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CONGRESSIONAL TESTIMONY

Clean Technology: Manufacturing Competitiveness The Role of Tax Incentives

Testimony before Senate Finance Committee Subcommittee on Energy, Natural Resources, and Infrastructure

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J. D. Foster, Ph.D.
Norman B. Ture Senior Fellow in the Economics of Fiscal Policy

The Heritage Foundation

Mr. Chairman, members of the Committee, my name is J.D. Foster and I am the Norman B. Ture Senior Fellow in the Economics of Fiscal Policy at the Heritage Foundation. I am pleased to testify before the Committee on some of the issues surrounding the use of tax incentives with respect to advanced energy manufacturing, most especially the tax credit allocation authority provided in the I.R.C. Section 48 C program. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The advanced energy manufacturing tax credit (MTC) was created as part of the American Reinvestment and Recovery Act of 2009. The MTC provides a 30 percent credit for investments in new, expanded, or re-equipped advanced energy projects. Up to $2.3 billion of MTCs were to be allocated through a joint process of the Department of Energy and the Internal Revenue Service. A qualifying energy project involves the production of:

(1) property designed to produce energy from renewable sources;
(2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric vehicles;
(3) electric grids to support the transmission, including storage, or intermittent sources of renewable energy;
(4) property designed to capture and sequester carbon dioxide emissions;
(5) property designed to refine or blend renewable fuels or to produce energy conservation technologies;
(6) electric drive motor vehicles that qualify for tax credits or components designed for use with such vehicles; and
(7) other advanced energy property designed to reduce greenhouse gas emissions.

In his annual budget submission, President Obama has called for increasing the cap on the available credit by $5 billion, from $2.3 billion to $7.3 billion.

One Perspective on Tax Subsidies

In its "Reasons for Change" discussion, the Treasury Green Book describing the President's Fiscal Year 2010 tax proposals explains with respect to one credit, like other preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the industry than would occur under a neutral tax system. To the extent the credit encourages overproduction, it is detrimental to long-term energy security.

This slightly paraphrased language appears on page 75. To be clear, the reference in the Green Book is to the oil and gas industry and the President's proposals to eliminate fossil fuel preferences, proposals with which I agree fully. However, what is bad for the goose is bad for the gander. Just as these oil and gas subsidies distort economic decisions, so too does the MTC and similar subsidies, and so while the recipient of the subsidy differs, the essential outcome remains the same – it is detrimental to long-term energy security and to the economy -- as Treasury rightly observed.

From this introduction one can quickly surmise my views with respect to the MTC. It is bad energy policy, bad tax policy, and bad economic policy. I do not in the least question the intentions of the credit's supporters, but to adapt a popular aphorism, the road to bad policy is paved with good intentions.

The issue I raise is not the relative advantages of clean energy manufacturing. The issue is the government's bad habit of attempting to pick successful technologies of any sort to favor, and others to disfavor. There is nothing wrong with hoping or expecting that one sort of energy or one sort of technology will ultimately prevail in the marketplace. For example, I have long expected that America would overcome its misplaced phobia over nuclear energy, and I am pleased to see that this is coming to pass as the President's recent comments and the solid nuclear title in the otherwise misguided Kerry-Lieberman climate bill demonstrate.

Moreover, if one believes so firmly in the advantages of one energy or technology over another, we have capital markets that allow one to encourage and participate in its success, or failure. If confidence so merits, one can even take a more proactive approach and become directly involved in some way in the industry.

Tax provisions like the MTC do something else entirely. They involve the power of the federal purse to influence artificially the development of these markets and technologies. Is this taxpayer investment based on any information superior to what the market already has and has processed? No.

Specifically in the case of the MTC, for all their professionalism and due diligence is there any reason to believe the employees at the Internal Revenue Service and the Department of Energy are more adept at picking technologically promising and economically sustainable technologies than the market? On the contrary, the market is vastly superior than even the most sagacious government employee at sifting information and rendering judgments regarding economic viability. No doubt there are some excellent players in fantasy football at both DoE and the IRS, but that does not mean they're qualified to run an NFL franchise.

The approach to public policy evidenced by the MTC is commonplace, unfortunately. A now largely discarded practice is to erect trade barriers to succor and advantage domestic industries, often "infant" industries, hoping they will someday compete effectively. The tax code is replete with subsidies for businesses and individuals to encourage some activities and discourage others. We have a multitude of federal welfare programs garbed as subsidies, price supports, regulatory inhibitions, and marketing compacts such as the various forms of welfare for farmers that goes under the more politically correct label of a farm program. And along with carrots we have sticks, such as the punitive federal excises on so-called "sin" products. The MTC is not in the least unique, but that makes it no less meddlesome and no less harmful to the long-run economic strength of the nation.

