



FALKLAND ISLANDS GOVERNMENT

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

BACKGROUND TECHNICAL PAPER

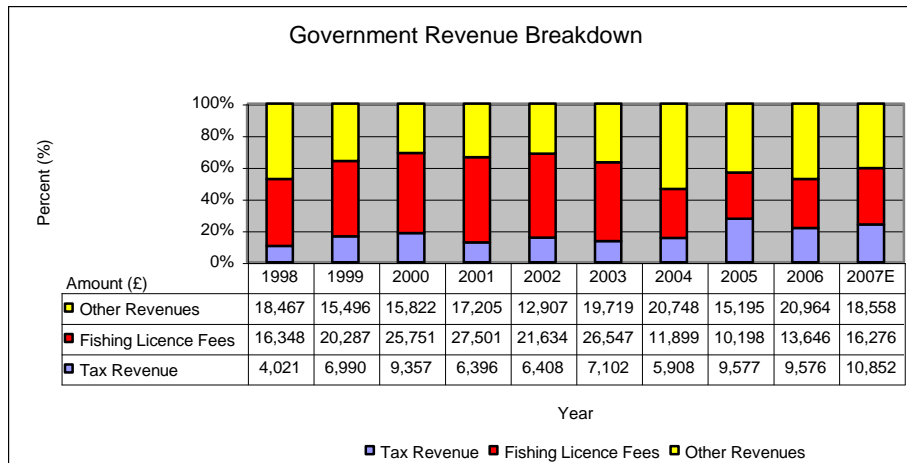
FEBRUARY 2009

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.

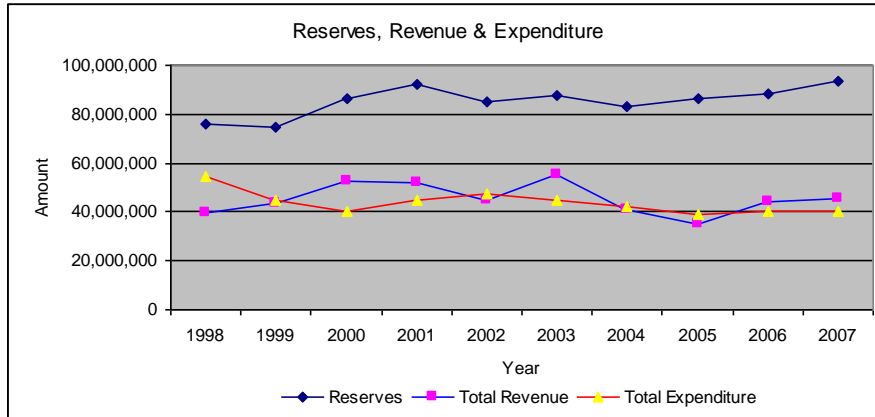
Background

Tax policy in the Falklands faces unusual challenges. Being a small island economy, the revenue base is highly volatile (fluctuating) and narrow (few taxpayers). Fishing licence fees and taxes provide the bulk of government revenues (see chart). However, the former fluctuates widely, reflecting variable fish catch, exchange rate movements, weather, and oceanographic trends.



Despite these issues, 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. Likewise, the recent global credit crisis and the ensuing financial market decline which started in the latter half of 2008 have totally changed the fiscal circumstances of FIG.

The MTFP targets annual reductions in current spending of £0.5 million and increase in revenue by £0.5 million. Based on recent experience, there has been some success in achieving revenue targets, but reducing spending appears more challenging. While the level of actual government expenditure (at current prices) has declined from £44.9 million in 1998/99 to £40.3 million in 2006/07 (after peaking at £47.5 million in 2001/02), government spending in real terms (based on 1999 prices) has actually declined by 28% during the same period.



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.

Meantime, the makeup of FIG revenues affects how the budgetary spending programme could maintain and sustain long-term fiscal balance. (As defined, fiscal balance is the balance of a government's tax revenues, plus any proceeds of asset sales, minus government spending. If the balance is positive the government has a fiscal surplus, if negative there is a fiscal deficit.) This will, likewise, be addressed in the upcoming Economic Development Strategy project.

On the revenue side, 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 important question 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.

Objectives

Government revenue raising should strike a balance among 4 objectives:-

- revenue generation;
- efficient and simple administration;
- socio-economic equity (acceptable, fair and equitable); and
- meeting economic policy goals (conducive to long-term economic growth and wealth creation).

This paper investigates the scope for raising taxes if at all the 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?

