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POLICY COUNCIL

FUTURE ECONOMIC AND TAXATION STRATEGY, p. 1109

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B I L L E T D'ÉTAT

TO THE MEMBERS OF THE STATES OF

THE ISLAND OF GUERNSEY

I have the honour to inform you that a Meeting of the States of Deliberation will be held at **THE ROYAL COURT HOUSE, on WEDNESDAY,** the **28th JUNE, 2006,** at 9.30am, to consider the item contained in this Billet d'État which has been submitted for debate by the Policy Council.

G. R. ROWLAND
Bailiff and Presiding Officer

The Royal Court House
Guernsey
26th May 2006

POLICY COUNCIL

FUTURE ECONOMIC AND TAXATION STRATEGY

Executive Summary

1. This States Report contains proposals which are of fundamental importance to the economic and social well-being of Guernsey and Alderney. Therefore, in formulating the proposals an unprecedented amount of consultation has taken place with a wide variety of parties.

2. **The key objective of the proposals is to maintain a healthy economy where its residents are in well-paid, secure and sustainable jobs which add value to the businesses in which they are employed.**

3. The Policy Council believes that:

   - Change is in the community's best long-term economic and social interests.

   - It is in the community's long-term best interests to maintain and enhance both the finance sector and non-finance sectors.

   - Public sector expenditure (revenue and capital) must be rigorously controlled.

4. It is proposed that from 1 January 2008 the basic rate of income tax on company profits should be 0% with only a limited amount of regulated business (i.e. specific banking activities) subject to taxation at 10%. This is the so-called "Zero-Ten" regime.

5. In order to ensure that there is sufficient public sector revenue to fund an acceptable level of essential public services and infrastructure, income from other sources will have to be increased. In order to achieve this it is proposed that a two-stage approach be undertaken.

6. In the first stage the States will run annual budget deficits, funded by the use of up to half of the Contingency Reserve, which currently has a balance of over £200m. There will be increases in existing rates of indirect taxation (alcohol, tobacco, taxes on property and motoring) and an increase in the amounts collected through social security contributions. Economic growth will be actively promoted and public sector expenditure robustly controlled with only modest annual increases.

7. During this first phase a system of goods and services tax will be fully investigated, and legislation developed and put on the Statute books, but not introduced.

8. Having run a deficit budget for three to five years (i.e. until 2011/2013) and then after taking account of international events, the history of goods and services tax in Jersey and economic performance, the States will need to evaluate and produce an overall package that delivers a balanced States budget.

9. As has been made explicit during the previous consultation periods, the immediate impact of the above proposals will inevitably mean that individuals will have less disposable income. However, the proposals included in this Report will have considerably less impact on the majority of islanders than previously envisaged. The Policy Council proposals minimise the financial impact of the reforms on middle income earners.

10. **The overall package of proposals is designed to ensure that Guernsey remains a good place for businesses to operate and to provide well-paid jobs, hence enabling wages to remain high and to increase.**

11. It has always been recognised that those on lower incomes must be protected from any changes and that taxation increases need to be targeted on those who can afford to pay, not those who are already vulnerable, including those on low fixed incomes and pensions. This is one of the main reasons why the majority of the Policy Council do not favour the introduction of a general sales tax as it will have the greatest proportional impact on those on lower incomes. The Corporate Anti-Poverty Programme will need to continue to be a key policy of the States and be adequately funded.

12. However, it is emphasised that even with the proposed tax increases, individuals in Guernsey will still be subject to tax levels which are far less than the vast majority of other jurisdictions in the world, and disposable income of individuals will also continue to be very high. Guernsey will continue to be a good place to live and bring up children because it is safe, attractive and forward-looking.

Background

13. Guernsey has over recent decades developed a prosperous and resilient business environment which has been able to respond quickly to changing local and international developments. It has created a business-friendly and competitive environment that attracts prosperous activity, entrepreneurship and diversification.

14. **The fundamental purpose of the proposals contained in this Report is to maintain a vibrant and sustainable economy that generates corporate profits, offers well-paid job opportunities and makes a positive contribution to the continuing prosperity of the Island.**

15. The future clearly lies in maintaining a business environment where its residents are in well-paid, secure and sustainable jobs which add value to the businesses

in which they are employed. It is only through this economic activity that the States will be able to raise revenues to fund public services and infrastructure improvements. Unemployment, or employment in low paid jobs will simply not generate the necessary public sector revenues required to fund basic public services.

16. **Therefore the key objective for these proposals has been the maintenance of competitiveness for business and jobs.**

17. The main drivers for change are twofold, the need to meet our international obligations (in order to secure access to world markets) and **the need to be competitive with other similar jurisdictions**.

18. The European Union has developed a Code of Conduct on Business Taxation. Although Guernsey is not within the EU's fiscal territory and is not within the EU single market for financial services, the countries of the EU (including of course the United Kingdom) are its major economic trading partners.

19. The Code of Conduct listed a total of 66 measures which it considers harmful in EU Member States and their associated or dependent territories. Five regimes were identified in Guernsey as being considered harmful. These were exempt companies, international loan business, international bodies, offshore insurance companies and insurance companies.

20. The main reason that the Code of Conduct listed these regimes as harmful is that the beneficial tax treatment that they provide is 'ring fenced' from the domestic economy. The existence of a zero or low tax regime is not deemed to be harmful in itself. A regime is deemed to be harmful if preferential rates are made available to non-residents but not to a jurisdiction's own residents.

21. Throughout the entire process (i.e. since before 2002) and during the development of the proposals the appropriate authorities in H M Treasury have been kept informed. There is every reason to be confident that the proposals as set out in this Report are fully compliant with the Code of Conduct on Business Taxation and will therefore be supported by H M Government in the UK should it be challenged by the UK's EU partners.

22. In December 2002 the Advisory and Finance Committee set out its views for the future direction of Guernsey's corporate taxation strategy. Essentially, this long-term strategy consisted of a general rate of income tax for companies of zero per cent with certain activities licensed by the Guernsey Financial Services Commission being taxed on their profits at 10% (the Zero-Ten option).

23. Since 2002 there has been considerable activity across the world in response to the various international tax initiatives. **Most competitor jurisdictions have already made announcements to the effect that they intend to introduce a Zero-Ten model**. In the case of the Isle of Man this approach is now already in place and Jersey will be following suit, albeit with some further variations.

24. It is important to acknowledge that the need to change is not one that is only being faced by this Island. Other jurisdictions, many of which are direct competitors, are also faced with these issues and will, of course, continue to respond in their own best interests. These jurisdictions are competing with Guernsey for businesses and well-paid jobs.

25. As has been stated on previous occasions, the Policy Council, with the support of the Treasury and Resources Department, is determined to carry out this vital work in a methodical and measured manner. The process thus far has demonstrated that this is the correct approach.

26. In order to progress this vitally important matter in June 2004 the Policy Council established the Fiscal and Economic Policy Steering Group. This Group comprised the Chief Minister as Chairman, the Deputy Chief Minister and the Ministers of the Treasury and Resources and Commerce and Employment Departments. The Group recognised that it was essential that this matter was subject to the fullest possible amount of consultation and was responsible for two separate and intensive consultation processes. The Group's second consultation document is included in the Report as appendix 3.

27. **To repeat, the main drivers for change are twofold: the need to meet our international obligations (in order to secure access to world markets) and the need to be competitive with other similar jurisdictions.**

Consultation Process

28. The development of the future Economic and Taxation Strategy has, quite rightly, been the subject of an unprecedented consultation process.

29. Nearly 100 responses were received as part of that first consultation process (March to May 2005). However, these were mostly from States Members, Departments and from businesses. Very few responses were from what could be described as the general public. Hence, one of the key objectives of the second consultation document was specifically to ensure that the general public became more aware of, and involved, in the process.

30. As part of the second consultation process (September to November 2005), a series of very well attended public presentations were held across the Island and in Alderney. In fact, so great was the demand that an extra presentation was included and the consultation period extended. During the second consultation process over 1,500 copies of the report were issued (in addition to those who obtained copies from the government website) and it is estimated that well over 1,300 people attended the presentations.

31. As a result of the above presentations and resultant media coverage, in excess of 500 responses were received from a wide range of individual businesses, professional associations and, importantly, members of the general public. An

independent analysis of the responses received is included as appendix 4 of this States Report.

32. As set out in that independent report "although there was no unanimity on any of the points, there was a broad consensus in a number of areas. In particular, many respondents recognised both the difficulty of determining the appropriate tax strategy and equally the importance of the task to Guernsey. Furthermore, there was general support for and agreement with most of the proposals made in the Document".

33. In addition to the public presentations and States Members only briefings, a very large number of meetings with business leaders (finance and non-finance), professional advisors, representative bodies and associations have been held over the past 18 months. Some of these meetings were with a few key members of a particular business or organisation, others were relatively large meetings organised for all of the members of a particular association.

34. **The Policy Council is grateful to all those who were involved for their time and effort.** Although it has not been possible to please all those concerned all of the time, the feedback received during the consultation process has been not only extremely important but also positive. It is clear that the level of understanding between the business community and government has been greatly enhanced as a result of this extensive consultation exercise.

35. It should also be noted that both the Fiscal and Economic Policy Steering Group and the Policy Council have consistently adopted a policy of issuing various reports (such as the independent analysis of the consultation responses referred to above) as and when received to enable the business community and the general public to understand, as far as possible, the evolutionary nature of the process and the development of the proposals. However, such reports were always provided to States Members ahead of any general release. States Members have also had an unprecedented number of briefings on this issue.

The Two-Stage Approach

36. The Policy Council is recommending that a two-stage approach be adopted. The advantage of such an approach is that it will allow a period of transition which will allow businesses and individuals time to adjust. Introducing in one stage unprecedented changes to the corporate tax regime, increasing existing indirect taxes, changing social security rates, public sector expenditure reform and introducing a new goods and services tax (if that is the method adopted in the future) would run the risk of destabilising the economy, or at the very least reducing the chance of the growth that is required. It would also place significant burden on the administration of businesses, their professional advisors and the various collection agencies.

37. **The Policy Council therefore believes that adopting a two-stage approach is a prudent and sensible economic policy which will greatly reduce the**

likelihood of economic slowdown and, very importantly, provide a further opportunity for further refinement and reflection after a period of real experience of the new taxation environment.

38. In stage one (until 2011/2013) the States will run a budget deficit, funded by use of up to half of the Contingency Reserve with:

- Robust Public Sector expenditure control with only modest annual increases.
- Existing indirect taxes increased.
- Social Security: The employer rate to be increased by 1%, self-employed, non-employed and employee rates stay the same as currently. The Upper Earnings Limit for employers, employees, self-employed and non-employed raised to £60,000.
- No Goods and Services Tax.
- The promotion of economic growth.

39. In stage two the States, having run a deficit budget for three to five years (i.e. until 2011/2013)**,** and then after taking into account international events, GST history in Jersey and economic performance, will evaluate and produce an overall package which sustains the economic position and delivers a balanced States Revenue budget.

40. The Policy Council acknowledges that adopting this two-stage approach means that the Contingency Reserve (presently valued at just over £200m) will be reduced. However, it is worth noting that using up to half of the Reserve as proposed will merely bring its balance down to where it was in 1999, i.e. before the States accelerated its policy of building up the Reserve for such an eventuality as it is currently facing. Furthermore, the States is, and will remain, free of debt.

41. If during stage one, either growth does not come through as fast as predicted and/or public sector expenditure increases, the effect will be that the Contingency Reserve will be depleted quicker than predicted. If this were to be the case then the adoption of stage two will need to be accelerated. Alternatively, if growth does deliver increased tax receipts, the introduction of phase two can be delayed, or may even be unnecessary. Either way informed choices will be possible. In its report entitled "The Economic Impact of Guernsey's Tax Strategy" (Appendix 6) the Independent Working Group endorsed such an approach and stressed the need for early planning.

42. The only realistic alternative to using up to half of the Contingency Reserve to fund the annual budget deficit through the transitional phase is:

- To reduce the level of public sector services to an unacceptable level and/or

- To increase taxes significantly, by whatever means, immediately.

43. The Policy Council does not believe that these are acceptable alternatives.

Detailed Proposals

Zero Corporation Tax Rate

44. As set out in previous reports, in order to be an effective and competitive International Financial Centre, a zero tax product is absolutely essential. The existence of a zero tax product is a fundamental principal element of the taxation strategies of the Island's competitors and therefore Guernsey must respond accordingly. **There is simply no option other than to respond and reform the corporate tax regime.**

45. **It is therefore strongly recommended that the basic rate of income tax on company profits should be 0%.**

Zero-Ten, Flat Rate and Zero-Twenty

46. The adoption of a Zero-Ten regime would be consistent, in general outline, with previous proposals and be very competitive with other jurisdictions.

47. Having listened very carefully during the consultation process and taken into account the recent actions of competitors (including the Isle of Man), the Policy Council is proposing that all businesses (Finance and Non-Finance) are subject to the general rate of corporate tax (i.e. zero) other than in respect of specific banking activity.

48. **This approach is internationally competitive and welcomed by the finance industry and will enable the island's single most important industry to continue to compete and grow.**

49. In the first consultation document (March 2005), for completeness, the flat rate tax alternative was considered. The view that adopting such a fundamentally different regime would be a very high risk strategy that was likely to see the rapid demise of the finance sector was universally supported by the industry and professional advisors. Such an approach was therefore discounted in the second consultation process.

50. **Furthermore, it is clear from the responses received that the vast majority of the finance sector strongly believe that a Zero-Twenty regime would be deeply damaging to the competitiveness and sustainability of the finance sector.** Some responses even went as far as to say that, in their opinion, the continuing debate as to the possibility of a Zero-Twenty regime was in itself damaging.

51. Although some business would, at least for a while, remain under such a regime, **there would be an inevitable decline in existing business and a cessation of new business**. Businesses, and therefore employment prospects, would simply relocate to those jurisdictions, such as the Isle of Man and Jersey where a Zero-Ten regime would apply. It therefore fails the key criteria test that any proposals must support and encourage competitiveness.

52. The independent economic assessment panel's report entitled "The Economic Case for a 0/10% Corporate Tax Rate Structure in Guernsey" is included as Appendix 5 to this Report. In their report the Panel concluded:

- Guernsey's financial services industry is pivotal to the future of the Bailiwick's economy.
- The Bailiwick has no option but to respond to international pressure and reform its corporate tax regime
- Further, if the Bailiwick's international competitiveness is to be sustained there is no option but to adopt a 0%/10% corporate tax structure.

53. **As regards a Zero-Twenty regime the Panel has concluded that although such an approach appears superficially attractive it would, in their opinion, be extremely risky.** There is no alternative but to adopt the 0%/10% model. Continuation of a 20% regime would see financial services companies seeking to reduce their tax burden by moving to jurisdictions enjoying lower rates. This would have repercussions on the Island's economy through a loss of jobs in the finance sector and non-finance sector as the knock-on effects impact on suppliers.

54. **The Policy Council therefore recommends that an internationally competitive Zero-Ten regime be implemented and that, with the exception of specific banking activities, the rate of corporate taxation should be Zero.**

<u>Utilities and States Trading Activities Regulated by the Office of Utility Regulation</u>

55. The amounts of taxation collected from this area, which includes Guernsey Electricity and Guernsey Post (which are both wholly owned by the States of Guernsey) is likely to be modest. However, having considered the alternatives (i.e. zero, ten or twenty), and as set out in the previous consultation documents, **it is recommended that any entity subject to regulation by the Office of Utility Regulation should be taxed on its profits at 20%, as this was a key principle of the States commercialisation process.**

<u>Guernsey Resident Shareholders: Taxation of Distribution of Profits</u>

56. Although the finance sector is presently the dominant part of the Island's economy, it is by no means the only sector. There are also a whole range of

economic activities on the Island including light industry, retail services, tourism, horticulture and other local service and traditional businesses.

57. Under the proposed corporate tax regime the general rate of income tax paid by companies would be 0%. In order to protect the Island's tax revenues, it was originally proposed that Guernsey resident individual shareholders would be taxed (at 20%) on the profits of the company in proportion to their ownership.

58. In the first consultation document it was proposed that Guernsey resident individuals should be taxed in proportion to their ownership, the so-called "look through" or attribution basis.

59. Although this basis has many advantages, not least the protection of States revenues, a number of drawbacks exist. For example, complex rules on how to deal with minority shareholders and anti-avoidance legislation would need to be developed, implemented and enforced.

60. A major concern (which was confirmed by the responses received during the first consultation process) was the widely held perception of the creation of an unfair regime that would lead to some shareholders selling up or leaving the Island. This would almost inevitably result in less vitality and investment in local businesses, a decline in job opportunities and a fall in local owner-operated businesses.

61. The alternative approach, which was set out in the Second Consultation Document, (and supported by the majority of responses) was to adopt a distribution-only process. Under this approach individual taxpayers would be subject to taxation at the standard 20% tax rate on the amounts actually distributed by way of dividend or as otherwise defined.

62. From the responses it has received from key businesses and their local shareholders, the Policy Council believes that a distribution-only policy on business profits would encourage inward investment and re-investment, and provide an incentive to local ownership which would enhance the Island's competitiveness.

63. In addition to business profits on trading activities, some companies also make profits from investment and rental activities. Due to the nature of how investment and rental incomes arise, it is still considered appropriate to treat these income streams on an attribution basis. As set out in the second consultation document, approximately £10m per annum will be collected from this source.

64. It is recognised that with either the distribution-only or full attribution basis anti-avoidance measures will need to be introduced. Such measures, although relatively rare in Guernsey until now, are widely used in other jurisdictions.

65. The actual anti-avoidance measures used in practice will depend upon the behaviour of taxpayers (i.e. how aggressively individuals attempt to exploit the situation) and the overall cost-benefit of their implementation.

66. **It is recommended that Guernsey resident shareholders should be taxed at 20% on their distributed profits and on all rental and investment income, but with some effective anti-avoidance measures including deemed distribution in certain circumstances.**

Annual Company Filing Fees

67. At present all Guernsey companies pay an annual filing fee of £100. In addition exempt companies pay an annual fee of £600 which raised £4.8m in 2005. Under the new tax regime this income stream will be substantially depleted.

68. In order to compensate for the loss of exempt company fees, it is proposed that the annual filing fee will be increased. However it is fully recognised that different types of companies should be subject to different fees. For example, subject to rates in other jurisdictions, those companies that are currently subject to the £600 exempt company fee are likely to see the largest increases (possibly up to £1,000 per annum). Smaller trading companies would be subject to much lower fees.

69. The Commerce and Employment Department is currently carrying out work and undertaking wide-ranging consultation on a new company law and company registration system. This work will address, in detail, future company fees and charges.

70. **The Policy Council is making no specific recommendations at this particular point as further work, including comparison with other jurisdictions, is required.** The Treasury and Resources and Commerce and Employment Departments will be bringing forward appropriate detailed proposals in due course.

Personal Income Tax Rates, Allowances and Reliefs

71. The principle of a basic 20% rate of income tax in Guernsey for individuals is very well established, competitive, equitable (in that those who earn more contribute more) and administratively simple. **It is therefore recommended that the standard rate of income tax for individuals remains at 20%.**

72. However, the Policy Council believes that although the 20% standard rate of income tax for individuals continues to be appropriate, the present system of reliefs and allowances needs to be revised.

73. The system of giving interest payments tax relief is very simple and, compared to some other jurisdictions, extremely generous. At present interest payments are allowable as a deduction against assessable income without limit.

74. Tax relief on interest paid is, in effect, a subsidy to borrowers from the general taxpayer. Whilst it could be argued that there may be valid reasons for such subsidies as mortgage interest relief, it is difficult to support the case for subsidising holiday homes, cars, boats, aircraft, holidays and other personal borrowings without limit.

75. In the present tighter financial climate, it is not unreasonable to expect that the generous existing wide ranging interest relief system should be reduced.

76. The Policy Council therefore recommends that the amount of interest relief should only continue to be provided on principal private residences. The Policy Council believes that a maximum value for mortgages of not exceeding £400,000 is, at this time, appropriate. It is not intended to change the basis on which business interest relief is granted.

77. Generous relief from income tax is also currently provided on life assurance policies. In summary, with certain restrictions, half of the insurance premiums on such polices are given tax relief. Although initially intended to provide a tax free capital element on the death of the policy holder, many of these policies are now in fact investment vehicles which are entered into because of their favourable taxation treatment.

78. **The Policy Council believes that the existing allowances in respect of life assurance polices, including those already in place, should be removed.**

79. Although it is acknowledged that the introduction of the above restrictions will, to a certain extent, mean that some individuals will rearrange their affairs (by re-mortgaging their principal private residences etc.) to avoid paying any increased tax, it is estimated that a further £7m of income tax will be collected.

<u>Significant Individual Tax Payers</u>

80. Guernsey, like many small economies, has a number of individuals who because of their exceptionally high business profits or personal wealth can potentially pay income tax of an amount far in excess of any possible drain on public services.

81. Such individuals are extremely important to the Island and potentially the target of other jurisdictions. It is therefore very important that the Island remains attractive to such individuals especially those who, through their own expertise and future business activities, would generate new economic activity and well-paid employment opportunities.

82. It is therefore recommended that a system be introduced whereby significant individual taxpayers pay tax on their non-Guernsey income at the standard 20% rate up to a certain ceiling only. It is emphasised that normal Guernsey income would be subject to tax at the standard 20% rate without limit.

83. **It is therefore recommended that individual taxpayers should be liable to the standard rate on their investment and non-Guernsey trading income up to a defined income ceiling with a maximum tax payable of £250,000 on any individual's income from such sources.**

84. Any threshold would need to be further revised from time to time in the light of experience and competitor jurisdictions and in view of ongoing considerations on population and economic policy.

Inheritance and Capital Gains Tax

85. As set out in the previous consultation documents, **the Policy Council recommends that no wealth taxes, such as Inheritance Tax and Capital Gains Tax should be introduced.** Such taxes, as well as being cumbersome to introduce and administer (and probably only raising relatively small amounts) would be extremely detrimental to the finance and rentier sectors. This approach was strongly endorsed by the Economic Independent Working Group.

Social Security Contributions

86. The States of Guernsey has a long established and well administered Social Security system, which due to consistent and prudent management over a long period, is well funded. There has been a long standing principle that contributions (from employees, employers, non-employed and the self-employed) are not a tax, but an insurance premium.

87. Another long standing principle of the funding has been that those individuals who are on incomes less than the upper earning limits (2006: £36,036 per year) have the difference paid by the States by means of an annual grant from general revenue. At present only 25% pay the full amount of contribution, the remaining 75% being subsidised by general revenue.

88. The present social security arrangements mean that if an individual has income in excess of the Upper Earnings Limit then the amount paid by the employer and the employee is the same whether that individual earns £40,000, £75,000 or even more than £100,000.

89. The proposals within this Report are designed so that the grant from the General Revenue account is approximately halved and are therefore much less onerous on the contributor than those proposed by the Steering Group in its second consultation document.

90. These proposals will make more of an impact on employers (i.e. the party directly benefiting from the introduction of a zero corporate taxation rate) than on employees. **Furthermore, since no increase is proposed in the employees contribution rate, those employees earning less than the present upper earning limit (approximately 75% of all employees) will be unaffected by these proposals.**

91. The changes to the various contribution rates and Upper Earnings Limits can be summarised as follows:

	Present	Second Consultation Document	**Proposed**
Employees	6.0%	7.0%	**6.0%**
Employers	5.5%	7.0%	**6.5%**
Self-employed	10.5%	13%	**10.5%**
Non-employed	9.9%	10.9%	**9.9%**
Upper Earnings Limit	£36,036	£60,000	**£60,000**

92. Appendix 14 sets out the extra contributions that would be collected under various scenarios of increased contributions and Upper Earnings Limits. However, it is stressed that the figures are estimates, provided by the Social Security Department, which must be treated with increasing caution at the higher levels of Upper Earnings Limits. Even if revenues were proved to be fairly accurate, they are vulnerable to avoidance and business behaviour.

93. Appendix 15 sets out the impact of the proposed changes on individual contributors.

94. The Policy Council acknowledges that reducing the General Revenue grant by increasing the burden on the contributors is a fundamental change to the existing funding arrangements. However, it is one that it believes is justified and required in the present circumstances.

95. **It is therefore recommended that the General Revenue grant to social security be reduced from 1 January 2008 by increasing the rate of employers' contribution by 1% and increasing the Upper Earnings Limit for employers, self-employed, non-employed and employees to the equivalent of £60,000.**

96. Furthermore, for the reasons set out more fully below, the Policy Council believes that there is considerable support for introducing some of the detailed revenue raising measures in a phased manner. **It is therefore recommended that the Social Security Department be directed to take account of the above proposals when bringing forward recommendations as part of that Department's reports on Benefit and Contribution Rates for 2007 and future years.**

97. It is again emphasised that General Revenue will continue to fully fund the non-contributory elements of the present social security system (Family Allowances, Supplementary Benefit, etc) of around £22m per year.

<u>Indirect Taxes</u>

98. Any detailed proposals to change the rates of indirect taxes will be brought by the Treasury and Resources Department to the States in the normal way, i.e. as part of the annual Budget process.

99. **The purpose of this Report is to enable the States to provide general guidance to the Treasury and Resources Department on the proposals it should be bringing forward in fulfilment of its mandate.**

100. In common with most developed economies, Guernsey has a long established tradition of levying indirect taxes. However, indirect taxation rates in Guernsey have traditionally been low compared to other neighbouring jurisdictions (Jersey, United Kingdom, France etc.) and in recent years many have been further eroded in real terms.

101. Details of the existing types and levels of indirect taxation are provided in Appendix 7 of this Report and on pages 25 to 27 of the Second Consultation Document (Appendix 3).

102. Increasing indirect tax levels, using existing legislative and administrative processes, would be an efficient method of increasing States Revenues.

103. The second consultation document recommended that by raising the levels of duty to those similar to other jurisdictions, £5m more could be collected from Alcohol and Tobacco and £3m from motor vehicle usage.

104. The Policy Council also believes that there is considerable scope for increasing revenue from property (2005: £4m) in particular from commercial property.

105. In March 2006, the States approved proposals from the Treasury and Resources Department for a simplified system for property taxes. As set out in that report, a phased approach to this process is required. However, it is possible to introduce some increases in 2007.

106. The Policy Council recommends that an extra £6m to £10m should be raised from property taxes and that the Treasury and Resources Department should report back, as part of its annual budget process, on how this could be achieved. In doing so it is again important that those who are on lower incomes are protected.

107. The independent analysis of the consultation responses (Appendix 4) indicates that there is "general support for the increase in excise duties, TRV and other indirect taxes. Many respondents favoured measures that targeted motor vehicle usage."

108. Increasing indirect taxes, as well as raising revenues, can sometimes be effective

as part of a strategy for supporting specific targeted social and environmental objectives. For example, tobacco and alcohol duties are subject to existing States Resolutions in support of agreed Health Strategies.

109. **The Policy Council recommends that the rates of existing indirect taxes should be increased, in particular duties on alcohol, tobacco and motoring, and Tax on Rateable Values, and that the Treasury and Resources Department be directed to bring forward appropriate recommendations commencing with the 2007 Budget.**

<u>Goods and Services Tax</u>

110. The advantages of a broad based sales tax regime are that it can be seen as fair in that it is widely applied to the majority of citizens (who benefit from public services), gives relatively stable income flows, once established can be efficient, and is capable of raising substantial sums of money for the public purse. There are various ways in which a general sales tax could be implemented. However, all of them, to a greater or lesser extent, result in increased administrative burden and expense on businesses and the public sector administration and those on lower incomes would experience a relatively significant increase in their cost of living unless compensatory measures, for example though the social benefits system, were also introduced.

111. A general sales tax regime would increase the cost of visiting and doing business in the Island and therefore could act as a disincentive for businesses to locate in the Island and for tourists to visit.

112. In its second consultation document, the Fiscal and Economic Policy Steering Group concluded that "increasing employer and employee social security contributions is a better alternative to introducing a general goods and services tax".

113. It was perhaps no surprise that the issue of increased Social Security contributions or a goods and services tax was the most debated part of that Group's proposals.

114. As set out in the PricewaterhouseCoopers independent report on the consultations responses (Appendix 4), "many respondents indicated a preference for some form of goods and services tax to the proposed social security contribution increases. **There was a majority view that such a measure should be given greater consideration than currently was the case".**

115. Appendix 16 sets out the estimated annual net revenue (up to £30m) that could be collected by introducing a 3% goods and services tax analysed by the various areas of household expenditure. It would be possible to introduce a system that exempted specific areas or charged more in certain areas than others. Such a system, although flexible, would be more complex to introduce and administer.

116. There were also a number of responses which were strongly opposed to the introduction of any form of goods and services tax.

117. It should also be noted that, as a result of the consultation exercise, the proposals for increases in social security contributions contained within this report are significantly less than those proposed by the Group.

118. **The Policy Council therefore proposes that although in the short term a goods and services tax should not be introduced, the possibility of doing so at a later date must be considered. It is therefore recommending that an appropriate system of goods and services tax for Guernsey should be investigated, including the experience of introducing such a measure in Jersey. The Policy Council also recommends that the necessary enabling legislation be developed. However, this does not mean that the introduction of such a tax should be considered inevitable.**

Contingency Reserve

119. The purpose of the Contingency Reserve is to provide protection against major emergencies including significant economic downturns having a severe adverse effect on the Island.

120. The Contingency Reserve is expected to continue to increase in size as a result of investment growth (the investments are mainly fixed interest and similar financial instruments). It would also be possible to make further appropriations into the Reserve from General Revenue if, as proposed, some of the proposals are implemented on a phased approach commencing in 2007.

121. Although the Contingency Reserve clearly cannot be used to make good any shortfall in revenue over an indefinite period, **it is appropriate, and consistent with its original purpose that it should be used in the short to medium term to help balance the books in order to smooth any transitional arrangements.**

122. **The Policy Council recommends that up to half of the Contingency Reserve (interest and capital) should be used to fund the shortfall in public sector expenditure during a transitional phase.**

Public Sector Expenditure

123. The primary purpose of this Report is to seek States approval for the implementation of a Future Economic and Taxation Strategy and therefore, by its nature, concentrates mainly on promoting the economic well being of the private sector and the raising of public revenues (i.e. raising taxes).

124. However, from the very start of the process it was recognised that a key part of the overall package would be the need to consider very critically public sector expenditure.

125. The general public's views on States expenditure were very strongly expressed in the consultation responses. The need to control public sector expenditure was the item which was commented upon by the largest number of responses, with 97% wishing to see restraint. As set out in the PricewaterhouseCoopers report (Appendix 4) "a strong message from many respondents was that any new taxes introduced or increases in existing ones should not be a substitute for reductions in States expenditure". **It is therefore clear that a genuine commitment to public sector control is required and must be delivered.**

126. As set out in its comments on the 2006 Budget, "the Policy Council strongly endorses the view that States finances are under considerable pressure and that the trend of ever increasing revenue and capital expenditure is unsustainable. There is a clear need for control and prioritisation of expenditure. Low priority services and projects will need to be curtailed."

127. **It is clear from the progress being made in this area that States Departments, individual States Members and staff have engaged in this process and that there is already a change in culture and attitude about public sector expenditure emerging.** Difficult challenges lie ahead and hard decisions will need to be taken.

128. While every effort will be taken to control public sector expenditure, it must be acknowledged that, if essential public sector services (such as health, education, social security, law and order, etc.) are to be maintained at standards that are appropriate for a modern society, public sector expenditure will need to remain at acceptable levels. The Economic Independent Working Group, while acknowledging the need for efficiencies in the public sector, warned of the potentially economically damaging effects of cutting public sector expenditure (in particular capital expenditure) too much. **Cutting public sector expenditure by the levels demanded in some quarters is simply unrealistic, unachievable and politically undeliverable.**

129. **However, it is also essential that public services must be delivered in an efficient and effective manner and value for money must always be achieved.**

130. If Guernsey is to continue to be a thriving community with the self-confidence and sense of civic pride to succeed, good public services and infrastructure are essential. It is also essential that those on lower incomes are able to share in the success of the Island through the provision of an appropriate social security system.

131. It must therefore be accepted that in order to fund an acceptable level of public services, whatever the mechanism, there will need to be a significant increase in the amounts raised through taxation.

Introduction of Detailed Proposals

132. The purpose of this Report is to seek the States approval for the future Economic and Taxation Strategy. If, as recommended, the States accept the Strategy then more detailed work, including the drafting of the necessary legislation, will continue in order to ensure its implementation. **The detailed proposals will be brought before the States for approval in the normal way at every stage.**

133. The implementation of the detailed proposals (for example, the specific rates of duties on tobacco, alcohol and fuel) will be introduced in the normal way as part of the annual Budget prepared by the Treasury and Resources Department. In future, any changes to such matters as tax capping will also form part of that annual process.

134. Similarly, any changes to the social security contribution rates and Upper Earnings Limit, will be made at the time of the Social Security Department's Annual Benefit Uprating Report (traditionally in September each year).

Phased Introduction of Proposals

135. As set out above, the Strategy is essentially a two-stage process with the second stage commencing in 2011/2013. However, the Policy Council believes that there is considerable support for introducing some of the detailed revenue raising measures in a phased manner.

136. By increasing some of the revenue raising measures in a phased approach it will allow the general public and businesses to experience their gradual introduction and plan accordingly. This phased approach would also allow some extra revenue to be collected and set aside probably by way of transfer to the Contingency Reserve.

137. It is therefore proposed that the Treasury and Resources Department be directed to take account of the Strategy and introduce some of the proposed changes as part of its 2007 Budget (i.e. to be debated in December 2006).

138. Similarly, it is proposed to direct the Social Security Department to include some transitional changes as part of its September 2006 Benefit and Contribution Rates Report (i.e. to take effect from 1 January 2007).

139. It will also be the responsibility of the individual Departments to consider the necessary fee and charges changes included within their own mandates and bring forward the necessary proposals. A number of Departments have already started to address this issue by bringing forward their own States Reports.

140. The Policy Council is not recommending in this Report any detailed proposals for the transitional phase as it believes that it would be appropriate for these two Departments to consider for themselves the precise details of those transitional arrangements once the Strategy has been agreed by the States, and bring forward their own reports accordingly.

Conclusions

141. The future clearly lies in providing a business environment where residents are in well-paid, secure and sustainable jobs which add value to the businesses in which they are employed. It is only through this economic activity that the States will be able to raise revenues to fund public services and infrastructure improvements.

142. The key objective must therefore be the maintenance of competitiveness for business and jobs.

143. The Policy Council believes that in order to maintain a vibrant and sustainable economy it is in the community's own best interests to change its taxation regime. Furthermore, the Policy Council concludes:

- That it is in the long term best interests of Guernsey to maintain and enhance a vibrant and sustainable finance sector.

- That any changes to the corporate tax structure must protect and enhance the business environment and create opportunities within the non-finance sector as well as the finance sector.

- That local entrepreneurs and businesses must continue to be encouraged and supported.

- That there needs to be a clear commitment to deliver public sector expenditure control. However, public sector expenditure, both revenue and capital, must be kept at levels which do not inflict serious damage on essential public services and continue to provide adequate benefits for the less well-off members of Society.

- That in order to fund an acceptable level of public services, existing rates of indirect taxation will need to rise along the lines set out in the second consultation document.

- That it would be very beneficial for any proposed measures to be introduced in a phased manner and that in order to manage the transitional phase the Contingency Reserve should be used to fund a deficit budget.

144. **The Policy Council also strongly believes that, although there are many challenges to be faced, there is also every reason to have confidence and optimism in the economic and social future well-being of Guernsey and Alderney.**

145. **The Policy Council believes that the proposals included in this Report provide the necessary environment for that confidence to be justified.**

Minority Views

146. Two members of the Policy Council do not support all of the recommendations set out in this report.

147. Deputy Lowe does not agree that the proposed changes should be made to the Social Security insurance principle and therefore does not support recommendation 9.

148. Deputy Roffey has indicated that he believes that the Upper Earnings Limit for Social Security contributions should be increased to £100,000 rather than the £60,000 proposed in recommendation 9. It is estimated that this would increase the total contributions by a further £8.2m.

Recommendations

149. The Policy Council therefore recommends the States to agree that:

1. From 1 January 2008 the basic rate of income tax on company profits should be 0%.

2. Only a limited amount of regulated business (i.e. specific banking activities) should be subject to income tax at 10%.

3. Trading activities regulated by the Office of Utility Regulation should be subject to income tax at 20%.

4. Resident individuals should continue to pay income tax at 20% on assessable income.

5. Guernsey resident shareholders should be taxed at 20% on their distributed profits and on all rental and investment income but with effective anti-avoidance measures including deemed distribution in certain circumstances.

6. Individual taxpayers should be liable to the standard rate on their investment and non-Guernsey trading income up to a defined income ceiling with a maximum tax payable of £250,000 on any individual's income from such sources.

7. "Wealth taxes" such as inheritance and capital gains taxes should not be introduced.

8. The rates of existing indirect taxes should be increased, in particular duties on alcohol, tobacco and motoring, and Tax on Rateable Values in line with the contents of this report.

9. The General Revenue grant to social security should be reduced from 1

January 2008 by increasing the rate of employers contribution by 1% and increasing the Upper Earnings Limit for employers, self-employed, non-employed and employees to the equivalent of £60,000.

10. General Revenue will continue to fully fund the non-contributory elements of the present social security system (Family Allowances, Supplementary Benefit, etc).

11. Up to half of the Contingency Reserve (interest and capital) may be used to fund the shortfall in public sector expenditure during a transitional phase.

12. Income tax relief on interest payable and life assurance policies should be revised in accordance with the proposals set out in this Report.

13. The Treasury and Resources Department should be directed to investigate a system of goods and services tax, including that introduced by the States of Jersey, and the preparation of the necessary enabling legislation should be directed.

