

## Energy, Competition, Taxes and Trade: Some Policy Suggestions

Notes for talk by Irwin M. Stelzer\*  
at a meeting of a section of  
The Prosperity Caucus  
May 8, 2006 Washington, D.C

I much appreciate this invitation to share some thoughts with you on some aspects of economic policy. Some of my suggestions are trial balloons, designed to attract the fire of the sharpshooters in the audience, and to be abandoned if shot down by powerful contrary arguments. My assumption is that sessions such as these are for the education of the speaker as much as for the education of the audience.

I have divided my suggestions into two groups. The first set contains two ideas that would constitute major revisions of the policy of this administration, and fly in the face of the antipathy of both parties to taxes on gasoline, and to some conservatives' suspicion of vigorous government enforcement of competition policy. The second pair of ideas is more modest, being in the nature of suggestions for what

---

\* Irwin Stelzer is Director of Economic Policy Studies at the Hudson Institute, a contributing editor to The Weekly Standard, and a columnist at The Sunday Times (London). He is also a consultant some of whose clients have interests in energy and competition policy.

might be called mid-course corrections of tax and trade policy.

### Policy Revisions

Energy:

Since \$3 gasoline seems to have roiled the political waters, and more than most problems unmoored politicians in both parties from their senses, let me begin with energy policy. No need here to rehearse the broad division that has characterized past debates: Democrats concentrating by and large on reducing demand, Republicans concentrating on increasing supply. I paint with a broad brush, of course, but I think it not unfair to contend that each party is proposing a one-bladed scissors with which to cut the Gordian policy knots that seem to bind us.

So let me suggest that when we are treated to suggestions

- that we subsidize this or that technology that some politicians know, just know, will provide relief from our current addiction to oil;<sup>1</sup> or
- that we maintain environmental restrictions that are based on cost:benefits analyses that measure benefits using a low and obsolete price of oil; or

---

<sup>1</sup> For those who now share the President's infatuation with switch grass, I recommend a study of the massive failure of government-favored coal liquefaction projects in the 1970s.

- that we mail checks to voters who know full well that politicians can only prevent those checks from bouncing by picking the pockets of the recipients; or
- that we once again hunt for collusion among oil companies intent on gauging consumers, while refusing to move against the self-confessed, blatant cartel that is OPEC; or
- that we enact a windfall tax, the only sure consequence of which is to transfer money from companies that might use it to expand supplies, to Washington's famously spendthrift congress,

we realize that we are on a hiding to nowhere.

My notion is that we should jettison all of these proposals: they range from the nonsensical to the harmful. Instead, let's adopt the only measure that we know will both increase the supply of oil, and curtail demand, without involving government in making detailed decisions concerning how to enhance supply or reduce the amount of oil we consume. Let's raise the price of oil by taxing its consumption.

Not by an arbitrary amount, and not in a way that will increase the flow of funds to Washington, but in a way that

makes economic sense, and at the same time will stimulate economic growth and job creation.

The amount of such a tax should not be set arbitrarily, but instead to reflect an approximation of the uninternalized social costs of our consumption of oil. Consumers of oil – all consumers, not only those who fill their gasoline tanks at the pump, but also those who fill the fuel oil tanks in their basements – are imposing costs on society by driving, and by heating their homes. We long ago came to realize that these costs include those imposed on the environment. Lately, we have become acutely aware that our consumption of oil imposes additional costs incident to the fact that God chose to put crude oil in the hands of bad guys. With the exception of Canada, and possibly but no longer certainly Mexico, we and the world get our oil from

- Saudi Arabia, which supports the terrorism that we are expanding blood and treasure to defeat;
- Iran, which is threatening to turn off its spigot if the world angers it by moving against its nuclear weapons program to forestall it from achieving its stated goal of wiping Israel from the face of the earth;
- Nigeria, not a bastion of democratic stability;

- Venezuela where a Castro-with-oil is using the money we send him to forge a continent-wide anti-American alliance; and
- Russia, where, as Vice President Cheney has pointed out, our new and revised look into the soul of Vladimir Putin has revealed a man eroding the freedoms of the Russian people, and using his nation's vast resources of oil and natural gas to cow European nations into submission to his aggressive, anti-American foreign policy.

