STATES OF JERSEY

GOODS AND SERVICES TAX: EXEMPTION OR ZERO-RATING FOR FOODSTUFFS, DOMESTIC ENERGY AND FUEL (P.36/2011) – COMMENTS

Presented to the States on 13th May 2011
by Minister for Treasury and Resources

STATES GREFFE

COMMENTS

The Minister for Treasury and Resources opposes this amendment and urges members to reject this proposition for the following reasons –

- One of the hallmarks of Jersey's GST system is its simplicity, which would be lost if this proposition was adopted.
- We need an efficient system of taxation that places the lowest possible burden on local taxpayers, both in terms of the tax charged and the cost of administering the system.
- A system of exclusions (whether by zero rating or exemption) requires detailed legislation and the added complexity greatly increases the scope for fraud and error.
- Introducing exclusions for food and domestic fuel would cost businesses more in compliance and administration and would lose the States approximately £8.2 million in revenue.
- However, this important issue should be argued on its merits and not only on cost.
- The complexities involved with zero rating food and domestic energy will increase the cost of compliance for those businesses involved by an amount that cannot be quantified. It would also increase the cost of administration for the Taxes Office and Customs and Immigration by at least £200 – 300,000 per annum.
- The Senator suggests that abolishing GST on food and/or domestic energy would reduce prices because retailers would simply pass the reduction on to customers. The experience of other countries has shown that there is a real risk that some or all of the reduction would not be passed on through lower prices. As a result, the States would lose significant revenue and incur increased administrative cost, with Islanders seeing little or no real benefit.
- The UK VAT system is recognised as being excessively complex and outdated. The UK's system is also not compliant with EU rules, and may be required to be changed at some time. Jersey should seek to follow the best examples of international tax practice, not adopt a regime like the UK's which, almost 40 years after implementation, is still subject to constant challenge and change.
- All the expert international advice available indicates that introducing GST exclusions would be a less efficient way to support those on lower incomes than the current system of income support and GST bonuses.
- Of the over £8 million revenue that would be lost from excluding food and domestic energy, less than £1 million would go to the 20% of the population on the lowest income (those with less than £20,000 a year) but more than

£2.5 million would go to the top 20% (those earning more than £73,000 a year).

- These exclusions would also reduce the voluntary compliance rates by businesses, which so far have been very high at around 92%. This high level of compliance is partly due to the relatively simple GST system we have. The equivalent compliance rates in VAT systems elsewhere are much lower – in the UK it is around 70%. Lower compliance rates increase the costs of collecting GST revenues, and reduce the revenue collected.

- Consideration will need to be given to revoking those elements of the income support system which were introduced in order to compensate the less well off for the introduction of GST on food and fuel if GST was removed from these items. This could result in £600,000 of income support and the GST food bonus being withdrawn from those on the lowest incomes.

- The States has voted for the following measures to compensate the less well-off for the introduction of GST –

  - Increased income tax thresholds by an extra 3.5% from 3% to 6.5% for 2008 in the 2008 Budget at a then cost of £4 million;
  - Included protection from GST for those on the original income support scheme at a cost of £1.75 million;
  - An allowance for those households between the income support scheme and income tax system known as the GST bonus scheme at a cost of £0.4 million;
  - The Deputy J.A.N. Le Fondré of St. Lawrence's proposition P.138/2008 to further increase income support by £3 million, double the GST Bonus Scheme at a cost of a further £0.4 million and provide an increase in income tax exemption thresholds from 3% to 5% in 2009 at a cost of £2.4 million.

  In total, this equated to a total financial benefit from those on low to middle incomes of £12 million, twice the estimated cost of exempting fuel and food from GST in 2008.

- As requested in the proposition, the Minister for Treasury and Resources has considered what alternative tax raising measures would be required in order to compensate for this reduction in GST revenues. These could include increasing the standard rate of GST to 6%, increasing social security contributions by 1% or increasing income tax rates by 1% across the board.

Supporting analysis

The proposition to introduce exclusions for food and domestic energy is not new and the concept has been debated in the States at least 6 times. The first such debate was in 2005, the last as recent as December 2010. The arguments for and against have not changed significantly – they are the same now as they were when this issue was last discussed, and on many other occasions since 2005.

One difference at the time of this debate is that we have had nearly 3 years of live tax experience since the "simple" GST was implemented and we can make judgements as to how well the tax system has performed.

Jersey GST has been independently judged a success in terms of the target revenue yield, impact on inflation, administration/business costs and voluntary compliance rates[1]. The base measure of compliance is how many taxpayers submit and pay their returns on time (i.e. by the due dates). The compliance rate in Jersey has been consistently very high at around 92% for each tax period since the tax system was introduced.