14. The Treasury and Resources Department should be directed to take account of the above proposals when bringing forward recommendations as part of that Department's 2007 and future Budget reports.

15. The Social Security Department should be directed to take account of the above proposals when bringing forward recommendations as part of that Department's reports on Benefit and Contribution Rates for 2007 and future years.

And to direct the preparation of such legislation as may be necessary to give effect to their above decisions.

L C Morgan
Chief Minister

8th May 2006

LIST OF APPENDICES

		page
1.	**Timetable of Events**	**1131**
2.	**Future Fiscal & Economic Structure**	**1132**
3.	**Second Consultation Document**	**1134**
4.	**Analysis of Consultation Responses: Prepared by PricewaterhouseCoopers**	**1181**
5.	**The Economic Case for a 0%/10% Corporate Tax Structure**	**1210**
6.	**The Economic Impact of Guernsey's Tax Strategy**	**1220**
7.	**Public Sector Revenues 2004 & 2005**	**1271**
8.	**Analysis of Corporate Tax paid 2004 & 2005**	**1272**
9.	**ETI Growth 1999 to 2005**	**1273**
10.	**Public Sector Expenditure 2004 & 2005**	**1274**
11.	**Projected Public Sector Revenues 2008**	**1275**
12.	**Alternative Scenarios for 2008 Public Sector Finances**	**1276**
13.	**Contingency Reserve Projections**	**1277**
14.	**Social Security Collections: Alternative Scenarios**	**1278**
15.	**Comparison of Present and Proposed Social Security Contributions**	**1279**
16.	**Goods and Services Tax**	**1281**
17.	**Glossary**	**1282**

Appendix 1

TIMETABLE OF EVENTS

December 2002	Advisory and Finance Committee issue Supplement to the 2003 Budget Report entitled "Future Corporate Taxation Strategy"
June 2004	Policy Council established the Fiscal & Economic Policy Steering Group (the " Steering Group")
March 2005	The Steering Group issue first Consultation Document
September 2005	The Steering Group issue second Consultation Document
October 2005 & November 2005	Public Presentations held in Guernsey and Alderney
December 2005	Statement to December States by Chief Minister setting out revised timetable
February 2006	Independent analysis of 500+ Consultation Responses issued
March 2006	Future Fiscal & Economic Structure issued by Policy Council
March 2006	Economic case for 0%/10% issued by Independent Economic Working Group
April 2006	Independent Economic Working Group issue Economic Impact Analysis
June 2006	States Debate

Appendix 2

FUTURE FISCAL & ECONOMIC STRUCTURE

The key objective is maintaining a healthy economy. Managing the States Finances should support that objective.

The Island's future clearly lies in providing a business environment where its residents are in well-paid, secure and sustainable jobs which add value to the businesses in which they are employed.

- Change is in the best long term economic, social and political interests of Guernsey.
- Public sector expenditure (revenue and capital) must be curtailed.
- It is in the long term best interests of Guernsey to maintain and enhance both the finance sector and non-finance sectors.

PROPOSALS

- The basic rate of income tax on company profits should be 0%.
- Only a limited amount of regulated business (i.e. specific banking activities) should be subject to taxation at 10%.
- Trading activities regulated by the Office of Utility Regulation should be subject to taxation at 20%.
- Resident individuals should continue to pay tax at 20% on assessable income.
- Guernsey resident shareholders should be taxed at 20% on their distributed profits and on all rental and investment income but with some rules to ensure compulsory distribution in certain circumstances.
- Significant individual taxpayers should be liable to the standard rate on their non-Guernsey income only up to a defined income ceiling with a total tax payable of £250,000. Guernsey income to be taxed as above.
- "Wealth taxes" such as inheritance and capital gains taxes should not be introduced.
- The rates of existing indirect taxes should be increased, in particular duties on alcohol, tobacco and Tax on Rateable Values, but less so than previously indicated.
- The General Revenue grant to social security to be reduced by about half (£20m).
- General revenue would continue to fully fund the non-contributory elements of the present social security system (Family Allowances, Supplementary Benefit,

etc) of around £22m per year.

- Half of the Contingency Reserve (interest and capital) used to fund the shortfall in public sector expenditure.
- Income tax reliefs on interest payable and life assurance policies to be less generous.
- The Corporate Anti-Poverty Programme will continue to be a key policy of the States and will need to continue to be funded.
- A system of goods and services tax should be fully investigated, and legislation developed, but not introduced in the short term.

DELIVERY

In order to move from the existing tax regime to a future competitive regime, a two stage process to be adopted:

Stage One

The States to run a deficit budget, funded by use of half of the Contingency Reserve with:

- Robust Public Sector expenditure control with only modest annual increases.
- Existing indirect taxes increased.
- Social Security: employer rate up by 1%, self-employed rates and employee rate stay as is. Upper Earning Limit for employees, employers and self-employed raised to £60,000.
- No Goods and Services Tax.
- Promote economic growth.

Stage Two

Having run a deficit budget for three to five years (i.e. till 2011/2013)**,** and then after taking into account international events, GST history in Jersey and economic performance evaluate and produce an overall package which sustains the economic position and delivers a balanced States Revenue budget.

In the long term, the decisions for the States will revolve around: Will economic growth be used to fund extra services and/or used to avoid introduction of other taxes?

Appendix 3

STATES OF GUERNSEY

FUTURE ECONOMIC & TAXATION STRATEGY

SECOND CONSULTATION DOCUMENT

September 2005

FOREWORD

As a result of the first Consultation Document issued in March 2005, nearly 100 responses were received. The Group is extremely grateful to all those that responded. **However, the Group believes that it is essential that during this second consultation process the general public needs to be more engaged in the debate.**

Having considered very carefully all of the responses received during the first consultation process, this document sets out the Group's proposals.

The purpose of this second Consultation Document is therefore to further assist the States of Guernsey to establish a strategy to safeguard the future economic well being of the Island.

It is emphasised that any decisions on a revised taxation structure will require the approval of the States of Deliberation. However, in order to take those decisions the States must be presented with a well researched and argued case. This Consultation Document is an important part of that process.

Individuals, organisations or representative bodies should submit their views by no later than **14 November 2005** to:

The Chairman
The Fiscal & Economic Policy Steering Group
Sir Charles Frossard House
PO Box 43
La Charroterie
St Peter Port
Guernsey
GY1 1FH

L C Morgan	L S Trott	S J Falla
Chairman &	Minister	Minister
Chief Minister	Treasury & Resources	Commerce & Employment

INTRODUCTION AND SUMMARY 1

MAIN CONSIDERATIONS

Competitive Business Environment 6

Public Sector Expenditure 8

Public Sector Revenues 10

Case for the Zero-Ten Option 13

Effect of Proposals on States Revenues and Individuals 15

DETAILED PROPOSALS

Business

- Zero Tax 18
- Collective Investment Schemes 18
- Captive Insurance Companies 18
- Regulated Finance Sector 19
- Non-Finance Sector 19
- Annual Company Filing Fees 20
- Utilities and States Trading Entities 21
- Payroll Tax 21

Earnings

- Personal Income Tax Rates, Allowances and Reliefs 22
- Significant Individual Taxpayers 23
- Social Security Contributions 23

Consumption

- Indirect Taxes 25
- General Sales Tax 27

List of Appendices 28

INTRODUCTION AND SUMMARY

Guernsey has over recent decades developed a prosperous and resilient business environment which has been able to respond quickly to changing local and international developments. It has created a business-friendly and competitive environment that attracts prosperous activity, entrepreneurship and diversification.

It is emphasised that the fundamental purpose of the Group's work is to maintain a vibrant and sustainable economy that generates corporate profits, offers well-paid job opportunities and makes a positive contribution to the prosperity of the Island.

The Island's future clearly lies in providing a business environment where its residents are in well-paid, secure and sustainable jobs which add value to the businesses in which they are employed. It is only through this economic activity that the States will be able to raise revenues to fund public services and infrastructure improvements. Unemployment, or employment in low paid jobs will simply not generate the necessary public sector revenues required to fund basic public services.

Therefore the key criteria used by the Group in putting together its proposals has been the maintenance of competitiveness for business and jobs.

Those options which would lead to the creation of a less competitive environment, and would therefore discourage new businesses locating in Guernsey, or existing ones moving away to competitor jurisdictions, have been discarded.

The purpose of this consultation process, of which this Consultation Document is the second part, is to assist the States of Guernsey in determining a strategy to enhance the Island's competitiveness, encourage more value added business coming to Guernsey, and thereby safeguard the future economic well being of our community.

As a result of the first Consultation Document, nearly one hundred separate responses were received (see Appendix XII) from a wide range of individuals, businesses, organisations and associations. The responses from a number of associations were a summary of the results of their own consultation exercise with their membership. The areas covered were also extremely varied, some were on single issues, others were more wide ranging.

In addition, important contributions to this debate were also made through a significant range of formal and informal discussions, and other channels of communication, not least through the local media. Representatives of the Group gave a number of presentations to various associations. A common theme emerging from these presentations was that they were the best-ever attended meetings of those associations. **However, the Group was disappointed with the level of involvement of the general public.**

A key part of the process going forward is ensuring that the general public becomes more aware of, and involved in this process. The proposals that the States ultimately adopt will have a direct impact on everyone’s daily life.

Background

The European Union has developed a Code of Conduct on Business Taxation. Although, Guernsey is not within the EU’s fiscal territory and is not within the EU single market for financial services, the countries of the EU (including of course the United Kingdom) are its major economic trading partners. Therefore, Guernsey continues to indicate its willingness to participate in a constructive dialogue with the EU.

The Code of Conduct listed a total of 66 measures which it considers harmful in EU Member States and their associated or dependent territories. Five regimes were identified in Guernsey as being considered harmful.

The main reason that the Code of Conduct listed these regimes as harmful is that the beneficial tax treatment that they provide is considered to be 'ring fenced' from the domestic economy. (Ring fencing is a term used to describe the situation when a preferential tax regime is available fully or in part only to non-residents rather than to residents in the country providing the regime.)

The existence of a zero or low tax regime is not deemed to be harmful in itself. A regime is deemed to be harmful if preferential rates are made available to non-residents but not to its own residents.

Hence, a corporate tax regime where the general rate of tax applied to resident and non-resident companies is zero is not deemed to be harmful. Furthermore, a regime that then charges a proportion of its companies at higher rates of tax (specified by sector) is also not deemed to be harmful provided that, as a proportion of the overall economy, these companies are a minority. **This is why the Zero-Ten option is compliant with the code of conduct.**

In December 2002, as part of the 2003 Budget a separate supplement (the “2002 Report”) was published which set out the then Advisory and Finance Committee’s views for the future direction of Guernsey’s corporate taxation strategy. Essentially, this long-term strategy consisted of a general rate of income tax for companies of zero per cent in respect of tax year 2008 onwards. The profits of certain companies licensed by the Guernsey Financial Services Commission would be taxed at 10%. (The Zero-Ten option).

Since the 2002 Report there has been considerable activity across the world in response to the various international tax initiatives. Most competitor jurisdictions, including Jersey and the Isle of Man, have made announcements to the effect that they intend to adopt the approach set out in the December 2002 Report and introduce some variant of the Zero-Ten model.

A considerable amount of work has been carried out to investigate and model the effects of adopting a similar tax regime in Guernsey. Having carefully carried out various modelling exercises, using the best available data, it is estimated that the annual loss of revenue to the States of Guernsey from adopting the Zero-Ten option would be of the order of £48 million. This is now based on more up to date information and is slightly more than previously calculated.

In the 2002 Report the Advisory and Finance Committee was able to take a very positive approach to the adoption of a revised tax structure. One of the main reasons why it was originally possible to take such a view was that public finances had very high surpluses which had enabled substantial reserves to be built up. However, the States finances are no longer that strong. Therefore, this report also addresses some of the options that need to be taken in respect of the delivery of public services.

It is important to acknowledge that the need to change is not one that is only being faced by this Island. Other jurisdictions, many of which are direct competitors, are also faced with these issues and will, of course, continue to respond in their own best interests. These jurisdictions are competing with Guernsey for businesses and well-paid jobs.

The main drivers for change are therefore twofold, the need to meet our international obligations (in order to secure access to world markets) and the need to be competitive with other similar jurisdictions.

Summary and Conclusions

In order to maintain a vibrant and sustainable economy Guernsey needs, in its own best interests, to change its taxation regime to comply with international standards and respond to competitive pressures.

Such fundamental change will be difficult and challenging. Not only is this change unprecedented in the Island's recent history, it is recognised that very few other jurisdictions in the world have ever faced such radical changes to their tax regimes.

Change of this magnitude presents risks and can create uncertainty but also presents opportunity. This opportunity must be grasped so that it can be the catalyst for future benefits and prosperity. In order to meet these challenges, it is essential that all parts of the community join together in a positive and constructive manner.

As has been stated on previous occasions, the Policy Council and the Treasury and Resources Department are determined to carry out this vital work in a methodical and measured manner and avoid the temptation to reach any premature conclusions without all options first being fully thought through, costed and consulted upon. The process thus far has demonstrated that this was, and remains, the correct approach.

This second Consultation Document is a further vital part of that process.

Having carefully considered the representations made to it during the past months, and bearing in mind the key criteria of maintaining business competitiveness and securing well-paid jobs the Group's proposals are that:

- Change is in the best long term economic, social and political interests of Guernsey.
- Public sector expenditure (revenue and capital) must be curtailed as a matter of urgency.
- It is in the long term best interests of Guernsey to maintain and enhance a vibrant and sustainable finance sector.
- Any changes must also protect and enhance the business environment and opportunities within the non-finance sector.
- The basic rate of income tax on company profits should be 0%.
- Captive insurance companies and collective investment schemes should continue to be subject to taxation at 0%.
- Guernsey resident shareholders should be taxed at 20% on the profits of the company in proportion to their ownership. (The attribution or "look through" basis). However, further consultation is required on an alternative whereby business profits should be taxed on a distribution only basis.
- Regulated finance institutions, other than captive insurance companies and collective investment schemes, should be subject to taxation at 10%.
- A payroll tax should **NOT** be introduced.
- Trading activities regulated by the Office of Utility Regulation should be subject to taxation at 20%.
- Resident individuals should continue to pay tax at 20% on assessable income.
- Significant individual taxpayers should be liable to the standard rate on their non-Guernsey income only up to a defined income ceiling after which point their liability should be capped. Guernsey income to be taxed at the standard 20% rate.
- The present level of personal income tax allowances and reliefs should be revised with interest relief restricted to principal private residences.
- "Wealth taxes" such as inheritance and capital gains taxes should **NOT** be introduced.
- The rates of existing indirect taxes should be increased, in particular duties on alcohol, tobacco and Tax on Rateable Values.
- The costs of the social security contributory scheme to be fully met from contributions. Employee and employer contributions should be increased to 7% each and the upper earnings limit increased to £60,000. The grants payable by general revenue (£35m per year) to social security to cease.

- General revenue would continue to fully fund the non-contributory elements of the present social security system (Family Allowances, Supplementary Benefit, etc) of around £22m per year.

- The Contingency Reserve (estimated to be £225m by 2008) to be used as a short-term measure to cover any initial shortfall in public sector funding.

The Group believes that increasing employer and employee social security contributions is a better alternative than introducing a general goods and services tax.

Guernsey, especially in the past decade or so, has seen unprecedented growth in the level of wages paid to islanders and the quantity and quality of public services provided. At the same time, taxes, in real terms, have reduced so that the level of disposable income for the vast majority of the population has become, by any standard, very high. There is no doubt that this has been made possible largely because of the finance sector.

The immediate impact of the Group's proposals will inevitably mean that individuals will have less disposable income. However, the overall package of proposals is designed to ensure that Guernsey remains a good place for business to operate and to provide well-paid jobs, hence enabling wages to remain high and, in many cases, to increase. **Even with the proposed tax increases, individuals in Guernsey will still be subject to tax at levels which are far less than the vast majority of other jurisdictions in the world, and disposable incomes of individuals will therefore continue to be very high.**

The Group also recognises that those on lower incomes must be protected from any changes and that taxation increases need to be targeted on those who can afford to pay, not those who are most vulnerable, including those on fixed incomes and pensions. The Corporate Anti-Poverty Programme will continue to be a key policy of the States and will need to continue to be funded.

The Group believes that by introducing this package of measures, including curtailing public sector expenditure, the challenges of the future can be met with confidence.

Within each of the proposed methods of raising income and cutting expenditure there is a range of detailed options which are explored in this document.

In order to take the necessary actions, the States of Guernsey needs to hear the views and opinions of the general public and the business community. Any individual, organisation or representative body who wishes to submit their views is asked to do so to the address shown in the Foreword to this document.

This second period of consultation, which is as important as the first, will then enable specific proposals to be put before the States to discuss at the beginning of February 2006.

Competitive Business Environment

The finance sector is the dominant part of the Island's economy. This sector generates significant revenues which help to pay for public services (see Appendices VI & VII). Any taxation strategy therefore needs to address the competitive position of the finance sector as a priority. Failing to support this sector is not an option as it would lead to the Island's most important economic sector becoming uncompetitive and leading to an economic void which the other sectors could not hope to fill.

The finance sector is not one single type of business; it is made up of a number of inter-related and inter-dependent sectors. Professional support services (accountants, lawyers, actuaries etc.) are essential in order to provide very high standards of service. The inter-relationship between these various components is also complex. In addition, in order to remain competitive and help differentiate the Island in the marketplace, Guernsey needs this high level of expertise across all sectors of the economy.

It is worth emphasising that the success of the Island is based on a number of factors unrelated to the system of taxation. Most notably:

- Economic prosperity that relies on political and economic stability and fiscal autonomy.
- High quality institutions and professional service providers of international repute staffed by a highly skilled workforce.
- Independent professional supervisory and regulatory regimes with a pragmatic and responsive legislative framework.
- Accessible judicial system which is based on integrity and respect for the rule of law.
- Good local infrastructure and communications within a convenient time zone.
- Pleasant and safe place to live and do business.

However, it is indisputable that like any other finance centre, be it New York, London or Dublin, an important element of success is the existence of a competitive tax environment.

In view of the recent and growing competitive pressures facing the Island, it is clear that Guernsey needs to amend its taxation regime if the finance sector is to remain competitive and if the Island's overall economy is to be protected.

It is also recognised that any proposed package of measures for reform of corporate taxation has to take into account international standards in addition to competitive pressures.

Although the finance sector is presently the dominant part of the Island's economy, it is by no means the only sector. There are also a whole range of economic activities on the

Island that includes light industry, retail services, tourism, horticulture and other local service and traditional businesses.

However, regardless of which sector is considered, the Island's future clearly lies in providing a business environment where its residents are in well-paid, secure and sustainable jobs which add value to the businesses in which they are employed. It is only through economic activity that the States will be able to raise revenues to fund public services and infrastructure improvements.

Any proposals that are implemented at the end of this process must protect the competitiveness of the finance sector and attract and retain non-finance sector businesses.

If Guernsey can attract and retain businesses that support well-paid jobs, public revenues can be raised to fund public services. If Guernsey fails to do this, unemployment, or employment in low paid jobs, will simply not generate sufficient public sector revenues to fund basic public services to support the community.

Public Sector Expenditure

Annual revenue expenditure over the period 1999 to 2005 has increased by £105m, which represents 53% in cash terms, or 25% in real terms. In recent years it has consistently grown by over 3% in real terms each year.

General increases in revenue expenditure have been experienced in most areas, but in particular in health and education. However, a number of new services and initiatives, and associated increased expenditure, have been introduced or substantially increased during that period. Each of these projects were approved by the States, and in isolation were considered worthy of support, however, cumulatively they have increased the ongoing burden on the taxpayer.

In addition to the increase in revenue expenditure there has been an unprecedented increase in capital expenditure in the past few years. (It is estimated that for the years 2000 to 2005 inclusive, capital expenditure will total around £250m).

The overwhelming majority of the responses received as part of the first consultation period strongly endorsed the need for States expenditure to be curtailed.

It has to be accepted by all Departments, States Members and staff, and indeed the public, that the culture of increased public sector service provision and ever growing expenditure needs to be reversed. In the coming years the introduction of any new services can only be contemplated in very exceptional circumstances and then only if existing (lesser priority) services are reduced or withdrawn. It must also be seriously questioned whether “RPI plus” pay awards in addition to promotions and a final salary pension scheme are sustainable for public sector workers.

Although the level of States expenditure has risen in the past few years, the independent benchmarking exercise carried out in cooperation with Jersey and the Isle of Man, showed that, in general, Guernsey has a well deserved reputation for delivering public services at a cost which compares favourably with the other jurisdictions. **Nonetheless efficiencies and savings must be delivered.** Appendix IV sets out the major areas of expenditure for 2004 and 2005.

Of course, as a major employer and with a substantial property portfolio, any increases in the rates of employer social security contributions, TRV etc. will have the effect of increasing States expenditure. Such increases must be absorbed by increased efficiencies and productivities if real savings are to be delivered.

The Group is aware that there are already considerable existing pressures to increase public sector expenditure in a number of areas, (public sector employee pensions contributions, various social policy initiatives, medical inflation and healthcare workers pay to name but a few). Efforts must be made to contain these additional costs. However, while recognising that expenditure in some areas will inevitably need to grow, compensating reductions will need to be made elsewhere.

The Group believes that public sector expenditure must be curtailed and, over the next five years, a maximum target figure of no more than the amount spent in 2005 in cash terms (i.e. £290m) for ongoing annual revenue expenditure and £15m for annual capital expenditure should be established.

As set out in the table in the next section, the £305m target above is before the removal of General Revenue grants to social security for contributory benefits. Total annual target expenditure on public services will be £268m.

In absorbing both the inevitable cost increases referred to above, and inflation (including wage inflation), the States public sector will be expected to cut around £15m (or 5%) compared to present expenditure levels.

Restraining public sector expenditure to this extent will be a challenging task and, as set out in the July 2005 Interim Financial Report, the Treasury and Resources Department, Policy Council and all other States Departments, undoubtedly have a more difficult task than has faced the States for many years. During this time of change every effort must be made to ensure that Budgets are, as far as possible, contained. Difficult decisions will have to be taken and a significant change of culture achieved. Where necessary, previous States approved spending plans will have to be revisited. Although this may well prove difficult to achieve, it is essential that States revenue expenditure is controlled, not least to enable money to be set aside for high priority capital expenditure.

Public Sector Revenues

In order to pay for public services (including capital infrastructure maintenance and improvements), taxes need to be raised from business, employment and consumption. The following table sets out in summary form how the Group proposes to raise the revenues to fund public sector expenditure.

	Post 2008 £m
Ongoing Expenditure	290
Capital Expenditure	15
Total Annual Expenditure Requirements	305
Less: reduction in grants to Social Security	35
Less: additional fees and charges retained by Departments	2
Target Annual Expenditure	268
	£m
ETI, self employed and investment income	145
Business profits	48
Indirect taxes	60
Miscellaneous income	3
Annual Company fees	5
Initial deficit funded from interest on the Contingency Reserve	7
Target Annual Income	268

In the later sections of this document (and in Appendix IX), more specific details are provided on the effect on individuals of the proposals and the impact on the overall pattern of States Revenues. The above table also assumes that the Capital Reserve is fully depleted.

In recent years there has been strong growth in ETI and self-employed tax receipts (of the order of 6% per year). If the Group's proposals are successful this should continue or even increase. However, given the difficulty in quantifying such growth, especially at a time of significant change, no attempt has been made to include increased revenue in the above figures. The effect of revenue growth will be to reduce the amount needed from the Contingency Reserve.

Other Income Streams

In addition to the direct and indirect taxes, (which are accounted for "centrally" and then allocated to individual Departments to fund their revenue and capital programmes), a wide variety of fees and charges are levied by individual Departments (and retained by them). Some of these charges raise several million pounds a year, others just a few thousand.

Examples of such fees and charges include admission charges to the Museums, property rents, various health service fees, refuse disposal fees, sewage tanker fees etc.

Although many of the fees and charges have been kept under careful review, others have been allowed to reduce in real terms, in particular in the last decade when Committees and Departments have been under less financial pressure.

The level of charges and fees was the subject of a comprehensive review by the National Audit Office on behalf of the Public Accounts Committee which identified a number of areas where charges and fees could be considered for increase**. It is proposed that a minimum of £2 million should be raised in this area.**

As has been stated on many occasions, the States of Guernsey has a large and varied portfolio of property. Some of this property is not being used to its full potential. The Treasury and Resources Department is already committed to reviewing the States property portfolio to ensure that it is rationalised. This process will identify any properties that can be released, either by sale, lease or used more effectively for another purpose, including by another Department.

Borrowing

The States of Guernsey has traditionally had a very prudent approach to borrowing and as a result the taxpayer has not had to bear the cost of interest charges. In recent decades the States has not borrowed to fund either ongoing revenue or individual capital projects.

The Corporate Agenda, as approved by the States in December 2004, includes the following statement on borrowing:

"Take a cautious approach to public sector borrowing, only doing so where the debt can be serviced by a secure, associated income stream".

The Group continues to believe that this remains a sensible and prudent approach.

Contingency Reserve

The purpose of the Contingency Reserve is to provide protection against major emergencies including significant economic downturns having a severe adverse effect on the Island.

Since 1998 the Contingency Reserve has increased from £71m to £190m at the end of 2004 and is expected to reach £225m by 2008.

The increase since 1998 has been the result of appropriations from General Revenue (£47m), the sale proceeds of Guernsey Telecoms (£23.8m) and net increase in investments (£48m).

Although the Contingency Reserve is expected to continue to increase in size as a result of investment growth (the Fund investments are mainly fixed interest and similar financial instruments), it is very unlikely that any further appropriations will be possible from General Revenue.

Although the Contingency Reserve cannot be used to make good any shortfall in revenue over an indefinite period, the Group believes it should be used in the short to medium term to help balance the books in order to smooth any transitional arrangements.

<u>Case for the Zero-Ten Option</u>

The European Union has developed a Code of Conduct on Business Taxation. Although, Guernsey is not within the EU's fiscal territory and is not within the EU single market for financial services, the countries of the EU are its major economic trading partners. Therefore, Guernsey continues to indicate its willingness to participate in a constructive dialogue with the EU.

The Code of Conduct listed a total of 66 measures which it considers harmful in EU Member States and their associated or dependent territories. The following five regimes in Guernsey are listed:

- Exempt Companies.
- International loan business.
- International bodies.
- Offshore Insurance companies.
- Insurance companies.

The main reason that the Code of Conduct listed the above regimes as harmful is that the beneficial tax treatment that they provide is considered to be 'ring fenced' from the domestic economy. (Ring fencing is a term used to describe the situation when a preferential tax regime is available fully or in part only to non-residents rather than to residents in the country providing the regime.)

The existence of a zero or low tax regime is not deemed to be harmful in itself. A regime is deemed to be harmful if preferential rates are made available to non-residents but not to its own residents.

Hence, a corporate tax regime where the general rate of tax applied to resident and non-resident companies is zero is not deemed to be harmful. Furthermore, a regime that then charges a proportion of its companies at higher rates of tax (specified by sector) is also not deemed to be harmful provided that, as a proportion of the overall economy, these companies are a minority. This is why the Zero-Ten option is compliant with the code of conduct.

The 2002 Report and subsequent States Reports have all acknowledged the need for change. Simply doing nothing is not a viable or realistic option. Not to respond to the competitive and international pressures would result in a very rapid, severe and irreversible decline in the Island's finance sector. This would have the most severe effect on the Island's economy, employment and ability to fund public services.

The first Consultation Document concentrated on two main options, Zero–Ten and Flat rate.

The Flat rate option was not favoured by the former Advisory and Finance Committee (in its 2002 Report) or by the Group. It also found little support within the consultation responses.

Most competitor jurisdictions, including Jersey and the Isle of Man, have made announcements to the effect that they intend to adopt the approach set out in the December 2002 Report and introduce some variant of the Zero-Ten model.

The main features of a Zero-Ten regime are:

- The basic rate of income tax on company profits (from business and investment activities) would be 0%.

- Certain companies regulated by the Guernsey Financial Services Commission would be subject to tax at 10%.

If Guernsey was to adopt such a regime it would, in general outline, be consistent with the 2002 proposals and competitive with other jurisdictions.

In the previous Consultation Document mention was made that, “initial consultations with some of the regulated finance companies have revealed a preference for them continuing to pay tax at 20% if this would avoid the need for other charges which would impact adversely on their pre-tax profits.”

On the face of it a Zero-Twenty regime, (or one that has some regulated sectors taxed at 10% and others at 20%) has some attractions. Not least that, initially, it could potentially halve the size of the annual loss of revenue (see Appendix XI).

Considerable work has been carried out in this area, in particular detailed consultation has been held with the finance sector, including individual companies, various associations and professional advisors. **It is clear from the responses received that the majority of the finance sector strongly believe that a Zero-Twenty regime would be deeply damaging to the competitiveness and sustainability of the finance sector. It therefore fails the key criteria test that any proposals must support and encourage competitiveness.**

Although some business would, at least for a while, remain under such a regime, there would be an inevitable decline in existing business and a cessation of new business. Businesses, and therefore employment prospects, would simply relocate to those jurisdictions, such as the Isle of Man and Jersey where a 10% taxation rate would apply.

Having considered very carefully the arguments made in the responses received to the first Consultation Document, the Group believes that a Zero-Ten regime should be adopted.

EFFECT OF PROPOSALS ON STATES REVENUES AND INDIVIDUALS

The fundamental purpose of the Group's work is to maintain a vibrant and sustainable economy that generates corporate profits, offers well-paid job opportunities and makes a positive contribution to the life of the Island.

The Island's future clearly lies in providing a business environment where its residents are in well-paid, secure and sustainable jobs which add value to the businesses in which they are employed. It is only through this economic activity that the States will be able to raise revenues to fund public services and infrastructure improvements. Unemployment, or employment in low paid jobs will simply not generate the necessary public sector revenues to fund basic public services.

Therefore the key criteria used by the Group in putting together its proposals has been the maintenance of competitiveness for business and well-paid jobs.

How Will the Changes Affect States Revenues?

As well as impacting on individuals and businesses, the changes to the Zero-Ten tax regime, will also have a marked impact on where public sector revenues come from. In broad terms, States revenues come from three main sources:

- Taxation on the profits of business.
- Revenues arising as a result of employment (ETI, employee and employer social security contributions).
- Tax on consumption (duty on tobacco, alcohol, property taxes, etc.).

As set out in Appendix III, between 1999 and 2004 there has already been a move away from revenues raised from business profits to employment generated revenues. This is a trend that has also been experienced by other jurisdictions elsewhere in the world.

Under the Group's proposals, this trend will be more marked and the majority of revenue raised will come from employment and consumption sources.

It is emphasised that "revenues arising from employment" includes amounts payable by employers in respect of employing individuals, (i.e. employers social security contribution) and not solely that paid by individuals.

Revenue Source	1999 %	2004 %	2008 %
Business Profits	44	29	15
Employment	40	58	66
Consumption	16	13	19

Planning public sector expenditure based upon the predicted level of tax receipts from business profits is much harder to do than using predicted tax revenues from indirect taxes and taxes based on employment. Moving to a tax regime where the majority of taxes are no longer based on business profits, which can be unpredictable, will provide a much greater degree of certainty in planning public sector revenues and therefore expenditure.

<u>How Will the Tax Changes Affect Individuals?</u>

Appendix VIII sets out a comparison between Guernsey, Jersey and the Isle of Man of the amounts currently payable in respect of various individual scenarios for income tax and social security contributions.

From these figures it can be seen, especially for those on middle to high incomes, that taxes payable currently in Guernsey are less than Jersey and much less than in the Isle of Man.

Furthermore, as shown in the National Audit Office's report on Income Generation, the level of duties, fees and charges in Guernsey are also much less than most other jurisdictions and many of them have fallen in real terms over the past decade.

The Group does not advocate tax rises for their own sake. However, there is considerable scope for tax rises and for Guernsey still to remain competitive.

It is by remaining a competitive jurisdiction that businesses will continue to be attracted and flourish in the Island and therefore offer well-paid jobs to enable taxes to be paid.

Under the Group's proposals most individuals will be affected as follows:

- Social Security contributions to be increased to 7% for both employer and employee and the upper earnings threshold increased to £60,000. For an individual earning £40,000 per year this would be an increase of £740 per year or £14 per week. (An individual on £60,000 would pay £2,140 per year or £40 per week more). Self-employed and non-employed contribution rates will also be increased.

- The amount of tax on rateable value on domestic dwellings will increase threefold, which will increase the amount payable on a typical dwelling from £75 to £225 per year.

- Smokers and drinkers will be paying duties more in line with other jurisdictions and can expect them to increase at least in line with inflation thereafter. This could mean an extra 6p to 10p duty on a pint of beer and an extra 60p duty on a packet of twenty cigarettes.

- The duty on motor fuel and vehicle licence fees will increase up to the levels in other jurisdictions.

- Personal income tax allowances (2006: £8,250 for a single person) will increase, at best, in line with inflation.

- Income tax relief on interest paid for individuals will be limited to principal private residences of a modest value only, i.e. relief removed from general borrowings for boats, cars and second houses etc.
- Some **non-essential** services will be reduced or discontinued and some existing subsidies reduced. Other charges, for example on waste disposal to rise to more directly cover operating costs.
- Islanders will, under the Group's proposals, pay no general Goods and Services Tax.

As set out in Appendix IX, the immediate impact of the above proposals will inevitably mean that individuals will have less disposable income. However, the overall package of proposals is designed to ensure that Guernsey remains a good place for businesses to operate and to provide well-paid jobs, hence enabling wages to remain high and to increase.

The Group also recognises that those on lower incomes must be protected from any changes and that taxation increases need to be targeted on those who can afford to pay, not those who are already vulnerable, including those on fixed incomes and pensions. This is one of the main reasons why the Group does not favour the introduction of a general sales tax as it will have the greatest proportional impact on those on lower and fixed incomes. The Corporate Anti-Poverty Programme will need to be a key policy of the States and be funded.

The Group believes that even with the proposed tax increases, individuals in Guernsey will still be subject to tax levels which are far less than the vast majority of other jurisdictions in the world, and disposable income of individuals will also continue to be very high. Guernsey will continue to be a good place to live and bring up children because it is safe, attractive and forward-looking.

DETAILED PROPOSALS

Zero Tax

As set out in previous reports, in order to be an effective and competitive International Financial Centre, a zero tax product needs to be available. The existence of a zero tax product is already a fundamental principal element of the taxation strategies of the Island's competitors.

Collective Investment Schemes

Collective Investment Schemes, including closed ended investment vehicles, were **not** one of the regimes in Guernsey (or elsewhere) identified by the EU Code of Conduct Group as being considered harmful. **Therefore, in order to protect the Island's competitiveness it is proposed that Collective Investment Schemes, including closed ended investment vehicles, will continue to be subject to tax at 0%.**

Captive Insurance Companies

Guernsey is the leading captive insurance centre in Europe. It is a sector that is often cited as being a part of the finance sector which distinguishes Guernsey from its main competitor jurisdictions.

At present the majority of captive insurance companies are exempt from taxation (the captive **managers** are subject to 20% taxation).

In addition to making a substantial value added contribution to the island's economy (the contribution per employee in this sector is higher than in the banking and investment fund sectors), it also makes a major contribution to other sectors. Substantial sums are invested locally with banks and investment managers. The captive insurance sector also generates substantial fees in the accountancy and legal support professions and spends large sums of money in the hospitality, travel and service industries.

The Group recognised the importance of the captive insurance sector very early on in its deliberations and commissioned a separate targeted consultation exercise during October and November 2004. During that exercise a large proportion of interested parties in this sector were contacted directly and asked for their views.

The views of the captive insurance sector were very clear. If captive insurance companies were made subject to taxation, (of say 10%), there would be an immediate decline in the captive insurance sector in Guernsey. New business opportunities would cease and existing business would very soon relocate to other jurisdictions where a zero tax regime was available. A loss of critical mass for the sector would soon be reached and this part of the Island's finance sector would be lost with commensurate damage to the Island's international reputation and knock on effects on other sectors.

The Group continues to support a 0% tax rate for captive insurance companies in order to maintain the Island's competitiveness.

Regulated Finance Sector

As set out in the 2002 Report, under the Zero-Ten regime, the profits of certain companies licensed by the Guernsey Financial Services Commission would be subject to taxation at 10%.

The types of regulated entities to be taxed at 10% include:

- Banks
- Fiduciaries
- Money Brokers
- Stockbrokers
- Insurance & Captive Insurance Managers
- Fund Managers

Types of regulated activities which would be taxed at 0% include:

- Domestic and off-shore insurers (including Captives)
- Collective Investment Schemes
- Treasury or Referred business

As emphasised throughout this and previous Reports, the Finance Sector in Guernsey must remain internationally competitive. The adoption of a Zero-Ten regime recognises this and is a measured response to that competitive pressure.

Non-Finance Sector

Although the finance sector is presently the dominant part of the Island's economy, it is by no means the only sector. There are also a whole range of economic activities on the Island including light industry, retail services, tourism, horticulture and other local service and traditional businesses.

Under the Zero-Ten option, the general rate of income tax paid by companies would be 0% from 2008 onwards. This would apply to former exempt companies (including general partners of limited partnerships).

In order to prevent avoidance of personal tax liabilities and to protect the Island's tax revenues, it was originally proposed that Guernsey resident individual shareholders would be taxed (at 20%) on the profits of the company in proportion to their ownership.

The tax charged would be on an assumed 100% distribution of profits basis, not on an actual distribution paid basis (i.e. shareholders would not be able to avoid taxation simply by not paying out dividends). **In the context of this Consultation Document, this process is termed "attribution".**

For a company that is wholly owned by Guernsey residents the effective tax liability would be the same under the new regime as the present time. However, tax would be charged on the shareholders.

