VAT on fuel & power

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On 1 April 1994 domestic supplies of fuel & power became liable to value added tax (VAT) at the reduced rate of 8%. It had been the Conservative Government's intention that these supplies would be charged the standard rate of VAT - currently 17.5% - the following year. However in December 1994 the Government was defeated on a Budget Resolution vote on this question, and was required to introduce amending legislation so that these supplies continued to be charged VAT at 8%. In October 1995 the Labour party announced its intention to cut the rate of VAT on domestic supplies of fuel & power from 8% to 5%, a commitment included in their election manifesto. On 2 July 1997 in his Budget speech the Chancellor, Gordon Brown, announced that the new 5% rate would come into effect on 1 September 1997. Legislation to this effect is included in the *Finance Bill 1997* [HC Bill 37 1997/98]. This paper describes the background to VAT first being imposed on fuel & power supplies, before discussing the Labour Government's decision to cut the rate to 5%, and the implications this will have on different types of household. Under European VAT law the UK cannot charge a VAT rate lower than 5% on these supplies. A summary of the current rules governing Member States' VAT rates is attached as an appendix to this paper.

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Summary

- On 2 July 1997 in his Budget speech the Chancellor, Gordon Brown, announced that a new 5% value added tax (VAT) rate on domestic supplies of fuel & power would come into effect on 1 September 1997. It is estimated that reducing the VAT rate on these supplies from the current 8% rate to 5% will cost £220 million in 1997-98 and £485 million in the first full year (1998-99).

- When VAT was first introduced in 1973 supplies of fuel & power were charged the zero rate. On 1 July 1990 'non-domestic' supplies to industry and commerce became liable to VAT at the standard-rate, leaving the zero rate covering supplies to final consumers only: ie, supplies used in houses, flats, dwellings, etc, as well as supplies used by a charity for its non-business activities. On 1 April 1994 these 'domestic' supplies of fuel & power became liable to VAT at the reduced rate of 8%.

- It had been the Conservative Government's intention that these supplies would become liable to the standard rate of VAT - currently 17.5% - the following year. However in December 1994 it was defeated on a Budget Resolution vote on this question, and was required to introduce amending legislation so that these supplies continued to be charged VAT at 8%. The imposition of VAT at 8% on these supplies has raised £850 million in 1994-95, and £1,100 million in 1995-96.

- In 1995/96 the average household spent £12.92 per week on domestic fuel and power (equivalent to 4.2% of average disposable income). At 8% the VAT element of such spending is some 96 pence per week. Assuming no change in consumption, reducing VAT to 5% reduces the VAT bill to 60 pence - a saving of 36 pence per week. For the fifth of households with the lowest incomes, expenditure on fuel and power is lower than the average (£9.87 per week) but this represents a significantly higher proportion of disposable income (12.0%). Reducing VAT on fuel to 5% would be equal to 27 pence per week at this level of expenditure. For the fifth of households with the highest incomes expenditure on fuel and power is higher than the average (£16.43 per week) but this represents a lower proportion of disposable income (2.5%). Reducing VAT on fuel to 5% would be equal to 46 pence per week at this level of expenditure.

- No Member State has complete freedom in setting their VAT rates under European VAT law. In brief, all EC countries must charge a standard rate of VAT no lower than 15%. Member States are allowed, if they so wish, to charge a reduced rate of VAT no lower than 5% on a specified list of goods and services, a list which includes "supplies of natural gas and electricity provided that no risk of distortion of competition exists."

- Member States are only permitted to charge zero rates which were in place on 1 January 1991. No Member State can introduce a new zero rate or reintroduce a zero rate once it has been abolished. Following the abolition of the zero rate on fuel & power on 1 April 1994, the UK may charge a rate as low as 5% on these supplies, but no lower. A number of other EC countries charge a reduced rate of VAT on fuel & power: details are given in the appendix to this paper.

CONTENTS

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I Charging VAT on fuel & power

A. Introduction

In his March 1993 Budget speech the then Chancellor, Norman Lamont, proposed to introduce VAT at the standard rate on domestic supplies of fuel and power. These supplies had been zero-rated since the introduction of VAT in 1973. Supplies would be taxed at a reduced rate of 8% from 1 April 1994, before becoming liable to VAT at the standard rate - currently 17.5% - on 1 April 1995. In his speech Mr Lamont argued this measure would help the UK meet its commitment under the United Nations Framework Convention on Climate Change, signed at the Rio summit in 1992, to reduce greenhouse gas emissions by the year 2000 to their level in 1990:[1]

> Against this background, I have one further measure to propose that will not only encourage greater energy efficiency in every household in the country, but will also raise a considerable amount of revenue for the Exchequer over the years ahead. Fuel and energy supplies to industry pay VAT in Britain. Those to the home do not. In this respect, we are unique in the European Community. I therefore propose, over the next two years, to end the zero rate of VAT on domestic fuel and power. Again, this change will not come into effect immediately, but in 1994. VAT will be charged at 8 per cent. from 1 April 1994 and at 17½ per cent. from 1 April 1995 ... For the first time, the rate of VAT on domestic fuel and power will be the same as that charged on goods like loft insulation material, which improve energy efficiency. This will bring to an end the current anomaly, which makes nonsense of any attempt to use the tax system to improve the environment...
>
> Social security benefits will, of course, rise automatically to reflect the price effect of this change, but I recognise that this will cause particular problems for those on low incomes. My right hon. Friend the Secretary of State for Social Security will take this into account when the income-related benefits are uprated next year. Taken together with the measures which have already been announced, these tax proposals take Britain two thirds of the way to meeting the Rio target, and they will do so in a way that does the least possible damage to the competitiveness of British industry. I am confident that the remaining gap can be filled through sensible energy-saving measures, as and when the convention is ratified by our major industrial competitors.

At an earlier point in his speech Mr Lamont proposed a second measure to help the UK cut CO_2 emissions: a commitment to increase road fuel duties by at least 3% a year in real terms. This target was increased to 5% a year by Mr Lamont's successor, Kenneth Clarke, in his November 1993 Budget,[2] and to 6% a year by the present Chancellor, Gordon Brown, in his July 1997 Budget.[3]

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1 HC Deb 16 March 1993 cc 182-184

2 HC Deb 30 November 1993 c.937

3 HC Deb 2 July 1997 c.311

The abolition of this zero rate was implemented under section 42 of the *Finance Act 1993*. On 23 January 1995 the Government was required to introduce amending legislation following its defeat on the Budget Resolution vote relating to VAT on domestic fuel,[4] so that these supplies have continued to be charged the 8% reduced rate.[5] It should be emphasised that the decision to end the zero-rating of these supplies was the Government's alone; the UK was not forced to take this step under EC VAT law as some have thought.[6]

The imposition of VAT at 8% on domestic supplies of fuel & power has raised £850 million in 1994-95, and £1,100 million in 1995-96.[7] The benefit to the Exchequer was reduced by the cost of the special compensation given to pensioners and the disabled, which over and above normal RPI-linked uprating to benefits, has been of the order of £500 million.[8] By way of comparison, it is estimated that reducing the VAT rate to 5% as the present Government now propose will cost £485 million in a full year.[9]

At the time the Conservative Government gave two reasons for abolishing the zero rate, in addition to the need to raise additional revenue in the medium term: first, to encourage energy conservation and contribute to the reduction of CO_2 emissions; and second, to widen the VAT base. The topic of energy conservation is discussed in section ID of this paper. Before discussing the VAT base, it may be helpful to say a few words about VAT itself.

