WORLD TRAVEL & TOURISM TAX POLICY CENTER
ISSUES IN TAX POLICY

Economics of Travel & Tourism Taxes

Governments rely on an array of taxes and other fees to generate funds, or to modify behavior. Taxation, depending on its design and application, can also act to stimulate or dampen economic activity in specific sectors. Although sector-specific taxes are normally created with good intent as a means to create revenue and possibly stimulate economic activity, the total effects of these taxes are often not felt in the short-term, and negative repercussions can result.

Travel & Tourism is a willing contributor to the public welfare in general, and a major supporter of government services and infrastructure that enable the industry to thrive in particular. It has become clear, however, that Travel & Tourism is vulnerable to nonproductive taxation. This vulnerability is based on the lack of quality information and knowledge of taxation and the industry as a whole. The first report from the World Travel & Tourism Tax Policy Center (TPC) will introduce crucial concepts to fill this void. It will also discuss practical implications of tax policy as it relates to Travel & Tourism and outline the Center's research agenda designed to provide a basis for sound analysis and decision making by policymakers.

GENERATING REVENUE

There are a number of ways, including taxation, by which governments can secure resources. Most of these alternatives have political and economic consequences which are unacceptable in most peace time free market economies. However, these alternatives to taxes have been, and continue to be, employed by many countries:

- Direct commandeering of resources
- Printing more money
- Borrowing from the private sector
- Direct competition with the private sector

Most free market economies employ a mix of borrowing, direct competition and taxation to secure the resources needed to fund government operations. Taxation weighs more heavily in the mix as it is preferred both by government and the private sector; it is essentially the least disruptive means of securing government funds.

Given that taxes are a fundamental reality in modern economies, the question becomes "How and what to tax?" This question is often at the core of any political debate on taxation. To answer the question requires an understanding of the socio-political and economic dimensions of the item to be taxed.

The socio-political and economic dimensions outlined in this report serve to guide policymakers in the process of formulating fiscal policy relative to Travel & Tourism. In considering the costs and benefits of taxing Travel & Tourism, policymakers will be able to achieve their objectives of raising revenues with minimal disruption to the workings of the economy.

TRAVEL & TOURISM'S GLOBAL TAX CONTRIBUTION

In general, governments can raise revenue from taxes on consumption, income and/or wealth. Travel & Tourism contributes to the tax base primarily through taxes on consumption and corporate and personal income.   Based on research by the WEFA Group, the World Travel & Tourism Council recently released a report on the economic contribution of Travel & Tourism to the global economy.

The WTTC Research Report shows that, by 1998, Travel & Tourism will:

- Generate $4.4 trillion in total demand
- Produce 11.6% of direct and indirect GDP
- Generate employment for 230.8 million direct and indirect employees, or 1 in every 10.7 workers
- Invest $779 billion (11.8% of total investment) in new facilities and equipment
- Account for 10.5% of all consumer expenditures and 6.8% of all government spending

The WTTC Research Report has also projected that Travel & Tourism's global direct, indirect and personal tax contribution will exceed $802.6 billion in 1998. This contribution is projected to grow to $1,765.3 billion by 2010.

The industry's indirect tax contribution has been estimated at 10.6% of total collections worldwide. Estimates for each of the 24 OECD counties put the Travel & Tourism indirect contribution between 9% and 24%.

The largest Travel & Tourism contributors are the United States at $187.4 billion, Japan at $63.0 billion and Germany at $57.5 billion.

The industry and the traveling public are increasingly called upon to contribute more to the global tax base. The fundamental question that must be addressed by both the industry and policymakers is "What are the impacts of a growing tax burden on the world's largest industry?"

REASONS FOR CONCERN

The imposition of any tax distorts the "normal" workings of a market, because the tax acts as wedge between the price consumers are willing to pay and the price at which suppliers are willing to provide goods and services. Taxes essentially shift the price curve upward resulting in a reduction of the quantity demanded. In Travel & Tourism, the reduction in demand may have the effect of reversing many of the economic benefits generally associated with a strong Travel & Tourism industry. These benefits include foreign exchange generation, job creation, economic multiplier effect, new business start up and service economy stimulus.

