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Recent VAT changes: who gained? who lost?

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SUMMARY

Across the EU changes to indirect taxes, and particularly VAT, have been a central part of countries response to the economic crisis. By mid-2014, 22 of the 28 EU member states had increased VAT rates since the onset of the economic crisis in 2008.

Over that period VAT rates have featured as an area of change in a number of Republic of Ireland budgets. This *inBrief*, profiles the distributive effects of the two most recent changes to these rates, introduced as part of the international bailout programme agreed by the Irish Government and the Troika. These saw:

(i) The temporary introduction, and subsequent retention, of a second reduced rate of VAT for specific items related to the tourism sector (where the rate decreased from 13.5% to 9%);

(ii) An increase in the standard rate of VAT from 21% to 23%.

KEY POINTS

- The two policy reforms examined in this research total more than €1 billion per annum, equivalent to 9% of annual VAT revenues.
- The 2011 'Jobs Initiative' introduction of a new 9% tourism related VAT rate is found to be a progressive tax change – with the bottom 60% of the income distribution gaining at above the average level.
- The greatest gains were to those living below the povery line.
- The Budget 2012 increase in the standard rate of VAT, from 21% to 23%, was found to be regressive - the bottom 70% of the income distribution experienced an above average loss with the poorest decile the most affected.
- Collectively, both changes were regressive; only those in the top 30% of the income distribution experienced a lower than average (negative) impact.

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Research for new economic policies

Chart 1: The Distributive Impact of the reduction of items to the second reduced rate of VAT (from 13.5% to 9%), % Gross Income by income decile

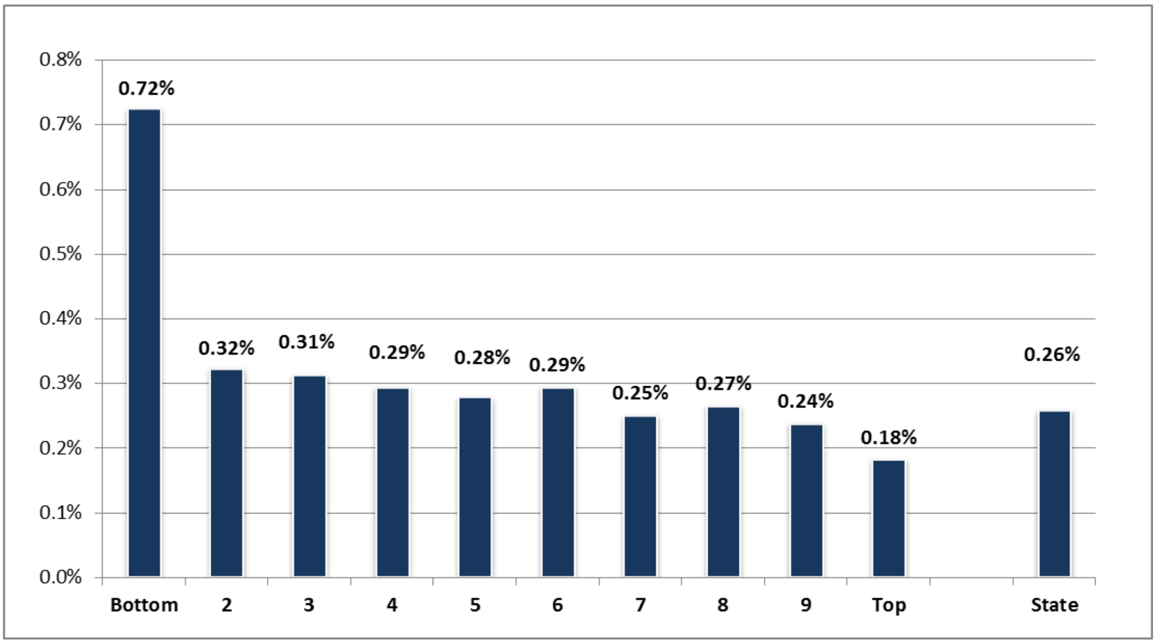

Chart 2: The Distributive Impact of an increase in the standard VAT rate (from 21% to 23%), % Gross Income by income decile

