A WISCONSIN POLICY RESEARCH INSTITUTE REPORT:

THE TRUTH BEHIND WISCONSIN'S OIL COMPANY TAX:

Why You'll Pay More at the Pump

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TABLE OF CONTENTS:

EXECUTIVE SUMMARY

Last February, in his speech before the full Legislature, Governor Doyle unveiled a plan to give all Wisconsin drivers a free lunch. The centerpiece of his transportation budget was a new tax on oil companies, a tax that would pump $272 million into the state treasury in the coming two years. That's $272 million, and not a dime of it will come from anyone in Wisconsin. According to the Governor, we will have miles of new roads, the potholes in the old ones will be smoothed and state government will be able to pay off some debt. The free lunch will be paid by the oil companies. They will be stuck with the bill and they will not be permitted to pass it on in the form of higher pump prices.

Of course, that is not what will happen. The reality is laid out in this report. It details how the new tax, if approved by the Legislature, will indeed be paid by Wisconsin motorists.

Just sixteen months ago Governor Doyle signed a bill erasing indexing of the Wisconsin gas tax from state law. This year that change is saving motorists one cent per gallon. Now along comes this new gross receipts tax and those same motorists will see the pump price of gas increase by five cents per gallon, beginning this fall. The new tax will raise the gas tax five times what the old indexing system would have.

This report examines this proposed new tax from a variety of perspectives all of which suggest the new tax simply cannot work in the way the Governor has described. The report includes an economic refresher showing that, if the no-pass-through feature stays, markets will adjust to the added cost and pump prices will rise. There is nothing nefarious about this phenomenon; it is the way a free market works.

The report also identifies the no-pass-through feature for what it is: a cost control. The federal government and a few states have tried to control the price of gasoline. In every instance, the results were the opposite of what was intended. Most recently, Hawaii scrapped its cost control after just eight months when it discovered that prices were actually higher after the controls were implemented than they were before.

A legal review shows that the new tax is built on shaky legal ground. Similar no-pass-through provisions have been found to be a violation of the Commerce Clause of the U.S. Constitution.

Finally, the report notes that the staff at the Department of Revenue warned that, "The Department's auditors may have no rational basis to isolate the cause of price increases as the oil company assessment (the gross receipts tax)." Implementing the no-pass-through provision will prove to be nearly impossible.

This tax should be called what it is – a five cent increase in the gas tax. That is the reality that should frame the debate in the Legislature. The no-pass-through provision, with its promises of jailed oil company executives and cheap gasoline, should have no place in a serious discussion of transportation finance.

INTRODUCTION

After having handily won reelection last November, Governor Doyle, surrounded by his budget team, turned his attention to the next two-year budget. In his East Wing office, he dispatched hundreds of fiscal and policy decisions that would eventually fit within the covers of his budget book he delivered to the Legislature. Compared to the previous two budgets Governor Doyle had prepared, this budget had a little breathing room. The revenue forecast showed state revenues growing by 6.8% over the next two years.

Yet, as the Governor and his top advisors buttoned down decision after decision, one stubborn problem remained. There was a gaping hole in the transportation budget. This was hardly a surprise since it was a hole Governor Doyle and the Legislature created in previous budgets. They had used $1.1 billion from the transportation fund to cover shortfalls in the general fund and had backfilled the transportation fund by issuing debt.

The hole in the transportation fund presented both a fiscal and a political challenge for the Governor. Fiscally, the gap was too large to be finessed with a transfer of one-time funding or a technical adjustment. There simply had to be more money added, which led to the Governor's political problem. The logical source of transportation funding is the gas tax, but gas tax increases are always a dicey proposition. An increase now would be a particularly tough sell since, just over a year ago, the Governor and the Legislature had repealed the indexing of the gas tax. Rather than increasing every April 1 as had been the case for twenty-two years, the tax would remain fixed at 30.9 cents per gallon. How could he act so soon to increase the hated gas tax?

To solve this dilemma, Governor Doyle turned to the unlikeliest of sources, Tommy Thompson. What was Governor Doyle's solution? He borrowed a long forgotten idea from the playbook of Governor Thompson. In spite of the fact that the two men have never been close, Governor Doyle followed Governor Thompson's lead and turned to a gross receipts tax on oil companies to resolve a shortfall in the transportation fund. Governor Thompson's gross receipts tax was removed by the Legislature. Removing Governor Doyle's gross receipts tax may prove more difficult for the current Legislature.

In a bold political move, Governor Doyle announced that he would force the oil companies to eat his 2.5% gross receipts tax. When the Governor delivered his budget and announced his new oil company tax, he cast it as an initiative that was pro-consumer. He decried the gas tax increases and toll roads that governors in other states had served up. In fact, giving the Wisconsin taxpayers a "refund" is how Governor Doyle portrayed the new tax. The state would get miles of smooth new roads and the taxpayers wouldn't pay a dime. Big oil companies would be forced to cover the cost entirely out of their profits. To ensure that the tax would not be passed on, the Governor included criminal penalties for companies caught adding the tax to the pump price. In that one stroke, the Governor had solved both his fiscal and his political problem.

This report puts the gross receipts tax and its no-pass-through feature under a microscope. Has the Governor found a way to create a tax that will not affect consumers? According to basic economic theory he has not. According to the courts he has not. And even according to the Wisconsin Department of Revenue he has not.

What Governor Doyle has done is to propose a tax that will be almost certainly be passed on to consumers. The bad news to the motoring public is that the new tax will add five cents to the price of a gallon of gas beginning this fall. This far surpasses the one cent increase they would have paid under indexing.

This report will explain the budget hole the Governor's new tax is intended to fill. Further, the report will detail why, in spite of the way the new tax has been portrayed, it will indeed show up at the pump. The analysis here might surprise a few people who have been promised the ultimate free lunch, as well as those who might have been looking forward to "sticking it" to big oil.

Of course, the new tax will only become law if the Legislature agrees with the Governor and leaves the new tax in the budget. But will the tax be included in the bill sent to the Governor later this summer? The options available to the Legislature are:

- Eliminate the tax and cut spending commensurately;
- Enact a traditional gas tax increase to support the level of spending in the Governor's budget; or
- Cobble together short-term funding and push the ultimate solution off to a future budget.

It will be interesting to watch as the Legislature grapples how to fund the transportation budget. Clearly the fact that the tax will add five cents to the pump price should influence their deliberations.

THE BUDGET DILEMMA

The focus of this report, Governor Doyle's proposed 2.5% tax on the gross receipts of oil companies, is estimated to produce $272 million of new revenue in the coming two-year budget. Is that significant in the context of the overall transportation budget and why is the new money so necessary? Those two questions will be addressed in this section. As to the importance of the new revenue, suffice it to say that without the revenues from the tax, the budget would be significantly unbalanced. And the imbalance would affect the general fund as well as the transportation fund.

