Personal Tax, Pensions and Benefits Review

Principles and Issues

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States of Guernsey

This document is important because...

It outlines the key principles and issues identified as part of the Personal Tax, Pensions and Benefits Review process, together with some of the options available to mitigate some of the risks and challenges faced by Guernsey and Alderney in the long-term. Its intention is to promote informed debate on these issues in the wider community.

This report does not contain any formal recommendations.

The Treasury and Resources and Social Security Departments will submit specific recommendations to the States for debate later in 2014.

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

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1 Executive Summary

Unless major changes are made to the way in which Guernsey and Alderney raise taxes and fund old age pensions and social insurance, universal and welfare benefits, the time is fast approaching when the States will be unable to fulfil its commitments to provide a wide range of public services, to invest in essential Island infrastructure and to support those in greatest need.

As explained in this paper, while Guernsey's system of raising the majority of public funds through direct taxation and social insurance contributions has served the Island well for the past fifty years, it is no longer sustainable in the face of a number of critical changes and increasing fiscal pressures.

Recognising the need for change in response to these growing pressures on income and expenditure, the States have embarked on a Review of Personal Taxation, Pensions and Benefits. Over the past 18 months, the Treasury and Resources and Social Security Departments (working together as the "Joint Boards") have examined the issues in detail, carried out public consultation, and identified the key challenges and potential options for addressing the issues identified, the results of which are contained in this paper.

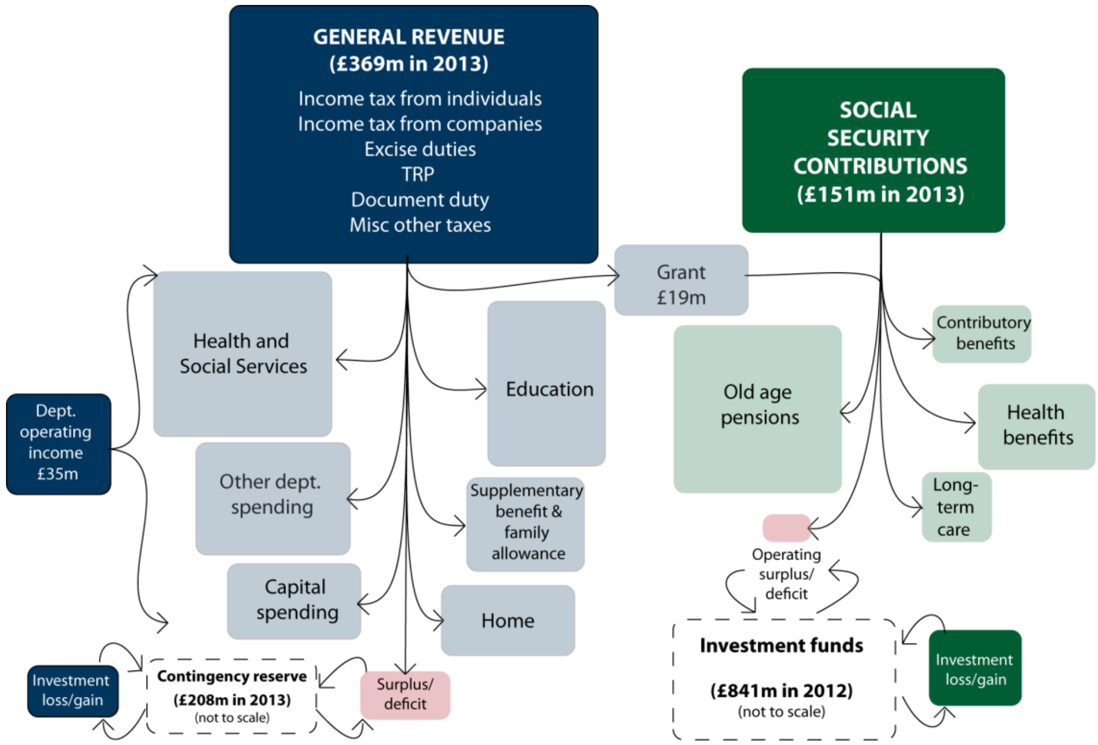
2 Background

Guernsey funds its public services from two separate, but connected, systems as demonstrated in the diagram below.

The General Revenue budget receives money from general taxes such as income tax, tax on real property (TRP) and excise duties. The budget is administered by the Treasury and Resources Department and money is allocated to the operational departments which provide services such as education, law enforcement and the majority of health and social care services. Overall expenditure and appropriations[1] from the General Revenue budget totalled £394m in 2013 and net income totalled £369m[2], leaving a deficit of £25m.

The Social Insurance system receives income from social insurance contributions. It also receives a grant from General Revenue to supplement its income, which totalled £19m in 2013. This money is divided between three funds[3], which act as buffers for the provision of insurance-based benefits such as old age pensions, unemployment, long-term care and some healthcare services (such as prescription and primary medical care subsidies). Net expenditure from the Social Insurance system (including the grant from General Revenue) totalled £178m in 2013 and income totalled £170m, leaving an operating deficit (excluding investment income) of £8m.

Figure 2.1: Illustration of General Revenue and Social Insurance systems



[1] Including the transfer of funds to the Capital Reserve for the investment in major infrastructure projects.
[2] A further £35m is raised at departmental level through fees and charges and other operating income. This income is netted off revenue expenditure for each department.
[3] The Guernsey Insurance Fund, The Guernsey Health Service Fund and The Long-Term Care Fund. For investment purposes, the reserves held in these funds are combined to form a single consolidated fund.

The basic structure of Guernsey's income tax system (including the standard rate of 20%) had been largely unchanged for more than fifty years until, in 2006, in response to growing pressure from Europe to remove perceived harmful aspects of Guernsey's tax system, Guernsey, alongside Jersey and the Isle of Man, approved the introduction of the Zero/10 tax regime (Billet D'Etat XI, June 2006). The Zero/10 system introduced a standard rate of tax on company profits at 0% with effect from 2008. There is also an intermediate rate of 10% which initially applied to income from banking activities. This has subsequently been extended to income from fiduciary, domestic insurance and insurance management activities in 2013. A higher rate of 20% applies to income from land and buildings in Guernsey and activities regulated by the Office of Utility Regulation.

The introduction of Zero/10 led to a significant reduction in income tax receipts from companies, resulting in a deficit in the General Revenue budget. Various measures have been employed to reduce the deficit which, if successful, will have reduced the potential deficit by an estimated £70m in total (see page 34). These have included:

- Increasing Tax on Real Property (TRP) (primarily those applicable to commercial premises, although some increases were made to domestic rates of TRP) and other indirect taxes;
- Reducing the revenue subsidy paid to Social Security and, to compensate, increasing the social insurance contributions paid by employers and increasing the upper earnings limit on contributions, increasing the liability for mid- to high-earning individuals;
- Reducing States' expenditure through the Financial Transformation Programme [FTP] - the FTP's objective is to achieve a minimum of £31m per annum of recurrent savings by the end of 2014[4].

In respect of the second of these measures, in contrast to personal income tax, the rates and application of social insurance contributions have been changed several times over the last forty years, as new benefits have been added to the social insurance scheme. Nonetheless, 2007 represented a milestone in the evolution of the social insurance scheme as, prior to that year, the limit on the total amount an individual could contribute was set with reference to the total expenditure of the Social Security funds and the number of contributors. In addition, it had been the practice that a grant was paid from General Revenue as a top-up for those whose contributions were below the maximum (see figure 2.1).

In 2007, the grant paid from General Revenue to the Social Security funds was lowered to reduce General Revenue expenditure ahead of the changes to the corporate tax system explained above. This reduced the income to the Social Security funds. To compensate for this, the upper earnings limit (or non-earned income for those not employed) on which social insurance contributions are paid was increased progressively, rising from £36,000 in 2006 to £132,444 in 2014. The rate of contributions paid by employers was also increased from 5.5% to 6.5% in 2008.

However, it was always intended that there would be a second stage to the realignment of public finances following the introduction of Zero/10; specifically the report at the time stated:

[4] The programme had achieved annual savings of £26m by April 2014, with a further £5m of savings to be achieved by December 2014 to meet its target.

"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."

**Goods and Services Tax*

While the States did not approve the introduction of a consumption tax at the time zero/10 was agreed, enabling legislation, which sets the ground work for a GST, was approved by the States in 2009.

The system of taxing companies was further reviewed in 2011, as a result of further questions raised by the European Union's Code of Conduct Group regarding the compliance of Zero/10 with the EU Code of Conduct for Business Taxation. As a result, Guernsey's deemed distribution provisions were removed in order to make the tax system compliant with the Code of Conduct for Business Taxation, but further review of the Economic and Taxation Strategy was delayed until the closure of the Corporate Tax Review in December 2012.

In the 2013 Budget (published in October 2012), the Treasury and Resources Department stated its intention to complete a review of taxation in Guernsey by launching a review of personal tax. It was decided that any review should provide a wholesale review of taxation against personal income and, for completeness, should also include social insurance contributions and indirect taxation measures. As a result, it was decided that this Review should be conducted jointly by the Treasury and Resources and Social Security Departments.

In undertaking the review it was clear that a critical factor determining the income and expenditure of the States in future was the fact that the age distribution of Guernsey's population was changing. The number of people above retirement age relative to the number of people in the working age population is projected to increase significantly over the next few decades, and this will present challenges in the provision of those publicly funded services which older people typically make the most use of. The effects of this will be particularly felt in relation to pensions and health and social care provision. Given that these issues may have considerable bearing on the need for revenue in the future they have been incorporated within the scope of the Review.

The Review began in January 2013 and a public consultation was launched to gauge the feeling of the public on the issues involved. The public consultation took place over an eight week period between April and June 2013. Approximately 250 responses were received from both private individuals and organisations. A report summarising responses to the consultation was released in August 2013, the summary of which is included as Appendix A.

Towards the end of 2014, a formal States Report will lay out a vision of how the Tax, Pensions and Benefits systems should look in 2025. Clear recommendations for change will be presented with the intention that, if approved, changes will be phased in over a ten year period. In the meantime, as a prelude to that debate, the Joint Boards are issuing this report and supporting materials in order that the communities in both islands are well-informed and have sufficient time to reflect on the issues, the options and their implications, before the States is asked to agree the way forward.

However, it is important to understand that there will be no single solution. The recommendations presented will almost certainly contain a broad package of measures to mitigate the risks to both expenditure and income.

3 Setting the Context

Fiscal pressures

Growing pressure from the European Union, which considered Guernsey's former corporate tax practices harmful, and the need to remain competitive on an international stage, made it necessary for Guernsey to adopt the Zero/10 tax regime in 2008, as part of a co-ordinated approach with Jersey and the Isle of Man. Whilst this strategic policy change addressed these external pressures, it resulted in a significant reduction in the amount of income tax paid by corporations and led to a structural deficit in the Island's public finances.

Although the States have made good progress in reducing this resulting deficit through the Financial Transformation Programme (FTP) and other measures (such as increasing commercial property tax rates and increasing the upper limit on social insurance contributions), in the short-term the States' budget has been running a deficit equivalent to 4% of general revenues.

There are several work-streams that are intended to reduce this deficit further. These include work to continue to drive internal efficiency beyond the end of the FTP in Dec 2014; a further review of the extent of the application of the intermediate (10%) tax rate on companies (in particular, to capture fund administration businesses); and efforts to develop and diversify Guernsey's economy through the Island's Economic Development Framework. However, whilst these measures may successfully address the deficit in the short-term, on their own, none of these measures will address the fundamental issues outlined in this paper.

Whilst the focus of this paper is on the impact of increasing health, pensions and social costs largely as a result of demographic change, it would be foolish to overlook other financial challenges, such as capital investment required in public infrastructure, such as a new school, a new computer system or an extension to the airport runway.

The States have set themselves a target of capital spending of 3% of GDP per annum. This is not designed to encourage unnecessary spending, but as a guide to ensure that an adequate amount of money is being invested in the Island's infrastructure on an ongoing and planned basis.

Since the 3% target was established, the pressure on the General Revenue budget has meant that the States have been unable to generate the surpluses required to enable sufficient allocations to the Capital Reserve to meet the target. The States have allocated an average of 2.2% GDP to capital spending over the past 10 years; a shortfall of approximately £16m per annum.

Long-term, if the States are to maintain and develop the public infrastructure, a sustainable way to support the investment is needed.

Population size

Many of the long-term issues facing Guernsey are as a result of the changing age profile of the population, rather than its size. Currently, States' policy is to aim to keep population size to 2007 levels, albeit that to date it has not been possible to achieve this. Looking forward, if no growth in population is to be achieved, the changes in demographic make-up mean that this could only be through **net emigration**; and if, as seems more likely, this emigration was to be of people of working age, it would amplify many of the issues outlined in this paper. Reviewing the States' policy on population growth is, therefore, part of the package of options under consideration.

Demographic Change

Demographic change is not a new issue, but one that has been on the horizon for many years. Neither is it one unique to Guernsey, but a challenge faced by most western economies; a consequence of changes in birth rates and life expectancies over the last century, and a normal part of the evolution of an economically advanced community. Indeed, increased life expectancy reflects improvements in social conditions and medical care, and is something that all nations aspire to achieve. However, the negative consequence is that the changing age composition of our population will alter the level of income received by the States and increase the demand for public expenditure. The States must plan **now** to adapt to this changing environment.

To explain in more detail, the average number of people in Guernsey turning 65 each year between 2012 and 2015 is expected to be about 28% higher than it was between 2004 and 2008 - an increase of approximately 330 new pensioners each year. Furthermore, the annual number of new pensioners is expected to continue at this level for at least another twenty years. As a result, in the future there will be more people above retirement age and fewer people of working age than there are today.

Although there are steps that can be taken to mitigate the effects of this change in demographic profile, the fact remains that the increase in the **number** of older people in our society will increase the overall level of demand for services and it is essential this is planned for. In particular, to avoid expenditure on health and social care growing to unsustainable levels, our current models of delivery of housing, health and social care must change because these are based on a presumption of dependence, not independence. The work being undertaken to prepare a Supported Living and Ageing Well Strategy (SLAWS) is thus fundamental to achieving the necessary shift in our community mind-set to address conventional notions of what it means to be old and to plan the services required to meet the challenges of a vastly different Island population. It will also help to set in context improvements in medical technology and the costs associated with providing more sophisticated services, which, as they have always done, will exert a continuous upward pressure on medical care costs.

A shift in our demographic profile also presents challenges for States' income. As people who are working typically pay more income tax and social insurance than those who are retired, it follows that, unless changes are made, as the percentage of pensioners increases and the percentage of people of working age falls, the value of receipts from income tax and social insurance contributions will also fall.

Overdependence on personal income tax

Notwithstanding some of the positive benefits of an ageing population outlined later in this paper, there is a real risk that our current system, which is so heavily dependent on personal income tax and social insurance contributions, will become increasingly vulnerable as the age distribution of our population changes, or if there is a downturn in the economy and unemployment rises. Unusually, personal income tax and social insurance contributions account for some 73% of the States' total income (see section 6). This is at least 10% more than any comparable island jurisdiction or OECD country. Without diversifying the tax base this vulnerability will remain.

Review assumptions

Population policy, and the success or otherwise of achieving economic diversification and/or growth, will each impact on the scale of the issues outlined in this paper.

While there is a need for an informed debate on what size Guernsey's population should be, for the purpose of this report, levels of future migration are assumed to be consistent with Guernsey's recent history, i.e. **net immigration of about 200 people per year**[5].

With regard to the economy, the Economic Development Framework has outlined how the States aim to promote long-term economic growth and, clearly, enhanced growth would benefit Guernsey financially. However, whilst promoting the conditions for growth and removing barriers to business should be very high priorities for the States, basing long-term fiscal planning on over-optimistic levels of growth would be imprudent. Therefore the projections presented in this paper incorporate modest levels of GDP growth, based on an assumption of **1.5% annual growth in real earnings**[6]. The final recommendations of this review will need to be flexible enough to allow Guernsey's finances to adapt to an outcome better or worse than these projections.

[5] Figures published in April 2014 showed that, counter to recent trends, Guernsey experienced **net emigration** in the year ending 31 March 2013. It is, at present, too early to establish whether or not this is an isolated event or the beginning of a new trend.
[6] Using this type of modelling, levels of GDP growth vary with the changing size of the workforce.

4 Review Objectives

At the outset of the review process, the Joint Boards agreed that their prime objective was to present to the States a series of measures that would deliver long-term sustainability of public finances, pensions and benefits, and ensure a greater degree of efficiency and fairness.

There is some inevitable conflict between these objectives. Those taxes considered “economically efficient” are often not considered “fair” by the wider population, although the judgement of “fairness” is inherently subjective. The Joint Boards therefore established a priority of objectives.

4.1 Sustainability

The Joint Boards agreed that **sustainability** should be the key objective. A secure and stable Tax, Pensions and Benefits system is crucial to the ongoing provision of public services. An unsustainable Tax, Pensions or Benefits system is a threat to our social and economic success.

By ‘sustainability’, the Joint Boards mean that:

- In the long-term, Guernsey’s tax system needs to generate sufficient revenues to meet its expenditure needs, and that a balance between tax and expenditure pressures is needed to achieve this. The Fiscal Framework already commits the States of Guernsey to a principle of permanent balance (i.e. in the long-term it should not spend more than it receives) within General Revenue and this principle should be upheld.
- The total value of money extracted from the economy to fund public services should remain at a level consistent with Guernsey’s status as a relatively low tax jurisdiction. Expenditure should remain at a level at which permanent balance is achievable without increase in taxation beyond this.
- Benefits, pensions and services, in particular health and social care, should be structured in such a way as to provide an appropriate level of care and support without exerting unsustainable pressure on the public purse.
- Revenues need to be generated in a way which provides predictability and, where possible, resilience to economic conditions and demographic change.
- Both the population and the business community need confidence about the level of tax they are required to pay, and the level of public services they can expect to receive in return, in the long-term.

4.2 Efficiency

An efficient tax, in economic terms, is a tax which has little effect on the behaviour of a taxpayer and, by implication, on the economy as a whole.

Taxing any activity is similar to the usual impact of a price increase in that it tends to discourage that activity. Taxes on income reduce the value of work, reducing the amount of money taken home in exchange for work. Taxes on wealth reduce the benefit from savings and investments. Taxes on consumption increase the cost of goods and services purchased. A more detailed explanation of economic efficiency is provided in Appendix B.

Taxes which reduce the incentive to work, invest or save are generally considered less efficient than those that discourage consumption or leisure. The OECD ranks taxes in the following order with the most efficient tax first:

a) Property taxes (recurrent on immovable property) (e.g. TRP or council tax)
b) Consumption taxes (e.g. excise taxes, General Sales Tax [GST] or Value Added Tax [VAT])
c) Personal income taxes (including social insurance contributions)
d) Corporate taxes

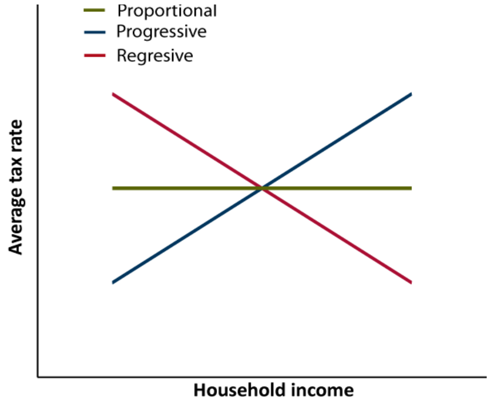
Administrative efficiency, i.e. the annual cost of collecting a tax versus the revenue gained from it, should also be considered.