The equivalent compliance rates in VAT systems elsewhere are much lower – in the UK it is around 65-70%. The high compliance rate and low compliance and administration costs in Jersey are due mainly to the relatively simple GST system that the States decided to adopt and have so far managed to preserve.

1. Is the UK VAT system the best model to follow?

The UK VAT system was introduced in 1973, almost 40 years ago, and is now beginning to show its age – as such it is considered very much to be a first generation system. Internationally a fundamental review of the UK VAT system is considered long overdue.

As an EU Member State the UK should comply with the EU common VAT rules which determine, amongst other things, the rates of tax charged and what exclusions are permitted (whether by zero rating or exemption). Food and domestic energy are both taxable under EU rules but the UK, Ireland and Malta have been allowed to retain their different treatment as a transitional measure. This matter is kept under regular review; at some point the UK may be required to fall into line with the rest of the EU regarding its treatment of food for VAT purposes.

If the EU required the UK to change its treatment of food for VAT purposes, would Jersey then be required to do the same, under this proposition?

The minimum rate of VAT permitted by the EU to be charged on food and domestic fuel is 5%.

Impact of exclusions on the complexity of GST/VAT systems

The range, type and number of exclusions under any GST/VAT have a direct impact on the complexity of the system.

The overall impact assessment of mirroring the UK VAT treatment of food is very high, while the impact of following the UK treatment of fuel would be lower.

The box below provides further comment on the proposed exclusions under the UK VAT system and the ongoing problems of definition and interpretation of the law.

[1] Post Implementation Review of GST, HMRC, January 2009

Proposed exclusion 1 – Food (based on UK treatment)

Retailers would have to identify whether or not every individual item they sold was subject to GST. They would need to maintain sophisticated systems to collect and account for the tax. The compliance impact would be easier for retailers of pre-priced/pre-packed food products imported from the UK It would therefore be likely to be felt more keenly by smaller retailers than by the largest.

Box 1 – UK model for zero rating food

The exclusions proposed are based on the UK VAT model which is regarded internationally as one of the most complex systems in the world and is even non-compliant in terms of the European Union (EU) directives on VAT harmonisation). The difficulties of applying the UK rules are striking, even after over 30 years of live tax experience.

The UK exclusion for zero-rating "food" includes 4 general items as sub-categories –

1. *Food for human consumption*
2. *Animal feedstuffs*
3. *Seeds of plants*
4. *Live animals.*

There is no specific legal definition for food (but it includes drink) –but catering is excluded, as are a list of 7 other excepted items (including ice-cream and confectionery). A further 7 items then override these exceptions.

From the list above it is easy to see that many other business sectors would be affected. Hotels, cafés, restaurants, takeaways, and sandwich shops would have different rates of GST for food (hot soup, sandwiches, cereal bars and apples) which would vary yet again depending whether they were consumed on or off the premises. Bakeries would have to determine the liability of many products – biscuits and cakes are zero-rated as food but confectionery is taxable. Chocolate-chip biscuits are zero-rated if the chocolate chips are included in the dough or pressed into the surface. Chocolate shortbread biscuits are taxable. Even cake decorations take on different liabilities – chocolate chips are zero-rated whereas chocolate buttons and flakes are taxable.

Mention has been made during previous debates of specific examples of the UK treatment of food which have inspired ridicule elsewhere in the world (such as the Jaffa cake and gingerbread man cases). After 30 years of tax experience the UK is still having difficulties in definition – a series of cases on whether Pringles could be considered to be crisps for VAT purposes went as far as the Court of Appeal, with different decisions at every stage.

Pet shops and garden centres will be affected. Animal feedstuffs are zero-rated but pet food is taxable. Rabbit food is zero-rated whereas guinea pig food is taxable. Hay and straw if sold as animal feed would be zero-rated but taxable if sold as bedding. Seeds and plants grown for human consumption or

animal feedstuffs are zero-rated – grass seed is zero-rated, but not if pre-germinated and turf is taxable. Flower plants and seeds are taxable, other than specifically listed edible varieties.

Farmers, butchers and fishmongers will also be affected. Bones and off cuts of meat sold as pet food would be taxable but if sold for making soup would be zero rated. Meat and dairy animals would be eligible for zero-rating as would rabbits (other than ornamental breeds) even if kept as pets. Honey bees would be eligible for zero-rating but bumble bees are taxable.

The above demonstrates the continuing difficulty experienced in the UK of making the distinction between food eligible for zero rating and items taxable at the standard rate. Over the years changing legislation has almost spiralled out of control and the law has been overtaken by developments in the food manufacturing and processing industry. As a result it has constantly been challenged across Europe, and has become a hotch potch of seemingly contradictory tribunal rulings which leave plenty of scope for mistakes and confusion not to mention miss-description and fraud.

