

Air Departure Tax

A Post-Brexit Analysis

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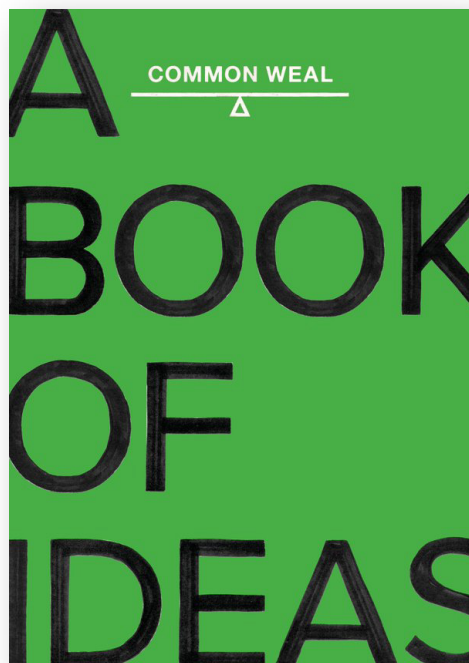
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Executive Summary

This report forms a response to a request for opinion on the Scottish Government's plan to cut Air Departure Tax (formerly Air Passenger Duty) by 50% starting in 2018 and to eliminate it entirely at an unspecified future date. There is significant evidence that the economic impacts of the cut will not be as great or as beneficial as has been claimed.

Key Points:-

- Even under the most optimistic circumstances put forward by proponents of the tax cut, additional revenue is unlikely to replace revenue lost by the cut.
- The case for increases in tourist traffic is substantially undermined by the impact of cheaper tickets inducing more domestic tourists taking foreign trips instead. Overall tourism numbers are at risk of reducing as a result of this tax cut.
- The spending of inbound tourists are generally more weakly linked to the economy than the domestic consumers who more likely to be induced to leave which may lead to a reduction in gross value added to the economy even if tourist spending remains constant.
- The reduction of the value of the pound sterling in the aftermath of "Brexit" is likely to have a substantially greater impact on tourism than the ADT cut is capable of inducing. The tax cut can only partially subsidise this Brexit effect.
- The case for business growth due to a cut in ADT appears particularly weak as business flights are driven by need and time pressures rather than price.
- The case for an ADT cut encouraging more visits to Scotland for the purposes of international trade and business deals is particularly weak as long haul business flights between the UK and the US and Asia is almost entirely price insensitive.
- If an ADT cut results in a transfer of revenue from ADT to corporation tax there may be deeper implications for the robustness of the Scottish budget under the devolved tax structure. This will be exacerbated in the case of corporate profits transferred outside of the UK entirely.
- Whilst the economy most directly linked to airport traffic will see an increase, this increase will ultimately be capped by the capacity of the airports in question. The seasonal nature of tourist traffic will exacerbate this impact.
- The greater impact on the transport network due to increased traffic needs to be considered in light of this proposal as do the economic imbalances created by the ADT cut inducing greater traffic in the Central Belt but little growth elsewhere.
- If the reduction in revenue due to the ADT cut is not at least recouped in full then additional cuts in public spending may be required. The negative impacts on the economy of this additional austerity would then be dependent on precisely where those cuts occurred.

Introduction

Air Passenger Duty was first announced by the UK Government in the 1993 budget and was introduced in 1994 as a tax paid by any passenger departing from a UK or Isle of Man airport and levied according to the destination with longer flights charged more than shorter ones (special exemptions made such as for international passengers on connecting flights and leaving the UK within 24 hours of arrival or for small aircraft such as those serving the Scottish islands). Currently it is levied according to two bands with Band A covering shorter (<2000 miles as measured between London and the destination country's capital city¹) and Band B covering longer (>2000 miles) journeys and according to three rates namely Reduced (for the lowest cost seats), Standard (for any other seat) and Higher (for non-exempt aircraft weighing more than 20 tonnes and with fewer than 19 passenger seats).²

Air Passenger Duty / Air Departure Tax (2016-17)	Reduced Rate	Standard Rate	Higher Rate
Band A	£13	£26	£78
Band B	£75	£150	£450

The devolution of powers over air passenger duty to the Scottish Government was granted as part of the Scotland Bill 2015 and is due to be in place not later than April 2018, by cutting the tax initially by 50% and then eliminating it altogether “when finances allow”. On the 14th March 2016, the Scottish Government launched a public consultation to seek views for or against this policy. This report takes on the views of The Common Weal and presents them as a contribution to the consultation.

