

The Government's Rebalancing Strategy

Some Comments from the Review Team on the Scope of Government

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1 INTRODUCTION

- 1.1 On 8 February 2012 we met with the Chief Minister to seek his input into our discussions on the delivery of Government services by alternative means, a subject on which we had been asked to report. At that meeting, the Chief Minister extended an invitation to us to contribute our thoughts to Government's on-going discussions on how best to respond to the effects of the renegotiation of the revenue sharing arrangements with the UK Government.
- 1.2 We set out below; our response to this invitation which we hope will be of some value to the Chief Minister and Government in the difficult and important work of planning Government's activities over the rest of the life of the current House of Keys and beyond.

2 GOVERNMENT'S REBALANCING STRATEGY

- 2.1 The loss of revenue arising from the renegotiation of the revenue sharing arrangement (plus some reductions in projected direct tax receipts) amounts to an estimated £205M in 2013-14 or approximately 24% of gross revenue and is a major challenge to the new Government and the new House of Keys. A rebalancing strategy such as has been adopted, is the only sensible approach to the problem and the Chief Minister and his Government are to be congratulated on the determination that it has expressed to get its finances back in balance by 2015-16 and on the willingness it has declared to make the difficult decisions that are necessary to achieve this.
- 2.2 The scale of the problem and Government's response are shown in the 2012-13 Isle of Man Government Budget documents:-
- The annual loss of tax revenue was £100M in 2011 and is estimated to increase to £214M in 2015-16;
 - Government proposes to meet part of this shortfall in revenue by increases in taxation and charges (rising by £26M p.a. by 2015-16) and more significantly, by spending reductions (falling by £103M p.a. by 2015-16);
 - The remaining shortfall will be met in the 5 years 2011-12 to 2015-16 by drawing moneys from the Reserve Fund (£76M) and by withholding revenue contributions to the Capital Transactions Account (£335M);
 - Government anticipates that by the end of the rebalancing in 2015-16, i.e. during the life of the present House of Keys, annual income and expenditure will be brought into balance at a figure currently estimated at £581M.
- 2.3 Government's rebalancing strategy has as its aim, the rebalancing of the Budget by 2015-16, so that there will be no requirement to utilise reserves for ongoing spending commitments after the end of 2015-16. We have a concern that this may not be a sufficiently ambitious strategy, but we will revert to this a little later. First of all, we will comment on the strategy as it stands.
- 2.4 In the public and political mind the most sensitive part of the rebalancing strategy is the reduction of spending on services, shown in paragraph 2.2 above as being

£103M p.a. by 2015-16. Government's estimates for 2012-13 show that by the end of the current year, reductions in spending will have reached £63M p.a. This means that by the end of March 2013 Government will be close to two-thirds of the way to meeting its target and that the remaining £40M p.a. must be achieved over the following three years. This £40M represents about 4% of gross expenditure, an annual reduction of 1.33% p.a. on average. But this is a reduction in projected rather than actual spending; a reduction in what might have been. Over the same three year period Government expenditure is actually estimated to rise by £42M.

- 2.5 It is hard to conceive that such a level of savings would not be achievable. Indeed we would be confident, provided there is no major occurrence which impacts on Government's income or liabilities, that a combination of:-
- a. Economic growth;
 - b. Increases in Government income;
 - c. A Change Agenda based on the Alternative Means of Service Delivery and Value for Money issues we have promoted in our reports in 2006 and 2012 and;
 - d. Continuation of Government's current 'top slicing' approach to reducing expenditure

should be sufficiently effective to achieve the £40M target within the prescribed timescale. We comment on each of these four elements below.

3 ECONOMIC GROWTH

- 3.1 The prosperity of the Island over the last generation has been characterised by the inter-related issues of a growing economy, full employment and an improvement in the population profile. Economic growth and full employment have raised standards of living and have led to buoyancy in Government's revenues. The increasing size of the workforce necessary to deliver that economic growth has resulted in a more balanced age profile in the population, which previously had been skewed towards those of retirement age. A continuation of these trends would be of enormous assistance to the Government in its rebalancing strategy.

The Economy

- 3.2 It would be ideal if the economy were to grow sufficiently rapidly for tax revenues to increase to the extent that the budget would rebalance itself, thus solving the problem. Whilst this is very unlikely to happen within the timeframe of the rebalancing programme, any level of economic growth will help in the rebalancing and the more rapid the growth the better. Government should and, no doubt, will pursue economic growth to maximise this increase in income and to minimise the need for reducing services, but economic growth is not in the Government's gift and cannot be guaranteed.
- 3.3 Whilst the economy has performed well, there are uncertainties about the future growth of the UK, European and World economies. It is not impossible, if the wider economic situation worsens, that the Island's economy could contract, making the budget situation worse. But that is pessimism and in the longer term, the best hope

for restoring Government income to the levels of the recent past, is a strong and sustained economic growth.

