Readings

Black Gold down the Drain

The Genie out of the Bottle: World Oil since 1970
by M.A. Adelman
(MIT Press, 1995), 350 pp.

Reviewed by Richard L. Gordon

This book masterfully recapitulates a long study of political folly in international oil policy. In the early 1960s M.A. Adelman began research designed ultimately to produce a comprehensive survey of the world oil market. A thorough effort to develop the germane theory, acquire requisite data, master the details of the industry, and prepare a full review took more than a decade. This produced the classic 1972 study *The World Petroleum Market*, in which Adelman argued that governments often adopt anti-competitive policies and that markets function better than policymakers generally realize. While others went on to win acclaim for developing such views as generalizations, Adelman concentrated on applying the propositions to oil. Fatefully, his book appeared just as world oil markets plunged into turmoil.

Since that time, Adelman has produced a steady flow of papers on petroleum for both technical and lay audiences (many of these writings are conveniently collected in a 1993 anthology, *The Economics of Petroleum Supply*). Several years ago Adelman decided that an updated and revised appraisal of oil history was needed. (Those familiar with the flood of books on world oil might wonder why. However, none of those books dealt satisfactorily with the past quarter century. Indeed, many, notably Yergin in *The Prize*, managed to waste so much time on the well-documented years prior to 1972 that they nodded off when dealing with the post-crisis period.)

The Genie out of the Bottle is Adelman's new survey. It begins by developing a theme that was central to *The World Petroleum Market*. Adelman, more effectively than before, argues that oil scarcity will not be a problem for the foreseeable future. He updates and improves his calculations of oil production cost trends. He shows that oil supplies, as he predicted in 1972, have increased substantially, and that the evidence suggests that the situation will not change in the next few decades.

Exhaustible Resources?

The new volume includes Adelman's evaluation of the theory of exhaustible resources. Though the theory indicates that the exhaustability of minerals can imply that their prices inexorably increase, Adelman vigorously, and validly, argues that such a result is not inevitable. The extent of the price pressures depends on the balance between supply and demand. The best measure of the state of such balances is the cost of new supply through the development of proven reserves. Those not familiar with Adelman's analysis should note that he points out that reported reserves consist of that part of the total physical stock that is known to exist and is in fields in which production facilities exist. Moreover, the bulk of investment outlays is spent on "development" wells that allow production from such known fields; exploration is a small part of total activity and is undertaken to expand the always substantial backlog of promising opportunities for further development. Thus, while physical laws require the physical stock to decline over time, developed reserves can, and historically have, risen over time.) The record on

Richard L. Gordon, a professor of mineral economics at Pennsylvania State University, has written widely on energy issues.

the cost of oil reserve additions then indicates that no such exhaustion pressures exist.

Adelman's viewpoint is standard among veteran natural-resource economists. Barnett and Morse's 1963 *Scarcity and Growth* presented similar evidence on all raw material except timber. Until the energy price shocks of the 1970s, the contrary view was held mainly by noneconomists. However, many of the economic theorists who in the 1970s plunged into exhaustible resource theory uncritically accepted the view that oil price rises reflected market conditions that made steady, substantial price rises the optimal responses. Worse, such theorists seemed to feel that the theory clearly implied such a result. Adelman is quite correct that this misinterprets the theory. Indeed, the one prominent theorist who bothered to master the literature, T. C. Koopmans, quickly endorsed the traditional, optimistic view of resources.

"GARFIELD HAS TOLD THE OIL COMPANIES TO GO TO HELL."

Combating Cartels

Adelman argues that we must also have a realistic view of the other key element of world oil, the efforts of the OPEC countries to cartelize. He insists that we should look at the OPEC countries as wealth-maximizers with peculiar characteristics. Sovereignty simultaneously unbinds and limits the OPEC countries. An aggressive search for maximum wealth is possible because, unlike private firms headquartered in industrialized countries, OPEC countries need not fear governmental retaliation. However, political instability and the undiversified nature of OPEC countries' assets mean that investments are riskier for those countries than for private oil companies. Corruption, the need to share revenues with other government programs, and the political difficulties of arranging deals with private oil companies mean that state oil companies are less efficient than their privately owned foreign predecessors. The OPEC countries face the classic problems of cartelization, such as reaching and maintaining accords, correctly and continuously estimating the group optimum in an ever-changing world, and fending off rivals.

