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Article

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CESifo Forum

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Suggested Citation: Hoel, Michael (2000) : Should taxes be reduced to offset a higher oil price (Pro and contra) : contra - taxes on motor fuel should not be reduced, CESifo Forum, ISSN 2190-717X, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 01, Iss. 4, pp. 22-

This Version is available at:

<https://hdl.handle.net/10419/166064>

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CONTRA: TAXES ON MOTOR FUEL SHOULD NOT BE REDUCED

BY MICHAEL HOEL*

Last summer and fall prices on motor fuel (gasoline and motor diesel) rose sharply in most countries, as a consequence of the increase in the international price of oil. In several countries this led to large demonstrations, blockades etc by truck drivers and to some extent by drivers of private cars. Since the international price of oil is more or less beyond the control of the consuming countries, the protests were directed towards the level of taxes on motor fuel, which constitute a large portion of the total price of fuel in most countries. Put simply, there was a strong pressure on politicians to reduce these taxes as a response to the increase of the international price of oil. However, there are good reasons for politicians to resist this pressure.

There are at least two reasons why taxes on motor fuel should not be reduced as a response to an increased international price of oil. The first reason is that a tax should only be reduced if it is found to be "too high" compared with other taxes. The economic justification for a tax on motor fuel is partly that it is a "good" tax from a fiscal point of view, and partly that it is used to correct for various types of externalities in road traffic. The externalities from road traffic include air pollution (CO₂ and local air pollution), increased accident risk to other road users, increased congestion to other road users, and increased road maintenance expenditures. Ideally, most of these externalities should be taken care of through road user charges, more directly aimed at the externalities than via a tax on the use of motor fuel. In the absence of other road user charges, however, a tax on motor fuel is an obvious policy instrument to use in order to correct (although imperfectly) for these externalities.

It is by no means obvious that taxes on motor fuel are at the "correct" level from an efficiency point

of view. However, whatever this level is, there is no reason to believe that it declines as the international price of oil goes up. As David Newbery has pointed out¹, the tax on motor fuel should, if anything, be *higher* the higher the international price of oil is. The reason for this is that several of the externalities depend on the distance driven, and not directly on the use of fuel (accident risk, congestion, road maintenance). In the long run an increased international price of fuel will lead to more fuel-efficient motor vehicles, thus making the distance driven per unit of fuel increase. To keep the cost per km driven constant, the tax per liter of fuel must therefore increase.

The second reason why taxes on motor fuel should not be reduced when oil prices go up has to do with the determination of the international price of oil. If OPEC were a profit maximizing cartel, we know from textbook economics that the price this cartel would set is higher the lower is the price elasticity for crude oil. Even if OPEC is a more complex organization than a textbook cartel, there is good reason to believe that the price elasticity for crude oil plays an important role in the determination of the international price of oil. If taxes on motor fuel (and perhaps also on other oil products) are reduced as a response to an increase in the price of crude oil, this will imply that the prices that consumers face on oil products will rise less than they would have had taxes remained unchanged. This in turn means that the demand for oil products and therefore indirectly for crude oil will go down by less than it would have had taxes remained unchanged. In other words, the reduction in taxes on oil products implies a lower price elasticity for crude oil than if taxes were constant (or increased). If major oil importing countries follow a policy of reducing their taxes on oil products when crude oil prices increase, the international price of oil will thus be higher than if taxes were held constant. A policy of reducing taxes on oil products as a response to higher crude oil prices is therefore not in the interest of consumers in the oil-importing countries.

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¹ "Should carbon taxes be additional to other transport fuel taxes?", *The Energy Journal* 13, 1992, pp. 49–60.

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