OIL AND TAXES: 
REFOCUSBING THE TAX POLICY QUESTION IN THE 
AFTERMATH OF THE BP OIL SPILL

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I. INTRODUCTION

In April 2010, an explosion occurred on the Deepwater Horizon oil rig in the Gulf of Mexico.1 The accident resulted in oil leaking into the ocean for eighty-seven days, at which point BP p.l.c. (BP), the company which owned the well, installed a cap to contain the flow of oil.2 Although the full extent of the oil spill damage may take years to assess, President Obama called the accident “the worst environmental disaster America has ever faced.”3 Shortly after the catastrophe, BP assessed the cost of the clean-up efforts, damages, and claims payments to businesses hurt by the oil spill to be $32 billion, but warned that the actual cost could easily exceed this number.4 In light of the impending elections, both political parties saw the accident as an opportunity to direct public discontent to “local issues and larger ideologies.”5 As a result, politicians and the media devoted much of their attention to BP’s tax treatment and, more generally, the tax treat-

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1 Campbell Robertson, Search Continues After Oil Rig Blast, N.Y. TIMES, Apr. 22, 2010, at A13.
2 Suzanne Goldenberg, BP Stops Oil Leak in Gulf of Mexico for First Time Since April, GUARDIAN (London), July 16, 2010, at 1.
3 President Barack Obama, Remarks by the President to the Nation on the BP Oil Spill (June 15, 2010) [hereinafter President’s Remarks], available at http://www.whitehouse.gov/the-press-office/remarks-president-nation-bp-oil-spill.
ment of the oil industry. BP’s financial statements for the second quarter of 2010 indicated that BP took a tax deduction for the $32 billion in expected remedial spill costs. Thus, BP’s tax liabilities could have decreased by as much as $10 billion. For some, the possibility of a reduced tax burden for BP in the aftermath of such an environmental disaster meant that oil companies were not paying their “fair share of taxes.” Although this particular criticism was misguided, it reinvigorated a more fundamental debate—whether the oil industry merits favorable tax treatment.

This Comment explores the preferential treatment of the oil industry under the current Internal Revenue Code (the “Code”). Oil companies have enjoyed tax incentives since the beginning of the twentieth century. According to some government estimates, the industry saves $4 billion in taxes per year. Past attempts to repeal oil tax incentives have failed. The BP oil spill, however, reignited the debate over the tax treatment of oil companies and presented a new opportunity for legislative action. This Comment argues that the preferential tax treatment for oil companies lacks adequate justification and is contrary to important policy goals. Furthermore, repealing these tax provisions may not be sufficient. Decades of excessive oil consumption have created security, environmental, and economic vulnerabilities that need to be addressed through specially-tailored measures, which should complement the repeal of oil tax incentives.

Part II of this Comment provides background information about the BP oil spill and the tax questions that emerged after the accident. Part III then lists and analyzes the numerous provisions in the current

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7 BP, p.l.c., Report of Foreign Private Issuer, (Form 6-K) 16 (Jul. 27, 2010) [hereinafter Form 6-K]. BP’s estimate of the oil spill costs was later increased to $40.9 billion. See supra note 4. Thus, BP’s tax liability could decrease even more than initially estimated.
10 See, e.g., 156 CONG. REC. E1,252 (daily ed. June 30, 2010) (statement of Rep. Earl Blumenauer) (arguing that oil companies do not need tax subsidies and that such subsidies are harmful to the future of the American economy).
12 Kocieniewski, supra note 6.
Code that afford preferential treatment to the oil industry. In Part IV, the Author explains why these subsidies have no justification today and gives some additional reasons for their repeal. Part IV also evaluates the current legislative actions designed to curb oil tax incentives. Part V identifies some issues that repeal alone may not be able to address and proposes a possible solution.

II. BACKGROUND: THE BP OIL SPILL AND THE TAX CONTROVERSY

BP is an international oil and gas company operating in more than eighty countries. In 2009, it ranked as the fourth largest company in the world by total sales (over $361 billion). On April 22, 2010, a rig leased by BP off the Gulf Coast sank, and oil leaked into the Gulf for almost three months. The public was outraged. One survey indicated that eighty-one percent of respondents disapproved of BP’s response to the spill and that sixty-four percent supported criminal charges against the company. Public criticism had a spillover effect on the industry as a whole.

On July 27, 2010, BP released the company’s quarterly financial statements and announced that it was taking a deduction for the estimated oil spill costs. These costs included the clean-up expenses and the $20 billion fund that BP established to settle the claims related to the spill. The public received the news with disapproval. Robert Gibbs, the White House Press Secretary at that time, cautiously expressed his doubt that the public would approve of BP taking the deduction. But others outright described BP’s deduction as shifting...
oil spill liabilities “to the back of the American taxpayers.”

Although the sum is larger than usual, BP relied on standard accounting practices to claim the deduction.

As a British corporation, BP is subject to U.S. income tax on the income derived from the corporation’s U.S. operations. Under the U.S. corporate tax system, taxable income is calculated by subtracting qualified business expenses and other deductions from total business income. Tax liability is calculated by multiplying the taxable income by the applicable corporate income tax rate, less any tax credits that the business may be able to claim. Section 162(a) of the Code provides for the deduction of trade or business expenses. In relevant part, the section states that “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying of any trade or business” are deductible. Among others, “ordinary and necessary” include “insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business.” The deduction is allowed even if it exceeds the gross income of the applicable period.

In a report on BP’s expense deductibility, the Congressional Research Service explained that, if an oil spill results directly from a company’s operations, the clean-up and claim settlement costs must be treated as “ordinary and necessary” business expenses. Other tax professionals agreed that BP was authorized to deduct the $32 billion costs that the company incurred in relation to the oil spill. The main rationale behind the deduction under §162 is a simple one—income is to be taxed, not revenue. The deduction properly reflects

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24 King, supra note 4.
26 Id. at 1.
27 Id.
29 Id.
31 Id.
32 SHERLOCK, supra note 25, at 3.
33 See King, supra note 4.
34 Income is a measure of taxpayer’s enrichment and enrichment is considered to be the best indicator of a taxpayer’s ability to pay taxes. See MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 104 (11th ed. 2009).
the cost of earning the income.\textsuperscript{35} In other words, refusing BP the deduction would be contrary to one of the fundamental principles of the U.S. income tax system.

The fact that the deduction could allow BP to take a refund for taxes paid in previous years raised public concerns.\textsuperscript{36} This too has a reasonable explanation under the Code. When a corporation’s business deductions exceed its income, the corporation has a net operating loss (NOL).\textsuperscript{37} The Code permits a corporation to spread such losses over a period of time\textsuperscript{38} to protect businesses with fluctuating income from the negative effects of an accounting system that calculates taxes on a yearly basis.\textsuperscript{39} Thus, the taxpayer can ease the income and liability changes during different business cycles and reduce financial risk.\textsuperscript{40} In effect, the government works with the taxpayer in sharing both the benefits and losses of revenue.\textsuperscript{41} When NOL is carried back, the taxpayer can receive a refund for taxes paid during previous years; when NOL is carried forward, it reduces future tax burdens.\textsuperscript{42} Currently, a taxpayer can carry back losses for up to the two preceding years and forward for up to twenty years.\textsuperscript{43}

When initially reported, BP’s tax savings were estimated as of the time when the firm’s second-quarter financial statements were filed, which did not allow a conclusive determination as to whether BP would actually be able to realize NOL benefits.\textsuperscript{44} Later, BP reported that it recorded a net loss of $4.8 billion for the fiscal year 2010 and confirmed that it would pay no U.S. income tax based on this overall loss for the year.\textsuperscript{45} In addition, the net loss could result in additional tax savings\textsuperscript{46} in the form of NOL.

