



VAT on energy-saving materials

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Author: Antony Seely

Business & Transport Section

VAT is charged on the supply of all goods and services, unless specifically exempt, either at the standard rate - currently 17½% - or the zero rate. In September 1997 a reduced VAT rate of 5% was introduced on the supply of domestic fuel and power.¹ Since then the coverage of the reduced rate has been extended to a small number of other supplies including children's car seats (from 12 May 2001), sanitary protection (from 1 January 2001), and the installation of energy-saving materials (though *not* to purchases for DIY installation).²

When a reduced rate on energy-saving materials was first introduced in July 1998, it applied only to materials installed by builders and other businesses for those helped under the Home Energy Efficiency Scheme (HEES), the Domestic Energy Efficiency Scheme or equivalent grant schemes operated by local authorities. In the March 2000 Budget the Government announced that this reduced rate would be extended to the installation of energy-saving materials in all homes, and to the installation of central heating and home security systems for those eligible for funds from the 'new HEES'.³ Legislation was introduced in the *Finance Act 2000*, and applies to supplies made on or after 1 April 2000.⁴ Detailed guidance on the scope of this relief is published by HM Customs & Excise.⁵

This note examines the introduction, and recent extension, of this particular VAT relief.

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¹ Initially zero-rated, this supply had been charged an 8% rate of VAT from 1 April 1994. The commitment to cut the rate from 8% to 5% was included in the Labour party's 1997 general election manifesto.

² Goods and services charged the 5% reduced rate are now set out in schedule 7A to *VATA 1994*.

³ Details of this grant scheme to help the 'fuel poor', which came into operation in April 2000, were given in DETR press notice 99/947, 29 September 1999.

⁴ HM Customs & Excise Budget Press Notice C&E 6, 21 March 2000

⁵ *VAT Notice 708/6: Energy-saving materials*, February 2002. This is available on Customs' internet site at: <http://www.hmce.gov.uk/forms/graphics/708-6.pdf>

A. Introducing VAT relief for energy-saving materials

At the Report Stage of the *Finance Act 1997*,⁶ the Conservative Government accepted a new clause which required 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.”⁷ When Norman Lamont, the then Chancellor, first proposed standard-rating domestic supplies of fuel & power in his March 1993 Budget speech, 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.”⁸ The Conservative Government had planned to standard-rate domestic fuel & power in two steps: an 8% rate from 1 April 1994, moving to the standard rate from 1 April 1995. In December 1994 the Government was defeated on a Budget Resolution vote, and had to introduce amending legislation so that these supplies continued to be charged VAT at 8%.

In January 1995 Alan Simpson introduced a Private Members Bill to charge an 8% 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.⁹ In his speech Mr Simpson quoted Mr Lamont’s comments, 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.”¹⁰ Though the debate was adjourned for want of time and the Bill did not complete a Second Reading, it did attract cross-party support.¹¹

On 2 July 1997 in his Budget speech the Chancellor, Gordon Brown, announced that the rate of VAT on domestic supplies of fuel & power would be cut from 8% to 5%, with effect from 1 September 1997.¹² The Chancellor also confirmed that the report on the potential for a reduced rate on energy-saving materials 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. The report was published in November, when the Government announced that as part of the forthcoming Budget in spring 1998, VAT on the installation of energy-saving materials for the less well-off under the Home Energy Efficiency Scheme (HEES), and similar Government-funded schemes, would be cut to 5%.¹³

⁶ HC Deb 11 March 1997 cc 189-206

⁷ New clause 15 - now section 111 of the *Finance Act 1997*

⁸ HC Deb 16 March 1993 c 183

⁹ *Energy Saving Materials (Rate of Value Added Tax) Bill* [HC Bill 31 1994/95] Mr Simpson presented a Bill with a similar purpose [Bill 68 of 1998-99] on 18 March 1999, though it did not receive a Second Reading.