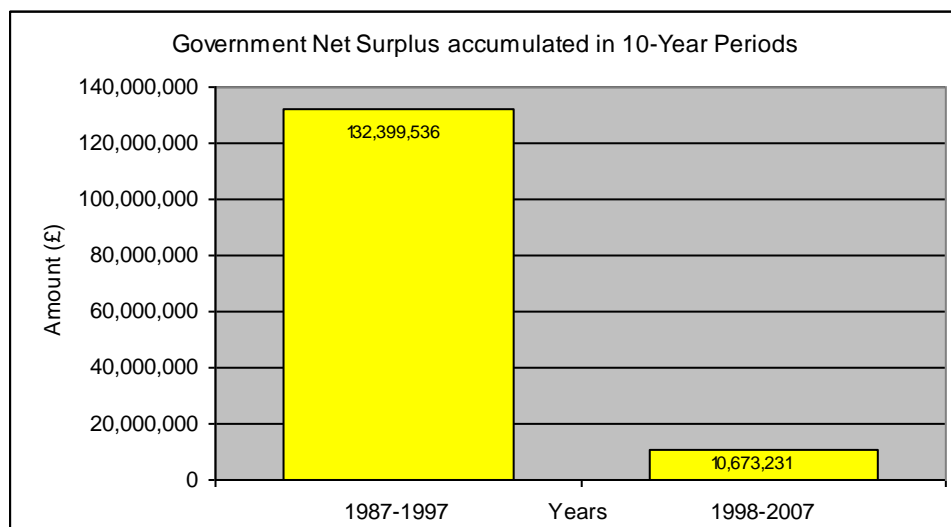
The suggestions for revenue-raising measures presented here should not be seen as policy intentions at this stage.

Key Findings and Summary

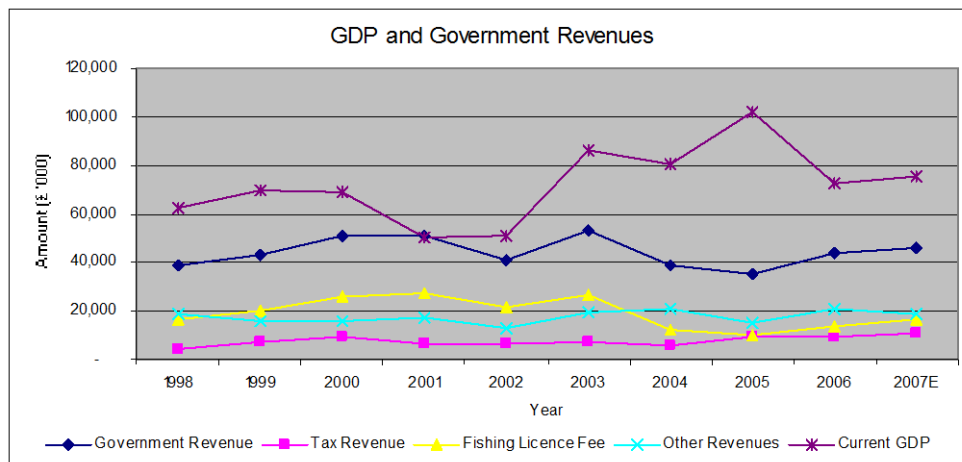
- Tax levels in FI are low, particularly in personal tax terms. For corporate taxes, because of the tax structure, some sectors pay more tax than others.
- FI's high cost of living and low taxes help equalise its living costs and earnings with Western Europe.
- Even if we tax more, there appears limited 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).

Current taxes and revenue levels

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. For much of the 1990s, the windfall revenues were substantial, and arose in periods of bumper fish catches. Government amassed a surplus of £132 million of income over spending between 1987 and 1997. Net surplus in the next ten years was only £11 million. 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.



The following table shows how the Falklands compare with other countries' levels of government income (incl. its tax/GDP ratio or tax effort) and spending, and how fast these economies grew in the last decade. The tax burden or tax effort 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. Many factors affect the tax/GDP ratio. This includes the extent to which a country provides social or economic assistance through tax expenditures (e.g., tax exemptions, deductions, rebates, etc.) or direct public spending, differences in the degree of tax avoidance and the size of the underground economy, and differences in GDP measurement.

	Government Revenue (% of GDP)	Government Expenditure (% of GDP)	Total Tax Receipts (% of GDP)	Economic Growth, 1996-2006 (%)
Australia	36.1	34.4	31.2	3.4
Canada	40.7	39.3	33.5	3.5
Falkland Islands	61.1 (42.2)¹	56.0 (49.0)¹	13.2	2.6²
France	50.8	53.4	43.4	2.3
Germany	44.0	45.7	34.7	1.5
Ireland	35.5	34.4	30.1	7.2
Japan	31.7	38.1	26.4	1.1
Mexico	21.7	21.1	19.0	3.6
New Zealand	42.0	38.1	35.6	2.8
Norway	59.8	40.5	44.0	2.7
South Korea	30.6	28.1	24.6	4.2
Sweden	57.6	55.5	50.4	3.1
United Kingdom	42.2	45.0	36.0	2.8
United States	33.1	36.6	25.5	3.2
OECD Average	42.1	42.2	35.9	2.6
OECD Median	40.7	42.8	35.3	3.0

¹ Excluding fishing licence fees and fisheries budget.

² Period covering 1998-2006 only.

