Fiscal Strategy Review: Supporting Research

Introduction

1.1.1 This report sets out the background research prepared for the Treasury and Resources Minister and the Fiscal Strategy Review Steering Group to help them consider the economic issues ahead of the proposed consultation on the Fiscal Strategy Review (FSR).

1.1.2 It sets out the framework used for assessing the options for raising revenue and includes detailed analysis of the main tax options.

Assessing the tax options

1.1.3 The principal aim of the tax system is to finance the level of public expenditure chosen by society. But because taxes affect economic behaviour, it is necessary to consider their impact on economic prosperity at the same time. Further, the tax system also aims to achieve other objectives, such as increasing social equity (e.g. through a progressive tax system), reducing harm to health (e.g. through specific taxes on alcohol and tobacco) and addressing environmental concerns (e.g. through specific taxes on motor fuel). There may be trade-offs between the aim of choosing taxes that do not create significant distortions in the economy and those that achieve these other aims of taxation.

1.1.4 To this end, taxes are generally assessed against five criteria:

- **Fairness**
- **Economic efficiency**
- **Competitiveness**
- **Revenue stability**
- **Administrative cost**

Each of these criteria is discussed in more detail below.

Fairness

1.1.5 The distributional impact or fairness of taxes and tax systems can be characterised as:

- **Regressive:** The average tax rate falls as income rises. This means that those with the lowest incomes pay more tax relative to their incomes (even though they may pay less in tax in monetary terms).
- **Proportional:** The average tax rate is constant as income rises. This means that everyone pays the same percentage of income in tax.
- **Progressive:** The average tax rate rises as income rises. This means that those with higher incomes pay a higher proportion of this income in tax.

1.1.6 Figure 1.1 shows the average tax rate (income tax, social security/national insurance and VAT/GST) that a single person and a married couple without any children or mortgage would pay in the UK and the three Crown Dependencies (CDs). It can be seen that, at almost all levels of income, more tax would be paid in the UK than in any of the CDs, and the difference depends on the level of income.

1.1.7 The UK system of tax is more progressive than the system in any of the CDs. This is partly because it has a higher marginal rate of 40% on taxable income over £37,400 (which was increased to 50% for those earning over £150k in 2010), and no cap on National Insurance, so average tax rates continue to rise with income. In contrast, because the CDs have relatively flat income tax systems at higher incomes and ceilings on their social security systems, the average tax rate tends to fall when this ceiling is reached.

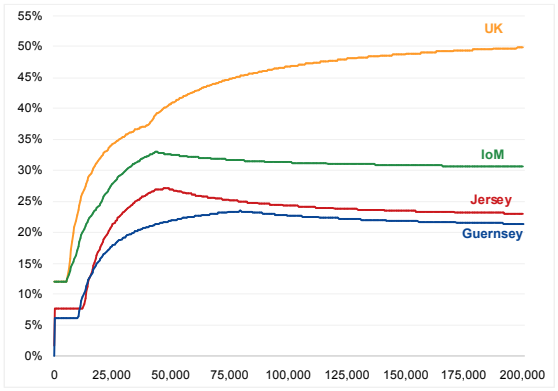
1.1.8 Both the households in Figure 1.1 would pay slightly more tax in Jersey than in Guernsey, although less than in the Isle of Man (mainly due to VAT). Although, like Jersey, Guernsey has a top marginal rate of 20%, households paying this rate are still eligible for significant tax-free income (in the form of allowances), so the average rate never reaches 20%. By contrast, in Jersey, particularly after '20 means 20', households on higher incomes get close to paying an average rate of 20%. In addition, Jersey has a 27% marginal rate for those on lower incomes, which causes the average rate that a household pays to increase more quickly with income.

1.1.9 It is worth noting that Figure 1.1 is based on the tax rates in 2009. In the 2010-11 budget, the Isle of Man increased its top rate of income tax from 18% to 20%, which would shift the green line in the charts upward slightly.

Figure 1.1: Average tax rates (income tax, social security and VAT/GST) by income in the UK and the Crown Dependencies in 2009

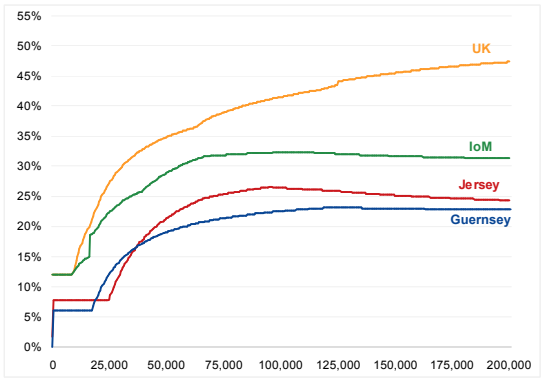
Single person, no mortgage or children

Average rate, percent



Married couple, no mortgage or children

Average rate, percent



Sources: Economics Unit calculations using information from national tax offices and social security departments

1.1.10 The paper looks in detail at alternative tax changes and the distributional impact of them by assessing the change in the average rate paid by people at different income levels.

Economic efficiency

1.1.11 All widely used taxes create distortions to some extent because they influence, for example, the decisions of households to work and to save and the decisions of companies to create jobs and make investments.

1.1.12 Economic efficiency refers to the extent to which a tax distorts behaviour and decision-making, which in turn can result in a sub-optimal allocation of resources and lower prosperity and welfare. It is concerned with how marginal tax rates cause economic distortions by altering the marginal decisions – the decision, for example, on whether to work an extra hour or save an extra pound – of households to work and to save and the decisions of companies to create jobs and invest.

1.1.13 The empirical evidence on tax distortions was recently summarised by advice from the OECD (2009):

> *"Growth-oriented tax reforms would generally involve shifting revenue from corporate and personal income taxation or social security contributions onto consumption and property taxes, including housing taxation."*

1.1.14 The research underpinning this OECD advice suggests the following ranking of taxes in terms of how growth-friendly they are.

Figure 1.2: How growth-friendly are various taxes?

Ranking	*Tax*	*Examples*
1st best	Recurrent tax on immovable property	Island Rate
2nd	Consumption tax	GST
3rd	Personal income tax	Personal income tax
4th worst	Corporate income tax	Corporate income tax

Source: Arnold (OECD, 2008).

Competitiveness

1.1.15 In small open economies like Jersey international competitiveness is a key determinant of the strength of our economy. Taxes can have an impact on competitiveness directly by raising the cost of doing business in the Island and indirectly through the way people respond to tax changes.

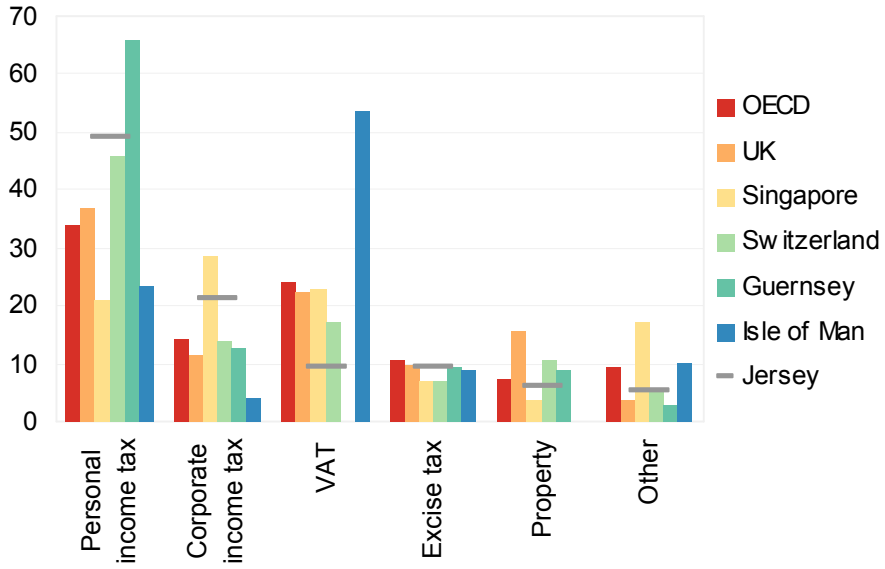
1.1.16 The evidence on the impact on competitiveness of the main tax options supports the hierarchy above shown in Figure 1.2.

1.1.17 In the long-run, economic theory suggests that individuals bear the full incidence of tax rises and companies bear no incidence. Section 5 explains in more detail that this is because companies do not pay tax, people do. If employees do not bear the tax directly and it is passed on to shareholders (in lower profits/dividends) or customers in higher prices then this will reduce profitability, growth and employment meaning that employees will eventually face the costs of the tax. The real difference will be the transition process that occurs if employees try to deflect the tax onto shareholders or customers – it leads to a more painful adjustment process that also involves some of them losing their jobs. It is for these reasons that consumption and property taxes score better on competitiveness than income or payroll taxes.

1.1.18 Figure 1.3 shows the tax mix in the OECD, UK, Switzerland, Singapore and the Crown Dependencies, with the position in Jersey highlighted by a horizontal grey line. The proportion of tax collected from personal and corporate income tax is relatively high in Jersey, while the proportion of tax collected from VAT/GST and property tax is relatively low in Jersey. There is therefore significant scope for tax reform in Jersey that could support economic efficiency and competitiveness. That is, for the tax mix to achieve a better balance between direct and indirect taxation.

Figure1.3: Tax mix in the OECD, UK, Switzerland, Singapore and Crown Dependencies

Percent of total tax revenue (excluding social security) latest year*



Source: OECD and budget documents for Singapore and the Crown Dependencies.
*Note: OECD, UK, Switzerland and Guernsey data for 2007. Isle of Man data for 2008/09. Singapore data for 2009. Jersey and Guernsey data for 2010, so they have lower corporate tax revenue following the introduction of 0/10.

Revenue stability

1.1.19 To the extent that tax revenues tend to finance expenditure on public services, the stability and predictability of revenue is a desirable property. Consumption and property taxes tend to have a less volatile tax base (expenditure and base property values) than income and payroll taxes (earned and unearned income).

Administrative cost

1.1.20 Some taxes can cost more per unit of revenue than others can and ideally taxes will raise revenue in an efficient way. As the main taxation options are all changes to existing taxes – income, social security, GST and domestic rates – the scope for significant variation in administration costs is reduced.

Assessing the options

1.1.21 Figure 1.4 shows the main sources of revenue for the States in 2009. The largest source of income was personal income tax, which raised nearly £250m (£287m including income tax on self-employed and investment holders), followed closely by company income tax of £208m. GST and impôts both raised in the region of £50m each. All remaining taxes between them raised £31m.

Figure 1.4: Source of States' revenue, 2009

	2009	
	£m	**%**
Personal income tax	243	37.2%
Companies	208	31.8%
Self-employed and Investment Holders	37	5.7%
Total Income Tax	**488**	**74.7%**
Goods and Services Tax	50	7.7%
Impots	51	7.8%
Stamp Duty	20	3.0%
Total Taxation Revenue	**609**	**93.1%**
Island Rate	11	1.6%
Total Other Income	34	5.2%
Total Income	**654**	**100.0%**

Note: Although 0/10 was introduced in 2009, it will not show up in the revenue figures until 2010

Source: States of Jersey Budget 2010

1.1.22 Although social security contributions are not included in Figure 1.4, they amounted to £145m in 2008, while supplementation – the States contribution to the social security fund – costs around £60m a year (£61.8m in 2008).

1.1.23 It should be clear from this that the major options that are capable of raising significant amounts of revenue on their own are personal income tax, social security contributions and consumption taxes (GST and impôts). The Island rate would have to increase significantly if it was to make a telling contribution.

1.1.24 Sections 4 and 5 consider all the main tax options and other smaller measures in detail and on the basis of the five criteria. Figure 1.5 below summarises the findings.

1.1.25 Figure 1.5 shows that tax measures that score well in terms of efficiency and competitiveness (GST and domestic rates) tend to score less well in terms of fairness and progressivity. Similarly, tax measures that contain a significant progressive element – income tax and social security changes – score less well in terms of competitiveness and efficiency. It is clear that any package designed to meet the potential shortfall in states revenue will need to balance the requirement to deliver a progressive package with the need to deliver one with the least damaging economic impact. This will ultimately be a political choice.

Figure 1.5: Assessing the tax options against the five criteria

Measure	Revenue	Fairness	Economic efficiency	Competitive-ness	Revenue Stability	Admin. costs
Main options						
Income tax						
Freeze exemptions	£4m	Regressive	Negative	Negative	Volatile	Low
Raise basic rate by 1%	£8m	Progressive	Negative	Negative	Volatile	Low
30% rate over £100k	£30m	Progressive	Negative	Negative	Volatile	Low
Extend '20 means 20' *	£4m	Progressive	Neutral	Negative	Volatile	Low
Social security						
Raise rate by 1%**	£15m***	Neutral****	Negative	Negative	Volatile	Low
Raise ceiling to £115,000	£30m#	Progressive	Negative	Negative	Volatile	Low
Remove ceiling	£45m#	Progressive	Negative	Negative	Volatile	Low
GST						
Raise GST by 1%	£15m	Mildly Regressive	Positive	Positive	Stable	Low
Domestic rates						
Double Island wide rate	£6m	Mildly Regressive	Positive	Positive	Stable	Low
Other options						
Raise impôts by 10%	£5m	Mildly Regressive	Neutral	Positive	Stable	Low
Removing MITR	£20m	Unclear	Positive	Positive	Neutral	Low

* Remove remaining allowances for higher earners
** 0.5% on employees and employers
*** net of supplementation
**** Progressive for incomes up to the ceiling/regressive above it
# Excludes any increase in revenue to the Health Insurance Fund, should changes apply to those contributions

2 Introduction

2.1 Fiscal Strategy Review Steering group

2.1.1 This report was prepared for the Treasury and Resources Minister and the Fiscal Strategy Review Steering Group. The Fiscal Strategy Review is being led by the Treasury and Resources Minister. A Steering group consisting of the Chief Minister and other Ministerial and States colleagues was set up to advise him.

2.1.2 So far the Steering group has considered the challenges that will be faced and the possible ways in which they could be addressed. They have helped to guide the direction and focus of the research. All of the research findings are contained in this report, which is intended to support the consultation process by providing the detailed analysis to interested readers.

2.2 Report structure

2.2.1 Section 3 and 4 cover the economic analysis, evidence and findings to date for the tax options that - if needed - could be considered for raising revenue.

2.3 A forecast structural deficit

2.3.1 The financial crisis and the subsequent turmoil has adversely affected economies all around the world. Consequently, the world economy is expected to have contracted by just over 1% in 2009 (for the first time in over 60 years) before returning to growth in 2010[1]. The speed and strength of economic recovery is likely to be weaker in the UK and Euro area compared to elsewhere. Jersey is also feeling the effects and it is clear that there will be longer term consequences for the States budget balance that will need to be addressed.

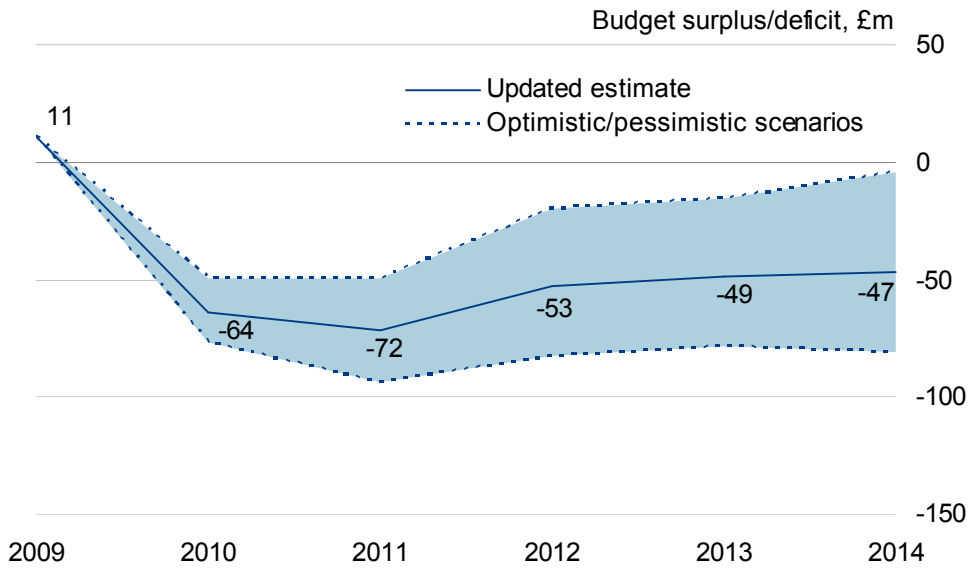
2.3.2 The Budget 2009, presented in late 2008, contained forecasts that revenue and expenditure would broadly balance from 2010 onwards. Since then, the picture has deteriorated.

2.3.3 The expectation in Budget 2010 was that the States will record deficits from 2010 onwards (Figure 2.1). The budget deficit is forecast to be around £64m in 2010 and

[1] National Institute Economic Review No. 211 January 2010.

around £72m in 2011, partly caused by the cyclical (temporary) economic downturn feeding through to the public finances.[2]

Figure 2.1: Budget 2010 forecast budget position



Source: Treasury and Resources Department.

2.3.4 Consistent with the Fiscal Framework and the advice of the Fiscal Policy Panel, money will be drawn down from the Stabilisation Fund to pay for these deficits. So there is no financing problem for the budget deficits expected in 2010 and 2011.

2.3.5 The budget deficit is forecast to be around £53m in 2012 and around £49m in 2013. These budget positions are not caused by the cyclical (temporary) economic downturn, because economic growth is expected to have returned to normal rates in 2011. Instead, because the budget deficits are forecast to be persistent, it is possible that they are structural (permanent in the absence of changes to taxes or spending).

2.3.6 There is a large degree of uncertainty around these forecast budget deficits, illustrated by the blue area in Figure 2.1, so it is not possible to say for certain to what extent budget deficits will materialise or the degree to which they are structural. The opinion of the Fiscal Policy Panel (2009) is that, *"although the scale is somewhat uncertain, because the deficit persists well beyond the two-year cyclical economic*

[2] During an economic downturn company profits tend to fall, which reduces tax payments (States' income), and Income Support payments (States' expenditure) are expected to be higher. These two effects combine to worsen the budget position.

downturn expected, it is likely that much of it is structural." So there is a potential financing problem for deficits expected in 2012 and beyond.

2.3.7 This wide degree of uncertainty is likely to persist until first estimates for tax revenue in 2010 become available in early 2011 and give a first indication of the scale of the impact of the economic downturn on tax revenues.

3 Criteria

3.1 Aims of a tax system

3.1.1 The principal aim of the tax system is to finance the level of public expenditure chosen by society. But because taxes affect economic behaviour, it is necessary to consider their impact on economic prosperity at the same time. Further, the tax system also aims to achieve other objectives, such as increasing social equity (through a progressive tax system), reducing harm to health (through specific taxes on alcohol and tobacco) and addressing environmental concerns (through specific taxes on motor fuel). There may be trade-offs between the aim of choosing taxes that do not create significant distortions in choices and achieving these other aims of taxation.

3.1.2 To this end, taxes are generally assessed against five desirable criteria. In no particular order, these are:

- Fairness
- Economic efficiency
- Competitiveness
- Revenue stability
- Administrative cost

Each of these criteria is considered in more detail in turn below.

3.2 Fairness

3.2.1 Since the purpose of tax increases is to raise revenue for the government, taxes must take money out of the economy and reduce aggregate after-tax income. In other words, at least some taxpayers must have lower after-tax income than they had before a tax increase.[3] The question of fairness concerns who is affected and how.

3.2.2 The Oxera 0/10 Fiscal Strategy Paper (Oxera, 2004) defined fairness as "all should contribute as far as possible, while taking account of relative 'ability to pay',[4] and ability to pay is most often measured in terms of income.

3.2.3 When considering the distributional consequences of the existing tax system and changes to it, it is important to consider average and marginal tax rates.

