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AMERICA'S NEW FUEL ECONOMY CARTEL:
Trading Freedom for Barrels of Oil

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Fuel Economy in the Rose Garden

In a lovely May 16, 2009 Rose Garden setting, President Obama announced stricter fuel economy/carbon emission standards for the U.S. fleet. The new fuel economy rules, which also form the first national carbon dioxide emission standards, require the 2016 U.S. auto/light truck fleet to achieve an average economy of 35.5 miles per gallon. Stated in the simplest terms, the car fleet will have to meet a 39 mpg average; trucks, 30 mpg. The stricter standards are about the same as previously required for year 2020 by rules adopted in 2007 during the Bush Administration, but the starting date arrives four years earlier.

While the fuel efficiency goal is the same for Mr. Bush and Mr. Obama, the Obama rationale is different. Mr. Bush seemed driven by concern about Middle East turmoil and energy security. The Obama standards are motivated apparently by pursuit of the new Holy Grail, carbon emission reductions and climate change mitigation. As it turns out, reducing tailpipe carbon emissions from internal combustion engines maps directly to requiring more efficient fuel consumption.

On stage with Mr. Obama for the Rose Garden announcement was what amounts to a newly sanctioned fuel economy cartel and perhaps one of the largest gatherings of Bootleggers and Baptists ever to assemble for a presidential announcement. Anticipating the unusual gathering, Obama Press Secretary Robert Gibbs, in advance of the meeting, gave a Bootlegger/Baptist forecast: "You will see people that normally are at odds with each other in agreement with each other."

CEOs and executives from Ford, GM, Chrysler, Toyota, BMW, Mercedes, Honda, Nissan, and Mazda were joined by UAW president Ron Gettelfinger and leaders of the League of Conservation Voters, Natural Resources Defense Council, Sierra Club, Environmental Defense Fund, and Union of Concerned Scientists. As in past regulatory episodes, the "Baptist" component sang the praises of Mr. Obama's environmental foresight. And the cheerful auto producer/bootleggers saw the uniform national rules as a more profitable way to escape a nettlesome set of separate state regulations already

brewing.[i] Along with this stellar assembly was a smiling California Governor Arnold Schwarzenegger, now an ordained member of the fuel economy cartel. Mr. Schwarzenegger's presence gave assurance that California would not disturb the cartel by venturing forth with even stricter emission standards.

Commenting on Mr. Obama's extraordinary ability to stage the event, David McCurdy, president of the Alliance of Automobile Manufacturers, remarked, "It launches a new beginning. The president has succeeded in bringing three regulatory bodies, 15 states, a dozen automakers and many environmental groups to the table." Indeed. The newly announced rules will be monitored and enforced by EPA, the Department of Transportation, and the Department of Energy—the triumvirate that forms the cartel's management.

In a statement that first ascribed almost supernatural engineering powers to the new administration, Ann Mesnikoff, director of the Green Transportation Campaign at the Sierra Club, said, "The Obama administration is making automobiles go farther on a gallon of gas." She then repeated a popular mischaracterization about achieving improved fuel economy by saying: "We have an industry that after years of fighting tooth and nail against higher standards is finally coming to the table and saying they have technology and can do it."

Difficulties in achieving higher fuel economy in the United States has never been about technology or the inability of auto manufacturers to produce fuel-efficient cars. Indeed, the 1975 diesel equipped Volkswagen Rabbit, produced in Westmoreland County, Pennsylvania, achieved 45 mpg in city driving and up to 57 mpg on the highway. My 2005 Tennessee-produced Nissan Altima averages 29.4 mpg in mixed city and highway driving, well above the current 27.5 standard. And General Motors 1990 Suzuki-made GEOs would yield 40 mpg from their three-cylinder engines. There was and are a number of technologies that offer high fuel economy in light automobiles.

No, the U.S. fuel economy regulatory problem has never been about technologies or auto engineering. The problem has always been about freedom, freedom for consumers to choose what they want, not what some authority wants them to buy.

When people are free to choose, they will inevitably match auto attributes to the cost of operating and owning their vehicles of choice. Cheap gas yields preferences for larger cars and less fuel efficiency. Expensive gas yields preferences for smaller, more fuel efficient, vehicles.

Mr. Obama's Cartel

The fact that Mr. Obama could assemble leaders of an entire industry and their lobbyists in the Rose Garden on short notice is on its face an extraordinary accomplishment. Mr. Obama is doubtlessly an able communicator and politician. But

there was a series of recent events that helped set the preconditions for his triumph. In a public-choice sense, the Rose Garden event was the logical culmination of past political and judicial actions. It was not the equivalent of taking an unexpected political walk on water.

