Energy and the U.S. Economy: A Biophysical Perspective

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Stable consumer prices, full employment, and increasing per capita wealth have been economic and political goals in the United States since at least the 1930's. Aggregate economic growth has been the principal means for realizing these goals. On average, these goals were met from the mid-1940's to the in any perceptible way, a systematic understanding of the structure and the operations of a real economic system.' Instead, they are based on "sets of more or less plausible but entirely arbitrary assumptions" leading to "precisely stated but irrelevant theoretical conclusions." Bailey and others (3) chronicled the last 90 years to test the hypotheses generated by our model. Empirical testing of economic theories is a difficult but essential procedure which is too frequently ignored. Simultaneous changes in variables make controlled observations difficult if not impossible. The empirical analyses of time series and cross-sectional data presented below cannot be used to prove hypotheses unequivocally, nor do they assure that the parameters will not change in new ways in the future. Empirical assessments, however, can be used to identify hypotheses that are consistent with reality and to reject hypotheses that are not.

Statement of Hypotheses

We approach macroeconomics from a thermodynamic perspective that emphasizes the production of goods, rather than the neoclassical perspective that emphasizes the exchange of goods according to subjective human preferences. Production is the economic process that upgrades the organizational state of matter into lower entropy goods and services. Those commodities are allocated according to human wants, needs, and ability to pay. Upgrading matter during the production process involves a unidirectional, one-time throughput of low entropy fuel that is eventually lost (for economic purposes) as waste heat. Production is explicitly a work process during which materials are concentrated, refined, and otherwise transformed. Like any work process, production uses and depends on the availability of free energy. The laws of energy and matter control the availability, rate, and efficiency of energy and matter use in the economy and therefore are essential to a comprehensive and accurate analysis of economic production.

Changes in natural resource quality affect the ease and cost of fuel and matter throughput in human economies because lower quality resources nearly always require more work directly and indirectly to upgrade them into goods and services. Technological change can counter changes in natural resource quality to varying degrees, but historically, many technical advances that have lowered unit labor costs have been realized by...
increasing the quantity of fuel used directly and indirectly to perform a specific task. The degree to which technological change can offset declining resource quality as some basic resources are depleted (for example, fuel and metal ores) and/or mismanaged (some biotic resources) is an empirical question and cannot be easily predicted. Nevertheless, such resource changes have important implications for what is and is not possible in the economy. Economic theory and policy must incorporate the physical properties of resources if economic predictions are to be accurate and economic policies effective.

In the section below, we present a series of specific hypotheses derived from our biophysical perspective, accompanied by an alternative example of a more traditional hypothesis. In our empirical assessments of how changes in fuel quantity and quality have affected the U.S. economy, we examine (i) various relations between fuel use, economic output, productivity, and inflation over the past 90 years and (ii) cross-sectional relations between direct and indirect fuel use and economic value for 1963, 1967, and 1972. We use real gross national product (GNP) as a measure of aggregate output in the time series analysis, while acknowledging some of the inadequacies of GNP as a measure of output and social welfare. As a measure of fuel use we sum the quantities of fossil, nuclear, and hydropower fuels used in the economy and analyze the effects of changing fuel mix by adjusting caloric heat measures for fuel quality. Except as indicated, nuclear and hydropower fuels are converted to heat equivalents based on the prevailing heat rate at fossil steam electric plants.

1) A strong link between fuel use and economic output exists and will continue to exist, both temporally and cross-sectionally. The correlation is strengthened when adjustments are made for fuel quality and the sector in which fuel is combusted. Alternative hypotheses are that such a link never existed, or that it can be and has been substantially decoupled, especially as the price of fuel increases (6).

2) A large component of increased labor productivity over the past 70 years resulted from increasing the ability of human labor to do physical work by empowering workers with increasing quantities of fuel, both directly and as embodied in our industrial capital equipment and technologies. One alternative hypothesis views productivity as an exogenous technical driving force that has increased the productivity of capital and labor (7).

3) Changes in the general price level have been correlated with changes in the money supply relative to the physical supply of energy. This suggests that the rising real physical cost of obtaining energy and other resources from the environment is an important factor in inflation. Various economic models emphasize either monetary or fiscal measures for explaining inflation (8).

