Submission for the

2014 Autumn Statement

From the Campaign for Reduced Tourism VAT

1. Introduction

The Campaign for Reduced Tourism VAT is led by the British Hospitality Association, Bourne Leisure Group, Merlin Entertainments Group, and the British Association of Leisure Parks, Piers and Attractions (BALPPA). The Campaign was established in 2011, representing over 3,500 individual businesses and over 45 national and regional trade associations.

2. Executive Summary

For over 20 years the UK tourism industry has been concerned at the competitive disadvantage which it faces as VAT is applied to tourism in the UK at the standard rate. The UK is one of only four EU states not to take advantage of a reduced rate of VAT on visitor accommodation, and one of 14 EU countries that apply the full rate of VAT on admissions to amusement parks.[1] The United Kingdom is the only major tourist destination in the EU not to benefit from a reduced rate of VAT.

The Government has an opportunity to announce a popular and economy-boosting measure in the Autumn Statement, which is simple, effective, progressive, fiscally neutral and does not need changes to legislation. Indeed, the announcement will generate growth immediately.

"The Impact of Reduced VAT Rates on British Visitor Accommodation, Attractions and the Wider Economy: Report of Discussions with HM Treasury and Results of a Computable General Equilibrium (CGE) model and a Dynamic Partial Equilibrium (DPE) model", published in December 2012, **found that a reduction in those sectors would be revenue neutral and contribute £4 billion each year to the UK economy.**[2] This research was carried out between 2011 and 2012 by Professor Adam Blake, a Treasury Adviser using the core of the Computable General Equilibrium (CGE) model in use by HMT.

The research shows that announcing a cut in tourism VAT will have a significant positive effect before the VAT cut becomes effective. This is because the industry will respond very positively to the announcement and will begin to invest immediately in decorative upgrades, taking on more staff and increasing wages. The HMT model shows that this impact will add £315m to GDP and will add £77m to fiscal income before the end of this Parliament.

An earlier report on the same subject was undertaken by Deloitte/Wason/Nevin and published in 2011. This has been updated by Nevin Associates in a report published in July 2014. This research used a Dynamic Partial Equilibrium model and predicted an annual net fiscal gain to HM Treasury and the creation of 123,000 new jobs in the sector.[3]

Major companies backing the campaign are prepared to commit to passing on the full VAT cut in the form of lower prices on the day the cut becomes effective. This will reduce the fiscal deficit in the first year of the new Parliament to £610m, reduce it to £72m in year 2, and generate net fiscal surpluses thereafter.

[1] European Commission, VAT Rates Applied in the Member States of the EU, 13 July 2014 http://www.cuttourismvat.co.uk/wp-content/uploads/2013/08/140717-Table-of-all-EU-Tourism-VAT-rates.pdf
[2] Campaign for Reduced Tourism VAT (December 2012) http://www.cuttourismvat.co.uk/wp-content/uploads/2013/08/Cut-Tourism-VAT-HMT-discussion-SUMMARY-report-04dec12.pdf
[3] Nevin Associates, (July 2014) http://www.cuttourismvat.co.uk/wp-content/uploads/2013/08/Tourism-Respect-VAT-Report-2014-07-04.pdf

This submission calls on Government to announce a reduction of VAT applied to visitor accommodation and attractions in the United Kingdom as a measure to assist long-term and sustainable growth for the UK economy.

3. The case for a reduced rate of VAT for the sector

Numerous detailed independent analyses have found that reducing VAT on UK tourism to a reduced rate of 5% would stimulate both domestic and overseas demand leading to expansion of the sector, the creation of jobs and a fiscal return to HM Treasury that would reverse the long-term trend of Britain's worsening tourism balance of payments.

This submission provides an overview of the findings of the two most recent studies which used a Computable Equilibrium Model and a Dynamic Equilibrium Model. The Campaign is grateful to HMT officials for having suggested and granted permission for the use of their CGE model.

