TREASURY MINISTER'S SPEECH TO THE CHAMBER OF COMMERCE – 17TH MARCH 2014

"2025 and beyond: transforming Guernsey's future"

Before I begin, I want just to respond to the comments made by your President in the media last week, expressing a fear of political paralysis as a result of the unexpected change in Chief Minister mid-term. I want to reassure Rupert – and indeed you all – that in my view there is no risk whatsoever of paralysis. The transition has been smooth and swift and everyone is now back to business. In fact, on the contrary, there is a real determination to drive forward and deliver in the next two years.

73. I want you to remember that number. In fact, if you remember nothing else from this speech today, I want you to remember that number. I will return to it.

Of course, we want it all: high quality, low cost public services funded by low taxes – and taxes preferably borne by someone else. However, before I talk about our current position, our future challenges and what we can do about them, I want to spend a few minutes updating you on progress on our Financial Transformation Programme, FTP.

The FTP and *true* transformation

Let me first be very clear about one point. The personal tax, benefits and pensions review – to which I will return to later - should not be confused with the FTP. The FTP, as I have set out, is a relatively short-term programme designed by the previous States, with other measures, to help bring the budget out of deficit. In business terms, it is simply a cost reduction programme. Any proposals from the personal tax, benefits and pensions review are not part of the plans to address the budget deficit, nor to meet any shortfall or delay in meeting FTP targets.

Now to the credit of the last States, it was they that initiated the FTP. It took a while to get any traction, but it has done so, particularly in the last year or so.

Much has been achieved - but as has been said, there is much still to do. £24m a year of recurring savings should help confound the sceptics who said that it could not, should not or would not be done. To be fair to the sceptics, governments around the world struggle to contain, let alone reduce spending. We have done both. We are on track to hit our target of £31m a year of recurring savings by the end of 2014. So we can take a moment to congratulate - but cannot be complacent.

While overall progress with the inter-departmental themes of Property, Procurement and Support Services has continued to prove challenging, I take encouragement that this gives as real opportunity for further substantial savings in the post-FTP world. This includes, for example, the delivery of the States Strategic Asset Management Plan for the management of its property portfolio.

And this is even before the yet further opportunities which would come from truly embracing e-government with a robust digital strategy.

We need to continue transformation beyond 2014. The Fundamental Spending Review in 2009 always envisaged a *States* Transformation Programme, not just a *financial* one.

I will welcome us finally adopting a more broadly based transformation programme. Whilst not financially driven in the first instance, I would expect that successor transformation programme to identify and deliver real benefits, including financial ones.

True transformation

When we use the term, 'transformation', we think it applies to the States as a whole – or at least that it speaks to the need for changes in the behaviours of others, not ourselves. But actually we need to challenge and transform some of the unchallenged

shibboleths which we seem to hold – sometimes, it seems, dogmatically. So let me set out some of the sacred cows that need slaughtering:

The first sacred cow is that the 'Contingency Reserve is our Rainy Day Fund.' No it isn't. It's our Core Capital Fund, our sovereign wealth fund. In business terms, it is our share capital. How can it be a rainy day fund, if we have never attempted to define the conditions which need to be met for it to be raining? We need to think of these reserves as our long-term savings account, the core of which is untouchable. If we do this, then four advantages will flow: firstly, it will inject further discipline into our fiscal planning, because the States will never be able to rely on access to the rainy day fund as an ultimate fall back; secondly, we will invest and manage the fund with growth and income as more important objectives than liquidity, so producing greater returns in the long run; thirdly, the investment returns, over and above that necessary to preserve the real value of the fund, could then be made available for funding, for example, capital investment in the island. Fourthly, there is also a real opportunity for structuring in such a way, as to provide us with an option, for the first time, to be able to invest *our own* reserves in *our own* island infrastructure.

The second sacred cow is the pretence that we can 'manage our population.' We are engaged in a huge amount of angst to design a 'population management regime' and we continue to pay lip

service to a 2007 States resolution seeking to fix population numbers. All the while, the reality is that our population will continue to be driven by the state of our economy and our housing market – and the housing market itself will be as much a factor of the supply of new housing, as it will be a factor of demand. We also need to face the harsh truth, that so long as our public revenues are highly dependent on the taxation of individuals' earnings and profits – of which more later - we will have an ongoing need to attract and retain economically active, taxpaying people to our community – and quite possibly in increasing numbers as the dependency ratio (of non-earning elderly to earners) increases.

