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COMMENT

ENERGY SUBSIDIES, MARKET DISTORTION, AND A FREE MARKET ALTERNATIVE

Hans Biebl*

Gas and coal are cheap. They are cheap because the U.S. government subsidizes their production.¹ The result is that the marketplace does not recognize the true cost of fossil fuels. Without the subsidies, Americans—for the first time in nearly a hundred years—would experience the cost of unsubsidized fossil fuels.² In a newly competitive marketplace, renewable sources of energy would be in a better position to compete. Without gas and coal subsidies, clean energy producers, who have not been able to compete with the low price of fossil fuels, might be more willing to invest in “clean, renewable, and more energy efficient technologies.”³ This Comment first provides a brief history of U.S. energy policy over the last 100 years. Next, this Comment discusses how past free market reforms have failed to change the energy marketplace. Third, this Comment proposes that two provisions of the U.S. tax code that give preferential treatment to oil and gas producers be eliminated.

In 2011, the United States spent \$24 billion in tax preferences for and direct funding of energy programs.⁴ Of that, about \$18 billion was spent on renewable energy and \$6 billion on

* J.D. Candidate, May 2014, University of Michigan Law School.

1. *See generally, e.g.*, MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R41227, ENERGY TAX POLICY: HISTORICAL PERSPECTIVES ON AND CURRENT STATUS OF ENERGY TAX EXPENDITURES (2011), *available at* <http://www.leahy.senate.gov/imo/media/doc/R41227EnergyLegReport.pdf>.

2. *See id.* at 2-3.

3. OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2013, CUTS, CONSOLIDATIONS, AND SAVINGS, BUDGET OF THE U.S. GOVERNMENT 80 (2012), *available at* <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/ccs.pdf>.

4. *See* CONG. BUDGET OFFICE, FEDERAL FINANCIAL SUPPORT FOR THE DEVELOPMENT AND PRODUCTION OF FUELS AND ENERGY TECHNOLOGIES 1 (2012), *available at* http://www.cbo.gov/sites/default/files/cbofiles/attachments/03-06-FuelsandEnergy_Brief.pdf.

traditional fossil fuels.⁵ This distribution is a major shift in U.S. policy from the last century and even the early twenty-first century. From 1916 until the 1970s, the U.S. promoted domestic oil and gas production at the expense of renewable energy sources.⁶ The policy “sought to reduce oil import dependence and enhance national security” by lessening the U.S.’s reliance on foreign oil.⁷ In so doing, the U.S. government hid the true cost of oil and gas.⁸

Since domestic oil and gas production has been subsidized for so long, it is nearly impossible to gauge the true cost of production.⁹ But even without knowing the true cost, “market distortions created by fossil fuel subsidies” have led to inefficient market share “allocation within the energy sector.”¹⁰

In the past, market-based reforms in the energy market have been largely concentrated on cap-and-trade provisions. For example, in 1990, Congress passed amendments to the Clean Air

5. *See id.* (explaining that “energy efficiency and renewable energy accounted for 78 percent of the budgetary cost of federal energy-related tax preferences ” and “more than half” of DOE funding was spent on “energy efficiency and renewable energy”).

6. *See* MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R41227, ENERGY TAX POLICY: HISTORICAL PERSPECTIVES ON AND CURRENT STATUS OF ENERGY TAX EXPENDITURES 2 (2011), available at <http://www.leahy.senate.gov/imo/media/doc/R41227EnergyLegReport.pdf>.

7. *Id.* at 1.

8. Negative externalities are another reason that the price of oil and gas does not reflect their true cost. The largest oil spill in U.S. history, the explosion and spill from the Deepwater Horizon oil rig, will cost BP an estimated \$30 billion. *See* Abrahm Lustgarten, *A Stain That Won't Wash Away*, N.Y. TIMES, Apr. 19, 2012, at A23. The cost of a discrete event like this can be calculated. But the cost of oil and gas consumption over the past one hundred years cannot be so easily computed. There are various health and environmental effects of oil and gas use. *See generally* NATURAL RESOURCES DEFENSE COUNCIL, DRILLING DOWN: PROTECTING WESTERN COMMUNITIES FROM THE HEALTH AND ENVIRONMENTAL EFFECTS OF OIL AND GAS PRODUCTION (2007), available at <http://www.nrdc.org/land/use/down/fdown.pdf> (describing the health effects of chemicals such as hydrocarbons and mercury that can be released during oil and gas use).

