

EXTERNALITIES AND TOURIST TAX

EVIDENCE FROM ITALY

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ABSTRACT

During the last 60 years, international tourist arrivals increased despite the 2001 and 2008 economic shocks. Tourism has become a mass-consumption practice. And it also happened thanks to price reductions, due to low cost flights and last minutes, that overcame seasonality and created a sort of routine in tourism consumption. While the economic benefits generated by tourism are quite clear, since they are related to increasing production and an higher employment rate, a deeper focus is needed on its negative impacts such as congestion and environmental degradation. Indeed, tourism is a good with external costs, because it is associated with negative externalities due to both the supply and the demand. In order to internalize external costs so that they can be reflected in the market price, governments increasingly levy specific tourism taxes.

Keywords: externalities, fiscal policy, market failures, tourism, tourist taxation.

1. TOURISM MASS CONSUMPTION

During the last 60 years, international tourist arrivals increased despite the 2001 and 2008 economic shocks. In 2010, in the middle of the financial crisis that hit many advanced and developing countries, international tourist arrivals grew by 6.6% (23 millions), totaling 940 millions. In the same year, international tourism receipts rose by 4.7% respect to 2009, getting to 610 billions of euro.

These data show that tourism has become a mass-consumption practice. And it also happened thanks to price reductions, due to low

cost flights and last minutes, that overcame seasonality and created a sort of routine in tourism consumption. It is then unbelievable that the economics literature does not provide an extensive and modeled theoretical analysis of tourism particularly regarding the public regulation of tourism and social welfare¹.

2. TOURISM EXTERNALITIES

Indeed, even though tourism increases GDP and helps developing countries to grow, yet it is not costless. Tourism has been considered as a low environmental-impact industry for a long time, but in recent years we found that tourism supply and tourism demand have significant economic impacts both at the microeconomic level, since they modify local supply, and at the macroeconomic level of GDP and economic policies, since national government have to deal with it and with the consequences that it produces.

While the economic benefits generated by tourism are quite clear, since they are related to increasing production and an higher employment rate, a deeper focus is needed on its negative impacts such as congestion and environmental degradation (Gooroochurn - Sinclair, 2003, 2005).

Indeed, tourism is a good with external costs, because it is associated with negative externalities due to both the supply (new infrastructures and new hotels mean landscape deterioration) and the demand. The entry and the stay of tourists cause congestion, pollution, rising cost of living, conflict between them and resident, overuse of natural and heritage resources, congestion in the use of tourism-related infrastructures, such as roads, highways and airports.

This happens because social costs deriving from the production process are not taken into account by private firms.

It is generally recognized that externalities are the major reason that an economy might not rely only on market system in order to allo-

¹ Chang *et al.*, 2011.

cate resources, because when an external cost is present, the quantity of a good produced by the market is greater than the efficient quantity. In presence of consumption externalities, markets do not provide the optimal level of the produced good and this creates a wedge between private and social costs, because private costs related to the production process are lower regarding to the social costs that affect the whole community. That is, the inflow of tourists may generate extra public costs related to the provision and conservation of local natural resources and it is well known that natural resources are crucially important to tourism. It is also well known that, since they are public goods, environmental resources are subject to market failure. It means that their utilization is non-optimal, since they are overused; this way, the production of tourism-related goods presents limited returns, because the prices of natural resources cannot be fully internalized.

Mainly for such destinations with limited tourism-carrying capacity, negative externalities may be critical in the face of remarkable tourism inflows. In this case, costs related to the tourism service cause the reduction of welfare of the local population. This inefficient allocation may be rectified by imposing a tax on those who are responsible for the environment deterioration.

Since externalities are not usually taken into account by individual firms, tourism expansion is undoubtedly more desirable to an individual firm than it is to society. So, in order to re-establish a social welfare equilibrium, in the presence of higher externalities, a higher rate of tax is necessary.