\textsuperscript{35} Id. at 1.
\textsuperscript{36} See SHERLOCK, supra note 25, at 6 (noting suggestions that BP should not take the deduction).
\textsuperscript{38} See § 172(b).
\textsuperscript{40} SHERLOCK, supra note 25, at 4.
\textsuperscript{41} Id. at 4–5.
\textsuperscript{42} Id. at 4.
\textsuperscript{43} § 172(b).
\textsuperscript{44} See SHERLOCK, supra note 25, at 6.
\textsuperscript{46} See id. While BP reported part of this information, it must be noted that any conclusions about the taxes actually paid by BP for a given tax year are not completely accurate when based solely on the information from the company’s annual report.
The fact that BP’s actions were legitimate under tax law principles did not prevent public ire. Senator Bill Nelson called for a congressional inquiry into the deductibility of the settlement fund and the anticipated legal costs that BP could incur defending spill-related lawsuits. Three days after BP’s deduction announcement, Representative Raul Grijalva introduced the Closing Oil Spill Tax Loopholes Act of 2010. The bill proposes that taxpayers cannot claim deductions for certain damages paid in relation to oil spills. In a similar effort, Representative Eliot Engel introduced the Denial of Certain Tax Benefits to Offending Oil Polluters Act of 2010. The bill denies certain tax benefits to oil companies involved in oil discharge incidents. As of publication, the House has not considered either bill. Nothing about the BP expense deduction conflicts with the fundamental principles of the U.S. income tax system. Yet, a lot of political energy was spent on preventing BP from claiming the deduction most likely because of a desire to please the unhappy oil-spill-sensitive voters. Media outlets reported that taxpayers viewed the deduction as wrongful and inappropriate. While the emotionally charged criticism of the deduction is not well-founded in general tax principles, the debate about tax fairness for oil companies should be refocused on far more significant issue—the tax treatment of the oil industry as a whole.


49 See id.


51 See id.


53 See Kocieniewski, supra note 6 (observing that the oil industry is among the most-subsidized industries).
III. OIL INDUSTRY PREFERENCES IN THE INTERNAL REVENUE CODE

The Code is drafted in such a way as to provide multiple tax incentives for the oil industry. Since the 1970s, the tax incentives for the oil industry have decreased, but they still remain extremely high. Some of the preferential tax provisions date back almost a century. Income tax provisions that provide benefit to specific taxpayers at the expense of government revenue are described as tax expenditures. Tax expenditures include all provisions that lower the tax liability of favored taxpayers. Such provisions are the functional equivalent to direct spending by the government and are viewed as a mechanism for achieving “budget policy objectives.”

The provisions discussed below are tax expenditures in the sense that they confer special benefits to the oil industry. The provisions are discussed in groups according to their type: (A) deductions, (B) credits, and (C) other provisions.

A. Deductions

As discussed in Part II, the Code allows the subtraction of certain outlays and expenditures from the taxpayer’s income, which are called deductions.

1. Percentage Depletion Deduction

As a general matter, the Code recognizes that long-lived tangible assets used for business or investment purposes wear out after continued use, and it therefore allows taxpayers an annual deduction for depreciation to compensate for this “loss.” The depreciation deduction is limited to the basis of the property (the cost of the property to the taxpayer). Similarly, the depletion deduction, unique to extraction and timber businesses, allows the recovery of investments in

54 See LAZZARI, supra note 13, at 1–2 (summarizing the major features of U.S. oil tax policy since its inception).
55 Kocieniewski, supra note 6.
56 Id.
58 Id.
59 Id.
60 CHIRELSTEIN, supra note 34, at 1.
61 Id. at 162; see 26 U.S.C. § 167 (2006).
62 CHIRELSTEIN, supra note 34, at 163.
mineral property. There are two types of depletion deduction, cost depletion and percentage depletion, which differ in the way they are calculated.

Like the depreciation deduction, depletion deduction can be used only up to the basis of the depletable mineral property. Thus, a taxpayer’s recovery is limited to the investment in the property. By contrast, percentage depletion is calculated as a fixed rate of the gross income derived from the property. What sets percentage depletion apart from both depreciation and cost depletion is that the percentage depletion deduction is not limited to the basis that the taxpayer has in the property. Therefore, the sum of all percentage depletion deductions can exceed a taxpayer’s investment in the property. If production is successful, this treatment can reduce the tax rate substantially. The General Accounting Office estimates that revenue loss from the excess use of percentage depletion over cost depletion for the three decades prior to 2000 exceeds $82 billion. According to the latest estimates of the Joint Committee on Taxation (JCT), the revenue loss for the period between 2009 and 2013 alone will be $6.5 billion. The original purpose of the percentage depletion was to stimulate exploration and production. The depletion deduction and other tax incentives led to an increase in oil and gas production from sixteen percent of all energy in 1929 to seventy-one percent.

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64 Hymel, supra note 11, at 48. Some scholars argue that depletion is different in “character and effect” from depreciation because the depletion deduction is applied to an asset which is the product itself, rather than to a product-producing asset. Wendy B. Davis, Elimination of the Depletion Deduction for Fossil Fuels, 26 SEATTLE U. L. REV. 197, 200 (2002).
65 See OIL & GAS: FEDERAL INCOME TAXATION 215–16 (Patrick Hennessee & Sean Hennessee eds., 2009) (discussing the two types of depletion deductions).
66 Id. at 215–16. Cost depletion is determined by dividing the basis of the oil interest by the mineral units sold during the tax year and multiplying the result (which is the cost per unit) by the number of units sold during the year. Id. at 215.
67 Id. at 216. The rate is fifteen percent but can increase up to twenty-five percent. Id. This increase is triggered when the reference price of oil is below twenty dollars per barrel. Id. The depletion rate will increase one percentage point for every dollar the reference price is below twenty dollars. Id. The reference price of oil is based on an estimate of the unregulated crude oil prices. Id. at 216 n.24.
68 Id. at 216.
69 Id., supra note 11, at 48.
70 Id. at 48–49.
71 U.S. GOV’T ACCOUNTABILITY OFFICE, GAO/RCED-00-301R, TAX INCENTIVES FOR PETROLEUM AND ETHANOL FUELS 7 tbl.2 (2000).
72 STAFF OF THE JOINT COMMITTEE ON TAXATION, supra note 57, at 31 tbl.3.
73 Hymel, supra note 11, at 49. The depletion deduction was originally included in the Tariff Act of 1913. U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 71, at 6.
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percent of all energy in 1970. These tax provisions generally resulted in more profitable, accelerated oil production and faster depletion of energy resources.

2. Intangible Drilling Costs Deduction

Intangible drilling costs (IDC) include expenditures for “wages, fuel, repairs, hauling, supplies, etc.” associated with the drilling and preparation of wells for oil production. Ordinarily, taxpayers cannot deduct such expenses and must capitalize them. The idea behind capitalization is to spread the cost of assets over the period during which the taxpayer will benefit from these assets. An oil producer, however, is allowed to make a one-time election to deduct IDC instead of capitalizing them. Thus, the producer can recover IDC immediately rather than spread the recovery over several years.

