THE VALUE ADDED TAX AND TOURISM IN EUROPE

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ABSTRACT

The introduction of the Value Added Tax in England and Ireland was required for membership in the European Union. The change to this system of taxation had broad consequences for the economies of these nations. The tourist industry successful lobbied for an exemption from the tax for customers from America and the Common Wealth of nations. A multiple linear regression analysis, using the .01 level of significance, found three factors to be statistically significant predictors of the increases in sales for the largest of these company; The number of outlets, the number of visitors and the VAT.

INTRODUCTION

On January 1, 1973 the United Kingdom and Ireland were both formally admitted to the European Union (EU) by April 1 the UK had instituted a value added tax (VAT) with Ireland following suit in September. This ended a decades long debate among politicians and academia over the merits of the VAT relative to current consumption and direct taxes in existence in the UK and Ireland.

VAT "is a method of taxing, by installments, once and only once, final consumer spending in the domestic economy... [A tax imposed] as goods change hands on their way through the production and selling chain." [1,5]

There are three major arguments made in favor of the VAT over other forms of taxation. First the VAT shifts the tax burden away from more productive activity toward consumption. This should promote economic growth in the private sector. Direct taxes, like the income tax, tend to reduce work incentive. Even more important they reduce net savings and investment. Investment and savings taxes can be reduced to promote growth in the private sector.

Traditionally economists have opposed consumption taxes because of their regressive nature. The VAT is a consumption tax that can be made relatively progressive by eliminating the taxes on vital consumer goods, such as food and clothing, while increasing the tax rate on luxuries. Since the poor spend more of their scarce income on necessities and the wealthy buy more luxuries the tax burden is shifted to wealthier members of society.

Secondly VAT spreads the consumption tax more evenly over a broad range of goods and services reducing excessive taxes on particular industries, like the automobile industry, and the negative economic aspects of such a tax.

Finally, by exempting exports from the tax, the VAT favors exports over imports further promoting sales abroad. Increased exports provides jobs and growth to the national economy.

The VAT has other advantages that must also be considered. The VAT is relatively neutral. It does not favor one industry over another, except to the extent that it is used to promote social goals like tax progressiveness. This reduces the need for lobbying to gain tax advantages and also levels the playing field for business.

VAT is nearly impossible to avoid, unlike income tax. Participants in the underground economy, which is estimated to be as much as 15% of Gross Domestic Product, are no longer able to avoid taxation by dealing in cash and under-reporting income.

VAT has worked particularly well in the EU because it's standardization in 1967 by the Council of Ministers allowed for great uniformity among the member nations. It also leveled the field with respect to trade among the member nations. It further promoted trade among member states, who were taxed at the same rate as domestically produced goods. A rate which was considerably lower than the rate imposed on nonmember nations. At the same time VAT does not provide an advantage in trade to nations with lower VAT rates. Goods produced in England, with a lower VAT of 17%, pay the going rate of 22% on their goods sold in France. This further allowed member governments more flexibility in establishing tax rates to support varied levels of government expenditures, particularly on social programs. Reducing the direct tax in favor of a VAT also discourages worker movement for the sole purpose of lowering income tax burden.

Despite all of the advantages of the VAT there were some concerns about this method of taxation, particularly in the UK. The major concern was in controlling the costs of administering the VAT. Costs were monitored in part by looking at the VAT as a simple accounting procedure that could by standardized, and then training businesses in its use. Some businesses still incur extra administrative costs as the result of complexities in the law regarding exemptions and special cases. There was also a very costly one time only expense as the result of adding the VAT and phasing out other taxes.

Another major concern was over double taxing that occurs when businesses make purchases of capital for business use. They must pay a VAT on those products as well as a second tax on their own output.

These issues were addressed by the EU in their regulations regarding the VAT established in 1967. These regulations allow each member nation to set their own VAT rate within a range of 12% to 22%. The UK has one of the lowest rates in the EU of 17%, 18% in Ireland, compared to 22% in France and Germany. Further the regulations require that businesses be allowed to deduct the VAT on capital and other materials purchased for production from VAT payments on final output. Exports are exempted to promote trade and economic activity. Nations may also impose some flexibility in the rates to promote social and economic goals, upon consultation with the EU. These regulations were designed to promote a consistent levelized tax base among member states while allowing some flexibility in recognition of differences in the needs and attitudes of the nations.

THE PROBLEM

The regulation of primary concern to this paper is article ten which allows for exemptions from VAT for goods in transit, exports, and other exemptions deemed necessary by the member nation. The purpose of this regulation was to encourage exports and tax imports from non-EU nations. The effects of the regulations should increase trade and promote economic activity and growth. In 1979 the UK and Ireland, with pressure from the tourist industry, broaden the scope of these regulations to include purchases made by foreign nationals from non-EU nations within the UK and Ireland. Those individuals making purchases in England or Ireland could receive a rebate from the business. The business could then receive compensation from the government for that rebate. Some businesses imposed a price restriction exempting purchases of less than 50 pounds, to reduce the paper work. Other businesses gave the exemption to all buyers at the moment of purchase requiring special forms. Most of these businesses used a professional tax service that calculated the tax rates on exempt purchases, applied for rebates from the government and even issued checks directly to consumers for qualified purchases.

