Forty Years *of* Folly

BY PHILIP K. VERLEGER, JR.

The failure of U.S. energy policy.

Richard Nixon sent the first presidential message on energy policy to Congress in 1971. He began by explaining that, throughout history, the United States had always been able to count on bountiful energy, and then warned that "the assumption that sufficient energy will always be readily available has been brought sharply into question within the last year." He proposed a broad program to address the threat of a shortage, mostly by boosting supplies. Included in his proposal were the accelerated leasing of federal lands, the development of a shale oil program, the removal of barriers to constructing electric power plants and transmission lines, and the rapid expansion of the nation's nuclear industry, which included the development of a fast breeder reactor.

Two years later the Arab oil embargo occurred and President Nixon reiterated his call for supply-side initiatives. At the same time, he introduced "Project Independence," a program intended to free the United States from its reliance on imported oil by 1980.

In his 1971 remarks, Nixon cautioned that the United States could not rely on natural gas. Referring to the Clean Air Act amendments that had just become law, he observed that "our present supply of natural gas is limited … and we are beginning to face shortages which could intensify as we move to implement the clean air standards."

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Presidents Ford, Carter, Reagan, George H.W. Bush, Clinton, and George W. Bush followed in Nixon's footsteps. All accepted the idea that future gas supplies would not be plentiful. All advanced ways to achieve independence, none of which went anywhere. Who, for example, remembers the Synfuels Corporation?

In hindsight, it appears that President Nixon got it all wrong. The United States failed to develop a fast breeder reactor. Shale oil proved impractical. The siting of power plants and transmission lines remains problematic. Hopes for bountiful low-cost nuclear-generated electricity died a harsh death after Chernobyl and Three Mile Island. Natural gas supplies, instead of vanishing suddenly, now seem unlimited. In short, the last forty years of U.S. energy policy appear to have been a total disaster. The nation would have been better off had the government taken a hands-off approach.

During those four decades, our focus on energy independence has been the greatest error. The United States has embraced free trade and free markets in every economic sector except energy. Today, we rely on China to supply our needs for critical rare earth elements, key components for almost every manufactured good, and, in some cases, the manufactured goods themselves. Every mainstream economist who has examined the move to free markets and free trade has concluded that, on net, the United States has benefited greatly from this approach. Six years ago, Larry Summers suggested in a Peterson Institute study that the gain summed to trillions. Again, the only sector where free trade has not been endorsed is energy. This is a tragedy of immense proportions.

For the last forty years, we have lived in a fantasy world, failing to acknowledge the possibility of much higher energy costs.

The 1973 Arab oil embargo triggered our infatuation with energy independence. For three months, Middle Eastern oil exporters refused to sell oil to the United States and the Netherlands. In response, the United States has invested billions, if not trillions, in pursuit of reduced oil imports. Further trillions have been doled out to the energy industry as tax benefits in the mistaken belief that this

Richard Nixon

Nixon Got It Wrong

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would boost GDP. In my view, the tax credits restrained growth instead.

This focus on energy independence is almost un-American. Consider that in 1973, thirty-two years after the start of World War II, the United States government had strong positive relationships with the former Axis powers despite the fact that over 400,000 Americans died in the conflict. Yet thirty-eight years after a three-month oil cutoff by Mideast exporters, we still obsess over energy independence. Some might suggest that our priorities are screwed up.

Those adversely affected by the Macondo oil spill, the groundwater pollution by careless natural gas drilling, or the flooding caused by mountaintop coal mining in West Virginia will certainly not be mollified to learn that the pain they have endured as a result of our chasing after energy independence was unnecessary. Indeed, the primary result of this quest has been the accelerated environmental rape and pillage of much of the United States, which has heaped economic benefit on a few while offering nothing to the nation as a whole.

In an ideal world, President Obama would recognize the failure of U.S. energy policy and turn the economy in a new direction. In doing so, he and his advisers should recognize that, as part of a global economy, the United States will continue to import some energy resources, such as oil, and export others, such as coal and natural gas. These are facts. The administration would also recognize that energy policy must be part of economic policy and that the energy sector can make a large contribution to closing the national budget deficit.

