

BUDGET - RESTRICTED

FROM : _____
DATE : 31 January 2000
EXTN : 4803
ROOM: 121/3

FINANCIAL SECRETARY

cc: PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
Sir Andrew Turnbull _____

Ed Balls
Ed Miliband
Chris Wales
Shriti Vadera
Spencer Livermore

STARTERS 808-809: VEHICLE EXCISE DUTY (VED) RATES

ISSUE: VED rates for new cars under the graduated VED system and existing vehicles in the Private and Light Goods (PLG) tax class.

TIMING:

2. The options for VED rates and bands in this submission can remain on the table to allow for late decisions in the run-up to the Budget.
3. However, if you feel: (i) that additional options need to be developed; or (ii) the assumptions on which these options are based are inaccurate, we would appreciate an early steer.

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RECOMMENDATION:

4.

CO2 bands (g/km)	Discount rate (clean fuels)	Standard (petrol)	Premium (diesel)	% of new cars (rounded up)
A - 0-145g	£90	£100	£110	15%
B - 146-160g	£110	£120	£130	25%
C - 161-175g	£130	£140	£150	25%
D - 176g +	£150	£155	£160	35%
New light goods vehicles (vans, etc.)			£160	
Reduced rate for existing PLG vehicles			£105	
Standard rate for existing PLG vehicles			£160	

PREVIOUS PAPERS:

to EST, 9 June 1999
EST to Chancellor, 22 July 1999
to FST, 17 November 1999

LINKED STARTERS:

- Starter 807** (VED rates for goods vehicles) is linked because we will need to preserve some headroom between the top rate for passenger vehicles (currently £155) and the rates for the smallest goods vehicles (£160). Raising the top rate for passenger vehicles to £160 would require a £5 increase for 175,000 small lorries (a third of the total lorry fleet), raising around £875,000.
- Starter 808** (increasing the 1,100cc reduced rate threshold for existing cars in the PLG class) will affect the revenue yield from changes to the VED rates for existing cars, and the numbers of winners and losers from the VED changes as a whole. The main options for increasing the threshold are:
 - 1,125cc (1.6m cars - including a Ford Fiesta - costing £85m);
 - and 1,150cc (1.7m cars at a cost of around £90m).

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DISCUSSION

7. We have looked at a number of factors in determining the options for the VED bands and rates outlined in Annex B. If you feel that any of our assumptions and conclusions (as set out below) require further discussion, we would be grateful for an early steer.

SETTING OF BANDS FOR THE GRADUATED VED SYSTEM

8. Within the new system, there will be **four bands (A, B, C, D) grouped by rates of carbon dioxide emissions** (measured in grams per kilometre).
9. There will also be a **separate tax class for new vans** and other new light goods vehicles which would previously have gone into the PLG class but - legally - fall outside the scope of the graduated VED system for new cars (see my submission of 17 November).
10. We will want to set the bands in the graduated VED system at **convenient 'break-points'** in order to avoid large volumes of vehicles falling just the wrong side of thresholds, the issue which took the shine off the 1,100cc reduced rate announced in the last Budget.
11. The 1,100cc reduced rate was also criticised because it applied to only 8% of the car fleet, and to very few well-known cars. **We will want to ensure that a reasonable proportion of the new car fleet falls into each CO2 band, while keeping the majority of cars in the upper two bands** to avoid large long-term revenue losses as the average fuel-efficiency of the fleet improves.
12. With these factors in mind, we have identified the following as our most suitable range of options from which to select the band break-points¹:

CO2 g/km	% of (rounded)	fleet	Most fuel-efficient petrol and diesel models of the UK's 20 best-selling new cars
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¹ Breakpoints at 140g (10%), 155g (30%) and 170 g (55%) were excluded because large volumes of cars fall just the wrong side of these thresholds. Breakpoints below 140g were excluded because of the small number of cars (5% or less) they would capture. Breakpoints above 185g were also excluded because we will want to keep at least 30% of new cars in the top band to limit revenue losses.