The Case Presented For the Cut

The Scottish Government's case for a cut and eventual elimination of air passenger duty is based on three economic premises. First, it shall increase the profitability of business trips undertaken from Scotland and shall encourage trips to Scotland for the purposes of business negotiations and deals. Second, it shall increase net tourism in Scotland thus provide a direct economic boost to the tourist sector and, indirectly, to the wider economy. Third, it shall increase traffic within the airport service industry itself and boost economic activity undertaken whilst people are travelling. Together, it is claimed, these positive economic impacts will result in government revenue exceeding that lost directly by the cut in ADT.

These cases have been largely drawn from two studies undertaken by the airport industry sector themselves. Once by Edinburgh Airport³ and other by finance company PwC on behalf of a consortium of airlines including EasyJet.⁴

This report shall look in detail at the claims made in these papers to support the three growth factors that the Scottish Government are aiming to achieve. The report shall also draw on additional resources where required such as a prominent study into the impact on passenger flow due to taxation, prices and incomes by IATA.⁵

Throughout this report much of the discussion will be spoken of in terms of “price elasticity” which is a measure of how much demand for a service changes as a function of price. For example, if a tax rise increases costs by 1% and this results in a drop in demand of 0.3% (or if a price reduction of 1% causes a 0.3% rise in demand) then the price elasticity is said to be -0.3. Any service in which elasticity is greater than ± 0.5 is considered to be “price elastic” (i.e. it is significantly affected by price changes), whereas if the value is less than ± 0.5 then the service can be said to be relatively price inelastic.

The Impact on Business Travel

According to the Edinburgh study business travel makes up approximately 31% of all air travel departing from a UK airport with around two thirds of that consisting of intra-UK domestic travel. According to both Edinburgh and IATA business travel of all kinds is particularly inelastic with regards to pricing as business requiring the physical presence of a worker will generally occur regardless of cost. The author has had personal experience of this kind of impact within the context of a previous occupation which required frequent flights (>20 over the course of a year) to various destinations in Europe and the United States. In only one instance would it have been possible to substitute a flight for one by road or rail in an economically viable manner and all of the trips were time sensitive enough that cost was not generally a significant factor in the decision making process.

Edinburgh estimates precisely zero change in behaviour for all international business travel except for European travel (-0.3) and domestic business (-0.3) and freely admits that this kind of travel will have little impact on the business community.

One aspect seems self-evident but also appears to have not been studied at all. ADT is collected directly at the point of purchase of the ticket and will be collected directly by the Scottish Government. If the ADT cut translates simply into reduced transport costs and hence increased final profits for a company and even assuming that the company is legally domiciled in the UK (and assuming that it uses no accounting mechanisms to transfer its profits outside of the country) then the ADT cut may be partially offset by a rise in revenue in corporation tax. However, as corporation tax is not collected by the Scottish Government and is a reserved power, there may be implications both in terms of funding via the Block Grant and in terms of the structure of devolution itself if tax revenue is transferred outside of the

Scottish Government's control. This impact may be worse in the cases of companies which do not pay corporation tax in the UK as this revenue would essentially become lost entirely.

The secondary aspect of the business case lies in cheaper flights attracting longer term business growth via making Scotland more attractive as a destination to conduct trade deals and other business linkages. Given that longer air journeys to the markets with which those deals are likely to be conducted (for example the US or South East Asia) are entirely inelastic there simply does not appear to be a mechanism by which a cut in ADT could leverage this effect. The flagship aspect of the proposed ADT cut is its claimed ability to make Scotland a more attractive location to visit by tourists. The three major studies highlighted here, Edinburgh, PwC and IATA, are all in broad agreement that lower prices and, in particular, prices undercutting similar nearby markets, are significant drivers of traffic towards a particular location although IATA and PwC are both careful to highlight that it is growing income in general which is the largest driver towards making a leisure flight in the

The Impact on Tourism

first place. IATA specifically states whilst destinations may change in response to local price cuts total travel does not and that this would “significantly limit the effectiveness of national passenger taxes as a way of managing demand or limiting the rise of greenhouse gas emissions from air travel”.⁶

The primary apparent flaw in the rationale behind the attraction of more tourists to Scotland via an ADT cut lies in the elasticity of outbound Scottish holidaymakers as well as inbound tourists. The Edinburgh study makes great effort to show the increased traffic inbound to Scotland but, unlike IATA, does not appear to mention the effect of Scottish holiday makers taking advantage of cheaper flights over what would have otherwise been a domestic holiday.

Data from VisitScotland⁷ estimates that in 2015 5.85 million trips were taken in Scotland by people from Scotland whereas only 2.7 million trips to Scotland and 12.27 million total by tourists from anywhere in the UK. This is compared to the 2.59 million trips which were taken by people from outside the UK. Data from The Association of British Travel Agents also indicates that people from Scotland take around 5.2 million trips overseas every year.⁸ This suggests that a small percentage rise in outbound tourism may more than counteract a larger percentage rise in inbound tourism and therefore lead to a net tourism decrease.

