

# Annual Independent Fiscal Policy Review



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Data presented in this report was compiled by the States of Guernsey, Policy and Research Unit and any data errors are the responsibility of the Unit.

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## 1. Executive Summary

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*The States has wisely committed to a long-term policy of permanent balance. Whilst the current deficits are planned and funded through the Corporate Tax Contingency Reserve, the States will need to address replenishment of those reserves in the future once structural balance is attained a) to meet the long-run policy commitment, and b) as a sensible precautionary move to ensure the States is as well placed to weather future external economic shocks, as it was placed to meet the recent global downturn and the decision to introduce the zero/ten tax regime.*

Guernsey's economy has displayed remarkable resilience during the global downturn of recent years. The economy did experience a significant slowdown but suffered, assuming present estimates are accurate<sup>1</sup>, only a mild loss of output during the period. The present indications from the labour market are that a weak but relatively well-entrenched recovery has been underway since the third quarter of 2010. However, business and consumer confidence are likely to have been negatively impacted by the events of the summer of 2011 and it is likely that employment growth will subside in the coming quarters.

The global outlook remains weak and has steadily deteriorated over the course of the year as concerns have risen about the negative effects on growth of public sector debt in the West. Policy Council forecasts are for growth of the local economy to resume in 2011 and to rise to slightly 'above trend' following three years of below trend growth. The risks to these forecasts are clearly on the downside and the current 'central case' could well prove to be optimistic.

The negative impact of the introduction of zero/ten on total tax revenues remains in evidence. The current fiscal deficit, whilst in part a result of the cyclical downturn in revenues, also reflects an unsustainable long-run position. The States has demonstrated recent success in controlling net Revenue Budget funded expenditure, but this success is flattered slightly by the growth of expenditure funded by revenues from fees and charges.

The States has a clear strategy in place to eradicate the deficit through a policy of freezing net expenditure in real terms and achieving savings through the Financial Transformation Programme (FTP). This is a challenging strategy; there are risks to successful delivery on both the revenue and expenditure side. Progress will need to be carefully monitored and the States may need to consider further expenditure reduction or revenue raising measures if the outturn fails to meet the current projections.

The Fiscal Framework's 'permanent balance' constraint will mean that the States will need to consider replenishment of those reserves that are to be run-down to fund the projected deficit in the next few years. This is not an immediate issue but one that will most probably need to be addressed after the current States Strategic Plan planning horizon. It should also be noted that, at present, insufficient funds are being allocated to maintain capital expenditure at the 3% target over the medium term.

Finally, the Fiscal Framework sets parameters for the General Revenue Budget. However a significant portion of public sector expenditure (including the majority of expenditure on social benefits) is currently presented outside the General Revenue Budget and is therefore beyond the scope of the Fiscal Framework. Expenditure in this area has been growing relative to expenditure covered by the General Revenue Budget in recent years and, due to Guernsey's changing demographics, significant pressures are projected to build up in the medium to long-term. The States will need to address these matters in the next few years.

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<sup>1</sup> Estimates of GDP are subject to revision for three years after the end of the calendar year. As is demonstrated in **Box 2**, revisions to 'first estimates' can be significant.

## 2. Introduction

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This report is the second annual independent review of fiscal policy published as part of the institutional arrangements to support the Fiscal Framework, adopted by the States in April 2009<sup>2</sup>. The role of this report is to provide an independent, external assessment of the States' fiscal conduct against the criteria in the Framework. That Framework sets out clear numerical parameters and commits the States to long-run permanent balance. A summary extract of the framework is included in **Appendix 1**.

The role of the report is to provide independent analysis, review current fiscal conduct and draw attention to any areas where actions are in conflict with the long-term objective. It is also to provide an assessment of risks relating to fiscal strategy and to raise any general areas of concern that policymakers should be seeking to address. It is not an advisory report; its remit is not to provide or recommend policy solutions to those issues raised.

In making these assessments, various judgements are required: any assessment of the state of the economy, and thus its position relative to its long-run 'norms' on which the Framework is based, is in some respects by necessity subjective. There has to be a reliance on official data provided by the States; but official data in all jurisdictions are prone to inaccuracy and subsequent revision and Guernsey is no exception. As GDP is estimated with a nine-month lag, an assessment of present conditions is dependent on assessment of indirect variables such as levels of employment and unemployment.

Assessing the true fiscal picture is also made more difficult at this time due to the combination of the cyclical downturn in revenues resulting from the global downturn, as well as the structural downturn resulting from zero/ten. Attempting to disentangle the effects of the two is problematic. Therefore, there is still uncertainty about the structural position. In assessing the future path of revenues for the States, the backdrop of continuing uncertainty and pressure on the corporate tax regime creates additional difficulty.

With these caveats, this report sets out to fulfil its mandate of providing an independent assessment of the fiscal picture of the States.

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<sup>2</sup> Fiscal Framework, Appendix 1, Billet D'Etat XI, April 2009.

### 3. Commentary on the Fiscal Framework

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As a small, very open economy, Guernsey is very susceptible to external events and conditions. It also has available to it few policy levers which could be considered traditional economic management tools. In terms of general demand, conditions and prospects for the finance sector (Guernsey's dominant industry) are almost wholly driven by the state of global financial markets and the health of the City of London. Monetary policy is set by the Bank of England and any inflationary consequences of current UK monetary or fiscal policy typically feed straight through to Guernsey. This is despite the current differential between local and mainland inflation rates due to VAT rises.

Recognising that there are limits to what the States can control, the prudent and conservative policy set out by the States is principally to commit to achieving 'permanent balance'. This recognises what is known in economists' circles as the 'intertemporal budget constraint', or, to put it in layman's terms, acknowledging that, in the long-run, the States cannot spend more than it generates in revenues. It will, therefore, be necessary at some time to replenish reserves that are to be spent funding the deficit projected over the course of the next few years.

To help achieve this objective, the Fiscal Framework also sets strict numerical parameters for States' revenue funded expenditure, setting an upper bound for revenue income and expenditure of 21% of GDP. The purpose of these limits is to guard against unforeseen and unintended rises in public sector expenditure. It is for this reason that this report not only provides an assessment of current and future States fiscal conduct against the Fiscal Framework, but also seeks to develop the theme of controllable and uncontrollable costs to help improve understanding of the pressures on public sector expenditure.

The States' Fiscal and Economic Plan recognises the private sector as the driver of the economy and fiscal competitiveness as a key factor supporting the economy. The size (and cost) of the public sector in its entirety is therefore of keen economic interest. The majority of Social Security income and expenditure relating to contributory benefits is 'off budget', administrated and reported through accounts and budgets separate from the States' Revenue Budget. Although such expenditure is outside of the current scope of the Fiscal Framework, it is of economic relevance. In the medium term, there are likely to be significant pressures on Social Security expenditure as a result of demographic change; consideration is, therefore, given at times in the report to looking at public sector expenditure and income 'in totality'.

#### Box 1. Parameters of the Fiscal Framework

The Fiscal Framework sets a number of parameters and commitments:

- Maintenance of long-run 'permanent balance'.
- Total General Revenue and capital expenditure averaging no more than 21% of GDP.
- Restraint on any temporary operating deficit positions to less than 3% of GDP in any one year.
- Agreement to measures to remove any temporary deficit position within two years and removing them within five years.
- Annual capital expenditure averaging 3% of GDP.
- Total borrowing never to exceed 15% of GDP (and only to fund capital expenditure).
- The level of borrowing in any one year not to exceed 3% of GDP.

## 4. International economic outlook

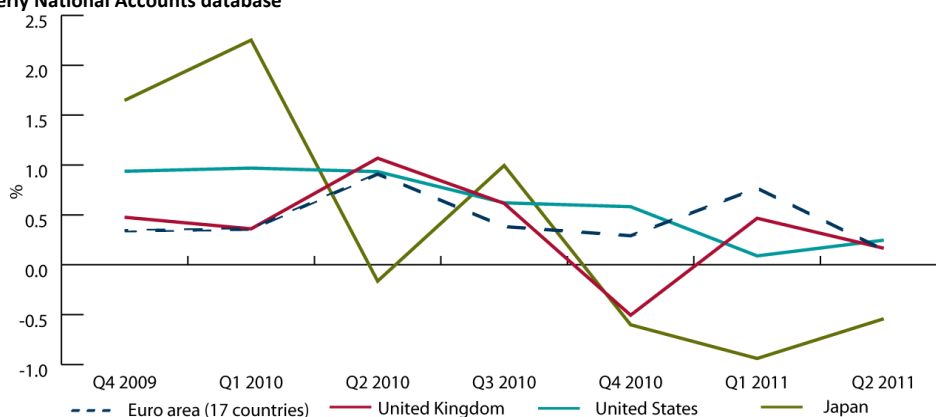
The Interim Assessment, published by the Organisation for Economic Co-operation and Development (OECD) in September 2011<sup>3</sup>, reported that the recovery from the global downturn almost came to a halt in the second quarter of 2011 (see **Figure 4.1.1**). Growth estimates for the first half of 2011 in both the Euro Area and the USA were lower than had been anticipated, pointing to weaker conditions than previously expected. Many countries (including the UK) have also revised down their growth forecasts for the coming quarters.

