Power Lunch

Eliminating Oil Subsidies: Two Cheers For President Obama

Jerry Taylor and Peter Van Doren 05.03.11, 6:00 AM ET

Last week President Barack Obama responded to rising public anger over soaring gasoline prices by banging the drums for the elimination of various tax breaks enjoyed by the oil and gas industry. Although House Speaker John Boehner, R-Ohio, initially suggested that he might be open to President Obama's proposal, the House GOP leadership chose to answer the president's weekly radio address--which advocated elimination of those tax breaks--with freshman Tea Party Congressman James Lankford, R-Okla., who charged that the plan was about "hiking taxes by billions of dollars."

"The president may think he's punishing CEOs of big companies," said Lankford, "but his plan will hurt the everyday consumer of energy and imperil the jobs of millions of hardworking people in American-based companies."

First of all, let the record show that President Obama is right and the GOP is wrong about these tax breaks. They make the economy less--not more--efficient and do nothing to reduce prices at the pump.

Although the president hopes to eliminate eight specific tax breaks--which cost the Treasury $43.6 billion over 10 years--only three, accounting for $31.9 billion of that total, are particularly important. Conservatives have no business defending any of them.

The largest tax break at issue is a tax credit passed in 2005, which is available to all U.S. manufacturers. Oil and gas companies qualify for that credit, so they will likely deduct somewhere in the neighborhood of $18.3 billion from their tax bill over the next 10 years. Note that this isn't really an "oil subsidy"; it's a manufacturing subsidy that oil and gas companies--along with many other companies--enjoy.

Rigging the tax code to make investments in manufacturing artificially more attractive than investments in something else is an enterprise designed to harm non-manufacturers for the benefit of ... manufacturers. Conservatives who want government to leave markets alone have no business throwing their political bodies in front of this tax break. If their political rhetoric means anything, they would see the president's bid and raise him by calling for total repeal of this tax break for *everyone*, not just for oil and gas companies.

Another significant tax break allows companies to accelerate the deductions of the costs of labor and various other inputs associated with drilling oil or gas wells. Now, there's nothing wrong with deducting the cost of doing business from one's tax bill. In other industries these expenses would be capitalized and deducted over time as income is earned. But in the oil and gas sector, the tax code allows oil and gas firms to deduct 70% of these expenses in the very first year of a well's operation and the remainder over the next five years. These accelerated deductions are far more valuable to small producers than they are to large producers because the Alternative Minimum Tax for vertically integrated oil companies usually prevents "Big Oil" from using this tax break to its advantage. Still, it will likely cost the treasury $12.4 billion over the next 10 years.

Finally, small oil companies (not, incidentally, "Big Oil" companies) are allowed to deduct a specified percentage of their gross income from the taxes due from producing fields rather than simply deduct the actual costs of the capital investment over time. The subsidy arises when the deductions exceed the actual investment costs. This aspect of the tax code will cost the treasury $11.2 billion over 10 years.

There is no good economic argument for either of these tax breaks. They are simply statements that "we won't tax you for the cost of doing business like we would if you were in any other industry because ... we like you!"

Many conservatives argue that the elimination of these energy tax provisions and others like them for other sectors are tax increases. They are correct in a narrow sense. But in a larger sense they are incorrect because the elimination of such tax provisions makes the tax code more neutral and a more neutral tax code is a more conservative tax code.

Whether you call them "subsidies" or "purple roses," what's going on here is the elimination of a favor not provided to other tax-paying businesses. Such favors direct private investment to the favored businesses and away from the unfavored as market actors chase the artificially higher profits in the favored sector. And such favors are as much a part of big government as explicit appropriated spending. Tax breaks like this constitute big government on the sly. The size of government is best measured by its total effect on the allocation of resources--not by some crude and incomplete accounting of the government's tax bite.

The Republican charge that eliminating these tax preferences will increase prices at the pump is for the most part nonsense. Given stable demand, oil prices are determined by whatever factors increase or decrease production anywhere in the world. So the relevant question is whether elimination of these tax provisions--i.e. decreasing the profits of those producers who enjoy these tax deductions – will decrease production.

One possibility is that the composition of producers changes rather than the volume of production. Remember that these tax provisions apply mostly to small, non-vertically integrated companies. So eliminating these preferences reduces the relative advantage of being a small rather than a large producer, and mergers and acquisitions--not changes in output--will follow.

A second possibility is that the elimination of the tax provisions reduces excess profits in the oil and gas sector but not output because none of the marginal wells in the world oil market are located in the U.S. That is, given the large gulf between the market price for crude and the production cost of crude for the recipients of these tax breaks, all that will change is the value of mineral rights in the U. S.

A third possibility is that some wells in the U.S. have high enough costs that even with a price above $100 a barrel, investors won't bear the risk of production without the tax provisions. Now while this is a theoretical possibility, it is quite unlikely. In 2003, when oil prices were less than $30 a barrel, the tax preferences were worth just over 2% of domestic oil and gas production according to the GAO. Tufts economist Gilbert Metcalf calculates that even if domestic production subsidies were worth 10% of the current price of oil--far above what they are at present--the increased production that might result would only reduce oil prices by about 0.4%.

But oil and gas companies have a point when they cry foul. After all, about 41% of the net income earned by the oil and gas industry is already paid out in federal taxes compared to 26.5% for the rest of the businesses in the S&P 500. To be sure, this result stems, in part, from the narrowing of the income base because of the tax preferences. Regardless, the appropriate answer to Boehner's statement that oil companies "ought to be paying their fair share" is they already more than do so.

Defending and expanding tax breaks to remedy high taxes is a poor way to deal with this problem. The economic insight of the 1986 tax reform--widely credited by economists as one of the best pieces of legislation ever to come down the pike--is that eliminating deductions and reducing rates is better than leaving rates high but littering the tax code with inefficient tax breaks because the economic distortions caused by the latter are far greater than are those caused by the former.

In a perfect world, of course, there would be no corporate income taxes because they represent double taxation (once when the profits are earned and once again when those profits are distributed to real, live, taxpaying individuals). This unfairly punishes income earned by corporations relatively to income earned by non-corporate actors and introduces economic inefficiencies that reduce growth. But if zeroing-out corporate taxes is too much for the GOP to swallow, the least it can do is to ensure that oil companies are treated no differently for tax purposes than any other companies and to reform corporate tax codes accordingly.

So while Obama has the better of this debate in a narrow sense, he only earns two rather than three cheers for four reasons. First, there's the demagogic suggestion that oil companies are getting a relative free ride when it comes to their federal tax bill, which they most certainly are not. Second, he offers this tax loophole-elimination program as an answer to high gasoline prices despite the fact that eliminating these tax breaks will do nothing to reduce fuel prices. Third, by leaving the manufacturing tax credit in place and just narrowing its scope, he arguably increases--not decreases--the economic inefficiencies that follow. Fourth, he links elimination of oil and gas tax breaks with an expansion of the tax credits associated with renewable energy, which does nothing on balance to make energy markets work more efficiently (indeed, it probably makes matters worse). Even left-of-center energy activists like Amory Lovins of the Rocky Mountain Institute, Carl Pope, executive chairman of the Sierra Club, and green energy investor Jeffrey Leonard, chairman of the Global Environment Fund, think the time is ripe to eliminate all energy subsidies in the tax code and let the best fuel win.

If the left can entertain this idea seriously, why can't Tea Party Republicans?

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