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# The Impact of Introducing a Goods and Services Tax to the Bailiwick of Guernsey


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## Overview

This report has been produced as a result of a request I had from a group of business people during the autumn of 2013.

The request was to bring an objective analysis of a Goods and Sales Tax (GST) to the question of how to resolve the challenges of a fiscal deficit that are facing the States of Guernsey. The sponsors of the report wanted to bring a fresh pair of eyes from off the islands to review what could be done.

In doing this, I clearly brought to bear my own background and experience as a Professor of Business Economics and a substantial period of time consulting with companies - both small and large - in helping them develop and implement their commercial strategies in a world full of change and uncertainty. I understand their challenges and opportunities. At the same time, this was a process of consultation. It was my privilege to meet and discuss the issues of growth and commercial prosperity in relation to GST with a wide range of interested stakeholders as I compiled this report.

I acknowledge the contribution made to my thinking and analysis by all those that took part in the consultation meetings and exchanges of emails. I thank them. The output, I hope, will be a timely and valuable contribution to the debate over GST and the longer term prosperity of Guernsey as well as the role of the Public Sector in the provision of services on the islands.

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June 2014

## Contents


| | Page |
|---|---|
| * Executive Summary | 3 |
| * Introduction | 5 |
| * Taxes on Consumption: what are the differences between General Sales Taxes, a Goods and Services Tax and Value Added Tax? | 9 |
| * How does a GST generate its revenue? | 12 |
| * The state of public finances on the islands | 14 |
| * Sustainability of a GST for Guernsey | 17 |
| * There are other options to deal with the fiscal gap | 24 |
| * Conclusions and recommendations | 26 |

References

Appendix A - The technical analysis of the impact of a Goods and Sales Tax

Appendix B - List of the sponsors of the report

Appendix C - List of those involved in the consultation process

Appendix D - Countries that do not have a VAT or GST regime

Appendix E - Profile of the author

## Executive Summary

This report assesses the case for the introduction of a Goods and Services Tax (GST) to the States of Guernsey[1] as a part of a strategy to eradicate its long term structural fiscal deficit. To add to the debate around this issue, we have taken a business perspective on the tax.

The starting point of the analysis is to accept and support the reality that public finances need to be brought back into a stable and sustainable balance. That is necessary for the future prosperity and stability of the islands.

After discussing definitions and the widespread use of a GST across the globe, the report examines and discusses the mechanics of a GST: how it generates revenue and its impact on the dynamic of an economy such as Guernsey's. At this point, examples from the Guernsey economic sectors of Travel, Tourism and Retail are provided to illustrate the analysis.

There are three main conclusions to the report in respect of its potential impact on business and the community on the islands:

1) It is likely that there would be a very negative impact of a GST on some key sectors for the islands. In particular, the retail, travel, tourism and hospitality sectors rely on a distinctive reputation as a 'low tax jurisdiction' in general and a 'No VAT' status in particular as a significant part of their competitiveness. Our analysis suggests that a GST would potentially damage these sectors in both the short- and long- term. As such, a GST would harm the achievement of the goal of developing a more prosperous future for the islands based on a more diverse range of economic sectors than at present. To make the point even more timely, as this report was compiled the States published its 'Economic Development Plan' for the islands and highlighted these very sectors as core to their future development. Not only would a GST harm this aspiration it would actually target for revenue generation some of the very elements of island commerce that should be positively nurtured.

2) As a small and open jurisdiction, and with a large proportion of small and micro businesses within its economy, the impact of a GST would have a disproportionate and negative effect on growth and innovation in these important sectors. This unique business demography of a large proportion of small businesses would make a GST

[1] It is not clear at this point whether a GST would apply to the whole of the Bailiwick of Guernsey or simply to the island of Guernsey itself which is a detail of the decision about how to implement the policy if accepted. In this report we will simply refer to 'Guernsey' as a reference point for the analysis without pre-judging its precise remit

particularly expensive and inefficient to operate on the islands as it would place a large administrative and compliance cost on these important local businesses.

3) A GST is a regressive tax in that it has a pronounced impact on the consumption and living standards of the lower income. While measures can be taken to offset this impact, it causes greater complexity and costs in the tax system which will both distort employment market incentives and also further damage the islands' low and simple tax reputation.

It is the overall conclusion of the report that a GST should not be introduced at this time as a part of a new fiscal strategy because of these potential detrimental features. It would pose major risks for the future prosperity of the islands. Before deciding whether or not to introduce a GST, it is urged that a more thorough re-assessment of the future vision for public services on the islands should be at the centre of the task of solving the fiscal challenge. Taking a fundamental strategic review of spending should be a precursor to a decision about the revenue side of the equation. One important principle that has emerged in the consultation process that has been at the centre of the production of this report is that decisions need to be seen against the context of the whole tax and spending system and not assessed on a tax by tax basis.

The report concludes by suggesting some alternative ways in which the fiscal imbalance could be reduced without harming the longer term commercial health of the islands.

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## Introduction

This report discusses the pros and cons of recent proposals to introduce a GST as part of a strategy to rectify what has been identified as an unsustainable fiscal deficit on the Islands.

The islands have a global reputation for their low taxation regime. They have a particularly large financial services sector which is the single biggest contributor to GDP accounting for some 40% of GDP. There are also other strong sectors such as ICT, construction, tourism, retail and hotels which together account for a further 47% with light industry (10%) and agriculture (3%) accounting for the rest of economic activity.

The 'big four' employment sectors on the islands are Finance (6756 in 2013), Wholesale, Retail, Repairs and Hostelry (5842), Public Administration (5466) and Construction (3224) which together account for some 67% of goal employment. Some 62% of employees work in businesses with 1 - 5 employees.

With an estimated GDP of some £2010 million for 2013, the islands enjoy a per capita income of some £30,000 and are ranked amongst the top 12 countries globally by income.

Until the financial crisis of 2008, the States of Guernsey had a very healthy fiscal performance, with a budget surplus year-on-year, and GDP growth in the region of 3 - 4%.

Since that time, three key factors have seen the emergence of a long-term structural budget deficit.

Firstly, the global slow down and financial difficulties have hit growth on the islands. As well as the general squeeze on employment and spending felt throughout the West, the islands' high exposure to financial services has seen a particularly severe impact on economic activity. Growth has fallen to around 2% per annum and has actually contracted in two out of the last five years.

