

## **Strong Foundations for the future**

### **Introduction**

Madam President, this, the final budget of this administration, is for securing 'Strong Foundations for the future'.

Our focus must now be to move away from managing the immediate and short term effects of the financial challenges we have faced. We have done much to address these issues, we are now looking to the long term future of our Island.

The main objectives of this budget are:

- To build on our achievements,
- To support and grow our economy,
- To set in place the foundations for a sustainable future

We have every reason to be confident.

We are confident because we have delivered what we set out to do five years ago by addressing the immediate financial challenges facing us.

The Island has robust reserves which will support us as we rebalance in the longer term.

And do not take our word for it. Moody's, our credit rating agency, reported in September 2015 that, and I quote.

*"The Isle of Man's Aa1 sovereign rating and stable outlook reflect the island's resilient economy and the government's robust finances. The former is supported by the economy's growth, which is stronger and less volatile growth than that of other offshore centres, as well as its significant diversification away from banking towards high growth sectors such as ICT, despite being a small economy."*

So we are confident for the future.

### **The Economy**

#### Economic Performance

Our economy continues to be one of the fastest growing in Europe – we are enjoying our 33<sup>rd</sup> year of unbroken growth. When this Government came to power, we were facing three major headwinds to our growth.

Firstly, the loss of Government income due to the changes to the VAT agreement meant we have had to substantially reduce the size of the public sector workforce.

Secondly, the global banking crisis caused our banking sector to shrink, resulting in jobs lost, reduced profitability and thus declining corporate tax revenues.

Thirdly, the global economic downturn meant that for several years the earnings of many workers fell in real terms, reducing their spending power. Businesses and households were spending less, affecting the domestic economy.

The fact that we achieved growth throughout this period despite these three powerful headwinds is an impressive achievement. This is a direct result of our policy to diversify the Island's economy which has brought growth in areas ranging from E-Business, to specialist financial services for businesses and wealthy individuals, from manufacturing to tourism. Today our economy is more diverse than ever, both in terms of the over 20 export-earning sectors, as well as the range of global markets served.

To continue this growth and diversification, this Government worked with the private sector to develop Vision 2020 which this Honourable Court approved in February 2014. Since then a wide range of actions have been taken to:

- create the right environment for business to flourish;
- make Government more responsive to the needs of business;
- invest in the Island's future.

Madam President, I will briefly highlight some of the key actions underway.

**Access to capital** is vital to help existing businesses grow and making the Island attractive to new businesses.

- The new £50m Enterprise Development Scheme will create jobs here.
- This Scheme also encourages the Island's private sector to invest too.
- The new alternative banking regime will be launched later this year.
- The Financial Services Authority will put its new crowdfunding regime in place by the end of this year, providing another avenue of finance for business while ensuring appropriate legislation to protect investors.

**Access to land and buildings** is also vital. To counteract the shortage of zoned land available for enterprise, Government is working to bring new Development Orders before this Honourable Court by July to ensure sufficient land is made available until the Eastern Area Plan is updated.

**Effective legislation and regulation** remain vital to many of our key sectors. I believe the new Financial Services Authority has shown it understands that we must both meet international obligations and also innovate to help our businesses create economic opportunities. International regulatory standards are developing all the time and in April this year the Isle of Man faces another major inspection of its defences against money laundering and terrorism financing with the visit of evaluators from the MONEYVAL organisation.

**Meeting the skills challenge** is imperative if we are to remain competitive. We have been successful in attracting many successful global businesses to the Island which need

highly skilled individuals to drive growth. We need more skilled workers in areas including ICT, Engineering, financial services and healthcare. Appropriate education and vocational training to help employees take full advantage of these opportunities and also attracting skilled workers and entrepreneurs to grow our economically active population is essential.

As Honourable Members will recall, Government invested an additional £1m in **Manufacturing Engineering** to provide a new, dedicated engineering training facility at Hills Meadow. This has proved very successful – indeed, the Island’s leading manufacturers have already invested millions here on the Island with the prospect of hundreds of additional jobs being created over the next 5 years.

We also listened to business when they told us the **work permit** system wasn’t working as well as it could. This Government – with the approval of Tynwald – implemented a wide range of reforms to the system with effect from October of last year. These have been warmly welcomed by the business community and have encouraged businesses to bring jobs here.

- The Department of Education and Children is investing more in **STEM subjects** (Science, Technology, Engineering and Maths) to give our young people the skills they need. We are also investing in language skills which are essential for a modern outward-facing economy.

Educating our young people takes years and cannot fill all of our short-term vacancies. That is why we have been clear that we want to grow the economically active population. This will help us in our aim for economic growth to generate additional taxes to support public services.

So our economic fundamentals remain strong and there is real reason for optimism. The evidence is clear:

- Unemployment is down by 10% from a year ago, although I do expect an upward spike as some individuals move from other benefits to Job Seekers Allowance.
- The number of young and long-term unemployed are both down by well over 25%.
- Job vacancies throughout 2015 and so far this year are at levels not seen since 2008, prior to the banking and VAT crises.
- As a result, the working population has been maintained over the last year and the evidence suggests it will grow this year.
- Inflation remains low or negative, a direct result of the dramatic fall in world oil prices. This is having a real benefit on heating and transport costs.
- Workers’ earnings are rising strongly in real terms, with average earnings up 2% in the last year.
- Growth in National Income is above 4% in real terms.

I believe the actions we have taken and the economic performance we have achieved show that we are resilient and are well placed for continued growth.

## **Madam President**

### **Our fiscal position**

In July 2015, Tynwald approved the key policies and objectives of the Medium Term Financial Management Strategy. In my speech, I estimated that the underlying deficit in our public finances was in the region of £75M. Addressing this gap must be the focus for us and our successors.

I have been working closely with fellow members of the Council of Ministers to develop a detailed financial plan to deliver those objectives. The main policy objectives were:

- ❑ Public finances will be sustainable when general revenue account expenditure is met from income without the need to draw upon reserves;
- ❑ The Reserve Fund will be managed to grow in real terms, with investment income being retained rather than drawn upon to support revenue expenditure;
- ❑ In the medium-term, Government should aim to achieve annual surpluses on the general revenue account, which can be used to replenish internal or external reserves.

