



**THE IMPACT OF LOWER  
VAT RATES ON UK VISITOR  
ATTRACTIONS AND  
ACCOMMODATION**

**Summary Report**

**February 2008**

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# GRAHAM WASON

## TOURISM STRATEGY ADVISER

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22<sup>nd</sup> February 2008

Mr Colin Dawson  
Chief Executive  
BALPPA  
Suite 12  
37 Tanner Street  
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Dear Sir

### **The Impact of Lower VAT Rates on UK Visitor Attractions and Accommodation**

We have pleasure in submitting our Summary Report on the above.

Our Full Report is based on thorough research into: UK tourism competitiveness; VAT rates on tourism in Europe; case studies of countries where the rate of VAT on tourism has changed; and tourism price competitiveness. We have prepared a detailed model to demonstrate the anticipated fiscal effects of a reduction in the rate of VAT on tourism in the UK. Our report provides a comprehensive update and expansion of work undertaken by teams led by myself on behalf of Deloitte during the 1990s.

This document contains a Summary of the Full Report and one page of Executive Highlights. The Full Report and an extended Appendix are available on request.

Based on conservative estimates, our findings show that if VAT were to be reduced on visitor attractions and accommodation, the loss of VAT receipts to the UK Treasury would be more than made good by wider economic benefits, and would spark off a virtuous cycle of investment and growth, assisting the whole UK economy.

We have enjoyed preparing this report on your behalf and hope that it assists you in presenting this opportunity to politicians.

Yours faithfully



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## CONTENTS

<b>EXECUTIVE HIGHLIGHTS</b> .....	2
<b>SUMMARY REPORT</b> .....	3
1. Introduction .....	3
2. Background .....	3
3. Key findings of the Deloitte reports .....	4
4. VAT in the European Union .....	4
5. Rates of VAT on tourism services in the EU .....	6
6. Performance of the UK tourism sector .....	7
7. The UK's performance compared with other countries .....	8
8. Case Studies .....	9
9. Other factors affecting tourism performance .....	11
10. The outlook for the economy and tourism .....	11
11. The price sensitivity of tourism .....	12
12. The fiscal effects of lower VAT .....	13

## EXECUTIVE HIGHLIGHTS

- I. The UK is facing considerable economic challenges. Our oil revenues are declining. Last autumn's 'credit crunch' suggests that our increasing reliance on the financial services sector is unwise. And the wider picture is not reassuring; the USA appears on the brink of recession and growth in China and India is providing threats as well as opportunities. Our economy could do with a shot in the arm; tourism can provide such a shot.
- II. Tourism can be a valuable source of 'invisible exports', but the UK's share of world tourism is in decline, falling from 5.1 per cent in 1995 to 4.5 per cent in 2005. The UK's Tourism Balance of Payments (income spent in the UK by overseas visitors, less spending by British residents who travel overseas) was positive until the early 1980s. Since 1985, the last year in which there was a positive balance, there have been rising deficits. In 1996 the deficit was £3.9 billion. It now stands at more than £18 billion per annum.
- III. Britain's tourism industry is at a competitive disadvantage compared to that of its European neighbours. Most EU member countries choose to apply a reduced rate of VAT to their tourism industries, whereas the UK does not. Reduced rates account for one-third of all VAT income within the EU - countries use them widely because they give competitive advantage, particularly to socially beneficial sectors like tourism.
- IV. In 1986, when tourism in the Republic of Ireland was stagnating, the rate of VAT on tourism services was reduced to ten per cent (from 18 per cent on hotels and 23 per cent on restaurants). Since then, Ireland's foreign exchange receipts have increased by just under €170 million per annum – an excellent performance for an economy less than a tenth of the size of the UK – resulting in the Republic significantly increasing its share of world tourism.
- V. If the UK were to reduce the rate of VAT on visitor attractions and accommodation to five per cent (the UK's only reduced VAT rate currently), there would a direct loss of just over £1 billion in VAT receipts to the Treasury. Estimated conservatively, this loss would be more than offset by indirect gains arising from a widening of the tax base, income and corporation tax gains and savings in social security payments of £770 million, and multiplier gains of £445 million. The VAT cut would spark off a virtuous cycle of investment and growth and reverse the decline in the Balance of Payments, adding back £1.6 billion in the first year with further gains in each successive year.
- VI. Reducing VAT on tourism services to stimulate the sector is not an unknown phenomenon to the UK Government. In 1994, the Isle of Man was granted approval to reduce the rate of VAT on hotels to five per cent. This measure was intended to prevent the complete collapse of the island's tourism sector, as had been forecast. As a result, tourism on the Isle of Man has recovered and stabilised, despite fierce competition from destinations throughout Europe.
- VII. The conclusion of our report is that, on equity, fiscal and economic grounds, the case for providing a boost to the UK economy by reducing the rate of VAT on tourism services is highly compelling.