For the period between 1968 and 2000, the revenue losses from the IDC deduction were $42.8 billion. For the period between 2009 and 2013, the revenue losses are estimated to be $2.6 billion. Like the depletion deduction, the IDC deduction was introduced in 1918 to stimulate the then-budding oil industry.

3. Passive Activity Loss Exception

Section 469 of the Code denies taxpayers a deduction for any net loss that results from a passive activity against income from other sources. The oil industry benefits from a special exception to this rule. The Code does not consider a working interest in oil property

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74 LAZZARI, supra note 13, at 3.  
75 Id. at 2.  
77 Hymel, supra note 11, at 49; see 26 U.S.C. § 263(a) (2006). While some expenses can be deducted immediately from income, capitalization mandates a yearly allowance for the exhaustion of capital assets. CHIRELSTEIN, supra note 34, at 126. In this way the cost is recovered over a period of time. Id.  
78 CHIRELSTEIN, supra note 34, at 126.  
79 Treas. Reg. § 1.612-4(a) (1965). The producer can even deduct expenses related to nonproductive wells, which represent approximately eighty percent of all wells drilled. Hymel, supra note 11, at 49.  
80 U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 71, at 9 tbl.3.  
81 STAFF OF THE JOINT COMM. ON TAXATION, supra note 57, at 31 tbl.1. The estimates include revenue losses from oil and gas exploration. Id.  
83 CHIRELSTEIN, supra note 34, at 316; see 26 U.S.C. § 469(a) (2006). Passive activities are defined as activities that involve trade or business in which the taxpayer “does not materially participate.” Id. § 469(c)(1).
to be a passive activity, regardless of a taxpayer’s actual participation. Thus, while most taxpayers cannot use passive activity losses to offset income from other sources, such as wages, an oil interest owner may be able to do so. The passive activity loss exception was introduced with the Tax Reform Act of 1986. Until 2000, the exclusion cost roughly $1.06 billion in lost revenue.

4. Amortization of Geological and Geophysical Expenses

As previously explained, a taxpayer can claim an annual depreciation deduction to compensate for the gradual exhaustion of certain assets and these allowances are spread over the useful life of the assets. Costs related to the exploration and development of oil or gas, called geological and geophysical (“G & G”) expense, are considered capital expenses and must be amortized. Oil producers, however, are entitled to accelerated amortization of G & G expenses, for a period as short as two years for some producers. The Energy Tax Policy Act of 2005 introduced the accelerated amortization provision to stimulate domestic oil production. The projected revenue loss from the accelerated amortization provision for the period between 2009 and 2013 is $600 million. Repealing the accelerated

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84 U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 71, at 11. A working interest within the meaning of § 469 exists only if the taxpayer holds the interest in a way that does not limit his liability. OIL & GAS: FEDERAL INCOME TAXATION, supra note 65, at 483. One example of ownership interest that qualifies for the exception is general partnership interest. Id.

85 U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 71, at 12.

86 Id. at 12 tbl.5.

87 See Chirelstein, supra note 34, at 162.

88 Treas. Reg. § 1.167(a)-1(a) (as amended in 1972). Useful life is not the actual time during which the taxpayer uses the asset but a period during which it is expected that the asset will confer a benefit to the owner. Treas. Reg. § 1.167(a)–(1)(b) (as amended in 1972).


90 OIL & GAS: FEDERAL INCOME TAXATION, supra note 65, at 145. Such costs include the cost of hiring geologists, conducting various geological surveys, and drilling core holes. Id.

91 See § 167(h); OIL & GAS: FEDERAL INCOME TAXATION, supra note 65, at 145. Independent producers and independent oil companies can amortize G & G costs ratably over a two-year-period. § 167(h). Major integrated producers can amortize the costs over a seven-year period. Id.


93 STAFF OF THE JOINT COMM. ON TAXATION, supra note 57, at 31 tbl.1.
amortization provision would result in $1.1 billion revenue gains over a ten-year period.94

5. Tertiary Injectants Deduction

Some oil producers use tertiary recovery methods to increase the oil recovery from certain wells.95 Producers inject fluid, gaseous, and other chemical substances into the oil reservoir to recover oil that is too viscous to recover through ordinary methods.96 Absent special provisions related to those costs, the taxpayer would have to capitalize such costs.97 Section 193 of the Code, however, authorizes a deduction for the cost of tertiary injectants.98 In the twenty-year period between 1980 and 2000, the estimated cost of this measure was $330 million.99

B. Credits

Tax credits are tax incentives subtracted directly from the tax liability of the taxpayer.100 Thus, a credit is a dollar-for-dollar reduction in tax liability, rather than a reduction in gross income.101 There are two major tax credits that benefit the oil industry: the enhanced oil recovery credit and the credit for marginal wells.

1. Enhanced Oil Recovery Credit

Under § 43 of the Code, oil producers are permitted to take a credit for qualified enhanced oil recovery (EOR) expenses.102 Qualified EOR expenses include tangible property integral to the recovery project, IDC costs, and tertiary injectant expenses.103 To the extent that any of these costs are deducted under any other sections of the Code, the deductions must be reduced by the credit amount.104 Tax-

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95 OIL & GAS: FEDERAL INCOME TAXATION, supra note 65, at 518.
96 U.S. GOV'T ACCOUNTABILITY OFFICE, supra note 71, at 14.
97 See id.
99 U.S. GOV'T ACCOUNTABILITY OFFICE, supra note 71, at 15 tbl.7.
100 CHRIELSTEIN, supra note 34, at 2.
101 Id.
103 § 43(c). As discussed earlier, these costs must typically be capitalized. See supra notes 77–78 and accompanying text.
104 See § 43(d); OIL & GAS: FEDERAL INCOME TAXATION, supra note 65, at 515.
payers can earn credit for up to fifteen percent of the qualified oil recovery costs.

For the period between 1990 and 2000, the EOR credit cost over $1 billion in lost revenue. The credit’s purpose is to incentivize domestic oil producers by stimulating the extraction of residual oil from abandoned domestic wells that cannot be extracted through conventional extraction methods.

2. Credit for Marginal Wells

The credit for marginal wells allows producers to offset tax liability by three dollars per barrel for oil produced from marginal wells. A qualified well is a well that is both domestic and has an average daily production below a certain limit. Like in the case of the EOR credit, when the reference price of crude oil exceeds a certain level, the marginal wells credit phases out gradually. The American Job Creations Act of 2004 created the tax credit, but it has not been used since its inception because crude oil prices have remained high since 2004. The credit was designed to keep domestic supply at a maximum even at times of low oil prices, but there is no empirical data about the credit’s actual effect because it has never been used.

C. Other Provisions

Some generally applicable Code provisions confer disproportionate benefits to the oil industry as well. These provisions are discussed in some detail in this subsection.

105 § 43(a). The credit availability depends on the price of crude oil and it is phased out ratably when the price exceeds twenty-eight dollars per barrel. Oil & Gas: Federal Income Taxation, supra note 65, at 515. A complete phase-out occurs when the reference price exceeds the statutory limit by six dollars per barrel. Id.


