

**FISCAL REVIEW WORKING GROUP: SECOND REPORT**

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**Presented to the States on 28th September 1999  
by the Finance and Economics Committee**

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**STATES OF JERSEY**

**STATES GREFFE**

140

1999

R.C.37

Price code: E

## FISCAL REVIEW WORKING GROUP - SECOND REPORT

### Introduction

1. The Fiscal Review Working Group was set up by the Finance and Economics Committee with the following membership and terms of reference.

#### Membership

Colin Powell - Chairman  
Senator Wendy Kinnard  
Deputy Imogen Nicholls  
Deputy Mike Vibert  
Margaret Alexander - Representative for the Jersey Taxation Society  
Peter Walsh - Representative for the Chamber of Commerce  
Martyn Scriven - Representative for the Finance Industry  
Mick Kavanagh - Representative for the Transport and General Workers Union  
George Baird - Treasurer of the States (for a time)  
Dr. Michael Romeril - Environmental Adviser  
Bob Gaiger - Comptroller of Income Tax  
Tony Renouf - Agent of the Impôts  
Ann Esterson - Controller of Employment and Social Security  
John Christensen - Assistant Adviser - Economics (for a time)

#### Terms of reference

To review all aspects of States' "fiscal" policy including -

- direct taxation;
- indirect taxation;
- public sector charges;

and having regard for -

- the States' policy objectives in "2000 and Beyond";
- the experience of other countries and the lessons they have learned;
- the "user pays" principle;
- the need for greater equity in the tax system,

and to make recommendations to the Finance and Economics Committee on the nature of any changes required.

2. The Group invited submissions from States members, Chief Officers, private organisations and private individuals. The Group also invited written representations on any matter that fell within the Group's terms of reference. The Group is most grateful to all those who responded to these invitations. The Group produced an Interim Report in September 1998 (R.C.41/98) which referred to a range of tax options and some of the Group's initial thoughts thereon. This second report expands on these matters.
3. The Group would emphasise that this second report should be seen as a further stimulus for discussion on the issues covered and not be seen as a prescriptive document. It is hopefully a basis for decisions in principle to be made, which should then be built upon through further research in depth, and most importantly through full consultation with all the main interested parties. It should be further emphasised that what is included in this report does not necessarily have the full support of all members of the Group. The Report is best described as a "map" that should be used for future reference when fiscal policy proposals are being brought forward for consideration.
4. **The Group in approaching its task has recognised the importance of -**

- **looking at fiscal policy in the round and not adopting individual fiscal measures in isolation;**
- **considering the proposals in this report as a package and not individually;**
- **fiscal policy being seen as part of a long-term strategy for the Island;**
- **resisting the temptation to engage in ad hoc decisions unconnected with and therefore likely to be in conflict with the underlying long-term strategy;**
- **considering any individual fiscal measures that might be proposed by others within the framework of the report as a whole;**
- **engaging in a comprehensive dialogue with all those likely to be affected by any of the measures referred to in the report.**

### **Fundamentals of taxation**

5. The Group, in considering the tax options, has had regard for the following criteria, which were also attached to the terms of reference when inviting submissions. (The criteria are not listed in any priority order.)

- Will it assist in achieving the States environmental objectives?
- Will it protect and provide for proper incentives?
- Will it encourage initiatives?
- Will it provide for choice?
- Will it limit administrative costs?
- Will it provide for equity and social justice?
- Will it satisfy public expectation?
- Will the yield/pain or cost ratio be positive?
- Will it assist in achieving the States population policy objectives?
- Will it have an adverse impact on the Island's relations and competitiveness?
- Will it be inflationary?
- Will it be achieved in an appropriate time scale?
- Will it have health benefits?
- Will it encourage enterprise and wealth creation?
- Will it enhance the quality of life of the Island's residents?

6. The Group has had regard also for the principles which should govern tax policy, such as the following, which are taken from the report of the Commission on Social Justice published in the United Kingdom in 1994. The Group recognises that the individual principles may not in every case be compatible with each other -

- no taxation without justification;
- taxes must be fair;
- taxes must be acceptable to the public;

- the connection between taxes and achievements should be as clear as possible;
- as far as possible taxes should contribute to improving a country's economic performance;
- the structure of tax reliefs and allowances should be made as simple as possible, and used sparingly to pursue policy objectives;
- taxation should respect an individual's independence;
- subject to the principle of fairness, taxes should be levied on as broad a base as possible;
- taxes should be easy to understand and collect.

7. The Working Group, in considering its remit, has not been motivated by revenue requirements. The Group has been concerned to address what it has considered to be the fundamentals which are referred to above. Particular attention has been focused on -

- equity;
- simplicity;
- diversity;
- long-term security;
- economic interests;
- poverty issues/social policy;
- environmental policy objectives.

8. Other points that the Working Group has considered to be of particular relevance to its considerations are -

- that the role of the Working Party is to address strategic issues;
- that there should be no change for change's sake;
- that there should be recognition that the introduction of any new form of taxation calls for a prior full and effective consultation process;
- that for any change in the structure of taxation the gainers should significantly exceed the losers;
- that any losers will be vociferous in their opposition to any proposed tax change;
- that in proposing change there needs to be a package of proposals so that the positive aspects can be compared with and can offset any negative aspects;
- that taxation cannot be considered in isolation and should be considered in the context of wider policy issues;
- that taxation must be considered together with the payment of social benefits;
- that tax measures must be distinguished between those that are short, medium or long-term in their possible implementation;
- that any change in taxation policy must be gradual;
- that a distinction should be drawn between the essential and the non-essential and what are core and non-core in the pursuit of strategic policy objectives.

9. **In addressing fiscal policy, the Group has recognised the role that this policy can play in the achieving of the States' strategic policy objectives set out in the 1995 Strategic Policy Report "2000 and Beyond". While fiscal policy must not be seen necessarily as an end in itself, it can be a means to an end. For example, fiscal policy can assist in achieving -**

- **population policy objectives by encouraging the best use of manpower and generally helping to raise productivity;**
- **sustainability by encouraging the best use of the Island's resources, by helping markets work better and by discouraging harmful or wasteful activity, and by promoting equity;**
- **social policy objectives by minimising social and material deprivation through a co-ordinated approach to taxation and social benefit provision;**
- **transport policy objectives through discouraging the use of private transport;**
- **health policy objectives through discouraging the consumption of alcohol and tobacco products;**
- **economic policy objectives by, among other things, supporting the diversification of the economy;**
- **a counter-inflationary policy, thereby helping to ensure the competitiveness of the Island's industries in both overseas and domestic markets;**
- **the Island's international policy objectives, including playing an effective role in the current discussions in international fora on reducing harmful tax competition.**

10. As stated in paragraph 7 above, the Working Group has not been motivated by revenue requirements. At the same time the Group has recognised the continuing pressure on the tax revenues arising from, for example -

- a growing demand for public services;
- an ageing of the population;
- the high cost incurred in the acquiring commercial land for residential development within the urban area,

and is conscious of the policy restraints that are imposed by the present income tax structure with its high tax thresholds and the absence of a progressive rate of tax.

## **Equity**

11. In considering the question of equity the Working Group has considered the following options -

- (i) Steepen the gradient for the increase in the effective<sup>[1]</sup> rate of income tax as incomes rise, while retaining the standard and maximum<sup>[2]</sup> rate of income tax at 20 per cent.

Possible steps considered are to -

- reduce the value of allowances enjoyed by those in the higher income bracket (e.g. a progressive reduction in the value of tax relief on interest payments over an agreed period of years; use a lower rate of tax for certain tax reliefs);
- reduce the marginal<sup>[3]</sup> rate of tax for those with incomes above the tax threshold from 27 per cent to 20 per cent in accordance with current Finance and Economics Committee policy;
- introduce a lower rate of tax (e.g. ten per cent) for an initial tranche of income.

- (ii) Ensure that a higher proportion of the resident population are contributing to tax revenues. This could be achieved by -

- freezing income tax thresholds;
  - broadening the base of indirect taxation.
- (iii) Reviewing the interaction of fiscal and social policies. Reference is frequently made in this context to the concept of a “basic income” for all, and this point is returned to in paragraphs 74/75 in the later section on taxation and social benefits.

### **Simplicity**

12. The Working Group, in considering tax proposals, has recognised the importance of simplicity in the tax structure. Not only is the tax system then better understood, but the resource cost of compliance is minimised.

### **Better balance**

13. In considering a better balance in the tax structure, the Working Group has considered the following -
- the present tax structure is grossly imbalanced, and the Island is extremely vulnerable to changes in the yield from income tax, which accounts for 90 per cent of tax revenues;
  - to lower the proportion of total tax revenues obtained from the taxing of incomes requires an increase in indirect taxation. Any significant change in the balance of taxation will not be achieved simply by increasing the rates of taxation on existing dutiable items (e.g. tobacco goods, alcoholic drinks and motor fuel). There would need to be a new form of indirect taxation with a significant tax yield;
  - any attempt to improve the balance will need to have regard for equity (i.e. to limit the adverse affect on those with lowest incomes);
  - consideration also will need to be given to the effect of indirect taxation on the competitiveness on the Island’s industries. In this context it should be recognised that fiscal change that may have short-term economic effects, which may appear detrimental to the future of the economy, can provide long-term benefits.

(See paragraphs 38-57 for more detailed comments on indirect taxation proposals.)

## **Long-term stability of tax revenues**

14. In considering the need for long term stability of tax revenues, the Working Group has recognised the need to -
- lessen the dependence on income tax as a source of revenue and thereby lessen the vulnerability to unforeseen changes in the level of profit, investment income, or wages and salaries liable to income tax;
  - increase the proportion of tax revenues arising from the taxing of expenditure subject to safeguards regarding any impact on those with lowest incomes and the price competitiveness of the Island.

## **Support for States' social policies**

15. The Working Group has had particular regard for the relevance of fiscal policy for States' strategic policy objectives, such as the objective of minimising social and material deprivation. With regard to this objective, particular attention needs to be given to -
- providing for greater equity in the treatment of those in receipt of social benefits and those benefiting from the income tax regime;
  - the targeting of social benefits and the tax regime to ensure that those with relatively low incomes, in greatest need, receive the greatest benefit.

(See paragraphs 70-75 for further comments on the inter-relationship between taxation and social benefits.)

## **Environmental policies**

16. The Working Group has considered how the pursuit of strategic environmental policy objectives can be assisted through fiscal policy. However, the Group has recognised that taxation is only one of a number of instruments that can be used to this end. Charges can be attached to certain activities (e.g. parking charges). Subsidies can be paid to lower the cost of environmentally friendly products/activities. Regulations can be applied to limit the use of environmentally harmful goods (e.g. through restricting importation). There are nevertheless examples where "green" taxation can make a useful contribution in ensuring that the full "environmental" costs are borne by the users of, for example, energy or motor vehicles.

(See paragraphs 59-69 for more detailed comment on "green" taxation proposals.)