Secondly, from January 1 2008, the States introduced a new zero-ten tax regime for companies in which resident companies are tax exempt and banking activities are taxed at a 10% tax rate. Introduced at the very start of the financial crisis, this has also contributed to the emergence of an under-lying public sector deficit.

These issues in themselves have led to the short-term deficit on public finances being currently felt: a forecast deficit of some £20 million for 2014. They are likely to persist as the prospects for a rapid return to the strong growth and levels of activity experienced in the pre-2008 decade are limited.

In addition, the islands face the impact of an ageing population: 'a demographic time-bomb' that is being experienced throughout the developed world. As the population ages, so the demands on pensions and healthcare will place a significantly growing burden on public sector provisions if no changes are made to these arrangements. The twin issues here are that while the demand for services related to an ageing population will grow the proportion of the population of working age will decline meaning fewer people will have to support a growing 'age related' level of expenditure. It is this aspect of the future of public spending that has caused many economies to review and revise assumptions about the right balance between the public and private sectors in these areas.

Taken together, these factors explain the situation currently facing the islands over the long-term. This is not a sustainable position and needs to be remedied so that a long-term balance or small surplus is achieved to balance spending and revenue and also to replenish capital reserves. As already suggested, while global growth does seem to be returning, it is not something that can be relied on to improve the fiscal imbalance. The States need to look at ways of reducing government spending or increasing taxes or a combination of both.

At the same time, we should recognise that there are two distinct though related issues: the one is the short-term funding gap and the other is the long-term consequences of the demographic time-bomb on fiscal balances. It would be inadvisable to put into operation a short-term fiscal fix without first fully exploring and challenging assumptions about the future of public sector spending in relation to the ageing population.

**So, what can be done to remedy the fiscal challenge?**

The potential to introduce a GST has recently entered the debate as a component of a new fiscal strategy for the islands. At present its absence is a distinctive part of the islands' international profile. The islands are internationally known as a 'No VAT' destination. This proposal is the key focus for this report. The brief is to assess whether a GST would be a successful tax to close the fiscal gap in the context of the specific circumstances of Guernsey as a small but highly innovative and attractive place to do business as a low tax jurisdiction. In what follows, we will examine the case for a GST very much from a business perspective. The choice of whether or not to introduce a GST does not have a simple 'yes' or 'no' answer. A GST has several relevant aspects from a business perspective:

1) it raises its revenue by diverting market expenditure away from businesses and consumers in favour of government: it reduces business margins and profitability and reduces real living standards. As we will discuss in this report this has significant effects in the short term. It may also damage the prospects for particular sectors such as travel, tourism, hospitality and construction which are an important part of the future strength and performance of the islands by imposing these costs on the market.

2) The implementation and running costs of a GST are largely hidden because they are spread amongst the businesses who are GST registered. While a low rate of GST might appear successful in raising revenue for the authorities, it is at the expense of these costs. Overall net gains are diminished once these costs are factored in. Indeed, at very low rates of GST, the net revenue might be negative once we take these costs and impacts into account. Moreover, experience in many countries tells us that once introduced it is an easy tax to increase: there has been a worldwide increase in the rate of GST or VAT over the last decades.

3) A GST also has social consequences. It has distributional effects as it is a regressive form of taxation (it impacts those on lower incomes relatively harder than those on higher incomes) and we must be concerned with these on the standards of living of those on the islands and on their incentives to work.

This report will address these issues and assess the case for a GST on the States of Guernsey from this perspective. The goal is to comment on a GST as part of a tax strategy that resolves the fiscal imbalance facing the islands while preparing the ground for a diverse and dynamic economy into the future. Options discussed later in the report essentially propose that:

* if additional tax revenues are required they should optimise the use of existing tax mechanisms first before considering an entirely new tax

* any increase in tax take should be designed and targeted so as to avoid damaging the long-term development of Guernsey in an effort to correct a short-term fiscal deficit - we should remember that much of Guernsey's prosperity relies on its status as a low tax economy and

* should go hand in hand with a thorough review of long-term commitments to public sector provision - the islands should have a clear vision of what the state should and should not provide

We begin by establishing some background by defining a GST (Goods and Services Tax) as compared to a more General Sales Tax and examine its widespread use across OECD member countries.

## Taxes on Consumption: what are the differences between General Sales Taxes, a Goods and Services Tax and Value Added Tax?

A GST as being considered by Guernsey is in fact a Value Added Tax (VAT) and is the most common form of sales tax applied to goods and services (which will be referred to from here as 'products') used internationally. It is a tax that is applied along the value chain of a product and is ultimately paid for by the end consumer although its impact is shared between the consumer and suppler of the product according to conditions in the market: basically whether businesses are able to 'pass on' the tax to consumers.

It is expressed as a percentage of the sales price of a product. Usually, a standard rate is applied which covers the majority or all products. Differential rates are quite common in order to ameliorate the impact of the tax on certain products such as food, for example. Products can be zero rated meaning they are part of the VAT/GST system but attract no tax. Others might also be tax entirely exempt and outside of the VAT/GST system. The more complex the arrangements for a GST, however, the more costly it becomes to administer and such complexities should be avoided if the goal is to create a simple and efficient means of raising tax revenues.

This report will refer to the tax under discussion as a Good and Services (GST) rather than a VAT as that is the term being used in present policy discussions.

An alternative form of consumption tax - a simple General Sales Tax - is one that is levied at the final point of sale. It is usually levied as a percentage of the sales price although can also include a fixed amount. It has the merit of simplicity but is said to encourage tax avoidance since there is no real incentive for the company selling its products to apply the tax. After all, it has the effect of increasing the selling price and might put consumers off buying their products. In the case of GST, where businesses recoup the tax they pay from their customers, there is a huge incentive to apply the system correctly. Studies are ambiguous on this point, however. Many find that even a strict GST system can be subject to a similar degree of avoidance and evasion as a simple sales tax. Such avoidance is especially present in economies with many small businesses and where an 'informal' cash based economy exists - clearly in these circumstances the opportunities for evasion are abundant.