Other European nations, with a major tourism industry, had enacted similar legislation in the past. The argument for this exemption was that sales to foreigners within the nation were no different than exports made to that country. The governments concurred with respect to purchases made by non-EU citizens, which made up the bulk of the purchases in many of these businesses. EU tourist were not exempt form the tax by agreement since that could jeopardize the leveling aspects of the EU rules by encouraging nationals from high tax nations, particularly France which is close by geographically, to simply travel to England and Ireland to avoid the higher tax.

The real motivation of the tourist industry to pressure for the exemption was the fall in sales that occurred after the imposition of the VAT in 1973. Tourist sales in 1973 and 1974 fell 12% over the 1972 figures nationwide. Sales, particularly to non-EU travelers, continued to fall throughout the 1970s. The passage of the exemption in 1979 saw a modest increase in sales in 1980 that sky rocketed throughout the 1980's and into the 1990's. The purpose of this paper is to analyze the effects of the VAT exemption on sales to foreigners.

The study is based on data obtained from a major manufacturer of fine woolen products and a retailer of products from Ireland and the UK. The company headquarters are in Ireland. The company requested confidentiality as a condition of releasing sales information. The company operates 17 major outlets throughout the Britain and Ireland, making it one of the regions largest retailers. They are the largest single retailer in the tourist market and have additional sales to 2,733 smaller businesses and outlets throughout the region. In 1991 their outlet sales totaled 44.7 million with another 13.6 million in catalog sales and 21 million in sales to other retail outlets for a total of 79.3 pounds. This study examined only those sales from their outlets, which concentrate on the tourist trade. The company has important contracts with most of the major tourist operations. The outlets are always located near major tourist attractions in England, Ireland and Scotland. The outlets provided tourists with restaurant services and sales of their own woolen products as well as crystal, stoneware, and assorted trinkets from Ireland and the UK. In 1991 83% of their outlet sales were to citizens of non-EU nations, while only 9% were to EU citizens and 8% to nationals. The largest sales were to Americans (42%), followed by Canadians (18%), Australians (15%) and other common wealth nationals (20%).

THE STUDY

Table one indicates outlet sales from 1972 to 1998. Sales in 1972 reflected a growth in the tourist industry with 17.2 million pounds in sales. Sales for the company dropped significantly in 1973, the year that VAT was imposed, as they did for all similar retail businesses catering to visitors. Sales remained relatively flat throughout the 1970's. The exemption was enacted midway through the 1979 season and had no significant impact on sales. The 1980 season, the first full year of exemption for purchases, showed a dramatic increase in sales from 13.9 million to 17.4 million. This sales increase continued throughout the 80's and 90's. The sales in 1990 were nearly three times greater than those in 1979. Was the increase in sales due solely to the change in the VAT exemption or did other factors play a significant role?

TABLE I
Company Outlet Sales 1972 - 1998

YEAR	OUTLET SALES (millions of pounds)	YEAR	OUTLET SALES (millions of pounds)
1972	17.2	1984	21.6
1973	12.1	1985	23.1
1974	13.6	1989	38.2
1975	13.8	1990	42.3
1976	14.1	1991	44.7
1977	13.2	1992	48.2
1978	13.8	1993	51.6
1979	13.9	1994	51.7
1980	17.4	1995	53.1
1981	18.6	1996	55.6
1982	18.2	1997	59.9
1983	21.3	1998	62.2

To find out a multiple linear regression analysis was developed that examined other factors, which became the independent x variables. The regression model was:

$$S1 = Bo + B1ln1 + B2N01 + B3Iv1 + B4CE1 + B5V1 + B6ExR + e$$

Annual Sales to Non-EU Citizens (Dependent variable) S1 for each year from 1972 to 1998. The company sales figures to citizens of non-EU nations were used as the dependent variable.

Independent variables

The Rate of Inflation. (In1) Price inflation alone might explain the increase in sales figures during the period. It was important to use annual increases in the inflation rates to determine if they were a significant factor in determining sales increase.

The Number of Outlets. (N01) The company increased the number of outlets from 3 in 1973 to 17 in 1991. The greater the number of outlets the greater the exposure of the product. It was important to determine if that increase in the number of outlets was responsible for the changes in sales.

Increases in the number of Visitors to the Business. (Iv1) The company registered an increase in the number of visitors to their establishment. These increases alone could account for higher sales.

Changes in Total Export Sales for the UK. (CE1) Export figures fluctuated for total sales. The increases may be a reflection of total export increases.

