The Impact of Reduced VAT Rates on British Visitor Accommodation, Attractions and the Wider Economy:

Report of Discussions with HM Treasury and Results of Dynamic Partial Equilibrium and Computable General Equilibrium Models

SUMMARY

December 2012

Campaign for Reduced Tourism VAT
c/o British Hospitality Association
Queens House
55/56 Lincoln's Inn Fields
London WC2A 3BH
Tel: 020 7404 7744
Fax: 020 7404 7799
Email: info@cuttourismvat.co.uk
www.cuttourismvat.co.uk

4th December 2012

SUMMARY REPORT:

The Impact of Reduced VAT Rates on British Visitor Accommodation, Attractions and the Wider Economy: Report of Discussions with HM Treasury and Results of Dynamic Partial Equilibrium and Computable General Equilibrium Models

The Campaign for Reduced Tourism VAT is pleased to present this report on submissions to and discussions with officials at HM Treasury (HMT) on the impact of reduced VAT rates on tourism services in the UK.

Representatives of the Campaign first met HMT officials in September 2011 to discuss a comprehensive report on the impact of reduced VAT rates on UK visitor accommodation and attractions. At this meeting it was suggested that this impact be modelled using a Computable General Equilibrium (CGE) model and that the Campaign work with Professor Adam Blake of Bournemouth University who built and helps maintain a CGE model owned by HMRC and used by HMT. Permission was granted for Professor Blake to use the core of this model on behalf of the Campaign. A further meeting was held to discuss the findings of the CGE analysis in September 2012. The Campaign is most grateful to HMT officials for permission to use the Government's model and for their readiness to engage actively in these discussions.

This report contains a review of the background to the Campaign, results of the models, additional submissions to HMT and our conclusions from this analysis.

Professor Blake's conclusion from his analysis is that reduced VAT on tourism services 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". This analysis has reinforced the Campaign's firm view that reducing VAT on visitor accommodation and attractions represents the Government's best option to create jobs and stimulate growth throughout the economy at a time of great need, and at very low risk to Exchequer income.

We ask the Government to reduce VAT on visitor accommodation and attractions at the earliest opportunity.

Graham Wason
Campaign Chairman

SUMMARY

Background to this study

1. 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, whereas most EU member countries apply VAT to tourism at a reduced rate, as is specifically permitted. **The rate of VAT on visitor accommodation (e.g. hotels) and admissions to cultural services in France and Germany is 7%, in Spain 8% and Italy 10%, compared to 20% in the UK.**

2. Over this same 20 year timespan numerous detailed independent analyses have found that reducing VAT on UK tourism to the UK's only prevailing reduced rate of 5%[1] 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. The latest report, carried out by Deloitte with Graham Wason and Michael Nevin[2], included detailed fiscal analysis based on a Dynamic Partial Equilibrium (DPE) model. **The results of this model indicate that reducing VAT on visitor accommodation and attractions will create 78,000 jobs and provide a Net Present Value (NPV) fiscal return to the Exchequer over 10 years of £2.6 billion (2011 prices).**

3. In early 2011, the current Campaign for Reduced Tourism VAT (the Campaign) was set up by Bourne Leisure Group, Merlin Entertainments Group, The British Hospitality Association (BHA) and the British Association of Leisure Parks, Piers and Attractions (BALPPA). The Campaign brings together commercial operators and industry bodies, including the Tourism Alliance, and is supported by over 350 companies and associations. A full list is included in Appendix D.

4. In September 2011, officials from HM Treasury (HMT) met the Deloitte/Wason/Nevin team to discuss their report. The officials suggested that the impact of reduced tourism VAT be analysed using a Computable General Equilibrium (CGE) model, and provided the name of Professor Adam Blake of Bournemouth University who built and maintains a CGE model owned by HMRC and used by HMT. Subsequent to the meeting, HMT officials gave permission for Professor Blake to use the core of the existing model on behalf of the Campaign, provided no sensitive data were revealed.

[1] Applying the reduced VAT rate for tourism in the UK is not unprecedented. The 5% rate applies to hotels in the Isle of Man, sale of holiday caravans and small cable car transport.
[2] Messrs Wason and Nevin were respectively Partner and Senior Economist at Deloitte at the time of the 1995, 1997 and 1998 reports and were involved in the 2002, 2008, 2010 and 2011 studies.

5. This report presents the results of the analysis using the adapted Government CGE model, compares these results with those of the DPE model in the Deloitte/Wason/Nevin report and reports on discussions concerning these results with HMT officials.