Employment

- 3.4 The Island has enjoyed full employment for many years and that must continue to be the aim. Not only does full employment maximise wealth and the standard of living, but it engenders self-respect and minimises the welfare expenditure associated with supporting those who are unemployed. Conversely, a failing economy and rising unemployment would result in young people leaving the Island in search of better prospects. That would reduce the standard of living, Government's ability to sustain services generally and would result in a deteriorating age profile.

Population

- 3.5 In 2006, the proportion of the population aged 65 or over was 17.04%. In 2011 that figure has risen to 17.7%, reversing a reducing trend of the last 20 years or so.
- 3.6 Projections from the Economic Affairs Division of Treasury show that the number of older people within our community will continue to rise rapidly. In the period 2006 to 2026, the projections indicate that:
- The population of the Isle of Man will grow by 14%;
 - The number of people aged 65+ will grow much faster, by 59%;
 - The number of people aged 75+ will grow even faster, by 63%.
- 3.7 If the economy grows, it is likely that the workforce will also grow. This will mean that there will be an increasing number of contributors to assist with the funding of services to dependent sectors, particularly the elderly.
- 3.8 To digress from our theme for a moment - Whether or not the population of working age and the national income produces growth at a rate sufficient to sustain public services to the elderly at the level to which we might aspire, there is a need to recognise the implications for public services of an increasing number of elderly residents. It seems to us that it is time for there to be a study which identifies the scale and proportion of resources, particularly health, social security and social services which are devoted to the care and support of the elderly. This level of resource needs to be projected forward as a first step in assessing what the requirements will be and whether or not they are likely to be sustainable and/or whether any changes in policy will be necessary.

4 INCREASES IN GOVERNMENT REVENUE

- 4.1 It is important to look at the contribution that increasing income can play in the rebalancing strategy. On the revenue side there are a number of options.

Use of Reserves

- 4.2 It is a proper use of reserves to reduce them in order to assist the phasing in of the new lower levels of income and some diminution of reserves should feature as a part of the rebalancing. As we would expect, the run-down of reserves planned by

Government will be greater in the early years and then taper away to zero as the rebalancing takes effect. In addition, use of reserves has a diminishing value as an option because reserves are of finite size. Also, there are further uncertainties ahead and it would not be sensible to run reserves down too far. There will always be the need for reserves and some must be kept for future eventualities. Current Government plans are reasonable, but we would not wish to see any increase in the use of reserves beyond what is planned.

Sale of Assets

- 4.3 It is self-evidently bad practice to sell assets in order to fund current revenue expenditure and asset sales could not, in any event, be a major contributor to the rebalancing exercise. However, if there are surplus assets or assets that can be made surplus to needs or sold off as part of a privatisation, the proceeds of their sale could (and should) be added to the Capital Transactions Account and used to help in the financing of future capital projects. This could have the effect of reducing the revenue costs of the capital programme. However, we would not see sale of assets as being more than a modest contributor to the wider strategy.

Borrowing

- 4.4 Borrowing should only be an option in relation to funding capital expenditure and it, therefore, does not solve the problem of rebalancing Government's revenue account. Also borrowing requires future repayment so merely serves to defer the reckoning until a future date. Whilst acknowledging that borrowing might be used to provide a bridge during a period of particularly tight finances, we would be very concerned to see external borrowing making a direct contribution to the Revenue Account rebalancing strategy.

4.5 Increased Tax Receipts from Growth

Discussed more fully in section 3 above, this is dependent on economic growth, which is always unquantifiable in advance, but hopefully, tax receipts from growth will be the biggest contributor to the rebalancing programme on the income side. Generally we consider it would be sensible for Government to plan on a continuation of recent economic trends and to calculate its estimates of tax receipts accordingly; albeit there needs to be flexibility built in to Government's planning to allow for fluctuations and the inevitable differences between estimates and outcomes.

4.6 Increased Rates of Taxation

The scope for addressing the imbalance between income and expenditure through changes in taxation is very limited. Indirect taxes are, in effect, determined by the UK Government. Direct taxes need to be kept in line with competitors so as not to prejudice the economy. If there is some scope for increases in taxes which would not harm the Island's economic prospects they should be considered. There is the option to peg personal allowances so that income tax receipts increase in real terms and there may be some room for manoeuvre at the margin at the higher rate of personal tax but generally, we would not see changes to tax rates, direct or indirect, making more than a moderately useful contribution.

4.7 **Increased Local Taxation**

We point out below (paragraph 7.2) that local taxation (rates) is lower than in the United Kingdom (Council Tax). This suggests that there is scope for some part of Government's expenditure being met from an increase in local taxation, either by transferring functions and relevant funding responsibilities to local authorities or by Government raising additional revenues for services directly through the local taxation (rating) system. (If revenues from the rating system are to be increased substantially, it may be necessary for reforms to be made to reduce unfairness due to inequalities associated with outdated rateable values and to make it more progressive e.g. by introducing a rate rebate scheme).