4.3 Fairness

The concept of fairness is subjective; each person's view of what is fair or unfair will differ. Three terms are commonly used when discussing the fairness of a tax regime, all of which describe the distribution of tax relative to income (see Figure 3.3.1):

- **Proportional:** where each individual pays the same proportion of their income in tax
- **Progressive**: where higher earning individuals pay a larger proportion of their income in tax
- **Regressive**: where higher earning individuals pay a smaller proportion of their income in tax

Figure 3.3.1: Illustration of progressive, proportional and regressive taxation



The concept of horizontal equity (i.e. that people with the same income should pay the same tax) is also important. Arrangements which mean that two households with a similar income, but different circumstances, pay different amounts of tax are often considered unfair, e.g. a household with a mortgage is entitled to tax relief on the interest while another household renting a similar property is not entitled to any tax relief on their housing costs.

Similarly, tax systems which are considered economically efficient often do not meet the criteria of what people would typically consider "fair". The reverse is also true. For example, progressive taxes, such as higher rates of income tax for higher earners, are considered fair by some (and unfair by others); but they reduce the incentive to work and earn for those above the threshold, and are not considered to be economically efficient.

The Joint Boards accept that a compromise between fairness and efficiency is unavoidable, but believe that there are measures which can be taken to mitigate aspects of any final proposal that might be considered unfair.

5 Guiding Principles

Using the recurring themes that emerged from the public consultation as a starting point, the Joint Boards developed the following set of principles to guide the design of the future Tax, Pensions and Benefits system.

5.1 The tax and benefits systems should incentivise people to work and support themselves

There are benefits to the individual, the community and the States in encouraging people to support themselves and become independent of States' support where ever possible.

For individuals, self-support is healthy, often resulting in employment and greater engagement with the community. By contrast, long-term over-dependence on government to provide for all social and financial needs is not healthy. Long-term dependence on benefits can have a tendency not to incentivise work, leaving some households trapped in relative poverty. Indeed, there are well-recognised links between long-term dependence on financial support and low self-esteem and poorer physical and mental health.

From the perspective of the States, a person in work is contributing towards the shared cost of providing services to the population. A person not in work is often a person needing financial and social support. There will always be people who, for a wide variety of reasons, may not be able to support themselves without help. However, it is in the interests of all to encourage people to make as much contribution to their own support as they are able.

5.2 People should be encouraged to take responsibility for their financial wellbeing in later life

As a community, we encourage those of working age to support themselves. However, most people are not currently setting aside enough (or in many cases, any) resources for their retirement. A survey conducted by the Policy Council in 2012 revealed that less than half of the working population is contributing to a private or workplace pension, and many of those that are may not be contributing enough to provide them with a sufficient return to provide for a comfortable retirement.

The promotion of positive outcomes, such as economic and social independence and the taking of personal responsibility, were set as objectives in the 2013 Social Policy Plan. If the States is to meet these objectives and avoid those who have not made sufficient pension provision becoming dependent on the welfare system for their financial support in retirement, it will need to ensure that people make more provision for themselves. In this regard, that tomorrow's older people may be fitter and healthier than their counterparts today means that, in general, they should be able to remain economically active for longer.

5.3 The tax and benefits systems should be, as far as is possible, simple and easy to understand

A simple tax system has many benefits. Most people are more comfortable paying a tax they understand; and the number of people who do not comply with its requirements (for example by not submitting a tax return) is typically much lower if the reporting requirements are straightforward. A high level of compliance means fewer resources required to enforce it, making the system less expensive to run.

Simple tax systems are also more transparent. In an era where tax transparency is the subject of international scrutiny, this is an important consideration for Guernsey.

5.4 The personal tax system needs to be competitive on an international stage

Guernsey's economy is founded on its reputation as a well-regulated, transparent and relatively low tax jurisdiction, of which an internationally competitive personal tax system is an important element.

In the international environment, the taxing of corporate bodies is rapidly evolving. The emphasis on tax transparency and information exchange has increased; corporate tax rates are being reduced in many jurisdictions; and there are initiatives, such as the OECD Action Plan on Base Erosion and Profit Sharing which could ultimately lead to a more territorial basis of taxation for corporates[7]. Guernsey needs to be constantly monitoring and reviewing its options to ensure that it's corporate tax strategy remains competitive. While any resulting changes could create beneficial opportunities, it would be unwise to assume that these will emerge during the period envisaged for this review.

Of more immediate relevance is that the highly mobile businesses which form the basis of Guernsey's finance industry - and which make up 40% of our economy - need to be able to attract staff to work for them from outside the Island, in areas where the skills and expertise needed may not be available locally. Particularly at a senior level, such staff can be as internationally mobile as the firms for whom they work. In order to be able to attract the right expertise to help our economy grow, Guernsey needs to be able to offer a personal tax package that will compare favourably with other territories competing for the same staff.

Guernsey also needs to import skilled staff to fill key positions in its social infrastructure, including teachers and nurses. The personal tax system must be competitive for lower and middle income earners to help attract the high quality staff needed to support the Island's health and education systems.

In this regard, it is relevant to note that indirect taxes paid by Guernsey residents remain low: the average domestic property tax is about one-tenth of the average Council tax bill in the UK and consumption taxes are currently limited to fuel and excise duties. Nonetheless, Guernsey's direct personal taxation has become less competitive in recent years. From April 2014, personal tax allowances in the UK are higher than those in Guernsey and, whilst the rate of employee social insurance contributions remains relatively low, the upper earnings limit on contributions is now significantly higher than it is in Jersey, the UK or the Isle of Man.

[7] A territorial tax system taxes only domestic income (E.g. profits earned in Guernsey) but not foreign income (e.g. profits earned outside Guernsey).

Combined, these factors mean that, in some cases, the direct tax burden of lower and middle income households in Guernsey may not compare favourably with the UK or Jersey.

5.5 The States have a duty to ensure that expenditure is controlled and public money is used efficiently

One of the primary roles of the States is to decide how public money is spent in the best long-term interest of the community. States' Members have a responsibility to ensure that funds are used wisely and that the population is receiving value for money for the taxes they pay.

In this respect, whilst the FTP may end in December 2014, longer-term there are projects underway which will deliver savings beyond the Programme's timescale. An example of this would be property savings from the delivery of the Strategic Asset Management Plan. In addition, the ongoing transformation of services provided by the Health and Social Services, Education and Home Departments each have the potential to release further efficiency savings beyond the Programme's timescale.

6 Issue 1: Spending public money

6.1 Short- and long-term issues

The States face two major challenges in relation to its spending:

- its short-term budget deficit, predicted to be approximately £14m in 2014; and
- a long-term increase in demand for services as a result of the changing demographics.

The two issues are independent of one another. Measures to reduce the current deficit and solve the immediate fiscal problem will not prevent the increase in expenditure on pensions, health and social care needed by a greater number of people over retirement age over the next few decades. Conversely, measures to mitigate expenditure in the long-term may not remove the current deficit.

Whilst closing the deficit is important; the focus of this review is to look at the more significant, long-term pressures on public spending and service provision.

6.2 More retired people and fewer workers

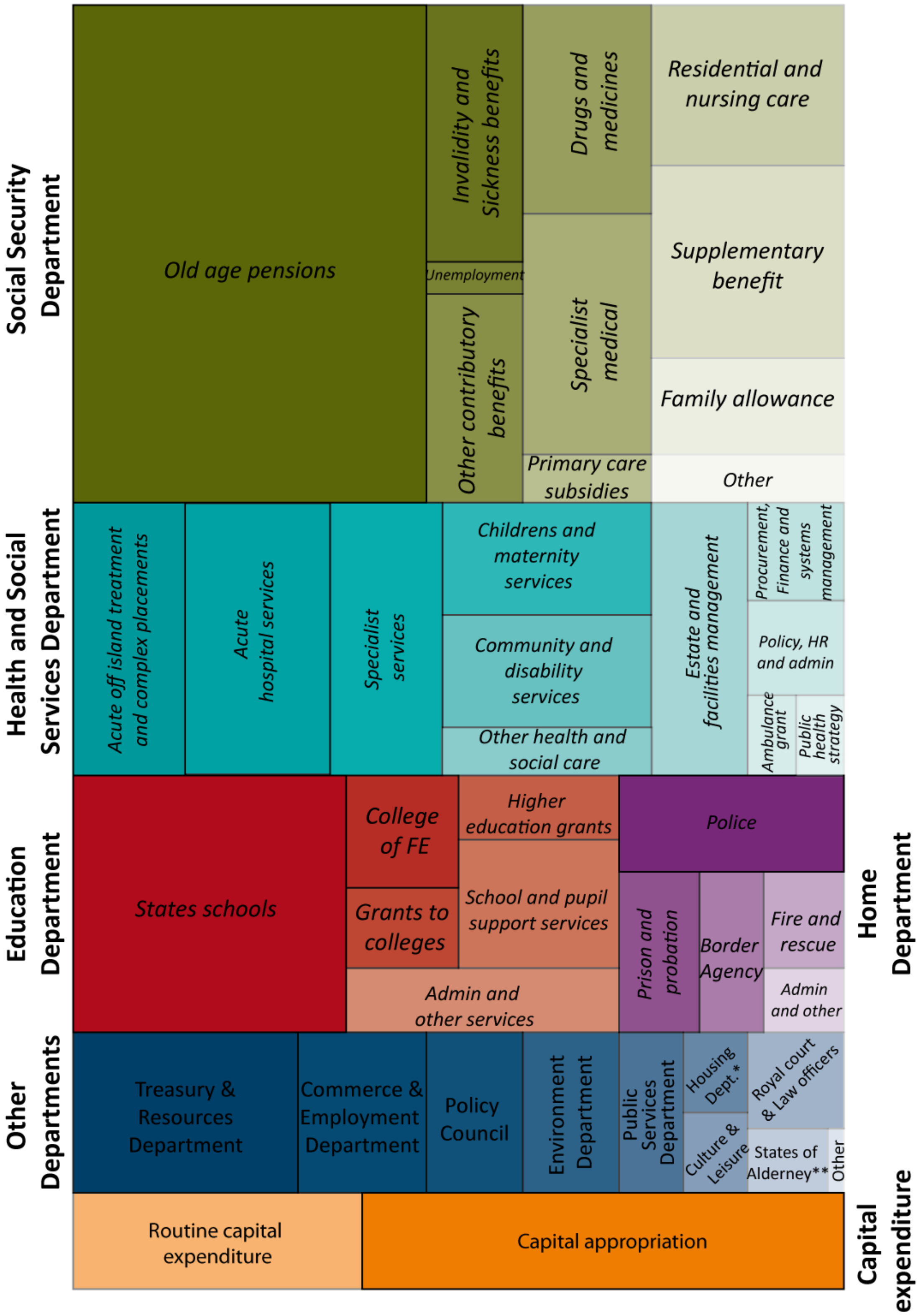
Simply put, the predicted demographic change means that in future a larger proportion of our population will be above retirement age and a smaller proportion will be of working age. The difficulty posed by this is that typically a working age person pays more in tax than a retired person; a retired person typically makes more use of services such as:

- old-age pensions;
- health and social care;
- welfare benefits.

As a consequence, the States will face the prospect of increased spending at the very time income from taxes is being eroded. As Figure 6.2.1 shows, these services already make up a large proportion of States' spending and the proportion of States' expenditure in these areas will increase over time.

Figure 6.2.1: Overview of total government spending

Presented to scale, net of operating income

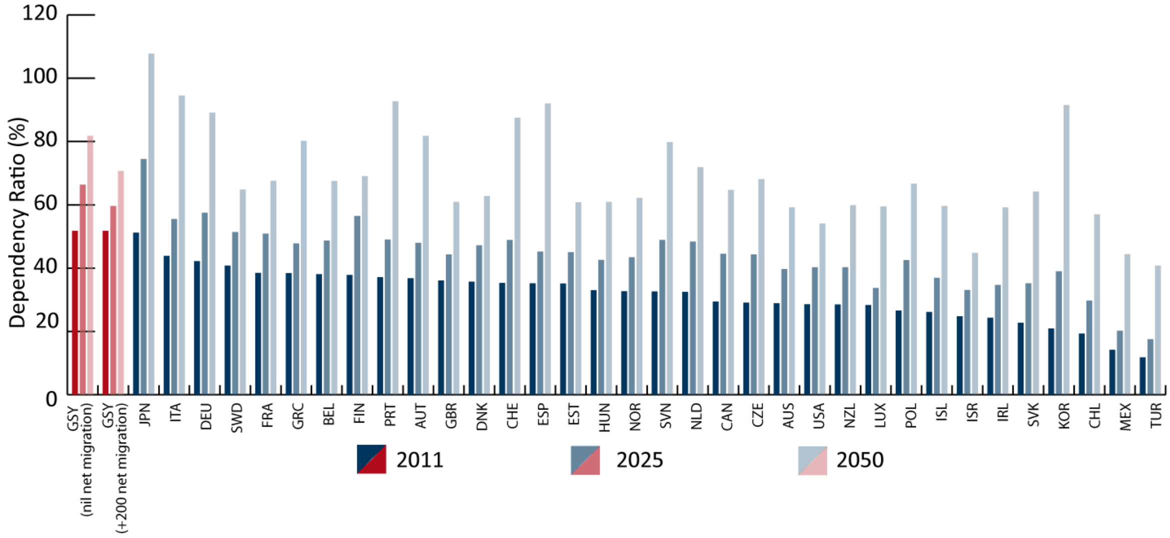


*Housing Department expenditure does not include £11m expenditure from the Corporate Housing Fund. £6m of this is captured as a transfer of rent rebates to the Corporate Housing Fund from routine capital expenditure.

**Central administration cost only. The cost of service provision in Alderney is incorporated within the budget of the operational departments.

Figure 6.2.2: Comparison of Dependency ratio with OECD countries[8]

Source: Policy Council; OECD Stats database



Demographic change is not a new issue, nor unique to Guernsey, but it has been on the horizon for many years. However, whilst the general issue is widespread, the situation in Guernsey is more pronounced than in many countries. Combined, Guernsey and Alderney have one of the highest dependency ratios in the world (see Figure 6.2.2). In 2011[9], for every 100 people of working age in the Bailiwick there were almost 52 people either of, or below, compulsory school age or above pensionable age. The only OECD jurisdiction with a comparable dependency ratio is Japan.

Demographic change is, of course, inherently positive: people are living longer, healthier lives and shifts in the make-up of the population are a normal part of the evolution of an advanced economy. However, because it will change the pattern of both the States' income and the demand for public expenditure, the States will need to adapt to the changing environment.

In the past, the States have been able to maintain balance between the money it takes in taxes - the majority of which is taken from the working age population - and the amount it pays for providing services, much of which is provided to those not of working age. The States need to consider how best to maintain the balance between income and expenditure as the age distribution of the population changes.

This pressure from an ageing population is a result of two factors: (i) the greater than anticipated improvement in life expectancy since the introduction of the pension scheme in Guernsey; and (ii) the increase in the birth rate between the end of World War II and the mid-1960s (generally referred to as the 'baby boom' generation). These two factors exert subtly different pressures on expenditure.

As stated above, the increase in life expectancy is a good thing. It demonstrates improvements in social conditions and the effectiveness of medical care. However, the current pension age of 65 is lower than it was when pensions were first introduced in the 1920s (when the pension age was 70), and the pension age has

[8] The data presented represents the combined dependency ratios of Guernsey and Alderney. Considered separately the dependency ratio in Alderney is significantly higher than for the Bailiwick as a whole. In March 2011 the dependency ratio for Alderney was 63%, the dependency ratio for Guernsey was 48%.

[9] 2011 figures are used to allow comparison to international data sources. 2013 data are available at www.gov.gg/population

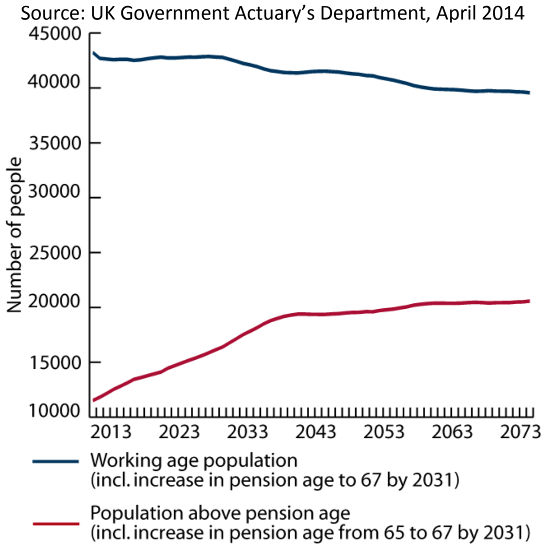
not been increased since the current pension law was established in 1965 (although an increase to 67 by 2031 has already been approved). Consequently, people are living longer in retirement and receiving more pension payments, but the period during which they pay into the pension fund remains unchanged. Indeed, the period over which pension contributions are paid may be reducing for many, given that people tend to stay in education longer than they may have in the 1960s. Any pension system where people are paying in the same number of contributions but getting out, on average, more payments, is not sustainable.

As the 'baby boom' generation (currently aged between 51 and 67) reach the age at which they can claim an old age pension, so there is an increase in the number of people drawing funds from the Guernsey Insurance Fund, from which pension payments are paid. The increase in the number of new old age pension claims each year is significant. For example, between March 2004 and March 2008 the annual average number of Bailiwick residents turning 65 was 521; between March 2012 and March 2015, the annual average is estimated to be around 850[10], an increase of about 28%.

Figure 6.2.3: Projected population: Working age and those above pension age

Assuming net immigration of 200 people per annum, incl. increase in pension age to 67 by 2031

Source: UK Government Actuary's Department, April 2014



By 2025 the number of people aged 65 or over is expected to be 44% higher than in 2012; indeed, by 2050 it is expected to have doubled. The States' decision in 2009 to increase the pension age to 67 by 2031 will lessen the issue but, even if this change is included, the change in the number of people of pensionable age relative to those of working age is significant (see Figure 6.2.3). As the large group of people in the 'Baby Boom' generation move beyond working age, they are being replaced by a smaller group of people moving into employment at the other end of the age scale. As a result, the working age population (at present those aged 16 to 64) is expected to decline.

This has consequences for States' income streams as, on average, a working age person pays about 60% more tax than someone of pension age and six times as much in social insurance (those over 65 being no longer required to contribute to their pension). However, as more people move into retirement, at which point their income is likely to be smaller and typically increases at a slower rate than earnings[11] in the working age population, the direct tax base will be eroded.

To make matters worse, in addition to an increasing number of claims for old age pension, as more people live for longer so the overall need for health and social care services will increase; and this will increase the total cost of providing these services. Combined, these issues could present a significant funding problem.

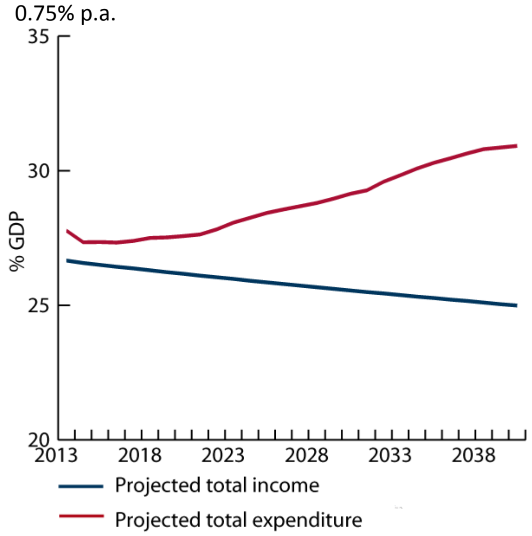
[10] This follows a spike between March 2011 and March 2012 when more than 1,000 people turned 65 over a twelve month period. This age group represents Guernsey's largest age cohort, those born in the year immediately following the end of World War II.
[11] The majority of private pension annuities are linked to inflation.

