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SHOULD STATES SUSPEND THEIR GASOLINE TAXES?

By Nicholas Johnson

Policymakers in several states, responding to the recent sharp upturn in gasoline prices, are considering suspending state taxes on gasoline. One state, Georgia, has already done so, and other states are considering following suit. Although rising gasoline prices are a clear burden on family incomes, there are several reasons why it does not make sense to reduce this tax at this time.

- States cannot guarantee that a gasoline tax reduction will be passed along to consumers. Gasoline taxes typically are incorporated into the price of gasoline. In order for a consumer to benefit from a gas-tax reduction or suspension, an oil distributor or supplier must be willing to pass along the tax cut to consumers. There is evidence that major portions of this type of tax reduction are likely to be captured by the sellers of gasoline, not the purchasers.

- Suspension of a gasoline tax will cost states substantial revenue at a time they can little afford it. Far from receiving a windfall, current price fluctuations are costing most states money due to reduced consumption. Moreover, state and local governments are paying more themselves for gasoline to fuel school buses, police cars, ambulances and so on. The lost revenue and increased costs affect not only transportation budgets but also general fund budgets.

- Gasoline taxes are not related to the current increase in prices. In July, before the most recent price increases, less than one-fifth of the total price of a gallon of gas represented federal and state taxes; that proportion is even lower now. State gasoline taxes, in inflation-adjusted terms, have been flat or declining in recent years.

- Gasoline and other energy prices are likely to retreat from their post-Katrina high in the near future. The Congressional Budget Office reports that the pipelines for refined products have largely been restored, crude oil is coming to refineries from the strategic reserve and other countries to compensate at least in part for reduced Gulf production, and spot energy prices have begun to fall from last week's highs.

- More efficient ways of addressing increased gasoline and energy costs include expanding assistance to low-income families for increased heating and cooling costs; providing increased funds to school districts, police departments, and others to compensate for increased fuel costs; or giving direct rebates to consumers, perhaps in the form of a sales tax rebate or increased EITC, to compensate for the increased financial burden imposed by higher fuel costs.

TABLE 1: STATE GASOLINE TAX RATES AS OF JANUARY 1, 2005			
	Cents Per Gallon		**Cents Per Gallon**
Alabama	18	Montana	27
Alaska	8	Nebraska	26.3
Arizona	18	Nevada	23
Arkansas	21.5	New Hampshire	19.5
California	18	New Jersey	14.5
Colorado	22	New Mexico	18.9
Connecticut	25	New York	23.2
Delaware	23	North Carolina	26.85
Florida	14.5	North Dakota	21
Georgia	7.5	Ohio	26
Hawaii	16	Oklahoma	17
Idaho	25	Oregon	24
Illinois	20.1	Pennsylvania	30
Indiana	18	Rhode Island	31
Iowa	20.5	South Carolina	16
Kansas	24	South Dakota	22
Kentucky	17.4	Tennessee	21.4
Louisiana	20	Texas	20
Maine	25.2	Utah	24.5
Maryland	23.5	Vermont	20
Massachusetts	21	Virginia	17.5
Michigan	19	Washington	28
Minnesota	20	West Virginia	27
Mississippi	18.4	Wisconsin	29.1
Missouri	17.03	Wyoming	14
		District of Columbia	22.5

Source: Federation of Tax Administrators.

Consumers may benefit little from gasoline tax reductions. Gasoline taxes are incorporated into pump prices. If the tax is suspended, pump prices may or may not be reduced in order to pass along the full savings from a gasoline tax suspension to consumers. With the supply of gasoline relatively fixed, at least in the short term, there is very little to stop the distributors and suppliers of gasoline from reducing prices by something less than the full reduction in tax and retaining the balance in the form of increased profits. As a result, of the millions of dollars lost by states from a tax suspension, only a portion may benefit consumers. The remainder will go toward gasoline seller profits. There is some evidence this has occurred with other suspensions of state consumption

Suspending State Sales Taxes and Gross Receipts Taxes on Gasoline

A handful of states, including California, Delaware, Georgia, Hawaii, Illinois, Indiana, Kentucky, Michigan, New York, and West Virginia, levy not only a per-gallon excise tax on gasoline but also a sales or gross receipts tax which equals a percentage of the retail price. In these states, the increase in gasoline prices results in an increase in the sales-tax portion of the state's levy and, therefore, an increase in state revenue per gallon of gas. News reports suggest that the idea of suspending this tax is particular appealing to some policymakers.