Foreign Exchange Generation

International travelers inject hard currency directly into the economy, boosting export income. Any tax-induced reduction in travel has the effect to reducing export income and direct monetary exchange.

Job Creation

A thriving Travel & Tourism industry directly and indirectly employs large numbers of people. A tax that directly affects Travel & Tourism volume will be felt across the economy as reductions in demand slow down employment growth in Travel & Tourism services and in the sectors which support and supply the industry.

The Travel & Tourism industry generated jobs across a broad spectrum of economic activities:

- Creating direct employment for Travel & Tourism consumer services like airlines, hotels, car rental companies, tour operators, travel agents, restaurants and retail shops.
- Creating indirect employment in agriculture, mining, manufacturing, utilities, construction, communications, finance and business services, and personal service sectors, which supply Travel & Tourism with infrastructure, equipment, supplies, and services.
- Creating indirect employment for public service employees who provide government Travel & Tourism services.

Economic Multiplier Effect

Travel & Tourism can stimulate economic activity across a wide range of related sectors, generating an indirect contribution equal to 100% of direct output. However, when money is removed from the economy by taxes, the effectiveness of Travel & Tourism’s multiplier is reduced. On the other hand, if tax revenues generated by Travel & Tourism are used to develop Travel & Tourism infrastructure and promote the industry, the multiplier effect can actually be enhanced.

New Business Start Up

It is well known that small and medium-sized firms are one of the fastest growing and important sectors of the global economy. This is important because, by its very nature, Travel & Tourism is very effective in activating small and medium-sized businesses.

However, small firms thrive when regulatory and tax barriers are minimal, so even the smallest reduction in demand or the slightest increase in cost structure can drastically effect their profitability and longevity.

Service Economy Stimulus

Because Travel & Tourism enterprises purchase business services from other sectors like finance, insurance and communications, the industry stimulates activity across the entire service sector. In addition, the act of Travel & Tourism itself serves to facilitate international technology transfer, again helping to stimulate the service sector. In this regard, fiscal policy plays an important role in determining how much people travel and, therefore, how much the Travel & Tourism industry can influence the creation of a vibrant service economy accompanied by high skill, high paying jobs.

Travel & Tourism is an important and powerful economic catalyst. It is an industry which, when taxed and regulated intelligently, can create twice as many jobs as the average industry.

Tax Theory

Taxes act as a wedge between the price paid by consumers and the price received by suppliers. The imposition of a tax (represented by "t" in the diagram) will shift quantity demanded from the original market equilibrium (Q1) to the post tax quantity (Q2). If consumers are relatively price sensitive, suppliers will be forced to factor the cost of any new tax (aircraft fuel taxes are a good example) into their cost structure. However, if suppliers are relatively more price sensitive, the tax will be passed onto consumers. The revenue raised by the tax is represented by the shaded rectangle formed by P2, P1 and the quantity at Q2. The excess tax burden or, in other words, the loss to society in the form of reduced consumer and producer surplus, is represented by the shaded triangle to the left of Q1 and to the right of Q2.