4) Energy costs of locating, extracting, and refining fuel and other resources from the environment have increased and will continue to increase despite technical improvements in the extractive sector. This reduces the supply of non-energy goods producible from a given quantity of energy. One alternative hypothesis is that resource-augmenting technical change and/or the development of inexhaustible fuel supply systems will mitigate any foreseeable natural resource scarcity (9).

Our hypotheses are not necessarily inimical to standard economics. Rather, we believe such an approach provides a physical basis for some macroeconomic

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Fig. 1. (a) Annual rate of change in fuel use and real GNP in the United States from 1890 to 1982 (55, 56). Fuel use includes fossil fuels, nuclear, and hydropower. (b) Fuel use and real GNP per year. (c) Results of linear regression model between fuel use and real GNP in the United States from 1890 to 1982. The numbers in parentheses are t-statistics. Hydro and nuclear power converted to thermal units based on prevailing heat rates at fossil steam electric plants (55, 56).
phenomena. Such an analysis leads neither to an unrealistic cornucopian view of our future material condition, nor to one of "gloom and doom." We believe a physical analysis of economic production provides realistic assessments of the problems we face and some of the needed characteristics of any plausible solution.

Energy and Economic Production

The economic process is frequently depicted in basic economic texts as a closed system in which the flow of output is "circular, self-feeding, and self-renewing" (10). This model is seriously incomplete. In reality, the human economy is an open system embedded in a global environment that depends on a continuous throughput of solar energy. The global system produces the environmental services, foodstuffs, fossil and atomic fuels derived from solar and radiation energies, and various other resources that are essential inputs to the human economy. The human economy uses fossil and other fuels to support and empower labor and to produce capital. Fuel, capital, and labor are then combined to upgrade natural resources to useful goods and services. Economic production can therefore be viewed as the process of upgrading matter into highly ordered (thermodynamically improbable) structures, both physical structures and information. Where one speaks of "adding value" at successive stages of production, one may also speak of "adding order" to matter through the use of free energy (11).

Fuel quality as well as quantity limits economic production because fuels differ in the amount of economic work they can do per unit heat equivalent (kilocalorie). Petroleum, for example, can perform a more versatile array of tasks and do many of them more efficiently than coal (12). Per kilocalorie, petroleum is estimated to be 1.3 to 2.45 times as valuable as coal (13). Similarly, electricity can be converted to mechanical and heat energy at the point of application and can be controlled precisely, reducing the heat equivalents required to perform many tasks (14). One measure of the quality of electrical energy is the opportunity cost of transforming fossil fuels to electricity (3 to 4 kilocalories of fossil fuel per kilocalorie of electricity in 1983).

Another important quality of fuels is the amount of energy required to locate, extract, and refine them to a socially useful state. This aspect of fuel quality is measured by a fuel's energy return on investment (EROI), which is the ratio of gross fuel extracted to economic energy required directly and indirectly to deliver the fuel to society in a useful form. As the EROI for fuel declines, the energy opportunity costs of securing additional amounts increase, and increasing amounts of already extracted energy must be diverted from the production of nonenergy goods to extract a given quantity of new fuel. Net energy is a more relevant measure of fuel supply than gross energy because it represents the energy available to produce final-demand goods and services. At an absolute minimum, the aggregate EROI for fuels must be greater than 1 for an economic system to function, and probably much greater for it to grow. Ceteris paribus, economies with access to higher quality natural resources, particularly fuels with higher EROI, can do more economic work than those with lower EROI fuel resources.

Energy costs of capital and labor. Fuels, nonfuel minerals, capital, and labor are all necessary to produce economic output. Most standard models of production consider fuel and other natural resources to be qualitatively different from other factors of production. As a result, many believe that natural resource inputs to production are "small potatoes compared to labor, or even to capital," and that "reproducible capital is a near perfect substitute for land and other exhaustible resources" (15). This view is inaccurate because free energy is required to upgrade and maintain all organized structures, including capital and laborers, against the ravages of entropy. It ignores the physical interdependence of capital, labor, and natural resources.