Today's budget is based on those principles and is the first step in a strategy which, if followed, will match our revenue income to our expenditure in six years' time, at the end of the next administration.

The revised Pink Book is a significant development in the way in which we carry out financial planning and manage the public finances. I hope this will allow all readers to better understand the budget both in terms of our current position and the proposed plans for the future. A clear direction of travel which sets firmly in the place the parameters for achieving stage two of our rebalancing exercise.

In setting our financial strategy we must be responsible and, as I have said on previous occasions, we must plan to leave robust finances for future generations.

### **Achievements**

Despite the pressures to readjust our finances I would like to take this opportunity to remind Honourable Members of what we have achieved:-

- Made Government smaller, merging Government entities, reducing their overall number.
- Reduced the Government salary budget in real terms, but this will have an impact on our pension costs as more people retire and are not replaced.
- Delivered nearly £15 million in internal efficiency savings, whilst protecting frontline services

- Raised over £14.5 million from the disposal of Government properties and delivered rental savings, from shrinking the amount of space Government occupies by in excess of £1.5million per annum
- Made Child Benefit fairer by means testing, and releasing capacity to increase funding for pre-school nursery places for children.
- Introduced fixed tenancies for public sector housing, helping to ensure that this resource supports those most in need
- Building 327 new homes, including 61 for first time buyers and 241 for people on lower incomes
- Supporting business growth and jobs across the economic sectors, including a £5 million investment in engineering skills
- Continued to demonstrate our commitment to a more transparent and open territory by signing up to the new model of global automatic information exchange.
- Committing over £10 million to the regeneration of towns and villages.

## **Strategy**

Madam President,

Whilst our reserves are under increasing pressure, they are still strong. There is no need for panic, or for kneejerk reactions. Our fiscal strength, growing economy and the actions we have taken so far to reduce the deficit allow us time to address the issues strategically.

In previous budgets and reports I have made reference to two stages to address our fiscal gap; today I would like to expand that to three, all of which will tie in with the three principles of this budget:

- Stage 1: Budgeting for a surplus on the revenue account, which we achieved last year after taking into account drawdown from reserves;
- Stage 2: Setting in place a Medium Term Financial Strategy that will match our revenue account income and expenditure and reduce our reliance on reserves, whilst protecting the economy and encouraging economic growth. Revenue expenditure will be reflected in the revenue budget. This budget commences the start of that six year strategy; and
- Stage 3: Addressing key areas of expenditure where we are simply spending too much, but the solution is much longer term. By this I mean balancing the National Insurance Fund, public sector pensions and other pressures brought by an increasing and ageing population.

As I stated in July 2015 there are effectively three ways of addressing the deficit 1) by increasing income through fees, charges and taxation, 2) by reducing public sector spend and 3) by increasing Government revenue by growing the economy.

Great consideration has gone into the formation of this strategy, carefully balancing the advantages and disadvantages of each approach against our circumstances. I can announce today that the principles underpinning our Medium Term Financial Strategy or MTFS are:

## **Managing over the medium term**

### **Growing the Economy**

- Increasing income through economic growth
- No increases in headline tax rates

### **Delivering a Smaller Smarter Government**

- Taking a managed approach, not slash and burn
- Ensuring there is no ring-fencing – priority based budgeting
- Controlling costs and spending
- Targeting and securing efficiencies through:
  - Critical review of Government's services and service levels
  - Driving efficiency in our processes and delivery
  - Structured procurement programme.

**Madam President,** I will explain each element.

There are varying approaches that can be taken in restructuring public finances.

Removing significant amounts of Government spending in a very short period of time, would have the effect of impacting severely on our local economy. Our approach has minimised the impact upon the local economy.

We must protect our economy; it is a fundamental aspect of this budget and indeed the Medium Term Financial Strategy. For this reason our MTFS sets out a plan for managing the medium term controllable finances over the next six years.

## **Income**

Our competitive tax environment is of vital importance to our economy, our plans for growth and our strategy. One of the factors in our success has been our stable taxation regime. In support of this philosophy, I can confirm that, in line with our existing Tax Strategy, the MTFS has been developed on the assumption that there will be no increase in the headline rates of taxation during the planning period.

The projections for increases in exchequer receipts, as I will explain later, are based on increased revenue arising from a growing economy. This demonstrates our confidence in the Island's ability to maintain growth throughout the next six years.

Honourable Members and members of the public will be aware that our stage one rebalancing strategy has resulted in an overall increase in fees and charges for Government

services. This has resulted, in effect, in a form of taxation directed at the users of those services. This is not sustainable.

I believe that we have now, largely, reached the stage with fees and charges where only marginal increases can be justified in future. Our strategy going forward is based on the assumption that charges for local services will be held at a level in line with our expectations for inflation at 2%. However, this may not be possible for our utilities which have external and unpredictable cost pressures.

As such, the plan I set out before you today is based on a balanced approach where we address our reliance on the reserves, through increased income from growing the economy, coupled with tight control over our expenditure. In effect a two pronged approach.

The impact of this will be to increase Government's net income by £141M by 2021/22 to around £1.1 billion pounds. This equates to growth of 15% over 6 years.

I believe that this represents a responsible, prudent, realistic and balanced approach.

## **Expenditure**

Since the reduction in our income from VAT, the strategy for expenditure reduction has centred around the introduction of shared services and the implementation of a cost cap on pay. The effect of these policies, especially the broad pay cap, has been to apply a top slice to Government expenditure.

This approach has been effective in reducing our overall expenditure, when adjusted for inflation. We realise that in future top slice cuts will become much harder to achieve, as the immediate efficiency opportunities have been delivered. This will become an increasingly blunt instrument and there is a risk that the impact of the reductions could have unintentional consequences.

Tough decisions are needed to determine which services Government should provide and how we provide them. These decisions will not always be easy or popular, but without making these difficult choices achieving a sustainable position will not be possible.

