

## It's Time To End The Ethanol Tax Credit

by Arlan DeBlieck

Lower Iowa farm earnings and California's recent concern over groundwater contamination caused by methyl tertiary butyl ether (MTBE) have reenergized efforts to promote ethanol-blended gasoline. A lot of Iowans are excited about the prospect of getting California's oxygenated-fuel market to help relieve a depressed farm economy, but they may be overlooking another opportunity in the process — the elimination of the ethanol tax credit. Taxpayers and consumers can benefit alike by allowing free market mechanisms to determine the best combination fuels and fuel additives without subsidizing any one product over another.

Ethanol production is the "poster-child" for a lot of political causes. If one is opposed to corporate welfare, the ethanol tax credit is a glaring example. If one is concerned about air pollution and the U.S.'s dependence on foreign oil, then ethanol represents a homegrown, renewable-fuel additive. If one works in

the agricultural sector, ethanol is an example of value-added agriculture.

Regardless of what ethanol represents, positive or negative, the true value of ethanol has yet to be determined. Some will claim that ethanol-blended gasoline reduces carbon monoxide emissions. However, ethanol also increases the amount of nitrogen oxide (NO<sub>x</sub>)<sup>1</sup>, a greenhouse gas<sup>2</sup>, that is put into the air. It can also be argued that the artificial demand for ethanol maintains pressure on farmers to keep using intensive farming practices that allegedly cause harm to our soils and underground water supplies. Ethanol has benefits, but it also has some drawbacks that the marketplace has not been allowed to evaluate.

Subsidies distort market signals and only serve to help certain groups of people over others. It is a zero-sum game. Free market mechanisms

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### The Iowa Scorecard Forecast

Item	1999 3rd Qtr	1999 4th Qtr	Comments	Source
State Tax Revenue	1,156,600,000	1,208,800,000	dollars	Revenue Estimating Conference
Personal Income Tax	503,400,000	530,800,000	dollars	Revenue Estimating Conference
Corporate Income Tax	56,100,000	73,800,000	dollars	Revenue Estimating Conference
Personal Income	73,520,000,000	74,680,000,000	dollars	Iowa Economic Forecast
Farm Income	2,200,000,000	2,360,000,000	dollars	Iowa Economic Forecast
Non-Farm Employment	1,476,440	1,489,290	total	Iowa Economic Forecast
CPI	2.2%	2.3%	national	Blue Chip Economic Indicators

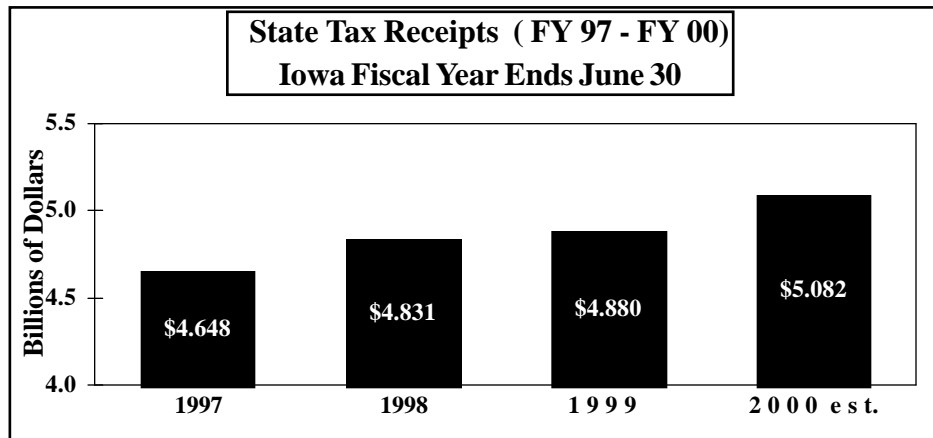
### The Iowa Scorecard For Recent Quarters

Item	1999 1st Qtr	1999 2nd Qtr	Comments	Source
Business Formations	1,845	1,811	actual	Secretary of State's Office
Consumer Confidence	140.3	131.3	Midwest Region	Consumer Confidence Survey
Housing Permits	867	1,428	actual	Department of Economic Development
Total Employment	1,518,800	1,554,100	estimated	Department of Employment Services
Unemployment Rate	2.4%	2.5%	estimated	Department of Employment Services

Figure 1.

