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Fossil Fuel Subsidies: The Politics and Economics of Climate Change

Figure 1 Obama at the G-20 Summit. (image: dailyadvance.com)

When President Barack Obama spoke in front of the United Nations global warming summit and promised to "work with my colleagues at the G-20 to phase out fossil fuel subsidies so that we can better address our climate challenge," his proposal was alternately applauded and condemned. "It's a great idea," said Frank O'Donnell, the president of Clean Air Watch. "Wrong-headed," said Jack Gerard, president of the American Petroleum Institute.

Observers of the politics of climate change are not surprised by such starkly opposed points of view. The confluence of the UN Summit on Climate Change (September 22), the G-20 Pittsburgh Summit (September 24–25), and the United Nations Climate Change Conference in Copenhagen (December 7–18) has made

late 2009 a pivotal moment for the international community to shape environmental and energy policy, and both environmental groups and the fossil fuel industry have been preparing for it.

Global actors like the Organization for Economic Cooperation and Development (OECD), the United Nations Environment Program (UNEP), and the International Energy Agency (IEA) have all chosen to weigh in on climate change at this moment. It all builds to the Copenhagen conference in December, which now appears to be the precursor to an informal agreement on emissions reductions goals rather than a legally binding treaty.

While no mainstream voices bother to deny the powerful effect that greenhouse gas emissions have on climate change, the policy debates over the best means of reducing greenhouse gas are vigorous. Cap and trade has garnered the most attention out of the policy tools aimed at combating emissions, especially in the United States since the Waxman-Markey bill passed the House in June and the Senate debates its own cap and trade proposal. But the biggest incentive for emitters may not be the absence of a limit—it may be that the government subsidizes those emissions.

Big Oil Gets Subsidies?

The oil and gas industry seems an unlikely recipient of subsidies. It's a mature and established industry capable of immense profit—Exxon-Mobil enjoyed record profits in 2007, only to break their own record in 2008. Yet a September report by the Environmental Law Institute (ELI) shows that oil and gas do get subsidies, more than renewable energies get, and the largest subsidies took the form of tax breaks rather than direct subsidies.

The ELI's report has been widely cited—by the Associated Press, the Economist, and Bloomberg News, among others—in media commentary surrounding recent climate talks. Its analysis of subsidies in an advanced industrial nation complements data from the OECD that found ending fossil fuel subsidies in non-OECD countries—which the OECD calls "emerging economies and developing countries" and which subsidize fossil fuels more than OECD countries—could reduce global emissions by 10% in 2050.

According to the ELI, government subsidies to fossil fuel companies totaled $72 billion from 2002-2008. Over $18 billion took the form of grants and direct payments. The two largest programs to receive grants were LIHEAP and the Strategic Petroleum Reserve, each of which received more than $6 billion. LIHEAP stands for the Low Income Home Energy Assistance Program, a program

that distributes funds to states, which in turn distribute money to households in danger of having their heat turned off in the winter. The Strategic Petroleum Reserve provides the US with stores of oil to protect against shortages and skyrocketing prices in the case of a disruption of the global oil supply.

