



## The Affectability of Iran's Tourism Industry from the New VAT Law

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### Abstract

The VAT law amendment in Iran, enforced since the beginning of 2022, includes three key changes in the VAT of the tourism industry: 1- tax exemptions in the transport sector (except for domestic air transport), 2- tax exemption in the accommodation sector (except for 4- and 5-star hotels), and 3- tax exemption in other tourism services, including travel agencies and attractions (except for domestic travel agencies). According to this law, and due to the price change in the rate of providing tourism services in Iran, the cost that tourists pay to receive tourism services will also change. The present study seeks to answer how much this price change will change the final price of the product (or service). For this purpose, it uses the national input-output model. The input-output table for 2019, prepared in the conditions of economic stability and the absence of COVID-19 and its negative effects on tourism, has been updated. The results suggest that tax exemptions in the tourism sector will not significantly affect the whole economy and even the tourism industry. However, tax exemptions on the services of travel agencies can be felt in this sector. Given the current very competitive price of Iran's tourism industry compared to other countries, it can be stated that these exemptions will not have a significant effect on the growth of foreign tourism in the country and domestic tourism will be affected slightly.

**Keywords:** Input-output Analysis, Tourism Services Chain, VAT.

**JEL Classification:** C67, Z3, H25, D57.

### 1. Introduction

The major tourism destinations in the world have enforced tax exemption policies in the tourism industry for more than two decades. The approach of these policies has shifted from an approach of generating revenue for the government and developing infrastructure towards an approach of incentive policies and increasing the number of tourists (Pazienza, 2011). Although the issues related to "destinations' carrying capacity" and the negative external consequences of the tourism industry have recently been addressed, governments are still moving towards tax exemptions and incentive policies to improve the destinations' tourism industry competitiveness. At current, about 50% exemption applies to many

activities in the tourism service chain (OECD, 2014). Tourism industry taxes are collected from two groups: first, they are collected from economic enterprises operating in the tourism industry, and second, from tourists. Iran has a much lower share of tax revenues compared to other countries in the world, and extensive tax exemptions are applied in various sectors (including a range of tourism activities).

As a result, the government's reliance on tax revenues is much lower than in other countries. Thus, compared to the tax revenue collected from tourists, the share of tax revenue collected from tourism enterprises is much lower. In other words, the tourism tax burden of the tourism industry is borne more by tourists than by economic enterprises. The most important of these taxes is VAT, which is equivalent to 9% of the selling price in Iran. Despite the extensive VAT exemptions, this tax still applies to many tourism operators, including 4- and 5-star hotels, restaurant services, ticket sales fees by the agency, travel agencies, and air transport ... (Islamic Consultative Assembly, 2021).

Attracting foreign currency and encouraging exports has forced the government to support tourism as a foreign currency-generating industry. In addition, the above-mentioned tourism enterprises are seeking to eliminate the existing taxes to maintain their competitiveness compared to other tourism enterprises. Thus, the combination of these forces led the government to apply some VAT exemptions from the beginning of 2022. They include tax exemption for all tourism services provided to foreign tourists, tax exemptions for 3-star hotels and other official and licensed accommodation units (except for 4- and 5-star hotels), tax exemptions for rail transport, and tax exemptions for travel services offices active in the incoming tourist. Tourist attraction services were previously exempt from VAT. The present study aims to analyze the effect of these exemptions on the price of tourism services, the rate of price change along with direct and indirect price changes. Research methodology can be a model for similar studies in other countries.

## **2. Theoretical Foundations**

Diamond and Mirrlees (1971) introduced a Ramsey model to obtain a certain level of tax revenue in the tourism sector by maximizing the social utility function. This model has been proposed as the efficiency effect in the theoretical literature of the tourism industry. However, theories related to tax issues were later developed further in the tourism industry. An important part of the theoretical foundations related to the topic of tourism tax has been expanded by three studies (Bird, 1992; Forsyth and Dwyer, 2002; Clarke and Ng, 1993). The first two studies do not consider a basic model, but formulate a strong conceptual basis for tourism tax, so that Forsyth and Dwyer (2002) have explained how market power affects maximizing tax and toll receipts from the tourism industry and Bird (1992) has

studied the economic constraints of designing an optimal tourism tax and using it as a financial tool in the tourism industry. In contrast to these two studies, Clarke and Ng (1993) used a basic model to explain the relationship between tourism tax and welfare.

