States of Jersey

FACING UP TO THE FUTURE:

reforming public spending and taxation to sustain a prosperous and competitive economy

February 2004
Finance and Economics Committee

We want to hear your views

The Finance and Economics Committee seeks to explain and discuss its proposals for tax and spending with as many people as possible during February 2004. Public meetings will take place at:

7.30pm February 18th at Highlands College

7.30pm February 19th at St Clement's Parish Hall

7.30pm February 23rd at Communicare

7.30pm February 24th at the Town Hall

These meetings are listed, together with other opportunities for discussion and comment, on the website at

www.gov.je/taxandspending

A short guide outlining the Finance and Economics Committee's Tax Reform Proposals is available from the States Bookshop, at the public library and parish halls. It is also on the States website given above.

A detailed background Paper written by OXERA is also available. The Finance and Economics Committee would encourage as many people as possible to read these papers and to attend the public meetings.

The Committee also invites people to write in with their views to:

Tax Proposals, States Treasury,
PO Box 353, Jersey, JE4 8UL or

e-mail : taxproposals@gov.je

Financial Plan for Jersey 2005-2010

The Finance and Economics Committee's priority for Jersey is to maintain the economy so that it can deliver continued prosperity to benefit all Islanders.

This requires ensuring that the international financial services industry can continue to flourish in Jersey. At present this is the *only* identifiable industry that is capable of underpining the Island's prosperity. Should the Jersey finance industry become uncompetitive, jobs and profits would rapidly move elsewhere.

To retain, support and expand this sector of the economy requires two changes to the current tax structure. The Committee proposes the following changes:

- a general rate of corporate profits tax in the rest of the economy of 0%
- an internationally competitive rate on corporate profits for this sector (i.e. financial service providers) ~ at approximately 10%.

The move to 0% corporate rate is required in order to meet the threat of unilateral action by the UK, EU and others if Jersey were to refuse to remove what they have identified as "harmful business taxes".

Jersey residents who own or control their own companies will pay broadly the same amount of tax on profits as their companies do now. New provisions will be introduced so that profits of these companies are taxed as personal income.

Most non-locally owned businesses who pay the 0% corporate tax rate will not be able to increase their profits because their tax liability will increase in their home jurisdictions. These businesses will therefore not gain from this measure.

Even so, the effect of these two measures is to reduce Jersey's annual tax revenue by up to £80-£100 million. The majority of this money, which leaves the Island, cannot be recovered without making Jersey less competitive.

To meet that shortfall and to be able to deliver a good level of public services, the Committee proposes the following additional measures:

- eliminate waste and increase efficiency in the delivery of public services ~ to achieve £20m pa in savings by 2010
- expand the economy through economic growth ~ to achieve an additional £20m annual tax revenue by 2010
- make the maximum rate of income tax of 20% **mean** 20% for well-off households by phasing out allowances ~ to raise up to an additional £10m of annual tax revenue by 2006
- introduce a goods and services tax of 5% in 2007 ~ to raise £40-£45million annually
- introduce an Income Tax Instalment System (a form of pay-as-you-earn) from 2006 ~ to raise around £5m annually.

This package of measures should ensure that Islanders can continue to enjoy the very high standard of living that they have enjoyed over the last few decades.

Foreword

By Senator Terry Le Sueur, President, Finance and Economics Committee

For the last few decades Jersey has had a comfortable life. The Island has enjoyed a very high standard of public services which have largely been paid for by the financial services industry.

This paper sets out how we can make sure that Jersey's economy continues to prosper in the years ahead, providing a sound and stable environment in which we can raise the taxes we need to pay for the public services we want.

At the heart of our economic success over the last thirty or so years has been the financial services industry. As it has thrived, we have come to take rising prosperity and increased public spending almost for granted. We cannot afford to do so. We face new challenges on a number of fronts - from increasingly aggressive international competition, from pressure from the UK and OECD, and from new laws being passed by the EU, which could reduce our income by up to £80 - £100 million. The international marketplace is constantly changing, and Jersey must itself adapt if the economy is to continue to flourish. At the same time, the very success of Jersey in recent years has helped fuel big increases in public spending. Over that period, the basic tax system has not been reviewed and we have become far more dependent upon income tax than our competitors.

Now is the right time to make sure that we are only spending what we can afford and that we have an economy in the right shape for the future with a modern tax system. An early decision will allow for better implementation, greater certainty and a smoother transition.

