Annual Independent Fiscal Policy Review 2017

Dr. Andrew McLaughlin

Professor Geoffrey Wood

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Dr Andrew McLaughlin

Andrew McLaughlin became the Chief Executive Officer of Royal Bank of Scotland International in July 2015, having formerly served as their Group Director of Communications and Chief Economist.

Before joining the bank, he worked in corporate finance for Ernst & Young. Andrew holds a First Class Honours degree in Economics and Politics and a PhD, for which he was awarded the Walter Bagehot prize for best UK dissertation in the field of government and public administration. He published a book on the automobile industry in 1998.

He served for 6 years on the Confederation of British Industry Economics and Tax Committee and is a member of the Oxford Business School Business Economics Programme. He Chairs the Prince's Trust Scottish Advisory Council and sits on the UK-wide equivalent.

Professor Geoffrey Wood

Geoffrey Wood is Professor Emeritus at Cass Business School in London and Professor Emeritus of Monetary Economics at the University of Buckingham.

A graduate of Aberdeen and Essex universities, he has worked for the Federal Reserve System, the Bank of England and several other central banks and national treasuries. He is currently a director of an investment trust and an adviser to several financial institutions, a pension fund, and the Treasury Select Committee of the House of Commons. He has also served as adviser to the Parliamentary Commission on Banking Standards. He has authored, co-authored and edited over 20 books and has published over 100 academic papers.

His fields of interest are monetary economics & history, governmental budget constraints and financial regulation.

1. Executive summary

- The States of Guernsey has again exercised notable fiscal control with revenue expenditure in 2016, having fallen below budget despite some large Committee overspends. The Committee *for* Health & Social Care has been instrumental in helping achieve this, reversing years of overspend and positioning itself to be able to return funds to the general reserves in 2017.

- The Medium Term Financial Plan 2017 demonstrated that the underlying annual structural deficit could increase to £70m by 2020 if no government action were taken. In publishing this and illustrating the steps it would take to fill the shortfall through the Future Guernsey Plan, the attempt to co-ordinate and prioritise objectives over the next political cycle is to be welcomed.

- Structural issues remain, particularly with regards to the size of the working age population and the pressures an ageing population puts on public services. Long term ways to alleviate budgetary pressures are being explored, notably dividends expected from States-owned entities and a taxation review.

- Guernsey's total GDP has undergone a significant restatement and GDP for 2016 is now stated as £2,868 million with a GDP per capita of £45,913 (approximately 5th in the world per World Bank statistics). In 2015 GDP had been estimated at around £2,400 million and £38,100 respectively. The restatement has a substantial impact on the relative size of public sector activity and the implications for this report are that the States easily meets most fiscal rules, but now misses the 3% target for capital spending by some margin, despite efforts to increase capital allocations.

- Many of the detailed policy debates that are happening currently on-island can be seen as proxies for a wider debate about the affordability and desirability of government spending. The island's GDP changes represent an historic opportunity for the island to re-evaluate its fiscal position, spending levels and core strategies. When the question is settled it will be prudent for the States to revisit its fiscal rules.

- Despite the authors' confidence in the new GDP figures, more investment should be made in the States' ability to capture "live" economic data. This will broaden the statistics available to its analysts and decision-makers. More timely and accurate data may better inform States' decision making.

- Attempts to promote the diversification of the local economy with high value, low footprint economic activity through the publishing of reports like the Digital Sector Strategic Framework Document are to be welcomed in the interests of the island's long term fiscal health.

- Brexit and further economic uncertainty in the UK remain a considerable risk to Guernsey's economic growth. The outcome of the EU process of screening for standards of good governance in tax matters should be considered a positive for Guernsey and economic risks from this direction have receded somewhat. However, challenges remain for Guernsey in protecting its international reputation and relationships.

Contents

2. Introduction

This is the eighth annual independent review of the States of Guernsey's fiscal policy and is intended to support the Fiscal Framework adopted by the States in April 2009[1]. The Framework sets clear numerical parameters and commits the States to long-term balance in its finances.

The primary purpose of this report is to provide an independent review of the government's performance against the Fiscal Framework (last updated November 2016). This report also analyses current and past fiscal positions to assess as best one can whether improvements and/or deficits are structural or temporary.

This report presents a review and analysis of current fiscal conduct and draws attention to any areas where actions conflict with the long-term objectives. It also provides an assessment of risks relating to the fiscal strategy and raises any general areas of concern that policymakers should be seeking to address. This report does not provide, nor recommend, detailed solutions to the problems noted. Some existing proposals are appraised, and some possibilities reviewed.

In making assessments, judgements are required. Any assessments of the state of the economy (and thus its position relative to its long-run "norms" on which the Framework is based) is, by necessity, subjective in some respects. Macroeconomic data are prone to inaccuracy and must frequently be revisited, and Guernsey's statistics are no different. Gross Domestic Product (GDP) was previously estimated with a nine-month lag and is subject to revision for up to three years; an assessment of current conditions is therefore dependent on an assessment of indirect variables such as employment levels and unemployment. Predictions and projections of future economic conditions also necessarily require a deal of judgement.

December 2017 saw a material revision to the way the island's GDP was calculated, and this will be discussed and explored further throughout the report.

Any reference to "real" term figures has been calculated using 2016 as the base year for prices.

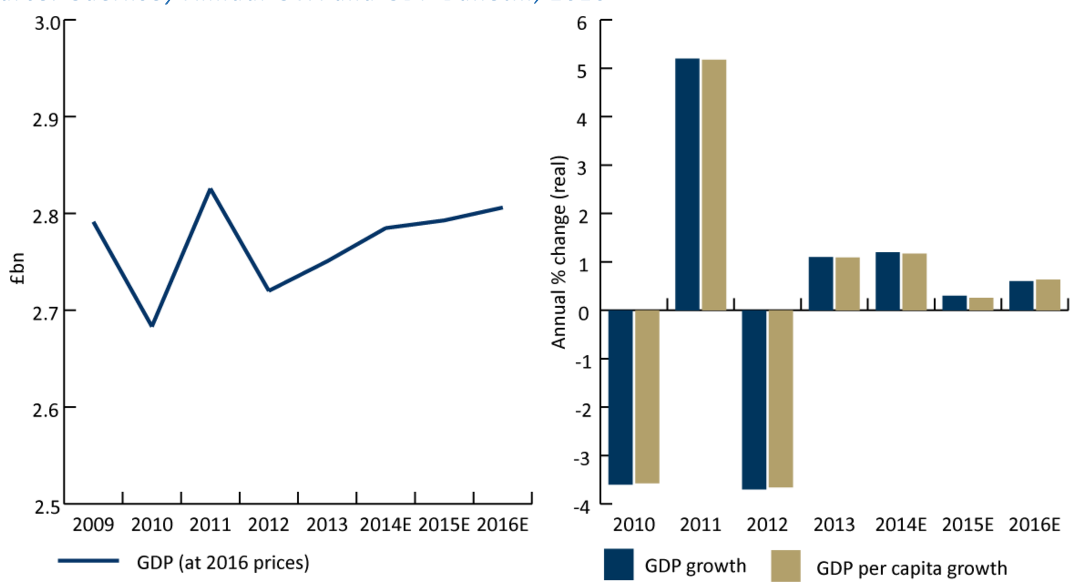
[1] States of Guernsey Policy Council, *Fiscal Policy Framework*, 2009, https://gov.gg/CHttpHandler.ashx?id=4913&p=0

3.GDP Changes

Throughout the drafting of this report, the authors were aware of an ongoing recalculation of Guernsey's GDP. The method had not been updated since the 1990s, and a reassessment was desirable in order to make the figures more internationally comparable and indeed reliable. It is to allow for the completion of the review and restatement that the publication of the 2017 Annual Independent Fiscal Policy Review report has been delayed until early 2018.

