



## Taxation of road fuels: the road fuel escalator (1993-2000)

Standard Note: SN3015  
Last updated: 21 January 2011  
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The Conservative Government introduced a 'road fuel escalator' (the commitment to increase duty rates by a specified percentage each year) in the March 1993 Budget. Initially this was set at 3% though it was increased to 5% in the November 1993 Budget. The then Chancellor, Gordon Brown, announced a further 1 percentage point increase in his July 1997 Budget.<sup>1</sup> Duty rates on the main categories of road fuel were increased over the next three years:

- between 8.2% and 9.3% from 1 July 1997<sup>2</sup>
- between 9.2% and 11.8% from 17 March 1998<sup>3</sup>
- between 7.3% and 11.6% from 9 March 1999.<sup>4</sup>

Over this period total receipts from excise duties on oils rose from £17.2 billion in 1996-97 to £22.5 billion in 1999-2000.<sup>5</sup> In his pre-Budget statement on 9 November 1999 Mr Brown proposed removing the escalator:

The fuel escalator was inherited from the previous Government. *[Interruption.]* The Conservatives cannot deny their history. Since 1997, the escalator has been needed to reduce the £28 billion deficit that we inherited, as we put in place our new measures to protect the environment. Those who have opposed the escalator--including some of those who originally imposed it--have to explain how, without it, they would have cut the deficit, made money available for public services and met our environmental commitments in the past two years. Having cut the deficit and introduced our new environmental policies, we are now in a position--instead of the pre-announced 6 per cent. escalator--to make our decisions Budget by Budget, with the following commitment: if there are any real terms rises in road fuel duties, they will be lower and the revenues will go straight to a ring-fenced fund for the modernisation of roads and public transport.<sup>6</sup>

In his March 2000 Budget he confirmed that any real-terms rises in road fuel duties would be "an annual Budget decision". Given a substantial rise in world oil prices since the previous November, Mr Brown announced that duties would be frozen in real terms.<sup>7</sup> This note provides a short chronology of the use of the escalator.

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<sup>1</sup> HC 85 July 1997 p 37

<sup>2</sup> HM Customs & Excise Budget Notice C&E3, 2 July 1997

<sup>3</sup> HM Customs & Excise Budget Notice C&E17, 17 March 1998

<sup>4</sup> HM Customs & Excise Budget Notice C&E11, 9 March 1999

<sup>5</sup> HM Customs & Excise, *Hydrocarbon Oils Factsheet*, February 2004 p1

<sup>6</sup> HC Deb 9 November 1999 cc 889-890

<sup>7</sup> HC Deb 21 March 2000 c 868

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### A. The introduction of a road fuel escalator

In the March 1993 Budget the then Chancellor, Norman Lamont, announced a 10% increase in road fuel duties, partly to compensate for the revenue loss from the abolition of car tax in November 1992.<sup>8</sup> He went on to state that it was the Government's intention to increase duties on average by at least 3% a year in real terms in future Budgets:

I turn now to motoring taxes, where I propose to combine raising revenue with tax reforms. When I abolished car tax in my autumn statement, I said that I would recoup the cost from other motoring taxes. I therefore propose to raise all fuel duties by 10 per cent. from 6 pm today, putting 12p on a gallon of unleaded petrol and 15p on a gallon of four-star. From midnight tonight, vehicle excise duty for cars--the tax disc--will also rise, by £15, to £125. Taken together with the abolition of car tax, those measures will raise a net £400 million in 1993-94. The overall impact will be to shift the tax burden from car buyers to car users ; and to help both the environment and the industry ...

