

**PROTECTING PARADISE:
A SOCIALLY OPTIMAL TOURIST
TAX FRAMEWORK**

Position Paper

Todd Montgomery

*Robin and Curt Baney Endowed Professor
Director - OSU Sustainable Tourism Lab*

BACKGROUND:

Tourism is an important economic driver for the global economy.

In fact, “the travel and tourism sector contributed approximately 7.9 trillion US dollars to the global economy in 2017. This translates to a 10.2% share of the global Gross Domestic Product” (Nepal & Nepal, 2021). Tourism accounts for about the same percentage in terms of jobs globally and has the power to uplift rural communities and support livelihoods.



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COST AND BENEFITS OF TOURISM:



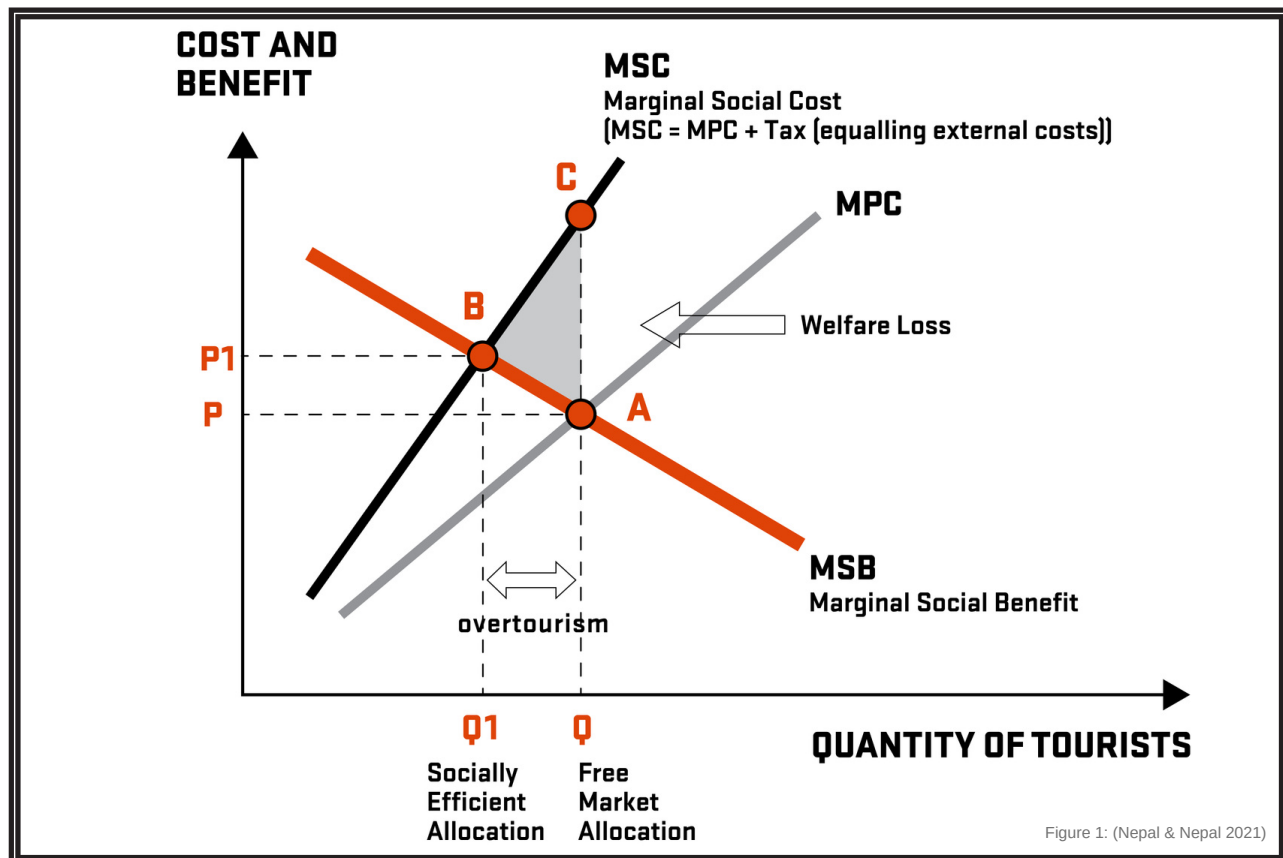
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Tourism is primarily viewed as an economic benefit, based on my research over the last three years. These economic benefits occur through jobs, business revenue, and additional tax revenue. The costs of tourism are less obvious. According to Nepal and Nepal, costs of tourism can include “problems of alienation, environmental damages, degraded tourist experience, wear and tear of infrastructure and cultural damages induced by overtourism generates economic, social and environmental costs to the society at large” (2021). Economists refer to these costs as negative externalities or the unintended costs of consuming a product or service. In other words, it is when an individual “decision imposes on others costs” that do not impact the individual themselves (Gruber & Johnson, 2022). The most cited costs—of externalities—of tourism mentioned by community members are increased traffic and vacation rentals.