The underlying position of Jersey is strong. We have a Strategic Reserve of around £400 million. We have record sums invested in the Island. Figures published by the Jersey Financial Services Commission show that bank deposits alone currently stand at £156 billion. The challenges we face from new EU laws will not really start bearing down for at least another 5 years. So why do we need to do anything now?

It is only by acting now and planning ahead, that Jersey will be able to keep its competitive edge. By facing up to issues in good time, we will not only be able to keep the economy secure, but also avoid the need for far tougher choices in the future. In the interests of future generations we have to act now to raise more money to put the economy on a sound footing for the long-term. We will be asking everyone to make more of a contribution to Jersey's future because by sharing the burden we can spread the load more fairly.

People have asked me whether it is essential to put taxes up. Could we not do more to cut waste and inefficiency? Certainly, we can, and we have plans to do just that. But the sums we could realistically save are only a fraction of what we need to raise if we are to be prudent. The only way to make savings of the size we need would be to make deep cuts into the very bones of our public services. I do not believe this would be acceptable to the people of Jersey.

No one likes paying more, but that is the issue we have to confront if we want our standard of services over the next thirty years to be as high as the last thirty years. We would be failing in our duty to you and the next generation if we did not face up to this.

Although we have some difficult choices ahead of us, I am confident that when people see the case set out, they will agree that the wise and prudent course of action for Jersey is to act now to secure a bright and prosperous future for us all. When considered alongside the proposed reforms to the machinery of government and the aims of the Island's Strategic Plan, we have a chance with this package to create a successful economy backed up with a modern and effective administration.

Let's seize that chance.

Introduction

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 quality public services has risen. It is the growth of our financial services industry which has made this possible.

Today it is the engine of our economy and generates two-thirds - nearly £250 million - of all our taxes. Other industries and sectors are important and, given the right conditions and encouragement, might be able to increase the contribution they make. But if we are to maintain our current way of life, the financial services industry must remain at the heart of our 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 financial plan for Jersey must therefore be the preservation and strengthening of the financial services industry. For Jersey to thrive, we have to ensure that we remain competitive internationally and are able to attract companies to invest, do business, employ people and pay tax here.

In recent years, Jersey has faced increasing competition and a number of challenges to its position from the OECD and the EU. Through successful negotiation, Jersey has minimised the threat it faces and bought itself more time to prepare for the future. It has helped shape an outcome which means that it can continue to be a world-class centre for financial services. The result of the EU negotiations is far better for Jersey than at one time looked possible. Nevertheless, the 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 to balance its books.

In this document the Finance and Economics Committee sets out the background to this decision, examines various options, and proposes a recommended course of action for generating the taxes we need.

1. Background to the Committee's Analysis

(i) Safeguarding the Financial Services Industry

The International financial services sector is by far the most profitable of the Island's industries. It also tends 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 also very high. 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 the financial services sector of the economy that the States are able to deliver public services broadly similar to that of the UK with very much lower 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. Thus 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 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.

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 to line with what Jersey's competitors are doing (Singapore, Guernsey and the Isle of Man are moving to a rate of 10% and Dublin is moving to a rate of 12.5%.) Above this level Jersey would rapidly become un-competitive.

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 entity, legally 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 EU and the UK, means that we can no longer maintain this discrimination. Failure to address this issue could well result in action by the UK or the EU 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 safeguard as much as possible of the tax revenue generated from corporate profits tax, those entities regulated by the Jersey Financial Services Commission, 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.

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

These two measures will, inevitably, lead to a substantial loss of tax revenue from the current economy. But 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 un-competitive 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.

Annex 1 sets out in more detail what would happen if Jersey became un-competitive for the finance industry, by identifying the likely effects on employment, population, incomes, tax revenues and public services.

(ii) Why we must balance the 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 as a location for international financial services. Although the Island has a Strategic Reserve of some £400m 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 tax rate. 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 is not a solution to our fiscal deficits. 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 as to be able to meet any shortfall arising from adopting the 0%/10% regime. 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.

(iii) Maintaining public services

In theory, the budget could be balanced by making cuts in public expenditure. But these cuts would have to be very deep, cutting into the heart of spending on education, health and so on. 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.

