STATES OF JERSEY

EXPENDITURE PROPOSALS FOR 2012 AND 2013 AND DRAFT BUDGET STATEMENT 2011 (P.157/2010) – THIRD AMENDMENT (P.157/2010 Amd.(3)) – COMMENTS

Presented to the States on 3rd December 2010
by the Minister for Treasury and Resources

STATES GREFFE

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COMMENTS

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

- All the expert advice suggests that GST exemptions would be an inefficient and blunt way to support those on lower incomes, since those on higher incomes actually receive more in cash terms from such a policy.

- Of the £8 million revenue that would be lost from excluding food and domestic energy at a GST rate of 5% – assuming that prices are reduced correspondingly – less than £1 million would go to the 20% of the population on the lowest income (those with less than £20,000 a year) where as more than £2.5 million would go to the top 20% (those earning more than £73,000 a year).

- There would be substantial administrative costs if this proposition is adopted. A system of exemptions requires detailed legislation and – due to the added complexity – greatly increases the scope for fraud and error. Therefore substantial additional resources would be necessary for compliance and administration.

    - The complexities involved with zero rating food and domestic energy will increase both the cost of compliance for those businesses involved and increase the cost of administration for the Taxes Office and Customs and Immigration by £200-300,000 per annum.

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

- A broad-based consumption tax like the current GST system has a number of economic advantages over a system with exemptions. In particular, it does not distort consumption decisions and so is likely to be less harmful to growth.

- There is a real risk in Jersey that some or all of the reduction in GST on food and/or domestic energy would not be passed on through lower prices meaning the States loses significant revenue and increases administration costs with little or no benefit to Islanders.

Supporting Analysis

GST is closer to being a proportional tax

Deputy Green asserts that GST is "unfair and falls disproportionately on the less well-off". The basis for this statement does not reflect the evidence on indirect consumption taxes as applied to GST. GST is much closer to being a proportional tax.

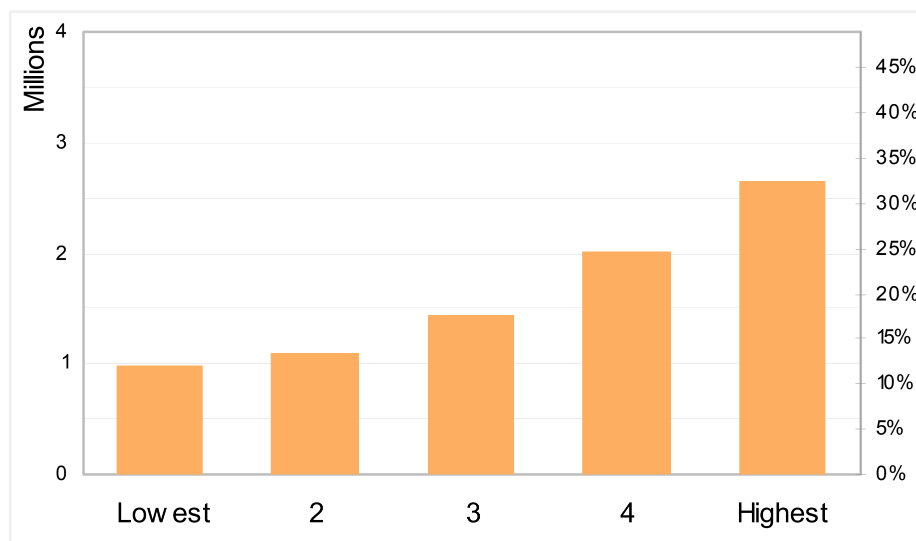
Exemptions to protect those on lower incomes is not efficient

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

For example, if GST were to be increased to 5%, the cost of putting exemptions and/or zero-rates on food and domestic energy would be in the region of £8 million. Just 12% (£980,000) of this would go to the 20% of the population with the lowest income (those on less than £20,000 a year), while 33% (£2.67 million) would go to the 20% with the highest income (those with incomes above £73,000) (Figure 1).