By contrast, the negative impact of the Japanese earthquake in March 2011 was less severe than had been anticipated.

**Figure 4.1.1. Growth rates in the Euro area, UK, USA and Japan**

Quarterly percentage growth in real GDP, annualised, as at September 2011

Source: OECD Quarterly National Accounts database



The OECD highlights that the most significant risks are on the down side and there is concern that the global economy could enter a double dip. Downside risks include subsiding business and consumer confidence and a stagnation of business profits growth. The OECD also states that the sovereign debt crisis remains a concern; should attempts to manage the issue prove ineffective, it will likely have a negative impact on the European and Global economies in the short term, although long-term effects remain unknown.

<sup>3</sup> What is the economic Outlook for OECD countries?, An interim assessment, Paris, 8 September 2011

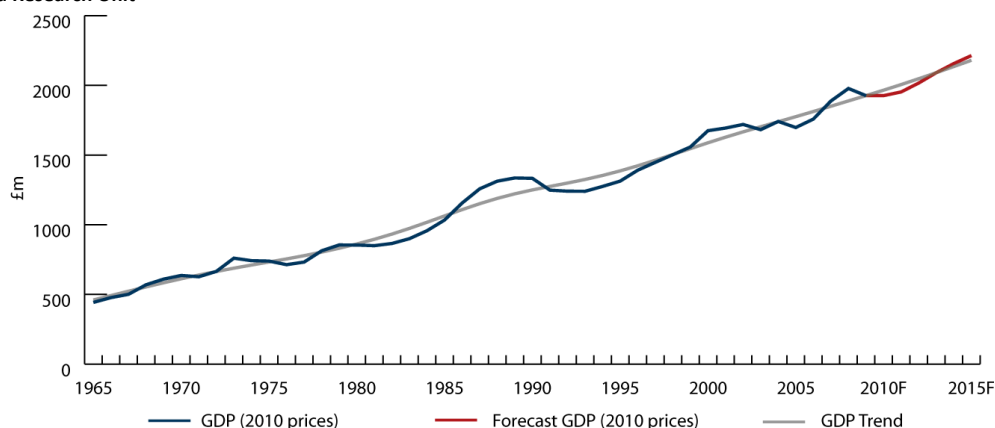
## 5. The Guernsey economy

### 5.1. Long-term trends of the Guernsey economy

**Figure 5.1.1. Long-term GDP trends**

At 2010 prices, as at September 2011

Source: Policy and Research Unit



**Figure 5.1.1** illustrates the long-run upward trend in GDP. It furthermore demonstrates that, whilst present Policy and Research Unit central forecasts are for real growth over the course of the next few years (see **Section 5.4** later), like most of the Western developed economies economic output is likely to be below trend over the course of that period. Guernsey clearly experienced rapid growth through the eighties, but that was then followed by the recession of the early nineties and it took the best part of a decade for economic output to return to its pre-recession level. Guernsey's experience of the recent global downturn has been much less severe in comparison<sup>4</sup>, with output only mildly below trend.

Growth was experienced year in year out for the ten years from 1992 to 2002. During the last decade, however, growth has been much more volatile, with years of contraction followed by years of expansion. The cause of this is the significant volatility of profits of the finance sector. These are linked to global financial conditions which, themselves, have been extremely volatile over the last ten years. As the finance sector has accounted for between 30 and 40% of total output over the last 10 years, this volatility directly feeds into volatile growth patterns. Guernsey is a small, open economy with a very large export-driven finance sector, and its economic behaviour does not fully follow the more predictable patterns of larger, more traditional economies.

Trend growth itself has slowed over the time period, as would be expected by a maturing economy with essentially fully-deployed resources. It should be noted that first estimates of GDP in Guernsey are available approximately nine months after the end of the calendar year and are subject to revision (see **Box 2**).

<sup>4</sup> In fact, unemployment peaked in 1993 at 2.5% compared to 1.6% in early 2009 using the equivalent measure.



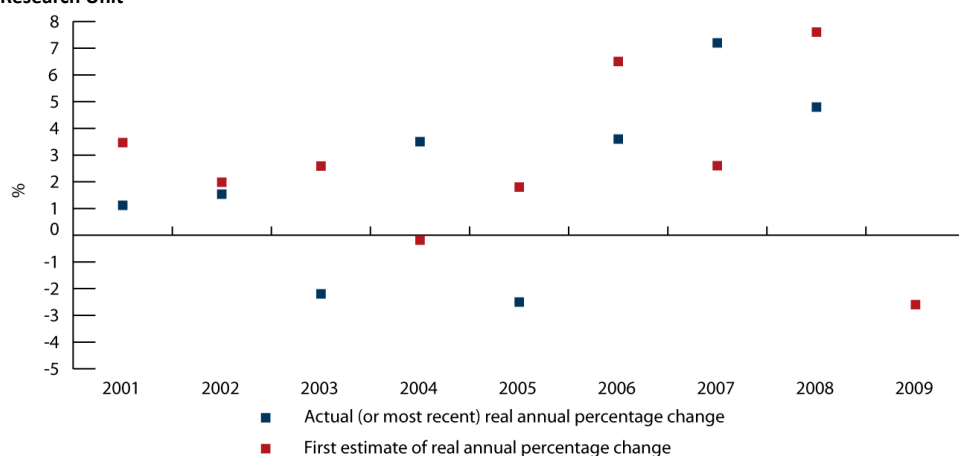
## Box 2. Growth estimates

Guernsey sources its primary data for GDP calculations from administrative sources (income tax), unlike many jurisdictions which rely on survey data. Because of the delays in the availability of final data sets, it is routine to revise initial estimates of GDP each year as additional data become available. The limited amount of data available at the time of the release of initial estimates means that the total revision between the initial estimates and the final data can be significant, particularly in years of rapid growth or contraction. Between 2001 and 2008, first estimates of growth deviated from the final (or current) estimates by an average of 3 percentage points.

**Figure 1. GDP estimates**

In real terms, as at October 2010

Source: Policy and Research Unit



**Figures 5.1.2 to 5.1.7** provide an illustration of the movement of various economic variables over the last 20 years. For ease of visual presentation, where possible values are displayed as an index, using 1991 as the base year equalling 100.

**Figure 5.1.2** vividly demonstrates the dependence of Guernsey for both output and growth on the finance sector. Whilst the non-finance sector has grown by 50% in real absolute terms over the course of the last 20 years, output of the finance sector has doubled. Total economic output grew by approximately 18% in real terms between 1990 and 1999 and by approximately 14% between 2000 and 2009. Other income sources (which include both personal and public sector interest and investment income) have declined by 36% over the last 20 years. The effects of the disparity in growth of the finance and non-finance sector are illustrated by the plot of the finance sector share of GDP in **Figure 5.1.3**. Whilst suffering a decline during the early to mid 2000s, the finance sector's share has trended upwards over the last 20 years and was 15 percentage points higher in 2010 than in 1991.

**Figures 5.1.4 and 5.1.5** illustrate several points:

- 1) the much greater volatility of finance sector profits in comparison to total profits;
- 2) the much greater volatility of profits compared to aggregate earnings growth; and
- 3) the greater increase in finance sector profits and, more obviously, the greater increase in aggregate earnings of the finance sector compared to other sectors.

Whilst aggregate earnings growth has been much smoother than profits growth, it too suffered a decline in the middle part of the last decade. **Figure 5.1.6** plots an approximate 'labour share' illustrating, as would be expected, an increasing labour share during periods of contraction and a decreasing share during periods of expansion. The long-term average share seems relatively stable at around 60%.

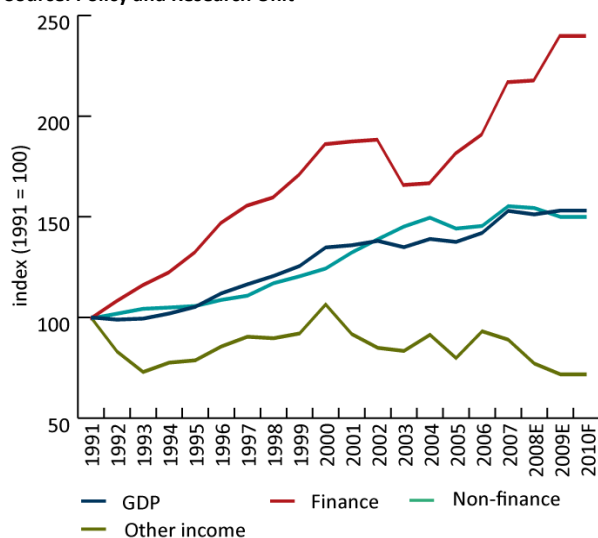
In real terms, aggregate earnings in the finance sector in 2010 were more than two and half times those reported in 1991 (see **Figure 5.1.4**). Aggregate earnings in other sectors increased to a lesser extent, with the total aggregate earnings of all non-finance sector employees increasing by just less than 50% over the same time period

Total employment levels in the finance sector were approximately 25% higher in 2011 than in 1997 (the first year in which employment figures were disaggregated on a sectoral basis) (see **Figure 5.1.**). Total employment also grew in non-finance sectors by 2% across the same period. Policy and Research Unit estimates show that mean average earnings in the finance and non-finance sectors have increased by 38% and 36% respectively.