Consider some key events:

- George W. Bush, in his January 23, 2007 State of the Union address, set a high legislative priority to break the U.S. "gasoline addiction." On December 18, 2007, legislation was passed setting stricter rules to be achieved in 2020, far beyond a time of political accountability. The U.S. fleet was to average 35 mpg. The Obama move, which accelerated the Bush rules, was marginal, but nonetheless significant.
- On April 2, 2007, the U.S. Supreme Court, in *Massachusetts v. EPA*, ruled that carbon dioxide is a pollutant under the Clean Air Act. The Court indicated that contrary to the EPA's argued position on the matter, the agency has authority under the Clean Air Act to regulate the emission and other greenhouse gases. The Court then instructed the EPA to follow the requirements of the Clean Air Act in reaching a regulatory decision. This required making an endangerment analysis of the effects of carbon emissions on human health and welfare. The Bush EPA made no finding.
- On January 2, 2008, the State of California, joined by 15 other states, brought suit against the EPA contesting the agency's refusal to allow the state to set carbon emission regulations for autos. To implement the rules, California had to gain an EPA exemption from the Clean Air Act, which controls California standards. Mr. Obama promised to assist California in its effort to mandate carbon emission reductions.
- Following a 2008 sharp increase in the price of crude oil, gasoline prices rose from $3 to more than $4 a gallon. Gasoline shortages occurred in major market areas. Consumers scrambled for fuel-efficient cars. The price of SUVs plummeted. Hybrid vehicles moved to the front row of dealer lots nationwide. Then, in 2009, gasoline prices fell even more dramatically. The prices of hybrid and other fuel efficient vehicles fell to the basement. The demand for SUVs recovered somewhat, even in the face of the Great Recession.
- The 2008–09 Great Recession pushed General Motors and Chrysler to bankruptcy and becoming wards of the state. Ford Motor Company, the other major U.S.-headquartered producer, was burning cash at a high rate but avoided bankruptcy and government bailout while requesting a cautionary taxpayer line of credit. When May 16 rolled around, the once-Big Three were in a mood to cooperate with the hand that could feed them. Auto producers worldwide had suffered a 30 percent to 40 percent sales decline. Every affected nation was providing some kind of taxpayer support for home-grown auto producers. It was a new day for the auto industry.
- On April 17, 2009, the last shoe dropped when EPA issued its proposed carbon emission endangerment findings; the proposed, not yet final, findings identified carbon emissions as harmful to human life and wellbeing. When and if final, the

endangerment findings will trigger regulatory action under the Clean Air Act or provide a basis for a separate greenhouse gas emission control statute.

But while the series of recent events affecting fuel economy laid a rock-solid foundation for forming the May 16 fuel economy cartel, the May event itself marked the frenzied end of an era when industrial capitalism characterized the operation of the U.S. auto industry. When tied to the market process, industrial capitalists and their proxies must respond to consumer demand if they expect to avoid bankruptcy. Profits rise and fall on the basis of competition-driven decisions. Of course, government intervention has been present from the beginning of the industry, but not a dominant systemic force.

May 16 marked an end point of sorts; the day also signaled the rising dominance of national capitalism where politicians and their appointees exert strong and highly visible influence on what will be produced by the auto industry, where, and by whom.

Crippling Choice Became the American Way

In a paradoxical way, given the May 16 celebration, it was America's peculiar form of fuel economy standards that set a regulatory trap that General Motors, Ford, and Chrysler ultimately could not escape. The beginning of the end of auto industrial capitalism arrived in 1975 with the passage of the Energy Policy and Conservation Act. This statute followed on the heels of economic shocks caused by the 1973–74 Arab embargoes on crude oil shipments to the United States. The embargoes set in motion a series of laws regulating petroleum and gasoline markets that forced consumers to purchase and drive cars that government planners thought they would have purchased and driven if the price of gasoline had been allowed to rise to market-determined levels. (Eventually, of course, the Reagan administration deregulated gasoline markets.)

One of the laws, the Motor Vehicle Information and Cost Saving Act of 1975, directed the Department of Transportation to establish fuel economy standards for each model year from 1981 through 1985. Congress had established the 1980 and 1985 standards at 20 mpg and 27.5 mpg respectively. At the time, the standards seemed severe. In 1975, the actual U.S. fleet average fuel economy for combined domestic and foreign produced cars was 15.8 mpg. The imported fleet at the time averaged 23.3 mpg, while the domestic fleet was hitting 14.8 mpg.