109 See Oil & Gas: Federal Income Taxation, supra note 65, at 522.

110 Id. at 522–23.

111 See id. at 523. The reference price limit is fifteen dollars per barrel. Id. After the reference price passes this mark, the credit is reduced proportionately. Id. Once the reference price of crude oil reaches eighteen dollars per barrel, the credit is completely phased out. Id.

112 Id. at 522.


114 Id. at 3.
1. Foreign Tax Credit

Foreign countries may exercise their tax power to levy taxes on income earned by foreigners within their territory. To avoid taxing American taxpayers twice on income earned abroad, the United States allows taxpayers to claim credit for income taxes paid or accrued abroad. When a foreign levy is a compulsory payment under a foreign state’s taxation power, it is a creditable tax. But if the taxpayer receives an economic benefit in exchange for the payment, the levy is not a creditable tax. A taxpayer who is both subject to a foreign levy and receives some economic benefit from the foreign country is designated as a dual-capacity taxpayer. In some cases the whole levy may not qualify for a credit, but the taxpayer has the option of demonstrating that he can credit at least a part of the levy against domestic tax liability.

Section 907 of the Code caps the amount of the credit available for foreign oil and gas income at the tax liability such income would create under the applicable U.S. tax rate. Although § 907 was enacted to restrict the ability of oil companies to claim foreign tax credit for special payments, it does not prevent them from taking credit for disguised royalties. Sometimes it is simply not clear whether a payment that an oil company made was in exchange for an economic benefit (royalty) or not. Thus, oil companies may get im-

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116 Id.

117 Id.

118 See Treas. Reg. § 1.901-2(a)(ii)(2) (as amended in 2011). An economic benefit is a benefit that is not made available under the general income tax system of the foreign country to other taxpayers. Joint Comm. on Taxation, supra note 115, at 85.

119 Joint Comm. on Taxation, supra note 115, at 85.

120 Oil & Gas: Federal Income Taxation, supra note 65, at 580. There are two methods that a taxpayer can use to demonstrate payment of creditable tax. First, a safe harbor authorizes the taxpayer to credit a portion of the levy that is equivalent to the amount that the taxpayer would have paid under the generally applicable income tax of the foreign country. See Joint Comm. on Taxation, supra note 115, at 86. The remainder of the levy is not creditable. See id. If the foreign country does not impose a generally applicable income tax, the taxpayer can claim a credit for a portion of the levy that the taxpayer would have to pay under the U.S. income tax rate. See id. Alternatively, the taxpayer may chose to show that, in light of all facts and circumstances, a certain levy is a tax. See id.


122 See Joint Comm. on Taxation, supra note 115, at 88.

proper tax benefits by relying on the foreign tax credit. For the pe-
riod between 2002 and 2008, the estimated revenue losses from such
practices were $15.3 billion.

2. Domestic Manufacturing Deduction

The domestic manufacturing deduction is a generally applicable
deduction for manufacturing activities performed within the United
States.\textsuperscript{126} The deduction is a statutory percentage of the lesser of the
taxpayer’s qualified production activity income or the taxpayer’s taxable
income.\textsuperscript{127} The American Job Creation Act added § 199 to the
Code in 2004, and the purpose of the Act was to expand employment
in the manufacturing sector of the U.S. economy.\textsuperscript{128}

\textsuperscript{124} In the 1950s, certain oil-producing countries reclassified royalties from U.S. oil
companies as income taxes based on a suggestion by the State Department. \textit{Id}. De-
spite the restrictions on this practice that followed in later years, major oil-producing
countries continue to impose higher income tax rates on oil businesses than on oth-
er taxpayers. \textit{See id}. For example, in Saudi Arabia the income tax rate for oil-
producing businesses is eighty-five percent, but the income tax rate for non-oil busi-
nesses is twenty percent; in Nigeria, the income tax rate for oil companies is eighty
percent, but the general income tax rate is thirty percent. \textit{Id}.

The subsidy that oil companies are entitled to receive under the current rules can
be best illustrated through an example. The following example is adapted from
\textbf{ESTIMATING U.S. GOVERNMENTAL SUBSIDIES TO ENERGY SOURCES: 2002–2008} published
by the \textbf{ENVIRONMENTAL LAW INSTITUTE}. \textit{See id}. at 11. Country A imposes a general
income tax rate of twenty percent but levies fifty percent taxes on oil companies. If a
U.S. oil company has taxable income of $1,000, it pays $500 in taxes to country A, and
can claim tax credit of $350 against U.S. tax liability (limited to thirty-five per-
cent of taxable income). \textit{See id}. They can carry the $150 difference forward for up to
ten years. \textit{See id}. Thus, the difference between the payment that the company would
have made under the twenty-percent tax rate and the special fifty-percent rate is not
recognized as a royalty. \textit{See id}. If the difference is treated as a royalty payment, the
taxpayer would be considered to have paid only $200 in income tax to country A
(based on the generally applicable twenty-percent tax rate) and would be entitled to
foreign tax credit of only $200. \textit{See id}. The remaining $300 are deductible by the
company but are not counted towards the credit. \textit{See id}. The revenue loss for the
Treasury is the difference between the credit available under the first scenario and
the second scenario reduced by the effect of the deduction: $(350 - 200) \times .65 =
$97.5. \textit{See id}. at 11.

\textsuperscript{125} \textit{Id}. at 7.

\textsuperscript{126} \textit{26 U.S.C. § 199(c)(4) (2006)}. The deduction applies to income derived
from qualifying property that has been “manufactured, produced, grown or ex-
tacted” in the United States. \textit{See id}.

\textsuperscript{127} \textbf{OIL & GAS: FEDERAL INCOME TAXATION, supra} note 65, at 499; \textbf{JOINT COMM. ON
TAXATION, supra} note 115, at 72. The statutory percentage limit for 2009 was six per-
cent. \textit{JOINT COMM. ON TAXATION, supra} note 115, at 72. The percentage is set at nine

\textsuperscript{128} \textit{Id}.
Although the oil industry is designated as a manufacturing industry for reporting purposes, it differs significantly from other manufacturing industries. Unlike manufacturing, the production level is only indirectly related to the level of employment, and a much bigger portion of oil industry investments are capital in nature. In addition, since the high prices of oil during the last few years have spurred record profits for oil companies, oil prices are more likely to influence capital investment decisions in the industry. Thus, it seems unlikely that the domestic manufacturing credit will play a significant role in oil companies’ employment decisions. Repealing the deduction for the oil industry alone would eliminate $7.3 billion in tax expenditures over four years.