## **Economic policies**

17. The Working Group has considered whether fiscal policy could be used to support the achievement of strategic economic policy objectives. The Group recognises that fiscal policy is only one option and is generally considered to be not the most effective way of encouraging investment or specific areas of economic activity.
18. A successful economy depends more on appropriate States' policies helping to produce an overall favourable environment for business development. Fiscal policy can assist, but generally in an insufficiently focused way. It is a blunt instrument.
19. Areas where fiscal policy has been suggested are -
- incentives to investment in the tourism industry;
  - incentives to invest in information technology;
  - incentives to invest in labour-saving activities;
  - incentives to encourage people to take up employment (e.g. child care tax allowances, lower marginal rates of taxation);
  - incentives to train;
  - lower corporate tax rates to attract new business;

- lower corporate taxation to improve the overall competitiveness of the Island's industries through reducing business costs.
20. The Working Group has noted however that -
- tax incentives only act as an incentive if the businesses concerned are making a profit and are able to benefit from tax allowances;
  - if businesses are profitable or business ventures offer the prospect of profit enhancement, tax incentives are not needed to encourage investment;
  - with a tax rate of 20 per cent, tax incentives have limited appeal compared to grants or low interest rate loans;
  - for tax incentives for investment to be of value, the business environment generally must be such to encourage investment;
  - tax incentives like subsidies can distort the market place, and when introduced can disadvantage those who have acted prior to the introduction of the new measures.
21. In considering the interaction of fiscal policy and economic policy, particular regard should be had for the effect of fiscal policy on the competitiveness of the Island's industries. This can be both positive through incentives to invest, to diversify the economy or to train and raise the productivity of the Island's workforce; or negative through increasing the cost base for the Island's industries, particularly where a difficult market climate is confronted and price competition is keen. Of particular importance is the potential impact of the Island's fiscal policy on the international comparisons that will be made by many in deciding where to locate their business activities.
22. A particular area where fiscal policy can impact on economic policy is in the development of e-commerce and the status of the Island as an "intelligent" Island. This is a highly competitive area where costs comparisons can be a significant influence on the success in attracting business, and the fiscal policy approach to e-commerce can be a material factor in deciding whether the Island is cost competitive.

### **Proposals for further consideration**

23. The Working Group in putting forward the following proposals would repeat the point made earlier that the proposals are not to be read as being prescriptive but more with a view to being exposed to a full process of consultation and discussion. The Group also has sought to produce what can be described as a 'map' for future reference to be used when fiscal policy proposals are being brought forward for consideration. This second report is a document that it is intended should stimulate discussion and wider consultation with all interested parties. It should, however, be emphasised that not all the points carry the full support of all members of the Group. In some cases points included in this report reflect a majority view rather than a unanimous view.

### **Direct taxation**

24. In reviewing the present system of direct taxation, the Group has sought to apply the criteria referred to earlier in this report to the existing structure to see whether there are areas where change would bring about an improvement. Primarily the Group has been concerned to see whether the existing system of direct taxation could be made fairer, more equitable and simpler.
25. Not all matters referred to in submissions to the Group have been referred to in the text of this report. The following matters that have been focused on are those the Group would propose be further considered, a number of which the Group is aware have already been referred to in policy statements issued by the Finance and Economics Committee.



- Reforming the personal tax system
  - reducing the marginal rate to 20 per cent;
  - abolishing the two-tier system of allowances/ exemptions;
  - simplification of current personal allowances structure;
  - restricting relief for interest/payments;
  - changing the ways in which wages and salaries are assessed to tax.
- Taxation of benefits in kind
  - controlling directors taking advantage of the tax system.

**Tax relief on mortgage and other interest (see also Appendix 1)**

26. The Group on this, as on other matters covered by this report, is seeking to stimulate discussion on the issues raised when reviewing the tax treatment of interest payments.
27. The Group addressed this specific proposal of tax relief on mortgage and other interests because of the particular political interest in this issue reflected in Deputy Breckon's proposition (P.194/97) on the removal of mortgage interest relief where mortgages are above a minimum figure of £180 000.
28. The Group has considered the arguments that have been advanced in favour of removing tax relief on mortgage interest -
- on grounds of equity - to remove what was seen as an inequity between home owners with a mortgage who receive tax relief on mortgage interest and tenants who receive no tax relief for rent paid;
  - as part of a counter-inflationary policy - to reduce the rate of house price inflation through reducing the level of demand in the housing market.
29. In responding to the points made on equity the Group has had regard for the fact -
- that many of those in rental accommodation benefit from rent rebates;
  - those who have existing mortgages should not be penalised. Therefore either the withdrawal of tax relief, should it be adopted, should be phased over a long period of years or there should be compensatory adjustments to other tax allowances so that the tax burden generally is not increased particularly for those with relatively low incomes;
  - withdrawing tax relief on mortgage interest without also removing tax relief on all interest would produce conditions of inequity between tax payers;
  - withdrawing tax relief on all mortgage interest would have a proportionately greater impact on those with relatively low incomes.
30. On the question of the influence of mortgage interest tax relief on house prices, the Group is of the view that (to the extent that there is an influence) the greatest impact can be expected to be at the margin where the tax relief can be material in facilitating house purchase by those on relatively low incomes. To influence house prices therefore, the removal of mortgage interest tax relief would need to be across the board while recognising, as noted above, that this would have a particularly adverse effect on those with relatively low incomes.
31. The Group has concluded that, if it is decided that mortgage interest should be withdrawn, the following principles should apply -

- both mortgage interest and other interest should be restricted for tax relief purposes; no distinction should be made between the two types;
- tax relief should be restricted to a proportion of the interest paid, with that proportion reducing, over a long period of years, to nil;
- there should be no differentiation according to the price of property or the size of the mortgage;
- within the constraints of the budgetary position, the Finance and Economics Committee should direct the extra tax yielded back into tax allowances so that the tax burden of the majority of tax-paying individuals is not increased by the process of restricting tax relief for interest;
- interest on existing mortgages or loans should fall within the restriction; in other words the restriction should not merely apply to new borrowings;
- interest payments for business purposes, i.e. incurred for the purpose of carrying on a trade, should continue to be allowed in full; in this connection “business” would include the letting of property on a commercial basis.

32. Consideration was given to means of abolishing tax relief for other interest first, leaving mortgage interest unscathed (for the time being at least). This was what happened in the United Kingdom, but in Jersey an opportunity exists to set a long-term target of abolishing tax relief for all interest. In the United Kingdom the first step (abolishing tax relief on other interest) was not seen as having abolition of all interest tax relief as its ultimate goal. However, any scheme to distinguish between mortgage interest and other interest would require complex legislation, leading to an administrative burden being placed on the Income Tax Department in interpreting/explaining the legislation and restricting attempts to circumvent it. The conclusion therefore is that both types of interest should be treated in the same way.

#### **Changes in the way wages and salaries are assessed to tax (see also Appendix 2)**

33. The Income Tax Department has engaged in a consultation process regarding a change in the way wages and salaries are assessed to tax. The Group supports the recommendation of the Department that the basis of assessment in respect of wages and salaries should be changed from the amount arising in the year to the amount received in the year.
34. New legislation will be required to introduce the receipts basis. In addition, transitional provisions will be needed to cover those situations where income would otherwise be assessable twice or not at all. Care will be required when the amount of income assessable forms the basis of income related benefits. However, the Group is of the opinion that any difficulties in the short-term will be offset by long-term gains through simplification.

#### **Controlling directors taking advantage of the tax system (see also Appendix 3)**

35. The Income Tax Department has undertaken research into the ways in which a director who controls and owns his company can so arrange the amount and type of his income from that company in order to minimise his tax and social security and maximise his income-related States benefits. The Group supports the idea of overarching legislation being enacted to deal with general abuse covering both the tax and benefits systems.

#### **Taxation of benefits in kind (see also Appendix 4)**

36. The Group recognise the inequity of the present arrangements, whereby benefits in kind are received without charge to tax, whereas payments of cash are subject to tax. At the same time the Group recognise that there are considerable difficulties to be faced in taking action of this respect, and that there is a danger that proposals, if implemented, would introduce considerable complexity and would bring in their train a higher compliance cost.

## **International concerns**

37. The Group support the approach being adopted by the Insular Authorities in response to the OECD and EU initiatives on harmful tax competition. The Group accept that there are aspects of the Jersey tax system which might constitute potential harmful tax regimes, but that this is no different to the position in many other countries, including the Member States of the European Union and of the OECD. In the circumstances it would appear to the Group that, as proposed by the Insular Authorities, the way forward is to engage in a dialogue that is constructive in its approach, providing this is on an international level playing field basis.

## **Indirect taxation**

38. If it is thought that the present balance of taxation should be altered over time, for the reasons stated earlier in this report, the Group is of the opinion that consideration needs to be given to how this might be achieved.

## **Impôt duties**

39. In the short-term, to effect a modest adjustment to the balance between direct and indirect tax revenues, the only realistic option is to work with the present impôt duties. This can take the form of increasing the rates of duty or removing current exemptions.
40. In the past, impôt duties were increased in response to revenue requirements. More recently, the Finance and Economics Committee has moved to a policy of supporting health and environmental issues through the level of impôt duties. This has taken the form of significant increases in real terms in the tax on tobacco goods, and also in an increase in the real level of taxation on motor fuels. Against the background of a more difficult tourism market climate, as impôt duties have been increased, there has been concern expressed about the fairness of a tax structure that imposes what is considered by those affected to be a disproportionate burden on their trading area. Reference has also been made to the inflationary effect of higher indirect taxation, although this can be countered by the use of indirect taxation to remove money from current consumption and limit the demand pressures in the Island.
41. In deciding on future duty levels there will continue to be conflicting priorities in respect of -
- health/social policies versus tourism/inflation;
  - health and social policy objectives versus traders interests;
  - economic interests versus health, social and environmental interests;
  - the Island's image as a low tax destination;
  - equity across a range of goods attracting duty;
  - local residents versus visitors.
42. When reasons other than raising funds to meet expenditure are included in discussions on the appropriate level of the present impôt duties - particularly where the requirement is to set duty levels in order to reduce consumption in the interest of health and environmental policy objectives - it is essential that a proper analytical approach is undertaken. Statistical research and monitoring is required to inform policy decisions.
43. There has been considerable research undertaken elsewhere than in the Island on the subject of the factors influencing consumer behaviour in respect of the consumption of alcoholic drinks and tobacco products. The result of that research suggests that the cost of the items concerned is a major influence on the level of consumption.
44. However, in English-speaking countries it has been found that the relationship between price and consumption varies according to the individual items taxed. For example, the demand for beer has generally been less sensitive to price increases than the demand for wines or spirits. In essence, this means that a price increase for beer would need to be greater than an increase for wines or spirits to achieve a similar reduction in consumption, with the degree of responsiveness also being influenced by social and cultural circumstances.
45. In Jersey, price levels remain significantly lower than in the majority of countries where such research has taken place. It is therefore reasonable to assume that if duties are increased slightly, then the price sensitivity will not be affected significantly in the short-term. However, if agreed policy is to progressively increase duties by a significant

amount annually, then in the medium to long-term, consumption could be reduced, resulting in health and social benefits.

