Lower VAT rate improves competitiveness, delivers jobs and helps tourism recover.

The Government's Jobs Initiative of 2011 acknowledged that tourism can make a very substantial contribution to Ireland's economic recovery, and to the creation of employment in all parts of the country. The industry is delivering on both fronts, even though economic conditions in key source markets remain difficult. Recovery in Irish tourism is underway, but its sustainability is not yet assured. The continuation of the lower VAT rate introduced in 2011 is critically important to allow the nascent recovery gain traction.

On behalf of the tourism industry, ITIC makes the case that not only is this extension vitally important, it also makes sense.

RESTAURANTS ASSOCIATION OF IRELAND

ITOA INCOMING TOUR OPERATORS ASSOCIATION - IRELAND

IRISH HOTELS FEDERATION

itic

Introduction

Irish tourism suffered a major setback with the onset of the great global recession in 2008. The severity of the decline in demand for Ireland was all the more marked due to an already significant loss of competitiveness during the Celtic Tiger boom years. Between 2008 and 2010, overseas tourism to Ireland slumped by over 20% in volume and value – a loss of 1.8 million visitors and over €1 billion each year. As a consequence 50,000 jobs were lost in the sector.

A reduction in the applicable VAT rate from 13.5% to 9% was a key measure aimed at accelerating recovery in tourism in the Government's Jobs Initiative of May 2011. The Minister for Finance recognised that "*much economic activity within the tourism industry is highly intensive in its use of labour, particularly true of hotels and restaurants, recreation and entertainment*". The Minister further stated that, "*tourism can make a very substantial contribution to our economic recovery and to the creation of employment in all parts of our country*".

The reduction in the VAT rate provided a much needed shot in the arm to help restore competitiveness and a return to growth in demand, as predicted by the Minister. The sharp decline was arrested in 2011 with an increase in overseas visitors for the first time in 4 years. This modest recovery was maintained in 2012, and is forecast to be further consolidated in 2013. More encouragingly, results for the early part of this year suggest that revenue growth is outpacing volume growth – a major turnaround given the economic and trading conditions in Ireland's main source tourism markets.

It is evident that the changes to the VAT and PRSI regimes complemented each other in having a favourable impact on both prices and employment.

However, it is also clear that the recovery is fragile and sustainable growth is not yet assured. To underpin the incipient recovery it is critical that the lower VAT rate be maintained.

The Irish Tourist Industry Confederation is grateful to Fáilte Ireland for allowing access to material compiled on their behalf by Deloitte which evaluated the effectiveness of the initiative. ITIC worked with Economist Jim O'Leary in further analysis of this and broader material available to us, including the report by the Department of Finance on the affects of the lower rate of VAT. We are satisfied that our submission affirms that the VAT initiative is working, and the industry is delivering on recovery and on job creation.

Further analysis by IBEC in their pre-budget submission supports the evidence that the initiative is achieving its aim in providing a demand side stimulus, while also providing an employment incentive in the form of lower employer PRSI.

For these reasons it is imperative that the VAT and PRSI sections of the Jobs Initiative are retained.

Paul Carty
Chairman
Irish Tourist Industry Confederation

July 10th 2013

Summary

1. **The cost of the measure**
   Even before allowing for the stimulatory effects of the 9% VAT rate on tourist 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 Jobs Initiative package was first announced. When the resultant boost to employment is accounted for, the cost to the Exchequer is further reduced and may in fact become a net gain.

2. **Was the VAT cut passed on?**
   Common sense, international experience and the available empirical evidence, including a recently published Department of Finance paper, strongly support the argument that the VAT cut has been passed on to consumers. This has happened at the same time as visitors' perceptions of value-for-money in Ireland have improved substantially and despite the fact that key input costs have been rising.

3. **The effect on employment**
   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%.

4. **Competitiveness**
   Maintaining and improving competitiveness is crucial to sustaining the recovery in Irish tourism, especially in the current global economic climate. Reverting to the 13.5% rate for tourism would be entirely at odds with this agenda. It would be especially unwelcome in relation to our most important market, Britain, where Sterling weakness is currently acting as a significant headwind.

