STATES OF JERSEY

FISCAL STRATEGY

Lodged au Greffe on 1st June 2004
by the Finance and Economics Committee

STATES GREFFE

PROPOSITION

THE STATES are asked to decide whether they are of opinion −

(a) to agree, in order to maintain a strong and competitive economy, that a 0% standard rate of corporate profits taxation and a 10% rate of corporate profits taxation for companies in particular sectors, including financial services, be introduced by no later than 1st January 2008 and to charge the Finance and Economics Committee to bring forward for approval by the States the necessary legislation to give effect to the proposal;

(b) to charge the Finance and Economics Committee to research measures to mitigate the loss of taxation revenues as a result of the changes to the corporate taxation structure in paragraph (a) above, without damaging the competitiveness of the Jersey economy, such measures to include –

(i) taxation provisions requiring Jersey resident participators to pay personal taxation based upon the profits of the Jersey companies accruing to them as a result of their direct or indirect ownership of those companies;

(ii) mechanisms for withholding tax from non-resident shareholders of local trading companies;

(iii) developing such anti-avoidance measures as may be necessary to enforce (b)(i) and (b)(ii) above;

and to bring forward detailed proposals for consideration by the States by February 2005;

(c) to agree an overall strategy for addressing the funding deficit arising from (a) above, yet not fully mitigated by (b) above, specifically –

(i) to agree that the annual increase in total States' net expenditure should be limited to 1% less than the underlying increase in the Retail Prices Index for each of the years 2005 to 2009 and to vary their decision of 18th September 2003 in P.118/2003 (Resource Plan 2004-8) accordingly;

(ii) to agree that a target for economic growth of 2% per annum should be set for the period 2005 to 2009 and to request the Economic Development Committee, in conjunction with other Committees as necessary, to bring forward, for approval by the States, a strategy for delivery of this growth by February 2005;

(iii) to agree in principle that, in order to balance States' income and expenditure, any remaining budget deficit arising be addressed by taxation measures, to be implemented by no later than 1st January 2008.

(d) in connection with introducing a package of new tax measures which will be broadly progressive to balance the States' income and expenditure –

(i) to agree to the introduction of an Income Tax Instalment System (I.T.I.S.) and to charge the Finance and Economics Committee to bring forward detailed proposals to the States to enable the system to be implemented from 1st January 2006;

(ii) to agree in principle that tax allowances for taxpayers on high incomes be phased out and to charge the Finance and Economics Committee to bring forward detailed proposals to give effect to the proposal as part of the 2005 budget;

(iii) to charge the Finance and Economics Committee to undertake further research into a goods and services tax, a payroll tax, environmental taxes, development levies and further tax enforcement measures in order to investigate the feasibility of their introduction, and to bring forward details to the States with recommendations for approval by February 2005;

(e) to charge the Finance and Economics and Employment and Social Security Committees, in consultation with other Committees as appropriate, to take steps to ensure that the effect of any new tax proposals on those with low incomes can be mitigated by the prior or simultaneous implementation of a new income support scheme.

FINANCE AND ECONOMICS COMMITTEE

REPORT

THE REFORM OF PUBLIC SPENDING AND TAXATION

Introduction

This Report is the latest stage in a project which began in 1998, when the current review of Jersey's tax structure began and the external forces which were driving the need for change were first examined.

It is not the final stage, but it is an important milestone in the reform process. During the last 6 years, successive Finance and Economics Committees have undertaken probably the longest and most extensive consultation process ever seen in the Island. They have also initiated thousands of man-hours of work to examine the problems and to identify solutions. A note on the research and consultation undertaken by the Committee is included in Appendix 1.

This Report and Proposition is the result of all that research, analysis and consultation. It proposes a framework for the future which –

- safeguards Jersey's principal source of prosperity by changing the corporate tax rate;
- assesses the likely effects of making such changes;
- proposes a strategy to bridge the potential revenue deficit of £80-£100 million per annum;
- recommends a package of measures which increases the tax-take from Island residents while, at the same time, ensuring that those who earn more shoulder the greater share of the burden.

In February 2004, the Finance and Economics Committee published a package of proposals which could provide this framework and embarked upon a programme of consultation. This included public meetings, seminars, discussions and an on-line forum. The Committee's objective was to explain its thinking and to stimulate public discussion and debate. As a result, the Committee has modified its original proposals to some extent, as the proposition reveals, but the feedback generally was one of support for the overall direction but concern over a lack of detail, particularly in respect of new tax measures. The Committee appreciates these concerns, and the Proposition makes it clear that having confirmed the need to move to a 0/10% tax regime, further work is needed on many areas of detail.

The core purpose of this package of proposals was to safeguard the financial services industry, which is paramount to the economy of Jersey. The consultation did not produce any evidence that this was not the right approach.

To safeguard this industry, the Committee proposed changing corporate taxation. The consultation did not produce any credible alternative. Furthermore, it became even clearer from the responses received that doing nothing is not an option, and that delaying a decision increases the risk of a loss of jobs and revenue.

Changing corporate taxation will result in a revenue shortfall – the States will be unable to fund sufficiently the social services and benefits which Islanders currently enjoy. The Committee proposed to deal with this shortfall by three measures –

(1) public sector efficiency savings,
(2) economic growth, and
(3) increased taxation.

The consultation revealed little dissent that these 3 elements should be used, but did raise some questions as to whether the growth or efficiency targets could actually be met.

The consultation programme, subsequent discussion, and also feedback obtained through 'Imagine Jersey', showed no significant support for cutting the services provided by the government, which would have been a possible alternative means of dealing with this shortfall. There was, however, strong support for improving the efficiency of the public sector.

The Committee, therefore, still believes that using these 3 elements is the best strategy for Jersey, and while the efficiency and growth targets might be challenging, they are realistic and achievable. However, the questions raised about achievability reinforce the Committee's belief that any new tax structure should be capable of raising up to £100 million per annum. If the efficiency or growth targets were not met, we would have to lean more heavily upon increases in taxation. £100 million is– in the view of the Committee – the 'worst case' shortfall which would be caused by changing corporate taxation.

This has focused the Committee's thinking – and the debate throughout the period of consultation – on the critical decision about the nature of the new taxes that should be introduced.

A number of alternatives to the Committee's tax proposals have been put forward both in the consultation and subsequently in the independent evaluation of the Committee's proposals carried out by PricewaterhouseCoopers ("the Whiting Report"). These include income taxes, environmental taxes, payroll taxes, visitor taxes, foreign worker taxes, wealth taxes, capital gains taxes, accommodation taxes etc.

The Committee has examined these suggestions and concludes that some of them merit further research and analysis.

This work has already begun. Officers are looking at a range of extra taxes which – while not adequately dealing with the full shortfall – might help to broaden Jersey's tax base and reduce the Island's over-dependence on income tax. Some of the suggestions, such as environmental taxes, would also have the benefit of encouraging behavioural change which would be to the benefit of the Island. However, it would be irresponsible to view these measures as feasible alternatives to the Committee's main tax proposals if they are not capable of meeting the revenue requirements identified, or if they would have a significant detrimental impact on the economy.

However, there are other principles to consider. In designing the tax structure the Committee is concerned to ensure that as far as possible any new tax structure –

- is efficient;
- is fair;
- maintains Jersey's competitiveness in the global financial services industry;
- is as simple as possible;
- increases the flexibility of the tax system;
- produces reasonably stable tax revenues.

The Committee was particularly concerned about fairness, and this led to the conclusion that the relatively well-off on the Island should pay more than the less well-off.

Compared with most other jurisdictions, the level of income at which people first start to pay income tax is extremely high. The Committee, therefore, also believes it to be fair that some of those households which do not pay income tax should also contribute to helping to deal with the shortfall. Indeed it is almost impossible to design a system capable of generating £80-£100 million without most members of society making some contribution. Those on very low incomes should clearly be protected. The Committee concluded that keeping the basic rate of personal income tax at 20% has significant advantages for Jersey. The consultation has not led the Committee to change this view.

The Committee believed – on the grounds of fairness – that as far as possible both earned and unearned income should be taxed. The consultation has not led the Committee to change this view. Therefore on these grounds payroll taxes only affecting employees and/or employers would not provide the best solution.

Employers' payroll taxes would put up the cost of business. The consultation has reinforced the view that employer's payroll taxes would adversely affect the Island's competitive edge in the global finance industry.

It is these objectives and constraints, and the feedback which has resulted from 4 months' discussion and consultation, that have guided and reinforced the Committee's proposals.

To maximise the contribution from the well-off, while keeping the basic rate at 20%, the Committee has proposed to withdraw tax allowances from this section of the community. The effect of this will be that for those who can afford to pay, the 20% rate of tax will mean 20%. The consultation has not resulted in any significant challenge to this approach, nor feasible alternatives. The principle therefore remains.

However, the consultation did identify concern about the way in which allowances should be phased out, so that people's personal circumstances can be taken into account. The Committee is carrying out further work to find a way in which this can be achieved.

The Committee continues to favour a goods and services tax – whether it be a VAT-style tax or a sales tax – a view with which the local business community generally concurs.

The disadvantage is that it does tax those with very low incomes. The Committee takes the view that this undesirable effect can be dealt with through a modified income support scheme.

The combination of removing tax allowances from the well-off, a goods and services tax and a new income support scheme meets the Committee's objectives of maintaining Jersey's international competitiveness, diversifying the tax base to reduce the over-dependence on income taxes, being sufficiently flexible to respond to future needs and ensuring that most members of society contribute to the cost of public services.

The consultation and resulting public debate has not produced a better approach which would meet these objectives.

This Report and Proposition proposes a framework which would be capable of reforming Jersey's tax structure so that the Island retains a competitive finance industry and maintains its existing level of services and benefits without unduly damaging any section of our society.

Many of the implementation details still need to be worked out, particularly to ensure that the other objectives of efficiency and simplicity are met. The Committee will report back to the States by February 2005 when these details have been developed.

Another result of the consultation was a clear message from the business community of the Island that the worst outcome would be delay.

Again, the Committee wants to act on the outcome of the consultation.

To keep our Island competitive and prosperous, the basic framework needs to be decided soon.

Background

Jersey's underlying position is strong. The Strategic Reserve stands at around £400 million. Record sums are invested in the Island. Figures published by the Jersey Financial Services Commission (JFSC) show that bank deposits alone currently stand at £156 billion. Successful negotiations with the E.U. mean the challenges faced from new E.U. laws will not start bearing down for at least another 5 years despite a much faster timetable originally having been sought.

So why is it necessary to do anything now?

- By acting now and planning ahead Jersey will keep its competitive edge, encouraging the financial services industry to thrive.

- The business community will have the certainty it needs to formulate its future plans.
- By facing up to these issues in good time, Jersey will keep its economy secure and will avoid far tougher choices in the future.
- Phasing in changes to the tax structure over the next few years means being able to spread the impact of the reforms.
- In the interests of future generations the Island has to act now to raise more money to put the economy on a sound footing for the long-term. Everyone will be asked to make more of a contribution to Jersey's future because by sharing the burden the load can be spread more fairly.

Although there are some difficult choices ahead, the Finance and Economics Committee is confident that the States can agree that the prudent course of action for Jersey is to act now to secure a bright and prosperous future.

When considered alongside the proposed reforms to the machinery of government and the aims of the Island's Strategic Plan, States Members can, with this package, create a successful economy backed by a modern and effective administration.

From the 1960s onwards, the people of Jersey have enjoyed a rising standard of living. Tax rates have been kept low at the same time as investment in high-quality public services has risen. It is the growth of the financial services industry which has made this possible.

Today it is the engine of our economy and generates two-thirds – about £250 million– of all taxes. Other industries and sectors are important, albeit they too derive much of their business flow from interaction with the financial services industry and, given the right conditions and encouragement, might be able to increase the contribution they make. However, if the Island's current way of life is to be maintained, the financial services industry must remain at the heart of the economy. Without it, tax revenues would fall substantially, public services decline, and jobs – and people – would leave the Island.

The starting point for any long-term fiscal plan for Jersey must be the preservation and strengthening of the financial services industry. For Jersey to thrive, it is essential to ensure that it remains competitive internationally and is able to attract companies to invest, do business, employ people and pay tax on-Island.

In recent years, Jersey has faced increasing competition and a number of challenges to its position from the OECD and the E.U.. Through successful negotiation, Jersey has minimised the threat it faces and bought itself more time to prepare for the future. Specifically, in the negotiations with the E.U. on 'harmful tax practices' Jersey achieved a recognition that in seeking to remedy the harmful features of the regimes identified in Jersey, the Island would need to undertake a significant amount of general tax reform. The E.U. conceded that, as Jersey had maintained, the degree of complexity and scope of this was such that it could not be undertaken and implemented in less than 5 years, whereas the original demand being placed on the Island would have required reform within the period 2003-2005. We now have until 2008/9 to achieve the necessary reforms which, although more manageable, is still likely to be the minimum time period necessary and which still demands a successful start to the strategy sooner rather than later.

Jersey has helped shape an outcome to these negotiations, which means that it has the potential to continue to be a world-class centre for financial services. The result of the E.U. negotiations is far better for Jersey than at one time seemed possible. Nevertheless, the financial cost to us will still be significant. The bottom line is that by 2008, Jersey may need to generate up to a further £80 – £100 million a year in taxes (or the equivalent in expenditure cuts and efficiency improvements) to balance its books.

(a) The need to change to 0/10%

Safeguarding the Financial Services Industry

International financial services are by far the most profitable of the Island's industries. They also tend to pay the highest wages.

As a result of the high level of profitability per worker – in the order of £90,000 per worker a year – and high average salaries, the total tax contribution from this industry is very considerable. In the rest of the economy the average profitability per worker is very much lower – roughly £5,000 a year. It is mainly because of the very high profits in this sector of the economy that the States are able to deliver public services broadly similar to that of the U.K. with very much lower tax rates – in particular personal tax rates.

It would be difficult to imagine an industry, other than financial services, which was better suited to a small island economy such as Jersey. It is one of the most profitable industries in the world and it uses relatively little land. Any alternative international industry that might be tempted to locate in Jersey would be very unlikely to be able to contribute so much to the economy and tax revenues. Therefore, losing the international financial services sector would reduce average wages and reduce the average profitability per worker on the Island. To continue to deliver the same public services would inevitably mean higher tax rates, for fewer people, on the significantly lower income and profits that would be left to tax.

The Committee has concluded that the future economic well being of the Island is dependent on ensuring that Jersey is, and remains, internationally competitive as a place to provide international financial services.

There are 2 key elements which influence the competitiveness of Jersey's financial services industry in the current international environment in which the industry must work. These elements have arisen independently of each other but do interact in terms of the solution to be proposed to the different challenges they pose. These 2 elements are–

- tax competition generally by rival jurisdictions competing for the establishment and/or retention of large financial services providers such as banks and fund managers; and

- changing E.U. rules on harmful tax practices, applicable to corporate taxes only, which affect the corporate vehicles used by customers of financial services providers.

General tax competition

To meet recent and growing international competition, the Committee has concluded that **the rate of corporate profits tax applied to the providers of international financial services needs to be at, or close to, a maximum of 10%**. This would bring it in line with what Jersey's competitors are doing (Singapore, Guernsey and the Isle of Man are moving to a rate of 10% and Dublin already has a rate of 12.5%). Above this level Jersey would rapidly become uncompetitive as a place to locate providers of international financial services. It should be stressed that this situation would have arisen irrespective of the E.U. tax rules which also lie at the heart of the fiscal strategy. In that respect, Jersey would in any event have been facing significant pressure on its revenues derived from the corporate taxes of large Jersey-based financial institutions because of the need to stay aligned with rates being offered by major competitors. The competition element is calculated to account for up to £50 million of the potential £80-£100 million shortfall identified as the monetary consequence of a move to the new fiscal structure.

E.U. rules on harmful tax practices

In addition to a competitive rate of corporate profits tax, the providers of international financial services also require the legal mechanisms to be able to deliver the type of financial services their customers require. One very important service is the provision of a corporate legal entity, resident in Jersey, that does not have its profits taxed. Such legal vehicles are currently available in Jersey through the Exempt Company structure. However, these company structures are not available to Jersey residents. International pressure, particularly from the E.U. and the U.K. resulting from the initiative on harmful business taxation (known as the Code of Conduct on Business Taxation), means that we can no longer maintain this discrimination. Failure to address this issue could well result in action by the U.K. or the E.U. which would very seriously undermine the ability of international financial institutions to continue to operate from Jersey. Again the consequences for the Jersey economy would be serious.

In order to ensure that the providers of financial services can provide the products they need for their international customers, the facilities of the existing Exempt Company structure will be made available to residents as well as non-residents of the Island. This will be achieved by introducing a general rate of corporate profits tax in Jersey of 0%. This removes the discrimination between companies with resident and non-resident shareholders, and hence removes the threat of unilateral action by the U.K. and E.U.

However, in order to safeguard as much as possible of the tax revenue generated from corporate profits tax, those entities regulated by the JFSC, and a few others, will be excluded from the 0% rate and a higher rate applied to them. In particular the 10% internationally competitive rate will be applied to the financial services sector.

Implemented in this form, the E.U. harmful tax rules element is calculated to account for up to around a further £30 million of the potential £80-£100 million shortfall identified as the monetary consequence of a move to the new fiscal structure.

It is a feature of the way the E.U. interprets its approach on harmful tax practices that a ‘top-up’ sector at a higher rate of corporate tax (10%) than is the general rate in the economy (0%) should be acceptable. It is nevertheless important to consider 2 further points in this respect, one of which legitimises the higher rate, and the other which limits the wider application of a 10% rate in the Jersey economy –

- It is considered acceptable to have a higher rate in the economy than is the norm on the basis that the sector chosen is effectively being ‘discriminated against’ compared to the general rate of corporation tax applied.

- In order to justify that the general rate is indeed 0%, it may be unwise to seek to add any additional sectors to that defined for financial services and subject to the higher 10% rate. This would call into question the viability of the general 0% structure which, as can be seen, is vital for the separate purpose of maintaining the benefits of Exempt Companies by another method.

The Committee has concluded, therefore, that in order to keep the financial services sector competitive, the zero profits tax legal entity must, in general, be made available to all companies, irrespective of the place of residency of the beneficial owners. This involves setting the general rate of corporation tax at 0%.

These 2 measures will, inevitably, lead to a substantial loss of tax revenue from the current economy. However the Committee has concluded that the alternative of leaving the current tax structure unchanged would result in a considerably worse outcome. The financial services sector of the economy would become uncompetitive in its international markets, and companies would move to more competitive jurisdictions. This process of moving both jobs and business to more competitive jurisdictions is not just a theoretical threat, but can already be seen to be happening worldwide as mobile business, such as financial services, seeks to maximise its advantages in terms of differential costs, of which labour costs and total tax burden are 2 key determinants in location decisions.

Some attention has been given to the durability of a 0/10% corporation tax structure in a fast-changing world. The E.U. agreement specific to our proposals is contained in the record of the meeting of the combined E.U. Finance Ministers, known as ECOFIN, on 3rd June 2003. These ECOFIN Council Conclusions recognise the acceptability and timescale for implementation of the 0/10% proposals to the European Union, which throughout the negotiation process had also gained the full support of the United Kingdom Government. It should be stressed, however, that the proposals from the side of the States of Jersey were presented as subject to the approval of this Assembly. For this reason the present proposition hereby invites States Members to put in place the final element to formalise the ECOFIN agreement of 3rd June 2003 and to create the full certainty on future corporation tax structure for the Island which our business community urgently requires.

It must be acknowledged that future developments within the E.U. or in other international bodies, or even matters involving individual countries, could evolve over time to bring the 0/10% structure back for further debate. However, we have received specific assurances from the U.K. Government that the issue at the heart of these reforms is one of perceived harmful tax practices, i.e. discrimination in tax treatment between different types of company and differing residence of shareholder, and that in our proposals we have addressed these issues. In addition, we have been assured by the U.K., the E.U. and the OECD in different discussions that the various international initiatives on taxation with which we are involved do not have the harmonisation of tax rates as their objective. Second, the U.K. Government, together with other like-minded nations such as the United States, Australia, Canada, Ireland and some others, are clearly working to an agenda which recognises and espouses tax competition internationally as the acceptable norm. Given that the 0/10% structure is inherently about tax competition then alignment with those countries on the acceptability of the tax competition approach should provide some comfort as to the potential durability of the proposed 0/10% solution.

Some attention has been given to the prospects for defying the E.U. rules – since Jersey is not within the E.U.'s fiscal territory – and therefore avoiding the need for change contained within the fiscal strategy. The Committee strongly believes that this would be contrary to the interests of the Island and regard the following as the principal reasons for this stance –

- The E.U. element of the proposed changes only accounts for some £30 million of the identified £80-£100 million shortfall identified as the monetary consequence of the proposed change in the Island's fiscal system. The remaining part is derived from downward pressure on corporate taxes generally from increasing international competition. A policy of refusal to consider aligning ourselves with E.U. rules which, even on the best possible outcome, might result in addressing less than 50% of our actual problem would not seem to represent an acceptable balance between risk and reward.

- Jersey is positioned on the periphery of the European Union and conducts much trade with it and derives significant opportunities from such positioning to develop financial services and other business with E.U. nationals. A policy which contemplates not just isolationism in this respect, but also one which would have the effect of undermining the E.U. Code of Conduct exercise, with attendant damage to the U.K. relationship with its E.U. partners, would seem again to represent a very high-risk approach.

- The United Kingdom is determined to ensure compliance by its Dependent Territories with the E.U. Code of Conduct with similar pressures faced both by Guernsey and Isle of Man in this respect. Although there are constitutional arguments to invoke to resist this, Jersey has already seen the U.K. prepared to contemplate a highly pressurised approach to forcing this compliance with threats of unilateral action by them against the Island to achieve such an outcome should the Island ignore the Code of Conduct requests. One such measure would be the revocation of the exemptions permitted to Island-based businesses within the U.K.'s Controlled Foreign Companies legislation. Such revocation would have a rapid and detrimental tax impact on all U.K.-owned businesses in the Island and probably force them to re-evaluate their options for representation on the Island over time. Where this would create most immediate concern would be in the banking sector with a handful of large U.K.-owned banks accounting for a very high share of the Island's direct tax revenues and nearly 50% of the Island's financial services workforce. There are other areas where the U.K. could take unilateral economic actions with severe consequences for Jersey, such as in withdrawing existing double tax exemptions, and the possible implementation of withholding taxes on inter-bank deposits by Jersey-based institutions into the U.K. All such measures are potentially serious for any large U.K.-owned business, particularly in financial services, in the Island. Therefore, they do not in the eyes of the Committee represent an acceptable balance of risk if our policies were to invite their implementation or even threat, recognising that business cannot function well in the face of uncertainty and that threat alone may be sufficient to create such uncertainty and attendant adverse economic decision making.

Consequences of delaying decisions

A final, but vital, component of the need for change is the requirement to act quickly and decisively. Whilst the Island was successful in winning a longer period to enact tax reform than had originally been likely, there is no doubt that competition for financial services business worldwide is accelerating, based in no small part on the attraction of low rates for providers in key competitor jurisdictions and the absolute minimum requirement of being able to continue to provide tax neutral vehicles to global investors by finding a solution to replace the Exempt Company structures on which so much of the business flow of our financial services industry depends.

Business in the Island will not welcome any drawn out period of uncertainty regarding the Island's recognition of these challenges and the willingness to address them quickly. Customer business can be lost unless certainty of applicable tax treatment can be given on any given structure for the whole of its intended life span – sometimes up to 20 years. Separately, large multi-national financial services providers, who are represented in Jersey and in many of our competitor jurisdictions at the same time, have many options for switching business, capital and jobs at a rapid rate away from the Island to such competitor jurisdictions with relative ease. It should also be borne in mind that once such economic activity is lost by Jersey to competitor places then it is unlikely to return in the future without a very compelling reason to do so – if at all.

The potential impact of not adopting 0/10%: Jersey without an International Financial Services Industry

In considering its options, the Committee has looked at how the Island's economy might look in the absence of the international financial services industry at its present level. This might be the outcome if the States failed to introduce measures to reform the corporate structure in response to the changes which are taking place in competitor jurisdictions. It looked particularly closely at that part of the financial services industry that provides services to the international markets including those serving non-resident clients. This industry is highly mobile and it would probably be that the most profitable parts that would leave first if the Island's corporate tax structure became uncompetitive. There could be a substantial change in the structure of the financial services industry in the Island within a relatively short period.

There would be a major shock to the Island's economy during the first few years after companies had gone, though they would be unlikely to leave the Island at the same time. The loss of some companies could have a bigger effect on the overall economy than others. The following effects would be likely to be felt in the Island during the first few years after the shock of the emigration of these key companies –

- Employment in financial services would fall from today's level of 12,000 jobs to 1200-1500 jobs;
- a large fall in demand for goods and services (for example in the shops) since employees in the financial services industry have the highest disposable incomes and spending power;
- employment outside the financial services sector would also fall. Significant unemployment outside the financial services sector would be likely;
- property prices would fall and the age structure would alter as younger people would be likely to dominate the leavers, or those who would no longer choose to stay in or come to the Island;
- total population would fall, and the fall could be considerable – possibly by 20-22,000 (with the working population falling by 14-16,000);
- under the current tax structure, States' revenue could decline by £250-£300 million per annum compared to the present total of £450 million;
- if current levels of services were maintained, States' spending could fall by much less (perhaps only by £100 million or less) because it would tend to be older residents who would remain in the Island. The immediate liability for States' pensions would hardly fall at all;
- the potential deficit in the States Budget could amount to £200 million in each and every year;
- the potential tax base on which to make up this shortfall would be much smaller than it is now;
- to meet any shortfall by tax increases or service level reductions would require higher tax rates, or deeper

cuts, than meeting a similar shortfall from the current tax base.

The Island would probably begin to recover after this initial shock, but the economy would look very different from the way it does now. Exactly how the economy would look would depend on what, if anything, replaced financial services. In the absence of a replacement the following chain of events would be likely to unfold after the first few years following the shock –

- Wages in the Island would fall as firms would be able to offer lower wages with the rise in unemployment and in response to the decline in overall profitability;

- to maintain anything like the current population, an alternative export industry would be required. This industry would need to be one where any additional costs arising from Jersey's physical location were at least off-set by some cost or quality advantage of operating from the Island;

- assuming such an industry could be found, output in the Island would start to recover, though almost certainly with much lower levels of profits and wages compared to now;

- population would stabilise, and might even start to grow again, though the new people coming into the Island would have a different set of skills;

- house prices would stabilise, but very likely at levels considerably lower than now. It is likely that many younger people would find that their mortgage debts were larger than the (now lower) value of their properties.

If the population had fallen significantly (which is likely), it might take a considerable time for property prices to recover. The problem of "negative equity" in property could last for a considerable time. The reduction in both property prices and wages would make tourism and, possibly, agriculture more competitive. In the absence of a significant new industry they would probably become the dominant industries again in Jersey.

Unless any new industry was capable of generating similar tax revenues for the States and wages for residents it would not be possible to maintain the current position of low tax rates with similar public spending per head as the U.K. Either tax rates would need to increase very significantly (i.e. up to the equivalent of U.K. rates) or public services would need to be cut drastically. If the former was adopted, high-income residents, particularly those with significant investment income, would be discouraged from remaining in Jersey because of the higher tax rates. To the extent that such residents left the Island this would lead to further downward pressure on tax revenues.

Exactly where the economy would end up is impossible to predict with any accuracy as there are too many unknowns. However, the typical pattern for small Island economies is that they tend to have lower average (economic) standards of living than their relevant 'mainland'. Among other things, this reflects the additional transport costs of getting to and from the Island. The exceptions are where the Island has some clear and significant underlying economic advantage over the mainland. In the case of Jersey there is currently little evidence that the advantages of the Island for agriculture or tourism are that significant. The economic value of the Island's characteristics for these 2 industries may, therefore, be limited. As a result, levels of Gross National Income per head might fall from the present level of £24,000 to £25,000 (in 2003 – based on £21,000 in 1999 and inflated by 4% per annum) to around or below the average U.K. level – £18,000 (2002), once the economic adjustments had worked through the Island.

The delivery of the current level of public services combined with the current tax structure could result in a deficit in the States Budget of around £200 million every year. This is not sustainable, even in the short term, so some very large adjustments in either taxation or spending would be needed.

Conclusion

In the absence of a high-profit, high-wages alternative, the flight of international financial services from

Jersey would lead to an economy that could not sustain the current public services on the current tax structure.

This loss of tax revenue would be likely to be bigger than the shortfall produced by altering the tax structure to meet the changing competitive conditions in international financial services, and thus keeping this business on Jersey.

In addition, the total economic activity on the Island would be likely to be lower, but with a less than proportionate decrease in the demand for public expenditure (including States' pensions). The net result is that for any given level of public services delivery, tax rates for residents would be likely to be significantly *higher* in the absence of the international financial services business.

