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Briefing Note

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Impact of reducing the VAT rate on tourism goods and services in the Republic of Ireland

1 Introduction

The following paper, in response to a query by the Enterprise, Trade and Investment Committee, looks at the impact of the Republic of Ireland's decision to reduce the VAT rate on tourism related goods and services from 13.5% to 9%.

The paper outlines the findings of three separate analyses of the impact of the reduction. These are:

- The Department of Finance report *'Measuring the Impact of the Jobs Initiative: Was the VAT Reduction Passed on and were Jobs Created?'* –published in 2012 and examining the impact of the VAT change over the first year of its operation;
- The Irish Tourist Industry Confederation report *'Lower VAT rate improves competitiveness, delivers jobs and helps tourism recover'* – published in 2013 in advance of Budget 2014; and
- The Fáilte Ireland commissioned, Deloitte report *'Analysis of the Impact of the VAT Reduction on Irish Tourism & Tourism Employment'* – published in 2014.

2 Background

On 1 July 2011 the RoI Government introduced a reduced rate of VAT for tourism related goods and services. This formed part of a range of measures introduced to support tourism as part of the Jobs Initiative.

The new VAT rate reduced the VAT on certain categories of goods and services from 13.5% to 9%. The good and services affected fell into two categories – tourism sectors and other labour-intensive sectors. The *'9% categories'* were as follows:

- Hotel and holiday accommodation;
- Restaurant and catering services;
- Admission to cinemas, certain live theatrical or musical performances, museums and art exhibitions and galleries;
- Fairgrounds and amusement parks;
- Use of sporting facilities (labour-intensive);
- Hairdressing services (labour-intensive);
- Printed materials such as newspapers, magazines, brochures, maps, leaflets, flyers and catalogues (labour-intensive).[1]

The reduction was originally intended to be a temporary measure, with an end date of 31 December 2013. The Government has chosen to extend the VAT reduction in each of the last three budgets (Budget 2014, 2015 and 2016).[2]

3 Measuring the Impact of the Jobs Initiative - 2012

In 2012, a Department of Finance's Economics Division paper *'Measuring the Impact of the Jobs Initiative: Was the VAT Reduction Passed on and were Jobs Created?'* found that:

> *The 9% reduced VAT rate appears to have had the desired impact both in terms of price pass through and by contributing to employment gains, with an additional 3,000 jobs in quarter 1 2012 relative to quarter 2 2012 in the labour intensive food and accommodations services sector of the economy.*
>
> *When considered as an overall group there is evidence of pass through of the VAT rate reduction, though not the full amount, with an aggregate reduction of 1.3% recorded between June 2011 and June 2012 and 1.7% when the highly seasonal hotel price series category is excluded. This*

[1] Deloitte Analysis of the Impact of the VAT Reduction on Irish Tourism & Tourism Employment (2014) http://www.failteireland.ie/FailteIreland/media/WebsiteStructure/Documents/3_Research_Insights/3_General_SurveysReports/FA%C2%A1ilte-Ireland-Tourism-VAT-Study-Report-2014.pdf?ext=.pdf

[2] See for example http://www.rte.ie/news/budget/2014/1014/652326-vat/ on Budget 2014, http://www.irishtimes.com/news/environment/retention-of-9-per-cent-tourism-vat-rate-in-budget-welcomed-1.1963110 on Budget 2015, http://www.irishtimes.com/news/ireland/irish-news/hoteliers-welcome-budget-move-to-retain-9-tourism-vat-rate-1.2390148 on Budget 2016

> *compares favourably with economy wide inflation which increased by 1.7% over the same period on a headline basis and underlying inflation increased by 0.3%.*[3]

The Department's analysis of the VAT rate pass through is based on Central Statistics Office data for the period June 2011 (the month before the rate was reduced) to June 2012. It notes that while overall prices within the areas covered by the VAT reduction fell relative to the economy as a whole; this was not evenly felt across the 9% categories. The Department's analysis found *'clear evidence of pass through'* in the following sectors:

- Meals out;
- Hairdressing;
- Admissions to cinemas, theatres, musicals, museums and art galleries; and,
- Newspapers.[4]

They add:

> *Significant price volatility occurred in the 'hotels and other accommodation' series which fell by 13% from July 2011 to January 2012, and recovered to within 1% of the June 2011 price level by June 2012. This is driven by the cyclical nature of hotel prices which peak in mid-year and decline thereafter. Another series impacted by seasonality is hairdressing services with a clear 'December effect' causing a temporary spike in prices around the Christmas period.*[5]

Table 1 provides a summary of price changes across the 9% categories. This shows price changes for the entire first year of the measure (June 2011 to June 2012), as well as price changes in the June to December 2011 and January to June 2012.

