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Carole Gardner

Productivity Commission

Barriers to Services Exports Inquiry

Dear Carole

Please find attached a submission to the Inquiry on Barriers to Export Services.

The emphasis of this submission is on the export of tourism and aviation services. It follows on from the Commission's recent Research Report on Australia's International Tourism Industry, and looks at several of the issues discussed in this Report in greater detail.

The submission reflects research done over the past twenty or so years, much of it supported by the Sustainable Tourism Cooperative Research Centre, which has now ended. Much of this work was done in conjunction with Professor Larry Dwyer and Ray Spurr of the University of NSW, and Professor Leo Jago of the University of Surrey. Karl Flowers of Decisive Economics has also been helpful. None of these persons bears any responsibility for this submission, and all mistakes are my own.

Yours Sincerely

Peter Forsyth

Barriers to Services Exports

Submission to Productivity Commission Inquiry

Peter Forsyth

Measuring the Benefits and Costs of Tourism and Airline Liberalisation

The Research Report on Australia's International Tourism Industry called for cost-benefit studies of various policies. Computable general equilibrium (CGE) models can be used to evaluate how much better Australia is as a result of adopting a tourism or aviation policy, provided they include a sound welfare measure.

The Issues Paper invites comment on the Commission's recent Research Report on Australia's International Tourism Industry (Productivity Commission, 2015). This submission comments on the Report, and also goes further in some directions.

One way in which the Research Report is valuable is that it clarifies the ways in which the impacts and benefits or costs of policies and investments can be evaluated. In this respect, it follows on from the Commission's Infrastructure Report of 2014 (Productivity Commission, 2014). This is relevant not just in the present context of tourism and aviation, but in a wide range of other policy evaluation problems. The Report recognises that there is a difference between impacts (say, on GDP, GNP or employment) and net benefits, as measured in cost-benefit analysis. If the objective is to assess how much better off the economy is, the correct measure is that of net benefits, not GDP, GNP or similar measures.

This has implications for the tools used to measure net benefits, and in particular, the use of cost-benefit analysis (CBA) and computable general equilibrium (CGE) modelling. The Report argues that the correct technique is that of CBA, and that CGE is not recommended. One can object to this recommendation. It is the case that CBA is a correct way of measuring whether the economy gains from a particular policy, such as the international promotion of tourism, though it does have a number of limitations. However, a CGE approach can be equally correct, and in cases more comprehensive, as long as the model used has a net benefit or welfare measure.

This is not the case with most CGE models used in evaluating tourism and aviation policies in Australia, such as the benefits from tourism promotion or special events. Indeed, most Australian studies in other areas, which seek to assess whether Australia is better or worse off as a result of a policy, do not measure welfare or net benefits accurately. Instead, they use changes to GDP, GNP or total consumption as a measure of whether they are better off or not. This is recognised in the Research Report.

It is a straightforward matter to include a net benefit measure in a CGE model, and in other countries, especially those in Europe, this is done regularly (Broecker and Mercenier, 2011). This means that CGE models can be used to assess whether the country is better off or not as

a result of a policy- there is no need to rely on inaccurate and misleading proxies, such as the impact on GDP or consumption.

Thus CGE models can be used to measure the net benefits of policies, such as funding of tourism promotion or greater access to Australia from foreign airlines, in the same way as CBA can. Indeed, it will be argued below that in the tourism and aviation context, there are several situations which CBA cannot handle adequately- these include measuring the benefits from tourism promotion, the benefits of special events, the tourism benefits from airline liberalisation, and the costs and benefits of a tax such as the Australian Passenger Movement Charge (PMC). A CGE approach can handle all of these situations.

The Costs and Benefits of Tourism Promotion

The Research Report recommends that a cost-benefit calculation be made of Tourism Australia's International Promotion. This can be done using a CGE model, though not with a conventional Cost-Benefit Analysis (CBA).

The Commission recommends that the return to investment in tourism promotion (such as that by Tourism Australia) should be subjected to cost-benefit analysis, though it does not recommend how this could be done. Such an exercise would make an estimate of the effect of promotion on Australia's economic welfare. In other words, does promotion improve Australia's economic wellbeing? So far as I am aware, this type of exercise, which compares like with like, has not been done, for Australia over any other country. However, based on the research done by the Sustainable Tourism Cooperative Research Centre, it is a straightforward matter to do it.

