BIG OIL PROFITS AND MASSIVE ANALYTICAL CONFUSION

Armen A. Alchian

The high and rising price of oil has increased the wealth of owners of oil reserves. Did that price rise occur purely because of OPEC cartel machinations, or because of enhanced awareness of a more rapid increase in future demand for oil, coupled with a slower than formerly expected discovery of new reserves? The facts that support the second interpretation are strong enough not to be dismissed outright. However, for the present we pass over that unresolved query and instead examine the *effects* of the oil price rise, whatever its cause, on the distribution of wealth, on future productivity, and on investment and inflation.

Such an inquiry is worthwhile, as evidenced by popular writings containing basic fallacies. If oil company profits have been deemed "excessive" and thus supposedly taxed, it should be eminently reasonable to penalize excess confusion of financial journalists.

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Examples of misunderstanding abound, even in so reputable a journal as *Business Week* (August 18, 1980). *Business Week* correctly observes that the wealth of oil producers has increased enormously. However, it speaks of profits of "oil companies," when it should have distinguished between refiners and producers of crude, since refiners lost wealth because of higher crude prices with less production, while crude producers gained. The oil industry is not comprised only of crude producers.

Current income of society in general is no larger because of the higher prices; indeed, it is smaller in real terms, because less oil is being produced. What *new* problem in organizing and redirecting economic activy does that cause? None.

Yet, many believe it does. One of the imagined and alleged new problems is called "recycling the profits." What does that mean? It means that those who have become richer must decide what new assets to acquire. Like winners of a sweepstake, they have a "problem" of deciding what to do with the increased wealth, i.e., in what kinds of assets to hold it. But that is no special problem. It is solved every day in ordinary markets. They can spend some of their wealth on gambling in Las Vegas, or for land in California, or for supermarkets, or for U.S. government bonds and corporate stocks in various parts of the world. The oil reserve owners, as they sell oil, will consume or own more of the resources of the world. But markets are constantly and efficiently adjusting to changing fortunes, which generates no special or horrendous "problem" for the economy and its operation.

There is no problem even in the markets where one country's money is traded for another country's money. Some fret because of resultant changes in exchange rates. But fluctuating prices are not a problem—prices are *supposed* to fluctuate as market circumstances change—nor is government action required to make "recycling" easier. Instead, the allegation of a problem appears to be a way to camouflage desire to expropriate the wealth of the now richer people for the benefit of those who gain government favors—expropriation under the guise of solving a fictitious "problem."

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Another fanciful problem is "lower economic growth as more and more companies find it increasingly difficult to acquire funds for capital investment" (to cite the *Business Week* article). This assertion reverses the actual relationship between production and financing. Companies find it difficult to borrow or attract investment funds because *they* can't show prospects of *profitable* investment. A lack of profitable investment *prospects*, not a lack of sufficient *funds*, is the problem. No one need abandon profitable ventures because of lack of funds; rather, projects are abandoned because of lack of attractive prospects. If you can show a profitable prospect, the money will come running.

The oil price rise has reduced the value of some older types of activity and has made some newer ones more attractive. Hence the investment shift to more insulation production, computer controls, and solar energy devices, and the location shift to the Sunbelt. Different kinds of investments now become profitable. The illusion of a problem stems from confusing past profits as a *source* of funds with future profitability of new *investment.*

No industry, no firm, no person has to have earned profits in order to have funds for future profitable investments. Past profits are totally irrelevant when considering ability to finance profitable investment prospects. The computer industry had no past profits, but it attracted enormous investments that proved profitable. Where did those funds come from? Not from its past profits—there weren't any. It got them from "*savings*"—from people who were willing *not* to consume some current income (no matter how they happened to get their current income) and who were attracted by the prospect of a profitable investment.

Several oil industry spokesmen themselves have nurtured the fallacy. They have argued that, unless allowed to keep their past profits from the crude oil price rise, they could not make investments in the future. The oil companies advertised that their large profits have been a good thing because they were necessary if the companies were to be able to invest in future exploration and in other sources of energy. Those particular profits are not required for that particular purpose. Past pro nothing to do with either creating or financin profitable investments. So long as the future inve look profitable, funds will be available from peo ing a share of the profits.

Yet, there *is* a valid idea that has been confu the preceding nonsense about recycling and f growth. If past earnings or wealth are *expropr* confiscatory taxation, then future investments t profitable will be ignored, because investors wil future profits also will be confiscated. It is that v of future confiscation—fear based on a proje past behavior into the expectation of future beh that dissuades investments. It is the *prospect of fu fiscation*, not the *absence of past profits*, that prev vestment.