¹⁰ HC Deb 20 January 1995 c 976

¹¹ At this time an Early Day Motion supporting Mr Simpson's Bill attracted 342 signatures: EDM 383 of 1994-95, “Reducing VAT on energy-saving materials”, 12 January 1995.

¹² For further details see, *VAT on fuel & power*, Library Research paper 97/87, 9 July 1997.

¹³ HM Customs & Excise press notice, *VAT cut on energy-saving brings better insulation to 40,000 homes a year*, 25 November 1997

Clearly an alternative to introducing the reduced rate would have been to provide increased funding for the HEES and its equivalents. In their report Customs argued that on balance extending VAT relief might have a more positive effect in the long run: “Increasing resources for such schemes would lead to the same end with similar benefits but in view of the possibility of exploring at EU level the scope for a wider VAT relief in the future, restricted VAT relief now, rather than direct funding, might be preferable as the first step along that road, and give a better signal, particularly in relation to the environment.”¹⁴ Details on the scope of the new reduced rate were published in the March 1998 Budget:

The Budget extends the reduced VAT rate of 5 per cent to the installation of energy-saving materials insofar as the work is funded by certain Government grants and equivalent local authority schemes. The VAT rate cut will mean the funding for these schemes will go further so that more people will be able to get help with having energy-saving materials installed.

“Energy-saving materials” means:

- cavity wall insulation
- loft insulation
- insulation for hot water tanks
- insulation for pipes and other plumbing fittings
- draught proofing
- heating controls.

“The less well-off” means people who are entitled to receive one or more of:

- Attendance Allowance
- Council Tax Benefit
- Disability Living Allowance
- Disability Working Allowance
- Family Credit
- Housing Benefit
- Income Based Jobseekers Allowance
- Income Support
- Industrial Injuries Disablement Benefit (which must include Constant Attendance Allowance)
- War Disablement Pension (which must include the Mobility Supplement or Constant Attendance Allowance).

In addition, all pensioners will benefit from the reduced rate, to the extent that work is grant funded.¹⁵

¹⁴ *Energy-saving materials: the scope for a reduced rate of VAT*, 26 November 1997 p 13

¹⁵ HM Customs & Excise Budget Notice 63/98 17 March 1998. Further details were given in *VAT Information Sheet 9/98*, June 1998.

The *Value Added Tax (Reduced Rate) Order* SI 1998/1375 was laid before the House on 3 June, and came into force on 1 July 1998. The annual cost of this measure was estimated to be about £10 million, “equivalent to an increase of over 10 per cent in the budget for the existing Home Energy Efficiency Scheme.”¹⁶ The Order was debated on 24 June; on this occasion the then Financial Secretary Dawn Primarolo, now Paymaster General, summarised its purpose as follows:

The order introduces, with effect from 1 July, a new targeted VAT relief for the installation of energy-saving materials ... The order defines the goods that are covered by the new relief, the people who can benefit and the grant relief schemes that are involved. It is designed to build on the good work that has already been done by Government and local authority schemes that are targeted at the less well-off and all over-60s, regardless of means. We are sure that, in practice the relief will work smoothly. Simplicity of operation is one of the points to which the Government gave particular attention, particularly in the consultation period ...

As savings are recycled into funding more installations, the relief will pay for an extra 40,000 households a year to be covered. That will mean that a third of all households are covered by the grant schemes. Each year, an extra 40,000 households will be warmer and will, on average, use 15 per cent. less fuel in the process. The order has social policy consequences and helps the fuel poor. It marks the beginning of the environmental aspect of developing policy to ensure that we encourage energy efficiency. It therefore sends clear signals that we want to encourage people to install energy-saving materials.¹⁷

B. DIY installation and EU VAT law

Clearly 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 - and some commentators have argued that the reduced rate should cover this supply. One obstacle to doing this is that it would be contrary to European VAT law.¹⁸ Member States may only charge a reduced rate of VAT - between 5% and 15% - 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 provided as part of a social policy” (item 9), though it makes no specific mention of energy-saving materials. It is important to note the condition that the supply be provided as part of a *social policy*.