In order to understand the need for the money from the new tax, it is necessary to go back four years - since the budgeting decisions made over the past two biennia have created the need for new revenue in the current proposed budget. At the center of the Governor's budget dilemma stands the transportation fund. For four years the transportation fund has been used to make up for shortages in the general fund. This time, as the Governor prepared his two-year budget plan for the 2007-09 biennium, he likely recognized that the overextended transportation fund could not be relied upon to supplement the general fund. More importantly, if he wanted to accomplish his transportation agenda it would be necessary to add significant revenues to the fund.

<u>The 2003-05 Budget</u>

Let's back up and look at what caused the current shortfall in the transportation fund. The transportation fund is one of several segregated funds within the state budget. The segregated nature of the fund means that transportation revenues and expenses are not to be commingled with the general fund. The principle behind keeping these funds separate is that transportation users, mostly drivers, are assured that their user fees are to be used exclusively for transportation purposes. For decades there was a fiscal brick wall between the transportation fund and the general fund. Rarely was there movement of dollars or expenses between the two funds. However, four years ago, in constructing the 2003-05 budget, the Governor and the Legislature effectively replaced that brick wall with something akin to a tennis net. For the past four years, revenues and expenses have flowed freely between the two funds.

In 2003, Governor Doyle entered office while state finances were still reeling from the effects of the 2001 recession. Also pinching the state budget was the full effect of a tax cut package which was phased-in between 2001 and 2003. Overall, the new governor was welcomed to the East Wing of the Capitol with a $3.2 billion mismatch between revenues and spending.

His first budget was marked by some significant cuts, including a $250 million reduction in the University of Wisconsin budget and eliminating the requirement to pay for 2/3 of local school costs. In order to avoid even deeper cuts, the Governor and the Legislature turned to the transportation fund. The budget Governor Doyle signed into law included a $675 million transfer of transportation revenues to the general fund, including $400 million for shared revenue payments to local government and $100 million for school aids.

To mitigate the impact that this transfer would have on transportation projects, the Governor and the Legislature significantly increased the degree to which highway construction and rehabilitation costs were debt financed. Table 1 shows the new bonding authorized in that budget.

Table1

New Transportation Bonding in the 2003-05 Budget

2005 Budget	**Bonding Authorization**
Major Highway Development	$342,516,400
State Highway Rehabilitation	$860,000,000
Assembly Bill 602 Reduction	-$434,519,600
Total New Bonding	$767,996,800

Source: Legislative Fiscal Bureau Comparative Summary of Budget Provisions Enacted as 2003 Act 33

The move to increasingly rely on debt to finance road projects did not thrill the road builders. The road building community has historically advocated a conservative use of debt financing and they made their displeasure known. The Executive Director of the Transportation Development Association of Wisconsin, in discussing the 2003 budget as initially introduced, predicted the transportation fund would be "devastated" after 2005. He referred to Governor Doyle's plan to bond for portions of the rehabilitation fund "unprecedented," and said the proposal went against the Governor's promise not to bond for day-to-day operations. "Rehab is an everyday operation for transportation. There's never been bonding for rehabilitation," he said.[1]

The Governor's Secretary of Transportation felt compelled to articulate the pragmatics of budgeting. He emphasized that the focus of the administration was getting through the next two years. The future," he said, "can wait." "The Governor's philosophy, and our philosophy, is let's fix this now," said the Secretary. "We'll face what we have to face in the next biennium. I think that's a sound strategy to have economically."[2]

When the budget was signed, the Governor and legislators alike hailed the tough job they had done in closing a seemingly insurmountable budget gap. Little note was made about the hole that was building in the transportation budget. Also not mentioned at the time was the expenses that had been pushed off into the future. When work began on the next two-year budget, it became apparent that once again the general fund would have insufficient revenues to support the ongoing spending needs.

The 2005-07 Budget:

While the subsequent 2005-07 biennial budget was slightly less contentious, the state entered the biennium facing a deficit largely due to the use of one-time money (including transportation revenue) in the previous budget. By this time, the Governor and the Legislature had conquered whatever shyness they might have had about dipping into the transportation fund. In the course of budget deliberations, the Governor and the Legislature both forwarded ideas for the general fund to use transportation revenues. In the final analysis, the Governor settled the matter with one sweep of his veto pen. In a controversial move, he vetoed 752 words to cobble together a single sentence. When the words of that sentence were reassembled, $427 million had been transferred from the transportation fund. In its place, the Governor and Legislature authorized $250 million in new bonding to fund highway rehabilitation.

Further exacerbating the fiscal challenge facing the Governor was the repeal of gas tax indexing. In 2005, the Governor signed the repeal of gas tax indexing, which further restricted growth to the transportation fund. According to the Legislative Fiscal Bureau, indexing repeal reduced revenues to the transportation fund by an estimated $5.2 million in 2006-07, $26 million in 2007-08, and $49.1 million in 2008-09.

Table 2 shows the net effect of the transfers out of the transportation fund in the previous two budgets:

Table 2

Loss to Transportation Programs Associated with Transfers in 2003-05 and 2005-07

	2003-05	2005-07	4-Year Total
Transfers and Appropriations	$675.0	$427.0	$1,102.0
Less General Obligation Bonds	-$565.5	-$250.0	-$815.5
Plus Transportation Fund Debt Service	$43.9	$0.0	$43.9
Total	$153.4	$177.0	$330.4

Source: Legislative Fiscal Bureau, 2007 Informational Paper 40, "Transportation Finance,"p. 6.

The imbalance between transfers out of transportation and bonding provided to replace those transfers presented two problems to the Governor for the 2007-09 budget. First, additional transfers from the transportation fund were probably unsustainable. It would not be possible to continue to supplement the general fund while also funding an acceptable highway construction and rehab program. Thus a new revenue source had to be found to replace the $330 million that had come from the transportation fund. A second and related issue was that the debt service on transportation bonds that had been earmarked for repayment by the general fund would have to be shifted back to the transportation fund where they belonged. This post-election budget would be the logical time to put the transportation fund back onto sound footing.

<u>The 2007-09 Budget</u>

Entering the next two years, the Governor needed to address the long-term repayment of transportation debt for the debt service from previous bonding. The budget currently before the Legislature estimates debt service on the bonds issued to offset transfers to the general fund to be

$175.9 million for the biennium. The Governor's budget proposes splitting payment on the debt service for these bonds, assigning $69.9 million to the transportation fund and $106 million to the general fund.

