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Transportation Fuel Taxes: Impacts of a Repeal or Moratorium

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Summary

Legislation that would repeal or otherwise provide for a summer-long moratorium of federal transportation fuel taxes has been introduced in the 110th Congress. Simultaneously, Senators McCain and Clinton are proposing a summer fuel tax collection moratorium as part of their Presidential campaigns. Fuel prices have risen rapidly in 2008 for a variety of reasons. Those seeking to alter federal fuel tax collection are doing so in the belief that a reduction in fuel taxes would give Americans a modest level of economic relief from high pump prices. Current market conditions and the marginal amount of tax relief incorporated in most proposals, however, raise uncertainty as to whether prices to individuals and businesses would fall and whether any price decline would be meaningful to consumers in economic terms. Also of concern is the possible impact of any repeal or moratorium on the overall federal budget deficit.

A reduction in transportation fuel taxes would result in a decrease in spending for Highway Trust Fund-supported federal programs, unless Congress designated alternate sources of funding for these programs. As a result of the structure of the federal programs, the effects of a fuel tax repeal on federal transportation programs would not necessarily be immediate, but depending on the length and scope of the repeal or suspension, they could be substantial.

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Increase in Crude Oil and Refined Product Prices

Due to the continued tightness in crude oil markets, spot prices of crude oil rose by almost $20 per barrel between the end of December 2007 and the end of April 2008, from about $91 per barrel to about $112 per barrel. Perhaps more publicized, the futures price of one grade of crude oil exceeded $115 per barrel in late April. The average acquisition cost of crude oil to U.S. petroleum refiners (which excludes some transportation costs) increased by approximately 15% over almost the same period, from $85 per barrel at the end of December 2007 to $98 per barrel in March 2008.

Because the cost of crude oil to refiners accounts for a substantial portion of the price of refined petroleum products to users, retail prices of gasoline, diesel fuel, and heating oil have risen. The average U.S. retail price of gasoline of all grades increased from about $3.07 per gallon at the end of December 2007 to $3.51 per gallon by the end of April 2008, an increase of about 14%. The average price of diesel fuel per gallon increased from about $3.34 in December 2007 to $4.08 in late April 2008, or 22%. Jet fuel prices rose from $2.68 per gallon in December 2007 to $3.10 in late April 2008. Home heating oil prices increased by 25% from December 2007, the beginning of the winter heating season, to April 2008, the end of the winter heating season, from $2.60 per gallon to $3.24 per gallon.

Proposals to Offset Effects of Higher Crude Oil Prices

The steep increases in the retail prices of refined petroleum products over a six-month period have prompted some Members of Congress to seek means of countering the consequences of higher crude oil prices and/or reducing the retail

prices. Among other policy options, interest has focused on a possible moratorium on the federal excise taxes on transportation fuels, especially gasoline and diesel fuel.

Virtually all transportation fuels are taxed under a complicated structure of excise tax rates and exemptions that vary by transportation mode and fuel type. Gasoline used in highway transportation is taxed at a rate of 18.4 cents per gallon. This is composed of an 18.3-cent-per-gallon Highway Trust Fund rate, the revenues from which are earmarked for the federal Highway Trust Fund, and a 0.1-cent-per-gallon rate dedicated to funding the Leaking Underground Storage Tank (LUST) Trust Fund. Diesel fuel used in highway transportation is subject to total federal excise taxes of 24.4 cents per gallon, 24.3 cents of which is earmarked for the Highway Trust Fund and 0.1 cent of which goes to the LUST fund. Every state also has excise taxes on fuels used for highway transportation; these differ widely by state. Some states have employed fuel tax moratoriums in the past, with varying results.[1]

In the current situation, congressional attention has focused on temporary and extended suspension of highway fuel excise taxes. Higher gasoline costs for consumers reduce the amount of disposable income available for other purchases, and may be especially disruptive to consumers during the summer driving season.[2] Higher fuel costs for truckers potentially increase hauling charges, transportation costs, and consumer prices, and may also decrease trucking company profits and/or drivers' income. Fuel costs constitute a significant portion of trucking company operating costs.[3]

Selected Legislative Proposals in the 110th Congress

S. 2890 (Senator McCain, April 17, 2008) would suspend the fuel taxes for the summer driving season (May 26, 2008, to September 1, 2008), and requires that the Highway Trust Fund and LUST accounts be reimbursed by Treasury general funds for revenues not collected from fuel taxes. S. 2971 (Senator Clinton, May 2, 2008) would suspend fuel taxes for the same period. It would also reimburse the Highway Trust Fund and LUST deposits from the Treasury general funds, although it does provide offsetting new revenues from a windfall profits tax on the oil industry. A third Senate bill, S. 2896 (Senator Snowe, April 21, 2008) would partially suspend only the diesel highway fuel excise tax, setting it at 18.3 cents per gallon from passage until December 31, 2008. This bill would also provide for Highway Trust Fund and LUST reimbursement from Treasury general funds.

