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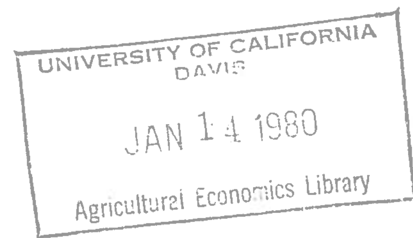
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LIMITING OIL IMPORTS

by

Peter H. Lindert

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Department of Economics
University of California
Davis, California

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LIMITING OIL IMPORTS

Peter H. Lindert
Professor of Economics
University of California - Davis
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Of all the proposals in President Carter's energy message of mid-July, the one that has received the least study is the one deserving the most.

The President's many proposals for government encouragement of domestic energy sources and domestic conservation received widespread comment, much of it sceptical. The scepticism is generally warranted. The setting up of an Energy Security Corporation and an Energy Mobilization Board, the retreat from decontrol toward new standby gas rationing authority, and the imposition of state fuel conservation targets enforceable by the federal government -- these proposals in particular are very expensive ways of trying to close the energy gap. They are probably worse than having no new federal policy at all, and at best can only begin to approach the efficiency of leaving citizens to their own devices in meeting the soaring cost of energy. For all the initial fanfare and debate, they are likely to get the quiet Congressional burial they deserve.

An eerie silence has greeted the President's lead-off announcement that he intended to impose quotas limiting oil imports. Even the President himself dropped the subject within two days and administration officials have only just begun to work out the specifics of the import quota system. Apparently little was said about quota arrangements at the earlier Camp David powwows.

This is remarkable, given that the quotas will, if implemented, guarantee a bigger cut in oil imports than can be expected from all the other proposals.

History may well record that in setting up oil import quotas in 1979, the Carter administration took a big step toward cutting America's oil import dependence. On the surface, a well-designed quota system seems to have some big advantages. It can be set up immediately by the President himself, without the cost of trying to push a bill through Congress. Import quotas attack the problem of excessive imports head-on, and honor the U.S. commitment at the Tokyo energy summit to participate in an international restriction of imports. Quotas help solve the key puzzle: how to make imported oil both cheap to the nation as a whole and expensive to those Americans who use it up. And they could be handled in a way that strikes most Americans as fair and just.

The oil import quotas could, however, be a complete disaster. They could prove that all the sceptics were right about U.S. energy policy. To some, an unfair system of import quota allocations would show that Big Oil still rules Washington. To others, an inefficient system of quotas would show once again that Washington messes up everything it touches. And a system that backfires and let OPEC itself end up collecting still higher prices would be devastating. Any of these nightmares can come true. Whether they do or not depends entirely on how the Carter administration designs the new oil import system in the next few months.

How not to give out import tickets

There are three kinds of rationing systems for something in fixed supply: fixed favoritism, allocation by "need" or "merit," and a public auction. The first of these is unfair. The second is unfair and inefficient. The third is

an economic theorist's ideal, but would, like the other two, backfire if it is not changed to meet the peculiar case of oil in the age of OPEC.

Fixed favoritism. The government could simply give out the same number of barrels of oil import rights to the same parties year after year. With the list of license-receivers known in advance, nobody would waste time trying to get a license from the government. They would simply offer to buy licenses from the perennial licensees. Starting around early 1981, President Carter's import limits will fall short of import demand. Firms would probably be willing to pay rising amounts just to buy the import tickets, even though they must also pay the suppliers the world price for the imported crude. The favored few could pocket several dollars a barrel -- maybe $2 in 1981 and maybe $20 in 1990 -- just by reselling their import rights. Not a bad return on zero effort and zero expense.

Many will argue that this fixed allocation is a fine system if we just get the free tickets to the right people. For example, state governments might be given tickets to import barrels in proportion to population (or oil consumption, or whatever). They could sell these to oil firms and hand over the revenues to the poor, to taxpayers, to oil-conservers -- or to oil companies. The outcome would depend on the usual balance of political power.

