EXECUTIVE COUNCIL

CONFIDENTIAL

Title of Report: Medium Term Financial Plan Review

Paper Number: 41/09

Date of Meeting: 26 February 2009

Report of: Financial Secretary

Purpose

1. This report has been prepared to allow honourable members to review the objectives and targets associated with the Medium Term Financial Plan (MTFP) in the light of the recent turmoil in international financial markets and the potential local economic considerations.

Recommendation

2. It is recommended that:

   a) the MTFP include a longer term aspiration to reduce the reliance of government on volatile Illex revenues;
   b) the targets in the MTFP be relaxed to take account of the unprecedented recent turmoil in financial markets;
   c) the impact of the anticipated effect of investment returns be accommodated in the short term targets of the MTFP
   d) the MTFP targets for 2009/10 onwards be set as follows:

2009/10	2010/11	2011/12	2012/13	2013/14
£2M Deficit	£1M Deficit	-	£1M Surplus	£2M Surplus

Summary of Financial Implications

3. There are no direct implications in terms of specific expenditure proposals but the adoption of revised financial targets will influence future budget objectives.

Background

4. Historical Perspective

4.1 For a number of years the operating budget strategy was essentially concerned with setting annual balanced budgets (preferably with a budget surplus) and maintaining the level of operational reserves at least at 2 ½ times annual operating expenditure; the aim being to increase this multiple over time. In general terms the strategy was successful in achieving these objectives but the annual process often involved measures being introduced at a late stage to achieve it. In addition, the philosophy tended to focus on the forthcoming financial year, with a consequent lack of focus on the medium and longer term.

4.2 Following the introduction of resource accounting, the balance sheet was expanded to include non-cash assets and liabilities. This allowed focus to be directed to the overall level of taxpayers equity (assets) and hence the impact of spending to be seen at a corporate level in much broader terms.

4.3 As a result of the reduction of Illex licence revenues in recent years, greater thought was given to the future finances of government. Although the level of reserves was and remains high, it was recognised that a firmer grip needed to be taken of expenditure and financial plans needed to be viewed in the light of future revenue streams.

4.4 As a result, in December 2007, Executive Council adopted the MTFP concept. The MTFP was intended to compensate for a potentially catastrophic reduction in Illex revenues (which could amount to £6M pa) and thus reduce the government's reliance on this volatile source of revenue. The achievement of this target would also allow for investment in other projects and initiatives as set out in the Islands Plan. In order to achieve this £6M reduction, targets were set for reductions in expenditure and increases in revenue of £0.5M pa each (a total £1M pa).

4.5 It should be noted that the target split was largely an arbitrary decision. In practice, potential reductions in expenditure are significantly more difficult to identify than potential increases in revenue; and this has been evident in the budget discussions that have taken place since the MTFP was adopted. Furthermore, the overall strategy of a £6M reduction, though arguably logically sound, was originally suggested in 2006. Its formal adoption resulted from a casual comment made to an FCO economic advisor during a study conducted in November of that year. It did not necessarily reflect local circumstances nor take account of the potential impact on FIG or the wider economy.

5. <u>International and Local Developments</u>

5.1 The past few years have been relatively good for investment markets. FIG has benefitted from high returns on invested balances and these have been used to support a significant part of its expenditure programmes. However, the last few months have seen a precipitous decline in international financial markets, with credit availability being squeezed to the point of withdrawal. This has impacted on governments and economies around the world, with the failure of huge international companies and small businesses alike. This turmoil has resulted in most governments pumping huge sums of money into their respective economies to prevent further decline. Times are therefore very different to those in which the MTFP aspirations were set!

5.2 It could be argued that the impacts on the Falklands economy will be more limited than other countries. A large part of the government's revenue comes from asset rentals (fishing licences) rather than export earnings and the government does not have any external debt that needs to be serviced. In addition, a sustained recession in countries from where imports are sourced could lead to reduced prices in Stanley. The low value of the pound and reduced fuel prices will also be beneficial to the fishing industry. However, the fishing, wool, meat and tourism markets do export and there may be an impact on the sustainability of revenue for associated businesses, particularly if one or more of these key markets fail. In addition, the value of FIG's investments has fallen and returns from those investments will also decline until market conditions improve.

5.3 It should also be remembered that FIG is a major part of the economy of the Falkland Islands. If FIG reduces expenditure significantly by reducing services, this will result in a reduction in money flowing around the local economy. This could further impact on local businesses at a time when other countries are stimulating their economies on a massive scale.