Suspending a sales tax on gasoline is just as flawed an idea as suspending the per-gallon excise tax. As with an excise-tax suspension, a substantial portion of a sales-tax suspension is likely to benefit oil producers and suppliers at the expense of consumers. Moreover, any windfalls of state revenue are likely to be shortlived, as consumers adjust their consumption patterns over time. If the sales tax on gasoline raises more money, the per-gallon tax will raise less. Every additional dollar spent by consumers on gasoline is one less dollar available to be spent on other goods, including other goods subject to state sales tax. The reduction in revenue from sales tax on those other goods will further undermine any windfall.

taxes. For instance, a Florida study found that retailers recaptured some 80 percent of the benefit of a sales tax holiday for clothing by offering fewer discounts and sales than they normally would.[1]

States could seek to mandate that the full benefit of tax reductions be passed along to consumers, but this is likely to be nearly unenforceable. Because gasoline taxes fluctuate from week to week and vary from region to region, documenting the extent to which prices are reduced from what they otherwise would be is very difficult. With the exception of the most outrageous price-gouging, it will be very hard to prove that any oil producer, distributor, or retailer is pocketing some of the benefits of a tax reduction. For instance, if a state reduces gasoline taxes by 10 cents, but prices only decline 5 cents, oil companies and suppliers may plausibly argue that prices would have increased 5 cents in the absence of the tax cut, because 5-cent variations are quite common anyway. Even if gasoline prices do, in fact, decline by the full amount of the tax reduction, there is no way to guarantee that the price decline might not have occurred anyway.

Suspension of gasoline tax will cost states substantial revenue at a time they can little afford it.

Suspending gasoline taxes will cost states revenue that they can ill afford to lose. States are only just emerging from a prolonged fiscal crisis. Most states' financial reserves are at low levels, and the need for expenditures is rising as a result of several years of flat or reduced funding. Although state revenues have strengthened in recent months, it is unclear how rising oil prices or other effects from Hurricane Katrina will affect state economies and state fiscal conditions. Indeed, some states are already reporting reduced revenues from gasoline taxes because of reduced consumption. And to the extent that consumers have to maintain most of their expenditures on gasoline

[1] Richard K. Harper, Richard R. Hawkins, Gregory S. Martin, and Richard Sjolander, "Price Effects Around a Sales Tax Holiday: An Exploratory Study," *Public Budgeting & Finance*, Winter 2003.

for commuting to work and other purposes, they are likely to cut back on other purchases — reducing state and local sales tax revenues.

Although the immediate result of gasoline tax suspension in most states would be loss of funding for highways and other transportation needs, all other state expenditures may be affected over time. States that suspend their gasoline taxes may, in the short run or in the long run, seek to offset the loss of revenue in transportation funds by drawing on other sources of funding. They might raise other general taxes. They might seek to reduce other areas of public expenditures. Or they might draw on reserve funds, further weakening states' finances.

There are alternative, better-targeted ways to help consumers and communities cope with the adverse effects of rising fuel prices than suspending gasoline taxes.

Gas taxes are not causing the increase in prices. In the United States, taxes represent a small share of total prices. According to the U.S. Department of Energy, federal *and* state taxes in July 2005 represented about 19 percent of the price of gasoline; the balance represented payments to oil producers (55 percent) plus the costs of refining (18 percent) and distributing and marketing (8 percent) the gasoline. For August and September, the share going to taxes will be well below 19 percent, since most states' gas taxes are levied on a per-gallon basis and do not fluctuate with prices. Nationwide, taxes as a share of pump prices are at their lowest level in at least five years.

Gasoline tax rates in most states have changed relatively little, in nominal terms, in recent months or years, meaning that in most states they have declined in inflation-adjusted terms. From 1995 to 2003, the average state tax on a gallon of gasoline has barely changed, rising from 18.5 cents to 19.1 cents in nominal terms, an increase well below the rate of inflation. Since 2003, only 11 states have raised their gasoline taxes, and only three – North Carolina, Ohio and Pennsylvania – by more than two cents.

Gasoline prices are likely to decline in the coming weeks and months even without any change to tax rates. The Congressional Budget Office reports that spot prices for energy prices have already begun to fall, and pipelines largely have been restored. Additional petroleum is being shipped from overseas and should arrive in a few weeks. Indeed, there are initial indications that prices already are easing. The American Automobile Association reports that since a September 5 peak of $3.057 per gallon, the national average cost of gasoline has fallen by an average of one cent per day.