Guernsey's total GDP for 2016 is now stated as £2,868 million with a GDP per capita of £45,913 (see figure 1). This now places Guernsey approximately 5th in the world in per capita GDP[2]. Before this it had been estimated at around £2,400 million and £38,100 respectively (for 2015). The growth year on year is also different (Table 1, Section 4.3).

Figure 1: GDP at constant prices and annual growth rates (as at December 2017)
Source: Guernsey Annual GVA and GDP Bulletin, 2016



This 19.5% increase is clearly material. Given that the criteria of the Framework are presented relative to GDP, each one in Section 5 (Performance Against the Fiscal Framework) has been affected significantly, causing some targets to be comfortably met and others to be missed to a much greater degree than previously expected. Given the extent of the revision, it is clear that further consideration is needed regarding the current criteria, specifically if and how these should be adjusted to reflect the revised data.

The changes may spark a debate about the nature of government spending, particularly with regard to infrastructure investment and taxation. While remaining impartial in this discussion, some of the choices that can be made are briefly explored in the final section of this report. However, it is important to remember that these changes to income are methodological. The economy is the same as it has always been; only the way it is measured has changed.

The revised method was audited by GDP specialists from the UK's Office of National Statistics (ONS), who sought to ensure that international statistical norms were being followed and

[2] World Bank national accounts data, and OECD National Accounts data files, *GDP per capita (current US$),* https://data.worldbank.org/indicator/NY.GDP.PCAP.CD

nothing was omitted from the final calculation. They have confirmed that the restatement represents a "significant improvement in data quality". The authors would add their support to the ongoing efforts of the Data and Analysis Unit to improve and develop the core data sets in Guernsey. Regular review of statistical practices to ensure that they remain, as far as is practicable for a jurisdiction as small as Guernsey, aligned with international best practice should be encouraged.

While acknowledging that hindsight is 20:20 it may be true that historic tax revenues, employment figures and business confidence levels indicated that the island experienced a considerable slowing of growth after 2011. This now appears to have been corroborated by the restatement. It may therefore be useful for the States of Guernsey to spend more in capturing 'live' economic data in order to broaden and improve the armoury of data available to States analysts. Having a solid grasp of the economic lie of the land through better data is obviously beneficial, but this does not necessarily mean better management of the economy. Policymakers ought to avoid exacerbating problems through well-meaning fine-tuning or micromanagement of the short-term economic levers.

4. Economic outlook

4.1 Global context

In spite of continuing political and economic uncertainties, which are of course always present, there are signs that the world economy has been regaining growth momentum. Both the International Monetary Fund (IMF)[3] and the Organisation for Economic Co-operation and Development (OECD)[4] have forecast global growth of 3.5% and 3.6% for 2017 and 2018 respectively. Much of this is driven by a sustained pickup in activity in emerging and developing economies. For the developed countries which potentially have the greatest impact on the Guernsey economy, the projections are mixed.

Major Eurozone countries have the prospect of increasingly healthy growth. In the US the election of Donald Trump as President saw a general boost to the confidence of US and global financial markets on the back of tax, infrastructure and regulatory reforms promised during the campaign.

The Base Erosion Profit Shifting (BEPS) programme led by the OECD has increased the need for firms to justify their profits earned in each location, including “offshore”. The treaty to implement BEPS was signed by the President of the Policy & Resources Committee, Gavin St. Pier, alongside the representatives of over 60 other countries in Paris in June 2017.

Despite international interest in the tax affairs of the Channel Islands following the recent reporting of the “Paradise Papers”, Guernsey was not on a list of 17 non-cooperative jurisdictions for tax purposes published by the Council of the European Union (EU)[5] in December 2017. They have however raised concerns about the degree of substance attached to some financial activity which takes place in the Crown Dependencies. This is not unexpected, though compliance with the international tax agenda is a key risk for Guernsey. The States’ work to defend Guernsey’s position as an international finance centre remains of paramount importance.

4.2 The UK & Brexit

Guernsey’s economy is highly sensitive to the performance of the UK. On 23rd June 2016, the UK voted to leave the EU. UK economic growth held up better than many forecast in the months following the vote but has slowed as inflation has risen fairly sharply, partly as a consequence of the depreciation of Sterling[6].

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[3] International Monetary Fund (July 2017), *World Economic Outlook Update, July 2017,* *http://www.imf.org/en/Publications/WEO/Issues/2017/07/07/world-economic-outlook-update-july-2017*

[4] Organisation of Economic Co-operation and Development (OECD), *General Assessment of the Macroeconomic Situation, Volume 2017 Issue 1, http://www.oecd.org/eco/outlook/general-assessment-of-the-macroeconomic-situation-oecd-economic-outlook-june-2017.pdf*

[5] Council of the European Union (December 2017), *Outcome of EU list of non-cooperative jurisdictions for tax purposes*, *http://www.consilium.europa.eu/media/31945/st15429en17.pdf*

[6] PwC UK Economic Outlook (July 2017), *https://www.pwc.co.uk/economic-services/ukeo/pwc-uk-economic-outlook-full-report-july-2017.pdf*

The start of the formal process of exit, the signing of Article 50, was triggered in March 2017 and negotiations have begun between the UK Government and EU authorities. In June 2017 a General Election was held in the UK which saw the Prime Minister, Theresa May, lose a Conservative majority in the House of Commons, which has an effect on the stability of the government and its ability to negotiate. Since the referendum vote there have been several rounds of talks relating to the first phase of negotiations. These negotiations did not progress according to the timetable the European Union and the UK government had hoped for due to disagreement over the financial settlement and the Irish border. It is still too early in the process to draw solid conclusions about what a post-Brexit UK might look like and this weighs on business investment and decision making in both the UK and Guernsey.

Guernsey and the EU

Guernsey has a formal relationship with the EU through Protocol 3 of the UK's Act of Accession. With regard to Financial Services, the Bailiwick is a jurisdiction that is outside both the EU and the European Economic Area (EEA). This means it is treated as a "third country", and this relationship with the EU will not change after the UK's exit. Hence, there are fewer immediate concerns over a financial services "cliff edge" and the possible relocation of finance companies than there may be for the City of London[7][8]. However, given the close association between Guernsey and the UK, Guernsey's own relationship with the EU will likely be heavily influenced by the state of relations between the UK and the EU as negotiations for exit develop further. This may have a negative impact on Guernsey's status as a global financial centre in the long term.

A Brexit that harms the UK's financial services will harm the island's economy, finances and possibly long-term growth. Choices the UK makes with regards to its post-EU future also are a major factor – whether it chooses to seek to become a low-tax and light-touch regulatory jurisdiction or continues largely the same path it has travelled thus far.

4.3 Domestic Context

Estimated total GDP for 2016 in Guernsey is £2,868 million, 0.6% higher than 2015 in real terms. The restatement of the GDP figures after the data review has considerably altered the narrative of Guernsey's recent economic history. Revised figures now show a significantly lower level of cumulative GDP growth between 2010 and 2015, primarily due to a contraction which is now apparent in 2012. More recent figures show weak growth for 2015 and 2016.