(b) Mitigating the loss of corporate tax revenues

The estimated loss of some £80 – £100 million in tax revenues arising from the move to 0/10% is likely to be a worst case scenario which can be broadly categorised as follows –

International business companies – up to 10%. Many of the international business companies who pay substantial tax revenues are already close to an effective rate of tax of 10%, so the majority of that business should stay once the proposed 10% rate is introduced, but a few may well go.

Exempt Companies – up to 10%. This relates to the loss of the exempt company fee of some £10 million as they will all be categorised as zero rate. However, it should be possible, subject to international competitive pressures, to recoup this loss through, for example, increasing the annual filing fee.

Non-finance business. In broad terms, some 40% of the potential loss relates to non-finance business. Some 20% to 30% relates to non-finance business trading locally whose shareholder base is outside the Island and the balance (10% to 20%) relates to locally owned business.

Finance industry companies. The majority of the loss, perhaps 50%, is estimated to come from income tax companies involved in the finance industry currently paying at an effective rate of tax close to the standard rate of 20% which will fall to be taxed at 10% under the proposals.

The above represents an analysis of a constantly changing picture, and although carried out many months ago on the basis of the tax information available at that time, the Committee is confident that it does remain a realistic estimate of the size and nature of the potential problem.

(b)(i) Minimising the potential tax loss through 'look through' provisions

It will be possible to contain the loss of tax from locally owned businesses to the levels shown above by taxing the Jersey resident participator of such a company on the actual profits of the company under 'look through' arrangements.

In essence, the profits arising to a Jersey resident corporate will be imputed to any Jersey resident participator in proportion to his participation in the corporate so that any Jersey resident participator who has the income of the corporate accruing to him, no matter how many structures or other corporates or trusts are placed between the Jersey resident participator and the Jersey corporate, will be assessed on that person as personal income.

The corporate income that accrues to a Jersey resident participator will be defined in the Income Tax (Jersey) Law 1961 as amended and will have a wide meaning attributed to it.

All Jersey residents will have to declare on their Income Tax Returns all of the corporates in which they are a participator, whether Jersey or foreign corporates, as well as declaring the profits which accrue to them in all these corporates in proportion to their participation in each of them.

Prior to the introduction of the new regime, and by virtue of new powers to be introduced into the Income Tax

Law, a return will be issued to all Jersey resident taxpayers, asking for a declaration of all the Jersey resident corporates, as well as all the foreign corporates, in which the Jersey resident has a participation. The return will also ask for a declaration of all trusts, including offshore trusts, in which the Jersey resident taxpayer has an interest, whether as settlor or beneficiary, and whether he has, through that trust, an interest in any Jersey resident corporate, foreign corporate or a similar structure.

The Jersey resident corporate will also be required to make a declaration on the Income Tax Return issued to it, by virtue of new powers to be introduced into the Income Tax Law, of the names and addresses of all Jersey resident participators in the corporate.

A Jersey resident participator in a foreign corporate will also have the corporate profits of that foreign corporate imputed to him in proportion to his participation in that foreign company. Where a Jersey resident is a participator in a non-resident corporate and his participation in that corporate and the corporate itself has been established for a bona fide commercial reason and not designed in any way for the avoidance of Jersey tax, the corporate profits will not be attributed to that Jersey resident participator but all dividends received by him from that non-resident corporate will be charged to tax under Case 5 of Schedule D. The Jersey resident individual will need to satisf the Comptroller of Income Tax that his participation in that non-resident corporate and the corporate itself is for a bona fide commercial reason and not designed in any way for the avoidance of Jersey tax, so he will need pre-clearance of any and all such transactions from the Comptroller.

There will be a ‘de minimis’ limit, yet to be decided but likely to be around 2% – 5%, so that those Jersey resident participators with a participation of less than that ‘de minimis’ limit in a corporate will not have the corporate profits applicable to that holding imputed to him.

Special purpose vehicle companies used, for example, in ‘off-balance sheet’ financing, are typically owned by the trustees of a charitable trust and the company in question is commonly referred to as an ‘orphan’. The profits made by the trustees are paid to charities or applied for charitable purposes so these profits will not be imputed to the Jersey resident trustees, or, where the trustee is a company, to that company’s Jersey resident participators.

Penalties will be imposed, under revised Articles 136 and 137, on any taxpayer who makes a false declaration in relation to these new provisions.

(b)(ii) Possible withholding tax on profit distributions by non-Jersey owned companies

It is a direct consequence of the zero tax strategy that companies operating in Jersey which are owned by non-resident shareholders pose a much more difficult challenge to any proposed look through arrangement similar to that proposed for Jersey resident shareholders. In the first place this is because those shareholders resident outside the Island are not in the ordinary course assessable nor chargeable to Jersey tax on any dividends or other profit distribution that they receive. This admittedly creates an imbalance in terms of available tax recovery measures with non-resident shareholders arguably enjoying an advantage over their Jersey resident counterparts. However, whilst this may be the case purely in terms of what takes place in Jersey itself it does not represent the full picture of those non-Jersey based shareholders’ full liabilities. This is particularly the case for U.K.-owned businesses, which account for the vast majority of locally operated businesses outside the financial services sector which are owned by overseas residents, either corporations or individuals. The Committee has therefore focused primarily on such U.K.-owned businesses in considering the issues raised.

It is important to convey that a zero corporation tax treatment in Jersey for non-locally owned businesses does not confer any ultimate competitive advantage over locally owned businesses because the first category will continue to pay overall the same amount of tax on the profits they make, but the tax will arise only in one place, (for example in the U.K.), rather than shared between two places, (for example in Jersey and in the U.K.), as is currently the case under U.K. unilateral relief provisions. These provisions permit an offset of corporation tax paid in Jersey against the ultimate home country tax liability. Thus, the technical consequence of zero tax for overseas owned businesses is a net outflow of revenue from Jersey to the foreign revenue authority (principally to the U.K.), neutrality in cost terms to the entity itself, but an anomaly within a Jersey only context in that equity locally between the tax treatment at shareholder level of resident-owned businesses compared to non-resident owned businesses is undermined. This perception of inequity needs to be acknowledged even though neither the foreign owned Jersey entity itself, nor its non-resident shareholders, will actually benefit. The beneficiaries are the revenue authorities of other jurisdictions, particularly, for the reasons discussed, the United Kingdom.

In these circumstances, it is not an answer simply to impose alternative taxes on the Jersey entity (such as, for example, a payroll tax) if such taxes will not qualify for relief under overseas tax laws. If this course of action is taken we will actually be placing these businesses at a competitive disadvantage in the future because the additional tax liability generated will be an additional cost to the overall business, possibly resulting over time in their closure and re-location or lack of future investment with accompanying implications for the loss of local job opportunities.

The Committee has sought numerous ways to address this difficulty and continues to do so. However, it has been evident from the outset that any solution, even partial, will depend on the tax treatment in the hands of foreign revenue authorities which will be applied to any revenue-raising measures which Jersey might take in respect of the respective foreign resident shareholders. With the bulk of the revenue transfer going to the U.K. we have been working particularly closely with H.M. Treasury to seek ways in which at a technical level any measures enacted in this respect in Jersey would continue to be ‘recognised’ as relievable tax under existing U.K. tax provisions. For success, the possible measures must also continue to have no implications for taxes imposed directly on company profits (which might otherwise undermine the fundamental wish to preserve the tax neutrality of the current Exempt Company universe), stand up when viewed in relation to the competitive position of the Island and at the same time continue to fall within the prescription of the E.U. Code of Conduct of Business Taxation.

On the basis of these four criteria we have not been successful in establishing any solution based on Jersey introducing a territorially based, or general permanent establishment based, system of taxation. There may, however, be some limited prospects for a system which seeks to impose a withholding tax on the distributed and undistributed dividends of foreign-owned companies operating in Jersey based on a very limited permanent establishment test on the underlying entity making the distribution. The key question as to whether such a system would fit within overseas tax rules for ‘relievable’ taxes and other technical questions are still being evaluated with relevant overseas revenue authorities and will continue to be pursued. Even a partial solution on this basis would reduce the inequity of tax treatment for shareholders of Jersey businesses arising from their residential status and would also result in some limited revenue recovery.

It is not possible to state definitively at this juncture what will be the outcome of this complex exercise. Members will be kept informed of progress and in view of the inherent uncertainties which still exist on the issue the Committee believes that any success in the enterprise should be regarded essentially as a future opportunity gain and not factored directly into the present calculations and considerations.

(b)(iii) Tax enforcement measures

As the Whiting report commented, anti-avoidance will always be an issue, so there is a need to look at tax enforcement, the general anti-avoidance rule (Article 134A) and information powers. The Income Tax Law will be changed to ensure that the Comptroller has, as outlined earlier in this Report, sufficient information and enforcement powers to administer the proposed ‘look through’ provisions. It is also the Committee's view that Article 134A needs to be strengthened, probably by placing an obligation on every taxpayer to report to the Comptroller any investment or financial scheme or arrangement that will result in the avoidance of tax. This will be a pre-clearance system so that the Comptroller will be able to rule on a transaction, but it will not be designed to catch or overturn bona fide commercial transactions entered into which do not have as their purpose the avoidance or reduction of tax.

(c) Raising up to £80-£100 million

The net revenue shortfall arising from adopting the 0/10% corporate tax structure is currently estimated to be in the order of £80-£100 million per annum. To maintain a balanced budget this revenue shortfall must be met in a sustainable way. Without significantly reducing the range and quality of public services delivered to Islanders there are only 3 practical ways that this can be done –

- increase the efficiency of public services;

- increase the size of the economy without significantly increasing the demand for public services;
- introduce new taxes.

The need for a balanced Budget

The Island's primary industry is dependent on both political and fiscal stability. Any indication that the Island's government could not meet its financial obligations would seriously damage Jersey's reputation as a location for international financial services. Although the Island has a Strategic Reserve of some £400 million and a significant capacity to take on debt to pay for public services in the short term, neither spending the Strategic Reserve, nor borrowing, represent *sustainable* solutions to meeting the revenue shortfall caused by moving to 0/10% corporate profits tax. The Strategic Reserve would quickly run out and any borrowing would have to be repaid with interest, at which point the fiscal problem would be very likely to be much worse. Using the Strategic Reserve (or borrowing) is not a solution for fiscal deficits caused by a permanent change in the taxation structure. It would merely put off having to address the problem for a few years, by which point the problem would be far worse.

The Committee has, therefore, decided that the Jersey tax structure must be reformed without delay so that the Island is in the best position possible to meet any shortfall arising from adopting the 0/10% regime as it occurs. This move should be sooner rather than later so that deficits do not mount up and so that there can be a relatively smooth transition to the new structure.

(c)(i) Maintaining public services

In theory, the budget could be balanced by making cuts in public expenditure. However, these cuts would have to be very deep, cutting into the heart of spending on education, health and social benefits. Although there is considerable public support for making the government more efficient and reducing waste, the Committee does not see any general support for large cuts in the services actually delivered by the States.

Indeed, in the major areas of public expenditure – health, education and social security – the public if anything seem to want to improve the quality and quantity of our public services.

This has been reflected in the outcomes of the recent Fundamental Spending Review (FSR) for 2005 where additional funding for Health and Social Services, Education and Housing were agreed together with funds to preserve the real value of benefit payments.

The 2005 FSR also proposes some cuts in non-essential services and the public and staff representative groups have not been wholly supportive of these. In contrast, the 2005 FSR process introduced the concept of efficiency savings, to be delivered both across and within Committees, to be achieved without any noticeable adverse effect on service delivery, such savings being regarded as more palatable.

However, it is debatable whether these levels of savings can be sustained over the longer term. The net effect of all of these issues is that it is unrealistic to expect the £80 – 100 million shortfall to be met primarily from reductions in public expenditure – indeed it will be a significant challenge simply to fund essential service growth within the target expenditure increase of 1% less than the Retail Price Index.

The Committee has concluded that the public will want to maintain the existing high standards of public services while, of course, eliminating inefficiency and waste. The implication of this conclusion is that the major part of the shortfall arising from the adoption of 0%/10% will have to be made up from additional taxes.

The Fundamental Spending Review has already tackled the historic trend of rising public expenditure and the recent benchmarking process identified where further efficiency gains are possible. Although public spending as a proportion of the economy is low compared to most other developed nations, public opinion sees the elimination of waste and inefficiency in the provision of States' services as a very high priority, and the Committee agrees with this.

The FSR has helped to reduce the growth in net revenue expenditure from 10% to 2.5% in both 2004 and 2005, which is below the rate of inflation. It will continue to be the main vehicle for the reallocation of resources necessary to continue to maintain such low increases, identifying savings in order to fund essential growth. Without these savings in recent years, net revenue expenditure (and hence the deficit) would have been significantly higher.

The Public Sector Reforms programme (or Visioning) will assist in the delivery of efficiency savings over the next five years targeted at £20 million per annum by 2010. In addition, the benchmarking report and the improvec performance management framework will identify services with relatively high cost where savings may be possible.

The indications from the Imagine Jersey consultation process and the development of the Island Strategic Plan are that the people of Jersey do not want significant reductions in the level of services that they receive from the States, particularly in the areas of Education, Health and Social Services. **The Committee has taken the view that the major services delivered by the States to the residents of Jersey will continue, but that there will be a sustained drive on waste and inefficiency. The Committee proposes that the change in States expenditure should be constrained to 1% less than the change in the Retail Prices Index.** This would save approximately £20 million per annum by 2009.

(c)(ii) Increasing the size of the economy: **policies for growth**

Meeting the challenges from the E.U. and the changes in the international market for financial services, as described above, should maintain Jersey’s competitive position. The Island will continue to offer international financial institutions a good base from which to operate. If allowed to, these institutions should be able to expand their output on the Island, and increase their contributions to States’ revenue, as well as supplying jobs to Islanders. Such an expansion should reduce the projected deficit. The greater the expansion, the lower the deficit. Economic growth of 2% p.a. should yield£20 million additional tax revenue over 5 years. Clearly, there are als opportunities to expand other parts of the economy through the adoption of growth-orientated policies. Undoubtedly there will be implications for population growth. Expansion in the finance industry could generate significant economic growth with relatively few people and relatively little extra demand on public services. Other industries might require more additional staff.

The Finance and Economics Committee proposes that the States should pursue and promote economic policies which will deliver 2% real growth in the Island’s economy between 2005 and 2009. This is a crucial element in the Island’s Strategic Plan. The reform of tax and spending policies is a crucial part of that overall strategy. Policies for growth will be a vital thrust of overall economic policy during a period when the Island is facing a major shift in the tax burden to resident households. These policies will also be vital during the next decade when the public finances will come under strain due to the ageing in the population.

Sustained higher growth in the economy can generate more tax revenue and enable the size of the potential increase in the tax burden for residents to be eased. Policies for growth must have as a primary objective the encouragement of private sector enterprise and initiative. Private sector enterprise and initiative have been the keys to Jersey’s enviable economic success over past decades. The international financial services industry must be encouraged to remain as a key player in the Island’s economic future and the reform of the corporate tax structure is a primary policy in support of this objective.

However, the policies for growth should be designed to support and encourage the enterprise and initiative of all of the industries and all of the people in the Island. Policies will need to be pursued on several fronts. Considerable progress has already been made in reforming the management of the public finances and more will need to be done. The pursuit of greater efficiency in the public sector for example should free up labour market resources for the private sector to employ. The policy of restraining the rate of growth in States’ expenditure will lighten the upward pressure on personal taxation following the reform of corporate taxation and help maintain incentives for hard work and enterprise.

Policies with respect to the age of retirement may need to be reviewed carefully in the context of labour supply, as well as the implications for the public finances. The Island’s housing policies, particularly with respect to the supply of land for new housing, will have to be kept under constant scrutiny. There will be close links between any reforms to inward migration policy, or the size of the Island's population and the stock of available housing in the private sector.

It is with a view to addressing many of these issues that the Island's Strategic Plan has been developed. The first aim of the Island's Strategic Plan is to create a strong and competitive economy and it sets out the framework for which this can be achieved with a sustainable population. It highlights that the States will –

- reform taxation to sustain a competitive low tax environment;
- pursue a sustainable Anti-Inflation Strategy;
- actively support the promotion, diversification and further development of the financial services industry in the Island;
- encourage the development of new enterprises and companies with high value-added potential and which contribute most to the community;
- develop a strategy which will explore and promote new opportunities for the rural economy;
- develop a Tourism Strategy which will investigate new opportunities and 'niche' markets;
- formulate a comprehensive external transport and communications strategy which will benefit both business and residents;
- reduce unnecessary regulation and bureaucracy in the Island;
- allow regulated inward migration and housing by license;
- develop a skilled and qualified workforce which meets the Island's needs.

The States is already pursuing a reform of those administrative structures which control new business start-ups in the Island and this work will continue over the coming months. The intention is to introduce a reform which creates a one-stop shop to cover these processes, thereby encouraging the setting-up of new companies and encouraging their development.

The Economic Development Committee, working with other States Committees, the Economic Adviser and economic experts, will further develop policies over the coming months and will publish a 'Plan for Economic Growth' by February 2005.

The Committee believes that a combination of economic growth and tight control of public expenditure can help reduce the projected deficit that arises from the adoption of the corporate tax measures outlined above. However, the Committee recognises that the delivery of these benefits is outside of its direct control. Only the States (acting together), and the various States' Committees (acting in cooperation), combined with appropriate responses from the private sector, can deliver these benefits. The Committee believes that this level of cooperation and response is very likely**.** However, the Committee believes that it would be irresponsible to develop a fiscal strategy that relied on such an outcome, particularly where the risks to the economy of failure would be severe.

(d) Taxation measures

Background

The Committee therefore believes that any new taxation system must be **capable** of raising the full £80 – £100 million projected shortfall, if that turns out to be necessary.**However, in the first instance it is identifying increases in tax to raise £50 – £60 million.** The remainder of the shortfall should be met by the measures outlined above to constrain public expenditure and to grow the economy.

In proposing new taxation measures the Committee has been guided by a number of generic principles. In particular –

Fairness: as far as possible the taxation system should be inclusive – to avoid moral hazard issues – but taxes should be seen to be fair in terms of their relative impact on households and businesses, thus all should contribute as far as possible whilst taking account of relative 'ability to pay'.

Efficiency: the cost of collecting taxes is a deadweight loss on the economy, and should be minimised as far as possible. Taxes should also aim to minimise the (unintended) distortion of economic choices.

Competitiveness and competition: taxes should not adversely affect the Island's competitiveness.

Simplicity: taxes should be as simple as possible to introduce and administer, in order to maximise their cost effectiveness and ease of introduction, and minimise the diversion of resources away from productive activity; from the taxpayers point of view a simple tax system, that is transparent, easy to understand and predictable is required for efficient tax planning and wider decision-making.

Flexibility: taxes should be flexible to enable them to be adapted quickly to changing circumstances.

Revenue stability: taxes should be designed to minimise the potential for tax avoidance and, as far as possible, based on a stable tax base.

In practice not all of these criteria can be met simultaneously and compromises are necessary. However, in coming to its conclusions the Committee has taken account of these criteria in choosing between the different options that are possible.

Potential sources of revenue

In order to raise even £50 – £60 million any tax will have to tap into a significant tax base. There are a very limited number of such tax bases. Those that are available include –

Corporate profits of Island businesses

The changes to the corporate tax structure already outlined above are required to keep the Jersey international financial services sector competitive and able to meet its customers' requirements from Jersey. **Changes to the 0/10% regime that significantly increased the tax take would almost certainly defeat the objective of keeping a healthy financial services sector on the Island.** The Committee could not support such a risky approach. However, there does appear to be some limited scope to develop additional tax measures in the form of a profits transfer tax that might recover some of the tax lost by the introduction of the 0/10% regime, without significantly impacting on the competitive position of Jersey-based companies. This avenue will continue to be explored and further tax measures will be proposed as appropriate. It is possible that any measures coming out of this initiative will be able to make some contribution to the prospective deficit, but it is unlikely that it will be substantial.

Personal wealth of residents

A general wealth tax or capital gains tax would not be consistent with Jersey's position as a location for international financial services, and could seriously harm Jersey's international reputation. The Committee does not recommend such a tax. However, Jersey residential and commercial properties could form a basis for a more limited form of taxation. A substantial tax on commercial property would increase the cost base of Jersey industry, which would not be consistent with encouraging economic growth. It would also tend to increase the price of goods and services sold in Jersey, as well as in Jersey's export markets. Although a residential property tax would be likely to be roughly related to income, the detailed relationship is currently unknown. Such a tax could also require a new taxation administrative infrastructure if it were to raise substantial amounts of money. As alternative tax raising measures that reasonably meet the Committee's criteria are available, **the Committee does not recommend the use of residential property values as the basis for meeting any significant part of the prospective revenue shortfall**.

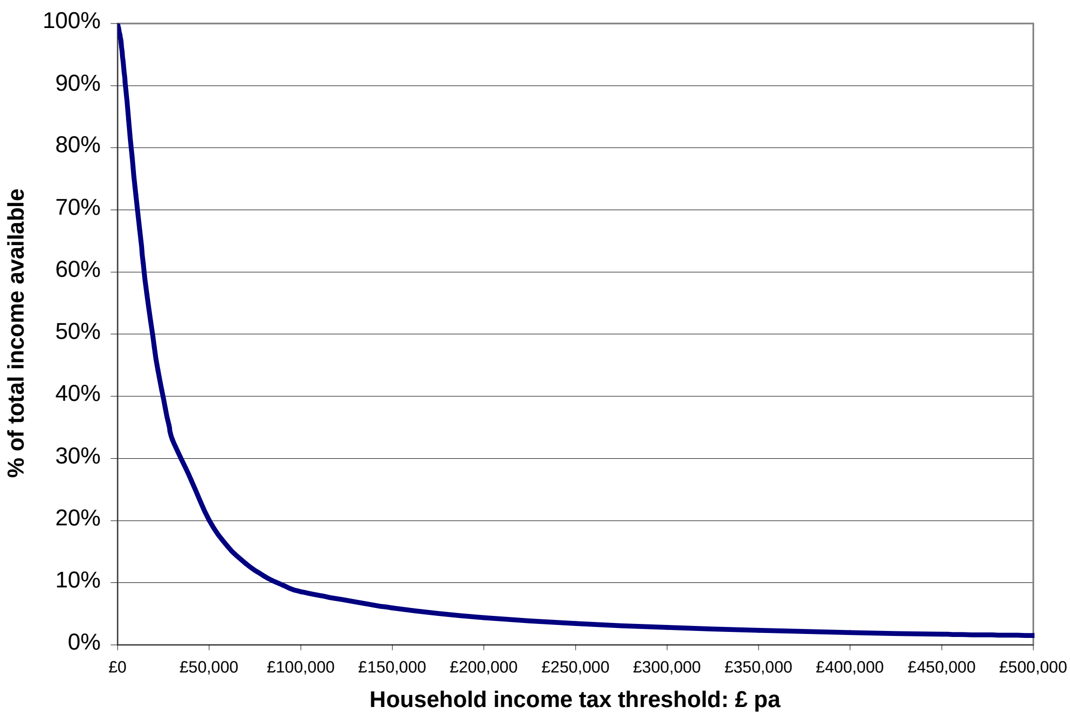
It is the Committee's conclusion, therefore, that the prospective revenue shortfall should be met from taxes based on the other three tax bases: income, consumption and payroll.

Personal Income tax

In introducing any changes to personal income taxes the Committee's objectives are to ensure that any new tax burden is fair and equitable; that Jersey's competitive position in the international market place is maintained; that the economy remains stable and can continue to flourish; and that public services can be adequately funded. The current structure of personal taxation and liability for social contributions is broadly progressive, and the policy of the Committee is that this structure should be maintained.

However, any new personal income tax measures must take account of the income distribution on the Island. Figure 1 below shows household income distribution for Jersey (in 2001) in the form of the proportion of household income that is available to tax for any given level of tax threshold.

Figure 1: % of household income available to tax for any given (gross) income tax threshold



Source: Jersey tax records (2001), OXERA calculations.

The above chart indicates that only around 10% of household income is available to tax above a (gross) household income threshold of £80,000. **As a result, tax measures that are exclusively aimed at households with high incomes do not yield particularly large amounts of tax revenue.** The Committee has taken this income distribution into account in formulating its preferred option.

Maintaining the 20% standard rate of income tax

20% has been the standard rate of income tax in Jersey for over 60 years, contributing to what is internationally recognised as a very stable fiscal regime. This recognition contributes to Jersey's appeal as a finance centre. The rate has therefore served the Island well in the past and there is no reason to suppose that it will not serve Islanders well in the future as far as personal taxpayers are concerned.

The Committee's proposal to phase out allowances for high earners is a very effective way of increasing the amount of tax paid by those taxpayers, whilst maintaining that 20% rate.

It is the Committee's view that increasing the tax paid by high earners using this method is preferable to raising the standard rate of tax above 20%, particularly when some of our main competitors, such as the Isle of Man, have already announced a reduction in direct rates of tax on their residents.

The Committee has concluded that **there are considerable advantages in maintaining the current 20% headline rate of personal income tax**. These advantages stem from maintaining Jersey's international reputation as a low tax rate jurisdiction; its ability to attract workers with high incomes and, therefore, high contributions to the States tax revenues; and the considerable contribution made to the States' revenues by the comparatively high levels of unearned (and, therefore, highly mobile) income that might leave the Island if the rate was raised substantially.

Wealthy residents

The only wealthy persons who are able to negotiate how much tax they pay are non-residents who wish to become resident in Jersey by virtue of paragraph 1(1)(k) of the Housing (General Provisions) (Jersey) Regulations 1970 under the Housing (Jersey) Law 1949. That Regulation was approved by the States in 1970 and still exists. As long as it does, any wealthy non-resident who wishes to take up residence in Jersey is able to make a specific application to the Housing Committee who will consider whether consent can be justified on social or economic grounds. It is a condition that a 1(1)(k) resident who takes up residence on economic grounds must pay an agreed amount of tax every year.

This does not equate to an alternative rate of tax applicable to 1(1)(k) residents. The Notice of Assessment issued by the Comptroller of Income Tax, either to the individual personally, or to the company they beneficially own, or the trust in which they have an interest and which makes the tax contribution on their behalf, is still charged at the standard rate of 20% to collect the amount of tax contribution agreed for each year.

Those 1(1)(k) residents already in Jersey paid a total of £10.7 million in tax in 2002. It may well be that Jersey should be encouraging more 1(1)(k) residents to Jersey as a means of contributing to the deficit and thereby keeping down the tax increases for other islanders.

(d)(i) Income Tax Instalment System (I.T.I.S.)

It is the intention of the Committee to bring in a form of pay-as-you-earn. This will be known as the **Income Tax Instalment System (I.T.I.S.)**. This will help to ensure that all those who should pay their income tax do so, as well as help taxpayers budget for their tax liability by eliminating the large single payments that are a general feature of the present system. This measure should raise up to £5 million per year.

It is proposed that I.T.I.S. will apply to all employees, whether full-time, part-time or contract, as well as to all directors who get paid a salary or fees, plus all labour only subcontractors who do not have an exemption certificate from the Income Tax Office – which would only be issued if they have a good tax compliance record.

I.T.I.S. will not apply to sole traders, partnerships, those individuals living off investment income and pensioners in receipt of a pension. A mandatory system of early payment on account during the year will be introduced for those types of taxpayers, i.e. half the previous year's tax liability at the end of April and a final settling up when the Notice of Assessment goes out in September. Such a system would increase the flow of funds into the States Treasury in a broadly similar manner to I.T.I.S. for employees.

Employers and main contractors will need to deduct the correct tax at each pay day, in accordance with the effective rate of tax applicable to each employee, director or labour only subcontractor, and notify all such employees, etc., of the amounts withheld, keep records of the amounts deducted for each person, send a schedule of the names and Tax Reference Number of all persons, and the tax deducted on their behalf, plus a remittance, preferably by telegraphic transfer or through BACS, of the total tax deducted, to the Income Tax Office, within 15 days of the end of every month.

Income Tax currently gets 75% of employers' returns of employees' earnings electronically and the intention is to work with Social Security to develop a CD which will allow the employer to declare both Income Tax and Social Security deductions on the same CD which can then be sent with the relevant details to Social Security and Income Tax. Neither Income Tax nor Social Security will see or be able to download the confidential details relating to the other. The employers who are unable to make electronic returns will have to complete two separate paper schedules, one for Income Tax and one for Social Security.

The employer will have to provide, both to the Income Tax Office and the employee, an annual summary, within 30 days of the year end, of remuneration and tax deducted for each employee.

When both a husband and wife are employed and there is no election for separate assessment, there will be provisions to allow them both to share the tax deducted, from each of their salaries, rather than have all the tax deductions coming from the husband's salary.

