Funding the Future

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This weekend much attention will be drawn to the use of the Isle of Man for VAT abuse. It is a story I know well, and in which I can fairly say I have played a part. This is because in 2007 I noted something odd about the Isle of Man government's accounts. As I put it at the time:

To put to simply I noticed an odd fact about that income. When I compared the VAT that it claimed to receive in its government accounts with its declared GDP the ratio was 21.7%. That's odd as their maximum VAT rate is 17.5%. It's even stranger as the UK, using a slightly more onerous VAT regime which is however broadly similar to the IoM's collects just 6.1% of GDP as net VAT revenue.

As a result I said that the UK was subsidising the Isle of Man to the tune of at least £233 million a year to be a tax haven - which was well over a third of its government's income at the time.

To understand this it has to be appreciated that the Isle of Man and the UK share a VAT system. The Isle of Man might be a tax haven, but unlike Jersey and Guernsey, it operates UK based VAT, as it had prior to 1973 and the arrival of the EU operated UK purchase tax for many decades. There is literally no difference between the two jurisdictions' VAT systems.

And, to make the admin easier what happens is that the UK and Isle of Man operate the systems in common. As I put it in 2007:

*The ... UK and the Isle of Man share a '*common purse' agreement on VAT. This means the Isle of Man's VAT is paid into the UK Exchequer, in effect. And then the UK gives it a payment in exchange based on a formula which is unpublished but which clearly has nothing to do with the real level of economic activity in the Isle of Man.

In 2007 the Isle of Man was none too happy about my allegation, which was reported in the Observer. All sorts of unkind things were said of my abilities but the simple unavoidable fact was that no state could recover more in VAT then the headline VAT rate multiplied by GDP. Why I was the first to spot this is a good question. If just so happens that I was.

Suffice to say that I was proved right. The UK was, in effect, wholly inappropriately giving the Isle of Man a significant part of its government income without there being any economic justification for doing so. This money it then used to offer low and zero rate taxes to tax abusers who in return undermined the UK tax system. It would have been hard to make up a story much more bizarre.

To cut a long story short, I repeated my suggestions in 2009 and in October of that year the UK government announced a change in the rules. My popularity in the Isle of Man was not too high at the time, and fell further when the rules were revised again in 2011, by which time pretty much all the change that I had said were required in 2007 had taken place. In addition, welcome transparency had been added into the arrangements, part of which let me appreciate that the Isle of Man was not above restating its GDP to try to gain favour in this relationship.

As I noted in 2011, by then the withdrawal of the subsidy had cost the Isle of Man a total of £215 million a year, which was very close to the sum I first calculated in 2007 of £233 million. This amounted to about a third of the Isle of Man government's income at the time. My role in denying them this revenue has long been acknowledged in the island.

Now stories relating to the Isle of Man and VAT are back in the news, so I wondered if the abuse reached government levels, again. A little research shows that quite emphatically they do. The reality is that it still appears to be true that the UK is subsiding the Isle of Man to be a tax haven. My estimate that the current subsidy may be more than £70 million a year. The scale is not as big as it was, but it's still serious. As ever some data helps explain the conclusion.

All the data referred to in what follows is summarised in this one table:

UK GDP data is from HM Treasury and VAT revenue from budget data. Similarly, Isle of Man data for GDP and revenue comes from Isle of Man government published sources. The first two columns compare these ratios at face value. The Isle of Man now seems to collect less VAT as a ratio to GDP than the UK, which is a complete reversal of the situation observed a decade ago, and so it would appear that all is now OK with the world, and that the shortfall might be explained, logically, by the higher level of supply of financial services in the Isle of Man economy, with these sales being considered exempt for the purposes of VAT.

Experience has, however, taught me not to take numbers at face value. I thought I'd rummage a little deeper because what we now know is that GDP is a notoriously unreliable indicator of national income in a tax haven, as Ireland has proved. As we now know the real economy there is vastly lower than the GDP figures imply. So I looked into the Isle of Man's GDP and found this (page 8, here):

Sixty two per cent of the Isle of Man's GDP is corporate profits. For comparison the UK equivalent data (from table D in the PDF download here) is 21%. To put it another way, 41% of Isle of Man GDP is made up of corporate profits that flow through the place, but which do not stick there (of course), which do not represent sales arising or value added in the island. Knock this out and the result is a much better indication of what really actually happens in the island on real economic activity that might happen there, which is, of course, the basis on which VAT can be recovered because VAT relates to sales, not corporate profit flows. And when this is done then it is readily apparent that the rate of VAT attributed to the Isle of Man is still way over the odds when it comes to the VAT common purse. It is collecting nearly 9% of GDP in VAT whilst the UK, which has an identical VAT system, collects just over 6%.

The result is obvious: we are still paying the Isle of Man to be a tax haven. The subsidy is now likely to exceed £70 million a year.

And in case you are wondering where all the profits come from, page 6 of the Isle of Man data already noted explains this.

Let's be quite clear that the egaming earnings of the Isle of Man are not domestic. It's a pretty bleak place, but the whole island does not egame constantly as a consequence. Nor are 15% insurance or 8% banking or 9% other finance sectors mainly domestic either (and all are VAT free, of course). Finance makes up about 10% of UK GDP (give or take). Add these together and they are 51% of GDP. If 10% out of that total is domestic I'd be surprised. The rest is excess profit flows having nothing to do with domestic activity. That's 41% to eliminate then - or exactly the difference in profit rates, noted above, corroborated in a different way.

The evidence is clear: current rules are still letting the Isle of Man get away with VAT claims against the UK which seem excessive. I am aware that the situation has been under review, but the reality is that it's now clear that nothing has yet stopped the VAT subsidy to the Isle of Man to be a tax haven. It's time it was made clear that this has ended, for good.