Commenting on these figures overall, the Department states:

> *Looking at the 9% VAT rate items as a group, it is interesting that following a 2.5% price reduction in the first six months, prices increased by 1.9% in the second six month period, resulting in an overall price reduction of 1.3% by June 2012 compared with June 2011. It is also noteworthy that the rate increase in the second six month period outpaced both headline and underlying inflation. This rate rise was however accounted for mainly by seasonally driven prices in 'hotels and other accommodation; in the first half of 2012.*

[3] The Department of Finance Measuring the Impact of the Jobs Initiative: Was the VAT Reduction Passed on and were Jobs Created? (2012) http://www.finance.gov.ie/sites/default/files/Measuring-the-Impact-of-the-Jobs-Initiative-Was-the-VAT-Reduction-Passed-On-and-Were-Jobs-Created1_1.pdf

[4] *Ibid*

[5] *Ibid*

The cyclical nature of pricing in hotels and other accommodation overstated in the decline in the overall Jobs Initiative series in the final six months of 2011 and similarly overstated the price increase in the overall series in the six months of 2012. By excluding hotels and other accommodation from the overall Jobs series a more modest decline in prices of just under 2% relative to June 2011 can be observed for most of the period with the exception of a slight increase around Christmas 2012 which was largely account for by seasonal hairdressing prices driven by supply and demand factors in that sector. Controlling for the impact of this 'Christmas effect' on hairdressing prices, the overall pass-through of close to 2% held consistently since the 9% reduced VAT rate came into existence. This suggests that close to half of the VAT reduction has been passed through to consumer prices.

Given that headline inflation ran a close to 2% for the full period it is likely that some of the gap between the actual price decrease in the affected sectors and the rate reduction is accounted for by economy wide inflation.[6]

Table 1: Rates of Inflation June 2011 to June 2012[7]

Category	June – Dec 2011	Jan – June 2012	June 2011 – June 2012
Cinemas, theatres, musicals, museums, art galleries	-2.8%	2.4%	-0.6%
Hairdressings services	3.5%	-4.3%	-1.6%
Hot take away foods and hot drinks	-0.4%	-0.4%	-0.5%
Hotels and other accommodation	-10.2%	13.6%	0.9%
Meals out including rail car dining	-1.3%	0.1%	-1.3%
Newspapers	-1.7%	-0.5%	-2.2%
Sport	0.0%	-4.5%	-4.5%
All 9% items	-2.5%	1.9%	-1.3%
Headline CPI	0.5%	1.7%	1.7%
Underlying CPI	0.0%	1.4%	0.3%

In analysing effect on employment, the Department of Finance again uses CSO data as the basis of their analysis. CSO data does not, however, disaggregate to all the 9% categories. The Department has therefore used accommodation and food services as a proxy for the wider Jobs Initiative Categories, on the basis that these sectors cover *'70% of the Jobs Initiative basket according to expenditure data provided by the CSO as part of its price series'.*[8]

[6] *Ibid*
[7] *Ibid*
[8] *Ibid*

Based on this data the Department concludes that there were 114,500 people employed on a seasonally adjusted basis in the accommodation and food services sector in Q2 2012 compared with 108,300 in Q2 2011 – an increase in jobs of 6,200 (+6%).[9]

4 Lower VAT rate improves competitiveness, delivers jobs and helps tourism recover – 2013

In advance of Budget 2014, the Irish Tourist Industry Confederation (ITIC) published an analysis of the impact of the lower VAT rate on the tourism industry.[10]

4.1 What did the measure cost the exchequer?

On the cost of the measure, ITIC concluded:

> *Even before allowing for the stimulatory effects of the 9% VAT rate of tourism spending and employment, it looks like the budgetary cost of the measure as it applies to tourism-related products and services is about €90m. This contrasts sharply with the €350m estimate published at the time the Job Initiative package was first announced. When the resultant boost to employment is account for, the cost to the Exchequer is further reduced and may in fact become a net gain.*[11]

