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The Virtues of a Tariff - Severance Tax Route

Hyman P. Minsky Ph.D.

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Trendline in One Economist's View on Op Ed Piece

III. The Virtues of ^athe Tariff & Severance Tax Route

Economists, since Adam Smith's days, have anathematized tariffs and extolled the virtues of free trade. Although little of ~~the~~ serious thinking of economists affects public policy, the lesson that tariffs are accursed has sunk into the consciousness of the public and the politicians. Thus we have the spectacle of low tariffs combined with ^{Factor on in boxes / on in parts} import quotas for a wide variety of items: automobiles, television sets, textiles, etc.... ^{Perhaps the quota approach} However in a world ^{reflect an awareness - man in the future level that is a world} where giant multi-national firms produce and sell in many countries, the price base for tariffs is likely to be controlled, ^{Under these circumstances} ~~so that~~ quotas become the manageable basis for protection. Sunny

The tariff route for oil and energy policy is apt because of the dual nature of oil; once found and developed an oil field is a depletable resource but the finding and developing of oil fields involves investment. In order to encourage exploitation of existing fields the ruling expectation must be that the price of oil will not rise appreciably; in order to encourage exploration and development investments the ruling expectation must be that the price of oil will not fall appreciably. The closest approximation to prices simultaneously not rising and not falling is to have prices remain constant.

Until the power of the oil cartel is broken the expectation is that posted international oil prices will rise. If oil fields that are newly found and developed carry an international or market (decontrolled) price then the best strategy for an oil firm is to find and develop new fields even as the rate of pumping from the field once developed is next to a minimum determined largely by the need to generate cash by the sale of oil. If oil fields can be bought and sold and if proven reserves are bankable in that they can be collateral for borrowing, then ways exist for the discoverer and developer of oil fields to make profits without pumping oil.

The price of oil from oil fields that have old oil are now presumably controlled; however this controlled price has risen and is expected to continue to rise - at some date in the not too distant future old oil will be priced at the market. Thus the expectation is that old oil prices will rise at a faster rate than new oil; the incentive not to extract is even greater for old oil than for new oil. If old oil is to rise to the market in time it is best for production for this rise to take place immediately; a phased introduction of higher prices is especially counterproductive.

The present regime where the power of the oil cartel seems to guarantee ever rising price of oil encourages investment and discourages production. Investment which does not quickly lead to production is inflationary for resources are used and income is generated without any visible consequences for output. A first requisite of policy with respect to oil is to introduce a pricing system which encourages pumping out of current fields and which is not simultaneously a barrier to investment in new fields. In order to do this we have to break the link between the domestic U.S. price of oil and the cartel price.

The link can be broken if the United States does not import oil. It is no accident that the international oil cartel became possible only after the United States became a large scale importer of oil. If the United States were independent of OPEC oil, then the excess supply for the rest of the world would be so large that a cartel would not be viable. If the United States were a potential oil exporter then the cartel would almost immediately collapse.

Oil policy therefore must aim at breaking the expectations of ever rising oil prices and the dependency of the United States upon imported oil. High and stable prices of oil achieved by a flexible tariff will attain these two objectives simultaneously. A tariff that raises the price of imported oil by

a substantial amount over the current market price but which maintains a stable domestic price by offsetting changes in cartel prices by lowering or raising tariffs would encourage pumping from existing fields, encourage investment in exploration and development of new fields, and would use the price mechanism for conservation.

In order to explain how a flexible tariff would operate, let us assume the present landed price of cartel oil in the United States is \$12.00 a barrel and that the initial tariff is \$6.00 a barrel. After the tariff the domestic price of foreign oil is \$18.00 a barrel and this immediately becomes the maximum market price of domestic oil. If at \$18.00 a barrel domestic oil supply exceeds domestic demand then the market price will fall. However given the vast dependency of the United States on imported oil, the expectation is that the domestic price will be \$18.00 a barrel, that demand for oil products at prices that follow from this will exceed domestic supply. Thus a substantial revenue will accrue to the Federal Government from the oil tariff.

If the oil cartel varies its price the tariff will be cut so that the United States price will not rise. Thus if OPEC oil becomes \$13.20 a barrel the tariff will fall to \$4.80. United States policy must encourage independent arbitrage and importing of oil; it should be American policy to vigorously oppose any attempt by the cartel to set up a two price system.

If the cartel breaks the international price of oil will break to well below the \$12.00 price of our example. Let us assume it breaks to \$6.00. This price break will be evidence that a world glut of oil exists, and policy should respond: the domestic price should respond to the international price break, but unless domestic production exceeds domestic demand the domestic price should not fully reflect the fall in the foreign price. Perhaps the

tariff should respond to falling international prices by offsetting half of the fall in the international price; in this example of a fall in the cartel price to \$ 6, the tariff will rise to \$9.00 and the domestic market price will be \$15.00.