Without changes to the way in which income is raised, or restructuring in the provision of pensions, health and social care, revenue growth will lag progressively further behind expenditure growth. For example, if the States is to continue current income and expenditure patterns, between 2015 and 2025, government income is projected to fall relative to GDP by 0.6%, whilst expenditure is projected to grow by 1% of GDP. As the change in the population profile progresses, this gap is projected to get wider, so that by 2035, income relative to GDP is projected to be 1.2% lower than in 2015 and expenditure is projected to have increased by 3% of GDP.

The Social Security funds will be able to absorb some of the additional expenditure on pensions and long-term care; however, the reserves are not sufficient to absorb the whole of the projected cost if we continue to provide the same level of services and apply the same level of annual uprating (halfway between the increase in retail price inflation and the increase in median earnings) as are currently assumed.

Figure 6.2.4: Projected income and expenditure

Assuming net immigration of 200 people per year, annual earnings growth of 1.5% p.a., increase in healthcare costs of 1.5%pa, pension uprating of 0.75% p.a.



6.3 Demographic impact: Pension provision

Please note that the projections presented in this section are under review by the UK Government Actuary's Department and those presented in the final States report may differ from those presented here.

6.3.1 The States' Old Age Pension

Pensions are the most obvious area of expenditure impacted by the increased proportion of people of retirement age; more pensioners means more money is needed to pay their pensions.

Some action has already been taken to mitigate this issue; in 2009 the States approved a resolution to increase the pension age from 65 to 67 by 2031, **but this alone is not sufficient to resolve the problem**.

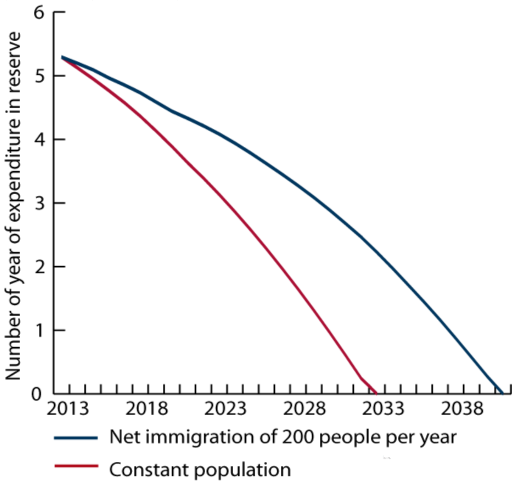
The Social Security Department currently spends around £100m per year on the payment of old age pensions. This is the largest single item of expenditure in the States' portfolio of services and expenditure on pensions is rising at an accelerating rate. By 2025, annual expenditure on pensions could be as high as £150m (at 2014 prices).

By contrast, even allowing for a real increase in earnings and net immigration of 200 people per year, the total income of the Guernsey Insurance Fund over the same period is projected to be less than half of this.

As a consequence, if no action is taken, the Guernsey Insurance Fund is projected to be exhausted by the early 2040s (see Figure 6.3.1); and if the States' policy of 'no growth' in population is achieved, the point of exhaustion could be as early as 2032.

Figure 6.3.1: Projected reserves held by the Guernsey Insurance Fund

Assuming: 1.5% real annual increase in earnings; annual uprating of pensions by 0.75%; an increase in the pension age to 67 by 2031; current contribution rates



However, unlike the UK, Guernsey is fortunate enough to have a significant amount of money held in reserve for the payment of pensions; enough to fund more than 5 years of expenditure, but not sufficient to fund all the projected growth in demand. Nonetheless, the income generated from the investment of these reserves supplements the contributions needed to fund expenditure year by year, and means that the mitigating actions needed are less severe than would be required to fund the pension system solely out of annual contribution receipts (as they are in the UK).

Previously, options presented for tackling this problem have assumed that reserves should not be reduced to less than two years of expenditure. **The Joint Boards have considered this assumption and consider that it would be imprudent to make long-term plans which would reduce the level of reserves to any less than this.**

In addition to using reserves, there are a number of other options available for resolving the old age pension issue. The options presented below outline the ways in which the Guernsey Insurance Fund could be stabilised, either by increasing the Fund's income or by reducing its projected expenditure. The options are not mutually exclusive; the solution could be to combine elements of two or more to achieve the desired result.

Option 1: Increasing the income of the Guernsey Insurance Fund

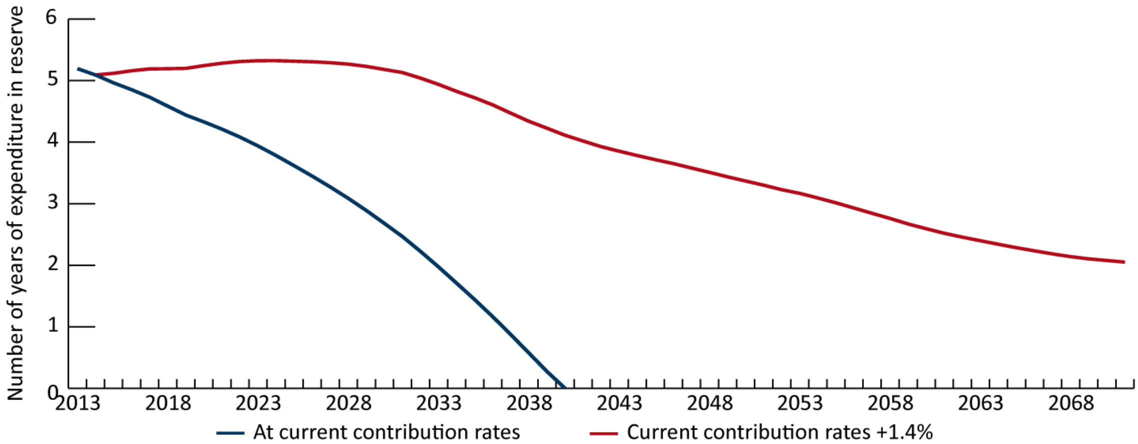
One solution to this problem would be either to increase social insurance contributions, or the grant paid from General Revenue, to provide for the extra demand for expenditure. If this was to be proposed as the entire solution, an increase in the contribution rate of approximately 1.4% (which could potentially be divided between the rates paid by employers and employees) would be needed (assuming net immigration of 200 people per year over the entire 60 year period projected). This would increase the combined percentage of earnings paid into the Fund by employers and employees from 8.3%[12] to 9.7%.

For individuals, this would mean an increase in social insurance contributions paid by working age people. For someone on median earnings (£29,640 a year) this would mean an increase in their contributions of £7.98 per week.

At 2014 prices, the effect of such a measure would be equivalent to an increase of approximately £19m in the Fund's annual income. Figure 6.3.2 below demonstrates the impact this could have on the Fund reserves.

Figure 6.3.2: Projected reserves held by the Guernsey Insurance Fund

Assuming: 1.5% real annual increase in earnings; annual uprating of pensions by 0.75%; an increase in the pension age to 67 by 2031; net immigration of 200 people per annum.



[12] Employees pay 6.0% of their earnings in Social Security contribution up to the upper limit; employers pay an additional 6.5%. The total contribution for each employed person of 12.5% is divided between Social Security's three funds as follows: 8.3% paid into the Guernsey Insurance fund; 2.9% paid into the Guernsey Health Service Fund; 1.3% paid into the Long-Term Care Insurance Fund.

Option 2: Reduce the assumed level of annual uprating of pensions

The central assumption used in the 2011 actuarial review was that pensions would be increased each year at a rate half way between the increase in retail price inflation (RPIX) and the increase in median earnings (which is typically slightly higher). Increasing pension payments by more than inflation each year has a very significant impact on the Fund's reserves. The actuarial review published in 2011 showed that if the annual increase in pension payments was reduced to inflation only, the Fund could be maintained without any other mitigating actions (see Figure 6.3.3).

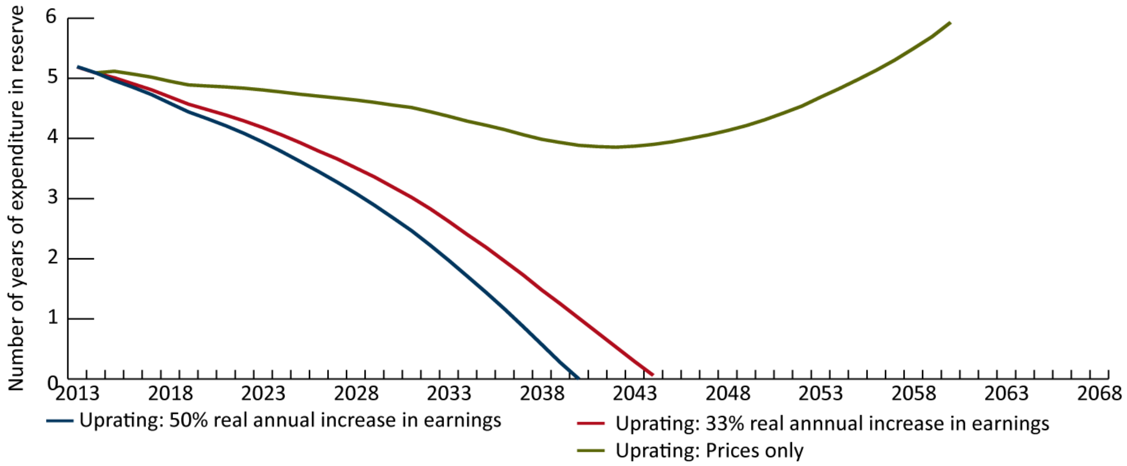
Increasing the old age pension by inflation means that a pensioner should be able to buy about the same amount of goods and services with their pension as they do today. (NB This is not exact because the actual change in the cost of living experienced by an individual or household depends on how they spend their money and can vary significantly from person to person.)

However, keeping the annual increase in pensions below the increase in median earnings means that, over time, the value of the old age pension relative to what people in the workforce are earning will reduce.

For example, in 2014 the Guernsey old age pension is equivalent to approximately 40% of median earnings (after the payment of income tax and social insurance contributions). If the rate of pension uprating is maintained at the same rate as the increase in earnings, this will not change; but if it is reduced to half the rate of increase in real earnings by 2025, this could reduce to 38% and if it is reduced to inflation only this could reduce to 33% by 2025.

Figure 6.3.3: Projected reserves held by the Guernsey Insurance Fund

Assuming: 1.5% real annual increase in earnings; an increase in the pension age to 67 by 2031; net immigration of 200 people per annum; current contribution rates.



Option 3: Increase the pension age

Increasing the pension age has the effect of increasing the number of contributions an individual might make over their lifetime and decreasing the number of pension payments they will receive. Many countries have already begun to increase their pension ages. The UK has approved increases to 68 and are indicating their intention to link pension age to life expectancy, which is expected to result in an eventual increase in pension age to 70.

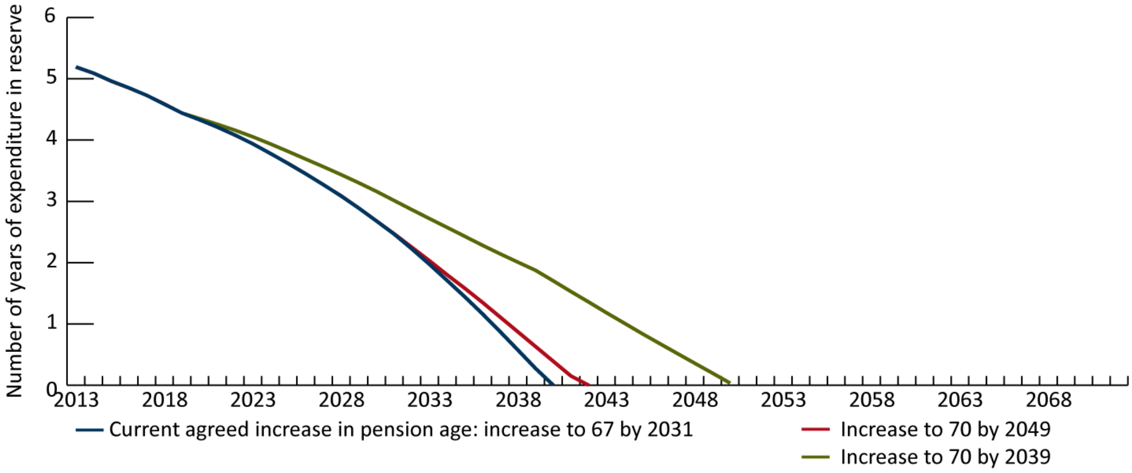
The States have already approved an increase in the pension age to 67 by 2031: the first increase in the pension age approved since the current scheme was established in the 1960s. However, whilst the pension age will have increased by 2 years, between 1965 and 2031 life expectancy beyond 65 is projected to have increased by 11 years for men and 10 years for women.

The implication of this is that, even allowing for the agreed increase, the average person will be paying up to two years' more contributions (possibly less, given the increase in post-16 and higher education[13]) and claiming their pension for eight or nine years longer.

A further increase in the pension age may form part of the solution; however, if the increase is continued at two months a year and from the end of the current policy to increase the pension age to 67 by 2031, the Fund's reserves will have been depleted to such an extent that, on its own, this measure will have little impact (see Figure 6.3.4). If implementation of the increase to age 67 already agreed is accelerated, or this measure is applied in combination with other mitigating measures, it will be more effective. **However, unless the States are willing to extend the pension age beyond 70 and to increase the pension age at a faster rate, extension of the pension age, on its own, is not a complete solution to this problem.**

Figure 6.3.4: Projected reserves held by the Guernsey Insurance Fund

Assuming: 1.5% real annual increase in earnings; annual uprating of pensions by 0.75%; current contribution rates; net immigration of 200 people per annum.



[13] Over this period the percentage of younger people who stay in education beyond the age of 16 has increased significantly. An increase in the number of people undertaking full-time undergraduate and post-graduate qualification means that it is increasingly common for people not to enter full-time employment until well into their twenties.

Increasing the pension age may not mean that everyone will work longer. As is currently the case, those who wish to retire before the State pension age (as many people choose to) will need to make their own financial provisions between their retirement and the States pension age.

Of course, many people will need to work for longer and this has its difficulties. If an individual's fitness declines as they approach retirement, the likelihood of experiencing difficulty in carrying out particular areas of a job increases. In addition, the 'baby boom' generation will hold a large proportion of senior executive positions and the progression of this group into retirement may strip valuable skills and expertise from the workforce. If people are to continue in work – and contribute economically - for longer, working practices will need to become more flexible to accommodate the needs of an older workforce.

Option 4: Means testing the old-age pension

The option of means testing the old age pension, and restricting access to lower income households only, was raised in the initial consultation paper. Australia introduced a scheme like this in 1992 making government-paid old age pension a means-tested safety net and placing the majority of the burden for providing for pensions in retirement on compulsory workplace pensions, with a compulsory employer's contribution of 9%.

The suggestion was highly unpopular with those who responded to the consultation paper. The current scheme is recognised and generally supported as a contributory system. People have paid into the Social Security system with the expectation that they will receive a pension and, as they approach retirement, plan their finances on the assumption that they will receive one. If an alternative means-tested scheme was to be pursued, the lead-in time required to make the transition to such a system would need to be very long – and well in excess of the 10-year transition period outlined for this review process - to give people enough time to adjust their savings' plans and expectations.

The fairest way to make the transition to a means-tested scheme may be a "closed to new members" approach; however, this would entail a transition period of 40 years or more. If this were followed it could be a long time before any significant impact on expenditure was apparent. The majority of the 'baby boom' generation are already contributors to the pension scheme and most are well over half way through their working lives. Unless the States are willing to change the package these people have expected throughout their working lives, they would continue to be entitled to a pension.

In short, although in the very long-term this option could very significantly reduce expenditure on old age pensions, it is not a viable solution within the period of this review.

Option 5: Allowing voluntary deferral of the old age pension

Many countries, including the UK and Canada, offer the option to delay the age at which a pension can be claimed in return for a slight enhancement of the amount received. Typically the benefit of deferral is shared between the individual deferring their claim and the government, which receives additional contributions from the person deferring their claim and makes fewer payments. The benefit the individual would receive from deferral varies by country, but pension payments might be expected to be increased by approximately 5% for each year a pension claim is deferred. At the current level of payments that is equivalent to just under £10 a week.

In most places, only a small proportion of people opt to defer their pension and the administration is more complicated than Guernsey's current system. **Financially, the benefits of a voluntary deferred pension scheme are unlikely to be large enough to make a significant improvement in the issue of financing pension provision. It could, however, be a useful way of encouraging people to stay in work longer.**

6.3.2 Private pension provision

The provision of private pensions has changed significantly over the last decades. In the private sector, *defined benefit pension schemes* (where you know at the outset how much pension income you will receive relative to your salary and the amount of contributions you make) have been almost entirely replaced with *defined contribution schemes* (where what you receive is based on how much you have paid in and the performance of the funds your money was invested in). The pensions received by those contributing to defined contributions schemes are less certain and, if the investments have fared poorly, may be significantly lower in value than those received by contributors to defined benefit schemes.

This is important because the States' old age pension is not intended to be sufficient to provide individuals with a full financial safety net in retirement, but as a supplement to personal income.

However, a survey conducted on behalf of the Policy Council in 2012 revealed that only 45% of people in Guernsey currently contribute to a private or workplace pension and that non-provision was commonest in the young and those on low salaries (see Figure 6.3.5). Of those that do contribute, many will be enrolled in defined contribution schemes which may well not pay out as much as might have been expected. This research suggests that a significant number of people do not make any private provision for themselves at all or they do not start their contributions early enough or make a large enough contribution to gain a significant income from it. This indicates that many of the next two generations of retirees are not making enough personal provision to support the lifestyle they have enjoyed during their working lives. As a result, they may need to work into later life to continue the lifestyles they have come to expect.