This is based upon Revenue Commissioners data which places the one year cost of the entire VAT cut at €160m, which includes the cost applying the 9% rate to non-tourism related items. Excluding these non-tourism items reduces the total cost to €140m. The €90m figure is arrived by taking into account 'buoyancy effects', that is the assumption that *'one-third of the gross cost of a tax reduction will automatically flow back to the Exchequer through a range of revenue channels'.*[12]

ITIC further argue that *'the increases in tourism spending and in employment brought about by the VAT reduction – may be expected to reduce the cost of the measure'.*[13]

4.2 Was the VAT cut passed on?

On whether or not the VAT cut was passed on, ITIC concluded:

> *Common sense, international experience and the available empirical evidence including a recently published Department of Finance paper* [see Section 3] *, strongly support the argument that the VAT cut has been passed on to consumers. This has happened at the same time as visitors'*

[9] *Ibid*

[10] The Irish Tourist Industry Confederation report Lower VAT rate improves competitiveness, delivers jobs and helps tourism recover (2013) http://www.itic.ie/wp-content/uploads/2015/05/Final_ITIC_Submission_-_Lower_VAT_Rate_100713.pdf

[11] *Ibid*

[12] *Ibid*

[13] *Ibid*

> *perceptions of value-for-money in Ireland have improved substantially and despite the fact the key input costs have been rising.*[14]

ITEC's conclusions here are based upon a number of other studies not least the conclusion of the Department of Finance analysis outlined above. It also drew on a report by Copenhagen Economics for the European Commission which examined the effect of reducing VAT on tourism-related products and services across a number of Member States. This report found that *'the empirical evidence from major changes in VAT rates supports the conclusion that changes of VAT rates to a very large extent are passed on to consumers'.*[15]

4.3 What was the effect on employment?

On the impact the tax cut had upon employment ITIC note that employment in accommodation and food services increased by 6,100 from the time of the tax reduction to Q1, 2013. This is in contrast to the period prior to the VAT reduction when employment in these sectors contracting – in the two years leading up to Q2 2011 employment in accommodation and food services fell by 12,000.[16]

The rate of employment growth in these industries from the introduction of the VAT reduction and Q1 2013 was 5.3% which was *'the fastest of any sector outside agriculture, and contrasts with the employment declines recorded by the overall non-agricultural economy and by private sector services as a whole'.*[17]

Accommodation and food services is used here as a proxy for the wider tourism industry, as is the case in the Department of Finance's analysis. ITIC argue that extending this growth rate to the tourism industry as a whole *'suggests an employment increase of around 9,000 for the tourism industry as a whole from the time the 9% VAT rate was introduced'.*[18]

Additionally, ITIC apply a number of different methodologies to establish how employment has been affected by the policy. They conclude that:

> *Tourism employment is higher than it would have been in the absence of the VAT reduction. A variety of methods have been used to quantify the effect. The most conservative of these produce estimates in the range 4,000-9,000; the most bullish points to a gain of 25,000. These figures capture the direct impact on the tourism industry. When jobs supported in the rest of the economy are included, the estimated employment gain is increased by 40%* [i.e. a gain of 35,000].[19]

[14] *Ibid*
[15] *Ibid*
[16] *Ibid*
[17] *Ibid*
[18] *Ibid*
[19] *Ibid*

4.4 What was the effect on competitiveness?

On the issue of competitiveness, the ITIC comment:

> *Irish tourism is currently recovering from a major downturn. A key factor contributing to that downturn was the deterioration in the competitiveness of the sector that occurred during the Celtic Tiger boom. Competitiveness is now being restored and perceptions of value for money amongst international visitors have improved dramatically in recent years. The introduction of the 9% VAT rate has been an important part of that turnaround. Its abandonment at this stage would be a move in the opposite direction and would send a strange and confusing signal to Ireland's tourism markets.*[20]

A more detailed analysis of value for money in the sector was taken forward by Deloitte on behalf of Fáilte Ireland. This is explored in the following section.

5 Analysis of the Impact of the VAT Reduction on Irish Tourism & Tourism Employment – 2014

In 2014, Fáilte Ireland commissioned Deloitte to carry out an *'analysis of the impact of the VAT reduction on Irish tourism and tourism employment'.*[21] This sought to address a series of questions. The report found a positive or strongly positive impact in each area addressed. These questions and the headline results are outlined below.

