TREASURY MINISTER'S SPEECH TO THE INSTITUTE OF DIRECTORS – 14TH MARCH 2014

"Setting Guernsey's finances on a sustainable, long-term path"

We do not need a goods and services tax to balance our budget. Let me say that again, for the avoidance of doubt, for the hard of hearing and for journalists in the room to note it down accurately: we do not need a goods and services tax to balance our budget.

Indeed in my election manifesto, which is still on my website, I said: "*I will oppose the introduction of new taxes (direct and indirect) until we are genuinely satisfied that we have – where possible – eradicated waste and inefficiency."* I stand by that statement. But the debate is not, or should not be, about our current budget deficit or our FTP-driven efficiency drive; it is - or should be - about setting Guernsey's finances on a sustainable, long-term path for 2025 and beyond.

If I was a career politician, I would sit tight and do nothing very much for the next two years. There is no burning platform. The deficit is heading in the right direction. In fact, I think we could probably get through the next 4 year term as well, without doing very much - and then leave it to the next generation of politicians elected in 2020 to face the consequences of our inaction now. I don't think that is responsible.

Today I want to set out what we are doing to build a robust and sustainable financial infrastructure. One that brings together work on capital spending and funding, with how we most effectively use the Contingency Reserve; and one that looks at the sustainability of public finances, through the Personal Tax, Benefits and Pensions Review.

The challenges for Guernsey

But before we talk about *what* the solutions could be and *how* they should be implemented, I want to talk about 'the why?' I want to set out, in the clearest possible terms the challenges we face.

Our economy has flat-lined for 5 years. There has been some attrition in the labour market, particularly from the financial services sector; we have a soft property market, and until recently there has been a lack of economic confidence. We have imposed fiscal contraction on the economy – albeit that spending control has been offset by growing welfare expenditure. We have an increasing proportion of expenditure supported by social insurance contributions, such as pensions and long-term care, driven by both demographics and policy.

We have a stubborn deficit, even with capital spending below our 3% GDP target and as such current funding is insufficient to meet our recommended capital programme.

And, in the midst of this, we need to consider how we balance the level of taxation, with the demand for public services. In other words, how big do we want our government to be?

Long-term sustainability is our objective, not least to ensure we have a stable and competitive environment for you, our business community. But to get there we need a clear fiscal strategy.

The importance of a fiscal strategy

Previous States prided themselves on being fiscally prudent. However, this was relatively straightforward when revenues were plenty.

The Contingency Reserve was introduced and built at a time when there was more income than the States knew what to do with.

The introduction of zero/ten, brought this era to an end.

Operating in a deficit environment has forced increased fiscal discipline. The last States introduced a Fiscal Framework setting limits for deficit, revenues, and borrowing, and it also introduced a Fiscal and Economic Plan.

0/10 moved the tax burden squarely onto individuals. Those in the States who were behind zero/ten knew what this meant; that the price for economic competitiveness could, in the future, be a dangerously narrow tax base. And that is why, in 2009, they also passed legislation to enable a goods and services tax to be brought in, should it be needed. They realised, that in fixing one problem they had created another. They pushed the problem on to the next States: this States.

Capital prioritisation has meant a move away from a 'first come first served' approach. Capital prioritisation is maturing and now seeks to ensure that we do the right things, at the right time for the Island. It seeks to ensure capital spending identifies and produces benefits and provides a good return on investment.

Our focus has for too long been simply on how much income and expenditure we expect in any particular year and managing against this. Our time horizons are too short and we need to move our fiscal planning horizons out. So developing a Government Service Plan is a further demonstration of the evolving fiscal framework. The plan would help prioritise spending, integrate business and financial planning and move to longer-term timeframes for revenue budgeting.

We have had a Financial Transformation Programme which has, successfully, focussed on expenditure restraint and reduction, with a targeted 10% cut in baseline expenditure by the end of the five year period, at the end of this year.

And we are now undertaking a Personal Tax, Pensions and Benefits Review which seeks to transform our thinking on how we can fund public services in the long term. This is especially important given our current narrow tax base, which is focussed on taxation from income; a tax base which will face acute pressure as our changing demographics see a declining workforce, leading to a yet narrower income base. A problem which would be further exacerbated if the finance sector declines as a proportion of our economy and as a result we lose some high value and high tax-paying finance sector jobs.