5.4 There are a number of service policy reviews currently underway. These are being conducted in the form of a Green/White Paper process to consult individuals and organisations on potential service options for the future. There will probably be some 'quick wins' from this process but it is also likely that there will be options that will take time to implement. Full savings may not be available for the forthcoming financial year since there may be practical issues to consider and new systems may need to be developed. It may also be appropriate to phase-in some options in.

5.5 Late in 2008 the government published the Green Paper on the Budget for consultation. This paper was the subject of a discussion at the public meeting in November. A small number of written responses have also been received (8). It is difficult to draw any firm conclusions from the consultation exercise or perform any empirical analysis but there are some common themes surrounding the original consultation questions (though not many responses were framed in line with the consultation questions and the themes are not universally accepted):

- The financial situation is complex and solutions are likely to be the same
- The government's approach should take account of the economic situation within and outside the Islands and a longer term view might be appropriate
- The MTFP targets should not be ideological; they should be reasonable and achievable
- Balances could be used to support spending programmes to manage temporary 'blips' or to fund projects with the prospect of an economic return
- There should be a balance between reducing expenditure and increasing revenue but there is scope to reduce the size of government
- Education and Health should be priorities for spending rather than casualties of reductions; Economic Development less so, particularly high cost projects. There was some support for additional charges if necessary.
- As anticipated there is little support for raising taxes but, if it is necessary there should be a balance and the impact on the economy should be assessed. There were also several comments in favour of indirect taxes as opposed to direct taxes.
- There is scope for student loans, with more limited acceptance of means testing. Means testing should reflect need.

As anticipated, a number of the respondents also made specific comments regarding the advisability of continued support for economic investment priorities (FIMCo, FLH, Dairy, and support for Camp) and several respondents questioned the wisdom of investing in a new port facility.

5.6 In view of the factors identified in the above paragraphs, it has to be questioned whether it is prudent to continue blithely with the current MTFP targets or whether to relax those targets, at least in the short term, in the light of the above factors.

6. <u>Balances and Reserves</u>

6.1 For the size of the organisation, FIG has a high level of balances. The following table shows the balance at the last year end (30 June 2008) and 31 December 2008 for each of the individual funds (to take account of recent falls in investment values and other expenditure/ revenue variations in the first half of the year):

		30 June £M	31 Dec £M
1	Consolidated Fund – Net Liquid Assets	86.7	89.2
2	Capital Equalisation Fund	21.3	20.1
3	Insurance Fund	25.0	26.2
4	Currency Fund	4.8	5.1
5	Pensions (Old Scheme) Fund	11.0	11.0
6	Retirement Pensions Fund	30.9	28.2
	Total	179.7	179.8

6.2 The purpose of the Consolidated Fund has never been fully defined in strategic terms. The fund was built up over the last 20 years from operating budget surpluses; both planned and fortuitous. The rationale behind the 2 ½ times multiple of operating expenditure is for the Fund to be a backup or ‘rainy day’ fund, which would be available if needed to support the budget in times of hardship or need. However, it is also seen as a contingency fund (available to support unforeseen expenditure or new developments) and an economic development fund (to finance major projects which will benefit the economy). In practice it is probably an amalgamation of all these.

6.3 In theory there are other funds potentially available to support the government’s spending programmes. The Capital Equalisation and Insurance Funds could (with appropriate legislative changes) be absorbed into the Consolidated Fund to be made available as general balances. However, the former is used to equalise the impact of annual fluctuations in capital spending (which seems to be working well) and the latter is held in case of catastrophic uninsured losses (which would result in more insurance being required and higher insurance premiums). The two pension funds could also theoretically be absorbed (again with appropriate legislative amendments). Many countries have ‘pay as you go’ pension schemes rather than establishing funded schemes. Again there would be an impact on future ongoing budgets and expenditure and the liabilities will increase over time. The situation regarding the Currency Fund is somewhat different since this is required to contain the sterling equivalent of the currency in circulation (ie as a guarantee to support the Falkland Islands own currency internationally). In conclusion, since the level of the consolidated fund is currently high and there would be ongoing financial consequences on future budgets (leaving aside the legal complexities and consequences) the absorption of any of the other funds is not considered to be appropriate.

