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TAXING AMERICA'S ENERGY AND VITALITY

INTRODUCTION

President Bill Clinton has included a tax on energy in his budget deficit reduction plan. The stated purposes of the new tax are to reduce the budget deficit, conserve energy, protect the environment, and reduce foreign imports of oil. The Clinton energy tax was included in the budget package just passed by the House Ways and Means Committee, as part of the Revenue Reconciliation Act of 1993, and is scheduled to go to the House floor this week for debate.

Under the measure passed by the Ways and Means Committee, a tax on the heat generating capacity of different fuels would be phased in over three years. This would mean a 26.8 cent tax on each million British thermal units (mmbtu) of energy consumed by Americans from coal, natural gas, oil, and other sources. If the measure becomes law, a 34.2 cent "supplemental" tax, will be placed on oil (except home heating oil), for a maximum total tax of 61 cents per mmbtu. In addition to this tax, Clinton proposes in the same package a gasoline tax of 2.5 cents. This would take the form of extending the existing tax, which is scheduled to terminate in 1996.

The energy tax has attracted widespread criticism, especially from those who fear that it will weaken the economy—the rationale for the entire package is that it will strengthen the economy. Pressure from industry and many Members of Congress already has forced the Administration to make numerous concessions in an effort to win sufficient support in Congress. But although numerous exemptions from the tax have been granted, the projected revenue (calculated by the Administration) remains unchanged at \$71.5 billion over five years, because the base tax rate has been raised from 25.7 cents per mmbtu in the original proposal to 26.8 mmbtu.

Despite the changes, the Clinton energy tax still will be harmful to the economy. In particular it will:

- ✓ **Fail to raise its projected revenue.** According to the Institute for Research on the Economics of Taxation (IRET), a Washington-based tax research organization, losses in payroll taxes and increased welfare benefits associated with the tax will cut net revenue to just \$5 billion per year.¹
- ✓ **Throw thousands of Americans out of work.** The Btu tax will cost one American his or her job for every \$10,000 of annual net revenue raised by the tax. In all, over 500,000 people will lose their jobs.
- ✓ **Slow economic growth.** Although the tax will raise a net amount of just \$5 billion per year, the tax will cause America's gross national product to decline by as much as \$50 billion each year. Additionally, the Btu tax will increase the cost of goods and services for the typical family of four by about \$450 a year.
- ✓ **Hurt the poor.** Millions of poor families will pay more for fuel and other goods. Despite Clinton's welfare hikes intended to offset the tax's impact, the poor still will be worse off.
- ✓ **Harm the environment.** The great irony of the tax is that it will hurt, rather than help, the environment. The reason is that the tax will discourage use of the cleanest fossil fuel, which is natural gas. Additionally, it will encourage Americans to use dirty high-sulphur eastern coal in place of cleaner-burning western coal.

Many lawmakers already are skeptical of White House promises that the energy tax, and indeed the whole budget package, will actually reduce the deficit. If they also consider the economic and environmental effects of the measure, they will conclude that the Btu tax is bad policy.

WHEELING AND DEALING OVER THE TAX

Since proposing the tax in February, the Administration has backpedaled on its structure in an effort to appease critics. The Administration so far has expanded its original list of exemptions from the tax from three to fourteen.

Originally, the White House claimed that this was to be a tax on the energy consumer, and not on the energy industry. But officials resisted changes that would move the collection point closer to the consumer. The aim of this apparently was to obscure the level and extent of the tax on consumers. In fact, the tax was designed to be hidden within the prices of goods by collecting the tax early in the manufacturing process, such as at the wellhead in the case of oil.

Critics from industry, as well as Members of Congress and energy experts, pointed out that the tax, structured in this way, would have the effect of reducing American competitiveness. For instance, as originally proposed, the tax would have reduced domestic oil production. Thus, under the scheme, foreign oil dependence would have increased—even if Clinton's estimate that total energy consumption would fall by 1.9 percent proved true.²

1 "Clinton Energy Tax Increases — Much Damage, Little Gain," Press Release, Institute for Research on the Economics of Taxation, March 19, 1993.

