



**Tax Policy Center**  
Urban Institute and Brookings Institution

## **THE TAX POLICY**

### **BRIEFING BOOK**

*A Citizens' Guide for the  
2008 Election and Beyond*

# **TAXES AND ENERGY**

Taxes and Energy: What tax incentives encourage energy production? .....II-10-1



## Taxes and Energy: What tax incentives encourage energy production?

Several major provisions of the federal income tax subsidize domestic production of fossil fuels, including expensing of exploration and development costs and intangible drilling costs, the use of percentage instead of cost depletion to recover costs of drilling and development of oil and gas wells and development of mining properties, and the production credit for alternative fuels. These incentives promote investment in fuel development at the expense of investment in other assets with higher pretax yields. Several recent studies have found that the effective tax rate—that is, the extent to which all applicable tax provisions reduce the after-tax return on a new investment—is much lower for oil, gas, and mineral development than for other assets.

These tax incentives are justified by some on the grounds that they reduce U.S. dependence on imported oil by increasing domestic production of oil and substitute fuels. But they also encourage more rapid exhaustion of domestic supplies, which may increase dependence on imports in the long run. The three largest energy tax incentives are expected to reduce federal tax revenue by \$11 billion or \$17 billion over 2007-11, depending on the agency doing the estimate (see table).

Revenue Losses from Largest Tax Incentives for Energy Production, 2007-11 (billions of dollars)		
Provision	Treasury estimate	JCT estimate
Excess of percentage over cost depletion, fuels	3.9	6.6
Expensing of exploration and development costs, fuels	3.5	3.7
Alternative fuel production credit	3.2	6.2
Total	10.5	16.5

Sources: Office of Management and Budget, Budget of the United States Government, Fiscal Year 2008, Analytical Perspectives, p. 287; Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2007-11, pp. 24-25.

- Intangible drilling costs consist of the labor, machinery, and materials costs of drilling and developing oil and gas wells and mines. Independent oil producers (that is, those without related refining and marketing operations) may deduct these costs from income in the year incurred even though, as capital investments, they produce returns over a number of years. Integrated oil companies may deduct 70 percent of these costs in the first year and recover the remaining 30 percent over five years.
- Under percentage depletion, producers deduct each year as capital expenses a fixed percentage of gross revenue from a property; in contrast, under cost depletion, producers deduct their actual outlays as the resources from a well or mine are depleted. The federal income tax allows independent producers, but not integrated companies, to deduct 15 percent of gross revenue from their oil and gas properties as percentage depletion, without regard to how much they have invested in the properties. Percentage depletion is permitted only on the company's first 1,000 barrels per day from a property and is limited to net income from oil and gas properties. Percentage depletion is also available for coal and other minerals at varying rates.

- The tax code also provides a credit for production of alternative fuels of about \$7.25 per barrel-equivalent in 2007 dollars, indexed to future changes in the GDP deflator. The credit phases out at oil prices between \$23.50 and \$29.50 a barrel in 1979 prices (about \$56 and \$70 a barrel in prices of the second quarter of 2007); oil prices in late 2007 were above the phase-out range. Enacted in 1980, the credit initially supported some additional production of synthetic fuels (mainly oil and gas produced from coal), but subsequent reports indicated substantial abuse in claiming the credit. Investments made after July 1, 1998, and production from qualifying facilities after January 1, 2008, do not qualify for the credit. Thus without further congressional action the credit will expire even if oil prices decline.
- The tax law includes a number of smaller incentives for investments in refineries, pipelines, oil and gas exploration, and selected coal technologies. In addition, domestic energy properties benefit from the domestic production deduction provided in the American Jobs Creation Act of 2004. Some members of Congress have proposed denying oil and gas companies the benefits of the domestic production deduction (although the deduction in itself does not favor oil and gas over other domestic manufacturing) and removing some additional incentives for refining and oil exploration enacted in 2005.
- Subsidizing domestic production of fossil fuels is inconsistent with a broader policy goal of reducing fossil fuel use to counter global climate change. But the adverse effects of the incentives on climate change are probably very minor, because any increase in domestic production they induce mostly displaces imports instead of raising domestic or worldwide fuel consumption. A recent study concludes that the incentives reduce the world oil price by less than 0.1 percent. Thus the resulting increase in consumption cannot be large.

### Further Reading

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Sullivan, Martin A. "Multibillion Dollar Coal Credit: Lots of Form, Little Substance," *Tax Notes*, October 3, 2003.

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