



STATEMENT OF TED GAYER

PRESIDENT, NISKANEN CENTER

TESTIMONY FOR THE UNITED STATES SENATE COMMITTEE ON THE BUDGET

FULL COMMITTEE HEARING ON:

“Who Pays the Price: The Real Cost of Fossil Fuels”

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Chairman Whitehouse, Ranking Member Grassley, and Members of the Committee, thank you for inviting me to testify on fossil fuel subsidies. My name is Ted Gayer, and I’m the President of the Niskanen Center. I am an economist who served in the Department of Treasury and the Council of Economic Advisers in the George W. Bush Administration. I have also worked at the Brookings Institution, the American Enterprise Institute, Georgetown University, and the Public Policy Institute of California.

In my testimony, I will address three points. First, instead of providing subsidies to fossil fuels, our tax code should promote market-friendly incentives that factor in the external costs of energy use. Second, the size of existing fossil fuel subsidies depends on various factors, such as whether one is focusing on their overall size or their size compared to subsidies granted to other industries. And third, since fossil fuel subsidies are relatively small, their elimination would have a minimal impact on both fossil fuel production and prices.

Historically, federal energy tax policies have sought to boost domestic energy production, generate tax revenue, and promote environmental quality. These goals are often in conflict, such as when we impose a gas guzzler tax to reduce fuel consumption while we simultaneously subsidize oil production to increase domestic output. Energy policy should instead account for the sizable external cost of energy consumption, such as the costs associated with climate change and particulate pollution, by implementing a carbon tax that encourages consumers and producers to reduce emissions through market incentives. However, current tax provisions include several fossil fuel subsidies that contradict this goal.

Most fossil fuel subsidies exist in the tax code. Under current law, a handful of tax provisions provide benefits to oil and natural gas production in the United States. These provisions generally reduce the tax burden on oil and natural gas companies in the United States. They either directly reduce tax liability by providing tax credits or indirectly by reducing taxable income.

Most fossil fuel subsidies are implemented as tax expenditures in our tax code. Quantifying the precise value of these tax expenditures is challenging and depends on the baseline tax definition. The Joint Committee on Taxation (JCT) deems a tax provision a tax expenditure if it deviates from a baseline income tax.¹ If one instead considers a consumption tax as the baseline tax system, then many current provisions would not qualify as tax expenditures. Furthermore, several fossil fuel tax expenditures apply to other industries within and outside the energy sector, so their magnitude depends on whether one is focusing on their overall size or their size compared to subsidies granted to other industries.

It is also worth noting that the U.S. Treasury Department maintains estimates of tax expenditures. However, their list includes provisions not included in the JCT list, and some provisions included in the JCT list are not in the Treasury list.²

Fossil fuel tax provisions included in most lists fall into four general categories: cost recovery, the treatment of inventories, the treatment of foreign profits, and tax credits.

The Tax Treatment of Cost Recovery

Cost recovery concerns the rules by which businesses can recover the costs of their capital assets through tax deductions over a specified period. For fossil fuel businesses, these include provisions such as expensing of intangible drilling costs and expensing of tertiary injectants.

A large portion of fossil fuel tax provisions are cost recovery provisions. As such, they are deductions oil and natural gas companies receive for capital investments. They are considered tax expenditures because they are more accelerated than what would occur under a typical baseline income tax, according to the JCT. Table 1 provides 5-year estimates by JCT of the budgetary costs of these tax provisions.

Table 1. Fossil Fuel Cost Recovery Tax Provisions

Provision	5-Year Budgetary Cost 2022-26, billions
Expensing of intangible drilling costs (IDCs)	\$2.2*
Expensing of oil and gas exploration and development costs	
Expensing of tertiary injectants	De minimis
Amortization of geological and geophysical expenditures associated with oil and gas exploration	\$0.6
Accelerated amortization of air pollution control equipment	\$2.3
Excess of percentage over cost depletion for oil and gas	\$2.7
Seven-year MACRS Alaska natural gas pipeline	De minimis
15-year MACRS for natural gas distribution line	\$0.3

Source: "[Estimates of Federal Tax Expenditures for Fiscal Year 2022-2026](#)," Joint Committee on Taxation, 28, 36.

¹ "Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026," Joint Committee on Taxation, JCX-22-22 (U.S. Congress, Dec. 22, 2022), <https://www.jct.gov/publications/2022/jcx-22-22>, p. 3-4.

² "[Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026](#)," Joint Committee on Taxation, p. 20.

