HOW WISCONSIN POLITICIANS BLEW THE GAS PRICE ISSUE

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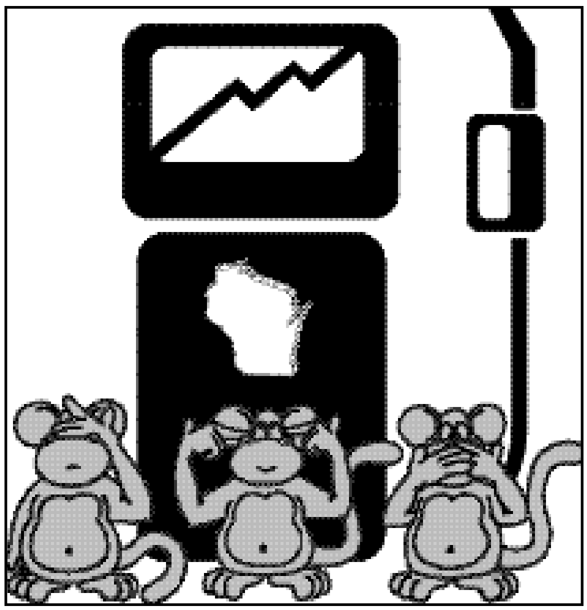

Wisconsin motorists have been whipsawed by gasoline prices in the last six months, with prices topping out at over $2 a gallon in June before plummeting below $1.30 scarcely a month later. Despite the return of prices to lower levels, the frustration of consumers with the high price of gasoline has yet to dissipate. Sensing an opportunity, the state's politicians have jumped on this as a campaign issue, duly promising to get to the bottom of the matter as soon as possible, no doubt by early November.

However, to the extent that anyone besides OPEC can be blamed for high prices, this dubious distinction falls square on the shoulders of Wisconsin's politicians, with an assist from the federal government. Through ill-thought out legislation, an acquiescence to corporate welfare, a failure to do any legwork, and sheer incompetence, both Democrat and Republican legislators played a key role in the high gas prices in the state. In an election that could determine which party controls the legislature, the bungling of the gas issue could cost several incumbents their jobs.

Is There Evidence Of Price Collusion In The State?

Many economists have done research on retail gasoline markets, for the simple reasons that it is relatively easy to get data on retail and wholesale prices, and the topic is "sexy" enough to merit publication regardless of the focus or outcome of the study. One factoid that has resulted from the plethora of studies is that some degree of price uniformity is fairly common in retail markets. This alone is not sufficient to merit a charge of collusion: Given that gas is for the most part a homogeneous good, and that the mandatory posting of prices makes it easy to shop, the manager of a typical gasoline station is stuck charging the same price as his rival across the street or else he'll see a steep drop in sales.

However, some stations have enough market power to charge a slightly higher price. For instance, Amoco and Shell usually charge a price 3¢-5¢ a gallon higher than nearby stations, owing to a significant advertising effort that creates a perception that they sell a superior

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gasoline, as well as their extensive credit card distribution. Also, stations located near an interstate highway usually get away with a higher price, as customers hopping off the highway generally don't want to put any effort into any price comparison shopping

These price differences, however minor, make it difficult for gasoline stations in a given market to collude on prices. Collusion, whether explicit or implicit, is a very fragile situation; when other firms reach an agreement (either explicitly or tacitly) on a higher price, it creates an opening for one firm to break the agreement and undercut the rest of the stations, reaping greatly increased sales as long as the other stations don't find out about it and match prices. A market generally cannot maintain collusion with different price rules for different competitors; firms won't be able to agree on one price and stick with it.

In a summer tour I made through various smaller cities in Illinois (part of a sensory deprivation exercise recommended by my doctor) I noted wide differences between the lowest prices in different cities. The low price leader, Springfield, was a dime below Moline and Rock Island, while Galesburg, Peoria, Rockford, and Bloomington-Normal fell somewhere in between. This difference also exists in Wisconsin, although the differences here appear to be higher; in the eastern half of the state, Kenosha tends to be as much as 10¢-12¢ lower than Oshkosh (despite the higher cost of reformulated gas used in Kenosha) with Milwaukee and Madison somewhere in between.

However, the differences *within* cities are much greater in Illinois than in Wisconsin. A 10¢ difference existed between the high price and low price within the city limits in Springfield, with a 5¢ spread in the other cities in Illinois. In Wisconsin, even this 5¢ spread is often non-existent. In my city, Oshkosh, I have yet to see any price difference between the stations in the city. A 1999 study I did with Frank Kelly of Indiana University-Purdue University, Indianapolis, found that price uniformity was also common in Eau Claire, but not in Beloit, a border city.

A wide price dispersion *between* markets is consistent with price collusion but is not, by itself, proof that collusion is taking place. For instance, wide price variations between markets can occur for a variety of reasons; Moline's higher prices are likely due to higher wholesale prices charged by the closest terminal in the area, in nearby Bettendorf. However, the differences between Oshkosh and Kenosha cannot be explained by differences in wholesale prices; Kenosha has significantly *higher* wholesale prices yet lower average retail prices.