The importance of UK tourism

6. The UK tourism industry is a major contributor to the economy. Research by Deloitte (2010) values this contribution at £52 billion in direct contribution or 4% of GDP, and a further £63 billion in indirect contribution or 4.9% of GDP[3]. The UK Tourism Satellite accounts compiled by the Office of National Statistics (ONS) shows that tourism demand was responsible for 3.6% of all goods and services supplied in the UK economy and its direct gross value added (GVA) amounted to £44.6 billion[4] in 2009. **However the contribution of the tourism industry to the UK is quantified, one thing is clear: the tourism industry plays a key role in generating growth for the UK economy and should not be underestimated.**

7. The industry provides crucial employment opportunities: the number of people employed in businesses directly relating to tourism, or “tourism direct employment”, amounts to 1.8 million[5], many of whom tend to be entry-level and lower-skilled, thus offering critical employment opportunities in the current climate of economic uncertainty. The majority of employees in this sector are women, who tend to be under-represented in the labour market[6]. **The labour-intensive nature of the industry, and the fact that many of these jobs cannot be off-shored, means that tourism plays a crucial role in providing diverse employment opportunities, especially amongst young people and those seeking a start on the employment ladder.**

8. In addition, tourism is important to every local authority area in the UK, including rural and seaside communities, many of which are dependent on tourism for their livelihood in the face of much economic uncertainty. Tourism is particularly relevant for Wales and Scotland, where the tourism industry contributes around 5.8% and 4.9% of Welsh and Scottish GDP respectively[7].

[3] Deloitte (2010) *Economic Contribution of the Visitor Economy*
[4] ONS (2012) *The Economic Importance of Tourism: UK Tourism Satellite Account 2009*
[5] Research by Deloitte (2010) calculates the amount jobs supported by the tourism industry to be 2.5 million
[6] ONS (2012) *The Economic Importance of Tourism: UK Tourism Satellite Account 2009*
[7] Deloitte (2010) *Economic Contribution of the Visitor Economy*

The impact of a VAT reduction – the DPE model

9. 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.

10. A report for the EU in 2007 on the impact of reduced VAT rates by Copenhagen Economics ApS concluded 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". The Nevin/Wason DPE model makes a more cautious assumption that only 60% of the VAT cut will be passed on in lower prices, the remainder being allocated to investment in new or improved facilities, more employment and training and higher wages. It is assumed that 5% will be retained as increased profits. A further assumption is that most of this effect will take place within two years after the VAT cut and the full effect will occur within four years.

11. The immediate impact of cutting VAT on visitor accommodation and attractions from 20% to a reduced rate of 5% 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, benefiting the whole economy and not just the tourism sector. Using reasonable and plausible assumptions, the loss of fiscal income from the cut in VAT will more than be made good by additional income tax receipts, savings in social security payments, and an increase in profits, corporation tax payments and tax on dividends. The DPE Model indicates that 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, and the Net Present Value (NPV) of the fiscal gains generated for the Exchequer over 10 years, compared to a 'no change' policy scenario, is £2.6 billion, at 2011 prices.

12. 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, representing approximately 52,000 full-time equivalent jobs. It is further assumed that 65% of these jobs will be new jobs that would not exist without the VAT reduction, while 35% will represent displaced jobs.

The impact of a VAT reduction – the CGE model

13. 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 2013 (compared to the direct VAT loss of £1.7 billion in 2013) and slowly increasing year-on-year deficits thereafter.

14. 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 GDP 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 been seen with the CGE model", according to Professor Blake.

15. Professor Blake considered a number of alternative assumptions in the CGE model reflecting those that underlie the DPE model. 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 (hypothetical) 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.

Comparing the DPE and CGE model results

16. The DPE and CGE models are constructed in very different ways and comparison between the two is not straightforward. The estimated direct fiscal loss to the Exchequer as a result of cutting VAT on visitor accommodation and attractions after four years is quite close – at £479 million in the CGE model before additional assumptions compared to £439 million in the DPE model. However, the composition of this net effect is different and, in addition, the DPE model estimates a multiplied gain of £754 million for the Exchequer from taxation gains elsewhere in the supply chain.

17. Both CGE and DPE models have advantages and limitations. According to the Inter-American Development Bank, "results from CGE models should be used as 'road maps' for policy implementation, which are advised to be complemented by additional analytical work using alternative quantitative methods"[8].