2 John Shanahan, "The Flaws in Clinton's Energy Tax," Heritage Foundation *Background* No. 934, March 18, 1993.

Another criticism was that the tax would cripple domestic refineries. Domestic refiners would have paid a tax on the substantial amounts of energy consumed during the refining process itself, as well as the Btu value of their refined fuel. But foreign refiners would have been taxed only on the energy level of their refined fuel when it crossed the U.S. border.

Such criticisms led the Administration to try to reduce the cost disadvantages to domestic producers and refiners. For domestic producers, the Administration exempted fuels used for "enhanced recovery" of heavy oils. For refiners, the tax collection point was moved to the refinery "tailgate"—the term denoting the point after refining is completed. However, unlike their foreign competitors, American refiners still will be taxed on the transportation fuel needed to bring the crude oil to the refineries.

The Administration also granted a partial exemption from the tax to the aluminum industry. The reason: The tax would have been extremely damaging to the aluminum industry, which is highly energy-intensive.³

According to a May 14, 1993, Ways and Means Committee press release summarizing the provisions approved by the Committee, the following would not be subject to tax:

- 1) *Electricity generated with solar, wind, and geothermal energy;*
- 2) *Biomass, including landfill gas, woodwaste, and bagasse used as a fuel;*
- 3) *Municipal solid waste and tires burned as fuel;*
- 4) *Nonfuel products such as asphalt, lubricants, and waxes;*
- 5) *Electricity used in pump storage generation of other electricity;*
- 6) *Coal used in the production of synthetic natural gas;*
- 7) *Crude oil or natural gas used on the premises where it is produced to produce crude oil or natural gas;*
- 8) *Crude oil or petroleum products (other than natural gas) used in a refinery or natural gas used in a natural gas processing or fractionation plant;*
- 9) *Exports of taxable energy sources;*
- 10) *Nonfuel uses (e.g., feedstock uses) of fossil fuels and electricity;*
- 11) *Ship and jet fuel used in international commercial transportation;*
- 12) *Refined petroleum products used in the production of synthetic natural gas;*
- 13) *Methane from biomass or coal seam methane from coal mining operations; and*
- 14) *Natural gas and coal used in enhanced oil recovery for heavy oil.*

The exemptions listed here do not include changes in the collection point, concessions to utilities, exemptions from the supplemental tax for farmers' diesel and gasoline, or other miscellaneous provisions.

3 The tax exemption does not specifically target the aluminum industry. Rather, it exempts the non-fuel uses of electricity during the electrolytic process, which is the technical name for the manufacturing process used. About half of the energy in this process is not consumed, but rather is converted into solid form by "transferring" electrons to the aluminum. Since about 60 percent of the energy used in making aluminum is during this process, only about 30 percent of the aluminum industry's energy use will be exempt.

While other industries also will benefit, the aluminum industry will be affected most by the change. Prior to the exemption, the tax would have raised the production cost of aluminum by \$289 million or 4 percent each year. This cost increase would have been burdensome to an already struggling industry. The number of domestic primary plants have decreased by over 20 percent in the last decade, and while world prices are now 52 to 54 cents per pound, due in part to Russia's increased aluminum sales, U.S. costs of production range up to 60 to 62 cents per pound. With the exemption, however, the tax still will impose a cost of more than \$220 million on the industry.

The Administration has agreed to numerous other exemptions. For instance, the White House acceded to demands by electric utilities to pass through the price of the energy tax to the consumer without approval from local rate commissions. In addition, home heating oil has been exempted from the "supplemental" oil tax (thus, home heating oil will be taxed at the 26.8 cent per mmbtu rate). Another new provision exempts from the tax fuels used in enhanced oil recovery—for instance, pumping natural gas into the ground to generate steam pressure to force oil to the surface.

