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# Energy Policy: Wisdom or Waste?

BY ROGER D. MCKINNEY

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We can't help ourselves. Americans crave the black gold that pulses through the concrete arteries of our nation's transportation system. In the opinion of many, we have hocked our future for a cheap fix with a drug that abandons our nation to unscrupulous foreign dealers and causes convulsions in the national economy.

President Bush in his 2006 State of the Union speech said, "Here we have a serious problem. America is addicted to oil, which is often imported from unstable parts of the world." The President echoed the sentiments of many Americans that importing oil harms the nation. As part of his plan to combat the threat, he praised the \$10 billion his administration has spent on alternative energy sources and proposed a 22 percent increase in such spending. The new Democratically controlled Congress plans to increase taxes on oil companies to pay for even greater subsidies to ethanol producers.

I will challenge the assumptions that imported oil damages the U.S. economy and that government-funded research into alternative energy would provide solutions.

Does importing oil damage the U.S. economy? Some argue that spikes in oil prices can trigger recessions because they raise costs and force businesses to lay off people. However, as Bharat Trehan of the Federal Reserve Bank of San Francisco wrote in the *FRBSF Economic Letter* in 2005, the record shows that several past

recessions started before oil prices rose, suggesting that something else caused the recession, a tightening of monetary policy being the most likely suspect.

Other economists reason that sharp oil-price increases ignite inflation, forcing the Federal Reserve to raise interest rates, but again the evidence against oil is circumstantial at best. Research conducted in 2005 by the San Francisco Fed concludes that oil prices rise

and fall with other commodities, such as gold, silver, and copper. Commodity prices respond to changes in the rate of inflation, which the Federal Reserve controls via the money supply. In other words, the Fed is the main culprit in the recent commodity, and oil, price increases.

Common sense tells us that if the money supply remains constant, an increase in oil prices will merely shift spending from other products and services to oil-related ones. As a result, averages prices will not change. Only if the Fed increases the supply of money can consumers spend more on gasoline while maintaining their spending on all

other goods and services, thereby causing a general increase in prices.

Evidence of the Fed's complicity in the rising price of oil is found in the fact that oil prices failed to keep pace with inflation from 1986 until about 2003, as the chart below demonstrates. The top curve with the bro-

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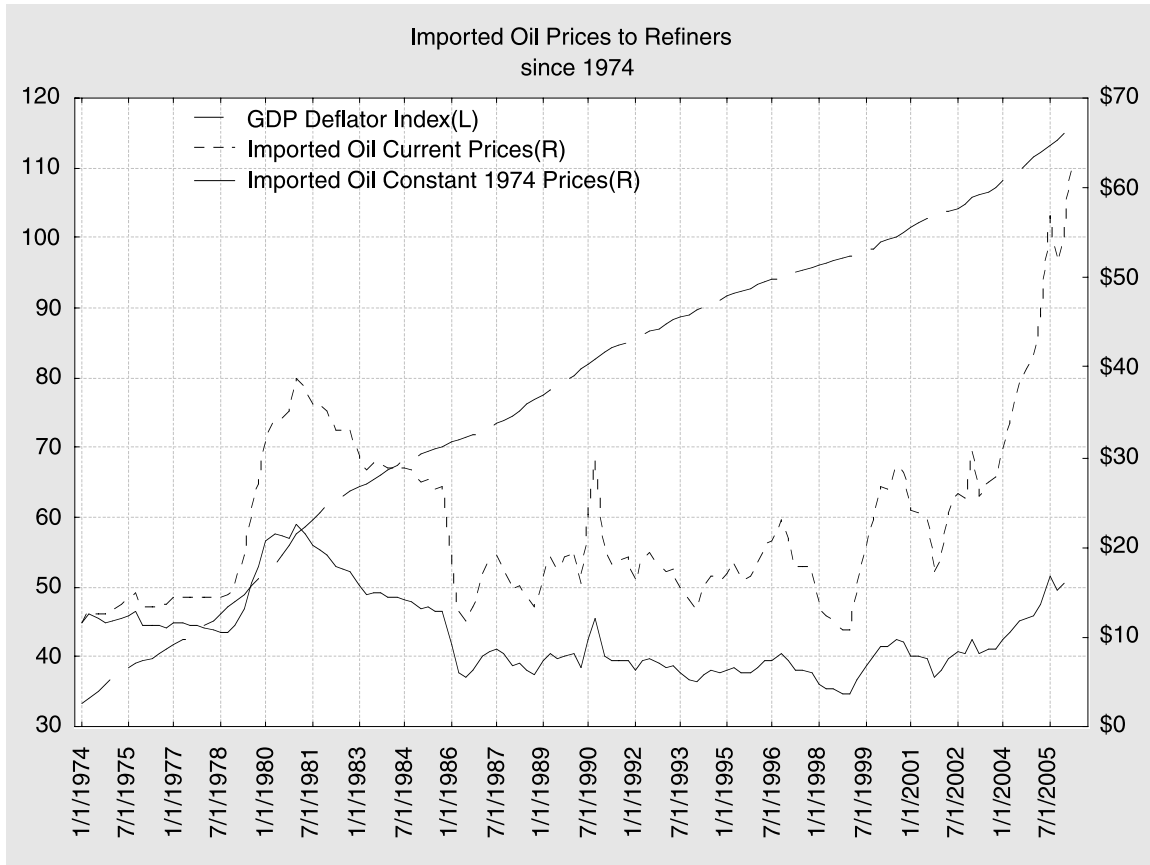


