

# Stale CAFE

By PAUL GODEK

Competition Policy Associates

Gas prices are rising—round up the usual suspects. Price-fixing investigations, check; taxing oil company profits, check; tougher fuel economy standards, check. As the saying goes: same circus, different clowns.

Before anybody goes too far down the path of more and better fuel economy standards, however, it would pay to review the whole sorry history of CAFE. In the beginning, the National Highway Traffic Safety Administration (NHTSA) created cars and light trucks. That is, in establishing the corporate average fuel economy (CAFE) standards back in 1978, NHTSA created those two classes of vehicles. The CAFE standard for cars was strict, increasing from 18.0 miles per gallon in 1978 to 27.5 mpg in 2004, which has made cars smaller, lighter—and, therefore, more dangerous and less desirable. The CAFE standard for light trucks was less strict because light trucks were utilitarian, less common, and, thus, not the focus of the regulation.

The inevitable result was, of course, a dramatic increase in the popularity of light trucks: sport-utility vehicles, minivans, and even pickup trucks, which now are often equipped with four doors. Americans used to drive a lot of large sedans and station wagons. Now, thanks to CAFE, they drive a lot of SUVs and minivans. Light trucks currently make up about half of all passenger vehicle sales.

NHTSA decided last year that it had to close the light-truck loophole. The recently proposed CAFE standards for 2008 and beyond create six different types of light trucks, each with its own CAFE standard. The six types are defined by the “footprint” of the vehicle measured in square feet, footprint being the vehicle’s wheelbase (the length of the vehicle measured as the distance between the front and rear wheel centers) multiplied by the track (the width of the vehicle measured from the middle of the tires). You cannot make this stuff up.

So how did we end up here? The short answer is that CAFE’s provisions reflected the U.S. auto companies’ strategy for coping with the first oil shock in the 1970s. Not only does CAFE set minimum average fleet gas mileage standards for firms selling passenger vehicles in the United States, the standards apply separately to two sources of vehicles—domestically produced and imported. That is, a company that sells both domestically produced and imported vehicles must meet the standards for both fleets separately.

The reason for that distinction lies in the political influence



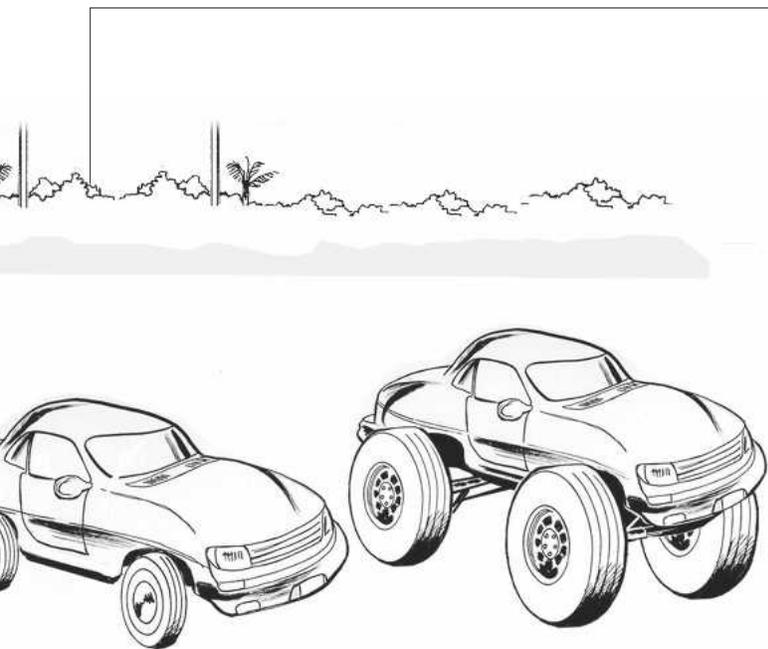
of organized labor. Because the standards treat a company’s imports and domestic production as separate fleets, GM, Ford, and Chrysler could not comply with CAFE by selling, under their own brand names, fuel-efficient imported cars. Imports of Japanese cars surged in the 1970s, and the low profits on domestic small cars were leading the Big Three automakers to displace domestic small cars with captive imports. Under CAFE, the Big Three had to continue to produce small cars in the United States, to the benefit of the UAW. This was not a secret. A NHTSA document, describing the separate fleet provision, stated: “Congressional intent of this provision was to discourage manufacturers from importing large numbers of fuel efficient vehicles to the detriment of employment in the U.S. manufacturing industry.”

Does CAFE have anything to do with gasoline consumption? Of course not. To paraphrase Rockefeller, the price of gas will fluctuate; and people will react accordingly. U.S. energy policy is schizophrenic anyway. If gas should be less available and more expensive, then tax it. Well, they already do. Federal and state taxes amount to about 40 cents per gallon. But the authorities do not want gas to be less available (more expensive), they want it to be more available (less expensive). So why do they want to compel “conservation” when they also want gas to be more available? Go figure.