46. An increase in duty rates may not affect consumption levels to the same extent if there are means of avoiding those duties through the purchase of alcoholic drink and tobacco products from duty-free shops in the United Kingdom or from the transport companies, or where differential rates of tax between Jersey and Guernsey simply cause those concerned to change their purchase arrangements rather than to reduce consumption. In those circumstances, the overall affect is to lower the revenue from duties in Jersey without obtaining the health and environmental benefits that the duty increase was intended to secure. These are matters that the Committees concerned need to address when considering duty adjustments.

### **Sharing the tax burden**

47. Compared to direct taxation, indirect taxation is a matter of choice. The point is also made that only through indirect taxation will that proportion of the population who do not contribute to income tax revenues because of the high thresholds make a contribution towards the cost of public services.
48. The Group has considered whether a case can be made for exemptions for the taxing of duty-free items where particular purchases are involved. The general view is that if there are sections of the community that would be adversely affected by a duty, they should be dealt with through means other than duty exemptions, particularly if the intention is that through the application of the duty the consumer is to be discouraged from consumption of products that are considered to be harmful to health or harmful to the environment.
49. However, recent experience would indicate that taking a benefit away from individual groups can give rise to a political reaction which is far greater than the impact of the duty on the price of the product or on the revenues of the States would seem to justify.

### **Extending the indirect tax base**

50. The Group would conclude that there are opportunities for using the present impôt duties to help achieve health and environmental policy objectives, but in terms of significantly affecting the balance of taxation between direct and indirect taxation, the objective will only be achieved if there is introduced additional means of raising revenue through indirect taxation.
51. The Group has concluded that if there is a requirement in the future to significantly change the balance of taxation to give greater security of tax revenues, attention will need to be focused on a form of sales tax either imposed on a general basis or in respect of specific items. Where specific items are involved it can be argued that the simplest route is to impose a tax at the point of importation. Where a general tax is envisaged, and where it is intended that services as well as goods should be covered, and where the tax is applied in a form where the revenue is greater if the retail rather than wholesale price is the basis upon which the tax is levied, a general sales tax applied at the point of final sale in the Island would be more justified.
52. The Group consider that if it is felt necessary to extend indirect taxation in the future, the first option to consider would be the introduction of an import tax on motor vehicles levied at higher rates on a sliding scale according to engine capacity. As emphasised earlier in this report, however, it is important that any such proposal should be the subject of full and effective consultation with all those who might be affected by it.
53. The advantages of such a tax against other forms of indirect taxation are that -
- it is supportive of the sustainability strategy by encouraging the use of smaller, lower fuel consumption vehicles;
  - it is supportive of a transport policy designed to encourage the greater use of public transport;
  - it would be relatively easy to collect at the point of importation;
  - it would have a comparative advantage over other forms of indirect taxation by limiting its adverse impact on those with relatively low incomes;
  - it would have less adverse impact on the competitiveness of the tourism industry than would a general sales tax;

- it would be more a tax of choice in that it would only fall on those who purchase a vehicle;
- it would be capable of raising significant income with relatively low administration costs.

### **Duty-free petrol for marine use**

54. The Group was asked by the Finance and Economics Committee to comment on the matter of duty-free petrol for marine use. In doing so, the Group addressed the issue from the standpoint of the criteria set out in paragraph 5 of this report. The issue had been brought to the fore because of the pressure for duty-free petrol from jet-ski operators.
55. The Group is opposed to making duty-free petrol more generally available for marine use, not least because of the control of use difficulties that would ensue. The Group would also question whether the States' environmental policy objectives are served by either the present policy of providing duty-free petrol for marine use, or by the required extension of that facility to jet-ski operators. The States have accepted the policy of increasing the duty on petrol generally by an amount above the rate of inflation to discourage petrol consumption in support of environmental policy objectives, and the Group considers it must be open to question whether the consumption of petrol by marine users should not be similarly discouraged through the imposition of duty.
56. The Group recognises, however, that while at present there is a lack of equity in some marine users being able to obtain duty-free petrol and others not, the removal of duty-free petrol would create inequity between the users of petrol and the users of diesel for marine use unless the latter also ceased to be duty-free.
57. From the response of boat owners to the proposal by the Finance and Economics Committee to introduce duty on petrol sales for marine use, the Group has drawn a number of messages of relevance to consideration of fiscal measures generally. That is, there is a need -
- for full prior consultation to be entered into with all interested parties on any tax proposal;
  - for individual tax proposals to be considered in the context of an overall fiscal policy and not in isolation;
  - to address the taxation of fuels generally as part of an overall energy policy, which in turn should form part of the environmental policy of the States;
  - to recognise that the strength of the reaction to a tax proposal will not necessarily be in proportion to the extent of the tax burden incurred;
  - to recognise that no tax proposal can be expected to be welcomed by those required to bear the burden.

## **Sewage disposal charge**

58. The Group was asked for a view on the possible introduction by the Public Services Committee of a sewage disposal charge. The Group considered the proposal in the context of the general criteria set out in paragraph 5 of this report and concluded that -

- while it could be argued that what was proposed was in accordance with the user pays principle, the Group is of the view that this principle applies more appropriately to those situations where, through a charge for a service, users can be discouraged from placing additional demands on the service provider. Thereby the Island's limited resources would be used more effectively. A sewage charge would not satisfy this condition and would be concerned more with collecting revenue than seeking to influence the demand for the service;
- if the purpose behind the charge is to raise revenue there are simpler ways of doing this. By comparison with other forms of taxation there would be a relatively high administration cost incurred in collecting a sewage charge;
- the group is not in favour of the funds raised from the sewage charge being "ring fenced" and set aside to meet the ongoing total costs of the sewage programme. It is felt that this would have the disadvantage that expenditure on sewer extensions would be removed from the States' capital programme prioritisation exercise and high cost/low benefit schemes could well be implemented simply because the money was available rather than that they were justified;
- applying a sewage charge on the basis of the rateable values of the properties served, as is proposed by the Public Services Committee, will present problems because of the variation in rateable values between individual parishes;
- the imposition of a service charge would be inflationary - although it is recognised that this would be the case with any form of indirect taxation;
- there would be hardship for those on relatively low incomes, and some arrangement would need to be found for relieving that hardship, recognising that this would add further to the administration costs.

## **Green taxation**

59. The introduction of 'Green Taxes' as a means of more fully embracing the environmental agenda is now seen as a natural consequence of adopting a sustainable way of life. The arguments are well set out in the sustainability strategy consultation document produced by Dr. Romeril. They are also referred to in a paper on "Environmental Taxation, Equity and Competitiveness" produced by the Programme Director of the Forum for the Future, Dr. Paul Elkins, which is attached as Appendix 5.

60. The pressure to change the structure of taxation and integrate economic instruments into environmental policy has arisen because, in many respects, present systems encourage the inefficient use of resources and fail to discourage environmentally damaging activities.

61. Many of the principles which apply to the subject of 'Green Taxation' apply to discussion on the future of indirect taxation to which the previous section has referred. However, there are other key principles which need to be taken into account -

- the need to incorporate the 'polluter pays' principle;
- the introduction of taxes to discourage particular activities;
- the use of incentives/reduced taxation to encourage particular activities.

62. There is a whole range of fiscal measures that can be used to support environmental policy objectives embracing direct taxes, indirect taxes, public sector charges, specific rates charges, incentives and grants. It is also often considered necessary - and this is very much the view of the European Union - that the introduction of environmental taxes should be fiscally neutral and should be concerned to shift the balance of taxation rather than to add to the total burden. There is a concern that "green taxes" will be regressive in their impact so that environmental improvements are achieved at the expense of those with relatively low incomes.

63. The following provides an indication of potential options. These options have not been developed in detail and they are presented as a basis for further discussion, consultation and research.

#### An energy tax

64. Sustainability calls for action to reduce the overall demands for energy and also to replace environmental and socially damaging types of energy supply with benign ones. Internationally, and especially within the European Union, there has been considerable debate on the matter of a carbon/energy tax. A difficulty in introducing such a tax on all fuels entering the Island is how to avoid raising costs for those less able to pay, such as the elderly. The general view is that at present there are too many complexities to see this tax as one to which a high priority should be accorded.

#### Motor fuel tax

65. There are two aspects to consider. One is to discourage the use of the motor vehicle, and the other is to encourage environmentally less damaging vehicles to be used.

66. There are a number of ways in which these objectives can be achieved. They can be achieved through a tax on the motor vehicles themselves as has been suggested in the previous section on indirect taxation or they can be addressed through a tax on fuel consumption. These are issues that should be addressed as part of the overall process of developing a sustainable strategy for the Island.

#### Other options

67. Other options which can be considered to make a contribution to the environment, but without any significant contribution to tax revenues are -

- a land tax to discourage development in the countryside;
- a landfill tax to act as a deterrent to dumping on the reclamation site;
- a tax on the use of fertilisers and pesticides;
- waste disposal charges;
- mineral and extraction charges.

68. It should be recognised however that taxation measures are but one possible tool in achieving the policy objectives to which the above proposals might be directed. In many cases - for example, in seeking to discourage the use of environmentally unfriendly fertilisers and pesticides - it is easier to control through regulation over the use of the items concerned than to seek to discourage their use through the tax mechanism.

69. The Group endorses the principle of the introduction of economic instruments to achieve environmental goals and it endorses the basic principles that lie behind the introduction of environmental taxes. However, the Group considers that the complex issues that such taxation often gives rise to should be considered further through the mechanism of the sustainability development strategy, and through the economic model building exercise which will have an environmental dimension, before any decisions are taken.

#### Taxation and social benefits

70. The Group, in considering fiscal policy, quickly realised the important interaction of fiscal and social policies. The Group in considering this aspect of its work has also had the benefit of the report of the Benefit and Welfare Working Party's Task Group on marginal tax rates. That report identifies the problems faced by those on relatively low incomes arising from the reduction in benefits as incomes rise, and the fact that when their income increases to the point where they cross the income tax threshold, this loss of benefit is added to by the introduction of a marginal tax rate (which at the time of the report was 30 per cent but which is now 27 per cent). The executive summary of the report is included as Appendix 6 to this report.

71. **Under the present arrangements -**

- there is a lack of co-ordination between the fiscal and social benefit systems;
- there are relatively high marginal “tax” rates (a marginal “tax” rate is defined for the purposes of this report as the percentage by which a given increment in income is offset or reduced by either a tax or by a reduction of any income-related benefit);
- there are problems of income assessment for the purpose of defining the level of benefit entitlement because the income information obtained from the Income Tax records will be for the previous year, and this may not reflect current circumstances and current needs.

