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The 2008 House Energy Tax Bill: Repeating Past Mistakes

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Taxing successful energy sources and subsidizing unsuccessful ones: That is the essence of Washington's energy policy mistakes during the 1970s and early 1980s. These mistakes are about to be repeated in the Renewable Energy and Energy Conservation Tax Act of 2008, recently introduced in the House. This bill would effectively raise taxes on the oil and natural gas sector and spend much of the revenue on alternative energy sources like wind, solar, and biofuels. As it did decades ago, this approach would likely backfire and raise prices for consumers while reducing energy security. Congress should craft a new energy policy that relies on the market to meet the nation's energy needs.

The Tax Code: The Wrong Weapon in the Energy Battle. The bill proposes a number of changes in the tax code, the effect of which would be to raise taxes paid by 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. Under the current proposal, this deduction against income, which applies to domestic industries, would exclude major oil companies producing oil and gas in the U.S. and would be reduced for smaller companies. The total tax increase is estimated by the Joint Committee on Taxation to be $13.5 billion over ten years. Other tax increases in the bill would bring the total raised to $18 billion.

The push for this bill has been sparked in part by anger over recent announcements of record profits by ExxonMobil and other major oil companies. The suggestion that the domestic oil and gas sector is currently undertaxed may be a popular sound byte, but it 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 actually higher then the average rate of 32.3 percent for the market as a whole, according to the Tax Foundation.[1]

Also, record profits for oil companies have been accompanied by record tax bills. According to the Energy Information Administration, gross revenues from the 27 biggest energy companies hit a record high of $220 billion in 2006 (the most recent information available), well above the $188 billion in 2005 and $129 billion in 2004.[2] But total income taxes also rose to a record high of $81 billion in 2006, compared to $67 billion in 2005 and $45 billion in 2004. This effective tax rate of 37 percent in 2006 is in line with (and actually a bit higher than) large corporations in general.

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The push for this bill has also been sparked by consumer anger over high gasoline prices. However, the tax code has nothing to do with recent increases in energy prices, so tinkering with tax laws would not benefit the driving public. In fact, consumers would actually be hurt over the long term.

These tax increases 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 more domestic oil and natural gas supplies will be needed in the years ahead. However, 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.

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. Increased imports, rather than increased alternatives, would fill the void. And, assuming that demand continues to grow, these provisions would increase prices for consumers.

This 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. Then, as now, anger at "big oil" over high prices led to calls for a punitive tax. But 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 tax hikes in the current bill have different names and operate somewhat differently, but the end result 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, the additional burden will raise the cost of that product. Congress has been politically wise enough not to raise the federal gas tax, especially at a time of nearly $3.00 per gallon prices, but a tax hike on the producers of oil would filter down to drivers in the form of higher gas prices. This is the exact opposite of what the American people want.

Subsidizing Unsuccessful Energy Sources. Much of the extra revenue generated from these taxes would go toward subsidizing politically correct alternative energy sources such as wind and solar power. However, the 30-plus-year history of federal attempts to encourage such alternatives includes numerous failures and few, if any, successes. Indeed, many of the recipients of tax breaks and incentives in the bill have been subsidized for decades—ethanol since 1978, for example—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. Instead, Congress just passed a huge expansion of the ethanol mandate, essentially forcing Americans to use more of it even as it continues to be heavily subsidized. Wind and solar are doing no better.

Even after decades of special tax breaks, alternative energy still provides only a small fraction of America's energy needs. For example, wind and solar energy account for less than 3 percent of America's electricity because of their high costs and unreliability.[3] Further, the overall percentage of electricity attributable to renewable sources is not expected to increase by 2030, according to the Energy Information Administration.[4]

1. Scott A. Hodge and Jonathan Williams, "Large Oil Industry Tax Payments Undercut Case for Windfall Profits Tax," Tax Foundation, January 31, 2006.
2. U.S. Department of Energy, Energy Information Administration, "Performance Profiles of Major Energy Producers," December 2007, Table B12, at *www.eia.doe.gov/emeu/perfpro/btab12.html.*
3. U.S. Department of Energy, Energy Information Administration, "Renewable Energy Consumption and Electricity Preliminary 2006 Statistics," August 2007, Table 4, at *http://tonto.eia.doe.gov/FTPROOT/renewables/pretrends.pdf.*
4. U.S. Department of Energy, Energy Information Administration, "Annual Energy Outlook 2007," p. 82.

After all these years, Washington has failed to grasp the serious economic and technological shortcomings of these technologies, which is why they needed special treatment in the first place. Federal efforts to pick winners and losers among energy sources—and to lavish mandates and subsidies on the perceived winners—have a dismal track record relative to allowing market forces to decide the direction of energy innovation.

Conclusion. This bill boosts taxes on the energy sources America relies upon—oil and natural gas—in order to subsidize alternatives with a spotty track record. Raising taxes on what works and heaping subsidies on what doesn't: This policy has failed in the past and would not fare any better this time around. Congress should go back to the drawing board and craft a policy that places greater emphasis on the market.

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