

Increasing Gas Prices: Good Economics, but Bad Public Relations

Rising gasoline prices captured the attention of the press and politicians in recent months, culminating with the price spike after Hurricane Katrina. Much bad economic analysis underlies most commentaries explaining why a much higher gas price emerged and recommending policy actions to deal with that higher price.

Higher gas prices serve the public interest during our current gasoline shortage. That is, a higher price rations the product to the best use, on a willingness to pay basis. Absent a higher pump price, the public faces implicit gas rationing whereby gas stations run out of product and people wait in line to fill their tanks. Then the economy will experience a rerun of the unhappy events during the two OPEC-induced oil price spikes in 1973-74 and 1979-80.

Why did the supply of gasoline become relatively scarcer? First, the growth of the Chinese and Indian economies boosted the demand for oil products. Second, the major oil companies did not build new oil refineries in the last three decades, arguing that the return on such investments did not justify making the long-term commitments. Finally, Hurricane Katrina shut down numerous oil refineries and oil production facilities in the Gulf region.

One national pundit recommends that big oil companies voluntarily lower their prices enough to give back 20-percent of their expected profits. But a lower gas price only means that the existing supplies will get consumed too quickly, including some hoarding, and leave the economy to relive the 1970s.

This same pundit also called for a national boycott of gasoline purchases on Sundays. Of course, even if that “call to arms” succeeds, participants can always fill up on Monday through Saturday. Voluntary reductions in gasoline demand seem far-fetched and fruitless. Moreover, it goes against the fundamental role of a market economy, whereby prices signal relative scarcity and allocate scarce resources to their best use. Such recommendations cause Adam Smith to spin in his grave.

Our own Senator Beers calls for temporarily foregoing the state gasoline tax. Will that lower gas prices? No. Gas prices rose not because of higher taxes or higher costs of production. Rather the induced shortage because of converging events, including

Hurricane Katrina, necessitated a higher gas price to ration a short supply, at least temporarily.

Eliminating the state gas tax, however, will create a public relations disaster for the oil industry. If the gas price does not fall, but rations the short supply, the industry receives bad press. If the gas price does fall, as it should not, then the economy will face long lines and stock outs of product. Once again, the industry receives bad press. It's a Catch 22. Moreover, the retail gasoline stations stand in the crosshairs of public opinion, since the problem gains traction when we fill your tanks. The retailers, however, probably will not benefit from excessive profits.

Will big oil companies make extremely high profits as a result of Hurricane Katrina? You bet. They reap the benefits of windfall profits, something that they did not engineer. Will local gasoline stations also make high profits? Maybe, maybe not. Local gasoline stations will compete with each other to acquire the short supply of gasoline from distributors. Thus, it seems more likely that the local stations will not participate in a big way in the excessive profits. Although gasoline distributors may experience some market power vis-à-vis the retail gasoline stations, these wholesalers will also compete for the scarce supply from big oil companies. As such, big oil probably becomes the likely beneficiary of excessive profits.

Can government take action to put a dent into those extraordinary profits? You bet. Government can impose a windfall profit tax to absorb as much of the current profits of big oil that the government deems excessive. And contrary to Senator Beers's recommendation, a higher, not lower, state gasoline tax could reduce the excessive profits of gasoline retailers, if their profits appear excessive.

Frequent stories appear in the press about price gouging at gas stations. Nothing could differ from the truth more than such reports. Can one gas station raise their price significantly above their competitors' prices? Not if they plan on selling gas. True, the higher price does not reflect higher costs, but merely the short supply, leading to higher profits in the oil industry. But, the higher price proves necessary to ration the short supply to its most productive and best uses. In that sense, the higher price performs a public service.

In sum, big oil will see its profits soar during the current market situation. A lower gas price, however, corresponds to precisely the wrong policy recommendation. Moreover, a lower gas tax endorses exactly the wrong policy recommendation to achieve a lower gas price. It will not lower the gas price, but will only increase profit for big oil. The right policy recognizes the necessity of rationing the short supply of oil and does not try to lower the price of gas. A windfall profit tax provides the best solution for excessive profit.

Stephen M. Miller is Professor and Chair of the Department of Economics, College of Business at the University of Nevada, Las Vegas.
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