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Tax vehicle area instead of petrol

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Petrol now sells across the Indian metros at around R66.42 a litre, up from R50 during 2008. Opinion is divided as to whether the state -owned oil marketing companies (Indian Oil Corporation, Hindustan Petroleum Corporation Limited, and others) should be allowed to continue hiking prices, as they have been doing recently. The rationale for hiking prices is straightforward. The oil marketing companies (OMCs) are unable to cover costs of crude oil prices that have risen a lot. Hence, these companies are bleeding financially due to huge under-recoveries.

These under-recoveries in turn push up the fiscal deficit, whether paid for by direct subsidies or via special petroleum bonds bought by the Reserve Bank of India. Senior policymakers from the Prime Minister down have been repeatedly calling for market pricing of all petroleum products, and an end to these ruinous subsidies. In their view, petrol prices must be raised right now. The sooner short-term pain is incurred to ensure long-term gain, the better.

The opposing view is that the extremely high taxes should be reduced to ease the burden on the consumer. Petrol prices can cover the cost of crude, and yet be lowered, if the current high taxes are removed. At present, across major countries, India has one of the highest burdens of petrol taxes in the world (See Table). Although some European countries have higher taxes in absolute terms or in relation to the final price, when adjusted to their high income levels, their tax burden is much lower.

There is growing awareness and resentment among the Indian public about the burden of petrol taxes. As such, the demand that these taxes be lowered cannot be faulted—when put forth by fiscal puritans, such as myself. If all along, government spending were capped at low levels by legislation, petrol taxes would not have been so high to begin with. There has been massive spending due to the Keynesian and left-wing policies over the decades. Petrol taxes, easy to impose, have been the milch cow to finance this wasteful spending. It is hypocritical of the Left (or what is left of the Left) and the “pro-poor” in the UPA, having pushed up spending, to now demand an end to petrol taxes needed to finance this spending.

The establishment view, that petrol prices must be market-determined and that petrol taxes cannot be lowered, since the fiscal deficit would go up, is certainly correct. The chairman of the Prime Minister’s Economic Advisory Council, the deputy chairman of the Planning Commission and others have been saying so for years. However, they can be faulted for not exploring the full gamut of policy options—in particular, replacing petrol taxes (and other automotive taxes) with a ‘tax’ only on vehicle area.

More precisely, the government should impose a stiff, revenue neutral levy on the area of all motor vehicles, with the revenues being earmarked to replace petrol taxes (I use the word ‘levy’ instead of tax since the word levy implies a charge for the resource being used, while tax is a burden on the consumer to finance government spending, not necessarily related to usage of the item in question. Revenue neutral means that the money collected has to be used to reduce taxes elsewhere).

In a few articles from 2006 onwards, I have been advocating such a revenue neutral Vehicle Area (Annual) Levy, or VAAL, as a composite transport-cum-energy-cum-environmental-cum-fiscal policy—not just for India, but globally. Even when there are no or low petrol taxes, there are umpteen benefits from VAAL. It would lead to less road area per passenger-km of travel, and hence less congestion and faster travel. It would lead to less energy consumption, less carbon emissions, less demolition of existing roads and heritage buildings and green cover to widen or build roads, and so on. The list is long. When petrol taxes are high, the revenues from VAAL should be strictly earmarked to lower petrol taxes.

These various considerations apart, in India the rationale for such a policy is compelling on macroeconomic grounds. The current account deficit, largely due to petroleum imports, is huge. Simultaneously, expenditure on road building keeps raising the fiscal deficit. The fiscal deficit and the current account deficit are the two perennial negatives in our economy.

A stiff revenue-neutral VAAL by reducing the consumption of petrol and the amount spent on building roads will reduce both deficits simultaneously, with immense long term benefits. For such a policy to be operationally implemented will take at least several years. For such a policy to deliver, i.e. reduce congestion and petrol consumption without reducing travel (defined as number of passenger-km), certain complimentary policies are required. These are discussed on my Website unclogroads.com.

The time is ripe to initiate such policies. The demands of populist politicians, that petrol prices be reduced, will only grow louder. Whichever government is in power, or comes to power, should seriously start thinking about how to lower petrol taxes. Nobody, least of all the ‘anti-subsidy’ policy economists have paid attention to how vehicle area is indirectly subsidised. Road construction is massively subsidised, from the power of the state to acquire land using its powers of eminent domain, to the massive spending, invariably financed by deficits, on building roads and related infrastructure.

Motor vehicle owners do pay huge taxes on petrol, ownership or other usage related taxes. However, these are highly distortionary and indirect, not targeted to the underlying scarce resource—road area. Despite the repeated emphasis by our policymakers on the need to remove subsidies, they remain silent on the need to remove subsidies given to buyers of mobile land—also known as motor vehicles.

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