The unfortunate fact is that when we experience a jump in oil prices from, say, \$50 per barrel to \$70 per barrel, American consumers increase their annual payments to these various hostile regimes by some \$70 billion. That pays for scores of suicide bombers, for the maintenance of Wahhabi preachers and their mosques and madrasas, and provides a lot of money which Hugo Chávez can use to corrupt elections and policies in Latin America.

Were we to impose a tax on oil that would make the profit-maximizing price include a substantial payment to our treasury, the flow of funds to the bad guys would be sharply reduced. Oil producing nations know this, which is why they are so incensed by the high taxes on petrol in Europe –

European governments are snatching funds that the producers would prefer to see flow to them.

But surely, you might reasonably argue, we don't want to take the high-tax, low-growth economies of Europe as a model. Of course not. Which is why any increase in taxes on oil consumption should be accompanied by a reduction in the regressive, job-destroying tax we now levy on payrolls, a tax that reduces employers' incentives to hire, and employees' incentives to work.

Such a transfer of the tax burden to oil consumption from payrolls will, of course, have distributional consequences, and I confess that I have not worked all of those out. But I have considered one aspect. Many are calling for a tax on so-called gas-guzzlers. That makes little sense, since it is the use of vehicles, not their purchase that determines how much they contribute to our oil addiction. Many more are calling for a tax on gasoline, but that ignores other uses of oil, and would probably fall more heavily on consumers out West, where we drive large distances merely to do our shopping, than on those in the Northeast, who rely less on their vehicles but more heavily on fuel oil to heat their homes.

Note that the multiple advantages of the tax I am proposing are that (1) it has no punitive element: it only charges consumers for the costs of their consumption; (2) it gets government out of the business of picking technological winners, as the higher cost of oil consumption will encourage private entrepreneurs to bring to market the most efficient new technologies; (3) it transfers some of the burden of financing our government from a regressive, job-destroying tax on payrolls to a tax on the consumption of a product that is now under-priced because it does not reflecting the social costs of its use; and, (4) it transfers funds from the treasuries of hostile oil-producing nations to our own coffers.

But there is more to the solution of our energy problem than taxing oil consumption. We need to change the institutional arrangements used by our government to make energy policy. The less charitable among you will find favor with my long-ago proposal that we eliminate the Department of Energy, a dysfunctional organization that historically has contributed little of intellectual value to the debate about energy policy. The more pragmatic will say that DOE does perform valuable functions in the nuclear energy research and clean-up areas. If that is true, and if it is indeed the case that its nuclear activities cannot be more effectively

performed by the private sector – I have my suspicions, but they are based merely on ideology, an unreliable guide to policy – then let a renamed Department of Energy continue with that work.

But transfer its energy-policy functions, along with its very valuable data-gathering activities, to the State Department. Now, I am no fan of that Department, which in prior incarnations has tended to confuse being cordially received at international functions with implementing policies that are in America's national interests. But energy policy now has so large a geopolitical, geostrategic component that it cannot be left to economists and narrowly focused energy experts alone.

We know that the supply sides of the oil and, increasingly, the natural gas market, are dominated by state players. Russia's decisions about sales of its natural gas are not made on the basis of the profit-and-loss calculations used in the boardrooms of America's oil companies, which have a fiduciary responsibility to maximize shareholder value. Saudi Arabia's decisions concerning the terms on which Western capital will be permitted to help it increase its output are not made after a study of economic texts extolling the virtues of the free international flow of capital, but after

calculating the level of production that will maximize the cartel profits of OPEC. Mexico prefers lower profits and less output of oil to an invasion of Yanqi dollars, so long as it can export the workers victimized by its failure to stimulate economic growth. Venezuela is not acting as a traditional profit-maximizer when it replaces skilled oil-field technicians with political appointees whose lack of knowledge reduces its output, or when it gives Fidel Castro and others, including friends in the Republic of Massachusetts, oil at below-market prices.