Figure 1 Beneficiaries of exempting food and domestic energy from 5% GST

£, Millions (LHS), Proportion of total, % (RHS)



Source: Economics Unit calculations based on HES data

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

The costs of exemptions: Complexity, administration and compliance

It is widely acknowledged that consumption taxes with more than one rate or exemptions significantly increase complexity, administration costs and risks to compliance. For example, a US Government Accounting Office (GAO) report noted that –

> *"Tax preferences – in the form of zero rates, exemptions or reduced rates – reduce revenue, add complexity and increase compliance risks. The end result is an increase in compliance burden for businesses and administrative costs for Government"*. ("VAT lessons from other countries"; dated April 2008).

This would be true in Jersey as well, as is illustrated below.

1. Complexity

The impact of exclusions on the complexity of GST is dependent on the supplies involved; the type of exclusion given and the number of businesses involved. Based on the assumption that food would be zero rated the overall impact assessment for food is very high and the impact assessment for domestic energy is low. Taken together the overall impact assessment would still be high. The paragraphs below provide further comment on the exclusions proposed –

Food

The exclusions proposed are based on the UK VAT model which is regarded internationally as one of the most complex systems in the world and is even non-compliant in terms of the European Union (EU) directives on VAT harmonisation (see Section 14 for further details). The following analysis has attempted, where possible, to follow the UK VAT interpretation on liability, but the difficulties, even after over 30 years of live tax experience, are striking.

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

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

There is no specific legal definition for food (but it includes drink) – "it is what the average person would consider it so" but it excludes catering and a list of 7 excepted items (including ice-cream, confectionery) and a further 7 items overriding the exceptions.

Retail shops selling food, confectionery, beverages and other household items will have to identify, for every individual item they sell, whether or not it is subject to GST, and they will need to maintain sophisticated systems to collect and account for the tax. However, in many ways the compliance impact will be easier on retailers of pre-priced/pre-packed food products imported from the UK.

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

Mention has been made during previous debates specific examples of UK food liability which inspired ridicule elsewhere in the world (the Jaffa cake and Gingerbread man). After 30 years of tax experience the UK is still having difficulties in definition – a recent Tribunal case ruled that the supply of Pringle crisps is eligible for zero rating as they are not considered to be crisps (based on the content mix of potato and maize).

Pet shops and garden centres will be affected. Animal feedstuffs are zero-rated but pet food is taxable. But rabbit food is zero-rated whereas guinea pig food is taxable. Hay and straw if sold as animal feed would be zero-rated but taxable if sold as bedding. Seeds and plants grown for human consumption or animal feedstuffs are zero-rated – grass seed is zero-rated, but not if pre-germinated and turf is taxable. Flower plants and seeds are taxable, other than specifically listed edible varieties.

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

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

Every type of exclusion in terms of supply (goods and/or services) presents a different challenge but international experience shows that any system with mixed liability goods will present difficulties even at the very start of the supply chain. Under the current system designed for Jersey all imported goods are taxable – this has been welcomed as clean and simple by the main importers and Chamber of Commerce. The only problems likely to be encountered are with valuation of consignments. However, as soon as goods are excluded there is a great potential for mis-description, both accidentally and deliberately.

Problems would also occur further down the supply chain in identifying taxed and untaxed goods at the point of supply whether by segregation on tax invoices, or at the point of consumption using retail schemes.

Domestic energy

If the proposition was approved the States would need to agree exactly what supplies were intended to be covered by "domestic energy". The proposition does not mention using the same liability treatment as in the UK but this would be a possibility. It should also be stressed that in the UK all forms of energy supplies are taxed under VAT but what are described as "qualifying supplies" are eligible to be taxed at the lower 5% rate rather than the standard rate of 17.5% (soon to be 20%). The qualifying supplies use quantitative measures to determine what is intended as being "domestic" and as such taxed at the lower rate of 5%. This UK system could be adopted in Jersey to determine what is eligible for zero rating.

