

How the undertaxed, polluting aviation sector can help fix the EU budget

Taxing climate-intensive transport would encourage smarter transport behaviour

February 2018

Summary

Transport is Europe's biggest climate problem, representing 27% of the bloc's greenhouse gas emissions. In order to meet its climate targets and avoid the severe impacts of climate change, stronger EU action on transport emissions is needed and fiscal policy has a key role to play – especially in the aviation sector which enjoys fuel tax and VAT exemptions and copious amounts of state aid.

The EU is now drafting its post-2020 budget with a proposal expected in May 2018. The annual €10-14 billion gap that will be left as a result of the UK's departure from the EU has triggered debate on alternative sources of revenue for the EU budget.

Taxing climate-intensive transport would encourage smarter transport behaviour and accelerate the uptake of cleaner technologies. The potential revenue from such taxation is just over €50 billion per year – and of that €38 billion could potentially come from the aviation sector. A small part of these revenues could be used as EU own resources – where it should be earmarked for climate spending. But the bulk would become available to member states to reduce labour taxes or other economically harmful taxes.

T&E estimates that taxing aviation fuel for domestic and intra-EU flights at the EU minimum rate of 33 cents/litre set by the Energy Tax Directive could generate about €9.5 billion in additional revenues each year. Abolishing the exemptions and applying a 15% VAT to all passenger transport could generate a further €17 billion while a common ticket tax on EU departures could generate around €11 billion – or more. Ticket taxes are widely levied around the world.

1. Aviation taxation

Historically, all aviation fuel has been tax exempt. Domestic fuel taxation was permitted from 2003 and on intra-EU routes only when subject to bilateral agreement. Air Services Agreements with non-EU aviation partner countries mutually exempt kerosene from taxation. For similar historical reasons, air tickets are subject to VAT only on domestic flights and this applies only in some member states. These exemptions cause distortions with rail, artificially stimulate demand, drive uncontrolled growth in aviation emissions and constitute unjustifiable subsidies. The sector is fastest growing climate problem and the €150 million/year ETS¹ cost to airlines does little to address this imbalance.

An explanation is provided below of how VAT or an airline ticket tax could be introduced on both intra-EU and extra EU flights to third countries. Domestic and intra-EU fuel taxation could be introduced and will raise €9.5bn in revenue while helping to address aviation's carbon footprint and the sector's external costs.

¹ https://www.transportenvironment.org/sites/te/files/2016_09_Aviation_ETS_gaining_altitude.pdf

1.1. VAT and ticket taxes

Historical VAT exemptions on tickets for international flights were grandfathered on a “temporary” basis when states joined the EU but these exemptions continue to apply. VAT on domestic airline tickets is allowed - and most notably is applied at 19% in Germany. But many other member states continue to zero rate domestic aviation. On the other hand, VAT is applied to cleaner intra-EU modes of transport like bus and rail across some Member States², which creates competitive distortions. One reason why states have held onto the exemptions is practical; intra-EU passenger transport VAT is levied according to the distance travelled and at the applicable rate in each member state. This creates inordinate administrative burdens for bus and rail, which often leads to under-collection. If applied to aviation, it might well require a complex tracking of individual flights to determine actual distances as routes can vary according to weather conditions, air traffic control or military airspace considerations.

The Commission has been trying for years to simplify these “place of supply rules” but the airline lobby has successfully resisted. However reforms are now underway to implement the “definitive” VAT regime in 2022 using the “destination” principle to determine VAT payable. This will mean that the place of supply for passenger transport will be at the country of departure. VAT would apply on an airline tickets’ full value at the VAT rate of the country of departure with all revenue accruing to the departing state. This will be a major and positive step forward as it was always hoped that reform of the place of supply rules for passenger transport might convince some member states to apply VAT on intra and possibly extra-EU flights. The revenue potential is significant (see chart below). However in its proposal on a review of VAT rates, the Commission proposed on 18 January 2018 a more flexible system of standard, reduced and zero VAT rates that in theory and potentially in practice could see all passenger transport zero-rated.

