

The Net-Zero Gas Tax

A once-in-a-generation chance.

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Americans have a deep and understandable aversion to gasoline taxes. In a culture more single-mindedly devoted to individual freedom than any other, tampering with access to the open road is met with visceral opposition. That's why earnest efforts to alter American driving habits take the form of regulation of the auto *companies*--the better to hide the hand of government and protect politicians from the inevitable popular backlash.

But it's not just love of the car. America is a nation of continental expanses. Distances between population centers can be vast. The mass-transit mini-car culture of Europe just doesn't work in big sky country.

This combination of geography and romance is the principal reason gas taxes are so astonishingly low in America. The federal tax is 18.4 cents per gallon. In Britain, as in much of Europe, the tax approaches \$4 per gallon--more than 20 times the federal levy here.

Savvy politicians (i.e., those who succeed in getting themselves elected president) know this and tread carefully. Ronald Reagan managed a 5-cent increase. So did Bush 41. Bill Clinton needed a big fight to get a 4.3-cent increase. The lesson has been widely learned. No one with national ambitions proposes a major gas tax. Indeed, this summer featured the absurd spectacle of two leading presidential candidates (John McCain and Hillary Clinton) seriously proposing a temporary gas tax *suspension*.

Today's economic climate of financial instability and deepening recession, moreover, makes the piling on of new taxes--gasoline or otherwise--not just politically unpalatable but economically dubious in the extreme.

So why even think about it? Because the virtues of a gas tax remain what they have always been. A tax that suppresses U.S. gas consumption can have a major effect on reducing world oil prices. And the benefits of low world oil prices are obvious: They put tremendous pressure on OPEC, as evidenced by its disarray during the current collapse; they deal serious economic damage to energy-exporting geopolitical adversaries such as Russia, Venezuela, and Iran; and they reduce the enormous U.S. imbalance of oil trade which last year alone diverted a quarter of \$1 trillion abroad. Furthermore, a reduction in U.S. demand alters the balance of power between producer and consumer, making us less dependent on oil exporters. It begins weaning us off foreign oil, and, if combined with nuclear power and renewed U.S. oil and gas drilling, puts us on the road to energy independence.

High gas prices, whether achieved by market forces or by government imposition, encourage fuel economy. In the short term, they simply reduce the amount of driving. In the longer term, they lead to the increased (voluntary) shift to more fuel-efficient cars. They render redundant and unnecessary the absurd CAFE standards--the ever-changing Corporate Average Fuel Economy regulations that mandate the fuel efficiency of various car and truck fleets--which introduce terrible distortions into the market. As the consumer market adjusts itself to more fuel-efficient autos, the green car culture of the future that environmentalists are attempting to impose by decree begins to shape itself unmandated. This shift has the collateral

environmental effect of reducing pollution and CO2 emissions, an important benefit for those who believe in man-made global warming and a painless bonus for agnostics (like me) who nonetheless believe that the endless pumping of CO2 into the atmosphere cannot be a good thing.

These benefits are blindingly obvious. They always have been. But the only time you can possibly think of imposing a tax to achieve them is when oil prices are very low. We had such an opportunity when prices collapsed in the mid-1980s and again in the late 1990s. Both opportunities were squandered. Nothing was done.

Today we are experiencing a unique moment. Oil prices are in a historic free fall from a peak of \$147 a barrel to \$39 today. In July, U.S. gasoline was selling for \$4.11 a gallon. It now sells for \$1.65. With \$4 gas still fresh in our memories, the psychological impact of a tax that boosts the pump price to near \$3 would be far less than at any point in decades. Indeed, an immediate \$1 tax would still leave the price more than one-third below its July peak.

The rub, of course, is that this price drop is happening at a time of severe recession. Not only would the cash-strapped consumer rebel against a gas tax. The economic pitfalls would be enormous. At a time when overall consumer demand is shrinking, any tax would further drain the economy of disposable income, decreasing purchasing power just when consumer spending needs to be supported.