HM Customs & Excise’s 1997 report on this issue noted the European Commission’s view that “all supplies in this area, be it of a service or of a good, can only benefit from the reduced

¹⁶ HM Customs & Excise press notice, *Chancellor cuts VAT to help less well off keep warm*, 17 March 1998

¹⁷ Third Standing Committee on Delegated Legislation 24 June 1998 cc 3-4

¹⁸ Obviously other arguments might be made against such a measure: for example, charging a reduced VAT rate might be thought too blunt an instrument for encouraging lower income households to purchase energy-saving materials, rewarding as it does, all households irrespective of their income.

rate when they are targeted on less-well off people.” Customs went on to conclude that “a reduced rate on this basis must be restricted firstly to installations of materials rather than materials alone and secondly to supplies to poorer people.”¹⁹ This obstacle was avoided by the 1998 Order as it restricted the coverage of the reduced rate to installation work, subsidised by the HEES and other grant-funded schemes which operate according to social criteria.

Since the introduction of a reduced VAT rate on energy-saving materials, there have been two important developments (the second of these is discussed in the next section of this note). In October 1999 the European Council agreed to an amendment to the sixth VAT directive, to give Member States the *option*, should they so wish, to apply a reduced VAT rate to certain ‘labour-intensive services’ listed in Annex K, as a means to reduce unemployment.²⁰ Member States may choose two, or in exceptional circumstances, three items from Annex K in the sixth directive, to apply a VAT rate as low as 5%. Item 2 to Annex K is, “renovation and repairing of private dwellings, excluding materials which form a significant part of the value of the supply” – and both France and Italy have taken the opportunity to use this provision:

Dr. Iddon: To ask the Chancellor of the Exchequer if he will estimate the VAT rates levied on a private citizen on (a) 1 January 1999 and (b) 1 January 2000 installing energy-saving measures using a contractor in (i) France, (ii) Italy and (iii) the UK.

Dawn Primarolo: The VAT rates for the installation of energy-saving measures by a private citizen on 1 January 1999 and 1 January 2000 are:

(i) *For installation in France* On 1 January 1999 the VAT rate for the installation of energy-saving materials was 22.5 per cent. France brought in a reduced rate of 5.5 per cent. for renovation and repair to private dwellings over two years old as part of their Autumn Budget in September 1999. The installation of energy-saving materials is included within the scope of this reduced rate.

(ii) *For installation in Italy* On 1 January 1999 the VAT rate for the installation of energy-saving materials was 20 per cent. Italy has applied to the European Commission to apply a reduced rate of 10 per cent. to the renovation, routine maintenance and repair of private dwellings from 1 January 2000. It is not clear whether Italy intend to include the installation of energy-saving materials in their reduced rate.

(iii) *For installation in the UK* In July 1998 this Government introduced a reduced VAT rate of 5 per cent. for the grant-funded installation of energy-saving materials in the homes of the less well off. All other installations of energy-saving materials attracted VAT at the standard rate of 17.5 per cent. on 1 January 1999 and continue to do so.²¹

¹⁹ *Energy-saving materials: the scope for a reduced rate of VAT*, 26 November 1997 p 9

²⁰ Directive 1999/85/EC [OJ L 28 October 1999 277/34-36]. More details on this specific measure are given in, “VAT on labour-intensive services”, Library standard note SN/B/1122, 12 November 2003.

²¹ HC Deb 17 January 2000 c 352W

Initially the VAT ‘labour intensive services experiment’, as it is known, was to last for only three years – between 1 January 2000 and 31 December 2002 – though Member States agreed recently to extend its life to 31 December 2005.²²

However this provision would *not* allow a reduced rate for DIY purposes, as it only allows for goods and services to be charged a reduced rate “when supplied as part of an overall service.”²³ There has been a considerable amount of interest in this idea,²⁴ and the UK has taken it up with the Commission:

Dr. Iddon: To ask the Chancellor of the Exchequer what progress he has made with his discussions with the EU on lowering VAT on all energy-saving materials.

