

## **HACAN ClearSkies**

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# ***The Future Development of Air Transport in the United Kingdom: South East Consultation Documents***

**HACAN ClearSkies** is submitting a **general response** and **six supplementary responses** to the Department for Transport Consultation Documents

### **LIST OF SUPPLEMENTARY RESPONSES**

- 1: Effect of Third Runway on Exposure to Noise
- 2: Effect of Third Runway on Exposure to Nitrogen Dioxide
- 3: Airline Tax Exemptions, Passenger Demand and Runway Capacity
- 4: Runway Capacity and the UK Economy
- 5: Hub Airports in South East England
- 6: Alternative Policies to Runway Expansion in South East England

## **HACAN ClearSkies Supplementary Response 3**

# **AIRLINE TAX EXEMPTIONS, PASSENGER DEMAND AND RUNWAY CAPACITY**

**June 2003**

## 1. INTRODUCTION

1.1 The first and second editions of the Department for Transport Consultation Document *The Future Development of Air Transport in the United Kingdom: South East* state that runway capacity in South East England needs to be expanded in order to handle an expected near-tripling of air passenger numbers by 2030. But the Consultation Documents do not consider the role that airline tax exemptions play in stimulating a level of demand that would not exist if the tax exemptions were withdrawn or were offset by an increase in air passenger duty.

1.2 This paper sets out an assessment by HACAN ClearSkies of the effect of the airline tax exemptions on present and forecast levels of passenger demand, and should be read in conjunction with three related papers on the economics of runway expansion that form part of the response to the Consultation Documents by HACAN ClearSkies:

- Supplementary Response 4: *Runway Capacity and the UK Economy*.
- Supplementary Response 5: *Hub Airports in South East England*.
- Supplementary Response 6: *Alternative Policies to Runway Expansion in South East England*.

### ***What about the Taxpayer?***

1.3 Earlier this year the Government said that the taxpayer should not be asked to subsidise the costs of studying for higher educational qualifications, on the grounds that those studying benefit most from the process. The Government should explain why it does not apply the same logic to air travel.

### ***Main Findings***

1.4 The Consultation Documents fail to discuss any of the following:

- The airlines currently benefit from tax exemptions worth about £9 billion per year. The value of these exemptions would increase to about £25 billion per year if additional runway capacity is built in South East England and passenger demand increases as forecast.
- Other taxpayers compensate the Treasury for the airline tax exemptions, regardless of whether or how frequently they fly. Thus, each taxpayer paid £352 more income tax in 2000; and would pay £950 more income tax in 2030 if passenger demand increases as forecast.
- The airline tax exemptions feed through into lower airfares, stimulating demand for more leisure flying (e.g. frequent week-end breaks), and hence the demand for more runways.
- Less than half the population leisure flies at present or is forecast to leisure fly in 2030, even with additional runway capacity. Those leisure flying most frequently have most disposable income; and so benefit more from the tax exemptions than those with least disposable income.
- If the airline tax exemptions were withdrawn, the forecast growth in leisure flying would slow to such an extent that existing runway capacity could accommodate all South East demand in 2030.

### ***Main Conclusions***

1.5 The proposals in the Consultation Documents for expanding runway capacity in South East England are based on the assumption that the airlines will continue to receive generous exemptions from tax and that the exemptions will feed through to raise passenger demand to 300 million by 2030. The Government should publish figures for the present and future values of the tax exemptions to the airlines and the cost to the taxpayer; and should initiate a public debate about whether air transport should continue to benefit from tax exemptions before any decision is taken about whether to expand runway capacity in South East England or in other parts of the UK.