3. DEALING WITH EXTERNALITIES REDUCTION: HOW TO INTERNALIZE SOCIAL COSTS

It is a shared opinion that when market presents negative externalities, external costs should be internalized by governments, that should introduce a specific taxation. Among the public policies that the public sector could implement, taxation plays a fundamental role, both for the corrective function that it may grant and for the volume of the poten-

tial tax revenue. Taxes can be imposed both on tourism enterprises and on tourism consumers and, this way, tourism taxation may correct for market failures that affect this productive sector. Tourism industry may be taxed through airline fuel taxes or, in most cases, taxes related to the use of other natural resources (like carbon). Taxation on tourists may be much wider, including taxes like departure tax, transit tax, VAT or sales tax, bed-night tax.

Tourism taxation may give rise to higher revenues that governments may spend in order to give impulse to the development of the sector, or also to provide infrastructures and new services for resident population. Governments find themselves needing to choose which tax to levy and on whom. In the literature, it is widely accepted that taxation should respect the following principles: equity, efficiency, stability, simplicity and cost effectiveness.

In the theory developed by Musgrave², we find two different doctrines for equity. The first one is based on the benefits people get by using public services. The second one is related to the ability of each individual to pay.

According to the benefit doctrine, a system is equitable only if each taxpayer who has a benefit from public services contributes to the provision of those services.

The doctrine focused on the ability to pay posits that each taxpayer should contribute to the provision of public services in line with his ability to pay. This doctrine also distinguishes between horizontal equity and vertical equity. Horizontal equity is reached when people with equal ability actually pay the same amounts, while vertical equity is granted when a progressiveness criterion is satisfied and people with greater ability pay more.

From an efficiency point of view, the ideal taxation is consistent with Pareto optimal allocation. In a Pareto optimal allocation of resources, there is no further improvement from an individual, without detracting from elsewhere. If we take into consideration the Pareto optimality, the optimal tax is simply a lump-sum tax. Some examples for tourism service could be visa charges, departure taxes or even air

² Musgrave, 1959.

travel taxes. Also a VAT modification may be used: governments could raise VAT or its local equivalent. This choice reveals itself to be optimal also under a strategic point of view: indeed, voters seem to be less conscious of consumption tax increase than changes to income tax rates. Furthermore, VAT has the characteristic of being non distortionary on the relative price set that consumers should bear.

All of this considered, lump-sum taxes would seem to be the perfect choice for governments that decide to levy a tourism tax. Anyway, lump-sum taxes perfectly work when there are no market imperfections, such as an externality and only if we assume that all the consumers in society have the same preferences. Besides that, lump-sum taxes are rarely used because they fall equally on each member of the society, whether rich or poor, placing a greater relative burden on the latter.

These are the reasons why the most common method is to use a Pigouvian tax. As we know, Pigou argued that, in presence of negative externalities, indirect taxes can be used to improve the efficiency of market allocation. With reference to the tourism sector, external costs caused by congestion or pollution, for example, can be internalized if polluters (in our case, tourists) pay a tax which value is equal to the one of the external cost.

A Pigouvian tax corrects for the divergence between the market price and the social marginal cost. Indeed, in order to internalize external costs so that they can be reflected in the market price, governments increasingly levy specific tourism taxes, for two main reasons.

The first is related to the classic argument governments use for a tourist tax, that is to allocate to the supply price the external costs that otherwise local community should pay for. This way, tourist tax would correct for market failure. Revenues raised by taxation would be reinvested to ensure the sustainability of the local destination and would be used to provide public amenities for tourists and residents.

There is a second rationale for this in so far as tourist taxation generates revenues that governments can use for specific purpose. As the United Nations World Tourism Organisation noted: «Not only are tourists easy to collect taxes from (i.e. when they buy their airline ticket, depart or arrive at an airport or pay their hotel bill), but it is often the case that the tourist will not be a voter in the country or region where

the tax is levied». It is obviously needed that governments levy taxes on overseas tourism, rather than on domestic one. Indeed, a welfare-maximizing government, in order to raise revenues from overseas tourism taxation, has to discriminate between domestic and overseas tourism consumption and impose a tax surcharge on foreign tourists. Some governments are able to discriminate between domestic and tourism consumption and tax the latter at a higher rate.

In addition to levying a general tourism tax, in the social optimum the government should also discriminate between domestic and overseas tourism consumption, in such a way that a positive tax surcharge is imposed on foreign tourists to generate more revenues from taxes on overseas tourism. Our study has also shown that the optimal rate of tax surcharge is decreasing in terms of both the elasticity of foreign demand for tourism and the congestion externality of tourism.³

Taxing tourism may be more efficient and equitable than levying tax on other sectors⁴. Indeed, tourism tax can lead to an higher domestic welfare. Tourists raise the demand and an higher demand means more revenues due to an higher tax base.

