STATES OF GUERNSEY

Personal Tax, Pensions and Benefits

A joint review by the Social Security and Treasury and Resources Departments

Public Consultation – Part B

Technical analysis and background information

8 April 2013

This document is important because...

It contains the background and technical information which will help you make informed answers to the questions asked in part A. The questions are repeated in this document however they are presented in a different order.

Please understand...

A number of the ideas presented make sense only if we use examples. Different tax options are mentioned and illustrated with example rates to demonstrate the effects they would have on our public finances and on people with different incomes. **These are examples only. No decisions have been made yet on what proposals will be brought forward.** Final proposals may not reflect any one example in isolation. We can make recommendations only after we hear what you have to say.

The deadline for submission of responses to this consultation is **31 May 2013.**

Instructions on how to respond are provided on the back page of this document.

Contents

1. Introduction

This section of the consultation document provides additional context and detail to the summary and questions presented in Part A. The questions presented in this section are the same although the ordering of the questions differs. The numbering in brackets reflects how these questions are numbered in part A.

Instructions on how to submit your response are provided on the back of this document.

Space to answer the questions is provided at the end of part A.

2. Principles of personal tax

Whilst taxation at the technical level can be quite complicated, at the level of principle there are in fact few methods of taxation.

In general summary the following are the components of the tax base which can be taxed:

- Income
- Wealth
- Consumption

2.1.1. Income taxes

Income comes in two forms; earned and unearned. Earned income (e.g. wages) is relatively straightforward to tax. Unearned income (such as income from investments) is more difficult to tax and easier to avoid. Separate to this review, the States is reviewing measures to combat tax avoidance.

Social insurance contributions are also levied on income.

2.1.2. Wealth taxes

Immovable property taxes (which would include Tax on Real Property ['TRP'] in Guernsey) are a form of indirect wealth tax.[1]

Other forms of wealth tax which are not charged in Guernsey include capital gains taxes, charged against profit made from the sale of capital assets; and inheritance tax or death duties, charged against the transfer of the assets of an estate to the heirs of the deceased. Their introduction would undermine Guernsey's 'tax neutral' offer for international financial services, particularly in funds and pensions administration. Such taxes would be very damaging to Guernsey's competitive position and as such are not under consideration in this review.

2.1.3. Consumption taxes

Consumption taxes are charged against the purchase of goods and services. They are most efficient (i.e. have the least distortion on behaviour) when charged at a flat rate.

Environmental taxes are a subset of consumption taxes and tax the consumption of goods considered to have harmful effects on the environment.

Duties and excises are, in practice, little more than indirect consumption taxes. In Guernsey they are paid by wholesalers on the import of goods to the Island. However, this cost is ultimately passed on to the consumer. Excise taxes are often used to discourage behaviour which has a harmful effect on society or a cost implication for the Government (such as the consumption of alcohol and tobacco).

The OECD[2] has listed the following four taxes in descending order of economic efficiency:

- property tax (recurrent on immovable property);
- consumption tax;
- personal income tax;
- corporate tax.

Corporate tax is outside the scope of this review as the corporate tax review was closed in December 2012. **Figure 2.1.3a** compares how much revenue is generated from these sources in Guernsey, Jersey and the UK.

Figure 2.1.3a. Comparison of revenue sources by tax efficiency

Tax	GSY	JSY	UK
Immovable property taxes (domestic and commercial)	3% (1/3 of which is domestic)	3%	5%
Consumption taxes (not including excise taxes)	0%	9%	17%
Personal Income taxes	44%	44%	31%
Social/national insurance	29%	20%	17%
Other taxes	24%	24%	30%
Total	**100%**	**100%**	**100%**

[1] They can also be considered as a quasi-service consumption tax as consumption of household public services (such as maintenance of public highways) is loosely correlated with size of property.

[2] Organisation for Economic Co-operation and Development

3. Practical examples

3.1. Revenue neutral scenarios

In order to illustrate the relative pros and cons of the options available for revising the personal tax system, this section provides analysis of three alternatives, each of which assumes a significant modification to the personal tax regime. Each alternative is measured against the three principles of fairness, efficiency and sustainability.

The scenarios presented in this section have been calculated to be broadly revenue neutral – they will raise the same amount of revenue as the current system but could redistribute the burden between household types.

The alternatives presented are:

- **Introducing different income tax rates for low and high earners**
- **Reducing the general rate of income tax and introducing a Goods and Services Tax ('GST')**
- **Removing specific tax allowances and Family Allowance and increasing the universal personal tax allowance**

These scenarios are presented for illustration only and are not mutually exclusive - none of these changes are being proposed at this time.

Box 1: Deciles

Each decile represents 10% of a sample when ranked in ascending order. If all islanders stood in a line according to height, then the first decile would the shortest ten percent (or tenth) of islanders; the tenth decile the tallest ten percent.

In the examples given in the following section, if all households were ranked in order of their income decile 1 would capture the poorest 10%; decile 2 would capture those between 10% and 20%; decile 10 would capture the richest 10% (i.e. between 90% and 100%).

3.1.1. Introducing a lower earnings and a higher earnings income tax rate

Guernsey's current personal tax regime is relatively simple. There are personal allowances (and specific allowances including mortgage interest relief) and one rate of income tax. As is shown in Section 6, the system of allowances and reliefs does favour certain tax payer groups over others[3] but these are few. Otherwise the combined income tax and Social Insurance system is mildly progressive and generally proportionate.

Many other places (including Jersey, the Isle of Man and the UK) use several rates of tax graduated by earnings limits. Such a system in Guernsey could, for example, include introducing a lower earnings rate of 15% on earnings above the current personal allowances and up to a second threshold. The current general rate of 20% would be charged above that and a further rate at, say, 25% would be charged against earnings above a third threshold. **Figure 3.1.1a** outlines a possible system which would produce approximately the same level of income as the current system.

Figure 3.1.1a. Rates and earnings thresholds used in presented scenario of three tier personal income tax system

Tax band	Earnings threshold (for single adult, no other allowances)	Tax rate
Personal Allowance	Below £9,475	0%
Lower	£9,476 - £18,400	15%
Standard	£18,401 - £44,000	20%
Higher	£44,001+	25%

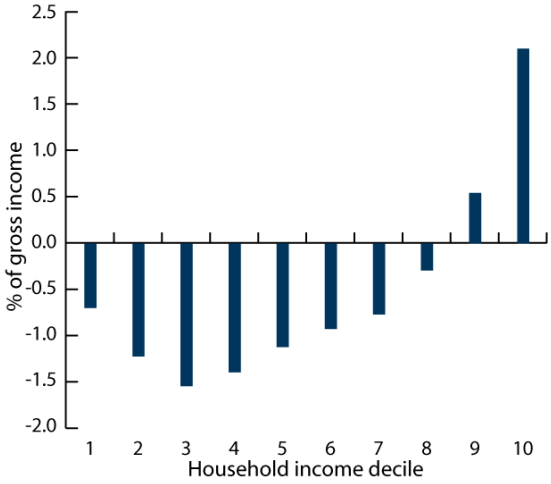
The impact on households by income deciles is shown in **Figure 3.1.1b**. The majority of households would pay less tax under this system. However, if ranked in order of annual income, households in the top 20% would pay more tax under this system with the top 1% of earners paying as much as an additional 4.5% of their gross income in tax.

This system is more progressive than the present system, but also much more complicated and difficult to administer. At present, tax avoidance is low in Guernsey; however, a higher earner's rate could also lead to greater incentives to try to avoid tax. For example, bonuses for higher earners would be subject to tax at the highest rate.

[3] The households which currently benefit the most from the current system of specific allowances are low to middle income households with a substantial mortgage.

Figure 3.1.1b. Average net change in tax payable by income decile

Source: Policy Council



It can also be argued that higher earners' rates can reduce the incentive to progress to higher earning positions. When considered together with the current Social Insurance contributions, employed individuals earning over the higher income tax threshold (£44,001 a year) and up to the upper limit on Social Insurance payments (£119,000 in 2013) would pay 31p[4] in tax and Social Insurance for each additional £1 earned. This could create competitive issues by reducing Guernsey's attractiveness for firms and professionals to locate here and drive away jobs and employment.

Measured against the criteria of efficiency, fairness and sustainability, this system would improve fairness and be as sustainable as the current system but would decrease both the economic and administrative efficiency of our personal tax system.

	Fairness	Efficiency	Sustainability
Lower earnings rate & higher earnings rate	☑☑☑	☒	☑☒

[4] Self-employed people would pay 35.5p.

3.1.2. Introducing a lower general rate alongside a Goods and Services Tax

Consumption taxes are considered among the most economically efficient methods of taxation and most developed economies have a high dependence on value added or goods and services taxes. In the UK, VAT generates about £1 in every £6 of government revenue and Jersey generates about £1 in every £11 from GST (£66m in 2011). Although considered in the past, to date Guernsey has avoided the introduction of GST, despite its attractiveness in terms of economic efficiency.

The arguments against GST are that it is considered regressive, as lower income households typically spend a larger proportion of their income on taxable goods and services than higher income households. The introduction of GST would result in an increase in prices and inflation; however, the effect on inflation would be temporary.

GST could be combined with a lower rate of income tax to increase the efficiency of our tax system without increasing the total amount of revenue generated by the States. Two examples have been used to illustrate how this might work.

Example 1: GST of 10% accompanied by a reduction of the general rate of tax to 12%.

Example 2: GST of 5% accompanied by a reduction of the general rate of tax to 16%.

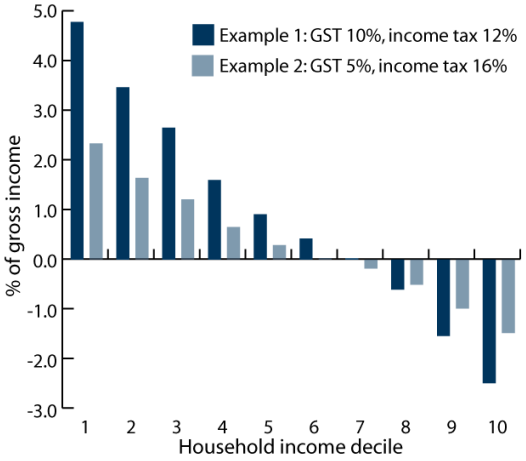
The economic efficiency of Guernsey's tax regime would be improved by introducing a GST, as would the sustainability of revenues as consumption varies less than income during economic downturns. As consumption taxes are considered more economically efficient and sustainable than income taxes, both these benefits would be greater in example 1 than in example 2.

In terms of fairness, both examples are more regressive than the present system. However, example 2 would be less regressive than example 1.

The rise of internet shopping has led some to question whether in the long term there might be a reduction in the tax base. Presently, an estimated 15% of Guernsey shopping is done online, often importing direct from the UK. Introducing a high rate of GST might accelerate this trend.

Figure 3.1.2a. Average net change in tax payable by income decile

Source: Policy Council



It is estimated that there would be an initial one off set up cost of £2m to create administration systems for GST and an on-going cost of approximately £1m a year. Similarly there would be an (unquantifiable) cost of administration for business on the island. These costs would be similar regardless of the rate at which GST was charged. As a result the lower the rate of GST the more administratively inefficient it would be.

	Fairness	Efficiency	Sustainability
10% GST, 12% income tax	☒☒	☑☑☑	☑☑
5% GST, 16% income tax	☒	☑☑	☑

3.1.3. Removing of specific tax allowances and Family Allowance and replacement with higher personal allowances

At present the current system of specific tax allowances reward or penalise certain behaviour; providing benefits to households in specific circumstances (e.g. households with a mortgage, or single parents) which are not available to everyone. Although this is a controversial issue, many would consider it fairer to treat the income of all taxpayers in the same way and give everybody the same allowances.

More than 7,000 households claimed mortgage interest relief in 2011 costing the States £7m. This relief is economically inefficient. The issues surrounding this are explained further in Box 2 (page 13).

Pensioners receive an additional tax relief of £1,750 above the standard personal allowance. This extension of the personal allowance for older people cost £3m in 2011. As a result of the ageing population, increases in the number of older people eligible for this relief could increase this cost to £5.5m by 2040. Other specific allowances, including the single parent, dependent relative and housekeeper allowances are included in this scenario. Their combined cost in 2011 total approximately £1m.

