IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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GASOLINE PRICE HIKES SPAWN POOR POLICY PRESCRIPTIONS

Recent increases in the price of gasoline and other energy products have led to calls for federal action. The best policy is to be patient and let markets work to increase supply and restrain demand. Patience, however, is in short supply in an election year, and policy makers delight in having an excuse to increase their power and their press coverage. The resulting proposals are almost universally bad.

For example, Charles Krauthammer's May 21st column in the *Washington Post* and *Investor's Business Daily* on the spike in gasoline prices gets an "A" for angst and an "E" for economics. He laments that we did not impose a high tax on gasoline when oil prices were $7 a barrel to push conservation, drive down oil prices for producers, and drive gasoline prices to $3 a gallon with the extra money pumped "into the U.S. economy (via the U.S. Treasury) rather than having it shipped to Saudi Arabia..." His statement assumes that suppliers would pay much of the tax in the form of lower world oil prices. As for the tax revenue, he assumes that Congress would lower other taxes with the revenues, with consumers no worse off. He would use tax policy to reorder the U.S. economy to be less dependent on foreign oil.

Krauthammer's willingness to intervene massively in the U.S. economy for geopolitical advantage is unnerving. His belief that it would be relatively costless rests on two wrong assumptions: that producers would continue to sell willingly at the depressed price (inelastic supply) and that consumers would readily reduce their consumption with little inconvenience (elastic demand). Only then would suppliers bear most of the tax, and consumers suffer little pain of adjustment. (Chart 1.)

Real world measurements show a highly elastic energy supply — short term, if the U.S. doesn't pay the world price, it doesn't get the goods; long term, price increases induce new supplies and new technologies that have kept energy prices falling in real terms for decades — and fairly inelastic demand — consumers cut back very little in the short run and only modestly in the long run when the real price changes. (Chart 2.) Krauthammer's prescription would have cost consumers a bundle for years, and would have left pre-tax world oil and gasoline prices about where they are now, with tax-inclusive gasoline prices about $0.50 to $1.00 above current prices at the pump. Economic distortions would be large and permanent. Krauthammer makes a third wrong assumption: that Congress would cut other taxes in a beneficial manner that would leave the economy and the consumer better off in spite of the distortions. History suggests Congress would spend every cent.

It makes no sense to create an artificial scarcity today because a resource ***might*** become scarce in the future. That just moves the potential pain forward and turns it into a certainty. Even ignoring the benefits in present value of deferring the (hypothetical) cost of adjustment, note that future technology will be more advanced and future generations will be richer; new reserves will be tapped more easily in the future and the need, if any, to switch to alternative fuels will be handled more easily then than now. In fact, the 21st century may well see declining real energy prices, just like the 20th.

As for geopolitical concerns that we shouldn't be dependent for our energy on people who hate us, that

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sword has two edges. The Middle East producing countries need oil revenue at least as much as we need oil. If they stop pumping, we would carpool, but they would starve. If they keep pumping but try to boycott the United States, we would buy directly from other producers or indirectly from other buyers who would resell Middle East oil to us (as during the 1970s "embargoes").

Higher oil prices have been caused by several factors: geopolitical fears about disruption of supply; very loose Federal Reserve policy that has depressed the dollar, increased the price of internationally traded goods, and threatens higher inflation; and faster real economic growth in the U.S., China, and elsewhere that has temporarily lifted demand relative to supply.

The surge in gasoline prices has been made worse by domestic U.S. environmental policies and politics, including specially tailored gasolines for California and other areas with smog problems, which makes the gasoline harder to produce and impossible to supplement with supplies from other regions when refineries are down for repairs; politically motivated requirements for additives such as ethanol; a dearth of refining capacity, as new refinery construction has been blocked since 1976; and restrictions on drilling in the ANWR and federal lands in the lower 48 states and offshore. All of these policies represent government interference in the market for energy, and their adverse consequences certainly do not justify more intervention to fix the damage. Better to roll back the existing obstructions, mandates, and subsidies than create more.

A number of Senators have called for selling oil out of the strategic petroleum reserve (SPRO) to hold down prices, while others, including Senator Kerry, have called for suspending purchases to add to the SPRO, which is 90 percent full. It might be a good time to review whether we need a reserve as large as is currently planned. It might make economic sense to refrain from adding to reserves for a few months until the price comes down, but only to save money on the reserves. Amounts scheduled to go into the SPRO are only about 0.2 percent of world supply and demand. The effect of the suspension on the world market price of oil and the price of gasoline would be trivial, as would any impact from selling the small quantities that could be pumped out of existing stocks (given the limited pumping capacity of the facilities).

There are other, more useful policy changes that would help consumes, boost energy supplies, and make the energy market and the economy more efficient. However, they involve reducing regulatory burdens, taxes and mandates that inhibit and distort production, not piling on more. The government could stop micro-managing gasoline mixtures and the mileage of auto fleets, reduce federal and state taxes on gasoline, and remove barriers to interstate transportation and to exploration on and offshore. It could scrap the distorting subsidies for uneconomical alternative energy sources in the pending energy and FSC-ETI bills in the Congress, and advance the provisions that provide electric grid and PUCO reforms and provide shorter recovery periods for expenses incurred in energy production and transportation. In fact, it could go further and allow fuller, faster recovery of the cost of modernizing the nation's stock of equipment and structures, which are more energy efficient than old capital, by extending the partial equipment expensing provisions of the 2003 tax act and expanding them to include buildings. These are not quick fixes; they are steps that should be taken to promote economic growth and efficiency regardless of what is happening to gasoline prices today.

