

IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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ENERGY BILL COMPROMISE: TWO WRONGS MAKE A MESS

Concern over rising energy prices has spurred efforts by the Congress and the Administration to finalize an energy bill. A scaled back, compromise version of the House- and Senate-passed energy bills is being negotiated for presentation to the Congress. (The House bill is H.R. 3221; the Senate bill is H.R. 6, a House bill agreed to earlier in the Senate.)

The compromise consists chiefly of an increase in mandatory fuel economy standards for motor vehicles and mandates for increased use of ethanol in gasoline, with a requirement that a portion of the ethanol supply come from non-corn sources (such as wood chips and switch grass). Both the Congress and the White House have supported this shift toward alternative sources of motor fuel. The compromise is mainly a bow to the environmental lobby to reduce carbon emissions by a tiny amount, and will inconvenience car and truck buyers and drivers and consumers of many other products.

Other provisions of the earlier bills appear to have been either scaled back or dropped for now. These sections involve a large number of tax changes relating to energy. They include tax subsidies and credits for development of alternative fuels, for purchasing hybrid (electric/gasoline) powered vehicles or dual fuel (gasoline or ethanol 85) vehicles, and for making buildings more energy efficient. The subsidies were to be paid for by some controversial and unhelpful tax increases on domestic energy producers. As this is being written, it is not

clear how many of the subsidies and taxes are omitted from the compromise.

The rationales for the original bills were a jumble of incoherent and often conflicting promises to improve the environment by reducing carbon emissions, save consumers money by reducing global energy prices, and enhance U.S. energy independence or energy security. Neither the original bills nor the scaled down version would reduce world energy prices significantly, and would not promote energy security. They would force consumers to pay more for domestically-produced energy and drive smaller vehicles that are less crash-worthy.

One is left wondering and asking, "Why are we doing this?"

It would be better for the country if the Congress were to defer the whole issue until next year, and to start from scratch with a focus on removing government tax and regulatory obstacles to efficient energy exploration and production.

The mandates in the compromise.

Higher CAFE standards. The Senate bill contained an increase in the Corporate Average Fuel Economy standards (CAFE) from the current 25 miles per gallon to 35 miles per gallon by 2020, and would have included cars and light trucks in the

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same fleet-wide calculation for each company. The House originally had no provision. The House is reportedly suggesting a compromise, with 35 miles per gallon for cars and a separate lower standard for light trucks. The Administration and the House have insisted on the separate standard to keep domestic car makers competitive with foreign producers who have fewer trucks in their fleets.

The CAFE standards are a rather arbitrary and inefficient means of reducing carbon emissions (even assuming it is needful to do so). Car and truck producers and consumers would be forced away from vehicles they now prefer, imposing the cost of reduced consumer satisfaction with the product. Also, smaller, lighter cars are not as safe in a collision as larger vehicles. The result would be several thousand additional deaths and injuries each year.

The standards cannot be justified as a way to save on energy costs, even if the better gas mileage did not simply encourage more driving. There would be little impact on world energy prices. Even if there were, forcing some consumers to cut back on their desired use of gasoline so that others can get it cheaper is poor public policy. It is akin to observing that obese people eat a lot, driving up the cost of food for others, and recommending limits in caloric intake per person so the non-obese can get cheaper food. (Let's say 3,000 calories per adult male of average height, and 2,500 per adult female of average height, scaled for inches above and below the mean.) Absurd? You bet.

Motor fuels from renewable sources. The compromise is said to contain a significant increase (between three to four times current usage of about 6.5 billion gallons a year) in the amount of renewable fuels (chiefly ethanol) added to gasoline over the next 10 to 15 years. There would be a new

requirement that a portion of the increase come from non-food (i.e., non-corn) sources such as cellulosic ethanol.

It is very easy and cheap to obtain energy by growing corn: just trade the corn for foreign oil. We have been exporting corn and importing oil for fifty years, and it works fine. It gives us the maximum amount of motor fuel per bushel.

Transforming corn directly into motor fuel here at home is much harder. Converting corn to ethanol produces less fuel per bushel than trade, and makes fuel obtained in this manner more expensive. It also raises the prices of cereal, beverages sweetened with corn syrup, and meat from corn-fed animals. It makes other foodstuffs cost more by diverting land to corn growing. It drains scarce U.S. water resources in the corn belt. It is not a good deal.

Cellulosic ethanol technology is still in its infancy. This fuel is years away from being available in the quantities demanded in the legislation, and the cost is still unknown, although it will surely be higher than that of fuel from conventional sources. Mandating its use years in advance of the technology is an act of faith turned into an act of Congress.

The environmental benefits of ethanol have been greatly exaggerated. One must factor in the energy/carbon cost of growing the corn and refining and transporting the ethanol, and the reduced energy efficiency of ethanol blended gasoline in powering vehicles. Any resulting energy or carbon saving is minimal.

Electricity generation from renewable sources. The House bill would have required producers of electricity to obtain 15 percent of their output from renewable fuels, chiefly wind and solar (and not

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nuclear) by 2020. This should be dropped from the package. Wind and solar power are not ready for prime time. These generation methods require large subsidies to be marketable, meaning the total cost of electricity from these sources is greater than from conventional sources. The mandate would simply require utilities to use more of these alternative sources without a higher federal subsidy, forcing the additional cost onto the rate payers instead of the taxpayers. (Pay me now or pay me later!)

Wind and solar power are not suited to all areas of the country. The South, for example, has little opportunity to generate wind power. One hears the argument that southern state utilities could meet their obligations under the mandate by buying "offsets" to encourage wind farms in other parts of the country. That would still raise the cost of energy for southern utility customers, as the cost of the offsets would have to be included in the rate base.