## SUMMARY

### 1. Introduction

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

The report was commissioned by the British Association of Leisure Parks, Piers and Attractions (BALPPA) on behalf of the UK visitor attractions and accommodation sector. BALPPA is a non-profit-making trade association which represents 300 members who between them attract many millions of domestic and overseas visitors to their attractions each year.

### 2. Background

VAT in the UK is levied on visitor attractions and accommodation at the standard rate of 17.5 per cent. This is higher than the rate prevailing in most other member countries of the European Union (EU), the majority of which choose to apply a reduced rate of VAT to visitor attractions and accommodation.

Demand for tourism services is highly sensitive to price and subject to intense international competition. Countries where the tourism sector is subject to a lower rate of VAT therefore have a competitive advantage over those countries where a higher rate is levied.

This report considers the extent to which the UK's tourism industry is facing such a competitive disadvantage. It then goes on to consider what might happen if a reduced rate of VAT were applied to UK visitor attractions and accommodation.

The report builds on previous work undertaken by Deloitte on behalf of the VAT Working Group of the British Tourist Authority (now VisitBritain). Deloitte produced reports in 1995 and 1998.

The Consultant Team that has undertaken this present study comprises:

- Graham Wason: Tourism Strategy Adviser and former Deloitte partner;
- Mike Nevin: Tourism Economist and former Deloitte Consultant;
- Roger Perman: Reader at the University of Strathclyde; and
- Morten Fogh Christiansen: market researcher and economist.

Messrs Wason, Nevin and Perman were the three main members of the team that prepared the 1995 and 1998 Deloitte reports.

For the purposes of the Deloitte studies, the tourism sector was defined as comprising: visitor accommodation (such as hotels, guest houses, self-catering establishments, camping sites); visitor attractions (such as theme and leisure parks, zoos, historical sites, piers and museums); and restaurants.

Restaurants have been excluded from the present study. This is because restaurants are primarily used by residents rather than tourists and because the UK Government does not have the right to apply a reduced rate of VAT to restaurants under current EU legislation.

The study reviewed relevant events that have had an impact on tourism in the UK, Europe and the world during the ten years since the last Deloitte report. We then revised and updated the econometric model to simulate the impact of a reduction in the rate of VAT applying to visitor attractions and accommodation.

### **3. Key findings of the Deloitte reports**

The Deloitte reports found that:

- VAT on tourism services was higher in the UK than 13 of the other 14 member countries of the EU (at that time);
- the performance of the UK's tourism sector over the previous 15 years had been marked by a declining market share and a progressive deterioration in the Balance of Payments on tourism services;
- there was compelling evidence of a causal relationship between these two facts.

A detailed model was prepared to simulate the effects of a reduction in the rate of VAT on tourism services in the UK from 17.5 per cent to an assumed rate of eight per cent. The model forecast that if VAT were not reduced, the UK's tourism industry would further lose competitiveness and the Tourism Balance of Payments deficit would worsen. If VAT were reduced, the loss in VAT income to the Treasury would be more than made good by other economic benefits and the decline in the Balance of Payments deficit would be reversed.

In the event, VAT rates were not reduced and over the past decade the UK's Tourism Balance has deteriorated sharply, from a deficit of £3.9 billion in 1996 to over £18 billion in 2006.

### **4. VAT in the European Union**

VAT is a compulsory and widely-used instrument in the EU. In the period up to 31<sup>st</sup> December 2010, each member country of the EU must apply a standard rate of VAT, which must be at least 15 per cent. Total VAT revenue makes up 20 per cent of all taxation income collected in the EU.

Each Member State of the EU may also use a maximum of two reduced rates with a minimum rate of five per cent. The reduced rates may be applied to industry goods and services on a specific list, which includes hotels and some

forms of culture and entertainment. Countries may also apply a reduced rate of VAT to certain specified labour-intensive services on an experimental basis.

Of the EU's 25 countries (excluding Bulgaria and Romania), all but one applies at least one reduced rate. These reduced rates are very widely used: approximately one-third of all consumption in the EU is taxed at reduced rates; the other two-thirds are taxed at the standard rate of VAT, with this rate ranging from 15 to 25 per cent.