At present Family Allowance[5] (£15.90 per child per week) is available to all households regardless of their level of income. In 2011, 6,900 families claimed Family Allowance costing £9m. The removal of Family Allowance for all but the poorest households could be justified on the principle that it is irrational for the States to give money to a household only to reclaim it in taxes.

The removal of these tax reliefs and the universal Family Allowance could be used to increase personal allowances by an estimated £4,100 per year. This would make individuals not currently receiving these allowances better off by over £800 per year.

As it is not possible to accurately incorporate the net impact of the withdrawal of allowances by income decile, **Figure 3.1.3a** provides examples of the impact on specific households. Non retired households with neither a mortgage nor children would be the biggest beneficiaries of this change.

[5] Prior to 1981 this benefit was mainly offered as a tax allowance. It was converted to a universal benefit payment to make it more accessible to low income households.

A couple with one child or a small mortgage would also be better off. Single parents (currently entitled to tax relief not available to couples), those with larger mortgages or couples with more than one child would be worse off. As the system stands, the impact on low income households would be absorbed by the benefit system.

Figure 3.1.3a. Impact by household type

Household description					Net change in disposable income (% of gross household income)
Adults	Children	Receiving Supplementary benefit	Mortgage interest	Gross income (after tax before supplementary benefit)	
1	0	Y	-	£15,000	No change
1	1	y	-	£15,000	No change
1	2	y	-	£15,000	No change
1	0	n	-	£40,000	2.1% better off
1	1	n	-	£40,000	3.2% worse off
1	2	n	-	£40,000	5.3% worse off
2	0	n	-	£40,000	4.1% better off
2	1	n	-	£40,000	2.0% better off
2	2	n	-	£40,000	0.1% worse off
2	0	n	£5,000	£40,000	1.6% better off
2	1	n	£5,000	£40,000	0.5% worse off
2	2	n	£5,000	£40,000	2.5% worse off
2	0	n	£5,000	£60,000	1.1% better off
2	1	n	£5,000	£60,000	0.3% worse off
2	2	n	£5,000	£60,000	1.7% worse off
2	0	n	£10,000	£60,000	0.6% worse off
2	1	n	£10,000	£60,000	2.0% worse off
2	2	n	£10,000	£60,000	3.4% worse off

	Fairness	Efficiency	Sustainability
Remove specific tax allowances & Family Allowance; replace with higher personal allowance	☒☑	☑☑☑	☑☑

3.1.4. Conclusion and questions

It is evident from the scenarios presented in this section that it is difficult to design a system that scores highly (or even positively) against all three criteria of fairness, efficiency and sustainability.

What are your views on the options above?

Q1 (a) (Part A Q7 (a)): Which, if any of the three examples presented would you favour and why?

Q1 (b) (Part A Q7 (b)): Are there any aspects of these examples (even if you do not favour the example as a whole) that you find attractive or worthy of comment?

3.2. Increased revenue scenarios

The previous section provided revenue neutral examples to illustrate what approaches could be explored to increase the fairness, efficiency and sustainability of the personal tax regime. The classic policy trade-off is evident; no scenario will satisfactorily meet all three criteria.

Although strategies are in place to close the current deficit through savings and efficiencies, this cannot reduce the long term pressures on our finances. The increasing number of people over retirement age in our population will increase demand for pensions and care services. No amount of efficiency will prevent the increase in expenditure required to continue to provide these services at the current level to an increasing number of people.

Given this situation, this section provides further examples which will generate £20m of additional revenue from the personal tax system. This figure is only for illustrative purposes. The actual amount of future revenue (if any) that may be required is impossible to determine. This will depend on many factors: whether current services are reduced; whether new services are introduced; our economic conditions; and most importantly whether the population projections turn out to be accurate. The actual revenue required in the future could be £10m, £100m or indeed nothing.

Again, each is measured against the three principles of fairness, efficiency and sustainability.

The options presented are:

- **Raising domestic tax on real property**
- **Introducing a higher earner's rate**
- **Increasing the general tax rate**
- **Increasing Social Insurance contributions**
- **Introducing GST**
- **Removing specific tax allowances and Family Allowance**
- **Introducing environmental taxes**

3.2.1. Raising domestic tax on real property[6]

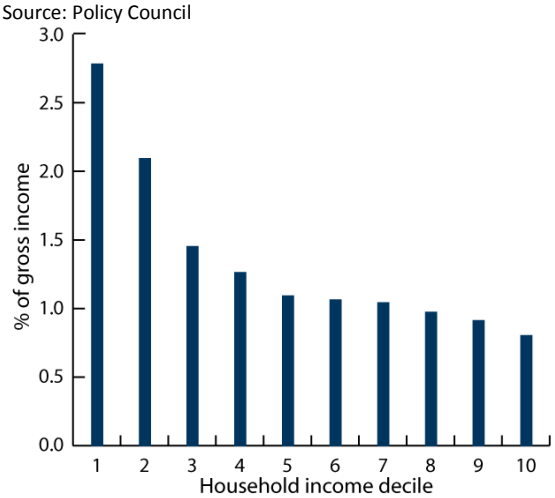
The average domestic TRP bill is about £150 per year. The average parish rates bill is approximately £90. By comparison, average UK council tax is around £1,150 per year. In Jersey, typical total property taxes (parish and TRP equivalent) are about 30% higher than in Guernsey.

Property taxes are economically efficient; they do not affect company investment or hiring decisions, nor do they impact household consumption or spending choices (other than reducing disposable income which is true of any tax).

Increasing domestic TRP rates to five times its current level would generate net revenues of approximately £20m resulting in an average bill of £750 per annum[7]. The monetary value of the increase would be greater for high income households who generally have bigger properties. However, for households on a lower income, their TRP bill may be lower in value but it is likely to represent a much larger proportion of their income. As such, any increase will have a larger effect on lower income households.

Figure 3.2.1a. Average net change in tax payable by income decile

Source: Policy Council



Higher TRP rates could be combined and partially offset by reduced stamp duty rates.

	Fairness	Efficiency	Sustainability
Domestic TRP five times current rate	☒	☑☑☑	☑

[6] This review is of the personal tax and Social Insurance system and excludes consideration of measures for business rates that may be reviewed by the States as an ordinary part of their business.

[7] Though administratively more difficult, a higher £/TRP rate could be applied to higher TRP value properties.

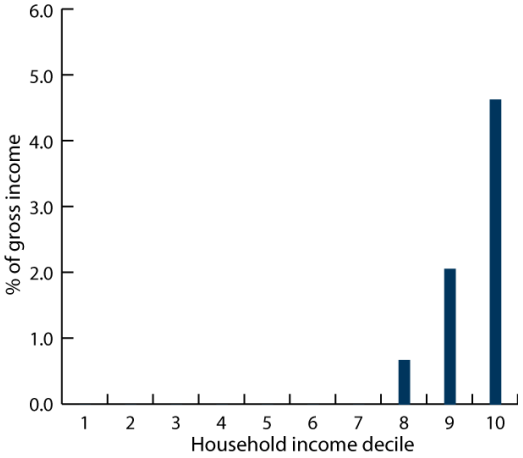
3.2.2. Introducing a higher earner's rate

The revenue generated by a higher earner's rate is dependent on the rate charged and the income threshold at which this rate becomes applicable. There are many combinations of rates and thresholds which could be used. However, the example shown could raise an estimated £20m by implementing a higher earner's tax rate of 30% on individual income above £44,000.

This would affect around 25% of the working population and would have a very significant impact on the highest earning groups. For those at the very highest levels of income, this could increase their tax bill by up to 9% of their gross income, increasing the amount of tax they pay by almost 50%.

Figure 3.2.2a. Average net change in tax payable by income decile

Source: Policy Council



When considered in combination with Social Insurance contributions, a higher earner's rate would mean that approximately 20% of employed individuals would be paying a combined rate of 36% in income tax and Social Insurance contributions on their income between £44,000 and £119,000. This is a higher proportion of income than the 29% of GDP currently spent on public services. There are only a few hundred people with earned income greater than the upper threshold for Social Insurance contributions (i.e. £119,000 per year). Levying a higher rate on income above this level would not yield revenues on the scale used for illustration in this section. Perhaps more significantly, a high earner's rate above this would erode Guernsey's attractiveness as a place for international business.

As explained in Section 6, the top 10% of earners already pay 40% of the total value of personal tax and Social Insurance collected in Guernsey. A higher earner's rate would increase their share to more than their share of total income which many would consider unfair.

A higher earner's rate would result in a more progressive system. However, there is a very high risk that it would undermine Guernsey's competitive attraction for middle and senior executive staff. It could affect firms' ability to attract skilled workers and make Guernsey less attractive to businesses looking to locate here. Ultimately, a higher earner's rate combined with the higher upper threshold on Social Insurance contributions would not compare favourably with Jersey and could direct investment and relocation in their favour.

An alternative to a higher earner's rate would be to introduce a phased withdrawal of tax allowances (including the personal allowance) for those with an income above a set threshold. For example, personal allowances could be withdrawn at a rate of £1 for every £5 earned above £44,000[8]. An individual with an annual income of £43,999 would receive an allowance of £9,475; at £50,000 this would reduce to £8,275; at £95,000 he/she would receive no allowance at all. This would face similar issues as levying a higher rate. The marginal rate of income tax would be 24% and the combined marginal rate up to the Social Insurance upper earnings limit would be 30%.

Guernsey currently employs a tax cap; a system which limits the tax liability of any individual. The cap limits the amount of tax any individual must pay on their income to £220,000[9] (or £110,000 on non-Guernsey based income). The cap was introduced on the principle that the contribution of very wealthy individuals to the public purse far outstrips the benefit they receive from it and there is a limit to how much they can be expected to contribute. There are currently only 32 individuals in Guernsey subject to the cap (There are no current plans to change these arrangements).

	Fairness	Efficiency	Sustainability
Higher earner's rate: 30% on income over £44K	☑☒	☒	☒

[8] Jersey operates a system of withdrawing allowance for high earners. This system is more complex and relies on a higher general rate of tax. Personal income is assessed under two parallel rate systems and tax payers pay the lower of the two assessments. Individuals can receive allowances and be taxed at the marginal rate of 27% or receive no (or very few) allowances and be taxed at the standard rate of 20% on their entire income.

[9] To be liable to pay this much tax an individual would need an annual income in excess of £1.1m.

3.2.3. Introducing a higher general rate

A rise in the general rate of around 2.5% would generate approximately £20m of revenue. As the rate has been in place for some 50 years, a change to the general rate could be interpreted as undermining the stability and predictability of the personal tax system and would need to be carefully considered.

In distributional terms, a higher general rate would impact all personal taxpayers. However, the system of allowances means that higher income households pay tax on a larger percentage of their income than lower income households and as a result will experience a slightly larger increase in their tax bill relative to their income (see **Figure 3.2.3a**).

A higher general rate would also have a smaller impact on those receiving specific allowances (i.e. single parents and mortgage interest relief) than on households at similar income level not eligible for these allowances (see **Figure 3.2.3b**).