State Tax Receipts Forecast for Fiscal Year 1999 and Fiscal Year 2000.<sup>1</sup>

<sup>1</sup> Iowa Revenue Estimating Conference, August 12, 1999.



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allow for combinations of products and do not have to operate in a zero-sum environment. A free marketplace finds the best combinations of resources that meet both consumers' and producers' needs.

In the case of ethanol, Archer-Daniels-Midland Company (ADM) has been accused of collecting the bulk of \$10 billion in ethanol tax credits since 1980.<sup>3</sup> This, however, may be misplaced blame. According to the Renewable Fuels Association in Washington D.C., "Gasoline marketers (not ethanol producers) have a choice of either the income tax credit or the partial exemption from excise taxes, but not both. [U]nder IRS Sec 40 (Blender's Income Tax Credit), the blenders credit amounts to \$0.54 per gallon of ethanol used in the production of ethanol-blended gasolines." The other option is the Excise Tax Exemption: "the current federal excise tax on gasoline is \$0.183 per gallon which is paid by refiners and marketers as gasoline leaves terminal gate. [M]arketers that blend their product with ethanol are eligible for a \$0.054 per gallon reduced tax payment (at the 10% blend)."

This is not to say that ADM does not benefit; it does, but so do the actual users of ethanol-blended gasoline. Consumers can, in most cases, pull into a gas station and pump a higher octane, ethanol-blended gasoline into their cars for the same price as an unblended fuel. Higher octane improves performance. So, consumers end up purchasing a higher quality product at a subsidized price. But where did the money come from? Not all gasoline markets get to sell subsidized gasoline. In essence, the taxpayers in these other markets pay for the subsidized ethanol-blended gasoline. Nonusers of ethanol-blended gasoline lose, consumers of the blended gasoline win.

Archer-Daniels-Midland and ethanol-blended gasoline consumers are not the only parties to benefit from ethanol subsidies. Iowa's corn farmers and economy become winners at taxpayer expense. A study conducted by economists Daniel Otto and Paul Gallagher of Iowa State University estimate that 96 million gallons of new demand for ethanol could increase a bushel of corn by \$0.20 per bushel near an ethanol plant to \$0.02 per bushel statewide. This

Figure 2.

Blue Chip Economic Indicators<sup>2</sup>

Published by Capitol Publications, Inc.

<sup>2</sup> September 10, 1999; includes long-range projections 2000.

Blue Chip U.S. Economic Outlook							
Indicator	94	95	96	97	98	99	2000
Real GDP Growth	3.5 %	2.0 %	2.8 %	3.8 %	3.6 %	3.8 %	2.7 %
GDP Implicit Price Deflator	2.3 %	2.5 %	2.3 %	2.0 %	1.0 %	1.4 %	1.8 %
Consumer Price Index	2.6 %	2.8 %	3.0 %	2.3 %	1.6 %	2.1 %	2.4 %
Industrial Production Index	5.9 %	3.3 %	2.8 %	5.0 %	3.3 %	2.6 %	2.8 %
Non-Residential Investment	9.8 %	9.0 %	9.2 %	9.9 %	11.2 %	8.8 %	5.9 %
3-Month T-Bill Rates	4.3 %	5.5 %	5.1 %	5.1 %	4.8 %	4.7 %	4.9 %
10-Year Treasury Note Rates	8.0 %	6.6 %	6.4 %	6.4 %	5.2 %	5.6 %	5.8 %
Jobless Rate	6.1 %	5.6 %	5.4 %	4.9 %	4.5 %	4.3 %	4.4 %
Housing Starts (millions)	1.46	1.35	1.47	1.48	1.59	1.64	1.52

increased demand could also mean as many as 1100 additional jobs, \$36 million in extra revenue, \$67.16 million in value-added products, and \$2.52 million in additional tax revenue.<sup>4</sup>

Some will claim that if we do not require the usage of American-produced ethanol, then EPA regulations requiring the use of oxygenated fuels will force the use of foreign-made methanol-based products (such as MTBE). Their argument stems from the fact that demand for ethanol-blended gasoline has traditionally not been high enough to lower the cost of production and compete with MTBE. If profit potential does not exist, then companies like ADM will not take the risk to produce ethanol. The only other way to induce companies like ADM to spend millions of dollars in building ethanol production facilities is to guarantee at least enough demand to cover production costs. Though ADM does not get the direct subsidy, it and other producers of ethanol are guaranteed enough demand (through the subsidy) to cover their production costs.