In general (except for the lightly-taxed deflationary Japanese economy and the modestly growing but highly-taxed Scandinavian economies), countries with a government size of about 40%-42% of GDP (and tax receipts of 35% of GDP) have economies growing between 2.6% and 3% annually. The Falklands basically fall within this range. (Those with a smaller public sector – revenue/GDP ratio in the 30% range – tend to grow faster, notably Ireland, Korea, Australia, Mexico and the United States.³)

	Government Revenue (% of GDP)	Total Tax Receipts (% of GDP)	Government Expenditure (% of GDP)	Per Capita Public Spending (£)	Economic Growth Rate (%)
Bermuda	22.3	17.6	21.5	5,490	5.3 ⁴
Guernsey	20.6	n.a.	19.4	4,437	2.8 ⁴
Jersey	16.3	n.a.	16.7	6,717	7.0 ⁴
Isle of Man	35.9	10.7/35.4	34.3	5,107	2.3 ⁴
Falkland Islands	61.1 (42.2)¹	13.2	56.0 (49.0)¹	13,088	2.6²

The Falklands also have a per capita public spending of £13,088 (2005), on average about 2.4 times more than other OTCs. 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 to FIDC and FIMCO. These public services and subsidies are mainly carried out by the private sector elsewhere.

FIG's extensive economic development role in providing basic economic and social services reflects the islands' limited business capacity and small consumer market. As a case in point, FIG spending/GDP ratio drops to 48.4% when basic economic services (about 7.5% of GDP) are excluded.

Minimum Level of Tax Collection

In the early 1970s, international tax advisors used the tax/GDP ratio of 18% as a benchmark for a desirable minimum level of tax collection. The Falkland tax/GDP ratio is currently 13.2%, 5 percentage points below the 18% benchmark.⁵

A study on what is the optimal size of Government (in the U.S.) showed that to maximize economic growth, the tax effort should be between 21.5% and 22.9% of GDP (versus 40% at the time of the study in 1994, and has since declined to 26% today). Taxes have not been in this range since 1949. But the average American family would have twice as much real income as it actually has (NCPA Policy Report No. 188, 1994).

³ Interestingly, Christina and David Romer, economic historians from UC Berkeley, published a paper showing how raising taxes retards growth.

⁴ Period covering 2004-2006 (Bermuda), 1997-2006 (Guernsey), 2006-2007 (Jersey), and IOM (1998-2007).

⁵ World Bank Policy Research Working Paper 4559, March 2008.

The pattern and worldwide trend in taxation has changed since. An international tax study indicated 25% as an optimal corporate tax rate and 30% for personal taxes. Two recent studies cited in a KPMG comparative tax study have found that those jurisdictions with corporate income tax rates above 28% would be better off to cut rates to increase revenues. It argued that if countries like the U.S. and Canada with existing corporate income tax rates of 35% and 35.5% respectively, cut their tax rates, they may actually raise revenues, or certainly not lose much money (J. Mintz, National Post article, August 2008). The FI's top corporate tax rate is at the suggested level, but the top personal tax rate is still below the suggested norm.⁶

Are we highly taxed?

At first glance, with tax rates of 21% to 26%, the Falklands appear to be in the low end of the tax spectrum, comparable to Bermuda and the Channel Islands. Falkland tax rates are below the average and median for personal and corporate taxes. Falkland companies, however, fall within the international norm (25%-27%). The absence of a consumption tax (indirect tax) reinforces the notion that the islands' residents are lightly taxed. Import duties represent only 3.2% of the total value of imports. Based on the currently predicted £3 million annual gap in the MTFP, the onus is on the tax system to generate sufficient revenues to meet this budget shortfall.

	Corporate Income Tax (%)	Individual Income Tax (%)	VAT or GST (%)
Australia	30	17-47	10
Canada	29.5-35.5	4-7.95	0-10
China	25	5-45	17
Falkland Islands	21/26	0/21/26	n.a.
France	33.33	10-48.09	19.6
Germany	30-33	15-45	19
Hong Kong	17.5	2-17	n.a.
Ireland	12.5	20-41	21
Japan	30	5-40	5
Mexico	28	0-28	15
New Zealand	33	0-39	12.5
Norway	28	28-51.3	25
South Korea	13-25	9-21.375	10
Sweden	28	0-56	25
United Kingdom	30	0-40 + 23.8 payroll	17.5
United States	13-35	15-35 + 15.3 payroll	0
Average⁷	27.1 (25.4)	33.7 (38.0)	16.5 (12.6)
Median⁷	25.5 (25.5)	35 (40.0)	18.0 (13.8)

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. By comparison, Falkland living costs are at par with the more expensive West European cities, based on a RPI basket of goods and services worth £15,227 (while a more stringent budget estimate of £11,135 was made to exclude big ticket items like foreign travel, appliance and vehicle purchases, etc.).

⁶ The 2003 FIG tax study recommended aligning personal and corporate rates which are in effect today.

⁷ Figures in brackets indicate average and median for 90 countries.

A review of the spending breakdown in the UBS Price and Earnings Survey illustrates a pattern of household consumption in Western Europe and the ROW similar and comparable to that of the FI's RPI basket of goods and services.

