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Tourism Sector VAT analysis:

A Report on the Impact of Reduced VAT Rates on British Visitor Accommodation, Attractions and the Wider Economy

7 February 2011

Undertaken jointly with

Graham Wason and Michael Nevin

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EXECUTIVE SUMMARY

Introduction

This report presents the findings of a study into the projected impact of lower rates of Value Added Tax (VAT) on UK visitor accommodation and attractions.

The report was commissioned by the Bourne Leisure Group (BLG). BLG was established in the 1960s and is one of the largest holiday businesses in the UK. It operates holiday brands including Haven Holidays, Warner Leisure Hotels and Butlins. It is estimated that BLG provides around one in seven of all holidays taken in Britain by UK holidaymakers.

The aim of this study is to articulate the case, should evidence support the hypothesis, that a cut in VAT on tourist accommodation and visitor attractions should benefit Her Majesty's Treasury (HMT) in terms of net tax reciepts, as well UK businesses (in terms of visitor numbers, expenditure and spillover effects) and citizens (in terms of greater access to employment and lower cost domestic holidays and leisure trips).

Background

The UK is facing a period of major economic uncertainty, with the highest budget deficit in history. In response, the Coalition Government has introduced tough austerity measures, notably in the form of cuts to government spending. There is concern that spending cuts and a hike in taxes will reduce growth forecasts, which therefore increases the possibility of a double dip recession.

On 12th August 2010, David Cameron, the Prime Minister (PM), gave a major speech on Tourism. The PM declared his government's recognition of the size, importance and potential of Tourism, citing the industry as one of the best and fastest ways of generating jobs. He referred to the fact that the UK has fallen from sixth to eleventh place in the World Economic Forum's Travel and Tourism Competitiveness Index (WEF TTCI) Ratings between 2008 and 2009. The PM said: *"At the moment 36 per cent of what Brits spend on holidays is spent at home. Can we up our game to raise that to 50 per cent?"*

This study explores the hypothesis that reducing VAT on UK visitor accommodation and attractions might be one way of helping achieve this target.

The case for a reduction in the rate of UK VAT on Tourism has been made by the industry since the mid 1990s, as VAT rates in the UK are higher than that of its European competitors, the majority of which apply a reduced rate of VAT to Tourism.

This study has been undertaken by a team comprising:

- Deloitte MCS Limited
- Graham Wason of Tourism Respect
- Mike Nevin of Nevin Associates
- Dr Roger Perman of the University of Strathclyde

The study builds on previous reports on the impact of a reduced VAT rate on UK Tourism undertaken in 1995, 1998 by Deloitte[1] and further reports by Messers Wason and Nevin in 2002, 2008 and 2010. Roger Perman was involved in the studies in 1995, 1998 and 2008.

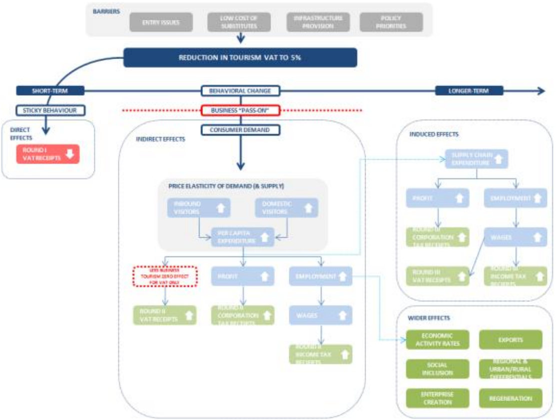
Further information on relevant experience of members of the study team is contained in Annex A.

Method

The study considers the way in which changes in VAT rates in the UK may influence industry outcomes, through 'pass-on' to consumers, increased demand and increased Exchequer revenues.

To do this, a framework for the study was devised (shown overleaf) based on previous work by Wason and Nevin and Deloitte analysis. The framework acts as a visual representation of the impacts of a VAT cut and the research that is conducted to allow a balanced discussion of the outcomes.

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



Source: Deloitte, Wason and Nevin analysis.

In theory, a reduction in Tourism VAT will take time to pass through the system. In the short-term the effects are expected to be lower Exchequer revenues. In time, behavioural change – by both suppliers and consumers – should result in lower prices and increased demand for Tourism goods and services by domestic residents and international visitors. The effect on Exchequer revenues will be dependent upon the extent to which increased demand offsets the lower rate of VAT. Greater levels of economic activity will benefit the UK, and further tax revenues would accrue from increased profits, wages and demand in the supply-chain.

This study has included:

- A review of economic conditions;
- A review of the past, present and future prospects for UK Tourism;
- Comparative analysis of EU tax rates;
- Case studies of reductions in VAT in the EU;
- Comparative analysis of the VAT and Total Tax Burden on UK Tourism relative to EU countries;
- A survey of business behaviour due to VAT cuts;
- Econometric modelling of the sensitivity of Tourism demand to changes in prices and incomes;
- Fiscal modelling of the effects of a VAT cut from 20 per cent to 5 per cent;
- As assessment of the impact of a VAT reduction on employment; and
- Synthesis of findings.

Economic Context

Following significant turmoil in financial markets and the subsequent recession, most advanced economies are expected to recover over the next few years, albeit with slower growth rates than pre-recession. Both consumers and businesses are proving frugal and are still proceeding with caution. Associated changes in spending patterns, both within the UK and in other countries, have the potential to affect visitor economy outcomes.

In the UK, despite strong growth in two quarters of 2010, the outlook remains weak. The fiscal retrenchment proposed by the coalition Government is expected to shave a significant amount from growth, at least in the short-term. Moreover, indicators suggest that external factors (export demand) are likely to be unsupportive of growth in the short-term.

