

Labour intensive services

Evaluation Report by

Isle of Man Government

Under The

Labour Intensive Services (LIS)

Experiment

(Council Decision 2000/185/EC)

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Report's Objective

As the objective of the experiment of a reduced rate is to increase employment and reduce the size of the black economy the report sets out what evidence is available and offers what the Isle of Man Government considers are sound arguments which in its view establish a link between -

- the reduced rate;
- lower price;
- higher demand;
- higher employment; and
- a reduction in the size of the black economy.

1. INTRODUCTION

- 1.1 The Isle of Man is a self-governing jurisdiction which is one of the British Crown Dependencies. It has had a close relationship with the United Kingdom (UK) for many centuries and this closeness extends not only from language and way of life, but into taxation and expectation of what Government is expected to provide/facilitate.
- 1.2 Under Article 299 of the Treaty establishing the EEC and Protocol 3 of the UK's Treaty of Accession, the Isle of Man is part of the EC for customs purposes and certain aspects of the CAP only. In respect of indirect taxation, the IOM effectively forms part of a single tax area with the UK. Under the 1979 Customs & Excise Agreement, the Island is committed to mirroring the UK (and EC) excise and VAT regimes, as well as maintaining equivalent controls and revenue management procedures. This special relationship is recognised in EC legislation through Article 3(4) of the Sixth VAT Directive (77/388/EEC), and Article 2(4) of the Excise Holding and Movements Directive (92/12/EEC), which provide that transactions in or to and from the IOM should be treated as in or to and from the UK i.e. the Island is not to be treated as a third country but part of the UK (and EC) territory for VAT and excise purposes.
- 1.3 Therefore, with regards to indirect taxation and customs matters, there is very close alignment between the Isle of Man and the UK (and the EU). However, although UK (and Sixth VAT Directive) rules, regulations and best practice are mirrored in the Isle of Man with very few variations the Island remains responsible for its own indirect taxation policy and legislation and all aspects of administration and, control, are carried out, locally by Isle of Man Customs & Excise.
- 1.4 An application was submitted on behalf of the Isle of Man, by the UK, to apply a reduced VAT rate on an experimental basis to certain labour intensive services under Council Directive 1999/85/EC. This application was approved thus allowing the Isle of Man to apply a reduced rate of 5% the services referred to in point 2 of the new Annex K to the 6th Directive (as amended) ie "the renovation and repairing of private dwellings". The reduced rate was applied from 1st January 2000.
- 1.5 In view of the fact that the Isle of Man is not part of the EU, not all EU Regulations, Directives, Decisions etc have been adopted by the Island. One area where the Isle of Man has not followed the EU, is in respect of EC statistical conventions such as NACE Rev 1. This presents a problem in that on the whole very little data is available on these indicators and, where it is available, it would not necessarily be consistent with the Statistical Standard NACE Rev 1.
- 1.6 Therefore, for the purposes of this report, the main sources of data available are taken from
- VAT returns
 - VAT office statistics and data
 - Business records
 - Isle of Man Census
 - Isle of Man Digest of Economic and Social Statistics 2002

- Survey of traders involved in the experiment

2. BACKGROUND

- 2.1 When applying to take part in the experiment, the Island's expectations were not only related to creating employment, and, of equal importance cutting back on the black or shadow economy in the building industry sector, but also the recognition, by both Government and people, that the existing housing stock needed improvement. Whereas current Isle of Man policy and practical experience tended to favour green field site development, a potential difficulty on a relatively small Island, this measure appeared to address the problems of renovation, rejuvenation and regeneration of existing property in built up areas.
- 2.2 Over recent years unemployment has been relatively insignificant on the Island. The Isle of Man census in 1996 shows that out of the economically active population of 34811, that 1140 (3.2%) were unemployed, whilst in 2001 out of the economically active population of 39685 a total of 157 (0.40%) were unemployed. However, it is interesting to note that employment in construction over the same period had diminished from 3372 in 1996 to 2512 in 2001 a reduction of some 25.50%, which might give the impression of an industry in decline.
- 2.3 The Island's previous experience when employing a reduced VAT rate, as it had done for the provision of hotel accommodation in 1995, was that it acted as a direct stimulus to that specific sector in the economy. The Isle of Man's tourist industry, like many seaside resorts in the UK, was in the 80's and early 90's suffering a continuous decline in numbers of establishments, bed spaces and visitors. This had a knock on effect on associated services, including in the Isle of Man's case, transport to and from the Island.
- 2.4 The resultant effects of the 5% rate on accommodation created and continues to produce a variety of effects comprising
- increased investment of retained profits in the sector;• some reduction in price to compete with the unregistered sector and the UK/rest of the world;
 - development of better value for money packages including transport etc;
 - the feeling by visitors of value for money and something different/separate from the UK;
 - the belief of the industry that people were listening to their needs (and the disincentive to the benefit of keeping two sets of accounts);
- 2.5 All this inspired re-investment and made those outside the tax net see little benefit remaining there, thereby encouraging better overall compliance not only for the VAT regime, but also acting as a catalyst for inclusion in other Government and control regimes not associated with taxation. With regards to impact on Customs and Excise, the charts (Appendix 7) show that prior to 1994 there was a steady decline in the numbers of VAT registrations in the hotel sector. The introduction of the reduced rate has arrested this decline. Growth, in turnover of VAT registered traders has accelerated and the total output tax has only marginally dropped despite the rate falling from 17½% to 5%.
- 2.6 By introducing the new rate to home improvements, through renovations and repair, the Island aspired to give everyone the opportunity and incentive to upgrade their homes and therefore the housing stock generally, stimulate the regeneration of certain run down properties and to create new permanent meaningful jobs, especially apprenticeships. There had been concerns expressed to Government by the industry that whilst there were several

major building projects underway, this did little to benefit, (and may even have disadvantaged) small businesses operating in the domestic property and small commercial building trade sector.

- 2.7 From the perspective of revenue collection, the reduced rate in this business sector was seen as a possible means of redressing the balance between the legitimate and shadow economy. Evidence already existed in the Isle of Man Office of Fair Trading of work done by 'cowboy' builders and the generally poor workmanship associated with their work on the periphery of the sector. Moreover, it was believed that there had been incidences of opportunist traders and labourers visiting the Island from both the UK and Ireland being involved in short term work, usually for cash, who remained completely outside the regulatory regimes. It was believed by the trade, population and many politicians that the existing tax situation did nothing but exacerbate the situation with these opportunistic traders often indirectly encouraging local people to ask bona-fide tradesmen for heavily reduced prices which they simply could not afford to discount legitimately.

3. IMPLEMENTATION

- 3.1 The Isle of Man Parliament, known as The Tynwald, enacted the Value Added Tax (Reduced Rate) Order 2000 (Appendix 1), which came into operation on 1st April 2000 and which is due to expire on 31st December 2002. In order that the Island's community might benefit fully from the three- year period of the experiment, the Isle of Man Treasury also put into effect an Extra Statutory Concession (Appendix 2), which provided for the 5% rate to operate during the period between 1st January to 31st March 2000.
- 3.2 To communicate the changes to the public and relevant trades, the measures were included in the Treasury Minister's budget statement of the 15th February 2000. This publicity was then supported by a press release outlining the broad terms and aspirations for the reduced rate. A copy of the press release is included (Appendix 3) in this report. This publicity created substantial interest in the media, local political and social circles with news items and debate taking place over many weeks. (It should be remembered that in an Isle of Man context local budgets are severely restricted in what they can do, as much of the law is tied to the UK. Thus such an announcement became the main budget issue on the Island).
- 3.3 The details of how the reduced rate should apply were set out in a public notice. The notice was sent to all those who were in the qualifying trade classifications and published on the Isle of Man Customs and Excise web-site. A form was included within the notice, which gave instructions on how to deal with the transitional arrangements. A hard copy of the notice and transitional arrangements is included in this report (Appendix 4). The web-site address is www.gov.im/Customs.
- 3.4 At all times during this process, UK HM Customs and Excise were involved in developing and assisting the various documents, procedures and mechanisms necessary for the experiment and to ensure that there was no leakage to properties situated outside the Isle of Man.

