The High Cost of Misunderstanding Gasoline Economics

BY ARTHUR E. FOULKES

National emergencies, wars, natural disasters—all these things tend to bring about expanded government power.[1] Hurricane Katrina was no exception. In addition to promising to spend billions of dollars of other people's money allegedly to "rebuild" New Orleans and other stricken areas, politicians have been equally generous with other people's gasoline supplies. In many states, anyone attempting to sell gasoline at prices deemed socially "unconscionable" risks heavy fines.[2]

Government officials all across the country joined the expanding chorus. President Bush led the way early in the disaster's aftermath calling for "zero tolerance" for looters, scammers, and price gougers "at the gasoline pump."[3] Other politicians echoed his message.

None of this is surprising. Even before Katrina knocked out half the Gulf of Mexico's oil production (sending gas prices soaring to over $3 per gallon Labor Day weekend), politicians and "consumer advocates" were calling for investigations into gasoline prices, which had been rising for about two years, reaching $2.64 cents per gallon by last August 30.[4] Indeed, this has become commonplace; since 1973 the government has investigated the oil industry about once every two years.[5] A 2002 Senate investigation into the oil industry purported to have discovered oil companies "manipulating the market." However, the report, sponsored by Senator Carl Levin of Michigan, was in the words of economist William Anderson "an exercise in economic illiteracy."[6]

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There is no mystery about recent rising gas prices. Strong economic growth in China, along with improved growth in the United States, has been pushing on the demand side of the gasoline market for some time. Meanwhile, political unrest in Venezuela and Iraq along with strict environmental restrictions and regulations in the United States have helped keep the supply side anemic and uncertain. The result is unsurprising—strong new demand with insufficient new supply (coupled with uncertainty) means higher prices at the pump.

Environmental regulations are often blamed for the fact that no new refineries have been built in the United States since 1976; however, the Cato Institute's Jerry Taylor and Peter Van Doren point to other reasons. They write that "meager" profits in the refining business over the past 30 years, cheaper imports, and the fact that it is less expensive to add capacity to an existing refinery than to build a brand-new one have all kept the number of refineries from rising. They note further that while there are fewer refineries than 30 years ago, "[d]ramatic improvements

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in the operational efficiency of oil refineries" have actually permitted domestic gasoline production to increase "by 20 percent since the last oil refinery was built."[7]

Hurricane Katrina merely made the prevailing situation worse. Oil prices peaked at over $70 dollars per barrel shortly after the storm, while average U.S. gasoline prices peaked at $3.07 in early September, "just a nickel shy of the inflation-adjusted record of $3.12 averaged over March 1981."[8] Prices fell significantly after that, before creeping up again as the winter came on. The public was nervous and angry; politicians were quick to respond.

No one likes paying more for gasoline (except maybe folks who have always resented America's relatively cheap gasoline, its SUVs, and other signs of bourgeois opulence), but government-imposed price restrictions would only make matters worse. By interfering in the market's pricing mechanism, price controls simply hinder the ability of entrepreneurs and investors to provide the goods and services consumers desire most.

Much of the support for price controls stems from a lack of understanding of where prices come from. Many politicians and other critics of markets believe that market prices (or at least "fair" market prices) can be calculated using production costs. For example, they believe it is evidence of gouging if a gas station raises its pump price on news of higher oil prices—even if the gas sitting in the station's fuel tanks was purchased days or weeks earlier at a lower price. This thinking is mistaken on at least two counts.

First, "production costs" (themselves actually impossible to calculate since they are, in reality, subjective opportunity costs) don't determine a good's current market price. While it is true an entrepreneur will use his estimated accounting costs of production when deciding whether to produce a good or service, the actual market price of the finished good is a result of consumer desire to obtain the particular good as well as the ability and willingness of sellers to provide it. In other words, price is a function of supply and demand.

Second (and along the same lines), prices for final goods do not have to wait for immediate input prices to rise before they can change. The fact that retail gas prices skyrocketed on the news of Katrina's devastation to the Gulf's oil production—long before new, more expensive gasoline from the Gulf reached those stations—is no proof of any wrongdoing. On the contrary, it is a blessing that the price system can work so quickly.