3. LIFO Method of Accounting for Inventories

The “last-in, first-out” (LIFO) method is a method of accounting for inventories. It authorizes companies to record as “sold first” the products that the company acquired last. The LIFO method closely reflects the current inventory costs, despite the fact that often the company bought the goods at a lower price. In a world of rising prices, LIFO permits companies to declare a higher measure of costs of goods sold and thus lower income, as compared to the “first-in, first-out” (FIFO) method of accounting. Another criticism of LIFO

129 Id.
130 Id. Therefore, if the deduction lowers oil companies’ production and labor costs, it is unlikely that they will employ more people. Id. Any increase in employment would likely be minor. Id.
131 Id. at 5.
132 Id. at 2 tbl.1.
134 § 467(b).
135 JOINT COMM. ON TAXATION, supra note 115, at 78.
136 David Reilly, Outside Audit: Big Oil’s Accounting Methods Fuel Criticism—LIFO Leaves the Likes of Exxon with Big Balance-Sheet Reserves as Gas-Pump Prices Slam Drivers, WALL ST. J., Aug. 8, 2006, at C1.
137 JOINT COMM. ON TAXATION, supra note 115, at 78; see Reilly, supra note 136. Alternatively, if prices are falling, LIFO would produce lower measures of goods sold and higher income. Cf. JOINT COMM. ON TAXATION, supra note 115, at 78. Some proponents of the LIFO method argue that it shields companies from the effect of inflation by matching current revenue with current costs. Reilly, supra note 136. But the method also allows companies to declare higher inventory costs provided that assets were purchased at a lower cost initially. Id. The inventory that a company carries from the end of one year to the next under LIFO can relate back to the year when the company adopted the method, which may go back decades. Id. Notably, LIFO has been used since the 1930s. Id. Thus, LIFO can be over-inclusive because it allows the taxpayer to shield income beyond the mere effects of inflation. Id.
is that it provides selective and preferential protection for inflationary gains because only businesses with physical inventories can use it.\textsuperscript{138} Also, LIFO is not generally accepted internationally.\textsuperscript{139}

In addition to the oil industry, LIFO is available to many retailers and manufacturers.\textsuperscript{140} Empirical evidence shows, however, that the oil industry benefits disproportionately from its use.\textsuperscript{141} While the average difference between “[the] amount reported under LIFO and [the] market value of inventory” is 15%, for Exxon Mobil, for example, this difference is 200%.\textsuperscript{142} In 2006, the JCT predicted that the effect of repealing LIFO for the oil industry would bring $4.3 billion in tax revenue.\textsuperscript{143}

IV. SHOULD CONGRESS REPEAL OIL TAX INCENTIVES?

Reviewing the multiple ways in which oil companies receive disproportionate tax benefits indicates that allowing BP to take a generally applicable deduction is not the real tax policy problem. But proponents of oil industry tax subsidies advance various arguments why these subsidies should be part of the Code. Historically, the proponents have cited various justifications for the tax subsidies, including that the subsidies provide support for the industry in its infancy, develop the industry for national security purposes, benefit consumers, and mitigate the high economic risks associated with the oil industry.\textsuperscript{144} As the analysis below demonstrates, though, none of these reasons sufficiently justifies the need for oil tax incentives today. Therefore, Congress should consider repealing the incentives.

One of the oldest justifications for subsidizing the oil industry is the infant industry theory. One of the first proponents of the theory was Alexander Hamilton, who believed that the government is justi-
fied in granting monopolies to new and risky trades. The theory incorporated the use of “subsidies, tariffs, and quantitative restrictions” to achieve the same purpose. The infant industry theory seeks to help an industry that is not currently competitive grow through temporary government protection.

In the beginning of the twentieth century, the federal government perceived the potential of fossil fuels and directed incentives to help develop the budding industry. Today, however, this justification is inapplicable. Even though the oil industry was in its infancy at the beginning of the twentieth century, currently it is one of the most profitable sectors of the economy, not only domestically but globally. Domestic oil production has increased more than thirty-fold since the early 1900s. Today, the oil industry is mature, competitive, and highly profitable, rendering a governmental boost unnecessary. Furthermore, infant industry theory necessarily requires that government protects the industry temporarily. By contrast, some of the oil subsidies have existed for almost a century, and all of them are permanent provisions of the Code. The oil industry is too developed and has received assistance for too long to fit within the fundamental rationales of infant industry theory.

Another frequently used argument is the national security or defense argument. Proponents suggest that subsidies are necessary for maintaining domestic oil production for national security purposes. This argument focuses on the external non-market costs that can result from oil imports, such as the risk of disproportionate depen-
dence on oil imports from hostile or politically unstable countries. This risk is associated with possible disruptions in supply and the costs of ensuring supply levels. A tariff on oil imports could be an effective policy step to address these risks. Nevertheless, such action could be challenged as contrary to the United States’ obligations under international trade agreements, and this has lead policymakers to implement subsidies instead.

Oil tax subsidies, however, have failed to immunize the U.S. economy against the risks associated with dependence on foreign oil imports. It is true that domestic production facilitates the creation of a domestic oil reserve that can be diverted for national defense and military purposes without causing a civilian shortage in the case of a supply disruption. But it is also true that U.S. oil consumption continues to exceed production and thus continues to expose the economy to the risks of dependence on oil imports. More importantly, some of the subsidies support foreign oil production. Although many of the biggest subsidies to the domestic oil industry have been available for years and even decades, oil imports have grown steadily throughout the years. Thus, the assertion that tax subsidies reduce oil imports seems doubtful in reality.

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156 See id.
157 Id.
158 Id. Whether an oil import tariff could be successfully challenged as a violation of United States’ obligations under international trade agreements is debatable. For example, the prohibition against quantitative restrictions on trade under the General Agreement on Tariffs and Trade (GATT) is subject to a number of exceptions, including the national security exception under Article XXI. See U.N. Conference on Trade & Dev., Trade Agreements, Petroleum and Energy Policies at 2, U.N. Doc. UNCTAD/ITCD/TSB/9 (2000), available at http://www.unctad.org/en/docs/poitcdtsbd9.en.pdf. In fact, crude oil tariffs are not subject to the World Trade Organization (WTO) system and the United States could impose a higher tariff on crude oil imports than the tariff currently in force without violating its obligations. See id. at 117. A more detailed analysis of this issue is beyond the scope of this Comment.
159 Hymel, supra note 11, at 70.
160 Id. at 70–71.
161 Id. at 71.
162 One such example is the foreign tax credit. See supra Part III.B.1.
163 One example is the percentage depletion deduction which has been available for almost a century. See Hymel, supra note 11, at 48.
Another argument for maintaining oil subsidies is that they compensate for the high risk inherent in the industry. \(^{165}\) The reasoning behind this proposition is that the high volatility of oil prices increases the risk of under-investment in the industry. \(^{166}\) The oil industry contends that without the current subsidies, the inherent industry risks will lead to domestic job losses. \(^{167}\) Studies on the effect of oil tax subsidies on risk, though, have not confirmed conclusively that such subsidies are indeed beneficial. \(^{168}\) Furthermore, to some extent “all prices fluctuate in a free market.” \(^{169}\) Thus, most subsidies do not seem to be directed toward stabilizing prices.

The risks to the job market are also overstated. The oil industry is capital-intensive and subsidizing it is likely to have limited effect on labor demand. \(^{170}\) Some estimate that repeal of the subsidies will not lead to a significant reduction in domestic production levels either, resulting in possible reduction in employment levels of no more than 0.5%. \(^{171}\)

Not only do tax subsidies lack sufficient justification, but they also seem wasteful in light of the federal budget deficit. The deficit has reached its highest levels since World War II. \(^{172}\) It is expected to reach eighty percent of gross domestic product (GDP) by 2015. \(^{173}\) As Senator Bernard Sanders stated, repealing oil industry tax subsidies “could be an important step forward” to deficit reduction. \(^{174}\) A repeal of the oil tax subsidies discussed in Part II would result in $36.5 billion in revenue over a ten-year period. \(^{175}\) This revenue could either be applied directly towards deficit reduction or provide valuable funds for other programs without burdening the current deficit.

\(^{165}\) See Hymel, supra note 11, at 68.