VAT Effect. (V1) The VAT effect was measured with three dummy variables. A zero indicated pre-VAT revenue years (1966 - 1972), a one was used for the exemption years (1980-1998) and a 2 represented the VAT years with no exemption (1973-1979). The assumption is that the VAT exemption resulted in increased sales over the nonexempt years to a level enjoyed before the imposition of the tax.

Average Annual Exchange Rate. (ExR) The rate of exchange between the British/Irish Pound and the Dollar should have some impact on sales.

Error Term (e)

CONCLUSIONS

The multiple linear regression analysis, using the .01 level of significance, found three of the statistics to be consistently significant predictors of the increases in sales for the company.

The number of outlets, was as would be expected, a significant factor for every year except 1978 and 1984. Two new outlets were added in both 1985 and 1987 and sales increased most dramatically. Sales dropped in 1982, the same year that one outlet was closed.

The number of visitors also turned out to be significant for every year except 1984. There was some fluctuation but the overall increases in sales matched the overall increases in revenue.

Finally, the VAT was a significant predictor for every year in the study. Sales dropped significantly with the introduction of VAT in 1973, but increased significantly when the exemption was instituted in 1979. None of the other factors were consistently significant at the .01 level. The exchange rate factor was significant in 1982, 1984 and 1989 but not in any of the other years. This was surprising since that factor would seem to be significant in determining total sales. This may be explained by the fact that average exchange rates did not fluctuate dramatically during most of the years in question.

The t-statistic supported the finding of the regression analysis. All of the signs in the study were positive.

Other factors may have also played an important role in the increase in sales over time that were not included in this study. The recognized quality of goods may prove to be an important factor. This factor was left out because of the difficulty in quantifying such a subjective element. Competition pricing policies and frequency of special pricing "sales" may have also been important contributors to total income but data for those statistics were not available to the investigator.

There is further indication of the effect of VAT on sales to non-EU citizens in the fact that the per customer expenditure also increased after the tax exemption was introduced. In 1979, the last year visitors paid the VAT, sales per customer for non-EU buyers was an average of 138 pounds per sale. Sales per customer jumped significantly to 225 pounds in 1981. There was no change in the average purchase of EU citizens during the same period. Since EU visitors did not benefit from the exemption their purchase volume remained constant.

Another indication of the importance of the VAT exemption on sales to visitors was the increase in the percentage of sales going to non-EU citizens after the exemption was created. While the total number of sales transactions increased between 1979 and 1985, sales to domestic and EU visitors actually dropped slightly. In 1979 sales to EU citizens constituted 11% of the total customer base and sales to local residents 16%. In 1985 sales to EU visitors constituted only 9% of the total, a 2% drop, and the percentage of sales to domestic citizens fell from 16% to only 8% of the total. There was only a slight drop in the actual number of EU and domestic purchases per customer, less than 1%, however their was a big increase in the number of sales to non-EU citizens and an even bigger increase in the average value of sales per transaction. All of this indicates that the exemption of foreign travelers from the VAT did encourage sales. This company's policy was to refund the tax on the spot for customers buying in excess of 50 pounds worth of merchandise. This service reduced paperwork and waiting for the consumer making the rebate more attractive than a direct refund from the government, which requires up to one year processing time.

Another explanation for the increase in sales per visitor is the 50 pound limit imposed by the company to qualify for the exemption. It is important to note that the law does not require merchants to exempt foreign visitors, it merely makes it possible for them to pass on an exemption savings. The 50 pounds exemption limit could cause an increase in sales per transaction. For example, a person purchasing 40 pounds worth of material would get no exemption rebate directly from the establishment. The additional purchase of an item for ten pounds would qualify them for the exemption and a savings of 8.5 pounds, well worth the additional costs. The effect is to encourage additional consumption, particularly at the margin. While exact sales figures are not available for other tourist oriented businesses the general trends seem to apply to the industry as a whole making it possible to assume that the effects of a change in the VAT favoring foreign visitors were felt in sales growth for the entire industry. Industry wide sales figures to tourist grew at an annual rate of 11%, well above the annual inflation rate for the period after 1979, and only slightly lower than the 13% average rate for the company in this study.

The VAT has become a significant source of revenue for the government of the UK and Ireland. The tourist industry has exercised its considerable clout in providing an exemption for foreign visitors that has encouraged domestic sales and income but at a loss in revenue of approximately two billion dollars to the government. However, the increased sales of over 3.7 billion to tourist may offset the VAT losses in higher payroll taxes and reduced unemployment costs. Government analyst have taken that position and thwarted at least two attempts by the British Parliament to revoke the special exemption.

The American Congress has considered using the VAT as a new source of revenue for the Federal government. Opposition from the states, who have become very depemndnet on the sales tax as a source of revenue, has prevented the congress from taking action on this tax. One of the implications of this study for governmtnet is to condider the pressure form lobbying groups to alter such a federal tax in support of their industry. This is a cautionary warning about the problems associated with a consumption tax.

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