The largest contribution to the growth in United Kingdom carbon dioxide emissions in the coming years is expected to come from the transport sector. I therefore propose to make clear today the Government's long-term intention on road fuel duty. We intend to raise road fuel duties on average by at least 3 per cent. a year in real terms in future Budgets, in addition to the increase I have already announced for this year. In deciding the level of duty to be levied in any particular Budget, we will, of course, take full account of conditions at the time--including, if charges for motorways and urban roads are introduced, the overall level of taxes and charges which road users are paying. However, my announcement today will help manufacturers and consumers to plan ahead. It should provide a strong incentive for motorists to buy more fuel-efficient vehicles, and it will raise at least a further £520 million in 1994-95 and £950 million in 1995-96.<sup>9</sup>

With the imposition of VAT on domestic supplies of fuel and power, this long term strategy sought to return greenhouse gas emissions in the UK to 1990 levels by the year 2000, as agreed at the United Nations convention on climate change at Rio.

In the November 1993 Budget, the then Chancellor, Kenneth Clarke, increased road fuel duties by 3p per litre, representing an increase of between 8% and 10%, and announced that all road fuel duties would be increased on average by at least 5% in real terms in future Budgets.<sup>10</sup> Mr Clarke reaffirmed the 5% target in his 1996 Budget:

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<sup>8</sup> [A car tax of 10 per cent was payable on all new cars and some other vehicles from 1973 to March 1992. It was cut to 5 per cent in the March 1992 Budget, before being abolished in the Autumn Statement on 12 November 1992. For more details see, *Car tax*, Library Research Note 92/99, 16 November 1992.]

<sup>9</sup> HC Deb 16 March 1993 c177, cc182-183

<sup>10</sup> HC Deb 30 November 1993 c937

I firmly believe that motorists should bear the full costs of driving - not only wear and tear and congestion on the roads, but the wider environmental costs. Even those of us who frequently have to drive - and, contrary to rumours that Ministers always travel in limousines, that includes most hon. Members - can take steps to cut fuel consumption and we all ought to consider carefully the use of our car. I intend to stick to my 1993 Budget commitment to raise motor fuel duties by an average of at least 5 per cent. each year in real terms.<sup>11</sup>

## **B. Increasing the escalator**

Following the Labour Party's victory in the 1997 General Election, the new Chancellor, Gordon Brown, presented his first Budget on 2 July that year; in his speech Mr Brown announced a significant increase in duty rates as part of a wider reform in tax policy:

A country equipped for the future should also have a modern tax system based on principle. The tax system sends critical signals about the economic activities that a society wishes to promote and deter. Today I shall start to put those principles into practice by demonstrating our commitment to the environment. As the statement of environmental principles ... - published today - shows, we are determined that our tax system and economic policies as a whole encourage the good and discourage the harmful. The extraction of aggregates - including stone, sand and gravel - involves significant environmental costs and damage to the landscape, which may go beyond that recognised in the scope and level of the landfill tax. Too little is also being done to discourage water pollution. The environmental case for charges on polluters needs to be examined carefully. After a period of consultation, I will return with any proposals in those two areas in my next Budget.

Existing taxes, including our excise duties, must also advance the Government's environmental objectives. So to reduce pollution, lorries and buses that meet low emission standards will, from next year, attract a reduction of vehicle excise duty by a maximum of £500. Rises in vehicle excise duty, broadly in line with inflation, will take place from 17 November. In line with the environmental objectives that I have set out, road fuel duties will increase by an extra 1 per cent. every year over and above the annual 5 per cent. real rate of increase established by the previous Government. Petrol will go up by the equivalent of 4p a litre from 6 pm this evening.<sup>12</sup>

Further details on the new Government's aim in increasing its commitment to raise duty rates were given in a press notice issued at the time:

The increased commitment to 6 per cent recognises the environmental and other costs attached to road use. Road traffic is the fastest growing source of carbon dioxide and the increased commitment will therefore provide a significant contribution to meeting the Government's target for a 20 per cent reduction in emissions of carbon dioxide by the year 2010. Assuming that such 6 per cent increases are made for the lifetime of this Parliament, this will produce additional savings, by the year 2010, of around 2 1/2 million tonnes of carbon annually.