**Figure 5.1.2. GDP and sector output indices**

Real indices, 1991 = 100, as at September 2011

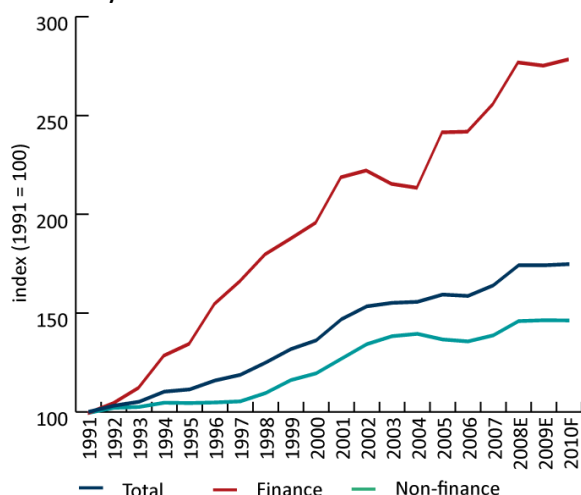
Source: Policy and Research Unit



**Figure 5.1.4. Aggregate earnings indices**

Real indices, 1991 = 100, as at September 2011

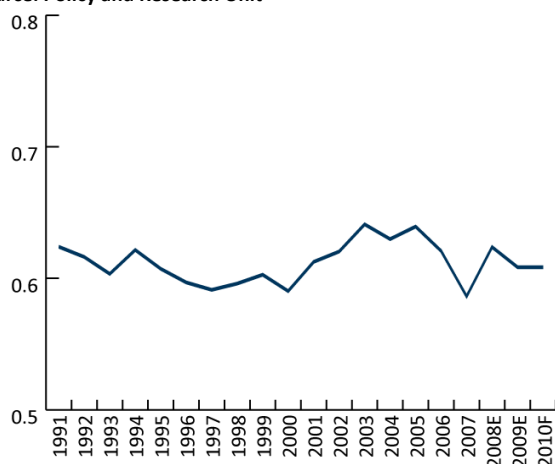
Source: Policy and Research Unit



**Figure 5.1.6. Earnings to earnings+ profits ratio**

As at September 2011

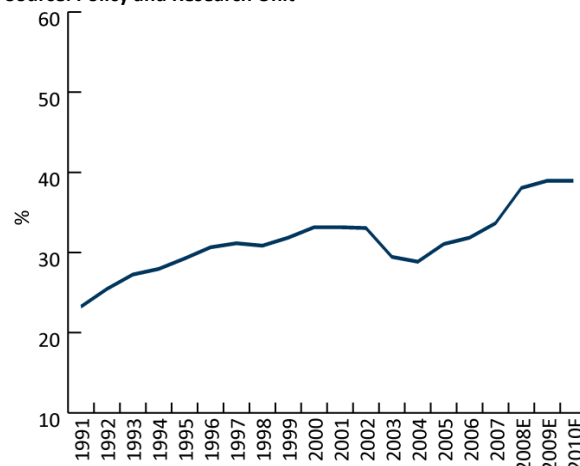
Source: Policy and Research Unit



**Figure 5.1.3. Finance sector share of GDP**

Percentage of total GDP, as at September 2011

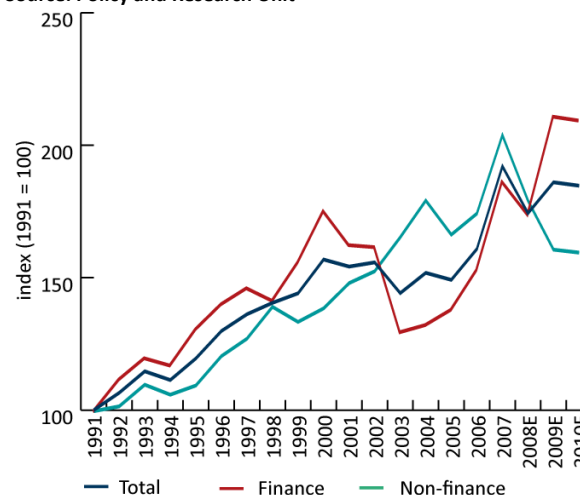
Source: Policy and Research Unit



**Figure 5.1.5. Aggregate profit indices**

Real indices, 1991 = 100, as at September 2011

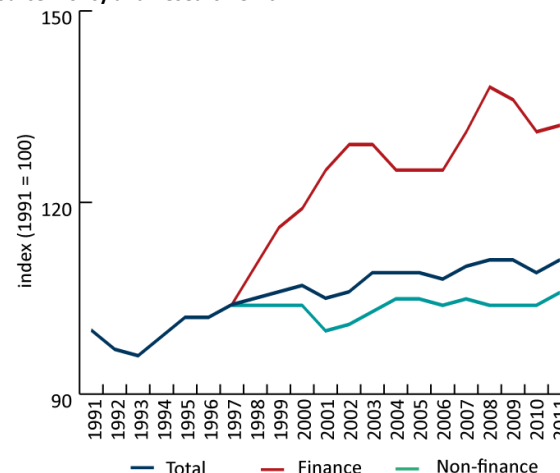
Source: Policy and Research Unit



**Figure 5.1.7. Total employment indices<sup>5</sup>**

Real indices, 1991 = 100, as at September 2011

Source: Policy and Research Unit



<sup>5</sup> Data on employment by sector is unavailable prior to 1997.

## 5.2. Recent economic performance

Guernsey does not presently collect data on quarterly business and consumer confidence or spending. Therefore, assessing recent economic conditions is dependent on a review of indirect measures. **Figures 5.2.1 to 5.2.4** present a range of such measures and clearly show the recent economic cycle. **Figures 5.2.1 and 5.2.2** provide an illustration of the performance of the labour market over the course of the last three and a half years. Employment levels declined from late 2008 onwards but have now been growing since the second half of 2010. Conversely, unemployment grew rapidly in early 2008, rising at double digit rates and peaking in mid-2009. It has gradually declined since late 2009, although remaining above pre-crisis levels.

Headline inflation, RPIX, after spiking in the second quarter of 2008 just before the credit crunch, has remained remarkably benign, at or around 3%, for the past two and a half years. Real average earnings growth (not shown) grew rapidly in 2007 and has slowed markedly in the last two years, with mean average growth remaining positive, although median average earnings declined marginally in 2010<sup>6</sup>. The number of part-time workers claiming supplementary benefit has grown by 170% since 2008, which indicates an increase in the number of people working part-time. This would in part account for the decline in median earning in Guernsey<sup>7</sup>. Subdued inflation and weak earnings growth both suggest domestic demand remains weak.

Property prices have continued their rising trend throughout the course of the last three years. However, prices did decline by around 10% between mid-2008 and mid-2009, driven probably by a slump in demand evidenced by the drop in sales volumes through 2008<sup>8</sup>. However, local market sales volumes rebounded in 2009, stabilised in 2010 and rose gently in the first half of 2011.

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<sup>6</sup> See States Strategic Plan Monitoring Report 2011, Policy & Research Unit, [www.gov.gg/pru](http://www.gov.gg/pru)

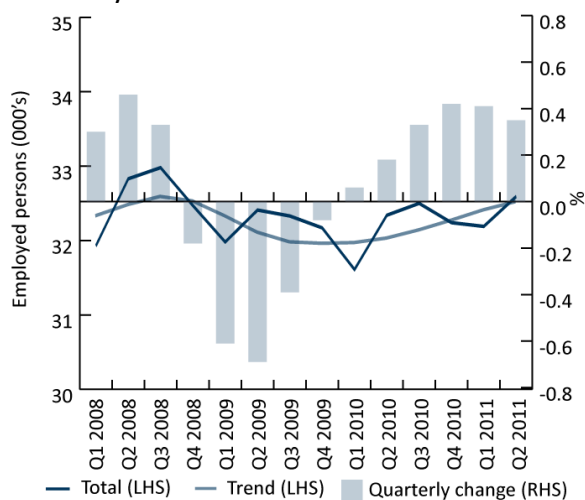
<sup>7</sup> This includes part-time employment as it is not possible to remove these from the primary data source.

<sup>8</sup> Although relative to other (e.g. UK, Ireland) property markets, this drop in volumes was mild.