Non-resident employers employing people locally will be included in I.T.I.S..

The current complex dual system of exemptions/allowances does not lend itself to breaking down the tax entry point into weekly/monthly tax codes for each employee as under a true PAYE system and, unlike the uniform deduction rates for Social Security, the amount of tax due from each employee involves a complex calculation dependent upon their individual circumstances. Instead, an effective rate of tax for each employee will be identified, reflecting their last known level of income and tax liability. (Although the standard rate of tax is 20%, individuals do not pay tax at 20%, but at an effective rate ranging from 1% to some 19% depending on individual circumstances, such as whether they are married, have children, a mortgage, etc.). For those employees who continue to be exempt from tax, of course, their effective rate will be 0%.

The use of such a simple and straightforward methodology will also help employers as there will be no need for complex codes and a booklet of tax deduction tables.

This individual effective rate for each employee will be communicated to him annually in the period October-December for the calendar year ahead. It will be subject to amendment where the Income Tax Office is satisfied that there has been a significant change in circumstances, or as the Income Tax Return of the employee is processed and it is apparent that refinement is necessary, (e.g., if the level of over/under payment of tax from previous years is substantial).

It will be necessary to create a comprehensive employee and labour-only subcontractor database to enable the timely and effective transmission of data and tax deductions between employers, main contractors and the Income Tax Office. The default position, the one that will apply, for example, to new taxpayers who arrive in the Island without an effective rate of tax, or those from previous employment who no longer know their effective rate, or school leavers, will be an emergency effective rate of tax deduction until the employer sees official notification from the Income Tax Office – set at 15%. However, those new taxpayers who call in promptly to the Income Tax Office outlining their personal circumstances and expected income, will have an effective rate issued immediately.

The effective rate of tax calculated will need to be increased for those with existing tax arrears. A statutory maximum effective rate of tax will need to be set out in law, as this is considered vital to protect the employee from oppressive levels of tax deduction.

Penalty provisions will be incorporated into the law to require employers to make timely returns of their employees' monthly schedules and the tax deducted. New businesses who take on employees and who fail to register with Income Tax within one month will also be subject to a penalty regime. However, new businesses, such as sole traders and partnerships who do not take on any employees, will not be subject to such a penalty regime.

It will still be the intention that all employees, directors and labour-only subcontractors continue to complete an Income Tax Return for each year of assessment and that will be issued in the usual manner.

It is proposed that, for established taxpayers, the tax deduction system will operate to deduct tax in year 2 to pay the liability that will arise on earnings received in year 1 (i.e., deductions start in January, 2006, in respect of the 2005 tax liability).

New taxpayers (those arriving on the Island and taking up employment, whether on contract or otherwise and those entering the labour market from the education system here in Jersey) must register with the Income Tax Office within 15 days of taking up employment. They will have tax deductions imposed upon them from the first month of employment. The proposal is that they will be on an alternative I.T.I.S. which sees deductions in year 1 to satisfy the liability arising upon year 1 earnings. This will ensure, for example, that those who come and work here on short-term contract will have tax deducted from their earnings all the way through their contract and will not be able to leave Jersey owing tax.

In addition, it is proposed that those who reside in Jersey for only part of the tax year will only get tax allowances and reliefs for that part of the year that they were resident in the Island. In other words, a full year's tax allowances or tax exemptions will only be available to a taxpayer who has been, and continues to be, permanently resident in the Island, excluding holidays or business trips abroad. This will prevent those who work in the Island for only part of the year claiming tax repayments based on a full year's tax allowances or tax exemptions.

The tax deductions of new taxpayers, therefore, will be accelerated in relation to the rest of the taxpaying population. This means that there will be 2 bases to operate concurrently for different groups of employees.

In order to get new taxpayers who intend to remain permanently in Jersey on to the system for established taxpayers, there will be a transition, probably after 5 years of paying tax as a new taxpayer. This will operate so as to have tax deductions from the new employee's earnings for years 6 and 7 at half of the usual effective rate of tax. This will enable new taxpayers to be absorbed into the mainstream tax deduction system without too much difficulty in their 7th year of residency.

(d)(ii) 20% means 20%

The Committee believes that for those with high incomes the 20% standard rate of income tax should mean exactly that – a tax of 20% of *gross personal* income (excluding allowable pension contributions and directly related employment expenses). Tax-free allowances and income exemptions are appropriate for those on lower incomes, and are a useful way of reflecting a household's particular circumstances – for example, the number of children being supported, the mortgage interest being paid – in their tax liability. However, for those on high incomes this help is inappropriate, especially within the relatively low standard tax rate of 20%. Currently, for many households with an income of £50,000 a year, the effective rate of tax paid on that income is less than 10%. For the majority of households, the effective rate is 5% or less. Making 20% mean 20% for high-income households would ensure that the progressive elements of income tax were maximised, while keeping within the constraint of having a headline rate of tax of 20%.

The Committee, therefore, proposes that all tax-free income should be abolished for those households with high incomes. In the first instance, up to £10 million of revenue could be generated by abolishing these allowances. To avoid excessively high marginal rates of tax as the allowances relevant to individuals, children and mortgage interest tax relief are removed, the benefits would be phased out as income increases. In addition, the household composition and circumstances would need to be taken into account so that, for example, a married couple household was treated equitably compared to a similar, but cohabiting, household. Based on these principles, and to raise £5 million– £10 million in total, for a household with 2 children and a mortgage of around £120,000, the allowances would need to start being phased out at an income of around £80,000 with all the tax-free income gone by an income of around £150,000. Single-person households would see their tax-free exemptions and allowances phased out earlier.

In introducing this measure the Committee is also mindful of the need not to unduly complicate the tax system. Indeed, one of the aims of the Committee is to simplify the income tax system so that administering the tax system consumes less resources. The Committee is, therefore, investigating whether it is possible to achieve the objective of making 20% mean 20% for high-income households by building on the existing income tax Exemption Limits. The objective would be to create an income tax system that contained only 2 elements.

- The first element would involve keeping more or less the same income tax-free exemptions and allowances as are now available, with any remaining taxable income being taxed at the current marginal rate of 27%.

- The second element would have no tax free exemptions or allowances, but income would be taxed at only 20%.

Tax-payers would pay the *lower* of the 2 tax bills as calculated by these 2 methods.

Such an approach would create a simpler tax structure than the one that exists at present, and simpler than any system that specifies the income range over which tax-free exemptions and allowances are phased out. However, because of the very generous tax-free exemptions and allowances currently available, those households with children and a large mortgage (i.e. in excess of £200,000) would not be paying tax at 20% of gross income until their household income was in excess of £150,000. So for them 20% would not mean 20% until their household income was in the region of £180,000. Should interest rates rise, the value of the mortgage interest tax relief also rises and the point at which 20% would mean 20% would also rise.

In addition, those tax-payers with only the personal exemptions as tax-free income (e.g. no children and no mortgage) would end up paying 20% of gross income considerably before they reached an income £150,000 (for a couple) and £75,000 (for a single). They would also start to lose their tax-free allowances and exemptions slightly before £80,000 (for a couple) and £40,000 (for a single). However, for these tax-payers the additional tax they would pay is limited because the value of their allowances is also limited (to around £1,000 for a couple and £500 for a single person).

It is the Committee's view that these changes work in the direction of ensuring that the tax increases arising from the introduction of 20% means 20% are linked to the ability to pay. Those with high tax-free allowances and exemptions will, in general, have higher living costs than those with lower tax-free allowances and exemptions. The slightly later phasing out of the tax-free income for the former, and slightly earlier for the latter, will also reflect these differences in living costs. The Committee also believes that simplifying the tax structure is itself an outcome worth having.

The proposition asks the States to agree that the principle of '20% means 20%' should be introduced for higher earners. Detailed proposals, based on the structure outlined above, would then be brought back to the States in the 2005 budget. The details would then be subject to a debate and decision by the States before they could be introduced.

(d)(iii) Goods and Services Tax (GST) and other taxes

GST

Jersey (and, currently, Guernsey) is one of the few developed countries without some form of tax on goods and services. Introducing such a tax in Jersey would be a significant change to the Island's tax structure, **but would spread the burden of tax across all residents and reduce tax revenue volatility.** As has been demonstrated by other countries, including the U.K. and the Isle of Man, this is a tax base that is capable of raising significant revenue for the government.

A goods and services tax also has the effect of **raising the effective tax rate paid by resident high-income households,** without raising the headline rate of personal income tax. It thus provides the mechanism to raise more revenue from the better-off so that, together with the phasing out of allowances, the *overall* tax and income support system can be broadly progressive.

To maintain Jersey's international competitiveness it is important to try to limit the way any increase in taxation feeds through into export prices. With a goods and services tax the Committee feels it has the ability to do this by being able to exclude exported goods and services from the scope of the tax and include imported goods and services. **One of the key advantages of such a tax is that it could be designed to allow Jersey suppliers to continue to compete on a level competitive base.**

The Committee is, therefore, recommending a broadly based goods and services tax as a further mechanism to meet the projected shortfall. The gross yield is estimated to be in the region of £8 – £9 million per 1% point and the Committee would recommend generating a net revenue of up to £40 – £45 million from this tax source. This would mean a tax set at 5% and achieve the goal of raising the significant sums required. The Committee also recommends earmarking a proportion of this revenue to protect the poorest from its impact by increasing benefits.

The consultation exercise has shown a preference for a lower tax rate and few (or no) exemptions. Within the above objectives, the Committee will be looking to keep exemptions to the absolute minimum in order to ensure that the rate is as low as possible and to ease the administrative burden on business and government.

If necessary, the rate of the goods and services tax can be adjusted in the future to respond to changing economic conditions in the Island.

The Committee has undertaken research into the type of GST that would best suit the economy and business environment of Jersey. Two types of tax have warranted further research - Value Added Tax (VAT) and Retail Sales Tax (RST). VAT is a tax applied at each stage of a supply chain and allows business to offset tax suffered on inputs against tax charged on outputs (i.e. it is a tax charged on the value added). RST is only due at the last stage in the supply chain. The revenue raised and the amount the consumer pays is the same with either type of tax as they are considered to be economically equivalent.

VAT is by far the most popular broad based consumption tax operating in the world today. Although the Committee has not yet identified a preferred option, it is recognised that the supply chains operating in an economy are a critical factor in informing the decision. The Committee is undertaking research into this.

The Committee appreciates that more information and further research is needed before the States approves the introduction of a GST. The States are asked to approve this further research and instruct the Committee to bring forward details by February 2005 with recommendations for approval for the type of tax, its scope and administration.

Payroll tax

If the full £80 – £100 million is required– which would imply that the States has been unable to identify and implement significant efficiency savings, and unable to generate economic growth – the Committee believes that it would be appropriate to introduce an additional payroll tax to make up the shortfall. To reduce the administrative costs of collecting such a tax it would piggy-back on the existing Social Security Contributions infrastructure, and would cover the same tax base. Such a tax would further help to spread the tax base and help reduce tax volatility. However, there are some real drawbacks in using this type of tax to generate significant tax revenues, which is why the Committee sees this tax as the third to be employed, and only if absolutely necessary. The Committee is particularly aware that within the relevant time horizon for these proposals there is likely to be increased pressure on the Social Security Contributions system as a result of the ageing population. This may result in a need to increase the level of contributions to meet the cost of States pensions. The Committee is aware that for an overall equitable outcome the Social Security Contributions and tax structure need to be taken into account together.

Where the tax liability falls on the employer, such a tax directly impacts on the cost of doing business in Jersey. It is bound to be counter-productive in terms of encouraging economic growth, and would make it more difficult to ensure that Jersey remained internationally competitive as a place to provide international financial services. It would also act as a severe deterrent, over time, to job creation and retention. In addition, these increased employment costs would tend to be reflected in higher prices in Jersey.

The Committee did consider removing the earnings limit for employer and employees contributions to the Social Security Fund. However, the Committee concludes that this is not an option it should pursue at present. Removal of the cap on the employer's side raises the cost of doing business in the Island and, therefore, hampers economic growth. Removal of the cap on the employee side is like a higher rate of income tax but it only raises tax from the wage earner and not from unearned income. When used to fund generally available public services it is not a particularly fair tax.

Distributional impacts of proposed tax package

The Committee is very aware of the concerns that have been raised in relation to the distributional impacts of different ways of raising the necessary tax revenue (i.e. who pays the extra taxes). The Committee's proposed solution contains 3 main elements with significant distributional consequences. These are –

- 20% means 20% - this has the effect of increasing the relative tax burden of high income households, by removing the existing tax-free allowances they enjoy. Low income households are not affected by this element of the proposals.

- GST – this has the effect of impacting all residents of the Island, and visitors. The incidence of this tax follows on-Island expenditure. It has the effect of significantly widening the tax base. It is, however, mildly regressive, particularly at very low incomes.

- The income support structure – to help counter the mildly regressive nature of GST the income support structure will take into account the impact of GST on the real incomes of the low paid.

Taken in combination, the resulting impact of the Committee's proposals is to maintain the existing progressive tax structure on Jersey. That has always been the policy of this Committee.

Other solutions to the revenue shortfall produce other distributions of the increased tax burden on Jersey. Appendix 2 has been commissioned from OXERA to provide the States with the distributional consequences of a number of different approaches, so that these can be compared with the Committee's proposals (*excluding* the impact of the Low Income Support scheme). Additional information of this sort can also be found in Appendix 2 of the OXERA background paper previously published by the Committee in February 2004.

A note on the inflationary effects of tax-raising measure is contained in Appendix 3.

(e) Income Support Scheme

The Committee is very mindful that any changes to the tax structure in Jersey should be fully integrated with the Income Support Scheme to ensure that those on the lowest incomes receive some protection from the effects of such changes.

A goods and services tax is at best neutral, and is often mildly regressive, even if the very basics necessary for life, such as food, are excluded from the tax. As incomes rise the proportion of gross income spent on taxed items tends to fall. In addition, this tax would affect the very low paid, a group that is usually excluded from income tax. For these reasons **the application of a goods and services tax in Jersey would, in the Committee's view, have to be accompanied by a mechanism to protect the very poorest from its impact**. The Income Support system will be structured and funded to ensure that those on the lowest incomes will be protected from the effects of the goods and services tax.

The entire benefits and health systems are currently under review, including future funding arrangements, with a view to the demographic changes and sustainability of the system.

The aim of the current review is to integrate and simplify the present system of support available to low income groups by replacing all existing means-tested benefits with a single, graduated one consisting of different components. These components cover various needs such as those relating to housing, disability, health, childcare, transport, care and general costs arising from frailty in old age.

The Finance and Economics Committee is determined to work closely with the Employment and Social Security Committee during 2004 and 2005 to ensure that the phased-in changes to the tax structure are fully integrated with the Low Income Support Scheme for full implementation of a new tax/benefit structure in 2006. Indeed, the recently lodged Strategic Plan 2005-2010 has this issue as a key success indicator.

Other tax measures considered and presented as possible options

Environmental taxes

The Finance and Economic Committee, if charged to do so, will investigate further the feasibility of the introduction of environmental taxes. Such instruments need to be considered alongside clear environmental goals, rather than in isolation or as ways of raising revenue. As a solution to closing the fiscal shortfall it is hard to construct an environmental tax that will raise the significant sums required. However, there are arguments for and against environmental taxation that could, depending on the exact balance, mean they are suitable for introduction in Jersey.

Environmental taxes are usually introduced to achieve one of two goals –

(1) change behaviour,
(2) raise revenue.

These 2 factors are of course linked. If a certain activity is taxed because it is deemed bad for the environment then the aim is to reduce that activity, rather than raise revenue. If the tax is unsuccessful at changing behaviour it will raise more revenue. However, should the activity be widespread and the aim be to reduce it rather than eradicate it, then the tax could change behaviour and raise revenue at the same time. Even if revenue is raised through a particular environmental tax it is unlikely to be enough to make significant inroads into the projected fiscal shortfall and there might be justification for it to be hypothecated to a use related to the activity being taxed e.g. a tax aimed at reducing congestion/emissions might have the funds hypothecated to public transport or health.

The costs of collecting a particular environmental tax might be high especially if it is a new tax and if the yield is low due to the fact that there is a relatively small level of such activity in Jersey. Each tax needs to be considered on its own merits as the change in behaviour it may bring about may not be desirable e.g. a landfill tax could lead to more fly tipping.

If required, then further consideration would be given to environmental taxes that –

- reduce pollution e.g. sewage charges, petrol/diesel duties;
- reduce congestion e.g. car taxation, parking fees;
- improve resource efficiency e.g. waste charging.

The Committee believes that before any such measure can be given serious consideration the following questions must be asked in general terms and relative to the Jersey context –

(1) Can an environmental tax change the specific behaviour targeted?

(2) Are there better ways to change behaviour?

(3) What are the revenue implications?

(4) What are the costs of collection?

If charged to do so the Committee will undertake a detailed analysis of these issues for the main environmental taxes and report back to the States with recommendations by February 2005.

Development levies

The scope for a development tax in Jersey is also worthy of further consideration. The concept is that the States should capture a proportion of the development gain when a piece of land gets planning permission for development. For example, the value of agricultural land that gets planning permission for a residential development will rise significantly. The rise in the value of the land is a direct result of the development decision and were the States to capture some of this gain it would enable the community as a whole to benefit from such developments of what is primarily a public good – the countryside.

However, careful consideration is needed of the appropriateness of such a policy as generally imposing a tax on an activity discourages the supply of that activity. The Barker Review of such issues in the U.K. points out that ‘given the interaction of land supply with the planning system this effect could be expected to be small, provided that the tax rate is not set at too high a level. More importantly, the proposed tax is part of a package of policies set out in this Review, which, taken together, aim to increase the supply of land and planning permission.’ This implies that there is a danger that a development tax could work against the aim of increasing the supply of land for development if it is not supported by the right policies. Clearly, further consideration is needed as to whether in Jersey it would be possible to have such polices in place to ensure that it led to the required increase in supply of land for development.

Other measures considered and not promoted as options

The Committee considered a number of alternatives to some form of a goods and services tax, and reviewed alternatives against a number of tests –

- Firstly, any measures have to be capable of generating significant revenues to help contribute to the expected States deficit of up to £80 – £100 million. In short, the Committee preferred a limited number of measures as opposed to a plethora of relatively low yielding measures.

- Secondly, any new taxes must not harm Jersey's competitive position as a major offshore financial centre.

- Thirdly, the Committee sought taxation options which minimise complexity and are appropriate for a small island economy like Jersey. It must be recognised that simply duplicating the range of taxes used in larger jurisdictions could create an excessive legislative and bureaucratic burden.

- Fourthly, any changes to the Island’s fiscal structure must be acceptable to the international community and unlikely to provoke retaliatory action that could harm Jersey's economy.

Finally, any new tax should not incur administrative costs disproportionate to their yield.

Unfortunately, many of the alternative taxes considered by the Committee do not meet one or more of the tests. The Committee considered a number of alternative taxes including:

Capital Gains Tax (CGT)

The Comptroller of Income Tax has estimated that if implemented in a similar manner to the U.K., CGT would raise £5 million a year. It cannot therefore significantly reduce the projected deficit.

Whilst many jurisdictions have adopted CGT, several of Jersey’s principal financial services competitors, including Guernsey and the Isle of Man, several jurisdictions in the Caribbean and some others do not tax capital gains. The imposition of this tax would therefore risk making our financial services industry less competitive and be seen by clients and their professional advisers worldwide to be a significant move in that direction.

CGT also has a relatively high cost of collection and needs complex legislation, which can become progressively detailed as avoidance takes place. The imposition of CGT would therefore be contrary to our tradition of seeking clear, straightforward taxation legislation in Jersey. The Committee feels that this policy has served us well for many years and should be continued.

Permanent Establishment Tax

The concept of any Permanent Establishment Tax (e.g. corporate profits tax, withholding tax) is one whereby the group or organisation charged is recognised as having an identified place of business – involving property, locally employed persons and other signs of local establishment – within the jurisdiction which is seeking to raise the tax.

The U.K. (and indeed Jersey) does recognise Permanent Establishment as a determinant to liability to tax in certain specialist situations, such as property owned by non-residents. However, these are not comparable to the general system that Jersey would require to make a success of such a proposal.

A Permanent Establishment Tax for all companies in Jersey – which is essentially a territorial basis of taxation found in few international tax systems – has nevertheless been carefully considered by a specialist group set up by the Finance and Economics Committee. This group includes individuals with considerable private sector tax expertise and its remit has been to focus on areas where alternatives might exist to replicate or replenish, at least in part, corporate taxes and fees lost as a consequence of the 0/10% strategy.

There was a possibility that a Permanent Establishment system could have provided a partial answer to the fiscal shortfall the Island faces if the home country of incorporation of the company or group concerned – which in Jersey’s situation primarily means the United Kingdom – was prepared to accept that corporate taxes paid in Jersey under such a system can be offset against home country tax liabilities of the company or group.

If that home country treatment could not be obtained, then the corporate tax paid in Jersey under a permanent Establishment system immediately becomes an additional cost to the company or group arising from operating in Jersey. As the aim is to make business more rather than less competitive this outcome holds few attractions.

Accordingly, the Island has been, and continues to be, engaged in sensitive discussions with the U.K. Treasury on the issue generally of alternative measures to seek some measure of replenishment of corporate taxes foregone under the 0/10% proposals. These discussions reflect the importance of unilateral tax treatment by the U.K. of any taxes imposed on profits made in Jersey by U.K. owned businesses. These discussions are highly technical and thus far remain at a technical level.

In the specific context of Permanent Establishment based system of corporate taxation, it should be noted though that even if the U.K. would be prepared to grant the recognition of Permanent Establishment Tax as a unilateral matter, significant problems remain with convincing E.U. partners that such a system complies with the E.U. Code of Conduct on Business Taxation rules. The U.K. has already indicated that in its view it does not and has not hitherto been prepared to discuss the matter further with other E.U. member states. It takes the view that such a system is simply another form of discrimination in favour of non-resident shareholders of companies. It was the elimination of the discrimination which was at the core of the E.U. Code of Conduct initiative in the first place.

This part of the proposals being discussed with the U.K. Treasury are therefore unlikely to be successfully pursued. However, discussions continue on any potential alternatives, including the possible imposition of a withholding tax on the profit distributions of Jersey based subsidiaries and branches of U.K. companies. This too will in part rely on an acceptance by the United Kingdom of a more limited form of Permanent Establishment assessment being the key determinant to chargeability and thus remains uncertain at this juncture. Nevertheless, the Committee assures members that it will keep them informed of progress as these discussions continue but also consider that it would be unwise in the circumstances to rely on any significant stream of tax income arising from this source given the inherent uncertainties of being able to conclude the exercise successfully.

Exempt company fees

It is clearly unacceptable to lose the current 'fees' received from Jersey's Exempt Companies sources (£600 per company per annum) as these amount to approximately £10 million per annum at present. However, some recovery of these monies has already been assumed in arriving at the figure of the £80 – £100 million shortfall the Committee is seeking to address.

The modifications required to Jersey's fiscal structure mean that it will not be possible in the future to have different fee levels for exempt and income tax paying companies. The recovery of this £10 million will therefore depend on setting a one size fits all, single rate for all Jersey companies.

By way of an example, if the core annual return fee proposal for Jersey companies was to be raised from the current £150 per annum to around £400-£450, then this could recoup most of the £10 million as this rate would also apply to companies currently exempt. It would, however, represent an increased cost of around £250-£300 for those local companies.

This does not raise any additional monies. To achieve that, the harmonised fee level would need to rise significantly above £600 per annum for ALL companies. There are competitive limits on how high this fee can go before the Jersey financial services sector becomes internationally disadvantaged.

Essentially then, finding a solution to recoup lost revenues as a consequence of the abolition of exempt companies will be something of a balancing act. For competitive reasons the Committee feels it is not possible to raise any significant additional sums from this source. The best that can be done is get back most of what the Island stands to lose from the loss of exempt company status and the Committee has already assumed that recovery in the estimation of the £80 – £100 million shortfall.

Registration fees

The issue of charging registration fees for companies which are incorporated by foreign investors from foreign jurisdictions, (i.e. the British Virgin Islands), but which are administered on behalf of those investors by Jersey-based institutions, has been raised.

The question of extending a registration fee at some level to such companies is also currently being considered. However, naturally here the competitive situation must also be carefully taken into account. There could be significant migration of these entities from Jersey to be administered elsewhere should we begin to impose a cost which another jurisdiction is prepared to waive. The loss of business and associated employment activity would of course be damaging to the Committee's proposition to grow the Island's economy.

Were a registration charge to be feasible then it would require a low fee level. A modest fee of around £100 per company per year might raise around £7 – £8 million. This is not in itself a decisive contribution towards reducing the overall fiscal shortfall identified, although the Committee remains open-minded about all measures which could practically reduce the amount required. The Committee has not ruled out this measure entirely, however, considering the competitive risks identified it feels it would be unwise to rely on any contribution from this source.

Trust registration charges equate to a tax on the capital of foreign sourced business at the heart of the Island's finance industry.

The Committee has severe reservations about this suggestion since no other major financial centre proposes to impose trust registration charges. Jersey is viewed internationally as a major, if not pre-eminent, Trust services provider. In consequence, when considering this option the Committee concluded that trust registration charges would create a significant competitive disadvantage in an area which has hitherto been one of the Island's unique selling points in the competition to provide financial services to a global clientele. Such a measure is therefore likely to diminish the Island's share of its existing key market and is incompatible with the main aims of the fiscal reform package.

Losing market share in any industry inevitably translates into less business, fewer jobs and ultimately less taxes, which then poses a repeat cycle of questions about how to fund essential services through taxation but this time from a smaller economy.

The Committee has always sought solutions to the proposed deficit based upon the premise that the more competitive Jersey's businesses can become, the more there will be benefits for the population as a whole because taxation can be kept to a minimum.

Introducing higher rates of income tax

The Committee considered various ways of introducing higher rates of income tax for those with higher incomes. It sought to achieve a level of greater tax contribution from wealthy residents, which would not ultimately be counter-productive by causing this highly mobile segment of the population to move to jurisdictions with a lower tax burden.

If a higher rate of income tax was levied on taxable household income over £80,000 it would be likely to raise slightly more than £1 million per annum per 1% point increase above 20%. So a rate of 35% might potentially yield somewhere in the order of £16 million to£17 million.

However, at this rate of 35%, the highest income households in the Island could save a considerable amount of tax by moving to a lower tax rate jurisdiction like the Isle of Man. Excluding 1(1)(k) residents, the households on Jersey with incomes above £500,000 p.a. will see their total tax bills rise in total by over £6.5 million per annum varying from a rise of around £60,000 to more than £150,000 each. If only one in five of taxpayers whose increase was over £120,000 decided to move, the total reduction in income tax paid would be in the order of more than £2 million, rather than any increase.

If all of the top 10 tax paying households moved, the reduction in income tax would be in the order of £4 million per annum. Even on these assumptions as to how an increase in tax rates from 20% to 35% might influence behaviour, there is a significant reduction in the net tax increase and the proposal could become counter-productive.

In addition to the reduction in tax revenues, emigration of this sort would be likely to cause a reduction in on-Island expenditure and other economic activities, so there would be additional knock-on effects in the economy.

The Committee takes the view that at a top rate of even 30%, let alone 35%, there is a real risk that a significant amount of taxable income would leave the Island. It is almost impossible to accurately estimate such a risk, but nonetheless the judgement of the Committee is that the risk is real and should be taken into account. The Committee believes that under its proposals the risk of income leaving the Island is minimal as the headline top rate of income tax remains at 20%.

In addition, this 35% top rate above £80,000 would not by itself be anywhere near sufficient to meet the challenge of moving to 0/10%, so additional significant tax increases would still be necessary. If these were also aimed at those with incomes above £80,000 this would further increase the risk of 'income flight'.

Conclusion

The Finance and Economics Committee believes that this Report and Proposition proposes a framework which would be capable of reforming Jersey's tax structure so that the Island retains a competitive finance industry and maintains its existing level of services and benefits without unduly damaging any section of our society. This framework proposes a future which –

- safeguards Jersey's principal source of revenue by changing the corporate tax rate;

- provides a solution to the resultant tax revenue deficit which increases the tax-take from Island residents while, at the same time, ensuring that those who earn more shoulder the larger share of the burden;

- maintains a broadly progressive tax system.

Finally, the Committee would remind States Members of the following key dates for progressing these tax proposals –

- September 2004 – Resource Plan debate;

- December 2004 – 2005 Budget debate (including reporting on the phasing out of income tax allowances for higher earners);

- February 2005 – Finance and Economics Committee to report back with further details on a goods and services tax, environmental taxes, development levies and a framework for a new Income support system (presented by Employment and Social Security Committee);

- 2006 – introduction of I.T.I.S.;

- 2008 – Final date for implementation of remaining tax proposals and the move to a 0/10% corporate tax regime.