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<sup>11</sup> HC Deb 26 November 1996 c167

<sup>12</sup> HC Deb 2 July 1997 c311

Increased road fuel taxation meets the general principles for good taxation set out in the Government's Statement of Intent on Environmental Taxation.<sup>13</sup>

The Government's 'statement of intent', mentioned by the Chancellor, is reproduced below:

The Government's central economic objectives are the promotion of high and sustainable levels of growth and high levels of employment. By that we mean that growth must be both stable and environmentally sustainable. Quality of growth matters; not just quantity. Delivering sustainable growth is a task that falls across government. It will be a core feature of economic policy under this administration. The Treasury is committed to that goal. How and what governments tax sends clear signals about the economic activities they believe should be encouraged or discouraged, and the values they wish to entrench in society. Just as work should be encouraged through the tax system, environmental pollution should be discouraged.

To that end, the Government will explore the scope for using the tax system to deliver environmental objectives - as one instrument, in combination with others like regulation and voluntary action. Over time, the Government will aim to reform the tax system to increase incentives to reduce environmental damage. That will shift the burden of tax from "goods" to "bads"; encourage innovation in meeting higher environmental standards; and deliver a more dynamic economy and a cleaner environment, to the benefit of everyone.

But environmental taxation must meet the general tests of good taxation. It must be well designed, to meet objectives without undesirable side-effects; it must keep deadweight compliance costs to a minimum; distributional impact must be acceptable; and care must be had to implications for international competitiveness. Where environmental taxes meet these tests, the Government will use them.<sup>14</sup>

In his spring 1998 Budget speech Mr Brown reiterated the commitment to increasing fuel duties by at least 6% in real terms each year:

The previous Government introduced a road fuel escalator, the principle of which we supported. They set it at 5 per cent., and since July it has been 6 per cent. There is agreement that only with the use of an escalator can emission levels be reduced by 2010 towards our environmental commitments. As a result of the escalator, road fuel tax will rise by 4.4p a litre for unleaded petrol and for ultra-low sulphur diesel. As is normal, that change will take effect on Budget day at 6 pm.

To encourage all diesel users to switch to cleaner fuels, ordinary diesel will increase by 1p more than that. These increases will reduce carbon emissions by 1.7 million tonnes of carbon. Of course, the price of petrol will also be affected by movements in oil prices. The oil price has fallen by 25 per cent. in the past six months: a benefit enjoyed by oil companies which has yet to be passed on to consumers, especially consumers in rural areas, who already pay higher fuel prices, which is something the Office of Fair Trading is already investigating. Whatever the short-term changes in oil prices, however, the Government have a duty to take a long-term and consistent view of the environmental impact of emissions, and that is what we have done.<sup>15</sup>

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<sup>13</sup> HM Customs & Excise press notice, *Increases in fuel duties to help the environment*, 2 July 1997

<sup>14</sup> HM Treasury press notice, *Tax measures to help the environment*, 2 July 1997

<sup>15</sup> HC Deb 17 March 1998 c1110

At this time the Government suggested that if it maintained the escalator for another four years, it would cut greenhouse gases by 2-5 million tons of carbon by 2010:

**Mr. Whittingdale:** To ask the Chancellor of the Exchequer what plans he has to continue to implement the road fuel duty escalator in future years; and if he will set a final date for implementation of the duty escalator.

**Ms Hewitt:** The road fuel escalator, which provides for duty increases on road fuels of at least 6 per cent. above inflation, shows the Government's continuing commitment to the environment and to the 'polluter pays' principle. It will help the Government to deliver the UK's share of the EU target to reduce emissions of greenhouse gases by 8 per cent. by 2008-2012. Our environmental assessment shows that the escalator, if continued at its present level until 2002, will improve urban air quality and reduce greenhouse gases by between 2 and 5 million tonnes of carbon a year by 2010. The future of the road duty escalator will be considered each year in the Budget.<sup>16</sup>

Excise duty on tobacco products was also subject to a duty escalator at this time, first set at 3% by the Conservative Government in November 1993.<sup>17</sup> In the Labour Government's first Budget after the 1997 General Election, it was announced that duties on tobacco - except hand rolling tobacco - would be increased by around 8% from 1 December 1997, and that the duty escalator would be increased from 3% to 5% for future Budgets.<sup>18</sup> In the March 1999 Budget tobacco duties - with the exception of hand rolling tobacco - were increased by 6.3% in line with the escalator.

