CALIFORNIA
▪ BUDGET PROJECT ▪

Budget Brief

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WHAT WOULD PROPOSITION 7 MEAN FOR CALIFORNIA?

INTRODUCTION

Proposition 7, the California Air Quality Improvement Act of 1998, creates a new state program to subsidize the purchase or retrofit of specified equipment to utilize cleaner burning technology. Proposition 7 aims to reduce emissions from diesel and other heavy-duty trucks, busses, locomotives, and other vehicles, and secondarily from households and agricultural sources by providing $218 million per year in tax credits to businesses or individuals that purchase certain types of new equipment or retrofit existing equipment. Proposition 7 is sponsored by the Planning and Conservation League.

CURRENT LAW

The state Air Resources Board (ARB) and local air quality districts are responsible for enforcing state and federal air quality standards. The ARB holds primary responsibility for regulating pollution from mobile sources, such as trucks and cars, while local air quality districts regulate stationary sources of pollution. Both the ARB and local districts utilize a number of approaches to improve the quality of California's air. Current regulatory measures include requirements for cleaner burning fuel; requirements that businesses install pollution control equipment; and vehicle inspection and repair requirements for automobiles. Most of the sources of pollution eligible for Proposition 7's tax credits are currently subject to state or federal air pollution control standards.[1]

The State Implementation Plan (SIP), approved by the ARB in 1994 and by the federal Environment Protection Agency (EPA) in 1997, provides a framework for state efforts to bring California into compliance with federal clean air standards. The SIP uses a combination of standards and incentives in an attempt to improve air quality. It is unclear, however, whether current efforts will bring the state into compliance with current federal standards, much less the stricter standards due to be implemented in 2004. Proposition 7 targets diesel and other heavy-duty trucks and busses, which account for a disproportionate share of NOx, a major component air pollution emitted by mobile sources. According to data provided by the ARB, sources that will be eligible to receive tax credits under Proposition 7 are responsible for 24.4 percent of statewide NOx emissions, 9.5 percent of particulate matter emissions, and 8.7 percent of hydrocarbon emissions.[2]

[1] Air Resources Board, *Correspondence to the Legislative Analyst's Office* (no date).
[2] Air Resources Board, *Correspondence to the Legislative Analyst's Office* (no date). For 1995, measured in tons per day.

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California currently provides several tax incentives to encourage taxpayers to reduce air pollution. All of these programs are relatively small in size and budgetary impact.[3] Current incentives include:

- ✓ A tax credit for taxpayers that purchase rice straw that would otherwise be burned. This tax credit is anticipated to cost less than $500,000 in 1998-99;
- ✓ Partial excise tax exemptions for alternative fuels; and
- ✓ Accelerated depreciation deductions for certain pollution control equipment.

AB 1368 (Villaraigosa) and SB 1857 (Brulte), passed by the legislature in August, create a new Air Quality Standards Attainment Program to provide grants for the purchase or retrofit of low-emission, heavy-duty engines for vehicles, equipment, vessels, and locomotives. The 1998-99 budget includes a $25 million appropriation to establish the program and SB 1857 includes an additional $2.5 million to fund an Infrastructure Development Project to encourage the purchase and installation of equipment used for dispensing "alternative" fuels, including recharging facilities for electric vehicles. Both measures are currently awaiting action by the Governor. The program created by AB 1368 and SB 1857 will be repealed if Proposition 7 is enacted by the voters.

In 1997-98, the state spent an estimated $116.7 million on efforts to improve air quality. This amount includes $74.3 million from the Motor Vehicle Account and $11 million of federal funds.[4]

WHAT DOES PROPOSITION 7 DO?

Proposition 7 consists of three main components:

1. A new tax credit program.
2. A requirement that fire suppression fee revenues be used for controlled burns designed to reduce pollution from wildfires.
3. A prohibition on the diversion of local transportation sales tax revenues.

New Tax Credit Program

Proposition 7 establishes a new state program to subsidize the cost of replacing, repowering, or retrofitting vehicles, stationary engines and facilities, fireplaces, lawn and garden equipment, and agricultural waste disposal in an effort to reduce emissions and improve air quality. The state's Air Resources Board (ARB) is charged with administering the new program. The ARB, in turn, is authorized to delegate certain duties to local air quality districts.

The subsidies created by Proposition 7 would take the form of an allocated tax credit. An allocated tax credit program requires taxpayers to apply for and receive authorization to claim tax credits. In contrast, traditional tax credits are available to any taxpayers incurring a qualifying expense. For example, the state's manufacturing investment tax credit is available to any manufacturer that invests in qualified equipment. An allocated tax credit, unlike a traditional tax credit, caps the cost of the program at a predetermined amount and allows for the competitive evaluation of projects receiving credits. Tax credits may be awarded to individual or corporate income taxpayers. Proposition 7 requires the ARB to publish a list of all projects awarded tax credits on a quarterly basis.