With the development of these models, Copeland (1991) in his analysis of the increase or decrease (exemption) of domestic tourism tax and its benefits has stated that the increase in taxes has more economic benefits in general than the application of tax exemptions. However, Chen and Devereux (1999) confirmed the existence of greater benefits only when import tariffs and export subsidies are established. In general, the differences in the way of effects are quite evident in the single-sector models (which have only focused on the tourism industry). Thus, the use of comprehensive and cross-sectoral models such as input-output or social accounting matrix to analyze the effects of taxation is more appropriate than other methods that are modeled as a single sector. One of the topics in this area, which focuses on VAT, is the redistributive effect. This effect was developed from the Ramsey model to include several household groups instead of analyzing one tourist and one consumer (Gooroochurn, 2004; Barati, 2022).

The negative economic growth that has prevailed in the Iranian economy in recent years and the government's financial weakness (significant reduction of development credits and lack of its realization by the end of the fiscal year) a factors involved in reducing the growth of providing services in the tourism industry. In contrast, to provide more and more stable financing, governments are raising tax rates or generating new tax revenues, which in the tourism industry include measures such as changing the tax inclusion of tourist service units (tourism facilities) and the creation of new tax revenue (collection and increase of tolls received from foreign tourists entering or leaving the country) to manage the tourism industry. Despite various financial pressures on the government, measures have been taken to develop tourism, including "providing tax incentives". An important point in reducing (or increasing) taxes is the possibility of market segregation. For example, the market (or customers) related to high-quality accommodation is different from the market (or customers) for other accommodations. Thus, the application of pricing or tariff policy (tax exemption or collection) should be different for this type of market. In other words, market segregation is the first condition to provide competitive conditions in the market. In addition, market segregation will prevent cross-subsidies, which is a factor in competition destruction (Memarnejad and Hadifar, 2013). Therefore, the pricing and application of tax exemptions should be separable according to the type of markets or customers.

In Iran, based on the new tax law, tax exemption does not apply to 4- and 5-star hotels, and tax exemption on revenue of this group of accommodation units is

different from other accommodation units. These exemptions have been enforced since the beginning of 2022, and travel agencies' VAT is collected for domestic tours, but agencies operating with incoming tourists are still exempt from tax. The same conditions apply to air transport. Any policy that leads to a change in the price of services in tourism will shift the demand and transfer of demand between different units of the service provider. These changes can be calculated using the general input-output model. Separating activities from each other and examining the direct and indirect effects separately can be useful in analyzing the effects of price change resulting from the application of tax policies for policymakers.

### **3. Research Background**

The first idea for the expansion of tax policies in the tourism sector dates back to the 1980s (Hughes, 1981). Then, other studies were conducted to expand tax policies in the tourism industry (Murphy, 1985; Lipmann, 1996; Forsyth and Dwyer, 2002; Palmer and Riera, 2003; Aguilo et al., 2005). However, since the beginning of the 21st century, the orientation of studies changed, and many studies have focused on reducing tax rates or merging existing taxes into a specific type of tax. Jensen and Wanhill (2002) proposed the integration of all taxes collected from tourism activities into a specific type of tax (VAT). Dombrovski and Hodzic (2010) stated that the reduction of VAT rate increases the destinations' tourism industry competitiveness and suggested that for the development of the tourism industry, the tax collected on tourism should be returned to the same industry for development.