[7] House of Lords European Union Committee (23 March 2016), *Brexit: The Crown Dependencies*, (Evidence from the Chief Ministers of Guernsey & Jersey) *https://publications.parliament.uk/pa/ld201617/ldselect/ldeucom/136/136.pdf*

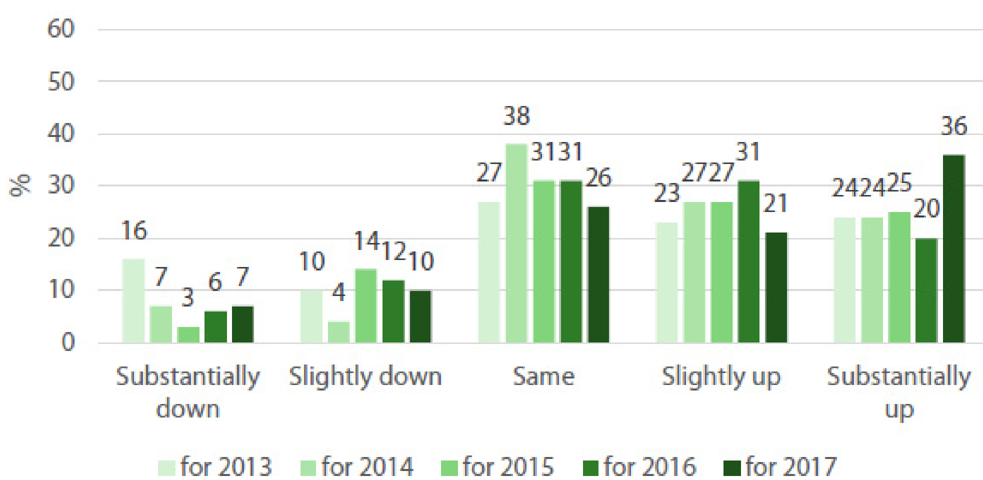
[8] House of Commons Justice Committee (21 March 2017), *The Implications of Brexit for the Crown Dependencies,* (Evidence from the Chief Ministers of Guernsey & Jersey) *https://publications.parliament.uk/pa/cm201617/cmselect/cmjust/752/752.pdf*

Table 1: Comparison of restated GDP time series with that previously published

	GDP published Aug 2016			***GDP published Dec 2017 (restated)***		
	Real GDP £m	Annual Change	Cumulative change (from 2010)	Real GDP £m	Annual Change	Cumulative change (from 2010)
2011	2,259	4.5%	*4.5%*	**2,885**	**5.2%**	*5.2%*
2012	2,362	4.5%	*9.2%*	**2,780**	**-3.7%**	*1.4%*
2013	2,371	0.4%	*9.7%*	**2,810**	**1.1%**	*2.5%*
2014	2,372	0.0%	*9.7%*	**2,843**	**1.2%**	*3.7%*
2015	2,382	0.4%	*10.2%*	**2,850**	**0.3%**	*3.9%*
2016	n/a	n/a	n/a	**2,868**	**0.6%**	*4.6%*

Businesses continue to remain optimistic about their future, with a majority predicting their revenue and profit growth will be either "substantially" or "slightly up" for the year ahead, while those believing their profitability will fall are considerably down on previous years.

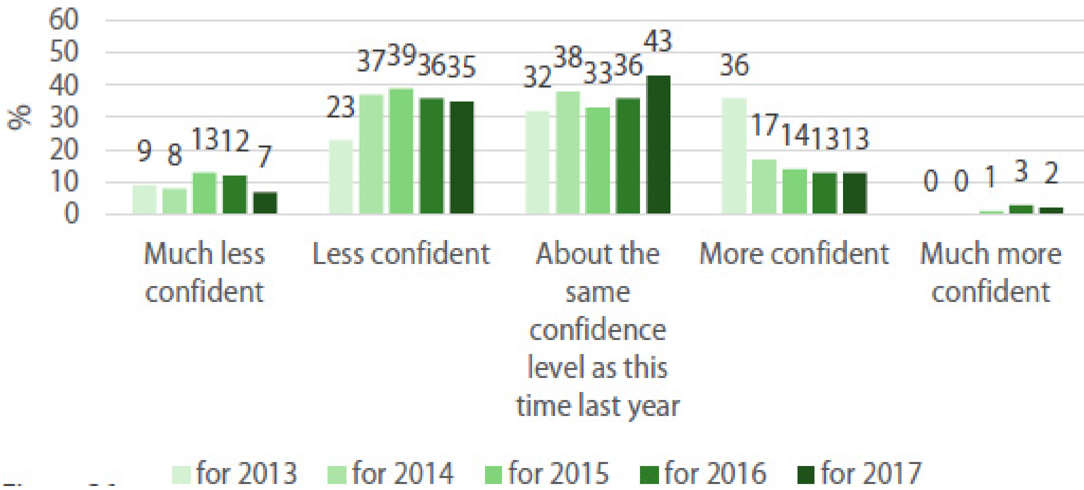
Figure 2: Expectations of profitability for the year ahead (versus previous year)
Source: Guernsey Business Trends Survey 2017



Views of the island's economy in the short and medium term are more conservative, as a plurality are "about the same confidence level [as the previous year]" and 38-42% are "less" or "much less" confident[9]. These are largely similar to the figures from 2016's report, and may reflect the uncertainty surrounding the outcome of Brexit negotiations and their long term implications. While the coverage of this survey is limited in some areas, the overall impression of uncertainty about the medium term prospects is consistent with feedback received in conversation with industry representatives generally.

[9] Young Business Group/Guernsey Chamber of Commerce (June 2017), 2017 Business Trends Survey, http://www.guernseychamber.com/wp-content/uploads/2017/07/Business-Trends-Survey-2017-Final.pdf

Figure 3: Confidence in Guernsey's economic prospects over the medium term (versus previous year)
Source: Guernsey Business Trends Survey 2017



There was an overall increase of 0.3% in the number of people either employed or self-employed on the island over the year ending June 2017 and median earnings were 1.9% higher. Due to increased levels of inflation in the first two quarters, this translated to a 0.4% real terms decrease. The island's population has also continued to grow. The increase of 0.1% (39 people) over the year ending 31 December 2016 includes net emigration of 23 people. The continuing overall pattern of net emigration combined with an aging population has meant that Guernsey's working age population continues to fall. It also contrasts strongly with Jersey, which saw 1300 more immigrants than emigrants and suggests more might be done to make the island more attractive to potential incomers.

If low population growth continues it will have an impact on the dependency ratio and the sustainability of public finances in the long term. Risks surrounding this have been discussed in prior reports, and other structural issues are discussed in further detail in Section 6 of this report.

Last year's report noted reforms passed by the States which related to reorganising the various Committees of government. A key outcome of this was the establishment of the Policy & Resources Committee, the overarching committee responsible for both policy co-ordination and resource allocation. That report also noted the development of the Policy & Resource Plan, an attempt to co-ordinate and prioritise objectives over the next political cycle and establish principles to guide longer term policymaking. This was in two phases:

- **Phase one** (known as "Future Guernsey"), which set out the vision for the island in 20 years' time and what the States would need to focus on over the next 5 years to achieve it. This was approved by the States on 16 November 2016.
- **Phase two** required the six Principal Committees to draw up their Committee Policy Plans, setting out the actions they intended to pursue over the short and medium term to fulfil the objectives agreed in phase one. These were collated into a single policy letter and were approved by the States on 30 June 2017. Phase two has subsequently been augmented to include a "Phase 2b".