Significant Opposition. Despite these and other changes, the Administration still faces significant opposition to the proposed tax. Although certain industry groups have been content merely to obtain a special exemption, other groups have remained firmly opposed to the tax. A coalition, known as the Affordable Energy Alliance, has been formed to oppose the Btu tax. In addition, the most prominent farm lobby is actively fighting the entire tax bill. Declares Dick Newpher, Executive Director of the Farm Bureau's Washington office, "Efforts will be made to exempt agriculture from the tax. The Farm Bureau position is one of complete opposition to the tax rather than pushing for an exemption.... We oppose the tax in its entirety and are not seeking an agricultural exemption. This tax is bad and the whole thing must be defeated."⁴

Despite the Farm Bureau's position, some lawmakers are trying to appease farmers with exemptions. Senators in many farming states, such as North Dakota—where the cost of growing 2,000 acres of typical crops would rise by an estimated \$4,789—will not want to outrage farmers.⁵ The farming community already has been granted some major exemptions. Farmers have been freed from the supplemental oil tax on diesel fuel, for instance, as well as for gasoline used for off-road equipment, such as tractors. There may be a push to grant further farm exemptions.

The problem for the Administration is that the entire tax could collapse under the weight of a growing list of exemptions. Many industry groups, such as the American Gas Association, have begun to realize that they suffer a competitive disadvantage with every new exemption. In addition to creating competitive disadvantages, the increasing number of exemptions led to the base tax on energy being raised by more than a penny, from 25.7 cents to 26.8 cents, to make up for the revenue lost.

After exemption upon exemption, the claimed benefits of the tax are more in question than ever. Each exemption seems to have merit, because it relieves some industries of un-

4 Internal Farm Bureau memo, May 7, 1993.

5 Numbers prepared by Nodak Mutual Farm Bureau, April 1993.

justifiably burdensome taxes. But the same rationale then applies to other industrial sectors. Instead of relieving these industries as well, their tax is raised even higher.

HOW THE TAX NEEDLESSLY WILL DESTROY JOBS

The Clinton Administration's claim that the energy tax will raise \$71.5 billion over the next five years, or \$22 billion annually when fully phased in, is wildly optimistic. According to the Institute for Research on the Economics of Taxation, income and payroll taxes will decline as a result of the job losses, and this means net tax revenues will be about \$10 billion per year less than the Treasury Department estimates, when the tax is fully phased in.⁶ IRET estimates, moreover, that when the revenue shortfall is combined with welfare increases intended—ineffectively—to eliminate the tax burden on poor families, the total net income from the Btu and gasoline taxes, when fully phased in, will be a mere \$5 billion per year. The annual loss of GNP, on the other hand, will be about one percent, or \$50 billion each year.⁷ Thus, the tax will reduce private sector output by \$10 for every dollar of net revenue raised. Moreover, IRET estimates these taxes will cause roughly 500,000 job losses. Therefore, the Btu tax will throw one American out of work for every \$10,000 of net revenue it raises.

The impact will vary by region. For instance, Oklahoma will lose an estimated 11,000 jobs, or 1 percent of the state's work force.⁸ As IRET notes, the federal deficit easily could be lowered by \$5 billion without job losses and the resulting contraction in the economy simply by reducing spending by that amount.⁹

Bipartisan Alternative. Recognizing this economic truth, and how damaging this tax would be to his home state, Senator David Boren, the Democrat from Oklahoma, along with John Danforth, the Republican from Missouri (both members of the Senate Finance Committee), announced a bipartisan deficit reduction plan on May 20, 1993. Their plan would strike the Btu tax, as well as some others, and replace them with spending cuts. The Administration called this an unacceptable alternative.