Furthermore it has led to a disproportionate administration burden with numerous appeals, reviews and tribunal decisions influencing a policy which is seemingly ever changing. It is important to note that the standard rate of VAT liability was extended to take away food in 1984 but the system is far from being bedded down and is still regularly challenged 25 years later. The box below provides further detail on some more recent cases of dispute.

Box 2 – Recent dispute cases involving food

The sale of hot food which is intended for immediate consumption is treated at catering for VAT purposes and therefore standard rated. Cold food sold as part of catering is also standard rated, although cold food which is intended to be taken away from the premises in question is zero rated. Not surprisingly, this has given rise to numerous disputes.

German sausage
A German court has ruled that a sausage vendor's sausages required so little preparation that they did not constitute catering for VAT purposes. This suggests that simple hot takeaway food products such as sausages will be potentially VAT free whereas more complex food which needs more preparation will be subject to VAT. This ruling was made on March 16th 2011, so the full impact has yet to be measured. However, VAT advisers are already encouraging businesses to make claims for backdated over paid VAT.

Because UK VAT law follows the EU model, rulings by courts in other countries are binding on the UK, and by extension, Jersey, if we were to follow the UK practice.

This precedent will doubtless give rise to more cases – if sausages require very little preparation, can the same be said for other "simple" foods like eggs, tinned foods, or pre-packaged reheated meals? How many stages of preparation will tip the balance between zero-rating and standard rating?

Doubtless the courts will be called upon to consider these issues in the near future.

Subway sandwiches
250 repayment claims were made by Subway franchisees, who argued that supplies of toasted sandwiches were not 'hot food' for the purposes of VAT and were therefore zero-rated, in that no VAT should be charged on the supply of these goods.

Both sides in the dispute employed food scientists to testify, who took their own measurements of sandwich temperature. It was eventually agreed that the temperature of the food was above ambient air temperature at the point of supply and was therefore "hot".

The case then hinged on whether the food was hot merely as a by-product of the preparation process, or whether the supplier had heated the food in order for the customer to consume it warm. A number of expert witnesses were employed to give evidence on the effect on the flavour of toasting sandwiches, and that Subway made efforts to deliver the products to the customer so that they could be consumed hot. The tribunal held that the products were intended to be served hot and so should be standard rated. The franchisees have appealed, partly on the grounds that other takeaway restaurants are treated differently, and this case looks likely to run for some time.

Marks & Spencers Teacakes
After 12 years of litigation and 2 trips to the European Court of Justice, they were finally deemed to be a chocolate cake not a biscuit and therefore zero rated. At that stage, the company filed a claim for a repayment of £3.5 million in overpaid VAT.

VAT on beverages
Two similar tribunal decisions on what seem like identical products arrived at different outcomes. A liquidized fruit and vegetable drink was held to be zero rated whereas a pulped fruit and vegetable drink was held to be standard rated.

Some other quirks of VAT legislation, as it currently stands

- *Nuts in their shells are zero-rated; out of their shells are standard rated.*
- *Frozen foods are zero rated, apart from ice-cream and frozen yoghurt which are standard rated.*
- *Dog food is standard rated unless intended for working dogs when it is classed as animal feed and zero rated; the difference here being in how the product is presented at point of sale.*
- *Ferret food has recently been ruled standard rated, following the "Ferret Census 2009", which recorded that 80% of ferrets were kept for companionship, not as working animals.*

Proposed exclusion 2 – Domestic energy and fuel

It is not clear from the proposition what exactly is intended by "Domestic Energy and Fuel" but this has been taken to apply mainly to supplies of

electricity, gas, heating oil and coal products for use in private dwellings. Such supplies under UK VAT are not excluded from the tax base and are taxable at either the reduced rate of 5% if they qualify for domestic usage and if not, at the standard rate of 20%.

If the proposition was approved we would need to agree exactly what supplies were intended to be covered by "domestic energy". The proposition does not mention using the same liability treatment as in the UK but this would be a possibility. It should also be stressed that in the UK all forms of energy supplies are taxed under VAT but what are described as "qualifying supplies" are eligible to be taxed at the lower 5% rate rather than the standard rate of 20%. The qualifying supplies use quantitative measures to determine what is intended as being "domestic" and as such taxed at the lower rate of 5%. This UK system could be adopted in Jersey to determine what is eligible for zero rating.

Increasing the complexity of the tax, with mixed rates, provides in-built opportunities for error, or, worse, fraud by miscoding whether goods sold are subject to tax or zero-rated. Not only does this reduce revenue yield it also requires the States to employ additional staff to monitor compliance.

How easy will it be to mirror the UK VAT law?

