2006

We Need a Stiff Oil Tax? It Just Aint So!

Henderson, David R.

FEE

THE FREEMAN
IDEAS ON LIBERTY

Filed Under: Columns

by David R. Henderson

We Need a Stiff Oil Tax? It Just Ain't So!

March 2006 • Volume: 56 • Issue: 2 • Print This Post • 0 comments

In an article last fall in the Washington Post, one of my favorite economic journalists , Robert J. Samuelson, argued for "a stiff oil tax" and "stricter fuel economy standards" (September 14, 2005). His rationale for this increased government intervention is that "we are vulnerable to any major cutoff of oil." We can reduce our vulnerability, he argues, if we tax oil heavily and require auto companies to increase fuel "efficiency" by roughly 50 percent. (The reason "efficiency" is in quotation marks will be clear shortly.) What this country needs, writes Samuelson, "is $4-a-gallon gasoline or, maybe, $5 ."

It just ain't so. To see why, we need to look at three issues in turn. First, does vulnerability to higher world oil prices justify some special role for government? Second, is it always efficient to use vehicles that get high fuel economy? Third, is there a good case for government regulations that require higher fuel economy? The answers: no, no, and no.

First, consider our vulnerability to world oil prices. Samuelson is right that we are vulnerable, but any time you buy a good, you're vulnerable to higher prices. If suppliers decide to supply less or buyers decide to buy more, the price will typically rise. How does Samuelson get from that simple fact to his conclusion that stiff taxes on oil are a good idea? His reasoning seems to be that when the price suddenly rises, we consumers lose wealth, and we could avoid some of these wealth losses if we drove cars that use less gasoline per mile. This is true. But we still haven't arrived at a case for government intervention. If Samuelson gets the higher taxes he wants, and if, as he seems to wish, these taxes last forever, then we know we will pay those higher prices forever and not just occasionally. How am I less vulnerable by paying $5 a gallon forever instead of $2 a gallon usually and $3 a gallon occasionally? High gas taxes would turn the possibility of an occasional consumer loss from increased gasoline prices into the certainty of a permanent loss.

Samuelson would probably argue that we'd be less vulnerable because, in response to the tax, we would buy cars that use less gasoline. It's true that we would respond that way to a stiff tax: Exhibit A is the many European countries whose governments impose the stiff taxes that Samuelson wants and most of whose people, if they have a car at all, have small, high-fuel-economy cars. But why use a tax to force us to that point rather than leting us make a choice?

Maybe Samuelson would argue that we don't take account of future gasoline prices when we buy a car. But the nice thing about freedom is that if we want to take future prices into account, we can. How? Here's where the market comes in. Every day, experts enter the futures market for oil and bet millions of dollars of their

own money on their best guesses about what will happen to the price of oil in the future. And thanks to another market — the market in information — information suppliers provide the latest futures-market data at low cost. In fact, the website www.wsj.com/free provides that information free. And this information can help you decide whether buying a high-fuel-economy hybrid is worth it.

That brings us t o the second question: is it efficient to buy a high-fuel-economy car? Samuelson himself admits that hybrids are priced $3,000—$4,000 more than conventional cars. This means that when you buy a hybrid, you're trading off a higher up-front price against a stream of savings on fuel. If you use your car a lot, especially for in-town driving, where hybrids' advantage is greatest, it may pay. If you use your car a little and much of that little is for long-distance driving, it won't pay. Say, for example, that you expect gasoline prices to remain at $3 for the ten-year lifetime of a car. Imagine you're comparing a conventional car that averages 25 mpg with a hybrid that gets 40 mpg and that you drive 12,000 miles a year. With a conventional car, you would buy 480 gallons a year, for an annual expenditure of $1,440. With a hybrid, you would buy 300 gallons a year, for an annual expenditure of $900. So you would save $540 a year. Using a real interest rate of 4 percent, the present value of this saving would be $4,379, which out weighs the extra $3,000 – $4,000 up front. But note that it barely outweighs a $4,000 increment in price. Buying a hybrid is, therefore, a good deal, not a great deal, for this hypothetical driver. If this person drove only 8,000 miles a year, and if gasoline prices averaged $2.50 a gallon, he would save only 120 gallons a year, or $300. At an interest rate of 4 percent, this person, or the person he resold it to, would have to get 12 years of service out of the car to offset even an extra $3,000 up front. In short, whether it's efficient to buy such a car depends on future gasoline prices, the person's driving pattern, and miles driven. No general statement can be made that a high-fuel-economy car is necessarily efficient. It's efficient only if the incremental cost is less than the saving in fuel expenditures, and, in many cases it won't be.

Government Standards

Third, there's no good case for government imposition of fuel-economy standards. Let's take a trip down memory lane. Fuel-economy standards were imposed during President Ford's administration and tightened during President Carter's because price controls on oil and gasoline, which President Nixon had in initiated, kept prices from rising to world levels. The results of price controls were predictable: shortages, lines, and wasteful uses of gasoline by those lucky enough to get it. Although Carter finally pushed successfully for a bill to phase out the price controls, the damage was done. The government kept gasoline artificially cheap and then had the gall to accuse us of being " energy pigs." Thus the plethora of government controls to restrain our usage. While President Reagan eliminated many of these controls, one that remains is the fuel-economy standards. This is the story of most government regulation, as I lay out in my book *"The Joy of Freedom: An Economist's Odyssey"*. The government imposes a regulation that creates a crisis, and then responds to this crisis by creating more regulation. Then, even if it eliminates the first regulation, it often keeps the second.

Finally, even if we grant, which I don't, that there's a case for a higher tax on gasoline, it doesn't follow that there's a case for compulsory fuel-economy standards. Instead, people can respond to the tax by choosing the level of fuel economy appropriate for their circumstances. As Brookings Institution economist Robert W. Crandall points out, the mandated fuel-economy regime comes down like a hammer on the newest vehicles, which, ironically, have the highest fuel economy, and does nothing to increase fuel economy for the used vehicles already out there.

Samuelson writes: " At times, individual freedom must be compromised to improve collective security." Even if you believe that, it doesn't apply in this case. Higher taxes on gasoline and oil and compulsory fuel-economy standards "compromise" individual freedom with no improvement in security. Rather, they reduce our freedom and destroy our wealth. That's a bad trade-off.

About the Author

David Henderson is a research fellow with the Hoover Institution and an economics professor at the Graduate School of Business Public Policy, Naval Postgraduate School, Monterey, California. He is editor of The Concise Encyclopedia of Economics *(Liberty Fund) and blogs at econlib.org.*