

March 18, 1993

## THE FLAWS IN CLINTON'S ENERGY TAX

### INTRODUCTION

As part of his budget deficit reduction plan, President Bill Clinton has proposed a tax on the energy content of various fuels. The plan is to impose a 25.7 cent tax on coal, natural gas, nuclear power, oil, and even hydropower, for every million Btu's or mmbtu's.<sup>1</sup> The plan also calls for a 34.2 cent mmbtu "Supplemental Oil Tax," which would make the effective tax on oil 59.9 cents. The only energy sources that would not be taxed are wind and solar power. The tax would be phased in over a three-year period beginning in mid-1994.

The proposed energy tax, which is designed to raise approximately one-fourth of the total revenue for Clinton's budget package, is ill conceived and is being sold to working class and poor Americans on false pretenses. The Administration is building support for this tax by maintaining that it will reduce dependence on foreign oil and that it will help the environment. Clinton also claims that the tax will not unduly burden middle-class families and will not affect the poor.

But the tax will have very different effects from those claimed by the White House. Specifically:

- ✗ The cost to the average family will be about 40 percent higher than Clinton claims.
- ✗ Millions of poor families will be worse off if the tax is enacted.
- ✗ The economy is likely to be dampened by this tax's negative effect on international trade.
- ✗ Foreign refiners will gain at the expense of domestic refiners.
- ✗ Foreign oil dependence likely will increase because domestic production will fall.
- ✗ The environment may be harmed because greater use of high-sulphur eastern coal will be encouraged.

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<sup>1</sup> British thermal units, which is the amount of energy consumed to warm a pound of water one degree Fahrenheit at 39°F.

The Clinton Administration thus is attempting to push through Congress a huge new energy tax, claiming that it will bring benefits while imposing little or no burden on Americans with low or modest incomes. But the "benefits" are unlikely to occur, and the cost will be much higher to families than the Administration claims. Even worse, the tax will increase dependence on foreign oil, while doing little or nothing to help the environment.

## HOW THE WHITE HOUSE HIDES THE COST

In his February 17, 1993, speech to a joint session of Congress outlining his economic strategy, Bill Clinton proposed a new tax on energy to raise funds for his deficit reduction package. He promised that the tax would cost families making over \$30,000 only \$17 a month (or \$204 per year). He further promised that those making under \$30,000 would feel no tax bite due to offsetting government spending.

Both of these promises were false.

Soon after the speech, it became clear that the White House definition of "income" is very different from that understood by average Americans. For instance, the Administration counts as household income the rentable value of the home the family owns, as well as the value of employer-provided health benefits.<sup>2</sup> Thus, when Clinton says the tax will apply only to those families making over \$30,000, he means that it will apply to those families whose gross income according to the IRS is nearer to \$20,000.

The Administration also began to shift ground on the size of the tax. Energy Secretary Hazel O'Leary now says that the average family of four making \$40,000 would feel a tax bite of \$320 a year when the tax is fully implemented.<sup>3</sup> And even this much larger figure understates the true impact of the energy tax. Figures prepared by the American Petroleum Institute (API), for instance, indicate that the annual tax bite on an average family of four actually would be \$471.<sup>4</sup> Why the discrepancy?

The Administration's estimate of a \$320 cost for the average family of four is likely to be well below the true cost. One reason for this is that in calculating the cost the Administration uses a novel economic theory which assumes that not one penny of the energy tax will be passed on to consumers through higher prices. The White House is telling industry a very different story. As Kenneth Lay, Chairman of Enron, the country's largest natural gas company, said earlier this month within hours of meeting with Secretary O'Leary, "The Administration has assured [the energy industry] at every turn that the tax [is designed] to be passed on to the consumer...that this is to be a tax on energy, not on the energy industry."<sup>5</sup>

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4 The government and the American Petroleum Institute both used a family of four to calculate the effect of the energy tax on households. API calculated the per capita effect of the tax and then multiplied this by four. This method does slightly overstate the effect of the tax on an "average" family of four because larger families usually use less energy per person than smaller families. The average size household is 2.7 people. The exact methodology used by the Administration to arrive at the cost for a family of four is unknown.