## 2. THE AIRLINE TAX EXEMPTIONS

### *Tax Exemptions and Rationale*

2.1 Airlines that use UK airports for domestic and international flights for passengers and freight are exempt from **fuel duty** and **VAT** (e.g. on aviation fuel, passenger tickets, freight fees and consumer goods sold to passengers to non-EC destinations). These exemptions are explained on three grounds:

- **International Obligations:** The Government is a party to international agreements that aviation fuel may not be taxed on international flights and that VAT may not be charged on flights to destinations outside the EC.
- **Tax Avoidance:** It would not be practicable to tax aviation fuel or charge VAT because different countries could charge different rates of tax (or no tax), so airlines would purchase their fuel and passengers and freight shippers would buy their passage in the cheapest country.
- **Fiscal Equity:** Other forms of public transport - particularly trains and busses - are exempt from fuel duty and VAT.

### *Air Passenger Duty and Rationale*

2.2 **Air passenger duty** was introduced in the early 1990s, under which the airlines are charged for most categories of passenger on domestic and international flights departing from UK airports<sup>1</sup>. The Chancellor of the Exchequer at the time, Kenneth Clarke, justified air passenger duty because he considered that the effect of the exemptions from fuel duty and VAT was that “*air travel is under-taxed compared with other sectors of the economy*”<sup>2</sup>. That is to say, Clarke accepted that he could not collect fuel duty and VAT from the airlines, but introducing a new tax ensures that the airlines **make more of a contribution to general revenue than they had done previously**.

2.3 Air passenger duty has proved to be a simple and effective way round the international agreement and tax avoidance barriers to taxing the airlines. It is still the case that other forms of public transport are not charged an equivalent of air passenger duty. But there are sound policy reasons for not doing so: the majority of passengers by bus or train are travelling much shorter distances than the typical air journey, and so are not in competition with air travel. More importantly, most local journeys are to places of work, education, etc., and it is desirable on road management and environmental grounds to encourage the use of public transport rather than the private car. In terms of longer journeys, the majority of passengers are on holiday or business. Wherever train is a viable alternative to air, **tax discrimination to encourage the use of train can be justified on transport and environmental management grounds**.

### *Exemptions from Air Passenger Duty*

2.4 There are no figures available for the value of the **tax exemptions from air passenger duty** on international transfer passengers and domestic-to-international transfer passengers. The number of international transfers at UK airports (Heathrow and Gatwick) was 21.5 million in 2000. Assuming that their destinations and class of seat were divided equally between the four rates of air passenger duty<sup>3</sup>, the value of the exemptions would be about **£400 million** in 2000. Figures are not published for the number of domestic-to-international transfers. Assuming that they constitute half of all domestic passengers and are divided equally between standard and reduced rates of duty, the value of the exemptions would be about **£100 million** in 2000, giving a total figure from international transfers and domestic-to-international transfers of **£500 million** in 2000.

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<sup>1</sup> International transfer passengers and domestic passengers on the first and final leg of an international journey via another UK airport are exempt from air passenger duty.

<sup>2</sup> Kenneth Clarke MP, Chancellor of the Exchequer, Budget Statement, 30 November 1993. See also statements by Sir John Cope MP, Paymaster General, on 1 December 1993 and 31 January 1994 during the debate on the Budget Statement.

<sup>3</sup> Standard and reduced rates, to destinations within the EEA and outside the EEA.

## *Environmental Taxes on Air Transport*

2.5 When air passenger duty was introduced, it was justified by the Government as a **general revenue tax**, in lieu of the fuel duty and VAT that the airlines do not pay. But in recent years the airlines have argued that air passenger duty represents payment for the **environmental damage** done by air transport. The full scale of environmental damage from air transport has not been quantified, but is likely to exceed the amount that the airlines currently pay in air passenger duty (see paragraph 2.6 below). The logic of the airline argument would also mean that, in determining how much the airlines should contribute towards general revenue, the present air passenger duties should be discounted as a separate down payment against environmental damage.