Ihalanayak (2012) concluded that although full tax exemption in the tourism industry will boost the tourism sector, other economic sectors will not benefit from this policy. Mahadevan et al. (2016) considered the VAT exemption ineffective in reducing poverty and inequality, and the only effect of this policy was to inject capital into different sectors of the country. Based on a study conducted by Kristjánsdóttir (2020), the application of tax policies to tourism destinations that are approaching maturity is generally ineffective, while countries that are "still on the path of growth" in tourism are more sensitive to tax policies. Barati and Rasoulzadeh (2021) concluded that an increase in tax coverage of 4- and 5-star hotels on the entire body of the economy in Iran is insignificant and due to the high share of occupancy of these hotels by foreign tourists, they concluded that the enforcement of tax exemptions on this group of accommodation units might be appropriate. In Iran, no other study has analyzed the tax effects and changes in VAT rates or changes in the tax base in the tourism industry. The present study is the first study conducted to take a more comprehensive look at such a goal to guide policymakers in enforcing tax policies in the tourism industry.

#### 4. Methods

This study uses an input-output model to analyze the effects of VAT changes in the Iranian tourism industry. Tax amendment in the form of different scenarios will be done on the added value of different actors in the tourism service chain. Sectors considered in the tourism service chain are accommodation, transport, and travel agencies (which also include tour operators). In this study, the input-output table (IO) of industry in industry and base prices will be used. The tax impacts at the national level are examined and compared. 2018 updated national input-output table based on the 2011 statistical table prepared by the Statistics Center of Iran is the basis of applied studies of this study. In the analysis of VAT and using the study conducted by Faridzad et al. (2011), it is necessary to deduct the investment and service compensation of the government from GDP and what remains should be considered as a tax base. Using the cost approach in input-output modeling, the general form of price equations will be as follows:

$$X_j = \sum_i X_{ij} + V_j \quad (1)$$

where  $X_{ij}$  is the elements of the first region of the table, and  $X_j$  and  $V_j$  are the intermediate consumption and value-added of the  $j^{\text{th}}$  part of the economy, respectively.  $X$  represents the output of the whole economy under study, which is obtained from the sum of intermediate consumption and value-added. To calculate the price and enter the relative price index in this regard, the economy can be easily considered to include two parts,  $i$  (supplier) and  $j$  (demander). For this purpose, it is necessary to write the nature of intermediate consumption from the value state as a physical unit multiplied by the price.

$$P_j X_j = \sum_i P_i X_{ij} + V_j \quad (2)$$

By dividing two parts of the equation by the output of sector  $j$ , relative prices will be obtained:

$$\frac{P_j X_j}{X_j} = \frac{\sum_i P_i X_{ij}}{X_j} + \frac{V_j}{X_j} \quad (3)$$

$$P_j = \sum_i a_{ij} + P_i + V_j \quad (4)$$

In the above calculations, the assumption is that all transactions are in the form of physical value to obtain price changes due to any financial shock (such as taxes). In Equation 4,  $P_i$  and  $P_j$  are the price indices of products  $i$  and  $j$ , respectively, at base prices, and  $a_{ij}$  is the technical coefficient of the product. By writing Equation 4 extensively, we will have the general form of equations for the  $n$ -sector economy and writing these equations in matrix form:

$$\begin{bmatrix} P_1 \\ P_2 \\ P_3 \\ \vdots \\ P_n \end{bmatrix} = \begin{bmatrix} a_{11} & a_{21} & \dots & a_{n1} \\ a_{12} & a_{22} & \dots & a_{n2} \\ a_{13} & a_{23} & \dots & a_{n3} \\ \vdots & \vdots & \ddots & \vdots \\ a_{1n} & a_{2n} & \dots & a_{nn} \end{bmatrix} \times \begin{bmatrix} P_1 \\ P_2 \\ P_3 \\ \vdots \\ P_n \end{bmatrix} + \begin{bmatrix} V_1 \\ V_2 \\ V_3 \\ \vdots \\ V_n \end{bmatrix} \quad (5)$$

$$P = [I - \hat{A}]^{-1}V \quad (6)$$

In this equation, P is the relative price in the base year, which is equal to 1 for all goods and services. Considering the principle of destination and the tax base of the consumption type, investments, and exports should be exempt from tax and should be considered as amounts deducted from the tax base. By subtracting these items, Equation 6 after applying tax  $\tau$  will be in this form:

$$P_j = \sum_{i=1}^n a_{ij}P_i + V_j + \tau_j \left\{ P_j(1 - e_j) - \left[ \sum_{i=1}^n a_{ij} + \sum_{i=1}^n k_{ij} \right] P_i \right\} \quad (i, j = 1, 2, \dots, n) \quad (7)$$

