

Senate Democratic Policy Committee Hearing
**“An Oversight Hearing on Record High Gasoline Prices
and Windfall Oil Company Profits”**

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The recovery from Hurricane Katrina will be long and expensive. In addition to the many people killed by the storm and its aftermath, hundreds of thousands of homes have been damaged or destroyed, as have businesses and much of the infrastructure of the affected region. The need for public money for immediate relief and reconstruction will almost certainly top \$100 billion, and could run as high as \$150-\$200 billion (6-8 percent of the federal budget). With the federal government already facing large budget deficits, these additional expenditures are not coming at a good time.

For this reason, it is appropriate to look for new revenue sources. One obvious possibility is the windfall profits being earned by many oil companies in the wake of Katrina's damage and the recent worldwide surge in oil prices. Taxing these windfalls could easily generate \$10 billion a year (half the sum raised through the estate tax), without in any way worsening current shortages.

The basic logic behind a windfall profit tax is quite simple. The oil industry made its investment and production plans under the assumption that oil would be selling for far less than today's prices. As recently as 1998, oil was selling for less than \$15 a barrel, and it was averaging less than \$25 a barrel until the United States began preparing to invade Iraq in 2002. The uncertainty and supply disruptions associated with the war, along with unexpectedly rapid growth of demand in China and India, caused an unexpected surge in energy prices. The surge has been furthered by the disruption of crude oil production in the Gulf of Mexico and refining operations in the Mississippi delta region due to Katrina.

Since the industry was looking at much lower prices when it made most of its investment and production decisions, it can cover its costs and make a normal profit at prices that are less than half the \$60-\$70 a barrel price seen at present in world markets. This surge in prices has led to an unexpected glut of profits for the oil industry. The oil industry's profits were running at annual rate of \$62.8 billion in the first quarter of 2005, several months before the most recent run-up in prices.¹ This compares to an average of just \$24.3 billion (in 2005 dollars) over the last five years. The world's largest oil company, Exxon Mobil, will likely have over \$10 billion in profits this quarter.

¹ This data is taken from the Bureau of Economic Analysis, National Income and Product Accounts, Table 6.16D, line 25.

The additional \$38.5 billion can be seen as unexpected windfall due to the run-up in oil prices.² A portion of this unexpected windfall can be taxed away, with virtually no near-term impact on oil supplies. A tax directed at windfall profits should also have very little impact on prices to consumers, since it does not directly affect the conditions of supply and demand in the market, at least in the short-term.

If a windfall profit tax of 30 percent was imposed on profits that exceed the average of the last five years by more than 10 percent, it would generate more than \$10 billion in annual revenue based on the first quarter profit data, as shown in Table 1 below.³ Given the more recent run-ups in the price of crude oil and gasoline, it is possible that a windfall profit tax could generate substantially more revenue.

Table 1 Calculating Windfall Profit Tax Revenue (2005)

Average Oil Industry Profit 2000-2004 (2005 dollars)	—	\$24.3 billion
Oil Industry Profit, 2005, first quarter	—	\$62.8 billion
Excess Profit (more than 10 percent above average)	—	\$38.5 billion
Windfall Tax Revenue (30 percent of excess profit)	—	\$11.6 billion

Source: Bureau of Economic Analysis, National Income and Product Accounts, Table 6.16D, line 25 [<http://bea.gov/bea/dn/nipaweb/index.asp>] and author's calculations.

A windfall profit tax could have negative incentive effects and would lead to economic distortion over time, but these might prove acceptable under current circumstances. In terms of incentive, any reduction in industry profits will reduce the oil industry's incentive to drill for new oil. In the past, when windfall profit taxes were imposed, this problem was dealt with by distinguishing between new oil and old oil – wells that were drilled after the imposition of the tax and pre-existing wells. However, the distinction between old and new oil can make enforcement complicated and create opportunities for gaming the system.

Since oil consumption is itself a major world environmental problem due to global warming, it is not clear that the country should be concerned about limiting the incentive to drill new fields. The major thrust of energy policy clearly must be to divert the economy away from fossil fuels, not to increase their production. For this reason, the modest long-term disincentives for opening up new and expensive oil fields that could

² Some of this increase in profits is attributable to foreign profits that have been repatriated to take advantage of a temporary tax break in 2005.

³ Taxing windfall profits would reduce normal corporate income tax collections from the industry. The most simple way to structure the tax would be to impose the tax on excess profits and then have it deducted from profits for the purpose of calculating corporate income tax liability.

result from a windfall profit tax is not necessarily a problem. The energy and /or promoting conservation.

Of course, oil firms will find ways to game a tax based on their profits over time as well. They can merge with other companies, sell off parts of their operations, and engage in other maneuvers that would make it difficult to construct a useful baseline against which to assess a windfall profits tax. In this respect, the uncertainty around a temporary tax, that could in principle be renewed, is a huge advantage.

There are costs to gaming the system. If a major oil company does not know whether or not they will still be paying the windfall profit tax in 4 years, then it makes it much less likely that they will choose to absorb the expenses associated with gaming the system. For example, if it is possible to evade much of the tax by selling a division of an oil company to another firm, then a company will be much less likely to incur the legal and consulting fees associated with organizing this sale, if they don't know whether the tax will even be in place after three years.

It is possible that oil prices will move back toward their pre-Iraq war levels, thereby eliminating the windfall profits currently being enjoyed by the oil industry and the resulting tax revenue. If such a price decline happened, then the near-term boost to the economy would almost certainly lead to an increase in other tax revenues that would far more than offset the loss of the windfall profit tax revenue. In this way, the windfall profit tax effectively provides a limited hedge – if oil prices rise a great deal and slow the economy, then the government has a new source of revenue that it can tap. However, if oil prices drop back to their levels of three years ago, then the economy will be growing fast enough that the windfall profit tax revenue will not be needed.

The country will have to incur substantial expenses to rebuild the region hit by Katrina and to support the hurricane victims through the recovery period. This cost will have a substantial impact on the size of the federal deficit. However, this impact can be reduced by taxing the windfall profits that the oil industry is earning, at least in part due to the crisis created by the hurricane. It is difficult to envision a less painful way to raise money than taxing away a portion of these windfall profits.