Fees and Charges

- 4.8 Treasury's income for 2012-13 is estimated at £485M (principally taxation), but Government's total estimated income for 2012-13 is estimated at £842M. There are, therefore, other sources of Government revenue - fees, charges and contributions etc., which amount to some £358M annually. There is the potential for these sources of revenue to make a contribution to the rebalancing programme. They should be reviewed annually and increased, generally, at least in line with inflation. Where any fees and charges are found to be unduly low or where untapped sources of income are identified, increases greater than inflation or new fees and charges should be considered.

5 A CHANGE AGENDA

- 5.1 In our reports of 2006 and 2012 we have made a series of recommendations relating to Alternative Means of Service Provision and Value for Money. We believe very strongly that our recommendations under both headings, if vigorously pursued, have the potential to make a significant contribution to the rebalancing strategy.

Alternative Means of Service Delivery

- 5.2 This was a matter discussed in our 2006 report and has been the subject of a separate and current follow up report. It is noted here, albeit briefly, for completeness.
- 5.3 We have defined Alternative Means of Service Delivery widely to include three distinct types of organisational structure:-
- Services delivered through outside agencies;
 - Services delivered within the Government structure (using Executive Agencies);
 - Services delivered through the local government structure.

All of these differ from the traditional form of Government service provision which uses directly employed staff, with political involvement in day to day executive decision making.

- 5.4 In our most recent report we recommended that as a general principle there should be a presumption that, subject to certain exceptions, all those Government services

which are now delivered in the traditional way should, in future, be delivered through one or other of the alternative means of service delivery that we have identified. We attached to this presumption a number of guiding principles to help identify those services which should remain subject to direct delivery by Government.

5.5 The benefits we see flowing from this are:–

- A reduction in the scope of Government;
- Improved value for money (most important from the point of view of this paper);
- Separation of policy and operation;
- Separation of service delivery and regulation;
- Improved transparency.

Value for Money

5.6 In our report on the Scope and Structure of Government in 2006 we said of value for money that:-

'This is the core of our report and underscores all that we propose, as all the areas of improvement which we discuss later have, as part of their rationale, the improvement of Government value for money.'

We also said:-

'the scale of Government's operations is such that even a small percentage improvement in value for money would produce very sizeable savings.'

This did not seem to strike much of a chord in 2006 (Government's expenditure continued to grow rapidly until 2009), but, the sort of enthusiasm for reform we advocated in 2006 is now much in evidence and we more than welcome that. Significant savings have been made and Government has committed itself to more. Hopefully this will yield real dividends in the task of rebalancing Government's finances.

5.7 We particularly welcome the steps that have been taken to centralise some of Government's common services. This was a specific recommendation in our 2006 report. Also in the 2006 report was another recommendation which has not been taken on board with the same enthusiasm and which is, in our view, very much more important and potentially very much more beneficial. The recommendation was:–

'Government should commit to programmes of regular and systematic external benchmarking and expert external reviews of service provision driven and coordinated centrally which, over a period of time, would potentially cover all significant areas of Government service provision.'

5.8 We envisaged this being driven and coordinated by what we called the Department of Corporate Development, but, no doubt, some alternative central mechanism that was sufficiently robust could be made to work. We are firmly of the view that the

implementation of this recommendation would yield important savings and would ultimately give assurance that Government was providing real value for money in its delivery of services. It is not a comfortable recommendation to embrace, but comfort is surely not at the top of Government's current agenda.

6 TOP SLICING

6.1 Government claims to have reduced its expenditure so far in the rebalancing exercise by £63M (albeit net expenditure has continued to rise) and has reduced its personnel budget by approximately 300 fte. This has involved reviewing existing operations and identifying areas, preferably not front line services, where savings are possible which do not impact on services – discretionary spending, optional extras, over-specified services and marginal activities and budgets. These results have been achieved at little detriment to services. These savings have been made by a top-slicing process with Council of Ministers and Treasury telling Departments to slim down to a centrally determined cash limit. No doubt this process can continue, albeit with increasing annual difficulty as cuts get closer and closer to the bone.

6.2 Top Slicing is, in a sense, the mirror image of the usual budgetary process, but instead of the process being used to allocate increases in expenditure, which has been the norm, what are being allocated are reductions. This is an iterative, democratic process, which involves:-

- The Council of Ministers, advised by Treasury, allocating overall savings;
- Each Department defending its services during the process of allocating savings, then using its in-depth service-specific knowledge to identify where cuts might be made;
- Treasury scrutinising Departments to limit 'shroud waving', to ensure that sensible proposals are brought forward and then that agreed savings are implemented;
- Departments will need to identify to the Council of Ministers for discussion those proposed savings which are likely to be particularly sensitive and there should then be an involvement of Tynwald Members to build the greatest possible political consensus.

6.3 As the annual process of top slicing continues, increasingly politically sensitive areas of expenditure (which can sometimes be quite small in cost terms) will come under threat. So there needs to be a mechanism which allows for the identification of problematical Departmental proposals and allows a sufficiently wide political consultation on those proposals to ensure that better options are not missed.