Figure 3.2.3a. Average net change in tax payable by income decile

Source: Policy Council

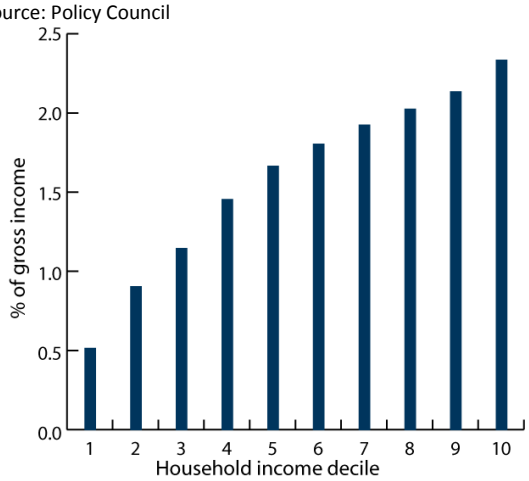


Figure 3.2.3b. Impact by household type

Household description					Net change in disposable income (% of gross household income)
Adults	Children	Receiving Supplementary benefit	Mortgage interest	Gross earnings	
1	0	Y	-	£15,000	No change
1	1	y	-	£15,000	No change
1	2	y	-	£15,000	No change
1	0	n	-	£40,000	1.9% worse off
1	1	n	-	£40,000	1.5% worse off
1	2	n	-	£40,000	1.5% worse off
2	0	n	-	£40,000	1.3% worse off
2	1	n	-	£40,000	1.3% worse off
2	2	n	-	£40,000	1.3% worse off
2	0	n	£5,000	£40,000	1.0% worse off
2	1	n	£5,000	£40,000	1.0% worse off
2	2	n	£5,000	£40,000	1.0% worse off
2	0	n	£5,000	£60,000	1.5% worse off
2	1	n	£5,000	£60,000	1.5% worse off
2	2	n	£5,000	£60,000	1.5% worse off
2	0	n	£10,000	£60,000	1.3% worse off
2	1	n	£10,000	£60,000	1.3% worse off
2	2	n	£10,000	£60,000	1.3% worse off

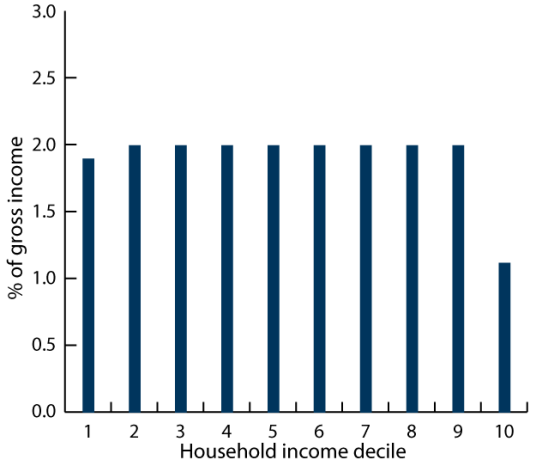
	Fairness	Efficiency	Sustainability
Increase general rate to 22.5%	☑	☑	☑☑

3.2.4. Increasing the rate of Social Insurance contributions

In order to raise £20m via the Social Insurance system, Class 1 contributions (for employed people) would need to be increased by 2%. For 97% of the employed population this increase would be proportionate. However, because of the cap on contributions, the mildly regressive element at very high incomes would remain.

Figure 3.2.4a. Average net change in tax payable by income decile

Source: Policy Council



Under current arrangements the cost of Social Insurance for employed people is split between the employee (who pays 6.0% of their income up to £119,000) and the employer (who pays a further 6.5% of an each employee's income up to £130,000). Any increase in Class 1 contributions could also be split between employers and employees. Self-employed people pay contributions (Class 2) at 10.5% up to £119,000, more than the employee's rate but less than the combined 12.5% paid by employees and their employers. Non-employed individuals are also liable for Social Insurance at a rate of 9.9% for those under 65 and 2.9% for those over 65.

Guernsey's Social Insurance contributions are already higher on middle and higher incomes than our closest competitors as a result of the increase in upper earnings limits between 2006 and 2008. Whist there was no significant evidence that the previous increases in employee upper earnings had any immediate impact on employment levels, their effects (negative or neutral) are more likely to be seen over a longer period. They also took place during better economic conditions.

	Fairness	Efficiency	Sustainability
Increase class 1 contributions by 2%	☑	☑	☑☑

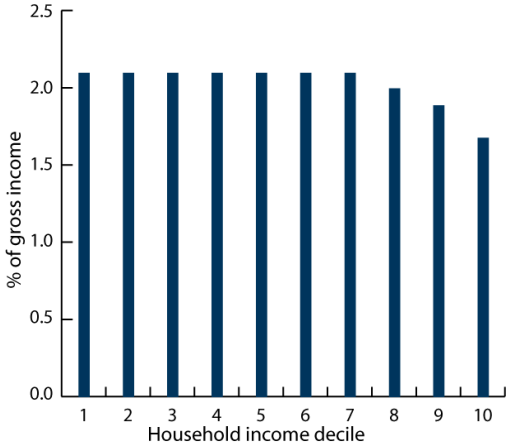
3.2.5. Introducing a Goods and Services Tax

To raise £20m through the introduction of a goods and services tax ('GST') would require a flat rate on all goods and services of 3%. A flat rate GST would be an economically efficient method of raising additional revenue and would have little impact on Guernsey's competitive position. Revenues from consumption taxes are also likely to be sustainable. Consumption varies less than income or profits during economic downturns and their associated revenue streams are more reliable.

However GST is likely to be mildly regressive, imposing a slightly higher burden relative to income on poorer households than higher earners.

Figure 3.2.5a. Average net change in tax payable by income decile

Source: Policy Council



As demonstrated in both Jersey and the UK over the last three years, the introduction (or change) of GST would also impact on retail price inflation creating a temporary increase in inflation. It is estimated that the introduction of 3% GST would increase RPIX by 2%, although the effect would be temporary as there would be only a one off increase in prices. Presently, an estimated 15% of Guernsey shopping is done online. Introducing a high rate of GST might accelerate this trend.

Introducing GST would also require an estimated £2m one-off investment in new collection systems and £1m a year for ongoing administration costs. Although the ultimate cost of paying GST is borne by the consumer, businesses would carry an additional cost burden in administering the payment of GST receipts to the States.

	Fairness	Efficiency	Sustainability
GST of 3%	☒	☑☑☑	☑☑

3.2.6. Streamlining allowances: removing specific allowances (incl. mortgage interest relief) and withdrawing Family Allowance.

Removing all specific allowances and the withdrawal of Family Allowance could result in a net saving to the States of £18m. Removing such allowances would be economically and administratively efficient.

There are fairness arguments both for and against such an approach. Many of these, including Family Allowance, single parents and mortgage interest relief, are applied irrespective of the income level of the household and, in terms of distributional equity, are unfair. Their removal would have a greater impact on lower earners but as they are based on circumstance, not income, their impact cannot be assessed against the income distribution as has been provided in the other cases presented. The issues for these allowances are more based on questions of principle.

The corresponding increases in personal allowances they could fund were fully covered in the previous section.

Mortgage interest relief is economically inefficient. Relief on interest payable reduces the net cost to an individual purchasing property. As the net cost of any given loan is lower, a bank is correspondingly willing to lend a higher amount than in the absence of the relief. The supply of property is basically fixed, thus purchasers' greater ability to borrow leads straight to higher prices (as a result, the taxpayer is effectively subsidising lenders' profits).

Acknowledging that property purchase is a long term commitment, any revisions to mortgage interest relief would need to be phased in gradually. Gradually reducing the relief available ought, in time, to temper house prices which have become relatively (to earnings) much more expensive over the last decade. There are other factors that influence prices; demand (immigration and general increase in household numbers due to social change) will continue to exert upward pressure on prices. Thus, timed correctly and implemented gradually, it is quite possible to implement the removal of mortgage interest relief without damaging the housing market. Such an approach could also be combined with a temporary reduction in document duty rates to provide support to market activity to temper any negative effects (see **Box 2**).

Mortgage interest relief presently costs the States £7m a year. As relief is claimable on all interest paid on a loan on a primary residence up to the maximum loan value (£400,000 in 2013), there is a risk that this cost could increase significantly as interest rates rise. This risk could be mitigated if a cap were placed on the amount of relief provided (as is the case in the Isle of Man). For example, a £20,000 limit on the amount interest you could claim relief for would capture all relief given at current interest rates, but would limit the cost of each claim (i.e. the maximum reduction in the amount of tax due) to £4,000 per annum should interest rates rise.

Table 3.2.6a Impact on specific households

Household description					Net change in disposable income (% of gross household income)
Adults	Children	Receiving Supplementary benefit	Mortgage interest	Gross earnings	
1	0	Y	-	£15,000	None
1	1	y	-	£15,000	None
1	2	y	-	£15,000	None
1	0	n	-	£40,000	None
1	1	n	-	£40,000	5.3% worse off
1	2	n	-	£40,000	7.4% worse off
2	0	n	-	£40,000	None
2	1	n	-	£40,000	2.1% worse off
2	2	n	-	£40,000	4.1% worse off
2	0	n	£5,000	£40,000	2.5% worse off
2	1	n	£5,000	£40,000	4.6% worse off
2	2	n	£5,000	£40,000	6.6% worse off
2	0	n	£5,000	£60,000	1.7% worse off
2	1	n	£5,000	£60,000	3.1% worse off
2	2	n	£5,000	£60,000	4.4% worse off
2	0	n	£10,000	£60,000	3.3% worse off
2	1	n	£10,000	£60,000	4.7% worse off
2	2	n	£10,000	£60,000	6.1% worse off

	Fairness	Efficiency	Sustainability
Streamlining allowances	☒	☑☑	☑☑

Box 2: Mortgage interest relief

The current system of mortgage interest relief provides tax relief on the entire value of interest paid on a mortgage on your primary dwelling up to £400,000. Because the amount of relief claimed is based on the interest paid, its value to the claimant depends on two factors; the size of the mortgage and the interest rate charged.

As a result, the States face a significant risk from increases in the interest rate. The average effective rate[10] (AER) in Guernsey is currently about 3% compared to a UK average over the past decade of 5%[11]. If the Guernsey AER were to increase to 4% (in response to an increase in the Bank of England base rate for example) the annual cost of this allowance could increase from £7m to £9m. In the UK the AER has reached 7% within the past decade. If the AER in Guernsey were to increase this high, the annual cost of proving tax relief on mortgage interest payments could increase to £16m.

In the mortgage market, interest relief is typically considered when assessing mortgage applications. As a result, households are able to borrow a proportionally higher amount on their mortgage. This has a knock-on effect on the property market, adding an additional upward pressure to domestic house prices.

Loans by banks for mortgages take into account affordability. On that basis, banks set multiples (the amount that they are willing to lend relative to your income). Lending multiples in Guernsey are higher than the UK due to the lower general rate of tax and the availability of mortgage interest relief. Early in the 2000s, lenders increased the multiples that they were prepared to lend at from on average four times an applicant's salary to five times their salary. Regression analysis reports that the impact of this has been to increase the price of houses (in today's terms) by between £20,000 and £30,000. Or put another way, had this not occurred, the average house price today would be £410,000, not £440,000.

Removing mortgage interest relief would effectively have the reverse effect (i.e. it would reduce the amount of money a bank would lend relative to your income). On the same set of assumptions, and assuming that houses would increase by no more than inflation for 10 years if mortgage interest relief were withdrawn, the average house price in 2023 could be £50,000 less (i.e. the average price in 10 years time would be £540,000 if mortgage interest relief were withdrawn compared to £590,000 if it were to remain).

Withdrawing mortgage interest relief over a period of ten years would smooth the impact on the housing market. A temporary reduction in stamp duty for lower priced property could provide support to the market if introduced, particularly as stamp duty and legal fees are very difficult to fund for first time buyers when saving for a deposit.

[10] the average interest rate charge on mortgages

[11] Local data is not available prior to 2010. However, the rates in Guernsey are closely linked to those in the UK.

3.2.7. Introducing environmental taxes

Environmental taxes are a special type of consumption tax. Whilst consumption taxes such as GST are applied on all goods and services, environmental taxes are levied purely on goods or activities which are considered environmentally damaging to discourage their use. A carbon tax is based on a 'polluter pays' principle and taxes are levied in proportion to the carbon content of fuels. As both companies and individuals consume energy, levying a carbon tax cannot be done within the personal tax regime in isolation.

A carbon tax of £121 per tonne of carbon would result in a net increase in revenues of approximately £20m. The associated individual energy price rises this would cause are compared to present prices in **Figure 3.2.7a**. Note that if a carbon tax were to be levied at a rate of £121 per tonne of carbon emitted by common fuel types, the duty currently charged against motor fuels would reduce, whilst new charges would be introduced on other fuel types.

