Windfall profits

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by Walter E. Williams

In the wake of high gasoline prices and high oil company profits, House Speaker Dennis Hastert demands that oil companies explain why they are making so much money and what they plan to do to bring down the cost of gasoline. Sen. Byron Dorgan, D-N.D., has introduced a 50 percent windfall profit tax on every barrel of oil selling for more than $40. Let’s talk about profits.

First, there’s normal profit, which is defined as the minimum amount necessary to keep entrepreneurial resources in their current usage in the long run. Normal profits reflect the opportunity cost of using funds to finance an operation, and they must be equal to, or greater than, the returns available elsewhere in the economy. Normal profits are indeed a cost of business -- the payment to equity owners.

Windfall or supernormal profits are any profits in excess of normal profit and are above and beyond that necessary to keep entrepreneurial resources in their current usage. However, windfall profits are a vital component to a smoothly operating economy. Windfall profits serve as a signal that there are unmet human wants. Let’s look at it with a simple example.

Suppose there’s a disaster wiping out food resources in Harrisburg, Pa., and I live in Philadelphia. Prior to the disaster, bread prices in both cities were $2 a loaf. I buy a truckload of bread, cart it to Harrisburg and sell it for $20 a loaf, earning huge windfall profits. When the word gets out that there are profits to be made, what do you think happens? If you said other people will start carting bread to Harrisburg, bakers will start working overtime to produce more bread, people who formerly used their oven to bake cakes and pies will switch to baking bread, there’ll be bread conservation in Philadelphia and elsewhere and eventually bread prices will start to fall in Harrisburg and windfall profits would vanish, go to the head of the class. While some might find people earning windfall profits objectionable, the result of their actions, getting more bread to Harrisburg, is precisely what’s desired.

What if politicians said, “People are profiting from the misery of others, and we’re going to impose a bread windfall profits tax”? Say they legislated a 100 percent tax, taking all of the $18 of windfall profits. Would you expect to see people making all those efforts to get bread to Harrisburg? Suppose there were huge startup costs for companies to expand their operation or onerous regulations for people to get into the bread business, would that be good news or bad news for people in Harrisburg?

What prevents a robust supply response to changes in scarcity conditions in the gasoline market? U.S. oil refining capacity is now less than it was in 1980, and since that time there’s been a 25 percent increase in demand. Because of costly environmental regulations, it’s been 30 years since a new refinery has been built. According to the American Petroleum Institute, over the last 10 years, it has cost the oil industry $47 billion to comply with costly and sometimes useless environmental controls. There are restrictions on exploiting the huge oil reserves in Alaska, the Gulf and the Atlantic and Pacific coasts.

Speaker Hastert said, “These are extraordinary times that call for extraordinary measures. We expect oil companies to do their part to help ease the pain American families are feeling from high energy prices.” Instead of mouthing platitudes and beating up on oil executives, Speaker Hastert should lead the effort to reduce restrictions on drilling and refinery construction. Sen. Dorgan should review our 1970s experience with an oil windfall profits tax that reduced American production and increased our dependence on foreign sources.

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