In the above equation,  $e_j$ s are the principal diameters of matrix E obtained from the export-to-output ratio (export coefficients). Also,  $k_j$  are the elements of the matrix of investment coefficients that are obtained from the ratio of capital formation to output (diagonal matrix K). In the above equation,  $k_{ij}$  becomes the  $k_j$  matrix due to the diagonal of the matrix, and the non-diagonal elements are zero. The elements of  $\tau_j$  also show the VAT rate by constructing the diameter matrix  $\tau$ . By writing the above equation in the form of a matrix, we will have:

$$P = [I - \hat{A} - [\tau](I - E - \hat{A} - \hat{K})_{(i)}]^{-1}V \quad (8)$$

Index (i) indicates that a tax change has been applied to the  $i^{\text{th}}$  row. This price index shows the price index after tax changes. A comparison of equations 6 and 8 is used to examine the effects of tax amendment (increase, exemption, or any rate change). To assess the effects of the VAT law amendment that has been enforced in Iran since January 2022, the effects of VAT exemption for all accommodation units except 4- and 5-star hotels, VAT exemption on travel agency services, and on-air transport focused on incoming tourists, as well as VAT exemptions on rail transport are examined.

## 5. Results and Discussion

The results of the input-output model for analyzing the price effects of VAT in the Iranian tourism industry are presented below separately for accommodation, air transport, rail transport, travel agencies, and tour operators. As mentioned before, the selection of these activities is based on the changes made according to the new VAT law approved on May 23, 2021. Effects on the services of official accommodation units:

- *Effects on the accommodation sector:*

The accommodation services sector in the input-output table and terms of economic accounts includes all short-term accommodations, some of which are not included within the tourism industry. For this purpose, the share of capacity of this type of accommodation has been identified and deducted as a ratio of the total available accommodation capacity. The results suggest that by enforcing tax exemptions for 1-, 2- and 3-star hotels as well as apartment hotels and guesthouses (all hotel services as well as cheap accommodation such as pilgrimages, public camps, etc.), about 83% of the change in the selling price of services is due to the reduction in the cost of hotel services (direct effect) and only 17% is related to the decreasing effect on the price of other economic sectors (indirect effect). However, the elimination of VAT (9%) will reduce the final price of residential services by about 1.38%. However, since the accommodation capacity of tourism accommodation units is about 20% of the total capacity of "short-term accommodation", the share of price reduction for "hotels" is much less than this amount. In total, the direct and indirect effects of the change in the general prices of the whole economy reach about 1.65%. It should be noted that the elimination of VAT for the tourism accommodation sector (3-star and less-star hotels) has practically little effect on the whole economy. Since accommodation in 4- and 5-star hotels is done by a special group of tourists who are not very sensitive to price changes (Soleimanpour et al., 2014; Agharkakli et al., 2019), it seems that the elimination of VAT for this type of hotel is far less important than other accommodation units.

**Table 1.** The Effect of Tax Exemptions on the Short-Term Accommodation Sector

Economic sectors	Percentage of price change due to VAT exemption for the accommodation sector except for 4- and 5-star hotels	
	economic sectors	Tourism industry
	Short-term accommodation	1.383
Public service	0.0260	-
Air transport	0.0210	0.021
Water supply, waste management, wastewater	0.0165	-
Chemical, disinfectant, and hygienic products	0.0149	-
rail transport	0.0102	0.0102
Other sectors ( a total of 71 economic activities)	0.1773	*0.0095
Sum	1.6489	1.4237

**Source:** Research finding.

**Note:** \* Other activities in the tourism industry include agency and tour guide activities, road transport, arts and entertainment services, wholesale and retail, and health and medical services.