9. Current federal energy policy has shifted subsidies from oil and gas producers to renewable energy producers. This has again distorted the market, albeit in a different direction. Now the true cost of producing solar and wind energy is hidden. One argument as to why the government should subsidize these energies is that private sector firms will not conduct as much research and development as is beneficial for society because research and development is typically expensive and takes years to become profitable for a company. *See* CONG. BUDGET OFFICE, *supra* note 4, at 1. But subsidizing renewable energy is the same mistake that America has made since 1916. Just as subsidizing oil and gas distorted American consumption in the past, so too do the current subsidies distort American consumption of renewable energy.

10. OFFICE OF MGMT. & BUDGET, *supra* note 3, at 80.

Act (CAA) that limited the sulfur dioxide emissions of coal plants and established a marketplace to trade permits to emit the gas.¹¹ In 2009, the House of Representatives passed the American Clean Energy and Security Act (ACES), which included a provision to establish a cap on national carbon dioxide emissions.¹² The bill would have allowed companies that emit carbon dioxide to trade their rights to emit carbon dioxide among one another. The Senate did not pass the bill, however, and it died. Both the CAA and ACES tried to incentivize clean energy production by raising the cost to emit fossil fuels. In essence, these reforms tried to create a marketplace for emissions on top of the existing, real-life marketplace. But such an artificial solution is unnecessary. Why not first remove the distortions in the existing marketplace?

A free market alternative to energy subsidies is the fastest and most efficient way to find the energy balance of the future. Two reforms to the tax code could eliminate a large portion of the subsidies to oil and gas companies. First, the U.S. tax code gives preferential treatment to oil and gas companies by allowing them to deduct as expenses intangible drilling costs in the first year of expenditure.¹³ The U.S. allows this “current-year expensing ... to attract capital to what has historically been a highly risky investment. Current expensing allows for a quicker return of invested funds through reduced tax payments.”¹⁴ In other words, the U.S. government gives special status to the costs that an oil company incurs as it prepares to drill for oil. The U.S. government has, for nearly the past one hundred years, been allowing oil companies to deduct a basic cost of doing business. Second, since 2010, oil and gas companies have been able to deduct 6 percent of their net income from domestic manufacturing activities.¹⁵ This subsidy was designed to spur domestic manufacturing and “to expand employment, increase output, and reduce prices, making domestically manufactured goods more competitive in the U.S.

11. Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2399 (codified as amended in scattered sections of 42 U.S.C. ch. 85)

12. H.R. 2454, 111th Cong. (2009) (as passed by House, June 26, 2009).

13. See I.R.C. § 263(c) (2006).

14. ROBERT PIROG, CONG. RESEARCH SERV., R42374, OIL AND NATURAL GAS INDUSTRY TAX ISSUES IN THE FY2013 BUDGET PROPOSAL 3 (2012), available at <http://budget.house.gov/uploadedfiles/crsr42374.pdf>.

15. See I.R.C. §§ 199(a)(2) and § 199(d)(9) (2006). The tax code allows oil and gas manufacturers to deduct up to 6 percent of their income from domestic production, but allows other domestic manufacturers (industrial companies, for example) to deduct up to 9 percent of their taxable income from domestic production.

and world markets.”¹⁶ Taken together, these two subsidies would give oil and gas companies a tax benefit of \$25.5 billion over the next ten years.¹⁷

After the repeal of these tax benefits, domestic oil and gas producers would be forced to take into account the additional tax expenses on their balance sheets. Faced with rising costs of production, the oil and gas companies would likely pass along the additional cost to consumers. The cost of oil and gas would likely rise. And for the first time in a century, the price of oil and gas in the marketplace would reflect their true cost. With market distortions removed, American energy companies would be forced to compete on a level playing field. Whether clean and renewable energies would become the fuel of American economic growth over the next one hundred years remains to be seen. But with market distortions removed, these new technologies would be given a fair chance to compete in the marketplace.

16. Pirog, *supra* note 14, at 6.

17. See OFFICE OF MGMT. & BUDGET, *supra* note 3, at 80. The Office of Management and Budget estimates that repealing the intangible drilling credit would generate an additional \$13.9 billion in revenue, and repealing the domestic manufacturing tax deduction for oil and natural gas companies would result in \$11.6 billion in added revenue.