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INCREASING THE MOTOR FUELS TAX: STALLING THE ECONOMY AND FUELING HIGHER DEFICIT SPENDING

Dear Colleague:

Some Congressional leaders have recently suggested increasing the Federal gasoline tax. However, close analysis of the economic effects of gasoline tax hikes shows this policy to be ill-considered.

The attached JEC/GOP study on the gasoline tax demonstrates that each five cent per gallon increase in the Federal excise tax on gasoline would reduce real GDP by 0.15 percent, or \$6.4 billion in the first year. A fifteen cent per gallon increase would shave nearly a half a percentage point off GDP, amounting to \$19.2 billion of lost output in the first year of implementation. Over five years, this policy would destroy nearly \$100 billion of economic output, along with thousands of jobs associated with it.

Each five cent increase in the gasoline tax would eliminate over 637,000 jobs over five years. A fifteen cent gasoline tax would destroy well over 1.5 million jobs over this period. About 120,000 of these job losses would come in the auto and auto-related industries alone.

Furthermore, the net revenue gains projected from the gasoline tax are often overstated. Static revenue analysis typically ignores the negative impact of this tax on GDP, and budget effects driven by tax-induced increases in Federal COLA's usually are not considered. Consequently, congressional spending of higher gross gasoline tax receipts would actually increase the deficit by 48 cents for every dollar of gross receipts budgeted.

Finally, the regressivity of the gasoline tax is documented in this study. Consumers in the lowest income bracket would be hit four times harder than those in the highest bracket.

Please take a moment to read through this study and consider the negative economic impact of such a misguided tax increase before this proposal begins to gain momentum. While this study was prepared in the last Congress, it is still relevant, and its conclusions are conservative.

Sincerely,

A handwritten signature in cursive script that reads "Dick".

DICK ARMEY, M.C.

House Senior Republican Member
Joint Economic Committee

**INCREASING THE MOTOR FUELS TAX:
STALLING THE ECONOMY AND
FUELING HIGHER DEFICIT SPENDING**

Report by

Congressman Richard Armey, Ph.D.
(Ranking Republican Member, Joint Economic Committee)

and Joint Economic Committee Republican Staff

September 1991

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AND FUELING HIGHER DEFICIT SPENDING**

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EXECUTIVE SUMMARY

Recently the Office of Management and Budget readjusted upward its deficit projections for the year by about \$67 billion, chalking much of the misforecast up to harmless sounding "technical reestimates."

Where do these technical reestimates come from? The stork doesn't bring them in a bundle and drop them down the Capitol Dome. They are conceived in bills like the proposed five-cent gas tax increase, which, thanks to a sophomoric approach to Federal revenue estimating, could cost the government an additional 48 cents for every dollar it raises.

This analysis of the proposed gas tax, drawing on conclusions from various and widely accepted estimates of increased gasoline taxes on economic growth, employment and the Consumer Price Index (CPI), concludes:

- A five-cent per gallon increase in the Federal excise tax on gasoline would reduce real gross national product (GNP) by 0.15 percent, or \$6.4 billion in lost output for 1992, and \$32 billion in lost output over a five-year period.
- This reduction in real GNP would lower the employment level by 130,000 jobs in the first year of the tax, and 233,000 in the second year.
- The tax-related increase in the CPI would be incorporated in cost-of-living-adjustments (COLAs) for some \$700 billion in mandatory Federal spending programs, adding an estimated \$7 billion to Federal outlays over a five-year period. The impact of such increased spending has serious implications under the current budget process.
- The actual net revenue impact from the gas tax is 48 percent less than the gross receipts generated, which means every billion dollars of gross receipts spent increases the deficit by \$480 million.

This study also demonstrates what many already know intuitively: Increasing the tax on gasoline is regressive tax policy. Based on 1989 consumption patterns, the gasoline tax would hit consumers in the lowest income bracket four times harder than those in the top bracket.

RICHARD K. ARMEY
Ranking Republican
Joint Economic Committee

INCREASING THE MOTOR FUELS TAX: STALLING THE ECONOMY AND FUELING HIGHER DEFICIT SPENDING

INTRODUCTION

Advocates of a five-cent per gallon increase in the Federal gasoline and motor fuels tax assert that it would raise about \$6.5 billion annually, or \$32.4 billion over a five-year period, to invest in America's infrastructure.

These are static revenue estimates that do not take into account the impact of higher gasoline prices on the economy, nor increased Federal outlays in mandatory spending programs unrelated to transportation but tied to increases in the Consumer Price Index (CPI).