Tourism in the UK

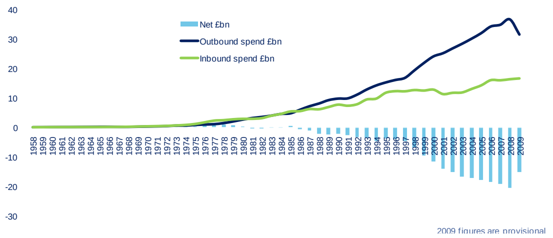
Tourism is a significant contributor to UK Plc – generating around a tenth of the UK's GDP.

The industry supports over 2.5 million jobs, providing many entry level jobs as well as opportunities at higher levels. The industry is responsible for significant levels of training and up-skilling, and, because of its local labour intensiveness, employment cannot be relocated offshore.

However, the UK's Tourism Balance of Payments (the difference between UK receipts from non-resident tourists and expenditure by UK residents on visits abroad) has deteriorated significantly over the last 25 years. Some 15 years ago, Graham Wason and Mike Nevin, then at Deloitte, reported the UK's uncompetitive position through having a higher rate of VAT on Tourism than competitor countries and predicted that, if this were not addressed, the Balance of Payments deficit would continue to deteriorate. This has been borne out by events.

Figure A charts the Tourism balance since 1985, the last year in which the account showed a modest surplus. Since then the account has been in deficit and has worsened year-on-year until 2009, when the downward trend was interrupted as the recession led to British people taking 'staycations' boosting domestic Tourism and the weak pound encouraged overseas visitors in the UK.

Figure A. UK Tourism Balance of Payments

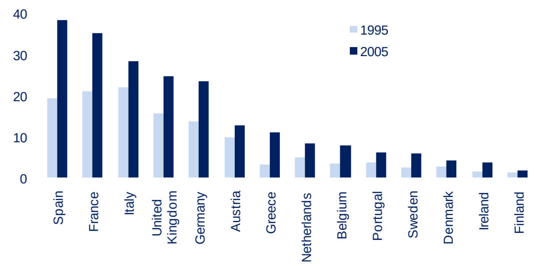


Source: Deloitte, Wason and Nevin analysis, VisitBritain.

The improvement in the UK's Tourism balance in 2009 tends to confirm that lower Tourism prices – whether as a result of a lower external value of the pound, or as a result of a reduced rate of VAT – would have the effect of stimulating demand for Tourism services, which are highly price-sensitive.

The UK currently accounts for 3.5 per cent of international Tourism receipts (3.8 per cent in 2008). Figure B shows the international Tourism receipts (in millions of euro) of the 14 Member States of the EU in 1995 and the same countries in 2005.

Figure B. International Tourism Receipts (ITR), millions of euro



Source: Deloitte, Wason and Nevin analysis, VisitBritain.

Over the ten years between 1995 and 2005, the total receipts of these 14 EU Member States grew by 69 per cent in nominal terms. Over the same period, the growth in UK receipts was lower than the average, at 57 per cent in nominal terms, leading to a decline in the UK's share of both the EU and world markets.

The decline in the UK Tourism balance is mirrored by the decline in the UK's competitiveness as a destination, particularly due to high cost. According to the WEF TTCI, the UK ranks 133rd out of 133 countries on cost. In addition to comparatively high taxes on Tourism, especially VAT and Air Passenger Duty, residents of many countries, notably China and other growth economies, incur high visa charges to visit the UK, making the UK even less attractive to many long-haul visitors.

Overall, the UK ranked 11th out of 133 in the 2009 WEF TTCI – down five places from 6th place in 2008. This, combined with large scale investment in emerging Tourism markets, signals a challenge for the UK to remain competitive.

Figure C. WEF ranking of cultural and natural resources

Source: Deloitte analysis, WEF.

The next update to the WEF Travel and Tourism Competitiveness Index is likely to paint an even starker picture for the UK as competitor destinations have reduced VAT in that period, where the UK's rate has risen.

However, given that the UK is deemed to be the least price competitive of 133 destinations, it does speak volumes for the quality of the offer in the UK that it is ranked so highly in aggregate. Research conducted for VisitBritain as well as forecasts from WTTC suggest that future growth potential is significant for the UK if a number of conditions are met – namely generating sufficient support from Government and business.

Challenges to and opportunities for future growth in UK Tourism are summarised in Figure D in a 'traffic light' format, with red denoting threats and green denoting opportunities.

Figure D. Challenges and opportunities

	Issue
Political	Geopolitics
	Capacity Considerations - including infrastructure
	Funding/public spending
Economic	Macroeconomic conditions
	- Exchange rates
	- Consumer spending
	London 2012
	Growth in emerging economies
	Investment in transport and other infrastructure
	Competition and the changing market place
Social	Delivering the 'experience'
	Culture and heritage reputation
	Shifts in consumer behaviour and general perceptions
	- Lower spend/perception of expenses
	- Growth in food/health/wellbeing tourism
	- Shift in consumer tastes to 'exotic' places
	Demographics
	Income distribution
Technological	Digital distribution
	Innovation e.g. social networking
	Competition
Environmental	Climate change
	Potential health/travel scares
	Commodities - e.g price of oil
	Environment
Legislation	Taxation & Visa Cost
	Visa process
	Minimum wage

Source: Deloitte analysis.

The UK's unique offer in terms of culture and 'experience', technological and channel advancements, and the growth in emerging markets are amongst the major opportunities for the UK to leverage in coming years. On the downside, investment/capacity issues, funding issues, and growing competition from abroad are seen as significant threats. Another significant threat contributing to cost is tax legislation for the sector.

VAT in the EU

Whilst the EU does not have major competences in the area of direct taxation (i.e. company and personal tax), it does in the case of VAT. VAT is a widely-used instrument in the EU and must be used by every Member State.