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	2000	2001	2002	
-145	15%	15%	20%	Ford Focus (d), Ford Fiesta (d), Vauxhall Corsa (p/d), Renault Megane (d), Renault Clio (d), VW Golf (d), VW Polo (p/d), Fiat Punto (p/d), Citroen Saxo (d), Peugeot 306 (d)
-150	20%	25%	25%	Vauxhall Astra (gas/petrol bi-fuel), Peugeot 406 (d)
-160	40%	40%	45%	Peugeot 206 (d), Ford Focus (p), Nissan Micra (p/d), BMW 3-series (d), Renault Clio (p), Citroen Saxo (p), Vauxhall Vectra (d), Vauxhall Astra (d), Renault Megane (p)
-165	45%	50%	50%	Rover 200 (p), Ford Fiesta (p), Ford Ka (p), VW Golf (p), Peugeot 206 (p)
-175	65%	65%	65%	Ford Mondeo (d), Vauxhall Astra (p), Vauxhall Vectra (p), Peugeot 306 (p), Rover 200 (d), Rover 400 (p/d)
-185	70%	70%	70%	Ford Mondeo (p), BMW 3-series (p)
185 +	includes most fuel-efficient Peugeot 406 (p) and least fuel-efficient models of Ford Focus, Vauxhall Astra, Vauxhall Corsa, Vauxhall Vectra, VW Golf, VW Polo, Ford Mondeo, Renault Clio, Peugeot 206, Peugeot 306, Peugeot 406, BMW 3-series, Citroen Saxo, Fiat Punto, Rover 200 and Rover 400.			

DIFFERENTIATION BY FUEL TYPES

13. We have worked on the assumption that within each of the four bands, there will be:
- a discount for cars which do less damage to local air quality;
 - a supplement for cars which run on diesel; and
 - a standard rate for cars which run on petrol.

Supplement on diesel vehicles

14. Relative to petrol, diesel has lower emissions of CO₂ but higher emissions of the particulates and pollutants which damage local air quality. A diesel supplement is necessary so that we do not create incentives for people to choose diesel vehicles over similar petrol models in order to attract a lower VED rate. Presentationally, this should

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be seen as ensuring fair treatment of petrol and diesel, rather than as a penalty on diesel users.

15. There are two main options on the supplement for diesel vehicles:
 - charging up to £10 more than the standard rate in each band; or
 - charging the same as the standard rate in the next highest band.
16. At least for the first year of the system, **we would prefer the smaller £10 supplement** so we are not seen to be 'penalising' diesel vehicles. However, we may want to re-visit this decision closer to the Budget if:
 - we need extra revenue (a higher supplement could raise £5-20m); or
 - if any decision not to increase the petrol/diesel differential for fuel duty opens us up to criticism of doing too little on local air quality.

Discount for cleaner vehicles

17. A discount rate for vehicles which do less damage to local air quality will be a useful part of the environmental package in the next Budget, and can be delivered at negligible cost. The main issues are the types of vehicles which should qualify for the discount rate, and the level of discount.
18. On the type of vehicles, we would recommend giving **discounts to vehicles powered by cleaner, alternative fuels** (i.e. gas-powered vehicles; gas-petrol bi-fuel vehicles; hybrid electric/fuel vehicles; and vehicles powered by fuel cell technology). DETR estimate that around 10-20,000 new vehicles of these types will be manufactured this year.
19. Other options include giving a discount to diesel vehicles fitted with particulate traps; or using the discount to incentivise the early achievement of future EC emissions standards. We will want to keep these options open for the future, but there would be insurmountable legal and regulatory difficulties in bringing them in by Autumn 2000.
20. On the level of discount for cleaner vehicles, there are again two options:
 - charging them up to £10 less than the standard rate in their band; or
 - charging them a much lower rate (e.g. £50) along the lines of the £45 rate currently paid by purely electric-powered vehicles.

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21. Again, we would prefer the smaller £10 discount. To go further would carry large revenue costs in future years as the market for alternative fuel vehicles increases; and would probably overstate the environmental benefits of these fuels relative to petrol and diesel.
22. The Finance Bill will give us powers to nominate by order the types of vehicle which will attract the discount rate - rather than listing the qualifying vehicles in the Bill itself. This will give us maximum flexibility, cut the length of the legislation, and avoid Finance Bill debate becoming bogged down discussing the relative merits of different vehicles.