## The widespread use of GST

Across the globe, all OECD countries have a GST with the exception of the USA who have a simple sales tax at federal and state level and also India who does not have a national and consistent system. The USA tax is a simple percentage tax that is added purely at the final point of sale. The rates vary by state as do the products that are covered or exempt. There are five states where there is no sales tax. These are Delaware, New Hampshire, Oregon, Alaska and Montana amongst whom Delaware uses its zero taxation profile as a component of its international business profile.

The main reason for the continued use of a simple sales tax in the USA is that historically they have had a strong federal basis of tax and revenue with a significant degree of local autonomy. The activity of banks, for example, has long limited them to operating largely within the state of their origin. A tax which is applied in a state, at the local rate and paid by those within the state's physical jurisdiction is a culturally and politically acceptable solution. It shows that a tax system should sit well within the social, economic and political context for it to work effectively.

The rate of GST varies widely. At present, according to the OECD, of the some 115 countries that have a GST the rate used ranges from 2% (Afghanistan) to 27% (Hungary). More than half of all countries (some 68) fall within the 10% to 25% range and some 45 (nearly 40%) within the range of 17% to 21%. These latter include most of the EU countries such as Germany (19%), France (19.6%) and the UK (20%). The modal rate is 18% with some 13 countries adopting this rate with 20% the second most common rate (11 countries).

The level at which GST is levied across the world illustrates two issues. Firstly, its relatively high rate reflects the fact that according to a number of studies there is an optimal rate for GST: one that ensures that its revenues exceeds its costs and negative impacts. This rate is suggested to be in excess of 5% with some studies suggesting it should exceed a rate of 10%. Secondly, it shows the experience of the last two decades of a rising rate of GST: once introduced to an economy the rate of GST tends to rise. Of course. there is no built-in reason for this phenomenon. Rather it is the case that such a tax is more easily raised then the more obviously politically sensitive alternatives of income tax and corporation tax.

In contrast to the global trend to adopt GST in recent decades, there are a number of exceptions where the tax is seen as not compatible with an appropriate tax strategy for a specific country. After all, its widespread adoption is not of itself a good reason to introduce such a tax. The most notable example of a 'non-GST' state is Hong Kong who undertook a

widespread consultation in 2006 over the possible introduction of GST. Its aims were to consider widening the tax base of the economy and provide a sustainable future stream of revenue in view of its ageing population. These are views heard frequently in the debate over a GST in the States of Guernsey. Hong Kong, however, decided decisively against a GST as it was seen as a tax that would potentially harm the core USP of the islands as a low tax trading centre.

Likewise the Turks and Caicos Islands in early 2013 decided to abandon plans to introduce a GST largely due to the realisation of its potentially harmful effect on its tourist industry and its excessive complex nature for what is a simply structured island economy.

Both of these jurisdictions resisted a powerful force to introduce GST because they looked at the longer term consequence of a such a tax given the unique circumstances of their economies. In the case of Hong Kong it was to protect their international low taxation reputation. In the case of the Turks and Caicos it was to protect the future of their tourism sector. They also looked to the alternatives that they could choose.

If we consider the position of other non-GST states and countries such as the Gulf States, we see a similar conclusion: that the lack of a GST is a key component of the international brand of those economies as a 'low tax' destination or place to do business. It is a perspective that should be remembered in the current debate about taxation in Guernsey. As already mentioned, the global reputation and a source of competitiveness are strongly related to the islands' 'VAT Free' status. It is a status that should not be let go of lightly. Although we do not argue that these examples should define the decision for the States of Guernsey, they illustrate the key principle: that decisions need to be seen against the social, economic and business context of the whole tax and spending system and not assessed on a tax by tax basis.

## How does a GST generate its revenue?

To assess this question of the appropriateness of a GST to the present and future performance of the States of Guernsey, we need to understand the dynamics of the potential tax within the economy. The key question to ask is how a GST actually affects an economy and how it generates the revenue that it does.

The answer to this core question is really quite simple. A GST generates its revenue at the expense of businesses or consumers: or a mix of the two. Businesses have to pay a proportion of their revenue to government that they would otherwise keep: their margins are reduced. Consumers have to pay more for what they buy which means that real incomes will fall: they will therefore be able to buy fewer goods and services than before the introduction of the GST unless they receive some compensating increase in their incomes.

The particular balance of who bears the impact of the tax will depend on market factors such as the price sensitivity of consumers, whether the good is a luxury or a necessity, the degree of competition in the market and the cost flexibility of businesses supplying the product. To illustrate, let us consider three examples:

**Firstly, think of the classic case of tobacco and alcohol:** these are traditionally taxed at high rates in many countries at least partly because governments know that they will generate large revenues. The reason? It is because even faced with higher prices for these goods, consumers will tend to still buy them. Therefore, the main impact of these taxes is felt by consumers and overall market activity falls little.

**Secondly, take the example of restaurant meals and other forms of 'eating out':** this is generally a highly competitive market that relies on people feeling they can afford to eat out: perhaps for a special occasion, or while on holiday. It is very much a 'discretionary spend' product meaning people will look to alternatives if prices rise. Consequently, a GST will likely have a direct impact on businesses who will try to avoid passing prices on to consumers in the knowledge that they will go to other competitors or simply reduce their incidence of eating out. When margins are already tight, then this in turn will put pressure on businesses who might find it hard to pay competitive wage rates and to maintain planned levels of investment in their businesses. The market might also see a trend towards the growth of more 'lower end' businesses selling more value-related propositions to offset the impact of the tax.

**Finally, consider the market for food and non-alcoholic drinks:** while eating out has a high element of discretionary spend, the market for basic foodstuffs is much more a necessity. Households in the whole of the UK spend between some 10% and 25% of their monthly budget on these items, according to the Office for National Statistics, with lower income families spending the highest proportion of their incomes on these categories. For this reason, a GST has a substantial impact on real incomes - especially of low income groups - and a knock-on effect on spending on non-food items as families absorb the GST induced price increases on their food outlay. In this case, while overall market activity might not fall, the government revenue raised is simply a transfer from consumers' income directly to government and spending on non-food items will suffer.

In addition, the administration and monitoring of GST would also require additional staffing and resources within the public sector which would create an additional layer of cost to an already over-burdened public purse.

