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THE IMPACT OF VAT ON THE UAE'S HOSPITALITY INDUSTRY

As of February 2017, all Gulf Cooperation Council (GCC) countries have signed the Unified Value Added Tax (VAT) Agreement. The framework will form the basis for national legislation, which will be introduced in each GCC country.

VAT will be introduced at a 5 percent rate and whilst the implementation date is 1 January 2018 in the UAE, there is a long-stop date set which requires full implementation by all GCC countries on 1 January 2019.

Although there has been very limited official information released regarding the specifics of how the VAT system to be introduced will operate, the expectation is that the GCC Countries will replicate a lot of the features of the European Union VAT System.

Why introduce VAT?

While some GCC countries have large oil reserves, resources in a number of others (e.g. Bahrain, Oman) are expected to be depleted in the foreseeable future. Governments' resources will diminish and their capacity to support economic growth will be impaired.

Sustaining growth requires developing new sectors and providing alternative sources of revenues.

Over-reliance on oil also exacerbates macroeconomic volatility - when oil prices drop, oil-exporting countries experience significant declines in government revenue resulting in reduced public spending and current account balances and reserves.

Insulating the economy from the impact of oil price volatility is necessary to lay a sound foundation for economic diversification.

The introduction of VAT is designed to set up a system for more sustainable and diversified government revenues. With the introduction of VAT, governments will have a new source of income which, in turn, will contribute to the continued provision of public services into the future.

Industry Concerns

The impending introduction of VAT in the UAE has sparked debate about the role of tourism taxation and its impact on the competitiveness and attractiveness of destinations. Today, VAT can be found in more than 160 countries.

Recent introductions of the tax into major economies have taken place in Malaysia (2015) and China (2014), while all of the EU member states, New Zealand and Australia have been operating the tax or its equivalent, goods and services tax (GST), for decades.

According to KPMG's '2016 Global Tax Rate Survey' the global average VAT rate stood at 15.64 percent. It should however be noted that most countries apply a reduced rate to tourism services. For instance, the average rate applicable to hotel accommodation in the EU is 10.54 percent with rates ranging from 25 percent in Denmark, who don't apply a reduced rate, to 3 percent in Luxembourg.

VAT Rates Applied in the Member States of the EU at 1 January 2017

	Standard Rate (%)	Hotel Accommodation (%)
Luxembourg	17	3
Belgium	21	6
Netherlands	21	6
Portugal	23	6
Germany	19	7
Malta	18	7
Poland	23	8
Bulgaria	20	9
Estonia	20	9
Ireland	23	9
Cyprus	19	9
Lithuania	21	9
Romania	19	9
Slovenia	22	9.5
Spain	21	10
France	20	10
Italy	22	10
Austria	20	10
Finland	24	10
Latvia	21	12
Sweden	25	12
Greece	24	13
Croatia	25	13
Czech Republic	21	15
Hungary	27	18
Slovakia	20	20
UK	20	20
Denmark	25	25

Source: European Commission

Some have argued that the comparatively low rate of 5 percent being introduced should have a minimal impact, if any, on the Emirate's tourism sector.

However, while of significant importance to Dubai's economy, tourism is also one of the few areas of economic activity to have seen a multitude of fees and charges introduced over recent years.

Hotel stays in Dubai are currently subject to 20 percent of surcharges made up of a 10 percent municipality fee and 10 percent in services charges.

Moreover, in 2014 the Dubai government announced the introduction of the "Tourism Dirham" for hotel stays. The Tourism Dirham is akin to an occupancy or room tax and is applied at varying rates ranging from USD 1.9 to USD 5.5 per room per night depending on the classification category of the hotel and the number of bedrooms.

Accommodation Classification Category	Dhs (per occupied room per night)
5 star or higher rated Hotel or Resort	20
4-star Hotel or Resort	15
3-star Hotel or Resort	10
2-star Hotel	10
1-star Hotel/Budget Hotel	7
Deluxe Hotel Apartment	20
Superior Hotel Apartment	15
Standard Hotel Apartment	10
Guest House	7
Deluxe Holiday Home	15
Standard Holiday Home	10

Source: Department of Tourism and Commerce Marketing

Assuming all existing fees and charges are subject to VAT, tourists and residents staying overnight in Dubai could end up paying anywhere between **28.6 percent** and **32.3 percent** of surcharges depending on the category of accommodation and the number of bedrooms.

