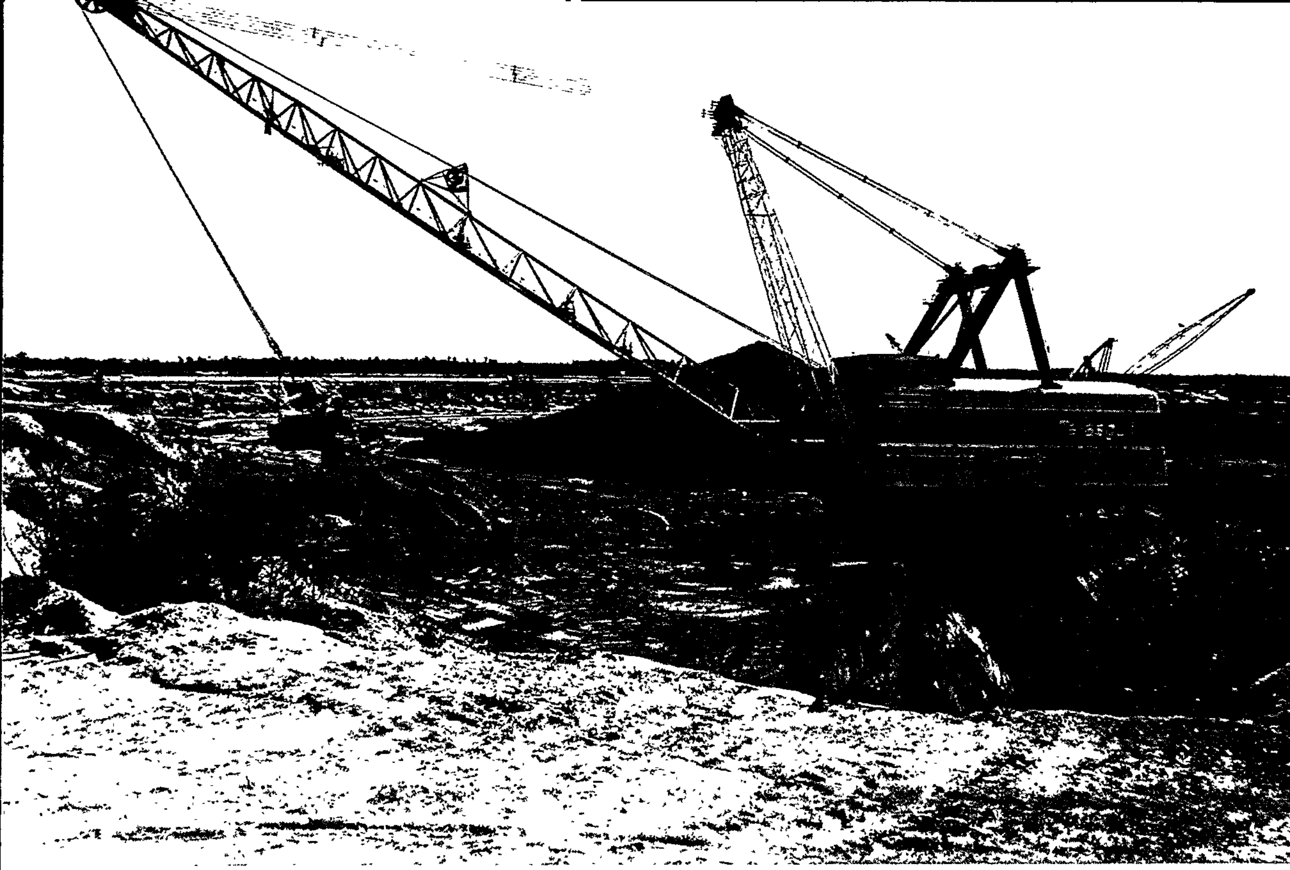

Photo taken by Jerry Hughes, courtesy of Texasgulf, Inc.

Balancing budgets and politics with the environment

Severance Tax or Depletion Allowance Repeal?

by Bruce Siceloff

Large draglines mine phosphate at the Texasgulf Lee Creek Mine, Aurora, N.C.

