

Draft Comments by Steve Ellis for Brookings/WRI event on environmental harmful tax breaks.

I appreciate the opportunity to present Taxpayers for Common Sense's views on environmentally harmful tax expenditures that are ripe for elimination. In the big picture these provisions make little economic, fiscal or environmental sense.

When you survey the tax code, there are tax expenditures – tax provisions – that are directed to every imaginable economic activity or interest, from bow & arrow manufacturers to horse racing, from rum manufacturers to yacht owners.

As a budget watchdog, we obviously think eliminating many of these provisions that have spread like weeds since the 1986 reforms would be a sound foundation of any tax reform effort. But we have limited our presentation today to those that have a negative environmental impact.

There are several key factors to remember about tax policy. One is that, believe it or not, the Second Law of Thermodynamics can be applied to tax complexity. Or more appropriately, what I'll call tax entropy. Entropy is the scientific rule that dictates that over time, all matter moves from an ordered state to less ordered state. This certainly holds true with tax policy. No sooner do you clean up the tax code - like in 1986 - than complexity creeps back in. Provisions like the sales tax deduction have come back to life like a zombie in a "B-movie" horror flick. Some have estimated that there have been 10,000 changes to the tax code since the 1986 Act was passed.¹ It seems that every effort by Congress to tweak the tax code ends up creating a host of new, convoluted tax provisions. Last year, for example, Congress passed a bill to fix a trade-distorting subsidy. A relatively straightforward \$5 billion fix mushroomed into a \$140 billion behemoth that included hundreds of unrelated tax provisions.

We cannot afford to throw up our hands and give up in the face of tax entropy. A pockmarked, scattered tax code invites confusion, increases costs, reduces transparency and generally engenders skepticism among the populace that everyone is paying their fair share. Occasional housecleaning helps consolidate and simplify important provisions, provides an opportunity to remove redundancy or waste, and closes unintended loopholes.

There is a final critical point to remember about the code: no fix, no change is ever easy. In this day and age, every tax expenditure and provision has a constituency behind it. No matter what, eliminating any item in the tax code will gore someone's ox. While each provision has lobbyists, members of Congress and advocates supporting it, we cannot allow that to dissuade us from simplifying and improving the code.

As we all know, taxes are not only intended to pay the bills of the federal government; they are also designed to influence our behavior. Exceptions to income taxes (earned and unearned) and excise taxes are meant to encourage certain activities. The most commonly cited example of influencing behavior regards homeownership. Years ago, we decided

that we wanted to be a nation of homeowners, so we made interest paid on a mortgage tax deductible from income tax. You can't deduct rent payments, creating a clear incentive to obtain a home mortgage. Homeownership rates in the U.S. are just under 70 percent², far higher than most countries. But there are consequences to all incentives, including this one.

When considering tax expenditures that harm the environment, there are a few general categories. One is expenditures with relatively direct impacts: subsidies for extractive industries, for example.

I'll borrow from the game of billiards and call the second category "bank shots." You have to think about them a little more carefully to see the impact because it's at least a two step process. The SUV business tax break that was mentioned is one such example.

Finally, there are the mixed signals, or cross subsidies that end up sending the wrong signal to a taxable entity.

Direct Impacts

I'll start with the direct, which will almost exclusively be a discussion of the energy-related tax breaks:

Energy Tax Policy - The American economy depends heavily on fossil fuels, in part because federal tax policy has kept them inexpensive. While energy tax policy as a whole has been shaped by the coming and going of different administrations, the federal government's incentive structure has always favored conventional sources, notably oil and gas.³ The impact of these subsidies are quite clear: the U.S. uses four times as much oil as any other nation,⁴ and fossil fuels add up to more than 85% of the energy used domestically.⁵

