Backgrounder

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No More Energy Subsidies: Prevent the New, Repeal the Old

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Abstract: *Are Americans energy dependent? Yes—dependent on government energy subsidies. In 2007, American taxpayers subsidized government-preferred energy sources to the tune of nearly $17 billion. Increasingly, it is politicians in Washington who decide how Americans produce and consume energy. But subsidies for special interests stifle competition, raise energy prices, and decrease economic opportunities. It is time for Washington to eliminate all government subsidies and special policy treatments that benefit certain industries at the expense of others. Energy companies should rely on innovation and efficiency, not American taxpayers, to thrive in a system of free enterprise.*

Americans are becoming too energy dependent. But it is not dependence on foreign sources of energy that is the problem; it is growing dependence on the federal government. According to the Energy Information Administration, the United States spent $8.2 billion on energy subsidies in 1999. That spending more than doubled to $16.6 billion in 2007, and with the stimulus funding and other provisions, it promises to have a much higher price tag in the years ahead. With direct expenditures, targeted tax breaks, mandates, loan guarantees, and other preferential treatment, Washington is deciding how Americans produce and consume energy. Increasing America's access to energy resources creates competition, lowers prices, drives innovation, and creates economic opportunity. Subsidies do the opposite. Congress should make it a priority to ensure that no new subsidies are put in place and remove the ones already in place.

Talking Points

- Energy subsidies have not reduced America's reliance on foreign energy sources, but have merely boosted politically preferred technologies.
- Subsidies waste taxpayer dollars, stifle innovation, create industry complacency, crowd out investment, and give industries the incentive to lobby Washington for handouts and special protections.
- Congress should prohibit any new energy subsidies and remove the ones currently in place. The private sector is far better equipped to allocate resources and develop commercially viable technologies.
- The government must stop using the tax code to pick industry winners and losers. Congress should allow sunsetting credits to expire and expedite sunsetting credits that extend multiple years, and lower taxes elsewhere, such as allowing all companies to expense their full capital costs immediately.

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What Are Subsidies and Why Are They Harmful?

In public policy, subsidies come in many shapes and sizes and are thus often difficult to define comprehensively. The definition "direct transfer of money to a group or industry" is too narrow, so for the purpose of this paper, a better definition is "Using the political process to support the production or consumption of one good over another."

Providing subsidies is bad economic policy for a number of reasons. Government support that targets one group or industry artificially props up that market. Rather than increase competition, a special endorsement from the government gives one technology an unfair price advantage over other ones. Further, subsidies reduce the incentive for that technology to become cost-competitive and encourage dependence on the preferential treatment that government gives them. Those energy sources that need help from the government are those that cannot compete economically without them. If a project makes economic sense, however, the investments will occur without the subsidy. In that case, the subsidies simply offset the private-sector investments that would have been made either way.

Another destructive feature of subsidies is that they allow Washington to direct the flow of private-sector investments. Targeted direct expenditures, tax breaks, loan guarantees, and other government subsidies allocate resources away from more competitive projects. If the government gives a tax credit to banana producers only, it shifts more labor and capital towards banana production and away from other economic activities, like strawberry or grape production. The market, not politicians in Washington, is a good determinant of how to allocate resources and meet consumer demand.

Furthermore, when the government dictates how private-sector resources are spent, those industries that benefit greatly from such policy decisions will spend more money lobbying for government handouts. The banana producers will push for tax-credit extensions. The apple producers will complain that they are at a disadvantage and lobby for their own handouts. This process results in the continuous picking of winners and losers. It is not the role of the government to determine what type of energy consumers use and using the political process to pick winners and losers distorts the marketplace and increases the incentive to energy companies to lobby for handouts. Conversely, reducing government control of the energy economy reduces the incentive to use the political process for gain.

Congress should make it a priority to prevent any new subsidization of energy sources and technologies and peel back the ones in place. Forcing sunsets of preferential tax credits and offsetting the tax increases with lower rates across the board would simplify and improve the tax code.

