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ECONOMIC ASPECTS OF A COMMUNITY INITIATIVE ON ENERGY

(Communication from the Commission to the Council)

Economic aspects of a Community initiative on energy

Energy has become a central factor in shaping and pursuing economic policy for the following two reasons:

(a) energy and, in particular, oil plays a major role in the economy of every country (energy represents approximately 10% of the GDP and one quarter of the Community's total imports);

(b) it is hard to resolve the contradiction between two imperatives which are equally fundamental to a return to balanced and autonomous economic development; these are:

(i) the need to restore a balance in economies thrown into disarray by the successive and savage increases in oil prices - in 1973/74 and 1979 - which have been difficult and slow to absorb and which have caused serious balance of payments deficits, problems in recycling capital, soaring inflation, and lastly reduced growth and higher unemployment;

(ii) the need to give immediate attention to the problem of energy independence, i.e. to introduce as soon as possible a mechanism which will ensure, via legislation and energy prices, a rapid transition to more modest energy growth which is based on the exploitation of more diversified energy sources and will thus ensure future security of supply.

I. The oil shocks and their repercussions

(a) The oil crises of 1973/74 and 1979/80 have highlighted the fact that oil and energy are so important to the world economy that our economies cannot absorb such abrupt and drastic increases in oil prices without suffering very serious economic consequences. It is the severity and magnitude of - and the external constraints imposed by -

the oil price increases rather than the absolute level of these prices which affect economies which, even when highly developed, have a limited capacity for reaction and adjustment.

The developments which followed in the wake of the 1973/74 oil crisis may well (if they have not already done so) occur again in the aftermath of the increases of 1979/80 even though the underlying situation is rather different:

- (i) huge balance of payment deficits and for the first time a large balance of payment deficit for the Community as a whole in 1979/80;
- (ii) the inflationary effects have been intensified by the scramble for a share of the oil and by exchange rate movements (e.g. recent trend of the yen);
- (iii) demand has contracted as a result of endogenous factors (trading conditions, insufficient recycling of OPEC revenue, negative effects of the general increase in uncertainty on the domestic propensity to spend) and also to restrictive policies which seek to counter increasing inflation or the external imbalance;
- (iv) difficulties in making the requisite structural adjustments because of faster obsolescence of capital stock and changing pattern of labour and capital costs which make investment not only even more necessary but also more difficult;
- (v) concentration of disproportionate effects on some economies (in relation to their relative share in GDP): Mediterranean countries but particularly non-oil-producing developing countries.

In 1978 Community energy consumption was virtually the same as in 1973 despite an economic growth of 10.7% in GDP. In other words, the link between economic growth and energy consumption (income elasticity of energy demand) had changed.

The price of crude oil has increased by approximately 120% since the end of 1978; the Community's oil bill has risen by some 60 000 million dollars (compared with about 150 000 million dollars for the OECD or 2 $\frac{1}{4}$ % of GDP in the OECD area).

The general effect of this huge increase has been for consumer prices of oil products to shoot up, the reason being that governments have generally decided to pass on the whole of the nominal increases in crude oil prices to the prices of oil products.

(b) Drastic increases imposed from outside

The drastic increases in oil prices dictated by producer countries led to higher prices but did not cause any significant reduction in energy demand. There are two main reasons for this:

(i) the price of oil as fixed in 1973/74 fell in real terms, giving

consumer countries the misleading impression that they had plenty of time ahead of them and leading to a reduction in economic investment or investment in alternative fuels;

- (ii) because of the drop in the real value of tax receipts from oil products in a large number of countries (see Table 1), some of the costs of the increase in energy prices have been absorbed by public budgets to the benefit of consumers.

The level of specific taxes (excise duty) on oil products, for example, did not change in absolute value terms between 1973 and 1978; its influence on the final price has hence declined, lightening the burden to final consumers but failing to create the desirable changes in energy consumption behaviour.

These phenomena reoccurred in virtually the same form early this year and last year. Since taxes have generally remained at the same level, the proportion represented by excise duty in the final price of oil products has again fallen. Thus, despite the fact that countries have for the most part passed on increases by producer countries to the oil products prices, these have generally risen less than the price of crude.

II. Economic policy strategy

A. Policy objectives

The Member States' first aim should be to avoid the regular reoccurrence of crises such as that last year. Everyone knows how this can be achieved; the courses of action open are in the main the same as

the principal objectives of Community energy policy:

- (i) reduced dependence on imported oil;
- (ii) a weaker link between economic growth and energy consumption;
- (iii) greater efforts to save energy;
- (iv) more systematic development of domestic production of primary energy sources which replace imported crude oil;
- (v) diversification of types of energy and of geographical location of energy supplies from outside the Community.

B. In the short term - need to restore stability

It is essential in the short term to restore basic economic balance in order to contain inflation, modernize economic structures and reduce the balance of payment deficits. Two points should be noted:

- (i) the structure of the public finances in the Member States must first be put in order; the level and methods of financing deficits in the public sector are often a major cause of inflation;
- (ii) the next step is to maintain monetary stability and avoid a return to the competitive devaluation policies which were pursued in the aftermath of the 1973/74 crisis. Not only do they have intrinsic drawbacks but they are also a direct incitement to producers

to increase crude prices. It should be remembered that the 1973, 1974 and 1979 price increases were preceded by a marked fall of the dollar. Monetary stability is thus the first imperative of any energy policy.