It is hard to imagine a sector that benefits from the tax code as much as the energy industry does. Some of the tax benefits include accelerated depreciation of assets, tax credits for production at marginal wells, and immediate expensing of intangible drilling and development costs. The tax code's generous expensing of exploration and development costs for environmentally harmful extractive industries alone will cost the federal government more than \$17.1 billion over the next five years.⁶

As a federal fiscal instrument, energy tax policy is supposed to be used to correct a problem in the marketplace, or to reach some type of social, environmental or fiscal objective. Yet in reality, energy tax policy has been politicized, driven by politicians' desires to prop up their favorite company, assist cherished special interests or help trade associations make their members richer, rather than create true incentives to push industry to find bigger and better ways to drill and or conserve more energy. Because of this influence, tax policy generally creates new distortions by intervening in the market rather than fixing current problems. At the same time, tax policy has not reduced our dependence on foreign sources of oil.

Percentage Depletion Allowances - Percentage depletion allowance lets certain oil and gas producers claim a tax write-off when the value of their assets decline over time – that is to say, as their wells are depleted. Current law allows independent producers, but not integrated oil companies, to deduct up to 15 percent of the gross income from an oil or gas producing property, so long as the deduction does not exceed 65 percent of the net taxable income from that property in any year (referred to as the “net-income limitation”).⁷ In years where a well’s percentage depletion is greater than the 65 percent threshold, the well’s producer can carry the deduction over to future years until it is fully utilized.

The problem with percentage depletion is that it often allows firms to deduct in excess of their original investment on the well. This lucrative tax provision will cost the federal treasury about \$3 billion over the next five years, and it leaves certain oil and gas producers with tax rates that are much lower than most other industries.⁸ A related percentage depletion allowance for hard rock mining will cost taxpayers an additional \$900 million over five years.⁹ Proponents argue that the percentage depletion write-off helps to create economic incentives to get energy companies to produce more oil and gas domestically. But with oil hovering around \$50 a barrel, many wonder why the oil and gas industry needs any government incentives at all – they already have all the incentive they need.

Section 29 - In 1980, Congress established a tax credit in Section 29 of the Internal Revenue Code for companies producing fuels from nonconventional sources. Created as a part of the Crude Oil Windfall Profit Tax Act of 1980, proponents of the Section 29 credit argued it would increase development of alternative domestic energy sources at a time when concerns about oil import dependence and national security were high. Section 29 applies to fuels such as oil produced from shale or tar sands; gas produced from pressurized brine; Devonian shale; tight formations; biomass; and coalbed methane, all of which were deemed "uneconomical" for conventional production.¹⁰

Section 29 grants a \$3 per barrel or \$0.50 per thousand cubic feet tax credit. The production tax credit began at \$3 per barrel of oil equivalent and was designed to phase out as oil prices rose from \$23.50 to \$29.50 per barrel. However, both the credit and the phase out were tied to inflation. Currently, the credit is worth more than \$6 per barrel and more than \$1 per thousand cubic feet, and oil prices must reach between \$47 to \$60 for the phase out to occur. Despite oil being in the \$50 dollar range, producers have still been able to claim this credit. This tax credit will cost \$4.0 billion over the next five years.¹¹

Exemption for Income Earned by Public Electric Power Utilities – Unlike private or investor-owned utilities, public utilities are exempt from federal income tax on income earned from their facilities for generation, transmitting and distributing electricity. This tax expenditure can lead to increased consumption and inhibits competition in the marketplace with private power. Eliminating this provision could save \$3.6 billion over the next five years.¹²

Many More – There are many more tax expenditures that encourage environmentally harmful activities, expensing of exploration and development costs for nonfuel minerals (\$300 million over five years), expensing and amortization of timber-growing costs (\$1.1 billion over five years).¹³

Where Does it Get Us

As you can see, for decades every energy and other extractive industry has fought to get their piece of the tax policy pie. Some still believe that the nation's distorted tax priorities can be balanced by adding additional breaks that favor newer energy sources or sustainable activities that are currently underrepresented in the nation's tax code. So you end up with credits for electricity production from renewable resources (\$2 billion over five years), credits for investments in solar and geothermal facilities (\$100 million over five years), and other scattered credits.

