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THE OIL FACTOR IN THE BTU TAX

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On February 17, 1993, as part of the Administration's comprehensive economic plan, President Clinton proposed a "Modified BTU Tax." The major components included a 25.7¢/Million ("MM") BTU tax on energy sources other than oil and a 59.9¢/MMBTU tax on oil (the "base tax" of 25.7¢ plus a "supplemental oil tax" of 34.2¢). Other details of the initial proposal are shown in the box on this page. The Administration estimated that the tax would raise \$22 billion per year (net) when fully phased in.

There will undoubtedly be many modifications of the Administration's original proposal, especially regarding the place of the tax collection and the exemption of certain fuels or certain uses of fuels, because of their non-fuel function. The Administration has acknowledged the need for some such modifications, others will be subject to the customary political give-and-take.

In my brief remarks here I will not go into these matters but analyze the Administration's basic justification for a BTU tax on all fossil fuels as well as a supplementary tax on oil products.

Outline of the Administration's "Modified BTU Tax" Proposal

Rates

Base Tax: 25.7¢/MMBTU
Supplemental Oil Tax: 34.2¢/MMBTU
All rates indexed for general inflation after 1997

Coverage/Point of Imposition

Oil: Crude oil at the refinery; imported products at the point of importation
Natural Gas: At the pipeline
Coal: At the minemouth
Nuclear: At the utility
Hydro: At the utility
Imported Electricity: At the point of importation

Exclusions

Non-conventional fuels (solar, geothermal, biomass, wind)
Exported taxable products
Non-fuel uses of fossil and alcohol fuels

Date of Imposition

Three-year phase-in beginning July 1, 1994
Full implementation by July 1, 1996
"Appropriate delay" in the phase-in of the supplemental oil tax on heating oil

What does the Administration expect to achieve with the BTU tax? Obviously, the principal purpose is to collect revenue. It was explained that by taxing all forms of energy the tax would be imposed on a very broad base since most consumer, business and governmental activities have an energy component. However, if putting the tax on the broadest base, so as to distribute its burden as widely as possible, was really the Administration's intent, it should have opted for a general consumption tax instead of one limited to energy. This would have expanded the tax base much further and distributed the tax burden more widely and evenly. Furthermore, since the proposed BTU tax raises the cost of energy to all U.S. industry it reduces the international competitiveness of the U.S. economy. A general consumption tax or an increase in income taxes does not have this effect.

Hence, the decision to limit the consumption tax to the energy sector of the economy is at least in part a reflection of the Administration's energy policy. This has been clearly stated; the Administration expects the tax not only to raise revenue but also reduce energy consumption in order to improve environmental conditions and reduce our balance of trade deficit as well as our reliance on "insecure" foreign energy supplies. Let us look at each of these non-revenue justifications for selecting energy as the sole bearer of the Administration's consumption tax and for imposing a heavier tax burden on oil than on the other fuels. We will start with the environment.

The Environmental Factor

a) Coal

Environmentally, coal is of course the most polluting of the three fossil fuels. Its carbon content per BTU is about 30% higher than that of most oil products, it accounts for the bulk of U.S. sulfur emissions (precursors to acid rain) and has a NO_x emission comparable to oil per BTU. Yet, under the proposed legislation, it would be taxed no higher than natural gas, the cleanest fossil fuel, and 57% below oil which is environmentally cleaner than coal. So, obviously the decision to tax coal at the same rate as gas and much lower than oil was not based on environmental considerations but other factors. President Clinton himself stated this clearly in an off-the-cuff remark in New York when he explained that a tax on carbon, the principal contributor to greenhouse gas, would be "very tough on . . . coal states that have been very hard hit." Thus, the allocation of the BTU tax among the three fossil fuels was based more on political than environmental considerations. Given the fact that coal mining is a very labor intensive industry and is important in the economies of many states, this is understandable. On the basis of the Administration's preliminary calculations, coal consumption by 2000 would be just 1-1.5% lower than without the 25.7¢/MMBTU tax.