WELFARE LOSS:

These costs of tourism are problematic for the destination because public attractions, such as beaches, parks, forests, etc., are a primary reason visitors come to a destination. These attractions are public goods; both residents and visitors have access to them, and this public access cannot be restricted. If tourists visit a destination in large numbers or in harmful ways, there can be an additional burden (cost) on the attraction that diminishes it over time. This can result in a “market failure, because tourism products are a public good” (Socher, 2000). When market failure exists, there is a welfare loss or deadweight loss, resulting in economic inefficiency.

This takes place when the marginal social benefit does not equal the marginal social cost. Figure 1 illustrates both concepts. When there is no social equilibrium in tourism, the prices tourists pay do not internalize (include) these additional social costs, which results in overtourism (the gap between Q1 and Q). This is often caused by the free rider problem, which is “when an investment has personal costs, but common benefits” (Gruber & Johnson, 2022). In the case of tourism, the visitors are enjoying public goods without paying the costs that their visit imposes on these goods.



PIGOUVIAN TAX:

To address this social welfare loss, governments apply a Pigouvian tax, which is designed to tax any market transaction that causes negative externalities. Examples of other applications of a Pigouvian tax include alcohol and tobacco taxes. The goal “for selecting a tax is to maximize the likelihood of choosing a welfare-enhancing tax” (Sheng, 2017). But how best to structure this tax is difficult at best. According to Sheng, “Optimal taxation in the tourism industry has been long debated among both academics and businesses. It is not an easy task to determine whether tax rates should be reduced, as is suggested and supported by tourism businesses, or increased, as is suggested and supported by a number of stakeholders in a host community” (2017). This debate is playing out across the world today at popular tourism destinations as leaders try to determine how best to make tourists pay for their negative externalities and how and where those tax revenues should be allocated. Although this issue has been bubbling up for years, COVID-19 has brought the issue to the forefront. The pandemic “has had a detrimental effect on people’s livelihoods and economies worldwide. Social, economic, religious, and cultural activities have been interrupted throughout this epidemic” (Khan et al., 2021). We now see the manifestation of this debate playing out in newspaper headlines in Figure 2.

To respond to the challenging community environment, Destination Management Organizations (DMO) have started rebranding by changing the “M” in DMO, which stood for Marketing pre-COVID, to Management to highlight destination stewardship. A small fraction of DMOs started surveying community members to preempt resident concerns. Unfortunately, many of these surveys have been used as validation tools for existing policies rather than authentic engagement with communities.

They typically include a significant amount of bias due to oversampling of tourism stakeholders, undersampling of underrepresented residents, selection bias due to survey distribution, and leading questions. These efforts often more closely resemble PR exercises than research. Not surprisingly, the public, and particularly politicians, have taken note and continue to disregard these self-serving research efforts and push to reduce or redirect DMO funding sources, as illustrated by the article headlines.