Indirect effects of this tax amendment for the sectors of "public affairs", "Air transport", "Water and wastewater services and waste management", "chemical and disinfectant and hygienic products", "rail transport", and "other services not classified elsewhere" are higher than other sectors. After the cost of wages and facilities, the highest cost of accommodation units is related to the purchase of raw materials and inputs, which are included in the above-mentioned sectors. Thus, the elimination of VAT will have an indirect effect on reducing the price of inputs from those sectors. It should be noted that in Iran, the share of national tourists who use official accommodation is very small. Thus, it seems that the tax exemption in the accommodation sector will not have a significant effect on changing the behavior of tourists.

- *Effects on the transport sector:*

Based on the previous VAT law, air transport is exempt from VAT only for foreign tourists, and rail and road transport are completely exempt from tax. VAT exemption in the air transport sector has a relatively higher direct effect on this sector itself, but will also have relatively significant indirect effects on the whole economy. However, these effects have a small share in the tourism industry (by differentiating the passenger's share from the cargo). Based on the investigations, the relationship between air transport and the services of "travel agencies and tour operators" is very low, and this relationship is weak due to the low share of specialized tourism and the activities of travel agencies from the whole air transport sector. In other words, most of the air travel and air transport services provided to tourists are for tourists who have not used the services of travel agencies. In contrast, the application of VAT on the rates of air transport services has a high effect on the price of the products due to the great dependence of this activity on the industry and agriculture. However, if this tax exemption is applied only to air passengers, the effects will be much less. Since these exemptions are not for national passengers but are only for foreign passengers, the effects on the whole economy will be very small.

The most indirect effect of taxation on air passenger transport is related to rail transport services. In general, due to price competition in the transport sector, the variety of transport services available to tourists, and the high price sensitivity for this type of service, any tax policy for the transport sector will change the composition of demand for this type of service. Thus, it will have different distributive effects on the whole economy, which requires more detailed investigations. Although only national effects have been examined here, according to Barati (2019a), the effects will be different at the provincial level.



**Table 2.** The Effect of VAT Exemption in the Air Transport Sector

Economic sectors	Percentage of price changes due to VAT exemption on air transport	
	Economic sectors	Tourism industry
Air transport	1.9789	1.9789
rail transport	0.0596	0.0596
Aviculture	0.0473	0
Livestock, beekeeping, silkworm breeding and hunting	0.035	0
Construction of residential buildings	0.0335	0
Production of other non-metallic mineral products	0.0345	0
Production of base metals	0.0324	0
Construction of other buildings and construction activities	0.0319	*0.0319
Manufacture, repair, and installation of fabricated metal products	0.03	0
Manufacture of food p and tobacco products	0.0303	0
Manufacture and repair of other transport equipment	0.0282	0
Production of computer products, electrical equipment	0.0277	0
Manufacture of all kinds of drinks	0.029	0
Manufacture of furniture	0.023	0
Manufacture of rubber and plastic products	0.0251	0
Manufacture of paper and paper products	0.0249	0
Manufacture of wood and products of wood and cork	0.0231	0
Fish farming	0.022	0
Other sectors (a total of 59 economic activities)	0.4769	0.0394
Sum	2.9935	2.1098

**Source:** Research finding.

**Note:** \* Based on ISIC codes, which are the basis of input-output analysis, infrastructure costs such as road construction, construction of rail and airlines, construction and repair and restoration of historical attractions, and even construction of commercial and industrial centers are included under the section of "Other buildings". Only the service section of accommodation services, transport services, and other tourism services are included in the relevant subsections and the construction and operation section is included under "other buildings" (Barati, 2019b).

The 9% VAT exemption for the rail passenger sector (not freight) in the total rail sector (total freight and passenger) by about 1.27% leads to a reduction in the final price. After that, the most effect on the prices of other sectors will be related to "recruitment activity", "travel agency services and tour operators", "construction and repair of motor vehicles", "bank", "other buildings" and "art, entertainment and recreation". "Recruitment activity" refers to the relocation of labor force

(industrial, service and commercial units) and job search activities that this group of relocations is not included in the definition of tourist.