For non-Guernsey resident shareholders, no tax would be due to the Guernsey authorities. Profits accruing to a UK based shareholder from a Guernsey business would be liable to taxation in the UK, not in Guernsey.

In the first Consultation Document, and as set out in the 2002 Report and in line with the proposals agreed in Jersey, in order to protect States revenues, it was proposed that Guernsey resident individuals should be taxed at 20% on the profits of the company in proportion to their ownership. This is the so-called "look through" or attribution basis.

Although this basis has many advantages, not least the protection of States revenues, a number of drawbacks exist. For example, complex rules on how to deal with minority shareholders, timings of dividend payment and anti-avoidance legislation etc. would need to be developed, implemented and enforced.

A major concern (which was confirmed by the responses received during the first consultation process) was the widely held perception of the creation of an unfair regime that would lead to shareholders selling up or leaving the Island. This would almost inevitably result in less vitality and investment in local businesses, a decline in job opportunities and a fall in local owner-operated businesses.

A distribution-only policy on business profits would encourage inward investment and re-investment, and provide an incentive to local ownership. Investment income would be treated on an attribution basis. Adopting a distribution-only policy and taxing resident shareholders at 20% on the distributions that they actually receive would enhance the Island's competitiveness.

The actual impact on States revenues of adopting a distribution-only policy on business profits is very difficult to quantify with any degree of certainty due to assumptions and judgements that need to be made on predicting future business behaviour. However, it is estimated that this policy could, at least in the short term, reduce States income anywhere in the range between £7m and £17m.

The Group therefore believes that further consultation on this issue is required.

<u>Annual Company Filing Fees</u>

At present all Guernsey companies pay an annual filing fee of £100. In addition exempt companies pay an annual fee of £600, which raises around £4.7m per annum. Under the new tax regime, exempt companies, and therefore the associated fees will cease. In order to compensate for the loss of exempt company fees, it is proposed that the annual filing fee will increase up to £1,000 per annum, subject to the level of comparable fees established in other jurisdictions. Different types of companies, for example smaller trading companies, might be subject to lower fees.

The Group therefore believes that annual filing fees for all companies should be increased to compensate for the fall in exempt company fees.

Utilities and States Trading Entities

Having considered the main alternatives:

- Treat the incorporated utilities in the same way as all other companies (i.e. zero tax).
- Treat all regulated incorporated utilities as a special category subject to taxation on their profits.
- Treat utilities and States Trading Entities as a special category subject to taxation.

The Group's conclusion is that any entity subject to regulation by the OUR should continue to be subject to taxation at 20% as this was a key principle of the commercialisation process.

Payroll Tax

The first Consultation Document put forward the concept of introducing a payroll tax which would be creditable against resident shareholders tax liabilities.

In summary, the regime proposed that companies would be liable to a payroll tax and the amount payable would be limited to 20% of the profits of the company. The payroll tax would be the liability of the company. For any company, payroll tax would be payable to the States and therefore would be a contribution to public sector revenues in Guernsey which can then be used to fund public sector expenditure.

Initial calculations suggested that such a regime would generate about £8m annually in tax revenues (£3m from the finance sector and £5m elsewhere).

The payroll tax would then be available as a credit or deduction against the Guernsey tax liability of the shareholder on their part of the profits of the business.

In terms of the actual payment of payroll tax it was envisaged that this would be done as part of the annual tax return process rather than as an extension of the present ETI system (i.e. cash flows for local businesses would not be adversely affected).

For Guernsey companies subject to the payroll tax but owned by non-residents, there would be no Guernsey tax against which to credit the payroll tax.

It was highly unlikely that any overseas parent company of such a Guernsey company would be able to credit the Guernsey payroll tax against any corporation tax liability that the parent might have in its home jurisdiction. In such a case, the Guernsey payroll tax would increase the overall cost of doing business in Guernsey. It would therefore act as a disincentive to investment by non-residents in the non-finance sector industries of Guernsey and would therefore run contrary to the need to sustain and grow the economy.

The Group is therefore recommending that a payroll tax is NOT introduced.

Personal Income Tax Rates, Allowances and Reliefs

As set out in the original 2002 Report, the principle of a basic 20% rate of income tax in Guernsey for individuals is very well established, competitive, equitable (in that those who earn more contribute more) and administratively simple. The Group believes that the 20% basic rate of income tax for individuals continues to be appropriate but that the present system of reliefs and allowances needs to be revised. The Group also believes that the absence of "wealth taxes" such as inheritance and capital gains taxes remains appropriate.

In common with other jurisdictions, deductions are given against an individual's income when calculating their tax liability. The main deductions, in terms of financial effect, are personal allowances and relief for interest payments.

In recent years personal allowances have been increased above the general rate of inflation. The single persons allowance for 2006 will be £8,250.

Increasing the personal allowances in such a blanket manner is a relatively expensive measure. For example, increasing the personal allowances by 3% increases the weekly take home pay of a single person by just £4, but "costs" the Treasury around £2m in reduced income tax receipts. This, of course, means that there is less money to spend on health, education and other public services. It is more appropriate, over a period of time, to introduce much more targeted allowances to benefit those who need it most rather than adopt a blanket approach.

The system of giving interest payments tax relief is very simple and, compared to some other jurisdictions, generous. At present interest payments are allowable as a deduction against assessable income without limit.

Tax relief on interest paid is, in effect, a subsidy to borrowers from the general taxpayer. Whilst it could be argued that there may be valid reasons for such subsidies in limited circumstances (for example, to encourage an expansion of home ownership although even this could be regarded as preferential treatment for homeowners compared to the rental sector) it is difficult to support the case for subsidising holiday homes, cars, boats, aircraft, holidays and other personal borrowings without limit.

In the present tighter financial climate, it is not unreasonable to expect that the existing wide ranging interest relief system, which costs around £12m per year, should be reduced. Therefore, the amount of interest relief should only continue to be provided on principal private residences of a modest value with an upper limit on mortgage relief.

The Group believes that a basic 20% income tax rate for individuals remains appropriate as it is well established, competitive, equitable (in that those who earn more contribute more) and administratively simple.

The Group believes that "wealth taxes" such as inheritance and capital gains taxes should NOT be introduced.

The Group proposes that, through restricting interest relief to just principal private residences, and restricting various personal income tax allowances and reliefs, £5m of extra income tax revenue should be raised.

Significant Individual Taxpayers

Guernsey, like many small economies, has a number of individuals who because of their exceptionally high business profits or personal wealth can potentially pay income tax of an amount far in excess of any possible drain on public services.

In Guernsey such high taxpayers have typically kept a low profile. Nonetheless many of them have made significant contributions to the Island's economic and social well being by paying tax, supporting local industries and (in some cases to a large degree) supporting social and charitable activities.

Such individuals are therefore extremely important to the Island and potentially the target of other jurisdictions. It is therefore very important that the Island remains attractive to such individuals especially those who, through their own expertise and future business activities, would generate new economic activity and well-paid employment opportunities.

The Group therefore believes that it may be desirable to introduce a system whereby significant individual taxpayers pay taxation on their non-Guernsey income at the standard 20% rate up to a certain ceiling only. Other income would be subject to tax at the standard 20% rate. **The Group believes consideration should be given to introducing a total tax payable threshold on non-Guernsey income of around £1m to £1.25m (i.e. tax payable of £200,000 to £250,000).** Any threshold would need to be further evaluated, and if adopted, revised from time to time in the light of experience and competitor jurisdictions and in view of ongoing considerations on population and economic policy.

Although the introduction of such an arrangement would lead to a small initial drop in tax receipts, the attractiveness of this measure will produce substantial direct and indirect long-term benefits.

Social Security Contributions

The States of Guernsey has a long established and well administered Social Security Benefits system, which due to consistent and prudent management over a long period, is well funded.

There is a long standing principle that contributions (from employees, employers and the self-employed) are not a tax, but an insurance premium.

The current contribution rates (for an employed person) are 5.5% for the employer and 6% from the employee (a total of 11.5%). The contribution rate for self-employed persons is 10.5%.

Another long standing principle of the funding is that those individuals who are on incomes less than the upper earning limits (2005: £34,320 per year) have the difference paid by the States by means of an annual grant from general revenue. At present only 25% pay the full amount of contribution, the remaining 75% being subsidised by general revenue.

The grant from general revenue is set following periodic review by the UK Government Actuary's Department. With effect from 1 January 2004 the grant was reduced to 50% (from 57%) of contribution receipts. As a result of this change, the grant paid by general revenue was reduced by £3.6m per year.

From a general revenue point of view, the mechanics of the contribution matching process means that as more people are employed and pay more contributions (because of a buoyant economy) there is an increased drain on general revenue resources.
Despite the above change, the amount of grant paid by general revenue has increased steadily in recent years. In 2004 the grant from general revenue was £35m (see Appendix V) which represents 13% of total States revenue expenditure (in 1999 the grant from general revenue was £25m which also represented 13% of total States expenditure).

The present social security arrangements mean that if an individual has income in excess of the upper earnings limit (2005: £34,320 per year) then the amount paid by the employer and the employee is the same whether that individual earns £35,000, £75,000 or even more than £100,000.

Compared to Jersey and the Isle of Man (which has replicated the UK social security legislation) the amounts raised annually by social security in Guernsey are much less. Appendix VIII includes a comparison between Guernsey, Jersey and the Isle of Man of the present amounts payable for income tax and employer and employee social security contributions for various scenarios.

Although the rates of contribution and earnings limits are designed to finance different ranges and levels of benefit, if Guernsey adopted the Jersey scheme, an extra £11.5m would be raised or £59.6m for the Isle of Man.

The effect of changing the various percentages and thresholds is as follows:

Increase of 1% in employer contribution:	£6.85m
Increase of 1% in employee contribution:	£6.71m
Increase of 1% in self-employed contribution:	£0.66m

Increasing the employee and employer contribution levels by 1% and 1.5% respectively (so that both are 7%) and raising the threshold up to £60,000 would generate an extra £35m, (i.e. the amount payable by general revenue to fund the contributory social security payments). The Contributory Scheme would therefore be entirely funded from contributions without general revenue subsidy.

General revenue would continue to fully fund the non-contributory elements of the present social security system (Family Allowances, Supplementary Benefit, etc) of around £22m per year (see Appendix V).

The Group believes that revising the present system and removing the grant payable from general revenue is a better alternative to introducing a General Sales Tax.

In order to achieve this and to raise the necessary £35m, the Group proposes that employee and employer contributions should increase by 1% and 1.5% respectively so that both are 7%, and the upper earnings threshold be increased to £60,000.

Contribution rates for the self-employed will increase from 10.5% to 13% (i.e. still 1% less than combined employee and employer rates) and non-employed contribution rate will rise from 9.9% to 10.9%.

Indirect taxes

In common with most developed economies, Guernsey has a long established tradition of levying indirect taxes. The major indirect taxes (and their projected income levels for 2005) are set out below:

	£'000
Alcohol duties	6,425
Tobacco duties	7,850
Duty on foreign goods	500
Document duty: other	4,900
Document duty: property	11,650
Tax on Rateable Values	4,050
Motor Vehicle Tax	6,000
Motor Spirit duty	2,040
	43,415

In recent years the rates of indirect taxation (with the exception of tobacco) have not been increased in line with inflation. Nonetheless, the actual amounts collected in indirect taxes have increased since 1999 mainly due to increased document duty as a result of increased property prices.

The duty on tobacco has been increased, as a deliberate States policy, in excess of the increase in Guernsey RPI, as a measure to discourage smoking.

Indirect taxation rates in Guernsey have traditionally been low compared to other neighbouring jurisdictions (Jersey, United Kingdom, France etc.) and in recent years have been further eroded in real terms.

Increasing indirect tax levels, using existing legislative and administrative processes, would therefore be an efficient method of increasing States Revenues. It is estimated that if the rates of existing indirect taxation were raised to the equivalent levels elsewhere, then between £10m and £15m per year extra would be raised. Appendix X sets out the potential impact on the Guernsey Retail Price Index of increasing duties etc.

By way of illustration, increasing duties in line with Jersey rates in the following areas would raise an extra:

Tobacco	£2.7m
Alcohol	£2.0m
Petrol and Motor Vehicle duties	£3.3m

The Tax on Rateable Value system has already been identified as requiring fundamental review. The Treasury and Resources Department is committed to bringing forward outline proposals for a simplified system during 2006. This is seen as a preliminary step to raising significantly the amount currently raised from this source.

TRV has no direct comparison in other jurisdictions, however, as a broad principle, property taxes are generally considerably higher elsewhere.

Except for an 18% increase in TRV in 2001 (as part of a compensating adjustment for a reduction in document duty) the rate of TRV has remained unchanged since 1994. The increase in the total amount of TRV received has been marginal and caused by new buildings and extensions to existing ones (domestic and business).

The total amount of TRV collected in 2004 was £4.1m from the following sources:

	£'000
Domestic: Local Market	1,553
Domestic: Open Market	250
Tourism	178
Horticulture & Agriculture	167
Utilities and Public Buildings	822
Business Premises	1,152
Total	4,122

Although there are, of course, individual variances the TRV on an individual domestic property represents a very small percentage of its value. For example, a mid-sized property whose value may be around £300,000 would pay TRV of around £60 per year (0.02%).

Since 1994 average house prices in Guernsey have increased threefold. A similar increase in TRV, if applied to all sectors, would increase TRV receipts by £8m.

The individual rates of TRV could be increased by different amounts for each sector, for example different rates could apply to large open market properties compared to small local market dwellings. Different sectors of the economy could also be charged different rates.

It is proposed that TRV on domestic properties should be increased in line with house price inflation (threefold) and TRV on business premises increased fourfold to increase TRV receipts by a total of £10 million.

The Group proposes that the duty on alcohol & tobacco (£5m), motor vehicle & fuel duties (£3m) and TRV (£10m) should be increased to raise an extra £18m of revenue.

General Sales Tax

In addition to raising revenues from duties on certain goods (alcohol, tobacco, motor spirit etc.) many jurisdictions have a general sales tax (for example VAT in the UK and the Isle of Man).

The advantages of a broad based sales tax regime are that it can be seen as fair in that it is widely applied to the majority of citizens (who benefit from public services), gives relatively stable income flows, once established can be efficient, and is capable of raising substantial sums of money for the public purse.

There are a variety of ways in which a general sales tax could be implemented. However, all of them, to a greater or lesser extent, result in increased administrative burden and expense on businesses and the public sector administration. Furthermore, in order to raise substantial sums of money they need to be levied on a very wide range of goods and services.

As a result, those on lower incomes would experience a relatively significant increase in their cost of living.

If the States wishes to hold true to the principles of the Corporate Anti-Poverty Programme, those on lower incomes would need to be protected from the impact of the introduction of a general sales tax (i.e. benefits would need to increase).

A general sales tax regime would increase the cost of visiting and doing business in the Island and therefore acts as a disincentive for businesses to locate in the Island and for tourists to visit.

In its Report entitled "Income Generation in Guernsey" the National Audit Office estimates that if Value Added Tax at the rates applied in the UK (and the Isle of Man) were to be introduced, £110 million per year could be raised.

As part of its strategy the States of Jersey, in order to make good its £80m to £100m shortfall in tax receipts, have announced that it will introduce a general goods and services tax of 3% to raise £40m.

If such an approach was adopted in Guernsey approximately £30m per year would be raised. Alternatively, introducing a 5% Goods and Services Tax, with exemptions for food, drink, medicines and services could raise £10m net of collection charges. However, such a system would have administration, enforcement and collections costs.

The Group believes that increasing social security contributions is a better alternative to introducing a General Sales Tax.

LIST OF APPENDICES

I	Summary of Proposed Revenue Raising Measures
II	Public Sector Revenues: Detailed 2004 Figures
III	Changes to Public Sector Revenue Sources 1999 to 2008
IV	Public Sector Expenditure
V	Funds Controlled and Managed by Social Security Department
VI	Analysis of Corporate Tax paid in 2004
VII	Analysis of ETI paid in 2004
VIII	Comparison of Present Income Tax and Social Security Rates
IX	Comparison of Present and Proposed Social Security Contributions
X	Impact on Guernsey RPI
XI	Corporate Tax Models: Comparison of Regimes
XII	List of Responses to First Consultation Document
XIII	Sources of Other Information

Appendix I

SUMMARY OF PROPOSED REVENUE RAISING MEASURES

The Group's proposals are that the following revenue raising measures be introduced:

	Annual £m
Increasing Tobacco & Alcohol Duty	5
Increasing Motor Vehicle and Fuel	3
Increasing Tax on Rateable Values	10
Increasing Other Fees & Charges	2
Revising Personal Allowances, Interest Relief etc.	5
Increases in employers, self employed, non-employed and employees social security contributions	35
Total	60

In addition to raising revenues as set out above, the Group is recommending that public sector revenue expenditure is curtailed to a maximum of £290m (i.e. at 2005 levels). Capital expenditure should be £15m per year. In addition to the above, the Contingency Reserve would be used to fund any short to medium term deficit.

Appendix II

PUBLIC SECTOR REVENUES: DETAILED 2004 FIGURES

		2004 Actual £m	2004 Actual £m
Income Tax	ETI	109.0	
	Companies	96.0	
	Self-employed, investment income etc.	30.9	
			235.9
Excise Duties			
	Alcohol	6.1	
	Tobacco	7.2	
	Others	0.6	
	Motor Spirit	1.9	
			15.8
Motor Vehicle Tax			5.5
Document Duty	Property	11.4	
	Other	5.1	
			16.5
Exempt Company fees			4.7
Tax on Rateable Values			4.1
Miscellaneous			2.5
			285

For ease of comparison with the figures on page 10 the above figures can be reanalysed as follows:

	2004 £m
ETI, self employed and investment income	140
Business profits	96
Indirect taxes	42
Miscellaneous income	2
Exempt Company fees	5
	285

Appendix III

CHANGES TO PUBLIC SECTOR REVENUE SOURCES 1999 TO 2008

SOURCE	1999 Actual £m	2004 Actual £m	2008 Projected £m
Business Profits	105	96	48
Employment (ETI, employer & employee contributions)	95	191	215
Consumption taxes (Alcohol, Petrol, property, etc.)	37	42	60

The above table is an analysis of where public sector revenues (including contributions from insured persons and employers) originate.

The table shows the existing trend of more States revenue coming from the employment of individuals (both by employee, self employed and employer) compared to taxing business profits and consumption taxes.

The third column shows the effect of the change to the tax regime, i.e. increased rates of indirect taxation and increased employer and employee social security contributions to compensate for the decline in direct taxation of business profits.

Appendix IV

PUBLIC SECTOR EXPENDITURE

Revenue Expenditure	2004 Actual £m	2005 Budget £m
Policy Council	8.1	8.5
Treasury & Resources	19.5	19.9
Commerce & Employment	11.8	12.3
Culture & Leisure	2.8	3.2
Education	59.0	62.2
Environment	7.9	8.7
Health and Social Services	73.6	79.8
Home	22.7	24.9
Housing	2.7	1.6
Public Services	10.5	9.2
Social Security	57.1	59.2
	275.7	289.5

Capital Expenditure		
Major Construction Projects	29.7	28.5
Miscellaneous Capital Works	8.2	12.4
Equipment, Machinery and Vehicles	3.0	3.0
ICT Projects	3.5	3.0
	44.4	46.9

Appendix V

FUNDS CONTROLLED AND MANAGED BY SOCIAL SECURITY DEPARTMENT

	Guernsey Insurance	Health Service	Long-Term Care	Total
	2004 £m	2004 £m	2004 £m	2004 £m
Contributions	50.7	20.9	11.1	82.7
Grants from General Revenue	25.3	8.3	1.3	34.9
Total	76.0	29.2	12.4	117.6
Reserves & Fund Assets	405.5	27.2	10.9	443.6

Contributions are the amounts payable by employers, employees, self-employed and non-employed.

In addition to the above, in 2004 General Revenue financed the Non-Contributory Services of £22m to pay for Supplementary Benefit payments (£9.8m), Family Allowances (£7.4m), Attendance and Invalid Allowances (£1.9m) etc.

Appendix VI

ANALYSIS OF CORPORATE TAX PAID IN 2004

Sector		Tax paid in 2004 £m
Finance		
	Banking	37.8
	Investment Companies	9.6
	Captive Managers & Captives	6.1
	Insurance	3.4
	Investment Managers	8.0
	Fiduciary	2.3
	Others	6.6
		73.8
Non-Finance		
	Primary	0.5
	Manufacturing	1.2
	Construction	3.7
	Hostelry	2.0
	Wholesale & Retail	8.3
	Information Handling	1.1
	Miscellaneous	5.4
		22.2
Total		96.0

Appendix VII

ANALYSIS OF ETI PAID IN 2004

Sector		ETI 2004 £m
Finance		
	Banking	14
	Captive Managers	1
	Investment Managers	2
	Accounting, Legal and Stockbrokers	7
	Fiduciary	6
	Others	7
		37
Non-Finance		
	Primary	2
	Manufacturing	4
	Construction	9
	Hostelry	4
	Wholesale & Retail	9
	Information Handling	4
	Miscellaneous	13
	Transport	3
	Utilities	2
	Public Sector	22
		72
Total		109

Appendix VIII

COMPARISON OF PRESENT INCOME TAX AND SOCIAL SECURITY RATES

Social Security Rates for Employed Persons

	Employer rate	Employee rate	Total	Upper Earnings Threshold
Guernsey	5.5%	6%	11.5%	£34,320
Jersey	6.5%	6%	12.5%	£35,760
Isle of Man	12.8%	10%	22.8%	£30,940

Note: For the Isle of Man there is no upper earnings threshold for employers contribution.

The following are some worked examples comparing the amounts payable in income tax and employee and employer social security contributions. These are for illustrative purposes only based on 2005 figures.

Scenario One

Single Person earning £20,000 and paying no mortgage interest

	Guernsey	Jersey	Isle of Man
	£	£	£
Income Tax	2,400	2,425	1,246
Employee contribution	1,200	1,200	1,510
Employer contribution	1,100	1,300	1,932
Total	4,700	4,925	4,688

Scenario Two

Married Person earning £40,000 and paying £9,000 mortgage interest

	Guernsey	Jersey	Isle of Man
	£	£	£
Income Tax	3,000	3,596	1,400
Employee contribution	2,059	2,145	2,786
Employer contribution	1,888	2,324	4,493
Total	6,947	8,065	8,679

Scenario Three

Married Person earning £60,000 and paying £12,000 mortgage interest

	Guernsey	Jersey	Isle of Man
	£	£	£
Income Tax	6,400	7,880	3,932
Employee contribution	2,059	2,145	2,786
Employer contribution	1,888	2,324	7,053
Total	10,347	12,349	13,771

Scenario Four

Married Person earning £100,000 and paying £18,000 mortgage interest

	Guernsey	Jersey	Isle of Man
	£	£	£
Income Tax	13,200	14,680	10,052
Employee contribution	2,059	2,145	2,786
Employer contribution	1,888	2,324	12,173
Total	17,147	19,149	25,011

In addition to the above taxes, individuals in the Isle of Man are subject to VAT on a range of goods and services at 17.5%. As patterns of expenditure will vary considerably between individuals, is it very difficult to give anything but a very rough estimate of the amount of VAT payable by individuals. In 2004/5 the Isle of Man estimates that it will collect over £260m from VAT, an average of approximately £3,000 per person per year.

Appendix IX

COMPARISON OF PRESENT AND PROPOSED SOCIAL SECURITY CONTRIBUTIONS

Social Security Rates for Employed Persons

	Employer rate	Employee rate	Upper Earnings Threshold
Guernsey			
Present	5.5%	6.0%	£34,320
Proposed	7.0%	7.0%	£60,000

The following are some worked examples comparing the amounts payable in employee and employer social security contributions. These are for illustrative purposes only.

Scenario One: Person earning £20,000

	Present £	Proposed £
Employee contribution	1,200	1,400
Employer contribution	1,100	1,400
Total	2,300	2,800

Scenario Two: Person earning £40,000

	Present £	Proposed £
Employee contribution	2,059	2,800
Employer contribution	1,888	2,800
Total	3,947	5,600

Scenario Three: Person earning £60,000

	Present £	Proposed £
Employee contribution	2,059	4,200
Employer contribution	1,888	4,200
Total	3,947	8,400

Scenario Four: Person earning £100,000

	Present £	Proposed £
Employee contribution	2,059	4,200
Employer contribution	1,888	4,200
Total	3,947	8,400

Appendix X

IMPACT ON GUERNSEY RPI

Unfortunately increasing taxes will have an impact on the Guernsey Retail Price Index. However, this impact will be a one-off at the time of introduction and then after a year its impact will be lost.

The effect of the Group's proposals on RPI (all other things being equal) will be:

	Effect on Guernsey RPI
Increase TRV threefold	0.6%
Increase Motor Vehicle licences and petrol duties by 50%	0.2%
Increase tobacco duty by 30%	0.3%
Increase alcohol duties by 30%	0.3%

Note:

Increase employee and employer contributions	No direct impact
The introduction of a 3% tax on all goods and services	One off 3%

Appendix XI

CORPORATE TAX MODELS: COMPARISON OF REGIMES

	Zero-Ten £m	Zero-Twenty £m
Tax payable (2004)	96.0	96.0
Tax payable (2008)	(25.3)	(50.7)
Beneficial Ownership Receipts	(23.2)	(20.1)
Shortfall of Revenues	47.5	25.2

It is important to note that the above figures take no account of corporate behaviour and assume that all existing business stays on the Island and no new business is attracted.

The Group strongly believes that under a Flat ten regime there would be a very rapid demise of the finance sector. Under a Zero-Twenty regime this decline would be slower, but irreversible, and little or no new business attracted.

The beneficial ownership receipts are based on a full attribution or "look through policy" with £13m deriving from business profits and £10m from investment income. Under a distribution-only policy on business profits, depending on business behaviour, receipts could decrease by up to £13m.

Appendix XII

LIST OF RESPONSES TO FIRST CONSULTATION DOCUMENT

Deputy Roffey
Deputy Jones
Deputy Guille
Deputy Le Pelley
Deputy De Jersey
Deputy Le Moignan
Deputy De Lisle
Deputy Sirett
Deputy Gabriel
Deputy Brouard
Deputy Parkinson
Deputy McNulty Bauer
Deputy Gollop
Deputy Brehaut
Deputy Matthews
Alderney Rep. Richard Cox

Culture & Leisure Department
Health & Social Services Department
Education Department
Commerce & Employment Department
Social Security Department
Housing Department
Environment Department

Guernsey Training Agency
Guernsey Trustees Association
Chamber of Commerce
Transport & General Workers Union
Guernsey International Business Association
Guernsey Investment Fund Association
Guernsey Insurance Company Management Association
International Bankers Association
Institute of Directors
Assoc. Guernsey Civil Servants
Guernsey Building Trades Employers Association
Institute of Financial Services
Confederation of Guernsey Industry
Guernsey Public Employees' Consultative Committee
Guernsey Assoc. of Pension Funds
Assoc. Guernsey Insurers
Friends of the Earth
Guernsey Bar Council

Guernsey Society of Chartered and Certified Accountants
Acumen International
Active Management Services
Specsavers Optical Group
Healthspan Limited
Ozannes
McKean & Roberts
St Peters Trust
W Le R Robilliard
Constables of the Forest
Le Lacheur & Co
R Northley
P Hame
HSBC
J Hazzan
C Bowker
M Wadsworth
N Crocker
Cheshire Home
H Lancaster
S Perry
C J Thornburn
Guernsey Financial Services Commission
Constables of St Sampson
Guernsey Post Limited
Guernsey Electricity
Cable & Wireless
Generali Insurance Ltd
P Gillson
N G Wilkinson
St Saviours Douzaine
International Private Equity Services Limited
J F Peters
Island Coachways
Nordben Insurance
NRG Limited
A J O Field
M J Sandle
R A Laurent
Cleland & Co
Heritage Group Limited
R Bisson
K J Tydeman
PricewaterhouseCoopers
Ernst & Young
Deloitte & Touche
PKF
BDO

Appendix XIII

SOURCES OF OTHER INFORMATION

In June 2005 the United Kingdom National Audit Office published a report for the States Of Guernsey Public Accounts Committee entitled “Income Generation in Guernsey”. This Report contains an analysis of various income streams and comparisons with other jurisdiction, mainly Jersey and the United Kingdom.

The 2005 Guernsey facts and figures booklet issued by the Policy Council in July 2005 includes a wide variety of information on the Island, including economic, environmental and social data.

The Commerce & Employment Department’s “Building Confidence” Consultation Documents are also very useful background information.

These reports are available on line on the States of Guernsey website: www.gov.gg

PRICEWATERHOUSECOOPERS

ANALYSIS OF THE RESPONSES TO THE SECOND CONSULTATION DOCUMENT ON THE STATES OF GUERNSEY FUTURE ECONOMIC AND TAXATION STRATEGY

31 JANUARY 2006

CONTENTS

	Page
1. Executive Summary	3
2. Introduction	4
2.1 The Scope of the Project	
2.2 Basis of our Report	
3. Overview of Consultation Responses	6
4. Background to Responses on Taxation Matters	7
4.1 Competitive Environment	
4.2 EU Code of Conduct	
4.3 Other Relevant Factors	
5. Responses to Tax Proposals in the Document	9
5.1 Zero Tax	
5.2 Regulated Finance Sector	
5.3 Regulated Utility Companies	
5.4 Taxation of Guernsey Resident Shareholders	
5.5 Increased Social Security Contributions	
5.6 Personal Income Tax	
5.7 Tax Capping for Significant Taxpayers	
5.8 Other Proposals	
6. Alternative Measures	15
6.1 Consumption Taxes	
6.2 Taxation of Retailers and Wholesalers Owned by Non-Residents	
6.3 Taxation of Permanent Establishments	
6.4 Taxation of Income from Guernsey Property	
6.5 Dividend Withholding Taxes	
6.6 Taxation of Undistributed Profits	
6.7 Other Proposals	
7. Responses to Non-Tax Matters	18
Appendix I – List of all Respondents	19
Appendix II – Summary of Responses	24
Appendix III – International Finance Centres Post 2008 Comparative Tax Rates	29
Appendix IV – Isle of Man Tax Strategy	30

1. EXECUTIVE SUMMARY

The Second Consultation Document on the Future Economic and Taxation Strategy for the States of Guernsey was published on 30 September 2005. The Fiscal and Economic Policy Steering Group invited the general public, the business community and other interested parties to submit their views on the Document and the issue of taxation reform generally.

By the end of the process on 21 November, over 500 submissions had been received from a broad range of respondents and over 1,300 people had attended the various public meetings organised by the Steering Group. The responses ranged from submissions that concentrated on single issues to very comprehensive and detailed commentaries. Although there was no unanimity on any of the points, there was a broad consensus in a number of areas. In particular, many respondents recognised both the difficulty of determining the appropriate tax strategy and equally the importance of the task to Guernsey. Furthermore, there was general support for and agreement with most of the proposals made in the Document.

The purpose of this report is to review the submissions in respect of the proposed tax measures. However, we felt that the attention of the Steering Group should be drawn to the responses to some of the proposals not related to tax measures. The key themes arising from the responses were:

- There was a strong emphasis on the need for increased efficiencies in States expenditure. This issue prompted the most number of responses with over 97% of the respondents supporting the need for restraint in public expenditure. Many of these felt that the proposed restrictions in overall expenditure in the Document did not go far enough.
- An analysis and understanding of the economic impact of the proposals was required.
- There was support for restricted and measured use of the States Contingency Reserve.

In addition to these comments, there was a significant level of engagement on the tax measures. Specifically:

- There was broad support for the “zero-ten” proposals. Whilst a number of alternative models were proposed, we believe that these were either unlikely to be compatible with the Code of Conduct or would not fulfil the other objectives of the tax reform proposals.
- Many respondents indicated a preference for some form of goods and services tax to the proposed social security contribution increases. There was a majority view that such a measure should be given greater consideration than currently was the case.
- Whilst there was some support for the proposed increases in social security contributions, the majority of respondents who commented on this measure were opposed to the level of increases proposed in the Document.
- On the question of taxing Guernsey resident company shareholders, the majority of respondents favoured “distribution-only” over “attribution”.
- Most respondents supported the proposed changes to personal income taxes, including the proposal to introduce tax capping for significant taxpayers.
- There was general support for the increases in excise duties, TRV and other indirect taxes. Many respondents favoured measures that targeted motor vehicle usage.
- A strong message from many respondents was that any new taxes introduced or increases in existing ones should not be a substitute for reductions in States’ expenditure.

A number of alternative models were suggested by respondents. With the exception of goods and services taxes, our review indicated that very few, if indeed any, of these measures would meet all the criteria set out by the Steering Group. In particular, it seemed unlikely that many would comply with the Code of Conduct or would generate significant additional revenues.

2. INTRODUCTION

The States of Guernsey Fiscal and Economic Policy Steering Group ("the Steering Group") issued its Second Consultation Document ("the Document") on the Future Economic and Taxation Strategy on 30 September 2005. The Steering Group then invited the general public, the business community and other interested parties to submit responses and comments on the proposals made in the Document. Over 500 responses were received.

The Steering Group has appointed PricewaterhouseCoopers CI LLP ("PwC") to undertake an independent and objective review of these responses. The purpose of this review is to:

- Analyse the profile of respondents and briefly summarise the content of the submissions;
- Review and comment on responses made to the tax measures proposed in the Document;
- Review and comment on any submissions that set out alternative tax measures to those proposed in the Second Consultation Document.

PwC have been asked to comment on the submissions in our capacity as tax experts and, as such, we have focused purely on the specific tax measures and the tax implications of any alternative measures. We have not been asked to consider or comment on the economic or other aspects of the measures and alternative proposals made by respondents. We have also not been asked to undertake a full appraisal of the current proposals or to undertake an analysis of what changes should be made to Guernsey's taxation system.

We have not been asked to examine the relative importance and contribution to the Bailiwick of the financial services industry. Annual statistics published by the States indicate that this sector generates by far the predominant proportion of Gross National Product. It seems self-evident that to replace this contribution in the short to medium term would be extremely difficult. We have also not reviewed the scope and likelihood of encouraging growth in other industry sectors. However, we fully endorse the view that diversification away from the finance sector into other sectors capable of producing similar levels of contribution is likely to be beneficial to the Bailiwick's economy.

This report has been prepared as a report to the States of Guernsey. Although our work has been commissioned by the Steering Group we are given to understand that the report may become a public document.

We are happy for the report to be used on this basis. However, any reader of the report must understand the above terms of reference under which the work has been undertaken and the objectives of our work. We have prepared it to enable the Steering Group to progress the debate on tax reform in Guernsey. It cannot be a full analysis of the situation in Guernsey; it cannot be a comprehensive statement of all tax options open to the Bailiwick. Nor is it in any way an aid to tax planning. We will not accept any liability for actions taken on the basis of the report.

2.1 The Scope of the Project

The work involved in completing the project included:

- Analysis of the consultation documents produced by the Steering Group with regard to tax reform so as to be assured of the States' objectives and aims;
- Review of the submissions received by the States from the public during the consultation period;

We should like to stress that whilst we have carried out a review of the responses to the Document we have not in any way attempted to perform a survey of public opinion.

2.2 Basis of our Report

We have been asked to undertake an independent review. PwC, as a leading professional services organisation, has member firms or correspondent organisations in virtually all territories in the world, including Guernsey. We do not have any direct interest in the Guernsey tax system, except that our Guernsey practice, employees and partners pay Guernsey tax in the same way that all Guernsey taxpayers do – in accordance with the tax legislation currently in place.

Any change in the Guernsey tax system will affect our business as a tax advisory practice and the individuals concerned in their personal capacity, in the same way that it will affect all other tax advisers in Guernsey. However, although we acknowledge this effect, we have taken no account of it in producing this report.

As stated above, we have written this report in our capacity as tax experts – this is not an economic study. It is inevitable that others will have views on aspects of the current proposals that are opposed to those expressed in this report. We are dispassionate in our views as we are working from a basis of wide-ranging and extensive tax experience. We have no political views as a firm and our work is completely apolitical.

It should be noted that this Firm has made its own submissions to the Steering Group, as have most of the leading accounting and tax firms. We have also assisted a number of our clients and other organisations in preparing their submissions. That said, the report has been subject to review and challenge by PwC tax partners from outside the Channel Islands. We therefore believe that we have been able to undertake an objective and independent review of the responses.

3. OVERVIEW OF CONSULTATION RESPONSES

The Steering Group received 504 responses from the public during the consultation period, and approximately 1,325 people attended the various public meetings that were organised.

Of the responses received, 352 were received from individuals, 66 from Guernsey businesses, 33 from various committees and business associations in the Bailiwick including 18 which are financial services forums and 11 from accountancy practices. The remaining 24 were received from Constables and Deputies. A full schedule detailing the respondents is attached in Appendix I.

A large number of the responses, rather than commenting on the specific proposals, focused instead on the management of the reform process. It appeared to us that many respondents were taking the opportunity to raise concerns and issues not necessarily related to the tax reform process. For this reason, we have not necessarily commented on them in this report. However, it would seem appropriate that the States give some consideration to addressing them.

4. BACKGROUND TO THE RESPONSES ON TAXATION MATTERS

The majority of the respondents commented on taxation issues, both tax raising measures and the use of tax incentives. The responses would often focus on one or two specific matters and they fell broadly into two categories:

- Comment on the actual tax proposals made in the Document;
- Suggested alternative measures.

Before examining the comments and alternative suggestions, it is worthwhile revisiting the underlying principles of the taxation strategy. Understanding these principles is the key to assessing how effective the various measures are likely to be and whether they will help the States achieve its objectives.

The Steering Group set out two fundamental criteria which shaped their proposals:

- Sustaining an environment for businesses in the Bailiwick that enabled both the finance and non-finance sectors to compete in the international marketplace; and
- Satisfying the commitment made by the States to the European Union to eliminate harmful tax measures and thus comply with the EU Code of Conduct on Business Taxation.