Financial and manpower implications

The development of the detailed proposals for consideration by the States will be within existing manpower and financial budgets. There will, however, be significant on-going costs arising from the implementation of the Strategy. These financial and manpower implications will be included in each of the propositions on individual measures which will be brought to the States.

APPENDIX 1

RESEARCH AND CONSULTATION UNDERTAKEN BY THE FINANCE AND ECONOMICS COMMITTEE

It has been said that the Finance and Economics Committee should do more to discuss the tax proposals with the community and that it should produce more information to enable decisions to be made.

The time for talking about the broad principles is coming to an end. The time for making a decision on those broad principles has arrived. Once a decision has been made on the principle, there will then be further discussion on the detail.

Discussion has been taking place and information made available since 1998. This has indeed been the biggest consultation ever undertaken in Jersey, reflecting the significance of the decisions which now have to be taken.

In January 1998, the Finance and Economics Committee was alert to the looming economic changes and established the Fiscal Review Working Group to review overall fiscal policy and to make recommendations for change. This Working Group was chaired by the then Chief Adviser to the States, Colin Powell.

The States received the Group's Interim Report in September 1998. The Group had consulted widely. This first report included preliminary thoughts on both a Payroll Tax and a Sales Tax – effectively flagging them up as possibilities for the future and as matters for further discussion.

The Working Group's second Report was presented to the States in September 1999. Amongst its recommendations, it warned – '*…if there is a requirement in the future to significantly change the balance of taxation to give greater security of tax revenues, attention will need to be focused on a form of sales tax either imposed on a general basis or in respect of specific items.'*

In July 2001, the Finance and Economics Committee of the day published its first consultation paper on tax and spending. It warned that States spending could not be financed in the future by the taxes of the day and that changes would need to be made. It flagged up the possibility of the introduction of a goods and services tax, *'…..to make our tax revenues more stable and predictable in the future.*'

In May 2002, the second consultation paper was published. It stated: '*…The Island must be ready to adapt tax policy to support its key industries – particularly finance and related services – in the face of significant global pressures.'* It also repeated – '*…we could introduce a new tax on sales of goods and services.'*

In August 2002, the third consultation paper was published. It said that while States spending had been cut in the fundamental spending review process, '*…higher taxes and duties will still be necessary.*' This paper specifically warned of the likelihood of having to cut corporate tax to the zero rate.

The Committee sent a summary of these consultation papers to every household in the Island. In addition, meetings were held at all parish halls and there was an on-line consultation.

More recently, this Finance and Economics Committee published the fourth consultative paper, 'Facing Up To The Future' in which proposals for a new tax structure were clearly set out.

Again, there have been several public meetings, an on-line consultation and presentations to any group which requested one.

During the last 3 years, approximately 500 written responses have been submitted by members of the community to these consultation documents.

All these consultation documents have been supported by detailed economic research, which has guided successive Committees and directed the formulation of the proposals in this Report. It is clear that successive Finance and Economics Committees have indeed consulted widely. It is hard to imagine what additional work could have been done which would have done more to explain the evolution of the tax proposals now before the States.

If the Island is serious about safeguarding its future prosperity; about ensuring that jobs will exist for our young people, and about ensuring that it will in future be able to support the less able members of our community, it is time to make decisions.

Once decisions on the principles have been made, it will then be necessary to start talking again about the detail.

APPENDIX 2

DISTRIBUTIONAL CONSEQUENCES OF DIFFERENT TAX OPTIONS

This Appendix shows the approximate distributional consequences of using different tax structures to generate the same level of revenue. Seven family types are modelled, using 5 different tax structures, and the distributional information is displayed in 4 different ways. The relevant parameters are as follows.

Family types

• Single person, no children, no mortgage	Section A
• Single person with child, no mortgage	Section B
• Single person with child and a mortgage of £120,000	Section C
• Couple, no children, no mortgage	Section D
• Couple with two children, no mortgage	Section E
• Couple with two children and a mortgage of £120,000	Section F
• Couple with two children and a mortgage of £300,000	Section G

Tax structures

- The Committee’s proposal: GST 5%, 20% means 20%
- A higher rate of tax of 35%, introduced after a taxable income of £13,000
- An income tax rate of 25% and a reduction in personal allowances/exemptions of approximately 40%
- Employee payroll tax of 5.2%, with a ceiling of £30,000 per annum
- Employee payroll tax of 4%, applied to all earned income

Information displayed

Information is given for household incomes up to £250,000 p.a.

• The average effective tax rate: both the current level and the level under each option	Graphs 1-5
• The increase from the current level of the average effective tax rate	Graphs 6-9
• The increase (in £) paid from the current level	Graphs 10-13
• The additional taxes to be paid, expressed as a percentage of disposable income (i.e., after the existing income tax and social contributions have been taken into account)	Graphs 13-17.

Notes

It has been assumed that I.T.I.S. will be introduced under all tax structure. As this will not make any difference to the *relative* distribution of the tax burden of the options, it has not been modelled in this Appendix.

No examples are given of using employers’ payroll taxes. This is because the impact of such a tax would manifest itself in an increase in the costs of doing business in Jersey, which would feed through into prices charged in Jersey and, to the extent possible, in Jersey’s export markets. Overall, the distributional impact will be similar to GST. However, unlike GST, the impact on prices will be influenced by the relative labour cost intensity of the *Jersey* production process – information that is not available for this analysis.

For the purposes of this Appendix, it has been assumed that all income is earned. For households with *unearned* income, the distributional impacts are the same under the first 3 tax structures. However, for the employee payroll tax structures (4 and 5), unearned income will not be subject to the tax. As a result, the increase in the total tax paid will be reduced in proportion to the unearned income received. If all income is unearned, no tax increase is experienced. This applies to all levels of gross income.

The results are set out by family type and then the type of information displayed. This is designed to make it as easy as possible to compare the effects of the different tax structures.

APPENDIX 2 GRAPHS

Section A: Single without children – average effective tax rates

Figure A1: Average effective tax rates

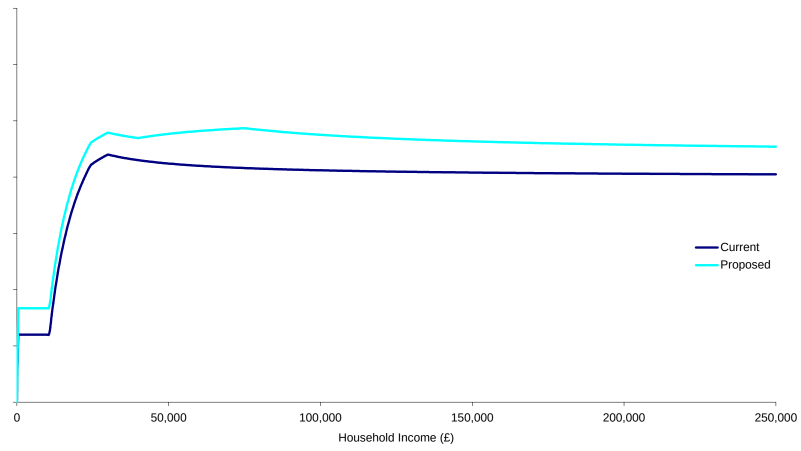


Figure A2: Ave

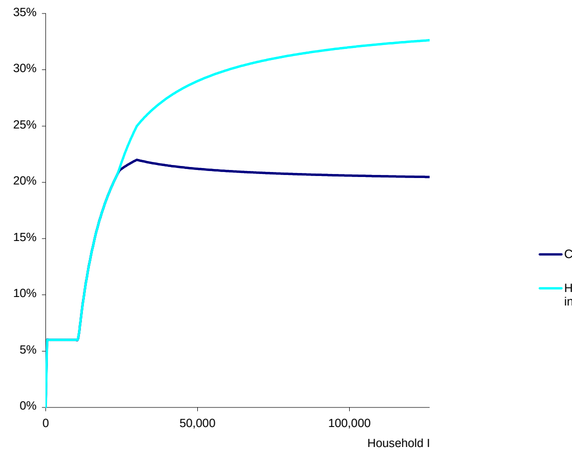
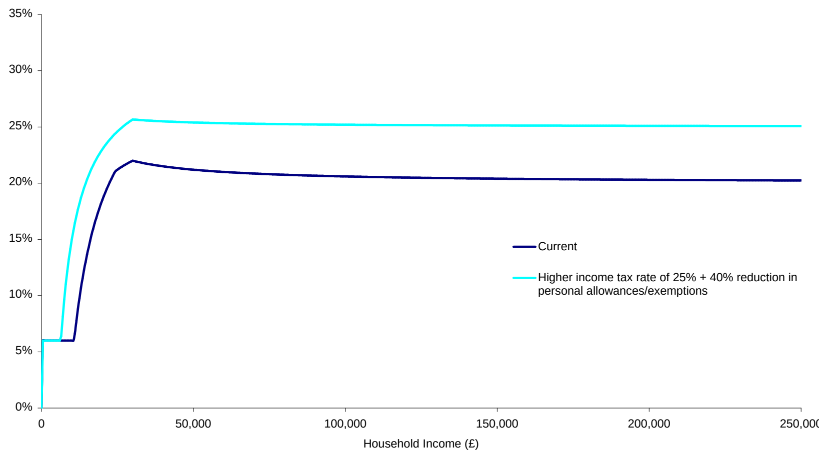


Figure A3: Average effective tax rates



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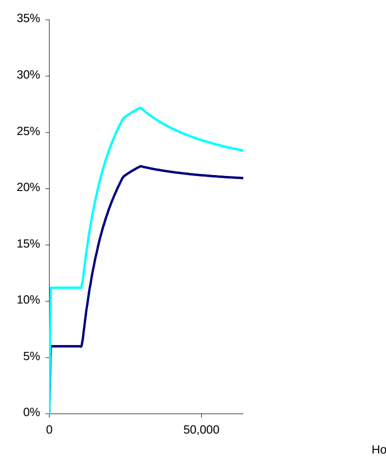
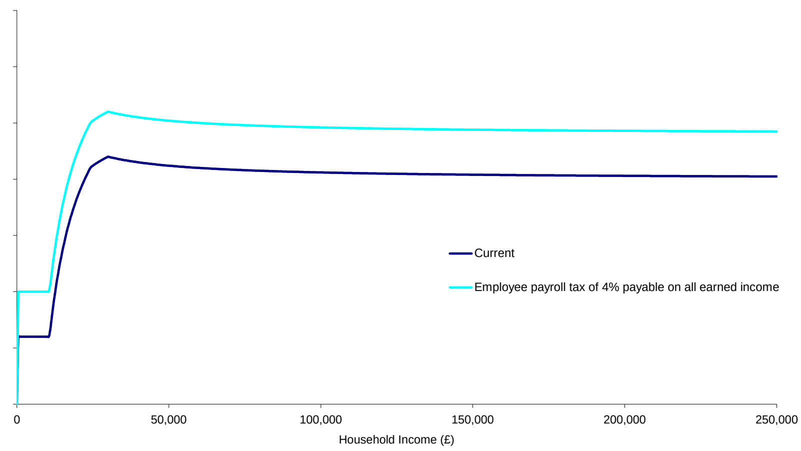


Figure A5: Average effective tax rates



Section A: Single without children – Increase in effective tax rates

Figure A6: Increase in effective tax rates

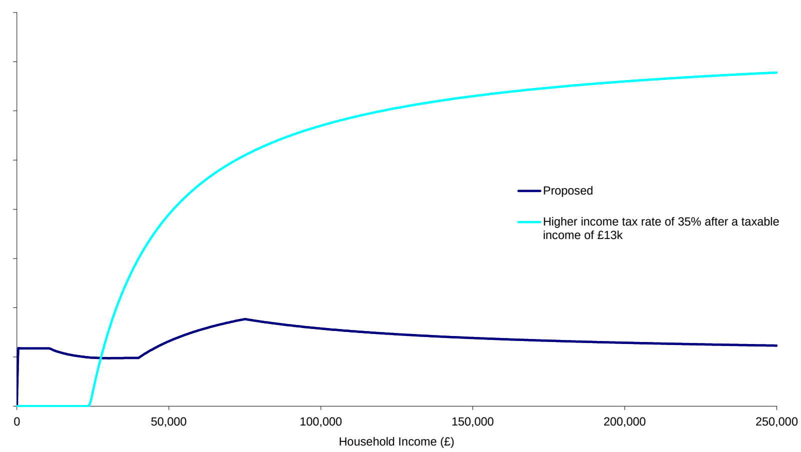


Figure A7

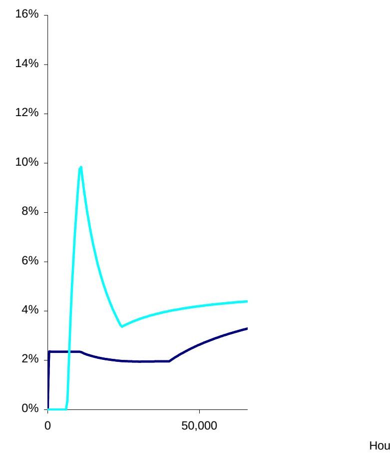


Figure A8: Increase in effective tax rates

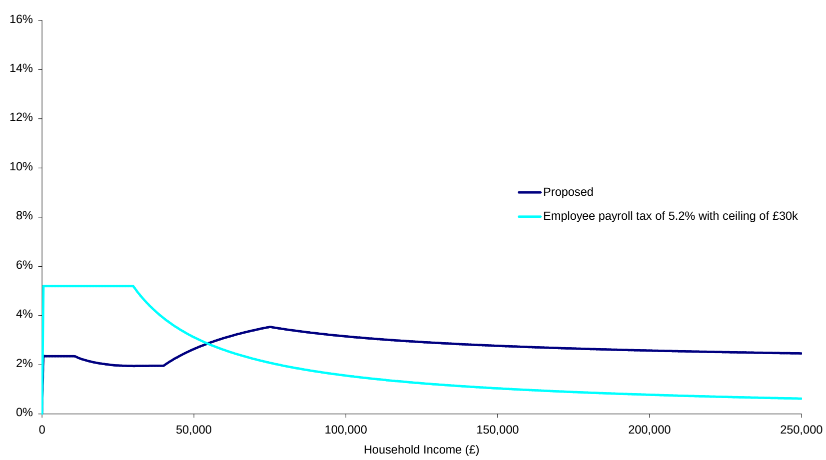
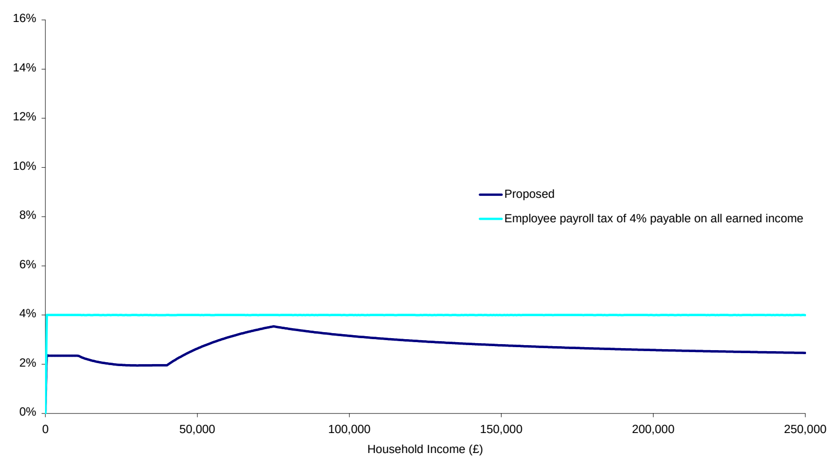
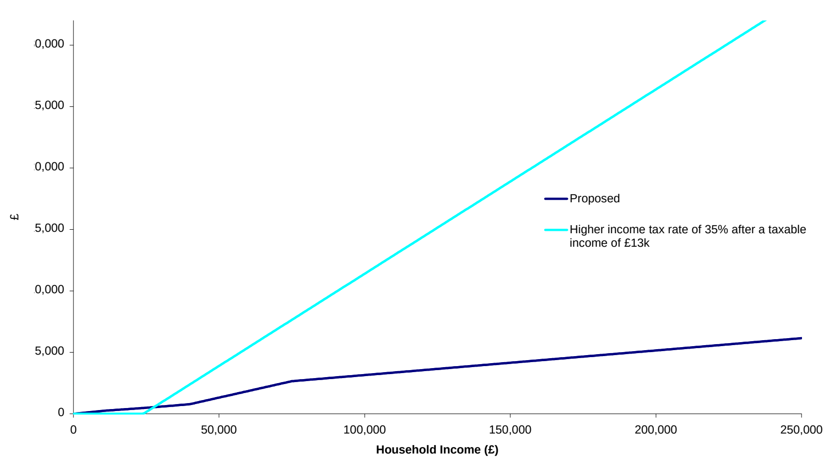


Figure A9: Increase in effective tax rates



Section A: Single without children – Increase in tax paid

Figure A10: Increase in tax paid



Figu

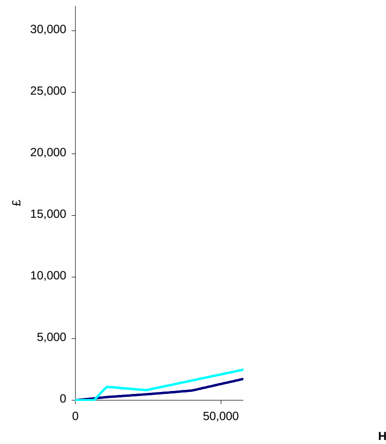


Figure A12: Increase in tax paid

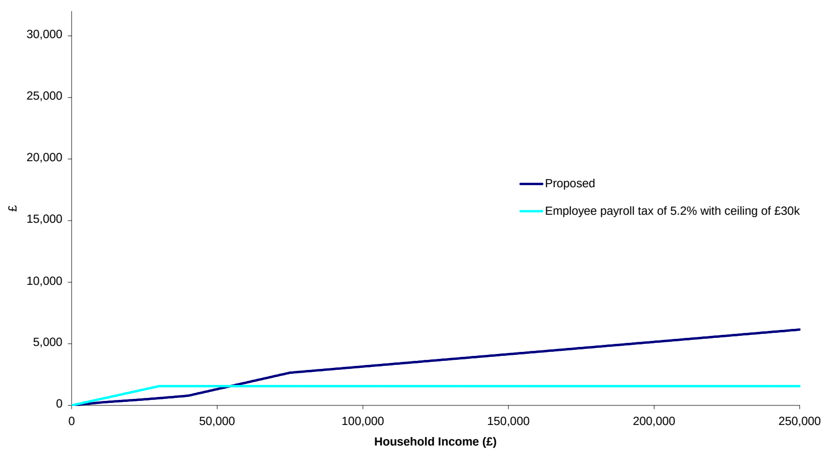
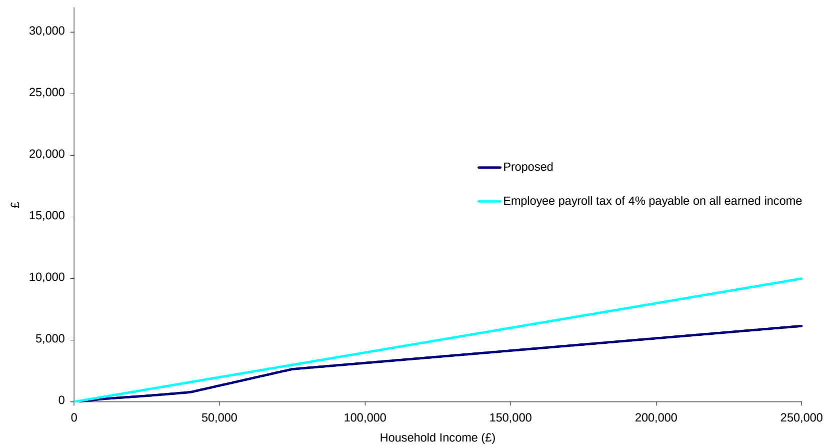


Figure A13: Increase in tax paid



Section A: Single without children – Increase in tax paid as a % of disposable income

Figure A14: Increase in tax paid as a % of disposable income

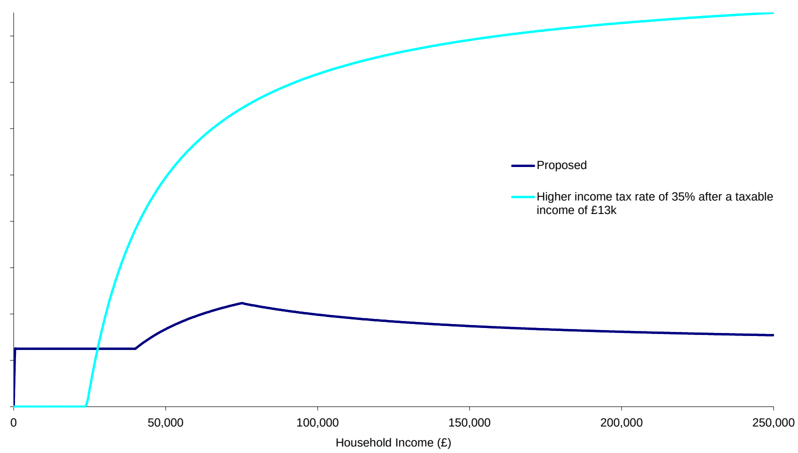


Figure A15: Increas

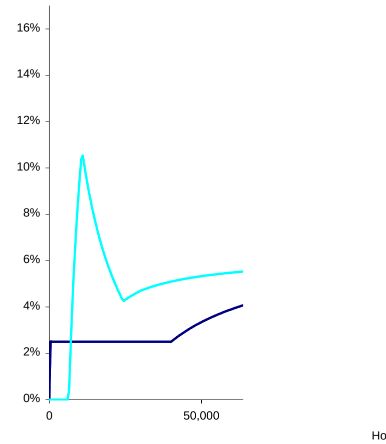


Figure A16: Increase in tax paid as a % of disposable income

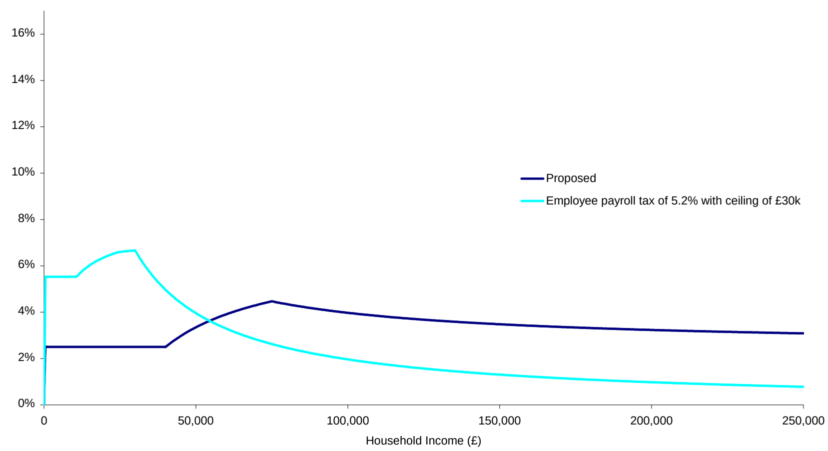
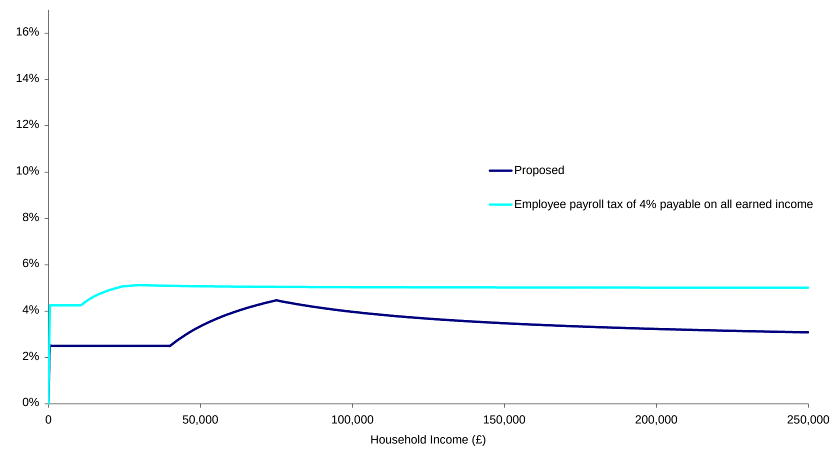


Figure A17: Increase in tax paid as a % of disposable income



Section B: Single with one child – Average effective tax rates

Figure B1: Average effective tax rates

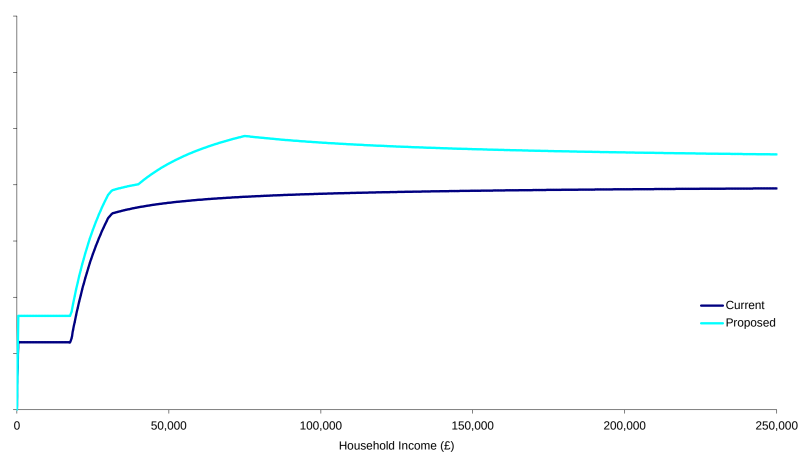


Figure B

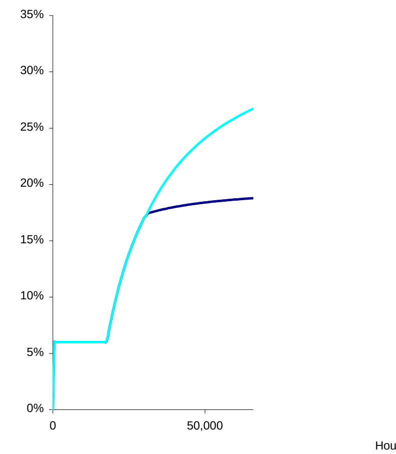


Figure B3: Average effective tax rates

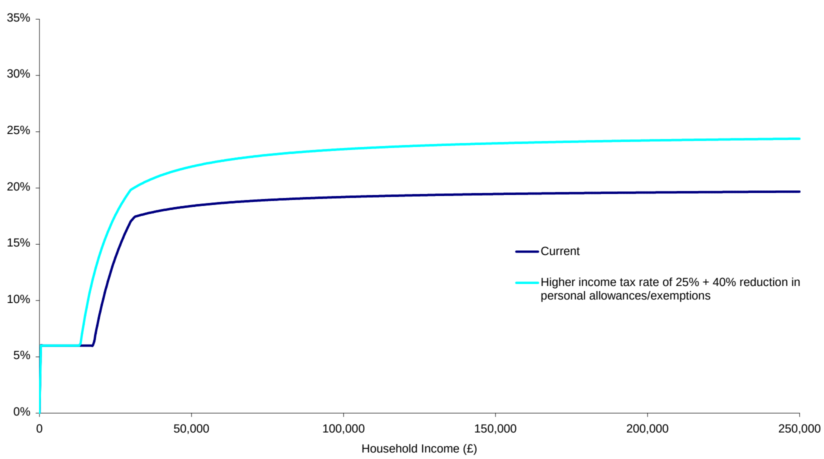


Figure B4: Average effective tax rates

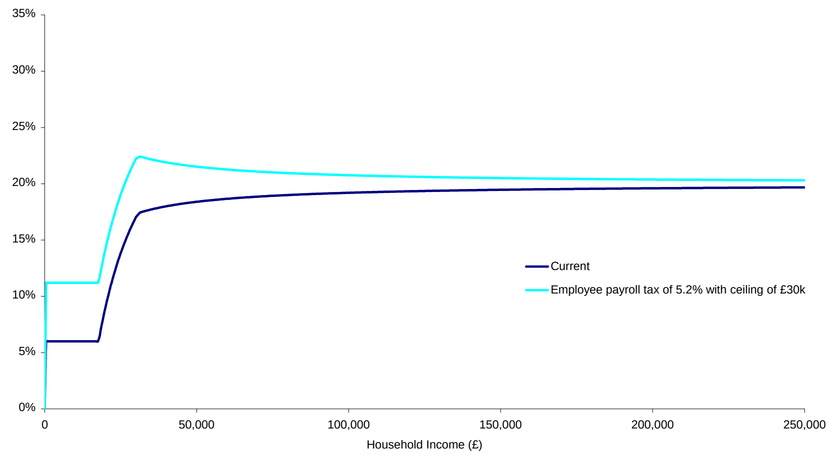
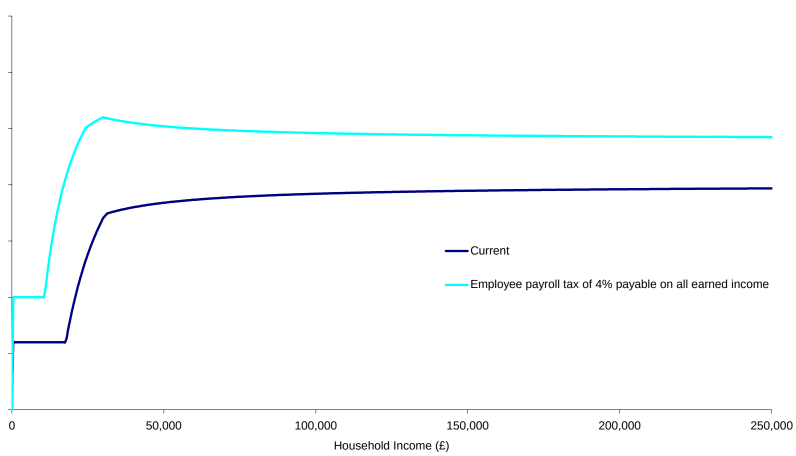


