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

The economic impact of Guernsey's Tax Strategy

Paper One

Presented by the Independent Working Group

March 2006

1. **Introduction**

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

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

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

- In Section 2, Economic Background, we provide a brief overview of the role of the financial services sector and its importance to the Bailiwick's economy. In this Section we also place in context the main factors driving the need to reform Guernsey's corporate tax regime, and summarise the Government's response to date.

- In Section 3 we provide a high level assessment of the economic case for 0%/10% and explain the reasons for reform. We also look at what the consequences of 0%/10% might be for the public finances.

Annexes 1 and 2 provide supporting statistical information.

Our key conclusions are as follows:

- Guernsey's financial services industry is pivotal to the future of the Bailiwick's economy.

- The Bailiwick has no option but to respond to international pressure and reform its corporate tax regime.

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

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

2. Economic background

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

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

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

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

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

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

2.2 International developments affecting the Bailiwick

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

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

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

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

2.3 Guernsey's response to date

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

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

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

3.1 The need for reform

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

Guernsey's financial services industry has built up a significant export market with an estimated total value of funds under management, in 2005, well in excess of £100bn. The maintenance of competitiveness is essential for sustaining the Bailiwick's wider economy and its performance is largely beyond the control of individual jurisdictions. There are, however, several factors which affect decisions about where to locate international business; these include the following:

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

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

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

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

3.2 The options for reform

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

Other options have been advanced, most notably an approach based on 0%/20% for certain businesses that might prefer this whilst others would be subject to 0%/10%. Such an approach, it has been argued, would result in higher tax revenues for Guernsey than a pure 0%10% regime, thus reducing the need to levy extra taxes on residents, and those businesses paying at the higher rate would not suffer detriment as

[2] KPMG, 2003, Finance Sector Study

their additional liability in Guernsey would merely be offset against a liability in other jurisdictions. Whilst it appears superficially attractive, this option nonetheless presents significant problems. It would in our view be extremely risky to adopt a variant of 0%/20% for some finance businesses for the following reasons:

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

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

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

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

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

3.3 The consequences of reform

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

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

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

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

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

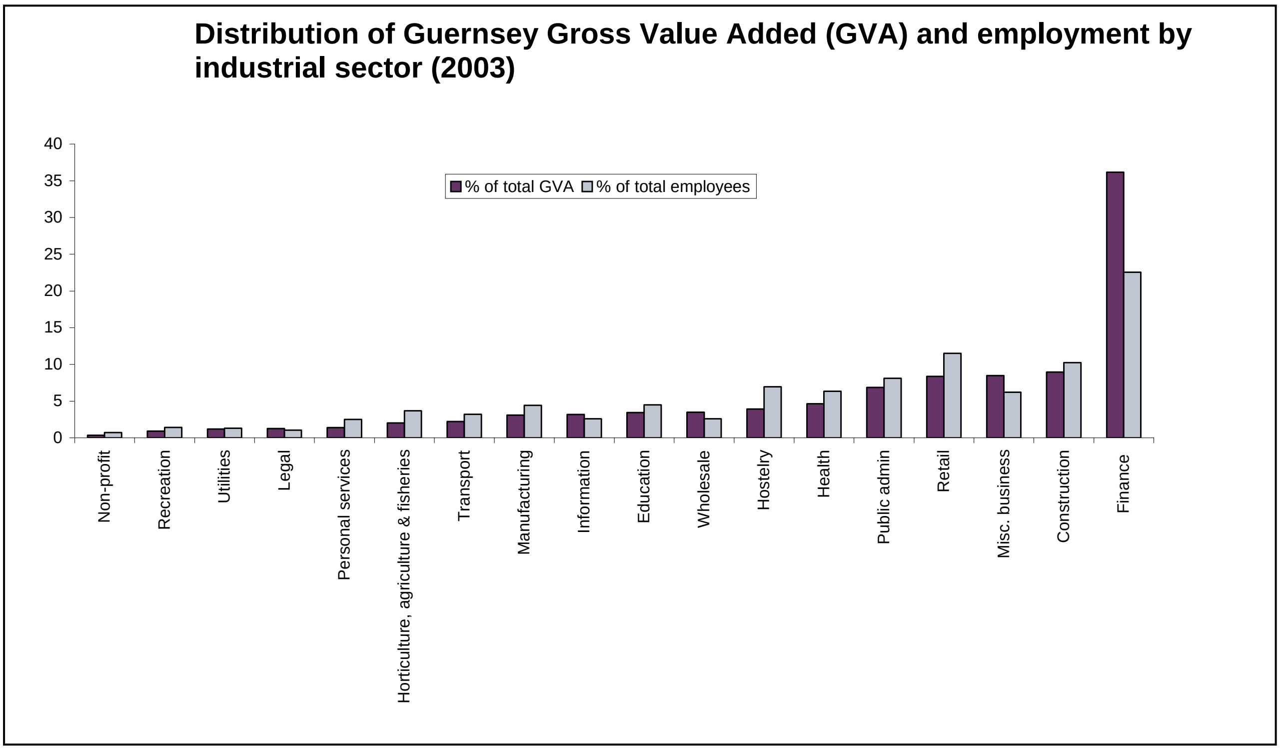
The approach to capital expenditure provides just one example of this: governments frequently respond to pressure on the public finances by cutting capital expenditure but this can have deleterious, and sometimes unexpected, economic consequences. In Guernsey, capital expenditure over the last two years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

