



Federation of Small Businesses
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A Fuel Duty Stabiliser – is it really that complicated?

With fuel prices at a record high much attention has been given to the possible introduction of a Fuel Duty Stabiliser (FDS) – a mechanism to adjust fuel duties in order to mitigate the impact of oil price shocks on pump prices.

The Federation of Small Businesses (FSB), together with leading economists and senior politicians, believe a stabiliser would help take the pressure off hard-pressed small firms and families across the country, giving the economy a fighting chance of returning to growth.

The stabiliser is a common sense and relatively simple measure to introduce. Whilst in opposition, the Conservative Party favoured the introduction of a FDS “[which] ... would cut fuel duty when oil prices rise, and vice versa ... [and] ensure families, businesses and the whole British economy are less exposed to volatile oil markets, and that there is a more stable environment for low carbon investment.” They maintained that the stabiliser would be “relatively simple to administer”.

In government, the Conservatives and their Coalition partners argue that a FDS would be too complicated and expensive. The third argument against introducing a FDS is that it is not sufficiently ‘green’. This is not the case.

Is it really that difficult?

"It's a complicated idea and it's difficult to see precisely how we achieve it, but it's something that we are looking at very carefully to see if we can reduce the burden of fuel duty"

(Danny Alexander, Chief Secretary to the Treasury, January 2011)

The FSB does not agree. A fuel duty stabiliser is relatively simple to implement and could be introduced within a matter of months.

The concept is straightforward. When oil prices increase, the stabiliser would allow Government to reduce duty to a lower limit; and when oil prices fall, the Government would be able to raise duty levels to a higher limit.

However, critics cite the difficulty of knowing whether fluctuations in the price of oil are temporary or are likely to persist beyond the near term, therefore it would be difficult for a fuel duty stabiliser to set fuel duties effectively.

To counter volatility in the price of oil, a fuel duty stabiliser would need to be based on an official forecast for the future price of oil and adjusted at regular periods according to the actual price of oil. There is a simple way of doing this.

A fuel duty stabiliser should be based on official forecasts for the oil price cycle as advocated by the economist Andrew Lilico. This is the long term prediction economists give for patterns in fluctuations in the price of oil over a period of time. Using the oil price cycle as a basis for a FDS, the level of fuel duty would be calculated against a trend price for oil. This would then be adjusted following changes to the official view of the oil price cycle.

This means that any given time, setting the level of the stabiliser would be straight forward – fuel duty is X pence per litre minus a proportion of the difference between the current oil price and trend oil price. So when the price of oil fluctuates, fuel duty would automatically fall or rise accordingly.

Is it bad for the public finances?

"We can't sacrifice income willy nilly."

(Danny Alexander, Chief Secretary to the Treasury, responding to calls for the introduction of a fuel duty stabiliser in January 2011)

Critics argue that a stabiliser would be too expensive to implement during a time of austerity. This criticism fails to take into account the wider implications of high fuel prices on the UK economy. If set correctly a FDS can still be generally fiscally neutral for the public finances and actually help provide much needed economic stability for the UK economy.

In September 2010 the Office of Budget Responsibility produced a report looking at the effect of oil price increases on the economy, with a possible view to introducing a FDS. The report looked at the effect of oil price increases over a four year period and came to the conclusion that while Government would receive extra revenue from increased oil prices this would be wiped out by other offsetting effects on the economy such as a contraction in economic output due to the high price of oil.

This analysis is correct, but it fails to take account of the flexibility afforded by a stabiliser based on the oil price cycle, which would make it fiscally neutral.

If the price of oil falls as well as rises (which it does) and if, as Andrew Lilico advocates, a FDS is based on economic forecasts of the oil cycle and adjusted at regular time intervals, a FDS would be fiscally neutral for the Government over the cycle.

- **The wider impact of high fuel costs would outweigh any short cost of implementing a FDS**

Critics fail to take account of the wider economic damage that high fuel prices have on the economy as a whole. Last month the International Energy Agency warned that high oil prices *'are becoming a threat to the economic recovery'* of OECD nations, of which the UK is part, due to its effect on national and personal budgets.

The current high price of fuel, and the lack of mid to long-term certainty over future prices means that our economy is being hit hard and at a time when we can ill-afford it. Recent FSB research shows that 62 per cent said they will have to increase prices if fuel costs continue to rise, one in 10 small businesses said they will lay off staff, and a quarter (26%) said they will freeze wages - a huge concern as unemployment has reached 2.5 million.

Small businesses are not able to absorb the cost of fuel price increases like big business and they are being badly hurt by the current prices. But, perhaps more than the high price of fuel, it is the uncertainty over future fuel costs that stops small businesses from being able to plan effectively and grow their business in the future. A FDS would give the certainty and stability the UK's five million small businesses need to factor in fuel costs to business expansion plans.

