"Oil and the Middle East"

by Milton Friedman

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Few U.S. industries sing the praises of free enterprise more loudly than the oil industry. Yet few industries rely so heavily on special governmental favors.

These favors are defended in the name of national security. A strong domestic oil industry, it is said, is needed because international disturbances can so readily interfere with the supply of foreign oil. The Israeli-Arab war has produced just such a disturbance, and the oil industry is certain to point to it as confirmation of the need for special favors. Are they right? I believe not.

The main special favors are:

1. Percentage depletion. This is a special provision of the Federal income tax under which oil producers can treat up to 27½ per cent of their income as exempt from income tax—supposedly to compensate for the depletion of oil reserves. This name is a misnomer. In effect, this provision simply gives the oil industry (and a few others to which similar treatment has been extended) a lower tax rate than other industries.

2. Limitation of oil production. Texas, Oklahoma and some other oil-producing states limit the number of days a month that oil wells may operate or the amount that they may produce. The purpose of these limitations is said to be "conservation." In practice, they have led to the wasteful drilling of multiple wells draining the same field. And the amount of production permitted has been determined primarily by estimates of market demand, not by the needs of conservation. The state regulatory authorities have simply been running a producers' cartel to keep up the price of oil.

3. Oil import quotas. The high domestic prices enforced by restriction of production were threatened by imports from abroad. So, in 1959, President Eisenhower imposed a quota on imports by sea. This quota is still in effect. Currently, it is slightly more than 1 million barrels a day (under one-fifth of our total consumption).

Foreign oil can be landed at East Coast refineries for about $1 to $1.50 a barrel less than the cost of domestic oil. The companies fortunate enough to be granted import permits are therefore in effect getting a Federal subsidy of this amount per barrel—or a total of about $400 million a year.

These special favors cost U.S. consumers of oil products something over $3.5 billion a year (Gilbert Burck, Fortune, April 1965). This staggering cost cannot be justified by its contribution to national security.

The following points indicate the basis for this judgment:

1. Restricting imports may promote the domestic industry but why pay a $400 million subsidy to oil importers? A tariff of $1.25 a barrel would restrict imports just as much—and the U.S.

Government rather than the oil importers would get the revenue. (I do not favor such a tariff but it would be less bad than a quota.)

2. Oil from Venezuela—after the U.S., the largest oil producer in the world—is most unlikely to be cut off by international disturbances threatening our national security. Yet it too is covered by the import quota.

3. Restrictions on domestic oil production at least have the virtue that domestic production could be expanded rapidly in case of need. But such restrictions are an incredibly expensive way to achieve flexibility.

4. The world oil industry is highly competitive and far-flung and getting more so. The Mideast crisis has left large oil-producing areas undisturbed. Moreover, the Arabian countries themselves cannot afford to refuse to sell for long. Only World War III is likely to produce severe disruptions of supply—and then the emergency is likely to be brief.

5. If all the special favors to the oil industry were abandoned, prices to the consumer would decline sharply. Domestic production also might decline—but then again, if the industry were freed of all the artificial props that raise costs and stifle initiative, production might rise rather than decline. In either event, a vigorous and extensive domestic industry would remain, protected by the natural barrier of transportation costs.

If domestic output did decline, we might want to insure against an emergency by stockpiling oil, paying for holding reserve wells in readiness, making plans for sharp reductions in nonessential consumption, or in other ways. Measures such as these could provide insurance at a small fraction of the $3.5 billion a year the U.S. consumer is now paying.

The political power of the oil industry, not national security, is the reason for the present subsidies to the industry. International disturbances simply offer a convenient excuse.

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