Chart 1

ken line plots the GDP Deflator, an index of price increases across all industries and a measure of the loss in the purchasing power of the U.S. dollar since 1974. The middle, dashed line plots the quarterly average of the actual price of imported oil. The solid line at the bottom indicates what the price of imported oil would have been had the dollar maintained the value it had in 1974. The left scale measures the index and the right measures the two prices of oil.

The chart shows that the purchasing power of the dollar declined by 47 percent from 1986 through 2002 as oil prices averaged \$20 per barrel in current dollars. Destruction of the dollar's purchasing power damaged the economies of oil-producing nations because oil prices around the world are set in dollars. By 2002 oil producers were able to purchase only about half as many goods and services with the dollars they received as they had in 1986. From our perspective, we were paying almost half as much for imported oil in 2002, in real dollars, as we paid in 1986.

The price of gasoline since 1990, the latest available from the Department of Energy, demonstrates similar effects, as the chart below illustrates. Gasoline would sell for an average of about \$1.70 per gallon today in 1990 dollars. Without taxes, which make up about 20 percent of the price, gasoline would sell for about \$1.35 in 1990 dollars.

Others who believe imported oil hurts the U.S. economy insist that the country would prosper if we could keep home the billions of dollars we send overseas to pay for oil imports. However, the country will become poorer if producing any product at home costs us more than if we imported it, whether the products are sweaters from China or oil from Canada. That is because Americans spend the money we save by importing cheaper oil on American-made products, such as movie tickets and music CDs.

In addition, we must examine what happens to the dollars we export in exchange for oil. Foreign holders will spend some of those dollars on American-made products, which increases U.S. exports, but many of