All goods and services (both economic and environmental) have quantifiable direct and indirect energy costs of production, termed their embodied energy. The embodied energy of a good or service can be calculated with input-output techniques developed by Herendeen and Bullard and by Hannon et al. (16), which were based on the pioneering economic work of Leontief (17). Early attempts to quantify the embodied energy of goods ignored the energy costs of labor, capital, and government services. These factors do have substantial energy costs. Labor consumes energy directly in the form of fuel and food, and indirectly as fuel energy embodied in shelter, clothing, education, and social services, and other commodities. These energy costs can be incorporated directly in calculations of embodied energy (18), or can be thought of as an energy opportunity cost (19) for labor, which is the amount of fuel that would have to be diverted from other uses to substitute for labor at the margin.

Standard production functions do not account for the important physical interdependence between energy and all oth-
er factors: the availability of all factors created by humans depends on the existence of free energy in the natural environment. Capital and labor are combined to extract energy from the environment, but they cannot create in a physical sense the free energy and matter from which they are derived. Thus, elasticities of substitution between natural resources and capital and labor calculated at the level of the firm or industry do not necessarily reflect true substitution possibilities over the economy as a whole. Including the direct and indirect energy costs of producing capital and labor reduces the degree to which capital and labor can be substituted for fuel in production (20).

**Fuel use and economic output.** Fuel use and economic output in the United States have been highly correlated for at least the past 90 years (21). This relation is shown in various ways in Figs. 1 and 2. The high coefficient of determination of Fig. 1c is consistent with the hypothesis that, at least in the past, economic output and fuel use have been tightly linked. While a causal relation from fuel use to GNP or vice versa cannot be verified, a strong contemporaneous link between the two variables is supported (22).

The results of statistical analyses of long time series of economic variables often are dominated by trends rather than correlations between annual variations in the variables. The validity of the statistical correlation of Fig. 1 was analyzed further with a Box-Jenkins transfer function analysis, a procedure that can remove the nonstationary components of the two time series. When this analysis is applied to the first differenced time series of real GNP and fuel use in the United States from 1900 to 1980, the results support a significant interregression between the annual rates of change of GNP and fuel use (23).

Cross-sectional analysis of direct plus indirect fuel use and economic output in the United States reinforces the results of the time series analysis. Regression analysis of embodied fossil fuel, hydro, and nuclear energy use and dollar value of output across 87 sectors of the U.S. economy indicates a strong correlation between the two variables if the energy costs of labor and government services are included (18, 24) (Fig. 2). This relation holds true for all the years for which the requisite national input-output tables are available.

**Fuel efficiency.** Despite problems inherent in measuring fuel quality, fuel use, and GNP as a measure of welfare (25), the fuel use/real GNP (E/NGP) ratio remains a popular and not inappropriate measure of fuel efficiency (26). The U.S. E/NGP ratio has declined 42 percent since 1929, about half of this since 1973 (Fig. 3a). This decline has been interpreted by some as meaning that factor substitution and conservation measures have decreased substantially the quantity of fuel used per unit of economic output and that similar improvements are possible in the future (6). We believe this interpretation of changes in the E/NGP ratio overestimates past improvements and potential future gains in actual energy efficiency.

Figure 3 shows the sensitivity of the E/NGP ratio to corrections made for fuel quality and to GNP modifications to account for relative shifts in fuel use between sectors of the economy. Between 1929 and 1981, a period when the ratio was declining, three factors which are not normally considered as contributing to improved fuel efficiency account for 96 percent of the annual variation in the E/NGP ratio (27). The factors are (i) the proportion of total fuel use accounted for by petroleum, (ii) the proportion of total fuel use accounted for by primary electricity (hydro and nuclear), and (iii) the proportion of direct fuel use in final demand (that is, gasoline or electricity used by households) versus intermediate demand sectors (oil or electricity used in manufacturing).

An empirical examination of the relation between these factors indicates that 69 percent of the variation in the E/NGP ratio since 1929 can be attributed to changes in the type of fuel used. As the percentage of high-quality fuels such as petroleum and primary electricity increased, more economic work was done (more GNP produced) per heat equivalent burned, and the E/NGP ratio declined. Correcting fuel use data for changing fuel quality produces a smaller overall decline in the E/NGP ratio (Fig. 3, lines a, b, and d) and even a slight increase in the ratio if the quality factors derived from our regression analysis (27) are used (Fig. 3, line d). Thus, much of the decline in the E/NGP ratio has been due to our ability to expand the use of higher quality fuels.