VAT is charged on the supply of all goods and services made in the course of a business by a taxable person unless specifically exempt from tax. With the one exception of domestic supplies of fuel & power, VAT is charged at the standard rate or the zero rate. The tax is levied on the additional value of each transaction and collected at each stage of production and distribution. All businesses must register for VAT if their turnover of taxable goods and/or services is above a given threshold - £48,000 at present.[10] A business pays VAT on its purchases - known as input tax, and charges VAT on its sales - known as output tax. It settles up with HM Customs and Excise for the difference between the two. In the end the cost of the tax is borne by the final consumer.

It is worth emphasising the difference between exempt supplies and those charged the zero rate. Zero-rated supplies are technically taxable though no actual tax is paid on them. They count as part of the taxable turnover of a business for registration purposes, and VAT charged on inputs related to zero-rated activities can be reclaimed. This is not the case with exempt supplies, which are outside the tax system.

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4 HC Deb 23 January 1995 cc 38-63

5 Under section 21 of the *Finance Act 1995*, which amended the *VAT Act 1994* accordingly.

6 A summary of the EC VAT rules is provided in an appendix to this paper. The issue is discussed in detail in the Library Research Paper, *VAT Harmonisation*, Research Paper 97/31, 27 February 1997.

7 HC Deb 13 February 1997 c.313W

8 Derived from HM Treasury Budget press notice no.5, 30 November 1993 The issue of compensation for pensioners is discussed in section IC of this paper.

9 HM Customs & Excise press notice, *Brown delivers on fuel VAT cut*, 2 July 1997

10 The VAT threshold is to be increased to £49,000 from 1 December 1997: HM Customs & Excise press notice, *VAT thresholds increased*, 2 July 1997.

Businesses which make exempt supplies do not charge output tax, and cannot reclaim input tax. In effect, a business making exempt supplies has to absorb the VAT charged it by its suppliers. At present exempt supplies account for 25% of consumer expenditure on goods and services in this country. 56% of consumers' expenditure is taxed at the standard rate and 15% at the zero rate. Domestic supplies of fuel & power account for the remaining 4%.[11]

The case for a wider VAT base is that a VAT system which differentiates between goods distorts prices, making for a less efficient use of resources. Consumers are likely to switch their spending to low-taxed items, a sacrifice of the goods they most want at the cost of lower Exchequer revenues. In addition, for zero or reduced rates of VAT to be charged on selected goods, precise descriptions of those goods need to be devised, descriptions which have to be legally watertight, since they represent opportunities for companies to avoid tax by having their goods and services covered by these reduced-VAT categories.

At the time of the November 1994 Budget the Treasury forecast VAT revenues for 1995-96 would be £49 billion, yet the outturn for this year proved to be just £43.1 billion. Though a review by the Treasury and HM Customs & Excise into this £6 billion shortfall found no single explanation, it concluded that two significant contributory factors were losses resulting from successful legal challenges to Customs' interpretation of VAT law, and better tax planning and increasing tax avoidance by companies.[12] One obvious way of limiting the scope of this tax avoidance is to widen the tax base.

The table overleaf lists the goods and services that are currently liable to the zero rate of VAT. For each product the table shows the revenue that would have accrued in 1996/97 had these products been liable to VAT for the full-year. The revenue effect of varying VAT on domestic fuel and power from 8% is also included.[13]

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11 *HM Customs & Excise Annual Report 1995-96* p.78

12 *Financial Statement & Budget Report 1997-98,* HC 90 November 1996 pp 68-69

13 The cost of reducing VAT on fuel and power to 5% at 1996/97 levels would have been £430 million. The actual cost in 1998/99 is forecast to be £485 million.

Revenue from imposing VAT on goods & services currently zero rated
£ million at 1996/97 levels (a)

Category	At 5%	At 8%	At 17.5%
Food	2,160	3,450	7,550
Construction of new dwellings (b)	630	1,010	2,200
Domestic passenger transport	410	660	1,450
International passenger transport	340	550	1,200
Books, newspapers & magazines	340	550	1,200
Children's clothing	230	370	800
Water & sewerage services	260	410	900
Drugs & medicines on prescription	210	340	750
Supplies to charities (c)	60	90	200
Ships & aircraft above a certain size	130	210	450
Vehicles and other supplies to the disabled (c)	60	90	200
Domestic fuel and power (d)	-430	0	1,350

Notes: (a) Assuming no behavioural changes.
(b) These estimates are particularly tentative.
(c) Excluding zero-rating of items apperaring higher in the list and reduced rate on domestic fuel and power.
(d) Changes compared to rate of 8%.

Source: Derived from HM Treasury, "Tax ready-reckoner & reliefs", July 1996

In their 1997 election manifesto the Labour party made the commitment to cut the rate of VAT on fuel & power to 5%, and to maintain zero rating on food, children's clothes, books & newspapers, and public transport fares (a commitment confirmed in the Chancellor's Budget speech). The party's case against extending VAT in this way is that since food, fuel and similar goods form a higher proportion of the spending of the poor than of the rich, taxing them would be regressive. Of the tax changes introduced between 1992 and 1997 by the Conservative Government, the party commented, "the tragedy is that those hardest hit are least able to pay. That is why we strongly opposed the imposition of VAT on fuel."[14] In his Budget speech, Gordon Brown put forward a similar case for cutting VAT to 5%: "The principle of fairness in taxation will guide all my Budget decisions. I can announce today that at this, the first opportunity, the Government will honour their pledge to cut value-added tax on fuel and power."[15]

Certainly cutting the rate of VAT on fuel & power will be of benefit to poorer households, as the Institute for Fiscal Studies confirmed in their most recent *Green Budget*: "The main reason given [by the Labour party] for the reduction [in VAT on fuel & power] is distributional. Domestic fuels

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14 Labour Party, *New Labour: because Britain deserves better*, April 1997 p.12