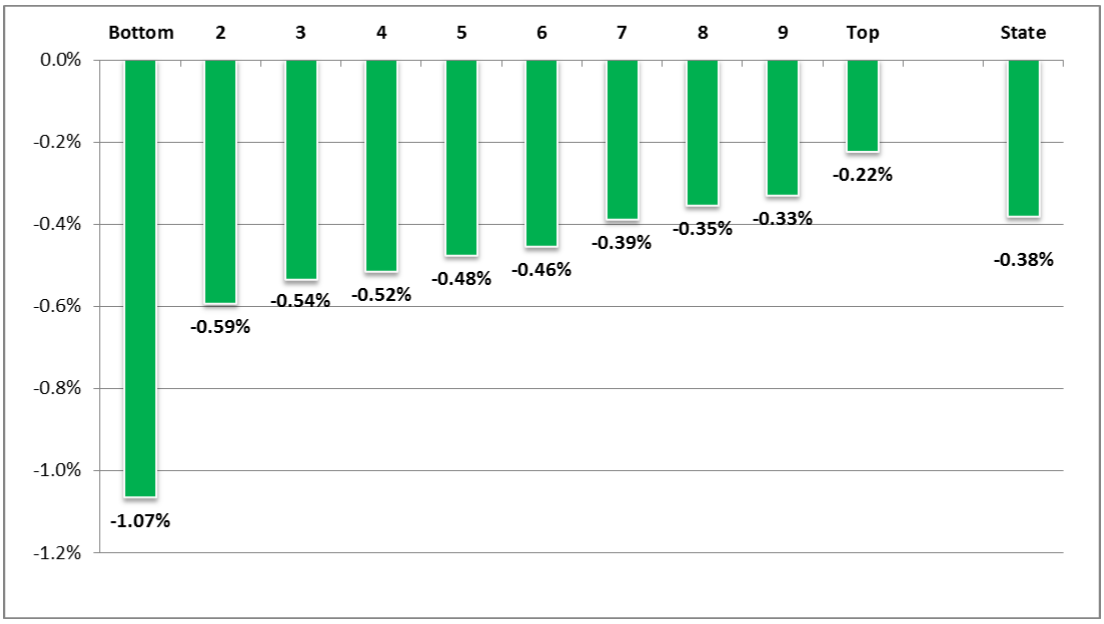

Table 1: The Distributive Impact of the Recent VAT changes by decile as a % of Gross Income

Decile	Reduction of items to 2nd reduced VAT rate (13.5% to 9%)	Increase in the standard rate (21% to 23%)	Cumulative policy impact
Bottom	+0.72%	-1.07%	-0.34%
2	+0.32%	-0.59%	-0.27%
3	+0.31%	-0.54%	-0.22%
4	+0.29%	-0.52%	-0.22%
5	+0.28%	-0.48%	-0.20%
6	+0.29%	-0.46%	-0.16%
7	+0.25%	-0.39%	-0.14%
8	+0.27%	-0.35%	-0.09%
9	+0.24%	-0.33%	-0.09%
Top	+0.18%	-0.22%	-0.04%
State	***+0.26%**	****-0.38%**	**-0.12%**

Notes: This table is a reproduction of sections of tables 10a and 11a in the accompanying *NERI working paper.*
*The state/average per adult figure transformed into an average household figure implies a gain of €140 per annum.
**The state/average per adult figure transformed into an average household figure implies a loss of €207 per annum.
Differences in the combined individual changes and the reported cumulative impact are due to data rounding.

Introduction and Context

Across the EU changes to indirect taxes, and particularly VAT, have been a central part of countries response to the economic crisis. By mid-2014, 22 of the 28 EU member states had increased VAT rates since the onset of the economic crisis in 2008.