The proposition states that Jersey should copy the UK VAT arrangements. It does not state at what point in time this should be done. The date is important as the proposition wishes to transplant legislation which is constantly being challenged and shaped both in the UK and other EU Member States.

VAT law on food is intricate, complex and is constantly being challenged and altered as a result of tribunal decisions, which can be at odds with previous decisions. This has resulted in the UK having a VAT regime in which it is not clear exactly what can and cannot be zero rated. In the UK this has led to mistakes, manipulation and fraud. It has also led to HMRC being embroiled in long drawn out litigation.

The examples provided in this report are recent decisions which demonstrate just how contentious, complex and time consuming this area of VAT law is in practice. Furthermore when a judgment goes against a tax authority it then leaves the door open for backdated claims of a similar nature for either over declared output tax or under-declared input tax to be successfully filed against the revenue agency/Government.

At this stage the exact scale of legislative reform is difficult to predict. However, even if we tried to mirror the UK it would require significant work on clarification and definitions, drafting instructions to amend and expand Schedule 6 of the Goods and Services Tax (Jersey) Law 2007 and the more onerous task for the agencies involved (Taxes Office/Customs) of re-training staff, producing internal guidance, issuing leaflets/notices and re-educating the taxpayer population.

There would also be an unknown but potentially significant amount of work to mirror changes in the UK/EU as and when they occurred and from local

rulings provided by the Commissioners of Appeal in dispute cases which could be at variance with UK VAT legislation.

2. Impact on business and the States

Businesses affected

The UK exclusions are wide ranging and if replicated in Jersey would impact on hotels, restaurants, cafes, takeaways, bakeries, butchers, fishmongers, agricultural merchants, farmers, garden centres, pet shops, garages and chemists. Perhaps there would be less of challenge for the large supermarkets importing pre-priced goods for resale in the same state but the changes do not simply affect those that supply direct to the public but also importers, manufacturers and wholesalers.

If the proposed exclusions are approved by the States we estimate that the total number of businesses involved in some way with redefined liability supplies is between 150 to 200. They would all need to be engaged in a "re-education" programme by the Taxes Office commencing as soon as possible after the new legislation is finalised. The cost of this to business is impossible to quantify and ultimately will likely be passed on to consumers through higher prices, defeating the key objective of the proposals.

Accounting systems

If the proposed exclusions were approved the GST registered businesses involved would need to make significant changes to their accounting systems. This task should be easier for businesses using automated systems but we should not underestimate the availability of software, the time needed to implement changes and the costs involved. Many UK software suppliers will not supply into Jersey; they make most of their profit from post-sales support, and the costs of providing this to a customer in Jersey make it unattractive to do so.

Many smaller businesses do not have computer based accounting so the impact of complex GST liability may fall disproportionately on them.

Increased complexity

In most GST/VAT systems the basic accounting record for registered businesses is the tax invoice which must be issued for all taxable supplies. Retailers are however allowed to assess tax on their sales by use of a retail scheme instead. Because of the complexity of the VAT system in the UK they now have 8 different retail schemes and bespoke systems which must be approved by Her Majesty's Revenue and Customs. In Jersey GST we only need one retail scheme as all sales are currently taxable. If the proposition was approved we anticipate that we would need to provide 6 different retail schemes.

Why do further exclusions increase administration burden?

It is a fact that the more complicated a tax system becomes the more problems taxpayers have in trying to comply with their legal responsibilities. Taxpayers fall into 3 general categories –

- willing and able;
- needing help; and
- prepared to avoid and evade.

If the proposed exclusions are approved then Jersey GST will no longer be classified as a good/simple system. Taxpayers will migrate between the categories above – there will be a shift from category (i) to (ii) and (iii). More taxpayers will require assistance and more will be tempted to avoid and evade. All levels of taxpayer contact (enquiries, error returns, non-filing and non-payment of debts) with the Taxes Office will increase and so will the consequential casework. The audit programme of visits will need to be increased to counter the greater incidence of avoidance / evasion.

> *"One overriding lesson about VAT/GST design is that adding tax preferences (exclusions by zero rating / exemption) to the system may satisfy economic, distributional or other policy goals but at a cost. Tax preferences – in the form of zero rates, exemptions or reduced rates – reduce revenue, add complexity and increase compliance risks. The end result is an increase in compliance burden for businesses and administrative costs for Government".*[2]

Box 3 – Background on the case for increased staff resources

There still seems to be general misunderstanding on the part of many States members as to the inter relationship between the design of a tax system and the compliance risks, compliance costs and administration costs. Some views expressed on tax administration in general are rather simplistic to say the least and far from reality. In some ways this is understandable – it is a complex issue which was certainly not helped by the Corporate Services Scrutiny Panel's first interim report on GST (S.R.6/2006) – dated October 2006. Section 6 covers compliance and appears to rely on an Australian Senate Select Committee review dating back to April 1999 which in turn quotes from a UK National Audit Office study into compliance costs in 1995. Although we have generally been impressed with the work of the Corporate Scrutiny Panel on GST (the conduct, methodology and outputs) we have never accepted these conclusions which are not evidence based and focus mainly on business compliance costs.