Whatever the original motivation, CAFE seems to have evolved into a sort of environmental sacred cow. And so, the CAFE-induced switch to light trucks has become part of the problem. But let us not forget that the switch to light trucks is the reaction to the problems caused by the original, misguided regulation. NHTSA even concedes the deleterious consequences of CAFE. In a recent notice, NHTSA states: “The current structure of the CAFE program encourages the development of vehicles that are larger and heavier, and which may have higher

KEVIN TUMA

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centers of gravity. Thus, the CAFE program may contribute to the two principal vehicle safety problems on the road today: vehicle compatibility and rollover.” Vehicle compatibility is a polite term for a collision between a big SUV and a small car. Rollover is a malady prevalent in SUVs and politicians.

The natural conclusion to draw from the consequences of CAFE is that, instead of raising the standard for either cars or trucks, CAFE should be repealed. In the present political climate, that will not happen. We will be fortunate if things do not get worse. Let this latest episode at least be a lesson in how regulations grow, mutate, and seldom die. In other words, there is no market so screwed up that the government cannot make it worse. **R**

# Fidelity Bond Foolishness

BY JAMES P. CLARK

**F**rom the beginning of time, financial institutions have been challenged by the problem of embezzlement and employee dishonesty. One reasonable response to this problem is to insure against it. By statute, the Federal Deposit Insurance Company can require insured financial institutions to maintain fidelity bonds to insure against such losses, and the FDIC has chosen to mandate that requirement. Other federal bank-

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ing regulators, as well as most state regulators, also require universal fidelity coverage. For instance, the comptroller of the currency requires national banks to have “adequate fidelity coverage.”

According to surety industry figures, between 1989 and 2000, FDIC-insured financial institutions paid sureties \$2.337 billion in premiums for fidelity bond coverage. During that time, FDIC-insured institutions recovered a total of \$919 million on fidelity bond claims. Therefore, overall, insured financial institutions recovered only 39 cents for every dollar spent on premiums. Of the \$919 million recovered under fidelity bond policies, the FDIC or the Resolution Trust Corporation (as successor for failed institutions) recovered about \$350 million.

One reason that fidelity bonds have such low premium-to-payout ratios is that the bond policies are complicated and somewhat ambiguous. Whether a loss is covered is frequently heavily negotiated and litigated. For instance, banks litigate whether losses were “discovered” during the policy period.

**COSTS AND BENEFITS** The 39 cent payout per premium dollar figure underestimates the true value of banks’ recoveries from fidelity bonds. Because the actual payment may not occur for years after the bond’s purchase and because of the cost of pursuing a fidelity bond claim, the real return on fidelity bonds is lower.

I estimate that the time value of money decreases the value of bond payouts by an average of 10 percent. To reach this figure, I assign a 5 percent annual discount rate and project that, on average, the time between when the bank pays the bond premium and when the bank receives a payout on a claim is two years. (In litigated cases, this period can be much longer than two years.)

I also estimate that a bank incurs, on average, about 10 percent of the value of a bond’s payout in legal costs—investigating the loss, putting together the proof of loss, negotiating with the insurer, and, in some cases, litigating the claim. In cases where institutions litigate bond claims, legal costs can easily swallow 30 percent or more of the value of the payout. Given those considerations, I calculate that fidelity bonds really only return about 31 cents on each dollar of premium.

Ordinarily, spending \$1 on a product that you expect will pay a 31 cent return is a bad investment. Of course, insurance works differently than investments; insureds as a group do not expect to realize a positive rate of return on insurance. Instead, they buy insurance to transfer risk, at a price, to the insurer. But in the case of fidelity bonds, where the price is 69 cents out of each dollar of premium, that price seems unjustifiably high.

**LIFELINE** Comparing bond payouts to premiums paid may not capture all of the benefits of fidelity coverage. In some cases, a timely bond payment can provide a thinly capitalized bank with a lifeline that can save it from incurring the liquidation costs associated with failure or with the selling of assets to meet minimum capital requirements.

For example, suppose that a \$2 million bond payment allows a thinly capitalized institution with \$100 million in assets to survive by meeting its minimum capital requirement.

According to FDIC deputy chairman and chief operating officer John Bovenzi, the moment that the FDIC takes over the assets of a failed institution, the value of the institution's assets declines by 10 percent or more. Thus, in such a case, a timely \$2 million bond payment that allows the bank to survive could save the bank or the FDIC \$10 million or more.

But how often is this lifeline needed and, when it is needed, does it come through in time? While calculating the extra value from such fortuitous fidelity bond payouts is difficult, I believe that cases in which payments are worth more than face value are rare, for three reasons:

First, bond payments are usually not material to an institution's capital. Most institutions have substantially more capital than is required by regulation. Most bond payouts are relatively small and do not materially affect the institution's capital.

Second, even if a bond payout were material and could save the institution, bond payouts frequently come too late, after the institution has failed. This is especially true of large bond claims, which are frequently subject to lengthy litigation. In fact, from 1989 through 2000, about 39 percent of total financial institution bond payments went to the FDIC as receiver for institutions that had failed. This money came too late to prevent failure.