The basic rules are:

- Supplies of goods and services subject to VAT are normally subject to a standard rate of at least 15 per cent;
- Member States may apply one or a maximum of two reduced rates of not less than 5 per cent to goods and services enumerated in a restricted list (see Annex B).

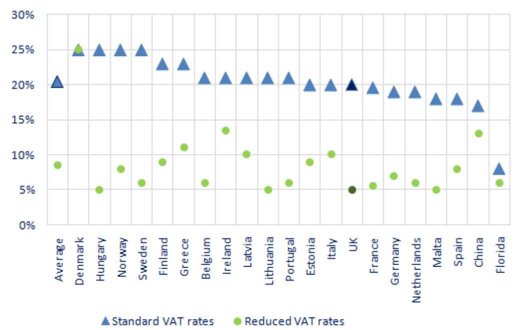
As a general rule the standard rate has to be applied. The standard rate varies from the permitted minimum of 15 per cent to a current maximum rate of 25 per cent. The average standard rate of the 27 EU Member States currently is 20.4 per cent. All but one of these countries, Denmark, applies at least one reduced rate. The average reduced rate, depending on how calculated, is between 6.3 per cent and 9.2 per cent.

In 2007, the EU commissioned Copenhagen Economics ApS to carry out an overall assessment report on the impact of reduced rates applying to locally supplied services, including restaurant services, notably in terms of job creation, economic growth and the proper functioning of the internal market.

Based on the report, the Commission made various recommendations and proposals to the Council. On 5th May 2009, the Council adopted a new directive allowing the optional use of reduced rates of VAT for certain labour-intensive local services, including restaurant services.

Figure E below shows current standard and reduced VAT rates in selected EU countries, China and Florida.

Figure E. Standard and Reduced VAT rates of selected EU countries, Florida and China



Source: Deloitte, Wason and Nevin analysis, EU Taxation and Customs Union.

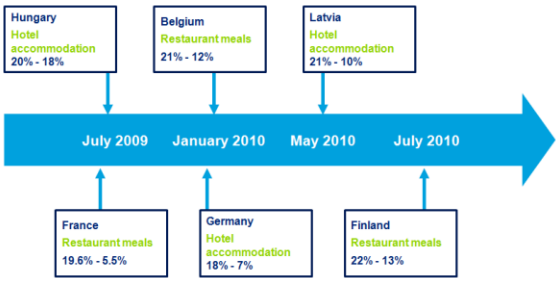
The UK's standard rate of VAT at 20 per cent (from 4th January 2011) is very close to the 20.4 per cent average of the 27 EU countries, and its reduced rate of 5 per cent is at the minimum level permitted by the EU.

VAT on Tourism services

The recent EU VAT legislation removes an anomaly that has existed since its foundation, by which the two largest components of the Tourism industry – hotels and restaurants – were treated differently under the EU VAT rules. While Member States were eligible to voluntarily apply a reduced VAT rate to hotels, by virtue of hotels being included on the relevant annex, restaurant services were subject to the standard rate. However some Member States were eligible to apply a reduced rate to restaurants due to derogations and early or pre-accession agreements.

Since 5th May 2009, a number of Member States have taken the opportunity of the new regulations that permit them to adopt a reduced VAT rate for restaurants. These include Belgium, Finland and France. In the same period, Germany and Hungary have moved hotels from the standard to a reduced rate of VAT. These recent changes are shown on the chart below.

Figure F. Recent VAT reductions in Tourism in selected EU destinations



Source: Deloitte, Wason and Nevin analysis.

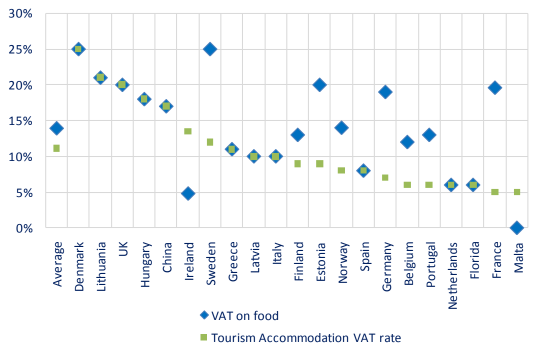
A number of countries, all recent accession Member States of the EU, have increased the rates of VAT on Tourism services, in some cases moving them from a reduced rate to the standard rate. Such moves have been strongly influenced by the IMF as part of a wider economic support package.

Most EU Member States exercise their right to apply a reduced rate of VAT to Tourism services because they recognise that Tourism is a highly price-sensitive sector and that reduced VAT results in lower prices and increased demand. Furthermore as Tourism services are labour-intensive, reducing VAT can represent a highly cost-effective means of promoting employment. Lower prices enable countries to compete more effectively against others with higher taxation regimes. And this can lead to an increase in total fiscal income that more than outweighs the lower direct income from VAT.

Spending by non-resident visitors to a country is an export, and exports in most EU countries fall outside the scope of VAT. Approximately half of UK hotel turnover is accounted for by overseas visitors, yet the service provider cannot charge zero VAT at the point of invoicing, unlike other export services such as consultancy, finance and insurance. Thus a further reason why other EU Member States apply lower rates of VAT to visitor accommodation might be to help correct this anomalous position.

The rates of VAT that apply to hotels and restaurants in the main EU Member States are shown on the chart below.

Figure G. VAT rates for tourist accommodation and food, selected EU countries



Source: Deloitte, Wason and Nevin analysis, EU Taxation and Customs Union.