Figure B5: Average effective tax rates



Section B: Single with one child – Increase in effective tax rates

Figure B6: Increase in effective tax rates

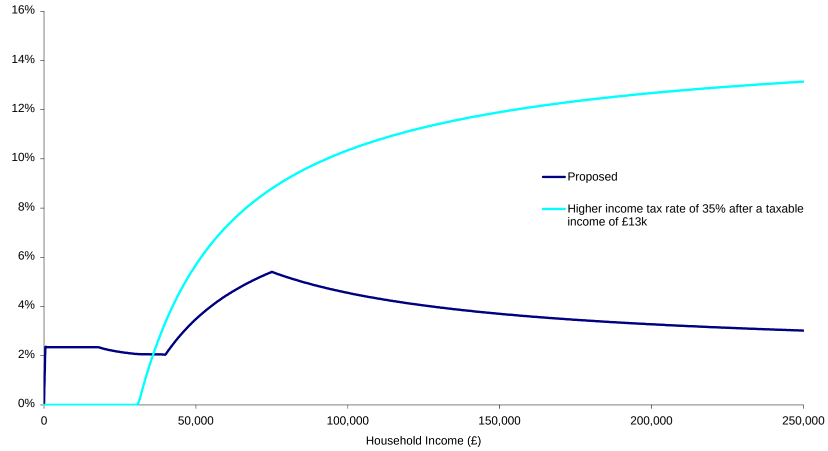


Figure B7

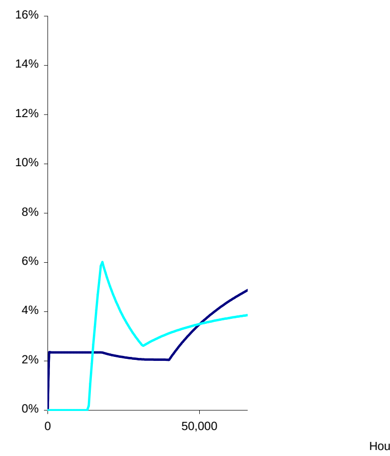


Figure B8: Increase in effective tax rates

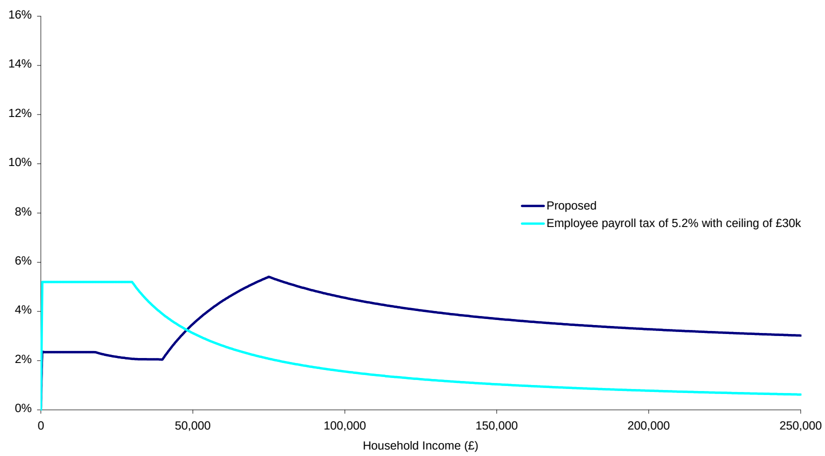
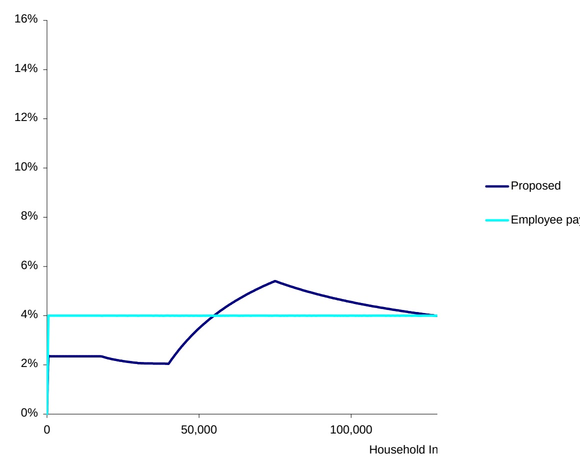
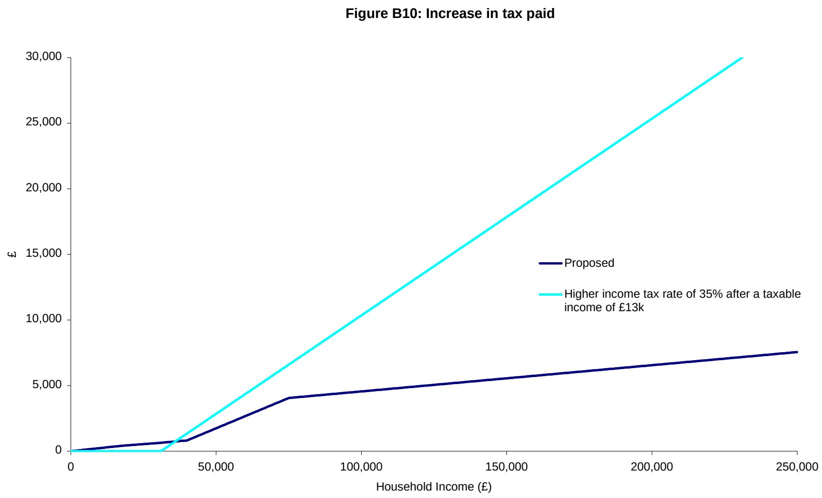


Figure B9: Increa



Section B: Single with one child – Increase in tax paid



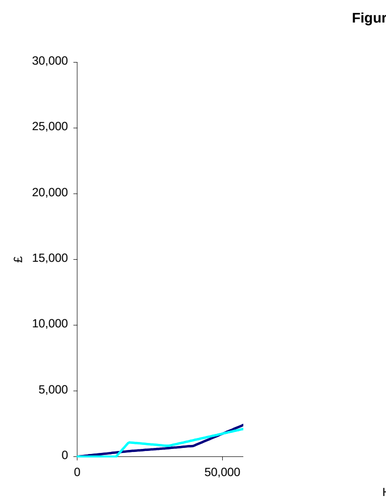
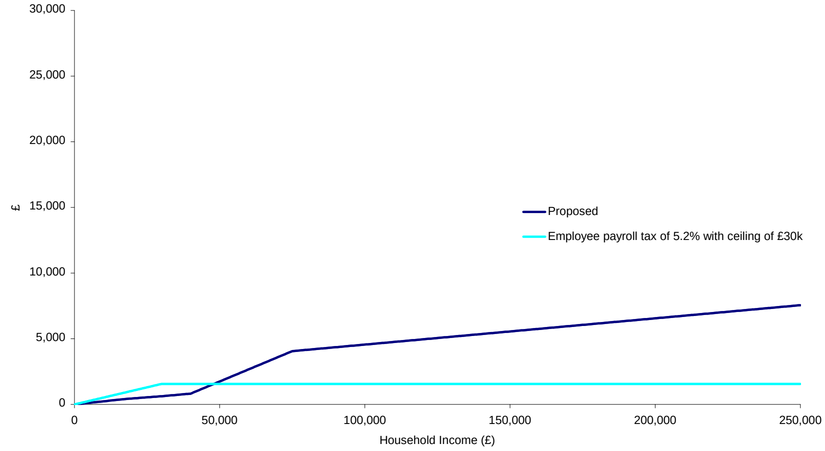


Figure B12: Increase in tax paid



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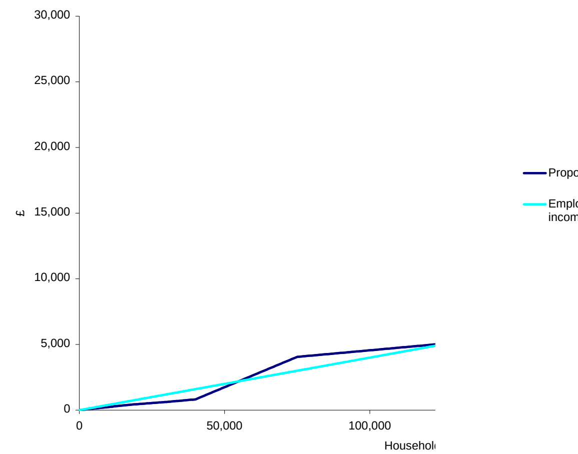
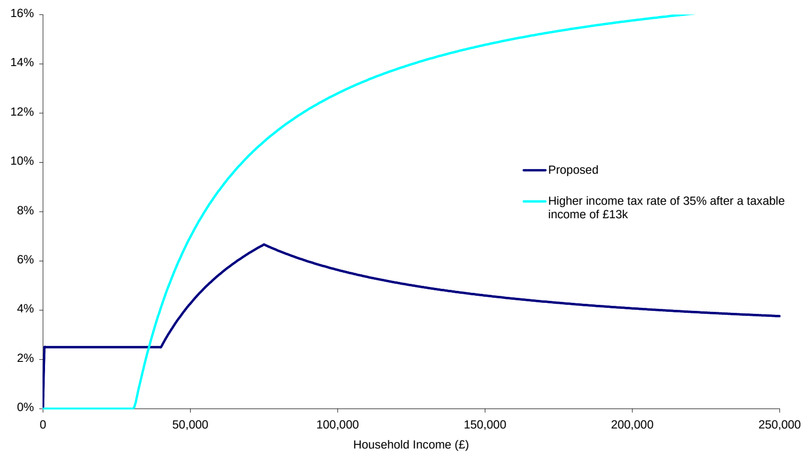


Section B: Single with one child – increase in tax paid as a % of disposable income

Figure B14: Increase in tax paid as a % of disposable income



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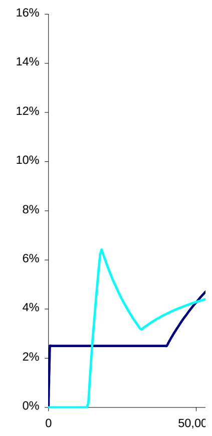


Figure B16: Increase in tax paid as a % of disposable income

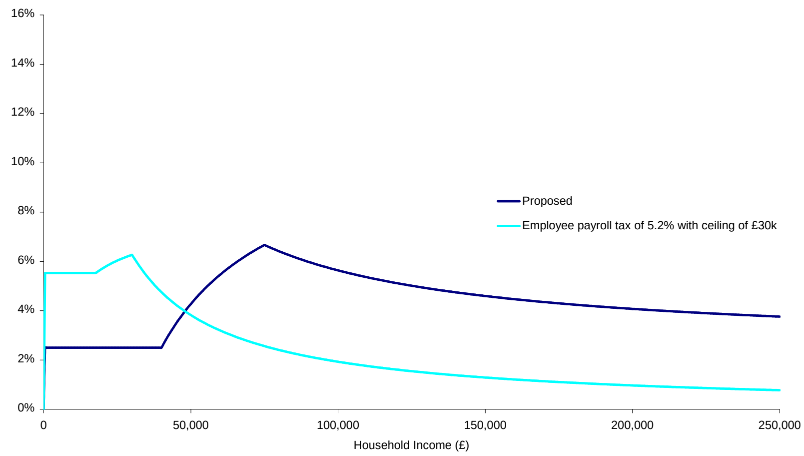
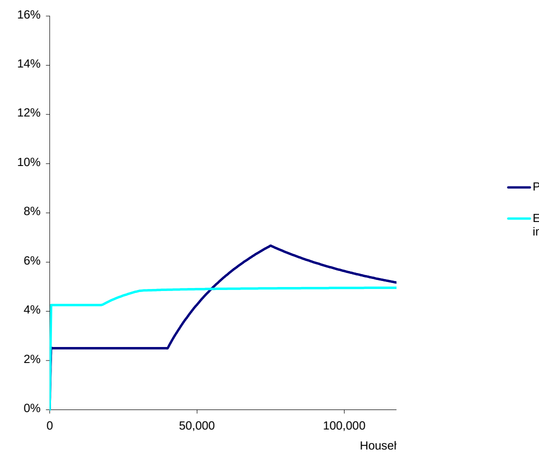
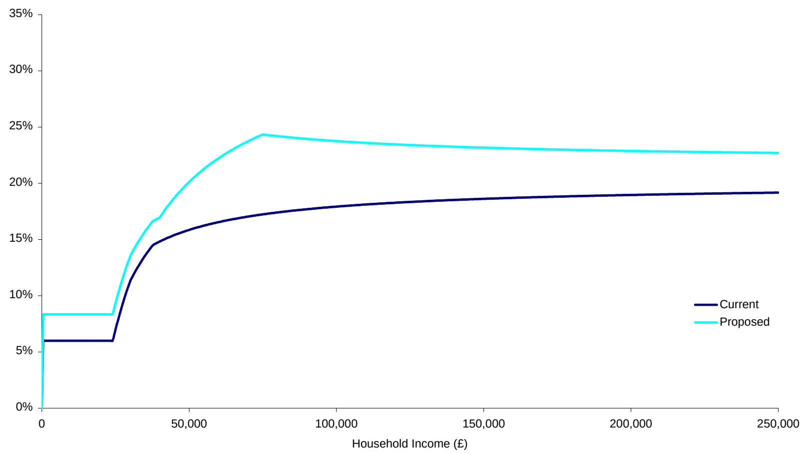


Figure B17: Increase in



Section C: Single with one child and a mortgage of £120k – Average effective tax rates

Figure C1: Average effective tax rates



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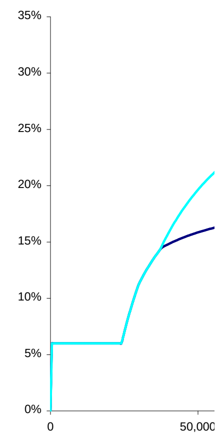


Figure C3: Average effective tax rates

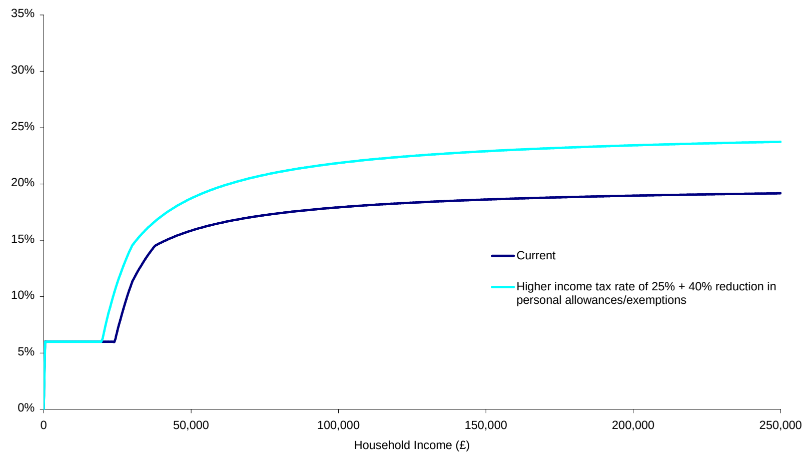


Figure C4: A

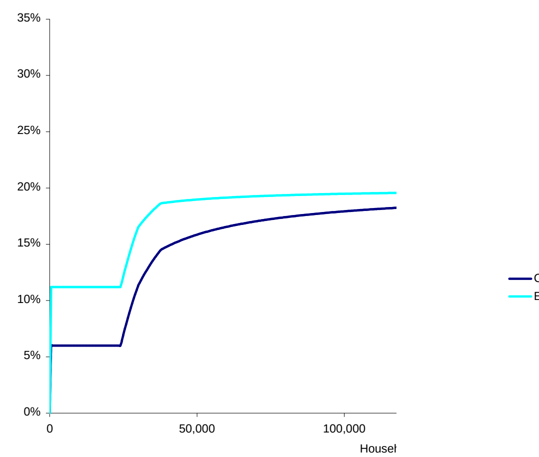
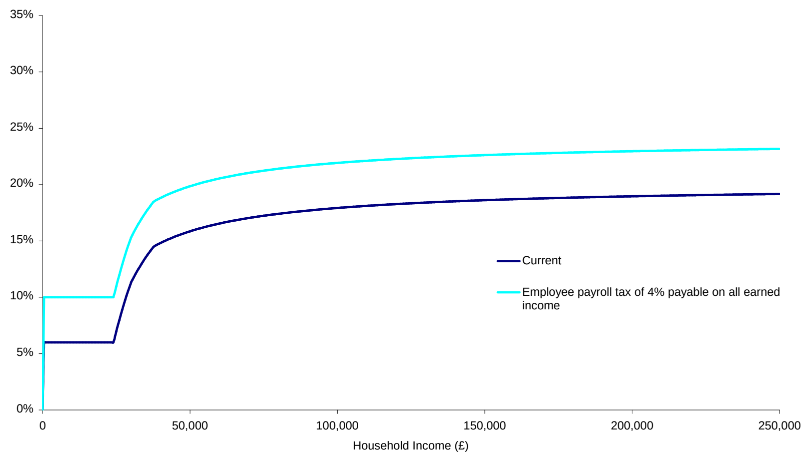


Figure C5: Average effective tax rates



Section C: Single with one child and a mortgage of £120k – Increase in effective tax rates

Figure C6: Increase in effective tax rates

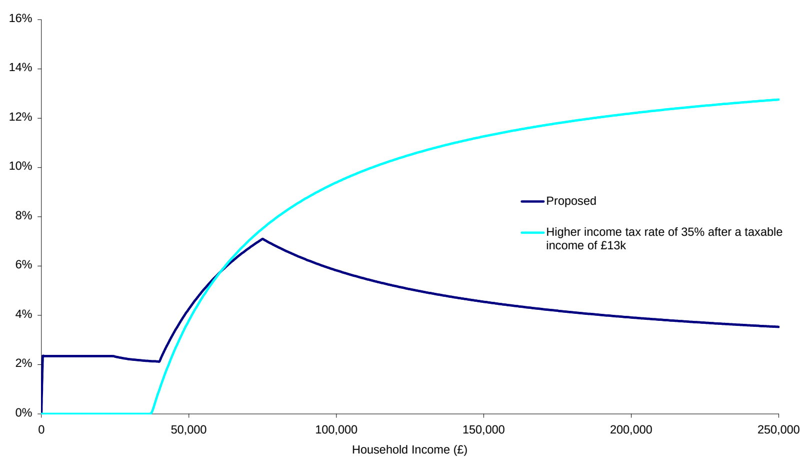


Figure C7: Inc

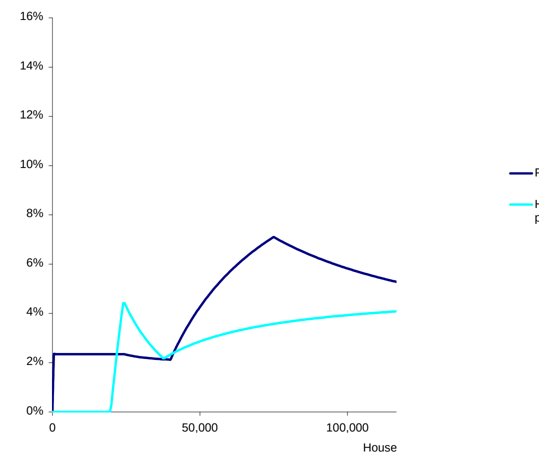


Figure C8: Increase in effective tax rates

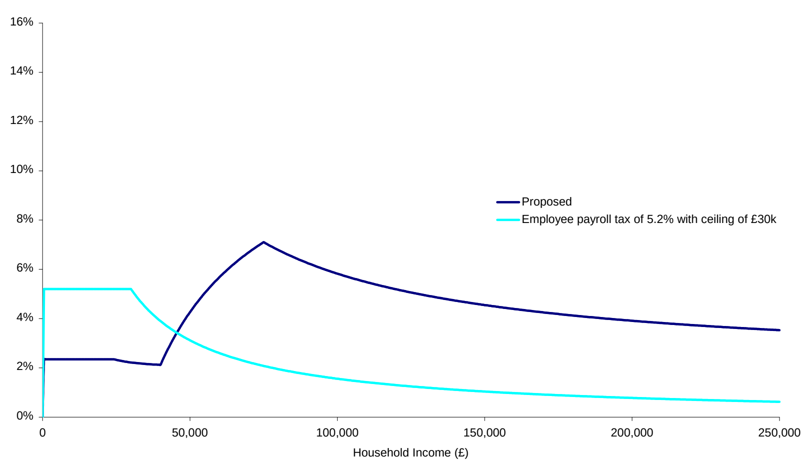
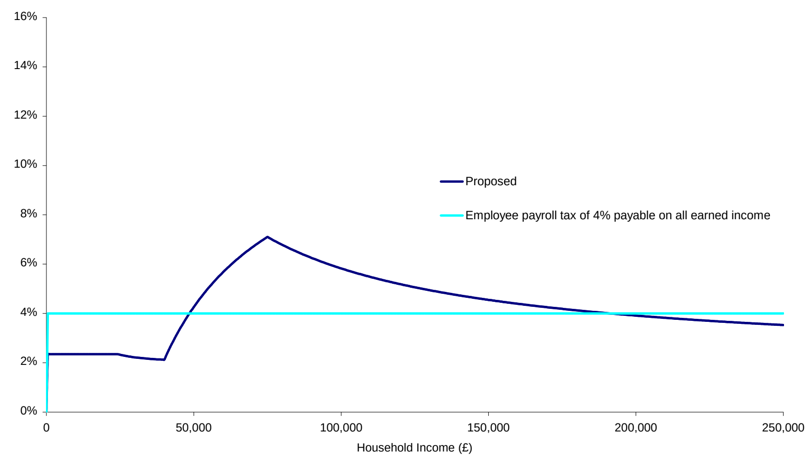


Figure C9: Increase in effective tax rates



Section C: Single with one child and a mortgage of £120k – Increase in tax paid

Figure C10: Increase in tax paid

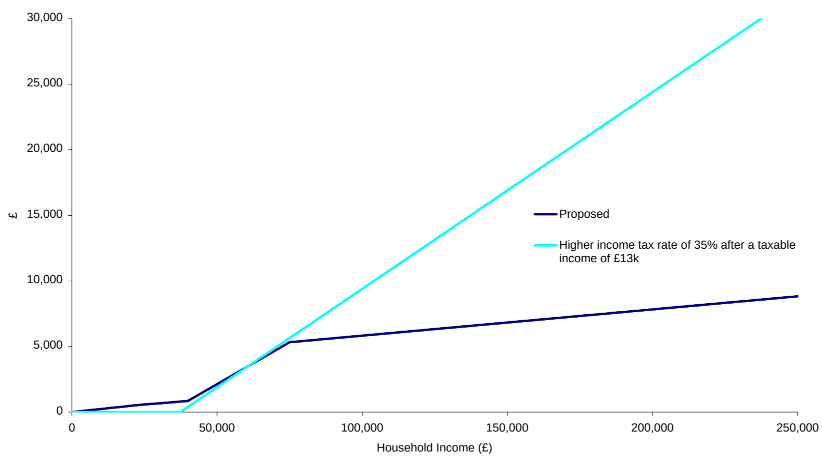


Figure C1

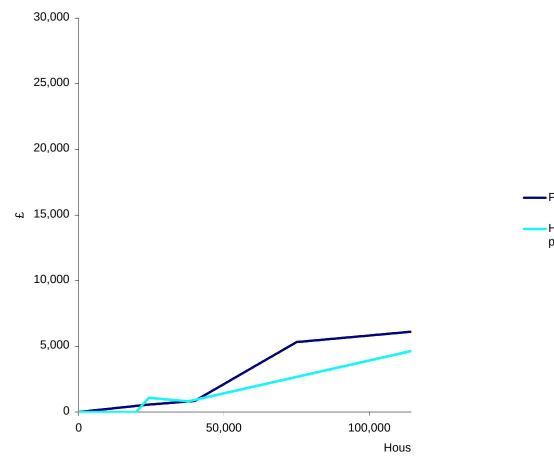


Figure C12: Increase in tax paid

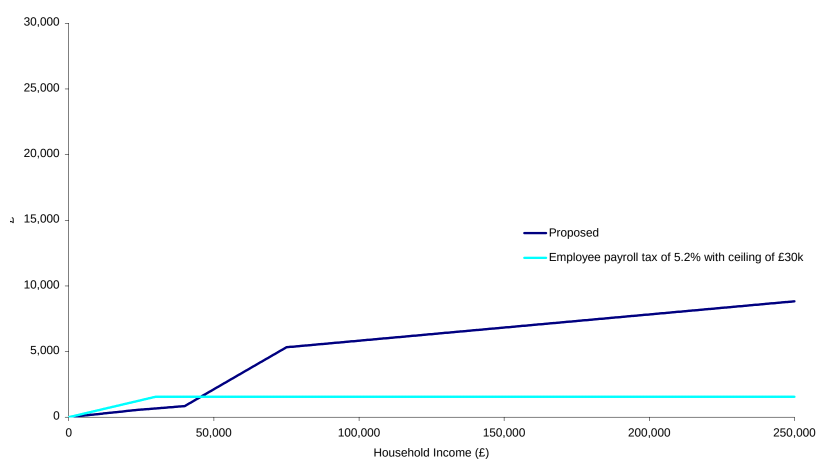
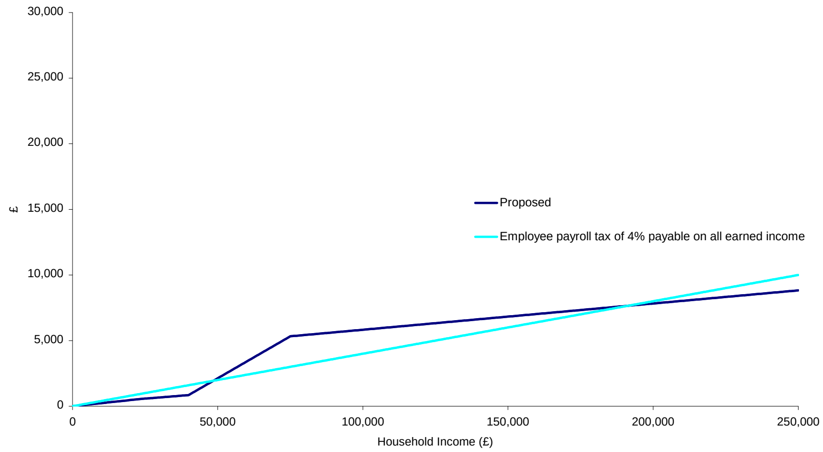


Figure C13: Increase in tax paid



Section C: Single with one child and a mortgage of £120k – Increase in tax paid as a % of disposable income

