

Externalities – Standards, Suing for Damages

I. The Article

San Francisco Chronicle

SUV mileage knocked California, 9 other states sue federal government

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California officials launched their latest skirmish with the Bush administration over environmental rules Tuesday, suing the federal government over SUV gas-mileage standards the state considers too lax.

The suit, led by California and joined by nine other states, argues that the federal government didn't fully consider potential damage to the environment when it drafted new fuel efficiency standards for sport utility vehicles and light trucks. The plaintiffs say that loose standards don't do enough to combat global warming.

Under the administration's standards issued in March, those vehicles -- the biggest gas guzzlers in American garages -- must have a fleetwide average of 24 miles per gallon by 2011. Trucks and SUVs made this year must average 21.6 mpg. The rules don't affect passenger cars.

"We would hope the court would order them back to the drawing board," said California Attorney General Bill Lockyer. "Frankly, we're not sure that there are any genuine savings with the standards they've announced."

The defendant in the case is the National Highway Traffic Safety Administration, the federal agency that issued the new rules.

It describes the regulations as an attempt to balance reduction of oil use with protection of jobs. American automakers suffering big financial losses say that tightening mileage standards too much would give an unfair advantage to foreign competitors with smaller, more fuel-efficient cars.

"Keep in mind that we need to be very careful that we don't do something that will have unintended consequences," said Rae Tyson, spokesman for the traffic safety administration.

"The process of developing a light truck fuel-economy standard for 2008 through 2011 was a very thorough and rigorous process, and we think it will be upheld in court."

Other parties joining in the suit are Connecticut, Maine, Massachusetts, New Jersey, New Mexico, New York, Oregon, Rhode Island and Vermont, as well as the District of Columbia and New York City.

California and the Bush administration have repeatedly clashed over environmental policies, with the state pushing for tougher regulations and the federal government attempting to rein California in.

The state, for example, passed a law requiring automakers to lower the amount of carbon dioxide and other greenhouse gases their cars emit. When it published the new mileage standards, the

federal government argued that states don't have that authority, a position likely to help automakers as they try to overturn the California law in court.

Facing staunch opposition from carmakers and auto industry labor unions, politicians for years have avoided imposing dramatically tougher fuel-efficiency requirements. But with gasoline prices setting fresh records, several members of Congress have started pushing for tougher standards as a way to cut America's dependence on foreign oil.

The Bush administration last week added its voice, calling for new standards for passenger cars. The first public hearings on the proposal are scheduled for today.

Backers view fuel-economy standards as a sure-fire way to reduce the amount of oil consumed in the United States. A 2001 study by the National Academy of Sciences estimated that standards imposed after the energy crises of the 1970s cut domestic oil use by 2.8 million barrels per day.

This spring's new rules for SUVs struck many environmentalists as a missed opportunity.

"The fundamental problem is they simply don't save as much oil as they could," said David Doniger, staff attorney for the Natural Resources Defense Council, which has challenged the new standards in court. "They fall far short of what's technically feasible and economically feasible."

Opponents, however, say fuel standards can jeopardize U.S. jobs if set too high. They also argue that higher requirements can lead to more deaths on the highway, since automakers typically lighten their cars to increase mileage.

The 2001 National Academy of Sciences report, for example, said that fuel standards may have contributed to 1,300 to 2,600 traffic fatalities in one year alone -- a finding that provoked heated debate.

Automakers Tuesday balked at raising fuel standards higher than this spring's new requirements.

"To meet a higher number than the one (the federal agency) set, based on sound science, would force automakers to strip vehicles of features consumers demand, such as passenger room, cargo space, towing capacity and other attributes," said Eron Shosteck, director of communications for the Alliance of Automobile Manufacturers.

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II. Analysis

The U.S. currently has a gas-mileage standard rather than a fee. A gas-mileage standard is a legal minimum miles-per-gallon target specific to various classes of vehicles. This is a means of correcting market failure because externalities are not reflected in market prices. Negative externalities will generally cause a larger than efficient amount of a product or service to be consumed. To meet the standard, SUV manufacturing companies must install additional technologies and equipment, causing the average cost curve to rise, resulting in a higher price and less SUVs to be consumed. This particular standard has the net effect of both reducing the consumption of SUVs (which generally have lower MPGs than passenger cars) and gasoline.