Size of the tax credit. Proposition 7 authorizes the ARB to award credits in an amount up to the incremental cost of eligible projects, including any higher operating costs associated with the cleaner

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[3] Franchise Tax Board, *1998 Tax Expenditure Report* (no date).

[4] Department of Finance, *Governor's Budget 1998-99* (January 1998). This amount reflects spending through the State Air Resources Board and does not include expenditures through other state agencies and departments.

burning technology. The amount of credits awarded to any particular project would be determined by the ARB. The measure also allows the ARB to award additional credits as an incentive to encourage the acquisition or retrofit of vehicles and equipment.[5] The new credits could be used to reduce taxpayers' state personal or corporate income tax liability on a dollar for dollar basis.

Where would the money go? Tax credits would be allocated to projects in fourteen categories (Table 1). A portion of the credits in each category would be designated for pilot projects. If the ARB fails to award the full amount of tax credits in any year, the unused balance can be carried forward and awarded in future years.

Table 1: Where Will The Credits Go?

Category	Tax Credits (in millions)
New state and local government fleet vehicles	$45
Retrofitting and repowering state and local fleet vehicles	$10
Retrofit of older, heavy-duty trucks and vehicles	$34
Port equipment	$15
Locomotives	$10
Hearth products (i.e., household fireplace equipment and stoves)	$10
Lawn and garden equipment	$5
Research and development	$20
Stationary and portable equipment	$3
Ambient air pollution destruction technologies	$15
Agricultural waste conversion facilities	$17
New heavy-duty and 50+ horsepower motor vehicles	$25
New off-road, nonrecreational motor vehicles	$3
Rice straw conversion facilities	$6
TOTAL	**$218**

Application process. Tax credits will be awarded by the ARB through a competitive application process. Proposition 7 requires the ARB to rank applications received from most to least cost effective on a quarterly basis and to award tax credits in rank order. Projects involving public fleets, heavy-duty equipment retrofit, and heavy-duty vehicle and engine purchases must meet targeted reductions in emissions in order to qualify for tax credits. Proposition 7 also establishes a process for reviewing the emissions reductions targets and for monitoring projects receiving credits.

Credits available for projects required under future, but not current, regulations. Proposition 7 states that tax credits shall not be awarded to projects that are federal, state, or local laws or regulations that are in effect as of the date the tax credit is awarded. Proposition 7 specifically states that tax credits may, however, be awarded for projects that are designed to bring equipment into compliance with regulations scheduled to take effect after the date the tax credits are awarded.[6] By allowing tax credits to be awarded for projects that would be required under proposed regulations, Proposition 7 provides a public subsidy for pollution reduction efforts that would occur in the absence of the credits.

Not a gift of public funds. The state constitution prohibits gifts of public funds to private parties. This provision has been interpreted to prohibit certain types of tax incentives. Proposition 7 states that the tax credits created by this initiative are not gifts of public funds and thus are permissible under state law.

Fire Suppression Fees

Proposition 7 appropriates funds collected for fire suppression costs for controlled burns that are designed to reduce air pollution caused by wildfires.[7] Any amounts currently collected are treated as

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[5] For projects involving lawn and garden equipment, the amount of any tax credits awarded must be less than the cost of acquiring the new equipment.
[6] Proposed Health and Safety Code §44475.9(b).
[7] Fire suppression fees are amounts collected from private parties who negligently or illegally allow a fire to be set on public or private land, or who fail to correct a fire hazard on their property. Individuals who do so are liable for the cost of fighting a fire, emergency rescue services, and hazard mitigation costs.

reimbursement for costs incurred for fire suppression. By earmarking these funds for prescribed burning, Proposition 7 will increase state costs for fire suppression. The Legislative Analyst's Office estimates that the state collects, on average, "hundreds of thousands of dollars" each year from fire suppression fees.[8]

Annual Budget Impact of Proposition 7	
Tax Credits	$218 million
Administration	$4.35 million
Audit Costs	$0.15 - $0.35 million
Fire Suppression Costs	"hundreds of thousands of dollars"

