

Lessons From the Energy Crisis

By Lawrence M. Stone

In 2012 *Tax Notes* will celebrate the 40th anniversary of its inaugural issue, published on September 18, 1972. In recognition of that milestone and to show its appreciation for your continued readership, *Tax Notes* will be republishing select archived articles from each of the past 40 years. *Tax Notes* hopes that readers will enjoy these valuable contributions from prominent members of the tax community on issues that were and are of central importance to the field. Readers are invited to submit their own recommendations for our retrospective to taxnotes@tax.org, along with a short explanation for why the article has been recommended.

This article was originally published on July 22, 1974. Lawrence M. Stone was a professor at the University of California, Berkeley, a partner in the Los Angeles firm Irell & Manella LLP, and a member of the IRS commissioner's advisory group. During his career, he served as tax legislative counsel in Treasury's Office of Tax Policy and on the president's nominating commission for appointments to the U.S. Tax Court.

Stone argued that tax policies regarding the oil and gas industry contributed heavily to the energy crisis of the early 1970s and he presented proposals for how Congress could pare back or eliminate some of those benefits.

In the continuing talkathons about tax reform, the loophole closers often talk of unfairness, lack of progressivity, and "loopholes for the rich." The defenders of the special provisions usually talk in terms of the economic or social good the special tax benefits stimulate. However, we don't know too much about the real incidence of taxation — does General Motors pass its tax bill on to its automobile buyers in the form of higher prices, or do GM shareholders receive less dividends; does your doctor pay high taxes or do you pay his taxes through higher bills? Therefore, we generally get nowhere arguing about fairness. Similarly, we can chase our tails in arguments about who benefits from the special tax incentive — the public or the taxpayer who receives the incentive. Also, in answer to the unfairness arguments, it has become increasingly fashionable to point out that some of the biggest

"holes" in the tax law benefit millions of taxpayers — for example, tax-assisted company pension plans.

Let the Marketplace Decide

The present oil and energy situation teaches us that the best case for tax reform is 19th century liberalism — let the consumer tell us through the market place what to produce and in what quantities, and in the long run we'll all get more of what we really want. Serious interference with free market forces — whether through a monopoly, government price setting or government subsidies — can mess things up badly! The Russians, after more than half a century, are apparently beginning to learn this lesson. Surprisingly, we have yet to learn it in certain "planned" areas of our capitalism.

How do the tax system and the energy crisis fit in with all these generalities? One aspect of the "crisis" is a heavy reliance on the automobile of the large gas-guzzling type. Did this happen in the natural course of events? Not without massive help from the tax system, is the surprising answer.

First are the direct income tax benefits to the oil industry. These consist of percentage depletion, which quite simply exempts a substantial percentage of crude oil profits from tax. Less well known, but important, are the "intangible drilling" rules which permit an immediate deduction of capital expenditures, expenses which other industries can deduct only over a period of years. Finally, there are many generous rules associated with the way in which we tax (actually do not tax) the foreign-related profits of the major oil companies. If we take the arguments of the oil companies, these benefits have in the long run served not so much to inflate their profits and dividends as they have to keep the price of gasoline unnaturally low and thus to encourage more consumption of gasoline. Without these benefits, Americans would probably drive less, in smaller cars, and would own fewer cars and use more public transportation.

Second, the dispersal of the American city population to the suburbs and the system of driving to buy even a bottle of milk or a pack of cigarettes has also been encouraged in part by the relatively insignificant cost of gasoline in the United States. How many people would buy a subdivision home 20 or 30 miles from work, that necessitates the ownership of two or three automobiles per family, if the price of gasoline and the cost of home fuel had

been substantially higher? It stands to reason the answer is fewer, and that more of us would live closer to work, and drive less, and even rely on public transportation to a greater extent.

Homeowner Subsidies

The move to the suburbs would also have been dampened if it were not for tax benefits that made home ownership more competitive with rental housing. Rent is not deductible for tax purposes, and interest on your saving is taxable. However, if you put those savings into a dream home in the suburbs, the interest (now free rent) is no longer taxed, and the real property taxes and mortgage interest you pay are deductible.

Another factor encouraging the dispersal of the population and the consequent heavy per capita consumption of fuel is the practice of tax-based trust funds for highway construction. Where would our public transportation systems be today if we had provided them with the same heavy flow of tax funds as were given the highways over the past decades? And where would all those subdivisions be without all the “interstate roads” built with highway trust funds in order to make housing far from centers of work “20 minutes from downtown”?

The cost of single home housing has been encouraged in other tax ways — for example, through the favorable treatment long accorded to mortgage money suppliers such as savings and loan institutions and insurance companies.

The story could go on. Since the automobile directly uses the product of a substantial portion of our heavy industry, the huge tax benefits to heavy industry — especially the investment tax credit and accelerated depreciation — may also be a form of subsidy to the production and use of large automobiles.

In all, it can be said that the tax system has probably significantly encouraged the American consumer to use more automobile fuel and probably more home fuels than he would have used under a non-planned system. Thus, the tax system fed the energy crisis. I conclude, then, that the best case for tax reform is a pure economic argument — let market forces determine the allocation and use of scarce resources.

Ending Addiction Difficulties

The unwinding of the tax subsidy process is difficult. Once addicted, the patient doesn’t want to and can’t let go of his drugs so easily. On the one hand, we have the present spectacle of the oil companies asking the Congress for further tax benefits so they can produce more oil. On the other hand, the politicians orate about excess profits of oil companies, the need to tax these, and the need to

keep oil prices down. The Congress seems to be in the process of trying to ride all three of these horses right now. We’d all be better off in the long run if the simple but painful process of weaning us away from the drug of tax subsidies were started.

And painful it will be. Big cars don’t change into little ones by wishing it so. One doesn’t easily and quickly decide to move closer to work after investing a lifetime in the dream house in the country. Teenagers raised on the automobile aren’t easily convinced to use the bus or to walk. Owners of homes who couldn’t afford them without a tax deduction for mortgage interest and real property taxes can’t be expected to give up tax benefits which make the difference between being able to pay the mortgage and a house which is more than they can afford. But the process of allowing market forces to ration scarce resources must begin, in stages at least, or we will simply have “crisis” after “crisis” in this country.

Begin With Oil Benefits

One obvious way to start the process is for Congress to take away the tax benefits of the oil industry now, while their profits are inflated, rather than giving them more benefits. This is far simpler and more sensible than worrying about complicated and ineffective excess profits taxes. Unfortunately, neither the president nor the Congress seems to see this logic. A second step would be to gradually encroach on that sacred cow, the highway trust fund, by dividing its resources between highways and public transportation, while gradually cutting back on the trust fund altogether. A third step is to start weakening the tax benefits for home ownership, through increases in the standard deduction that would dilute the benefits of itemized deductions such as interest and property taxes. At the same time, the process initiated in the sixties, of gradually moving toward the full taxation of financial institutions, should be continued.

The best way to get more oil and other fuels is to establish prices that are high enough to bring forth the desired quantities. The best way to ration the wise use of oil (and other resources) is through free market prices. The best tax policy, it follows, is a neutral one — the oil industry should be taxed neither higher nor lower than other industries. Tax reform based on such economic principles may go a long way further than tax reform based on slippery considerations of fairness.