However, we have to change and adapt to reflect the changed economic environment.

I also have confidence in our economy and the measures we are setting in place to support its continued growth.

This is reflected in the Medium Term Financial Forecast income assumptions which are based on an average increase in income from taxation at 2.5% per annum for 2016/17 to 2018/19 and 3% thereafter across the planning period. The measures we are putting in place to control expenditure mean that we are budgeting for an average increase of 1.6% per annum. By growing income above the expected level of inflation and controlling expenditure below inflation we will be able to generate the surplus we require to meet our medium term funding pressures.

## **Staff**

Madam President,

One key part of our cost reduction approach has been to cap the level of expenditure on wages and salaries. This approach has over the past four years helped control our expenditure. However, as time passes it brings with it an increasing pressure on the staff and departments' ability to deliver services. We have to attract and retain quality staff.

Previously we controlled staff costs through the Personal Control Mechanism, which placed a cap on the total number of staff that can be employed in each area of Government. This process has not led to the most efficient and effective outcome tending to push departments towards the use of temporary or bank staff. This expenditure was outside of the headcount control and the salary and wages budget. This has been neither cost effective nor transparent.

A different approach is required. The salary cap has been effective in controlling overall costs but the budgeted figures for staff costs shown in our financial projections has increased due to the reclassification of 'staff costs'. We seek to more accurately reflect the costs of public service pension provision, with employer's pension contribution costs being allocated directly to the appropriate cost centres rather than being funded from Executive Government.

The expenditure projections within the MTFS are based on an increase in pay **costs** of 1% per annum. This is below our projections for inflation. It calls for responsibility from those charged with negotiating pay settlements. I call on the unions and staff alike to conduct negotiations sensibly, acknowledge the financial constraints and work with Government.

To be clear this policy does not mean that all staff will receive a 1% pay increase, rather that the cap on any funded increase in overall staff costs will be 1%. Any pay increases in excess of that cap will mean reductions in staff and, inevitably, in some cases redundancies. Unfettered pay growth will lead to curtailed services and/or provide incentives to outsource activities.

To illustrate this, should pay costs increase by 1% per annum above the cap for the next six years, I estimate this will require a reduction in overall staff numbers of 500. Responsible pay negotiations will help to manage the impact and I hope reductions can be managed through natural wastage. This also emphasises the importance of the implementation of initiatives such as the development of 'new terms and conditions for new starters and promotions'.

Control of staff costs, which when adjusted for back pay has been successful to date.

### **Madam President**

As I said earlier, we now need to be more focussed in controlling and achieving more reductions in Government expenditure. In addition to the pay restraint outlined above, the MTFS requires a savings programme of on average £5.6M per annum, or £34M by 2021/22.

In introducing this programme, all areas of Government are expected to contribute, nothing can be ring fenced. The achievement of these efficiencies and reductions will require Government to think differently and all areas of Government to work together. Only by doing this will we achieve a truly smaller and smarter operation and move towards a prioritised budgeting process.

A considerable amount of work has already been undertaken and plans to achieve these savings are already in train. There are three strands to the savings strategy:

- Investing in technology, through the Digital Strategy
- Critically evaluating Government's services and service levels, robustly considering whether they are all necessary or set at the optimal level and delivering cost reductions.
- Delivering value for money in Government's purchasing activity

I believe utilisation of new technologies is vital to the future delivery of public services. It will allow Government to interact more effectively with the public, help to automate and streamline our administrative functions. To support this important work I propose that the ICT Fund will be renamed the Digital Strategy Fund and an allocation of £5m made as seed funding to deliver the longer term savings.

To support innovation for Government services I propose that the Restructure Fund be renamed the 'Invest to Save Fund' and that £5m is made available to support investment in Government services, subject to future savings.

We have improved significantly our procurement procedures and activities since the introduction of Treasury Procurement services. This activity has not only rationalised how we purchase goods and services, but has also secured significant savings, in excess of £4.5m. I believe it is now the time to take the next step and develop a Commercial Service for Government. The intention is for Treasury Procurement Services to move to the Attorney General's Chambers from the 1 April 2016. This will allow a combination of legal and procurement expertise to deliver a commercial service that will help to secure savings from our purchases.

The MTFS plans for cashable reductions in spending from our commercial purchasing activity of £1.2M per annum. To support this initiative Treasury will require that all major contracts plan to achieve reductions. These savings will not only be secured from generating competition in our purchasing but by ensuring that all parts of Government critically review their service levels when contracting for goods and services. We continue to open up our purchasing to effective, transparent competition which may be uncomfortable for some of our existing suppliers.

I am pleased to report that the work on delivering the savings target has commenced and initial savings of £1.8M for 2016/17 have been identified and have been built into Department's targets for next year. This is in addition to the £1.2m from commercial savings.

Work has commenced on building a programme for savings for the following five years and already further opportunities for £14m have been identified.

The savings targets that are included in the MTFS for 2017/18 – 2019/20 are based on that work. However until further more detailed work is undertaken, it is not possible, at this stage, to allocate them to individual Departments.

I am confident that we can deliver the savings. However, should the programme fail to deliver the expected benefits, there will be a need to review what services Government provides and how they are delivered. I hope this course of action can be avoided, but this will need to be subject to annual review. We have to remain firm in our efforts to control expenditure.

The Medium Term Financial Strategy provides a much longer term view and planning horizon for Government Finances than we have used in the past. It will be for the next administration to determine the priorities within it, but this plan will allow for a responsible and managed approach. It meets the second and third principles of this budget in protecting our economy whilst moving towards sustainability.

### **Madam President,**

There are risks to achieving this strategy which cannot be ignored. The strategy assumes that income from both direct and indirect taxation grows faster than the rate of inflation, that Departments are able to absorb inflation increase for goods and services and that any increases in population do not give rise to costs which cannot be managed within existing budgets.

### **Capital Expenditure**

Our funding of capital expenditure is not sustainable. We need to maintain our £1.8bn of infrastructure assets. The traditional method of capital funding is through loan charges to Departments and a sustainable level of loan charge is a cornerstone of the MTFS, with the charge rising this year to 1.5%, and then to 2% in 2017/18.