Despite the wealth of evidence, the Administration clings to its belief that the energy tax will not hurt the economy. Energy Secretary Hazel O'Leary stated in February on NBC's *Today* show that the tax will "enrich the nation and create jobs."¹⁰ But as Thomas DiLorenzo, Professor of Economics from Loyola College in Baltimore explains, "if that were true, one wonders why the Clinton Administration doesn't propose a tax of \$6,000 per million Btu's instead of a measly 60 cents, thereby 'enriching' the nation even more."¹¹

6 IRET, *op cit.*

7 *Ibid.*

8 Robert Dauffenbach, David Penn, and William Talley, "Impact of the Proposed Btu Tax on Oklahoma and Oklahomans," Center for Economic Research, University of Oklahoma, May 1993.

9 IRET, *op cit.*

10 NBC *Today* Show, February 22, 1993. This assertion has been made repeatedly since then by both Secretary O'Leary and Treasury Secretary Lloyd Bentsen.

11 Thomas DiLorenzo, "Clinton Attacks Energy," *The Free Market*, May 1993.

HOW U.S. COMPETITIVENESS WOULD SUFFER

The tax also will hurt domestic producers relative to foreign competitors. The original Administration plan intended that the tax would not apply to the energy used in goods manufactured abroad, only to domestic products. The Ways and Means Committee bill will tax the most energy-intensive imports, but the majority of Btus consumed to make all imported goods still will not be taxed.¹² Since most foreign countries subsidize energy used in industrial sectors, the Clinton tax would give foreign manufacturers an additional competitive edge. The myth that foreign manufacturers pay heavy taxes stems from the (correct) notion that many foreign countries impose heavy taxes on gasoline. But industrial energy subsidies more than offset the impact of these high gasoline taxes.

HOW PRICES WILL RISE

The energy tax will hurt all sectors of the U.S. economy. The reason: The price of virtually every domestic product will increase as a result of this tax because all goods, and even services, require energy for their production or delivery. Even those industries that would be partially or fully exempt from paying a tax will bear higher costs due to other energy used in production and the transportation of their products to market. Items requiring the most energy consumption to produce will tend to experience the biggest price hikes. The tax will raise the cost of new cars substantially and even increase the cost of simple household items such as cans of soda.

The Costs to American Families

The tax would not be easy on family budgets. The cost of the tax will be about \$112 per capita annually, for a total cost of about \$450 for a typical family of four.¹³ But the cost to particular households will vary, depending on the size of the household and on the region of the country.

The Administration maintains that the tax will cost just under 1 percent of a family's budget. But this figure obscures the fact that 90 percent of the average family expenditures are on basic goods such as housing, clothing, and food. Spending on these items cannot easily be reduced. Only 10 percent of most families expenditures are "luxury" items, such as vacations or going to the movies. Thus, it turns out that the Btu tax will extract almost one-tenth of the typical household budget after the family pays for basic goods. Of course, those families already unable to afford "luxury" items will be forced to cut down on basic purchases, such as clothes.

12 This provision, with its inherent problems of calculation, will encourage trade retaliations.

13 Shanahan, *op. cit.* Note that the cost per capita for family will probably decline with each additional family member since not all energy usages are proportionally increased with the addition of each family member. Also, note that many experts claim that the tax will only cost about \$310 to \$320 per household. The reason for the difference in the stated household cost is that those claiming the \$320 cost are basing their figure on a household of 2.7 people (the national average), while this paper bases its figure on a household of four to conform with the Department of the Treasury's cost presentation.

Hurting the Poor

The energy tax will be particularly burdensome to the poor. Larry Hobart, Executive Director of American Public Power Association, puts it this way: "An energy tax is a Marie Antoinette levy: it's a piece of cake for the economic upper crust, but slices significant dough out of the pockets of daily breadwinners."

By choosing a Btu tax to raise revenue, the Administration surprisingly has chosen a regressive tax. The Administration freely confesses to this, but insists that the poor will not be hurt by the tax because much of the revenue raised by the tax will be returned to the poor through an expansion of earned income tax credits (EITC), food stamps, and energy assistance payments.