3.1 Analysis under the Computable General Equilibrium (CGE) model

The CGE model, before adjustment to reflect some of the assumptions in the DPE model and particular characteristics of tourism, shows a net fiscal cost to the Exchequer of a reduction in VAT on visitor accommodation and attractions. However this cost is far lower than the direct VAT loss. There is actually a small fiscal gain of £77 million in the year prior to the reduced rate becoming effective, followed by a loss of £232 million in the first year following the cut (compared to the direct VAT loss of £1.7 billion in that year) and slowly increasing year-on-year deficits thereafter.

Professor Blake considered a number of alternative assumptions in the CGE model reflecting those that underlie the Dynamic Partial Equilibrium (DPE) model.[4] Not all of these could readily be reflected due to the structure of the CGE model. Of the assumptions discussed, Professor Blake chose to consider four, two assumptions relating to elasticities within the model and two alternate assumptions relating to employment.

One of these relates to a proposed commitment by which the tourism industry, as part of a collaborative agreement, agrees to take on an additional 10,000 workers who have previously been long-term unemployed. **These results show substantially higher GDP gains, peaking at £4 billion per year (rather than £3 billion without these additional assumptions), a positive fiscal impact for the first 4 years and a cumulative fiscal impact over the 2012-2020 period that is only slightly negative at -£151 million.**

The results of the impact of a reduction in tourism VAT in the CGE model were compared with the results of other hypothetical tax changes as follows:

- Scenario 1 - a reduction In VAT on accommodation and visitor attractions to 5%; and
- Scenario 2 – Scenario 1, plus a reduction in VAT on food and beverage services to 5%
- A 2p reduction in the standard rate of corporation tax (simulation CT)
- A 20% reduction in rates for employers' national insurance contributions (NIC)
- A 1p reduction in the standard VAT rate (VAT).

To make the comparison between these five scenarios more precise, GDP and fiscal impact effects over the nine year period 2012-2020 are discounted and added up. This gives a resulting ratio between fiscal impact to

GDP, which can be interpreted as the fiscal cost (when, as is always the case in these results, it is negative) of each pound of GDP gained. The results are:

Comparisons between discounted GSP and fiscal impacts from tax comparison scenarios (£m, discounted at a rate of 3% p.a.)

	Scenario 1	Scenario 2	CT	NIC	VAT
Discounted GDP over 9 years	19,271	79,430	29,615	103,354	28,337
Discounted fiscal impact over 9 years	-3,493	-18,150	-17,973	-24,603	17,830
Fiscal impact to GDP ratio	-0.18	-0.23	-0.61	0.24	-0.63

With a ratio of -0.18, reducing VAT on visitor accommodation and attractions represents *"one of the most efficient, if not the most efficient, means of generating GDP gains at low cost to the exchequer that I have seen with the CGE model",* according to Professor Blake.

Further research by PWC supports this conclusion. HMT has published the findings of two further analyses of proposed fiscal measures, lower corporation tax and reduced fuel duty. PwC has compared the results of these two measures with reduced tourism VAT, all three results emanating from what is effectively the same model.

The HMRC-HMT studies constructs a measure of the economic efficiency of corporation tax and fuel duty. This is measured as the cost/benefit to GDP per £1 of tax cut/tax rise and is referred to as the fiscal multiplier. This is a standard measure and is widely used in the academic literature. Modelling suggests that for every £1 cut in fuel duty, then in the medium-term, GDP will increase by £0.78. The equivalent figure for corporation tax is £62p. The *HMRC-HMT fuel duty study* refers to this result placing fuel duty at the "distortive end of the tax efficiency spectrum".

The HMRC-HMT model also reports a recovery rate. This is defined as the percentage of the initial fiscal cost that is recovered through additional tax receipts generated by the rise in the level of economic output attributable to the policy measure (fuel duty or corporation tax). The recovery rate will include receipts from other tax heads (e.g. income tax, VAT etc). In the case of fuel duty HMRC-HMT estimate that 49% of the initial fiscal cost will be recovered through additional tax receipts generated through additional economic output. The corresponding figure for corporation tax is 46%. The results are shown in the table below, together with the equivalent result for cutting tourism VAT:

	Fuel Duty	Corporation tax	Tourism VAT
Fiscal multiplier	£0.78	£0.62	£0.83
Recovery rate	49%	46%	78%

