Scrutiny Panel – Overseas Aid Review
Scrutiny Office,
Morier House,
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22 February 2007

Dear Sirs

Overseas Aid Funding and Economic Growth
At the Overseas Aid Scrutiny Review hearing held on 7th February 2007 I drew attention to the additional tax revenues that may be generated by economic growth. I noted that this provides a potential means of funding an increase in the overseas aid without recourse to higher tax rates or cuts in services. At that hearing I suggested that the Sub Panel seek expert guidance on this from, for example, the States Economic Advisor. You have subsequently asked me to provide "*a numerical illustration outlining how this proposal would work*". I regret that I have not been able to research this thoroughly nor have I had opportunity to consult persons with relevant expertise and specific knowledge of the current Treasury forecasts. Nonetheless I am writing to set out my initial thoughts on the understanding that the Sub Panel will regard these as a basis for consulting those in possession of the information and expertise required to advise the Sub Panel in these matters.

Economic Growth
Economic growth occurs when there is an increase in value of the goods and services produced by an economy. Other things being equal, one would expect economic growth to flow through into increased tax revenue if the tax regime remains unchanged. However, other things are not equal. In Jersey's case the relationship between economic growth and tax revenue over the next five years will be affected by a number of significant factors. For example:

- The Fiscal Strategy introduces far reaching changes to Jersey's tax regime and this inevitably increases uncertainty in regard to the future yield that each element of the new tax regime will generate - especially in the early years.

- The States of Jersey may come under pressure to reduce the taxation burden on some tax payers. For example in response to moves by jurisdictions competing for mobile activities there may be a case to reduce the tax burden on certain firms. The

States are also likely to face increased pressure from the electorate as the effects of the higher tax burden imposed on residents by the fiscal strategy are felt.

- There may be some delay before economic growth flows through to tax yields. For example profits may be accumulated in companies before distribution to Jersey resident shareholders (Under the "0/10" regime the profits earned by many companies will not be taxed). Anti-avoidance measures may place some limit on the period of any such deferment.

- Foreign owned companies, other than certain financial services firms, will be subject to 0% tax and growth in the profits of these businesses will therefore not generate increased tax revenues except insofar as the growth is reflected in more local staff or higher wages. On the other hand, profits of these foreign owned companies are not included in the Gross National Income ("GNI") figure used to determine the aid target. Furthermore any growth in the profits of foreign owned financial services firms paying 10% tax will be reflected in increased tax revenue even though these profits are not included in the GNI figure.

- Sophisticated tax planning strategies may be employed to reduce the tax paid by businesses and individuals. This may lead to intentional or unintentional loss of tax revenue.

- To the extent that economic growth is accompanied by population growth this may increase demand for services (health, education, law enforcement etc.) and this funding requirement may have a higher priority than aid.

This list is not exhaustive; other factors will also have a bearing on the timing and relationship between economic growth and tax revenues. Significant work would be required to analyse each of these factors and estimate the likely effect in each case. Even if this work were undertaken the level of residual uncertainty may be such that the final figures are of limited practical assistance.

Finally, the future rate of economic growth will be affected by global trends, developments in the competitive and regulatory landscape, international political developments, cyclical effects, demographic changes, resource constraints and other factors.

Numerical Illustration

In summary there are many uncertainties in regard to forecasting the timing and amount of any tax yield that may be generated by economic growth. Notwithstanding these difficulties economic growth is likely to generate increased tax revenue so long as tax rates are not reduced by a corresponding amount. Indeed the Fiscal Strategy (P44/2005) banks on economic growth yielding £20 million additional tax revenue per year. In principle it may therefore be possible to fund growth in the overseas aid budget through increases in tax revenues attributable to economic growth without recourse to, for example, an increase in GST rate or real cuts in services.

By way of illustration the States of Jersey Annual Business Plan 2007 includes the following forecast (table 3.1):

	2006 £m	2007 £m	2008 £m	2009 £m	2010 £m	2011 £m
Total Income	490	505	521	537	556	570
Net Revenue Expenditure	449	474	492	507	518	532
Net Capital Expenditure Allocation	39	42	40	38	41	38
Total States Net Expenditure	488	516	532	545	559	570
Transfer to Strategic Reserve						
Total States Net Expenditure and Transfers	488	516	532	545	559	570
Fiscal Measures to be approved:						
"0/10" Corporate Tax Structure			-3	-3	-70	-75
Goods and Services Tax			45	45	45	45
20 means 20 Income Tax Proposals			2	4	6	8
Revised Forecast Surplus/(Deficit)	2	-11	33	38	-22	-22

I calculate the percentage growth in total income assumed in the forecast as follows:

	2006	2007	2008	2009	2010	2011
Assumed revenue growth (%)		3.1	3.2	3.1	3.5	2.5

The footnotes to the forecast indicate that a "*3% increase in base income tax revenues*" has been assumed. Income tax revenues are the largest component of total income. However it is not clear what assumptions about real economic growth and inflation underpin the (presumably composite) 3% assumption. The fiscal strategy (P44/2005) assumed that real economic growth of 2% would yield £20 million additional tax revenue. I would expect that a conservative assumption has been used in regard to *real* growth in the above figures – it would be imprudent to rely to a significant extent on the uncertainties of future growth to balance the budget[1].