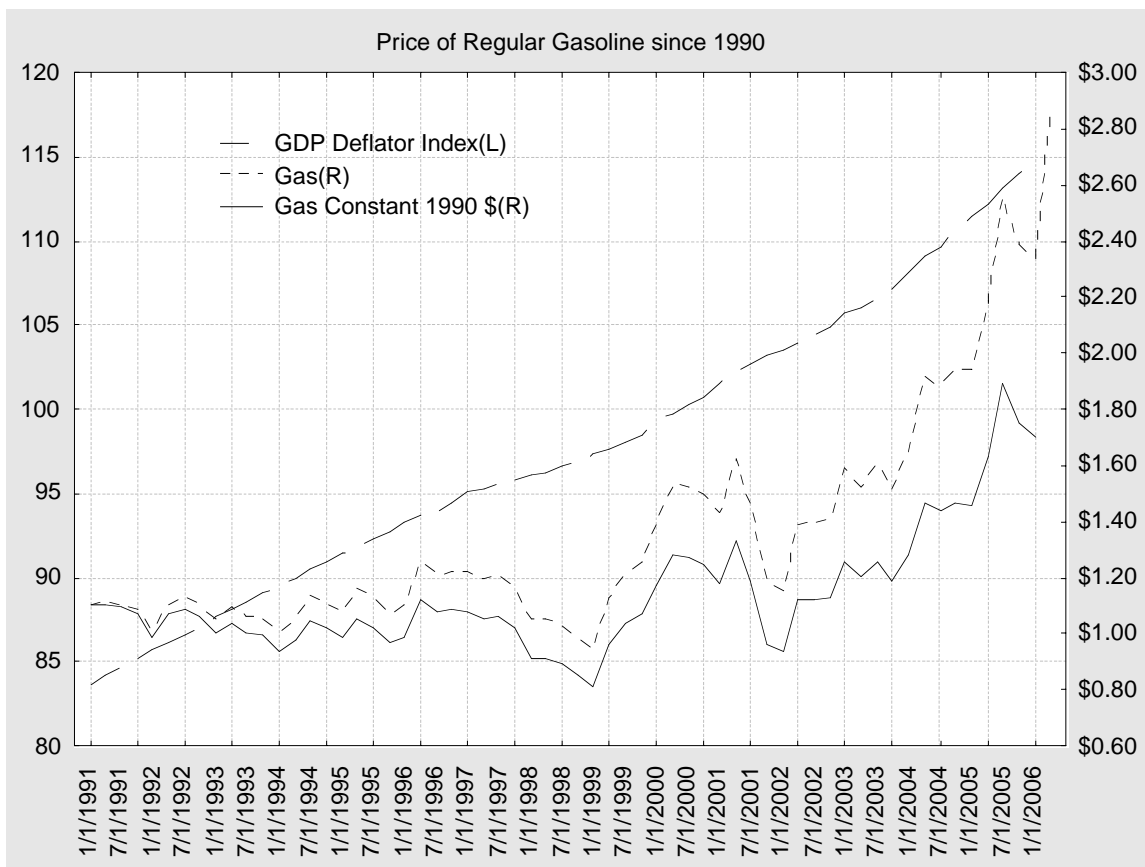


Chart 2

them will return to the U.S. to purchase government and corporate bonds and stocks, and as direct investment in U.S. businesses.

For example, our largest supplier of oil, Canada, reinvested \$13.6 billion directly in businesses in the United States; Middle Eastern countries contributed \$3.1 billion. Those dollars may travel around the world, being exchanged for European or Asian products, before finding their way home. Altogether, according to the U.S. Bureau of Economic Analysis, foreign investors purchased more than \$1 trillion in 2005 of corporate stocks, bonds, and U.S. treasury securities, including \$109.7 billion directly invested in companies. Such investment benefits the United States by creating jobs, boosting wages and productivity, strengthening manufacturing, and keeping interest rates low for other businesses.

### Will DOE Research Rescue the United States?

President Jimmy Carter responded to soaring oil prices by creating the Department of Energy (DOE)

in 1977, empowering it to regulate prices, allocate resources, and fund research. Oil prices peaked in early 1981 at just under \$40 per barrel before newly elected President Ronald Reagan eliminated price controls and slashed funding for the DOE.

The price of oil collapsed in 1986, and through 1998 averaged just \$17 per barrel for several reasons: Many OPEC countries ignored quotas set by the cartel, while non-OPEC nations increased production. Also, the new technology of horizontal drilling dramatically increased the productivity of new wells. Private enterprise, not the federal government, rescued the country from oil shortages and high prices.

In spite of lower oil prices, the DOE continued funding research into alternative fuels, spending \$22.3 billion between 1978 and 1999. It shared costs with the major oil companies, which invested in projects with the greatest potential in the marketplace. For example, private industry carried 71 percent of the burden of research into oil and gas production and upgrading,

including 87 percent of the cost of research for producing fuel from oil shale, but it contributed just 42 percent of the cost of research for squeezing fuel from coal.

In 2000 Congress appraised the results of its investment and reported it had largely been wasted: “RD&D programs such as coal liquefaction have been extremely risky and prone to cost overruns and generally have yielded relatively small economic, environmental or security benefits relative to their high costs” (*Energy Research at DOE: Was it Worth it? Energy Efficiency and Fossil Energy Research 1978 to 2000*, National Research Council, 2000).

In addition to the DOE funds for research, Congress has spent billions of dollars on ethanol, a form of alcohol made from corn in the United States. Before 1979 the country produced virtually no fuel ethanol. By 1999 the DOE says, we were distilling 1.5 billion gallons per year. To achieve this the federal government spends \$725 million each year in subsidies to producers. In addition, the petroleum and ethanol industries received tax incentives estimated between \$142.5 and \$161.3 billion from 1968 to 2000. The Government Accountability Office assessed the benefits of the ethanol program this way:

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Although the available evidence suggests that the tax incentives for alcohol fuels increase ethanol fuel use, it also indicates that these incentives do not significantly reduce petroleum imports. Therefore, the tax incentives do not significantly contribute to U.S. energy independence. . . . In addition, ethanol tax incentives have not significantly enhanced U.S. energy security. . . .