In 2006, the European Commission (EC) was requested to present to the European Parliament and the Council an overall assessment of the impact of reduced rates. The EC commissioned the Danish firm Copenhagen Economics ApS to carry out such a study. Copenhagen Economics issued its report to the EC in June 2007. Key findings of the Copenhagen Economics report include:

- the wide variety of different rates between sectors and countries creates considerable distortions within the 'single market'. Tourism is quoted as a sector where these distortions are particularly marked;
- A case for further use of reduced rates can be made in certain circumstances, such as: services employing a high proportion of relatively low-skilled workers (hotels, restaurants and tourism are specifically quoted examples); and goods and services that are seen as having merit (e.g. books, cultural events, theatre and museum tickets and weekend breaks at hotels);
- 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; this so-called 'full pass through' will occur relatively quickly for price-sensitive services such as tourism;
- the price cuts that result from a permanent lowering of VAT rate will lead to increased consumption, production and employment. Such increases will occur rapidly and be more significant in sectors which are labour-intensive, highly price-elastic and very competitive, such as tourism; and
- the 'hospitality industry' is particularly well suited to reduced rates as it attracts a high proportion of demand from foreign visitors, employs low-skilled workers, and has high price-elasticity. The report observes that hotels in countries with reduced rates of VAT have a significant competitive advantage over others.

In its report to the European Parliament and Council, also dated June 2007, the EC invites Member States to consider the desirability of:

- a very low rate (between 0 and 5 per cent) for goods and services of first necessity, such as food; and
- a second reduced rate, possibly between 10 and 12 per cent, for other goods and servicing meriting preferential treatment for a variety of reasons, such as those of cultural and social benefit. The EC questions

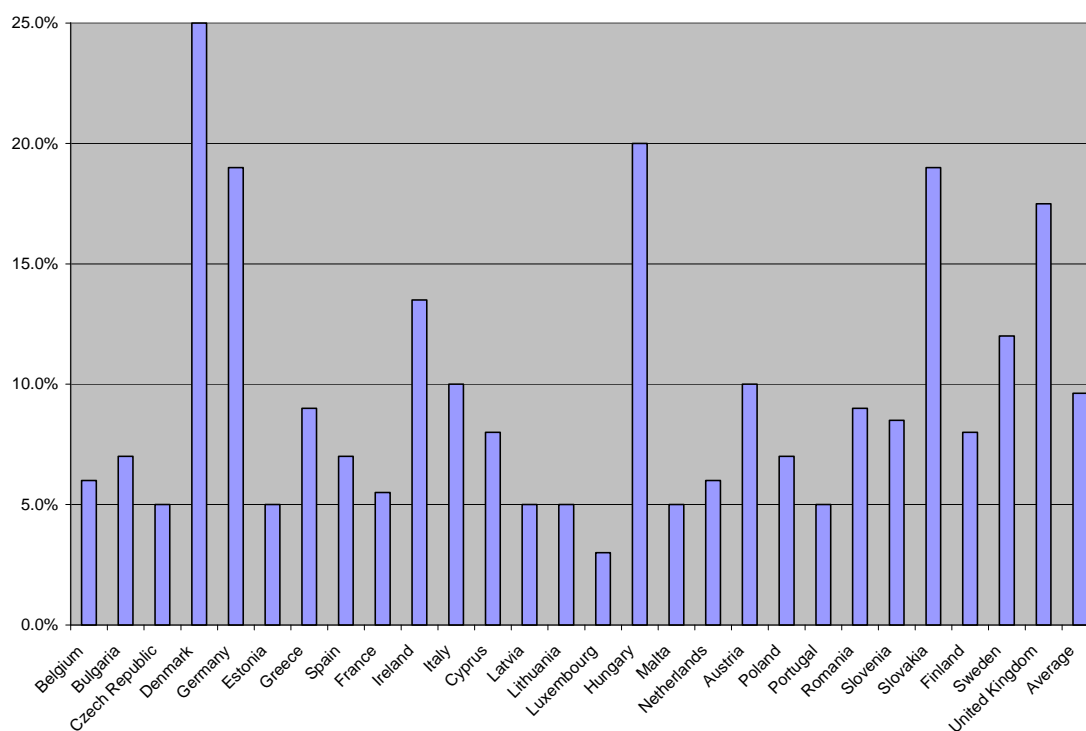
whether tourism services should be included, and whether this reduced rate should then be compulsory for tourism.

