The Impact of Reduced VAT Rates on British Visitor Accommodation, Attractions, Employment & the Economy

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Tourism delivers for UK Plc

Tourism is a significant contributor to the UK economy – generating around a tenth of the UK's GDP and supporting over 2.5 million jobs including many at entry level and opportunities throughout the skills spectrum. The industry is responsible for significant levels of training and upskilling and, because of its local labour intensiveness, employment cannot be offshored.

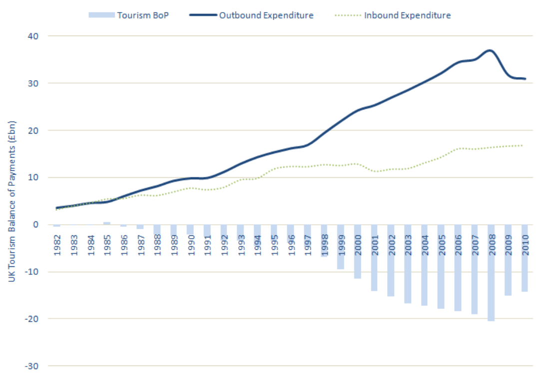
As recent Deloitte analysis used in the Government's Tourism Strategy has evidenced, the sector provides significant growth potential, even in turbulent economic times.

Evidence shows the UK is uncompetitive

Tourism growth is hindered somewhat because the UK is an expensive destination. According to the World Economic Forum's latest Travel and Tourism Competitiveness Index, the UK ranks 135th out of 139 countries on price competitiveness. High Tourism taxes include VAT, Air Passenger Duty and visa charges, which make the UK less attractive to residents of other countries, notably China and other growth economies. The UK's position has further worsened following the VAT increase from 17.5 to 20 per cent on 4th January 2011.

Data shows that the UK's Tourism Balance of Payments has deteriorated significantly over the last 15 years – see Figure A. This outcome was predicted by Deloitte[1] as early as 1995 on the basis of the UK's uncompetitive position, part of which was then attributed to the UK's higher rate of VAT on Tourism compared with competitor countries.

Figure A. UK Tourism BoP



Source: Deloitte, Wason and Nevin analysis, VisitBritain.

Over the last two years, the trend in the Balance of Payments deficit has been interrupted and partially reversed. This interruption is believed to be due to both the recession and a relatively weak pound and, as economic conditions improve, the long-term trend could continue without measures to assist the underlying drivers of competitiveness.

Industry recognition has increased

In August 2010, the Prime Minister expressed his government's recognition of the size, importance and potential of Tourism, citing the industry as one of the best and fastest ways to generate jobs. Since then the Government has published a new tourism strategy, which, whilst addressing some industry issues, does not seek to address the issue of price competitiveness.

In his original speech, the Prime Minister noted that British residents spend 36 per cent of their holiday expenditure in the UK and questioned whether this could be increased to 50 per cent.

One measure that could help achieve this objective and reverse the UK's deteriorating Tourism Balance of Payments is to bring the UK into line with the rest of the EU by applying a reduced rate of VAT to Tourism services.

Tourism is different

Tourism is one of a limited number of goods and services to which the EU permits Member States to apply a reduced rate of VAT. Nearly all Member States exercise this option because they recognise that:

- tourism is highly price-sensitive;
- reduced VAT can result in increased demand and thus the creation of jobs; and
- hotel accommodation and visitor attractions have a significant export element.

Tourism is also unusual in its position as the only export sector which is subject to VAT.

But, there is an uneven playing field

Figure B. VAT rates on Tourism-related goods in the UK and competitor nations (%), July 2011

Country	Tourism Accommodation VAT rate	Minimum VAT rate for admission to cultural services	Maximum VAT rate for admission to cultural services	VAT rate for admission to amusement parks
France	5.5	5.5	19.6	19.6
Portugal	6.0	0.0	6.0	6.0
Greece	6.5	6.5	13.0	13.0
Germany	7.0	0.0	7.0	19.0
Spain	8.0	0.0	8.0	8.0
Ireland	9.0	0.0	9.0	9.0
Italy	10.0	10.0	10.0	10.0
UK	20.0	0.0	20.0	20.0

Source: Deloitte, Wason and Nevin analysis.

[1] Messrs Wason and Nevin were respectively Partner and Senior Economist at Deloitte at this time.

Case studies illustrate positive effects

The UK is one of only three of the 27 EU Member States that does not apply a reduced rate of VAT to hotels, and most countries also apply reduced rates to tourist attractions.

