Can Montana Afford an Oil and Gas Tax Holiday?

Tax breaks for energy companies are costing Montana millions

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All Montanans want a state we can be proud of--a state where our children can learn, grow, prosper, and stay to raise their own families. That future depends on our ability to invest in the public structures that educate our children, keep our communities safe, protect our land and water, and provide health care and other services when we struggle to make ends meet.

Like all other states, the Great Recession is threatening Montana's ability to adequately invest in these public structures. State revenues are plummeting, and legislative staff is estimating that the next legislature may face over a $400 million revenue gap.

Montana deserves a balanced approach to this revenue crisis that looks not just at dramatic and harmful cuts to public services, but also targeted efforts to increase revenue. This brief is one in a series of MBPC reports that explores policies to responsibly raise revenue in the state.

Years ago, the legislature created a tax break for oil and gas companies that now costs the state tens of millions of dollars per year, and does not deliver on its promise of economic development. The dollars given to oil and gas companies as a tax holiday would be better spent maintaining public structures like education; public sewers and water systems; good roads and healthy communities that help Montana retain and grow jobs.

In short, the oil and gas tax holiday is costing Montana valuable revenue for public services. It's time to take a hard look at the usefulness of this corporate tax break.

Severance Taxes

A tax on oil, gas or other resource extraction is called a severance tax because it is a tax on severing a nonrenewable resource from the earth. In other words, this tax applies to resources that we cannot recover or use again.

Severance taxes reimburse communities for the permanently reduced value of their land. There is broad agreement today that the severance tax represents good tax policy. The underlying principle is that private companies should compensate Montana for irreversibly removing natural resources from the state.

Severance taxes are based on the value of the resources extracted. The value of the resource varies with the price of the resource and therefore so does the amount of severance tax collected. In Montana, the severance tax on oil and gas extraction is called the oil and gas production tax.[1]

Oil and Gas Tax Holiday

Newly drilled wells in Montana are not subject to the same oil and gas production tax as older wells. Newly drilled wells are taxed at a much lower rate, 0.76 percent versus 9.26 percent.[2] Wells are subject to the lower oil and gas production tax rates for 12 months for vertical wells and 18 months for horizontal wells.[3] The period of substantially lower tax rates has become known as a tax "holiday."

Cost of the Tax Holiday to Montanans

Estimates vary as to the cost of the tax holiday. In 2008, the Montana Department of Revenue estimated that during the five-year period of 2003-2007, $258 million in revenue was lost to the state and counties due to the tax holiday (Table 1). Revenues are split approximately 52/48 between the state and counties, and approximately 90% of the state share goes to the state general fund.[4] Consequently the general fund lost approximately $120 million over the five-year period.

Table 1: Cost of Oil and Gas Tax Holiday, 2003-2007

Year	Oil and Gas Severence Taxes Collected	Cost of Holiday to State	Cost of Holiday to Counties	Total Cost of Holiday	Holiday as a Percent of Oil and Gas Severence Taxes
2003	$71,922,156	$6,732,742	$5,872,810	$12,605,552	18%
2004	$110,747,774	$18,325,284	$15,912,574	$34,237,858	31%
2005	$173,989,848	$37,276,220	$33,075,425	$70,351,645	40%
2006	$197,430,225	$37,374,593	$34,504,817	$71,879,410	36%
2007	$235,479,551	$34,701,200	$33,883,820	$68,585,020	29%
5-Year Total	$789,569,554	$134,410,039	$123,249,446	$257,659,485	33%

Source: Montana Department of Revenue

The cost of the holiday to the general fund for the 2013 biennium is estimated to be over $22 million. Counties will lose over $21 million over the same time period.[5]

The Oil and Gas Tax Holiday is Ineffective Policy

One argument used to justify the oil and gas tax holiday has been that it will encourage more development. However, a comparison of the effective tax rates of our neighboring states casts doubt on that claim.

The table to the right details the production value (the quantity of resources extracted times the price) of fossil fuels and the effective rate of taxation for states in the intermountain West. While actual tax rates vary due to numerous factors--like the length of time a well has been in operation--the effective rate is the average tax rate paid on all extraction.

Montana's effective rate of taxation on oil and gas is lower than both Wyoming and New Mexico. Yet Wyoming and New Mexico have higher total production value.

Table 2: Production Value and Effective Taxes Rates for Fossil Fuel Extraction by State in the Intermountain West

State	Total Production Value	Effective Tax Rate
Wyoming	$19.2 billion	15.9%
New Mexico	$14.5 billion	15.0%
Montana	$3.1 billion	10.4%
Utah	$3.8 billion	9.9%
Colorado	$10.9 billion	6.2%

Source: Headwaters Economics, 2008

In other words, the amount of production does not appear to be related to the effective tax rate.

The evidence continues to mount that repealing the oil and gas tax holiday would not harm, and may actually help, the Montana economy. Three studies in particular are relevant when considering the impact the holiday has had on Montana's economy.

- The Montana-based Headwaters Economics' historical analysis of Montana's tax shows that lower rates have not improved the production in Montana relative to other states. Montana had the smallest growth in production of the five Intermountain states studied after reducing the state's oil and gas rates in 1999.[6] Montana production grew by $2 billion, while production in Wyoming, with a tax rate 50% higher, grew by $10 billion.[7]
- University of Utah Professor of Economics Gabriel Lozada studied Utah's exemptions on oil and gas for development of new wells, and found that eliminating the tax holiday for new wells would result in a less than 1% reduction in new wells. However, severance tax collections would increase by 15-16%. In addition, he asserts that because the additional tax revenue dollars would be spent on other activities within the state, there should be no reduction in economic activity in the state.[8]
- A study commissioned by the Wyoming legislature of Wyoming's oil and gas tax rate found that tax decreases would lead to a very small increase in the number of wells and a large decrease in the amount of revenue to the state.[9]

It is not surprising that oil and gas taxes have little effect on the amount of resources extracted in a state. Oil and gas companies will operate where there is oil and cannot afford to base their decisions on state taxes, which are a small fraction of their total costs.