The Scrutiny Panel findings have repeatedly been misinterpreted in previous propositions and this proposition is no exception. The comment under Financial and Manpower includes "as was demonstrated convincingly by Scrutiny, claims of excessive administration cost associated with exemptions or zero rating were grossly overstated". Scrutiny demonstrated no such thing and the panel members have never seen the NAO report. If they had they

[2] Concluding comment from a US Government Accounting Office report: "VAT lessons from other countries", April 2008

would have seen an important footnote in the comparison of gross compliance costs – "The purpose of this comparison is to illustrate the similarity of the compliance cost: turnover curve. Comparison between individual countries figures (UK, Netherlands, New Zealand, Germany and Canada) are not valid because the tax regimes are different and the research has been carried on a different basis". Finally it must be emphasised that the NAO report was a study into the "Cost to Business of Complying with VAT requirements" and not the cost of administration of VAT by the then HM Customs & Excise.

Based on more recent HMRC research referred to as the "Compliance Continuum" it is certain that voluntary compliance would decline as a result of having a complicated GST system. The tax gap (measured as the difference between actual revenue receipts and potential yield) would increase as a result of the range of exclusions suggested by the proposition.

The complexity of the system has a major influence on most of these factors. The UK National Audit Office reported in 1994 that VAT Audit staff found underdeclarations at 55% of traders visited. This is high by international standards and was still occurring after 20 years of live tax experience and is a direct result of having a complicated VAT system.

3. The case for a simple system of GST

Economic merits, international advice and evidence for a simple GST

A recent review of taxation in the UK, headed by Nobel laureate Sir James Mirrlees, recommended that the UK abandon its current system of VAT exclusions and differential rates, and instead move towards a broad-based system. In the words of that review –

> *"Even if the better off spend a smaller proportion of their current income on such items as food than do the less well-off, they are unlikely to spend a smaller absolute amount on them. If there were no other way of transferring resources to the poorest, setting a low tax rate on these items might be sensible policy. But it is unlikely to be so when, as in the UK, there is a range of other instruments—not only the income tax, but tax credits and benefits— that could be targeted more directly upon them."* (Dimensions of Tax Design, Mirrlees Review, 2010)

And the International Monetary Fund (IMF) agrees, noting that –

> *"…reduced and zero VAT rates are an expensive and poorly targeted means of addressing distributional concerns. Most G-20 countries apply zero and/or reduced rates of VAT to "essential" goods and services that are consumed disproportionately by the less well off, such as fuel, housing and basic foodstuffs. However, the degree of income redistribution that can be achieved is limited by the fact that rich individuals spend large amounts on these essentials in absolute terms. Progressive income tax and expenditure policies are better suited to providing targeted support to low-income households at a*

lower fiscal cost. In the United Kingdom, for example, eliminating zero- and reduced-rating, while increasing income-related benefits to protect the poor, would raise net revenue of around 0.75 percent of GDP." (IMF, Fiscal Monitor, Nov 2010)

For Jersey to move towards the system that the UK currently has would be contrary to this advice.

The evidence also suggests that a broad-based consumption tax, as an element of a wider, progressive tax system, is economically efficient as it does not distort decisions about productive economic activity, and therefore is more conducive to economic growth than taxes that discourage this type of activity such as income tax. In the words of the Mirrlees Review –

> *"A more uniform rate would increase consumers' welfare by distorting their spending decisions less. People would make choices based on relative prices that reflect the underlying costs of producing the goods rather than differences in tax rates."* (Tax by Design, Mirrlees Review, 2010)

Again the International Monetary Fund (IMF) agrees –

> *"[A] "pure" VAT with a single rate and minimal exemptions is an efficient way to raise revenues. Taxing consumption is equivalent to taxing accumulated assets and labour income: thus it falls partly on a completely inelastic base – previously existing assets – and partly on a base less internationally mobile than capital income. Broad-based consumption taxes are therefore considered less harmful to growth than income taxes."* (IMF, Fiscal Monitor, Nov 2010)

4. Would introducing exclusions achieve the desired result?

Senator A. Breckon suggests that there are 2 main aims to introducing these exclusions, namely –

- Reducing costs for the consumer; and
- Benefitting those on low incomes and "middle Jersey".

Adjusting GST rates is an inefficient tool for achieving either of these goals.

<u>Introducing exclusions may not result in lower prices for consumers</u>

The proposition assumes that the reduction in GST will be reflected in reduced prices and that the potential saving will be passed on by the business community to the consumer.