15 HC Deb 2 July 1997 c.312

are a necessity and their consumption rises less than proportionately with income. Poorer households, therefore, allocate a greater proportion of their weekly budgets to fuel than richer households, and, consequently, the immediate incidence of the tax on their standard of living is greater. The 3 percentage point reduction in the VAT rate will reduce the proportionate burden of this tax for poorer households more than it will for richer households, although richer households will gain more in absolute terms."[16] Nonetheless, as the IFS has argued elsewhere, the problem with using indirect taxation to redistribute society's resources is that it distorts relative prices for rich and poor alike, and a progressive income tax plus transfers might well achieve the same results more efficiently.[17]

A second criticism of this measure that might be made is that it will lead to greater use of domestic energy and an increase in CO_2 emissions. To the extent that extending VAT on domestic energy can be seen as an environmental measure, cutting the rate from 8% to 5% might be considered a retrograde step. The impact of VAT on CO_2 emissions is examined in section ID of this paper, and the Labour Government's views on climate change are discussed in section II. Nonetheless it is worth noting here that households' demand for fuel & power has proved relatively price-insensitive. Indeed it is estimated that cutting VAT to 5% will result in an increase in emissions by the year 2010 of about 0.24 million tonnes of carbon, representing just 0.15 per cent of current CO_2 emissions.[18]

B. Standing charges

VAT is charged on both parts of someone's fuel bill; that is, both the standing charge element, and the variable charge. This is common practice whenever a business splits a bill between a standing charge and a variable one.

Generally VAT is charged on the entire cost or value of any taxable supplies - that is, the consideration in money which the business receives in return for this supply. The definition of "value" is given in section 19 of the *Value Added Tax Act (VATA) 1994*, subsection 2 of which states, "if the supply is for a consideration of money its value shall be taken to be such amount as, with the addition of the VAT chargeable, is equal to the consideration." So, if a supplier divides any bill for a single supply into a variable element and a standing charge, both parts will be charged VAT in the normal way. As a consequence standing charges for domestic supplies of fuel & power have been charged VAT at the same 8% rate. The utility companies do not have any discretion in charging VAT on standing charges, though some customers have mistakenly believed otherwise.

The Conservative Government ruled out making an exception in the case of fuel & power - and zero-rating standing charges - when it first announced the abolition of the zero rate as part of the March 1993 Budget. The then Chancellor, Norman Lamont, confirmed that standing charges would be treated in the normal fashion during Treasury questions on 1 April 1993.[19] The then

16 IFS, *The IFS Green Budget: summer 1997*, May 1997 p.63
17 IFS, *Options for 1997: the Green Budget*, October 1996 p.123
18 HC Deb 10 June 1997 cc 404-405W
19 HC Deb 1 April 1993 c.483

Financial Secretary to the Treasury, Stephen Dorrell, reiterated the point when pressed by Gordon Brown:[20]

> **Mr. Gordon Brown:** Given the hon. Gentleman's admission with regard to standing charges; will he now tell us how much more, in pounds and pence, a typical pensioner will have to pay because of the imposition of VAT on standing charges for gas and electricity? Will he also explain the environmental justification for that imposition?
>
> **Mr. Dorrell:** The hon. Gentleman might explain to the House why Labour thought that it was entirely consistent to impose VAT on telephone standing charges. [Hon.Members:"Answer."] The simplest layman - apart, apparently, from the hon. Gentleman - can see that the standing charge for the supply of energy to a household is part of the integrated cost that has to be charged by the supplier. The hon. Gentleman is pressing upon us the creation of a blatant tax loophole something that he does not normally like to do. I can assure him that we shall resist his pressure.

The Government gave its reasons for proceeding with this measure during the Committee stage of the *Finance Act 1993.* The then Chief Secretary to the Treasury, Michael Portillo, explained that it would be too costly to charge VAT on only one part of the charge for supply:[21]

> VAT is normally chargeable on the whole of a charge for supply, both the fixed and the variable element. If we were to exclude standing charges from VAT that would mean a substantial reduction in the revenue and we would then have to seek that revenue elsewhere. It would be administratively extremely inefficient to exclude standing charges, and it would certainly mean that in the long term the industries would be given the opportunity to restructure the way in which they charged people in order to avoid VAT falling on their supplies.

The then Paymaster General, Sir John Cope, went on to make an additional argument for charging VAT in this fashion:[22]

> **Mr. Marlow:** Many people support and understand the logic of taxing fuel consumption, but what about the standing charge which is purely about making available to people an essential service?
>
> **Sir John Cope:** If my hon. Friend will forgive me, I shall deal with the standing charge. It has been suggested that we should not apply VAT to the standing charge as that would somehow offer help to the most needy. Some of the least well-off gas consumers pay by token meters. Their standing charge is lower and their unit charge is higher. As a result, that suggestion would not help the most needy. They would benefit less than other consumers from zero-rated standing charges. In any case, it is difficult to see how one could divide up a fuel bill and avoid problems.

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20 *op.cit.* c.493
21 HC Deb 10 May 1993 c.519
22 *op.cit.* c.594

It has been argued that standing charges represent a charge for the supply of other services, quite separate from the actual supply of fuel & power, and should not now be included in the assessment of electricity and gas bills for VAT. However, if this were the case, standing charges would now have to be charged VAT at the standard rate of 17.5%, since there is no separate provision in *VATA 1994* for their zero-rating.[23]

C. Compensation for pensioners[24]

When the abolition of zero-rating was first announced, the Conservative Government intended to compensate poorer pensioners and relevant disabled persons on income-related benefits. This compensation was in addition to the increases made to benefits under the normal uprating rules, which keep benefits in line with inflation. In his November 1993 Budget the then Chancellor, Kenneth Clarke, announced that this extra compensation would be given to all pensioners, in two staged increases in the weekly retirement pension: one from April 1994; the second from April 1995.

In April 1994 a retirement pension was uprated by 50p (single) and 70p (married) on top of the normal uprating in anticipation of VAT being imposed on fuel & power. However, following the decision in December 1994 not to impose the standard rate of VAT on fuel & power, the second element of this compensation was withdrawn. In April 1995 the weekly rate of retirement pension for a single person rose from £57.60 to £58.85. The rate for a married couple (wife on husband's insurance) increased from £92.10 to £94.10. Both these represented increases in line with the 2.2% change in the Retail Prices Index (RPI) in the year to September 1994. These rates replaced those which had previously been announced at the time of the 1994 Budget - £59.15 single and £94.45 married.[25]

Existing compensation for the first phase of VAT on fuel remained part of the benefit rates. So, for example, from April 1995 the basic pension for a single pensioner included 70p compensation and for a pensioner couple £1.05 per week. This compensation is composed of two parts: first, the help awarded on top of the normal uprating in April 1994 in anticipation of the first phase of VAT on fuel (50p for single and 70p for married); and second, an element of the 2.2% uprating which results from the effect of the first phase of VAT on fuel & power on the rise in the RPI in the year to September 1994 (20p single and 35p married). These amounts are subsumed within the normal benefit rates and, contrary to what some thought, they were not separately identified in social security order books. Moreover, the enhancements were not a separate benefit but an integral part of the existing benefit which will be uprated in future years.