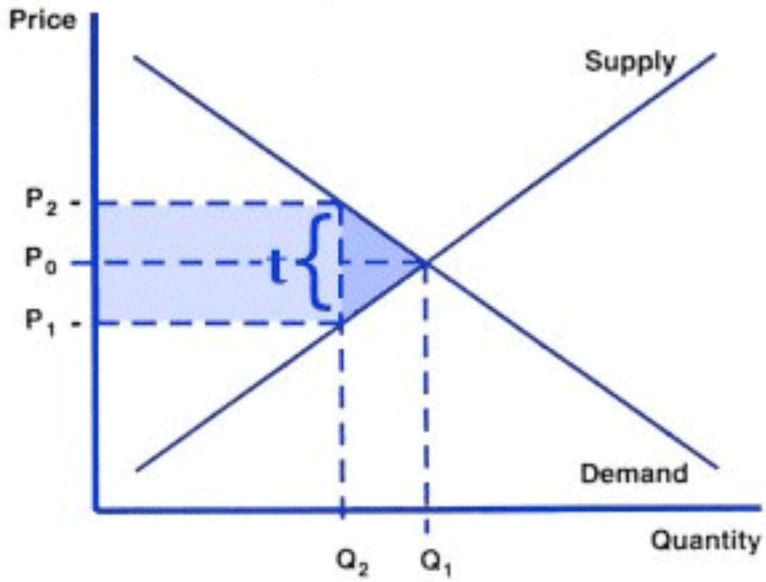

Figure A

When considering tax policy, governments seldom have ready access to information about demand and supply such as that depicted in Figure A. Without this information, they may demonstrate an insensitivity to the basic economic realities that function in competitive markets. Whatever the reasons, governments appear to derive simple and naïve assumptions about market demand. To project added tax collections from new tax, it is common for government analysts to simply multiply the per unit tax by the level of current sales. For example, a new $2 room tax in a market where 1,000,000 room nights were sold last year might be expected to yield $2,000,000 in new tax revenues. However, for this projection to hold, the room demand would have to be totally inelastic as depicted in Figure B.

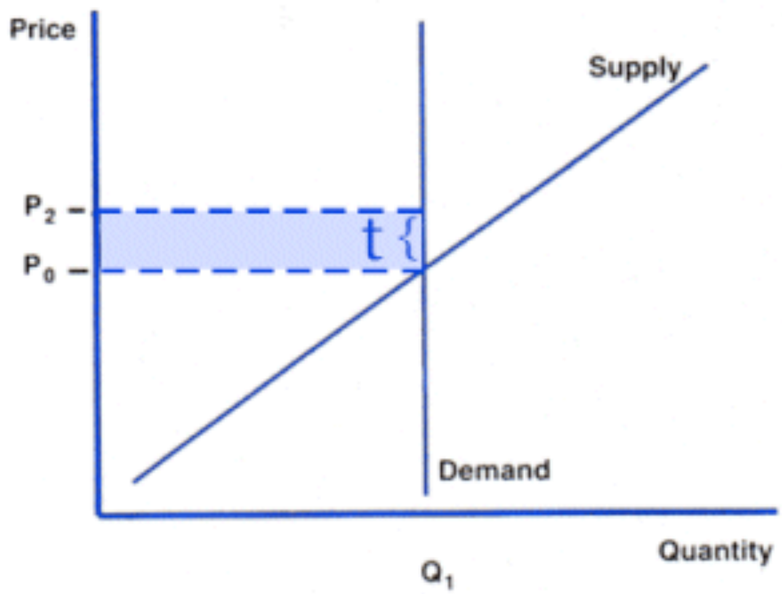

Figure B

Under such circumstances, the quantity sold would not be altered by the tax, new tax revenues would equal those projected and the tax would not alter the function of the economy with respect to the product taxed. Unfortunately, this view generally proves to be inaccurate, because few markets are totally insensitive to price increases.

Principles of Intelligent Taxation

A WTTC study of taxation policy by the London School of Economics has produced five basic economic principles that should be applied to the design of taxes and user charges for all industries, including Travel & Tourism.

Equity

All economies should be treated fairly in regards to taxation. Evenhanded treatment reduces imbalances that can result in political, social and economic difficulties.

Efficiency

Taxes must generate revenue without a significant impact on the demand for a good or service (unless the tax is designed to modify behavior). At a certain threshold, the revenue gained from a tax increase can be lost because of reduced demand. Even more, the decrease in demand sends a debilitating wave throughout the economy as suppliers are affected. The negative impact swells, because of the subsequent loss of tax revenue in many sectors.

Simplicity

Complicated taxing schemes eat up revenues through administrative costs. These costs include both those borne by government in the process of collecting and enforcing taxes, and those borne by taxpayers. One objective of good tax policy is to achieve the highest possible ratio of revenues generated per dollar invested in collecting the tax. Special note should be made to consider the taxpayers' costs of compliance in calculating this ratio. Simplicity in taxing also dictates that governments should make it clear what the tax rates are, and how the revenues are to be used.

Fair Revenue Generation

Fair revenue generation arises from the concept of equity. In the evenhanded capturing of tax revenue, it is unreasonable to assess special fees or levies on specific goods or services. These types of taxes are often cloaked by language and terminology to hide their real intent. Although special charges and fees may appear on face value to be modest, they can quickly accumulate and become an unreasonable burden to a sector.

