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TESTIMONY

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TESTIMONY BEFORE THE MISSOURI SENATE AGRICULTURE, FOOD PRODUCTION, AND OUTDOOR RESOURCES COMMITTEE

By David Stokes

Chairman Clemens, Vice-Chairman Stouffer, and Members of this Committee:

Thank you for the opportunity to briefly discuss Senate Bill 11 before your committee. I have attached four papers to my testimony for your review. These four papers are: "The Impact of the Ethanol Boom on Rural America," by Jason Henderson of the Federal Reserve Bank of Kansas City; "Emerging Biofuels: Outlook of Effects on U.S. Grain, Oilseed, and Livestock Markets," by researchers at Iowa State University; "Ethanol: No Free Lunch," by economists at the University of Florida; and, a case study published by the Show-Me Institute, "The Economic Impact of Missouri's E-10 Ethanol Mandate."

Sen. Matt Bartle's bill proposes rescinding Missouri's ethanol mandate. This entire subject is a perfect example of Thomas Sowell's famed statement about public policy, "There are no solutions, only trade-offs." Corn farmers gain from ethanol production, as do investors in ethanol plants. Missouri has a large number of corn farmers, as you well know. The argument has been made that ethanol has resulted in lower visible gas prices at the pump. In immediate terms, that seems to benefit Missouri drivers.

No discussion of the benefits of ethanol

can be had, however, without considering the tradeoffs. The paper from Iowa State University documents how ethanol production has led to an increase in corn prices that has, in turn, led to an increase in food prices for people and livestock. This increase in food prices for livestock has resulted in additional food price increases for people. But our focus here is not the larger questions of ethanol production, but specifically Missouri's E-10 mandate.

I attended a conference at Washington University this past fall. One of the major themes conference participants addressed, in particular Jason Henderson with the Federal Reserve Bank of Kansas City, was the inherent problems that exist with industries like ethanol that are so dependent on government policy rather than market-based demand. It does not matter whether that policy is necessarily good or bad in itself, but if a demand is created by government policy and mandates, that same demand could be easily eliminated simply by reversals in government policy. **Industries that exist to satisfy a market demand will exist and profit no matter whether the government supports them (as it does with tourism or scientific research), largely leaves them alone**

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(entertainment), regulates them heavily (alcohol or utilities), or attempts to suppress them (the drug trade). Industries that exist because the government dictates that they exist, and are only profitable with government support — ethanol falls substantially into both categories — will likely fail at some point.

It is one thing for the free market to set prices based on the laws of supply and demand in commodities. It is quite another for the state of Missouri to mandate that a product be added to every gallon of gasoline. The state mandate and federal subsidies both limit risk in the ethanol industry. The Iowa State study authors note that they expect the price of ethanol to fall, because (p. 11):

The reason why ethanol prices fall significantly below the price of gasoline is that we assume that consumers are rational and realize that ethanol has lower energy value than gasoline so that a E-10 blend will have to sell for less than gasoline at increased production levels. Thus, the price of ethanol must fall so that blenders will choose to include it in their blends and consumers will choose to use the blended fuels.

If Missouri consumers are not allowed to choose whether or not to use ethanol fuels, then there is no pressure to lower the price of ethanol in Missouri. The intended safety valve of the E-10 legislation, which nullifies the mandate if the price of ethanol exceeds that of gasoline, is lacking important points because it fails to consider the reduced energy content of ethanol. An equally important proposal from the Florida paper would be to eliminate the mandate when gasoline is selling at prices that justify ethanol production without a subsidy and mandate, a phenomenon we recently experienced. If the ethanol industry could not succeed in 2007 and 2008 without subsidies, tariffs, and mandates, when will it ever do so?

The La Chatelier principle, when applied to economics, states that as market constraints are added to an equilibrium, other variables will react to that change. In the short run, those reactions will minimize the change. Thus, cattle farmers will not purposefully starve the cattle they are raising just because feed prices have increased; nor will the price of beef rise so dramatically as to price most consumers out of the market. However, over the long run, constraints such as an E-10 mandate can change the parameters of the market — and dramatic changes, such as a significant reduction in the number of cattle brought to market, are possible. I am not saying that the E-10 mandate is going to force most people to stop eating meat and dairy. I am merely repeating that government mandates have negative effects on markets that might be difficult to judge at first, but may have serious repercussions in the long run.

One change to Missouri-based policies that your committee may wish to consider is a modification to the Missouri E-10 mandate. Instead of requiring that all gasoline sold in the state contain the E-10 blend, you could alter the mandate to require only that all gas stations offer an E-10 blend from at least one pump. Gasoline station owners would be free to sell ethanol blends at more pumps if they so chose. That would give Missouri consumers the choice of whether or not they would like to use the blended fuel. This would instill more market forces into the production and sale of ethanol. Finally — and this is very important — this altered mandate would still give ethanol producers the access to consumers that they desire and deserve.

For more of the Show-Me Institute's research about Missouri ethanol and energy, visit www.showmeinstitute.org.



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