



**FALKLAND ISLANDS GOVERNMENT**

**GREEN PAPER ON GOVERNMENT  
REVENUE & FISCAL POLICY**

**EXECUTIVE SUMMARY & KEY  
CONCLUSIONS**

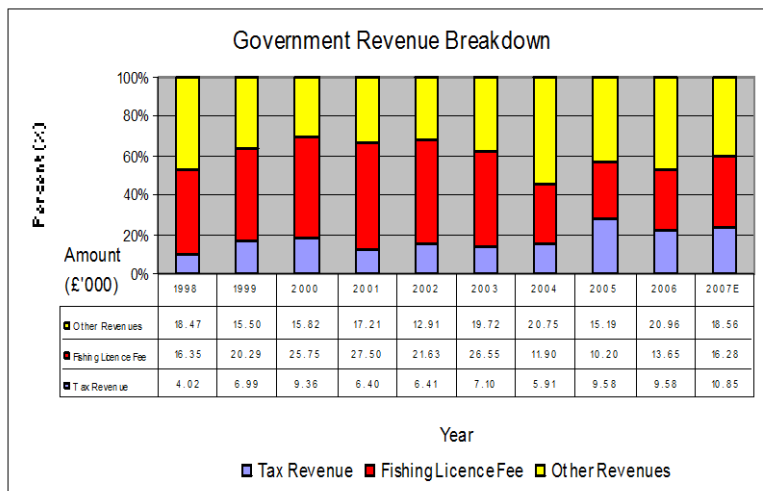
**FEBRUARY 2009**

## 1. Introduction

This Green Paper is fifth in a series of discussion papers. It will explore revenue-raising alternatives to ease the financial situation and meet the Medium Term Financial Plan (MTFP) targets. With the current global economic downturn (recession) and its likely negative impact on both the Falkland economy and fiscal balance, the issue of raising additional revenues to sustain current rates of economic growth and increases in the cost of provision of social services and public infrastructure takes on a wider dimension.

## 2.. Background

Tax policy in the Falklands faces unusual challenges. The revenue base is highly volatile and narrow. Fishing license fees and taxes provide the bulk of government revenues. However, the former fluctuates widely due to variable fish catch, exchange rate movements, weather, and oceanographic trends.



The Falklands have enjoyed many years of strong government finances. Recent fiscal policy was based on maintaining reserves in proportion to operating expenditures (i.e., government reserves were kept at 2.5 times public spending) and meeting MTFP targets. However, this has been threatened by static government revenues and rising cost of social services and public infrastructure.

The current global credit crisis and financial market decline have totally changed the fiscal circumstances of FIG.

The MTFP targets annual current spending reductions of £0.5 million and increase in revenue by £0.5 million. Recent experience demonstrates some success in achieving revenue targets, but reducing spending appears more challenging. While actual government spending (at current prices) has declined from £45 million in 1998/99 to £40 million in 2006/07 (peaked at £47.5 million in 2001/02), this in real terms (based on 1999 prices) has actually declined by 28%.

A new Tax Policy Framework which led to tax simplification was adopted in July 2003. This identified the need for FIG to raise revenue to invest in health, education and basic infrastructure and the need to reward and encourage enterprise and innovation. Some of its recommendations are now in place, but certain proposed revenue measures have not been introduced.

A key issue is to enhance the overall economic well-being of Falkland Islanders by reducing the costs of imposing taxes – or making the tax system more “efficient” and broad-based – while promoting fairness and continuing to raise sufficient revenue to provide public services. Another key issue is what will be the effect of various tax levels and tax measures on the FI economy in comparison with other economies, together with the issues of equity and sustainability?

FIG has initiated a general review of public and fiscal policy with a series of green and white papers open to public consultation. The overall review of fiscal policy and MTFP indicate we cannot carry on as is and there is a need to “do something.” This may necessitate deficit spending (public outlays greater than revenue intake). This examination may possibly result in a policy mix involving means-testing, public spending cuts and new revenue-raising measures. If we want to continue current levels of public services, one option is to reduce the range of services that government pays for. Another is to raise more taxes.

### 3. Objectives

Government revenue raising should strike a balance among 4 objectives: (1) revenue generation; (2) efficient and simple administration; (3) socio-economic equity (acceptable, fair and equitable); and (4) meeting economic policy goals (conducive to long-term economic growth and wealth creation).

This paper investigates the scope for raising taxes if the chosen decision path is to generate revenue. It will define what are the current FI tax levels, and answer the question “are we lowly taxed?” If taxes contribute to higher cost of living here, how do we compare elsewhere? Is there scope for raising tax on a comparative basis? And what sort of taxes would we want to raise?

