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THE OIL IMPORT FEE ISSUE

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There is a growing active interest among senior Administration officials and members of Congress in the imposition of an import fee on crude oil and refined products brought into the United States. The principal attraction of the fee for the Administration and its Congressional supporters lies in its revenue yield. The principal public justification for the fee is the presumed incentive it would provide for continued oil conservation, substitution and domestic exploration.

The revenue attraction is obvious. With an expected oil import level of about 5.5 million B/D of crude oil and products in 1983, each dollar in import fee would yield about $2 billion annually in direct gross revenue. In addition, there would be considerable government revenue from the indirect effect of the import fee on domestic crude oil and natural gas liquids (NGL) prices. Domestic crude oil prices are of course directly related to the delivered cost of imported oil and would over time rise by approximately the amount of the import fee.

If we assume that the Windfall Profits Tax and the corporate income tax together skim off about 60% of any marginal price increase, each one dollar price increase in domestic crude oil would yield about $1.8 billion in incremental annual revenue for the federal government. Increases in domestic NGL prices (which would be substantially smaller than those for crude oil) could raise this figure by roughly $200 million for each dollar of the full import fee. Furthermore, the government's income from oil royalties and the sale of oil from the Naval Petroleum Reserve would rise by some $100 million annually for each dollar price increase.

Thus, if fully passed through, a $5/Bbl import fee, the figure most frequently mentioned in recent reports, might cost oil consumers about $29 billion annually and provide the U.S. Treasury with a gross revenue of $20-21 billion, divided about evenly between the import fee itself and windfall profit and corporate tax payments. However, as we shall see, the net revenue from all sources accruing to the Treasury in consequence of the imposition of such a fee would be considerably less, due to the significant negative effects which the oil price increase would have on sectors of the economy other than energy production.

The argument that an oil import fee is required to assure continuation of the trend to reduce U.S. dependence on foreign oil has been greatly strengthened by the actual price declines of the last 12 months--U.S. refinery crude oil acquisition costs dropped from a peak of $37.48/Bbl in March 1981 to an estimated March 1982 level of $33/Bbl--and the predictions by some analysts of further price reductions in the near future. Prior to this development, the price of oil to U.S. refiners had increased consistently, though unevenly, since 1973 due to the combination of foreign price increases imposed by OPEC and the controlled rise of domestic crude oil prices towards the foreign level. From April 1973 until April 1979 an oil import fee was actually in effect, at the President's direction but from the beginning of 1974 on it was too small relative to the price of imported oil to have any measurable effect on domestic demand nor was it intended to do so.

Until recently there was some concern that a substantial import fee would be considered a hostile action by OPEC which might react by raising its price by the same amount or more. Since OPEC's price structure was generally firm until about mid-1981 because commercially available excess production capacity was relatively small, the organization might have been able to carry out such action without a significant loss in export volumes--at least in the short run. Currently, this is of course not the case. OPEC will do well in the near future if it can keep its prices from sliding further. OPEC members are therefore not in a position to react to a U.S. oil import fee by raising their export prices. However, they would probably view it as a hostile measure directed against them, as some of their spokesmen have already indicated.

Most advocates of the import fee as an energy measure view its potential impact on OPEC as a by-product of its principal purpose which is to counteract the economic impact of the drop in foreign oil prices on domestic energy consumers and producers. The logic underlying this purpose cannot be faulted. Obviously, a continuing decline in the price of imported oil would over time cause domestic consumers to consume more and producers to explore less, leading to an eventual increase in the level of oil imports over what it would have been in the absence of the price decline. Equally obvious, an import fee would offset the impact of declining foreign oil prices on domestic supply and demand to an extent determined by the level of the fee.

But the fee would also constitute a major market intervention by the government for the purpose of redressing or preventing a market-oriented economic development. Since such interventions inevitably distort the existing market balance and, to judge from considerable historical evidence, do not inevitably achieve their desired goals, the oil import fee should be carefully examined prior to its imposition, regarding its economic cost, its effectiveness, its equity, the urgency of the need for it, and whether it is superior to alternate measures which could achieve similar results. In the following discussions we propose to do this.