Instead of nibbling at the edges of tax policy through small provisions, we believe that government should eliminate all the tax subsidies and let the market take its course. The only way you can level the playing field is through subtraction and simplification in the tax code. For all of the advocates of renewable energy out there, they will always be outmanned and outgunned by the forces of big energy.

Hybrid Vehicle Tax Credit - Even tax expenditures purportedly written for the environment can have little effect, or even worse, unintended consequences. The much touted \$2,000 tax credit for hybrid vehicles appears to be having very little effect. Why do we need to be encouraging this? Given that demand outstrips supply of these vehicles, this expenditure has no effect other than reducing revenue and adding complexity.

Federal tax policy should be designed to alter consumer vehicle choices, not to reimburse consumers for choices they'd make anyway. This tax break probably isn't working because it's putting money into the pockets of people who would have bought this product even without a tax incentive.

The Toyota Prius, for example, was the best selling hybrid vehicle last year; it is bought generally by couples with no children making at least \$100,000 per year. Jack Black, the actor may own one, but the tax credit isn't creating enough of an incentive to the average American family to go out to the dealership to buy one.¹⁴

Congress and the President want to encourage emerging technology that can help the environment. But will raising the tax credit to \$4,000 as the President proposes encourage families not considering a hybrid vehicle to actually purchase a vehicle? Will it create a broader market than currently exists?

Bank Shots

SUV Tax Credit - Under current tax policy, the U.S. government grants a \$25,000 tax break for the business purchase of sports utility vehicles over 6,000 pounds. The original

intent of the provision was to increase capital investments by farmers and other small business owners who rely on light-trucks or vans (i.e. construction companies). When this provision was added to the tax code, luxury passenger SUVs were not the market force they have become, and it appeared a good way to help small business owners by accelerating depreciation and avoiding a luxury-tax surcharge.¹⁵

The problem has arisen largely because the tax code classifies vehicles by weight instead of function. First, a truck or van is defined as a vehicle that weighs more than 6,000 pounds.¹⁶ Before the advent of the SUV, this was a sufficient way to separate passenger automobiles from other classes of vehicles. But, the growth of the market for large, luxury SUVs has dramatically expanded the number of passenger vehicles weighing over 6,000 pounds. In addition, the weight classification of a passenger automobile is determined by the "unloaded gross vehicle weight," or the amount the vehicle weighs with nothing in it.¹⁷ SUVs are weighed according to the "gross vehicle weight" rating, which is the weight of the car itself plus the load the vehicle should be able to carry.¹⁸ This distinction makes it easier for certain vehicles to achieve the status of "light-truck" even if the actual vehicle weight is more in line with passenger automobiles.

The SUV break has been reduced from 100,000 to \$25,000, but it should still be eliminated.¹⁹ Buying a \$100,000 SUV still brings a \$58,000 tax deduction. This tax break isn't helping reduce our dependence on foreign oil. In fact, it does the exact opposite.²⁰ Expensing all business vehicles equally would save the federal treasury \$700 million over five years.²¹

Second Home Mortgage – Interest payments on second home mortgages qualify for a tax deduction.²² Think about where people most often buy a vacation home - in remote or environmentally sensitive areas. When my parents took the money they saved to send me to college and bought a second home, they bought in the hills of central Vermont. Don't worry, I went to college at the Coast Guard Academy – all of us paid for my education, and I guess, my parents' down payment. Other people buy their second home on the coast. The deduction helps people buy more permanent, elaborate homes than they would otherwise. This can have significant impact on local environments and certainly has contributed to the post-WWII coastal building boom.

Another interesting note on this tax expenditure. The provision is more expansive than many people realize: anything with basic living accommodations meets the threshold.²³ That means RVs and boats can qualify for this deduction.