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Another fallacious contention is that since c panies' executives are not experts in other inc they will not be successful investors elsewhere wi new funds. Again, refer to the *Business Week* where it is asserted that conglomerate manage been unequal to their task. We have plenty of e that that is not correct. Lots of conglomerates ar very well.

Indeed, oil executives are *not* commonly exp other industries in which they might invest. But are ordinary stockholders who invest in othe panies' experts as managers. Efficiency does not that either oil executives or ordinary stockholders naissance men with the knowledge and skills to a ter all the businesses which are candidates for t vestment. For investors are not managers. In select and hire managers. There is nothing to that investments by oil companies in other con would create inefficiencies of management. Or gued with a straight face that, mysteriously, o stockholders are better selectors of managers th other proven managers?

Will the large oil profits lead to *less*—as wel legedly poorer—investments? If relatively wealth ple tend to save proportionately more, then inc concentration of wealth of crude oil producers lead to *more* savings and investible funds. It ha argued that the increased wealth of the few Arab ficiaries of higher oil prices has increased the sup investible savings. Certainly, the argument that oil-producer wealth and income will make inve more difficult is nonsense, at best.

A proposal by those who allege that oil com have more wealth than their managements know invest well, while other companies must abandon projects because of lack of funds, is that oil com should be forced to distribute profits more fully to holders, who then can reinvest the funds. That

only force the stockholders to pay a tax as the funds are passed through stockholders back to investment in other companies or into consumption—which suggests that those who advocate the increased dividend procedure really are interested in taxing that wealth.

Even in the absence of that tax, the investing of funds would not be improved. If the funds are invested by oil company executives, they will strive to invest where it is most profitable. Why would one expect private dividend receivers to do better? If stockholders reinvest the dividends, the investments would be no different, at best, for there is no reason to presume individual dividend receivers can perceive investment opportunities more reliably or more cheaply than can managers of oil companies.

If stockholders want more of their wealth paid out to them rather than reinvested in the oil companies, they can sell their oil shares to other people who do prefer reinvestment. With the proceeds of such sales, the original stockholders then acquire other things instead, as if they had been paid greater dividends. The capital markets are powerful means of directing investment activity, whether done in the first instance by managers or by the general public in purchasing other shares.

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One more fallacy. "Oil company profits exacerbate inflation, as other companies with reduced profits seek to boost their declining profit margins by raising prices." That, too, is from the article in *Business Week*. If that silly belief were true, who would ever experience a loss? Simply raise the price and thereby increase your profit margin. Unfortunately, it can't be done. There is the problem of finding buyers. If you don't think about the response of buyers, you will go through life poor as a church mouse, and no smarter. No company can raise its prices to recover profits in the face of decreased demand for its goods. Even if every seller foolishly tried that suicidal tactic, it would not exacerbate inflation, because the lower demand initially causing the problem would not support the higher prices at current rates of output.

But there is a deeper, more fundamental error in that inflation allegation. Inflation is caused by an increase in the quantity of money *relative to the stock of goods* of the economy. Reduce the stock of goods and keep the money supply constant, and you will experience a jump in prices. But no *continuing* rise will occur thereafter, unless the stock of goods is persistently reduced thereafter. That has not happened. What has happened are *one-time* changes in the stock of real goods—as in 1973, when oil output was cut back, and prices, with the same amount of money, were pushed up once and for all. That jump did not create the continuing inflation.

What does cause a persisting inflation is, as a matter of historical fact, the quantity of money in the economy rising faster than the stock of real goods and services. *That and only that* has been the source of our persisting inflation. To argue that the large oil company profits will or can lead to inflation is simply wrong. Whether the increased value of crude oil is taxed and given to governmental beneficiaries or is retained by stockholders has *nothing* to do with the rate of inflation.

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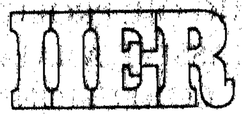
When we consider oil industry profits, the numbers are big, and the stakes are large. All the more reason for exhibiting some sophistication in sorting out the issues and implications. Aberrations of psychology and temptations of political gain, along with simplistic analysis, have hindered the community in getting straight the economics of the matter. Some complications (e.g., wealth redistribution within the oil industry itself) have been generally ignored, and nonexistent complications (e.g., the "problem" of "recycling" and the "problem" of "oil profits leading to underfinanced and badly directed investment") have been imagined. Such confusions largely reflect lack of comprehension of, and resulting lack of confidence in, our highly efficient capital and production markets.



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