The Private Sector Advantage

Markets are not perfect. Markets make mistakes. And government has a modest but clear role to play in the process. But on balance and over time market participants facing price signals undistorted by government policies make fewer mistakes, less costly mistakes, and more quickly correct mistakes. Consequently, private market participants will generally allocate our nation's resources so as to produce the most value at the least cost. Every instance in which government decides it knows best is another instance in which policymakers have decided they know better. Our economy would be stronger if Washington's humility ran deeper.

The process of putting Uncles Sam's big thumb on the market's scales through taxation, through spending, or through regulation is coupled with the process of creating new classes of political supplicants and corporate welfare recipients with their hands out for Washington's goodies. One can hardly blame the companies for participating in this game, but it makes it no less unseemly. If government intends to play Lotto based on political winds using taxpayer dollars, who can blame those who want a ticket?

Further, for those who decry the amount of money spent to influence Washington, they should recognize that the monies spent to influence policy are closely proportional to the monies Washington seeks to influence. The surest way to limit the amount of money seeking to influence decisions over national policy in Washington is to limit the amount of influence Washington has over the nation's money.

Infant Industries and International Markets

Two of the arguments that may be raised to defend the MTC are that the credit is needed temporarily to get the industry moving forward and that the credit is needed for the United States to catch up to other countries in the use and development of advanced energy manufacturing technology. Both arguments miss the mark badly.

The obvious and traditional problem with the temporary tax credit/infant industry argument is that the word temporary is typically redefined over time to include periods that can last for decades. "Temporary" can take on near cosmological dimensions. The "temporary" ethanol tax credit comes to mind.

Another problem is that the industry, protected from the pressures to improve economic efficiency by the subsidy value of the credit typically fails to advance to become internationally competitive. The infant industry argument would be better labeled the "Peter Pan" argument because it means the industry never needs to grow up.

Perhaps the greater danger than simply distorting the marketplace is that the tax credit may condemn the coddled industry to second class status on the world stage. Members looking favorably on the advanced energy manufacturing industry in all its hopes and facets should think carefully upon this very real possibility.

However, if there is a concern about more rapid advances in foreign countries, then the industry is not in a particularly early or "infant" stage, but rather the U.S. industry appears to be in an early stage. Perhaps under the financial encouragements of their own tax subsidies, direct payments, loan guarantees, and the like similar industries in other countries have advanced beyond their U.S. counterparts. If so, interpreting the situation requires a couple facts. First, note that the technology is inherently mobile. As China and India demonstrate powerfully, neither the development nor the application of technologies to the manufacture of goods or the goods manufactured is limited by national boundaries. So the U.S. position likely has little to do with access to technology.

Second, the United States generally offers perhaps the best economic environment in the world to incubate a high-tech industry. We have an enormous market with a solid institutional framework, highly mature capital markets, highly skilled labor, and the best university system in the world. Given the mobility of capital and the advantages of the U.S. economy, if the U.S. lags in this area as some suggest then one of two factors is almost certainly at work. The first is that perhaps the United States has adopted some especially counterproductive policies that restrain this activity, in which case the proper remedy is to correct those policies rather than to offset a bad policy with another bad policy.

The alternative is that these other countries have borne heavy costs in creating subsidies to distort their markets badly so as to gain a temporary advantage. While it is tempting to match these countries foolishness for foolishness, that is not a gap we should seek to close. Their advantage will prove temporary as market distortions accrete while their industries become ever-more dependent on these subsidies to survive in the global marketplace.

Conclusion

The MTC, like so many provisions that litter the tax code, is bad economic policy because it distorts the allocation of the nation's resources – its capital, its labor, its talent, its technological advancements – pushing more resources into these activities than the economics of the market dictate.

The credit is bad energy policy for precisely the reasons the Treasury Department laid out in the context of the oil and gas credits: to the extent the credit encourages overproduction, it is detrimental to long-term energy security.

And of course, the credit is bad tax policy, adding to the litter of special exemptions, deductions, credit, exceptions, and exceptions to exceptions that constitute the sum total of past efforts to micromanage our economy through an already inherently complex income tax system. While calls for examining tax expenditures for review and possible repeal in pursuit of revenues are problematic for a number of reasons, it is abundantly clear that the MTC credit would certainly be captured in any such effort.

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