Economic Cost of the Import Fee

If the fee is fully passed through to consumers and foreign suppliers do not absorb any part of it through offsetting price reductions while domestic oil producers raise their price by the full amount of the fee, a $5 import fee would cost oil consumers $29 billion in its first full year. Partial absorption of the import fee by foreign suppliers would of course blunt its impact on oil conservation and exploration but this is unlikely to occur on a significant scale. Given oil's observed very low short-term price elasticity of demand, a $5/Bbl crude price increase, resulting in average increases of about 12% in products retail prices*, would reduce U.S. oil demand by only around 250,000 B/D in the first year of the fee's imposition and only slightly more in the second year. Given the 25 million B/D of global oil trade, this is far too small a volume to cause foreign producers to risk lowering their prices to all customers in order to maintain their sales volume to the U.S.

Domestic oil producers, all of whom are producing at capacity, would want to raise their prices by the full equivalent of the import fee. However, if the crude market remains soft, as we expect it to be for the next several years, these price rises are likely to be instituted with a lag. This would be in line with the domestic producers' recent and current price policies and could temporarily raise the existing differential between foreign and domestic crude oil prices.

Domestic refiners, most of which currently operate under conditions of very low margins, would attempt to pass all foreign and domestic crude oil cost increases engendered by the import fee through to their product prices. Those refiners unable to do so may have to shut down capacity. Thus, over time, the

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*Somewhat less for light products but significantly more for residual fuel oil.

full import fee and most of its maximum potential impact on domestic oil prices would have to be borne by consumers.

There are still other costs to the economy from the oil import fee. The ripple effect of the higher oil prices throughout the economy would increase the inflation rate in the first full year by about 1.3 percentage points, according to separate estimates by the U.S. Treasury and a well known private economic consulting firm . If we assume next year's inflation base rate in the 6.5-7.0% range, a 1.3 point increase due to the import fee would be quite substantial. The ramifications of the rise in the oil price would also cause a slow-down in the general economic growth rate. For 1983 this has been estimated at more than 1 percentage point, assuming a $5/Bbl import fee for the entire year, or a loss in GNP of nearly $30 billion.

By and large, both the rise in inflation and the drop in the GNP would be limited to the first year of the fee imposition if there is no subsequent increase in the fee. However, there is one significant exception to this. The impact of the oil price increase on natural gas would initially be relatively modest but would grow steadily until 1985 when price controls will be removed from about 55% of all flowing gas under the Natural Gas Policy Act (NGPA). The average price of gas will be increasingly determined by free-market parity with those oil products with which gas competes. Thus, the higher oil prices resulting from the import fee would permit correspondingly higher gas prices. We estimate the gas cost increase to consumers from a $5 import fee at $12-15 billion no later than 1985. Under the NGPA most of this increase would be accumulated by the unregulated segment of the U.S. gas producing industry. Hypothetically, up to 46% of this money could flow to the Treasury in the form of income taxes. Actually, the Treasury's net receipts in consequence of the gas price increase would be significantly smaller because of the inflationary and other negative economic impacts resulting from the higher gas price.

Gas would also be likely to benefit in the <u>short run</u> from the oil import fee. If the fee were to add $5/Bbl to the cost of residual fuel oil, currently shut-in gas production would be able to displace the oil at short notice in some industrial plants and electric power stations.

<u>Effectiveness of the Import Fee</u>

One measure of the effectiveness, or ineffectiveness, of the import fee is the calculation by the Congressional Budget Office that a $5 import fee would yield a net federal revenue of $11-13 billion in 1983, if foreign producers absorbed no part of the import fee, which we consider likely. Since the gross cost of the fee to consumers in the first full year is $29 billion, this would mean that of each dollar oil price increase attributable to the fee only 38-45¢ would go into the federal treasury. Thus, if the purpose of the import fee were to be revenue collection it would have to be considered a very inefficient vehicle to do this.

The fee's effectiveness in offsetting the potential impact in the U.S. of declining foreign oil prices is likely to be seriously limited by both short-term and long-term considerations. As pointed out earlier, in the short term (up to 2 years) the response of demand to price changes is quite low, so that a $5 import fee would reduce demand by no more than 1.5-1.8%. While this is not insignificant, it pales in relation to the market-induced 13% reduction between the first quarters of 1980 and 1982. Of course, the demand reduction would fall almost entirely on oil imports which might be reduced by as much as 5% by the import fee.

The long-run limitations on the effectiveness of the import fee are likely to result from uncertainty about its political longevity. The emerging political controversy over the fee proposal reflects in part the reality that some sectors of the economy would inevitably be hurt by it while others would benefit. Passage or imposition of the import fee would by no means end this controversy, as can be seen from an examination of the period 1957-1973 when the level of oil imports was controlled by the government. Since reliance on politically controversial legislation or policy is by its nature hazardous, private companies would probably be reluctant to undertake long-range projects requiring large capital investments if the economic feasibility of these projects depended on maintenance of the import fee existing at the time the project is considered. This reluctance to rely on the import fee for the pay-out of future energy investments would be even greater if the fee were to be imposed by the President under the National Security clause of the Trade Expansion Act* than if it were legislated by an act of Congress, since the President could reduce or remove the fee at his discretion.