4. RESULTS AND DISCUSSIONS

- 4.1 The overwhelming impression from all sectors of the Island community is that the experiment has been a huge success. Those offering this view include, the public, the trade, politicians and Government Departments and bodies. There is also hearsay evidence from the trade that those operating in the shadow economy are complaining about the measure.
- 4.2 However, is what all these individual groups consider to be ‘a success’, that which the European Commission define in respect of the experiment a success? - eg create employment and reduce the size of the shadow economy.
- 4.3 In order to consider whether or not the result can be considered a success, the available data (sourced from Isle of Man Customs and Excise and Isle of Man Treasury Economic Affairs) together with a survey of the VAT registered traders using the reduced rate, needs to be analysed.

The Survey

- 4.4 A copy of the survey form is included in the report (Appendix 5). It was conducted on a random sample basis and sent to some 15% of the traders using the 5% reduced rate. A response rate of 56% was achieved. Thus some 7% of traders involved in the experiment submitted their views.
- 4.5 Bar charts in respect of each survey question are reproduced below, together with the most common points made in the general comments section.

Table 1

Effect of reduced rate on prices charged to customers

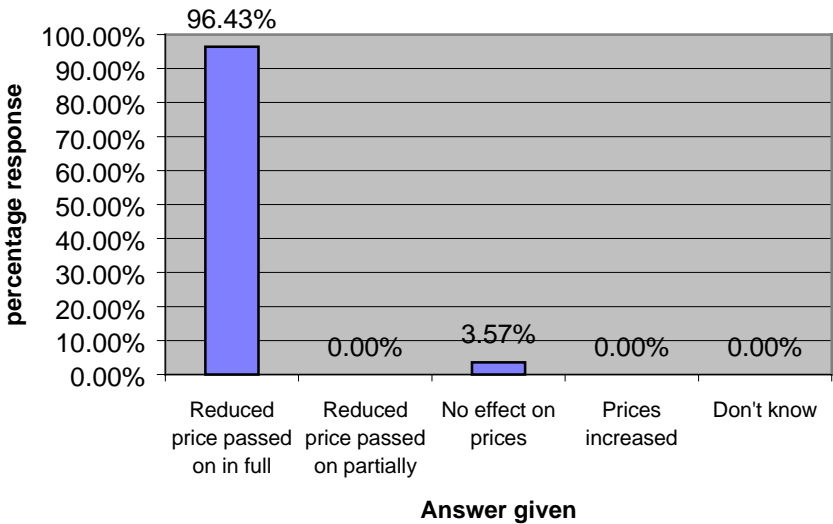


Table 2

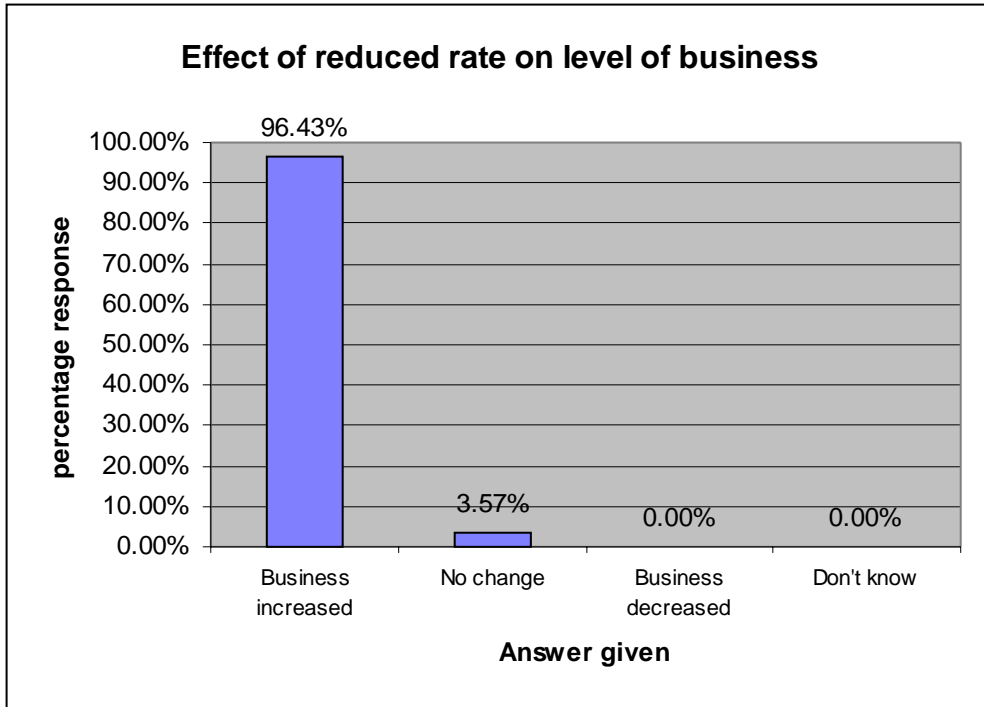


Table 3

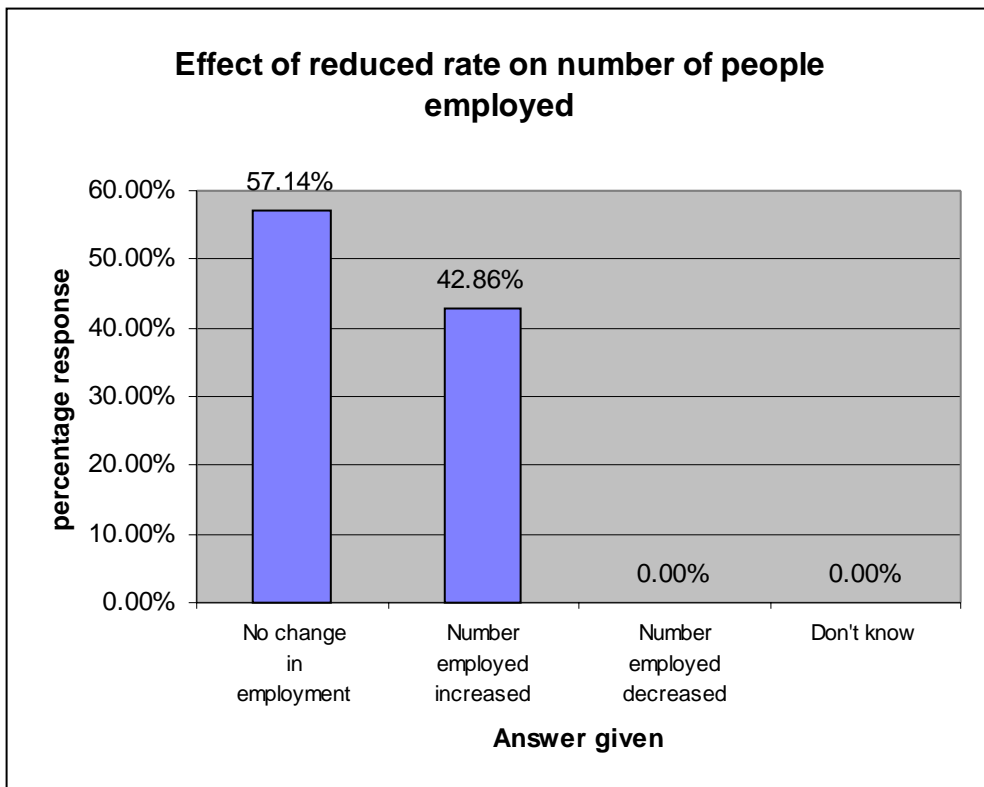
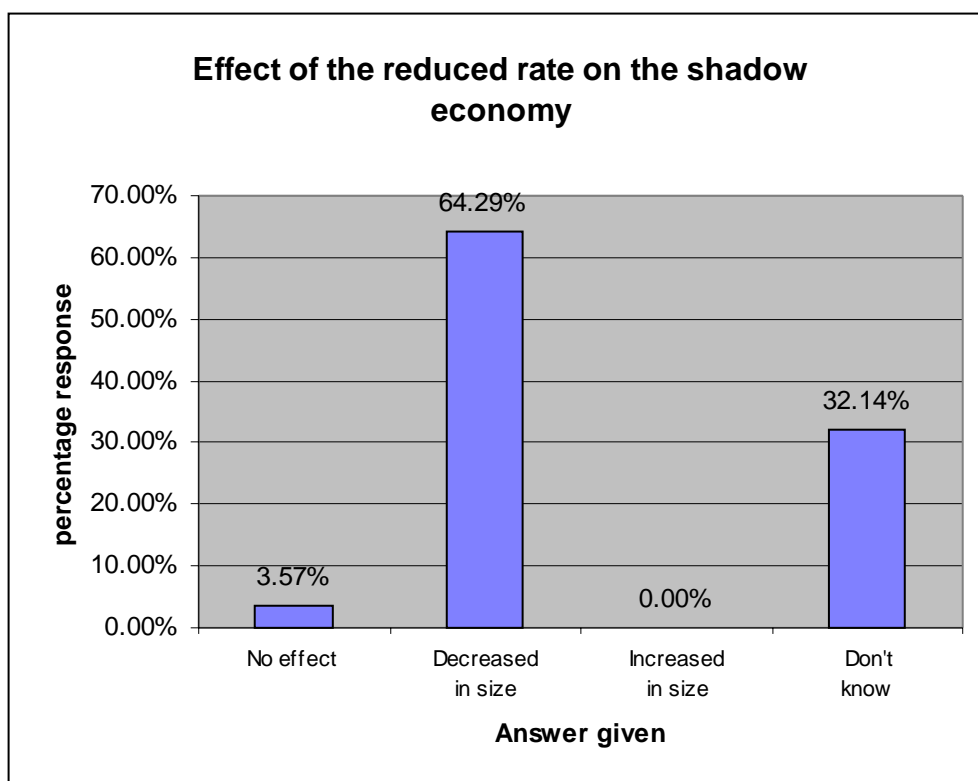


