



## Specific and general taxation of tourism activities. Evidence from Spain

Alberto Gago<sup>a,b</sup>, Xavier Labandeira<sup>a,b,c</sup>, Fidel Picos<sup>a,b</sup>, Miguel Rodríguez<sup>a,b,c,\*</sup>

<sup>a</sup> REDE, Universidade de Vigo, Spain

<sup>b</sup> Department of Applied Economics, Universidade de Vigo, Spain

<sup>c</sup> FEDEA, Madrid, Spain

### ARTICLE INFO

#### Article history:

Received 3 September 2006

Accepted 10 August 2008

#### Keywords:

Taxes

Distortions

Tourism

Sustainability

Spain

### ABSTRACT

This article mainly discusses whether the introduction or increase of tourism taxation should be addressed through specific or general indirect taxation. With this aim, the paper describes the concept of tourism taxes and presents the several reasons that back their use. The paper also offers some numerical exercises comparing the effects of specific and general tourism taxation in Spain, a developed country with a sizeable tourism industry. The article suggests that both specific and general taxes on tourism would be able to yield improvements in terms of revenues and internalization of costs without hampering the economy. Yet, in comparative terms, general indirect taxes may be a more feasible, equitable and neutral way to obtain tax revenues from tourism activities.

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### 1. Introduction

Tourism activities have always been subject to indirect taxation. For instance, tourists must pay general taxes when they consume different goods and services in the destination country. They may also pay specific taxes on tourism that have gained acceptance over the years, with currently more than 40 different applications around the world (WTO, 1998). The broad use of tourist taxation can be put down to several reasons: (i) the magnitude of revenue potential, that could represent more than 10% of the tax receipts collected by some developed countries, approaching 100% in certain small tourist economies (McAleer, Shareef, & Da Veiga, 2005); (ii) the low distortionary effects of taxation and the exportability of the fiscal burden, especially in countries where tourism is an important economic activity; (iii) the ability to act as a price substitute for the public goods and services consumed by tourists; and (iv) the corrective role that could be played by these taxes (e.g., environmental pricing).

This explains the growing academic interest for analyzing the design and effects of indirect taxation on tourist activities, which began in the late 1970s. Most of the work has dealt with specific levies on hotels (e.g., Bonham, Fujii, Im, & Mak, 1992; Bonham & Gangnes, 1996; Combs & Elledge, 1979; Fujii, Khaled, & Mak, 1985, 1988; Hiemstra & Ismail, 1992, 1993; Im & Sakai, 1996; Mak, 1988;

Mak & Nishimura, 1979; Spengler & Uysal, 1989). However, the effects of other taxes (mainly general indirect taxation) have attracted less attention until recent years (e.g., Blake, 2000; Gooroochurn & Milner, 2004; Gooroochurn & Sinclair, 2005; Wanhill, 1995).

Although there are many advocates for the use of specific indirect tourism taxes, such proposals are usually opposed by local and international tourism businesses because they are largely seen as a disruption of their activities. For example, long-term contracts between tour operators and hotels are a common practice in this sector and so a new tax cannot be added to the prices paid by tourists, without resulting in a reduction of hotel profit margins. Furthermore, specific tourism taxes generate negative attitudes in tourists and businesses against what is perceived as discriminatory policies (fiscally predatory governments) that also encourage bad practices (tax evasion through black markets). This is probably the main reason behind the sudden demise of the *ecotasa* tourism tax in the Spanish Balearic Islands (approved in April 2001, repealed in October 2003). Similar lobbying activities are currently in place in the Dominican Republic, Puerto Rico and Mexico, among other countries, against municipal hotel room taxes.

A second option for taxing tourism is, as indicated above, through general indirect taxation. Yet these taxes are usually low in relative terms; for example, Value Added Tax (VAT) rates applied to hotels are approximately 50% lower than general tax rates in the former 15 EU members and 40% lower than general rates in new EU member countries, whereas tax rates in restaurants, bars and cafes are, respectively, about 30% and 20% lower (European Commission, 2005; World Travel & Tourism Tax Policy Center, 2002). Therefore,

\* Corresponding author. Faculdade de CC. Empresariais e Turismo, Universidade de Vigo, Campus As Lagoas, 32004 Ourense, Spain.

E-mail address: [miguel.r@uvigo.es](mailto:miguel.r@uvigo.es) (M. Rodríguez).

many governments are implicitly subsidizing tourist activities through reduced VAT rates.

In this context, a major aim of this article is to study whether the likely future increases in the taxation of tourist activities should be addressed through specific tourism taxes, the most common approach so far, or by increasing the usually low VAT rates levied on typical tourist goods and services (hotels, restaurants, cafes, bars and similar services). There are several reasons for our concern about this issue: (i) the efficiency properties of the VAT system in the EU, whose 'credit method' is neutral on consumers' behavior by leaving relative prices unchanged in the domestic market (Jensen & Wanhill, 2002); (ii) the fact that the use of increased VAT rates requires no additional revenue-collecting methods and thus administration and compliance costs are under control, also observing of the principles of 'intelligent taxation': simplicity (World Travel & Tourism Tax Policy Center, 1994) and finally (iii) the ongoing debate about reduced VAT rates in EU institutions, where the study of its impact on job creation, economic growth and the functioning of the internal market may lead to new tax scenarios (more homogeneous across countries and goods).

