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The Big Spend

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On 11th September the States published a 159-page paper the "Funding and Investment Plan". It is a document exploring considerable detail.

In summary, we conclude as follows:

1. Proposition 1 to temporarily stabilise the financial position, should be voted through. The proposition is not clear on cost cuts.
2. All of the other propositions have major drawbacks.
3. We are not in favour of significant further borrowings (at a realistic rate of 7%) The assumption for investment return is 5%, so why should we borrow rather than sell investments?
4. We estimate that less than £100m of the proposed capital expenditure headlines is really essential. Capital spending should very tightly controlled. Reductions must be available.
5. Until it is proved we need to introduce GST, it should not be introduced. We have major concerns that the rate will not stop at 5%. We see a need for a significant effort to achieve cost savings and not to introduce new spending. The Plan assumes this austerity, but the States are already working on proposals which would worsen the fiscal position.
6. If we see the States attempt to fund all it seems it wants to, then spending will way exceed income. GST rates as high as 20% could well be with us in a few years, along with painful borrowings and the sale of our investments.

It is easy to get confused as you will see. But we do our best and have tried to focus on the main things.

In June 2021 £160m of the proceeds of the 2015 Bond Issue were diverted from their original purpose, which was as the then (2015) Chief Minister said "*The bond issuance is not about raising money to spend on public services. It is about refinancing more cost-effectively our States-related trading entities, all of which have income streams to support their own borrowings*." The £160m is already allocated to capital projects, whatever else is now decided on the propositions below.

The States offer 4 options to address the fact that "the financial position of the States require urgent attention".

First just tidying up – all of the options below assume £3m a year for the development of “Guernsey Work Plan priorities”. Doubles all round for the consultants! (What do the civil servants do?)

Also, they all assume that £20m (in addition to the headline numbers in each Proposition) of “Minor Capital Expenditure” is to be incurred every year.

Proposition 1.

This is essential but inadequate.

The first option, (contained in Proposition 1) is said to “temporarily stabilise the position” (in reality it’s a sort of very holey financial parachute) then breaks down into 4 headings (a) to (d) below:

(a) “Implementing the package of core cost reduction targets …” – in vain will you look for a decent list of savings – it is simply an assumption of £10m pa in 5 years’ time from somewhere. The Policy and Resources Committee has already acknowledged that this will likely not be achieved.

Its rather pathetic - £10m is roughly 1% of annual States expenditure and we are targeting achieving that in 5 years – in reality we probably would not be able to clearly see such a tiny saving in amongst inflation, accounting changes and changes in services. In 2022 the States budgeted £3m of cost savings and none were realised – no-one seems to have been held responsible.

The Chamber of Commerce has just published a paper (https://guernseychamber.com/wp-content/uploads/2019/04/Funding-and-Investment-Plan-Review-Final.pdf) on this Plan. This recommends as an urgent review to reduce the costs of the Civil Service pension Fund. We strongly support this. It is alarming that Civil Servants get so much better a pension than the private sector. Several hundred million pounds can be saved over time. This is not mentioned in the Plan.

Then there is the implementation of a tax on large multinationals (over -£750m revenue) estimated to raise £10m. The remaining £5m of extra corporate taxation is vaguely assumed to come from half a dozen other revenue raising sources that are to be reviewed. It seems odd that these have not been finalised.

Taxes on transport are to raise £10m (as yet unspecified). An annual tax on motor vehicle ownership is to be "prioritised". But actually, it is now in the Plan assumptions.

(*One potentially very significant review is to look at taxing "accumulated, untaxed, undistributed profits in Guernsey resident companies". This could apply to family investment companies or amount to retrospective taxation on trading companies. This would greatly reduce the fiscal attractiveness of Guernsey with a very significant impact likely. A thinly disguised capital tax seems to be being thought about).*

(b) "Maintaining the current level of the General Revenue Reserve for this term".

As usual many taxpayers will not know what this really means. It is easy to follow investments, borrowings, cash spending and tax raising but this is not what movements in General Reserve seem to be.

Maintaining the General Revenue Reserve actually means neither selling investments nor not spending any annual surplus. It is unclear what happens if we have a deficit!