Table 4



4.6 From the declarations made by these traders the impact of the experiment is striking. With almost 100% reporting an increase in business, two thirds believing the shadow economy (and in their own sector) decreasing and just under half increasing the number of employees. The general comments also show that

- 40% of respondents said customers were having work done they would not normally have done or done so soon.
- 20% said it has stopped customers asking for 'cash deals', using 'cowboys' or doing it themselves.
- 10% believed that it made their small firm more competitive against the larger businesses.

4.7 These comments on employment are also reflected in the Isle of Man Department of Trade and Industry's figures for construction industry apprentices under Isle of Man DTI training agreements, with 2001 being up over 70% compared to 1996.

4.8 The comments on the shadow economy and quality of work are reflected in the experience of the Isle of Man Office of Fair Trading who comment

".... It would appear that the reduction in VAT has encouraged consumers to use bona fide traders for home improvement works which in turn has either driven the cowboys out of the market or driven them to register for VAT. From our point of view this movement towards the bona fide traders has also meant that redress and remedial action has been forthcoming and consumers have not suffered losses to the same extent as in previous years. I believe the building industry as a whole has also benefited through what seems to be an overall increase

in contracts and also by an improvement in the reputation of the industry which is now less affected by the cowboy element.”. (The Isle of Man Office of Fair Trading’s complete memo is attached at Appendix 6).

Customs and Excise figures and data from VAT returns

- 4.9 Customs and Excise data falls into two main areas, ie registration details and VAT return data.
- 4.10 Analysis of the VAT register numbers shows that from April 1991 through to the end of 1999 there was a fairly steady rise in the total number of VAT registered traders. The register increasing from 4286 in April 1999 to a high of 6611 in January 2000. However due to other actions and events in the Island the VAT register shrank by some 5% during 2000 before recovery to 6651 in July 2002.
- 4.11 With regard to the position regarding traders in the relevant construction industry codes, these have increased from 453 in December 1999 to 616 at the end of June 2002 (Table 5). 265 traders used the reduced rate in 2000 rising to 359 in 2001 (Table 6).

Table 5

Number of traders in the trade classes					
		As at 31/12/99	As at 31/12/00	As at 31/12/01	As at 31/06/02
45210	General construction of building and civil engineering works	153	154	171	186
45212	Domestic construction	12	18	17	20
45220	Erection of roof covering	10	11	9	9
45250	Other construction work involving special trades	54	60	68	71
45310	Electrical wiring and fittings	44	50	53	54
45330	Plumbing	45	53	59	61
45340	Other building installation	22	43	46	46
45410	Plastering	17	17	19	20
45420	Joinery installation	37	50	54	55
45430	Floor and wall covering	11	13	18	19
45440	Painting and glazing	35	40	40	40
45450	Other building completion	13	25	34	35
Total		453	534	588	616

It should be noted that not all traders in the above categories work on domestic property or charge the final customer. Many work as subcontractors and/or exclusively on commercial building projects.

Table 6

Count of traders who have made a box10 declaration within the specified period					
		During 1999	During 2000	During 2001	Up to 30/06/02
45210	General construction of building and civil engineering works	0	62	80	78
45212	Domestic construction	0	1	5	6
45220	Erection of roof covering	0	6	7	9
45250	Other construction work involving special trades	0	21	30	30
45310	Electrical wiring and fittings	0	29	39	38
45330	Plumbing	0	41	48	48
45340	Other building installation	0	23	30	28
45410	Plastering	0	7	11	10
45420	Joinery installation	0	29	41	35
45430	Floor and wall covering	0	6	12	10
45440	Painting and glazing	0	28	35	33
45450	Other building completion	0	12	23	22
Total		0	265	359	347

To put this change in context, the total trader population compared to those in the affected construction codes over a 10- year period is shown below (Tables 7 and 8).

Table 7

Ratio of reduced rate trade codes to the remainder on the live register as at 1 January