This fall the General Assembly will consider a severance tax proposal that was introduced a day before the legislators adjourned for the summer on July 10.* If enacted, North Carolina will become the 31st state to assess a levy on nonrenewable resources taken from its land. But mining interests and some legislators have lobbied against the idea since its first airing in April, and Gov. James B. Hunt Jr.'s moderate enthusiasm for a severance tax appeared during the summer recess to be shifting toward an alternative proposal that was introduced in the legislature the same day: a bill to repeal the state income tax depletion allowance for oil, gas, and mineral royalties.**

The Hunt administration is seeking substantial new revenues to strengthen the inflation-struck Highway Fund. A severance tax in North Carolina would not be the bonanza it is in petroleum-rich states such as Alaska, Louisiana, and Texas. But a

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*HB 1383, "North Carolina Severance Tax Act"
**HB 1382, "Eliminate Depletion Allowances"

Until a major phosphate deposit was discovered in the 1960s, officials did not consider this a mining state.

tax on two Tar Heel commodities – peat and phosphate – would produce substantial returns in the years to come.

"Basically, the Governor wants revenue for the 'Good Roads' package, and he wants it levied fairly and against people who can afford to pay," said John A. Williams, Hunt's budget officer and executive assistant. "It's a matter of how we can get the revenue and where does this burden fall."

The proposed four percent severance tax on the gross value of all solid minerals would have generated $14.4 million in revenues if applied to the $360,893,000 in minerals produced in the state in 1980. That revenue figure would probably grow rapidly in the coming years, thanks to the state's burgeoning phosphate industry and to the booming prospects for eastern North Carolina peat, soon to be mined for both methane conversion and electricity generation. Administration officials estimate that removing the depletion allowance would bring the state about $11 million in additional tax revenues annually. That figure, too, would increase, but not as rapidly as the severance tax return.

The oil, gas, and mineral depletion allowance – also a feature of federal tax laws – is the frequent target of tax reformers in Congress, but it has not been an issue in the General Assembly for 60 years since the depletion allowance was enacted as part of state tax laws. The theory behind granting a depletion allowance is the opposite of that behind levying a severance tax. One compensates producers for the gradual depletion of their resources and encourages them to find and produce more, while the other taxes producers for the privilege of severing what usually are nonrenewable resources from the land of a state.

Theory aside, the depletion allowance acts as a device by which oil, gas, and mineral producers – and all those with an interest in their wells and mines – are exempt from paying the full tax that is standard for most corporations. When Congress established the allowance in the federal tax laws in 1926, it allowed oil and gas producers to subtract 27½ percent of the gross incomes of their wells before computing their taxable income. In 1969 Congress trimmed that figure to 22 percent, by which time the concept had been extended to other minerals, all at different rates. In 1975 Congress made the major oil firms ineligible for the oil allowance and voted to phase down gradually the rate allowed independent oil producers until it reaches 15 percent in 1983.

Any corporation that extracts oil, gas, or minerals anywhere in the world and sells part of it in North Carolina pays state income taxes – and, if eligible for the federal depletion allowance, receives a state depletion allowance – on that part sold in this state. North Carolina tax laws permit such corporations to claim the depletion allowance rates set by Congress for federal income taxes. The removal of the state depletion allowance would in effect increase North Carolina's share in the profits of wells and mines around the world since the extra corporate income taxes paid would come from the profits of corporations based, in many cases, outside North Carolina. A severance tax, in contrast, would draw revenues only from mining interests within the state.

Until a major phosphate deposit was discovered in the 1960s in eastern North Carolina, officials did not consider this a mining state. Consequently, policymakers had paid little attention to the strengths and weaknesses of various mining taxes. The volume of sand, gravel, stone, and other minerals had been too modest to warrant a legislative fight over a severance tax, for example. During the 1970s, phosphate mining increased in importance but still the severance tax never became a legislative issue. Not until the fiscal crunch in 1981 due to a depleted Highway Fund and federal budget cuts, did the severance tax become a serious possibility.