The decision to increase fuel duties well in excess of inflation over these eight years raised a considerable amount of money for the Exchequer – in 2000 the department estimated that this was in the order of £37.6 billion:

HM Customs and Excise's estimate of the revenues that would have been foregone since 1992 had petrol and diesel fuel duties been increased in line with the retail price index is shown in the table.

Financial year	Revenues foregone (£ billion)
1992-93	0.2
1993-94	1.4
1994-95	2.7
1995-96	3.9
1996-97	5.0
1997-98	6.6
1998-99	8.4
1999-00	9.4

The estimates include VAT and take account of expected changes in the pattern of consumers' expenditure as a result of the lower duty increases.<sup>19</sup>

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<sup>16</sup> HC Deb 24 March 1999 cc257-258W. In turn this estimate was based on the Government's *1997 National Road Traffic Forecast* (HC Deb 24 March 1999 c257W; *Budget 99* HC 298 March 1999 Table 5.1).

<sup>17</sup> HC Deb 30 November 1993 c937

<sup>18</sup> HC Deb 2 July 1997 c311. Neither Conservative nor Labour governments applied the escalator consistently to hand rolling tobacco, for fears of encouraging the considerable smuggling trade in this product.

<sup>19</sup> HC Deb 1 November 2000 cc101-2WA

## C. The withdrawal of the road fuel escalator

In their 1999 Green Budget, the Institute for Fiscal Studies suggested that the duty escalator might not be sustainable in the long term:

Revenue from excise duties has grown rapidly in recent years – more quickly than revenue from income tax and corporation tax. Most of this growth has come from large real increases in duties on tobacco and petrol. There is an economic justification for duties on these goods if there are additional costs to society from their consumption. This is not to say that the amount of social cost associated with smoking and driving is reflected exactly in the level of duty each year. But the fact that smoking and driving are known to have harmful consequences makes them soft targets for a government reluctant to raise income taxes.

One question is whether the large real duty increases can continue, particularly given the distributional consequences of high excise duties. Tobacco taxes are becoming more regressive to the extent that smoking is increasingly concentrated among poorer households, while high taxes on petrol have a greater impact on those with little access to public transport. There are also the revenue effects of higher excise duties to consider.

Cross-border shopping has led to some debate over the revenue consequences of further increases in alcohol duties, although, as we show, cutting duties on beer and wine would probably lead to a loss in revenue rather than an increase. Cross-border trade in cigarettes appears to be less about the revenue effects of shopping than the revenue effects of smuggling, for which changes to excise duties are not the most appropriate response. A greater threat to future revenue from tobacco duties comes from the government's aim of cutting the number of smokers for health reasons.

Equally, duties on petrol have been raised in the hope of reducing car use for environmental reasons. This is the contradiction that lies at the heart of excise duties. They are targeted at changing behaviour. They are also good sources of revenue. In the long run they cannot be both.<sup>20</sup>

In a piece published at the time in the *Financial Times*, Richard Tomkins argued that the Government's policy to use the price of petrol to deter road use was fundamentally flawed, drawing an analogy with the impact of tobacco taxes on smokers' decision to give up tobacco:

Cars, you could say, are like cigarettes. They pollute the air we breathe; they kill large numbers of people; and they are associated with high levels of dependency among users. But does it follow that governments should treat drivers like smokers, portraying their habit as anti-social and trying to discourage it with punitively high taxes? In Britain, where traffic congestion has become a troublesome political issue, the response of governments has been to try to price motorists off the roads ... The idea of using price to regulate people's behaviour grew in popularity in the 1980s, when - at least in the US and UK - free market economics replaced government regulation as the favoured means of achieving social objectives ... An attractive

