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“Letting the Windfall Profits Bandwagon Pass Me By”

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Reacting to quickly rising home prices in some parts of the country, U.S. Senator Brian Gordon recently said he plans to introduce a bill which would tax the gains of price gougers who sell homes at unfairly high prices. “These are windfall profits reaped at the expense of new home buyers,” he said, adding that “the public needs relief from these quickly inflating prices.”

OK, so there really isn't a senator named Brian Gordon. There is no impending legislation that would shield home buyers in New England or California from price gouging sellers. In fact, this column isn't even about house prices. It's about oil prices, oil company profits, and the cavalier use of terms such as “price gouging” and “windfall profits.” These terms re-entered our lexicon in late October, shortly after five of the largest oil companies announced their third quarter earnings, which cumulatively amounted to about \$33 billion. At that time, a handful of real senators did suggest that a windfall profits tax would be an appropriate response to such profits.

The 19th century British moral philosopher and economist John Stuart Mill once remarked that economists can be unpopular because they often remind others of unpleasant facts. While we may not like shelling out \$3 a gallon for gasoline while reading headlines of record oil company profits, it might be useful to examine a few

unpleasant facts about gasoline prices and oil company profits before we jump on the windfall profits tax bandwagon.

The first unpleasant fact is that high gasoline prices probably have more to do with our preferences for big vehicles and long commutes than any conspiracy against the public. In 1980, about 19% of household vehicles were vans, pickups, or SUVs. Today it's about 38%. In 1975, the average American's commute to or from work was about 9 miles. Today it's about 12 miles. In 1975, Americans drove about 4,100 miles and consumed about 500 gallons of gasoline per person. In 2002, we drove almost twice that amount per person and we consumed about 600 gallons of gasoline for every man, woman and child.

The truth is that we like our cars, and as long as that doesn't change, we'll pay for gasoline with minimal regard to the price. In economic terms, our demand for gasoline is *inelastic*, which means that we are not very price sensitive, even when supply is disrupted and prices start rising. As its price goes up, we continue to use almost as much of it because changing our usage patterns is difficult and painful. As a counter example, our demand for orange juice is probably somewhat elastic – we respond to higher prices by finding other breakfast drinks. To call that an unfair analogy by pointing out that our cars will only run on gasoline misses the point. Fundamentally, the only difference between decisions about how we get to and from different places and decisions about what juice to drink at breakfast is that it takes more time to change our spending habits with the first set of decisions.

When supply disruptions occur in a market where demand is strong and inelastic, we can expect price spikes. Does that mean we were “price gouged” when gasoline

approached \$4 a gallon? No, it means that the market mechanism worked to make sure that those who were most willing to pay for gasoline were the ones that got it. It's important to remember that there were no shortages when gasoline prices spiked in September and October, or that if there were, they were very short lived. The market worked. We didn't like it, but it worked.

A second unpleasant fact is that profits of any kind are volatile and generally thought to be a reward for risk taking. Capping them or penalizing companies who earn them will probably stifle risk taking. Levying taxes on oil company profits after the fact because we think they are ill-gotten windfalls would make it less likely that those companies would invest in the productive capacity to supply our demands for fuel. There is some evidence to suggest that this is exactly what happened the last time we imposed windfall profits taxes on oil companies in the early 1980s. If we really want to expose ourselves to gasoline crises, then by all means tax away the profits of oil companies when those profits offend our sense of propriety.

Furthermore, labeling profits as windfalls can be a very arbitrary process. Why is it that when oil companies sell gasoline at record prices and report record earnings, they are guilty of price gouging and their profits are ill-gotten, yet when a homeowner in Boston buys a house for \$300,000 and sells it a year later for \$400,000 they are savvy investors? Do we really want to establish guidelines concerning the "correct" maximum level of profits a company (or an individual) may earn? And if we do that, should we also consider the opposite policy – making compensatory payments to companies when their profits fall below some correct minimum level?

In the wake of the Gulf Coast disasters, we might think that gasoline prices are unfair, and we might find the record oil company profits distasteful, but before we conclude that we've been victimized by corporate bandits, remember another fact. What goes up generally comes down. That's already the case with gasoline prices. Given the historical pattern of profits in the oil industry, it wouldn't be surprising if the same thing eventually happens to those oil company profits. In the mean time, trying to take them away is likely to do more harm than good.