b) Gas

Since natural gas is the environmentally cleanest fossil fuel and since this Administration, as well as the previous one, is actively promoting conversion from oil and

coal to gas as a means to improve air quality and reduce the greenhouse effect of fossil fuel combustion, it is unlikely that *environmental* considerations played a role in imposing a BTU tax on gas.

c) Oil

Can one expect a significant environmental impact from the BTU tax on oil which is 133% higher than that on coal and gas? According to the DOE's calculations, the full BTU tax will reduce oil consumption by 350,000 B/D by 2000. This would be a 1.8% reduction from the 19.25 million B/D level forecast by the DOE in its latest Reference Case. In other words, instead of rising by 2.25 million B/D between 1992 and 2000, demand would rise by 1.9 million B/D. If you consider only the proposed Supplemental Tax on oil, the reduction in demand from that measure will be less than 1% by 2000. Thus, while the supplemental tax on oil will yield \$9 billion annually in real dollars from 1997 on, its impact on air pollution and global warming will be *negligible* by any reasonable definition of that term.

It should also be pointed out in this connection that the mandated environmental quality of oil products -- from gasoline to heavy fuel oil -- has been improving steadily since the 1970's, as have the engines which burn it, particularly in transportation. This is an ongoing process, as refiners and automakers know only too well. I need not tell this audience that it is a costly process. But it does increasingly transfer the external environmental costs of oil consumption into the product's price structure. Thus, conceptually and functionally, it is difficult to justify any part of the supplemental BTU tax on oil products as necessary for environmental reasons.

The Balance-of-Trade Rationale

Next, let us look at the *balance-of-trade* argument for the BTU tax, used by both the White House and the Treasury. Obviously, the argument applies only to oil since the U.S. is a net exporter of coal and its only significant gas imports are by pipeline from Canada. Thus, we can assume that a major reason for the supplemental BTU tax on oil is the fact that net oil imports last year supplied 40% of our total domestic oil requirements and this share is likely to increase significantly between now and 2000.

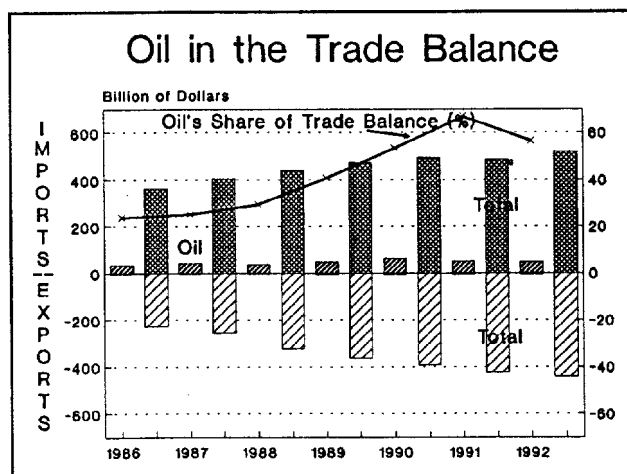


Figure 1

In 1992 our gross oil imports amounted to \$51 billion, equal to not quite 10% of our total merchandise imports -- about the same as in 1989 and 1991*. By comparison, our imports of motor vehicles and parts amounted to over \$71 billion last year, our chemical imports were about \$28 billion and our manufactured goods imports \$60 billion.

As far as the balance of trade is concerned there is no difference between any of these import categories, except that in all the other categories a reduction in imports could be readily made up by higher domestic production since most U.S. industries have spare capacity. For oil, however, a reduction in imports can only be achieved by a reduction in domestic consumption through conservation or fuel substitution. In fact, if the tax burden can not be fully passed through by refiners, as is likely, some plants may close. This could lead to a shift in imports from crude oil to products which would raise the cost of oil imports.