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[1] Cave, Damien. "States Get In on Calls for a Gas Tax Holiday." *The New York Times*. May 6, 2008.

[2] The summer driving season, from Memorial Day until Labor Day, is believed to result in an increase in the demand for gasoline due to holiday and vacation travel as well as increased driving for personal errands and commercial activity due to longer benign weather daylight hours.

[3] CRS has estimated fuel costs as at least 15% of total operating costs, based upon data from trucking company annual reports, the American Trucking Associations, Global Insight, and the Energy Information Administration (U.S. Department of Energy).

Two House bills were introduced in the first session of the 110th Congress that take a different approach to providing fuel tax relief. H.R. 1569 (Representative McHugh, March 19, 2007) suspends highway fuel taxes whenever the per-gallon price of gasoline exceeds $2.75. H.R. 2448 (Representative Kuhl, May 23, 2007) reduces the highway gasoline excise tax by 10 cents per gallon whenever the price of gasoline exceeds $3.00 per gallon. H.R. 1569 would provide for Highway Trust Fund and LUST reimbursement; H.R. 2448 would not.

Impacts on Markets and Prices

As indicated, the measures described are motivated by the steep and rapid increases in the retail prices of refined petroleum products, and are intended to reverse those increases, at least to some extent, for a limited period of time. *Under "normal" market conditions and assuming a reasonable degree of competition in oil and petroleum product markets*, the market response to a cut in the excise taxes would be a tendency to reduce user prices by an amount less than or equal to the tax cut.

Economic theory suggests that the key factor in determining the extent of the pass-through to consumers of the reduced tax is the degree of price responsiveness of the supply of petroleum products.[4] If the quantity supplied is extremely responsive to even tiny price changes, the entire tax cut would be passed on to consumers.[5] If, as is more likely in the real world, there is a less sensitive relationship between prices and the supply of refined petroleum products, less of the tax cut would be passed on to consumers. In the case of no sensitivity of petroleum product supply to changes in price, none of the tax cut is likely to be passed on to consumers. In the latter two cases, the taxed entities — refiners, importers, and terminal operators[6] — would view the tax cut as a decrease in the cost of doing business, take advantage of the quantity-constrained nature of supply, and pass forward some, or none, of the tax cut in the form of lower prices.

Current market conditions, however, may limit, or even prevent, an observed reduction in prices to end-users. Rising crude oil prices have resulted from a continued growth in world demand that has put pressure on available world supplies, resulting in diminished world excess oil production capacity and generally tight inventories. These conditions have persisted in the oil market since 2003. In addition, some analysts have identified other factors, including speculation on oil futures markets, inflation hedging, political disruption, and mismanagement by national oil companies, as contributing to high oil prices. Rising crude oil prices may continue to push up the price of gasoline, offsetting any reduction in the fuel taxes.

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[4] Economists measure the responsiveness of the supply by estimating the value of the "supply elasticity."

[5] Economists identify this situation as an infinite elasticity of supply.

[6] Depending on the particular circumstances, federal transportation fuel excise taxes are levied on and remitted by the refiner, terminal operator, or importer.

With respect to refined petroleum products, especially gasoline and diesel fuel, demand in the United States has exceeded domestic refining capacity, even though the refining industry has run at high capacity utilization rates. As a result, about 1 million barrels per day of finished gasoline and gasoline blending stocks are imported to meet U.S. demand.[7] The combination of limited capacity and high capacity utilization rates greatly limits the ability of the refining industry to increase the availability of refined petroleum products. Under these conditions, most experts would likely conclude that it is probable that little, if any, of a tax cut due to a temporary suspension of the fuel excise taxes would be passed forward to final consumers.