The decision in previous budgets to back-fill transportation funds with borrowing has been a costly one. By the end of the 2007-09 budget, Wisconsin taxpayers will have had to pay $332 million in interest on the bonds used to replenish the transportation fund. When these replacement bonds are retired, they will have cost taxpayers an extra $1.1 billion in debt service.

The residual effects of previous budgets created transportation-related problems in both the transportation fund as well as the general fund. Strategically, the Governor needed to add new revenues and to isolate the impact of the new revenues within the transportation fund. The Governor's budget attacked both problems with vigor by creating new taxes and fees.

The major revenue increases included in the Governor's budget came in the form of an increase in auto registration and titling fees, and the subject of this report, the gross receipts tax on oil companies. The auto fee increase will generate an estimated $171.8 million while the oil company tax will generate an estimated $272.1 million.

With the repeal of the indexed gas tax, base transportation revenue growth is projected to be modest, growing by just $75 million in the coming two-year budget. Revenue from the new taxes and fees account for 85.5% of the growth in the transportation fund for the 2007-09 budget. Without the new fees, the Governor could not have funded general fund programs and paid the debt service on the past replacement bonds, as his budget proposes. In addition, it is likely that cuts would have to be made to the spending plan for road construction and renovation. The new revenues are the lynchpin of the Governor's transportation budget.

Table 3

New Revenues to the Transportation Fund 2007-09

	2007-08	**2008-09**	**2007-09**
Oil Company Tax	$114.8	$157.3	$272.1
Auto Registration Increase	$71.0	$96.9	$167.9
Supplemental Title Fee Increase	$1.5	$2.4	$3.9
Total New Revenue	$187.3	$256.6	$443.9

Source: Legislative Fiscal Bureau, Summary of Governor's Budget Recommendations

Table 4 lists the major transportation spending increases included in the Governor's budget. Not only did the Governor's budget include many expected increases, e.g. transportation aids, it also transferred $164 million of spending obligations related to 16 programs from the general fund to the transportation fund. Therefore, the new revenues accomplished several objectives, including supporting a robust highway package, and it permitted the transportation fund to pick up part of the responsibility to fund debt service on transportation bonds issued in the previous two budgets. Further, the new money allowed the Governor to once again aid the general fund through the back door, this time by moving whole programs over to the transportation fund. As the legislative debate of the budget unfolds, it will become apparent that the impact of the new transportation money affects nearly every nook and cranny of the budget.

Table 4

Major transportation expenditures in the proposed 2007-09 budget

Expenditure	**2007-08**	**2008-09**	**07-09 Total**
Debt Service on Replacement Bonds	$26.6	$43.3	$69.9
Use of Trans Fund Revenues for GPR Purposes	$46.7	$47.6	$94.3
Transportation Debt Service Re-Estimate	$24.2	$30.3	$54.5
Marquette GO Bond Re-Estimate	$10.7	$10.7	$21.4
General Transportation Aids	$7.7	$15.5	$23.2
Mass Transit	$2.0	$4.1	$6.1
I-94 North South Southeast Rehab	$17.0	$50.0	$67.0
Zoo Interchange Reconstruction	$17.0	$7.0	$24.0
Major Highway Development*	-$14.5	-$11.6	-$26.1
State Highway Maintenance	$28.9	$37.3	$66.2
State Highway Rehabilitation	$18.0	$43.2	$61.2
Standard Adjustments	$9.7	$9.6	$19.3
Total Transportation Fund New Spending	$194.0	$287.0	$481.0

**- Funding was replaced by new bonding*

Source: Legislative Fiscal Bureau, Summary of Governor's Budget Recommendations

THE PROPOSED GROSS RECEIPTS TAX

The gross receipts tax proposed in the Governor's budget would impose a quarterly tax of 2.5% on the gross receipts of every supplier selling gasoline to retailers in Wisconsin. The tax would be assessed on the first sale of motor vehicle fuel in the state, which is usually the terminal where the gas is metered out. The tax would go into effect in October of 2007 and is estimated to generate $272.1 million in the coming biennium.

While it is a tax on gasoline, it differs from what is commonly referred to as the gas tax in two significant ways. First, the gas tax is an excise tax and is attached at a fixed amount per gallon. By contrast, the gross receipts tax is assessed as a percentage of revenue and, as such, is dependent on volume and price. As volume or price change, the proceeds from the tax will change. For example, at the time the Governor announced the tax in his budget speech, the wholesale price was approximately $1.69 per gallon. By April 17, the price had risen to $2.18 per gallon. Had the tax been in place during that time, it would have generated an additional $9 million based on the price increase alone.

Several states have taxes in place that are tied to both volume and price. For example, a number of states attach a sales tax to gasoline sales. A complete listing of fuel taxes can be found in Appendix A.

The other difference between the gross receipts tax and the excise tax is that, as proposed, the payers of the tax are precluded from passing on the tax to retailers. The intent is to assess the tax a tax on oil companies, not on motorists. The Governor even included stiff penalties for companies discovered passing the tax along to consumers. Specifically, any company would have to pay a fine equal to the amount they have illegally passed on to consumers and those responsible could face up to six months imprisonment. The fact that the tax would be absorbed by oil companies and that stiff penalties would be imposed was a major feature of Governor Doyle's budget speech.

By taking a snapshot of current gasoline prices, it is possible to estimate how much the new tax will add to a gallon of gas in the upcoming two years. The revenue estimates in the Governor's proposal assumed gasoline and diesel prices to be $2.51 in 2007, $2.50 per gallon in 2008, and $2.49 in 2009. Naturally, if those costs are higher, the amount the tax collects will be greater. These estimates exempt taxes from the equation (32.9 cents in state tax, 18.4 cents in federal gasoline tax, and 24.4 cents for federal diesel tax), which leaves the wholesale price as the basis for the estimate. According to these assumptions, the tax would amount to five cents per gallon on gasoline and 4.8 cents per gallon on diesel fuel. Of course, in theory, this tax is supposed to be paid by the oil companies rather than consumers.

The Department of Revenue (DOR) is assigned responsibility for administering the tax, and four positions were added to the agency budget to carry out the new responsibility. Based on discussions with DOR officials, the department has yet to determine how they will implement the no-pass-through provision. They have no detailed explanation of how they will ascertain whether or not the tax is passed along by suppliers. While it is not unusual for the administrative agency not to have a detailed plan for the operation of a new program until later in the process, in this case the ambiguity is troublesome. It is troublesome because the Governor has gone to considerable lengths to ensure consumers that the tax will not be passed on to them. Yet it is conceivable, and even likely, that there is no way for the Department of Revenue to determine whether the tax has been included in the price of gasoline.

Given the fact that this significant question has yet to be addressed, the entire initiative is open to speculation that this new tax is simply an attempt to disguise a five-cent per gallon increase in the gas tax. Until the administrative agency can identify how the no-pass-through provision will be enforced, that is a reasonable conclusion.

