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# America's Hidden Power Bill

## Examining Federal Energy Tax Expenditures

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# Introduction and summary

The most important day of the year for the many energy companies that receive federal financial support isn't the day the president releases his proposed budget, or the day appropriations bills get passed, or even the day when government checks get sent out. It's tax day. Why? Because each tax day energy companies—electric utilities, oil refiners, renewable energy developers, coal miners, ethanol producers, and others—record billions of dollars worth of special tax credits and deductions.

Tax expenditures—government spending programs that deliver subsidies through the tax code via special tax credits, deductions, exclusions, exemptions, and preferential rates—are the dominant type of federal support for the U.S. energy industry. Altogether, these spending programs amount to 60 percent of the government's total support to the industry. These tax expenditures are functionally equivalent to direct spending, but they are often subject to less scrutiny.

## A quick tax expenditures glossary

- **Tax credit:** A direct reduction in the amount of taxes owed. A taxpayer who originally owed \$10,000 but receives a tax credit for \$3,000 will only owe \$7,000 in taxes.
- **Tax deduction:** A reduction in the amount of income that is subject to a tax. A taxpayer who made \$60,000 in a year but is eligible for a \$10,000 deduction will only pay taxes on \$50,000.
- **Tax exclusion:** An item of income that is excluded from taxable income. For example, health care premiums paid by employers for their employees do not count as the employee's income and are therefore excluded from the income tax.
- **Tax exemption:** A reduction in taxable income offered to taxpayers because of their status or circumstances. For example, every individual taxpayer is entitled to exempt a certain amount of their income each year.
- **Preferential rates:** A reduction of the tax rate on some forms of income, such as capital gains and dividends.
- **Tax deferral:** Allows taxpayers to delay paying their taxes. For example, taxpayers delay paying taxes on income they contribute to an IRA until they withdraw those amounts. This delay, in effect, provides an interest-free "loan" to the taxpayer.

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Energy-related tax expenditures serve a broad range of purposes, from promoting renewable electricity generation to encouraging domestic production of oil. But the question is, are these energy programs working? And is implementing programs through the tax code the best way to achieve government goals?

The Center for American Progress demonstrated in “Audit the Tax Code: Doing What Works for Tax Expenditures” (released in conjunction with this paper) that tax expenditures suffer from a lack of transparency, evaluation, measurement, and oversight. Energy-related tax expenditures are not immune to these problems, and in fact they suffer from the same shortcomings as other tax expenditure programs.

The basic problem with tax expenditures is that they are often not thought of as a form of spending, which makes for a dangerous double standard. When considering spending policymakers ask themselves, “Is offering hard-earned taxpayer dollars as a subsidy to a private, profit-making company a good idea?” But if the spending is cast as a tax expenditure the assessment is different. Even though tax expenditures come at a cost to taxpayers—as with any other type of spending—they are viewed through a different, less critical lens. Viewing tax expenditures through the same lens as other government expenditures provides a clearer image of both how they support public policy and use public resources.

This paper will adopt that lens to look at two energy-related tax expenditures: the percentage depletion allowance in the oil industry and the production tax credit, or PTC, in the wind industry. We also consider a program in which a tax expenditure was temporarily converted into direct spending: the cash grant in lieu of the investment tax credit, or ITC, for wind generation.

We chose these three areas both for their political timeliness—the president’s budget proposes the elimination of some fossil fuel subsidies, and ITC provisions will expire unless renewed—and their size (these are all fairly large expenditures). Through these three examples we are able to explore the major issues in tax expenditure design and evaluation.

Through this analysis, we find these tax expenditures lack accountability, transparency, and measurability, yet there is some indication that the wind-related expenditures are effective. We find little justification for the percentage-depletion allowance, but we do find that when tax expenditures are redesigned and offered as direct spending—as with the cash grant in lieu of the ITC—the program can be more effectively monitored and managed.

Our analysis in the pages that follow illustrate that spending programs implemented through the tax code play an important role in supporting energy policies. Accordingly, these programs must be examined with the same level of scrutiny as direct spending. The following recommendations can help the government use its limited financial resources to most effectively promote desirable energy policies:

- **Tax expenditures need to be held to the same standards as other government spending.** This means Congress should clearly state the goals of expenditures, should contain sunset provisions so that they expire and are re-evaluated, and should require periodic reviews of their effectiveness. Any safeguard that is designed to prevent wasteful spending should also be applied to tax expenditures.
- **Tax expenditures are a form of government spending and should be considered as such.** This includes not just considering tax expenditures and direct spending at the same time but thinking about them in the right way. Every time a legislator thinks about a tax expenditure, they should ask themselves, “Is it a good idea for the government to pay someone for this reason?” This will encourage legislators to explore direct spending alternatives when appropriate, which are often better policy tools.
- **Congress should provide a rationale for each tax expenditure.** When Congress decides to provide financial support to an industry through either a tax expenditure or direct spending, they should state why the chosen method is better than the other.
- **Congress should hold agencies responsible for budgeting tax expenditures.** Agency budget requests that are sent to Congress should include the tax expenditure spending programs that support their policy areas. Just as agencies are required to explain and report on their direct spending request, they should perform the same exercise on each tax expenditure within their purview. This exercise would hold agencies responsible for explaining how all forms of government spending it uses support its policy areas, and it would empower Congress with the ability to cohesively examine how spending streams work together.
- **Tax expenditures should be measured and evaluated.** The government collects large amounts of data on many industries, but sometimes this data isn’t sufficient to evaluate a tax expenditure. If an evaluator finds that they don’t have appropriate data for the evaluation, there should be a clear process by which they can communicate that need to Congress. Congress should require beneficiaries of tax expenditures to report all data that is necessary for evaluation.
- **Congress should adopt standard practices for reviewing tax expenditures.** A good start would be to ensure that each expenditure is covered by a requirement that the Joint Committee on Taxation, the Congressional Budget Office, or the relevant agency report on the expenditure’s history, size, and effectiveness.
- **The Department of Energy should be the agency instructed to assess all energy-related tax expenditures.** In particular, the Energy Information Administration is probably the best office within the DOE to conduct this review. Additionally, EIA should periodically issue a report on federal financial supports for the energy industry.

- **The JCT and the Office of Management and Budget should agree on a standardized measurement system for tax expenditures.** There may be value to both of their current methodologies, but congressional review would be easier if they used the same methodology. Congress should work with the JCT and the OMB to determine the appropriate system.

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