Price uniformity within a market is also consistent with price collusion; in fact, federal courts have ruled before that in certain markets it is sufficient to prove price collusion exists. Firms that collude cannot countenance price differences, even if there are cost or demand differences facing individual firms within the market. Such differences inevitably create large differences in profits between firms and too much pressure for the higher-priced firms to cut their prices.

In short, there is quite a bit of *prima facie* evidence of gasoline price collusion in the state. The FTC has apparently noticed this as well, as it has begun an investigation into the behavior of station owners in Oshkosh.

If Price Collusion Occurred, What Caused It?

If the FTC is looking for a smoking gun in their investigation, such as some kind of memo from one station to another agreeing to keep prices high, they are unlikely to be successful. Thanks to Wisconsin's legislators, collusion is now much easier to maintain, owing to the state's Unfair Sales Act.

The Unfair Sales Act, which has been around since the Great Depression, forbids the sale of any goods or services below cost, and specifically mandates that gasoline retailers sell gasoline at a price at least 9.3% above the wholesale price of gasoline in their market. In 1998, the Republicans in the state legislature increased the penalties for violating the Unfair Sales Act, with fines of $2000 a day for each violation. The act also made it easier for aggrieved firms to file lawsuits against "unfair" competitors, by making the firm violating the act responsible for all attorneys' fees.

The Unfair Sales Act is just one of a number of laws the state enacted in recent years to dampen competition in many retail markets. The declared motivation for the Unfair Sales Act is predatory pricing, a quaint idea that no economist has taken seriously for 20 years. The idea behind predatory pricing is that one firm will undercut all the other firms until they go out of business, allowing the surviving firm to charge much higher prices and earn monopoly profits. The problem with predatory pricing theory is that there is nothing from stopping new firms from entering the markets once they see a firm earning high profits.

In the last few years most states have gotten rid of such laws, for the simple reason that they are not needed. Wisconsin, however, seems to be the exception. No study has been produced to demonstrate that there has ever been a problem with predatory pricing in Wisconsin's gasoline markets. Shouldn't the state at least show some evidence of a problem before passing a law that virtually no other state has? What makes the retail gasoline markets in Wisconsin so different from the markets in Illinois, Minnesota, or Indiana, all states without an Unfair Sales Act but with reasonable prices?[1]

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The real answer for the existence of this law lies in the pleadings of the Wisconsin Petroleum Council, which complained loudly about the onerous environmental regulations imposed on stations in the 1990s that dramatically increased operating costs for most station owners. As a former president of the Wisconsin Petroleum Council told me, if the government was going to impose costly restrictions on stations, many of which actually did little to improve the environment, then the least it could do is help stations make a few more cents per gallon with the Unfair Sales Act. It was an argument that, combined with substantial campaign donations, proved compelling to the state's politicians.

What Should Wisconsin Do About High Gas Prices?

Despite the posturing of politicians, the government did very little this summer that had any impact on the high gasoline prices in the state, and it was probably for the best. There really isn't all that much that government could do that would have helped gas prices, and most of the options that were bandied about would have had a deleterious effect on the overall market for gasoline.

The main thing to consider is that, adjusted for inflation, prices in June were not all that high, historically. The price of gasoline has been falling in real terms virtually since it was discovered, with a few spikes during the oil embargo of the 1970s. The gas prices of the 1970s and early 1980s were much higher in real terms than the peak prices this summer, again adjusting for inflation. If we decide to make it policy for the government to intervene in markets every time the price briefly goes up to levels that really aren't all that high compared to the past, we're going to have a very busy government.

To be sure, if there is evidence of collusion somewhere then the government ought to investigate, but it is difficult to believe that collusion occurred either between the big oil companies that sell gasoline to Wisconsin stations or between the independent gas stations and gas station franchises that operate in the state. In smaller markets that only have a handful of operators controlling the market, collusion probably occurred, but such collusion probably occurs all the time and the state pretty much sanctioned this behavior in the first place by passing laws that any economist would recognize as facilitating cartelization. It may be a way to score some points by blaming some evil cabal of oil executives, out-of-touch Washington bureaucrats, and shady gas station franchises for sticking it to the little guy, but that doesn't make it right. The last time politicians came up with a solution to high gas prices they came up with a price ceiling, which kept prices lower but at the expense of long lines and alternating days at the pump.

It is also important to remember that high gas prices serve to deter driving to some extent, and this is probably a good thing. Each driver on the road generates a negative externality by adding to congestion on the road and increasing air pollution. Discouraging driving to some degree through higher gas prices is an imperfect solution; much better would be to figure out a way to charge people for how much pollution their car actually spews into the environment, or to monitor people's driving habits and replace the gasoline tax with a tax based on how much a driver actually adds to the congestion on the state's roads. Neither, of course, is feasible at present. Better, then, to leave gasoline prices alone to at least discourage some driving at the margin.