23 HC Deb 29 March 1994 c.643W

24 Contributed by Richard Cracknell, Social Policy Section

25 These figures included the 2.2% uprating factor, and the second tranche of extra compensation for VAT on fuel & power which had been withdrawn.

The summary of the compensation afforded pensioners was provided in a written answer given in December 1994:[26]

> **Mr. Arbuthnot:** Using the 1990-91-92 family expenditure surveys, uprated to 1994-95 and 1995-96 prices and benefit levels the estimated average amounts of compensation for the introduction of VAT on fuel are contained in the following table.

Client group	*Average weekly amount of help in 1994-95*	*Average weekly amount of help in 1995-96*
Single pensioner	50 pence	75 pence
Couple pensioner[1]	75 pence	£1.15
All disabled[2]	65 pence	£1.00

[1]Couple where the head of the couple is over pension age.
[2]Average compensation for all single disabled people, and all couples where at least one person in the couple is disabled.

> *Note:*
> Average amounts of help are higher than the amounts contained in standard rate retirement pension (RP), because some pensioners receive other benefits, and some receive RP at a higher rate.

Initially it was estimated that the total additional help given to compensate for the imposition of VAT on fuel & power would have cost £1.3 billion by 1996-97. This included raising the pension and other benefits, increasing cold weather payments and energy efficiency grants. However, following the withdrawal of the second part of this compensation, the cost of this help over and above normal RPI-linked uprating has been of the order of £500 million.[27] By way of comparison, charging VAT at 8% on these supplies raised £1,100 million in 1995-96.

The Government has confirmed that it will keep in place the existing special benefits for pensioners and the disabled, which form part of their income-related benefits.[28] That said, the cut in VAT will have an indirect effect on these benefits, when it comes to their being uprated in line with inflation, since reducing VAT from 8% to 5% will reduce RPI inflation[29] (though the maximum effect on the RPI of this cut will be of the order of 0.1 percentage points).

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26 HC Deb 20 December 1994 cc 1027-1028W
27 Derived from HM Treasury Budget press notice no.5, 30 November 1993
28 HM Customs & Excise press notice, *Brown delivers promise on fuel VAT cut*, 2 July 1997
29 HC Deb 3 July 1997 c.258W

D. Reducing CO_2 emissions

One of the Conservative Government's reasons for abolishing the zero rate on domestic fuel & power was that it would help the UK meet its commitment under the United Nations Framework Convention on Climate Change (FCCC) signed at the Rio summit in 1992. The Convention committed the participant developed countries, including the UK, to produce plans with the aim of returning their emissions of greenhouse gases to 1990 levels by the year 2000 and to report progress regularly to the UN.[30]

Carbon dioxide (CO_2) is the most important greenhouse gas. In 1990 it accounted for 81% of the direct global warming potential from national greenhouse gas emissions in the UK.[31] CO_2 emissions in that year were an estimated 611 million tonnes, containing 167 million tonnes of carbon (MtC).[32] In December 1992 the Government published its forecast that, on unchanged policies, emissions would rise by 10MtC over the decade to 170MtC by the year 2000. Clearly, to meet its Rio commitment the UK was required to introduce measures to bring about a fall in emissions of at least 10MtC.[33] The burning of fossil fuels - coal, oil, gas - causes nearly all CO_2 emissions. If one divides emissions by end user, the residential sector and transport each account for roughly one quarter of all emissions, while industry and the commercial/ institutional sectors account for 30% and 14% respectively.[34] Imposing VAT at the standard rate on domestic energy, and so increasing the price of fuels to households, is one method of tackling emissions. Indeed it has been argued that VAT should be imposed at a higher rate on energy than anything else, given the consumption of energy by households may have greater environmental costs than the consumption of other goods and services, and that those costs are unlikely to be fully reflected in the price of energy.

The use of VAT on domestic fuel & power as an environmental measure depends on the responsiveness of demand to changes in the price of energy. The less sensitive demand is to changes in price, the less effective an environmental policy instrument VAT would be. Of course if demand proves relatively insensitive to changes in price - 'inelastic' rather than 'elastic' - the imposition of VAT can be seen as a rather efficient way to generate extra tax revenues. At the time of the March 1993 Budget, the Government expected the demand for domestic energy to be rather inelastic, and that VAT on fuel & power would play a relatively small part in the UK achieving its CO_2 emission target, cutting emissions by 1.5 MtC by the year 2000.[35] Naturally this estimate was

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30 The background to Rio and its implications for the participant countries is discussed in three Library Research papers: *The Earth Summit: the outcome* 92/63, 24 June 1992; *Global Warming: policy responses* 95/86, 14 July 1995; *Sustainable development: Agenda 21 and Earth Summit II* 96/87, 16 August 1996.

31 Dept of the Environment press notice, *UK on course to meet international obligations on climate change*, 18 February 1997

32 Dept of the Environment, *Climate change: the UK programme*, February 1997 p.12

33 Dept of the Environment, *Climate change: our national programme for CO_2 emissions*, December 1992 At this time the Department's estimate of the UK's carbon dioxide emissions in 1990 was 160MtC.

34 *Climate change: the UK programme*, February 1997 p.12 In 1990 92% of emissions came from burning fossil fuels, 5% came from land use change, 2% from industrial process emissions, and 1% from fugitive emissions from oil and gas production.

35 HM Treasury press notice, *The Budget: climate change*, 16 March 1993

revised following the decision to continue to charge VAT at 8% on these supplies: down from 1.5MtC to just 0.4MtC.[36]

Nonetheless the UK remains on course to meet its Rio commitments thanks to several other developments in this sector. In February 1997 the then Environment Secretary John Gummer announced the publication of the UK's second report on climate change, which showed that by the year 2000 total emissions of CO_2 were likely to be between four to eight per cent below the 1990 baseline. The projected savings in emissions were just over 35MtC in total by the end of the century.

A press notice issued at the time summarised the key factors which had put the UK on course to exceed its target for 2000; notably VAT on fuel & power was not among them:[37]

> "The key factors which have put the UK on course to exceed its target for 2000 are:
>
> - the widespread introduction of competition into the UK's energy markets leading to a reduction in emissions from electricity generation through the switch from oil and coal to gas and improvements in the productivity of the nuclear sector;
> - achieving 5,000 megawatts of combined heat and power capacity by 2000 and stimulating the development of new and renewable sources of energy with a target of 1,500 megawatts of capacity by 2000;
> - major campaigns to encourage the take up of energy efficiency measures;
> - the Government's strategy of increasing road fuel duties by an average of at least five percent a year in real terms since 1993 which is encouraging savings in the use of fuel;
> - a fall in emissions of methane from coal mining and landfill waste;
> - a 95 percent cut in emissions of nitrous oxide from the manufacture of chemicals used in the production of nylon; and
> - voluntary agreements with industry to minimise the use and emissions of HFCs."