<u>UBS (EU/ ROW)</u>		<u>Falklands</u>
• Food, beverage & tobacco	23%	23%
• Housing	14%	18%
• Heating & utilities	15%	5%
• Clothing	3%	6%
• Transport	11%	14%
• Household appliances	4%	7%
• Household supplies/hygiene & health care	6%	7%
• Entertainment, recreation, vacation/misc. services	24%	20%

Gross earnings from a cross section of 14 industrial and service occupations show Falkland public sector pay to be 8% below Western European levels (average of 23 cities) and the private sector to be 26% lower. The weighted average FI average hourly gross pay of £9.18 (35% FIG + 65% private sector) is 19% below Western European levels, 28% behind London, and 6% less than ANZ (but 2.5 times Latin American pay).

Taxes in FI are lower than Western Europe, ANZ and Latin America. The UBS study did not take into account the cost of other taxes (e.g., property tax) other than the personal income tax and social security contributions. While FI's effective tax rate ranges from 8% to 10% only, Western Europe's reaches 28% (a lower 26% in London), 30% in ANZ, and 19% in Latin America. Lower taxes in effect equalize the islanders' lower earnings level with those of Western European counterparts. The island's weighted after-tax income (£8.36/hour) is at par with Western Europe's 23 (although 12% below London's), 16% higher than ANZ, and 2.8 times Latin American net earnings. As a result, a FIG employee's take home pay is comparable to a Londoner's, but a FI private sector worker is 18% poorer than a London counterpart. The lower taxation in the Falklands 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).

	FI Private Sector Employee	FI Government Employee	FI Weighted Average	W. Euro Avg of 23 cities	W. Euro Avg of 6 cities	London, UK	ANZ Avg of SYD/AUK (2 cities)	LatAm Avg of BA/SCL/SP (3 cities)
Expenditure ⁸	14,890	14,890	15,227	15,873	15,552	19,035	13,320	9,760
Gross Earnings (£ per hour)	8.47	10.5	9.18	11.38	10.59	12.79	9.73	3.74
1. Industrial	9.53	11.49	10.22	12.52	11.55	14.44	11.05	4.41
2. Services	7.40	9.51	8.14	10.25	9.62	11.14	8.41	3.07
Less: Taxes & Social Security	8%	10%	8.7%	28%	28%	26%	30%	19%
Net Earnings (£ per hour)	7.78	9.43	8.36	8.13	7.44	9.45	7.18	2.96
1. Industrial	8.65	10.19	9.19	8.89	8.05	10.64	7.91	3.44
2. Services	6.91	8.67	7.53	7.36	6.83	8.27	6.44	2.48

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 17th, compared to April 22nd in both Australia and the USA, May 22nd in New Zealand, June 3rd in the UK, June 13th in Canada, July 8th in Germany, July 15th in France, and July 26-27 for Norway and Sweden. This indicates there may be scope for more taxes in FI.

Revenue Trends and Volatility

This paper considers the size and extent of revenue volatility as it adds risks to service provision. The Falkland government's revenue base is one of the most volatile in the world, mainly due to huge swings in fisheries income. Two questions arise:-

- does the very small, open nature of the economy induce greater volatility into fiscal policy than is typical for other (larger) economies?; and
- has the availability of the government reserves contributed to a loosening of fiscal discipline?

The answer to both questions may be a qualified "yes."

Comparative revenue volatility shows FI government revenues to be as volatile as several South Pacific island states', such as Tonga, Kiribati, Vanuatu, Fiji and Samoa. Revenue growth in the Falklands is about twice as volatile as that in Africa! The volatility in government revenue primarily reflects a narrow tax base and an undiversified economy. It is highly dependent on non-tax (i.e., fishing licence) and investment income, each contributing 35% of operating revenues from 2003-2007.

⁸ FI expenditures are based on the RPI basket of goods and services; international data sourced from UBS comparative cost of living and earnings study.

Between 2003 and 2007, the operating revenues fluctuated annually by 15% (standard deviation). Volatility of fishing licence fees (at 31%) is extremely high, mainly due to unstable Illex revenues (37%). Loligo fees fluctuated less widely (14%). The same is true for corporate income taxes which are heavily drawn from the fishing industry.

The most volatile revenue sources were airport departure fees and investment income (S.D. of over 50%). Oil licence fees also fluctuated by 34%.

On the other hand, personal income tax and customs duties were less volatile (6%-11%) than corporate taxes (14%). More stable revenue sources were road traffic and other licences (with a similar 6%-11% S.D.).