C. In the medium term - a balanced policy

Medium-term economic policy could take two approaches:

- (i) specific measures to encourage the requisite adjustments: either legislative or regulative measures, or incentives to encourage priority investment with varying rates of return. Some of these measures will require funding from the Budget;

- (ii) an energy pricing policy - the best way of reaching a large number of scattered economic operators - which attempts to promote the attainment of energy policy objectives and incorporates the extra costs involved in order to ensure future security of supply, while also underlining the need to combat inflation and the need for greater monetary stability.

III. Summary

(a) The price must be passed on to the final consumer

The increase in oil prices has not yet been fully passed on to the end consumers; part of the burden is in fact borne by the public budget, owing to the relative decline in tax receipts, and part by Community energy producers insofar as governments do not pass on the full increase in the real cost of energy in the pre-tax prices of energy products. Clearly, the reason for this situation is the desire to reduce, at least temporarily, the inflationary consequences of the increases in the price of oil, but in the long term this distorts the forward calculations of the economic operators, makes economic calculations more difficult and less certain and delays the implementation of investment projects which are suited to the real scarcity of resources.

What is required, therefore, in the first instance is to see that any increase in the price of a primary energy source should be passed on quickly and in full to the final consumer; to avoid any secondary inflationary effect, incomes should not be raised to offset the increase.

(b) The cost of the extra investment required

It will also be necessary from now onwards to invest more quickly than planned in sectors which are not immediately profitable but which, in the long term, will ensure greater energy independence.

Despite the fact that energy prices are already at a level which is difficult to tolerate, the final consumer will have to bear a further rise in costs as the result of medium-term requirements.

(c) Guidelines for energy taxation

In this context, taxation is a particularly effective instrument; it makes it possible to avoid transferring the energy burden from the consumer to the public budget and, at the same time, to make the user pay for the extra cost which independence in the long term requires. Measures of this sort should be integrated into a Community framework; indeed an effort should be made to harmonize national taxation and domestic energy and - price formation systems, which are the root cause of a number of problems, such as the deflection of trade between Member States and distortions of consumption within the Member States, etc.

It would be advisable, therefore, to harmonize energy taxation in the Community gradually. With regard to tax structures and tax levels, the system should be consistent with a policy which encourages energy saving and the development of alternative energy sources. In view of the various differences which exist to begin with, a measure of this kind might well involve an increase in the average tax burden on energy products.

More detailed proposals can only be made, however, when the precise effects of such harmonization have been analysed in greater detail.

This means in particular:

1. The effects on inflation: the inflationary consequences of a progressive alignment of the tax systems on a common base (as proposed above) will depend on the scale of the operation. They could be at least partially offset by the fact that it will be possible to programme the trend of energy prices more effectively; it will be necessary, incidentally, to offset these increases by reducing other sources of budgetary revenue at the same time. Such an approach should take into account the differences which exist in the Community between price formation systems, tax structures, budgetary situations and the customs or regulations affecting wage negotiations (sliding scales, etc.).
2. The effects on the international competitiveness of the Member States' economies. The scale of these effects will depend on the attitude of other oil-importing industrialized countries, as trade outside the Community represents no more than some 50% of the external trade of the Member States. In the long run, such a policy would have the advantage of accelerating the changes required if the Community is to adapt to a higher price for energy.
3. Other problems would deserve special treatment. These would include sectors which were heavily dependent on energy, the location of certain forms of production and the general effects on employment. More detailed cost-benefit analysis should be carried out in these cases.
4. It would probably be difficult to increase the domestic price for energy after the recent sudden jolt and in a period of cyclical downturn. Adjustments to taxation could therefore be gradual and of a temporary nature. Thus, it would still be possible to reduce the level of energy taxation, in the long term, as greater independence is achieved.

5. The possible ways of applying such taxation (VAT, excise charges, customs duties, new taxes, specific or ad valorem taxes, a measure of harmonization, the level of rates to set, etc.) are obviously not equal in their effect, especially from the energy point of view. There will certainly also be problems with regard to relative prices and substitution.

Table I. Taxes on mineral oils as % of GDP¹

	1972	1973	1974	1975	1976	1977	1978	1979
D	1.72	1.81	1.63	1.66	1.61	1.60	1.60	1.51
F	1.63	1.60	1.48	1.40	1.28	1.50	1.68	1.94
I	2.77	2.38	2.30	2.83	2.44	2.65 2.41*	2.27*	2.12*
NL	1.46	1.41	1.31	1.30	1.21	1.18	1.15	1.12
B	1.73	1.81	1.46	1.66	1.54	1.46	1.40	1.35
L	1.54	1.48	1.13	1.52	1.43	1.36	-	-
UK	2.41	2.23	1.89	1.48	1.58	1.69	1.52	1.49
IRL	2.43	2.12	2.05	2.47	3.28	2.64	-	-
DK	1.05	1.00	0.86	0.85	0.87	1.07	1.13	1.28

* As a percentage of a larger, revised Italian GDP from 1977.

¹ The expression of tax receipts as a percentage of GDP gives a good idea of their real value, since it takes both price trends and economic activity into account.