In addition to the loan charges and to support our capital programme, I will be bringing forward a proposal to Tynwald to issue a bond to assist with some specific funding for key infrastructure assets. This bond will be targeted at the local savings market and also provide a secure investment for local savers.

The first area for which it is proposed that bond finance will be used is the local housing market. The three areas under consideration are:

- a house purchase scheme to assist buyers who are outside of the existing First Time Buyers Scheme;
- funding for mid rent property purchase to ensure there are enough properties for a growing workforce; and
- an equity release scheme for those who are asset rich but cash poor to fund, for example, conservation or energy efficient work to property.

A local bond will help to retain money in the local market and boost the economy by interest being spent and taxed locally.

We have struggled to deliver the full capital programme over the last few years and are anticipating a delivery level of only around 68% for 2015/16. To improve Government capacity and capability in delivering the Capital Programme, in October 2015 the resources from the Treasury Capital Projects Unit were transferred to the Department of Infrastructure to create a new Capital Projects Delivery function. There will still be Treasury oversight as projects require Treasury approval.

I believe this is a positive step and once again demonstrates the Treasury's commitment and willingness to redirect its resources to priority areas.

### **Fund Expenditure**

Madam President, in this budget and financial plan we have commenced a policy of moving revenue expenditure from reserves to the revenue budget. However, the majority of the funds remain. In the MTF5 it was proposed to roll all internal funds into a contingency fund, but this has not been possible at this stage without the loss of transparency.

The various funds that are in the rundown stage and will not be replenished are the Marketing Initiatives Fund, Legal Cost Reserve, Insurance Fund and Energy Initiatives Fund.

A Contingency Fund of £5 million will be available for Departments to drawdown in exceptional cases. The last few months have shown how the weather can lead to unexpected and unplanned expenditure.

I propose to bring to Tynwald changes to the Economic Development Fund to enable this to be used in a manner which can help provide loan finance to organisations offering services to the local community, to improve and repair community facilities and provide financing for joint ventures with Government for the benefit of the community.

The Pink Book sets out the anticipated reliance on reserves over the next six years. We will seek to use our reserves wisely, but spending from them will never be entirely eliminated, indeed their use is good financial management.

### **Longer term financial pressures**

In implementing the MTF5, as I have said, we would be successful in matching revenue income with expenditure. However the finances will not be fully sustainable until we have dealt with three long term pressures:

1. Public Sector Pensions
2. Welfare Payments
3. Challenges from an ageing population, including healthcare and pension costs.

**Madam President,**

The Pink Book sets out in detail the gross expenditure and the reliance on reserves required to maintain public sector pensions payments. For 2016/17 pensions expenditure is forecasted at £107M gross. This is 10% of our total revenue spending. The MTFS plans to control expenditure to allow us to meet the shortfall in pensions funding which is currently met from the Public Service Pension Reserve, after it is depleted in 2021/22. Given the rights of the existing members of the pension scheme, the lead time that any changes to new entrants take effect and the scale of the funding deficit, solutions to this major problem cannot be achieved in the short or medium term.

However I cannot over emphasise how important it is, for Government and its staff, that an affordable solution to the long term funding of public service pensions is determined. In reaching this arrangement Government, as the employer, must be firm, but fair and everyone involved in the process must be responsible for delivering an affordable solution which provides confidence and certainty for all.

**Madam President,**

### **State pensions and welfare reform**

As Honourable Members are aware, Treasury has a mandate to review the entire Isle of Man welfare and state pension system over the next 3 years, based on the 5 recommendations approved by this Honourable Court last July.

Work in the latter half of 2015 was focussed on managing the divergence of UK and Isle of Man state pension arrangements from April 2016, consequent on the introduction of the UK's new state pension, including necessary changes to the social security reciprocal agreement with the United Kingdom.

On the 28<sup>th</sup> January I, along with my counterparts in the UK Government and Northern Ireland Assembly, signed the new Agreement that formally separates us from the UK on state pension matters in relation to anyone reaching State Pension Age on or after the 6<sup>th</sup> April 2016. The new agreement was ratified by the Privy Council on the 10<sup>th</sup> February and I will be bringing an order to this Honourable Court in March that will seek Tynwald's approval to its application to the Island.

The agreement means that each country will now pay a state pension based on the contributions paid in that country only. It also contains provisions that each country will uprate the pensions of those it pays to individuals resident in the other.

I recently had the opportunity to meet the UK Pensions Minister, Baroness Altmann and I thanked her and her team for work that had been completed in a short period of time which has enabled us to have a new agreement in place. I would also like to thank the staff within Treasury's Social Security and Income Tax Divisions who have represented the Island in these negotiations and who have achieved so much in a short period of time.

Madam President, the signing of this agreement is the first step in the process of the Island developing its own National Insurance and Welfare scheme that is truly independent from the UK and over which this Court will have full policy and financial control.

Work is now underway to look at the design of a new **Manx State Pension** and I intend to report back to this Honourable Court in July with some firm proposals. Treasury will, of course, continue to be guided by Honourable Members' views and those of the Island's citizens, businesses and representative groups.

In the interim, and subject to this Honourable Court's approval, I intend to abolish the provision which allows people to defer claiming their Isle of Man state pension and in return receive a rate of return which is far in excess of what they might expect to receive from depositing their cash in a bank or building society. This provision benefits only those who can afford not to draw their state pension as soon as they reach state pension age and does nothing to protect the vulnerable. The removal of this provision would only be in respect of people reaching state pension age on or after 6<sup>th</sup> April this year.

I also intend to abolish the non-contributory pension for the over 80s for new awards only. This pension was introduced at a time when there was no effective safety-net to ensure people who may have spent much of their working lives in uninsurable employment did not suffer hardship in their old age. Furthermore, subject to a residency test, it is possible for a person who has never paid a penny into the Manx National Insurance Fund, and who has lived all their working life abroad, to be entitled to an Old Person's Pension **irrespective of their needs**. I believe this is simply wrong. There are very few awards of these so-called "old person's pensions" – in fact, there were only 4 new awards during the whole of 2015. The caseload is also diminishing – it is now just over half what it was 15 years ago.