5 Speech at a CATO Institute conference on Natural Gas Deregulation, Washington, D.C., March 4, 1993.

The cost to families depends greatly on whether the tax will be passed on to the consumer or absorbed by the energy industry. If the tax is absorbed by the industry, the money would come from pre-tax income either by suppressing wages for workers or income and dividends in the industry. If passed on, it would come out of the after-tax incomes of consumers—implying a higher effective burden. If a larger share of the tax is not passed on, then the Administration's figures would be fairly accurate—although still about 10 percent too low because the Administration ignored its own projections of future energy consumption.<sup>6</sup> However, if tax costs are substantially passed on to the consumer, then the tax bite to the average American could be over 40 percent higher than the White House claims.

While not all costs of the tax would be passed through to the consumer, previous experience, as well as standard economic analysis, suggests that most of the tax would be passed on to the consumer in the form of higher prices on almost all goods and services. Although estimates vary, the percentage of the energy tax likely to be passed on to the consumer is between 60 percent and 80 percent.<sup>7</sup> Thus, most of the tax will be on consumers' after-tax incomes rather than, as the Administration claims, on their before-tax income (due to lost wages). Using this more realistic assumption, the total tax collected would be \$29.3 billion to \$30.9 billion (or \$109 to \$115 per capita). For a typical family of four, this works out to be \$437 to \$461 per household.

Household costs would, of course, vary by region. For instance, a four-member household in Rhode Island could expect to pay only up to \$285 in direct and indirect energy taxes, while a household in Montana, a state with cold, long winters and low population density, would pay up to \$566. Unfortunate Alaskans would pay up to \$1,407.<sup>8</sup>

## HOW THE TAX HELPS FOREIGN COMPETITORS

Refined gasoline coming over the border would cost less to produce than gasoline refined in the United States. So foreign suppliers of refined petroleum would have an advantage over domestic suppliers. The reason? Approximately 42 percent of the costs of refining are due to the energy content that is used in the refining process.<sup>9</sup> Thus, while both foreign and American refiners would pay a tax on the energy content of the refined gasoline, the American refiner would be saddled with an additional tax on the energy used in the refining process. Thus, on average, American refiners would pay much more tax than their foreign counterparts. Since only the part of the tax that both countries' refiners pay could be passed on to consum-

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  - 7 Telephone interview with Philip Verlenger, Visiting Fellow at the Institute for International Economics. Note that the range indicated is a conservative estimate.
  - 8 Based on per capita expenditures, adjusted downward to account for average tax costs absorbed as wage suppression, multiplied by four.
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ers, American refiners would be forced to absorb much of the additional tax.<sup>10</sup> This tax will be on an already overburdened industry. An ongoing National Petroleum Council study reportedly finds that U.S. refiners now face a penalty of about 7 cents a gallon (when compared with foreign refiners) due to environmental compliance costs. Within six or seven years, moreover, this penalty will increase to 13 cents a gallon.

Other foreign companies supplying the United States also would gain a competitive advantage from the energy tax. The tax would not apply to the energy used in goods manufactured abroad, only to domestic products. Since most foreign countries subsidize energy used by their industrial sectors, the Clinton tax would give foreign manufacturers an additional competitive edge.<sup>11</sup> As Michael Schuyler, Senior Economist at the Washington, D.C.-based Institute for Research on the Economics of Taxation, wrote in 1990, "It seems bizarre to propose a tax that would raise production costs of American businesses across the board. The tax would penalize U.S. exports and invite the substitution of foreign for American production in the domestic U.S. market."<sup>12</sup>

## WHY THE TAX IS REGRESSIVE

The Administration candidly admits that the energy tax is regressive, but claims to have offset its impact on families making under \$30,000 a year. This is not accurate.

Many Americans, and lawmakers, have the wrong impression that this tax operates like a flat, proportional tax on income. In reality, it taxes the spending of the poor more than the wealthy. The reason is that poorer families, and to a lesser extent middle-class families, spend disproportionately more of their annual budget (including government entitlements) on basic goods such as heating and gasoline than do wealthier families.<sup>13</sup> Hence, an increase in the price of energy would harm them disproportionately.

