

Mick Jagger Explains High Crude Oil Prices

How can Mick Jagger of The Rolling Stones help explain the current high crude oil price? It does not relate to Mick' short stint at the London School of Economics prior to forming the Stones. Rather, it traces to a famous economist, David Ricardo, and his theory of economic rent. To wit, any resource in fixed (or scarce) supply for which no close substitute goods exist will command higher and higher premiums in its price as the demand for it rises. Economists dub this extra compensation economic rent.

The Rolling Stones represent a one-of-a-kind product that still commands a high premium for its concert ticket prices, even after more than 40 years of performing. Many rock bands exist, but The Rolling Stones provide a unique experience for which the true-blue fan pays the high ticket price.

Similar stories explain the ticket prices for Celine Dion and other popular shows in Vegas, such as "O" and "KA." Since the demand for seats generally outstrips the supply, the price of a ticket rises dramatically and does not necessarily connect in any way to the cost of putting on the show.

At its base, the oil industry operates on the same principle, at least in the short run. The industry relies on proven reserves and the current rate of production of those reserves.

In the past, the Organization of Petroleum Exporting Countries (OPEC) controlled enough of proven reserves and current production, given the demand for crude oil, that they attempted to control the price of crude on international markets. Their ability to do so, however, proved largely ineffective.

When prices began to fall, they needed to coordinate a reduction in supplies of crude oil going to world markets to stem the price fall. Cheating by some OPEC members frequently caused that control of falling prices to fail.

On the up side, when crude oil prices rose on world markets, OPEC needed to increase the supplies going to world markets to abort the price rise. Saudi Arabia provided the necessary supplies, since they possessed the largest proven reserves and the necessary slack to stabilize crude prices.

Today's world crude oil market faces different conditions. The growth of world demand, especially in China and India, dried up the slack in crude oil production. That is,

no country currently can withhold proven reserves from the world markets to keep prices stabilized. Moreover, political strife and war exacerbates the shortage of crude oil. In other words, as a first approximation, we can assume that the supply of crude oil to world markets does not respond to price in the short run. World supply of crude is fixed.

Other sources of energy such as nuclear and coal do not provide viable short-run substitutes for crude oil products, such as gasoline and fuel oil. In that sense, the crude oil market shares some similarities to the world market for Rolling Stones concerts.

With a fixed world supply, a rise in demand either causes prices to rise, or the market experiences an excess demand for the product and some form of non-price rationing must occur, to clear the market. Spikes in the price of crude oil quickly transmit themselves through the “food chain,” quickly hitting gasoline prices.

The changeover of refining toward increased demand for gasoline during the summer vacation months provides an additional pop to the price. In addition, the futures markets draw off gasoline from existing stocks to supply more gasoline in the near future, when even higher prices are expected. In other words, prices will not rise as far this summer because of the increases we experience today, not of much comfort when you stop at the pump today. In fact, most analysts believe that gas prices will moderate and fall somewhat in June.

Similar “speculative” activity also exists in the crude oil market for the longer term. The nature of the political systems within which a large share of the world’s crude oil reserves lie causes such speculation. That is, only ten countries hold over 85-percent of proven reserves – Saudi Arabia (20.6), Canada (13.8), Iran (10.2), Iraq (8.9), Kuwait (8.0), United Arab Emirates (7.6), Venezuela (6.2), Russia (4.6), Libya (3.0), and Nigeria (2.8).

Prospects of instability and disruptions exist in a number of those countries. We know about the current problems in Iraq. Interruptions in crude oil production in another country will likely provide another spike to crude prices.

Thus, some “speculative” activity bets that crude prices will spike in the future. To the extent that supplies get diverted for future use, future prices will be lower than they otherwise would be, absent the speculative activity. Of course, if the speculators

prove incorrect, then they take a bath on their activity and we live with higher-than-needed prices today and lower prices in the future.

Many pundits argue that Big Oil should not raise prices and add to their profits. But, at a lower price, the demand for gasoline would exceed its supply and rationing would occur. How would we know that rationing occurs? The history of the 1970s teaches that long lines would form at gas stations.

Here, the Rolling Stones and popular Las Vegas shows also provide some insight. That is, typically the Stones want sell-out crowds. At what price does that occur? Some uncertainty exists. Prices usually get set somewhat below the price for which the promoters expect a sell out and a shadow (scalper) market appears. Or in the case of Las Vegas shows, you may wait some time before seeing a show. For tourists, this probably prices them out of the market, if they did not order in advance, since they cannot wait. But locals can wait, which proves similar to gas lines.

What can the government do? First, some argue for doing away with the gasoline tax. If implemented, however, we can predict no fall in gasoline prices, higher profits for oil companies, and less money collected for road construction and maintenance – a trifecta of bad outcomes.

Second, government could stay out and rely on Big Oil to make the necessary investment to expand energy supplies from carbon and non-carbon sources. It could impose an excess profits tax and provide support for R&D investment to raise such energy supplies. Or it could impose an excess profits tax and provide a tax write-off for such R&D activity. John Stuart Mill, another famous economist, argued strongly for taxing economic rent.

In sum, crude oil is a natural resource with fixed supply in the short run. Thus, demand determines its price. To permit rationing by any other means than price requires that the government interfere with market pricing decisions. As a general rule, the market works better when left to fend for itself.

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Edited version appeared in *Las Vegas Business Press*, May 23, 2007.