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THE WINDFALL PROFITS TAX BILL

STATUS

H.R. 3919 (the Windfall Profits Tax bill) has been adopted by both Houses of Congress. It was first enacted by the House of Representatives, which passed the bill on June 28 with a voice vote. The measure adopted in the House was actually an amendment in the form of a substitute offered by Representatives James R. Jones (D-Okla), and W. Henson Moore (R-La.). Their measure replaced a somewhat more stringent one which had been reported by the House Ways and Means Committee, and was adopted by a vote of 236 to 183.

Some three weeks of debate preceded adoption of the Senate version of H.R. 3919. Included in that period was a three-day filibuster led by Senator Robert Dole (R-Kansas). The Senate version was heavily amended on the floor, adding some $40 billion in taxes which were not included in the bill as reported by the Senate Finance Committee. After failing twice to win cloture, the Senate voted to limit debate by a margin of 84 to 14, but this action was anticlimactic in that a compromise had been struck prior to the vote. The compromise led to adoption of the amended version of the Senate Finance Committee bill on December 17 by a vote of 74 to 24.

A conference committee to resolve differences between the two bills first met on December 19. In their first session, the conferees agreed to a revenue target between the targets set by the House and Senate versions of the bill. This figure came to $227.3 billion, or roughly $50 billion more than the Senate's version. There is no agreement yet as to how to raise the added revenue, but it is certain that adjustments to the tax rates, and the exemptions, must be made in order to come up with the additional money. Conferees are scheduled to meet again on January 17, but some members would rather put off their deliberations until February.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

PROVISIONS: HOUSE VERSION

The version of the windfall profits tax adopted by the House of Representatives is expected to raise an estimated $277 billion. It is considered to be far stricter than the Senate version, and has virtually no exemptions. The lack of exemptions is the main reason why the House measure will raise some $99 billion more than the Senate bill even though its nominal tax rate is 15 percent less.

Under the House version, Lower Tier oil, or so-called old oil (i.e., that which was in production prior to 1973), would be subject to a tax of 60 percent of all revenues above the current controlled price of around $6 per barrel. The amount of oil categorized in this fashion would be reduced at the rate of 1½ percent per month (the decline rate) and all oil currently being produced would gradually be phased into the Upper Tier of so-called new oil. New oil is essentially that which has been brought into production between 1973 and 1978. This Upper Tier oil would be taxed at the rate of 60 percent on all revenues in excess of approximately $13, the controlled price for this category. All of the oil from the Lower Tier would be phased into the Upper Tier by July of 1984. Between November of 1986, and December of 1990, Upper Tier oil (which by then would include any remnants of Lower Tier oil) would be phased in the third Tier, newly discovered oil.

Newly discovered oil would include all of that oil which is brought into production from now on. This oil would also be subject to a tax, but its tax would come in two stages. The first is on the increment of revenue between $17 per barrel and $26 per barrel. This increment would be taxed at the rate of 50 percent. The next increment is that portion of revenue above $26 per barrel. This increment would be taxed at the rate of 60 percent. All taxes under this measure would terminate after 1990.

The only exemptions allowed in the House bill are for oil produced by state and local governments and oil produced by tax-exempt educational institutions where the revenue goes to tax-exempt purposes. This move was made essentially to satisfy concerns of Members from producing states where the state governments received considerable revenues in this fashion. The House did not even exempt heavy oil from the tax although the Administration indicated that it favored such a move.

PROVISIONS: SENATE VERSION

The Senate version, while including a higher nominal tax rate would raise some $99 billion less than the House version due to a number of exemptions it allows which are not in the House measure. The version which passed, it should be noted, raised the revenue projection by $40 billion from that reported by the

Senate Finance Committee. This was largely due to the elimination of many of the exemptions that were in the original version.

Under the measure voted in the Senate, Lower Tier oil would be taxed at the rate of 75 percent. The Finance Committee version of the bill called for a 60 percent tax rate similar to that voted in the House. Upper Tier oil would also be subject to a 60 percent tax. In both instances, the tax applies to that portion of revenue which is in excess of the current controlled price of oil in each category. Newly discovered oil would be exempt from the windfall tax, but would be subject to a minimum tax. The minimum tax on newly discovered oil would be on the portion of revenue above $19.30 per barrel, and would be at the rate of 10 percent. Several other categories of oil are exempt from the windfall profits tax, but are subject to a so-called minimum tax. These include heavy oil, incremental stripper oil (the additional stripper production which will result from decontrol) and incremental additions to supplies brought about through the use of tertiary recovery techniques. In these instances, there will be a 20 percent tax on the amount of revenues above $16.30 per barrel.