In an April editorial, the *News and Observer* of Raleigh noted that North Carolina was one of the few states without a tax on mineral extraction. Still not geared to thinking about mining as a revenue source, state officials developing the

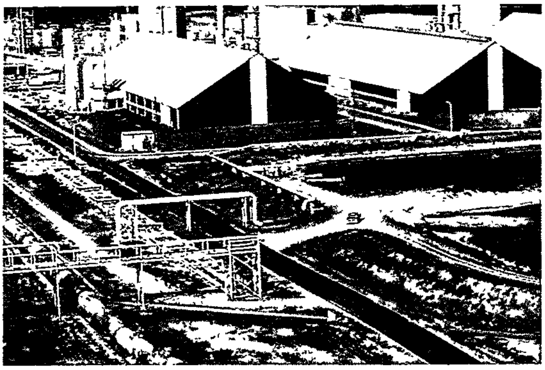

Photo taken by Jerry Hughes, courtesy of Texasgulf, Inc.

The fertilizer material plants at Lee Creek manufacture Diammonium phosphate and Granular triple superphosphate.

highway revenue package said that they had not seriously considered a severance tax before the *News and Observer* raised the issue. Noncommittal toward the tax at first, Hunt later said a modest severance tax would be included in the revenue package. But throughout the session, the Hunt forces seemed to be preoccupied with the motor fuels, alcohol, and other tax proposals, which involved far more money than did the severance tax proposal.

Because it was introduced as legislators were packing their bags to leave Raleigh, the severance tax proposal has not yet been debated publicly. Even the lobbying against it was said to be restrained before the details were laid out in the bill, and the depletion allowance repeal alternative was introduced without any advance mention from Hunt. In the rush of business during the legislative session, little attention seems to have been given to examining mining tax options. Consequently, the lawmakers may well approach the choice between a severance tax or repeal of the depletion allowance only from a fiscal and political point of view.

But other considerations demand examination – from the environmental impact of peat mining to the claims of industrial spokesmen that a severance tax would make them non-competitive. When the alternative proposals are debated this fall, members of the General Assembly should consider not only fiscal questions but also environmental and moral implications of taxing – or failing to tax – the depletion of the state's natural resources.

How a Severance Tax Would Affect North Carolina

Severance taxes have been around since the state of Michigan imposed a mineral levy in 1846. Revenues from severance taxes are used for a variety of purposes around the nation. In Montana, North Dakota, Utah and Wyoming, for example, a share of the coal severance tax is channeled to communities where mines are under construction but are not generating tax revenues to fund the expanded public services they require. Many states earmark part of the revenues for mine reclamation. Such is the case with Florida, which has a 10 percent tax on phosphate. (Florida now leads the nation in phosphate production but is expected to fall behind North Carolina before the end of the century.) These and similar uses for the revenues in other states reflect the philosophy behind a severance tax: The removal of a state's nonrenewable resources is a privilege for the miner and a deprivation to the state, which should be compensated.

Some groups, such as the congressional Northeast-Midwest Coalition, warn that a substantial severance tax by states rich in coal and oil hurts energy-poor states, where consumers must pay increased costs that companies charge as a result of the severance tax. In July 1981, The U.S. Supreme Court ruled against a challenge to Montana's 30 percent tax on coal, finding that a state has a right to levy substantial severance taxes.* This complaint would not be applicable to North Carolina, however, since the state does not have mineral deposits of the magnitude of a state like Montana and the proposed rate is four rather than Montana's 30 percent.

There are 30 states with oil, gas, or mineral severance taxes that generated more than $4 billion in state revenues last year. If you expand the group to include severance taxes on timber, a renewable resource, the number climbs to 33. (One of this number, the Commonwealth of Virginia, goes a step further with severance taxes on both timber and oysters.)

North Carolina belongs to this larger group, with a modest timber severance tax. The "forest products assessment" is not known widely even in the N.C. Department of Revenue, which collects it but forgets to mention it in the 14-page description of state and local taxes it updates each year for out-of-state businesses. In 1980, the tax brought a modest $1.29 million, all of it funneled to the N.C. Forest Service's Forest Development Fund, which helps landowners pay for reforesting cut timberland. The General Assembly levied the tax in 1977 and applied it to all timber harvested in the state except Christmas trees, home firewood and wood used for construction on one's own property.

North Carolina also has on its tax books a kind of severance tax on oil and gas, a levy to pay for

**Commonwealth Edison Co. v. Montana* 49 U.S.L.W. 5957 (1981).

the administration and enforcement of oil and gas conservation laws. In 1945, exploratory drilling in the state prompted the General Assembly to set up a skeleton oil and gas conservation statute – in case anyone struck paydirt – and to provide a modest tax to fund it (five mills per barrel of oil, one-half mill per 1,000 cubic feet of natural gas). But no oil or gas has ever been extracted from North Carolina wells. Consequently, North Carolina and Georgia – which has a similar statute – are the only states in the nation with a severance tax that produces no revenue.