7 SOME ISSUES IN RELATION TO REDUCTIONS IN EXPENDITURE

- 7.1 Reducing existing levels of spending is potentially a difficult, even fraught, issue. There are some general points that should be made:-

The United Kingdom Yardstick

- 7.2 Our public services have long been broadly comparable to those in the UK. Public and political opinion has always insisted on nothing less and, in fact, recent buoyant revenues have allowed greater levels of spending, per capita, in respect of some services, than in the UK. Following the renegotiation of the revenue sharing arrangement, the situation has changed. Total tax revenue as a percentage of national income will in future be significantly less than the comparable UK figure. This relative lack of financial resources is compounded by:-

- The fact that local taxation (rates in the Island/Council Tax in the UK) is also relatively low on the Island compared to the UK and
- The Island, in many public services, is unable to enjoy the same economies of scale as larger communities in the UK.

There must be a presumption from this that, unless and until economic growth can redress the position, our public services in total, will not be maintainable at UK levels. A particular question mark should be placed against any service which is more generous or is, without obvious good cause, more expensive per head than in the UK.

- 7.3 We do not have the resources or information which would allow us to quantify the disparity which we anticipate between the Island and the UK. But it seems to us to be important, in the context of the public and political debate that must take place on the rebalancing strategy and on priorities, that the disparity is quantified and we would certainly urge the Government to undertake that exercise.

The Impact on Services to the Individual

- 7.4 It is an oversimplification, but a useful one conceptually, to assume that Government's expenditure can be divided into two parts:-

- a. **Collective Services:** Expenditure on matters which provide, protect and develop the economic and social fabric of the Island as a whole for the benefit of all and
- b. **Individual Services:** Expenditure on the health, education, welfare and the quality-of-life of individuals. (Broadly this equates to the expenditures of the Departments of Education and Children, Social Care and Health which amount to £583M or 66% of Government's gross expenditure.)

- 7.5 The collective services largely pre-date the individual ones as responsibilities of the Government and they include expenditures which are intended to ensure the security and continuity of the Island, law and order, justice, public health, infrastructure and the facilities and services that are necessary to enable the Island's economy to function and grow.

- 7.6 The individual services are there, primarily, to help the sick, the elderly, the young and those faced by particular difficulties and disadvantages, financial or otherwise. For those individuals who do not fall within these categories the benefits they receive from Government's expenditure are limited to the shared benefit in the common good created and sustained by Government's expenditure on the collective services and the assurance of the availability of individual services as and when necessary.
- 7.7 The Island is confronted by the need to reduce its expenditure very significantly. Some of this reduction will be achieved through efficiency savings (see below). Some will come from Collective Services expenditure where, no doubt, there are some economies to be made. But the scope for savings on Collective Services is finite. There is an irreducible minimum which must be spent to ensure the Island's social and economic well-being and it is improbable that savings on Collective Services will be sufficient on their own to allow Government to balance its books. It follows therefore, that there will be a need for savings within the expenditure on Individual Services. As indicated above, this expenditure is devoted to helping the sick, the elderly, the young and those faced by particular difficulties and disadvantages. It therefore also follows that these groups cannot be wholly exempted from the effects of the expenditure cuts that will be necessary. Indeed, it must be the case that the greater the total reductions made in expenditure, the greater the amount and the proportion that must be borne by Individual Services.

The Effects on Services – the Alternatives

- 7.8 In determining where economies are to be made which will have a real impact, there are three alternatives:-

a. Reducing the Scope of the Service

This involves redefining the boundaries of the service, usually in relation to Individual Services. Who should be eligible to receive a particular benefit, for instance?

b. Reducing the Quality of the Service

Quality may be varied to match resources available. This can apply to either Collective or Individual services e.g. the quality of service standard, the specification for a piece of infrastructure.

c. Reducing the Amount of the Service

This can apply to either Collective or Individual services. The reduction in service can be partial or complete and it can be temporary or permanent.

Any plan to reduce expenditure will include a mix of these three.