This study analyzes some of the dynamic effects of the proposed gasoline tax and their implications for the Federal budget, and also quantifies the regressive impact of the tax on low-income families.

EFFECTS ON GNP AND EMPLOYMENT

A number of econometric studies have demonstrated that imposing gas taxes reduces real gross national product (GNP), business investment, and personal consumption expenditures. These studies have estimated that a 15-cent per gallon hike in the gas tax would reduce real GNP by 0.3 to 0.7 percent annually for several years.¹ For the purposes of this analysis, we conservatively accept that a five-cent per gallon tax hike would reduce real GNP by about 0.15 percent. Though this change appears small, its implications are significant given the size of the U.S. economy. **A 0.15 percent reduction in real GNP would amount to about \$6.4 billion in lost output in 1992.**

¹ French, Mark, "Efficiency and Equity of a Gasoline Tax Increase," Finance and Economics Discussion Series, Number 33, Federal Reserve Board, July 1988; and Uri, Noel, D., and Roy Boyd, "The Potential Benefits and Costs of an Increase in U.S. Gasoline Tax," Energy Policy, pgs. 17, 356-369, August 1989.

According to a study by Data Resources, Inc. (DRI),² an 8.9-cent per gallon tax increase would result in \$69 billion of lost GNP over five years. (Although the report was produced in 1987, it provides a useful guide to the cumulative impact of a gas tax on the U.S. economy.) A conservative estimate would put the five-year impact of a five-cent tax at \$32 to 34 billion in lost GNP.

This reduction of real growth would also result in a decline in employment. Scaling of the tax increase effects under consideration here with larger tax increases analyzed by the Federal Reserve³ translates into **130,000 lost jobs in the first year of the nickel gas tax, and 233,000 in the second year.** A summary of the nickel tax's projected economic effects over a five-year period is presented in Table 1 below.

Table 1 -- Economic Effects of a Five-Cent Increase in the Motor Fuels Tax
(five-year cumulative effect)

Real GNP	Down	0.15%
Real GNP (1982 dollars)	Down	\$32 - 34 billion
Employment (person years)	Down	637,280
Consumer Price Index	Up	0.20%
Federal Spending	Up	\$8.5 billion

Source: Joint Economic Committee Republican (JEC/GOP) staff calculations.

The inelastic short-run demand in the gasoline market means that the immediate impact of the tax increase borne by gasoline producers will be modest when compared to the impact on consumers. However, over the long term, the elasticity of demand is generally considered much higher, reducing the quantity demanded by consumers much more and magnifying the negative impact on energy producers.⁴ This, of course, would entail further lost output, employment, and revenues to the Federal and state governments.

Furthermore, new taxes have different effects on various sectors of the private economy. One analysis estimated that the impact of a 15-cent increase in the gas tax would

² Yanchal, Joyce, "Closing the Deficit: An Income Tax Surcharge versus Energy Taxes," Data Resources U.S. Review, November 1987.

³ French, Mark, op.cit., pg. 32-33.

⁴ Dahl, Carol A., "Consumer Adjustment to a Gasoline Tax," The Review of Economics and Statistics, 41, 3, 427-432, August 1979.

be to reduce auto sales by several hundred thousand and eliminate 120,000 jobs in the auto and related industries.⁵ According to this measure, each five-cent rise in the gas tax could eliminate up to 40,000 auto-related jobs.

It is often argued that public works spending generates employment gains. However, this argument ignores the fact that public works spending normally crowds out other forms of economic activity and employment gains. The econometric studies reviewed here do not specifically evaluate this issue, but conclude that the damage inflicted by the gas tax more than offsets any positive results, even when revenues are dedicated to reducing the crowding-out effects of Federal deficit spending.

Unfortunately, the negative effects of new taxes on real or nominal GNP are not considered in Congressional Budget Office revenue estimates. Consequently, policy makers are less aware of the actual economic costs produced by alternative policies.

REVENUE EFFECTS

A rough determination of the revenue effects from the imposition of a gasoline excise tax is a fairly straightforward exercise. The responsiveness of the quantity demanded by consumers to changes in price, called demand elasticity, is generally considered low for gasoline in the short run. Thus, in the short run, increases in the gas tax should not lead to a significant reduction in consumer purchases of gasoline.

A mid-range estimate of the short-run elasticity of demand for gasoline would be about -0.2 to -0.3 percent.⁶ Thus every 1 percent increase in the total purchase price (gas cost plus tax) would be expected to reduce the quantity demanded by about 0.25 percent. The inelasticity of demand for gasoline makes approximate calculation of the direct impact of a gas tax relatively simple.