The point of this analysis is to show the way in which a GST actually generates its revenue. It essentially represents an additional participant - the government - in a market that receives a share of the revenue spent on goods and services. In practice it means that business margins will fall or consumers will have to bear the brunt of the tax: or a mix of the two. In the short-term it will have a significant re-distributive effect as the government takes its share of the economic cake away from businesses and/or consumers. In the long-term it may distort the development of the market as business revenues are squeezed: this latter point will be returned to in a latter section looking at the long-term growth aspirations of the islands. For now we note this potentially 'self-defeating' nature of taxes such as GST. They are applied to sectors which are expected to yield a good tax take. However, their introduction increases costs and/or reduces demand in such a way that they can reduce that yield in the future. This point is developed in the next section on the state of public finances on the islands.

As argued by Nobel prize winning economists Gary Becker and Richard Posner, a GST is frequently the least best alternative for an economy looking to modernise its tax system or even simply to fill a fiscal gap. They argue that it has a hidden and destructive affect on business prosperity. They also point to the way in which GST usually suffers 'rate creep' after its introduction: it is, in their view, an apparently successful tax in raising revenue but is equally successful in raising business costs and damaging growth.

A more detailed technical analysis of the impact of a GST is shown in Appendix A

We now turn to the specific nature and size of the structural fiscal deficit.

## The state of public finances on the islands

In his 2013 annual review of the finances of the State of Guernsey, Prof Wood notes the existence of a continued fiscal deficit:

***'… At the aggregate level, the shortfall between income and expenditure in 2012 (excluding the investment income from the Common Investment Fund) is almost unchanged from the previous year, despite the improvement in the General Revenue position. ….. this is largely due to increased expenditure from the Social Insurance funds. The budget projections show an aggregate shortfall of approximately £20m in 2014….'***

There is therefore a projected budget deficit of some £20 million for the coming fiscal year according to the review, notwithstanding recent efforts to restrain public expenditure:

***'… The increase in the proportion of total public expenditure on the provision of old-age pensions and welfare benefits must also be understood. Taking public spending in totality, this increase in expenditure on Social Security has effectively offset the progress made in restraining revenue expenditure…'***

And will continue into the future unless changes are made:

***'… Barring any structural change to the way these services are provided in Guernsey, this trend is likely to continue for the foreseeable future. Although this may be driven principally by the ageing population, the States should nevertheless be aware that the cost of providing income support type benefits can rise significantly beyond expectations, as it has in many developed economies. Many of these are facing substantial current or future budgetary problems as a result of the growth of such expenditures….'***

This suggests that options should be considered about the relative balance between state and private provision of services based on decisions on the ability and desire to afford such services:

***'… Against the background of a slower average rate of economic growth than in the previous decade, and mounting demographic pressures, the States is unlikely to find itself in a position where it is able to support all future demand for services without changes to either the level or structure of services it provides or the amount of revenue it raises. Again, this necessitates tough choices but deferral merely delays and risks exacerbating the problem….'***

At the heart of the matter is a debate about the size of the state. What do the States of Guernsey and the population of the islands want the size and shape of government provision to look like into the future? Once that is clear, the question becomes how to finance the desired level and form of services:

***'… The launch of the Personal Tax, Pensions and Benefits Review [PTR] has brought the issues of sustainable provision of public services in the long-term into the public domain. It is evident that there are choices to be made regarding the most appropriate balance between the level of taxation and the demand for public services; particularly healthcare, pensions and long-term care, in the context of an ageing population. It would be advisable for the States to make an early decision on whether (and how far) it is willing to increase the relative size of the state to cater for the increased demand; or whether a reduction or restructuring of long-term provision of pensions and healthcare services is preferable to the significant increase in taxation, which could be required to continue providing services under the current model….'***

These choices must be carefully taken. The starting point for this discussion must be to create clarity over what level of public service provision is actually demanded by the present and future population of the islands. This aspiration is not established in a vacuum. It must be made with a sense of affordability: what level of income can be expected to be made within the States of Guernsey over the forecast period that can be used to finance public provided services? It is then a matter of establishing a robust structure of taxation to support

these goals. In creating a plan for the tax system, it must be remembered too that the presence of a tax will itself affect the level of income generated. As Prof Wood later commented when interviewed about his latest report:

***"… Since the revenue is falling short of expenditure, to correct the situation, and they (the States of Guernsey) do need to correct it, they either need to raise taxes or cut spending. And it's not my job to advise which they should do but the island should surely always remember that it's become so prosperous as it has by being a low tax jurisdiction."***

see: http://www.channelonline.tv/channelonline_guernseynews/displayarticle.asp?id=507679

The key point here is that a tax has the potential effect of reducing the very activity that it depends on to be successful in raising government revenue. Income tax might reduce the incentive to work, for example, or a consumer tax such as a GST might reduce the level of consumption in the market. To the extent that a significant amount of Guernsey's success as a wealth creating economy has rested on its low tax status, any increase in taxes will likely damage the very source of the islands' performance and prosperity. Thus a new tax such as a GST tax may to a degree be self-defeating in raising government revenue. This point will be focused on in the following section as we address the impact of a GST on specific sectors of the islands' economy.

## Sustainability of a GST for Guernsey

Guernsey is an internationally successful island which has developed a significant profile and reliance on the financial serves sector. This is a sector in which the island has a distinctive position globally and which has potential to grow further in the future (see: Oxford Economics and States Strategic Plan). This is a major strength of the island and both should and will continue to be a focus for commercial and government support over the foreseeable future. At the same time, Guernsey has many other capabilities and distinctive attractions as the basis for its destination annually for a large number of visitors and who add to spending in the retail, hospitality, leisure and tourism sectors. In addition, there is a domestic construction sector that meets the needs of its residents.

As described in the Commerce and Employment Business Plan for 2013, the future prosperity of the islands is dependent on, amongst other factors: :

* Having a vibrant and diversified economy is key to Guernsey's success to ensure we have an excellent infrastructure and high quality welfare services for Guernsey's citizens;

* Belief that Guernsey's unique selling point (USP) for businesses is not simply financial but a combination of lifestyle, accessibility to London, time zone, excellent health and education provision, stable government and safe and secure society;

* An acknowledgement that Guernsey's economy is not sustainable from local demand and needs outward facing businesses generating inward competitive income streams;

* Recognition that Guernsey is a unique and special place and that it is important to encourage the development of local businesses to support the community and infrastructure of the island;

* Cognisant of the changing demands of the modern world and that we need to adapt to meet the Islands' wants but remain vigilant of the uniqueness and charms of Guernsey.

