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Oil Prices and the “Gassy” Political Classes

by William L. Anderson

In the wake of the twin behemoths, Katrina and Rita, gasoline prices went past \$3 a gallon for the first time in U.S. history. Even accounting for inflation, the nation saw its highest prices ever at the pump. It was a made-to-order moment for the political classes in this country, and they did not disappoint, putting on a combination dog-and-pony show and show trial in Washington, as executives from major oil companies were called to “testify” before Congress as to how in the world gasoline prices could possibly rise, just because the storms disrupted about a third of the nation’s oil-refining capacity.

Now, economists tend not to be shocked when higher prices follow a quick and significant cutback in available supply of a good, but politicians are not governed by such logic. If the only people demonstrating economic ignorance were those in the political classes, then one might simply consider the source when economic illiteracy flowed from Washington. Unfortunately, however, politicians are not the only ones fanning the flames, and if this latest wave of economic ignorance actually becomes policy, we could well be journeying back to the 1970s when oil crises abounded and a familiar sight was the line at the gas station.

Although it seems that the political classes, along with their intellectual and journalistic allies, are unable (and unwilling) to permit themselves to receive even a basic education when it comes to prices, profits, and markets, many people outside those circles are not as intellectually and morally obtuse. In other words, one suspects that most readers of this article are open to an explanation of the present state of oil markets that does not involve dark conspiracies by oil executives bent on “manipulating” markets in order to fatten up their coffers with “unjustified” profits.

In simplest terms, a firm earns a profit over a certain period of time if its revenues are greater than its costs. (In economics, we speak of “economic profit” being the returns to investment when they are greater than the opportunity costs of that investment. This is opposed to “accounting profit,” in which the sum of revenue numbers is greater than the sum of numbers

representing costs.) All business firms seek profit; otherwise, they would not be in business, as no one can absorb losses indefinitely.

People have attacked the notion of profit throughout history. Since, in economic terms, profits represent payments to the capitalists/investors/entrepreneurs/owners of a firm, some critics of private enterprise have claimed that these groups should not be paid at all and are socially useless. In his writings, Karl Marx declared that profits were an unjust and immoral “expropriation” of the payments that legitimately belonged to laborers, as Marx believed that labor was the source of all value.

While few politicians (and mainstream critics of business firms) actively quote Marx today, nonetheless there is a prejudice against profits. The slogan “people before profits” comes from sources that do not claim Marx’s philosophy as a guiding light, and congressional Republicans, the supposed friends of free enterprise and the profit system, have been at the forefront of condemning oil companies for being profitable.

Although we speak of a profit system, it is really a profit-and-loss system. Firms make profits, but they also can post losses, as is the case in the airline industry today. Other once-profitable U.S. industries, such as the auto industry, also are experiencing economic losses, and bond rating firms recently placed corporate bonds for General Motors in the “junk” category.

Profitability is tied to the old axiom, “buy low and sell high.” In fact, as the late Murray Rothbard pointed out in his treatise on economics, *Man, Economy, and State*, economic profits come about because at least some factors of production are “underpriced.” That means that the price for at least some of the factors is less than what one might expect, given the price for which a “final good” sells.

For the most part, owners of factors such as labor or capital are well aware of the “final price” of goods, and demand accordingly. Professional athletes who perform well will demand higher pay if they are at least partly responsible for increased fan interest in their teams and if that interest translates into higher revenues. However, there are times when the owners of the factors could not anticipate that the final price of an item might be higher than they initially expected, and that is when one sees dramatic increases in profitability.

Katrina, Rita, and the market

Hurricanes Katrina and Rita affected about a third of U.S. oil and gasoline production, and Katrina also forced the temporary shutdown of a vital gasoline pipeline that pumped fuel into the Eastern states. That meant that less gasoline was available than before, and the resulting shortfall led to dramatic increases in the price of gasoline. (What is amazing is *not* that gasoline prices rose as quickly as they did, but rather that they did not increase by even more and that they also came down as quickly as they ran up.)

Critics did not like the fact that prices went up and immediately accused oil companies of “price-gouging” the consumers. Such criticism represents extreme ignorance, extreme dishonesty, or a combination of the two. The criticisms come in two phases, the first being that the prices were not “justified” by higher costs, and the second being that price controls were needed to reduce such “gouging.” (It is not surprising that members of Congress have introduced legislation calling for nationwide price controls on gasoline. The lessons of the disastrous 1970s, when the government controlled gasoline and oil prices and controlled distribution, apparently are not learned in Washington.)