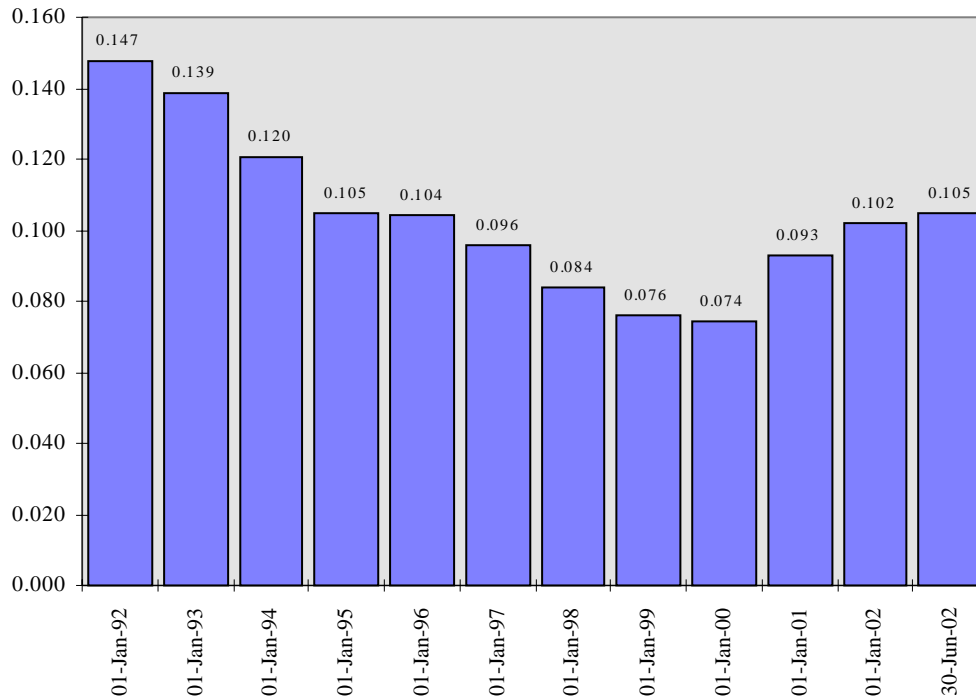
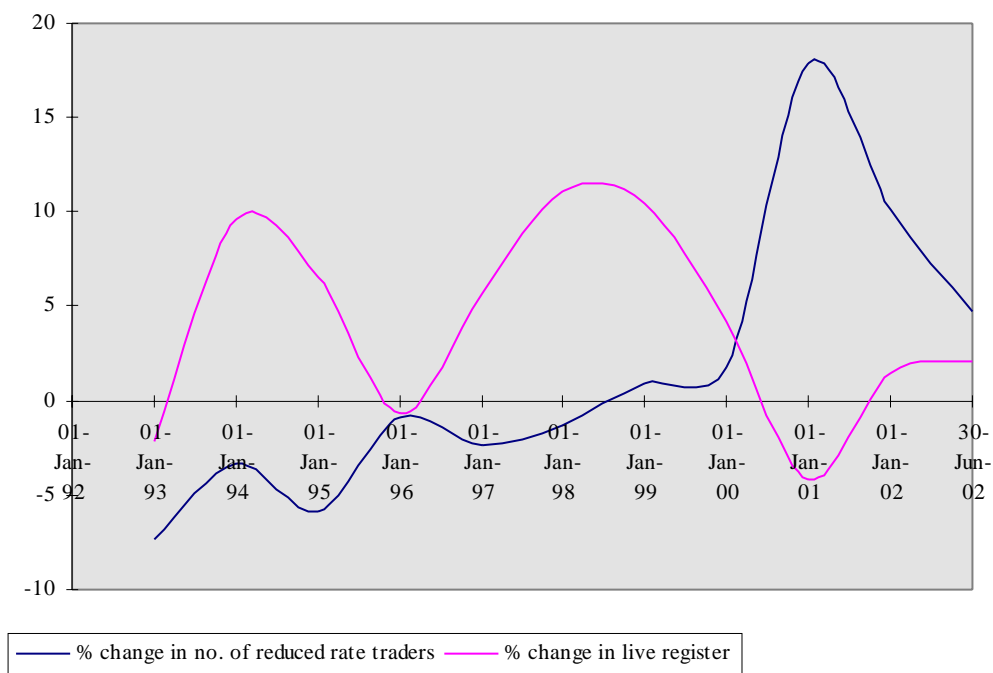


Table 8

% change in number of traders



Turning to the return data. This is depicted in the following tables and graphs (Tables 9 to 26).

Table 9

Year	Total sales			Output tax		
1998	51,063,488	139,638,539	37%	7,814,143	17,635,556	44%
1999	57,987,749	163,505,436	35%	8,511,969	18,812,370	45%
2000	72,198,586	186,008,385	39%	9,387,313	20,203,178	46%
2001	88,474,931	223,657,185	40%	10,623,404	22,060,545	48%

The table above shows the distribution of both turnover and tax in the building trade. Since the reduced rate was introduced, the shares attributable to those firms applying the reduced rate have increased.