Adding to the accommodation charges, both arrival and departure fees are levied in the form visa charges and deposits for certain nationalities and a Dhs 35 (USD 9.5) departure fee for all passengers leaving the UAE from any of Dubai's airports, including transit passengers.

Fiscal Policy

A long-standing principle in public finance holds that public expenditure should be targeted where it provides the most benefit, while taxes should be targeted where they cause the least harm.

And therein lies the predicament, a government intent on growing the relative share of travel and tourism GDP in order to diversify its economy away from oil dependency may well replace those lost revenues by means of (additional) taxation but at what expense. Does taxing the sector work against the ambition of growing it?

Pending a detailed analysis of the price sensitivity and elasticity of tourism demand in the UAE and the relationship between the level of surcharges and tourism receipts, it is hard to say but a number of factors such as the following would suggest that a cautious approach to levying additional fees to the sector is advisable:

- The importance of the sector to the country's economy and diversification efforts,
- The growing mid- and budget market segments,
- The country's ambitious tourism arrival and receipts targets
- And the fact that Dubai is already perceived as one of the world's most expensive cities for tourists

The Importance of Travel and Tourism to the UAE Economy

Travel and Tourism is a sector of existing and growing importance to the UAE economy and has been earmarked as one of the key pillars of the economic diversification policy.

According to research by the World Travel & Tourism Council (WTTC) travel and tourism combined contributed Dhs 68.5bn (USD 18.65bn) directly to the UAE's economy in 2016, or 5.2 percent of total GDP, and it forecast this would rise by 3.2 percent in 2017. Furthermore, the WTTC reported that the total contribution of the sector to GDP, including indirect revenues, was Dhs 159.1bn (USD 43.32bn) in 2016, or some 12.1 percent of the economy.

In 2013, His Highness Shaikh Mohammed bin Rashid Al Maktoum, Vice-President and Prime Minister of the UAE and Ruler of Dubai, approved Dubai's 2020 Vision for Tourism. Developed by the Department of Tourism and Commerce Marketing (DTCM) the Vision sets out how the city aims to both double its annual visitor numbers from 10 million in 2012 to 20 million in 2020, and treble the economic contribution of the tourism sector.

Diversifying Market

In order to achieve these ambitious targets Dubai's hospitality and tourism offerings are diversifying. As the city seeks to both diversify its visitor base and widen its attraction, the growing middle-class and millennial travellers become important but price sensitive target markets.

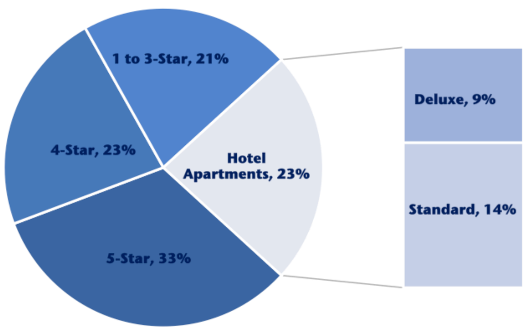
The world's middle-class population is expected to increase to nearly 5 billion by 2030 with most of this growth expected from Asia whereas millennials are expected to represent 50 percent of all travellers by 2050.

Given the growing importance of these segments and the fact that the market in Dubai has traditionally been dominated by 5-star products and experiences the development of the mid-, and budget market segments are priority for the Dubai government.

To further stimulate the diversification process DTCM, in October 2013, announced a series of incentives focused on encouraging the development of more three-, and four-star hotels in the Emirate.

Diversification efforts are well on their way with the one- to three-star hotel categories accounting for 21.4 percent, and the 4-star category accounting for 22.6 percent of the total room inventory (101,845) at the end of 2016. However, further diversification is still required.