This ambition requires that any measures that are taken now to deal with the fiscal gap must have as a critical priority their impact on the development of a diverse economy for the future.

The status of Guernsey as a 'No VAT' destination is significant. It is an unambiguous statement of there being no taxes on the sales of products. And while many products are, for other reasons, the same price as in the UK which has a 20% VAT rate, many luxury products command a price discount compared with UK, French and other EU retailers. It is a point that drives visitor numbers according to the tourism and retail representatives

interviewed as part of this research. Anecdotal evidence of the attraction of this 'No VAT' status - combined as it is with the quality of the port and retail facilities on the island - is reflected in the number of tourist ships visiting the island in recent years: rising from 62 in 2012, 84 in 2013 and a planned 106 in 2014 according to the latest data from Guernsey Harbours. Industry representatives suggest that some 80% of high-end jewellery sales are based on their non-VAT price status.

These factors represent a cluster of strategic assets that are core to the retail and visitor proposition for the island. They provide a competitive advantage. It is an advantage that might be enhanced over its near neighbour's decision to introduce a GST. It is also a binary state. It is not credible to market Guernsey as being 'Low VAT' or having 'Less VAT than our competitors'. No VAT is exactly that. Even if set at a low rate, the psychological effect of a GST will undoubtedly be harmful to the island.

When people travel to the island for 'No VAT' purchases, they also bring spend for other attractions such as food, accommodation and leisure. Once on the island it is an opportunity to encourage them to stay and use more of the islands' attractions. In the context of a long-term decline in visitor numbers and the desire to increase the tourism and related industries on the islands, this is a serious concern. The removal of that status would clearly have a damaging effect on these sectors and would severely damage the ability of the islands to develop them. In turn, other businesses in related sectors would be harmed in their ability to grow a more diverse and prosperous proposition.

It is also notable that Guernsey's economy is built on a foundation of micro- and small-businesses. Nearly half of all employing of businesses are accounted for by Construction (381), Wholesale, Retail and Repairs (336), Finance (315) and Hostelry (188). Overall, some 67% of employees work in businesses of between 1 and 5 employees with Construction standing at 70%, Wholesale, Retail and Repairs at 58%, Hostelry at 53% an Finance at 45%. The balance that would need to be achieved in introducing a GST is where to set the registration threshold. Too low and it will maximise its negative impact on the costs and administration for small businesses. Too high and it will lose the revenue that it aims to generate.

We have chosen to look in more depth at two sectors of the islands' economy that have a strong part of its 'unique' future and who would be certainly impacted by a GST. These are Retail and Travel and Tourism

## Retailing on the islands

The retail sector on the islands, just as for any economy, represents an important source of employment and tax revenue. According to data compiled by The Guernsey Retail Strategy Group (December 2013) Guernsey's spend on all retail goods in 2009 (when the most recent cross island data are available) was £5,099 per head. Based on a 2009 population of 62,184 people that suggests an aggregate spend of some £317 million. To this can be added £16 million spent by tourists in 2009, providing a total retail spend of £333 million.

The period 2008 – 2012 has probably been of the toughest ever for retail in the UK, with large numbers of retailers going to the wall and revenues down. Guernsey by comparison has fared well. This positive point of view is based on a number of different measures. It is more like a prosperous Southern town or London rather than some of those High Streets in the regions of the UK that have suffered so badly since the crisis.

The primary area of Guernsey's main shopping location, Town, has a relatively low level of empty premises. As of the end of 2013, the Town primary area (very roughly the Upper Pollet, the lower part of Smith Street, High Street and the Commercial Arcade) had just three empty Ground Floor premises, which is approximately 2% of the town centre premises. This compares to the town centre vacancy rates of circa 10% in England and Scotland and approximately 17% in Wales and Northern Ireland.

There are challenges to the islands' retail sector. Internet shopping seems to know few boundaries to its expansion and islanders are, according to the report, above average in their online spending. Moreover, the close location and easy access to places such as French coastal towns, the South coast of England and London can see a significant amount of 'retail leakage' from the islands. Evenso, it is clear that the retail sector on the islands is in a good position to grow: both from the demand of islanders and from visitors. With appropriate long-term investment in access and parking and creative use of available retail space to expand floor space, the report concludes that there is huge potential for retailing on the islands to grow and become an even more significant element of the economy.

If we apply the logic of our analysis of a GST so far to the retail sector, we can conclude some potential impacts:

1) At a level of some £333 million per annum there appears to be a huge source of tax revenue. If, for example, a GST were introduced at a level of 3% on this level of revenue, it

might be expected to raise up to almost £10 million as that amount of retail income would simply transferred from retailers to the States.

2) But we know that from the technical analysis above that there will be some reduction in sales due to the tax induced price increase. This will likely be a higher impact for visitor spending as a significant part of their spending is on high value 'No VAT" purchases and that status would be removed by the introduction of a GST. It is difficult to model precisely this price reaction, but it can be expected that for the visitor trade it will be large and perhaps reduce much of the trade in high value goods for which the basic reason for a purchase on Guernsey is that it is 'VAT free'. Indeed we can look to the experience of the UK at the start of the recession when the VAT rate was reduced temporarily from 17.5% to 15.0% by then Chancellor Gordon Brown. The reduction did have a significant uplift effect on spending. We can by inference conclude that the introduction of a GST, even at a low rate, would have a pronounced and significant effect on retail sales.

3) Some part of the tax take will have to be re-distributed to compensate lower income groups for the rise in their cost of living. On comparable experiences of other states that have used such measures after the introduction of a GST, as much as 10-25% of the actual tax take can be needed to offset the negative impact on the prices of necessities such as food and heating.

4) In addition, there is a cost – mainly to business – of the application of GST to their operations. If we apply the OECD estimate, this can be as much as 2% of GDP or business activity in a sector. Even a conservative estimate of 1% of these hidden costs will effectively reduce the theoretical GST take by a third.

Now this analysis is very simplistic but it does serve to illustrate that a high headline revenue that could accrue to a low rate of GST is actually quickly eroded by associated direct costs, the impact the tax has on total market revenue and the need to increase social spending to offset the cost of living effects of the tax. In the long-term, the concern is that one of the key elements that makes the islands a distinctive destination would be removed by the introduction of a GST and so its future development and contribution to the economy would be massively damaged.