Estimation of the long-term revenue effects of higher gas taxes are beyond the scope of this study, but it is important to note that the dynamic response of energy producers to the new tax would generally be negative and would tend to increase unemployment relative to the short-run impact.

⁵ Whitman, Marina V.N., Letter to Federal Reserve Board Chairman Greenspan on impacts of a gasoline tax increase, March 8, 1988, in French, op.cit., p. 14.

⁶ For example, see Horwich, George, and David Leo Weimer, Oil Shocks, Market Response, and Contingency Planning, American Enterprise Institute, 1984, p. 26.

In the short run, a five-cent per gallon increase in gasoline prices would amount to a price increase of 3.75 cents per gallon after accounting for elasticity of supply and demand. Based on an average per gallon price of \$1.19, this would translate into a price increase of about 3.2 percent, according to a recent study.⁷ This 3.2 percent price increase, times the elasticity of demand of negative 0.25, results in a reduction of the quantity demanded of about 0.8 percent. Thus, the tax will induce a short-run sales decline of about one billion gallons of the 130 billion gallons that would otherwise have been purchased annually.

Of the 129 billion gallons of gasoline and diesel fuel remaining, each cent of gas tax will generate about \$1.29 billion. Since a 14.1 cent per gallon Federal excise tax already applies, \$141 million in Federal revenues is lost due to the billion gallon decrease in sales. In the short term, a five-cent gas tax should increase gross annual revenues by \$6.31 billion, after the \$141 million from lost sales is factored out. This \$6.31 billion does not factor in the lost output caused by imposition of the tax.

As noted previously, the GNP loss could easily amount to over \$6.4 billion in 1992. **Application of an average tax rate of 19.5 percent⁸ would realize a revenue loss of \$1.3 billion. Thus the net receipt effect of the gas tax is further reduced from \$6.31 billion to about \$5.0 billion.**

In the calculations above, for every \$6 raised by the gas tax, over \$1 is lost in other Federal revenues. This conclusion is supported by the DRI study, which found an even more adverse revenue impact from the gas tax.⁹ By the third year of the gas tax hike, every dollar of new gas tax revenue was offset by 65 cents in lost revenue elsewhere. These effects in the second and third years would be similar to those imposed by a new nickel tax on top of the five-cent increase enacted as part of the 1990 budget agreement. One more pessimistic study has even found that gas tax increases can "be expected to result in a negligible increase in gasoline tax revenue."¹⁰

⁷ Gelb, Bernard A., and Salvatore Lazzari, "Gasoline Excise Tax: Economic Impacts of an Increase," Congressional Research Service Issue Brief, July 12, 1991, p. 7.

⁸ An even higher rate in coming years is projected in Part 7, pg. 177 of the Budget of the U.S. Government: FY 1992.

⁹ Yanchal, Joyce, op. cit., pg. 20.

¹⁰ Talley, Wayne K., and Stanley E. Warner, Jr., "Energy Legislation and Gasoline Tax Revenue," Public Finance Quarterly, Vol. 9, No. 1, 35-46, January 1981.

BUDGET EFFECTS

One aspect of a gas tax increase virtually ignored by policy makers is its stimulation of Federal outlay growth. This effect is very important under the new budget rules established in the Omnibus Budget Reconciliation Act of 1990. Unexpected increases in spending can trigger unpredictable policy results including sequestration, tax increases, and offsetting spending cuts. An examination of the facts shows that a gas tax increase could throw the new budget process into chaos. The clumsy attempt to identify a portion of the spending on parochial projects in the current highway bill as "entitlement" spending is only one illustration of the potential problems.

The available evidence suggests that a five-cent increase in gas taxes could increase the CPI by about 0.2 percent. While this appears to be a relatively minor change, it has significant budgetary implications.

A two-tenths percent increase in the CPI would be incorporated into cost-of-living adjustments (COLA's) and other adjustments for some \$700 billion in mandatory Federal spending programs, adding \$1.4 billion annually to Federal spending, \$7 billion over five years.

In addition, other Federal spending would be affected by a measured rise in the price level, and could increase by up to \$300 million. **A total annual increase of as much as \$1.7 billion is consistent with available estimates.** Another appraisal of the budget impact was supplied by the Federal Reserve study, which found that each dollar of new gas tax revenues would directly generate 40 cents of new non-transportation spending and revenue losses. While these amounts are not trivial, their significance is magnified by the compartmentalization of spending under the new budget process. The exact effect and timing of how the new spending will flow through the various budget categories is impossible to determine. This unpredictability is virtually the only certainty, except that the amounts involved may be larger than many would expect.