Tying these together is the Medium Term Financial Plan, the first medium-term fiscal strategy published by the States. It sought to identify the greatest problems for the future, demonstrating that if no action were taken the underlying structural deficit would persist through the next four years and could reach £70 million per annum.

5. Performance against the Fiscal Framework

Monitoring the States' performance against its Fiscal Framework is the primary purpose of this report.

The Framework was introduced in 2009 and is based on the following principles[10]:

- Stability is at the heart of sustainable economic prosperity;
- Fiscal policy needs to be focussed on the medium term;
- Economic and fiscal policy should be stable, transparent and predictable.

The Framework was updated and amended in 2016 as part of Phase 1 of the Policy and Resource plan[11]. The update included some minor revision of the parameters but left the underlying principles behind them unchanged. The parameters as they presently apply are outlined below.

Box 1. The Parameters of the Fiscal Framework

The Framework rules state that the States should:

- maintain a long run "permanent balance", i.e. that the States should not in the long term spend more than it receives from taxation (and profits), and that periods of deficit should be balanced by periods of surplus;
- ensure annual overall deficits on general revenue do not exceed 3% of GDP;
- address identified deficits within five years of their appearance, and structural deficits within two years of their discovery;
- not increase expenditure on public services above real terms at the aggregate level during a period of deficit;
- limit the total government income (general revenue, social security contributions, fees and charges) of the States to no more than 28% of GDP;
- ensure the level of gross borrowing by the States does not exceed 15% of Guernsey's GDP;
- set the level of new borrowing in any year so as not to exceed 3% of GDP;
- sustain capital expenditure at an average of 3% of GDP per annum.

This section outlines the States of Guernsey's general performance against the Fiscal Framework. The Fiscal Framework rules are marked green if the rule is met and red if the rule is not met.

[10] States of Guernsey, Fiscal Framework https://www.gov.gg/article/152940/Fiscal-Framework
[11] States of Guernsey, Fiscal Policy Framework - Update 2016, Approved 16 November 2016 https://www.gov.gg/CHttpHandler.ashx?id=105659&p=0

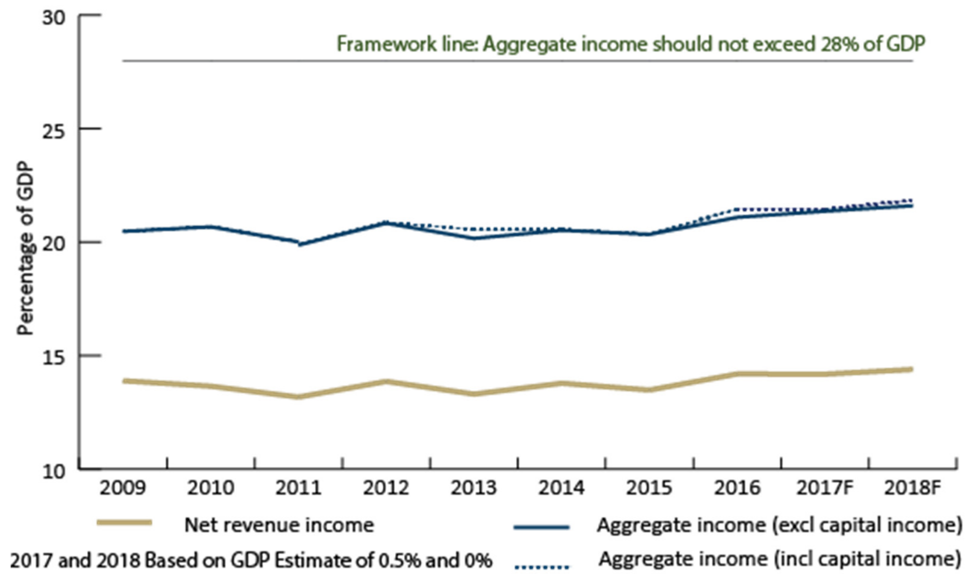
5.1 General revenue and income expenditure:

Fiscal Framework rule:

- **Total government income, incorporating general revenue, social security contributions and fees and charges, should not exceed 28% of Gross Domestic Product.**

Figure 4: Net general revenue and aggregate government income[12]

Source: General Revenue Accounts, Misc. Accounts, Data and Analysis, States of Guernsey



Aggregate income totalled £615m in 2016, an increase of £42m from £573m in 2015. This represents a nominal increase of 7.3% or 5.6% in real terms. Before the restatement of GDP this measure was comfortably within the limits set by the Fiscal Framework (at approximately 25% of GDP) but the revised data show aggregate revenue for 2016 at 21.4% of GDP, significantly lower than the limit in the rule. The implications of this are discussed further in Section 7.

It is noted that the increase in social security contribution rates which was implemented in January 2017 will have increased revenues for 2017. The increase of 0.7% for combined employer/employee contributions and 0.5% for all other contribution classes is the primary contributor to the increase in aggregate revenues expected for 2017, although the budget also raises the expectation of higher than budgeted general revenue receipts for 2017. Further analysis of the factors contributing to the change in the financial position are discussed in Section 6.

[12] Net general revenue income incorporates all income sources (excluding capital) reported in the annual accounts available for distribution between departments. Aggregate income incorporates net general income plus Social Security contributions and departmental operating income.

Net general revenue represented 14.2% of GDP in 2016, well below the Fiscal Framework rule of no more than 21%. It totalled £407m in 2016, an increase of £27.2m from 2015. This represents a nominal increase of 7.2%, or 5.6% in real terms.

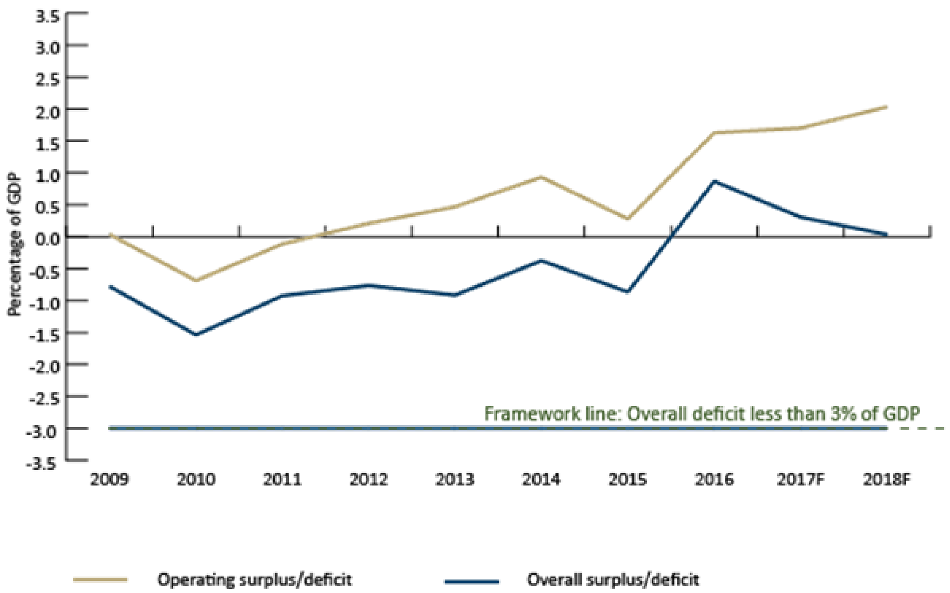
5.2 General revenue and operating and overall position

Fiscal Framework rule:

- **Restraint on any temporary overall deficit positions to less than 3% of GDP in any one year;**
- **Ensure that identified deficits will be addressed within five years of their appearance and that measures to counter identified structural deficits are agreed within two years of their identification;**
- **Not increase expenditure on public services above real terms at the aggregate level during a period of deficit.**

Figure 5: General operating and overall revenue position

Source: General Revenue Accounts, Misc. Accounts, Data and Analysis, States of Guernsey



2016 saw the island achieve an overall surplus of £24m, a position not seen since before the financial crisis of 2007-8. This is largely due to revenue income being some £7.2m (1.8%) higher than expected, the improved global economy leading to exceptional investment returns of £8m and net revenue expenditure falling £9m below the expected level. The States' Trading Supervisory Board was also asked to make a return to General Revenue from the unincorporated trading assets.