GASOLINE TAXES IN WISCONSIN AND AROUND THE NATION

Wisconsin

Currently, Wisconsin imposes a 30.9 cent per gallon excise tax on motor fuel sold in the state. In addition, a two cent per gallon tax assessed to pay for the state's petroleum inspection program. The 32.9 cent fuel tax is collected by the Wisconsin Department of Revenue and deposited in the transportation fund. The tax is imposed when the fuel is withdrawn and metered out at the terminal or refinery rack, and is collected monthly from licensed suppliers, which is typically the terminal operator. Gas tax revenues in fiscal year 2007 are estimated to yield $971 million to the transportation fund, which will account for 61% of all the revenue to the fund.

Wisconsin has had a fuel tax since 1925, when it was set at two cents per gallon and deposited in the state's general fund. In 1945, Wisconsin created the transportation fund, where fuel tax revenue was then deposited. Lawmakers saw a natural connection between paying a fee to drive and developing and maintaining highways.

The fuel tax remained below ten cents per gallon until 1980, when it began to increase rapidly. In the early 1980's, escalating fuel costs and the rising cost of highway construction labor prompted the Governor and the Legislature to approve higher gas taxes. Fuel consumption between 1979 and 1982 declined 14%, due in large part to more fuel-efficient cars being produced, modifications in driving habits for consumers, and a slowing economy.

In response to the compound impact of rising costs and declining fuel consumption, Wisconsin passed a law that provided for indexing of the state's gas tax. Under indexing, the state's gas tax was automatically increased each April based on inflation and consumption (in 1998 consumption was eliminated as an indexing factor). Indexing proved to be a convenient, albeit controversial, method for keeping dollars flowing into the transportation fund. Even with indexing in place, the gas tax was further increased through legislation twice, in 1987 and 1997.

Chart 1 shows the historical motor fuel tax rate in Wisconsin, and the reason for the increase:

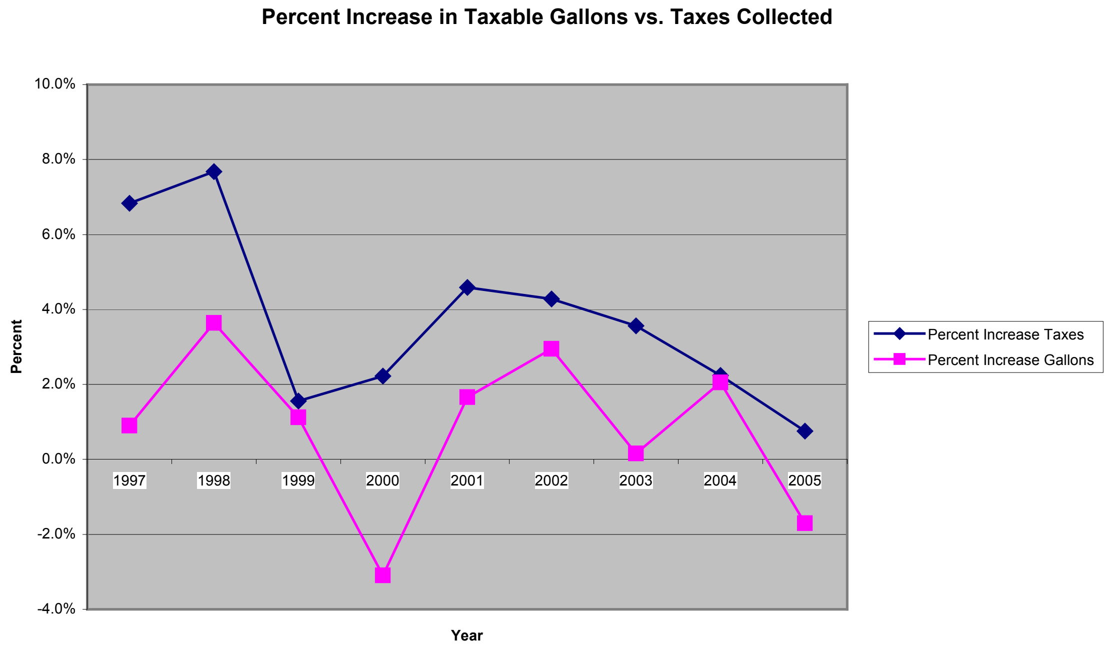
Chart 1

Year	Tax Rate Per Gallon	Type of Rate Change
1925	2 cents	Statutory
1931	4.0	Statutory
1955	6.0	Statutory
1966	7.0	Statutory
1980	9.0	Statutory
1981	13.0	Statutory
1983	15.0	Statutory
1984	16.0	Statutory
1985	16.5	Index Adjustment
1986	17.5	Index Adjustment
1987	18.0	Index Adjustment
1987	20.0	Statutory
1988	20.9	Index Adjustment
1989	20.8	Index Adjustment
1990	21.5	Index Adjustment
1991	22.2	Index Adjustment
1993	23.2	Index Adjustment
1994	23.1	Index Adjustment
1995	23.4	Index Adjustment
1996	23.7	Index Adjustment
1997	23.8	Index Adjustment
1997	24.8	Statutory
1998	25.4	Index Adjustment
1999	25.8	Index Adjustment
2000	26.4	Index Adjustment
2001	27.3	Index Adjustment
2002	28.1	Index Adjustment
2003	28.5	Index Adjustment
2004	29.1	Index Adjustment
2005	29.9	Index Adjustment
2006	30.9	Index Adjustment

Source: Legislative Fiscal Bureau Informational Paper 41, "Motor Vehicle Fuel and Alternative Fuel Tax" p. 2.

Gas tax indexing allowed for growth in the transportation fund even when the number of gallons being purchased by drivers dropped:

Chart 2



(Note: Total gallons consumed is depicted on a per-year basis, while the tax collected is shown on a per-fiscal year basis. Thus, where the chart says "1997," for the taxes collected, it actually means the 1997-98 fiscal year. *Source: Legislative Fiscal Bureau*)

Chart 2 shows the annual percentage increase in the number of gallons of gasoline purchased in Wisconsin versus the amount of tax collected from the purchase of gasoline. The chart illustrates that in years where the number of gallons purchased actually decreased (2000 and 2005), the amount of gas taxes collected still grew.

During its lifespan, indexing the gas tax proved somewhat controversial in that no approval was required to increase the tax. Periodically, there were moves to repeal the indexing mechanism, and in 2006 indexing was eliminated. The final indexing adjustment was made on April 1 of 2006. Estimates peg the elimination of indexing as costing the transportation fund $26 million in 2007-08 and $49.1 million in 2008-09.