We need to start making our balance sheet work for us. We have significant assets which we should start to sweat and we need to manage our liabilities without continuing the pretence we don't carry any.

The overarching objective of the Fiscal Framework is that fiscal policy should achieve the economic position of 'long run permanent balance'.

If our goal is – as it must be – 'long run permanent balance' we need to ensure that we can actually sustainably raise sufficient revenues to meet the needs of the island.. This is why the Personal Tax, Benefits and Pensions review is so important.

We can only do this if we recognise the cost pressures on our public services arising from an aging population. We can only do this if we recognise our infrastructure requirements.

If our fiscal policy is focussed on the medium term, it ensures that we don't make short-term expedient decisions which risks compromising us in the longer term. For example, not investing in our infrastructure.

Capital Investment and Funding

We need to start looking at our capital investment requirements in a wider sense. The fledgling Island Infrastructure Plan starts to look beyond those projects and investments traditionally funded through general taxation, to the overall infrastructure requirements of the Island.

We need to take a holistic approach to government capital spending. Treasury & Resources has sought to do this in the most recent capital portfolio. It has incorporated not only our general revenue funded schools and hospitals, but also the requirements of our trading assets, such as the Ports, clean and waste water investment as well as the States' investment into public housing stock through the Guernsey Housing Association. We need to be able to manage the projects to ensure that they deliver identified benefits – or, in other words, a return on our investment.

When considering financing capital investment, we need to look wider still. What are the requirements of our wholly owned, but independently managed companies – Aurigny, Guernsey Electricity, Guernsey Post and the tanker ships. How do we get the best deal for taxpayers and consumers - and not one at the expense of the other?

The last States rejected borrowing proposals although it agreed that borrowing for capital investment should only in future be countenanced when the asset could generate income streams capable of repaying the debt.

But what was not recognised at the time, was that the States already has material off balance sheet borrowing. The States provides guarantees to Aurigny, the Guernsey Housing Association and Guernsey Electricity. The States has lent money to JamesCo, the company that holds the tankships. And a back of the envelope exercise quickly gets us to debt in excess of £150m - and there are other examples of planned borrowing in the name of the States which because of the dislike of the idea of borrowing, is not therefore being undertaken in a managed way or in the most cost efficient way. One consequence, is that the public as consumers will be paying more for services supplied by those businesses than might be possible if they had a cheaper debt structure.

Further, since changing our approach a few years ago to managing the States' financial assets, first through the Contingency Reserve and more recently the States General Investment Pool, we now seek and make significant returns on these investments. This success has created another problem. Now, the opportunity cost of using these reserves to fund capital expenditure is greater than the cost of financing projects through well-placed debt.

So – always cognisant of the extant resolution that requires borrowing to have an income stream to enable its repayment - we are now actively examining the options for consolidating existing public sector debts and funding future income generating capital investment to ensure that we get the best value for money, looking at our assets and liabilities in the round: in effect, properly managing our net assets.

The Contingency Reserve

I want to move on to talk about our Contingency Reserve – and the importance of deciding whether it is our rainy day, or our family silver fund.

The Contingency Reserve was built up at a time when surpluses were common and significant. The States should be commended for having the foresight to do this. It has enabled a planned, phased and proportionate approach to be taken with the zero/ten implementation and managing the resulting deficit.

But what is this reserve for? If it's for a rainy day then, quite rightly, when it rains, people want to dip into it. This status has driven the current investment strategy which has to ensure it remains relatively liquid in case we need to withdraw funds – you never know when it's going to rain!

However, if we saw this fund as the family silver fund – our sovereign wealth fund – our core capital – as I firmly believe we should, then it would take on a different purpose. What, instead, if we decided that the investment objective should be to generate an income? If that were the case, the investment strategy would subtly change and we could start to use the excess investment returns – over and above those required to maintain the real value of the fund - to help, for example, finance future capital investment. Then we could start to make this fund really work for us, supporting our wider fiscal strategy. I hope that my Department will be in a position to make recommendations in this regard as part of the 2015 Budget.

It would also mean that we would need a more robust, disciplined and sustainable approach to our public finances. If we don't have a rainy day fund, we need to change the way we plan for the future.