\(^{166}\) See LAZZARI, supra note 155, at 12.

\(^{167}\) See Kocieniewski, supra note 6.

\(^{168}\) See Hymel, supra note 11, at 69 (“[W]hen risk is evaluated, studies indicate that the benefit of oil and gas tax incentives is not clear.”).

\(^{169}\) See LAZZARI, supra note 155, at 12.

\(^{170}\) See PIROG, supra note 113, at 4.

\(^{171}\) Oil and Gas Tax Provisions: A Consideration of the President’s FY 2010 Budget Proposal Before the Subcomm. on Energy, Natural Res. and Infrastructure of the Subcomm. on Fin., 111th Cong. 5–6 (2010) (statement of Alan Krueger, Assistant Sec’y for Econ. Policy, Dep’t of Treasury).

\(^{172}\) See INTL. MONETARY FUND, UNITED STATES: SELECTED ISSUES PAPER 37 (2010).

\(^{173}\) Id.


\(^{175}\) See ANALYTICAL PERSPECTIVES 2011, supra note 94, at 186.
Supporters of oil subsidies often assume that the subsidies will pass through oil producers and benefit consumers. Lower prices for consumers can be reasonably expected when the industry is price-competitive. Oil prices, however, may not be competitive enough. In the international market, crude oil prices are largely determined by the Organization of Oil Producing Nations (OPEC). In addition, the domestic petroleum industry seems to be highly concentrated, which presents an additional obstacle for competitive pricing. If the industry is sufficiently concentrated and non-competitive, subsidies are likely to benefit producers far more than they benefit consumers.

Perhaps the strongest argument against oil subsidies is the economic vulnerability created by excessive oil dependence. In 2006, President Bush articulated these economic risks when he stated that “America is addicted to oil” and recognized the need to “move beyond a petroleum-based economy.” America’s oil demand has been rising rapidly over the past century and is yet to reach its highest point. At the same time, global oil demand has risen too, largely driven by developing countries such as China and India. Failure of oil supply to keep up with the growing demand could cause prices to rise, which could have negative effect on an oil-dependent economy. The robust governmental support for the oil industry throughout the

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180 See Hymel, supra note 11, at 53.

181 In 2003, “China surpassed Japan to become the world’s second largest consumer of petroleum products,” while between 1987 and 2001 India’s demand doubled. See FED. TRADE COMM’N, supra note 177, at 19.
years contributes to the problem. Reducing petroleum dependence has become one of President Obama's central policy goals. Both the current and the previous administrations ushered in various tax incentives designed to support the development of renewable energy industries to increase energy efficiency and conservation.

Tax incentives for alternative energy are just one part of the solution to the oil dependence problem. Despite efforts to stimulate alternative energy, favorable tax provisions for the oil industry still remain firmly in place. Maintaining subsidies for both alternative and traditional energy sources “is clearly inconsistent with the policy goal of moving energy policy in the direction of renewable sources.” Not only would cutting oil tax subsidies be “a beneficial undertaking” but it is also a necessary condition for a permanent solution to the oil dependence problem.

The current Obama Administration considers reduction of dependence on fossil fuels one of its primary domestic goals. Consistent with this commitment, the Administration has taken steps to address the fossil fuel tax subsidies. For example, President Obama’s proposed budget for 2011 envisioned the elimination of the preferential tax treatment for fossil fuels. The budget proposed the repeal of the percentage depletion deduction, the IDC deduction, the exception for passive activity loss for oil and gas interests, the tertiary injectants deduction, the EOR credit, the marginal wells credit, and the domestic manufacturing deduction for the oil industry. The budget also recommended the two-year amortization period for D &

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182 Oil dependence could be linked to oil’s dominance as a transportation fuel, which can be traced to “a century of favorable government policies and deeply ingrained cultural patterns.” DAVID SANDALOW, THE BROOKINGS INST., ENDING OIL DEPENDENCE 2 (2007), available at http://www.brookings.edu/views/papers/fellows/sandalow20070122.pdf.

183 See, e.g., President’s Remarks, supra note 3 (declaring determination for transition away from fossil fuels and emphasizing the long-term environmental, economic, and security costs that will result from maintaining the status quo).


186 Id.


188 See ANALYTICAL PERSPECTIVES 2011, supra note 94, at 177.

189 Id.
D expenses applicable to independent oil companies to be equalized with the seven-year period available to integrated oil producers.\(^{190}\) The budget proposal also incorporated reforms in the foreign tax credit for dual-capacity tax payers, which would not allow such taxpayers to claim credit for the amount of a foreign levy that exceeded the generally applicable levy in the foreign country.\(^{191}\) In addition, the budget proposed the extension, modification, and enactment of tax incentives for energy conservation and alternative energy.\(^{192}\) The President’s budget for fiscal year 2012 included similar proposals.\(^{193}\) Neither proposal was successful.

After the BP spill, legislators were quick to harness the atmosphere of public discontent towards the oil industry and introduced two new repeal bills in the Senate. In May 2010, Senator Robert Menendez introduced a bill entitled the Close Big Oil Tax Loopholes Act, which essentially mimics the 2011 budget proposal.\(^{194}\) In June 2010, Senator Bernard Sanders followed with an amendment to the Unemployment Compensation Extension Act of 2010 that proposed cutting the percentage depletion deduction, the IDC deduction, and the manufacturing credit for oil and gas activities.\(^{195}\) The amendment failed to muster even a simple majority in Senate as only thirty-five senators voted in its favor.\(^{196}\) Notably, the vote occurred right in the midst of the BP oil spill crisis; even this fact did not give momentum to the proposed legislation. A similar effort to repeal tax breaks for the oil industry failed in Senate in May 2011.\(^{197}\)

Judging by these failures, the odds that Congress will repeal oil tax subsidies in the near future are slim. The oil industry’s strong lobby in Washington, especially as compared to the alternative energy industry’s lobby, could reduce these chances even further.\(^{198}\) Last but

\(^{190}\) Id.


\(^{192}\) See generally ANALYTICAL PERSPECTIVES 2011, supra note 94. A detailed discussion of these provisions is beyond the scope of this Comment.


\(^{194}\) See S. 3405, 111th Cong. (2010). There has been no vote on the bill.

\(^{195}\) 156 CONG. REC. S4753–54 (daily ed. June 15, 2010).


\(^{198}\) Over the past twelve years, oil and gas interest groups contributed over $288 million to members of Congress. Oil & Gas: Long-Term Contribution Trends, OPEN
not least, oil exporting countries are the fourth largest holder of U.S. treasury securities. This fact may serve as a further incentive to maintain the status quo of generous oil subsidies.

V. FURTHER PROBLEMS AND POSSIBLE SOLUTIONS

A. The Effect of Repeal

Repealing oil tax subsidies may not be sufficient to address all problems without additional measures in place. The first problem is directly related to the incentives for oil production and oil consumption. By cutting oil tax subsidies and making the cost of production higher than it currently is, the Obama Administration hopes to discourage overproduction of oil. In reality, however, terminating tax incentives is unlikely to cause a decrease in oil production levels. The subsidies are dwarfed by high profits. A repeal will yield as much as $36.5 billion in government revenue over a ten-year period. But from the perspective of oil companies, the cost of repealing the percentage depletion deduction, the domestic manufacturing credit, and the IDC deduction represents less than one percent of total oil revenues. The market itself, driven by strong demand, would likely provide sufficient incentives for the domestic production of oil even without subsidies. Thus, repeal alone would not be sufficient to counteract the strong market incentives for oil production.