Prevent and Remove Direct Spending

There has been a growth in direct energy expenditures in the United States, largely because of the more than $40 billion awarded to the Department of Energy (DOE) from the American Recovery and Reinvestment Act (ARRA), known as the stimulus bill. Of that amount, $16.8 billion went to the Office of Energy Efficiency and Renewable Energy (EERE). But even through its yearly budget process, the Department of Energy spends billions of dollars to fund applied-research programs. Another program the Energy Information Administration (EIA) lists as a direct expenditure is the Low Income Home Energy Assistance Program (LIHEAP). To prevent more direct government market distortions in the energy sector and prevent wasting taxpayer dollars, Congress should:

- **Prohibit any new funding.** Congress should ensure that no taxpayer dollars go directly to energy production, storage, efficiency, infrastructure, or transportation for non-government consumers. While this type of spending may be important, it is better financed through the private sector, which is better positioned to make efficient investments that meet consumers' needs.
- **Eliminate government attempts to commercialize technologies.** The DOE has spent billions of research dollars on technologies to reduce carbon dioxide emissions, including energy efficiency technologies, renewable energy sources, carbon capture and sequestration, clean coal technologies, nuclear energy, and alternative-energy vehicles. All these energy sources and technologies are available today, but they are

not commercially viable, whether due to burdensome regulations or simply because they are still prohibitively expensive. It is not the government's role to force these technologies into the marketplace and Congress should remove all funding for DOE-funded commercial activities and focus on removing the onerous regulatory barriers that prevent energy technologies from reaching the market.[1] Congress should focus on a more efficient system in which the private sector can use government resources such as national laboratories funded by the private sector.

- **Eliminate LIHEAP.** LIHEAP is meant to help low-income households pay fuel bills, but it has rapidly expanded, is duplicative, and has been riddled with fraud and abuse. A 2010 Government Accountability Office (GAO) study found that the Department of Health and Human Services distributed funds to thousands of deceased and incarcerated people and claims that LIHEAP-application processors awarded funds to GAO officials using fake addresses and fake energy bills.[2] Eliminating LIHEAP certainly does not mean there will be no money for low-income households to pay for energy costs. The federal government runs more than 70 means-tested aid programs that provide cash for food, housing, medical care, and social services. Total federal and state spending on means-tested assistance to low-income persons will exceed $900 billion this year.[3] Furthermore, cash, food, housing, and energy aid are highly fungible when they reach the household level, so households are in the best position to determine which good they need most. While President Barack Obama proposed to significantly cut LIHEAP in his FY 2012 budget request, Congress should eliminate LIHEAP funding entirely.

Tax Credits

Special tax treatment can serve the same purpose as a subsidy by uniquely favoring one industry. Targeted tax credits divert resources to the special interests that Congress wants to succeed and moves the decision-making process away from the marketplace.[4] This has been an increasingly attractive way for the government to award preferential treatment to certain energy industries. The number of energy tax programs expanded from 11 in 1999 to 38 in President George W. Bush's 2007 budget.[5] According to the EIA, tax expenditures comprise almost two-thirds of electricity subsidies.[6] Ideally, Congress should immediately remove all distortionary energy tax policy—meaning any tax policy that picks certain industries as winners and losers in the market—and offset those repeals with a broad lower tax cut. In order to wean industries off preferential treatment, Congress should create a three-year window for all energy tax expenditures in effect. This should not include broadly available tax deductions that apply across multiple sectors.[7] Three priorities for Congress should be:

1. Nicolas D. Loris, "Department of Energy Spending Cuts: A Guide to Trimming President Obama's 2012 Budget Request," Heritage Foundation *Backgrounder* No. 2545, April 18, 2011, at *http://www.heritage.org/Research/Reports/2011/04/Department-of-Energy-Spending-Cuts-A-Guide-to-Trimming-President-Obamas-2012-Budget-Request#_ftn13*.
2. U.S. Government Accountability Office, "Low-Income Home Energy Assistance Program: Greater Fraud Prevention Controls Are Needed," June 2010, at *http://www.gao.gov/new.items/d10621.pdf* (July 10, 2011).
3. Katherine Bradley and Robert Rector, "Confronting the Unsustainable Growth of Welfare Entitlements: Principles of Reform and the Next Steps," Heritage Foundation *Backgrounder* No. 2427, June 24, 2010, at *http://www.heritage.org/research/reports/2010/06/confronting-the-unsustainable-growth-of-welfare-entitlements-principles-of-reform-and-the-next-steps*.
4. Curtis S. Dubay, "The 2010 Tax Deal: A Chance for Congress to Lay the Groundwork for Tax Reform," Heritage Foundation *Backgrounder* No. 2569, June 13, 2011, at *http://www.heritage.org/Research/Reports/2011/06/The-2010-Tax-Deal-A-Chance-for-Congress-to-Lay-the-Groundwork-for-Tax-Reform*.
5. Molly F. Sherlock, "Energy Tax Policy: Historical Perspectives on and Current Status of Energy Tax Expenditures," Congressional Research Service *Report for Congress*, May 2, 2011.
6. Energy Information Administration, "Federal Financial Interventions and Subsidies in Energy Markets 2007," April 2008, at *http://www.eia.doe.gov/oiaf/servicerpt/subsidy2/pdf/subsidy08.pdf* (July 8, 2011).
7. For instance, some policymakers want to remove the manufacturer's tax deduction for the oil and gas industry under the Internal Revenue Code Section 199, which applies to all domestic manufacturers, including windmill and solar-panel manufacturers. For more information, see Nicolas D. Loris and Curtis S. Dubay, "What's an Oil Subsidy?" Heritage Foundation *WebMemo* No. 3251, May 12, 2011, at *http://www.heritage.org/research/reports/2011/05/whats-an-oil-subsidy*.

- **No new tax credits.** Congress should not implement any new tax credits for energy production, energy infrastructure, transportation (production and consumption), or energy efficiency initiatives. This will prevent the federal government from continuing to pick winners and losers, and will also ensure that Congress cannot use the tax code to direct investments.
- **Force sunsetting tax credits to sunset.** One of the larger problems with targeted tax credits is that upon expiration, industry groups will lobby Members to expand them for another year, or multiple years. Congress should specify that any tax credit set to expire on December 31, 2011, or on December 31, 2012, cannot be extended and should be accompanied with an offsetting tax reduction.
- **Expedite sunsetting.** Congress should set expedited sunset clauses for any energy tax expenditure not set to expire at the end of the 2012. Moreover, Congress should create a three-year window for all other tax credits that extend multiple years or do not expire and reduce the percentage by one-third after every year. Any tax credit tied to production should follow the same schedule.[8] This timeframe will give industries a predictable window to lower costs and determine whether they can compete without the federal government's help. Congress should then reduce other taxes by the amount of revenue that expediting the elimination of these unsound policies would raise.

Immediate Expensing Rules

Another way in which certain industries benefit over others relates to how companies can expense capital costs. For instance, oil and gas companies receive more generous treatment than do other industries through expensing of intangible drilling costs. A simple solution is to allow all companies, including oil and gas companies, to be able to expense their full capital costs immediately.

Immediate expensing allows companies to deduct the cost of capital purchases at the time they occur rather than deducting that cost over many years based on cumbersome depreciation schedules. Expensing is the proper treatment of capital expenditures. Depreciation raises the cost of capital and discourages companies from hiring new workers and increasing wages for existing employees. Immediate expensing for all new plant and equipment costs—for any industry or type of equipment—would allow newer equipment to come online faster, which would improve energy efficiency and overall economic efficiency.

Immediate expensing is good policy and Congress should simplify the tax code and make immediate expensing permanently available for all business investments.