This represents a significant improvement against the original budget and mid-year forecast which projected a deficit resulting from both reduced incomes and overspending in some areas. At the time of the 2017 Budget Report the anticipated deficit was £5.6m and the States agreed to reduce the allocation to the Capital Reserve by that amount to ensure balance.

Because of this forecast, measures were also put in place to reduce spending and Committees were asked to review their routine capital expenditure.

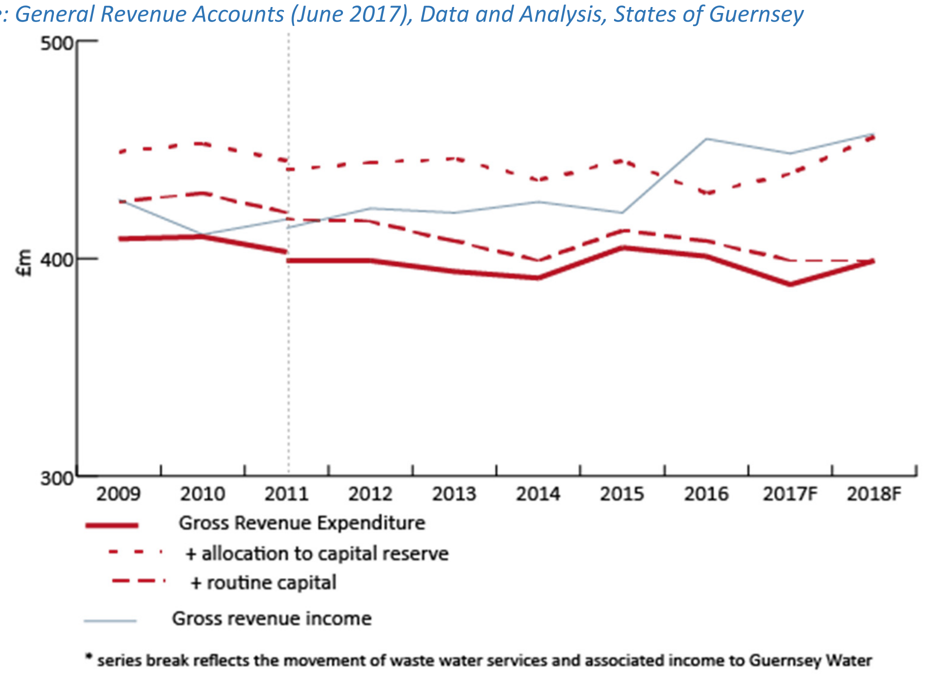
Until 2016 the overall deficit had persisted for eight years and led to four consecutive breaches of the Fiscal Framework rule. The authors of this report welcome the return to surplus but note that some of the revenue generated, such as the capital income from the repurchase of shares by Guernsey Post and Guernsey Electricity, cannot be repeated year on year and do not represent a sustainable solution. However, the authors note the continued surplus forecast for 2017 and balance for 2018 and encourage the States to continue their efforts towards achieving a sustainable balance.

Whilst the Framework did not explicitly place any restrictions on expenditure (given that the accounts were in surplus in 2016 and are expected to be so again in 2017) the authors note that during 2017 the update to the Fiscal Framework directed the States to adopt a policy that limited increases in expenditure to inflation during periods of deficit.

Gross revenue expenditure (before capital spending) totalled £401m in 2016, nominally the same as 2015 but equivalent to a 1.6% real-terms decrease after adjusting for inflation. Indeed, allowing for some yearly variation gross revenue spend has been largely unchanged in real terms since 2011.

Figure 6: Gross revenue expenditure (at 2016 prices)

Source: General Revenue Accounts (June 2017), Data and Analysis, States of Guernsey



Including routine capital expenditure[13] and allocation to the capital reserve, gross revenue expenditure totalled £431m in the year, equivalent to a 5.4% decrease in real terms from 2015. Whilst the aforementioned unexpected surplus in 2016 has made such a reduction unnecessary to comply with the rule, restraint is still to be welcomed as the surplus was

[13] The authors note that the treatment of what is termed routine capital expenditure in the government accounts is under review

achieved in part by one-off measures. Uncertainty will always remain surrounding the true estimate of the underlying structural position. Some of this year's one-off and structural factors are discussed further in Section 6.

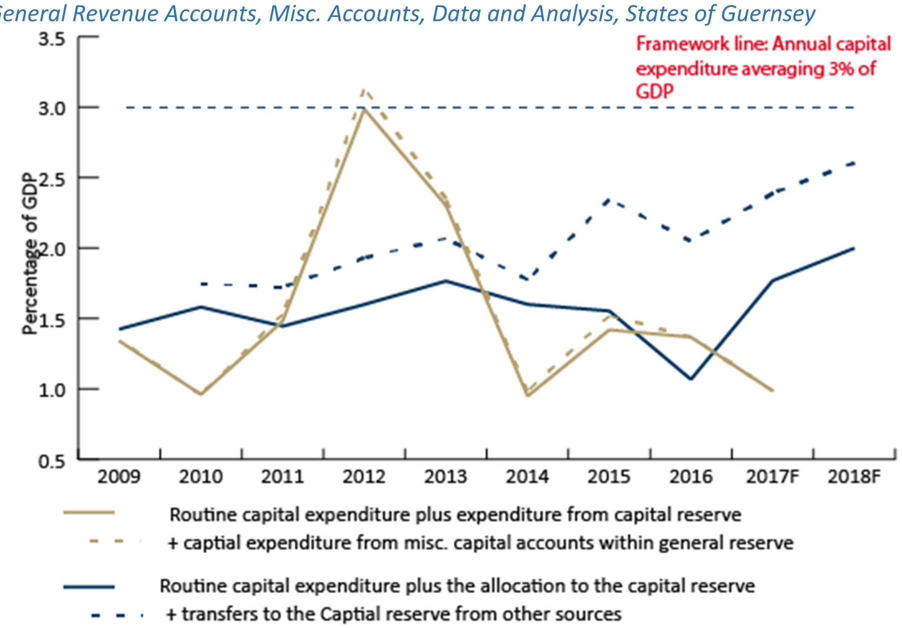
5.3 Capital expenditure

Fiscal Framework rule:

- **Annual capital expenditure averaging 3% of GDP**

Figure 7: Capital expenditure

Source: General Revenue Accounts, Misc. Accounts, Data and Analysis, States of Guernsey



The authors have highlighted in previous reports that the States has consistently struggled to meet this criterion. Capital allocations budgeted for 2018 have been increased in an effort to meet it, and this target may have been met (in terms of money set aside for investment) had the restatement of GDP not pushed the monetary value of the target upwards. However, measured against the revised GDP series annual capital expenditure in 2016 has again fallen below the 3% specified by the rule and the forecasts for 2017 and 2018 are for it to remain below this level.