2016, Total Available Rooms - Dubai



Source: DTCM Performance Report 2016

Price Sensitivity of Tourism Demand

Classical economic theory provides guidelines as to the nature of the demand/price relationship, accepting that price and demand are inversely related. Price can be an index of the amount of sacrifice the individual has to incur to consume the product or service, as well as the level of quality that the individual might expect.

Tourism, in particular, is a very price sensitive industry and while business travellers seem to be less sensitive to price changes, tourists who travel for leisure purposes are – especially those in the budget and mid-market segments.

The price of foreign currency is also important in international tourism demand and the strength of the dollar and currency fluctuations in key source markets have already had an impact on the performance of hotels in Dubai. According to data provided by STR, Revenue Per Available Room (RevPAR) has declined 5.2% in 2016 as compared to 2015.

Further exacerbating the potential for a negative impact on the performance of the industry are the comparatively high room rates being charged. The World Economic forum's 'Travel and Tourism Competitiveness Report 2017' released in April of this year ranks the UAE 29th overall out of 136 countries – registering a drop of 5 places as compared to 2015. In terms of price competitiveness however, the UAE achieved an overall rank of 56 out of 136 with hotel price competitiveness coming in at 88 out of 101 countries ranked.

Dubai is perceived as an "expensive" destination and with the city achieving among the world's highest Average Daily Rates (ADR) – and notwithstanding the city's comparatively larger proportion of luxury properties (32.5 percent), this perception may have some merit to it.

2016 - Global Markets by ADR Performance, in USD

Region	ADR	Middle East	ADR	Key Cities	ADR
Middle East	**182.96**	**Dubai**	**223.35**	New York	298.11
South Africa	131.99	Muscat	216.20	Paris	242.39
Americas	120.63	Manama	205.95	**Dubai**	**223.35**
Europe	108.66	Riyadh	197.3	Hong Kong	201.75
Asia Pacific	104.71	Jeddah	191.18	London	182.23

Source: STR, 'Middle East / Africa Hotel Review, 2016'

According to consumer behaviour research, consumer's perception carries the greatest weight in the various decisions made by tourists - the choice of a destination, the consumption of goods and services while on vacation, and the decision to return. Perception is important because today's tourists are becoming more and more discriminating. They are more experienced travellers, older and more value conscious.

A Trade-Off

The downside risk to the wider economic benefits derived from imposing additional levies on tourism might outweigh the associated revenue benefits (especially at 5 percent). And while the hospitality industry too, recognizes the need for additional sources of revenue, the question does not become one for, or against, the introduction of VAT but rather one of a trade-off.

One recent example of a similar situation is that of the Bahamas where they introduced VAT at a standard rate of 7.5 percent in 2015. However, at the same time, this economy, that is heavily reliant on tourism receipts, removed its 10 percent hotel guest tax. The main reasoning behind this decision was the perception that tourists were unfairly targeted by a multitude of charges and a fear that this would translate into changes in consumer behaviour and have an adverse effect on the economy.

Considering the example of the Bahamas and the importance of the sector to the UAE economy and diversification efforts you might question the need for overnight tourists in Dubai to be paying municipality fees, Tourism Dirham fees and VAT. Instead, we would argue that, in the interest of the sector's sustained growth prospects, it would be advisable to consider alternative approaches such as removing or reducing some of the existing charges imposed on overnight tourists in favour of the introduction of VAT.

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Kim joined Horwath HTL in 2015 to oversee operations and expansion to the Middle East. Kim has over 15 years of experience in the mixed-use real estate and hospitality management and development sectors, of which over 10 years in the Middle East.

She draws from significant international experience having worked with a number of renowned hotel operators, event planners, destination management companies, and hospitality operations specialists in the Netherlands, Belgium, France, Italy and the Caribbean prior to relocating to the Middle East in 2005.

She is a trusted adviser to many of the region's leading developers and investors, assisting them to assure the commercial and investment competitiveness of their projects. Able to effectively leverage her international hospitality and real estate experience Kim has brought significant value to numerous engagements in over 20 countries in the region and beyond.

She has worked on multiple large and high-profile developments in the MENA region, Europe and the United Sates representing a combined investment value in excess of USD 75 billion.

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