Marginal and Average Tax Rates

A **marginal tax rate** is the amount of tax paid on each *additional* £1 of income. If 50p of an additional £1 in income is taken away in tax, then the marginal rate is 50%.

An **average tax rate** is the amount of tax paid out of *all* income. For example, if a person earns £100 and pays £30 in tax, then their average tax rate is 30%.

Marginal tax rates are important because they may affect the choices people make concerning how much they work or save. Average tax rates are important as they tell us whether a tax system is progressive, regressive or proportional.

3.2.4 The distributional impact of taxes and tax systems can be characterised as:

- **Regressive:** The average tax rate falls as income rises. This means that those with the lowest incomes pay more tax relative to their incomes (even though they may pay less in tax in monetary terms).
- **Proportional:** The average tax rate is constant as income rises. This means that everyone pays the same percentage of income in tax.
- **Progressive:** The average tax rate rises as income rises. This means that those with higher incomes pay a higher proportion of their income in tax.

[3] The effect on living standards is more ambiguous and depends on the uses to which tax revenues are put.

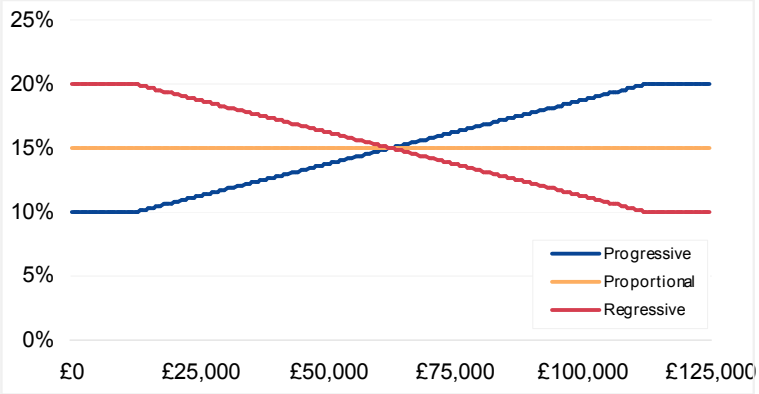
[4] This is the 'ability to pay' principle of taxation. An alternative principle of taxation would be that burdens should fall in proportion to the benefit received from public expenditure. Where this principle is relied on, it makes the implicit judgement that the tax is purely to finance the benefits (such as public goods) and not serve any redistributive role. The tax system that this principle would imply would depend on how benefits vary with income.

3.2.5 Figure 3.1 illustrates how the average tax rate varies across income levels for hypothetical regressive, proportional and progressive systems.

3.2.6 An individual tax – such as income tax or GST – or an entire tax system (adding up the individual taxes) can be described as regressive, proportional or progressive. An individual tax or a tax system can be progressive up to a certain income level, and then become regressive. For example in Figure 3.1 the blue line labelled progressive is actually only progressive for people with incomes from £12,500 to £112,500, while it is proportional at very low and very high incomes.

Figure 3.1: Regressive, proportional and progressive tax systems

Average tax rate by income

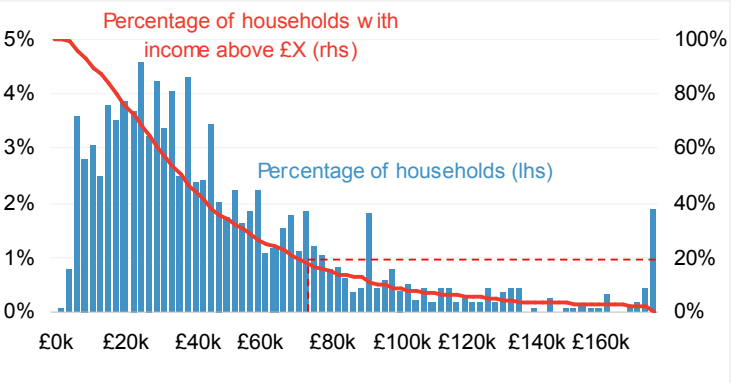


3.2.7 If it is thought that taxes should be paid with regard to ability to pay, a progressive system is typically thought to be fair because those who can afford to contribute more do so. Most countries tend to aim for their tax system as a whole to be progressive to some degree, although there is great variety among countries. What is considered to be 'fair' is ultimately a political, rather than economic, consideration.

3.2.8 Before considering the impact of tax changes it is important to look at the distribution of income. Figure 3.2 shows an estimate of the income distribution in Jersey from the most recent Household Expenditure Survey (which is useful for illustrating broad trends in income distribution but not for more detailed analysis). The blue bars show that a high proportion of households have income in the £20,000 to £40,000 range. The red line shows the percentage of households with an income above a certain amount. It shows that 80% of households have an income below £72,500 and 90% of households have in income below £97,500. It is important to focus most attention on the impact of tax changes at income levels that are relevant for the majority of households, which is those in the area to the left of Figure 3.2, rather than the long tail to the right.

Figure 3.2: Income distribution in Jersey

2005 data up rated to 2009 prices

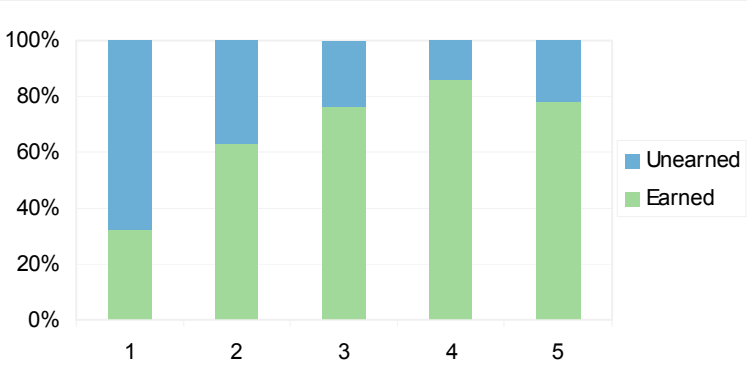


Note: Uprated by the 16.1% growth in the Average Earnings Index between 2005 and 2009

Source: Household Expenditure Survey 2004/05, States of Jersey Statistics Unit

3.2.9 It is also possible to look at how the split of earned and unearned income varies across the income distribution and how household type varies across the income distribution. It is possible for these variations to be shown by income quintile, that is, households ordered by their income and then split into five equally populated groups. Figure 3.3 shows how the split of earned and unearned income varies across the quintiles for all households. Unearned income forms the largest share for the lowest quintile and progressively less in higher quintiles. This is likely to reflect the fact that there are more households in the lowest quintile where the head of household is not working; for example, around 40% of the lowest quintile is accounted for by pensioner households (Figure 3.4).

Figure 3.3: Earned and unearned income by income quintile, 2004/05



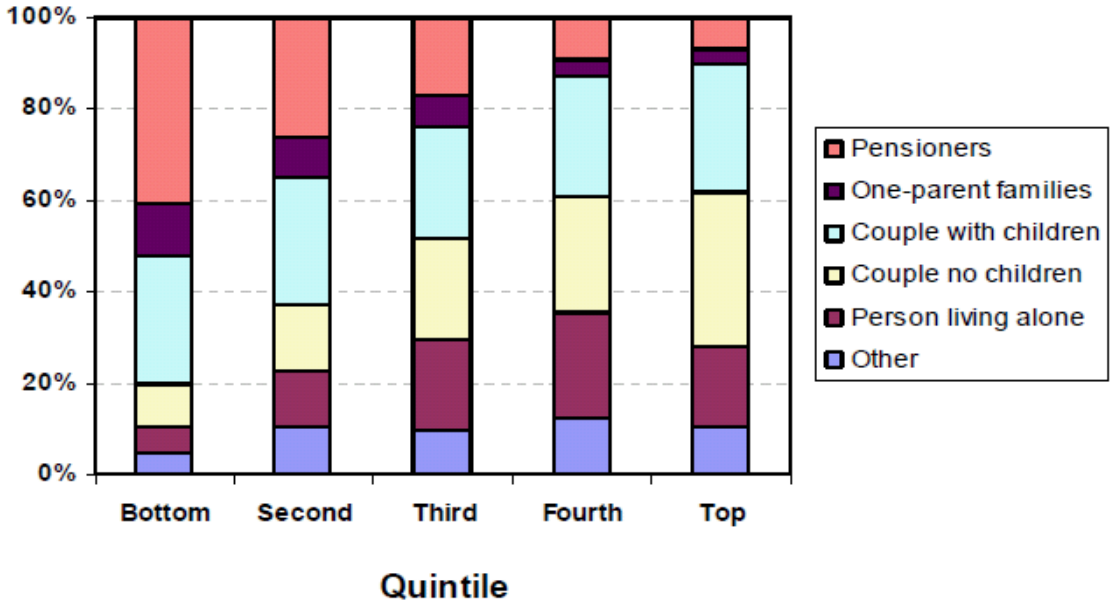
Source: Household Expenditure Survey 2004/05, States of Jersey Statistics Unit

3.2.10 Figure 3.4 shows how household type varies across the quintiles. It uses data from the Income Distribution Survey 2002. It is clear that the lowest quintile has a higher

proportion of pensioners and one-parent families than the other quintiles. The proportion of couples with children is similar across the quintiles. The proportions of couples without children and persons living alone are highest in fourth and fifth quintiles.

Figure 3.4: Household types across income quintiles before housing costs, 2002

Quintiles based on equivalised income[5]



Source: Income Distribution Survey 2002, States of Jersey Statistics Unit

3.2.11 To understand the overall tax burden, it is necessary to add together all taxes paid (income tax, social security contributions and consumption taxes). It is also necessary to look at variations by household circumstances, as the income tax system takes some of these factors into account.

[5] In other words, the quintiles can be thought of as denoting relative standards of living rather than simply nominal gross income.

Household Types

It is not practical to illustrate the effects of changes on a large number of different household circumstances, so five household types have been chosen that represent different circumstances. The five households chosen here are:

Household 1: Single person, no children, no mortgage.

Household 2: Married couple, no children, no mortgage

Household 3: Married couple, two young children, £300k mortgage

Household 4: Married couple, one schoolchild, one older child, £150k mortgage

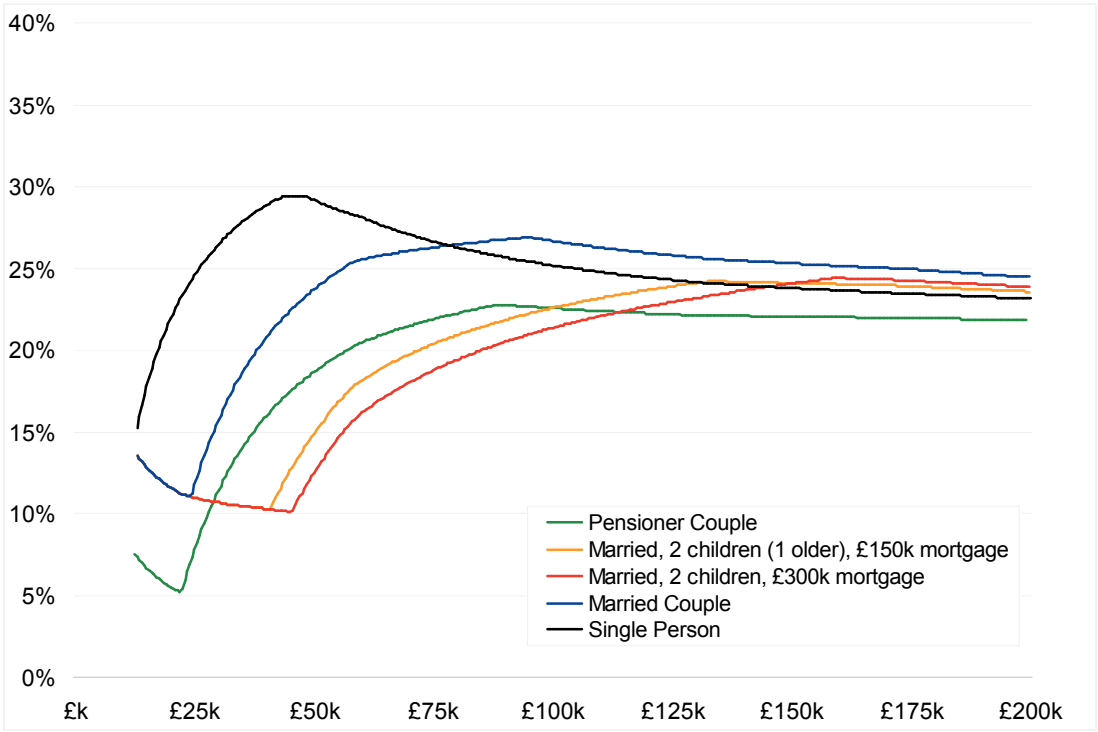
Household 5: Pensioner couple, no children, no mortgage

For households 2-5, the household income is assumed to be split 75%/25% between the spouses.

3.2.12 Figure 3.5 shows the total tax burden (as the average tax rate) in Jersey for each of the households in the box by income level. It can be seen that a single person with no children or mortgage pays the most, as they are not entitled to significant allowances or exemptions. A household of a married couple with two children and a mortgage will pay a significantly lower proportion of their income in tax as they get substantially greater allowances or exemptions.

Figure 3.5: Average tax rates by income for selected Jersey household types

Includes income tax, social security, GST and impôts



Source: Economics Unit calculations

3.2.13 Countries differ in the way they grant tax relief to low-income households and the way and the extent to which they take into account personal circumstances (such as marital status or children), but it can be useful to compare the average tax rate that a taxpayer would pay across jurisdictions.

3.2.14 Figure 3.6 shows the average tax rate (income tax, social security/national insurance and VAT/GST) that a single person and a married couple without any children or mortgage would pay in the UK and the three Crown Dependencies (CDs). It can be seen that, at almost all levels of income, more tax would be paid in the UK than in any of the CDs, and the difference depends on the level of income.

3.2.15 The UK system of tax is more progressive than the system in any of the CDs. This is partly because it has a higher marginal rate of 40% on taxable income over £37,400, and no cap on National Insurance, so average tax rates continue to rise with income (the UK has also introduced a new 50% rate on income over £150,000 in 2010). In contrast, because the CDs have relatively flat income tax systems at higher incomes and ceilings on their social security systems, the average tax rate tends to fall when this ceiling is reached.

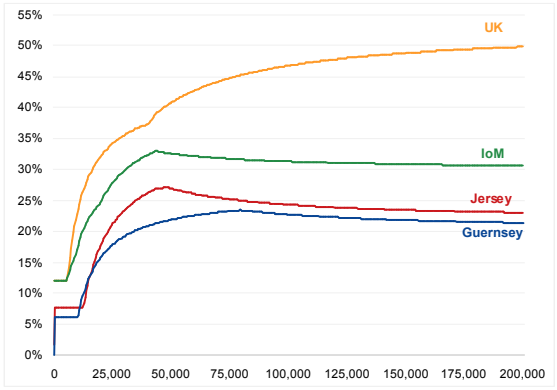
3.2.16 Both the households in Figure 3.6 would pay slightly more tax in Jersey than in Guernsey, although less than in the Isle of Man (mainly due to VAT). Although, like Jersey, Guernsey has a top marginal rate of 20%, households paying this rate are still eligible for significant tax-free income (in the form of exemptions), so the average rate never reaches 20%. By contrast, in Jersey, particularly after '20 means 20', households on higher incomes get close to paying an average rate of 20%. In addition, Jersey has a 27% marginal rate for those on lower incomes, which causes the average rate that a household pays to increase more quickly with income.

3.2.17 It is worth noting that Figure 3.6 is based on the tax rates in 2009. In the 2010-11 budget, the Isle of Man increased its top rate of income tax from 18% to 20%, which would shift the green line in the charts upward slightly.

Figure 3.6: Average tax rates (income tax, social security and VAT/GST) by income in the UK and the Crown Dependencies in 2009

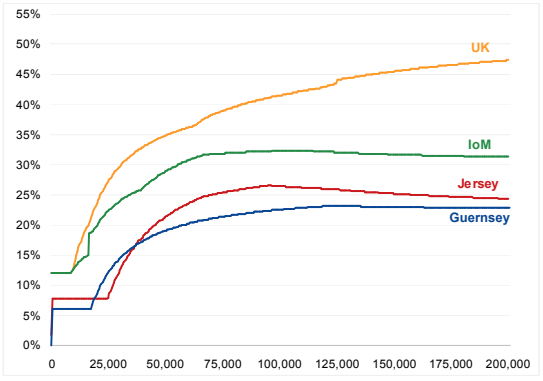
Single person, no mortgage or children

Average rate, percent



Married couple, no mortgage or children

Average rate, percent



Sources: Economics Unit calculations using information from national tax offices and social security departments

3.3 Economic Efficiency

3.3.1 All widely used taxes create distortions to some extent because they influence, for example, the decisions of households to work and to save and the decisions of companies to create jobs and make investments.

3.3.2 Economic efficiency refers to the extent to which a tax distorts behaviour and decision-making, which in turn results in a sub-optimal allocation of resources and lower prosperity and welfare. It is concerned with how marginal tax rates cause economic distortions by altering the marginal decisions – the decision, for example, on whether to work an extra hour or save an extra pound – of households to work and to save and the decisions of companies to create jobs and invest.

3.3.3 If the purpose of a tax is to raise revenue, then the less effect it has on behaviour the better.[6]

3.3.4 However, a number of studies have investigated whether there is a link between the overall level of taxation as a percentage of GDP and economic growth across countries, and there is little evidence of a relationship. Myles (OECD, 2009b) states, "empirical evidence for the hypothesis that the level of taxation affects economic growth is very weak." Arnold (OECD, 2008) notes that this is not surprising because there are two offsetting effects: higher taxes potentially mean greater economic distortions, which would reduce economic growth, but higher taxes pay for higher public spending, such as the provision of infrastructure, public education and healthcare, which may foster economic growth.

3.3.5 This evidence is based on the experience of large economies and does not take into account specific characteristics of offshore financial centres (OFCs). In particular, in financial centres many of the companies and individuals on which the economy depends are highly mobile, and thus a high tax level, especially corporate tax, is likely to have a significant impact on economic growth.

3.3.6 Further, although at the macroeconomic level there is no discernible relationship between the level of taxation and economic growth for large economies, economic growth can be influenced by the choice of particular tax measure (those that cause least distortion are likely to be positive for economic growth) and the focus of public spending (public investment is likely to more positive for economic growth than public consumption).

3.3.7 Personal income tax is levied on both labour income (from working) and capital income (from savings and investments). Personal income tax on labour income affects the decisions households make between working and not working in theory. Similar to social security contributions, in practice there is some evidence that higher personal income taxes lead to a negative effect on the amount of labour supplied by women. Personal income tax on labour income also affects the decision on whether to become an entrepreneur, and research suggests that high personal taxes might have a negative impact. Personal income tax on capital income affects the decision between spending today (not saving) and spending in the future (from savings).

[6] In some cases the stated purpose of taxes is to alter behaviour. For example, taxes on cigarettes and alcohol are often justified on grounds of public health. In this case the behavioural response may be desirable (in technical terms, the tax exists to correct another distortion or 'externality').

Theory suggests that this might be particularly distorting, although in practice there is little evidence of much impact from taxes on saving behaviour.

3.3.8 Corporate income tax affects the decisions companies make on whether and where to undertake an investment in theory. There is evidence in practice that high corporate income tax negatively affects investment, especially in open economies (including offshore financial centres), where investment can easily be undertaken elsewhere.

3.3.9 A key source of evidence is a recent study by Arnold (OECD, 2008), which investigated the impact of various taxes on economic growth using data for 21 OECD countries over the period 1971-2004. In broad terms, the study finds that property taxes are the least harmful to economic growth, followed by consumption taxes, with income taxes being the most harmful to growth. The estimated results were statistically significant at the 1% level and were robust to alternative specifications. Within property taxes, the study finds that recurrent taxes on immovable property are the least harmful to growth, while other property taxes have an insignificant impact. Within income taxes, the study finds that personal income taxes are less harmful to growth than corporate income taxes. Taking the results together, Figure 3.7 summarises the ranking of the various taxes in terms of how growth-friendly they are.