**Figure 5.2.1. Total employment**

Actual and with SA trend, as at August 2011

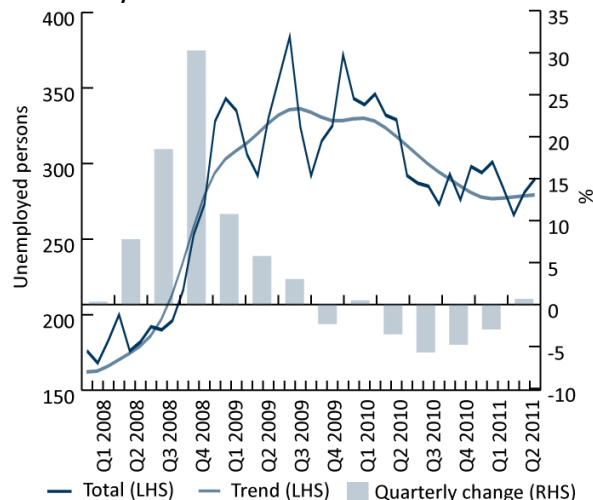
Source: Policy and Research Unit



**Figure 5.2.2. Total unemployment**

By ILO definition, actual and with SA trend, as at August 2011

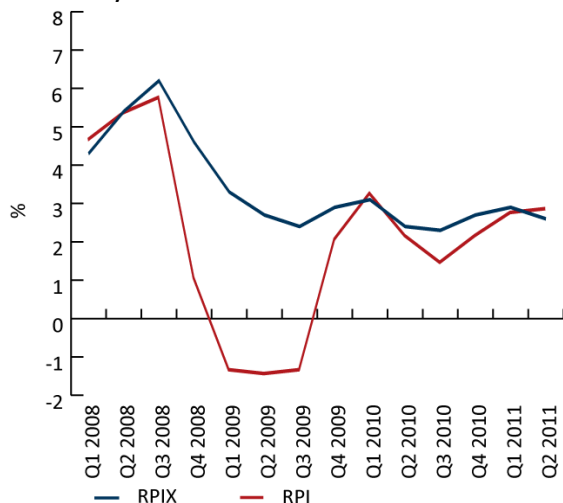
Source: Policy and Research Unit



**Figure 5.2.3. Inflation**

Annual percentage change, as at July 2011

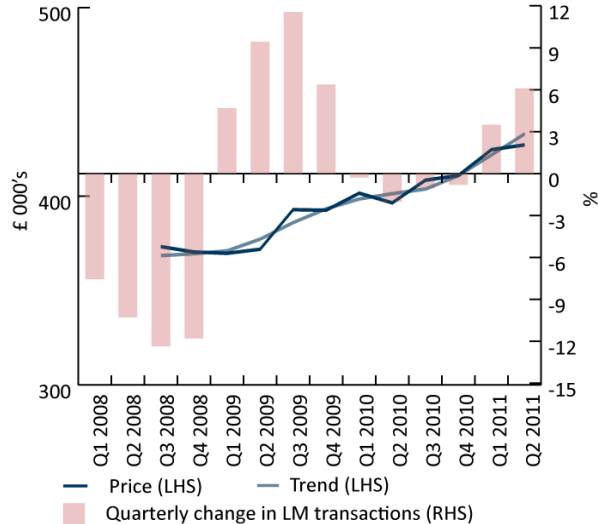
Source: Policy and Research Unit



**Figure 5.2.4. Local market property**

LM mix adjusted purchase price with SA trend, as at August 2011

Source: Policy and Research Unit



## 5.3. Finance Sector Conditions

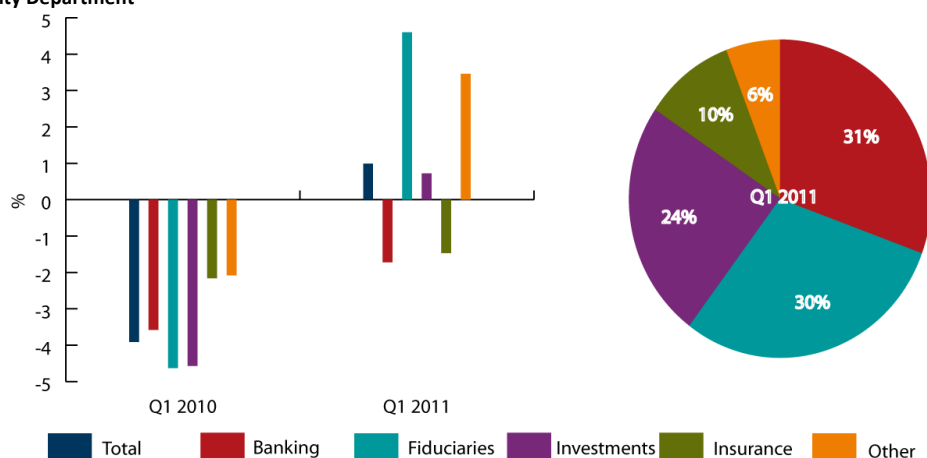
### 5.3.1. Employment

Guernsey's finance sector can be divided into four major sub-sectors: banking, investments, insurance, and fiduciaries. Total employment levels across the whole sector fell in 2009 by 4% and remained broadly flat in 2010 (employment in fiduciaries and investment sectors increased by 3% and 1% respectively, but this was offset by decreases in banking and insurance sectors of 2% and 3% respectively). At the end of June 2011, total employment in the finance sector showed no significant change on the previous year.

**Figure 5.3.2. Annual change and distribution of employment in the finance sector in March each year**

Annual percentage change and total employment, as at June 2011

Source: Social Security Department



**Table 5.3.1. Total employment in the finance sector**

As at June 2011

Source: Social Security Department

	2009 Q1 <sup>9</sup>	2010 Q1	2011 Q1
Banking	2,235	2,155	2,118
Fiduciaries	2,051	1,956	2,046
Investments	1,750	1,670	1,682
Insurance	693	678	668
Other	384	376	389
<b>Total</b>	<b>7,113</b>	<b>6,835</b>	<b>6,903</b>

Employment in the finance sector remains approximately 7% off its peak in the third quarter of 2008 but, as illustrated above in **Table 5.3.1**, has begun to grow once more.

### 5.3.2. Other indicators

**Figure 5.1.5** illustrates the significant volatility of finance sector profits in the last decade, driven by global financial conditions rather than conditions of the global real economy, often with a lag. Using the FTSE as a proxy, **Figure 1** in **Box 3** illustrates the relationship between the two.

**Figure 5.3.3** and **Figure 5.3.4** plot levels and quarterly changes of banking deposits and funds values respectively. Profits and, thus, economic output are not tightly correlated with these variables; there are leads and lags involved and the relationship is not linear. However, the evidence of the global downturn is

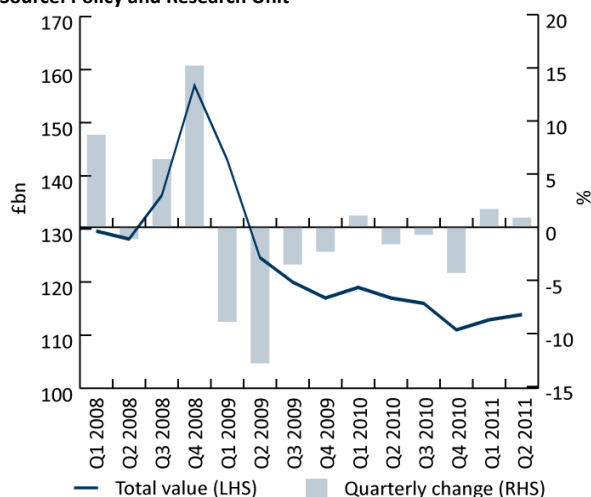
<sup>9</sup>Figures for 2009 include a manual adjustment to correct a coding error (corrected in the raw data collection in Q3 2009). This resulted in the transfer of approximately 100 employees from the fiduciary sub-sector to the banking sub-sector

clear, as is the improvement in conditions from mid-2009 onwards. Fund values have grown significantly and, in June 2011, were well above their previous peak (albeit prior to the fall in stock market indices in August 2011 - see **Box 3**). In contrast, banking deposits have stabilised, but levels remain depressed compared to their pre-crisis levels.

**Figure 5.3.3. Banking deposits**

At current prices, nominal change, as at August 2011

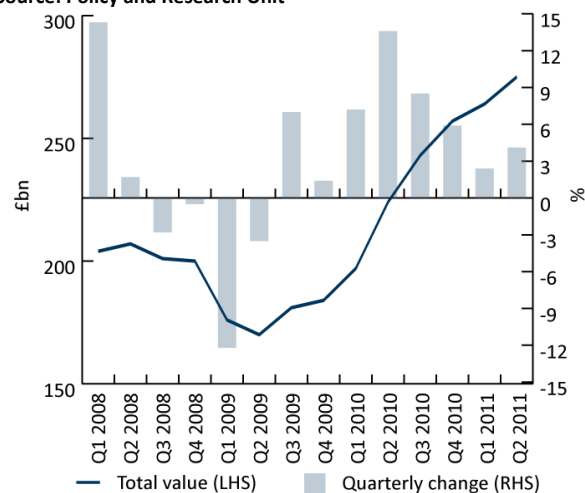
Source: Policy and Research Unit



**Figure 5.3.4. Fund values**

At current prices, nominal change, as at August 2011

Source: Policy and Research Unit



The decline in global conditions experienced in the summer of 2011, particularly the fall in stock market indices, may have an adverse effect on fund values and on finance sector profits for the latter half of 2011.

