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High Oil Prices: Our Friend for the Future

After what seemed a never ending period of rising oil prices, the oil bubble has burst and gasoline is again below $2.00 per gallon. During the rise, many forgot that oil prices can also fall. Recent reports of OPEC disarray and fears of inadequate revenues from oil exports show that oil price variability is a two edged sword. Price changes affect the behavior of both parties to the oil trade, and intelligent policy making makes this variability the cornerstone of good policy changes. The first item on the policy agenda should be to **keep the price of oil (products) high to the users of oil products! This can be done through the use of a time-varying oil use tax that rises when the crude oil price falls and reverses when the crude oil price rises.** A time varying oil tax can and should also be seen as a foreign and domestic security policy device. We should call that tax a national security tax so that we are always reminded that the tax is being levied to increase both our foreign and domestic security.

That "high oil product prices" are our friend might seem to be a paradox, but it is not. It is the key to good policy planning. The "paradox" arises from the fact that higher prices deter consumption now and in the future. Deterring oil product consumption is in our national interest for financial and environmental reasons and that deterrent should remain or increase. The tax should also be variable so that when crude prices fall, the tax rate goes up and conversely, when crude oil prices rise, the tax rate goes down. That would create a firm price trajectory for planning alternative energy production while at the same time, creating insulation to our economy from disturbances in the crude oil price. Tax policy can even set a rising trajectory of petroleum product prices signaling even larger incentives to innovation in the alternative energy field over time. Such a measure is well termed a 'national security tax' because it will indicate to our citizens that hydro-carbon based energy is costly as well as a threat to our national security. We need to fund these security improvements and a time-varying oil products tax would do just that.

Because the revenue raising capability of an oil products tax is large, these revenues will be a temptation to special interests. Therefore, we should couple the tax to a "lock box" to insure these additional taxes are spent solely on (broadly but well defined) national security needs. It costs a great deal for our military to protect our valued sources of supply in the Middle East and if Global Warming is a security threat, as many argue, encouraging non-hydrocarbon sources of energy can improve our security.

In some ways, a national energy revenue lock box which is purely a financial reserve would complement the strategic petroleum reserve which is a source of crude oil supply in the event of a physical blockage to our imported crude oil supplies. The SPR is limited—it just holds oil. A national energy lockbox would be fungible---a resource to be used for a wide variety of purposes. It is, of course, true such funds could be wasted, but that is true of all government expenditures. They must be thoughtfully made and carefully administered.

It is essential that the tax be variable. It must rise when the crude oil price falls and it should fall when petroleum prices rise to very high levels. It is a variable tax wedge that will keep the price at the pump, or the airfield, or the diesel truck stop from falling (and inducing more consumption) when crude oil prices fall. That outcome will indicate a permanently, higher price of petroleum products that will induce needed substitution away from petroleum based energy use for the future. High prices for petroleum products are a friend to be recognized.

We should also recognize that an oil products based national security tax has the potential of raising substantial revenues. For example, even at the currently suppressed consumption levels, some 553,880,000 barrels of oil were used in September 2008. A ten cent per gallon tax would raise nearly 30 Billion Dollars per year, and that does not count all hydro-carbon based energy sources. That is more than twice what President

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Elect Obama has called for to finance his alternative energy program. If we labeled the tax for what it is---a device to further national security---Americans would gladly pay at least 10 cents per gallon and probably far more. Think of the stimulus to alternative energy production that a dollar a gallon would do, and 300 billion in revenues would be more than necessary allowing some significant rebates through payroll tax relief.

President Elect Obama has signaled government funds will be allocated to incentivizing alternative energy development. Doing it that way makes Government the inevitable “chooser” of those projects that get a subsidy and those that do not. Raising the price of petroleum based products allows the market to respond in its own way, with the market being the judge of the proper winners and losers. It is also clear, however, that the proper tax policy on petroleum products must also carry over to all hydro-carbons, in greater or lesser degree. Between the devil of cheaper coal and the angel of cleaner natural gas, all hydrocarbons are sources of energy and hydrocarbon-based environmental issues. A variable tax on other hydrocarbons should be set consistently with the variable tax on petroleum just to prevent inter-fuel substitution. (For purposes of setting a quick policy into effect, it would be advisable not to contaminate this “security tax” with a “global warming tax” that seeks to retard generation of CO2). That issue can be dealt with quite separately.

The principal objection levied against ‘higher prices at the pump’ is that it is a regressive tax in the sense that many working class job holders have to drive to work and are thus heavy users of gasoline. There is some truth to that claim and if “equity” considerations are to be taken into account, it would not be hard to allow some relief to this “variable national security tax” through payroll tax rollbacks.

Former Vice President Gore suggested a similar measure although his ostensible purpose of the petroleum tax was to deal with “an inconvenient truth.” Whatever the merits of the claim that man-made energy consumption drives global warming, the principle that higher cost energy will induce substitution toward non-hydrocarbon supplied energy remains valid. While it is also true that a ‘variable national energy security tax” can hit unequally, it is quite possible to mitigate some of the major impact of the tax on those workers least able to afford it. It will take time for our national auto, truck and air fleets to adapt to these circumstances but the most important part of changing our energy policy is change now…and keep on changing.

National energy policy will always be the target of lobbyist politics. Every one has some skin in the game. What is undeniable now---if it were ever a confused matter---is that oil and politics are mixed together both domestically and internationally. This country needs to have its foreign policies sensitized to the cost of maintaining stable global oil supplies, and that is a real drain on national resources. We should fund these costs less opaquely so that each user of energy knows in part what his tax is being used for. Second, it should be a lock box concept so that it is not abused by the “pet projects” of ear-marking Congresspeople. Third, it needs to happen now and indefinitely into the future. Innovators of alternative energy production should know what price path they face. Nothing illustrates this more than the shutdown of the Boone Pickens’ Wind project as energy prices cheapened dramatically. That kind of setback has happened more than once, and we need to have a clear path to energy alternatives, irrespective of what happens elsewhere in the world. To do that, oil product prices have to stay high and perhaps move higher in the future.

Roger Howard has given a clear picture of two edge sword nature of fluctuating oil prices.[1] They can help or harm our international relations. The key is to use price variability to our advantage. By staking out a future price trajectory for all to see, the world’s oil producers know how to plan their own further oil developments in an environment of certainty. They may or may not be able to control the price of their output, but we can control the cost of our input! It’s time to make that change.

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[1] Roger Howard, “An Ode to Oil,” WSJ 11 29 2008