Had indexing not been eliminated, it is estimated that the 30.9 cent gas tax would have risen to 31.9 cents in April of 2007. Subsequently, the tax would have risen to 32.5 cents in 2008 and 33.2 cents in 2009, an increase of less than one cent per year. This compares to the approximately five-cent per gallon impact of the proposed gross receipts tax. The no-pass-through provision was a critical element of the Governor's proposal budget strategy. Without the provision, when the new tax goes into effect in the fall of 2007, it would have been portrayed as increasing the gas tax more than five times the increase that would have occurred under indexing.

Gasoline can either be imported to Wisconsin by pipeline or boat, or it can be manufactured or refined in the state and stored by a refiner without having to pay the tax until the product is actually metered out. The tax on gasoline imported into Wisconsin by any other method is payable by the licensed supplier. After crude oil is refined into gasoline and other petroleum products, the majority of gasoline is shipped first by pipeline to storage terminals near consuming areas. After shipment through the pipeline, gasoline is typically held in bulk storage terminals that often service many companies. At these terminals the gasoline is loaded into tanker trucks destined for various retail gas stations. It is at this point that the gas tax is paid.

There are 65 licensed, unrestricted suppliers that remit nearly all of the tax revenues to the state. There are 86 other restricted suppliers, or suppliers that deliver across state lines, who pay a small portion of state revenues.

Wisconsin's current motor fuel tax is an excise tax, meaning the tax is charged to the consumer, and not the seller. Excise taxes tend to be product-specific and usually represent a set rate per unit, as opposed to general sales taxes that are applied as a percentage of the cost of sale. For instance, the excise tax on motor fuel is 30.9 cents per gallon, rather than being applied as a percentage of the cost of gas. Other excise taxes in Wisconsin include taxes on cigarettes, tobacco, beer, and liquor.

Other States

Wisconsin's Governor Doyle is not alone in proposing a gross receipts tax on gasoline. Pennsylvania Governor Rendell has introduced a 6.17% gross receipts tax that also includes a no-pass-through feature. The actual language used to implement the tax has yet to be introduced, but it is clear that the Pennsylvania proposal is considerably different than what has been introduced in Wisconsin. One difference is that the Pennsylvania tax will apply to every company in the supply chain with the exception of retailers. It will apply to oil producers, oil haulers, refiners and distributors. A second major difference is that the new gross receipts tax will be offset by exempting oil companies from the state's 9.9% corporate income tax. There is no similar provision in Wisconsin.

The other state that is relevant to the Wisconsin discussion is Connecticut, which currently has a 6.1% tax on oil company gross receipts. The gross receipts tax, which Connecticut has imposed since the 1980s, has recently become a favorite of Connecticut politicians. In 2005, the Governor and Legislature didn't simply raise the rate, but also codified future increases in state law. The rate rose from 5.8% to 6.1% in 2006 and is scheduled to gradually increase to 8.1% by 2013. The tax rate increases were put into law as a way to support future transportation spending. With the recent spike in the price of gasoline, there was some consideration given to capping the rate, but discussion of a cap has waned.

Overall, gas taxes among the fifty states are a crazy quilt of taxes and fees. No two states tax in the same manner or at the same level. It seems that the design of gas taxes provides state governments the chance to exhibit creativity. According the American Petroleum Institute,[3] the average state gas tax is 45.8 cents per gallon (including the 18.4 cent federal excise tax). State taxes range from eight cents in Alaska at the low end, to 40.2 cents in California, 42 cents in Hawaii and 42.4 cents in New York. The complete list of state gas taxes is included in Attachment A. In displaying state gas taxes, the American Petroleum Institute includes excise taxes as well as other taxes. Where other taxes are not based on a rate per gallon, the API has converted the revenue into a rate per gallon.

Wisconsin's rate of 32.9 cents per gallon (including the 2 cent petroleum inspection tax) is the seventh highest in the nation. If the proposed gross receipts tax was in effect, it would raise the rate to 37.9 cents, making it the fourth highest.

THE HISTORY OF FAILED COST CONTROLS

Governor Doyle's announcement of a proposed tax on oil companies, and the related no-pass-through provision, produced a skeptical response from the public. The public is rightfully skeptical since they have been exposed to market forces their whole lives. They know what happens when anyone, from government to the corner retailer, artificially manipulates prices. They know that price manipulation affects the supply of goods. They have come to expect that when the price of any product is synthetically lowered, they will experience shortages. Conversely, overpriced items will quickly gather dust while the public waits for the price to lower to an acceptable level.

The no-pass-through feature of the proposed oil company gross receipts tax is a form of a price control. It is the State of Wisconsin's attempt to raise a significant amount of money by manipulating the natural tendencies of the market for gasoline. Price controls, especially controls on the price of gasoline, have a sorry economic history. Since the early 1970s, when OPEC jolted gasoline prices by restricting the supply, government has periodically dabbled in price controls. In every instance, the effect of the control proved to be counterproductive. As a result, nowhere in America is the price of gasoline controlled. If the proposal forwarded by Governor Doyle is enacted into law, Wisconsin will have the only price controls in America.

Let's briefly review the history of price controls on gasoline. In 1971, the Nixon administration enacted broad price and wage controls in an attempt to control inflation. The Economic Stabilization Act of 1970 was originally intended as a ninety-day restriction on wages and prices. The controls were left in place for nearly three years, during which time inflation actually increased from approximately 4% to just under 14%.[4] Only later did it become accepted that monetary policy, not government regulation, was the most effective way to address inflation.

In 1973, it was generally feared in Washington that when the controls were lifted, the price of gasoline would skyrocket and damage the nation's economy. Thus, in 1973, when the controls were lifted for other commodities, the federal government extended the price controls on gasoline and related products. The actual regulation was embodied in the Emergency Petroleum Allocation Act of 1973, a complex series of regulations that created a two-tiered system of price controls on domestic oil. The EPPA significantly affected the economics within the oil industry.[5] However, the lasting overall impact was to restrict the supply of oil.

The reaction of the market to the price controls embodied in the EPPA and the subsequent Emergency Policy and Conservation Act of 1975 was swift and severe. As economists had predicted, the price caps resulted in restricted supplies. Motorists were subjected to Sunday closures, even-odd day purchasing and even restrictions on the amount that could be purchased in any single trip. The market forces worked with the certainty and efficiency of gravity.

By the late 1970s, pressure mounted for the federal government to lift the price controls. However, there lingered a residual concern that the complete lifting of controls would lead to rising prices and rising oil company profits. This led the federal government to a gradual lifting of controls and the simultaneous imposition of a windfall profit tax. The tax was actually was an excise tax on the domestic production of oil. It was applied to the difference between a base price of oil (adjusted quarterly for inflation) and the current market price. Different tax rates were applied to different tiers of oil and exceptions to the tax were made for government and other public uses.

