

**Statement of Stephen J. Entin
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before the

**Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Representatives**

**Hearing on
"Minerals and Energy: Outsourcing American Jobs Overseas"
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Madam Chairman and members of the Subcommittee:

My name is Stephen J. Entin. I am President of the Institute for Research On the Economics of Taxation, but the views I express here are my own. Thank you for the opportunity to testify on the domestic and international implications of our energy policy.

I served as staff economist on the Joint Economic Committee of the Congress from 1975 to 1981. The 1970s were a time of significant disruptions in international energy markets, which were compounded by ill-advised government price controls and allocation rules that led to shortages and unnecessary economic damage. From 1981 to 1988, I served as Deputy Assistant Secretary for Economic Policy at the Treasury. In that job, I advised on the policy implications of several energy supply and price fluctuations. The easing of federal regulations and price controls in that period

greatly mitigated any domestic impact that the international situation might have caused. I see a basic lesson from that history that should inform our debates even twenty to thirty years later.

In recent months, oil prices have spiked to over \$35 a barrel, driven in part by the recovery of the world economy, in part by OPEC's actions to restrict supply, and in part by the falling dollar. Looking forward, the resumption of production in Iraq and the prospects for development of new oil and natural gas sources in Central Asia and Russia may help to rein in OPEC's power, but these sources are months or years away. Meanwhile, the rise in the price of oil acts like a tax increase, raising the cost of production and the cost of living in the United States.

Federal energy policy aids OPEC

While OPEC is an important source of the price increases, the U.S. government is also partly to blame. Government has intervened heavily in energy markets since the 1970s. Government regulations on domestic energy exploration, production, and sales have supported OPEC's monopoly power.

In a free market, cartels usually break down quickly because of cheating and entry. Historically, cartels have not been able to exist for long without government enforcement of price fixing and barriers to entry. OPEC is a governmental cartel, but it would not have the power it has if private companies could operate freely elsewhere in the world, and other governments did not enable OPEC to the extent that they do.

By manipulating prices and restricting competition from American oil companies, the U.S. Government has aided OPEC. Anti-energy policies include locking up coal reserves, increased regulations on oil refining, and restrictions on drilling for new oil and gas.

In 1996, President Clinton issued an executive order locking up more than a million acres of coal-rich lands in Utah. Coal is a substitute for oil, especially for producing electricity. Restricting coal production puts pressure on oil and natural gas supplies and drives up their prices.

We have been adding restrictions on offshore oil drilling, and restricted oil exploration on millions of acres of federal lands. The Arctic National Wildlife Reserve (ANWR) may be the largest oil reserve in the nation (with up to 16 billion barrels of oil). Drilling in ANWR would involve only about 2,000 of the refuge's 19 million acres, but it is stalled by environmental concerns. (Ironically, at the same time that we are locking up the ANWR oil, we are proposing to subsidize an Alaska gas pipeline whose construction would involve a far larger swath of more sensitive terrain, and are favoring that longer pipeline route over a shorter alternative spur into Canada to hook up with a Canadian pipeline that has been proposed to unlock their Arctic resources. In fact, all of these projects can proceed in an environmentally safe manner.)

Blocking oil exploration also blocks supplies of natural gas, which is often found with oil. At the same time, we have mandated the use of natural gas in generating electricity to curtail

emissions. Increasing demand while restricting supply has pushed natural gas prices to new heights. Making it more difficult for oil companies to produce and refine oil and for companies to mine coal in this country has restricted world energy supplies and contributed to high oil and natural gas prices. These policies have bolstered OPEC's ability to raise prices and injure American consumers.

Professor William Anderson of North Greenville College summarized the consequences this way: "Restricting U.S. energy development lowers our standard of living by forcing us to pay higher prices for fuel and to incur the costs and inconvenience of adapting to less energy use to power our automobiles, heat and cool our homes, and run our businesses. U.S. taxes and restrictions on energy production force artificial and uneconomical conservation of energy, and guarantee a stronger future for the OPEC oil cartel and a weaker future for the U.S. economy than would otherwise be the case."¹

Distortions hurt, whether domestic or international

Tying up resources deprives the economy of productive assets. It deprives other factors, either workers or capital, of their use. It lowers the productivity of labor and capital, and depresses their wages and rates of return. This is true whether the closest substitutes for the resources are foreign or domestic. The adjustment process is the same either way.

A closed economy example. Suppose the United States were the only country in the world. Suppose the Northeast specialized in financial services and fishing; the South in cotton and produce; the West in mining, movies, and trees; the Midwest in manufacturing; and the Plains states in grain, oil and gas. Now suppose that the environmental movement became focused on the destruction of the prairie, and convinced Congress to make all of Kansas into a national prairie park, closed to all forms of agriculture. The farmers of Kansas would have to find other employment.

Some of the Kansas farmers would compete with other agriculture workers for jobs in other states. There would be more production of grain in other states, but working their land more intensively and bringing marginal land into production could only be done at higher cost, and not all of the lost grain production would be made up. The land to labor ratio would fall, and with it the wages of everyone working in agriculture all over the country.

Some of the displaced workers would move into other sectors of the economy, driving down wages there. Some workers, not necessarily the displaced farmers, would leave the work force. Most of the displaced workers would find and accept other employment. However, it would generally be at lower wages. Presumably, the workers had been farming in Kansas because that was the best and highest paid use of their skills, and being forced to work elsewhere pushes them into

¹ William L. Anderson, "Uncle Sam's Energy Mess: How the U.S. Government Empowers the OPEC Cartel and Takes Power from the People," *Studies in Social Cost, Regulation and the Environment: No. 5*, Institute for Research on the Economics of Taxation, Washington, DC, March, 2001.

a second best use of their time. We would produce a bit more of other products, and less grain, a different mix of production yielding less satisfaction than the original mix. In the aggregate, national output and income would fall.

