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Severance Taxes as an Issue of Energy Sectionalism

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SEVERANCE TAXES
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A. Introduction

The energy crisis that began in the mid-1970s exacerbated a long standing conflict between the energy producing states and the energy consuming states. "Freeze a Yankee" jeered the energy producers! In turn, the inhabitants of the producing states were labeled "blue eyed Arabs" by many consumers.

The sectionalist conflict itself dates back at least to the enactment of the percentage depletion allowance and the intangible drilling cost deductions for oil and gas wells in the first half of the century.[1] These tax benefits generally have been supported by both the populations and congressional representatives of producing states as essential elements of a strong oil industry, and a strong oil industry as a key to a strong national economy. On the other hand, the consuming states have tended to view both percentage depletion and the intangible drilling cost deduction as unnecessary subsidies to the oil industry that increase the tax burden their citizens must bear. The balance of power between the groups has shifted back and forth over time, and the debate has often been acrimonious.[2]

The historic tension between the producing and consuming states over energy matters was worsened by the rapid escalation of energy prices in the 1970s and early 1980s. As prices and production soared, the economies of the major producing states boomed.[3] In contrast, the major consuming states found themselves mired in

7 *B.A. with highest honors, Denison 1963; LL.B., Harvard, 1966. Professor of Law and Associate Director of the National Energy Law and Policy Institute, The University of Tulsa. This paper is developed from a joint study of Energy Sectionalism conducted from 1982 to 1984 by the American Bar Association Coordinating Group on Energy Law and the National Energy Law and Policy Institute of The University of Tulsa. Thanks are due to the members of the Committee and to the staff of the study, particularly the Honorable Carol Dinkins, Professor Gary D. Allison, James L. Mitchell, Esq., Robert B. Krueger, Esq. and Nancy C. Dodson, Esq. Copyright American Bar Association Coordinating Group on Energy Law and the National Energy Law and Policy Institute, 1984.

[1]The percentage depletion allowance was created by the Revenue Act of 1932, § 114(b)(3), 47 Stat. 169 (1932). The intangible drilling cost deduction was enacted into law by § 263 of the Internal Revenue Code of 1954. However its existence as a Treasury regulation dates back to February 8, 1917, in Treasury Decision 2447, issued in connection with the Revenue Act of 1916.

[2]In 1975, the consuming states succeeded in virtually eliminating percentage depletion because of the robust state of the oil and gas industry. I.R.C. § 613A, added by the Tax Reduction Act of 1975, Publ. L. No. 94-12, 89 Stat. 47 (1975).

[3]See generally the analysis at Miernyk, "The Differential Effects of Rising Energy Prices or Regional Income and Employment," in H. Landsberg, *High Energy Costs: Assessing the Burden.* (Resources for the Future, Inc. 1980). For a discussion of the likely long-range impacts of high energy prices upon producing and consuming states, see Miernyk, "Regional Economic Consequences of High Energy Prices in the United States," 1 *J. of Energy and Development* 213 (1976), and Miernyk, "Regional Employment and Impacts of Rising Energy Prices." 26 *Labor Law J* 518 (1975). Of course, the major energy producing states in the Sun Belt have had other economic advantages in addition to rising energy prices. Furthermore, the relative advantages of the energy producing states have been substantially and adversely affected by the downturn in oil and gas prices, as is discussed in the text accompanying notes 165-171.

the most severe economic recession since the Great Depression, in part because of high energy prices.

The relative strengths and weaknesses of the states' economies were reflected in their finances. While many consuming states enjoyed only modest revenue increases in the inflationary 70's, the revenues of producing states shot up.[4] For example, personal income tax collections in Oklahoma increased by 270 percent from 1972 to 1980, while comparable collections were up only 163 percent in Michigan, 150 percent in Massachusetts, and 129 percent in Pennsylvania.[5] Corporate tax collections in Oklahoma increased by 221 percent over the same period, but by only 122 percent in Massachusetts, 74 percent in Pennsylvania, and a mere 22 percent in Michigan. Sales tax receipts increased by 207 percent and 334 percent in Texas and Wyoming from 1972 to 1980, but by only 73 percent in Michigan and 94 percent in Ohio.[6] Bonuses, rents and royalties for leases of state-owned lands by Alaska, California, Colorado, Montana, New Mexico, Louisiana, Oklahoma, Texas and Wyoming more than doubled just from fiscal year 1979 to fiscal year 1981.[7] Distributions to the states by the federal government from federal leasing proceeds increased approximately 50 percent just from 1979 to 1980.[8]

Perhaps the clearest example of how producing states have benefited from rising energy prices is severance tax revenues. Total severance tax collections in Fiscal Year 1981 were 124 percent greater than in Fiscal Year 1979 and 770 percent greater than in Fiscal Year 1971.[9] In 1981, eight states obtained 20 percent or more of

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[4]The State of Alaska's revenues increased so much that the legislature tried to rebate a portion of them to its residents. In 1969, that state had a budget of only $124 million. By 1981, its oil revenues totaled $3.7 billion for a popoulation of only approximately 270,000. A statutory dividend distribution scheme that favored long time residents was struck down by the Supreme Court on Equal Protection grounds in Zobel v. Williams, 457 U.S. 55, 102 S. Ct. 2309 (1982).

[5]Statistics developed from COUNCIL OF STATE GOVERNMENTS, *The Book of the States,* 1982-1983, Table 3, p. 378 and COUNCIL OF STATE GOVERNMENTS, *The Book of the States,* 1972-1973, Table 3, p. 206.

[6]*Id.*

[7]Staff Study, Advisory Commission On Intergovernmental Relations, *"State Taxation of Energy Resources,"* Table 19, 3-30 (Information Paper, Preliminary Copy, January, 1983).

[8]*Id,* Table 22, at 3-36.

[9]*Id,* at 3-7.

their total tax collections from energy-related severance taxes.[10] A staff study by the Advisory Commission on Intergovernmental Affairs indicates that rapid growth in severance tax collections, both in real terms and in relation to other revenue sources of the primary producing states, will continue.[11]

Declining or flat prices for oil and gas such as those that prevailed in 1982, 1983 and 1984 will lessen the advantage of the energy producing states. In fact, several states whose reliance upon severance tax income has been heaviest now face budget crises.[12] However, the prospect for the long term is that the primary energy producing states will continue to have a substantial economic advantage over the major energy consuming states, and that advantage will be in part due to their ability to subject energy resources to severance taxation. A variety of concerns about this probability have been articulated. An excellent summary is provided by a staff study of the Advisory Commission on Intergovernmental Relations:

> 1. *Fiscal Disparities.* Energy revenues might result in unacceptably large disparities among states in their ability to finance public services. . . . While fiscal equalization is only of secondary importance in the American federal system, a finding of major new disparities in fiscal capacity could lead to a rethinking of the need for equalizing policies.
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> 2. *Unfair Competition.* The fiscal advantage accruing to producer states might be so large as to result in a distortion in the allocation of economic resources among states and regions. Such an effect might be expected if, for example, energy capacity allows a state to significantly improve its public services and/or offer tax relief to its residents and businesses. This assumes of course that location choices can be affected by fiscal variables.

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[10]The following table summarizes the importance of severance taxes to several states:

State	Severance tax as % of state tax revenues 1979	1980	1981	Severance tax 1981 revenue (Million $)	% revenue increase 1980-81
Texas	18	23	27	2,197	44
Alaska	21	35	50	1,170	131
Louisiana	21	22	29	815	55
Oklahoma	19	25	27	601	38
New Mexico	19	23	27	323	51
Kentucky	7	8	0	194	10
Florida	2	3	3	169	40
Wyoming	25	27	29	138	30
North Dakota	8	12	23	103	134
Michigan	2	3	3	99	19
Montana	14	22	21	99	4
Mississippi	3	4	6	88	66

Source: WORLD OIL, June 1983, p. 207.

[11]Staff Study, *supra* note 7 at 3-10 to 3-15.

[12]Oklahoma is an example. Oil and gas severance tax revenues rose from $135 million in 1979 to $322 million in 1981 and $415 million in 1982. When revenues in 1983 decreased to $399 million, with the expectation of further declines, the state was thrown into a major financial crisis. Forest Lowery, Channel 6 Eyewitness News, 30 Minutes, December 3, 1983. In the spring of 1984, the Oklahoma Legislature adopted a variety of new taxes to cope with the problem.

3. *Tax Exporting.* Energy capacity may allow a state to export a disproportionate share of its tax burden to non-residents. The distribution of tax burdens which results when some states export their tax burden may be considered unfair and may result in retaliatory actions by other states attempting to protect their own citizens' interests. Furthermore, tax exporting weakens the link within a state between public sector benefits and burdens, thereby potentially reducing political accountability and possibly contributing to an excessive expansion of the state-local public sector in some states.

4. *Conflict with National Energy Policy.* Energy is so important to the functioning of the economy that national security requires a lessening of dependence on foreign energy supplies. State tax practices might be obstructing the achievement of this goal by discouraging investment in domestic energy production or by encouraging inefficient production patterns.