News of increased demand for housing in a community (say, a new factory is coming to town with 10,000 employees) would immediately drive up the price of housing there. Housing prices might double or triple in a month, regardless of how much people paid for their houses. In a free market these higher prices would rapidly signal producers to redirect scarce resources—lumber, labor, cement mixers, and so on—from places where they are less urgently sought to where housing prices are rising. Likewise, if a plant closing in a community meant there would soon be a housing glut, home prices would immediately fall, discouraging the investment (and waste) of scarce resources. Because these prices change quickly, regardless of production costs, resources are redirected to more urgently desired areas more quickly than would otherwise be the case. Thus rapidly changing gasoline prices are a blessing because they send a clear signal early in a supply disruption, before things become much worse.

Emergent Phenomena

Politicians and others are undoubtedly frustrated by the teachings of economics because they more often than not tell political leaders what they cannot or should not do, not what they can do to change reality. In a recent essay *Freeman* columnist Russell Roberts wrote of the human desire to control what he calls "emergent phenomena," which he defines as things that are the result of human action but *not subject to human design or control*. Such phenomena include language and market prices. Efforts to control emergent phenomena, Roberts writes, confuse engineering problems (which are subject to human design) with economic problems (which are not). "[T]he engineering way of thinking doesn't work with emergent phenomena. Trying to change emergent results is inherently more complex than building a bridge or expanding your kitchen or even putting a man on the moon. Understanding the challenge involved is to begin to answer the old question that asks why we can put a man on the moon but we can't eliminate poverty."[9]

Despite talk of inelastic markets for retail gasoline, higher fuel prices over the past two years have started to have their anticipated effect on both supply and demand. The world's largest oil producers have recently and significantly increased their spending on oil exploration in response to higher prices, while consumers have started to move away from SUVs and large trucks to more fuel-efficient autos.[10]

Left unregulated and unsubsidized, markets would lead human beings to cooperate and prosper in ways unimaginable by interventionist-minded government officials and politicians. And prices play a central role, acting as signals that help direct diverse and disconnected people into activities that serve other people's most urgently felt wants and needs. Entrepreneurs also play a critical role by directing scarce resources toward ends most valued by consumers. If an endeavor proves mistaken, an entrepreneur fails and tries something else. All the while, consumers are likewise seeking out the most "profitable" (in a psychic sense) goods and services they can find. Thus a free market is in a never-ending flux, constantly shifting resources from less-valued to more highly valued uses. This is not a process that can be improved on by political means.

Government officials may wish to magically or legally make gasoline more plentiful or less expensive, but they cannot change the forces of supply and demand. Indeed, their tampering only makes matters worse. The gas lines, shortages, and occasional violence that accompanied gasoline price caps in the 1970s should serve as an effective reminder. Politicians should heed the lessons of history and sound economics. To be sure, end all privileges for the oil companies, but leave gasoline prices alone.

1. See Robert Higgs, *Crisis and Leviathan* (Oxford University Press: New York, Oxford, 1987).

2. In the words of University of Chicago economist Austan Goolsbee, "States tend to make their anti-gouging laws purposely vague, forbidding 'unconscionable profiteering' during a state of emergency or the like." "Pump It Up," *Slate*, September 7, 2005, www.slate.com/id/2125814/.

3. Nedra Pickler, "Bush: Rebuilding Must Address Inequality," Associated Press, September 16, 2005, www.newsmax.com/archives/articles/2005/9/16/134806.shtml.

4. "What *Not* to Do About Rising Energy Prices," *Research Reports*, American Institute for Economic Research, September 12, 2005.

5. Rob Bradley, "Gasoline Prices: Still Good News," Cato Institute Daily Dispatch, April 13, 2002, www.cato.org/dailys/04-13-02.html.

6. William Anderson, "Congress and Oil Prices: The Outrage Continues," Mises.org Daily Article, May 6, 2002, www.mises.org/story/951.

7. "High Pump-Price Fairy Tales," *Nationalreview.com*, June 3, 2005, www.nationalreview.com/nrof_comment/taylor_van_doren200506030857.asp.

8. Figures provided by the U.S. Energy Information Administration, Department of Energy, http://tonto.eia.doe.gov./oog/info/twip/twip.asp.

9. Russell Roberts, "The Reality of Markets," *Library of Economics and Liberty,* September 5, 2005, www.econlib.org/library/Columns/y2005/Robertsmarkets.html.

10. Carola Hoyos and Javier Blas in London, "Search for Oil Stepped up as Price Rises," *Financial Times,* September 12, 2005; Amy Lee and Brett Canton, "Gas Costs Stall Used Truck Sales," *Detroit News*, July 11, 2005.