

The International Economy, Summer 2006

Q: How disruptive would \$80-\$100 oil be to the US and global economies?

A: The answer depends on the source of the increase in the oil price. The implications might actually be good for the economy if it were the result of rapid economic growth in China and elsewhere in the world. But it would be bad for the economy if it were the result of disruptions such as new terrorist attacks, or political instability in Nigeria or the Gulf, or aggressive moves by the heads of state of Venezuela or Russia, or military conflict with Iran or – the most disruptive nightmare of all – a genuine democratic election in Saudi Arabia. Of course a sudden shock to oil prices would be more disruptive than a gradual rise.

The more interesting question is “what would good US public policy be?” Good policy, in pursuit of the triple goals of national security, environmental quality, and economic stability, would be to increase overall US energy conservation and switch the composition of energy away from fossil fuels. The slogan of decreasing dependence on imported oil is prone to misuse, but roughly captures the idea. Then the country would be less vulnerable to future disruptions.

The most efficient way to put such a policy in place is to raise the price of oil (and coal) to US consumers and firms, gradually over time, for example through a tax on fossil fuels. The revenue could be used for some combination of federal deficit reduction, reducing the marginal tax rate on lower-income workers, and intelligently chosen spending programs, e.g., to reduce the security dangers from nuclear proliferation. Of course such a tax has always been considered politically unacceptable to the American people. But they would have accepted it the day after September 11, 2001, and they would accept it the next time – the military option having been discredited in the meantime.

*-- Jeffrey Frankel, Harpel Professor of Capital Formation and Growth, Harvard University,
4/10/06*