Patience, please. Let markets work. Note that, two days after Krauthammer's column, Saudi Arabia announced that it will boost current production and, longer term, open two new oil fields to accommodate increased demand. Drilling is up worldwide in response to higher prices. That is a far better answer to the problem than the self-inflicted punishment of a tax-induced artificial scarcity. The nation will be stronger if the economy is stronger, and the economy will be stronger the less that policy makers meddle with it.

Stephen J. Entin
President and Executive Director

Chart 1 Effect of Tax When Supply Is Inelastic And Demand Is Elastic

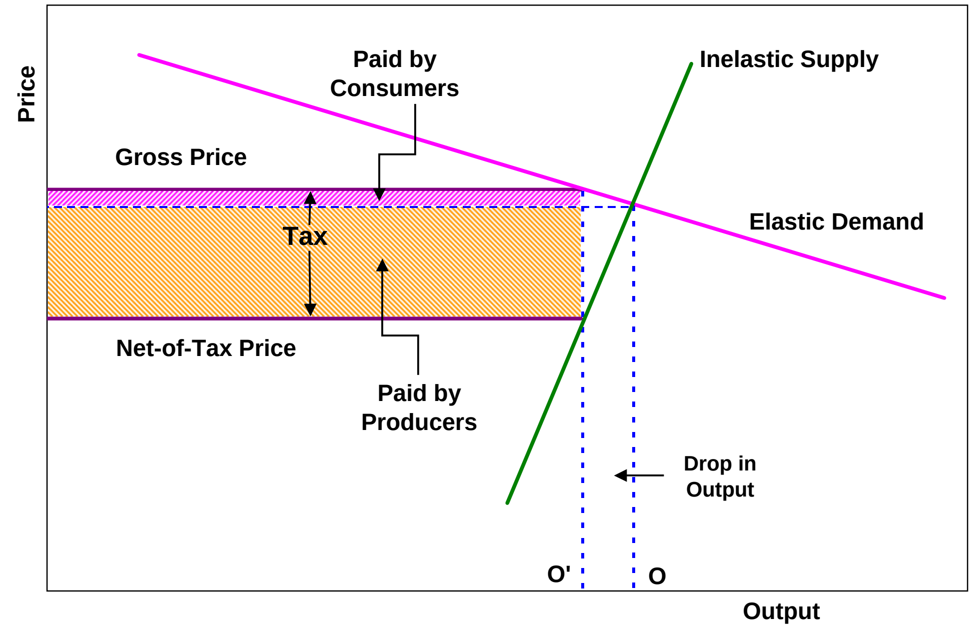
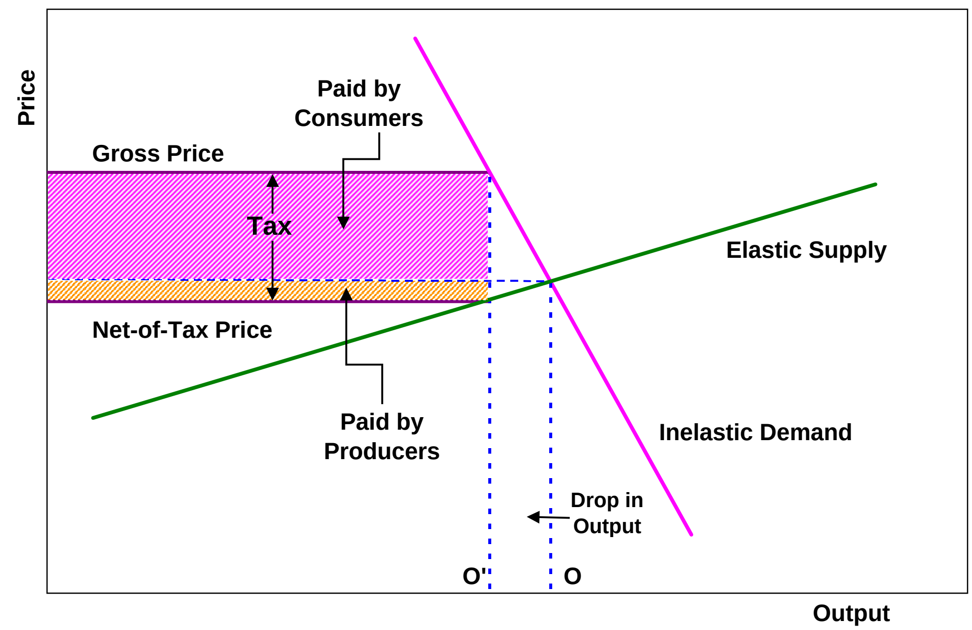


Chart 2 Effect of Tax When Supply Is Elastic And Demand Is Inelastic



Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.