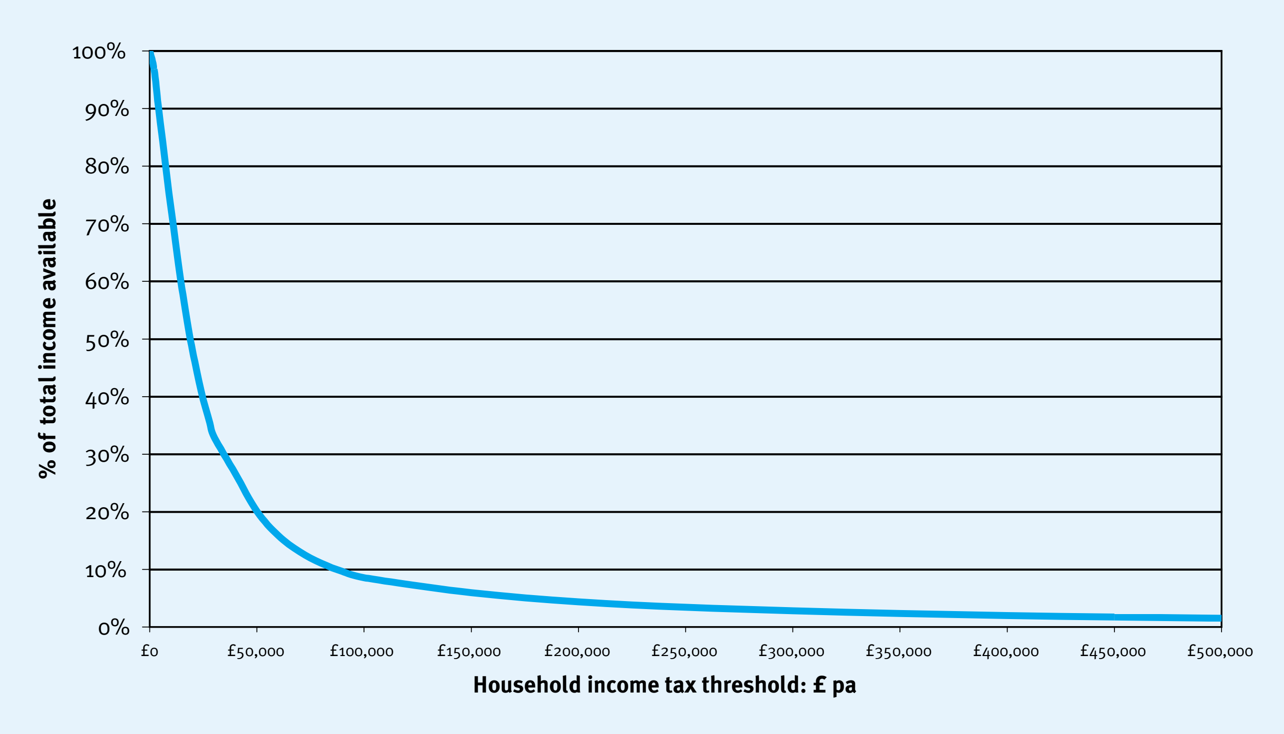
Indeed, in the major areas of public expenditure - health, education and social benefits - the public, if anything, seem to want to improve the quality and quantity of our public services. This message was reinforced at "Imagine Jersey".

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, and from economic growth.

(iv) Household incomes in Jersey

Any new tax measures must take account of the income distribution on the Island. Figure 1 *(on page 6)* 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 rate 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.

2. The Committee's Proposals

In introducing new 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 security contributions is broadly progressive, and the policy of the Committee is that this structure should be maintained.

If it becomes necessary to raise the full £80 - £100 million, there are realistically only three broad options:

- Reduce public expenditure
- Increase the size of the economy
- Increase taxes.

It is the Committee's view that all three elements will have a role to play in ensuring the future success of the Jersey economy and the maintenance of the high standards of living in the Island.

(i) Public expenditure and public services

The Fundamental Spending Review has already tackled the historic trend of rising public expenditure and a new benchmarking process will identify 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.

However, the indications from the Imagine Jersey consultation process and the development of the Island Strategic Plan are that the people of Jersey may not want significant reductions in the level of services that they receive from the States, particularly in the areas of education, health and social benefits.

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 for the next five years the annual change in States expenditure should be constrained to 1% less than the change in the Retail Prices Index. This would save approximately £20 million pa by 2010.

ii) Increasing the size of the economy

Meeting the challenges from the EU 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 in the Island, and increase their contributions to States' revenue, as well as providing jobs for Islanders. Such an expansion should reduce the projected deficit. The greater the expansion, the lower the deficit. Economic growth of 2% pa should yield £20 million additional tax revenue after 4 years. Clearly, there are also 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. Other industries with much lower profits such as tourism would require many more additional staff.