One hopes that, in structuring economic policy, the president would recognize as well that the oil industry in particular and the energy sector in general play very different roles in the economy than companies like Boeing, Apple, and GE.

These companies and others create value in the economy through creative thought. As the late Theodore Levitt of Harvard noted, these firms grow by inventing new things, getting customers excited about buying them, and then moving on to produce even better items. Businesses like these drive our economy.

Energy companies, on the other hand, create little. Yes, they discover, transport, transform, and deliver energy. In general, they profit, not through ingenuity, but through commodity price increases. The governments of Norway and the United Kingdom have long recognized this difference and, as a result, have taxed resource production while rewarding firms engaged in innovative practices. At the end of 2010, the Israeli government did the same, adopting a proposal by Professor Eytan Sheshinski for taxing the large natural gas reserves recently found there. The Israeli tax law, like those imposed by former UK Prime Minister Margaret Thatcher, provides very large deductions for exploration and development expenditures while capturing up to fifty percent of the revenue above costs.

U.S. economic policy going forward should embrace the same idea. Every possible step should be taken to promote innovation while using resource extraction firms to close the budget deficit. If we were to follow Israel's example, we could probably eliminate the deficit by 2020.

Many will object violently to this idea, particularly the organization that speaks for the oil industry, the American Petroleum Institute. These critics will assert that adopting such a policy would lead to higher prices and a larger trade deficit while making the nation more vulnerable to energy disruptions.

Continued on page 66

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Sheik Yamani's Warning

Sheik Ahmed Zaki Yamani

Nothing cures high prices, however, like high prices. Officials from Saudi Arabia and other enlightened oil-exporting countries recognize that price increases accelerate conservation, fuel substitution, and the development of renewable fuels. They recall **Sheik Yamani**'s warning that "the Stone Age did not end from a lack of stones." Such exporters, who will do everything they can to prevent price increases, would welcome an integrated U.S. energy and economic policy that reduced the deficit and dismantled trade barriers.

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VERLEGER

Continued from page 51

I agree with the first conclusion. Prices may go higher. In fact, I hope they do rise. For the last forty years, we have lived in a fantasy world, failing to acknowledge the possibility of much higher energy costs. Ford, GM, and Chrysler, for example, ignored this prospect for at least three decades and suffered dire consequences.

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On the other hand, I disagree with the second conclusion. Arguing that reduced domestic production will boost the trade deficit is just wrong, as the readers of this magazine understand well. The trade gap has resulted from a savings/investment imbalance. Ironically, increased energy taxes could help lower the deficit by cutting the government budget gap.

Finally, one must dismiss the idea that ending our forty-year subsidization of oil and energy would increase the nation's vulnerability to supply shocks. Such claims are nothing but utterances from the energy industry's self-serving proponents. Today, oil shocks should be of no concern for three reasons. First, the world's major consuming countries hold very large strategic reserves that can be deployed during a disruption. Second, economic research by Bernanke, Strock, Watson, and Killian has shown that the economic impacts of past energy shocks were drastically overestimated. In a seminal Brookings Institute paper, for example, Chairman Bernanke demonstrated that effective monetary policy can moderate the effect of shocks. Third, the United States can no longer afford to prop up the energy industry to the tune of hundreds of billions per year in return for the modest benefits that might be derived from strategic reserves during a supply disruption, benefits which, ironically, the industry seems to capture fully.

It is time, in short, to combine energy and economic policy. For forty years, the United States has pursued one bad idea after another, invariably operating as if it knew the dimensions of future energy markets. Its forecasts have been terrible. The nation would have gained far more by adopting policies that promoted innovation in firms such as Apple, Boeing, and GE while capturing a good portion of the rents generated by resource production. The country would be stronger today had it followed this path. It will undoubtedly be much stronger if takes this course over the next twenty years. ◆