Figure C14: Increase in tax paid as a % of disposable income

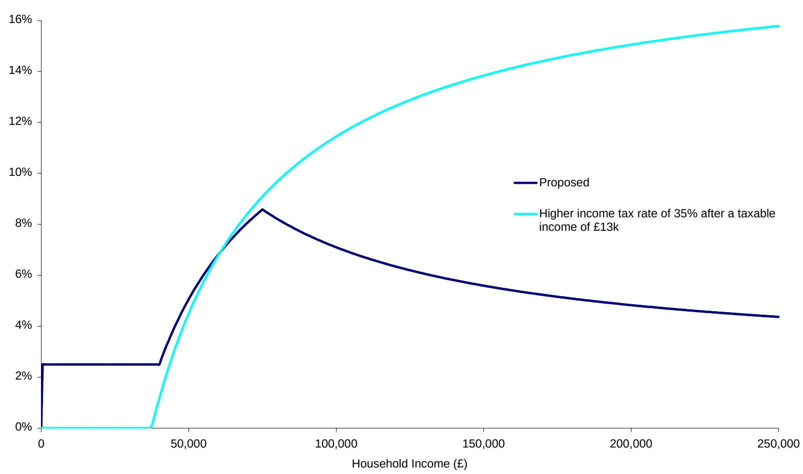


Figure C15: Increase in

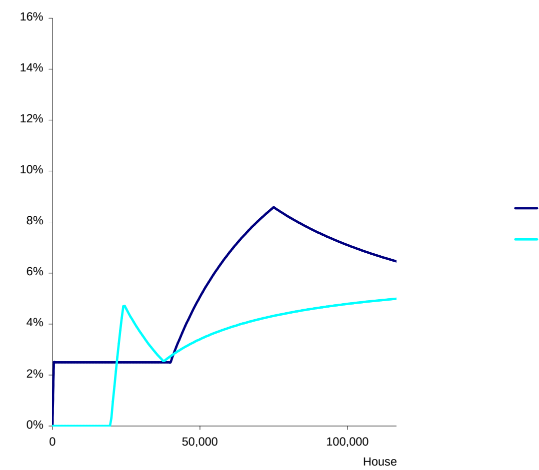


Figure C16: Increase in tax paid as a % of disposable income

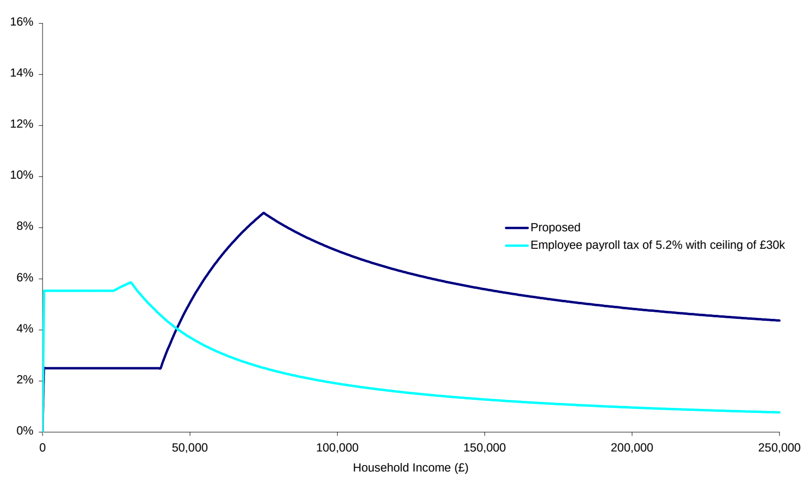
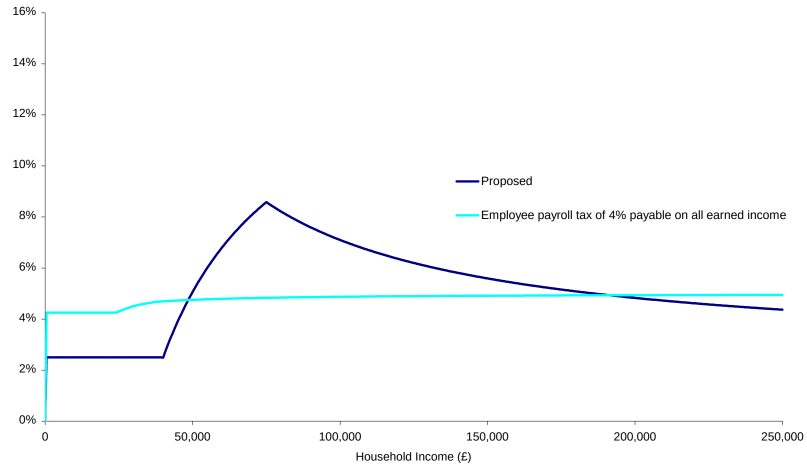


Figure C17: Increase in tax paid as a % of disposable income



Section D: Married couple without children – Average effective tax rates

Figure D1: Average effective tax rates

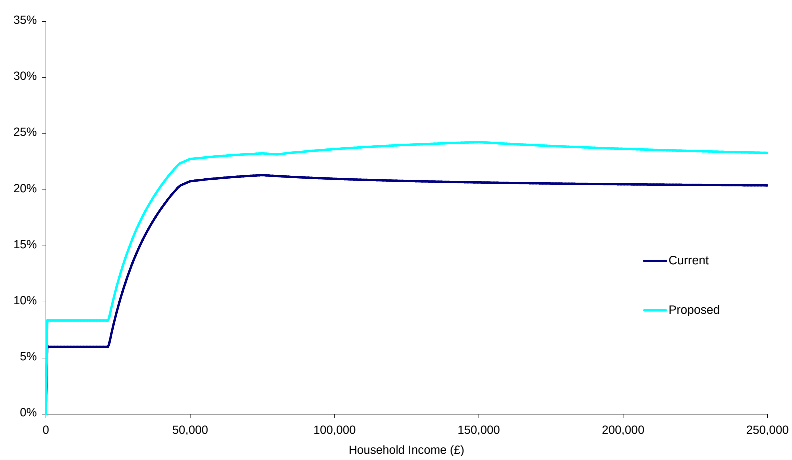


Figure D2: Av

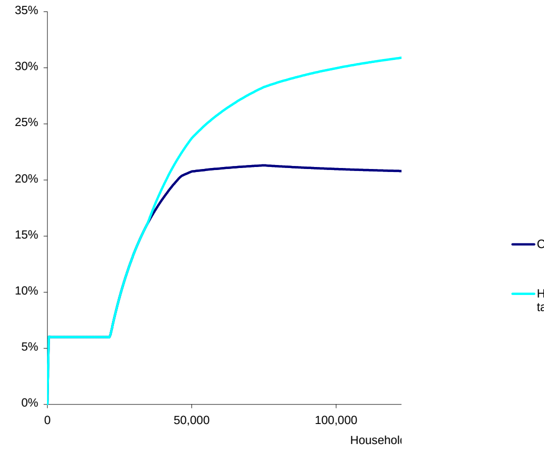


Figure D3: Average effective tax rates

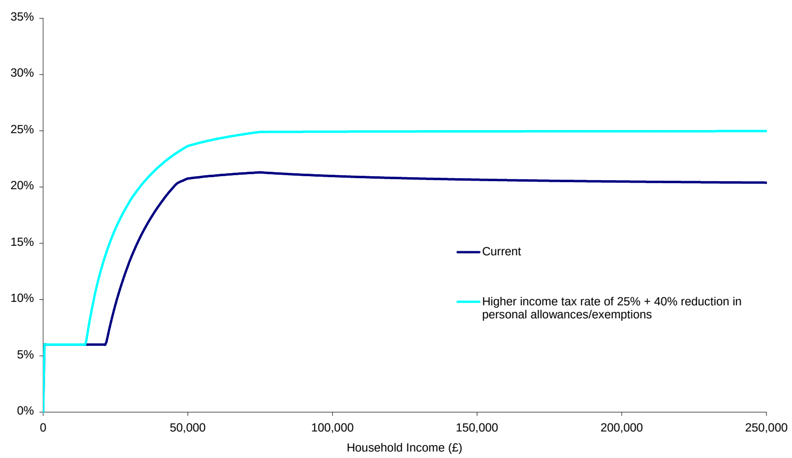


Figure D4: Average effective tax rates

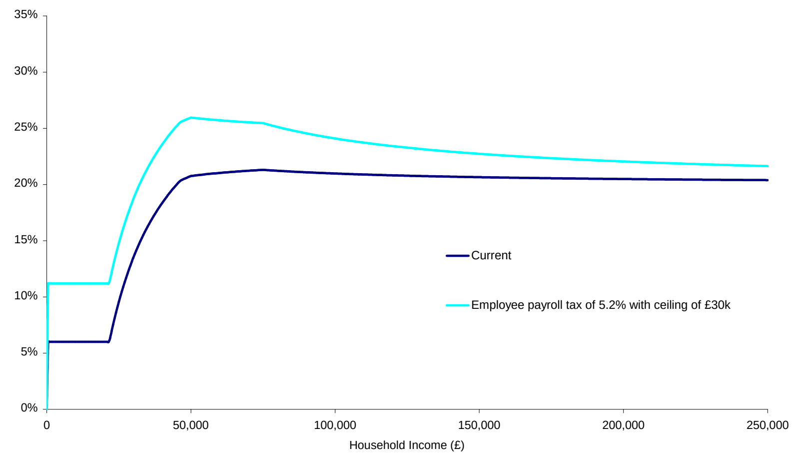
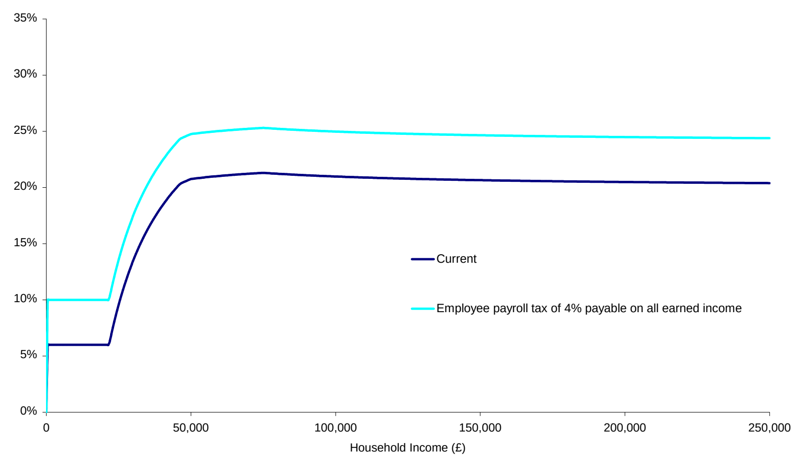


Figure D5: Average effective tax rates



Section D: Married couple without children – Increase in effective tax rates

Figure D6: Increase in effective tax rates

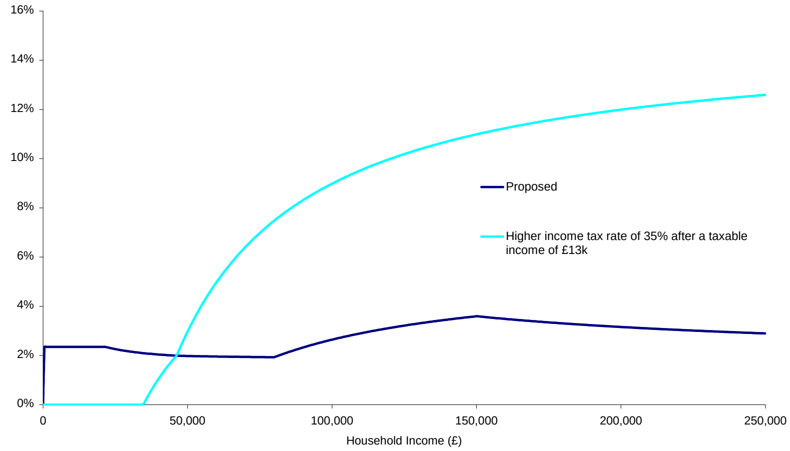


Figure D7: Inc

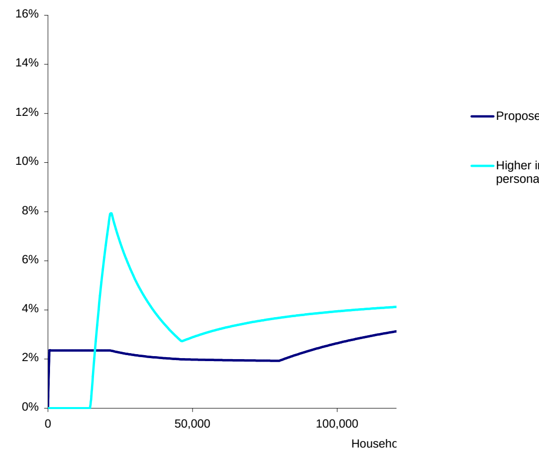
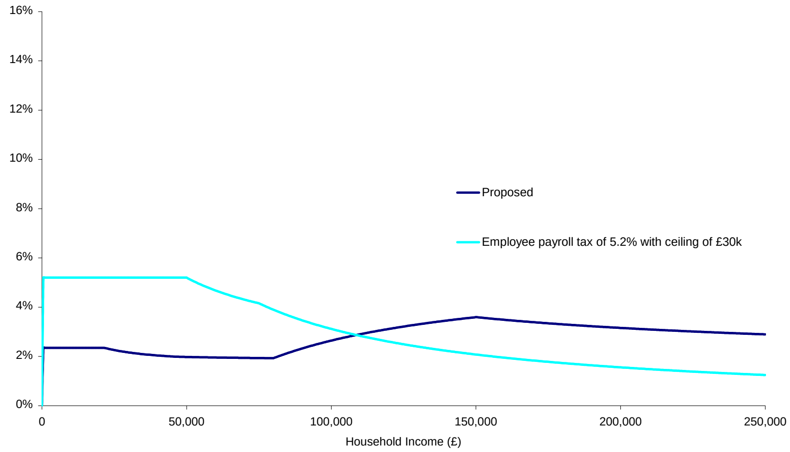
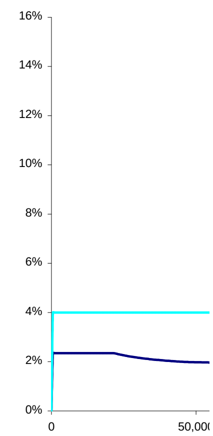


Figure D8: Increase in effective tax rates



Figure



Section D: Married couple without children – Increase in tax paid

Figure D10: Increase in tax paid

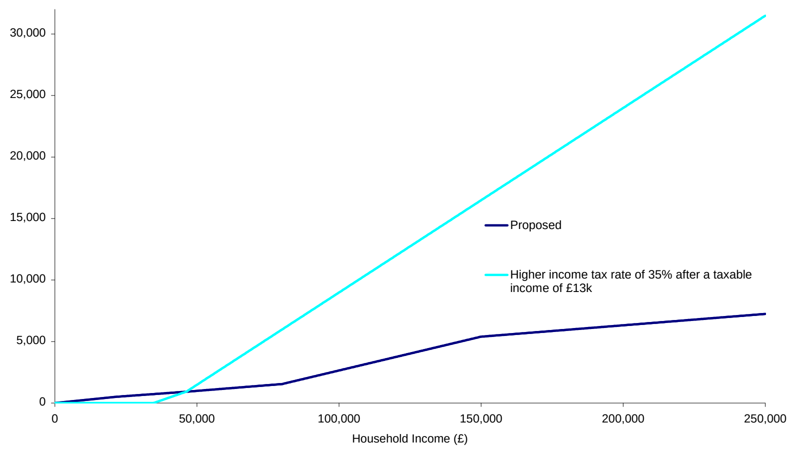


Figure D1

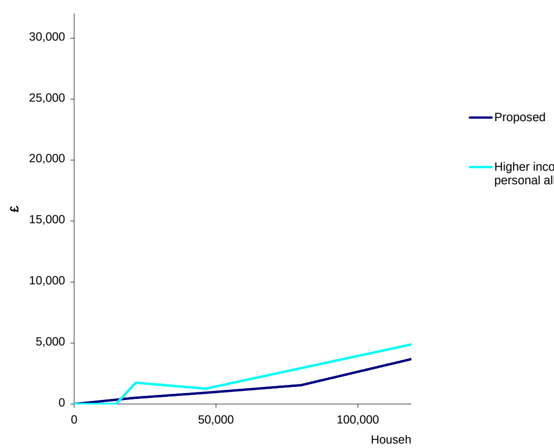
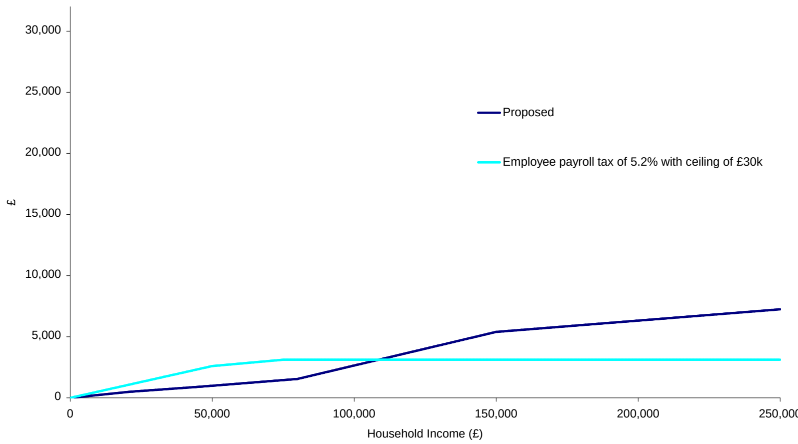


Figure D12: Increase in tax paid



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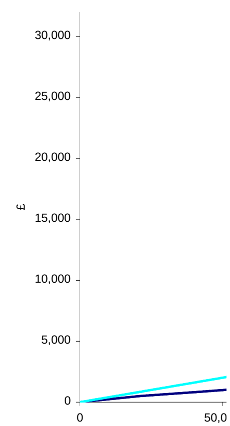


Section D: Married couple without children – Increase in tax paid as % of disposable income

Figure D14: Increase in tax paid as a % of disposable income

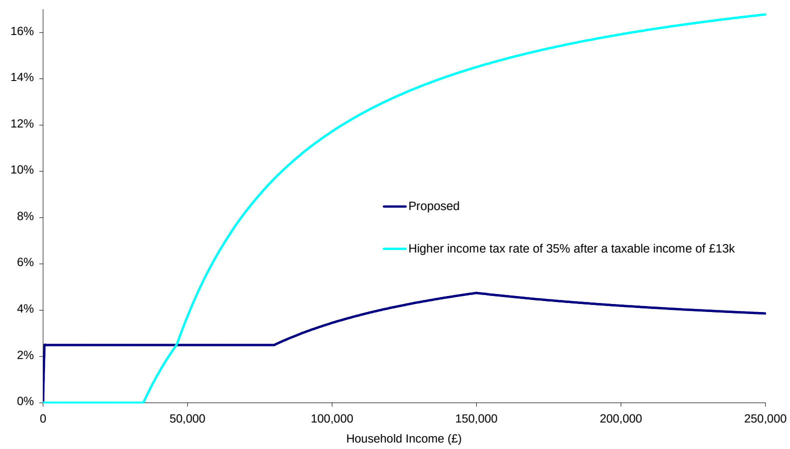
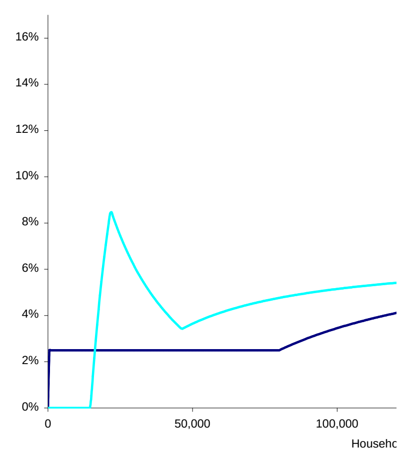


Figure D15: Increase in



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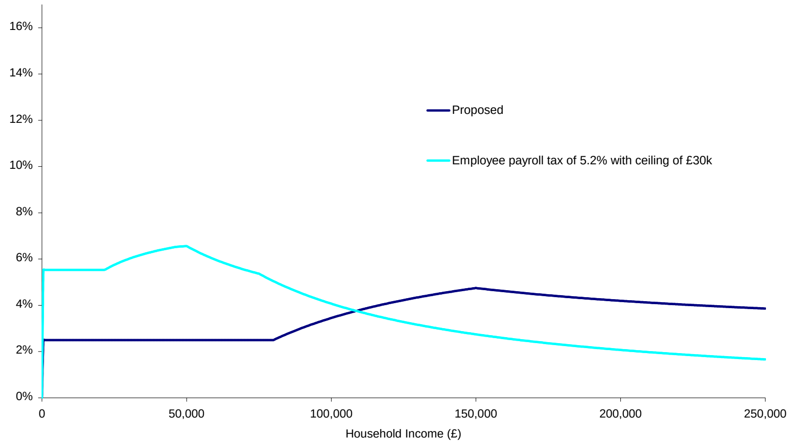

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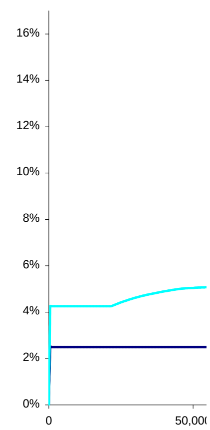
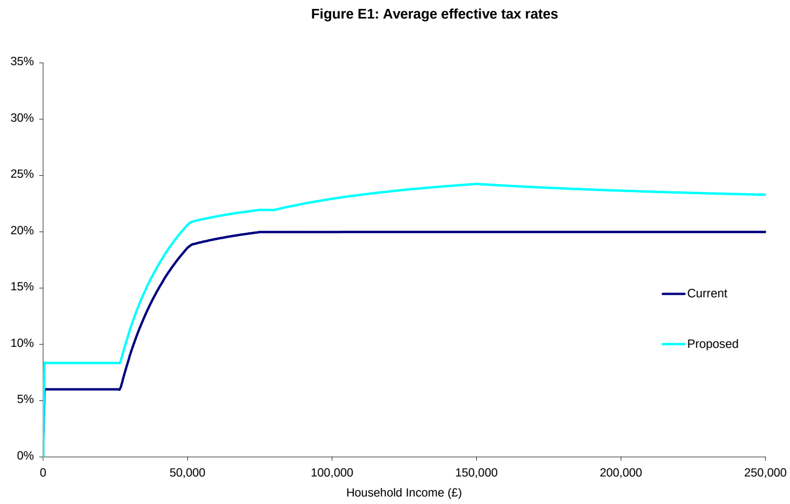


Section E: Married couple with 2 children – Average effective tax rates



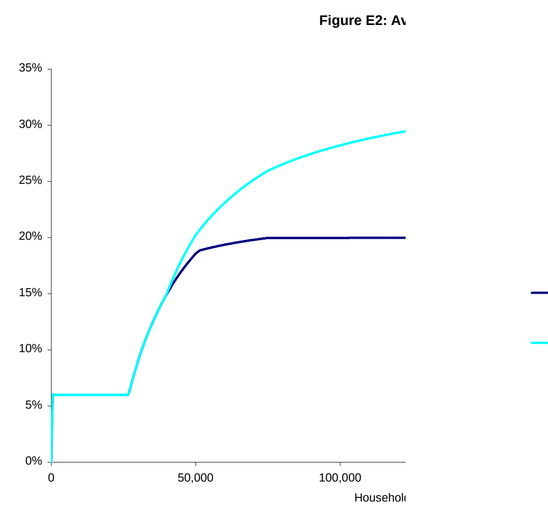
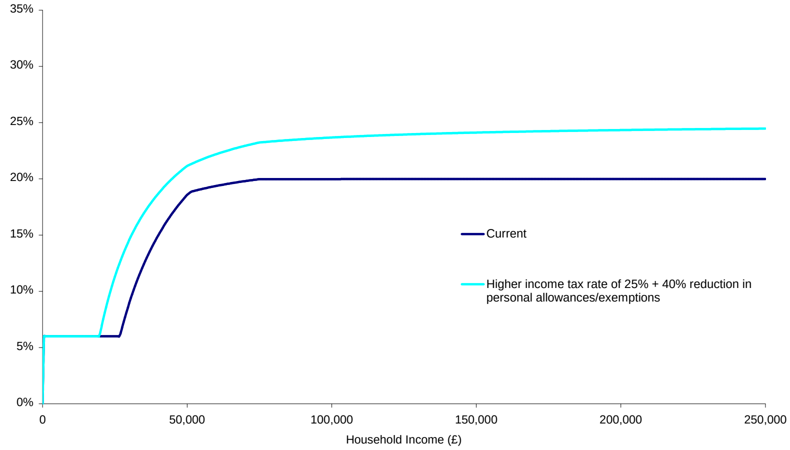


Figure E3: Average effective tax rates



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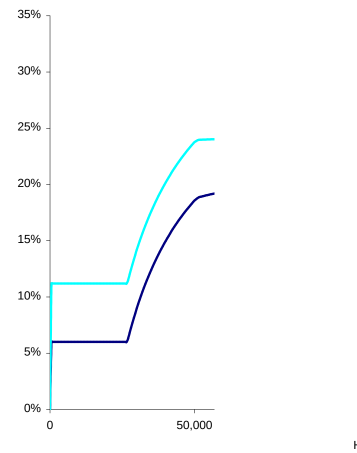
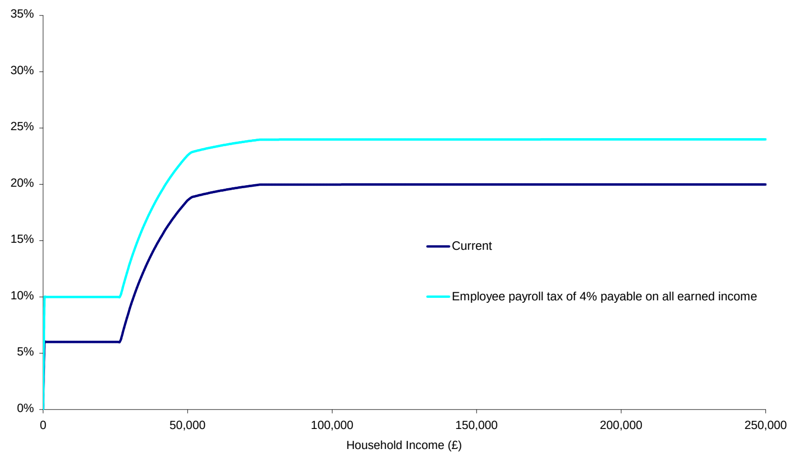
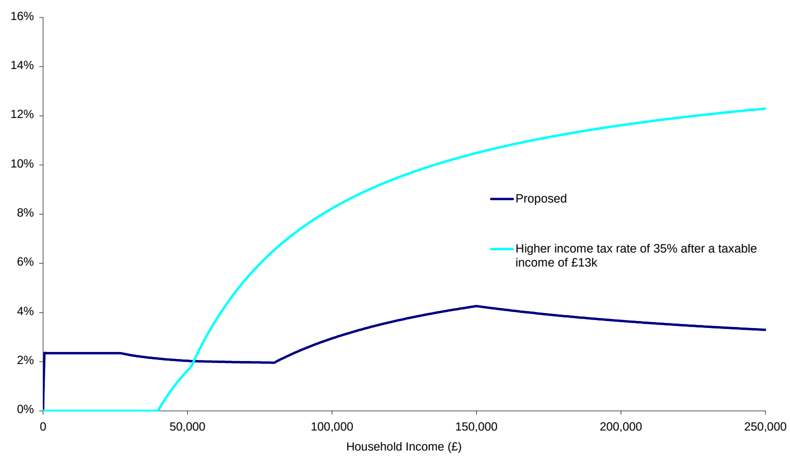


Figure E5: Average effective tax rates



Section E: Married couple with 2 children – Increase in effective tax rates

Figure E6: Increase in effective tax rates



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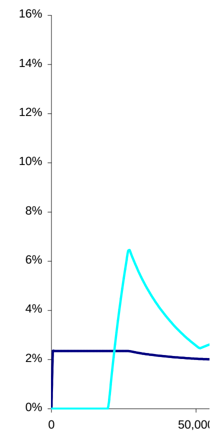