The Independent Working Group
March 2006

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

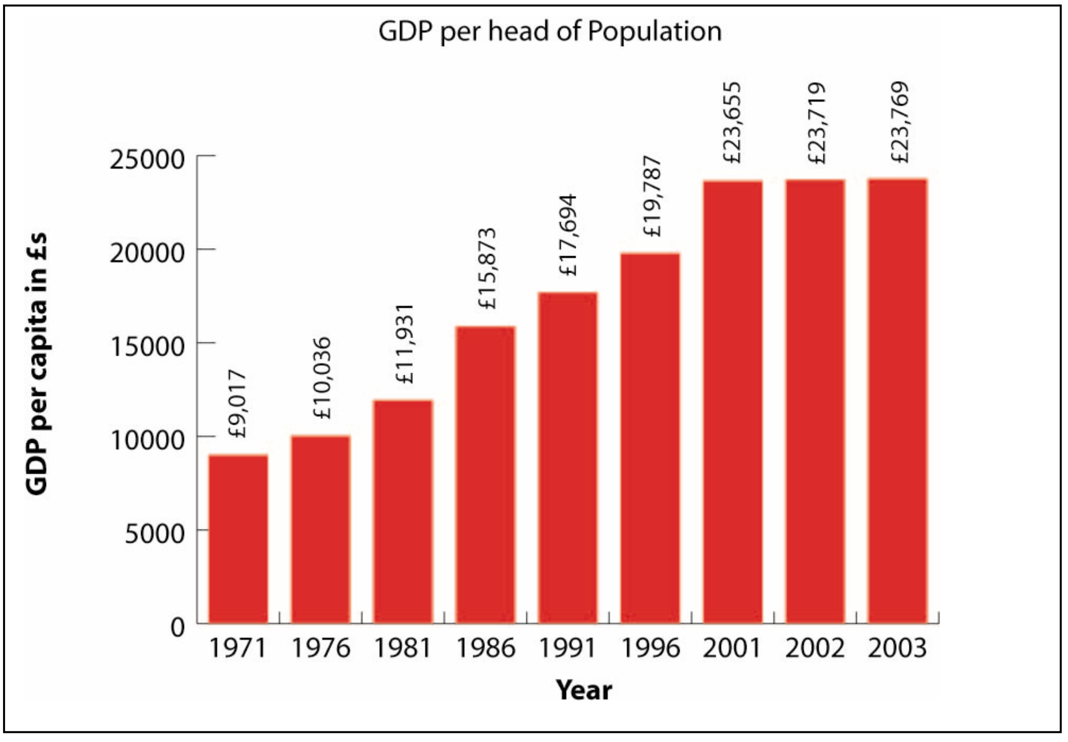
Annex 1: Economic Background