Staffing Costs

- 7.9 Government will spend £296M in 2012-13 on salaries and wages. This represents almost 33% of total gross expenditure. In the case of the Department of Education and Children, salaries and wages are 67% of gross expenditure and in the case of the Department of Home Affairs the figure is 71%. Salaries and wages are therefore a huge component of Government's expenditure.
- 7.10 In 2006 we were clear that the scope of Government needed to be reduced. One piece of evidence that helped to make the case about the size of Government was some research undertaken by KPMG for the States of Jersey in 2004 which showed that the cost of Government services per head of population was higher in the Isle of Man than in a number of other small financial services jurisdictions – Bermuda, Cayman Islands, Gibraltar, Guernsey and Jersey. Our figure was 30% higher than Jersey and 61% higher than Guernsey.
- 7.11 More recent data published in July 2010 by a Working Group chaired by Hon PA Gawne MHK, which reported on HR Management Functions within Government, showed that the number of public sector employees per head of population is much higher in the Isle of Man than jurisdictions such as Jersey, Guernsey, Gibraltar and Malta. In the Isle of Man the ratio is 1:8, whereas in Jersey and Gibraltar, for example, it is 1:13.
- 7.12 The Government's Annual Earning Survey has, in recent years, consistently shown average earnings in the public sector as being higher than in the private sector. (It is not of course safe to assume from this that pay for like work is more generous within Government than outside – the jobs are not necessarily comparable. But, it does suggest that this is a phenomenon which requires investigation).
- 7.13 Still more recently, our revisit of the subject of alternative means of service delivery has produced evidence of some Government workers earning more than their UK counterparts and some restrictive practices and terms and conditions of employment which are outdated, costly and not providing value for money to the taxpayer.
- 7.14 We arrive at a picture which suggests a Government providing too many services, with too many staff, some of whom are too expensive. We are forced to conclude that, if there are to be substantial economies, they cannot be achieved without impacting substantially on staff costs and we believe that that is necessary.
- 7.15 The Chief Minister has publicly stated his aim of reducing staff costs by 10% in real terms over the next four years, so that the overall cost of salaries and wages should be kept at around £300M. Because of the economic uncertainties, we cannot be sure what scale of economies will be necessary. But it may be that this aim will prove to be at the modest end of the spectrum and however difficult it may be to achieve in practice, it is possible that the 10% figure will require upward amendment before rebalancing is complete.
- 7.16 Securing economies in staff costs is not easy:-
- In the case of many professional staff, the Government has to secure its staff in a competitive external market, where the terms and conditions of employment are largely beyond its control. For instance, in recruiting

doctors, nurses, school teachers and others, Government has to offer comparable terms to those offered by other competing employers (principally in the UK) who are seeking to recruit from the same pool of labour. A failure to match the market rate would result in a shortfall of trained staff.

- Reducing existing established terms and conditions, however arcane they may be, involves renegotiating established employment rights and securing agreement on changes with the staff involved, who may have little incentive to make concessions.
- Redundancies yield limited savings. Where Government is the employer any annual savings arising from redundancies must be offset by the unemployment benefit that is payable and by the loss of the individual's National Insurance contributions. There is also the question of redundancy pay which will always affect the viability of a redundancy and which, in some cases, may be a sum so substantial that it cannot be recouped through subsequent savings.
- The Island is particularly vulnerable to industrial action. The Government is the monopoly supplier of most essential services, the disruption of any of which causes, at least, some community discomfort. No doubt, Government, in seeking to economise on staff costs will seek to avoid provoking industrial action. But depending on the issue and the individuals involved some industrial action may occur as part of the process, to the detriment of others.

7.17 Recognising the difficulties inherent in seeking to make financial savings in relation to Human Resources, it is encouraging to note some progress. If we look at total staff numbers, we can see that they peaked in 2009 i.e. prior to the first VAT announcement and that the current figure (2012-13) represents a return to the levels of 2004-05. This is a reduction since the high point in 2009 of 284 or 4% – a reasonable start.

7.18 It is also worth recording the achievement and cooperation of both sides in the recent agreement to reform the current public sector pension schemes and the agreement to introduce a new Unified Pension Scheme for the public service which will take effect from 1 April 2012. This agreement and the reduction in staff numbers must offer some hope for future negotiations on other important HR issues.

7.19 The aim must be to maximise value for money for the taxpayer in the services which Tynwald decides should be provided, whilst providing fair remuneration and terms and conditions for the Government workforce which delivers those services. To the extent that Government's concept of fair remuneration and terms and conditions differs from what currently exists, Government needs to plan how to move towards achieving its aim. It seems to us that there may be merit in determining a set of new and fair structures and conditions of service which would apply, in the first instance, only to new staff appointed after a certain date. There could then be negotiations with existing employment groups about the potential of moving them into the new arrangements and agreeing concessions that might be necessary for such a transfer. This is indeed a major undertaking and under existing collective bargaining arrangements would still require joint agreement even for new recruits, but we would see this providing significant efficiency benefits in the longer term.

- 7.20 All this has inevitable and serious consequences for those employed by Government and for their representatives. Economies are inevitable and it has to be remembered that jobs within Government are there to provide services for the public – not the other way round, and if there is less money to spend on those services there is less money to be spent on those jobs.
- 7.21 In the unenviable circumstances in which the Government finds itself, the representatives of the workforce have a choice:-
- They can simply decide to ignore the circumstances, pursue a narrow agenda and seek to defend their members' position, in which case, they will simply become an obstruction which needs to be overcome, or
 - They can recognise the circumstances and seek to work with Government to secure an outcome that balances the achievement of economies with the best possible outcome for staff, in which case they will become partners in the exercise.

The first choice is easier. But in our view, the second is likely to achieve better results for all those involved.