Why would we borrow rather than sell investments – which is the proposal?
If you use the assumptions in the Plan you would earn on average 5% on the investment portfolio which you would lose if you sold the investments – however we would pay around 7% currently for long term fixed rate borrowing. You do not need a Nobel Prize in economics to appreciate which is the better option if the assumptions are valid.

The General Revenue Reserve comprises £112m of Guernsey Health Reserve, £15m of Seized Asset Reserve, £15m of Insurance Deductible Reserve and £327m of "unallocated". Confusing it is.

There are segregated assets to support the Health Reserve which investments it is proposed under Scenario 2 are to be largely sold to fund the "Our Hospital Modernisation Programme".

The term “reserve” should be dumped. In practice any Government can raid reserves in line with its then priorities. The current Government is doing this in these proposals for both the Bond proceeds and the Guernsey Health Reserve.

(c) Investing (mostly really spending) of “up to £95m” (or £96m depending on the page) to complete the 17 “in flight” capital schemes.

These are schemes that are already in progress – despite a statement that full details of these schemes can be found in Appendix 5 – they are not there. There is a list of 20 projects (without attributable spends – why not?), including some completed projects, in Appendix 7. But it is hard to form any opinion on these other than that stopping projects halfway through is generally an unattractive act!

(d) “Investing in the policy, strategies and plans agreed as part of the Work Plan over the remainder of this term of government.”

This seems like a good idea but would obviously be constrained financially given the constraints of this Proposition 1. It is however a bit vague.

AND IF PASSED:

Proposition 2, Scenario 3

The structure of the proposals put to the States is that if Proposition 1 is passed then they would move to Proposition 2 – which is helpfully also called Scenario 3. (It is all too easy to see members voting for the wrong thing.)

This Proposition 2 is the full dose.

All the tax measures and GST implementation (itself targeted at £75m of income each year) that were put forward a few months back and rejected are up for another go (with inflation increases). New borrowings of £350m would be raised. £520m of "investment" would be undertaken.

This is part of a revenue raising set of rescue measures which bizarrely starts by a fairly major income redistribution such that the top third of taxpayers bear not just the cost of the desired capital and revenue spends but also the cost of an improvement in the net income for the rest of the population.

To get out of a hole you first make it bigger?

You may or may not agree with this redistribution policy but surely it should not be buried in a financial rescue? It obviously increases the tax to be raised.

If this Proposition is passed, Guernsey will have an increase in households who are net takers from the States from 2 in 3 households to around 3 in 4 households.

The UK is less than 1 in 2.

So, we get:

"The….package of tax measures as described in detail in Billet d'État II, January 2023 raising an estimated £59m (vs 2023 baseline) incorporating:

• The application of a lower rate of personal income tax at 15% to income up to £30,000.

• A £600 increase in the personal income tax allowance.

• The restructure of the Social Security contributions system to apply an allowance and align the definition of income for all contributors (requiring an increase in rates to compensate for the lost revenues) and the application of a 2% rate for employers on the income earned by their employees between the Upper Earnings Limit and £250,000.

• The application of a broad-based GST.

• An increase in pensions and benefits sufficient to cover the estimated impact of the GST on inflation, applied before the application of the GST.

• A cost support *(GPEG Comment – it's an increase in income)* scheme available to low-income households who are not in receipt of income support at an initial rate of £450 for a single adult and £675 for a couple."

We also get “A capital portfolio with an estimated total cost of £520m from 1st January 2023 to completion, including £5m for pipeline schemes and £30m for an unforeseen contingency.”

Some time ago GPEG produced a paper (see our website) on capital expenditure.

There are 3 broad types of capital expenditure; essential works (water, roads, medical equipment etc); nice to have – not economically justified but good for the standard of living (sport, cliff paths etc) and investment which is economically justified as it generates a return sufficient to justify its cost (electricity, broadband, etc).

According to our Chief Minister NONE of the proposed capital expenditure is economically justified expenditure.

And it should be appreciated that capital expenditure does not mean the spend is “infrastructure spend” – some people assume that all capital spending is good for the economy. It isn’t – wasted expenditure is just that – even if is labelled capital!