Equity Considerations

Obviously, an import fee would benefit domestic crude oil producers. As we pointed out earlier, the bulk of the domestic crude oil price increase in consequence of the fee would go to the government in the form of taxes but the after-tax benefit accruing to the producer would still be significant. Furthermore, it would grow over time as the Windfall Profit Tax rate on new oil production declines (under existing legislation) and the cumulative volume of new production increases. For producers of deregulated gas the benefit would be larger per unit of output, since there is no Windfall Profit Tax on gas production.

Doubtless, the higher price would stimulate some additional drilling and, hence, probably bring forth some additional production. But the government-induced price increase would benefit an industry which has done exceptionally well, particularly since the removal of oil price controls in January 1981, and has operated at full

*He can do so without Congressional approval if the Secretary of Commerce makes a finding that unrestricted oil imports threaten to impair the national security. The Act does not permit the President to impose an import fee for any purpose other than National Security, such as revenue collection.

capacity and maintained satisfactory earnings throughout the current recession.

By contrast, several of the industries on which the price increase would impact negatively have done very poorly last year and are in worse shape, so far, this year. Prominent among these are the oil refining industry already mentioned, the airline industry, the trucking industry, the railroad industry, and the petrochemical industry. Electric power plants which use oil as a power generating fuel (about 9% of total U.S. generation but 20% at the east coast) would also be significantly negatively affected. So would heating oil distributors, particularly those who must compete with natural gas in their markets.

These industries can be expected to protest loudly and strongly against this particular distribution of the burden of the import fee, especially if the fee is perceived to be primarily a revenue raising measure rather than an oil conservation and production incentive. The advocates of the fee may point out to these industries that a $5 import fee would not even fully offset the price drop in crude oil and most products which has occurred in the last 12 months. But the affected industries could reply that the recent price drop was quite moderate and was preceded by an explosive and unprecedented price increase between early 1979 and early 1981 which they had to absorb in full.

Another equity consideration as well as an economic one is the impact of an import fee on U.S. foreign trade. Since it appears unlikely that Europe, Japan or Canada will take steps to raise their oil costs above the world price level, most U.S. products will become less competitive internationally than they would otherwise be, for they generally have some direct or indirect petroleum component in their cost structure in the form of processing, heating or transportation. The competitiveness of U.S. products made in plants requiring natural gas, which is much more widely used than oil for industrial purposes, would also be increasingly negatively affected for the reasons explained earlier.

Another foreign trade consideration is the possibility of a conflict between the oil import fee and the President's recently prposed "Caribbean Basin Economic Recovery Act". The Act would permit duty free imports into the U.S. of most goods processed or produced in the Caribbean islands. Presumably, this would include oil products from the several Caribbean export refineries. If the import fee did not apply to these refineries they would have a substantial competitive advantage over domestic refineries as well as non-Caribbean foreign ones. This could obviously have far reaching consequences, both domestically and internationally.

Urgency of Import Fee

There is little disagreement with the proposition that a sharp decline in the price of imported oil would in time create disincentives to domestic exploration as well as to oil conservation and substitution. An import fee may be one viable approach to correct such a development. However, up to now--mid-April 1982--such a price decline has not occurred nor do we consider it likely in the near future. Here is the U.S. refiner acquisition cost for the month of March for the last four years:

U.S. REFINER CRUDE OIL ACQUISITION COST

	$/Bbl	% Change
March 1979	13.70	
March 1980	26.80	+95.6
March 1981	37.48	+39.8
March 1982 (est'd)	33.00	-12.0

Since the March 1981 figure represents the peak of the price run-up which started at the beginning of 1979, the price reduction, so far, can only be described as a moderate drop from the all-time high.

There is no evidence that this price drop has encouraged consumption which has declined by 7-8% in the first quarter of 1982 and is generally projected to remain below the 1981 level at least in the second and third quarter and possibly also in the fourth quarter of this year.

There is also no evidence that the price drop has curtailed domestic exploration. In January-February 1982 total U.S. drilling activity was 40% above the same period of a year ago, as was exploratory drilling. At the end of March rotary rig activity was down 15% from the historic peak month of 1981 but was still 5% above the year-ago count.