Dawn Primarolo: I wrote to the Commission in September 1998 to suggest changes to current Community law to allow a reduced rate to apply to a wider range of energy-saving materials, particularly those purchased for DIY use. The Commission replied at the beginning of December last year, saying that there is currently no provision which would allow for this reduced rate. They raised the possibility of future Commission proposals relating to Annex H of the EC Sixth Directive, which allows for reduced rates, and maintain that these proposals would provide the right context in which to tackle the energy-saving materials question. We believe that the Commission may put forward these proposals next year and, when they arrive, we will consider again the case for a reduced rate for energy-saving materials.²⁵

In the event there was some delay in the Commission publishing proposals for reduced VAT rates, which it did in July 2003.²⁶ These proved quite controversial – especially from the UK’s perspective, as they anticipated the loss of certain zero rates, including the zero rate on children’s clothing. Indeed the Government has stated that in their present form the Commission’s proposals are unacceptable.²⁷ Moreover, although the Commission suggested that the way housing was treated for VAT should be rationalised, it did not propose any change in the taxation of DIY supplies.

Negotiations continue, and although strongly opposed to any changes to UK zero rates, the Government has stated it will continue to lobby for a reduced rate to cover “the purchase of energy-saving materials for do-it-yourself installation, and also for energy-efficient products.”²⁸

²² HC Deb 11 December 2003 cc 601-2W

²³ HC Deb 25 February 2003 c 388W. This point has also been made by the Paymaster General in a letter to the *Financial Times*: “Letter: VAT on domestic fuel and power is 5%”, 21 February 2000.

²⁴ see for example EDMs 29 & 79 of 2002-03 and EDMs 149 & 208 of 2003-04

²⁵ HC Deb 16 December 1999 cc 297-298W

²⁶ COM (2003) 397 final, 23 July 2003

²⁷ HC Deb 23 February 2004 c 122W. Further details are given in, “VAT reduced rates: recent EU proposals”. Library standard note SN/BT/2683, 12 November 2003.

²⁸ HC Deb 17 November 2003 cc 529-30W

C. Extending VAT relief

One further development in the area of EU VAT law with implications for this particular relief relates to the existing provisions for charging reduced rates. When the UK first considered the introduction of the reduced rate, it was the consensus view that the scope of the relief had to be limited to the less-well off, to comply with EU law.²⁹ Subsequently the Commission has taken a more relaxed view on what constitutes “supply ... provided as part of a *social policy*” – and as a result, the Government decided in its March 2000 Budget to extend the scope of the reduced rate, to the installation of energy-saving materials in all homes – including the installation of solar panels – and to the installation of central heating and home security systems for those eligible for funds from the new HEES. Details were given in a Budget Notice issued at this time:

VAT at 5% has applied to the grant funded installation of energy-saving materials since 1998. This measure extends the reduced rate to include: the installation of energy-saving materials in all homes; the grant funded installation, maintenance and repair of central heating systems and home security goods in the homes of qualifying pensioners; and, the grant funded installation of heating system measures in the homes of the less well off.

Energy-saving materials which may be installed in all homes at the reduced rate are:

- insulation for walls, floors, ceilings, roofs or lofts, or for water tanks, pipes or other plumbing fittings;
- draught stripping for windows and doors;
- central heating controls, including thermostatic radiator valves;
- hot water system controls; and
- solar panels.