### Box 3. Risks to the finance sector

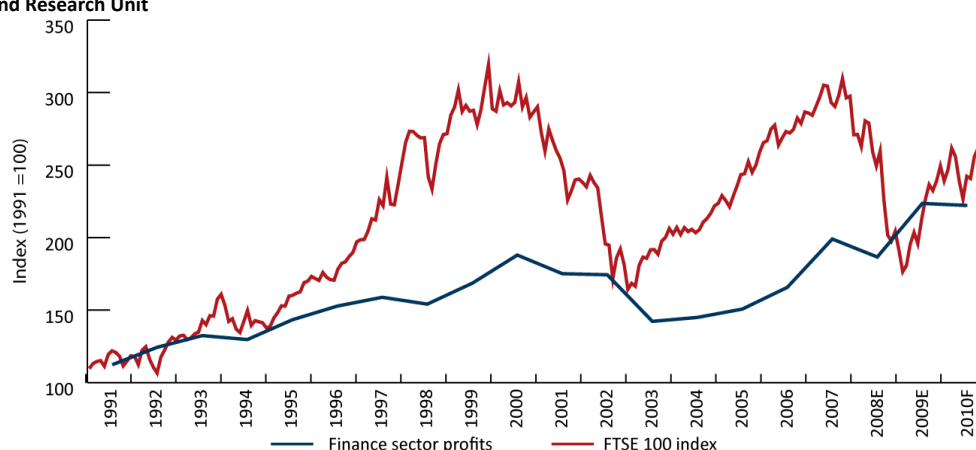
Whilst it is well recognised that Guernsey's finance sector held up well during the global downturn, there are real risks to the long-term health of the sector. Setting aside the risks from general global economic and financial conditions, the changing regulatory environment, particularly in banking, has the potential to have a detrimental impact on the business models of the industry, both those operating offshore and generally. The banking sector is facing pressures on multiple fronts and in general is operating in a global environment of increased capital requirements. The natural consequence of this, irrespective of other short-term political imperatives on banks to increase lending, is most likely to lead to a consolidation and contraction of the sector globally.

In the short term, global financial conditions have clearly worsened over the course of 2011 and there is likely to be an impact on profits of the finance sector in Guernsey (see **Figure 1**). Whilst employment is likely to be less affected, as was shown in **Section 4**, this is likely to have an impact on GDP.

**Figure 1. Finance sector profits and FTSE 100 index**

As at September 2011

Source: Policy and Research Unit



The regulatory risk from Europe is well-known to Guernsey through its recent experience of the passage of the AIFM directive. There are numerous policy initiatives emanating from Brussels, such as the proposed Financial Transactions Tax, the final form and impact of which is still unknown. On other fronts, the pressure on the zero/ten regimes from the EU Code of Conduct remains. With access to the UK financial markets dependent on EU access, these factors will by necessity continue to exert an influence on Guernsey policymakers' deliberations.

Having said that, despite current conditions, global wealth is still set to grow markedly over the coming decades and the demand for global financial services will continue to grow. Growth opportunities for well-regulated, tax-transparent jurisdictions are still likely to exist.



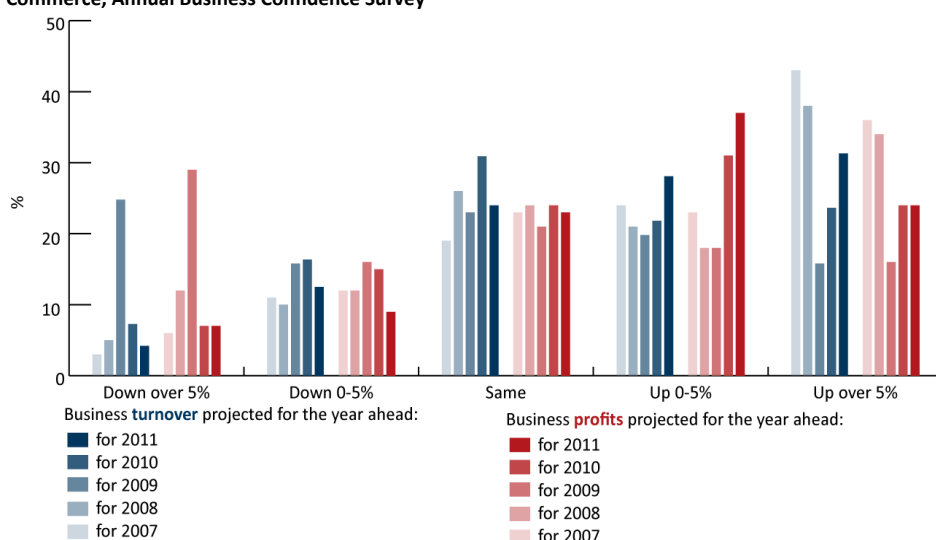
## 5.4. Outlook and forecasts for the Guernsey economy

The Guernsey Chamber of Commerce (through Young Business Group) has conducted an annual survey of business conditions for the last six years. Conducted during January and February, it demonstrated that at the beginning of the year Guernsey businesses were remarkably confident about prospects for 2011, a net balance of plus 42% anticipating higher profits than 2010 and a net balance of plus 46% anticipating higher turnover. However, this confidence may well have been adversely impacted during the course of 2011 as the global economic recovery has been fragile and global confidence in the recovery has fallen.

**Figure 5.4.1. Annual profitability and turnover projections compared to a year previously**

As at March 2011

Source: Chamber of Commerce, Annual Business Confidence Survey



### Box 4. Risks to domestic demand

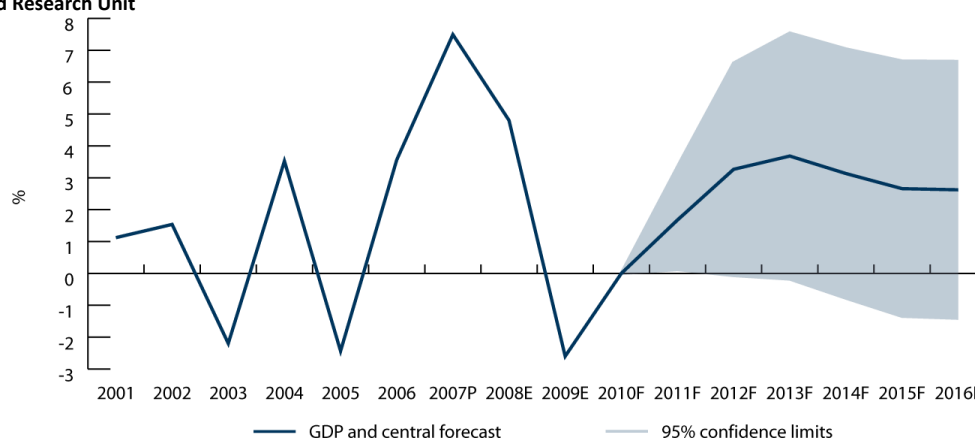
The main risks to domestic demand are falling business and consumer confidence (and thus spending) and declining household income. Guernsey was fortunate during the global downturn as business and consumer confidence levels held up well (particularly relative to elsewhere, including the UK). The likelihood of a significant decline in confidence remains a risk given the turbulence experienced over the summer. Similarly, if post-recession growth is at a lower trend, the response of households and firms would be to curtail spending; as a result, post-recession spending growth would be at a lower rate.

Whilst there is presently no published data to confirm the hypothesis, it is Policy and Research Unit's belief that levels of unsecured household and corporate debt relative to incomes are lower on average in Guernsey compared to the UK. Thus, spending is probably less prone to pressure from continued efforts to repair balance sheets. On the other hand, with the average house price in Guernsey more than two and a half times the UK national average in June 2011, average mortgage debt levels are likely to be higher relative to earnings and consumer incomes would be negatively impaired by future interest rate movements when they occur. The impact on spending could be offset to some extent by increased investment income of Guernsey households feeding through into increased spending of households dependent on non-earned income.

**Figure 5.4.2. Annual growth in Gross Domestic Product**

Real change, as at June 2011

Source: Policy and Research Unit



GDP is measured annually in Guernsey, with around a nine-month lag. Internal Policy Council estimates suggest growth resumed in the third quarter of 2010. The Policy Council forecasts a resumption of real growth in 2011 of around 1.4%, followed by ‘above trend’ growth of 3.3% and 3.7% in 2012 and 2013, subsiding to around trend thereafter. Forecasts are prone to much uncertainty and if the risks to global growth are, using the language of economists, ‘on the downside’, the same applies to Guernsey. In addition, official estimates of all jurisdictions are prone to inaccuracy and subsequent revision and Guernsey is no exception. **Box 2** illustrates that initial estimates are prone on average to a 3 percentage point final revision either way.

With that health warning, the corollary is that the assumption that growth resumed in late 2010 is based primarily on improvements in the labour market where unemployment fell and employment rose for three consecutive quarters of growth from quarter three 2010.

## 6. Guernsey's public finances

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### 6.1. Introduction

Guernsey's public finances can be broadly divided into two distinct revenue streams: General Revenue income, mainly derived from taxation (as presented in the States' Annual Budget (*'the General Revenue Budget'*) in December), paying for departmental and capital expenditure; and Social Security income, mainly derived from social insurance contributions (*'the Social Security Budget'*), although having recourse to investment income and some revenue grants, paying for Social Security benefits. The two are related by a complex series of interrelated accounts and transfers (see **Appendix 4**).