Member states are keen on greater subsidiarity on VAT and there has been little evidence over the years of anomalous reduced or zero rates being rectified. At the same time and in order to preserve a minimum level of VAT revenues across the EU, a “negative list” of items which must be subject to standard VAT rates post 2022 will be drawn up. As there is no equity justification whatsoever for exempting aviation from VAT, a clear option for the Commission would be to propose the inclusion of both intra and extra-EU air tickets in the negative list under the definitive VAT regime. Total estimated revenues from applying a 15% VAT to all domestic, intra and extra EU flights tickets is some €17bn. This measure alone could solve the budget problem, address the inequity of equating a flight ticket with necessities like baby food and school books by zero rating both, and make a major contribution to addressing aviation’s climate impact by remove a perverse subsidy to the most climate intensive form of transport.

Among the proposals considered by the Monti Commission was one to levy an EU-wide carbon air ticket tax to become a new EU own resource. Ticket taxes are solely national competence. The UK applied a ticket tax (APD) on all departing flights in the early 90s and gains enormous revenues as a result. Germany introduced a similar ticket tax in 2011 at lower rates. Norway and Sweden recently introduced ticket taxes and the new Dutch Government has raised the prospect of one from 2020. Smaller member states are reluctant to implement ticket taxes fearing leakage of passengers to neighboring cross border airports while southern member states fear tourists will divert to avoid the tax. The irony of this situation is demonstrated by the following example: Of the 36 million passengers traveling between the UK and Spain, the journeys originating in the UK are subject to a high ticket tax (APD UK). Spain collects no tax revenue on these UK passengers returning home. Because of these concerns and potential distortions, a further option would be for the Commission to propose an EU-wide own resources ticket tax.

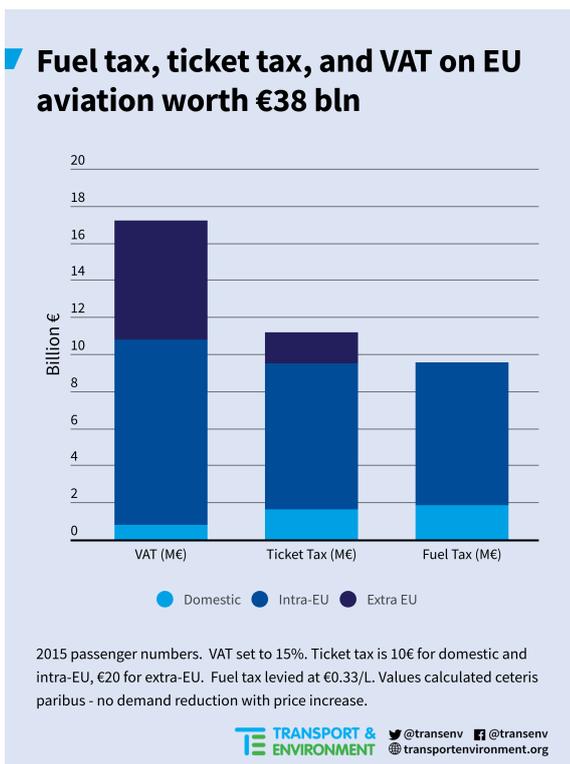
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1.2. Aviation Kerosene Tax

1.2.1. Domestic Flights

The ETD first permitted taxation but on domestic aviation fuel only in 2003. The Netherlands (and Norway) proceeded to do so but domestic flights in the Netherlands have now been phased out. Not taxing domestic aviation kerosene denies member state revenues, fuels the unbridled growth of aviation emissions and creates distortions with low carbon alternatives (particularly rail). Nothing in international law, either in air service agreements or the ICAO Chicago Convention, prohibits domestic fuel taxation. The US, Japan, Brazil and India all tax domestic aviation fuel.