Table 10

All Building Trade Classes - Total Sales

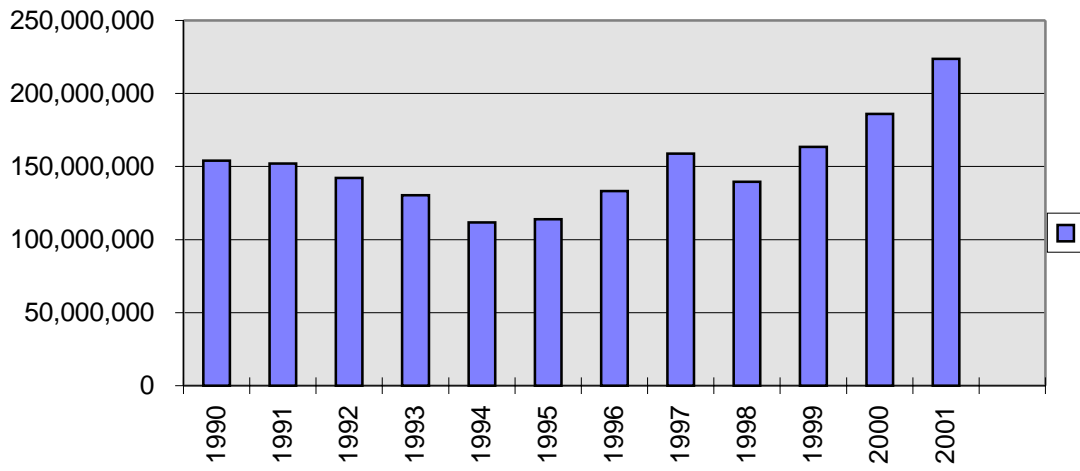


Table 11

All Building Trade Classes - Total Sales - percentage changes

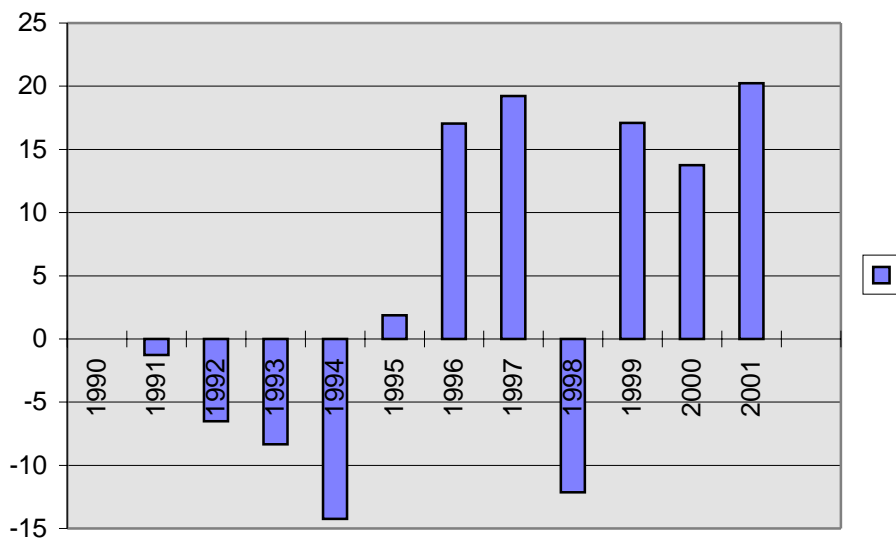


Table 12

All Building Trade Classes - Output Tax

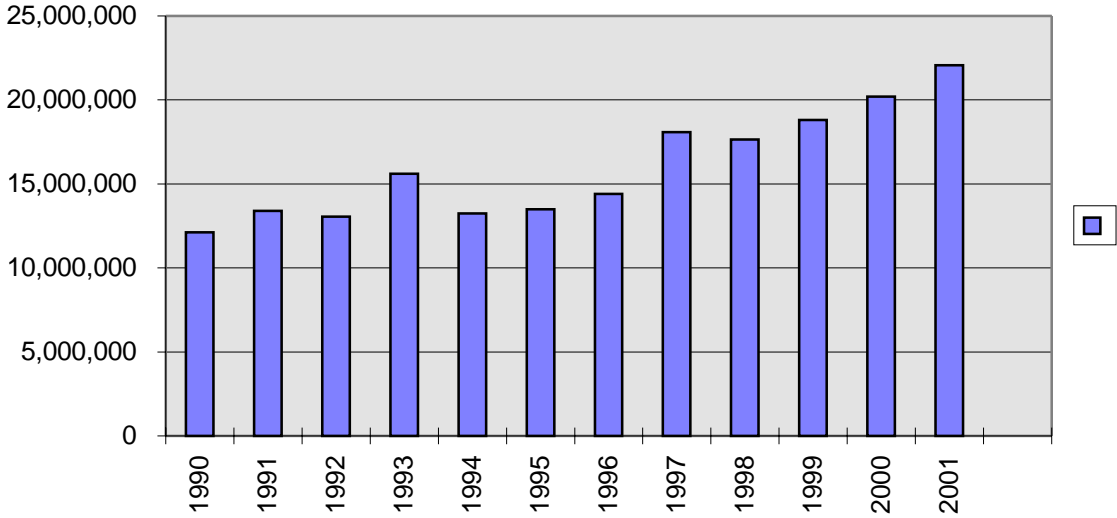


Table 13

All Building Trade Classes - Output Tax - Percentage Changes

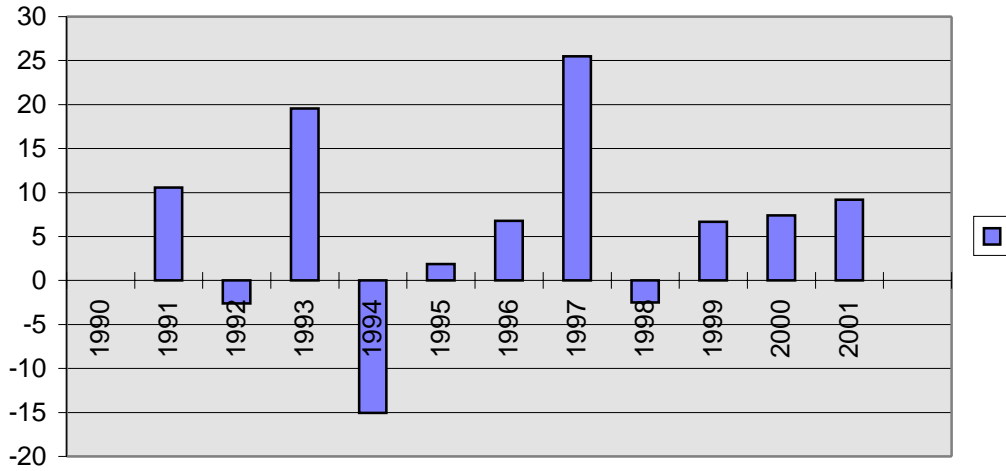
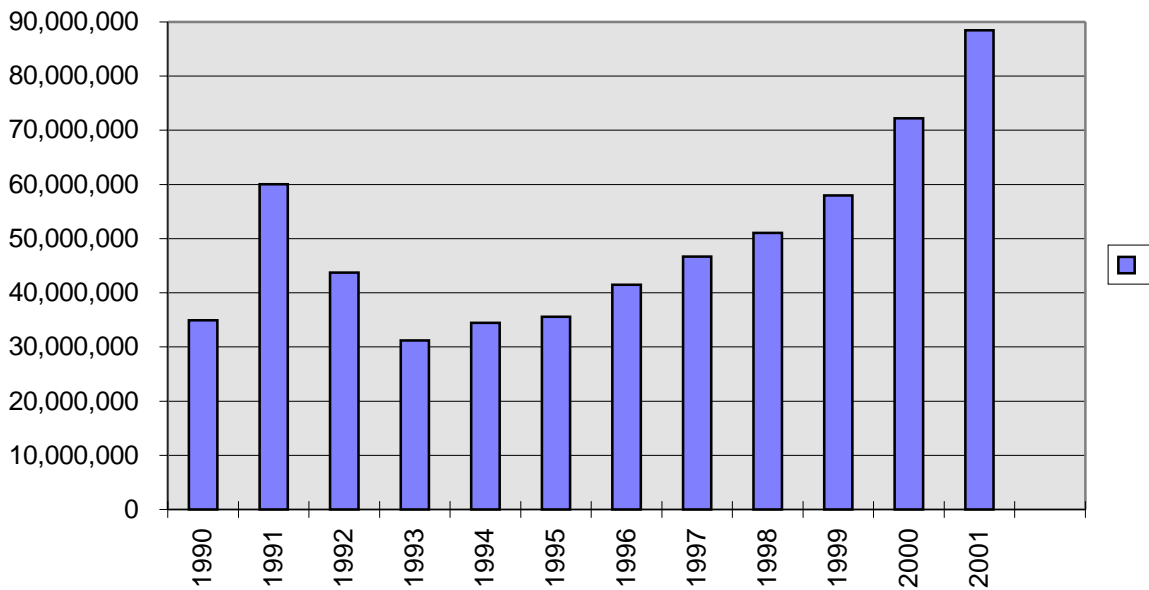


Table 14

1.

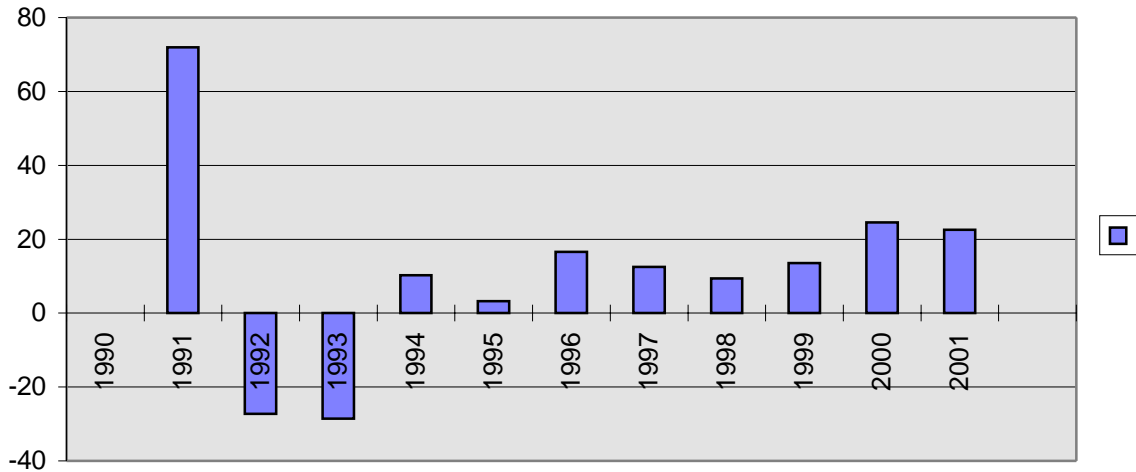
Building Trade Classes (5%) - Sales



Note: Exceptional items plus commercial and domestic new build trade codes removed

Table 15

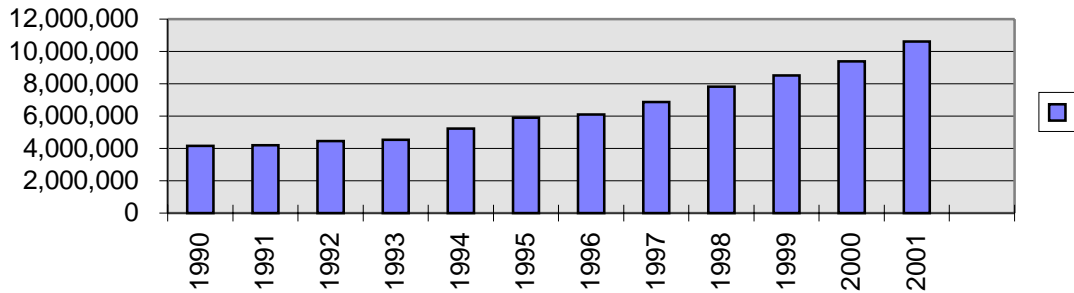
Building Trade Classes (5%) - Sales - Percentage Changes



Note: exceptional items plus commercial and domestic new build trade codes removed