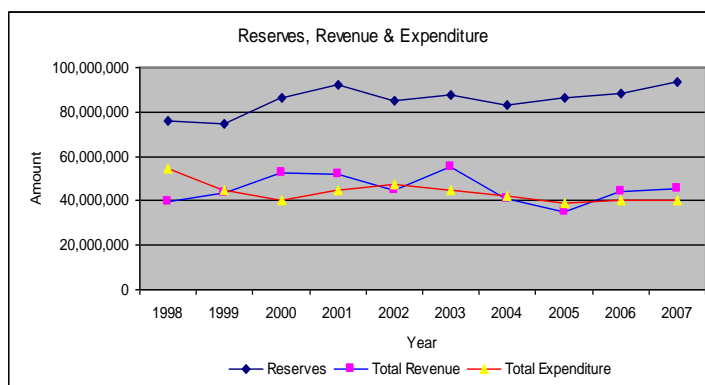
### 4. Key Findings and Summary

- Tax levels in FI are low, particularly in personal tax terms. For corporate taxes, because of the tax structure, some sectors pay more tax than others.
- FI’s high cost of living and low taxes help equalise its living costs and earnings with Western Europe.
- Even if we tax more, there appears limited room for further direct taxation on account of the narrow tax base.
- But based on the previous tax policy study (2003), there is scope for broad-based indirect taxes (consumption taxes).
- At present, FIG cannot run a surplus, but a balanced budget may be achievable.
- There is also a need to balance revenue generation with encouragement of enterprise and innovation.
- Tax incentives are an important tool in the government’s fiscal armoury. The tough choice is whether to forego tax revenue today (and grow the economic pie/stimulate economic activity) or government lives within its means and cut spending (to achieve fiscal balance).

### 5. State of Government Finances

FIG has had a tradition of prudent fiscal management and has built up substantial savings through its reserve fund. On average, it has successfully controlled spending pressures in times of plenty. These surpluses have generated the present fiscal reserves which act as buffer against volatile revenue and fiscal risk.

Government revenues in 2007 amounted to £45.7 million. Taxes and duties contribute only 22% of total receipts. The balance is funded by fishery licence revenues. And with fishery licence revenues static, we have to consider alternative ways of funding growth.



How does the Falklands compare with other countries’ levels of government income (incl. its tax/GDP ratio or tax effort) and spending, and how fast did these economies grow in the last decade? Tax effort or tax burden is defined as the tax/GDP ratio. It shows how much of the economy’s “productive wealth” is controlled by the state. It also shows how large a part of our incomes we pay in tax.

	Total Tax Receipts (% of GDP)	Econ. Growth 1996-2006 (%)
Australia	31.2	3.4
<b>Falkland Islands</b>	<b>13.2</b>	<b>2.6<sup>2</sup></b>
United Kingdom	36.0	2.8
United States	25.5	3.2
<b>OECD Average</b>	<b>35.9</b>	<b>2.6</b>
<b>OECD Median</b>	<b>35.3</b>	<b>3.0</b>

The level of public spending (as % of GDP) in the Falklands is high because several services are provided by the government, such as the coastal ferry, air service, public utilities and development subsidies by FIDC and FIMCO. These public services and subsidies are mainly carried out by the private sector elsewhere.

## 6. Are we highly taxed?

	Corp. Income Tax (%)	Indiv'l Income Tax (%)	VAT/GST (%)
Australia	30	17-47	10
<b>Falkland Islands</b>	<b>21/26</b>	<b>0/21/26</b>	<b>n.a.</b>
United Kingdom	30	0-40 + 23.8 payroll	17.5
United States	13-35	15-35 + 15.3 payroll	0
<b>Average<sup>3</sup></b>	<b>27.1 (25.4)</b>	<b>33.7 (38.0)</b>	<b>16.5 (12.6)</b>
<b>Median<sup>3</sup></b>	<b>25.5 (25.5)</b>	<b>35 (40.0)</b>	<b>18.0 (13.8)</b>

At first glance, the Falklands appear to be lightly taxed, like Bermuda and the Channel Islands. FI tax rates are below the international average and median

personal and corporate taxes. Import duties represent only 3% of the value of imports. The absence of consumption (indirect), capital gains and property taxes indicates FI residents are lightly taxed.

## 7. Comparative Cost of Living: How does FI fare versus Western Europe?

It is argued that because of the high cost of living in FI, taxes should be kept low. Falkland COL, based on a retail basket of goods and services worth £15,227/person, is comparably expensive as West European cities.