Not surprisingly, the windfall profit tax proved to be a considerable administrative burden, requiring an army of government regulators. Worse, the revenue raised by the tax fell far short of expectations. By 1988, the federal government was more than willing to let the tax lapse. The federal government's forays into the control of gasoline prices, while providing popular talking points for elected officials, provided uniformly disappointing results, especially at the pump. Since the tax was attached to the production of domestic oil, the production of domestic oil lagged and the country became increasingly dependent on foreign oil, just the opposite of the original intent.

Move forward to February of 2007: The rhetoric used in Governor Doyle's budget address harkened back to the language used in the 1980s in describing the need for price controls. The following quotes from the Governor's 2007 speech could just as easily have emanated from the Carter administration:

> "Oil companies have gouged this country in every way they can think of."
>
> "Exxon announced forty billion dollars in profits…That's not just pure profit, it's coming right out of our pockets."
>
> "Let's turn the tables on big oil."

Those listening to Governor Doyle's budget speech heard him say, "It will be illegal for them (oil companies) to pass the fee on to consumers." Economists listening to the speech heard, "State government will attempt to manipulate natural market forces affecting gasoline."

From time to time, state governments have attempted to regulate the price of gasoline. Most recently, Hawaii implemented price controls on gasoline in September of 2005. The Hawaiian controls attempted to limit gasoline prices based on the prices charged at the major centers on the mainland. The intent was to reduce the gap between Hawaiian prices and mainland prices. They failed to heed the advice of the Federal Trade Commission, which warned,

> "A significant body of research and experience suggests that price controls have a poor record of improving consumer welfare in markets where competition is possible, and may in fact cause more harm than good in the long term."[6]

After just eight months, Hawaii decided to end its attempt to control the price of gasoline. The gap between the price of gasoline in Hawaii and the mainland had actually increased from forty-four cents per gallon to fifty cents per gallon.[7] Hawaiian regulators, in imposing price caps, had actually succeeded in doing exactly the opposite of what they had intended; they raised the price of gasoline. Although the controls used by the State of Hawaii differed from the controls proposed in Wisconsin, there is a lesson to be learned from Hawaii.

The lesson is obvious; attempts to control the price of gasoline, either through blunt price controls, or through subtler taxing mechanisms that attempt to suppress prices, have all failed. With the demise of the Hawaiian cost controls, there are no controls in effect anywhere in the United States. If Wisconsin enacts the no-pass-through legislation proposed by the Governor, it will be the only state in the nation where price controls are in effect. As with the experiment in Hawaii and the experience at the federal level, it is likely that any such artificial price controls will be counterproductive and doomed to failure. Those advocating price controls in Wisconsin seem intent on ignoring the lessons of history and continue to suggest that the Wisconsin system for controlling the price of gasoline will be the first to succeed.

THREE REASONS THE TAX WILL BE PASSED ON TO CONSUMERS

I. THE REALITY OF ECONOMIC FORCES

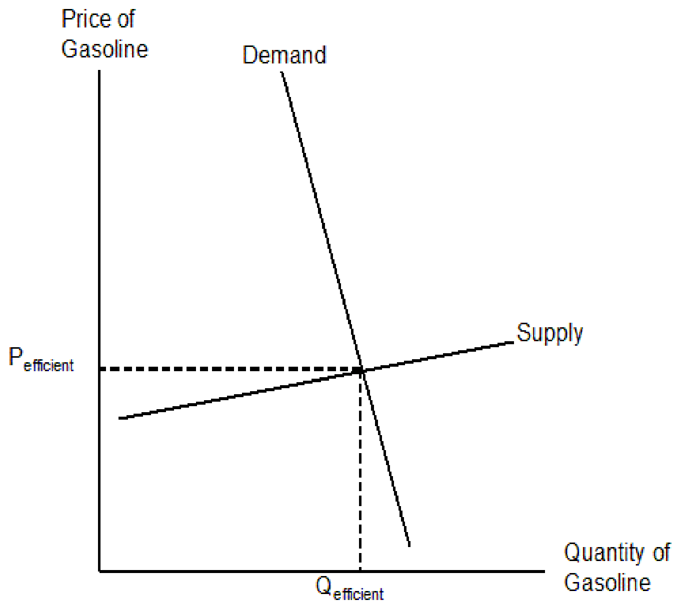
To understand what is likely to occur when a new tax is enacted, it is instructive to review economic research. Specifically, to what extent is gasoline supply and demand affected by the tax? In a nutshell, research consistently shows that demand for gasoline is very inelastic, meaning that short-term consumption is relatively unaffected by price. We complain about the price of gasoline, largely because we know we have no option but to purchase it. Conversely, the supply of gasoline is relatively inelastic, meaning it is very sensitive to price. Relatively small price changes on the spot market will change where wholesalers choose to sell their product.

The no-pass-through provision in the Governor's budget is an attempt to reverse the flow of economic theory. The expectation is that the oil companies will pass none of the new tax on to consumers, even though consumer demand is somewhat price insensitive. Further, the budget assumes that oil companies will not alter the supply of gasoline to Wisconsin, even though they have ready options (surrounding states) where the cost of doing business will be lower.

Let's back up and examine economic theory and research. Economists have long studied the impact of taxes on the sales of goods and services. The government uses these taxes in order to raise revenue to pay for publicly provided goods and services that cannot be traded in markets. However, there is certainly an impact on consumers and sellers alike and the impact is generally unpleasant. A gross receipts tax on oil companies is no exception.