## 5. Rates of VAT on tourism services in the EU

Figure S.1 (below) shows the current rates of VAT applying to visitor accommodation within the EU. It shows that the UK is one of only five EU Member States (out of 27) that levy VAT at the standard rate on visitor accommodation. The fact that 22 Member States apply a reduced rate to visitor accommodation suggests that:

- they recognise that tourism is a price-sensitive sector, subject to international competition;
- they are prepared to use the fiscal powers given to them to provide a reduced rate to increase the international competitiveness of the sector;
- they might consider that income foregone by this concession is compensated for by the additional demand that lower taxes stimulate.

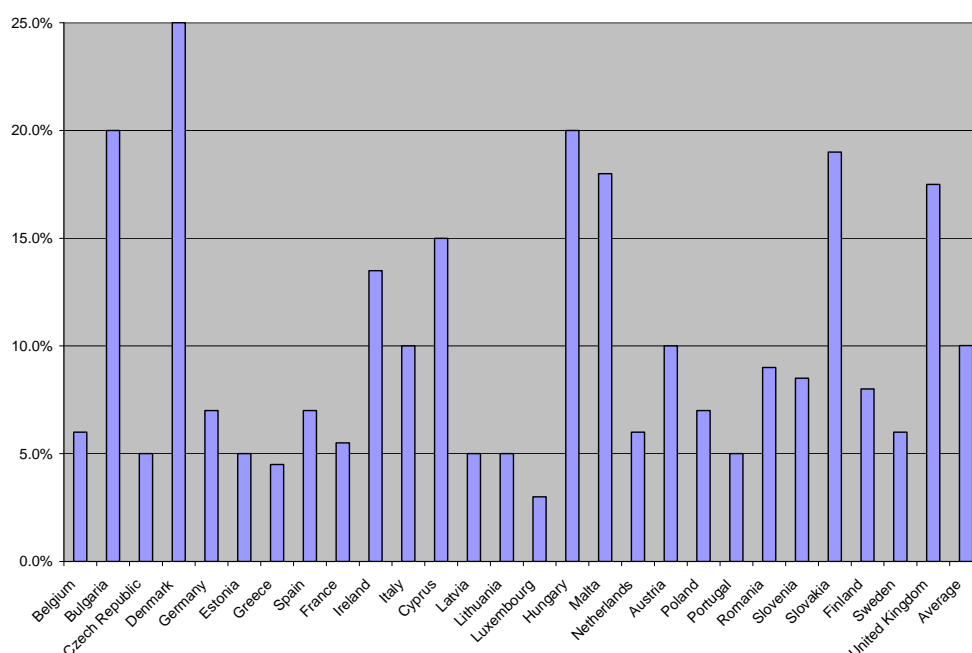
**Figure S.1:**  
**VAT Rates on Visitor Accommodation in the EU**



**Source:** VAT Rates applied in the Member States of the EC, May 2007

The position with regard to visitor attractions is similar. Although more Member States charge the standard rate on the two visitor attraction categories defined by the EU for VAT purposes – ‘admission to cultural services & shows’ and ‘admission to amusement parks’ – Figure S.2 (overpage) shows that the standard rate of 17.5 per cent applying in the UK is well above the EU average.

**Figure S.2:**  
**VAT Rates on Admission to Cultural Services in the EU**



**Source:** VAT Rates applied in the Member States of the EC, May 2007

Furthermore, the degree of distortion in the treatment of VAT amongst UK attractions is significant.