Against the restated series, total allocation to capital spending from general revenue (routine capital spending plus that allocated to the capital reserve) has averaged 1.5% of GDP between the introduction of the Fiscal Framework in 2009 and the update to the Framework in 2016. The budget shows this increasing to 2.0% by 2018. When transfers to the capital reserve from other sources are taken into account this increases to an average of 1.9% of GDP between 2009 and 2016 increasing to 2.6% by 2018.

Over the same period, actual capital spending (routine capital expenditure plus expenditure from the capital reserve) has averaged 1.6% of GDP since 2009 including spending from miscellaneous accounts within the General Reserve[14]. Since the inception of the framework the States has managed to spend the full 3% of GDP outlined by the target once, in 2012. Through discussions with States of Guernsey officers the authors discovered that particular fiscal year saw two concurrent major construction projects, and was therefore something of an outlier.

It is clear that the States has consistently struggled to meet the 3% of GDP target for capital investment set by the Fiscal Framework in 2009, even before the current GDP restatement. Policymakers may wish to examine in more detail the reasons for the persistent underspend, and whether it is due to a lack of resources to manage capital projects or a lack of demand in a community of Guernsey's size. The importance of this debate is explored further in Section 7.

5.4 Borrowing

Fiscal Framework rules:

- **Total borrowing never to exceed 15% of GDP (and only to fund capital expenditure),**
- **The level of new borrowing in any one year not to exceed 3% of GDP.**

In December 2014 the States of Guernsey successfully completed a £330m bond issuance. The States of Guernsey was able to secure a 3.375% per annum interest rate with a final maturity of 2046. The original purchasers of the bond were primarily investment and pension funds.

While at the time of borrowing this amount was close to the 15% limit on borrowing and no change to the amount of money borrowed has been made, the restatement of GDP has reduced its value relative to the size of the economy. The States of Guernsey is now directly liable for debt representing 11.5% of its GDP.

Low GDP growth since 2014 means that this figure has not materially changed since the bond issuance. There is a risk that future negative growth may lead to a rule breach, though the restatement of GDP has significantly reduced this risk. As at 31st December 2016, a total of £127m had been loaned to States' Trading Bodies.

The investment returns on the bond issue's proceeds form part of the income from general revenue investment assets. During 2015 these returns were not sufficient to cover the coupon payment on the bond, which led to a £5.7m deficit on the Bond Reserve. The strength of the global economy in 2016/17 means this position has been reversed, with investment return exceeding the amount necessary to pay the coupon and clear the accrued deficit.

[14] Spending from the miscellaneous accounts within the general reserve includes: Solid Waste Trading Account; Economic Development Fund; Transformation and Transition Fund; and the Wilfred Carey Purchase Fund.

The States' Scrutiny Management Committee commissioned a report into this issuance, which was completed in May 2017[15]. There were many key findings with regard to the way in which the bond was issued, several of which are relevant to users of this report.

Relating directly to the Fiscal Framework guidelines for the maximum level of government borrowing, it discusses whether the 15% of GDP limit for external borrowing should include amounts owed by the wider States' Trading Bodies, and concluded that:

> *"Given that the business case put forward for the Bond was to refinance existing States borrowings (including those held by the States' Trading Bodies), it would appear inconsistent to not include all States borrowings when comparing against the Fiscal Framework hurdle of 15% of GDP."*[16]

The long-term financial costs and/or benefits of the issuance were also discussed. The report states that it is unclear whether any financial benefits have yet been received by the States & its associated bodies. Additionally, in the current commercial climate some bodies may well have been able to find debt at a cheaper rate than the bond's coupon rate.

A caveat is that being 2 years into a 32-year bond means it may yet be too early to tell. The States has insured itself against an increase in interest rates in the long term, potentially allowing significant benefits to accrue. The report recommends that a cost/benefit analysis be performed and monitored on an ongoing basis, and the authors would welcome this.

[15] KPMG (May 2017), *States Bond Issue report commissioned by the Scrutiny Management Committee*, *https://gov.gg/CHttpHandler.ashx?id=107882&p=0*

[16] The restatement of GDP is such that if these debts are included the fiscal rule remains unbroken.

6. Structural Risks and Cyclical Improvements

Central to any analysis of Guernsey's finances is whether factors affecting the fiscal position are structural or cyclical. This section will explore the extent to which the balanced budget we have seen this year is due to increased economic activity locally or is a result of decisions by government.

6.1 Structural Issues

Revenue extensions

Revenue from taxation is the vast majority of government income and increasing or broadening the tax base can be difficult taking into account Guernsey's status as a low tax jurisdiction. The States has voted against the possibility of a Goods and Services Tax (GST) in recent years, but during discussions around the approval of the Policy & Resource Plan (Phase II) the following amendment was accepted:

> *"To direct the Policy & Resources Committee, in developing its proposals for income measures from 2018 onwards, to consider the merits and disadvantages of any new forms of taxation, with the exception of taxes on capital; this recognises that there will be a clear presumption that over this period (in light of the island's changing demographics) the tax base will broaden and diversify consistent with the principles of seeking a greater contribution from those individuals and entities most able to bear the burden."*

Now that the full extent of the GDP uplift is known, and general revenue income as a percentage of GDP has fallen to 21.4%, it is opportune to explore ways of broadening the tax base and setting a vision for the island. This will be explored further in Section 7.

Return from trading entities

It was agreed that a major contribution to filling the £70m deficit identified in the Medium Term Financial Plan would be a £30m dividend return from the States' Trading Supervisory Board (STSB) entities. However, throughout meetings with the Board it was clear that they felt this was optimistic and that to deliver an additional return of 1% of Net Asset Value, a 10% increase in fees and charges would be required. In tackling this further cooperation between the Policy & Resources Committee and the STSB is encouraged, particularly with regard to the establishment of a Cost of Capital and Discount Rate review. Legislation may also require reform, as the STSB is legally obliged to pass surpluses directly to the customers.

The commercialisation of the States' trading assets can provide a longer term contribution to the accounts by generating on-going returns. This will require the Policy & Resources Committee and the States' Trading Supervisory Board working together.

Social Security and Pensions

This year saw an increase in social security contribution rates of 0.7% for combined employer/employee contributions and 0.5% for all other contribution classes. The increase, the majority of which will be allocated to the Guernsey Long Term Care Fund (GLTCF), is not sufficient to meet demand as obligations to an ageing population increase, and a structural review of the GLTCF is currently ongoing. Alongside this the Committee *for* Health & Social Care is continuing work on developing their target operating model which will include the provision of social care for older people in their own homes. Social care for an increasing older population is a significant matter for Guernsey and the current system is clearly not sustainable. A consensus needs to be reached between the private providers of the services and the States, seeking to control costs while maintaining an acceptable standard of care. Throughout discussions with the Committees *for* both Employment & Social Security and Health & Social Care it was clear a wider debate needs to be held around the division of the cost burden between the States and the customer.

A secondary problem in this area is that only an estimated 40% of the working age population currently has access to an existing occupational or personal pension scheme. The implication of this is that approximately 60% of the working age population (around 25,000 people) are not making any personal pension provision. Unless a strategy is developed to help these people save for old age, the States' pension liabilities and the degree to which the States must support older people will continue to increase. This may lead to a poor standard of living for some pensioners. The authors of this report therefore welcome the States' request for proposals from local providers to deliver a Secondary Pension Scheme to provide more general access to a savings scheme.

Combined, these two issues may well result in pressure to increase contributions further on multiple fronts and there is the potential for costs within the social security system to spiral. This risks creating an increasing intergenerational transfer from the young to the old with no guarantee that these services will survive to provide care for the current generation of tax payers when they need them in their turn.

