

IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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THE "GANG OF 10'S" ENERGY PROPOSAL

While Americans pay \$4 per gallon at the gas pump, vast domestic reserves of oil, gas, and coal are being kept from development because of government edicts. Ten senators, five Democrats and five Republicans, have introduced a compromise plan that would tinker with the restrictions.¹ The Senators call their plan the New Energy Reform Act of 2008 (New ERA), although they have not yet formally introduced it in legislative form.² A far more sweeping reform would better serve the nation.

With energy prices at heights that would have been nearly unimaginable just a few years ago, it would make sense to allow drilling in most of the areas the federal government has placed off limits, while retaining no-trespassing signs in only a few places of genuine environmental sensitivity.³ The self-described "Gang of 10", however, proposes to unlock only a small portion of the reserves that are now off limits. In return, the senators would impose higher taxes on major oil companies, pour more taxpayer money into subsidies for uneconomical alternative fuels, and demand greater cutbacks in energy use from American households and producers.

The main features of the "Gang of 10's" plan

The heart of the "New ERA" proposal is \$84 billion of additional federal spending, mostly for alternative energy programs. These include "a \$20 billion 'Apollo Project' like effort to support the goal of transitioning 85% of America's new motor vehicles to non-petroleum-based fuels within 20

years."⁴ Six examples of where the money would go are: \$7.5 billion to help the auto industry "to re-tool and re-equip ... in making alternative fuel vehicles," a consumer tax credit of up to \$2,500 to retrofit existing vehicles to run on alternative fuels, a consumer tax credit of up to \$7,500 to buy alternative fuel vehicles, tax incentives for alternative fuel pipelines, \$2.5 billion for R&D on "next generation biofuels and infrastructure," and "grants and loan guarantees for ... coal-to-liquid fuel plants with carbon capture capability."⁵ The government would deliver the money through tax credits, other tax incentives, loans and grants, and explicit outlays. In nearly all these cases, the fuel savings are not worth the cost. Oil would need to be far above its current price to justify these retrofits and other changes, and if it were, then people would make the changes without government subsidies.

A second part of the plan is \$84 billion of tax increases and other revenue raisers to offset the added spending. Almost \$30 billion of this would come from the oil and gas industry in higher taxes and other charges. In particular, the plan would retroactively change the terms of some existing oil and gas leases in the Gulf of Mexico, and it would deny the major oil companies the section 199 tax deduction that U.S. manufacturers and producers received in the American Jobs Creation Act of 2004 (a 9 percent deduction that effectively reduces the corporate tax rate to 31.85 percent). The proposal calls for nearly \$55 billion of other revenue raisers from elsewhere in the economy, but does not say whose taxes would go up.

A third component of the plan would allow drilling in one area where the federal government now bans it, and would give four states the option of lifting the federal drilling ban in some other areas. Specifically, the plan would permit drilling in the eastern Gulf of Mexico if the drilling occurs at least 50 miles off the coast. (The government now prohibits drilling within 125 miles of the eastern Gulf coast.) In addition, the federal government would permit four states (Georgia, the Carolinas, and Virginia) to authorize drilling in Atlantic waters at least 50 miles off their coasts. However, the plan would explicitly create a no-drill zone for waters that are within 50 miles of most of the Atlantic and eastern Gulf coasts.

The drilling provisions are weak

The "New ERA" proposal is modest in terms of the added drilling it would allow. Furthermore, the plan misses many opportunities to provide more domestic oil, at lower cost, to U.S. consumers and businesses. Instead, it is a "use the expensive stuff first" plan.

The "New ERA" proposal would decree that waters within 50 miles of the eastern Gulf coast and most of the Atlantic coast are no-drill zones. That would keep off limits large oil and gas reserves that could be tapped more economically than reserves farther out. Further, the plan would do nothing to free the huge, immensely valuable oil and gas reserves in northern Alaska lying below the Arctic National Wildlife Refuge (ANWR). Those vast quantities of U.S. oil, which could economically replace hundreds of billions of dollars of foreign oil, would stay in the ground unused.

The proposal does not address government restrictions that prevent developing the enormous reserves of shale oil on federal lands in the Western states. It is estimated that there is more oil in shale deposits in Wyoming, Colorado, and Utah than in the oil fields of Saudi Arabia. Companies are devising new, cheaper, and more environmentally friendly ways to "crack" shale and release oil in

shale deposits on private land from Texas to Pennsylvania, but they are barred from looking in the most promising regions under federal control in the West.