### *Past, Present and Future Values of Tax Exemptions*

2.6 The value of the tax exemptions to the airlines increases or decreases in line with the rise and fall in the volume of air traffic: more passengers and freight = more fuel consumption, tickets and fees; more fuel consumption, tickets and fees = the larger the amount of exempt tax. Although air passenger duty is also linked to demand - the more passengers an airline carries, the more air passenger duty it is charged - the rates at which air passenger duty is charged have always been significantly less than the rates of fuel duty and VAT. Currently the airlines pay less than **£800 million per year** in air passenger duty and are estimated to be exempt from more than **£9.2 billion per year** in fuel duty and VAT<sup>4</sup>. That is to say, there is a gap of **£8.4 billion** between what the airlines under air passenger duty compared with what they would pay under fuel duty and VAT.

2.7 The Consultation Documents forecast that passenger numbers at UK airports will increase from 180 million in 2002 to 500 million by 2030. Table 1 below shows that if passenger numbers increase as forecast and the present tax exemptions remain in place, the value of the tax exemptions would increase from **£9 billion** in 2002 to **£25 billion** in 2030. Table 1 also shows that the tax exemptions were worth just over **£5 billion** in 1992 - the year before Kenneth Clarke introduced air passenger duty - an indication of the link between the rate of growth in passenger numbers and in the value of the tax exemptions over the last decade.

	1992	2002	2030
Air passenger numbers	106 million	180 million	500 million
Cash value	£5.3 billion	£9 billion	£25 billion

These estimates were derived by dividing the cash value in 2002 by the number of passengers in 2002 and then multiplying by the number of passengers in 1992 and 2030.

<sup>4</sup> Brendon Sewill, *The Hidden Costs of Flying*, (2003).

### 3. BENEFITS AND COSTS OF THE AIRLINE TAX EXEMPTIONS

#### *Winners and Losers*

3.1 The main direct benefit of the tax exemptions is that the airlines have smaller tax bills than they would if the tax exemptions did not exist. The main indirect benefit is that the price of fares and freight transfer are lower than they would be if the tax exemptions did not exist. The evidence suggests that lower prices stimulate demand from passengers (particularly leisure passengers) and freight. Increased demand in turn means more business for the airlines, and consequently more business for the airline support industries (including the airports and aircraft manufacturers). This demand inevitably spills over into increased employment opportunities.

3.2 The main direct cost is the revenue that the Treasury loses from the airlines, with the result that the Treasury must either cutback on public expenditure or increase the burden on other taxpayers. The main indirect cost is to the individuals or projects dependent on State funding (e.g. students in higher education, National Insurance pensioners or a new hospital), or the general taxpayer.

3.3 The Consultation Documents state that air transport has an indirect wider benefit to the economy by attracting overseas investment and overseas tourists to the UK. But in fact the UK exports more investment and tourist spending than it attracts (see HACAN ClearSkies Supplementary Response 4: *Runway Capacity and the UK Economy*). It would therefore seem that at best the benefits of more imports and more exports, as a result of more air passenger flying, largely cancel each other out; although that may not be much of a consolation to people who lose their job because their work has been transferred to a cheaper overseas supplier.

#### *Swings and Roundabouts?*

3.4 Although many air passengers are also taxpayers, the evidence does not suggest that each taxpayer gains from lower airfares what he loses in foregone public expenditure or in higher taxes. Table 2 below shows that 14.4 million UK residents flew more than once in 2001; 14.4 million flew once; and 30 million did not fly. According to data from the Office for National Statistics and the Civil Aviation Authority, UK residents made a total of 51.4 million **business** or **leisure** visits by air in 2001 (42.9 million **overseas visits** and 8.5 million **domestic visits**), indicating that the 14.4 million UK residents who flew more than once in 2001 made 37 million visits (**two and a half visits per person**). It would therefore seem that there is a strong element of cross-subsidy among taxpayers, **with frequent flyers subsidised by less frequent flyers and non-flyers**.

