Environmental Benefits of Tax Reform

by Brent Blackwelder

The Tax Reform Act of 1986 provides a significant turnaround in the environmental implications of U.S. tax policy. Congress approved a number of major tax code changes to eliminate subsidies for destruction of wetlands, cultivation of highly erodible lands and centralized energy facilities.

Until the passage of the Tax Reform Act, the tax code provided many subsidies that had adverse impacts on the environment in energy, agricultural, and land use areas. For example, tax benefits have been provided to individuals for draining wetlands and to utilities for constructing large coal and nuclear power plants.

National conservation organizations, including the Sierra Club, the Natural Resources Defense Council, the National Wildlife Federation, Environmental Action, and the Environmental Policy Institute, recognized the environmental importance of changing U.S. tax policy and lobbied extensively. On July 15, 1986, we summarized:

Tax policy is environmental policy. Current tax provisions are the major cause of much environmentally destructive and economically inefficient investment. They subsidize and promote destruction of erodible lands and wetlands, excessive extraction of minerals, oil and gas, construction of unnecessary nuclear and coal-fired power plants and creation of high-density development in ecologically sensitive areas. Many of these subsidized investments are inconsistent with other Federal policies and laws, and frustrate government efforts to protect the environment and conserve natural resources.2

The new tax code will address many of these concerns. Outlined below are improvements in the areas of energy, agriculture, timber, and a tax-exempt bonds where environmentally beneficial changes will be made.

Energy3
Conservation organizations made energy a prime target for reform. The most resource-damaging energy projects were being heavily subsidized by the tax code while the most environmentally sound investments, such as in energy conservation and solar power, were receiving insufficient support. The basic strategy adopted by environmentalists was to argue that all energy subsidies should be eliminated so that energy conservation and renewable technologies could compete fairly with nuclear power, coal, oil, and gas to supply energy needs. The overall result in the energy area was notable gains in curtailing tax advantages for centralized facilities but failure to eliminate several key tax breaks for the oil and gas industry.

The Tax Reform Act repeals the investment tax credit, which removes a big tax break for utilities constructing nuclear and coal-fired power plants. Furthermore, the legislation also repeals the expensing of construction period interest which is a tax write-off that skews utility investment decisions toward centralized facilities and away from improvements in energy efficiency. These provisions will hit those utilities with major ongoing construction projects the hardest. According to the Western Interstate Energy Board, the consensus among industry trade groups is that the new tax bill will not be good for capital intensive industries.4

Conservationists strongly supported the elimination of two big tax breaks for the oil and gas industry in the House bill: the percentage depletion allowance and intangible drilling costs. Unfortunately, the Senate conferees, a number of whom came from oil and gas producing states, prevailed and these tax breaks remain in law. The intangible drilling costs, which are the expenses of drilling apart from the purchase of physical assets, can be deducted even if drilling is fruitful. Oil extraction is...
thus favored relative to other investments in energy which have higher pretax returns, and investment is steered into energy sources where capital costs are a relatively high share of total costs. The Treasury Department estimated that repealing these subsidies alone would have increased tax revenues by seven billion dollars per year.\textsuperscript{5}

The results were mixed in the area of energy conservation and renewable energy sources. The conferees extended until 1988 the renewable energy business tax credits but dropped credits for renewable residential energy and for wind energy. The renewable technologies covered for businesses are solar, geothermal, and ocean thermal. The conference report allows a ten percent credit for biomass investments placed in service before January 1, 1986.\textsuperscript{6} The conferees' acceptance of the Senate's five-year tax write-off for renewable energy business investments, rather than the House's ten-year version, will spur investment in this environmentally beneficial area.

Hydropower is widely touted as an environmentally benign renewable energy source, and Congress provided various subsidies in the Public Utility Regulatory Policies Act in 1978\textsuperscript{7} to encourage development of small hydro. Unfortunately, recent experience has shown that small hydro projects can have many adverse environmental impacts such as the taking of parkland, the bulldozing of access roads in remote areas, and the diverting of water through pipes and conduits so as to greatly reduce and in some cases actually dry up streams. Furthermore, the sheer volume of these small projects\textsuperscript{8} can cause cumulative adverse impacts in a river basin.

As a result of these concerns, conservationists pushed for an end to the hydroelectric energy tax credits, but the conferees in a surprising move went beyond the bounds of either bill and provided a ten percent investment tax credit and accelerated depreciation on all preliminary permits and license applications filed before March 2, 1986.\textsuperscript{9} These tax advantages will continue until 1990 and could cause environmental damage to some scenic rivers. The only offsetting factor is the recent passage of the Electric Consumers Protection Act of 1986, which will require the Federal Energy Regulatory Commission to give equal consideration to fish and wildlife concerns in the licensing process.\textsuperscript{10}

**Agriculture\textsuperscript{11}**

Some of the significant reforms in the tax bill concern agricultural policy. The new law will deny capital gains treatment on the disposition of converted wetlands and highly erodible cropland starting in January 1987. The law therefore removes a major incentive for plowing steep slopes and other fragile land (often called “sodbusting”) as well as the incentive to drain wetlands (“swampbusting”). The rate of soil loss in some parts of the United States today is greater than during the Dust Bowl era. Conservationists recognized the urgency of eliminating those tax subsidies that encourage more erosion at the same time laws like the Clean Water Act are attempting to combat erosion, and consider this tax code change a major victory.