A relative shift in direct fuel use from final demand sectors to intermediate sectors, or vice versa, also changes the E/NGP ratio. For example, a dollar’s worth of fuel purchased by households represented 145,000 kilocalories in 1972, whereas a dollar’s worth of nonfuel good or service purchased by households represented only 5,600 to 11,800 kilocalories (28). Thus, the E/NGP ratio is sensitive to the partitioning of fuel between direct household use and fuel use to produce goods consumed by households. Such relative shifts in the point of fuel combustion account for 27 percent of the variation in the ratio since 1929; they were most important during World War II, when petroleum use was rationed, and since 1973, when the high price of fuel has discouraged its direct use by households. Eighty-eight percent of the decline in the E/NGP ratio since 1973 can be explained by the declining proportion of GNP spent on fuel by households. Lines c and e in Fig. 3 show the effects on the ratio of including corrections for fuel quality and for relative shifts in fuel use between households and intermediate sectors. When these effects are accounted for, the corrected E/NGP ratio shows little or no long-term trend since 1929 (Fig. 3, line e).

We do not argue that there have been no energy efficiency improvements during this period. Even with corrections, the E/NGP ratio does show a modest decline since 1973, indicating that higher fuel prices have led to real efficiency improvements, as other analysts have suggested (29). The fuel quality and GNP modifications are an attempt to include important attributes of fuel use and social welfare not accounted for in uncorrected fuel use and GNP statistics. The E/NGP ratio is sensitive to such modifications. Our regression analysis suggests that technological change which has led to a decline in the E/NGP ratio has often relied on intensified use of higher quality fuels. Our analysis does not support the hypothesis that the shift toward a service-oriented economy, such as the United States has undergone since World War II, is a significant factor in the decline in the E/NGP ratio.
Labor Productivity and
Technical Change

In many economic models, technological advance is presented as an exogenous driving force powered by advances in human knowledge that increase labor and capital productivity. Denison (7) states that advances in "human knowledge of how to produce things at low cost" are the most important causes of the increase in per capita national income observed between 1948 and 1973. In this and other analyses, technological change is not measured directly, but rather is assigned the residual of increases in per capita income after all "tangible" factors have been accounted for. Because energy and natural resources are not considered tangible factors by most analysts, a large residual remains. Grilliches and Jorgenson (30) stated that relabeling changes in factor productivity as "technical progress" or "advance in knowledge leaves the problem of explaining growth in total output unresolved."

From an energy perspective, productivity gains are facilitated by technical advances that enable laborers to empower their efforts with greater quantities of high-quality fuel embodied in and used by capital structures. As Cottrell (5) observed, "productivity increases with the per capita increase in available energy." Various empirical analyses support this view, and cross-sectional and temporal changes in labor productivity are correlated with the quantity of fuel used to empower a worker's efforts. Boretsky (31) noted that higher labor productivity rates in the United States than in Western Europe nations were associated with the substantially greater quantities of fuel used per employee in the United States. We found that in the U.S. manufacturing sector, output per worker-hour is closely related to the quantity of fuel used per worker-hour (32) (Fig. 4). A similar relation exists in the U.S. agricultural industry.

Such relations can be merged with standard economic models to explain historical changes in labor productivity. From 1900 to 1973 the real price of fuel declined relative to the wage rate, and fuel was substituted for labor in many processes. Labor productivity increased during this period. Since 1973 the price of fuel has risen relative to the wage rate, and labor has been substituted for fuel, thereby reducing productivity. While other factors certainly affected the decline in labor productivity in the 1970's, a biophysical analysis supports those analyses which indicate higher fuel prices as a significant contributor (33).