The first criticism is relatively easy to dismiss. Prices that we pay for goods at any particular time are based not only on present demand, but also on what people anticipate will be demanded in the future. For example, if one hears that bad weather has destroyed half of the coffee crop in South America, one can anticipate that less coffee will be available in the near future. As people realize that fact, they will demand *more* coffee at the present time, an act that will drive up the *present* price of coffee. Some people may claim this to be “price-gouging” because those who are selling the coffee purchased it at the lower, “old” prices. But the claim of “price-gouging” is unfair because, in reality, the “old” prices are irrelevant: the current demand for coffee is being driven by the newly understood circumstances caused by bad weather.

We saw the same thing after the hurricanes. Once it became clear that the storms had shut down a major portion of U.S. production, it was also clear that not as much gasoline would be available in the near future as had previously been the case. That meant immediate higher prices in gasoline.

Although people complained loudly about paying more for gasoline, the higher prices kept the larger disruptions from occurring. Keep in mind that under the 1970s regime, a 5 percent disturbance in oil flows due to political unrest in Iran translated into wild gasoline lines and massive chaos at the pump. The twin hurricanes disrupted about a third of production, yet the system worked with relative smoothness — except in the states where “price-gouging” laws went into effect, slapping price controls on gasoline and everything else, which resulted in long lines for gasoline, groceries, and other basic commodities. Places where such laws were not enacted saw much more orderly markets.

As was witnessed in places such as Mississippi, Alabama, Florida, and Texas, when gasoline prices were not permitted to rise — with the accompanying disruption in supplies — the result was chaos. In Houston, which had a mandatory evacuation, the crush of cars waiting for fill-ups overwhelmed gas stations that already were hamstrung by “price-gouging” laws, and supplies ran out much more quickly than they would have, had prices been permitted to adjust to demand.

In the wake of high gasoline prices, then, oil company profits jumped rapidly, and that has led to a public outcry. The mistake is to assume that high profits have led to the problem; in

reality, those profits are quite temporary and reflect the fact that oil companies purchased and refined crude oil in anticipation of much lower gasoline prices, and the factors of production were paid accordingly.

What people forget is that not only large oil companies benefited. A number of people living in the Appalachian region of the country own small “stripper” wells that pump relatively small amounts of oil. When oil prices went up, those people also received much more income for their product than they had previously received. Likewise, people holding oil stocks in their pensions were better off than before.

Nor will this level of profitability in the oil industry last very long. Gasoline prices already have fallen by about a dollar a gallon since their post-hurricane high, and no doubt oil companies themselves will be facing higher costs, which will cut into their profits. Crude oil prices also have fallen by more than \$10 a barrel. As I found in previous research, the oil industry for the past two decades has had a lower level of profitability than the average for the Standard and Poor’s Industrial Index, and whatever good fortune the oil firms may be having right now will be short-lived.

Energy and regulations

The process of refining crude oil into useful products finds itself under constant attack from environmental groups as well as regulatory agencies. The last time a new oil refinery was constructed in this country was during the administration of Gerald Ford in the mid 1970s. Even before then, Congress had already made it more difficult for domestic refiners, pushing through a system of quotas in 1959 that blocked crude importation but encouraged more importation of refined products.

Beginning with the 1969 National Environmental Policy Act, the government has made it extremely difficult for anyone to complete the process of building new refineries. Because of federal regulations and private lawsuits, most companies simply are reluctant to invest in what historically have been low-margin ventures. When one adds the huge environmental costs to the mix, it is not difficult to understand why oil executives have taken a pass.

(The fact that the government has been much more aggressive in criminalizing violations of environmental regulations also is a contributing factor. The scalp of an oil executive or two would boost the career of any U.S. attorney, who would be hailed for efforts to “clean up the environment.”)

This deliberate attempt by government to squeeze supplies of crude oil and refined products has been remarkably successful. Thus, when emergencies occur, one must remember that, in a very real way, government policies have contributed both to the long-term problems in the oil industry and to the short-term spikes in profitability.

Furthermore, politicians simply do not have any answers. In condemning current oil profits, they inadvertently condemn themselves. Unfortunately, most of the general public will not be told the real story, and people will continue to believe the nonsense that we can have government policies that are strangling the life out of the oil industry — and low gasoline prices, all at the same time.

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