Establishing Principles

- 7.22 It seems to be an obvious starting point that in approaching the need to cut services we should identify Government's Core Services so that they can be ring-fenced and so that economies can be focussed outside this ring – in the non-Core Services. But we have failed in the endeavour of defining Government's Core Services and have seen some work, worthy in itself, by Government Chief Officers' Group which similarly fails to provide a definition that would assist in the task in hand. We can identify a set of services, historically functions of the Island's Government and of Government's elsewhere which are collectively vital to the continuance of society – security, law and order, justice, infrastructure, public health, services necessary for sustaining the economy etc. These may represent some sort of irreducible minimum but they scarcely represent the totality of Government's Core Services, which even with our reduced income, must be drawn much more widely. In fact, whilst the concept of Core Services is a valuable one in some respects, we feel that it is not capable of the sort of precise definition that is necessary for our purpose. Core Service is a subjective and fluid concept defined differently by different persons and it varies in relation to the funds available i.e. if funds are significantly increased or reduced the definition of Core Services is necessarily rewritten. Core Services in that sense has no fixed meaning.
- 7.23 An alternative line of thought is to define Core Services in terms of the spending decisions taken, so that once decisions on economies have been made and those decisions have been implemented, what is left are the Core Services of Government. Core Services are thus a residue not a starting point. Either way, the concept of Core Services does not seem to have a precise enough meaning to serve as a useful starting point for the rebalancing strategy.
- 7.24 In the absence of a useful definition of Core Services, we are thrown back on the democratic process: on the Island's elected representatives across the whole spectrum of Government making informed choices between different alternatives

which aggregate into a statement of what Government is best able to do with the resources available at any particular time. This is the mechanics of the political/budget process and it recognises that often policy is determined by decisions (rather than the other way round) and that decisions rather than policies are what will be needed.

- 7.25 Determining where economies should be made and the size of those individual economies is a daunting task. There are some thousands of services, large and small, provided by the Government (the health service alone provides many hundreds). These are of hugely varying cost and complexity. Given the number and range of services – we are looking at a vast canvas - no one individual (or small committee) can know all the options available in detail, let alone permutate sensible choices between all the options. All services, however important they are, must be reviewed and tested to identify savings. There needs to be a collective process and that process will need leadership, but there must be an involvement from the whole of Government with the support of Tynwald, within the totality of which lies the necessary knowledge. Much of the task will need to be devolved and delegated to those who know the services best and who can judge where economies will be least damaging and at every level people must participate and be willing to suggest and embrace economies or efficiencies to help the general cause.
- 7.26 Of course there can and should be some central guidelines about making savings but these can scarcely be more than high level safeguards for the more important principles of public service. We would suggest, for example, that proposed economies should not:-
- Cause the Island to be in breach of its international obligations or legal duties;
 - Cause significant harm to the prospects of the Island's economy;
 - Prejudice public safety;
 - Prejudice Law and Order, justice or the access to justice;
 - Result in the loss of essential infrastructure;
 - Prejudice public health;
 - Result in the death, injury or destitution of any resident or the unnecessary breakup of any family.

The Need for Increases in Expenditure

- 7.27 Whilst we are discussing here the need to reduce expenditure, it is important to recognise that there are areas within Government where expenditure will need to increase. We have drawn attention to the importance of expanding the economy. Expenditure by Government in pursuit of this objective must be allowed to increase if the additional expenditure offers good prospects of yielding a sufficient return. In addition, there will be inexorable growth in demand and increased costs in respect of some statutory services. Either this must be budgeted for and met or the statute must be changed. Meeting these needs obviously places a greater burden of cost reduction on other services. The scale of this issue may be seen in the fact that, notwithstanding the economies being effected by the rebalancing programme,

Government's tax-funded expenditure is estimated to rise from £539M in 2012-13 to £581M in 2015-16.

8 THE RESIDUAL DEBT PROBLEM

8.1 We said in paragraph 2.3 above that we had a concern that Government's rebalancing strategy may not be sufficiently ambitious. It is time to return to that point. Our concern is that the strategy leaves three unresolved issues.

- The rebalancing strategy does not reverse the withholding of capital transfers which are playing a significant part in the rebalancing strategy. The withholding of these transfers reflects the fact that Government Departments are not making the same payments into the Capital Transactions Account in respect of capital expenditure that they used to. It was always a very positive aspect of the Government's finances that it was able to fund its substantial capital programme without recourse to external borrowing because Departments made these revenue contributions to the Capital Fund. If these payments are not reinstated, the Capital Fund will be very much reduced and either Government will have to curtail its capital spending or it will need to have recourse to external borrowing.
- The reduction in the Reserve Fund of £76M will not have been made good. In 2009 the then Treasury Minister sensibly suggested that the target size for the Fund should be 50% of Government's gross expenditure. It appears to us that by 2015-16 the value of the Fund is likely to be down to about £310M, some £170M below the figure suggested by the 2009 target. It would be unrealistic to plan in the short term to achieve this target but there should at least be a commitment to remedy the current depletions. In the longer term, the goal of the 2009 target should be pursued.
- There is insufficient provision within the rebalancing strategy to tackle the debts of the Manx Electricity Authority (MEA), whose accumulated indebtedness was shown in 2010-11 as £392M (more than half of which is external) – a sum greater than the balance on Government's Reserve Fund. There is no prospect of the MEA being able to repay a debt of this size out of its normal trading and at some stage; Government is going to have to assume responsibility for much of the repayment.