In short, the Administration will increase the number of the welfare recipients and working poor by reducing their standard of living through indirect taxation. It will then return some of their lost disposable income in the form of welfare payments and other assistance. Those working poor or retirees who are too proud to accept hand-outs or who do not qualify for the earned income tax credits, simply will be saddled with the tax.

Misleading Claim. Clinton claims that the taxes of those making under \$30,000 per year will be offset by these increased welfare programs. This claim is so misleading as to be false. One reason for this is that the White House definition of income differs widely from the ordinary definition of gross income reported by a family to the IRS. For example, the White House includes in its definition of income such items as the rentable value of the home the family owns, and the value of employer-provided fringe benefits. Thus when Clinton says the tax will affect only those making over \$30,000, he means it will affect families that, according to the definition of income used by ordinary families and the IRS, make nearer to \$20,000.

Perhaps more important, and contrary to Clinton's assurances, millions of low-income families will be burdened by this tax. Over 40 percent of families earn less than \$25,000. Even if, in the aggregate, the government gives more assistance to this income group, and so offsets all the other amount this group pays in taxes, individual families will not fare as well. Families that commute long distances to work or live in rural areas, for instance, will be especially hit hard by the Btu tax. The Btu tax will amount 10 to 12 cents per gallon,¹⁴ and when the 2.5 cents from Clinton's gasoline tax extension is added, every gallon of gasoline will cost an additional 12.5 to 14.5 cents. Thus, high mileage families will pay a higher share of the tax.

Similarly, low-income families will differ in the amount of additional government assistance they receive. Families already receiving food stamps will not benefit much from an expansion in program eligibility because they will not receive more food stamps. Nor should they, since the program already is designed to ensure that each family eats nutritiously. Yet the tax will reduce their real income. On the other hand, those newly eligible will see their income (cash plus in-kind benefits) increase.

14 "The Clinton Btu Tax Proposal," Cambridge Energy Research Associates, February 1993. The Administration assumes that the additional tax on gasoline will be only about 8 cents. This figure is rejected by Cambridge Energy Research Associates. Regardless of which figure is correct, the argument outlined in the text holds.

Those hit hardest of all will tend to be the high mileage working poor living in rural areas who must travel long distances to work but who already receive benefits or only narrowly miss eligibility. These families will experience much higher costs without offsetting welfare transfers. In contrast, "low mileage" families newly eligible for benefits potentially will gain a windfall because their costs will not increase greatly, but their income will rise.

The real tragedy is that economic growth will be stifled. Since the poor are the most dependent on growth, they will suffer the economic consequences of this tax the most.

HOW THE TAX WILL HURT SOME STATES DISPROPORTIONATELY

The tax burden would vary across the country because of the differences in demographics, climate, and state sizes. If enacted, the tax will range from just \$60 per capita in New Hampshire to \$280 per capita in Alaska, according to the Tax Foundation.¹⁵ Other states in which citizens will be most heavily taxed include, in decreasing order of severity, Wyoming, Louisiana, Texas, North Dakota, West Virginia, Indiana, Oklahoma, Montana, and Kansas.

A corollary of this is that more populated states will bear a much larger portion of the energy tax burden. For instance, Texas and California, the most heavily taxed states, would pay the federal government \$2.7 billion and \$2 billion, respectively. In contrast, Washington, D.C., and Vermont will pay only \$47 million and \$35 million, respectively. Other hard-hit states include, in decreasing order, Ohio, New York, Pennsylvania, Illinois, Louisiana, Florida, Michigan, and Indiana.¹⁶

TURNING ENVIRONMENTAL POLICY ON ITS HEAD

Despite the Administration's assertions to the contrary, the tax also will be bad for the environment. The Administration contends that the tax will encourage energy conservation. In fact, it estimates that the nation will reduce energy usage by 1.9 percent annually.¹⁷ Ironically, part of the attraction to the White House is that consumption would not fall very much, thus generating maximum tax revenue.