SETTING OF VED RATES

23. The 1999 FSBR baseline assumed revalorisation (£5 a year) of the standard PLG rate of VED, as follows:

	1999	2000	2001	2002
VED rate baseline (£)	£155	£160	£165	£170
Revenue baseline (£m)	3385	3523	3675	3833
Number of cars (m) ²	21.8	22.0	22.3	22.5

24. The graduation of VED was to have been delivered on a revenue-neutral basis, taking into account:
- the cost of the 1,100cc reduced rate announced in Budget 99;
 - the rates for new cars under the graduated VED system; and
 - the revenue effects of any change in the PLG rates.
25. However, in order to make these changes revenue-neutral, we would need to increase the standard PLG rate by more than £5 (the revalorisation from £155 to £160 assumed in the baseline). Given the current sensitivity about taxes on motoring, it might seem preferable to absorb the cost of the 1,100cc reduced rate for PLG cars (and any

² There are currently around 22m VED-paying vehicles in the Private and Light Goods class, plus a further 1m exempt cars (disabled, etc). About 2m new cars are registered each year. For every 10 new cars which join the vehicle fleet, around 9 older cars are scrapped. Net growth in car numbers is around 1% p/a.

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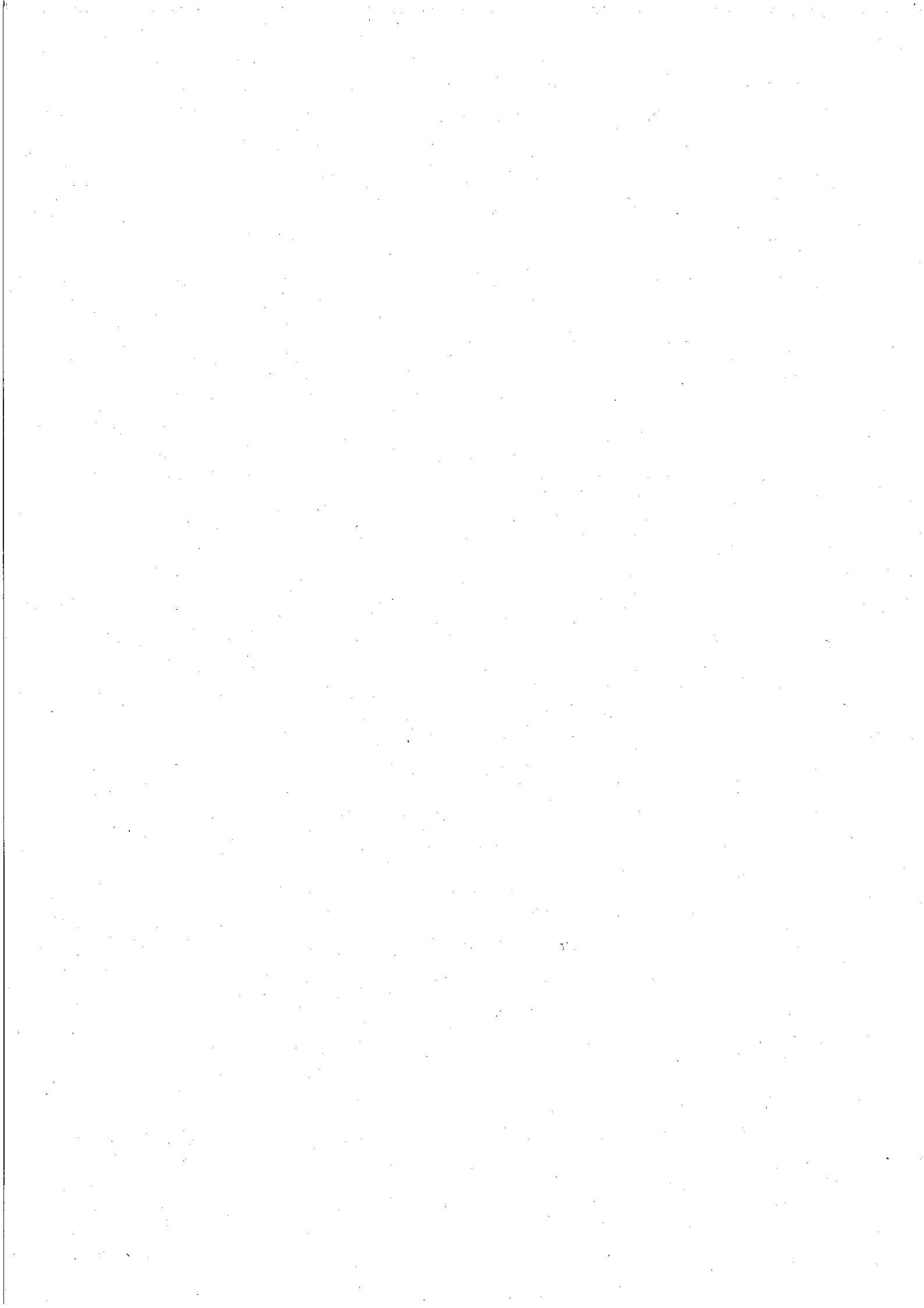
additional cost from extending that threshold) rather than try to recover that revenue from above-inflation increases in the standard rate.