Oil and Gas as Economic Development

Oil and gas jobs pay well, and they are often located in rural communities remote from cities where job opportunities tend to be greater. Even so, relying on the extraction of oil and gas for economic development alone is not a good overall strategy for communities in the increasingly diverse West. Counties with extractive resources love the boom-times, but fear the bust. In the long-run, these counties are often poorer and have slower job growth than their peers that don't have oil and gas resources (and even recent booms can't measure up to growth occurring in other counties).[10] Extraction counties tend to lack characteristics that will make them competitive in the long run. They have:

- Less economic diversity and resilience,
- A less educated workforce,
- High levels of net outmigration (more people move out than in), and
- Greater disparity in household income levels.[11]

These counties still need jobs, and oil and gas will continue to be part of the mix. But giving these resources away means forgoing other investments that will lead to future prosperity. Responsible taxation retains jobs (the booms will still come), but will allow oil and gas counties to better weather the busts and begin diversifying their economies.

Conclusion

Communities across Montana have lost millions of dollars through this exclusive tax break for oil and gas companies – money that could be invested in schools, infrastructure, and job training. These public structures create the conditions for reliable, long-term development.

Furthermore, research has shown that oil and gas tax breaks do not substantially influence the amount of drilling that occurs, and that drilling alone is not a reliable means to grow the economy over the long run. State taxes are unlikely to influence oil and gas companies' decisions to drill new wells because companies have to drill where the oil exists, and state taxes are a small share of total productions costs.

Montana cannot afford the oil and gas tax holiday. Our state would be better served by using these revenues to invest in communities where our children can learn, grow, prosper, and stay to raise their own families well into the future.

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Endnotes

1. Some have argued that the term "production tax" is a misnomer. See, for example, Gabriel Lozada, "The Effect of Proposed 2009 Tax Changes on Utah's Oil and Gas Industry," December 18, 2008 ("On a final note, "production" of oil and gas is in a sense a misnomer. Oil and gas were produced millions of years ago; none are produced today. The oil and gas industries extract these products today, and if their activity is reduced, more oil and gas will remain in the ground for future generations of Americans to use. So diminishing "production" of oil and gas from Utah today is properly understood not as decreasing the total amount of oil and gas ever extracted from the state, but instead as shifting extraction from today to the future.")
2. These rates apply to the working interest entities on wells drilled after 1999. Entities with a working interest are those that do the work to extract the oil or gas from the ground. In addition to the working interest entity, there is the royalty interest entity that owns the mineral rights, but does not invest in the extraction. There is no tax holiday for royalty interest entities.
3. The current definition of newly drilled wells was created in 1999; severance tax rates were also lowered at that time from 12 percent on oil and 15 percent on natural gas to 9 percent on both. Generally Revise the Taxation of Oil and Natural Gas Production, SB530, Montana Legislature, 1999 Regular Legislative Session (1999).
4. Vern Vogle, "Analysis of Oil and Natural Gas Tax Production Incentives for Production In Calendar Years 2003 through 2007," Montana Department of Revenue, Office of Tax Policy Research, September 2, 2008.
5. This is based on the fiscal note for SB 258, which would have eliminated the oil and gas tax holiday when the prices reach certain thresholds. It was estimated that the price of oil would reach the threshold in all 8 quarters of the 2013 biennium and that gas would reach the threshold in 5 of the 8 quarters. Thus this is a low estimate of the cost of the holiday. Governor's Office of Budget and Program Planning, "SB 0258 Fiscal Note 2011 Biennium," February 3, 2009, http://data.opi.mt.gov/bills/FNPDF/SB0258.pdf.
6. The Intermountain states studied were Colorado, Montana, New Mexico, Utah and Wyoming.
7. Headwaters Economics, "Energy Revenue in the Intermountain West: State and Local Government Taxes and Royalties from Oil, Natural Gas and Coal," October 2008, http://www.headwaterseconomics.org/energy/HeadwatersEconomics_EnergyRevenue.pdf.
8. Gabriel Lozada, "The Effect of Proposed 2009 Tax Changes on Utah's Oil and Gas Industry," December 18, 2008.
9. Shelby Gerking, et. al., "Mineral Tax Incentive, Mineral Production and the Wyoming Economy." December 1, 2000, http://eadiv.state.wy.us/mtim/StateReport.pdf.
10. "As measured by average annual job growth, only one of 26 [energy-focusing] counties ranks among the top 30 economic performers in the West, while during the last energy boom half were top performers. In addition, more than half of EF counties are losing population in the midst of today's energy surge." Headwaters Economics, "Fossil Fuel Extraction as a County Economic Development Strategy: Are Energy-Focusing Counties Benefiting?" September 2008, http://www.headwaterseconomics.org/energy/HeadwatersEconomics_EnergyFocusing.pdf.
11. Headwaters Economics, "Fossil Fuel Extraction as a County Economic Development Strategy: Are Energy-focusing Counties Benefitting?" September 2008, http://www.headwaterseconomics.org/energy/HeadwatersEconomics_EnergyFocusing.pdf.