Energy conservation, however, is not always a benefit. As a general rule, the scarcity value of energy resources is already built into the market price of that good. This means that consumers have the incentive to avoid energy sources that are relatively scarce, and use sources that are relatively plentiful. But when government interferes with this market measure of the conservation "worth" of a resource, by applying a tax, it distorts the market.¹⁸ In the process it can encourage firms to avoid more plentiful fuels and to over-consume scarcer resources in order to make the same goods.¹⁹ The new mix of resources being consumed in-

15 "Proposed Energy Tax Hits States, Sectors Unevenly," Tax Foundation, April 22, 1993.

16 *Ibid.*

17 The Energy Department admits that energy use will continue to grow in absolute terms. The 1.9 percent figure refers to the percent of energy consumption that will not occur, given the tax, as compared to consumption levels in its absence.

18 For a good discussion of why government mandates cannot save resources, see John Shanahan, "A Plain Man's Guide to Garbage: The Reauthorization of the Resource Conservation and Recovery Act, Heritage Foundation *Issue Bulletin* No. 172, March 30, 1992, p. 19.

19 This comment holds true for any given level of output. Some of the increased resource usage will be raw resources, but some of the increased resource usage will be labor. But this does not mean that employment will increase because the

variably is more valuable than the energy saved or businesses would have used that mix of resources in the first place.

The better argument for conservation of energy rests on the argument that certain fuels will reduce pollution. The "externality" pollution cost is not automatically built into the market price of a fuel. But this argument fails unless there is a uniform reduction among all fuel sources, or unless the tax falls more heavily on the fuels causing more pollution. Under the Administration's proposal, however, reductions will not be uniform because of distortions created by the tax.

For instance, the purchase of natural gas, which is a clean-burning source of energy, will be discouraged. In the co-generation market, in which waste energy can be used to produce electricity, renewable waste products such as wood chips will gain market share from natural gas. Yet renewable fuels do not burn as cleanly as natural gas, and thus they pollute the air more.

Similarly, the tax will discourage potential markets in less-polluting gas heat pumps and natural gas vehicles. Perversely, it also will cause a loss of market share for natural gas in favor of electricity. This is counterproductive from an environmental viewpoint, because using natural gas directly to generate heat is typically more energy efficient than using electricity generated from natural gas.

Another damaging environmental result of this tax is that it will cause high-sulphur eastern coal to gain market share relative to low-sulphur western coal. Both utilities and industrial firms will be motivated to substitute eastern for western coal. This is because the Btu tax will significantly increase the costs of transportation. Western coal, which is the nation's cleanest, must be brought long distances to market. Since the Btu tax will apply to those transportation costs, western coal will suffer a competitive disadvantage relative to the dirtier eastern coal.²⁰

CONCLUSION

The energy tax on the heat content of fuels should be eliminated from the tax package before Congress. The package unfairly taxes some industries while exempting others. The tax will not raise the projected revenue, nor will it help the economy. It will hurt American families, cost jobs, undermine U.S. competitiveness, and slow growth. Moreover, contrary to President Clinton's assertions, it will hurt the poor and the environment.

Specifically, the Btu tax will:

- ✗ Cost 500,000 jobs;**
- ✗ Raise only \$5 billion per year (\$10,000 for every job lost);**
- ✗ Increase the trade deficit by penalizing domestic producers.**

new mix of resources will by definition be less than optimum, thus, output will contract from its optimal state.

20 See testimony of Philip Verleger of the Institute of International Economics before the U.S. Senate Committee on Energy and Natural Resources, February 24, 1993.

- ✗ Burden low-income families; in fact, they will bear a disproportionate share of the tax relative to their income;**
- ✗ Hurt the environment by discouraging use of cleaner fuels such as natural gas and low-sulphur western coal (relative to high-sulphur eastern coal).**

Many lawmakers understand that the energy tax is bad deficit-reduction policy. They need to consider the tax's damaging effects on the economy, and on ordinary Americans when they debate the flawed measure.

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