

from the Tax Policy Center

Tax Incentives for Energy Production

By Troy Kravitz

In the midst of record gas prices and oil company profits, President Bush and members of Congress have proposed scaling back recent tax breaks for the oil and gas industry. The recently enacted Tax Increase Prevention and Reconciliation Act of 2005 lengthened the amortization period for exploration expenditures, increasing Treasury revenues by \$160 million by 2010 (out of \$800 million in tax incentives originally enacted eight months earlier). Bush has also called for repealing several other tax and spending provisions that collectively cost \$2 billion over 10 years; bipartisan Senate proposals would repeal tax breaks worth up to \$7 billion.

If those cutbacks happen, they would mark a partial reversal of a trend to expand tax incentives for exploration and energy production. The Joint Committee on Taxation estimated the revenue effect of 21 separate energy tax expenditure items in 2006, up from 9 as recently as 2004. Several of those provisions will reduce federal tax revenues by more than \$1 billion between

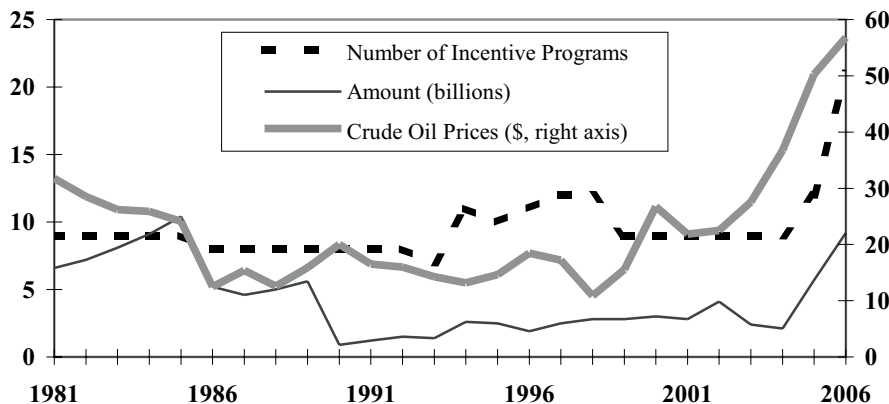
2006 and 2010 according to the JCT's estimates, including the expensing of exploration and development costs (\$5.4 billion), the excess of percentage over cost depletion (\$4.7 billion), and enhanced oil recovery costs (\$1.8 billion).

Economists are generally skeptical of such tax incentives. It is usually bad policy to favor one industry over another or one kind of production over another because it distorts investment and production decisions. Moreover, some of the preferential tax treatments received by energy producers provide incentives for relatively inefficient investments within the industry.¹

Some energy subsidies might be justified on the grounds that encouraging fuel efficiency or alternative energy sources might reduce pollution or slow global warming. Even in those limited cases, policies that are not tied to specific technologies, energy sources, or production methods, such as a carbon tax, are likely superior alternatives because they allow the market to decide the best way to achieve the policy goals.

¹See General Accounting Office, "Additional Petroleum Production Tax Incentives Are of Questionable Merit," July 1990, available at <http://archive.gao.gov/d23t8/141866.pdf>.

Energy Expenditure Items and Oil Prices



Sources: JCT; Energy Information Administration.

The amount portrayed represents the sum of costs of each expenditure item, estimated independently; because of interactions among the incentive programs, the total tax expenditure for all items may be more or less than the sum. Items costing less than \$50 million are included in the count of programs, but their dollar costs are not reported by the JCT and thus are excluded from the total amount.



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