Some have also suggested that repealing the subsidies may increase fossil fuel prices, which could lead to both reduced consump-


200 See GREEN BOOK, supra note 191, at 75–90.

201 Crude oil production’s return on revenues was 19.8% for 2008—the highest among all industries. See Top Industries: Most Profitable, FORTUNE (July 20, 2009), http://money.cnn.com/magazines/fortune/global500/2009/performers/industries/profits/.

202 See ANALYTICAL PERSPECTIVES 2011, supra note 94, at 186.


204 See PIROG, supra note 113, at 6.
tion of oil products and increased consumption of renewable energy resources. This argument, however, seems misplaced because subsidies for oil producers are not the major determinant of consumer oil prices. Oil products are refined from crude oil. In the United States gasoline accounts for roughly forty-five percent of all oil use and is the most important oil product. The next most widely-used oil-based fuel groups are distillate fuel oil products (diesel, heating oil and other fuels), jet fuel, and residual fuel oil. Although different factors affect fuel prices, the price of crude oil is the biggest component of consumer price of most of these fuel products, and it depends mainly on the supply and demand in the world oil markets. The growing industrialization of developing countries increases their oil demand. On the supply side, OPEC’s policy of setting production ceilings for its members has been an important determinant for oil prices. Because subsidies are not the key factor

205 STAFF OF THE JOINT COMM. ON TAXATION, supra note 57, at 131.
207 Id.
211 Fed. Trade COMM’n, supra note 177, at 18.
212 Although OPEC has used its market leverage with varied success, studies indicate that OPEC has generally “been successful in exercising a significant degree of market power in obtaining prices above competitive levels.” Id. at 23. OPEC’s crude oil production accounts for a lesser percentage of global production than in the
determining oil prices, their repeal will likely affect prices minimally. Consequently, consumption would not decrease either.

Failure to deal with oil dependence comes at a cost. Defense spending is largely affected by the need to secure continuous supply of oil. OPEC countries, the largest numbers of which are located in the Middle East, hold eighty percent of world oil reserves. Iraq and Iran, for example, face significant political risks such as civil war, coup, or general strike. Most recently, unrest in Libya, as well as across other countries in the Middle East, caused oil prices to soar because of fears that supplies could be disrupted. Although it may be difficult to allocate military spending in the Middle East to securing American energy needs, it is plausible to infer that a significant portion of defense spending is for energy security purposes. In 1996, it was estimated that securing oil supplies in the region cost anywhere between $6 billion and $60 billion a year. Thus, ensuring oil security is an expensive endeavor. There is overwhelming agreement in the scholarly community that the road to better energy security is reduction in the overall oil consumption, rather than increase in domestic production at the expense of oil imports.

1970s, but OPEC still produces a large enough share of crude oil to influence strongly oil prices. See id. at 14.


U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 210, at 15. “OPEC controls most of the estimated world oil reserves” and OPEC’s decisions may affect “future oil exploration and production.” Id. at 4, 25. The current OPEC members are Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela. Member Countries, ORG. PETROLEUM EXP. COUNTRIES, http://www.opec.org/opec_web/en/about_us/25.htm (last visited Jan. 6, 2012).

U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 210, at 21. Together with Venezuela and Nigeria, which face the same high degree of political risk, these countries account for more than one third of world oil reserves. Id. at 21–22.


U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 210, at 21–22.

Id.

Another cost of excessive oil use is the detrimental effect it has on the environment. Damage includes air and water pollution, land deterioration, and dangers to human health. The BP oil spill is a prime example of the environmental risks that the quest for securing oil supplies carries. Similarly, motor vehicles, which use oil-based fuel products, are responsible for large quantities of the toxic emissions in the air, including “[c]arbon monoxide, hydrocarbons, nitrogen oxides, and particulate matter . . . produced by fossil fuel combustion.” Combustion of fossil fuels, including oil, also emits carbon dioxide, which has been linked to global warming. These detrimental effects impose costs on society that the market fails to take into account. Therefore, corrective measures are necessary to account for these costs. Although repealing tax subsidies for oil production is sound policy in other regards, it cannot compensate for the external costs of pollution and other environmental damage. Usually, negative externalities call for a separate tax.

The third—and perhaps most serious—cost related to American oil dependence is the risk it poses to economic stability. Empirical research has established a relationship between oil price shocks and subsequent periods of economic decline. The oil shock of 2007–2008, when the price per barrel reached new records, primarily resulted from two factors: the low elasticity of demand for oil and the failure of oil production to increase along with demand. Price elasticity of demand represents the relationship between the percentage change in demand that results from a percentage change in a product’s price. Low price elasticity demonstrates that the demand for a product is less sensitive to the increase of the product’s price. In other words, consumption fails to decrease significantly in response to relatively small increases in the price of oil.

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220 Lazzari, supra note 155, at 8.
221 Mann, supra note 219, at 599.
222 Lazzari, supra note 155, at 8 n.9; see Mann, supra note 219, at 603–05.
223 See Lazzari, supra note 155, at 8.
224 Id.
225 Joint Comm. on Taxation, supra note 115, at 131.
226 Lazzari, supra note 155, at 8.
228 Id. at 23.
229 See 1 Palgrave, supra note 145, at 126–27.
230 Id.
231 Some scholars have also suggested that short-term demand for gasoline today is less elastic than it was two to three decades ago. See Jonathan Hughes et al., Evi-
There is persuasive evidence that, had it not been for the recent oil price shock, the United States would not have entered a period of recession in 2007. The global demand for oil grew rapidly from 2005 to 2007, while at the same time production stagnated. Although energy prices increased as a result of growing demand, consumers continued to buy gasoline at the same levels as before simply because they “could afford to do just that.” With the growing disparity between supply and demand and the unwillingness of consumers to reduce consumption accordingly, the prices needed to rise “by whatever it took to persuade [consumers] to do so.” Thus, gasoline needed to reach the record price of four dollars per gallon to finally affect consumption in a meaningful way. The shock led to significant decline in the automobile industry, as well as declines in overall consumer spending and consumer sentiment.

The recent recession demonstrates the troubling vulnerability of the U.S. economy created by its dependence on oil. Policy measures are urgently needed to address this challenge. Because a repeal of oil subsidies is not likely to decrease oil production or to increase the price of oil products, additional measures are necessary to address America’s overconsumption of oil.

B. A Proposed Solution—Production Tax

As this Comment demonstrated earlier, oil subsidies are unnecessary and contradict important policy goals. While repeal is a necessary step in the creation of effective tax oil policy, it must achieve at least two important policy goals. First, it needs to address the costs of oil dependence. Second, it should foster United States’ competitiveness in the global market for clean energy technologies. The driving force of oil dependence is America’s appetite for oil. As noted...
earlier, scholars suggest that the only viable alternative to address oil security is through reduction of overall reliance on oil. The environmental damages and the economic vulnerabilities that oil creates can also be alleviated by general reduction in demand.