The situation is complicated further by the relative spending of tourists to from various origins which may be more elastic than others. In general, tourists from ADT Band A countries served by low costs flights such as Europe will be reasonably elastic (Edinburgh: -0.7) whereas longer haul flights to the US, Australia, Asia etc will be inelastic (Edinburgh: -0.3).

IATA highlights the impact of changes in flight taxation and specifically draws attention to the differential elasticity caused by these taxes on domestic outbound and foreign inbound tourists.⁹ They apply an estimated additional elasticity multiplier of 1.3 for inbound tourism and 0.8 for outbound tourism. This means that a trip with a base price elasticity of -0.7 would actually experience a price elasticity of -0.09 for inbound travellers and -0.56 for outbound travellers.

The final point required to be able to calculate the impact of changes to ADT is the magnitude by which such a change would affect flight prices. This is a complicated issue as ADT is calculated as a flat payment whereas flight prices are extremely variable based on destination, season, time of booking and a myriad of other factors. Data from Skyscanner suggests that ADT in both Band A and Band B regions during peak seasons makes up between 5% and 15% of the total flight price. A median figure of 10% is assumed for the purposes of this report thus a cut in ADT of 50% shall reduce flight prices by 5%. Combined with the other factors outlined previously, it is therefore expected that demand for any particular flight route shall increase by between 1.2% and 4.6% depending on overall elasticity.

The table below extracts data from VisitScotland¹⁰ and the UK Government's Travel Trends¹¹ database to attempt to estimate the impact of these various elasticities and forcings on travel numbers by travellers to Scotland from the top ten countries of origin (which includes more than 70% of all non-UK tourists to Scotland).

Country of Origin	Inbound trips before ADT cut	Additional inbound trips due to 50% ADT cut	Outbound trips before ADT cut	Additional outbound trips due to 50% ADT cut
USA	409,000	7,976	264,174	3,170
Germany	323,000	14,697	151,218	4,234
France	196,000	8,918	317,799	8,898
Netherlands	157,000	7,144	150,231	4,206
Spain	146,000	6,643	1,211,860	33,932
Australia	142,000	2,769	36,590	439
Canada	98,000	1,911	48,736	585
Italy	92,000	4,186	199,436	5,584
Poland	87,000	3,956	114,285	3,200
Ireland	78,000	3,549	112,339	3,145
Total Additional Trips		61,750		67,395

The numbers for additional inbound tourists tie relatively closely to those implied by the Edinburgh study but, as can be seen, the number of additional outbound tourists exceeds this number and thus implies that the cut in ADT could lead to a net reduction in tourism within Scotland.

With regard to intra-UK tourism, whilst domestic leisure flights are relatively elastic (-0.7), only approximately 6% of English and Welsh tourists travel to Scotland by aircraft. The vast majority either drive (69%) or arrive by train (16%). It could be expected that some of this travel may transition to travelling by plane in the event of an ADT cut but, as indicated earlier, it is unlikely to significantly increase total tourist volume as the overall impact will be subject to the same bi-directional traffic increases as international travel.

When the increased carbon footprint per passenger mile of aircraft compared to train and even car is included in these considerations, the Scottish Government should reflect carefully on this potential transition with respect to their carbon emission targets.

A final factor which may influence tax policy considerations lies within the spending patterns of foreign tourists compared to domestic consumers was uncovered within the PwC study¹² which found that:

“[T]he positive effects of increased foreign tourism spending have weaker linkages with the rest of the economy. Foreign tourists tend to purchase a more limited range of lower value-added goods and services than domestic consumers. The net effect is a reduction in domestic production and consumption.”

In other words, even if inbound tourists match both the numbers and spending power of outbound tourists, their differing spending habits may lead to a decrease in GVA. This would run directly contrary to the stated goals of an ADT cut.

It is worth noting at this point that the Edinburgh study estimated that tourism expenditure growth due to the tax cut would be around £68 million per year and that overall GVA would increase by up to £200 million per year by 2020. Even if this upper range were reached despite the loss of GVA from formerly domestic tourists, the overall tax revenue growth from this GVA increase is unlikely to replace the £137 million revenue lost from a 50% reduction in ADT.

The shape of an economy is perhaps as important as its sheer size in GDP terms and the stated goal of the ADT cut is to attempt to boost the relative size of the inbound tourist industry. However it may be more effective to devise and implement a policy which has the effect of boosting inbound tourism in Scotland which does not also encourage domestic tourism to go abroad. Such a policy would have a far stronger positive impact on the tourism industry than a cut to ADT appears capable. It is clear that focusing simply on a change in GDP may not give a complete picture of the impact of the proposed change in taxation.

