



HM Treasury

Discussion paper on options for supporting English regional airports from the impacts of air passenger duty devolution

July 2015



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1 Introduction

1.1 The government has a long term economic plan to rebalance growth across the regions and nations of the UK, closing the long term gaps between the north and south, London and the rest of the country, and strengthening the UK economy as a whole. This includes the commitment to a major transfer of power to our great cities and counties and nations so that local people can take more control of the decisions that affect them.

1.2 As part of this plan, the government is delivering the Smith Agreement for Scotland and the St David's Day Agreement for Wales, as well as further devolution to cities, towns and counties in England. In England, the government is creating a 'Northern Powerhouse' by pushing ahead to deliver a package of devolved powers to major northern cities, following the Greater Manchester Deal, and investing in transport and infrastructure.

1.3 In July 2012, the government devolved powers over rates of Air Passenger duty (APD) for direct long haul flights to the Northern Ireland Assembly. In September 2014, the cross-party Smith Commission recommended the devolution of APD to the Scottish Parliament. The government introduced legislation to enable this in May 2015, as part of the Scotland Bill. In February 2015, as part of the St David's Day Agreement on the future of devolution in Wales, the government announced it will consider the case for devolving APD to the Welsh Assembly.

1.4 Regional airports in England have expressed concern about the impacts of APD devolution to Scotland and Wales on their business. Specifically, they are concerned that a decision to lower APD rates in Scotland or Wales could draw passengers and airlines away from their airports.

1.5 The government appreciates these concerns. Regional airports play an important role as local employers and enable the transport of people and products nationally and internationally. This improves connectivity, increases trade and helps to create new jobs.

1.6 The government is therefore reviewing potential options to help mitigate the impacts of the devolution of APD on regional airports. As part of this review, the government would like to explore the following three options in more detail:

- 1 Devolving APD within England
- 2 Varying APD rates within England
- 3 Providing aid to regional airports within England

1.7 This discussion paper sets out how these options could work, and highlights key points for consideration. The government welcomes views on the options, together with any further evidence on the likely impact of the options on airlines, airports, passenger numbers and growth – both in specific regions and across the UK as a whole. The government will also welcome the opportunity to meet with interested parties to explore their views further. Interested parties are invited to submit their comments on the paper to HM Treasury by 8 September 2015, by emailing ETTanswers@hmtreasury.gsi.gov.uk or writing to:

APD Discussion Paper
Energy and Transport Tax Team
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London, SW1A 2HQ

2 Devolving APD within England

2.1 This option would see powers over APD devolved fully or partially to local authorities or Combined Authorities (including mayoral city-regions) within England.

2.2 Full devolution would entail UK APD being “switched off” in an area, and local authorities given the power to raise their own APD on passengers leaving airports within their geographic boundaries.

2.3 Partial devolution would entail UK APD continuing to apply within a local authority’s boundaries, but with the authority being given the power over one or more rates of APD. One option for the partial devolution of APD would be to devolve power over long haul rates only. For example, powers over APD rates for direct long haul flights are devolved to the Northern Ireland Assembly.

State aid and the Azores criteria

2.4 Under EU State aid rules, Member States must not vary national tax rates in a way that is more favourable to individual regions, as to do so would be to provide a selective economic advantage to businesses operating in those regions.

2.5 Consequently, for the devolution of a tax power to be compliant with EU State aid rules it must meet the ‘Azores criteria’. Broadly, these criteria require that when tax powers are devolved within a Member State, the regional authority to which they are devolved must bear a sufficient degree of fiscal and economic autonomy from central government.

2.6 The criteria provide for three required measures of autonomy. These are that the decision by a regional authority to apply a tax rate lower than the national rate must be:

- 1 **Institutionally autonomous** – the decision must be taken by an authority with its own constitutional, political and administrative status separate from that of central government.
- 2 **Procedurally autonomous** – the decision must be taken through a procedure in which central government does not have the power to intervene in the setting of the tax rate and where the regional authority has no obligation to take the central government’s interests into account.
- 3 **Economically autonomous** – the lower tax rate within a region must not be cross-subsidised or financed by central government, so that the economic consequences of the reduction are borne by the region itself.