In 1996 the authors of an IPPR study of green taxes argued the imposition of VAT on fuel was wholly regrettable. The measure was unpopular and yet did little to curb CO_2 emissions. Moreover the attention paid to compensation and the price paid by households for this extension in the VAT base skewed the public perception of green taxes, and their potential to raise revenue while improving the environment:[38]

> The political price was high ... The environmental price was also high. The scope for sensible debate about environmental taxes has been radically reduced. The impression of a trade-off between environmental protection and social policy, which environmentalists have

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36 *Climate change: the UK programme*, February 1997 p.23

37 Dept of the Environment press notice, *UK on course to meet international obligations on climate change*, 18 February 1997

38 Stephen Tindale & Gerald Holtham, *Green Tax Reform*, Institute for Public Policy Research 1996 p.25

> been striving to overcome for a decade, was reinforced. So too was the widespread view that environmentalism equals sacrifice and so will not be popular with the voters, another misconception which environmentalists have sought mightily to bury.

E. Energy saving materials

When Norman Lamont first proposed charging the standard rate of VAT on fuel & power, he commented "for the first time the rate of VAT on domestic fuel and power will be the same as that charged on goods like loft insulation material, which improve energy efficiency. This will bring to an end the current anomaly, which makes nonsense of any attempt to use the tax system to improve the environment".[39]

Following the decision to retain the 8% VAT rate on these supplies, Alan Simpson introduced a Private Members Bill in January 1995 to charge the reduced rate on a range of materials which reduce domestic use of energy, such as domestic heating controls, draught-proofing materials, loft insulation, cavity wall insulation, hot water tank jackets and low-emissivity glazing.[40] At the time Mr Simpson quoted the former Chancellor's comments in his 1993 Budget speech, arguing "there is no point in having environmental or energy conservation policies that are moving in one direction, when the weight of the tax system pulls in the opposite direction."[41] Though the debate was adjourned for want of time and the Bill did not complete a Second Reading, it did attract cross-party support.[42]

Opponents of the Bill argued that charging a reduced VAT rate was too blunt an instrument for encouraging lower income households to purchase energy saving materials, rewarding as it does, all households irrespective of their income. It threatened to be an expensive instrument as well, encouraging companies to challenge Customs in defining their products as 'energy saving' ones, and other groups to lobby for similar VAT reliefs which would erode the tax base significantly.

In addition, charging an 8% rate on these supplies would be contrary to European VAT law, a point confirmed by the then Paymaster General, David Heathcoat-Amory, when he set out the reasons for the Conservative Government's opposition to this measure during the Committee stage of that year's Finance Bill:[43]

> We do not intend to bring in any more reduced rates of VAT. To do so would undermine the comparative simplicity of the VAT system in this country. It would create new boundary lines between rates and types of products and services, which would provide endless scope for disputes and difficult decisions ... In answer to a question about energy saving materials, I can confirm - it was apparently not understood by the hon. Member for Nottingham, South (Mr. Simpson), who introduced his Bill

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39 HC Deb 16 March 1993 c.183

40 *Energy Saving Materials (Rate of Value Added Tax) Bill* [HC Bill 31 1994/95]

41 HC Deb 20 January 1995 c.976

42 At this time an Early Day Motion supporting Mr Simpson's Bill attracted 342 signatories: EDM 383 of 1994-95, *Reducing VAT on energy saving materials*, 12 January 1995.

43 HC Deb 23 January 1995 c.58

> last Friday - that such products are not on the annexe to the sixth VAT directive and therefore we could not introduce a reduced rate for such products, even if we wished to.

At present Member States may only charge a reduced rate of VAT on those goods and services listed in Annex H to the sixth EC VAT directive (77/388/EEC). Annex H includes certain supplies which are standard-rated for VAT at present in the UK - including the renovation and alteration of housing (item 9) - but it makes no specific mention of energy saving materials.[44]

It is feasible that a limited reduced rate of VAT could be introduced, for supplies made by a person altering or renovating a house by installing energy-saving materials, but certainly there is currently no provision in EC law that could relieve DIY materials. A high proportion of the cheaper and most effective energy-saving materials, such as loft insulation and draught-stripping, are installed on a DIY basis or by people who are not registered for VAT, and they would not receive any benefit from such a measure. The only benefit would be to householders who paid a VAT-registered business to carry out such work.[45]

Most recently the issue was raised at the Report stage of the *Finance Act 1997* when Alan Simpson put down a new clause to allow taxpayers to claim part of the cost of purchasing these products against income tax.[46] The proposed tax relief was strongly criticised, for being exploitable and for only providing relief for those with sufficient incomes to be paying income tax, and in the event it was not adopted. However the Conservative Government accepted a second new clause put foward at the same time. This requires the Treasury to prepare a report within twelve months of the *Finance Act* receiving the Royal Assent "on the consequences to the Exchequer of reducing VAT on energy saving materials."[47]

In his July 1997 Budget the Chancellor, Gordon Brown, announced that the review would be completed by the end of October 1997, and that its scope would be widened, so that it would also look at the best way of giving help where it was needed.

Details were given in a press notice issued at the time:[48]

> "The main aim of the expanded review is to identify the most effective and efficient ways of helping those on low incomes to reduce the consumption of the fuel they need to keep warm. Customs will lead the review and welcome views by the end of August from individuals, social action and environmental groups, manufacturers, trade and business associations, academic and research bodies and consumer associations. The review is expected to be completed by the end of October 1997. The wider scope of the review will enable the Chancellor to explore a

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44 Further details of EU VAT legislation are given in the appendix to this paper.

45 HM Customs & Excise press notice, *Helping the less well off to save energy*, 2 July 1997

46 HC Deb 11 March 1997 cc 189-206

47 New clause 15 - now section 111 of the *Finance Act 1997*

48 HM Customs & Excise press notice, *Helping the less well off to save energy*, 2 July 1997

number of options for helping those on low incomes to reduce fuel consumption, and compare these with the effect of any VAT relief. The review will focus on:

- Who are least able to keep themselves warm?
- How energy-efficient are their homes?
- What goods or services provide the best value for money in terms of energy savings?
- Are such goods or services appropriate for the properties of people least able to keep themselves warm?
- Can such goods/services easily be distinguished from others with a dual purpose or with only an incidental energy-saving role?"

II Cutting the rate of VAT to 5%

On 2 July 1997 in his Budget speech the Chancellor, Gordon Brown, announced that a new 5% VAT rate on domestic supplies of fuel & power would come into effect on 1 September 1997. Legislation to this effect is included in the *Finance Bill 1997* [HC Bill 37 1997/98]; specifically clause 6 of the Bill, which amends the *VAT Act 1994* accordingly.