In light of the evidence, Adelman naturally concludes that the three visions about oil widely held by policymakers are dangerous delusions. The first is that oil is becoming scarce. The second is that good relations with oil suppliers are critical to satisfactory availability of oil. The third is that OPEC countries have enough money and must be coaxed to produce more oil.

These basic arguments are stated in general terms in the first sections of the book and then, in the next six chapters, applied to the history of world oil. These chapters deal successively with the pre-1970 record, the 1970-71 price reversal, the 1971-74 "price breakout," the peak years ("at High Noon") of the cartel to 1981, the retreat from 1981 to 1986, and the subsequent stagnation.

The first two chapters discuss the much-reviewed events through early 1971. Adelman goes into greater depth in his discussion of the subsequent years. The first story is of the series of OPEC-country moves to negate the commitments made in 1971. While these actions culminated in the production cutbacks of 1973-74, they started only six months after the Tehran agreements. Two of Adelman's key conclusions are that the accords of early 1971 did not add to stability, but instead led to steadily increasing demand by OPEC countries; and that Saudi Arabia, far from being the enemy of high prices, was the principal source of the output restrictions that raised oil prices.

The next tale is that of the events leading up to the second price explosion of 1979-80. The chapter includes data on consumption, prices, and OPEC capacity utilization that in many cases go back to the late 1960s and in every case extend to the latest date available when the book was completed. The main elements of the history of 1974-81 are a sketch of how the cartel held together from 1974-77 and an extensive review of the subsequent price surges. Here Adelman first juxtaposes evidence of OPEC-country thirst for revenues with the continued desire of the U.S. government for special relationships. After terse remarks about such attitudes in the Nixon and Ford administrations, Adelman extensively documents a Carter administration stance characterized as "much more articulate." Adelman contrasts the administrations' faith in Saudi good will with Saudi actions, specifically, production cutbacks that were a major contributor to the 1989-90 price exposition.

In his discussion of the forces leading up to the massive oil price cuts of 1986, Adelman inserts examples of how those advocating high oil prices failed to foresee the coming collapse and continued to urge cooperation. The basic story is that Saudi Arabia had to take drastic actions to offset the erosion of its market share because of slower consumption growth, the rise of non-OPEC energy alternatives, and the tendency of other OPEC countries to capture markets from the Saudis. As Adelman is well aware, these are classic problems in efforts to cartelize. The Saudis retaliated by acting to preserve sales via a strategy of meeting prevailing prices. The resulting spur to availability slashed prices.

The chapter on the subsequent years deals with many developments. The Gulf War is the key event of the period and Adelman deals extensively with the critical events before, during, and after that episode. He also shows the persistence of continued assertions (mainly by the same people) that deficient capacity development would soon force higher oil prices. A key conclusion from the record is that OPEC is caught in 1996, as it was in 1971, in a limbo of prices too high for competitive markets but below monopoly profit-maximizing levels. His brief conclusions deal with the instability of such a price level. He recognizes that successful efforts may be made to get closer to monopoly prices. However, he also recognizes that a move closer to competitive levels is possible. He considers the latter development desirable for political as well as economic reasons. He limits his economic arguments to the increased price stability that would result if the cycle of cartel growth and breakdown ceased.

Learning the Right Lessons

Adelman's policy conclusions are sensibly restrained. He argues that while anti-cartel measures (not discussed in this book, but amply treated in *The Economics of Petroleum Supply*) might have worked up to the early 1980s, they are no longer appropriate: "The right public policy, in my view, is the doctors' oath: do no harm." This would involve avoiding unwise policies such as price and import controls. In addition, the search for accords with OPEC countries should be avoided. Adelman adds a sentence of praise for consumer taxes on oil as a device to keep funds out of the hands of OPEC. Others can be forgiven for doubting whether the governments that engineered disastrous oil policies would do any better at taxing oil.