Our analysis of case studies where countries recently have changed the rate of VAT applied to Tourism supports the above findings. Two recent examples are:

- Germany, where the rate of VAT on hotels was reduced from 19 per cent to 7 per cent from 1st January 2010. Although too soon for the full effects to be seen, reports suggest increased demand for hotels, employment, salary levels and investment by hoteliers;
- France, where the rate of VAT applied to meals in restaurants was reduced from 19.6 per cent to 5.5 per cent from 1st July 2009. In the first five quarters since the cut, an estimated 28,200 jobs have been created, 15,000 businesses have been saved from closure safeguarding a further 30,000 jobs and there has been a signifcant decrease in the 'Shadow Economy'.

Recently Ireland announced a further reduction in VAT in tourism: from 13.5 per cent to 9 per cent in July 2011 until 1st January 2014. This is to "to boost tourism and stimulate employment in the sector". Ireland received a considerable boost to its tourism industry after reducing VAT on tourism from the standard rate in 1986. June 2011 saw Greece follow suit: further reducing the rate of VAT on tourist accommodation to 6.5 (from 11) per cent.

The significant difference between the UK's VAT rate on Tourism and competitor destination VAT reduces the sector's competitiveness, but the impact of reducing VAT will depend on a number of factors.

Economic theory suggests that where competition exists and demand is relatively responsive to price, a VAT reduction will lead to lower prices, increases in demand and the possibility of greater aggregate tax revenues.

This theory was examined in depth by Copenhagen Economics ApS in a report commissioned for the EU in 2007. The report analysed the impact of a change in the VAT rate in six case studies, and suggests that permanently lowering the VAT rate leads, in typically up to two years, to a reduction in prices of goods or services corresponding to the value of the tax cut.

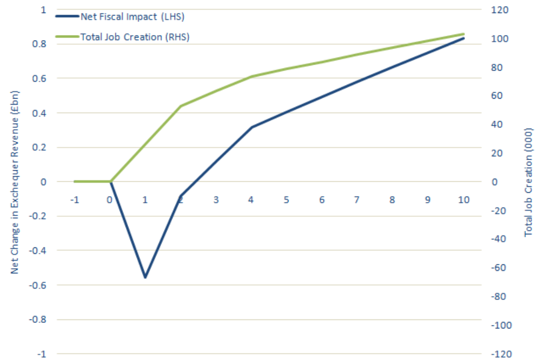
These price cuts will lead to increased consumption, production and employment, especially in labour-intensive, price-elastic services such as hotels and other Tourism services.

Employment creation and longer term tax gains for the UK

Scenario analysis for this study utilises econometric analysis of the price sensitivity of UK and international Tourism and includes a fiscal model simulating the effects of a cut in the rate of VAT on UK visitor accommodation and attractions: from the standard rate of 20 per cent to the UK's existing reduced rate of 5 per cent.

The growth in demand stemming from such a VAT reduction could generate 78,000 jobs in the medium-term [rising to 100,000 after 10 years]– going some way to fulfilling UK Government's stated aim of quickly creating sustainable private sector jobs. Many of these jobs are suitable for new entrants to the labour market; and many of them could absorb employees with transferable skills from other sectors.

Figure C: Impacts of a VAT Reduction on Accommodation and Attractions over Time



Source: Deloitte, Wason and Nevin analysis.

Fiscally, our analysis shows that in the first year after a VAT reduction there would be a loss in direct VAT receipts to the UK Treasury of just over £1.2 billion. However, there will be almost immediate gains to offset this loss as lower VAT leads to lower prices; increasing demand; job creation and longer-term fiscal returns.

We estimate that in the first year following the VAT cut, the £1.2 billion will be partially off-set by indirect benefits of £277 million plus multiplier benefits of £278 million. Thus, the year one investment is reduced to £645 million. HMT begins to recoup its investment in the third year after imposition and the Net Present Value (NPV) of the fiscal gains generated for the Treasury over 10 years, compared to a "no change" policy scenario, is £2.6 billion.

A reduction in VAT could spark off a virtuous cycle of investment and growth and go some way to reverse the decline in the Tourism Balance of Payments.

A time for serious consideration?

Combined with a basket of complementary policy measures – such as increased marketing spend – reducing VAT could assist in achieving the Prime Minister's goal of increasing the proportion of UK residents' spend on domestic Tourism from 36 per cent to 50 per cent.

It would also work to increase the UK's share of international Tourism, create jobs and produce an overall financial gain for the government in the medium-term.

On these grounds, this policy measure merits consideration by HM Treasury.