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When Prices Are Wrong, Markets Don't Work

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The one concept that all students, even those sleeping in the back of the lecture hall, learn from an introductory economics class is that prices matter. And more particularly, students learn that as prices increase, the quantity consumed goes down. So if fossil fuel combustion produces byproducts that cause negative health effects on third parties as well as changes in the temperature of the atmosphere, the obvious lesson from economics is to increase fossil fuel prices enough through taxation to account for these effects. Then firms and consumers will react to these prices in thousands of different ways, the net result of which is less aggregate fossil fuel combustion.

If fuel combustion hurts third parties and the planet, increase fossil fuel prices enough through taxation to account for these effects.

For example, if gas prices go up and a commuter decides to start driving a Prius, or to move closer to work so the old gas guzzler travels fewer miles, this will have equivalent beneficial effects on aggregate fossil fuel consumption. One does not have to purchase an energy efficient vehicle to reduce fossil fuel consumption.

Even though I used just two paragraphs and no math to articulate this obvious point, voters and their elected officials resist this simple insight and instead prefer to impose only energy efficiency standards on manufacturers of consumer appliances and automobiles. A singular emphasis on energy efficiency rather than prices has two important drawbacks. First, more efficient appliances and automobiles cost much more to achieve equivalent energy savings than a tax on fossil fuel consumption. This occurs because higher prices encourage all possible avenues of reducing energy consumption — which efficiency standards do not. Second, more efficient appliances and automobiles reduce operating costs, which leads consumers to use more energy than they would if prices had increased.

Why are efficiency standards so popular? They put the blame and the need to "fix things" on corporations rather than on individuals, who vote. They also create invisible rather than explicit costs. Finally, they allow corporations and other interest groups like unions to shape the regulations to their advantage, whereas taxes on fossil fuel consumption are harder to avoid. For example, most seem to have forgotten that — at the behest of domestic auto manufacturers and their unionized auto workers — the Corporate Average Fuel Economy standards were created with separate rules for imports and domestic cars, to restrict the use of imports as a mechanism of achieving greater fuel economy.

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