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WHY AUTO MILEAGE RULES SHOULD BE RELAXED

INTRODUCTION

In the near-panic following the 1973 Arab oil embargo, Congress passed the Energy Policy and Conservation Act (EPCA) of 1975. Among the Act's provisions is the requirement that U.S. auto manufacturers meet annual miles per gallon targets set by the Department of Transportation (DOT) beginning in 1985. Termed the "Corporate Average Fuel Economy" standards, or "CAFE," these rules called for the U.S. auto industry to achieve an average fuel economy for all of its cars of 18 miles per gallon (mpg) by 1978, rising to 27.5 mpg in 1985. Failure to meet these standards would result in fines and penalties for the companies.

In establishing the CAFE standards, Congress recognized that changing circumstances might require adjustment in the targets. It thus authorized the Secretary of Transportation to reduce the 1985 standard to 26.0 mpg if conditions warranted it. In response to petitions from General Motors and Ford, DOT recently proposed such an action, citing changes in consumer demand and the negligible effect the move would have on energy consumption. Predictably, however, the Chrysler Corporation, which does not produce large cars, together with environmental groups, opposes the DOT proposal to relax the CAFE standards.

Strictly enforcing the 27.5 mpg standard would reduce U.S. oil consumption by a miniscule 0.0006 percent. This tiny savings would come at an enormous price. It would cost U.S. manufacturers $750 million this year and raise the selling price of a full-sized car at least $500. It also could force U.S. GM and Ford to stop producing full-size autos. This would wipe out 500,000 jobs in the U.S. auto industry. Disappearance of full-sized domestic models almost certainly would not be made up by sales of smaller domestic cars. More likely would be stepped-up imports of large automobiles from foreign manufacturers which, of course, are not

bound by CAFE standards. This would undermine further America's serious balance of trade and weaken the U.S. auto industry.

THE GENESIS OF CAFE

When Congress extended the price controls on domestic crude oil and refined products after the 1973 oil embargo, it ensured that foreign oil imports would rise. The controls reduced the incentive for domestic oil exploration and production, and removed from the users of petroleum products the cost pressure to conserve. Consumers thus continued to purchase the large fuel-inefficient vehicles they preferred. And U.S. manufacturers, acting to meet the market's demands, continued to produce them. Moreover, price controls guaranteed that the demand for oil products would remain strong, and lower cost imports would continue to supply most of the market.

While logic dictates that the appropriate response to the increasing level of oil imports would have been to allow the market to operate, making consumers pay the true cost of oil, Congress opted for a regulatory fix by passing the Energy Policy and Conservation Act of 1975. Under the CAFE provisions of this law, U.S. manufacturers would be fined $5 for every vehicle they produced for each 1/10th of a mile per gallon by which their fleet average failed to meet the mandated mileage targets. The fines were to apply to all vehicles if the company missed the fleet target, not merely the inefficient ones. This meant that if a company failed to meet a target by one mpg, and produced 8 million vehicles, it would have to pay $400 million in fines for that model year. Recognizing the punitive nature of these penalties, Congress left open the option of a reduction in the mileage targets in certain cases.

The legislation set forth a series of criteria to be taken into consideration in setting the standards and considering appeals for their modification. These were: 1) the technological feasibility of attaining the target; 2) the effect of other federal regulations on automobile fuel efficiency; 3) the economic practicality of enforcing the standard; and 4) the nation's need to conserve energy. It is these last two criteria, in particular, that are central to the current debate on CAFE.

THE AUTO INDUSTRY IMPROVES FUEL EFFICIENCY

In the past decade, the U.S. auto industry has made an enormous investment to improve fuel efficiency. Most of the impetus for that investment came not from the federal regulations, but rather from the changes in consumer demand that accompanied the second oil crisis in 1979. That oil crisis, which drove the retail price of gasoline above $1 per gallon--despite price controls--gave consumers their first real economic incentive to purchase fuel efficient automobiles. They did so in great numbers.

In response, U.S. auto makers embarked on an $88 billion capital expenditure program to increase gasoline mileage and improve the quality of their products. By 1984 the fuel efficiency of the U.S. automobile fleet had improved by 70 percent over 1975 levels. In addition, the average weight of a U.S. built car had dropped by 1,000 lbs., a key change since weight is the single most important determinant of automobile fuel efficiency. Other improvements, including a 40 percent increase in the use of fuel injection and a 50 percent reduction in average engine size, also contributed to the mileage increase. But these changes did not come without cost. According to estimates by General Motors, each 0.5 mpg gain in fuel performance required an investment of $1 billion.