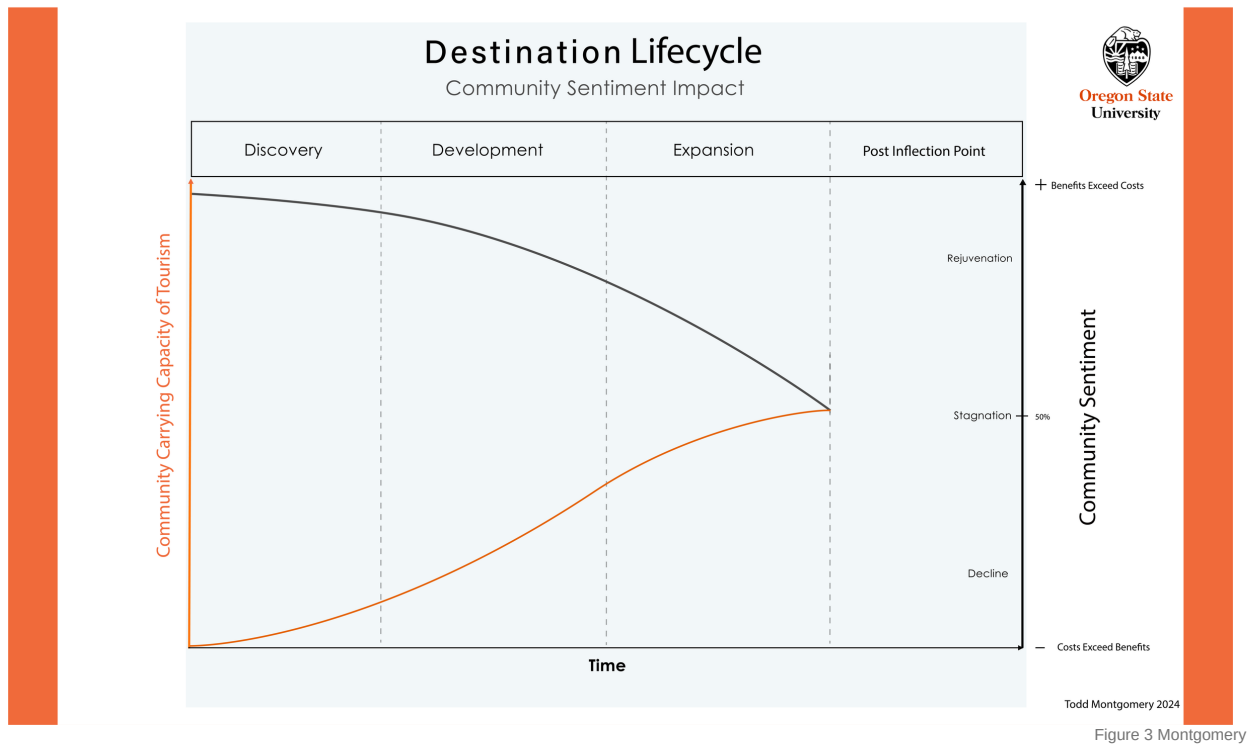
Figure 2. Montgomery

TOURIST TAX POLICY CHALLENGES

Challenge One – Destination Lifecycle:

For every product or service, such as an iPhone, there is a lifecycle to that product. This concept also applies to tourist destinations. According to Yang et al. (2023), “Tourism destinations evolve over time, akin to a product that goes through the process of a lifecycle”; Yang goes on to refer to Butler’s (1980) model of a multistage lifecycle of a tourism area. Once a destination nears the end of this lifecycle and begins to decline, it can be particularly painful for the residents of the destination. At this point, the attractions that tourists initially flocked to, like a beach, trail, etc., could be greatly diminished and damaged.

This could also include abandoned hotels that once flourished during earlier lifecycle stages. Consider an example in Saipan, a small Pacific Island that is south of Japan. The land this casino was built on was a premiere beachfront property on a small island with a limited amount of quality beaches. When the developers ran out of money years ago for a casino that they were building, they abandoned the project, leaving a massive concrete structure that will likely remain for generations as an eyesore since there are no funds to dismantle this massive structure.



Challenge Two - Short-Termism:

Destinations, and specifically the DMO, face tremendous short-term pressures. Whether responding to an economic downturn, a natural disaster, or even community pushback to tourist policies, DMOs can find it difficult to balance short and long-term needs. However, making decisions based on short-term needs can have a profound effect on the destination's lifecycle. It can also have an impact on social welfare loss, as discussed earlier. In fact, "political short-termism is generally considered to have a negative effect on social welfare," which can go hand in hand with negative externalities (Garri, 2010).