Real Estate Tax – Real estate taxes are deductible, for all your homes, first, second, third, fourth – doesn't matter.²⁴ This has many of the same impacts of the second home mortgage deduction. Eliminating this provision would save \$74.1 billion over five years for the primary residence alone.²⁵

Mixed Signals

Tax expenditures inherently send many mixed signals. Attempts to influence behavior do not necessarily have the intended impact. For instance, the primary effect of creating a shelter to encourage savings may actually have its greatest effect of shifting savings from one type of vehicle to another with only a small increase in savings.

Other mixed signals provide cross subsidies that do not provide the purported incentives.

Harbor Maintenance Tax – The Harbor Maintenance Tax (HMT) is in effect a cross-subsidy between high and low maintenance ports. If eliminated or replaced with a true user fee – which the HMT is purported to be – costs and environmental damage could be significantly reduced. Implemented in 1986, the HMT is an *ad valorem* tax, that is a tax on the value of the commodities shipped, which actually has little to do with the cost of maintaining the port. In fact, the export portion of this tax was struck down by the Supreme Court as an unconstitutional tax on exports, because it was not a true “user fee” for maintenance.²⁶ The major factor in maintaining ports is dredging, which can have significant impacts on the environment, both aquatic and terrestrial (for disposal). By taxing a container ship full of DVD players entering the port of Seattle – a naturally deep, low maintenance port – the same amount as a similar container ship entering the port of New York / New Jersey – a significantly shallower, high maintenance port – we are providing expensive, environmentally harmful cross-subsidies. The Harbor Maintenance Tax is expected to yield roughly \$5 billion over the next five years, although only approximately 75% of the revenue raised is used on deepening or dredging projects.²⁷

A more equitable and environmentally sound proposal would charge container ships based not on the value of goods they carry, but on the impacts to the port they visit. This would mean that a trip to the port of New York / New Jersey would cost significantly more than a stop at the port of Seattle. Such a reform would discourage heavy traffic at ports that require frequent dredging, and shift traffic to ports that can handle more use. Alternatively, eliminating the HMT altogether would end an environmentally harmful cross-subsidy.

“Big Kahuna”

I’ve left for last what I’ll call the “Big Kahuna”. Sorry, I just got back from a vacation in Hawaii last week.

Mortgage Interest Deduction – Arguably the single most celebrated tax expenditure, the mortgage interest deduction, allows taxpayers to deduct up to \$1.1 million of the interest on the debt they accrued to buy, build or improve their homes.²⁸ This tax expenditure was created after WWII to encourage Americans to buy homes. The concept that property ownership creates a stake in society far predates the republic. However, this tax expenditure – which I, like many Americans, use – also provides a significant incentive for newer and bigger development and sprawl. Concomitantly, this deduction provides a disincentive to more compact, urban development. Even reducing the size of this tax expenditure, by either eliminating the deductibility of second home mortgage interest or the amount of interest deductibility, would reap a significant savings. This tax expenditure comes to \$434.2 billion over five years.²⁹

I have highlighted only a few of the myriad of tax expenditures that affect the environment. In many cases tax simplification by subtraction – the elimination of certain tax expenditures - would help the environment and our pocket book far more than big spending programs. Taxpayers for Common Sense urges the President’s Advisory Panel on Tax Reform to look closely at many of the expensive tax expenditures that could be eliminated, to increase federal revenues in these tight budgetary times³⁰ while helping the environment.

¹ Wells, Rob. “Bush Tax Panel’s Breaux Seeks Income-Consumption Hybrid” Dow Jones Newswire. February 17, 2005.

² Home ownership rates are 69.1%. U.S. Department of Commerce. “Census Bureau Reports on Residential Vacancies and Home Ownership.” Available at <http://www.census.gov/hhes/www/housing/hvs/qtr105/q105prss.pdf>

³ Lazzari, Salvatore. “Energy Tax Policy,” Congressional Research Service. January 10, 2005.

