The Oil Drum
DISCUSSIONS ABOUT ENERGY AND OUR FUTURE

Understanding the Ethanol Tariff Issue

Posted by Robert Rapier on May 14, 2010 - 10:17am
Topic: Policy/Politics
Tags: energy policy, ethanol, ethanol subsidies, imports, protectionism, tariffs [list all tags]

You probably saw the recent announcement that Brazil has lifted its tariff on imported ethanol until 2012. It's hoping to put pressure on the U.S. to remove or reduce its own import tariffs on the alternative fuel.

In order to better understand the intricacies of the issues involved, I have been engaged in dialogue with a number of industry groups and economists. Here I will try to shed some light on the tariff issue.

I believe there are three key issues to explore regarding the tariffs:

1. The argument that the tariff offsets the VEETC.
2. The argument that the tariff is warranted because Brazil subsidizes their domestic ethanol.
3. The argument that the tariff is ineffective in any case due to a “Caribbean loophole.”

Each of these issues will be examined in an attempt to separate out facts from hype and misinformation. In this essay, I will break down the first argument. In the next essay, I will address the 2nd and 3rd arguments.

The VEETC Offset Argument

U.S. taxpayers directly support ethanol usage through the Volumetric Ethanol Excise Tax Credit (VEETC). But that tax credit does not require that the ethanol be domestically produced. A gasoline blender that purchases ethanol imported from Brazil can receive the same VEETC as ethanol purchased from a producer in Iowa.

Therefore, one justification that has been cited for the tariff is to offset the VEETC. A tariff of equal value to the VEETC would mean that any taxpayer money that is directed at imported ethanol is refunded via the tariff.

One may wonder, since each gallon of domestically produced ethanol is assigned a unique serial number called the Renewable Identification Number (RIN), why it isn’t straightforward to make sure the VEETC is only paid on domestic ethanol. I have inquired and learned that this would likely be ruled a violation of Article 3 of the WTO Agreement on Subsidies and Countervailing Measures which states that subsidies that are contingent on the use of domestic over imported goods are prohibited. The tariff is essentially a loophole that accomplishes the same thing, although I have learned that the tariff may itself violate Article III of GATT 1994.

However, there are two points to consider regarding the VEETC offset argument. First, the amount of the tariff is higher than the amount of the VEETC. At present, the VEETC is $0.45/gallon, but the tariff is a 2.5 percent tax plus $0.54/gallon. The total tariff is approximately $0.60/gallon, which is 33% beyond merely offsetting the VEETC. Of course I still maintain that with the ethanol mandate, the VEETC is redundant because it merely pays oil companies to obey the law. If we did away with the VEETC, we could kill two birds because that would no longer be a justification for the tariff.

Second, even if the offset argument is valid with the VEETC in place, the tariff still represents a substantial barrier to trade. For instance, imagine that the wholesale price of ethanol at a U.S. port is $2.00 per gallon. An ethanol exporter's full costs to put ethanol into a U.S. port must then be below $2.00 per gallon if they are to make money. In fact, under the present system their costs would need to be under $1.85/gal because they would pay the $0.60/gal tariff, but a blender could get back $0.45/gal via the VEETC. In this case, with the exporter's costs at $1.85/gal, the cost to the ethanol buyer is $2.00/gal.

But because of the VEETC/tariff combination, the domestic producer is in a far better position than those exporting ethanol to the U.S. For a domestic producer with an ethanol price of $2.00/gallon, the purchaser receives the $0.45/gal VEETC, with no offsetting tariff. Thus, the bottom-line costs to the ethanol buyer are $1.55 per gallon, providing a very large incentive for them to purchase the $2 domestic ethanol over imports priced at $1.70 (for example).

In other words, under the present system Brazil would have to put ethanol into a U.S. port at $1.40 per gallon (to offset the $0.60 tariff) to compete with U.S. ethanol priced at $2.00 per gallon. This essentially eliminates the competition for domestic ethanol producers, which for consumers also reduces the opportunity to save money on their fuel costs.

The overriding question here is "What are the goals?" Of course different interest groups have different goals. Consumers will tend to want product at the cheapest price. Domestic ethanol producers will want to protect their markets and avoid competition that could cut into their margins (as their new lobbying effort amply demonstrates). Foreign producers will want more open access to markets. Some see the reduction of fossil fuel usage (this is my personal position) or carbon emissions as the most important goal. Others would argue that energy independence is the goal, and that trading oil imports for ethanol imports does little to achieve that.

My intention here is not to answer that question, but rather to cut through the lobbying and explain the implications of the policy. If our energy policy goals are promotion of renewable energy, then the tariff is a partial obstacle. If our energy policy goals are only to promote domestically produced ethanol, then the tariff serves that purpose at the potential expense of taxpayers, consumers, and ethanol exporters.