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Real Energy Tax Reform Eliminates Subsidies

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Targeted tax credits have become a popular and prevalent method for the government to award preferential treatment to certain energy industries. Over the past decade, the number of tax preferences for the production and consumption of government-picked energy technologies has expanded considerably.[1] This favored tax treatment acts as a subsidy by favoring one industry or technology at the expense of another. Such political decisions misallocate resources, waste taxpayer dollars, and prematurely force technologies into the marketplace, while taking away the incentive to lower costs.

Some Members of Congress are pushing to extend and expand energy tax subsidies, but eliminating them would be best for American producers, consumers, and taxpayers. The Energy Freedom and Economic Prosperity Act of 2011(HR 3308) sponsored by Representative Mike Pompeo (R–KS) would do just that, while lowering the corporate tax rate to encourage investment and spur economic growth in America.

Not the Right Kind of Tax Cut. Lower tax rates are good, but using the tax code to pick winners and losers is not, and it has a number of adverse effects on the economic system. Special tax credits for politically picked technologies artificially reduce the price for producers and consumers—and those costs are picked up by the taxpayer. Rather than increasing competition, the energy tax subsidy distortion gives these technologies an unfair price advantage over other technologies and allocates labor and capital away from other areas of the economy where it could be used more efficiently. In effect, by politically picking winners, these tax credits crowd out investment and make it difficult for new technologies that do not receive a handout from the government to enter the market. Furthermore, targeted tax credits move the decision-making process away from the market and consolidate power with policymakers and lobbyists, who then determine who produces what products.

Companies seeking special tax treatment justify their handouts by convincing Congress that they need only a small subsidy for a limited time until their technology becomes profitable. Inevitably, successful requests for subsidies beget more requests, and soon the companies call for tax credit expansions or extensions.

Ethanol is a prime example of a policy that has enjoyed preferential tax treatment for decades, and when the 2004 Volumetric Ethanol Excise Tax Credit (VEETC) was set to expire at the end of 2010, Congress extended the credit yet another year. Now the corn lobby is pushing for tax credits for blender pumps and infrastructure technology to fur-

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ther push ethanol onto the market. The industry's continual clinging to taxpayer-funded handouts is a result of receiving the initial tax credit. Once an industry secures the initial tax credits, it will push hard to keep them from expiring, since it either keeps the business afloat or pads the bottom line.

In the event that the tax credit goes to a market-viable industry, it still has harmful effects. The tax subsidy:

1. Offsets private-sector investments that would have been made instead and wastes taxpayer dollars,
2. Creates industry complacency and perpetuates economic inefficiency by disconnecting market success from production costs, and
3. Provides policymakers the ability to tout the tax credit as a success, thereby increasing the likelihood of Members of Congress wanting to expand targeted tax credits with more lobbyists telling them they should do so.

Ending Energy Tax Subsidies. The Energy Freedom and Economic Prosperity Act of 2011 would remove all distortionary energy tax policy—meaning any tax policy that picks certain industries as winners and losers in the market—by allowing the energy tax credits set to expire at the end of 2011 to expire and by expediting the sunsetting of all other energy tax credits that extend beyond December 31, 2011, to the end of 2012.[2] Furthermore, the legislation would offset those repeals and expedited sunsets with a broad corporate income tax cut. The legislation eliminates the broad array of energy tax credits available today, such as:

- **Transportation Sector.** Tax credits exist for alcohol fuels, biodiesels, renewable diesels, hydrogen, and other alternative fuel mixtures, as do credits for certain plug-in electric vehicles, alternative motor vehicles, and alternative vehicle refueling infrastructure.
- **Oil.** The oil and gas industry has two directly targeted tax credits that are intended to kick in when the price of a barrel of oil falls below a certain price. One is an enhanced oil recovery tax credit, in which oil producers receive a 15 percent tax credit for costlier methods and technologies, such as injecting liquids and carbon dioxide, into the earth. The other is the marginal well production credit for wells that produce 15 or fewer barrels of oil per day, produce heavy oil, or produce mostly water and fewer than 25 barrels of oil per day. Representative Pompeo's legislation rightly repeals both tax credits but stays away from broad tax credits the oil industry receives that apply to many industries.[3]
- **Renewable Energy.** Throughout the years, Congress changed the Internal Revenue Code to provide a number of tax credits for large-scale and small-scale renewable generation projects including solar, wind, fuel cells, geothermal, and other qualified sources. The legislation also rightly ends the energy grant program. In lieu of receiving a tax credit, section 1603(b) of the American Recovery and Reinvestment Act of 2009 offered a direct grant from the Treasury for 30 percent of a renewable energy project's qualifying cost.
- **Nuclear.** 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. Although no producer has taken advantage of the credit—since industry has not built an advanced nuclear reactor that has come online—the bill is right to remove the credit.

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1. Molly Sherlock, "Energy Tax Policy: Historical Perspectives on and Current Status of Energy Tax Expenditures," Congressional Research Service, May 2, 2011, at *http://leahy.senate.gov/imo/media/doc/R41227EnergyLegReport.pdf* (October 24, 2011).
2. The exception is liquefied hydrogen, which expires September 30, 2014, and would expire September 30, 2012, under the Energy Freedom and Economic Prosperity Act.
3. 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.*

- **Qualifying Gasification and Advanced Coal Projects.** Tax credits are in place for gasification technologies that use high temperatures to convert coal, petrochemical residue, or biomass into a gas composed primarily of hydrogen and carbon monoxide used for industrial purposes and synthetic fuels. They are also in place for advanced coal projects that use integrated gasification combined cycle, a process that turns coal into gas, or projects that employ carbon capture and sequestration technologies, among other qualifying projects.

Lowered Corporate Tax Rate. Eliminating these economically unsound tax credits would raise revenue and thus be a tax increase, so the Energy Freedom and Economic Prosperity Act of 2011 would offset the tax increase by requiring the Treasury to lower the corporate tax rate permanently. This would offset the 10-year savings accumulated from permanent elimination of the tax credits. Not only would this ensure that there is no tax increase, but lowering the corporate tax rate would also be sound policy because it would spur investment, create jobs, and increase gross domestic product and capital stock.[4]

Important Step to Ending Energy Subsidies. Energy subsidies come in a wide variety of forms, including targeted direct expenditures, tax breaks, loan guarantees, and mandates, among others, with tax credits representing a large portion of those subsidies. The Energy Freedom and Economic Prosperity Act would take the country in the right direction: toward removing energy subsidies. Doing so will allow the most efficient technologies that provide the most value to the consumer to reach the marketplace. It is time to stop using the tax code to pick winners and losers in the energy sector.

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4. Karen A. Campbell and John L. Ligon, "The Economic Impact of a 25 Percent Corporate Income Tax Rate," Heritage Foundation *WebMemo* No. 3080, December 10, 2010 at *http://www.heritage.org/research/reports/2010/12/the-economic-impact-of-a-25-percent-corporate-income-tax-rate?utm_source=Chartbook&utm_medium=researchpaper&utm_campaign=budgetchartbook.*