The parameters of the Fiscal Framework currently cover General Revenue income and expenditure only. In practical terms, the Framework has little impact on the expenditure and income of the Social Security Budget. However, as non-contributory benefits rates are set through the Social Security Budget but funded from the General Revenue Budget, Social Security expenditure has an impact on General Budgetary balance.

In addition, total revenue and expenditure figures presented in the General Revenue Budget are also typically presented net of departmental operating income<sup>10</sup> and expenditure funded from that source.

Whilst the primary purpose of this report is to assess the States' fiscal policy conduct against the parameters of the Fiscal Framework, an attempt is made to present an illustration of the levels of total public income and expenditures, to provide a more transparent picture of aggregate trends: total public sector expenditure and income are the variables of particular interest and importance.

The concept of controllable and uncontrollable costs is also introduced to assist an understanding of the nature and extent of control the States has over its own total budget.

The overall deficit of the General Revenue Budget was £37m in 2010. On current estimates, this will marginally improve in 2011. In the States Strategic Plan (SSP), the States sets out its strategy to eliminate this deficit by 2014; that strategy is discussed in **Section 7**.

This chapter separately analyses income and expenditure for the General Revenue Budget and the Social Security Budget, trends in both, and trends in public sector income and expenditure 'in totality'. This is followed by a discussion of trends in income and expenditure in the context of the Fiscal Framework before concluding with a discussion of the issue of 'permanent balance', capital spending and reserves. **Section 8** provides an assessment of the States' fiscal strategy and projected spending and revenues against the criteria of the Fiscal Framework.

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<sup>10</sup> Income from fees and charges levied by individual departments for certain services and the subsidies paid from the Social Security funds to other States departments.

## 6.2. Income

### 6.2.1 General Revenue income

General Revenue income totalled £331m in 2010, declining in 2009 and 2010 by 2% and 3% in nominal terms (5% and 4% in real terms) respectively (see **Figure 6.2.1**). Employee Tax Instalment (ETI) receipts are the greatest single revenue source and comprised 45% and 49% of General Revenue income in 2009 and 2010 respectively. ETI receipts rose in nominal terms in both 2009 and 2010, decreasing in real terms by 0.5% in 2009 and increasing by 2% in 2010<sup>11</sup>. Direct tax receipts from other personal income sources fell by £10m in 2010, a nominal decrease of 19%.

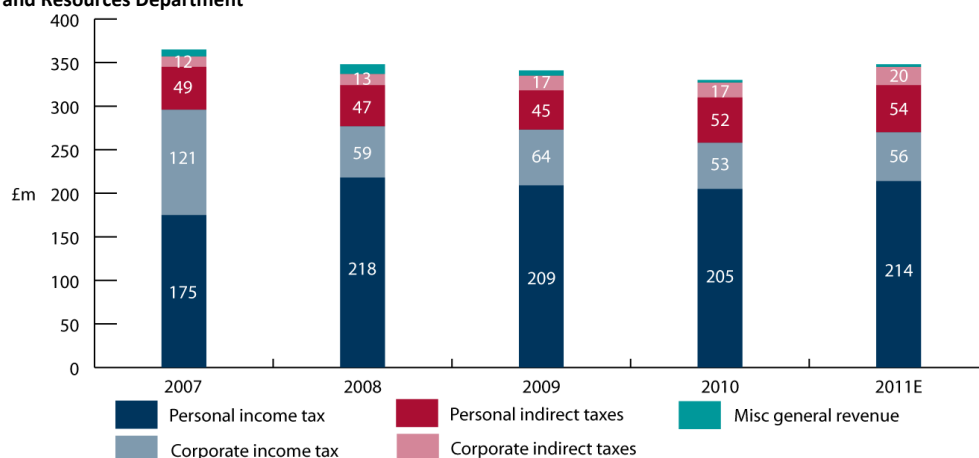
Corporate income taxes (which are collected/reported with a lag due to the collections and accounting process) increased in nominal terms by 8% in 2009 before declining by 18% in 2010. Much of the decrease in 2010 was attributable to a £8m decrease in transitional company tax receipts as the final stages of the transition to the zero/ten tax regime near completion. Receipts from indirect taxes increased in nominal terms in 2009 and 2010 by 4% and 12% respectively, relating to rises in excise duty and in the Tax on Real Property (TRP). Document duty receipts declined by 9% in 2009 but increased by 28% in 2010 as a result of declining and then rising property sales volumes in those years.

The most recent projections for 2011 (published in the 2011 SSP) project an increase in General Revenue of £17m, boosted by an anticipated increase in ETI receipts and a general uplift in indirect taxation income (the majority of indirect tax rises being limited to (an expected) inflationary uplift only) as economic growth is forecast to resume.

**Figure 6.2.1. General Revenue income by source, £m**

At current prices, as at September 2011<sup>12</sup>

Source: Treasury and Resources Department



	2007	2008	2009	2010	2011E	Cumulative change 2007-2011
<b>General Revenue income (£m nominal)</b>	365	349	341	331	348	-18
<b>% Change (nominal)</b>	12.3	-4.4	-2.2	-3.1	5.1	-4.8
<b>% Change (real)</b>	7.0	-5.5	-4.3	-5.2	1.9	-12.7

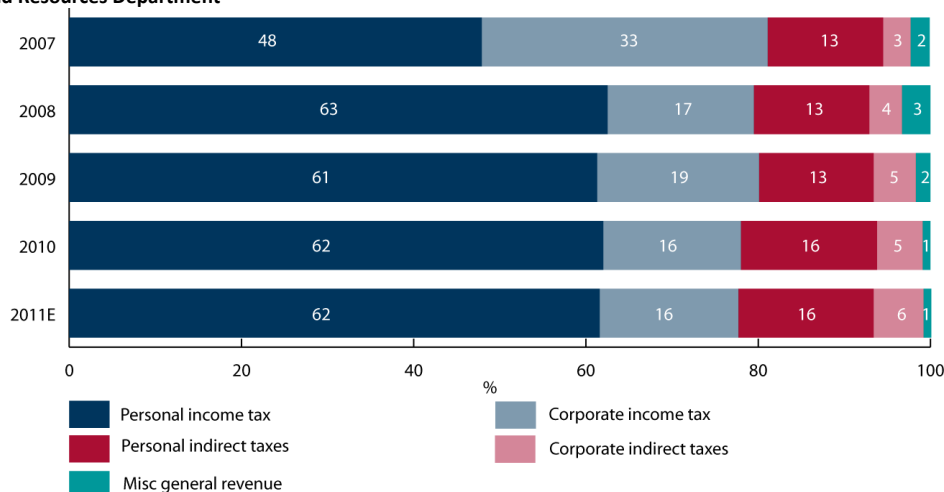
<sup>11</sup> The above inflation rises in personal income tax allowances will have had an impact on total revenues.

<sup>12</sup> All 2011 estimates presented are those published in States Strategic Plan in September 2011 (which incorporated revisions of the 2011 budget based on income and expenditure in the first six months of 2011) unless otherwise stated.

**Figure 6.2.2. General Revenue income by source, percentage**

As at September 2011

Source: Treasury and Resources Department



The distributional effects of the introduction of zero/ten are readily apparent from **Figure 6.2.2**, which shows personal taxation accounting for just over three quarters of revenue from 2008 onwards (having accounted for about 60% of revenues previously). The split between direct and indirect taxation (both personal and corporate) has also changed, but to a lesser extent, with indirect taxes comprising 21% of General Revenue income in 2010 against 17% in 2007.

#### Box 5. Risks to revenue income

Most General Revenue income streams are dependent to some extent on the economic conditions in any given year, most of which are largely beyond the States' control. Personal income tax revenues are determined predominantly by aggregate earnings. This in turn is determined by total employment numbers and average earnings, both of which are likely to fall during periods of economic stress.

To a lesser extent, interest rates also affect revenue as the States allow tax relief on mortgages up to £400,000. It is estimated that each 1 percentage point increase in the average effective rate<sup>13</sup> of interest applied to mortgages would result in the loss of between £4m and £6m in revenues<sup>14</sup>. However, this would likely be offset to some extent by the increased revenues tax on personal savings and investments income (for which no estimates have been produced to date).

Since the introduction of zero/ten, the impact of the business cycle on company profits has had a smaller effect on General Revenue income as the majority of companies are no longer subject to taxation. However, profits from banking activity, some of which is still taxed, are subject to a range of external factors including exchange rates, interest rates and the performance of global markets.

Indirect taxes, particularly document duty charged on property sales, are also subject to economic conditions as was clearly illustrated by the fall in document duty revenues from £24m at the market peak in 2007 to £14m in 2009 following a 26% reduction in the annual number of local market property sales.

<sup>13</sup> The average effective rate is the actual average annual percentage rate of interest paid on loans (in this case, residential mortgages) calculated from the total value of loans and the monetary value of interest paid over a given period.

<sup>14</sup> Policy Council Research Unit estimates.

### 6.2.2. Departmental operating income

Departmental operating income includes revenue from fees and charges for services, rental income, recoveries of funds (such as the reimbursement of expenses) and transfers of funds between departments and from the Social Security<sup>15</sup> system and is added directly to the gross budget of each Department (see **Appendix 2** for further details).