From a peak in 2000 GNI declined by 8.7% in real terms by the end of 2004. However in 2005 the economy experienced real economic growth of 2.8%[2]. Looking forward, if Jersey's economy outperforms the assumptions on which the 2007 business plan forecast has been prepared then, subject to the caveats discussed above, tax revenues may also exceed the (assumedly conservative) assumptions contained in the plan. For example, if

[1] Sustained real growth of 2% per year could yield more than £20 million per annum by 2010.
[2] A review of the Jersey Economy, 2006, States of Jersey, Economic Advisor. According to this document the latest data suggests that the economy has maintained this momentum into 2006.

the economy achieves average annual *real* growth 0.6% higher than the level assumed the forecast (and this flows through into increased tax revenues) the projection would be revised as follows (ignoring any effect on the fiscal measures yet to be approved):

	2006	2007	2008	2009	2010	2011
	£m	£m	£m	£m	£m	£m
Total Income	490	508	527	546	569	587
Net Revenue Expenditure	449	474	492	507	518	532
Net Capital Expenditure Allocation	39	42	40	38	41	38
Total States Net Expenditure	488	516	532	545	559	570
Transfer to Strategic Reserve						
Total States Net Expenditure and Transfers	488	516	532	545	559	570
Fiscal Measures to be approved:						
"0/10" Corporate Tax Structure			-3	-3	-70	-75
Goods and Services Tax			45	45	45	45
20 means 20 Income Tax Proposals			2	4	6	8
Revised Forecast Surplus/(Deficit)	2	-8	39	47	-9	-5

Thus, over the five year period, circa £48 million additional tax revenue could be generated in these circumstances. This would be of the right order of magnitude to phase in an increase in overseas aid to a level of around £20 million by 2011. This increase in overseas aid would be contingent on growth yielding tax revenues in excess of the projections set out in the Annual Business Plan 2007. Note also that once the £80 to £100 million shortfall attributable to "0/10" has been made good it will not be necessary to ring fence further economic growth.

Pragmatically the Minister for Treasury and Resources may wish to create some buffer to reflect the significant uncertainties discussed above and the potential variability of revenue in the next few years. Furthermore there may be other pressing demands on funding in the period to 2011. Thus, unless economic growth is exceptionally strong, a commitment to reach the 0.7% GNI aid target by 2015 may be more easily attainable. A 2015 target would be consistent with the timescales within which neighbouring countries have committed to reach 0.7% of GNI.

Final Remarks

In considering these figures there is a danger that we may not see the wood for the trees. In May 2002 Oxera advised the then Finance and Economics Committee that Jersey's "*current economic position is healthy, but there are one or two clouds on the horizon that could have an adverse impact on the financial balance of the government. The scope for raising additional taxes by widening or deepening the tax base seems substantial, as does* *the scope to reduce States expenditure. What mix of policies Jersey should adopt to meet these challenges is largely a political, not an economic, decision*"[3]. At the time these words were written the authors may not have anticipated the economic stagnation of 2001 to 2004. Nonetheless, it is quite possible that such clouds as may be on the horizon will recede. Given a fair wind and reasonably conservative current forecasts, it may prove possible to increase aid in a politically palatable way by 2015 even within the existing fiscal strategy. If the current fiscal strategy is not compatible with a substantial increase aid in the absence of a fair wind it is because that increase was not taken into account in the formulation of the strategy.

There is evidence to suggest that a significant and growing number of informed islanders who are aware of the Jersey's economic situation wish to see Jersey standing shoulder to shoulder with other nations in working towards the Millennium poverty reduction goals – even if this could mean an increase in their tax burden. In my view the focus of attention should be how far we, as a community, regard this as important. It is a key aspect of a wider dialogue about the ideals and values that give a sense of identity to this community at a time when that identify has a new relevance – not least because of the success of the financial services sector. We certainly must understand the financial implications of our choices. But if political choices are mistaken for economic exigencies we miss the opportunity to engage in that important debate.

Yours faithfully

B Coutanche

Brian Coutanche

[3] The Future of Jersey's Tax and Spending Polices, OXERA, May 2002, Page vi