72. Consideration needs to be given to how best to achieve the targeting of social benefits and the tax regime to ensure that those with relatively low incomes, in greatest need, receive the greatest benefit. Options include -

- independent current income assessment by the agencies responsible for the payment of social benefits, although this would have significant resource implications;
- a change to current year income assessment by the Income Tax authority (e.g. in part probably through the introduction of PAYE, although this would have significant resource implications);
- the co-ordinated use of fiscal policies to support the Employment and Social Security Committee in social security reforms and employment strategy “to help create a society that is inclusive and fair but competitive in the global market”, with the main emphasis on “self sufficiency” primarily through well-paid work backed with a compulsory insurance system to ensure everyone has a basic coverage for interruptions to work and for retirement;
- the need to reform and improve upon the “safety nets” by obtaining agreement on the definition of poverty, on the introduction of a common “means” test for use by all benefit agencies (Parish and States) and on the provision of a claims system with access at any one point of choice;
- the need for steps to be taken to improve customer service, streamline administration, meet immediate need for those in work as well as out of work, bring transparency to the system, “join up” policies through the benefit and taxation systems to avoid disincentive poverty traps;
- the targeting of social benefits through the identification of the areas of greatest need (for example - housing costs, cost of medical care) and the assessment of meeting that need. The Group has recognised the requirement for areas of social expenditure to be prioritised and costed, consideration given to the required level of benefits and their allocation, and for attention to be focused on how the additional costs are to be funded and the various schemes resourced administratively;
- the use of taxation to support specific social policies (e.g. the taxing of tobacco goods and of alcohol in support of health policy objectives). The Group is of the view that while indirect taxation should be used to support the social policies, they should not lead to the hypothecation of revenues. The revenues obtained from all indirect taxation should be included in the general revenues of the States and allocated according to a proper prioritisation process.

73. For the future there is therefore a need -

- for greater focus in determining what needs exist and how best they should be met;
- for more effective co-ordination between fiscal and social policies (this will be particularly required if greater emphasis is placed on indirect taxation);
- for a current year income assessment process;
- to ensure that, if action is taken to reduce the burden of income tax on those with incomes immediately above the present thresholds (e.g. by reducing the marginal rate of tax from 27 per cent to the standard rate of tax of 20 per cent as proposed by the Finance and Economics Committee), action is taken at the same time to adjust the relevant social benefits to ensure that those with incomes below the tax thresholds also benefit. Otherwise the relative position of those with the lowest incomes after “tax” will be adversely affected;



- consideration needs to be given to ways of relieving hardship by reducing the marginal rate of tax and avoiding the poverty trap.

74. Some have suggested that what is needed is a flat rate benefit across the board. A flat rate benefit scheme (sometimes referred to as Basic Income or Universal Benefit, sometimes also referred to as a Negative Income Tax) whereby an income is paid to every man, woman and child as a right would not, as some suggest, avoid all the difficulties arising from the present multiplicity of benefits. Those with special requirements (for example those who have a need to visit the doctor frequently) can only be provided for through a flexible system of benefit provision reflecting their particular needs. Income-related benefits have the disadvantage of bringing in their train a marginal rate of “tax” as benefit is reduced with an increase in income, but have the advantage that for a given outlay of public funds a much higher level of assistance can be given to those with the lowest incomes than would be possible with a flat rate benefit scheme. The marginal rate of “tax” or loss of benefit can be reduced by raising the maximum income below which the benefit is lost altogether, but only at a higher cost to the taxpayer if the level of income support at the lowest income level remains unchanged.

75. The concept of a flat rate benefit paid to all would also be more difficult to apply in Jersey - particularly in terms of its affordability - because of -

- the high taxation thresholds before liability to income tax arises;
- the maximum rate of tax on incomes of 20 per cent, which limits the ability to “claw back” the benefit at higher income levels;
- the absence of a comprehensive range of indirect taxes that could be used to generate additional tax revenues to fund a more expensive benefit scheme.

### **Other matters addressed by the group**

#### Child care payments

76. The Group was asked by the Finance and Economics Committee to consider the provision of tax relief for child care payments, and in its Interim Report it agreed to support tax relief for child care payments, providing that a parallel scheme for non-taxpayers was adopted at the same time. In support of these measures, which have now been adopted by the States for those up to the age of five years, the Group drew attention to the following principles -

- the intention of tax relief should be to subsidise child care costs so as to act as a modest incentive to the individual to enter, or stay in, work;
- tax relief should only subsidise child care of known quality;
- tax relief should be limited to those in the middle income, high marginal rate band, identified by the report of the Working Party on Child Care as the group most in need of help with child care costs;
- a means-tested child care allowance based on the principle of making work pay should be available for low income parents below the tax threshold who would not benefit from tax relief on child care.

77. The Group has subsequently been asked by the Finance and Economics Committee to consider the possible extension of child care payments to parents of children aged five to 12 years. In the view of the Group, the principles advanced in connection with child care payments for children up to the age of five years have equal application for children aged five to 12 years. Whether such a scheme is adopted, however, must depend on whether the financial and manpower resources required can be made available, and this should be considered in terms not only of what can be afforded, but also in terms of the relative priority of such a scheme vis-a-vis other areas of social policy.

#### Stamp duty on property transactions conducted by share transfer

The Group was requested by Deputy Le Main to consider the position of those faced with the payment of document duty where property transactions are conducted by share transfer. The Group is agreed that there should be equity in any tax burden and that the present arrangements are inequitable, in that two individuals in a similar situation could be faced with a different tax burden according to whether a property was purchased individually or through the acquisition of shares in a property-owning company. In Guernsey a calculation of the value of share transfer

transactions was undertaken through a request for information from local estate agents. The Group considers that in order for the Finance and Economics Committee to take a view on this matter it would be necessary to follow the Guernsey course of action and first obtain some facts about the value of share transfer transactions.

79. Pension schemes: income drawdown

The Group was requested, by representatives of the Jersey Life and Pensions Society, to consider the position of people faced with having to buy an annuity when they retire from an employment which provides them with a money-purchase pension or when their personal pension plans mature.

At that time the whole of the pension fund (less 25 per cent which may be taken as a tax-free lump sum) has to be used to buy an annuity. However, annuity rates have been falling for some time now and are presently at a thirty-year low. A United Kingdom resident in that position has the option to defer the purchase of an annuity until he reaches the age of 75 and, in the interim, take income of between 35 per cent and 100 per cent of the annuity that he could have brought.

The advantages perceived in such deferred arrangements are that as a person grows older, his annuity rates increase, and time may also bring increases in annuity rates generally.

The disadvantages are: that annuity rates generally may fall; that bad investment advice may wipe-out some of the fund's value; and, the costs involved (up to seven per cent annual commission is charged by intermediaries for managing this type of fund as opposed to a typical one per cent one-off charged on conventional annuities).

The Group considered that no recommendations should be made in this regard until the United Kingdom Inland Revenue had produced its first triennial report on the way income drawdown had worked there, nor until the Employment and Social Security Department has completed its own review of pensions and secondary pensions and the means by which people might be encouraged to make provision for their old age.

## TAX RELIEF ON MORTGAGE AND OTHER INTEREST

### Method of restricting tax relief on mortgage and other interest

If the decision is taken to restrict tax relief on mortgage and other interest there are a number of ways of proceeding -

- (a) allow relief at a reduced rate of tax i.e. less than 20 per cent;
- (b) cap the total tax relief at a certain figure;
- (c) allow a full relief up to a certain figure and disallow a proportion of the balance;
- (d) limit the relief to a percentage of the claimant's income;
- (e) disallow a percentage of the total interest paid.

The effect of (a) would be limited in Jersey by the absence of a progressive tax system. With (b) and (c) there would be discrimination between a single person and a married couple. For example, if each single person had a cap, an unmarried couple would be better off than a married couple. Caps would exclude relatively well-off individuals who have reduced their mortgage over the years.

The idea under (d) that the higher the income the more the relief is unlikely to be seen as equitable.

The preferred course of action therefore is that tax relief should be restricted by disallowing a proportion of the total interest paid as in (e).

### Softening the blow

It is assumed that the purpose of restricting tax relief for interest payments is to create more equity and not to raise more tax. If this is a reasonable assumption, the Finance and Economics Committee would be in a position, given continued favourable budgetary conditions, to recycle the extra tax raised as a result of restricting tax relief on interest payments back into tax allowances that would benefit those at the lower levels of taxable income who would be most affected by the restriction on tax relief for interest. It would be possible to ensure that tax payers in the low to medium income ranges remained unaffected by the restriction of tax relief for interest by raising the tax threshold and/or by reducing the marginal rate (currently 27 per cent). The Finance and Economics Committee indicated in its budget report for 1998 that it was planning to help finance further reductions in the marginal rate by restricting interest rate relief. An example is given in Table A attached to this Appendix.

### Existing mortgages/loans to be caught

On grounds of equity there should be no distinction between existing borrowings and new borrowings. The counter-argument is that individuals have taken on borrowing commitments believing that tax relief will continue. This would be less of a problem if, as referred to above, the majority would be compensated for the loss of tax relief for interest payments by adjustments to tax thresholds or the marginal rate of tax.

Distinguishing between existing and new borrowings would also lead to the injection of further demand into the housing market as people scramble to meet the deadline.

It would be inequitable that an individual with a large existing mortgage should continue to get full tax relief while a young couple new to the housing market faced capping.

### Interest as a business expense

If interest is allowed as a business expense this would introduce complications into the administration of tax relief for interest. Defining what is allowable, interpreting the legislation and preventing circumvention of the legislation's intention would be troublesome matters. There might also be demands for special treatment for employees who have to incur expenditure on expensive capital items essential to their employment.

The counter-argument is that abolishing tax relief for interest incurred for business purposes would hinder commercial

activity and possibly discourage new entrepreneurs from setting up in business.

### **Other issues**

Individuals with private mortgages are entitled to deduct their tax relief at the time the interest is paid. The problem to be addressed, therefore, is how to restrict tax relief. One answer would be to require all such interest to be paid in full and to give tax relief in the annual notice of assessment. However, this would cause cash flow problems for the payer. An alternative would be for the payer to continue to pay net (after tax relief deducted) and to claw back the excess relief in the notice of assessment.

Those individuals paying interest at a rate subsidised by their employer also present a problem. The only valid solution would be to assess the subsidy as a benefit in kind and then to disallow a proportion of the total interest (including that taxed as a benefit). This solution depends on the introduction of legislation to tax benefits in kind to which Appendix 4 refers.

### **Comparison with other jurisdictions**

Although the United Kingdom has abolished mortgage interest relief, it continues to give a deduction for interest paid for business purposes. A number of countries give full relief across the board for interest payment including Guernsey, the Isle of Man and the United States of America.

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**TABLE A**

The taxpayer is a married man with two children aged three and seven years. His wife also works, so they employ a registered childminder to look after the younger child at a cost of £5,000 a year. They have a mortgage of £150,000 on which they pay £8,500 interest and a personal loan of £10,000 on which the interest is £1,500.