Better ways exist to help consumers with high energy costs. The very high gasoline prices experienced in many states in recent days result partly from the disruption to refineries and supply lines related to Hurricane Katrina. Prices are likely to decline in coming days. But the price of crude oil, which affects gasoline, natural gas and electricity prices nationwide, was unusually high even before Katrina and is likely to remain high because oil drilling operations in the Gulf of Mexico have been disrupted.

So even as the crisis of extraordinarily high gasoline prices eases over the next few days, consumers are likely to face higher-than-normal energy costs for a longer period of time, perhaps through the winter.

TABLE 2: MOTOR FUELS TAX REVENUES, APRIL 2004-MARCH 2005						
	Collections ($millions)	**Share of total state tax collections**			**Collections ($millions)**	**Share of total state tax collections**
Alabama	547.2	7.5%		Montana	209.0	12.4%
Alaska	39.6	2.5%		Nebraska	303.8	8.1%
Arizona	675.5	7.2%		Nevada	303.8	6.6%
Arkansas	464.5	7.9%		New Hampshire	137.6	6.8%
California	3,420.0	3.7%		New Jersey	541.3	2.4%
Colorado	591.0	8.1%		New Mexico	223.6	5.5%
Connecticut	450.1	3.9%		New York	532.7	1.1%
Delaware	111.9	4.4%		North Carolina	1,294.8	7.4%
Florida	2,527.6	7.5%		North Dakota	120.3	9.0%
Georgia	784.3	5.3%		Ohio	1,849.6	8.7%
Hawaii	86.9	2.0%		Oklahoma	429.7	6.5%
Idaho	229.7	8.6%		Oregon	398.9	6.3%
Illinois	1,435.7	5.5%		Pennsylvania	1,850.5	6.9%
Indiana	796.1	6.4%		Rhode Island	130.9	5.1%
Iowa	365.3	7.0%		South Carolina	481.6	6.9%
Kansas	423.0	7.8%		South Dakota	129.7	11.7%
Kentucky	406.8	4.8%		Tennessee	834.3	8.5%
Louisiana	572.0	7.3%		Texas	2,924.5	9.2%
Maine	225.8	7.6%		Utah	346.4	7.7%
Maryland	723.3	5.7%		Vermont	86.2	4.8%
Massachusetts	686.9	4.0%		Virginia	922.2	6.0%
Michigan	998.0	4.4%		Washington	968.9	6.7%
Minnesota	651.6	4.2%		West Virginia	306.7	7.8%
Mississippi	437.3	8.3%		Wisconsin	883.6	7.3%
Missouri	744.6	8.0%		Wyoming	65.9	4.1%
				Washington, D.C.	27.0	0.7%

Source: U.S. Census Bureau, Government Finances.

There are alternative, better-targeted ways to help consumers and communities cope with the adverse effects of rising fuel prices than suspending gasoline taxes. Rather than forgoing revenue through a gasoline tax reduction or hiatus, states could use the revenue in the following ways.

- States could set aside additional funds to cope with higher-than-expected home heating and cooling costs facing individuals and families, particularly those with lower incomes, as a result of high oil prices. The federal LIHEAP program provides some such funds, but these funds are limited (technically "capped appropriations") and are likely to prove inadequate.

- States could help local governments, school boards, transit agencies, and nonprofits continue to provide vital services in the face of rising oil prices. For instance, news reports indicate that school districts around the country are considering reducing school bus services, police departments are reducing patrols, and Meals on Wheels services are losing drivers due to higher gas prices. States could provide grants to schools, localities, and nonprofits targeted at offsetting these higher prices.

- States could provide direct assistance, in the form of refundable tax rebates, to targeted populations such as low- and moderate-income families, based on estimated gasoline-tax expenditures. For instance, a state might calculate that a typical family is spending $20 per person on gasoline taxes and distribute rebate checks to residents in roughly that amount. Such rebates could be administered through state income taxes; in recent years several states including Colorado, Georgia, Kansas, and Minnesota have distributed tax relief or excess revenues to consumers through such mechanisms. Or states could increase Earned Income Tax Credits or other existing tax rebates targeted toward families likely to be hardest hit. Not only would such an approach benefit the most needy families, but families that take measures to reduce their gasoline consumption would receive the same level of benefit as families that do not.