The fuel economy rules set a costly pattern for U.S. consumers. The rules did not allow domestic producers to include their own European-made fuel efficient cars when measuring fuel efficiency for the domestic fleet. At the behest of the United Auto Workers, the Big Three were cut off from their own global supply of lower-cost fuel-efficient vehicles. There were separate tallies required for the domestic- and foreign-built fleets. U.S. producers could not just import more high mileage cars to help meet the new standard. The rules required a definition of a domestic car, which turned out to be a vehicle with a majority of U.S. labor contained in the vehicle. The domestic content rules gave an advantage to Asian producers, since they, at the time, had no U.S. production to worry about. When voluntary restraints on the importation of Japanese

cars were introduced in 1981 in an effort to buttress the UAW and a beleaguered domestic industry, the Japanese firms jumped the trade barrier and built U.S. nonunion plants. (The voluntary restraint program ended in 1994.) In the years that followed, the Asian product line expanded to include larger cars. They had fuel efficiency to burn. Cut off from their European small-car specialists, the U.S. producers shifted with great difficulty toward smaller cars. The costly move to smaller vehicles worked against the historic large vehicle production and marketing specialization of the domestic firms.

One other feature of the U.S. regulations became the teeth in the trap. There were different and more relaxed standards for light trucks. The fuel-efficiency standard for light trucks, stated simply, was initially set at 20.7 mpg and rose to the current 23.0 mpg. When U.S. producers became constrained in meeting the auto standard, SUVs and more elaborate pickup trucks became the order of the day. U.S. producers then played costly bureaucratic games involving the design of vehicles, such as the fuel-sipping 2001 Chrysler PT Cruiser, so that it would meet the *Federal Register* definition of a truck and therefore make it possible for more gas-guzzling pickup trucks to be sold.

When gasoline prices fell, the U.S. producers were caught in a cyclical dynamic that saw them force-feeding light cars to their dealers while rationing the supply of larger vehicles that most consumers preferred. And when prices rose, the reverse dynamic obtained. Each severe change in prices and every Middle East flare-up led to calls for new fuel economy legislation. There was never a serious movement within Congress for gasoline taxes or for taxes on imported crude oil to compensate for national defense risk that might be associated with keeping the shipping lanes safe. For rent-seeking reasons, the U.S. showed a preference for a command-and-control economy.

All along, the political economy has favored mileage standards that often do not square with the price of gasoline at the pump and therefore make it almost impossible for full-line producers of automobiles and trucks to effectively respond to market-driven demand. Critics of the failed efforts of U.S. producers to meet multiple objectives of fuel efficiency and vehicles that satisfy consumer demand often point to European and Japanese market successes in meeting higher mileage standards. Japan's current fuel-efficiency standard is 42.6 mpg, but the price of gasoline is close to $5.00 a gallon. The European fuel-efficiency standard is 43.3 mpg; their price of gasoline ranges from $6.50 to $7.00 a gallon. Environmental Baptists celebrate the 43 mpg result and say, "Why not here?" But not many are calling for $7.00 gasoline. Unfortunately, you just can't have one without the other, except in a command-and-control economy.

The Costly New Standards

In his Rose Garden comments, Mr. Obama was careful to say that the new standards would save U.S. consumers money on fuel even after paying the estimated $600 incremental cost associated with accelerating the 35.5 mpg standard to 2016. The president also indicated that when implemented the rules would save more than one billion barrels of oil over the life of the vehicles produced in the next five years. There

was no indication as to where the saved oil would be stored or how consumers would share in the bounty.

But while consumers may indeed save fuel dollars from government-mandated fuel efficiency, there are other costs that have not been explicitly considered. First off, the cost of lost freedom to choose the most desirable consumption bundle has not been calculated. It may be that consumers would collectively save consumption dollars if the variety of cars produced was constrained and every car required to be more economical to operate, but freedom to choose is about gaining happiness as defined by free individuals; it is not about barrels of oil. Then, the resources committed to reducing carbon emissions are resources that will not be used in achieving urban air quality standards still unmet in major U.S. cities. Even though EPA estimates that carbon emissions may endanger human welfare, there is more evidence supporting the case that excessive Clean Air Act criteria emissions are clearly harmful. And there is also the tradeoff between traffic fatalities and fuel economy that is confronted if lighter and less crash resistant vehicles emerge in a more regulated world.

Yet, while these costs are real and substantial, there is another longer-run cost that emerges when national capitalism with centralized political management replaces industrial capitalism and decentralized market forces. Politically designed and produced automobiles turned out by a fuel economy cartel may indeed be more fuel efficient, but it is highly doubtful that they will form the basis of a dynamic industry that can compete and excel in tomorrow's globally competitive market. There is high risk that the U.S. industry will become part of an industrial backwater that can only survive when nurtured with subsidies or protected by nontariff barriers.

America's difficulty in building a fuel-efficient fleet of cars has never been about a lack of technology and production expertise.

It is about freedom.

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