Energy and Inflation

The high rates of inflation that have recently plagued most industrialized nations can be explained by uniting the importance of fuel use and money supply. If an expanding money supply stimulates demand beyond the level that can be satisfied by existing fuel supplies, price levels must rise (34). A historical analysis indicates that changes in the ratio of money supply to fuel use are significantly correlated with changes in the consumer price index since 1890 (35) (Fig. 5). Manipulation of the monetary, and even fiscal, policy as a means of stimulating economic growth may now be less effective due to the increasing real physical cost of obtaining new quantities of fuel from the environment.

Natural Resource Quality from an Energy Perspective

The issue of natural resource scarcity has received considerable attention in recent years (36). Many suggest that the negative economic effects of depleting high-quality mineral deposits can be mitigated indefinitely through technical innovation and/or the use of more energy and capital structures to mine vast quantities of low-quality ore (9). Evidence for this hypothesis is that capital and labor inputs per unit output in the extractive sectors have either declined or remained stable throughout most of this century (37), a trend attributed to technical advances in those industries.

When analyzed from a physical perspective, the trend in the scarcity of some important natural resources is less reassuring. Technical improvements in the extractive sectors have made available previously uneconomic deposits only at the expense of more energy-intensive forms of capital and labor inputs (38). Physical output per kilocalorie of direct fuel input in the U.S. metal mining industries has declined 60 percent since 1939 (Fig. 6a), although a few exceptions to the trend are known (39). The energy cost per ton of metal at the mine

<table>
<thead>
<tr>
<th>Process</th>
<th>EROI</th>
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<tbody>
<tr>
<td><strong>Nonrenewable</strong></td>
<td></td>
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<tr>
<td>Oil and gas (domestic wellhead)</td>
<td></td>
</tr>
<tr>
<td>1940's</td>
<td>80.0</td>
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<tr>
<td>1970's</td>
<td>30.0</td>
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<tr>
<td>Coal (mine mouth)</td>
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<tr>
<td>1950's</td>
<td>0.5 to 8.2</td>
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<tr>
<td>1970's</td>
<td>1.0 to 5.0</td>
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<tr>
<td>Oil shale</td>
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<td>Coal liquefaction</td>
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<td>Geopresseded gas</td>
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<tr>
<td><strong>Renewable</strong></td>
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<tr>
<td>Ethanol (sugarcane)</td>
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<td>Ethanol (corn)</td>
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<td>Ethanol (corn residues)</td>
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<td>Methanol (wood)</td>
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<td>Solar space heat (fossil backup)</td>
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<td>Flat-plate collector</td>
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<td>Concentrating collector</td>
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*Based on discovery rates reported by Hubbert (44) and the assumption that energy use in drilling was less than 1 barrel per foot [Hall and Cleveland (44)].

**Does not include energy in fuel.
Declining resource quality and higher fuel prices impede economic growth by diverting increasing amounts of capital and labor to the extractive and resource processing sectors. Throughout most of this century, the real dollar value of the mining sector share of real GNP was relatively small and constant, averaging 3 to 4 percent (Fig. 7). This led some to conclude that natural resources were a small and unimportant factor of production (47). By 1982, however, more than 10 percent of real GNP was needed to extract mineral resources from the environment. Most of this increase was for fossil fuel purchases, which in 1981 were 4.5 times greater in inflation-corrected dollars than in 1972, despite the fact that total fossil fuel use was about the same in both years. Clearly, the cost of minerals is not “irrelevant” to our standard of living, as some suggest (9).

Alternative fuel sources. Because of the importance of net fuel supply, continued economic growth hinges in large part on our ability to develop new fuel...
sources with EROI’s comparable to those we use today. As the values in Table 1 indicate, most alternative fuel sources have a positive but small EROI relative to fossil fuels. For proposed "inexhaustible" sources such as large-scale photovoltaics and fusion and breeder reactors, it is not yet clear whether the EROI will be large, marginal, or less than break-even. Current estimates of the EROI for new technologies are probably overly optimistic because the record shows we have routinely underestimated actual capital costs of new energy process plants by more than 100 percent (48). A recent survey of 40 nuclear power plants in various stages of construction in the United States indicates that they will all eventually cost an average of seven times their first cost estimates (49).

Conclusions

In one of the first detailed empirical analyses of fuel use in the United States, Tryon (50) stated in 1927 that

Anything as important in industrial life as power deserves more attention than it has yet received from economists. ... A theory of production that will really explain how wealth is produced must analyze the contribution of this element energy.

