



Gross Profits: Why Pennsylvania Should Enact the Oil Company Profits Tax

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Gross Profits: Why Pennsylvania Should Enact the Oil Company Profits Tax

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Introduction

Governor Rendell has proposed a new Oil Company Gross Profits Tax (OCGPT), which is projected to raise \$722 million in Fiscal Year 07-08 and a net \$760 million in a full year. The revenue from the tax would be allocated to mass transit through the creation of an Oil Company Gross Profits Tax Fund.

Pennsylvania is one of four states looking to capture some of the excess profits enjoyed by the nation's major oil companies. It is no wonder. In 2006, Exxon Mobil made \$39.5 billion in profit on \$365 billion in revenue. In contrast, Wal-Mart, the nation's number two company, earned \$11.3 billion, just one-third of Exxon's profits, on revenues of \$345 billion.¹ As citizens have struggled to pay the rising cost of gasoline in the past five years, the profits of major oil companies increased by 344%. The strong world demand for oil, coupled with increased concentration and reduced competition in the industry, will likely result in high oil company profit levels for the foreseeable future.

Even when oil companies have record profits, however, Pennsylvania's porous corporate tax system currently makes it possible for large corporations, like Exxon Mobil, Chevron, and ConocoPhillips, to shelter billions of dollars of income from taxation. Using transfer pricing and other "paper profit" minimizing techniques, oil companies have the ability to shift profits to low-tax states and nations, reducing their Pennsylvania tax liability.

The proposed OCGPT would close tax loopholes that now allow oil companies to lower their Pennsylvania taxes. It would also raise in tax revenues an amount more proportional to (a) the benefits that oil companies enjoy from public investment in roads and bridges and (b) the damage use of their product does to the environment.

The public transit programs the OCGPT would help pay for are vital to Pennsylvania's competitiveness and quality of life (Box 1). Pennsylvanians take 300 million trips each year by mass transit. These trips reduce road congestion and travel time for all commuters. Investment in transit is also vital to the state's economy, moving goods as well as people, and providing mobility that economic developers say is essential to attract business investment.

Moreover, public transit is critical to the nation's and the state's ability to reduce greenhouse gases that contribute to global warming and to reduce reliance on foreign oil.

A myriad of federal, state, and local funding streams currently help cover the cost of public transit, augmenting local fares. While no public transit system in Pennsylvania is self-sufficient, fares cover more of mass transit operating costs here than in most states, approximately 50%, compared to the national average of roughly 30%.² Even so, Pennsylvania local transit systems struggle to keep up with demand for services in the face of rising costs.

Without additional state funding, public transit systems will have to reduce service, increase fares, or both. Such cuts will lead to decreased ridership and more cars on the road. Anyone who has driven on the Schuylkill Expressway or the Squirrel Hill Tunnel can tell you that there is not room on our highway system to accommodate increased traffic. Without more investment in public transit, many workers will not have reliable transportation to the growing number of health care, service and retail jobs in exurbs around Pennsylvania's large and small metropolitan areas.

A consensus now exists that a dedicated funding stream must be established to allow broader investments in public transportation and to better leverage available federal funds. The question is what the dedicated source should be.

This paper examines one funding option, the proposed tax Oil Company Gross Profits Tax and some major criticisms of the tax. The paper finds that, based on widely accepted tax principles, the Oil Company Gross Profits Tax is a viable approach to raising revenue for mass transit:

- It would help the Commonwealth achieve revenues adequate to invest in public transit systems in economically vibrant urban-suburban corridors and in rural communities with aging populations.

Box 1. Pennsylvania Public Transit

Public transit is not merely an issue for the Philadelphia and Pittsburgh areas, although they have the most extensive systems. Pennsylvania has over 70 transit authorities providing service to every county in the Commonwealth. For many seniors, disabled people, students, and low-income individuals, public transit provides the only means to get to work, shopping, or a doctor's office. More than one-third of all trips on rural transit systems are for medical appointments.¹

A typical example of a smaller transit system is the Indiana County Transit Authority (also known as IndiGO). IndiGO's 20-vehicle fleet provides fixed route bus service, shared ride services, and even regularly scheduled trips to Pittsburgh. Fares make up 23% of the system's \$1.25 million operating budget. IndiGO provided approximately 225,000 rides in 2006.²

By slashing commuting times and through reduced environmental damage, public transit delivers benefits that far exceed the current public investment. According to the longest running independent analysis of traffic in 75 US metropolitan areas, transit services in the Philadelphia area saved drivers more than 31,000 hours in travel time in 2001. Without transit, traffic delays would have increased by about one-third, costing residents \$614 million in lost time and fuel.³

According to the Pennsylvania Public Transit Association:

Public transit produces 95% less carbon monoxide, more than 92% fewer volatile organic compounds and nearly half as much carbon dioxide and nitrogen oxides than the auto for every passenger mile traveled. It also reduces annual emissions of pollutants that create smog—volatile organic compounds and nitrogen oxides—by more than 70,000 tons and 27,000 tons respectively. Public transportation uses about one-half the fuel of private autos, SUV's and light trucks.³

¹ Pennsylvania Economy League, *Transportation Infrastructure: The Impact of Public Transit*, October 2006 at <http://www.issuespa.net/articles/17909/>.

² Information taken from IndiGO's website, <<http://www.indigobus.com>>, and from Pennsylvania Department of Transportation, Bureau of Public Transportation, *Pennsylvania Public Transportation Systems and Services At a Glance Fiscal Year 2005-2006*.

³ David Schrank and Tim Lomax, *2003 Annual Urban Mobility Report*, Texas Transportation Institute, The Texas A&M University System, September 2003 <http://tti.tamu.edu/documents/ums/mobility_report_2003.pdf>, as cited in Pennsylvania Public Transportation Association, *History of Mass Transit Funding in Pennsylvania*, Feb. 23, 2004.

- It would be paid by oil companies that benefit directly from state investments in roads, bridges, and other transit infrastructure.
- It would somewhat moderate the unfairness of Pennsylvania's highly regressive tax system because a substantial part of the OCGPT would fall on shareholders who have high incomes. (Most of these shareholders are also out-of-state).
- It would reduce the environmental damage (or "negative externalities") from oil use by maintaining public transit as a viable alternative to driving.

The oil companies can spend millions, and they might, to try to stop this tax. But in today's reform-minded political climate, more than ever, Pennsylvania citizens look to their lawmakers to craft legislation based on what is in the public good, not what serves private gain. On that basis, the Oil Company Gross Profits Tax should be implemented.

Can Oil Companies Afford a New Tax on Profits?

Oil companies, like any other business, operate to earn a profit. In the past few years, these companies have been exceedingly profitable. Exxon Mobil, the world's largest publicly traded oil company, earned \$39.5 billion worldwide in 2006 on sales of \$365 billion.³ Thirty-one percent of Exxon Mobil's sales are in the United States. Assigning this share of the company's global profit to the United States, Exxon Mobil made \$40.71 from each person in the United States in 2006.⁴

Other major oil companies are also reaping record profits. The global net income of the eight major oil companies listed in Table 1 has increased 344% since 2002 and almost 50% since 2004. Figure 1 shows the trends for the five largest oil companies operating in the US in 2006.

Company	Net Income, in millions of dollars					Increase in Profits		Increase in Profits	
						from 2002 to 2006		from 2004 to 2006	
	2002	2003	2004	2005	2006	\$ millions	percent	\$ millions	percent
Exxon Mobil	11,460	21,510	25,330	36,130	39,500	28,040	245%	14,170	56%
Chevron	1,189	7,506	13,328	14,099	17,138	15,949	1341%	3,810	29%
ConocoPhillips	(295)	4,735	8,129	13,529	15,550	15,845	NA	7,421	91%
Royal Dutch Shell	9,577	12,606	19,257	26,261	26,311	16,734	175%	7,054	37%
BP	6,872	12,618	17,262	22,632	22,286	15,414	224%	5,024	29%
Hess	(218)	467	977	1,242	1,916	2,134	NA	939	96%
Marathon	516	1,321	1,261	3,032	5,234	4,718	914%	3,973	315%
Sunoco	(47)	312	605	974	979	1,026	NA	374	62%
Total	29,054	61,075	86,149	117,899	128,914	99,860	344%	42,765	50%