What to do? Something radically new. A net-zero gas tax. Not a freestanding gas tax but a swap that couples the tax with an equal payroll tax reduction. A two-part solution that yields the government no net increase in revenue and, more importantly--that is why this proposal is different from others--immediately renders the average gasoline consumer financially whole.

Here is how it works. The simultaneous enactment of two measures: A \$1 increase in the federal gasoline tax--together with an immediate \$14 a week reduction of the FICA tax. Indeed, that reduction in payroll tax should go into effect the preceding week, so that the upside of the swap (the cash from the payroll tax rebate) is in hand even before the downside (the tax) kicks in.

The math is simple. The average American buys roughly 14 gallons of gasoline a week. The \$1 gas tax takes \$14 out of his pocket. The reduction in payroll tax puts it right back. The average driver comes out even, and the government makes nothing on the transaction. (There are, of course, more drivers than workers--203 million vs. 163 million. The 10 million unemployed would receive the extra \$14 in their unemployment insurance checks. And the elderly who drive--there are 30 million licensed drivers over 65--would receive it with their Social Security payments.)

Revenue neutrality is essential. No money is taken out of the economy. Washington doesn't get fatter. Nor does it get leaner. It is simply a transfer agent moving money from one activity (gasoline purchasing) to another (employment) with zero net revenue for the government.

Revenue neutrality for the consumer is perhaps even more important. Unlike the stand-alone gas tax, it does not drain his wallet, which would produce not only insuperable popular resistance but also a new drag on purchasing power in the midst of a severe recession. Unlike other tax rebate plans, moreover, the consumer doesn't have to wait for a lump-sum reimbursement at tax time next April, after having seethed for a year about government robbing him every time he fills up. The reimbursement is immediate. Indeed, at its inception, the reimbursement *precedes* the tax expenditure.

One nice detail is that the \$14 rebate is mildly progressive. The lower wage earner gets a slightly greater percentage of his payroll tax reduced than does the higher earner. But that's a side effect. The main point is that the federal government is left with no net revenue--even temporarily. And the average worker is left

with no net loss. (As the tax takes effect and demand is suppressed, average gas consumption will begin to fall below 14 gallons a week. There would need to be a review, say yearly, to adjust the payroll tax rebate to maintain revenue neutrality. For example, at 13 gallons purchased per week, the rebate would be reduced to \$13.)

Of course, as with any simple proposal, there are complications. Doesn't reimbursement-by-payroll-tax-cut just cancel out the incentive to drive less and shift to fuel-efficient cars? No. The \$14 in cash can be spent on anything. You can blow it all on gas by driving your usual number of miles, or you can drive a bit less and actually have money in your pocket for something else. There's no particular reason why the individual consumer would want to plow it all back into a commodity that is now \$1 more expensive. When something becomes more expensive, less of it is bought.

The idea that the demand for gasoline is inelastic is a myth. A 2007 study done at the University of California, Davis, shows that during the oil shocks of the late 1970s, a 20 percent increase in oil prices produced a 6 percent drop in per capita gas consumption. During the first half of this decade, demand proved more resistant to change--until the dramatic increases of the last two years. Between November 2007 and October 2008, the United States experienced the largest continual decline in driving history (100 billion miles). Last August, shortly after pump prices peaked at \$4.11 per gallon, the year-on-year decrease in driving reached 5.6 percent--the largest ever year-to-year decline recorded in a single month, reported the Department of Transportation. (Records go back to 1942.) At the same time, mass transit--buses, subways, and light rail--has seen record increases in ridership. Amtrak reported more riders and revenue in fiscal 2008 than ever in its 37-year history.

Gasoline demand can be stubbornly inelastic, but only up to a point. In this last run-up, the point of free fall appeared to be around \$4. If it turns out that at the current world price of \$39 a barrel, a \$1 tax does not discourage demand enough to keep the price down, we simply increase the tax. The beauty of the gas tax is that we--and not OPEC--do the adjusting. And that increase in price doesn't go into the pocket of various foreign thugs and unfriendlies, but back into the pocket of the American consumer.