The application of a minimum tax to these categories, coupled with the elimination of many of the exemptions included in the original bill reported by the Senate Finance Committee, was one of the key points of controversy in the floor debate. Exemptions for oil produced by federally recognized Indian tribes, and the first 1000 barrels per day of stripper production were eliminated. The only exemptions which remained unmodified were those for oil produced by state and local governments, and by charitable medical or educational institutions. One exemption, for independent producers, was expanded.

Under an amendment offered by Senator Lloyd Bentsen (D-Texas), the first 1000 barrels per day of production by independent producers would be exempt from tax in any form. The term independent producer is defined as one which qualifies for the percentage depletion allowance under the provisions of the Internal Revenue Code.

Unlike the House bill, the Senate version would not phase out Upper Tier oil. Rather, it would raise the base above which a tax is levied by $3 for the period between November of 1986 and December of 1990. As with the House bill, Lower Tier oil would be phased into Upper Tier by July of 1984. The Senate measure also includes a maximum amount of tax which can be collected. Under an amendment offered by Senator Daniel Moynihan (D-NY), all taxes would begin to be phased out when receipts reach 90 percent of $200 billion. The effect of this amendment would be to limit the revenues collected through these taxes to a maximum of $214 billion.

A number of amendments not related to oil have been tacked on to the Senate bill. Of these, the most important is one which would allow up to $200 in interest and dividends to be exempt

from federal income taxes on an individual's return, or up to $400 on a joint return. This popular move was adopted by an overwhelming margin in the Senate, but has caused some dismay among House Members. Many of the Members who support the small saver exemption also oppose the windfall profits bill. They therefore find themselves in the position of having to vote contrary to their feelings on one issue in order to vote with their beliefs on another.

POINTS OF CONTROVERSY

There are a number of points of controversy which the conference committee will have to address. One of the most significant of these will be the question of the exemption for independent producers. This was not included in the House version, and is strongly opposed by the Administration. At present, the Senate version of the measure would exempt the first 1000 barrels per day of production by independents from any tax. Whether this exemption will remain in the final bill, or whether a minimum tax will be imposed, is uncertain. A related question is whether the current depletion allowance to which independents are entitled will be retained if they are allowed an exemption. Some House Members would eliminate the depletion allowance even if they are not given the exemption on the first 1000 barrels of production.

A major difference between the House and Senate versions lies in the phase-out of the tax. The Senate demonstrated considerable sentiment for limiting the absolute amount of taxes collected, whereas the House did not. This difference between the two measures may pose a major stumbling block to agreement, as may the question of the rate of taxation on newly discovered oil. The two approaches to newly discovered oil reflect sharply differing viewpoints as to the need for incentives to spur additional production, and as to the degree to which the discovery of oil is price responsive. Given these differences in philosophies, reaching agreement may be difficult.

A final question is whether severance taxes will be allowed as a deduction from the windfall profits tax. Severance taxes are in effect excise taxes levied by the states on oil production. The House measure would not allow them as a deduction; the Senate bill would. The difference in terms of revenue to producing states would be considerable, and this, therefore, will be a major point of contention. Members representing consuming states would naturally be inclined to limit deductions which were tailored to producing states' revenue bases, as monies going into the federal treasury have a far better chance of finding their way to consuming states. This issue flared up during the floor debate when an attempt was made to tax the oil income of producing states, and Senator Russell Long (D-La) threatened to filibuster the bill to death.

The overall attitudes within the two Houses of Congress also signals a potentially acrimonious conference committee. House Speaker Tip O'Neill has indicated less concern with moving the legislation than with coming out with a strong bill. Senator Robert Byrd (D-W.Va.) has indicated a desire to complete legislative action. The Administration has indicated that it hopes to recapture as much of what it has lost in the Senate as possible. None of these conflicting attitudes holds promise for a speedy conclusion of the conference committee's deliberations.

THE QUESTION OF WINDFALL PROFITS

One of the questions which will not be addressed within the context of the conference committee's deliberations is whether the concept of a "windfall profits" tax is valid to begin with, and the extent to which it might hamper the development of domestic oil reserves. A study performed by the Congressional Budget Office, and cited in the Energy Daily, indicated that in all instances the amount of oil produced with a windfall profits tax would be substantially less than the amount which would be produced without it. Further, the same study noted that even without the imposition of a windfall tax, there would still be significant revenues accruing to the federal government as a result of oil decontrol.

For example, were the stricter version of the House bill enacted, total new producer revenues would come to $722.9 billion through 1990. Federal taxes would take $442.8 billion of these revenues, and $99.1 billion would go to the states. Domestic oil production in 1985 would be 7.9 mbd, and in 1990 would be 7.1 mbd. Without the tax, producer revenues for the same period would be $831.8 billion, federal taxes would come to $197.5 billion, and state taxes would come to $115.1 billion. Oil production would be 8.3 mbd in 1985, and 7.9 mbd in 1990. As can be seen from even these conservative estimates, the effect of the tax could be to reduce domestic production by as much as 800,000 b/d by 1990, and to reduce state revenues by more than $16 billion. It should be noted that the CBO study indicated that even without the imposition of a windfall profits tax, there would still be an effective tax rate of 38 percent imposed on the new revenues.

