



**IMPROVING TOURISM
COMPETITIVENESS**

AND

PROMOTING DEVELOPMENT

SUBMISSION

To the

MINISTER For FINANCE

on

BUDGET 2005

from the

IRISH HOTELS FEDERATION

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Executive Summary

The tourism industry is a large and valuable economic resource. It has doubled in size over the past decade. It attracts 6.2M visitors, generates €4.1B foreign exchange, provides 140K jobs and generates €2.3B for the exchequer. It is the most important segment of indigenous enterprise. It has the potential to generate more economic benefits.

Despite long term performance and good overall headline recent performance there are serious concerns. Hotel bednights grew by only 1.4% in Q2 2004 relative to 2003. Real revenue per tourist is declining. There is now a tourism balance of payments deficit. High labour costs and the euro appreciation have fundamentally worsened the cost base. Hotel profitability is being squeezed.

The industry is hindered by self-imposed VAT penalties relative to other countries, is being hit by large local authority charges and taxes which reduce or remove the benefits of low direct tax.

To protect the gains already made and to begin a new phase of high growth tourism requires that

- VAT should be reduced to 10%
- Corporate expenditure on hospitality should be VAT refundable
- Local authority charges and taxes should be capped at 50% of the inflation rate and a new system of local government taxation introduced
- An additional €15M marketing support should be allocated each year over the next three years

These measures will improve competitiveness and promote development in tourism and represent a solid value for money investment.

1. The 2005 Budget Should Support Tourism

The Irish tourism and hotel sectors are operating in a very difficult economic environment, much of which is beyond the influence of the government. These difficulties include a lowering of growth in the USA and UK, currency appreciation and higher interest rates. However much of what is adversely affecting tourism and the hotel industry is within the control of government. The government's desirable fiscal model of low direct taxes is not repeated in its indirect tax model. Given the degree of competition and the price sensitiveness of the Irish tourism product Irish tourism is placed at a competitive disadvantage by high tourism VAT rates and non refundability of VAT on corporate hospitality expenditure. In addition the failure to halt the large increases in local taxes and charges negates the direct tax benefits.

The sector has great potential, has invested significantly in the past and has proven it can deliver. It now operates with a fundamentally changed exchange rate and labour cost base. It faces competition from more and more locations.

Budget 2005 should correct the VAT disadvantages, restrict local cost increases and support marketing to assist the industry in realising higher levels of performance and economic contribution.

2. The Economic and Business Environment for Tourism 2005.

2.1 Economic Growth

The international economic growth performance in 2005 will be slightly below the 2004 performance. Overall OECD growth was 3.4% in 2004 compared with a forecast of 3.3% for 2005. United States growth will drop from a relatively high 4.7% in 2004 to 3.7% in 2005. Euro area growth will increase from 1.6% to 2.4%. The UK economy will continue to perform just below the 2004 level. Continuing high prices for oil will result in lower growth than stated above in 2005.

The Irish economy is expected to have a GDP growth of 4.7% in 2004, substantially ahead of forecasts at the time of Budget 2004. Growth of about 5% is expected in 2005. This better economic performance, allied with various once-off factors, has had a positive impact on the public finances. The Budget Day forecast was a borrowing requirement of 1.1% of GDP. This is now expected to be 0.4%. The Exchequer Borrowing requirement will be €1.8B compared to a projected €2.8B. The actual public finances situation would have facilitated implementation of much of the strategy proposed by the Irish Hotels Federation Budget 2004 submission.

International Growth Position 2005

GDP growth (real) %

	2004	2005
USA	4.7	3.7
Euro Area	1.6	2.4
OECD	3.4	3.3
UK	3.1	2.7

Source: OECD Economic Outlook.

The international political situation could rapidly worsen and the price of oil could stay high and this would solely result in lower growth than currently envisaged. It would be a very risky strategy to depend on international demand factors sustaining and improving the tourism performance. It is necessary to compliment the international situation with the budgetary measures identified in this submission.

International economic growth in 2005 will be a little below the 2004 performance. USA growth will be lower. UK growth will be lower. The public finances are in better shape than envisaged.

