California might levy a new tax on oil companies. Here's what to know

By Grace Gedye

Few things agitate drivers — and make politicians sweat — like rising prices at the pump.

Gas prices in California are consistently higher than the rest of the country, thanks to state taxes, a cleaner fuel blend, an isolated gas refining market and more. But in September, California prices jumped even higher and that gap grew wider.

Gov. Gavin Newsom pointed the finger at the gas industry when he talked to reporters in early October, saying companies were "fleecing" drivers and called for a new "windfall profit" tax on oil companies.

Valero, an international oil company that owns refineries in California, saw its profits from July to September increase 500% over the same period last year. And profits on West Coast gas operations increased dramatically in April through June, compared to the same time last year, at companies that own some of the state's largest refineries, an analysis by Consumer Watchdog found.

With Newsom planning to convene a special legislative session in early December to focus on the new tax, CalMatters spoke to experts about how the idea has worked in the U.S. and abroad.

Windfall profit tax's checkered past

This isn't something states have done often.

No state has done a windfall profit tax before, said David Brunori, a visiting professor of public policy at George Mason University and an expert on state-level tax policy. The one debatable exception: In 2006, Alaska began taxing net revenues on oil production, with a tax rate that increased as the price of a barrel of oil increased. After some tweaks in 2007, the tax brought in billions of dollars for the state, some of which was used to issue $1,200 payments to residents to help with high gas prices, according to the Seattle Times.

After the tax was imposed, however, drilling decreased and the amount oil companies invested in developing new oil dropped, according to the Alaska Journal of Commerce. But, Brunori said, it wasn't really a windfall profit tax because it wasn't a direct tax on profits. It's also not clear whether Newsom's proposal will look anything like Alaska's tax.

A windfall tax isn't likely to raise or lower gas prices, says Severin Borenstein, an energy economist at UC Berkeley, but it would be "very difficult to actually implement."

Policymakers have to decide exactly how much profit constitutes a windfall. "Above what level do we say, 'That's too much profit and we're going to tax it away?'" he said.

The United States temporarily embraced excess profit taxes during World War I, World War II and the Korean War, with mixed results. When the U.S. government massively ramped up spending during WWI, some companies saw their profit margins balloon. So, the government began taxing all industries' profits above a certain return on investment, which wound up bringing in about 40% of the tax revenue raised for the war.

But, because the taxes were complicated, well-paid attorneys at large companies could use "creative gamesmanship" to reduce their employers' tax bill, while small companies without a phalanx of lawyers shouldered more of the burden, said Joe Thorndike, director of the Tax History Project at Tax Analysts.

"These taxes, more than most, really are dependent on a moral argument, a moral justification, to exist, and when that starts to get picked apart by these fairness failures it really makes it a problem," said Thorndike.

The idea was revived in 1980, as the federal government prepared to relax price controls on oil produced in the U.S. That year, Congress passed what it dubbed a windfall profit tax, aimed at oil industry profits. The thinking, said Thorndike, was that companies would profit massively as crude oil rose to the market price, and the process would be expensive and painful for consumers. The tax, however, was not a tax on profits, but rather a system of excise taxes on oil, according to a Congressional Research Service report.

It wasn't a resounding success. During the eight years it was in effect, it brought in $80 billion — far lower than the $393 billion it was projected to generate, according to congressional researchers. Because the tax only applied to oil produced in the U.S., it likely decreased domestic production while increasing the country's reliance on foreign oil, congressional researchers found. It was also difficult for the Internal Revenue Service to administer, and difficult for the oil industry to comply with. So, in 1988 it was repealed.

Europe embraces the windfall tax

As energy prices have spiked in Europe and the United Kingdom, leaders there have also turned to windfall taxes. Greece, Hungary, Italy, Romania, Spain and the U.K. have all implemented their own, and six other countries have shown intentions to impose similar taxes, according to a September analysis by the Tax Foundation. In late September, the European Union agreed to a windfall tax on oil and gas profits.

Different countries have taken different approaches. Hungary, for example, is taxing a wide range of sectors, from petroleum producers to renewable energy companies to pharmaceutical companies, while the U.K. is taxing oil and gas companies within the country. Italy has seen much less revenue than expected, seemingly caused by Italian energy companies not complying with the tax.

Because these taxes in Europe are so recent — and because they are temporary — it's hard to tell what impact they will have, said Sean Bray, the EU tax policy analyst at the Tax Foundation.

Here in California, Borenstein, the energy economist at Berkeley, hopes the Legislature will use the special session to discuss what he sees as the Golden State's "fundamental problem" when it comes to gas: figuring out how to maintain adequate supplies while the state is using its cleaner blend and is trying to phase out fossil fuel usage.

"We ignore this issue entirely, until there's a big price spike," said Borenstein. "And then everybody runs around yelling about how outrageous this is, instead of actually having a serious policy discussion of what's the right way to deal with this."

So how would this work?

Details are spare at this point. But the basic idea is that companies that extract, produce and refine oil would pay a higher tax rate on their earnings above a set amount each year, a spokesperson for the governor said. The money raised by the tax would be sent via refunds to "California taxpayers impacted by high gas prices," said a spokesperson for the governor in an email.

The logic behind windfall profit taxes is to tax a company at a higher rate when they're making giant profits — a "windfall" — for some reason not of their own making.

Often there's a moral dimension to the thinking as well, said Kirk Stark, a tax law professor at UCLA. Theoretically, taxing extra high profits at an extra high rate should make companies less likely to capitalize on circumstances like war and natural disasters to jack up prices — like a shopkeeper who raises the price of bottled water from $2 to $40 following a hurricane. "There's almost a kind of moral judgment that, in some situations, market prices can be immoral," said Stark.

Getting the incentives right is tricky, said Borenstein, as is preventing companies from evading the tax. If, for example, the state taxes profits at California refineries, those refineries — owned by companies including Chevron and Valero — could start buying oil from another division of their parent companies at higher prices.

By doing that, they could reduce their profit. And if they're no longer making large profits, their tax bill would go down.

"The devil is in the details," said Borenstein.