Challenge Three – Who Protects the Destination’s Long-Term Interests:

To preserve the destination for future generations of residents and visitors and put the destination on a sustainable path in its lifecycle, the destination needs a long-term vision and a protector. DMOs were intended to be primarily economic development organizations and can often succumb to immediate needs for self-presentation and relevancy. Also, the current structures of many DMOs lack the incentives, authority, and expertise to play the role of long-term protector. Fyall and Garrod discuss this dynamic, saying that DMOs are “notoriously difficult to manage due to the complex systems of stakeholders they possess. Such complexity implies that destinations are driven by a wide range of forces in their internal and external environments” (Fyall & Garrod, 2020). As a result, they can devolve into political and bureaucratic entities.

Challenge Four – Tax Collection Often Does Not Address Negative Externalities:

Tourism tax revenue allocation varies, in some cases greatly, by each community. It also varies if and how tax revenue's intended purpose is stated in the law or municipal code. For those cases where the tax revenue allocation is stated, it can be vague or overly broad. There are also cases where the allocation is deferred to a third party like a City Council. Regardless of how the laws are written, specific negative externalities or the costs associated with tourism are almost never stated outright. For example, "Cancun's taxation system has traditionally placed 80% of tourist revenues into the budgets of the national tourism authority and not local municipal accounts. This has forced local government to depend on national transfusions of funds to manage local costs for health, well-being and environmental protection, which was left largely unattended at the municipal level" (Wood & Ahamed-Broadhurst, 2019). The result is that tourism tax revenue allocation rarely addresses externalities, even if the intent of the law is to do so. It can lead to misinterpretation or even abuse by political entities looking at the tourism tax as a pot of money to address political fires that may have nothing to do with the externalities that the funds were intended to address.



RECOMMENDATIONS

Recommendation One – Set Tourism Tax Policy Goals:

Given the challenges, and particularly the short-termism challenge mentioned above, the destination must reevaluate its relationship with tourism and recognize the natural lifecycle of its destination. One simple but powerful first step is to clearly articulate the destination's goals so that as needs arise, the community has goals that have already been defined. Although every destination has a different set of factors, one overarching goal shared by all destinations is the objective of preserving the destination long term. Doing so provides a backstop to reactionary policies with a short-term focus.

Another elementary goal should be to redefine what success looks like in tourism because “today’s tourism managers focus on an incomplete set of economic measures to assess the health of the tourism destination – total number of visitors, as well as direct and indirect economic impacts. Those figures provide a one-sided view of tourism’s contributions to local economies and fail to account for management costs at the local level” (Wood & Ahamed-Broadhurst, 2019).



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Recommendation Two – Tax Allocation Needs Codified:

The first step to achieving these goals is to address the lack of transparency in tourism tax revenue allocation and codify it into law. This basic step has not gone unnoticed, as “although the growth of the industry has been steady for decades, policies for addressing its significant economic, social and environmental impacts continue to lag” (Wood & Ahamed-Broadhurst, 2019). So most destinations are working with outdated codes. No one should be under any illusion how difficult this might be. Sheng and Tsui discuss this, saying “Though taxing tourism is welfare-enhancing for the host community as a whole, interests and lobbies vary significantly within the host community. Different social groups have different ‘benefit-externalities’ preferences, leading to different preferences on taxing tourism” (Sheng & Tsui, 2009).



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Recommendation Three – Tax Allocation Needs an Ongoing Feedback Loop:

As COVID-19 made clear to the world, both internal and external events can change the tourism industry on its head. Therefore, the tax allocation needs to be adaptive and responsive to events on the ground. Therefore, “which type of tax and how much tax rate is welfare maximizing depends upon both the particular socio-economic mix of the destination and the international tourism market, which constantly changes. Therefore, while taxing tourism is, in general, a well-justified policy tool to improve a destinations’ welfare, specific policies may drastically vary across destinations and through time” (Sheng & Tsui, 2009). As the challenges above already stated, the destination lifecycle has different costs and benefits as it moves through its lifecycle. This will require different tax approaches and funding at different stages of the lifecycle. On the surface, this would seem counterintuitive to recommendation two which would codify tourism tax allocation. But, the balance between codifying and having an adaptive policy is the balance a destination must find, which will be addressed in the next section.