Until recently, the state's most valuable mining commodity was crushed stone. Stone, sand, and gravel production totaled $159 million in 1979, a figure that dipped to $149 million in 1980 due to its dependence on the sagging construction industry. But in the mid-1960s, a vast lode of phosphate rock was discovered in Beaufort County on the coast, a find that has changed the nature of the state's mineral wealth. In 1980, that deposit yielded Texasgulf Chemicals Company of Raleigh 4.3 million tons of phosphate worth $107.5 million at the $25-per-ton price common at the beginning of 1981. The only firm now mining phosphate in the state, Texasgulf has built an industrial complex at Aurora, a Beaufort County community. But N.C. Phosphate Corporation is now building a mine near the Texasgulf facility that is expected to enter production on a comparable scale in 1983.

Since starting production 15 years ago, Texasgulf has steadily increased its phosphate output to meet an increasing worldwide demand and now plans to mine at least 6 million tons per year by 1984. Its 50,000-acre North Carolina holdings contain some 2.2 billion tons of ore that will last a century, even if current production levels are quadrupled. While unrefined phosphate rock sells for about $25 a ton, much of Texasgulf's ore is processed at Aurora into several fertilizer products. Diammonium phosphate, a major product of the Texasgulf Aurora complex, sells for more than $215 a ton.

Virtually all of Texasgulf's competitors are Florida phosphate producers which pay a ten percent tax on the gross value of phosphate at the time it is removed from the earth. Even though the North Carolina proposal calls for only a four percent gross value tax, Texasgulf officials still say it would be an unfair levy that would make it difficult for them to compete. "The best way to tax a corporation is on its profits," Lucius W. Pullen, Texasgulf vice president for law and communications, said when the severance tax idea was broached in April. "The severance tax could retard growth."

But some commentators in the state feel the severance tax could be an asset, not a liability. "The state collects nothing for commercial depletion of its natural resources," *The News and Observer* wrote in a June 30 editorial. "(Phosphate) has a healthy severance tax potential." And phosphate is no longer the only such mineral in the state.

North Carolina's peat reserves – hundreds of millions of tons in 1.2 million acres of Coastal

Severance Taxes in the United States

State	Oil	Gas	Coal	Metals	Nonmetals Minerals	Other	Amount (1979) (in thousands of dollars)
AL	x	x	x	x	x	x	$ 22,281
AK	x	x				x	173,685
AR	x	x	x	x	x		12,502
CA	x[1]	x[1]					48,093
CO	x	x	x	x	x		19,803
FL	x	x		x	x		91,902
GA	x[1]	x[1]					–
ID	x	x		x	x		552
IN	x	x					673
KS	x	x					1,097
KY	x			x			154,017
LA	x	x	x	x	x		511,589
MI	x	x					13,724
MN				x			71,263
MS	x	x			x	x	32,922
MO						x	45
MT	x	x	x	x	x		53,919
NE	x	x					1,516
NV	x[1]	x[1]		x	x		54
NH	x						207
NM	x	x	x	x	x		159,431
NC	x[1]	x[1]				x	1,013
ND	x	x	x				25,503
OH	x	x	x		x		4,582
OK	x	x		x	x		280,982
OR						x	47,625
SD	x	x	x	x	x		884
TN	x	x	x				2,155
TX	x	x					1,025,550
UT	x	x		x			8,993
VA						x	1,003
WA						x	37,802
WI				x			362
WY	x	x	x	x	x		87,419

[1]Conservation purposes only. Since there is no oil or gas mined in Georgia there is no income.

Sources: Columns 1-6 are March, 1978 data, from Commerce Clearing House, Inc. *State Tax Guide: All States.* New York, Chicago and Washington, 1967 (with updated supplements to March 1978).

Column 7 is from U.S. Bureau of the Census, *State Tax Collections in 1979,* as reported in *The Book of the States 1980-81,* The Council of State Governments, 1980.

