



The Treasury

Yn Tashtey

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CUSTOMS AND EXCISE AGREEMENT

ADDITIONAL INFORMATION ON THE REVISED REVENUE SHARING ARRANGEMENT

In the High Court of Tynwald on the 12th July 2011 the Minister for the Treasury, Hon A. V. Craine MHK, made a significant announcement regarding changes to the Island's revenue sharing arrangement with the UK. In order to provide further clarification of the changes that have been agreed and how these will impact the Island's economy, the following information has been collated.

Background

The governments of the Isle of Man (IOM) and the United Kingdom (UK) both freely entered into the Customs and Excise Agreement in 1979 (the Agreement) replacing what was most commonly known as the 'Common Purse Agreement'. Amongst many things the 1979 Agreement provides for the revenue sharing arrangement (the RSA), removes the need for customs barriers between the Island and the UK and the EU and makes the Island part of the European VAT territory.

The IOM and the UK pool VAT and most other indirect tax revenues and share them according to an agreed RSA. This means that businesses in one territory can do business in the other without having to register separately in each territory. It also means that it makes no difference whether VAT is paid to businesses in the IOM or UK; the IOM gets its fair share in either case (including on purchases over the internet or by mail order from the UK).

To ensure that the joint 'pooled' revenues are being shared fairly the RSA can be reviewed, at the request of either party at any time. However, should both parties not be able to agree to a change then it is open to either party to give notice of its intent to terminate the 1979 Customs and Excise Agreement; this invokes a 2 year notice period.

The RSA has previously been calculated on the basis of the ratio of total IOM gross national income (GNI) to total UK + IOM GNI. In October 2010 following the publication of the IOM National Income Account the UK stated it believed that the composition of the UK and IOM economies was so fundamentally different that they would no longer accept sharing the revenues on the basis of the "Share of GNI".

The 2011 renegotiation introduces a new RSA (the "Tax Base Measurement Method" – TBMM) that takes account of the size and composition of the IOM economy. Although the broad concept underpinning TBMM is known, understood and accepted, the details of how it is to be implemented and maintained by the IOM and UK tax administrations needs to be developed (e.g. what data is to be collected, how, and how frequently, and how it will be operated by staff day-to-day).

In brief, the TBMM measures the Isle of Man VAT base (essentially GDP) for each identified economic sector using (in the absence of Manx data) estimates of the UK average effective VAT rate for each sector, with adjustments for the Isle of Man's reduced rates in domestic construction and hotel accommodation.

By calculating the Island's VAT share on a sector by sector basis the TBMM recognises the structural differences in the composition of the two economies that the previous "Share of GNI" sharing arrangement ignored. Under the previous "Share of GNI" formula the Island's share of the pooled revenues increased in direct relationship to the relative growth in size of the Island's economy to the UK's economy, no matter which sectors of our economy were growing. The TBMM takes into account the fact that, compared to the UK economy, a much greater proportion of the Island's GDP is generated by VAT exempt sectors (e.g. banking, insurance, finance etc.) which by their very nature generate very little VAT on their sales.

Next Steps

The Isle of Man does not currently collect all the data necessary to drive the TBMM. Therefore the current version of TBMM uses 2008/09 Isle of Man national income data combined with proxy data estimated from UK National Accounts and some internal HMRC data.

Over the next couple of years the Economic Affairs Division of the Isle of Man Treasury will, amongst other data collection exercises, conduct household and business expenditure and import/export surveys to fill the gaps in the Island's data. This will produce the data necessary to drive the TBMM when it becomes the basis for the Island's indirect tax shares from 2013/14 onwards. Until then the Island will receive the negotiated £272 million in 2011/12 and £252 million in 2012/13.

The Other Duties

The July 2011 political agreement to apply TBMM to determine the Isle of Man's share of VAT revenues extends to the other common duties. Under the new RSA, the Isle of Man's share of these duties is an average of the Isle of Man's VAT share and the Isle of Man's share of the UK plus Isle of Man resident populations.

Frequently Asked Questions – Appendix 1

Further information is provided in the Questions and Answers at Appendix 1 hereto.

Frequently Asked Questions

- **Is there is still an opportunity to revisit the revenue sharing negotiations with the UK and argue for a better result for the IOM?**

No there isn't. An agreement has been reached between the two Governments and the new revenue sharing arrangement and financial details of that agreement determined.

- **How much will our share be in 2011/12, 2012/13? (and how much has this cost us?)**

The share as agreed is £272 million this year and £252 million next.

