

# **IRET Congressional Advisory**

August 20, 2001 No. 118

## **GOOD AND BAD TAX PROVISIONS IN THE ENERGY BILL**

The House of Representative's has passed H.R. 4, which contains much of the energy plan proposed by the Bush Administration. Ahead lies Senate consideration, and if the Senate approves an energy bill, a House-Senate conference. The Administration's energy blueprint emphasizes both production and conservation, and it looks to tax relief and incentives to achieve some of its goals. As the energy plan emerged from the House, it includes among its provisions tax changes with an estimated 10-year revenue cost of \$33.5 billion.

Are the tax provisions of H.R. 4 sensible? Some are consistent with good tax policy and a reformed tax system. Others are not. One advantage is that all the provisions would cut taxes. That would slow the growth of government by leaving Washington with less taxpayer money to spend. (This advantage would be lost, of course, if revenue offsets should be added later to the bill.)

On the negative side, a theme underlying many of the tax provisions is that the government knows better than individuals acting through free markets what to produce and consume. Attempts to influence people's behavior are most evident in provisions concerning energy conservation and alternative fuels. Four examples are a proposed 15% tax credit for certain residential solar energy expenditures, a 10% tax credit for qualified investments in clean-coal facilities with an additional tax credit for production from those facilities, a 10% tax credit for certain stationary fuel-cell power plants, and an extension and expansion of tax credits for alternative-fuel vehicles. These provisions are politically popular and have received little criticism.

One of the few such items to raise eyebrows is a proposed credit to washing machine and refrigerator manufacturers for selling energy efficient machines. The federal government, with the approval of these manufacturers, recently mandated appliance standards that will reduce energy use but sharply raise prices for washing machine and refrigerator buyers. The credit would offset some of the additional cost, preventing the drop in appliance sales caused by the government mandate from being as great as otherwise.

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Notwithstanding the political appeal of "green" tax credits and other incentives, a key economic principle should be kept in mind: people acting through voluntary exchanges in response to undistorted free-market price signals are usually better than those in government at making

good production and consumption decisions. One reason is that individuals participating in free markets have greater and more timely information than do government leaders and bureaucrats because markets continuously reveal through relative prices which products are most desired, how best to produce them, and what they really cost in terms of scarce resources. Another reason is that individuals acting through free markets have better incentives: it is their own money and well-being on the line when they make production and consumption decisions. When those in government tell others what to do, the decisions are more apt to be colored by political and bureaucratic considerations. (For a fuller discussion of the informational difficulties and incentive problems that beset government planners, see Roy E. Cordato, "Global Warming, Kyoto, and Tradeable Emissions Permits: The Myth of Efficient Central Planning," *Studies in Social Cost, Regulation, and the Environment*, No. 1, Institute for Research on the Economics of Taxation, September 1999; and Roy E. Cordato, "The Polluter Pays Principle: A Proper Guide for Environmental Policy," *Studies in Social Cost, Regulation, and the Environment*, No. 6, Institute for Research on the Economics of Taxation, April 2001.)

Thus, it is not surprising that government efforts at micromanagement are often failures. Three examples in the energy area are the gas lines of the 1970s (caused when the government misallocated gasoline supplies among regions so that some parts of the country had too much gasoline while other areas suffered government-created shortages), the Carter Administration's Synfuels boondoggle, and this year's energy fiasco in California (caused by an ill-conceived and

misnamed "deregulation" program that the State of California imposed on the electric utility industry).

It is true that carrots offered by the tax system tend to cause less harm than command-and-control mandates and quotas. Nevertheless, tax incentives are likely to do more harm than good if they are based on exaggerated external costs, if they overestimate the benefits of the actions they try to promote, or if they are poorly designed to bring about the intended results.

People use resources as long as the benefit of an extra unit covers the cost of that unit. (They stop using more of a resource when another unit

would add more to costs than benefits.) People's decisions about wise resource use include evaluating whether to spend more up front on energy efficient housing, cars, and appliances to save on future energy use. There is an optimal level of conservation, given the prices of the resources. For example, better insulation will make a home more energy efficient. But

insulation materials themselves have resource costs: their production requires energy, various non-energy natural resources, and the resources of labor and capital. Given both those costs and the savings from insulation, it is sensible to insulate a home well, but it is not sensible to add insulation without limit. Past a certain point, further insulation would use up resources with a greater value than the energy saved, and consumer well-being would fall. By artificially raising energy prices with taxes, the government already forces more conservation than the real-world availability of energy warrants. Additional steps in this direction would induce us wastefully (in terms of total resources) to curtail further our use of energy; we would be giving up

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To its credit, the Bush Administration recognizes that the government has created many barriers to adequate and efficient energy production, and has included several major non-tax provisions in its energy plan to lower those barriers. Also on the plus side, while many of H.R. 4's tax provisions would be subsidies, many others would move in the direction of tax neutrality: they would provide modest relief from existing tax biases against saving and investment, especially investment in energy production. That has the potential to enhance market efficiency and bolster growth. Provisions that ease tax biases are not tax favors. The only complaint against the pro-neutrality tax provisions in H.R. 4 is that they would not be applied more widely; ideally, such provisions should be extended to savers and investors throughout the economy.

Among H.R. 4's anti-tax-bias provisions are those that would improve the tax treatment of investment by shortening depreciation schedules. Ideally, businesses should be allowed to deduct investment costs when they incur those costs. (Being able to deduct costs in the period when they occur is known as expensing.) The tax code usually allows labor costs to be expensed, but delays the write-off of most investment costs through the use of depreciation schedules. As a result, businesses' tax deductions based on depreciation generally understate actual investment costs in present value terms, because depreciation makes no allowance for the time value of money and inflation. In response to that tax distortion, businesses underinvest and productivity suffers. H.R. 4's improvements in this area include treating natural gas gathering pipelines as 7-year property,

gas distribution pipelines as 10-year property, and petroleum refining property as 7-year property, instead of the longer depreciation lives in current law, and permitting the expensing of certain energy-efficient commercial building property and certain geological and geophysical expenditures.

The bill also contains limited relief from the alternative minimum tax (AMT). The AMT is complex, inconsistent with the regular income tax, and arbitrary. Further, the AMT on businesses has the perverse tendency to hit companies going through financial difficulties, as well as businesses that invest heavily. Ideally, the AMT should be abolished. Several provisions in H.R. 4 would take small steps in that direction by ensuring that nonbusiness energy credits, business energy credits, the enhanced oil recovery credit, and intangible drilling costs do not trigger the AMT.

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Another bias against saving and investment in the current tax system is the capital gains tax. Again, the best remedy would be to remove the tax. Short of that, one way to lessen the problem is to permit investors to defer the tax when they roll over funds from one investment to another. The energy bill would do that on certain dispositions of stock and electric transmission property made to implement federal or state electric regulatory policy. (An additional reason to permit rollover treatment in these cases is that the government is forcing many of the sales.)

As one more illustration of a provision that would improve the tax system, H.R. 4 would let oil and gas producers carry back certain net operating losses up to 5 years, instead of only the 2 years allowed under current law. In effect, a carryback provides income averaging, and a longer carryback provides more income averaging. Regrettably, the

federal government has severely restricted carryback periods in order to pick up extra revenue. A longer carryback period here is a good idea (and a better idea would be applying the rule throughout the economy).

As the energy bill moves to the Senate, it faces many challenges. With regard to taxes, one priority is to keep it a straight tax cut, which means not

adding revenue offsets. Another challenge is to restrain the apparent enthusiasm in the Senate for "green" tax subsidies. A third priority is to retain those provisions that would help correct existing tax biases.

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