5. **The policy context**
   The Minister's intended review of tourism policy would be welcome. Such a review should acknowledge, as policy currently does, that the contribution of the industry extends well beyond its direct effects on employment and economic activity. It would seem odd if the start of a review of policy were to be marked by abandoning the 9% VAT rate, one of the most tourism-friendly initiatives taken by government in recent years.

1. The cost of the measure

- It was originally estimated that the introduction of the 9% VAT rate would result in tax revenue foregone of €350m in a full year. Detailed Revenue Commissioners data for the relevant period suggest that this figure was a substantial overestimate and that the correct figure, calculated on the same basis as the original estimate, is less than €160m.

- This is a gross estimate and allows for neither buoyancy effects nor for the effects of behavioural changes induced by the reduction in the VAT rate. It also includes the cost of applying the 9% rate to items that are not tourism-related.

- What are called 'buoyancy effects' are routinely taken into account in the overall budgetary arithmetic. Here, the convention is to assume that about one-third of the gross cost of a tax reduction will automatically flow back to the Exchequer through a range of revenue channels. Thus, for the purposes of compiling the budgetary arithmetic, a measure costing €160m gross would be estimated to cost not much more than €100m on a net basis.

- When non-tourism related items (printed matter, hairdressing, films) are excluded, the gross cost is reduced to less than €140m and the net cost to little more than €90m in a full year.

- Behavioural changes - the increases in tourism spending and in employment brought about by the VAT reduction - may be expected to further reduce the cost of the measure. Indeed, the analysis set out in the IBEC pre-budget submission suggests that the boost to employment from the VAT cut (together with the halving of the lower PRSI rate announced at the same time) was big enough to generate a net gain for the Exchequer.

Summary*: *Even before allowing for the stimulatory effects of the 9% VAT rate on tourist 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 figure prominent at the time the Jobs Initiative package was first announced. When the resultant boost to employment is accounted for, the cost to the Exchequer is further reduced and may in fact become a net gain.

2. Was the VAT cut passed on?

- Common sense suggests that a tax cut is likely to be passed on to consumers in circumstances where the industry concerned is marked by intense competition and/or is operating with a high degree of spare capacity.

- International research indicates that VAT reductions are typically passed on to consumers in the tourism sector. For example, a 2007 report by Copenhagen Economics for the EU Commission, which examined the consequences of cutting VAT on tourism-related products and services in a number of actual cases across EU Member States, 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."

- The tourism sector in Ireland is composed of a large number of relatively small enterprises, and is characterised by intense competition. Moreover, there is plenty of spare capacity in the sector, meaning that supply can respond rapidly to increases in demand. As detailed in the Deloitte report, occupancy rates, though rising again, are still low. Under these conditions, it is reasonable to believe that most of the reduction in VAT brought about by the introduction of the new 9% rate was passed on to consumers.

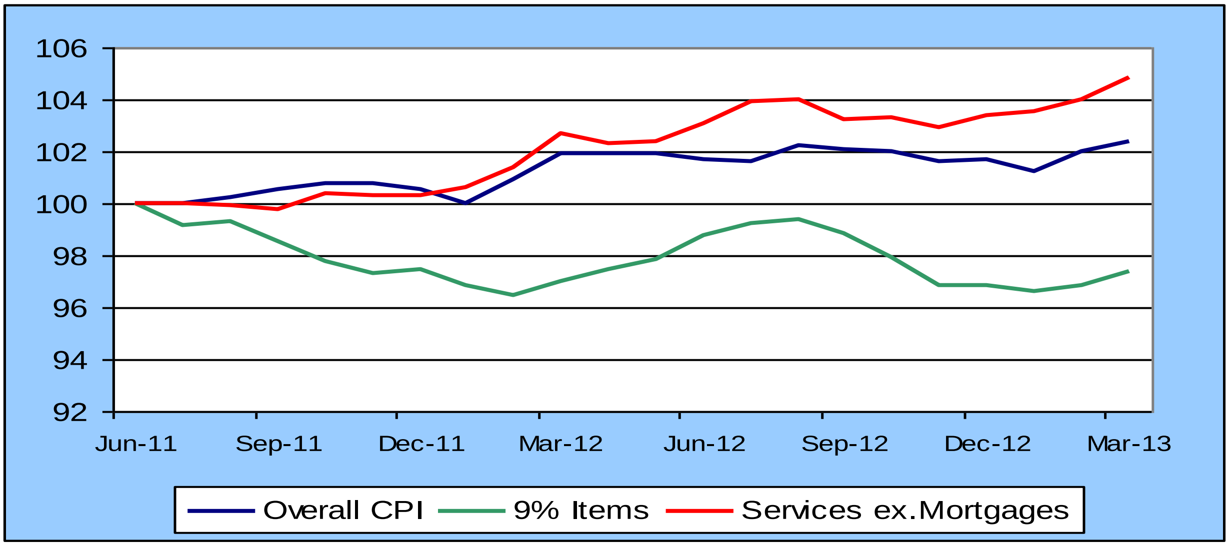
- The Incoming Tour Operators Association (ITOA), whose members provide contractual arrangements in Ireland for overseas travel companies that collectively bring almost half a million visitors to Ireland annually, confirm that the reduced VAT rate was fully reflected in prices from the time of its introduction.

