proposition 87, voters should consider whether it is appropriate to impose a tax on oil producers, whether the programs outlined in the measure are an appropriate use of revenues raised, and whether the measure provides for sufficient accountability in the expenditure of public funds.

David Carroll and Jean Ross prepared this Budget Brief. The California Budget Project (CBP) neither supports nor opposes Proposition 87. This Budget Brief is designed to help voters reach an informed decision based on the merits of the issues. The CBP was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

1 Secretary of State, *Campaign Finance: Californians For Clean Alternative Energy, A Coalition Of Environmentalists, Entrepeneurs, and Scientists*, downloaded from http://cal-access.ss.ca.gov/Campaign/Committees/Detail.aspx?id=1282352&session=2005&view=received on August 28, 2006.

2 The authority must adopt two-year and 10-year strategic plans within nine months of passage of Proposition 87 to guide funding decisions.

3 In some cases, board members might have to disqualify themselves if they have a financial interest in a decision.

4 Insurance companies pay the insurance gross premiums tax in lieu of most other taxes.

5 Legislative Analyst's Office, *Proposition 87 Alternative Energy. Research, Production, Incentives. Tax on California Oil. Initiative Constitutional Amendment and Statute*. (July 20, 2006).

6 Legislative Analyst's Office, *Proposition 87 Alternative Energy. Research, Production, Incentives. Tax on California Oil. Initiative Constitutional Amendment and Statute*. (July 20, 2006).

7 Proposition 87 defines "gross value" as the selling price of oil at the well.

8 Legislative Analyst's Office, *Proposition 87 Alternative Energy. Research, Production, Incentives. Tax on California Oil. Initiative Constitutional Amendment and Statute*. (July 20, 2006).

9 Legislative Analyst's Office, *Proposition 87 Alternative Energy. Research, Production, Incentives. Tax on California Oil. Initiative Constitutional Amendment and Statute*. (July 20, 2006).

10 Legislative Analyst's Office, *Proposition 87 Alternative Energy. Research, Production, Incentives. Tax on California Oil*. Initiative *Constitutional Amendment and Statute*. (July 20, 2006). If bond financing is used, the tax would remain in effect longer since tax revenues would repay interest on the bonds, plus the $4 billion in authorized spending.

11 The measure defines a producer as any person who produces or extracts oil from the water or earth in California; any person who owns, controls, manages, or leases oil wells; any person who acquires oil from a person or agency exempt from property taxation under federal or state laws; or any person who owns a royalty or other interest in oil production. Oil from wells that produce 10 barrels a day or fewer would not be taxed if the price of oil is less than $50 per barrel and would be subject to a lower tax when the price of oil is above $50 per barrel.

12 In contrast, a major disruption in production, such as the recent shutdown in Alaska, can influence the price of oil.

13 Frank Camm, et al., *Effects of a Severance Tax on Oil Produced in California* (RAND: September 1982).

14 Personal communication with Severin Borenstein, Director, University of California Energy Institute (August 23, 2006) and Frank Camm, et al., *Effects of a Severance Tax on Oil Produced in California* (RAND: September 1982).

15 Legislative Analyst's Office, *Proposition 87 Alternative Energy. Research, Production, Incentives. Tax on California Oil. Initiative Constitutional Amendment and Statute*. (July 20, 2006).

16 For a detailed discussion of the Proposition 98 guarantee, see California Budget Project, *School Finance in California and the Proposition 98 Guarantee* (April 2006). Schools could receive less in years that "Test 1" or "Test 3" of the school funding guarantee applies.

17 Basic aid districts receive a minimum $120 per student payment and receive most of their funds from the local property tax.

18 Amendments to Proposition 87 would require a two-thirds vote of each house of the Legislature and could only be made to further the purposes of the measure.