Over that period VAT rates have featured as an area of change in a number of Republic of Ireland budgets. This *inBrief*, and the accompanying *NERI Working Paper* (Collins, 2014), focus on the two most recent changes to these rates, introduced as part of the international bailout programme agreed by the Irish Government and the Troika. These saw:

(i) The temporary introduction, and subsequent retention, of a second reduced rate of VAT for specific items related to the tourism sector (where the rate decreased from 13.5% to 9%); and

(ii) An increase in the standard rate of VAT from 21% to 23%.

To date, a detailed *ex post* empirical examination of these changes has been missing from assessments of recent crisis-induced policy reforms; a void this research attempts to address. Building on the development of an indirect taxation model in earlier papers, this paper examines the distributive impact of two recent changes to the principal source of indirect taxation, VAT.

Taken together, both policy reforms totalled more than €1 billion per annum, equivalent to 9% of annual VAT revenues and many multiples of the capital expenditure threshold (€20m) that triggers a full CBA.

Reduction of items to a second reduced rate of VAT

In 2011 Ireland possessed a standard VAT rate of 21% and a reduced rate of 13.5%. As part of that years 'Jobs Initiative' programme, the Government introduced a new second reduced rate of 9%.

The VAT reform was targeted at the tourism sector, perceived as an under-utilised labour intensive sector which had suffered a

25% decline in inbound tourist numbers and a 30% decline in earnings over the period from 2007-2010. The goods and services reclassified to the 9% rate mainly included restaurant and catering services, hotel/holiday accommodation, various entertainment services and the use of sporting facilities. It also applied to hairdressing and printed matter (brochures, newspapers etc). The annual cost of the reform (in revenue forgone terms) was estimated by the Department of Finance at €350 million.

Although first announced as a temporary measure, due to expire at the end of 2013, the reform was retained as an ongoing feature of the VAT structure in Budget 2014.

Table 1 and Chart 1 present the results of the modelled policy simulation. Overall the measure is notably progressive, impacting more positively on lower income households than on those further up the income distribution. On average, the VAT reduction was equivalent to an increase in gross income of 0.26% per annum. The decile analysis reveals that the bottom six deciles gained at above the average level. A more detailed analysis in the accompanying working paper shows that it was those living in poverty and those living just above the poverty line who gained most.

An increase in the standard VAT rate from 21% to 23%

Ireland's programme of fiscal reforms between 2008-2015 witness a series of ten contractionary adjustments, which by 2014 had seen more than 18% of GDP removed from the economy. As part of that process Budget 2012 (December 2011) included an increase in the standard rate of VAT from 21% to 23% yielding an additional €670 million per annum to the exchequer. The increase, while part of the programme of measures implemented under the Troika programme, was initially proposed as part of the 2010 *National Recovery Plan* and was to be phase in over two years.

Table 1 and Chart 2 present the results of the modelled policy simulation. Overall the measure is notably regressive, impacting more heavily on lower income households than on those further up the income distribution. On average, the standard rate VAT increase was equivalent to a decrease in gross income of 0.38% per annum. The decile analysis reveals that the bottom 70% of the income distribution experienced an above average loss with the poorest decile the most effected (spending 1% more of their income on VAT). The average household impact was €207 per annum, a finding that supports the assertion by the Minister for Finance in his Budget 2012 speech that the average impact on households would not be €500 per annum as suggested by some commentators.

Conclusion

Collectively, recent VAT reforms have been regressive (Table 1). However, the results of this paper point towards the possibility of reforms to that system being both progressive and regressive.

While acknowledging that indirect taxation changes generally take place in the context of a Budget/Fiscal package, and that Governments may consider any distributional impacts in the context of the overall Budgetary package, this research at the least offers a heretofore lacking insight into the distributive impact of these recent VAT changes. Given the structure of the taxation system, and the composition of household contributions to it, it remains important that considerations of the impact of taxation changes are more comprehensive than just exclusively looking at income taxation changes.

References

This NERI *Research inBrief* summarises an accompanying *NERI Working Paper* which provides further details on the data, methods and calculations presented here. The paper is available on the institute's website and its reference is:

Collins, M.L. (2014), 'The Distributive Effects of Recent VAT Changes in the Republic of Ireland' *NERI Working Paper*, 2014/19. Dublin, NERI.