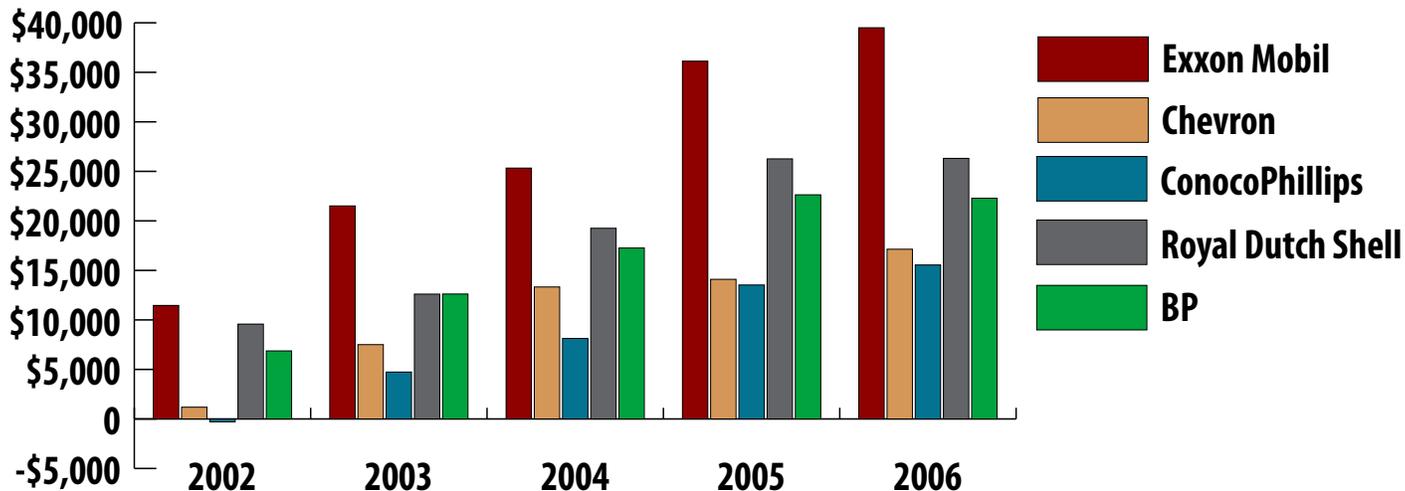
Source. John Burbank, *Regulating the Oil Industry and Coralling Oil Industry Profits* (Seattle, Washington: Institute, February 2006) and company annual reports.

While 2002 was a low-profit year, exponential growth in oil company profits is not just a result of the business cycle or the rebound from the 2001 recession (Figure 1). Over the past nine years, starting in the middle of the long 1990s economic expansion, oil company profits have increased an average of 13% per year.⁵ Over this period, as Figure 2 shows, major US oil company profits and increasing gasoline prices have gone hand in hand.⁶ As consumers have paid more, oil companies have earned more.

The American Petroleum Institute has argued that the industry's profits are no big deal, and rejects the notion that the industry is earning windfall profits. The industry argues that its profits are comparable to returns in other sectors.⁷

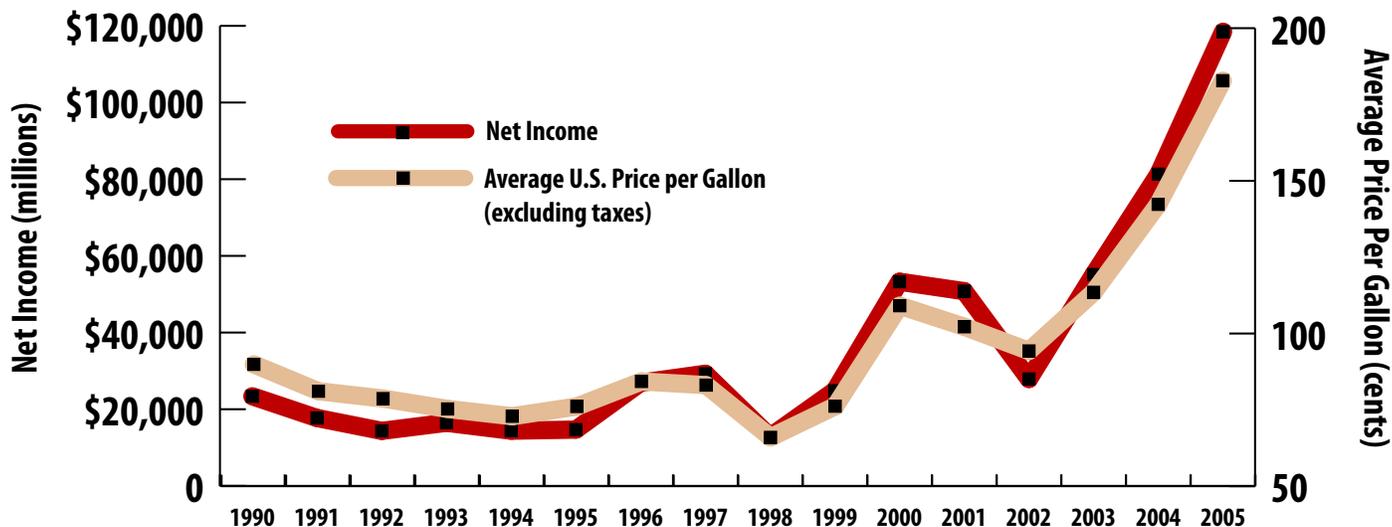
John Burbank of the Economic Opportunity Institute, however, demonstrates that major oil company profits are out of line with average corporate profit rates in the US.⁸ For example, Exxon's profits as a percent of stockholders' equity were 25% in 2004, while Chevron's were almost 30%. In contrast, Microsoft's profits were less than 11% of stockholders' equity, while Boeing's profits were 4% of stockholders' equity.

Figure 1. Top 5 Oil Company Profit Growth, 2002-2006



Source. John Burbank, *Regulating the Oil Industry and Coralling Oil Industry Profits* (Seattle, Washington: Institute, February 2006) and company annual reports.

Figure 2. Comparison of Major US Oil Company Net Income and the Average Price of Gasoline per Gallon, 1990-2005



Source. US Energy Information Administration

In testimony before the US Senate Judiciary Committee, Professor Severin Borenstein, the Director of the University of California Energy Institute, noted that, “Spokespeople for the oil industry often compare their profits as a share of sales to other industries, but cross-industry comparisons of ‘return on sales’ are meaningless. . . This is purely a public relations attempt to downplay the extremely high profits they have made because they were producing oil when the price of oil jumped.”⁹

Oil Companies Claim They Pay Enough in Taxes. Do They?

Despite making record profits, the oil industry claims it pays enough in federal and state taxes. According to the American Petroleum Institute, major oil companies paid \$46 billion in federal and state income taxes from 2000-2006.¹⁰

The available data, however, suggest that the oil companies are not paying an equitable amount in Pennsylvania under the current Corporate Net Income Tax (CNIT).

One way to estimate what the oil companies “should” pay is to look at the combined profit in 2006 of the three largest US-based oil companies (Exxon Mobil, ConocoPhillips, and Chevron). According to company 10K reports, the profits attributed to the US of these companies equaled \$29 billion in 2006.¹¹ Under reasonable assumptions for the share of these companies’ sales, employment, and property in Pennsylvania, these companies should be paying \$63-\$104 million in tax.¹² If we assume that these three companies account for somewhere between 60% and two-thirds of all oil company profits earned in Pennsylvania (Table 1 indicates that globally they represent only about half the industry), the oil industry as a whole should be paying \$94 to \$174 million. According to the Pennsylvania Department of Revenue, however current CNIT collections from *all* oil companies total approximately \$70 million.¹³