Rather oddly the “Transformation” projects (£25m in this scenario) are not in the £520m capital spend and obviously have costs but without apparently any benefit in the projections. Given the dire outcome of States IT transformation expenditure in recent years, benefit might well not exist.

Something to be aware of – the “Transformational” spends are rather treated as one-offs. Labelling regular spending (e.g. computers in schools) as “Transforming” makes things look better…..

Just the interest cost of funding the £520m with commercial debt would be around £36m p.a.. , roughly £1,000 per taxpayer each year. Any repayment obviously increases this in cash terms.

It is not possible from the information provided to work out what capital spend is essential, but it is probably less than £100m of the Scenario 3 £520m. “Nice to have” spending is therefore something like £420m.

Also added under Proposition 2, scenario 3, is a pet project fund.

“In addition to the increase in funding made available to the capital portfolio this scenario allows for £2.5m per annum to be ringfenced for new initiatives that result in a social or community benefit such as a green fund that could be

used to provide insulation credits to encourage homeowners to make energy efficient homes and/or funding for arts or sports initiatives."

We wonder how this apparently unrelated, deficit increasing, fund got introduced in a financial rescue package and agreed! Definitely there is a sporting chance that this was part of a deal to get the more members to vote for GST. You hope not but…

General comments – these broadly apply to all scenarios:

- Guernsey is like most Governments which routinely greatly overspend their capital estimates. It would not be a surprise if the £520m became £800m. The Guernsey Press has very recently reported a 50% overrun – some £30m in the construction of the new Les Ozouets campus. This is a fairly normal outcome. (We do not know if the £30m is in or out of the projected expenditures in the Plan.)

- The Island lacks adequate resources to deal with this volume of spend. Our already overstretched construction and project management capabilities will choke and costs will rise and timescales extend. Public spending will crowd out the private sector. The Funding and Investment Plan does in fairness point this out – **this is a very real threat**. There will be adverse economic effects if we try (and likely fail) to get all the Scenario 3 (particularly) capital spend done in a few years.

- THE ELEPHANT. There is no provision for the costs of the electricity strategy. But it will be several hundreds of millions and could rise to a billion.

- The Plan also points out the absence of provision for the Guernsey Housing Authority capital need of around £100m to develop the States' Affordable Housing Programme.
- These two items are likely to happen and potentially make a real mess of the island finances and taxes.

Proposition 3, Scenario 2

If the Members don't vote for the previous option, then they vote on this one. Capital spend is cut back to £440m. However, there are important other differences from the previous Proposition.

We could not readily grasp the actual impact of the following "The States have approved plans to increase the percentage contribution rates to the Guernsey Insurance Fund (GIF) over ten years and the Long-Term Care Insurance Fund (LTCIF) over four years. This could be replaced by a restructured system of contributions raising an equivalent amount of revenue." Whatever the effect it applies to Scenario 1 too.

The big difference from the previous scenario is that there are no tax changes apart from those in Proposition 1. No GST etc.

£200m would be borrowed and the Health Service Reserve investments would be raided for £90m.

The big drawback of this is that it does not provide anything that looks like a sustainable tax and spending regime.

And finally if you don't vote for the previous two-

Proposition 4, Scenario 1

As scenario 2 but with capital spending cut back to £190m. No new borrowing.

A hopeless expedient which would be a very short term "solution". It might however conveniently leave the further aggravated problem to the unfortunates in the next States.

This proposal is (deliberately?) unrealistic.

A Few Concerns

The Plan's authors do address the larger uncertainties associated with all the Propositions.

Probably most alarming is a statement that "The GWP includes a range of workstreams which may result in additional cost to the States once policy work is concluded and proposals for changes to service provision are brought back to the States." Long term care could be a big bill. Equal pay, housing and the Health Strategic Portfolio are potentially large bills but, rather improbably, we have 20 Strategic Portfolios – all with costs. Net Zero could be a big bill?

Given the propensity of the States to vote through expenditure, concern is appropriate – tax (probably GST!) could well have to rise further. As ever we remain as an economy critically dependent on the financial services industry and a downturn there would be very bad for the economy. High taxes cannot do other than hurt that industry.

But the largest issue is the non-funding of the electricity spending.