8.2 In our view, rebalancing in terms of what has been normal for the Government, cannot be said to be complete until:-

- The practice of revenue transfers to capital, sufficient to avoid the necessity to borrow to fund capital expenditure have been reinstated;
- The Reserve Fund has been restored to its pre-rebalancing level and
- A sustainable programme is in place for bringing the MEA debt down to a level where it can be serviced by the MEA out of its own revenue.

As the current strategy does not make provision for these important matters we are forced to conclude that, on current projections, rebalancing will not be complete by the time of the next election and that either it will be necessary:-

- To accelerate the rebalancing, or

- To continue the rebalancing exercise beyond the election, or
- To accept a considerable on-going public debt burden, or
- To use a mix of these options.

8.3 We have endeavoured to translate our three reservations into monetary terms:-

- **Capital Transactions Account**

It would appear that Government's plans for capital expenditure may well be less ambitious than in earlier years when there was a greater requirement to replace aging infrastructure. It is also likely that the Capital Transactions Account had a healthier balance than was strictly necessary to meet Government's capital needs. But in our view, Government should seek to restore the Account to a point where external borrowing can be avoided. We do not know Government's long term capital plans so cannot propose a particular size for the Account. However, if we look at the loss of revenue to the Account over the rebalancing period (£335M) and assume that perhaps 5% of this would be sensible as a restorative annual contribution until such time as the Account is judged sufficient, that could require a revenue contribution of about £17M p.a.

- **Reserve Fund**

The Reserve Fund is to be reduced by £76M by 2015-16. We would favour the phased restoration of this sum over perhaps five years. This would require a revenue contribution of £15M p.a. Restoring the Reserve Fund to a level equal to six months of Government's gross expenditure would have implications for Government's finances going beyond the current rebalancing period.

- **Manx Electricity Authority**

Restoring the MEA to a position where it can service its debt from its own revenues is in part a financial question and in part a political question as to what level of electricity charges would be acceptable to Government. We are not able to prejudge the outcome but for illustrative purposes, if we assume that Government would shoulder £200M of the MEA indebtedness, the annual costs of redeeming that debt over 20 years might be about £10M p.a.

8.4 If we aggregate the above notional annual costs of our reservations we arrive at an additional annual cost to Government of £42M, so that planned savings in expenditure over the three years ending 2015-16 represent only about half of what is necessary to properly restore and rebalance Government's finances. Further economies will be necessary, otherwise, and unless economic growth comes to the rescue, a substantial long-term Government debt must be contemplated.

8.5 How vigorously should Government seek to address the residual debt position? We would advocate an early start but clearly, depending on the degree of vigour, this doubles the size of the remaining task and there is the tempting option of deferring action until after the current rebalancing programme is complete in the hope that the economy will come to the rescue with a substantial boost to tax revenue. If that fails restoration of the Government's finances to their pre-Customs Renegotiation, status

will only be achieved through serious reductions in spending. This would mean that the stresses and difficulties of the current rebalancing programme would continue for some years beyond the life of the current House of Keys. This all presupposes no further serious losses of revenue. Any further losses would obviously have serious implications.

9 MAJOR SAVINGS

- 9.1 We now need to raise the issue of what we would call major savings which we would see as being likely to be necessary if a decision were taken to accelerate rebalancing or if it was necessary to continue rebalancing beyond the timescale currently envisaged. What can be achieved with efficiency savings, top slicing etc. is finite and if significant savings beyond that are required, recourse must be had to major savings which will yield big economies for Government but which, necessarily, will have serious implications for services and/or employment. For the sake of putting a scale on what we are considering here, we would suggest a saving of perhaps £2M to £3M or more would be regarded as major.
- 9.2 The identification of candidates for major savings and particularly any subsequent decisions to implement major savings would be contentious. Leadership of the highest order would be required and it would be necessary to secure the greatest possible political consensus and public acquiescence as part of the initial selection and implementation process. In our view there would be merit in the list of candidate services being a public one to raise awareness, facilitate public debate and encourage acceptance of any subsequent decisions.

Identification of Major Savings

- 9.3 How should Government approach the identification of Major Savings?
- There needs to be an open-minded review across Government coordinated by the Council of Ministers aimed at drawing up a list of possible major savings.
 - Each major saving should be too financially and politically significant for the relevant Department to consider it as a candidate for top slicing.
 - Only those Departments with large distinct areas of expenditure will be able to contribute major savings. (Note that Health and Social Care must be included in this process as they represent too large (56%) a proportion of total gross expenditure. To exclude them would place too great a burden on other services. It cannot be argued that every bit of these services is a matter of life or death and should have priority over everything else done within Government.)
 - In evaluating major savings and deciding their priority, they should not each be looked at in isolation: in isolation a saving on any of them may well be regarded as politically 'unacceptable'. They need to be compared i.e. what is the relative importance of service X and service Y? If there had to be a choice between them, where should Government's priorities lie? The major savings would need to be placed in an order of priority based on the outcome of such comparisons.