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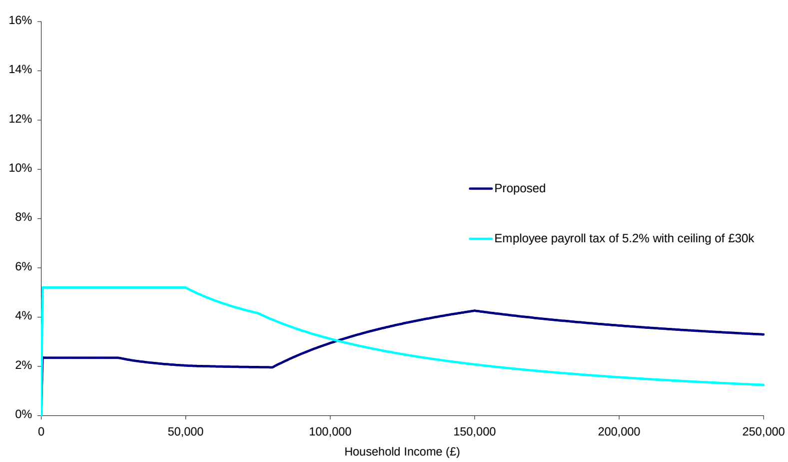
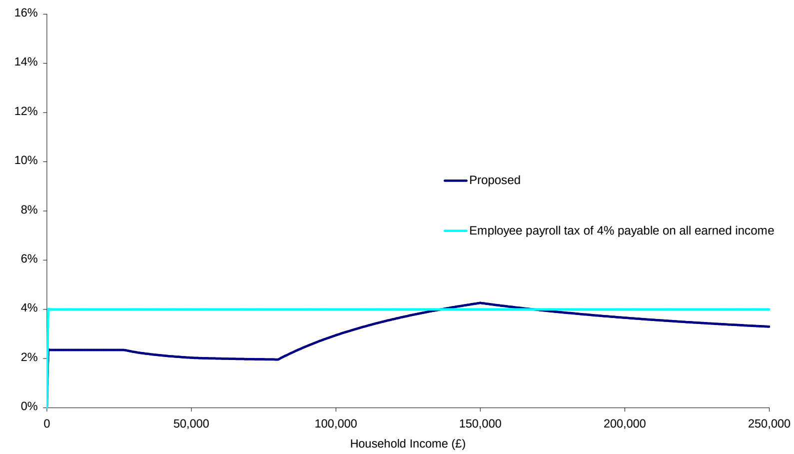
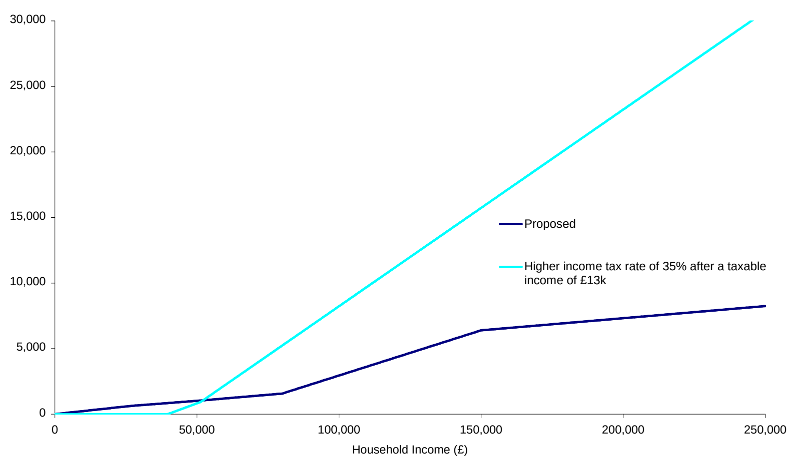


Figure E9: Increase in effective tax rates



Section E: Married couple with 2 children – Increase in tax paid

Figure E10: Increase in tax paid



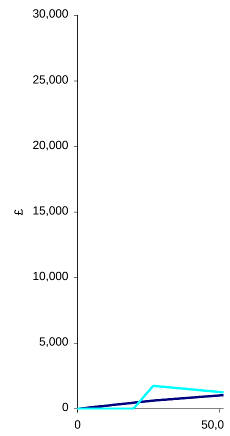


Figure E12: Increase in tax paid

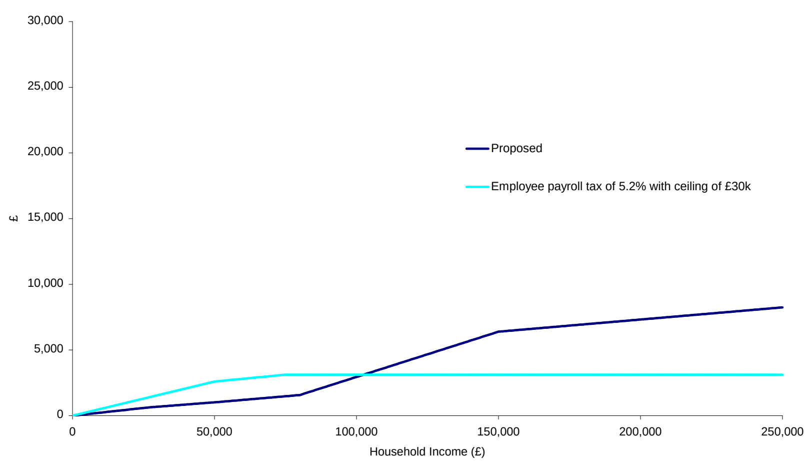
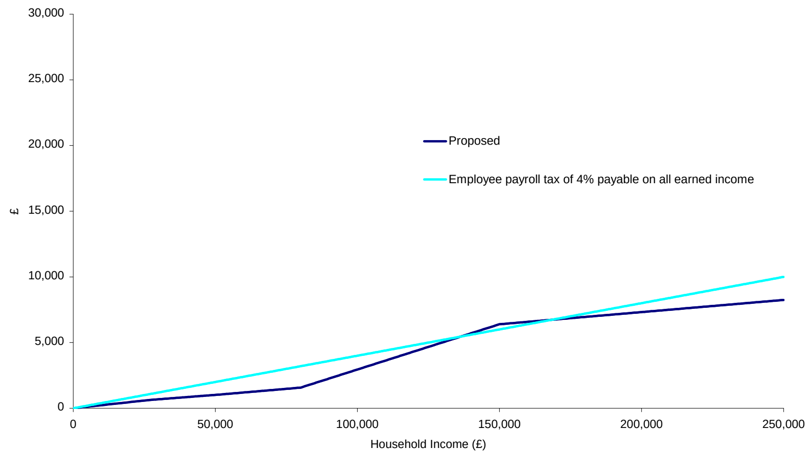
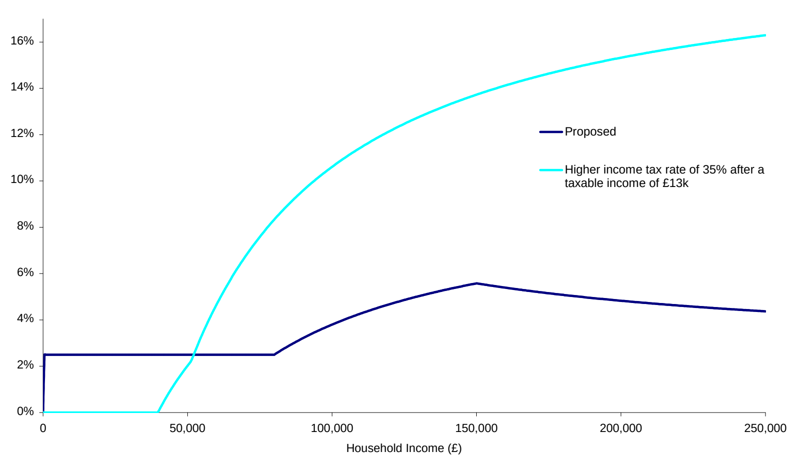


Figure E13: Increase in tax paid



Section E: Married couple with 2 children – Increase in tax paid as a % of disposable income

Figure E14: Increase in tax paid as a % of disposable income



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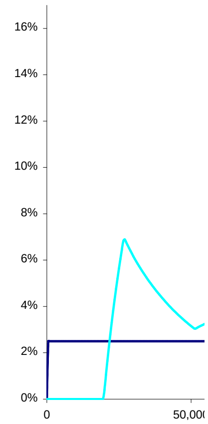


Figure E16: Increase in tax paid as a % of disposable income

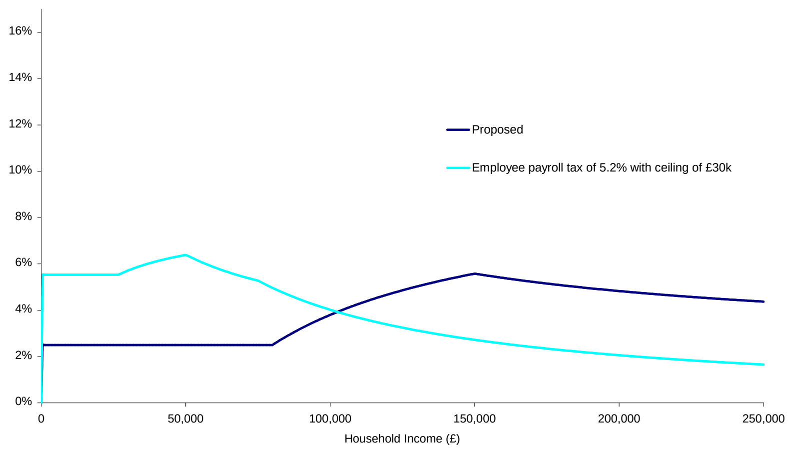
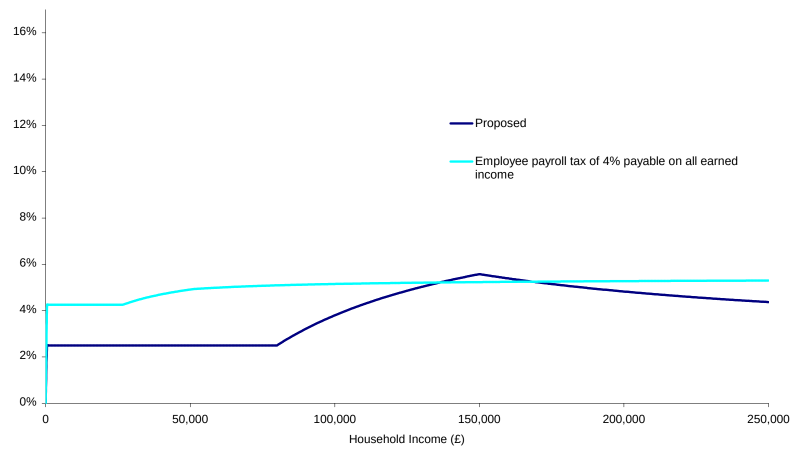
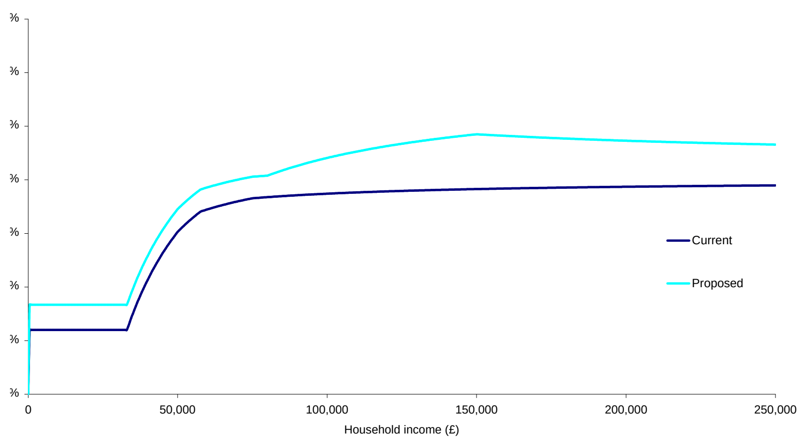


Figure E17: Increase in tax paid as a % of disposable income



Section F: Married couple with 2 children and a mortgage of £120k – Average effective tax rates

Figure F1: Average effective tax rates



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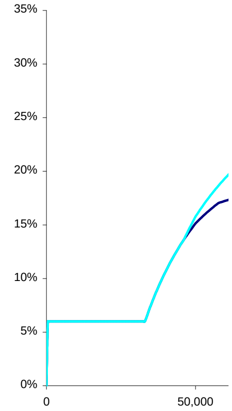

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Figure F3: Average effective tax rates

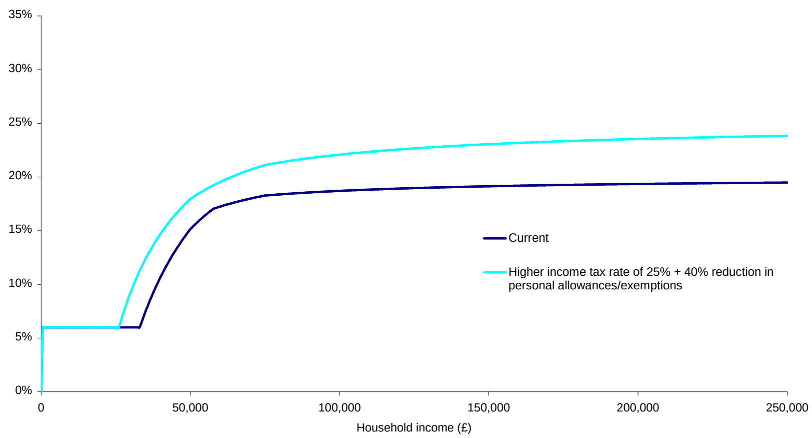


Figure F4: Average effective tax rates

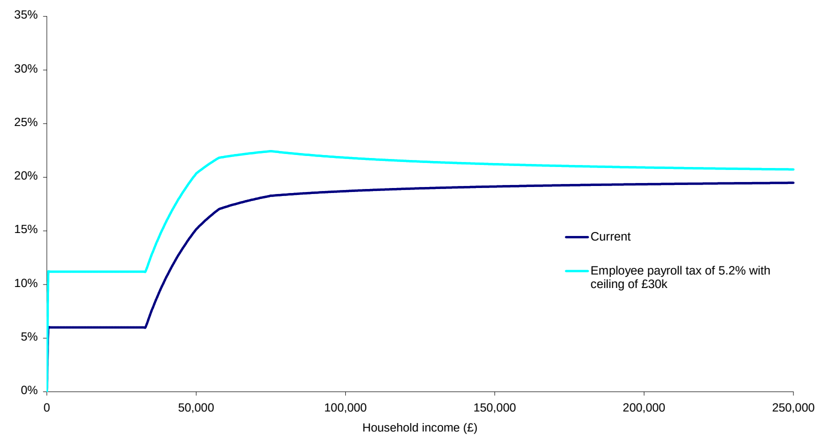
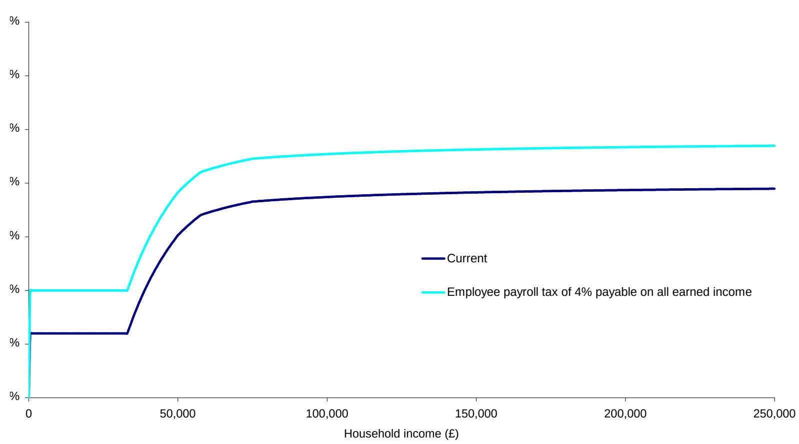
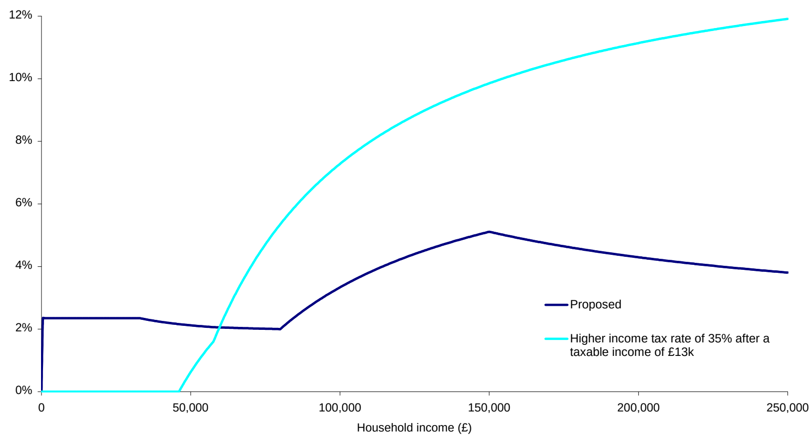


Figure F5: Average effective tax rates



Section F: Married couple with 2 children and a mortgage of £120k – Increase in effective tax rates

Figure F6: Increase in effective tax rates



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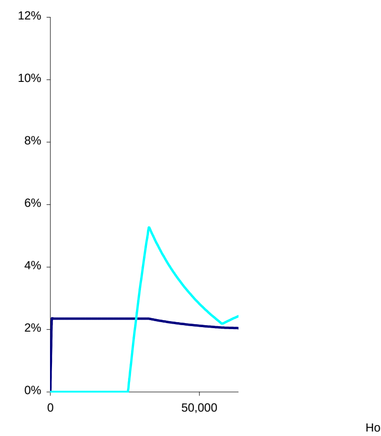


Figure F8: Increase in effective tax rates

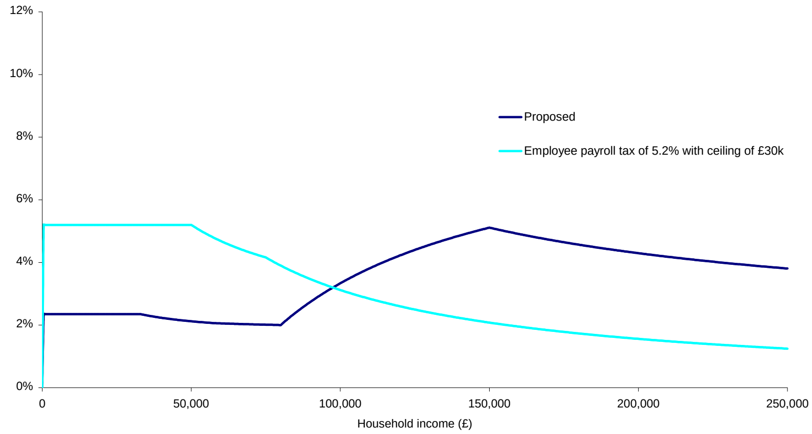
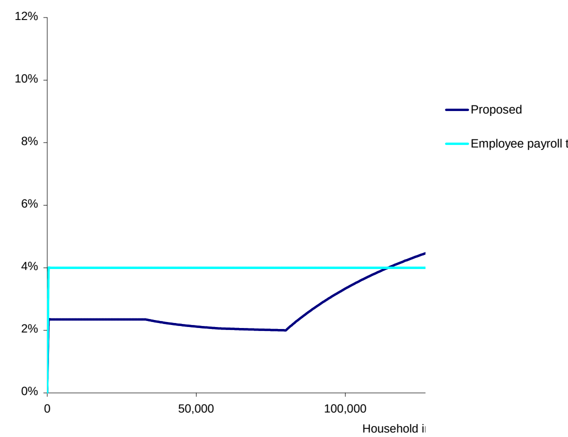
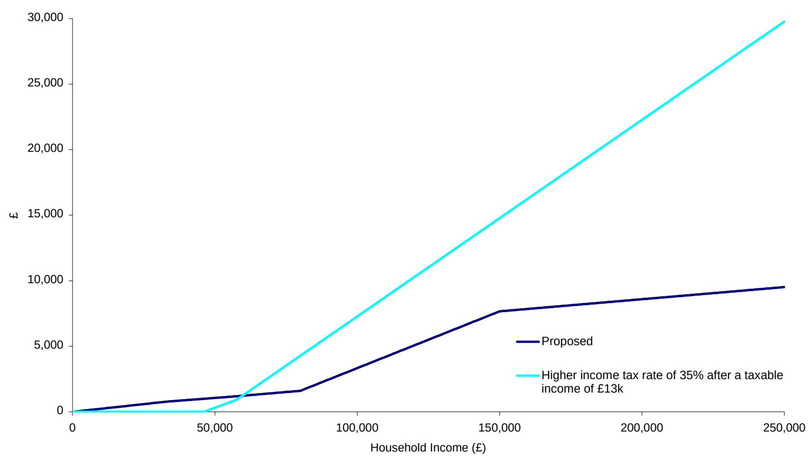


Figure F9: Incr



Section F: Married couple with 2 children and a mortgage of £120k – Increase in tax paid

Figure F10: Increase in tax paid



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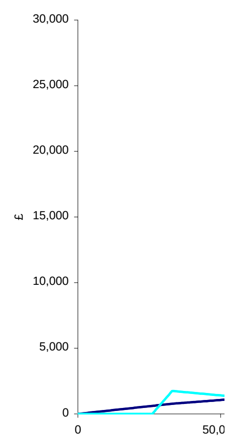


Figure F12: Increase in tax paid

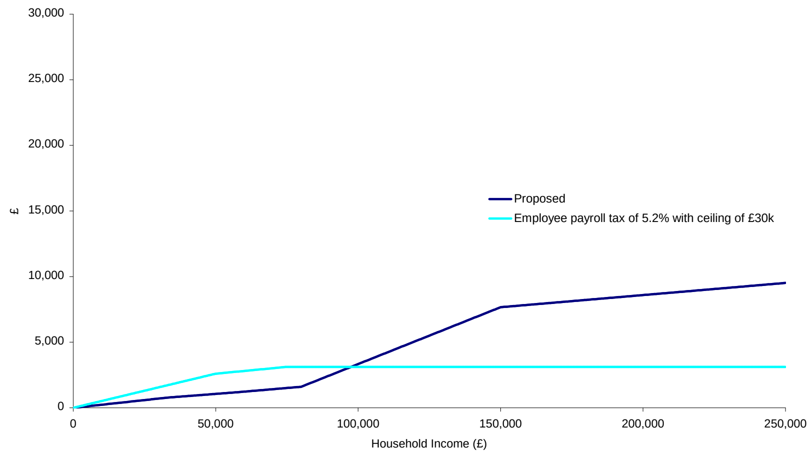
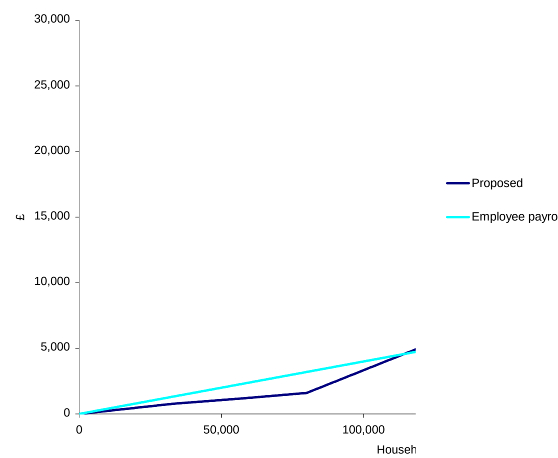
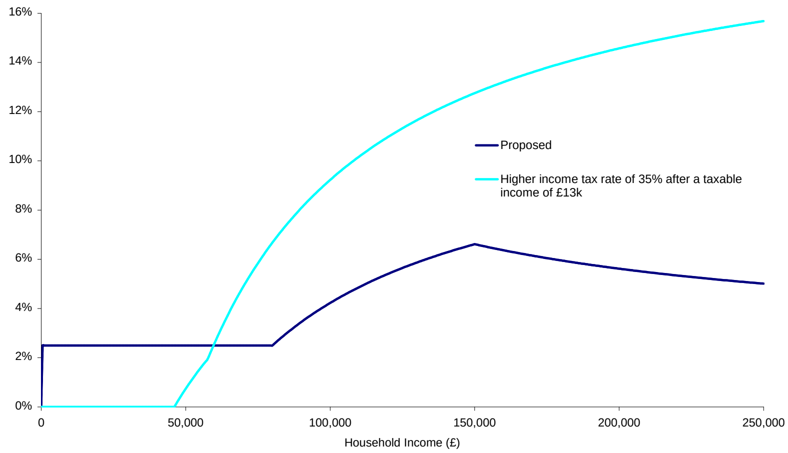


Figure F1



Section F: Married couple with 2 children and a mortgage of £120k – Increase in tax paid as a % of disposable income

Figure F14: Increase in tax paid as a % of disposable income



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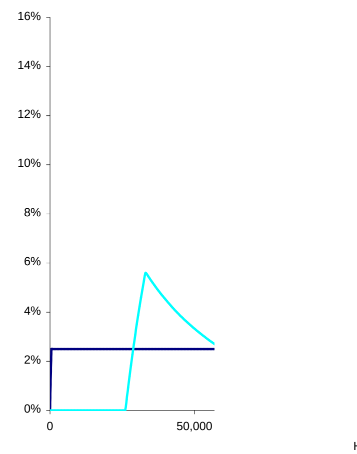
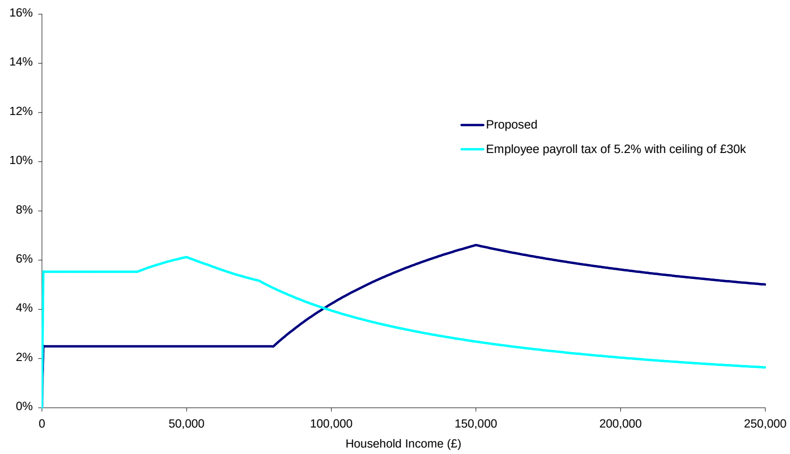


Figure F16: Increase in tax paid as a % of disposable income



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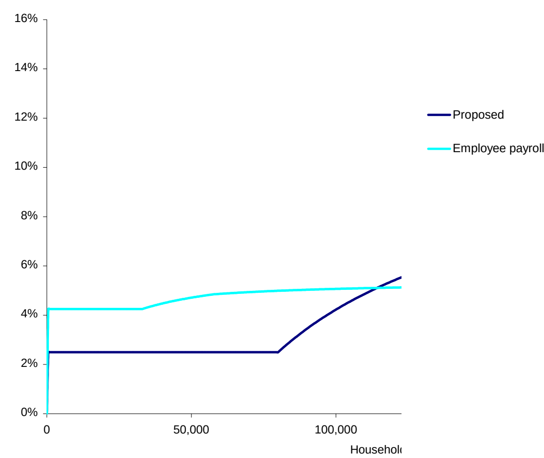
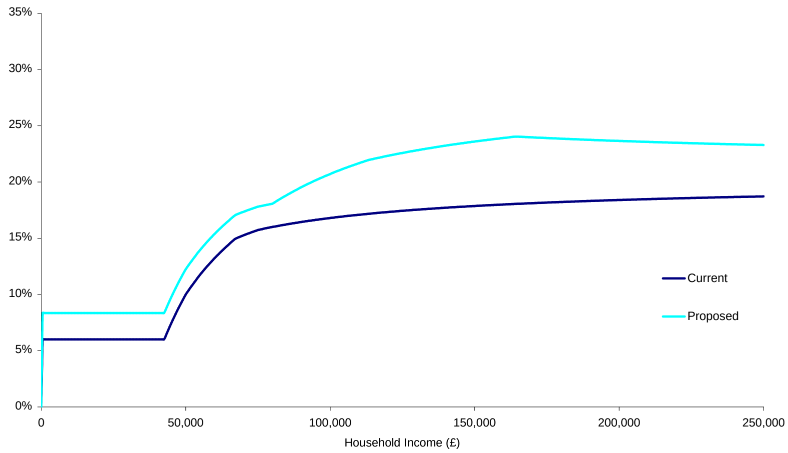


Section G: Married couple with 2 children and a mortgage of £300k – Average effective tax rates

Figure G1: Average effective tax rates



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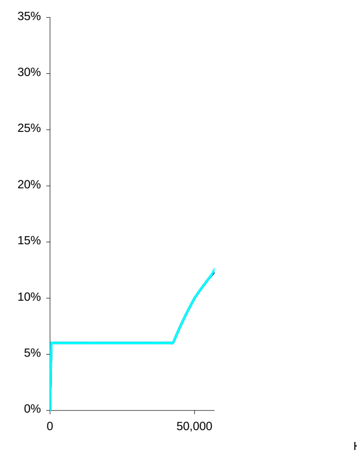
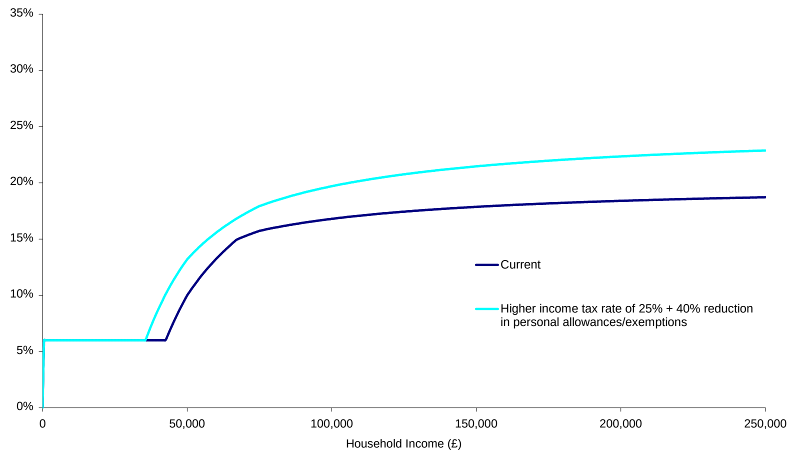