In addition, the majority of the activities of "banks" and "other buildings" are not included in the tourism industry. However, since it is not possible to separate the type of rail passenger according to the purpose of the travel and it is not possible to distinguish the tourist from the non-tourist, its effect on the whole economy must be analyzed. Since rail transport accounts for only 0.2% of Iran's total output and certain groups use this type of transport for specific purposes, it seems that the reduction in prices resulting from VAT exemptions on passenger rail transport has a very small effect on the whole economy. The price competition between this type of transport and other types of transport might change the way tourists travel and significantly change the demand for rail transport by tourists.

**Table 3.** The Effect of VAT Exemption on The Rail Transport Sector

Economic sectors	Percentage of price changes due to VAT exemption on rail transport	
	Economic sectors	tourism industry
Rail transport	1.27	1.27
Recruitment activities	0.192	0
Travel agency services, tour operators, reservations	0.133	0.133
Construction of motor vehicles, trailers and semi-trailers	0.116	0
Bank	0.109	0
Construction of other buildings and construction activities	0.079	*0.079
Art, entertainment, and recreation	0.072	0.072
Private higher education	0.044	0
Other sectors (a total of 69 economic activities)	0.354	0.1377
Sum	2.369	1.6917

**Source:** Research finding.

**Note:** \* Based on ISIC codes, which are the basis of input-output analysis, infrastructure costs such as road construction, construction of rail and airlines, construction and restoration of historical attractions, and even construction of commercial and industrial centers are included under the section of "Other buildings". Only the service section of accommodation services, transport services, and other tourism services are included in the relevant subsections.

- *Effects on the travel agencies and tour guides:*

The price change due to VAT exemption on the services of travel agencies and tour operators is direct by 97% and indirect only by 3%. However, since only those travel agencies that focus on incoming tourists are exempt from tax, and the share

of such agencies is much less than the total travel agency services in the country, the exemptions have very little effect on the tourism industry and the whole economy. Among other activities, two activities "air transport" and "rail transport" have far higher indirect effects, so 72% of the mentioned 3% indirect effect is related to these two activities. Compared to the effects of other activities in the previous sections, travel agency services will have little indirect effect on the economy due to the purity of their performance in the tourism industry. The table below shows the direct and indirect effects of VAT exemptions for travel agency services.

**Table 4.** The Effect of VAT Exemption on the Services of Travel Agencies and Tour Operators

Economic sectors	Percentage of price changes due to VAT exemption for travel agencies and tour operators	
	tourism industry	tourism industry
Travel agency services, tour operators	1.01867	1.01867
Air transport	0.01482	0.01482
Rail transport	0.00613	0.00613
Construction of residential buildings	0.00027	0.00027
Construction of other buildings	0.00026	0.00026
Religious and political service	0.00012	0.00012
Other sectors (a total of 74 economic activities)	0.00742	0.00023
<b>Sum</b>	<b>1.04769</b>	<b>1.04049</b>

**Source:** Research finding.

## 6. Conclusion

The present study used the input-output model to analyze the price effects of VAT in the Iranian tourism industry. Introducing VAT in the supply chain of products is one of the advantages of using this model. Because of the new VAT law enforced in January 2022, some changes have occurred in the tax exemption and application of tourism activities and travel agencies. Accordingly, the present study separately examined the accommodation, transport (air and rail), and travel agencies undergone tax changes due to new laws. The results showed that in the accommodation sector, VAT exemption for accommodation units would not have a significant effect on tourism development. In the transport sector, tax exemptions on air passenger transport services will have an extensive distributive effect on the tourism industry, although they have a relatively small effect on the whole Iranian economy. The rail transport sector has a similar status to the air transport sector, and due to the very small share of tourism in the total rail transport services, the effect of tourism exemptions on the whole rail sector will be very small.

In the services of travel agencies and tour guides, VAT exemptions have few indirect price effects on the whole economy. According to the results of this study

and due to the lack of tangible effect of tax exemptions on tourism demand, it is recommended that the VAT cover a wider range of hotel services to bring direct benefits for the government and indirect benefits for tourists without a significant effect on demand change and negative impact on the accommodation sector. In contrast, the application of taxes on agency services and tourism has a direct effect, and any tax on this group of tourism industry activists will practically affect the development of services of travel agencies. Thus, increasing VAT is not recommended for this group of tourism industry activists.

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