Clinton claims that the burden on the poor will be offset by other policies, such as an increase in the food stamp and earned income tax credit programs. However, even if there were a full offset, the Administration's assertion that families making up to \$30,000 will be spared the effect of the tax is based on the inflated income statistics discussed earlier. Moreover,

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- 10 Another problem of the tax centers on the tax's incidental effect on domestic refiners exports. In essence, the tax would impose tariffs on exports of \$3.15 on a barrel of gasoline and \$3.50 a barrel on distillate fuel and crude oil. Thus, refiners would suffer on world markets.
  - 11 The myth that foreign manufacturers pay heavy energy taxes stems from the correct notion that many foreign countries impose heavy taxes on gasoline. But industrial energy subsidies offset, and often more than offset, the impact of high gasoline taxes. Because of foreign competition, U.S. industries that are energy intensive could not simply pass on all costs. A business also might not be able to raise prices simply because people forego or substitute the good when small increases in price occur. A potential example of one of these phenomena might be the airline industry. It would see its jet fuel cost rise by 12 percent, or \$800 million per year, according to Philip Verlenger, Visiting Fellow at the Institute for International Economics, in testimony before the U.S. Senate Committee on Energy and Natural Resources, January 24, 1993. If the tax were passed through to consumers, the costs for air travel would increase dramatically domestically and U.S. airlines would lose business on some international routes.
  - 12 Michael Schuyler, "Energy Taxation is Not the Answer," Institute for Research on the Economics of Taxation *IRET Byline*, No. 90, July 20, 1990.
  - 13 Based on calculations by author using data from the Bureau of Labor Statistics.

when the offsets proposed are examined, it appears that millions of lower income families will not be protected from the tax's effect.

This means that the assertion that low-income families will not face added financial burdens is untrue. Almost 50 percent of families earn less than \$30,000 annually (and over 40 percent earn less than \$25,000).<sup>14</sup> The Administration intends to increase government income assistance programs, such as food stamps, earned income tax credits, and energy assistance to this group. In the aggregate, spending increases on this income group may indeed equal the amount this group pays in taxes—although the Administration's underestimate of the tax burden means this assertion probably is not true. Nevertheless, individual families will not all fare as well.

For instance, some families live in rural areas or must travel long distances to work. These "high mileage" families buy more gasoline and will pay a higher share of the tax. On these families, the additional 10-12 cents a gallon due to the Clinton energy tax will be a greater burden than on those families living in cities.<sup>15</sup> Similarly, low-income families will differ in the amount of additional government assistance they receive. For instance, those families already receiving food stamps are unlikely to benefit from an expansion of the food stamp program, because food stamp benefits are not likely to increase significantly. Rather, the increased funding mostly will be used to expand eligibility. Thus, those newly eligible will benefit greatly.

When the disparate impacts of the tax and the entitlement benefits are combined, the effects will differ widely. Those facing the highest burdens will be the unfortunate "high mileage" or other energy-intensive families currently receiving welfare, who will see their additional costs far outstrip their increased benefits. Those experiencing windfall benefits will be the "low mileage" families who will become eligible for welfare for the first time, and who will enjoy larger benefits than their increased costs.

## A BLOW TO ENVIRONMENTALISM

The energy tax has also been touted as a way to protect the environment. But rather than helping the environment, it will be neutral — or even harmful.

It is true that some conservation will take place because of the tax. The Administration estimates that this conservation will reduce energy usage 1.9 percent by 1997 over the energy use that would have occurred without the tax. While this may be slightly optimistic, it is plausible. But conservation should not be looked at as an end in itself. Arguments that energy needs to be conserved are based on a fundamental misunderstanding of the underlying economics. The scarcity of energy resources is already incorporated into the market price. Any attempt to in-

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- 14 The 40 percent figure is given because Clinton defines income differently than does the rest of the United States Government. Thus, his offsets actually will be to those making several thousand dollars less than the \$25,000 and below category released by the Census Bureau.
- 15 "The Clinton Btu Tax Proposal," Cambridge Energy Research Associates, February 1993. The Administration assumes that the additional tax on gasoline will be only about 8 cents. This figure is rejected by Cambridge Energy research Associates. The Cambridge figures, however, seem more credible since they reflect the amount of the tax on crude which can only be passed on to light fuels, rather than to heavy residuals. Regardless of which figure is correct, the argument outlined in the text holds.

crease energy conservation by raising a tax encourages firms to increase their use of other resources.

Thus the argument for conservation rests on the contention that it will reduce pollution. Naturally, a reduction in the burning of fossil fuels would reduce air pollution, if there were a uniform reduction among all fuel sources. However, the reductions would not occur uniformly due to distortions created by the tax.