The Committee recommends that policies which encourage economic growth should be implemented across the States to achieve an expansion of the economy to contribute a net £20m per year of additional tax revenue by 2010.

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 also believes that this level of cooperation and response is very likely. But the Committee believes that it would be irresponsible to develop a fiscal strategy that relied on such responses, particularly where the risks of failure to the economy would be severe.

(iii) Increasing taxation

The Committee therefore believes that any new taxation system must be capable of raising the full £80m - £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**. To raise such large sums any tax will have to tap into a significant tax base. There are a very limited number of such tax bases:

- Corporate profits of Island business
- Personal wealth of residents
- Personal incomes of residents
- Spending in the Island
- Payroll of Island businesses and employees (including the self employed).

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, in a way that does not significantly impact 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 arising from this initiative will be able to make some contribution to the prospective deficit, but it is unlikely that it will be substantial.

There are a number of related proposals that will need to be implemented in conjunction with the introduction of 0%/10% to reduce the loss of tax revenue. In particular, **Jersey residents who own or control their own companies** (for example, small service companies with the husband and wife team as the only two shareholders) **will have the profits of their companies treated as personal income and taxed under the personal income tax structure. Under the Committee's proposals this will leave the net taxation of their company profits in a broadly similar position to now**. This change has already been taken into account in estimating the loss of revenue from the introduction of the 0%/10% structure.

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 property could form a basis for a more limited form of taxation. A substantial tax on commercial property would tend to 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 broadly related to income, the detailed relationship is currently unknown. Such a tax would also require a new taxation administrative infrastructure if it were to raise substantial amounts of money. As alternative tax raising measures that more readily meet the Committee's criteria are available (see below) the **Committee does not recommend the use of 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.

Income tax: 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.

However, 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* income**. 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 £10m 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 to a similar, but cohabiting, household. Based on these principles, and to raise up to £10m in total, **for a household with two 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 at proportionately lower levels.

Goods and services tax: 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 and reduce tax revenue volatility**. As has been demonstrated by other countries, including the UK and the Isle of Man, this is a tax base that is capable of raising significant revenue for the government.

But such a tax is at best neutral, and is often mildly regressive, even when the very basics necessary for life are excluded from the tax (eg food and children's clothing). As incomes rise the proportion of 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 have some protection from the effects of the goods and services tax.

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

The Committee is, therefore, recommending a broadly based goods and services tax as a further mechanism to meet the projected shortfall. The scope of the tax would be similar to that current in the UK, and the gross yield is estimated to be in the region of £8m-£9m per 1% point. The Committee recommends generating a net revenue of up to £40-£45 million from this tax source. This would mean a rate of tax set at 5 per cent.

The Committee also recommends earmarking a proportion of this revenue to protect the poorest from its impact by increasing the funding for benefits.

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.

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 help 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 employee contributions to the Social Security Fund. However, the Committee concluded that this is not an option it should pursue at present. Removal of the cap not only raises the cost of doing business in the Island and, thereby, hampers economic growth; it also has the effect of only raising income from the wage earner and not from unearned income.

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

In addition to the measures outlined above, 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 feature of the present system. This measure should raise up to £5m per year.

3. Implementing the new tax package

As indicated above, the Committee believes that a new tax system must be put in place that will be capable of generating at least an additional £100m per annum, *if necessary*. But in practice the Committee believes that, with cooperation and coordination across the States, some easing of population controls and other measures to allow economic growth, and the further exploration of recovering some of the lost corporate tax in a relatively cost-less way, the actual requirement for additional tax as the 0%/10% corporate tax regime is introduced by 2008, will be lower than that. The Committee's implementation proposals are designed to take this into account.

The mechanism for phasing out tax-free income for those with high incomes will probably be brought forward in the 2005 Budget, so implementation of this aspect of the policy could start in the 2005 year of assessment. To avoid very large changes in any individual household's tax liability from one year to the next, the change itself may need to be phased in over two or three years.

However successful the States are in cutting out waste and increasing efficiency, and with realistic economic growth, the Committee believes that a general goods and services tax is going to be necessary. Such a tax will, however, take some time to implement for both the government and the private sector. **Additional research and consultation will start immediately to determine the type of goods and services tax that would be best for Jersey, given the particular circumstances of the Island. A proposition will be brought forward for decision in July 2004 that will enable the necessary administrative structures to be created and to enable the tax to be introduced during 2007**. The precise rate will be determined nearer the time, but the Committee is hopeful that the funding generated from expenditure reductions and economic growth measures should mean that a rate of 5% (generating a net income of £40-£45 million at today's prices) should be sufficient.