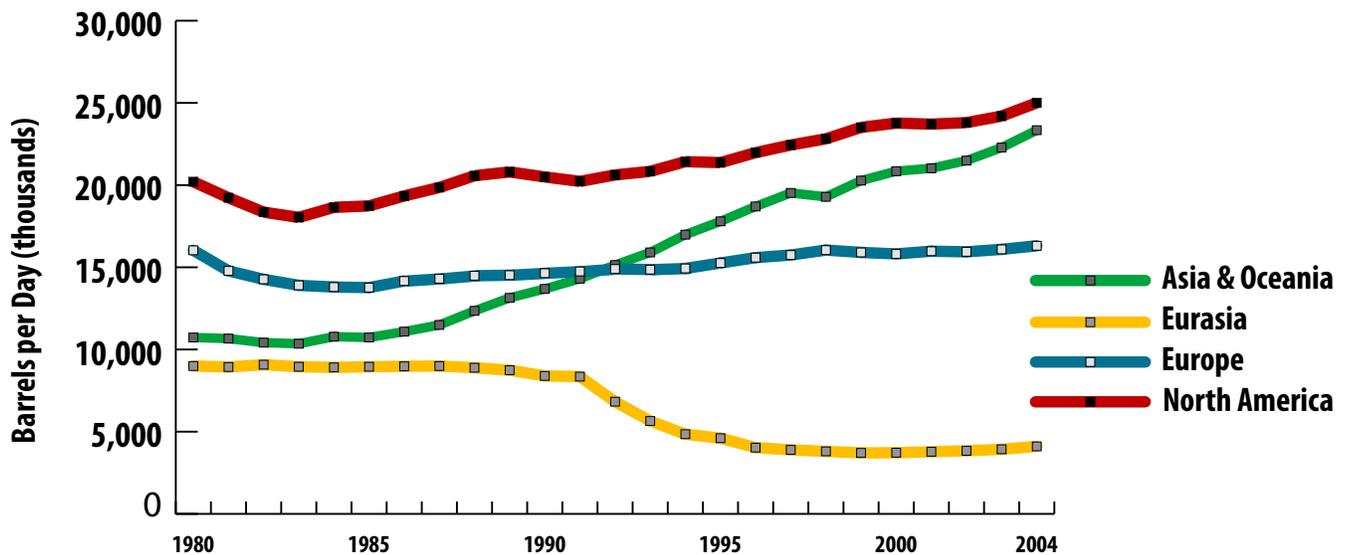
This calculation suggests that oil companies are paying an effective tax rate that is well below the statutory 9.99%, somewhere in the range of 4% to 7.4%. In sum, oil companies, similar to other large companies, successfully practice tax avoidance (or what they euphemistically call “tax planning”) to sharply reduce what they pay in CNI taxes in a high-tax state such as Pennsylvania.¹⁴ One of the tax avoidance techniques especially well suited to the oil industry is the manipulation of transfer pricing. If Pennsylvania oil refineries and distributors are charged more (than the true market price) for their oil by related companies, this will drive down reported profit in Pennsylvania and hence drive down CNI tax payments.

Rising Demand and Industry Consolidation, a Recipe for Profits

The recent rapid increase in oil company profits coincides with two circumstances: increased worldwide demand for oil and the consolidation of the petroleum industry into fewer, larger companies. While demand has risen, supplies have not kept pace, causing the price of oil to increase.

Demand for oil products worldwide increased on average 1.1% per year since 1980, led by a doubling of Asian demand and a 360% increase in Chinese consumption (Figure 3).

With demand rising, a wave of mergers and acquisitions has led to the industry’s consolidation. British Petroleum (BP) acquired Amoco in 1998 and ARCO in 2000. Exxon and Mobil merged in 1999 to create, at

Figure 3. Demand for Oil, Selected Regions, 1980-2004

Source: Energy Information Administration, *International Energy Annual 2004*.

the time, the world's third-largest company. Conoco and Phillips merged in 2002 and purchased Burlington Resources in 2006. Chevron acquired Texaco in 2001 and Unocal in 2005.¹⁵

In the United States, according to the US Energy Information Administration, from 1998 to 2006, the number of major US refiners decreased from 33 to 17.¹⁶

The major companies that now dominate the oil market are vertically integrated. They control a number of links in the value-added chain, in some cases taking the product all the way from exploration to pumping, refining, distribution, and even retail sale.

Vertical integration gives oil companies a great deal of flexibility to shift reported profits to the subsidiaries and places that will be taxed the least. Oil companies are able to do this using “transfer prices” different points in the value-added chain. For example, if distribution and retail operations fall in a country or state with high corporate net income taxes, those operations may be charged more by the refinery so that few or no book profits appear in the high-tax country or state.

Supply Constraints

Concentration and vertical integration also mean that a small number of companies control the US supply of oil products through their ownership of existing refining capacity, decisions to invest in new refining and storage facilities, and through scheduled maintenance that temporarily shuts down existing refineries.¹⁷

Refineries process oil into useful petroleum products. Building refineries is extremely expensive, so much so that no new refineries have been built in the US in 25 years. Oil companies have increased the fuel supply by improving the efficiency of existing refineries and purchasing refined fuels from other regions, notably Europe, which has seen a decrease in demand.¹⁸

Box 2. Other States Consider Oil Profits Taxes

Several other state governments are looking to recoup more of oil company record profits. States plan to use the funds to spur investment in alternative energy sources or aid highway construction.

As part of his 2007-2009 budget plan, Governor Jim Doyle proposes to add a tax of 2.5% on gasoline bought or sold in Wisconsin. The tax is prohibited from being passed on to consumers in the form of higher gas prices.¹ The tax is projected to provide \$270 million over two years for highway construction.

In 2006, California Proposition 87 proposed to levy for the first time a severance tax on oil production and use this money to fund alternative energy research.² A severance tax is a tax imposed by a state on the extraction of natural resources, such as oil, coal, or gas. The proposition was defeated 55% to 45%, with oil companies contributing \$71 million of the \$95 million raised to defeat the measure.

In Maryland, Senate Bill 590 of 2006 sought to impose a 50% tax on “windfall profits” to fund an energy-savings investment program.

In February 2007, House Bill 1510 was introduced in the state of Washington to create a “windfall profits tax” on oil companies. The tax is proposed to be levied on parent companies, rather than oil distributors and is projected to generate at least \$600 million for a variety of uses, including mass transit, alternative energy, and to reduce the business tax rate.³

The federal government is also considering action to reduce oil company profits.⁴ In the past, federal tax credits and other subsidies boosted oil company after-tax profits through incentives for exploration, production, and refining of oil to reduce dependence on foreign oil.

¹ Jason Stein, “Doyle’s Oil Tax Plan Difficult to Enforce,” *Wisconsin State Journal*, Feb. 17, 2007 <<http://www.madison.com/toolbox/index.php?action=printme2&ref=wsj&storyURL=%2Fwsj%2Fhome%2Flocal%2Findex.php%3Fntid%3D119503>>.

² Timothy Leslie, “Californians Reject Oil Tax, But Observers Think the Issue Will Resurface,” UC Berkley Graduate School of Journalism, Election 2006, Nov. 8, 2006. <http://journalism.berkeley.edu/projects/election2006/2006/11/californians_reject_oil_tax_bu.php>.

³ Washington State House of Representatives, “State News Release: New Bill Would Pump Oil Windfall Profits Back Into the Community,” Feb. 7, 2007 <http://access.wa.gov/leg/2007/Feb/n200717_3219.aspx>.

⁴ In January 2007, the Clean Energy Act of 2007 (H.R. 6) has passed the US House of Representatives and has been placed in the Senate calendar. The Congressional Research Service (CRS) describes the bill as seeking to “reduce certain oil and natural gas tax subsidies to create a revenue stream to support energy efficiency and renewable energy.” Congressional Research Service, *The Strategic Energy Efficiency and Renewables Reserve Fund in the CLEAN Energy Act of 2007 (H.R. 6)*, (Washington D.C.: Jan. 17, 2007 <http://openncrs.cdt.org/rpts/RS22571_20070117.pdf>). In response to the passage of the House bill, US Energy Secretary Samuel W. Bodman said: “We support the bill’s effort to repeal some of the unnecessary oil and gas incentives from the Energy Policy Act of 2005 (EPAAct). In addition, we would ask that Members consider repealing other unneeded incentives contained in EPAAct, such as federal funding for oil and gas research and development.” Jan. 18, 2007 <<http://www.energy.gov/news/4616.htm>>.

Even with improvements in refinery efficiency and imports of more refined products from Europe, refinery capacity has been stretched to meet expanding demand. As this has occurred, oil company refineries have become significantly more profitable. In 1999, refiners made 18.9 cents for every gallon refined from crude oil. By 2005, this profit margin had jumped to 48.8 cents.¹⁹

If profit is so high, per gallon, what stops oil companies from increasing the supply by increasing US refining capacity or purchasing additional refined product? Some speculate that oil companies fear flooding the US market, which would cause gas prices, and company profits, to drop.

Is this lack of supply a natural market condition? It is difficult to say. *San Francisco Chronicle* reporter David Baker quotes economist and oil industry expert Severin Borenstein:

“It comes down to this: There’s a scarcity, and the question is whether it’s a real scarcity or if it’s being constructed,” said Severin Borenstein, director of the University of California Energy Institute. Figuring out the answer is practically impossible, he said. All the maintenance delays and production problems could be real. Or refineries could be doing little things, bit by bit, to limit California’s gasoline supply, he said. “If somebody told them, ‘Use your market power,’ this is how they’d do it,” Borenstein said.²⁰

A March 2001 US Federal Trade Commission investigation into Midwest gasoline prices found evidence of anti-competitive practices in the industry:

An executive of [one] company made clear that he would rather sell less gasoline and earn a higher margin on each gallon sold than sell more gasoline and earn a lower margin. Another employee of this firm raised concerns about oversupplying the market and thereby reducing the high market prices. A decision to limit supply does not violate the antitrust laws, absent some agreement among firms. Firms that withheld or delayed shipping additional supply in the face of a price spike did not violate the antitrust laws. In each instance, the firms chose strategies they thought would maximize their profits.²¹

Pennsylvania’s Oil Company Gross Profits Tax Proposal

What Is the Tax?