The third sacred cow is that 'all borrowing is bad.' As you will know, in your businesses, borrowing is a perfectly normal way to manage your working capital and finance your long-term capital projects. Now, to be clear, I am absolutely not advocating the kind of borrowing that other governments indulge in to pay their bills. But when we already have £150m of public sector agency debts for organisations like Guernsey Electricity, the Guernsey Housing Association and Aurigny, we really do have a duty to properly investigate and manage that debt programme in a structured way – and not continue with the myth that Guernsey 'doesn't do debt.' As consumers, we will be paying more for services from those public sector agencies than we ought, if they had been more cost effectively financed.

The present state – why is there a problem?

So what are the problems? Well, our economy has gone nowhere in 5 years, largely because of the global financial crisis and the resultant deep recession in developed economies, particularly, of course, the UK as our largest trading partner. Throughout that period, our main industry of financial services, has remained under pressure from being firmly under the international spotlight. Having said that, we have had a relatively good recession: unemployment has risen, but only gently; real incomes have fallen, but only modestly and fortunately, some of the fall has been partially offset by record low mortgage rates; the property market has been soft, but has not collapsed. On the upside, the States – unlike most governments – has actually delivered on real terms restraint in government spending and, as I have said, has actually, through the Financial Transformation Programme, delivered on its targeted reductions in spending; on the downside, welfare spending has increased.

So that is a snap shot of where we are, but what does the future hold? Well, financial services is now a mature industry and so even without any further pressures from the international community, it would be bold to predict anything other than modest rates of growth for that sector – we are certainly not picking up from any in the sector or from any commentators (or even from the ever exuberant Minister for Commerce & Employment,)

anyone predicting a return to the glory days of growth in our economy of 6% or 7% per annum.

But taking a longer lens – and politicians are, of course, famously poor at doing this – the uncertainties only seem to increase. On the income side, irrespective of future growth prospects for the economy – and even assuming our population continues to grow at a net 200 each year, which it has historically done, despite the King Canute-like States resolution from 2007 to which I referred earlier – we know that our population is gently aging. Given that our main source of government revenue (which I shall return to) is by taxation and social security contributions on the earnings (both income and profits) of our resident population, the decline in the proportion of those who will be economically active, has obvious implications for States income in the long-term.

But what about the spending side? Donald Rumsfeld famously spoke – or as George W Bush may have said 'misspoke' – about 'known knowns', 'known unknowns' and 'unknown unknowns.' I want to talk a little about these in the context of our public finances. The 'unknown unknowns' might include such things as the unforeseen and rapid contraction of our economy; or a major event, such as an environmental disaster which produced huge public cost. These we can speculate about, think about and have on a risk register but probably not, I suggest, build our public finances around.

Then we have our 'known unknowns.' Into this bucket, I would put the most obvious candidates of increased costs in terms of healthcare and long term care from an aging population. We know it's going to happen, but we just can't be sure by how much. These we need to start planning for and making some assumptions for in our budgeting process. For example, each 1% real terms increase in health spending will cost us around an additional £1.25m. The only question then, is how many per cent real terms increase do we budget for and what – if any – mitigating actions can we take to reduce this. There are some more unknowns to throw into the health equation. We know, for example, from the numerous reports in the last 12 months from internal audit, the Public Accounts Committee and Finnamore, a consultancy, that the Health & Social Services Department has a huge change programme required to secure adequate financial management. Without this, planning and forecasting is nigh on impossible with any degree of accuracy. And as I have said on numerous occasions, in that environment, I would challenge anyone to be able to say with any degree of certainty whether HSSD is underfunded or indeed overfunded and either way, by how much. Secondly, until such time as we have the resources (both financial and people) to conduct a full scale review of our healthcare system, it is very difficult to say what, if any, impact on budgets there would be from any reorganisation of our (currently) very fragmented healthcare system.

Finally, we have a long list of 'known knowns,' or spending pressures that we know are already in the system. In the near term alone, we have the commitment to enhanced maternity benefits; we have the States commitment to deliver on its Disability and Inclusion Strategy; we have the Education's Department's long-held ambition to provide free access to pre-school education for all; we have the work of the Social Welfare Benefits Investigation Committee, whose chief challenge is to merge the Supplementary Benefit and Rent Rebate systems. Tot that lot up and we have probably just added several million a year to our expenditure. We also have the need to properly fund our capital programme, which for long-run planning purposes assumes a requirement of around 3% of GDP, or £60m per year, to maintain our infrastructure needs.