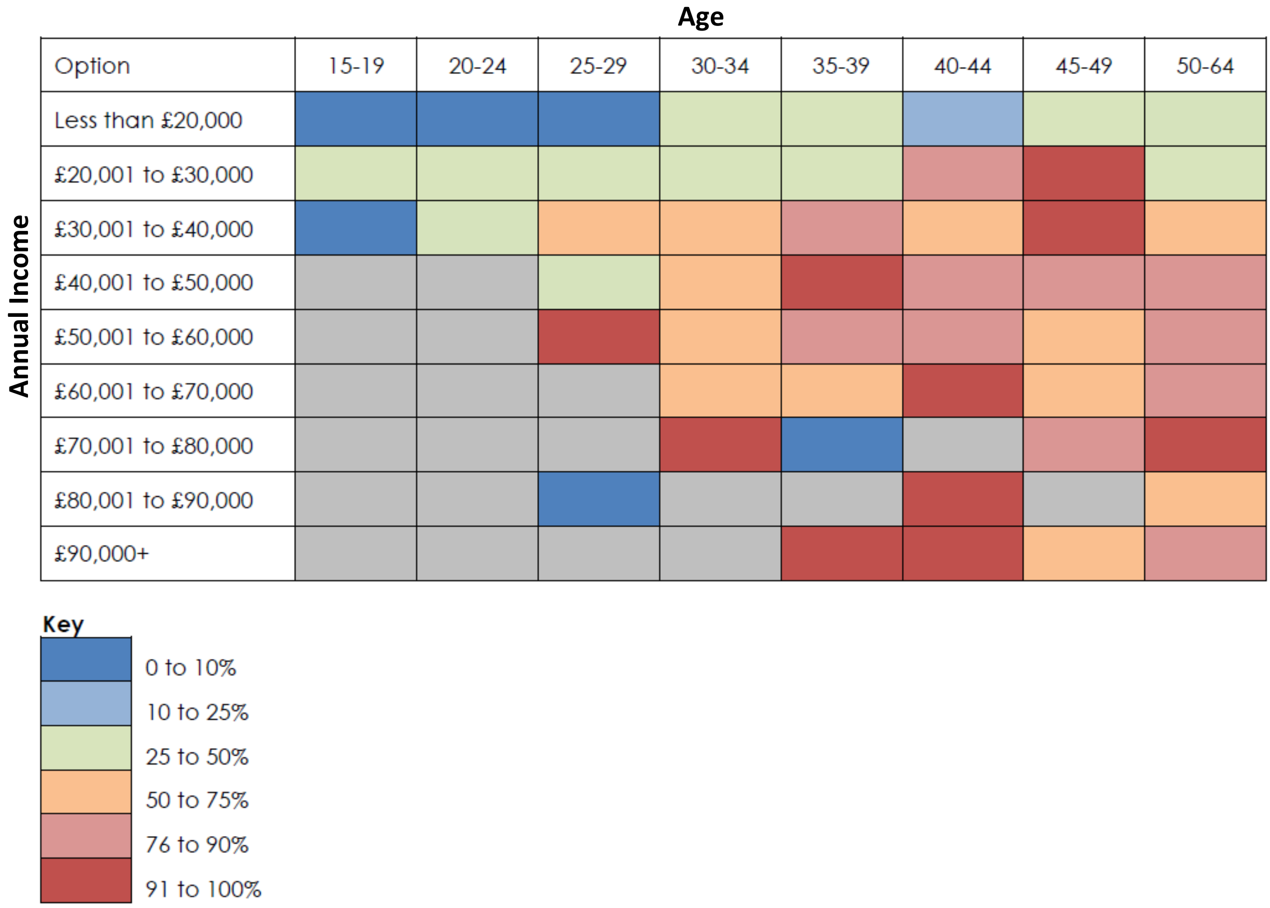
For those whose personal income in retirement is not sufficient to meet their basic needs, the supplementary benefit system is available to provide extra support. However, the increasing number of pensioners who do not have sufficient income on which to support themselves and who are likely to claim supplementary benefit as a result, is itself a significant funding issue.

Given that one of the principles of this review is that people should be encouraged to be more responsible for their own financial wellbeing, promoting private or workplace pension provision, particularly among those not currently making any provision, is important if these people are to be able to support themselves in retirement.

The provision of private pensions is outside the mandate of this review, but the Joint Departments recognise that it is a key area of work and acknowledges that is one which the Social Security Department is currently progressing.

Figure 6.3.5: Proportion of people contributing to private or workplace pension schemes

Source: States of Guernsey, Pensions Survey 2012



6.4 Demographic impact: Health and social care

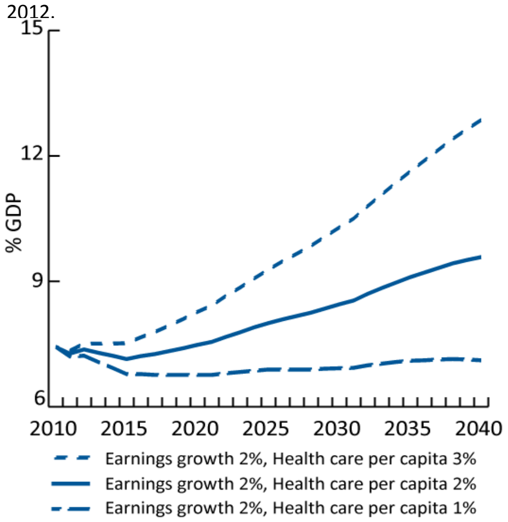
As people age they tend to suffer from more medical conditions for which they need treatment and their medical needs become more complex. As a result, the cost of providing healthcare to an individual typically increases as they age. Healthcare costs also increase dramatically at the end of someone's life. It is estimated that, in the UK, 29% of healthcare expenditure is spent on people in the last year of their lives. Older people also often require more social care services, such as assistance with daily tasks like cooking and cleaning, in order to support them in their daily lives.

The cost of providing healthcare also tends to increase at a rate above inflation. The development of new and more sophisticated drugs and medical techniques means that people's expectations of the treatments to which they should have access are always increasing. The experience of many countries, including the UK, shows that government healthcare spending can increase very rapidly if not tightly controlled.

Figure 6.4.1: Total public expenditure on health and social care: The effect of varying real annual growth in expenditure per capita

Assuming net immigration of 200 people per annum

Source: Potential long-term implications of demographic change on the demand for public services, Policy Council, 2012.



About 75% of health and social care in Guernsey is funded directly from General Revenue. This includes the running of the hospital, as well as treatment for patients sent off-Island, mental health, children's and community care services. Increased pressure on spending in this area would need to be met from general revenue on a year-by-year basis.

The remaining 25% of health and social care expenditure, including the subsidy on prescriptions and GP appointments and the secondary care provided by the Medical Specialist Group, is funded on an insurance basis. As with the provision of old–age pensions and long-term care services (see below), a portion of each person's contributions are paid into the Guernsey Health Service Fund. In 2012, this Fund contained the equivalent of just over 2 years of expenditure. These reserves could be used to mitigate some of the cost pressures in this area.

Modelling health and social care costs is very difficult. The relationship between age and health and social care needs is complex, and technological developments and the impact these might have on cost are almost impossible to forecast accurately in the long-term. Nonetheless, some modelling of this has been attempted in Guernsey, leading to the prediction that additional costs could amount to as much as 4% of GDP by 2040. To put this in perspective, at 2014 prices, this could mean an additional cost of anywhere up to £125m per year.

6.5 Demographic impact: Long-term care

Bailiwick residents are entitled to substantial assistance with the cost of privately-provided long-term residential and nursing home care. The States pay £413.90 per week towards the cost of each person in private residential care and £772.87 towards the cost of private nursing care. Each person is required to make a minimum co-payment of £186.83 per week towards the cost of their care. (NB The co-payment is also payable by those accommodated in States-provided care homes, which are otherwise funded from General Revenue.)

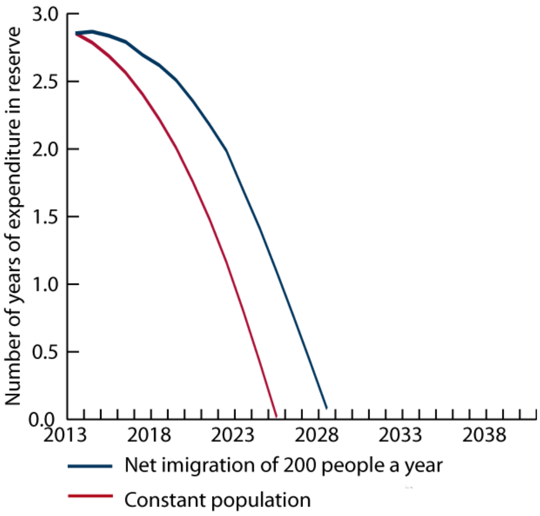
Those persons whose income is not enough to cover the co-payment can claim supplementary benefit to assist with this cost. The value of any property assets are fully protected both in providing long-term care benefit and in any assessment for assistance with paying the co-payment, although any income from property (such as rental income) may be included in the assessment of the latter.

Long-term care benefit is paid from the Long-Term Care Insurance Fund and a portion of each person's social insurance contributions (1.3% for an employed person) is allocated to this fund for the provision of this benefit. In reality, not every Islander will claim a benefit from this Fund, particularly as coverage is limited to care in private residential or nursing homes. It is estimated that approximately one in three people require care in a residential or nursing facility in later life.

Like the Guernsey Insurance Fund, the Long-Term Care Fund holds money in reserve. However, the reserves are much smaller: less than 3 years of expenditure. The projections for the Fund are also significantly worse. Assuming net migration of 200 people per year, this Fund is expected to be exhausted by about 2028; and as early as 2024 if a constant total population is assumed (see Figure 6.5.1).

Figure 6.5.1: Projected reserves held by the Long-Term Care Fund

Assuming: 1.5% real annual increase in earnings; annual increase in care cost per person of 1%; an increase in the pension age to 67 by 2031;



To make the current system sustainable would need an increase in contribution rates of 1.3% (raising a total of about £18m per year); almost as much as would be required to stabilise the old age pension system.

However, as noted already, the benefits provided from this Fund cover only those long-term care services provided in private residential and nursing care homes. They do not cover care provided in a person's own home, or in extra care or sheltered housing. Provision of community-based services for the elderly is divided between the Health and Social Services and Housing Departments, charitable organisations and private sector firms. The costs relating to the provision of all these services are in addition to the £18m quoted above.

The States has established a working party to develop recommendations for the Supported Living and Ageing Well Strategy (SLAWS), partly in acknowledgement that the financing of long-term care is unbalanced in its coverage and unsustainable in its funding. The working party is in the process of undertaking a comprehensive review of the provision of housing, health and social care services for older people and other adults in the community who require long-term care services. This will consider the unsustainable nature of the current system, which is based on models of dependency, and will bring forward recommendations for restructuring provision into a more sustainable system before the end of this States' term.

6.6 Provision of benefits

6.6.1 Means tested benefits

In 2012, Guernsey spent £20m on providing households with supplementary benefit. In addition, it provided a further £10m of rent rebates through the social housing system.

Both the supplementary benefit and rent rebate systems are means tested, i.e. they are only available to people whose income is below a set threshold. The two systems apply different requirements for assessing whether a household is eligible to claim the benefits they offer and how much they receive. The two systems overlap; there are households that claim only a rent rebate or only supplementary benefit, but there are also households which claim both.

In 2013, the States set up the Social Welfare Benefits Investigation Committee (SWBIC) to devise a single system of means-tested benefits where there would be only one set of rules, one assessment process and one claim to be made by each household.

However, reconciling the two systems has a cost implication. Because the two systems assess a household's need in different ways, moving to a single system would change the amount of benefit people receive. Two previous reports have been presented to the States outlining proposals for combining the two systems and the most recent proposals, presented in October 2013, estimated the annual additional cost of a new system to be between £4m and £7m. The 2013 report proposed that the Personal Tax, Pensions and Benefits Review considers how this money could be found, with particular reference to reducing the money spent on providing the universal benefits administered by the Social Security Department such as family allowance (see further below).

Although a final decision on the future of means-tested benefits was deferred to allow further review and analysis by the Social Welfare Benefits Review Committee (SWIBC), the Personal Tax, Pensions and Benefits Review will consider the possible reduction in spending on the universal benefits administered by the Social Security Department. At various times it has been suggested that this money could be reallocated to fund other welfare or social projects.

6.6.2 Universal benefits

The Social Security Department provides a number of so-called "universal" benefits. These benefits can be claimed by anyone living on the Island, who is registered with the Social Security Department and fits the claim criteria; there is no requirement to have paid any social insurance contributions and they are not restricted to those on low incomes.

These benefits include:

- Family allowance
  - Families in Guernsey can claim £15.90 per week from the Social Security Department for each child that they have.
  - Family allowance was paid to households at a total cost of £10m in 2012.
- The subsidy on medical prescriptions
  - The total amount a Guernsey resident has to pay for each item they are prescribed is limited to £3.30. The remaining cost of any prescription is paid for by the States.
  - Households on supplementary benefit, or people who are over 65, or those in receipt of severe disability benefit are exempt from any charge on prescriptions, i.e. they are free.
  - In 2012, paying for prescriptions cost the States £15m.
- The subsidy on GP and nurses' appointments
  - Most people in Guernsey have to pay to visit their GP. However, the States provides a £12 subsidy towards the cost of a doctor's visit and £6 for a visit to the nurse.
  - In 2012, this cost the States £4m.
- Free TV licences for all people aged over 75 (or aged over 65 for those receiving supplementary benefit)
  - As they do in the UK, in Guernsey, people over 75 receive a free TV licence, the cost of which is met by Social Security.
  - In 2012 this cost the States £600,000.

The continued provision of these types of benefits is under review in many countries. In the UK, child benefit – the equivalent of family allowance in Guernsey - was withdrawn for those liable for tax at the higher rate, and questions have been raised about the mounting cost of continuing the practice of providing free TV licences to those over 75.

6.7 General expenditure: financial discipline and justified spending

If the States continues on its current path with its current system of tax, pensions and benefits, then to meet all the expenditure areas outlined above under the current funding model (excluding the largely unknown pressure on healthcare) **the States would need to find an estimated £60m to £70m[14] per annum to support it.**

[14] This estimate includes a "do nothing" cost of supporting the Long-term Care Fund in its current form and an assumed cost of the SWIBC proposals. The recommendations of both SWIBC and SLAWS will impact on these estimates.

As highlighted, there are some realistic options for reducing the amount spent on providing old age pensions and there are a number of projects currently underway examining (among other things) how money is spent in particular areas. Measures to reduce expenditure on pensions and a withdrawal of universal benefits could reduce the above estimate to the £30m to £40m range. The outcome of projects such as SWIBC and SLAWS will also impact these costs.

The FTP, which commenced in 2008, aimed to achieve savings from the States' budgets through a series of efficiency measures. If it meets its targets, when it ends in December 2014 it will have reduced States spending by £31m a year, or about 10% of the General Revenue budget. However, the need to continue scrutinising the way in which the States provide services and whether these are being managed in the most effective way should not end with the FTP. The States should continue their commitment to financial discipline and be able to justify the way in which it spends public money.

Whilst the FTP may end in December 2014, longer-term there are projects underway which will deliver savings beyond the Programme's timescale. For example, the Strategic Asset Management Plan aims to accrue savings by making better use of the States' property portfolio. In addition, the ongoing transformation of services provided by the Health and Social Services, Education and Home Departments each have the potential to release further efficiency savings beyond the Programme's timescale. A review of longer-term savings is an integral part of this process.

On the other hand, as the community's standards and expectations change there are frequently demands on government expenditure to increase public service provision; for example, the recent States' decision to provide universal pre-school provision.

It is impossible to predict accurately all the expenditure pressures we may face in the future. We can plan for and mitigate pressures which we know and can predict but there are areas, such as health and social care, where predicting expenditure demand accurately is difficult, if not impossible. **If the States is to control expenditure effectively it needs to tackle a difficult question: how big should our government be?** It does not follow that, just because the States has traditionally provided a public service, it should be duty bound to do so in the future.

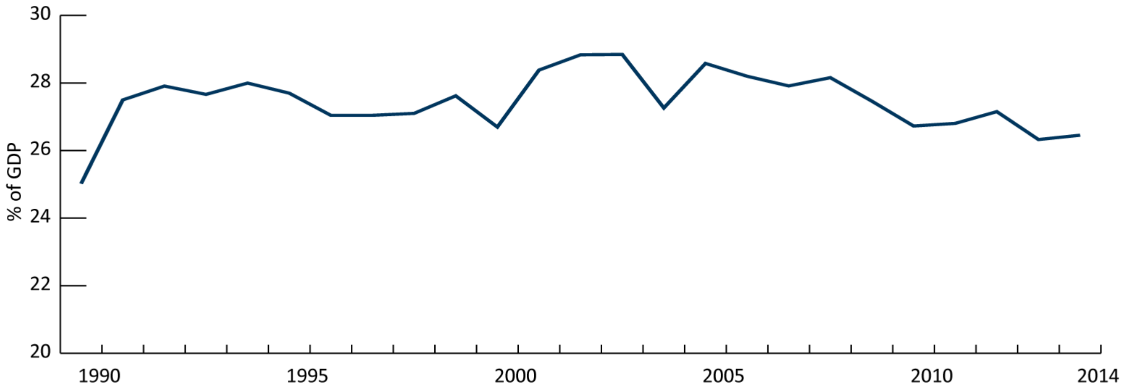
The States has already committed to a limit on General Revenue income and expenditure of 21% of GDP in the Fiscal Framework, agreed by the States in 2009. However, to some degree this limit is misleading, in that it did not cover social insurance contributions and the services funded by them.

At first glance it might seem appealing to place a limit on **total spending**, including that spent from the Social Security funds. However, because of the funding mechanisms for the Social Security funds, setting a limit on expenditure for these is not practicable. If enough money is held in reserve, it will be possible to draw down the reserves to cover a period of high expenditure needs without this being unsustainable in the long-term, but only if the reserves can be rebuilt at a later date.

Placing a limit on **aggregate income** is more practicable. This would limit the amount of money the States could take in total in the form of taxes and social insurance contributions. To continue its commitment to permanent balance, the States would need to manage expenditure to maintain the sustainable position of the Social Security funds in the face of a limit on the amount of additional money the States can ask the community to pay in.

Prior to 2010 (i.e. the completion of the transition arrangements for Zero/10), total government income had been consistently between 27% and 29% of GDP. In the 1990s, income was typically at the lower end of this bracket (between 27% and 28%). In the 2000s, this increased to between 28% and 29% of GDP. Since 2010, revenues have averaged just less than 27% of GDP, with total revenues in 2014 expected to total approximately 26.5% of GDP with a deficit of approximately 1% of GDP.

Figure 6.7.1: Guernsey estimated total public income as a percentage of GDP



Nevertheless, as outlined above, we know that, in the long-term, we may need to raise more money from the tax system to pay for public services generally; and for old age pensions, health and social care in particular. As such, the limit on total income will need to be higher than current revenues, which are, in any case, well below their historic average.

However, if the limit is to deliver real financial discipline, it must be set at a level which will require serious restraint to maintain. To pay for all the known pressures outlined in this paper without any form of mitigation would require an increase in income to approximately 30% of GDP. This does not include the unknown expenditure pressure on health and social care.

The Joint Boards believe that it is possible to reduce this to 28% of GDP by mitigating some of the pressures outlined. This could be further aided by continuing the work begun by the Financial Transformation Programme in improving the efficiency of States' services and by making better use of our physical and financial assets. However, we could still face a mounting annual bill for health and social care services.

The Joint Boards believe that the States should be recommended to set a limit on aggregate income in order to ensure ongoing expenditure discipline and control. This limit should not be viewed as a target. The temptation to relax fiscal discipline, and increase taxes and States' revenues to meet short-term objectives, simply because there is currently scope within a limit, should be avoided. If such short-sightedness is favoured, it could make it increasingly difficult to stay within the limit as pressures increase over the longer-term.

Decisions to meet short-term objectives should not undermine long-term stability.

Box 1: How much tax do we pay and how is it spent?

The tables below present a range of examples of how much income tax and social insurance households may pay in a year and illustrates how much various services cost the States. For reference, median average earnings for an employed adult in Guernsey in 2013 was £29,250.