	Two or more visits	One visit	No visits
UK residents who flew/ did not fly (millions)	14.4	14.4	30
% of UK population who flew/ did not fly	24.5%	24.5%	51%

Source: Department for Transport, *Attitudes to Flying*, (2002)

3.5 Table 3 below shows that **more than half of UK residents will not fly overseas for leisure in 2020 and 2030, even with more runway capacity**. Row 2 gives the number of overseas leisure visits in 2001 and the forecast number of overseas leisure visits in 2020 and 2030. Row 3 assumes that UK residents who flew in 2001 will make three leisure trips in 2020 and 2030, on the basis that the majority of UK residents who flew in 2001 want to fly more frequently in future<sup>5</sup>. Row 4 shows that the forecast number of visits in Row 2 **does not allow any visits by UK residents who did not fly in 2001**. Given that leisure flying is a luxury rather than a necessity, it is almost certainly the case that the cross-subsidy works to the benefit of those with most disposable income for frequent leisure flying at the expense of those with least disposable income for leisure flying: **a form of wealth re-distribution from the poorer to the richer sections of the community**.

<sup>5</sup> Department for Transport, *Attitudes to Flying*, (2002).

	2001	2020	2030
1. UK population	58.8	61.7	63.2
2. Actual and forecast number of visits by UK residents	35.8	67.5	83.0
3. Three visits per year by 50 per cent of UK residents	88.2	92.5	94.8
4. Visits per year by other 50 per cent of UK residents	-	-	-

The figures for 2020 (Forecast 1) are from: Department for Transport, Local Government and the Regions, *Air Traffic Forecasts for the United Kingdom 2000*, (2000). The figures for 2030 (Forecast 1) are derived from the overall passenger forecast for 2030 in: Department for Transport, *The Future Development of Air Transport in the United Kingdom: South East Consultation Document*, (2002), on the assumption that the ratio of business-to-leisure passenger in 2030 remains the same as in 2020.

Forecasts 1 for 2020 and 2030 reflect the Department for Transport's assumption that business passengers will increase more quickly than leisure passengers. Forecasts 2 for 2020 and 2030 assume that business and leisure passenger s will increase at the same rate. The number of business passengers – and therefore the number of all passengers – is therefore less in 2020 and 2030 in Forecast 2 than in Forecast 1. The historic trend shows a larger increase per year in leisure passengers than business passengers.

International transfer passengers and domestic passengers are excluded from Table 3.

### **Total Tax Loss**

3.6 In addition to the direct loss of VAT from the airline tax exemptions (see Table 1 above), the Treasury loses a significant amount of VAT each year because UK residents flying overseas spend more on consumer goods and services (on which VAT is payable) overseas than do overseas visitors who fly to the UK. Table 4 below shows that between 1998 and 2001 the amount of lost VAT increased from **£700 million** to **£1.7 billion**. Table 5 below shows that the VAT loss in 2030, with additional runway capacity in South East England, is still likely to be **£1.7 billion**, if not more.

	1998	1999	2000	2001
UK residents:				
1. visits overseas (millions)	34	38	41	43
2. spending overseas (£ billions)	£13.1	£15.3	£17.7	£18.7
Overseas residents:				
3. visits to UK (millions)	17	17	18	16
4. spending in UK (£ billions)	£8.6	£8.6	£9.1	£7.6
UK deficit:				
5. visitor spending (£ billions)	-£4.5	-£6.8	-£8.6	-£11.1
<b>6. VAT element (£ billions)</b>	<b>-£0.7</b>	<b>-£1.0</b>	<b>-£1.3</b>	<b>-£1.7</b>

The figures in rows 1 and 3 are taken from *Overseas Travel and Tourism: Business Monitor MQ6: Data for Quarter 4, 2001* (Office for National Statistics, 2002). The figures in row 2 and 4 are derived from data from the same source on spending on visits to and from the UK by all modes of transport. The figures are for the number of visits (i.e. outward and return journeys by the same visitor are not counted separately). The figures consist of business and non-business air passengers to and from the UK, but do not include international interlining passengers (i.e. overseas passengers who arrive at a UK airport by air in order to catch a connecting flight to another overseas destination). The figures in row 5 are calculated from the figures in rows 2 and 4. **The figures in row 6 represent the amount of VAT the Treasury loses because UK visitors spend more overseas than overseas visitors spend in the UK.**