Notwithstanding generally high profits in the oil industry, profit margins in the the refining sector have been much lower. Four (Shell, BP, Chevron, and Marathon) of the six (ExxonMobil, ConocoPhillips) largest integrated oil companies experienced declining income growth in downstream operations in 2007.[8] Reduced profits in the refining sector might provide a further incentive for the firms not to pass tax cuts on to consumers, especially in light of the temporary nature of the tax cut.

Moreover, because 18.4 cents is small in relation to current end user prices for transportation fuels, about 5%, most experts would likely conclude that even a full pass-through of a suspension or repeal would have little effect on end user prices. In an environment of rapidly increasing prices, even a full pass-through might only offset the price increases emanating from market pressures. In that case, consumers might continue to see increasing prices at the pump, even though the tax cut was made fully available to them. If lesser amounts than the full tax cut were passed on to consumers, market-generated price increases might make the effect of the tax cut inconsequential.

Proposals to suspend the full amount of only the gasoline, or diesel, fuel tax could be expected to have more complicated market effects. Although temporary, singling out one fuel for tax relief could change the relative price structure among refined products and introduce incentives to change the proportions of products derived from each barrel of crude oil, all of which would be affected by the seasonality of demand. Also, it is possible that refiners would apply some of a particular product tax cut to the prices of one or more other refined products. Thus, it is uncertain not only that measures that give excise tax relief will result in reductions in prices to end users, but that any reductions will apply to the product given tax relief.

If the tax cut is passed on to users of gasoline, and prices are reduced, it is likely that consumption will increase. An increased consumption of gasoline will lead to an increased demand for oil that will likely increase its price and lead to further increases in the price of gasoline. In addition, increased demand for gasoline in the United States is likely to be met by an increase in imported gasoline, increasing U.S.

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[7] Energy Information Administration, *Weekly Imports and Exports*, available at [http://www.eia.doe.gov].

[8] Downstream operations include refining, distribution, and marketing.

dependence on foreign supplies. Increased consumption of gasoline will also increase carbon emissions.

Also, although it may not be likely, some states experiencing budget pressure could substitute increased state fuel taxes for the reduced federal tax. In that case, if the refiners did not pass through the full tax cut to consumers, and if a state raised its tax by an amount equal to the proposed reduction in the federal tax, the net tax effect on consumers might increase. This response could result from a decrease in funding from the Highway Trust Fund. A few states have provisions that automatically increase their taxes to some extent when federal taxes fall below a certain level.

Surface Transportation Program Effects

Federal funding for surface transportation is closely linked to the revenue stream provided by the Highway Trust Fund. In actuality, the trust fund consists of two separate accounts — highways and mass transit. In common usage, the term Highway Trust Fund normally refers to the highway account. As mentioned earlier, the primary revenue sources for these accounts are the 18.4-cent-per-gallon tax on gasoline and a 24.4-cent-per-gallon tax on diesel fuel. Although there are other sources of revenue for the trust fund, these fuel taxes provide about 90% of the income to the funds. Of these amounts, the transit account receives 2.86 cents per gallon, and 0.1 cent per gallon is reserved for an unrelated leaking underground storage tank (LUST) fund. Over the almost 50-year life of the trust fund, there have been several increases in the level of taxation. The last increase in the fuel tax occurred in 1993.[9]

Growth in the trust fund revenue stream over the last five decades has remained reliable largely because of continued growth in auto and truck registrations, which, combined with increased auto and truck use, has resulted in a relatively constant annual increase in national fuel consumption. Growth in fuel consumption has also been enabled by changes in the makeup of the national vehicular fleet. This was especially the case in the 1990s, when consumer demand for SUVs and light trucks led to an even higher level of growth in fuel usage.

Although driving has not yet decreased significantly as a result of $3.50-plus-per-gallon fuel costs, it is believed that these price levels are affecting vehicle purchase decisions and other use-related decisions.[10] For example, fuel-efficient vehicles such as hybrids are selling well, and less fuel-efficient vehicles are selling at a much reduced rate. This situation will, if it continues, potentially reduce long-term growth in fuel tax revenue. Other fuel cost-related trends may develop over time. For example, a significant shift to alcohol-based fuels would put pressure on the overall federal budget because of federal subsidies afforded these fuels.

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[9] A significant portion of the 1993 increase was initially deposited in the Treasury general funds for deficit reduction purposes. These funds were redirected to the Highway Trust Fund beginning in FY1998.

[10] Vlasic, Bill. "As Gas Costs Soar, Buyers Are Flocking to Small Cars." *The New York Times*. May 2, 2008.