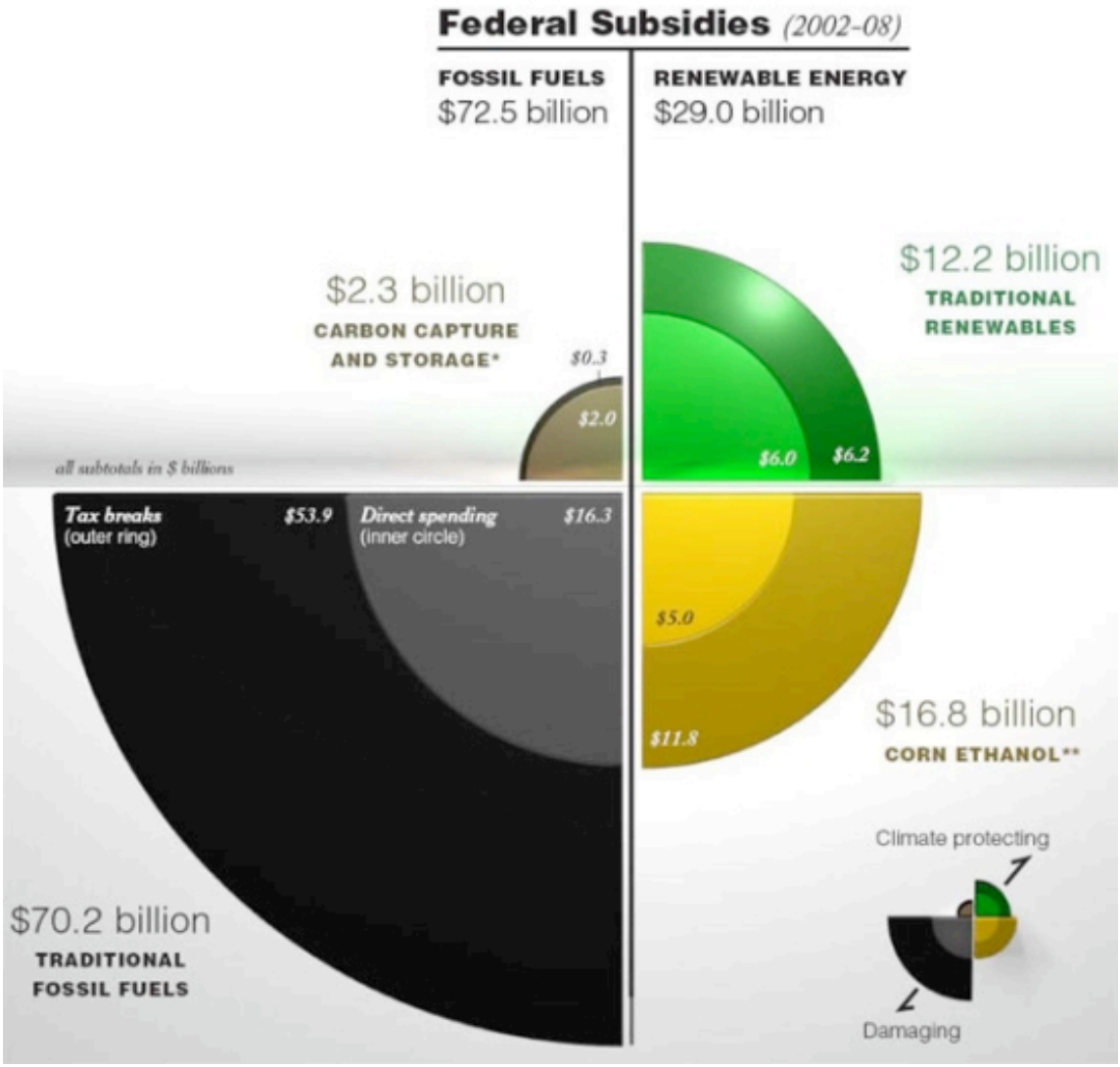

Figure 3 The ELI's graphical representation of energy subsidies, 2002-2008. (image: wilderness.org)

These programs have clear non-economic functions which may require a subsidy, but opponents of fossil fuel subsidies claim that mature and profitable industries like the fossil fuel industry do not need the protection afforded by the bulk of the subsidies analyzed by the ELI, the majority of which were indirect subsidies—tax breaks.

The foreign tax credit.

The foreign tax credit is, by the ELI's accounting, the single largest subsidy to oil and gas companies, coming to more than $15 billion from 2002-2008. The foreign tax credit dates back to 1918, and was created to avoid taxing US companies twice for the same income; any income taxed abroad would be credited at home. While the foreign tax credit is available to all US taxpayers, the particular application of this credit to the fossil fuel industry led ELI to classify it as a subsidy.

Income tax paid to foreign governments is meant to qualify for a tax credit, but oil and gas companies have another significant payment to make to the owner of the resource they're extracting—royalties. Royalties are paid to the resource owner—which in many cases in the Middle East is a national government—according to a percentage of revenues. These payments are eligible for a tax deduction, reducing the amount of income eligible for taxation, but not a tax credit, which reduces the tax bill by the amount paid in foreign taxes.

While this distinction is important to the oil or gas company and the US government, it matters little to a resource-owning foreign government whether it receives revenue as income tax or royalty payment. In the early Cold War period of the late 1940s and early 1950s, the US State Department embarked on a series of profit-sharing revisions between foreign powers and domestic oil companies. Venezuela, Saudi Arabia, and Kuwait wanted a more equitable share of the profits being reaped on their land by foreign companies, and the US was eager to keep these countries friendly to the West and to head off nationalization of oil companies, for economic but also geopolitical concerns. If an alienated Saudi Arabia turned to the Soviet Union, the US would lose money, strategic resources, and a strategic location. The stakes were very high; when Iran nationalized its oil industry it triggered a CIA-engineered coup in 1953.

The ingenious solution of re-categorizing royalty payments as income tax was developed by the Saudi government and received quick approval from the US State Department. The oil companies went along because it amounted to the same total tax payment—it just went to a different country now. Oil-producing countries continue to capitalize on this arrangement by taxing oil and gas income at a significantly higher rate than all other income. In Saudi Arabia, for example, the regular income tax rate is 20 percent, but for oil and gas it is 85 percent.

The foreign tax credit exemplifies the ELI's implicit argument that the fossil fuel industry profits from a web of little known and poorly understood indirect

subsidies. A policy crafted in the early Cold War for the exigencies of global battle with the Soviet Union—a policy that was, of course, ignorant of climate change and the impact of greenhouse gas emissions—still plays a significant role in the oil and gas industries and steers $15 billion dollars a year away from the US.