## 6. Performance of the UK tourism sector

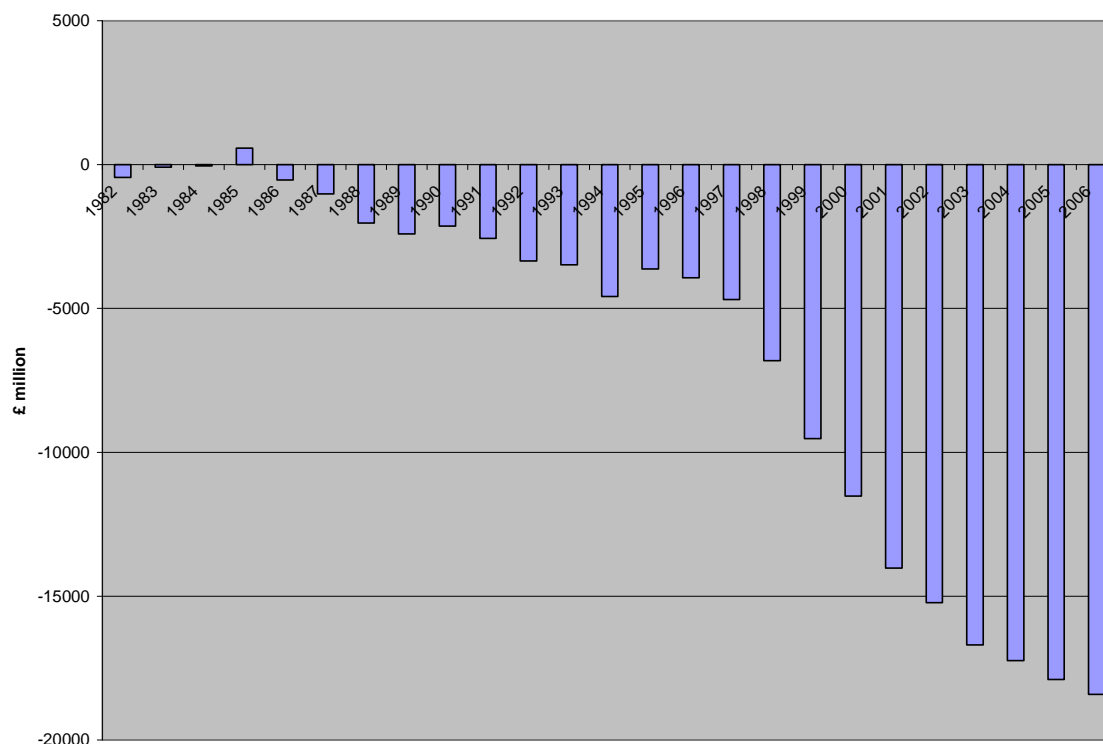
Tourism makes a major contribution to the UK economy. It generates over £85 billion a year, contributing 3.5 per cent to national GDP. Over two million jobs are sustained by the tourism industry; of these, 1.4 million are directly employed in the sector, representing five per cent of UK employment.

Ten years ago, the contribution of tourism to the UK economy, as reported in the 1998 Deloitte report, represented five per cent of national GDP and seven per cent of employment.

Tourism's importance to the UK economy in relative terms has therefore declined significantly during the last ten years.

The UK enjoyed a positive Tourism Balance of Payments (income spent in the UK by overseas visitors, less spending by British residents who travel overseas) until the 1970s. In 1979, the surplus was equivalent to almost a quarter of that year's international tourism receipts. In the early 1980s, the account was more or less in balance. There was a final surplus in 1985, and then increasing deficits from 1986. The trend over the past quarter century can be seen in Figure S.3 (overpage).

**Figure S.3:**  
**The UK's Tourism Balance, 1982-2006**



**Source:** ONS data on International Passenger Receipts and Expenditure published in *Overseas Travel & Tourism*

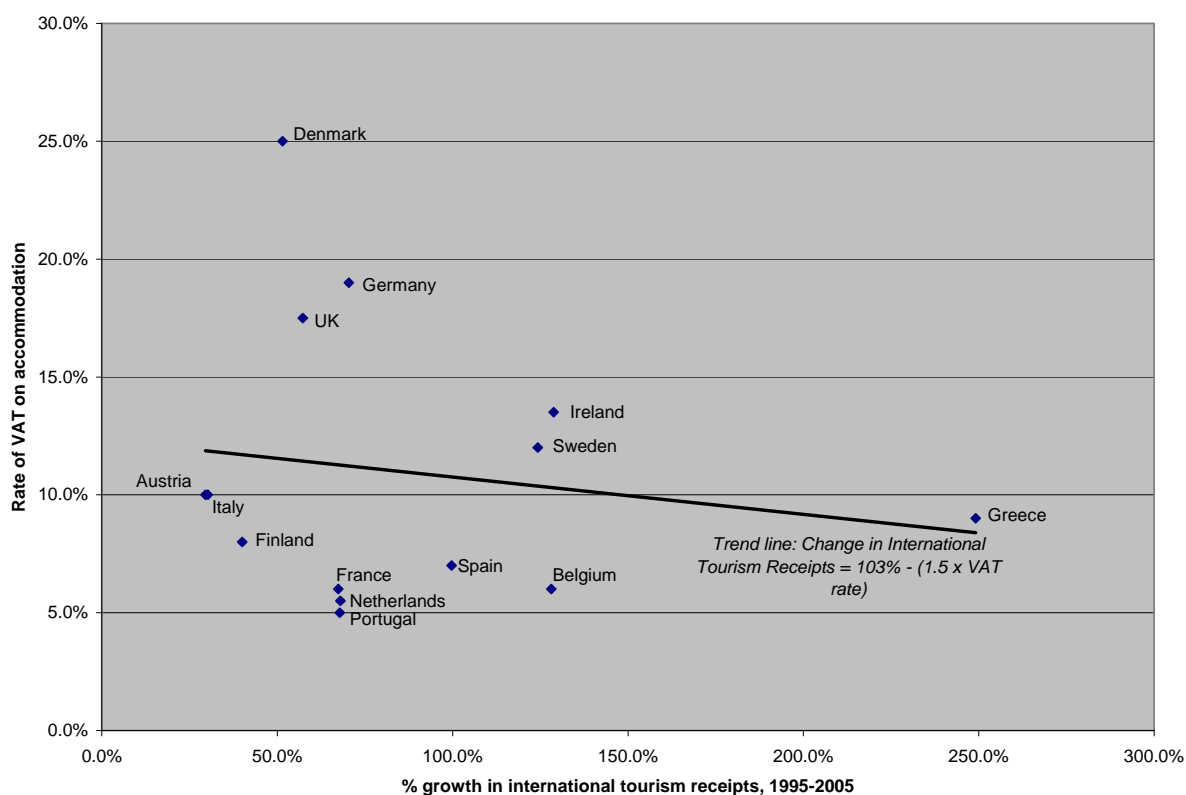
Whilst there are many factors that affect a country's international competitiveness, it is relevant to note the timing of increases in the rate of VAT on tourism services in the UK: VAT increased from eight to 15 per cent in 1980/81 and to 17.5 per cent in 1991.