**Travel and Tourism**

The tourism and hospitality industry on Guernsey is significant to the island's economy. Although sometimes neglected due to the fact that it generates a lower GDP per job than

other industries such as finance it is nevertheless of great economic value. If there was a serious decline in the finance industry it could again become a major source of revenue for the island. In fact many small island economies around the world rely on tourism for up to 75% of their income.

Tourism and hostelry makes up 8% of the 31,000 total employed on the island. The current figure of 2.5% of GDP is based on the tax paid by employees and does not fully represent the industry's effect on other industries such as the suppliers to trade of food, beverage and other consumables. It also does not take into account the effect to the building industry of the significant investment made in recent times. Some would believe the combined economic multiplier of this to be four to five times the figure of 2.5% i.e. some 10% of total island GDP is associated in some way with travel and tourism.

This investment in building is illustrative of the way the industry has adapted to the changing tourism market and the offering on the island. The Oxford Economics report, 'Towards an Economic Development Strategy' recommends that strategically the 'quality over quantity' approach is the correct long-term approach for the island.

Tourism globally is set to rise by no less than 54% in the ten years leading up to 2021 and Guernsey has a very real opportunity to tap into this global growth. The Tourism and Hospitality sub-group of the Chamber of Commerce are very focussed on and committed to a strategic partnership with government to realise growth of at least 4% year on year into the future

If the sector were to realise a 4% yearly growth in tourism then there is a compelling argument that this growth would have a very real effect on the significant subsidies that the government pays towards Aurigny and the bus service (circa £3m annually), to name but two. Growth in tourism would also have a significant impact on the amount of landing charges paid at the airport (circa £6m annually).

As they develop this strategy and focus on the USP's that Guernsey has over its competitors it is very clear that the current position of 'no VAT' is in itself a distinctive part of the islands' competitiveness and has considerable value, particularly given the context of the economic environment of the islands' most important demographic of UK based travellers.

If GST was to be introduced on the islands it is likely that it would detract from the offering and the competitive advantage over rival destinations with Jersey being the nearest and most significant.

Guernsey's tourism and hospitality industry has a very real opportunity in the coming years to grow and significantly add to the island's economy. They currently sit in an enviable position from its neighbours and competitors. It is likely that a GST would harm that future development at a time when measures should be taken to enhance and development and potential as part of a more diverse economy for the long term.

**Visitor Spending and a GST**

The central relevance of this analysis of the travel, tourism and retailing sectors on Guernsey ultimately relates to how much these actives can contribute towards the States' tax take now and in the future. Taking all these sectors together, we can talk about the 'visitor' contribution to economic activity on the islands. If we can rely on the experience of Jersey and their introduction of GST, we can expect the visitor economy to contribute a significant amount of tax revenue.

For example, according to a report by the economic consultancy Oxera in 2012, the visitor economy contributed some 4 - 5% of the total net tax take for Jersey with GST accounting for some 1-1.5% of total taxes. With some 335,000 staying leisure visitors (SLVs) per annum, this suggests that each visitor to Jersey contributes some £17.90 to GST tax revenue. Oxera point out that, if this is an accurate order of magnitude, then a growing tourism sector could provide a significant amount of tax revenue to the island in the future. Applied to Guernsey's some 150,000 SLVs each year, this could be expected to generate some additional £2.7 million per annum. However, the experience of Jersey also reflects a decline in SLV numbers in recent years. Notwithstanding a rise of 1.2% in 2011, SLV statistics have shown falls in the years since the introduction of GST: 2009 -7.0%, 2010 -1.0%, 2011 1.2%, 2012 -1.9% and 2013 -2.2%. It is difficult to allocate any specific part of this performance to the introduction of GST, however the falls in 2009 directly after its introduction and again in 2012 after it was increased to 5% are somewhat troubling.

The Channels Islands as a destination have been suffering from a long-term decline in visitors as holiday and leisure patterns have changed. And within that decline there have been some growth areas as they have diversified their offering to visitors. Three conclusions should be drawn from these figures that:

1) while the visitor economy has provided GST revenue on Jersey and, by extension, might be expected to do so on Guernsey, it would be a declining source of such revenue in the short- to medium-term because of the trend behaviour of leisure visitors to the islands

2) the data are consistent with our analysis that the introduction of GST to Jersey may have had a negative impact on the visitor economy in terms of total activity and/or business income

3) with regard to the visitor economy a GST would place an additional cost burden on businesses in this sector which is already experiencing severe competitive pressure. A GST represents exactly the opposite type of support that would be recommended to help develop a more prosperous performance for the visitor economy into the future.

## There are other options

In the case of Guernsey, we should not conduct our discussion in terms of whether a GST is the right solution or not. Rather it is to be clear about the underlying problem and then to identify its optimal solution. In particular, the size of the fiscal gap is not as large as it was in Jersey when it chose to introduce a GST. That provides some relief to this situation and enables both a tactical short term and strategic long term approach to be taken.

A first tactical step is to identify whether there are other revenue raising measures that already exist that can be used which do not have the negative effects of the GST and which do not carry with them the potential for rate creep that typifies GST. These might include:

* a re-introduction of some form of **taxation for road** use for example. If set appropriately this could avoid the regressive nature of a GST, although it does tend simply to take spending power from Guernsey residents.

* changes to the **Tax on Real Property (TRP).** This could take the form of changes in the rate of TRP and/or changes to the banding within the scheme. As with the previous example, this could be designed in such a way that it was progressive rather than regressive in impact and take more from those at the higher end of the income and wealth scale. As with a road tax, this would also tend to draw in 'on island' income and so could reduce domestic real spending but without the likely social costs of a GST.

* an **extension of the 10% tax rate to fund administrators** based on the islands was suggested during the consultation. This would generate a significant new revenue and would not be harmful to the industry according to a number of those consulted from within the sector. It would also have the advantage that it would not have any harmful effects on the potential sectors for Guernsey discussed in this report. Nor would it harm domestic consumption or living costs. The nature of the industry would mean its impact would be transferred to clients outside of the island and so would generate new tax take not from Guernsey residents.