We repeat our advice in previous reports that these issues not be viewed in isolation. With long term spending pressure growing in multiple areas, the States should be cautious about making decisions to apply multiple small increases in contribution rates in isolation without considering how large the total increase in overall taxation may become.

Management of healthcare costs

The achievement of the Committee *for* Health & Social Care in gaining control of a budget that has historically experienced overspends must be commended. Figure 8 shows turnaround in the deficit.

Risks remain. The high service level expectations, supply led demand, difficulty in controlling costs led by private sector agents, (such as diagnostic tests and prescriptions issued by GPs) and the underlying pressure of an ageing population still pose significant challenges to sustainable budget control.

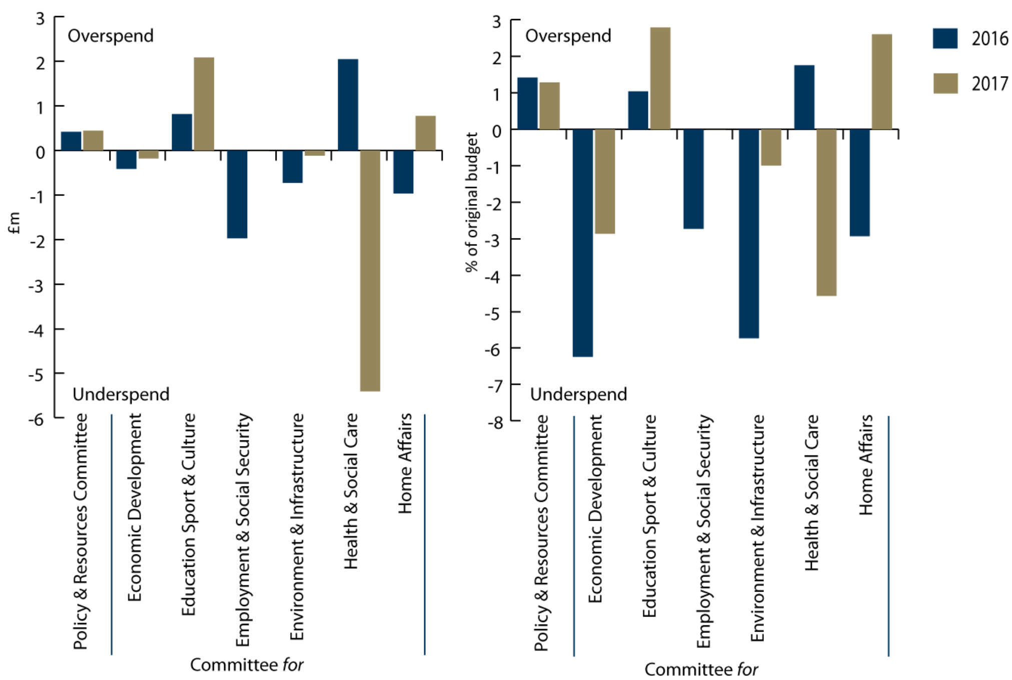
Recruitment and retention is an additional cost, as housing laws and the cost of living on the island can result in a high staff turnover in health and care services. A solution to this could be exploiting Guernsey's control over its population and making it easier to employ nurses from elsewhere in the world.

Committee Over/Underspends

The figure below shows the 2016 over/underspends against that originally budgeted and the expected over/underspends for 2017 as reported in Guernsey's budget in November of that year.

In line with most advanced economies the departments relating to education, health and social security dominate the island's spending, and the restraint shown by the Committee *for* Health & Social Care in 2017 has already been noted. The Committee *for* Employment & Social Security has also come under budget in its general expenditure but this has been offset by greater than budgeted increases in formula led spending. The Committee *for* Education, Sport & Culture has overrun by around 3% of its original budget. It is incumbent on the Policy & Resources Committee, Committee members and States members at large to understand the reasons for these differences and assess what changes can be made in management practices and culture from Committee to Committee.

Figure 8: 2016 and 2017 forecast spending against budget (£m and budget-relative)
Source: States of Guernsey Accounts



The variance from budget is calculated against the original budget limits. Authorised limits as published in the accounts include inter-committee transfers and £900,000 of transfers from the Budget reserves including £400,000 in respect of pay awards. The size of the Committee *for* Health & Social Care's budget and total underspend in 2017 is notable for the fact it is equal to approximately 1% of total general revenue receipts.

Population Growth

Skills shortages on-island can have an impact on competitiveness and an increasing dependency ratio adversely affects public finances in the long term. Population growth remains below the States' target to ensure fiscal stability and more needs to be done to increase the island's attractiveness to immigrants and those already living here. Government should maintain a grasp on the priorities of the local economy through consulting employers and businesspeople.

6.2 Cyclical Factors

Real improvement in income tax revenues

Both individual and corporate tax revenues in 2016 and those expected for 2017 grew beyond what can be attributed to extensions in the 10% tax rate on corporate profits and other minor extensions to the tax base. Some of this is due to the improving economic climate locally and internationally. Unemployment fell below 1% during 2017 for the first time in 6 years and is at such a level that Guernsey could be considered to be at full employment, and many of those remaining unemployed face additional barriers to returning to work. It is noted that the Committee *for* Employment & Social Security views the cost of helping these and other underemployed individuals as not only a social obligation but an investment that will generate a return through the taxes they pay and money they spend on this island when gainfully employed. This is sensible and could be applied on a wider scale to other forms of public spending.

Despite the difficulty in judging where the island is in the economic cycle (and exogenous shocks such as Brexit remain) current data suggest that total employment (up to June 2017) is still growing although, like the UK, median earnings growth is not keeping pace with the higher level of inflation. Both factors will have an impact on government revenues but current forecasts suggest the positive factors are dominating.

Investment return and capital income

The bullishness of global markets has meant that investment returns in 2016 were substantially higher than they have been in recent years. This is positive, but it is not prudent to rely on income received in this way for long term budgeting.

6.3 Material One-Off Factors

Reduced funding of Capital

The allocation to the capital reserve has been reduced once more in 2016 in response to an expected deficit at the mid-point of the year. For many years the States has sought to use the allocation to the capital reserve as a mechanism for managing the size of the deficit but continually reducing the funding is unsustainable in the long term, and may lead to a permanent reduction in potential output of the island. The one off reduction contributed to the return to surplus in 2016 and the current budget plans full allocations in 2017 and 2018.

This will worsen the overall deficit position but will progress towards achieving more sustainable capital funding. This is discussed further in the next section.

Capital Income

The States gained £10m from the repurchase of shares by two of the States' trading entities (Guernsey Post and Guernsey Electricity). Whilst this has provided a boost to revenues it is not a sustainable source of funding.