The reduced rate will apply to energy-saving materials installed in:

- owner occupied homes;
- homes rented from private landlords;
- homes rented from local authorities and housing associations;
- caravans;
- residential boats;
- residential buildings such as old peoples’ homes, childrens’ homes and nursing homes;
- non-business charity buildings.³⁰

These changes applied to supplies made on or after 1 April 2000, and were estimated to cost approximately £35 million in 2000/01. The relevant legislative provisions were scrutinised at the Committee stage of the Finance Bill on 27 June that year. On this occasion, the Paymaster General announced that amendments would be tabled to the schedule at the Report stage, to extend the scope of the reduced rate to the installation of wind and water turbines, as

²⁹ *Energy-saving materials: the scope for a reduced rate of VAT*, 26 November 1997 pp 9-10

³⁰ HM Customs & Excise Budget Notice BN 39/00, 21 March 2000

well as the installation of solar panels.³¹ Ms Primarolo also touched on concerns raised by Members earlier in the debate that the new rules might be too complex. She noted that the scheme had already been operating in part since July 1998, and that since April this year, installers had not experienced any trouble with it. Part of her speech is reproduced below:

The schedule took effect on 1 April. It set a rate of 5 per cent. on the installation of insulation, draught strips, hot water, central heating controls and solar panels supplied and fitted by a contractor in all homes. Government-funded schemes such as the home energy efficiency scheme are being extended to tackle fuel poverty even more effectively. The new home energy efficiency scheme now provides a combination of insulation and heating measures to help the fuel poor. The aim is to help 450,000 households by 2002. To mirror that, the clause extends the reduced VAT rate to all grant-funded installations under the new schemes. The VAT cut will help an extra 7,000 fuel-poor households. Keeping the reduced rate in line with the scheme also means that the grant schemes remain simpler for installers to operate ... I had hoped to be able to table amendments for today's sitting to include in the schedule the installation of wind and water turbines at all homes-for completeness and given that solar panels have been included. However, for technical reasons related to parliamentary procedure, I must table them on Report ...

The installation of energy-saving materials at the reduced rate will reduce annual carbon emissions by 140,000 tonnes per annum. The compliance costs are very small, because the scheme is simple to implement. The majority of installers are already familiar with the reduced rate in HEES ... The installers are not expected to establish whether customers are entitled to a grant. That is up to the grant-giving body ... Much play has been made of the question whether the scheme is too complicated and whether installers will struggle with it. As I hope that I have made clear, the scheme was already operating in part, and installers have not experienced any trouble with it since April.

The right hon. Member for Charnwood suggested that the measure might be another paradise for ingenious tax planners, who would redefine a spyhole in order to find some way around the legislation. However, Governments would be paralysed if they were constantly concerned about whether people would abuse the tax system. I believe that the provision is drafted sufficiently tightly to prevent such activity, but as has previously been said in Committee, it is a foolish Treasury Minister who says, "never", because abuse is a constant challenge across the entire tax system ... The Committee must view the schedule in the broad context of environmental and social policy relating to cold homes and the associated illness... it is valid for Governments to consider whether the cost of such a measure is justified by the benefits. We believe that the cost of our proposal is justified as part of a broader strategy on warm homes and reducing carbon emissions. If people's homes are better insulated, they will use less energy. I commend the schedule to the Committee.³²

³¹ This amendment was adopted, without debate, at the Report stage of the Bill on 19 July 2000 (HC Deb c 492). This one change took effect the day following Royal Assent, rather than 1 April 2000.

³² SC Deb (H) 27 June 2000 cc 940-943

The impact of the reduced rate was raised in a PQ in February 1999:

Mr. Gummer: To ask the Chancellor of the Exchequer what price incentives the Government support to encourage consumers to purchase energy efficient products.

Ms Hewitt: On 1 July 1998 a reduced VAT rate of 5 per cent. was introduced for the installation of certain energy-saving materials under Government funded grant schemes. The reduced rate is targeted at the less well-off. So far, over 135,000 people have benefited from Government-funded incentive schemes run by the Energy-saving Trust to encourage consumers to install energy efficiency measures.