	FIG Revenues FY 2006/7	Avg Op Rev 1997-2007	Std Dev (1997-2007)	Std Dev (2003-2007)
Operating Revenue	45,873,056	48,230,927	12.2%	14.7%
GDP	74,921,000E	71,771,876E	23.2%	26.4%
1. Fishing Licence Fee	16,275,858	21,129,159	28.4%	30.6%
a. Illex	6,151,412	10,579,177	47.6%	37.0%
b. Loligo	4,997,687	5,512,758	21.9%	13.6%
c. Others	4,625,334	5,177,311	9.4%	6.9%
2. Tax Revenue	10,852,418	8,032,304	28.3%	25.3%
a. Direct Taxes				
i) Personal	3,789,769	3,303,293	18.8%	11.0%
ii) Corporate Tax	5,504,250	3,622,959	45.8%	14.2%
iii) Airport Tax	755,062	355,406	78.0%	51.8%
b. Indirect Taxes				
i) Customs Duties	803,336	750,645	11.0%	5.6%
3. Other Licence Fees	589,295	455,629	22.0%	24.2%
a. Oil Licences	363,741	272,306	28.9%	34.4%
b. Road Use Licence	208,971	165,747	24.5%	11.1%
c. Other Licences	16,583	17,578	12.2%	5.8%
4. Investment Income	13,067,090	10,570,152	30.7%	37.4%
5. Grants	1,051,181	346,877	132.6%	155.4%
6. Residual	4,037,214	7,696,806	50.5%	63.6%

Tax Base

The tax base in the Falklands is narrow with respect to the number of taxpayers and the range of taxes and 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), only two in three actually paid income tax (67% of eligible taxpayers). The £13,000 standard personal income tax deduction basically reflects the cost of living, measured by the RPI basket of goods and services (average of £13,181).⁹

⁹ It might also be worthwhile to point out that while progressive taxation has its political appeal to the broader population, an OECD (1981) study showed that in the late 1970s (a decade when progressive taxation peaked) -- the top tax rate generally in the vicinity of 50-80% and since hence has decline -- was typically applicable to less than 1% of taxpayers.

Based on 2006 Tax Data	No. of indiv'l'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%
Number of paying taxpayers	1,302	£18.15mn	£32.89 mn	67.3 %
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%

- Lowering the income tax deduction below £13,000 would penalize the low-income earners (57% of the population).
- Generating more revenue from higher income earners may not raise substantial revenues either (this group produced only £2 million in taxes for FIG).
 - For instance, doubling the top rate to 50% will raise another £2 million; also, increase tax evasion, possibly emigration (vote with their feet), discourage initiative and achievement, as well as erode social cohesion (create class divisions).
 - Another scenario is to raise the current tax rates from 21/26 to 25/30. Additional revenue of £726,000 can be raised, but still short of the £3 million budget shortfall. This will also raise fear of creeping tax inflation.
 - One identifiable tax gap is the MPA. Only 26 employees are subject to FI income taxation, while 542 expat work permit holders (working for sub-contractors) are not taxed.¹⁰ How FIG could extend its tax reach to MPA is a political matter.

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.

Based on 2006 Tax Data	No. of companies	Net Chargeable Income	Company Tax Collected	Per cent of Total Companies
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%

¹⁰ Limited information provided by BFSAI show an average pay for 11 locally employed civilians (LEC) of £14,822 in 2007/08. Average pay for 20 UKBC (expats) was £47,621. (These figures cover basic pay, payroll taxes, pension and allowances.

- This implies that 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 (i.e., less tax loopholes in UK). Further research is required.
- Lowering the corporate tax threshold below £1 million may bring more of the smaller firms into the tax net. The incremental tax take may not be substantial enough to offset the risk of discouraging small- and medium- sized enterprises.
- Another option is to raise additional revenue from the 25% tax group. The tax base is extremely narrow (only 8 taxpayers in this group). It will require a steep rise in the top tax rate to generate revenues in the magnitude of £3 million.
 - The risks include penalizing labour and capital productivity (i.e., less jobs, less investments to create new jobs and upgrade/replace equipment), as well as encouraging tax avoidance as has been the case in other countries.

At this juncture, it might be appropriate to raise the point that personal taxpayers enjoy a £13,000 personal exemption (i.e., do not pay tax until the first £13,000 is earned) whereas corporate taxpayers get taxed on the first £1 of taxable earnings. Does this mean that a business operator is better off taking out a salary and gets 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).

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, taxes on average account for 85% of total revenues in the OECD (and UK). Breaking down taxes into direct and indirect, the EU-25 average is 35% direct versus 65% indirect. UK has a 58/42 ratio whereas the newer (higher growth Baltic and East European) members have 34/66. In the case of FI, the ratio is 93/7, highly skewed towards direct taxes. Currently, customs duties (which apply only to alcoholic and tobacco products) contribute less than £1 million to the state coffers. What does this mean? 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 75% of total government revenues. The OECD average is 85% (and median is 87%). Norway, with a large component of public revenues derived 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, and adding volatile fishing license fees, the ratio increases to 56% - 65%. Given the thin tax base, direct taxation has a rather limited revenue raising potential. Therefore, the only remaining revenue raising tax avenue would then be:-

- indirect (or consumption) taxes,
- ad hoc taxes (targeted taxation, e.g., on luxury goods, vehicle imports, fuel, etc.), or
- more cost recovery measures (user pays principle).

What are the main options for raising more revenue?

¹¹ OECD paper, 2006 citing C. & D. Romer's NBER Working Paper No. 13264.

