September 11, 2000

Holding the Line: The Economic Case for High Fuel Taxes

by

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There is a strong economic case for high taxes on fuel. To the European protesters who are pressing for cuts in excise duty on petrol, we should just say no.

The first reason is strategic. OPEC is watching. It would be a mistake to let the cartel come to believe that if it raises the price of crude oil the western nations will capitulate to honking road-blockers by lowering tax on petrol. Once OPEC came to think that, life would become difficult for the industrial nations, and Western drivers would not gain. The oil producers' cartel would realise that it could hike the price of black gold with impunity and thereby be able, because of European politicians' fear of their voting drivers, to take more and more of consumers' cash while gradually forcing down the tax-take to European governments. Far-sighted monopolists are tricky to stop once they start.

Second, fuel is an unusually efficient thing to tax. The reason is that its demand is comparatively insensitive to price. In other words, when petrol becomes more expensive, delivery trucks taking computer chips to Edinburgh continue to do so, and Oxfordshire children being driven to school are not sentenced to the vagaries of the bus. The current best estimate is that the responsiveness of petrol demand to petrol prices is about 0.2 (meaning that a 100% rise in the price of petrol leads to a 20% decline in the amount of petrol purchased). This makes fuel an ideal thing for a government to tax. Consumers' choices are not much changed by the taxation, so, from the point of view of economic efficiency, little harm is done by the taxes.

Third, volatility in taxes is undesirable. Firms and citizens need to plan. A long-term perspective in fiscal policy is also desirable. Despite what Europe's protesters hope, this means being willing to take the rough with the smooth. Crude oil has been cheap, has been dear, and may be cheap again. Things average out. When the economy enters a boom, nobody blocks the streets to argue that now is a good time to raise the rate of income tax.

Fourth, there is an asymmetry deep in human beings – one that is well-known to every politician. Most of those who argue for lower fuel taxes would be unwilling to accept that, in their proposed world, things would have to work symmetrically. If crude petroleum falls back to $10 dollars a barrel, they will not appear on television to ask Finance Ministers to increase the duty on fuel. Tax revenue is self-evidently a price paid for publicly funded schools and hospitals. It would be possible to introduce private provision for these goods, but British sentiment has traditionally resisted doing so. Tax revenue, from somewhere, is the other side of that coin.

Fifth, fuel is special. Cars pollute. Drivers unwittingly lift the globe's temperature and worsen asthma among pedestrians. They create external effects on other people, in other words, that are not taken into account by the individual driver. Hence there is a logical case for taxing individuals more heavily in this sphere of life than in most. Strawberries and newspaper do not create bad 'externalities' for the planet. Burning gasoline does.

There is a commonly heard sixth reason. It is that a country like Britain is small and heavily congested, so taxing fuel makes sense. There is something to this argument. It is not, however, as strong as is widely presumed: people do not cut back on their driving very much even in the face of large increases in the price at the petrol pumps. It would thus be better to have road pricing (that is, tolls on roads or so-called congestion charging), because that would address the underlying congestion problem more directly. But road pricing has not yet won political support. As a second-best policy, therefore, there is a case for steep taxes on fuel, but they are not ideal and have less impact on drivers' behaviour than is traditionally hoped.

Seventh, taxing petrol is equitable. It is a progressive rather than regressive fiscal strategy. Having high excise duty on petrol penalises the rich more than the poor, and that is usually taken to be a desirable characteristic. Among those in the bottom one fifth of the income distribution of a typical European country, only a small proportion have cars. Among those in the top fifth of the income distribution, most both have access to two cars and drive long distances. There are few common goods of this sort – ones that signal where in the income distribution their buyers lie. For any government interested in creating a more equal distribution of post-tax income, therefore, fuel taxes are ethically attractive.

Eighth, oil reserves will run short during our grandchildren's lives. High taxes today slow the rate of oil depletion and thereby spread the availability of petroleum more evenly across generations. Currently the production flow of world petroleum is likely to reach its peak a little after the year 2020. Most European voters are probably unaware that oil production in the United States reached its maximum in the 1970s and since then has been steadily declining. Although reserves of world oil are large, an engineer called Hubbert famously pointed out that the flow from an oilfield actually peaks many decades before the last drop of the reserve is extracted.

Each day, the world economy burns 70 million barrels of liquid black energy, and 10 million of those go to America's drivers. Europe can choose a different road.