The resulting allocation formula would strike many as unfair. Disagreements are inevitable when a windfall is being distributed across the nation, especially when we have to pay for the windfall outselves, in this case by buying petroleum products. And it is not hard to predict that egalitarian intentions will slip up when they run across that slickest of all lubricants, Oil in Washington. Major oil firms should have little trouble convincing Congress and the administration that they deserve perennial oil-import allocations

to compensate them for their having to import less (or to save them from having to pay others for rights they have always enjoyed for free).

After all, that's how it worked last time, when the U.S. had oil import quotas from March 1959 to May 1973. When the quota system was unveiled by President Eisenhower, the public was fobbed off with a phony national-defense argument that looked something like this in cold daylight: to prepare for the day when Russia brushes aside the U.S. Navy and surrounds our shores, we should force ourselves to consume more domestic oil now, without stockpiling.... In fact, the quotas were a careful deal between the White House and two groups of oil companies. The more domestic-pumping companies were crying for protection against the flood of ruinously cheap oil from the Persian Gulf (ah, the good old 'fifties), but the more international majors were profiting on the same flood. To buy off the internationals, Ike and his advisers gave them the free and marketable import licenses in proportion to their pre-1959 oil imports. It cost U.S. consumers about $1.08 a barrel, or about $3.8 billion a year. This system and its national-defense packaging survived the constant criticism of economists until President Nixon repealed it in May 1973 -- ironically, at the moment in history when oil import restrictions were beginning to have an economic justification.

This is a sobering precedent in a time of rampant suspicion about U.S. energy policy. It will be hard for the public to see the merits of a system that is likely to favor the oil companies, who have for so long enjoyed such special breaks as the depletion allowance and the foreign-tax-credit subsidy to pumping oil abroad.

Allocation by "need' or "merit." Fairness could be pursued by having the Department of Energy or another federal agency screen applications for imports of

crude and award licenses to those most in need or most deserving. Officials could favor those who have conserved energy the most, or those most dependent on imported oil, or those who need oil for winter heating, or whomever they wish. While this approach is the favorite of bureaucrats and planners the world over, past experience resoundingly supports the textbook argument against such rationing. Striving to serve officially-determined need or merit would make a daily routine out of the intense lobbying that occurs only at the outset of a system of fixed favoritism. Official decisions would still look unjust to different people at different times. A large bureaucracy would also be required.

Third-World experience with allocating import rights according to need or merit reveals another kind of waste: to compete for import rights, firms waste enormous amounts of time and goods trying to impress the allocating officials. If they believe that current imports will entitle them to future imports, they will import all they can before the system gets tighter. If they believe that idle plant and equipment would show that they need more oil, refineries will try to build more excess capacity. If simple personal persuasion seems to hold the key, firms will keep large lobbying staffs in Washington. That's how it works in countries like India and Turkey, where, as Professor Anne Krueger has shown, a large number of the best and brightest waste their time either hustling for, or giving out, a fixed amount of import licenses. And in deciding whether the licenses should be marketable, the fair-minded official will be forced to choose between further inequity and further waste: letting licenses be sold gives windfalls that shift uncontrollably with shifting market conditions, and prohibiting resale guarantees that some of the import licenses will fall to firms that end up needing them less.

A public auction alone. By comparison, a public auction has some real advantages. It has a chance of looking fair, since everybody could bid for import rights. The auction would not require a large bureaucracy or large private lobbying effort: bids could be sent by mail, processed by a computer and policed by a small staff. Most importantly, the proceeds would go into general federal revenues and not to private windfall recipients. The proceeds could be used to retire government debt (reducing interest rates to homebuilders and other investors), to cut other federal taxes, or to finance worthwhile government programs.