Note: A de minimis tax expenditure is less than \$50 million during FY2022-FY2026; these are not listed in JCT's tax expenditure table but noted separately in the report.

**JCT included expensing of intangible drilling costs as part of the expensing of oil and gas exploration and development costs.*

Again, these JCT estimates are for total tax expenditures, not relative to the tax expenditures received by other companies. Current law allows companies in other industries to accelerate their cost recovery. For example, a corporation that invests in computer equipment can immediately deduct 80 percent of the cost up front. Meanwhile, an oil company can immediately deduct tertiary injectants investment.³ Both companies get accelerated depreciation, but the oil company gets a slightly larger benefit.

It is also worth noting that not all oil and natural gas companies can receive the full benefit of these provisions.⁴ For example, nonintegrated oil and gas producers can fully expense their intangible drilling costs (IDCs). In contrast, integrated producers can fully expense 70% of their IDCs and recover the remaining 30% over five years.⁵

According to the JCT, cost recovery provisions amount to approximately \$8.1 billion over fiscal year 2022-2026 in tax expenditures for fossil fuel companies, which is approximately \$1.6 billion annually.

The Tax Treatment of Inventories

Under current law, businesses with inventories cannot immediately deduct their costs until they are sold. Consistent with Generally Acceptable Accounting Practices, corporations can make assumptions about what inventories are sold in what order. The two most common inventory valuation methods are First-in, First-out (FIFO) and Last-in, First-out (LIFO).

Under FIFO, a corporation can assume that the cost of the first inventory purchased or produced is deducted against the sale of an inventory. In contrast, a corporation using LIFO can deduct the costs of producing the last unit of an inventory. If costs of inventory production rise over time, this method reduces the business's tax burden relative to deducting the costs associated with the first unit of inventory. One could draw the analogy between LIFO and accelerated depreciation of capital assets, which does a similar thing for capital assets. However, if prices are expected to fall, LIFO is less generous than FIFO.⁶ LIFO is a tax expenditure, and is considered as such by JCT, but it is available to any corporation. JCT does not break out the costs specific to LIFO available to fossil fuel companies.

³ Molly F. Sherlock, "Energy Tax Provisions: Overview and Budgetary Cost," Congressional Research Service report R46865 (Aug, 34, 2021), <https://crsreports.congress.gov/product/pdf/R/R46865>, p. 13.

⁴ Kevin A. Hassett and Alan D. Viard, "Big Oil, Targeted Taxes, and the Rule of Law," *Tax Notes* 135, no. 2 (April 9, 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2218386.

⁵ CRS, "Energy Tax Provisions," p. 13; Hassett and Viard, "Big Oil," p. 220.

⁶ Kyle Pomerleau, "The Tax Treatment of Inventories and the Economic and Budgetary Impact of LIFO Repeal," *Tax Foundation Fiscal Fact*, no. 501 (Tax Foundation, February 2016), https://files.taxfoundation.org/legacy/docs/TaxFoundation-FF501.pdf?_gl=1*8j44rc*_ga*ODM5MTU2NjE3LjE2NTU0MDY5NTU.*_ga_FP7KWDV08V*MTY4MTc1NjI5OS40NS4xLjE2ODE3NTYzMTYuNDguMC4w; Alan D. Viard, "Why LIFO Repeal is Not the Way to Go," *Tax Notes* 113, no. 6 (November 6, 2006), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2218442.

The Tax Treatment of Foreign Profits

The Tax Cuts and Jobs Act (TCJA) included significant reforms to the tax treatment of foreign profits of multinational corporations. It replaced the previous system that subjected worldwide profits to U.S. taxation with a deferral for active foreign profits with a territorial or source-based tax system that only applies U.S. tax on U.S.-source profits. To dissuade multinationals from shifting highly mobile income out of the United States, the law included provisions to continue taxing certain types of profit on a global basis, albeit below the standard corporate tax rate.⁷⁸

The two most important components of the new provisions are two new definitions of income: Global Intangible Low-Taxed Income (GILTI) and Foreign Derived Intangible Income (FDII). GILTI creates a 13.125 percent minimum tax on the returns to intangible income in foreign jurisdictions. FDII is a mirror image of GILTI that creates a special lower rate of 13.125 percent on intellectual property products located in the United States and used to serve foreign markets.⁹

GILTI excludes what is called “FOGEI” or foreign oil and gas extraction income. The JCT considers any tax exemption on foreign profits (less a credit for foreign taxes paid) to be a tax expenditure. JCT’s baseline tax code would tax the worldwide profits of U.S.-based multinational corporations. As such, FOGEI would be considered a tax expenditure because it exempts a portion of foreign profits from immediate taxation in the United States. However, the JCT does not break out the cost of this provision.