Listed below are possible revenue-raising options.

Tax	Pros	Cons
<p>1. <u>Direct Taxes</u></p> <p>a. Personal tax increase</p> <p>b. Corporate tax increase</p> <p>c. Payroll taxes</p> <p>d. Social security contributions</p>	<ul style="list-style-type: none"> • Revenue potential modest - high (£500K-6mn est.) • More progressive than indirect taxes • Revenue potential modest - high (£700K-9mn est.) • Capture taxes from MPA employees (max £300K-400K) • Raise additional funds for health and pension, unemployment insurance, etc. 	<ul style="list-style-type: none"> • Increase tax burden • Increase tax avoidance • Drop in disposable income and stunt household savings • Not broad-based • Reduce profits retained by companies of certain size • Increase tax evasion • Stunt economic growth, savings and investment • Very narrow tax base (54) • May be unpopular at MPA • May reduce service contracts • Push MPA business to have permanent establishment in Ascension (rather than pay FI Corporate Tax); lose annual collection of £216K CT) • Higher cost for workers and businesses; loss of economic competitiveness (as in EU) • Disincentive to find work
<p>2. <u>Indirect Taxes</u></p> <p>a. GST / VAT</p> <p>b. <u>Import Duties</u></p> <p>i. General tariff (ad</p>	<ul style="list-style-type: none"> • Realise broad-based and potentially high amount of tax revenue (@5% x £35mn = £1.75mn) • Reduce income tax evasion through indirect taxation • Stronger case for economic growth, savings & increased employment vs. direct taxes (promote international competitiveness) • Realise broad-based and potentially high amount of 	<ul style="list-style-type: none"> • Increase tax burden • Inflationary (one-off price increase) • Tax admin & compliance cost • Negative effect on low income households (but room for GST tax rebate & 0% tax on selected basic consumables; Canada's GST exempts residential rent, housing/apartment re-sale, health services and prescription drugs, educational and financial services, daycare and legal aid) • Inflationary (one-off price increase)

<p>valorem)</p> <p>ii. Vehicles & boats</p> <p>iii. Luxury goods</p> <p>iv. Tobacco and alcoholic drinks</p>	<p>revenue from customs duties (@5% x £21.3mn non-FIG imports = £1.1 mn)</p> <ul style="list-style-type: none"> • Reduce income tax evasion through indirect taxation • Will boost sale of local products (import substitution) • Similar to GST/VAT <p>• Modest revenue potential from low volumes (@25% = £500K-800K)</p> <ul style="list-style-type: none"> • Gain some revenues from high value (low volume) items • Target wealthier individuals who can afford luxury goods <p>• “Sin” taxes (moral hazard) can yield additional revenue of £170K (@25% additional tariff)</p>	<ul style="list-style-type: none"> • Negative effect on low income households • Tax admin & compliance cost (incl. smuggling) • Possibility of EU being less willing to grant derogations on imports of FI products as it works against EU tariff-free entry of FI exports • Have vehicle imports already peaked? Revenues may be low if imports contract • Wouldn’t generate very much revenue (luxury goods imports < £200K pa) • Difficult and time-consuming to administer • Inflationary effect • Unpopular to smokers and drinkers
<p>3. <u>Environmental Tax</u></p> <p>a. Road use tax: <i>graduated</i> vehicle tax (on 2nd and subsequent vehicles); <i>and/or</i> <i>MPA Toll Rd</i></p> <p>b. Fuel surcharge (at the pump)</p> <p>c. Landfill tax</p>	<ul style="list-style-type: none"> • May limit road users/traffic • May generate a good level of revenue, high numbers of road users to pay for road upgrade (3,000 per week) • Collect additional revenue from owners of more than 1 vehicle (environmental & road tax) or raise annual road tax <p>• Motor diesel fuel, 4.6mn liters consumed annually, potentially high revenue source (exclude kerosene for home heating); @10p/litre = £460K pa</p> <ul style="list-style-type: none"> • Encourage fuel savings & planned trips • Harmonize prices of kerosene and diesel <p>• Simple to administer</p> <ul style="list-style-type: none"> • Encourage recycling & reduce waste production (green tax) 	<ul style="list-style-type: none"> • Road tax already in place • Adds to the cost of travelling to Stanley for Camp dwellers • Add financial strain on households and businesses • Costlier travel • Unpopular among Camp dwellers • May not generate much revenue and require person(s) to work at the landfill (better to use user fees) • May increase litter and dumping of rubbish elsewhere