Long-term, we have the 'known-known' pressure on the Guernsey Insurance Fund from rising numbers of pensioners which has been well trailed for years. If you turn to graph 4, you will see that with no action, the fund will run out by around 2040. If we make some tweaks in relation to further extending the age of entitlement to 70, and reduce the rate of annual increase in the pension, we can solve this particular problem relatively easily, without the need to increase contributions. However, we still need to face the fact that, since the demise of defined benefit pension schemes, a huge number of people nowadays are simply not providing anywhere near enough to ensure that they will have an adequate

income in their old age. The States old age pension was never intended to do that; it was always intended to be a top-up. The extent of this latter risk is very much a ‘known unknown’, but if we do nothing about it, we will have increasing number of people coming to rely upon the States to support them in their old age. Individuals must take personal responsibility to ensure that they do make adequate provision for their retirement; but it is also incumbent on government to ensure that it has reviewed and provided all the appropriate incentives and tools to enable them to do this. This might require, for example, changes to tax incentives; or by ensuring people can actually access cost effective savings provision for themselves.

Personal tax, pensions and benefits review

Before talking about the review of personal taxes, benefits and pensions, I think it worth remembering the words of Andrew Jackson, the 7th US President, when he said: “*The wisdom of man never contrived a system of taxation that would operate with perfect equality.*” Those words are as true in the 21st century, as there were when first spoken in the 19th century.

As I said earlier, the personal tax, pensions and benefits review is looking much longer term. It is all about designing a sustainable tax, benefits and pensions system for 2025 and beyond. As I have repeatedly said, including during debate in

February's States meeting, in the longer term, we must broaden and diversify our current tax base; and the review will put a package of proposals to the States later this year, for further investigation, which aims to do that.

At the moment, 73% - this is the number I want you to remember - of everything we collect through tax and social security comes from income. This is a significantly higher proportion than any other island jurisdiction or OECD member state. If you turn to graph 2 in your pack, you will see that we are an outlier by some considerable way. This is no surprise and has been exacerbated by the adoption of the 0/10 corporate tax strategy, which knowingly and consciously shifted the burden onto individuals. You will see this in graph 1 of your pack – and the dotted red line shows the shift up in 2008 in dependence on income from around 60% to over 70%.

You are all in business, so I must ask you this: how comfortable would *you* be if 73% of your business' revenue came from a single customer or client? Would you regard it as a risk? Would you, in the longer term, regard it as a strategic imperative to try and reduce that reliance? Of course you would.

This leaves Guernsey very exposed to a declining tax base. The risks of this are already with us. Next week, in a Ministerial Statement in the States of Deliberation, I will be giving confirming that our income tax receipts under the Employees' Tax

Instalment scheme (itself constituting 70% of our general revenue receipts) fell short of budget. Not disastrously so and fortunately still showing growth in total receipts on 2012. But the risks are apparent - and they are real. We cannot and should not dismiss them lightly. As our population ages, this risk will increase as the numbers who are economically active (and generating taxable income from which we derive revenue) will fall – and it will fall at just the time that our needs will increase to fund more pensions, healthcare and long-term care for the same cohort. So what am *I* going to do about it? What are *we* going to do about it? Addressing those long-term issues is the focus of the personal tax, pensions and benefits review.

So what are our options?

We have no particular concerns about managing our budget in the short run. And in the medium term, our modelling would suggest we can probably meet the 'known knowns' of expenditure I referred to earlier. How? It won't be easy. It assumes some financial benefits from a wider States transformation programme succeeding FTP; it assumes some additional revenue from closing the document duty loophole on share transfers and extending the 10 of 0/10 to fund administration businesses, which is as far as we could go with the corporate regime; it would also be dependent on making some sensible decisions around managing our Core Capital and public borrowing that I referred to earlier, which we think could release a

few more million a year.

But this is all tinkering and in the long term, we still have the problem of how do we reduce our dependence on personal income as our main revenue source? What are the options for shifting the burden from direct to indirect taxes? Well, consumption taxes in general – and a goods and services tax in particular – have been in the news recently. I spoke at length about this at the IoD on Friday and that speech is on the States website in full, and I am sure there will be plenty more debate to come, so I don't intend to dwell on it in the same depth today.