What about special cases? Of course there are variations in how much people drive. It depends on geography, occupation, and a host of other factors. These variations are unavoidable, and in part, welcome. The whole idea is to reward those who drive less and to disadvantage those who drive more. Indeed, inequities of this sort are always introduced when, for overarching national reasons, government creates incentives and disincentives for certain behaviors. A tax credit for college tuition essentially takes money out of the non-college going population to subsidize those who do go--and will likely be wealthier in the end than their non-college contributors. Not very fair. Nonetheless, we support such incentives because college education is a national good that we wish to encourage. Decreased oil consumption is a similarly desirable national good.

There will certainly be special cases, such as truck drivers and others for whom longer distance driving is a necessity that might warrant some special program of relief. That would require some small bureaucracy, some filings for exemption or rebate, and perhaps even some very minor tweak of the gas tax (say, an extra penny or two beyond the dollar). But that's a detail. Most people can drive less. They already do.

Why a \$1 tax? Because we need a significant increase in the cost of gasoline to change our habits--or, more accurately, maintain the new driving habits and auto purchase patterns that have already occurred as a result of the recent oil shock. We know from the history of the 1980s and 1990s that these habits will be undone and unlearned if gasoline remains at today's amazingly low price. In the very short time that prices have been this low, we have already seen a slight rebound in SUV sales. They remain far below the level of last year--in part because no one is buying anything in this recession, and in part because we have not fully recovered from the psychological impact of \$4 gasoline. We are not quite ready to believe that gas will

remain this low. But if it does remain this low, as the night follows day, we will resume our gas-guzzling habits.

It might therefore be objected that a \$1 gasoline tax won't be enough. If \$4 was the price point that precipitated a major decrease in driving and a collapse of SUV sales, an immediate imposition of a \$1 gas tax would only bring the average price to \$2.65.

To which I have two answers. First, my preliminary assumption is that it takes \$4 to break the habit of gas-guzzling profligacy. But once that is done, it might take something less, only in the range of \$3, to maintain the new habit. It may turn out that these guesses are slightly off. The virtue of a gas tax is that these conjectures can be empirically tested and refined, and the precise amount of the tax adjusted to consumer response.

Second, my personal preference would be a \$1.25 tax today (at \$1.65 gasoline) or even a \$1.50 tax if gas prices begin to slide below \$1.50--the target being near-\$3 gasoline. (The payroll tax rebate would, of course, be adjusted accordingly: If the tax is \$1.50, the rebate is \$21 a week.) The \$1 proposal is offered because it seems more politically palatable. My personal preference for a higher initial tax stems from my assumption that the more sharply and quickly the higher prices are imposed, the greater and more lasting the effect on consumption.

But whatever one's assumptions and choice of initial tax, the net-zero tax swap remains flexible, adjustable, testable, and nonbureaucratic. Behavior is changed, driving is curtailed, fuel efficiency is increased, without any of the arbitrary, shifting, often mindless mandates decreed by Congress.

This is a major benefit of the gas tax that is generally overlooked. It is not just an alternative to regulation; because it is so much more efficient, it is a killer of regulation. The most egregious of these regulations are the fleet fuel efficiency (CAFE) standards forced on auto companies. Rather than creating market conditions that encourage people to voluntarily buy greener cars, the CAFE standards simply impose them. And once the regulations are written--with their arbitrary miles-per-gallon numbers and target dates--they are not easily changed. If they are changed, moreover, they cause massive dislocation, and yet more inefficiency, in the auto industry.

CAFE standards have proven devastating to Detroit. When oil prices were relatively low, they forced U.S. auto companies to produce small cars that they could only sell at a loss. They were essentially making unsellable cars to fulfill mandated quotas, like steel producers in socialist countries meeting five-year plan production targets with equal disregard for demand.

Yet the great 2008 run-up in world oil prices showed what happens without any government coercion. As the price of gas approached \$4 a gallon, there was a collapse of big-car sales that caused U.S. manufacturers to begin cutting SUV production and restructuring the composition of their fleets. GM's CEO, for example, declared in June, "these prices are changing consumer behavior and changing it rapidly," and announced the closing of four SUV plants and the addition of a third shift in two plants making smaller cars.