The Impact of 'Brexit'

The analysis above so far discounts the impact of the 2016 referendum decision for the UK to leave the European Union. The referendum decision had a particularly significant impact on the value of the pound sterling (GBP) compared to other currencies with the GBP falling in value by 15% compared to the euro (EUR) and by 20% compared to the US dollar (USD) since June 2015. Unlike the case of the ADT cut which would make flights cheaper for both inbound and outbound passengers, the drop in the value

of the currency has the effect of making holidays cheaper for inbound tourists from Europe whilst making them more expensive for Scottish tourists wishing to travel abroad. Further, this price impact has an effect on the entire price of the trip not just the price of the flight therefore can be expected to be a far larger contributor to the decision making process. It can therefore be seen therefore that the currency devaluation will have the effect of encouraging inbound tourism whilst discouraging outbound tourism.

For example, an average Scottish holidaymaker travelling to Spain would find that a trip which would have cost them £541 per trip in 2015 could rise by up to £106 to £647 whereas the proposed 50% cut in ADT would only reduce that bill by less than £7 per trip at reduced rate and even the elimination of ADT entirely would reduce the price by only £13. Similarly, an average trip to the USA which cost £1,450 in 2015 may cost closer to £1,800 at current exchange rates whilst ADT only contributes £75 of this total spend at reduced rate and £150 at standard rate.

A cut in ADT – or even the complete elimination of the tax – can therefore only partially subsidise the impact of Brexit upon the spending power of outbound tourists.

The Impact on Airport Traffic

With a potential increase in both inbound and outbound traffic it is reasonably indisputable that the airports themselves will be a beneficiary of any cut in prices. Edinburgh airport in particular derives around half of its total income from aircraft landing charges and baggage handling and around a third from retail sales and parking charges.¹³ The Edinburgh study caveats its growth projections for Scotland wide airports by re-iterating that growth will be greatest in airports which see a higher proportion of leisure traffic such as Glasgow and Edinburgh whereas business oriented airports such as Aberdeen and Inverness will not be significantly affected due to the previously mentioned inelasticities in this sector. Ultimately this growth will be limited by the overall capacity of the airports in question particularly at peak tourist travel seasons. Glasgow in particular is operating already at near peak capacity (8.7 million passengers served in 2015¹⁴ compared to a rated capacity of 9.0 million¹⁵) and whilst Prestwick, which has recently experienced a substantial decline in passenger traffic, could reasonably be assumed to take up some of that capacity the subject then must turn to the topic of the capacity of local wider transport infrastructure, for example the long discussed Glasgow Airport Rail Link (GARL), which itself may require careful planning. Another consideration must be that if traffic and investment is increasing substantially in the Central Belt due to the proposed ADT cut but not in Aberdeen, Inverness or other areas not closely served by an airport then an economic imbalance may be created and some form of redistributive measures may need to be taken.

Conclusion

The economic case for a cut and eventual elimination of ADT appears far less strong than has been claimed by proponents. The business case in particular appears very weak or almost non-existent as business traffic is not particularly price sensitive. The implications for the overall Scottish budget under the incoming devolved tax structure reveals some potential vulnerabilities with regard to the revenue from the devolved ADT transferring either partially to the reserved corporation tax or being transferred out of the UK entirely. Additionally, if any or all of the impacts highlighted in this report occur and result in the loss of revenue from the ADT cut (some £153.5 million per year for a 50% cut) not being at least fully recouped by growth in revenue from other sources then additional cuts in public spending may be required. The negative impacts on the economy of this additional Austerity would then be dependent on precisely where those cuts occurred. The case made for tourism growth appears to be weakened by the lack of consideration for an increase in outbound tourism countering the increase in inbound tourism. A case has been made that the effect will be an overall net decrease in the amount of tourism within Scotland and a reduction in the gross value added to the economy by tourist spending.

The direct economy of the airport infrastructure is likely to increase as a result of increases in both inbound and outbound tourism but this increase will ultimately be capped by the carrying capacity of not only the airports but the transport infrastructure surrounding them. Further, the increase will disproportionately benefit the Central Belt of Scotland whilst leaving the North East airports and areas of Scotland not well served by any airports largely unaffected. The infrastructure requirements and economic imbalances would need to be addressed as part of the larger economic plan associated with the tax cut.

A holistic approach to policy-making – which analysed tourism in the round, took a realistic attitude towards business travel and considered Scotland as a totality and its respective transport needs – would be greatly preferable to a clumsy slashing of a single tax power.

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