The Oil Company Gross Profits Tax (OCGPT) is being pursued by the Administration as the preferred method to fund mass transit improvements. The Department of Revenue describes the tax as follows:

The OCGPT is to be a new tax on the gross profits of oil companies, on a combined reporting basis. Gross profits would be defined as the total sales of the oil company minus the costs of goods sold. Oil companies subject to the OCGPT would be exempt from the corporate net income tax (CNIT). The tax rate is proposed to be 6.17%.²²

Who Pays It?

Oil companies, under this proposal, are “entities that perform exploration, drilling, importation, refining or wholesale distribution of petroleum products. Petroleum products are any products that contain or are made from petroleum or a petroleum derivative.”²³ This definition of oil companies would exclude retail fuel sellers. What does this mean? Producers, pipelines, refiners, and distributors would be subject to the tax, not home heating oil or retail gas stations.

According to the US Energy Information Administration, Pennsylvania has five major refineries, two major distribution centers, and six major petroleum product pipelines.²⁴ These would be subject to the new tax, as well as companies owning the 16,000 oil wells in Pennsylvania. Wholesale distributors would also be subject to the tax. In total, the Pennsylvania Department of Revenue projects the tax will be paid by approximately 270 companies.²⁵

How Does the Tax Work?

The tax is to be levied on gross profits, which is what remains after subtracting cost of goods sold from sales. Taxing this, rather than net income, provides for a more stable funding base as companies are more likely to have positive gross profits throughout the business cycle rather than net taxable income. Gross profits are not affected by special federal credits, deductions, and other tax breaks afforded to oil companies at the federal level.

Oil companies are to be taxed on a combined reporting basis. Combined reporting is not a new concept in Pennsylvania, having been proposed as recently as the 2005-06 Executive Budget.²⁶ Combined reporting, in this case, requires that all related oil companies doing business in Pennsylvania merge their financial information as if they were one company and file a tax return based on the merged results.

Currently, under Pennsylvania's separate company reporting system, each of the subsidiaries of an oil company files separate returns in Pennsylvania, as if they were unrelated. Since these companies buy and sell goods and services from and to each other, they charge each other "transfer prices" for these transactions. By increasing costs or lowering selling prices for subsidiaries subject to Pennsylvania tax, the companies can effectively move profits outside of Pennsylvania, reducing their tax.

Combined reporting eliminates these inter-company transactions and provides a more accurate view of the activity that the company as a whole conducts in Pennsylvania. The proposal uses model language developed by the Multistate Tax Commission to define the scope of these combined groups.²⁷

The Oil Company Gross Profits Tax would only be levied on entities within a unitary group that meet the "oil company" definition.²⁸ By structuring the tax in this manner, a new "class" of taxpayer is created, making the proposal consistent with the uniformity clause of the Pennsylvania constitution. (This clause requires that taxes be uniform on any "class" of taxpayer.)

Once the oil companies in a unitary group are combined to determine their collective gross profit, a tax of 6.17% is to be levied on their gross profit apportioned to Pennsylvania. Apportionment is a way of measuring how much of a total company's activity occurs in Pennsylvania, thus is subject to tax. This proposal uses sales in Pennsylvania compared to total sales to make this determination.

Oil companies are prohibited from passing this tax onto consumers in any form.

Box 3. How Is Gross Profit Different from Taxable Income?

Gross profit measures the core activity of a business, the difference between sales and the direct cost of those sales. In this case, the sales are the sales of petroleum products. The direct cost of those sales include the cost of the unrefined input and any costs (labor, energy, supplies, depreciation on production machinery) directly incurred in the processing of the product sold. Taxable income is a measure of the difference between all types of income (including sales, interest and dividend income, rents, royalties, and capital gains) net of expenses (including cost of goods sold, indirect salaries and benefits, taxes, interest expense, advertising, depletion, and depreciation). Using gross profit as a basis of the tax helps ensure that only the oil-related activity funds the tax, not financial services and costs or other transactions not directly related to oil purchase, processing, and sales.

Does the Oil Profits Tax Represent “Good” Tax Policy?

In 2003, the Pennsylvania 21st Century Tax Policy (or “PA21”) Project, a collaboration between Pennsylvania business and labor groups, examined and recommended changes to Pennsylvania’s tax structure. To help determine its recommendations, the PA21 project developed “tax principles” describing objectives that a “good” tax, and a good tax system, should meet.

How does the OCGPT by itself, and the Pennsylvania tax system as a whole with the addition of the OCGPT, fare against the most important PA21 tax principles?²⁹

The first PA21 tax objective is *the Benefit Principle*. This principle holds that taxes should be distributed in line with the value of public goods and services received by taxpayers. Taxpayers that benefit more from public goods and services should pay more in taxes. Clearly, oil companies will not directly benefit from their increased tax payments due to the OCGPT. However, looking broadly at Pennsylvania public investments, spending on roads create demand for oil that enables the oil companies to earn high profits in Pennsylvania. Because oil companies benefit so directly from public investments in transportation systems, enacting the OCGPT to increase oil company contributions to state revenues is consistent with the benefit principle.

A second PA21 tax objective is *vertical equity*, more commonly known as tax progressivity. This principle requires that tax rates rise with ability to pay. Pennsylvania’s starting point before consideration of the OCGPT is a state and local system that violates the vertical equity principle badly. Overall, while the poorest fifth of Pennsylvania taxpayers pays 11.4% of its income in state and local taxes, the most affluent 1% of taxpayers pays 4.8% of its income in taxes (or 3.5% if you take account of the reduction in federal taxes that high-income taxpayers receive because of the state and local taxes they pay).³⁰ In this context, the OCGPT tax, because it would be paid in part by shareholders who tend to be high income, could slightly offset the overall regressivity of the Pennsylvania tax system.

A third tax objective highlighted by PA21 is *long-run revenue sufficiency*, i.e., the state should collect enough revenue to meet its long term needs. Currently, Pennsylvania does not meet this long-run revenue sufficiency objective because its projected revenues fall short of projected needs. The lack of adequate funding for transportation in general, and the lack of a dedicated source of funding for public transit in particular, are just two of the indicators of the state’s failure to meet the long-run revenue sufficiency objective. The OGCPT would help redress the state’s shortfall of revenues for mass transit and thus help improve the state’s tax system evaluated against the long-run revenue sufficiency objective.

A fourth tax objective is *revenue stability over the economic cycle*. While the OGCPT may vary to some extent in times of oil boom and bust, as discussed earlier, it will be much more stable than a net income tax on oil companies.

A fifth tax objective is *exportability*, which means that taxes should be shifted, if possible, to taxpayers from out of state. To the extent that the OGCPT is paid by shareholders, most of whom are out of state, it would be highly exportable.

Another PA21 tax principle relates to the impact of a tax on a state’s *competitiveness* and on the creation of jobs and investment in Pennsylvania. Taxes can impact competitiveness in two ways. Some argue that

increasing or lowering Pennsylvania tax rates lowers or increases business investment in the state, although the literature on this suggests that the link between state and local taxes and location or expansion decisions is weak.³¹ Pennsylvania taxes can also impact competitiveness by raising the funds necessary to invest in infrastructure, education, and other services which improve business efficiency and profitability. With regard to the first impact on competitiveness, there is likely little impact from the OCGPT. Oil wells, pipelines and refineries are fixed and immovable assets, not subject to relocation as a more mobile asset. With regard to the second, the tax would enhance competitiveness by giving the Commonwealth more resources to invest in its transportation infrastructure.

Another widely accepted economic policy objective, although not one on the PA21 list of tax principles, is that markets should not generate costs (or benefits) for third parties that are not factored into consideration when consumers make purchasing decisions. Such costs or benefits are called “externalities.” Related to the oil market, the most obvious costs (negative externalities) are the global warming gases that result from the burning of oil. The OGCPT would reduce these negative externalities in two ways. First, improved mass transit systems made possible with the revenue from the tax will help lower automobile use and gasoline emissions. Second, in the event that some small portion of the tax is passed onto consumers, the price will better reflect some of the environmental cost from oil and gasoline use. This higher price will help stimulate energy-saving consumer behavior, such as the purchase of more fuel-efficient vehicles.