## 7. The UK's performance compared with other countries

If the UK's tourism Balance of Payments is deteriorating, that of other countries must on average be improving. To an extent, the UK pattern is following a Europe-wide trend of a declining share of global tourism. But this overall trend masks the UK's poor performance compared with other European countries. Based on international tourism receipts over the ten year period from 1995 to 2005, the UK has under-performed the EU average, with only four countries performing worse than the UK.

To assess the extent to which higher than average VAT rates may have contributed to the decline in the UK's market share, we regressed the change in EU Member States' international tourism receipts over the past ten years against the rate of VAT applied to visitor accommodation. The results are shown in Figure S.4 (overpage).

**Figure S.4:**  
**The Negative Relationship between the rate of VAT on visitor accommodation and the growth in international tourism receipts in 14 EU Member States, 1995-2005**



**Source:** Adapted from WTO data

The results shown in Figure S.4 reveal a distinct though weak relationship between these two variables, with the three Member States levying standard rates of VAT – the UK, Denmark and Germany – experiencing among the slowest rates of growth. The fact that a relationship is evident at all is to an extent surprising in that many other factors over the past ten years, such as terrorism, wars and pandemics, have reduced the influence of price. When we undertook the same exercise ten years ago, the correlation between VAT rate and tourism growth was stronger.

## 8. Case Studies

Case studies of the impact of VAT on tourism suggest that lower VAT rates are associated with enhanced tourism performance.

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 ten per cent and on restaurant meals from 23 to ten 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, and representing a considerably faster growth rate than the UK, and resulting 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.

In the **Isle of Man**, tourism was the main source of income until the 1970s but suffered when the British switched from domestic to overseas holidays. As short break holidays became popular, the Isle of Man, with high prices and an outdated product, proved a poor competitor.

The Isle of Man Government put a case to the UK Government for a reduced rate of VAT for hotels, arguing that this was essential for the island's tourism to compete with short breaks to the Channel Islands, which are exempt from VAT, and hotels in European destinations, taxed at reduced rates. The case was accepted and VAT on hotels was reduced to five per cent in 1994, and has remained at that level since. Following a sharp fall in visitor numbers to under a quarter of a million immediately before the VAT reduction, visitor numbers to the island recovered and have stabilised at between 300,000 and 340,000 per annum since the mid-1990s. The view of Isle of Man officials is that the decline in tourism would have continued without the reduction in VAT.

Elsewhere in the EU, there is evidence of the industry's sensitivity to VAT rates. During the 1990s, the governments of **France** and **Spain** introduced higher rates of VAT for the top grade of hotels. In both countries, a majority of these hotels voluntarily downgraded so that they would be charged the reduced rate of VAT and could remain competitive on price. The governments quickly reversed their decisions and applied the reduced rate to all hotels. **Finland** reduced its rate of VAT on hotels in January 1995 from 22 per cent to six per cent in response to industry pressure; nevertheless, Finland's Tourism Balance of Payments deteriorated from €389 million in 1998 to €32 million in 2006. The recent EU **accession states** have been lobbying for the right to apply reduced rates of VAT to tourism services. Estonia won this right and reduced its VAT on hotels from 18 to five per cent in 2004; conversely Bulgaria must charge VAT at 20 per cent which, it is feared, will have a very damaging impact on its price-sensitive tourism sector.