It is estimated that reducing the VAT rate on these supplies from the current 8% rate to 5% will cost £220 million in 1997-98 and £485 million in the first full year (1998-99).[49] It is estimated that the full year gain in 1997-98 for the average household will be about £18 per annum.[50] The Government has confirmed that it will keep in place the existing special benefits for pensioners and the disabled, which form part of their income-related benefits, though the cut in VAT will have an indirect effect on these benefits, when it comes to their being uprated in line with inflation, since reducing VAT from 8% to 5% will reduce RPI inflation.[51]

Part of this revenue shortfall is to be met by the abolition of tax relief for private health care, which will cost an estimated £120 million for 1997-98, rising to £140 million in 1999-2000.[52] Although there is no general tax relief for those facing the costs of private health care, tax relief is given for private health insurance for the over-60s. Those who pay private medical insurance premiums for someone aged 60 or over can receive income tax relief on the payments, assuming certain conditions are met. Relief has been limited to the basic rate of tax since 6 April 1994. It is paid in respect of some 400,000 contracts to provide cover for around 600,000 individuals.[53] The Labour Party has been committed to abolishing this relief for some time[54] and has stated on several occasions that it will use the money saved by abolishing this relief to subsidise some of the cost of cutting VAT on domestic supplies of fuel & power from 8% to 5%.[55]

It is estimated that cutting VAT to 5% will result in an increase in emissions by 2010 of about 0.24 million tonnes of carbon (MtC), representing 0.15 per cent of current CO_2 emissions.[56] By way of comparison, in order to meet its commitment to cut emissions to the level attained in 1990 under the United Nations Framework Convention on Climate Change, the Government forecast in 1992 that emissions would have to be cut by 10MtC.[57] Since then the targets for emissions reduction set

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49 HM Customs & Excise press notice, *Brown delivers on fuel VAT cut*, 2 July 1997

50 HC Deb 2 June 1997 c.95W

51 HC Deb 3 July 1997 c.258W

52 Inland Revenue press notice, *Tax relief for private medical insurance to be ended*, 2 July 1997

53 HC Deb 13 March 1997 c.322W

54 For example, in *A New Economic Future for Britain*, June 1995 p.70

55 Alistair Darling, now Chief Secretary to the Treasury, said in the Budget Resolutions debate on the economy in December 1996, "we have made clear that the shortfall [in cutting VAT from 8% to 5%] will be met by removing the relief from private medical insurance, closing the loopholes on inheritance tax on chattels and making certain changes to the corporate tax regime." [HC Deb 3 December 1996 c.892]

56 HC Deb 10 June 1997 cc 404-405W

57 Dept of the Environment, *Climate change: our national programme for CO_2 emissions*, December 1992

by the UK have been tightened ambitiously. In March 1997 EC environment ministers made a preliminary agreement to cut greenhouse gas emissions - in CO_2 as well as methane and nitrogen oxides - across Europe by 10% by 2010, through a burden-sharing agreement providing different quotas for emission standards, related to the development of each Member State (ie, allowing less developed nations to raise emissions, while the more advanced ones reduce their own).[58] A final commitment will await the negotiation of a protocol to the Convention on climate change, which is to be addressed by the UN summit in Kyoto in December 1997.

More recently the new Labour Government has confirmed a commitment made when in opposition to cut CO_2 emissions by 20% on 1990 levels by 2010. On 4 June Environment Minister Michael Meacher explained to a conference on global warming that this "reflected a serious priority throughout Government. I am under no illusion ... that reducing carbon dioxide emissions by 20 per cent will be an easy target to aim at. But it is a challenging target and it would serve no useful purpose at all if it were not."[59] As yet the Government have not published any detailed proposals on how this target may be met. Angela Eagle, Parliamentary Under Secretary at Environment, has stated that the Government will "be developing measures to reduce carbon dioxide in fields such as energy efficiency, renewable energy, combined heat and power, and our integrated transport strategy so as to deliver our proposed target of a 20 per cent reduction in carbon dioxide emissions below 1990 levels by 2010."[60]

In their election manifesto the Labour Party referred to the use of fiscal instruments to discourage certain activities, including environmental pollution: "Taxation is not neutral in the way it raises revenue. 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, for example, work should be encouraged through the tax system, environmental pollution should be discouraged."[61] Following this, the Government made a wider statement of intent on the use of environmental taxes at the time of the Budget:[62]

> 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.

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58 "Environment Council: Agreement on 'differentiated' reduction of greenhouse gases," *Europe Environment No. 495*, 11 March 1997 Though the Council considered that emissions should be cut by 15% - rather than just 10% - quotas for individual Member States to meet this tighter target have not been agreed: for details see Library Research paper, *Green Taxes 97/46*, 7 April 1997 p.20.

59 Dept of the Environment press notice, *UK will take the lead in fight against global warming*, 4 June 1997

60 HC Deb 2 June 1997 cc 42-43W

61 Labour Party, *New Labour : because Britain deserves better*, April 1997 p.12

> 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.[63]

One example of this statement being put in practice is the announcement that an on-going Treasury review of reducing VAT on energy saving materials is to be extended, to explore a range of options to help those on low incomes reduce fuel consumption. The review is to be completed by the end of October 1997.[64]

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62 HM Treasury press notice, *Tax measures to help the environment*, 2 July 1997

63 The use of taxes in pursuit of environmental policy objectives is discussed in some detail in the Library Research paper, *Green Taxes 97/46*, 7 April 1997.

64 HM Customs & Excise press notice, *Helping the less well off to save energy*, 2 July 1997

III The impact of VAT on fuel & power on different households

This section looks at the impact of VAT on domestic fuel & power on different types of household. In general, expenditure on fuel and power falls as a proportion of income as income rises. Thus the burden of VAT on fuel falls disproportionately on poorer households (ie, the tax is regressive). The following table, based on the results of the 1995/96 *Family Expenditure Survey* illustrates the situation:

Table 1

Household Expenditure on Domestic Fuel and Power
Analysis by income: 1995/96

Quintile of unequivalised gross income	Weekly spending £ per week	Weekly spending As % of disposable income	VAT element at 8%	VAT at 5%	VAT at 17.5%
All households	£12.92	4.2%	£0.96	£0.60	£2.09
Lowest 20 percent	£9.87	12.0%	£0.73	£0.46	£1.60
Second quintile group	£11.54	7.1%	£0.85	£0.53	£1.87
Third quintile group	£12.59	4.8%	£0.93	£0.58	£2.04
Fourth quintile group	£14.16	3.8%	£1.05	£0.66	£2.29
Highest 20 percent	£16.43	2.5%	£1.22	£0.76	£2.66

Source: ONS, "Family Spending: a report of the 1995/96 Family Expenditure Survey"

In 1995/96 the average household spent £12.92 per week on domestic fuel & power (equivalent to 4.2% of average disposable income).[65] At 8% the VAT element of such spending is some 96 pence per week. Assuming no change in consumption, reducing VAT to 5% reduces the VAT bill to 60 pence - a saving of 36 pence per week.