PUTTING IT INTO PRACTICE

The Wheel Exists, It Just Needs Updated:

Although the challenges and recommendations can feel too difficult, most destinations are lucky in that they don't have to reinvent the wheel. The wheel exists in the DMO; it just needs to be updated to reflect today's tourism environment.

A New Long-Term Vision:

The DMO is the natural organization within a local destination to be the destination protector for generations to come. Of all government entities and subsidiaries, the DMO is the most informed about tourism and often has the experience and relationships to play that role.

DMO Board:

The board has fiduciary control of the DMO budget and, therefore, its spending priorities, a.k.a. tax revenue allocations. This provides the board with the ability to implement and enforce the three recommendations above of setting goals, codifying tax revenue allocation, and providing a feedback loop to respond to changing micro and macro environments. However, the DMO board must also be improved. First, the board must be representative of the entire community and not just tourist stakeholders. For many current DMOs, that will require a change to their by-laws as these laws can be restrictive for who can serve on a board. An example of that is some DMOs require that tax remitters automatically get a seat on the board or that only people with roles in tourism are allowed to join. These obstacles and other impediments to broad community representation will require amending.



DMO Structure:

The DMOs' structures and the roles they play are also a mixed bag. In fact, according to Garri: "Most DMOs in the sample are integrated parts of the city administration (31%) and typically function as city departments with direct relationships with a mayor or the city council. This is especially the case with the smaller DMOs. A popular model is to organise DMOs as either part of an independent and sometimes city-owned and controlled management organisation (21%) or as an independent foundation (19%). These organisations are at arms length of the city administration, often with their own executive boards, working side by side with similar city agencies for investment promotion or economic development. Finally, 16% of the responding DMOs report as industry association and seven percent as a public-private partnership (ppp)" (Garri, 2010).

The lack of uniformity is both a challenge and an opportunity. Given the lack of uniformity in DMO structures, it provides flexibility for destinations to structure the DMO around the city's existing structure and also navigate around existing obstacles to sustainable economic development. The challenge, though, is that there is no template to follow. In my own experience, the independent foundation model is most in line with the challenges and recommendations discussed in this paper as long as the independent foundation mission is aligned with the public good.

DMO Empowerment and Independence:

Although the DMO's relationship with the city can vary greatly, the DMO can still be successful if it is empowered, independent, and appropriately incentivized.

As the long-term steward of the destination, DMOs experiencing some element of the short-termism and political pressure identified earlier are inevitable. This is particularly the case for the DMOs on fixed-length contracts (i.e. five years) with the city that are subject to renewals. Often the DMO must reapply every few years to renew its DMO contract. This puts tremendous pressure on the DMO to enact public welfare-reducing steps in the short-term. This is why the DMO must be empowered and have long-term security to resist this pressure and fulfill its mission for a destination's long-term preservation.



DMO Leadership Team:

Since most DMOs prior to COVID-19 were economic development organizations, many of the leaders came from sales and marketing backgrounds. Destination marketing is fun, and people may enjoy creating new and inspiring videos that highlight the places they themselves already enjoy. On the other hand, destination management is hard and messy. It requires building consensus, working with various stakeholders with possibly significantly different cultures and interests, and prioritizing what is best for the community overall, which may be at odds with short-term economic interests. It's likely that some current DMO leaders will not have the skill set to adjust, and the DMO may require new leadership and vision as a result.

The Outcome is Inevitable:

The proposals above can seem daunting and a bit overwhelming for any tourism leader. Given the transformation the tourism industry is going through and the significant uptick of political activity around tourism, it will be difficult. However, what is happening is also inevitable within the community carrying capacity model, as shown in Figure 4. The market—in this case, the community—will find a way to optimize the destination's carrying capacity through political action within a democracy. The headline articles highlighted at the beginning of the paper show that this process is well underway and will continue as long as the negative externalities of tourism exist and the costs of tourism outweigh the benefits of tourism. In other words, it is only a matter of time before the community, using market forces, ushers through many of the recommendations in this paper to find a socially optimal equilibrium for tourism. This equilibrium could be months, years or even decades from now, but it will come in time.