Table 16

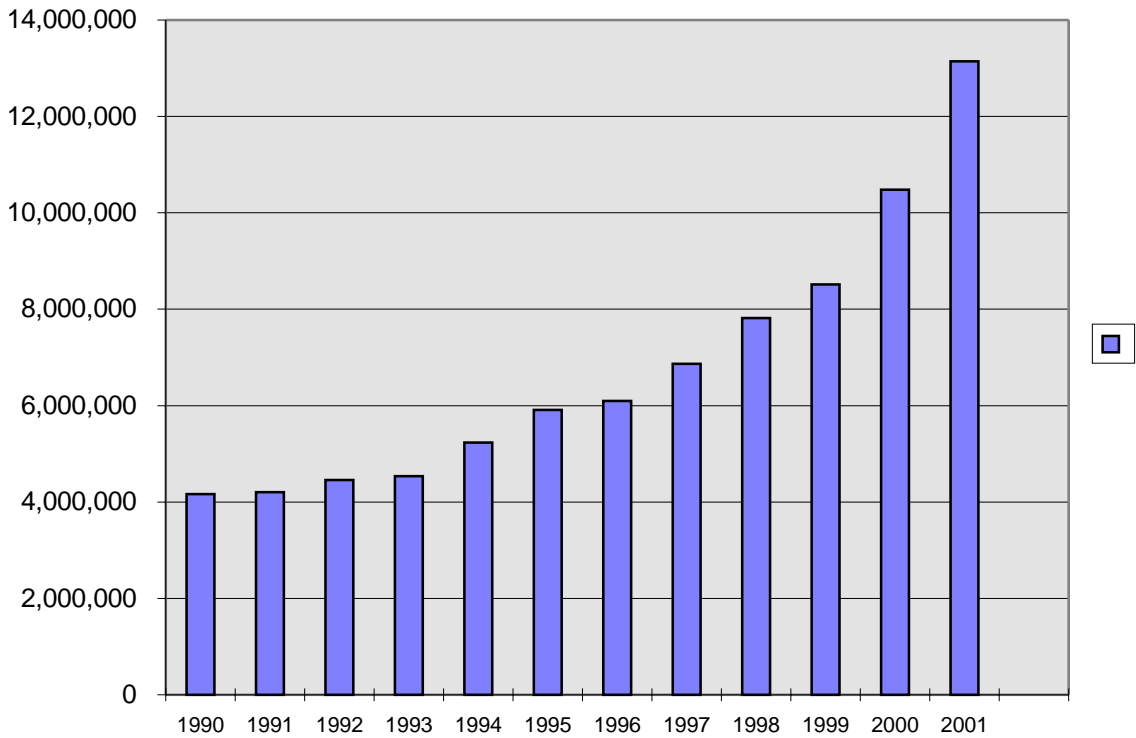
Building Trade (5%) - Output Tax



Note: exceptional items plus commercial and domestic new build trade codes removed

Table 17

Building Trade Classes (5%) - Output Tax



Note: exceptional items and commercial and domestic new build trade codes removed, showing notional tax for 2000 and 2001

