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Oil Company Profits and Tax Collections: Does the U.S. Need a New Windfall Profits Tax?

by Scott A. Hodge and Jonathan Williams

This week, the Senate will hold hearings on rising oil and fuel prices and the subsequent record earnings recently posted by U.S. oil companies. Some lawmakers have suggested that these profits are unseemly and, thus, should be subject to a new "windfall profits" tax.

Before rushing to create a new federal tax, lawmakers should ask two questions:

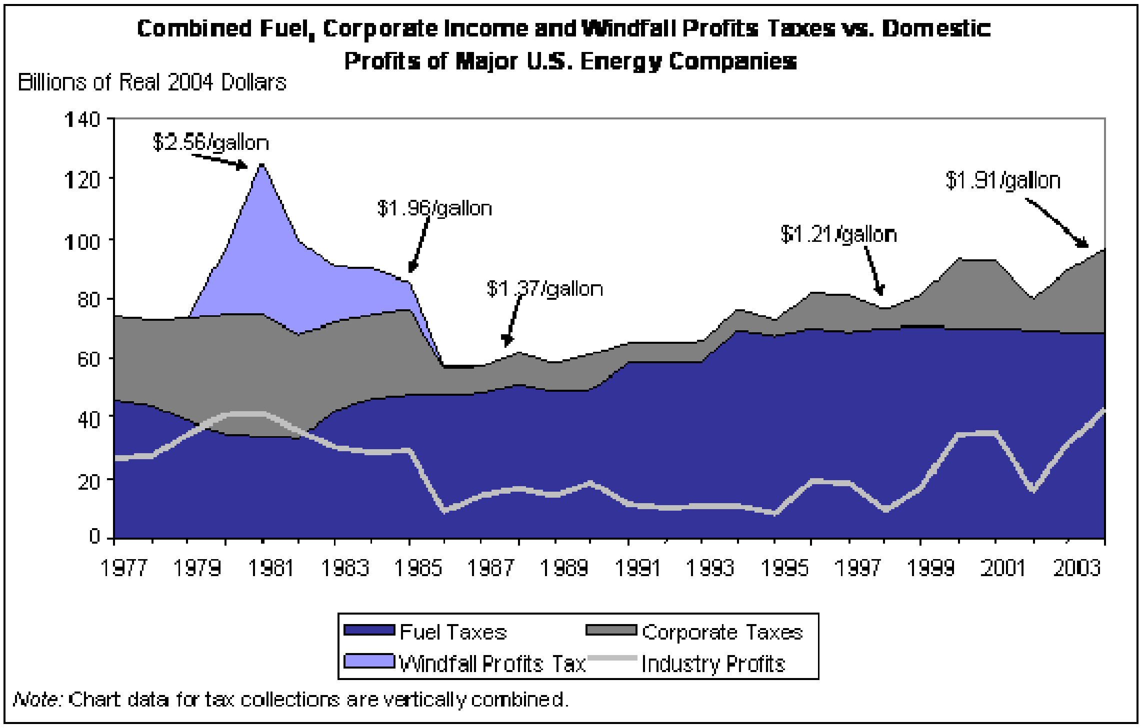
(1) Do oil companies currently pay too little in taxes compared to profits?
(2) What was the effect of the last windfall profits tax enacted in 1980?

The answer to the first question is that over the past 25 years, oil companies directly paid or remitted more than $2.2 trillion in taxes, after adjusting for inflation, to federal and state governments—including excise taxes, royalty payments and state and federal corporate income taxes. That amounts to more than three times what they earned in profits during the same period, according to the latest numbers from the Bureau of Economic Analysis and U.S. Department of Energy.

These figures do not include local property taxes, state sales and severance taxes and on-shore royalty payments.

The answer to the second question, according to the Congressional Research Service (CRS), is that the 1980s windfall profits tax depressed the domestic production and extraction industry and furthered our dependence on foreign sources of oil.[1]

Figure 1. Oil Industry Taxes Have Outpaced Oil Industry Profits Since 1977.



Source: Bureau of Economic Analysis, U.S. Energy Information Administration.

Figure 1 illustrates the magnitude of government tax collections versus industry profits between 1977 and 2004. During this period, the 29 largest domestic energy firms earned a collective $630 billion after adjusting for inflation. These profits varied dramatically—from a low of $7.9 billion in 1995 to a high of $42.6 billion in 2004—based upon world market demand, supply, and international events.

In contrast, the taxes paid or remitted by domestic oil companies have been consistently far greater than their profits and now total more than $2.2 trillion (adjusted for inflation) over the past quarter century. The largest share of those taxes is federal and state gasoline excise taxes. In 2004, governments collected $58 billion in gasoline excise taxes. Overall, governments have collected $1.34 trillion in gasoline excise taxes since 1977.

Today, U.S. consumers pay an average of 45.9 cents per gallon in gasoline taxes. The federal gasoline excise tax is 18.4 cents per gallon while the average state and local tax is 27.5 cents. The vast majority of these taxes are levied at a flat rate per gallon—regardless of whether a gallon of gas costs $1.49, $2.49, or $3.49. Thus, the effective rate of these taxes can vary wildly, from roughly 31 percent in the former case to 13 percent in the later.

Federal and state governments also collect a substantial amount of excise tax from the sale of diesel fuel. In today's dollars, governments have collected $160 billion in diesel fuel excise taxes since 1977.