3.3.10 The empirical evidence on tax distortions was recently summarised by advice from the OECD (2009):

> *"Growth-oriented tax reforms would generally involve shifting revenue from corporate and personal income taxation or social security contributions onto consumption and property taxes, including housing taxation."*

3.3.11 The research underpinning this OECD advice suggests the following ranking of taxes in terms of how growth-friendly they are.

Figure 3.7: How growth-friendly are various taxes?

Ranking	Tax	Examples
1st best	Recurrent tax on immovable property	Island Rate
2nd	Consumption tax	GST
3rd	Personal income tax	Personal income tax
4th worst	Corporate income tax	Corporate income tax

Source: Arnold (OECD, 2008).

3.3.12 Three caveats need to be borne in mind with this evidence. First, choosing a growth-friendly mix is not the only objective of taxes. As mentioned above, concerns about social equity might imply a trade-off with growth-friendliness, although Arnold (OECD,

2008) states that "in many cases such a trade-off does not exist." Second, the analysis only reveals a picture that is true on average across the countries in the sample over the time considered. Third, the research was conducted on OECD countries, not OFCs. Economic agents, including individuals and companies, in OFCs are much more mobile than in large OECD countries. For example, the financial sector in Jersey typically serves clients based in other countries and these clients could easily be served from another location. The increased mobility of economic agents in OFCs suggests that the relative preference should be more strongly biased away from corporate income tax and personal income tax towards recurrent tax on immovable property and consumption taxes than for a large OECD country to minimise economic distortions.

3.3.13 Other sources of evidence seem to confirm the relative ranking shown in Figure 3.7. Johansson, Heady, Arnold, Brys and Vartia (OECD, 2008) state that "A revenue-neutral growth-oriented tax reform would be to shift part of the revenue base from income taxes to less distortive taxes. Taxes on residential property are likely to be best for growth." Myles (OECD, 2009b) notes that "There is evidence that income taxes are damaging for growth relative to consumption taxes" and finds support for the conclusion that "corporate taxes that are most damaging for growth since they reduce entrepreneurial activities and lessen the incentive for innovation". Keuschnigg, Keuschnigg and Jaag (2009) use a calibrated model for Switzerland, which shows that "VAT is considerably less harmful to incentives for extensive labor supply [participation in work] than wage taxes because it taxes the income in both active and inactive states while the wage tax reduces only the employed income." Most recently, an OECD report on 'Strategies for aligning stimulus measures with long-term growth' stated that "Growth-oriented tax reforms would generally involve shifting revenue from corporate and personal income taxation or social security contributions onto consumption and property taxes, including housing taxation" (OECD (2009)).[7]

3.3.14 Jersey is much more reliant on income from taxes on companies than the UK (21% of tax revenue vs. 12%). It raises significantly less of its revenue from consumption

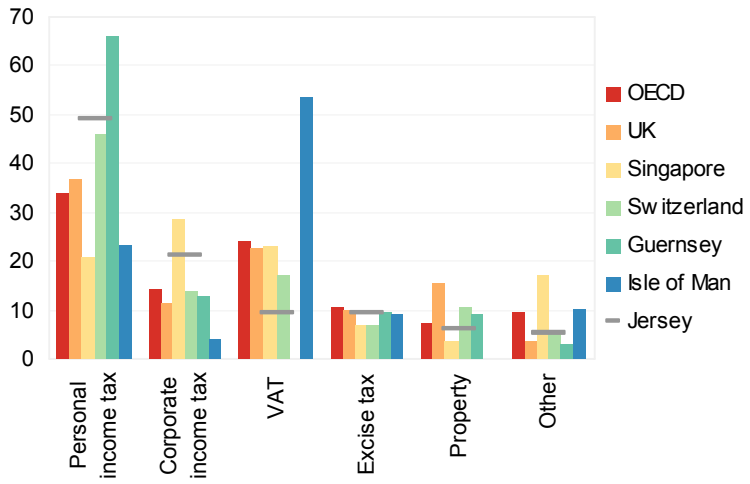
[7] The evidence presented is about the relative mix of tax sources. There is little evidence about the absolute proportion of tax that each tax source should account for to maximise economic growth. But one study, mentioned by Myles (OECD, 2009c), found that in New Zealand over 1945-95, the "mean growth maximising tax mix comprises 65% direct taxes and 35% indirect taxes." Jersey has a much lower share of indirect taxes (see Figure 3.8), but Jersey's unique economy, in particular the importance of the finance sector in corporate profits, means it is not appropriate to simply read across from other countries.

taxes (19% vs. 32%) and property taxes (6% vs. 16%) than the UK. One significant difference between Jersey and the other Crown Dependencies is the degree to which revenue is raised from consumption taxes: Guernsey does not have a GST, while the Isle of Man raises a large share of its revenue from VAT.[8]

3.3.15 Figure 3.8 shows the tax mix in the OECD, UK, Switzerland, Singapore and the Crown Dependencies, with the position in Jersey highlighted by a horizontal grey line. The proportion of tax collected from personal and corporate income tax is relatively high in Jersey, while the proportion of tax collected from VAT/GST and property tax is relatively low in Jersey. Any change towards more growth-friendly taxes would make the tax mix in Jersey more similar to that in other jurisdictions.

Figure 3.8: Tax mix in the OECD, UK, Switzerland, Singapore and Crown Dependencies

Percent of total tax revenue (excluding social security)



Source: OECD and budget documents for Singapore and the Crown Dependencies.
Note: OECD, UK, Switzerland and Guernsey data for 2007. Isle of Man data for 2008/09. Singapore data for 2009. Jersey and Guernsey data for 2010, so they have lower corporate tax revenue following the introduction of 0/10.

3.3.16 Johansson, Heady, Arnold, Brys and Vartia (OECD, 2008) make the important point that changing the balance between different tax sources is not a substitute for improving the design of individual taxes, noting that "generally, most taxes would benefit from a combination of base broadening and rate reduction." The Economist (2009) echoes this, stating, "Flat tax-rates on a broad base are less distortive than high marginal rates on a narrow base." In Jersey, the tax base for GST is currently broad and the tax base of personal income tax has been widened with the

[8] The proportion of revenue that the IoM raises from VAT is likely to fall going forward as the money it receives through the Common Purse Agreement, which governs the sharing of VAT revenue between the UK and the IoM, is set to fall.

introduction of '20 means 20'. The economic evidence is clear that tax bases should be kept wide to minimise economic distortions.

3.4 Competitiveness

3.4.1 The prosperity of an economy depends on its ability to create value. In most economies, international competitiveness will be a key determinant. This is particularly the case in a small, open, international financial centre such as Jersey where a large proportion of the economy depends on highly mobile industries that are highly competitive.

3.4.2 From the perspective of businesses, taxes will affect their costs, which in turn will feed through into their ability to compete internationally and affect their decisions about where to locate, how much to invest and how many jobs to create.

3.4.3 An economy like Jersey also relies on its ability to attract highly skilled individuals to locate in the Island. The location choices of individuals will also be affected by the relative levels of taxation and the types of taxation in different jurisdictions.

3.4.4 The effect of tax changes on competitiveness will not be the same in the long run and the short-run.

3.4.5 In the long run, economic theory suggests that individuals bear the full incidence of tax rises and companies bear no incidence. As Arpaia and Carone (2004) explain, in a small open economy with international capital mobility, returns on domestic and foreign investment must be the same, so "in the medium-long term any increase in tax wedge (labour taxes) will be entirely borne by labour." In the long run, therefore, there is no change to the international competitive position of firms from higher taxes.

3.4.6 This means there would be no adverse impact on competitiveness from higher taxes – in any form – in the long run, because (the shareholders of) companies based in Jersey are no worse off than (the shareholders of) companies based elsewhere.

3.4.7 However, if employees have bargaining power, at least some of the incidence of a tax rise is likely to be borne by 'companies' in the short-run. It is worth noting that, even in the short-run, 'companies' do not pay tax. If a company has higher costs as a consequence of higher taxes, the effect or 'incidence' can be felt in three ways:

- **Customers** foot the bill as the company raises it prices to compensate
- **Employees** foot the bill as the company cuts other costs to compensate

- **Shareholders** foot the bill and absorb the costs by receiving lower returns on their investments if they are unable to pass the costs on to customers or employees

3.4.8 For example, taxes imposed on labour, such as social security contributions, drive a wedge between the cost of labour to the employer and the post-tax wage received by the employee. It is a question of who – the employer or the employee – bears the incidence of the tax, which may differ between the short-run and the long-run.

3.4.9 In the short-run, who bears the incidence of the tax depends on the degree of real wage rigidity. The degree of rigidity describes the ease with which wages adjust to a new equilibrium. In a hypothetical world with no product or labour market imperfections, wages are perfectly flexible, so there is no real wage rigidity. As a result, following a tax rise, real wages would immediately adjust down to the new lower level, reaching the long-run equilibrium immediately. The incidence of the tax rise falls fully on the employee with none falling on the employer. In this case, there is no change to the international competitive position of firms from higher taxes.

3.4.10 In contrast, in the real world with product and labour market imperfections, wages are 'sticky', so there is some real wage rigidity. As a result, following a tax rise, real wages do not immediately adjust to the new lower level. Instead wages take some time to reach the long-run equilibrium. A number of labour market imperfections are likely to be present in practice in large developed economies including:

- the extent of unionisation.
- the degree of central wage bargaining and wage co-ordination.
- the level of out-of-work benefits.
- the level of minimum wages.

3.4.11 Each of these labour market features is likely to be positively related to the degree of real wage rigidity. For example, extensive trade union coverage is likely to be associated with real wage rigidity. Each of these labour market features result in workers having bargaining power, which means that at least some of the incidence of a tax rise is likely to be borne by companies. Companies will attempt to either lower costs, by reducing the number of workers employed for example, or pass on the higher tax by raising their prices charged, which are considered in turn below.

3.4.12 Companies may attempt to lower costs by reducing the number of workers employed. There are many studies on the impact of the tax wedge – the difference between post-tax wage received by employees and the cost of labour to employers –

on the level of employment. A regular finding is that higher employment taxes have a statistically significant, but small, negative effect on jobs in studies on large developed economies (see Nickell, Nunziata and Ochel (2005) and Griffith, Harrison and Macartney (2007)). It is plausible that there would be a stronger negative effect on jobs in offshore financial centres, because those jobs can be relocated away relatively easily.

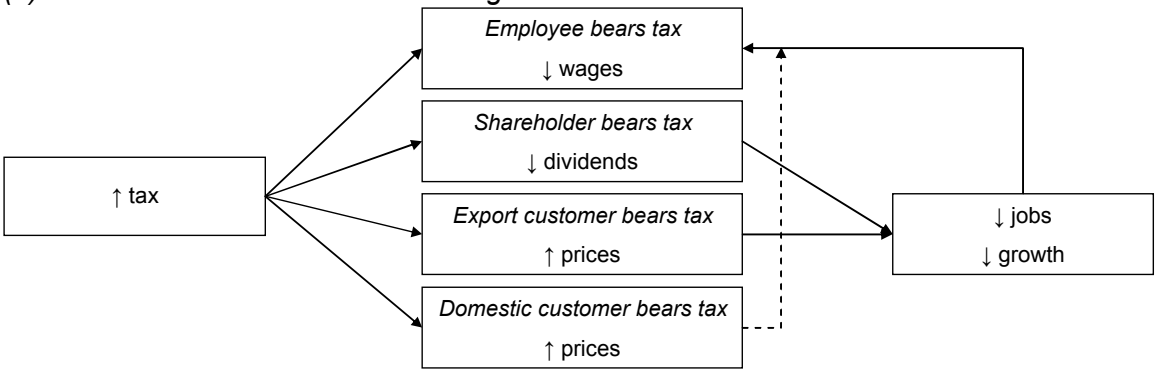
3.4.13 Companies may also attempt to raise prices. It may be possible to raise prices for domestic customers (if there is little or no competition from outside the Island), which is equivalent to passing the burden on to residents, a large proportion of whom will be employees, and so this would not worsen competitiveness.

3.4.14 It is difficult to raise prices for export customers because customers can choose other suppliers who have not raised their prices, so this would worsen competitiveness, which may lead to a reduction in jobs and/or growth. Companies will also attempt to regain profit margins so that dividends paid to shareholders can be restored, by reducing costs, including employment costs, by cutting the number employees for example.

3.4.15 When export customers or shareholders bear the tax, companies based in Jersey are less competitive than companies based elsewhere in the short-run, while the adjustment process is underway. Figure 3.9 summarises the incidence of tax on different economic agents (upper panel (a)) and in short- and long-run (lower panel (b)).

Figure 3.9: Incidence of taxes on different economic agents in the short- and long-run

(a) Incidence on different economic agents



(b) Incidence in the short- and long-run

	Short-run	*Long-run*
No product or labour market imperfections	Employee (full)	Employee (full)
Product or labour market imperfections	Employee (partial) and employer (partial)	Employee (full)

3.4.16 These insights also hold for taxes other than social security contributions. For instance, if the GST rate was raised, workers would suffer a reduction of net real wages, because higher GST would mean that they could buy fewer goods with their wages. Similarly, if personal income taxes were raised, workers would suffer a reduction of net real wages, because higher personal income tax would mean that they could buy fewer goods with their wages.

3.4.17 In both examples, if there was no real wage rigidity, the adjustment to long-run equilibrium occurs immediately, with workers bearing the full incidence of the tax rise. If there was real wage rigidity, workers would use their bargaining power to ensure that the incidence of the tax rise falls at least partially on the employer by demanding higher wages. If employers grant those higher wage demands, this might lead to a second-round effect, where companies put up prices to regain profitability, which could spark a wage-price spiral.

3.4.18 So although most taxes should have little or no effect on competitiveness in the long run, different taxes will have different effects on international competitiveness in the short-run due to the different adjustment processes involved. Higher payroll taxes affect competitiveness directly, because they typically feed through to employers at least partially in the short-run, which worsens the position of exports relative to imports. Raising personal income tax should only have an indirect effect on competitiveness, to the extent that it feeds through into higher wage demands. The

same is true of GST, with the benefit that exports are excluded from GST, so international competitiveness will be less affected.

3.4.19 In a previous report by Oxera (2004), it was concluded that measures with first-order (direct) effects of increasing business costs may pose more of a risk then those with an impact that relies initially on being translated into costs through wage demands.

3.4.20 The labour market in Jersey is potentially subject to typical imperfections found in other developed economies, such as the extent of unionisation, and to unique imperfections, such as the Regulation of Undertakings restrictions. Judged against typical labour market imperfections, Jersey appears to be moderately flexible. Outside the public sector, there is little information to suggest pervasive unionisation or central wage bargaining, although there is some evidence of wage indexation, including in the private sector, suggested by the co-movement between average earnings and retail prices shown in Figure 4.21.

3.4.21 Judged against unique labour market imperfections, Jersey appears to be relatively less flexible. Under the Regulation of Undertakings Law, businesses must apply for and be granted a licence before employing additional staff, including locally qualified and J category, which introduces an imperfection into the labour market relative to the position in other jurisdictions, where employment decisions are made without the approval of the government. The typical and unique labour market imperfections factors tentatively suggest moderate private sector real wage rigidity in Jersey.

3.4.22 In countries with an exchange rate that is fully floating, the exchange rate could depreciate, which would serve to offset the worsening in international competitiveness. In Jersey, in a common currency area with the UK, the exchange rate is fully fixed against sterling, so it is not possible for the Jersey exchange rate to depreciate to offset the worsening in international competitiveness. This situation is similar to countries in the euro area, which can no longer rely on 'external exchange rate depreciation' to boost competitiveness, but must instead rely on 'internal exchange rate depreciation'.[9] Internal exchange rate depreciation means companies holding down their costs, including labour costs, until they have fully passed on the tax incidence.

3.4.23 This section looks at how taxes in the domestic economy affect the international position. Economic theory suggests that location decisions – of individuals and

[9] Arpaia and Carone (2004) note that a reduction of employers' social security contributions can enhance international competitiveness, through 'internal exchange rate depreciation', so it has been "suggested as [a] counter-cyclical policy tool[s] in EMU to support macro-stabilisation objectives."

companies – will be made by comparing post-tax earnings or profits (taking full account of costs) between alternative locations, among other considerations. Data on VAT, personal income tax, social security contributions and corporate income tax are compared across a range of competitor jurisdictions including the Crown Dependencies, the UK, Switzerland and Singapore, although in practice location decisions are likely to be based on a much wider range of factors. Key aspects of competitiveness are likely to include:

- the total costs of doing business, including wages, rents, taxes etc.
- the attractiveness of the location to employees.
- the flexibility and skills of the potential labour force.
- the stability of the government and the rules (including laws and taxes).
- the connectivity of location (including transport and telecommunications).

3.4.24 It is important for a jurisdiction to be competitive in all aspects, but the focus here is on competitiveness in terms of tax. Globalisation has made companies' activities (or profits) and some individuals more internationally mobile.

3.4.25 Other jurisdictions are also facing fiscal pressures, which make comparisons between potential higher future tax rates in Jersey and current tax rates in other jurisdictions more difficult to interpret. If the other jurisdictions were to deal with their fiscal pressures by raising similar taxes, this might reduce any marginal competitive disadvantage, although timing differences in any changes would be important.

Individuals

3.4.26 Johansson, Heady, Arnold, Brys and Vartia (OECD, 2008) note that, "highly skilled workers are also becoming more mobile and some countries are taking this into account in designing their personal tax systems."

3.4.27 Different types of individuals are likely to consider different aspects of taxation in making location decisions. In Jersey, there are two potential groups of individuals: K category (high net worth) and others considering living in the Island, including J category (essential employees) and non-locally qualified. K category individuals are likely to focus on personal taxation of worldwide income in making location decisions, rather than social security contributions because they would typically not be

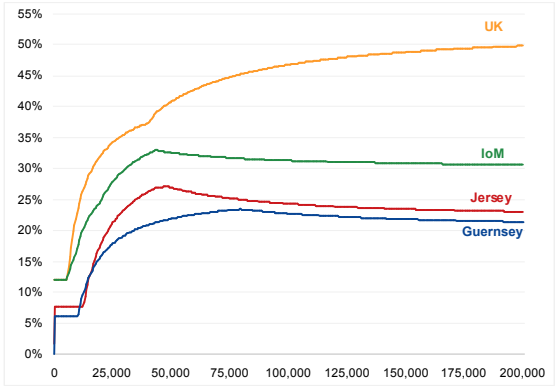
employed. K category individuals have a separate personal income tax schedule and are not compared across jurisdictions here.[10]

3.4.28 J category and non-locally qualified individuals are typically concentrated in different sectors. In June 2009, private sector employment was 49,500, of which 39,870 individuals were locally qualified, 1,120 individuals were J category (66% of whom worked in the finance sector, which has the highest average earnings) and 8,510 individuals were non-locally qualified (61% of whom worked in the agriculture, hotels, bars and restaurants, and wholesale and retail sectors, which have the lowest average earnings). Both J category and non-locally qualified individuals are likely to consider VAT/GST, personal income tax and employee social security contributions in making location decisions, which are shown in Figure 3.11 and 3.12. Compared with the other jurisdictions, Jersey seems relatively competitive at present, with low GST, low social security contributions (shown in Figure 3.12(a)) and personal income tax rates that are lower than the UK and Switzerland, but similar to the other Crown Dependencies and Singapore. Highly skilled workers, who have the highest GVA per head, such as in the finance sector, pay high amounts of tax and are likely to be the most mobile, so it is especially important to consider this group to maximise tax revenue.