	FI Wtd Average	W. Euro Avg of 23 cities	London, UK	ANZ Avg of SYD/AUK (2 cities)	LatAm Avg of BA/SCL/SP (3 cities)
Expenditure <sup>4</sup>	15,227	15,873	19,035	13,320	9,760
Gross Earnings (£ per hour)	9.18	11.38	12.79	9.73	3.74
Less: Taxes & Social Security	8.7%	28%	26%	30%	19%
Net Earnings (£ per hour)	8.36	8.13	9.45	7.18	2.96

From an international earnings survey, average Falkland gross pay is

19% below Western Europe, 28% behind London, and 6% less than ANZ. FI taxes are fewer and lower than in Western Europe, ANZ and Latin America. Lower taxes in effect equalise the islanders' lower earnings level with those of Western European counterparts. After personal income and social security taxes, FI net pay (£8.36/hour) is slightly above EU-23's (but 12% below London's). Falkland's lower taxation therefore serves:-

- to equalize the lower pay levels in FI with those of Western Europe,
- to attract expatriate workers with a competitive after-tax income, and
- to retain local employees (from emigrating).

Interestingly, tax freedom day (i.e., first day of the year in which a country as a whole has theoretically earned enough income to fund its annual tax burden) in the Falklands falls on February 17<sup>th</sup>, compared to April 22<sup>nd</sup> in both Australia and the USA, May 22<sup>nd</sup> in New Zealand, June 3<sup>rd</sup> in the UK, June 13<sup>th</sup> in Canada, and July 26-27 for Norway and Sweden. This indicates there may be scope for more taxes in FI.

<sup>2</sup> Period covering 1998-2006 only.

<sup>3</sup> Figures in brackets indicate average and median for 90 countries.

<sup>4</sup> FI expenditures are based on the RPI basket of goods & services and compared with UBS international cost of living and earnings data; tax comparison did not take into account other taxes (e.g., property tax) but personal income tax and social security contributions.

## 8. Revenue Trends and Volatility

Revenue volatility adds risks to the provision of public services. FIG's revenue base is one of the most volatile in the world, mainly due to huge swings in fisheries income, not unlike those in several South Pacific island states. This volatility reflects a narrow tax base and an undiversified economy. It is highly dependent on non-tax (i.e., fishing licence) and investment income. Volatility of fishing licence fees is exacerbated by unstable Illex revenues. But loligo, user fees and corporate income taxes fluctuated less widely. And personal income tax and customs duties were even less volatile than corporate taxes.

## 9. Tax Base

The tax base in the Falklands is narrow with respect to the number of taxpayers and the range of taxes and

Based on 2006 Tax Data	No. of indiv's	Net Chargeable Income	Total Worldwide Income	Pct of Eligible Taxpayers
Total number of eligible taxpayers	1,934 est.			100.0%
Number of personal tax assessments	1,734			89.6%
Number not assessed & exempted	200 est.			10.3%
No. assessed but fall below £13K threshold (non-paying taxpayers)	432			22.3%
<b>Number of paying taxpayers</b>	<b>1,302</b>	<b>£18.15mn</b>	<b>£32.89 mn</b>	<b>67.3 %</b>
1) in the 20% tax bracket	825	£4.27 mn	£13.23 mn	42.6%
2) in the top 25% tax bracket	477	£13.88 mn	£19.66 mn	24.7%

duties in place. Personal and corporate taxes raised £9.3 million in 2006/07, split 41/59. Only 1,734 individuals received income tax assessments (90% of eligible taxpayers), and only two in three actually paid income tax

(67% of the eligible taxpayers).

Based on 2006 Tax Data	No. of Co's	Net Chargeable Income	Corp. Tax Collected	Pct of Total Co's
Number of company tax assessments	142			52.6%
No. of cos. w/ Nil NCI Co. Tax (CT) profit	80	n.a.	0	29.6%
No. of cos. w/ CT profit in 20% tax bracket	46	£5.03 mn	£1.0 mn	17.0%
No. of cos. w/ CT profit in 25% tax bracket	8	£14.25 mn	£3.56 mn	3.0%

On the corporate side, the tax base is even smaller. About 270 operating businesses reported a total turnover of £232.7 million in 2006. A number of these include

husband and wife-owned businesses which pay taxes at personal rates, leaving us 142 assessed companies. Among the 142 companies assessed, £4.6 million was raised from only 54 corporate taxpayers (1 in 5 firms). Therefore, 80% of businesses do not pay corporation tax, and about 75% of the corporate taxes came from a select number of export-focused firms.