<p>4. <u>Ad Hoc Tax Measures</u></p> <p>a. Foreign travel tax</p> <p>b. Capital gains tax / estate duty</p> <p>c. Transaction tax / Documentary stamp tax</p> <p>d. Hotel & lodging</p> <p>e. Real estate / property tax</p>	<ul style="list-style-type: none"> • Could generate a good level of revenue due to high number of residents travelling abroad (c. 8,000 pax departing x £50/trip = £400K pa) • Encourage local tourism • Tax on well-off travelers • Only charges on profits made from sale of capital assets • Alternative tax on the well-off (property owners) instead of higher income taxes • A nominal tax per banking, legal, financial, property or similar transactions • Could generate a good level of revenue if there is high number of transactions • May generate a decent level of revenue, particularly in the summer (tourist season); est. revenue potential = £200K • Per 2006 census, FI has 1,582 houses, potential to raise a good level of revenue (e.g., 1,000 houses in Stanley with average MV of £80,000, assessed at 60% of MV & taxed at a mill rate of 1.25% = £521K & another £55K from Camp = £576K pa) • Efficient way to tax the better-off (property owners) in lieu of higher income taxes • Good substitute for higher personal income taxes 	<ul style="list-style-type: none"> • Adds to already high cost of air travel & cruising for local residents • Similar airport departure tax already in place (£22) • Small volume of purchases / re-sale of real estate, shares and bonds • Added workload on tax administration staff • Added cost of administration and compliance to firms • Higher cost of hotel accommodations may discourage land-based tourists • Very seasonal revenue • Tax office will need additional staff for assessment branch to appraise property • Can be difficult to regularly appraise property every 2-3 years and can be time consuming
<p>5. <u>Cost Recovery Measures</u></p> <p>a. MSL</p> <p>b. Minimum company tax</p>	<ul style="list-style-type: none"> • Provide additional funding for the high cost of medical treatment • Only 20% of companies pay corporate taxes; this would raise revenue from every FI company (216 out of 270 FI 	<ul style="list-style-type: none"> • Low-income households & elderly may not be able to afford as they are most vulnerable (need tax rebate/exemption clause) • Additional cost to a financially strapped company • Could have a negative impact on small companies

	co's don't pay any corp. tax; @£1,000/non-CT paying co. x 216 = £216K pa)	and the FI economy
c. Tuition fee / cost of overseas education co-pay	<ul style="list-style-type: none"> • Potential cost recovery if applied to FE/HE 	<ul style="list-style-type: none"> • Low income families cannot afford cost sharing
d. Land use tax	<ul style="list-style-type: none"> • Raise revenue from real estate developers and from home & site improvement permit applicants 	<ul style="list-style-type: none"> • Increase the cost of housing dev't & construction
e. Immigration / work permit processing fee increase	<ul style="list-style-type: none"> • Covers the admin cost to process immigration & work permits 	<ul style="list-style-type: none"> • May deter skilled/educated workers seeking employment in the islands • Adds to the cost for government recruiting expats
6. <u>Efficiency-Linked Taxes</u>		
a. Oil licence acreage rents	<ul style="list-style-type: none"> • Raise rent if inactive and to induce further prospecting, surveying and surveying activity 	<ul style="list-style-type: none"> • Low oil prices may induce departure of current licence holders
b. Higher export tax on higher micron wool	<ul style="list-style-type: none"> • Encourage farmers to produce higher micron wool and accelerate switch to higher value wool produce • Farms may raise more revenue, require less subsidy 	<ul style="list-style-type: none"> • May have a negative effect on farmers who have difficulty producing higher micron wool especially in a declining wool price environment
c. Head tax on sheep & cattle	<ul style="list-style-type: none"> • May generate a good level of revenue if farmers fail to raise flock density to minimum sustainable level per hectare of farmland 	<ul style="list-style-type: none"> • Same as above
d. Excess baggage surcharge	<ul style="list-style-type: none"> • Easy to implement (green tax) 	<ul style="list-style-type: none"> • Negatively affects returning students, who exceed baggage allowance (may apply only to regular travellers)

One concern is that self-employed business owners and professionals who may be classified as well off, as well as some companies, may typically escape appropriate taxation. This has led some countries (mainly Latin America) to impose an alternative minimum tax based on gross assets and/or turnover usually at a rate of 1-2% (Mexico being a successful model). This option can raise revenue from targeted taxpayers but may have long-run effects on economic development and must only be a temporary “bridge” toward achieving equity. Other bases for an alternative minimum tax, such as net worth or physical assets, may be considered. But again, the tax base tends to be narrow, requiring higher taxes for the same revenue.

In France (forfeit system) and some developing francophone countries, presumptive taxation is more commonly used where government assigns a particular income to taxpayers on the basis of their standard of living, value of homes, cars, among others. While not generally considered to tax the well off, this form of tax may be subject to abuse by rent-seeking tax officials.

In Canada, an exit tax applies to emigrants (residents permanently leaving Canada) as a means to recoup profits from capital gains on sale of property and stocks, as well as withholding tax on income from interest and rent.

Other possible means of raising revenues to recover the cost of providing public services will be covered in other green papers. Funding could be sourced from a government-administered means-testing mechanism or by introduction of private medical insurance.

- Medical services fee on non-residents (in place);
- MTO co-pay (subject to means-tested);
- Prescription drug co-pay (subject to means-testing); and
- Dental care co-pay (subject to means-testing).

Output Growth and Taxation

It would be helpful to make mention of empirical studies that examined the effect of taxes on economic growth. We need to balance revenue generation with encouragement of enterprise and innovation.