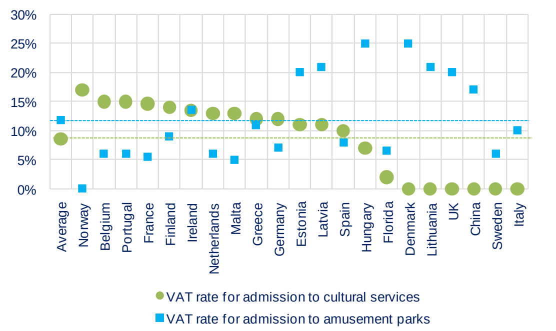
Twenty-two of the 27 EU Member States currently apply a reduced rate of VAT to hotel accommodation. The UK is one of the exceptions. Of the remaining four exceptions, one, Bulgaria, applies a reduced rate of VAT to hotels purchased as part of a tourist package. Two of the others, Lithuania and Slovakia, applied a standard rate due to pressure from the International Monetary Fund (IMF) in 2010. The fourth country, Denmark, has no reduced rates of VAT.

The UK is therefore the only country in the EU which has an option to apply VAT to hotels at an existing reduced rate but does not exercise this in any part of its visitor accommodation sector.

The majority of other EU Member States also apply a reduced rate of VAT to meals served in restaurants and cultural and entertainment services. Analysis suggests that EU-wide, only Denmark and Lithuania are more expensive than the UK in terms of the total VAT-take on tourists.

The treatment of "visitor attractions" within EU Member States is complicated by different definitions as to what this sector encompasses. Although some Member States charge the standard rate on the two visitor attraction categories defined by the EU for VAT purposes – admission to cultural services and shows and admission to amusement parks – Figure H shows that most EU Member States apply a reduced VAT rate to these services, and that the standard rate of 20 per cent applying to certain services in the UK is well above the EU average.

Figure H. VAT rates for admission to cultural services and amusement parks, selected EU countries



Source: Deloitte, Wason and Nevin analysis, EU Taxation and Customs Union.

Conversely, certain services in the UK, such as national museums and galleries and cultural services provided by charities and local authorities, are not subject to VAT. However, commercial visitor attractions and entertainment facilities are subject to VAT at the standard rate. This creates distortion within the sector in the UK.

The UK's position on VAT on Tourism services places it at a competitive disadvantage in contrast with all other major European players – as alternative locations for both international and domestic tourists.

Other Comparative Tax rates

Although the UK has high rates of VAT on Tourism, UK taxes on income and profits are broadly in line with EU averages. According to recent research by the Institute of Directors the UK is neither a high nor low tax economy.

Figure I ranks major EU nations by a simple average of income and corporation tax, with the UK placed firmly mid-table.

Figure I. Average income and corporation tax

	Income Tax Rate (%)		Corporation tax (%)	
	Low	High	Low	High
Denmark	38.0	59.0	25.0	25.0
Belgium	25.0	50.0	34.0	34.0
Norway	28.0	49.0	28.0	28.0
Spain	24.0	43.0	30.0	30.0
Germany	30.0	33.0	14.0	45.0
Italy	23.0	43.0	27.5	27.5
Malta	15.0	35.0	35.0	35.0
France	5.5	40.0	33.3	33.3
Sweden	0.0	57.0	26.3	26.3
UK	**0.0**	**50.0**	**28.0**	**28.0**
China	5.0	45.0	25.0	25.0
Netherlands	20.0	25.5	0.0	52.0
USA	10.0	35.0	15.0	35.0
Greece	0.0	40.0	25.0	25.0
Finland	6.5	30.0	26.0	26.0
Ireland	20.0	41.0	12.5	12.5
Estonia	20.0	20.0	21.0	21.0
Portugal	0.0	42.0	12.5	25.0
Hungary	17.0	32.0	10.0	19.0
Latvia	23.0	23.0	15.0	15.0
Lithuania	15.0	20.0	15.0	15.0
Isle of Man	10.0	18.0	0.0	18.0

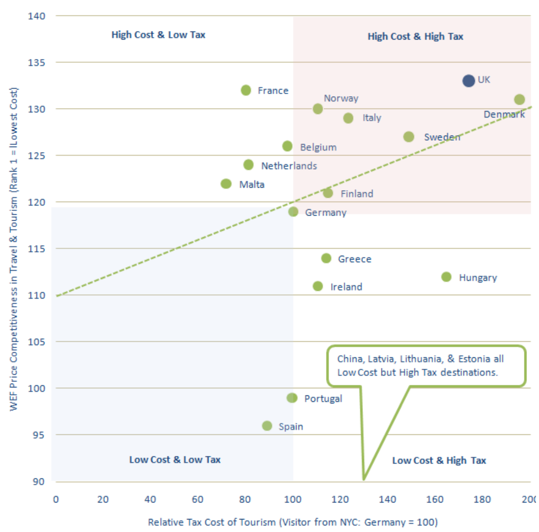
Source: Deloitte, Wason and Nevin analysis, Individual Tax Rates.

When coupled with high VAT rates in Tourism, however, the competiveness of the industry is affected, as shown by subsequent analysis of VAT take in Tourism for an average consumer and the comparative tax take on the industry as a whole.

Tax Cost and Tax Take

Analysis of a typical basket of goods consumed by a tourist shows that of the major EU economies sampled, only Denmark and Lithuania are more expensive than the UK in terms of the VAT take on tourists.

Figure J. International Taxes and Costs in Tourism



Source: Deloitte analysis, WTTC.

Our estimates suggest that VAT accounts for around 10 per cent of total expenditure in the UK Tourism industry (after accounting for spending below the VAT threshold and reclaim) and thus a reduction in the VAT rate from 20 to 5 per cent is an effective 7.5 per cent fall in costs facing consumers, if passed on in its entirety.

The total Tourism tax burden in the UK, also including income, corporation and production taxes, is estimated at 22 to 30 per cent (the upper and lower bounds representing no reclaim and all reclaim scenarios). This is higher than all but two destinations – Denmark and China.

Figure K. Tourism Industry Tax Take (As per cent Demand)

Source: Deloitte analysis.

