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April 15, 2013

Via Email: tax.reform@mail.house.gov

The Honorable Kevin Brady - Chair
The Honorable Mike Thompson – Vice Chair
Energy Tax Reform Working Group
House Ways and Means Committee

Subject: Comments to Energy Tax Reform Working Group

Dear Congressmen Brady and Thompson:

Thank you for providing us the opportunity to comment on the Committee's interest in energy tax reform.

Energy tax preferences at present are substantial. A good catalogue of such preferences, recently published by the Center for American Progress, finds that only 40 percent of government spending in the energy sector comes from direct appropriations. The balance comes from tax expenditures.[1]

Our recommendations regarding potential reforms are premised upon three priors. First, government intervention in energy markets should only be entertained when clear market failures are at issue. Otherwise, intervention will make energy markets less – not more – economically efficient. Second, when market failures *are* identified, the intervention should be crisply targeted to directly address the market failure(s) at issue. Third, energy tax preferences represent governmental intervention in markets; they are designed to direct private investment away from some activities to activities favored by the tax preference(s).

While there is resistance from some quarters to label tax preferences as "tax expenditures" or "subsidies" (the argument being that allowing parties to keep x percent of their earnings is not to "subsidize" them by x percent), that semantic debate ignores the

[1] Richard W. Caperton and Sima Gandhi, "America's Hidden Power Bill: Examining Energy Tax Expenditures," Center for American Progress, April 2010; http://www.americanprogress.org/wp-content/uploads/issues/2010/04/pdf/energytaxexpenditures.pdf.

broader point; tax preferences represent the government's attempt to take resources from some parties in the energy sector and reallocate them to other parties in the energy sector. Whether that reallocation occurs via direct taxation-and-appropriation or via the tax code does not change this underlying reality.

There are three alleged market failures that are frequently cited to justify energy tax preferences: the national security costs and economic risks associated with energy imports; the inability of "infant industries" to compete in the market due to a mix of incumbent market power and (past and present) government preferences to market incumbents; and the environmental costs of energy consumption that are not internalized in energy prices. While other rationales for intervention are frequently offered – for instance, steering investment into more labor-intensive energy investments – those rationales are not related to any identifiable market failure in energy markets. Those rationales are only persuasive if we posit that government actors are better judges of how to efficiently allocate resources than private actors … and we find that proposition unpersuasive.

The only market failure charge that we find persuasive relates to the issue of environmental costs. The alleged national security costs of energy imports are for the most part nonexistent.[2] The infant industries argument ignores both the long record of incumbent market actors that have been displaced by new competitors without significant governmental help and the inability of government to successfully promote politically promising infant industries.

While there is a good argument to be made that energy prices do not fully account for the environmental costs imposed on others when energy is consumed (resulting in more pollution-intensive energy production and consumption than would otherwise be the case),[3] tax preferences are a poor means of addressing this problem. A far better remedy would be to internalize those environmental costs by either increasing existing regulation to address emissions or – better – to tax emissions so as to internalize those costs directly.[4] Tax preferences constitute interventions that presuppose that governmental agents know *a priori* the most efficient mix of energy investments that would occur in a well functioning energy market (a dubious proposition). The market failure at issue, however, is not that market actors make poor investment choices; it is that prices are inaccurate and thus market actors invest inefficiently. Correct the price signals and efficient investment will follow.

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[2] Jerry Taylor and Peter Van Doren, "The Energy Security Obsession," *The Georgetown Journal of Law & Public Policy* 6:2, Summer 2008; http://www.cato.org/sites/cato.org/files/articles/taylor_vandoren_energy_security_obsession.pdf.

[3] Ian Parry, Margaret Walls, and Winston Harrington, "Automobile Externalities and Policies," *Journal of Economic Literature* 45:2, 2007, p. 373. Michael Greenstone and Adam Looney, "Paying Too Much for Energy? The True Costs of Our Energy Choices," Social Science Research Network #2010862, February 2012.

[4] Ian Parry, "Are Energy Efficiency Standards Justified?" Social Science Research Network #1713991, November 2010. Gilbert Metcalf, "Market-Based Policy Options to Control U.S. Greenhouse Gas Emissions," *Journal of Economic Perspectives* 23:2, 2009, p. 5.

We believe that the above analysis provides a good road map for reform. To wit, the Congress should completely eliminate all energy tax preferences. If the Congress is interested in addressing the environmental issues associated with energy consumption, it should do so directly via increased environmental regulation or via emission taxes.[5] It should not do so via tax preferences. The largest tax preference claimed by the energy industry – the Section 199 deduction afforded to all U.S. manufacturers – is best addressed by eliminating the Section 199 deduction in full. Allowing all manufacturers save for those in the energy sector to claim this credit will likely increase the economic inefficiencies associated with this particular tax preference. That's because a narrower, more targeted tax preference is – all things being equal – more distortionary than a broader, less targeted tax preference.

Some might argue that some existing preferences increase energy production and thus, contribute to lower energy prices. Yet many of the preferences at issue have little or no impact on energy production; they simply represent wealth transfers. Those preferences that *do* reduce energy production costs simply encourage market actors to produce costly, economically uncompetitive energy.[6] Markets are not made more efficient by producing costly relative to less costly energy.

Recipients of these energy tax preferences – most notably, the oil and gas industry – have argued that their corporate income tax burden is already punishingly high (effectively paying over 40 percent on earnings) and that eliminating tax preferences in this context is unjustifiable. While we will not address here the larger issue of what constitutes a "first-best" corporate income tax regime, we simply note that the best remedy for excessive corporate income tax burdens is a direct reform of the corporate income tax. Targeted tax preferences to moderate industry tax burdens are a poor way to address the problem.[7]

The House Ways & Means committee is to be commended for its interest in reconsidering the existing tax code as it pertains to the energy sector. We hope that our suggestions will prove useful in that forthcoming project.

Sincerely,
Jerry Taylor & Peter Van Doren
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[5] An example of how to execute nationwide pricing of conventional emissions can be found in Nicholas Z. Muller and Robert Mendelsohn, "Weighing the Value of a Ton of Pollution," *Regulation*, Summer 2010, p. 20; http://www.cato.org/sites/cato.org/files/serials/files/regulation/2010/6/regv33n2-5.pdf

[6] Gilbert Metcalf, "Using Tax Expenditures to Achieve Energy Policy Goals," *The American Economic Review* 98:2, May 2008, pp. 90-94; http://www.jstor.org/stable/29730001?seq=1. A longer version of that paper can be found in Gilbert Metcalf, "Federal Tax Policy Towards Energy," NBER Working Paper w12568, October 2006; http://papers.ssrn.com/sol3/papers.cfm?abstract_id=934763.

[7] Jerry Taylor and Peter Van Doren, "Eliminating Oil Subsidies: Two Cheers for President Obama," Forbes.com, May 3, 2011; http://www.cato.org/publications/commentary/eliminating-oil-subsidies-two-cheers-president-obama.