It can be argued that these two imperatives are intertwined. Many of the jurisdictions with which Guernsey businesses compete are reforming their tax regimes to comply with the Code of Conduct (in particular Jersey and the Isle of Man). If Guernsey do not do likewise, the Steering Group believes there is a significant potential risk of undermining the competitive position of Guernsey businesses. Very few respondents disagreed with this view.

A brief review of these two criteria will provide the context for comment on the responses to Document.

4.1 Competitive Environment

Historically, Guernsey has had a tax regime that has enabled businesses to compete successfully with jurisdictions such as Jersey, the Isle of Man, Bermuda and some of the Caribbean Islands. In recent years, there have been new entrants to this marketplace, including the Republic of Ireland, Cyprus and Malta. All these locations offer some form of low or zero tax regime.

Therefore, if Guernsey is to maintain its competitive position, the view of the Steering Group is that the Bailiwick must respond to developments in competitor jurisdictions. The experience of PwC when advising international finance businesses bears out this view. For ease of reference, we have included in Appendix III a table of the respective tax rates in some of the key competitor jurisdictions.

4.2 EU Code of Conduct

The States has committed to comply with the EU Code of Conduct on Business Taxation (the "Code of Conduct"). The Code of Conduct has a long and complex history and it is outside the scope of this report to examine it in detail.

The purpose of establishing the Code was to eliminate "harmful tax measures" in the EU Member States and their associated or dependent territories. The Code set out broad criteria for identifying harmful practices and specifically named 66 such measures that were features of the tax regimes in the Member States and their associated or dependent territories. Five of these were part of the Guernsey tax regime.

Broadly, the Code of Conduct seeks to eradicate tax advantages available fully or in part only to non-residents rather than to residents in a jurisdiction. This includes tax advantages for transactions with non-residents. The Code also views as harmful measures that include rules for determining taxable profit which are inconsistent with internationally accepted principles. Furthermore, the Code maintains that it is unacceptable for tax regimes to allow a lack of transparency both in how businesses are taxed and in the way measures are administered (eg, case by case special arrangements should not be allowed).

The Document (but not the Code) also states that "a regime that then charges a proportion of its companies at higher rates of tax (specified by sector) is also not deemed to be harmful provided that, as a proportion of the overall economy, these companies are a minority." In other words, as long as the businesses that are subject to a low or nil tax rate make up the larger part of the overall economy, it is acceptable to apply a higher tax rate to certain specific sectors.

When adopting the Code of Conduct, the EU Working Group did not set out detailed or comprehensive rules against which proposed measures can be judged. We are informed that there have been high level discussions with the UK government on the types of measures that are likely to be acceptable under the Code of Conduct. It seems that the preference is for an overall regime that is simple and straightforward with as few different tax rates as possible. It is also understood that the basic principle of the "zero-ten" model has been accepted as compliant with the Code.

4.3 Other Relevant Factors

Whilst the above two factors are key to determining an appropriate tax regime for Guernsey, it appears to us that there are a number of other factors that should be borne in mind when assessing the effectiveness of potential tax measures.

- Its fairness and transparency;
- The ease of assessment and collection of taxes;
- The simplicity and ease of taxpayer compliance;
- The absence of overly complex anti-avoidance provisions;
- Minimal implementation and administration costs.

Overriding these criteria will naturally be whether the measures will actually raise the intended tax revenues. This links to a further aspect to be borne in mind when considering the effectiveness of a tax measure is the extent to which it allows a government to react easily and quickly to economic change.

In this Firm's experience, governments tend to favour taxes that are levied on the income and expenditure of significant numbers of taxpayers, primarily because that allows significant revenues to be raised at low actual rates of tax and spreads the burden.

5. RESPONSES TO THE TAX PROPOSALS IN THE DOCUMENT

All of the tax proposals made by the Steering Group elicited responses. As stated elsewhere in this report, there was often a broad spectrum of responses and we have endeavoured to reflect this range as much as possible, but it has not been possible to comment on every single response so we have concentrated on those where the same or similar comment has been made by a number of respondents.

Where there was broad consensus on a particular measure and overwhelming evidence that it meets all or most of the criteria, we have not sought to go beyond acknowledging this. We have only been asked to review responses to the proposals in the Document. It is not within the remit of the report to examine the proposals themselves. .

5.1 Zero Tax

Where a preference was expressed, there was overwhelming support for the introduction of a general corporate income tax rate of zero. There was a similar level of support for the proposal that captive insurance companies and collective investment schemes should fall within the zero rate.

The vast majority of respondents who commented on this measure, accepted the Steering Group's argument about the need to preserve the competitive position of the finance industry and that the zero tax rate was a key element of this. A number of respondents also felt that the zero rate could encourage growth in the other business sectors.

5.2 Regulated Finance Sector

The Steering Group has proposed that certain finance businesses regulated by the GFSC should be taxed at 10%. It is accepted that in principle this concept is compliant with the Code of Conduct. We have not undertaken any business analysis to determine whether these businesses as a sector make up a sufficiently small proportion of the overall economy and would suggest such an analysis may be worthwhile.

Assuming that this will be compliant with the Code of Conduct, the impact on the Bailiwick's competitive position must be considered. This point is covered in many of the responses and is one of the most debated aspects of the overall package of proposals.

Where respondents commented on this measure, there was a general acceptance that applying a higher positive rate to some sectors of the finance industry was a justifiable means of raising tax revenues, provided that this would not be detrimental to the industry in the long term. The majority of respondents who expressed a view also supported the proposed rate of 10%, with most agreeing with the Steering Group that this best balanced the need to maintain the competitive position with raising public revenues.

Within the respondents who supported the 10% rate for regulated finance businesses, there were a number who advocated narrowing the spectrum of business subject to that rate (particularly to exclude Principal Fund Managers). Indeed, there were some who saw merit in restricting this rate to banking business in its purest sense. It was also suggested by a few respondents that the 10% rate should be a temporary measure only, with all businesses moving to zero at the earliest opportunity.

However, outside of this majority, there were those respondents who proposed:

- The application of a range of rates from zero up to 20%. This could be on a company by company basis dependent on the sector in which a company operated or could be applied to different income streams. Proponents of the latter suggested differing rates for trading income and investment income.
- A single tax rate applicable to the finance industry of 20%.

It was apparent that this debate was influenced by the publication of a revised tax strategy by the Isle of Man on 3 October 2005. This was cited by many respondents and for many it changed the competitive position. (A summary of the Isle of Man proposals is included at Appendix IV.) Prior to this, the Isle of Man had proposed to adopt a zero-ten model similar that proposed in Jersey.

On the face of it, the debate was over whether the tax rate for finance companies should be 10%, 20% or a combination of the two. However, on closer examination, the issue that respondents sought to address was the extent to which international businesses are influenced by income tax rates and by other business costs such as social security, property taxes and indirect tax costs.

The businesses that will fall within the regulated company rate are primarily service providers. With the exception of some of the banking sector, they tend to be providing administration, management and other services to "zero tax" entities such as trusts, captive insurance companies and investment funds. This is an important sector because in many instances, these businesses tend to employ relatively large numbers of people.

5.2.1 The Case for 20%

The respondents who favoured a 20% rate asserted that some businesses are less motivated by the rate of tax, but are more interested in their profits before tax. The argument is that, when assessing the performance of operational units, some international businesses regard the profits before tax as the most important measure. To the extent that this is true, such businesses would be indifferent to paying tax at 20% but much more sensitive to increases that impact on profit such as social security contributions and property taxes. The respondents imply that this is the case even if these businesses are currently paying tax in Guernsey at less than 20%.

However, this is not true for many businesses, for whom the tax rate is very important. The acceptance of these two factors appears to have prompted some respondents to advocate a range of alternatives:

- A single rate of 20% to be applied, coupled with much restricted increases in social security contributions;
- Businesses could choose between 10% plus increased other taxes and 20% without the other increases;
- A range of different rates to be available, with a small number suggesting that businesses should have the capacity to agree with the Administrator of Income Taxes on how they will be taxed.

However, it is very difficult to reach a consensus opinion on this matter. All businesses have different individual circumstances that often generate conflicting tax requirements. This is equally true for businesses within one sector of the finance industry and for the different sectors themselves. The lack of consensus arises from a number of factors:

- Finance businesses in Guernsey are owned by parent companies in many different jurisdictions (the UK, Germany, France, Italy, Canada, the US and Switzerland) all of which have different ways of taxing Guernsey-based subsidiaries.
- Some parent companies are taxed in their home jurisdictions on the profits in Guernsey and receive full credit for any Guernsey income tax while others are taxed but get restricted or no credit.
- Many parent companies are not taxed at all on Guernsey profits, for a variety of reasons.
- Some groups effectively "mix" profits from low tax jurisdictions with those from higher tax territories to manage the overall tax burden of the group.

At first sight, therefore, it can be seen why the ability to offer a menu of tax options would make Guernsey an attractive business location. However, we foresee a number of practical and technical obstacles to such a regime:

- One of the fundamental principles of the Code of Conduct is that a tax regime should be transparent. A regime with a range of different tax rates applying to different industry sectors is less transparent than one with fewer rates. This potential problem is compounded by the fact that in Guernsey it is not just different sectors that desire different rates, but companies within the same sector that have divergent tax requirements. A regime that is that flexible is unlikely to be regarded as sufficiently transparent.
- The same point applies equally to having a range of different rates for the various income streams within a single company, as some respondents have suggested.
- The Code of Conduct does not allow for businesses to choose a tax rate or have optional taxes. Thus, allowing a company to pay income tax at 20% rather than increased employers' social security is unlikely to be acceptable.
- Many jurisdictions (including the UK and the US) restrict or deny credit for overseas tax where a business has the ability to chose the rate or quantum of this tax.
- Seeking to tax investment income at different rates from trading income can be very difficult within the finance sector where the distinction is more blurred. For example, captive insurance, fund management and certain banking activities are likely to be trading, although they have many of the features of an investment business.
- The commitment to transparency greatly reduces the ability of the Tax Office to enter into special arrangements.
- As mentioned above, a simple tax system can allow a government to more easily react to economic change. A system with a range of different tax rates offers less flexibility, especially when taxpayers have the ability to move between rates.

It is also important to address the competitive position. In our experience, the tax rate is certainly a factor that international businesses consider when locating, expanding or restructuring operations. We believe that it would be a more important factor if a significantly different tax rate is available in another jurisdiction less than 40 miles away, where labour costs are broadly comparable, i.e. Jersey. Given this factor, applying any rate to the finance sector which is higher than 10% looks uncompetitive.

5.3 Regulated Utility Companies

The Steering Group proposed that the trading activities that are regulated by the Office of Utility Regulation should be subject to a tax rate of 20%. The small number of respondents to this proposal included several utility companies. The respondents were all supportive of the measure.

5.4 Taxation of Guernsey Resident Shareholders

The Document specifically sought views on how to tax the profits of companies that are owned by Guernsey resident individuals. The Steering Group presented two options:

- Guernsey resident individuals will be taxed on the profits of companies in which they are shareholders. Their proportionate share of the company's profits would be treated as their own taxable income. This option has been termed "attribution".
- Guernsey resident individuals would only be taxed on dividends received from companies carrying on trading activities. Any investment income would be taxed on an attribution basis. This option has been termed "distribution-only", although it may be more accurate to describe the proposal as "attribution of investment income".

A large majority of the respondents who expressed a view on this matter supported distribution-only. Many felt that it had the capacity to stimulate and encourage new entrepreneurial businesses, especially outside the finance sector. A common thread among respondents was a concern over the potential complexity of an attribution regime. That said, it was accepted that a number of safeguards would be required to discourage abuse of the regime, particularly with regard to investment income. However, a large number of respondents did not appear to realise that it was intended to apply distribution-only to trading profits and not to investment income.

The supporters of attribution generally felt that it could be an effective means of maintaining States revenues. It was felt that its absence could result in a much increased use of companies in tax planning. Many such respondents believed that business owners would use distribution-only to make payment of income effectively optional through accumulating profits until the sale of the business.

This Firm is very well acquainted with the complexities and potential difficulties of addressing this issue. Our experience indicates that there are a number of disadvantages with attribution as well as a number of advantages with distribution-only.

- Although attribution has the apparent attraction of maintaining tax revenues, it would require substantial policing and anti-avoidance legislation. In addition to this, successful operation would require an unprecedented level of disclosure by Guernsey taxpayers when making annual tax returns. These factors are likely to prompt a major change in the culture of tax compliance in the Bailiwick. Similar proposals made in Jersey and the Isle of Man have provoked significant concern among their business communities.
- There are significant legal obstacles (beyond the tax ones) that could potentially render attribution unworkable and expose the States to judicial challenge. Our understanding (based on discussions with legal experts) is that an attribution regime is potentially very vulnerable to challenge under both company law and human rights law.
- It is likely that enforcement of the attribution rules would require provisions forcing the company to act as agent for the resident shareholders in certain circumstances. It is doubtful that such provisions would comply with the Code of Conduct.
- It seems likely that distribution-only would be regarded as less unfair than attribution and has the potential to encourage investment in trading businesses.
- Distribution-only would require new legislation and administration. In particular, it would be necessary to define clearly what is meant by “trade” and “investment income”. Provisions would also be required to tax loans by companies to shareholders and the provision of assets and other benefits to shareholders to discourage abuse. However, this is still potentially less onerous than the provisions required to effect attribution, as it would reduce the population of taxpayers within the scope of the charge. Moreover, the proposal to tax investment income on an attribution basis may well deal with the potential tax leakage that some respondents identified.

In short, we felt that neither attribution nor distribution-only were perfect solutions but distribution-only was the less imperfect of the two. Furthermore, we did not identify any workable alternatives that complied with the overall objectives of tax reform.

5.5 Increased Social Security Contributions

This appears to be the most controversial of the proposals made in the Document. It was also one of the few areas where the majority view did not agree with the Steering Group. Out of the Steering Group’s tax-raising proposals, this was by far the most significant, proposing to generate £35m out of a total of £60m.

Respondents identified a number of problems with the proposals.

- Social security contributions are part of the cost of employing staff. Guernsey’s economy is dominated by service industries for whom the biggest costs are wages and salaries. Increasing employers’ social security contributions will add to this cost. Many respondents believed that Guernsey already has a relatively high cost of labour. It was generally felt that any measure that increased the cost of employing staff in Guernsey will have a negative impact on the competitive position of the Bailiwick.

- The proposed increases to employee contribution rates would have an immediate impact upon individuals' disposable income. This could lead to pressure for pay increases. To the extent that this was addressed, this is a further impact on the cost of labour.
- For many correspondents, the link between the contributions made by an individual and their eventual entitlement to a pension was important. Respondents felt that the proposals potentially eroded this link; the consequence is that the contributions would increasingly be viewed as an income tax rather than an insurance premium.
- The measures impact most on Guernsey's "middle income" earners. Many respondents felt that too much of the proposed additional tax burden was being borne by this group.
- Although much of the additional revenue would come from the middle earners, many respondents felt that the proposed increase would have a disproportionate impact on the low paid, who would face an increase in the rate of contribution, and on the self-employed.
- The contributions paid and the resultant burden would be increasing significantly as a result of the proposals. However, because the increased contributions would only replace funding by the States, there would not actually be an increase in the investment into the Social Insurance Fund. Many respondents feared that the combination of falling investment returns and the increasing proportion of the population nearing retirement age would mean that in the near future additional investment into the Fund would be required. They felt that this would be difficult to achieve if contributions rates had already been increased so sharply in 2008. If rates did have to rise again, the negative impact could be multiplied.

The respondents who did support the proposed increases in contribution rates identified a number of factors that made this measure attractive:

- The administration to assess and collect the contributions is already in place so there would be only marginal costs of implementation.
- There is a broad base of contributors therefore relatively large sums of revenue can be generated with modest rate rises.
- The most affected employees are likely to be those earning between £34,320 and £60,000 per year. Many respondents felt that this group is probably most able to afford a greater contribution.
- Much of the impact also falls on employers, many if not most of whom would be beneficiaries of reductions in business income tax. Increasing their social security contributions was seen as a means of them contributing to public revenues.

Taking these factors into account, a significant minority of supporters of this measure felt that there was merit in removing the contribution threshold altogether.

Clearly, strong arguments have been made on either side. Indeed, many respondents felt that the debate distils down to the relative impacts of the introduction of a consumption tax or the proposed increases in social security contributions, particularly with regard to the affect on the Bailiwick's competitive position.

Where many of the respondents on both sides of the debate did agree was over the need to better understand the economic impact of both measures.

5.6 Personal Income Tax

There was general support for the proposal to maintain the personal income tax rate at 20%. A small number of respondents proposed reductions in the rate to increase the attraction of the Bailiwick while others proposed increases in the rate as a straightforward means of raising significant revenues.

Compared to many other jurisdictions, including a number of relatively nearby jurisdictions such as the UK, France and Ireland, the current rate of 20% is already very attractive, particularly when coupled with the absence of capital gains tax and wealth taxes.

Furthermore, if significant amounts of additional tax are to be raised, the rate actually needs to be increased substantially. Arguably, a significant increase could have a negative impact on the Bailiwick's competitiveness as it makes it less attractive for entrepreneurs and senior executives.

5.7 Tax Capping for Significant Taxpayers

Relatively few respondents commented on the proposal to introduce a cap on the tax payable on non-Guernsey income by taxpayers with very high income. Where comments were made, many respondents favoured it because they felt that it has the potential to attract wealthy individuals to relocate to Guernsey. Although little if any empirical evidence was provided, it was generally felt that an influx of a small number of higher wealth individuals could have beneficial impact on the wider economy.

Jersey has for a number of years operated similar measures and attracted a number of high net wealth individuals to relocate there. However, to make such a move really attractive, we would agree with the respondents who felt that the arrangements should not be restricted to non-Guernsey income but apply to all income, as this is more likely to encourage the retention of funds and investments in Guernsey.

Therefore, when designing such a regime, it would need to be understood:

- What the impact on the wider economy may be of applying a lower tax rate to non-Guernsey income; and
- How such a regime would interact with attribution or distribution-only.

5.8 Other Proposals

The other measures proposed in the Document have been accepted as reasonable by the majority of respondents and therefore it is not proposed to comment on them other than to record some of the more common observations made. These are:

- Rather than freezing personal allowances, it may be better to phase out allowances for incomes above certain levels, as this better protects those on low incomes. No indications were made of what this level should be.
- It was suggested that relief for interest payments should continue to be available for loans with a business purpose. The Document not been specific on this point which had caused a certain amount of disquiet.
- There was general support for restrictions on mortgage interest relief, but many called for greater clarity on the levels at which relief would be restricted.
- Measures to increase vehicle excise duty and fuel duties were particularly welcomed.
- Although the increases in TRV are accepted, some respondents felt that support for those on lower incomes should be included.
- Some respondents suggested raising alcohol and tobacco taxes to UK levels. A small number of respondents also called for complete prohibition with regard to smoking, on the basis that it would reduce healthcare costs.

6. ALTERNATIVE MEASURES

In addition to commenting on the specific proposals in the Document a number of respondents advocated alternative tax raising measures. It is not the purpose of this report to undertake a thorough analysis of these alternative proposals; rather it is intended to highlight those that have most support and identify those that we believe may merit further consideration by the Steering Group.

6.1 Consumption Taxes

The term “consumption taxes” covers a multitude of taxes from a complex EU-style VAT regime to simple sales taxes levied on retail transactions. The introduction of such a tax is not proposed by the Steering Group. However, a very significant number of respondents have challenged this stance. In particular, as discussed above, many saw this measure as preferable to increased social security contributions. There are a number of opponents to such a measure but these are very much in the minority.

Most of the respondents appreciated the distinction between a sales tax, typically applying to a single point of sale and normally only levied on goods, and a Goods and Services Tax, similar to VAT. Many explicitly pointed to the proposed Goods and Services Tax in Jersey as a potential model to adopt. Whilst many accepted that the introduction of such a tax would be a significant departure for Guernsey and would involve implementation and administration costs not associated with measures such as social security contributions, they believed that the benefits outweighed these factors.

- Provided it was accompanied by support for those on lower incomes, it was regarded as more equitable than other measures.
- By applying it to a wider range of economic activity, a GST/VAT could generate relatively large sums of money at a low rate.
- It would be easy to understand particularly if exemptions and similar measures are minimised.
- It was argued that the costs of collection are largely borne by businesses, most of which would be benefiting from reductions in income tax.
- GST/VAT has a wider base of contributors, catching visitors and businesses that may not otherwise pay tax.

A full analysis and discussion of consumption taxes is outside the scope of this report. It is clear that there is substantial support to further investigate its merits. However, a very strong message from many respondents is that it should not be considered as a substitute for reductions in public expenditure.

6.2 Taxation of Retailers and Wholesalers Owned by Non-Residents

The Isle of Man has proposed to tax at 10% the profits of businesses that are owned off-island which sell (both retail and wholesale) imported goods. Several respondents have suggested that Guernsey should consider such a measure.

The proposal is attractive in that it offers a solution to the perceived inequity between retailers owned outside Guernsey and those owned by Guernsey residents. However, there are a number of drawbacks.

- It has the potential to be very complex, particularly where there is a mixed ownership or where a business sells both imported and locally-sourced goods.
- The profits generated in this sector as a whole would not appear to be significant enough to generate significant tax revenues.
- The introduction of a special rate of tax may prompt some of the potentially affected businesses to reconsider the scale and profitability of their Guernsey operations.
- It is not clear how this measure would be viewed from the Code of Conduct perspective.

Moreover, the perception of inequity may be better addressed through the policy of distribution-only rather than attribution for Guernsey resident shareholders.

6.3 Taxation of Permanent Establishments

The proposal has been made to only tax a business with physical presence or other place of business in Guernsey (which can include employees based here) rather than by virtue of the company being registered here. Currently, Guernsey, along with very many jurisdictions, taxes both companies that are resident and those that have a place of business here. On the face of it, this would give the ability to exempt investment companies and many of the current exempt and international companies.

There are two key problems with such a measure:

- Under internationally accepted definitions of a permanent establishment, it would catch many of the businesses that would require a zero rate, such as principal fund managers, general partners of investment funds structured through limited partnerships, banking activities and captive insurance companies.
- Whilst compliance or otherwise with the Code of Conduct is not absolutely clear, it is apparent that taxation on a territorial basis is likely to be less acceptable than on a residence basis.

6.4 Taxation of Income from Guernsey Property

A number of respondents have proposed the introduction of property taxes whereby rental and other income from property ownership is specifically taxable. Suggestions included:

- Applying some form of withholding from rental payments made to non-resident landlords, similar to the regime operated in the UK.
- A tax on profits from property development and speculation.
- Extension of the existing Dwellings Profits Tax regime to include commercial property.
- Introduction of a specific class of taxable income based on rentals, applying to all landlords.

It is felt that such measures are unlikely to fall foul of the Code of Conduct as the generally passive nature of rental income is more akin to investment than business activities. To that extent therefore these suggestions may merit further consideration. Such consideration should include:

- The potential complexity of operating such a regime and
- The capacity to raise significant tax revenues.

6.5 Dividend Withholding Taxes

Many jurisdictions levy withholding taxes on dividends and similar payments made to non-residents. Indeed, Guernsey currently applies withholding taxes on interest payments made in certain circumstances. The attraction of such a measure is its ability to generate tax revenues from non-resident shareholders.

The drawback with such a measure is that, in order to comply with the Code of Conduct, withholding taxes would need to apply to dividends paid by all companies. International businesses and the finance industry in particular (especially in the funds and insurance sectors) look for entities and similar vehicles that are tax neutral. An absence of withholding taxes on dividends is a vital component of this and the success of the finance sector in Guernsey has relied heavily upon the ability to offer tax neutrality. To introduce dividend withholding taxes would destroy that neutrality and, therefore, in our view, would undermine the objective to preserve Guernsey's competitive position.

6.6 Taxation of Undistributed Profits

In commenting on the taxation of company shareholders, a number of respondents pointed to the ability of Guernsey resident shareholders to accumulate profits in a company until the business is sold for a capital gain such that the profits are potentially received tax free. A suggested solution to this perceived problem (put forward by one respondent) is to tax the undistributed profits of a company every five years. However, there are a number of very significant obstacles to such a measure:

- Such a charge would be levied on the company and, according to the respondent, in order to comply with the Code of Conduct, it will need to apply to all companies. This would include all the various companies where the intention is to accumulate profits, such as certain investment companies, captive insurance companies and special purpose companies. If such entities are required to pay 20% on their retained earnings every five years, it is unlikely that many of them will remain in Guernsey after 2013.
- The level of a company's distributable profits is important for a number of company and regulatory law purposes. Companies are required to account for estimated and actual tax liabilities in calculating their distributable profits. This is done on an annual basis. It is hard to conceive how a finance director can estimate what tax the company may have to pay on the profits for 2009 that may be taxed in 2014 given the changes that could happen in that period which might impact on this calculation.
- Many of the regulated finance companies are required by law to maintain minimum levels of capital which frequently include its retained earnings. It is easy to envisage a potential conflict between tax and regulatory requirements.

6.7 Other Proposals

A variety of other proposals were made by respondents including such measures as:

- Energy consumption taxes
- Bank collection taxes
- Importation duties
- Additional increases in TRV levels for Open Market properties.

Whilst some such measures can be mechanisms for changing people's behaviour, unless they are introduced at very high levels or rates, they are unlikely to generate substantial revenues. Furthermore, as many represent new taxes for Guernsey, they have implementation and administration costs that would reduce these revenues.

7. RESPONSES ON NON-TAX MATTERS

As set out above, this report is prepared by us as tax experts and so we are only able to comment on the taxation aspects of the submissions that were made. However, many submissions included proposals and suggestions that are not related to tax and whilst we have not commented on these, we have summarised the most common ones below:

- A number of residents of Alderney expressed concerns that the particular position of that island was not taken into account sufficiently in setting the proposals.
- There was frequent comment on the need for a full economic analysis of the proposals and their impact. It is our understanding that the Steering Group have commissioned such an economic analysis.
- The most common response was for more restraint in public expenditure. In many cases, respondents felt that the proposed 5% reductions did not go far enough. In addition, a large number of respondents called for specific and clear details of how the Steering Group proposed to reduce public expenditure.
- It was noted by a large proportion of contributors that the States currently has little, if no, debt and a large Contingency Reserve. It was suggested that this Reserve be utilised in part and that borrowing could be a resource utilised in order to assist the transition to a new tax regime.
- Rather than the increase proposed in company registration fees (to £1,000 per year), most respondents confirmed that they would prefer to see a sliding scale method of applying the charge, based on turnover or profit, rather than a single one off increase. A number of respondents were concerned about the potential damage to the Bailiwick’s fiduciary businesses if fees were significantly higher than other offshore jurisdictions.
- A high number of individuals were concerned about the payment of social security benefits in Guernsey. Many respondents felt that the benefit system should be overhauled and claimants should be given greater incentives to work.
- A significant portion of the contributors discussed the concept of “selling” Open Market licences, or imposing criteria on their availability so that only very high net worth individuals could live in the Bailiwick on the Open Market.
- A number of respondents encouraged the States to consider the sale of surplus assets such as land and property.
- A small number of contributors advocated the introduction of compulsory private health insurance to reduce the costs of publicly provided healthcare.
- Some respondents noted that the opportunities to work more closely with Jersey in areas of common concern should be explored. It was felt that this could reduce costs for both States and increase expertise on certain issues, for example, waste disposal.

APPENDIX I

List of all Respondents

General Public

A Archer
A Edirisooriya
A Falla
A J Bracegirdle
A Johnston
A K Masterton
A Lindsay
A P Clark
A S Ozanne
A Taxpayer
Alma Harradine
Alec Forty
Alex Lindsay
Allan Bougourd
Amanda Fasola
Andrew Bisson
Andrew Round
Andy Coleman
Ann Bowditch
Anne Shakerley
Anon. 86 year old pensioner
Anon. Local Accountant
Anonymous (4)
Anthony J O Field
B A Whitworth
B L & M H Timms
Barbara Lesley
Barry Cash
Barry Paint
Bob Battye
Brian Chapman
Brian Seth-Smith
Brian Singleton
Brian Veillard (2)
Bridget Cowans
C Archer
C Baker
C J G Russell
C J Hurley
C R Lowe
C Radford
C S Barnes
Caroline Allisette
Caroline Bowker
Chris Coles
Chris Copperwaite
Chris Le Tissier
Chris Mallandaine
Christopher R Hawden
Clifford Edgecombe
Colin Langlois
Colin Le Bachelet
Colin Le Conte
D A Hardman
D A Paul
D Cornwall
D R McIntosh
D T F Ozanne
D V Allen
Dave Barrett
David & J W Bromley
David Bastable
David Evans
David Godfrey
David J Kershaw
David Piesing
David J Warr
David Staples
David Thompson
Denis and Patricia Leech
Derek Lewry
Derek Smith
Don & Chris Grant
Donald Hughes
Dr B E Mealing
Dr Brian Parkin
Dr Colin Clark-Monks
Dr E H Laidlow
Dr Ian Gee
Dr J E C Twentyman
Dr R Creery
Dr Robin P J Endean
E A Davies
E McKay
Eddie Martel
Edward Atter
Eric Gaudion
Eric Legg
Evelyn & Graham Rabey
Felicity J Haskins
Francis X Paul
Frank Dean
G A Kelly
G B Heath
G F Sargent
G Fusellier
G G Robert
G Johns
Gary Hart
Gavin S Ferguson
Geoff Monks
Geoffrey Chapman
Geoffrey Dorey
Geoffrey Lambert

Geoffrey W Mahy
George Le Couteur
Gordon Rive
Graham Parrott
Grant Hamilton
Grant Hutchins
Greta Souter
H C Reading
Harold Bull
H D & JG Joyce
Herbert Nicholls
Herbert Winterffood
H M Green
Huw Evans
I H Ogier
Ian Brouard
Ian Haddow
Ian Larby & Mya Roberts
Ian Partington
Irene Simonet
Ivan Roberts
J D Mounter
J E Antill
J Gosney
J H Lenfestey
J J Rihoy
J M McKean
J M Parnwell
J N Bewey
J R & B M Le Pelley
J S Guilbert
J T Charman
J W Belshaw
James McDonald
Jan Kuttelwascher
Jane Livermore
Janet, Louise & James Wallis
Jason Cook
Jean Jorgensen
Jenny Duncan
JGM Geach
Jo Carre
Joan Fisher
John & Ann Fox
John Dempster
John A Masterton
John Angliss
John Bracegirdle
John Buchanan
John Cowley
John Eyre
John F Dyke
John Ogier
John F Peters
John Russell
John F Seymour
John Higgs
John Le Page
John M Eker
John Schute (3)
John Torode
John West
Jon Collenette
Jonathan Hazzan
Jonathan Skelton
Judith Hayman
Julian Lane
Julian Parker
Jurat L A Moss OBE
Jurat Rev'd Peter Lane
K T Savident
Keith Corbin
Ken Rowe
Kevin Bown
Kevin McGoldrick
Kevin Mechem
L & A Z Wheeler (2)
L N Stewart
Lawrence Adkins
Linda Gallienne
Lloyd & Enid Le Prevost
Lucy Brouard
Lucy Skelton
Lynne De Guerin
M F Cooper
M J Atkinson
M J Blampied
M J Collenette
M J Tidd
M Le Poidevin
Marc Winn
Marco Ciotti
Margaret Laws
Marion Phair
Marjorie Angell
Mark Aslett
Mark Colver
Mark Le Ray
Mark Winter
Mark Woodall
Martin Bienvenu
Martin Harvey
Martin Le Lievre
Martin Sandle
Martin Tolcher
Martyn & Alison Torode
Martyn & Rachel Barbe
Mason Paul
Maureen Wadsworth
McKean & Roberts
Michael Comerford
Michael Corbin
Michael Ewins
Michael Head
Michael Heyworth
Michael Le Conte
Michael O'Gorman
Michael Paul
Michael S Thornton
Michael Wilkinson
Michelle Levrier
Michelle Norman

Michelle Trott
Mike Appleqvist
Mike Collins
Miriam Bisson
Miss P Bourgaize
Mr W & Mrs O Allen
Mrs Emma Edwards
Mrs Joan Bichard
Mrs P A Smith
Mrs P B Ashworth
Mrs S C Endean
Mrs S Conder
Mrs Susan Shaw
N G Wilkinson
N L Parnwell
Nicholas Day
Nicholas J Falla
Owen T Le Tissier
P A Voute
P Cataroche
P D Hyde
P Edge
P Falla
P O Gallienne
P R Winter
P Rowlinson
Pamela Russell
Pat Swoffer
Pat Wisher
Paul Elliott
Paul Grabham
Paul Heald
Paul Holloway
Paul J Cutter
Paul Sloman
Paul Srodzinsky
Pauline Marquis
Peter Cumming
Peter Davies
Peter Ferbrache
Peter Gill
Peter Gillson
Peter Hamer
Peter Lihou
Peter M van der Tang (2)
Peter McGovern
Peter Ogier
Phil Saunders & Kate Smith
P L Randell
R H Bartlett
R K Keyho
R Oswald
R P Barton
R S Taylor
R W Mabire
R Weston
Raymond Berry
Rees Bryant
Rev Marc Trickey
Richard Battersby
Richard Conder
Richard Mather
Richard Pearson
Rick H Felbabal
Rihoy & Son
R J Raymond
Rob & Sharon Prow
Robert A Gill
Robert Holdsworth
Robert M Chilcott
Roger Dadd
Roger Perrot
Roselle Bourgaize
Rosie Dorey
Roy & Elizabeth Northey
Roy Bisson (2)
Rudi Stockreiter
Rupert Dorey
Rupert Evans
Russel Michel
Russell & Sue Scandrett
Ruth Hoffmann-Sales
S F Carnegie
S J Barton
S R Bott
Sean Green
Shane Langlois
Shirley Meader
Simon Naftel
Simon Perry
Simon Thornton
Sophie Bennett (2)
St John A Robilliard
Stephen Black
Stephen Wiltshire
Steve & Janet Foss
Steve Bichard
Steve Brooks
Steven Le Huray
Struan Robertson
Sue Childs
Suki Summer
T A C Bush
T A Wetherall
T G White
T M Le Tissier
T W S Holder
Terry Moore
Terry Naftel
Tim Henderson
Tom Wright
Tony Booth
Tony Carey
Tony Grange
Tony Talmage
Tony Wills
Trevor Matthews
Val Rowland
W Neville
Wendy Green
William De Saumarez

Committees/Associations

Alderney Chamber of Commerce
Confederation of Gsy Industry
Citizens Advice Bureau
C.I. Tobacco Importers & Manufacturers Association
Committee of Gsy Retail Banks
Friends of the Earth
Gsy Association of Pension Funds
Gsy Association of Trustees
Gsy Building Traders Association
Gsy Classic Vehicle Club
Gsy Consumer Group
Gsy Enterprise Agency
Gsy Healthcare Group
Gsy Insurance Company Management Association
Gsy Investment Fund Association
Gsy Marine Traders Association
Gsy Motor Traders Association
Gsy Organic Growers
Gsy Police Association
Gsy Public Sectors Association
Gsy Society of Chartered & Certified Accountants
Gsy Welfare Service Ltd
Institute of Directors
Insitute of Financial Services
STEP Gsy Branch
Gsy Chamber of Commerce
Gsy International Business Association

Douzaines

Island Douzaine Council
Constables of the Castel
Constables of the Forest
Constables of St Andrew
Constables of St Martin
Constables of St Pierre du Bois
Constables of St Saviour
Constables of Torteval

States Members

Deputy Peter Roffey (2)
Deputy Geoff Mahy
Deputy Brian De Jersey
Deputy Janine Le Sauvage
Deputy Le Moignan
Deputy Hunter Adam
Deputy Al Brouard
Deputy Martin Ozanne
Deputy Mike O'Hara
Deputy Diane Lewis
Deputy Mary Lowe
Deputy Barry Brehaut
Deputy Carla McNulty Bauer
Deputy Scott Ogier
Deputy David De Lisle
Deputy Peter Sirrett
Deputy David Jones
Deputy William Bell
Deputy Parkinson
Deputy Le Tocq
Deputy Dorey
Deputy Honeybill

States Departments

Commerce and Employment Dept
Culture and Leisure Department
Education Department
Environment Department
Health & Social Services Dept
Home Department
Housing Department
Public Services Department
Scrutiny Committee
Social Security Department
States of Alderney – Policy & Finance Committee

Finance Business

Abacus
Anson Group Ltd
Bachmann Group
Callum Beaton Insurance Consulting
Carey Group
Carey Olsen
De Putron Fund Management (Gsy) Ltd
Federal Trust Co Ltd
Heritage Group Ltd
Investec Bank (CI) Ltd
Mees Pierson Reads
Nordben Life & Pension Insurance
Private Equity Fund Managers Ltd
Royal Bank of Scotland Int’l
Safehaven International Ltd
St Peter’s Trust
Trust Corporation of the C.I.
Acumen International
BDO
Brehon Chartered Accountants
Chandler Backer Fiduciaries
Cleland & Co Ltd
Deloitte & Touche
Featherstone Leach
KPMG
Le Lacheur & Co
PKF (Gsy) Ltd
PricewaterhouseCoopers

General Businesses

Amisfield Invesmtents Ltd
Barras Car Centre
Blackwell Jewellers
Brennan & Co

Belton Associated Ltd
Boatworks +
Cable & Wireless (Guernsey)
CDM Management
Claire's Curls Hairdressing Salon
Creasey's Ltd
E A Carey (Europe) Ltd
Focus Publications Ltd
Fuller Developments Ltd
G&B Gardening
Garenne Group
Goldridge Estate Agents
Graham Ogier Ltd
Guernsey Electricity Ltd
Guernsey Post
Healthspan
Heating & Plumbing Engineers
Herm Island
International Energy Group
Island Waste Ltd
L'Aumone & St Sampson's Medical Practice
Le Mont Saint Garage
McKean & Roberts
Nicholas Day
Notre Monde Ltd
Ogier's Ltd
Offshore Electronics
Organisation Development Ltd
Pyramid Construction
Radio & Electronic Services Ltd
Revolve Theatre Co Ltd
Sarnia Hotels
Sphere Management Ltd
Specsavers
Stan Brouard Group
Swallow Apartments
Swoffers
Vets 4 Pets
Vision (Alderney)
Walter Property Ltd

Miscellaneous

Methodist Church – Gsy Circuit
St Johns Ambulance Alderney
The Ladies' College Gsy
Gsy Financial Services Commission

APPENDIX II

Summary of Responses:

		Overall %
General Public	352	70
States Deputies	22	4
Representative Bodies/Association	33	7
Businesses	66	13
Parish Constables	7	1
States Bodies	14	3
Miscellaneous	10	2
Total	**504**	

Not all respondents commented on all of the proposals in the Document. Where statistical analysis has been provided, this is based on respondents clearly expressing support or opposition to a particular proposal.