Source: Legislative Analyst's Office, text of Proposition 7

Local Transportation Fund

Proposition 7 prohibits the use of local transportation fund revenues for purposes unrelated to transportation. This provision pertains to revenues from the ¼ cent of the local sales tax rate designated for transportation. This rate is part of the so-called "Bradley-Burns" rate levied uniformly by all California counties. In recent years, the legislature has authorized two diversions in response to severe county fiscal crises. In 1995, the legislature authorized Los Angeles County to use $60 million in transportation tax moneys to help solve its budget crises. In 1996, the legislature authorized Orange County to divert revenues from this sales tax rate as part of the county's bankruptcy bailout plan.[9]

Proposition 7 would prevent the legislature from authorizing similar diversions in the future without subsequent statewide voter approval. Proposition 2, a constitutional amendment placed on the November ballot by the legislature, also prohibits the use of local transportation fund revenues for purposes other than transportation and restricts the use of local transportation fund moneys to purposes specified in state law as it read on October 1, 1997.

Amendments And Severability

Proposition 7 prohibits the legislature from altering or deleting the tax credits established through the initiative prior to January 1, 2011. The legislature is authorized to make limited changes in certain parts of the measure so long as any changes are consistent with the initiative's original intent. The measure includes a severability clause stating that if one or more parts are found to be invalid, the remainder shall be allowed to take effect.

HOW WILL PROPOSITION 7 IMPACT THE BUDGET?

Proposition 7 authorizes the ARB to award $218 million in tax credits and appropriates $4.35 million to cover the cost of administering the program each year from 1998-99 through 2010-11. The state would also incur annual costs in the range of $150,000 to $350,000 to perform required audits and increased costs for fire suppression activities to make up for amounts diverted to the new controlled burn program. To the extent Proposition 7 results in the implementation of air quality improvements that would otherwise not occur, there is the potential for savings in public and private expenditures for health services. The magnitude of these savings is unknown.[10]

Proposition 7's actual impact on the budget will depend on taxpayers' ability to claim awarded credits in any given year, which in turn depends on whether a taxpayer has sufficient tax liability to fully utilize their tax credits. Since both the ARB and taxpayers can carryforward any unused tax credits for use in

[8] Legislative Analyst's Office, *Analysis of Measures on the November 3, 1998 Ballot* (July 21, 1998).
[9] Government Code § 29530.2 and 29530.5.
[10] Legislative Analyst's Office, *Analysis of Measures on the November 3, 1998 Ballot* (July 21, 1998).

future years, including years beyond the expiration of the program, the cost to the state in any given year could be higher or lower than $218 million.

School funding held harmless. Proposition 7 includes a provision that adjusts the minimum school funding guarantee established by Proposition 98 so that it is not reduced by the revenue loss caused by the new tax credits.[11] If enacted, this "hold harmless" provision could establish a precedent for future state tax reductions. While the policy of holding school funding harmless may be desirable from the standpoint of protecting public education, it means that the remainder of the budget must absorb the entire revenue loss attributable to Proposition 7. Programs covered by the Proposition 98 guarantee account for approximately 42 percent of 1998-99 state General Fund expenditures. Programs outside the Proposition 98 guarantee include the University of California and California State University systems, local government assistance, public safety, social services, and other environmental spending. While the initiative insures that Proposition 7 will not reduce schools' minimum funding level, the revenue loss limits the legislature's ability to augment school funding above the minimum required by Proposition 98.

No reduction in ARB funding. Proposition 7 specifies that funding for the ARB shall not be reduced or reallocated to cover the cost of administering the new program. This provision potentially limits the legislature's ability to reduce funding for the ARB in the future in response to changing policy or fiscal priorities.

Budget accord ties tax cuts to defeat of Proposition 7. The 1998-99 budget agreement includes a set of targeted tax reductions that only take effect if Proposition 7 is defeated. Tax cuts linked to the defeat of Proposition 7 include a permanent extension of the Employer Child Care Tax Credit; expansion of the Manufacturers Investment Tax Credit to software developers; an increase in the Research and Development Tax Credit; expansion and permanent extension of the sales tax exemption for materials used in space launches; a reduction in the interest rate levied on delinquent estate tax payments; creation of a sales tax exemption for teleproduction and postproduction equipment; a reduction in the minimum franchise tax for new, small corporations; creation of a sales tax exemption for perennial plants; expansion of the state's Enterprise Zone program; and larger tax deductions for the purchase of health insurance by self-employed persons. The provisions tied to the defeat of Proposition 7 would reduce General Fund revenues by $52.4 million in 1998-99, $87.8 million in 1999-00, and $102.8 million in 2002-03.[12]