7. Current Budget Position

7.1 The initial stages of the budget process for 2009/10 onwards are reaching a conclusion. Members will consider the initial submissions and the proposed budget variations shortly but the current situation is summarised in the following table:

BUDGET SURPLUSES/(DEFICITS)

	Estimate 2009/10 £M	Projection 2010/11 £M	Projection 2011/12 £M	Projection 2012/13 £M	Projection 2013/14 £M
Operating Revenue	43.133	43.132	44.251	44.548	44.686
Less Expenditure:					
Operating	39.969	38.632	38.663	38.478	38.664
Fund Transfers	4.512	4.362	4.362	4.362	4.362
Transfer Payments (net)	5.179	5.126	4.693	4.635	4.589
Operating Cash Surplus/(Deficit)	**(6.526)**	**(4.987)**	**(3.467)**	**(2.926)**	**(2.928)**
Less Depreciation	3.408	3.405	3.324	3.329	3.329
NET SURPLUS/(DEFICIT)	**(3.118)**	**(1.582)**	**(0.143)**	**0.403**	**0.400**

7.2 It can be seen that we are a long way off achieving the budget surpluses that were envisaged in the MTFP (£2M in 2009/10 rising to £6M in 2013/14). Whilst there will be further work done on the budget prior to Budget Select Committee in May and the above table includes no effects of service policy reviews, it is unrealistic to anticipate that this £4-5M difference will be overcome in the short term without drastic action and associated consequential effects.

7.3 The above figures include an estimated impact of the recent turmoil in financial markets. Assumptions have been made regarding a global economic recovery over the next 2 years but it should be stressed that these are obviously uncertain. In financial terms it has been assumed that there will be a negative impact on the operating budget (re reduced investment returns and lack of investment appreciation) of £1.5M in 2009/10 and £0.75M in 2010/11. Given that these are not anticipated to be sustained impacts, it might be appropriate to disregard equivalent sums in formulating revised MTFP targets.

7.4 It may also be appropriate to consider an additional element of funding for ‘investment in the economy’ over the next 2 or 3 years to counteract the potential for recessionary impacts. The suggested budget deficits for 2009/10 and 2010/11 include sums of £0.5M and £0.25M respectively for this purpose.

7.5 The above proposals would result in a deficit budget being approved for the next two financial years with the aim of a balanced budget in three years time. It is hoped that the current depressed economic outlook will have recovered by that time and that financial markets and world economies will be more optimistic. From 2012/13 the strategy would be to return to a budget surplus.

7.6 If Members are minded to accept the revised MTFP targets there is still some way to go to achieve them. The following table shows the savings that would be required (or additional revenue) based on the figures that are currently included in the draft budget submissions:

	2009/10	2010/11	2011/12	2012/13	2013/14
	£000's	£000's	£000's	£000's	£000's
Draft Budget Surplus/(Deficit)	(3,118)	(1,582)	(143)	403	400
Proposed New MTFP Target	(2,000)	(1,000)	-	1,000	2,000
Savings Required	1,118	582	143	597	1,600

It should be noted that the above savings required are in addition to those already identified prior to the submission of the draft estimates to Members. (However, it also assumes that all additional expenditure items are ultimately approved which is unlikely to be the case). They also exclude and proposals that may arise from the strategic policy reviews that are underway.

8. Conclusions

8.1 Whilst the concept of maintaining a MTFP remains sound, and the ultimate aims of the original plan are still relevant in terms of potential revenue reductions from Illex licences, the original MTFP targets were arbitrarily determined. The global financial climate is now very different to that which existed when the plan was conceived.

8.2 Any financial plan must be realistic and achievable. The indications from the initial budget submissions are that the original target surpluses are not, unless drastic action is taken to curtail services or increase government revenues. It might be more appropriate to consider temporary budget deficits, together with action to achieve a balanced budget over the next two or three years, before actions to consider significant budget surpluses are considered.

8.3 The recent turmoil in the financial markets will have ongoing consequences on investment returns for some time to come. It is anticipated that these consequences will reduce over time and will ultimately be eliminated but, in the short term, they need to be reflected in any revised plan.

8.4 The objective to reduce the reliance of FIG on fishing licence revenue is still relevant. However, it must be questioned whether the scale of this reduction as planned is relevant and realistic. Bearing in mind the implications for the local population and local businesses, do we plan for something that is anticipated or something that is possible?

8.5 The government has a high level of balances and reserves. The Consolidated Fund was built up to allow future flexibility on budgets in times of financial hardship. It would not be unreasonable to utilise some of these funds as a short term measure, whilst action is taken to re-stabilise the budget in the context of a longer term plan. An appropriate objective might be to achieve a balanced budget by the time that the consequential impacts of the 'credit crunch' have been worked through; with future budget surpluses thereafter.

9. Financial Implications

9.1 There are no direct implications in terms of specific expenditure proposals but the adoption of revised financial targets will influence future budget objectives. These implications are set out in the preceding sections of this report.

10. Legal Implications None

11. Human Resources Implications None