- The Council of Ministers will need to identify the major savings initially and then involve Members generally and consult widely. The compilation of the list of possible major savings and any subsequent decisions should be a collaborative enterprise and as great a political consensus as possible should be sought.
- Major savings which are just cash can be delivered more quickly and with fewer complications than those which involve closure of facilities and reductions in staff.
- The prioritised list should be considered and used flexibly. Circumstances can change affecting priorities and if and when the time comes, it may be a valid political judgement to select a larger single item from higher up the list than several smaller, ostensibly lower priority items.

9.4 As an aid to further discussion, we offer a number of possible candidates for a list of major savings. In no sense is this list definitive, nor is it in any order of priority and none of the items listed should be regarded as recommendations. But they do represent an indication of the sort of services which might need to be considered:-

- Charging for some aspects of the Health Service as happens elsewhere e.g. prescription charges;
- Limit some universal benefits to take into account need e.g. child benefit;
- Phase out or limit recipients for the Manx Pension Supplement;
- Curtail university benefit for students;
- Rationalise availability of hospital services in outlying areas;
- Transfer sewerage costs from Central Government to the Water and Sewerage Authority;
- Reduce financial support for agriculture;
- Reduce financial support for social housing;
- Cross-departmental initiatives to jointly deliver outcomes which meet identified needs;
- Mothball/restrict use of Government facilities e.g. Gaiety/Villa Marina Complex.

9.5. While unlikely to qualify as a major saving, it has been suggested that there is scope to expand sponsorship from the Private Sector, targeted at major businesses who do not pay Corporation Tax and whose profits in the main go off Island. The view expressed is that it is not unrealistic for such undertakings to make some contribution towards the budget rebalancing exercise. Unlike existing sponsorship, the proposition advanced is that Government identify and offer packages to such companies in return for advertising. We are not in position to offer an evaluation of this proposal but recognise that it could be an alternative, when viewed in the context of cumulative benefit, as a substitute for some of the 'mothballing' referred to in the preceding paragraph.

9.5 One final point on major savings – we have structured our comments as though major savings are something of a last resort. In fact, if a consensus can be achieved that one or more major savings would be preferable or less disadvantageous and more deliverable than a more numerous series of savings affecting a range of services proposed as part of the top slicing programme, it would be legitimate to pursue this in lieu of the more numerous top slicing measures.

10 REALISM, RESTRAINT AND DIFFICULT DECISIONS

10.1 When we reported on the Scope and Structure of Government in 2006, we argued that there needed to be a change in the political and public expectations of what Government should provide. Government could not be expected to do everything and could not respond to everybody's problems. Events over the last five to six years have more than reinforced our 2006 stance. In promoting this argument again in 2012 in the changed financial circumstances, hopefully we are pushing against an open door.

10.2 Building on the consensus that surely now exists on this, we would argue that so far as possible, there needs to be a moratorium on expansionist proposals in relation to Government services until rebalancing is complete. Capital projects, new legislation and new revenue proposals should be held in abeyance unless:-

- They are essential (international obligations, legal obligations, growth in committed services, matters of life and death or replacement of an essential piece of social/economic fabric)
- They will serve to increase Government's income or reduce Government's expenditure
- They will make a contribution to the growth of the economy

Desirable improvement should not be seen as a sufficient justification for increasing expenditure.

10.3 As part of this change in approach, we would hope that Members of Tynwald would respond in sympathy and move away from the routine diet of questions and motions that expressly or by implication press for more and better services. In the current climate they would at best be a waste of Tynwald's time and at worst a cynical hypocrisy. To be fair, the questions at recent sittings of Tynwald offer some grounds for optimism on this score. But, we cannot overstress the absolute need for a refocusing of political effort away from growth and towards a smaller, leaner, more efficient Government service. We would hope that the public and the media would understand and be sympathetic to this.

10.4 Since the renegotiation of the VAT agreement was first announced, it has been frequently stated that Government will be required to make difficult decisions. Some uncomfortable decisions have indeed been made and more increasingly uncomfortable decisions will continue to be needed as part of the on-going annual top slicing of Government expenditure. Difficult decisions will be needed also in relation to HR matters and possibly in relation to alternative means of service delivery.

10.5 However, most conspicuously, difficult decisions will be needed if and when major savings need to be made. In practice, if the alternatives are properly researched and presented, the decisions themselves are unlikely to be that difficult. Given a series of choices and a requirement to choose at least one, it should be possible for Members to isolate those major saving items of services which if chosen, will cause least harm or be least missed. The difficulty arises in terms of the fear of facing, subsequently, the reactions of those disadvantaged by the choice(s) made and those whose principles or emotions have been offended. It is that fear which may well motivate Members who are not up to the task to opt out of the decision. This is after all, unfamiliar territory to Members who may have spent their whole political careers championing individual constituent interests and pressing for more and ever better services. It will be a time for Members of wisdom, courage and strong stomachs. We can only hope that there are enough of them to give the Island the leadership it needs.

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