The decision of the Finance and Economics Committee is to restrict interest tax relief by ten per cent but at the same time to reduce the marginal rate from 27 per cent to 25 per cent. The effect on this couple is to reduce their tax bill by £141, as follows -

		<b>No restriction</b>		<b>Ten per cent restriction</b>
		£		£
Husband's salary		40,000		40,000
Wife's salary		20,000		20,000
		<hr/>		<hr/>
		60,000		60,000
Less interest paid	(100 per cent)	10,000	(90 per cent)	9,000
		<hr/>		<hr/>
		50,000		51,000
Exemptions -				
Married man	16,750			
Wife	4,100			
Children	4,600			
Child care	5,000			
		<hr/>		<hr/>
		30,450		30,450
		<hr/>		<hr/>
		19,550		20,550
Tax @ 27 per cent		5,278	@ 25 per cent	5,137

## A CHANGE TO THE WAY WAGES AND SALARIES ARE ASSESSED FOR TAX

### 1. Introduction

1.1 Wages and salaries are charged to tax on the “full amount of the emoluments ..... arising in the year of assessment” (Article 65 of the Income Tax Law). This is called “The arising basis”.

1.2 After a succession of decided tax cases it is now well settled that income of this sort arises when it is earned. The date it is paid is immaterial. Thus, if an employee earns a bonus in return for his efforts in year 1 which is not paid to him until year 2 it is, nevertheless, assessable to tax for year 1.

1.3 There is a need to -

- simplify this system thus making it more understandable to all concerned;
- reduce administrative effort in applying the Law.

### 2. The problems

2.1 The problems surrounding this basis of assessment, and particularly its administration, have been evolving over the past two or three decades as trends in the means by which employees are rewarded have evolved. Not only is time wasted explaining the fairly esoteric principles involved, but taxpayers also have real difficulties in meeting their statutory obligations and tax staff have trouble meeting their targets.

2.2 Income tax returns are issued to employers and employees early in the year following the year of assessment ended on the preceding 31st December. The employer has thirty days in which to report the income arising to each of his employees for the year just ended: the employee has the same time in which to make a declaration of the income arising to him from the employment.

2.3 The days when an employee’s earnings consisted simply of his weekly wage or monthly salary are long gone. Nowadays a typical remuneration package will include such things as: profit-related pay; profit shares; bonuses of many descriptions, and so on.

2.4 It is often the case, particularly where these emoluments are linked to the employer’s profits, that the amounts payable cannot be quantified until several months after the end of the year of assessment. Neither the employer nor the employee can make a proper return of the assessable income within the time allowed. Simply extending the time allowed to make a return would achieve nothing because, by February or March at the latest, income tax staff must start making income tax assessments for the previous year in order that they are all ready in time for issue in the following September.

2.5 Further problems arise when pay deals are settled late and back-pay becomes due. Assessments already made and paid have to be done again and a further bill paid. Income related benefits paid by other States departments may have to be clawed back.

2.6 A summary of all the problems that can and do arise is set out in Annex A.

### 3. A possible solution: the “Receipts Basis”

3.1 One possible solution is to adopt the receipts basis that has applied in the United Kingdom since 1989. Under this basis of assessment, the amount chargeable to tax is the amount received by the employee in the year of assessment - irrespective of the year for which it was earned. Annex B sets out the many advantages to be gained from this, and it also mentions the disadvantages and the problems to be overcome.

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**PROBLEMS ASSOCIATED WITH THE ARISING BASIS**

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**Problems**

1. Because such things as bonuses, profit share, etc. are not quantified until after the end of the year for which they are earned -
  - employers' and employees' returns are submitted late or incomplete;
  - assessments made on the basis of the late or incomplete returns have to be done again when the return or supplementary return arrives;
  - if the final figures are not available until after the assessments are issued, the appeal process has to be invoked with all the attendant problems;
  - payment of earnings-related benefits are delayed, or are wrong and have to be re-certified and re-calculated;
  - direct debit arrangements have to be amended;
  - time is spent in explaining the tax principles involved.
  - other States departments spend time in answering questions about earnings related benefits.
2. It is not uncommon for wage negotiations to be protracted. Final agreement is often reached only in a subsequent year.
  - Most of the problems mentioned under 1 above are encountered plus the employee will be faced with an unwelcome additional tax bill.



**ADVANTAGES/DISADVANTAGES PROBLEMS TO BE OVERCOME IN ADOPTING THE RECEIPTS BASIS**

**Advantages**

- The tax bill is final and no longer subject to amendment in the light of subsequent events.
- It is easily understood: tax is levied for the year on income received during the year. The taxpayer and his employer are no longer confused by the difficult concept of when income is earned.
- All the administrative problems listed in Annex A are solved.

**Disadvantages**

- Fairly extensive legislation will be required.
- In some circumstances a person's tax bill would be greater than under the arising basis. For example, arrears of pay received after protracted pay negotiations assessed in the year of receipt might generate a liability to tax which would have been less had the arising basis applied - due to the level of income and personal circumstances in the earlier year(s). On the other hand, again depending on income and personal circumstances, it could be less.
- Where arrears of pay are involved, income-related benefits paid by other States departments may be more severely hit than if they were claimed by reference to the arising basis. But again they may not be.

## Problems

- Transitional provisions will be needed to cover situations where income is either assessable twice or not at all -
  - \* income earned but not received before the year of change;
  - \* income received but not earned before the year of change;
  - \* income historically assessed on the non-statutory “accounts basis” (which operates to charge company directors to tax by reference to the remuneration shown in the company accounts ending in the year of assessment).

## CONTROLLING DIRECTORS TAKING ADVANTAGE OF THE TAX SYSTEM

### 1. Introduction

1.1 A company is an artificial legal entity. It is quite separate from those people who own it (its shareholders) and it is taxed as a "person" in its own right.

1.2 Companies fall into two main categories -

- those which carry on a trade;
- those which own investments,

and there are sound commercial reasons why a person would choose to trade, or own investments, through the medium of a company rather than personally.

1.3 A company is controlled by its directors and influenced by its shareholders. Not infrequently, these are the same people and members of the same family. The most common example is where a husband and wife own all the shares and are the only directors. Of the 9700 active companies resident in Jersey, 9000 are estimated to be under common shareholder/director control.

### 2. The problem

2.1 Because the shareholder/director is in total control of the remuneration he is paid by his company, he is able to fix the amount and the nature of his income. This enables him to maximise his income at the expense of others.

2.2 Tax revenue suffers in the following ways -

- controlling directors are entitled to the same tax thresholds as anyone else, so they can fix their salary at an amount that keeps them at or below that threshold;
- a married man will take advantage of the increased thresholds for working wives by appointing his wife a director - fees of up to £4,100 will be paid to her without incurring any tax liability and perhaps in return for no real work by her.

All of these payments are, of course, deducted when charging tax on his company.

2.3 The Island's revenue suffers in other ways where income-related benefits are involved -

- if making full use of the tax threshold has an adverse implication on the level of social security contributions he must pay, the director/shareholder will take only the social security minimum as salary and the balance of his threshold as a taxed dividend (the tax on the dividend has to be refunded to him);
- where family allowances are claimed, it can benefit the director/shareholder to give up the tax deduction for his company and vote himself the minimum salary to earn the maximum family allowance payment;
- student grants; subsidised States' housing and agricultural loans; and rent rebates in the public and private sectors are all means-tested. It is believed that Education and Housing will take an interest in the company accounts where it is known that the applicant can manipulate his income, but it is not known how effective or complete their controls might be.

### 3. Other matters

3.1 Unearned income from investments can be turned into earned income by the simple means of transferring the ownership of the investments to a company. The shareholders appoint themselves directors and the income from the bank deposits, rents, etc. flows to them as salary. This is earned income and qualifies for reliefs which would not have been available had the assets remained in their own names.

3.2 The director/shareholder is able to borrow money from his company (usually at no interest) and these borrowings

could well be funded by interest-bearing loans to the company, the interest paid by the company being tax-deductible. While there are no tax implications at the moment - because tax relief is available for all types of interest - this could become an avoidance device if restrictions on tax relief are introduced.

#### 4. **Other jurisdictions**

4.1 Jersey's two-tier system of taxation is unique in the four jurisdictions. Because of the absence of high thresholds in Guernsey, the Isle of Man and the United Kingdom, they do not suffer from the income manipulation problem so far as it affects tax revenues. Nor does it impact on their child benefit payments, because they all pay a universal child benefit irrespective of need.

4.2 The United Kingdom has a whole raft of highly developed legislation to thwart any advantages which director/shareholders may otherwise gain ("close company" legislation).

#### 5. **Disadvantages/advantages of legislation**

5.1 Some disadvantages in legislating are -

- the size of the task: the changes needed would be substantial unless it was possible to construct effective over-arching legislation;
- policing a new law would require significant manpower.

5.2 Advantages are -

- greater equity in the tax and benefit systems;
- removal of practices which, while legal under the Income Tax Law, are perceived as abuses of the system;  
and
- unquantifiable increase in Island tax revenues/reduction in benefits paid out.

## THE TAXATION OF BENEFITS IN KIND

### 1. Introduction

1.1 First a definition: “Benefits in kind” are goods or services provided by an employer to an employee at no cost to the employee.

(Employee in this sense, and in all that follows, includes a director of a company.)

1.2 The Jersey Income Tax Law is based on ancient legislation framed in very different times, and it has no power to tax the value of benefits in kind. All that can be taxed under the legislation, as it stands at the moment, are payments made in cash or in a form that can be converted into cash.

1.3 On the other hand, the cost of providing the benefits in kind is fully deductible for income tax purposes so far as the person providing them is concerned.

1.4 The purpose of this Appendix is to -

- examine the position in Jersey;
- compare systems in other jurisdictions;
- consider whether any change to the Jersey system should be recommended.

### 2. The Jersey position

2.1 The position in Jersey needs to be examined under two separate headings -

- unconnected employees (those where there is no relationship other than an employer/employee relationship);
- connected employees (mainly company directors who also are their own employer).

#### 2.1 Unconnected employees

2.2.1 The majority of the working population in Jersey work on an arms-length basis for their employer. That is to say, that there is no connection between them other than that of an employer and employee.

2.2.2 When Jersey’s tax legislation was enacted, it was unusual for such an employee’s remuneration to consist of anything other than his weekly wage or his monthly salary. This basic method of payment still exists in some jobs - notably in the manual labour force and in the non-professional service industries. But in other sectors, particularly the professional services and the financial sectors, the position is very different today than it was back in 1928 when the Tax Law first came into force.

2.2.3 In the professional service and finance sectors, companies are in fierce competition for staff. They compete by offering non-cash rewards such as -

- cheap loans;
- rent-free accommodation;
- company cars;
- free health insurance,

to match or exceed similar benefits offered by their competitors in order to attract and retain the specialist staff they need. This competition increases because it is, by its nature, self-perpetuating.