It is hoped to put forward legislation in the 2005 Budget in order to introduce an Income Tax Instalment System for implementation beginning January 2006.

In formulating its preferred package of tax reform proposals the Finance and Economics Committee also considered alternative tax raising measures. These are detailed in Annex 2.

Annex 3 outlines the approximate impact of the proposed measures on Jersey households.

Summary of tax reform proposals

The Finance and Economics Committee proposes to:

- **Introduce a standard rate of corporate profits tax of 0%, to be applied generally in the economy, whether or not the beneficial owners live in Jersey**
- **Introduce a rate of corporate tax of 10% for companies regulated by the Jersey Financial Services Commission**.

The Committee recommends that to meet a projected deficit of up to between £80- £100 million resulting from this structural change, the States should:

- Continue to make **efficiency savings** in **States expenditure** and limit the growth in States expenditure to 1% less than the RPI
- Implement policies that encourage **economic growth** of approximately 2% per annum
- Phase out (over 2 - 3 years) **Income Tax Allowances** on a sliding scale on household (2 adults, 2 children) incomes between **£80,000 - £150,000** pa from **2005**, with no Allowances available on incomes above £150,000. Equivalent changes will be made for other household types
- Introduce a **general goods and services tax of 5 % in 2007 with exemptions on food and children's clothing and income support for those on very low incomes**
- Introduce a local form of **pay as you earn in 2006**. This will be known as the **Income Tax Instalment System (I.T.I.S.)**.

The Finance & Economics Committee believes that with continued **economic growth** the above proposals should be sufficient to fill the projected deficit.

If the deficit proves to be higher, the Finance and Economics Committee recommends that in addition the States should consider:

- Increasing the rate of **the goods and services tax**, up to a **maximum** of **7.5%**
- Then, and only if **absolutely necessary**, it should consider introducing a **Payroll Tax**.

Annex 1

The Potential Impact of Failing to Implement Corporate Tax Changes: *Jersey without an International Financial Services Industry*

In considering its options, the Committee has looked at how the Island 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 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 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 dramatically from today's level of 12,000 jobs to a level of 1,200-1,500 jobs
- A large fall in demand for goods and services (for example in the shops) since employees in the financial services industry generally 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 no longer chose to 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 and the immediate liability for 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 in to 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 UK. Either tax rates would need to increase very significantly (ie up to the equivalent of UK 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 two 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 UK 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.

Annex 2
Alternative Tax Raising Measures

It would be possible to raise the necessary revenue using a different combination of measures from those recommended by the Committee. In particular, a goods and services tax could be used on its own, or income tax could be used on its own, especially if the headline rate of income tax of 20% was increased. This annex looks at F&E's preferred option and compares it to two alternatives - a goods and services tax only and using just income tax - to generate the same amount of revenue. The OXERA background paper describes a number of other alternatives that the Committee has also looked at.

As none of the options considered here involve changing the existing rates of Impôts duty (eg on alcohol, tobacco, petrol) the current tax paid on these items has not been included in the figures or tables to simplify the comparisons. The effect is to underestimate the tax currently being paid, but to make virtually no difference to the *additional* tax that would have to be paid under the different approaches.