Figure 3.10: Average tax rates (income tax, social security and VAT/GST) by income in the UK and the Crown Dependencies

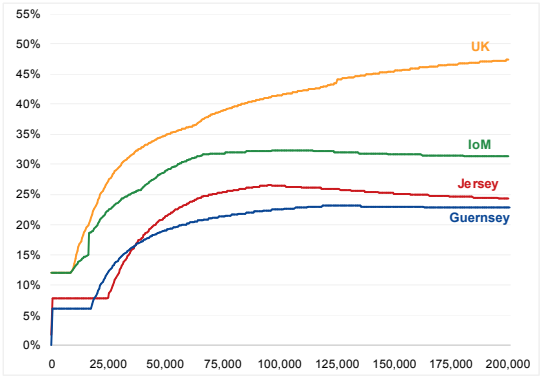
Single person, no mortgage or children

Average rate, percent



Married couple, no mortgage or children

Average rate, percent



Sources: Economics Unit calculations using information from national tax offices and social security departments

[10] In Jersey, K category residents are typically charged personal income tax on Jersey source income at 20% and on non-Jersey source income, at 20% on the first £1 million, 10% on the next £0.5 million and 1% on the remainder, all subject to a minimum tax liability of £100,000.

Companies

3.4.29 Location decisions, which are discrete choices, are likely to depend on the average tax rate.[11] Figure 3.11 compares average tax rates and office rents in Jersey and other jurisdictions, a sub-set of the criteria likely to be considered when making location decisions.

Figure 3.11: Average tax rates in Jersey and selected competitor jurisdictions 2009

	Jersey	Guernsey	Isle of Man
VAT	3% broadbased	none	17.5% standard rate 0% or 5% reduced rates
Personal income tax	20% top marginal rate	20% top marginal rate	18% top marginal rate
Employee social security contributions	6% up to ceiling of £42,484	6% up to ceiling of £79,000	10% up to ceiling of £37,960
Employer social security contributions	6.5% up to ceiling of £42,484	6.5% up to ceiling of £115,128	12.8% no ceiling
Corporate income tax	10% finance companies 0% non-finance companies	10% finance companies 0% non-finance companies	10% finance companies 0% non-finance companies

Continued	UK	Switzerland	Singapore
VAT	17.5% standard rate 0% or 5% reduced rates	7.6% standard rate 2.4% reduced rate	7% broadbased
Personal income tax	40% top marginal rate	c40% top marginal rate[(1)]	20% top marginal rate[(2)]
Employee social security contributions	11% up to £43,875 1% above that (no ceiling)	6.55% up to £64,000 6.05% up to £159,000 5.05% above that (no ceiling)[(4)]	20% of wage up to age 50 5% of wage above age 65[(3)] sliding scale, ages 50-65
Employer social security contributions	12.8% no ceiling	6.55% up to £64,000 6.05% up to £159,000 5.05% above that (no ceiling)[(4)]	14.5% of wage up to age 50 5% of wage above age 60 sliding scale, ages 50-60
Corporate income tax	28%	8.5% federal corp tax rate up to 20% cantonal corp tax rate	18%

[(1)] In Switzerland, the maximum marginal federal income tax rate is 11.5%. Example shown also includes canton and commune income taxes for Geneva.
[(2)] In Singapore, there are 6 marginal tax rates: 3.5% (up to £13k), 5.5% (up to £18k), 8.5% (up to £35k), 14% (up to £71k), 17% (up to £142k) and 20% (above £142k
[(3)] In Singapore, people pay into individual savings accounts from which they can draw down for medical expenses, old age and asset purchases (eg house).
[(4)] In Switzerland, social security contributions do not cover healthcare; private medical insurance must be purchased separately.
Sources: National tax and social security departments.

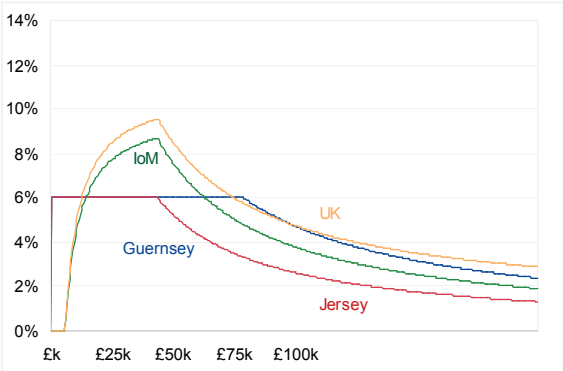
3.4.30 Companies are likely to consider the rates of employer social security contributions and corporate income tax. Separate work on the future of the 0/10 corporate tax system will consider competitive issues arising from any changes to corporate taxes. Corporate tax is especially important in an OFC. Compared with the other jurisdictions, Jersey seems relatively competitive in terms of lower employer social security contributions (shown in Figure 3.12(b)) at present.

[11] This contrasts with marginal decisions, discussed in Section 2, say of an individual to supply an extra hour of labour, which is likely to depend on the marginal tax rate.

Figure 3.12: Average social security contributions in the UK and Crown Dependencies

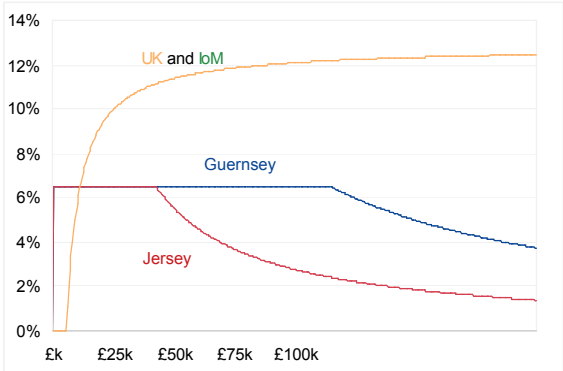
(a) Employees' contributions

Average rate, percent



(b) Employer's contributions

Average rate, percent



Sources: National social security departments.
Note: Singapore and Switzerland are not shown because social security systems in those countries are quite different in nature and coverage, described in the footnotes to Figure 3.11.

3.5 Revenue Stability

3.5.1 To the extent that tax revenues tend to finance expenditure on public services, the stability and predictability of revenue is a desirable property. If tax revenues are unpredictable it makes financial planning difficult, which can in turn lead to unexpected fiscal deficits and the provision of certain public services may be vulnerable if fluctuations in revenue are large. The revenue from some taxes is particularly 'lumpy', such as taxes that depend on large, infrequent transactions, whereas others, such as those on consumption, tend to be very predictable.

3.6 Administrative Cost

3.6.1 Ideally taxes will raise revenue in an efficient way. Some taxes can cost more per unit of revenue than others can. Generally simple taxes that are difficult to evade are cheaper, and altering existing taxes tends to be significantly cheaper than introducing new taxes from scratch.

Evidence base

A wide base of theoretical results and empirical evidence has been drawn upon in preparing this paper. A number of individual academic studies are considered, but the two key sources of evidence are outlined below.

Mirrlees Review. The Mirrlees Review brings together a high-profile group of international experts to "identify the characteristics of a good tax system for any open

developed economy in the 21st century."[12] The Review is being run by the Institute for Fiscal Studies, the leading independent tax research institute in the UK. The Review will be formally published later in 2010, but pre-publication drafts of each of the chapters have been drawn on throughout this paper to use the most up-to-date evidence.

Organisation for Economic Co-operation and Development. The OECD is the leading international institution researching comparative economic policy experiences across open developed economies. Various pieces of recent tax research and advice by the OECD have been drawn on throughout this paper.

The evidence available, from the Mirrlees Review, the OECD and other sources, typically refers to the experience of large developed countries, rather than offshore financial centres (OFCs) like Jersey. There are many similarities between the economies of Jersey and the large countries: both are developed, market-oriented and open to international trade. But there are also important differences between the economies of Jersey and OECD countries: economic agents, including individuals and companies, in OFCs are much more mobile than in large OECD countries. For example, the financial sector in Jersey typically serves clients based in other countries and these clients could easily be served from another location. The implications for the unique position of OFCs, relative to the standard research, are drawn out where applicable.

3.7 Deciding on the appropriate balance

3.7.1 There are inevitable and unavoidable trade-offs between each of these objectives. For example, a poll tax levied at a fixed amount on every adult would score highly on the economic efficiency objective, because it would not distort economic choices, but would score very poorly on the fairness objective, because the fixed amount would not be related to ability to pay.

3.7.2 Given the number of different objectives to be met, it is possible that a combination of several different taxes may be desirable to achieve an appropriate balance between the goals.

3.7.3 The relative importance of these criteria is ultimately a subjective, political decision, but an objective assessment of how a variety of different tax options compare against

[12] http://www.ifs.org.uk/mirrleesReview

each of the criteria is the purpose of this report. In Section 4 and 5 each option is looked at in terms of its revenue raising potential and objectively assessed against the five main criteria.

4 Main Tax Options

4.1 Overview

4.1.1 Figure 4.1 shows the main sources of revenue for the States in 2009. The largest source of income was personal income tax, which raised £243m (£280m including income tax on self-employed and investment holders), followed closely by company income tax of £208m. GST and impôts both raised in the region of £50m each. All remaining taxes between them raised £31m.

Figure 4.1: Source of States' revenue, 2009

	2009	
	£m	**%**
Personal income tax	243	37.2%
Companies	208	31.8%
Self-employed and Investment Holders	37	5.7%
Total Income Tax	**488**	**74.7%**
Goods and Services Tax	50	7.7%
Impots	51	7.8%
Stamp Duty	20	3.0%
Total Taxation Revenue	**609**	**93.1%**
Island Rate	11	1.6%
Total Other Income	34	5.2%
Total Income	**654**	**100.0%**

Note: Although 0/10 was introduced in 2009, it will not show up in the revenue figures until 2010

Source: States of Jersey Budget 2010

4.1.2 Although social security contributions are not included in Figure 4.1, they amounted to £145m in 2008, while supplementation – the States contribution to the social security fund – costs around £60m a year (£61.8m in 2008).

4.1.3 It should be clear from this that the major options that are capable of raising significant amounts of revenue on their own are personal income tax, social security contributions and consumption taxes (GST and impôts). Other jurisdictions also tend to raise significantly more from property taxes such as our domestic (parish and Island-wide) rates. While other taxes could potentially be changed in addition to these main taxes, the scope to raise significant amounts of revenue from anything but a radical overhaul is likely to be limited. Further, the degree of change required to raise significant revenue from these smaller taxes can in most cases be ruled out by their consequences for fairness or competitiveness.

4.2 Income tax

4.2.1 Jersey has an unusual personal income tax system. In essence it is a two-tiered income tax system whereby each taxpayer is assessed under two distinct methods of assessment, and then pays the lower of the two tax liabilities.

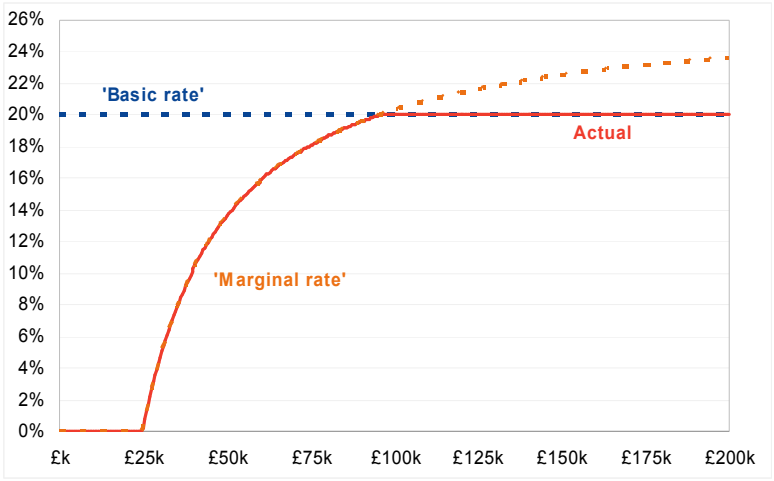
4.2.2 The two systems are generally referred to as the 'marginal rate' (currently 27%) and the 'basic rate' (currently 20%) assessment. Under the marginal rate assessment income under a certain amount – determined by individual circumstances – is exempt from taxation, while any income over this amount is taxed at 27p in every additional £1. Under the 'basic rate' assessment all income – with the exception of some small allowances[13] – is subject to tax at 20p in every £1. The current allowances and exemptions can be found in Figure 6.1 in the Appendix.

4.2.3 The method which will result in a lower tax rate will depend on the level of income and the particular circumstances of the taxpayer. Figure 4.2 shows how this works in practice for a married couple (without children or a mortgage). Under the marginal rate assessment the household would be entitled to £20,280 tax-free (married couple exemption), and then they would pay 27p on every extra £1 (orange line). Under the 'basic rate' assessment, the household would pay 20p on *every* £1 of income (blue line); they would no longer receive any tax-free income, but they would be subject to 20% tax on all taxable income. With an income of less than £78,500, the household would be liable for less tax under the 'marginal rate' system – paying 27p out of every £1 in excess of £20,280 – and so their tax liability would be calculated using this system. However, once their income exceeds £78,500, paying 20p of every £1 would be cheaper, so the household would be assessed under the 'basic rate' system. The actual tax paid at each income level for this particular household is shown by the red line, which is the lower of the two other lines.

[13] There are still a few allowances for certain circumstances, even under 20 means 20, including allowances for children and single parents.

Figure 4.2: Average tax rates under the two systems of assessment

Married couple, without children or mortgage



4.2.4 The average rate of tax a household pays at a given level of income is dependent on household circumstances. However, as the income of that household increases, the proportion of income paid in income tax will tend towards 20%. Some households are still eligible for allowances even under the 'basic rate' assessment (for children, for example), so they will never pay an average rate of 20%. However, as a result of the previous fiscal strategy, it was agreed that Jersey would limit the allowances that those on higher incomes are entitled to, such that more of them pay a 20% average rate. This is generally referred to as '20 means 20'. It removed allowances for earned income, wife's earned income, the single and married allowances and mortgage interest tax relief that were all previously available to households under the allowances system.

4.2.5 There are a range of different changes to the current income tax system that could raise revenue. Some of the key ones are described below.

4.2.6 Earnings tend to rise on average over time, which in tax systems that are progressive can give rise to a phenomenon known as 'fiscal drag'. Most simply, as earnings increase and allowances, exemptions and thresholds are kept the same, taxpayers pay slightly more of their income in tax every year. As a consequence, these features of the tax system can be periodically uprated in order to counter this effect. One option to raise extra revenue would be to **freeze the income tax exemptions and allowances**, rather than increasing them in line with inflation. This would bring more people into the tax net, while existing taxpayers would pay more than they would have if exemptions had been raised in line with inflation. This would raise about £4m per annum.

4.2.7 **Raising the basic rate** This would only affect existing taxpayers, and therefore would reinforce the progressive nature of the current income tax structure. 1 percentage point on the basic rate (with no increase in the marginal rate) would raise about £8m per annum, although each extra percentage point would raise less and less as the number of taxpayers affected by each increase falls.

4.2.8 **Extend 20 means 20** '20 means 20' was introduced as part of the previous fiscal strategy as a way of withdrawing allowances for those who were most able to afford it. It could be extended further by removing some of the remaining allowances that basic rate taxpayers are entitled to, and in particular the child allowance and the single parent allowance. While this would mean a greater number of people be affected by 20 means 20, it would still be targeted at those who are better off and would raise in the region of £4m.

4.2.9 The number of basic rate taxpayers could also be extended by **increasing the marginal rate of tax**, and every addition 1 percentage point on the marginal rate would raise about £15m. However, this measure would increase the tax burden of those on the marginal rate without changing the tax burden of those on the basic rate, and as such it would be regressive.

4.2.10 **Introduce a new higher rate of income tax** For example, this could be a 30% marginal rate above a given level of taxable income (e.g. £100,000), which would only affect those households with taxable income above that level. However, it would mean that Jersey departs from its long-standing position of having a top average income tax rate of 20%, which in turn could reduce the Island's ability to attract the mobile, highly skilled individuals that are essential to the Island's economy. A 30% rate over £100k would raise about £30m. Thought would need to be given on how such a change would interact with the rules for 1(1)(k)s and their current tax structure of 20:10:1. Similarly to minimise complexity further consideration would need to be given on how such a rate would interact with 20 means 20.

4.2.11 Each of these income tax options is assessed in turn against the five criteria outlined above.

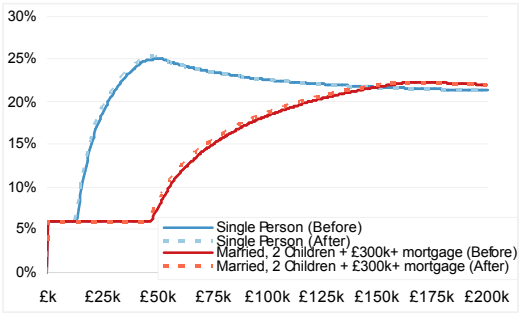
Fairness

4.2.12 **Freezing thresholds**: Figure 4.3 shows the impact of freezing personal income thresholds for one year. The average rate increases most for taxpayers on the marginal rate, and has little impact on taxpayers on the basic rate. The change in the

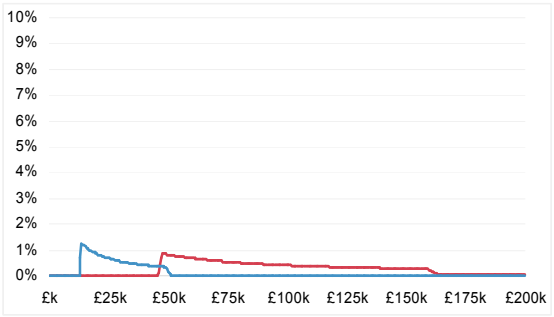
average rate is largest for both household types at the lower income end and falls as income rises, so this is a regressive measure.

Figure 4.3: Personal income tax thresholds frozen for one year

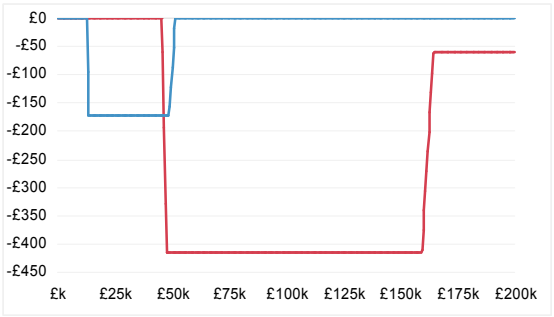
Average tax rate (% of income)



Change in average tax rate (% of income)



Change in disposable income (£)



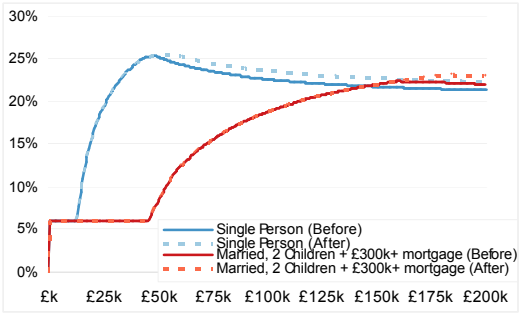
Note: The baseline here includes all exemptions and allowances increasing by nominal income growth

Source: Economics Unit calculations

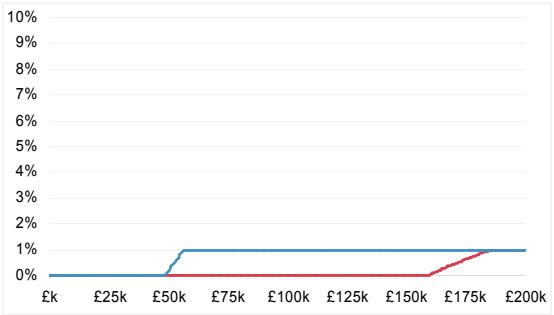
4.2.13 **Raising the basic rate**: This would only affect those on the basic rate under the current system (i.e. those on higher incomes). The effect would be to increase the average rate for these households, and it would be a progressive change. The impact of a 1 percentage point increase is illustrated in Figure 4.4.