For the same reason, cutting the state's gas tax is a bad idea. Unlike the state's (very high) state income tax, which encourages tax evasion and the relocation of retirees to other states, the gasoline tax creates the proper incentives, namely for people to economize on their driving to some degree. Reasonable people can disagree about whether the amount of money generated by the gas tax encourages too much road construction, but there is no reason for the money generated by the gas tax to be used exclusively for road projects. The federal government no longer adheres to this practice, for example.

However, there is still room for the government to act in the gasoline market to lower prices. First, the mandate for reformulated gas in major metropolitan areas needs to be closely examined. Reformulated gasoline made with MTBE has already been shown to cause extensive contamination of groundwater in the country, even in places where it is not being used. Its use will soon be phased out.

It is also time to closely examine the alleged environmental benefits of reformulated gasoline containing Ethanol. The steady progression of Ethanol in our nation's pumps has nothing to do with any benefits of ethanol *per se* and everything to do with the unholy alliance of Democrats, Republicans, and Archer-Daniels-Midland (ADM), which gets my vote as the most evil corporation in America. It takes almost as much energy to create Ethanol in the first place as it gives out when burned; studies exist that show its alleged environmental benefits may be nonexistent, and it is harmful to engines. The state and federal government has inserted all kinds of direct, indirect, and downright hidden subsidies to encourage its production and usage without a complete understanding of its true environmental and economic benefits. It is time that someone embarks on a complete study of its usage before we expand this nationwide boondoggle for the benefit of one corrupt company and a few thousand corn farmers.

Kevin Rask, an Economist at Colgate University, examined data from emissions stations in California and found that most of the noxious emissions from vehicles comes from either older cars made before about 1990 or the trucks and SUVs that are not bound by today's strict emissions standards. California, under stricter federal environmental mandates, responded by encouraging the purchase and destruction of older cars in their emissions-trading program. If we are serious about wanting to improve our environment the state government should try to encourage similar behavior here in Wisconsin, and the federal government should apply emissions standards to cover all vehicles and scrap reformulated gasoline.

But if the state really wants to do something to reduce prices, it should repeal the Unfair Sales Act immediately. This is a law designed to reduce competition and increase the profit margins for gas stations in the state. The supposed bogeyman that it was supposed to extinguish, predatory pricing, has been thoroughly debunked by economists, and little evidence exists to suggest that it was ever much of a problem in Wisconsin's retail gasoline markets.

Who's To Blame?

Wisconsin politicians have made three mistakes in their fight against high gasoline prices in the state. First, they should have attacked the EPA for its rules regarding reformulated gasoline much sooner, even before gas prices skyrocketed. Of course, hindsight is 20-20, but someone with their ear to the ground could have easily recognized that the new reformulated gas was going to push up prices and have pushed for a short extension, which would have been easier to obtain before its phase-in in early June.

Second, the state abandoned efforts to get rid of reformulated gasoline too soon. Reformulated gasoline with Ethanol is still a bad idea, both for cost and environmental reasons. By pointing out the inefficacy of reformulated gasoline in achieving improved air quality and at the same time offering an alternative environmental plan, such as one that would reduce the number of older cars on the road, advocates of reformulated gasoline would be put on the defensive. If our state's politicians had the temerity to denounce the reformulated gas mandate for what it is, namely a sop to ADM and corn farmers, then it would be tough for the EPA not to back down.

Third, the state should have immediately used the excuse of high gasoline prices to repeal the Unfair Sales Act. Besides its problems from being designed to combat an economic phenomenon that doesn't exist, the law actually requires the markup on gas to go up as wholesale prices go up, owing to its nonsensical design. A timely repeal of this law, say right before the election, would undoubtedly remove one thorn from incumbents' heels.

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The dirty little secret of Wisconsin government illustrated by the gas issue is that, despite complaints to the contrary, it is not pro-capitalism: It is pro-business, and there is a big difference between the two. Competition and unpredictability are part and parcel with capitalism, and the state's politicians want nothing to do with this. They would rather pursue an incoherent and inchoate industrial policy, giving millions to large, politically connected manufacturing firms while keeping taxes high on the small entrepreneurial companies that will actually create most of the new jobs. While subsidizing the large manufacturing firms, Wisconsin concomitantly enacts other policies to restrict the amount of competition firms face in the state, claiming increasingly shaky excuses to justify this situation.

The state has gotten away with this so far mainly because of a booming economy that has had little to do with any subsidies or laws passed in the last decade. However, it is becoming apparent that the statist industrial policy may be harming Wisconsin's economy, as evidenced by the fact that wage growth in the state lags the rest of the country. When the U.S. economy stumbles in the next few years, as it eventually will, the Wisconsin economy will likely be leading the way, thanks to its dependence on manufacturing employment that is quickly disappearing. When such a downturn happens, the state's politicians will have set themselves up to receive the blame.

Note

1. Given the way the state uses studies, perhaps it's best they didn't waste their money. In 1994, the state's politicians worried that price discrimination by large drug companies was driving small drug stores out of business. The state commissioned a study to determine whether this was a problem, and the study, completed a year later, showed that there was no evidence that price discrimination was affecting small drug stores. However, the state legislature went ahead and prohibited retail price discrimination anyway before the study was completed.