JOINT ECONOMIC COMMITTEE
Senator Charles E. Schumer (D-NY) – Chairman

The Proposed Modification of Internal Revenue Code Section 199 Will Not Increase Consumer Energy Prices

The following analysis by the majority staff of the Joint Economic Committee (JEC) at the request of Senators Jeff Bingaman, Chairman of the Senate Energy and Natural Resources Committee, and Max Baucus, Chairman of the Senate Finance Committee examines the impact of denying the Internal Revenue Code (IRC) Section 199 manufacturing deduction to major integrated oil and gas producers on consumer prices of oil and natural gas. The report finds that the removal of this deduction would have a negligible effect, if any, on consumer energy prices. This tax provision will likely be included in a larger Senate energy bill as a way to finance renewable and energy conservation efforts.[1]

Key Points

- **Because the removal of the tax deduction does not affect production decisions in the near term, removing or modifying the tax deduction will have no effect on consumer prices for gasoline and natural gas in the immediate future.**

- **In the long run, the removal of the tax deduction is unlikely to have any effect on consumer prices for oil and gas. Oil prices are more than three times higher than they were when the tax deduction was implemented in 2004 – and those high prices are an incentive for investors to continue to invest in oil and gas companies. Although natural gas prices are not significantly different from their 2005 levels, natural gas prices rose significantly over the last decade and those higher prices also provide good incentives for investors.**

What is the current tax deduction and what is the proposed removal?

IRC Section 199 was modified in 2004, as part of the American Jobs Creation Act, to allow manufacturers to deduct, as a business expense, up to a specified percentage of qualified domestic production activity income in a given year. Initially, manufacturers were allowed to deduct up to 3 percent of qualified income. The specified percentage rose to 6 percent in 2007 and will increase to 9 percent in 2010. For the domestic oil and gas industry, the deduction applies to oil or gas that was "manufactured, produced, or extracted in whole or in significant part in the United States."[2] Currently, the marginal corporate income tax rate is 35 percent and

[1] See the Senate Finance Committee's summary of the tax provisions in the Clean Renewable Energy and Conservation Tax Act of 2007.
[2] See American Jobs Creation Act of 2004, Public Law 108-357 § 199 (c)(4)(A)(i)(I), available online here. This deduction allows manufacturers, including oil and gas producers, to deduct, as a business expense, the specified percentage of domestic income subject to a limit of 50 percent of wages that are allocable to the domestic production during the taxable year.

this credit will reduce the marginal tax to 31.85 percent when the deduction is fully implemented.[3]

The proposal excludes gross receipts of major integrated oil companies derived from the sale, exchange or other disposition of oil, natural gas, or any primary product thereof from the domestic production deduction for purposes of Section 199. The Joint Committee on Taxation estimates that removal of the credit for major integrated oil and gas producers would bring in $9.433 billion in federal revenue over the next eleven years.[4]

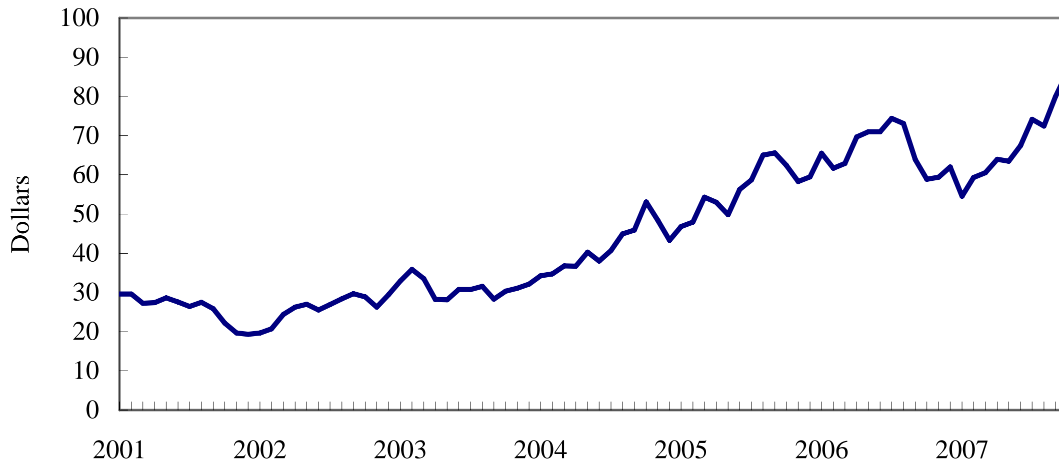
Why the removal of this income tax deduction won't cause a consumer price hike:

1. In the short run, an effective increase in the marginal corporate income tax rate for oil and gas producers would not affect output or price of either domestic crude oil or natural gas. In the short run, these producers will continue to produce where the marginal cost of extracting (or refining or transporting) the next unit of crude oil (or natural gas) is equal to the price of crude oil (or natural gas). While an increase in the marginal income tax will raise average costs of engaging in the activity, it will not affect the short-run marginal cost. In the short run, firms make production decisions based only on marginal costs.