18. As both CGE and DPE models have their place, there is merit in modelling the impact of reduced tourism VAT using both approaches and the Campaign is grateful to HMT officials for having suggested and granted permission for the use of their CGE model. Furthermore, this exploration has led, in effect, to a partial bringing together of the two approaches in the 'Additional Assumptions' that have been applied by Professor Blake to the CGE model. This scenario in the CGE model with additional assumptions represents, arguably, the most comprehensive analysis to date of the likely impact of reduced tourism VAT rates. **Professor Blake and the consultants to the Campaign came to the agreement that "in summary, based on reasonable and plausible assumptions, the modelling exercise seems to support a general case that a reduction of VAT on tourism services would be fairly close to fiscal neutrality."**

19. One of Professor Blake's conclusions from this exercise is that "the joint consumption of tourism and leisure products does seem to mean that VAT simulations are substantially different to 'normal' VAT simulations". A limitation of the CGE model as regards tourism is the focus exclusively on the UK economy. To an extent, what the VAT reduction on UK visitor accommodation and attractions is doing is growing the UK economy at the same time as

[8] Inter-American Development Bank website (http://www.iadb.org/en/topics/trade/frequently-asked-questions-faqs,1284.html)

reducing the economy of the rest of Europe. This it is believed by the Campaign will lead to fiscal surpluses over time that will - combined with a basket of complementary policy measures such as increased marketing spend – 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%.

20. However, a further important difference between the CGE and DPE models concerns what happens beyond the initial year following the reduction in VAT. Changes in the CGE model are particularly static in nature with a change occurring in the year that tax reductions are implemented and little change thereafter. The Campaign team believe that reducing tourism VAT will have dynamic benefits 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 has occurred in countries where a permanent reduction has been applied to tourism VAT, such as Ireland in the 1980s.

Industry commitment to job creation and growth

21. 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.

22. A further assumption, to underpin the plausibility of tourism jobs being taken by the unemployed, is that the tourism industry would enter a collaborative agreement including the VAT reduction, along the lines of the French 'contrat d'avenir'[9], which might include taking on more workers who have previously been long-term unemployed. In the CGE model with additional assumptions, it is assumed that an additional 10,000 long-term unemployed would be taken into employment in visitor accommodation and attractions.

[9] The 'contrat d'avenir' between restaurant owners in France and the French government included industry commitments regarding remuneration, holidays and training and accompanied a reduction in VAT on restaurant meals in 2009.

23. As part of a government decision to reduce VAT on visitor accommodation and attractions the industry would be willing to explore a series of further commitments that would seek to ensure that the benefits of the VAT reduction would reach consumers, employees, suppliers and the economy as a whole. Such commitments might encompass:

- passing on at least 50% of the VAT reduction in the form of lower prices;
- creating an agreed number of new jobs, including those for young people;
- increasing spend on staff training, working with the Department of Business Innovation & Skills; and
- investing in improvements to the tourism product, thereby generating demand in building services.

These assumptions were to an extent tested by a survey of Campaign supporters undertaken in January 2012. Over 95% of over 200 respondents said that if a 5% VAT rate were achieved some or all of it would be passed on. Eighty-two per cent said they would invest more in their product/facilities, 67% would employ more people, 57% would invest more in training and just under half (48%) would increase staff wages.

Compliance with the Chancellor's taxation principles

24. Consideration has been given by the Campaign to how well the tourism VAT reduction proposal adheres to the key principles that should underpin formulations of tax policy as enumerated in the Chancellor's Budget 2011 speech[10].

- **Growth and Economic Efficiency**: Our modelling shows that a VAT cut in the tourism sector could do more to boost growth than the Government's current strategy of reducing the rate of corporation tax. VAT on the tourism sector represents a highly economically distortive tax that adversely affects UK business investment and the balance of payments. The tourism sector has the potential to provide the right kind of jobs that are needed to support the wider government policy agenda of reducing benefit dependency and helping young people, part-time workers and the long-term unemployed to find valuable and structured employment opportunities.

- **Fairness**: Not only is the current VAT regime highly distortive, it is uncompetitive too. Key European tourism destinations have cut their tourism sector VAT rate in order to obtain a greater share of European tourist spend. Analysis shows that the UK is an attractive destination to visit, but it is not price competitive.

[10] 2011 Budget statement by the Chancellor of the Exchequer, the Rt Hon George Osborne MP, http://www.hm-treasury.gov.uk/2011budget_speech.htm

- **Certainty and Simplicity**: A lower VAT rate will increase demand in the tourism sector and help businesses generate the cash internally to drive investment.

- **Practicability and Coherence**: While VAT can be claimed back on some foreign tourist purchases, the system is only partial and can be confusing. Lower VAT payments for items such as accommodation could stimulate tourism spending in other areas of the economy.

- **Sustainability**: The tax system faces a range of long-term challenges. A VAT rate cut in the tourism sector can help rebalance the tax system to become more growth supporting, thus sustaining tax revenues in the long-term.

Conclusions

25. 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 a time of great need, and at very low risk to Exchequer income.

26. 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%.

27. 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. The tourism sector is willing to explore working with the Government to support 10,000 long-term unemployed back into work to make this policy measure fiscally viable.