Current schemes include incentives to install insulation, efficient heating, efficient lighting and appliances and small scale Combined Heat and Power. The Government's Home Energy Efficiency Scheme provides grants for energy efficiency measures for householders receiving income related benefits, disability allowance, or who are over sixty years old. HEES has helped over 2.5 million households over the last seven years.³³

In October 2001 the Government estimated that reducing VAT on energy-saving materials will have cut carbon dioxide emissions by 0.1 MtC (million tonnes of carbon) by 2010; this compares with the impact of cutting the rate of VAT on domestic supplies of fuel and power, from 8% to 5%, which is estimated to *increase* emissions by 0.2 MtC by 2010.³⁴

In the 2002 Budget a second minor extension in this VAT relief was announced: the reduced rate on the grant-funded installation of certain heating equipment in households would be extended to “the installation of factory-insulated hot water tanks, micro combined heat and power systems, and heating systems that use renewable energy, to the extent that the costs of installation are funded by government grants and equivalent local authority schemes.” This change reflected “changes to the installation work eligible for grant funding.”³⁵

In July 2002 the Treasury issued a consultation paper asking for “views on ways in which economic instruments could be used to overcome market failures which prevent improvements in household energy efficiency.”³⁶ On the question of tax relief it noted:

At present a reduced rate of VAT is charged on a range of energy-efficient products installed as part of a grant scheme ... While European Union VAT directives limit the scope for using VAT reductions more widely, subsidies could potentially be provided in the form of a reduction against other forms of personal tax liability, although this would probably involve considerable administrative complexity. An

³³ HC Deb 1 February 1999 c 413W

³⁴ HC Deb 22 October 2001 c 206W; *Budget 2001* HC 279 March 2001 p 123

³⁵ HM Customs & Excise Budget Notice CE41, 17 April 2002. This change was made by Order (SI 2002/1100) and took effect on 1 June 2002.

³⁶ HM Treasury/DEFRA, *Economic instruments to improve household energy efficiency*, July 2002 para 5

alternative approach to providing tax subsidies would be to introduce additional charges on less efficient products.³⁷

A number of changes to the reduced rate were suggested in response, extending it to “the supply and installation of energy efficient products or materials in non-grant schemes when householders employ contractors”, “DIY energy-saving materials, bought by a householder to install him/herself”, and “energy-efficient equipment.”³⁸ In a follow-up paper issued in August 2003 the Government noted that only the first of these changes was possible under current EU VAT law and, as with all European tax law, changes to Annex H to the sixth VAT directive required the unanimous agreement of Member States. The paper did not debate the merits of these changes but asked for views on their likely impact.³⁹ In turn a large proportion of respondents to this second paper supported a general VAT reduction for contractor-installed energy-efficient products or materials.⁴⁰

The current position was set out by the Economic Secretary, John Healey, in answer to a series of PQs recently; the text of the Minister’s answer is given below:

The Government are committed to improving household energy efficiency, as part of its programme to meet Energy White Paper targets. The Government routinely evaluate the impact of policy initiatives, including environmental tax measures. The Government have a long-standing commitment to pursue EU changes to permit a reduced rate of VAT for the DIY installation of energy saving materials, and have already applied a reduced rate of VAT for the installation of materials in certain other circumstances.

The Government consulted on further measures to improve household energy efficiency in 2003, including a tax allowance for private landlords investing in energy efficiency. The Government also invited views on other possible policy initiatives. Responses were published and are being taken into account in further policy development. In the pre-Budget report (Cm 6042) we confirmed that we believe that there is a case for the further use of economic instruments as part of a package of measures to promote energy efficiency. A further announcement will be made around Budget 2004.⁴¹

³⁷ *op.cit.* para 20

³⁸ HM Treasury/DEFRA, *Economic instruments to improve household energy efficiency: consultation document on specific measures*, August 2003 para 33

³⁹ *op.cit.* paras 35-39

⁴⁰ *Economic instruments to improve household energy efficiency ... summary of responses*, December 2003 para 1.16

⁴¹ HC Deb 21 January 2004 cc 1258-9W