5. *Equitable Distribution of "Economic Rents."* The combination of OPEC cartel power and federal policy allowing domestic prices to rise to world market levels has resulted in large "economic rents" or "windfall gains" accruing to domestic energy producers and the governments which can tax them. It may be argued that the current allocation of rents is unfair in that too small a share is going to the federal government which represents all of the consumers who must bear the burden of higher prices.[13]

Because of concerns such as these, state severance taxes became a focal point of sectionalist debate. But are these threats real? And can such pressures be accommodated comfortably within the federal system? This paper will review what has happened and provide an assessment.

B. *Background of Conflict over Severance Taxes*

A severance tax may be defined as:

> a levy assessed at flat or graduated rates by government on the privilege, process, or act of commercially severing or extracting natural resources from the soil or water and measured by the amount of the gross or the net value of the natural resources produced or sold.[14]

Severance taxes are called by a variety of names, including production taxes, license fees and conservation taxes. They come in two basic forms; unit and ad valorem. A unit severance tax is based upon the *amount* of the resource produced; e.g., $.65 per ton of coal. An ad valorem severance tax is based upon the *value* of the production; e.g., seven percent of the market value at the wellhead of natural gas produced and saved. However, unit and ad valorem severance taxes are alike in that they are applied before the resource enters into interstate commerce, triggered by removal of the taxed resource from the ground. They are an excise tax upon the privilege of removing resources from the ground.

Two rationales are advanced to support the imposition of severance taxes. One is that mining or resource production imposes burdens upon the host community

[13]Staff Study, *supra* note 7 at 1-9.

[14]Lockner, "The Effect of the Severance Tax on the Decisions of the Mining Firm," 4 *Nat. Resources L.J.* 468, 469 (1965).

for which it should be compensated.[15] By this view, severance taxes are necessary to repay the levying jurisdiction for damage to its infrastructure, environment, lifestyle and heritage caused by extraction of natural resources. While few argue against this rationale as a guiding principle, many disagreements surface when attempts are made to relate amounts collected in severance taxes to specific damages. The damage to the state and its people is often indirect and hard to value.

A second rationale supporting imposition of severance taxes is the need of the state for revenues to pay for public services, quite apart from those provided to the severing industry.[16] Severance taxes are particularly attractive as devices for fund raising because natural resources are relatively immobile. Imposition of a severance tax on production of coal or oil and gas is less likely to result in a movement of business activity from the state than an increase in the general corporate or individual income taxes, in part because businessmen cannot take the resources with them. More important, to the extent that natural resources produced are used outside of the state, it is possible that a substantial proportion of the burden of severance taxes can be exported to the ultimate consumers. If the burden can be exported then the exporting state enjoys two benefits.[17] First, the price of public goods is effectively reduced, which gives the tax exporting state a competitive advantage over its sister states and may lead to relocation of industry. Second, the real income of citizens of the tax-exporting state is increased because they can buy a larger bundle of public and private goods with a given personal income.[18] The effect of tax exportation upon real income is accentuated by federal grant formulae that make "tax effort," the ratio of personal income to tax burden, an important factor in alloting federal funds. To the extent that a state's taxes are exported, the real personal income of its citizens is understated and its tax effort is overstated.

C. *The Judicial Response to Conflict over Severance Taxes*

1. *The Montana Coal Case: Theory Put to the Test*

Theory is neutral. Conflict comes from its application. No severance tax has aroused more heated debate in recent years than the Montana coal severance tax. Both a desire to compensate the state for the burdens imposed on it by coal development and the need to raise additional general revenues were probably motivating factors in increasing the tax in 1975, when the Montana Legislature

[15]Staff Study, *supra* note 7 at 3-2.

[16]*Id.*

[17]Parker, "State Severance Taxes from Mineral Extraction on Federal Lands," 12 (Congressional Research Service, Library of Congress, Main File Typed Report, Sept. 21, 1982).

[18]*Id.*

raised the state's ad valorem severance tax to a maximum of 30 percent.[19] Value was defined as the price for which coal is sold after extraction and preparation for shipment, f.o.b. at the mine, less production taxes.[20] The effective rate of the tax, about 22 percent in 1979,[21] was substantially higher than any other coal severance tax then in effect. Half of the proceeds from the tax are paid into a permanent trust fund to pay future and unforeseen social and environmental costs of coal stripping.[22]

The stated reason of the State of Montana for the tax increase and the trust fund was that they were necessary to compensate it for loss of its natural resources:

> "Montana's experience had shown that its mineral wealth could be exhausted and exported with little left in Montana to make up the loss of its irreplaceable resources. Montana has been painfully educated about the extreme economic jolts that follow when the mine runs out, the oil depletes, or the timber saws come still. We have a good many examples that teach us what happens to our hills when the riches of our Treasure State are spent. For these and other reasons, when strip coal mining was beginning to burgeon, in 1975, the legislature moved to fix a tax that would provide both for the present and the future when the coal deposits were gone."[23]

Others saw the tax increase differently:

> [C]oal which was taxed at a rate of 34 cents per ton, is now being taxed at a rate of over $2 per ton — an effective increase of over 600%.
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> What, we ask, could justify such an inordinate tax increase? It couldn't be need . . . the states impose a variety of other taxes on coal production and related activity to cover impacts . . . Montana made no attempt to tailor the tax to meet legitimate needs. This was a tax increase justified only by opportunity. Montana knew that there would be an increasing and serious need for coal as a result of the newly developing national energy policy. It knew that a

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[19]Mont. Code Ann. § 15-35-101 to 15-35-107 (1979). Essentially the statute provided for taxation under the following scheme:

Heating Quality (BTU per pound of coal):	Surface Mining	Underground Mining
Under 7,000	12 cents or 20% of value	5 cents or 3% of value
7000 - 8000	22 cents or 30% of value	8 cents or 4% of value
8000 - 9000	34 cents or 30% of value	10 cents or 4% of value

The formula requires that the higher tax figure be used at each stage.

[20]MONT. CODE ANN. § 15-35-102(1) (1979).

[21]Staff Study, *supra* note 7 at 3-7.

[22]The fund was established through an amendment to the Montana Constitution. *See* MONT. CONST. art. IX, § 5. Distribution of tax revenues to the fund is provided for in MONT. CODE ANN. § 15-35-108 (1979).

[23]Commonwealth Edison Co. v. State, 615 P.2d 847, 850 (Mont. 1980). *See also* "Fiscal Disparities: Hearings Before the Subcomm. on Intergovernmental Relations of the Senate Comm. on Governmental Affairs," 97th Cong., 1st Sess. 72 (1981) (Testimony of Senator John Melcher).

> number of midwestern and southern utility companies had entered into long-term contracts to purchase large quantities of Montana coal over the next twenty or so years. It knew that there were pass-through clauses in these coal contracts which would pass the burden of the tax on to consumers in its sister states. Montana sought to capitalize on this opportunity and fixed the rate of the tax at what it thought the market would bear.[24]

The dispute quickly moved to the courts. Four coal producers paid the tax under protest. Along with 11 out-of-state utilities, they filed suit in state court against Montana. They sought refund of all taxes paid under protest, an injunction against further collection of the tax, and a declaration that the tax was invalid under the Commerce and Supremacy Clauses[25] of the U.S. Constitution.

The trial court dismissed the suit and the Montana Supreme Court affirmed,[26] holding that: (1) the tax was not subject to scrutiny under the Commerce Clause because the severance of coal was a "local" event preceding entry of the coal into interstate commerce;[27] (2) even if the tax were subject to such scrutiny, it was valid because it met constitutional requirements;[28] and (3) the severance tax was not unconstitutional under the Supremacy Clause because it did not conflict with any federal law or policy.[29]

Predictably, *Commonwealth Edison Co. v. State* was appealed to the United States Supreme Court.[30] The appeal presented the Court with a difficult line to draw between clear precedent and current theory. The Montana Supreme Court had held the Montana severance tax not subject to scrutiny under the Commerce Clause on the authority of *Heisler v. Thomas Colliery Co.*[31] Under the reasoning of *Heisler*, the validity of a state tax was determined by whether the tax was levied upon goods before or after their entry into interstate commerce. By this reasoning, the distinction between in*tra*state and in*ter*state commerce was crucial. The Commerce Clause was thought to invalidate any direct state taxation of in*ter*state commerce and to permit any tax levied in in*tra*state commerce.

However, though *Heisler* had never been overruled, the United States Supreme Court had moved away from the theory that state taxes on interstate commerce were invalid, while those on intrastate commerce were *per se* valid. Instead, the Court had focused upon "the practical effect of a challenged tax"[32] because it recognized that state taxes on a local activity may affect interstate commerce so significantly that

[24]"Hearings on S. 2695 Before the Senate Comm. on Energy and Natural Resources," 96th Cong., 2d Sess. 249-50 (1980) (Statement of William P. Rogers), quoted in Gray, "Coal Severance Taxes: Outbreak of the Domestic Energy War?," XIV *Nat. Resources Law.* 741 (1982).

[25]U.S. CONST. art. I, § 8, cl. 2 and U.S. CONST. art. VI, cl.2.

[26]Commonwealth Edison Co. v. State, *supra* note 23.

[27]*Id.* at 854.

[28]*Id.* at 855.

