

Suspending the Fuels Tax: Be Careful What You Wish For

President Trump has asked Congress to suspend federal fuels taxes temporarily in order to lower prices paid by drivers at the pump. Unfortunately, doing so probably won't produce the desired result, but energy companies certainly won't object. Here's why.

Refresher from Econ 101. The supply of fuels is an increasing function of the price received by suppliers excluding fuels taxes:

$$\log(S) = a \log(P)$$

where a is the price elasticity of supply. The demand for fuels is a decreasing function of the retail price paid at the pump including fuels taxes:

$$\log(D) = b \log(P(1 + t))$$

where b is the price elasticity of demand. Solve for the market-clearing retail price (i.e., the price at which supply equals demand, or $S = D$) and then differentiate:

$$\Delta \log(P(1 + t)) \approx \left(\frac{a}{a + b} \right) \Delta t$$

If supply is inelastic in the near-term ($a = 0$), as is almost certainly the case now with the Straits of Hormuz closed and gasoline stocks near historic lows, then the retail price including fuels taxes remains unchanged if the tax is eliminated because the price received by suppliers gets bid up by an offsetting amount. The \$37 billion (annual rate) of revenue currently collected by the Treasury instead accrues to energy companies.

Ironically, this is the same logic (just reversed in direction) that the Administration has used to argue that an increase in tariffs won't lead to higher consumer prices but instead will be pushed back onto lower prices of imports.