Outside the EU, **Norway** introduced a reduced VAT rate for hotels of eight per cent in September 2006, after many years of applying a zero rate to the sector. Conversely, **Turkey** has suffered from stagnation of its substantial tourism sector and the government therefore reduced VAT from 18 to eight per cent on 1<sup>st</sup> January 2008.

## 9. Other factors affecting tourism performance

Price, and VAT's strong influence on price, is only one factor affecting tourism performance. The past ten years have seen many events having a strong influence on tourism demand. Some of these have had global influence, others regional. Notable examples include:

- the terrorist attacks in the USA on 11<sup>th</sup> September 2001, which caused the first year-on-year decline in global tourism for over a decade;
- the invasions of Afghanistan and Iraq;
- terrorist activity in Bali, Mombassa, Moscow, Madrid, London, Glasgow and elsewhere;
- the tsunami; and
- outbreaks of SARS and bird flu.

The UK has had its own mix of challenges. Of particular note was the outbreak of Food & Mouth Disease in early 2001. The Tourism & Travel Research Institute of the University of Nottingham estimated that the consequent reduction in tourism expenditures sustained by the UK tourism industry was between £6.7 and £8.8 billion, which dwarfs the loss sustained by agriculture.

## 10. The outlook for the economy and tourism

At the time of writing in early 2008, the outlook for the global economy is somewhat bleak: gold at record levels; the price of oil having pierced the \$100 mark; a slump in the Dow Jones; paralysis in the credit markets; weakened consumer confidence; an ongoing housing slump in the US. Although US recession is by no means a foregone conclusion, the expected sharp deceleration in spending by American households will affect the rest of the world. There is some hope of a counter-effect from the powerful growth in countries such as China and India, though even here some forecasters predict a slowdown or worse.

The year 2007 was the best for travel and tourism globally since the 9/11 terrorist attacks. However, historically, when consumer confidence falters, so does spending on travel and tourism, and it appears unlikely that the growth seen in 2007 will be repeated this year.

The official outlook for the UK economy is one of continuing, albeit slowing growth. Forecasters are divided as to whether or not the UK is heading for recession, but nearly all predict a bumpy ride ahead.

Last year brought an accumulation of challenges for the UK tourism sector:

- the doubling of APD in February;
- doubling of visa fees in April;
- the pound growing in strength to twice the dollar value in April;
- terrorist attacks in June;
- airport chaos in July;
- a new Foot & Mouth scare in September;

- the announcement in October of an 18 per cent cut in funding for Visit Britain; and
- the roll-out of biometric passports in October to December.

Industry experts are predicting a fall in international arrivals to the UK in 2008 of around 1-2 per cent and a fall in spending of 4-5 per cent. These reductions compare unfavourably with the UNWTO's prediction for further growth in the rest of Europe this year.

The UK economy could desperately do with a shot in the arm. Tourism has the potential to provide that shot – if given a stimulus such as a reduction in VAT.

## 11. The price sensitivity of tourism

If the UK Government were to reduce the rate of VAT applying to visitor attractions and accommodation, the overall impact on employment, turnover and taxes would depend on two factors:

- how much of any reduction is passed through in lower prices; and
- how sensitive consumers – and particularly international visitors – are likely to be to any reduction in prices.

In simple terms, the greater the price reduction, and the greater the response of visitors to lower prices, the greater the boost to turnover, employment, profitability and tax receipts is likely to be.

We believe that a large part of any decrease in VAT would be passed through in lower prices. A considerable body of research has been undertaken on the price sensitivity of international tourism, which confirms that tourism is highly price sensitive. Our own analysis in the 1995 and 1998 VAT reports, and our subsequent report for the British Tourist Authority on *The Price Sensitivity of International Tourism* (2001), confirmed this finding and estimated a 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 the pound sterling (and thus in the price of UK tourism against overseas destinations) leads to a 12.8 per cent increase in real UK international tourism receipts.