### **The Ageing Population**

This is a factor which all Honourable Members are aware of, but is worth repeating. The balance between the age groups in our community is changing steadily as people live longer. We need to plan carefully in order to ensure that we provide good services for the older people in the Isle of Man: ranging from specialised healthcare through to residential, nursing and elderly mentally infirm – 'EMI' – care for people who need it. Providing these services comes with a cost, and I expect that the DHSC will need to come regularly to Tynwald to inform us how their plans are developing.

However there is no doubt that this is a significant long term challenge.

### **Transparency**

Madam President, I am pleased to be able to state today that we have modernised the presentation of the budget, in an attempt to make the financial information more transparent and understandable. The scope of the Pink Book has been expanded to demonstrate how the year's budget links to longer term strategies and, hopefully sets out, the information in a more accessible, understandable and meaningful way. The current year's budget links with the Medium Term Financial Strategy to show our strategic direction.

The budget had been presented in much the same way for at least the last four decades. I believe the changes represent a significant step forward, but would welcome comments or suggestions.

These changes are the beginning of a programme of work that I have set in train to improve our financial management and reporting. Work is underway to produce a detailed financial model setting out the Medium Term Financial Strategy and a review of our financial reporting processes to provide greater linkage between the financial planning, budgeting processes and our financial reporting.

In addition a fundamental review of the Financial Regulations is in progress to ensure that the Directions in place reflect our financial risk appetite, minimise internal bureaucracy and are fit for the future.

For the first time this year a narrative has been provided by each Department, Board and Office in the Pink Book.

Madam President, I now move to the 2016/17 budget settlement.

### **The 2016 settlement**

This is the first year of the Medium Term Financial Strategy and should be considered in that context.

### **VAT**

Agreement on revisions to the revenue sharing arrangement with the United Kingdom will soon be concluded, hopefully by the end of this month. However, until agreement is reached, the shared revenues of VAT, customs duty and the excise duties of alcohol and tobacco, which together make up some £295 million pounds of the forecast in this budget, remain provisional. Currently the Island's share of these equal duties is calculated using national income measures as a proxy for consumption but this methodology, or basis if you will, is what is being renegotiated with the UK at present. I do not expect the revenue outcome of the new agreement to be materially different to the provisional figures; however, until agreement is finally reached and the ink is dried I can say no more. What is certain is that the new arrangements will be effective from 2013-14 and so will impact both previous years and projected income. I hope to be able to sign off on the revised Revenue Sharing Arrangement in the next few weeks and as soon as I have I will update this Honourable Court on its detail and its revenue impact, hopefully at March Tynwald.

On an equally positive note it is pleasing to see that usage of Online VAT Services has continued to grow with now four out of every five businesses using the online service by choice. This has resulted in around 80% of all VAT returns and European Sales List lines being filed electronically.

### **Hydrocarbon Oil Duty**

I am pleased to announce that the Island's Hydrocarbon Oil Duty rates for road fuel are to remain frozen for the third year. The falling price of road fuel combined with the duty freeze is seeing an increase in consumption which in turn is giving rise to an improved duty forecast rising from an estimate of £30 million in 2015/16 to £31.6 million in 2016/17.

### **Air Passenger Duty**

I am also pleased to reveal that the exemption from Air Passenger Duty for children younger than 12 years of age on 1<sup>st</sup> May 2015 has led to an 133%, or 9,100, increase in passengers claiming the exemption. The overall number of passengers paying Air Passenger Duty in the period to the end of November rose by 12,600 over the same period in the previous year. Therefore rather than seeing a reduction in APD we expect a small increase in revenue. As previously announced I will be extending this exemption to children under 16 from 1 of March 2016 and improving the revenue forecast in 2016/17 to £5.2 million.

### **Gambling Duty**

Last year, recognising the burden that the new UK Place of Consumption tax rules would place on our businesses, I responded by allowing Isle of Man e-gaming operators to claim Double Duty Relief up to a monetary maximum equivalent to the amount of gambling duty which would have been paid to the Isle of Man Treasury on the same activity. Activity in this sector continues enabling the 2016/17 forecast to increase to £3.9 million. Recognising the importance of this industry to the Island in employment terms and noting the forecast upturn in all the local non-shared duties, I will again be freezing the rates and bandings of on-line gambling duty.

### **Income tax/NI**

Madam President, now to Income Tax. This has been a particularly difficult Budget to prepare as I have had to balance my aspirations to improve our tax system with the reality of the Island's fiscal position. Income tax revenues have grown, but not as much as was expected this time last year.

My previous Budget speeches have all had a similar underlying theme; I insist on fairness and will do all I can to ensure that our tax and national insurance systems remain competitive but fair. It is more important than ever to ensure that those individuals that should pay income tax or national insurance do pay.

As a final introductory comment, Madam President, I want to mention that 2016 will see the expiry of the Island's most recent public tax strategy. This document, approved by Tynwald in 2013, has been important in ensuring the certainty and stability the Island's tax system needs to remain an attractive place to invest.

Any updated strategy needs to cover all taxes and charges and place more emphasis on the fairness of our system. I will say more on this shortly but firstly I will cover the taxation of individuals.

Last year I expressed my ambition to abolish the 10% rate band for individuals, increase the personal allowance to over £14,000 and announced a public consultation. The outcome of that consultation will be published today. The results were clear, there was strong support for the proposal but only if nobody was worse off as a result.

Given our fiscal position and the pressure on income tax revenues, this is currently unaffordable. However I remain convinced that abolishing the 10% rate band for individuals and increasing the personal allowance to over £14,000 is the right thing to do, so this year I am announcing what I hope will be the first step in this direction.

I will increase the personal allowance by £1,000 to £10,500 and the individuals 10% band will be reduced by £2,000 to £8,500. I appreciate that this is not the level of allowance that I had hoped, but given the current financial situation this is the most that can be achieved.

