

Suite 502

1150 Seventeenth Street, N.W., Washington, D.C. 20036

Telephone: (202) 777-3000 Facsimile: (202) 777-3010

ECONOMIC NEWS UPDATE

IRWIN M. STELZER

02 February 2006

He came, he saw, he spoke. His was the sound, the opposition Democrats, sullenly refusing to applaud at many points, provided the fury, and sober reflection reveals the significance to be nothing at all.

The president, apparently satisfied with the few cuts that Congress enacted last week, said nothing that indicates a burning desire to balance the federal budget. True, he called for the elimination of some 140 failed government programmers, but that merely repeated the unheeded requests of his predecessors. Congress isn't about to stop funding any programmed so long as there are votes to be had from continuing it.

He also asked that congress grant him what is called a "line item veto", which would permit him to veto spending on individual programmers, which he can't do now. Under present law, the president can either accept the budget congress passes, or veto the whole package, bringing government to a halt. Past presidents have asked for what amounts to a shift of power from the congress to the president; congress

quite naturally has declined to dilute its own power.

Add to that picture of continued profligacy two things, and it is clear that new Federal Reserve Board chairman Ben Bernanke will have to make monetary policy with continued budget deficits lurking in the background. Remember: loose fiscal policy puts greater pressure on the Fed to tighten monetary policy.

The president is asking congress to make permanent the tax cuts it voted when the economy needed an economic stimulus, and is proposing to fund several new programmers designed to end what he terms America's addiction to oil, and "move beyond a petroleum-based economy and make our dependence on Middle Eastern oil a thing of the past." These words must have come hard to a Texas oil man, who in the past has sought to feed our petroleum cravings with homegrown rather than imported oil by opening up the Arctic National Wildlife Refuge (ANWR) to drilling. The green lobby has repeatedly persuaded the congress to deny the president that wish.

President Bush set as his goal the replacement of some 75% of the oil America imports from the Middle East by 2025. Since only about 17% of our imported oil comes from that volatile region, that would mean reducing total imports by a bit less than 13%, although from what base -- current consumption, or consumption in 2025 -- is not clear.

Unfortunately, the oil market doesn't work that way. Unless America specifically targets Middle East producers with quotas, probably a violation of the WTO anti-discrimination rules, any import reductions will come out of the hides of higher-cost producers, not the Middle Eastern countries with their low production costs. Furthermore, our European allies, who made their reserves available to us during the supply interruptions caused by Katrina, would remain dependent on imports from the Middle East. And reduced consumption in America would probably be offset by increased demand from China and India, diluting any effect the President's proposed cutback in demand would have on the price of crude oil.

If the president has his way, the government will invest in a variety of alternative technologies: \$281 million already targeted for clean coal technologies is to be brought forward; \$54 million will be spent to develop emissions-free coal plants that capture and store carbon emissions; \$148 million is devoted to a Solar America Initiative; \$44 million will go for wind energy research; \$150 million to help develop bio-based transportation fuels from agricultural waste products such as "wood chips, stalks or switch grass" is on the Bush list.

There are more bits and pieces, but you get the idea: little projects resulting from big-government thinking, all sharing a fatal flaw. The central planners in the White House and the Department of Energy have decided which technologies hold the greatest promise, and are prepared to spend other people's money to find out if they can do a better job than markets in allocating resources to technologies that might, just might, yield alternatives to oil.

There is no reason why private-sector entrepreneurs cannot develop alternatives to oil -- if the price with which they are competing is certain enough, and high enough to reflect the risks to which our addiction is exposing us. Unfortunately, they aren't.

One reason alternatives to oil for transportation have not developed is that venture capitalists and potential innovators know that if they do come up with a product that competes with oil at anything like current prices, the Saudis, who can produce the stuff at a cost of around \$5 per barrel, can always lower the price, and wipe them out. The other is that consumers are smart, rather than addicted, and know that even at current "high" prices, gasoline is the best buy if you want to power a vehicle to work or on a vacation. Yes, hybrids are finding a niche among greener motorists and in Hollywood. But technologies that can really make a dent in gasoline-powered vehicles are not yet with us.

The President's men might be right, and wood chips and switch grass might be the answer. But history suggests that bureaucrats are not quite as good at picking winners as is the market. The President would have done better to set a floor under oil prices, with import fees to cut in if prices fell below a

certain level (\$35 was talked about by the speech's drafters), or to impose a tax on oil imports. The revenues can be used to lower other taxes such as the regressive payroll tax, which is in effect a tax on jobs. Then let the great American entrepreneurial genius, the praises of which the President often sings, go to work to develop technologies that can replace oil.

[ET



THE SUNDAY TIMES

Versions of this Update appeared in The Sunday Times (London) and in The Weekly Standard