Toward this theory of production, our analysis emphasizes the economic importance of changes in the quality and availability of fuel and other natural resources faced by the United States. Declining energy return on investment for fuels and increasing energy costs for nonfuel resources have a negative impact on economic growth, productivity, inflation, and technological change. Some economic models that guided economic growth during the preceding period of high-quality resource abundance have become increasingly less powerful because they do not account for the importance of changes in natural resource quality and availability.

Some resource analysts have suggested that there was no physical reason for domestic oil demand to outstrip domestic production by almost 100 percent in the 1970’s (51). The degree of depletion of domestic petroleum in the 1970’s, however, was predicted accurately with physically based models over a quarter-century ago by Davis, Hubbert, and others (44). The “energy crisis” and ensuing economic problems cannot, therefore, be blamed solely on misguided regulatory policies, the monopoly power of the Organization of Petroleum Exporting Countries, a conspiracy among the multination al oil companies, or lack of proper economic incentive for the petroleum exploration and development industry. While these factors may have exacerbated the situation, underlying the energy crisis and the ensuing economic malaise was the declining physical availability of high-EROI petroleum, and a reliance on economic and political models that did not account for it. Market incentives in response to a quadrupling of real oil prices and a 280 percent increase in drilling effort between 1972 and 1981 made no significant reversal in declining oil and gas production and discovery rates in the United States.

If we are to sustain current levels of economic growth and productivity as minimum long-run goals, alternative fuel technologies with EROI ratios comparable to that of petroleum today must be developed, or there must be unprecedented improvements in the efficiency with which we use fuel to produce economic output. Many discount the decreasing availability of high-quality fossil fuel deposits, stating that such depletion is merely a signal of our impending transition to a society based on a “boundless supply of energy at reasonably low cost” (52) such as breeder or fusion reactors or direct solar power. But past experience with capital-intensive ventures such as fission and synfuel suggests that it would be unwise to assume a priori that fusion or any other proposed fuel source will necessarily have a large EROI. Although we should research aggressively all potential fuel technologies, particularly in regard to their potential EROI, we should also plan for the contingency that new high-EROI sources might not be found.

Based on our analysis, the economic recovery from the 1980-1982 recession was due in part to declining OPEC oil prices, which themselves were due to decreased world oil demand brought about by the worldwide recession. In effect, the EROI for imported oil rose recently because importing nations had to divert less of their output to trade for oil. Rising economic activity and fuel use, however, will again confront the economy with the physical limits of declining domestic fuel quality, and thereby increase the chances of a tight oil market in the near future (53). Our ability to cope with any economic contingencies will depend on the ability of our economic models to account for the biophysical constraints on human economic activity, and on the ability of our citizenry to accept and adapt to the realities of physical constraints imposed on our economic possibilities.
parameters. A residual analysis showed that the remaining part is a random process. The mean of the residuals is 1.9860, and the t value of the mean for a test against zero is 0.0002. We thank K.-G. Berndt for bringing this point to our attention.


27. The regression equation is E = GNP - 60.41 + 25.23 (PETRO) - 344.27 (7% GEC) + 10.41 (7% PETRO). The standard error of the equation is 25.51. The regression was of the form

\[ E = \beta_0 + \beta_1 GNP - \beta_2 PETRO - \beta_3 7\% GEC + \beta_4 7\% PETRO \]


34. Both the (M2) money supply, P = 0.93, and fuel use (E) have been highly correlated with the CPI over the period analyzed. The highest statistical correlation, however, is between the ratio of the two variables and the CPI (r = 0.98, P < 0.001). If economic output is correlated with fuel use (E), then the price level can be described as the ratio of money supply (M) to fuel use (E). We assume that the ratio of the velocity of money (V) to fuel efficiency (n) has been relatively constant and unimportant.


53. Both the (M2) money supply, P = 0.93, and fuel use (E) have a high correlation, P < 0.001. If economic output is correlated with fuel use (E), then the price level can be described as the ratio of money supply (M) to fuel use (E). We assume that the ratio of the velocity of money (V) to fuel efficiency (n) has been relatively constant and unimportant.