There were several other options discussed during the consultation which are being considered and costed more fully. That task is outside of the remit of this report. The point is clear, however, that there are alternative ways of raising more revenue without recourse to introducing a GST. And many of these options are to do with taxes that are already in place. There is no need - as is the case with GST - to introduce an entirely new tax. There is no need either to introduce a tax which would have a lethal legacy for growth on the island.

From a strategic point of view, the issue should address the reality of the problems that the islands face: that of an excess of spending over revenue that will be exacerbated in the coming years due mainly to the ageing profile of the population and increased social spending. The major problem facing the islands is this demographic time bomb set against a number of structural issues which have driven tax receipts down. Put into this context, the introduction of a new tax such as GST which itself may damage the future buoyancy of the economy, impair its tax generating capability and add to upward pressure on social spending is not an optimal choice in the opinion of the author. A review of the totality of the tax system is required in this case rather than an incremental adjustment. At the same time a thorough assessment of spending priorities, resourcing levels and the choices that the community wishes to make between alternatives should be a part of this debate.

We should ask the question of what the islands will look like by 2020, for example, and the vision we have for that future as Guernsey grows as a social and business community and develops based on its international reputation for innovation and entrepreneurship. By then some of the fiscal difficulties created by the crisis will have moved on. We should be driven by these long-term goals rather than by short term expediency

## Conclusions and recommendations

A GST can appear an easy option for a government when faced with a fiscal challenge.

To recap some of the issues raised so far, it

1) can seem simple to implement since the main burden of its administration falls to the business sector

2) can appear to raise a significant amount of revenue, when viewed simply from the perspective of how much is generated by the Exchequer. In reality, it creates a significant cost burden on businesses through lost revenue and compliance costs and increases the cost of living to consumers. The revenue to government is in fact a diversion of money away from the market place which it can little afford at a time of slow growth and competition for the consumer pound

3) is a complex tax system with a high set up and compliance infrastructure requirement that may not be sensible to apply to a small island economy such as Guernsey whose main businesses that would implement the tax are actually quite simple.

4) has a disproportionate impact on lower income groups which would require some form of compensatory mechanism to offset the impact of GST on such groups.

When considering the best way to meet a gap in what has been rightly described in Guernsey's 'unsustainable fiscal strategy' (Prof Geoffrey Wood, Annual Fiscal Review, 2013) the solution should be assessed in terms of what is technically efficient, effective and sustainable rather than a short term fix for a fiscal difficulty.

The overwhelming conclusion of this report is that a GST should not be introduced to the States of Guernsey at this time. It may be that GST is a widely used tax by the majority of countries internationally. It is also the case that the use of a GST follows a trend around the world of using indirect taxes to raise revenue rather than direct taxes. And a GST may well be successful in generating its target level of revenue. The key issues in this analysis, however, have focussed on developing a tax strategy that fits the economic, social and political circumstances of a specific country. The islands have a global reputation as a low tax jurisdiction and part of that reputation is its 'No VAT' status. It is an important factor in attracting tourism and retail business to the islands which has positive multiplier effects on domestic sectors such as construction and agriculture. It is a reputation that should not be

relinquished too easily. And with many other jurisdictions adopting a GST, those remaining 'VAT free' have an increased source of competitiveness.

Looking to the future, the development of a more diverse economy that makes best use of the innovative talents of Guernsey businesses should not introduce a tax that actually hits at the heart of those sectors which are such a vibrant and key part of that future.

Finally, it is clear that a key driver of the fiscal imbalance over the long term is the presence of a demographic time-bomb. We argue that this issue should not be conflated with the question of the nature of the short-term fiscal position. Instead an urgent debate is needed to decide exactly how the consequences of the ageing population on public sector spending should be handled. And what is the role of the public sector in that respect. It may lead to difficult decisions but ones which are central to the question of achieving a sustainable fiscal future for the islands.

# References

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**‘Should the USA institute a federal VAT?’ - www.becker-posner-blog.com/2010/04/should-the-united-states-institute-a-federal-valueadded-tax-posner.html**

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# Appendix A

### The technical analysis of the impact of a Goods and Sales Tax

Any consumption based tax such as GST has several interacting effects on the market for a product. The imposition of a tax will add to the cost base of a product and is reflected in an upward movement of cost function shown in the diagram below: at all levels of supply the cost of the product will rise. As a consequence, consumers will buy less of the product: this is shown on the diagram as a movement from the initial market price of P1 to a new price of P2. The key issue in this analysis to understand how a tax will impact on the market is the degree of price sensitivity exhibited by consumers. If they are quite insensitive to price, as in markets such as for tobacco and alcohol, they might be willing to absorb the whole of the new tax and the total volume of trade in the market will therefore not change.

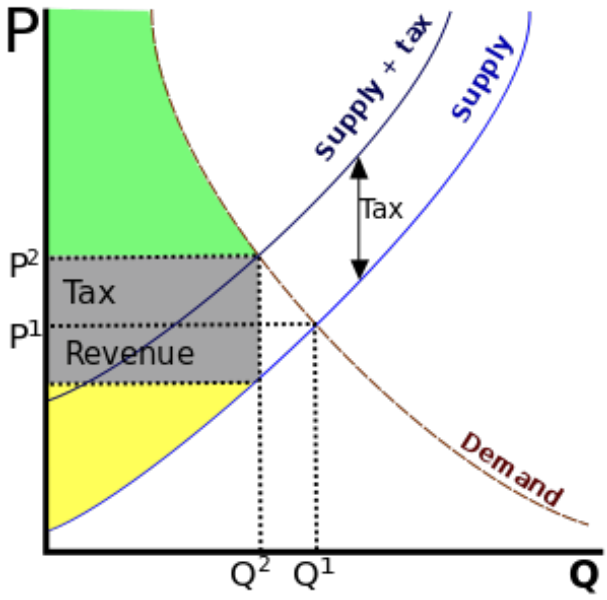



**Figure1:** the economic impact of a tax on consumption

Of course, part of the revenue will now go directly to the tax authorities but both they and the government will receive their share of the revenue. There is a simple transfer of money from

those who buy the product to the government. The net effect of the tax on consumers is then a matter of what the government chooses to spend its tax on. In addition, the tax paying public are now paying more for the products they had previously bought. Their real spending power is therefore reduced by the value of the tax.