Figure 3.2.7a. Comparison of retail fuel prices following the introduction of a carbon tax

Fuel Type	Current retail price	Retail price - tax @ £121 per tonne carbon	% change
Road diesel	£1.20/l	£1.06/l	-12%
Road petrol	£1.10/l	£0.91/l	-17%
Heating diesel	£0.65/l	£0.97/l	+50%
Marine petrol	£1.06/l	£1.03/l	-3%
Kerosene	£0.67/l	£0.98/l	+47%
LPG	£0.12/kWh	£0.15/kWh	+23%
Electricity	£0.14/kWh	£0.17/kWh	+17%
Coal	£393/tonne	£721/tonne	+84%

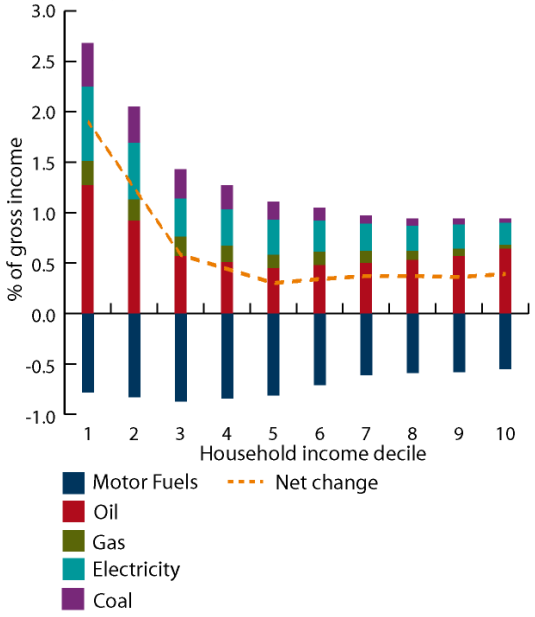
Figure 3.2.7b shows the estimated impact by decile of this level of carbon tax[12]. The impact on any individual household is dependent on their spending patterns. However, it is estimated that on average this would increase a household's total fuel and electricity costs by approximately £320 a year.

As the price rises would be common to both households and businesses, only around 40% of the burden of the net revenue increase would fall on households. A carbon tax would be regressive as lower income groups spend a higher proportion of their income on heating and fuel.

A carbon tax as illustrated could be net neutral in terms of personal tax revenues by offsetting the increase by an increase of individual personal allowances by £1,300. However, this does not factor in the accompanying increase in the costs for businesses. An increase in the cost base for firms would require much consideration and whether or not it would be possible to make arrangements for it to be net neutral for firms (for example to do so may require reducing commercial TRP) would need to be explored before serious consideration.

Figure 3.2.7b. Average net change in tax payable by income decile

Source: Policy Council



	Fairness	Efficiency	Sustainability
Environmental taxes	☒	☑☑☑	☑☑

Your views are sought on the options above:

- **Raising domestic tax on real property**
- **Introducing a higher earner's rate**
- **Increasing the general tax rate**
- **Increasing Social Insurance contributions**
- **Introducing GST**
- **Removing specific tax allowances and Family Allowance**
- **Introducing environmental taxes**

Q2 (Part A - Q8): What are your views on the pros and cons of these approaches, particularly with regards the fairness, efficiency and sustainability issues?

Other potential smaller scale measures under consideration though not the focus of this document include a review of dwelling profits tax, land profit tax and a review of personal anti-avoidance measures.

[12] Calculated using the data from last Household Expenditure Survey (2006)

4. Administrative issues

Presently, the tax and Social Security Insurance systems are separately administered, using different rules and are levied at different rates with differing treatment at upper and lower levels.[13] Social Insurance contributions are also ring fenced for spending on specific types of welfare, pensions, unemployment, long term care and healthcare. These funds continue to be topped up by a contribution from General Revenue.

The advantages of this system is that revenues to pay for pensions, unemployment and long-term care are set aside from and kept separate from other income. However, the disadvantage is that the consolidated picture of total public expenditure is not immediately obvious from the States' accounts.

The cost of the General Revenue contribution to the Social Security funds is £19m, equivalent to 8% of personal income tax receipts. Removing this contribution could move income tax rates down by just under 2% but Social Insurance contributions would need to rise by 2% to maintain present revenues.

Most non-contributory benefits are paid for from General Revenues, costing the equivalent of 17% of all personal tax revenues. Spending in this area is presently determined separately to the revenue budget itself (although this year should see both budgets presented at the same sitting of the States) and has to be accommodated within revenue limits when the budget is produced.

The burden of tax and Social Insurance is felt similarly by individuals, irrespective of the destination of the funds. Given that modernisation could make common collection and administration feasible (albeit only with significant set up costs), comments are invited regarding the attraction of consolidation of rates, collection or administration.

Q3 (Part A - Q9): What do you think could be done to make the system simpler?

[13] For those earning more than £125 a week (£6,500 a year), Social Insurance is levied at 6% (for employees) on all income up to £2,295 a week (£119,340 a year). Income tax is levied on all income above £9,475 a year for a single adult and £18,950 a year for a couple, with additional allowances available in specific circumstance. Although there is a cap on an individual's tax liability, at present this affects only 32 households.

5. Total public income and expenditure

Guernsey's public finances can be broadly divided into two distinct revenue streams: General Revenue income mainly derived from taxation, paying for departmental and capital expenditure; and Social Security income, mainly derived from Social Insurance contributions, although also having recourse to investment income and some revenue grants. The two are related by a complex series of interrelated accounts and transfers.

Guernsey's per capita expenditure on health, education, pensions and welfare is at levels broadly similar the other Crown Dependencies (see **Figure 5.1.1a**).

Figure 5.1.1a. Estimated expenditure per capita in Crown dependencies

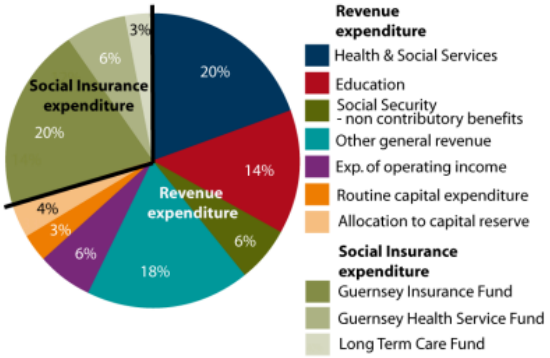
£ per annum, per capita in 2011

Sources: States of Guernsey General Revenue and misc accounts 2011; States of Jersey financial report and accounts 2011, Isle of Man government accounts 2011-12

	GSY	JSY	IOM
Health and social care[14]	£2,328	£2,217	£3,073
Education	£1,177	£1,238	£1,150
Pensions and welfare	£2,467	£2,725	£2,528
Other public services[15]	£2,479	£3,518	£3,524
Total	**£8,452**	**£9,698**	**£10,276**

Figure 5.1.1b. Distribution of Public expenditure in 2011

Sources: States of Guernsey General Revenue and misc. accounts 2011.



Balancing demands on public expenditure against the available income is a difficult task in any economy. Following the introduction of zero/10 in 2008, the level of States General Revenue (income from taxation sources) fell and as a result the

[14] incl. health insurance funds.

[15] Figures for Guernsey do not include expenditure of trading entities such as the harbours and airport which are operated on a commercialised basis. Expenditure of these entities are included in the accounts in Jersey and the Isle of Man.

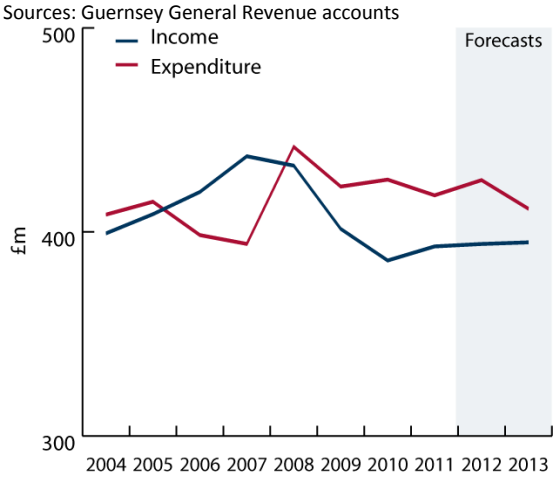
States currently has a General Revenue deficit – i.e. it is currently spending more than it receives[16]. The current deficit (forecast at £31m in 2012 and £17m in 2013) is less than was predicted in 2009.

In recent years, Guernsey has employed a policy of restraining General Revenue expenditure. Since 2009, General Revenue expenditure has not risen in real terms and was only 4% higher in real terms in 2012 than in 2004 despite the economy having grown by 6% over that time period. However, (weak) income growth has been insufficient to close the deficit and the imbalance remains (see **Figure 5.1.1c**). The States have employed several mechanisms to reduce the deficit. The present strategy is to close the deficit through savings achieved by the Financial Transformation Programme [FTP][17] which aim to make recurring savings of £31m per annum by the end of 2014. The modifications to zero/10 resulting from the corporate tax review made in 2013 are forecast to generate a net increase in revenue of £8m.

Figure 5.1.1c. General Revenue income and expenditure[18]

At 2012 prices, including dept. operating income and capital expenditure

Sources: Guernsey General Revenue accounts



However, that is only one half of the picture. Total public expenditure includes spending on pensions and contributory benefits (mainly funded through Social Insurance contributions) which are not incorporated in the General Revenue budget. As a result, despite recent restraint, total expenditure is some 16% higher in real terms than 2004 (see **Figure 5.1.1d**), increasing as a share of Gross Domestic Product ("GDP") from 27% in 2004 to 29% in 2012. This has been driven largely by increased health, pensions and welfare spending.

Figure 5.1.1d. Total public revenue income and expenditure

At 2012 prices, including dept. operating income and capital expenditure and expenditure for Social Security funds

Sources: Guernsey General Revenue and misc accounts

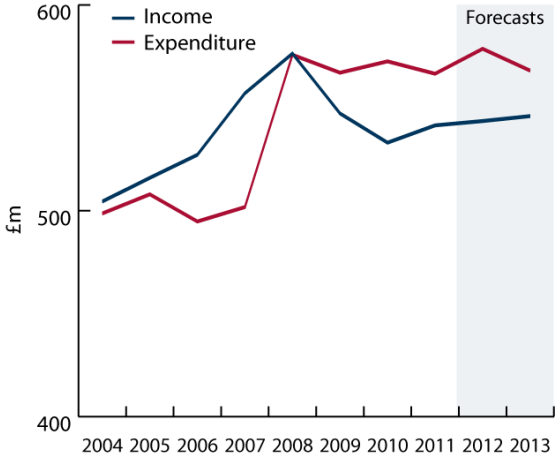
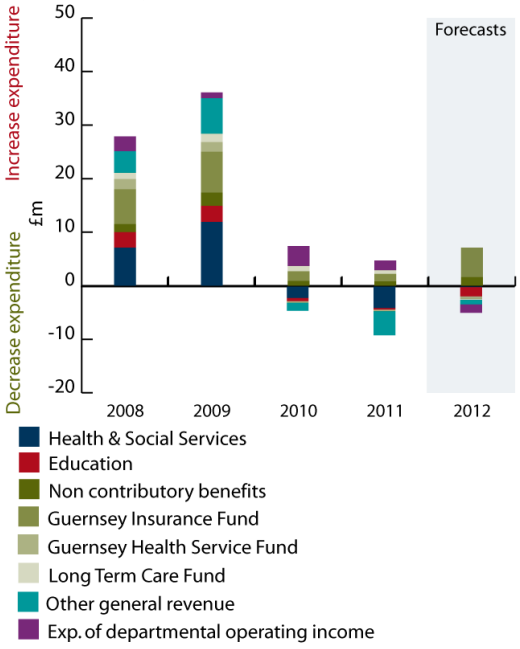


Figure 5.1.1e. Contributions to annual change in total public expenditure (excl. capital expenditure)

At 2012 prices

Sources: Guernsey General Revenue and misc accounts



Pensions and welfare expenditure growth has been caused by two factors (see Annual Independent Fiscal Review 2011): increases in the

[16] It is important to appreciate that the States does receive enough taxation revenues to fund its day to day expenditures but the deficit arises in supporting the necessary and continuing investment in our Island's infrastructure though capital expenditure.

[17] Other measures for reducing the deficit were incorporated in the programme to introduce zero/10, including raising indirect taxes (most notably TRP) and reducing the grant paid to the Guernsey Insurance and Health Service funds have already been completed.

[18] 2008 included a higher than typical capital allocation, capital allocations have been maintained at a higher level post 2008 than pre 2008.

number of households qualifying for pensions and benefits, which can be considered largely uncontrollable (e.g. increased numbers of pensioners, due to demographic change, and unemployed due to the economic downturn); and increases in the amounts people who are able to claim (e.g. increases in benefits rates) which are controllable and set each year as part of the budget process. However, the principle of payments of pensions and benefits is to provide income for those who are unable to earn a sufficient income for themselves. In order to maintain this principle, the level of payments needs to increase at the same rate as inflation or earnings to maintain their value in real terms.

