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Market Power - The mistake of subsidizing pet energy causes

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The story most conservatives tell about energy policy is different from the stories they tell about other economic-policy matters. Rather than defend free markets, they bang the table about the need for national energy plans and government timetables for energy-plant construction. (For example, see Lamar Alexander elsewhere in this issue.) We're told that markets will fail to provide the energy we need, fail to prevent demand for energy from surging beyond reason, and fail to attain such important objectives as environmental quality and a strong national defense.

The conservative case for government intervention in energy markets is just as flimsy as the liberal case for government intervention in any other sector of the economy. Energy markets may not work as perfectly as in a textbook model, but they work -- and government works even less perfectly.

Consider one of the premises underlying the present energy-policy debates: the fear that our reliance on foreign oil leaves us vulnerable to supply disruptions. Most conservatives seem to believe that a reduction in imports will insulate us from price shocks caused by developments overseas. That is nonsense. A supply disruption anywhere will increase the price of crude oil everywhere for the same reason that an early frost in Florida will increase the price of citrus produced in Florida and California by roughly the same amount. Energy independence provides no protection against supply disruptions abroad.

Others fear that reliance on imports requires us to undertake military commitments to ensure that oil continues to flow. But producers have even more reason to worry about the safety of their facilities than we do and, likewise, more reason to ensure the security of international oil-shipping lanes. Hence, they have every incentive to defend their oil infrastructure, whether we help foot the bill or not.

No less a conservative than Dick Cheney argues that producers and consumers make bad decisions in energy markets: They fail to appreciate the profit opportunities associated with certain investments, he says, be they renewable, nuclear, clean coal, ethanol -- whatever. Consumers, the argument goes, are too risk-averse to make expensive bets on promising technology, while they discount the certainty of energy depletion and the dwindling of power supplies. And, Cheney says, producers' time horizons are too short to invest in energy technologies that offer long-term promise. But economists investigating the issue find little evidence for assertions like Cheney's, and little reason to believe that markets in energy are different from markets in other commodities.

Policy activists are on somewhat firmer ground, however, when they argue that energy prices do not fully reflect the environmental costs associated with energy consumption. But economists are wildly divergent in their estimates of the costs of these energy-consumption externalities. Some studies find that present prices for conventional fuels, such as natural gas, are too high rather than too low -- owing to regulatory distortions in the market.

In the case of fuels for which the evidence about environmental externalities is clear, the solution is a tax that increases the price and allows producers and consumers complete freedom to adjust. But that would create visible costs and diffuse benefits, and politicians prefer the opposite: concentrated benefits for companies that collect subsidies and diffuse costs imposed on the taxpayers and the economy.

The strongest critique of a laissez-faire energy regime is that innovators in energy markets cannot capture the full benefits of their innovations. Hence, businessmen may underinvest in energy research and development. Notice that the complaint, however, is that industry will underinvest in R&D across the board -- not that investors back the wrong technologies. If this is a serious problem, the solution is to make all R&D more attractive through preferences in the tax code. Targeted energy R&D subsidies and mandates simply substitute political judgments about investments for market judgments, even though politicians have no comparative advantage in sorting technological winners from losers.

Consider the current love affair of the Right with "clean coal" technology. Billions of federal tax dollars have been spent since the 1980s on various iterations of this concept -- most recently via George W. Bush's "FutureGen" project and the "Clean Coal Power Initiative" -- yet the marketplace has not been friendly to new coal plants. From 2001 through 2007, 179,382 megawatts of natural-gas-fired electric generators were added, but only 3,311 megawatts of coal-fired generation capacity came online.

It's not that we don't know how to make coal facilities cleaner -- it's that we don't know how to make coal plants both cleaner and profitable. Throwing more tax money at this riddle will not necessarily produce an answer. Why are conservatives doubling down on the same ill-fated taxpayer adventure that Ronald Reagan labored so mightily to kill in the 1980s?

Nuclear power is another favored recipient of conservative largesse. Despite promises in the 1950s that nuclear power would soon become "too cheap to meter," 50 years of lavish federal subsidies and regulatory preferences have yet to produce an industry that can turn a profit without taxpayer help. That is an observation that even the nuclear-energy industry's trade association freely concedes, at least when it is time for politicians to reconsider the merits of existing subsidies such as the federal guarantee of private loans to the industry, federal protection against liabilities beyond a certain threshold, production tax credits, and the like. Tufts economist Gilbert Metcalf calculates that nuclear-power costs would increase by almost 50 percent if those subsidies were eliminated.

How is the conservative case for the above subsidies any different from the liberal case for subsidizing solar or wind energy, or high-mileage automobiles -- or, for that matter, the case for government backing of financial institutions and automobile companies? It isn't, and conservatives should not check their skepticism about central planning and the bureaucratic ordering of markets at the door when they walk into the energy-policy funhouse. There is no BTU exception to The Wealth of Nations.

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