The demand side, too, is increasingly dominated by non-market players. We compete for supplies with Chinese companies that have access to subsidized capital. More important, these companies can pay prices that reflect all of the external benefits to the regime of increased supplies: the jobs created by oil-driven factories that churn out exports being the principal one. In a bidding war, U.S. companies can invest only sums that they can recapture, with a profit margin that yields a competitive return on their capital. Chinese companies can invest without strict attention to return on capital, and in addition include what the regime estimates it is worth to fuel the production of exportable goods at prices that maximize, not profits, but employment.

We must find some way to reorganize our institutions so as preserve our private-sector structure, while at the same time factoring in our broader geopolitical interests. A State Department dedicated to pursuing America's national interests –it is possible to imagine such an organization – is more likely to achieve that objective than a more narrowly focused Department of Energy, which in any event must devote most of its resources to its nuclear responsibilities. Let me conjure up one example: the State Department would be more able to link immigration and energy policy – explaining to the Mexican government that we consider its policy of barring production-increasing American investment in its energy industries a factor in determining our immigration policy.

I have no way of knowing whether the State Department is willing to grasp this additional nettle. But Secretary of State Condoleezza Rice did tell the Senate Foreign Relations Committee recently, “I can tell you that nothing has taken me aback more as Secretary of State than the way that the politics of energy is – I will use the word ‘warping’ – diplomacy around the world.” Surely that suggests that she understands that the foreign policy establishment must become more deeply involved in energy

policy than merely proselytizing for the construction of pipelines that bypass territory owned or influenced by Russia, or chastising Putin for threatening to divert supplies of energies from Western Europe to China if the EU insists on creating competitive markets for natural gas in Europe, or if Vice President Cheney persists in pointing out the Russian president's renewed attraction to his old KGB style of governance.

#### Competition:

The second area I would like to suggest would benefit from correction is the drift towards a more relaxed competition policy. Most of my conservative friends do not approve of vigorous enforcement of our antitrust laws, with the possible exception of cases of price fixing. Some, the more libertarian, advocate repeal. I think both positions are wrong, and if applied will lead to a massive increase in government intervention in the economy.

I raise this issue now because the administration seems to have decided on a relaxed and unaggressive approach to enforcement,<sup>2</sup> and has ordered out a reexamination of our traditional policies, both by an independent commission that expects to share its deliberations with us after the summer,

---

<sup>2</sup> See Stephen Labaton, New View of Antitrust Law: See No Evil, Hear No Evil," The New York Times, May 5, 2006.

and by the enforcement agencies, which have scheduled a series of hearings on several aspects of antitrust policy.

The relaxed, even hostile approach to antitrust enforcement is reflected in the government's recent decision to enter the lists on the side of Microsoft in that company's long-running battle with antitrust authorities in the European Union. A few weeks ago the administration launched a global effort to persuade antitrust officials in the EU to be nicer to Microsoft, and forgive it its sins, or at least not penalize the company for them. It communicated its "substantial concern" at Microsoft's treatment to Europe's competition enforcer, Neelie Kroes, and had its embassies in all 25 EU countries notify those countries that our government is on Microsoft's side in its efforts to wriggle out from under adverse findings by the European competition authorities. That intervention matters: these countries must ratify any decision by the antitrust authorities to fine Microsoft.

Critics of the antitrust laws who see the reviews I have mentioned as an opportunity to relax strictures against anti-competitive behavior apparently believe antitrust policy interferes with the growth of successful firms. It does no such thing. Nothing in the laws discourages firms from

obtaining as large a market share as they can by building a better mousetrap. What the laws discourage is the use of that better mousetrap to monopolize the market for cheese.

Take the case of Microsoft, which I use not because of any special hostility to that company, but because I have never been involved in the litigation its business tactics have produced. Let us assume that the 90% market share enjoyed by its operating system was won because that system offers consumer the optimum mix of price and quality. (Candor compels me to add that I do not believe that is the case, since Microsoft's pricing policy required PC manufacturers that wanted to install its system in any of their machines to pay for its use in all of their machines, making installation of competitive products uneconomic.) Does that mean that economic efficiency is served if Microsoft is allowed to leverage that monopoly position by tying to it other products, thereby discouraging innovation in related markets? I think not.

Now I am aware of the argument that we need not worry about any of this, as all monopoly positions are in the end transient. Perhaps. But even so, a lot of resource misallocation can occur, and many innovations be stifled, if we allow such leveraging to take place until a monopoly

position is sufficiently weakened to make it useless as a tying device.