Table 18

Building Trade Classes (5%) - Output Tax - Percentage Changes

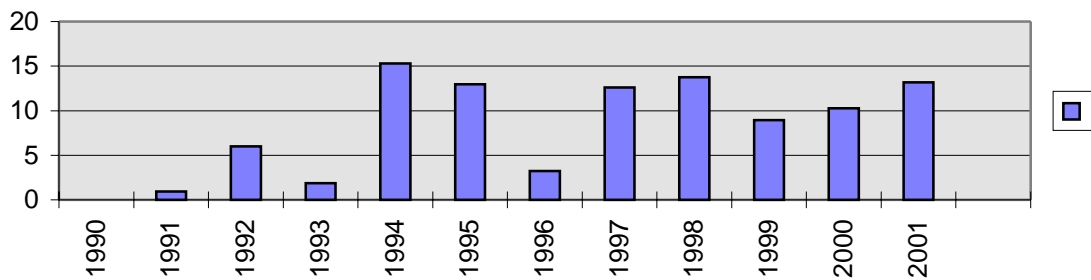


Table 19

Building Codes NOT eligible to use 5% rate - Sales

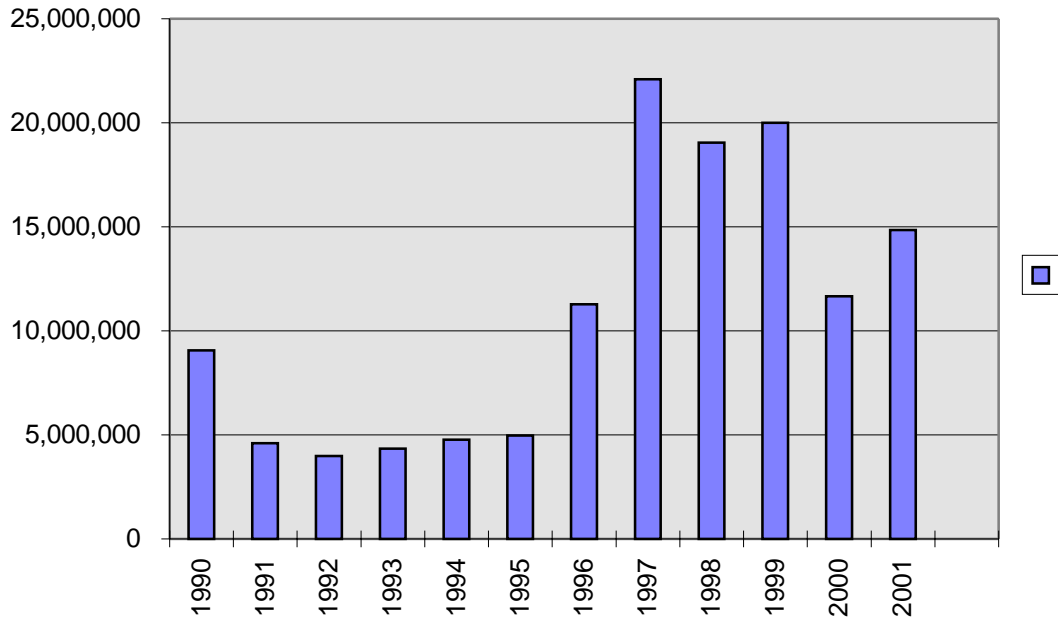


Table 20

Building Trade Classes NOT eligible to use 5% rate - Sales - percentage changes

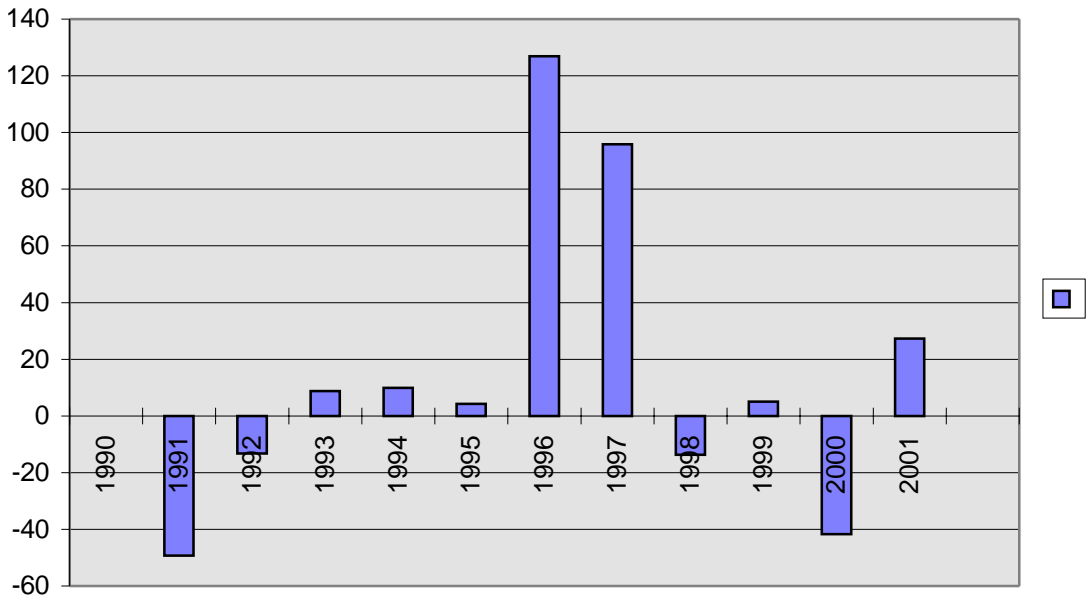


Table 21

**Building Trade Classes NOT eligible to use 5% rate -
Output Tax**

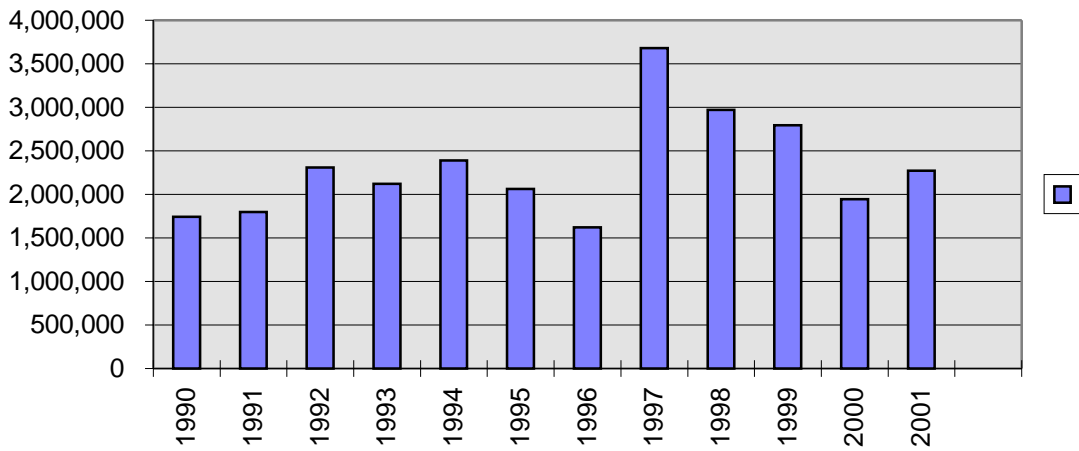


Table 22

**Building Trade Classes NOT eligible for 5% rate - Output
Tax - percentage changes**

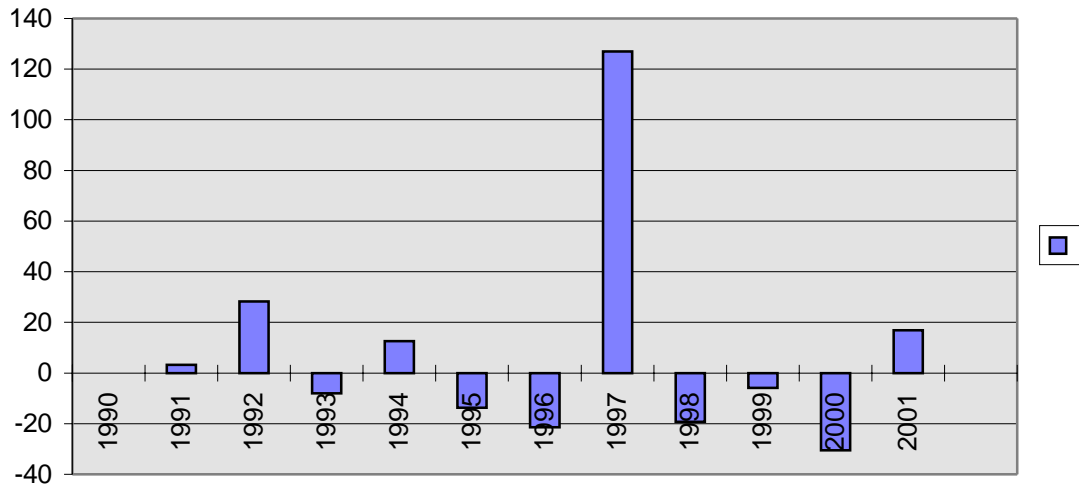


Table 23

Building Trade - Comparison of Sales

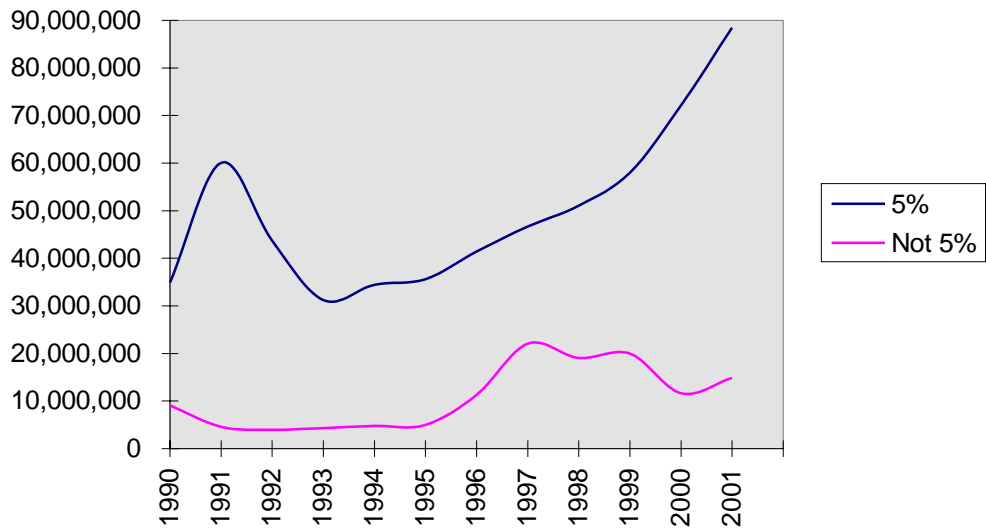


Table 24

Building Trade - Comparison of Output Tax

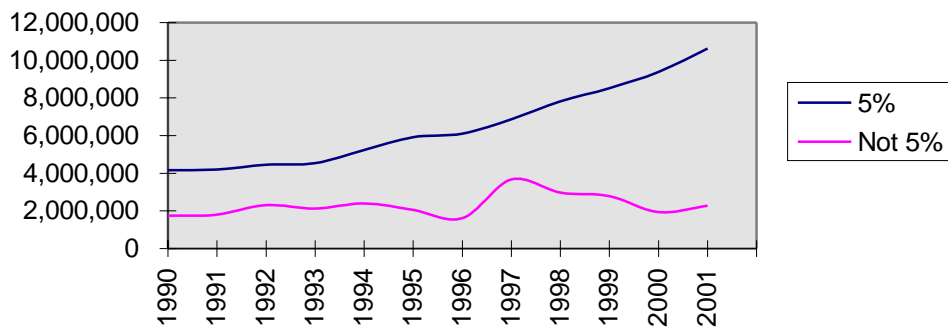


Table 25

Building Trade Classes - percentage changes

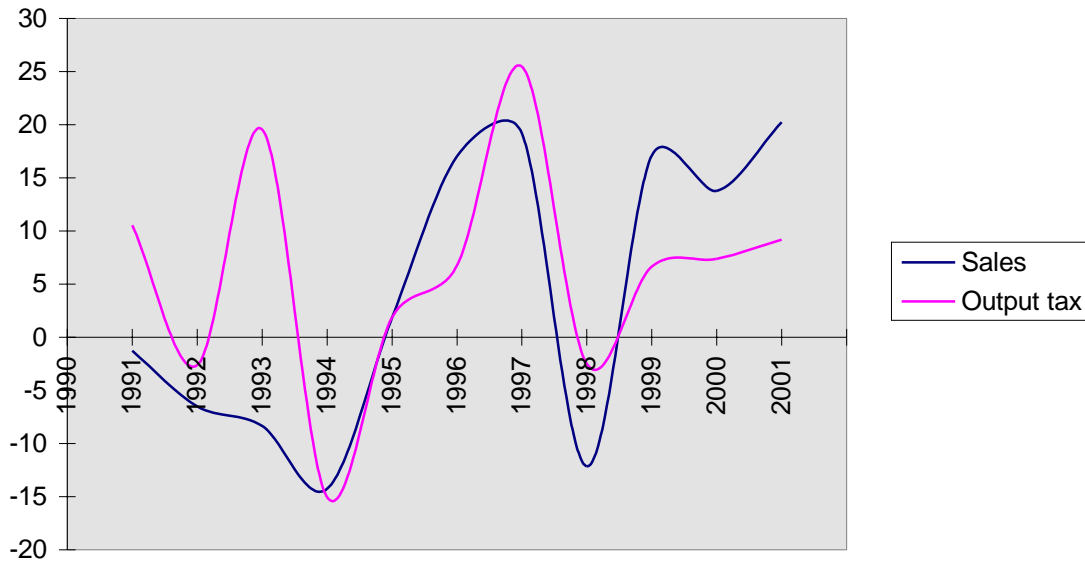
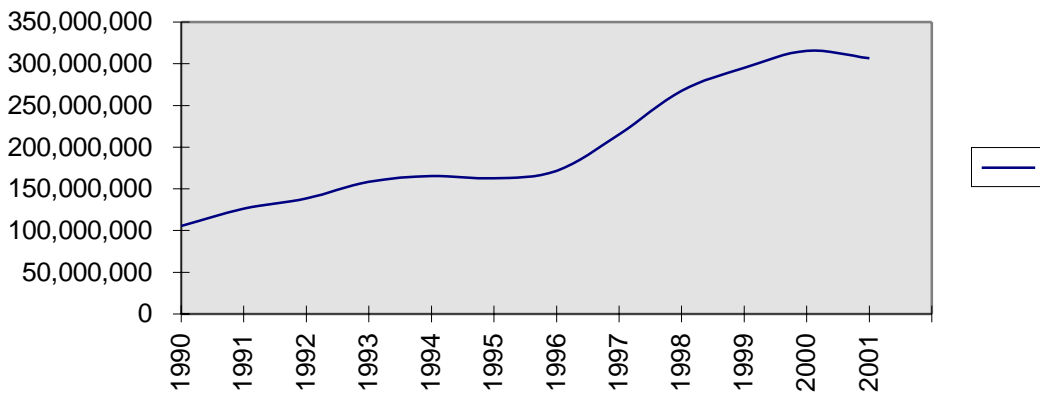


Table 26

ALL TRADE CLASSES - OUTPUT TAX



4.12 From this 'forest' of charts and graphs, it is apparent that the best and most consistently performing traders over the period are those participating in the experiment with substantial sales growth and no fall off in output tax being charged and declared.

5. OTHER DATA REQUESTED BY THE EUROPEAN COMMISSION

5.1 With regard to the other sets of data requested in the Commission's letter of 11 April, the Isle of Man does not unfortunately keep statistical information in the same format or in some cases the same level of detail as required of EU Member States. However, our comments upon each are as follows:

5.2 Number of businesses

Details of the number of VAT registered traders and the change thereto compared to movement in the general VAT register is given above in tables 5,6,7 and 8. Details of non - VAT registered businesses are not available.

5.3 Level of productivity

Other than that which can be deduced from the survey, eg 100% traders report an increase in business with 44% indicating an increasing labour force.

5.4 Number of jobs

Figures from the Isle of Man Census Reports for the construction industry show a decline in the number of those employed in the construction industry from 3372 to 2512 in the period 1996 to 2001 (compared to a rise in the economically active population from 34811 to 39685 in the same period). If the information from the survey is factored in, it would appear that this decline has at least been arrested, and from the Isle of Man DTI figures the number of young people commencing apprenticeships in the construction industry is rising.

5.5 Profitability

This measure as set out is not possible as the Island statistics do not detail cost per unit of labour. Turnover, or a version of it, has been identified from VAT returns and outlined in tables 9-24 and 26.

5.6 Price index

There was no reduction in prices shown up in the Isle of Man RPI as a result of the VAT reduction. This was expected as the VAT reduction applied to capital investment in property repairs and improvement and RPI methodology explicitly excludes savings and investments. Effect of VAT reduction on prices

5.7 Effect of VAT reduction on prices

Effectuated by the survey carried out, as demonstrated in table 1. In general the trade claims that the reductions were passed on in full.

5.8 Household expenditure in the sector

The last Household Income and Expenditure survey in the Isle of Man was carried out in 95/96. There are currently no plans for another.

5.9 Trends in VAT receipts

We do not have information of the VAT receipts but the output tax take is referred to in table 26.

- 5.10 Whether any other economic policy measures have to be taken into account
- 5.11 The standard rate of income tax on both personal earnings and company taxable profits was cut from 15% to 14% in March 2000 following many years when it had been fixed at 15%. The higher rate of tax remained unchanged at 20% on both personal and company income.