2.2.4 These non-cash rewards are not chargeable to tax in the employees’ hands but are, nevertheless, fully tax-deductible so far as the person paying them is concerned. The following (simplified) examples illustrate the effects.

<b>Example 1</b>	<b>Employee A</b>	<b>Employee B</b>
Salary	20,000	30,000
Rent paid by employer	10,000	-
<b>Total package</b>	<u>30,000</u>	<u>30,000</u>
<b>Incomings</b>	20,000	30,000
<b>Outgoings</b>		
Tax @ 20 per cent	4,000	6,000
Rent	NIL	10,000
<b>Total</b>	<u>4,000</u>	<u>16,000</u>
<b>Balance</b>	<u><b>16,000</b></u>	<u><b>14,000</b></u>

The result, so far as employee A is concerned, is extremely tax efficient. Identical total packages, identical rental payments, but because the rent paid by his employer cannot be taxed, his “take home pay” is £2000 more than that of employee B.

<b>Example 2</b>	<b>A’s employer</b>	<b>B’s employer</b>
Profits before A’s and B’s packages	130,000	130,000
Cost of packages	<u>30,000</u>	<u>30,000</u>
Net profits	<u>100,000</u>	<u>100,000</u>
Net profits	100,000	100,000
Tax @ 20 per cent	20,000	20,000

Both employers pay the same tax. The method by which they structure their employers’ remuneration is tax neutral so far as they are concerned: there is no (tax) reason why they should pay cash wages rather than provide benefits.

2.2.5 The obvious question is one of equity -

*Why should total remuneration of equal value give rise to different levels of taxation?*

### 2.3 **Connected employees**

2.3.1 Employees who are connected with their employer are, generally speaking, people who are directors of small and medium-sized companies.

2.3.2 A company is controlled by its directors and influenced by its shareholders. Quite often, the directors and the shareholders are the same people and members of the same family. The most common example is that of a local company involved in either carrying on a trade or in holding investments where a husband and wife own all the shares and are the only directors. Of the 10,000 or so active companies resident in Jersey, 9,000 are estimated to be under family shareholder/director control.

2.3.3 So far as such companies are concerned, it is not commercial considerations which lead them to provide their employees - themselves, the director/shareholders - with non-cash benefits: they are not in competition with others for themselves. Rather, pure tax planning drives this decision.

2.3.4 Clearly, the scope the company owner has for providing the company director (himself) with non-taxable benefits is boundless and open to abuse. Two common examples are -

- his investment-owning company will provide the director/shareholder with a car in order to collect rents from the company's tenants, (in reality the director/shareholder uses the car mainly for his own domestic purposes);
- his hotel-owning company will provide him and his family with a suite of rooms and all their meals.

Both these examples have been seen in practice. The director/shareholder pays no tax on these benefits, but the company he owns is able to claim full tax relief for all the costs involved in providing these valuable perks.

2.3.5 Again, the obvious question here is one of equity, this time not only between total remuneration of equal value giving rise to different levels of tax, but also between the man who has incorporated a company to own his investments or to carry on his trade, and those who keep their investments and trades in their own names. More importantly, perhaps, it takes on a different dimension when the system allows the scale and scope of the inequity to be wholly within that one person's power.

### 3. **Other jurisdictions**

3.1 Most of the world's tax jurisdictions which impose personal taxes are believed to have some system in place to prevent the inequities described in the preceding paragraphs. A study has been made of the measures in force in the Isle of Man, Guernsey, the United Kingdom and New Zealand. Brief details follow.

#### 3.2 **The Isle of Man**

3.2.1 Legislation to tax benefits in kind was introduced in the Isle of Man in 1988. Its thrust is to charge tax on the employee to the extent of the cost to the employer of providing the benefit to the employee. There are some deeming provisions on such things as cars and fuel. Some *de minimis* amounts apply.

3.2.2 It is administered by requiring every employer to complete, in respect of every employee in receipt of benefits, an annual return form. This completed form is submitted to the Assessor of Income Tax, examined by his staff and the resulting charge to income tax raised on the employee.

#### 3.3 **Guernsey**

3.3.1 Guernsey legislation to tax benefits is of recent origin. It was first introduced in respect of benefits arising after 1st January 1996. Again, its thrust is to charge tax on the employee to the extent of the cost to the employer of providing the benefits to him. There are some deeming provisions on capital items, cars and so on, and several exemptions from the charge. A *de minimis* aggregate of £400 applies.

3.3.2 Again, every employer is required to complete, in respect of every employee in receipt of benefits, an annual return form. The completed form is returned to the Administrator of Income Tax in Guernsey, followed by examination and the raising of the charge.

#### 3.4 **The United Kingdom**



3.4.1 The United Kingdom legislation was first introduced in 1948, and was aimed at director/shareholders and higher paid employees. (The term higher paid employees was removed from the legislation in 1989, as it was felt to be inappropriate in view of the definition of higher pay having been fixed at £8,500 for many years, and it is the Inland Revenue's intention not to increase this amount but to let it wither on the vine.)

3.4.2 The United Kingdom legislation is contained in Chapter 2 of the Taxes Act 1988 and runs to twenty-nine pages (although substantial amounts of it contain lengthy deeming provisions regarding, in particular, company cars) having evolved to that extent by reason of the last 50 years' experience closing loopholes. For example, the word director without definition was found to be futile. A director is now defined "... to include a person in accordance with whose instructions the directors are accustomed to act and in the case of a company managed by its members, a member. However, a person such as a solicitor or accountant is not deemed to be a director simply because he gives advice in his professional capacity."

The legislation goes on to deal with the problem of directors attempting to avoid the charge by having the benefits provided by an interposed third party, and it deals with the problem of those seeking to avoid tax by arranging for benefits to flow not to them but to their spouses or children instead.

3.4.3 On the other hand, there are many exceptions from the charge (either by statute or by extra-statutory concession) designed to make the legislation less onerous or in keeping with tradition, or to right perceived inequities or to deal with social trends. For example -

- free meals in a work's canteen are not chargeable;
- but meal vouchers (unless they are worth less than 15p per (working) day and are non-transferable) are taxable;
- accommodation provided by reason of strikes is not chargeable;
- extra travel costs for the severely disabled are not charged.

The list runs on to three sides of A4, in the explanatory booklet, and they are all surrounded by rules and regulations to do with time, percentages and periods and so on.

3.4.4 There are many deeming provisions in the United Kingdom legislation. They are mainly concerned with the value of capital assets provided to an employee, particularly to company cars, fuel, mobile phones and accommodation; and many subjective judgements must go in to deciding, for example, whether a car-parking space is "near" an employee's place of work, whether meals are provided on a "reasonable" scale or whether training is "work-related"... and so on and so forth.

3.4.5 The view held in the United Kingdom is that, given a clean sheet of paper, there would be no concessions or subjective judgements in the system, as these lead to interminable arguments that can end up in litigation.

3.4.6 The procedures to be followed by the employer and employee in the United Kingdom are, broadly speaking, as follows -

- at the end of each tax year every employer is required to give particulars to the Inland Revenue of the benefits and facilities provided for each of his employees (a form for each employee is provided by the Inland Revenue for this purpose);
- a similar return of payments from any person providing benefits to the employee of another person is also required;
- those people mentioned above are required to provide the employees concerned with details of the information given to the Inland Revenue;
- employees are required to give that same information on their own tax returns.

3.4.7 The resulting charge to income tax is either collected by direct assessment on the employee or by means of an adjustment to their tax code number for the current or following year(s).

3.4.8 There is a large, but unknown, compliance cost so far as employers are concerned. The Inland Revenue estimates that 2,000 of its own staff are employed full-time in examining the 4.5 million forms it issues each year.

### 3.5 **New Zealand**

3.5.1 The New Zealand legislation provides that all fringe benefits provided by employers to employees are subject to fringe benefit tax (FBT) in the hands of the employer and employees are not subject to tax on the benefit.

3.5.2 FBT is imposed on taxable fringe benefits provided or granted in relation to past, present or future employment by an employer to an employee. The tax is payable by the employer. "Employment" means the performance of an activity or activities by any person which gives rise to entitlement to a source deduction payment. FBT is also imposed on taxable benefits provided to shareholder employees.

3.5.3 Fringe benefits subject to FBT are -

- the private use or enjoyment, or availability for private use or enjoyment of a motor vehicle;
- subsidised transport if the employer carries on the business of transportation;
- loans from an employer or loans provided under an arrangement made by an employer;
- some contributions to superannuation schemes and payments of insurance premium;
- retirement allowances paid before a certain date;
- benefits of any other kind whatever.

FBT is also imposed where the fringe benefit is used or is available for use by an associated person of the employee.

3.5.4 There are a number of exemptions, including -

- allowances for the value of board and lodging provided to employees which are included in the assessable income of the employee;
- any benefit in the form of monetary remuneration or which is otherwise assessable to income tax, or which is income of the employee that is exempt from income tax;
- transport in a vehicle not designed principally for the carriage of passengers;
- certain benefits provided on an employer's premises;
- entertainment except where the employee can consume or enjoy the benefit at his discretion and other than in the course of his employment duties;
- distinctive work clothing provided by an employer to an employee.

## 4. **Should Jersey follow current trends?**

4.1 There are arguments both for and against. The equity grounds have been mentioned in the opening paragraphs.

- Can it be right that two remuneration packages of equal value result in differing tax charges?
- Should those people who are totally in control of their employer be able to manipulate their remuneration in the manner best suited to their tax planning wishes?

4.2 On the other hand, can Jersey's traditionally simple Tax Law survive wholesale importation of all embracing tax legislation of the United Kingdom kind? If not, are the fairly simplistic examples of Guernsey and Isle of Man worth emulating? Instead of attempting to create all embracing tax law closing every known loophole, should the common targets be aimed at?

4.3 What are the political implications for doing something or for doing nothing? What have we learned from what's been done already? What are the implications on resources? The United Kingdom's experience of 2,000 full-time staff being used to examine 4.5 million return forms suggests that 17 extra full-time staff would be needed by the Jersey tax office to process about 40,000 similar forms. There would inevitably be a large increase in jobs in the private sector as well: on the other hand, what are the benefits in terms of extra tax?

## 5 **An attempt to answer some of these questions**

5.1 Equity would be well-served by treating all people equally. People who control their tax liabilities to the detriment of the public exchequer should be denied that ability. So far as possible, taxing statutes should treat all people fairly.

5.2 Jersey Tax Law needs to be kept as simple as possible but it cannot stand still: it must evolve as social trends evolve. On the other hand, the watered-down legislation adopted by the Isle of Man and Guernsey should be viewed with some caution. Targeting popular perks simply created moving target. If legislation is to be introduced then it would make sense to make sure that it is as effective as is reasonable and does not create a need to legislate year by year to close the loopholes discovered by the tax avoidance industry.

5.3 Political implications of introducing legislation would be twofold -

- **positive** from those who complain of the privileged minority who say, "I put it down to the company" (when explaining about their expensive car/holiday);
- **negative** from those who benefit from our tax legislation and from those who retail those non-taxable benefits (car dealers etc.) and negative from employers as a whole (there would be a substantial burden in the cost of compliance).