2.2 Exchange Rates

The 2004 Budget Submission highlighted the dramatic change in Irish tourism competitiveness caused by the exchange rate movements against sterling and the US dollar. It remains a source of surprise to the hotel industry that the long term impact of this fundamental structural change in competitiveness does not appear to be understood by government and that compensatory measures have not been introduced.

The industry recognises that the value of the Euro is outside the control of Irish government policy. It also recognises that adjustment to the new rate requires a business response in terms of product upgrading, cost control and efficiency. There must also be a government response to assist in coping with this fundamental structural change

The dramatic change is illustrated below.

Euro Exchange Rate 2001/04

	Sept 01	Sept 02	Sept 03	Sept 04
Dollar	0.9072	0.991	1.0783	1.2175
Sterling	0.6235	0.6363	0.6900	0.6799

Between Sept 01 and Sept 04 the Euro has appreciated by 34% against the dollar and 9% against Sterling. These are our largest markets. Over the past year the situation against Sterling has improved slightly but the Sept 04 rate is still 7% above the Sept 02 rate.

The industry needs the support of government to effectively respond to the loss in competitiveness brought about by the appreciation of the Euro.

While the exchange rate appreciation will reduce the price of imported inputs this does not greatly benefit tourism directly as the industry has a high domestic content.

The Euro appreciation has greatly damaged tourism competitiveness

2.3 Domestic Inflation and the Hotel Industry

The high cost of doing business in Ireland has been acknowledged in several public policy reports. Over the past few years the Irish inflation rate has exceeded those of most other EU economies. In the recent past the gap has narrowed. The hotel industry still carries the burden of the legacy of high inflation. Despite the convergence of the overall inflation rate the hotel industry continues to be assaulted by very high input price increases, particularly from public providers. In addition large price increases are either being sought or already approved for electricity and other energy and for postal services. The Irish rate continues to exceed the UK rate of inflation.

Ireland's Inflation Rate Yr to July 04

	%
Ireland	2.5
Eurozone	2.4
UK	1.6

(Based on EU Harmonised Index; this is 2.7% on the CPI measure)

Some illustrative recent price increases are shown below.

Price Increases: Year to August 04

CPI	2.6
Water Supply, Refuse and Misc Services	12.7
Energy Products	12.0
Hospital Services	10.7
Air Transport	17.6
All Transport Services	5.6
Education	6.0
Health	5.6

The increase of 12.7% in local service charges is notable. In addition commercial rates over recent years have greatly exceeded the rate of inflation. The lowering and convergence of the overall inflation rate is welcomed by the hotel industry. The efforts to reduce the cost of insurance are also welcomed. But these benefits are being eroded by continuing excessive increases in many public sector provided services.

The lowering of the overall inflation rate and its convergence with the EU is welcomed but there are still very large increases in the costs of public sector services.

2.4 Labour Costs

In addition to the negative competitiveness impact of currency appreciation and input cost inflation, the Irish economy has experienced relatively high labour cost increases. Over the past few years Irish labour cost growth has exceeded other relevant countries. More recently the gap has narrowed but even still Irish labour cost increases are over twice those of the Euro area.

Compensation per Employee (in Private Sector) % change

	2003	2004	2005 (forecast)
OECD	3.2	3.5	3.7
Euro	2.3	2.2	2.2
USA	3.0	4.3	4.8
UK	4.3	5.2	4.7
Ireland	3.9	4.0	4.9

Source: OECD

The sector now operates in a high labour cost environment.

2.5 Other Economic Concerns

It is not clear what will happen EU interest rates in 2005 but there is a strong possibility that interest rates could rise over the next year. This would further worsen the finances of the hotel sector and compound the negative effects of currency appreciation, high costs of doing business in Ireland, increased labour cost and continuing growth of public services prices. The hotel industry appreciates the low profits tax rate but its benefit is being offset by the other negatives of the economic environment.

Fiscal and general public policy must be adjusted to compensate for the negative influences of:

- a) currency appreciation
- b) high local taxes and charges
- c) high labour cost

2.6 VAT

Much of the operating environment (interest rates, exchange rates, international growth, political instability, oil prices) is completely outside the control of the Irish government. However, its domestic fiscal policy is fully within its control. The low profits tax level and (up to the last two budgets) low income tax levels are very welcome aspects of the government's fiscal policy. However, other aspects of fiscal policy are very much against the interests of the tourism industry and the hotel sector. Ireland has among the highest alcohol excise taxes in the EU and has one of the worst VAT regimes for hotel tourism. In addition there are high and continually growing local government taxes and charges.