The Personal Tax, Benefits and Pensions Review

The hugely important Personal Tax, Benefits and Pensions Review is designed to ensure the long-term sustainability of public finances, pensions, benefits and services and to deliver a greater degree of equity in the tax system, whilst ensuring that benefits are received by those who really need them.

It is important to remember that this is entirely consistent with the Future Economic and Taxation Strategy debated in 2006, which said that, and I quote: "*Having run a deficit budget for three to five years (ie until 2011/2013) and then after taking account of international events, the history of goods and services tax in Jersey and economic performance, the States will need to evaluate and produce an overall package that delivers a balanced budget*."

For the States to be able to continue to offer the high level of public services demanded, we must have a stable and secure tax base from which to generate revenue in the long-term.

Our tax base is extremely narrow and this poses a risk for the sustainability of our revenues which are so heavily dependent on income on the Island.

The present tax system is overly reliant on direct personal taxation and social security contributions on income, deriving approximately 73% of Guernsey's total public revenue. This is a significantly higher proportion than any other Island jurisdiction or OECD member state - and is a significant concern for the long term sustainability of the tax base. This problem is not a surprise. It is a consequence of – and has been exacerbated by – the adoption of the 0/10 corporate tax strategy which, as we all know, increased the burden on personal taxpayers. This is a legacy problem which cannot be left unaddressed forever.

Anyone who has ever taken any investment advice will have received a message along the lines of: 'you need an appropriately diversified portfolio to reduce risk and best ensure a stable return.' The same applies to States income and its portfolio of taxes. And as the outlier among other comparable jurisdictions and developed economies, we most certainly do not have adequate diversification at present. The long and short of it is that we must diversify our tax base; we must reduce our over dependence on direct taxes; and we must increase the proportion of taxes we collect from indirect taxes.

As a political body we would be failing in our duty if we did not discuss all available options, no matter how difficult or controversial those options maybe. And so, yes, serious consideration of a consumption tax is a necessary and essential part of this Review process.

Again, this is also consistent with the 2006 Taxation Strategy which said, and again I quote, "*the Policy Council therefore proposes that although in the short term a goods and services tax should not be introduced, the possibility of doing so at a later date must be considered. It is therefore recommending that an appropriate system of goods and services tax for Guernsey should be investigated, including the experience of introducing such a measure in Jersey. The Policy Council also recommends that the necessary enabling legislation be developed*". And, of course, the enabling legislation was indeed developed and enacted by the States in 2009.

What does all this mean? In political terms it means that the previous States were aware that a discussion on consumption taxes was needed. But, may be, just maybe they did not wish to have that public conversation at the same time as 0/10.

You would be forgiven, at present, for thinking that the review is solely about consumption taxes. It is not.

Three key issues have been identified as part of the review:
1. Firstly, the need to cap the total amount of money extracted from taxpayers to pay for public services;
2. Secondly, the significant over dependence on direct taxes on income; and
3. Thirdly, the expenditure pressures resulting from an aging population and the risk to the sustainability of the Guernsey Insurance and Long-Term Care Funds.

As outlined in the Policy Council Paper recently released, the likely key recommendations will include:
- Establishing, for the first time, a cap on total government income, including General Revenue and Social Insurance, relative to the size of the economy;

- Diversification of the tax base to reduce reliance on and indeed the burden of direct personal tax; and
- Measures to mitigate, or at least partially mitigate, against the projected expenditure pressure on the Guernsey Insurance Fund, by reducing projected pension costs and establishing appropriate policies to support longer working lives and ensure adequate incomes in old age by delivering greater private provision.

The outcome of the review must be treated as a package. The final report may contain elements which, when viewed independently, may seem unappealing but when considered as part of the whole, negative aspects may be offset by other measures**.** Such measures are central to the success of the review's objectives.

The public and media debate at the moment is focused on consumption taxes. It really is far too early to start talking about some of detail, some of the 'what' and 'how' questions, but given some of the hyperbole, I think it is incumbent on me to challenge some of the points that will be made.

We're told that Guernsey does not do consumption taxes. Presumably then, that is, apart from our excise duties on fuel, alcohol and tobacco.

We're told that consumption taxes have dragged Jersey's economy to its knees. But isn't it that because Jersey introduced it just before the global economic meltdown? Isn't this a gross and misleading calculation of cause and effect?