2. Impact on businesses

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

If the proposed exclusions are approved by the States, the estimated total number of businesses involved in some way with redefined liability supplies is between 150 and 200. They would all need to be engaged in a re-education programme.

Accounting systems

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

Many smaller businesses do not have computer based accounting so the impact of complex GST liability may fall disproportionately on them (e.g. market traders).

Increased complexity

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

3. Impact on administration

It is not clear that many States members fully comprehend the relationship between the design of a tax system and compliance and administration costs. Arguably this is understandable as it is a complex issue, however we cannot afford to make decisions without fully understanding these relationships.

Understanding on this issue was probably not helped by the Corporate Services Scrutiny Panel's first interim report on GST (S.R.6/2006) – dated October 2006. Section 6 covers compliance and appears to rely on an Australian Senate Select Committee review dating back to April 1999 which in turn quotes from a UK National Audit Office (NAO) study into compliance costs in 1995. Although we have generally been impressed with the work of the Corporate Scrutiny Panel on GST (the conduct, methodology and outputs) we have never accepted these conclusions which are not evidence based and focus mainly on business compliance costs.

The Scrutiny Panel findings have repeatedly been mis-interpreted in previous propositions and this P.28/2009 is no exception. The comment under Financial and Manpower includes "as was demonstrated convincingly by Scrutiny, claims of excessive administration cost associated with exemptions or zero rating were grossly overstated". Scrutiny demonstrated no such thing and the panel members have never seen the NAO report. If they had they would have seen an important footnote in the comparison of gross compliance costs – "The purpose of this comparison is to illustrate the similarity of the compliance cost: turnover curve. Comparison between individual countries figures (UK; Netherlands; New Zealand; Germany; Canada) are not valid because the tax regimes are different and the research has been carried on a different basis". Finally it must be emphasised that the NAO report was a study into the "Cost to Business of Complying with VAT requirements" and not the cost of administration of VAT by HM Customs and Excise (as it was known then).

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

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

Staffing numbers

It is difficult to quantify the exact additional administrative costs of these exclusions. However, a reasonable approximation based on UK experience is that 3 additional staff will be required and the extra payroll, social security,

IT, accommodation and other costs would be approximately £200,000 to £300,000 a year.

Customs and imports

Under the current GST Law, all goods imported into Jersey are potentially taxable (there is a de *minimis* value below which goods will enter freely). Under these circumstances our proposed clearance procedures are simple and have been welcomed by the main importers and Chamber of Commerce. Any potential problems likely to be encountered by Customs are mainly limited to under-valuation.

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

If the proposition was approved in full we would be in very different position – we certainly would not have a simple GST and the costs to the revenue departments of administering the law and compliance costs borne by traders would both increase.

Economic merits, international advice and evidence for a simple GST

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

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

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

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

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

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

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

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

Again the International Monetary Fund (IMF) agrees –

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

Introducing exemptions may not pass through to lower prices

Finally, for the granting of exemptions and zero-rates to offer any relief to those on lower incomes, it is necessary that this favourable treatment is passed through to consumers in lower retail prices.

In theory, sales taxes should be entirely passed on to the consumer in competitive markets. Evidence from Iceland, Sweden and Norway suggests that cuts in sales taxes were entirely, or almost entirely, passed on to consumers. However, arguably all these countries have open economies where competition is vigorous and foreign competitors have relatively easy access to them.

Given that in Jersey the markets for the products that are often suggested as candidates for zero-rating or exemptions – food and domestic fuel – may not be fully competitive, there is a question about the degree to which permanent exemptions from GST would be passed on to consumers.

Protecting the less well-off from the impact of GST

The Minister for Treasury and Resources accepts that people are concerned about the impact of GST on the less well off. For that reason the proposal is to compensate the less well off for the impact of the rise in GST in a more direct and efficient way than exemptions on food and domestic fuel. In particular, the Minister for Treasury and Resources proposes to increase income support for those that receive it and to maintain an adequate GST bonus for those on low incomes that do not receive income

support. This is a much more targeted and effective way of helping out those that need support.

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