There are two major VAT related issues, the VAT rate applied to accommodation and meals and the fact that the Irish tax code does not allow the refunding of VAT paid on corporate hotel and restaurant expenditure. The latter has a major negative impact on the conference and corporate meetings sector, which is a growing sector internationally.

Ireland is in a relatively weak position in terms of tourism VAT.

Ireland relative to the EU (of 15) in VAT.

	Ireland	Ranking (of 15)	2 Lowest
Standard Rate	21	4 th Highest	15,16
Hotel Accom.	13.5	4 th Highest	3, 5
Restaurants	13.5	8 th Highest	3, 6

As of May 04, HOTREC

Ireland has the fourth highest hotel VAT rate of 13.5%. Denmark (25%), Germany (16%) and the UK (17.5%) are higher. Ireland is middle ranked on the restaurant

VAT rate. Five countries have a higher restaurant than hotel VAT rate and the other 10 have similar rates for both sectors.

The already weak competitive position on hotel VAT rates is substantially worsened by the fact that all three higher VAT rate countries allow VAT on hotel expenditure as a business input.

The effective VAT rate on legitimate hotel expenses for corporate customers is therefore zero in Germany, Denmark and the UK compared to the 13.5% in Ireland.

EU countries (of the EU 15) which allow VAT on hotels/restaurants as business inputs fully or partly are Austria, Denmark, Finland, Netherlands, Spain, Sweden, Germany and the UK. Because of the allowability issues Ireland's VAT rate of 13.5% significantly reduces its competitiveness relative to the above seven countries. The countries listed below do not allow VAT on accommodation as an input but as shown in the table their hotel VAT rates are generally much lower than Ireland.

	VAT allowed for hotel	Hotel VAT Rate
Belgium	No	6
France	No	5.5
Greece	No	8
Italy	No	10
Portugal	No	5
Ireland	No	13.5

Excluding Ireland, of the non deductible countries only Italy has a hotel VAT rate of 10% or higher. Relative to the EU, the Irish tourism sector for corporate business is substantially disadvantaged because of the high VAT rate and non deductibility. The VAT rates comparison understates the weak competitive position because all the higher VAT rate countries allow VAT on business hotel accommodation as an input. Of 14 EU countries Ireland's VAT position is worst in terms of business expenditure on hotels. Visit Britain make a substantial play of the fact that VAT is refunded on corporate hospitality expenditure in targeting the Irish and other markets.

Irish Tourism is greatly disadvantaged by the VAT regime

2.7 The Fiscal Model for Tourism Development

Ireland has followed a fiscal model of low profits tax and low income tax (in recent years the income tax burden has increased). The IHF strongly endorses this fiscal strategy. However, to compensate for the revenue impact of this approach Ireland has evolved into an indirect and local tax regime which significantly reduces tourism competitiveness. VAT rates are high, alcohol excise is high and local charges are rising at unsustainable rates. The lack of action of by government on these matters reduces the economic and incentive effects of the direct tax regime. It is necessary for the government to review its fiscal policy approach and model in the context of negative effects on tourism. This will require fiscal policy taking into account its impact on competitiveness and its position relative to other countries.

In addition, the improvements needed to support tourism will require control of expenditure at both national and local levels, more effective delivery of local and national public services and a widening of the local revenue base to reduce the burden on business.

Governments fiscal policy must go beyond the direct tax situation and address the very real problems created by the indirect and local tax regimes for tourism.