Federal Surface Transportation Program Revenue Issues

Federal surface transportation programs are currently authorized by the Safe, Accountable, Flexible, Efficient Transportation Equity Act — A Legacy for Users (SAFETEA-LU or SAFETEA) (P.L. 109-59). This act reauthorized federal surface transportation programs through the end of FY2009. The act provided $286.4 billion for a six-year authorization period (in actuality, the act provided $244.1 billion for the five years remaining in the authorization at the time of passage).

Of immediate concern to the transportation community is the fact that the federal-aid highway program is currently spending more on highways on an annual basis than the Highway Trust Fund is receiving annually in new revenues. Although this trend began prior to passage of SAFETEA, the funding levels provided by the act can only be met by spending down the cash balances in the highway and transit accounts of the trust fund. The authors of SAFETEA believed that the existing cash balances in the trust fund, when combined with new revenues, were sufficient to carry the program through the FY2009 authorization period. There is now widespread agreement in the transportation community that this was an optimistic prediction. Both the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) believe that the cash balances in the highway account will be negative prior to the end of FY2009.[11] A fuel tax repeal or moratorium without a concomitant increase in revenues from some other source, such as the Treasury general fund, could hasten and otherwise exacerbate this situation.

At the time of this writing, no CBO, OMB, or Joint Tax Committee estimate of the amount of revenue that would be forgone by a gas tax holiday is available. A rough estimate of how much a tax holiday could cost the trust fund can be derived as follows. The Bush Administration budget proposal for FY2009 estimates that the highway account of the trust fund will collect revenues of $34.19 billion in FY2008.[12] The transit account will collect an estimated $5.01 billion for the same period. Total estimated revenue collection for the fund for FY2008 would, therefore, be $39.2 billion. As mentioned earlier, approximately 90% of trust fund revenues derive from fuel taxes. Therefore, approximately $35.28 billion of FY2008 revenues would be from fuel taxes. If annual fuel sales are evenly divided over 12 months, each month that the fuel tax might be suspended would result in $2.94 billion in lost revenue. A three-month suspension, similar to those proposed by S. 2890 and S. 2971, equates to $8.8 billion under these assumptions. Since the suspension period proposed in this legislation represents the peak summer driving period, it is possible that the amount forgone could be slightly higher.

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[11] There is widespread concurrence within the transportation finance community that the trust funds are in financial difficulty and that the highway account balances will be negative before the end of FY2009. The primary item of continuing debate is the point during the fiscal year at which this might occur. For a discussion of the overall financing issue, see National Surface Transportation Infrastructure Financing Commission, Interim Report, *The Path Forward: Funding and Financing Our Surface Transportation System*. Washington. February 2008. p. 11.

[12] Office of Management and Budget. Budget of the U.S. Government, Fiscal Year 2009, Appendix. Washington. 2008. p. 888 and p. 917.

Because of the manner in which federal transportation programs operate, the effects of these reductions would not become apparent in highway project spending immediately. Federal transportation programs are reimbursable programs, meaning that actual outlays only occur after work has been completed at the state or local level. The FY2009 budget predicts that the Highway Trust Fund would have an end-of-year FY2008 balance of $3 billion. If alternative funding were not provided to make up for the fuel tax holiday lost revenues, it is likely, therefore, that the Highway Trust Fund will have a negative balance at some point prior to the end of FY2008. This would not be the case for the transit account which is operating with a larger unexpended balance. At some point, the Federal Highway Administration (FHWA) would have to defer outlays for highway project reimbursement, pending the accrual of revenues to the highway account, which would be minimal until the reinstatement of the fuel taxes. It is also likely that FHWA would deem it prudent to reduce or otherwise delay the award of new obligation authority to the states (this is the authority that allows states to enter into contracts for new projects).

The programs authorized by SAFETEA are due for reauthorization at the end of FY2009. Any disruption in surface transportation funding could hasten the reauthorization debate, which was expected to take place in the first session of the 111th Congress. Reauthorization is expected to include a significant discussion about the size of the overall federal commitment to surface transportation funding and the adequacy of existing revenues. A suspension of the fuel taxes, assuming that they would be reinstated at the end of the holiday period, could raise problematic questions about the supposed sanctity of the five-decade-old link between fuel taxes and surface transportation funding. This would especially be the case if surface transportation programs were to become ever more dependent on Treasury general funds.