[29]In so ruling the Montana Supreme Court considered the following statutes: Powerplant and Industrial Fuel Use Act, Pub. L. No. 95-620, 92 Stat. 3289 (1978), Natural Gas Policy Act, Pub. L. No. 95-621, 92 Stat. 3351 (1978), Federal Nonnuclear Energy Research and Development Act, Pub. L. No. 93-577, 88 Stat. 1878 (1974), Energy Reorganization Act, Pub. L. No. 93-438, 88 Stat. 1233 (1974), Energy Supply and Environmental Coordination Act, Pub. L. No. 93-319, 88 Stat. 246 (1974), Energy Petroleum Allocation Act, Pub. L. No. 93-159, 87 Stat. 627 (1973), and Clean Air Amendments of 1970, Pub. L. No. 91-604, 84 Stat. 1676 (1970).

[30]Commonwealth Edison Co. v. Montana, 453 U.S. 609 (1981).

[31]Heisler v. Thomas Colliery Co., 260 U.S. 245 (1922).

[32]Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 443 (1980).

Commerce Clause scrutiny is appropriate,[33] and that "a State has a significant interest in exacting from interstate commerce its fair share of the cost of state government."[34] In *Complete Auto Transit, Inc. v. Brady,* the Court had held that a state tax affecting interstate commerce does not violate the Commerce Clause if it (1) "is applied to an activity with a substantial nexus with the taxing state, (2) fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the state."[35]

Argument to the Supreme Court focused upon whether the mechanical approach of *Heisler* should be overruled and, if so, whether the *Complete Auto Transit* test was satisfied by the Montana tax. The severance tax unarguably satisfied the first and second prongs of the *Complete Auto Transit* test because the only nexus of the severance of the coal was in Montana, and apportionment was not an issue, since no other state could levy a severance tax on Montana coal.[36] Therefore, only the third and fourth prongs, whether the tax discriminated against interstate commerce and was fairly related to the services provided by the state, were argued. The appeal also addressed the issue of whether the state tax was preempted under the Supremacy Clause.[37]

The majority opinion written by Justice Marshall quickly discarded *Heisler* in favor of the later practical effect tests[38] and moved to consider the validity of the tax under the Commerce Clause. The appellants had asserted that the Montana severance tax discriminated against interstate commerce because ninety percent of Montana coal is shipped to other states under contracts that permit severance taxes to be passed through.[39] As a result, the burden of the Montana tax is borne mainly by non-Montana utility companies and consumers.

Previously, the Supreme Court had ruled invalid Louisiana's "First Use" tax on natural gas, which had insulated Louisianians from its impact by a system of credits and exclusions so that only gas moving out of the state was burdened.[40] It had also disallowed as discriminatory attempts to ban the export of natural resources, such as game,[41] or natural gas,[42] or to prevent the import of undesirable residues, such as wastes, for disposal.[43]

The Supreme Court held the Montana tax to be non-discriminatory.[44] It did not find the differential treatment that it had found in other "discrimination" cases because the Montana tax applied both to interstate and intrastate purchasers of Montana coal.[45] In fact, over 60 percent of Montana's electricity consumers were served by Montana Power Company, which burned only Montana coal in its

[33]*Id.*
[34]Dept. of Revenue etc. v. Ass'n of Wash. Stevedoring Co., 435 U.S. 734, 748 (1978).
[35]430 U.S. 274, 279 (1977) (numbering added).
[36]Commonwealth Edison Co. v. Montana, *supra* note 30 at 617.
[37]U.S. CONST. art. IV, cl. 2.
[38]Commonwealth Edison Co. v. Montana, *supra* note 30 at 617.
[39]*Id.* at 617-18.
[40]Maryland v. Louisiana, 451 U.S. 725 (1981).
[41]Hughes v. Oklahoma, 441 U.S. 322 (1979).
[42]Pennsylvania v. West Virginia, 262 U.S. 553 (1923).
[43]City of Philadelphia v. New Jersey, 437 U.S. 617 (1978).
[44]Commonwealth Edison Co. v. Montana, *supra* note 30 at 629.
[45]*Id.* at 618.

generating plants.[46] The Court stated that the premise of its discrimination cases was that the purpose of the Commerce Clause was to create an area of free trade among the states. "In matters of foreign and interstate commerce there are no state lines."[47] The Court held that:

> Consequently, to accept appellants' theory and invalidate the Montana tax solely because most of Montana's coal is shipped across the very state borders that ordinarily are to be considered irrelevant would require a significant and, in our view, unwarranted departure from the rationale of our prior discrimination cases.[48]

The Court also found that the severance tax complied with the fourth prong of the *Complete Auto Transit Case,* the requirement that a tax be fairly related to the services provided by the state.[49] The appellants had argued that the Court should permit introduction of economic data and analysis so that they could show that the tax was out of proportion to the additional services related to coal extraction provided by Montana.[50] The Court rejected the request, stating that the "fairly related" test did not require that the *amount* of the tax be fairly related to the services provided, but merely that the *measure* of the tax must be "reasonably related to the extent of the contact."[51] Essentially, the Court held that the judicial inquiry under the Commerce Clause into a severance tax levied by a state should be the same as that required by the Due Process Clause,[52] which clearly does not provide a basis for examining the relationship between the amount of a tax and the benefits provided by the state.[53] Where a general revenue tax does not discriminate overtly against interstate commerce, and is assessed proportionately to the taxpayer's activities within the state, as will always be the case with a tax based on production, the state:

> is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society.[54]

A factual inquiry into the relationship between the revenues generated by a severance tax and the costs incurred by the state in providing services to businesses is a matter for legislative inquiry, not for the federal courts, said the Court.[55] The only limitation to the power of the state to decide the proper rate of tax is that:

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[46]*Amicus Curia* Brief of Environmental Defense Fund, Natural Resources Defense Council, and Sierra Club at 5, Commonwealth Edison, 453 U.S. 609 (1981). (Brief in support of appellees).

[47]Charles West v. Kansas Natural Gas Co., 221 U.S. 229, 225 (1911).

[48]Commonwealth Edison Co. v. Montana, *supra* note 30 at 619.

[49]*Id.* at 626.

[50]Brief for appellants at 16, Commonwealth Edison Co., 453 U.S. 609 (1981).

[51]Commonwealth Edison Co. v. Montana, *supra* note 30 at 626.

[52]U.S. CONST. amend. XIV, § 1.

[53]A. Magnano Co. v. Hamilton, 292 U.S. 40 (1934).

[54]Commonwealth Edison Co. v. Montana, *supra* note 30 at 624-625, (quoting State of Wisconsin v. J. C. Penney Co., 311 U.S. 435, 444 (1940)).

[55]Commonwealth Edison Co. v. Montana, *supra* note 30 at 627.

> A taxing statute may be judicially disapproved if it is "so arbitrary as to compel the conclusion that it does not involve an exertion of the taxing power, but constitutes, in substance and effect, the direct exertion of a different and forbidden power, as, for example, the confiscation of property."[56]

Finally, the Court unanimously rejected the claim that the Montana tax was preempted by federal law.[57] The appellants had argued that the severance tax was invalid under the Supremacy Clause of the Constitution because it conflicted with one or more of several federal statutes. The thrust of their argument was that it frustrated the purpose of the Mineral Lands Leasing Act of 1920.[58] Under that Act, economic rents attributable to the mining of coal on federal lands are to be captured by royalty payments to the federal government, which then shares them with the states according to a formula prescribed in the law. It was asserted that the Montana severance tax defeated the purpose of the 1920 Act because it absorbed the economic rents; the royalty is subject to the severance tax,[59] and so the tax diminishes the royalty.

The Court found nothing in the 1920 Act, in its legislative history, or in the legislative history of its 1975 amendments to suggest that Congress meant to capture *all* economic rents from the mining of federal coal. The Act contemplates only a "fair return" to the public.[60] Further, the Court noted that section 32 of the 1920 Act specifically authorized the states to levy severance taxes on federal coal with no suggestion of any limit, and no limit was adopted when the Act was amended in 1975, though Congress was aware of the Montana tax.[61]

Arguments that the Montana tax was preempted by the general purposes of a variety of other federal energy and environmental statutes also failed. The Court found no indication of congressional intent to restrict the right of the states to levy severance taxes. In fact, it noted in the course of its statutory review that section 601 of the Powerplant and Industrial Fuel Use Act of 1978[62] and the legislative history supporting it impliedly sanctioned the Montana taxes. The Act provides federal assistance to areas badly affected by increased coal or uranium mining where the state governor certifies that the state or local government lacks the resources to meet increased demand for services and facilities,[63] but it requires that revenues from severance taxes be taken into account in the decision.[64]

Essentially, the United States Supreme Court adopted a "hands off" policy toward state severance taxes in *Commonwealth Edison Co. v. Montana.* While it overturned its *Heisler* position that state severance taxes were not subject to Commerce Clause scrutiny by the federal courts, it defined the required review so as

[56]*Id.* at n. 17 (quoting A. Magnano Co. v. Hamilton, *supra* note 53 at 44 (1934)).

[57]*Id.* at 632.

[58]Mineral Lands Leasing Act, ch. 85, 431 Stat. 437 (1920) (codified as amended at 30 U.S.C. § 181 (1976 Supp. III 1979)).

[59]Brief for appellants at 16, Commonwealth Edison Co., 453 U.S. 609 (1981).

[60]Commonwealth Edison Co. v. Montana, *supra* note 30 at 632 (citing H.R. No. 681, 94th Cong., *2d* Sess. 17-18, reprinted in 1976 U.S. Code Cong. & Ad. News 1943, 1953).