26. If the standard PLG rate only increases to £160, the top rate in the graduated VED system must also be pegged at £160 to **ensure that new cars are not charged more than old cars of the same type** - which would be presentationally and environmentally anomalous. 90-95% of new cars will therefore pay less under the graduated VED system than they would have done in the PLG class, leading to further revenue losses.
27. The rates options set out in the attached annex all broadly show that - even excluding the cost of the 1,100cc threshold or its potential extension - the baseline effects of introducing the new system will be approximately -20m/-80m/-120m. This assumes that:
- the standard PLG rate and top rate for new cars will be £160;
 - there will be a supplement of up to £10 for diesel vehicles and a discount of up to £10 for alternatively-fuelled vehicles; and
 - the new graduated rates will take effect from Autumn 2000 - applying to around 1m cars in 2000/01, 4m in 2001/02 and 6m in 2002/03.
28. If you feel we should continue to aim for a revenue-neutral system, or if we need to look to VED for additional revenue later in the run-up to the Budget, our options are:
- above-inflation increases in the standard PLG rate for existing cars (each £5 increase would raise around £100m);
 - above-inflation increases for the reduced PLG rate alone (each £5 increase would raise around £7.5m);
 - a supplement of more than £10 for new diesel vehicles (each additional £5 would raise around £2.5m); and
 - a further increase in the rates for the smallest goods vehicles (see paragraph 5 - each additional £5 would raise around £875,000).
29. Longer term, we can look to recover revenue through:
- above-inflation VED increases in future Budgets;
 - a higher, separate rate for the largest-engined PLG vehicles; and/or
 - increasing the number of bands in the graduated VED system.

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OPTIONS FOR VED RATES AND BANDS

30. Attached at Annex B are a range of possible bands and rates which we consider to be the most realistic options in light of the factors discussed above. We would recommend Option 1 - as described in paragraph 4 above - for the following reasons:
- it gives a 15%/25%/25%/30% split in the new car market, rising to 20%/25%/20%/35% by 2002, which will place a reasonable proportion of vehicles in each band, but ensure that the majority of vehicles remain in the upper two bands;
 - models of 10 out of the 20 best-selling new cars will fall in the lowest band (albeit 7 are diesel models only);
 - models of all 20 best-selling new cars will fall outside the top band (including 17 out of 20 petrol models of these cars);
 - over 95% of new cars will pay between £5 and £70 less under the graduated VED system than they would have done in the PLG class; only 4% (diesel cars in the top band) will pay the same amount;
 - the variation in rates between bands are relatively small and will avoid significant market distortions; and
 - excluding the cost of the PLG reduced rate and a possible extension of its threshold, the baseline impact of introducing these rates will be: -20m/-80m/-120m, assuming revalorisation in future Budgets, which we could claw back through the options set out in paragraph 29.
31. If you feel that additional alternative options should be worked up, we would be happy to do some more work on these.



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ANNEX B: OPTIONS FOR VED RATES AND BANDS

Option 1:

CO ₂ bands (g/km)	% of new car market			Popular vehicles
	2000	2001	2002	
0-150	15%			
151-170	25%			
171-190	25%			
191+	35%			

VED rates		2000	2001	2002	
Existing cars	Reduced rate	£105	£110	£115	
	Standard rate	£160	£165	£170	
New cars	Band A	Discount	£90	£95	£100
		Standard	£100	£105	£110
		Premium	£110	£115	£120
	Band B	Discount	£110	£115	£120
		Standard	£120	£125	£130
		Premium	£130	£135	£140
	Band C	Discount	£130	£135	£140
		Standard	£140	£145	£150
		Premium	£150	£155	£160
	Band D	Discount	£150	£155	£160
		Standard	£155	£160	£165
		Premium	£160	£165	£170
New vans		£160	£165	£170	
Revenue effect (£m)					