Third, even if a bond payout was quick enough and large enough to save an undercapitalized institution temporarily, the institution may fail later anyway if its competitive position and business fundamentals are poor. **R**



# Oil Prices and 'Folk Economics'

BY PAUL H. RUBIN

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As prices for gasoline increase and motorist-voters grow more angry, government is implementing or considering numerous counterproductive policies. *The Wall Street Journal* and other sources that understand fundamental economics have published several editorials and op-eds on this issue. They have pointed out that the price increase is due to the normal functioning of supply and demand in a situation where demand has increased, and that allowing the full functioning of the market will lead to increased supplies and other beneficial effects.

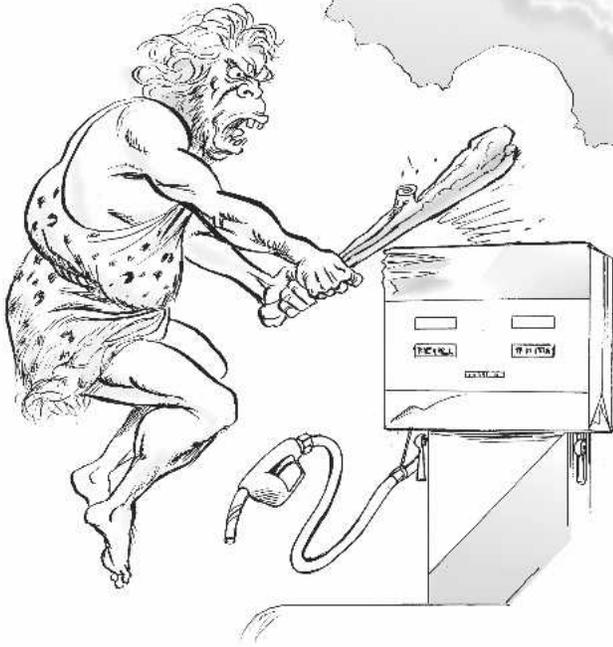
Nonetheless, consumers and voters do not understand this issue and the reaction of politicians is in response to pressures from voters. Gasoline prices peak every few years and voters are always irate. A standard response is to have the Federal Trade Commission investigate possibilities of collusion; after a few years of study by its Bureau of Economics, the FTC will announce that there was no wrongdoing. Additionally, Congress will subpoena industry executives to hearings where they will be castigated for high prices and high earnings. And the media will dutifully document the public's anger at "Big Oil."

Why do we have the same reaction from consumer-voters each time? To understand this reaction, it is necessary to go beyond simple economics and to consider the origin and nature of beliefs about economics—what has been called "folk economics." This requires consideration of the environment in which humans evolved and in which our intuitions about economics were formed.

Our instincts about economic issues were formed in the long period our ancestors spent as hunter-gathers. Humans have existed as humans for 50,000–100,000 years and our pre-human ancestors were around for millions of years before that. We have spent only about 10,000 years in settled communities. This is too short a time for much of an effect on our evolved preferences, so at some level we still have the instincts of hunter-gatherers. As Hayek has said, "Man's instincts were not made for the kinds of surroundings ... in which he now lives."

There were several important characteristics of the environment in which we evolved. It was highly static. There was virtually no technical change. (One authority refers to "major technical change" as a change in hand-axe construction over "a few thousand years.") There was little or no capital investment beyond a few simple tools, and a labor theory of value was

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appropriate. There was little specialization and division of labor, except perhaps by gender and age. Most importantly, the world was “zero sum”—there was little chance of increasing output by rearranging factors of production or creating more efficient methods of production. There was trade, but it was

mainly simple units of one good for another or even the same good at different times. “Prices” were rates of exchange and there was no reason for them to change radically. There was a sharing ethic that would serve to allocate food from one person to another when there was a danger of starvation—a danger that would always have been imminent.

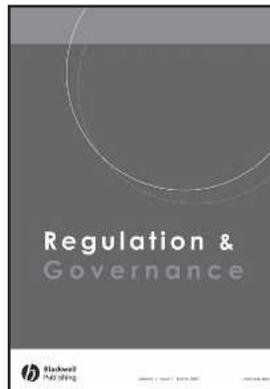
How does this relate to oil prices? Our reaction is governed mainly by the zero sum nature of our thinking. We have little or no intuition about the efficiency aspects of prices. In folk economics, prices serve to allocate wealth (“if I have more, you have less”) but we have no intuition about the effect of prices on allocating resources or leading to the creation of resources. If supplies are fixed, then higher prices cannot lead to increases in the amount of oil available. If demands are fixed, then higher prices cannot lead to efficient conservation. Moreover, a sudden increase in wealth appears to be the result of violating the norm of sharing.

If we are to make headway in explaining the benefits of free markets to those untutored in economics, we cannot begin with supply and demand. We must go beyond conventional economics and consider the intuitions about economics, and explain that free prices and free markets serve to do more than allocate a fixed amount. We must explain first that free markets can actually lead to increases in wealth and that allocating those increases is only second to creating wealth in the first place. Humans can learn this, but it must be taught; it is not part of our instinctive knowledge about the world. **R**

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