Experience elsewhere indicates that in all probability savings will not be passed on in full and over time they will more than likely be eradicated or absorbed through the supply chain, in part to deal with the additional cost of compliance by the business. Some examples are provided in the box below.

The key point for Jersey is that, even if the rate of GST is cut, businesses in an open market economy are not obliged to pass on the savings and nor do we have the means of making them do so.

Box 5 – Other countries' experience of reducing VAT rates

UK – BBC Watchdog ran a report when the VAT rate was temporarily reduced in the UK from 17.5% to 15% in 2008. It found that Asda had only reduced the VAT rate on certain of their products. Next and Matalan had reduced prices at first, but shortly afterwards increased prices, so they returned to the same level as they had been before the VAT rate change – the difference being that the store simply kept the amount that had previously been paid to the government in VAT. McDonalds reduced some of its prices but not all of them, so for those items the business took the difference as extra profit, and the end consumer did not benefit. Examples of this are many and varied.

France: As of 1st July 2009, French GST was reduced from 19.6% to 5.5% for all food and beverage outlets, especially at cafes and restaurants. Studies from the Economic Affairs Ministry showed that only 30% of independent restaurants reduced their prices in response.

Turkey: Similarly, the reduction of Turkey's VAT rate for some food and drink items from 18% to 8% has not generally been reflected in reduced costs for consumers. Many shopkeepers left prices at their original levels in order to take more profit. Restaurant owners stated that they could not reduce their prices because other costs had increased, so the VAT savings were absorbed and not passed on to customers.

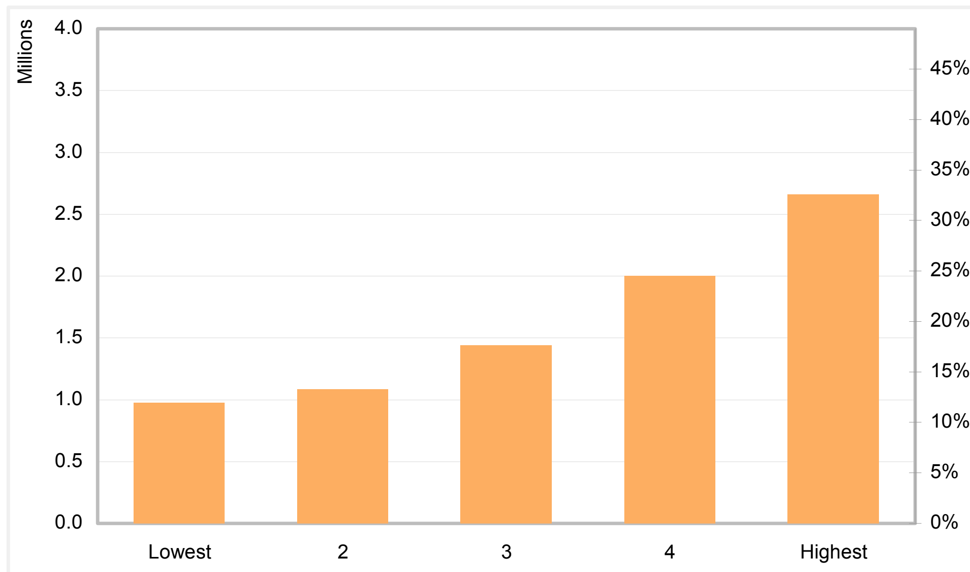
In both the French and Turkish examples above, the reduction in the VAT rate was far greater than what is proposed now, yet still these costs were not fully passed on to consumers.

Introducing exclusions is a blunt tool for protecting the less-well off from GST

The evidence is clear that indirect taxes, such as GST, are generally very blunt mechanisms for redistributing money and compensating the less well off since they cannot be targeted on those groups that are most in need. This is because, while the better off spend a smaller proportion of their current income on such items as food than do the less well off, they spend a larger absolute amount on them.

For example, the cost of zero-rating on food and domestic energy would be in the region of £8 million. Just 12% (£980,000) of this would go to the 20% of the population with the lowest income (those on less than £20,000 a year), while 33% (£2.67 million) would go to the 20% with the highest income (those with incomes above £73,000) (Figure 1).

Figure 1 Beneficiaries of exempting food and domestic energy from GST £, millions (LHS), Proportion of total, % (RHS)



The above assumes that all of the GST reduction would be passed on to consumers in the form of reduced prices, though in practice there is considerable doubt that this would happen in all instances (see below).

Trying to transfer resources to the less well off by setting a lower rate of GST on these items is not effective, especially when there are other options. There are a variety of other ways to target the less well off more directly; including benefits and income tax.