Criticism of the Proposed Tax

During the preliminary debate regarding this tax, a number of criticisms of the tax have been raised. Opponents have stated that the tax is unconstitutional, will harm investment in Pennsylvania, and will be passed along in total to Pennsylvania customers in the form of higher gasoline prices to dissuade lawmakers and their constituents from supporting the OCGPT.³² A full examination suggests that many of the arguments against the gross oil profits tax have been grossly misrepresented.

Is the Tax Unconstitutional or Unfair?

Some question whether a tax on one industry, like oil companies, would be constitutional in Pennsylvania. The Uniformity Clause of the Pennsylvania Constitutions states, “All taxes should be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and should be levied and collected under general laws.”³³

With this in mind, how can a tax such as the OCGPT be uniform? The key is in the phrase “upon the same class of subjects.” If oil companies are defined in a way that allows them to be a separate class, they can be taxed in any manner that the state chooses. Several industries are deemed their own class of taxpayer and are subject to a different tax than the Corporate Net Income Tax. Insurance companies, banks, and mutual thrifts each pay a unique tax in Pennsylvania.³⁴ There is no evidence that oil companies would be denied by the courts as a separate class.

Singling out a specific industry, as has been done with the OCGPT, has been claimed by the oil industry to be unfair. Yet, as noted above the oil industry is *different* than other industries because it relies more than any other industry on public investment in the transportation system to create demand for its product. To

this point, oil company investment in the transportation system has been marginal. (Gas taxes contribute more significantly to the transportation system but these are borne almost entirely by consumers and do not constitute contributions from oil companies.) The OCGPT provides an avenue for oil companies to contribute more equitably to the transit system on which it depends.

Will the Tax Be Passed Along to Consumers in the Form of Higher Gasoline Prices?

Others question if the tax can be legally prohibited from being passed on to consumers. There are several court decisions that indicate that state governments can limit the passing through of tax burdens to customers and others that identify the legal basis for such a prohibition.

In the case *P.R. Consumer Affairs Dept. v. Isla Petroleum*, 485 US 495 (1988), the US Supreme Court held that an excise tax imposed by Puerto Rico on oil refiners, including a provision prohibiting wholesalers from passing the tax on to retailers, was permissible.³⁵

California Proposition 87 of 2006, too, contained language prohibiting the pass-through of a proposed severance tax to consumers. The Capital Center for Government Law and Policy of the University of the Pacific reviewed the proposal and said that, although the pass-through prohibition may be challenged, such challenges would likely fail.³⁶

In sum, it does not seem likely that Pennsylvania's prohibition on passing the tax onto consumers would be struck down by the federal courts.

A second key question is whether, based on economic (not legal) considerations, the tax will be passed on dollar-for-dollar in the form of higher gasoline prices. There is little evidence for this point of view.

The short story on this issue is that corporate income taxes are generally borne by shareholders, not customers. Moreover, it is much less likely that this tax will be passed onto consumers than a per gallon gasoline tax or other sales tax. Especially in a market in which consumer demand does not fall much when prices rise (the case in the short run with oil), a gas tax or sales tax is borne largely by consumers. Profit taxes are different. According to the Institute on Taxation and Economic Policy, "corporate income taxes are paid by businesses. But as with any business tax, the corporate tax is ultimately paid by individuals. Corporate income taxes are usually passed through to shareholders. Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax is one of the most progressive taxes a state can levy."³⁷

In general, economists argue that taxes stick to their bases: payroll taxes are largely paid by employees, sales taxes by consumers, and profit taxes by shareholders.

A recent analysis of who shoulders the burden of taxation was done by the Wisconsin Department of Revenue. The study looked at who ultimately pays each of the state's taxes, with sector-specific models built to estimate the incidence of Wisconsin's Corporate and Franchise Tax.³⁸ Oil companies, as defined in the OCGPT, would fall under one of three categories using the Wisconsin system. Refiners would be classified as "manufacturers." According to the Wisconsin DOR study, manufacturing (in this case, refiners) shift only 0.6% of the tax to Wisconsin consumers. Oil company wholesalers (in the "wholesale/finance" category) shift an estimated 12.8 cents of each dollar in taxes to Wisconsin consumers. Finally, oil drillers (in the "other" category of industries in the Wisconsin study) shift 7.6% of their corporate tax burden

onto Wisconsin consumers in terms of higher prices. Using this model to estimate the tax incidence in Pennsylvania, we would expect that only 0.6% to 12.8% of the tax increase would be shifted from oil companies to Pennsylvania consumers.³⁹ This is significantly less of a burden than would be borne by Pennsylvania fuel consumers if gas taxes were increased.

While having significantly less impact on retail prices than a pump-levied gas tax, the OCGPT could also have environmental benefits by stimulating consumers to cut back oil and gas consumption, including through the use of fuel-efficient vehicles and alternative fuels. The impact of any fuel price increases on low-income families could be mitigated through a tax credit targeted to taxpayers below a certain income threshold.

In sum, while who will pay the OCGPT is impossible to predict precisely, it should be possible to ensure that a large portion of the tax will be paid through lower returns to shareholders. The Commonwealth will still need to monitor gas prices to ensure compliance with the law.

Is the OCGPT the “Failed” Windfall Profits Tax All Over Again?

Industry lobbyists have claimed that the OCGPT is another attempt to revive the federal windfall profit tax of the 1980s. The taxes are significantly different. The Crude Oil Windfall Profit Tax (WPT) was an excise tax levied on each barrel of domestic oil production. The tax was levied on the difference between the market cost of a barrel of domestic oil and an adjusted price based on the price-controlled era that existed before the imposition of the WPT.⁴⁰ The tax was repealed in 1988 after failing to meet revenue expectations and changes in the marketplace made the tax obsolete. Opponents of the tax claim that the tax caused increased dependency on foreign oil, as domestic production dropped.

The OCGPT is levied on the entire oil industry (production, refining, distributing, and wholesaling), not merely domestic production. The WPT was a national tax. The OCGPT is based solely on Pennsylvania sales, which comprises less than 4% of the US market. The WPT was criticized for being overly complicated, due to the computation of the price control-based floor price. The OCGPT is based on very basic, industry-accepted computations, including sales, sales in Pennsylvania, cost of goods sold, and gross profit.

How Does the OCGPT Compare with Other Funding Alternatives?

Compared to alternative funding sources, the OCGPT is less likely to be borne largely by Pennsylvanians. One alternative suggested was to raise the Realty Transfer Tax (RTT) by 0.9%.⁴¹ While this would raise almost \$600 million per year, the RTT would fall heavily on people buying property in Pennsylvania. Moreover, RTT collections fluctuate due to changes in the housing market, so it would provide a less predictable revenue stream for transit. However, because the bulk of revenues from the realty transfer tax come from the 10 most urban counties it would fall most directly on those with a higher proportion of transit use.

Another option was to raise the state sales tax, or empower localities to levy a higher sales tax and earmark the increase for transit. This would also provide a stable revenue stream, but it would make Pennsylvania's

regressive state and local taxes even more regressive.

Finally, raising the gasoline tax for transit use could also be considered. A fuel tax is more likely than the OCGPT be directly passed onto consumers in the form of higher gasoline prices in Pennsylvania. This would impact both businesses and individuals that use motor fuels. This tax would be regressive, similar to the overall sales tax, and would especially increase taxes as a share of income for low- and middle-income rural taxpayers that must drive long distances to work. Taxes would be shifted away from Pennsylvanians only to the extent that out-of-state visitors purchase fuel. A gas tax would have the benefit of modifying consumer behavior over time, and of better incorporating the environmental costs associated with oil consumption into the price. A gasoline tax could be made more palatable if accompanied by a tax credit designed to compensate low-income taxpayers for tax payments that are excessive relative to an individual's income.

Of the transit funding proposals, the OCGPT shows the most promise of shifting taxes towards out-of-state and higher-income shareholders.

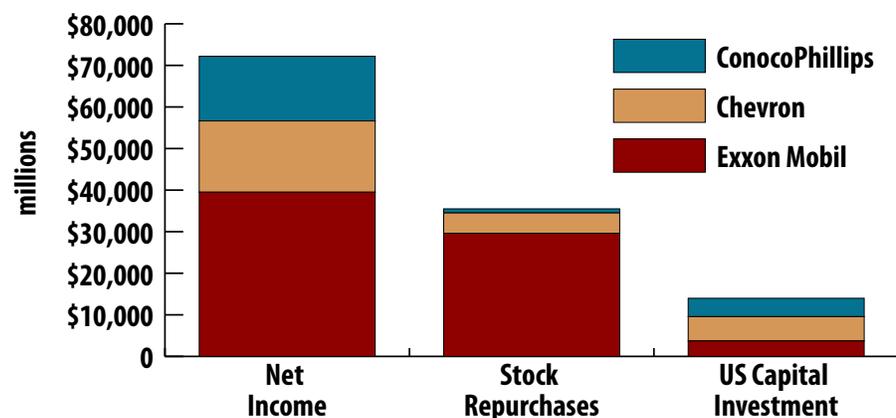
Will the Tax Affect Investment in Pennsylvania?