	2020 Forecast 1	2020 Forecast 2	2030 Forecast 1	2030 Forecast 2
UK residents:				
1. visits overseas (millions)	88	88	107	107
2. spending overseas (£ billions)	£37.5	£37.5	£45.7	£45.7
Overseas residents:				
3. visits to UK (millions)	54	49	67	62
4. spending in UK (£ billions)	£27.4	£24.9	£34	£31.5
UK deficit:				
5. visitor spending (£ billions)	- £10.1	- £12.7	- £11.7	- £14.2
<b>6. VAT element (£ billions)</b>	<b>- £1.5</b>	<b>- £1.9</b>	<b>- £1.7</b>	<b>- £2.1</b>

The expenditure rate is derived from Table 4 above for 2000 (i.e. excluding the effects on air travel of foot-and-mouth disease and the terrorist attack on New York in 2001). Forecast 1 reflects the Department for Transport assumption that overseas visits to the UK will increase more quickly than UK visits overseas. Forecast 2 assumes that visits to the UK will grow at the same rate as visits overseas. The historic trend shows expenditure by UK visitors overseas growing more rapidly than expenditure by overseas visitors in the UK. **The figures in Row 6 represent the amount of VAT the Treasury "loses" because UK tourists spend more overseas than overseas tourists spend in the UK.**

3.7 Table 6 below shows that the Government “lost” £10.3 billion revenue in 2000 as a direct or indirect consequence of the airline tax exemptions; and would “lose” £26.7 billion in 2030 if the airline tax exemptions still apply in those years and passenger numbers increase in line with the Department’s forecasts.

<b>Table 6: Airline Tax Exemptions and VAT Deficit on Tourism</b>		
	2000	2030
Airline tax exemptions	£9 billion	£25 billion
VAT deficit on tourism	£1.3 billion	£1.7 billion
Total	£10.3 billion	£26.7 billion

### ***Income Tax Surcharge***

3.8 Table 7 below estimates that every income tax payer - regardless whether individual tax payers flew or how many times they flew - paid **£352** extra income tax in 2000 in order to compensate the Treasury for the £10 billion lost to the airlines; and would pay **£950** extra income tax in 2030 if the tax exemptions remain in place, additional runway capacity is built and passenger numbers increase as the Consultation Documents forecast.

<b>Table 7: Income Tax Surcharge to Pay for Airline Tax Exemptions</b>		
	2000	2030
Personal allowance difference	£1600.00	£4320.00
Income tax on personal allowance difference	£352.00	£950.00
The basis of the estimates is the amount of income tax (Row 2) payable on the difference (Row 1) between the present personal allowance and the (higher) personal allowance that would apply if the Treasury did not have to recover the amounts shown in Table 5 lost directly or indirectly to the airlines.		

### ***Consumer Spending Remains the Same***

3.9 The airlines may argue that depressing passenger demand by cancelling out the effect of the tax exemptions (e.g. by increasing air passenger duty) would result in a loss of growth in the air transport, and therefore a loss of new employment opportunities in the airlines and across the aviation sector generally. **Such an argument merely begs the question of why growth in an allegedly dynamic sector should need to be sustained by tax exemptions.** In the wider economy, the funds that potential passengers would have put into more frequent flying would be used to buy other goods and services (e.g. new television, holiday in the UK, etc), thereby generating additional demand and employment in those sectors, on a more level playing field with the airlines than at present.