Table B1.1: Annual amount of tax and social insurance paid by example households

SI = Social Insurance contributions; IT = Income tax; assumes income for couples evenly distributed between spouses

Household description	Household income				
	£25,000	£50,000	£50,000 (self-employed)	£75,000	£100,000
Single adult	IT: £3,065 SI: £1,500	IT: £8,065 SI: £3,000	IT: £8,065 SI: £5,250	IT: £13,065 SI:£4,500	IT:£18,065 SI:£6,000
Single adult with a mortgage (paying £5,000 interest per year)	IT £2,065 SI: £1,500	IT: £7,065 SI: £3,000	IT: £7,065 SI: £5,250	IT: £12,065 SI: £4,500	IT: 17,065 SI: £6,000
Married couple	IT: £1,130 SI: £1,500	IT: £6,130 SI: £3,000	IT: £6,130 SI: £5,250	IT: £10,130 SI: £4,500	IT: £16,130 SI: £6,000
Married couple with mortgage (Paying £5,000 interest per year)	IT: £130 SI: £1,500	IT: £5,130 SI:£3,000	IT: £5,130 SI: £5,250	IT: £9,130 SI: £4,500	IT: £15,130 SI: £6,000
Single parent	IT: £1,755 SI: £1,500	IT: £6,755 SI: £3,000	IT: £6,755 SI: £5,250	IT: £11,755 SI: £4,500	IT: £16,755 SI:£6,000
Single pensioner	IT: £2,710 SI: £520	IT: £7,710 SI: £1,245	N/A	IT: £12,710 SI: £1,970	IT: £17,710 SI:£2,695
Pensioner couple	IT: £420 SI: £316	IT: £5,420 SI: £1,041	N/A	IT: £9,420 SI: £1,765	IT:£15,420 SI:£2,490

Table B1.2: Estimated average costs of various services

Funding source	Service	Typical cost
General Revenue	1 year of education: primary	£4,536
	1 year of education: secondary	£6,692
	Hip replacement	£9,740
	Delivery of a baby: natural birth, in hospital, no complications	£1,174
	Delivery of a baby: by Caesarean section	£3,785
	Family allowance – per child, per year	£827
Social Insurance	Insulin and other prescription items for type I diabetes for 1 year	£2,028
	One year of old age pensions at full rate	£10,239
	One year of long term residential care for an older person (States subsidy only)	£21,523
	One year of long term nursing care for an older person (States subsidy only)	£40,189

7 Issues 2: Raising government income

In order to provide public services, the States raises money from the community by charging taxes. However, as stated earlier, the challenges arising from the way the States raises revenues are distinct from the issues of pressures on spending. The two are not mutually exclusive. If it were possible to eliminate the upward pressure on expenditure, we could still face an erosion of revenues if the working age population falls as projected. The reverse is also true: if the risk to income were successfully mitigated the mounting pressure on pensions, health and social care costs would remain.

The States' first priority should be to seek to grow the tax base by growing the economy and, in particular, high value employment in the Island. This requires delivery against the Economic Development Framework and the creation of conditions conducive to growth and the removal of barriers. However, it would be imprudent to seek to design a sustainable fiscal system on the presumption that we can consistently achieve high growth rates.

The sections below outline the problems faced and some of the options available for mitigating them.

7.1 The distribution of the tax base

Broadly speaking there are four areas of the economy which can be taxed:

- Wealth *(e.g. inheritance taxes, capital gains tax)*
- Corporations *(e.g. corporate profit taxes)*
- Income *(e.g. income tax, social insurance contributions)*
- Consumption *(e.g. excise duties, GST)*

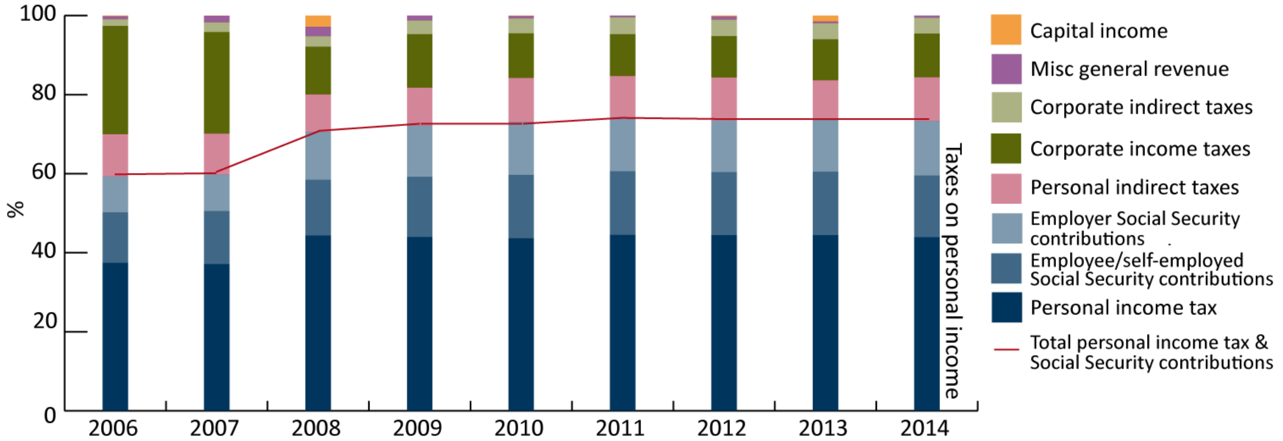
Guernsey does not impose any direct wealth taxes, such as capital gains or inheritance taxes. Such taxes are collected in response to specific events in the life of individuals and, therefore, the revenues generated are very volatile and difficult to predict with any accuracy. Introducing a capital gains or inheritance tax would undermine Guernsey's attractiveness to high net worth individuals to relocate and its 'tax neutral' offer for international financial services, particularly in funds and pensions administration. Furthermore, such taxes are rarely a significant revenue raiser, and they are very expensive to collect relative to the comparatively small amount of revenue they would generate. Such taxes would be damaging to Guernsey's competitive position, raise very little revenue and as such are not under consideration in this review.

Taxes paid by companies are also outside the scope of this review, although the Treasury and Resources Department is elsewhere considering whether there is further scope to extend the intermediate (10%) rate of income tax on company profits to fund administration businesses. However, the recent history of tax paid by companies in Guernsey must be taken into account when considering our current position.

In 2006, Guernsey sourced more than a quarter of its total government income from taxes on corporate income and 59% from personal income tax and social insurance contributions. In response to pressure from the European Union, Guernsey introduced the Zero/10 tax system in 2008. This reduced the proportion of income received from taxes on corporate income to 11% by 2010. This is equivalent to a reduction in tax receipts of approximately £80m at 2014 prices.

Figure 7.1.1: Distribution of total government income in Guernsey

Excluding departmental operating income



Unlike Jersey, Guernsey did not immediately move to introduce a consumption tax to replace the lost income, although the States did approve enabling legislation in 2009 to facilitate the introduction of a consumption tax, should it be necessary in the future.

Instead, Guernsey took an alternative approach:

- £31m of the lost revenue was to be reclaimed by making a reduction in annual General Revenue expenditure through the FTP between 2008 and 2014. £26m of these savings had been confirmed by the end of April 2014.
- Approximately £22m (at 2014 prices) was reclaimed by increasing employers' contributions to Social Insurance by 1% and increasing the upper limit on the earnings liable for social insurance contributions to £132,444.
- Approximately £17m was reclaimed by increases in indirect taxes, primarily those charged against companies. Specifically these included increased company registration fees and Tax on Real Property (TRP) rates charged on commercial properties.

In total, these measures have reduced the potential deficit by £65m, with a further £5m of savings to be made by the FTP by the end of 2014.

The intention had been to "wait and see" until 2012/13, and carry an intentional deficit on the Revenue budget for 5 years to allow the natural growth of the economy to erode the deficit. Five years have now elapsed and the hoped-for economic growth has not materialised: Guernsey's economy at the end of 2013 was, in real terms, about the same size as it was in 2008. Whilst this is not surprising given the global economic climate and its ongoing effect, particularly on international finance business, despite all the efforts referred to above, the General Revenue budget still showed a £25m deficit at the end of 2013.

The result of the changes to date has been to shift the burden of taxation towards that charged directly against personal income; namely: personal income tax and social insurance contributions.

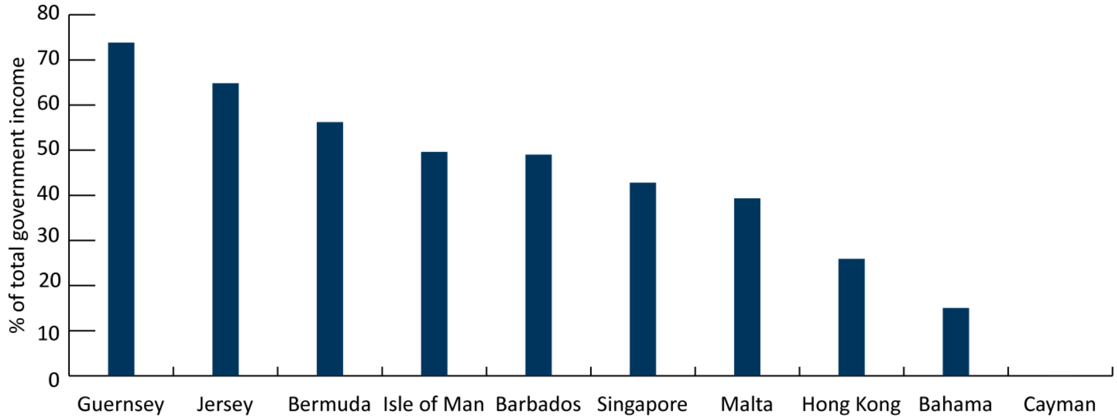
Figure 7.1.2: Proportion of tax gained from principal taxation sources in Guernsey (2013)

In 2014, Guernsey is expected to gain 74%[15] of its revenues from personal income taxes and social insurance contributions. Although conceptually theses taxes are charged on different principles, they are charged, for the most part, against the same income. The impact on income is also very similar; if the rate increases the amount of money people take home in exchange for their work is less.

This is very noticeably higher than in other jurisdictions. **Guernsey's dependence on these taxes is more than 10 percentage points higher than any OECD jurisdiction and any comparable island jurisdiction for which information is available.**

Figure 7.1.3: Comparison of reliance of direct taxes on income in Island Jurisdictions as a percentage of total funding

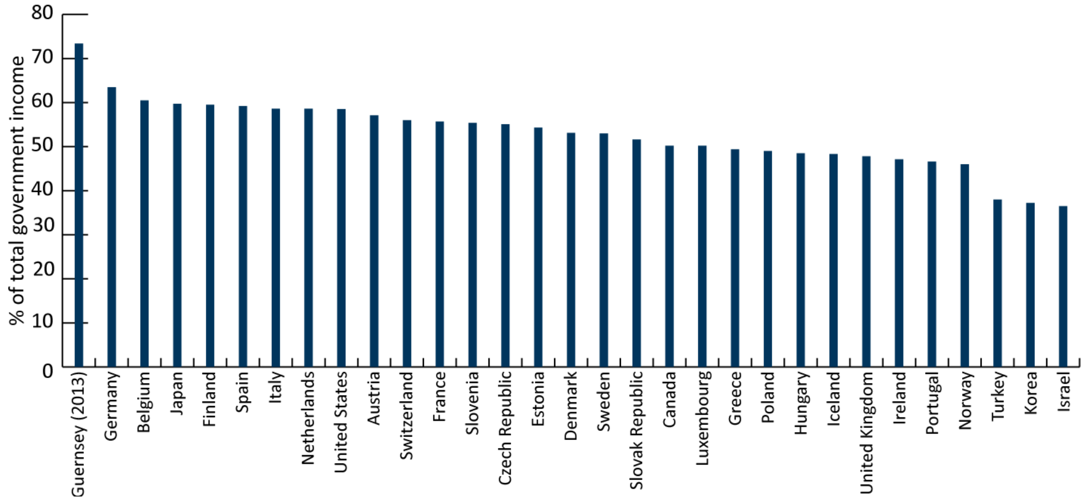
Includes: Personal income taxes, payroll taxes and social or national insurance contributions; excludes operational income
Source: Policy Council



[15] For ease of comparison with other jurisdictions this figure excludes revenue from departmental operating income (primarily fees and charges) as the services these cover can vary considerably between jurisdictions (for example if the provision of utilities is incorporated as a government service).

Figure 7.1.4: Comparison of the percentage of Government income from income taxes and social insurance contributions; Guernsey, Jersey and OECD countries (2010 unless otherwise stated)

Source: OECD Stats data base



Although Guernsey does not apply a broad-based consumption tax, it does apply more specific consumption taxes, namely excise taxes and fuel duties. Combined, these contribute about 6% to government income.

There are a number of reasons why an unusually high dependence on one type of tax might pose a risk to States' revenues and these are explored below.

7.2 The shrinking tax base: taxation and the changing population

If we return to the issue of the demographic change, in 10 years' time there will be a greater proportion of people in our population who are above pension age and a smaller proportion of people of working age.

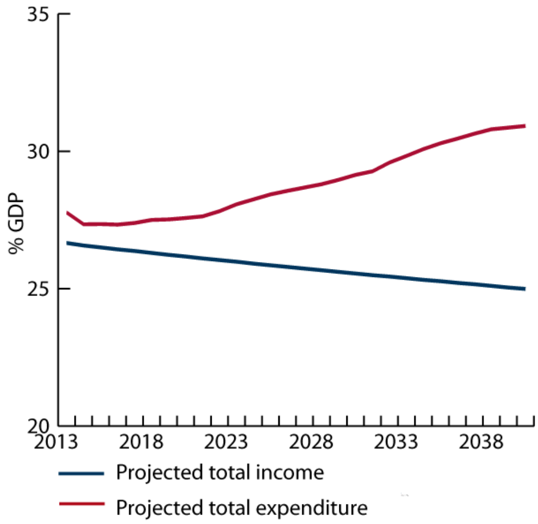
As more people move into retirement, when their income is likely to be smaller and typically increases at a slower rate than earnings[16] in the working age population, the direct tax base will be eroded. On average, a person of working age pays approximately 60% more in income tax then a person above the pension age.

This is more noticeable when social insurance contributions are considered; a person above retirement age is no longer required to contribute to the pension scheme, whilst a person of working age pays on average six times as much in social insurance contributions as the average pensioner.

Assuming that this pattern will continue, the logical

Figure 7.2.1: Projected income and expenditure

Assuming net immigration of 200 people per year, annual earnings growth of 1.5% pa, increase in healthcare costs of 1.5% pa, pension uprating of 0.75%pa.



[16] The majority of private pension annuities are linked to inflation.

progression of this argument is that over a period of time, the average amount of tax and social insurance paid per person will increase at a slower rate than the increase in earnings, reducing the value of direct tax receipts relative to the size of the economy.

Other taxes are more evenly distributed across the population:

- **Taxes on immovable property** (e.g. TRP) are not affected by the age profile of our population to any great extent. Property charges are the same regardless of the age of the person who lives in or owns the property.
- **Consumption** does vary with age, but less so than income. Estimates show that, excluding expenditure on housing and financial services, a person of working age spends on average 37%[17] more than a pensioner. As a result, although revenue from a consumption tax would be affected by the ageing population, the impact would be less than the impact on both Income Tax and social insurance.

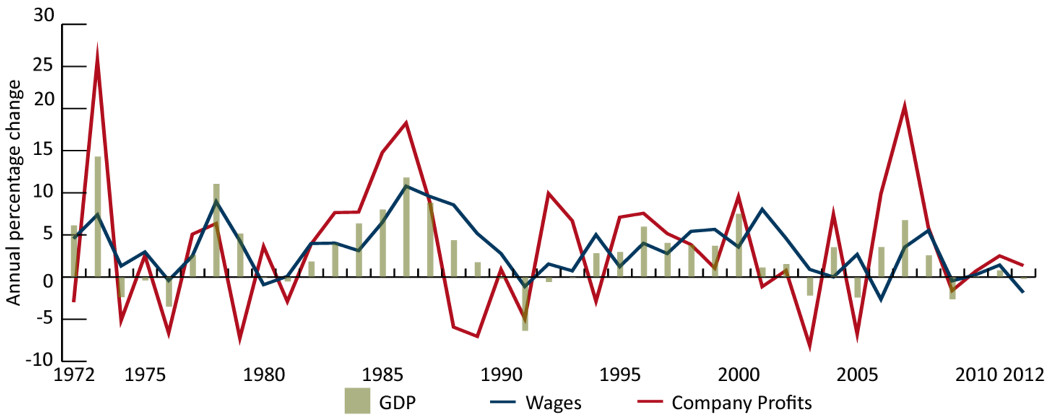
7.3 Volatility of revenues

Different taxes are affected by economic conditions in different ways. For example, taxes on corporate profits are typically the most volatile income stream. In times of economic boom, company profits (and the taxes charged on them) can show high levels of growth; conversely, they can show a rapid decrease in times of recession.

Personal income (and income tax) is less volatile than corporate profits; the reaction to changes in economic conditions tends to be smaller and to occur slightly later. A business taking less money is likely to absorb the drop in its takings for a period of time before it reduces staff numbers or wages. It is also likely to wait to be sure that business is picking up before hiring more staff or increasing wages (see Figure 7.3.1).

This "lag and smoothing" effect means that, comparing year on year, it is not uncommon for company profits to be down whilst aggregate wages increase or vice versa.

Figure 7.3.1: Movements in company profit and wages in Guernsey



[17] Household expenditure survey 2005/6

There is a similar relationship between income and consumption, although the relationship is a complex one[18]. Income is generally considered to be the principal driver of consumption, but the relationship is not one-to-one. For example, if you earn £100 more you may not spend £100 more on consumable goods. You may choose to save some of it, or put it towards paying off your debts instead. If you earn £100 less, rather than spending less, you may choose to save less, spend savings or borrow money, to help meet your spending needs.

How an individual will react to a change in income could depend on a number of factors: why income has changed (i.e. a reduced bonus, a reduction in overtime or the loss of a job); whether the change had been anticipated; how long it is believed the change in income might last; or how easy it would be to borrow money.

Monetary policy decisions to stimulate economic growth often aim to increase consumer spending in the first instance. For example, reducing interest rates reduces the amount people need to spend paying off their debt and make it cheaper for people to borrow money. In theory, this means they have more money to spend. If these policies are successful, consumption should be the first element of the economy to improve, with income and company profits following on from the increase in spending. Although the States of Guernsey does not have the same control of monetary policy as a large jurisdiction, it is affected by the policy decisions made by the UK government and the Bank of England.

Taxes on immovable property, such as TRP, are impacted very little by economic conditions. Liability for TRP does not change with income or with a person's pattern of spending. It is, therefore, among the most stable and predictable of the revenue streams collected in Guernsey. However, the amount paid by any individual does not readily adapt to changes in their circumstances.

Relying heavily on one form of taxation means that government income will be heavily impacted by changes in that area. In Guernsey's case that means changes in the amount people are earning.

More evenly distributing the amount of money the States take from different taxes will reduce the vulnerability to changes in the income from one area of taxation. Although most forms of taxation are affected by economic conditions to some extent, the differences in the way different income streams are affected means that distributing the tax take across a wider base will smooth the impact a change in economic conditions might have on government revenues. It could also provide the States with more time to adapt to a change in economic conditions and more options for doing so.

[18] There is little consumption data available for Guernsey but the relationship has been documented elsewhere. For more information see http://www.stanford.edu/~pista/ann_rev.pdf

7.4 Tax efficiency

As explained in section 4.2, taking money out of the economy in the form of taxes has a negative impact on the economy, but the extent to which taxes affect an economy is different for different income streams. A tax which has little effect on the economy is considered 'economically efficient'. (NB A more detailed explanation is provided in Appendix B.)