For the fifth of households with the lowest incomes, expenditure on fuel & power is lower than the average (£9.87 per week) but this represents a significantly higher proportion of disposable income (12.0%).[66] Reducing VAT on fuel to 5% would be equal to 27 pence per week at this level of expenditure. For the fifth of households with the highest incomes expenditure on fuel & power is higher than the average (£16.43 per week) but this represents a lower proportion of disposable income (2.5%). Reducing VAT on fuel to 5% would be equal to 46 pence per week at this level of expenditure.

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65 The statistics include a very small proportion of expenditure (e.g. on candles) which is liable to VAT at the standard rate. For these purposes this is ignored.

66 It should be remembered that households with lower incomes may be financing some expenditure from savings or by borrowing and total expenditure may exceed current income.

Tables 2 and 3 show how expenditure varies by region and type of household. Table 2 suggests that spending on domestic fuel and power is highest in Northern Ireland and lowest in Greater London. Table 3 shows that expenditure on fuel tends to increase with family size but is lower for retired households than for those non-retired households of the same size (presumably reflecting lower income).

Table 2

Household Expenditure on Domestic Fuel and Power
Analysis by Region: 1995/96

Region	Weekly expenditure £ per week	VAT element at 8%	VAT at 5%	VAT at 17.5%
United Kingdom	£12.92	£0.96	£0.60	£2.09
North	£12.77	£0.95	£0.59	£2.07
Yorkshire & Humberside	£12.90	£0.96	£0.60	£2.09
East Midlands	£13.17	£0.98	£0.61	£2.13
East Anglia	£12.45	£0.92	£0.58	£2.02
South East	£12.49	£0.93	£0.58	£2.02
Greater London	*£12.04*	*£0.89*	*£0.56*	*£1.95*
Rest of South East	*£12.73*	*£0.94*	*£0.59*	*£2.06*
South West	£12.59	£0.93	£0.58	£2.04
West Midlands	£12.79	£0.95	£0.59	£2.07
North West	£13.22	£0.98	£0.61	£2.14
Wales	£14.71	£1.09	£0.68	£2.38
Scotland	£13.14	£0.97	£0.61	£2.13
Northern Ireland	£14.88	£1.10	£0.69	£2.41

Source: ONS, "Family Spending: a report of the 1995/96 Family Expenditure Survey"

Table 3

Household Expenditure on Domestic Fuel and Power

Analysis by household composition: 1995/96

Household composition	Weekly expenditure £ per week	VAT element at 8%	VAT at 5%	VAT at 17.5%
All households (a)	£12.92	£0.96	£0.60	£2.09
One adult	£9.39	£0.70	£0.43	£1.52
Retired, mainly dependent on benefits (b)	*£8.72*	*£0.65*	*£0.40*	*£1.41*
Other retired households	*£10.87*	*£0.81*	*£0.50*	*£1.76*
Other households	*£9.07*	*£0.67*	*£0.42*	*£1.47*
One adult; one child	£11.36	£0.84	£0.53	£1.84
One adult; two or more children	£14.32	£1.06	£0.66	£2.32
One man and one woman	£12.81	£0.95	£0.59	£2.08
Retired, mainly dependent on benefits (b)	*£10.85*	*£0.80*	*£0.50*	*£1.76*
Other retired households	*£12.72*	*£0.94*	*£0.59*	*£2.06*
Other households	*£13.19*	*£0.98*	*£0.61*	*£2.14*
Two adults, one child	£13.82	£1.02	£0.64	£2.24
Two adults, two children	£15.29	£1.13	£0.71	£2.48
Two adults, three or more children	£17.07	£1.26	£0.79	£2.77
Three or more adults without children	£16.04	£1.19	£0.74	£2.60
Three or more adults with children	£19.38	£1.44	£0.90	£3.14

Note: (a) Includes 137 households consisting of two men or two women.
(b) Those deriving at least 75% of their income from state benefits.

Source: ONS, "Family Spending: a report of the 1995/96 Family Expenditure Survey"

Thus far only the direct effect on households has been considered. Particularly in the case of those on benefits, it is possible to identify other effects resulting from the up-rating of benefits and the compensation scheme for pensioners. For example, in April 1995 the basic pension for a single pensioner included 70 pence per week and for a pensioner couple £1.05 per week in compensation for the introduction of VAT on fuel & power. These figures represented the sum of two components:

- compensation awarded on top of the normal up-rating in April 1994 in anticipation of the first phase of VAT on fuel (50p for single and 70p for married) and
- an element of the 2.2% up-rating which resulted from the effect of the first phase of VAT on fuel on the rise in the Retail Prices Index in the year to September 1994 (20p single and 35p married).

The following written answer suggests that, taking these factors into account, the average net effect of introducing VAT on fuel and power was to make single pensioners no worse-off and make pensioner couples five pence per week better-off:[67]

> **Mr. Ian Bruce:** To ask the Secretary of State for Social Security what was the effect on (a) the average family on benefit, (b) a single pensioner and (c) a pensioner couple of the introduction of VAT on fuel at 8 per cent., taking into account (i) VAT fuel subsidy added to their benefits and (ii) the impact on the annual up-rating of benefits of the inflationary effect of increasing domestic fuel prices by 8 per cent.
>
> **Mr. Keith Bradley:** As part of our commitment to reducing poverty we will cut VAT on fuel from 8 to 5 per cent the lowest possible level.
>
> The net effect of the introduction of VAT on fuel at 8 per cent is given in the following table:
>
> | Family type | Net effect of VAT on fuel at 8 per cent (1997-98 prices and benefit levels |
> |---|---:|
> | Average family on income support (assumed to be a couple with 2 children aged under 11) | 15p per week worse off |
> | Single retirement pensioner | No net effect |
> | Couple retirement pensioner | 5p per week better off |
>
> 1. Expenditure estimates based on the 1994-95 Family Expenditure Survey, up-rated to 1997-98 levels using the fuel and light component of the Retail Prices Index.
>
> 2. Effect of VAT on domestic fuel and power on the up-rating indices estimated using the 1997 weight of the fuel and light component of the Retail Prices Index.

67 HC Deb 24 June 1997 c.491W

Appendix

The EC VAT rules

The harmonisation of VAT across the European Union is well advanced. Though the first steps toward harmonisation were taken in the late 1960s it was the sixth EC VAT directive (77/388/EEC), adopted on 17 May 1977, which marked a turning point in establishing common criteria for the VAT base. The directive specified those goods and services to be exempt from VAT. Like other Member States the UK cannot alter this list of exempt supplies; it could only be amended by a subsequent EC directive. Agreement on harmonising the rates of VAT charged in each Member State was not reached until June 1991 (this is discussed below).

