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Senate Energy Bill Tax Title Hikes Taxes and Promises Higher Prices for Consumers

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Taxing successful energy sources and subsidizing unsuccessful ones—that is the essence of Washington's energy policy during the 1970s and early 1980s, and it would be repeated by the Senate's version of the House's energy bill (H.R. 6). The bill would raise taxes by an estimated $28 billion over 10 years, mostly from the oil and natural gas sector, and spend much of this money on tax breaks for alternative energy sources like ethanol and wind power. If history is any guide, this approach is likely to backfire, raising prices and reducing energy security.

The Wrong Weapon in the Energy Battle. The tax title of the energy bill proposes a number of tax code changes, the combined effect of which would be to raise taxes paid by companies working to expand oil and natural gas supplies. This includes measures eliminating or reducing some existing deductions against income from energy production, most notably the manufacturer's deduction created by the American Jobs Creation Act of 2004. This deduction, which applies to domestic industries, would be modified to exclude major oil companies. The change would raise taxes on new oil and gas production by $9.433 billion over 10 years. The bill would also impose new taxes, such as a 13 percent excise tax on oil and gas from the Gulf of Mexico that is estimated to raise $10.644 billion over the next 10 years.

Consumer anger over high gasoline prices sparked Congress's current drive to pass energy legislation, but these measures will not offer any relief at the pump. Simply put, the current tax code has nothing to do with recent increases in energy prices, so Washington-style tinkering with it will not benefit the driving public.

Congress's misconception is a common one. The legislation's underlying assumption that the domestic oil and gas sector is currently undertaxed may be popular political rhetoric but is not supported by the evidence. By many measures, energy companies face tax rates comparable to or higher than those of other industrial sectors. For example, the average effective tax rate for major integrated oil and natural gas companies is 38.3 percent, which is actually higher then the average rate of 32.3 percent for the market as a whole, according to the Tax Foundation.[1] And these taxes have risen along with oil company profits. According to Department of Energy data, total income taxes paid by this sector reached a record $71 billion in 2005, the last year for which complete data is available. This was up from $48 billion in 2004 and $32 billion in 2003. Revenues from other taxes on the oil and gas sector also rose.

The Senate's proposed tax increases would likely reduce supplies and increase prices in the years ahead by discouraging investment in domestic drilling for oil and natural gas. America's demand for

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energy is growing along with its economy, and so it will need more domestic oil and natural gas supplies in the years ahead. However, raising taxes on energy would move America in the opposite direction, because it would raise the cost of capital for exploration and production, making some domestic energy projects less viable.

The Senate's tax provisions also undercut the energy security rationale that some proponents offer for the bill. The tax crackdown on domestic oil producers would give OPEC and other non-U.S. suppliers, whose imports would not be subject to most of these provisions, an advantage over U.S. producers.

The bottom line is that these tax measures would reduce domestic supplies of oil and gas, leading to increased imports to fill the void. And assuming that demand continues to grow, these provisions would raise prices for consumers.

This is the lesson of the infamous windfall profit tax (WPT) on oil firms imposed under the Carter Administration in 1980 and repealed under the Reagan Administration in 1988. Anger at "big oil" over high prices helped lead to this punitive tax. According to the Congressional Research Service, "The WPT reduced domestic oil production from between 3 and 6 percent, and increased oil imports from between 8 and 16 percent. This made the U.S. more dependent upon imported oil." There is little functional difference between the WPT and the tax hikes in the current Senate energy bill.

Subsidizing Unsuccessful Energy Sources. Much of the extra revenues generated from the energy bill's new taxes would be used to subsidize politically correct alternative energy sources such as ethanol and wind power. The bill includes both tax incentives to build plants that generate alternative energy and tax credits on the energy sold.

These policies have been tried before, with dismal results. The 30-plus-year history of federal attempts to encourage alternative energy sources contains numerous failures and few, if any, successes. Indeed, many of the recipients of tax breaks and incentives in the Senate bill have been subsidized for decades (for example, ethanol has enjoyed preferential treatment since 1978), with the goal that they would become viable within a few years and then go off the dole and compete in the marketplace. But this has never happened.

In addition to the tax breaks, other portions of the bill mandate that certain amounts of these alternatives be used. Thus, their producers will enjoy both favorable tax treatment and a guaranteed market, all at taxpayer and consumer expense.

Even after decades of assistance, alternative sources still provide only a small fraction of America's energy needs. For example, wind and solar energy generate only a few percent of America's electricity, due to their high costs and unreliability. Congress seems indisposed to learn that these alternatives have serious economic and technological shortcomings, which is why they needed special treatment in the first place.

Conclusion. The Senate's energy bill raises taxes on the energy sources America relies upon, namely oil and natural gas, in order to subsidize alternatives with unpromising track records. Raising taxes on what works and heaping subsidies on what does not was bad energy tax policy in the past and it will not fare any better this time around.

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1. Scott A. Hodge and Jonathan Williams, "Large Oil Industry Tax Payments Undercut Case for Windfall Profits Tax," Tax Foundation, January 31, 2006.