It is necessary to recognise that there are two key rationales for tourism promotion. One is an argument which is often advanced, namely that there is a public good aspect to promotion, since many firms are not able to promote effectively since they are too small, even they would be willing to contribute to it. The second is less commonly advanced, and it relies on the existence of distortions in markets, such as taxes. When tourists visit Australia, they spend money and Australia gains a benefit when they are taxed. The benefits associated with the first rationale are very difficult to measure, though those stemming the second can be measured easily. The benefits from promotion cannot readily be assessed using the normal tools of CBA, given that there are myriad effects spread throughout the economy. However, the benefits are straightforward to assess using the CGE approach.

Thus a cost-benefit calculation can be done using a CGE model. It involves measuring the impact of promotion spending on tourism spending, and determining the net benefit from this spending. This can be compared to the net cost of the promotion, and benefit-cost ratio can be estimated.

To show this, an example of the return on promotion in the Tourism Australia in its submission to the Commission's Research Report (Tourism Australia, 2014) is used. Using the same key parameters, namely the impact of promotion expenditure on tourism

expenditure (15\$ per \$1 promotion), a marginal welfare cost of taxation of 1.275 per \$1, and an administrative margin of 0.25 of promotion spending, the only change is to replace the estimated economic impact, as used by Tourism Australia, with the net benefit or welfare change from tourism. There have been several estimates of this net benefit. Using one from the Sustainable Tourism CRC (Dwyer et al, 2004), which estimates that an additional \$1 of tourism expenditure would yield benefits of \$1.135, a \$1 of promotion spending would cost \$1.59 to produce a net benefit of \$2.025, yielding a net cost-benefit ratio of 1.27.

This estimate of the net benefit to tourism spending ratio is on the high side, and lower estimates would yield lower cost-benefit ratios (see Forsyth, 2006). On the other hand, there is no allowance for the public good rationale for promotion.

These are rough calculations, though they do indicate that the type of cost-benefit calculations, as envisaged in the Commission's Research Report, are eminently feasible, though only by using a CGE approach. More rigorous examination of the returns to promotion are warranted. They also indicate, using the most rigorous ways possible, that tourism promotion is worthwhile in terms of its economic return to Australia.

Event Evaluation

The Research Report recommends that cost-benefit calculations be made of the benefits of events. In measuring the benefits from inbound tourism stimulated by the event, the more comprehensive approach is the CGE approach.

The Commission's Report takes a definite line on the appropriate way of evaluating events- it prefers CBA and says that all the methods are not appropriate. There is certainly a long history, in Australia and other countries, of poor evaluation. In particular, Economic Impact Analysis (EIA) (which seems to be a little less prevalent in Australia nowadays) is a very misleading technique (Jago and Dwyer, 2006). However, the Commission also includes the CGE approach as a technique which it does not recommend, and in this respect, it is following on from the Commission's Infrastructure Report (2014).

This recommendation can be challenged. Certainly, CGE models which do not include a welfare measure are limited in what they can say about whether the country or state gains economically from the event being held (this includes most of Australian event studies using a CGE model). The problem is that, if there is no welfare measure, it is not possible to determine whether Australia gains or loses from the event. This problem is fully addressed if there is a (correct) welfare measure. The result will be exactly equivalent to a CBA (though it will yield a different approximation to the net benefit measure). In this respect there should be no preference given to CBA as a tool for evaluation.

In fact, one can go further than this. Most events draw visitors from outside the region, state or country. For example, the Formula 1 Grand Prix held in Melbourne draws visitors from other states and overseas. If these visitors are making expenditures, how can the benefits or costs to the home economy be measured? CBA has no answer to this question, other than make assumptions, such as that benefits from visitor expenditures are equal to, say, 20% of

expenditures, or other arbitrary assumptions. A CGE approach can do a complete evaluation, (as noted above, there have been several CBE studies on the benefits from inbound tourism) while a CBA is, of necessity, incomplete.

Airline Liberalisation and Aviation Export Services

The Research Report recommends the transparent cost-benefit analysis be done of airline liberalisation options. There is a significant literature on the assessment of liberalisation on which to draw, and Australia has a track record second to no other country in using it. However, many of these studies are not publicly available.