Effective Stimulus to Growth

Tax incentives and disincentives should be imposed with the underlying goal of stimulating growth. Taxes that support infrastructure will ideally result in the attraction of investment and new employment. However, when taxes become excessive, economic growth often grinds to a halt.

Many taxes on Travel & Tourism violate some or all of the Principles of Intelligent Taxation. The practical reality is that taxes can be imposed to generate revenue, increase competitiveness or change consumptive behavior. However, if taxes follow these principles, they will result in both increased revenues for governments and strong competitive economies.

Travel & Tourism is the world's largest industry, the world's largest employer and a major generator of tax revenue. As such, the industry is a vital component of the global economy. Some governments have recognized the impact and potential of Travel & Tourism, and have worked cooperatively with the industry to develop fiscal policies that enhance competitiveness, encourage employment growth, and result in positive net fiscal proceeds to their treasuries. Unfortunately, many policymakers have taken a more shortsighted approach to taxing Travel & Tourism.

In many cities throughout the world, tax policies have been adopted which not only slow the revenue generating capacity of Travel & Tourism, but also slow or completely stifle job creation. In some cities, such as New York, the failure of policymakers to thoroughly consider the implications of increasing hotel room tax rates has actually resulted in a net loss of tax proceeds and jobs to the city and state. It is estimated that New York State lost $962 million in taxes on visitor spending to collect $463.2 million from a 5% room tax. A portion of this reduction in tax proceeds is attributed to fewer payroll taxes collected from the Travel & Tourism sector.

Key Issues in Travel & Tourism Development

On a superficial level, Travel & Tourism taxation issues seem relatively unimportant. However, upon deeper investigation, it is apparent that Travel & Tourism is directly linked to, if not a driving force for, world commerce. The following discussion focuses on the key issues that shape Travel & Tourism development, and the role the industry plays in world trade.

Taxpayers and Voters

For policymakers, taxing Travel & Tourism is attractive because the bulk of the tax burden is perceived to fall on the shoulders of non-constituents. The short-term injection of revenues paid by outsiders is politically seductive. The long-range implications can be sobering.

When taxes on Travel & Tourism reach a certain threshold, they can emerge as a net economic drain upon the economy. Total tax rates that surpass this threshold shift demand away from the taxing jurisdiction, resulting in effects that resonate throughout the whole economy. As total business revenues decline in the face of such ill advised taxes, adverse effects such as direct and indirect job losses are likely to occur. In this way, taxes on Travel & Tourism ultimately do fall on the shoulders of constituents.

Exports

Many policymakers do not understand that the sale of Travel & Tourism to international visitors is an export activity. Thus, taxes on Travel & Tourism may constitute taxing of exports. Although this practice has become common, it has negative economic and social impacts. Specifically, taxing Travel & Tourism is problematic because:

- **Sound economic policy for competing in the global marketplace states that taxing exports is self-defeating and should be avoided*.*** No other exporting sector is systematically taxed like Travel & Tourism. Policymakers form all types of market economies realize that taxing goods and services upon export functions to reduce sales and ultimately the economic viability of a region as export dependent employment declines.
- **Taxes on exports reduce competitiveness in the global marketplace**. Many counties rely on subsidies to keep goods and services priced competitively in export markets. Although subsidies create artificial market conditions, the practice demonstrates the length to which governments will go to gain and maintain market share. Taxing exports causes the opposite

effect. Taxes that raise prices significantly above free market values act to reduce competitiveness.

- **The stifling of competitiveness has an enormous impact on income generation and employment**. Many countries are grappling with high unemployment rates brought on by a variety of changes. As Travel & Tourism becomes less competitive, there are significant impacts on employment, because the industry is labor intensive. Those who become unemployed as export market share declines convert form tax payers to tax recipients, relying on a wide range of government supported services. The cost of unemployment also extends beyond the net revenue drain on government to a host of personal and social ills, ranging from the breakup of families to rising crime rates.
- **In an age of reducing trade barriers, taxing exports is a practice that runs contrary to worldwide efforts to streamline free trade.** The near total absence of any government systematically taxing exporters is ample evidence that such a practice represents a poorly conceived tax policy. Government revenue gains from such taxes are more than offset as their negative impact on sales is realized. Not only does government revenue decline, but also the economy is left with rising levels of unemployment.