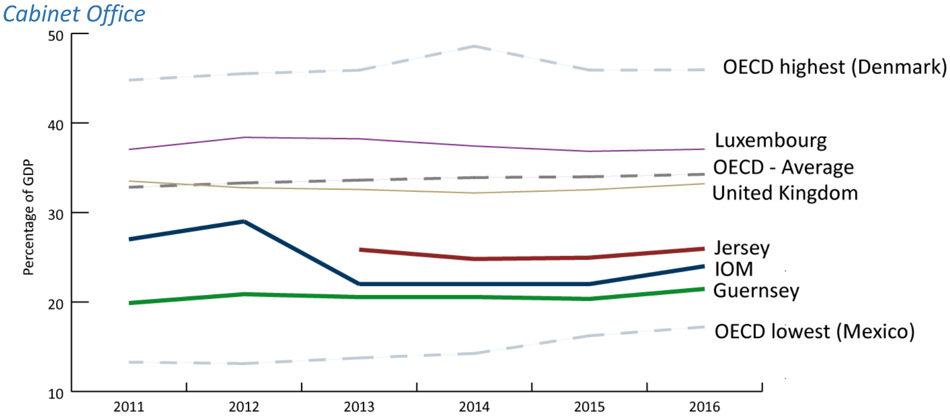
7. An Island Ready for the Future

7.1 A Necessary Debate

The size and role of government is a question found in every country in every era. Guernsey is no exception. Many of the detailed policy debates that are happening currently on-island can be seen as proxies for a wider debate about the affordability and desirability of government spending. The changes to the island's GDP and the corresponding effect on the Fiscal Framework's rules, reviewed in Section 5 of this report, represent an opportunity for the island to re-evaluate its fiscal position, spending levels and core strategies.

The revision of GDP places Guernsey's annual revenue collection (21.5% of GDP in 2016) well towards the lower end of those seen within the OECD. Of those reported in the OECD Statistical database, only Mexico and Chile collect a lower proportion of GDP as tax than Guernsey. Guernsey also collects less revenue than either of the other crown dependencies; the Isle of Man collecting 24% of GDP and Jersey collecting 26% (excluding the investment income from their various reserves) in 2016.

Figure 9: Comparison of tax revenues as a percentage of GDP
Source: OECD Stats database, States of Guernsey Accounts, States of Jersey Financial Report and Accounts, Isle of Man Cabinet Office



There are typically two perspectives on this. One is that having lower taxes than its closest competitors provides Guernsey with an advantage which could be beneficial in attracting and retaining international business. The other is it could be considered a demonstration that Guernsey has some headroom to raise revenues and still retain its competitive position.

Given how successful the States has been at restraining expenditure growth over the past eight years it would seem illogical to relax the budgetary vigilance simply because of a technical change in how GDP is measured. Conversely Guernsey, like many other jurisdictions, has long term demand challenges on the horizon, and revised data suggests Guernsey may be in a better position to meet these than previously thought.

It should be noted that many (but not all) of the criteria contained within the Fiscal Framework were set with reference to medium to long term historic averages. As an example, the 28% of GDP limit on aggregate revenues was established to reflect the relative value of government revenues before the introduction of zero-ten and in acknowledgement of long term pressures. While the revised GDP series does not extend back far enough to formally re-establish this level, it is clear that this justification no longer holds.

The authors of this review believe an open economy and the ability to react in turbulent times are fundamental to the success of Guernsey. Ensuring competitive advantage is a key objective. However, competitive advantage means different things to different people and establishing the States' "corporate view" may allow for greater strategic direction in the future.

7.2 Long-Term Economic Sustainability

Having re-established a balanced budget the Government needs to ensure that this balance is stable and provides a foundation for growth. Part of this is a requirement for planning for a rapidly changing future, looking to shape new markets and industries, and investing in Guernsey's infrastructure.

Government could work with the private sector to put the Bailiwick at the forefront of these advances, identifying the level and direction of capital investment required.

Overseas, Germany's "Industrie 4.0"[17] is an example of a government helping prepare the country to take advantage of major trends, while in the United States the "Defense Advanced Research Projects Agency" (DARPA) and other public research institutions have played a significant role in developing the technologies behind the internet and smartphone, spurring the growth of entire new markets. There is however some dispute about how cost-effective the US agency has been.

Other countries are already looking to capitalise upon the revolution in data and information technology, a revolution sometimes called the "Fourth Industrial Revolution". In Asia, advanced economies such as Japan and Korea are employing strategies to prepare for and embrace these transformational changes. In the Baltics, Estonia has become "the most advanced digital society in the world" through conscious choices by their government in developing e-Governance, online voting, Blockchain and the establishment of the world's first Data Embassy in Switzerland[18]. The UK government has also published its own Industrial

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[17]Innovations for Germany (2014), *'The new HighTech Strategy' https://www.hightech-strategie.de/de/The-new-High-Tech-Strategy-390.php*

[18] Estonian government website showcasing digital advancement, *https://e-estonia.com/*

Strategy[19], which sought to explain how it thought it could help businesses create better, higher-paying jobs with investment in new skills, industries and infrastructure.

The States is conscious of these opportunities – acknowledging that the digital industry, and the digital enablers for industry, ought to be a strong focus for Guernsey owing to it being a high value, low footprint economic activity that is suitable for a small island where land and workforce are at a premium. The authors of this report welcome the Digital Sector Strategic Framework Document published in April 2017, which prioritises the following:

- Driving digital sector growth,
- Delivering next generation digital infrastructure,
- Developing the digitally skilled workforce of the future,
- Providing a world leading and proportionate legal, compliance and regulatory environment.

Guernsey already has a sophisticated digital infrastructure and can attract talented people from the UK and beyond. If these priorities are acted upon they will not only reap great benefits for the existing industries on the island, but can diversify the economy and provide further long-term strength and stability in uncertain times.

[19]Department for Business, Energy & Industrial Strategy (2017), *'Industrial Strategy: Building a Britain fit for the Future' https://www.gov.uk/government/publications/industrial-strategy-building-a-britain-fit-for-the-future*

8. Conclusion

After running a deficit for nine years the States of Guernsey is in a position of surplus. This is clearly a desirable situation and the fact it has been done largely through fiscal responsibility is welcome.

As always the future is uncertain and there are many challenges ahead for the fiscal health of the island. The ageing population and low net migration will lead to further increases in the dependency ratio. Combined with this is the fact that many people have not yet made appropriate provision for their pension or the costs of social care; this may mean spiralling expenses. The advancing international tax transparency agenda and the as yet unknown effects of Brexit on our closest international partner may challenge the stability of the finance industry which forms 40% of the economy. A combination of these few pressures (out of many) could spell disaster for taxpayers in the Bailiwick.

However there are very praiseworthy moves to identify and manage future challenges. The Medium Term Financial Plan, the first medium-term fiscal strategy published by the States, demonstrated the risk that the structural deficit could resurface and become unmanageable by 2020 if no government action is taken. The establishment of the Policy and Resource Plan has indicated at least an attempt to co-ordinate and prioritise objectives over this political cycle. Additionally the Digital Sector Strategic Framework Document shows that the government is attempting to increase the diversity of Guernsey's economy with suitable high value, low footprint economic activities. This is key to the island's long-term prosperity.

It will be important to observe whether recent fiscal restraint continues in future, and whether the improvement in taxation receipts is cyclical or indicative of a longer term trend. Currently it is believed that there will have been a surplus in 2017 and a balance is forecast for 2018, which is encouraging.

The fact remains however that many short-term measures have been used to balance the budget, and the amount allocated to the capital reserve has been reduced once more in 2016. The recent methodological revisions mean that GDP is almost 20% higher than was reported at this point last year, placing Guernsey among the lowest taxing jurisdictions in the world. This is clearly material, and shows that Guernsey needs to have a wide-ranging debate with regard to the level of government spending, particularly with regard to capital spending and infrastructure investment.

This restatement of GDP may necessitate a root-and-branch review of the Fiscal Policy Framework and is in general an opportunity for the island to debate its fiscal position, spending levels and core strategies. The fiscal rules assessed in this report are an important place to start, as rules that are very easily met (or in the case of capital spending, easily ignored) may not provide the assurance or guidance intended when first implemented.