The OECD ranks taxes in the following order, with the most efficient first:

- Property taxes (recurrent on immovable property) (e.g. TRP or council tax)
- Consumption taxes (e.g. excise taxes, GST or VAT)
- Personal income taxes (including Social Insurance)
- Corporate taxes

If one combines the amount of tax received from companies and taxes, and contributions charged on personal income, Guernsey sources more than 80% of its income from the two least efficient taxes. It receives only 10% from the two most efficient sources.

The distorting effect of any given tax increases as the rate increases. It is generally considered less damaging for an economy to have a number of different kinds of taxes at low rates than a single type of taxation at a high rate.

7.5 Outline of options available

The section below provides an outline of the personal tax measures which could be taken to mitigate the potential erosion of income receipts and to address the issues of the heavy dependence on direct personal income taxes. The table presented at the beginning of each option provides a brief assessment in terms of sustainability, economic efficiency, fairness and the impact on the distribution of the tax base.

7.5.1 Increasing Income Tax or Social Insurance revenues

Increasing headline rates

Sustainability	Poor
Economic efficiency	Poor
Fairness	Proportional
Tax distribution	Narrower

The States could choose to increase income taxes or social insurance contributions to replace the income lost as the balance of the population shifts. This would be relatively easy to achieve, requiring no new administrative systems or processes. However, since this would gain more income from the same, narrowing tax base, this additional income would, itself, reduce as the population ages.

It would also not deal with the issue of Guernsey receiving a substantial proportion of its revenue from a single source and the risk that that implies; in fact it would make it worse. Increasing income tax or social insurance would only increase the vulnerability to changes in the amount people earn. **If the aim is to diversify the tax base to reduce the impact on revenues of the shrinking workforce and our vulnerability to changes in income, the proportion of revenue generated from these sources should be reduced.**

A higher headline tax rate could also be damaging to our competitive position. Guernsey must source specialist skills and experience from outside the Island and keep the skills it develops locally. These skilled individuals include specialist medical staff, teachers and senior executives in the finance industry. These individuals are very important to Guernsey, promoting high quality public services and generating economic growth, innovation and wider employment in the private sector. Such people are highly mobile and a competitive personal tax system is important in attracting them to Guernsey. Increasing the tax rate to a level higher than our closest competitors would put Guernsey at a disadvantage.

Higher rates for higher earners

Sustainability	Poor
Economic efficiency	Poor
Fairness	Progressive
Tax distribution	Narrower

The results of the public consultation indicate that some people would consider it fair to charge a higher rate of tax to those who have a higher income. Although this would be logistically more difficult than an increase in the general rate, it would not entail the development of any new tax systems.

However, this must be balanced against its competitive effects and the same argument can be made against higher rates of taxation for higher earners as were made against a higher rate. To raise a significant amount of additional money, either the higher rate threshold would need to be comparatively low or the higher rate would need to be high. For example, to raise £20m it is estimated that you would need to charge a rate of 30% on all earnings above £45,000, capturing about 25% of the employed population.

This must also be considered alongside social insurance contributions. The upper limit on contributions in Guernsey is very high - £132,444 compared with £47,016 in Jersey and £41,865 in the UK. The UK applies a higher rate of income tax (40%) to earnings above £41,866; £1 above the upper limit on National Insurance contributions (£41,865). This means that there is no overlap between the higher rate of tax and national insurance contributions. If the same principle was to be applied in Guernsey, only those earning over £132,445 would be subject to the higher rate. At this level, a 30% rate would raise an estimated £3m-£4m.

If set below the upper earnings limit on social insurance, higher rates for higher earners would mean high marginal tax rates (see Box 1) for upper middle and high earners . Using the example presented above, if you were earning £50,000 you would pay 30% on income above £45,000 and 6% social insurance on all your earnings. If you were to earn an extra £100 you would pay £30 in income tax and £6 in social insurance- a combined marginal rate of 36%. If you were self-employed, paying a 10.5% rate of social insurance, your marginal rate would be 40.5%. Such a move could encourage more tax avoidance by increasing the benefits of people planning their monetary affairs to reduce their Guernsey tax bill.

Highly skilled individuals tend to generate economic growth by developing businesses, and devising new products and services. This innovation creates jobs and wealth for people to spend in the wider economy and is good for the community in general. Taking more money from those who earn more may seem attractive, but charging tax rates which could discourage such people from moving to, or staying in, Guernsey could be detrimental for the Island’s economy and its growth potential, which must be the States’ first priority.

BOX 2: Marginal and average tax rates

- The **marginal tax rate** is the percentage of tax a person would pay on an additional £1 of income.
- The **average tax rate** is the total percentage a person pays in tax on their entire income.

The table below provides some examples of average and marginal rates for an individual paying Income Tax (IT) and Social Insurance (SI) in Guernsey.

Average combined tax rates in Guernsey typically increase up to the upper earnings limit on social insurance contributions. Marginal tax rates remain constant between the value of the personal tax allowance and the upper limit on social insurance.

Self-employed individuals, who pay a higher rate of social insurance (in lieu of the 6.5% paid by employers), pay higher average and marginal rates than employed people up to the limit on social insurance contributions.

Annual income	Employment status	Total IT and SI paid per year	Combined Average tax rate	IT and SI payable on £1 of additional income	Combined Marginal tax rate
£8,000	Employed	IT=£0.00 SI=£480 Total=£480	**6%**	IT = £0.00 SI = £0.06 Total = £0.06	**6%**
£20,000	Employed	IT=£2,065 SI=£1,200 Total=£3,265	**16%**	ITA = £0.20 SI = £0.06 Total = £0.26	**26%**
£20,000	Self-employed	IT=£2,065 SI=£2,100 Total=£4,165	**21%**	ITA = £0.20 SI = £0.105 Total = £0.305	**30.5%**
£50,000	Employed	IT=£8,065 SI=£3,000 Total=£11,065	**22%**	ITA = £0.20 SI = £0.06 Total = £0.26	**26%**
£75,000	Employed	IT=£13,065 SI=£4,500 Total=£17,565	**23%**	ITA = £0.20 SI = £0.06 Total = £0.26	**26%**
£100,000	Employed	IT=£18,065 SI=£6,000 Total=£24,065	**24%**	ITA = £0.20 SI = £0.06 Total = £0.26	**26%**
£100,000	Self-employed	IT=£18,065 SI=£10,500 Total=£28,565	**29%**	ITA = £0.20 SI = £0.105 Total = £0.305	**30.5%**
£150,000	Employed	IT=£28,065 SI=£7947 Total=£36,011	**24%**	ITA = £0.20 SI = £0.00 Total = £0.20	**20%**

Withdrawing tax allowances for higher earners

Sustainability	Moderate
Economic efficiency	Moderate
Fairness	Progressive
Tax distribution	Narrower

The option of withdrawing allowances for higher earners is similar to introducing a higher tax rate for higher earners. However, the impact on any one individual is limited by the size of the allowance. For example, at the current level of personal allowance - £9,675 - the maximum amount of extra tax any person would have to pay from having this withdrawn is £1,935. If other allowances are included, such as the relief given on mortgage interest or the additional allowance given to those over 65, this is higher.

The limited nature of the withdrawal of allowances means that the impact on economic efficiency or sustainability is less, but so are the financial benefits. The issue of high marginal rates outlined above continues to be an issue if the threshold for withdrawal is set lower than the upper limit for social insurance contributions. Withdrawing allowances at the current upper limit on contributions would raise an estimated £2m and affect about 2% of the working population. This figure will increase if personal allowances are increased.

Withdrawing specific tax allowances

Sustainability	Good
Economic efficiency	Good
Fairness	Proportional
Tax distribution	Narrower

The Guernsey tax system offers a small number of specific tax allowances for households in particular circumstances. Each allowance reduces the amount of tax payable by those eligible for it. Unless offset by increases in the personal allowance, withdrawing these would result in a further increase in the percentage of total government income, but there are other advantages to withdrawing these.

Giving specific tax allowances to households in defined circumstances is, in many ways, similar to the provision of a universal benefit. Like the provision of universal benefits, these allowances are in many cases not well-targeted and, in some cases, not effective in achieving their original well-intentioned purpose.

The effect of these specific allowances is to reduce the average tax rate (see Box 1) for households in particular circumstances; in some cases by a considerable amount. The provision of allowances with such narrow criteria inevitably produces inequities between households with similar incomes. For example:

- A married couple, renting, with two incomes earning £50,000 would pay in total approximately 12.3% of their total gross income in income tax (approx. £6,130 per year).
- If the same couple had a mortgage on which they paid £5,000 a year in interest, they would pay 10.3% of their gross income in income tax (approx. £5,130 per year).
- If the couple were both pensioners but had no mortgage, they would pay 10.8% in income tax (approx. £5,420 per year).

These allowances do not (and could not) address every circumstance which may affect a household's standard of living. Drawing on the example above; the cost of rent experienced by the first household could be more than the mortgage paid by the second. The pensioners may have paid off their mortgage and have no accommodation costs at all.

Mortgage interest relief

At the present time home owners can claim tax relief, at 20%, on the interest paid on the first £400,000 of a mortgage on their primary residence. As a result of an amendment placed to the 2014 Budget, this relief is also limited by a £25,000 cap on the amount of interest claimable. At this level, the limit affects 4 households.

Recommendations to remove the relief on mortgage interest were presented in the 2013 Budget, but were not approved at that time.

There are three issues identified with the provision of this relief:

i. The relief transfers a portion of the risk of increasing interest rates from the borrower to States' revenues and therefore, in effect, to all other taxpayers;
ii. Although intended to assist people to buy property, the relief has exerted an upward pressure on house prices. Analysis conducted by Oxford Economics in 2012 suggests it has added £44,000 (approximately 10%) to the average house price in Guernsey;
iii. Providing a subsidy on housing costs to those who have a mortgage, regardless of their financial position, and not to those who pay their housing costs in another form, is regarded unfair by many people.

Additional personal allowances for those over pension age

The personal allowance for someone aged 65 or more is 18% (£1,775) larger than that for a person of working age. This translates to a reduction in their annual income tax bill of £355. Like other allowances covered in this section, this relief is provided irrespective of a person's financial circumstances. This additional allowance for over 65s costs the States about £3m a year; a cost that will increase as more of the population reach pension age.

Making personal allowances uniform between those of working and pension age, as they are in the UK, would reduce the difference in tax payments between the groups outlined in section 7.2.

Allowances for married couples and children

Guernsey assesses married couples as a unit. This means that if one spouse does not have sufficient income to use all their personal allowance, their partner can use the excess to reduce their tax bill. Unmarried, but cohabiting couples, cannot do this unless they have a child together. With an increasing number of couples choosing not to get married, this situation no longer treats people equally.

If the ability to transfer allowances was extended to cohabiting couples the States would need to establish a clear definition of a cohabiting couple and be able to verify that people were living permanently at the same address. This could significantly increase administration of the system and costs and could also result in a significant loss of revenue as more couples use the ability to transfer allowances to reduce their tax bill[19].

Alternatively, Guernsey could adopt independent taxation, as they do in the UK, where each person must complete a tax return for themselves and the ability to transfer allowances between spouses is limited. Whilst this would increase the number of returns that would be submitted, more of these returns could be assessed automatically. The Income Tax Office are also progressing a number of initiatives designed to remove individuals with relatively straightforward financial affairs from the need to complete a return at all.

Related to this, single parents currently receive a charge of child allowance of £6,550 in lieu of the ability to transfer allowances from a spouse. If Guernsey was to move towards independent taxation, this would also need to be reviewed.

7.5.2 Increasing revenues from domestic TRP

Sustainability	Good
Economic efficiency	Very good
Fairness	Proportional/mildly regressive
Tax distribution	Broader

As mentioned previously, Tax on Real Property on commercial premises was increased significantly as part of the package of measures applied in the wake of the introduction of the Zero/10 tax regime. As such, there is little room for further increase in the context of this project. In contrast, domestic TRP is very low in comparison with many jurisdictions. The average TRP bill in Guernsey is about £150 a year (up to twice this much if you include Parish rates depending on where you live). The average property tax bill in most jurisdictions is much higher. By way of example, in the UK average council tax is closer to £1,500.

TRP is chargeable to the owner of a property, but it is possible that some landlords will seek to pass on any increase in TRP to their tenants via an increase in rent – although their ability to do so will depend on the rental market. A low income household is likely to have a smaller property, and thus a lower TRP bill. However, relative to income TRP typically represents a larger percentage of gross income for a low income household than middle or high income households. As such, TRP could be considered mildly regressive.

The amount of property on the Island changes very little from year-to-year, so the revenues generated are very stable and predictable. TRP also has very little impact on people's behaviour; it is very difficult to avoid; and it is very cheap and simple to administer. **Combined, all these factors make domestic TRP an attractive option to be included in any package of measures.**

However, domestic TRP raises only £4m a year. Whilst there may be scope to increase domestic TRP rates, to make a significant difference to the distribution of income revenues, it would need to be increased to a level comparable with that charged in the UK, and to offset this with a reduction in income tax or social insurance rates. Many people might find an increase to this level unacceptable. **In short, TRP may be part of the answer but it unlikely to be the whole solution.**

[19] It is not possible to produce an accurate estimate of the cost with the data currently available.

7.5.3 Annual vehicle taxes

Sustainability	Good
Economic efficiency	Moderate
Fairness	Mildly regressive
Tax distribution	Broader

The reintroduction of an annual motor tax fee was raised numerous times in the consultation process. The previous motor tax, which was abolished in 2008, raised £4m per annum in revenue. An annual vehicle tax could provide a reliable income stream of a similar revenue value to domestic TRP. Whilst the systems which were previously used to administer this system are no longer in use, there may be alternative, and more efficient, methods of collection; for example, it may be possible to arrange for insurers to collect the tax when collecting premiums.

However, to provide full context, there are two charges relating to vehicles which need to be considered: first; the duty on motor fuels, which was increased in 2008 when the annual tax was abolished and, secondly, the vehicle importation tax approved by the States in May 2014. In light of this, any further moves to tax motorists would need to be considered carefully.

7.5.4 Increasing revenues from consumption taxes

Sustainability	Good
Economic efficiency	Good
Fairness	Regressive
Tax distribution	Broader

As previously stated, Guernsey already receives approximately 6% of its revenues from consumption taxes in the form of excise duties on alcohol, tobacco and motor fuel. In total these raise £35m a year.

These consumption taxes are applied to a very limited number of products, often with the intention of discouraging people from buying them. In order to raise a significant amount of money on charges on such a narrow range of goods, the increase in the charges made would need to be high and this would have a knock on effect on consumption. For example, all duty charges could be doubled over a period of time, but final excise revenues would be substantially less than twice their current level as people would choose to buy fewer of the goods subject to punitive excise charges and to spend their money elsewhere.

Whilst this may be a desirable outcome if the aim was to discourage these activities, it is not the focus of this review. In terms of raising revenues for the purpose of diversifying the tax base, increases in excise taxes would show a diminishing return if increased too far.

Broader-based consumption taxes are applied almost universally throughout the developed world in various forms. In 2001, 120 countries applied some form of consumption tax and this is now believed to be approaching 150. Guernsey is in a very small minority in not applying one. When approached by a jurisdiction for assistance, the International Monetary Fund (IMF) routinely reviews the tax systems of the applicant and, where a consumption tax is absent, recommends its introduction. To quote from one such example:

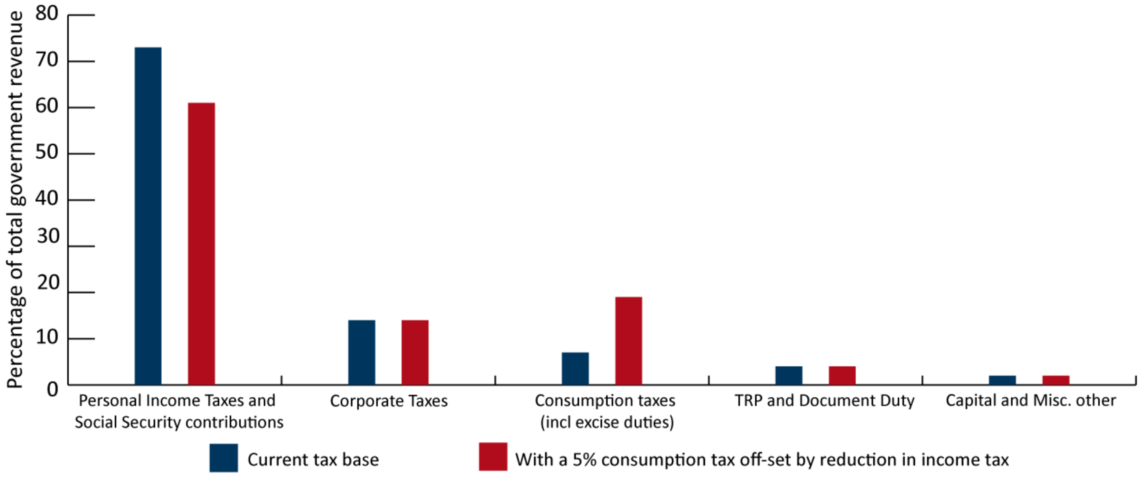
“The VAT has been seen as a key instrument for securing macroeconomic stability and growth by placing domestic revenue mobilization on a sounder basis, so that the IMF has attached considerable importance to its proper design and implementation.”

The modern VAT, IMF Nov 2001

If applied on a wide range of goods and services, a consumption tax could raise a significant amount of revenues at a comparatively low rate. At 5% (which would be a low rate compared with most jurisdictions and the same rate as applied in Jersey) a broad-based consumption tax could raise in the region of £50m per year. If offset against a reduction in the amount of revenue collected via direct taxes (i.e. income taxes), this could mean a significant change in the distribution of income (see Figure 7.5.1).

Consumption taxes also have the advantage of being applicable to anyone who spends money in Guernsey, including those not currently captured by the direct tax system in Guernsey. This will include low income households who are earning less than their personal allowance (who would need to be protected in any proposals), but would capture additional income from those living primarily on capital or accumulated wealth or whose income from outside of Guernsey is not wholly captured by the income tax system. In addition, whilst most consumption tax regimes include the facility for visitors to reclaim taxes paid on large purchases, tax on smaller purchases is not reclaimable. This would also extend the tax base to capture a contribution from visiting tourists and business visitors, allowing a smaller overall burden on local residents.

Figure 7.5.1: Broadening the tax base with a 5% consumption tax



In Jersey, the GST system also incorporates an optional flat rate exemption fee for financial institutions, which allows them to “opt out” of administering the tax that can be complicated for businesses with both taxable and non-taxable income streams. This contributes £9m to GST receipts in Jersey, enabling Jersey to increase the contribution to public revenues from the finance sector over and above the 10% income tax rate on profits typically applied to that sector.

Consumption taxes are considered regressive and become more so at higher rates. This is because those with a higher income tend to save and invest a larger proportion of their income than those with lower income and, therefore, pay slightly less tax as a proportion of their income[20]. This can, to some extent, be counteracted by introducing exemptions. For example, those on low incomes typically spend a larger proportion of their income on their rent and accommodation costs, so exempting these can make the system less regressive. However, exemptions reduce the amount of money a consumption tax would raise. They also make it more expensive to administer, typically reduce compliance and make it less economically efficient.