Under this option, the additional revenue effects (£m) of:

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- increasing reduced rate threshold to 1,125cc =
- increasing reduced rate threshold to 1,150cc =
- a £5 above inflation increase in the standard rate =
- increasing lowest lorry VED rates to keep £5 headroom =

Option 2:

Bands (g/km)	% of new car market			Popular vehicles
	2000	2001	2002	

VED rates		2000	2001	2002
PLG cars	Reduced rate			
	Standard rate			
New cars	Band A	Discount		
		Standard		
		Premium		
	Band B	Discount		
		Standard		
		Premium		
	Band C	Discount		
		Standard		
		Premium		
	Band D	Discount		
		Standard		
		Premium		
New vans				

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VED rates	2000	2001	2002
Revenue effect (£m)			

Under this option, the additional revenue effects (£m) of:

- increasing reduced rate threshold to 1,125cc =
- increasing reduced rate threshold to 1,150cc =
- a £5 above inflation increase in the standard rate =
- increasing lowest lorry VED rates to keep £5 headroom =

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Option 3:

Bands (g/km)	% of new car market			Popular vehicles (2,500 + sales)
	2000	2001	2002	

VED rates			1999	2000	2001	2002
PLG cars	Reduced rate		£100			
	Standard rate		£155			
New cars	Band A	Discount				
		Standard				
		Premium				
	Band B	Discount				
		Standard				
		Premium				
	Band C	Discount				
		Standard				
		Premium				
	Band D	Discount				
		Standard				
		Premium				
New vans						
Baseline rate						
Revenue effect (£m)			-85			

Under this option, the additional revenue effects (£m) of:

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- increasing reduced rate threshold to 1,125cc =
- increasing reduced rate threshold to 1,150cc =
- increasing reduced rate threshold to 1,200cc =
- increasing lowest lorry VED rates to keep £5 headroom =

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Option 4:

Bands (g/km)	% of new car market			Popular vehicles (2,500 + sales)
	2000	2001	2002	

VED rates		1999	2000	2001	2002
PLG cars	Reduced rate	£100			
	Standard rate	£155			
New cars	Band A	Discount			
		Standard			
		Premium			
	Band B	Discount			
		Standard			
		Premium			
	Band C	Discount			
		Standard			
		Premium			
	Band D	Discount			
		Standard			
		Premium			
New vans					
Baseline rate					
Revenue effect (£m)		-85			

Under this option, the additional revenue effects (£m) of:

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- increasing reduced rate threshold to 1,125cc =
- increasing reduced rate threshold to 1,150cc =
- increasing reduced rate threshold to 1,200cc =
- increasing lowest lorry VED rates to keep £5 headroom =

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Option 5:

Bands (g/km)	% of new car market			Popular vehicles (2,500 + sales)
	2000	2001	2002	

VED rates			1999	2000	2001	2002
PLG cars	Reduced rate		£100			
	Standard rate		£155			
New cars	Band A	Discount				
		Standard				
		Premium				
	Band B	Discount				
		Standard				
		Premium				
	Band C	Discount				
		Standard				
		Premium				
	Band D	Discount				
		Standard				
		Premium				
New vans						
Baseline rate						
Revenue effect (£m)			-85			

Under this option, the additional revenue effects (£m) of:

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- increasing reduced rate threshold to 1,125cc =
- increasing reduced rate threshold to 1,150cc =
- increasing reduced rate threshold to 1,200cc =
- increasing lowest lorry VED rates to keep £5 headroom =

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Option 6:

Bands (g/km)	% of new car market			Popular vehicles (2,500 + sales)
	2000	2001	2002	

VED rates			1999	2000	2001	2002	
PLG cars	Reduced rate		£100				
	Standard rate		£155				
New cars	Band A	Discount					
		Standard					
		Premium					
	Band B	Discount					
		Standard					
		Premium					
	Band C	Discount					
		Standard					
		Premium					
	Band D	Discount					
		Standard					
		Premium					
New vans							
Baseline rate							
Revenue effect (£m)			-85				

Under this option, the additional revenue effects (£m) of:

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- increasing reduced rate threshold to 1,125cc =
- increasing reduced rate threshold to 1,150cc =
- increasing reduced rate threshold to 1,200cc =
- increasing lowest lorry VED rates to keep £5 headroom =