Therefore, this paper offers a new contribution in this field, also providing valuable evidence for the Spanish economy. Spain is a developed country with an important tourism industry, so the results may differ from the usual (and probably less relevant) targets of other studies: small and developing tourist countries. Besides, Spain has recently seen some significant attempts to introduce tourist taxes and new proposals are expected in the next few years. Given that, such changes in tourism taxation may have important effects on efficiency and income distribution, a comprehensive analysis should be carried out on the possibilities and consequences of different policy options. In this article, we use a Computable General Equilibrium (CGE) model to assess the effects of two hypothetical taxes affecting tourism: a specific tax aimed at tourism (hotel room tax) and an indirect tax reform that significantly affects tourism through changes in VAT rates.

The article is structured in four sections, references and an Appendix. The following section analyzes the foundations underlying the indirect taxation of tourism. Section 3 deals with the description of some practical applications of tourism taxation in Spain. Section 4 shows the results of three hypothetical tax changes in Spain, with a thorough discussion of the CGE methodology and the simulations. Finally, the last section deals with the main conclusions and policy recommendations.

## 2. Indirect taxation of tourism activities

Indirect tax receipts generated by tourism either come from specific tourist taxes, in accordance with a wide range of formulas and circumstances (usually hotel room taxes and airport entry/exit taxes; see WTO, 1998, for details), and from general taxation on consumption. However, none of these formulas can be described strictly as tourism taxes, since nearly all goods and services used by tourists (hotels, restaurants, flights, car renting, etc.) are also used by non-tourists. Thus, the taxable item is not the tourism itself but rather a tax base roughly linked to it, so that any fiscal measure addressed to tourism activities also has effects on non-tourists. Consequently, when we refer to tourism taxation in this paper, we really mean indirect taxes affecting tourist activities. With such limitation in mind, this section first deals with the foundations of tourism taxation, to subsequently discuss the role of specific and general indirect taxes in the field.

### 2.1. Foundations of tourism taxation

Indirect tourism taxes can be justified on mainly three grounds: (i) revenue-raising objectives; (ii) coverage of conventional costs of public services; and (iii) internalization of external costs.

Firstly, the tourism sector is a natural candidate not only for, at least, average fiscal pressure (from general tax policies not focused on tourism), but also for higher-than-average pressure (from deliberated tax policies on tourism) when tourism represents a significant share of economic activity. The reason for the latter is twofold: the low distortionary effects of taxation and the exportability of the fiscal burden. On the one hand, it is well known that any tax is distortionary when supply and/or demand is relatively elastic, since the price differential caused by taxes leads to a significant change in the behavior of businesses and consumers. Traditionally, it has been considered that many tourist destinations have no clear substitutes (because of particular geographical or climatic reasons, distance, quality, etc.). This phenomenon creates monopoly power on the supply side (see, e.g., Gooroochurn & Sinclair, 2005), whereas on the demand side it means that price alterations may bring about minor behavioral changes (low elasticities of substitution). This situation calls for the use of tourism taxes as a means of an efficient collection of revenues, following the well-known prescriptions of public economics. On the other hand, when tax incidence falls mainly on non-resident tourists (that is, there is tax exportability), the excess burden or efficiency distortion disappears in the minds of the policy makers (Gooroochurn & Sinclair, 2003). Thus, tourism taxation becomes a highly attractive instrument for fiscal reform (see, e.g., Fujii et al., 1985) or to obtain extra revenues for funding new public expenditures. However, this only applies when tourists are not residents in the jurisdiction that levies the tax (e.g., foreigners in the case of central government taxes).

Regarding the second reason for tourism taxation, it could be used as a specific instrument for funding tourism-related extra costs brought about by a higher provision of public goods and services. For example, an intensive tourist activity may lead to the need for a larger supply of services or infrastructures, such as public safety, medical services, road maintenance, water supply, sewage sanitation services, garbage collection systems, etc., whose costs may not be covered by the taxes already paid by tourists. Moreover, local constituencies (councils, counties or even states) must provide adequate infrastructures to meet the demand in high seasons, investing in facilities underused during the rest of the year (Briassoulis, 2002). For instance, in the case for the Balearic Islands (Spain), one of the leading Mediterranean destinations where foreign arrivals represent more than 1% of world tourism, there is an extreme seasonal pattern, with around 80% of total arrivals in the May–September period (Roselló, Riera, & Sansó, 2004). In this context, local agents may express their legitimate concern about increased public expenditures and feel that they are subsidizing the tourist industry if these costs are not compensated by the tourists visiting the hosting constituency (Combs & Elledge, 1979). Here the tax could act as a price theoretically guided by the principle of benefit, that is, it must be paid by the users of public services according to the costs of provision. Indeed, this could be an implementation example of principle 10 of the Lanzarote Charter for Sustainable Tourism: "it is urgent that measures be developed to permit a more equitable distribution of the benefits and burdens of tourism."

Finally, the external costs resulting from tourism may be sizeable (Green, Hunter, & Moore, 1990) and, among other things, negatively affect tourist activity. Basically, this area includes congestion and environmental costs (pollution, unpleasant aesthetic effects and other factors contributing to a decrease of the quality of life for local citizens) which are not only a by-product of the tourism sector but also an input for this sector (Combs & Elledge, 1979). For instance, mass tourism may diminish the quality of the tourist experience through congested and overcrowded streets and other facilities, psychological stress on local users and visitors, and faster deterioration of natural resources and public

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