Protecting the less well-off from the impact of GST

The Minister for Treasury and Resources accepts that people are concerned about the impact of GST on the less well off. For that reason, income support has been increased to reflect the increase in the rate of GST, and the States will shortly debate proposals to increase the GST bonus for those on low incomes who do not receive income support. This is a much more targeted and effective way of helping those who need support.

Consideration will need to be given to revoking those elements of the income support system which were introduced in order to compensate the less well off for the introduction of GST on food and fuel if GST was removed from these items. This could result in £600,000 of income support and the GST food bonus being withdrawn from those on the lowest incomes.

In total, the States has voted for the following measures to compensate the less well-off for the introduction of GST –

- Increased income tax thresholds by an extra 3.5% from 3% to 6.5% for 2008 in the 2008 Budget at a then cost of £4 million;
- Included protection from GST for those on the original income support scheme at a cost of £1.75 million;

- An allowance for those households between the income support scheme and income tax system known as the GST bonus scheme at a cost of £0.4 million;
- The Deputy J.A.N. Le Fondré of St. Lawrence's proposition P.138/2008 to further increase income support by £3 million, double the GST Bonus Scheme at a cost of a further £0.4 million and provide an increase in income tax exemption thresholds from 3% to 5% in 2009 at a cost of £2.4 million.

In total, this equated to a total financial benefit from those on low to middle incomes of £12 million, twice the estimated cost of exempting fuel and food from GST in 2008.

In addition the Minister for Treasury and Resources has supported the economy, and by extension those vulnerable to its effects, through the downturn both by implementing an active fiscal stimulus programmes worth £44 million and by allowing deficits to occur naturally. The 2011 Budget included measures to ensure that the States will continue to support the economy right up to 2013.

5. Cost of introducing exclusions

Staffing numbers

In 2010, 5 staff were deployed directly on domestic GST administration. Based on results, the Taxes Office total cost of administration is 1.2p in the pound collected. This is very low by international standards and is a result of having –

- a good/simple system with few exclusions;
- a low rate of tax;
- business friendly support systems and procedures; and
- an ongoing education programme.

If the proposed exclusions are adopted by the States the added complications will have an impact on current staffing numbers although it is difficult to quantify the exact additional administrative costs involved. However, a reasonable approximation based on UK experience is that 3 additional staff will be required, between the Taxes Office and Customs Department (see below) and the extra payroll, social security, IT, accommodation and other costs would be approximately £200,000 to £300,000 a year.

Customs and imports

Every type of exclusion in terms of supply (goods and/or services) presents a different challenge but international experience shows that any system with mixed liability goods will present difficulties even at the very start of the supply chain.

Under the current GST Law, all goods imported into Jersey are potentially taxable (there is a *de minimis* value below which goods will enter freely). Under these circumstances our proposed clearance procedures are simple and

have been welcomed by the main importers and Chamber of Commerce. Any potential problems likely to be encountered by Customs are mainly limited to under-valuation.

However, if the proposed exclusions are approved, circumstances will be very different. Goods imported into Jersey will either be subject to the standard rate or zero rate of GST. Firstly Customs will be required to maintain an up-to-date and accurate Tariff to include a GST liability indicator for all commodities. Inevitably this will lead to additional problems of mis-description and perhaps a combination of mis-description and under-valuation.

This will undoubtedly require additional staffing for Customs, and for non-GST registered importers has the potential to lead to delays in the clearance of incoming goods.

Resolution of taxpayer disputes

All tax regimes must have what is judged to be a fair and transparent system for resolving disputes between taxpayers and the Taxes Office. When GST was introduced the legislation replicated the same well tried and tested procedure for resolving Income Tax disputes – the Commissioners of Appeal. In the 3 years since GST started only 2 appeal cases have been lodged and both were resolved before formal appeal hearings. The low number of disputes is a direct result of having a simple system and low rate of tax.

If the proposed exclusions are adopted by the States then based on international experience there will be an increase in the number of taxpayer disputes requiring both internal review/reconsideration and formal resolution by the Commissioners of Appeal. This will further increase pressure on the staff resources available and require an increase in the limited budget currently available to the Taxes Office for funding the appeal process. Because no GST appeals have been heard by the Commissioners of Appeal to date, it is difficult to predict the quantum of additional cost that could be required.

6. Additional tax revenue required

Tax revenue foregone

Zero-rating food would result in a loss of GST revenue to the States of approximately £6.3 million. Zero-rating fuel would result in lost revenues of £1.9 million, giving a total loss of revenue of adopting this proposition in its entirety of approximately £8.2 million.