5.4 Two important lessons have been learned from the United Kingdom Inland Revenue's experience -

- attempting to maintain the social status quo (free meals in the worker's canteen) and to cater for special needs (special treatment for minorities etc.) means excessively detailed legislation;
- importing existing highly developed legislation into Jersey tax system would commit the States to a large investment in human resources.

## 6 **What is the way forward?**

6.1 There are probably three alternatives -

- do nothing;
- legislate along existing lines;
- legislate in a new radical way and take the best from the four systems examined.

## 7. **The implications of those three alternatives**

### 7.1 Do nothing

The arguments that may be advanced for doing nothing are -

- the present system appears to have few critics (only one letter has been received by the Fiscal Review Working Group complaining of the favourable regime available to director/shareholders);
- tax revenues are buoyant and there is no vital necessity to generate extra income tax at the moment;
- legislation would require large investment in such things as -
  - \* the Law Draftsman's time;
  - \* education, both internal and external;

- \* human resources by the States and by the private sector.

## 7.2 Legislate along existing lines

This may be supported on the grounds that:

- public reaction is muted at present only because those aware of the large advantages do not publicise them;
- social justice would be served and would be welcomed by those in the community who are less fortunate.

## 7.3 Legislate in a new radical way and take the best from the four systems examined

7.3.1 There may be a way to embrace all that is worthwhile in other jurisdictions' legislation while rejecting that which is counter-productive and expensive in terms of administrative effort and thus human resources.

7.3.2 Whatever system is adopted, experience elsewhere would suggest -

- a substantial, yet realistic *de minimis* level needs to be set so as to reduce the compliance burden and to increase the credibility factor. *De-minimis* levels exist elsewhere but at very modest levels. This would eliminate the need to introduce a list of concessional exemptions designed to remove the need to quantify difficult concepts and to deal with particular difficulties of minority groups;
- the value of the chargeable benefit should be in precisely the same amount as the cost of the benefit to the employer. This is a matter of fact capable of quantification and would eliminate the need to introduce many, if not all, of the arbitrary deeming provisions that exist elsewhere covering things like car scale benefits and fuel benefits.

7.3.3 The Comptroller of Income Tax has put forward the proposal that the charge to tax should be made on the employer, not the employee. Thus, for example, if an employer provides an employee with benefits which cost him, the employer, an amount of £3,000, then his tax bill increased by £3,000 at 20 per cent; the employee's tax bill stays the same. This would eliminate the need for tens of thousands of annual return forms to be completed and checked, and would thus eliminate the need for an extra 17 or so tax staff. Instead of making an annual return for each of his employees showing the value of their benefits, resulting in a charge to tax on each of those employees, the employer would, when sending in his accounts for each year, declare the amount of the expenditure included in his profit and loss account laid out in providing benefits in kind. This expenditure would be disallowed for tax purposes and added to his taxable profits. By these means the tax on those benefits would be collected.

## 8. **Some issues to be addressed**

8.1 In measuring the impact of the introduction of the taxation of benefits in kind, a view has to be taken as to whether employers would switch from providing benefits in kind to paying their employees in cash. Many employers may be expected to continue to provide benefits packages without passing on the cost to their employees, as this is part of the package to attract and keep quality employees in a competitive labour market. Other employers, on the other hand, may feel the need to instigate pay cuts or freezes to compensate for the cost to the business. In so far as benefits packages are set outside the Island, they are less likely to be substantially influenced by local taxation rules.

8.2 It is to be questioned whether the accounting records for most businesses would be able to provide the necessary information to produce a correct tax computation if the charge to tax is made on the employer. This could lead to substantial increases in the costs businesses would incur in employing taxation and accounting experts to help them produce the necessary computations.

8.3 Whichever system is considered, there are a number of difficult areas to be addressed -

- How would benefits with no directly identifiable cost be dealt with (e.g. staff living rent free in accommodation owned by the employer)?
- What is the cost of providing an asset such as a car? Is it the whole capital cost at the moment it is first provided, even if the asset does not then belong to the employee?
- How would the provision of a benefit which is used both for personal and business use be dealt with?

- How would benefits provided affect income related benefits such as rent rebates, family allowances, education grants?
- How would companies be dealt with that are not paying tax at the same rate as the employee (e.g. companies with losses, IBCs, employees who are small income exempt, employees in the marginal rate, States' employees where the employer does not in any event pay tax)?

## ENVIRONMENTAL TAXATION, EQUITY AND COMPETITIVENESS

(A paper written by Dr. Paul Elkins, Programme Director of Forum for the Future and Reader in Environmental Policy, Keele University)

## 1. Background

During the 1990s, environmental taxes (here defined as any tax or charge that is payable to the government in respect of use of an environmental resource or actual or potential damage to the environment), have been introduced across a broad range of issues by most western European countries. Air emissions, water pollution and water supply, the landfilling or incineration of solid waste, aircraft noise, traffic congestion, and a range of environmentally sensitive products, such as pesticides, fertilisers, batteries, aggregates and, of course, fossil fuels, have all been made subject to a tax in one or more European countries over the last ten years, and more and more countries are announcing their intention to follow suit. In a relatively short period of time, environmental taxes have changed from being the esoteric enthusiasm of environmental economists to one of the most regularly implemented, and hotly debated, instruments in the environmental policy maker's tool-kit.

## 2. Rationale

There are a number of reasons why environmental economists have long considered that environmental taxes have an important role to play in environmental policy, reasons which increasingly seem to be commending themselves to policy makers -

- Cost-effectiveness: Unlike either regulation or voluntary agreements, environmental taxes attain environmental improvement at minimum overall cost (the standard definition of cost effectiveness in this context), by equalising the cost of abatement among polluters (thereby ensuring that the low-cost abatement options are implemented first), or making unviable low-value uses of the resource. Claims by business lobbyists in the current debate over the proposed Climate Change Levy (CCL) that the Levy is not a cost-effective way of reducing emissions (see for example the reports in the *Financial Times* on May 28th/29th/30th) are either based on a different definition of cost effectiveness, or are unjustifiable.
- Cost internalisation: Unlike either regulation or voluntary agreements, environmental taxes ensure that users of scarce environmental resources pay for all use of that resource, just as they have to pay for other scarce resources. These payments increase the price of activities that impact negatively on the environment, thereby encouraging producers and consumers throughout the economy to reduce either the impacts or the activities which cause them.
- Continuous environmental improvement: Because environmental taxes charge for all of a particular use of the environment, they give a continuous incentive to economise on that use. Unlike either regulation or voluntary agreements, which give no incentive to go beyond statutory or agreed targets, environmental taxes encourage continuous environmental improvement at all levels of environmental impact.
- Encouraging innovation: Innovation in markets is driven by incentives. The incentive for continuous environmental improvement represented by an environmental tax can spur companies to develop less environmentally intensive products and processes. In a world that is becoming increasingly aware of the need to make development more environmentally sustainable, new products and processes of that kind represent a clear competitive advantage.
- Raising revenue: Governments require revenue in order to provide public goods and services. Most sources of revenue (e.g. taxing incomes or the returns from capital) are economically distorting (i.e. they reduce economic production). In contrast, environmental taxes are both a source of revenue and *correct* an economic distortion (arising from the previous failure to charge for a scarce environmental resource). The revenues from environmental taxes can, like any government revenues, be put to a number of uses: general government purposes, compensation for those unfairly impacted by the tax (see below), further incentives for environmental improvement, or the lowering of other taxes. For any or all of these uses, provided it is still socially desirable to achieve the environmental benefit offered by the tax, an environmental tax is a preferable source of revenue to a tax on labour or capital.

While it is indisputable that an environmental tax will achieve some environmental improvement, it is often uncertain how much of such improvement will result from a given tax. This is because of uncertainties either in the responsiveness of the activities affected by the tax or in the technological or other changes which the tax may stimulate. This has caused some commentators (again, especially business lobbyists) to describe environmental taxation as “a blunt instrument”. It certainly means that taxes are not a suitable instrument for those environmental objectives where it is imperative to reach, and maintain, certain fixed standards (e.g. for drinking water quality), when regulation is likely to be more appropriate. However, the economic advantages of taxes over regulation (their cost effectiveness and their influence over the whole process of economic development), together with the fact that they limit the cost of abatement (no abatement that exceeds the cost of the tax will be undertaken) make environmental taxes appropriate when the cost of abatement is uncertain, or when it is desired to achieve certain broad objectives over an extended period of time. This suggests that environmental taxation is a particularly appropriate instrument for the reduction of carbon emissions to mitigate climate change.

### **3. Environmental tax reform (ETR)**

The combination of high unemployment and environmental degradation, in Europe as elsewhere, has given rise to the perception that European economies “underuse labour and overuse nature”. At the same time, most taxes are raised from labour, making it more expensive (and therefore encouraging even less use of it), while environmental resources still bear a relatively low tax burden, with a correspondingly low incentive to conserve them. ETR entails a *shift* of taxes from labour to the use of environmental resources, which leaves government expenditure unchanged overall, in the hope that this will increase employment and conserve the environment.

The employment effect is still a matter of academic debate, both with regard to its likely magnitude and even whether it exists at all. My view is that there are good theoretical reasons to expect a positive employment effect from ETR, and it is regularly predicted by economic models that are estimated on past data, rather than those which assume general economic equilibrium. So I would expect ETR to increase employment, but the effect is likely to be small. It is certainly no “solution” for unemployment.

ETR has been implemented on various scales in a number of European countries, normally by reducing employers’ social security contributions (in the United Kingdom employers’ National Insurance (NI) contributions) by the amount required to offset the environmental tax revenues. In the United Kingdom this mechanism was used with the landfill tax, and is the proposed means of offsetting the revenue from the CCL. Describing such a tax shift as “a cross-subsidy from manufacturing to the labour-intensive service sector”, as the CBI is reported to have done (*Financial Times*, 28th May 1999) is bizarre when labour currently bears many times the tax burden of all environmental taxes put together. It would be more correct to consider the shift as a partial correction to the present situation in which labour taxation gives economically distorting incentives for labour-saving capital investment.

Two issues, equity and competitiveness, always arise almost immediately in any consideration of environmental taxation. They will be briefly discussed in turn.

#### 4. **Equity**

By raising the prices of environmentally sensitive goods and services, environmental taxes seek to ration such goods and services according to willingness (and ability) to pay. This is, of course, the normal way of allocating scarce resources in a market economy and is the reason why well-functioning markets are economically efficient (they allocate resources to high-value uses first).

However, some environmental goods and services which have historically been very cheap or free (for example, energy and water) are also, at some level of consumption, a basic need. Rationing such resources entirely by price is unlikely to be socially just. Seeking environmental conservation simply by raising the prices of the targeted resources will, where these resources are basic needs, be likely to be regressive (the poor will pay a higher proportion of their income in tax than the rich) and therefore unfair. The campaign against the imposition of VAT on domestic fuel drew much of its momentum from perceptions of such unfairness.