In order for a consumption tax to improve the distribution of the tax base, it could be partially or wholly offset by a reduction in income tax receipts. There are two ways by which this could be achieved: reducing the headline tax rate or increasing the personal allowance. Figures 7.5.2 and 7.5.3 below compare how these two methods could affect the average tax rate of a household (including a consumption tax and other indirect taxes). The options presented are used simply to illustrate the different impacts on the tax burden experienced by different households. Allowing for the cost of administration and additional expenditure on pensions and benefits, the two alternatives presented are broadly net neutral (i.e. they would raise a similar amount of money to that currently received).

- An increase in the tax allowance could:
    - benefit middle income households. For many, a 5% consumption tax offset by an increase in tax allowance could mean a reduction in the total amount of tax they would pay;
    - remove some lower income households from the need to pay income tax at all;
    - return personal allowances to a level above the UK;
    - make the overall tax system more progressive; and
    - increase the overall tax burden for very low income households (these households would need to be protected by other means).
- A decrease in the headline rate could:
    - benefit higher income households proportionally more than those with lower incomes;
    - provide a competitive advantage in the international labour market;
    - make the overall tax system more proportional; and
    - increase the overall tax burden for very low income households (these households would need to be protected by other means).

[20] However, when these savings are spent, they are liable to consumption taxes. By this argument taxation on savings and investment is merely deferred until the money is spent.

Figure 7.5.2: Comparison of the impact of methods of offsetting consumption tax by reducing direct taxes- Couples, not pensioners

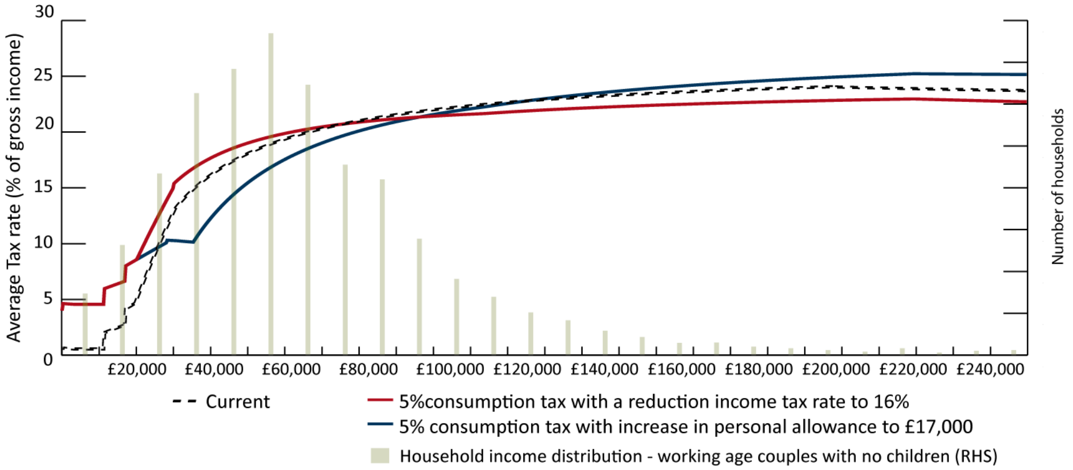
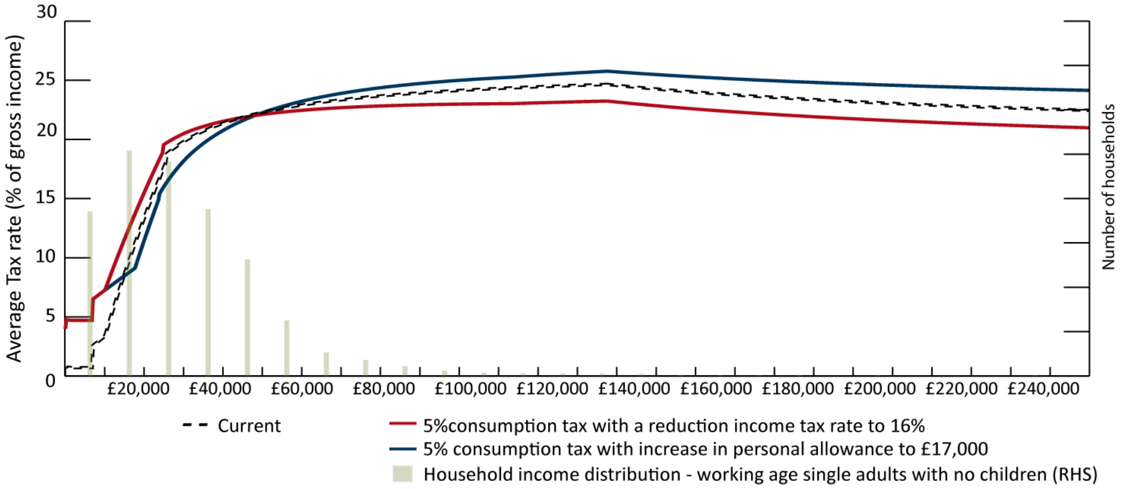


Figure 7.5.3: Comparison of the impact of methods of offsetting consumption tax by reducing direct taxes- Single adults, not pensioners



It should be noted that, once a household is removed from the income tax bracket, it will get no further benefit from tax allowances: people cannot be compensated via a reduction in their tax bill if they do not pay any tax. Others would argue that increasing the number of people not subject to direct taxes and, therefore, who may have little perception of a stake in government, could reduce public pressure on the States to restrain spending. At present, at any one time only about 70% of the adult population are direct taxpayers.

Those in the bottom quartile (the poorest 25%) are likely to be in this position. Since many of those in this category will already be in receipt of either a pension or benefit, the benefits system would be the simplest mechanism available to compensate them.

A consumption tax would result in a one-off increase in prices, which would be apparent in the annual change in the retail price index measures (RPI and RPIX) for 12 months. Provisional estimates suggest that a 5% GST would increase RPIX by just less than 4%. However, Jersey's experience was that the impact on RPI was less than expected. Anecdotally, this appears to be because some businesses, particularly national retailers who already charge the same VAT inclusive price as they use in the UK, absorbed GST rather than passing it on to their customers.

An increase in inflation would feed into the normal uprating practices for increasing pensions and benefits but, under normal circumstances, it could take up to a year for the increase to be applied. It is possible to estimate the impact a consumption tax would have on inflation, and this could be pre-empted so that those in a vulnerable position would not have to wait before their benefits were increased to reflect the increase in price. There is a cost implication of doing this.

There is a small minority of low income households who neither pay tax nor receive benefits. Mechanisms for protecting these households would need to be considered in any final proposals.

Despite public perception, a simple broad-based consumption tax would not be expensive for the States to administer. The experience in Jersey suggests that each £1 of income collected through GST costs 1p to collect. By comparison, it currently costs the Income Tax office about 1.5p for every £1 it collects (including tax on both personal and corporate income). Introducing a consumption tax would require new IT and administrative systems, which would entail an additional set-up cost.

Businesses are a key partner in the collection of these types of consumption tax and it is recognised that there would be a cost to businesses of administering the system and that this is, understandably, of some concern to the business community. The relative burden to a business will be dependent on the complexity of any proposed system and this is a strong argument in favour of keeping a consumption tax as broad and simple as possible, if this avenue is to be pursued further. OECD international guidelines on GST/VAT systems state:

"Compliance costs for businesses and administrative costs for the tax authorities should be minimized as far as possible;"

OECD international VAT/GST guidelines April 2014

How to minimise the compliance cost to businesses would therefore need to be an important consideration in the design of any new system.

It should be noted that, because of the wide use of consumption taxes in other jurisdictions, modern till systems and accounting packages are almost always designed with the capacity to calculate consumption tax and, provided the system is kept simple, the burden on companies would be much less than what may have been experienced by many business owners in the UK in the early days of VAT. Small businesses without access to modern systems may carry, in relative terms, a larger burden than their counterparts with access to more administrative resources and more sophisticated systems. A high turnover threshold for compulsory registration, such as those applied in Jersey, could protect these businesses.

8 Mitigating factors

The preceding paragraphs have outlined the negative consequences of an ageing population, but there are some lights on the horizon.

First and foremost, the States remain committed to the growth and diversification of the economy through the implementation of the Economic Development Framework drawn up by the Commerce and Employment Department in 2013 (see www.gov.gg/EconomicFramework).

Secondly, while the numbers of older Islanders are set to increase very significantly, the stereotype of the 'older person' is becoming outdated. The so-called "baby boomers" will not be the older people their parents were. They are, in general, better educated, wealthier, more assertive and fitter than any previous generation. Many will be looking forward to an active retirement and will continue to make a valuable contribution, both in the workplace and the community, well beyond the age at which they can begin claiming their pension. Promoting their independence and continuing contribution to society will thus be of benefit to all.

Thirdly, planning for the first era in which our population is more senior than junior using current health, housing and social care models would be both short sighted and expensive. If the States are to provide a sustainable support system for the next generation of older people and promote more independent lifestyles, they will need to move away from anachronistic models based on dependency and paternalism to models based on providing support and partnership. Rather than continuing systems of housing, health and social care designed to cater to, and care for, older people, the work on SLAWS is intended to offer the next generation of older people opportunities to promote their own health and wellbeing and to pursue lifelong growth and fulfilment, which will be of benefit to everyone.

9 Population and economic growth

As highlighted in the introduction, this paper has been compiled on the primary assumption that net migration levels will continue at a similar rate to that experienced in the recent past. However, whilst it is not the function of this review to set new population policy, it would not be complete unless it considered the impact that migration assumptions have on income and expenditure projections.

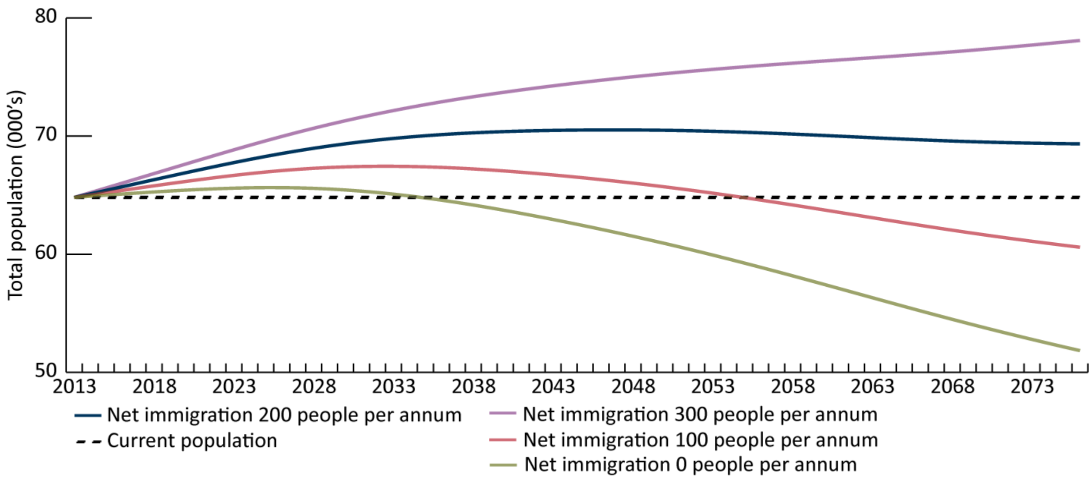
The States' agreed policy (Guernsey's Strategic Population and Migration Policy, Billet D'Etat IV, February 2007) is to maintain the population size at the level it was in March 2007. However, the population has already exceeded this level.

In addition, while the suite of recommendations agreed by the States in June 2013 were intended to establish a Population Management regime to provide greater control of levels of migration and ability to remain resident in the Island, it is highly unlikely that, through this alone, the States can achieve the level of control necessary to achieve the States' Population Policy.

For example, the number of births in Guernsey in any one year is typically higher than the number of deaths and is likely to continue to be so for a number of years yet. This means that even if there is no net immigration (i.e. the number of people who move to Guernsey is equal to the number of people who move away), the population will continue to increase until approximately 2026[21], reaching a projected peak of 63,739 (65,640 including Alderney). Therefore, in order to maintain a constant population, the States would need to achieve net *emigration* for approximately 10 years.

Figure 9.1.1: Population projections (Guernsey and Alderney) – Total population

Source: UK Government Actuary's Department



As explained earlier, migration assumptions can have a significant impact on the make-up of the population. Migration levels are typically highest among those of working age and, as such, changing migration assumptions has little impact on the retired population for another 30 years. However, the net movement of

[21] This is not the case in Alderney where there are typically more deaths than births each year. Alderney has also experienced net emigration in four of the last five years

people into the population does increase the number of people of working age. Dependent on the levels of migration assumed, this slows or even prevents the decline in the working age population that results from the 'baby boom' generation moving into retirement. **Therefore, there may be a trade-off: if the States wish to maintain the size of its working age population, total population growth is necessary; if the States choose to limit population growth, the working age population will decline.**

A declining working age population has both fiscal and economic implications. In simple terms, GDP - the principal measure of the size of an economy - is the sum of company profits and wages. This means that, for the most part, economic output is generated by people who are working. Fewer people of working age implies fewer people who are working and, therefore, less economic output. It also implies that the States will receive less money from the population in total, whilst needing to support a similar size population beyond the working age.

Figure 9.1.2: Population projections (Guernsey and Alderney) – Aged 65 or older

Source: UK Government Actuary's Department

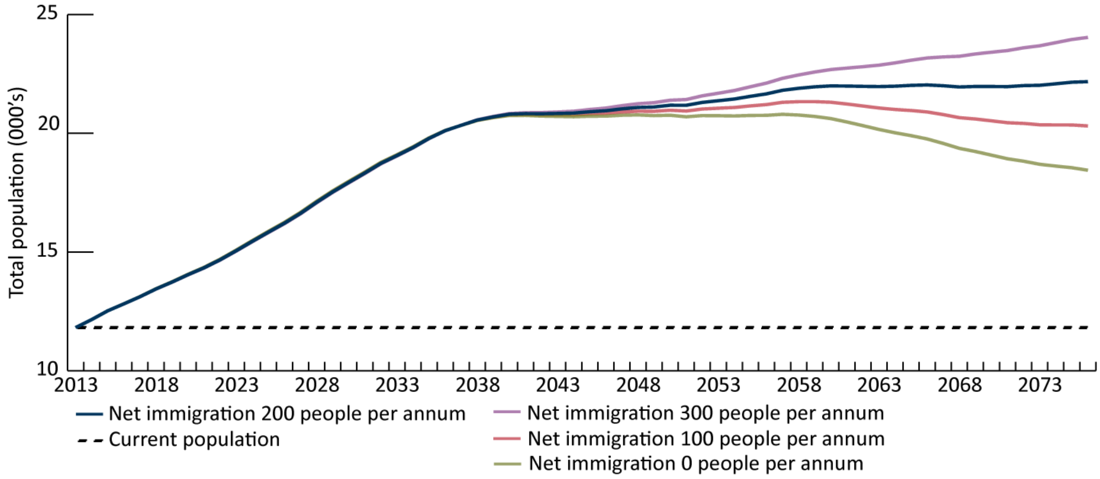
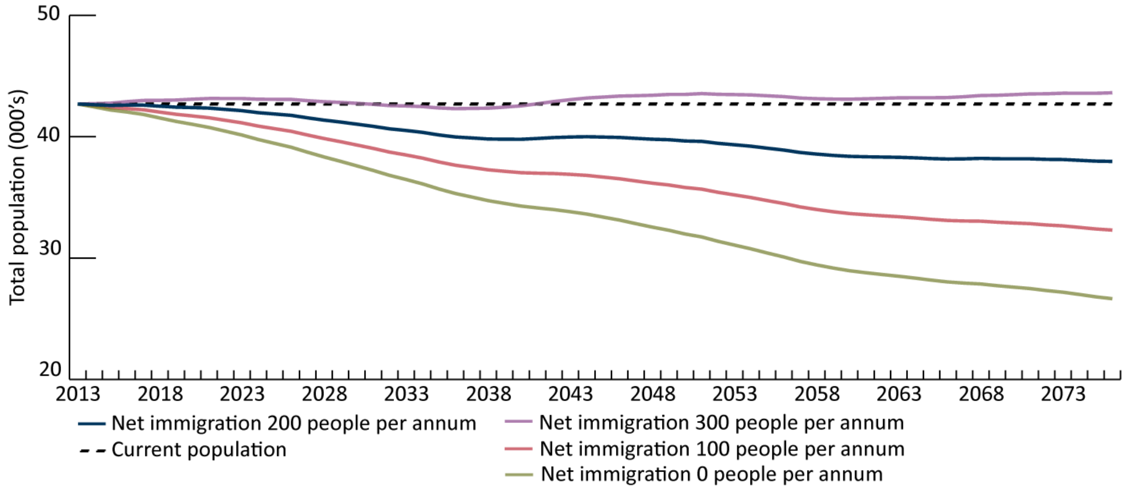


Figure 9.1.3: Population projections (Guernsey and Alderney) – Working age population aged 16-64

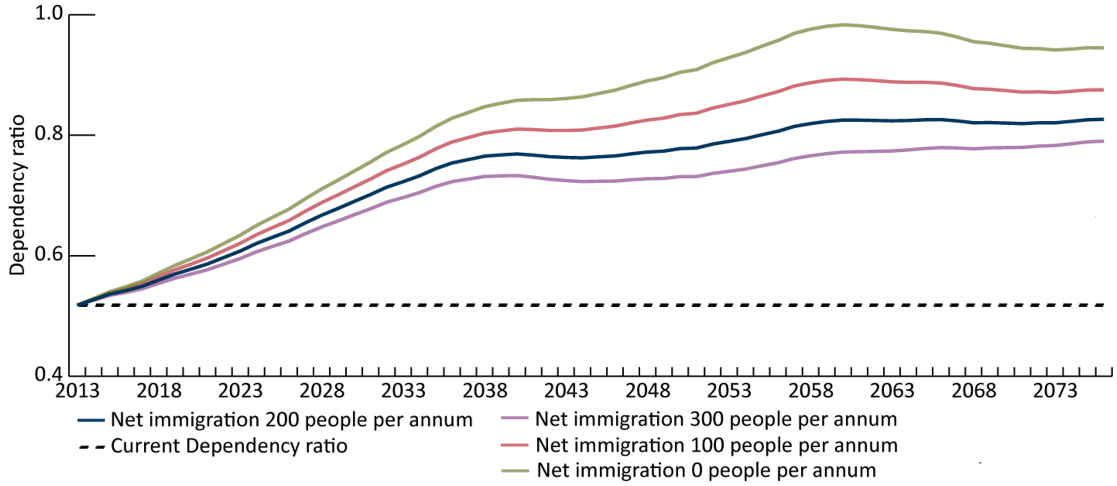
Source: UK Government Actuary's Department



This is best demonstrated by looking at the dependency ratio - the ratio of the number of people who are either above or below working age, compared with those who are of working age (currently 16-64). Broadly speaking, this is indicative of the number of people who, on balance, utilise a greater value of services (such as education, pensions and health and social care) than they are currently paying in tax and social insurance (net recipients), compared with the number of people who are typically paying more in tax than they are currently receiving in services (net contributors). The higher the dependency ratio, the greater the number of net recipients being supported by each net contributor.