The investment in fuel efficiency paid good dividends in the market for mid-sized and full-sized models. Americans have long preferred such cars, due to typically long driving distances in the U.S., fine superhighways, and because of work and family requirements. So considerable effort was made by U.S. manufacturers to improve the fuel consumption of their larger cars. This effort led to a rise in the average mileage rating of mid-sized and large-sized cars to 22.9 mpg for 1984, a near doubling of pre-embargo levels. In fact, the 22.9 mpg rating actually exceeds the 20.8 mpg rating subcompacts built in the U.S. averaged in 1977.

THE COST OF CAFE

It has been the marked success of U.S. manufacturers in improving the efficiency of their larger models which ironically has contributed to the current CAFE dilemma. While Americans hesitated to purchase large cars rated at 11 mpg, they were eager to buy them as efficiency ratings began to exceed 20 mpg. So although all U.S. auto makers offer many models that far exceed the 27.5 mpg CAFE standard, their product mix failed to meet the average 27.5 mpg target because customers did not have as strong a demand for the smaller cars as Congress expected. More important, gasoline consumption was simply not the key concern for the buying public. According to a poll by J. D. Power and Associates, only 15 percent of Americans surveyed indicated that mileage was the most important consideration in purchasing an automobile.

The American public has been making its choice evident through the purchase of large, yet relatively efficient, cars and that choice has been quite rational given conditions within the world oil market. Since President Ronald Reagan decontrolled oil prices in 1981, supplies have increased rapidly, and the cost of gasoline has plummeted. It is now possible to purchase motor fuel in some parts of the United States for as low as $1 per gallon, despite extra taxes on gasoline in recent years. Meanwhile, imports of oil and refined products are far below their 1977 peak levels--and these imports no longer come primarily from the crisis-prone Middle East, but from within the Western Hemisphere.

Most important, while the economic expansion is in its third year, overall U.S. domestic energy consumption is still below peak levels, meaning that a surprising degree of domestic energy conservation has been achieved. In short, the rationale for CAFE--conserving energy--has already been achieved by the market. Cumbersome and discriminatory federal rules never were effective, but no argument can be made for them now.

This conservation success, achieved by the market, makes the case for not enforcing the CAFE rules. The tiny reduction in energy consumption that would result from a 27.5 mpg CAFE standard would be a small benefit in return for a potentially disastrous cost to the automobile industry. U.S. manufacturers would face an immediate penalty of some $750 million in federal fines.

This may be the least of the harmful effects of enforcing the CAFE rule. Of far greater concern is that many of the manufacturers would likely curtail, or even abandon, large-car production. Should this happen, it is unlikely that the loss of large-car sales would be recouped through sales of smaller models. Instead, a significant portion of any increase in the small car market would go to foreign manufacturers. Moreover, the large car market would be abandoned to foreign suppliers. The curtailment of production would thus result in a direct, and possibly permanent, loss of market share by American-based firms.

According to figures from Ford and General Motors, the two firms most directly affected, up to 500,000 auto workers would lose their jobs as a result of CAFE enforcement. More than 2 million units of domestic auto sales could be lost. Assuming a retail price of approximately $9,000 per vehicle, this would constitute a direct loss of nearly $20 billion in annual GNP, and the addition of a similar amount to the balance of trade deficit. Worse, the loss of sales would come just as the need for revenues to finance capital investments which could improve mileage are most needed.

There would also be less tangible costs. Consumers benefit from having a wide range of choices. When their choices are limited by government prohibitions, they suffer a real loss. They would also suffer an indirect but measurable economic loss in terms of lower safety and higher insurance premiums. According to studies of automobile safety, a passenger in a compact or subcompact car is twice as likely to be fatally injured as one in a full-sized vehicle. In recognition of this fact and the high cost of repairs, many automobile insurance companies add a surcharge to premiums on smaller cars.

CONCLUSION

The argument for CAFE standards has been overtaken by events. The targets were to encourage energy conservation in the transportation sector in the face of continued controls on motor fuel

prices. But these price controls are no longer in force, and the market has achieved a better-than-expected level of conservation. More important, the nation's dependence on Middle East imports has been reduced drastically. The two basic arguments for the rules, therefore, no longer exist. Meanwhile, enforcement of the rules would mean the loss of up to 500,000 jobs and as much as $20 billion of GNP--and a similar addition to the trade imbalance.

This would be a high price to pay for a tiny reduction of oil consumption. CAFE was a bad idea when passed by Congress, and it is an enormously costly bad idea now. Transportation Secretary Elizabeth Dole should relieve the industry of this damaging regulation.

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