Which is precisely why a gas tax would render these government-dictated regulations irrelevant and obsolete. If you want to shift to fuel-efficient cars, don't mandate, don't scold, don't appeal to the better angels of our nature. Find the price point, reach it with a tax, and let the market do the rest.

Yes, a high gas tax constitutes a very serious government intervention. But it has the virtue of simplicity. It is clean, adaptable, and easy to administer. Admittedly, it takes a massive external force to alter behavior and tastes. But given the national security and the economic need for more fuel efficiency, and given the leverage that environmental considerations will have on the incoming Democratic administration and

Democratic Congress, *that change in behavior and taste will occur one way or the other*. Better a gas tax that activates free market mechanisms rather than regulation that causes cascading market distortions.

The net-zero gas tax not only obviates the need for government regulation. It obviates the need for government spending as well. Expensive gas creates the market for the fuel-efficient car without Washington having to pick winners and losers with massive government "investment" and arbitrary grants. No regulations, no mandates, no spending programs to prop up the production of green cars that consumer demand would not otherwise support. And if we find this transition going too quickly or too slowly, we can alter it with the simple expedient of altering the gas tax, rather than undertaking the enormously complicated review and rewriting of fuel-efficiency regulations.

Then there are the so-called externalities: national security, balance of payments, and the environment. The most important of these is national security. In July, when gasoline was at \$4, a full \$3 was going to the oil producer. (On average thus far this year, 70 percent of pump prices went to pay for the crude.) And God in his infinite wisdom has put oil in many unfortunate places. The American people understand that these dollars were going out of the U.S. economy and into the treasuries of Hugo Chávez, Vladimir Putin, the Iranian mullahs (indirectly, since the oil is fungible), and various other miscreants.

The point of a high U.S. gas tax is to suppress domestic demand and thus suppress the world price. Low world prices are a huge blow to overseas producers, particularly ones with relatively large populations, nationalized industries that are increasingly inefficient, and budgetary obligations built on the expectation of a continuing energy bonanza. Countries such as Russia, Venezuela, and Iran.

A UBS analysis estimates that Iran and Venezuela need \$90 oil to balance their budgets. And at \$70, according to Russian finance minister Alexei Kudrin, Russia goes into deficit. It is now draining the reserves built up during the fat years. At current oil prices, Russia will soon become a debtor nation. The World Bank's lead economist for Russia, Zeljko Bogetic, said on December 19 that at \$30 a barrel, "financing constraint would become so sharp that it's possible even to envisage Russia's return from a creditor to international organizations to [that of] a borrower." This will be a far humbler Russia than the one that invaded Georgia, built a nuclear reactor in Iran, threatens Poland and the Czech Republic, and is reestablishing naval bases in such former Soviet satellites as Syria.

The Russian navy just made calls in Nicaragua and Cuba. It has conducted joint exercises with Venezuela in an open challenge to America. These are, as yet, not serious threats. But with a stronger Russia and Venezuela, they could be. The projection of power is very expensive, as Americans very well know. Oil at \$39 would simply starve Russia and Venezuela of the means to sustain this adventurism.

Similarly Iran, which is already under sanctions, already suffering high inflation, already the subject of popular discontent over corruption and economic mismanagement. All this was cushioned by high oil prices. They allowed the Islamic republic to act like the regional superpower, giving military and financial support to Hezbollah in Lebanon, Hamas in Gaza, "special groups" and Sadrists militias in Iraq, and various other terrorists. And, of course, oil revenues permit the continued large-scale operation of Iran's nuclear weapons development program.

Of all the instruments of foreign policy, military and diplomatic, that we have at our disposal against these adversaries, none is as powerful as \$39 (or less) oil. It makes power projection by these regimes far more expensive and difficult. And even more profoundly, if world oil prices remain this low for a significant period of time, the very stability of the regimes in Russia, Venezuela, and Iran will be jeopardized--increasing the possibility of regime change without the expenditure of a single U.S. defense dollar and without the risk of a single U.S. soldier.