Plain bogs that were considered practically worthless only a decade ago – are among the highest in the nation, and North Carolina will be the first state to begin large-scale production of peat. Already, there are plans to construct a peat-methane conversion plant and a peat-fired electric power plant in eastern North Carolina. Possible threats to water quality and wildlife habitats will require extensive environmental monitoring by the state, and a Department of Natural Resources and Community Development staff paper this year suggested that a severance tax on peat might be needed to defray the costs of this environmental monitoring.*

Because the severance tax proposal, as drafted, applies to *all* mining products, it has drawn criticism from another industry. The severance tax would create "useless inflation, more government, higher road maintenance costs, few highway miles per dollar, and economic upheaval," said the North Carolina Aggregates Association, a sand, gravel, and crushed stone trade association. Half the state's sand, gravel, and stone output is sold for use in state-funded road projects. Thus, an increased tax on sand and stone would be passed along to the purchaser and would raise the cost of highway construction.

The severance tax would be assessed against the gross value of all minerals, including phosphate, peat, stone, sand, gravel and lesser products, at the time they are removed from the ground. The percentage rate in the bill, as introduced by Rep. Charles Holt (D-Cumberland), was left blank, but that was a typographical error according to State Budget Officer John A. Williams, who said the proposal was meant to include a four percent tax rate.

Is the Hunt Administration Backing Off?

In an interview, Williams said that Hunt is not pushing either the severance tax or the repeal of the depletion allowance. "We offered the legislation as alternatives," Williams said. But when asked to discuss the two measures, Williams emphasized the problems the severance tax raised with various industries. "We got resistance on the severance tax. Attention was called to the fact that the state is the largest customer for crushed stone in the state, and the severance tax would increase the cost of building highways. The phosphate companies said paying this tax in North Carolina would not make them competitive in other states and therefore would suppress development here."

*"Report of Peat Mining Task Force" submitted to Natural Resources and Community Development Secretary Howard Lee, March 25, 1981, by the 12-member group comprised entirely of NRCD staff.

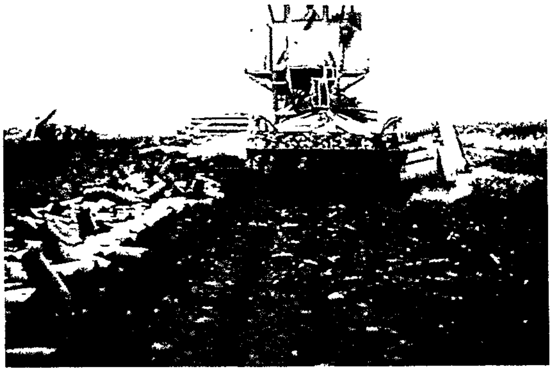

Photo courtesy of N.C. Electric Membership Corp.

Mining peat at First Colony Farms in eastern North Carolina.

In discussing the alternatives, Williams seemed to favor the depletion allowance repeal. "Small miners came in and said, 'We aren't making five percent, and if you take four percent, we can't exist.' These are good and valid reasons why the severance tax shouldn't be imposed on individual industries, and we think they are going to get a lot of attention," Williams said. On the other hand, Williams said that if the depletion allowance were repealed, people who have income from minerals would be taxed on the same basis as people who do not. "I think that [argument] may have a lot more appeal to some people in the General Assembly."

Williams estimated that one-fourth of severance tax revenues would be lost to increased stone and gravel costs paid by the state. "It really places a tax burden [on the state] without knowing there's the income [from minerals] to pay the tax. The severance tax is harder to sell," said Williams. The only advantage Williams cited for a severance tax was that it would raise more money.

Williams did not discuss – nor has Hunt in any public statements discussed – the environmental or moral concerns involved in this issue. A Department of Natural Resources and Community Development report suggesting the need for a severance tax to fund environmental monitoring of peat mining does indicate some environmental sensitivity within the Hunt administration. But for the mention in that report, there has not yet been a voice raised in the Hunt administration or the General Assembly to counter the complaints voiced by mining interests.

Lawmakers and Hunt administration officials seem absorbed, instead, in fiscal and political decisions. But if they do not consider other factors, the state's mineral resources become just another set of numbers to be used to balance a budget. Meanwhile, commercial ventures are extracting nonrenewable resources from the state in ever-increasing amounts without compensating the state for that irretrievable loss.□