The cost of doing nothing in the long-term will vastly outweigh the cost of implementing a FDS in the short term.

- **An FDS would increase the stability of the public finances**

Further to this, the introduction of a FDS would also help give more certainty to the state of public finances. In 2008, the Conservative Party explained the positive impact a FDS could have on the economy:

The current system also makes the public finances more unstable. This is because, when oil prices rise, the Government receives an unexpected windfall from taxes on North Sea Oil production. And when oil prices fall, the Government suffers an unexpected shortfall in revenues. This makes it more difficult for the Government to predict accurately the future state of the public finances.

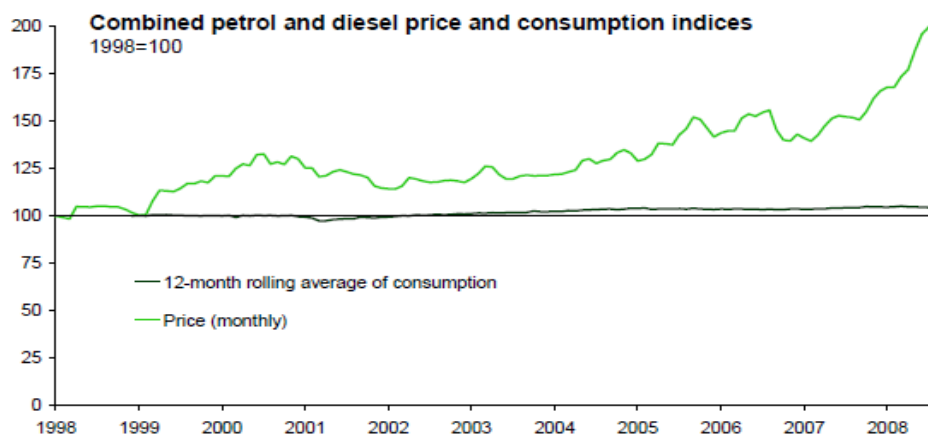
Additionally, increases in the price of oil lead to increases in the price of fuel - in turn raising inflation. This rise in inflation impacts on people's living standards and leads to wage increase demands, turning what could be a temporary impact of high oil prices into inflationary pressure on the economy.

A FDS would iron out the knock-on effects on inflation due to increases in the price of oil and act as a break on inflation limiting the damaging effect inflation has on our economy. In December 2010, inflation rose to 3.7%, the highest increase in the cost of living for eight months, this was largely due to the 2.8% rise in the cost of fuel - which is the largest increase since 1996. A FDS would not only help stabilise the finances of households and small businesses but that of the wider economy as well.

"It is time for the UK government to dust down its idea of a fuel price stabiliser operated through variable taxes on fuel, starting now with a reduction, to take some of the inflationary pressure of this latest move out of the system."

(John Redwood, January 2011)

Critics of a FDS also question whether high oil prices actually give scope for the Government to reduce fuel duty since higher fuel prices reduce demand. Yet consumer demand for fuel is generally inelastic with the price having little effect on demand – indeed, demand for fuel actually increased during previous periods of high fuel prices.



Sources: Quarterly energy prices, BERR, Table 4.1.1; Hydrocarbon oils bulletin, HMRC

The above chart clearly shows that despite significant fluctuations in the prices of petrol and diesel demand for fuel is generally inelastic.

Is a Fuel Duty Stabiliser bad for the environment?

“...the ‘fair fuel stabiliser’, look less like good environmental policy.”

(Institute of Fiscal Studies, Green Budget, February 2011)

Actually a FDS would have significant environmental benefits. Fuel duty is, at least in theory, an environmental tax that can play a vital role in reducing carbon emissions by encouraging a shift towards lower emission vehicles and alternative forms of transport.

The Stern Review on the economics of climate change argued that one of the key benefits of environmental taxes is that ‘they can be kept stable, and thus do not risk fluctuations in the marginal costs that could increase the total costs of mitigation policy’. A stable carbon price helps households and business plan ahead and factor in environmental costs into medium and long-term investment decisions.

“The reality is that global factors mean the days of cheap oil are over – and the Government must help us move to low-carbon transport to take the sting out of these price shocks. A fuel price stabiliser could help iron out yo-yoing petrol prices...”

(Friends of the Earth, ‘Fuel prices, transport and climate change, January 2011)

Therefore, a more efficient fuel duty mechanism would reduce volatility in pump prices and help consumers change behaviour accordingly to help in the fight against climate change – one of the key objectives of taxing fuel in the first place.

How would a Fuel Duty Stabiliser work?

- The Office of Budget Responsibility provides an oil price forecast based on the trend price of oil that is adjusted when the official estimates of the oil cycle changes.
- At regular intervals the Treasury must, by regulations made by statutory instrument, reduce or increase the rates of fuel duties(X) by X minus the difference between the current oil price and the forecast oil price.