1. Change Needed

	Yes	%	No	%
General Public	48	73	18	27
States Deputies	4	100	0	0
Representative Bodies	7	88	1	12
Businesses	9	100	0	0
Parish Constables	1	100	0	0
Summary	**69**	**78**	**19**	**22**

2. Corporate Tax Rate of 0%

	Yes	%	No	%
General Public	51	89	6	11
States Deputies	6	100	0	0
Representative Bodies	13	100	0	0
Businesses	21	88	3	12
Parish Constables	2	100	0	0
Summary	**93**	**91**	**9**	**9**

3. Captive Insurance Companies at 0%

	Yes	%	No	%
General Public	4	80	1	20
States Deputies	0	0	0	0
Representative Bodies	3	100	0	0
Businesses	5	100	0	0
Parish Constables	0	0	0	0
Summary	**12**	**92**	**1**	**8**

4. Regulated Financial service providers at 10%

	Yes	%	No	%
General Public	37	79	10	21
States Deputies	7	100	0	0
Representative Bodies	11	92	1	8
Businesses	9	56	7	44
Parish Constables	0	0	1	100
Summary	**64**	**77**	**19**	**23**

5. Personal Income Tax at 20% on assessable income

	Yes	%	No	%
General Public	14	38	23	62
States Deputies	2	67	1	33
Representative Bodies	7	100	0	0
Businesses	6	86	1	14
Parish Constables	0	0	0	0
Summary	**29**	**54**	**25**	**46**

6. Attribution to local shareholders

	Yes	%	No	%
General Public	12	27	33	73
States Deputies	0	0	2	100
Representative Bodies	1	14	6	86
Businesses	1	4	27	96
Parish Constables	0	0	0	0
Summary	**14**	**17**	**68**	**83**

7. Payroll tax

	Yes	%	No	%
General Public	0	0	16	100
States Deputies	0	0	1	100
Representative Bodies	0	0	8	100
Businesses	1	11	8	89
Parish Constables	0	0	1	100
Summary	**1**	**3**	**34**	**97**

8. Regulated utilities to be taxed at 20%

	Yes	%	No	%
General Public	4	100	0	0
States Deputies	0	0	0	0
Representative Bodies	1	50	1	50
Businesses	3	75	1	25
Parish Constables	0	0	0	0
Summary	**8**	**80**	**2**	**20**

9. Tax capping for significant tax payers

	Yes	%	No	%
General Public	20	51	19	49
States Deputies	2	67	1	33
Representative Bodies	9	100	0	0
Businesses	6	86	1	14
Parish Constables	1	100	0	0
Summary	**38**	**64**	**21**	**36**

10. Review personal income tax reliefs

	Yes	%	No	%
General Public	63	91	6	9
States Deputies	5	100	0	0
Representative Bodies	10	100	0	0
Businesses	11	79	3	21
Parish Constables	2	100	0	0
Summary	**91**	**91**	**9**	**9**

11. Increase Social Insurance contribution

	Yes	%	No	%
General Public	85	37	142	63
States Deputies	9	75	3	25
Representative Bodies	8	53	7	47
Businesses	19	45	23	55
Parish Constables	1	25	3	75
Summary	**122**	**41**	**178**	**59**

12. Proposed Increases to TRV

	Yes	%	No	%
General Public	49	46	57	54
States Deputies	7	78	2	22
Representative Bodies	8	73	3	27
Businesses	6	40	9	60
Parish Constables	0	0	3	100
Summary	**70**	**49**	**74**	**51**

13. Increase other indirect taxes

	Yes	%	No	%
General Public	103	90	11	10
States Deputies	5	100	0	0
Representative Bodies	9	82	2	18
Businesses	13	72	5	28
Parish Constables	0	0	0	0
Summary	**130**	**88**	**18**	**12**

14. Consider introduction of General Sales Tax (GST)

	Yes	%	No	%
General Public	112	66	57	34
States Deputies	8	73	3	27
Representative Bodies	8	57	6	43
Businesses	17	50	17	50
Parish Constables	3	75	1	25
Summary	**148**	**64**	**84**	**36**

15. Should Guernsey borrow?

	Yes	%	No	%
General Public	7	44	9	56
States Deputies	0	0	1	100
Representative Bodies	1	25	3	75
Businesses	1	50	1	50
Parish Constables	0	0	0	0
Summary	**9**	**39**	**14**	**61**

16. Use of Contingency Reserve

	Yes	%	No	%
General Public	7	58	5	42
States Deputies	1	50	1	50
Representative Bodies	4	80	1	20
Businesses	5	100	0	0
Parish Constables	1	100	0	0
Summary	**18**	**72**	**7**	**28**

17. Restrain public sector expenditure

	Yes	%	No	%
General Public	133	97	4	3
States Deputies	10	100	0	0
Representative Bodies	16	94	1	6
Businesses	35	97	1	3
Parish Constables	3	100	0	0
Summary	**197**	**97**	**6**	**3**

18. Increase company annual filing fees

	Yes	%	No	%
General Public	11	32	23	68
States Deputies	0	0	0	0
Representative Bodies	4	25	12	75
Guernsey Employers	4	17	19	83
Parish Constables	0	0	1	100
Summary	**19**	**26**	**55**	**74**

19. Increase and/or introduce fees and charges

	Yes	%	No	%
General Public	43	90	5	10
States Deputies	6	100	0	0
Representative Bodies	4	100	0	0
Businesses	7	100	0	0
Parish Constables	1	100	0	0
Summary	**61**	**92**	**5**	**8**

20. Dispose of surplus assets

	Yes	%	No	%
General Public	10	100	0	0
States Deputies	0	0	0	0
Representative Bodies	3	100	0	0
Businesses	3	100	0	0
Parish Constables	1	100	0	0
Summary	**17**	**100**	**0**	**0**

APPENDIX III

International Finance Centres
Post 2008 Comparative Tax Rates assuming current proposals are enacted

	Jersey	Isle of Man	Guernsey	Ireland	Cyprus	Cayman Islands
General profits tax rate	0.0%	0.0%	0.0%	12.5%	10.0%	0.0%
Tax Rates for banking business	10.0%	10.0%	10.0%	12.5%	10.0%	0.0%
Other FS business tax rate	10.0%	0.0%	10.0%	12.5%	10.0%	0.0%
Investment income tax rate	0/10%	0/10%	0/10%	25.0%	0.0%	0.0%
Tax on capital gains	0.0%	0.0%	0.0%	25.0%	0.0%	0.0%
Payroll / employers' social security	6.5%	12.8%	7.0%	10.75%	10.0%	0.0%
Top personal tax rate	20.0%	18.0%	20.0%	42.0%	30.0%	0.0%

APPENDIX IV

Isle of Man Tax Strategy

The rate of corporation tax

The standard rate of tax applicable to the profits of most Manx companies will be zero percent with effect from 6 April 2006. Higher rates will be applied to particular sources of income and to specific situations which will be identified on a scheduler basis as follows:-

Schedule		**Proposed rate of corporation tax %**
I	Income derived by licensed banks from banking business	10
II	Income derived by licensed banks from the investment of their 'tier 1' capital	2
III	Income derived from the post-importation retailing or wholesaling of goods in the Island by branches and subsidiaries of non-resident companies	10
IV	Income from land and property in the Isle of Man	10
V	All other forms of income not taxable under Schedules I – IV	0
VI	Income of companies that elect to pay tax at a higher rate than the standard rate	10
VII	Understatement of company profits	20

Appendix 5

The economic case for a 0%/10% corporate tax rate structure in Guernsey

The economic impact of Guernsey's Tax Strategy

Paper One

Presented by the Independent Working Group

March 2006

1. **Introduction**

In November 2005, at the request of the Treasury and Resources Department, an Independent Working Group was established and asked to examine the economic impact of changes to the Island's corporate tax regime.

The Working Group comprises John Roper (Chairman and expert on the Guernsey financial services sector) and Rosemary Radcliffe (UK economist and off-island expert**)** with support from the Policy and Research Unit and the Treasury and Resources Department. The Group is being advised by economic consultants Oxera.

This paper, Paper One, is the first in a series of papers that will examine the economic impact of changes to Guernsey's tax structure. Its objective is to examine the case for adopting a 0%/10% ('0%/10%') corporate tax rate for Guernsey and Alderney. It focuses on the key issues and summarises the arguments; it does not attempt to go into detail that is amply covered elsewhere in Consultation Documents. Subsequent papers will explore in more detail the economic impact of adopting '0%/10%' and will examine the distributional consequences of alternative approaches to managing the consequences for the public finances. The paper is structured as follows:

- In Section 2, Economic Background, we provide a brief overview of the role of the financial services sector and its importance to the Bailiwick's economy. In this Section we also place in context the main factors driving the need to reform Guernsey's corporate tax regime, and summarise the Government's response to date.
- In Section 3 we provide a high level assessment of the economic case for 0%/10% and explain the reasons for reform. We also look at what the consequences of 0%/10% might be for the public finances.

Annexes 1 and 2 provide supporting statistical information.

Our key conclusions are as follows:

- Guernsey's financial services industry is pivotal to the future of the Bailiwick's economy.
- The Bailiwick has no option but to respond to international pressure and reform its corporate tax regime.
- Further, if the Bailiwick's international competitiveness is to be sustained there is no option but to adopt a 0%/10% corporate tax structure; whilst it is inevitable that there will, as a consequence, be a significant negative impact on public revenues in comparison with the existing situation (the 'Black Hole' problem), this loss is likely to be significantly less than would be the effects on Guernsey of the decline in the financial services industry that would ensue if no changes are made.

- Different approaches to addressing the problem of the 'Black Hole' in the public finances will have different economic consequences. These will be the subject of subsequent papers.

2. Economic background

2.1 The role of financial services in the Bailiwick's economy

At the 'heart' of the Island's economy is the international financial services industry, which is by far the greatest contributor to economic well-being. In 2003, financial services in Guernsey accounted for around 36% of GDP (see Chart 1, Annex 1) and almost one quarter of employment.

In the highly integrated economy that has developed over the last 40 years, financial services have become pivotal in sustaining the economies of Guernsey and Alderney. For example, more than two thirds of financial services companies outsource such functions as ICT maintenance, security, human resources and payroll administration to local firms; in 2001 they spent around £92m in this way. [1]

As Guernsey's major exporter, an estimated 60% to 70% of export earnings is derived from the financial services industry. It is a truly globalised industry and has been very successful over the last 40 years; however, its very success does expose the Bailiwick's economy to international political and regulatory developments as well as to the vagaries of financial markets, thus creating a degree of vulnerability.

Nevertheless, the benefits of a successful financial services industry are clear: the Bailiwick community enjoys a very high standard of living relative to international comparisons. Guernsey's GDP per capita has grown significantly over the last 33 years (see Chart 2, Annex 1), from £9,000 to just under £24,000 per annum in 2003. This compares favourably with other small island economies operating finance centres such as the Isle of Man (£16,000) and Malta (£7,500).

The finance industry is also extremely important as a contributor to the Bailiwick's public finances. In 2004, around two-thirds of corporate tax receipts were derived from financial services. Because of the sector's profitability, financial services provided the largest contribution (£73.8m) of corporate tax receipts in Guernsey compared with non-finance (see Chart 3, Annex 2). Also, income raised from finance industry employees via income tax accounted for one third of all ETI paid (see Chart 4, Annex 2.

2.2 International developments affecting the Bailiwick

Changes in policy on the part of the European Union (EU) with regard to unfair tax competition provide a key driver for all jurisdictions having an international finance centre to pursue tax reform. EU rules on harmful tax practices (the Code of Conduct on Business Taxation) seek to eliminate tax structures that discriminate between residents

[1] KPMG, 2004, Economic impact of the Guernsey finance industry

and non-residents. This pressure on the Bailiwick has also impacted, to varying degrees, on several other small island economies such as Jersey and the Isle of Man.

To sustain the Bailiwick's financial services industry in increasingly competitive global markets, tax reforms are needed if the competitive position enjoyed by the Island is not to be lost. In response to these international pressures, competitor jurisdictions such as Jersey and the Isle of Man have announced changes to their tax regimes in order to comply and retain market share; these have taken the form of variants of 0%/10%. We consider that, in the light of these pressures, Guernsey and Alderney have no option but to respond and make changes to the tax structure, particularly in view of the fact that many financial service companies are highly mobile and will seek out competitive advantage to gain greater profit margins, by relocation if necessary.

2.3 Guernsey's response to date

In response to international developments, the States of Guernsey Government has undertaken a comprehensive consultation in the Bailiwick. Under the direction of the Fiscal & Economic Policy Steering Group (F&EPSG), a set of proposals to reform the Islands' tax structure has been produced. These have been presented in two documents for consultation, the first issued in March 2005 and the second in September 2005. The second consultation document advocates a package of measures underpinned by the adoption of a 0%/10% corporate tax regime. We are also aware that an additional paper has been produced by the F&EPSG, outlining Stage 1 of a longer-term approach to tax reform and thus providing an initial 'roadmap'.

It is not the purpose of this paper to examine or comment upon the results of consultation; however, we note that more than 500 responses from the community have been submitted to the Fiscal & Economic Policy Steering Group and have been analysed by PriceWaterhouseCoopers. As part of the decision-making process papers from the Independent Group analysing the economic impact of proposed tax changes, including this one, will also be made public.

3. The economic case for 0%/10% corporate tax

3.1 The need for reform

As indicated above, taking no action to address international developments (both competitive and policy changes) would be potentially catastrophic for the Bailiwick's economy. Simply retaining the status quo and not reforming Guernsey's tax regime would result in a very substantial loss of competitiveness for the financial services industry relative to financial services businesses in other jurisdictions. Non-compliance with EU approaches to 'harmful tax practices' would provide a considerable incentive for financial services firms to relocate their operations from the Bailiwick. This would have obvious and serious direct and 'knock on' consequences to the rest of the economy through loss of financial services business and damage to the Island's supplier network.

Guernsey's financial services industry has built up a significant export market with an estimated total value of funds under management, in 2005, well in excess of £100bn.

The maintenance of competitiveness is essential for sustaining the Bailiwick's wider economy and its performance is largely beyond the control of individual jurisdictions. There are, however, several factors which affect decisions about where to locate international business; these include the following:

- Tax rates and simplicity of system; skilled workforce; staff costs; office rents; transport links; reputation; stable political environment; legal and regulatory framework.

In the 2003 Guernsey Finance Sector Study[2], business managers rated beneficial fiscal arrangements for products, services and clients in the top four most important factors influencing company location.

In Guernsey there are 50 banks which are foreign-owned, either Guernsey subsidiaries or branch operations. The loss of these operations through relocation to jurisdictions with reformed, more advantageous, tax regimes would represent a very considerable loss of jobs and business. It would also have a detrimental effect on the Island's 'critical mass' as a provider of financial services. The presence of large banks supports Guernsey's credibility as a prime location for the finance industry; a decision by a large bank or banks to relocate would contribute to a loss of credibility that would deter firms not only from setting up new businesses, whether finance or non-finance, thus limiting inward investment, but also encourage other existing companies to withdraw. As a consequence, overall employment and tax revenues would, in our view, be very substantially reduced.

It may be concluded from the above that, if the States of Guernsey and Alderney wish to sustain a vibrant international finance centre and retain their competitive position, corporate tax reform is, quite simply, essential.

3.2 The options for reform

Over the last two years, the announcement by competitor jurisdictions such as Jersey and the Isle of Man of decisions to adopt a variant of the 0%/10% model has set the benchmark for other offshore finance centres, including Guernsey, to respond. It is clear that jurisdictions such as Jersey are reforming domestic tax policy in order to retain their financial services industry and have chosen to adopt a 0%/10% strategy. This places pressure on Guernsey to follow suit, if the Island's economy is to remain competitive and retain its international financial services.

Other options have been advanced, most notably an approach based on 0%/20% for certain businesses that might prefer this whilst others would be subject to 0%/10%. Such an approach, it has been argued, would result in higher tax revenues for Guernsey than a pure 0%10% regime, thus reducing the need to levy extra taxes on residents, and those businesses paying at the higher rate would not suffer detriment as their additional liability in Guernsey would merely be offset against a liability in other jurisdictions. Whilst it appears superficially attractive, this option nonetheless presents significant

[2] KPMG, 2003, Finance Sector Study

problems. It would in our view be extremely risky to adopt a variant of 0%/20% for some finance businesses for the following reasons:

- There is no guarantee that firms who might initially agree to participate in a 20% regime would continue to do so over a period of time, especially when the tax burden is lower in other competitor jurisdictions such as Jersey and the Isle of Man.

- At a practical level, it would be extremely difficult, perhaps impossible, to specify a set of clear objective criteria for determining which businesses would be liable at the 20% rate and which at the 10% rate that also ensured only those preferring the 20% regime were subject to it.

- There is in any event no guarantee that retaining a 20% rate for some businesses, together with either 0% or 10% rates for others, would be compliant with the EU Code of Conduct rules. This is particularly true because a fundamental principle of the Code is transparency. Multiple rates and complex criteria do not make for a transparent system.

In our view, therefore, there is no alternative but to adopt the 0%/10% model. If Guernsey continues with a 20% regime, financial services companies will seek to reduce their tax burden by moving to a jurisdiction enjoying lower rates. This would not only have repercussions on the Island's economy through a loss of jobs in finance but also in non-finance businesses, as the knock-on effects impact on suppliers.

No other high value sector could take the place of financial services in the near future and contribute significantly (£111m in corporate tax and ETI in 2004: see Charts 3 and 4) to the public finances.

3.3 The consequences of reform

Since there is no alternative but to reform Guernsey's tax policy, what are the likely implications? This will be the subject of further research and will be discussed in subsequent papers; however, there are some points about the consequences of shifting to a 0%/10% model that should be made here.

First, there is the matter of the nature and size of the consequent revenue loss. As to the nature of the loss, it is important to stress that, in comparison with existing arrangements, the revenue loss represents a permanent loss to Guernsey. Replacing it, in whole or in part will add to the burden on the community. Any increase in existing taxes, or the introduction of new ones, is likely to be largely borne by residents; the scope for replacing lost revenue by taxing non-residents, whilst it must be considered, is likely to be limited.

As to the size of the revenue loss, current estimates suggest that it could be of the order of £50m but might be as high as £80m depending upon the precise detail of the implementation arrangements and how taxpayers respond to them. Because regulated businesses, with the exception of the utilities (taxed at 20%), will be taxed on their profits at either 0% or 10% there will be a revenue loss estimated at £50m. This figure, however, assumes that resident beneficial owners will have company profits attributed to them and will pay tax at 20%, thus enabling significant (£23m) "clawback" in tax revenue to offset part of the loss. This position differs from the one specified in the "road map" (see 2.3 above) which states that Guernsey resident beneficial owners should be taxed at 20% on their *distributed* profits and on all rental and investment income. As not all corporate profits are distributed the tax base of distributed profits is smaller than the tax base of profits. In addition, therefore there has to be a strong possibility that sole traders will, as a consequence, decide to incorporate their business in order to take advantage of the possible tax shelter provided by the 0% rate, and as a consequence increase the overall loss.

We shall be commenting on this further in subsequent papers and refining the estimates of likely revenue loss, but it should be emphasised that, by any standards, the revenue loss is likely to amount to a substantial 'Black Hole'; £50m represents around 18% of current revenues, or about 3.5**%** of GDP. Future strategies with regard to the public finances will thus require very important decisions to be made as to the approach to both revenue and expenditure, and different choices will have different economic implications.

As noted above, to the extent that the 'Black Hole' problem is to be addressed at least in part by increasing other taxes or introducing new ones, or by increasing charges or imposing new ones, the burden will fall largely on residents who will then have less money to spend on other things. Which residents will bear the burden and how they will respond, and thus what the overall impact will be, will depend on the precise measures chosen, and their timing. And to the extent that public expenditure reductions feature, whilst there may be some scope for efficiency improvements, such reductions are likely potentially to affect the range and/or quality of services provided and this, in turn will have economic implications.

The approach to capital expenditure provides just one example of this: governments frequently respond to pressure on the public finances by cutting capital expenditure but this can have deleterious, and sometimes unexpected, economic consequences. In Guernsey, capital expenditure over the last two years has been £44.4m and £46.9m[3] respectively (i.e. around 3% of GDP). This has given a substantial fillip to the local economy by providing contracts and jobs. Significantly lower levels of capital expenditure may impact on the economic performance of the island directly by reducing demand in the construction sector, but it may also result in poorer-quality infrastructure that may, in turn, also affect economic performance. Thus an appreciation of the implications of alternative strategies for addressing the 'Black Hole' problem is very important in deciding what package of measures is appropriate and over what timescale the various measures should be implemented. These issues will be the subject of subsequent papers.

The Independent Working Group
March 2006

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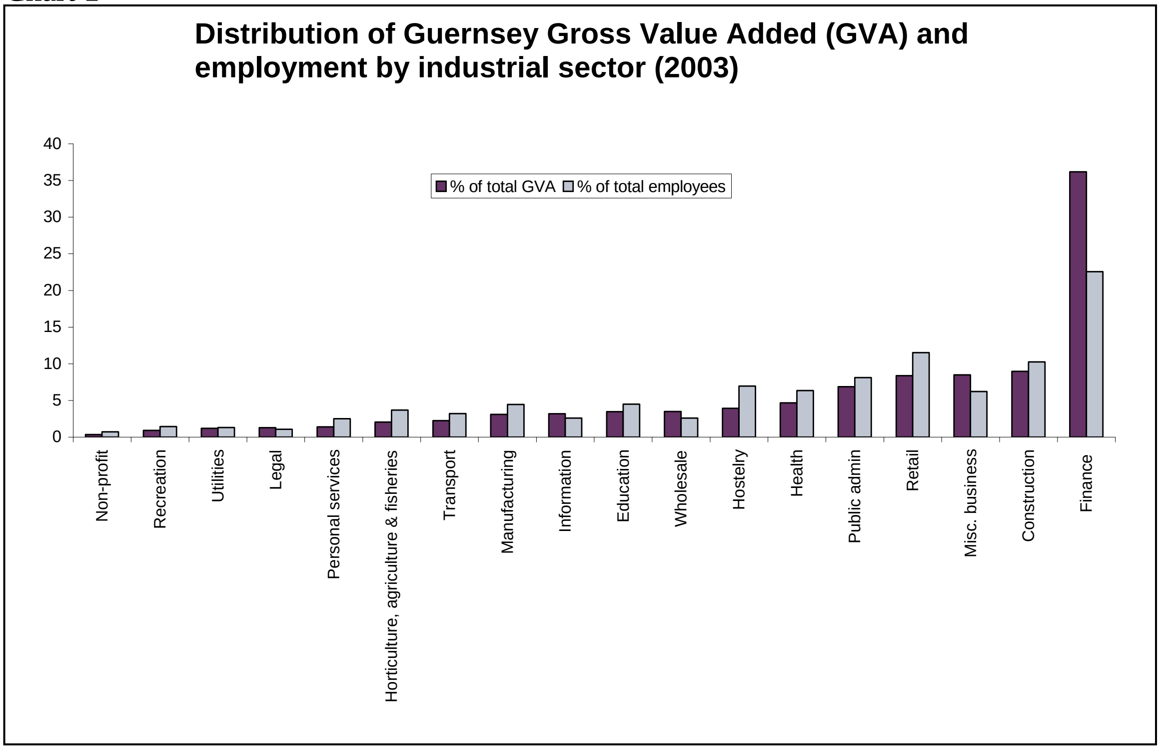
[3] States of Guernsey, Future Economic & Taxation Strategy, 2nd consultation document, Sept 2005

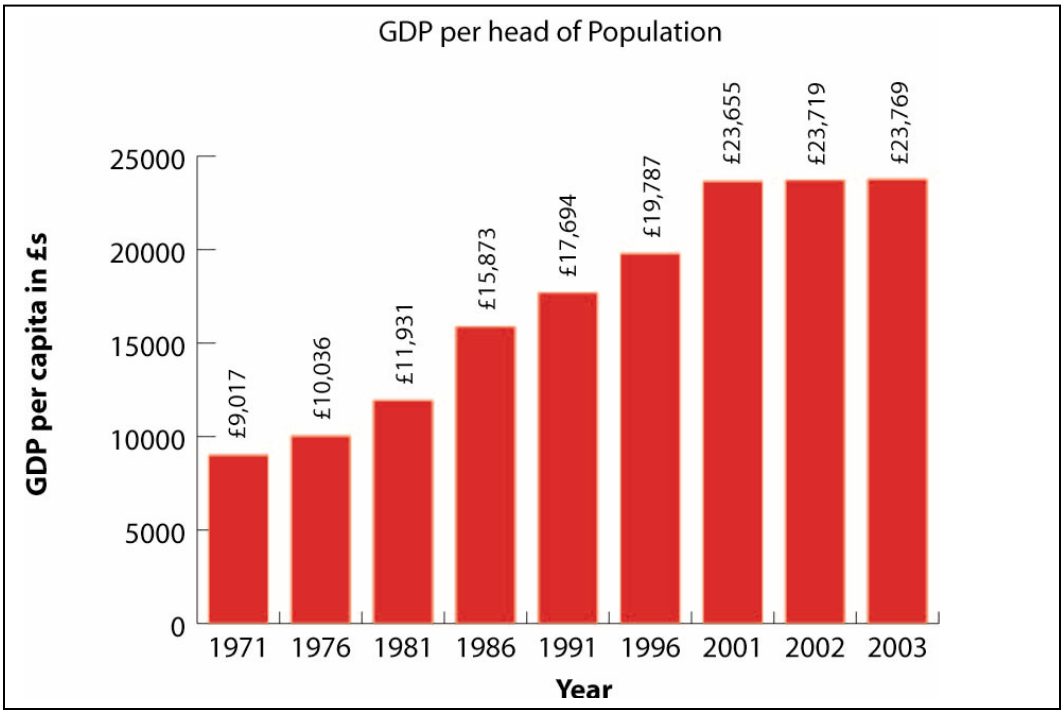
Annex 1: Economic Background

Chart 1



Source: Policy and Research Unit and Oxera

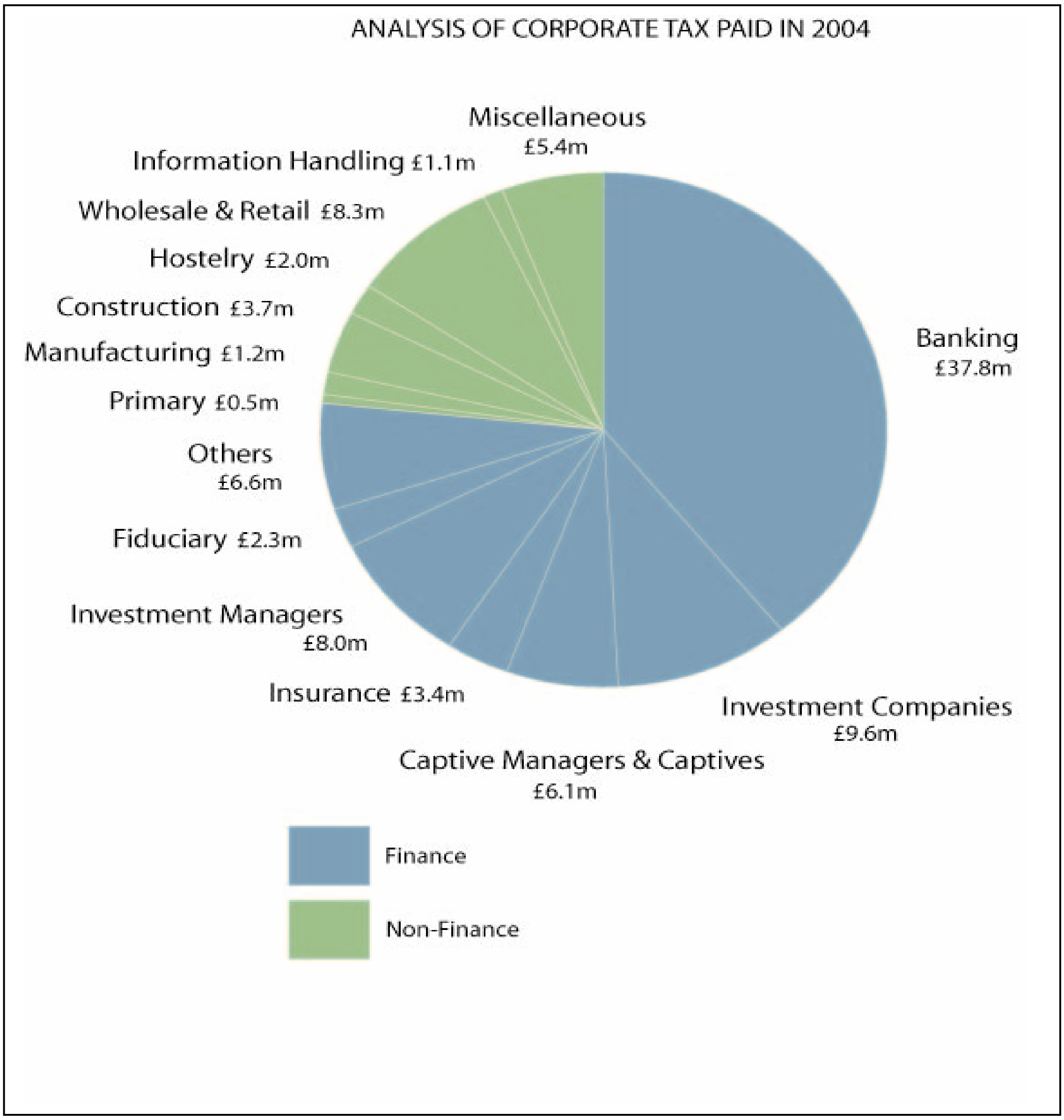
Chart 2 Guernsey Gross Domestic Product (GDP) per capita (1971 – 2003)



Source: Policy and Research Unit

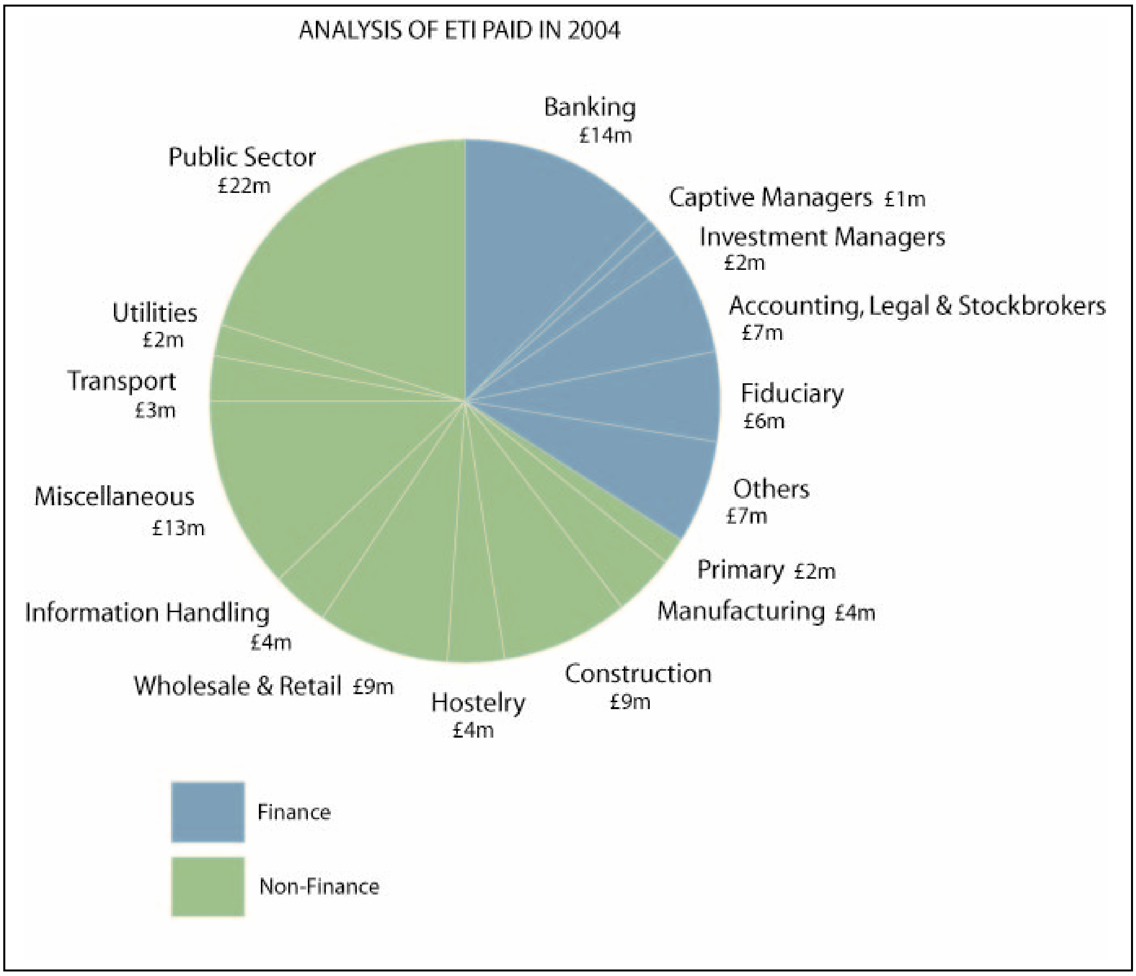
Annex 2: Background to the public finances

Chart 3 Financial Services contribution to Guernsey public finances



Source: States of Guernsey, Future Economic & Taxation Strategy, 2nd consultation document, Sept 2005

Chart 4 Financial Services contribution to Guernsey public finances



Source: States of Guernsey, Future Economic & Taxation Strategy, 2nd consultation document, Sept 2005

Appendix 6

The Economic Impact of Guernsey's Tax Strategy

Paper Two

Presented by the Independent Economic Working Group

April 2006

The Economic Impact of Guernsey's Tax Strategy

Section 1 - Introduction

1.1 In March 2006 the Independent Working Group charged by the Treasury and Resources Department with examining the economic impact of changes to the Island's corporate tax regime submitted its first paper: 'The economic case for a 0%/10% corporate tax rate structure in Guernsey'[1]. In that paper we concluded that the Bailiwick has no option but to respond to international pressure and reform its corporate tax base; we further concluded that, if its international competitiveness as a location for financial services businesses is to be maintained, there is no option but to adopt the '0%/10%' corporate tax structure. We noted that, whilst it is inevitable that there will, as a consequence, be a significant negative impact on public revenues in comparison with the existing situation (the 'Black Hole' problem'), we stated that this loss is likely to be significantly less than would be the effects on Guernsey of the decline in the financial services industry that would ensue if no changes are made to the tax structure.

1.2 We also noted that different approaches to addressing the problem of the 'Black Hole' in the public finances will have different economic consequences, and undertook to examine these in more detail in subsequent papers. This paper presents our analyses and conclusions on these matters. It is structured as follows:

- In Section 2 we set out, by way of background, some general principles relating to public finance, and the practical issues that policy-makers need to bear in mind in arriving at their decisions in this key area of public policy.

- In Section 3 we describe briefly how we have gone about our task; in this Section we also refer to the work done by economic consultants Oxera, who have undertaken much of the detailed analysis upon which we draw in subsequent Sections of our paper. Oxera's technical report[2], which describes their work in detail, is submitted in parallel with this paper.

- In Section 4 we look at the period up to 2011. The Policy Council has developed an economic and taxation strategy, set out in its document entitled "Future Fiscal and Economic Structure", in which a phased approach to the 'Black Hole' problem is advocated. The first phase, which covers the period to 2011, would see the implementation of some revenue raising-proposals, to take effect from 2008. We were asked to build the principles and policies set out in the Policy Council's document into our analysis and we have, therefore, used it to build a picture of the fiscal position of the Bailiwick

[1] The economic case for a 0%/10% corporate tax rate structure in Guernsey, Paper One, March 2006.

[2] What are the fiscal options for Guernsey after introducing the 0%/10% corporate tax regime? April 2006

after the proposals are implemented in 2008. Our key findings in this Section thus relate to the likely scale of the structural budget deficit after their introduction, under various assumptions.

- In Section 5 we look beyond 2011 to examine the various options open to the Bailiwick with regard to the management of the public finances, and consider the economic and distributional consequences of alternative courses of action.

- In Section 6 we summarise our key findings and conclusions.

Annexes A to D provide supporting information.

Section 2 - General principles and practical issues

2.1 There is, of course, a wealth of complex technical literature concerning the economics of public finance, and many studies have been undertaken of the effects of different strategies with regard to government revenue and expenditure in different economies. Wide variations in impacts can be found over time and as between economies of different sizes and structures and stages of development. Nevertheless, there are some general principles underlying these issues that are of relevance to policy-makers considering alternative strategies with regard to the public finances; there are also some practical issues that need to be borne in mind when evaluating options. Below in this Section we describe, in brief terms, some of those that are of most importance for the Bailiwick at this time and that we have had in mind in undertaking our analysis and arriving at our conclusions.