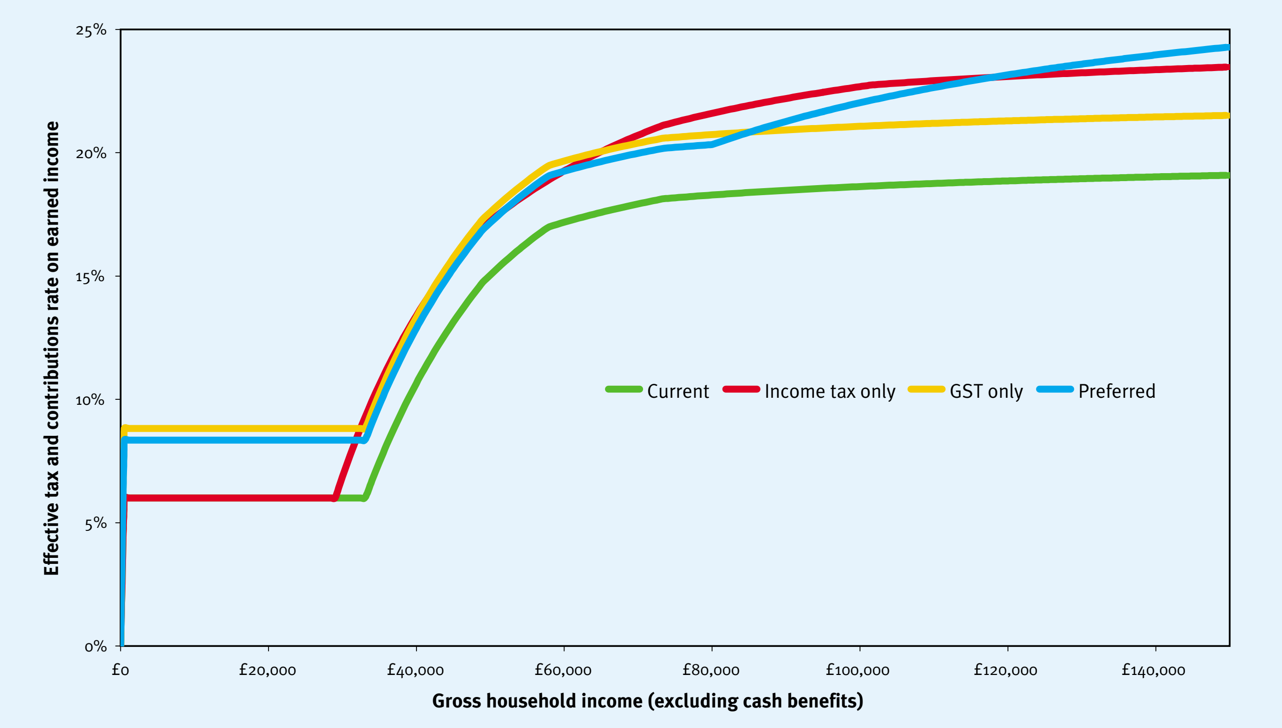
Adopting these alternative approaches would produce a different distribution of the tax burden. Figure A2.1 *(opposite)* compares the increase in the tax and social security contribution burden faced by a typical family household (married couple, two children, wife working, mortgage of £120,000) under three different tax structures. All three alternatives should raise around £50-60 million, and this is in the range of what the Committee believes will, in the event, be required. Under these circumstances the payroll tax elements of the Committee's preferred option has not been triggered.

- **Option 1:** An option that just uses income tax to raise the same amount (the "income tax only" option). Under this option the current 20% rate is raised to 25%. In addition, in order to raise sufficient revenue the tax-free income exemptions and allowances must also be reduced. This has been achieved by reducing the single and married personal income exemption and allowances by approximately 25%, with all other tax-free exemptions and allowances kept as they are (eg child allowance, earned income allowance).
- **Option 2:** An option that just uses a goods and services tax to generate the same total (the "GST only" option). In this case the goods and services tax rate required is approximately 1% higher than in the preferred option (ie 6%).
- **Option 3 (preferred):** The proposal from the Committee to phase out tax-free income from the high income households (for a couple, starting the phase out at £80,000 and finishing the phase out at £150,00) and introduce a goods and services tax (GST) of 5%.

The results shown in Figure A2.1 *(opposite)* are similar to those that occur for other household types. The main differences between the different tax options are as follows:

- The "income tax only" option (option 1) produces the least impact on the low paid, and for very high household incomes - above around £200,000 pa for this type of household - is likely to produce a higher average effective rate of tax. On the face of it, it is, therefore, the most progressive structure at low incomes (household incomes below about £25,000 in this example). However, the Committee believes that there is a real danger of income flight with a headline income tax rate of 25%, especially with the Isle of Man currently setting maximum income tax rates of 18%. Very few (in the order of 10s) of the very high income households would have to relocate to reduce the total tax take appreciably, increasing the necessary tax burden on those that are left
- For household incomes between £25,000 to £45,000 (in this example) the Committee's preferred option (option 3) produces a slightly lower tax rise than this "income tax only" option (option 1). Between around £60,000 to £110,000 (in this example) the Committee's preferred option also produces lower tax rises, and between £110,000 to