5.1 Did the reduction in the VAT rate result in lower consumer prices in the impacted categories?

The report found *'good evidence of price-pass through'* and that although this pass-through has varied by category *'it is apparent in all sectors'.* The report found a significant gap between the 9% categories and overall CPI. This gap has averaged 3.7% since the introduction of the VAT reduction.[22]

Deloitte also examined the gap between modelled inflation and actual inflation. On the basis of this analysis they found the average implied price pass-through of 2% across all categories.[23]

5.2 Has there been an impact on tourists' perceptions of value for money?

Considering the impact on tourist perceptions of value for money (VfM) the report found:

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[20] *Ibid*

[21] Deloitte Analysis of the Impact of the VAT Reduction on Irish Tourism & Tourism Employment (2014) http://www.failteireland.ie/FailteIreland/media/WebsiteStructure/Documents/3_Research_Insights/3_General_SurveysReports/FA%C2%A1ilte-Ireland-Tourism-VAT-Study-Report-2014.pdf?ext=.pdf

[22] *Ibid*

[23] *Ibid*

> *There has been a continued improvement of international visitors' assessment of Ireland's VfM, with the ratings achieved in 2013 reaching levels not seen since the early 2000s.*[24]

This conclusion is based on an analysis of Fáilte Ireland's annual survey of overseas visitors. The survey data shows that between 2005 and 2013 the proportion of visitors who rated VfM as 'good' or 'very good' increased from 29% (2005) to 41% (2013), while the number of visitors rating VfM as 'poor' or 'very poor' decreased from 36% to 15% in the same period.[25]

The report also assessed whether this improvement in VfM was a result of changes in exchange rates, concluding:

> *This increase* [in VfM] *could not simply be attributed to fluctuations in exchange rates, as evidenced by the widespread nature of the increase in VfM scores (including other euro zone nations) and the fact that the VfM scores did not move closely with the dollar and sterling rates during the period.*[26]

5.3 Has there been an increase in tourist numbers as a result of any improvements in perceived value for money and what has the impact on revenue been?

Analysing the impact of on visitor numbers the report found that *'a positive improvement in both international and domestic tourism numbers since the introduction of the VAT rate cut, with visitors from mainland Europe and North America seeing the strongest growth'.* The report's authors note that the VAT rate cut did not take place in isolation and stress the significance of other factors in driving visitor numbers, stating:

> *Given the number of other factors that impacted international tourism numbers (e.g. The Gathering and economic circumstances of origin), it is difficult to directly attribute this growth* [in visitor numbers] *to the VAT rate initiative.*[27]

The report found a positive impact on tourism revenue:

> *Unsurprisingly, tourism revenue declined with falls in the number of overseas tourists in 2009 and 20101. Total annual expenditure by tourists fell from €5.3 billion in 2009 to €5.1 billion in 2011… Expenditure then recovered modestly in 2012 before growing strongly by 7% to almost €5.5 billion in 2013.*[28]

[24] *Ibid*
[25] *Ibid*
[26] *Ibid*
[27] *Ibid*
[28] *Ibid*

It also notes an improvement in the tourism balance – the amount of expenditure by non-residents visitors plus the amount of expenditure by domestic travellers, less the amount of expenditure of Irish residents abroad – which increased by over €600m (excluding air fares) between 2009 and 2013.

5.4 Has there been an increase in demand/activity in the tourism industry as a result of the VAT rate reduction?

Answering the question of whether there has been an increase in demand/activity in the tourism industry, the report notes that the period following the VAT slowdown in the rate of decline in the stock of accommodation and a stabilisation in the number of rooms. They added that excess capacity in the hotel sector has declined. Hotel capacity in 2014 was approaching 2007 levels of 64%, which Fáilte Ireland considers sustainable in the long term. [29]

5.5 Has there been an increase in employment in the tourism industry as a result of the VAT reduction?

On employment, Deloitte adopted a similar methodology to the Department of Finance by using employment in the labour intensive food and accommodations services sectors as a proxy for overall employment in the wider tourism sector. This is because the source material, the CSO's Quarterly National Household Budget Survey (QNHS) data for Accommodation and Food Services, does not currently disaggregate the other 9% categories.[30]