The results in the table clearly suggest that tourism VAT is at the "distortive end of the tax spectrum" in a similar way to fuel duty. There are however issues relating to the comparability of the results and in particular the absence of corresponding analysis of detailed productivity responses implies that the estimates produced in all three studies are underestimates. **Overall PwC's analysis agrees with the findings of Professor Blake, that cutting VAT on tourism is a significantly more efficient measure.**

It should be borne in mind that a significant limitation of the HMRC-HMT computable general equilibrium model, as we reported in our report submitted to Treasury on 31st August 2012, is that it assumes that the UK economy remains of fixed size before and after the policy change being modelled. In other words, it assumes that gains in the tourism sector will result in reductions in other sectors of the economy. Reducing tourism VAT will to a significant extent grow the UK economy whilst reducing the economies of other countries. That is why the case studies presented to Treasury, such as the Irish experience reported in Section 5 below, are important.

3.2 Analysis under the Dynamic Partial Equilibrium (DPE) model

The first independent analysis of the impact of reduced rates of VAT on tourism and the UK economy in 1995 was based on comprehensive research, including case studies of tourism VAT changes in other countries and detailed analysis of the price sensitivity of UK tourism. Based on this research Messrs Nevin and Wason developed a fiscal model to illustrate the potential impact of the VAT reduction. The fiscal model was developed and refined for subsequent studies, resulting in the Nevin/Wason DPE model in the Deloitte/Wason/Nevin report completed in February 2011.

In July 2014, Nevin Associates completed a report for the Campaign on the impact of reduced VAT rates applied to visitor accommodation and attractions. This report reviewed trends between the previous Deloitte/Wason/Nevin report of February 2011 and July 2014. It then updated the DPE model using the latest available data. Key findings and conclusions of this report are:

- Adopting the same highly conservative assumptions regarding pass-through as in the Deloitte/Wason/Nevin report, the cost to Treasury in year 1 would be £783.7 mn, reducing to £161.9 mn in year 2, and netting fiscal gains thereafter. The surplus to Treasury over 10 years is £3.9 bn.

- As leading campaign supporters are willing to commit to passing on the whole of the VAT cut in the form of lower prices from day one, this will increase the speed of pass through. Still using conservative assumptions, this would reduce the year one fiscal deficit to £610.5 million, to £71.6 million in year two, and netting fiscal gains thereafter.

- Given the UK's emergence from recession, and the strengthening of the pound, it is likely that the UK's share of international tourism will continue to contract if tourism VAT remains at the standard rate. By contrast, a reduction in the VAT rate will stimulate the growth in overseas tourism to Britain, and domestic tourism, helping to increase the taxation base.

- A VAT reduction could help meet the Prime Minister's goal of raising the expenditure of domestic British tourism from 36% to 50%, as more visitors would choose to stay at home for their vacations rather than travel abroad. Additional spending – from both foreign and domestic tourists – would be circulated and spent in the UK economy and would continue to benefit the Exchequer over a longer period of time.

- By growing the tourism sector, the UK can reduce its balance of payments deficit. In 2011, travel expenditure by non-residents visiting the UK accounted for 4.4% of total UK exports. A VAT reduction for the tourism industry would provide a significant boost to the UK export market – a goal that the Chancellor of the Exchequer has signalled as a key aspect of the recovery

- Another indirect benefit to the Treasury would be a reduction in the so-called 'shadow economy'. The UK tourism industry is populated by a large number of small firms that may choose not to expand or invest in order to keep below the VAT threshold to avoid paying tax. In France, the 'shadow economy' has been estimated to have reduced by €720 million a year due to VAT reductions implemented.

- In summary, a lower VAT rate would represent a "win : win" strategy – helping to stimulate Britain's tourism industry, increase foreign exchange earnings, create additional jobs, and generate a net fiscal gain for Her Majesty's Treasury.