2.7 To meet the Azores criteria and ensure fiscal neutrality for the Exchequer, central government funding for the relevant local authorities would need to be reduced alongside the devolution of powers over APD. The size of the reduction would need to be equivalent to the amount of APD that central government would have collected in that area had APD not been devolved.

2.8 Therefore, if APD were fully devolved to a local authority, funding for that authority would be reduced by the full value of APD in the area. If only long haul rates of APD were devolved, funding would be reduced by the value of long haul APD in the area.

2.9 As an illustration, analysis by HMRC indicates that full devolution of APD to a local authority with one medium sized airport would require a reduction in the central government funding to that authority of around £45 million per year. If only long haul rates of APD were devolved, the reduction in funding would be around £15 million per year.

Boundaries and levels of local government

2.10 This option would require boundaries to be defined for APD purposes, so that all airports within a given boundary were subject to the same devolved system of APD. It would also require a local authority to take ownership of the devolved system of APD within its boundaries.

2.11 Where an airport is located within the boundaries of one authority, but close to another, or where an area has a combined authority, the local authorities may choose to consider coming together to share ownership of a devolved system of APD across authority boundaries.

Tax administration

2.12 A practical requirement that follows from the Azores criteria is that a local authority would either need to administer a devolved system of APD itself or seek agreement from and pay HMRC to do it for them. If a local authority administered the system itself, it would need to have the necessary resources and expertise to ensure collection and enforcement of the tax. This would include employing and training compliance officers to administer the tax and pursue tribunals where necessary.

Impact

2.13 This option would enable areas within England to lower APD rates for travel from their airports, to match or undercut APD levels in other parts of the country. However, authorities would need to bear the fiscal consequences of these decisions, so would need to weigh the economic or social benefits for a region of lower APD against the impact on a local authority's budget.

3 Varying APD rates within England

3.1 Under this option, central government would retain powers over APD, except where these had been devolved to Scotland, Wales and Northern Ireland. The rates of UK APD would be varied according to specific criteria, resulting in different rates in different parts of the country.

Selectivity

3.2 As noted above, under EU State aid rules, Member States must not vary national tax rates in a way that is more favourable to individual regions.

3.3 It has been suggested that setting rates of UK APD according to criteria related to levels of airport congestion may be compliant with the EU requirement of non-selectivity. However, the government would need to seek the view of the European Commission to confirm the legality of this approach.

Rates set according to congestion levels

3.4 Varying rates of APD according to congestion levels would involve setting higher rates on flights from more congested airports and lower rates on flights from less congested airports.

3.5 The Final Report of the Airports Commission, published in July 2015, assessed the impact of increasing APD at capacity constrained airports. It found that rather than driving more effective usage of existing capacity and delivering enhanced connectivity, the effect was a reduction in flights from Gatwick – but not from Heathrow – and an overall reduction in the UK's international connectivity.

3.6 Modelling published by HMRC in 2012 suggests that if prices at Heathrow and Gatwick increased by the equivalent of 50 per cent of APD the number of passengers would decline by 15 per cent at Heathrow and by 30 per cent at Gatwick, within a 5 year period. Moreover, the modelling suggests that the subsequent redistribution of passengers would benefit certain regional airports but have a negative impact on others.

Tax administration

3.7 Varying APD rates regionally would lead to a more complicated tax collection environment. This would increase administrative burdens on airlines and HMRC, and increase the scope for error and fraud.

Impact

3.8 This option would result in redistribution of passengers between airports, with some airports gaining passengers and flights and some losing out. Modelling the exact impacts of a change to determine likely winners and losers is complex, and it is unclear if this option would be effective in supporting those airports most likely to be affected by lower APD rates in Scotland or Wales.

4 Providing aid to regional airports within England

4.1 This option would involve the provision of aid to those airports or regions particularly affected by the devolution of APD.

Regional Air Connectivity Fund

4.2 The Regional Air Connectivity Fund was launched in June 2013 to help ensure that all regions of the country are well served by air transport links.