This step is affordable thanks to last year's acceleration of the payment of income tax for companies with income from land and property. It will mean that more than 2,000 of those on the lowest incomes fall out of the income tax net and reduce the tax of a further 19,000 in the low income group, while ensuring that no taxpayer will be worse off.

Before I move on I want to express my gratitude to those who responded to the consultation exercise on individual taxation and to the members of the local tax and accounting professions who gave up their time to work with the Income Tax Division. I know the team invested a huge amount of their own time to provide a vision for the future of the Island's tax system for individuals that is simple and practical.

I remain convinced that aligning the income tax allowances for all ages is ultimately the correct course of action but as I said last year the time to do this is when the personal allowance is significantly increased. As I am not yet able to increase the personal allowance to the level I had hoped, the age allowance will remain at its current level for 2016/17. The Personal Allowance Credit or PAC will also remain frozen at its current level for the elderly and disabled with taxable income of £9,500 or less, until either the existing benefit system can be adjusted to accommodate it or it can be replaced in a new benefits system.

The relocation expenses concession has not been increased since 1992. As the cost of relocating to the Island can be significant and economic growth relies on jobs growth in the Island, I propose increasing this from £10,000 to £20,000 for 2016/17.

Finally on personal tax, in July last year Tynwald passed a motion regarding pension freedoms. A working party was set up by the Department of Economic Development to review this issue as I consider myself to be conflicted in this matter. The working party continues to consider if it will be possible to introduce absolute freedom within pensions without destroying our pension industry or halting transfers from the UK. I am sure Members will appreciate this is a very complex issue and one which has to be dealt with carefully.

However the working party has asked the Treasury to consider a measure which in its view will deal with the majority of these cases without any negative effects. Today therefore I am announcing the increase in Triviality for Isle of Man approved schemes from £30,000 to

£50,000, I am also announcing a reduction in the age on which triviality can be claimed from 60 to 55. Finally the triviality payment will now form part of an individual's taxable income for a year of assessment. I hope you will agree that this is fair and will mean that individuals will pay at their marginal rate on any triviality lump sum received.

This amendment to the triviality will also be duplicated where a pension has already been taken and the fund is reduced to below £50,000.

Honourable Members this effectively means that anyone over the age of 55 can have access to their pension scheme in full if it is below roughly £70,000, I hope you will agree with me that this is a very positive step.

Turning now to National Insurance.

Earlier in the year the Income Tax Division consulted on a proposal that those working over state pension age should continue to pay National Insurance contributions. The outcome of this consultation exercise will also be published today. I wish to thank the many respondents who took the time to share their views on this topic. As the existing changes to the level of the state pension age will allow a steady increase in National Insurance contributions, without a need for changes in benefit and state pension entitlements, I have decided that this proposal will not be progressed at the current time.

A number of respondents did comment on the unfairness of the current scheme in relation to individuals who could reduce the amount of National Insurance they pay by paying dividends rather than a salary. The legislation that Treasury introduced concerning Personal Service Companies has gone some way to addressing this but in my opinion more should be done. I have therefore instructed the Assessor to look at ways in which this form of planning could be discouraged so that we do not have a situation where a section of the Island's workers can benefit from a system into which they have not contributed.

For the 2016/17 tax year I propose no increases in the National Insurance rates for employees, employers and the self-employed. The percentage rates will remain 1% less than the UK rates.

In order to simplify the current system for employers I propose to merge the primary and secondary thresholds, these are the points at which NI starts to be paid, at £118 per week. The measure will see a small increase in employee contributions of £11.44 a year and a decrease in employer contributions of £6.56 a year.

I also intend to merge the Small Earnings Exemption level, the point at which the self-employed start to pay Class 2 NI, with the Lower Profits Limit, the point at which Class 4 NI is due, at the amount of £6,136.

The UK has recently published a consultation document on the abolition of Class 2 contributions for the self-employed which would take effect from April 2017. This proposal, should it be implemented in the UK, would have implications for the Island and I have instructed the Assessor to report back to me on whether such a proposal should be adopted here and if so from when.

Finally on NI, I would like to take this opportunity to remind employers that a National Insurance Holiday Scheme is available if they take on a person who has been long-term unemployed or long-term sick or recently released from prison.

Madam President, before moving on to company taxation I want to talk more about fairness in our system. I wish to ensure that the Isle of Man system operates as equitably as possible and it is important that everyone should be paying their fair share.

I am advised by the Assessor that she is now frequently seeing tax planning around our zero ten regime. I do not consider this to be acceptable and I have asked the Assessor when working with the private sector on proposals for a new tax strategy, to include devising simple ways to tackle this and other unfair behaviour.

As the fairness of our tax system is so important, I will not hesitate to recommend to Tynwald that any new rules proposed are effective for planning undertaken **immediately** if that proves necessary.

I am also redirecting Treasury resources to enable the Income Tax Division to expand its work on uncovering undeclared income. The Assessor already receives some information directly from local banks and banks in Europe and it is of concern to me just how much of that income is not declared by local residents. If the Income Tax Division has to contact you because they find that you have not declared income that you should have done then interest and penalties are imposed. So far this year (April to December) the Income Tax Division has charged additional tax, penalties and interest of £1.8 Million.

The amount of information the Assessor receives about local residents will increase significantly between 2016 and 2018 as over [90] countries including EU Member States, Jersey and Guernsey have all committed to new reporting rules. Only a few weeks ago I signed a joint declaration with Switzerland for the reciprocal introduction of automatic exchange of information between Switzerland and the Isle of Man which will begin in 2018.

I am informed by the Assessor that some residents have already done the sensible thing and been in touch with the Division to get their affairs in order and have therefore avoided significant penalties. I am sure honourable members will agree that if anybody is in any doubt about what they should be declaring on their tax return they must contact the Division as soon as possible.