Though the sixth VAT directive dealt primarily with the VAT base, it had implications for the UK's zero rates. Article 28(2) of the directive permitted Member States to maintain "reduced rates and exemptions ... which are in force on 31 December 1975 and which satisfy the conditions stated in the last indent of Article 17 of the second council directive of 11 April 1967." Article 17 refers only to exemptions maintained for "clearly defined social reasons and for the benefit of the final consumer." As a result the UK was allowed to continue to charge its existing zero rates.

However in June 1988 the European Court of Justice found that certain items which the UK zero-rated did not fall under these criteria: the construction of industrial and commercial buildings; sewerage & water services to industry; and fuel & power supplies other than those made to final consumers. As a result of this judgement the UK was required to bring in amending legislation - included in the *Finance Act 1989* - with the effect that industrial and commercial construction became standard-rated on 1 April 1989, and non-domestic supplies of fuel & power, as well as water & sewerage services became standard-rated on 1 July 1990.[68] The Court ruled that the supply of these services - sewerage, water, fuel & power - to domestic customers, as well as the construction of private housing, *were* made for "clearly defined social reasons and for the benefit of the final consumer." As a consequence the UK was quite within its rights to continue to charge a zero rate of VAT on these supplies, as it has done.

Agreement on harmonising the rates of VAT was reached in June 1991 and incorporated in directive 92/77/EEC of 19 October 1992, which amended the sixth directive accordingly. In brief, all Member States:

- must apply a standard VAT rate of 15% or more from 1 January 1993
- have the option of applying one or two reduced rates, no lower than 5% to certain specified goods, as listed in Annex H of the directive

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68 A good summary of the case is provided in a written answer [HC Deb 18 October 1993 cc 6-7W].

- are able to continue charging any lower rates, including zero rates, that had been in place on 1 January 1991 for the duration of the "transitional period", assuming these rates were in accordance with Community law.

Under Article 12(3b) of the directive separate provision was made for Member States to apply a reduced rate to "supplies of natural gas and electricity provided that no risk of distortion of competition exists", should they so wish. In addition the UK secured a special right to bring any of its zero rates into a reduced rate band, even if they were not in Annex H (under Article 28(2b)). As a consequence the UK has been able to charge the reduced rate of 8% for domestic fuel & power on supplies of fuel oil, coal, and peat (since they are not covered by the provision dealing with supplies of natural gas and electricity). It is important to note that Member States may only continue to charge zero rates in place on 1 January 1991. No Member State can introduce a new zero rate or reintroduce a zero rate once it has been abolished.

Initially it was thought that the "transitional period" would come to an end on 31 December 1996, when a definitive VAT regime came into force. However, there has been considerable delay in the next stage of VAT harmonisation. No legislation has been proposed for a definitive system as yet, and without unanimous agreement on any future changes in EC VAT law, these arrangements may continue indefinitely.

As mentioned, there is provision for all Member States to charge a reduced rate of VAT - between 5% and 15% - on supplies of natural gas and electricity under Article 12(3b).[69] Article 12(3b) goes on to state, "a Member State intending to apply such a rate, must, before doing so, inform the Commission. The Commission shall give a decision on the existence of a risk of distortion of competition. If the Commission has not taken that decision within three months of the receipt of the information a risk of distortion of competition is deemed not to exist." This suggests the UK could cut the rate of VAT on domestic supplies of fuel and power from 8% down to 5%, but no further.

In February 1997 it was reported if the UK did this, this decision might be legally challenged.[70] Clearly a definitive answer lies with the European Court of Justice but one wonders if the possibility was rather overstated. When the Commission answered this question in November 1995,[71] it stated "any possible move by the British government to reduce the VAT rate on heating fuel from 8% to 5% would go against the objective of further harmonization and would not be within the spirit of the transitional arrangements. If any such request were to be received from the British Government, the Commission would examine it against this background." It is notable that the Commission did *not* state that it believed that this move would be illegal under European law. One suspects the Commission's choice of words may have had a good deal to do with its wish to see better progress toward a definitive VAT system.

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69 Ireland, Italy and Luxembourg do this in practice. VAT rates on fuel & power in other EC countries are shown below.

70 "Labour plan to cut VAT on fuel faces threat from EU", *Guardian*, 15 February 1997

71 EP written question H-748/95 OJ Annex 4-470 13-17 November 1995

This point was confirmed in May when the Chancellor, Gordon Brown, attended a meeting of the Economic and Finance Council (ECOFIN) in Brussels. In a written answer summarising the meeting, Mr Brown explained, "in the margins of the meeting, I spoke with Commissioner Monti [the Commissioner responsible for the internal market and taxation], who confirmed that the Commission would not oppose a cut in the rate of VAT on domestic fuel in the UK to 5 per cent."[72] A number of other Member States charge a reduced rate of VAT on certain domestic supplies of fuel and power. A summary of the EC VAT rates on business and domestic fuel at June 1997 is given below:[73]

Country	Rate
Austria	10%[1], 20%
Belgium	12%, 21%[2]
Denmark	25%
Finland	22%
France	20.6%[3]
Germany	15%
Greece	8% (6%), 18% (13%)[4]
Ireland	12.5%
Italy	10%, 16%, 19%[5]
Luxembourg	6%, 12%[6]
Netherlands	17.5%
Portugal	5% (4%), 17% (13%)[7]
Spain	16%
Sweden	25%
UK	17.5%, 8%[8,]

Notes:

1 The reduced rate applies to supplies of wood.

2 The reduced rate applies to coal and peat

3 The standing charge is subject to 5.5% and the actual supply of heating to 20.6%. The rates generally applied in Corsica are 0.9%, 2.1%, 8% and 13%.

4 Wood is subject to the reduced rate.
The rates in brackets apply in the departments of Lesbos, Chios, Samos, the Dodecanese and the Cyclades, and in the islands of Thasos, the Northern Sporades, Samothrace and Skyros. This special rate does not apply to goods sold from the rest of Greece to the Dodecanese, industrial-tobacco products, ready petroleum products, electricity, or the supply of services.

5 The following are subject to 9%: wood; electricity and gas for domestic and some industrial uses (excluding gas for domestic heating) and oil. Coal is subject to 12%.

6 The 6% rate applies to gas and electricity; wood, oil and coal are subject to 12%.

7 5% applies to electricity and oil. The rates in brackets apply in the autonomous regions of Madeira and the Azores archipelagoes.

8 17.5% applies to business fuel; 8% applies to domestic fuel from 1 April 1994.

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72 HC Deb 16 May 1997 cc 3-4W

73 source: HM Customs & Excise, June 1997

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