

IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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ENERGY PRICE BILL – S. 3044 – UP FOR CONSIDERATION

The Senate is again considering energy legislation that failed to pass last year. The bill (S. 3044 – the Energy Price Bill) would raise \$17 billion in revenue by denying the use of existing tax provisions to the largest energy companies (those that produce over 500,000 barrels of crude oil a day), and would impose a 25% windfall profits tax on major integrated oil companies and use the tax proceeds to fund research into alternative fuels. The tax revenue would be directed to a trust fund to support research into alternative fuels. The bill contains an anti-price gauging provision.

The tax provisions would reduce energy production by U.S. based companies and raise fuel prices. They would make the United States even more dependent on foreign oil. 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. The anti-price gouging provision is so vague as to be unenforceable, and would do more harm than good if any attempt were made to make it work.

Windfall profits tax.

Been there, done that, regretted it mightily. The windfall profits tax would discourage production by U.S. companies, especially here at home, and would raise prices of gasoline and other fuels. The tax

would make us even more dependent of foreign oil, just as it did in the 1970s and early 1980s. The energy industry has highly cyclical profits. Over time, these profits are very much in line with those of most other industries. Capping the industry's profits at the peaks would reduce average profitability and reduce investment in the sector, driving capital into other industries or offshore. The U.S. based companies would find it harder to compete with foreign rivals for supplies and reserves elsewhere in the world.

Denying standard tax treatment to large oil companies – \$17 billion over ten years.

Denial of the manufacturing deduction (Section 199) to certain producers of domestic energy. The bill would disallow the manufacturing deduction for all domestic producers of oil, gas, and derived primary products for the major U.S. based integrated oil companies (but not for their foreign-owned competitors in the U.S. market). 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.

Anti-price gouging provision.

The bill would outlaw selling oil and its products for "unconscionably excessive prices" in an area under a Presidential declaration of an energy emergency. "Unconscionably excessive price" is impossible to define. One supposes that, like pornography, the judge "will know it when I see it."

Such provisions are guaranteed to be both a legal nightmare to implement, and an economic nightmare if enforced. In the event of a serious energy shortage in a region, the remaining supplies should be directed to the most essential uses. That can best be achieved by price rationing. Price increase would also attract more supplies from outside the region, helping to moderate the shortage. Short-circuiting the price mechanism is a recipe for disaster.

A case in point, on a broader scale, was the fiasco in Charleston after hurricane Hugo. After the storm, people all over the eastern half of the country loaded up trucks with building supplies, generators, and ice, and headed for the city. They were acting as arbitragers, buying where goods were cheap and available, and hauling them to where they were in short supply and expensive, which would bring prices down in the affected area. But the mayor of

Charleston slapped on price controls. The flow of goods came to an abrupt halt. People who were bringing supplies stopped at the city limits, instead of coming into town and selling the supplies in the neighborhoods. If you needed building supplies, you had to make your way through storm-ravaged streets to get to the suburbs to pick them up.

Generators were in short supply, but shop owners could not reserve them for the highest bidders. They were sold out, first come first served, even if the buyer merely wanted to cool his beer and run his television. Left hanging were operators of gas stations who needed to restore power to their pumps, owners of food stores who needed to restart refrigeration to save their milk and meat, and owners of drug stores who needed to cool perishable medications, such as insulin. With the ice and foodstuffs stuck in the suburbs, and the gasoline stuck in the pumps, only the fortunate few could drive on out to the suburbs to get the relief supplies.

Using the tax revenue for an Energy Independence and Security Trust Fund.

The bill would put the taxes raised into an Energy Independence and Security Trust Fund. It would spend the money to support research into alternative fuels. The Congress has no particular insight into what sort (if any) of alternative fuels would prove cost effective, or what research would be the best route to discover them. The cost and risk of such ventures should be left for the private sector, not put on the taxpayers.

Previous efforts by Congress to mandate alternative fuels have not worked well. We have seen the food price consequences of the ethanol mandate, which has contributed to high world food prices and to rioting and death in many countries. Further meddling in energy markets by well-meaning but clueless governments should be avoided.

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. Gambling on this research 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.

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 in order 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, 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 by removing excessive licensing delays, would increase energy supplies, reduce electricity and fuel prices, and reduce our reliance on oil imports.

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