Government revenue and expenditure and the impact on the economy

2.2 We look first at how, in general terms, taxes and government spending impact on the economy**.** Different types of taxes have different effects on different groups of people. There is a welter of different types of tax (or charges) that take money out of the economy and put it into the hands of government but, in practical terms, they all get shifted to become **either** taxes on income **or** taxes on expenditure or some combination of the two, i.e. they reduce the disposable income of all or some individuals or groups and/or they increase the cost of goods and services to consumers. This is obviously true in the case of income tax, sales taxes, or customs duties on alcohol, tobacco or petrol; it is also true, for example, in the case of licence fees, registration charges or stamp duties[3]. Less obviously, it is even true of taxes on payroll – employee payroll taxes, for example, are effectively taxes on income[4] and of taxes on business profits:

[3] These are either absorbed as business costs thereby reducing profits or are passed on to customers or are, as in the case of stamp duty on residential property transactions, ultimately borne by the purchaser.

[4] The impact of employer payroll taxes are more complex but essentially these represent a business tax that is passed on to employees via reduced wages or to customers in the form of higher prices, or is absorbed in the form of lower profits.

ultimately these will be shifted to shareholders or to customers or to some combination of the two. The way in which this 'shifting' happens, and the consequences, may be complex, but there are, in essence, three key questions for policy makers to consider.

- First, which individuals or groups (e.g. residents, Non-residents guest residents or visitors; those with higher or lower incomes; those who earn income or those whose income is in the form of interest; drinkers or teetotallers; etc.) will in practice bear a particular tax? Here there will be an interaction between fiscal policy and other policy objectives: in many societies, for example, there is a commitment to compensate for some of the effects of poverty, hence measures that increase the tax burden on those on low incomes relative to those on higher incomes are not favoured. So we need to understand the distributional consequences of different measures. And a word is due here about residents versus others. Different measures do impact differentially on guest or overseas residents. The introduction of 0%/10%, for example, leads to a reduction in the effective tax on non-residents: the majority of those who stand to benefit from the change are non-resident owners of capital. A natural reaction is to look for other ways of taxing non-residents: a problem, however, is that this may be impossible or very difficult to achieve. Non-residents are, by definition, free to take their business and their capital elsewhere, and will if new taxes provide them with enough of an incentive to do so[5].

- The second question relates to how the individuals or groups affected will react to reduced incomes or higher costs (e.g. will they maintain their levels of consumption and save less; will they demand, and be able to obtain, higher wages; will businesses, whose shareholders are now relatively more squeezed by higher taxes, invest less; in the limit, will potential taxpayers move to an alternative location)?

- The third question relates to what, in the light of all these decisions, will be the potential effect on the economy. Other things being equal, reduced consumer demand and/or business investment result in lower growth, but other things are rarely equal and the pattern of effects, and the timescales over which they are felt, will be complex. They will be influenced by factors outside the local economy altogether (such as developments in the global economy and, in particular in the case of the Bailiwick, global financial services markets) as well as by the state of the local economy (e.g. the domestic labour market and the extent of inflationary pressures) and by other economic policies of government that may reinforce or reduce the impact of particular tax measures. Understanding all these effects is, accordingly, a complex business.

[5] Different tax measures present different risks in this regard. Non-residents can, for example, contribute to employer payroll taxes via lower returns to non-resident shareholders, or visitors can contribute, via higher prices charged, to increased customs duties or to a general consumption tax

2.3 Following on from this, one of the very important 'other things' that may not be equal is what the government does with its revenues: i.e. the size and composition of its expenditure. The importance of this can be illustrated by considering what happens if a government decides to cut it's spending. There are, in broad terms, three ways in which this can be done.

- First, a government may cut current expenditure by continuing to provide all the services it currently provides, but doing so more efficiently. This sounds appealing, but there are two issues here that need to be understood. Whilst efficiency is clearly desirable, experience from around the world suggests that efficiency gains in the public sector, particularly those to be achieved by use of new technology, rarely deliver in full what was hoped for. It is extremely important, therefore, to have realistic expectations in this regard. Further, given the nature of government services, these efficiency gains are likely to result in some job losses; to the extent that the individuals affected cannot be redeployed productively in some other part of the economy there will be a loss of purchasing power and, consequently, some negative effect on growth. Depending on the state of the labour market, this strategy may well nonetheless produce an acceptable outcome in comparison with revenue- raising measures, but the net effects need to be considered carefully.

- Second, a government may cut current expenditure by cutting services[6]. Here the negative effects that will need to be set against the cost savings are, potentially, rather more significant: cutting the number of teachers or health workers, for example, will reduce purchasing power unless these individuals can be redeployed elsewhere but will also have an indirect effect on the capacity of the economy through a reduction in the quality of education or health.

- Last, a government may decide to cut capital spending. We referred in our first paper[7] to the fact that governments frequently respond to pressure on the public finances by cutting capital expenditure but observed that this can have deleterious, and sometimes unexpected, economic consequences. Significantly lower levels of capital expenditure typically impact quite quickly on economic performance by reducing demand in the construction sector but they may also result in poorer-quality infrastructure that, in turn, can also affect economic performance in the medium and longer term.

Tax bases and tax yields

2.4 An important area for policy-makers relates to tax bases and tax yields. Taking

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[6] There is a special example of expenditure reduction (or increases) that involves the management of social security funds. Managing surpluses/deficits on such funds, as opposed to setting contribution levels in pay-as-you-go schemes, may well be a matter of managing timing issues rather than a way of cutting spending per se, unless the assumptions made are regarded as over-optimistic (or pessimistic) on an on-going basis.

[7] The economic case for a 0%/10% corporate tax rate structure in Guernsey, Paper One, March 2006.

tax bases first, determining the base for a particular tax can have important consequences in terms of its potential impacts. To take an obvious example, a consumption tax levied on all goods and services will, relatively, be more burdensome to the poor, who have lower incomes and save less. But a tax levied on luxuries rather than on necessities, or at a higher rate on luxuries, will have distributional consequences that are relatively less favourable to the better-off. The determination of the tax base to be used, therefore, as well as the type of tax, will have some distributional consequences in all cases.

2.5 Against these consequences, however, policy-makers will need to set practical issues, including the important matters of the costs of collection and the risks of avoidance[8]. An option that may be favoured for distributional reasons may result in high collection and/or enforcement costs. For example, until the late 1980's Guernsey's income tax structure provided for a three-tier system of personal allowances, including an exemption allowance/marginal relief provision that assisted those in the lower income groups. This relatively complex system, however, was not readily understood by taxpayers and was difficult to administer, hence the system was abolished in favour of a simple allowance structure that is still in operation. 'Efficiency versus equity' in the management of the public finances is a common dilemma facing policy-makers.

2.6 Determining likely yields from particular taxes is another area that needs careful analysis. There are two areas of particular difficulty:

- What, in the light of the tax base, are the basic drivers of likely yield from a particular tax? Clearly the yield from income tax, for example, is going to be driven by the evolution of personal incomes whilst the yield from profits tax will be driven by the evolution of corporate profits. To predict these yields requires assumptions to be made about economic growth and also about income distribution: in the case of income tax between different groups of individuals; and in the case of profits tax between the returns to capital and the returns to labour.

- How will tax payers adjust their behaviour in the light of a new or modified tax? Although there are well-documented approaches to some of these issues gained from other jurisdictions there are also some well-documented surprises: the assumptions that have to be made here may have as much to do with psychology as with economics.

The effect of inflation: 'real' versus 'nominal'

2.7 Following on from issues of yield is the matter of measurement. Real growth, i.e. growth that adjusts for the effect of inflation, is what measures the underlying performance of an economy and assessments of likely future

[8] In this context, it may be observed that new taxes involve set-up costs that may be substantial, as well as on-going collection costs. Changing the rates of an existing tax may be, and usually is, a cheaper way of raising revenue than looking for a new tax base, but may have less desirable distributional consequences.

economic performance are usually undertaken in real terms[9]. If, for example, inflation is 2.5% per annum and real growth ignoring inflation is 2.5% the nominal rate of growth is 5% per annum. For policy-makers, understanding these distinctions and their significance is important. Depending on the tax base and how a particular tax is specified, the yield may vary in quite complex ways: the tax authority may, for example, actually get a yield benefit out of inflation. Personal income tax rates, for example, are usually set in nominal terms – X% of taxable (money) income – but personal allowances, and rate bands where these are used, if not adjusted to allow for inflation have the effect of increasing the effective tax rate, or tax burden, an effect known as ‘fiscal drag’. And, of course, government income and expenditure in a given year are both in ‘the pounds of the year’, so surpluses and deficits, too, will be in the pounds of the year in which they arise. For this reason tax authorities, including the Guernsey Treasury, usually prepare their forecasts in cash terms, but in this event care needs to be taken in estimating yields and looking at the evolution of deficits and surpluses over time.

The economic cycle: surpluses and deficits

2.8 Continuing with the matter of surpluses and deficits, the balance between revenue and expenditure is a very important area. The approach to the management of surpluses and deficits has important economic implications and can thus be used as an instrument of economic policy. Spending more than is coming in by way of tax revenues represents an injection of purchasing power to the economy, thereby giving a stimulus to growth; running a deficit, or spending part of a reserve built up in the past, can thus be used to improve economic performance. Spending on capital works is the classic example here: in the same way that cuts in public spending can save money quickly but may have unlooked for consequences in the longer term, increases in capital spending can give a quick fillip to a construction sector that is working below capacity. Increased incomes in this sector will result in increased spending and further economic growth throughout the economy (the ‘multiplier effect’).

2.9 But a crucial point to bear in mind is that demand management policies of this kind need to be assessed in the context of the economic cycle. Deficit financing may be an appropriate instrument in the lower part of the cycle when resources are unemployed but is definitely not appropriate in the upper part of the cycle when the economy is working close to full capacity. This gives rise to an important distinction that needs to be well-understood: that between cyclical and structural deficits. Simply put, in the long term public sector budgets need to be balanced: in other words, across the economic cycle taken as a whole

[9] For example, the UK Treasury publishes its view as to the long term sustainable real growth rate of the UK economy (currently around 2.5% per annum). Sustainable growth is linked to a view about the relationship between economic growth, unemployment and inflation: the NAIRU (the Non-Accelerating Inflation Rate of Unemployment) is used by policy-makers wishing to manage an economy to produce non-inflationary growth.

expenditure should not exceed income[10]. Within a cycle, however, it may be entirely appropriate for deficits or surpluses to be aimed for in order to achieve other economic objectives. Understanding where the economy is in relation to the economic cycle, and whether budget deficits are cyclical or structural, is thus crucial to the management of the public finances[11].

Dealing with uncertainty

2.10 It will be clear from the foregoing that understanding the economic effects of tax and spending decisions and predicting the likely evolution of tax revenues is no easy task. It requires the making of assumptions about, for example, economic growth, the relative performance of different sectors and groups and the behaviour of individuals and groups. To take one example, a view is needed about economic growth. Forecasting economic growth is far from an exact science; although the models used by forecasting bodies have improved significantly in both scope and coverage, the one thing that can be said about any single-point forecast of economic growth for a particular economy is that, at a level of detail, it is more likely to be wrong than right.

2.11 Further, estimating the fiscal balance – the difference between revenue and expenditure – involves estimating the difference between two relatively large numbers, neither of which can readily be forecast with a great degree of accuracy. Thus estimates of budgetary surpluses and deficits are particularly prone to error.

2.12 This fact of life does not, however, mean that efforts to understand likely economic impacts are without value. What is does emphasise is the vital importance of understanding the key sensitivities (what are the factors that are likely to make a big difference to outcomes) and of using alternative scenarios to establish what the likely range of alternative outcomes might be. Thus in the case of economic growth, for example, it may be reasonable to take a central estimate of likely growth over three to five years and then look at the implications of (plausible) higher or lower figures.

Implementing change

2.13 The final area of importance to policy-makers relates to the implementation of

[10]The reverse is also true: across the cycle income should not exceed expenditure. Building up surpluses over the longer term, unless this is against a specific policy objective regarding their future use, will have a depressing effect on the economy.

[11]A word is due here about public borrowing. At present, the Bailiwick has a non-borrowing policy: it issues no debt. The comments above therefore apply to the use of the contingency reserve as the instrument of managing surpluses or deficits. Precisely similar arguments would apply if the Guernsey authorities were to borrow to finance deficits, although here the biting constraint is that current income and current expenditure should balance across the cycle, i.e. there should be no structural deficit. Borrowing to finance capital expenditure, i.e. to invest in public assets, raises different issues: if the capacity of the economy is improved by such investment then borrowing to finance it may be entirely appropriate. This gives rise to what has been termed the 'Golden Rule' of public finance: across the economic cycle borrow only to finance investment.

change. Here there are practical issues concerned with administrative efficiency such as the likely costs of collection and the approach to avoidance and evasion that, as we have seen, may be in opposition to equity considerations. But there are also issues relating to the management of uncertainty. If the outcome of a particular decision may be difficult to predict there may be arguments in favour of waiting until the effects are clearer before making any further decisions. Thus, if the outcome of the change to 0%/10% is difficult to predict with accuracy there may be a case for 'wait and see' before deciding on further changes. But there may also be costs in adopting such an approach. If, for example, further changes are needed they may then have to be implemented more rapidly than may be desirable and this can have both administrative and economic consequences.

Conclusions

2.14 In summary, we can say that the general principles and practical issues relevant to the management of the public finances and of particular importance to policy-makers in the Bailiwick at this time include the following:

- With regard to government revenues and their impact on the economy, it is important to recognise that, although there are many different types of tax (or charges), in practical terms they all reduce to being taxes on income or taxes on expenditure or some combination of the two: they reduce taxpayers' disposable incomes. They have different effects on different groups of people, however, and policy-makers need to understand, as far as is possible, these effects and be prepared to make decisions as to which groups should bear tax and how they will react as well as considering what will be the potential effect on the economy.

- Policy-makers also need to understand how government spending impacts on the economy: different types of spending will have more or less beneficial consequences and particular types of cuts in spending may have significantly deleterious consequences.

- Choice of tax base is important in terms of impacts, particularly distributional impacts, but also relevant are practical considerations concerning the costs of collection and combating avoidance. Efficiency and equity may pull in opposite directions.

- Determining likely yields from a particular tax requires an understanding both of the drivers of yield and of how tax payers will adjust their behaviour in the light of the tax.

- In analysing revenue and expenditure and the balance between them the effects of inflation need to be considered: the distinction between 'real' (after allowing for the effects of inflation) and 'nominal' (including inflation) measures is important.

- The balance between revenue and expenditure is a key issue: across the cycle revenue and expenditure need to be in balance. Structural deficits are not sustainable.

- In estimating the likely evolution of the public finances - income and expenditure and the difference between them - it is prudent to look at a range of assumptions and not to rely on single point forecasts.

- In considering change, issues of administration are important but so are issues relating to the management of uncertainty.

Section 3 – Our approach

Our remit

3.1 In November 2005, at the request of the States Treasury and Resources Department, the Independent Working Group was established and asked to examine the economic impact of changes to the Island's corporate tax regime. In March 2006 we produced our first paper: 'The economic case for a 0%/10% corporate tax rate structure in Guernsey'. As explained above, we concluded in that paper that there is no option for the Bailiwick but to adopt the '0%/10%' corporate tax structure. We acknowledged that there will, as a consequence, be a significant negative impact on public revenues in comparison with the existing situation (the 'Black Hole' problem'), and noted that different approaches to addressing the problem of the 'Black Hole' in the public finances will have different economic consequences. Our subsequent work, as described in this paper, has focused on examining these issues in more detail.

Time periods

3.2 Our analysis looks at two different time periods. First, we examine the period up to 2011 (Period 1) and, second, we look at the issues arising post- 2011 (Period 2). The reason for this distinction is that the period up to 2011, as was explained above, represents the first phase (to 2011) of the staged approach advocated by the Policy Council in its economic and taxation strategy described in its document entitled "Future Fiscal and Economic Structure". The document looks at the implementation of '0%/10%' and also sets out some revenue-raising proposals to be implemented in the near term, i.e. from 2008[12]. Our focus in respect of Period 1 has thus been to examine the evolution of the public finances to 2008 and beyond to 2011 and, in particular, to look at the likely scale of any budget deficit that may be apparent by then and that would need to be remedied in the following years. Our focus for Period 2 has, accordingly, been to examine, in the light of the conclusions relating to Period 1, the various options open to the Bailiwick with regard to the management of the public finances thereafter.

[12]Our analysis assumes implementation of these proposals from 2008; in practice some of them could be implemented earlier. And, of course, in the context of the analysis relating to Period 2, proposals for new and/or increased taxes could be implemented earlier than 2011.

Data and analysis

3.3 A significant volume of data collection and analysis has been required to discharge our remit. We have relied in particular on two sources of information and support.

- First, we have drawn on the resources of the States Treasury and Resources Department including the Income Tax Office and the States Policy Council, Policy and Research Unit. In particular, we have discussed with Treasury officials how they have gone about the work that has already been done in relation to government revenue and expenditure and the assumptions they have made. As will be explained below in Sections 4 and 5, in a number of areas we have made the same or similar assumptions; where our views differ this has been highlighted in the commentary[13]. In keeping with the key principles set out above in Section 2, however, we have also undertaken sensitivity analysis around key assumptions; this should be of assistance to policy-makers in considering the most important risk areas.

- Second, much of the detailed analysis has been undertaken by economic consultants Oxera, whose technical report describing their work is submitted in parallel with this one. Oxera have worked to the same key assumptions as we have; their role has been to perform the detailed calculations underpinning Section 4 and to model the various outcomes examined in Section 5. Where relevant, the Oxera technical report is accordingly quoted as a source in these Sections of our paper.

3.4 It should be stressed, however, that although we have made use of all the relevant information made available to us, there are various important areas where information is lacking. Some of the detailed economic data that, desirably, would inform parts of the analysis are simply not available. For example, only limited information is available in connection with the levels of beneficial ownership of Guernsey companies, i.e. the basis for establishing the amounts of profits that would be attributable to Guernsey resident shareholders under a partial attribution/distribution system. And, as was explained above in Section 2, in some areas, particularly those relating to how actual or potential tax payers may respond to certain new proposals, by definition there are no data available. For example, one can only 'best-guess' the extent to which Guernsey-resident beneficial owners of companies would 'distribute' their profits, which would then be subject to tax. No doubt some would leave the profits in the business, thereby escaping or deferring taxation, but how many is open to question[14]. In the commentary in Sections 4 and 5 we have made reference to some of these problems and have, where appropriate, applied a range of different

[13] We have also undertaken a more detailed comparison of Treasury estimates and our own. The results are shown at Annex A.

[14] And it is not possible accurately to determine how many self-employed people would choose to incorporate, and thereby shelter some of their profits. There are about 2,800 self-employed people in Guernsey, hence the issue is not insignificant.

assumptions. Inevitably, however, there remains scope for judgement on the part of policy-makers: our analysis will help to inform such judgements but cannot substitute for them.

Section 4 – The period to 2011

4.1 As explained above, our principle focus for Period 1 has been on analysing the evolution of the public finances in the medium term with a view to assessing whether or not there is likely to be a structural deficit by 2011 that will require to be remedied by further action on revenue/and or expenditure at that time. The analysis has two components: we need first to track the likely evolution of the public finances to 2008; then we need to consider the likely effect of the introduction of the revenue-raising proposals put forward by the Fiscal & Economic Policy Steering Group and published in the document "Future Fiscal and Economic Structure". In order to do this, however, we need to form a view about the likely evolution of the Guernsey economy as this is crucial to the analysis. Accordingly, this part of our paper is structured as follows.

- First, we consider what should be appropriate key assumptions relating to the economy to use in our analysis of public revenues.
- Second, we consider the likely evolution of government revenue and expenditure under the existing tax structure in the period to 2008 and look at the fiscal balance as it might be at that date.
- Third, we examine the likely effects of changes to be made in 2008 - the move to '0%/10%' and the other proposals put forward by the Policy Council - and look at the fiscal balance as it would be under the new tax structure. We also consider the implications for the contingency reserve and examine the extent to which economic growth can help to address the revenue loss arising from the move to '0%/10%'.
- Last, we draw some conclusions from this part of our analysis.

Key assumptions

4.2 The crucial areas to examine are likely trends in economic growth and inflation, the related matter of tax yields[15], and assumptions relating to government expenditure. Each of these is considered below.

4.3 Looking first at the key area of **economic growth**, Oxera has undertaken

[15]Our approach to the analysis of likely revenues is to consider real growth in the economy, and likely inflation, and then to see how this might translate into tax yields, taking account of inflation. The Guernsey Treasury adopts the approach of forecasting nominal tax yields directly. In doing this, however, it makes implicit assumptions about economic growth and about the relationship between economic growth and tax yields as well as an assumption about inflation. In our work we have sought to reconcile the Treasury's assumptions to our own, and this is reported on in the commentary below and in Annex A.

detailed analysis of the past performance of the Guernsey economy and this is described in their technical report. In our view the key points are as follows (Guernsey figures quoted are from Oxera's report).

- As we noted in our first paper, the Guernsey economy is a very open one but also highly specialised. Its performance is primarily driven by the financial services sector that accounts for one third of the island's remuneration and more than half of its profits. Whilst this has served Guernsey well in that average incomes on the island are 20% higher than in the UK (£28,000 per head[16] in 2004 as compared with £23,000 in the UK) it is also associated with a degree of risk: the health of the financial services sector, and its capacity to grow, is substantially influenced by global factors as well as by Guernsey's relative competitive position.

- This dependence on financial services as the key engine of growth is evidenced from Guernsey's past economic performance: recent (10- 15 years) growth has been largely driven by the expansion of the finance sector and the consequent expansion of other services (e.g. business and information services) depending on it.

- This dependence has also influenced the performance of the Guernsey economy year by year. In 2000, for example, when world economic growth was strong and global financial services were buoyant, Guernsey's GDP grew by 7.5% and total profits grew by 16%[17]. But in 2001, when global growth fell sharply, GDP growth fell to 1.2% and profits actually declined by 4%[18]. Since 2001 the picture has also been one of much more modest growth although there has more recently been some evidence of a pick-up. Again, global fortunes are relevant here: in 2005 the global economy slowed from the significantly above-trend growth recorded in 2004 but is expected to improve again this year before dropping back to its long run average rate in 2007.

- All this means that predicting future movements in Guernsey GDP year by year is a particularly hazardous business: movements in the global economy and in global financial services will have an effect but an effect that is likely to be amplified locally.

- Under these circumstances, and accepting that year-to-year fluctuations are difficult to predict, one approach is to iron these out by looking at longer term trends. Oxera has performed the calculations: they find that average annual real growth in GDP over the last 10 years is 2.9%; Although annual GDP growth has been volatile, statistically, this represents a reasonably accurate description of the past and might therefore provide a reasonable guide to the future, if not year-by-year at least over a run of years.

- The problem with this approach is that it assumes implicitly that the

[16] Average incomes in the finance sector were £39,000.
[17] Almost 70% of these were derived from financial services
[18] Around 65% of which were from the financial services sector

circumstances that have given rise to the historic pattern of growth will be continued into the future. Whilst this may be so, it can also be argued that Guernsey's recent past performance reflects its success in building, quite rapidly, a market in global financial services but that it may now have achieved a 'natural' market share and future growth will be through growth in the global market rather than from growth in market share, given that the island's competitiveness is maintained[19]. In other words, Guernsey has been going through a 'catch-up' period in economic growth which may now be coming to an end. If this is so, the sustainable real growth rate would be likely to fall to, perhaps, 2 to 2.5% on average rather than continue at the 10-year average rate of almost 3%.

- Also relevant to this is Guernsey's inflation rate. During periods of high growth Guernsey has paid a price in the form of increased inflation as demand in the growing financial services sector has outstripped supply. Since the recession of the early 1990's the headline rate of inflation in Guernsey has been as low as 1.4% but as high as 5.2%. Comparing inflation across the cycle with the UK, which has been on a similar economic cycle albeit with lower growth, Guernsey's headline rate of inflation has been around 1% to 1.5% higher.

- This, in turn, is linked to the state of the labour market. Clearly, even if more rapid growth, i.e. a continuing increase in Guernsey's share of global financial services, is theoretically possible this can only be achieved if a suitably-qualified workforce is there to deliver it. If it is not, a part of the theoretical gains disappears in the form of inflation. Our understanding is that the labour market in Guernsey is and has been very tight, with very low net immigration[20]. Unless the Bailiwick was minded to encourage more immigration of skilled and qualified people, or significantly increase the skills of the resident workforce, wage-push inflation at times of more rapid expansion remains a real risk.

- The Policy Council's document emphasises the importance of maintaining a healthy economy, and we are aware that policy-makers are looking to adopt pro-growth policies. There is, we understand, a hope on the part of some that growth will, of itself, address part, or maybe even all, of the 'Black Hole' problem. This would obviously be desirable, and real economic growth, at any level, will undoubtedly make a contribution to the 'Black Hole' problem. We consider below the effect that economic growth alone can have[21]; however, policies predicated on a substantial increase in the sustainable rate of growth over and above that dictated by the global

[19]Since 2001 there has been much more overt competition between offshore jurisdictions. Whilst Guernsey needs to ensure its competitiveness is maintained – the 0%/10% proposal has this as its objective – it is unlikely to be able to improve it significantly relative to other jurisdictions and needs to be vigilant in avoiding any deterioration.

[20]Between 1991 and 2001 immigration dropped from 7,695 to 6,902, and there were over the period almost the same number of leavers as arrivals.

[21]See Section 4.

macroeconomic environment tend to be fraught with hazard[22]. Certainly, supply-side policies, and in particular policies directed at raising the level of appropriate competencies in the workforce, may in general deliver some growth dividend, and should be actively pursued[23] but this dividend is likely to be relatively modest.

- In summary, therefore, on the matter of **economic growth** we are not convinced that, for Guernsey over the medium term, the past is necessarily the best guide to the future. We believe that, for the purposes of modelling the public finances, a central assumption on economic growth of 2.5% would be both prudent and appropriate. In our calculations, therefore, we have used this central assumption, but we have also looked at the implications of higher growth and lower growth, at 3% (the long term trend rate) and 1.5% (more recent experience since 2001) respectively[24].

4.4 Turning now to **inflation**, again Oxera has examined the historical situation. Long term (the last 14 years), inflation has been averaging around 3.3**%** per annum but**,** as noted above, there have been significant variations around the average. The analysis confirms how periods of high growth have been accompanied by significant inflationary pressures: this is the manifestation of ‘wage push’ inflation associated with excess demand for labour in relation to supply at periods of high demand. In the light of this, we believe an appropriate approach to modelling inflation is to recognise the relationship with growth: high growth is associated with higher inflation. Our central estimates assume inflation at 2.5%; which combined with real growth of 2.5% gives nominal growth of 5%. Our high real growth assumption of 3%would naturally go with a higher inflation assumption of 3%, thus giving nominal GDP growth of 6%, whilst our low real growth assumption of 1.5% would be associated with inflation of 2%[25], giving nominal GDP growth of 3.5%.

4.5 The third key area for the making of assumptions relates to **tax yields**. Here we need explicitly to consider the relationship between economic growth and tax yields under the current tax structure so that we can estimate government revenues in the years to 2008. After 2008 the key features of the new tax structure predicated in “Future Fiscal and Economic Structure” are factored into our analysis, as explained below in this Section. Again, Oxera have undertaken detailed analysis of tax yields and the results are set out in their report[26]. The key points are as follows.

[22] Unless such policies are directed towards exploiting ‘catch up’ opportunities, as explained above. Guernsey has, in all probability, in large measure been through this phase.

[23] For example, building on the work of the Commerce and Employment Department in its “Building Confidence” report on developing the economy. A key priority for Guernsey must be to develop the skills and competencies of the workforce if international competitiveness is to be maintained.

[24] As explained above, the Guernsey Treasury does not make an explicit assumption as to real GDP growth. The Treasury’s estimates for tax yield, however, combined with their inflation assumption, equates to real growth of the order of 2%.

[25] It is unlikely that, even in circumstances of low growth, inflation would fall below 2%.

[26] Oxera’s analysis takes account, where appropriate, of the timing of tax payments, e.g. payments of income tax are made in the year after the income is earned.

- There are three major tax bases currently in use in Guernsey: personal income tax; tax on corporate profits (also including companies paying income tax) ; and excise duties. Between them, these three taxes account for by far the greater part of government revenue (88% in 2004); the balance is made up of a number of other revenues and charges that are individually quite small[27].

- The personal income tax rate and the rate of tax on corporate profits are currently the same, at 20%. In any one year, personal incomes and corporate incomes may be growing at different rates, thus generating different shares of total revenue from these two sources[28], but because the rates are the same the joint yield in relation to GDP should be no more than 20%.

- In practice, over the period 1990 to 2004 total government income (95% of which comes from taxes) as a share of GDP has, as might be expected in the absence of any significant change in tax structure, been reasonably stable, at between 20% and 22.5% of GDP. The average over the period was 21.7%. This suggests that customs duties and other sources of revenue between them have a slightly higher yield in relation to GDP than do taxes on income (the average for all revenue, at 21.7% of GDP, is greater than the 20% maximum yield for taxes on income) but the difference is not great.

- It is the case that average figures can conceal important year-by-year variations. The period 2000 to 2003 illustrates the point: total tax receipts actually fell in real terms whilst real GDP, although flat, did not decline[29]; at this time there was a substantial fall in corporate profits at the same time as personal incomes in money terms continued to increase, i.e. the share of total income going to labour was increasing at the expense of that going to capital.

- Nonetheless, the fact remains that, taking one year with another, 20% should represent the relationship between government revenue and GDP under the present tax structure unless customs duties, and other revenues, have a stronger relationship and are increasing their share of revenue as a consequence. We have found no consistent evidence of this: in fact, if anything the contribution of excise duties has declined a little recently. In the light of this, we have taken as our assumption in relation to **tax yields** under the current structure a 20% relationship with GDP.

4.6 The final key area relates to assumptions concerning **government expenditure**.

[27]Interestingly, taxes on residential property that are used in many jurisdictions as a source of income to local and national governments do not feature as being of significance in Guernsey. This point is referred to below in Section 5.

[28]There may also be significant variations in the importance of different segments within these two sources. Within the corporate sector there have been quite significant variations in yield by sector, accounted for by the steep rise in yield from offshore insurance and, to a lesser extent, banking in the late 1990's and a fall in both after 2001.

[29] In other words the total percentage of GDP taken in tax actually declined somewhat. But there is now some evidence that the percentage is increasing again on the basis of new estimates of the outturn for tax receipts in 2005.

Looking first at **revenue expenditure,** Oxera have examined revenue expenditure over the 12 years from 1995 to 2006. They find that the average annualised real rate of growth over the period is 2.5%, but with some significant changes year to year. The last five years have seen a slightly higher average real growth rate of around 3%. At the same time, the downward trend in real revenue expenditure as a proportion of GDP apparent up to 2000 has reversed into an upward trend as GDP growth has declined. The Policy Council's objective as set out in its economic and taxation strategy is 'modest annual increases' in expenditure[30]; if this is taken to be growth in nominal rather than real terms a reasonable central assumption might be expenditure held constant in real terms, i.e. held at 2006 levels[31]. Again, we have looked at higher and lower estimates of the level of spend, reflecting real squeeze and real growth of 1% respectively (RPI minus 1% and RPI plus 1%). Here it may be noted that the Treasury is assuming a squeeze at least equivalent to the lower end of our range. They have assumed a nominal increase of 1.5% per annum; given our central inflation assumption of 2.5% this would represent real cuts of 1% per annum[32].

4.7 Looking now at **capital expenditure** (CAPEX), Oxera's analysis shows that real CAPEX has varied significantly year-on-year: from £9 million in 1996 to £53 million in 2003[33]. Owing to the 'lumpy' nature of CAPEX, one year's figures are a poor guide to trends; moreover, as we have already noted CAPEX can be relatively easily increased or decreased and is a favoured management tool of governments as a consequence, although the economic effects of cuts (or increases) can be of considerable significance. We understand that in the September Consultation Document the proposal was made to limit CAPEX to £15 million per annum[34], which is significantly below the long term average and would represent quite savage and possibly damaging cuts. We have therefore taken £15 million per annum as our lower estimate of CAPEX expenditure. Our central estimate is £20 million per annum whilst our higher estimate, at £25 million per annum, represents a return to the long run average rate of spend.

[30] Future Fiscal and Economic Structure, Policy Council, March 2006
[31] For consistency, as measured in 2004 prices. This would amount to £278 million in 2004 prices (£297 million in 2006 prices).
[32] The Treasury's implicit inflation assumption is 3%, which would generate real cuts of the order of 1.5% per annum. Such cuts would be difficult to achieve without damaging consequences; this is returned to below in the commentary on the fiscal balance in Sections 4 and 5.
[33] The probable outturn for 2005 is £60 million. This would appear to represent a considerable element of catch-up not likely to be repeated.
[34] Future Economic & Taxation Strategy, Second Consultation Document, September 2005

Revenue and expenditure and the fiscal balance to 2008

4.8 Using the above assumptions on economic growth[35] and tax yields, we have first computed the likely tax yield in 2008 under the existing tax structure, i.e. before taking into account any of the changes proposed by the Policy Council. The results are set out in Table IV.1 below[36].

Table IV.1
Tax yield in 2008 under current tax structure
£million: 2004 prices

	Real GDP in 2007	Tax Yield in 2008
Central growth assumption (2.5% p.a.)	1,528	306
High growth assumption (3% p.a.)	1,543	309
Low growth assumption (1.5% p.a.)	1,498	300

Note: Tax revenue in any one year is in large measure derived from economic activity in the previous year, hence the 2007 GDP figure is used to compute tax revenues for 2008.

Source: Oxera

4.9 The table illustrates the effect of varying the GDP growth assumption: the difference between a pessimistic and an optimistic view of likely growth translates into a difference in tax yields of £9 million by 2008. It is also worth noting at this point the importance of the tax yield assumption: as noted above we have taken 20% as this is the relationship implied by the current tax rates but by 2008 a variation in the yield assumption of 1% of GDP would translate into a change in receipts of the order of £15 million by 2008.

4.10 The next stage of our analysis has been to look at estimates of government revenue and expenditure, both revenue and capital, in 2008, under our set of three assumptions. The figures are set out in Table IV.2 below.

[35] It is important to recognise that our growth assumption is an average one and in practice growth will vary year by year across the cycle to generate this average. Thus in any one year the GDP growth may actually be above or below our average.
[36] In estimating GDP in 2007 we have also had to build assumptions about the starting point. GDP figures for 2004 are estimates and no figures are yet available for 2005. The approach we have adopted to address this problem is described in Annex B.

Table IV.2
Government expenditure in 2008
£million: 2004 prices

	Revenue Expenditure in 2008	CAPEX in 2008	Total expenditure in 2008
Central growth assumption (RPI growth)	281	19	300
High growth assumption (RPI + 1%)	286	24	310
Low growth assumption (RPI - 1%)	275	14	289

Source: Oxera

4.11 Again, the table illustrates the effect of the assumptions made about expenditure: by 2008 the difference between high and low spending assumptions amounts to £21 million in 2004 prices.

4.12 We can now look at the likely state of the fiscal balance in 2008 as it would be in the absence of any changes in policy. This is shown in Table IV.3 below; figures in brackets represent a deficit.

Table IV.3
Fiscal balance in 2008 under existing tax structure
£million: 2004 prices

	Central government expenditure assumption	High government expenditure assumption	Low government expenditure assumption
Central GDP growth assumption	6	-4	17
High GDP growth assumption	9	(1)	20
Low GDP growth assumption	0	10	11

Source: Oxera calculations

4.13 Variations in assumptions, as the table shows, feed straight through to the fiscal balance and, because the balance is the difference between two relatively large numbers, the results show quite a large spread. It should, however, be noted that some combinations of assumptions are more likely than others: if real growth is low, for example, there will naturally be much more pressure on the authorities to limit spending hence the more plausible outcomes would be those on a diagonal line from top left to bottom right on the table, i.e. on the current structure the outcome, measured in constant (2004) prices, is more likely to be a surplus than a deficit but only a very modest one. This suggests that, on reasonable assumptions and before taking account of changes to the tax structure, the underlying position with regard to the Bailiwick's finances in 2008 would be a budget that was just in balance but with very little margin to spare, i.e. the years of surplus would be at an end.

4.14 The above analysis looks at the position in 2008 on the assumption that the current tax structure is maintained until that date. In addition to the move to a 0%/10% corporate tax regime, the Policy Council's strategy document "Future Fiscal and Economic Structure" puts forward some proposals for revenue enhancement over the period 2008 to 2011/12 and we have been asked to take these into account in our analysis. In looking at the evolution of revenue and expenditure and the fiscal balance to 2011/12, therefore, the starting point is to examine the likely effect on total tax yields of all these proposals.

4.15 The proposals are summarised in Annex C, which is also reproduced in Oxera's technical report. As will be seen from Annex C, some of the proposals are quite specific and can readily be translated into assumptions about yield. Others, for entirely understandable reasons, are couched in more general terms. The first task, therefore, has been to examine the likely implications of the proposals in terms of government revenue; however, before presenting the results of this analysis a word is due about the use of the contingency reserve.

4.16 As will be seen from Annex C, the Policy Council's proposals for a phased approach to the management of the public finances envisage utilising up to one half of the contingency reserve (interest and capital) to part-fund the shortfall in receipts consequent upon the move to '0%/10%'. In the next part of our analysis we have taken the assumptions on expenditure set out above in this Section and then computed the overall effect on the contingency reserve of spending to these levels and looked at how this compares with the target of utilising no more than half of the reserve. Another way of looking at the issue is to examine what level of expenditure could be achieved if fully one half of the contingency reserve were to be utilised, and we look at this a little later in this Section.