Some think that the mere possibility of regressive effects from environmental taxation should rule it out of consideration. The Chancellor appears to hold such a view with regard to domestic fuel, because he has not only ruled out any increase in its price through environmental taxation, but also seems little inclined to stop its price falling (as it has done and seems set to go on doing). It is little wonder that households give so little thought to domestic energy efficiency, or that carbon emissions from the domestic sector currently look like being well above 1990 levels in 2010, rather than well below them, as required by the Government's targets.

I believe such arguments, whether applied to domestic fuel, water pricing or road fuel duty, to be profoundly mistaken, on the grounds that -

- it forces future generations to pay for present generations' unwillingness to face up to distributional issues;
- the regressive effects can always be removed if there is the political will.

The first point is derived from a belief that, in a market economy, the sustainable use of environmental resources will never be achieved unless they are priced to reflect their scarcity, especially if they remain more or less free goods. Environmental taxes on environmental resources that are subject to over-use will probably not be the only policy measure that will be required to secure their sustainable use. But unless the price signal is supporting, rather than undermining, other measures, they will not be effective. If there is one lesson that policy makers should have learned from the greater emphasis on markets since the 1980s, it is that policy measures which seek to go against markets normally fail. A realistic price signal is not a sufficient condition for environmental sustainability, but it is absolutely necessary.

The second point says simply that environmental taxes do not need to be regressive. When raising revenue from the relatively rich as well as from the poor, there is always enough money from the tax to give rebates to the latter so that regressivity is removed. Doing so through the social security system may be complex, and may need imagination, using the utilities as well as the benefit system, but it is surely both feasible and preferable to continuing to duck the issue.

Alternatively regressivity may be removed by exempting from the tax an initial tranche of use of the resource. This is done with water in some parts of Portugal, and with regard to domestic energy in the Netherlands. Water charging in the former case has been made absolutely imperative by the scarcity of the resource even for present (rather than just for future) generations. It is surely desirable to take considered action before a situation becomes so pressing.

#### 5. **Competitiveness**

Because they can increase the prices of affected goods and services, environmental taxes obviously have the potential to have impacts on the competitiveness of companies. It should first be noted in this connection that corporate competitiveness is not the same thing as national competitiveness. If through ETR, for example, some companies or economic sectors experience a net increase in costs, but other companies experience a net cost reduction, then national competitiveness may be unaffected, or may even improve, depending on the trading profiles of the sectors involved. This is discussed further below.

The effect on the competitiveness of, for example, a carbon tax, will depend on -

- The size of the carbon tax and the nature and extent of the offsets (how the revenues are recycled through the economy).



- Whether other countries are introducing, or have recently introduced, carbon or energy taxes. It is routine that whenever carbon or energy taxes are proposed for an individual country, companies opposed to this threaten to relocate elsewhere. But if *all* (or even many) countries are introducing such taxes, the existence of “pollution havens” (which would need to possess the other desirable market characteristics for the company concerned) to which such relocation can take place may be limited. This is especially true in the European Union, where six countries excluding the United Kingdom now have significant carbon or energy taxes or will soon have them. Obviously the competitiveness effects of carbon or energy taxation in Europe could be reduced further if such taxation could be harmonised across European Union countries.
- The carbon intensity of the product, which would determine its exposure to the tax.
- The trade intensity of the product (the ratio of exports plus imports to production). For products that are largely non-traded (e.g. cement), a carbon tax may raise their price in domestic markets (thereby encouraging their conservation and the development of less carbon-intensive substitutes, which is the intention of the tax), but it will not have implications for international competitiveness.
- The speed of introduction of the tax. The competitiveness effect can be minimised if the tax is introduced gradually so that more energy-efficient capital goods can be installed as part of the normal investment cycle, avoiding the premature scrapping of existing capital goods.
- Opportunities for increasing energy efficiency, thereby reducing the impact of the tax. Studies have consistently shown that there remain substantial unexploited, cost-effective opportunities for increased energy efficiency, even in energy-intensive sectors, and that these can be realised when the profile of energy management in companies is raised, as a tax might be expected to do.
- Stimulation of technical change, to develop new less carbon-intensive products and processes, which would, as with energy efficiency measures, reduce the cost burden of the tax. It has already been noted that such stimulation is one of the predicted advantages of environmental taxes over other instruments of environmental policy.

The last three points, taken together, mean that if a carbon tax is introduced gradually with, perhaps, tax credits for investment in energy efficiency, even quite carbon intensive sectors may find that its effects on competitiveness are small.

If the carbon tax is introduced as part of an ETR, for example by reducing employers’ NI contributions, then some sectors (those which are more labour than energy intensive) will benefit from the tax shift. Table 1 shows some results from a modelling study of such a tax shift. The sectors with lower costs from the tax shift (by no means all service sectors) are responsible for 70 per cent of United Kingdom exports. On this evidence it could be that ETR, such as is envisaged with the CCL, would be good for United Kingdom international competitiveness as a whole, rather than the reverse, as is often claimed by companies which find themselves in the Higher costs column.

Sectoral winners and losers in 2010: combined ETR package compared with base case

Source: Ekins 1998, p.24

	Higher costs	Lower costs
Higher employment	1 Agriculture 6 Drink 14 Chemicals nes <sup>[4]</sup> 16 Non-met. min. prods. 17 Basic metals 27 Electricity 28 Gas supply 29 Water supply 30 Construction 34 Rail transport 35 Other land transport 36 Water transport 37 Air transport 48 Waste treatment	5 Food 8 Textiles 9 Clothing and leather 10 Wood and wood products 11 Paper, print and publishing 13 Pharmaceuticals 15 Rubber and plastics 18 Metal goods 19 Mechanical engineering 21 Electrical engineering 22 Instruments 23 Motor vehicles 24 Aerospace 26 Manufacturing nes and recycling 31 Retailing 32 Distribution nes 33 Hotels and catering 38 Other transport services 39 Communications 40 Banking and finance 41 Insurance 42 Professional services 44 Other business services 45 Public admin. and defence 46 Education 47 Health/social 49 Misc. services
Lower employment	2 Coal 3 Oil and gas 4 Other mining 12 Manufactured fuels	7 Tobacco 20 Electronics 25 Other transport equipment 43 Computing services

However, those economic sectors that are losers from ETR or environmental taxation will inevitably, as has been noted in connection with CCL, protest about it. While their arguments should be treated with due scepticism, recognising that they are speaking for their sectoral interest rather than in the interests of the country as a whole, it may be worth giving the hardest hit sectors special treatment. First, however, it should be noted that any such treatment (for example, a lower tax rate) is likely to reduce the environmental effectiveness of the environmental taxation, and make it more expensive overall for society to achieve a given environmental target. By reducing the revenues to be recycled, it will also reduce the competitiveness benefits that will be gained from an ETR by non-environmentally intensive sectors.

It should be recognised that it is an important purpose of the tax to raise the prices of environmentally sensitive goods and services, and attempts to mitigate this effect on the grounds of preserving competitiveness will impede the structural change that is universally recognised to be necessary for the achievement of sustainable development. Rather than incurring efficiency costs by giving special treatment to environmentally intensive sectors, it may be preferable to deliberately guide the structural evolution of the economy, so that these sectors become less important in the wealth creation of the nation, and other activities take their place.

## **6. Conclusion**

Given that, for historical reasons, regulation is still dominant in most environmental policy regimes, a substantial increase in the use of environmental taxes is likely to be desirable before anything like the best mix of instruments in environmental policy has been achieved.

Issues of distributional regressivity and competitiveness require close attention in the design of environmental taxes, but there is no reason why, with such attention, environmental taxes should not achieve the environmental, economic and, to a lesser extent, employment benefits that are suggested by economic theory. However, that is not to say that they will be easy to introduce politically. As the current debate over the CCL, and the furore over the imposition of VAT on domestic fuel, have shown, the political road of environmental taxation can be uncomfortable. Both the theory and emerging practice suggest, however, that it is worth the journey.

**EXTRACT FROM THE REPORT OF THE TASK GROUP ON MARGINAL TAX RATES  
EXECUTIVE SUMMARY**

- “The Task Group on Marginal Tax Rates has identified and considered the various marginal rates of ‘tax’ and means tests that apply within the Island, implemented by States Committees and the Parish Welfare System. The Group has investigated whether these act as a financial disincentive for some to enter employment or to increase earnings. The Group has considered the variety of impacts that such ‘taxes’ have on different family clusters i.e. individuals, couples, lone parents and couples with children and individuals with dependants.
- This report focuses on three case studies, constructing simulated scenarios involving single parents, married couples and single pensioners. Figures were gathered from Income Tax, St. Helier Community Services Department, Housing, Social Security, and Centrepoint. The Task Group would wish to thank all those individuals and departments who assisted with the provision and analysis of the data contained in this report.
- The Task Group stresses that this exercise has been very complex, and that the caveat given at page 12 of this report must always be at the forefront of the thinking of anyone seeking to understand this study in a proper context - that the data in this exercise cannot be used to find the position of other individuals and/or groups, and the conclusions drawn must be regarded as being limited to the specific case studies described. However, the Group does conclude that various marginal rates of ‘tax’ are identified, and that they must be seen as acting as a disincentive for some to enter employment or increase earnings.
- The Group considered the variety of impacts that such ‘taxes’ have on different family clusters, not only in terms of disincentives to entering employment (the ‘unemployment trap’), but also disincentives to seek or accept promotion in the workplace (the ‘poverty trap’).
- Both single parents and married couples are vulnerable to the effects of these disincentives, and although the marginal deduction rates come into effect at different income levels for different groups, no group is immune to them. The evidence suggests that the problem is most acute in the lowest wage bands examined, and that child care costs are the largest single factor involved.
- The highest marginal deduction rates are found in the case of a single parent with child care costs to meet, in a low gross wage bracket. Child care costs are not the sole cause of marginal ‘tax’ rates in excess of 100 per cent, but they do give rise to the highest degree of disadvantage in the cases analysed by the Task Group.
- The range of the degree to which people are affected by these matters can be seen in the fact that the lowest rate of marginal ‘tax’ identified in any scenario was 29 per cent for a married man in the higher wage band (£380 per week). The highest marginal deduction rate was experienced by a lower paid single parent on £62 per week whose deductions, including child care costs, amounted to 930 per cent.”

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[1] The effective rate of tax is the tax actually paid after allowances as a percentage of the tax payer’s taxable income (the average effective rate of tax for all wage and salary earners is currently around nine per cent).

[2] The standard and maximum rate of tax is the published rate of 20 per cent.

[3] The marginal rate of tax is the “entry” rate paid once an individual’s income exceeds the tax threshold and is required over a range of income to adjust for the fact that the thresholds below which no tax is paid are much higher than the personal allowances available to those above the threshold.

[4] Not elsewhere specified.