This obviously raises the question of the purpose of the windfall profits tax, and whether or not its underlying assumptions are valid. First and foremost among these assumptions is that the imposition of the tax would not significantly affect production. This argument is seriously undermined by the CBO study. In 1990, 800,000 barrels of oil per day will be between 10 percent and 11 percent of projected domestic production. This is not an insignificant amount. Also, if this oil must be replaced with imported crude at the $30 per barrel prices expected to prevail during the first quarter of 1980, then the annual cost to the balance of payments deficit will be nearly $9 billion, and given the recent history of oil prices, the effect could be much greater.

A second assumption underlying the windfall profits tax is that the profits are for some reason unearned. Whereas no one questions the 1000 percent appreciation some homes have experienced over the past decade, or the 1100 percent increase in the price of gold since 1974, the increase in the price of oil is somehow felt to be different. In actuality, when adjusted for inflation, the increase in the real price of oil has been something less than that for other commodities.

INCREASE IN OIL PRICES IN REAL TERMS

Between 1950 and 1969, the average wellhead price for crude oil produced in the United States remained between $2.50 and $3. Even as recently as 1973, before the Arab oil embargo, the selling price for a barrel of domestically produced crude oil was just $3.89. While this price was on the surface higher than the 1950 selling price, when adjusted for inflation which took place during the ensuing years, it actually represented a 6 percent decline. In real terms, the adjustment in price which occured in 1974 actually amounted to around $1 more than oil sold for in 1950. Moreover, between 1974 and 1976, the real price of oil again began to decline. The 1978 increase in OPEC prices which was so shocking on the surface was in fact an inflation adjustment. Only the most recent round of increases represents a change in real terms. The unanswered question is, of course, whether any increase is justified, real or merely to keep pace with inflation, and whether such an adjustment should be granted to domestic producers.

One major argument on behalf of allowing U.S. producers to benefit from the increased price of oil is found in the fact that it is a depletable resource which is increasingly scarce. In the past, it was relatively simple to find oil in the U.S., but with the increase in regulations limiting the areas in which the search can be conducted, and the exhaustion of previous finds, the costs associated with adding to our domestic reserves have increased. It can therefore be argued that oil should be priced at its replacement cost, and in fact the Administration has made this very argument on behalf of its windfall profits tax. It is only the question of who should benefit from the revenues resulting from the increased price which is at issue.

WHAT TO DO WITH THE WINDFALL

In the final analysis, the arguments for and against the concept of a windfall profits tax come down to the question of who should benefit from the windfall. If in fact oil is a scarce resource which is rapidly being depleted, then there is little question that it should be priced in accordance with its scarcity. If it is not a scarce resource, but rather has had its price increased through a producers' cartel, then all efforts should be made to increase domestic exploration and development in order to

reduce the cartel's influence. Interestingly, it was the decrease in the domestic price of oil which led to the flight of exploration activity overseas, to areas where costs were lower and drilling activities could take place on a profitable basis. Were exploration and development made profitable domestically, the downward trend in domestic exploration and development might be reversed.

Some proponents of the tax contend that it is needed to finance energy resources, especially the synthetic fuels program. This argument has a certain logic on the surface, but on closer examination does not appear to have as much merit. In the advent of a stiff windfall profits tax, significant new revenues will accrue to the federal treasury, possibly as much as $443 billion. This is far more than the estimated $88 billion cost of the synthetic fuel program originally advanced. The question then becomes whether other financing might be available, and, in fact, it is. Merely decontrolling the price of crude oil results in new federal tax revenues of $197.5 billion, almost twice the cost of the synthetic fuel program. This could all be earmarked for alternative energy development if needed and still eliminate the impediment to domestic production which a windfall profits tax would appear to present. Some of this $197.5 billion could also be earmarked to offset the impact of higher oil prices on the poor.

CONCLUSION

On balance, it appears that some sort of windfall profits tax will be forthcoming within the next few months, regardless of its merit or lack thereof. The tax now stands as a symbol of the frustration of the American public over the government's inability to cope with the energy crisis. Political rhetoric aimed more towards garnering votes than towards clarifying the causes of the nation's energy dilemma has convinced the public that the oil companies are to blame, and the public is demanding retribution. The windfall profits tax is the way politicians see of granting the public its wish. The trouble is that the tax will not produce more energy; in fact, it will inhibit energy production. Nor is it a question of allowing the oil companies to reap huge profits without paying any taxes whatsoever. Rather, it is a question of whether their tax rate should be 38 percent or 60 percent or 75 percent.

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