Figure 4.4: Raising the basic rate of income tax by 1 percentage point (20% to 21%)

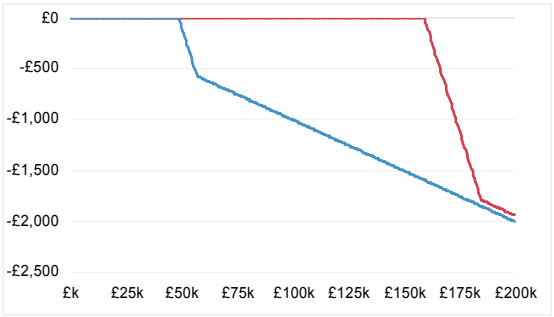
Average tax rate (% of income)



Change in average tax rate (% of income)



Change in disposable income (£)

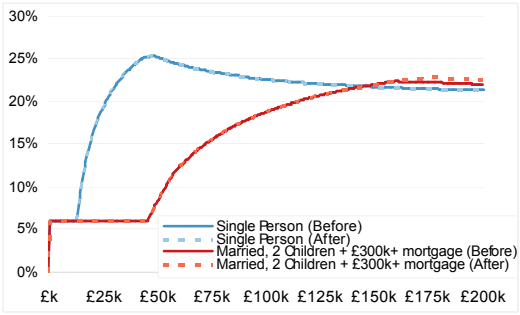


Source: Economics Unit calculations

4.2.14 **Extend 20 means 20**: In particular, this would involve removing the remaining allowances for children and potentially the single parent allowance for those taxpayers on the basic rate. This only affects those on higher incomes, so would be a progressive change. Figure 4.5 illustrates that it would have no impact on households without children (since they are not eligible for these allowances), and only affect households with children at higher incomes.

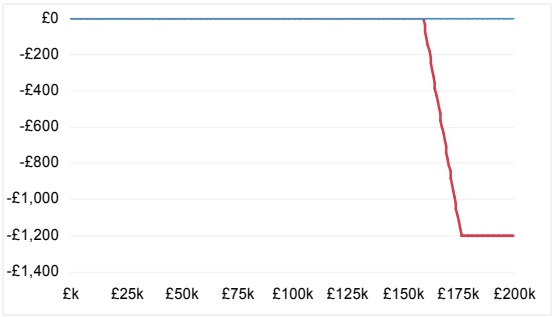
Figure 4.5: Extend '20 means 20' by removing remaining allowances

Average tax rate (% of income)



Change in average tax rate (% of income)

Change in disposable income (£)

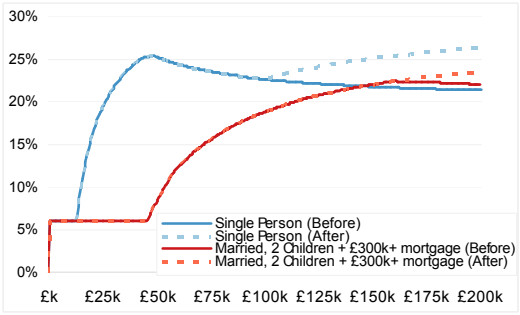


Source: Economics Unit calculations

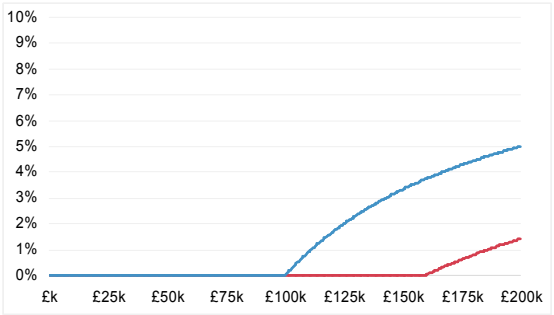
4.2.15 Introducing a **new higher rate** would only affect those taxpayers with taxable income above the chosen threshold, and those earning more would pay more. This is a progressive change. The effects of a 30% rate on taxable income above £100k are illustrated in Figure 4.6.

Figure 4.6: Introducing a higher rate of income tax (30%) above £100k in taxable income

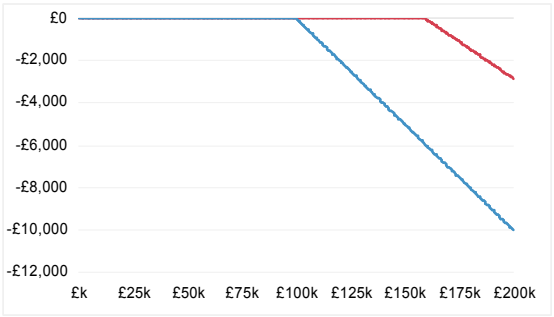
Average tax rate (% of income)



Change in average tax rate (% of income)



Change in disposable income (£)



Source: Economics Unit calculations

Economic Efficiency

4.2.16 Households can choose to either spend or save their income. Households also choose between work and leisure, a labour supply decision in terms both of participation in work and the number of hours worked. Personal income tax will influence both decisions to spend and to work in theory, although in practice there are reasons for "suspecting that the labour supply effect will be the larger of these two" according to Myles (OECD, 2009b).

4.2.17 But there is evidence that the impact on labour supply varies between different workers. Myles (OECD, 2009c) finds that the "labour supply of some groups of the population is sensitive to taxation", particularly females. Meghir and Phillips (Mirrlees Review, 2008) note that "hours of work do not respond particularly strongly to the financial incentives created by tax changes for men, but they are a little more responsive for married women and lone mothers. On the other hand, the decision whether or not to take paid work at all is quite sensitive to taxation and benefits for women and mothers in particular." As noted in Section 3.7, there may be conflict between the objectives of taxes that create few distortions and achieving the other

aims of taxation, such as equity. Brewer, Saez and Shephard (Mirrlees Review, 2008) summarise that "At the centre is a trade-off between the goals of equity and efficiency: governments want to transfer resources from the rich to the poor; on the other hand, such transfers reduce people's incentive to work."

4.2.18 Individuals make a choice between further education and working. Personal income tax reduces the returns to education, so would reduce the accumulation of human capital in theory, although in practice Myles (OECD, 2009b) notes that the "aggregate data provides no convincing explanation of this correlation."

4.2.19 Individuals make a choice between being an (unincorporated) entrepreneur and being an employee. Personal income tax, particularly in a progressive system, reduces the returns to successful entrepreneurship in theory. Myles (OECD, 2009c) states, "there is clear evidence that the personal income tax does affect the choice to enter entrepreneurship", because it reduces after-tax returns. Less entrepreneurship is likely to lead to fewer productive innovations, which may reduce economic growth.

4.2.20 As well as earned income, income derived from wealth holdings, such as savings interest and equity dividends tend also to be subject to income tax. Banks and Diamond (Mirrlees Review, 2008) discuss the theory "that capital income should not be taxed, in order that an individual's choices regarding saving for future consumption are left undistorted relative to choices over immediate consumption", with all the tax burden falling on labour income, which only distorts the decision (between work and leisure) within a period and does not distort decisions (between spending and saving) between periods. Myles (OECD, 2009a) echoes "the need to avoid intertemporal distortions".

4.2.21 There is no consensus on the optimal way of taxing capital income. Some researchers, such as Griffith, Hines and Sørensen (Mirrlees Review, 2008), argue that "personal capital income should be taxed at a relatively low flat rate separate from the progressive tax schedule applied to labour income, along the lines of the Nordic dual income tax." Others, such as Banks and Diamond (Mirrlees Review, 2008), argue for "relating marginal tax rates on capital and labour incomes to each other in some way (as in the US), as opposed to the Nordic dual tax where there is a universal flat rate of tax on capital income". In practice, there may be relatively little difference. Attanasio and Wakefield (Mirrlees Review, 2008) use model simulations to show that "it is unlikely that changes in interest rates due to preferential taxation, or other movements in interest rates, will cause big changes in the level of saving",

although Myles (OECD, 2009c) finds that "the empirical evidence on saving is mixed but on balance suggests some sensitivity to tax incentives."

4.2.22 Section 4 shows that income tax is considered to have one of the worst impacts on economic efficiency because it distorts the choice between saving and spending and is therefore considered one of the least growth friendly taxes.

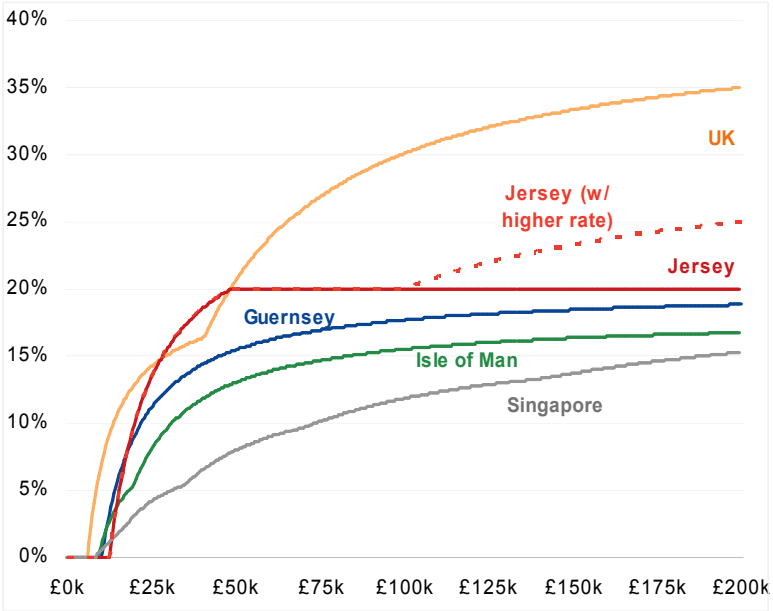
Competitiveness

4.2.23 In terms of competitiveness from the domestic feed-through of taxes, raising personal income tax should only affect competitiveness indirectly, to the extent that it feeds through into higher wage demands.

4.2.24 In terms of competitiveness of tax rates relative to other jurisdictions, introducing a higher personal income tax rate would put Jersey at a competitive disadvantage in attracting highly skilled workers compared to other offshore centres including the other Crown Dependencies and Singapore. Figure 4.7 illustrates how a higher rate of income tax in Jersey (30% over £100K) would make the Island relatively unattractive for those on high incomes from an income tax perspective.

Figure 4.7 Average income tax rates in the Crown Dependencies and Singapore

Income tax only, for a single person



Note that the Isle of Man line is based on a 18% top income tax rate, but from 2010/11 this will increase to 20%.

Revenue Stability

4.2.25 Personal income tax does fluctuate with the economic cycle, although less than proportionately. This means that it provides a relatively stable and predictable revenue stream. That said, income tends to be more volatile than expenditure, so

income tax revenues can be expected to be more volatile than revenues from a consumption tax such as GST.

Administrative costs

4.2.26 Administrative costs would likely be low for the majority of potential changes to income tax because it would require changes to the existing tax system. However, for the case of introducing a higher rate further consideration would need to be given to how to minimise complexity and therefore administrative costs for example through the interaction with 20 means 20.

Summary

Figure 4.8: Summary table of income tax options

Measure	Revenue	Fairness	Economic efficiency	Competitive-ness	Revenue stability	Admin. costs
Freeze exemptions	£4m	Regressive	Negative	Negative	Volatile	Low
Raise basic rate by 1%	£8m	Progressive	Negative	Negative	Volatile	Low
30% rate over £100k	£30m	Progressive	Negative	Negative	Volatile	Low
Extend 20 means 20*	£4m	Progressive	Neutral	Negative	Volatile	Low
*remove remaining allowances for higher earners						

4.3 Social Security

4.3.1 Social security contributions are effectively a payroll tax. That is, they are levied on earned income and exclude unearned income such as income from savings, investments and pension benefits. Social security contributions are paid by employers and employees (although they are usually paid from salaries and wages before they reach the employee) and the revenue goes towards the Social Security Fund and the Health Insurance Fund. The revenues are used to pay for benefits, state pensions and healthcare.

4.3.2 The main differences between social security and income tax are:

- Social security contributions start at a much lower income level
- The amount paid is determined by earnings from employment only
- Total contributions are capped at the ceiling
- Social security contributions are hypothecated to pay for specific benefits, the values of which are dependent on contributions.

4.3.3 Total social security contributions are 12.5% of earned income up to a ceiling of about £3,646 per month (£43,752 per year). A breakdown of the employer/employee split, and what the funds go towards, is shown in Figure 4.9.

4.3.4 For employees earning above the lower threshold of £770 per month (£9,240 per year) and below the ceiling the States supplements their contributions to the same extent as if they were earning the same as the ceiling i.e. £43,752. This is currently estimated to cost the States £60m a year.

Figure 4.9: Breakdown of payroll contributions

	Social Security Fund	Health Insurance Fund	Total
Employees	5.2%	0.8%	**6.0%**
Employers	5.3%	1.2%	**6.5%**
Total	**10.5%**	**2.0%**	**12.5%**

4.3.5 Social security is a proportional tax below the ceiling, but becomes regressive above the ceiling: from this point forward a maximum contribution is divided by a growing income, so the average rate falls (Figure 4.10).

Figure 4.10: Average and marginal rate on employee social security contributions

% of income

4.3.6 Payroll taxes like social security are not usually as progressive as income tax for two reasons. Firstly, they do not cover all income, so it is harder to target ability to pay. Secondly, it is sometimes argued that social security is not a standard tax since entitlements depend on contributions, and so one should pay in proportion to the benefits received: once benefits from the Social Security Fund and Health Insurance Fund are taken into account, social security would be less regressive. However, from a practical perspective, in absence of sufficient information on the benefits received, it is not possible to estimate their distribution robustly.

4.3.7 There are essentially two ways that States expenditure on supplementation can be reduced. Firstly, one can raise the contribution rate. Secondly, one can raise the ceiling above which contributions are not paid.

4.3.8 An increase in social security contributions has already been suggested as part of a package of measures to deal with the pressures of an ageing population over the next 20 to 30 years.

Increase rates for employers and/or employees (includes self-employed)

4.3.9 The current rates of 6% for employees and 6.5% for employers could be raised. For comparison, the equivalent rates are 11% and 12% in the UK. Every one percentage point (0.5pp both sides) that contribution rates are increased would raise around £15m (excluding supplementation). It should be borne in mind that some increase in contribution rates is likely to be required to finance the ageing population.

Increasing the contribution ceiling

4.3.10 At present, contributions are not levied on earned income above £43,752 per year (£3,646 a month). A 10% increase in the ceiling would raise an additional £5m for the Social Security Fund and if applied to the Health Insurance contributions would raise a further £1m for that Fund. Increasing the ceiling to the level that Guernsey set for employers in 2009 of £115,000 would raise £30m for the Social Security Fund (and a further £6m for the Health Insurance Fund if applied to those contributions). If the ceiling was removed completely it might raise £45m for the Social Security fund (and a further £8m for the Health Insurance Fund if applied to those contributions).

4.3.11 Those earning below the current ceiling would not be affected. Those earning above the ceiling would pay an additional £6 (for Social Security and Health contributions) for very £100 above the ceiling. So an individual earning £50,000 a year would pay an additional £400, while an individual earning £75,000 or £100,000 would pay an additional £1,900 and £3,400 respectively.

4.3.12 If the ceiling was removed for employers there would be additional issues around raising the cost of employing people and whether it would have a negative impact on competitiveness (and therefore employment and wages of employees) in the medium-term.

New rate above the ceiling

4.3.13 An additional rate of say 1% above the prescribed ceiling (and uncapped) could be introduced. Each 1% on employees and employers contributions in this manner would raise in the region of £8m.

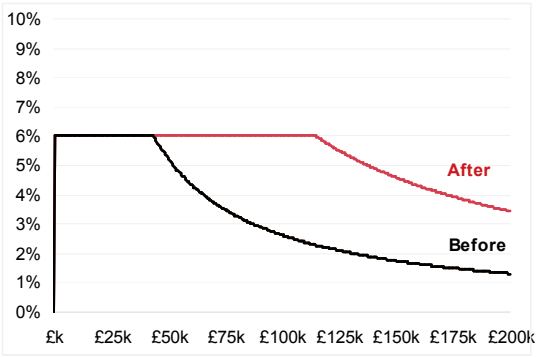
Fairness

4.3.14 Raising or removing the ceiling on social security contributions or introducing a new rate above the existing ceiling would all be progressive changes (Figure 4.11 to Figure 4.13).

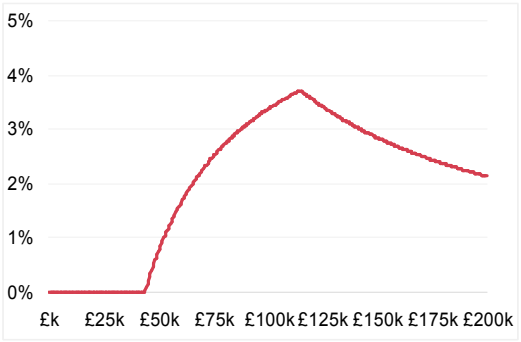
Figure 4.11: Raising the Social Security contribution ceiling to £115k

1 earner

Average rate (% of income)



Change in average rate (% of income)



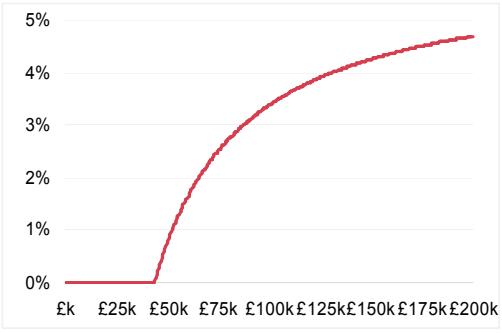
Change in tax paid

Figure 4.12: Removal of Social Security contribution ceiling

1 earner

Average rate (% of income)

Change in average rate (% of income)

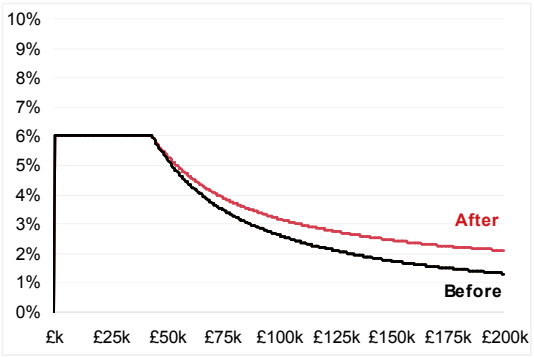


Change in tax paid

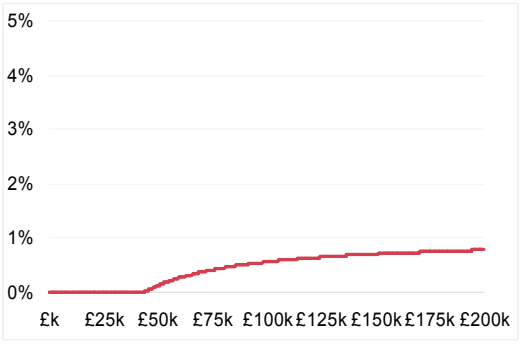
Figure 4.13: Introducing lower rate (1%) above the current contribution ceiling

1 earner

Average rate (% of income)



Change in average rate (% of income)



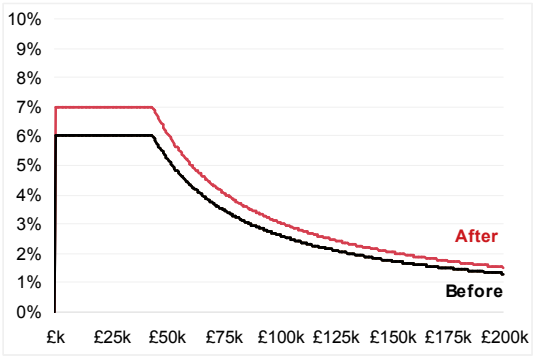
Change in tax paid

4.3.15 Increasing contribution rates is proportional up to the contributions ceiling, with those above the ceiling paying a fixed amount extra (which falls as a proportion of earnings as earnings rise). This is illustrated in Figure 4.14.