Still, ethanol supporters point to the success of Brazil’s program as a model for what the United States could accomplish. The International Energy Agency says ethanol contributed 15 percent of Brazil’s motor-vehicle fuel needs in 2005, but, according to Professor Emilio Lèbre La Rovere of the Federal University of Rio de Janeiro, the Brazilian government spent \$10 billion in

subsidies over 30 years to save \$1.8 billion in imported oil. Brazil encourages the sale of ethanol by taxing gasoline at much higher rates. In March 2006 gasoline sold for \$4.69 per gallon, pure ethanol for \$3.59. However, ethanol contains just 60 percent of the energy of gasoline, which means that a driver will travel 40 percent fewer miles on a tank of ethanol than one filled with gasoline. So for the price of ethanol to equal that of gasoline in terms of miles per gallon, ethanol would need to sell for \$2.81 per gallon in Brazil.

### Defending Oil Supplies

The United States spends billions of dollars on the military to protect oil supplies in the Middle East, which amounts to a hidden subsidy to oil importers. This subsidy has inspired many to call for a tax on oil imports to force oil companies to pay for the protection. However, determining which military expenditures relate to protecting oil supplies and those intended for the “war on terror,” or normal military activity, will prove difficult. Besides, oil importers will pass the tax on to consumers.

According to the DOE’s Energy Information Administration, the United States imports just 16 percent of its oil from the Persian Gulf, and that comes from Saudi Arabia, Kuwait, and Iraq; none comes from Iran, the world’s most belligerent producer. Our largest suppliers are Canada and Mexico, so a tax on all imported oil would harm our neighbors and most important trading partners.

Rather than raise taxes to pay for the military costs of protecting oil supplies and shipping routes, Americans should consider whether such protection is necessary. For example, Europe and Asia import the bulk of Middle Eastern oil, so our military expenses in the region amount to a far greater subsidy to those nations. If Europe and Asia want those supplies protected, shouldn’t they pay for it?

Suffering from frequent flashbacks to the Arab oil embargo of 1973, Americans shiver at the thought of depending on others for commodities as vital as oil. But in 1973 Middle Eastern nations were so backwards that

they didn't know what to do with their windfall oil revenues. Since then, oil producers have become addicted to oil income in order to feed their people and pay debts to other nations.

Except for Canada and Northern Europe, most oil-producing nations are very poor. For example, Iran's per capita income today is less than \$3,000. About 30 percent of the population lives on less than \$4 per day. Iran imports a large amount of its food and gasoline. Poverty and unemployment are high, and oil production stagnant. "In this regard, Iran's threats to use the oil weapon if attacked are hollow at best, because the country cannot fund the most basic programs for too long without the steady flow of oil revenues," according to the Middle East Media Research Institute. In other words, Iran must sell oil in order to feed its people.

Instead of halting all oil imports, Iran might halt exports to Europe while increasing those to Asia. But since oil is fungible, Europe could easily replace Iranian oil with oil from countries that would export less to Asia, such as Canada or Mexico. Americans should realize that the military cost of protecting oil supplies in the Middle East is as wasteful as DOE spending has been.

### Was It Worth It?

This isn't the first time the United States has faced an energy "crisis." The major source of artificial lighting in the early 1800s, whale oil, rose from 23 cents per

gallon in 1823 to \$2.55 per gallon in 1866, an increase of 1,000 percent. However, Canadian geologist Abraham Gesner discovered a method to extract kerosene from petroleum in 1846. Then, in 1859, Colonel E.L. Drake discovered commercial quantities of petroleum in Titusville, Pennsylvania, which soon sold for \$20 per barrel. By 1867, kerosene had replaced whale oil, even though the price of whale oil had declined to 40 cents per gallon. Private enterprise had lubricated the transition to a new form of energy, and the nation prospered.

The federal government has wasted hundreds of billions of dollars in the past three decades to achieve energy independence for the United States. What other things could we have bought with that money? At the least, we could have lowered federal deficits and debt.

Today, we are as far from the utopia of energy independence as ever. Political reasons may still exist for achieving self-sufficiency, but not economic ones. And rhetoric about America's oil "addiction" only

clouds the issue. Addiction connotes immoral acts that are unnatural and self-destructive, in which we surrender control of our lives to criminals. But the act of importing oil involves none of these. Oil enhances, not destroys, our lives.

The market has solved two energy problems; the federal government has solved none. Shouldn't we abandon 30 years of failed government efforts and let the market work its magic once again?



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