Chart 1



Source: Policy and Research Unit and Oxera

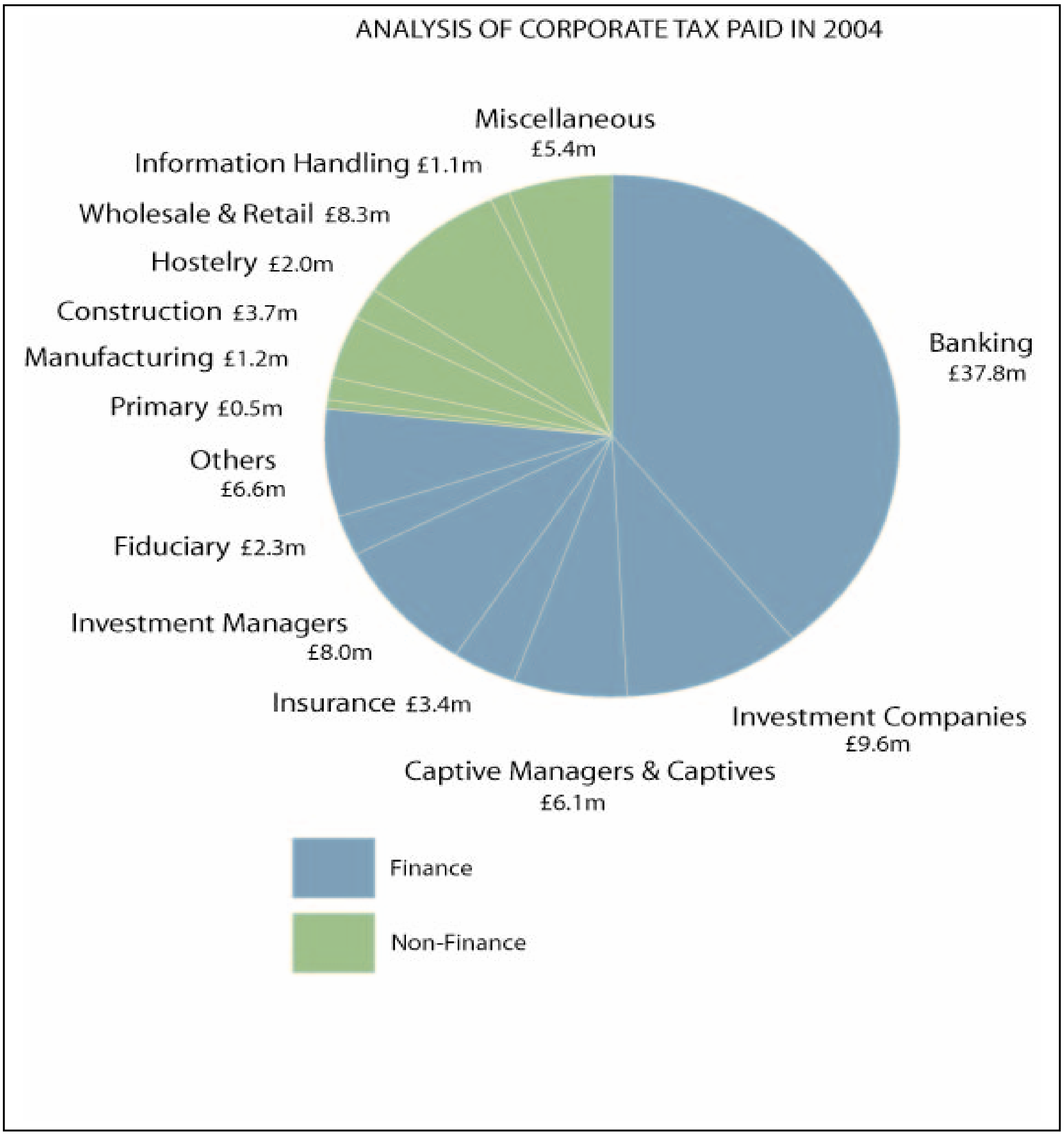
Chart 2 Guernsey Gross Domestic Product (GDP) per capita (1971 – 2003)