2. In the long run, it is likely that the high prices of crude oil will send adequate signals to investors in the domestic oil and natural gas industries. Indeed, an oil executive testified recently that removing the recent tax breaks (including Section 199) given to his company would not affect his company.[5] The effect of eliminating this deduction for the domestic oil and gas industry will raise long-run average costs and generally decrease rates of return to investments in the oil and natural gas industry, all other things being equal. However, the price of crude oil has more than doubled since 2005, when this deduction took effect. See Figure 1 below for the West Texas Intermediate spot price of crude oil from January, 2001 to the present. In January, 2005, when this deduction took effect, the spot price in West Texas was $46.84/barrel. Currently, the posted price of West Texas Intermediate oil is $94.62.[6]

[3] Congressional Budget Office, "Corporate Income Tax Rates: International Comparisons," November 2005, available online here. Currently, the 6 percent credit reduces the corporate marginal tax rates to 32.9 percent.
[4] This tax provision is identical to the S199 tax provision in an earlier Senate Finance bill, The Energy Advancement and Investment Act of 2007. See Joint Committee on Taxation, "Estimated Revenue Effects of the Energy Advancement and Investment Act of 2007," June 18, 2007, available online here.
[5] See transcript of the Joint Hearing before the Committee on Commerce, Science, and Transportation and the Committee on Energy and Natural Resources, 109th Congress, November 9, 2005, available online here. In that hearing, the chairman and CEO of Exxon-Mobil testified that if Congress took back the billions of dollars in brand-new tax breaks, it would not affect Exxon-Mobil.
[6] In real terms, this reflects more than an 85 percent increase in less than 3 years.

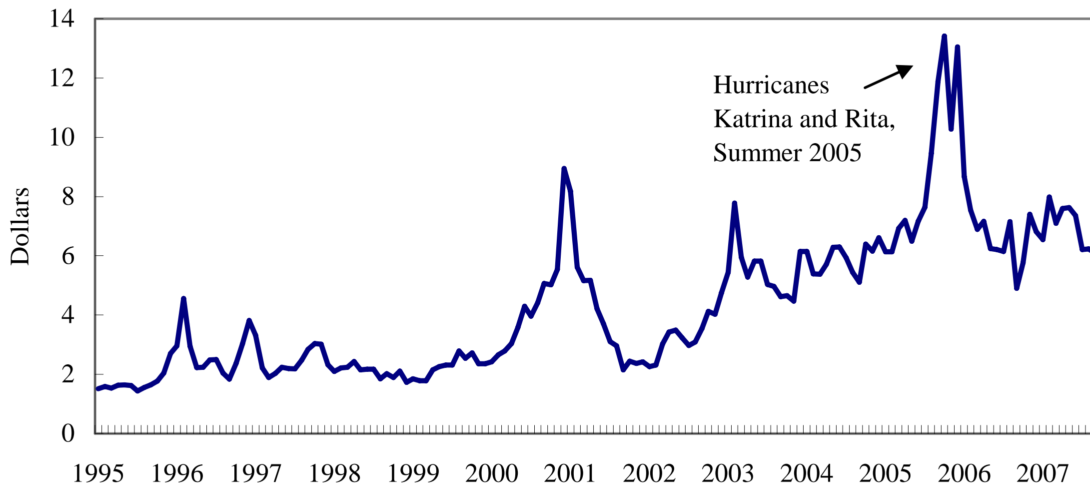
Figure 1: Spot Crude Oil Price: West Texas Intermediate
Dollars per Barrel



Source: Wall Street Journal
Note: Prices are in nominal (not inflation adjusted) dollars

3. While the price of natural gas has not risen as dramatically as crude oil in the last 3 years, the price of natural gas has increased substantially in the last decade from its low of $1.85 per million BTU in August, 1999 to its present level of $7.14 per million BTU in November, 2007. See Figure 2 below.

Figure 2: Spot Natural Gas Prices: Henry Hub, Louisiana
Dollars per Million BTU



Source: Wall Street Journal
Note: Prices are in nominal (not inflation adjusted) dollars.