Our estimate also suggests that the UK all-industry average tax take is 20 to 29 per cent. This indicates that the tax take on Tourism (22 to 30 per cent) is slightly higher than the all-sector average. As a benchmark from official sources projected UK tax revenues for 2010 represent 35 per cent of GDP, which also includes other non-industry applicable taxes.

On both VAT-only and all applicable tax measures the UK is a relatively high tax destination for tourists and businesses operating in Tourism.

Pass-through of VAT cuts

Economic theory suggests that where demand is relatively price elastic, a given reduction in the VAT rate (price) will lead to larger than average increase in demand. Producers have an incentive to pass-on to consumers to generate further demand, and in this instance the tax revenue accruing from the change may increase due to more than proportionate increases in demand.

Where demand is inelastic a given reduction in the VAT rate will lead to only small increases in demand. Here producers will not pass on VAT cuts, having less incentive to do so, and tax revenues for Government will tend to decrease.

The Danish firm Copenhagen Economics ApS was commissioned by the EU to carry out an "overall assessment of the impact of reduced rates applying to locally supplied services, including restaurant services, notably in terms of job creation, economic growth and the proper functioning of the internal market". The report was issued in June 2007.

The study considered six case studies where a significant change in VAT rate had occurred, one of which concerned hotels in Finland. The report concluded as follows:

"The empirical evidence from major changes in VAT rates supports the conclusion that changes of VAT rates to a very large extent are passed on to consumers."

"…there is little doubt that permanently lowering the VAT rate on a particular good (or service) sooner or later will lead to a reduction in the price of the good more or less corresponding to the monetary equivalent of the lower VAT rate…In economics jargon, there will be a strong tendency towards full pass-through."

Moreover, pass-through should happen on a faster basis with the 'Price + VAT' strategy being adopted by the industry to display price changes in a transparent manner.

The effects of reducing VAT – Case studies

A selection of case studies indicate that introducing a differential rate of VAT for Tourism has had positive effects on demand in the industry. Examples include:

Germany

The VAT rate on hotels was reduced from the standard rate of 19 per cent to 7 per cent from 1st January 2010, following a campaign by the industry since 1996. A key argument put forward for the cut was the lack of investment in hotels going back several decades due to difficult trading conditions. Another issue was that the impact of the high VAT was particularly acute in Bavaria, a region where Tourism is of considerable importance and where the sector was uncompetitive with directly accessible countries such as the Czech Republic, Austria and Switzerland, because of higher VAT rates.

The fact that the German Finance Ministry, traditionally one of the most fiscally conservative in the EU, has implemented this VAT reduction suggests that they believe the indirect impact of the VAT cut, in stimulating activity and employment in the sector and thus broadening the size of the VAT base and increasing income tax and corporation tax yields, is likely to be significant, and may largely offset the direct loss in VAT yields. Their decision was influenced by research undertaken by IFO, an economics research institute at the University of Munich, which predicts that this will be the case.

As stated previously, it can take two years before the impact of a change in tax rate can be fully seen. However, the results for the first half of 2010 from Accor, the largest hotel group in the EU, could be seen to be encouraging:

Accor Hotels: Performance in first 6 months of 2010 compared with same period in 2009		
	Upscale and midscale hotels	Economy hotels
Germany	+11.6 %	+10.5 %
UK	+4.8 %	+5.5 %
France	+6.8 %	+3.7 %

Source: Deloitte, Wason and Nevin analysis.

The table shows that in the first half of 2010, hotels in Germany have improved performance over the previous year by more than hotels in the UK and France. The report cites improved economic conditions as part of the reason in all three countries, together with an increase in the number of trade fairs in Germany. However, it also refers to the reduced rate of VAT in Germany and the increase in VAT in the UK, from the temporarily reduced standard rate of 15 per cent in the preceding year.

The *Hotelverband Deutschland* (IHA) represents around 20 per cent of hotels in Germany, primarily larger hotels and those belonging to groups. It is one of 21 association members of DEHOGA, the German hotel and restaurant association. The IHA undertook a survey of its members on their responses to the VAT cut. There were 4,923 responses. The results were announced on 30 September 2010. Key findings as a result of the cut in VAT were as follows:

- 89 per cent of respondents had commenced new investments or plan new investments in 2010. The total cost of all these investments amounts to €860 million
- 32 per cent of respondents have taken on more staff or plan to do so during 2010; the responses indicate the creation of 10,000 full time jobs, representing an increase on total employment in German hotels of 2 per cent, plus an additional increase in part-time employment of 2 per cent
- 35 per cent of respondents increased staff wage levels; the total value of wage increases reported amounts to € 29.2 million
- 32 per cent of respondents have reduced their prices, with the average price reduction being 6 per cent (i.e. slightly less than half the VAT cut).

It should be noted that these results represent actual or planned responses to the VAT cut in only the first year; further responses are expected during the following year.

Restaurants in France

The rate of VAT on restaurants in France was reduced from 19.6 per cent to 5.5 per cent from 1st July 2009, very shortly after the decision to allow EU Member States to apply a reduced rate of VAT to restaurants.

A survey published by GIRA Conseil on 7th January 2010 showed that restaurant net sales increased by 8 per cent for the period between July and November 2009 compared with the same period in 2008. This is believed to be due to the VAT decrease.

In the months following the VAT cut, there was criticism of restaurateurs in the press for not passing on the VAT cut to customers in the form of lower prices. This was particularly so in the case of independently-owned restaurants and cafes, which make up 70 per cent of the sector. However, pass-through of the cut is taking place, albeit gradually, as competitive pressures come to bear. This is in accordance with the findings of the Copenhagen Economics research referred to above which states that it typically requires a period of two years before the full impact of a change in tax rate occurs. Therefore the full effect of the cut in VAT on French restaurants is unlikely to have been realised.