Let me explain why I think we need to pay attention to this issue. Policy-makers disagree on many things, but one thing they do agree on is the superiority of the free-market system. I won't rehearse here the teachings of Adam Smith, or detail the differences in the material achievements of market- as compared with centrally directed economies. You know all of that. But what we sometimes need reminding of is the social consequences of free markets as compared with those in which dominant firms can rely on other than their efficiency to create barriers to entry.

Free-market capitalism retains broad support in part because it provides social mobility. Political campaigns based on class warfare fail in this country because voters believe that their turn at the top is achievable with hard work and, yes, a bit of luck. At a time when serious questions are being raised about the continued ability of our economy to provide social mobility, it is more important than ever to keep the doors open for entrepreneurs to make their marks. Free entry into economic markets provides not only an incentive to innovation and the progress that flows from the

Schumpeterian perennial gale of creative destruction,<sup>3</sup> but also the flow of arrivistes that we need to challenge established wealth and refresh the upper ranks of our society. Allow firms dominant in one area to extend that dominance by means other than sheer efficiency, and we weaken support for the market system and the social benefits it willy-nilly produces.

Worse still, with weak antitrust enforcement comes increased government regulation, something that should give any serious policy-maker pause. Private monopoly power begets government regulation as certainly as expanded government begets increased corruption. Competition, by limiting prices and profits to levels necessary to return to investors and entrepreneurs the risk-adjusted cost of the capital they deploy, makes it unnecessary for government to intervene – allow the invisible hand to atrophy, and the long arm of government is certain to make its appearance. The answer to those who want the government to control oil prices is that there is sufficient competition to make such controls unnecessary.

Let me conclude this discussion of competition policy with a word about the emerging battle between Google and

---

<sup>3</sup> See Joseph A. Schumpeter, Capitalism, Socialism and Democracy. New York: Harper & Brothers, 1942, part II, chapter VII.

Microsoft, in which I am not involved, and which therefore makes a handy case study for my purposes today. To some it seems ludicrous that a company as large and successful as Google should be crying foul when Microsoft builds into its operating system a feature that tips the competitive battle with Google in its favor. But good competition policy is not concerned with size; it is concerned with dominance of a definable market, when that dominance is combined with the use of exclusionary or predatory tactics.<sup>4</sup>

Thus, the fact that Google is big and successful is irrelevant to the question of whether Microsoft should be allowed to use techniques designed to extend its monopoly power, or dominant position, into a new field in a way that denies consumers the opportunity of freely determining whether it, or some competitor, better meets their needs. Yes, Google will survive, and more than survive, anything Microsoft can throw at it. But the fact that a victim survives a mugging, and even goes on to recover and prosper, doesn't mean that we should approve muggings. And if dominant firms are allowed to employ exclusionary tactics, there is always collateral damage, as potential entrants decide that

---

<sup>4</sup> "Exclusionary conduct ... strikes at the heart of the competitive system because it frustrates a market test of the relative social efficiency of the victim and the aggressor firms." Joseph F. Brodley, "The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress," in Harry First, Eleanore M. Fox and Robert Pitofsky (eds.), Revitalizing Antitrust In Its Second Century. New York: Quorum Books, 1991, p.112.

they have little chance of engaging in competition on the merits, and venture capitalists refuse them the means to do so even if they are willing to take the risk of being strangled at birth.

#### Midcourse Adjustments<sup>5</sup>:

I have two in mind: tax policy and trade policy.

Start with tax policy. Bush was right to listen to Larry Lindsey during the 2000 campaign and endorse a tax-cutting program that did two things: prevent an economic softening from turning into a major recession, and encourage risk-taking and job-creation with tax cuts that benefited both those in the lower middle class, and, more obviously and controversially, high earners (“the rich”, to liberals), and corporations. The Bush tax cuts thus met the compassionate (many families of modest means relieved of their tax burdens and benefiting from expanded child tax credits) conservative (maximize incentives) principles on which he campaigned.

