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Energy Bill Tax Title Promises More Pain at the Pump

Ben Lieberman

Taxing successful energy sources and subsidizing unsuccessful ones: That's the essence of Washington's energy policy mistakes during the 1970s and early 1980s. These mistakes are about to be repeated in the tax title to the Senate energy bill. This section would raise taxes by an estimated $21 billion over 10 years—including $13 billion from the oil and natural gas sector—and spend much of it on tax breaks for alternative energy sources like ethanol and wind power. As before, this approach will likely backfire and raise prices while reducing energy security. Overall, this tax title makes an anti-consumer energy bill even worse, and if it reaches the President, he should veto it.

The Wrong Weapon in the Energy Battle. The tax title of the energy bill proposes a number of tax code changes, the effect of which would be to raise taxes on companies working to expand domestic oil and natural gas supplies. This includes measures eliminating or reducing some existing deductions against income from energy production, most notably the manufacturer's deduction under the American Jobs Creation Act of 2004. This deduction against income, which applies to domestic industries, would now exclude major oil companies. The change would raise taxes on new oil and gas production by about $10 billion. Other tax changes would bring the total tax increase on oil and gas companies to an estimated $13 billion.

The push for energy legislation has been sparked by consumer anger over high gasoline prices, but these measures will not offer any relief at the pump. The current tax code has nothing to do with recent increases in energy prices, so Washington-style tinkering with the code will not benefit the driving public.

It should also be noted that the underlying assumption that the domestic oil and gas sector is currently undertaxed may be popular political rhetoric but is not supported by the evidence. By many measures, energy companies face tax rates comparable to or higher than those of other industrial sectors. For example, the average effective tax rate for major integrated oil and natural gas companies is 38.3 percent, which is actually higher then the average rate of 32.3 percent for the market as a whole, according to the Tax Foundation.[1] And these taxes have risen along with oil company profits.

Unfortunately for consumers, tax increases, such as those in the Senate legislation, would likely reduce supplies and increase prices in the years ahead by discouraging investment in new domestic drilling for oil and natural gas. America's demand for energy is growing along with its economy, and so it will need more domestic oil and natural gas supplies. Raising taxes on energy would move America in the opposite direction, because it would raise the cost of capital for exploration and production, making some domestic energy projects less viable.

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(202) 546-4400 • heritage.org

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These provisions also undercut the energy security rationale behind the bill. The tax crackdown on domestic oil producers confers an additional comparative advantage on OPEC and other non-U.S. suppliers whose imports are not subject to most of these provisions.

The bottom line is that these tax measures would reduce domestic supplies of oil and gas and require increased imports to fill the void. Assuming demand continues to grow, these provisions would also increase prices for consumers.

Back to the 1970s? That is the lesson of the infamous windfall profit tax (WPT) on oil firms imposed under the Carter Administration in 1980 and repealed under the Reagan Administration in 1988. In 1980, anger at "big oil" over high prices helped lead to this punitive tax, but the consequences of this tax was not what its supporters had hoped. According to the Congressional Research Service, "The WPT reduced domestic oil production from between 3 and 6 percent, and increased oil imports from between 8 and 16 percent. This made the U.S. more dependent upon imported oil."

The only difference between the WPT and the tax hikes in the current Senate energy bill is that the latter have different names and operate somewhat differently, but the end result of such measures would be the same.

Another way of thinking about tax increases is that no matter where a product is taxed—whether at the retail level or further upstream at the producer level—tax increases will raise the cost of that product. The Senate has been wise enough not to raise the federal gas tax, especially at a time of $3 per gallon prices, but a tax hike on the producers of motor fuels would filter down in the form of higher prices anyway. This is the exact opposite of what the American people want.

Worse yet, these tax provisions are in a bill filled with other costly provisions, the sum total of which may boost the price at the pump to $5 per gallon by 2016.[2]

Subsidizing Unsuccessful Energy Sources. Much of the extra revenue generated from these taxes would go toward subsidizing politically correct alternative energy sources, such as ethanol and wind power. The bill includes both tax incentives to build plants that generate alternative energy and tax credits on the energy sold. However, the 30-plus-year history of federal attempts to encourage alternatives contains numerous failures and few, if any, successes. Indeed, many of the recipients of tax breaks and incentives in the Senate bill have been subsidized for decades, originally with the promise that they would become viable within a few years and then go off the dole and compete in the marketplace. But this has never happened. For example, ethanol, which gets special breaks in the Senate bill, has enjoyed preferential treatment since 1978.

Even after decades of tax code assistance, alternative energy still provides only a small fraction of America's energy needs. For example, wind and solar energy account for only a few percent of America's electricity, due to their high costs and unreliability. In the end, Washington learns, the hard way, that these alternatives have serious economic and technological shortcomings, which is why they needed all these special tax breaks in the first place.

If the past is any guide, it is likely that the energy sources favored in the Senate bill will again disappoint.

In addition to the tax breaks, other portions of the bill mandate a five-fold increase in the amount of renewable fuels that must be used. Thus, their producers will enjoy both favorable tax treatment and a guaranteed market—all at consumer expense.

Conclusion. The pending energy bill would increase taxes on the energy sources America relies upon, namely oil and natural gas, in order to subsidize alternatives with a spotty track record. Raising

1. Scott A. Hodge and Jonathan Williams, "Large Oil Industry Tax Payments Undercut Case for Windfall Profits Tax," Tax Foundation, January 31, 2006.
2. See William W. Beach and Shanea Watkins, Ph.D., "Paying More at the Pump: Energy Bill Would Increase Gas Prices," Heritage Foundation *WebMemo* No. 1729, December 10, 2007, at *www.heritage.org/Research/EnergyandEnvironment/wm1729.cfm*.

taxes on what works and heaping subsidies on what doesn't was not good energy tax policy when tried in the past and won't fare any better this time around. For the sake of consumers, these provisions should be scrapped.

—Ben Lieberman is Senior Policy Analyst for Energy and the Environment in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.