The best way to induce economization of any product is by an increase in its price relative to other prices. In our economy this implies a rise in the money price of oil, gasoline, oil product inputs to petrochemicals, etc. A tariff plus decontrol of oil prices will mean a virtual doubling of the prices of oil products prices; and it will mean a substantial rise in the income of the residual claimants to oil revenues: the income of the owners of oil in the ground will rise as more is pumped at higher prices. The tax laws need be tightened so that at least half of this increase in income will accrue to the Federal Government in the form of tax revenues.

An \$18.00 a barrel price of oil that will be sustained by a tariff until the cartel breaks or domestic oil supplies exceed domestic demand is sufficiently high to induce massive investment in domestic exploration and development as well as to induce large scale pumping from existing sources. A major question arises as how to finance and control this development. The United States should borrow the techniques for handling such problems from the other oil producing and oil using countries. One way is to nationalize the major international oil companies; the United States should purchase half the stock in Exxon, Mobilgas, Texaco, etc; as it is these companies do work with nationalized or partially nationalized companies around the world.

Another way is for the United States to set up one or more oil companies that will be nationally owned. These oil companies will take a majority interest in all oil fields that will be developed on Federal Lands.

Potential and existing oil fields are either on privately owned land, on

Government land in the west, or offshore in either state controlled or Federal controlled areas. If the nationalization route for oil companies is rejected nothing much can be done about existing or new wells on private land except to impose a severance tax. Given existing prices and the profits implicit in an \$18.00 price of oil, a \$3.00 to \$5.00 severance tax on oil regardless of source and regardless of dating of oil can be imposed.

When oil from Federal Lands or offshore is considered, then the severance tax can be combined with Federal government participation. A three to five dollar severance tax combined with a 51% Participation by a Federal Government oil company in the exploitation and development of fields - which is the way the oil companies operate overseas - would be a way to assure that the enrichment from the high and protected price of oil would at least in part accrue to the public purse.

A sudden rise in the price of oil to the levels contemplated would have income and relative price effects upon the American economy. If oil imports are running at a rate of \$40 billion per year and if the initial impact of the tariff will not lead to any serious reduction in oil consumption and importing the tariff will earn about \$20 billions. If domestic production of oil is running about 3.5 billion barrels a year then the severance tax will yield (at a \$3 per barrel rate) about \$10 billion dollars. Let us assume that the tariff plus severance tax yield \$25 billion of revenue.

The Federal Government should return a major portion of this \$25 billion to the public in a way that is independent of income, age, or energy consumption. The simplest scheme is to return it in the form of a per-capita benefit. I therefore propose that 90% of the tariff, severance pay, and profits from government participation in the oil business be paid into an "oil and energy trust fund" and that these monies be distributed on a per capita basis to all.

Thus if the trust fund receives and pays out \$21 billions per year then every person regardless of age or income will receive a \$100 oil tax benefit. This oil tax benefit will be independent of the units actual use of oil or its derivative products.

Returning 90% of the oil tariff, severance tax, and government profits from oil to individuals in a manner which is independent of the individuals use of oil will offset in part but not in total the reduction in the purchasing power of income due to the rise in oil prices. However the high price of oil and oil products implicit in the \$18 price of imported and domestic oil will mean a substantial rise in the price of oil products. The rise in the price of oil products will induce substitution against oil products in consumption and in production. Price is a rationing device and price is also a determinant of the way output is produced.

It is true that there will be residual enrichments and impoverizations from the tariff and severance tax schemes. The enrichments and impoverizations can be modified by varying the severance tax and the per capita distribution. For example the per capita distribution can be made some 25% greater than indicated by the size of the trust fund if the distribution is made a part of the recipients taxable income. In that way the distribution can be a greater benefit to the poor than to the rich than it would be with a nontaxable per capita distribution.

However the tariff and severance tax schemes should not be judged primarily on their income distribution effect. An unequal distribution of income is deeply built into our economy and our society. If we are to do better on the income distribution score card we need deep structural changes. The oil crisis is not a proper vehicle for the correction of deep errors of our ways.

Enrichment or impoverization is an implicit feature of every public policy act that implies changes in the market prices of capital assets. As long as private property in producing assets exist, such enrichment and impoverization is implicit in every change in expected future profits. The existence of income effects and of capital value effects should not be used as an excuse for not allowing the price system to play its role as the inducer of conservation of oil both in the final use by households and in production by business.

The virtue of the tariff and its related severance tax is that it is simple to administer. Because it works by raising price and inducing sources of supply, the tariff and severance tax route need not be concerned with inducing specific substitution and techniques. There is no need for a complex system of taxes and subsidies, the price system does the job. Because the tariff and severance tax scheme sets an \$18.00 per barrel price of oil, it also sets equivalent prices for coal and other sources of energy. The coal price implicit in an \$18.00 per barrel price of oil is high enough to induce expanded coal production even after allowing for substitution against coal due to its price increase.