The prices which airlines can buy capital, labour and other inputs are important determinants of their international competitiveness in accessing export markets. Government restrictions can hinder airlines' access to low cost services, and thus their competitiveness.

The Assessment of Airline Liberalisation Options

International airlines are both export services industries, and import competing industries- the two need to be taken together. This is particularly so given the way international airline routes are regulated. Most routes are regulated on a bilateral basis. This often means that if a country is asked to allow Australian airline to have more capacity, it will expect more capacity for its own airlines. Imports and exports will be jointly determined. In reality, there tends to be situations where Australia is the net exporter of airline services (e.g. to the US) and others where it is a net importer (the UAE). Nevertheless, it is probably best to consider exports and imports of airline services together.

Another relationship which is important is the complementary one between international aviation and tourism. Efficient international aviation increases the benefits from tourism.

This was recognised by the Commission's Research Report on Tourism. It calls for "transparent cost-benefit analysis" to be used when liberalisation is being considered, such as when additional capacity is being "granted" to a country's airlines to fly to Australia.

There is a long history of using cost-benefit techniques to assess liberalisation proposals in Australia- in fact, this has been done more often in Australia than any other country. These studies date back to the Department of Transport and Communications Report (1988) which recommended an explicit cost-benefit framework be developed to evaluate liberalisation. This framework was used in the 1990s, though reports were not made public. The Bureau of Transport and Communications Economics did make a public assessment of the Australia-NZ aviation market in 1991. The Productivity Commission did a major report, using a CBA framework, in 1998 (Productivity Commission, 1998; see also Grogan and Johnson, 1999). From time to time, other (not published) studies were done, such as that done of possible flights by Singapore Airlines to the US, though there has not been a systematic use of the technique. Similar studies have been done in other countries- see Gillen et al (2002).

There have also been CGE studies done of liberalisation in Australia. An early study was that by the Industries Assistance Commission (IAC (1989). There have also been other studies, including a (confidential) one of allowing the Middle Eastern airlines more capacity into Australia, for the Department of Industry, Tourism and Resources in 2007. One serious limitation of these studies is that they measured “benefits” by changes to GDP and the like, rather than a rigorous welfare measure. This is a problem which can easily be rectified in future work.

The CBA and CGE approaches to evaluating liberalisation has been developed substantially over the last two decades, in Australia and elsewhere, and thus there should be no problem in following the Commission’s recommendation. Various factors which are new, such as foreign investment in national airlines, can be taken into account. It is possible to assess the gains and losses to different stakeholders, such as travellers and the airlines. Recent studies have given more attention to the benefits of tourism.

Both CBA and CGE approaches can be used to evaluate liberalisation. However, one limitation of CBA is that it does not have a rigorous way of measuring the benefits and costs of inbound and outbound tourism. In CBA, tourism benefits are simply assumed (for example, the Second Sydney Airport CBA simply assumed that they were equal to 25% of tourism expenditures) (Australian and NSW Governments, 2012). However this benefit has been examined in several CGE studies, as noted above. Thus a CBA of airline liberalisation needs to rely on estimates on tourism benefits from a CGE study.

Labour and Capital Supply Restriction

Factors which lower the competitiveness of international airlines affect their ability to export their services. By competitiveness is meant the costs incurred by a firm compared to the costs of its international competitors. If Australian airlines have to pay more for their inputs than their international competitors, they will be less competitive in export markets. In many respects, Australia has high input costs which limit its competitiveness. Some of these higher costs are the result of government restrictions. The situation is also affected by bilateral agreements which specify what constitutes ownership and control of an Australian airline. Other countries have different tests, such as the principal place of business test, and this might be something which Australia could move to, subject to its partners’ agreement.

One obvious case of this occurs with constraints on the capital structures of the airlines, particularly Qantas. International airlines would prefer to have more freedom to set their capital structures- if they had this freedom they could be more competitive in export markets.

Probably much more important are the labour supply constraints, and also the requirements about maintenance of aircraft. In spite of international airlines being an industry which moves people internationally, most airlines do not make much use of international labour markets. Some airlines do- Cathay Pacific has always done this, and the Middle Eastern airlines have owed much of their success to doing this. The Australian airlines would very much like to make more use of the international labour market. To a limited extent, Qantas has been able to do this through its subsidiaries, such as Jetstar. Several factors, such as government

restrictions, and union arrangements, limit the gains which Australia could make by being more competitive airline export and import competition markets. While airline/union arrangements are primarily a matter for the parties involved, there is some scope for the government to grant more freedom to the airlines, especially Qantas, to hire and maintain internationally.