The Genie out of the Bottle is a careful, but not dispassionate, look at oil. Villains are clearly delineated. These consist primarily of government officials fearing scarcity and seeking influence, and those in academia who support their views. Almost all government officials involved with oil rate among the goats. Adelman focuses on former ambassador James E. Akins. For many decades, inside and outside government, Akins indefatigably argued the political influence case. (After years of major roles in the U.S. government, Akins was fired in 1975 as ambassador to Saudi Arabia because of conflicts with Secretary of State Kissinger. The Carter administration then chose to rely on Akins for oil advice.) Several academics are cited as apologists for the OPEC countries. Robert Mabro of the Oxford Energy Institute serves as Adelman's chief example.

Adelman's heroes are conventional economic analysts. These include, but are not limited to, the many energy economists who have worked with Adelman. The tacit theme is that Adelman's oft-ridiculed view of world oil has more correctly predicted developments than any rival theory. Adelman's only major error, which he admits, was in underestimating the danger that oil prices could be cartelized. The book is more restrained than his earlier writings in arguing that U.S. government support was critical to this price reversal. He does correctly stress that the turnabout was unforeseen by either oil market participants or outside observers. Prior to 1971 even the most severe critics of oil policy could not imagine that the U.S. government would sink to the ineptitude displayed in the 1971 negotiations.

The book encapsulates many decades of research on oil by an astute observer. Anyone who cares seriously about public policy should read the book. Adelman clearly sets out the case for an optimistic view of oil's future from an economic standpoint; and for a pessimistic view from a political one. Given the importance of oil as an industry, the study is of enormous interest. Those concerned with broader issues of governmental overreach benefit from the documentation of a crucial example of the perpetual disparity between economic reality and political perception.

As the extensive quotations Adelman provides suggest, his is a viewpoint that many, including too many economists, have rejected. Long experience suggests that true believers are adept at explaining away their errors and will find ways to rationalize continued rejection of the Adelman position. Readers of *Regulation* will recognize that Adelman is grappling with a particularly important case study of political unwillingness to accept the good news that intervention is both unnecessary and harmful. Adelman refrains from stating—or denying—broader implications.

In Praise of Lost Mail and $900 Toilet Seats?

The Myth of Democratic Failure: Why Political Institutions are Efficient
by Donald Wittman
(University of Chicago Press, 1995), 229 pp.

Reviewed by John R. Lott Jr.

Donald Wittman's book, *The Myth of Democratic Failure: Why Political Institutions Are Efficient*, goes further than simply providing efficiency explanations for many government institutions and rules. Wittman argues that there is a "strong force" towards efficiency in political markets. Even the most devoted followers of the free market would not be comfortable making the claims for firms or customers that Wittman makes for governments. To those defending markets against the conceits of central planners, the argument is usually over which method is best able to coordinate different agents' actions. Yet Wittman believes that voters are so well informed, and politicians and bureaucrats so responsive to their desires, that voters would not do anything differently even if they had perfect information.

John R. Lott Jr. is the John M. Olin Visiting Law and Economics Fellow at the University of Chicago Law School.

This review first places the novelty of Wittman's central argument within the context of the existing literature on efficiency in political markets. Then it turns to issues of whether Wittman's logic also applies to totalitarian regimes; whether lowering the costs of transfers increases wealth; and whether entry barriers exist in political markets.

A "Strong" Force towards Efficiency

At least since a note by Becker in a 1976 *Journal of Law and Economics* article, economists have argued that the politicians who can create any given level of transfers at the lowest cost will tend to produce more political support. For example, in that article Becker wrote, "I would suggest that the traditional emphasis on the waste caused by industrial regulation be reversed: regulations that survive the keen competition for votes tend to be relatively efficient ways to redistribute resources." Becker attempted to show why the politicians who can create transfers at a lower cost generate more support, and thus are more likely to win. However, Wittman claims to be unsatisfied by the existing literature, and with Becker's position in particular. Wittman argues that "the thrust for efficiency is a strong force, while in his [Becker's] work it is a weak force."

Wittman's claim to be adding a new theoretical paradigm to the literature is puzzling for two reasons. He neither provides a reason why this tendency is stronger than Becker claims, nor does he always end up claiming that all government actions are efficient (to the contrary, he mentions severance taxes, rent controls, tariffs, and the still very limited use of tradable pollution permits).

The book's unstated premise seems to be that competition is simply a more powerful force than Becker believed. Yet despite Wittman's arguments to the contrary, it is hard to think of a more hard-core statement of government's efficiency than that found in Becker's 1976 article. Becker wrote, "The statement that cash transfers