Finally on the theme of fairness, I am putting forward new legislation to introduce a penalty that will apply if the Assessor successfully applies the general anti-avoidance provisions in schedule 1 to the Income Tax Act 1980. At present if a taxpayer is found to have avoided tax contrary to these provisions they must pay the tax due and interest but there is no penalty. It is rare that these provisions need to be invoked but when they are, I believe the downside for engaging in such tax avoidance activity should be greater and that a penalty is appropriate.

Madam President, I will now turn to company taxation.

I am making no changes at all to the zero ten regime of taxation for companies this year. As I have said previously, it serves the Island well encouraging inward investment.

Consultation for the Manx Enterprise Investment Scheme closed on Friday the 5<sup>th</sup> February. The response was disappointing with only 8 responses in all. Whilst many of the respondents were in favour of a scheme, many considered it too restrictive in its current form.

Given the work the Assessor will undertake on the tax strategy this year, I have asked her and the strategy group to take a fresh look at the scheme and report back to Treasury on the basis what is needed are initiatives that will help to grow the economy and provide new employment.

The final scheme adding to the initiatives to help re-energise the economy is the Land Development Tax Holiday. This will support investment in the Island's future by offering an exemption from income tax for up to five years on profits arising from new commercial developments that help to provide additional employment. Today the Assessor has released a Practice Note with the full details of this scheme and I hope that many new jobs are provided through this initiative.

### **Annual review of social security benefit rates**

Madam President, I turn now to the annual review of the rates of social security benefits and allowances payable in the Island.

As Honourable Members are aware, these can be divided into two groups: those which are funded out of National Insurance contributions and those which are funded out of general revenue.

As regards those benefits which are funded from NI contributions, the rates of benefits and allowances payable in the Island will continue to be the same as those payable in the UK from the week commencing 11th April 2016.

In particular, under the so-called triple lock guarantee, basic state pensions will rise by 2.9%, despite consumer prices inflation being less than zero. For those who are entitled to a full basic state pension this will mean an increase of £3.35 a week. In the Island this uplift will cost around £2.75 million a year. Total expenditure from the Manx National Insurance Fund in the 2016-17 financial year is expected to be around £199 million, of which £175 million - will be spent on state pensions and the pension supplement.

There is to be no increase in the other benefits payable out of the NI Fund, including the Manx Pension Supplement. As has happened in previous years, the Pension Supplement Scheme will be amended in order to avoid what would otherwise be an automatic increase.

As regards benefits paid out of general revenue - which include disability benefits, child benefit and the means-tested benefits - these are not being increased from April, with the following exceptions:-

- In order to ensure that the poorest pensioners benefit fully from the increase in the basic state pension, and indeed a little more, the income support pensioner premium is to increase by £5 a week for single pensioners and £10 a week for pensioner couples. This will also allow for the alignment of some transitionally protected premiums with contemporary rates and thus simplify the administration going forward.
- Also, the maxima allowable for housing costs for means-tested benefits for families with children are to be increased by 2.6% from April, equivalent to the uplift in public sector rentals.
- And the amounts that claimants of certain benefits can earn without losing entitlement are to increase, consequent on the recent increase in Isle of Man minimum wage rates.

### **Jobseeker's Allowance**

Madam President,

In November last year we introduced measures intended to ensure work pays and to increase the incentive for jobseekers to secure employment. There is no doubt that these measures are achieving their aims, with the number of long-term unemployed and younger unemployed, now 25% less than a year ago. I anticipate further reductions in the number unemployed among these groups over the coming months.

The 5% increase in the Isle of Man minimum wage rate from 1st January this year has resulted in a welcome widening of the gap between the maximum jobseeker's allowance payable to a single jobseeker and the amount of take home pay a worker would have at minimum wage levels. Based on a 40-hour week, that gap has grown from £25.56 a week a year ago to £38.32 today. This clearly demonstrates that people are better off in work.

### **Incapacity Benefits**

Madam President, at the beginning of 2015 there were around 2,200 people receiving long-term incapacity benefits.

This Government is committed to ensuring that those who can work are expected to do so. This would not only benefit them financially, but would also give them a sense of purpose and pride that comes from having a job.

Treasury is committed to reviewing the work capability of all those on long-term incapacity benefits over a three-year period and ensuring they are receiving the benefits appropriate to their circumstances. Of the 712 work capability assessments completed in 2015, 314 claimants were assessed as being capable of work. 40% of those found capable of work are no longer claiming any benefits, 30% transferred to jobseeker's allowance and have been able to access the specialist support they need to return to the workplace, and a further 30% have since been re-awarded incapacity benefits. Madam President, these work capability assessments will continue and will help improve the social fabric of our Island, and expand the labour pool thus reducing the need for further immigration and pressure on public services.

## **Other areas of spend**

For the current year most Departments are forecast to be largely to be in line with the budget targets. With one very significant exception; spending at Nobles Hospital which will require a supplementary vote.

Madam President, I will look firstly at the financial position of the Department of Health and Social Care. Minister Quayle, his political team and his officers face a number of current challenges: and can with some certainty predict further challenges which will affect the DHSC over the next few years. We should not forget that Tynwald Court approved a five-year strategy for health and social care in October last year, and that our approval was unanimous. I will repeat here some of the strategy's summary:

"...we do not have to choose between improving the quality of services and making them more efficient. Providing care closer to people's homes and doing things right first time will improve the quality of our service at the same time as increasing efficiency and reducing costs. This will become ever more important as the Isle of Man faces the same pressures on the health and social care budget that are causing concern throughout the developed world."

The DHSC overspend in the current financial year is largely accounted for by Noble's Hospital, and the excess costs are principally in temporary staffing. If we look across to NHS England, many hospital trusts are reporting exactly the same situation. At Noble's Hospital the main issue is recruitment, although there is a need to continue to review establishment staffing levels in some areas; guided by the recommendations in the reports of the West Midlands Quality Review Service. In terms of recruitment, there are severe shortages across the British Isles in a number of health professions, and the Isle of Man has found it difficult to compete with bigger hospital trusts. We are not able to leave vacancies unfilled, however, as this would compromise patient care and safety, and so must resort to temporary staff from agencies at costs which are multiples of regular staff salaries.