4. Industry commitment to job creation and growth

Professor Blake's CGE analysis with additional assumptions included an adjustment for the effects that the expansion of employment in tourism would have on benefit payments, particularly at a time of high unemployment, and notably youth unemployment. **This takes account of the high level of part-time employment and the relatively high proportion of low-skilled employment in tourism.** Thus it is believed that expansion of the tourism sector at the present time will create jobs, a significant proportion of which will be taken up by the unemployed, the young and part-time workers, many of whom may be new to the workforce and with limited alternative employment opportunities. **The opportunities will arise in all parts of the UK, including seaside resorts and rural communities.**

5. Case study: Tourism VAT reduction in the Republic of Ireland

A recent example that demonstrates the link between VAT rates and tourism activity is the Republic of Ireland. VAT on tourism in Ireland was reduced first during the 1980s, which led to a significant increase in tourism. Since then the rate has gone up and down but has always been at a reduced level. Ireland suffered a greater proportional national debt crisis in the current recession than the UK, consequently reducing government spending and increasing taxes, including the standard rate of VAT. However, recognising the potential for job creation and growth through tourism, the Irish government further reduced the rate applying to tourism from 13.5% to 9% as from 1st July 2011 until end December 2013.

A July 2014 assessment by Deloitte presents a compelling analysis of the resultant positive impact, despite the fact that this represents a fairly modest reduction of 4.5 points in the rate of VAT. **The report highlights: strong evidence of pass-through to lower prices; improved value-for-money perception of Ireland's tourism; the biggest increase in foreign visitors since 2007; and 30,000 jobs created netting the Exchequer €165m. There was a direct VAT income loss to the Exchequer, but this was much lower than had been forecast by government - €107m per annum rather than €350m.**

The overall conclusion of the report is as follows: *"To conclude, the introduction of the reduced VAT rate appears to have met its original aims of driving employment and stimulating activity in the sector and has achieved this without placing a significant burden on the exchequer". Although the reduction was originally set for only a year and a half, the Irish Government extended it indefinitely in 2013. This report is based on actual experience rather than a hypothetical case for VAT reduction.*

Another report on the impact of the further reduction in tourism VAT in Ireland from 13.5% to 9% was published by the Nevin Economic Research Institute (NERI). The NERI report concluded that: *"Overall the measure is notably progressive, impacting more positively on lower income households than on those further up the income distribution. On average, the VAT reduction was equivalent to an increase in gross income of 0.26% per annum, with the bottom six deciles gaining at above the average."*

It is notable that in the case of Ireland, the Irish government had anticipated that further reducing VAT on tourism from 13.5% to 9% would cost £350 million, whereas the actual cost was £107 million and according to a July 2014 assessment by Deloitte. **Interestingly, that represents an overstatement by the Government of 327%. If the UK Treasury's figure of £2 billion is overstated by the same margin, the cost to the UK government would be £611 million – the cost in year 1 according to the Nevin Associates assessment under a rapid pass-through scenario is £610.5 million[5], reducing to £71 million in year 2 and resulting in annual fiscal gains thereafter.**

6. Conclusions

Having examined the impact of reduced VAT on tourism using both CGE and DPE models, the Campaign is strongly of the view that reducing VAT on visitor accommodation and attractions will create jobs and stimulate growth throughout the economy at very low risk to Exchequer income.

It is believed by the Campaign that cutting VAT on tourism will lead to fiscal surpluses over time that will - combined with a basket of complementary policy measures such as increased marketing spend and improved visa regulations and procedures – reverse the long-term trend in the decline of the UK's tourism balance of payments and go some way towards achieving the Prime Minister's goal of increasing the proportion of UK residents' spend on domestic tourism from 36% to 50%.

This is not a request for stimulus or support for the tourism sector. This policy is commended as a measure to assist long-term and sustainable growth for the UK economy, and to put the UK on a level playing field with our EU competitors. The tourism sector is willing to work with the Government to support 10,000 long-term unemployed back into work to make this policy measure fiscally viable.

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[5] An alternative scenario posits that the Base Case is too conservative, in two regards: 1. The assumption that only 60% of the VAT cut gets passed through, whereas Copenhagen Economics, in their report for the European Commission on labour-intensive services4 concluded that full pass-through will be achieved.2. The assumption that it would take 4 years to reach that position, compared to 2-3 years in Copenhagen Economics' analysis. Accordingly, the Nevin analysis also modelled a "rapid adjustment" scenario, where 75% of the VAT reduction will pass through to lower prices, and the full price adjustment will take a total of three years, with 50% of the full adjustment occurring in Year One, 80% in Year Two, and 100% by Year Three and thereafter.