

July 10, 1985

## REAGAN'S TAX REVOLUTION: FAIR PLAY FOR ENERGY

### INTRODUCTION

Ronald Reagan's tax reform proposal could affect the U.S. energy industry profoundly. It would go far to extend the rules of fair play to energy by untangling the jumble of preferences, subsidies, and penalties which have been choking the development of an efficient and reliable national energy supply. These include such items as the tax credits for solar, conservation and other renewable energy resources, the expensing of Intangible Drilling costs (IDCs) for oil and gas producers, the depletion allowance, and the windfall profits tax.

Economic theory suggests that the ideal tax system neither favors nor penalizes any sector of the economy. Under such a system none of the current tax subsidies would exist. Yet a great many costly investments have been made based on the current code. It would be unfair to change the rules in mid-game. It must be recognized, moreover, that energy is an element without which a modern economy cannot function. And important security considerations are associated with energy production and consumption which are generally missing from other industries.

The Reagan tax proposal wisely takes these special conditions into account by retaining certain allowances for the energy industry and removing others. Far from being energy "loopholes," the allowances retained in the tax plan merely give energy the same tax treatment as other industries. If anything the Reagan plan fails to go far enough to end the tax code bias against energy firms.

Oil industry critics complain that the industry enjoys numerous special tax breaks allowing many companies to pay little or no federal tax. This simply is not true. The Joint Congressional Committee on Taxation, for example, has found that the oil industry is actually among the most heavily taxed in terms of federal levies on domestic income. When the windfall profits tax is included, the oil industry

actually bears the heaviest tax burden of any sector of the economy, amounting to nearly 44 percent of income.

A number of special taxes have been imposed on oil producers by Congress in recent years, such as the tax to finance the so-called "Superfund" to clean up hazardous waste sites. States have followed the federal lead in increasing taxes on crude oil production. In addition, there are special excise taxes on such petroleum products as gasoline and diesel fuel at both state and federal levels. Thus rather than enjoying a relatively light tax load, the oil industry struggles under an extremely heavy burden.

The Reagan tax proposal addresses a number of existing tax provisions. Among the most important are the tax credits designed to spur forms of alternative energy, such as solar and alcohol fuels, the option for oil producers to deduct Intangible Drilling Costs (IDCs) as a business expense, and the oil depletion allowance.

The Reagan proposal eliminates the alternative energy tax credits, phases out the depletion allowance and retains the option for expensing IDCs and the windfall profits tax. It would also make IDCs a preference item under the proposed minimum tax for both corporations and individuals.

Among the most difficult provision for average taxpaying Americans to understand are those related to Intangible Drilling Costs. These are business costs which do not contribute directly to the creation of a tangible asset such as a building or piece of machinery. IDCs typically include include such items as fuel, labor costs, or the lubricants used for the shaft of an oil drilling rig. In any other business, there would be no question of treating these as a straightforward expense, making them fully deductible in the year in which they were incurred. This is why oil drillers have traditionally been allowed the option of treating IDCs as an expense, an option the Reagan tax plan retains.

## TAXES AND THE OIL INDUSTRY

Congressional critics of the oil industry long have complained that the expensing of IDCs is a "loophole" for the oil industry. Their reasoning is that since the IDCs contribute to the creation of a long-term asset--an oil well--the driller should deduct them gradually, over the 10 to 15 years that the well is likely to be producing oil.

In this argument, critics are trying to equate the investment a wildcatter makes in an exploratory oil well to other, more conventional, and far less risky investments such as the construction of an office building. Worse, they confuse the issue by implying that

the expenses incurred for IDCs are somehow similar to "accounting" charges such as depreciation. This line of reasoning ignores key differences between high-risk investments, such as oil exploration, and relatively low-risk ones, such as office building construction.

Accounting charges such as depreciation, for example, are arbitrary figures often determined under relatively stringent guidelines provided by the Internal Revenue Service to take into account the gradual consumption of a capital asset. These charges bear no relation to the "real world" dollars and cents the investor pays out. It is not uncommon for a building that was depreciated over 30 years, and which therefore has a "book value" of zero, actually to have a market value many times its original purchase price. By contrast, the money an oil driller spent for drilling mud (an oil well shaft lubricant), fuel, or labor represents a real cash outlay that has no residual value. Therefore to treat IDCs as anything other than an immediate expense to be deductible immediately unfairly penalizes the industry.