In addition to the five-year strategy for health and social care, which will rebalance where and how services are delivered, the DHSC will also implement a comprehensive recruitment and retention policy for staff. That policy may have to include some forms of incentive, as are being seen increasingly in the UK NHS.

We cannot simply ignore this level of overspend and we must assist the Health service with the investment and turnaround support that is required to control future expenditure within our resources. To support this change the budget proposes transitional funding from the central Treasury Contingency account, and further support from the Health Inspection Fund. It is proposed that this support is temporary in nature and subject to reduction over the next three years and removed at the end of that period.

I believe this is a fair and pragmatic package of support. It will be challenging for the Department to meet these timescales, but we simply must keep control of the escalating costs.

## **Capital Programme**

Madam President, we have reviewed and updated the Capital Programme for 2016-17. In particular we have again sought to focus the budget on construction activity, and I am able to announce an increase in the overall value of construction and engineering activity next year of £23 million (compared to the current year's probable spend) to £70 million.

The largest scheme for next year will be the completion of the Phase 1 regional sewerage treatment programme, costing some £11 million. I have previously reported that capital costs have fallen substantially below previous estimates for the development and modernisation of this programme, which will help to alleviate the burden on both ratepayers and taxpayers alike. Following representations from the Honourable Member for Peel, Mr Harmer, I have brought forward funding for preliminary design work on the new sewerage scheme for the town. I hope that this will lead to the resolution of a long standing problem.

In addition, the new £9 million Henry Bloom Noble Primary School will complete in 2016. For some time I have been concerned that the fabric of Castle Rushen High School does not provide a suitable environment for our young people and following discussions with the Honourable Member for Castletown, Mr Ronan, I have included a provision in this budget to commence the business case for this project.

Investment in healthcare, housing and infrastructure all feature prominently in 2016-17, including completion of the new Adult Psychiatric in-patient facilities meeting one of the key aims of protecting the vulnerable.

The Local Authority Housing programme will provide a mix of refurbishment and new build housing for general use and the elderly; the essential refurbishment of the Willaston estate has commenced accounting for an investment of £30 million over the next 10 years.

We have also updated the Capital Programme to accommodate some additional works required following the damage caused by the recent flooding.

## **Grants**

Madam President,

Lottery duty forecasts remain healthy and as a result I am pleased to announce a slight increase in the amounts made available to the Manx Lottery Trust, Culture Vannin, Sports Council and Arts Council, to continue to support the important work they carry out.

The Veterans Welfare Service gives support to all veterans and their dependants. Since the Manx Ex-Services Fund was formed in 2002 it has given financial assistance to a large number of veterans in various ways. I am proposing to transfer £25,000 into this fund to enable continued support to be provided to those in need.

The fund has assisted with the installation of various equipment to enable both young and older veterans to stay in their own homes and remain independent, including help towards the cost of showers and wet rooms, the purchase of mobility aids, adjustable beds, reclining chairs, bath lifts etc.

Any aid, adaptation or other item needed to make life easier and more comfortable for a veteran or their dependant is considered by the fund.

The level of grant payable to the Manx Utility Authority is set at £1.7 million, in line with the financial projections in the Authority's financial plan. In addition £0.5 million is provided for Flood Defence.

The grant for the International Development Committee will remain at £2.4 million pounds, allowing the island to continue to provide support across the globe.

## **Rating**

Reform of our Rating system has been the subject of proposals for modernisation for at least 15 years and further work has been undertaken in this administration. Treasury is committed to implementing sensible changes to the existing legislation. Rating reform has not progressed as quickly as I would have liked and despite a successful consultation process, there are still some key policy decisions to be made and further work required to be undertaken before any changes to primary legislation can be implemented.

I intend to provide a report to June Tynwald updating Honourable Members and to seek Tynwald's direction on policy.

## **Summing up**

Madam President,

We should all be proud of what the Isle of Man and its Government have achieved in recent years. These achievements could not have happened without the support of Tynwald, our public sector staff, the Island's businesses and the wider community.

Working together we have maintained economic growth and confidence. We have kept unemployment low and protected frontline services to the public.

That would be an impressive outcome at the best of times, but it is all the more remarkable coming in the aftermath of financial tempest that could have blown us many miles off course.

But the Island has held its course in the most adverse of conditions, and having done so we can have confidence as we focus on rebuilding for the future.

This budget introduces a refreshed approach to medium term financial planning. It sets a new standard in the transparency of Government's finances and sets out clearly the rationale for policy decisions and an estimate of the impact of those policies.

Honourable Members, I believe this is a fair and responsible Budget that helps some of the least well off in our Island while providing a solid platform for the future. It protects the interests of the next generation by paving the way to sustainable public finances and new economic opportunities.

Some may not agree with the decisions we have taken and may wish to challenge them. I would actively encourage **constructive criticism** accompanied by alternatives from Honourable Members and the general public alike. This is a key element of an open democracy and the detail provided to you here today should allow that debate to take place in a more informed manner.

There are longer term financial pressures. However, we have commenced the work and set in place the processes and structures to allow the long term policy decisions that are required.

We must take action to ensure that public sector pensions are affordable to allow certainty for Government and staff alike.

The ageing population brings with it significant new challenges where future Governments must balance affordability, provision of high quality services and protecting the vulnerable. Our Health and Social Care services will need to continue to cope with increasing demand and we must find new ways of providing these vital services.

We should be proud of our economy and continue the support we have provided to allow it to flourish and diversify.

I started this budget setting out a number of objectives:

- To build on our achievements and leave a positive legacy for the future;
- To support and grow our economy, building a vibrant business environment
- To set in place the foundations for a sustainable future, cementing a course of fiscal prudence, responsible Government and a new realism in the way we plan our future finances.

This budget has delivered those objectives. We have every reason to be confident, but not complacent. More work needs to be done, but a great deal has been achieved.

I call on you all to join me in working together for the future of this Island, and I commend this budget to this Honourable Court.

**Hon W.E Teare MHK**

**Minister for Treasury**

**16 February 2015**