The Passenger Movement Charge and the “Backpacker Tax”

The PMC can be evaluated using a cost-benefit framework in the same way as other tourism policy issues. Australia gains more than it loses from implementing the charge, though the tourism industry is a loser. The same is true for the new “Backpacker Tax”. By better structuring the PMC it is possible to lessen the cost to the industry, and a link between PMC revenues and promotion should be considered.

The Passenger Movement Charge (PMC) is a barrier to tourism exports. The important question should be – does Australia gain from having this barrier? Most industry commentators argue that it does not. There have been many studies of equivalent taxes, such as the UK APD, and studies, invariably based on Economic Impact Analysis (EIA), conclude that they are harmful to the country imposing them. A study of the PMC in Australia, also based on EIA, concludes that it is harmful to Australia (IATA, 2013).

The criticisms which are made in the Commission’s Research Report are very applicable to these studies. However there has been a study done of the PMC which comes to a radically different conclusion (Forsyth et al, 2014). This study uses a CGE approach, and also takes into account the “tax exporting” aspect of the PMC. In effect, a country gains if it can export its taxes, i.e., get nations of other countries to pay them. This is the case with the PMC. This is an example of the “optimal tariff” argument, in that Australia can use its market power in the tourism market to raise its prices.

To assess whether a country gains or loses from imposing a tax such as the PMC, a cost-benefit calculation needs to be done. On the one hand there are the revenue effects, which are positive for the country since they involve substituting taxes paid by its nationals by taxes paid by foreigners. On the other hand, there is a loss of tourism benefits from inbound tourism, as well as a possible gain or loss from lower outbound tourism (usually a gain). Given that the reduction in gains from inbound tourism are small relative to tourism expenditure (the figure of 13.5% was used in the discussion of promotion above), it is very likely that the country will gain from imposing a tax. It may not be efficient from a global perspective, but it makes sense for an individual country, though its tourism industry suffers.

The new “Backpacker Tax” can be subjected to a cost-benefit assessment in much the same way as the PMC. Australia gains more taxes, paid by residents of other countries. On the other hand, it loses some tourists on working holidays and some spending from abroad (some of the spending of these tourists is funded by income from Australia). Again the net benefits to Australia from this spending will be much less than additional expenditure, since resources

are used in providing for these tourists. The net result is that it is likely that Australia gains from imposing this tax, even though the tourism industry loses: the issue does warrant further rigorous study however. The same type of assessment can be made if there is a tax element in visa charges.

There are ways in which the PMC can be changed. It would be possible to gain the same revenue at less cost to the tourism industry by a change its structure. Another possibility involves linking revenue to tourism promotion. While there are downsides to earmarking revenues from taxes, it may be worthwhile considering an arrangement whereby additional revenue from the PMC would be used for tourism promotion, thereby creating a benefit for the tourism industry and increasing the gains from tourism exports.

The Commission's Research Report argues, in several instances, that policy issues can be assessed using a cost-benefit framework. It is argued here that this can be applied to the discussion of the PMC, and that this is an improvement on the simplistic claims often made about the charge.

The Scope for Transparent Assessment

The Commission recommends transparent cost-benefit studies of tourism promotion, events and airline liberalisation. This is not likely to happen unless the decline in Australia's capabilities in analysing tourism and aviation policies is reversed.

The Commission's Research Report recommends, in several places, transparent cost benefit evaluations of options. Unfortunately, the chances of this happening have been falling rather than rising. There is now much less economic evaluation of options in tourism and aviation than there was ten years ago. This is because of the ending of the Sustainable Tourism Cooperative Research Centre, along with the declining interest by Universities in tourism research, and less research being done by government agencies such as Tourism Research Australia. The CRC sponsored a significant research program on the economic benefits and costs of tourism and aviation, of the type recommended by the Commission. Several of these studies have been referred to in this submission. Hopefully it contributed towards better policy choices and greater benefits to Australia from its exports of tourism and aviation services.

In the light of this, who is going to undertake the transparent and independent cost-benefit studies?

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