The reduction in VAT on restaurants came about as a result of an agreement between the government and the restaurant industry, the *Contrat d'Avenir*, which aims to bring down prices, create new jobs, increase salary levels and lead to modernisation of the sector. The contract sets targets for the creation of 10,000 jobs and 10,000 apprenticeships. In a speech made on 30th September 2010, French President Nicholas Sarkozy declared that since the tax cut, 40,000 jobs have been created in French restaurants and cafes – this estimate has since been revised down to 28,200. He quoted research that suggests the VAT cut has saved an estimated 15,000 establishments from bankruptcy, thus saving an estimated 30,000 jobs in addition to those created.

Since the French economy began to recover in January 2010, a total of 60,000 jobs have been created in the whole economy according to national statistics. Thus, it appears that a significant number of all jobs created in France in all sectors within the past six months to a year might have been in the restaurant sector, as a result of the cut in VAT.

Club TVA Jacques Borel, which lobbies for reduced rates of VAT on the restaurant and hospitality sectors in the EU, reports that French fiscal income has benefited from a significant reduction in the Shadow Economy related to restaurants. The potential impact of this reduction in the Shadow Economy has been put at €720 million per annum, partially off-setting an estimated loss to French public finances of €2.5 billion as a result of the cut in VAT. This loss will be off-set further by knock-on effects in the economy.

Ireland

In the Republic of Ireland, the rate of VAT applied to certain Tourism services reached a peak of 23 per cent in the mid 1980s, the second highest in Europe at that time. In 1986, the VAT rate on hotels was reduced from 18 per cent to 10 per cent and on restaurant meals from 23 to 10 per cent. The cut in VAT stimulated a period of strong growth in the Irish Tourism industry after a period of stagnation. The rate was raised to 12.5 per cent in 1990 and to 13.5 per cent in 2004.

Since 1980, Ireland's foreign exchange receipts have increased on average by just under €170 million per annum – a highly creditable performance for an economy less than a tenth of the size of the UK. This represents a considerably faster growth rate than the UK, and has resulted in a significant increase in the Republic's share of the world Tourism market.

Overall, the fortunes of the Irish tourist industry have correlated closely with changes in the rate of VAT. There have been many other factors that have contributed to the Republic's considerable success over this period, but industry representatives claim that the reduction in VAT was the most important single factor, providing a much-needed 'shot in the arm' to stimulate Tourism growth.

Hotels in France, Italy and Spain

During the 1990s, the governments of France, Italy and Spain introduced standard rates of VAT for the top grade of hotels, leaving all other hotels on a reduced rate of VAT. In each case, a substantial majority of top hotels voluntarily downgraded so that they would be charged the reduced rate of VAT, and thus be able to pass on this saving to consumers and so be competitive on price. This shows that hotels will readily forego the marketing advantage of having a higher grading for the much greater advantage of being able to compete with lower prices. Within a few years the governments of all three countries reversed their decisions and applied the reduced rate to all hotels.

The Baltic Countries

On accession to the EU, the three Baltic countries, Estonia, Latvia and Lithuania, all opted to apply a reduced rate of VAT to hotel accommodation.

Following a period of economic instability, the IMF required these three countries to implement tax increases from 1st January 2009 and urged them to move hotels from the reduced VAT band. The response was different in each country:

- Estonia resisted pressure to apply the standard rate to hotels, but did increase the reduced rate from 5 per cent to 9 per cent; following this change, there was a decline in the volume of foreign tourist arrivals;
- Latvia moved the rate for hotels from 5 per cent to the standard rate of 21 per cent; foreign visitor spending declined by 15 per cent; the government then moved hotels to a new reduced rate of 10 per cent from 1st May 2010, since when there has been a reported 10 per cent year-on-year increase in hotel bookings;
- Lithuania moved hotels from 5 per cent to the standard rate of 19 per cent, which increased further to 21 per cent on 1st September 2009. It has since reduced the rate back to 9 per cent, but as a temporary measure for 2011 only.

The price elasticity of Tourism

Work undertaken by Wason and Nevin at Deloitte for the 1995 and 1998 VAT reports, and their subsequent reports for the British Tourist Authority on The Price Sensitivity of International Tourism (2001) and for BALPPA (2008), estimated price elasticity for international Tourism to the UK of -1.28. In other words, a ten per cent decline in the trade-weighted exchange rate of sterling (a proxy for the relative price of UK Tourism versus overseas destinations) leads to a 12.8 per cent increase in real UK international Tourism receipts.

The elasticity of real Tourism receipts with respect to the UK's nominal trade weighted exchange rate (price) is approximately –1.2 (i.e. mildly elastic).

As part of this study, Dr Roger Perman updated the analysis. The regression indicates that a ten per cent fall in the price of UK Tourism relative to the OECD average Tourism, after full adjustment, a 12 per cent increase in total UK Tourism receipts in real (i.e. inflation adjusted) terms.

The elasticity of real Tourism receipts with respect to OECD GDP (income) is + 0.618 (that is, moderately inelastic).

The regression indicates that a ten per cent rise in OECD countries average real GDP generates, after full adjustment, a 6 per cent increase in total UK Tourism receipts in real terms.

Therefore, the income elasticity parameters imply that, whereas overseas visitors regard UK Tourism as an inferior product – i.e. one on which they spend relatively less money as their incomes rise – UK residents regard travel abroad as a superior product – one on which they spend relatively more as real incomes increase.

The implication of this is that the UK's Tourism Balance is likely to continue to deteriorate as real incomes increase, on a "no change" policy scenario where VAT continues to be levied at the standard rate on Tourism and hospitality services.