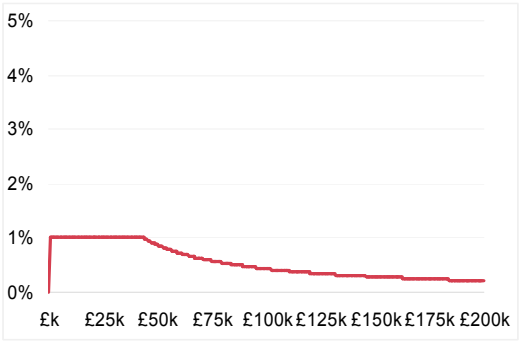
Figure 4.14: Increasing contribution rates below the ceiling (to 7%)

1 earner

Average rate (% of income)



Change in average rate (% of income)



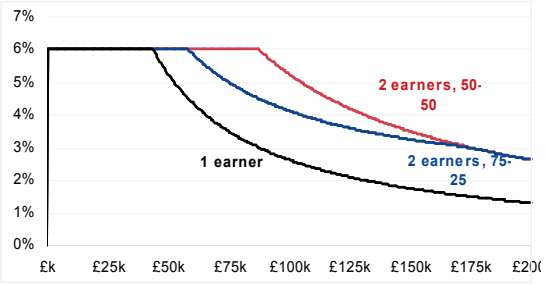
Change in tax paid

4.3.16 Removing the social security contribution ceiling would also reduce the anomaly that exists relating to the split of earnings within a household. Currently a household with total earnings above the ceiling would pay less social security if all that income is earned by one earner than if the income is split between two earners. This is because contributions are not paid on earnings over the ceiling. However, if the ceiling were to be removed this anomaly would disappear (Figure 4.15). Raising the ceiling would reduce the anomaly.

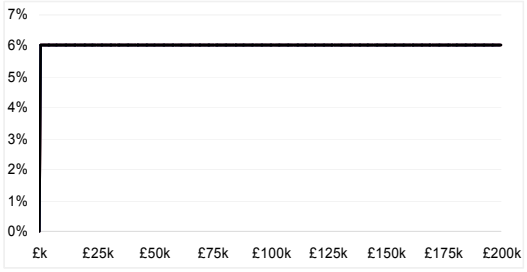
Figure 4.15: Effect of removal of earnings ceiling on different earnings splits within households

Change in average rate [1 earner, 2 earners (75-25 split), 2 earners (50-50 split)]

Before ceiling removed



After ceiling removed



Economic Efficiency

4.3.17 Employee social security contributions can be thought of as comprising two parts: a part which represents an actuarially fair price for individual insurance and a part which is an effective tax. For example, where there is no ceiling for contributions paid in, but there is a ceiling for benefits paid out, social security contributions will contain an effective tax.

4.3.18 Only the effective tax part of social security contributions adds to the general wage tax burden. The effective tax is reduced when there is a strong link between contributions and benefits, which strengthens labour market participation.[14] The mechanism is that if workers know that they will personally receive the benefit of higher contributions paid, it will not discourage extra work to the same extent as a pure tax. In the opposite situation, when there is little link between contributions and benefits, workers making contributions above the benefits ceiling will perceive it as a pure tax, which will reduce labour market participation.

4.3.19 Social security contributions, paid by employees and employers, drive a wedge between the post-tax wage received by employees and the cost of labour to employers. If employees bear the incidence of the tax wedge, it will shift their incentives towards leisure and away from work, which will reduce their labour supply.

4.3.20 For example, for those nearing retirement, higher contribution rates (levied on earned income only), relative to income taxes (levied on all income), diminish only earned income and not pension income, which will tend to reduce employment and increase

[14] For example, there is a very strong link in the system in Singapore, where individuals pay into individual savings accounts, from which they can draw down in various eventualities, mentioned in Figure 3.11.

retirement, according to the results of Keuschnigg, Keuschnigg and Jaag (2009). If employers bear the incidence of the tax wedge, it will reduce their labour demand.

4.3.21 The extent which the employer or the employee bears the incidence of the tax wedge will depend on labour market institutions. Theory suggests that if out-of-work benefits, the extent of unionisation and the degree of centralised wage bargaining are high, then more of the incidence of the tax wedge will fall on the employer, which will lead to lower employment, implying higher unemployment.

4.3.22 Disney (2004) finds that the labour supply of men is not very responsive to a change in the social security contribution rate, because working-age men are typically in work whatever the tax regime, while the activity rates of women are strongly affected.

4.3.23 Disney (2006) investigated the Irish public pension system, which is low cost (with low contributions) and highly targeted (redistributive through means testing). The study found that because social security contributions were low, there were limited impacts on incentives to work (especially for men), but that because pensions are highly redistributive, there was little disincentive to save (unlike other countries, with more actuarially fair pensions, which tend to negate the need for private savings).

4.3.24 In terms of efficiency, the OECD advice (see Section 3.3) suggests that social security contributions are less growth-friendly than consumption taxes and taxes on immovable property. This is due to the potential effects on decisions to spend and save as discussed above.

Competitiveness

4.3.25 In terms of competitiveness from the domestic feed-through of taxes, higher social security contributions are likely to adversely affect competitiveness directly, because they typically partially feed through to employers in the short-run, which worsens the position of exports relative to imports. In terms of competitiveness of tax rates relative to other jurisdictions, removing the social security ceiling for employers would replicate the practice in the other jurisdictions, although there are likely to be larger effects on the financial sector in Jersey than on other sectors. Removing the social security ceiling for employees would contrast with the position in the Isle of Man and the UK, where there are no or low rate contributions above the ceiling.

4.3.26 Changes in social security contributions – for employees and employers – could be expected to have a differential impact on different sectors of the economy. For example, if the current social security ceiling of £43,752pa was removed, this would

affect sectors where wages are relatively high and would have less of an impact on sectors where wages are relatively low.

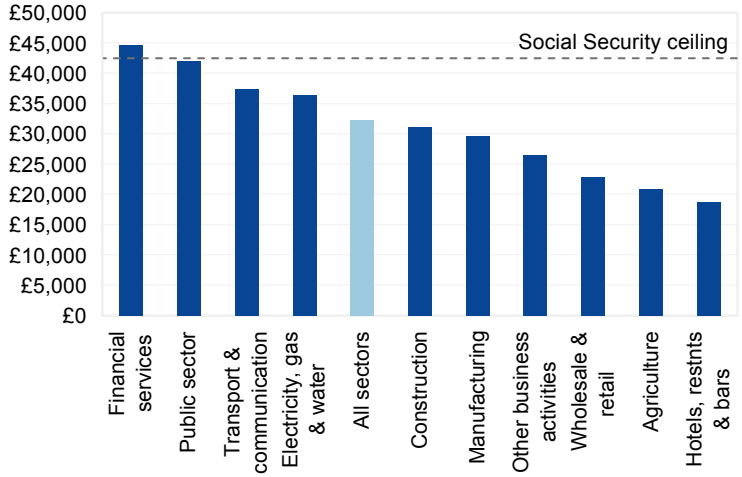
4.3.27 Removing the ceiling on social security contributions has been estimated to raise £30 million, £15 million of which would come from employers.

4.3.28 Figure 4.16 shows average earnings across the sectors in Jersey. It is likely that some workers in every sector will have earnings above the social security ceiling, so removing it will affect employers and employees in all sectors to some extent. However, average earnings across all workers in the financial services and the public sector are close to the social security ceiling, so removing it is likely to affect employers and employees in these sectors most, with relatively less impact on the sectors with lower average earnings. Because these sectors have the highest average earnings and because they jointly employ 35% of the workforce, any revenue raised from removing the social security ceiling is likely to be largely contributed by these two sectors.

4.3.29 It is estimated that removing the ceiling would cost States of Jersey as an employer £1.5-2 million and a lower bound for the cost to the finance sector would be £3.5 million, but the cost to the finance seems likely to be much higher than that. As a result the adverse impact on international competition seems likely to be most pronounced on financial services, particularly given the competition for business between offshore jurisdictions.

Figure 4.16: Average earnings (AEI) across industry sectors, June 2009

Average earnings excluding bonuses, £pa

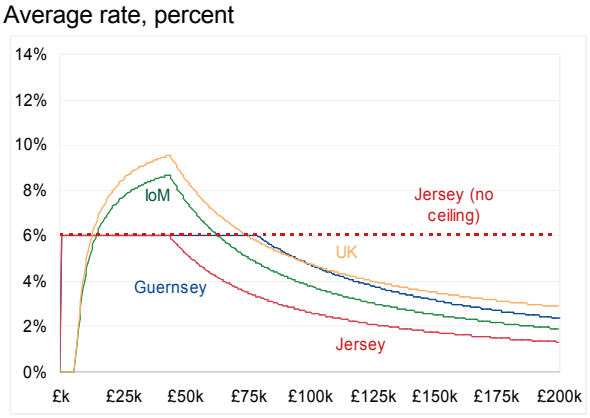


Source: Statistics Unit.
Note: In June 2009, financial services employed 13,210 people and the public sector employed 6,750 people, out of total employment of 56,250, representing 35% of total employment.

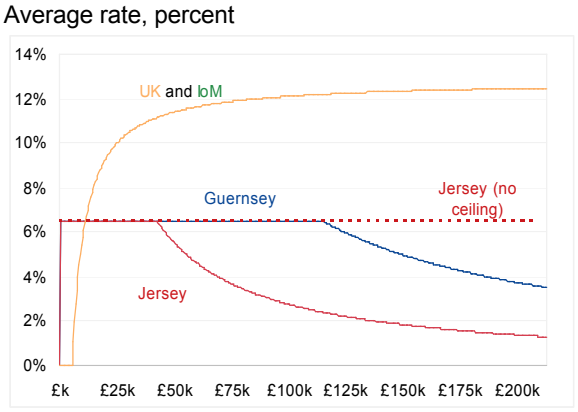
4.3.30 Although Jersey appears relatively competitive at the moment in terms of employer and employee social security contributions (Figure 4.17) this could change if the ceiling was raised or removed. For example, if the ceiling was completely removed employees and employers would pay 6 or 6.5% of all earnings above the current ceiling. This could hinder competitiveness by making Jersey less attractive for high skilled and high earning individuals and by making it more expensive for employers to employ these people (at least in the short-term).

Figure 4.17: Average social security contributions in the UK and Crown Dependencies

(a) Employees' contributions



(b) Employer's contributions



Sources: National social security departments.
Note: Singapore and Switzerland are not shown because social security systems in those countries are quite different in nature and coverage, described in the footnotes to Figure 3.11.

Revenue Stability

4.3.31 Social security contributions and supplementation do tend to fluctuate, although there is not a clear relationship. They are not particularly volatile, but earnings tend to be more volatile than expenditure.

Administrative cost

4.3.32 There should not be any significant ongoing administrative costs relating to changes in social security, because any of the key changes would simply be applied to the existing system. However, compliance issues may b need to be addressed if the ceiling was increased significantly or removed.

Summary

Figure 4.18: Summary table of social security options

Measure	Revenue	Fairness	Economic efficiency	Competitive-ness	Revenue stability	Admin. costs
Raise rate by 1%*	£15m**	Neutral****	Negative	Negative	Volatile	Low
Raise ceiling to £115K	£30m***	Progressive	Negative	Negative	Volatile	Low
Remove ceiling	£45m***	Progressive	Negative	Negative	Volatile	Low

* 0.5% on employees and employers

** net of supplementation

*** Revenue is that which would arise from Social Security change and does not include any additional revenue for Health Insurance Fund should it apply

***Progressive for incomes up to the ceiling/regressive above it

4.4 GST

4.4.1 There are not many different ways to use GST to raise more revenue. The options are limited to raising the standard rate and levying a higher fee on those exempt from GST (discussed further in Section 5.9: Company Annual Registration fees).

4.4.2 Reducing the registration threshold is not thought to be practical. Jersey has a high registration threshold for companies of £300k compared to c. £70k in the UK. However, a high threshold is good for compliance and administration so significantly reducing it might bring modest additional revenue but would dramatically increase compliance and administration costs, and it is thought that the costs would outweigh the benefits.

4.4.3 In theory in might be possible to introduce higher rates on certain goods such as luxury goods or unhealthy food. However, in practice this is fraught with difficulties as it becomes very hard to define the product groups, the distributional impacts may not be those anticipated and administration costs would increase significantly.

4.4.4 Each 1% on GST rate would raise about £15m and would maintain the mildly regressive nature of the tax. The impact of the increase could be made more progressive by compensating the less well off through income support. The actual choice of rate is also important as it impacts on compliance (for business) and administration (income tax) costs – 5%; 10%; and 15% (or combinations) are recommended as "good" rates.

Fairness

4.4.5 There are several different ways to analyse the distributional consequences of GST. In particular, one can look at:

- the proportion of ***gross income*** taken in GST
- the proportion of ***net (or disposable) income*** taken in GST
- the proportion of ***expenditure*** taken in GST

4.4.6 Using data from the Household Expenditure Survey (HES) it is possible to calculate how much households spend on GST by the level of their income.

4.4.7 However, looking at GST as a proportion of gross income may be slightly misleading because other taxes may already reduce household income, and these may affect households differently. For example, one way to reduce the proportion of income taken from the lowest quintile in GST would be to raise the rate of other taxes on this quintile. This would reduce the money that these household have to spend, and thus

reduce the amount of the GST as a proportion of income (although not necessarily disposable income). So another way to look at the distributional impact of GST is by proportion of disposable income.[15]

4.4.8 Looking purely as a proportion of income, even disposable income, while important, does not necessarily tell the whole story. In particular, it shows a snapshot of spending and income patterns in the population at a particular moment in time, and may be misleading given the variability of income over a lifetime: those with low incomes now may be the young or elderly or temporarily out of work who will be, or have been, amongst higher income groups at other times. As the IFS notes, "given that households can smooth consumption over their lifetime, expenditure is a better proxy for lifetime resources than current income."[16]

4.4.9 So under this measure, GST looks more regressive in part because those with high incomes tend to have high savings, and so appear to escape the tax. However, savings must be spent at some point, and they will be subject to the tax when they are. For example, people tend to spend more than their income when they are young and when they are old, while in-between they pay down debt and accumulate savings. Over the course of a lifetime, income will be broadly equal to expenditure (unless of course a large inheritance is left, but then the tax will be paid by the receiver when it is spent).

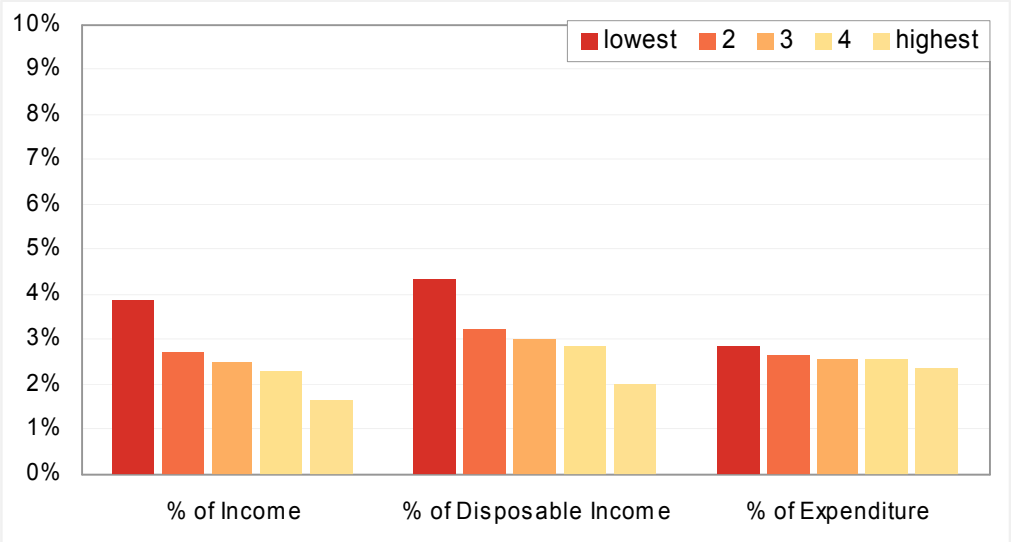
4.4.10 Looking at GST as a proportion of spending instead of income, addresses this concern to the extent that the latter is a better reflection of household's perceptions of their own lifetime spending ability. As to be expected, this measure shows GST as less regressive than as a proportion of income (and disposable income).

4.4.11 Estimates of these three measures are shown in Figure 4.19.

[15] Specifically, disposable income (1-t)X can be estimated using t, the average direct tax rate (i.e. income tax and social security).
[16] Brewer, Browne & Phillips (2008) *The Distributional Effects of the 2008 Pre-Budget Report*

Figure 4.19: Proportion of income spent on GST by income quintile

% of income, disposable income and expenditure



Source: Economics Unit calculations based on data from the HES and the Income Tax office

4.4.12 While the degree varies slightly by the measure chosen, GST is mildly regressive. This is mainly due to the effect on those households on the lowest incomes, which spend a larger proportion of their income on essential items such as food, domestic energy and so on.[17]

Fairness and differential rates

4.4.13 It is sometimes proposed that essential items should attract a more favourable rate, or that certain 'luxury' or 'harmful' goods and services be subject to a higher rate.

4.4.14 There are two reasons why this may not be the best solution to concerns about fairness. First, as noted by Johansson, Heady, Arnold, Brys and Vartia (OECD, 2008), "from a policy perspective, it is the overall progressivity of the tax system which is relevant. Thus, for example, the potential regressive effects of VAT may be affected by progressive elements in other parts of the tax system." Second, according to Deaton and Stern (1986), direct payments to households, depending only on their socio-economic characteristics, are better for both equity (fairness) and efficiency (reducing distortions), while Ebrill, Keen, Bodin and Summers (2001) argue that direct payments to low-income households are more effective in enhancing equity than VAT exemptions. Both results are explained by the fact that higher

[17] For example, according to the HES, an average household in the lowest 20% of incomes spends 14% of their income on food, while an average household in the top 20% of incomes spends just 8%.

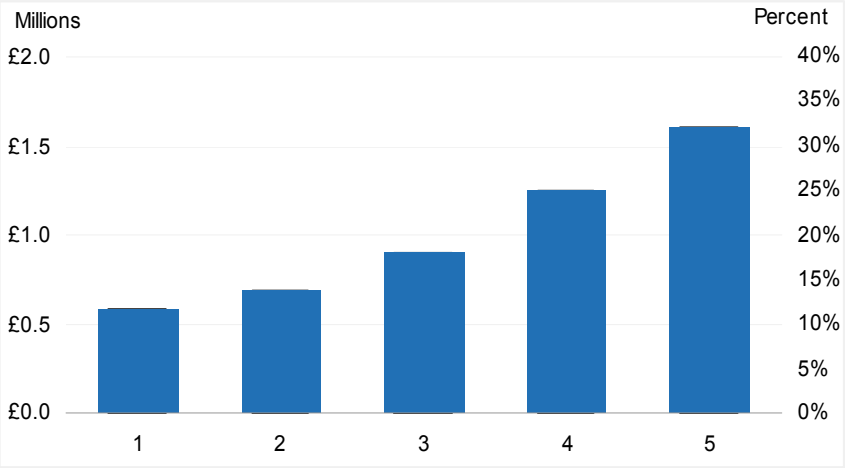
income households consume more of the exempt goods and so they benefit more from the exemption than lower income households do.

4.4.15 The economic evidence is clear that indirect taxes are generally a very blunt mechanism for redistribution 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. In the absence of other ways of transferring resources to the poorest, setting a low tax rate on these items might be sensible policy. However, there are a variety of other ways to target the less well off more directly; including income tax, tax credits and benefits.

4.4.16 The cost of putting exemptions and/or zero-rates on food and domestic energy would be in the region of £5m. Just 12% (around £600,000) of this would go to the 20% of the population with the lowest income (below £20,000), while 33% (£1.6m) would go to those with incomes above £73,000 (the top 20%) (Figure 4.20).