Hence, there is no balance-of-trade case for levying a special tax just on oil consumption. It should also be remembered that trade is a two-way street. Last year we imported \$33 billion from the OPEC countries and exported \$22 billion to them.

The National Security Justification

Finally, let us consider the Administration's argument that reducing energy imports would strengthen our national security. Again, this argument applies only to oil and, hence, if correct, must be viewed as providing a justification for the imposition of a supplementary BTU tax on this fuel only. The first point to make is that our 40% net import dependency includes over 1 million B/D of pipeline shipments from Canada which has no other export outlet. These imports can be considered as secure as domestic supplies. This reduces our strategic net import dependency to 35%.

As has been frequently pointed out, this percentage is far less than the oil import dependency of most industrial and industrializing countries. A frequently cited example is Japan which must import all its oil from overseas sources (as well as its gas). With the exception of the U.K. and Norway all European countries have an oil import dependence ratio at least twice as high as ours and are also dependent on imports for most of their gas requirements. The same is true of the industrializing countries of South East Asia. All of these countries seem to find this dependency quite viable and are not planning any action to reduce it. They recognize that in normal times there is a commercial *interdependence* between oil importers and exporters. The latter are as compelled to sell their oil as the former are to buy it. During the occasional disruptions, the shortage and accompanying price increases will be felt by all importers regardless of their source of supply or their degree of dependence on foreign supplies. Thus, even if we could reduce our import dependence substantially by 2000, we would still have to bear the full price impact of an international oil shortage.

* It was higher in 1990 because of the price increase caused by the Gulf War.

Actually, the supplemental oil tax would reduce our oil import dependency by only an insignificant amount. The Treasury's total tax impact would reduce imports by 350,000 B/D, or 3.5%, from the 10,770 MB/D projected in the EIA's Reference Case for 2000. This would mean that imports would *rise* by 50%, instead of 55%, between 1992 and 2000. The supplemental tax alone would account for 2/3 of the reduced import growth, or about 240 MB/D. Thus, as a measure to reduce U.S. dependence on "insecure" foreign oil supplies the supplemental BTU tax has virtually no effect. Whether our oil import dependence in 2000 is 56%, as projected in the EIA's Reference Case, or 54%, if the tax is implemented, is irrelevant for our security of supply.

If the Administration is really concerned about the threat of temporary foreign oil supply disruptions it should consider filling our Strategic Petroleum Reserve (SPR) from its current level of 576 million barrels to at least the 750 million barrel level for which storage facilities have already been built. At a fill rate of 70 MB/D this could be done in 5 years. I know this requires additional funding but some of the oil may be provided at reduced cost by foreign suppliers if a mutually beneficial arrangement can be worked out.

To recapitulate our conclusion: (1) a supplemental tax on oil consumption for *environmental* reasons is arbitrary if no similar tax is imposed on coal, an environmentally inferior fuel; and it is unwarranted in view of the mandated steps, past and future, taken by the industry to improve the environmental quality of oil products. (2) The argument that the supplementary tax reduces oil imports which in turn reduces our *balance of trade deficit* is no more valid for oil than for any other imported commodity, and would actually work better for those imported goods which can be readily replaced from domestic sources. (3) Regarding "*insecure*" *foreign supply* sources, most other developed and industrializing nations have a much higher ratio of foreign oil dependency than the U.S. and have managed to live with it. Furthermore, the supplemental BTU tax would reduce our oil import dependency so little as to make it irrelevant.

Thus, the question of why the Administration's "broad-based" energy BTU tax is substantially higher for oil than for the other fossil fuels is one of *equity* rather than revenue. It is simple to calculate that the government could collect the same total revenue in 1997 if it taxed all fossil fuels at 38.5¢/MMBTU rather than coal and gas at 25.7¢ and oil at 59.9¢. Since the oil industry sectors most affected by the supplemental tax would not be foreign suppliers but domestic refiners and distributors, the equity case for a BTU tax which burdens oil more than other fuels has not yet been made.