The one reasonably competitive, clean, and potentially abundant alternative technology is nuclear power, but that was not allowed to count toward the electricity mandate. If the Congress really wants to be helpful in finding clean additional energy sources, it could give nuclear power a boost by removing government-imposed barriers. It could finally open the Yucca Mountain depository for spent nuclear waste, and streamline the approval process for nuclear power plant design and construction. If Congress absolutely must dump money into research, then it might consider supporting development of the ultra-safe pebble-bed reactor concept.

The tax package: subsidies, credits, and tax hikes.

As this is being written, it appears that the alternative energy and conservation subsidies and credits and the tax package to pay for them will be largely scaled back or dropped from the bill. They may be considered separately at a later date. Postponement would be fortunate on two counts: the

energy credits and subsidies would be a waste of money, and the tax increases selected to pay for the subsidies and credits would be very bad, discriminatory tax policies that would raise energy costs.

The credits and subsidies.

The House and Senate bills included extension of existing credits and enhanced depreciation allowances for energy production from renewable sources by companies and homeowners, for clean coal programs, for enhancing energy efficiency of buildings and homes, for the purchase of hybrid or other alternative fuel motor vehicles, for cellulosic alcohol, biomass, and biodeisel production, and installation of alternative refueling facilities.

Combined with the biofuels mandate, they are President Carter's Synfuels program and his moral equivalent of war initiative (MEOW) redux, but inflated and repackaged in environmental garb. Rising energy prices should be sufficient to

encourage research into alternative fuels and vehicles, and to motivate consumers to shift to more energy efficient cars and to take other conservation steps, without the government dictating the details or pouring money into the effort.

The tax increases.

The taxes in the original bills would reduce energy production by U.S. based companies and raise prices. They would make it harder for U.S. companies to obtain foreign leases or to participate in consortia to develop and market foreign-source energy, leaving more of those activities for foreign private and state-owned companies. That would reduce the influence of U.S. firms and the U.S. government over global energy production and marketing, which would impede U.S. "energy security," if in fact that concept has any meaning to begin with.

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Denial of the manufacturing deduction (Section 199) to certain producers of domestic energy. The House bill would disallow the deduction for all domestic producers of oil, gas, and derived primary products; the Senate bill would end the deduction only for the major integrated oil companies. Section 199 allows a 9% deduction from income from manufacturing and certain food and natural resource processing activities. It effectively cuts the corporate tax rate from 35% to 31.85%, with a similar reduction in non-corporate tax rates. It replaced the DISC, FISC, and ETI credits to promote U.S. exports that were ruled illegal by the WTO. It would make more sense to reduce corporate and small business tax rates across the board, for manufacturing, mining, farming, and services. Nonetheless, if a fairly general reduction for manufacturing and processing industries is on the books, there is no legitimate reason to deny it to the energy sector. It would reduce energy output.

Tighter foreign tax credit limitations for the oil and gas industry (changes to FOGEI and FORI rules). This provision would make U.S. firms less competitive in their foreign operations, and reduce U.S. influence on the development and marketing of global energy resources.

Longer amortization period (seven years instead of five) of geological and geophysical expenditures for integrated oil companies.

Amortization (like depreciation) arbitrarily delays the recording of costs for tax purposes to accelerate tax payments. In present value, it understates cost and overstates profit over the life of the asset. The optimal tax treatment would be immediate expensing, which argues at least for shorter rather than longer write-off periods.

Coal tax? There has been some mention of a possible coal excise tax to fund some subsidies in the

compromise. Coal is the primary fuel for electricity generation, and it is an important source of heat for producing steel and other metals in the United States. Taxing the leading source of domestic fuel for electricity production cannot enhance energy independence, and would surely drive up prices for consumers.

The energy security mirage.

The concept of energy security or energy independence is inane. Energy independence would be pointless and impossibly expensive.

The United States produces more than enough oil domestically to fuel any conceivable military need. As for civilian use, most of our energy imports come from our neighbors Canada and Mexico, and from other friendly nations abroad. If a handful of foreign energy producers tried to cut off sales to the United States, and to sell to others instead, we would redirect our purchases to other suppliers, and other purchasers would buy more from the boycotters and less from the sources supplying the U.S. (E.g. if Hugo Chavez decides to sell Venezuelan gasoline to China instead of the U.S., we will buy more from Asia and Africa, and China will buy less from Asia and Africa.)

The only way a potential foe could raise our energy costs significantly would be to withhold its production from all buyers, to restrict world output. In that event, we would carpool, and the boycotters would starve. (Venezuela would have a budget meltdown, and have no money to pay for imports of food, consumer goods, or arms.) In fact, we could probably afford to bid the remaining oil away from other customers, and they would carpool or revert to mopeds and bicycles.

Perhaps the real security issue is a concern that potential foes are earning a fortune from oil and gas,

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and may use the money to arm themselves, or stir up trouble in the world. In that case, we need to reach an accommodation with (or work toward a change in) the governments in question. No reasonable unilateral drop in U.S. demand for energy could drive down world energy prices enough to starve the budgets of one or two nations we don't like. It would wreck our economy to try, and other nations would benefit greatly if we were to leave all the world's cheapest energy for their use.

We could make a moderate dent in our imports, and possibly reduce global energy prices a bit, if we

were to open up the areas of the United States that are currently closed to energy exploration. These include the ANWR, the continental shelves along the east and west coasts and the eastern Gulf of Mexico, and federal lands in the west. That, and expediting the use of nuclear power, would do much more to make a dent in energy prices for American consumers and reduce our reliance on oil imports than anything in the energy bill compromise.

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