Oil lobbyists claim that the tax will decrease investment in the US and force the purchase of more foreign oil. The scope of the tax and the manner in which it is levied do not support such a claim. Pennsylvania consumes a small fraction of total US demand for oil and oil products. The US Energy Information Administration estimates that in 2004, Pennsylvania accounted for 3.6% of total US demand for oil products.⁴² As no new refineries have been built in the US in 25 years, it is unlikely that the owners of the facilities in Pennsylvania will relocate elsewhere.

The tax is apportioned to Pennsylvania on the basis of sales in Pennsylvania compared to total company sales, rather than looking at the proportion of Pennsylvania sales, employment, and property. Economic development and business groups claim that using a "single sales factor" will level the taxation burden for companies with significant assets and employment in Pennsylvania with their out-of-state competitors.⁴³ The use of any single apportionment method will create "winners" and "losers" as compared to other methods.

Academic studies seem to corroborate that tax changes at the state level have little impact on the industry. A simulation of Wyoming taxation of oil production found that doubling the state's severance tax would have

Figure 4. Comparison of Major US-Based Oil Companies Uses of Cash, 2006



Source. 2006 company 10-K reports

a slight impact on production over forty years (-6%), while increasing the state's revenue by over 90% in real dollars.⁴⁴

The oil industry is claiming that US oil companies are preparing to invest \$125 billion in energy development this year, just in the US⁴⁵ If this proves to be true, it would be a substantial increase from current investment. In 2006, the three largest US-based oil companies (Exxon Mobil, ConocoPhillips, and Chevron) had combined net income of \$72 billion. Of this amount, only \$14 billion was reinvested as capital in their US operations, or 19% of net income (see Figure 4). However, \$36 billion was used to repurchase stock from shareholders to make the stock more attractive to investors (49% of net income).⁴⁶ This \$36 billion equals roughly \$118 per person in the United States. While gasoline prices for consumers at the pump soared, the oil companies continued to pursue a short-term profit maximization strategy, rather than finding new sources of energy or taking steps to reduce costs that would be passed on to their customers.

Will Combined Reporting Hurt the Business Community?

Others warn about what the combined reporting aspect of the proposal would do to the Pennsylvania business community. Business lobbyists have argued that few states have combined reporting requirements; that combined reporting increases business compliance costs; and are subject to increased litigation costs.

Combining the returns of related companies is not a new phenomenon being invented by Pennsylvania. Nationally, the IRS already gives companies with subsidiaries (called affiliated groups) the option to elect to file a single, consolidated tax return. This option is similar to the combining of subsidiaries into a unitary group that is required by states already using combined reporting. The Multistate Tax Commission has drafted and updated model legislation language to make compliance across states much easier.

The map in Figure 5 shows which states have adopted or are considering combined reporting. The 16 states with combined reporting since 1990 represent a significant portion of US Gross Domestic Product, accounting for 29% of US output according to US Bureau of Economic Analysis data.⁴⁷ With Vermont, Texas, New York, and West Virginia adopting combined reporting between 2004 and 2007, combined reporting states now account for 45% of GDP. Clearly, there has been no rush to abandon combined reporting because it significantly hinders business activity in a state.

Combined reporting is currently being considered in four other states besides Pennsylvania (Iowa, Michigan, Massachusetts, and North Carolina).⁴⁸

Fear of litigation due to adoption of combined reporting is a non-issue. The Multistate Tax Commission has developed model combined reporting language to assist states in making the tax as similar as possible in each jurisdiction. This language has evolved based on the experiences and case law surrounding the states that have used the system for years.⁴⁹

Changes in the scope of business and aggressive tax planning by multi-state corporations are necessitating changes in the manner in which states tax corporate earnings. The increasing complexity of corporate structures and the interconnection of corporate subsidiaries are making traditional, separate company taxation anachronistic and an invitation to tax avoidance. Combined reporting offers states an opportunity to better assess the full impact of corporations.

Conclusions

Using widely accepted tax principles, the Oil Company Gross Profits Tax creates a more equitable tax system and provides a viable approach to raising revenue for mass transit.

- It would help the Commonwealth achieve revenues adequate to invest in public transit systems in economically vibrant urban-suburban corridors and in rural communities with aging populations.
- It would fall in significant part on businesses that benefit directly from state investments in transit infrastructure such as highways and bridges.
- It would reduce the environmental costs (or “negative externalities”) that result from the use of oil and gasoline.
- In a state and local tax system that is one of the least progressive in the nation, the Oil Company Gross Profits Tax would fall substantially on shareholders, most of whom have a greater ability to pay than typical taxpayers and who also live outside of Pennsylvania.

To the extent, if any, that fuel prices increase because of the tax, it will stimulate positive changes in consumer behavior, including the purchase of more fuel-efficient vehicles and alternative fuels. In addition, the burden on lower-income families can be mitigated through the creation of an income-based fuel credit.

The Commonwealth should carefully monitor the impact of the tax through the creation of an Oil Price and Profits Monitoring Committee. This committee could have representation from each legislative caucus, the Governor’s Office, the Office of the Attorney General, consumer groups, advocates for low-income Pennsylvanians, environmentalists, and the oil industry. The committee could be housed in and staffed by the Department of Revenue, the Office of the Consumer Advocate at the Pennsylvania Utility Commission (PUC), or a combination of the two.

A prime responsibility of the committee would be to monitor prices for gasoline at the pump in Pennsylvania, neighboring states, and all 50 states, following implementation of the OCGPT. It should help enforce the legal requirement that the oil profits tax not be passed onto consumers. A further function would be to monitor oil company tax filings for evidence of tax avoidance strategies in Pennsylvania. The committee could also be a repository and clearinghouse for accessible information on oil company profits and the extent to which the market power of oil companies is misused at consumer expense to exacerbate periodic shortages.

Americans know from experience with Enron and the manipulation of electricity prices in California that energy companies in some circumstances may take advantage of consumers if inadequate public oversight and regulation create that opportunity. The OCGPT should be enacted in a way that helps close that opportunity and limit future opportunities for market manipulation and price gouging in Pennsylvania.

The Oil Price and Profits Monitoring Committee and other enforcement activity could be funded using OCGPT revenues, as it seems likely that the currently proposed funding levels of the Office of the Attorney General and Department of Revenue would not be sufficient to prepare for and administer this new tax.

To complement the prohibition on passing on the cost of the oil tax to consumers, and to protect low-income taxpayers from the rising cost of oil and gasoline whatever its origins, the Commonwealth could create a program to rebate the increased cost of transportation to low-income individuals. This safeguard could ensure that the tax system with the oil tax is not more regressive (than the current tax system); a generous enough rebate could even make the tax system with the oil tax more progressive.

A rebate could be implemented in conjunction with Pennsylvania's existing income tax forgiveness program or by creating a new and wholly separate credit program. (If the former, taxpayers eligible for the state's tax forgiveness program might be permitted a rebate based on either average consumption of oil-based products or based on actual use if that is higher and the taxpayer can provide evidence to that effect. The form for filing the rebate could be integrated with the form for income tax forgiveness.)

For drivers not eligible for a credit, any increasing cost of fossil fuel would help stimulate changes in consumer behavior toward less environmentally damaging technologies.

In sum, lawmakers should adopt the profits tax as a viable revenue source for mass transit funding.