The full adjustment of Tourism receipts to their new long-term equilibrium levels (as implied above) takes time. Dynamic simulations in the model indicate that it is likely to take 2 years for 80 per cent of the effects of price changes to filter through to demand, with a further 10 per cent filtering through in year 3.

The estimated dynamic model shows that, after a shock or change in one of the driving variables, the full adjustment of Tourism receipts to their new long equilibrium level takes a considerable length of time. The speed of adjustment is relatively fast compared with many other economics processes, with nearly 80 per cent of full adjustment reached within just two years of the initial shock.

The effects of reducing UK VAT to 5 per cent

That most EU Member States levy reduced rates of VAT on visitor accommodation and visitor attractions suggests that they recognise that, as demand for these services is highly price sensitive, higher tax *rates* could have the perverse effect of reducing tax *yields* if they result in a significant contraction in demand. The case studies cited in this report indicate that major EU Member States such as France and Germany recognise that introducing lower VAT rates to these sectors during a period of economic recession can be a valuable tool in helping to stimulate demand and increase employment.

The immediate impact of cutting VAT from 20 per cent to a reduced rate of 5 per cent would be a loss of VAT yields. However, the base on which VAT is levied will not remain constant. Lower tax rates will feed through to lower prices, which will stimulate higher demand and so increase the total revenue base on which VAT is levied. The VAT base will increase for two reasons. Firstly, more international and domestic visitors will take their holidays in the UK as a consequence of more competitive pricing. Secondly, we would expect a progressive broadening of the VAT base in response to the lower rate. At a rate of 20 per cent, small hotels and attractions have an incentive to remain outside the VAT regime if they can. If rates are reduced to 5 per cent, the disincentive to VAT registration will be considerably reduced.

Higher expenditure in response to lower VAT rates can be expected to have the following effects:

- It will generate higher levels of employment in Tourism and related services;
- This increase in employment will generate additional income tax receipts and savings in social security payments; and
- Higher expenditure will also generate an increase in profits and corporation tax payments by sector operators and, to the extent that profits are paid out as dividends, it will also result in a modest increase in tax paid on dividends.

Finally, higher Tourism incomes will feed through to higher expenditure in other sectors of the economy, which in turn will generate further tax receipts. Previous estimates of the value of the Tourism multiplier suggest it to be of the order of 1.7, implying that every additional £1 of Tourism expenditure feeds through to 70p of extra expenditure in other sectors of the UK economy.

One important effect of lower VAT rates will be to reduce the size of the Shadow Economy – that part of the economy on which no VAT is levied, either because it is unreported and "unofficial" or because operators deliberately keep their turnover below the VAT threshold, e.g. by closing during the winter, to avoid the cost and administrative burden of VAT registration.

Research undertaken since 2000 by Professor Friedrich Schneider at the University of Linz, Austria, estimates the size the UK Shadow Economy as approximately 15 per cent of the official economy.

Further evidence of the growth of the shadow or unofficial economy in the UK in suggested by the Comptroller and Auditor-General's report on the *Audit of Assumptions for Budget 2010*. This report indicated that the VAT Gap – defined as the difference between the amount that the UK Government should in theory collect from VAT, and the amount that it actually does collect – widened from 12 per cent of potential VAT receipts in the early 1990s to 14.5 per cent by 2009/10.

All these sources suggest that high VAT rates could act as a disincentive to the growth of small enterprises in the sector – for example small guest houses that close through the winter, in order to remain below the VAT threshold. They also suggest that there may be under-reporting of turnover, wages and profits in the SME sector, where a significant proportion of sales are made in cash. If the VAT rate in the UK were reduced to five per cent, the incentive to avoid the burden of VAT would be reduced and one would expect more enterprises to register for VAT.

We have used a figure of 14 per cent to estimate the current value of the total (legal and fraudulent) Shadow Economy in our fiscal analysis.

Evidence from France suggests that the reduction of VAT on restaurant meals has had significant impact in reducing the amount of tax avoidance and evasion in the restaurant and cafe sector there. We have assumed that a reduction in the VAT rate from 20 per cent to 5 per cent could reduce the size of the Shadow Economy in accommodation and attractions by a third compared with pre-reduction levels.

Overall, the base case fiscal model assumes that a 15 per cent reduction of VAT from 20 per cent to 5 per cent will feed through as follows:

- 60 per cent of the reduction will feed through in lower prices;
- 10 per cent will be used to recruit more workers and pay higher wages;
- 3 per cent will be allocated to training;

- 22 per cent will be allocated to investment; and
- 5 per cent will be allocated to higher profit after investment.

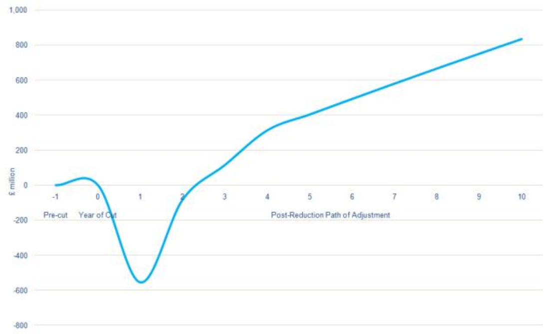
These changes will not feed through instantaneously. Based on evidence of the path of adjustment experienced in Ireland and France, and the dynamic equations in Dr Perman's econometric models summarised in this report, it may take up to four years for the full effects of lower VAT to feed through to lower prices. Initially, sector operators may seek to retain most of the reduction in higher profits, and only over time will competition drive prices down – a phenomenon being witnessed currently in the French restaurant sector. For the purposes of the fiscal analysis, it is assumed that the path of price adjustment is as follows:

- 40 per cent of the total price adjustment in Year 1 following the VAT reduction;
- 80 per cent occurs by Year 2;
- 90 per cent by Year 3; and
- 100 per cent by Year 4, after which sector pricing is in a post-reduction equilibrium.