## 4. EFFECT OF TAX EXEMPTIONS ON PASSENGER DEMAND AND RUNWAY CAPACITY IN SOUTH EAST ENGLAND

4.1 The Government acknowledges that exempting the airlines from tax can have an effect on the level of passenger demand. The exemption the airlines have from paying air passenger duty on international transfer passengers and on domestic-to-international transfers was explained entirely in terms of the need to avoid any drop in demand from either category of passenger:

*“We are concerned to maintain the international position of the British air transport industry and particularly that of Britain’s hub airports, such as Heathrow, and to help the British airlines serving them by preventing the tax acting as a disincentive to passengers changing planes in Britain.”<sup>6</sup>*

4.2 The Government also acknowledges that taxing the airlines can suppress demand, and that suppressing demand through taxation can be acceptable on policy grounds:

*“The air passenger duty is, if anything, likely to have a small but positive effect on United Kingdom tourism ... Even if some overseas visitors were deterred from taking a holiday in the United Kingdom, it would be likely that more United Kingdom residents would be deterred from holidaying from overseas.”<sup>7</sup>*

4.3 According to Department for Transport air traffic forecasts, an increase in air ticket prices by one per cent reduces passenger demand by one per cent. The sensitivity is greatest among leisure passengers because they generally pay a lower fare than business passengers:

*“The effect of air passenger duty is difficult to isolate because of the large number of other factors which influence demand. The impact of a flat rate tax is likely to be greatest on domestic and short haul services where it forms a greater percentage of the fare and in leisure markets where price sensitivity is higher than in business segments. Analysis suggests that the initial level of air passenger duty reduced demand in 1995 by less 2 per cent.”<sup>8</sup>*

4.4 The annual costs to the airlines would increase by more than **50 per cent** if the rate of air passenger duty was raised to equal the amount of tax that the airlines would pay if not exempt from fuel duty and VAT (and the exemption from air passenger duty on certain categories of passengers were removed).

4.5 A cost increase of 50 per cent could not be absorbed by the airlines, because they operate on very narrow profit margins. They would have to pass the cost on to customers. Table 8 below shows that - according to the Department’s price sensitivity test - a 50 per cent increase in ticket prices would reduce passenger demand at airports in South East England from **114 million to 57 million in 2000** and from the forecast **300 million to 150 million in 2030**.

Year	Demand with tax exemptions	Demand without tax exemptions
2000	114	57
2030	300	150

4.6 Table 9 below shows that the tax exemption would stimulate demand of 300 million passengers in the South East by 2030, which would exceed present runway capacity (200 million) by 100 million. But raising air passenger to the level of the tax exemptions would depress demand to 150 million passengers, **with present runway capacity exceeding demand by 50 million**.

	With tax exemptions	Without tax exemptions
Present runway capacity	200	200
Passenger demand	300	150
Capacity deficit (-) or surplus (+)	- 100	+ 50

<sup>6</sup> Sir John Cope MP, Paymaster General, House of Commons, Hansard, 1 December 1993, Column 643.

<sup>7</sup> Sir John Cope MP, Paymaster General, House of Commons, Hansard, 31 January 1994, Column 646.

<sup>8</sup> Department for Transport, *Air Traffic Forecasts for the United Kingdom 1997*, (1997).

## **5. AIRLINE TAX EXEMPTIONS AS STATE AID UNDER EC RULES**

5.1 Under European Community rules, tax exemptions constitute a form of State aid. As a general principle, the rules prohibit Member States from giving State aid that favours certain goods and services against competing goods and services, unless the aid is justified on social, regional or environmental grounds.

5.2 The airline tax exemptions are not justified on social grounds. Consumers with most disposable income fly most frequently, and therefore benefit most from the exemptions. Consumers with least disposable income fly least frequently, and therefore benefit least from the exemptions.

5.3 The airline tax exemptions are not justified on regional grounds. The Consultation Documents forecast that 60 per cent of passengers and runway capacity would continue to be concentrated in South East England in 2030, even with runway expansion in other regions; and that there would be relatively little re-location of passengers and runway capacity away from the South East to economically less dynamic regions. The tax exemptions would therefore not contribute towards regional regeneration.

5.4 The airline tax exemptions are not justified on environmental grounds. The exemptions stimulate a higher level of passenger demand than would exist if there were no exemptions. The exemptions therefore stimulate a higher level of environmental damage from air transport than would be the case if the tax exemptions were withdrawn.