If one considers a corporate tax based on worldwide profits of U.S. firms the baseline tax system, then FOGEI should be taxed along with all other foreign profits that are currently exempt. However, under the U.S. current source-based tax system, all foreign profits would be exempt from U.S. taxation. In the context of GILTI, FOGEI is neither intangible nor mobile, so there is a policy justification for its exemption.

The second major provision that impacts foreign profits of oil and natural gas companies is “dual capacity” regulations. These regulations set out rules that govern what payments oil and gas companies can count as “foreign income tax” for purposes of getting a U.S. credit. Generally, companies can only

⁷ Kyle Pomerleau, “Biden’s Reforms to the Tax Treatment of US Multinational Corporations: The Knowns and Unknowns,” *AEI Economic Perspectives* (American Enterprise Institute, July 2021), <https://www.aei.org/wp-content/uploads/2021/07/Bidens-Reforms-to-the-Tax-Treatment-of-US-Multinational-Corporations.pdf?x91208>
<https://taxfoundation.org/multinational-tax/>

⁸ Kyle Pomerleau, “A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act,” *Tax Foundation Fiscal Fact*, no. 586 (Tax Foundation, May 2018), https://files.taxfoundation.org/20180502205047/Tax-Foundation-FF586.pdf?_gl=1*1m8hwcz*_ga*ODM5MTU2NjE3LjE2NTU0MDY5NTU.*_ga_FP7KWDV08V*MTY4MTc1NjI5OS40NS4xLjE2ODE3NTg3NTkuNjAuMC4w.

⁹ Kyle Pomerleau, “Biden’s Reforms to the Tax Treatment of US Multinational Corporations: The Knowns and Unknowns,” *AEI Economic Perspectives* (American Enterprise Institute, July 2021), <https://www.aei.org/wp-content/uploads/2021/07/Bidens-Reforms-to-the-Tax-Treatment-of-US-Multinational-Corporations.pdf?x91208>.

consider income taxes creditable against U.S. tax liability on foreign profits. Other payments, such as royalties cannot be credited and are merely deductible against taxable income.¹⁰

The Biden Administration wants these rules tightened to classify more payments made to foreign governments as royalties.¹¹ This would raise the tax burden on foreign profits because deductions are less valuable than a credit. Current rules, however, allow for some flexibility. Some countries tend to blur the line between income tax payments and royalties and current rules allow companies to argue in court the proper treatment. Dual capacity regulations are not considered a tax expenditure by JCT.

Tax Credits

Under current law, oil and natural gas companies can receive several (generally small) tax credits. For example, firms can claim a credit for producing oil and gas from marginal wells when oil and gas prices fall below certain benchmarks.¹²

With some exceptions, credits are generally inconsistent with JCT’s benchmark tax code or under alternative tax systems like a consumption tax. These are more clearly subsidies than other provisions. Still, these provisions are very small (as shown in Table 2).

Table 2. Tax Credits

Provision	5-Year Budgetary Cost 2022-26, Billions
Credit for enhanced oil recovery costs	De minimis
Credit for producing oil and gas from marginal wells	De minimis
Credits for investments in Clean Coal Facilities	\$0.8
Production credit for refined coal	\$0.1
Production credit for Indian coal	\$0.1

Source: “[Estimates of Federal Tax Expenditures for Fiscal Year 2022-2026](#),” Joint Committee on Taxation, 28, 35.

Note: A de minimis tax expenditure is less than \$50 million during FY2022-FY2026; these are not listed in JCT’s tax expenditure table but noted separately in the report.

Other Provisions: Tax Exemptions, Deferrals, and Lower Rates

This category of tax benefits provides either lower rates for certain types of income, exempts certain types of income, or allows for deferral of taxation, as shown in Table 3. In some cases, these provisions are more generous to oil and gas companies than to other industries. For example, oil and gas

¹⁰ KPMG, “Tax Provisions in Biden Administration’s FY 2022 Budget Proposals,” June 18, 2021, <https://assets.kpmg.com/content/dam/kpmg/us/pdf/2021/06/tnf-biden-fy-2022-budget-energy-june18-2021.pdf>.