⁴ National Commission on Energy Policy. “Ending the Energy Stalemate: A Bipartisan Strategy to Meet America’s Energy Challenge.” December 2004. 2.

⁵ *Ibid.* 41. The source breakdown is : 40 % Oil. 23% Natural Gas. 23% Coal. 8% Nuclear. 6% Renewable and Hydropower.

⁶ Congressional Budget Office. “Budget Options.” February 2005. 302.

⁷ Independent Petroleum Association of America. “IPAA Fact Sheet: Percentage Depletion Modifications.” February, 2005.

⁸ Joint Committee of Taxation (JCT). “Estimates for Federal Tax Expenditures for Fiscal Years 2005-2009.” January 12, 2005. 30.

⁹ *Ibid.* 31.

¹⁰ Previously synthetic fuels (synfuels) produced from coal were under the group of section 29 credits. But under H.R. 4520, the "American Jobs Creation Act of 2004," refined coal was moved to become a tax credit under Section 45.

¹¹ Joint Committee of Taxation (JCT). “Estimates for Federal Tax Expenditures for Fiscal Years 2005-2009.” January 12, 2005. 31.

¹² Congressional Budget Office. “Budget Options.” February 2005. 304.

¹³ Joint Committee of Taxation (JCT). “Estimates for Federal Tax Expenditures for Fiscal Years 2005-2009.” January 12, 2005. 31.

¹⁴ Payne, Henry. “Hybrid Liberalism: The government and Detroit’s Big Three are trying to change the way you look at your car.” The Weekly Standard. January 24, 2005

¹⁵ The luxury excise tax on passenger automobiles expired on 12/31/02. It has not been reinstated yet.

¹⁶ 26 U.S.C. 280F(d)(5)(A)(ii).

¹⁷ *Ibid.*

¹⁸ Bill Sanders. "Annual Depreciation Limits and Gross Vehicle Weight Ratings for Trucks, Vans, and Sport Utility Vehicles." undated. Available online:

<http://www.biz.colostate.edu/faculty/cherieo/GrossVehicleWeights.doc>.

¹⁹ The SUV provision was reduced from \$100,000 to \$25,000 in the American Jobs Creation Act of 2004.

²⁰ Business purchased SUV’s also receive a "bonus deduction" from 30% to 50%, which they can utilize in the first year of purchase on the amount above the initial deduction. The bonus deduction in addition to the five-year depreciation schedule, which remained the same.

²¹ Congressional Budget Office. “Budget Options.” February 2005. 308.

²² Internal Revenue Service. “Publication 936, Home Mortgage Interest Deduction.”

²³ Caswell, Chris. “Can you deduct you boat? Read on . . .” Motorboating. Available at <http://www.motorboating.com/motorboat/features/article/0,12696,1043556,00.html>. The requirement is that the second “home” have sleeping, dining, and toilet facilities.

²⁴ IRS Fact Sheet. 3.6 Itemized Deductions/Standard Deductions: 6. Real Estate (Taxes, Mortgage Interest, Points, Other Property Expenses). Available at <http://www.irs.gov/faqs/faq3-6.html?source=ttcom4home1>.

²⁵ Joint Committee of Taxation (JCT). “Estimates for Federal Tax Expenditures for Fiscal Years 2005-2009.” January 12, 2005. 33.

²⁶ United States v. U.S. Shoe Corp., 523 U.S. 360 (1998).

²⁷ Statement of the American Society of Civil Engineers before the Subcommittee on Energy and Water Development on the U.S. Army Corps of Engineers budget for FY2006.

²⁸ This is an aggregate of all loans for first or second homes. This includes \$100,000 on home equity loans or other loans secured by the home.

²⁹ Joint Committee of Taxation (JCT). "Estimates for Federal Tax Expenditures for Fiscal Years 2005-2009." January 12, 2005. 33.