- A Department of Finance analysis of the effects of the VAT change, published last December and based on CSO data for the period up to June 2012, concluded that the 9% reduced VAT rate had had the desired impact in terms of price pass through. In reaching that conclusion, the Department noted that in the twelve months following the VAT change (that is from June 2011 to June 2012), the price index for the items covered by the 9% rate had fallen by 1.5% while the overall CPI had risen by 1.7%.

- The pattern observed by the Department of Finance has been reinforced by more recent CSO data, as prices of the items covered by the 9% rate have kept falling even as the overall CPI has continued to rise. Between June 2012 and March 2013, the overall CPI increased by a further 0.7% while the price index for the 9% items dropped by a further 1.4%.

- Thus, from the introduction of the 9% rate to March 2013, goods and services covered by that rate experienced an average price reduction of 2.7% while the overall CPI rose by 2.4% (see chart). It is worth emphasising the point that prices in the tourism sector have fallen despite the fact that the prices of many of the inputs used by the sector have risen. In some cases, for example alcohol and energy products, these input price increases have been especially sharp.

- It is also worth noting that in the period since the introduction of the 9% VAT rate, Ireland's performance in terms of visitors' value for money (VFM) perceptions has improved considerably. According to Fáilte Ireland's *Annual Survey of Overseas Travellers*, the VFM assessment for Ireland has risen from a score of +1 in 2010 to +24 in 2012.



<u>Summary</u>: Common sense, international experience and the available empirical evidence, including a recently published Department of Finance paper, strongly support the argument that the VAT cut has been passed on to consumers. This has happened at the same time as visitors' perceptions of value-for-money in Ireland have improved substantially and despite the fact that key input costs have been rising.

3. The effect on employment

- From the time the 9% VAT rate was introduced to Q1 2013, employment in the accommodation and food services sector (the best proxy for the tourism industry amongst those for which the CSO publishes jobs data) increased by 6,100. The rate of growth of employment in the sector over this period, at 5.3%, has been 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. It also contrasts with the sharp decline in employment in accommodation and food services recorded before the VAT cut: in the two years to Q2 2011, employment in the sector fell by 12,000.

- Accommodation and food services account for about two-thirds of total employment in tourism. Applying the growth rate recorded in the former suggests an employment increase of around 9,000 for the tourism industry as a whole from the time the 9% VAT rate was introduced.

- Assessing the effect of the VAT reduction is not just a matter of figuring out how much of this increase in employment may be attributed to the tax change, but also considering how many jobs in the sector have been retained on foot of the measure. In other words, what we are concerned with here is the answer to the question: what net difference has the VAT change made to employment? Or, how much greater than it would otherwise be is employment because of the VAT change? There are a variety of methods available for addressing this question.

- One is to use the results of international research that has addressed a similar question. For example, based on a sophisticated econometric model of the UK economy, whose tourism market is not dissimilar to Ireland's, a report published in 2011 concluded that cutting the VAT rate on visitor accommodation and attractions from 20% to 5% would create 78,000 jobs (and generate a net positive return to the Exchequer over 10 years).Transposing these results to Ireland, and making the appropriate scaling adjustments, would suggest a boost to employment of around **6,000** arising from the introduction of the 9% VAT rate. This estimate allows for the fact that the UK VAT rate reduction that was modelled was much narrower in scope but much larger in its absolute size.