4.17 Returning now to the effect of the Policy Council's proposals on revenue, this is illustrated in Table IV.4 below, which compares the revenue position in 2008 as it would be under the old (current) structure with the new structure that assumes implementation of the proposals. The first two lines replicate the figures in Table IV.1 that show tax yield under the current structure; the third line shows the proportion of that yield under the current structure derived from taxes on corporate profits. The ensuing lines show the net yield from implementation of the policy proposals; the total of these is then set against the loss in revenue– the yield from tax on corporate profits under the existing structure - to show first the difference and then the new total yield.

4.18 The figures for yield under the new structure make, quite naturally, a large number of assumptions. These are examined in detail in Oxera’s report but the key issues are commented upon in Annex D.

4.19 The table illustrates that, notwithstanding the implementation of some revenue-raising proposals, the net effect of change in 2008 is of the order of £40 million in 2004 prices, a figure which is not significantly affected by variations in the GDP growth assumptions. This amounts to a cut in government revenue of the order of 13% in the central growth scenario, or 2.6% of GDP.

Table IV.4
Tax yield in 2008 under new tax structure
£million: 2004 prices

	Central GDP growth assumption (2.5%)	**High GDP growth assumption (3%)**	**Low GDP growth assumption (1.5%)**
GDP in 2007 (see Table IV.1)	1,528	1,543	1,498
Total tax yield under existing structure (see Table IV.1)	306	309	300
Of which: derived from tax on corporate profits	104	105	102
1. Continuing tax on banking profits	10	10	10
2. Continuing taxation of investment companies	10	10	10
3. Taxation of distributed profits	6	6	3
4. Increase in duties etc.	8	8	8
5. Increase in social security payments	17	17	17
6. Changes to interest payments	7	7	7
7. Increases in fees	5	5	5
New yield from changed items	64	64	60
Difference	(40)	(41)	(42)
Total yield	265	267	258

Source: Policy proposals and calculations by the Guernsey Treasury and Oxera.

Note: In 2006 the forecast is for tax on corporate profits to make up 34% of revenue and this split has been carried forward to 2008. The assumptions concerning the distribution of profits are 30% in the case of the central and high growth cases and 15% in the low growth case. Totals may not fully reconcile owing to rounding

4.20 The next element of the analysis is to pull together the revenue figures under the new structure and the expenditure figures set out in Table IV.2 to derive an estimate of the likely fiscal balance under the new tax structure. This is done in Table IV.5

Table IV.5

Fiscal balance in 2008 under new tax structure
£million: 2004 prices

	Central government expenditure assumption	High government expenditure assumption	Low government expenditure assumption
Central GDP growth assumption	(34)	(45)	(24)
High GDP growth assumption	(32)	(43)	(22)
Low GDP growth assumption	(41)	(52)	(31)

Source: Oxera

Note: Totals may not fully reconcile owing to rounding.

4.21 The table illustrates how, although some benefit will be derived from the revenue-raising proposals of the Policy Council, there is likely to be a remaining and substantial structural deficit in the Bailiwick's finances ranging from £22 million to £52 million. Again, some combinations of assumptions are more plausible than others; nevertheless the fact remains that, on this analysis, the structural deficit is most likely to be between £30 million and a little over £40 million in 2004 prices, or around 2% of GDP in the central GDP growth scenario.

4.22 This is obviously a substantial deficit; however, it is pertinent to examine to what extent continuing economic growth from 2008 might, of itself, help to correct it. Oxera have performed some calculations to shed light on this, looking at the growth in GDP that would be required in order to eliminate the structural deficit by 2011. They find that, on our central assumption relating to government spending, i.e. that it is held constant in real terms, growth would have to average 4.2% per annum in real terms (6.7% nominal if inflation is 2.5%). With spending growth capped at RPI-1 (our low spending assumption), growth would have to be 3.% in real terms, whilst under our higher expenditure assumption (expenditure growth of RPI+ 1) would have to be 5.3% per annum in real terms. This sets a useful context for policy decisions: it suggests that, without further revenue-raising measures, only very substantial real growth can deliver a balanced budget by 2011.

4.23 To add to the picture, we now need to look at the likely evolution of the contingency reserve. As indicated above, the Policy Council has considered the use of up to one half of the reserve to help address the revenue reductions consequent on the move to '0%/10%'. It is therefore relevant to examine what effect the trend in the public finances described may have on the reserve in the period to 2011. Oxera have modelled the evolution of the reserve under various combinations of assumptions concerning growth, inflation, and government revenue and spending. Table IV.6 below reproduces their results using our central assumptions: real growth of 2.5%; inflation of 2.5%; and spending held constant in real terms.

Table IV.6

The Contingency Reserve from 2008

£million in nominal terms (£'s of the year)

	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Opening balance	218	188	163	145	133	130	135	151
Interest	8	7	6	6	6	6	6	8
Deficit on the year	-38	-32	-25	-17	-9	0	9	19
Closing balance	188	163	145	133	130	135	151	178
Accumulated spending of the Reserve from 2008	-38	-70	-95	-112	-121	-121	-112	-93

Source: Oxera calculations.

4.24 The table illustrates that, on our central assumptions, a full half of the reserve - in fact a little over one half - would indeed be utilised by the end of 2011. On the assumption of lower growth or higher spending (not illustrated in the Table but set out in Oxera's report) the outturn would be even less favourable. Using our low growth and central spending assumptions £214 million (virtually the entire Reserve) would have been utilised by the end of 2011; using our central growth and higher spending assumptions the comparable figure would be £133 million. Only with high growth or a continuing substantial expenditure squeeze do the figures give a reasonable margin: high growth and central spending gives £39 million whilst central growth and low spending gives £91 million.

4.25 A final useful piece of analysis is to look again at government expenditure and, instead of using our central, high and low assumptions, compute what spending growth would need to be in order to balance the budget by 2011. Oxera have undertaken some calculations: the results are set out in Table IV.7.

Table IV.7

Government spending for a balanced budget in 2011

	Central GDP growth assumption (2.5%)	High GDP growth assumption (3%)	Low GDP growth assumption (1.5%)
Real spending growth to 2008	0%	-1%	1%
Real growth to 2011	-1.7%	0.4%	-4.8%
Nominal growth to 2011	0.8%	3.4%	-2.8%

Source: Oxera

4.26 Again, the table shows how only under the high growth assumption can a very substantial squeeze be avoided if the budget is to be balanced in this way. It should be emphasised that the analysis builds in tight public spending controls in the period to 2008 as shown in the first line of the table; to achieve further real cuts thereafter, of close to 2% in the central growth scenario and nearly 5% in the low growth scenario, would be particularly hard to do.

Conclusions on the period to 2011

4.27 Our objective in this Section of our paper has been to analyse the evolution of the public finances in the medium term with a view to assessing whether or not a structural deficit will be apparent by 2011. We are aware that the Policy Council is proposing a phased approach to the management of the public finances, with some revenue-raising proposals that would take effect in 2008 at the same time as ‘0%/10%’ is introduced; policy-makers will therefore need to take a view as to the likely scale of any such structural deficit and whether further action on revenue and/or expenditure will therefore be required over and above that proposed in the document “Future Fiscal and Economic Structure”. Our conclusions are as follows.

- Key to the evolution of the public finances is the likely performance of the Guernsey economy, and in particular economic growth. Whilst the historic performance of the Guernsey economy has in general been strong as it has built up its position in the global financial serves market we do not believe that it will be so easy to grow rapidly in the future in this highly competitive market. Whilst we applaud the stated objective of adopting pro growth policies, we believe it is important not to overestimate what these can achieve. Accordingly, we think a central assumption of average real growth of 2.5% per annum over the medium term is both prudent and appropriate but we also think it is important to consider the consequences of growth both above and below this central estimate.

- Using assumptions on growth, inflation and tax yields, based on the relationship between tax receipts and GDP, and assumptions on government expenditure derived from the Policy Council's proposals, we have looked at the likely state of the public finances in 2008 under the existing tax structure, i.e. before the introduction of '0%/10%' and the other proposals of the Policy Council. We find that, on reasonable assumptions, the underlying position would be a budget that was just in balance but with very little margin to spare.

- We have gone on to examine the likely effects of implementing the proposed changes in 2008. We find that, on the revenue side, the net effect of these changes would be a cut in revenue of the order of £40 million in constant 2004 prices, which in turn translates into a structural deficit of around 2% of GDP.

- Looking beyond 2008, the analysis suggests that further action will be required unless real growth turns out to be at the top of, or above, the range that we have examined. Based on our central assumption on government spending (no real growth), a balanced budget by 2011 would require GDP to grow in real terms at over 4% per annum. Further, the figures suggest that the target of utilising only one half of the contingency reserve over this period would barely be met, if at all, on our central assumptions. Only with high growth or a very tight squeeze on government spending is there a reasonable margin against this target.

- We conclude, therefore, that unless the Guernsey economy performs very strongly in the future, by 2011 action will in all probability be needed over and above the proposals already under consideration. Of course, growth may turn out to be higher than we think it prudent to assume, and efforts should certainly be made to adopt supply-side policies to promote growth, but too much emphasis should not be placed on growth to solve the 'Black Hole' problem; action is likely to be needed either to increase revenue or to further control public expenditure or some combination of the two.

4.28 Overall, therefore, our analysis suggests that policy-makers would be well-advised to give consideration now to appropriate additional policies in order to secure fiscal balance in the future. In our view they will very likely be needed, but in any event to be prepared to implement policies that, in the event, turn out not to be needed is clearly to be preferred to having to design and implement such policies at speed. Accordingly, in the next Section of our paper we look at the options open to the Bailiwick in this regard, and their likely distributional and economic consequences.

Section 5 – Beyond 2011

5.1 We concluded above in Section 4 that further action was likely to be needed over and above that already under consideration to achieve fiscal balance. We now turn to a consideration of the options open to the Bailiwick in this regard.

- First, we look at the option of achieving balance through expenditure reductions.
- Second, we look at options in the event that the emerging structural deficit turns out to be relatively modest, i.e. less than 1% of GDP.
- Third, we examine those options that would be relevant to the management of a more substantial deficit, of 1% of GDP or more.
- Last, we summarise our conclusions from this part of our analysis

Achieving balance through expenditure reductions

5.2 The analysis presented above in Section 4 is predicated on a stringent approach to the management of public expenditure in the years to 2008. Following the objective set by the Policy Council of 'modest annual increases' in expenditure, our central assumption holds expenditure constant in real terms, i.e. nominal increases to cover inflation only. This is a challenging target. We have also looked at the effect of a real squeeze (growth at RPI -1) as well as very modest expansion (RPI + 1). As the analysis in Section 4 shows (see Table IV.5), only those scenarios that build in a real squeeze generate a structural deficit in 2004 prices of less than £30 million in 2008, and economic growth of 2.5% per annum or more is needed to contain it to around £20 million. To attempt to achieve balance, or even to make a significant contribution to achieving balance, by limiting expenditure would in our view be highly problematical.

5.3 To set the scale of the task in context, it is worth noting that, historically, both government income and government spending have moved closely with GDP, with a small (0.4%) wedge between them (i.e. GDP has been growing only a little more rapidly than government revenue and spending). If the structural deficit is to be eliminated by continuing to hold spending constant in real terms whilst the economy is growing the wedge would become very much bigger. If GDP grows at 2.5% per annum in real terms the wedge that historically has been only 0.4% would have to run at more like 2.5 percentage points for 5 years or more. We are very doubtful that this could be achieved in practice; certainly it would involve real cuts in services as the amounts are too large for efficiency gains realistically to solve the problem. And such cuts are unlikely to be achievable without economic damage.

Options to address a modest structural deficit

5.4 As we saw above in Section 4, under some assumptions the structural deficit might turn out to be relatively modest, at around £20 million in 2004 prices or 1% of GDP. These outcomes are likely to be associated with a real squeeze in spending but could also be achieved, or even improved upon, if economic growth turns out to be above the range we have looked at. It is therefore reasonable to enquire what might be a sensible strategy for dealing with a deficit of this order of magnitude.

5.5 Of course, a figure of around 1% of GDP in this regard is an arbitrary one. But the sums involved are such that the economic effects of alternative options are unlikely to be significantly different from one another and the distributional effects will not be massive, unless the entire burden is imposed on one group in the community. Policy-makers may therefore wish to look for pragmatic solutions and, subject to distributional considerations, put together a package of measures based on cost and efficiency considerations rather than on economic and distributional effects. This would point in the direction of using the existing tax base and increasing the effective rates rather than looking for new sources of revenue. Such a package might, for example, include some of the following measures.

- Some further increase in the rates of existing taxes on consumption (customs duties) might be imposed. These are relatively low now in comparison with other jurisdictions and will rise only modestly under the 2008 proposals. It is also noticeable that at present the Bailiwick taxes vehicle ownership (vehicle excise duty) rather than use (fuel duty) and some move to increase duties on petrol might be appropriate for other, environmental, reasons. Changes in rates of this kind, as opposed to changes in the tax base, are relatively cheap to implement and, if modest, would give only a modest impetus to inflation (where fuel is an input cost to industry, as in the distribution sector, the burden will in the main be shifted to final consumers).

- Some further adjustment to tax allowances over and above those already under consideration for 2008 might be made. These could include modest reductions in personal allowances; and abolishing altogether tax relief on non-business related interest, life assurance relief, and relief on pensionprovision. Again, implementation costs would be low and modest changes have only a marginal impact on the effective tax rate.

- Some further upward adjustment could be made to the various fees and charges that are included in ‘other income’. The 2008 proposals already include an amount in this regard (see Table IV.4); more could be done at the margin without major economic consequences. (As with fuel duties, fees and charges imposed on business are typically shifted to consumers and give an upward impetus to inflation, but again the amounts need not be so large as to have a significant impact on international competitiveness.)

5.6 In addition, a word is due about two other possible options. First, there is the matter of the Treasury's contribution to the Social Security fund. It has been suggested to us that the assumptions made by the Government Actuary in computing Fund requirements may be excessively pessimistic and the Treasury's contribution may therefore be higher than it needs to be. If lower contributions are required from the Treasury government spending would, effectively, be reduced. To investigate this would be beyond our remit and would require extensive analysis of the assumptions made by the Government Actuary, hence we are unable to comment on this issue. We would, however, urge caution in attaching too much weight to this as a potential solution to the 'Black Hole' problem; what is needed here are strategies to correct a structural deficit and policy-makers would need to be clear that any reduction in Treasury contributions to the Fund were not merely a temporary matter of timing.

5.7 Second, there is the matter of taxation of residential property[37]. We noted above that, at present, the Bailiwick collects very little by way of taxes on residential property, certainly when compared with some other jurisdictions. We would not advocate a wholesale revision of the approach to property taxation in order to address a relatively modest deficit[38] as such revisions take a considerable amount of time (and money) to plan and implement. But it may well be possible to increase the yield from the existing arrangements simply by raising the rates. Again, if the amounts involved are not very large the impacts will also be modest.

Options to address a substantial structural deficit

5.8 As we saw above in Section 4, the Bailiwick is, on the basis of reasonable assumptions, likely to face a structural deficit in excess of 1% of GDP. At this level of deficit consideration of new taxes (or significant changes to existing taxes), as opposed to merely adjusting the effective rates of existing taxes, becomes worthwhile, and issues relating to economic and distributional impacts become more relevant. We have, accordingly, considered what options are open to the Bailiwick in this regard. The following types of option may in principle be considered:

- significant changes to the income tax regime;
- significant changes to the payroll tax regime (in the Bailiwick management of social security contributions as a source of revenue is essentially a payroll tax), in relation to employer contributions or employee contributions or both;
- the introduction of a new tax on consumption, such as a general sales tax (GST);

[37]We are aware that the Treasury and Resources Department is currently revising the TRV system, including revisions to charges on residential and commercial property. We are supportive of this approach.

[38]As opposed to addressing a more significant deficit, where the case is much stronger. See below.

- a new approach to the tax base with regard to duties, which are a special type of consumption tax ; and

- a new approach to the taxation of residential property on occupiers and/or owners.

5.9 The only other new tax that could in principle yield significant amounts, and is in use in some other jurisdictions in various forms, is a general wealth tax. The Bailiwick has made clear that it does not wish to move in this direction, a decision that we would support. Wealth taxes are, notoriously, associated with big practical difficulties: defining the tax base is problematical; there are problems of avoidance; and, usually, high collection and enforcement costs. We have thus given no further consideration to the likely impact of a general wealth tax; otherwise, we consider below the advantages and disadvantages of each of the above options.

5.10 As was explained above in Section 2, there is only a limited number of ways in which, in practice, taxes can be imposed on an economy: all taxes get shifted to be ultimately taxes on income or taxes on consumption, hence all taxes reduce the spending power of individuals either directly or indirectly. Thus all these options reduce, in different ways, the spending power of Guernsey residents (and, to some extent in some cases, the spending power of non-residents). What is of importance to policy-makers is whose spending power is reduced (the distributional consequences); and how the affected individuals will react and what the economic consequences will be.

5.11 With regard to distributional consequences, Oxera has examined the consequences of some of the options and has conducted an extensive modelling exercise using a range of assumptions. We look at what their results show below in this Section; however, we first examine in general terms the key features of the options and their likely effects.

5.12 We look first at significant changes in **income tax.** Income tax is, of course, potentially paid by all residents with earned or unearned income. The economic consequences of the tax are relatively straightforward. The technical literature makes much of a possible distortion in taxpayers' choices as between work and leisure but in a modern society this is perhaps more theoretical than real for most employees[39]; of more significance is that disposable income is reduced and savings may therefore be lower than they would otherwise be. But income taxes do not affect international competitiveness other than insofar as they may affect the willingness or otherwise of mobile workers with specialist skills to live in Guernsey, which may in turn have an impact on the labour market.

5.13 In distributional terms, the distinguishing feature of income tax is that it can readily be targeted to capture personal circumstances and in this way can be adapted to create a system with the desired degree of progressivity. Personal

[39] It may be of more relevance to the self-employed.

allowances can be used to manage the level of income at which tax starts to be payable and to reduce the average rate of tax on taxpayers with low taxable incomes relative to those with high taxable incomes. In some jurisdictions the rate itself is used to achieve distributional objectives, with lower or higher rate bands used to adjust the marginal and average tax rate for people on different levels of taxable income. The system can distinguish between earned and unearned income. And, in the limit, tax credits can be used to address problems at the lower end of the income distribution. At present, the regime in Guernsey is both simple and relatively benign: married residents do not start to pay tax until they have taxable income of at least £16,500 per annum (£19,500 per annum if both are aged 64 or over). There is a single rate of tax and, as noted above, other allowances are available, including mortgage interest and personal pension relief.

5.14 The Policy Council's proposals already envisage some changes to the existing regime in 2008, and these have been taken into account in the analysis presented in Section 4 of this paper. It would, however, be possible to make more radical changes; these could include cutting personal and other allowances significantly or raising the rate of tax. And combinations are of course possible: if the rate were to be raised, for example, those on low incomes can be protected by, at the same time, increasing personal allowances to take some people out of the tax net altogether. This is returned to below; here, however, it may be noted that increasing yield by cutting personal allowances is, potentially a higher-cost option as it brings more people into tax and thus increases collection and enforcement costs.

5.15 Turning now to the **payroll tax** regime, it is important to distinguish between **employer** and **employee** payroll taxes as these have different economic impacts.

5.16 The **employer** payroll tax is a good example of a tax that is shifted, sometimes in quite complex ways. The first round economic effect is to increase the cost of employing labour, in both the private and the public sectors. The tax will then be shifted: it may be passed to employees in the form of lower wages; it may be borne by business in the form of lower profits; it may be passed on to customers in the form of higher prices; or it may be shifted by some combination of these. Lower wages reduce employees' purchasing power; higher prices and lower profits make Guernsey-based production of goods and services less competitive both in export markets and in domestic markets where there is competition from imports. In all cases the effect will be to reduce economic growth but the distributional consequences may differ. To the extent that the tax is shifted to employees, residents not in employment will not pay, but if it is shifted to prices they will pay indirectly through their purchases[40]. Over time, other effects may manifest themselves: the employer payroll tax changes the relative price of capital and labour in capital's favour and therefore provides an incentive to business employers to adopt practices that reduce the input of labour and increase the input of capital. And also relevant will be the precise specification

[40] This will include, of course, visitors to the Island.

of the tax: minimum thresholds below which no tax is payable reduce the impact on businesses employing low-wage low-skill labour; ceilings have the effect of reducing the impact on high-wage high-skill sectors.

5.17 As with the income tax regime, the Policy Council has proposed some changes to the existing arrangements to take effect in 2008; it would be possible to do more and/or change significantly the approach to thresholds and ceilings. We would, however, urge caution in making too much use of employer payroll taxes; unlike some of the other options they present more of a risk to international competitiveness at a time when the Bailiwick needs to maintain its overall position against competing jurisdictions.

5.18 An **employee** payroll tax is somewhat more straightforward in its impact. It reduces gross employment income and is thus equivalent to a tax on earned income. It affects only employees: households without earned income, including pensioners and those with only investment or rental income, do not bear the tax. As with the employer payroll tax, the tax base is therefore smaller than that applying to income taxes (or for that matter taxes on consumption); for the same total yield, employees thus pay more tax under an employee payroll option than they would under an income tax option. And, again, the precise specification of the tax is relevant: minimum thresholds and ceilings have the effect of (relatively) increasing the net income of those below or above the threshold/ceiling. Thus thresholds and ceilings make a payroll tax relatively more progressive (thresholds) or more regressive (ceilings).

5.19 Like income tax, however, the employee payroll tax does not have a direct effect on international competitiveness; whether it affects competitiveness indirectly will depend on the state of the labour market. If employees are able to bid up their wages to recover some of the income lost in tax there will be a negative effect on prices and/or profits.

5.20 The option of a new **tax on consumption**, such as a GST, has some different characteristics from taxes on income or on payroll. Unlike the employer payroll tax, it does not generally affect the competitive position of Guernsey businesses as a GST is not usually applied to exports and the tax rate on imported goods is the same as for locally-produced goods[41]. Consumption taxes do apply to visitor expenditure thus, unlike income tax, some part of the burden, albeit probably a relatively small part, is shifted to non-residents, although as a consequence there will be some effect on Guernsey's competitiveness as a tourist location. Further, taxes on consumption give an immediate upward impetus to inflation. Again, depending on the state of the labour market this may be translated into higher wages, thus impacting on competitiveness indirectly.

[41] The exception to this is where a VAT-type regime is chosen and some sectors are exempt. Exempt businesses (as distinct from zero-rated businesses) do not charge VAT on their sales but may not recover input VAT either. If such businesses are competing internationally with businesses in jurisdictions that have no such tax they will be at a competitive disadvantage.

5.21 Under a broadly-based GST, the burden is spread across all income groups and household types, although those groups who spend a larger proportion of their income (i.e. the less well-off) pay a larger proportion of their incomes in tax than do the better-off who save more, i.e. the tax is regressive rather than progressive, although features can be built in to reduce this, such as exempting necessities from tax altogether or imposing a lower rate of tax on them. One of the problems with a GST, however, is that is may be quite difficult in practice to remove regressive features. A more effective way of compensating the less well-off may be through the income tax system or through welfare payments. And, as a new tax, allowance needs to be made for the cost of setting up a GST, both for government and for those who need to operate it.

5.22 A different approach to the taxation of consumption would be to adopt a **new approach to the tax base with regard to duties**. We noted above for example that, at present, fuel duties are relatively low on the Island, the taxation of motoring being largely based on ownership (vehicle excise duty) rather than use, and we observed that a modest increase in the rate of duties generally could play a part in strategies to deal with a modest deficit. An option to help address a more substantial deficit could include a significant restructuring of duties to impose a greater burden on, for example, users of fuel. Insofar as fuel is an input to economic activity this would of course have an inflationary impact on Guernsey residents and would to some extent impact on international competitiveness, although this effect would be small as Guernsey's key sector in this regard, financial services, is not fuel-intensive. The distributional consequences would be the direct effect on users of private vehicles together with some secondary effect via inflation in the cost of fuel-intensive goods and services, including public transport. In general, like all consumption taxes, the effects are likely to be more regressive than progressive but, insofar as it may reduce private fuel consumption in response to its increased cost, such a move may help to achieve other objectives of policy. The implementation costs of making changes to the current system are likely to be minimal as these will consist of undertaking adaptations rather than major changes.

5.23 Last, there is the option of a **new approach to the taxation of residential property**. Again, we noted above that a modest adjustment in the rate of property tax could play a part in addressing a modest deficit. A more substantial role for property taxation is an option for addressing a more substantial deficit. This would involve a fundamental re-appraisal of tax bases and tax rates in the light of the special features of the Guernsey housing market and, , the implementation costs could be considerable. To examine it in any detail is beyond the scope of this paper[42]. At a level of generality, however, it may be said that taxation of residential property may have some of the positive features of a wealth tax without all of the latter's disadvantages. Like all taxes it is shifted: in this case by the reduction in the disposable income of taxpayers. If, however, there is a reasonable correlation between the value of a residential property and the overall income of its occupant and/or owner, the tax may not be

[42] And the Guernsey authorities have, we understand, started on such an exercise. See footnote 38.

regressive in the way that general consumption taxes are, although it will have consequences for the housing market that may make the Island a less favourable location for mobile workers.

5.24 In summary, we can say that, in terms of their impact on the economy, there are differences between the options that are in principle open to the Bailiwick but these are not huge. Perhaps of most significance is that income tax does not of itself affect international competitiveness directly, neither do employee payroll taxes, consumption taxes, or taxes on residential property. Employer payroll taxes do have a direct effect of this kind. All taxes may have indirect effects through the labour market, although taxes on consumption, because they have a direct effect on inflation, can more speedily feed through into increased wage demands. On the other hand, consumption taxes do ensure that some at least of the burden is borne by visitors to the Island as well as domestic residents. Of equal or greater significance are the costs of implementation- higher in the case of new taxes or radically revised existing ones - and, in particular, the likely differences in distributional consequences. We now look at distributional consequences in more detail by examining the impacts of particular revenue-raising measures on different groups of people.

5.25 Oxera has undertaken extensive modelling of these impacts under different assumptions; the examples we consider below are those designed to address a structural deficit of the order of £30 million in 2011, although the effects of addressing larger or smaller deficits would be, broadly, to increase or decrease the impacts proportionately. The consequences of different approaches are illustrated in Tables V.1 to V.6 at the end of this Section, which show, for six sample households on different income levels, the additional tax that would have to be paid by them in contributing to the elimination of the deficit. The following tax measures are assumed in the Tables, each of which generates the necessary revenue to address a £30 million deficit:

- an employee payroll tax (2.5% on all income from employment);
- an increase in the rate of income tax to 23%;
- a reduction in personal allowances by 35%; and
- introduction of a general consumption tax (GST) of 3%.

5.26 The figures are in nominal terms, i.e. in the pounds of 2011. Key assumptions used, together with explanatory notes, are set out in Annex D.

5.27 The tables illustrate the practical effect of the general principles discussed above. We look first at the lower income group: i.e. those with an income of £10,000 or £20,000. The payroll tax, of course, applies only to employees: where it does impact, at up to £500 (2.5% of £20,000) it is the second most expensive for those in this group and makes no allowance for different personal circumstances. Increasing the tax rate, by contrast, does make some allowance for different circumstances: those below the tax bracket pay nothing (virtually all those on £10,000), and the burden is close to zero for those on £20,000 as well unless they are single, in which case they pay £320. Personal allowances, again, are only of relevance to those who pay tax but in this case the impact will be greater as some people will come into the tax bracket as a result of the reduction in allowances. For those who are on lower incomes but who do pay, this is in fact the most expensive option in most cases, costing up to £1,318 for married couples. The consumption tax is also important for this lower income group: everyone pays, even those who pay no income tax, although it falls into second place behind the reduction in allowances for those who do. The relative burden is greatest for those on lower incomes: at £10,000 the burden is 2.4% of the income of a single earner whilst at £20,000 it falls to 1.5%. And, because the impact increases with household expenditure, the burden also increases with household size: a household with two children earning £10,000 pays £290, or 2.9% of income, whilst the same household on £20,000 pays £411, or just over 2%.

5.28 Looking now at the higher income group, those with incomes of £50,000 to £100,000, the payroll tax, where it is paid at all, is important and, as incomes rise, quickly becomes the most expensive option for all except the single earners, who suffer most from an increase in the rate of income tax. The impact rises proportionately to income. Increasing the rate of income tax, by contrast, does make allowance for personal circumstances and because at this level everyone is in the tax net everyone is affected. Relatively, the single pay most, and this is for all practical purposes the most expensive option for them. Otherwise, the burden on married couples is second only to the payroll tax for those liable to payroll, and rises to between £2,275 and £2,440 for those on incomes of £100,000, depending on their circumstances. The effect of a reduction in personal allowances, by contrast, because it is fixed in money terms becomes relatively less significant as we move up the income curve. The impact is, evidently, greatest where allowances are highest: the single lose £659 whilst older and/or married taxpayers lose more (up to £1,557). For married taxpayers the loss is £1,318: 2.6% of income at £50,000 or 1.3% at £100,000. In the case of the consumption tax, the impact continues to rise in money terms as incomes rise but the relative impact reduces a little: at £50,000 the burden on a married taxpayer with two children is 1.8% but at £100,000 it is 1.4%.

5.29 Finally, for the highest income groups the picture with regard to the payroll tax is similar to that for the middle income group. Where it is levied, it is second only to income tax in its impact, rising to £5,000 on incomes of £200,000. Under the option of an increase in the rate of income tax, some allowance is made for personal circumstances: the burden on the single is greatest, rising to £5,720 on incomes of £200,000. The reduction in personal allowances works in the same way as for the middle income group: the burden falls relatively as incomes rise. On an income of £200,000 the burden on a single taxpayer, at £659, is only 0.03%: for a married couple it is 0.07%. And, finally, the burden of the consumption tax continues to rise with household expenditure but not proportionately with income as those on higher incomes save more. At an income of £200,000 the impact on a married taxpayer with two children is

£2,646, or 1.3%.

5.30 In summary, therefore, it can be seen that, whereas the overall impact on the economy of different options to address a substantial deficit may not be markedly different, the distributional consequences are likely to vary rather more. An appropriate choice is thus likely to be driven at least in part by other objectives of policy. For example, if it is deemed important for everyone to contribute, the consumption tax has merit. If it is important to protect those on low incomes and impose a greater part of the burden on the better-off, raising the tax rate has merit. And, of course, combinations of options can be used and other policies deployed to compensate for consequences deemed to be less desirable; for example, welfare payments can be used to compensate those on low incomes if a consumption tax is chosen, or tax allowances can be increased if the general rate of income tax is increased, thus reducing the effective rate on some low earners and removing others from the tax net altogether.

5.31 To assist policy-makers, we have in Box V.1 at the end of this Section summarised the key features that may be relevant in decision-making in this regard, but it is important to stress that there are no right or wrong answers here: policy-makers will need to make their decisions based on their own objectives.

Conclusions on the period beyond 2011

5.32 Our aim in this Section of our paper has been to look at the options open to the Bailiwick for achieving fiscal balance in the years beyond 2011. Our conclusions are as follows:

- To aim to achieve balance through further expenditure reductions over and above those already proposed is not likely in our view to be a credible option. The analysis and conclusions set out in Section 4are predicated on a stringent approach to the management of public expenditure up to 2008. To limit expenditure still further after 2008 would be very difficult to achieve. It would certainly involve real cuts in services and a very limited capital expenditure programme; it could not realistically be achieved through efficiency gains. And such cuts are unlikely to be achievable without economic damage.

- If the deficit turns out to be relatively modest (i.e. less than 1% of GDP), as it might in the event that spending is constrained but economic growth turns out to be above the range we have looked at, a reasonable approach would be to look for pragmatic solutions and put together a package of measures based on cost and efficiency considerations rather than economic effects. This points in the direction of using the existing tax base and increasing the effective rates rather than looking for major new sources of revenue and could involve some combination of further increases in duties, further adjustment to tax allowances and further upward adjustment to various fees and charges. It could also include an upward revision to the rates of tax on residential property.

- If the Bailiwick has to address a more substantial deficit the options open are, in principle, significant changes to the income tax regime; significant changes to the payroll tax regime; the introduction of a new general tax on consumption; a new approach to the tax base with regard to duties; and a new approach to the taxation of residential property. We have not considered the introduction of a general wealth tax; we support the Bailiwick's decision not to move in this direction. Each of these options has different features but in terms of their impact on the economy the differences are not huge; we would however suggest avoiding measures that have a direct impact on international competitiveness, of which an employer payroll tax is the most obvious example. Of equal or greater significance are differences in the costs of implementation - we have not looked at these in any detail but they are likely to be significantly higher in the case of completely new taxes or radically revised existing ones – and, in particular, differences in distributional consequences. To assist policy-makers, we have summarised the key features of the various options in Box V.1 but, in conclusion, we would emphasise that appropriate decisions on options will depend on policy-makers' distributional and other objectives for the Bailiwick.

Table V.1

Additional tax to be paid: single, earned income, no children

Tax type	Income of £10,000	Income of £20,000	Income of £50,000	Income of £75,000	Income of £100,000	Income of £150,000	Income of £200,000
Apply an employee payroll tax of 2.5% on all income	250	500	1,250	1,875	2,500	3,750	5,000
Increase income tax rate to 23%	20	320	1,220	1,970	2,720	4,220	5,720
Reduce personal allowances by 35%	659	659	659	659	659	659	659
Introduce a general consumption tax of 3%	242	308	790	1,027	1,301	1,893	2,543

Table V.2

Additional tax to be paid: single, aged over 64, unearned income, no children

Tax type	Income of £10,000	Income of £20,000	Income of £50,000	Income of £75,000	Income of £100,000	Income of £150,000	Income of £200,000
Apply an employee payroll tax of 2.5% on all income	0	0	0	0	0	0	0
Increase income tax rate to 23%	0	269	1,169	1,919	2,669	4,169	5,669
Reduce personal allowances by 35%	580	779	779	779	779	779	779
Introduce a general consumption tax of 3%	263	338	845	1,082	1,355	1,947	2,597

Table V.3

Additional tax to be paid: married, earned income, no children

Tax type	Income of £10,000	Income of £20,000	Income of £50,000	Income of £75,000	Income of £100,000	Income of £150,000	Income of £200,000
Apply an employee payroll tax of 2.5% on all income	250	500	1,250	1,875	2,500	3,750	5,000
Increase income tax rate to 23%	0	40	940	1,690	2,440	3,940	5,440
Reduce personal allowances by 35%	0	1,318	1,318	1,318	1,318	1,318	1,318
Introduce a general consumption tax of 3%	242	364	846	1,083	1,357	1,949	2,599

Table V.4

Additional tax to be paid: married, aged over 64, unearned income, no children

Tax type	Income of £10,000	Income of £20,000	Income of £50,000	Income of £75,000	Income of £100,000	Income of £150,000	Income of £200,000
Apply an employee payroll tax of 2.5% on all income	0	0	0	0	0	0	0
Increase income tax rate to 23%	0	0	838	1,588	2,338	3,838	5,338
Reduce personal allowances by 35%	0	1,145	1,557	1,557	1,557	1,557	1,557
Introduce a general consumption tax of 3%	252	404	918	1,180	1,465	2,058	2,707

Table V.5

Additional tax to be paid: married, earned income, two children

Tax type	Income of £10,000	Income of £20,000	Income of £50,000	Income of £75,000	Income of £100,000	Income of £150,000	Income of £200,000
Apply an employee payroll tax of 2.5% on all income	250	500	1,250	1,875	2,500	3,750	5,000
Increase income tax rate to 23%	0	40	940	1,690	2,440	3,940	5,440
Reduce personal allowances by 35%	0	1,318	1,318	1,318	1,318	1,318	1,318
Introduce a general consumption tax of 3%	290	411	894	1,131	1,405	1,997	2,646

Table V.6

Additional tax to be paid: married, earned income, no children, £100,000 mortgage at 5.5% interest

Tax type	Income of £10,000	Income of £20,000	Income of £50,000	Income of £75,000	Income of £100,000	Income of £150,000	Income of £200,000
Apply an employee payroll tax of 2.5% on all income	250	500	1,250	1,875	2,500	3,750	5,000
Increase income tax rate to 23%	0	0	775	1,525	2,275	3,775	5,275
Reduce personal allowances by 35%	0	484	1,318	1,318	1,318	1,318	1,318
Introduce a general consumption tax of 3%	242	364	846	1,083	1,357	1,949	2,599

Box V.1
Comparison of options

	Tax base	Effect on international competitiveness	Other economic effects	Distributional effects	Implementation costs	Other comments
Income tax:						
Increase rates	Only those paying income tax now	None direct. Indirect via competitiveness as location for mobile labour	May increase pressure in the labour market owing to reduction in disposable incomes	For taxpayers, burden rises as income rise.	Low	Effect on those on lower incomes can be mitigated by increasing allowances
Reduce personal allowances	Above, plus new taxpayers now brought into tax	As increase in rates	May increase pressure in the labour market owing to reduction in disposable incomes	Regressive for those paying tax: those on lower incomes pay relatively more	Higher than increasing rates because new people brought into tax	Allowances are relatively high now, so those on very low incomes pay no tax at all
Payroll tax:						
Increase employer rates	All employees	Direct effect of raising labour costs	The burden may be shifted in complex ways depending on the state of the labour market	May be borne by employees, shareholders, or customers	Low if no change to thresholds/ceilings	Thresholds/ceilings can be used to modify impacts
Increase employee rates	All employees	None direct. Indirect through wage-push in the labour market		For employees, burden rises proportionately to income	Low if no change to thresholds/ceilings	Thresholds/ceilings can be used to modify impacts
Consumption tax:						
Introduce a general consumption tax	All consumers	None direct if imposed on imports but not exports	Direct impact on inflation and thereby on wage demands	Regressive if imposed on all goods and services	High, as a new tax	Necessities (food etc.) can be exempt, thereby reducing the relative burden on those on low incomes.
Restructure indirect taxes – increase fuel duty	Purchasers of fuel	Only via inflation in cost of fuel to business	As GST	Marginally regressive via effect on transport costs	Some increase in enforcement cost as greater incentive to evade	Exemptions can be applied for fuel used in public transport but tend to lead to evasion
Increase taxes on residential property (occupiers rates & rateable values)	All occupiers and/or owner of residential property	None direct. Indirect via competitiveness as location for mobile labour	Effect on housing market will depend on detailed approach taken	Not regressive if strong correlation between value of property and income	High, as a new approach to the tax	Can be made more or less progressive by use of rate bands

Section 6 – Summary of key findings and conclusions

6.1 Above in this paper we have sought to examine in more detail the 'Black Hole' in Guernsey's public finances consequent upon the adoption of the 0%/10% corporate tax rate, and the options open to the Bailiwick to address the 'Black Hole' problem. Our key findings and conclusions are summarised below.