An open economy example. The same analysis would apply if the products in question were oil and gas. The analysis would not change much even if we note that the United States is not the only country in the world, and if the substitute for domestic oil and gas production were imported oil and gas. The slight added complication of trade across national borders and the balance of payments does not change the basic picture.

Consider the restrictions on output imposed on coal in Utah and oil and gas in the ANWR, on the eastern slopes of the Rockies, and offshore. Workers have been forced into second best uses of their time, and have suffered reduced wages and living standards. Some of the energy workers have been employed expanding energy production from alternative domestic energy sources, but only at higher cost, digging and drilling deeper into less promising fields and seams. Since some of the alternative domestic energy sources are too hard to come by and too costly, we have shifted many of the energy workers to other sectors of the economy, producing more of other goods and services. These jobs "exported" to other sectors of the domestic economy have been less rewarding, and the production of lesser value than the foregone domestic energy jobs and domestic energy output. In the aggregate, national output and income is lower.

We have surely been exporting some of that additional domestic production of alternative goods and services in exchange for increased imports of foreign produced oil and gas. In many cases, it has been cheaper for us to produce and export other goods to obtain replacement energy rather than strain to produce more energy from old oil fields and coal seams at home, where the output is still allowed. Nonetheless, it has been more expensive than if we had not imposed restrictions on new domestic energy sources, and if we had employed our workers in their first best use.

Abroad, workers have shifted a bit into energy production, and a bit out of the production of the things we export in exchange. Our foreign energy suppliers have earned additional dollars, some of which have been used by them or their trading partners to purchase our exports. It is likely that exports and imports may have both risen as a consequence. Alternatively, the reduction in U.S. income levels may have curtailed other imports by enough to have held down total trade. If net imports have risen, the net increase in demand for foreign energy and other products has been matched by an increased supply of goods and services for export. Foreigners will not give us something for nothing. The balance of payments will not be a major problem per se; the current account (trade and earnings on investments) and the capital account (net U.S. asset sales or borrowing) will adjust such that the books will balance. However, the adjustment will reflect a reduced level of U.S. productivity and wages, and perhaps a weaker dollar (depending on whether or not the Federal Reserve reduced the money supply in proportion to the reduced quantity of domestic economic activity).

The real problem. The problem with our energy policy is not so much that we are exporting any particular job abroad, or that energy jobs are inherently higher value added than jobs in other sectors. Rather, the problem is that we are locking up a valuable resource and forcing people to take jobs elsewhere in the domestic economy that, because of the diminished resources and misallocation of labor, do not pay as well nor yield as much value added at the margin as the jobs that were destroyed in the energy sector.

Two special considerations in the international arena

There are really only two differences between the domestic and international examples. One involves security concerns, and the other stems from the existence of an oil cartel, OPEC, that is beyond the reach of U.S. law and which we cannot simply sue out of existence on anti-trust grounds.

As far as the security concerns go, the best practice is use lowest cost resources wherever they may be found, and build a reasonable reserve against emergencies. Utilizing higher cost domestic resources at the margin as the ordinary source of power is expensive. It requires significant subsidies, and there may never be a crisis to justify the cost. Furthermore, artificially draining domestic reserves only hastens the day when we will be even more dependent on foreign energy. "Drain America First" is not a prudent policy.

The existence of OPEC complicates the analysis, but does not change the policy prescription. Restricting the U.S. supply of energy helps to support the OPEC cartel. It makes it that much easier for OPEC to raise prices. Put another way, for any given degree of OPEC output restraint, the world price of energy will be a bit higher due to restrictions on the output from other sources.

The existence of the cartel does not justify the use of domestic subsidies to encourage otherwise uneconomical alternative fuels. If world and OPEC oil prices are at \$35 a barrel, then private companies have ample incentive to bring on stream alternative energy sources that cost only \$25 or \$30 a barrel to produce. The threat and the eventual reality of such competing energy sources will undermine OPEC's output restrictions and bring down the world price. It is unwise and unnecessary to go to the other extreme of subsidizing alternative energy sources.

Some may argue that a dollar of subsidy may save us something if the added output depresses OPEC prices, returning a bit of the cost of the subsidy. However, it makes no sense to overpay for one type of energy in order to avoid overpaying for another. The added production needed to bring down OPEC prices should take place wherever it is really cheapest to produce, whether here or in Central Asia. Therefore, domestic subsidies of alternative fuels are unnecessary. The correct policy is neither to artificially restrict nor to artificially subsidize alternative energy production.

Conclusion and recommendations

The best energy policy would be to avoid unnecessary restrictions on the development of economical energy sources and their transmission and transportation in the United States, without

indulging in subsidies. This would suggest opening up new areas to drilling, and passing those elements of the energy bill relating to improving the investment climate for electricity transmission and ensuring the smooth operation of the regional and national electric grids. It would also suggest removing tax obstacles to investment, which is treated more harshly under the income tax than income used for consumption. A useful place to start would be to extend the provision in the Jobs and Growth Tax Relief Reconciliation Act of 2003 allowing for 50% "bonus" expensing, which is due to expire at the end of 2004. Expensing is the ideal "neutral" treatment of all investment outlays. If corporate tax rate relief is provided in a bill to comply with the WTO ruling against the ETI, it should be applied equally to all businesses, including energy, and apply to the alternative minimum tax as well as the regular corporate tax. Evenhanded relief from the high tax burden on investment is a sufficient remedy. No additional subsidies are needed.