- Another way of estimating the potential employment effects of the 9% VAT rate is to use estimates of the price elasticity of demand for tourism, that is estimates of the sensitivity of tourism demand to changes in price. Thus, assuming an elasticity in the range -0.6 to -1.2 (the range in which most available estimates for Ireland and the UK fall), assuming full pass-through of the VAT reduction to consumers, and assuming that increases in tourism demand translate in to equi-proportionate increases in employment in the sector, the VAT reduction could be expected to boost employment in tourism by up to **9,000.**

- A third method is to construct a counterfactual scenario to answer the question of what would have happened to tourism employment had there been no VAT change, and to compare the actual evolution of employment with this counterfactual. This is the approach taken in the

Department of Finance paper referred to earlier. Taking employment in the rest of private sector services as the counterfactual, the Department's analysis pointed to a net employment growth differential of 9% (the equivalent of 10,000 jobs) in accommodation and food services between the introduction of the 9% VAT rate and Q2 2012. On this basis the Department concluded that the reduced VAT rate had had the desired impact in terms of employment gains.

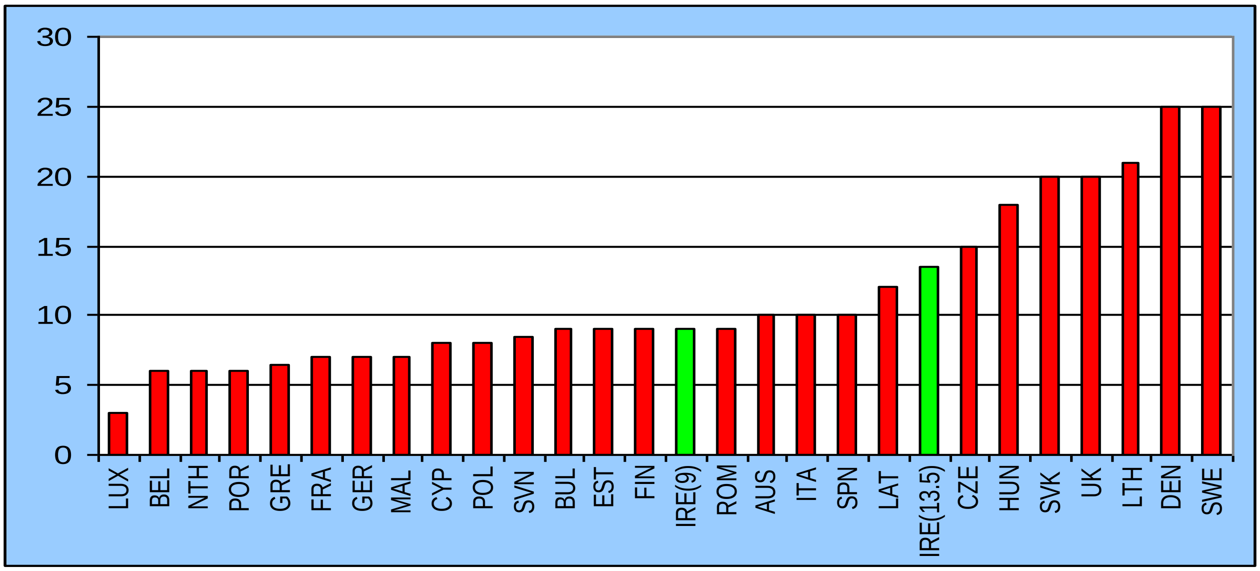
- This method is also the one used in IBEC's pre-budget submission, which extends the analysis to Q4 2012 and constructs a different counterfactual scenario, this time based on the proposition that, in the absence of the VAT change, employment in accommodation and food services would have changed at the same rate relative to overall private sector employment in the six-quarter period after Q2 2011 as it had done in the six-quarter period before that date. On this basis, IBEC suggests that the relevant Jobs Initiative measures (the changes to VAT and PRSI) has led to the recruitment or retention of about 17,000 more people in accommodation and food services than would otherwise have been employed in the sector. This would translate into an employment gain of about 25,000 for the tourism industry as a whole.