Compared to the forecasts in the Pink Book this represents respective revenue losses of £30 million, £50 million and then £75 million per annum thereafter. The new arrangements provide for certain and not insignificant revenues going forward and so allow greater certainty and stability when rebalancing our budget.

- **When does it start?**

The transitional agreement starts with effect from 1st April 2011 and covers the fiscal years 2011/12 and 2012/13.

- **What happens in 2013/14 and thereafter?**

Provided both the IOM and the UK are satisfied that the data obtained through the various household and business expenditure surveys and the import/export survey that will be undertaken over the next 18 months demonstrates that the TBMM model is continuing to produce a fair and equitable result then it will continue to provide the basis for sharing. If it does not then it may be subject to further modification or change. It is explicit that the model is open to adjustment whenever there are more relevant data available.

- **Could we not have obtained better transitional arrangements?**

It was made very clear by HMT from the beginning that the UK believed that despite the previous changes to the sharing mechanism starting in 2007, the IOM was continuing to receive a disproportionate share on top of the previously made transitional payments of £131 million. Government had to fight hard to get any further transitional payments and therefore did an excellent job in securing transitional payments of £45 million in 2011/12 and a further £25 million in 2012/13.

- **What happens if there are further VAT rate or scope changes?**

As now, revenues over the course of a current year will be shared on the basis of published forecasts that will be reconciled shortly after the close of the year, and through financial adjustments for up to five years subsequently, to reflect the normal updates to the underlying fiscal and economic data which will include changes to the rate or scope of the relevant taxes.

- **How do we grow our share? - Is economic development relevant (and how) to this mechanism?**

It is important that we see the direct customs revenue benefits of developing any particular part of the economy as only one aspect of all considerations. If there is one particular ramification of the new model it is that, irrespective of their VAT status, there will be a financial pay back to the IOM Treasury where our citizens and companies make purchases from Island suppliers as this will add to IOM national income (GDP).

- **When will the details of the new TBMM revenue sharing arrangement be made public?**

Although the broad concept underpinning TBMM is known, understood and accepted, the details of how it is to be implemented and maintained by the IOM and UK tax administrations needs to be developed (e.g. what data is to be collected, how, and how frequently, and what desk officers are expected to do for its day-to-day operation). Although it is not possible to say when this work will be concluded Government has committed to publish the document on its website as soon as it is completed.

- **What plans do we have to go it alone? If none, why not and what are you doing to rectify this?**

There is no current intention to 'go it alone'. The Customs and Excise Agreement has always been an issue of debate and ongoing evaluation. This will not change. If it was felt that it no longer worked to the Island's betterment then the abrogation option, with two years notice, still exists. If it could be concluded with sufficient certainty that an alternative indirect tax system would be better for the Isle of Man both economically and financially then that is a call that could then be made. But at the present time it is our judgement that the Agreement should be retained.

- **What effect will it have on the Island's economy?**

The Island's economy will not be affected directly by the change in the sharing arrangements. Business transactions continue as previously. More broadly, we do recognise that any subsequent reductions in Government spending that might be required will have the potential to impact on jobs and the local economy. But looking long-term, looking at the bigger picture, it is our belief that the Agreement provides most opportunity for the continued economic development of our Island.

- **What are the Other Duties?**

The Other Duties are Tobacco products duty; Beer end products duty; Spirits duty; Wine and made wine duty; Cider and Perry duty; Customs duty; Anti-dumping duty; Agricultural duties; and Pool betting duty.

Possible Implications for Public Services

- **What will this mean for public services?**
- **What are the implications for Government staff?**
- **If public services will not be cut how will you fund the shortfall – tax rises/benefit cuts? If so how much?**

Clearly the reduced revenue streams coming from the Revenue Sharing Arrangement will need to be taken on board within the budgeting process and Government's fiscal rebalancing exercise. But it remains the intention that any impact on front line services be minimised.

The broad strategy for rebalancing the Budget, as set out in last year's Pink Book remains valid, although clearly as future Budgets are put together, the relative balance between spending reductions, increased taxation revenue and use of Reserves will need to be adjusted.

Certainly there will need to be continued and even more rigorous downward pressure on public spending, including consideration of the scope of Government. It is too early to be too precise as to how this will be achieved and over what period. That will have to form part of ongoing Budget discussions with Departments and other public sector bodies.

However, we will continue to do this within the broad principles we have previously set out, namely to protect where possible front line services and the more vulnerable in our society.