The economic, revenue, and outlay effects of a five-cent gas tax are measured in the billions, and Congress recently enacted a five-cent per gallon tax increase, which took effect December 1, 1990. A new gas tax of like amount would exacerbate the budget increases, job losses, and output declines already underway.

The uncertain effect of a gas tax on the relationship between budget components has not been seriously addressed. If a gas tax results in an increase in entitlement outlays, how will these outlays be financed? **The gas tax is a fiscal time bomb which could eventually trigger another round of taxes or spending cuts.**

The revenue expected from the nickel tax is dedicated to transportation funding, and will be spent on public works projects rather than deficit reduction. **Spending the gross revenue generated without considering the tax's negative economic and budgetary effects will result in higher deficits.**

As Table 2 shows, there is a 48 percent difference between the net revenue impact and gross receipts. **As a result, every dollar of gross revenue spent on public works could add an additional 48 cents to the Federal deficit. Over five years, this spending pattern could increase the deficit by \$15 billion, not counting interest.**

Table 2 - Net Revenue Impact and Budgetary Effects

	One Year	Five Year
Gross Receipts	\$6.3 billion	\$31.5 billion
Lost Revenues	-\$1.3 billion	-\$6.5 billion
Increased Outlays	-\$1.7 billion	-\$8.5 billion
Net Revenue Impact	\$3.3 billion	\$16.5 billion
Percent Offset	48%	48%
Increase in Deficit from Spending Gross Receipts	\$3.0 billion	\$15.0 billion

Source: JEC/GOP staff calculations.

GAS TAXES AND "FAIRNESS"

Changes in Federal tax policy should be designed to lower tax barriers to the flow of resources into production so as to increase economic growth and job creation. However, some view the tax code as a vehicle for desired income redistribution. According to this point of view, the primary criterion for tax policy is the presumed impact of tax changes on various income groups.

The gas tax appears wholly undesirable from this perspective, since review of the consumption patterns of families by income quintile clearly shows that the cost of gasoline as a percentage of family income is much larger for the lower two quintiles than for the upper two.

Consider Table 3 below, based on 1989 consumption patterns (as reported in the Bureau of Labor Statistic's Consumer Expenditure Survey) before imposition of the gas tax increase enacted in the 1990 budget agreement. Gasoline and oil purchases amounted to

8.1 percent of before-tax income for the lowest fifth of households, declining to 2.1 percent of income for the top fifth of households. **In other words, the gasoline share of the household budget is four times as large for the bottom quintile as for the top quintile.**

Table 3 -- Gasoline Share of Household Budget

Income Quintile	Gasoline as a Share of Consumer Income
Lowest Fifth	8.1%
Second Fifth	5.0%
Third Fifth	4.2%
Fourth Fifth	3.2%
Top Fifth	2.1%

Source: 1989 BLS Consumer Expenditure Survey and JEC/GOP staff calculations.

The regressivity of the gasoline tax is widely known, as well as the regional disparities in its impact. **On a regional basis, the tax would fall relatively hardest on rural, Western, and Southern consumers.** To the extent that some of these areas also have disproportionate numbers of high mileage drivers and low-income households, the regressive features of the gas tax are magnified.

CONCLUSION

An extrapolation from reliable, previous analyses of the economic effects of increased gasoline taxes shows that the proposed nickel gas tax increase would retard economic growth by \$6.4 billion per year, and eliminate more than 100,000 jobs in its first year.

The impact on the Federal budget of these lost jobs and this lost GNP is substantial. The proposed gas tax increase will lose 48 cents for every dollar it generates.

Since the gross receipts from the tax are 91 percent higher than the tax's actual net revenue impact on the Treasury, every billion dollars in gas tax receipts spent on public works projects could result in a \$480 million increase in the Federal deficit.

This 91 percent overstatement of gross receipts relative to the actual net revenue impact is the type of methodological flaw that results in future adjustments to Federal deficit projections, often called "technical reestimates." It would be better if the government simply got it right the first time, rather than constantly going back and readjusting deficit forecasts ever upward.

Lastly, the tax affects low-income families much more adversely than those with high incomes, and falls relatively harder on rural, Western and Southern consumers.

This study was prepared by JEC/GOP staff: Senior Economist Chris Frenze (author) and Staff Director Edward Gillespie (editor).