But that was then and this is now. The economy is hardly any longer in need of an economic stimulus: it is growing at something like 3%-4%, or more, creating hundreds of thousands of jobs every month, and exhibiting

---

<sup>5</sup> I draw here on ideas I recently laid out in [The Weekly Standard](#).

enough signs of overheating to have the Fed raising interest rates.

Nor are high earners in need of further incentives to take risks and work harder. Corporations find themselves awash in cash, profits are claiming a record portion of national income, and share prices are closing in on levels not seen for years.

Meanwhile, the middle class is not sharing as fully in the economic recovery as maintenance of the American Dream requires, and compassion would suggest is desirable. The data are, to put it mildly, hazy, and we must beware not to fall into the trap, set almost daily by the New York Times and the liberal media, of mistaking the plural of anecdotes for data, to borrow from University of Pennsylvania political science professor and sometime Bush adviser, John Dilulio. Nor can we ignore the fact that the majority of Americans profess satisfaction with their lives (57% “very satisfied”, 28% “somewhat satisfied”, only 13% “dissatisfied”), that consumer confidence remains high, and that there are some signs that real wages are turning up.

And yet, and yet.... It is not unreasonable to read the data as telling us that inequality in America is increasing, and that economic and social mobility are decreasing, as

Richard Herrnstein and Charles Murray so convincingly demonstrated in The Bell Curve.<sup>6</sup>

Globalization has introduced billions of low-wage workers into the work force, and immigration millions more. Increase the supply of anything, including labor, and other things being equal, its price will be held down. That's what's seems to be happening to the incomes of unskilled workers. Indeed, competition from foreign workers is no longer confined to the unskilled and to the manufacturing industries: some skilled workers and the service industries are also under threat. There is considerable controversy among academics as to the effect of these developments on wage rates in America, with some arguing that the availability of cheap pool-maintenance labor increases the demand for pools and the skilled men and women who design and build them. Indeed, the net effects of immigration on economic growth and the behavior of wages remain the subject of studies and counter-studies. But there can be no denying that there has been little significant improvement at the lower end of the skill and wage scales, and perhaps an immigration-induced reduction on the order of 4%-8%

---

<sup>6</sup> Richard J. Herrnstein and Charles Murray, The Bell Curve: Intelligence and Class Structure in American Life. New York: The Free Press, 1994.

Fortunately, the widening gap between the skilled and unskilled is having the salutary effect that free-market conservatives would hope for: it has increased what economists call the education premium, to which hundreds of thousands are responding by pursuing higher education in community colleges. But it would not be folly for compassionate conservatives to ask themselves this question.

But, given the trends that have seen incomes rise so rapidly at the upper end of the income scale, is now not the time to reexamine the distribution of the tax burden with a view towards tipping it a bit more in favor of those who have not shared fully in our increasing affluence? Such restructuring need not result in a net increase in the tax burden, and might be a consequence of shifting the revenue burden away from payroll taxes and towards energy taxes, if upper income consumers travel more and heat and cool larger houses.

I hasten to add that I am less certain of my answer to this question than I am of my suggestions about energy and competition policy, especially in light of the facts that America's corporate tax rate is now at the high end of the international tables, and that the Bush tax cuts already

exempt so many middle income families from income tax – 32% of all those who file income tax returns have zero or negative tax liabilities, and the bottom 60% of earners pay only 0.6% of all income taxes. But I am certain that it is a question we should be asking, given what appear to be recent trends in income distribution, and the regressive nature of payroll taxes. As The Economist recently put it, “For most Americans the income tax is much less important than the payroll tax.”

A final observation, this about trade policy.

No need here to rehearse the virtues of free trade, or to detail the way trade-opening measures have contributed to world economic growth. Even the President’s severest critics cannot deny that he has led the fight for freer trade. Yes, he has had to take an occasional step back (think, steel and apparel) in order to take two steps forward. But he has authorized successive US Trade Representatives to negotiate bilateral Free Trade Agreements (FTAs) that will in aggregate cover 54% of US exports, and made an historic offer to eliminate all trade-distorting agricultural subsidies if our trading partners will do the same. (The French “non” was immediate and unequivocal.)

Freer trade has enriched American consumers by forcing down prices of everything from t-shirts and sneakers to computers and television sets; it has enabled the Fed to keep interest rates lower than they would be if inflation were a greater threat; it has forced domestic producers to become more efficient in producing goods that American consumers want to buy. All of these are the benign results of the sorts of policies that conservatives elected George Bush to push through a reluctant congress.