Endnotes

- ¹ Data taken from Wal-Mart Stores, Inc. 2006 10-K, filed March 27, 2007; <<http://investor.walmartstores.com/phoenix.zhtml?c=112761&p=irol-SECText&TEXT=aHR0cDovL2NjYm4uMTBrd2l6YXJkLmNvbS94bWwvZmlsaW5nLnhtbD9yZXBvPXRlbmsmaXBhZ2U9NDc2OTc2OCZkb2M9MyZudW09MzM=>>.
- ² Pennsylvania Public Transportation Association, “History of Mass Transit Funding in Pennsylvania,” Feb. 23, 2004. <http://www.ppta.net/pdf/funding_history.pdf>
- ³ 2006 Exxon Mobil Corp. 10-K filed Feb. 27, 2007 <<http://ir.exxonmobil.com/phoenix.zhtml?c=115024&p=irol-secToc&TOC=aHR0cDovL2NjYm4uMTBrd2l6YXJkLmNvbS94bWwvY29udGVudHMueG1sP2lwYWdlPTQ3MDg2NTImcmVwbz10ZW5r>>.
- ⁴ The US Census estimates the US population in 2006 at approximately 299,400,000. <<http://quickfacts.census.gov/qfd/states/42000.html>>.
- ⁵ Thomas W. Wolf, Secretary, Department of Revenue, Testimony before the Senate Transportation Committee, March 27, 2007.
- ⁶ Data taken from two US Energy Information Administration publications: “Gasoline Prices by Formula, Grade, Sales Type” <http://tonto.eia.doe.gov/dnav/pet/pet_pri_allmg_d_nus_PTA_cpgal_a.htm> and the spreadsheet: “Petroleum Operations, Statement of Income,” online at <<http://www.eia.doe.gov/emeu/finance/index.html>>.
- ⁷ An American Petroleum Institute issue paper entitled *Windfall Profits Tax* states: “The oil and natural gas industry is not earning ‘windfall profits.’ The reality is that the industry’s earnings have been very much in line with other industries, and often are lower. According to *Business Week* and *Oil Daily* magazines, the oil and natural gas industry earned 5.7 cents for every dollar of sales compared to an average of 5.5 cents for all US industry over the past five years. Even viewing the third quarter of 2005 in isolation shows that the oil and natural gas industry averaged earnings of 8.2 cents for every dollar of sales compared to an average of 6.8 cents for all US industries, below the returns achieved in the pharmaceutical, financial, semiconductor, consumer, software, and telecommunication services sectors, to name a few.” Online at <http://new.api.org/policy/tax/upload/WhitePaper2004_060CRSupdated.pdf>.
- ⁸ John Burbank, *Regulating the Oil Industry and Corraling Oil Industry Profits for the Benefit of Citizens and Businesses in Washington State* (Seattle, WA: Economic Opportunity Institute, 2006).
- ⁹ Severin Borenstein, Director of the University of California Energy Institute, Testimony before the US Senate Committee on the Judiciary, March 14, 2006 <http://judiciary.senate.gov/testimony.cfm?id=1804&wit_id=5156>. Mr. Borenstein explains further that oil industry “return on sales” is not comparable to other industries because that measure varies wildly depending on the capital intensity of the industry and the value added by the company.
- ¹⁰ American Petroleum Institute, “Issue: Oil and Gas Taxation,” 2006 <http://www.api.org/policy/tax/upload/Oil_and_Gas_2006_with_colored_lines.pdf>.
- ¹¹ Data taken from 2006 10K reports filed with the SEC. 2006 Exxon Mobil 10K was filed February

28, 2007 and can be located online at <http://ir.exxonmobil.com/phoenix.zhtml?c=115024&p=irol-sec&secCat01v1_rs=11&secCat01v1_rc=10>. 2006 ConocoPhillips 10K was filed on February 23, 2007 and can be located online at <<http://ccbn.tenkwizard.com/contents.php?ipage=4697170&repo=tenk&CK=1163165&FC=000000&BK=FFFFFF&SC=ON&TC=FFFFFF&TC1=FFFFFF&TC2=FFFFFF&LK=0000FF&AL=FF0000&VL=800080&CK2=1163165>>. 2006 Chevron 10K filed on Feb. 28, 2007 and can be located online at <<http://investor.chevron.com/phoenix.zhtml?c=130102&p=IROL-secToc&TOC=aHR0cDovL2NjYm4uMTBrd2l6YXJkLmNvbS94bWwvY29udGVudHMueG1sP2lwYWdlPTQ3MTAxNjkmcmVwbz10ZW5r>>.

¹² We know that 3.6% of all oil companies' sales are in Pennsylvania. We do not know what share of these three specific companies' sales, employment, and property are in Pennsylvania. If we assume that 3.6% of these companies sales, employment, and property are in Pennsylvania then we can apportion 3.6% of national profits, or \$1.04 billion, to Pennsylvania. Pennsylvania's CNI tax, at 9.99%, on \$1.04 billion is \$104 million. Alternatively, if we assume that 3.6% of these companies' sales are in Pennsylvania but *none* of their employment and property is in Pennsylvania, then we apportion only \$626 million in profit to Pennsylvania, which would generate \$63 million in CNI tax given the 9.99% rate.

¹³ Thomas W. Wolf, Secretary, Department of Revenue, Testimony before the Senate Transportation Committee, March 27, 2007.

¹⁴ For example, in 2003, a group of 252 companies paid an effective state corporate income tax rate of 2.3%, as compared to the computed average statutory rate of 6.8%. Robert S. McIntyre and T.D. Co Nguyen, *State Corporate Income Taxes 2001-2003* (Washington, D.C.: Citizens for Tax Justice and the Institute on Taxation and Economic Policy. February 2005).

¹⁵ US Energy Information Administration, "Petroleum Chronology of Events, 1970- 2006" <http://www.eia.doe.gov/pub/oil_gas/petroleum/analysis_publications/chronology/petroleumchronology2000.htm>.

¹⁶ US Energy Information Administration, "Genealogy of Major US Petroleum Refiners" <<http://www.eia.doe.gov/emeu/finance/mergers/dwnstream.pdf>>.

¹⁷ For a comprehensive overview of rising concentration and refining and storage bottlenecks in the oil industry, and their connection to profit levels above those in other industries, see Mark Cooper PhD, *Record Prices, Record Oil Company Profits: The Failure Of Antitrust Enforcement To Protect American Energy Consumers* (Washington, D.C.: Consumers Federation of America and Consumers Union, September 2004). For a more recent update, see Mark N. Cooper PhD, *The Role Of Supply, Demand, Industry Behavior And Financial Markets In The Gasoline Price Spiral*, prepared for Wisconsin Attorney General, May 2006.

¹⁸ Robert Pirog, *Oil Industry Profit Review 2005*, Congressional Research Service, April 18, 2006, pages 13-14.

¹⁹ US Energy Information Administration, *Annual Energy Review 2005*, "Table 5.22 Refiner Sales Prices and Refiner Margins for Selected Petroleum Products, 1989-2005," July 27, 2006 <www.eia.doe.gov/emeu/aer/pdf/pages/sec5_53.pdf>.

²⁰ David R. Baker, "Refinery Profit Margins Double in West," *San Francisco Chronicle*, March 9, 2007

<<http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2007/03/09/MNGF9OID9N1.DTL>>. For an extended discussion of the consistency of oil industry price trends in California with the exercise of market power by refiners, and of the difficulty of distinguishing true scarcity from the use of market power, see Severin Borenstein, James Bushnell And Matthew Lewis, *Market Power In California's Gasoline Market* (Berkeley, CA: Center for the Study of Energy Markets (CSEM), University of California Energy Institute, May 2004), CSEM Working Paper 132.

²¹ Testimony of Tyson Slocum, Director, Public Citizen's Energy Program Before the US Senate Committee on the Judiciary, "Consolidation in the Energy Industry: Raising Prices at the Pump?" February 1, 2006, p. 4-5.

²² Pennsylvania Department of Revenue, "Oil Company Gross Profits Tax," Feb. 6, 2007.

²³ Ibid.

²⁴ US Energy Information Administration, "State energy profile – Pennsylvania," March 8, 2007 <http://tonto.eia.doe.gov/state/state_energy_profiles.cfm?sid=PA>.

²⁵ Mark Levy, "Rendell's Oil Tax Debated," *Allentown Morning Call* online edition, March 28, 2007 <http://www.mcall.com/news/nationworld/state/all-a7_rendell-taxesmar28,0,5964229.story>.

²⁶ In 2004, the Pennsylvania Business Tax Reform Commission recommended mandatory combined reporting for Corporate Net Income Tax (CNIT) payers. The commission recommended this action as part of a revenue-neutral plan to broaden the tax's base, while lowering the tax rate. Elements of the commissions recommendations were included in the Commonwealth of Pennsylvania's 2005-06 Executive Budget, but were not enacted into law.

²⁷ Multistate Tax Commission, "Proposed Model Statute for Combined Reporting," Aug. 17, 2006 <http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Combined%20Reporting%20-%20FINAL%20version.pdf>. This language was developed to address issues litigated in California over its worldwide combination provisions.

²⁸ One critical piece in this is the definition of what will or will not be included in the unitary group that pays the OCGPT. If non-oil subsidiaries actively conduct business with the subsidiaries defined as "oil companies", the cost of the tax could be recovered through "fee" increases charge by non-oil subsidiaries. The Oil Price and Profits Committee needs to have the ability to examine transactions between the oil companies, who pay the tax, and their related subsidiaries that fall outside of the unitary business as described in the proposal.