- 5.12 March 2000 also saw major changes to the structure of social National Insurance contributions for the self-employed. This was likely to have a pronounced impact on the Island's construction sector since of the 2,512 persons employed in construction as at the Census April 2001, 1,173 (47%) were self-employed. This compares with an average of 15% self-employed in the whole economy. Only agriculture, forestry and fishing had a higher percentage of self-employed at 62%. By way of comparison, in 1996 the percentage self-employed was 48% in construction, 61% in agriculture, forestry and fishing and 17% for the whole economy, so there has been no substantial change between 1996 and 2001. If other factors remain equal, the reforms to National Insurance were likely to impact more heavily on construction than on any other sector with the exception of agriculture, forestry and fishing.
- 5.13 In March 2002, National Insurance contributions for the self-employed were cut from £6.55 per week to £2.00 per week for profits above a lower threshold and the rate of tax was increased from 6% to 7% above an upper threshold. In addition the upper threshold was cut from a profit level of £7,350 per year to £4,385 per year. A zero rate of National Insurance contribution applies to profits above a certain level.
- 5.14 In adopting these changes to National Insurance, the Isle of Man was meeting its obligations under the United Kingdom-Isle of Man reciprocal agreement on social security, the aims of which include mobility of labour factor supplies.
- 5.15 So in the year 2000 there were policy changes to VAT on supplies in the construction industry, personal taxation, company taxation and social contributions for the self-employed. Furthermore, there had been no major changes to any of these policy variables for many years before the year 2000.
- 5.16 With the exception of personal and company tax there have been no changes to any of these policy variables since March 2000. In 2001/2 the rates for personal and company income were reduced to 12% and 18% from 15% and 20%. In 2002/03 the lower rate was reduced to 10% for both personal and company income and the higher rate for companies was reduced to 15%.
- 5.17 In the circumstances described above and, in particular, since four policy changes were made in early 2000, even if aggregate data were to be available it would be difficult to isolate the effects of any one of these policy changes from the others by either statistical tests or econometric methods as envisaged by the European Commission. Also, given the form of the budget constraint for the self-employed noted above and the prevalence of self-employment in the construction industry, even if micro data were to be available, it would also be difficult to apply microsimulation methods to analyse the effects of the policy changes.

5.18 In addition, on 1st January 2002, the Isle of Man introduced a National Minimum Wage. Prior to this, statutory wage regulation had only applied to agricultural workers. The rates of the National Minimum Wage were announced in July 2001 and are £4.10 per hour for those 18 and over, £3.65 per hour for workers in accredited training and 17 year olds and £3.15 per hour for 16 year olds.

5.19 NACE Rev 1

The trends outlined through the VAT data above is as close as the Isle of Man can get to this Data set.

6. CONCLUSION

Whilst not all the data sets are available, it is apparent from the VAT details, the trade survey, other Government Departments input and general hearsay and discussion with the general public that, from the Isle of Man's perspective, the experiment has been successful in achieving its and the EU's aims of creating employment and reducing the size of the shadow economy. In addition there have been other benefits to the Government and people of the Island, including improvements to the existing housing stock and reduced pressure on green field site developments. There has been far less pressure on builders to cut corners, reduce prices and work outside the system - the knock on effect of this, according to the Employer's Federation is happier customers and staff, fewer complaints and staff movements, all of which contribute to improved profitability. All concerned have expressed the desire to continue with the regime and for it to become a permanent feature.