- Of course, jobs in tourism support jobs elsewhere in the economy. IBEC propose a ratio of 0.4. What this means is that 25,000 jobs in tourism support 10,000 jobs elsewhere. On this basis, IBEC concludes that the Jobs Initiative measures, through their effect on tourism, have directly and indirectly boosted economy-wide employment by some 35,000.

Summary*: 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%.

4. Competitiveness

- Even with a 9% rate, VAT on tourism in Ireland is not especially low by European standards. This is partly because the corresponding VAT rates have been reduced in a number of competitor countries in recent years, including France and Germany, each at 7%, while other major tourism destinations already have low rates e.g. Portugal 6%, Greece 6.5% and Spain and Italy both at 10%. Were tourism services to become subject to the 13.5% rate again, Ireland would revert to having one of the highest VAT rates on hotels in the EU, exceeded only by the UK and a handful of non-prime tourist destinations (see chart).



- The tourism sector is operating on tight margins. Its ability to absorb further increases in input costs is very limited; likewise its ability to absorb an increase in VAT. If the 9% VAT rate were to be abandoned, a consequence would likely be an increase in prices of 6-7% across the sector.

- Britain remains Ireland's single most important tourism market, accounting for 43% of overseas visits. Sterling weakness has recently been a significant obstacle to growth, and is likely to remain so in the period ahead. From the point of view of growing the British market, it is vital that this negative factor is not exacerbated by avoidable upward pressure on prices.

- 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.

- In the aftermath of the Great Recession, as unemployment rates remain high, income growth sluggish and uncertainty about the future elevated across Ireland's main markets, international tourists are more price sensitive and more insistent on value for money than in the past. This reinforces the need to maintain and further improve competitiveness if the recovery in Irish tourism is to be sustained.

<u>Summary</u>: Maintaining and improving competitiveness is crucial to sustaining the recovery in Irish tourism, especially in the current global economic climate. Reverting to the 13.5% rate for tourism would be entirely at odds with this agenda. It would be especially unwelcome in relation to our most important market, Britain, where Sterling weakness is currently acting as a significant headwind.

5. The policy context

- The Minister for Tourism, Transport and Sport has announced his intention to conduct a review of Irish tourism policy. Given the challenges facing the industry and the key role that policy has to play in helping to confront those challenges, such an initiative is very welcome. It would seem unwise to mark the start of a policy review by reversing one of the most tourism-friendly policy measures that has been promulgated by government in recent years.

- Amongst the considerations that should inform a policy review is the point that tourism activity benefits parts of the economy that other forms of economic activity leave largely untouched. As a result, the geographic distribution of employment in tourism, both between regions and within regions, is distinctly different from the geographic distribution of other employment. Measures to stimulate tourism are therefore instruments of regional policy and are arguably all the more important at a time when rationalisation in areas like public services and banking is resulting in the concentration of such activities in the larger population centres.

- Other aspects of tourism that should inform policy are well summarised in the government's *Action Plan for Jobs*: "*Tourism's contribution is not confined to directly generating employment, economic activity and exports. It also contributes by encouraging social inclusion and access to the labour market, because of the flexibility and diversity of its associated employment. Tourists also increase the payback from infrastructure and facilitate the efficient use of services.*"

- On a similar note, it is worth quoting from the *Jobs Initiative* document of May 2011: "*There is another strong reason why we should make every attempt to capitalise on the potential of tourism. It is that significant investment has already taken place in this sector and…we have a stock of accommodation, much of it of very high quality by international standards, which we must now utilise to full advantage. We also have a stock of entertainment and recreational facilities that has been significantly enhanced by public investment in recent years, not to mention a transport infrastructure that has been greatly augmented.*"

Summary: The Minister's intended review of tourism policy would be welcome. Such a review should acknowledge, as policy currently does, that the contribution of the industry extends well beyond its direct effects on employment and economic activity. It would seem odd if the start of a review of policy were to be marked by abandoning the 9% VAT rate, one of the most tourism-friendly initiatives taken by government in recent years.

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