MANY FEATURES OF PROPOSITION 7 ARE UNPRECEDENTED IN STATE LAW

Proposition 7 differs from existing state tax credit programs in a number of important respects. First, it would be the only significant tax credit established by initiative.[13] The fiscal impact of voter-approved initiatives is significant, since initiatives cannot be repealed or substantially modified without subsequent voter approval.[14] In contrast, allocations made through the state budget apply to a single year and tax reductions enacted by the legislature can be amended or repealed through legislative

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[11] In brief, Proposition 98 establishes a minimum funding level for K - 12 education and community colleges that depends on a number of factors, including enrollment growth and state general fund revenue growth. In years when state revenues or revenue growth are used to determine the level of the guarantee, measures that reduce state tax revenues also reduce the school-funding guarantee. The legislature can "overfund" the guarantee; however, this year (1998-99) is the first year where the guarantee has been intentionally overfunded.
[12] Legislative Analyst's Office, *Major Features of the 1998 California Budget* (August 24, 1998), p. 7.
[13] Proposition 139 of November 1990 established the Prison Industries program and created a tax credit for businesses that utilize inmate labor. In 1997-98, the revenue loss associated with this program was less than $500,000.
[14] Some initiatives, including Proposition 7, specifically allow the legislature to make changes that are consistent with the intent of the original ballot measure.

action.[15] Second, initiatives limit the legislature's ability to react to changing fiscal and policy considerations. Proposition 7, for example, specifically states that "the legislature may make no other amendments to this act nor repeal or supersede any provision of the act."[16] Other areas where Proposition 7's tax credit differs significantly from other state credits are discussed below.

What costs would qualify for tax credits? Proposition 7 authorizes the ARB to award tax credits for up to the "incremental costs" of a project. Qualifying costs can include higher operating, lease, and incremental capital costs. The measure does not, however, define what constitutes an "incremental cost" and there is no standard definition used in state tax law. The lack of a clear definition could lead to disputes over what constitutes an additional cost attributable to cleaner technology. The wording could also allow for a more expansive definition than the proponents may have intended.

Should tax credits pay the full cost of a project? Proposition 7 raises a more general policy question of whether tax credits should be used as an incentive, by offering a partial subsidy, or whether tax credits should pay the entire cost of acquiring new equipment or upgrading existing equipment. Currently, none of the state's existing tax credits subsidize the full amount of the targeted expense or investment. The state's Research and Development Tax Credit, for example, provides a credit equal to 11 percent of qualified research and development expenses and the Enterprise Zone Hiring Credit is equal to 50 percent of the first $8.63 per hour paid to qualified employees. Proposition 7 could encourage other interest groups to seek more generous tax credits, increasing the revenue loss associated with new or existing provisions.

Subsidy can exceed the cost of new investment. In addition to credits provided to offset the "incremental cost" of a project, the ARB can award credits to cover any "necessary incentives to encourage the acquisition of new vehicles and equipment, the retrofitting of existing vehicles and equipment, or the adoption of innovative technologies by users."[17] This provision potentially allows a taxpayer to receive more in tax credits than he or she original spent on cleaner equipment if the ARB determines that additional incentives are necessary to encourage the purchase of a technology.[18]

Should vendors that sell equipment to public agencies receive tax credits? Proposition 7 allocates $55 million in tax credits for businesses that sell or lease cleaner busses and other heavy-duty fleet vehicles to the state and local public agencies or that retrofit similar vehicles for public agencies. Since public agencies do not pay income taxes, a tax credit is of no use to them. Instead, the measure states that "The State Board shall award the tax credit to either the person selling or leasing the vehicles to the local public agency; or the person selling the vehicles to the person that has the contract or other entitlement from the local public agency; or the person that has the contract or other entitlement from the local public agency."[19]

As drafted, Proposition 7 could result in taxpayers paying twice for the same project. The measure does not require a seller or lessor who receives tax credits to return the value of the credits to the public agency that purchases, leases, or retrofits a vehicle. As a result, the public agency could pay the fair market cost of a vehicle, while the seller of the vehicle could receive a tax credit equal to up to the full cost of the vehicle or retrofit. Parallel provisions authorize tax credits for vendors that sell a vehicle or retrofitting or repowering equipment to the state. Currently, state tax credits are generally available

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[15] Measures that result in a net tax increase require approval of 2/3 of each house of the legislature.
[16] Section 12 of Proposition 7 of 1998.
[17] Proposed Health and Safety Code § 44475.42.
[18] Credits awarded for the purchase of lawn and garden equipment must be less than the full cost of new equipment. There is no such limit imposed on any of the other categories.
[19] Proposed Health and Safety Code §44475.21 - 44475.22.

only to a taxpayer that incurs the cost on which the credit is based.[20] Proposition 7 would establish a precedent for awarding credits to entities other than the individual or corporation making the targeted investment.