The present study updated our earlier estimates in 1995 and 1998 by analysing quarterly trends over the period between 1980 and 2007. This analysis identified a strong relationship between fluctuations in the exchange rate of sterling and the rate of growth in the UK's international tourism receipts up to 2000. During periods of sterling strength, the UK's international tourism receipts grew slowly and in some years actually fell – as during the UK's membership of the European Exchange Rate Mechanism (ERM) in the early 1990s, for example. During periods of sterling weakness – when the price of a holiday in the UK is lower in dollar or euro terms – the UK's international tourism receipts grew rapidly, as for example after the pound left the ERM in the mid-1990s. This confirms that, at a macro level, tourism is price sensitive.

Since 2000, the long-term relationship between the strength of the pound and inbound tourism has been disrupted by a number of special factors, most obviously the terrorist attacks of September 11<sup>th</sup> 2001, foot and mouth disease, the Iraq War and terrorism, which have contribute to a sharp decline in the

UK's inbound visitor numbers and revenues over that period. After a period of disruptions, the long-term relationship now appears to be reasserting itself.

Over the period from 1980 to 1999, the elasticity of the UK's real tourism receipts with respect to changes in the pound's exchange rate was -1.43, implying that a ten per cent fall in sterling was associated with a 14.3 per cent increase in the UK's international tourism receipts over that period.

In the light of the findings of this econometric analysis, a price elasticity parameter of -1.20 has been used in our fiscal model, which we believe to be prudent. We have conducted sensitivities with a lower range of -1.05 and a higher range of -1.35. The higher elasticity of -1.35 could represent a 'lower VAT plus higher marketing spend by VisitBritain and other tourism agencies' scenario, whereas the lower elasticity of -1.05 could represent a 'lower VAT plus difficult security position' scenario. All of these price elasticities are more conservative than the recommendation of -1.43 emanating from our macro-economic analysis (see Technical Appendix, page 94 of the Full report).

## **12. The fiscal effects of lower VAT**

We developed a fiscal model showing the direct and indirect effects of lower VAT rates on the Exchequer's taxation receipts. This model refined the analysis in the 1995 and 1998 Deloitte reports. In particular, the present model takes account of 'Shadow Economy' effects. If VAT rates were reduced, it would tend to lessen the temptation for businesses to under-report revenues or stay below the VAT threshold, and thereby widen the overall tax base.

The immediate impact of cutting VAT from its current rate of 17.5 per cent to a reduced rate of five 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. And secondly, we would expect a progressive broadening of the VAT base in response to the lower rate. At a rate of 17.5 per cent, small hotels and attractions have a clear incentive to remain outside the VAT regime if they can. If rates are reduced to five per cent, the disincentive to VAT registration will be considerably reduced. Particularly amongst attractions, a lower VAT rate will help to reduce the present significant levels of distortion.

Higher expenditure by visitors in response to lower VAT rates will 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.

In total, the net fiscal gain as a result of the VAT reduction is estimated to be just over £150 million per annum, based on the assumptions input to the fiscal model.

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.

These results were subject to a range of sensitivity tests, modelling the effects of different estimates of the price elasticity of demand and the impact on the Shadow Economy. We also tested the effect of assuming smaller reductions in the rate of VAT – down to eight per cent or 12 per cent. The sensitivity tests showed that, under a range of plausible scenarios, the Exchequer would still benefit in net terms. While there would be a direct loss of VAT yields, this would be more than offset by the indirect gains from an increase in turnover and the overall base on which VAT is levied, higher employment and corporation taxes, and savings in social security payments, generated by higher foreign exchange earnings from visitors to the UK. However the overall economic stimulus would be less than with a reduction to five per cent VAT.

These effects are likely to be more pronounced during a recession than during a period of full employment. Tourism is a labour-intensive sector, offering employment to young and unskilled workers who might otherwise have difficulty in securing regular employment. Fiscal principles suggest that reducing taxes on price-sensitive sectors open to international competition are likely to represent a cost-effective mechanism for improving the Balance of Payments and increasing national employment at a time of economic downturn.

A reduction in the rate of VAT applying to a price sensitive sector exposed to fierce international competition would have significant benefits for the UK's Balance of Payments in tourism. In 2006, the balance was in deficit to the tune of £18.4 billion. With no change to VAT and in the present challenging economic circumstances, we predict significant further decline. Our estimates suggest that a reduction in VAT on visitor attractions and accommodation would immediately reduce the deficit by £1.6 billion, with the prospect of considerable further gains in each successive year.

On these grounds, the case put by the visitor attraction and accommodation sector for reducing the rate of VAT merits serious consideration by Her Majesty's Treasury.