This does not include the cost of the additional man-power and administrative costs on the part of the States noted above of between £200,000 and £300,000. In addition, the considerable additional administrative burden placed on retailers (and as noted above, hotels, cafes, restaurants, garages and all the other affected businesses) in order to comply with the increasingly complex system. Finally, and potentially quite importantly, it does not include the cost to the States of administering appeals against the system, nor does it include the potential tax lost due to changes in the behaviour of businesses as a result of increasing the opportunities for avoidance or evasion of GST.

Compensating tax measures

The proposition asks the Minister for Treasury and Resources to introduce alternative tax raising measures in order to compensate for the GST lost through the introduction of these exemptions. There are a number of options available to the Minister to raise the level of tax revenues lost if this proposition was approved, including –

- Increasing the rate of GST by 0.7% to 5.7%, although due to the unquantifiable additional cost and tax loss it is more likely that the rate would have to increase to 6% in order to properly compensate;
- Increasing both employer's and employee's social security rates by an additional 1% above the current cap; or
- Increasing the income tax rate by 1% across the board.

Each of these options was fully considered during the course of the Fiscal Strategy Review undertaken during 2010, and the arguments for and against were fully enumerated at that point.

- Narrowing the tax base by excluding food and domestic fuel will reduce the number of goods that are subject to GST and could therefore force up the tax rate applied to other goods and services. While this proposition seeks to protect the less well off from the impact of GST, they would still be affected by the increased cost of other goods or services they bought.
- The Minister for Treasury and Resources has asked the Minister for Social Security to bring forward proposals to increase social security rates above the current cap, following the 2011 Budget. Other proposals are also being considered in order to fund the long-term care of Jersey's aging population. To add another 1% on top of this would be damaging to employment and ultimately to the economy.
- The arguments against increasing the Jersey income tax rate were rehearsed at length in the States Assembly in April 2011. Broadly, increasing Jersey's standard rate of tax would be damaging to the Island's reputation for stability and would damage the Island's economy. As a result, the States voted to maintain Jersey's 20% personal tax rate.

7. Balance of taxes

The Senator's report refers to the figures prepared by Deputy Southern regarding the balance of taxes paid by companies and individuals in Jersey. As has been said before, these figures are misleading for the following reasons –

- The figures do not include social security contributions, stamp taxes or rates, all of which are paid by companies and individuals. Including these amounts would change the proportions significantly.
- It is incorrect to state that all GST is paid by individuals. ISE fees accounted for some £5.6 million of revenue in 2010 and are estimated to be £8.7 million in 2011. Companies also pay GST directly if they are not registered for GST (a company whose taxable turnover is less

than £300,000 per annum is not required to register for GST) or if they make exempt supplies such as supplies of insurance, postage or medical supplies. It is difficult to quantify the total GST incurred by non registered businesses as they are not required to submit returns.

- A proportion of impôts and GST is paid by tourists and other visitors to Jersey.
- A proportion of GST charged by Customs on imports is paid by the non GST registered businesses.

The shift in the balance between corporate and personal taxes seen has been caused in part by the decision to introduce 0/10 to protect Jersey's economy and by the package of other tax measures introduced to compensate in part for the loss of corporate tax revenues, namely 20 Means 20, ITIS and GST – a policy that was voted for by the States Assembly.

The shift from a heavy reliance on corporate taxes to personal taxes has already been the subject of public consultation and States debate over a number of years, since the original 0/10 Design Proposal was published in 2004. The global trend over the past decades has been a shift away from corporate taxation in favour of personal taxation, and in that, Jersey is not alone. The reduction in tax revenues from companies has also been affected by the effects of the economic downturn and low interest rates, which have reduced the profits of the highest company income taxpayers. Although company profits have fallen, and with them company tax payments, Jersey has been fortunate that personal income tax receipts have not fallen, as absolute levels of wages and salaries have not been reduced by the effect of the downturn to date.

Fair taxation takes account of people's ability to pay. The tax changes agreed by the States as part of the 2011 Budget debate took account of this, alongside the need for competitiveness and efficiency. 20 means 20 has affected higher earners more than middle earners and has had no impact on low earners. The introduction of ITIS has resulted in more individuals paying the income tax they owe. With the introduction of GST, low earners have been protected by increased tax thresholds, uprating of income support and the GST bonus scheme.

8. GST and the financial services sector

Although not directly relevant to the proposition in hand, the Senator refers to the treatment of the financial services industry for GST purposes. He suggests that the introduction of P.37/2007 has led to the revenue raised from the finance industry being "at the bottom end of expectations".

When GST was first introduced it was anticipated that the revenue raised from the finance sector would be between £5 million and £10 million. Revenues raised in 2011 from International Services Entity (ISE) fees are predicted to be approximately £8.5 million. The Minister for Treasury and Resources has previously announced that this regime is being reviewed with the intention of increasing total revenues from 2012. A consultation document on this subject will be published shortly.