²⁹ For the PA21 Project's tax objectives and principles, see Pennsylvania 21st Century Tax Policy Project, *Moving Pennsylvania's Tax System Into the 21st Century*, report prepared by Ernst and Young, LLP, Keystone Research Center (KRC), and the Pennsylvania Economy League, December 2003, p. 3. The discussion in the text of the PA21 tax principles is based on discussion with KRC economist Stephen Herzenberg, who was a member of the team of PA21 consultants that prepared the PA21 report.

³⁰ Institute on Taxation and Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, 2nd Edition*, (Washington D.C., January 2003), online at <<http://www.itepnet.org/wp2000/text.pdf>>.

³¹ Robert A. Lynch, *Rethinking Growth Strategies* (Washington, D.C. EPI Press, 2005).

³² Numerous articles have flooded the newswire, including: John Hurdle, “Penn. gov. plans oil profits tax to fund transport,” *Reuters Online*, Feb. 6, 2007 <http://today.reuters.com/news/articleinvesting.aspx?type=bondsNews&storyID=2007-02-06T211104Z_01_N06267798_RTRIDST_0_PENNSYLVANIA-BUDGET.XML>. Mike Schreiber, “Causer calls Rendell’s oil tax plan ‘ill informed’,” *The Bradford Era*, March 29, 2007 <http://www.zwire.com/site/index.cfm?newsid=18146587&BRD=52&PAG=461&dept_id=569780&rft=8>. Jonathan Williams, “Why a windfall profits tax on oil companies won’t work,” *Northeastern Pennsylvania Business Journal*, April 06, 2007 <http://www.npbj.com/site/index.cfm?newsid=18178902&BRD=2231&PAG=461&dept_id=449419&rft=8>.

³³ Pennsylvania Constitution, Article VIII, Section 1.

³⁴ The Gross Premiums Tax is enabled by Article IX of the Act of March 4, 1971 (P.L. 6, No. 2), the Act of July 6, 1921 (P.L. 723), the Act of May 17, 1921 (P.L. 682), and the Act of May 13, 1927 (P.L. 998). The enabling legislation of Bank Shares is Article VII of the Tax Reform Code of 1971 (P.L. 6, No. 2). The Mutual Thrift Institutions Tax is enabled by Article XV of the Tax Reform Code of 1971 (P.L. 6, No. 2).

³⁵ *US Supreme Court, P.R. Consumer Affairs Dept. v. Isla Petroleum*, 485 US 495 (1988) <<http://supreme.justia.com/us/485/495/case.html>>. Justice Scalia indicated the following in the Court’s opinion, “Today’s conclusion that the DACO regulations are not pre-empted was plainly foreshadowed by our decision in *Tully v. Mobil Oil Corp.*, 455 US 245 (1982) (per curiam). In that case, the TECA had held that the EPAA pre-empted a state provision barring oil companies from passing on to subsequent purchasers the cost of the State’s gross-receipts tax. Since, by the time we decided that appeal, the EPCA-imposed expiration date for Presidential authority under the EPAA had already passed, we vacated the judgment, agreeing with the TECA’s own determination that expiration of the EPAA “will signal the end of federal concern in this area.” *Id.*, at 246, quoting 653 F.2d 497, 502 (1981). Our action was based on the theory that the pre-empting legislation was no more. 455 US, at 247, and n. 2.”

³⁶ Stephanie Lee, “Proposition 87: Alternative Energy. Research, Production, Incentives. Tax on California Oil Producers,” University of the Pacific McGeorge School of Law, Capital Center for Government Law and Policy, *California Initiative Review, November 2006 Initiatives*, 2006 <http://www.mcgeorge.edu/government_law_and_policy/california_initiative_review/november_2006/ccglp_cir_nov2006_prop_87.htm>. The author points out that in *Exxon Co. v. Exchange Oil & Gas.*, 462 US 176, 187 (1983), “the Court reasoned that since a State may establish a lower price ceiling, it may also impose a severance tax and forbid sellers from passing it through to their purchasers.” Regarding the Contracts Clause, the Court found “if the Contract Clause does not prevent a State from dictating that price that sellers may charge their customers, plainly it does not prevent a State from requiring that sellers absorb a tax increase themselves rather than pass it through to their customers.” The author also reasoned that it would be difficult to for an Equal Protection claim to be successful, as “the pass-through prohibition does not adversely affect a fundamental interest” or is “based upon suspect criterion”.

³⁷ Institute on Taxation and Economic Policy, *The ITEP Guide to Fair State and Local Taxation*. (Washington DC: ITEP. February 2005). <<http://www.itepnet.org/guide.pdf>>. For a classic academic analysis that also concludes that shareholders ultimately pay profit taxes, see Arnold C. Harberger. “The Incidence of the Corporation Income Tax,” *The Journal of Political Economy*, Vol. 70, No. 3. (Jun., 1962), pp. 215-240.

The Congressional Budget Office drew a similar conclusion in its *Effective Federal Tax Rates, 1979-1997* publication, published in Oct. 2001. In Chapter 2, the paper discusses who ultimately pays corporate income taxes: “Economists disagree on whether people bear the tax as shareholders in corporations, owners of all capital assets, employees, or consumers. Nonetheless, a survey of the economics literature on the issue indicates a dominant view that the corporate income tax reduces the return to all capital, and thus the burden of the tax falls on all owners of capital assets.” This report can be found online at <<http://www.cbo.gov/ftpdoc.cfm?index=3089&type=0&sequence=3>>.

³⁸ The Wisconsin Corporate and Franchise Tax is basically an income tax, much like Pennsylvania’s Corporate Net Income Tax, levied on all domestic (organized under Wisconsin law) and foreign corporations doing business in, owning property in, or having interstate sales in Wisconsin.

³⁹ Wisconsin Department of Revenue. *Wisconsin Tax Incidence Study*. December 16, 2004 <<http://www.revenue.wi.gov/ra/txinc04a.pdf>>.

⁴⁰ Joseph J. Thorndike, “Historical Perspective: The Windfall Profit Tax—Career of a Concept,” Tax History Project, Nov. 10, 2005.

⁴¹ Commonwealth of Pennsylvania *2007-08 Governor’s Executive Budget*, page A3.26.

⁴² US Energy Information Administration, *State Energy Profile —Pennsylvania*, March 8, 2007 <http://tonto.eia.doe.gov/state/state_energy_profiles.cfm?sid=PA>.

⁴³ No studies were located that document the economic development value of changing apportionment factors of state corporate taxation toward a “sales only” factor.

⁴⁴ Mitch Kunce, Shebly Gerking, William Morgan, and Ryan Maddux, *State Taxation, Exploration, and Production in the US Oil Industry*, Wyoming State Legislature, Jan. 22, 2002 <<http://legisweb.state.wy.us/2001/interim/app/reports/oiltaxpaper%2011-26-01.pdf>>.

⁴⁵ John J. Interval, “Why an Oil Profits Tax Would be Foolish,” *The Harrisburg Patriot-News*, March 30, 2007 <<http://www.pennlive.com/columns/patriotnews/asiseeit/index.ssf?/base/columnists/117519900894970.xml&coll=1>>.

⁴⁶ Data taken from Exxon Mobil, ConocoPhillips, and Chevron 2006 Annual Reports and 10K filings.

⁴⁷ Data taken from US Bureau of Economic Analysis, *Survey of Current Business*, “Table 654. Gross State Product in Current and Real (2000) Dollars by State: 1990 to 2004”, July 2005 <<http://www.bea.doc.gov/bea/regional/gsp/>>.

⁴⁸ Michael Mazerov, “Growing Number of States Considering a Key Corporate Tax Reform,” Center on Budget and Policy Priorities, April 5, 2007 <<http://www.cbpp.org/4-5-07sfp.htm>>.

⁴⁹ Multistate Tax Commission model language can be found here: <<http://www.mtc.gov/Uniformity.aspx?id=500&ItemId=500>>.



About the Pennsylvania Budget and Policy Center

Founded in 2005, The Pennsylvania Budget and Policy Center (PBPC), is a nonpartisan, statewide policy research project that provides independent, credible analysis on state tax, budget, and related policy matters, with attention to the impact of current or proposed policies on working families.

The Budget and Policy Center analyzes and disseminates information on short-term budget, policy and revenue proposals as well as long-term trends and challenges.

The Pennsylvania Budget and Policy Center participates in a national network of similar organizations that exist in over half the states as part of the State Fiscal Analysis Initiative coordinated by the Washington, DC-based Center on Budget and Policy Priorities.

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