The direct loss of revenue to HM Revenue and Customs (HMRC) from reducing VAT rates on accommodation would amount to £1,017 million in the first year following a VAT cut, while the loss from reducing VAT rates on visitor attractions would be £201 million.

This loss would be off-set by gains which would build up over the years following the VAT reduction, as the impact of price cuts and additional investment in the sector feeds through to higher demand from both overseas and domestic tourists compared to a scenario where VAT continued to be levied at 20 per cent.

Figure M: Net Fiscal Impact of a VAT Reduction on Accommodation and Attractions over Time



Source: Wason and Nevin analysis.

By Year 10, the indirect fiscal gains accruing to the Exchequer are calculated to be as follows:

- £56 million from the VAT on higher turnover stimulated by increased visitor numbers in the visitor accommodation sector, and £11 million in the visitor attraction sector.
- £30 million from a widening of the VAT base of the accommodation sector, and £4 million from the visitor attraction sector
- £177 million from income tax on new jobs created by higher turnover in the accommodation sector, and £46 million in the visitor attraction sector;
- £38 million from income tax on higher incomes generated by higher margins, of which £32 million would be generated in the accommodation sector and £6 million in the attraction sector;
- £228 million from savings in social security payments, of which £182 million would be generated in the accommodation sector, and £46 million in the visitor attraction sector;
- £91 million from corporation tax generated by improved margins, of which £78 million would be generated in the accommodation sector and £13 million in the visitor attraction sector;
- £133 million from corporation tax generated by higher turnover, of which £111 million would be generated in the accommodation sector and £22 million in the visitor attractions sector; and

- £53 million from additional income tax paid on increased dividends, of which £45 million would be generated in the accommodation sector and £8 million in the visitor attractions sector.
- In addition, we calculate that there will be additional gains from the multiplied effects of increased expenditure elsewhere in the economy. The fiscal value of these multiplier effects is computed to be £820 million in the accommodation sector and £158 million in the visitor attraction sector by Year 10.

In total, the net fiscal gain as a result of the VAT reduction is estimated to grow to £835 million per annum by Year 10 following a VAT cut, based on the assumptions input to the fiscal model.

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.

The reduction would also result in net job creation in the sector, and the generation of additional foreign exchange for the UK. There could be further net gains as a result of some UK residents switching from holidays abroad to holidays at home, at least for their second holiday. In addition, there could be a dynamic benefit as a result of a ‘virtuous circle’ of sector growth, with higher turnover generating greater profitability, which in turn is partly used to invest in product enhancement, attracting more customers and leading to further growth, as occurred in the Republic of Ireland.

Taking these factors into account, we have estimated that only 40 per cent of the total impact of a VAT reduction is felt in the first year following the reduction, rising to 80 per cent in the second year, 90 per cent in the third year and 100 per cent by Year 4.

The implication of this is that the full indirect and multiplied impact of a VAT reduction will take time to feed through, with the result that the Exchequer may suffer net losses in the years immediately following a VAT cut – as the immediate loss of yield is not offset by indirect and multiplied gains generated by the demand stimulus.

Additional jobs will be created as a result of the higher spending induced by lower VAT rates and lower prices. Based on an average gross turnover per job (full- and part-time) of approximately £35,000 in the attractions sector and £45,000 in the accommodation services sector, the total number of jobs created by higher sector turnover will be:

- 64,000 jobs in accommodation; and
- 14,000 jobs in visitor attractions.

Both sectors are highly labour-intensive, and both are characterised by comparatively large numbers of part-time employees. We estimate that approximately 42,500 full-time equivalent jobs will be created in accommodation services, and 9,500 in visitor attractions.

A further question is how many of these jobs are additional, as opposed to displaced from employment in other sectors. On the assumptions used in our analysis, 65 per cent of these jobs will be new jobs that would not exist without the VAT reduction, while 35 per cent will represent displaced jobs. This estimate is based on the fact that many industry employees will be young people and part-time workers, many of whom may be new to the workforce and with limited alternative employment opportunities.

As well as the monetised economic impacts of greater demand in the Visitor Economy and employment levels, there are a number of effects that are not quantifiable in the traditional sense. These include:

- Higher economic activity rates;
- Greater social inclusion;
- Lower benefit claims;
- More consumer choice through Tourism demand spillovers;
- Greater propensity for enterprise creation and innovation;
- Improved Tourism Balance of Payments – through lower imports and greater exports;
- Improved outcomes for local Tourism economies (both rural and urban);
- Preservation of cultural and heritage sites; and
- Regeneration effects arising from demand.

Conclusion

Our base case model indicates that If VAT is cut on Tourism services to 5 per cent, it would provide a shot in the arm to the sector, creating significant numbers of new jobs – as is happening in France and Germany – and generating a net gain for HM Treasury in the medium-term.

It will contribute to a reversal in the long-term decline in the UK's Tourism Balance of Payments, both by increasing the number of inbound visitors to the UK, and by inducing more UK residents to take holidays at home.

From a policy perspective, immediate changes in VAT rates for Tourism are likely to take two to three years to filter through to demand causing short-term reductions in VAT receipts.

Reducing VAT on visitor accommodation and attractions is likely to produce an overall financial gain for the UK Treasury within 4 years, but employment gains are likely to be significant in scale and faster to come to fruition.

The Government has stated its desire to quickly create private sector jobs, but there is a policy trade-off between short-term tax revenue and short-term employment creation. If employment creation is the imperative, and conditions are conducive, the Tourism sector could deliver job creation from tax cuts and this should be considered as a means of stimulating the sector and with it the demand for UK goods and services.

Combined with a basket of complementary policy measures – such as increased marketing spend – reducing VAT could go some way towards 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 80,000 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.