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<sup>20</sup> IFS, *The IFS Green Budget: Commentary 76*, January 1999 p90

precedent appeared to have been set by attempts to control smoking, another habit with high social costs. In the 1980s, big rises in cigarette taxes had been accompanied by a gradual decline in smoking, and the government was praised by anti-smoking advocates for discouraging socially undesirable behaviour.

In both cases, the author argued, changes in behaviour were motivated not by price signals, but other factors:

But, with hindsight, it seems likely that smokers who quit were motivated more by concerns about their health than by the government's price signal. In Britain, smoking also declined in the 1970s, even though the real price of cigarettes fell during the decade ... Moreover, in the 1990s, the long decline in smoking has ended in Britain in spite of further big tax increases. It seems that smoking has now settled at a level where those who indulge in it cannot or will not give up. Each successive tax increase simply results in higher levels of criminal activity: namely, soaring imports of contraband tobacco, now said to account for at least 10 per cent of the UK market.

The same sort of resistance to price increases is evident in people's driving behaviour. According to Britain's office for national statistics, motoring costs for the average household rose 96 per cent in the 10 years to financial year 1997-98, or 27 per cent in real terms. But the rise was not accompanied by a fall in traffic: the number of miles travelled by people in cars rose 24 per cent over the same period. It is also interesting to note that people's ability to absorb higher motoring costs is not just a side-effect of rising incomes. Instead, it has come at the expense of spending in other areas. The percentage of household expenditure taken by motoring rose from 12.6 per cent to 14.2 per cent over the decade to 1997-98: so it seems people would rather economise on food, heat or holidays than cut down on their driving.

At this point, economists usually start talking about elasticity of demand, pointing to neat charts tracking the relationship between price and consumption. This is fine when applied to goods for which an acceptable alternative exists, or that do not involve a high level of dependency. It is less successful at predicting outcomes when governments use taxes to stop people using things they cannot or will not go without. In theory, economists are right: there is a point at which price will cut demand for road transport. The trouble is that such a price is by definition unacceptable. If it were not, it would fail to cut consumption ...

Given the fact that driver behaviour appeared relatively resistant to the price of petrol, Mr Tomkins went on to suggest there was no single method for cutting congestion:

So if the government cannot tax traffic growth out of existence, what is the alternative? Some people think better public transport is a panacea. Unfortunately, it is not. Motorists like governments to spend money on public transport because they think it will encourage the idiot in the car in front to catch the train instead. But for most drivers, public transport is like the nicotine free cigarette: it's nice to know it's there, but you would never want to use it. Instead, the first priority should be to recognise that, contrary to popular perceptions, traffic growth is not inexorable. It will cease when everybody is driving 24 hours a day, and probably long before that. In the meantime, better traffic management will help absorb the extra traffic, and roads should be built or widened where environmental considerations permit.

But there is no magic bullet that will end traffic jams. Congestion is a part of modern life ... Drivers themselves are the best judges of how to deal with congestion. They

will adjust their journey times to maximise the use of the available road space, or they will change their lifestyles to minimise their travel needs. Eventually, like smokers, they may even decide to quit. But if they do, it will be when they are ready, not when the government tells them to.<sup>21</sup>

In his Pre-Budget Statement to the House on 9 November 1999 Gordon Brown announced that the 6% fuel escalator would not apply in future Budgets.<sup>22</sup> Further details were given in the *Pre-Budget Report* published at this time:

Road transport accounts for over 20 per cent of carbon dioxide and almost 50 per cent of nitrogen oxide emissions ... Since 1997, the Government has maintained and increased the fuel duty escalator introduced by the previous Government in 1993. This has given a clear signal to motorists and manufacturers to design more fuel efficient vehicles, avoid unnecessary journeys and consider alternatives to the car. Increases in fuel duties since 1996 are estimated to produce carbon savings of between 1 and 2.5 million tonnes of carbon by 2010.

