Insight

High Gas Prices and Low Tax Policy

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Executive Summary

- The strong global recovery from the COVID-19 pandemic, and more recently Russian aggression, has fueled a rapid rise in crude oil prices.
- Oil prices are set in the global marketplace, in which the United States is but one actor.
- Nevertheless, U.S. policymakers often propose performative policies – particularly taxes – to create the appearance of influencing the energy prices consumers face.
- The U.S. experience with windfall profit taxes demonstrates the futility, and ultimate harm, of such tax policies that create poor incentives, reduce energy supply, and fail to achieve policymakers' stated aims.

Introduction

High oil and gas prices are the quintessential "pocketbook" issues that policymakers regularly speak to, but rarely address effectively. The dynamics of global commodity prices, i.e. supply and demand, typically defy easy explanation to a skeptical public. Legislators instead look for quick fixes to complicated problems and do so with a limited quiver of policy options. The U.S. government variously regulates, taxes, and subsidizes U.S. energy production, but these policy regimes cannot defy the prevailing forces of global supply and demand. Simply put, there is no federal policy lever that can set global commodity prices. Congress periodically confronts this limitation and rediscovers a familiar playbook of ineffectual tax policies to *appear* to be salving voters' pocketbook woes. The most conspicuous of these performative policies is the windfall profits tax (WPT), which purports to tax the oil companies' "windfall" brought about by rapidly rising oil prices. It should perhaps not surprise that such taxes do not actually tax such windfalls, nor do they ameliorate high oil prices. Rather, as past iterations of this policy demonstrate, taxing oil companies reduces supply. As a tax, the measure is an inefficient source of revenue. Nevertheless, Congress periodically rediscovers failed policies – and the windfall profits tax is a serial favorite.

Windfall Profits Taxation

Windfall profit taxes are a classic expression of legislators' inclination to "do something" in the face of high gas prices. Nominally, a windfall profits tax would tax a windfall, which proponents argue is what oil companies have enjoyed as a result of a global increase in oil prices. But the price of a commodity does not signify a windfall, nor did today's oil price arise in a vacuum. Oil prices plummeted in the COVID-19 era as economies around the globe shut down. There was so much crude oil sloshing around the globe that prices went *negative* in April of 2020. In practical terms, suppliers were paying "buyers" to take oil supplies off their hands. The steep price decline also wiped out over 100 oil and gas companies along the way. The bankruptcies alone are expected to constrain supply, but so, too, did the steep decline in prices, which signaled producers to throttle back production. The rapid recovery from the COVID-19-induced recession similarly raised demand again for petroleum products, and prices rose accordingly. Supply will follow.

This dynamic is what some policymakers consider a windfall. But the internal revenue code is not well suited to such abstractions, and price levels themselves do not inherently signal a windfall. This is hardly the first time that policymakers have attempted to tax "excess" profits. Indeed, during World War I and again during World War II, the United States instituted a tax on corporate profits in excess of a certain rate of return on invested capital. One hundred years later, Congress enacted the Tax Cuts and Jobs Act that also exposed income of U.S. firms' foreign operations in excess of a deemed return (10 percent) on corporate investment to taxation. There is an underlying rationale to this kind of tax design, specifically to isolate supernormal returns, or returns to investment that exceed what a competitive market would return for a given investment over time and are often associated with monopoly power or other extraordinary market force. In theory, taxing supernormal returns should not distort investment decisions by firms and is therefore an efficient approach to tax design. In practice, separating normal and supernormal returns perfectly is impossible in statute – hence, the relatively blunt approaches such as the above-referenced deemed return.

If a tax can't be designed to achieve its stated purpose, a second-best alternative for advocates is to design a different tax, and argue it achieves the original intent. Such is the historical experience with windfall profits taxes in the United States.

The 1980s Windfall Profits Tax

In 1980, President Jimmy Carter signed into law the Crude Oil Windfall Profit Tax Act. It would be repealed eight years later by a bipartisan coalition. Fundamentally, the tax was repealed because it was eventually recognized as a demonstrable policy failure. It was not a windfall profits tax. Rather, it was simply a 70 percent excise tax on the difference between the market price for domestically produced oil and a statutory threshold. But irrespective of any statutory price, the price of oil is set by global markets. The excise simply made U.S.-produced oil more expensive. In 2006, the Congressional Research Service estimated that the WPT reduced domestic oil production between 1980–1988 by anywhere from 1.2–8.0 percent, or about 320–1,269 million barrels. At the same time, reliance on imported oil grew from somewhere between 3–13 percent. Not coincidentally, revenue collected by the tax similarly disappointed. An August 1987 Congressional Budget Office report found that the WPT collected $34.7 billion less than it was expected to between 1980–1987.

As political exercise, the tax was a failure. As a means to reduce the price of oil, the policy was a failure. As a stable and efficient source of federal revenue, the policy was a failure. In 1988, President Reagan signed its repeal. Regrettably, the failed history of this tax has not precluded successive policymakers from attempting to resurrect it.

Modern Proposals

In 2008, then-candidate Barack Obama proposed a nominal windfall profits tax that was not, wisely, revived during his presidency. With high oil and gas prices again threatening incumbents, Sen. Whitehouse and Rep. Khanna have dusted off the 1980s windfall profits tax, and introduced bills in the Senate and House that would apply a 50 percent excise tax to the difference between the market price of oil and a reference price based on the average oil price between 2015-2019. Unlike the 1980s tax, this tax would apply to imports as well. Accordingly, unlike the 1980s experience, consumers could not substitute untaxed imports. This would mitigate the observed effect from the 1980s tax that increased oil imports. Instead, the tax would apply more broadly…and increase the price at the pump more than did the 1980s tax.

Conclusion

There is no consumer product that is more politically significant than the price of gasoline. No other product is as visibly marketed on price alone. That the price of gasoline is essentially a function of a global marketplace that is utterly indifferent to public sentiment and politics is an enduring challenge for policymakers. This challenge has inspired a number of policy approaches, including taxation. The demonstrable failure of these policies is well documented. Nevertheless, like clockwork, in the face of high gas prices, some policymakers can’t help but repeat the mistakes of the past.