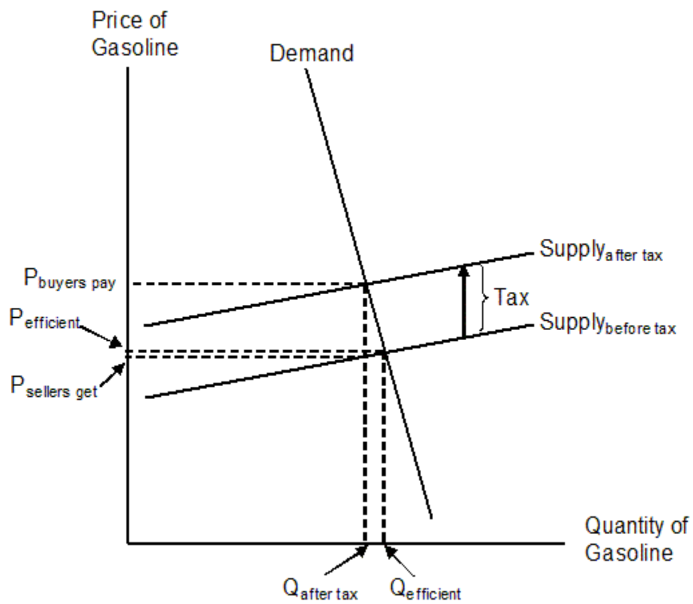
Graph A shows the before tax market for gasoline in Wisconsin. The demand curve represents how much gasoline consumers are willing and able to purchase at various price points. As economic theory states, when the price of gasoline increases, consumers are willing and able to purchase less gasoline; but how much less? As it turns out, demand for gasoline is unique in that consumer behavior is not very sensitive to changes in the price of gasoline. According to economic research[8], the short-term elasticity of demand for gasoline is between 0.03 and 0.07. This means that if the price for gasoline would double, consumers would only purchase between 3% and 7% less gasoline in the short term. This unwillingness to purchase less gasoline stems from the lack of close substitutes for gasoline. By comparison, beef has an elasticity of demand equal to 1.37[9], which means that a 10% increase in the price of beef will result in a 13.7% reduction in beef purchases. Consumers are quite sensitive to changes in beef prices due to close substitutes such as poultry. Since gasoline has few, if any, substitutes, consumers do not sacrifice gasoline consumption. Therefore, the demand curve in graph A is very steep to mirror this unwillingness to give up consumption of gasoline in the short term regardless of the price:

Graph A



The supply curve in Graph A above represent the willingness of sellers to provide product at any given price. Textbook economic theory holds that as the price of gasoline increases, the quantity of gasoline that sellers provide will increase, since higher prices yield higher profits. However, unlike the demand curve for gasoline, the supply line is relatively flat. Suppliers of gasoline are very sensitive to changes in the price. At one end of the supply chain this reflects the ability of oil refineries to easily switch to manufacturing other derivatives of oil whenever gasoline becomes less profitable. At the wholesale level, this reflects the ability of suppliers to divert product to states and localities where business costs are lower and profits higher. Therefore, the flat slope of the supply curve in Graph A mirrors the greater sensitivity of sellers to the price of gasoline. Where demand and supply meet determines the efficient market quantity of gasoline that will be sold, and also the price at which it is sold.

Graph B



Graph B shows how a tax impacts both the quantity of gasoline sold and the price that consumers must pay for gasoline. The gross receipts tax makes the product less profitable to sell at any market price. As a result, the supply of gasoline to Wisconsin will fall, effectively shrinking the market. This will increase the overall price of gasoline and, since the demand curve is so steep, consumers will pay nearly all of the price increase. Consumers will simply be less willing than sellers to change their behavior. Thus, they will bid up the price of the smaller market quantity of gasoline available.

However, advocates of the no-pass-through provision promise a different outcome. By imposing a legal requirement that sellers pay all of the tax, the Wisconsin initiative runs completely counter to what economic theory and evidence show. Even if the accountants could enforce the provision, sellers will still reduce their output in Wisconsin due to gasoline's lower profitability here. Since government intends to artificially restrict suppliers' ability to bid up the price of gasoline, in the long run supply to Wisconsin will be restricted, which will elevate the price consumers are pay for gasoline. At the end of the day, a two and one-half percent gross receipts tax – which equates to approximately five cents per gallon – will ultimately result in nearly all of the increase showing up in the pump price of gasoline - not as a reflection of a pass-through of the tax, but as a reaction to restricted supplies.

The intent here is not to overstate the potential impact of the Wisconsin price control. It is unlikely that state motorists will see rationing or substantial price spikes. Nor is it likely that oil companies will do anything other than abide by the letter of the law. However, even in the absence of nefarious actions on the part of oil companies, the tax will have a noticeable impact at the pump – if not in the short term, certainly in the long run.

According to industry experts,[10] approximately seventy-five percent of oil products in Wisconsin are sold under long-term contracts that exist between oil companies and retail contractors. Most of these contracts are between the large oil companies and their contractors that sell their product in retail markets. These contracts generally run three-to-five years and guarantee that retailers will be allocated a certain level of supply. Most of the major oil company outlets operated under this arrangement.

The remaining twenty-five percent is sold on the spot market. This is where the large oil companies sell product in excess of what is required to fulfill their commitments with retailers. It is also where independent wholesalers sell oil products. The spot market is the more volatile segment of the market and is the supply source for most of the independent retail outlets. On the spot market, wholesalers can sell to outlets either in Wisconsin or other states. It is on the spot market where the no-pass-through provision will have an immediate impact. Since wholesalers will be precluded from including the cost of the gross receipts tax in the price charged to buyers in Wisconsin, they are more likely to sell their product outside of Wisconsin. This will cause those Wisconsin outlets dependent on the spot market to go further afield to purchase product. This will effectively alter the supply of gasoline and increase the price they pay. Whatever benefit Wisconsin consumers realized by having less expensive fuel available at independent outlets will evaporate. Whether they like it or not, consumers will see prices rise when this tax is implemented.

A second short-term impact of the no-pass-through provision will be seen in the wholesale market throughout the upper Midwest. The Wisconsin tax will increase the cost of doing business, and since the oil companies are precluded from passing the tax along to Wisconsin outlets, they could resort to incorporating it into the price structure for outlets in other states. This is the phenomena the courts anticipated when they have found similar restrictions to violate the Commerce Clause.

In the longer run, the major oil companies are likely to push for shorter-term contracts with Wisconsin retail marketers and would reduce the volume they would guarantee to provide retailers. It would simply be more profitable to sell more product in states where the profit margin is higher. Of course the impact of a lower volume of gasoline being committed to Wisconsin retailers would have the effect of driving price up. As noted above, given the elasticity of demand for gasoline, as supplies shrink, consumers would be willing to pay a slightly higher price for gasoline. The net effect is that most or all of the cost of the gross receipts tax would show up in higher pump prices.

II. LITIGATION OF NO-PASS THROUGH LAWS

In explaining the legal basis for the no-pass-through provision, the Doyle administration relies on a 1988 U.S Supreme Court case. In that case, the Puerto Rico Department of Consumer Affairs argued in support of its imposition of a no-pass-through provision associated with an excise tax on refiners.

From 1973 until 1981, the federal government imposed price controls on petroleum products under the Emergency Petroleum Allocation Act (EPAA). A provision in that act preempted state and local government regulation of the supply and price of petroleum products.

In 1986, Puerto Rico enacted an excise tax and authorized the Department of Consumer Affairs to issue regulations. One of those regulations prohibited refiners from passing the tax on to retailers. The department also set maximum profit margins for wholesalers. As expected, the oil companies challenged the no-pass-through provision on the basis of the previous federal act (EPAA) that preempted state and local governments from regulating petroleum products. While the oil companies prevailed in District Court, the U.S. Supreme Court overturned the decision, thus ratifying Puerto Rico's no-pass-through provision. The Court found that Puerto Rico's law was not subject to preemption by the federal statute, and held that when the federal government withdrew from price regulation, the preemption provision was dissolved.