Due to an ageing population, public expenditure is projected to rise over the next twenty to thirty years. The majority of this is accounted for by increased spending on pensions and health care for an increased number of older people. This issue is compounded by a projected decrease in the working age population (those above compulsory school age and below the age at which you can claim your old-age pension), reducing the size of the primary tax base. Research published by Policy Council[19] stated:

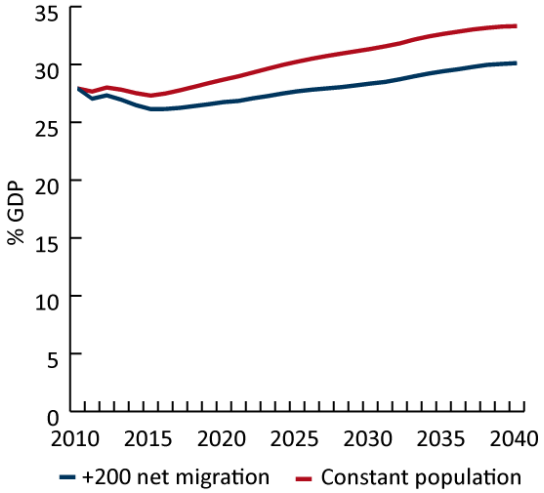
'What is apparent from the projections is that either revenue must rise as a share of GDP, or projected spending must fall—or some combination of the two outcomes must be achieved to ensure the States remains in balance'

Without any cuts in services or provision, and with no structural change in economic circumstance, it is estimated that current spending models for health, pensions and other welfare would require increased general rates of (combined) tax and Social Insurance of between 6% and 9% to remain in balance on a year on year basis. The savings made by the FTP will have little impact on these pressures. The choice will be between: (a) increased revenues; (b) reduced public service and welfare provision; or (c) more private provision e.g. encouraging investment in private pension schemes. These pressures are not unique to Guernsey. Throughout Western Europe demographic changes and future liabilities are expected to exert pressures on the sustainability of their welfare models. However, Guernsey (and Jersey) is in a better position than most in that significant reserves held by the Social Security funds are available to help finance some (but not all) of these additional costs and reduce the level of tax increases or expenditure cuts which would be required if this were not the case. The reserves held in these funds, which have been built up by many years of surplus in the Social Insurance contribution system, are ring-fenced for the payment of pensions, health, long term care and contributory benefits. They cannot be used to fund other public services.

Figure 5.1.1f. Projections of total public expenditure

As a percentage of GDP

Sources: Potential long term implications of demographic and population change on the demand for and costs of public services, Policy Council, March 2012



Whilst separate reviews are underway to analyse policy options for health and long term care provision, it is worthwhile to register the point that the conclusions drawn will have significant consequences for public expenditure. Key questions of principles will need to be addressed, such as the extent to which the public wishes to bear the burden of increased life expectancy, and to what extent in the future we will expect individuals to provide for their own retirements to reduce the burden of taxation on households.

What are your views on the total level of service provision in Guernsey?

Q4 (a) (part A- Q1 (a)): Should the States continue to provide the range of services it does today and increase taxation to pay for all increased future demand?

Q4 (b) (part A- Q1(b)): Or should it try and limit the growth in spending by encouraging people to make private provision (e.g. encouraging people to contribute to private pension schemes) or reducing the amount of pension and health benefits people can claim (e.g. reduced payments)?

[19] Potential long-term implications of demographic and population change on the demand for and costs of public services, Policy Council, March 2012

The Fiscal Framework ('the Framework') sets out clear parameters on expenditure and rules for the States to follow in terms of expenditure from the General Revenue budget. Those parameters include an effective upper bound (or limit) to how far expenditure can rise relative to GDP (presently no more than 21%). These are subject to an independent review published each autumn. These rules effectively safeguard against uncontrolled revenue expenditure growth and thus control the growth of the tax burden on households.

The creation of the Fiscal Framework was prompted by a proposal made in 2009 to borrow money to finance the States' capital programme (this proposal was subsequently rejected and the States' currently has no external debt[20]) and was designed to safeguard Guernsey against the risks of borrowing. As only General Revenue income would have been used to secure such borrowing, the scope of the Framework is limited to General Revenue expenditure and income.

The current Framework does not encompass expenditure funded by Social Insurance contributions as these contributions cannot be used as collateral. The principle of an upper limit on total public sector expenditures could be a useful safeguard against unsustainable growth in pensions and welfare expenditure in the future. However, given the demographic pressures, if such a rule were introduced, reductions in pension and/or benefit levels could become necessary in order to remain within prescribed limits.

Q5 (Part A Q2): Do you think there is a limit to how much of a household's income the States should take to fund public expenditure (be it on public services, pensions or welfare) and if so what should the limit be?

[20] However the States' has guaranteed commercial loans made to Aurigny, Guernsey Electricity, and The Guernsey Housing Association.

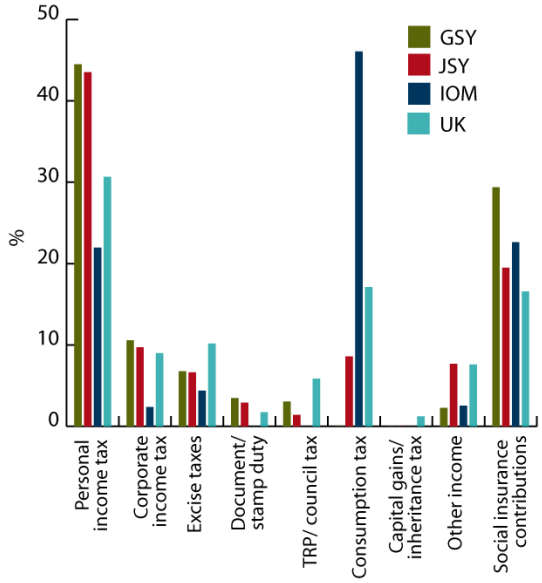
6. The current distributional burden of expenditures

Compared to the UK and the other Crown Dependencies, Guernsey raises the largest proportion of public income from personal tax and Social Insurance contributions. There is a much lesser dependence on consumption taxes than in the UK or the Isle of Man, where VAT is charged at 20%, or in Jersey where a 5% GST is applied.

The proportion of public income raised through corporate (business) taxes is similar in Guernsey and Jersey to that of the UK despite the lower general rate of corporate tax applied in the Channel Islands.

Figure 6.1.1a. Estimated distribution of public revenue income in sterling jurisdictions, 2011

Sources: States of Guernsey General Revenue and misc accounts 2011; States of Jersey financial report and accounts 2011; Isle of Man government accounts 2011-12; UK whole of government account 2011



Since the introduction of the zero/10 tax regime, corporate tax revenues have reduced and there is a greater dependence on personal income tax and Social Insurance contributions to fund public services. This has also resulted in a shortfall between income and expenditure.

Since the introduction of zero/10, there have been no significant changes to the personal income tax system and the increase in the proportion of revenue collected from households has come about through the reduction in the total amount of revenue collected rather than significant increases in the rates of personal income tax. However, Social Insurance contributions have risen: the increase in the upper earnings limit on

Social Insurance contributions[21] resulted in an increased burden for about 25% of the working population. There have also been increases in domestic and commercial TRP and excise taxes have risen in line with, or slightly faster than, inflation.

Figure 6.1.1b. Source of funding for public sector expenditure, 2012

Sources: Guernsey General Revenue and misc accounts

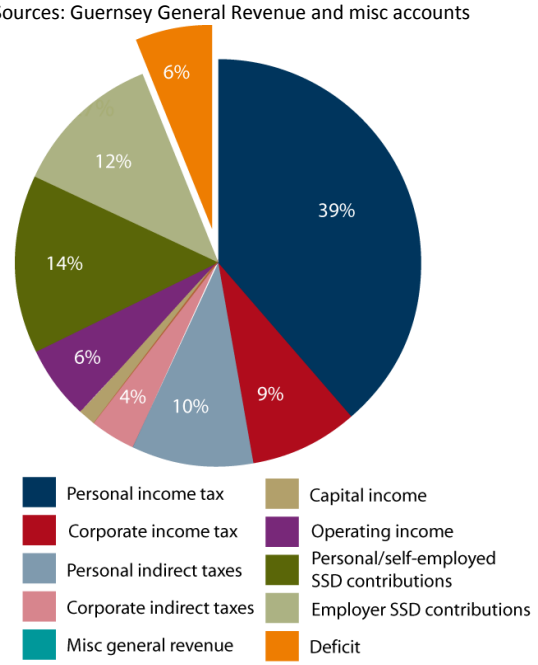


Figure 6.1.1c. A comparison of public revenue per capita in 2007 and in 2011

£ per annum per capita

Sources: Guernsey General Revenue and misc accounts

	2007 (at 2011 prices)	2011
Personal income tax	£3,008	£3,355
Corporate income tax	£2,081	£798
Excise taxes	£315	£510
Document duty	£414	£262
TRV/TRP	£106	£230
Other income	£409	£171
Social insurance contributions (employer and employee)	£1,834	£2,216
Operating income[22]	£401	£532
Investment/ capital income	£4	£3
Total	**£8,571**	**£8,077**

As shown in **Figure 6.1.1d**, the proportion of public income paid by higher earners increases the more they earn: the top 10% of high income households account for 40% of total personal tax and Social Insurance intake.

Figure 6.1.1d. Estimated distribution of tax burden by income decile

Source: Policy Council

Household income decile (gross equivalised)	Estimated percentage of total tax and SSD contributions
1	0%
2	1%
3	2%
4	3%
5	5%
6	7%
7	10%
8	13%
9	18%
10	40%

Figure 6.1.1e provides an illustration of the impact of the personal tax (including social security contributions) system on several different household types. They have been chosen for illustrative purposes and more analysis is provided in Appendix 1. The current system is indeed already mildly progressive, i.e. effective rates rise as income rises (albeit there is a tail-off after the upper earnings limit for social security is passed).

Despite the relative simplicity of Guernsey's income tax system, the system of allowances results in a situation where households in different circumstances will pay different combined (tax and Social Insurance contributions) effective rates[23]. The impact of mortgage interest relief on reducing effective household rates is evident.

Personal allowances were increased in line with inflation over the course of the last Assembly. By contrast, in the UK there have been significant increases in personal allowances with the stated objective of removing lower income from the tax system altogether. As a result, the gap between the levels of allowances available in Guernsey (which historically had been generous in comparison to the UK) and the UK has narrowed.

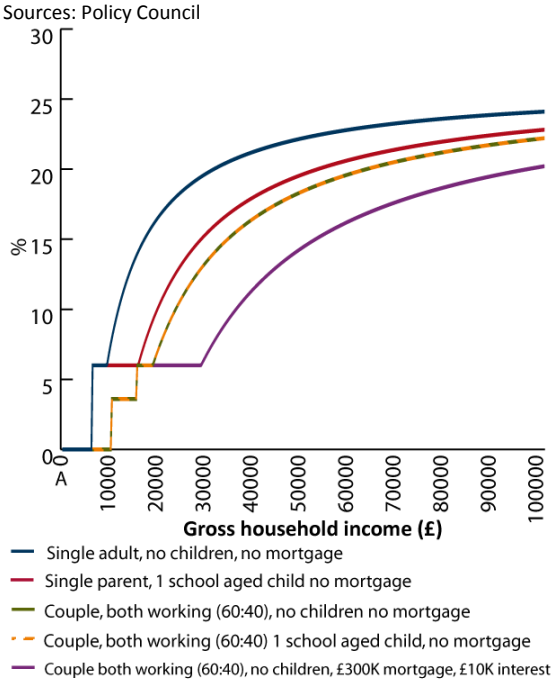
[21] The upper earnings limit on contributions from employees was also increased from £36,036 in 2006 to £119,340 in 2013. As a result, 97% of individuals pay 6% Social Insurance contributions on all of their earned income. The rate of Social Security contributions made by employers was also increased from 5.5% in 2007 to 6.5%.

[22] Operating income incorporates any income received by a department, which is not added to the General Revenue stream. This includes fees and charges for government services.

[23] The combined effective tax rate is the total of tax and Social Insurance contributions.