Ethanol is a substitute for the cheaper MTBE, which is mostly foreign-made and an easy target for demagoguery. MTBE is a methanol-based product that is extracted as a by-product from natural gas. The United States imports methanol and MTBE from OPEC nations such as Saudi Arabia. If Iowa gains 1100 jobs at the expense of methanol, how many Americans who help produce methanol lose their jobs? This is another example of the zero-sum game that is created when subsidies are used.

Natural gas is not the only source of methanol. Who is to say that ethanol should be the ordained replacement of MTBE? What if farmers from the western states, who currently produce crops on marginal land, could produce industrial grade hemp? Hemp can be manufactured into methanol. What if those farmers want a subsidy to start methanol plants that convert hemp into an oxygenated fuel additive? Who is to say this is not the best use of the land, of human resources, and of capital? If corn prices rise to \$4.00 or \$5.00 per bushel, what happens to ethanol consumption? Is gasohol the best use of corn at this price and quantity? Only a free market could determine this.

The problem with subsidies is that those with the most money and political clout win the battles rather than the producers with the better product. It may well be that the production of ethanol is the best use of resources especially if ADM can use the same facilities to produce both ethanol and corn sweetener. However, the only way to find out is to remove the ethanol subsidy and let resources go to those who value them most.

Now is the time to let the marketplace determine what the better product is, and what the best allocation of resources is. It may be that corn dry-milling is better than wet-milling; hemp a better environmental risk over corn; methanol is preferred over ethanol for rea-

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sons yet to be discovered. Only a non-distorted price will allow consumers to choose the best product, and therefore the best allocation of resources.

California's contemplated switch from MTBE to an ethanol-blended gasoline represents 200 million bushels of corn<sup>5</sup>, a huge boon for Iowa's farmers and economy. According to United States Department of Agriculture study AER-721, an average of 2.525 gallons of ethanol can be produced from one bushel of corn. The potential California market represents approximately 505 million gallons of ethanol.

There is no doubt that Iowa has a lot to gain if California switches to ethanol. But the time has come for ethanol to stand or fall on its own merit. If it is a good product, it does not need a subsidy. If it is not able to survive without a subsidy, then it's time to search for other substitutes that meet the consumers' needs. The only way this can happen efficiently is to remove petroleum-based subsidies, especially the ethanol tax credit.

**Endnotes:**

- <sup>1</sup>Doug Bandow, "Ethanol Keeps ADM Drunk on Tax Dollars", (Washington D.C.: CATO Institute, October 2, 1997) p. 2.  
URL: <http://www.cato.org/dailys/10-02-97.html>.
- <sup>2</sup>Energy Information Administration, "Executive Summary," Impacts of the Kyoto Protocol on U.S. Energy Markets and Economic Activity, (Washington D.C.: Department of Energy, October, 1998) p. xi.
- <sup>3</sup>*Ibid* note 1, p. 1.
- <sup>4</sup>Daniel Otto and Paul Gallagher, "Economic Impact Study of Iowa's Ethanol Industry," (Ames IA: Department of Economics, Iowa State University, November 1998) p. 3.  
This study was commissioned by the Iowa Corn Promotion Board and the Iowa Farm Bureau Federation.
- <sup>5</sup>Lucy Nerton, Iowa Corn Promotion Board, interviewed on September 1, 1999. Scenario 1 in the study done in note 4 was based on the usage of 45 million bushels of corn. If 200 million bushels of corn were used in California's market, the estimates for jobs and revenue could go much higher.

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