Source: Policy and Research Unit

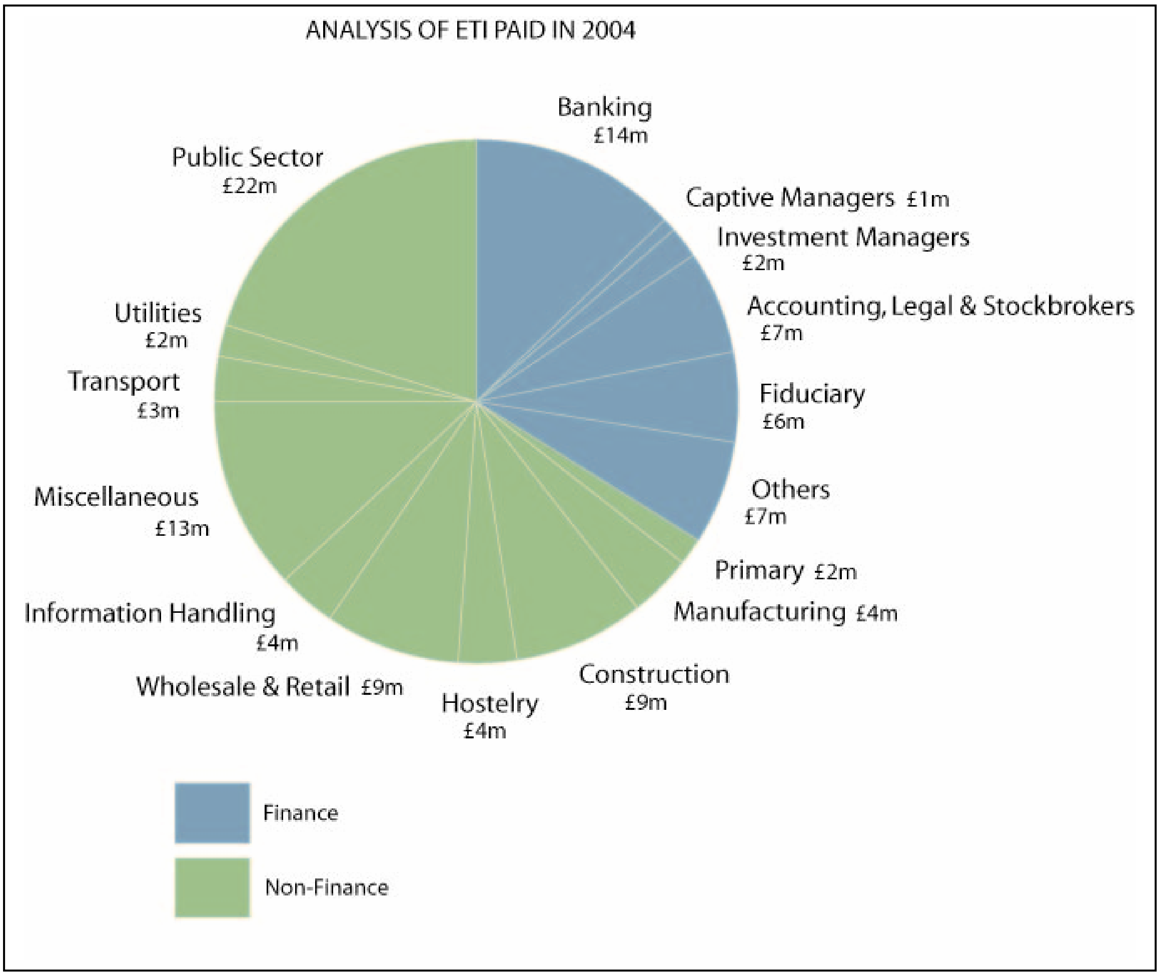
Annex 2: Background to the public finances

Chart 3 Financial Services contribution to Guernsey public finances



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

Chart 4 Financial Services contribution to Guernsey public finances



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