Figure 6.1.1e. Estimated combined effective rate of tax for various household types[24]

Sources: Policy Council



Guernsey has few significant other allowances. Mortgage interest relief has the largest single impact on revenues, which at present costs £7m[25], and as demonstrated in **Figure 6.1.1e** significantly reduces effective contribution rates for mortgage holders compared to other household types. This effectively provides mortgage holders with a subsidy towards their housing costs (see **Box 2**) (page 13). Tax relief on contributions to pension schemes amounted to £6m in 2011. Smaller allowances including those for single parents and the care of a dependent relative together cost £1m in revenues. The extension of the personal allowance for older people cost the States approximately £3m in revenues in 2011.

Although the personal tax systems in Guernsey, Jersey and the Isle of Man are quite different, the resulting effective rates of tax are broadly similar (see **Appendix 1**).

[24] In the current system there is a step change in a households' effective rate once an employee's income crosses the Social Security lower income threshold. This is because in Guernsey (and Jersey) contributions are charged on an individual's entire earned income, resulting in a very high marginal tax rate at the threshold. For example, a single adult earning £124 per week would pay no contribution to Social Security (the lower threshold being £125 per week); an individual earning £2 more (£127 per week) would pay a £7.62 contribution to Social Security. This equates to an effective marginal rate on the additional £2 in excess of 300%. In the UK and the Isle of Man earnings below the threshold are exempt.

[25] This cost is at current interest rates, which are historically low. Rising rates will increase the total cost of this relief.

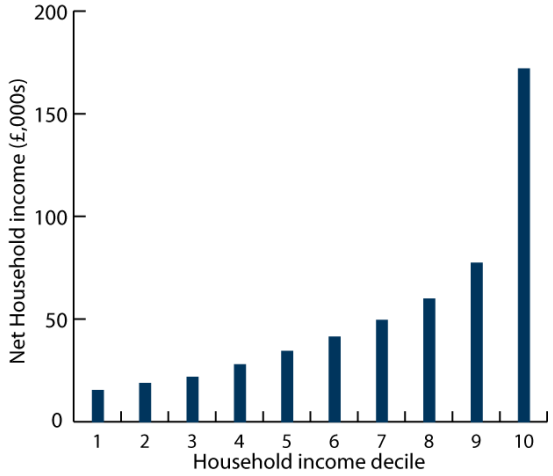
7. Household income and welfare

Guernsey's average (median) income levels, both at the level of the household and the individual, are higher than the UK. Measurement methods differ but it is estimated that individual median earnings in Guernsey are around 40% higher than the UK.

Estimates of average equivalised net income (after tax and after payment of benefits and old-age pension) per income decile are presented below (see **Box 3**).

Figure 7.1.1a. Net equivalised household income by deciles

Source: Policy Council



Estimates using standard OECD[26] measures of being at risk of 'relative poverty'[27] have been produced by Policy Council. Relative poverty is represented by those households with income below 60% of average (median) income levels, (which is a European standard indicator). The measures of relative poverty, used in international comparisons, incorporate allowances for benefits in kind provided by the government such as education and healthcare[28]. Incorporating these improves the income of lower income households proportionately more than the average, reducing the number of households in relative poverty.

Box 3: Equivalised income

Equivalising income is a way of adjusting income levels to account for the number of people living in a household so comparisons can be made between different household types. This is important because a household with two adults will need a larger household income to maintain the same standard of living as a household with one adult (although not twice as much). A household with two adults and two children will need a still larger household income to achieve the same standard of living.

Standard equivalisation scores (published by the OECD) are used to adjust the income of all households to the equivalent of a specific household type. In this document figures are equivalised to two adults with no children.

For example, the equivalisation score will adjust the income of a single adult household upwards as they will be able to live more comfortably on their income than a couple with the same household income. The household income of a couple with children will be adjusted downwards as they will be less comfortable on their combined income than a couple with the same income who have no children.

For more information see Appendix 2

For completeness, three measures of relative poverty are produced: a) on a gross income basis (i.e. before the effects of tax and benefits) b) on a net income basis (i.e. after the effects of tax and benefits) and c) on a net basis and incorporating the effects of benefits in kind received from the States (i.e. healthcare and education).

We are unable to produce measures before and after housing costs. However estimates produced including benefits in kind most closely reflect numbers used in international comparisons. According to these estimates, on this latter basis, approximately 12% of households in Guernsey are in relative poverty compared to 16% in the UK and 12% in Jersey.

[26] These have been estimated using a standard OECD equivalised income method. It should be noted that the available data does not allow these statistics to be produced in at the same level of detailed complexity as is used in larger jurisdictions. For more details see Appendix 2.

[27] Using the standard measures as net post transfer income less than 60% of median.

[28] There is no data available to make a comparison of before and after housing costs are taken into account as is also commonly done by larger jurisdictions.

Figure 7.1.1b. Estimated percentage of households in relative poverty (<60% median income) by household type.

% of households with income <60% of median
Source: Policy Council

	Gross income	Net income	Net income incl. benefits in kind	UK net income incl. benefits in kind
Single <65	43	28	34	20
Single + one child	60	30	23	22
Single 2+ children	80	49	17	
Couple	11	9	10	10
Couple + one child	9	8	5	15
Couple 2+ children	13	11	4	
Single pensioner	61	37	19	21
Pensioner Couples	33	19	3	15
All Households	**27**	**19**	**12**	**16**

Alternative measures of relative poverty have been attempted. These include pricing a notional basket of goods that is considered to constitute an acceptable minimum standard of living. However, such approaches are subjective. **Figure 7.1.1c** shows the net minimum income standards estimated and published last year by Loughborough University. For comparison, estimates are provided of what a household would need to earn before tax to achieve this level of disposable income.

Figure 7.1.1c. Estimated minimum household disposable income

Source: A Minimum income standard for Guernsey, Loughborough University. Adjusted for inflation

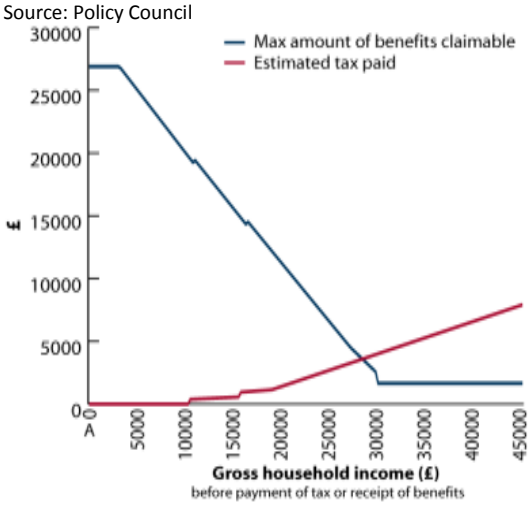
Household composition	Minimum disposable annual income - after tax (£000s)	Equivalent earnings before tax (£000s)
Single	20.5	25.2
Couple	26.8	31.2
Single 1 child	26.0	31.0
Single 2 children	34.0	41.8
Single 3 children	43.4	54.5
Couple 1 child	30.4	36.1
Couple 2 children	38.9	47.6
Couple 3 children	48.0	59.9

Separate to the contributory payments system (which includes pensions), the States presently relies upon a means-tested supplementary benefits system as its primary welfare tool. This system does achieve its social policy objective and changes the distribution of household income net of these benefits. The Social Security Department brought forward proposals to modify this regime in 2012, which were narrowly rejected by the States[29]. A key motivation for such proposals was the differential treatment between social housing and private tenants (the latter being worse off)[30].

Households claiming supplementary benefit are assessed against a requirement rate; the rate set by the Social Security Department as that required for a household to subsist. Presently, benefits payable through the supplementary benefits system (though not including benefits-in-kind) are capped at £500 per week. Qualifying claimants are eligible for additional cash (such as the winter fuel allowance) and non-cash (such as fully subsidised primary health care) benefits. This means that, although the primary benefit payment per household is capped at the equivalent of £26,000 per year, additional benefits could bring the total value of their claim to more than this. For example, a couple with two children could receive benefits up to a value of £27,000 a year (including Family Allowance payments and non-cash benefits).

Figure 7.1.1d. Estimated benefits claimable (incl. Family Allowance) and tax payable for a couple with two children by gross income

Source: Policy Council



[29] See Billet D'Etat V, March 2012
[30] See Billet D'Etat XIII, July 2011 for a very detailed working of the two systems.

One of the proposals brought forward last year was to remove the benefit cap and replace it with a maximum rent allowance[31]. Under this system, the maximum payable to this illustrative household, a couple with two children, would have risen to £37, 000. By contrast, providing sufficient benefits to raise the household to 60% of median income would cost up to £30,800. At this level of benefits, for those able to work, the incentive to do so is clearly affected as they may struggle to earn what they could receive in benefits. This highlights the unintended consequences of the welfare system.

What are your views on the payment of welfare benefits in Guernsey?

Q6 (a) (Part A- Q5(a)): What principles should be considered in setting benefit levels?

Q6 (b) (Part A- Q5(b)): What factors should be taken into account when assessing the needs of a household?

Q6 (c) (Part A- Q5(c)): Should there be a limit on the total amount a household can claim?

The States also retains a system of universal payments of Family Allowance. However, in terms of cost, it is second only to supplementary benefits. In the UK, proposals have been put forward to tax Family Allowance (albeit the specifics of their proposal have been subject to widespread criticism).

Q7 (Part A- Q6): Do you think the States should continue the payment of universal benefits such as the subsidy on prescription charges and Family Allowance or should they be means tested?

Long-term care is a growing and significant burden on Social Insurance funds. A separate review of long-term care is underway within the States. Therefore, this issue is out of the scope of this review at the present time, though consideration of the projections of the current funding model needs to be factored into the policy maker's deliberations of the results of this review.

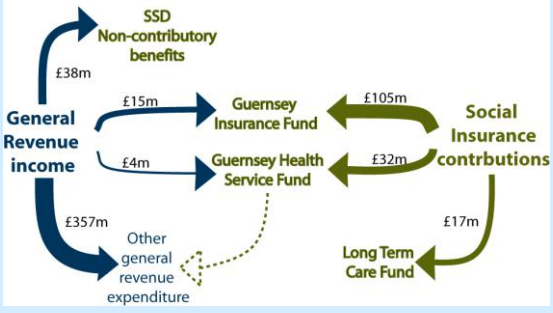
Box 4: Payment of pensions and benefits

Welfare is the provision of a minimal level of well-being and social support for all citizens. In Guernsey, most welfare benefits are administered by the Social Security Department. Contributory benefits including sickness, invalidity, maternity and unemployment, are dependent on the number of contributions you have paid to Social Security. The majority of such benefits are paid for from the Guernsey Insurance Fund (GIF), which also funds the payment of old-age pensions.

There are two further funds administered by Social Security which pay for different types of welfare. The Guernsey Health Service Fund (GHSF) pays for the subsidies paid towards prescription charges and GP and nurses appointments. It is also pays for specialist medical care offered by the Medical Specialist Group. The Long Term Care Fund (LTCF) pays for residential and nursing care for older people. All three funds have been built up and maintained with Social Insurance contributions over many years (although the GIF and GHSF receive a grant from General Revenue) and between them hold a significant reserve. These funds are ring fenced for the payment of pensions, health, long term care and other contributory benefits; they cannot be used to pay for other public expenditure such as education or transport.

Non-contributory benefits (which are paid regardless of your contribution record) are funded directly from General Revenue. These include supplementary benefit, which is means tested and therefore only available to low income families; and family allowance, which is available to every household with children regardless of income. General Revenue also funds the provision of social housing which is also a welfare benefit. **Figure 7.1.1e** below shows how the payment of welfare benefits in Guernsey is split between the two accounting systems.

Figure 7.1.1e. The funding of pensions and welfare in Guernsey (2011)



[31] Set with reference to current social housing rents

8. Old-Age Pensions - Current and future costs

The States operates a universal contributory old-age pension scheme. The scheme is universal in that it is available to everyone, but only if sufficient contributions have been made over time. The rationale for this type of old-age pension is to maintain the link between the contributions made and the benefits received in return. Up to 2006, the maximum annual contribution that a person would pay was set to match the average annual expenditure per contributor from the Guernsey Insurance Fund ("GIF"). This was termed 'the insurance principle'. The GIF also received approximately 33% of its income by way of a grant from General Revenue to top-up the contributions of people who were not paying the maximum level. From 2007, the upper limit on contributions was increased in stages increasing the amount of contributions payable by middle and higher earners and eroding 'the insurance principle'. Therefore, the current system is more accurately described as social assurance, as the contributions and General Revenue grant paid to the GIF are used only for the payment of Social Insurance benefits to insured persons.