4.3 Initially the Fund has been used to provide support – known as a Public Service Obligation (PSO) – for existing air routes from another region to London that are in danger of being withdrawn. This reflects the importance of attracting investment and tourism to peripheral regions and ensuring that no area is cut off from the economic and cultural centres of the capital. So far, two routes have been protected with PSO funding totalling over £5 million – from Dundee to London Stansted and Newquay to London Gatwick.

State aid compliance

4.4 Any further State aid provided by the government to regional airports would need to be compatible with the EU's State aid guidelines. The European Commission's 2014 guidelines state that certain categories of aid to regional airports can be justified, in particular to develop new services and contribute to local accessibility and economic development. However, consideration must be taken of competitive distortions on all markets concerned and aid must be 'proportionate' and 'necessary' to contribute to an objective of 'common interest'.

4.5 These guidelines further distinguish between 'regional' and 'large' airports. Regional airports – defined as those with traffic of up to 3 million passengers per year – may be permitted investment aid in 'case specific circumstances'. This would entail factors such as difficulties in financing investment on capital markets and whether the investment would be viable without state support. Airports with between 3 to 5 million passengers per year may also be permitted investment aid under certain 'case specific circumstances', but these would be judged more stringently than for 'regional' airports.

4.6 'Large' airports – defined as those with more than 5 million passengers per year – are allowed investment aid to finance airport infrastructure only 'under very exceptional circumstances'. The European Commission has not defined what 'very exceptional circumstances' are beyond 'a clear market failure'. However, in practice this would again include cases where a large investment would be unlikely to be viable without state support or where difficulties exist in financing the investment on capital markets.

Impact

4.7 While this option might provide support for the smallest regional airports potentially impacted by APD devolution to Scotland and Wales, many airports likely to be affected could be too large to be eligible for aid.

A APD background note

A.1 APD is a tax levied on the carriage of passengers on aircraft taking off from UK airports. It becomes due when a flight departs, and is payable by the operator of the aircraft. The amount due is dependent on the final destination and class of travel of the chargeable passengers on board the flight.

Table 4.A: 2015/16 APD rates

Band (miles from London to Capital of destination)	Reduced rate (economy class)	Standard rate (other classes)	Higher rate (flights on aircraft of 20 tonnes and above with less than 19 seats)
A (0-2000) "Short-haul"	£13	£26	£78
B (2000+) "Long haul"	£71	£142	£426

Source: HM Treasury

A.2 In line with International Civil Aviation Organization (ICAO) rules, the UK does not tax fuel used for international flights. Whilst many other countries levy VAT on domestic flights, there is also no VAT on flights from the UK.

A.3 In the absence of any tax on flying, aviation would be relatively under-taxed compared with other goods and services. APD recognises this fact and ensures that the aviation sector contributes toward general taxation.

Reform

A.4 Budget 2014 reduced the cost of flying to countries over 4,000 miles from London by reforming APD from a 4-band system to a 2-band system (essentially Europe and non-Europe) from 1 April 2015. This scrapped the two highest band rates for APD and cut the cost of flying to the furthest long haul destinations.

A.5 Autumn Statement 2014 exempted children from the reduced rate of APD. Since 1 May 2015, children under 12 have been exempted. This will be extended to include children under 16 from 1 March 2016.

Devolution

A.6 In response to the uniquely challenging situation faced by Northern Ireland, the only part of the UK to share a land border with another EU member state, the government took the decision, in line with the wishes of the Northern Ireland Executive, to devolve powers over APD rates for direct long haul flights to the Northern Ireland Assembly (NIA). This was provided for in Finance Bill 2012 and in November 2012 the NIA passed the Air Passenger Duty Bill. This Bill sets the APD rates on direct long haul flights departing from Northern Ireland airports to zero.

A.7 In September 2014, the cross-party Smith Commission recommended the devolution of APD to the Scottish Parliament. The government introduced legislation to enable this in May 2015, as part of the Scotland Bill. This will give the Scottish Parliament the power to introduce its own APD, with rates at the levels it chooses.

A.8 The government is currently considering the case for devolving APD to the Welsh Assembly, as agreed in the February 2015 St David's Day Agreement on the future of devolution in Wales.

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