Where there is a degree of price sensitivity in the market, the effects are slightly more complex. Consumers pay more for the product and they also buy less. The government receives its full tax take per unit, but retailers see their margin per unit fall. In part, therefore, the tax involves a simple transfer: from consumers and retailers to the government. In addition, it creates what economists describe a 'deadweight loss'. The fact that consumers now buy less of the product (shown by quantity Q2 on the diagram) compared with what they had bought (Q1) means that market activity is reduced and that a number of consumers are now priced out.

There are therefore five key impacts of market sales tax:

1) consumers pay more for fewer products

2) businesses receive lower revenues

3) government receives a part of market revenue as tax

4) there is a reduction in products bought which is referred to a 'deadweight loss' reflecting the fact that the introduction of the tax actually reduces overall market activity

5) there is an additional cost that is not shown in this analysis, which is the cost of implementation and compliance

In general terms, we find that:

1) products such as food and fuel (for travel and heating) are fairly price insensitive. Therefore, the biggest losers in the event of a GST being introduced are consumers and especially those on lower incomes who by definition tend to spend a relatively large proportion of their income on such products. It is this aspect which gives rise to the fact that a GST is a regressive form of taxation. It is therefore usually associated with a package of off-setting measures that ensure the lower paid are compensated for their higher cost of living.

2) the more a consumer can exercise discretion over the purchase i.e. they can go elsewhere in search of a lower price or decide to do without, then the losers will be both

the retailer and consumers themselves. The government will not have maximised its revenue compared with taxing a price insensitive market, but they can be assured of the flow of revenue. We will discuss these issues below in more detail, but it is already apparent that in an island economy such as the States of Guernsey, which relies in part on a low retail tax reputation to attract inbound travellers, the effect of a GST will likely have a large negative impact on tourist spending. Therefore, a prospect that a GST will enable the islands to reap rather more tax from visitors to the islands rather than residents may be mis-placed. This prospect will be damaged if there is a negative impact of tourist trade with the islands as a consequence of the GST.

3) the cost of introducing and running a GST is a hidden cost that is spread thinly across the community. Especially if set at a low rate as is being suggested for the States of Guernsey, it will have a relatively small incremental impact on the cost of living and on business revenue and margins per item. By contrast, it might accrue a significant sum for government. The fact of a large revenue to the government, however, does not of itself demonstrate that the tax is a success if it is reducing the under-lying competitiveness of businesses and standard of living of members of the community.

# APPENDIX B

## List of sponsors of the report

the report was commissioned by:

1) The Guernsey International Business Association and
2) The Confederation of Guernsey Industry

# APPENDIX C

**List of those involved in the consultation process**

**Confederation of Guernsey Industry**

Richard Battersby – member, industry sub-committee on finance

Larry Granger – Chair

**Chamber of Commerce**

Tony Rowbotham - President

**Guernsey International Business Association (GIBA)**

Peter Mills – Chairman

Dominic Wheatley

Tony Mancini (also representing Guernsey Investment Fund Association (GIFA))

**Guernsey Society of Chartered and Certified Accountants (GSCCA)**

Jo Huxtable

Harry Dick-Cleland

**Guernsey Association of Trustees (GAT)**

Michael Betley

Paul Backhouse

**Association of Guernsey Banks (AGB)**

Mark Bright

David Oxburgh

**Guernsey Investment Managers and Stock Brokers Association (GIMSA)**

Tim Martin

**Guernsey International Insurance Association (GIIA)**

Stewart McLaughlin

**Chamber of Commerce Hospitality & Tourism**

Luke Wheadon

**Guernsey Construction Industry Forum**

Eric Legg - Chair

# APPENDIX D

**Main countries that neither have nor plan to introduce a GST or VAT regime:**

Anguilla

Bermuda
British Virgin Islands
Brunei

Cayman Islands

Gibraltar
Guernsey
**Gulf Cooperation Council:**
- Saudi Arabia
- Qatar
- United Arab Emirates
- Kuwait
- Bahrain
- Oman

Hong Kong

Libya

Macau

San Marino

Turks and Caicos Islands

United States - Most states charge a sales tax on products. Delaware, New Hampshire, Oregon, Montana and Alaska charge no consumption tax

Vatican City

# APPENDIX E

**Profile of the author**

**Professor Dominic Swords** is a Business Economist, Independent Strategy Consultant and Visiting Professor of Business Economics at Henley Business School (University of Reading).

He has a background in the City working in Economic Intelligence at the Bank of England during the 80s. He has worked in a number of Business Schools in MBA and Executive Teaching for some 20 years including London Business School, Henley Business School and Ashridge Management Centre. His primary research, consulting and teaching areas are:

- Business Economics,
- Strategic Management
- Innovation

Dominic is a regular speaker at corporate conferences on the business impact of economic change. He has authored some 26 articles and books in his area including'Strategy from the Inside Out' a strategic handbook for business leaders.

He is a regular contributor to a number of TV and Radio programmes including the BBC Financial World Tonight, World Business Report, BBC News 24, the Money Programme and CNBC's 'Strictly Money'. Recent subjects have included commentary on topical issues such as the current financial crisis and the recession, economic prospects for the UK, the turnaround of EuroTunnel and restructuring of the European airline industry, analysis of fiscal policy and the Budget, Financial planning and inheritance, OPEC oil price decisions, revisions to the RPI and the impact of oil prices on industry growth and profitability.

He consults with a range of businesses, especially in the professional and financial services sector. Recent consulting work includes:

- Developing a Leadership Development Programme for 3M plc in the UK and Ireland for the next generation of the Senior Management Team including: learning events; coaching and integrating the programme with internal learning and development processes.
- Working at top team level with SABIC Europe –the Netherlands based Petro Chemicals business –
- Design of a global strategic toolkit for corporate finance and re-structuring professionals in KPMG

Areas of research and publications include:

- Industry and market analysis
- Business scenarios
- Strategic Management in Professional Services Firms
- Business Re-Structuring and Turnaround
- Demographic Trends and the Impact on Labour Markets, Pensions Inheritance flows and Financial Markets,
- Stock Market Efficiency –in particular the question of whether the Stock Market prices innovations efficiently.
- Risk Assessment

- ☒ Macro-economic Forecasting

He has over 20 years of international experience having run client projects in the EU, the US, South Africa, the Gulf, the Far East (in Hong Kong, mainland China, Malaysia and Japan) and Australia.