4. TOURISM TAX IN ITALY: SOME CRITICAL ISSUES

In Italy, national government doesn't charge any tourism tax, but a recent legislative decree established that local governments are free to decide their own policies. Since the Italian central government has to deal with the financial crisis (like many others), during last years, it tends to delegate to local governments the collection and management of many local taxes. Italian regulations allows bigger cities and tourist cities to impose a tourism room tax. Accommodation taxes are quite common since they are easily collectable and have a large base.

To be defined as a tourism city, each one has to receive a sort of authorization by the local government. Indeed, the legislative decree

³ Chang *et al.*, 2011.

⁴ Gooroochurn - Sinclair, 2005.

n. 23/2011, article 4, establishes that subjects as bigger cities, unions of municipalities, art cities and touristic cities may levy a tourist tax which maximum amount should be less than € 5.00. The principle is that tax should be proportional to the hotel category. The legislative decree also affirms that the revenues collected thanks to the tourist tax should be used in order to improve tourism, including specific maintenance interventions for natural and cultural heritage.

After refining the framework, when we started to deepen the analysis, some issues rapidly arose. Our intention was first to isolate every city or town that adopted a tourism tax and then to understand which kind of tax each local government chose and how they fixed the amount corresponding to the different types of accommodations. Since, in most cases, taxes have been levied since last summer, it was too early to understand the wider effects derived by the application of the tax. We could only try to delineate which were the conditions that favored (or rather that caused) the imposition of this new tax burden. So, as an early stage analysis, we hypothesized that some factors exercised influence over this decision that actually has strong political and strategical implications.

Anyway, as we anticipated, the first empirical approach to tourism taxation in Italy presented some problems. First of all, the entry of each town in the regional list. Each regional government had to draw up a list of the towns to which allowing the adoption of a tourism tax. We can see the ratio beneath this strategical decision. Indeed, local governments surely better know the geomorphological, cultural and natural characteristics of the area. Anyway, this decentralization may provoke a lack of homogeneity among the towns that may or may not levy a tourism tax according to the regions in which they are located. This is maybe the reason why, recently, national government declared that every municipality will be in the position to choose whether or not to impose a tourism tax and will need no longer to be included in any regional list.

Another critical issue is related to the national coordination of the municipalities that have imposed a tourism tax. Indeed, since there is no obligation for these municipalities to communicate their decision to a central authority, at the moment is almost impossible to know the

exact number of the municipalities that already adopted a tourism tax. This is the reason why, despite the intentions, we are not presenting a full list of these municipalities, that we only present in the statistical appendix. The attempt we made cannot be considered as exhaustive and it can't even be used for further statistical elaborations.

The lack of a coordination by the central government has also some kinds of political implications. Indeed, national government has no chance to control the process even in order to make the necessary adjustments. From a strategic point of view, the fact that national government does not know how many municipalities adopted a tourism tax weakens its role and its ability of managing even the political strategies related to the collection of revenues⁵. We noticed that there is also some confusion about the application of the tax. Indeed is not unusual to find that some hotels included the tax in the final price, while some others leave it separate.

Finally, many years ago, Fish⁶ showed that, in some cases, even if government imposes a tax on hotel bednights, hoteliers cannot increase prices, because they have to face a strong competition from other similar destinations. And we do know that this is the case of Italy, especially regarding the sea towns. National and international tourists may choose Croatia, Spain or Greece even thanks to the lower prices they offer. All these factors made it impossible for us to continue with a quantitative study and forced us to carry out a qualitative analysis.

5. TOURISM TAX IN ITALY: A QUALITATIVE ANALYSIS

Tourism tax in Italy essentially is an accommodation tax. Indeed, room taxes meet the criterion of effectiveness: they are simple, have Pigouvian properties and allow local governments to capture some of the revenues generated by tourists inflow in their destination.

⁵ National government doesn't collect revenues. Municipal governments have the duty to collect tourism taxes.

⁶ Fish, 1982.