Travel & Tourism is not immune to the perils most generally identified with the taxation of manufactured imports. Indirect taxes, as well as VAT and sales taxes, border taxes, departure and embarkation taxes, all qualify as taxes on the Travel & Tourism export.

Changing Behavior and the Ease of Product Substitution

In all cases, taxes modify the behavior of consumers and industry. Taxes are commonly used to change behavior that is deemed undesirable by society. For example, a "gas guzzler" tax may be imposed on some automobiles to encourage purchase of fuel-efficient vehicles. Likewise, the unwitting taxation of beneficial goods and services can also change behavior that is otherwise desirable. In the case of Travel & Tourism, taxes that are perceived as discriminatory or unfair will encourage consumers to seek substitutes by selecting alternative products and destinations,

Several factors combine to make a destination's Travel & Tourism industry especially vulnerable to tax-induced product substitution. Unlike most markets, where products are delivered to consumers, the travel market involves mobile consumers who must be delivered to the product. Furthermore, the consumer is usually an active participant in building the individual travel components into the final product.

Additionally, a significant proportion of Travel & Tourism is non-obligatory with respect to destination; in other words, the consumer is totally free to choose any destination that is accessible and affordable. In this respect, the speed of destination substitution is dramatic when any element, including cost, is perceived as being unattractive, This type of immediate response is evidenced by the travel market's reaction to terrorism activity. Although the mass media's penchant to cover such episodes is a significant factor in explaining why travelers abandon targeted destinations en masse, it serves to demonstrate the traveler's ability to freely substitute destinations whenever the need arises.

When faced with such potential extreme fluctuations in market conditions, destinations must exercise extreme care to avoid creating negative perceptions in the minds of the traveling public. This task is made even more difficult because one negative experience, such as an abnormally high tax on a hotel bill, can taint an otherwise enjoyable visit and discourage the visitor to return or recommend the destination to others.

Finally, the total effect of Travel & Tourism taxes is often underestimated as tax levies evolve incrementally over the years. However, the cumulative effect is readily apparent as travelers are increasingly barraged by a complicated array of mystifying taxes. Frequently, every step in the production of the service is taxed. This process is akin to taxing an export commodity upon planting, harvesting, transportation, refinement, packaging, and sale.

Tax Policy Guidelines

In order to assist decision-makers in developing sound Travel & Tourism tax policy, the World Travel & Tourism Tax Policy Center has developed the following guidelines for taxing the world's largest industry.

World Travel & Tourism Tax Policy Guidelines

- Tax officials should compile a complete picture of individual Travel & Tourism taxes and add-on charges, and compare this level with other strategic economic development priorities.
- The Travel & Tourism private sector should be an active participant in the formulation of tax policies effecting the industry. Policy-makers should seek input from the industry when considering any tax or fee on Travel & Tourism services, products or consumers.
- Taxes that directly inhibit the competitiveness and vitality of Travel & Tourism should be avoided. Consultation with the Travel & Tourism industry can help policymakers raise the needed revenue while sustaining the employment and revenue base of the industry.
- Policymakers should apply the same standards to Travel & Tourism exports that are applied to manufactured goods. International Travel & Tourism is essentially an export industry. Taxing inbound travel is equivalent to taxing an export product.
- Growing the Travel & Tourism tax base should have priority over raising tax rates. Sustainable economic growth in the industry will yield increased public revenues if taxes do not hinder market processes.

- Travel & Tourism development policy must be consistent and synchronized with fiscal policy. This requires an examination of the tax vehicles utilized across all sectors comprising the Travel & Tourism industry.
- Travel & Tourism taxes should be easily administered and collected. Imposing taxes that are difficult to administer and collect results in increased costs to government and industry, negating or reducing net proceeds to both entities.
- Education and research into the effects of Travel & Tourism taxes should be encouraged. Many policymakers are not familiar with the scope and economic power of Travel & Tourism. Every effort should be made to familiarize policymakers with the realities of Travel & Tourism tax economies. The research agenda outlined in this report attempts to highlight critical research needs.