Should tax credits be allowed to reduce taxpayers' liability to zero? In 1987, California established the alternative minimum tax (AMT) to insure that taxpayers claiming large amounts of preference items, such as tax credits, paid at least some minimum amount to reflect the value of the benefits they receive from public services.[21] Proposition 7 allows the newly created tax credits to reduce a taxpayers alternative tax liability. By doing so, Proposition 7 could allow taxpayers with considerable California income to pay no state income taxes. While several other tax credits are allowed to reduce a taxpayer's AMT liability, none are as generous as the credits established by this measure.

DOES THE RECESSION TRIGGER PROVIDE ADEQUATE PROTECTION TO CURRENT PROGRAMS?

Proposition 7 allows, but does not require, the Department of Finance to reduce the total amount of tax credits to be awarded in a fiscal year if General Fund "receipts" are lower than in the prior year.[22] This feature is designed to offer some protection to other spending priorities in the event of an economic downturn. While this trigger provides some protection, it does not insure that sufficient resources will be available to fund existing programs on an ongoing basis. The suspension provision does not allow for growth in revenues in order to keep pace with inflation and population growth. Thus, this program could be fully funded in a year where revenue growth was flat, but growth in demand for public services along with inflation required the legislature to make deep cuts in other programs. Over the past decade, General Fund revenues declined twice (1989-90 to 1990-91 and 1991-92 to 1992-93).[23]

Proposition 7 vests the decision to reduce the amount of tax credits available in the event of a budget shortfall with the Department of Finance, an agency controlled by the Governor, rather than with the legislature. In contrast, the legislature is responsible for allocating resources through the regular budget process.

ARGUMENTS IN FAVOR

Proponents argue that Proposition 7 creates a cost-effective tool for improving California's air quality. They further argue that the use of voluntary incentives is preferable to regulation and that improving air quality will improve public health and thereby reduce health care expenditures. The proponents argue that Proposition 7 will result in a reduction in pollution from sources that would be hard to regulate, such as fireplaces, old lawnmowers, other consumer equipment, and old diesel trucks. Moreover, proponents argue that it would not be fair to require owners of old equipment or vehicles to retrofit them to meet modern standards.[24] Proponents further argue that it is appropriate to prohibit the diversion of the ¼ cent local sales tax rate to insure that it is used for transportation, rather than diverted for other purposes.

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[20] The state's manufacturing investment credit has complicated rules regarding the available of tax credits to entities that are lessors of qualified equipment.
[21] The AMT replaced the state's previous preference tax, which had a similar goal.
[22] It appears that the authors intend for this provision to apply if state revenues are lower than in the prior year. The term "receipts," which is used in the initiative, is not used with respect to state revenue collections.
[23] Department of Finance, *Governor's Budget Summary 1998-99,* Appendix 24, Schedule 6.
[24] Planning and Conservation League, *The Air Quality Improvement Initiative: Questions and Answers About The Air Quality Initiative* (downloaded July 31, 1998). http://www.pcl.org/LEG/clean_air/initiative_questions.htm.

ARGUMENTS IN OPPOSITION

Opponents argue that Proposition 7 diverts nearly $3 billion of state tax dollars to untested technologies and diverts funds from other high priority spending needs. They further argue that a number of the features of the tax credits authorized by Proposition 7 are unprecedented under current state law and that, if enacted, this measure could encourage future erosion of the state's tax base. Opponents also argue that prior ballot measures and state legislative actions severely constrain local government's control over tax and spending policies and that it is inappropriate to prohibit the use of local sales tax revenues to address local budget crises.

CONCLUSION

Over the past two decades, the initiative process has played an increasingly important role in shaping state and local tax and budget policies. In general, initiatives have limited the ability of state and local governments to increase tax revenues, while imposing new program and spending responsibilities. The net result of these changes is to reduce the portion of the budget available for allocation through the annual budget process. Proposition 7 further limits discretionary revenues and establishes a precedent for creating tax credits through the initiative process.

Basic policy questions raised by Proposition 7 include:

- ✓ What should be the balance between regulation and subsidies as strategies for achieving cleaner air?
- ✓ Are tax credits a cost-effective tool for improving air quality?
- ✓ Do the benefits of cleaner air outweigh the loss of revenues for other general fund programs?
- ✓ Does Proposition 7 establish desirable precedents for other state tax credit programs?
- ✓ Should a portion of local sales tax revenues be restricted to transportation?
- ✓ Is the tax credit established by Proposition 7 of higher priority than the tax reductions enacted as part of the 1998-99 budget agreement?

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