[61]*Id.* at 632.

[62]42 U.S.C. § 8401(a)(1) (1976 & Supp. III 1979).

[63]Commonwealth Edison Co. v. Montana, *supra* note 30 at 634-35.

[64]*Id.* at 635.

[65]A. Magnano Co. v. Hamilton, *supra* note 53 at 44.

to give the states the broadest possible leeway in structuring severance taxes. A state severance tax may not be overtly discriminatory, as it will not be if it is applied to production consumed within the state as well as that shipped out of state. Nor may a state severance tax be designed to exercise a "forbidden power,"[65] such as confiscation of property under the pretext of taxing it; e.g., a 1000% severance tax might run afoul of this limit.[66] Within these broad limits, however, the states have discretion to structure severance taxes and determine rates subject only to congressional, not judicial, review. There is no constitutional requirement that a severance tax be structured to impose burdens only in proportion to the benefits conferred upon taxpayers. The only benefit to which taxpayers are constitutionally entitled is the " 'enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes.' "[67]

2. *Indian Severance Taxes*

Less than a year after *Commonwealth Edison Co. v. Montana,* the U.S. Supreme Court upheld a severance tax on oil and gas applied by an Indian tribe. Its opinion extended the principles that underlay the broad discretion given the states to levy severance taxes.

In 1976, the Jicarilla Apache Tribe in Northwestern New Mexico adopted a unit severance tax of $.05 per MMBTU on gas and $.29 per barrel of oil produced on the reservation.[68] These rates amounted to approximately 29 percent of the price for which "old" regulated gas was sold and approximately 12.5 percent of the price for which price-regulated oil was sold. The tax was approved by the Secretary of Interior,[69] as the tribal constitution required. Appellants, who held leases that predated the severance tax, challenged the tax and a federal district court enjoined its enforcement. However, the Tenth Circuit Court of Appeals reversed,[70] and certiorari was accepted by the Supreme Court.

The argument of the appellants in *Merrion v. Jicarilla Apache Tribe*[71] was three-pronged. First, they asserted that the tribe's authority to tax outsiders who do business on the reservation was implied from its right to exclude them, but since the Jicarilla tribe had not conditioned its leases upon payment of a severance tax, the tribe had no right to impose one in 1976.[72] Second, they argued that the severance

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[66]Montana had argued that it was free to tax its coal even at a 1000 percent rate under the *Heisler* principle. Justice Blackmun's dissent asserts that the decision in Commonwealth Edison Co. "implicitly ratifies" that contention. 453 U.S. at 645. However, such a rate would probably be viewed as beyond the pale of legitimate revenue raising. Williams, "Severance Taxes and Federalism: The Role of the Supreme Court in Preserving a National Consumer Market for Energy Supplies," 53 *Colo. L. Rev.* 281 (1982). Some commentators disagree, however. One commentator has said that "States with informed draftsmen can now make any tax rate constitutional by merely giving the tax the proper labels." Note, "Commerce Clause Restraints on State Taxation of Energy Resources: A Suggested Framework for Analysis." 60 *Wash. U.L.Q.* 425, 448 (1982).

[67]Commonwealth Edison Co. v. Montana, *supra* note 30 at 629 (quoting Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 522 (1937)).

[68]Merrion v. Jicarilla Apache Tribe, 455 U.S. 130, 136 (1982).

[69]*Id.*

[70]Merrion v. Jicarilla Apache Tribe, 617 F.2d 537 (1980) (en banc).

[71]Merrion v. Jicarilla Apache Tribe, *supra* note 68 at 149.

[72]*Id.* at 137.

tax was preempted by federal legislation because it was inconsistent with the regulatory scheme for leasing and developing oil and gas resources on Indian lands or with national energy policies.[73] Finally, they insisted that the tax violated the Commerce Clause because it discriminated against and imposed a multiple burden upon interstate commerce.[74]

Justice Marshall, again writing for the Court, rejected the first argument on two grounds. First, *Washington v. Confederated Tribes of Colville*,[75] had upheld the right of Indians to tax as one of the sovereign powers of the tribe. Citing *Commonwealth Edison Co. v. Montana*, he found "nothing exceptional in requiring petitioners to contribute through taxes to the general costs of tribal government,"[76] though the tribe already collected rents and royalties under its leases. He noted, however, that the tribe's sovereign authority to tax is subject to limitations because "the federal government can take away this power, and the Tribe must obtain the approval of the Secretary before any tax on nonmembers can take effect."[77] Second, in holding that, even if the tribe's power to tax derives from its power to exclude outsiders, a failure to exercise the power when a mineral lease is granted does not bar its exercise later, he stated:

> It is one thing to find that the Tribe has agreed to sell the right to use the land and take from it valuable minerals; it is quite another to find that the Tribe has abandoned its sovereign powers simply because it has not expressly reserved them. . . .[78]

Marshall's opinion for the majority also rejected the preemption argument. It found that the provisions of the Indian Mineral Leasing Act of 1927[79] permitting the states to levy severance taxes on production from Indian lands did not preempt the tribes from levying their own taxes.[80] It found nothing in the Indian Mineral Leasing Act of 1938[81] or in national energy policies inconsistent with tribal severance taxes.[82]

In addition, the majority questioned whether Commerce Clause review standards applied to Indian tribes, since the relationship between the tribes and the states is a matter for the "political departments of government."[83] Further, the majority said, it is appropriate for the courts to determine whether commerce is unduly burdened or discriminated against only where Congress has not acted. "When Congress has struck the balance it deems appropriate, the courts are no longer needed. . . ."[84]

Finally, the Court held that the four-pronged test of *Complete Auto Transit* would

[73]*Id.* at 149-52.
[74]*Id.* at 152-53.
[75]Washington v. Confederated Tribes of Colville, 477 U.S. 134 (1980).
[76]Merrion v. Jicarilla Apache Tribe, *supra* note 68 at 138.
[77]*Id.* at 141.
[78]*Id.* at 146.
[79]Indian Mineral leasing Act, Ch. 299, § 4, 41 Stat. 1347, (1927) (codified at 25 U.S.C. 398(c) (1971)).
[80]Merrion v. Jicarilla Apache Tribe, *supra* note 68 at 151.
[81]25 U.S.C. §§ 396(g) (1971).
[82]Merrion v. Jicarilla Apache Tribe, *supra* note 68 at 150.
[83]*Id.* at 153.
[84]*Id.* at 154.

be met if scrutiny were necessary.[85] The appellants asserted that the severance tax discriminated against interstate commerce because it exempted minerals sold on the reservation.[86] The Court interpreted the ordinance to exempt only production taken "in kind" by the Tribe, and held the exemption was not discriminatory because it merely avoided "administrative make-work" from the Tribe taxing itself.[87]

Thus, barring congressional action to limit their powers, both the states and the Indian tribes have broad discretion to structure and collect severance taxes.[88] Virtually any severance tax that does not overtly discriminate in favor of local citizens and against interstate commerce and that does not amount to a confiscation will be upheld. The judicial response to sectionalist conflicts over severance taxes has been to defer to the Congress.

D. Legislative Response to Conflict over Severance Taxes

It seems apparent from the reasoning of the U.S. Supreme Court in *Commonwealth Edison Co. v. Montana* and *Merrion v. Jicarilla Apache Tribe* that any substantial limitation upon severance tax rates must come from Congress. Because of these cases, Congress has considered imposing a variety of limitations upon the states' and tribes' power to impose high severance taxes. Whether action could be sustained and whether it is likely to be forthcoming are the issues explored in this section.

1. *Congressional Power under the Commerce Clause*

The Commerce Clause of the U.S. Constitution specifically gives Congress the power "to regulate commerce . . . among the several states."[89] That power has been interpreted very broadly in the twentieth century. Any activity that has a "substantial economic effect" may be regulated.[90] Such diverse activities as child labor, prostitution, sales of food and drugs, and strip mine reclamation have been held to have substantial economic effect upon interstate commerce and to be subject to regulation under the Commerce Clause. A variety of energy taxes and subsidies, including the Crude Oil Windfall Profit Tax, energy tax credits, and regulation of the price of natural gas have been enacted on the basis of "substantial economic effect." Where interstate commerce is substantially affected, the Commerce Clause gives Congress virtually unlimited power which is circumscribed only by *internal* limitations inherent to the political system and by the *external* limitations imposed by the Constitution.[91]

Internal limitations upon legislative initiative under the Commerce Clause are recognized by the principle that "unless Congress conveys its purpose clearly, it will

[85]*Id.* at 156.
[86]*Id.* at 157.
[87]*Id.* at 158.
[88]Because of the large amounts of energy resources in tribal lands, the power to tax is significant. The Council of Energy Resource Tribes has estimated that its member tribes own approximately one-third of Western coal suitable for strip mining, forty percent of non-government owned uranium, and four to five percent of onshore oil and gas resources.
[89]U.S. CONST. art. I, § 8, cl. 2.
[90]NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937).
[91]L. Tribe, *American Constitutional Law,* § 5-20, p. 303 (1978).