There is another way in which exploratory drilling expenses differ from those in more conventional investments: when the investment is made in an exploratory well, the driller has no idea whether his investment will yield an asset until after the expense is incurred. Investors in shopping centers, on the other hand, know for sure that their money will produce buildings and parking lots that will have some market value. In fact, since on average only one well in ten is successful, the odds are that a driller will not have an asset of any value when he is done.

A third key difference between oil drilling and more conventional investments is that most major long-term capital assets, such as construction of an office building, are purchased through some form of long-term financing. The investors typically only provide from 20 percent to 25 percent of the actual cost of acquiring the asset; the rest is provided through a mortgage. An exploratory oil well, by contrast, cannot be financed through a bank, but rather must be paid for with real dollars by the driller and his partners.

It is therefore a mistake to equate oil and gas exploration with low-risk investments. A more appropriate analog are investments in research and development. They too involve significant risks and do not provide the certainty that they will create a valuable asset. Yet many of those critics who are quick to fault provisions allowing the oil industry to expense their Intangible Drilling Costs are happy to provide significant tax relief for investors in research and development. Ironically, one of the main arguments used to justify research and development tax breaks is the need to maintain cash flow until a product is identified, developed, and brought to market. These are just as valid for oil and gas exploration and justify allowing drillers to take IDCs as an immediate tax deductible expense.

The Department of Energy, Data Resources Inc., and the American Petroleum Institute have conducted separate studies of the effect of eliminating the current provisions that allow expensing of IDCs. All agree that to prevent such expensing would lead to a dramatic decline in capital available for drilling, and a consequent decline in U.S. oil production. In fact, U.S. oil output could drop by as much as 1.7 million barrels per day, or nearly 20 percent of production, should drillers be forced to deduct IDCs over the life of an oil well. This drop in domestic production could only be made through an increased reliance on imports which in turn would further aggravate the U.S. balance of payments problems and vulnerability to the loss of energy supplies from abroad.

#### THE DEPLETION ALLOWANCE AND ALTERNATE ENERGY TAX CREDITS

The depletion allowance available to firms producing under 1,000 barrels of oil per day and the tax credits allowed for solar energy, conservation improvements, and other alternate energy sources differ fundamentally from IDC expensing. They provide a specific tax break intended to allow investors to recover their capital; IDC expensing simply treats oil drillers' costs for tax purposes in the same way as other industries' costs are treated. As such, the solar tax credits and percentage depletion are essentially similar to other capital recovery tax provisions such as depreciation or the Investment Tax Credit.

In an ideal tax system, of course, no special breaks would be given to any industry. Capital would be recovered through expensing, as advocated by Dr. Norman Ture, former Treasury Undersecretary and now President of the Institute for Research on the Economics of Taxation. The way this would work would be by allowing investors to deduct that portion of their capital costs equal to the asset's discounted present value. In other words, the deduction would equal the amount of money which would have to be set aside at prevailing interest rates when the asset was originally purchased to ensure that enough money was available to replace the asset when it wore out.

Such a system is far more equitable than the current hodge-podge of tax credits, special depreciation schedules, and so forth for it accurately would reflect true capital recovery costs. It also avoids the need for special tax treatment of capital gains.

While the Reagan proposal is a move towards such a "neutral" tax system, care must be taken not to move away from tax neutrality while the transition is taking place. Therefore, as long as capital recovery mechanisms such as depreciation remain in the tax code, the depletion allowance and the tax credits for solar energy and conservation improvements should be retained as well. At a minimum,

if the energy-related capital recovery mechanisms are eliminated from the tax codes, they should be eliminated simultaneously, so as not to create a bias which favors one type of energy over another.

The percentage depletion and solar credits address petroleum's unique and unfortunate status as what economists call a "wasting asset." Unlike other major capital assets, such as a building, "wasting assets" have no residual value once they are depreciated. A building which is depreciated over 30 or 40 years and which therefore would carry a "book" value of zero, can still have a "market" value equal to or even greater than its original purchase price. By contrast, after oil from a deposit is pumped, there is no residual value. Similarly, once the potential to conserve energy is exhausted, there is no residual value in the energy waste which is avoided. As a consequence, the recovery of capital which occurs through use of the depletion allowance and the solar and conservation tax credits more closely parallel the actual rate at which capital is consumed. As mechanisms, therefore, the depletion allowance and solar and conservation credits are actually much closer to being truly "tax neutral" than other more conventional capital recovery mechanisms.

