

Surprise! The Long-Term Decline in the Real Price of Gasoline

Richard B. McKenzie

The surge in the price of gas at the pump especially over the last several years has undercut Americans' standard of living. The recent price surge represents a *reversal* of the long-term downward trend in the *real* (inflation-adjusted) price of a gallon of regular gas from 1918 to 2008, which is fully evident in the chart on a website developed by InflationData.com (http://www.inflationdata.com/inflation/images/charts/Oil/Gasoline_inflation_chart.htm, accessed June 23, 2008). Not fully evident in the chart is the nearly third increase in the price of gas over the last six weeks.

In 1918, the nominal price of gas at the pump was a meager 25 cents. However, in 2008 prices, that price was the equivalent to \$3.52 – a real price that was not exceeded until this spring. The average price of regular gas across the country in June 2008 was \$4.10. A couple of prominent spikes in the real price of gas occurred during the nine decades since 1918, in the late 1920s and 1930s and then again in the 1970s and early 1980s, with a peak of \$3.17 in 1981. But the high real prices during those “energy crises” never broached the 1918 high real price.

The chart also shows that by 1998, the real price of gas had fallen to about \$1.30 a gallon, a decline of nearly two-thirds from 1918 (and a nearly 60 percent decline since the high of 1981). The bite of the gas price on Americans' household budgets was, of course, declining over the eight decades with the substantial rise in real (inflation-adjusted) household incomes.

In 1998, Americans also could choose to buy a car that was 60 to 70 percent more fuel efficient than in 1972, according to Cato Institute economists Jerry Taylor and Peter Van Doran,

which reduced further the dent any “high” price of gas had on American living standards.

Between 1949 and 2008, Taylor and Van Doren found a substantial downward trend in the price of gasoline after adjusting for inflation and the growth in household income (go to their chart at <http://www.cato.org/images/pubs/pub6440.jpg>, accessed June 23, 2008). The gallon of gas that sold for \$1.03 in 1949 had the same impact on American household budgets that a price of more than \$6.75 a gallon would have today, which suggests a drop in the real price of gas of about 60 percent between 1949 and this spring (2008).

Of course, many Americans have chosen to spend their increased real incomes, bolstered by the long-term decline in the real price of gas, on larger, less fuel-efficient cars and trucks, with the Hummer being the ultimate monster gas guzzler. They have further increased their energy dependence by living farther from work and shops, buying bigger houses, lawn mowers, and a variety of household appliances.

With lower real gas prices, Americans have packed on extra pounds. Researchers have found that 13 percent of the increased obesity in the 1980s and 1990s can be chalked up to the long-term decline in the real price of gas, because with the lower real prices Americans have walked less and gone out to eat more calorie-laden meals.

Without doubt, many Americans have increased their energy dependence because as the decades rolled by, they could project with greater confidence that the real price of gas would continue its downward slide for sometime into the future. Few stopped to think that the downfall of the Soviet Union, and the economic revival of its constituent countries; the liberalization of the Chinese economy; and the rise of the internet and the emergence of the global economy, which have made India an economic powerhouse, as well as the growing political instability of

the Middle East, would all coalesce at the start of this century into the perfect energy storm that would cause the surge in the real price of gas.

This month (June 2008), the average price of gas hit \$4.10, 16 percent higher than the real price of gas in 1918 – but three times the historically low real price of gas in 1999.

Many Americans now feel the pain of the current high price because the relative suddenness of the price surge has left them trapped with gas guzzling cars, added pounds on their backsides (which are undercutting the fuel efficiency of their cars), extra large houses that are some distances from their workplaces (the prices of which have declined, partially capitalizing the added energy costs that will have to be incurred both immediate and maybe years into the distant future). Understandably, the average resale price of SUVs has plunged. Nevertheless, in spite of the sharp rise gas prices, many Americans will continue driving their gas guzzlers because the greater demand for and higher prices of smaller cars, including hybrids, have made them barely more economical to drive than the SUVs.

Is there a silver lining in the recent reversal in the long-term decline in the real price of gas? Of course there is. The reduction in car travel should lead to lower accidents and deaths on the country's highways. People will drive less and walk more and go out to dinner less. Americans will come to realize also that lower-priced merchandise bought from producers in China, India, Vietnam, and points beyond has offset, at least partially, the impact of the gas-price increase.

If Americans become convinced (or to the extent they become convinced) that the recent gas-price surge is permanent, they will make adjustments in their lifestyles that will lessen the pain of higher energy costs. They will gradually replace their gas guzzlers with smaller, more

fuel-efficient cars. They will move closer to work. Shops will begin to spring up closer to where people live. But such adjustments will take time.

All we know from sad experience that there is no silver bullet, offering immediate relief, to surges in gas prices. Gas-price controls will only make Americans' economic lives worse, as was fully evident in the early 1970s when they were tried. Ditto for the imposition of any "windfall profits tax" on escalating oil company profits. We would do well to leave the oil profits with those oil companies responsible for the long-term decline in the real price of gas and for generating future oil reserves and, perhaps a return to the long-term downward trend in real gas prices. Price controls and profits taxes will ensure that the country might never see \$3 (or \$2)-gas again.

Richard McKenzie is an economics and management professor in the Merage School of Business at the University of California, Irvine. His most recent book is *Why Popcorn Costs So Much at the Movies, And Other Pricing Puzzles* (2008).