QNHS data shows a decline in employment in the two sectors from 2007 to 2011. Following the introduction of the reduced tax rate employment levels stabilised in late 2011. This was followed by a strong rise:

> *Seasonally adjusted employment levels were 11,025 higher on average versus 2012, with Q4 2013 a full 17,300 ahead of Q4 2012. The recovery has been such that employment levels are now actually ahead of those seen before the recession.*[31]

In addition, employment in these sectors was compared to overall employment:

> *To consider the impact of these overall employment trends on actual employment trends on actual employment numbers we compared the indexed performance of the Accommodation and Food Service sector against Total Employment levels and the Comparison Group* [the full services sector, excluding accommodation and food services, as well as the public sector and communications – the latter sectors are excluded as they are not directly comparable to the tourism sector] *from Quarter 3 2011*

[29] *Ibid*
[30] *Ibid*
[31] *Ibid*

to Quarter 4 2013. Over this period, employment in the Accommodation an Food Service category was consistently higher than would have been the case has this category performed in line with either total employment in the economy or with the selected comparator group. Overall, our interpretation is that employment is 19,400 above that if the sector had performed at the levels of overall employment, while it is 22,300 above the Comparison Service Group.[32]

Deloitte argue that employment in all 9% category sectors (including all tourist and non-tourist sectors) *'could be estimated at c30,000'* and that this job creation was equal to an *'Exchequer gain of €165 million in social welfare savings an additional tax'.*

5.6 How has the 'cost' of the introduction of the VAT rate reduction performed compared to initial expectations?

At the launch of the Jobs Initiative in May 2011, the Minister for Finance stated that the reduction in the VAT rate *'was estimated to cost €120 million in 2011 and €350 million in a full year'.*

Deloitte's analysis found that:

Actual VAT receipts in the 9% categories fell by €107 million in the first twelve months following the introduction of the reduced rate and have roughly flat since then. This compares favourably with the initial Department of Finance estimates that the introduction of the VAT reduction would cost €120 million in the final six months of 2011 and €320 million in a full year.[33]

6 Summary

In assessing the impact of the VAT reduction it is important to note that the Government of RoI has chosen to extend the lower rate beyond its original 2013 cut-off point in three subsequent budgets – 2014, 2015 and 2016.

On the issue of whether the VAT reduction was passed through to consumers, all three reports point to evidence of this occurring. The Department of Finance's analysis however, points out that this pass through was not evenly applied across all of the 9% categories and was affect by seasonal variability in two sectors - hotels and other accommodation, and hairdressing.

The cost to the Exchequer of the VAT reduction was originally estimated to be €120 million in 2011 and €350 million in a full year. The two reports which examine this estimate a much lower annual cost of the reduction. ITIC estimates that the reduction cost €140m if only tourism sectors are considered, reducing to €90m when buoyancy

[32] *Ibid*
[33] *Ibid*

effects are considered. Deloitte estimate the overall cost of the reduction, across all categories, was €107m in the first 12 months of its introduction. This conclusion is based on actual VAT receipts.

All three reports use CSO data to assess the impact on employment. This data does not allow a full analysis of the sectors due to the way it is disaggregated. As such all three reports use employment in the accommodation and food sectors as a proxy for the 9% categories. Examining the impact in the first 12 months, the Department of Finance conclude that employment levels increased by 6,200 or 6% over this period.

Examining the period Q3 2011 to Q4 2013, Deloitte conclude that employment in the accommodation and food sector is 19,400 higher than it would be if it followed trends in total employment.

ITIC apply a number of methods in estimating employment change up to Q1 2013, concluding that a conservative estimate would suggest employment growth in the tourism industry of between 4,000 and 9,000, while more optimistic estimates could be as high as 25,000 (increasing to 35,000 if indirect employment effects are considered).

Deloitte’s analysis examined aspects that were not included in the other reports. They found perceptions of value for money of the RoI tourism industry among visitors and argue that geographic spread of these perceptions suggests that they cannot be attributed to exchange rate fluctuations.

Deloitte also examined the impact on tourism visitor numbers and associated tourism revenue. Although improvements were noted in both measures, Deloitte cautioned that other factors may have influenced movement in these areas.

Finally, Deloitte examined the impact on activity in the tourism industry. These results suggest moderation in the decline of accommodation stock and stabilisation in the number of rooms.