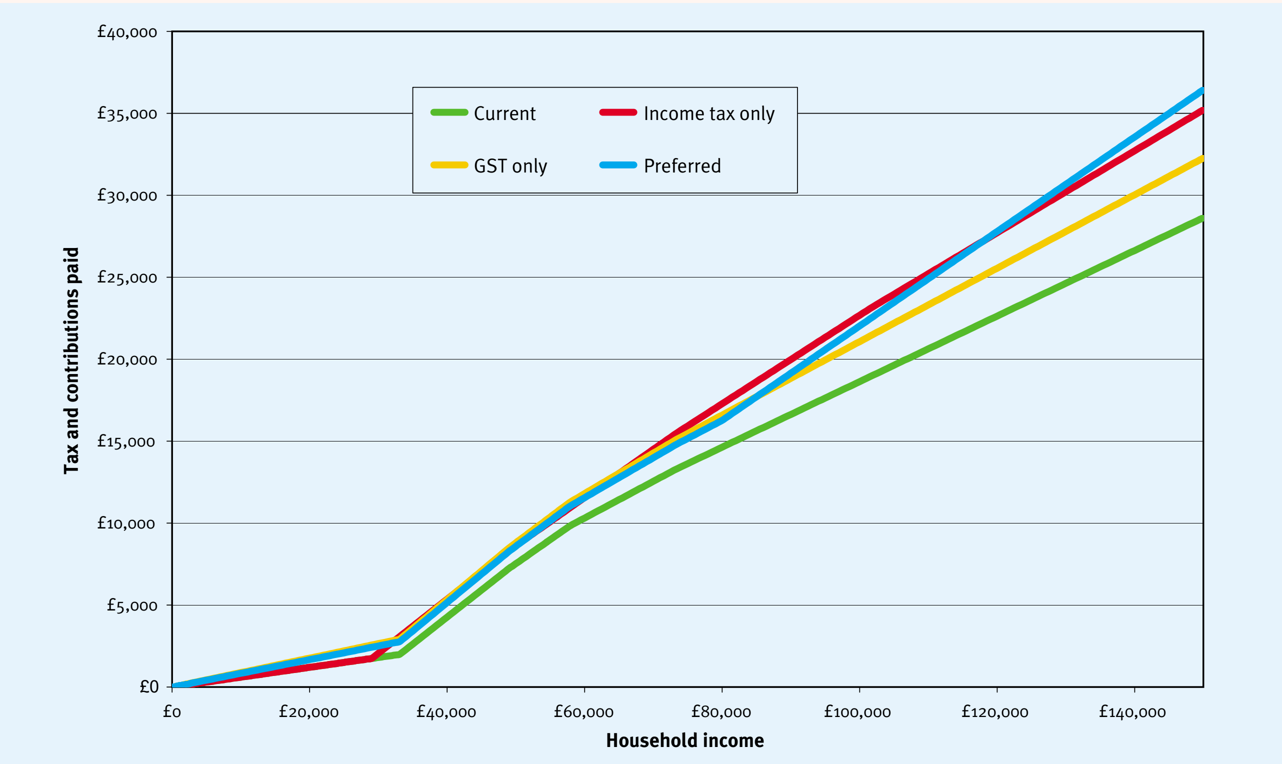
Figure A2.1: Comparison of tax and social security contributions structure: married couple, two children, mortgage £120,000, for incomes up to £150,000 - tax rates.



Source: Jersey income tax data (2001), OXERA calculations.

Note: Figure A2.1 does not include the impact of the Income Support System, and does not take account of the impact of any possible migration of income from the Island if income tax rates are increased

Figure A2.2: Comparison of tax and social security contributions structure: married couple, two children, mortgage £120,000, for incomes up to £150,000 - amount paid.



Source: Jersey income tax data (2001), OXERA calculations.

Note: Figure A2.2 does not show the impact of any Income Support Scheme.

£200,000 slightly higher tax rises. Above £200,000 the "income tax only" option produces higher total tax bills

- The "GST only" option (option 2) produces slightly higher tax bills than the preferred approach up to an income of just over £80,000. Above this income level the preferred approach creates a significantly higher tax bill. This arises because the additional tax raised from those households with incomes above £80,000 by phasing out the tax free income allowances is used to reduce the necessary rate of GST, which creates a net benefit for those with incomes below this level

- At the low income level the Committee does recognise the undesirable distributional impact of the GST, even in the preferred option. However, the Committee believes that the income support mechanisms can effectively deal with any real problems this will cause.

In terms of the different impact on actual tax bills, Figure A2.2 *(on page 17)* shows this impact for the same household. Table A2.1 *(below)* gives the same information for 8 different income levels.

Table A2.1: Comparison of tax and contributions structure: married couple, two children, mortgage £120,000, for incomes up to £150,000 - amount paid.