not be deemed to have significantly changed the federal-state balance."[92] This has been called the "clear statement" principle.[93] It is a real limit on congressional power because it may be impossible to identify any clear legislative intent to an enactment. The members of the majority voting for the law may have done so for differing reasons, none of which may show on the record. However, if the legislative process clearly indicates the intention of Congress to act under the Commerce Clause to invalidate a state law, or to withdraw from the states and Indian tribes the right to act in certain areas, that intention will likely to be given effect by the courts. "If Congress wishes to utilize the full reach of its power, it need only say so."[94]

External limitations upon congressional action under the Commerce Clause are those imposed by conflicting provisions of the Constitution, itself. Even here, the courts will give deference to congressional determinations. An example is *U.S. v. Ptasynski*,[95] where it was argued that the Uniformity Clause, which says that excise taxes must be "uniform throughout the United States,"[96] invalidated the Windfall Profit Tax.[97] The argument was that the act was unsupportable because it exempted certain newly discovered Alaskan oil. "Distinctions based on geography are simply not allowed,"[98] a district judge had held. However, the Supreme Court held that Congress may consider geographically isolated problems, though the courts will examine such classifications closely to see if there is actual geographic discrimination.[99] Applying that test, the Court found the Windfall Profit Tax constitutional because "exempt Alaskan oil" was subject to "disproportionate costs and difficulties," which justified its special treatment.[100] It noted that "where . . . Congress has exercised its considered judgment with respect to an enormously complex problem, we are reluctant to disturb its determination."[101]

In appropriate circumstances, the Tenth Amendment[102] to the Constitution may be an important external limit to congressional power under the Commerce Clause to control the levy of severance taxes. The purpose of the Tenth Amendment is to preserve for the states some of the independence that they had enjoyed before their entry into the Union.[103] The power of the states to tax has been consistently recognized. "Matters of State taxation are reserved to the states under the tenth amendment to the Constitution. . . . The power of the State legislature to levy and collect taxes is unrestricted where such tax is not otherwise unconstitutional."[104]

Because of the importance of the right of the states to levy taxes, direct attempts to limit state taxation of natural resources might be held improper under the Tenth

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[92]U.S. v. Bass, 404 U.S. 336, 349 (1971).

[93]L. Tribe, *supra* note 91, at § 5-8, p. 243.

[94]*Id.*

[95]United States v. Ptasynski, ___ U.S. ___ 103 S. Ct. 2239 (1983).

[96]U.S. CONST. art. I, § 8, cl. 1.

[97]I.R.C. § 4986 (Supp. IV, 1980).

[98]Ptasynski v. United States, 550 F. Supp. 549, 553 (1982).

[99]United States v. Ptasynski, *supra* note 95 at 2245.

[100]*Id.*

[101]*Id.* at 2246.

[102]U.S. CONST. amend. X provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

[103]L. Tribe, *supra* note 91, § 5-20, p. 301.

[104]Snow v. Dixon, 66 Ill. 2d 443, 362 N.E.2d 1052, 1062, *cert. denied*, 434 U.S. 939 (1977).

Amendment. In *National League of Cities v. Usery*,[105] the Supreme Court upheld the contention of several cities and states that the Tenth Amendment precluded federal regulation under the Commerce Clause that extended federal minimum wage and hour provisions to most of their public employees. It found that applying such regulation to the states would "impermissibly interfere with the integral governmental functions" of the states because it would so substantially affect the states' allocation of funds and provision of services.[106] The Court suggested that any federal action that "impairs the state's integrity,"[107] requires "relinquishment of important governmental activities,"[108] "interferes with traditional aspects of state sovereignty,"[109] or imposes directly upon the states federal choices "as to how essential decisions regarding the conduct of integral government functions are to be made"[110] would violate the Tenth Amendment.

This broad language was clarified in the companion cases of *Hodel v. Virginia Surface Mining and Reclamation Association*,[111] and *Hodel v. Indiana*[112] upholding the Surface Mining Control and Reclamation Act of 1977[113] against assertions that it robbed the states of the freedom to deal with restoration of strip mined lands within their borders. In *Hodel v. Indiana*, the Court restated a premise of deference to Congress, noting that:

> [L]egislative Acts adjusting the burdens and benefits of economic life ... [have] a presumption of constitutionality.... A court may invalidate legislation enacted under the Commerce Clause only if it is clear that there is no rational basis for a congressional finding that the regulated activity affects interstate commerce, or that there is no reasonable connection between the regulatory means selected and the asserted ends.[114]

In the *Virginia Surface Mining* case, the Court interpreted *National League of Cities* as setting a three-pronged test that must be met if federal legislation is to be invalidated by the courts:

> First, there must be a showing that the challenged statute regulates the 'States as States....' Second, the federal regulation must address matters that are indisputably 'attributes of state sovereignty....' And third, it must be apparent that the States' compliance with the federal law would directly impair their ability 'to structure integral operations in areas of traditional functions.'[115]

Unless all three parts of the test are breached, the legislation is valid.

If this test were applied to federal legislation limiting severance taxes, the first

[105]National League of Cities v. Usery, 426 U.S. 833 (1976).

[106]*Id.* at 851.

[107]*Id.* at 843, (quoting Fry v. U.S., 421 U.S. 542, 547 n. 7).

[108]*Id.* at 847.

[109]*Id.* at 852.

[110]*Id.* at 855.

[111]Hodel v. Virginia Surface Min. and Reclam. Ass'n., 452 U.S. 264 (1981).

[112]Hodel v. Indiana, 452 U.S. 314 (1981).

[113]30 U.S.C. § 1201 (1979).

[114]Hodel v. Indiana, *supra* note 112 at 323-24 (quoting Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 15 (1978)).

[115]Hodel v. Virginia Surface & Min. Reclam. Ass'n., *supra* note 111 at 287-88.

two parts of the disabling test would likely be met. Certainly legislation limiting levy of severance taxes by the states affects the states as states. Likewise, the power to tax is an attribute of state sovereignty and essential to their existence as separate entities.[116] Only as to the third requirement, direct impairment of the states' ability to structure integral operations, is there real doubt. A logical argument can be made that a severe restriction on severance tax rates could "directly impair" state functions such as conservation of natural resources and provision of services, at least in those states in which severance taxes are an important component of state finances. Determination of whether federal regulation under the Commerce clause constitutes a forbidden impairment of the states' sovereignty calls for a balancing of federal and state interests,[117] and the weight of the balance is not clear.

While the federal courts would be deferential to efforts of Congress to limit severance tax rates, the cases in which the *National League of Cities* doctrine has been held to have been satisifed are distinguishable. Establishment of a maximum severance tax rate would be a more direct and severe limitation on the states than any yet tested. In the *Virginia Surface Mining* case,[118] federal legislation setting minimum surface restoration provisions for the states was upheld. However, the states retained the right to set higher standards and, indeed, did not have to address the issue at all.[119] In *FERC v. Mississippi*,[120] provisions of the Public Utility Regulatory Policies Act of 1978 requiring that state public utility commissions "consider" specific rate designs and regulatory standards and adopt regulations to achieve certain goals were upheld.[121] However, the Court made a point of noting that nothing in the Act required exercise of the states' sovereign powers or set standards that had to be followed in all state regulation.[122] In contrast, the proposed severance tax legislation would set a maximum rate rather than mere minimum standards. In addition, severance taxes may be fiscally essential to some of the energy-rich states having no other feasible way of raising needed revenues. Therefore, the disabling test of *National League of Cities v. Usery* might be triggered by legislation limiting severance tax rates.[123]

An alternative to direct limitation upon the rate of severance taxes is *indirect* limitation by forbidding the states to apply such taxes to resources from federal lands within their borders. Since a large percentage of Western energy resources lie

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[116]Nathan v. Louisiana, 49 U.S. (8 How.) 73 (1850).

[117]Hodel v. Virginia Surface & Min. Reclam. Ass'n., *supra* note 111 at 287-88.

[118]*Id.* at 264.

[119]If the state does not act, a federal reclamation program is established for it. 91 Stat. 447, § 504.

[120]FERC v. Mississippi, 456 U.S. 742 (1982).

[121]Titles I, III and Section 210 of the Public Utilities Regulatory Policies Act, Pub. L. No. 95-617, 92 Stat. 3117 (1978), (codified at 16 U.S.C. § 2601 and 15 U.S.C. § 3201 (Supp. V 1981)).

[122] FERC v. Mississippi, *supra* note 120 at 771.