The auction could be designed in any of several ways. To sketch one, let us suppose that 720 million barrels of import rights were to be auctioned off for the fourth quarter of 1981. The official deadlines for bids should be far enough in advance to ease business planning and allow for shipment. Let us say that four equal auctions of 180 million barrels each have deadlines of September 30, 1980; December 31, 1980; March 31, 1981; and June 30, 1981. Those wanting to bid for part of the first batch must pick up their bidding and deposit-pledging forms, fill them out, and mail them before September 30, 1980. The bid forms could come in denominations as small as 2,500 barrels and as large as, say 100 million barrels. On each form the applicant states the maximum amount he is willing to pay for that many barrels of oil imports during October-December 1981. (He may revise his bid anytime before the deadline.)

The official computer ranks the applications by bid price and determines the price at which the full 180 million barrels is just taken up by persons and firms bidding that much or more per barrel. If this is $3 a barrel, any bids below $3 are rejected and bids of $3 or more are accepted. The buyers will be

charged only the $3 a barrel at the time of import, whether they bid $3 or bid more. The auction-clearing price will approximate the average expected gap between domestic and world prices of crude in late 1981, plus a slight premium for pure option value. The auction price must be paid by all winning bidders whether or not they import oil in late 1981. Any license-holder thus has an incentive to seek out willing buyers for any rights he later finds he won't use.

It is not difficult to work out the important technical details of the import-rights auction: what kinds of import rights an oil exporter earns, how many barrels of high-sulfur or heavy crudes equal a barrel of standard marker crude, which non-U.S. residents may enter bids, how many barrels a single buyer can buy in one auction, and so forth. The system can be simple, efficient and fair.

An administration official has questioned the auction idea because "You obviously don't want to create a speculative futures market" in oil, which the auction system would allow. This fear is misplaced. A futures market in oil is emerging anyway, as professional spot traders branch out more and more into delayed deliveries. The rise of oil futures trading is a natural result of the increasing importance of reducing uncertainties about oil supplies. Futures trading in import rights will spring up under <u>any</u> of the possible systems of allocating initial import permits, even without a government auction. The rise of futures markets is also not a bad thing. Futures markets give hedgers a way to buy or sell at a price fixed far in advance, just as they do in markets for other commodity futures or insurance.

<u>Inviting OPEC to lunch</u>.

All of the import-restricting proposals discussed so far share a fatal flaw: OPEC is watching. Without a tariff safeguard of the sort discussed below,

anything that creates U.S. oil shortages or raises the U.S. price of crude above the OPEC price invites OPEC to a feast. Seeing a gap between the U.S. price and its own price tells OPEC how much further it can raise its price before losing U.S. business. Similarly, oil shortages at controlled prices show OPEC how long is the queue of U.S. orders they could discourage with further price hikes before losing any real exports to the U.S.

OPEC has reacted this way in the past. Their stunning price hike of December 1973 came right on the heels of news of crippling shortages when the Arab boycott first hit major buying countries, and news of sky-high auction prices being offered to Iran, Libya and Nigeria. Again, in early 1979, OPEC cast aside the small price increases it had just announced and posted stiffer increases when it saw the extent of the shortages and auction-price jumps that followed the Iranian supply disruption.

This fact of life threatens to torpedo all of the quota schemes discussed so far. If government officials allocate import-quota rights according to fixed favoritism or merit, OPEC will gather key information in the process. They need only watch the gap between the U.S. domestic price of crude and the OPEC price to know how much further OPEC price increase the U.S. market will bear before actually importing less than the official quota. Oil shortages in the case of controlled U.S. prices would deliver the same kind of message. The neat oil import auction would add another piece of information: OPEC could watch either the gap between U.S. and OPEC oil prices or the market price of auctioned import rights to tell how much more Americans would pay for foreign oil before failing to import the legal limit. OPEC could gobble up the value of the

import rights themselves, if they wished to use the large U.S. market as a barometer of their overall power, just by raising prices over the years until U.S. oil prices no longer exceeded theirs and import rights became nearly worthless within the U.S.