The government's indirect tax model is inappropriate for tourism

3. Performance of Tourism and the Hotel Sector

3.1 Recent Hotel Tourism Performance: Q1 and Q2 2004

The latest CSO tourism data relate to the second quarter of 2004. Overall, the number of overseas visits grew by 3.4% between Q2 2003 and Q2 2004. Excluding same day visits the growth was 4.0%. The number of bednights associated with the visits grew by 5.0%. These are excellent performances in the context of the economic environment. However, the hotel sector has performed worse than the overall tourism activity. Hotel bednights grew by only 1.4 compared to the overall 5%. In the first quarter of 2004 total bednights grew by 3.8% compared with 2003 and hotel bednights grew by 11.4%. The 2004 second quarter hotel performance is much weaker than the first quarter performance. In the first six months of 2004 total bednights grew by 4.6% and hotel bednights grew by 4.8% but, as noted above with a substantial slowdown in the second quarter in 2004.

	Q2 2003	Q2 2004	% Change
Overseas Visits (K)	1704	1762	3.4
Bednights (excl. same day) Total (K)	11693	12275	5.0
Hotel (K)	2935	2977	1.4

Source: CSO Tourism and Travel

Hotel bednights grew by less than total tourism in Q2 2004

Hotel bednights from Britain declined by 11.4% in the second quarter of 2004 compared with the equivalent period in 2003. Hotel bednights from Canada and the USA increased by 5.0% and there was a growth of 7.1% from Europe.

Expenditure by tourists is also a significant indicator of performance. In the second quarter of 2004, compared with the equivalent period in 2003, tourism earnings grew by 5.1%. Allowing for the increase of 3.4% in number of visitors this is an increase in current prices of under 2% in revenue per tourist. This is less than the rate of Irish inflation. Real revenue per tourist has declined in Q2 2004.

Revenue per visitor Q2 03 and Q2 04 (€)

Q2 2003	621
Q2 2004	632
% increase	1.8

Source: CSO Tourism and Travel.

Real expenditure per tourist declined in Q2 2004

3.2 Tourism Review of 2003

The headline growth of 5% in visitor numbers in 2003 compared with 2002 was impressive but revenue grew by only 2.9%. Revenue per visitor decreased from €657 to €645, a drop of 1.8%. When carrier receipts are excluded the revenue per visitor remained unchanged in current price terms.

	2002	2003	% Change
Revenue (Incl. fare receipts) (M)	3989	4105	2.9
Visitors (K)	6065	6369	5.0
Revenue (Excl. fare receipts) (M)	3045	3198	5.0
Revenue per visitor (€)	657	645	-1.8
Excl. fares (€)	502	502	N/C

The visitor number indicator marks a worrying performance in revenue per visitor, which declined in real terms.

It is also notable that there was a net deficit in the tourism account in 2003 when expenditure on outward tourism exceed inward receipts.

Real expenditure per tourist declined in 2003

3.3 Hotel Review: Q2 2004

The Failte Ireland Hotel review covers this period to June 2004. The industry has continued to invest in new capacity. Between Jan-June 2003 and 2004 the number of rooms available increased by 2.7% to 7,668,000 rooms. The number of rooms sold grew by 3.1% and room occupancy rate grew slightly from 56% to 57%. However bed occupancy rate remained at 41% between 2003 and 2004.

The overseas market share of bednights was 43% in 2004 compared with 42% in 2003. Domestic sales account for over half of all hotel bednights.

Overall occupancy rates are relatively low at 57% (Jan-June) for rooms and 41% for beds and over half the sales depend on the domestic market.

3.4 Tourism Barometer June 2004: Operational Issues

The June 2004 Tourism Barometer from Failte Ireland identifies what the industry considers to be the main operational issues. Various elements of cost are identified as the major issues. Running costs/overheads (including waster and water) are reported by 18% of respondents, cost of insurance by 15% and cost of labour by 9%. Other issues causing concern are staff availability (7%) and competition/over capacity (6%).

Operational Issues Causing Concern by Tourism Operators

	%
Running Costs/Overheads (water/waste etc.)	18
Cost of Insurance	15
Cost of Labour	9
Staff Availability	7
Competition/Over Capacity	6
Cost of Energy	5
High Prices	5
Marketing Issues	5
Other issues each below 4%	

Cost is the major issue for tourism enterprises

3.5 Tourism Barometer June 2004: Performance

The evidence from Failte Ireland's Tourism Barometer suggests that 2004 will be a challenging year for most tourism enterprises. While hotels report a better performance than the corresponding period in 2003, on balance there is only a small net increase. All the other sectors report net declines.