[123]As has been noted above, energy severance taxes provided 20 percent or more of state revenues in eight states in 1981. See the text at note 10. *See also*, Bradford, "Beyond Commonwealth Edison Co. v. Montana: Direct Congressional Limitations on State Taxation of Natural Resources," 9 *J. Corp. Tax*, 253 (1982), and Wilson, "Severance Taxes, Energy Resources, and Blue-Eyed Arabs: 'Is the Power to Tax the Power to Survive?'", 29 (Bureau of Governmental Research and Service, University of Colorado, Boulder, July 1981). However, one commentator has concluded that imposition of a 12½ percent ceiling "is unlikely to meet any serious constitutional challenges." Note, "Commerce Clause Restraints on State Taxation of Energy Resources: A Suggested Framework for Analysis," 60 *Wash. U. L. Q.* 425, 455 (1982).

under federal lands, such a restriction would be a substantial limitation upon the taxing power of the states.[124] Presently, section 32 of the Mineral Lands Leasing Act,[125] expressly confers authority on the states to tax mining activities on federal lands. It is not clear whether the states would have the power to tax private lessees absent section 32. Congress was itself not sure in 1920 when it enacted the mineral lands leasing legislation and for this reason included section 32.[126] Both the principle of federal sovereign immunity and plenary congressional authority under the Property Clause arguably would support a federal law limiting the applicability of state taxes to federal lands.[127]

Tenth Amendment restrictions may apply to federal limiting legislation also, though such legislation would be based upon the federal government's powers under the Property Clause[128] and not the Commerce Clause. The *National League of Cities* test has been applied by the Supreme Court only to legislation enacted under the Commerce Clause, and federal power over federal lands has been termed "without limitations" by the Court.[129] However, the *National League of Cities* decision explicitly reserved the issue of "whether different results might obtain if Congress seeks to affect integral operations of state governments by exercising authority granted it under other sections of the Constitution . . .",[130] and was specifically discarded as inappropriate where the issue was Congress' power to enforce the substantive provisions of the Civil War Amendments.[131] One view is that *National League of Cities* is based upon a concern that the states should not lose the autonomy essential to their viability, rather than upon any special attribute of the Commerce Clause.[132] If so, its limits should apply to legislation enacted by Congress under the Property Clause as well as the Commerce Clause.

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[124]For example, 70-75% of Montana's coal lies under federal lands. Commonwealth Edison Co. v. Montana, *supra* note 30 at 608-609.

[125]33 U.S.C. 189 (1971).

[126]*See* 51 Cong. Rec. 14953, 14954-14955, 15039, 15055, 15060, 15064-15065, 15558-15559 (1914); 53 Cong. Rec. 980-981 (1916); 58 Cong. Rec. 7770-7774 (1919).

[127]*See* Maryland v. Louisiana, 451 U.S. 725, 752-54 n.26 (1981), suggesting that Congress could prohibit state taxes on natural resource mining on federal lands. For a full discussion of the extent of the Property Clause power, see Gaetke, "Congressional Discretion Under the Property Clause," 33 *Hastings L. J.* 381 (1981) and Frank and Eckhard, "Power of Congress Under the Property clause to Give Extraterritorial Effect to Federal Lands Law: Will 'Respecting Property' Go the Way of 'Affecting Commerce'?", XV *Nat. Res. Law* 663 (1983).

[128]U.S. CONST. art. IV, § 3, cl. 2, which provides: "The Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States; and nothing in this Constitution shall be so construed so as to Prejudice any Claims of the United States, or of any particular State."

[129]Kleppe v. New Mexico, 426 U.S. 529, 539 (1976).

[130]National League of Cities, *supra* note 105 at 852 n.17.

[131]City of Rome v. U.S., 446 U.S. 156, 179-180 (1980).

[132]Comment, "The Property Power, Federalism, and the Equal Footing Doctrine," 80 *Colum. L. Rev.* 817, 830 (1980). In addition it should be noted that the National League of Cities test could be overruled or weakened by the Court. The argument has been made that *National League of Cities* "is inconsistent with the central purpose of the Constitution itself. . . ." by Justice Stevens concurring in EEOC v. Wyoming, ___ U.S. ___, 103 S.Ct. 1054, 1067 (1983).

2. *Congressional Reticence to Act*

Despite the suggestion in *Commonwealth Edison Co. v. Montana* that Congress could limit state severance taxes, Congress has been slow to act. Bills have been introduced in the last three sessions of Congress to limit the maximum rate of severance taxes to 12.5 percent[133] but no final action has been taken on any proposal. Proponents have not been able to muster the political muscle for passage of these direct limitations for a variety of reasons.

One reason Congress has failed to act has been uncertainty about the incidence of severance taxes. Are they substantially exported from producing states to consuming states? The assumption that they are exported is the rationale of limiting legislation. However, the facts have not been clear.

The extent to which a given severance tax is actually exported from the levying state to consumers depends upon the market dominance of the state imposing the tax and the degree of inelasticity of the demand of the consuming public. Unless the producing state has a large share of the productive capacity of the resource, competition from other producing states will force the resource's local extractors to absorb the tax.[134] If consumers have readily-available alternative sources of the commodity, if they can substitute another resource for it (as large energy users frequently do), or if they can do without it altogether, then the tax cannot be exported.

Market dominance and demand elasticity may be determined by legal institutions, as well as by the laws of supply and demand. Environmental restraints upon sulphur emissions may give states with deposits of low sulphur coal market dominance.[135] Long term contracts with "pass through" provisions for variable costs such as severance taxes may make demand for the resource more inelastic.[136]

There is no general agreement among economists as to whether the incidence of severance taxes is exported. It has been argued that no state has the market dominance necessary,[137] and that a cartel of producing states would not be stable.[138]

[133]S. 463, 98th Cong., 1st Sess., 129 Cong. Rec. S 1073-75 (daily ed. Feb. 3, 1983); H.R. Res. 2690, 98th Cong., 1st Sess., 129 Cong. Rec. H2313, E1803-04 (daily ed. Apr. 21, 1983).

[134]To the extent that local extractors have out of state stockholders, an absorbed tax may be effectively exported.

[135]Approximately 86% of the low sulphur coal reserves of the U.S. are located west of the Mississippi River. P. Hamilton, *The Reserve Base of U.S. Coals on Sulphur Content – The Western States,* 2 (U.S. Bureau of Mine Circular 8693, 1975). Montana and Wyoming control 68% of U.S. low sulphur coal reserves and, in fact, that coal is in high demand because of the environmental restraints of legislation such as the Powerplant and Industrial Fuel Use Act of 1978, Pub. L. No. 95-620, § 102(a)(2), 92 Stat. 3298. *See* H.R. Rep. No. 1527, 96th Cong., 1st Sess., 3 (1980), quoted by J. Blackmun, dissenting in Commonwealth Edison Co. v. Montana, *supra* note 30 at 638. According to another source, Montana alone has 40% of low sulphur coal reserves. "Fiscal Disparities: Hearings Before the Subcomm. on Intergovernmental Relations of the Senate Comm. on Governmental Affairs," 97th Cong., 1st Sess. 9 (1981) (Testimony of William P. Rogers).

[136]Allegedly, 90% of coal mined in Montana was sold to purchasers in other states under long term contracts with "pass through" provisions. H.R. Rep. No. 1527, 96th Cong., 1st Sess., 3-4 (1980) quoted at 453 U.S. at 639.

[137]McLure, "Severance Taxes on Energy Resources in the United States: Comment," 10 *Growth and Change* 72, 72-73 (1979).

[138]Shelton and Morgan, "Resource Taxation, Tax Exportation and Regional Energy Policies," 17 *Nat. Resources J.* 261, 282 (1977).

On the other hand, others have concluded that a substantial portion of the incidence of severance taxes *is* exported.[139] Both groups have been cautious in their conclusions, however.[140] A neutral observer has noted:

> One must be cautious in interpreting the results of existing interstate tax exportation studies. The incidence assumptions for many business taxes remain a subject of debate, the data for allocating tax payments by residents must be improved, and the treatment of the Federal offset has a substantial effect on the estimates.[141]

The scenario is clouded further by the likelihood that market conditions will not be stable, so that the incidence of taxes may be exported at one time but absorbed at another.

A second reason for congressional inaction is disagreement over whether export of severance taxes, if it occurs, would be unfair. To the extent that severance taxes are necessary to compensate the levying state for damage to its environment and for the costs of developing and supporting the infrastructure required to support the extraction of the resource, then even if taxes are exported to ultimate consumers, they are not unfair. Those who reap the benefits of the energy should pay its real costs. Despite derision from consumer states, the producing states have argued forcefully that this is the case:

> While a 30 percent tax of any sort may seem excessive at first, a more careful analysis suggests that projected revenue in the energy-producing states will just about balance out with needed increases in public outlays for education, public safety, roads, water, health care and land reclamation associated with rapid energy development.[142]

The facts may differ from state to state. North Dakota, for example, may have actual costs associated with mining and use of its coal to generate electricity which is exported that exceed 12½ percent, while Montana might be able to recoup all of her costs by other existing levies.[143]

Likewise, to the extent that energy severance taxes exported by the producing states are offset by other taxes that are imported, the severance taxes are not unfair. It is inevitable that there will be economic "give and take" among the states in our

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[139] *See* R. Posner, *Economic Analysis of Law* 509-514 (2d Ed. 1977), and Shelton & Vogt, "The Incidence of Coal Severance Taxes: Political Perceptions and Economic Realities," 22 *Nat. Res. J.* 539, 557 (1982). *But see* Hellerstein, "Constitutional Constraints on State and Local Taxation of Energy Resources," 31 *Nat. Tax. J.* 245, 248-49 (1978); McLure, "Economic Constraints on State and Local Taxation of Energy Resources," 31 *Nat. Tax J.* 256, 159 (1978); Gillis, "Severance Taxes and Energy Resources in the United States: A Tale of Two Minerals," 10 *Growth and Change* 55, 63 (1979); and McLure, *supra* note 137 at 72.

[140] For example, two economists conclude that 29 percent to 40 percent of coal severance taxes are passed through to consumers, with the percentage of western taxes shifted to midwestern consumers even higher, but note that "a conservative estimate of two standard deviations yields a plus or minus 10% range" of error. Shelton and Vogt, "The Incidence of Coal Severance Taxes: Political Perceptions and Economic Realities," 22 *Nat. Resources J.* 539, 555 (1982).