¹¹ Alex Muresianu and William McBride, “A Guide to the Fossil Fuel Provisions of the Biden Budget,” Tax Foundation, Sept. 2, 2021, <https://taxfoundation.org/biden-fossil-fuel-tax>; White House Office of Management and Budget, *Budget of the U.S. Government: Fiscal Year 2024*, 155.

¹² CRS, “[Energy Tax Provisions](#),”

investments are exempt from the general rule that “passive losses,”—those from investments a taxpayer is not directly managing—cannot be used to offset active income (wages, salaries, active business income). However, this is not considered a tax expenditure by the JCT because loss deductions are a component of JCT’s baseline income tax. (The U.S. Treasury does consider this a tax expenditure).¹³

Table 3. Other Provisions

Provision	5-Year Budgetary Cost 2022-26, Billions
Capital gains treatment for royalties	N/A
Exceptions for publicly-traded partnership with qualified income derived from certain energy-related activities	\$2.7
Oil Spill Liability Trust Fund and Superfund excise tax exemption for crude oil derived from bitumen and kerogen-rich rock	N/A
Exception to passive loss limitations provided to working interests in oil and natural gas properties	N/A

Source: “[Estimates of Federal Tax Expenditures for Fiscal Year 2022-2026](#),” Joint Committee on Taxation, 24, 36.

Note: N/A denotes that a tax provision/rule is either not considered as a tax expenditure by JCT, or that an estimate is not available.

In total, JCT estimates the value of the value of fossil fuel tax expenditures at approximately \$11.8 billion for the five-year period of 2022-2026. The tax expenditures denoted as de minimis and the ones not quantified are not included in this estimate.

Given their relatively small magnitude, fossil fuel subsidies are unlikely to significantly increase production in the United States. The Congressional Budget Office estimates that fossil fuel tax subsidies led to a minimal impact of 0.4 to 0.8 percent more domestic oil production.¹⁴ The U.S. Treasury and other academic studies find similarly small effects of fossil fuel tax subsidies on domestic production.¹⁵ These small effects mean they do not achieve the goal of insulating domestic prices from foreign supply disruptions, particularly since prices are determined in the global market.

In conclusion, regardless of their magnitude, fossil fuel subsidies hinder efforts to reduce carbon emissions. A better approach is a border-adjusted carbon tax to create market incentives to account for

¹³ “[Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026](#),” Joint Committee on Taxation, p. 22.

¹⁴ Congressional Budget Office, “Federal Support for the Development, Production, and Use of Fuels and Energy Technologies,” November 2015, p. 12, <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/50980-energysupportonecol-3.pdf>.

¹⁵ Gilbert E. Metcalf, “The Impact of Removing Tax Preferences for U.S. Oil and Natural Gas Production: Measuring Tax Subsidies by an Equivalent Price Impact Approach,” NBER Working Paper 22537 (National Bureau of Economic Research, August 2016), https://www.nber.org/system/files/working_papers/w22537/w22537.pdf; Maura Allaire and Stephen Brown, “Eliminating Subsidies for Fossil Fuel Production: Implications for U.S. Oil and Natural Gas Markets,” Issue Brief 09-10 (Resources for the Future, December 2009), <https://media.rff.org/documents/RFF-IB-09-10.pdf>, p. 8; U.S. Treasury Department, “Statement of Alan B. Krueger Assistant Secretary for Economic Policy and Chief Economist, US Department of Treasury Subcommittee on Energy, Natural Resources, and Infrastructure,” Sept. 10, 2009.

the costs of energy use. Such taxes make use of market forces, which is preferable to subsidies that require government picking winners and losers.¹⁶

Mr. Chairman, Ranking Member Grassley, thank you once more for the opportunity to speak today. I look forward to your questions.

¹⁶ Ted Gayer, “Linking Climate Policy to Fiscal and Environmental Reform,” Brookings Institution, 2012, https://www.brookings.edu/wp-content/uploads/2016/06/0302_climate_policy_gayer.pdf; Ted Gayer and Phillip Swagel, “Pro-Growth Carbon Tax: A Catalyst for Regulatory and Tax Reform,” (Alliance for Market Solutions, June 1, 2016), <https://amsresearch.org/wp-content/uploads/2019/03/Pro-Growth-Carbon-Tax-A-Catalyst-for-Regulatory-and-Tax-Reform.pdf>; Shuting Pomerleau, “Border Adjustments in a Carbon Tax,” (Niskanen Center, July 2020), <https://www.niskanencenter.org/wp-content/uploads/2020/07/Border-Adjustments-in-a-Carbon-Tax.pdf>.