Crude Oil Windfall Profits Taxes: Background and Policy Considerations

Recent increases in gasoline prices and reports of high profits from large oil companies have contributed to congressional interest in a crude oil windfall profits tax.

What Are Windfall Profits?
Windfall (or excess) profits taxes are, in theory, designed to tax the portion of profits a firm derives from an external event. Windfall profits are generally believed to be those that represent an excessive, unearned, or unfair gain. Offentimes, windfall profits taxes are discussed in the context of oil markets, where fluctuations in the price of oil are associated with volatile profits in the industry. It is possible windfall or excess profits may be realized in other industries. It has been suggested that some companies (certain technology companies, for example) may have realized excess or windfall profits as a result of the Coronavirus Disease 2019 (COVID-19) pandemic.

Rising oil prices can be associated with rising industry profits, and falling oil prices may be associated with losses in the industry. Figure 1 plots the monthly average West Texas Intermediate (WTI) crude oil prices against annual profits, as reported by the Bureau of Economic Analysis (BEA), in the oil and gas extraction industry and petroleum and coal product manufacturing sector.

Oil industry profits have fluctuated with oil prices over time. Profits have tended to be stronger in periods when prices are relatively high, with losses occurring during periods when prices are comparatively low. Numerous economic factors affect industry profitability. Oil prices are highlighted here, as high oil prices are a motivation behind current windfall profit tax proposals.

Taxing Windfall Profits

Income Tax Approach
The income tax system could be used to impose a windfall profit tax (WPT). Under this approach, the tax base might be the excess of adjusted taxable income in the tax year over taxable income in a base period. Adjustments could allow taxpayers to avoid the WPT by making certain types of investments, for example. An alternative could be to tax profits above a legislatively determined rate of return.

Excise Tax Approach
From 1980 to 1988, the United States imposed a Crude Oil Windfall Profits Tax (P.L. 96-223), which was in the form of an excise tax on domestic production. The tax was a percentage of the difference between the price of oil and a base price indexed for inflation (70% for integrated oil companies; 50% for others). Lower rates applied to certain types of production (including marginally productive wells, called stripper wells, and newly discovered oil) and even lower rates to heavy oil and oil recovered by more costly tertiary methods.

The 1980s WPT was imposed following the elimination of price controls on crude oil, which had been in place beginning in 1971.

Figure 1. Oil Prices and Industry Profits

General price controls were imposed in 1971-1973, and the controls on crude oil were continued following the 1973 oil crisis (the Arab oil embargo). With the elimination of price controls, domestic oil prices were predicted to increase substantially, as they were below the world price.

Over time, the tax yielded less revenue as worldwide oil prices fell and the base was increased by inflation adjustments. It was repealed in 1988, prior to its legislated termination date of 1991.

Policy Design Considerations
There are numerous potential policy design considerations, in addition to the initial choice of an income or excise tax. Would the tax be imposed on imports? Would there be exemptions for small producers or producers with revenues or profits below some threshold? Could taxpayers avoid tax liability by making certain types of investments? How would “windfall profits” be determined—as the excess of profits over a base period or via some other method? These choices have implications for the potential economic effects of the tax, as discussed below.

Separately, if the policy objective is to raise additional federal revenues from the oil and gas sector, there are potential options other than a WPT. For example, numerous tax provisions supporting the oil and gas sector could be repealed. Alternatively, the tax treatment of multinational oil and gas companies could be modified in a way that generates additional federal tax revenue (e.g., modify the way foreign oil and gas extraction income is treated for the purposes of global intangible low-tax income [GILTI]).

Potential Economic Effects
How a WPT might affect domestic oil and gas production, imports, and prices depends on how the tax is designed.

An excise tax on domestic production, like the WPT of the 1980s, would tend to reduce domestic production, although effects are likely to be moderated by several factors. If the tax were only imposed on domestic production, the decline in domestic production could lead to increased imports. When oil prices are determined in global markets, an excise tax on domestic producers would likely reduce the price producers receive (i.e., be borne by firms that are producers), and not be passed forward to refiners or petroleum consumers. If, however, changes in domestic production contribute to reduced global market supply, there could be consumer price effects. If the tax is temporary, it would be unlikely to affect longer-term drilling or the number of wells in production (although it may cause producers to pause drilling activity or shift production to a later time period).

The effects of an excise tax type of WPT that applies to imports, or one that is imposed only on certain entities (e.g., large producers), might result in different outcomes. If an excise tax type of WPT is imposed on imports as well as domestic producers, the tax is more likely to be passed on, in part, to refiners and consumers, since refiners can no longer substitute nontaxed imported oil for taxed domestic oil. Limiting the tax to certain types of entities, however, makes it less likely that the tax can be passed forward via higher prices, since there would be competition from untaxed crude oil (both domestic and imported). If prices rise in response to the tax, higher prices could increase profits for the entities that are not subject to the tax (e.g., smaller producers). Effects could also differ by region, as some parts of the country rely more on imports of refined products (which would not be taxed) or on oil from smaller domestic producers or smaller refiners (also not taxed).

An income tax type of WPT may be less likely to distort short-run production choices. In the short run, the burden of the tax would likely fall on the oil producer. Economic theory suggests that income-based taxes that are taxes on excess profits (e.g., profits above the normal rate of return), or economic “rents,“ do not distort investment and production choices. If the tax falls on normal return, however, it could reduce investment in the long term. Taxpayers might also respond to a temporary income-based WPT by taking measures to reduce taxable income (by making additional investment, for example).

Legislation in the 117th Congress
The Big Oil Windfall Profits Tax Act (S. 3802; H.R. 7061) would impose an excise tax form of a WPT. The proposed tax would be 50% of the difference between the current price of Brent crude oil and the average price from 2015 to 2019 (inflation adjusted after 2022). The tax would be imposed on both domestic production and imports and would be limited to firms that produced or imported an average of at least 300,000 barrels per day. Senator Whitehouse (sponsor of the Senate legislation) claimed in a press release that approximately 70% of domestic production would be exempt.

Other proposals would impose an add-on tax on profits (structured as an excise tax on profits). The Stop Gas Price Gouging and Rebate Act (H.R. 7099) would, for 2022, impose a WPT on large integrated oil companies. A 50% tax would be levied on the amount by which an adjusted measure of taxable income exceeds 110% of adjusted taxable income during the base period (2015-2019). The Stop Profiting Off Putin’s War Act (H.R. 7103) would impose a 50% tax on the adjusted taxable income of large integrated oil companies, through 2023, if gas prices during the calendar quarter exceeded gas prices on February 24, 2022. The rate could be increased to 75% if taxpayers are found to have raised prices in response to the tax. Adjusted taxable income would be increased by amounts paid in bonuses and the amount of stock buybacks, and reduced by net operating loss deductions and deductions for depreciation, amortization, and depletion.

Each of the proposals discussed above would rebate revenues to individuals, with rebates phased out for higher-income taxpayers. Senator Whitehouse’s press release also claimed that at a price of $120 per barrel, revenues would be $45 billion per year, allowing for rebates of $240 for single filers and $360 for joint filers. Oil prices have decreased since the introduction of the legislation and have been fluctuating; lower oil prices would mean less revenue.

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