[141] Parker, *supra* note 17 at 19. *See also,* Miernyk, 1 *J. of Energy and Development, supra* note 3 at 321.

[142] Southern States Energy Board, *State Severance Taxes: The Growing Debate over Regional Differences* 3 (Dec. 1981).

[143] See the discussion at Note, "Commerce Clause Restraints on State Taxation of Energy Resources: A Suggested Framework for Analysis," 60 *Wash. U.L.Q.* 425, 456 notes 177 and 178 (1982).

federal union. In this respect, it is interesting to note that one of the studies on tax exportation reveals that the highest net tax export rates belong to Delaware and Nevada, neither of which are primarily reliant upon energy severance taxes.[144] Again, the energy-producing states have made the argument forcefully:

> To single out severance taxes on energy and to attempt to limit that particular tax overlooks many other taxes imposed by states on a vast range of commodities and services, all of which are exported to some extent to the consumers of other states. Should Michigan's power to impose a tax on an automobile manufactured in that state also be limited? Should we continue to allow New York to impose a transfer tax on each transaction on the New York Stock Exchange regardless of the stockholder's state of residence?[145]

The basic problem is that severance taxes cannot be analyzed in isolation. They are only one of a "crazy quilt" scheme of local, state, and federal taxes and subsidies, whose basis and impact are often hard to discern.

A third reason for congressional inaction on legislation to limit severance taxes is that, despite the recent increase in their relative importance, they are still small items in the big picture of government finance and economic activity. The Montana coal tax was a political *cause celebre,* but it raised only about $70 million in fiscal 1981.[146] Total collections in all states from severance taxes were less than $6.5 billion that year.[147] That amounted to only 4.3 percent of total tax collections of state governments in 1981.[148] In addition, although the rates of some severance taxes are high, their impact has not been severely felt by most consumers because they have been lost amid other inflationary pressures and because the price of the resource at the wellhead or mine is often a relatively small component of its price to the consumer; e.g., it has been asserted that the 30% Montana severance tax on coal adds two percent to the annual electricity bills of Midwestern consumers.[149]

Fourth, while Congress waited for the courts to decide the Constitutional issues of *Commonwealth Edison Co. v. Montana,* it enacted a variety of direct and indirect subsidies that more than offset the impact of whatever portion of energy severance taxes are exported from producing states to consuming states. A subsidy is the opposite of a tax. To the extent that energy usage is subsidized, the subsidy negates taxes paid on the energy used. With subsidies, the federal government can make redistribution of income that offset (or emphasize) sectionalist taxes. At least three kinds of energy subsidies were contained in legislation enacted in the late 1970's and early 1980's: (1) transfer payments from producers to consumers; (2) incentives to develop existing energy resources, and (3) subsidies to promote development and use of new energy resources, including conservation.

[144]C. Phaares, *Who Pays State and Local Taxes?* (Oelgeschlager, Gunn & Hain Publishers, Inc., Cambridge, Mass. 1980). Table 4-5.

[145]Southern States Energy Board, *supra* note 142 at 2. To some extent, this reasoning begs the question. There is a fundamental issue of fairness raised where citizens of one state are subject to the political externality of taxes imposed by another state without direct representation of their interests. That such a circumstance is inherent in a federal system does not make it fair.

[146]Staff Study, *supra* note 7 at 3-11.

[147]U.S. Dept. of Commerce, Bureau of The Census, "State Government Tax Collections in 1981," Table 3, p. 7 (GF81 No 1).

[148]Staff Study, *supra* note 7 at 3-7.

[149]"Fiscal Disparities: Hearings," *supra* note 135 at 72. (Testimony of Senator John Melcher).

Direct subsidies to energy consumers during the period in question included block grants to the states for payment of utility bills and weatherization of the residences of low income persons,[150] and energy tax credits for home owners' investments in conservation and renewable energy sources.[151] Indirect subsidies included a partial shelter for consumers from higher natural gas prices by provisions in the Natural Gas Policy Act of 1978 intended to shift the brunt of higher well-head prices to industrial users,[152] and an $88 billion program for development of a synthetic fuels industry.[153]

By far the most important of the legislation subsidizing energy consumers was the Crude Oil Windfall Profit Tax Act of 1980.[154] The Windfall Profit Tax, which accompanied deregulation of oil prices,[155] may be seen as a national severance tax transferring huge economic rents from oil producers to the coffers of the federal government.[156] It is an indirect subsidy to energy consumers in that, without it, their taxes would have to be higher to support the present level of government services. When it was enacted, it was estimated that it would raise a total of $228 billion by 1990.[157] The trend of actual collections suggests that the total will be substantially

[150]Such programs were authorized by the Headstart, Economic Opportunity, and Community Partnership Act of 1975, Pub. L. No. 93-644, 88 Stat. 2291, 2308 (1975), *repealed by* Pub. L. No. 97-35 § 683(a), 95 Stat. 519 (1981). A thorough analysis of their funding and operation is included in Manaster, "Energy Equity for the Poor: The Search for Fairness in Federal Energy Assistance Policy," 7 *Harv. Env. L. Rev.* 371, 375-402 (1983).

[151]Energy Tax Act of 1978, Pub. L. No. 95-618, 92 Stat. 3174, Title I, § 101 (codified as 26 U.S.C. 44C. (Supp II 1978).

[152]15 U.S.C. § 201 (Supp V. 1981).

[153]Energy Security Act of 1980, Pub. L. No. 96-294, 94 Stat. 611, Title I (codified as 42 U.S.C. §§ 8701-8795 (Supp. V 1981)).

[154]Pub. L. No. 96-223, 94 Stat. 229 (1980).

[155]With the OPEC-mandated increases that took the price of oil from about $2.50 to nearly $40.00 per barrel in less than 10 years there came a public outcry that the oil industry's "unearned" rents ought to be shared. Initially, price controls were imposed on oil. *See* 6 C.F.R., Part 150, Subpart L (1973). Then, President Carter made a decision to decontrol the price of oil, but recommended a Windfall Profit Tax. For a discussion of the background and working of the tax *see* Oosterhuis, "The Crude Oil Windfall Profit Tax Act of 1980," 39th *Inst. on Fed. Tax* Ch. 42 (Matthew Bender, 1981).

[156]This is a gross oversimplification of the Crude Oil Windfall Profit Tax Act, of course. The Act was much more than an excise tax. In addition, it included the Home Energy Assistance Act of 1980, Pub. L. No. 96-223, 94 Stat. 229 (1980), which provided for a Low Income Energy Assistance Trust Fund and authorized appropriations of $3.115 billion for fiscal year 1981. The Fund was to provide cash payments for energy costs to low income families. Half of the available funding was to be allocated among the states in proportion to the total costs of energy usage. The other half was to be allocated on the basis of the average annual number of heating degree days for each state multiplied by the number of low income households in the state. This formula favored the energy consuming states, which tend to be located in colder areas and to have larger numbers of low income households. In the final analysis, however, funding of only $1.85 billion was appropriated for 1981, and the program was subsequently substantially modified and divorced from the Windfall Profit Tax. See Manaster, *supra* note 150. The Act also included substantial subsidies for the development of alternative energy sources. It increased the rates of tax credits permitted for solar, wind, and geothermal energy equipment and extended the availability of tax credits to hydroelectric generating property, cogenerating equipment, petroleum coke and pitch plants, coke and coke gas equipment, intercity buses, and biomass techniques. It extended the gasohol exemption from the federal excise tax on motor fuels and permitted a credit for alcohol used as a fuel. It expanded the definitions of solid-waste disposal facilities and hydroelectric generating facilities as renewable energy property entitled to issue tax exempt industrial bonds.

[157]H.R. Rep. No. 817, 96th Cong., 2d Sess. 163, reprinted in 1980 U.S. Code Cong. & Ad. News 714 (Appendix, Budget Effects).

less, largely because of lower oil prices than had been anticipated.[158] Nonetheless, the sheer magnitude of the income transfer from oil producers has done much to eclipse the severance tax "export" issue.[159]

Fifth, though Congress did not act *directly* to limit the rates on state and Indian severance taxes, it placed indirect limits upon taxes of oil, the most important of the energy resources.[160] One of the issues that confronted Congress in framing the Windfall Profits Tax was whether severance taxes on oil should be deductible from the sale price in calculating the tax. Deduction seemed justified because, to the extent that sales proceeds are paid over to the state in severance taxes, there is no "profit" to the producer upon which a tax can be levied. On the other hand, to permit unlimited deductions would be to invite the states to increase severance taxes and short-circuit the Windfall Profit Tax by transferring revenues from the federal government to the producing states. As a result, the Act provided that there could be no severance tax deduction to the extent that the total rate exceeded 15 percent.[161] The Windfall Profit Tax Act contains an even stricter provision affecting Indian severance taxes. Indian severance levies are not deductible from the sales price in calculating windfall profits.[162] The effect of these provisions is to put a "cap" on the rate of state severance taxes on oil, and to provide a strong disincentive to the enactment of Indian severance taxes on oil. Severance taxes in excess of the limits will come out of producers' pockets and be a substantial detriment to continued activity within the state or on the reservation.[163]

[158]The table that follows contrasts the estimates of receipts from the Crude Oil Windfall Profit Tax anticipated when the Act was passed with actual receipts:

	(In Millions of Dollars)				
FY	1980	1981	1982	1983	1984
Conference Committee Estimate	3,172	13,436	19,543	19,958	21,144
Actual	5,959	23,290	18,881	14,264 (est.)	12,288 (est.)