When certain industries impose external costs on society (in this case security, environmental, and economic costs), a common policy choice is to tax them to compensate for these costs. Taxes that serve to correct the market for such costs are called Pigovian taxes. One of the most frequently mentioned Pigovian taxes today is a tax on carbon emissions. The objective of carbon tax is to reduce carbon emissions to fight global climate change. While reducing carbon emissions may correlate somewhat with a decrease in oil consumption, reduction in the one variable does not necessarily lead to decrease in the other. For example, recent legislative proposals aimed at curbing carbon emissions targeted electric utilities and would affect oil consumption relatively little. Effectively addressing oil externalities requires a more direct approach.

Taxing oil production targets production directly by making investments in oil projects less attractive and affects consumption by making it more expensive. Thus, this Comment proposes that an oil production tax could be a sensible way to address the problems that oil dependence creates. One of the first questions that emerge is who should pay the tax. It would be difficult and expensive to impose the tax on a broad tax base, such as oil consumers, because consumption is spread among many individuals and entities. Therefore, it is sensible to impose the tax upstream, at the earliest point of produc-

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239 See sources cited supra note 219.
240 LAZZARI, supra note 155, at 8.
243 See id. at 50.
244 Anne C. Mulkern, Would a Push to Curb Carbon Really Reduce U.S. Dependence on Oil, N.Y. TIMES (June 22, 2010), http://www.nytimes.com/gwire/2010/06/22/22greenwire-would-a-push-to-curb-carbon-really-reduce-us-d-19627.html. This Comment is not arguing against a carbon tax. A carbon tax can achieve important environmental policy goals and can be used in conjunction with other measures that address the oil dependence problem in a more direct way.
245 See Metcalf & Weisbach, supra note 241, at 501 (“As the [carbon tax] base gets broader, collection costs increase . . . .”). Although Professors Metcalf and Weisbach discuss the optimal tax design in terms of costs and basis of a carbon tax, the same concerns exist in the design of oil production tax.
Such design is more efficient because there are fewer upstream producers, which results in lower collection and monitoring costs. In substance, taxing oil production could raise the marginal cost of production and consequently discourage investments in oil. At the same time, such disincentives could have the opposite effect with respect to alternative energy sources and make them more attractive investment choices. The relative attractiveness of alternative energy sources as compared to oil could be further augmented by the myriad of renewable energy subsidies that the government currently provides.

Of course, it is also possible that oil companies pass at least part of the tax on to consumers. Thus, the oil production tax could turn into a consumption tax because consumers will bear it. As the consumer prices of oil products rise, they could discourage consumption of oil products and encourage energy consumption from alternative sources. One common criticism with this respect to oil taxes is that they are regressive. Regressivity, however, is not an immutable characteristic. The extent of regressivity largely depends on the way the tax revenues are returned back into the economy. One way of reducing the regressive effect of an oil tax is to pair it with a reduction in another tax. Such a design achieves both the main objective of the tax and alleviates its economic burden on the taxpayers.

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246 See id. at 523. A commensurate tax on oil imports may be necessary in order to prevent consumers from switching to cheaper oil imports.

247 See id.


249 One example of such an incentive is the credit for investment in manufacturing facilities for clean energy. See, e.g., 26 U.S.C. § 48C (2006). The credit equals thirty percent of the investment in such a facility and is distributed on a competitive basis. See § 48C(d).


251 See, e.g., LAZZARI, supra note 155. (noting that energy taxes tend to be regressive and could have dire macroeconomic effects).

252 Cf. Bento, supra note 250, at 283.

While an oil production tax is at the core of a program to curb oil consumption, there are other factors that could affect its success. Meaningful reduction in oil consumption can only be achieved if there are viable transportation alternatives for consumers. Federal policies have supported automobile-dependent transportation modes for decades.\textsuperscript{254} Intense highway construction, spurred by federal support, occurred at the same time that suburban living expanded as a result of local regulation favorable to single-family homes and housing subsidies for sparsely populated areas.\textsuperscript{255} New policies need to make alternative transportation modes accessible to consumers. For example, imposing congestion fees and tolls, providing policy incentives for telecommuting, using intelligent traffic management systems, increasing the flexibility of land development rules, and providing financial help to low-income individuals for mass transit use could achieve this goal.\textsuperscript{256}

Another critical factor for the success of the proposed tax policy is the development of a robust, green energy industry, which can both secure abundance of oil alternatives and create new jobs to absorb any job losses from traditional energy sectors.\textsuperscript{257} In this regard, China’s growing competitiveness in renewable energy manufacturing is a cause for concern. While the U.S. government has dedicated substantial resources for the development of the green economy, these resources are slow to trickle down to manufacturers.\textsuperscript{258} There are various bureaucratic reasons behind these delays, such as pay requirements for contractors and understaffed administrative bodies.\textsuperscript{259} Meanwhile, China is emerging as the world leader for green energy manufacturing.\textsuperscript{260} China is on its way of becoming the world’s largest

\textsuperscript{254} See Mann, supra note 219, at 589 (“For years, the government has subsidized a low density, petroleum-intensive lifestyle . . . .”).


\textsuperscript{256} Id. at 10–17.

\textsuperscript{257} Cf. BRUCE ARNOLD, CONG. BUDGET OFFICE, HOW POLICIES TO REDUCE GREENHOUSE GAS EMISSIONS COULD AFFECT EMPLOYMENT 10 (2010), available at http://www.cbo.gov/ftpdocs/105xx/doc10564/05-05-CapAndTrade_Brief.pdf (concluding that, in the case of job losses in the traditional energy sectors as a result of green-house-gas reduction policies, “most laid-off workers would find work” in industries with lower emissions and in industries specializing in cleaner energy).

\textsuperscript{258} See Kate Galbraith, Stimulus Aid is Slow to Reach Energy Savers, N.Y. TIMES, Apr. 22, 2010, at F7.

\textsuperscript{259} Id.

manufacturer of wind turbines and solar panels. Government policies give China a competitive edge. The Chinese government transfers free land and subsidizes loans for green energy initiatives on a regular basis. Despite criticism that such practices are in violation of international trade rules, many businesses are unwilling to protest due to fears that China will retaliate against foreign business ventures in the country. But China’s success teaches one thing—the United States’ green energy industry can flourish only with robust government subsidies. While the United States should adhere to its obligations under international trade agreements, the current Administration should devise innovative ways to support the green industry and ensure that the resources are distributed quickly and efficiently, without undue delay.

VI. CONCLUSION

In the aftermath of the BP oil spill, important policy questions about the tax treatment of the oil industry have emerged. These issues have spurred debate and legislative actions. Some of the questions were myopic. For one, in spite of the criticism, BP’s oil-spill related deduction reflects long-accepted tax principles and was perfectly legitimate. But, the oil spill also helped refocus the discussion on a more fundamental problem. Critics have aptly noted that the oil industry has enjoyed unprecedented favorable tax treatment for decades. Today, these benefits are unjustified, wasteful, and contradict important policies that are designed to steer the U.S. economy away from oil dependence into a clean energy future. Repealing oil tax subsidies is an important step towards achieving these policy goals, but it may be insufficient. Excessive oil consumption results in security, environmental, and economic costs that require separate actions. The linchpin of a plan designed to address these problems is a tax on oil production. Another important feature of such a plan is the implementation of policies that allow for auto-independent existence and adequate response to world competition in the clean energy industry. Ultimately, Congress must create a comprehensive, long-

262 Id.
term policy plan to address the challenges of oil consumption, in which taxes and tax incentives, together, should play a major role.