The proposal also misses the opportunity to streamline the regulatory approval process and to rationalize the thicket of regulations, studies, and lawsuits that often slows down or stops drilling in new areas. The plan also would not clear away any of the legal obstacles that have prevented a single new U.S. oil refinery from being built since the 1970s. The government-induced squeeze on domestic refining capacity makes this country more dependent on foreign refineries and pushes up gas prices at the pump.

Tax increases would restrict output and raise prices

Although the "New ERA" package is advertised as an energy program, it also includes \$84 billion in higher taxes and other revenue raisers.

The majority of the money, about \$54 billion, would come from unspecified tax increases.⁶ The lack of detail is not reassuring. It suggests that the "Gang of 10" either did not consider which taxes to boost or could not find any good candidates. Many possible revenue raisers commonly considered by the Congress would worsen tax biases against saving and investment or further complicate an already overly-complex tax system. We should not be asked to buy a pig in a poke. The approximately \$54 billion of unnamed tax increases should be identified as soon as possible, so that we can compare the full tax and economic costs of the program to the benefits.

The remaining \$30 billion would be collected from the oil and gas industry. The added taxes and fees on domestic oil producers would reduce domestic production and increase gasoline prices, just the opposite of the stated goals of the "New Era" reform bill. These provisions are reminiscent of similar anti-energy steps taken in the 1970s, and would have the same unfortunate results. The "New

Era" looks a lot like the Nixon, Ford, and Carter period.

If major oil companies are denied the Section 199 tax deduction for domestic production, they would have to become more selective regarding which future projects to undertake. Because of the bigger tax bite (due to the lost deduction), some projects that are economically feasible under current law would become infeasible. Smaller oil companies and foreign companies would pick up some of the slack, but the overall effect would still be negative.

The proposed retroactive change in the terms of some federal oil leases, requiring oil companies to pay higher royalties to the government, would also hurt production and future investment. Government-imposed changes in existing leases and contracts is a political risk more commonly associated with countries like Russia and Venezuela than the United States. Businesses normally respond to political risk by cutting back new investments until the expected returns of those that remain climb high enough to cover the added uncertainty, in addition to all other costs.

By opening more of the outer continental shelf, the "Gang of 10's" plan might increase domestic oil production, despite the taxes. However, a proposal that claims that two of its goals are higher oil output and lower oil prices should not include new taxes on the industry.

Expensive alternatives favored over cheaper traditional supplies

In contrast to the tax hikes on producers and consumers of traditional fuels, producers and consumers of alternative fuels would receive approximately \$84 billion of additional tax credits, loan guarantees, research grants, and other government subsidies. The government is already aiding the wind, solar, and biomass energy industries with mandates and generous subsidies. Indeed, these industries could scarcely exist without federal aid. In spite of this assistance, alternative fuels supply

only a tiny fraction of total U.S. energy production, about 4% for wind, solar, and biomass in 2007.⁷ Petroleum, natural gas, coal, nuclear, and hydroelectric furnish about 96% with little or no subsidy, and at lower cost.

Because people respond to incentives, the subsidies in the "Gang of 10's" plan would definitely increase the share of U.S. energy generated by alternative fuels. But is it worth it? These new fuel sources are more costly than increasing output of the more traditional fuels. What, if any, benefit do we get for paying more? Are there any environmental benefits or "energy independence" benefits? Are they worth the cost? The evidence is not encouraging. Many alternative fuels are far more expensive than conventional fuels or have performance shortcomings; otherwise, the market would have embraced them without any need for government prodding. Also, many alternative fuels are not better for the environment than conventional fuels. Consider two examples.

