The Distributional Impact of Windfall Profits Taxes and a Gas Tax Holiday

Fiscal Fact No. 127

by **Gerald Prante**

May 2, 2008

There has been considerable debate in recent weeks over what the federal government should do about the higher price of gasoline. Each of the three presidential candidates has put forth a proposal. Barack Obama would impose a windfall profits tax on U.S. oil companies based upon the price per barrel of oil. Hillary Clinton and John McCain both propose a temporary gas tax holiday which would repeal, from Memorial Day until Labor Day, the federal gas tax (18.4 cents) and the federal diesel fuels tax (24.4 cents). Such a holiday would cost approximately $9 billion. Hillary Clinton would pay for the gas tax holiday by imposing a windfall profits tax.

Unfortunately, the candidates' political rhetoric has little economic backing. A windfall profits tax on big oil companies may sound good in theory, but it will be paid by individuals. The individuals who bear the tax in the short run will be shareholders of the oil companies at the time of the imposition of the tax (or announcement thereof). That's because the value of the individuals' stock holdings (which reflect expected future net profits) will fall as soon as the new tax is announced. This means that although the owners of the oil companies are the ones who have benefited from the higher-than-expected profits, they will not necessarily be the ones who end up paying the windfall profits tax.

So who does have a stake in "Big Oil"? Shapiro and Pham (2006, 2007) have shown that a large fraction of the holdings of oil companies are in the form of pension funds, including federal, state and local employee pensions. Furthermore, they estimate that around 81.4 percent of the stock of 74 U.S.-based oil and natural gas companies in 2007 was owned by institutions such as asset management firms and pension funds. In Table 1, below, we use this data, combined with data on household asset holdings from the 2004 Survey of Consumer Finances, to estimate how a windfall profits tax would be distributed along the income spectrum.

The table summarizes the distributional impact of both a windfall profits tax and a gas tax holiday by income group. We distribute a $9 billion windfall profits tax (assumed to be borne by domestic owners of oil companies) and a $9 billion gas tax holiday. We show the results of the gas tax holiday under two scenarios: (1) the assumption made by Hillary Clinton and John McCain that the reduction in the tax will be fully passed forward to consumers and (2) the assumption of most economists that a temporary gas tax holiday would merely increase the profits of the oil industry due to the inability of domestic supply to respond to increased demand in the short run. It should be pointed out that Clinton attempts to reconcile these two assumptions with a provision that would force the Federal Trade Commission to mandate that the tax cut be reflected in the price at the pump. This is the worst provision of them all: essentially, she wants to control the economic incidence of a tax via legal mandate. Such a policy is economically equivalent to price controls.

Table 1
Average Change in Tax Burden per Family from Proposed Changes

Income Quintile	Windfall Profits Tax Burden per Family (Short-Run)	Gas Tax Holiday Savings (HRC/JM Assumption)	Gas Tax Holiday Savings (Economists' Assumption)	Net Change in Tax Burden (HRC/JM Assumption)	Net Change in Tax Burden (Economists' Assumption)
Bottom 20%	$6	$31	$6	$25	$0
Second 20%	$10	$53	$10	$43	$0
Middle 20%	$24	$75	$24	$51	$0
Fourth 20%	$48	$98	$48	$50	$0
80-90%	$68	$124	$68	$56	$0
Top 10%	$558	$165	$558	-$393	$0

Note: Income break points (2004 dollars): $18,900; $33,900; $53,600; $89,300; $129,400. HRC/JM assumption refers to the assumption of Hillary Clinton and John McCain that a gas tax holiday's benefits would be fully passed forward to consumers. Note that John McCain has not indicated support of a windfall profits tax.

Source: Survey of Consumer Finances (2004), Federal Reserve; Bureau of Labor Statistics Consumer Expenditures Survey; and Shapiro and Pham (2007)

The table shows that under the assumption of most economists, in the short run, the owners of oil companies would get hit by the windfall profits tax *and* would simultaneously benefit from the gas tax holiday, which would lead to a net wash for nearly all families. Most of the $9 billion windfall profits tax would be borne by families in the top 10 percent of the income spectrum. Interestingly, those very investors have been a target for possible tax hikes by both Hillary Clinton and Barack Obama; both candidates intend to raise the capital gains and dividends tax rate from its current 15 percent to either 20 percent (Clinton) or somewhere between 20 percent and 28 percent (Obama). While this policy would have its share of negative economic effects, it is more defensible from a fairness perspective than singling out one industry to impose taxes on.

If taxing economic profits that are earned for any reason (e.g. barriers to entry, collusion, government regulations, etc.) is the goal, then there are plenty of other industries that should be forced to pay similar taxes to a windfall profits tax. How many members of Congress discussed imposing extra taxes on the homebuilding or real estate industry when those industries earned record profits from 2000 through 2006? None, and now they even want to help those industries in the wake of their sudden fall from their record-breaking peak. Will we see the same generosity toward oil companies if their net incomes fall? That's doubtful given that it's politically popular to support increases in home prices and decreases in gas prices, as if such price manipulation, induced by fiscal policies, were one of the proper functions of government.

Tax policy in Washington needs to move beyond political gimmicks that may sound good on the nightly news and begin discussing the long-term fiscal policy challenges that the nation faces, both on the revenue side and on the spending side. Fundamental changes in both the corporate and individual tax systems are needed to move the tax code in a direction that dramatically reduces favors for special constituencies paid for by penalties imposed on other constituencies. This includes most notably the energy sector, the housing sector, the health care sector, and the research sector.

Methodology
This study uses information provided in the 2004 Survey of Consumer Finances (SCF) regarding financial information by family income quintile. Note that the term "family" here is similar to the Census definition of "household." For convenience, we assumed that the unit of analysis and the income measures used by the Federal Reserve and the Bureau of Labor Statistics were similar enough to calculate a reasonable net savings under the assumption that the savings from a gas tax holiday (under the Clinton/McCain pass-forward assumption) would be in line with gasoline consumption reported in the Consumer Expenditures Survey for 2004. The estimated diesel savings portion (27 percent) was allocated as follows: one-third wages and salaries, one-third capital income, and one-third gasoline consumption.

Data regarding types of institutions holding oil companies was taken from Table 4 on page 11 of Shapiro and Pham (2007). Variables from 2004 SCF used to allocate the windfall profits tax by family income percentile include NMMF, STOCKS, RETQLIQ, and EQUITY. Ownership by the category "Corporate Insiders" in Nam and Shapiro (2007) is assumed to all fall in the top 10 percent.

Income quintiles are defined based upon 2004 income levels given that the ownership data is from the 2004 SCF.

Sources
Federal Reserve. Survey of Consumer Finances, 2004. Chartbook accessed via:
http://www.federalreserve.gov/PUBS/oss/oss2/2004/Chartbook.xls

Shapiro, Robert J. and Pham, Nam D. "The Distribution of Ownership of U.S. Oil and Natural Gas Companies," September 2007. Accessed via:
http://www.energytomorrow.org/media_center/Shapiro_Pham_Study.pdf

Shapiro, Robert J. and Pham, Nam D. "The Economic Impact of a Windfall Profits Tax on Federal, State and Local Public Employee Pension Funds," February 2006.

Consumer Expenditures Survey, 2004. Bureau of Labor Statistics. Summary Tables by Income Class.

Tax Foundation
2001 L Street NW, Suite 1050
Washington, DC 20036
Ph: (202) 464-6200
Fax: (202) 464-6201
www.taxfoundation.org