Figure 4.20: The beneficiaries of excluding food and domestic fuel from GST by income quintile

Left-hand axis show cash benefit, right-hand axis show the % of total cost



Source: Economics Unit calculations using the Household Expenditure Survey

4.4.17 To see why this is the case, it is helpful to see an example. According to the Household Expenditure Survey, an average household on £13,000 per year spends £2,200 on food. In contrast, an average household on £132,000 spends £6,100 on the same. By removing GST from food, the States would give £60 back to the lower income household, but £160 to the higher income household. The net result is that the States makes the lower income household better off by £60, but it costs £220 to do so.

4.4.18 Consider instead the case where GST remains on food and the States gives the lower income household £120 in income support. In this case, the lower income household is better off by £120 (instead of £60), and the States still has £100 to more to spend than in the case where food is zero-rated. In other words, instead of giving back money to the better off households in the name of redistribution, this money can instead be used to support lower income households more and pay for necessary public services.

4.4.19 IFS (2008) notes that, "applying zero or reduced rates of VAT to items on which poorer households spend a relatively large proportion of their budgets is a blunt instrument with which to help the less well off, as richer households typically gain more in cash terms from these tax breaks than poorer ones." Crawford, Keen and Smith (Mirrlees Review, 2008) expresses concern about, "the fundamental unfairness – and wastefulness – of the existing rate structure" of the UK VAT system. The paper goes on to recommend fundamental reform to UK VAT by abolishing all zero and reduced rates of VAT, which would interfere less with spending decisions and raise enough revenue both to improve the living standards of poorer families through direct transfers and to cut other taxes by £11 billion, in addition to cutting compliance and administration costs. This proposed improvement would bring the UK VAT system more in line with Jersey GST.

4.4.20 It is clear that levying GST on all goods and services makes revenue available to redistribute to those on lower incomes while at the same time raises funds to finance essential public services.

4.4.21 The question then becomes one of whom to compensate, how, and by how much. Two groups are of particular concern when examining whether to exempt food, clothing and the other necessities of life from GST. These are:

- Pensioners;
- Low-paid workers and social security beneficiaries

4.4.22 Pensioners can be compensated with adjustments to benefits that reflect the effect of GST. Similarly, social security and income support beneficiaries can be compensated with adjustment to benefits.

4.4.23 The compensatory approach is an available and workable alternative to exempting food and other necessities from GST.

4.4.24 While GST may be mildly regressive, it can be combined with other measures to target low-income households more effectively. Further, the economic evidence

suggests GST does not undermine competitiveness, has relatively stable revenues and a very cost-effective way to raise revenue. Some of these benefits are lost if the tax is not broad-based.

Economic Efficiency

4.4.25 In theory consumption taxes, such as GST, affect the decisions households make between spending and saving or working and not working, but there is little empirical evidence on the impact of consumption taxes on these decisions in practice. Crawford, Keen and Smith (Mirrlees Review, 2008) state that "the close equivalence between a uniform tax on consumption and a uniform tax on wage and profit income means that – as long as people take price levels properly into account – the two taxes should have broadly equivalent effects on the labour market".

4.4.26 There is more evidence on the distortions that may arise as a consequence of having GST rates that vary over different product types, such as a lower rate on food. Households can also choose what products and services to spend their income on. A single flat-rate GST system creates fewer distortions than multiple GST rates, because it causes fewer changes to relative prices of goods and services and thus has less of an effect on the decisions of consumers.

4.4.27 In terms of efficiency, the OECD advice (see Section 3.3) suggests that consumption taxes are more growth-friendly than social security contributions or personal income tax. A broad-based GST is less distorting than differential GST rates and any distributional concerns can be better dealt with by direct transfers to low-income households.

Competitiveness

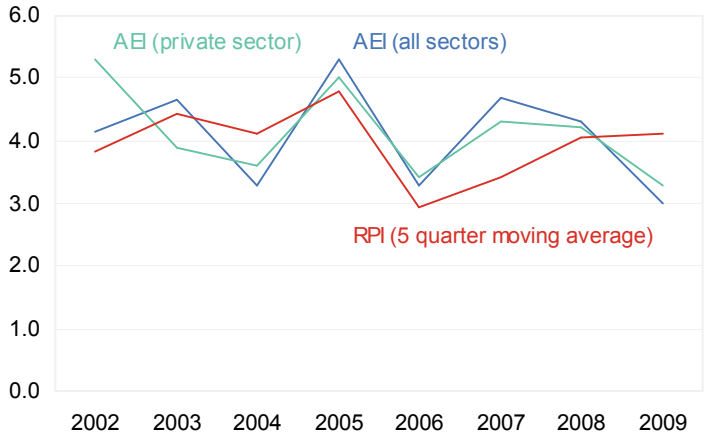
4.4.28 GST should only affect competitiveness indirectly, to the extent that it feeds through into higher wage demands, especially because exports are excluded from GST. In terms of tax rates relative to other jurisdictions, a small rise in GST in Jersey would still leave the rate below the other competitor jurisdictions (except Guernsey).

4.4.29 The recent introduction of GST in May 2008 should, in due course, provide a case study of the impact of a tax rise on wages. Figure 4.21 shows the evolution of average earnings and retail prices in Jersey. Retail price inflation rose following the introduction of GST. Average earnings growth slowed in June 2008 and slowed further in June 2009, but it is not possible to know the counter-factual average earnings growth may have slowed even more if GST had not been introduced.

4.4.30 There is not yet a sufficient run of data to provide firm evidence on whether there was real wage resistance to the introduction of GST. So it is inconclusive as to whether there was a change to the international competitive position of firms as a result of the introduction of GST.

Figure 4.21: Average earnings (AEI) and retail prices (RPI), 2002-2009

Percentage change on previous year



Source: Statistics Unit.
Note: A 5-quarter moving average is shown for RPI because wage settlements agreed in a 12-month period may be linked in some way to the RPI data published over the 12-month period. For example, as mentioned in the press release, the AEI figure for June 2009 may be linked to the RPI data for March 2008, June 2008, September 2008, December 2008 and March 2009.

Revenue Stability

4.4.31 GST is generally thought to perform well in terms of revenue stability. This is because consumption tends to be steady and relatively invariant to the economic cycle compared to other types of economic activity such as household income, business investment and large transactions like house purchases.

4.4.32 Further, as Crawford, Keen and Smith (Mirrlees Review, 2008) note, "running a broad-based consumption tax in parallel with taxes on income reduces the risk of revenue losses by spreading it across a number of sources each of which is to some degree independently enforced."

Administrative cost

4.4.33 Not only do broad-based taxes allow more targeted support of those on low incomes, but they are also significantly more efficient. New Zealand has a GST similar to Jersey in which there are no exemptions or zero-rates. Everything is taxed at a standard rate of 12 per cent. According to the most widely used indicator of VAT

performance, the C-efficiency ratio[18], the New Zealand GST scores twice as highly as UK VAT and significantly better than the OECD average. This has led Dickson and White (Mirrlees Review, 2008) to conclude that "the broad conclusion from two decades of the New Zealand GST is that the alleged benefits of maintaining a comprehensive base with a single domestic rate are, on balance, borne out by experience."

4.4.34 Changing the rate of GST will have a negligible cost, provided the rate chosen is a round number (for compliance reasons) and the tax base remains broad-based with few exemptions and one rate.

Summary

Figure 4.22: Summary table of GST options

Measure	Revenue	Fairness	Economic efficiency	Competitive-ness	Revenue Stability	Admin. costs
Raise GST by 1%	£15m	Mildly Regressive	Positive	Positive	Stable	Low

5 Other options

5.1.1 There are a number of other options worth considering in terms of existing taxes/duties beyond the three broad tax options explored above. However, it should be noted that the realistic revenue-raising potential of these options are limited by their size and the existing level or structure. For this reason they are likely to be only contributing elements to a larger package of tax measures.

5.2 Impôts

5.2.1 Impôts as a whole raise £50m a year with 40% coming from fuel, 30% alcohol and 25% tobacco. The current levels of duty plus GST in Jersey are all lower than in the UK (duty plus VAT). A 10% increase in impôts across the board would bring in about £5m, assuming that volumes remain constant.

Fairness

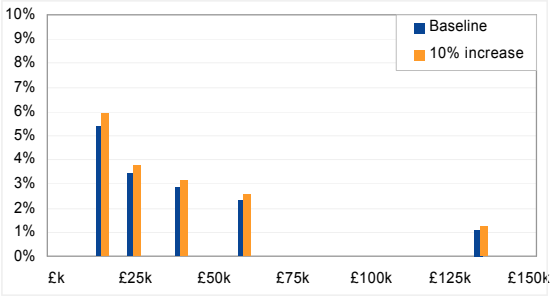
5.2.2 Increases in consumption taxes tend to be mildly regressive, and increases in impôts would be no exception, although there are certain anomalies across product types. For example, fuel duties may be progressive at low incomes because the less well off may not own a car, and revert back to being mildly regressive for higher incomes. The same results hold as in Section 4.4 in that expenditure on impôts can be looked

[18] The ratio of VAT revenue to consumption, divided by the standard rate of VAT

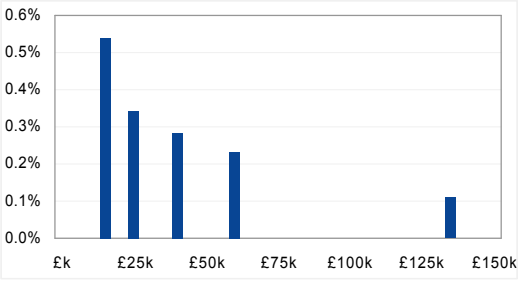
at as a proportion of income or as a proportion of expenditure, and the later will look less regressive. Figure 5.1 illustrates the effects of raising impôts by 10% as a proportion of income.

Figure 5.1: Raising all impôts by 10%

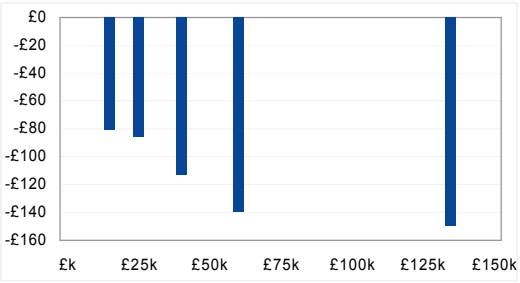
Average tax rate (% of income)



Change in average tax rate (% of income)



Change in tax paid (£)



Source: Economics Unit calculations

Economic Efficiency

5.2.3 Impôts could be seen as being detrimental to economic efficiency as they artificially raise the price of certain goods relative to others. However, impôts are usually justified on the basis that they correct an existing distortion or 'externality', and therefore may even improve economic efficiency.

5.2.4 For example, in Jersey impôts on alcohol and tobacco may help to reduce harm to health and impôts on motor fuel may help to address environmental concerns (including emissions). To maximise efficiency in this case, these product-specific taxes should be set at the appropriate level to address the harm they are seeking to correct, rather than as a general revenue-raising tool.[19]

[19] Fullerton, Leicester and Smith (Mirrlees Review, 2008) state that "The biggest external cost of motoring by far comes from congestion, yet existing taxes are targeted almost entirely on fuel purchases … [which] has little relationship to congestion."

Competitiveness

Like other consumption taxes, including GST, impôts do not have significant negative effects on competitiveness. This is because they only affect domestic goods (exports are excluded) and are unlikely to be passed on to employers through higher wage costs.

Revenue Stability

5.2.5 Impôts, like GST, perform well in terms of revenue stability. This is because consumption tends to be steady and relatively invariant to the economic cycle compared to other types of economic activity such as investment and large transactions like house purchases.

Administrative cost

5.2.6 Changing the rate of impôts will have a negligible cost as it involves changing an existing tax.

5.3 Vehicle Excise Duty (VED)

5.3.1 Vehicle excise duty will be introduced from 1 September 2010. The duty will be levied on vehicles based on CO_2 emissions (or, where information is not available, on engine size) as set out in Figure 5.2.

Figure 5.2: Proposed rates for VED

Manufacturer's CO_2 Emission specifications ($g/CO_2/km$)	Vehicle first registered in Jersey, or first registered outside Jersey one year or less ago	Vehicle first registered outside Jersey more than one but less than 2 years ago	Vehicle first registered outside Jersey more than 2 but less than 3 years ago
120g or less	£0	£0	£0
121-150g	£40	£25	£20
151-165g	£120	£80	£60
166-185g	£180	£115	£90
186-225g	£300	£195	£150
226-250g	£600	£390	£300
251-300	£1,000	£650	£500
More than 300g	£1,250	£815	£625

Fairness

5.3.2 It is difficult to say much about the fairness implications of VED. While it is likely that those more able to afford it will buy vehicles, and there may be a correlation between CO_2 emissions or engine size with income and wealth, analysis or conclusions along the lines of that conducted for some of the other taxes is not possible.

Economic Efficiency

5.3.3 To the extent that VED discourages the purchase of vehicles with relatively high CO_2 emissions, the change of behaviour that it induces will be beneficial from the perspective of economic efficiency because it corrects an existing externality. In

particular, it imposes more of the social cost of CO_2 emissions on the private individual.

Competitiveness

5.3.4 There are unlikely to be any significant effects on competitiveness of introducing or changing the rate of VED.

Revenue Stability

5.3.5 VED could be expected to be a relatively stable form of revenue as the number of vehicles registered on the Island does not change significantly from year to year.

Administrative cost

5.3.6 Changing the rate of VED once it is introduced would have no substantial administration costs.

5.4 The Island Rate

5.4.1 Currently the Island-wide rate raises around £10 million in revenue each year, while the Parish rates raise a further £12 million. That is a mixture of rates paid by domestic (c. £14 million) and non-domestic payers (c. £8 million). Doubling rates across the board would raise an additional £22 million.

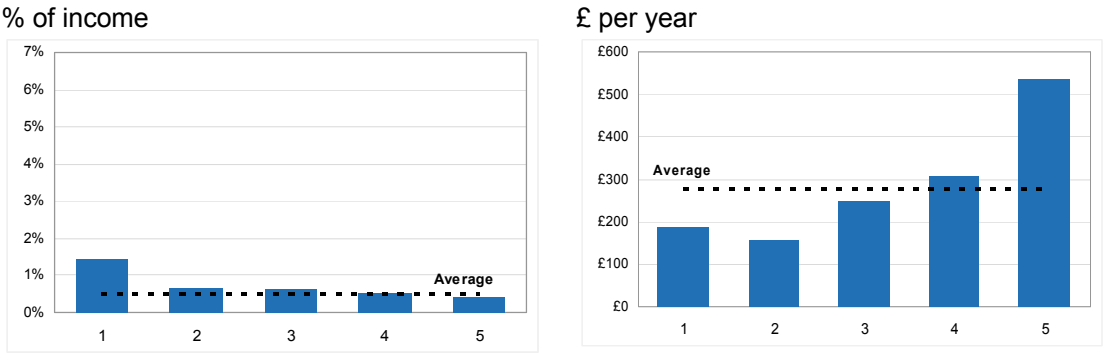
Fairness

5.4.2 For residents there may be some relationship between the value of property and the income of the resident. If the rates payable are proportionate to the value of the property the impact may be largely neutral on average. However, this relationship is unlikely to be perfect and there will be circumstances of high tax liability, low ability to pay and vice versa.

5.4.3 In Jersey the average rate paid (Parish plus Island-wide rate) equates to about £350 per household per year. In the UK average council tax paid per dwelling is about £1,100. Trebling domestic rates in Jersey would put them on a par with those in the UK and raise about £28m.

5.4.4 Figure 5.3 shows expenditure on rates by income quintile; however the data is from the Household Expenditure Survey, which was conducted before the introduction of the Island-wide rate.

Figure 5.3: Expenditure on Parish rates by income quintile



Source: Household Expenditure Survey

Economic Efficiency

5.4.5 Recurrent taxes on property generally do not distort the decisions of households or companies to supply labour, to save, to invest in human capital or to innovate to the same extent as other taxes.

5.4.6 In terms of efficiency, the OECD advice (see Section 3.3) suggests that recurrent taxes on domestic property are the most growth-friendly of all tax options because they distort behaviour much less than other taxes.

Competitiveness

5.4.7 In terms of competitiveness from the domestic feed-through of taxes, because domestic rates are levied on households, rather than companies, there is likely to be no negative impact on international competitiveness. In terms of competitiveness of tax rates relative to other jurisdictions, domestic rates are unlikely to be a key factor in location decisions.

5.4.8 Raising business rates increases the cost base of doing business and businesses will react to this change. Those operating in domestic markets might be more likely to increase prices where domestic markets are not subject to competition from outside the Island (as their competitors will also face such a cost increase). Export businesses, and there are many of them in Jersey, will be much less able to pass the increase on in prices as competitors in that market will not face a similar increase in costs. This may lead them to reduce employment costs by granting lower wage increases than would otherwise have been the case or reduce employment. This is a classic example of how businesses do not pay tax but people do and that Islanders will be likely to meet the costs either in terms of higher prices or lower wages (as in Section 3.4 and Figure 3.9).

Revenue Stability

5.4.9 Revenues from rates could be expected to be relatively stable as they tend to be based on historical property values, and do not fluctuate significantly from year to year.

Administrative cost

5.4.10 The administrative costs could be expected to be relatively low if the existing system was changed to raise more revenue. However, complexity could increase if there was a need to support those on low incomes affected by any change.

5.5 Stamp duty

5.5.1 Stamp duty on property transactions in Jersey raised £24m in 2008 and £20m in 2009, although annual revenue is likely to be lower in a less buoyant housing market. The new Land Transaction Tax (equivalent to stamp duty on share transfer) is expected to raise £1m a year.

5.5.2 If stamp duty was changed as set out in Figure 5.4 it would bring in approximately an additional £5.5m in revenue.

Figure 5.4: Stamp duty rates

Property Value	Current rate %	New rate %
£0-50,000	0.5	0.5
£50,001-300,000	1.5	1.5
£300,001-500,000	2.0	2.5
£500,001-700,000	2.5	3.0
£700,001-1,000,000	3.0	4.0
£1,000,001+	3.0	5.0

Source: Treasury and Resources

Fairness

5.5.3 It is difficult to estimate the fairness implications of an increase in stamp duty in Jersey.

Economic Efficiency

5.5.4 Stamp duty is a tax on transactions of immoveable property, and transaction taxes cause distortion by discouraging mutually beneficial transactions and so hindering the efficient allocation of assets in theory. However, at the current level of duty it is unlikely to cause significant distortions.

5.5.5 Transaction taxes on asset transfers, such as stamp duty on house purchase, might represent a partial user-charge, rather than a pure tax, if they are related to benefits received, including the government maintaining ownership records, although the revenue raised far outweighs the costs incurred.

5.5.6 Boadway, Chamberlain and Emmerson (Mirrlees Review, 2008) note that "stamp duties on the transfer of both property and equities raise significant revenue, but distort people's behaviour in an economically costly way, discouraging mutually beneficial transactions and thereby hindering the efficient allocation of assets." According to Johansson, Heady, Arnold, Brys and Vartia (OECD, 2008), "it is always less distortionary to tax the income and services provided by assets than the transaction involved in acquiring or disposing of them. … The lower distortionary effect arises because both transaction taxes and taxes on income/consumption discourage the ownership of assets, but the transaction taxes have the added distortionary cost of discouraging transactions that would allocate these assets more efficiently."

5.5.7 In theory, stamp duty on house purchase is also likely to be capitalised into lower house prices and may provide a disincentive for individuals to add value to their homes through improvements. Both issues are analogous to the situation for recurrent taxes on immovable property described above. But in practice, there is little evidence to suggest significant impacts from stamp duty set at a moderate level.

5.5.8 Transaction taxes on other asset transfers, including stamp duty on mortgages and personal estates, also exist in Jersey. Stamp duty on mortgages will distort decisions about financing a house away from mortgages towards other sources. The justification for stamp duty on mortgages is not clear and it does not seem to be used currently in other countries. It was abolished in Ireland in 2006 and the Australian state of New South Wales in 2007.