But we have lately been reminded that free trade has distributional consequences: it creates losers as well as winners. The winners are consumers, as any stroll down the aisles of Wal-Mart will make clear. The losers are producers -- those who have invested capital in companies that changing circumstances make uncompetitive with overseas suppliers, and workers employed by those companies. Not all of these workers are members of trade unions that have a history of exploiting monopsony power, as did auto and steel workers in the days when domestic manufacturers were not faced with effective competition from imports, and could pass on to captive consumers any wage increases needed to buy peace in the plants and quiet in the board rooms. Many workers hurt by imports have played the game the way

we have asked them to -- work hard, educate your children, pay your taxes.

Suddenly, the world changes, and through no fault of their own they find themselves unable to compete with labor in countries in which labor is abundant and cheap. Nothing in economic theory teaches that these workers are less worthy of the concern of policymakers than the consumers who benefit from low-cost imports, especially in an era in which the perfect markets assumed by theorists do not exist:

- currency manipulation is rife,
- the theft of our intellectual property runs into the billions, and
- barriers to the sale of America's important exports -- the three "A"s of aircraft, agriculture and audio-visual products -- are quite high.

What economics can teach is that attempts to prevent the adaptation of the economy to the new circumstances of global trade will either be costly or futile.<sup>7</sup> Which is where compassionate conservatism distinguishes itself from a market-based ideology that ignores the transition costs inevitably incident to change. Rather than attempt to slow

---

<sup>7</sup> "Countries drawn into the cutthroat rivalry of world markets were driven to hone their competitive skills and to focus on what they did best. As they did so, their economies became more efficient and grew rapidly." Jeffrey A. Frieden, Global Capitalism: Its Fall and Rise in the Twentieth Century. New York: W.W. Norton & Company, 2006, p.134.

change, it is better policy to transfer some of the gains of the winners to the losers. Consumers benefiting from cheaper goods can reasonably be asked to allocate some of their gains to the losers, so as to ameliorate the pain of the transition and thereby reduce the opposition to change.

The preferred transfer technique, the compassionate one and one that the Bush administration adopted, is to help with job retraining. But here we run into another complication -- the ineptitude of government in general, and this administration in particular. Compassion is fine, but only when accompanied by skill at policy implementation. But, to cite just one example of the gap between aspiration and achievement, Congress passed and the President approved a Trade Adjustment Assistance program in 2002, providing among other things that older workers displaced by foreign competition receive from the government half the difference between the wages at their old jobs, and what they are able to earn at such jobs as they find after being laid off. Great idea, poor implementation. Because the number of hoops through which an applicant must jump seem to be infinite, only 1,403 workers received checks between August 2003 and December 2004.

Surely, there is more to a sensible trade policy than doing what little can be done to salvage the Doha round, negotiating bilateral Free Trade Agreements (FTAs) with willing partners, and enacting retraining programs that cannot be implemented. We need workable programs for sharing the gains of consumers with deserving workers and businesses in the goods- and services-producing sectors.

Adam Smith, himself, saw no inconsistency between the free trade he espoused and measures to ease the pain of those adversely affected by it. He suggested that consideration be given to the impact of the removal of barriers to trade:

Were those high duties and prohibitions taken away all at once, cheaper foreign goods of the same kind might be poured so fast into the home market, as to deprive all at once many thousands of people of their ordinary employment and means of subsistence. The disorder which this would occasion might no doubt be very considerable.

I recognize that once in place such ameliorating programs are difficult to remove, so perhaps we should attempt to balance our need to ameliorate the consequences of opening our markets more fully against that risk, on a case-by-case basis.

And perhaps, only perhaps, we should reconsider the validity of the jump from the theoretical notion that barriers imposed by other nations on our products hurt them more than they do us, to the conclusion that reciprocity is counter-productive. Can we be certain that we might not be net beneficiaries of the dynamic effects of a policy that imposes duties on Chinese imports proportionate to the value of the intellectual property they steal annually?

Thank you for your attention. I hope I have contributed to your on-going policy deliberations.