Jan-June Performance 2004 compared with 2003

	Volume Up	Same	Volume Down
Hotels	40	22	37
Guesthouses	16	29	50
B&B's	15	29	54
Self-Catering	27	28	42
Caravans & Camping	28	34	38
Hostels	35	13	48

The hotel performance is being supported by the domestic market as shown overleaf.

Hotel Market Segment Performance

	Volume Up	Same	Volume Down
Overall	40	22	37
Overseas	39	22	38
R of I	39	39	20
N.I.	19	45	33

Only 20% of hotels report a decline in R of I business compared to 38% for overseas and 33% for N.I.

Expectations for business levels for June to September are on balance positive in the hotel, caravan/camping and hostel segments. There are negative expectations in the other three categories. This is an improvement on the 2003 Barometer. The hotel net increase is 8%.

% of tourism enterprises forecasting business volume levels (June to Sept 04 compared with 03)

	Volume Up	Same	Volume Down
Hotels	33	39	25
Guesthouses	26	28	40
B&B's	18	35	41
Self-Catering	19	41	36
Caravan & Camping	40	34	26
Hostels	45	30	25

3.6 Profitability

The 2004 Budget Submission reported that the Horwath Bastaw Charleton 2003 Hotel Industry Survey reported a decline in hotel profitability. The Failte Ireland 2004 June Barometer results confirm the continuation of that trend. It reports "There has, however, been no discernible change in average room yield (in hotels) while overall profitability for the hotel sector is down on last year".

The ongoing decline in profitability is not surprising given the rise in domestic input costs and labour costs and the currency appreciation. It is of major concern for the ongoing strength and viability of the sector and its capacity to reinvest and develop the sector. While there has been some response in higher prices as shown by the CPI the industry has absorbed much of the cost increase and currency appreciation. This has led to declines in operating margins. There is little or no scope within the hotel industry to continue to absorb cost increases through further reductions in margin.

Profitability is being squeezed
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4. The Proven Potential and Economic Contribution of Tourism

Reports such as the Irish Tourist Industry Confederation's The Impact of Tourism on the Economy; Report of the Tourism Policy Review Group and Failte Ireland reports show that tourism makes a substantial economic and social contribution.

Failte Ireland notes that in 2003 Irish tourism

- Attracted 6.2M visitors from abroad
- Generated €4.1B in foreign revenue
- Accounted for over 140K jobs
- Generated exchequer revenue of €2.3B in VAT, excise duties and income tax from domestic and overseas tourists
- Of every euro spent by overseas tourists 52% eventually ends up with the exchequer.

Failte Ireland estimates a tourism contribution of 4.4% of GNP in 2003.

Tourism has a very low import content in contrast to sectors such as electronics and pharmaceutical exports which have an import content of over 70%. Bearing in mind the economy's dependence on foreign direct investment, especially for overseas sales the IHF strongly endorses the Review Groups opinion that;

“The Irish tourism industry is, arguably, the most important Irish-owned sector of enterprise, national and regional wealth-creation and employment generation”

In addition to its scale, contribution to GNP and exchequer, role in export revenues and high domestic content the tourism industry has a strong regional dimension. The tourism sector is of exceptional economic importance and it is surprising that aspects of fiscal policy which inhibit it are allowed to continue.

The long-term performance of the sector is a clear indication of what tourism can achieve.

Between 1990 and 2000 visitor numbers more than doubled (+103.8%). Due to many negative features of 2001 (9/11, foot and mouth and growing domestic cost situation) numbers declined to 5,990,000, a drop of 5.1%. There was a slight recovery to 6,065,000 an increase of 1.3%, in 2002. The 2003 level was 6,369,000 which is above the 2000 level.

Associated with the doubling of visitors there has been an impressive growth in employment and foreign exchange receipts. The tourism industry has performed well over the past decade.

Growth in Tourism Foreign Exchange Earnings 1990/2001

Year	€M
1990	1147
2001	3922
% increase	241.9

Over the long term the balance of payment contribution of tourism went from large surplus to a deficit in 2003. Irish tourism must grow substantially to compensate for the rapid increase in outward tourism.

Based on employment surveys tourism related employment grew by 45.2% between 1992 and 2001.