- Ethanol production is booming thanks to mandates and generous tax subsidies. However, ethanol is more expensive than normal gasoline when one counts both its subsidies and its market price. Even though ethanol comprises only a small share of the fuel at the gas pump, its production is already consuming about one-third of the U.S. corn crop, which has raised food prices significantly. The higher grocery bills are painful to American consumers and disastrous to many struggling families in poorer nations. Despite its costs, ethanol does not lead to much, if any, reduction in fossil fuel consumption because fossil fuel is used to grow and harvest the corn, convert it to ethanol, and then meet ethanol's special transportation requirements. In addition, as more land is plowed under to grow more corn to burn, soil conservation suffers, and the need for fertilizers and pesticides rises.⁸

- Many early automobiles featured what would now be called unconventional power sources, such as steam and electricity. In 1900, electric cars outsold gasoline-powered cars.⁹ However, despite the

efforts of Thomas Edison and others to improve electric cars, gasoline-powered and diesel-powered automobiles soon became the standard because they offered greater economy and a longer driving range. Billions of dollars have been spent since then to develop efficient, low-cost alternative-fuel automobiles, but they continue to be expensive and require heavy subsidies to attract buyers. (Over time, alternative-fuel engines have improved, but gasoline and diesel engines have benefitted from their own technological breakthroughs and, if anything, improved even more.) Leaving aside cost, an electric car is not a zero-pollution vehicle when one considers the energy needed to manufacture it and the electric power plants needed to charge it. For instance, an electric car charged from a coal-fired electric plant will not necessarily be less polluting than an automobile powered by a conventional gasoline engine.

As these examples suggest, some alternative fuels have high monetary, environmental, and other costs and should not be encouraged through government mandates and subsidies. Further, the notion that alternative fuels can quickly and easily replace conventional fuels is a fantasy, barring major technological breakthroughs. With current technology, a drastic shift to alternative fuels would require wrenching changes in Americans' lifestyles. It would sharply lower standard of living in this country, and adversely impact the international competitiveness of U.S. businesses and workers.

Some practical alternatives

As mentioned earlier, the government should also allow oil and gas exploration and development in most of the offshore waters that would remain padlocked under the "Gang of 10's" proposal. It should open ANWR. Washington should lower the legal barricades that have blocked new oil refiners in the United States for over a generation. (As Europe and Canada have demonstrated, this can be done while maintaining high environmental standards.) It should let America's shale oil deposits replace some of the foreign oil we import.

Hydroelectric and nuclear power are practical with current technology, emit minimal carbon dioxide, and can replace large amounts of fossil fuels in generating electricity. The "New ERA" plan does nothing for hydroelectric power. It has some nuclear proposals. One would allow faster tax depreciation of new nuclear plants, making them cheaper. Another is the hiring of more staff at the Nuclear Regulatory Commission, on the assumption that more government regulators would speed up the current cumbersome approval process for design, construction, and operation of nuclear power plants. A more powerful initiative, though, is missing from the plan: streamline the nuclear regulatory process itself. France illustrates the potential. It generates about 80% of its electricity from nuclear energy and successfully reprocesses the fuel, without incurring outrageous costs or compromising safety.

There is one energy area in which government subsidization *might* make sense. That is basic research. (A great deal of research is already being done by the private sector without risking taxpayer money.) We could stumble upon some technological breakthrough that would turn some alternative resource (wood chips? switch grass? cosmic rays?) into a new, low-cost energy source that would force prices down for all types of energy. That does not require all U.S. consumers to go through the added cost and difficulty of switching prematurely to other, more expensive sources that have not yet achieved the cost savings. In particular, it would be foolhardy to pass legislation that requires people to use the breakthroughs before they are invented, on the assumption that they will necessarily occur if the government just spends more (taxpayer) money and issues more mandates.

More drilling would lower oil prices in the short and long runs

Some people argue that the current high price of oil is not a good reason to increase domestic oil and gas drilling because it would be years before most of the added production became available to start bringing down prices.

One response is that we'd be in better shape now if the government had relaxed some of its drilling restrictions 10 years ago. In other words, if we care about how much we'll be paying for oil several years from now and how much wealth we'll be transferring in the future to oil-rich foreign governments, many of them unstable or authoritarian, then it makes excellent sense for Washington to act now (although 10 years ago would have been better) and allow fuller use of this nation's own energy resources.

A second response is that we will start feeling some relief at the gas pump fairly quickly. The explanation is that many foreign and domestic oil producers have some flexibility in the rate at which they extract oil. If they expect oil prices to be lower in the future, they have an incentive to produce more now while the price is high. On the other hand, if they think oil prices will remain high or move higher, they have less motivation to raise current output. By easing its drilling restrictions, the U.S. government can boost future domestic oil output and lower expected future prices. Many producers around the world will respond by pumping more oil in the near term, and prices will begin falling as soon as that happens.¹⁰

The decline in oil prices will be strongest if more drilling is combined with some of the practical initiatives mentioned in the previous section.