5.6 Mortgage interest tax relief

5.6.1 Mortgage interest tax relief is currently a tax expenditure that costs the States approximately £20m each year.

5.6.2 Mortgage interest tax relief provides a subsidy to owner-occupiers who purchase their house with a mortgage. There is little economic justification for such a relief, and worse, its existence is not in keeping with policy to make housing more affordable since the evidence suggests that such tax relief simply gets capitalised into house prices.

Fairness

5.6.3 The distributional consequence of reducing mortgage interest tax relief is difficult to assess. It would disadvantage those homeowners currently benefiting from the relief who, once 20 means 20 is introduced, could be described as the middle earners i.e. those below the incomes where 20 means 20 takes effect and those above allowances.

Economic Efficiency

5.6.4 Reducing mortgage interest tax relief could be expected to increase economic efficiency. There is little economic justification for this relief, and the evidence suggests that it is capitalised into house prices and causes a misallocation of resources from other productive uses to housing.

Competitiveness

5.6.5 There is unlikely to be any significant competitiveness impacts from reducing mortgage interest tax relief.

Revenue Stability

5.6.6 Mortgage interest tax relief is a relief from income tax, therefore reducing it will not change the volatility of tax revenue overall, but will increase the income tax base, and the extra revenue will be as volatile as income tax.

Administrative Costs

5.6.7 Reducing mortgage interest tax relief is unlikely to have any significant administrative costs.

5.7 Land development tax

5.7.1 It is difficult to calculate what revenue such a tax might generate but it is unlikely to be significant and will be irregular (the revenue stream will be lumpy) because it will depend how often and how much land is re-zoned for development. Further work would be needed to assess what might be achievable.

5.7.2 Previous work has shown that there would be little adverse economic impact from the introduction of a land development tax if it was designed correctly. The tax would be likely to be paid by landowners, as they would receive less uplift on land rezoned for development. It would be unlikely to have any significant impact on house prices in the medium-term.

Fairness

5.7.3 It is difficult to say much about the fairness implications of a land development tax along the lines of the analysis conducted for most of the other taxes: i.e. whether it is progressive, regressive or neutral. This is because there is no clear relationship between income and land development, and the effects will depend on the incidence.

5.7.4 It is likely however, that a land development tax could be considered fair in the common use of the term since it would only tax the 'unearned' windfall resulting from a planning gain.

Economic Efficiency

5.7.5 A land development tax (that was credible) would not distort behaviour in any significant way, and could therefore be expected to be relatively benign from the perspective of economic efficiency.

Competitiveness

5.7.6 No effects on competitiveness would be expected from the introduction of a land development tax. In particular, this is the case because the incidence of a land development tax could be expected to fall mainly on landowners rather than developers or occupiers.

Revenue Stability

5.7.7 A land development tax would provide volatile tax revenues because the tax base would be restricted to cases where planning permission was granted which would increase the value of land over and above the value in current use. Significant events of this sort occur infrequently and unpredictably.

Administrative Costs

5.7.8 Designing and implementing a land development tax would involve significant administrative costs.

5.8 Capital Gains Tax/Inheritance Tax

5.8.1 Jersey does not currently have a capital gains tax or an inheritance tax (although it does have Probate Duty). A report was commissioned from John Whiting of PricewaterhouseCoopers in 2004 which considered these as potential tax raising measures to deal with the black hole created by the introduction of 0/10. Both these taxes were ruled out because of the risk that they would negatively affect the activities of the finance industry, the jobs it creates and the significant tax revenues that it generates.

5.8.2 On consideration of the main categories of persons or businesses likely to have gains in Jersey it was felt that few of them would pay significant capital gains taxes for the following reasons:

1. Financial services companies – the vast majority of what might to others be capital transactions will likely already be taxed as trading profits subject to tax at 10% so there would be limited, if any, additional tax take.
2. Other companies – might legitimately expect to pay tax on capital gains in the same way as on other income, i.e. at 0%.
3. Personal taxpayers – would normally be covered by an annual exemption (which is common in those jurisdictions which have a capital gains tax) so would pay no or negligible amounts of tax.

Fairness

5.8.3 The Mirrlees review noted that the taxation of wealth and wealth transfers is frequently justified on the grounds of fairness, rather than on the basis that it will raise revenue for public expenditure, and that *"taxing wealth and income has been seen by some, such as Meade (1978), as fairer than taxing income alone on the basis that the possession of wealth confers advantages over and above the income derived from wealth."*

5.8.4 However, the same review notes that in practice they often fail to redistribute wealth and are inherently unfair because they fall disproportionately on the middle classes, to the benefit of the rich who can often avoid them.

5.8.5 Inheritance tax is a tax on accrued income; that is income that has previously suffered tax already and may therefore raise other issues of fairness.

Economic Efficiency

5.8.6 Inheritance tax could be expected to have a negative effect on economic efficiency. This is because it reduces the incentive for wealth accumulation, which in turn may reduce investment in productive capital and the economies growth potential.

5.8.7 Capital gains tax may have a greater negative effect on economic efficiency. Firstly, capital gains taxes can distort the allocation of resources between assets that are subject to the tax and those that are not (for example in the UK principle private residences are not subject to CGT, while all other property is). Secondly, they can create a "lock-in" effect, whereby the owners of assets hold on to them for longer than they would otherwise in order to avoid having to pay capital gains tax on the sale of the asset.

5.8.8 Capital taxes can also encourage taxpayers to change their behaviour to restructure their affairs in order to avoid the tax, adding to the complexity of the law.

Competitiveness

5.8.9 Jersey's main international competitors do not have capital taxes such as a capital gains tax or inheritance tax. In general, the absence of capital taxes is seen as part of the appeal of a lower tax regime and the international perception of Jersey would be damaged by the introduction of these taxes. Indeed, our competitors would certainly use it as a marketing tool to their own advantage. Even if introduced at a low rate, it would impact Jersey's reputation as a low tax jurisdiction; given that so much of Jersey's financial services business relies on Jersey's international reputation a low rate of capital tax would likely do as much damage to the Island's competitiveness as a high rate.

5.8.10 Were Jersey to lose its reputation as a low-tax regime, which would be the case if capital taxes were introduced, the private wealth management side of the financial services industry would lose business as it would be perceived that Jersey could no longer offer a tax neutral regime to wealth management structures. Trust and company administrators would suffer with fewer structures to administer, banks

would be impacted by the loss of deposits from trust company client funds, and there would be fewer new structures on which lawyers and accountants could advise.

5.8.11 Capital taxes would also damage the chances of attracting and retaining wealthy residents, particularly those individuals intending to carry on a business in Jersey. Given the choice between relocating to a territory that levies capital taxes and one that does not, entrepreneurs are more likely to be attracted by those jurisdictions without capital taxes.

5.8.12 Should a capital gains tax be introduced, the majority of companies currently in Jersey would expect to pay the tax at the same rate applied to the rest of their profits, i.e. 0%. Companies considering relocating to Jersey would be concerned however that should the headline rate of corporate tax rise, they would be subject to tax on their capital gains, whereas many other low-tax regimes exist which do not have capital taxes. The same would apply if a separate capital gains tax was introduced for companies at a rate other than 0%.

Revenue Stability

5.8.13 Inheritance tax and capital gains tax are likely to be more volatile than income tax and GST since the value and turnover of assets will fluctuate more than income or consumption.

Administrative Costs

5.8.14 Capital taxes are inherently complex to administer, and create an incentive for taxpayers to reorder their affairs in such a way as to mitigate their liability. This in turn requires the tax authorities to devote greater resources to ensuring compliance, and to develop more complex legislation to counter tax planning opportunities. The experience of other jurisdictions which impose these taxes is that they consume large amount of resources for a comparatively low return. In the UK, capital gains tax and inheritance tax combined are estimated to raise less than 1% of total revenues for the year 2009/10, whereas a disproportionate amount of all UK direct tax legislation deals with these two taxes alone.

5.9 Company Annual Registration fees

5.9.1 All companies incorporated in Jersey pay an annual registration fee. The current annual registration fee is £150 per company, of which, since 2009, £35 is retained by the Jersey Financial Services Commission (JFSC) and £115 is retained by the

States. The States received around £3.7m from these fees in 2009. A review of this fee is currently being undertaken and the results will be published later this year.

Fairness

5.9.2 It is difficult to analyse the fairness implications of company fees, because it is not necessarily clear where the incidence of the tax falls. It could in theory be paid by shareholders, customers or employees, and each would have a different distributional impact. That said, company fees are relatively small in terms of revenue raised, so the fairness implications are unlikely to be substantial.

Economic Efficiency

5.9.3 The impact on economic efficiency of company fees is likely to be small. The only influence that such a fee will have will be to reduce the prospective return to registering a company. However, since the fees are so small relative to the turnover of even the smallest of companies, the impact is likely to be marginal at low levels.

Competitiveness

5.9.4 It is important that the cost of locating a company in Jersey continues to be set at a level that allows it to compete with other jurisdictions for international business. Although the level of individual fees may appear small it is important to bear in mind that the cumulative level of all such fees will influence a decision on where to locate a business if all other factors are equal. Many international companies established in Jersey will also suffer ISE fees of £100 or more depending on the nature of business carried on by them. The review of company fees mentioned above will take into account the total statutory fees payable by Jersey companies.

Revenue Stability

5.9.5 Company fees provide a relatively stable revenue stream as each company pays a fixed fee, and neither the number of companies nor the level of the fee vary significantly from one year to the next.

Administrative Costs

5.9.6 Since registration fees are already charged, an increase will not result in any significant additional administration costs.

5.10 International Services Entity (ISE) fees

5.10.1 As in other territories with a consumption tax similar to GST, most financial services activities are treated as being exempt from GST in Jersey. A business that makes exempt supplies may not recover the input GST associated with that supply and therefore suffers an irrecoverable cost. Banks, trust company businesses and fund services businesses are examples of businesses that make this type of exempt supply. Such businesses have the choice to apply for ISE status which allows them to pay a single annual fee that in effect represents an up-front payment of the GST they would otherwise suffer throughout the year. Businesses in this position are not required to opt for ISE status. They may instead apply the normal GST rules, although administering its GST can be more complex and costly for a business that makes exempt supplies.

5.10.2 The level of the ISE fee varies according to the type and amount of business activity they carry out and ranges from £500 to £30,000 per year, though in some cases may be higher.

5.10.3 Trust companies are required to pay a basic fee of £7,500 plus an additional amount of £100 in respect of the entities they administer, apart from trusts. Although this fee is the liability of the fiduciary services provider, in practice the cost is generally passed on to the administered entity in the form of higher fees. The financial services industry currently contributes about £6m towards GST through these flat rate fees.

5.10.4 A review of the level of ISE fees is currently being undertaken and is expected to report shortly.

Fairness

5.10.5 It is difficult to estimate the distributional impact of ISE fees because like other costs on business depending on the circumstances they could ultimately be paid by the shareholders, the employees or the customers.

Economic Efficiency

5.10.6 The impact on economic efficiency of ISE fees is likely to be small. The only influence that such a fee will have will be to reduce the prospective return to companies. However, since the fees are so small relative to the turnover of even the smallest of companies, the impact is likely to be marginal.

Competitiveness

5.10.7 The ISE regime was introduced in order to mitigate the impact of the introduction of GST on Jersey's financial services sector, particularly given that Guernsey, our nearest competitor, does not impose GST. Financial services companies in particular will look at the total cost of doing business in a territory when considering whether to locate a business there. A consideration of whether to increase ISE fees should therefore take into account how they and other fees payable by businesses in the Island compare to those charged in Jersey's international competitors.

Revenue Stability

5.10.8 ISE fees provide a relatively stable revenue stream as neither the number of companies paying them or the value of the fee alter dramatically from year to year.

Administrative Costs

5.10.9 A simple increase in the ISE fees should not lead to a significant increase in administration costs unless the increase prompted large numbers of those companies that currently claim ISE status to revert to the normal GST regime. As mentioned above, the system of taxing businesses that supply services that are exempt from GST is more complex than for normal businesses. This would therefore necessarily lead to increased costs to ensure the system was being administered correctly.

6 Conclusion

6.1.1 In summary, the evidence on economic efficiency implies that GST and domestic rates would be preferable to social security and higher personal tax rates. The evidence on competitiveness from domestic tax feed-through and relative to other jurisdictions both imply that GST and domestic rates would be preferable to social security, with mixed evidence on a higher personal tax rate. This is consistent with the advice of Oxera (2004), which noted that "from the perspective of preserving Jersey's competitiveness as a location for financial services, it would appear that measures with a first-order effect that increase net business costs [such as raising employer social security contributions] may pose more of a risk than those with an impact that relies initially on being translated into costs through wage demands [such as raising the GST rate], where there may be more scope to manage those demands."

6.1.2 The increased mobility of individuals and companies in financial centres suggests that competitiveness should have a higher weight attached to it than perhaps would be the case in a larger jurisdiction with a different mix of industry. In turn this would suggest that the relative preference should be more strongly biased away from corporate income tax, personal income tax and social security contributions towards recurrent tax on immovable property and consumption taxes than for a large OECD country.

References

Arnold, J (2008), 'Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries', OECD Economics Department Working Paper 643, October.

Arpaia, A and Carone, G (2004), 'Do labour taxes (and their composition) affect wages in the short and long run?', European Economy Economic Papers No 216, European Commission, October.

Attanasio, O, and Wakefield, M (2008), 'The effects on consumption and saving of taxing asset returns', Mirrlees Review, Institute of Fiscal Studies, March.

Banks, J, and Diamond, P (2008), 'The base for direct taxation', Mirrlees Review, Institute of Fiscal Studies, March.

Boadway, R, Chamberlain, E, and Emmerson, C (2008), 'Taxation of wealth and wealth transfers', Mirrlees Review, Institute of Fiscal Studies.

Crawford, I, Keen, M, and Smith, S (2008), 'Value-added tax and excises', Mirrlees Review, Institute of Fiscal Studies, July.

Deaton, A, and Stern, N (1986), 'Optimally uniform commodity taxes, taste differences and lump-sum grants', Economic Letters, Vol 20.

Dickson and White (Mirrlees Review, 2008) 'VAT and Excises: Commentary', Mirrlees Review, Institute of Fiscal Studies

Disney, R (2004), 'Are contributions to public pensions programmes a tax on employment?', Economic Policy, Vol 39, July.

Disney, R (2006), 'Macroeconomic performance and the design of public pension programmes', The Economic and Social Review, Vol 37, No 2, Summer/Autumn.

Ebrill, L, Keen, M, Bodin, J-P, and Summers, V (2001), 'The modern VAT', IMF.

Fiscal Policy Panel (2009) 'November 2009 Update'

Fullerton, D, Leicester, A, and Smith, S (2008), 'Environmental taxes', Mirrlees Review, Institute of Fiscal Studies, March.

Griffith, R, Harrison, R and Macartney, G (2007), 'Product market reforms, labour market institutions and unemployment', Economic Journal, Vol 117, No 519.

Griffith, R, Hines, J, and Sørensen, P (2008), 'International capital taxation', Mirrlees Review, Institute of Fiscal Studies, March.

IFS (2008), 'Simplify VAT to cut costs', Press Release on Crawford, I, Keen, M, and Smith, S (2008), 31 July.

Johansson, Å, Heady, C, Arnold, J, Brys, B, and Vartia, C (2008), 'Tax and economic growth', OECD Economics Department Working Paper 620, July.

Keuschnigg, C, Keuschnigg, M, and Jaag, C (2009), 'Aging and the financing of social security in Switzerland', Universität St Gallen, Discussion Paper 2009-26, September.

Meghir, C, and Phillips, D (2008), 'Labour supply and taxes', Mirrlees Review, Institute of Fiscal Studies, March.

Myles, G (2009a), 'Economic growth and the role of taxation – theory', OECD Economics Department Working Paper No 713, July.

Myles, G (2009b), 'Economic growth and the role of taxation – aggregate data', OECD Economics Department Working Paper No 714, July.

Myles, G (2009c), 'Economic growth and the role of taxation – disaggregate data', OECD Economics Department Working Paper No 715, July.

Nickell, S, Nunziata, L and Ochel, W (2005). 'Unemployment in the OECD since the 1960s: What do we know?', Economic Journal, Vol 115, January.

OECD (2009), 'Strategies for aligning stimulus measures with long-term growth', Report for the meeting of the Council at Ministerial Level, 24-25 June.

Oxera & Allsopp, C (2005), 'Which tax is best suited to Jersey's objectives? An evaluation of alternative tax options', February.

Oxera (2004), 'Fiscal strategy: Background paper', February.

The Economist (2009), 'The state's take', 21 November, pp92-93.

Appendix

Figure 6.1: Tax rates, allowances and exemptions

Income Tax

	2009	2010
Allowances		
Single Person	£1,040	£520
Married Person	£2,080	£1,040
Earned income	£1,360	£680
Wife's earned income	£1,800	£900
Child	£3,000	£3,000
Child (Higher education)	£6,000	£6,000
Additional (Single Parent)	£4,500	£4,500
Exemptions		
Single Person	£12,650	£12,650
Single person (63+)	£14,110	£14,110
Married Person	£20,280	£20,280
Married person (63+)	£23,220	£23,220
Allowances		
Wife earned income	£4,500	£4,500
Childcare tax relief	£6,500	£6,500
Additional (single parent)	£4,500	£4,500
Child	£3,000	£3,000
Child (Higher education)	£6,000	£6,000
Mortgage Interest relief cap	£300,000	£300,000

Social Security

	2009	2010
Employee Contribution Rate	6%	6%
Earnings ceiling	£42,484	£43,752
Lower earnings limit	£8,286	£9,240

Impôts

	2009	2010
Litre of whisky	£9.37	£9.37
Bottle of wine	£1.12	£1.12
Pint of beer <5% alcohol	£0.28	£0.28
Pint of beer >5% alcohol	£0.42	£0.42
20 cigarettes	£3.15	£3.15
Litre of diesel	£0.41	£0.41
Litre of unleaded petrol	£0.41	£0.41

Figure 6.2: States' income

	2009	%
Income Tax		
Employees	243,000,000	37.2%
Self-employed and Investment Holders	37,000,000	5.7%
Companies	208,000,000	31.8%
Total Income Tax	**488,000,000**	**74.7%**
Goods and Services Tax	**50,000,000**	**7.7%**
Impots		
Spirits	4,120,000	0.6%
Wines	6,330,000	1.0%
Cider	800,000	0.1%
Beer	5,340,000	0.8%
Tobacco	13,780,000	2.1%
Motor Fuel	20,700,000	3.2%
Impots on goods imported	150,000	0.0%
VRD/VED	-	-
Total Impots	**51,220,000**	**7.8%**
Stamp Duty	**19,500,000**	**3.0%**
Total Taxation Revenue	**608,720,000**	**93.1%**
Island Rate	**10,560,000**	**1.6%**
Other Income		
Interest on Cash	4,000,000	0.6%
Dividends	13,960,000	2.1%
JFSC	-	-
New Company Fees (JFSC)	3,710,000	0.6%
Income Tax Penalties	850,000	0.1%
Currency and coinage surplus	1,840,000	0.3%
Interest and repayments on loans	280,000	0.0%
Financial returns from States trading operations	250,000	0.0%
EU Retention Tax	89,000	0.0%
Misc	460,000	0.1%
Total Other Income	**34,250,000**	**5.2%**
Total Income	**653,530,000**	**100.0%**

Source: States of Jersey Draft Budget 2010

Figure 6.3: A 'ready reckoner' of tax and social security changes

	£m
Income tax options	
Freeze exemptions	4
1% on basic rate	8
30% rate over £100k	30
Extend 20 means 20	4
Remove mortgage interest tax relief	20
Social security options	
1% increase in contributions (0.5% each side) – net of supplementation	15
Raise ceiling to £115,000	30*
Remove ceiling	45*
Increase ceiling by 10%	5*
GST options	
Raise standard rate by 1%	15
Change financial services charge	0-4
Impôts options	
10% increase in impôts across the board	5
Marine fuel duty relief removal	0.5

* Excludes any increase in revenue to the Health Insurance Fund, should the changes apply to those contributions