What are the alternatives to consumption taxes? For the purposes of discussion today, let's assume that we thought it appropriate to aim to get personal taxes back down to their 2007 total of around 60% of total revenue. Even this would still leave us higher than the other jurisdictions in graph 2. This would require around £60m from other sources. Like consumption taxes, property taxes are pretty hard to avoid and cost effective to collect; but with domestic TRP currently raising around £4m per annum, at an average of £150 per home, even if we increased domestic TRP by a 1,000% to £1,500 per home, it would only raise £40m of the sum needed. So there may be some room for higher domestic TRP, but it is unlikely to be sole solution. As an alternative, document duty rates would need to quadruple to bring in the required quantum, but such high transaction rates would be very distortive

to the market. Capital taxes - such as capital gains, wealth taxes or death duties - are very expensive to administer, are highly inefficient - in that they distort economic behaviour - and ultimately raise very little, as those that can plan to avoid them, normally do. They would also be highly damaging to the competitiveness of our finance industry.

What about raising income tax rates by a penny or two or having a higher rate band? Firstly we need to remember that whilst the headline rate of income tax is 20%, the marginal rate of combined income tax and social security is 30.5% for many self-employed and 29.9% for many of those in the so called, 'non-employed' category. Also our top income decile, already contributes 40% of revenue – in other words, there is much less headroom to increase the taxation of income than may be popularly imagined. Secondly, and more fundamentally, it would not, of course, reduce our risk of overdependence on taxing income as our main source of revenue. In fact, quite the reverse as the personal tax burden would be increased.

Jean Baptiste Colbert, the French economist and minister of finance to Louis XIV, very famously said: "*The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.*" The irony of trying to introduce a consumption tax with the objective of diversifying our tax base, is that it will produce massive amounts of hissing but with no more feathers as a

result. But we believe that the greater stability that would give to our public finances to meet the 'known unknowns' or the 'unknown unknowns' could be worth the effort. One reason for this, is that by broadening our tax base, it provides an opportunity to reduce the burden of direct taxation. So if you take look at graph 3, you will see that for those in the second and third quartiles of earnings, if this were to be done by substantially increasing personal tax allowances – the blue line – rather than cutting the headline rate – the red line – they will actually have their overall tax burden cut compared to their present situation, the dotted line. The reason? Well, this is possible because a consumption tax would broaden the tax base including, for example, to corporates owned outside the island who benefitted from the abolition of corporate income tax.

Do we need a Fiscal Discipline Law?

One of the objections – and I have raised it myself – is that any consumption tax could be readily raised by subsequent States. This is a justifiable concern, not least because of the experiences in other jurisdictions. I think part of the output from the personal tax, benefits and pensions review should be the enactment of a Fiscal Discipline or Responsibility Law. This would do several things. Firstly, it could embed in law the limits for deficits and borrowing, first conceived in the Fiscal Framework which was introduced by the last States; secondly, it could, for the first time, include

an aggregate cap on government income from both taxation and social security; thirdly, it could cap the rates of taxation for both income and consumption tax; fourthly, it could provide for a super majority of the States, for example, two-thirds rather than a simple majority to change all or any element of the fiscal discipline rules. This could not, of course, entirely prevent any risk fiscal indiscipline by subsequent States, but it would substantially impede it.

What are the next steps?

This is not work that was taking place in secret – we consulted widely and openly last year and will continue to do so this year. No decisions have yet been made – and with such a major piece of work as this, we would be rightly criticised if we did not consider *all* options, however unpalatable some may at first seem.

When we report to the States later this year, it is unlikely that the report will seek final agreement to all proposals; I suspect that we may seek agreement on the nature of problems we think we face: in particular in relation to our narrow revenue base, and the sustainability of our pension and long-term care funds; and then we may seek that Treasury and Resources and Social Security be directed to go away and do further work before reporting back with any recommendations on proposed solutions.

It would be easy to take a populist view; and for the combined boards of the Treasury & Resources and Social Security Departments to sit on their hands. It is not my place to speak for Social Security, but I can speak for my Department and I am able to say that we are absolutely united in the necessity for us to face our challenges head on. It is not acceptable for us to leave this for our successors to sort out. My job – our job - is not to ignore tough challenges; our job is to inform and lead open and honest public debate on the state of our public finances. The personal tax, benefits and pension review is not about a binary choice between a consumption tax and no consumption tax. It is about planning to ensure that we can sustainably afford our public services in 2025 and beyond. Our job is to ensure that the community and its elected representatives fully understand the consequences of choosing to finance its public services through an increasingly narrow tax base. I hope that you will work with us to ensure we have an informed and constructive debate. Thank you.

Gavin St. Pier
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