Breaking some basic laws (of economics)

When the demand for a product increases, the private sector normally tries to meet that demand by increasing output in the most economical way. The cheapest methods and resources are used first, with increasingly costly sources taken in turn. This is the normal approach to meeting consumers' needs. It gets the most value out of available resources, and gives customers their energy at the lowest possible price. In economic terms, it is why "supply curves" slope up (i.e., to get more, you must pay more.)

As energy demand continues to grow, and the easiest and cheapest sources have been tapped and depleted, it will be more costly to provide additional supplies. Unfortunately, our government, and others around the world, seem bent on making the situation worse. They are blocking the use of the next-cheapest sources, and forcing us to leap over them to greatly-more-expensive alternatives that we would not normally touch for decades, and that may turn out to be completely impractical. These policies cut out the middle of the supply curve, and make us jump to the upper reaches. The result is a far higher price for any given amount of energy, forcing us to use less and to reduce our standard of living.

This sort of misbegotten policy is not new. For years, governments all over the world have intervened in energy markets. Low-cost sources have been made expensive through heavy taxation. High-cost sources have been made to appear cheap due to heavy subsidies. The market has been distorted. Investment has been lured into inappropriate projects. The population has been forced to pay more for any given amount of energy. That was bad enough. To further distort the market going forward when prices are already high and world demand is growing rapidly is to make a bad situation much worse.

The Gang of 10 proposal would raise the price of energy from proven, relatively cheap sources and technologies, would spend billions to encourage production from more expensive sources of energy, and would gamble that this as-yet-undeveloped upper end of the energy supply curve will actually exist when we need it.

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Endnotes

1. The group's leaders are Senators Kent Conrad (D-ND) and Saxby Chambliss (R-GA). Other members are senators Bob Corker (R-TN) Lindsey Graham (R-SC), Johnny Isakson (R-GA), Mary Landrieu (D-LA), Blanche Lincoln (D-AR), Ben Nelson (D-NE), Mark Pryor (D-AR), and John Thune (R-SD).
2. "New Energy Reform Act of 2008; Roadmap to a Secure Energy Future," accessed at http://landrieu.senate.gov/news/08.08.01_New_Energy_Reform_Act.pdf. Also see Senator Mary L. Landrieu, "Landrieu, 'Gang of 10' Unveil Bipartisan Plan to Lower Gas Prices, Break Gridlock," Press Release, August 1, 2008, accessed at <http://landrieu.senate.gov/~landrieu/releases/08/2008805B17.html>; and Senator Johnny Isakson, "New Energy Reform Act of 2008; Roadmap to a Secure Energy Future," accessed at <http://isakson.senate.gov/press/2008/081308newera.htm>.
3. Enormous advances in drilling and production technology in the last forty years have greatly diminished the chance of a major oil spill. Seabed shut-off valves and other safety features have allowed the production facilities in the Gulf of Mexico to weather some of the worst storms on record without spilling a drop. It is time for this new technological reality to enter the environmental calculus. There are a few special scenic areas that ought to be left pristine. But it is doubtful that energy production per se would damage either the land, the water, or the wildlife. The construction phase of some projects might temporarily annoy wildlife, but could be arranged almost everywhere to avoid migration and breeding periods.
4. "New Energy Reform Act of 2008; Roadmap to a Secure Energy Future," *op. cit.*
5. "New Energy Reform Act of 2008; Roadmap to a Secure Energy Future," *op. cit.*
6. The "Gang" says, "Remaining offsets will be finalized in consultation with the [Senate] Finance Committee..." ("New Energy Reform Act of 2008; Roadmap to a Secure Energy Future," *op. cit.*)
7. See U.S. Energy Administration, "Renewable & Alternative Fuels," accessed at <http://www.eia.doe.gov/fuelrenewable.html>.
8. Importing ethanol from Brazilian, where it is produced from sugar cane, would be somewhat less costly and energy inefficient, but the United States blocks that with a protectionist tariff.
9. See "The History of Electric Vehicles; The Early Years - Electric Cars (1890 - 1930)," About.com, accessed at <http://inventors.about.com/library/weekly/aacarselectrica.htm>.
10. For a fuller discussion, see Martin Feldstein, "We Can Lower Oil Prices Now," *The Wall Street Journal*, July 1, 2008, p. A17, accessed at http://online.wsj.com/public/article_print/SB121486800837317581.html.