There are many municipalities that adopted tourism tax since its introduction: this is the case of famous cities like Venice, Rome, Florence, Palermo or Taormina. We won't linger on the critical issues that emerged during the research, to which we decided to dedicate an entire paragraph, in which we explain the reasons why we couldn't statistically treat the collected data. So, we will only try to outline the main characteristics of the tourism taxes that have been adopted by the Italian municipalities.

Our first observation is that, in most cases, tourism tax respects the principle of progressiveness. In Italy, accommodation facilities are usually rated with stars, from 1 to five (or plus). By and large, hotels (or similar) with no stars or with one or two stars are charged with tax which maximum amount is 1 €. Structures with 5 stars are charged with a tax which amount varies from 3 to 5 €. As we said, the evidence showed that, in almost every case, progressiveness is related to the rating of accommodation facilities. Only Ancona chose to link progressiveness to the amount spent for an overnight stay. For example, after the application of the tax, an overnight stay which amount is less than 20 € will be charged with an extra amount of 0,50 €, a price less than 50 € will be charged with 1 € and so on.

Secondarily, in almost every municipality tourism tax is levied on a maximum of overnight stays. There is no municipality that overcomes 15 nights. In some cases, the amount of the tourist tax is higher for the first days and then in declines for the remaining days.

Finally, almost everywhere, municipalities provided some kinds of exemption. Usually, young people aged less than 13 are not charged, as well as disabled people with their companions and, often, coach drivers and tourist guides.

6. CONCLUSIONS

During the last decades, tourism has become a mass-consumption practice, even thanks to significant price reductions. Due to the huge volume of national and international tourists, we finally found out that tourism is a good with external costs.

It is a shared opinion that, in the presence of negative externalities, governments should find the way to internalize external costs and they may do this by introducing a specific taxation. Higher revenues collected this way may be spent by governments to develop tourism industry, or even to provide infrastructures and new services for resident population. This is why even Italian government recently approved a legislative decree that allows municipalities to levy an accommodation tax. To do so, each regional government had the duty to draw up a list of the municipalities that could adopt the tourism tax.

Our analysis of this phenomenon, that should have been quantitative, has been strongly affected by some critical issued that immediately emerged.

First, the decision to decentralize the management of revenues collection finished to provoke a lack of homogeneity among the municipalities that could levy a tourism tax and those that could not, only on the base of the regions in which they are located. Probably even to solve this situation, very recently, national government established that every municipality will be in the position to choose whether or not to impose a tourism tax and will need no longer to be included in any regional list.

Second, since there is no obligation for the municipalities that chose to levy a tourism tax to communicate their decision to a central authority, at the moment is almost impossible to know the exact number.

These factors made it impossible for us to continue with a quantitative study and forced us to carry out a qualitative analysis.

The main outlines worth highlighting are:

1. that many municipalities adopted tourism tax since its introduction;
2. that tourism tax respects the principle of progressiveness;
3. that, almost everywhere, municipalities provided some kinds of exemption.

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RIASSUNTO

Nel corso degli ultimi 60 anni, gli arrivi turistici internazionali hanno mostrato un andamento di crescita pressoché costante, nonostante le crisi economiche del 2001 e del 2008. Grazie anche alla riduzione dei prezzi di alcuni prodotti turistici determinata dai voli low cost e dalla modalità di acquisto last minute, il turismo è divenuto oggetto di consumo di massa ed il periodo di acquisto del servizio turistico si è ampliato nel corso dell'anno. Tuttavia, mentre i benefici economici generati dal turismo sono ben noti, essendo relativi all'incremento del reddito nazionale e dell'occupazione, si rendono necessari ulteriori approfondimenti sui suoi impatti negativi, come la congestione ed il degrado ambientale. Infatti, anche il bene turistico è un bene che comporta dei costi esterni, in quanto è associato alla creazione di esternalità negative sia sotto il profilo dell'offerta che sotto quello della domanda. Al fine di internalizzare i costi esterni in modo tale che essi siano compresi nel prezzo privato imposto dal produttore, alcuni governi nazionali iniziano ad imporre specifiche tasse sul servizio turistico.

Parole chiave: esternalità, fallimenti di mercato, politica fiscale, tasse turistiche, turismo.