We’re told consumption taxes would drive small businesses into the ground. But if, as in Jersey, a £300,000 turnover threshold were introduced with any consumption tax, then many Guernsey businesses will be exempted anyway.

We’re told that consumption taxes will raise prices. But we know there are retailers here who charge the same price as they do in the UK with 20% VAT, so for *some* retailers, isn’t this really about the size of their margin? In fact, many of those UK corporates benefited from the abolition of corporate tax, so why shouldn’t their tax contribution be increased on what they consume in our island? Indeed, the rise of the internet, means that there are a growing number of businesses outside the island supplying goods on our island, without any contribution whatsoever to our public services? Why would we not want to look at leveling the playing field for businesses on island that do contribute? Why shouldn’t visiting business people, with their expense accounts, be asked to make a small contribution to our public services when they stay in our lovely hotels and eat in our fantastic restaurants?

We’re told that consumption taxes are expensive to collect and so any benefit is squandered through administration. But in Jersey they predicted it would cost 1p to collect every pound, and half a decade on, that is just about right.

We’re told that consumption taxes are a threat to the finance industry’s prosperity, or to our economic competitiveness. But Jersey, the Isle of Man, Singapore, Dublin, Luxembourg, Malta, the UK and many more have all managed to implement consumption tax systems that have not directly or adversely affected their finance industries.

We're told that this will take money from hard-working families' pockets. But isn't it the case that those families will have more money in their pockets if we implement a series of proposals of which a consumption tax, if brought in, would be only one; that through less direct and more indirect taxation, they may have their tax burden eased? Do we think it is good enough to give hard-working people less choice on how they end up contributing to the public purse? Indeed, many taxpayers would be *better* off. Why? Because, of course, the tax base will have been broadened, so reducing their direct and overall tax burden. Any equitable income tax system must ensure that those on low incomes are excluded from the income tax net. The issue is always one of balance: where does exemption end and liability begin? We will have an opportunity to redraw those boundaries.

We're told that Guernsey will empty under the burden of a consumption tax. But as over 120 countries covering 60% of the world's population have such taxes, émigrés are going to struggle to avoid a jurisdiction without such a system.

We're told that Guernsey's government should sort itself out first before it plugs any gaps with more taxes. I agree. But this is about how we address our 21st century public spending needs, which will not be fundable simply by improving our efficiency - although that must continue to play its part with ongoing transformation after the end of FTP.

Yes, we know consumption taxes are by their nature regressive. But why can't we address the impact of that on the most vulnerable in our community through the pensions and benefits system?

Are we really saying that we can wait for another four years, or eight years, for a States to try to tackle these issues? This has been tackled at a snail's pace. The 2004-08 States brought in zero/10, thereby consciously shifting the tax burden to individuals. Presumably the 2008-12 States realised that this narrow tax base could become unsustainable in the future: why else would they have passed enabling legislation for GST?

They saw that a consumption tax was one of a package of measures which might potentially be needed to address the issue of sustainable public services. But, the matter was deferred. If needs be, it falls to this States to pick it up, consider it and not defer it once again.

I assume that you are all expecting me to ask you for something today, and you are right. I am asking you to keep an open mind, defer final judgment and in due course, look at the evidence; look at the full package of measures and how those different measures interplay. And to remember that this is not a problem that can be ducked. For those who say, the problem of our future needs can be met by raising income tax by a penny or two, remember, all you are doing is increasing the burden on the same narrow tax base. It is *a* solution, but not a *sustainable* one.

If, knowing all the likely pressures on us from a declining economically active population with increased pension, healthcare and long term care needs, after informed debate, as a community, we decide we don't want to diversify our tax base, then another option to us is to attract more people to our island to grow our economically active, tax paying population. That, too, would be a valid policy choice, but one which many will find unattractive.

In short, we are faced with some unenviable, difficult decisions – which we knew we would be. We must face reality. As politicians, we will do islanders a disservice, if we pander to a myth that we can continue to have it all: high quality public services for a gently aging community funded by low taxes and without any change in our population numbers.

The personal tax, benefits and pensions review is not about a binary choice between a consumption tax or no consumption tax. It part of the wider tax review which is all about ensuring we can afford our public services beyond 2025, by broadening our tax base to 'future proof' it for our community. The least our Island deserves is informed debate, not deferral to populist stereotypes.

Gavin St. Pier
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