Industry Reactions

Though the ELI's subsidies report has become a touchstone in the debate, it has been pilloried by the head of the American Petroleum Institute, Jack Gerard. "This study is an irresponsible rendition based on a contorted recycling of government data that should never be used to craft national policy," he said at the time of its release. When President Obama proposed phasing out fossil fuel subsidies, relying on reports such as the ones published by the ELI, OECD, and IEA, the Independent Petroleum Association of America (IPAA) joined the API in condemning the idea.

President Obama's proposal, said Gerard, "should be seen for what it really is: A giant tax hike on American consumers". Barry Russell, the president and CEO of the IPAA followed suit by referring to the repeal of subsidies as "massive tax increases" and belittling the research behind the proposal as "academic notions that simply do not apply in the real world". To act on those academic notions, he warned, would be "a tragic miscalculation."

What accounts for such dismissal of ideas supported by a variety of international organizations? It's not denial of the consensus of climate scientists; neither the API nor the IPAA refutes the role of greenhouse gases in man-made global warming. Rather, they stress the very particular and pivotal role that fossil fuels play in the US economy, and lament how misunderstood this role is by environmentalists and other supporters of eliminating subsidies—for them, the geopolitical necessities of the early Cold War that led to subsidies through the foreign tax credit haven't changed much. In fitting tribute to their industry, Gerard and Russell rely on automotive metaphors to illustrate their claims. For Gerard, oil and natural gas constitute "one of our nation's vital economic engines"; for Russell, the fossil fuel industry "drives the U.S. economy."

Additionally, the oil and gas industries face unique challenges. Discovering and developing new oil and gas sources requires significant investments. As discoveries become more difficult, and the technology needed to extract oil and gas gets more sophisticated, oil and gas production gets even more expensive.

To sustain production, oil executives might say, the fossil fuel industry needs more government help than ever.

Beyond their antipathy to intellectual analyses of their industry, the API and the IPAA object to the priorities that an end to subsidies implies. The focus of the API and IPAA is the immediate economic impact of such a plan, which could raise costs throughout the economy while adding pressure to an industry that employs millions. The environment does not play as meaningful a role in their thinking; neither do forecasts that look decades into the future. It's no wonder they sound so perplexed by policy designed to address climate change; they see environmental policy through an economic lens.

Outlook: Copenhagen and Beyond

This is not the first time that fossil fuel subsidies have come under scrutiny. A 2005 article in the Washington Post criticized that year's Energy Policy Act for including $85 million in subsidies for fossil fuel and renewable energies. A paper in the Annual Review of Energy and the Environment in 2001 was critical of fossil fuel subsidies, especially indirect subsidies that lack transparency and allow for government to act in ways that are inconsistent with broader government policy.

The G-20 summit appeared to be a launching pad to draft a concrete proposal in time for Copenhagen. Yet while the G-20 agreed to phase out fossil fuel subsidies at the Pittsburgh Summit, the timeline was vaguely set for "the medium term," to the disappointment of environmentalists who have high hopes for Copenhagen.

Fossil fuel subsidies are not facing their imminent demise, but momentum is mounting to eliminate them. For the G-20—usually splintered on environmental issues according to the fault line between "developed" and "developing" nations—to agree to phase out subsidies points to an emerging consensus. How this agreement will be translated into action remains unclear.

Fossil fuel companies see the possibilities of green energy as well as anyone. Oil companies are some of the largest investors in green technology. Whether it's Valero's windmills or Chevron's solar power, oil companies are preparing for an economy that doesn't put oil and gas in the driver's seat.

Overlaid on the policy debate is political gamesmanship. Republican opposition to climate legislation is amplified by partisan desire to prevent President Obama from securing a political victory. President Obama, on the other hand,

has asked the EPA to begin regulating and further restricting emissions from fossil fuel producers; this could be a move to either sidestep legislation or provide an incentive to Republicans to make some concessions on legislation rather than hand over decision-making to the EPA. Some in Congress have responded by opposing EPA funding, and these political tactics move the conversation further away from questions of climate change, how subsidies might contribute to climate change, and the economic cost of reducing greenhouse gas emissions.

Debate over climate science has moved to the fringe. Though the occasional energy executive (Don Blankenship, CEO of Massey Energy) or politician (Senator James Inhofe) denies the reality or seriousness of global warming, the voices of global warming skeptics are not a part of the current debate.

Instead, the central question has been whether or not we can afford the amount and pace of change that is proposed. The forecasts by the OECD look toward 2050; the API and the IPAA are talking about what could happen right now. How urgent is the need for change? Are the sacrifices being asked for—changes in lifestyle, redistributing employment and resources across industries, price fluctuations that affect every industry, car owner, and home heating oil user—worth the payoff of mitigating the effects of climate change?

It's telling that the climate bills in the US House of Representatives—passed this summer—and the US Senate—recently sponsored by Senators John Kerry and Barbara Boxer—omit the words "climate change" and "global warming." Instead, the American Clean Energy and Security Act (in the House) and the Clean Energy Jobs and American Power Act (in the Senate) keep the focus on jobs and national security. The science is in, but the potential catastrophe of climate change has been elbowed out of the conversation. During this recession, the climate change debate is about the economy.

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