Despite the universal nature of the payments, they are still based on the number of contributions paid over your working life. More than 700 pensioners claim supplementary benefits to supplement their income. These are non-contributory (i.e. not dependent on their contribution record), but means-tested General Revenue financed benefits. The level of the old-age pension is approximately 39% of net average individual earnings (after tax)[32]. The level of the proposed UK universal pension[33] is some 34%.

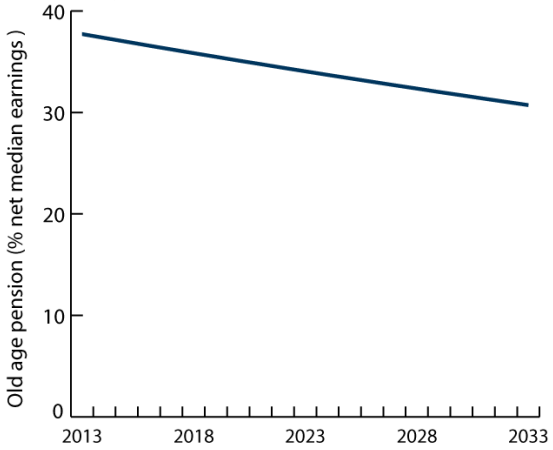
There is much debate about the correct method for increasing the rate of pensions (and other benefits for that matter). Pensions are a replacement income. Therefore, there is a strong rationale to link pension increases to the long-run increase in earnings to maintain their relative value. If that is not done, those who depend on the old-age pension become relatively poorer over time. **Figure 8.1.1a** demonstrates that if pensions are allowed to increase 1 percentage point per annum slower than average earnings, the value of the old-age pension relative to median earnings could decline to 32% by 2033.

According to a survey commissioned by Policy Council in 2011, only 50% of individuals working in the private sector have personal or private pension arrangements, and these are concentrated in middle and higher income groups and older age groups. The States encourages pension provision by providing tax relief on up to £50,000 of contributions per annum[34].

Figure 8.1.1a. Projected ratio of old-age pension to median earnings

Assuming 1% real annual increase in pensions and 2% real increase in median earnings; at 2013 prices

Source: Policy Council



With many people not contributing to a private pension scheme, or beginning their contributions too late in life to gain significant benefits, there is a risk that many pensioners in future will be totally dependent on the States for all their income.

In the long term, the costs of the current system are set to rise due to ageing demographics[35,36]. Originally designed as a pay as you go scheme, years of surplus contributions have enabled the GIF to build up significant reserves (to current levels of approximately five times the value of payments made from it each year). This reserve can be used as a buffer to reduce the required increase in future contributions to sustain the old-age pension system[37]. Estimates undertaken by

[32] However, for many pensioners home ownership costs are low as for many mortgages have been repaid and their property is owned outright.

[33] To be introduced in 2017.

[34] Although research shows that tax relief has little material positive impact on the level of retirement income as income from pensions is subject to tax. An alternative would be to make pension income tax free and not provide tax relief on contributions. Preliminary research suggests that this would cost the States less.

[35] Potential long-term implications of demographic and population change on the demand for and costs of public services, Policy Council, March 2012

[36] Report on the operation of the Social Insurance (Guernsey) Law in the period 1 January 2004 to 31 December 2009, UK Government Actuary's Dept.

[37] Running down reserves to fund the projected temporary, albeit lengthy, bulge in expenditure does involve operating the system at an operational deficit (i.e. spending more than is

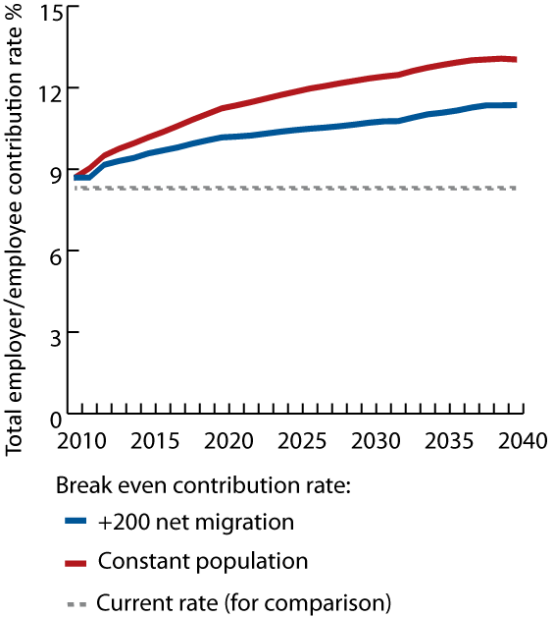
the UK Government Actuary's Department suggest that, even if the fund reserves are allowed to reduce to twice the annual expenditure, an immediate increase in contributions is required to ensure future liabilities can be met [38] (with certain assumptions for future growth and increase in pension rates). The earlier an increase in contributions is made, the increase required to maintain the stability of the GIF becomes less[39].

The level of increase in pension payments also has a significant impact on the sustainability of the GIF. The above example assumes that pensions will increase at a rate halfway between price inflation and increases in earnings. If this assumption is increased to the rate of increase expected in average earnings, the depletion of the funds is hastened by more than 10 years. By contrast, reducing the rate of increase to the level of inflation only could enable the fund to be maintained at (or even increased from) its current value relative to expenditure throughout the period without an increase in contributions.

Figure 8.1.1b. Projected contribution rate required to maintain the Guernsey Insurance Fund at an operational balance

Assuming 1% increase in pensions and 2% increase in average earnings

Source: Policy Council



As there is an increasing life expectancy, and people are now likely to claim their pension for many years longer than was anticipated thirty years ago[40], it is likely that total pension payments for the many future pensioners could be significantly more than their total contributions over the course of a typical lifetime. The increases in upper earnings limits since 2007 mean that there is now a much greater level of redistribution in the system than before. The high value of contributions made by very high earners subsidise those of lower earners who are unable to make sufficient contributions to fully finance their pension entitlement.

Today, 97% of earners pay Social Insurance contributions on their full earned income. The provision of a more generous old-age pension (effectively increasing the amount of income redistribution within the present system) would require increased contributions in addition to any contribution increases necessary to maintain the sustainability of the current system with present levels of pension.

The issue of the sustainability of the current regime is an unresolved issue. Maintenance of the universal principle requires increased contributions from some source.

received in contributions income). Thus, in this instance, operating deficits themselves do not imply benefit levels are unsustainable.

[38] Report on the operation of the Social Insurance (Guernsey) Law in the period 1 January 2004 to 31 December 2009, UK Government Actuary's Dept.

[39] A small increase in the contributions rate now will slow the fall in the fund value and enable more income to be generated in interest to supplement expenditure.

[40] ONS forecasts published in 1981 projected life expectancy at birth for males in 2031 of 74, in 2010 it was forecast at 83.

What are your views on old-age pension provision in Guernsey?

Q8 (a) (Part A- Q3 (a)): Do you support the present old-age pension arrangements and would you be prepared to pay extra in order to continue the current system?

Q8 (b) (Part A- Q3 (b)): Would you be prepared to pay more for a higher old-age pension?

Q8 (c) (Part A- Q3 (c)): How could the States encourage people to make greater private pension provision?

Q8 (d) (Part A- Q3 (d)): Would you support a second voluntary pension scheme administered by the Social Security Department?

Q8 (e) (Part A- Q3 (e)): Should the States consider means testing pension payments, effectively limiting old-age pensions so they are only available to those on lower incomes?

Q8 (f) (Part A- Q3 (f)): Should the States make payments less generous (for example by limiting future increases in pension payments to inflation only or by further extending the pension age[41])?

Q9 (a) (Part A- Q4 (a)): Would you accept an increase in taxation to fund all rising demand for health or long term care in the future?

Q9 (b) (Part A- Q4 (b)): Or do you think that the States should reduce the levels of tax funded health and long term care and that people should have to pay for more themselves?

Q10 (Part A- Q10): Do you have any further comments or suggestions you would like to put forward?

[41] In the recent past increases have been slightly above inflation. In addition, the pension age is being increased from 65 to 67 between 2020 and 2032.

Appendix 1: Comparison of tax and Social Insurance systems in Crown Dependencies

Figure A2, overleaf, presents an overview comparison of the tax and Social Insurance systems in Guernsey, Jersey, the Isle of Man and the UK.

The systems vary significantly in their level of complexity. Guernsey's single flat rate of 20% is the simplest, with Jersey, the Isle of Man and the UK having second (or third) rates applicable depending on income and household circumstances.

In the Isle of Man the first £10,500 of taxable income is taxed at 10% with additional earnings charged at 20%. Personal allowances are of a similar value to those in Guernsey.

In Jersey, tax liability is calculated by two methods and the lower of the two is charged. The standard rate (applicable at higher income) is assessed at a rate of 20% with no (or very limited) personal allowances. The marginal rate (applicable at low-mid income) provides more generous allowances but is charged at a higher rate (27%).

Guernsey, Jersey and the Isle of Man have an upper limit of personal income tax liability. However, in all three jurisdictions the limit is set at a level which would impact only a handful of households. In Guernsey the limit was applied to only 32 households in 2011.

The **Figure A1** provides the estimated cost or lost revenues resulting from the provision of tax allowances in Guernsey.

Of the allowances available beyond the personal allowance, the relief given on mortgage interest and on pension contributions have the most significant cost implication for the States. In the case of the relief on pension contributions, this money is recouped by taxing pensions on receipt.

Tax relief on mortgage interest in Guernsey is the most generous of the jurisdictions shown. It has been withdrawn entirely in the UK and is limited to an interest value of £7,500 in the Isle of Man. In Jersey relief is available only up to a capital value of £300,000 (compared to £400,000 in Guernsey) and is restricted to those on the marginal tax rate (lower income households).

Figure A1: Cost of personal and other tax allowances in Guernsey

Allowance	Cost/ lost revenue
Personal allowances (single, couple)	£71m
Extended personal allowance for pensioners	£3m
Mortgage interest relief	£7m
Charge of child (single parents allowance)	£1m
Dependent relative	<£1m
Housekeeper allowance	<£1m
Infirm persons allowance	<£1m
Pension contribution relief	£6m
Total	**£89m**

In the Isle of Man (which operate under the UK National Insurance scheme), National Insurance contributions for employees are paid at 11% of earnings, compared to Social Insurance contributions of only 6% in Guernsey and Jersey. However, the upper threshold for payments in Guernsey is substantially higher than in either of the other jurisdictions as a result of a deliberate decision to increase the threshold between 2006 and 2008 in order to reduce the subsidy received from general revenue. As a result, on a per capita basis, Guernsey collects a significantly larger amount of its total revenue via Social Insurance than either of the other jurisdictions.

Neither Guernsey nor Jersey charge Social Insurance contributions above their upper threshold. However, in the Isle of Man earnings above the upper threshold are subject to national insurance contributions of 1%.

Figure A2: Comparison of tax and social security rates in Guernsey Jersey and the Isle of Man (2013).

	Guernsey	Jersey[42]	Isle of Man
Income tax			
Standard Rate	20%	20%	10%
Other Rates	None	Marginal rate: 27%	Higher income rate: 20% (on taxable income over £10,500 for a single person, £21,000 for a couple)
Single person's Allowance	£9,475 (£11,225 if over 64)	Standard rate:£ 0 Marginal rate: £13,780 (£15,370 if over 64)	£9,300 (£11,320 if over 64)
Couple's allowance	£18,950 (£22,450 if both over 64)	Standard: £0 Marginal: £22,090 (£25,280 if both over 64)	£18,600 (£22,640 if over 64)
Second working adult allowance	-	Standard rate: £0 Marginal rate: £4,500	-
Child allowance	£6,450 claimable for single parents only	Single parents allowance: £4,500 Child: £3,000 Child in further education: £6,000 Child care: £6,150 max (marginal rate only) (£12,000 max if in pre-school)	Single parent allowance: £6,400
Mortgage interest relief limit	Capital value: £400,000	Capital value: £300,000 (marginal rate only)	Interest value £7,500 (x2 for couple) at 10% rate
Social Insurance			
Employees rate[43]	6.0%	6.0%	11.0%
Lower threshold	£125 per week	£184 per week	£118 per week
Upper threshold	£2,295 per week	£872 Per week	£770 per week
Treatment of earnings below lower threshold and above upper threshold	Once the lower threshold has been passed earnings below the threshold are taxable at full rate. Earnings above the upper threshold are not taxable.	All earnings are taxable but those paying less than the amount due at the lower earnings limit will not receive the States' contribution. Earnings above the upper threshold are not taxable.	Earnings below lower earning threshold are not taxable. Earnings above the upper threshold are taxable at 1%.