Sources: Executive Office of the President Office of Management and Budget, "Budget of the United States Government Fiscal Year 1984, 1983, 1982 (Government Printing Office), and H.R. Rep. No. 817 96th Cong., 2d Sess. 166. Reprinted in 1980 U.S. Code Cong., & Ad. News 717 1(Table 2).

[159]Of course, not all federal subsidies enacted in recent years have been to energy consumers. Approximately $103,000,000 per year has been paid since 1976 pursuant to 31 Stat. § 6901 et. seq. to local governments in which federally-owned lands are located under an entitlements program intended to compensate local government units for tax revenues that they would receive if the land were privately owned. Sources: Executive Office of the President Office of Management and Budget, "Budget of the United States Government," Fiscal Year 1985, 1984, 1983, 1982, 1981, 1980, 1979, (Government Printing Office).

[160]Oil accounts for approximately 55% of the value of non-renewable energy production in the United States.

[161]I.R.C. §§ 4988(a)(2) and 4996(c)(3)(A) (Supp. V 1981). The Act also defined severance taxes to exclude unit taxes; only ad valorem taxes, those determined on the basis of the gross value of the extracted oil will qualify. See § 4996(c)(2) (Supp. V 1981).

[162]I.R.C. § 4996(c)(2) (Supp. V 1981).

[163]Of course, severance taxes paid are still deductible from gross income to reach adjusted gross income for federal income tax purposes, as is Windfall Profit Tax paid. However, the producer's total tax bill is minimized if he can deduct severance taxes in calculating Windfall Profit Tax.

Finally, and perhaps most important, the economic pendulum has swung and largely eliminated for the present the economic advantages of the energy producing states that underlie the sectionalist conflict. The combination of lower prices for oil[164] caused by OPEC's inability to maintain price levels, deep recession and conservation made it apparent that the energy industry was grossly overcapitalized. The resulting shake-out has staggered the economies of the energy producing states. Major regional financial institutions that had encouraged frenetic development based on inflated estimates of demand and prices have been hard hit, and some have failed.[165] Literally thousands of independent producers have gone bankrupt or sold their properties at bargain prices. Even large oil companies and pipelines have not been immune. A wave of mergers swallowed up relative giants such as Gulf, Cities Service, Getty and Superior.[166] The plight of many pipelines is so dire that fundamental reorganization of the industry is under consideration.[167] These developments have left the major energy producing states with budget deficits, increased unemployment, and the prospect of more of the same[168] at the same time that the energy consuming states have been rebounding from the recession.[169] They have made it unnecessary and impolitic for Congress to enact severance tax limits.

In short, congressional action appears less and less likely. With the passage of time the higher rates of severance tax have become "normal," like the high energy prices that motivated them. Consumers and their representatives in Congress have other energy-related problems with which to contend, notably the issue of deregulation of natural gas prices. Economic changes have made sseverance tax limits unnecessary and impolitic. The life span of political issues is only as long as the period between crises, and the crisis is past for the moment.

E. *Conclusion: The Federal System Vindicated?*

It should not be concluded that, because neither the courts nor Congress have acted to place a limit on the rate of state and tribal severance taxes, the legal system has failed to cope with the problem. What the challenges to energy severance taxes in *Commonwealth Edison v. Montana* and *Merrion v. Jicarilla Apache Tribe* and the

[164]From June 1980 through January 1981 OPEC's official price was $37.00 per barrel. *See,* Knaverhase, "Saudi Arabian Oil Policies," Current History, p. 29 (Jan. 1984). However, spot market prices, i.e., non-contract prices negotiated according to the supply of and demand for oil, soared as high as $40 per barrel. *See* Monthly Energy Review, February 1984 (DOE/EIA-0035) (84/02) for FOB cost of crude oil imports from 1976 through February 1984. The current official OPEC price is $29.50 per barrel. Further price reductions announced by Great Britain and Nigeria in October, 1984, threaten maintenance of the official price.

[165]First National Bank of Midland, Texas became the nation's second largest bank failure on October 14, 1983. The Penn Square Bank of Oklahoma City also failed in the summer of 1983. *See* Business Week, October 31, 1983 at 49. *See* U.S. News & World Report, January 30, 1984, pp. 64-65. The Federal Deposit Insurance Corporation had to step in to save Continental Illinois Bank in the summer of 1984.

[166]*See,* Wall Street Journal, March 7, 1984, at 22, col. 1, at 23, col. 4.

[167]*See,* Pierce, "Reconsidering the Role of Regulation and Competition in the Natural Gas Industry," 97 Harvard L. Rev. 345 (1983) (advocating deregulation of natural gas pipeline companies).

[168]*See* U.S. News & World Report, December 5, 1983, p. 12.

[169]*See* U.S. News & World Report, January 30, 1984, pp. 64-65.

attempts to get Congress to pass limiting legislation *did* accomplish was to "buy time" for reflection of the issues involved and for fundamental economic forces to work. The threat of action by the courts and Congress no doubt caused the energy producing states to hesitate to follow Montana's lead in raising severance taxes to high levels. With the passage of time has come changed economic conditions that have made it more difficult for the producing states to export severance taxes to the consuming states and impolitic to further burden their own energy extractive industries.[170] While several states and Indian tribes have increased or levied severance taxes since 1975, only Wyoming and North Dakota have approached the level of Montana's tax on coal.[171] In fact, the 12.5 percent "cap" sought in the most popular bill to limit severance taxes apparently would presently affect only Montana, Wyoming, North Dakota, and perhaps Kansas.[172]

In short, one cannot forget that the legal system in the United States is a part of a broader, federal political system. Like the policeman on the beat, the role of the federal courts and Congress in disputes between the states is as much to deter anti-social behavior as to intervene to impose order. One function of the legal, administrative and legislative processes is to give the disputants time to reconsider their positions and compromise their goals, to reflect upon their long-term interests, and to consider the wisdom of avoiding a clear-cut determination of winners and losers. In the context of energy severance taxes, these processes have permitted the dispute to be put into the larger perspective that only time and operation of the economic system can give. Although neither the federal courts nor Congress have been willing to act directly to arbitrate the sectional conflict over energy severance taxes, the *power* of these legal institutions to act has played an important part in permitting economic forces to adjust, albeit it painfully, the energy severance tax controversy. While the Montana and Jicarilla Apache taxes remain in place, their impact upon consumers is minimal and other states have not followed suit. Montana and the Apache Tribe are isolated, their economies staggered by high unemployment and low growth caused in part by the unwise exercise of their sovereign authority to tax.[173] The system has worked to permit time and changed circumstances to defuse the energy severance tax controversy.

[170]Dr. Henry Steel, Professor of Economics at the University of Houston, has argued that current market conditions would bar the export of Texas severance tax increases. "The people in the East don't pay any more for their oil despite severance tax increases because the producers can't shift their prices above the OPEC ceiling." Houston Post, Sunday, Feb. 26, 1984, p. 13E.

[171]Wyoming applies an effective severance tax rate of 17 percent to coal. "Fiscal Disparities, Hearings," *supra* note 135 at 17. Testimony of William P. Rogers. North Dakota levies a tax estimated at 20% of value. *See* Commonwealth Edison Co. v. Montana, *supra* note 30 at 640, n. 5, and Ch. 57-61 North Dak. Cent. Code.

[172]Kansas levies a net severance tax of approximately 4.33 percent on oil and 7 percent on gas. S.B. 452, 1983 Sess. Laws of Kan., effective May 1, 1983. In addition, however, producing properties are subject to a county ad valorem tax on personal property measured by gross value, that has been treated by FERC as a severance tax. The total of the two taxes probably exceeds 15 percent in some counties.

[173]Arizona, home of the Jicarilla tribe, and Montana ranked 32nd and 37th respectively in per capita income growth in 1983 according to a recent Commerce Department report. Other energy-producing states had equally dismal rankings, with the exception of Alaska which had the highest per capita income growth in the country. See Tulsa World, August 29, 1984, B-2. Similarly, energy-producing states in general still have higher unemployment rates than non-producing states. *See* U.S. Department of Labor Statistics, Employment and Earnings, July 1984, pp. 142-146.

It is quite likely that state severance taxes will become a sectionalist issue sometime again in the future, for energy sectionalism is little more than a manifestation of the inherent tendency of human beings to take advantage of their neighbors (whom they may not trust anyway) when circumstances permit them to do so.[174] However *Commonwealth Edison v. Montana, Merrion v. Jicarilla Apache Tribe,* and the response of Congress to the phenomena that caused those cases should give confidence that the system will once more weather the storm. The constitutional powers of the federal courts and Congress are sufficient to protect one group of states from economically predatory actions of other groups, if the courts or Congress choose to exercise them. That those powers exist makes the need for their exercise less likely.

[174]See B. Ackerman, *Social Justice in the Liberal State* 176-177 (Yale 1980) and J. Dukemisier & J. Krier, *Property* 55, N.19 (Little, Brown 1981), for a discussion of the "Free Rider" or "Hold Out" principle of economics.