Figure 9.1.4: Population projections (Guernsey and Alderney) – Dependency ratios

Source: UK Government Actuary's Department, Policy Council



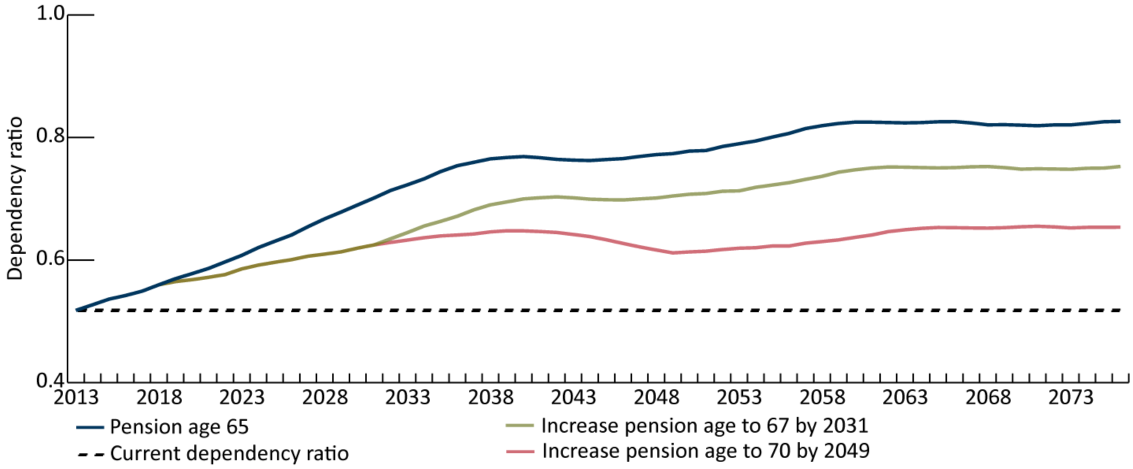
Increasing immigration assumptions has two primary impacts on the dependency ratio - it both delays and reduces the peak. For example, unadjusted for any increase in the retirement age, an assumption of no net migration results in a peak in the dependency ratio of 0.98 (i.e. 98 net recipients for every 100 net contributors) in 2060. If an assumption of net immigration of 200 people is used, the peak shifts to the late 2070s and reduces to 0.83 (i.e. 83 net recipients for every 100 net contributors).

Increasing the pension age lowers the dependency ratio by keeping people in the net contributor category for longer - increasing the number of net contributors and decreasing the number of net recipients. Increasing the pension age to 67 reduces the projected dependency ratio in 2060 from 0.83 to 0.75. If the pension age is increased as far as 70, this reduces to 0.64.

As mentioned above, the workforce is the primary driver of economic activity. A smaller workforce implies less economic activity and slower growth. Projections show that reducing the assumed rate of net immigration from 200 to 100 people per year reduces the level of GDP estimated for 2025 by 2.7%. By 2035, the difference between the projections of GDP using these two assumptions widens to 4.6%, more than £130m at today's prices. The total impact on total government income is expected to be similar, whilst the impact on government expenditure is less: as an estimate - 2.2% in 2025 and 3.3% in 2035.

Figure 9.1.5: Population projections (Guernsey and Alderney) – Impact of changing pension age on dependency ratios

Source: UK Government Actuary's Department, Policy Council, assuming net immigration of 200 people per year



However, if the States should decide to revise its policy on population, it is not as simple as opening the doors and letting people in. Increasing the levels of net immigration is only effective in softening the impact of the changing profile of the population if those people coming to the Island are economically active. If they simply stay and grow old, increased immigration simply adds to the problems of an ageing population.

Furthermore, whilst the economy will struggle to grow without a sufficient workforce to drive it, to increase net immigration will be difficult to achieve unless the economic conditions are attractive and there is suitable accommodation and work available to bring people to the Islands to make them net contributors. As would appear to be the experience in Alderney, a shrinking workforce and a struggling economy go hand in hand. In short, policies on population and economic development must work hand-in-hand if Guernsey is to maintain a healthy and vibrant economy.

10 Summary of challenges and options

Challenges

The challenges facing the Island, which are identified and explored in this report, are summarised below:

1. The current system of personal tax, pensions and benefits is unsustainable due to circumstances that were neither envisaged nor planned for when the present systems of taxation and social insurance were created some 50 years ago.

2. In the short-term, as a result of adopting the zero/10 tax regime coupled with global economic conditions, the States are running a budget deficit equivalent to 4% of General Revenue income.

3. In the long-term, Guernsey's ageing population will lead to significant increases in expenditure to fund both old age pensions and the health and social care needs of the growing number of older people who are increasingly living longer.

4. The single system of means-tested benefits, which it is proposed should replace the current overlapping rent rebate and supplementary benefit systems, is likely to require additional funding.

5. At the very time that States' expenditure increases to meet these needs, there is a risk that income will reduce as there will be a smaller proportion of the population of working age, the number of new people joining the work force being projected to be less than those retiring.

6. Continuing to rely on a tax base which is heavily dependent on personal income tax opens the Island to an increased risk of a serious drop in States' funds as the proportion of the population which is working diminishes, or if unemployment rises.

7. Beyond the need to fund the increased cost of old age pensions and related social and health care services, the Islands face the need to continue investment to maintain and develop key infrastructure (e.g. adapting coastal defences in response to climate change) at a level that cannot be met from current income.

8. The ability of the Islands to meet existing and future commitments in terms of public services and investment will be undermined if the States fail to exercise appropriate financial discipline and sacrifices long-term need for short-term gain.

9. To limit increases in the working age population in fulfilment of the State's Population Policy may inhibit economic growth and the resultant income that would be generated, at a time when it is most needed to meet changes in the demographic profile of the Island.

Options

The Joint Boards have identified a number of potential options for change with the aim of creating a more sustainable Personal Tax and Benefits system. These options have simply been set out in no particular order of priority at this stage, nor is any particular combination of options being recommended. A more detailed analysis of these options, their likely impact and an assessment of the degree to which they conform with the guiding principles adopted by the Joint Boards, will be presented in a States' Report later in 2014. That Report will contain clear recommendations.

Pensions

Option 1 Increasing the income of the Guernsey Insurance Fund

Option 2 Reducing the assumed level of annual uprating of pensions

Option 3 Increasing the pension age

Option 4 Allowing deferral of the old age pension

Option 5 Ensuring private pension provision

Benefits

Option 1 Restructuring the provision of long-term health and social care services

Option 2 Reducing or removing universal benefits e.g. family allowance, subsidies on medical prescriptions and GP and nurses consultations, and free TV licences for over 75s.

Financial Discipline

Option 1 Extending the effort to make better use of States' resources beyond the life of the FTP which ends in 2014.

Option 2 Setting a limit on aggregate States' income as a means of ensuring on-going expenditure control.

Taxation

Option 1 Increasing revenues from income tax or social insurance contributions including:

a) Increasing headline rates of tax and social insurance contributions
b) Higher rates for higher earners
c) Withdrawing tax allowances for higher earners
d) Withdrawing specific tax allowances (mortgage interest relief, the additional personal allowances for those over pension age, and the ability to transfer allowances for married couples and those with children)

Option 2 Increasing domestic TRP

Option 3 Introducing consumption taxes (GST)

Population

Option 1 Reviewing the current States' policy of 'no growth' in population

Next Steps

The Joint Boards fully recognise that, whilst this paper identifies the challenges and issues arising from our current systems of Tax, Pensions and Benefits and touches briefly on possible options to provide a more sustainable system, States' Members, the public, the business community and special interest groups will all want to consider these matters in more detail.

The purpose of this paper has been to provide a broad introduction to the subject as a backdrop to more detailed discussion on specific recommendations, which the Joint Boards are in the process of formulating and which will be published in a States Report later in 2014. At that time, more detail will be provided, including impact assessments of the likely implications of proposed changes.

Appendix A: Summary of responses to the public consultation

Extract from Personal Tax, Pensions and Benefits Review; Public Consultation Report 2013.
A full copy of the report is available at www.gov.gg/ptr.

Executive summary

We would like to offer our thanks to all those who took the time to complete the consultation on the Personal Tax, Pensions and Benefits Review. The number and diversity of responses received showed the complexity of the issues involved and their importance to us all. We have been impressed with the quality of responses received and the information gained from this exercise will be invaluable in informing the review and ensuring that the final proposals reflect what is best for Guernsey and Alderney in the long-term.

This report provides a summary of the responses to the public consultation on the issues covered and an outline of some of the alternative options available, which could be further investigated.

The objective of the review is to strike the right balance between the fairness, efficiency and sustainability of the tax and benefits regime in the long-term. At a political level, sustainability is considered the core principle with States' members of the two boards feeling that a sustainable tax system is key to providing high quality public services in the long-term.

The consultation highlighted the issues presented by the projected increase in the number of older people in our population. In March 2012 the Policy Council[22] published a report containing a projection of government expenditure over the next three decades, assuming a continuation of current services. The report stated that:

'What is apparent from the projections is that either revenue must rise as a share of GDP, or projected spending must fall—or some combination of the two outcomes must be achieved to ensure the States remains in balance over the projected period.'(to 2040)

Setting the scene for an analysis of the rest of the responses, most respondents felt that there was a limit to the amount of household income which the government could take to fund public expenditure. Limits provided averaged approximately 27%, slightly higher than the current 26% combined marginal rate of tax and social insurance experienced by most employed people. A key theme of responses to this question was the need to maintain Guernsey's competitive status as a relatively low tax jurisdiction.

In general, respondents were not in favour of increasing taxation to cater for all the increased cost associated with providing for the projected increase in demand for public services caused by ageing demographics. The general preference was for a reduction in expenditure (by implication, 'other' expenditure perhaps), whether by a move towards a greater level of personal responsibility for the costs involved or a reprioritising of public services. However, many people felt that a combination of the two

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

approaches would be most appropriate – a view mirroring the conclusions of Policy Council's 2012 report referenced above. The need for efficient provision of services was a key theme within the responses received with many people feeling that the States should demonstrate that the services provided are value for money before increasing revenues.

On the subject of how to continue the provision of the universal old age pension, education and personal responsibility were recurring themes expressed in the responses. The majority (63%) of respondents were supportive of the current scheme, but only 38% would be willing to pay more to continue it. Most would prefer to maintain the long-term sustainability of the old age pension scheme by either limiting increases in pensions to inflation or further extending the pension age to reflect increases in life expectancy (with the latter option receiving more support than the former).

Respondents were more willing to favour an increase in taxation in some form to pay for the increased demand in health than for pensions. Far fewer respondents were in favour of decreasing the level of tax funded healthcare (41%) than were in favour of limiting growth in States' spending generally (69%), with almost as many (37%) feeling that the level of tax funded healthcare should not be reduced. The theme of personal responsibility, although recurring in the section on health and long-term care, was balanced by a feeling that everyone should be entitled to access a good standard of healthcare and people should not be excluded for financial reasons.

In the area of welfare (in this context mainly supplementary benefit type expenditure) the majority of people expressed the view that a benefits system should provide sufficient income to fund essentials (food, fuel, housing and clothes etc.) but that it should not be generous enough to provide what respondents considered luxury items (e.g. Sky TV, alcohol, tobacco). One of the key themes recurring in response to the questions in this section was that the system should incentivise work and that people should be encouraged to become self-sufficient and not remain on benefits long-term. A majority (75%) of respondents felt that some form of benefit limitation should be retained; the largest consensus in the consultation.

The consultation presented three examples of how the tax system could be modified without raising additional revenues. Ranked in order of preference, with the most preferred first, these were:

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

Of the three options presented the removal of specific tax allowances and Family Allowance combined with an increase in the universal tax allowance received by far the largest number of favourable comments, with several respondents stating they viewed this as a simplification of the current system as well as creating a more transparent and equitable system. Most comments focused on the removal, reduction or limitation of Family Allowance and the limitation or removal of mortgage interest relief.

The introduction of different tax rates for lower and higher incomes received a more mixed response. Some expressed the opinion that higher earners could afford to pay more, whilst others felt that this would be unfair, particularly in light of the recent increases in the upper earnings limit on social insurance contributions. The overriding concern expressed by many would be the potential for this to damage

Guernsey's competitive position in attracting and recruiting firms and highly skilled professionals to the Island.

Respondents were, in general, not in favour of the introduction of a Goods and Services Tax (GST), even when offset by a lower general tax rate, referring to it as regressive and inflationary (albeit technically the inflation effect is a 'one off', impacting headline inflation figures for only twelve months), and a burden on business. A minority of people were in favour of this highlighting the difficulty in avoiding consumption taxes and the benefit of broadening the tax base.

The consultation documentation also set out a number of ways in which the States could raise additional revenue from the personal tax system. The seven examples, ranked in order of preference with the most preferred at the top, were:

- **Removing specific tax allowances and Family Allowance**
- **Raising domestic tax on real property**
- **Increasing social insurance contributions**
- **Introducing environmental taxes**
- **Introducing a higher earners' rate**
- **Increasing the general tax rate**
- **Introducing GST**

The removal of specific tax allowances and Family Allowance received the most positive comments. An increase in TRP also received, on balance, more positive comments than negative. Increases in social insurance contributions and the introduction of environmental taxes each received a similar number of positive and negative comments. A higher earner's rate, an increase in the general tax rate and introduction of GST all received more negative than positive comments with the latter receiving more than four times as many comments against its introduction than in favour of it.

It is recognised that, as far as identifiable[23], responses from Alderney had a different viewpoint to those from Guernsey. Hopes were expressed that consideration would be given to the possibility of different approaches for the two Islands. It is acknowledged that the difference in economic circumstances in Guernsey and Alderney would warrant this being considered and the issue of whether or not a differential approach is possible or appropriate will be reviewed.

As with all public consultations of this type, we must accept that the views submitted represent only those of a small proportion of the population and that some sectors of the population are more likely to respond to this type of exercise than others (a breakdown of the sample distribution is provided in **Appendix 1** together with the best available data on the distribution of the population as a whole). As such, the review of Personal Taxes, Pensions and Benefits will proceed with careful deliberation, with due consideration given both to the opinions expressed in this consultation and the potential impact of any changes on all members of our community.

[23] Respondents were not asked to identify which Island they were resident on.

Appendix B: Explaining efficiency

All taxes distort people's behaviour in some way; different taxes change behaviour in different ways.

Increasing income taxes reduces the value of work to the employee. For example, the current tax and social insurance rates, if you are an employee on an average salary and work some overtime and earn an extra £100 you would take home an extra £74; £100 less £20 of income tax and £6 of Social insurance.

If the income tax rates were increased to 30% you would take home £64 for working the same amount of overtime; £100 less £30 of income tax and £6 of social insurance. Increasing the income tax rate has reduced the amount of money you receive in return for your work and therefore reduced the benefit you get from working so your incentive to work is smaller.

Consumption taxes increase the cost of buying goods. For illustration, if you have £100 in the absence of any consumption tax you could buy £100 worth of goods. If you were to introduce a 10% consumption tax you would be able to buy £90.91 worth of goods on which you would have to pay £9.09 in tax (a total expenditure of £100). Increasing the consumption tax has reduced the amount of things you can buy with your money so your incentive to spend is smaller.

Taxes on property (such as TRP) increase the cost of owning a property (or renting, since the cost to your landlord would typically be included in your rent). At the current rates, the average TRP bill is about £150 a year. Increasing this would increase the cost of living in a property. Given that tax on property in Guernsey is charged based on its size, this means that increasing TRP reduces the incentive to live in larger properties. However, as you must live somewhere and your housing needs are likely to outweigh the financial incentive to live in a smaller house, the impact on people's behaviour is smaller than other forms of taxes.

Acronyms

EU	European Union
FTP	Financial Transformation Programme
GST	Goods and Services Tax
GDP	Gross Domestic Product
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
SWBIC	Social Welfare Benefits Investigation Committee
SLAWS	Supported Living and Ageing Well Strategy
TRP	Tax on real property
VAT	Value added tax

Glossary of Terms

Ageing population	a continuous increase in the median age of the population due to changes in birth rates and increases in life expectancy.
Allowances	refers to one or more income tax allowances.
Average tax rate	the combined income tax and social insurance contributions paid as a percentage of an individual's total income .
Baby boom	the period between the end of World War II and the mid to late 1960s that was characterised by a greatly increased birth rate.
Baby boomers	individuals born during the baby boom.
Budget deficit	the State's forecast expenditure exceeding expected revenue.
Consumption tax	a tax on spending on goods and/or services.
Co-payment	the portion paid by the consumer towards the cost of receiving long-term care.
Deficit	the amount that the State's expenditure or liabilities exceed income or assets.
Dependency ratio	the ratio of the number of people who are either above or below working age, to those who are of working age (currently 16 to 64 years).
Employee Tax Instalments	The total amount of income tax paid to the Income Tax Office (on a quarterly basis) by employers on behalf of their employees. Similar to Pay-as-you-earn (PAYE) schemes in the UK.
Excise duties/taxes	an tax on the import or sale of specific goods.
Financial Transformation Programme	programme whose aim is to deliver reoccurring annual saving by transforming the way the States deliver services in order to be more efficient.
Fiscal Framework	a set of principles that the States abide by to facilitate an economic position of long run permanent balance (i.e. income is equal to expenditure over the medium-term).
General revenue	funds received by the States, primarily through income taxation, that is not allocated for a specific purpose.
Guernsey Health Service Fund	portion of social insurance contributions allocated to the Guernsey Health Service Fund to fund health related services such as subsidies on primary care and prescriptions and specialist medical services provided by the Medical Specialist Group
Guernsey Insurance Fund	portion of social insurance contributions allocated to the Guernsey Insurance Fund to fund the old age pension and other contributory benefits such as unemployment and invalidity benefit.
Horizontal equity	when individuals or households with the same income pay the same amount of tax.
Independent taxation	each individual completes an annual tax return and is assessed independently of any other member of their household. Each individual has an annual personal allowance and is unable to transfer any portion of the personal allowance to a partner should the individual earn less than the personal allowance
Investment income	income generated from the investment of balances held in reserve in The Guernsey Insurance Fund, The Guernsey Health Service Fund and The Long-Term Care Fund.
Joint Boards	the Treasury and Resources Board and the Social Security Department Board.
Long-term	For the purpose of this report, long-term is considered to be 10 or more years.

Long-term care	care services provided to individuals who require assistance in caring for themselves for an extended period of time.
Long-Term Care Insurance Fund	portion of social insurance contributions allocated to the Long-Term Care Insurance Fund to fund long term residential or nursing care.
Marginal (tax) rate	the percentage of combined income tax and social insurance contributions which would be paid on an additional £1 of an individual's income.
Median	a method used to calculate an average number by arranging all the observations from lowest value to highest value and picking the middle one.
Net expenditure	total expenditure from general revenue, not including services funded by fees and charges and other departmental operating income.
Net income	total income received by general revenue, not including fees and charges and other departmental operating income.
Operating deficit	the amount that the States' expenditure exceeds income. This does not include any income generated from investment activities.
Per capita	per person
Proportional *(taxation)*	each individual pays the same proportion of their income in tax.
Progressive *(taxation)*	individuals pay a larger proportion of their income in tax as their income increases.
Regressive *(taxation)*	individual earners above a certain threshold pay a smaller proportion of their income in tax
Short-term	For the purpose of this report, short-term is considered to be less than 5 years.
Sub-prime mortgage market	the financial markets investing, directly or indirectly, in mortgages or other loans to high risk clients with low credit scores and poor quality assets.
Tax on real property "TRP"	tax paid on the plan view measurement of a property's built environment and land.
The Review	The Personal Tax, Pensions and Benefits Review
Universal benefit	welfare benefits available equally to all individuals, regardless of level of income and number of social insurance contributions
Uprating	increase (typically annual) in the monetary value of pensions or benefits
Zero/10	Guernsey's corporate tax regime, introduced in 2008, which applies a headline rate of income tax on company profits of 0%. A rate of 10% applied to specific regulated finance activities. A rate of 20% is applied to real estate activities and regulated utilities.

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