In seeming deference to the power of Senator Robert Byrd of West Virginia, high-sulphur eastern coal has been granted a competitive advantage not only against oil, but also against low-sulphur western coal. As Philip Verlenger of the Institute for International Economics—who is no foe of higher taxes—noted in his January 24, 1993, testimony before the U.S. Senate Committee on Energy and Natural Resources, “This tax will push electric utilities and industrial firms to use more eastern coal.” This will happen, said Verlenger, because the Btu tax would almost double the cost of coal at the mine mouth as well as increase already burdensome transportation costs. The “effect of the tax is to make the nation’s cleanest coal (western coal) less competitive with dirtier eastern coal.” Demand for eastern coal could very well increase under the new cost structure. The potential result: a net increase in pollution because of a switch to high-sulphur coal.

## **AN INCREASED DEPENDENCE ON FOREIGN OIL**

The most ironic of all Clinton’s rationales for an energy tax is his claim that a Btu tax will reduce U.S. dependence on foreign oil. If the tax is imposed, America in fact could become more dependent on foreign oil.

As discussed in the previous section, the level of energy conservation would be very modest, possibly 2 percent if the Administration projections are correct. Thus, the energy tax will reduce dependence on foreign oil only if domestic production remains constant or falls by less than 2 percent.<sup>16</sup> But a tax on energy will likely discourage domestic production because it will raise substantially the costs of using “enhanced recovery methods” to extend the life of oil fields. These are methods, such as pumping natural-gas-generated steam into oil fields, that require a large amount of energy to extract oil that otherwise could not be pumped. Since the tax would apply not only to the final product—oil—but also to the energy used in production, total costs would rise substantially. This could particularly be a problem for producers in such places as the San Joaquin Valley in California, where costs would rise by 50 cents per barrel, and in Alaska, where total costs could rise \$100 million a year. The effect of the tax would be so profound that Verlenger predicts that California production will decline by 10 percent to 20 percent. This state’s reduced production alone would probably more than offset any reduced overall demand for imports.

Thus total domestic production of oil will fall as a result of this tax—and will probably more than offset the modest conservation gains due to the tax. Consequently, foreign oil dependence will likely increase.

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**16** Actually, demand for energy is expected to increase overall, but other fuel sources are likely to be substituted for oil. Additionally, foreign producers still would compete under the same cost structure despite changes in demand. The important point thus is what level of domestic production will occur in relation to foreign oil competition.

## CONCLUSION

The energy tax proposed by the White House should be stricken from the budget package now before Congress.

None of the Administration's grocery list of reasons why the tax will benefit the country are valid. The White House has asserted that the energy tax will:

- ✓ Benefit the economy;

**In fact, the U.S. trade balance will suffer because American goods will be less competitive. U.S. refiners will be burdened, moreover, and many will fail.**

- ✓ Cost only \$322 per family of four;

**In fact, the cost will be around \$450.**

- ✓ Not affect the poor because of increased welfare;

**In fact, millions of poor families will pay more for fuel and other goods without offsetting increases in welfare benefits.**

- ✓ Benefit the environment;

**In fact, increased burning of high-sulphur eastern fuel will be encouraged, and fossil fuel burning overall will be decreased by less than 2 percent.**

- ✓ Decrease foreign oil dependence.

**In fact, domestic production is likely to fall by more than demand—thus oil imports will likely increase.**

This tax should be rejected for any one of these reasons. It certainly should be rejected when all are considered. This is not an investment in the American economy. It is a tax on America's economic growth.

**John Shanahan  
Policy Analyst**

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Both of these promises were false.

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## A BLOW TO ENVIRONMENTALISM

The energy tax has also been touted as a way to protect the environment. But rather than helping the environment, it will be neutral — or even harmful.

It is true that some conservation will take place because of the tax. The Administration estimates that this conservation will reduce energy usage 1.9 percent by 1997 over the energy use that would have occurred without the tax. While this may be slightly optimistic, it is plausible. But conservation should not be looked at as an end in itself. Arguments that energy needs to be conserved are based on a fundamental misunderstanding of the underlying economics. The scarcity of energy resources is already incorporated into the market price. Any attempt to in-

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- 14 The 40 percent figure is given because Clinton defines income differently than does the rest of the United States Government. Thus, his offsets actually will be to those making several thousand dollars less than the \$25,000 and below category released by the Census Bureau.
- 15 "The Clinton Btu Tax Proposal," Cambridge Energy Research Associates, February 1993. The Administration assumes that the additional tax on gasoline will be only about 8 cents. This figure is rejected by Cambridge Energy research Associates. The Cambridge figures, however, seem more credible since they reflect the amount of the tax on crude which can only be passed on to light fuels, rather than to heavy residuals. Regardless of which figure is correct, the argument outlined in the text holds.

crease energy conservation by raising a tax encourages firms to increase their use of other resources.