Nor does the ETS Directive say that the ETS can be the only charge on carbon emissions of covered entities. So a fuel tax and the ETS can coexist - alongside for that matter both VAT and ticket taxes (e.g. Germany). Taxing domestic fuel is a simple decision of national governments.



1.2.2. Kerosene tax on intra-EU flights

The ETD 2003 continued the longstanding exemption from taxation of fuels used on international flights but for the first time included a provision permitting member states on a bilateral basis to waive this exemption and tax fuel on flights between the two states concerned at the EU minimum currently 33 cents/l or at a lower rate. So far no member states have done so. Potential annual revenues in the largest 5 member states are €6.5bn alone at the minimum ETD rate of 33 cents/litre for their combined domestic and intra-EU flights **while the total across the EU is estimated at €9.5bn.**

Ticket prices are already very low and the impact on consumers of such a tax would be minimal. For example, low cost carriers like Ryanair, Easyjet, and Wizz account for over 50% of the intra-EU market with an average one way ticket price of €80³. If the cost is assumed to be passed on to the consumer, a 33 cent kerosene tax on an average intra EU flight would add €14 to the average ticket price⁴. If VAT at 15% was applied in isolation to air tickets and the

cost fully passed through by carriers, then the €80 average one way ticket price would increase by €12. Considering that average ticket prices have fallen dramatically from hundreds of euros over the past decade or so, and by 16% in the past 5 years alone⁵, these measures are manageable and politically defensible as a means to fund budgets and cover aviation's unmet external costs (e.g. climate change, noise and air pollution). The EU championed the liberalisation of the EU aviation market in the mid 90's, abolishing all restrictions on fares and routes. Traffic, especially on low cost carriers, expanded dramatically, helped along by generous and lax enforcement of rules on airport and airline state aid - all funded by the taxpayer.

A portion of revenue raised could be directed to the EU budget. This would be an appropriate step which would benefit align EU climate goals with the EU's fiscal policy.

³ Calculated from 4 annual reports FY16 representing the highest market shares of low cost carriers.