Figure G3: Average effective tax rates



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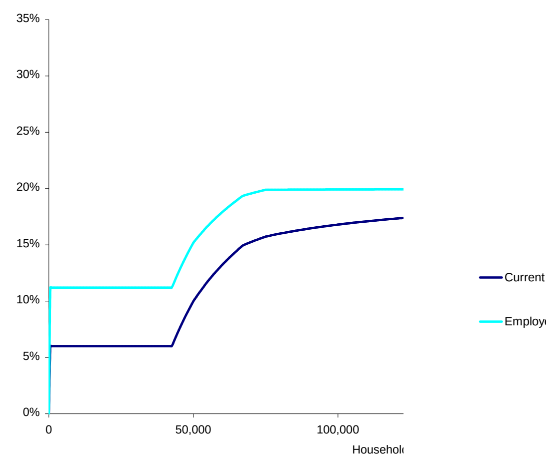
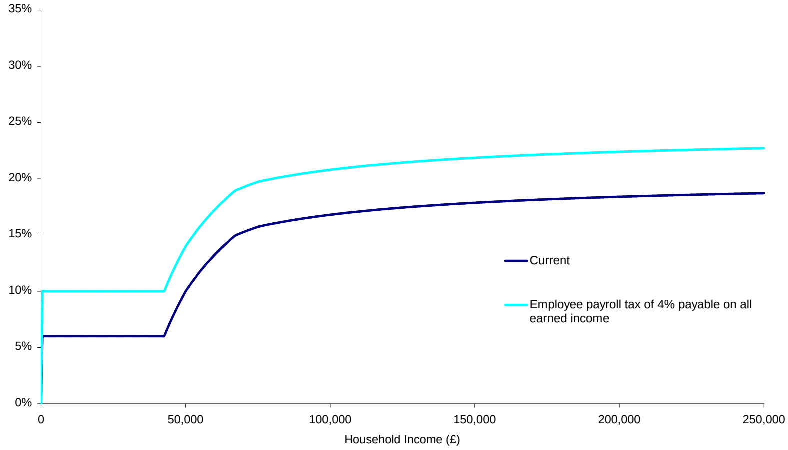
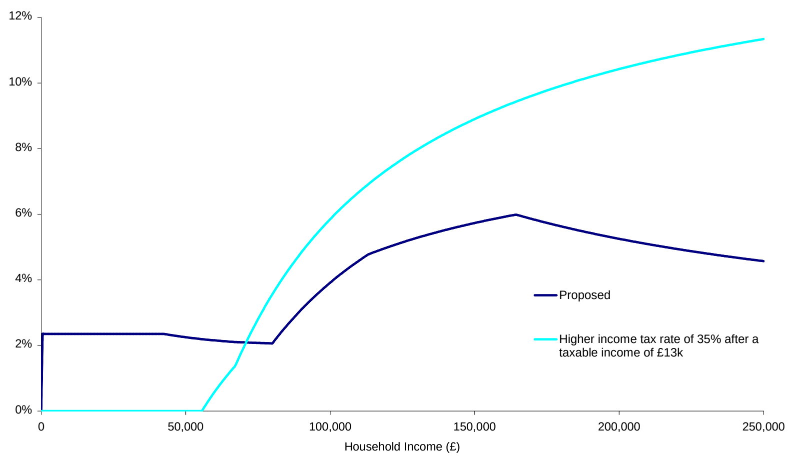


Figure G5: Average effective tax rates



Section G: Married couple with 2 children and a mortgage of £300k – Increase in effective tax rates

Figure G6: Increase in effective tax rates



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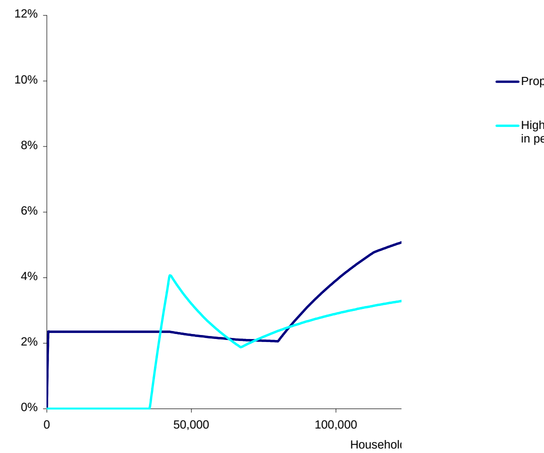


Figure G8: Increase in effective tax rates

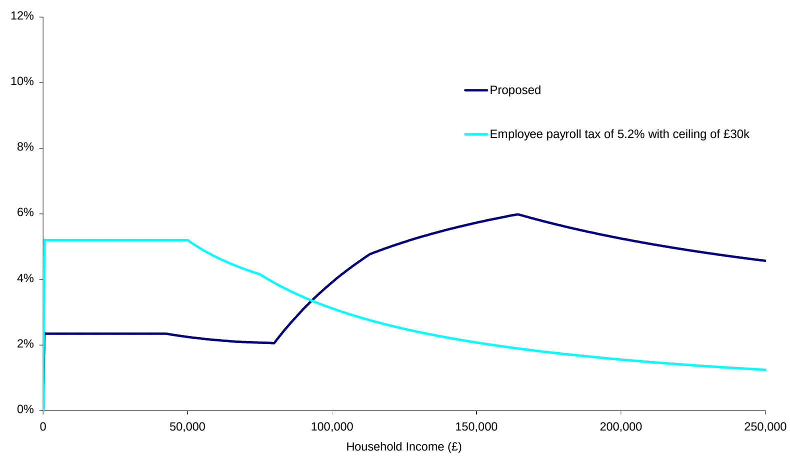
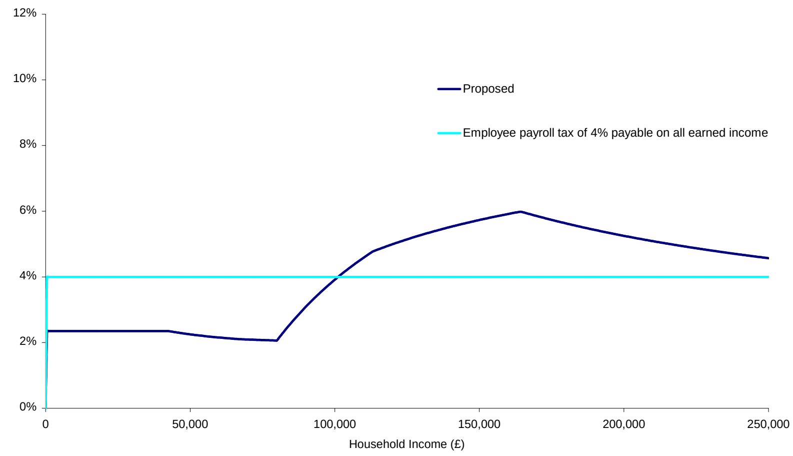
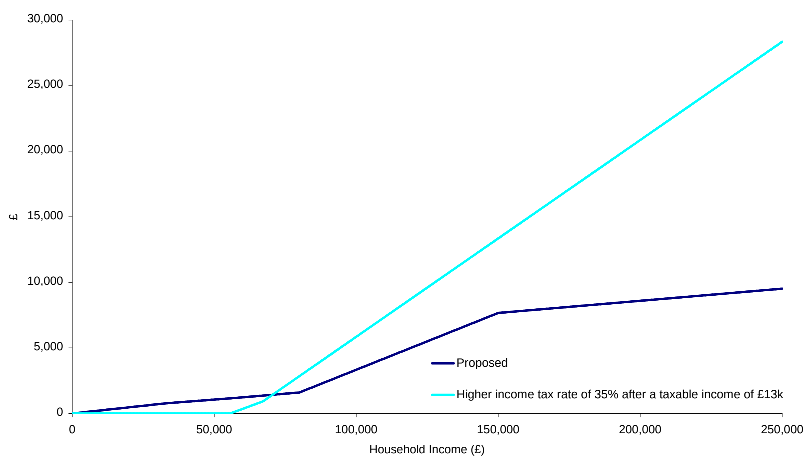


Figure G9: Increase in effective tax rates



Section G: Married couple with 2 children and a mortgage of £300k – Increase in tax paid

Figure G10: Increase in tax paid



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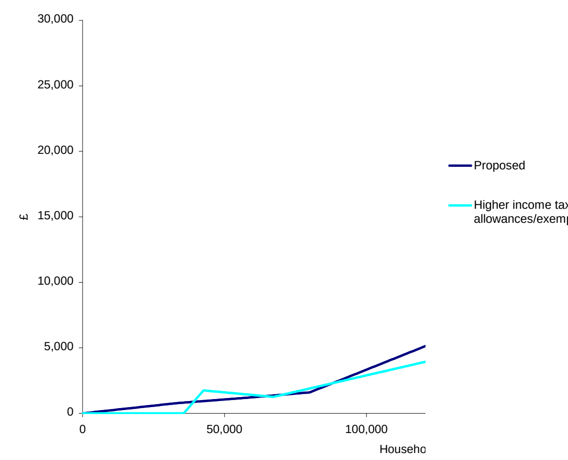


Figure G12: Increase in tax paid

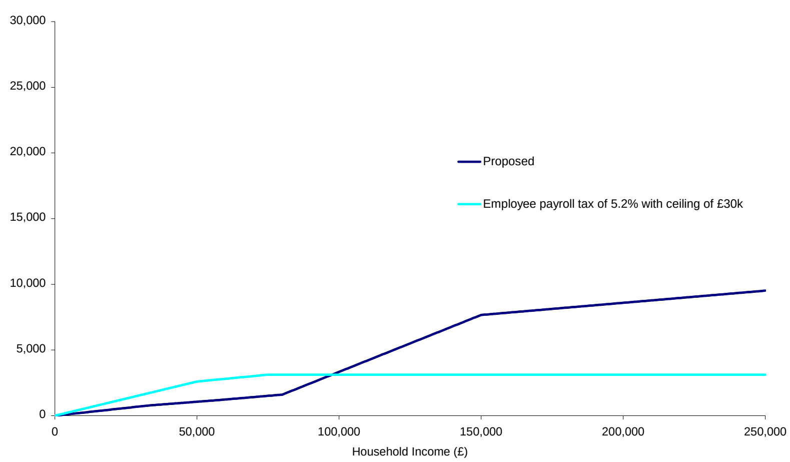
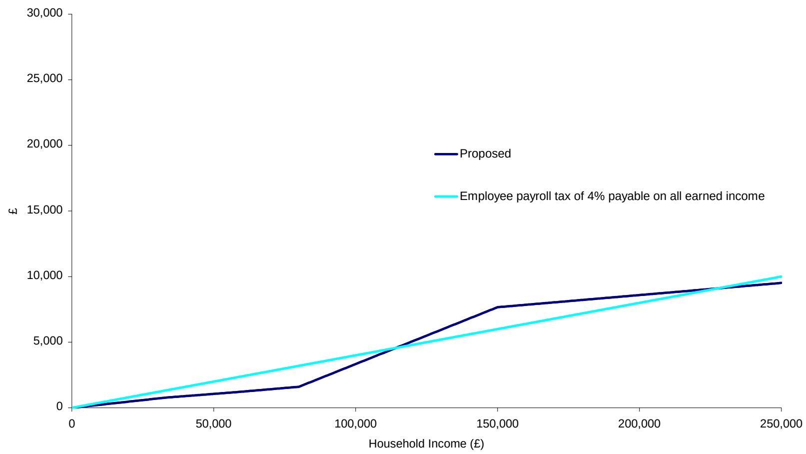


Figure G13: Increase in tax paid



Section G: Married couple with 2 children and a mortgage of £300k-

Figure G14: Increase in tax paid as a % of disposable income

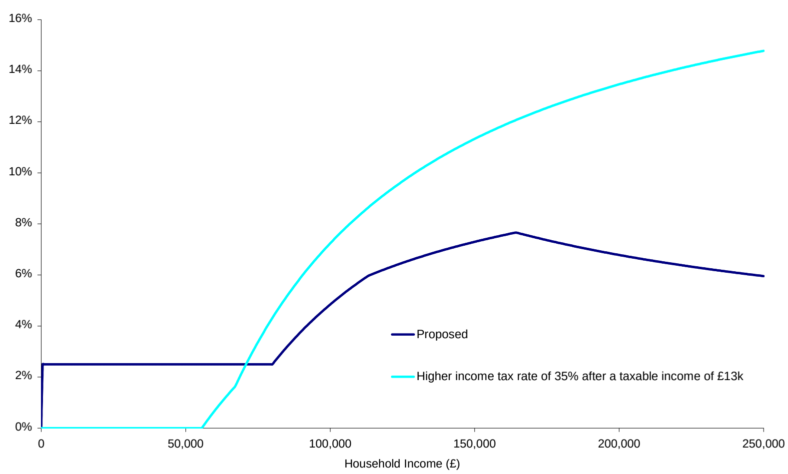


Figure G15: Increase in

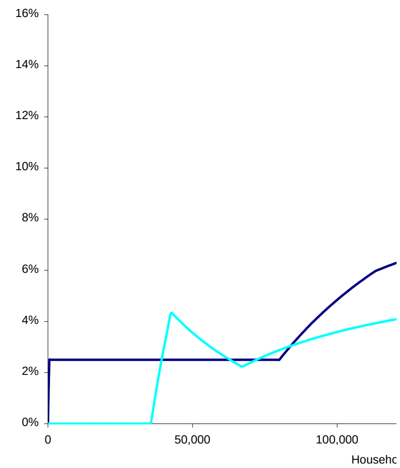


Figure G16: Increase in tax paid as a % of disposable income

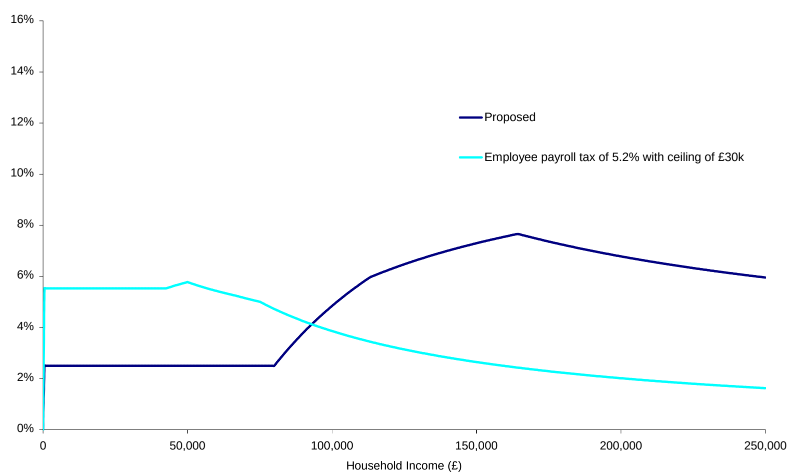
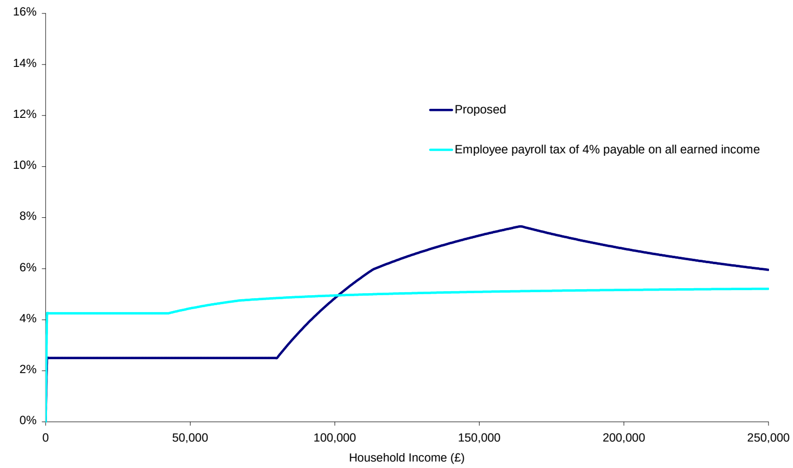


Figure G17: Increase in tax paid as a % of disposable income



APPENDIX 3

Inflationary effects of tax raising measures

Inflation, put simply, is a general rise in prices across the economy. The inflation rate is a measure of the average change in prices across the economy over a specified period (12 months in the case of the annual rate of inflation).

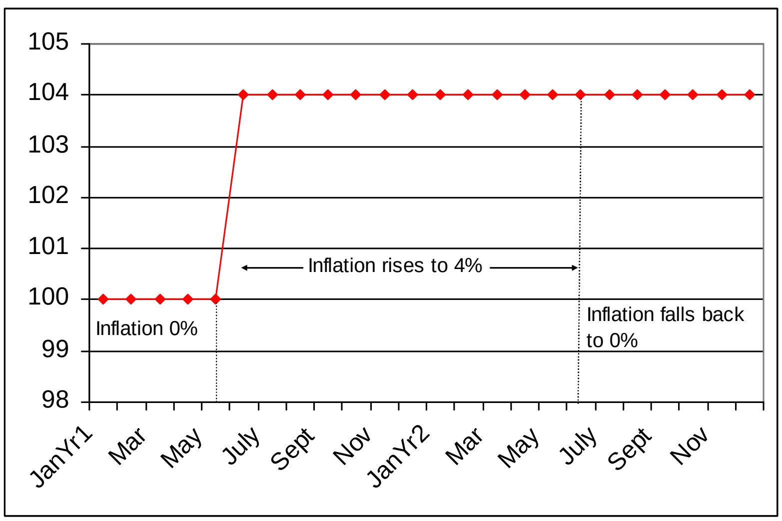
To get an understanding of what the current rate of inflation is it is necessary to measure the change in prices across the economy. This is normally done by constructing an index of prices and measuring its percentage change over time. The most commonly used index is a Retail Prices Index (RPI) which is made up of the weighted prices of hundreds of goods and services in retail outlets such as supermarkets, petrol stations, travel agents and insurance companies.

A rise in the price of any particular goods can influence the rate of inflation, if it is large and/or the goods have a significant weight in the index. For example, suppose the price of petrol has a weight of 20% in the RPI (far larger than is the case) and it rises by 20% in a particular month. If all other prices remain unchanged this would lead to a 4% rise in the index and inflation in that month. However, if all prices in the index stay unchanged, in the same month of the subsequent year the impact falls out of the annual comparison.

This example is illustrated in the chart below –

Chart 1: The impact of a one-off price increase on the RPI index and inflation

RPI index where January Year 1 =100 and petrol prices make up 20% of RPI index and rise by 20% in June of Year 1, with other prices constant.



Source: States of Jersey calculations[1]

A one-off increase in the price of a good, as demonstrated in the example outlined above, can clearly impact on the inflation rate but is not considered to be a rise in the general level of inflationary pressure in the economy. The fact that the impact falls out of the annual comparison shows that the impact is only short-term unless it generates any second round effects (discussed in more detail below).

How inflationary pressure affects the rate of inflation

The real inflationary danger in an economy is not then from a one-off price increase, but from a situation where there is a build up of inflationary pressure in the economy. Inflationary pressure occurs when the overall level of demand for goods and services exceeds the ability of the economy to supply them (putting upward pressure on prices).

This might occur is if incomes (personal and/or government) rise across the economy due to a windfall to the government. For instance, if oil was discovered in Bailiwick waters, the States of Jersey might be able to reduce taxes and increase expenditure. However, if there is no extra capacity in the economy to meet the extra demand for goods and services that this will generate (both from the government and consumers with additional spending power) then inflationary pressure will be created and the general rise in prices that comes with it.

Expectations can also have a crucial impact on the inflation rate and inflationary pressure. If businesses and employees expect inflation to rise over the coming months they are likely to factor this into the prices they charge and the wages they demand. If this results in even higher prices then an upwards spiral effect can be created. Central bankers across the globe have been successful at reducing inflation because of their ability to reduce inflation expectations across the economy by adopting inflation targets.

Why worry?

Having considered what inflation is and how it is measured, the obvious question is why so much emphasis is placed on controlling it? The best way to see how damaging inflation can be is to contrast it with a situation of price stability.

Price stability enables money to work as the means by which people and businesses transact and contract with one another. The main problem with inflation is that people and firms change their behaviour as they attempt to avoid the uncertainty associated with rising inflation. Price stability helps create an environment where economic growth may occur more easily. Inflation, on the other hand, results in the country's economic resources being used less effectively and efficiently than they could be: economic growth suffers as a result.

Another way in which inflation impacts on the economy is by clouding relative price signals. When inflation is high, for instance, it can be volatile. It therefore becomes less clear whether an increase or decrease in the price of a good/service reflects a change in the relative demand or supply, or whether it is just part of a generalised movement in prices across the board. On the other hand, if prices are stable, people and companies are able to make their investment, saving and purchase decisions more accurately without distorting signals. There is also the possibility that inflation will have an inequitable impact – hitting those people that save for retirement harder than those that simply spend their money on goods.

Many years of experience across different economies have shown that one of the main consequences of high inflation has been greater instability in economic conditions. Periods when demand has been growing more rapidly than output and inflation has risen have been followed by periods when demand and output (and employment) have fallen sharply (the boom and bust cycle). These falls were probably greater than would have been the case had demand and output grown at a steadier and more balanced pace.

GST, Income Tax and Inflation

Given the perils of rising inflation it is right to consider how changes in Jersey's economic policy will impact on the rate of inflation and inflationary pressure in the economy.

The move to 0/10% is expected to lead to a loss to the Jersey economy of £80 – £100 million annually. As long as the government does not borrow (or spend the strategic reserve) to make up for this shortfall this will be deflationary as the tax revenue foregone will almost exclusively leave the Island and will not be recycled into additional demand in Jersey.

Introducing a GST of 5% would take that £40 – £45 million out of the private sector, reducing private sector demand. Assuming that this revenue does not just translate into higher public expenditure (which would mean additional public sector demand), then the introduction of a GST would be deflationary[2].

A rise in income tax designed to raise the same level of money would have exactly the same effect under the same circumstances. The only real difference between the 2 types of tax increase is that a rise in GST would lead to a rise in the rate of inflation (measured by the change in RPI, assuming it was added to retail prices rather than absorbed by businesses). However, this increase in the inflation rate would have largely a similar effect to the one-off rise in the price of a good considered earlier.

If the GST had a similar coverage of goods and services as VAT in the U.K. (roughly 50% of consumer expenditure), then it would add 2.5% to Jersey inflation at the time of introduction (assuming other prices remain constant). This effect would, however, drop out of the annual comparison in 12 months' time.

There is little reason to believe that this increase in the inflation rate would dramatically alter the nature of demand relative to supply in the economy. Therefore, inflationary pressure would be unlikely to build up as a result unless the second round effects outlined below kick-in and wages rise to compensate for the rise in prices caused by GST.

It might also be the case that in Jersey the initial impact on inflation of a GST could be reduced if some stores (for example those part of U.K. chains) do not increase their prices. This could occur because of a desire to operate similar pricing strategies across the chain.

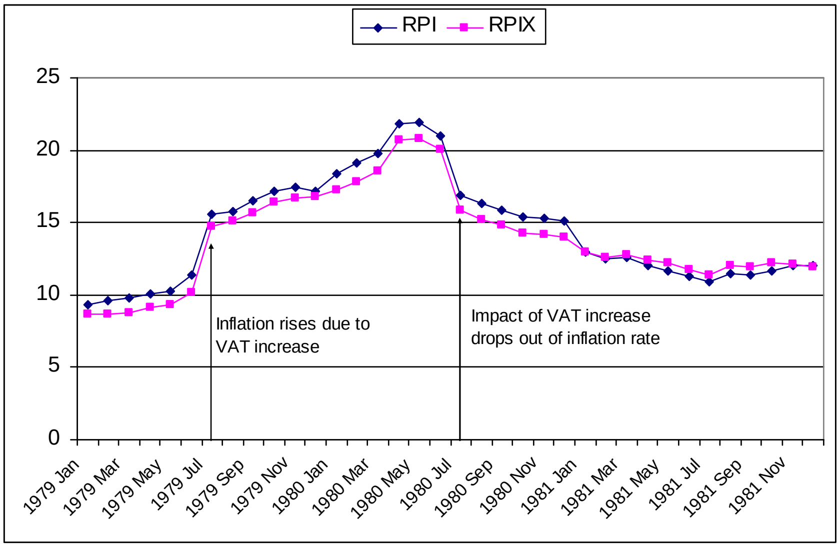
Introducing GST – the experience elsewhere

There has been a trend across the world for governments to use expenditure taxes such as GST to broaden the tax base, but this has not pre-occupied the world's central bankers, who are naturally concerned about issues affecting inflation. They have been more concerned about monitoring the relationship between demand and supply in the economy and trying to influence inflation expectations. The U.K. has made a number of changes to VAT since its introduction in 1973 and there has been little evidence to suggest that it has added to inflationary pressure in the U.K. economy.

For example, in the June 1979 Budget the incoming Conservative Government replaced the U.K.'s two-tier 8% and 12.5% rates of VAT with a single one of 15%. The economy was different to that in the U.K. today (interest rates rose from 12% to 17% in the second half of 1979) and clearly there is little similarity to the situation in Jersey today or that likely to prevail in 2007. However, it is interesting to see how a significant increase in VAT fed through the system at a time when labour markets in the U.K. were still considered inflexible and inflation was double digit.

The chart below shows that in July 1979 the rates of increase of RPI rose to nearly 15% and then a year later inflation fell from 20% to 16% as the increase dropped out of the annual comparison.

Chart 2: U.K. inflation after the 1979 VAT increase
% increase in UK RPI, RPIX



Source: National Statistics

Second round effects are critical

The purchasing power of Jersey residents would be reduced to the same extent whether a GST was introduced or income tax was raised to collect the same amount of money[3]. How residents respond to this reduction in their purchasing power will however have a significant impact on inflation and the performance of the economy over the medium term.

If their immediate response was to seek wage increases to compensate for the reduction in purchasing power, the Island is in danger of entering a wage-push inflationary spiral. But it is important to remember that this danger is clear and present under both tax scenarios.

The wage-push impact would add to the initial increase in inflation brought about by the introduction of a GST. This might prevent it dropping fully out of the annual comparison in a year's time. An increase in income tax would have a similar wage-push effect, but starting from a lower base, without the initial impact on RPI. In both cases the damage to the economy would be transmitted through a fall off in demand for Jersey exports and locally produced goods and a resultant fall in the demand for labour in Island.

There is no question that it is difficult to predict the extent to which these second round effects will occur and if they are more likely under a GST or income tax change. That said, given that the transmission mechanism is similar (with the collective behaviour of the Jersey workforce and employers at the centre) it is also wrong to confidently state that one measure would have a more pronounced effect on inflation than the other.

GST is part of a larger package

When considering the inflationary consequences of introducing GST in Jersey it is important to remember that it is part of a proposed overall package to reduce a fiscal shortfall of £80 – £100 million. When coupled with the required efficiency gains and output reductions in the public sector and the necessary economic growth that make up some of the other measures it is hard to see how such a package could be perceived as inflationary.

What is clear is that any inflationary effects from increased taxes will largely be dependent on the behaviour of Jersey businesses and employees. This must act as an impetus to ensure that by 2007 the traditional link between RPI and wages is broken. Wage growth should better reflect productivity improvements. Economic growth is vital to create a secure future for the Island. This must be managed so that inflationary pressure is minimised and the economic performance of the economy maximised.

[1] *It is assumed that there is zero inflation in the economy and that the 20% rise in the price of petrol takes place in June of Year 1 and the price remains at that level thereafter. This adds 4% to the index and annual inflation is 4% in June of that year through to May of the following year (the % increase in the index from 100 to 104). If there are no other price increases then from June of Year 2 onwards inflation falls back to zero (there is no % change in an index of 104 compared with 104). It is worth noting that if petrol prices were to increase by 20% again in June of Year 2, the inflation rate would remain unchanged at 4% again for the next 12 months.*

[2] *If public expenditure were to rise by the full £40 – 45 million then this would mean that the deflationary impact of the move to 0/10% is simply transferred from the public to private sector, although the overall deflationary impact of the 0/10% move would still be preserved.*

[3] *A GST would do this by raising prices and therefore reducing the quantity of goods and services people could afford. An income tax hike would reduce the amount of after-tax incomes available to spend.*