The IHF is concerned that in the new environment ongoing development will be impeded by the negative aspects of fiscal policy referred to above.

Much of the growth of the past decade is because of an effective partnership between the industry and government. The industry benefited from the supportive macroeconomic environment and direct tax regime generated by the Government. This was complimented by active entrepreneurial and investment activity by the industry to double the number of overseas visitors to Ireland. The industry has not been found wanting in providing investment, facilities, capacity and innovation.

Tourism makes a major economic contribution and has proved its potential

5. Tourism at a Crossroads

The IHF agrees with the Tourism Policy Review Group that the Irish tourism sector is in a period of uncertainty. Over recent years the international economic situation, 9/11, international political uncertainty, the Euro appreciation, increased numbers of competitor destinations and the major cost shifts in the Irish economy have created a difficult and uncertain situation. In addition consumer tastes and expectations are changing. The hotel industry has greatly increased capacity and faces the pressure of filling this capacity on an ongoing basis.

Public policy has contributed to the uncertainty in some of its actions instead of reducing it. These actions include;

- increased regulation
- unexpected VAT increase
- out of control local authority charges
- fears of ongoing tax and charges increases

The industry must deal with the market, the customer and competitors. External factors such as exchange rates and international economic recovery are not within the control of the government. It is reasonable that the policies which government can control should not worsen the position of the hotel and tourism sector. Budget 2005 and overall policy should support an industry which has delivered and which now faces a fundamentally different environment than the past. The tourism industry needs the government to move in partnership with it to deal with the changes and difficulties. If so the economy can expect to benefit from the likely long term growth in world tourism.

6. Budget Policy to Improve Competitiveness and Promote Development

6.1 Context

The IHF Budget proposals are based on the objective analysis of the previous sections. They are designed to enhance competitiveness and promote development.

The proposals take into account

- the likely international economic situation with weaker UK and USA growth
- the major structural impact of the euro appreciation
- the large economic role of tourism
- the worrying indicators of lower revenue per visitor
- the emergence of deficits in the tourism account of the balance of payments
- the improvement in the public finances relative to what was expected in Budget 2004
- the value for money aspect of investment in tourism
- the self imposed penalty of internationally high tourism VAT rates and VAT regulations on refunding.
- the self imposed penalty of high local taxes and charges

6.2 Four Budget 05 Proposals

To enhance competitiveness and to compliment the efforts being undertaken by the hotel industry IHF proposes

- a) The tourism VAT rate of 13.5% should be reduced to 10%
- b) VAT on corporate expenditure on hotels and restaurants should be allowable as a business input
- c) Increases in local authority charges and rates should be capped at a maximum of 50% of the 2004 inflation rate and a new system of financing local government should be introduced
- d) Increased funding for tourism marketing of €15M per year for three years

In keeping with the strategy of the IHF analysis proposals (a) and (b) reflect the need to remove self imposed competitive disadvantages which are broadly out of line with other countries. Proposal (c) reflects the view that a low tax rate on profits is insufficient to promote enterprise if monopoly local authorities can impose very large cost increases.

The VAT proposals should not be regarded as concessions. They simply remove an existing self imposed penalty which other competitor countries do not suffer.

The local authority situation is counter to all that government has achieved in financial management at national level. The situation where local authorities impose large cost increases on enterprises cannot be continued. It is ultimately a self-defeating approach. The IHF has submitted proposals to reform local government financing to the Department of the Environment, Heritage and Local Government. The IHF proposes that the existing rates system should be replaced by local taxation which for enterprises would be a local tax on profits and, for individuals a local tax on income.

The investment of an extra €45M over three years for additional marketing is a relatively small amount, given the current difficult operating environment for the industry and its growth potential. The same Euro appreciation which reduces competitiveness in tourism generates savings for the Government in servicing the national debt and tourism generates over €2B in exchequer receipts. Based on past experience an increase of €1 million in marketing expenditure could result in a tourism revenue increase of about €15 million and also produce a substantial return to the exchequer.

The VAT reduction and change allied to an increased marketing performance will present a strong and positive position on world tourism markets. These proposals continue the strategy presented in previous IHF submissions but it is essential that action be taken now.