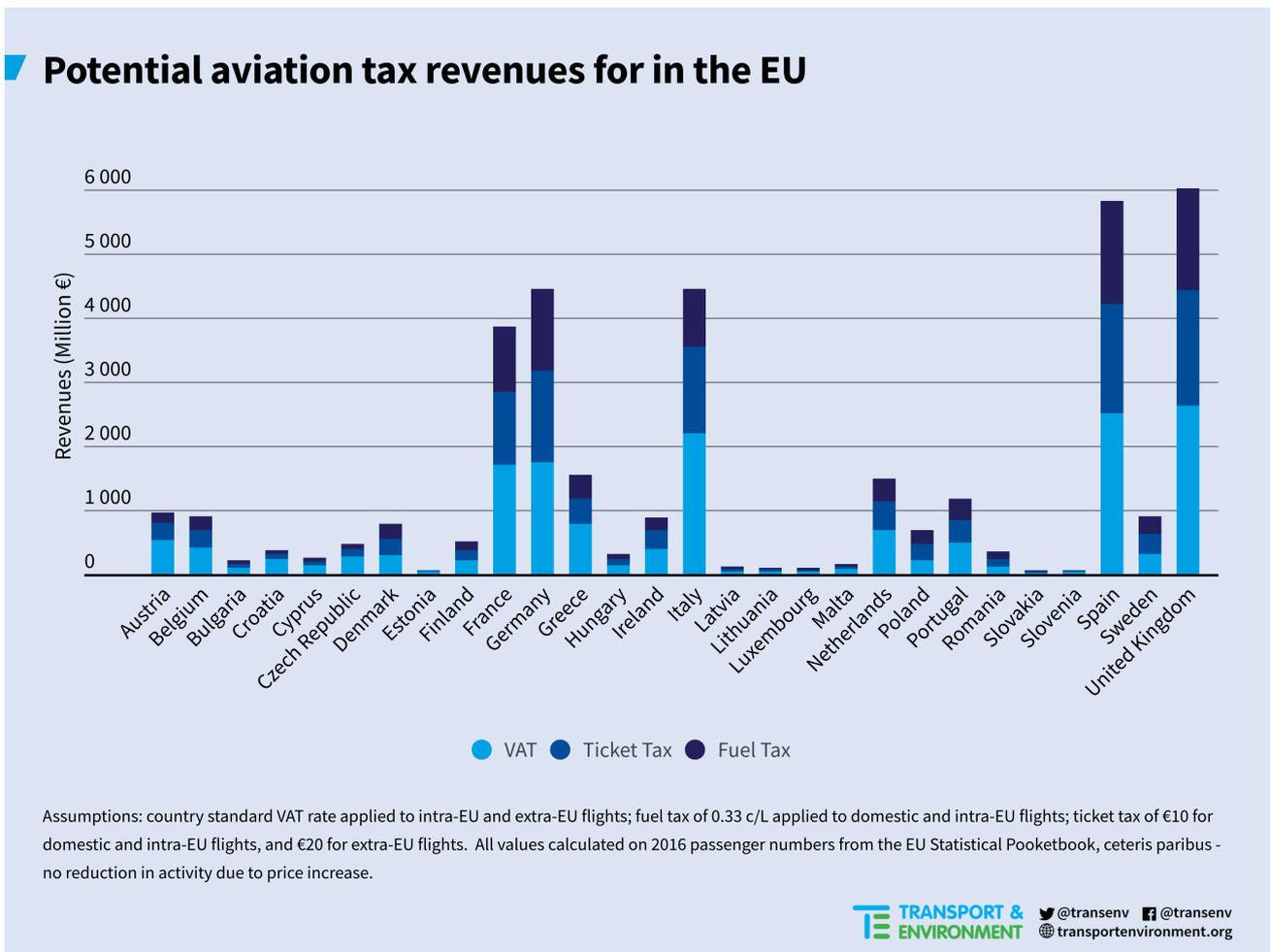
⁴ T&E analysis. The average intra-EU flight sector is 1200 km. Fuel burn from a 737-800 from the ICAO Carbon Emissions Calculator Methodology V.9 with an assumed load factor of 85% yields 43 litres of kerosene per passenger.

⁵ EU average of all available carriers in all available countries (24 of the EU28) from Euromonitor data. Disclaimer: While every attempt has been made to ensure accuracy and reliability, Euromonitor International cannot be held responsible for omissions or errors of historic figures or analyses

Such a tax would also send a price signal to airlines and aircraft manufacturers to increase efficiency, something not being sent by the emissions trading system.

Top 5 EU countries by measure of passenger numbers and potential fuel tax revenue for domestic and intra-EU flights⁶:

	Domestic passengers (millions)	intra-EU passengers (millions)	Potential fuel tax revenue (€ millions)
United Kingdom	22.8	137.9	1603
Spain	30.9	118.2	1614
Germany	23.2	102.9	1280
Italy	29.7	74.0	894
France	28.2	62.0	1022



⁶ Fuel taxes in this analysis are harmonised from Member State ETS allowance reporting of EUAAAs and from transponder data analysis from Plane Finder data expressed as fuel burn, and the number of domestic and intra-EU passengers in 2015, from the EU Transport Statistical Pocketbook 2017.

Tax is a sensitive topic within the EU context. Defining tax rates is considered a pillar of sovereignty for many member states. This national perspective changes though when the taxation relates to a European-wide area of interest. Climate change is a clear example of an issue that requires international action in order to be meaningfully addressed. Transport is a sector that is largely cross border and fundamental to trade and tourism between member states. The fact that transport is now Europe's largest climate problem means that the taxation of polluting transport can be considered a European tax and revenue generated from such taxation should at least in part contribute to the EU budget.

Further information

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