Not all oil exporters are adversaries. But many are indifferent to the economic repercussions of high world prices on the American consumer and the American economy. Three of the last four global recessions were preceded--and significantly precipitated--by major oil price spikes. Suppressing the world price through the help of a high U.S. gas tax weakens these producers and makes far more problematic their periodic attempt to extort yet more revenue from us by means of cartel-wide production cuts. Combined with reduction of our overall oil importation, that significantly reduces our dependence on--and our helplessness in the face of--their production decisions. It reduces the power of OPEC over oil prices, and thus over our economic life. And it constitutes the beginning of energy independence--particularly if coupled with increased production of various kinds at home. (But that's another subject.)

We underestimate our power. Of course, the slump in China and other rapidly growing economies has contributed to the current extreme price collapse. But China consumes only 9 percent of the world's oil. The United States consumes 24 percent. On the other hand, Saudi Arabia produces 13 percent of the world's oil. We don't generally see ourselves as the Saudi Arabia of oil consumers, but we are. The Saudis have the most effect on the world price because they are the swing producer. We are, in effect, the swing consumer. And since oil peaked earlier this year, we are consuming less. October was yet another month of record year-on-year decline of gasoline consumption in the United States. And that's just the immediate effect, before the long-term impact of changes in our automobile fleet can take hold. And that long-term change will only occur if we keep the domestic price high.

The further advantage of keeping it artificially high by means of a tax is that it keeps a large part of the money paid at the pump at home in the U.S. economy. Last year, we sent \$246 billion to foreign countries to pay for oil. With oil fetching a price today more than 70 percent below its peak, billions that just this summer were going overseas are now getting pumped back into the U.S. economy. This does not just look pretty on our trade balance sheet. It helps protect the dollar by reducing the number of dollars that would otherwise be held abroad, often by countries whose attitude towards America is ambivalent, if not hostile.

And finally there is the environmental effect. If anthropogenic global warming is real, a reduction in driving and increase in fuel-efficiency is an unvarnished good. If anthropogenic global warming is as yet unproved, as I happen to believe, then the reduction in CO2 pumped into the atmosphere is a reasonable bet in conditions of uncertainty.

Prudence would suggest taking modest steps. Politics makes such steps imperative. Whatever the scientific truth, climate change has become dogma in the West. In the schools, it is already a religion. Public policy is shaped not by scientific reality but by public perceptions. The environmental movement not only has hegemony in the media. Its political party is now in control of the U.S. executive and the legislature. They will see to it that actions are taken to reduce greenhouse gases.

We therefore have a choice. These measures can either be radical and economically ruinous, such as renewed moratoria on oil and gas drilling, the effective abolition of the coal industry, forced production of green cars that have no market and are so economically unviable that they will ruin the companies that make them. (The Chevy Volt will go 40 miles on a charge and cost about \$35,000 *after* a required \$7,500 government rebate. A real winner.) Or we can do it sensibly. Curtail oil consumption and encourage fuel-efficient technologies by means of a net-zero gas tax. It would reduce pollution and CO2 emissions at no economic cost. If we can do environmentally sensible things, particularly ones that will have overwhelming economic and national security advantages, why not pocket the environmental gains, and obviate the need for more extreme alternatives?

I am not a car hater. It is a wondrous source of connectedness, convenience, and individual freedom. But it has its social costs, its externalities. If we can control these fairly painlessly by keeping the price of gas relatively high--though lower than what it was just a few months ago--we can gain this subsidiary benefit

of prophylactic environmental action. Again, without mandates, without massive bureaucracies, and with a host of collateral benefits.

In our current economic crisis, there is but a single silver lining--the collapse of world oil prices. This in turn is already stimulating a struggling economy, helping our balance of payments, humbling OPEC, and weakening our adversaries. When economic conditions improve, and oil consumption and prices rise again, these benefits will evaporate precisely as they have time and again since the first oil shock of 1973. A time of \$1.65 gasoline is our chance to enact a net-zero gas tax. It is a once in a generation opportunity that we cannot afford to miss.

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