#### PRODUCTION TAX CREDITS FOR SYNTHETIC FUELS AND GASOLINE TAX EXEMPTION FOR ALCOHOL FUELS

Current law allows a number of special tax credits for the production of various types of synthetic fuels. These include: credits for fuels produced from tar sands, oil shale, and some forms of biomass. Unlike the credits for solar energy or conservation improvements, however, these tax credits are not designed as a device for capital recovery, but rather are a specific subsidy intended to lower a producer's cost. Generally, these credits equal \$3 per barrel of oil equivalent and gradually phase out as the price of oil on the world market exceeds \$29.50.

At current world oil prices, the synthetic fuels tax credits are insufficient to spur additional production. More important, the market is sending a clear signal that such products are not economic and should not be produced. As such, there is no justification for their continuation and the President is wise to urge their abolition.

The exemption from federal gasoline taxes for fuels blended with alcohol also constitutes a direct subsidy rather than a capital recovery mechanism. Since motorists' demand for unleaded premium motor fuel is increasing, the market for gasoline blends using alcohol is adequate to act as an incentive for production without the additional incentive of federal subsidies. This is because alcohol is one of the few octane boosters available to produce high-test gasoline under current environmental regulations.

Since the market will provide adequate incentives to produce alcohol for gasoline blending, there is clearly no need for the gasoline tax exemption. The President, therefore, is correct in his move to eliminate it.

#### SPECIAL TAXES ON ENERGY

The oil industry is subject to a number of special taxes which sharply increase its costs of producing and selling its product. These include the windfall profits tax, the Superfund Tax, and taxes on refined petroleum products such as gasoline and diesel fuel. All of these levies originally were promoted as user fees or funding sources for such specific projects as highway construction under the Federal Highway Trust Fund, or low income energy assistance and the development of alternative energy supplies with the Windfall Profits Tax. Whatever the original intent, each of these taxes has evolved into a general source of revenue for the Treasury and for Congress' pet projects. As a consequence, they distort the market, deprive energy producers of needed capital, and create disincentives for domestic energy production. While scrutinizing tax "loopholes" and subsidies which allegedly benefit the energy industry, the Administration also should investigate the penalties imposed on energy by the tax code.

#### CONCLUSION

Although Ronald Reagan's tax reform proposals go a long way toward achieving the goal of an equitable, neutral tax system, while recognizing the need to recapture capital investments, they remain a first step. The anti-energy bias of the tax code is so deeply ingrained that still further reforms must be undertaken. Among the most important are the elimination of punitive and counterproductive "targeted" tax levies such as the windfall profits tax, Superfund tax, and taxes on refined petroleum products. These taxes distort the market and amount, in some cases, to little more than an indirect subsidy for oil imports. After all, foreign suppliers who do not pay these taxes enjoy a significant advantage over U.S. producers.

The President wisely has recognized that the provision that allows oil drillers to take Intangible Drilling Costs as an expense is a legitimate tax deduction rather than a tax "loophole" as congressional critics would suggest. Yet White House tax planners still have failed to understand that the percentage depletion and capital recapture provisions concerning solar energy and conservation improvements also are legitimate capital recovery techniques. Eliminating these tax provisions, moreover, would impose enormous hidden energy costs on the American public.

Numerous studies by industry and U.S. government agencies agree that the elimination of capital recovery provisions in the tax code, especially those concerning IDCs, would lead to a sharp decline in domestic oil production and an accompanying rise in the level of oil imports.

An ideal tax system, of course, would eliminate most of the current devices for capital recovery, and replace them with a system that allows investors to treat a portion of their capital outlays as an expense in the year in which they are incurred. The extent of the deduction which would be allowed would be determined by calculating the amount of capital which would have to be set aside in order to replace the asset when it wore out--its discounted present value. At the same time, such an ideal system would eliminate all special tax subsidies and tax penalties.

Until an "ideal" system is in place, no move should be made which further increases the energy anti-investment bias of the current tax code. Therefore, in addition to retaining the provision allowing oil drillers to treat IDCs as an expense, the tax code should retain the depletion allowance and the solar and conservation tax credits, and should repeal the windfall profits tax, Superfund tax, and any other special taxes on energy investments. In so doing, the President's tax planners could ensure that the U.S. energy industry continues to operated at the maximum possible efficiency, in order to minimize U.S. dependence on foreign sources of supply.

Milton R. Copulos  
Senior Policy Analyst