The table above shows many registered companies do not pay any corporation tax either because they do not actively trade, are not profitable, or there are more corporate tax deductions allowed here than in the UK. Further research is required. Likewise, while personal tax filers enjoy a £13,000 personal exemption, companies get taxed from the first £1 of earnings. Does this mean a business operator is better off taking out a salary and getting taxed at a later point than pay corporate tax on the first £1 of earned profit? In most countries, corporate tax rates trail personal income tax rates (27% versus 34%, respectively).

## 10. Direct or Indirect Taxes?

The Falklands have an unusual tax structure. First, the resource rent from fisheries (which are access fees and are not a tax) account for 25-44% of total revenues. By comparison, on average taxes in OECD account for 85% of revenues. Breaking down taxes into direct and indirect, the EU-25 average is 35% direct versus 65% indirect. UK has a 58/42 split. The FI ratio is 93/7, highly skewed towards direct taxes. Currently, customs duties (on alcoholic and tobacco products) – an indirect tax – contribute less than £1 million to the state coffers. What does this mean for us? An OECD study indicates high rates of direct taxes have a negative effect on GDP growth and employment, but this is not the case with indirect taxes.

## 11. Tax or Non-tax Revenues?

In many countries, taxes account for at least 3/4 of total government revenues. The OECD average is 85%. Norway, which benefits from oil royalty, has a tax/non-tax ratio of 74%. The USA ratio is 77%. FI tax

revenues account for only 21% of total revenues. Given this thin tax base, direct taxation has a rather limited revenue raising potential. It seems the only remaining areas for raising future revenues would be indirect taxes (GST/VAT or import duties), ad hoc taxes, or more cost recovery measures (user pays).

## **12. What are the main options for raising more revenue?**

A detailed list of possible revenue-raising options, along with a selection of their key advantages and disadvantages, are outlined in a background technical paper which would be available separately. They include:-

- **Direct taxes** (personal, corporate, payroll taxes & social security contributions)
- **Indirect taxes** (GST/VAT, import duties, luxury & “sin” taxes)
- **Environmental tax** (road use, fuel surcharge, landfill tax)
- **Ad hoc tax measures** (foreign travel, capital gains, transactions, hotel & lodging, property taxes)
- **Efficiency-linked taxes** (oil licence, export tax on wool, head tax on sheep & cattle, excess baggage)
- **Cost recovery measures** (MSL, minimum company tax, tuition fee, land use tax, immigration fee)

The revenue-raising measures presented here should not be seen as policy intentions at this stage. Other green papers on wealth-related payments, education (FE/HE), and health will present alternative ways of raising revenues to recover the cost of providing public services.

## **13. Output Growth and Taxation**

Four notable studies measuring the effect of taxes on economic growth and investment were reviewed. These studies showed higher taxes could invite risks such as reducing growth and depressing a fragile economy. There is, therefore, a need to balance revenue generation with encouragement of enterprise and innovation. Higher tax rates might encourage the heavily taxed to enter into tax avoidance schemes to reduce taxes while FI already suffers from huge financial leakage thanks to a very open financial system.

## **14. Key questions**

Government wants to hear as many views as possible. Some of the questions which it particularly wishes to have views on are:-

- ***How will FIG sustain and meet the cost of current and future public spending, in particular education, health and other welfare services that make the islands so unique?***
- ***Are we a low tax economy? Can we afford to tax more?***
- ***If so, do we prefer direct or indirect taxes?***
- ***Should we raise current levels of individual tax rates?***
- ***Should more FI-owned companies pay taxes through higher company tax rates or a minimum company tax (based on assets and turnover)?***
- ***If indirect taxes, should we introduce a broad-based general sales tax/GST (or VAT)?***
- ***Or should we impose an across the board tariff on all imports?***
- ***Should we tax luxury goods? Vehicle and boat imports? Alcohol and tobacco? Other targeted goods?***
- ***Should we introduce a capital gains tax, wealth transfer/estate duty, or property tax (i.e., tax on the well-off)? Is the tax base broad enough? Will this erode social cohesion and invite “class” divisions?***
- ***Should we introduce withholding tax on dividend and profit repatriation, and/or general financial and legal transactions?***
- ***Should we raise more revenue via non-tax measures, like user fees (user pays) as part of government’s cost recovery strategy?***
- ***Should we introduce fiscal and tax incentives to boost investments, job creation and new business start-ups? (targeting industries, picking and choosing winners)***

**The public consultation period in relation to this Green Paper will close on 31<sup>st</sup> of March 2009.** Please submit your views on these and related issues before that time: either at a public meeting, other meetings called to discuss the Green Paper or by e-mail [councillors@sec.gov.fk](mailto:councillors@sec.gov.fk) or in writing to Legislative Members.