6.2 There are some **general principles and practical issues** relevant to the management of the public finances that are of particular importance to policy-makers in the Bailiwick at this time. They are discussed in detail in Section 2 and include the following:

- With regard to government revenues and their impact on the economy, it is important to recognise that, although there are many different types of tax (or charges), in practical terms they all reduce to being taxes on income or taxes on expenditure or some combination of the two: they reduce the disposable incomes of taxpayers.

- Different taxes do, however, have different effects on different groups of people, and policy-makers need to understand, as far as is possible, these distributional effects and be prepared to make decisions as to which groups should bear tax as well as considering what will be the potential effect on the economy.

- Policy-makers also need to understand how government spending impacts on the economy: different types of spending will have more or less beneficial consequences and particular types of cuts in spending may have significantly deleterious consequences.

- Choice of tax base is important in terms of impacts, particularly distributional impacts, but also relevant are practical considerations concerning the costs of collection and combating avoidance. Efficiency and equity may pull in opposite directions.

- Determining likely yields from a particular tax requires an understanding both of the drivers of yield and of how tax payers will adjust their behaviour in the light of the tax.

- In analysing revenue and expenditure and the balance between them, the effects of inflation need to be considered: the distinction between 'real' (after allowing for the effects of inflation) and 'nominal' (including inflation) measures is important.

- The balance between revenue and expenditure is a key issue: across the cycle revenue and expenditure need to be in balance. Structural deficits are not sustainable.

- In estimating the likely evolution of the public finances - income and expenditure and the difference between them - it is prudent to look at a range of assumptions and not to rely on single point forecasts.

- In considering change, issues of administration are important but so are issues relating to the management of uncertainty.

6.3 In **our approach** to discharging our remit we have, as explained in Section 3, made use of all the relevant information made available to us but there are, inevitably, various important areas where information is lacking. We have made reference above in this paper to some of these problems and have, where appropriate, applied a range of different assumptions. Inevitably, however, there remains scope for judgement on the part of policy-makers: our analysis will help to inform such judgements but cannot substitute for them.

6.4 In our examination of the **period to 2011** in Section 4 of the paper, we have analysed the evolution of the public finances in the medium term with a view to assessing whether or not a structural deficit will be apparent by 2011. Our conclusions are as follows.

- Key to the evolution of the public finances is the likely performance of the Guernsey economy, and in particular economic growth. Whilst we applaud the stated objective of adopting ‘pro growth’ policies, we believe it is important not to overestimate what these can achieve. Accordingly, we think a central assumption of average real growth of 2.5% per annum over the medium term is both prudent and appropriate although we also think it is important to consider the consequences of growth both above and below this central estimate.

- Using our assumptions on growth, inflation and tax yields, and assumptions on government expenditure derived from the Policy Council’s proposals, we find that, on reasonable assumptions, the underlying position in 2008 under the current tax structure would be a budget that was just in balance but with very little margin to spare.

- When we consider the likely effects of implementing in 2008 the changes proposed by the Policy Council, we find that, on the revenue side, the net effect would be a cut of the order of £40 million in constant 2004 prices, which in turn translates into a structural deficit of around 2% of GDP.

- Looking beyond 2008, our analysis suggests that further action will be required unless real growth turns out to be at the top of, or above, the range that we have examined. Based on our central assumption on government spending (no real growth), a balanced budget by 2011 would require GDP to grow in real terms at over 4% per annum. Further, the figures suggest that the target of utilising only one half of the contingency reserve over this period would barely be met, if at all, on our central assumptions. Only with high growth or a very tight squeeze on government spending is there a reasonable margin against this target.

- We conclude, therefore, that unless the Guernsey economy performs very strongly, by 2011 action will in all probability be needed over and above the proposals already under consideration. Of course, growth may turn out to be higher than we think it prudent to assume, and efforts should certainly be made to adopt supply-side policies to promote growth. We would urge the Bailiwick to pursue, in particular, policies to improve the skills base of the workforce; these will be necessary to maintain competitiveness. But too much emphasis should not, in our view, be placed on growth to solve the 'Black Hole' problem.

- Overall, therefore, our analysis suggests that policy-makers would be well-advised to give consideration now to appropriate additional policies in order to secure fiscal balance in the future. In our view they will very likely be needed, but in any event to be prepared to implement policies that, in the event, turn out not to be needed is clearly to be preferred to having to design and implement such policies at speed.

6.5 In examining the **period beyond 2011**, our aim in Section 5 of the paper has been to look at the options open to the Bailiwick for achieving fiscal balance. Our conclusions are as follows.

- To aim to achieve balance through further expenditure reductions over and above those already proposed is not likely in our view to be a credible option. A stringent approach to the management of public expenditure is already predicated in the period up to 2008. To limit expenditure still further after 2008 would be very difficult to achieve. It would certainly involve real cuts in services and a very limited capital expenditure programme; it could not realistically be achieved through efficiency gains. And such cuts are unlikely to be achievable without economic damage.

- If the deficit turns out to be relatively modest (i.e. less than 1% of GDP), as it might in the event that spending is constrained but economic growth turns out to be above the range we have looked at, a reasonable approach would be to look for pragmatic solutions and put together a package of measures based on cost and efficiency considerations rather than economic effects. This points in the direction of using the existing tax base and increasing effective rates rather than looking for major new sources of revenue and could involve some combination of further increases in duties, further adjustment to tax allowances and further upward adjustment to various fees and charges. It could also include some upward revision to the rates of tax on residential property.

- If the Bailiwick has to address a more substantial deficit the options open are, in principle, significant changes to the income tax regime; significant changes to the payroll tax regime; the introduction of a new general tax on consumption; a new approach to the tax base with regard to duties; and a new approach to the taxation of residential property. We have not considered the introduction of a general wealth tax; we support the Bailiwick's decision not to move in this direction. Each of these options has different features but in terms of their impact on the economy the differences are not huge; we would however, suggest avoiding measures that have a direct impact on international competitiveness, of which an employer payroll tax is the most obvious example. Of equal or greater significance are differences in the costs of implementation - we have not looked at these in any detail but they are likely to be significantly higher in the case of completely new taxes or radically revised existing ones – and, in particular, differences in distributional consequences. We have illustrated the latter in Section 5of this paper but we would emphasise, in conclusion, that the final choice of options must depend on policy-makers' distributional and other objectives for the Bailiwick.

In summary, below are our key conclusions.

- It is in our view appropriate to adopt a phased approach to the management of the public finances in seeking to address the 'Black Hole' problem, and sensible to take early action along the lines proposed by the Policy Council to raise revenue in 2008.

- Our analysis, however, suggests that these proposals will not be sufficient to remedy the structural deficit, unless the economy grows faster than the upper end of the range we have considered. We would emphasise the importance of pursuing pro-growth policies, particularly in relation to the labour market and the skills of the workforce; these will anyway be needed to maintain international competitiveness. But too much should not be expected of such policies in terms of rapid real growth of the economy.

- Further action will therefore, in our view, very likely be needed to remedy the deficit, although it will, of course, be appropriate to keep the performance of the economy, and the state of the public finances, under close review over the next five years.

- We do not think that further squeezes on public spending alone can remedy the problem; the scale of what would be needed would be likely to result in economic damage.

- If the deficit turns out to be modest (less than 1% of GDP), as it might be if public spending is constrained and growth is very strong, a package of measures based on cost and efficiency considerations might well be appropriate; this would involve using the existing tax base and increasing effective rates rather than looking for major new sources of revenue.

- In the likely event that a more substantial deficit has to be addressed we have set out above in this paper some options for consideration. We suggest avoiding measures, such as extensive use of an employer payroll tax, that have a direct impact on international competitiveness. Otherwise, the Bailiwick will wish to consider the different distributional effects of the various options and also take into consideration their likely costs of implementation. The analysis set out in Section 5, and the summary set out in Box V.1, should help in this regard, but policy-makers will, ultimately, have to make decisions in the light of their own distributional objectives.

- We would, therefore, urge policy-makers to give consideration now to the options open to them and to start to plan implementation of the chosen approaches. If things turn out more favourably than we think probable planning can always be suspended. But to be obliged to implement proposals in haste is likely to both high-cost and economically damaging.

The Independent Group
April 2006

Annex A

Comparison of estimates and computing the effect of the 2008 proposals

Table A.1 below compares the projected public sector revenues set out in ‘Future Economic & Taxation Strategy’ (Appendix 11 and 12) with the central assumptions used by Oxera.

Table A.1 Impact of policy proposals: comparison of assumptions

2008 prices (£m)

	Policy Council	Central assumption: 2.5% growth, 2.5% inflation	Explanation
Tax revenue in 2008 pre 0%10% and policy measures	343	340	Oxera figure based on real growth in revenue of 2.5% pa, Treasury figure estimated directly.
Component derived from corporate profits	116	116	Oxera estimate by taking the predicted split between corporate profits and other revenues in 2006 and rolling forward to 2008.
Tax revenue in 2008 post 0%10% and policy measures	278 plus 22 social security total = 300	276 plus 19social security 295	The £2m difference between the Treasury outcome and the Oxera outcome is likely to arise from rounding errors in both sets of calculations.
Policy measures			
1. Continuing tax on banking profits	10	11	Base figure provided by Treasury; difference arises due to small differences in growth assumptions.
2. Continuing taxation of investment companies		11	Figure provided by Treasury
3. Taxation of distributed profits	14	7	Oxera figure assumes that 30% of profits are distributed, based on actual average distribution of the S&P 500 index companies in 2005 (actual likely figure for Guernsey uncertain, as there is a financial incentive not to distribute profits; Combined Treasury figure appears to consist of £10m from investment companies (page 9) and, therefore, £4m from other distributed profits.
4. Increase in duties etc (including TRV)	6 to 10 from TRV, and other indirect taxes should be increased	9	Oxera estimate is based on halving the estimate contained in the September consultation document as a result of the proposal to raise these taxes ‘but less so than previously indicated’.
5. Increase in social security payments[2]	22	19	Differences in the Treasury and Oxera estimates are likely to arise due to differences in the data used in the calculation and differences in the methodology used to estimate the yield.
6. Changes to interest payments	7	8	Oxera estimate based on policy council, difference arises in conversion from nominal to real terms.
7. Increases in fees	8	6	Treasury estimate, provided to Oxera, New estimate used by Treasury includes changes in miscellaneous income, fees and charges.
Additional revenue	Up to £6m		The revenue projections by the Treasury with respect to increases in duties and TRV, results in a total tax yield in this category of £60m in 2008. Yield in the same categories in 2005 was approximately £45m (2005 money), which is the equivalent of approximately £48m in 2008 money. The total increase in this category is, therefore, around £12m.
Yield of policy proposals	73	71	

Source: Unless otherwise indicated, Guernsey Treasury; Policy Council (2006) Draft Future Economic and Taxation Strategy Policy, in particular Appendix 11 and 12; and Oxera calculations.

Annex B

Estimating GDP in 2004 and 2005

One important piece of information used to project future tax revenues are data on GDP.

The best available information regarding the trends in Guernsey's GDP are statistics calculated by the Policy and Research Unit. When Oxera began work in January 2006 GDP figures were available up to and including 2003, with a provisional estimate for 2004. The provisional estimate indicated that real GDP had shrunk slightly.

The Policy and Research Unit is currently revising its methodology to calculate GDP, and this revised methodology will be used to calculate the final 2004 GDP figure. The new methodology will also be used to re-calculate the 2003 figure so that comparisons with past GDP figures can continue to be used.

The revised figures are not yet available, but preliminary analysis suggests that, although the new figures are likely to produce a substantial increase in the level of measured GDP, the trends in GDP growth would be similar under both methodologies. The use of the historic data to learn about potential future trends thus remains valid.

Notwithstanding the change in methodology, the preliminary figure for 2004 used in the analysis was based on the old methodology. Data that have become available since the preliminary figure was calculated suggest that the remuneration and profit components of GDP will be higher in the final 2004 calculation than was used in the preliminary calculation.

It is therefore possible that the preliminary estimate of GDP for 2004 (based on the old methodology) may somewhat *understate* the level of GDP in 2004 that would finally emerge using the old methodology. Because it is the 2004 GDP level that is used to calculate the estimated 2007 GDP (under the assumption of real growth at 2.5% pa), and in turn the 2007 GDP is used to calculate the tax yield in 2008, an upward revision in the level of the 2004 GDP would result in an upward adjustment in the estimated level of tax receipts in 2008. Each 1% increase in the level of GDP in 2004 would translate into a 1% increase in projected tax revenues in 2008 (and in the intervening years as well). 1% of tax revenues in 2008 will be approximately £3m after the proposed changes to the tax structure have been made.

It will not be possible to finalise the estimates of tax revenues in 2008 using the central growth assumptions until the new GDP figures for 2004 are released. It should, however, be born in mind that there may be an understatement in the preliminary GDP figure in 2004 and, therefore, a similar understatement in the following years, and the results of the analysis should be interpreted accordingly.

Annex C

Summary of Policy Council's proposals

Overall objective

The key objective is maintaining a healthy economy. Managing the States Finances should support that objective.

The Island's future clearly lies in providing a business environment where its residents are in well-paid, secure and sustainable jobs which add value to the businesses in which they are employed.

- Change is in the best long term economic, social and political interests of Guernsey.
- Public sector expenditure (revenue and capital) must be curtailed.
- It is in the long term best interests of Guernsey to maintain and enhance both the finance and non-finance sectors.

Proposals

- The basic rate of income tax on company profits should be 0%.
- Only a limited amount of regulated business (ie, specific banking activities) should be subject to taxation at 10%.
- Trading activities regulated by the Office of Utility Regulation should be subject to taxation at 20%.
- Resident individuals should continue to pay tax at 20% on assessable income.
- Guernsey resident shareholders should be taxed at 20% on their distributed profits and on all rental and investment income but with some rules to ensure compulsory distribution in certain circumstances.
- Significant individual taxpayers should be liable to the standard rate on their non-Guernsey income only up to a defined income ceiling with a total tax payable of £250,000. Guernsey income to be taxed as above.
- 'Wealth taxes' such as inheritance and capital gains taxes should not be introduced.
- The rates of existing indirect taxes should be increased, in particular duties on alcohol, tobacco and Tax on Rateable Values, but less so than previously indicated.
- The General Revenue grant to social security should be reduced by about half (£20m).
- General Revenue should continue to fully fund the non-contributory elements of the present social security system (Family Allowances, Supplementary Benefit, etc) of around £22m per year.
- Half of the Contingency Reserve (interest and capital) should be used to fund the shortfall in public sector expenditure.
- Income tax reliefs on interest payable and life assurance policies should be less generous.
- The Corporate Anti-Poverty Programme will continue to be a key policy of the States and will need to continue to be funded.
- A system of goods and services tax should be fully investigated, and legislation developed, but not introduced in the short term.

Delivery
In order to move from the existing tax regime to a future competitive regime, a two stage process should be adopted:

Stage one
The States will need to run a deficit budget, funded by use of half of the Contingency Reserve with:

- Robust Public Sector expenditure control with only modest annual increases.
- Existing indirect taxes increased.
- Social Security: the employer rate increased by 1%, self-employed rates and employee rate staying the same. Upper Earning Limit for employees, employers and self-employed raised to £60,000.
- No Goods and Services Tax.
- The promotion of economic growth.

Stage Two
Having run a deficit budget for three to five years (ie, until 2011/12), and then after taking into account international events, GST history in Jersey and economic performance, evaluate and produce an overall package which sustains the economic position and delivers a balanced States Revenue budget.

Source: www.gov.gg

Annex D

Assumption used in the distributional analysis

The following assumptions have been used to calculate the distributional impact of using different taxes to meet a specific level of income generation – in this case £30m in 2011.

Calculation of the relevant tax base

The relevant tax bases have been calculated using 2004 data, mainly derived from the taxation records:

– Payroll – the total income recorded under income from remuneration. This includes income attributed to the self-employed.

– Income – the total personal income reported in the tax records

– Consumption – personal income, less net savings, less income spent outside the Island, plus visitor expenditure.

All three tax bases have been assumed to increase in line with GDP growth, and have been grossed up to 2011. An assumption has been made that 2% of the 2.5% pa growth in incomes arises from increases in real wages and 0.5% from increases in the number of workers.

For payroll taxes no other assumptions have been made.

For income taxes:

– Personal allowances have increased in line with inflation

For consumption taxes

– The proportion of income that is spent in each spending category in the Household Expenditure Survey, which was conducted in 1998/99, has remained stable for a household with the same real income in 2011 as in 1998/99.

Calculation of impact and different household types

– For **payroll taxes** the tax rate has been applied to earned income. Households analysed either have all unearned income (those over 64) or all earned income.

– For **income taxes** the taxable income of the household has been calculated and the changes in rates or allowances directly applied to the household in question.

– For **consumption taxes** further adjustments have been made with respect to different household circumstances.

- An assumption has been made that the spending pattern and relationship between gross income and spent income revealed in the Household Expenditure Survey (which is an average within each decile) relates to a household of a couple with no children. As a result, variations from this household type will see different relationships between gross income and disposable income (and hence potential consumption spending). The adjustments made are as follows (and have a relatively minor impact).

    - Those with children receive Family Allowance and there is an assumption that this is spent on taxed items.

    - Pensioners pay less tax (because they have higher personal allowances) and spend less on social security contributions. As a result they have a higher disposable income for any given level of gross income, and therefore, incur more consumption tax.

    - Those with a mortgage pay less tax as a result of the allowance against taxable income arising from mortgage interest payments. As a result they have higher disposable incomes for any given level of gross income and, therefore, incur more consumption tax. (If those with mortgages spend the same level of gross income on housing as those without mortgages – eg renters - their disposable income after housing costs will be the same as those without mortgages, and their spending on taxed items will be similar.)

The household types

The objective is to prove an illustrative range of households, and to illuminate the differences between them. There is no assumption that these household types are representative, or that they represent any particular household. This is particularly true of the illustrated impact of consumption taxes, where individual household’s consumption patterns may vary considerably from the average pattern revealed in the Household Expenditure Survey.

Appendix 7

PUBLIC SECTOR REVENUES 2004 & 2005

	2004 £m	2005 £m
Self–employed & Investment income	30.9	32.5
ETI	109.0	116.0
Companies	96.0	110.2
	235.9	258.7
Alcohol duty	6.1	6.4
Tobacco duty	7.2	6.4
Other duties	0.6	0.7
Motor Spirit duty	1.9	1.9
Motor Vehicle Tax	5.5	6.1
Document Duty	16.5	19.3
Exempt Company Fees	4.7	4.8
Tax on Rateable Value	4.1	4.1
Miscellaneous	2.5	2.1
	285.0	310.5

Appendix 8

ANALYSIS OF CORPORATE TAX PAID 2004 & 2005

		2004 £m	2005 £m
Finance			
	Banking	37.8	37.1
	Investment Companies	9.6	12.0
	Captive Managers & Captives	6.1	2.3
	Insurance	3.4	9.0
	Investment Managers	8.0	10.1
	Fiduciary	2.3	2.9
	Others	6.6	8.8
		73.8	82.2
Non-Finance			
	Primary	0.5	0.8
	Manufacturing	1.2	1.3
	Construction	3.7	4.1
	Hostelry	2.0	2.2
	Wholesale& Retail	8.3	9.1
	Information Handling	1.1	1.6
	Miscellaneous	5.4	8.9
		22.2	28.0
Total		96.0	110.2

Appendix 9

ETI GROWTH 1999 TO 2005

Under the proposed new tax regime income from employees (i.e. ETI) will become a greater proportion of States revenues.

Without any changes in the tax regime there has already been a marked increase in ETI receipts as follows:

	£m	% Annual increase	% Growth after inflation (RPI X)	ETI as a % of total tax receipts
1999	61	5.2%	2.4%	32%
2000	70	14.8%	11.0%	35%
2001	82	17.1%	14.2%	36%
2002	97	18.3%	14.5%	41%
2003	105	8.2%	4.8%	44%
2004	109	3.8%	0.9%	46%
2005	116	6.4%	3.4%	45%

Appendix 10

PUBLIC SECTOR EXPENDITURE: 2004 & 2005

Revenue Expenditure	2004 £m	2005 £m
Policy Council	8.1	7.9
Treasury & Resources	19.5	20.9
Commerce & Employment	11.8	11.7
Culture & Leisure	2.8	3.0
Education	59.0	64.1
Environment	7.9	8.4
Health & Social Services	73.6	80.2
Home	22.7	24.3
Housing	2.7	1.7
Public Services	10.5	9.2
Social Security	57.1	60.4
	275.7	291.8

Capital Expenditure		
Major Construction Projects	29.7	36.3
Miscellaneous Capital Works	8.2	10.4
Equipment, Machinery & Vehicles	3.0	2.9
ICT Projects	3.5	0.6
	44.4	50.2

The above figures can also be summarised as follows:	% of Annual Revenue Expenditure
Health	27%
Social Welfare	24%
Education	22%
Law & Order	11%
Infrastructure	5%
Economic Support	4%
Revenue Collection	3%
Central Government	2%
Culture	1%
Overseas Aid	1%
	100%

Appendix 11

PROJECTED PUBLIC SECTOR REVENUES 2008

The following table shows where the revenue raised to fund States expenditure in 2008 will be derived from if the proposals outlined in this Report are implemented:

	2008 £m
Revenue Income	
ETI, investment income & self-employed	179
Income from distributed profits	14
Income from banking profits	10
Indirect taxes	60
Miscellaneous income, fees & charges	10
Annual company fees	5
	278

Notes:

The difference between the above revenues and total States expenditure (revenue and capital) will be made up by use of the Contingency Reserve in the interim stage.

ETI, investment income & self-employed (£179m) is based on an annual growth of 5% **in cash terms (2.5% in real terms assuming RPI of 2.5%)** plus the effect of reducing income tax relief on interest payments and life assurance policies (£7m).

In its report, the Economic Independent Working Group modelled various scenarios, including a central projection of GDP growth of 2% **in real terms** against a ten-year average of growth of 2.9% in real terms.

Appendix 12

ALTERNATIVE SCENARIOS FOR 2008 PUBLIC SECTOR FINANCES

	A	B	C
	£m	£m	£m
Revenue income	278	278	268
Ongoing revenue expenditure	290	305	310
Capital expenditure	15	20	20
Reduced grant to Social Security	(22)	(22)	(22)
Use of Contingency Reserve	5	25	40

Notes:

Scenario A is based on the revenues as set out in appendix 11 with public sector expenditure of £290m (revenue) and £15m of capital, i.e. as set out in the second consultation document.

Scenario B is based on the revenues as set out in appendix 11 with increased public sector expenditure of £305m (revenue) and £20m of capital.

Scenario C is based on £10m of lower revenues and increased public sector expenditure of £310m (revenue) and £20m of capital.

All of the above figures are in cash terms.

Appendix 13

CONTINGENCY RESERVE PROJECTIONS

	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m
Opening balance	200	209	218	221	224	227	230
Interest received	9	9	10	10	10	10	11
Use of Fund			7	7	7	7	7
Closing balance	209	218	221	224	227	230	234

Opening balance	200	209	218	203	186	168	150
Interest received	9	9	10	8	7	7	6
Use of Fund			25	25	25	25	25
Closing balance	209	218	203	186	168	150	131

Opening balance	200	209	218	188	160	136	116
Interest received	9	9	10	7	6	5	4
Use of Fund			40	35	30	25	20
Closing balance	209	218	188	160	136	116	100

Notes:

In the above projections no account has been taken of any monies that would be collected as a result of early implementation of any of the extra revenue raising proposals.

As at 1 January 1999 the Contingency Reserve had a balance of just £85m. The significant increase to £200m as at 1 January 2006 has made it possible to consider using part of the Fund to fund a deficit budget in the short term.

Appendix 14

SOCIAL SECURITY CONTRIBUTIONS: ALTERNATIVE SCENARIOS

It is estimated that the extra revenue that would be collected under the following scenarios:

		£m
Employees’ rates	Increased by 1%	7.1
Employers’ rates	Increased by 1%	7.3
Self-Employed rates	Increased by 1%	0.7
Non-Employed rates	Increased by 1%	0.4
Upper Earnings Limit	Increased to £45,000	7.6
Upper Earnings Limit	Increased to £60,000	13.9
Upper Earnings Limit	Increased to £75,000	16.8
Upper Earnings Limit	Increased to £100,000	21.5
Upper Earnings Limit	Removed	31.5

Increasing employers’ rates by 1% and increasing the Upper Earnings Limits to £60,000 would increase revenues by £22.3m

Increasing employers’ rates by 1% and increasing the Upper Earnings Limits to £100,000 would increase revenues by £30.5m

It is stressed that the above figures are estimates, provided by the Social Security Department, which must be treated with increasing caution at the higher levels of Upper Earnings Limits. Even if revenues were proved to be fairly accurate, they are vulnerable to avoidance and business behaviour.

Appendix 15

COMPARISON OF PRESENT AND PROPOSED SOCIAL SECURITY CONTRIBUTIONS

	Employee	Employer	Self-employed	Non-employed	Upper Earnings Limit
Present	6.0%	5.5%	10.5%	9.9%	£36,036
Proposed	6.0%	6.5%	10.5%	9.9%	£60,000

It should be noted that approximately 75% of employed persons are currently earning less than the current Upper Earnings Limit and will therefore be unaffected by the above proposals.

The following are some worked examples comparing the payable in social security contributions. They are provided for illustrative purposes only. There will be no increase in benefits payable as a result of the increased contribution rates.

Scenario One: Person earning £20,000

	Employee	Employer	Self-employed	Non-employed
	£	£	£	£
Present	1,200	1,100	2,100	1,980
Proposed	1,200	1,300	2,100	1,980
Change	0	200	0	0

Scenario Two: Person earning £40,000

	Employee	Employer	Self-employed	Non-employed
	£	£	£	£
Present	2,162	1,982	3,784	3,568
Proposed	2,400	2,600	4,200	3,960
Change	238	618	416	392

Scenario Three: Person earning £60,000

	Employee	Employer	Self-employed	Non-employed
	£	£	£	£
Present	2,162	1,982	3,784	3,568
Proposed	3,600	3,900	6,300	5,940
Change	1,438	1,918	2,516	2,372

Scenario Four: Person earning £100,000

	Employee	Employer	Self-employed	Non-employed
	£	£	£	£
Present	2,162	1,982	3,784	3,568
Proposed	3,600	3,900	6,300	5,940
Change	1,438	1,918	2,516	2,372

Notes

Non-employed persons contributions are based upon assessable income, as provided to the Social Security Department by the Income Tax Office. The proposed increase in the Upper Earnings Limit also applies to non-employed persons paying “Health and Long-term Care” contributions and those over 65 paying “Specialist and Long-term Care” contributions.

The number of social insurance contributors can be summarised as follows:

Employed persons	29,158
Self-employed	2,942
Non-employed paying (under 65)	884
Non-employed paying (over 65)	3,058

Appendix 16

GOODS AND SERVICES TAX

In its Report entitled “Income Generation in Guernsey” the National Audit Office estimates that if Value Added Tax at the rates applied in the UK (and the Isle of Man) were to be introduced, £110 million per year could be raised.

As part of its strategy the States of Jersey, in order to make good its £80m to £100m shortfall in tax receipts, have announced that it will introduce a general goods and services tax of 3% to raise £40m.

Introducing a 3% goods and services tax locally could raise the following from the various areas of household expenditure:

	Estimated Net Annual Revenue £m
Housing	5.0
Food, drink & medicines	7.0
Fuel, Light & Power	1.0
Clothing and footwear	1.5
Household goods and services	3.0
Personal goods	2.5
Motoring & Travel	3.0
Leisure goods and services	4.0
Others	3.0
	30.0

Note:

It would be possible to devise a goods and services tax that exempted specific areas. However, such a system would be more complex to introduce and administer.

In the above estimates no account has been taken of the possible impacts of introducing a local goods and services tax and thereby encouraging islanders to purchase off island (via the internet etc.)

Appendix 17

GLOSSARY

Attribution means a regime where tax is calculated on 100% of the assessable profits of a company and charged to local shareholders, irrespective of whether the profits are distributed on not.

Cash terms means the actual amount of money that will be expended. Real Terms is cash terms less inflation.

Contingency Reserve is a Fund established by the States of Guernsey whose purpose is to provide protection against major emergencies including significant economic downturns having a severe adverse effect on the Island.

Distribution-only means a regime where the tax would be assessed on a local shareholders of a company based on the amounts actually distributed.

ETI (Employee Tax Instalment Scheme) is a tax collection scheme whereby an employer withholds tax from the emoluments of individual employees and pays them over to the Income Tax Office.

Fiscal & Economic Policy Steering Group is the sub-Group of the Policy Council tasked with overseeing the development of a future fiscal and economic strategy and was responsible for issuing the first and second consultation documents in 2005. The Group comprises the Chief Minister as Chairman, the Deputy Chief Minister and the Ministers of the Treasury & Resources and Commerce & Employment Departments

General Revenue means those parts of the States activities that are funded, fully or in part, by general taxation. For example, Health, Social Services, Education, Law and Order.

Goods and Services Tax is a generic term for a range of taxation systems where revenue is raised from the consumers of goods and services at the point of purchase. A ***Sales Tax*** refers to a type of goods and services tax which is chargeable at the point of sale.

Independent Economic Working Group was commissioned by the Treasury and Resources Department to undertake an economic analysis and comprises former Deputy John Roper as Chairman assisted by Rosemary Radcliffe CBE and economic consultants Oxera.

Island(s) means the islands of Alderney, Guernsey and Herm.

Ring-Fenced is a term used to describe the situation when a preferential tax regime is available only to non-residents rather than to residents of the country providing the regime.

States Trading Entities means those companies wholly owned by the States of Guernsey and subject to regulation by the Office of Utility Regulation, i.e. Guernsey Post Limited and Guernsey Electricity Limited.

Tax on Rateable Values is the current system of annual tax (which raises approximately £4m per year) on property. This system is under review and will be replaced by a simplified system to be referred to as Tax on Real Property.

Zero-Ten means a tax regime where the standard rate of tax on corporate profits is zero with some companies regulated by the Guernsey Financial Services Commission subject to a tax rate of 10%.

Zero-Twenty means a tax regime where the standard rate of tax on corporate profits is zero with some companies regulated by the Guernsey Financial Services Commission subject to a tax rate of 20%.

(NB The Treasury and Resources Department's comments are set out below.)

The Chief Minister
Policy Council
Sir Charles Frossard House
La Charroterie
St Peter Port

11th May 2006

Dear Sir

The Treasury and Resources Department acknowledges the significance of the States Report put forward by the Policy Council and recognises that the proposals need to be considered as a total package.

The Department fully endorses the Policy Council's proposals that new revenue raising measures should be undertaken on a phased basis and will be bringing forward the necessary proposals as part of its future Budget Reports, starting in December 2006. Such a phased approach is sensible and will allow additional monies to be collected and, subject to States approval, placed in the Contingency Reserve.

The Treasury and Resources Department also repeats the need for States expenditure to be restrained. The Department has consistently received strong support from the States for this policy and intends to continue to do whatever it can to achieve this necessary aim.

Although the Department recognises why the Policy Council feels it necessary to investigate the introduction of a goods and services tax and to develop legislation, it urges significant caution in this area. For the reasons previously stated, the Department continues to believe that a goods and services tax is best avoided. The Department believes that should additional tax raising measures become necessary, it would initially be considerably better to use existing taxes rather than introduce any new ones, especially those that are regressive in nature.

The Department believes that significant extra revenue would be better raised from the main beneficiaries of the proposed tax reforms i.e. employer contributions and commercial property taxes rather than from individual residents.

The Treasury and Resources Department, with the exception of Deputy Parkinson, supports the package of measures proposed by the Policy Council. Deputy Dorey does not support recommendation 11.

Yours faithfully

L S Trott
Minister

The States are asked to decide:-

Whether, after consideration of the Report dated 8th May, 2006, of the Policy Council, they are of the opinion:-

1. That from 1st January, 2008, the basic rate of income tax on company profits shall be 0%.

2. That only a limited amount of regulated business (ie specific banking activities) shall be subject to income tax at 10%.

3. That trading activities regulated by the Office of Utility Regulation shall be subject to income tax at 20%.

4. That resident individuals shall continue to pay income tax at 20% on assessable income.

5. That Guernsey resident shareholders shall be taxed at 20% on their distributed profits and on all rental and investment income but with effective anti-avoidance measures including deemed distribution in certain circumstances.

6. That individual taxpayers shall be liable to the standard rate on their investment and non-Guernsey trading income up to a defined income ceiling with a maximum tax payable of £250,000 on any individual's income from such sources.

7. That "wealth taxes" such as inheritance and capital gains taxes shall not be introduced.

8. That the rates of existing indirect taxes shall be increased, in particular duties on alcohol, tobacco and motoring, and Tax on Rateable Values, in line with the contents of that Report.

9. That the General Revenue grant to social security shall be reduced from 1st January, 2008, by increasing the rate of employers contribution by 1% and increasing the Upper Earnings Limit for employers, self-employed, non-employed and employees to the equivalent of £60,000.

10. That General Revenue shall continue to fully fund the non-contributory elements of the present social security system (Family Allowances, Supplementary Benefit etc).

11. That up to half of the Contingency Reserve (interest and capital) may be used to fund the shortfall in public sector expenditure during a transitional phase.

12. That income tax relief on interest payable and life assurance policies shall be revised in accordance with the proposals set out in that Report.

13. To direct the Treasury and Resources Department to investigate a system of goods and services tax, including that introduced by the States of Jersey, and to direct the preparation of the necessary enabling legislation.

14. To direct the Treasury and Resources Department to take account of the above proposals when bringing forward recommendations as part of that Department's 2007 and future Budget Reports.

15. To direct the Social Security Department to take account of the above proposals when bringing forward recommendations as part of that Department's Reports on Benefit and Contribution Rates for 2007 and future years.

16. To direct the preparation of such legislation as may be necessary to give effect to their above decisions.

IN THE STATES OF THE ISLAND OF GUERNSEY

ON THE 30TH DAY OF JUNE, 2006

The States resolved as follows concerning Billet d'État No. XI
dated 26th May, 2006

POLICY COUNCIL

FUTURE ECONOMIC AND TAXATION STRATEGY

After consideration of the Report dated 8th May, 2006, of the Policy Council:-

1. That from 1st January, 2008, the basic rate of income tax on company profits shall be 0%.

2. That only a limited amount of regulated business (ie specific banking activities) shall be subject to income tax at 10%.

3. That trading activities regulated by the Office of Utility Regulation shall be subject to income tax at 20%.

4. That resident individuals shall continue to pay income tax at 20% on assessable income.

5. That Guernsey resident shareholders shall be taxed at 20% on their distributed profits and on all rental and investment income but with effective anti-avoidance measures including deemed distribution in certain circumstances.

6. That individual taxpayers shall be liable to the standard rate on their investment and non-Guernsey trading income up to a defined income ceiling with a maximum tax payable of £250,000 on any individual’s income from such sources.

7. That “wealth taxes” such as inheritance and capital gains taxes shall not be introduced.

8. That the rates of existing indirect taxes shall be increased, in particular duties on alcohol, tobacco and motoring, and Tax on Rateable Values, in line with the contents of that Report.

9. That the General Revenue grant to social security shall be reduced from 1st January, 2008, by increasing the rate of employers contribution by 1% and

increasing the Upper Earnings Limit for employers to the equivalent of £100,000, and for self-employed, non-employed and employees to the equivalent of £60,000.

10. That General Revenue shall continue to fully fund the non-contributory elements of the present social security system (Family Allowances, Supplementary Benefit etc).

11. That up to half of the Contingency Reserve (interest and capital) may be used to fund the shortfall in public sector expenditure during a transitional phase.

12. That income tax relief on interest payable and life assurance policies shall be revised in accordance with the proposals set out in that Report.

13. To direct the Treasury and Resources Department to investigate a system of goods and services tax, including that introduced by the States of Jersey, and to direct the preparation of the necessary enabling legislation.

14. To direct the Treasury and Resources Department to take account of the above proposals when bringing forward recommendations as part of that Department's 2007 and future Budget Reports.

15. To direct the Social Security Department to take account of the above proposals when bringing forward recommendations as part of that Department's Reports on Benefit and Contribution Rates for 2007 and future years.

16. To direct the preparation of such legislation as may be necessary to give effect to their above decisions.

17. To direct the Policy Council to afford a high degree of priority to the identification of initiatives (including possible public/private sector partnerships) which are favourable to the development and/or revival of economic sectors other than the financial services sector, and to bring before the States practical proposals which, to some degree, will redress the current imbalance in the Island's economic base.

S. M. D. ROSS

HER MAJESTY'S DEPUTY GREFFIER