[42] Households in Jersey are assessed under both marginal and standard rates and pay the lower of the two assessments. Lower income household typically pay the marginal rate; higher income households the standard rate.

[43] Different rates are charged for self-employed and non-employed individuals. All rates and thresholds applicable in Guernsey can be accessed at http://www.gov.gg/contributionrates.

Figure A3 provides a comparison of effective tax rates for different household types in Guernsey. **Figures A4 to A7** provide a comparison of the theoretical effective tax rate (i.e. the actual amount paid as a percentage of gross income) for Guernsey, Jersey and the Isle of Man.

These rates include both personal income tax and contributions to Social Insurance schemes. **They do not include indirect or consumption taxes** (i.e. GST in Jersey or VAT in the Isle of Man).

These examples assume that all household income is sourced from employment and that, where there are two adults in the household, earnings are split between them at a ratio of 60:40.

Because of the practice of charging Social Insurance contributions on an individual's entire income once they have passed the lower threshold, effective tax rates in Guernsey show a step increase as each income passes the threshold. This means the marginal tax rate (the percentage of additional tax paid for each additional £1 earned) for those earning just above the threshold is very high.

The system of allowances and the upper limit on Social Insurance contributions result in an effective rate of tax for households, which is always less than the combined income tax and Social Insurance rates (26% in Guernsey and Jersey). The application of a "20 means 20" tax system in Jersey, where income tax allowances are effectively withdrawn for higher earners means that for some households the rate may approach to this level. However, because the marginal rate typically extends beyond the upper limit of Social Insurance contributions, it rarely reaches above 25%.

Figure A3: Estimated combined effective rate of tax and Social Insurance in Guernsey

Sources: Policy Council

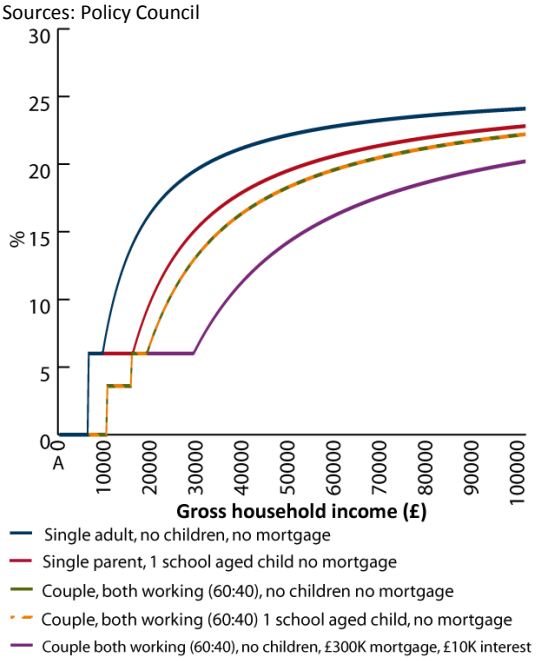


Figure A4: Estimated combined effective rate of tax and Social Insurance in Crown Dependencies: Adults=1, children = 0, Mortgage interest = £0

Sources: Policy Council

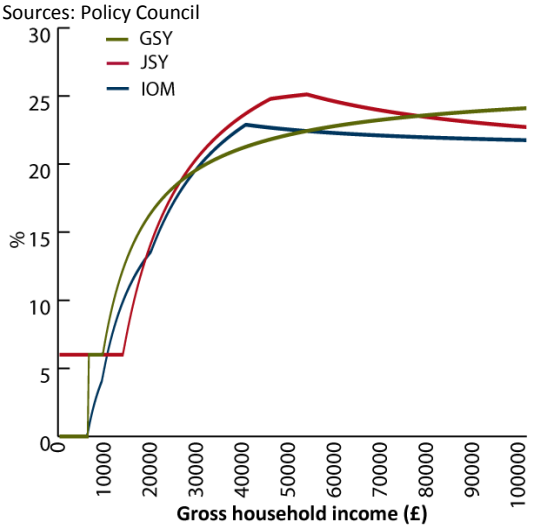


Figure A5: Estimated combined effective rate of tax and Social Insurance in Crown Dependencies: Adults=1, children = 1, Mortgage interest = £0

Sources: Policy Council

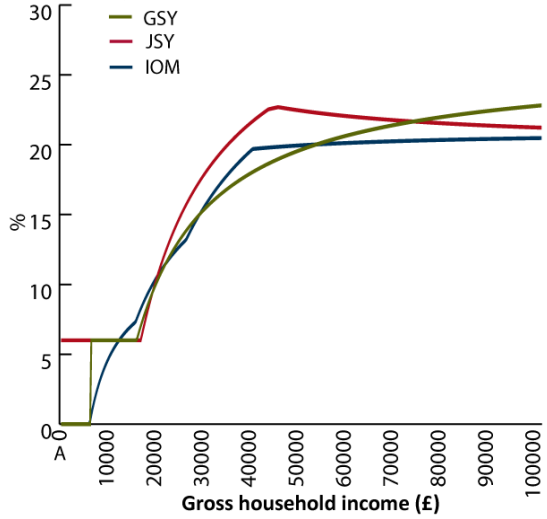


Figure A6: Estimated combined effective rate of tax and Social Insurance in Crown Dependencies: Adults=2, children = 0, Mortgage interest = £0

Sources: Policy Council

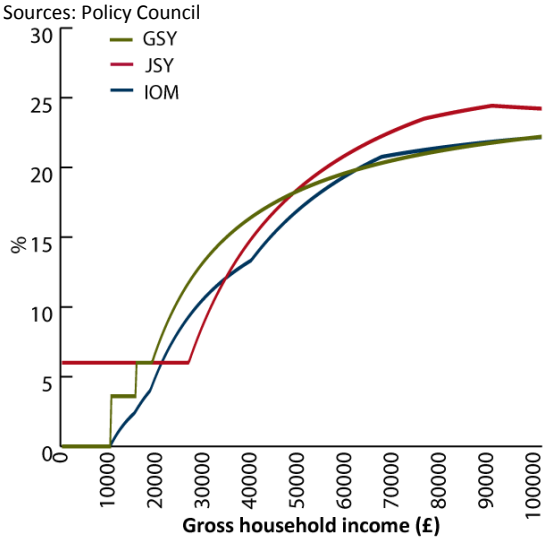
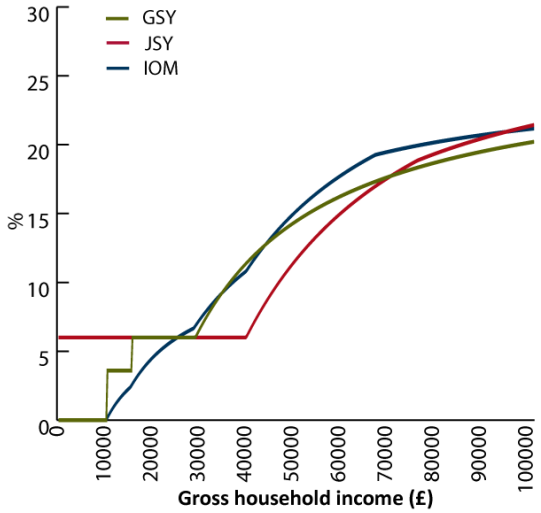


Figure A7: Estimated combined effective rate of tax and Social Insurance in Crown Dependencies: Adults=2, children = 1, Mortgage interest = £10,000

Sources: Policy Council



Appendix 2: Calculating relative poverty

Equivalising income

Income equivalisation is a technique used to adjust household income data to enable comparison between households with different numbers of adults and children and the relative cost burden that implies. Each household is assigned an equivalisation score which is used to adjust the household income to a level equivalent to two adults[44]. This means that the equivalised income for a couple with children is lower than their actual income to account for the additional burden on their income of providing for their child, i.e. they would need a higher actual income to provide the same standard of living as a couple without children. Income equivalisation is part of the standard method of calculating relative poverty. More details of the methodology are provided below.

The Modified OCED Equivalence Scale

This scale gives a weight to all members of the household, with the total of these determining the **equivalised household size,** in order to take into account the different sizes and compositions of households within a population so that income data can be produced that is widely comparable to other jurisdictions.

An adult couple with no dependent children is taken as the benchmark with an equivalence scale of one. The equivalence scales for other types of households can be calculated by adding together the implied contributions of each household member using the following weightings:

Head/Primary Adult	0.67
Subsequent Adults	0.33 per adult
Each child aged 0-13	0.20
Each child aged 14-18	0.33

In real terms, this means that a single adult (equivalence scale 0.67) can typically attain the same standard of living as a childless couple (equivalence scale of 1) on only 67% of its income.

The household income is then divided by the equivalised household size to produce comparable equivalised incomes as shown in the example:

Example 1: Household containing 1 adult only.

Equivalised household size = 0.67

Gross income = £30,000

Equivalised gross income = 30000 ÷ 0.67 = £44,776

Example 2: Household containing 2 adults and 1 child aged 0-13.

Eq. household size = 0.67 + 0.33 + 0.20 = 1.20

Gross income of £30, 000

Equivalised gross income = 30,000 ÷1.2 = £25,000

These two examples reflect that relative to each other a single adult with an income of £30,000 would be better able to support themselves financially than a couple with a child on the same household income.

Housing costs

In most countries poverty statistics are presented after housing costs. This means that the amount of money a household spends on housing (i.e. their rent or mortgage) is subtracted from their income during the calculation. This allows the statistics to better capture welfare provision in the form of social housing and the benefits of owning a property outright.

It was not possible to include housing costs within the calculation of relative poverty in Guernsey and statistics are, therefore, presented before housing costs.

Benefits in kind

International measures of relative poverty incorporate an adjustment for the provision of government services, predominantly healthcare and education. This is because levels of state provision vary from country to country. In countries where there is no or minimal provision, households must pay for these services from their disposable income. The adjustment is included in order to provide a meaningful comparison of poverty between different countries.

It should also be noted that the distribution of these benefits is not even. School age children receive significantly more benefit from education services than adults, whilst people tend to require significantly more health care as they age. An adjustment for benefits in kind has been included in Guernsey estimates of relative poverty based on estimates of healthcare and education costs by age group.

[44] There are various equivalisation methods available, many of which equivalise to a single adult household which result in lower level of reported equivalised income. However, distributional patterns observed would be very similar.

How to submit your response

The States of Guernsey has developed a full communications strategy. The main aim of that strategy is to secure the widest possible engagement across all parts of the community on the proposals for the sustainability of the Island's economy. This consultation process provides the opportunity for you to have an input and your say on how the Island should maintain its economic stability.

Space is provided in part A to respond to the questions presented. However, you can submit your response as a separate document if you wish. There are a number of ways in which you can submit your response:

You can email your response to:

personaltaxreview@gov.gg

You can post your response to:

Personal tax, pensions and benefits review
Sir Charles Frossard House
La Charroterie
St. Peter Port
Guernsey
GY1 1FH

You can complete the survey online or download a copy of this document from the States of Guernsey website:

www.gov.gg/ptr

Copies are also available for collection from the reception at Sir Charles Frossard House; Social Security (Edward T Wheadon House); Income Tax Offices; Guille-Allès Library and the Alderney Island Hall.

This consultation process is open for 8 weeks. The final deadline for submission is **31 May 2013.**

Review Timetable

Phase 1

8 April 2013: Launch of public consultation process

Public information evenings:

25 April
Venue: Harry Bound Room, Les Cotils
Time: 6pm – 7:30pm

1 May
Venue: St Martin's Community Centre
Time: 7pm - 8:30pm

These meetings and any additional public events will be confirmed via the local media.

31 May 2013: Public consultation period closes

August 2013: Public consultation report publication

October 2013: Publication of Budget 2014 and phase 1 proposals

Phase 2

October 2013 – September 2014: Detailed analysis and consultation of options for phase 2

October 2014: Publication of Budget 2015 and phase 2 proposals

If you have any queries or if you would like a large print version please contact us.

Tel: 01481 717192
Email: personaltaxreview@gov.gg