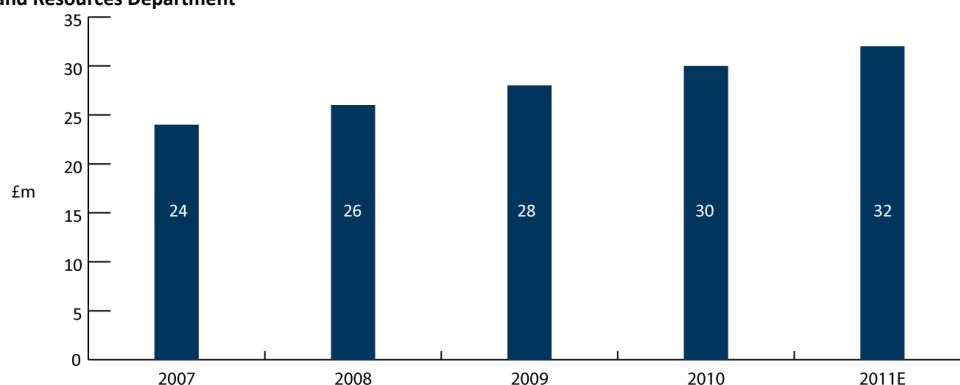
General Revenue income and expenditure, as presented in the executive summaries of the General Revenue Budget and States Accounts, are presented after departmental operating income and its subsequent expenditure are 'netted off' (see **Table 6.4.1** later in this section). Although this has no effect on the overall fiscal position, as the Fiscal Framework also sets limits on General Revenue net of departmental operating income this provides an avenue for expanding revenue income (and consequently expenditure) outside the parameters of the Framework.

Departmental operating income grew in nominal terms by 9% in 2010 to £30m and grew in real terms by 22% between 2007 and 2010 (see **Figure 6.2.3**).

#### Figure 6.2.3. Departmental operating income

At current prices, as at May 2011

Source: Treasury and Resources Department



### 6.2.3. Social Security (Social Insurance) income

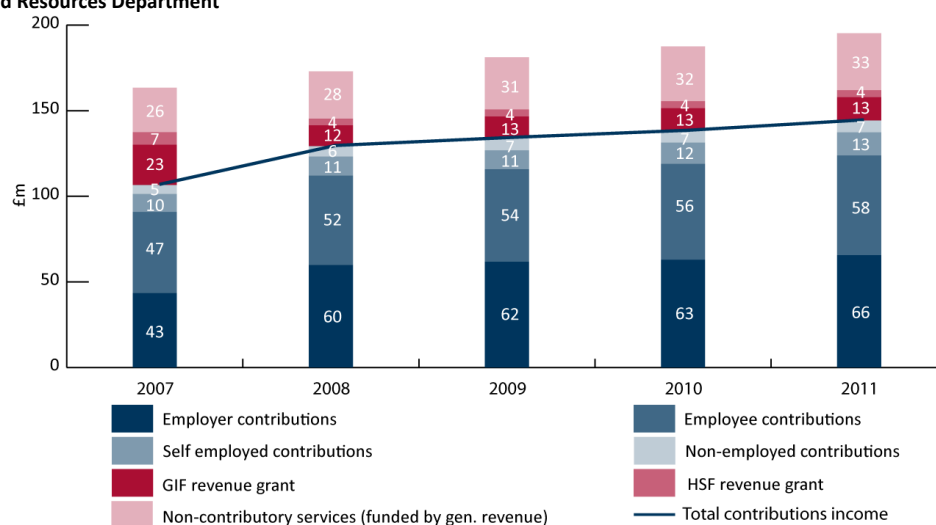
Social insurance collections rose by 24% in real terms over the period 2007 to 2010, caused by two main factors: 1) the natural drag of increased wages; and 2) increased contribution rates. Contribution rates have been increased twice over the last five years: firstly to compensate for the reduction in the Revenue Grant that was made as a result of the movement to the zero/ten corporate tax regime; and secondly as a result of the review of the long-term pensions liabilities of the fund (see **Appendix 3**).

<sup>15</sup>The inclusion of payments from Social Security as operating income in departmental budgets results in the double counting of income and expenditure in the SSD and central accounts. Whilst these accounts are considered separately, this does not pose a problem but it does make the issues of presenting an accurate aggregated figure more complex than it would otherwise appear.

**Figure 6.2.4. Social Security income<sup>16</sup>**

At current prices, as at May 2011

Source: Treasury and Resources Department



	2007	2008	2009	2010	2011E	Cumulative change 2007-2011
<b>Social Security income (£m nominal)</b>	163	173	181	188	195	32
<b>% Change (nominal)</b>	6.8	5.9	4.7	3.5	4.1	19.5
<b>% Change (real)</b>	1.9	4.7	2.4	1.2	1.0	9.6

#### 6.2.4. Aggregate public income

Consolidating these three separate income streams above presents a picture of total public sector income<sup>17</sup>. Total public sector income fell in real terms by just 5% from 2007 to 2010 against a fall of 14% of General Revenue income, the disparity mostly accounted for by the rise in Social Insurance generated revenues.

The share of total public income derived from social insurance contributions increased from 22% in 2007 to 28% in 2010. Correspondingly, the share of General Revenue Budget income declined from 74% in 2007 to 66% in 2010, while the share from operating income (fees and charges) increased from 5% to 6%. The share of income (and thus expenditure) constrained by the Fiscal Framework has declined and now accounts for just two thirds of aggregate public sector income.

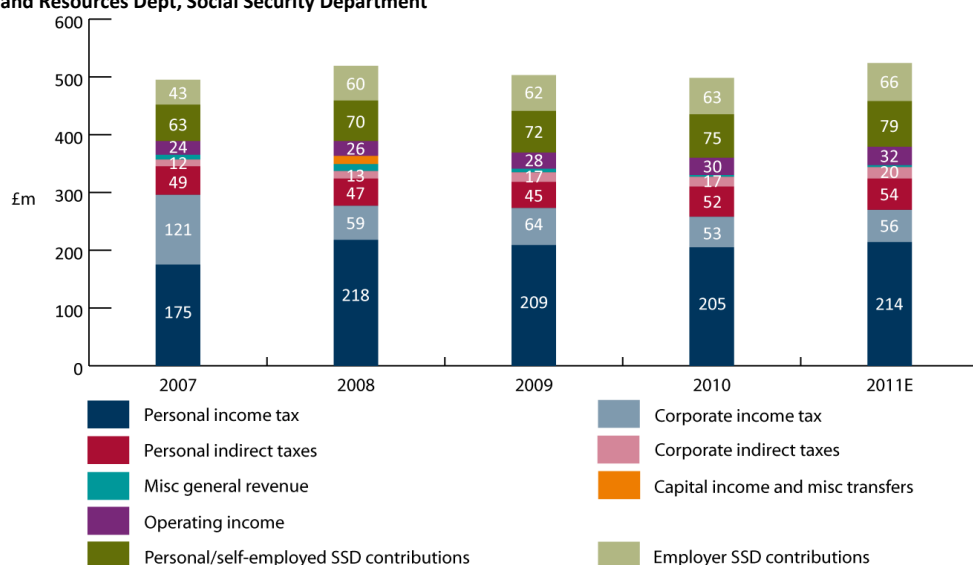
<sup>16</sup> Income below the line (shaded in various blues) is collected via social insurance contributions. Income above the line (shaded in various reds) is transferred from the revenue budget and thus is included in the total revenue income and needs to be netted off (to avoid double counting) when estimating total public income.

<sup>17</sup> This excludes public-owned utilities such as water, electric etc.

**Figure 6.2.5. Estimated aggregate income by source, £m<sup>18</sup>**

At current prices, as at September 2011

Source: Treasury and Resources Dept, Social Security Department



	2007	2008	2009	2010	2011E	Cumulative change 2007-2011
Estimated aggregate income (£m nominal)	495	518	503	499	526	31
% Change (nominal)	10.8	4.7	-2.9	-0.7	5.4	6.3
% Change (real)	5.7	3.5	-5.1	-2.9	2.3	-2.5

**Figure 6.2.6. Estimated aggregate income by source, percentage<sup>18</sup>**

As at September 2011

Source: Treasury and Resources Dept, Social Security Department



<sup>18</sup> These estimates include some degree of double counting between departmental operating income and the SSD accounting (approx £7 m in 2010) but it was not possible to eliminate this from the time series at the time of publication.