Wetlands have been disappearing at alarming rates. Estimates by the National Wildlife Federation place the loss at about 500,000 acres per year.\textsuperscript{12} By changing the tax breaks for wetland conversion, there is hope that the rate of loss will be substantially slowed.

**Timber\textsuperscript{13}**

Conservationists hoped to eliminate the capital gains treatment of timber harvested from public lands as we had eliminated capital gains treatment for disposition of highly erodible cropland and wetlands. The capital gains subsidy provides an incentive for timber companies to choose environmentally sensitive national forest land rather than private land for timber production. Unfortunately, the new law retains capital gains treatment for timber from public lands; however, conferees did retain certain beneficial provisions in current law pertaining to private lands. The conferees adopted provisions from the Senate bill that would retain the current law's provision for annual expensing of timber management costs and the amortization of reforestation costs over seven years on private lands. The bill would also retain the reforestation tax credit. Conservationists supported retention of these portions of the tax code, fearing that their removal might lead to conversion of private forest land to less desirable uses and might increase commercial pressure on public forests. A removal of the tax incentives for long-term private forestry might also lead to much more environmentally destructive lumbering with companies rapidly clearing the commercial timber and then abandoning the land without restoration.

**Tax Exempt Bonds\textsuperscript{14}**

Environmentalists have become increasingly concerned about the use of tax-exempt bonds, both governmental and nongovernmental, to finance environmentally damaging activities. These activities include development in critical resource areas such as wetlands, barrier islands, parks, and wildlife refuges, and even the filling in of rivers and streams. The hidden subsidies provided by tax-exempt bonds thus can encourage the destruction of very valuable natural areas whose protection is encouraged by various federal laws.

A prime example of how tax-exempt bonds can be used to undermine environmental victories can be seen in the case of the Westway highway and landfill project in New York City. Promoters of Westway wanted it primarily for real estate development along a landfill in the Hudson River and hoped to obtain federal funding for the project from the Federal Highway Trust Fund. When conservationists successfully cut off federal funding in the courts,\textsuperscript{14}\textsuperscript{15} promoters began looking to tax-exempt bonds as the source of financing for the landfill.

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Another very important provision of the new law is the limiting of deductions for soil and water conservation investments to expenditures that conform to a conservation plan approved by the United States Department of Agriculture, or in the event that the Department has no plan, the plan would be approved by a comparable state agency. Futhermore, in no event can expenditures for draining or filling of wetlands or the installation or operation of a center pivot irrigation system be deducted under this category. Starting in 1987, this provision will help ensure that where conservation deductions are allowed, the public receives tangible reductions in agricultural runoff and soil erosion.
Conservation organizations fought for provisions to prohibit tax-exempt bonds from being used to finance environmentally destructive projects. One important success is the Tax Reform Act's elimination of tax-exempt financing for industrial parks; sports, convention, and trade-show facilities; and parking facilities (except for public parking at airports).

The Senate wanted to relax conditions for tax-exempt bonds, while the House wanted to tighten requirements and place tougher limitations on the amount of money that could be tied up in these bonds in any given state. The conferees came down roughly in the middle, and the strict conditions that conservationists wanted were not adopted.

Conclusion
The Tax Reform Act of 1986 brings our nation's tax code from an environmental "F" to probably a "C+." Three extraordinarily significant changes will greatly benefit the environment: 1) the elimination of certain tax breaks that have encouraged big capital investments in nuclear and coal-fired power plants, 2) the curtailment of subsidies for draining wetlands, and 3) the removal of subsidies for cultivating highly erodible farmland. The new law creates a more level playing field in the area of energy so that energy efficiency improvements no longer are placed in unfair competition with investments in coal and nuclear power.

Despite important environmental gains, the new law continues large tax subsidies to the oil and gas industry. In the next round of tax changes strong environmental input could make a decisive difference in eliminating these oil and gas tax breaks. Furthermore, there are a number of areas for reform not addressed in the new law. One of the prime opportunities is to change national water policy so as not to encourage the overdrafting of groundwater. In current law the water depletion allowance actually rewards farmers in proportion to the speed at which they eliminate groundwater.

As a lobbyist who has worked many environmental issues, I was amazed at the amount of industry lobbying of the House Ways and Means and Senate Finance Committee members and the difficulty of reaching members who had been bombarded with tons of requests on the Tax Act. But since such crucial environmental decisions are made by these tax committees, it behooves conservationists around the country to look to all the ways in which to change the tax code to win key issues.

On the theory that a good offense is the best defense, conservationists are looking to push an agenda of unfinished reforms in the 100th Congress to include issues like the water depletion allow which were not taken up in the Tax Reform Act as well as issues on which we lost in the 99th Congress.

Notes
1Pub. L. No. 99-514 (signed by the President October 22, 1986).
2Letter from Brent Blackwelder et al. to members of the House Ways and Means and Senate Finance Committees (July 15, 1986).
4WESTERN INTERSTATE ENERGY BOARD, W. ENERGY UPDATE NEWSL., No. 86-16 (Aug. 29, 1986).
8About 10,000 applications have been filed with the Federal Energy Regulatory Commission since 1977.

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