Income	Current	Option 1 "Income tax only"	Option 2 "GST only"	Option 3 Preferred
£10,000	£600	£600	£880	£835
Additional tax		***£0***	***£280***	***£235***
£20,000	£1,200	£1,200	£1,765	£1,670
Additional tax		***£0***	***£565***	***£470***
£30,000	£1,800	£2,060	£2,645	£2,505
Additional tax		***£260***	***£845***	***£705***
£40,000	£4,260	£5,360	£5,330	£5,155
Additional tax		***£1,100***	***£1,070***	***£895***
£50,000	£7,520	£8,620	£8,795	£8,585
Additional tax		***£1,100***	***£1,275***	***£1,065***
£75,000	£13,630	£15,930	£15,470	£15,165
Additional tax		***£2,300***	***£1,840***	***£1,535***
£100,000	£18,630	£22,680	£21,070	£22,025
Additional tax		***£4,050***	***£2,440***	***£3,395***
£150,000	£28,630	£35,215	£32,270	£36,435
Additional tax		***£6,585***	***£3,640***	***£7,805***

Note: the figures in Table A2.1 include employee social security contributions, income tax and GST and are rounded to the nearest £5. The estimate of GST paid is based on an expenditure of half of disposable income being spent on goods or services subject to the tax.

As can be seen all options, including the Committee's preferred option, show a generally rising contribution as incomes rise.

Further analysis of this sort on more tax options is contained in the OXERA background paper.

Annex 3 shows the impact of the preferred option on a number of different household types.

The extensive analysis carried out for the Committee has lead the Committee to conclude that no tax option is perfect, and all realistic options require compromises between different objectives. On balance, however, the Committee has concluded that the tax option that is most likely to maximise the benefits to the Island as a whole is one that firstly maximises the realistic yield from a 20% headline rate of tax, then applies a goods and services tax to raise a significant amount of revenue while protecting the poorer members of society through an income support system and then, only if absolutely necessary, introduces a limited payroll tax.

Annex 3

Estimates of the Approximate Impact of the Proposed Measures on Jersey Households

Tables A3.1 and A3.2 *(below)* show the approximate impact on three different household types of the Committee's preferred option. Table A3.1 gives the estimate of the total increase in tax that would be paid and includes both the impact of the proposed changes in income tax and the goods and services tax. Table A3.2 gives the estimate of just the income tax element of the estimated increase.

These estimates are based on stylised households. The experience of actual households will vary from these estimates because of their specific circumstances. In particular households with incomes above the threshold at which tax free income is phased out, who currently enjoy higher tax allowances than used in the tables, will experience a higher increase in their income tax liability. In addition, households that concentrated their expenditure on goods and services excluded from the scope of the GST will experience a lower impact from this tax than is indicated in the tables. Nonetheless these examples are designed to give a realistic indication of the overall impact of the option preferred by the Finance and Economics Committee.

The three household types are as follows:

- Single person, no children, working, no mortgage
- Two adults (married), both working, two children (school age), £120,000 mortgage
- Two adults (married), not working, no children, no mortgage

Table A3.1: Impact of the preferred option on three household types - additional income tax and GST paid

Gross household income	Single person no mortgage	Married couple, 2 children, both working, £120K mortgage	Married couple, no children, no mortgage, unearned income
£10,000	£235	£235	£250
£20,000	£410	£470	£480
£30,000	£585	£705	£665
£40,000	£785	£895	£845
£50,000	£1,320	£1,065	£1,075
£75,000	£2,655	£1,535	£1,640
£100,000	£3,155	£3,395	£2,465
£150,000	£4,155	£7,805	£4,265

Table A3.2: Impact of the preferred option on three household types - additional income tax paid

Gross household income	Single person no mortgage	Married couple, 2 children, both working, £120K mortgage	Married couple, no children, no mortgage, unearned income
£10,000	£0	£0	£0
£20,000	£0	£0	£0
£30,000	£0	£0	£0
£40,000	£0	£0	£0
£50,000	£345	£0	£0
£75,000	£1,200	£0	£0
£100,000	£1,200	£1,400	£295
£150,000	£1,200	£4,890	£1,040

Note: Tables A3.1 and A3.2 are rounded to the nearest £5.

Next steps

The period of public presentations and discussions will continue until 16th April 2004.

The Finance and Economics Committee will then consider the responses from the consultation period before it formally submits its proposals to the States in May 2004.

The Committee will then aim to have these proposals debated by the States during early July 2004.