Fig 1. – Market Failure

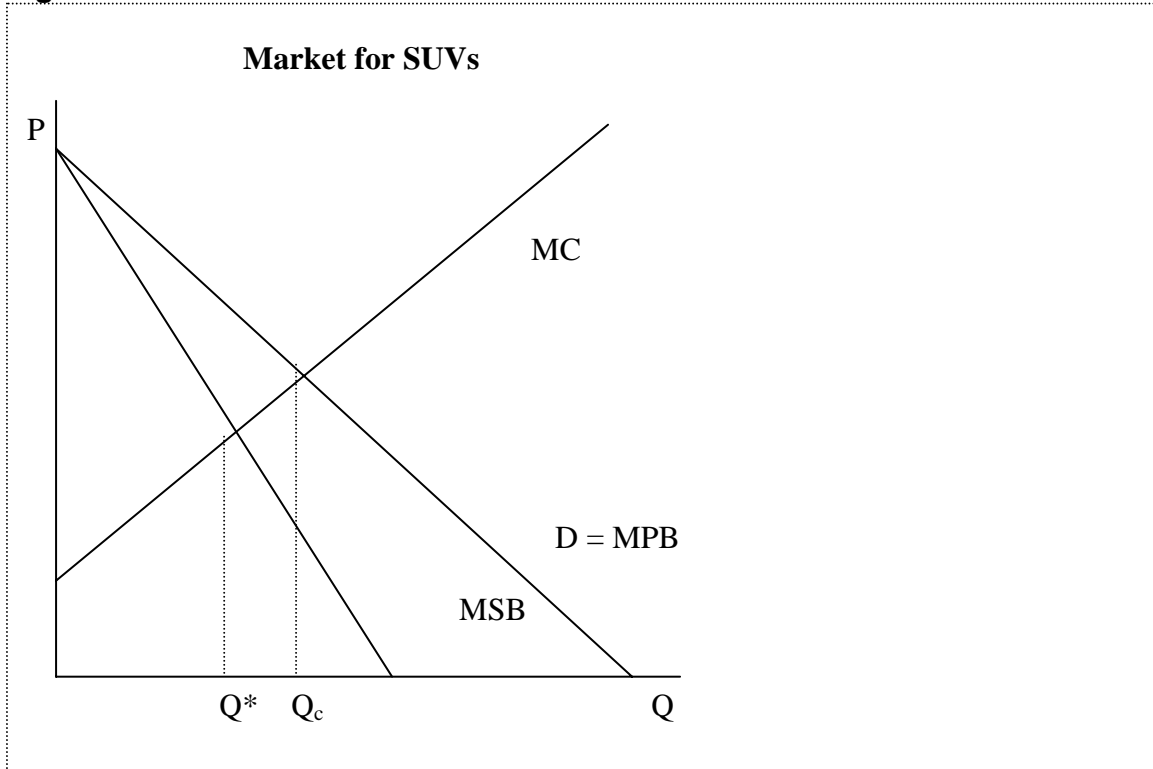


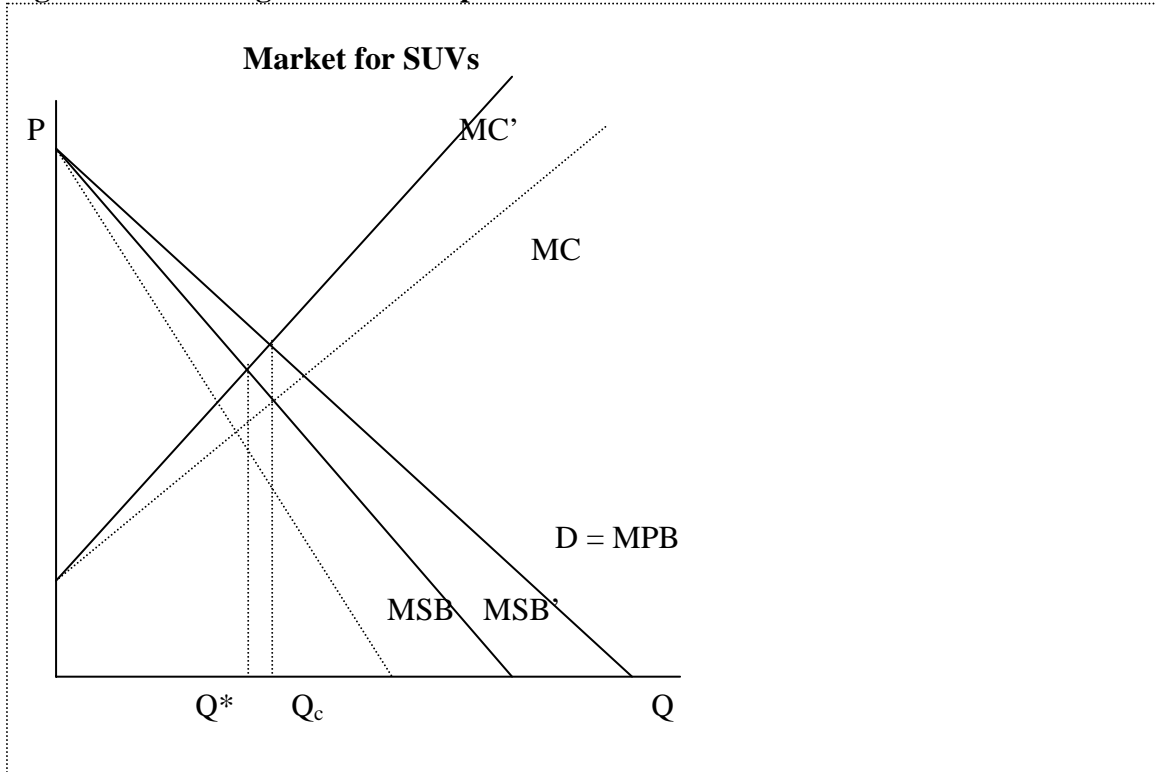
Fig. 1 shows the situation without government intervention, with negative externalities tied to consumption.

In the article, California and 9 other states are arguing that the standards set by the government did not fully consider the negative externalities caused by SUVs. In effect, they argue that by setting the standard, the government is responsible for managing the negative externalities generated by SUVs and liable for monetary damages.

In effect, the standard did not appropriately internalize the externality. In fact, the article states that the standard itself resulted in the loss of human life through increased accident fatalities, a controversial claim, but a significant externality in itself.

Unfortunately the standard is not the most effective way of internalizing the externality as shown by the following diagram.

Fig. 2 - Gas-mileage standard implemented



Note that DWL still exists although it has decreased due to the gas-mileage standard. The government is trying to internalize a demand side externality with a supply side strategy.