Tariff, quota and auction

To keep OPEC prices down while raising domestic prices and cutting our import dependence, the U.S. (and other importing governments) must collect an irreducible tariff on oil imports. The tariff on oil would strike at OPEC's monopoly power in two ways. First, like the import quota, it would cut U.S. demand for foreign oil at any world price, by making U.S. purchasers of foreign oil pay the world price plus the tariff. The drop in sales to the U.S. would pressure individual oil-exporting nations to consider cutting their prices to regain export sales. Second, a tariff would make it evident to OPEC that any further price rises would be passed on to the U.S. market, cutting U.S. imports below the quota level. The tariff revenues, meanwhile, would accrue to the U.S. government, not to price-raising foreign suppliers. We should impose an oil import tariff before mid-1980, by which time oil imports may threaten to match their peak 1977 rate.

Should we rely on the tariff alone, plus domestic measures for conservation and development of new energy sources? This simple approach is very attractive. Indeed, we should have been phasing in substantial percentage tariffs on oil since 1973 or earlier. The tariff has been, and still is, the proper mainstay of a long-range program to free ourselves from the grip OPEC is now gaining. But the U.S. has missed this point for six years, and has squandered credibility as well as time with hollow-drum program announcements like President Nixon's Operation Independence.

To regain credibility and help make up for lost time, the U.S. now needs the import quota as a supplement to the tariff. As part of a larger international effort to cut oil import dependence, we must guarantee that our net imports will not exceed their 1977 level. The same firm ceiling on imports will help stiffen domestic resolve to conserve energy and find other energy sources.

To coordinate the quota and tariff, and to help make sure the tariff is not leaving any price gap open for OPEC exploitation, import rights should be auctioned in the manner already described. If the auction prices paid for these rights are greater than, say, $2 a barrel, the tariff should be raised for future imports not yet licensed. In this way the full price gap between U.S. and world prices will be secured by the U.S. government, in tariff revenue plus smaller amounts of auction proceeds. If the import rights are undersubscribed the tariff should remain unchanged.

How much cold turkey?

How tightly should we restrict oil imports? We shall continue to feel pressure in both directions. The desire to be free from OPEC blackmail and to soften OPEC prices pushes us to slash imports drastically, with a small quota and a high tariff. So does the desire for clean urban air and clean beaches. On the other hand, going cold turkey and kicking the oil import habit suddenly is painful. We shall often feel it's unnecessary -- only to be disabused the next time OPEC hikes prices or cuts deliveries.

The U.S. is already showing the classic symptoms of an addict subjugated to its supplier. The slightest Saudi gesture toward temporarily higher output got President Carter to strike anti-OPEC passages from the draft of his July energy message. At the same time, pressure from Sheikh Yamani and other Arab oil representatives made the Carter administration cancel plans to resume building

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up the 750-million-barrel strategic oil reserve designed to resist blackmail by boycott. We are already being manipulated.

The more our oil imports grow, the more readily we must submit to any pressures from OPEC. This simple point is the most effective answer to the question: "What if OPEC retaliates against our import cuts with a massive boycott or supply cut?" The fact that this question can now be asked seriously shows how costly our new import dependence is becoming, and how urgent it is to keep this dependence from growing. If OPEC feels aggressive enough to flex its muscles now, we had better risk a manageable confrontation now rather than appeasing foreign oil suppliers and inviting more frequent and disastrous showdowns later.

With the stakes so high, oil imports must be cut. At the same time, the best course has to be slow and steady. We should resist the temptation to leave the import limits up to later official discretion and negotiation. If we now limit net oil imports to 8 million barrels a day through 1981, drop the quota to 7 million barrels a day by 1990, and phase in the tariff accordingly, oil imports will play a steadily declining role in a growing economy. With each passing year, our vulnerability to wars, revolutions, boycotts and price hikes in oil-exporting countries will diminish.