APD Cut: A flighty economic case
A response to the Consultation on Air Passenger Duty

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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 Passenger Duty (APD) 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 beneficial to the Scottish economy as has been claimed.

Key Points:-

- The case for business growth due to an APD cut appears particularly weak as business flights are driven by need and time pressures rather than price.

- The case for an APD 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 APD cut results in a transfer of revenue from APD 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.

- The case for increases in tourist traffic is substantially undermined by the impact of cheaper tickets inducing more domestic tourists taking foreign trips instead.

- The spending power of the outbound tourists most likely to take more trips outside of Scotland is greater than the typical spending power of the inbound tourists most likely to take more trips to Scotland.

- The inbound tourists which have a greater spending power than typical domestic tourists are the least likely to be sensitive to airline ticket prices.

- Inbound tourists are generally more weakly linked to the economy than consumers more likely to be induced to leave which may lead to negative economic impacts even in the face of increased tourist numbers.

- Whilst the economy most directly linked to airport traffic will see an increase in activity, 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 APD cut inducing greater traffic in the Central Belt but little growth elsewhere.

- If the reduction in revenue due to the APD 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 city*) 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).¹

The devolution of powers over air passenger duty to the Scottish Government was granted as part of the Scotland Bill 2016 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 APD.

These cases have been largely drawn from two studies undertaken by the airport industry sector themselves. Once by Edinburgh Airport² and other by finance company PwC on behalf of a consortium of airlines including EasyJet³. 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 IATA⁴.

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 Airport 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 Airport 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 that journey for one by road or rail and all were time sensitive enough that cost was not generally a significant factor in calculating the journey.)

Edinburgh Airport 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. APD is collected directly at the point of purchase of the ticket and will be collected directly by the Scottish Government. If the APD 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 APD 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 seem to be a mechanism by which a cut in APD could leverage this effect.

### The Impact on Tourism

The flagship aspect of the proposed APD cut is its claimed ability to make Scotland a more attractive location to visit for tourists. The three major studies highlighted here - Edinburgh Airport, 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 first place. IATA specifically states that while 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."

The primary flaw in the rationale behind the attraction of more tourists to Scotland via an APD 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.

IATA estimates that for every 13% rise in inbound tourists that a tax cut attracts to a particular location, there will be a rise in outbound tourists of around 8%. Data from VisitScotland estimates that in 2014 6.5 million trips were taken in Scotland by people from Scotland whereas only 2.7 million trips to Scotland were taken by people from overseas. Data from The Association of British Travel Agents also indicates that people from Scotland take around 5.2 million trips overseas every year. It can therefore be seen that a small percentage rise in outbound tourism may more than counteract a larger percentage rise in inbound tourism and therefore lead, possibly, to a net tourism decrease.

The situation is complicated further by the relative spending of tourists from various origins which may be more elastic than others. In general, tourists from APD 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).

<table>
<thead>
<tr>
<th>Country of Origin</th>
<th>Average Spend per Visitor per Trip (£)</th>
<th>Number of Trips (thousand per year)</th>
<th>% of Total Trips</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rest of the World</td>
<td>584</td>
<td>843</td>
<td>5.43</td>
</tr>
<tr>
<td>USA</td>
<td>436</td>
<td>418</td>
<td>2.69</td>
</tr>
<tr>
<td>England</td>
<td>288.68</td>
<td>5,570</td>
<td>35.89</td>
</tr>
<tr>
<td>Average GB</td>
<td>229.49</td>
<td>12,510</td>
<td>80.61</td>
</tr>
<tr>
<td>Wales</td>
<td>216.27</td>
<td>430</td>
<td>2.77</td>
</tr>
<tr>
<td>Scotland</td>
<td>179.72</td>
<td>6,510</td>
<td>41.95</td>
</tr>
<tr>
<td>Germany</td>
<td>174</td>
<td>343</td>
<td>2.21</td>
</tr>
<tr>
<td>Australia</td>
<td>130</td>
<td>158</td>
<td>1.02</td>
</tr>
<tr>
<td>France</td>
<td>110</td>
<td>190</td>
<td>1.22</td>
</tr>
<tr>
<td>Spain</td>
<td>97</td>
<td>101</td>
<td>0.65</td>
</tr>
<tr>
<td>Canada</td>
<td>88</td>
<td>122</td>
<td>0.79</td>
</tr>
<tr>
<td>Netherlands</td>
<td>80</td>
<td>149</td>
<td>0.96</td>
</tr>
<tr>
<td>Norway</td>
<td>68</td>
<td>125</td>
<td>0.81</td>
</tr>
<tr>
<td>Poland</td>
<td>45</td>
<td>138</td>
<td>0.89</td>
</tr>
<tr>
<td>Ireland</td>
<td>28</td>
<td>113</td>
<td>0.73</td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>No Data</td>
<td>31</td>
<td>2.00</td>
</tr>
</tbody>
</table>

It can be seen then that the highest spending incoming tourists are also the least likely to be significantly influenced by a cut in APD, whereas Scottish tourists generally spend more during Scottish trips than the European tourists most likely to be influenced by a cut in APD. This presents a scenario whereby even if the APD cut results in a net zero change in total tourism, the higher spending of formerly domestic Scottish tourists is not fully offset by the increase in new inbound tourists from Europe. This effect will be compounded in the event, as outlined above, that the absolute rise in outbound tourism is greater than the rise in inbound tourism.

It should be noted that whilst English and Welsh tourists tend to spend more than Scottish tourists per trip and that domestic leisure flights are relatively elastic (-0.7), only approximately 6% of GB 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 APD cut but, as indicated earlier, it is unlikely to increase total tourist volume. Indeed, given the increased carbon footprint per passenger mile of aircraft compared to train and even car, the Scottish Government should consider carefully this potential transition in light of their carbon emission targets.
Another consideration within the spending patterns of foreign tourists compared to domestic consumers was uncovered within the PwC study\(^9\) 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 APD cut.

The shape of an economy is perhaps as important as its sheer size in GDP terms. The stated goal of the APD 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 APD. 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.

**Conclusion**

The economic case for a cut and eventual elimination of APD 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 APD 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 APD cut (some £150 million per year initially 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. In particular, the demographic of tourist most likely to be attracted to come to Scotland as a result of the cut typically has a lower spending power than the type of tourist induced to leave Scotland as a result of lower prices.

The direct economy of the airport infrastructure is likely to increase as a result of increases in both inbound and outbound tourism but this 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, with its 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 — would be greatly preferable to a clumsy slashing of a single tax power.

**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\(^9\). 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 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 2015\(^1\) compared to a rated capacity of 9.0 million\(^2\)) 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 APD 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 taken.
References


2. Edinburgh Airport, “The Impact of Reducing APD on Scotland’s Airports”, March 2015


4. IATA, “Economics Briefing No 9 – Air Travel Demand”, April 2008

5. IATA, “Economics Briefing No 9 – Air Travel Demand”, April 2008, Page 40


12. A-Z World Airports Database