Oil companies also pay taxes to governments for the right to extract oil from public lands and waters. For example, the federal government has collected a total of $48.8 billion in royalty payments from oil companies in exchange for their ability to explore and drill in the U.S. outer continental shelf. Oil companies also pay severance taxes to state governments for the right to drill on state lands. Unfortunately, complete data on state severance tax collections for the period is not available at this time.

In contrast to excise taxes, corporate income tax payments vary as widely as industry profits. As mentioned above, domestic energy companies earned a total of $630 billion in post-tax profits between 1977 and 2004. Tax Foundation economists estimate that companies paid $518 billion in corporate income taxes to federal and state governments during the same period. These payments varied from a low of $5.1 billion in 1995 to a high of $40.4 billion in 1981.

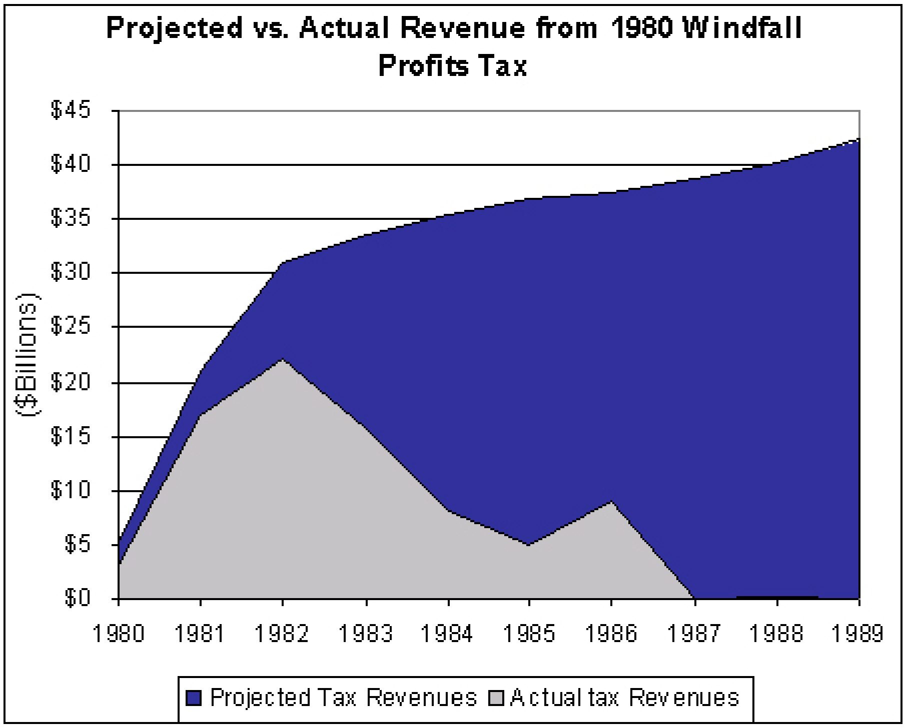
The 1980 Windfall Profits Tax

As is also illustrated by Figure 1, during the 1980s the federal government experimented with a new tax intended to limit the "windfall profits" of domestic oil companies. In reaction to the rise of energy prices during the late 1970s and the removal of price controls on the energy industry, President Jimmy Carter signed the Crude Oil Windfall Profits Tax Act into effect on April 2, 1980.

The tax was technically misnamed because it was in fact an excise tax, not a "profits" tax. The tax was imposed on the difference between the market price of oil and a government-determined base price. For example, a 70 percent tax was levied on the difference between the market price received by oil companies and the average base price of $12.81 per barrel. Independent producers, stripper wells and heavy oils were taxed at different rates.

As shown in Figure 2, the windfall profits tax was forecasted to raise more than $320 billion between 1980 and 1989. However, according to the CRS, the government collected only $80 billion in gross tax revenue ($146 billion in 2004 dollars). The net amount was actually less than this—roughly $40 billion—because the tax was deductible against corporate income.

Figure 2. Tax Revenues from the 1980 Windfall Profits Tax Were Dramatically Less Than Projections.



Source: Congressional Research Service.

CRS also found the windfall profits tax had the effect of decreasing domestic production by 3 percent to 6 percent, thereby increasing American dependence on foreign oil sources by 8 percent to 16 percent. A side effect was declining, not increasing, tax collections. Figure 1 clearly shows that while the tax raised considerable revenue in the initial years following its enactment, those revenues declined to almost nothing as the domestic industry collapsed.

The 1980 windfall profits tax was also found to be highly burdensome for the industry to comply with and for the Internal Revenue Service to administer, especially in years when no revenue was raised. It seems unlikely that a new tax could be designed in a less burdensome fashion. Tax Foundation economists estimate that U.S. companies currently spend nearly $150 billion annually to comply with the federal income tax alone. Enacting a new windfall profits tax would add an additional layer of complexity to the federal tax system.

The past year has clearly been a good year for oil companies. However, these large profits should be viewed in proper perspective, given the staggering amount of tax the industry currently pays and remits to governments at the federal, state, and local levels. As the experience of the past quarter-century has shown, governments have actually “profited” more from the oil industry than the industry has earned for its shareholders.

[1.] Salvatore Lazzari, “The Windfall Profit Tax On Crude Oil: Overview of the Issues,” *CRS Report for Congress*, Congressional Research Service (September 12, 1990), p. 3.

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