It would therefore seem that there is no urgency as yet to impose an import fee at this time if the real purpose of the fee is to counteract the economic effects of falling oil prices. Some forecasters have predicted that oil prices will fall to under $25/Bbl in the near future. If they are right and refiner acquisition costs really drop to that level for a sustained period the case for an oil import fee would be greatly strengthened. Meanwhile, we are about $7-8 above it and there are some preliminary, tentative indications that prices may bottom out at or near the present level.

Import Fee or Excise Tax

Whether the Import Fee is the best approach to achieve the desired goal depends of course in the first place on what the desired goal is. If it is primarily the collection of general revenue so as to reduce the federal budget deficit, the case for doing this by levying a tax on one single commodity, particularly one which has a very unequal regional and per capita consumption pattern, is far from convincing. The fact that the price of this commodity has recently declined from its all time peak so that consumers presumably would not pay more with the fee now than they paid without it a year ago does not strengthen the revenue-collection case for an oil import fee. There are many goods and services in the economy whose prices have declined or have risen less rapidly than the inflation rate. Anyone of these might be as good a candidate as oil to tax for the purpose of revenue collection. More importantly, the revenue collection justification for an oil import fee fails to address the basic question, namely why this method is superior to the traditional methods of tax collection, such as income taxes, business taxes, excise taxes, user taxes, etc. Is it because an oil import fee may not be perceived as a tax by those who would pay it?

To the extent to which the import fee is expected to carry out the dual task of offsetting the impact of declining oil prices and of generating revenue for budgetary purposes, it may be useful to compare it with recent proposals for an increase in the gasoline excise tax whose function would also be the dual one of revenue collection and oil conservation. (Legislatively the excise tax would have to be considered a revenue measure and would therefore require Congressional approval.)

A gasoline excise tax would of course have a smaller impact on the economy than the oil import fee because of its smaller base. Its direct effect would be limited to gasoline which accounts for 41% of total U.S. oil comsumption. It would have no impact on any other fuel since gasoline does not compete with non-oil fuels. Within the oil market it could affect the demand for diesel oil, depending on whether the excise tax would be limited to gasoline or be levied on all motor fuels.

Obviously, the tax would not affect the price of domestic crude or of natural gas. Thus, it would have no incentive impact on domestic energy supplies and a lesser impact on total domestic oil demand than the import fee. Whether this limitation makes the excise tax more desirable or less than the import fee depends again on what these levies are expected to accomplish.

From the point of view of affecting oil supply and demand, a government levy on gasoline only would be less effective than an oil import fee. However, as a revenue collection device the excise tax is clearly superior, since every cent paid by the consumer flows directly to the Treasury. Thus, the $11-13 billion net annual revenue which the Treasury could expect to receive from a $5 import fee could probably be obtained from a gasoline tax increase of approximately 16¢/gallon*--only 4¢ more than the estimated price increase of every refined product which would result from the import fee.

From the point of view of equitable distribution of the burden imposed on oil consumers a gasoline excise tax may also be preferable. With 110 million automobiles for a population of 220 million and with regional averages of annual miles driven per car not

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*The macroeconomic inflationary impact of the excise tax could be expected to reduce the net government revenue somewhat below the estimated gross excise tax revenue of $14-15 billion.

fluctuating widely, a gasoline excise tax would probably represent a more equitable burden distribution than a fee on all oil products. The reason is that kerosene, heating oil, residual fuel oil and LPG consumption are all regionally very unequally distributed. Even within regions, as well as communities, some consumers rely totally on some of these oil products while others do not use them at all.

Regarding the desirability for an increase in the federal gasoline excise tax (the current tax of 4¢/gallon has been in effect for nearly a quarter of a century), it may be interesting to note that the American automobile industry would apparently welcome it. A Ford Company official was recently quoted in the press as saying "these declines in gas prices scare the hell out of me",* and the Chairman of the Chrysler Corporation made the following comment:

> We'd better send a strong signal to the American car buyer that gasoline prices are going up. (A quarter-a-gallon excise tax would) restore the trend toward fuel-efficient cars and away from the gas guzzlers.*

The proposed oil import fee attempts to achieve two goals: to reduce the federal budget deficit and to encourage domestic oil and gas conservation and exploration. It proposes to do this through substantial direct government intervention in the U.S. energy market. The question which has yet to be answered is whether the expected benefits from this intervention would justify the inevitable dislocations resulting from it.

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*New York Times, Sunday Financial Section, p. 48. March 21, 1982.