While the court did authorize the no-pass-through provision, it is important to understand the basis for the finding. In that Puerto Rico case, the issue decided by the court was preemption as it related to the EPAA. The Court was asked to rule on whether the former federal law preempted Puerto Rico from enacting the rule it enacted. It did not consider the impact of the no-pass-through provision on the Commerce Clause. Perhaps that owes to the remote location of Puerto Rico.

A separate 1983 case decided in New York State Court also dealt with a no-pass-through provision. However, in that case the Commerce Clause constituted the crux of the case. Under the Commerce Clause of the U.S. Constitution, Congress is assigned power to regulate commerce in the U.S. States are precluded from taking action to limit trade, including discriminating against out-of-state business.

In 1980, New York passed a 2% gross profits tax on oil companies and included a provision that precluded the oil companies from including the tax in the retail price of gasoline. The New York law was eerily similar to the provision forwarded by Governor Doyle.

In 1983, a New York Appellate Court found the anti-pass-through provision to be in violation of the Commerce Clause. The logic of the decision was that the State of New York was effectively adding a cost to the oil companies that, while not affecting prices in New York, would result in higher prices in other states. The court recognized the reality that oil companies would recoup the cost of the New York tax by increasing prices in other states. The burden of the tax would fall to non-New York consumers. Before this court ruling took effect, the New York law was changed to eliminate the anti-pass-through provision. However, the tax remained.

This court case is outlined in a memorandum prepared for Wisconsin Speaker of the Assembly Mike Huebsch by the Wisconsin Legislative Council.[11] The Legislative Council memo notes that, while the New York decision is not a precedent for purposes of reviewing the proposed Wisconsin law, it is "indicative of how a Wisconsin court would assess a Commerce Clause challenge to the constitutionality of the anti-pass-through provision of Senate Bill 40" (the budget bill). There are undoubtedly other potential challenges to the proposed no-pass-through provision.

It is notable that the Puerto Rico case did not address the Commerce Clause. Therefore, relying on that case alone to support the Wisconsin initiative is quite tenuous. The proposed no-pass-through provision will undoubtedly be challenged, on the basis of the Commerce Clause and other factors. At best the legal basis for the provision is murky.

Furthermore, the gross receipts tax on oil companies is a key revenue feature of the Governor's budget. Without the $272 million generated by the tax, the transportation budget would have to be significantly reduced in order to stay in balance. The practicality is that, if the no-pass-through provision is successfully challenged in court, the Governor and the Legislature would have to do what was done in New York: delete the no-pass-through language and keep the tax. No matter how badly the legislation is crafted, in New York and in Wisconsin, the motorists will see the tax reflected in the price at the pump.

III. ADMINISTRATIVE REALITY

The difficulties in administering the technical aspects of the pass-through provision are illustrated in a memo prepared by the Department of Revenue (DOR) dated January 30, 2007. This memo indicates that DOR recognized inherent difficulties of enforcing the pass-through provision.

There are two components of any budget; the fiscal component and the statutory component, or the actual language required to carry out the budget. In the course of preparing the budget, staffs from various agencies routinely interact with the attorneys at the Legislative Reference Bureau, who actually draft the statutory language. This interaction is an essential step to ensure the soundness – especially the administrative soundness – of legislation. The notes maintained by the attorney drafting each piece of legislation are retained and available to the public once the legislation has been introduced. The interaction between agency staff and legislative bill drafters are largely devoid of political considerations, and instead focus on the nuts and bolts of administering laws.

In analyzing the oil company gross receipts tax, DOR raised a number of concerns, nearly all of which were addressed in the final version of the legislation. One item not addressed was a concern over the anti-pass-through provision. Specifically, the note from the staff at the Department of Revenue said:

> **Arbitrary Nature of Audits**
> Sec. 77.9982(4) provides that no supplier shall take any action to increase or influence the selling price of motor vehicle fuel in order to recover the amount of the assessment. A supplier could argue that any number of factors other than oil company assessment were the cause of a price increase. Prices are determined by a complex, interdependent set of economic factors. The Department's auditors may have no rational basis to isolate the cause of a price increase as the oil company assessment. The supplier may recover the assessment from purchasers by a gradual increase in the price and in some cases may not be able to bread down all the reasons why the price is increased. Therefore, actions to penalize suppliers for passing the tax through to purchasers may not be sustained.

The administration chose to ignore the advice of the Department of Revenue in the budget bill delivered to the Legislature. The Department of Revenue staff saw the inherent difficulty of administering the intent of the provision. The futility of the task is apparent in the communication to the bill drafter. However, the political attractiveness of the no-pass-through provision apparently outweighed the viability of the provision. And another shaky law was added to the state statutes.

SUMMARY

In Wisconsin, budget after budget has been assembled with a fiscal slight of hand. Moneys have been shifted from one year to the next, funds have been taken from "segregated" funds and one-time funds have been used to paper over long-term structural problems. As a result, state government is carrying a $2.2 billion deficit on its books. Addressing state government's finances in an honest, forthright manner has been a rarity.

The oil company gross receipts tax and its no-pass-through provision as proposed by Governor Doyle is the latest in a series of questionable fiscal maneuvers. But no one should be fooled; the proposal is a gas tax increase of five cents per gallon. The legislative consideration of the Governor's transportation budget must be based on this premise. Any thought of acquiescing to the Governor's proposed tax must be considered an endorsement of a five-cent per gallon increase in the tax on gasoline.

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[1] Jeremy Harrell, "Budget balanced on the 'back of transportation,'" *The Daily Reporter*, February 20, 2003.
[2] Ibid.
[3] Much of the discussion here of state gas taxes is taken from information produced by the American Petroleum Institute. The institute routinely tracks tax data. The most recent summary was prepared by the institute in March 2007.
[4] The Economic Review, www.economicreview.com
[5] For a detailed discussion of the different impact on old oil and new oil see Economic Amnesia the Case against Oil Price Controls and Windfall Profit Taxes, Cato Institute, January 12, 2006
[6] Federal Trade Commission Press Release, Gasoline Price Controls Would Likely Harm Hawaii's Consumers, January 28,2003
[7] World Net Daily, Gas-Price Controls Backfire in Hawaii, February 19,2006
[8] Hughes, Knittel and Sperling (2006), Chouinard and Perloff (2003)
[9] McConnell and Brue (2008)
[10] The discussion of the operation of gasoline markets in Wisconsin is based on interviews with representatives of the petroleum industry in Wisconsin.
[11] Memorandum from William Ford, Senior Staff Attorney for the Wisconsin Legislative Council, February 26, 2007.