The Government is committed to meeting its environmental targets. The time has now come to review the way that any increases in the fuel duties are determined. The Chancellor has, therefore, decided that the appropriate level of fuel duties will be set on a Budget by Budget basis, taking account of the Government's economic and social objectives as well as the UK's environmental commitments. The Chancellor has decided that the revenues from any real terms increases in fuel duties will, in future, go straight in to a ring-fenced fund for improving public transport and modernising the road network.<sup>23</sup>

The Chancellor also announced at this time that the duty escalator on tobacco would be withdrawn as well, and that any additional revenue raised from real increases in tobacco duties in future would be spent on improved health care.<sup>24</sup> For its part the Institute for Fiscal Studies was critical of the idea that the resources from future duty increases should be allocated to specific ends (a term known as 'hypothecation'):

One argument made in support of hypothecation is that it makes people more willing to pay tax, so that more revenue would be collected if hypothecation were used more widely. But if the reason why people are more willing to pay tax is that they believe the government is required to spend a minimum amount in those areas as a result, the fact that this is difficult to guarantee even in the short term, and even harder in the longer term, should be made clear. Even if the government could guarantee that allocating revenues in this way would lead to an increase in spending in these areas, it is still not clear that it is a good idea. Although there are some links between smoking behaviour and health spending, for example, the optimal levels of tobacco taxation and health spending are determined by a wide range of different factors. In addition, if spending in the absence of the hypothecation were fixed, and revenue from tobacco and road fuel duties were lower than expected, it is unlikely that people would be happy that spending on health and transport would be lower than expected as a result.

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<sup>21</sup> "Taxation road to nowhere", *Financial Times*, 2 September 1999

<sup>22</sup> HC Deb 9 November 1999 cc 889-890

<sup>23</sup> *Pre-Budget Report* Cm 4479 November 1999 p106

<sup>24</sup> *op.cit.* p94

Equally, if revenue from tobacco and road fuel duties were higher than expected, people might prefer the extra funds to be spent on areas other than health and transport, such as education for example. Also, the fact that the government is trying to reduce the consumption of tobacco and road fuel to meet health and environmental targets might imply lower revenue in future. Under genuine hypothecation, any reduction in consumption would lead to lower spending on health and transport, which does not seem sensible. Hypothecation of tobacco and road fuel taxes cannot guarantee higher spending on health and transport, particularly in the long term. Since it is not clear that it is desirable to link taxation on tobacco to spending on health or taxation on road fuel to spending on transport, even if it were possible to guarantee higher spending, this new development in taxation policy is not very appealing.<sup>25</sup>

In the March 2000 Budget duty rates were only increased in line with inflation,<sup>26</sup> a policy change that was welcomed by motorists organisations – such as the AA and RAC – but sharply criticised by environmental groups, such as Friends of the Earth.<sup>27</sup> However, the withdrawal of the escalator did not see an end to public concerns over fuel prices, which culminated in the summer that year with a campaign that drivers should boycott petrol stations. A second note looks in more detail at the ‘fuel crisis’ of 2000, the Labour Government’s initial response to it, and its subsequent approach to taxing road fuels.<sup>28</sup>

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<sup>25</sup> IFS, *The IFS Green Budget : Commentary 80*, January 2000 pp 109-110

<sup>26</sup> HC Deb 21 March 2000 c 868; *Budget 2000* HC 346 pp 146, 153

<sup>27</sup> “Drivers see light at end of tunnel as taxes are cut back”, *Times*, 22 March 2000

<sup>28</sup> *Taxation of road fuels: policy following the ‘fuel crisis’ (2000-2008)*, Library standard note SN/BT/3016, 21 January 2010.