Thus the argument for conservation rests on the contention that it will reduce pollution. Naturally, a reduction in the burning of fossil fuels would reduce air pollution, if there were a uniform reduction among all fuel sources. However, the reductions would not occur uniformly due to distortions created by the tax.

In seeming deference to the power of Senator Robert Byrd of West Virginia, high-sulphur eastern coal has been granted a competitive advantage not only against oil, but also against low-sulphur western coal. As Philip Verlenger of the Institute for International Economics—who is no foe of higher taxes—noted in his January 24, 1993, testimony before the U.S. Senate Committee on Energy and Natural Resources, “This tax will push electric utilities and industrial firms to use more eastern coal.” This will happen, said Verlenger, because the Btu tax would almost double the cost of coal at the mine mouth as well as increase already burdensome transportation costs. The “effect of the tax is to make the nation’s cleanest coal (western coal) less competitive with dirtier eastern coal.” Demand for eastern coal could very well increase under the new cost structure. The potential result: a net increase in pollution because of a switch to high-sulphur coal.

## AN INCREASED DEPENDENCE ON FOREIGN OIL

The most ironic of all Clinton’s rationales for an energy tax is his claim that a Btu tax will reduce U.S. dependence on foreign oil. If the tax is imposed, America in fact could become more dependent on foreign oil.

As discussed in the previous section, the level of energy conservation would be very modest, possibly 2 percent if the Administration projections are correct. Thus, the energy tax will reduce dependence on foreign oil only if domestic production remains constant or falls by less than 2 percent.<sup>16</sup> But a tax on energy will likely discourage domestic production because it will raise substantially the costs of using “enhanced recovery methods” to extend the life of oil fields. These are methods, such as pumping natural-gas-generated steam into oil fields, that require a large amount of energy to extract oil that otherwise could not be pumped. Since the tax would apply not only to the final product—oil—but also to the energy used in production, total costs would rise substantially. This could particularly be a problem for producers in such places as the San Joaquin Valley in California, where costs would rise by 50 cents per barrel, and in Alaska, where total costs could rise \$100 million a year. The effect of the tax would be so profound that Verlenger predicts that California production will decline by 10 percent to 20 percent. This state’s reduced production alone would probably more than offset any reduced overall demand for imports.

Thus total domestic production of oil will fall as a result of this tax—and will probably more than offset the modest conservation gains due to the tax. Consequently, foreign oil dependence will likely increase.

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<sup>16</sup> Actually, demand for energy is expected to increase overall, but other fuel sources are likely to be substituted for oil. Additionally, foreign producers still would compete under the same cost structure despite changes in demand. The important point thus is what level of domestic production will occur in relation to foreign oil competition.

## CONCLUSION

The energy tax proposed by the White House should be stricken from the budget package now before Congress.

None of the Administration's grocery list of reasons why the tax will benefit the country are valid. The White House has asserted that the energy tax will:

- ✓ Benefit the economy;

**In fact, the U.S. trade balance will suffer because American goods will be less competitive. U.S. refiners will be burdened, moreover, and many will fail.**

- ✓ Cost only \$322 per family of four;

**In fact, the cost will be around \$450.**

- ✓ Not affect the poor because of increased welfare;

**In fact, millions of poor families will pay more for fuel and other goods without offsetting increases in welfare benefits.**

- ✓ Benefit the environment;

**In fact, increased burning of high-sulphur eastern fuel will be encouraged, and fossil fuel burning overall will be decreased by less than 2 percent.**

- ✓ Decrease foreign oil dependence.

**In fact, domestic production is likely to fall by more than demand—thus oil imports will likely increase.**

This tax should be rejected for any one of these reasons. It certainly should be rejected when all are considered. This is not an investment in the American economy. It is a tax on America's economic growth.

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