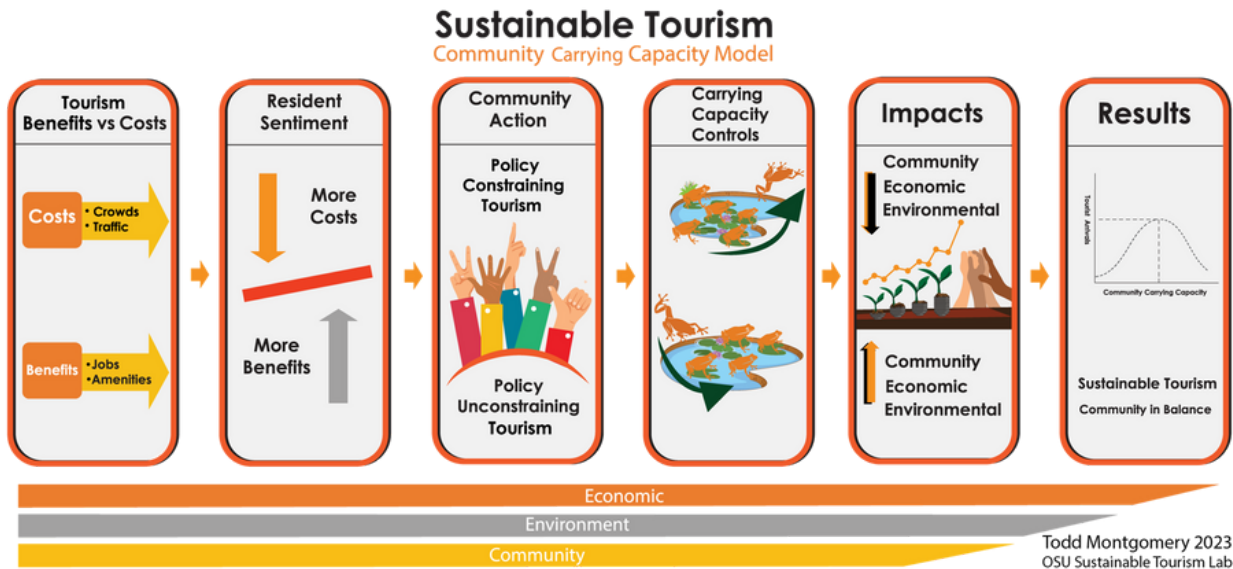


Figure 4 Montgomery

Why Not Just Wait for Market Forces to Find Equilibrium:

Based on this, some might say to just let the market correct and not take action now. There is no need to be proactive if these changes are inevitable. However, that argument is fundamentally flawed as it ignores the fact that a destination has a lifecycle. The faster the destination moves through the lifecycle, the more negative externalities (tourism costs) will impact the attractions that lure tourists to the destination in the first place. As the costs add up and those public goods are diminished, tourists will move on to the next destination, leaving the local community members without the ability or resources to restore what nature had provided. This puts their community, livelihoods, and culture at risk. This is exactly what happened to the Saipan community and what is happening at destinations across the globe today. It is my opinion that as a result, the choice destinations face is clear: wait for market forces to find the equilibrium when it will likely be too late and damage will already have been done, or act now, make difficult choices, be proactive and put the destination on a long-term sustainable path.

What Comes Next:

Currently, only the most progressive leading destinations are looking to get ahead of the inevitable curve by facing these challenges head-on. They are changing their structures, hiring passionate experts, and engaging the community not as a PR activity but in an authentic and scientifically rigorous way. The bravest and most innovative destinations are doing much more than fancy name changes and slick presentations; they are taking the community's feedback, putting financial resources behind these needs, and taking concrete actions. An example is the Visit Bend Sustainability Fund based in Bend Oregon, which provides a competitive grant program for organizations or people with ideas to enhance the community and improve the visitor experience.

Although destinations face similar challenges, no two solutions are the same. A community cannot take a template from one destination, insert it into another community, and expect the same results. The solutions need to be localized and rooted in what is best for their community, the environment, and local economics, which, in essence, is the definition of sustainable economic development.



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