However, you get the clear impression that the civil servants drafting the paper could be fairly readily willing to express the following view:

The projections that great effort has clearly been into, will be rapidly obsoleted as overspending piles up and further expenditures are voted through in the States.

GST would doubtless be the easiest substantial tax to raise…

We now have 3 categories of spending, revenue expenses, capital spending (watch for the £20m pa in "Minor Capital" often not mentioned) and transformation spend, the last of which offers flexibility in quoting numbers!

We will not trouble the reader with a detailed analysis of the financial projections but please note that "Transforming" expenditure is omitted from the summary projections in Appendix 3 of the Plan as is anything to do with Social Security where the spending (and its deficit) hides within a reserve.

We struggle to tie the assumptions stated in the Plan with the projections themselves. For example, the inflation assumption after 2024 is stated at 2.5% pa and assumed GDP growth of 0.5% pa. Ignoring the minor effect of compounding, you would expect General Revenue revenues to grow at £18m (3% x £595m) pa. It doesn't – Appendix 3 shows a growth of £2m-4m in each of the years to 2032. It may be somehow linked to a non-obvious inflation benefit shown in adjustments. (*In passing, The States are now forecasting*

(Appendix 3) some £24m on IT resilience revenue spending from now to 2032 – this is a very large figure.)

What Should We Be Doing?

You cannot really avoid Proposition 1. It should be voted through.

Civil Service pension rightsizing and other cost reductions need firmly to be implemented.

The full capital proposals will choke local construction capacity. For this reason alone, capital spend needs pulling back from scenarios 2 and 3.

We should recognise that a great deal of the proposed expenditure is "Nice to Have" rather than being essential, nor is it self-funding from economic benefits that the spend generates. We should put capital spending on a tight monetary limit and only do the Nice to Have projects that this allows.

Electricity needs careful consideration in its financing.

And until we have a better future economy the States should stop adding to costs with continuous new spends – by all means they should prioritise important things, but they should be willing to cut spending to less deserving areas to balance the books when implementing them.

GST

GPEG is not in favour of GST but if after implementing a careful review of cost cutting and a hard review of capital spending there is still a revenue gap then needs must. This more demanding level of review has not happened.

If we see the States attempt to fund all it seems it wants to, then spending will way exceed income. GST rates as high as 20% could well be with us in a few years, along with painful borrowings and the sale of our investments.

Appendix

GPEG Comments on the Funding and Investment Plan Review issued by Guernsey Chamber, October 2023

In summary form and not in priority order. This should be read in conjunction with the Chamber's Review.

1. We do not share their conviction that the full tax package proposed is needed– energetic cost savings and hard selection of capital projects would help a great deal.

2. Chamber do not seem to have picked up on the warnings as to still further States expenditure on a range of areas. Most notably the absence of funding for the Electricity. If all the expenditure in the Plan is made or exceeded and a further several hundred million is spent on Electricity, this will be followed by potentially large tax rises well beyond those in the Plan.

3. We share Chamber's disdain for the feeble efforts at cost cutting. Weak government. Chamber details some of the low-hanging fruit. But these are the small numbers.

4. The, apparently unrelated to the Plan, new annual cost of £2.5m for vague "social" or "community spend" is not commented on by Chamber.

5. The Plan has an assumption of 5% pa return on investments and 7% pa in borrowing cost. Chamber thinks we should borrow.

6. Chamber has a good idea in seeking to reduce the economically inactive 40-60s by getting them into employment. However, we do not see that increasing productivity, or improving housing for young professionals, as is suggested, would do this.

7. Chamber has remarkably proposed "Give us GST but not yet" – they, for reasons unstated, want inflation down to 1% to 3% for implementation before a backstop date of 2028. It's likely that the target would not be reached before the backstop. We do not know if the Chamber would trigger the rest of the package earlier.

8. Chamber seems to presume that capital spending is inherently good for the economy. In reality it will do nothing, or worse, for expenditure into assets of no or low economic merit.

9. We liked the income tax and GST analysis.

10. Chamber does not seem to have taken on board the very real concerns on the capacity of the island, especially construction activities, that the proposed level of capital spending will consume. The private sector will be "crowded out", prices will rise, and delays worsen in what already is a sector with real problems.