- World Bank's J. Marsden (1983): Countries with high tax rates (i.e., tax/GDP ratio) experienced a lower average growth rate than those with low tax rates. The study implies that an increase of 1 percentage point in the tax/GDP ratio decreases the rate of economic growth by 0.36 percentage points...that a 3 percent increase in the tax/GDP ratio will reduce the level of GDP 20 years in the future by 20 percentage points.
 - Conclusion: the introduction of taxation reduces labour and capital productivity, and hence lowers the country's growth rate.
- Ricardo Martin and Moshen Fardmanesh (1987) on the relative costs and benefits of tax-financed government spending: They found an insignificant but positive effect of taxes on output growth rates, but government spending has a negative and significant impact on GDP growth.
 - Conclusion: while reducing deficits will spur output growth, cutting government spending will have a greater impact on economic growth than raising taxes.
- UC Berkeley's Christina and David Romer (NBER, 2008): a tax increase of 1% of GDP lowers GDP by roughly 2% to 3%.

Higher tax rates might encourage the heavily taxed to enter into tax avoidance schemes by creating corporate vehicles or to resort to capital flight through offshore investment (FI already suffers from huge financial leakage thanks to a very open financial system), transfer pricing by firms, and the like solely to reduce or even evade taxes. Higher taxes could also 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.

Tax & Fiscal Incentives

While the scope of this paper is to explore additional revenue sources, a World Bank study cited empirical evidence (from Boskin & Gale, NBER, 1984) that there is a negative impact of taxation on investment, which suggests a pronounced role for tax policy in affecting the location and timing of investment.

It is important to note that tax incentives are an important tool in the government's fiscal armoury and it is vital that businesses can use it when planning investment. However, fiscal incentives (or tax expenditures) may translate to foregone income to government. The debate, therefore, shifts to FIG taking a pay cut now for the sake of growing the economic pie (to expand the tax base) and stimulating business activity in an economic downturn, or should government live within its means and cut spending, or strictly enforce a balanced budget?

Key questions

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

1. ***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?***
2. ***Are we a low tax economy? Can we afford to tax more?***
3. ***If so, do we prefer direct or indirect taxes?***
4. ***Should we raise current levels of individual tax rates?***
5. ***Should more FI-owned companies pay taxes through higher company tax rates or a minimum company tax (based on assets and turnover)?***
6. ***If indirect taxes, should we introduce a broad-based general sales tax/GST (or VAT)?***
7. ***Or should we impose an across the board tariff on all imports?***¹²

¹² Both the FCO OTC Coordinator and EU DG Development (Overseas Association Decision) were consulted re EU regulations on import duties. Current regulations on imports from OCTs per Article 40 of OAD will only be valid until the end of 2013, when the OAD is renewed. Per Stephane Verwilghen, "the OAD does allow an OCT to introduce customs duties on imports from the EU, provided that such duties apply to imports from all 27 Member States without discrimination (thus including imports from the UK) and that EU imports benefit from "Most Favoured Nation" treatment (except for imports from other OCTs or developing countries). As long as the tariffs are in line with these conditions and notified to the Commission, the Commission should not object to their introduction." FCO's Damien Reeves's only other comment at this stage is an economic one. "Importers may pass on the price of the tariff, making imports more expensive to individuals and to businesses." One risk is that retailers may be prone to pass on more than the cost of import duties to the consumers (or perhaps absorb the price increase themselves). This may meet with some opposition. Likewise, an import tariff may eventually mean a need for another tax increase or a new tax mechanism in that the taxable base is smaller (about £21 million, net of FIG imports) than that of a consumption tax, like GST or VAT. A GST should avoid this as it offers a larger tax base (anywhere from £30 to 45 million) than imports. For example, government revenues in NZ and Canada, after the introduction of GST, have grown, are more inflation proof, and less variable than changes in personal and corporate tax collections. Whereas GST would have the same one-off inflationary effect as import duties, FIG could exempt essential consumer goods and services (like food, clothing, prescription drugs, re-sale home and car purchase, and legal services) from GST, and may well have more discretion in granting GST rebates to the most vulnerable in society, whereas import duty relief cannot be practically implemented.

8. *Should we tax luxury goods? Vehicle and boat imports? Alcohol and tobacco? Other targeted goods?*
9. *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?*
10. *Should we introduce withholding tax on dividend and profit repatriation, and/or general financial and legal transactions?*
11. *Should we raise more revenue via non-tax measures, like user fees (user pays) as part of government’s cost recovery strategy?*
12. *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 31st 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 or in writing to Legislative Councillors.

One advantage of GST/VAT is that it is a perfectly acceptable tax/revenue instrument, whereas an import tax may be subject to shifts in multilateral trade policy and negotiation. While import duties may be acceptable in the short-term, there is a risk the EU may be less willing to grant derogations (or tariff concessions) to imports of FI products in the long run. By contrast, GST/VAT is more sustainable and completely within the control of FIG.