Prevent and Remove Other Market Distortions

The government distorts the energy market in several other ways, too—through loan guarantees, insurance programs, mandates, tariffs on imported energy, and energy sales at below-market costs. To eliminate these distortions, Congress should:

- **Prohibit any new loan guarantees or other capital subsidy programs.** The Energy Policy Act of 2005 (EPACT) included loan guarantees for nuclear power, and Section 1705 of the American Reinvestment and Recovery Act of 2009 amended EPACT to include loans for renewable energy and biofuel projects and electric power transmission systems that begin construction before October 1, 2011. Congress appropriated $6 billion for the credit subsidy costs of the Section 1705 loans. A new capital subsidy program gaining some traction in Congress would be to create a Clean Energy Deployment Administration within DOE, also known as a "green bank" to provide loans, loan guarantees, and clean-energy-backed bonds to carbon-free technologies that commercial lenders believe are too risky. The DOE has no role to play

8. For instance, the Energy Policy Act of 2005 provides a 1.8 cent-per-kilowatt-hour tax credit for advanced nuclear power produced during the first eight years of production. Congress should shorten the timeline of availability to three years of production and make the tax credit worth 1.8 cents through 2011, 1.2 cents through 2012, and 0.6 cents through 2013. In 2014, the tax credit would be no longer available.

as a banker. These capital subsidy programs distort normal market forces and encourage dependence on government because the government subsidizes a portion of the actual cost of a project and directs capital away from more competitive projects.[9] President Obama proposed expanding the program by $200 million, which could cover an additional $2 billion in loans. No loan guarantee program should be expanded, nor should the government implement any new capital subsidy programs.

- **Restructure public power.** Federal utilities, known as Power Marketing Administrations (PMAs), were set up to provide cheap electricity to rural areas. PMAs can sell electricity at below-market rates because of favorable financing terms—they receive federal tax exemptions and receive loans at below-market interest rates. Construction, rehabilitation, operation, and maintenance costs for PMAs are financed through the main DOE budget, offset collections, alternative financing, and a reimbursable agreement with the Bureau of Reclamation. Furthermore, rural electric cooperatives (RECs) are private organizations, in many cases non-profit, that provide about 12 percent of the nation's electricity sales. RECs receive special tax exemptions and low-interest loans from the government. Congress should remove privileges for federal utilities, municipal power companies, and electricity cooperatives and, ultimately, sell off PMAs to private buyers.
- **Restructure insurance and risk mitigation.** Several government programs offer liability insurance schemes for specific industries. While some of these programs may have been justifiable in the past to protect private entities that engaged in high-risk operations in support of vital national interests, they now often serve to subsidize insurance costs for private, profit-seeking industries. Two examples are the $75 million liability cap for offshore oil and gas operations and the Price–Anderson Act of 1957, which provides a liability regime for the nuclear industry that extends through 2025. Given the problem of uncapped tort liability that leads to frivolous lawsuits, removing the cap entirely without implementing a new system would subject covered industries to artificially high costs. Instead, Congress should reform liability caps, reforming Price–Anderson when it expires, in a way that accurately assigns risk and liability to those engaged covered activities.[10]
- **Eliminate production mandates and tariffs on imported energy.** Mandates such as the ethanol production quota guarantee ethanol producers a share of the marketplace. The tariff makes it more costly to import ethanol at a cheaper price. Congress should repeal both policies.

Removing Subsidies Benefits Consumers, Taxpayers, and Industry

Energy industries should be freed from all government subsidies and special policy treatment that benefit certain industries at the expense of others. This would allow companies to rely on innovation and efficiency, not American taxpayers, to remain competitive and thrive in a system of free enterprise. Removing market distortions would allow resources to be allocated to their most efficient use. The industries and companies that provide the most benefit to the consumer will be the ones that are successful.

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9. Jack Spencer, "Nuclear Power Federal Loan Guarantees: The Next Multi-Billion Dollar Bailout?" testimony before the Domestic Policy Subcommittee, Oversight and Government Reform Committee, U.S. House of Representatives, April 20, 2010, at *http://www.heritage.org/research/testimony/nuclear-power-federal-loan-guarantees-the-next-multi-billion-dollar-bailout*.
10. For a comprehensive solution to offshore oil spill liability, see Nicolas D. Loris, Jack Spencer, and James Jay Carafano, "Oil Spill Liability: A Plan for Reform," Heritage Foundation *Backgrounder* No. 2446, August 2, 2010, at *http://www.heritage.org/research/reports/2010/08/oil-spill-liability-a-plan-for-reform*.