## 6.3. Expenditure

### 6.3.1. Net General Revenue expenditure

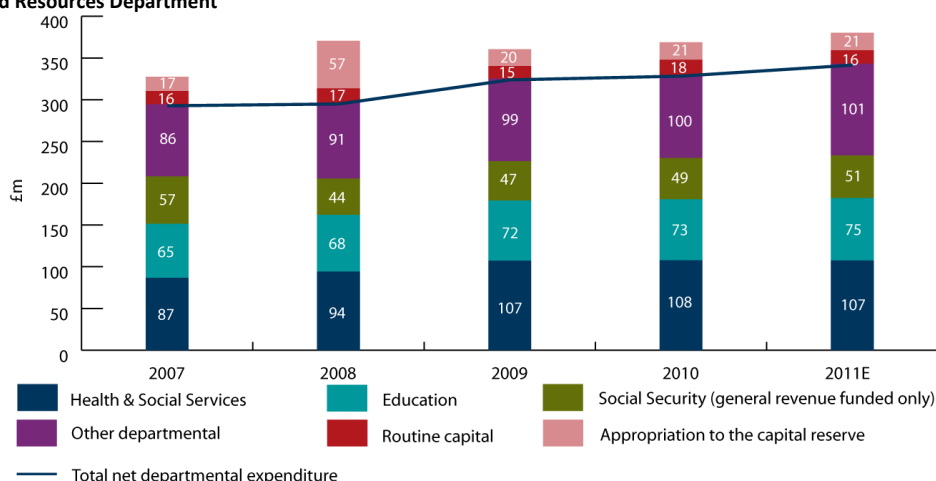
Including capital allocations, net General Revenue expenditure<sup>19</sup> grew by 12.2% in nominal terms between 2007 and 2010, a real terms increase of 6.5% (see **Figure 6.3.1**). Net departmental expenditure grew by a similar percentage.

The reported increase in departmental expenditure from 2007 to 2008 (excluding the impact of capital expenditure) was flattered by the reduction in the General Revenue grant to the Social Security Department (SSD) (see **Appendix 3**), resulting in a decrease in General Revenue expenditure by SSD from £57m in 2007 to £44m in 2008. Subsequently, the Revenue Grant grew by 8% in 2009 and 5% in 2010. General Revenue expenditure by the Health and Social Services Department (HSSD) grew by 9% in 2008, and 14% in 2009 but by less than 1% in 2010 in nominal terms. These two departments accounted for 43% of total States General Revenue Budget expenditure in 2010.

**Figure 6.3.1. Net General Revenue expenditure**

At current prices, as at May 2011<sup>20</sup>

Source: Treasury and Resources Department



	2007	2008	2009	2010	2011E	Cumulative change 2007-2011
<b>Net departmental revenue expenditure (£m nominal)</b>	294	297	326	330	340	46
<b>% Change (nominal)</b>	0.0	0.7	9.7	1.4	3.0	15.5
<b>% Change (real)</b>	-4.7	-0.4	7.3	-0.9	-0.1	5.9
<b>Net General Revenue expenditure (£m nom)</b>	327	371	360	368	378	51
<b>% Change (nom)</b>	6.2	13.5	-2.9	2.2	2.5	15.4
<b>% Change (real)</b>	1.2	12.2	-5.0	-0.1	-0.6	5.9

<sup>19</sup> Net departmental and General Revenue expenditure exclude expenditure funded by departmental operating income (see **Section 6.4** and **Appendix 2**). Net General Revenue expenditure also includes routine capital expenditure and the transfer of funds to the capital reserve.

<sup>20</sup> The 2011 SSP did not include a breakdown of expenditure by department, as such 2011 figures relate to the 2011 budget

### 6.3.2. Departmental expenditure funded by operating income

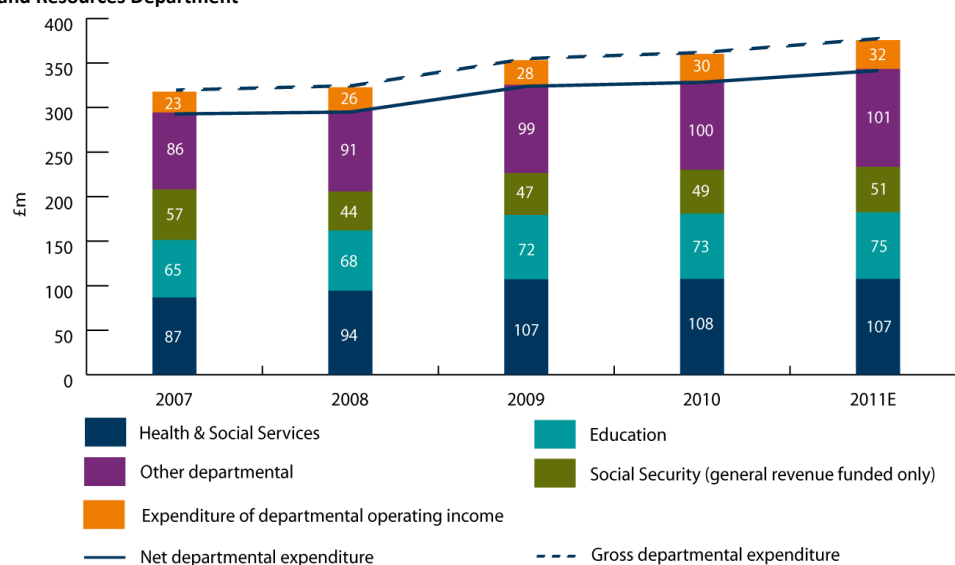
**Figure 6.3.2** shows the level of gross departmental revenue expenditure (net departmental expenditure plus expenditure of departmental operating income), compared to the net expenditure figures presented in the budget. As was explained in **Section 6.1**, departmental expenditure funded from operating income is netted-off against operating income in the General Revenue Budget (see **Appendix 2** for further details).

Departmental operating income (and its subsequent expenditure) has increased every year since 2007, growing by 30% between 2007 and 2010. As a result, gross departmental expenditure grew by 13.3% between 2007 and 2010, slightly more than the net figures.

**Figure 6.3.2. Gross departmental expenditure**

At current prices, as at May 2011<sup>21</sup>

Source: Treasury and Resources Department



	2007	2008	2009	2010	2011E	Cumulative change 2007-2011
Gross departmental revenue expenditure (£m nominal)	318	323	353	360	372	54
% Change (nominal)	-2.0	1.5	9.4	1.9	3.3	17.0
% Change (real)	-6.6	0.4	7.0	-0.3	0.2	7.4

<sup>21</sup> The 2011 SSP did not include a breakdown of expenditure by department, as such 2011 figures relate to the 2011 budget

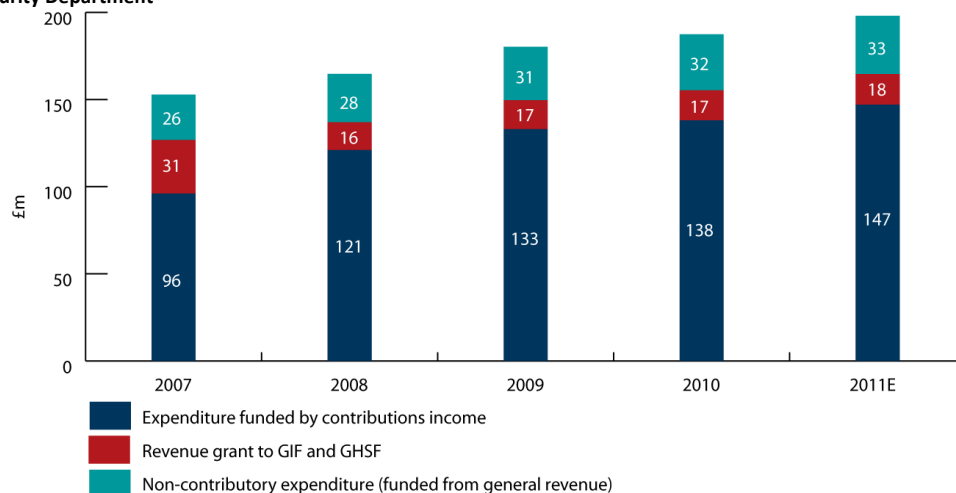
### 6.3.3. Social Security expenditure

Total expenditures grew by 4% in 2010 and by 23% from 2007 to 2010 (16% in real terms), with spending on both contributory and non-contributory benefits growing at similar rates across this time period.

**Figure 6.3.4. SSD expenditure by funding source<sup>22</sup>**

At current prices, as at May 2011

Source: Social Security Department



	2007	2008	2009	2010	2011E	Cumulative change 2007-2011
<b>SSD expenditure (£m nominal)</b>	153	164	180	188	198	45
<b>% Change (nominal)</b>	5.2	7.7	9.8	4.0	5.5	29.8
<b>% Change (real)</b>	0.2	6.5	7.4	1.7	2.4	19.0

The rise in Social Security expenditure has been more marked than revenue expenditure growth, although not all the rise is due to expenditure within States control (see **Box 6** on ‘controllable’ and ‘uncontrollable’ costs). Spending on pensions increased from £67m to £82m between 2007 and 2010. The number of pensions paid over this period grew by 9%. Thus, the “uncontrollable” element of this expenditure accounted for 37% of the total increase over the period.

Spending on unemployment benefits increased from £0.5m to £1.2m between 2007 and 2010, the number of unemployed increased by 105% over the time period. Thus, the “uncontrollable” element contributed to 72% of this rise.

### 6.3.4. Aggregate public expenditure

The States has had some success in controlling net General Revenue expenditure, although it has continued to gently trend higher over the period 2007 to 2010 (increasing by 13% in nominal terms (6% in real terms) between 2007 and 2010). The corresponding rise in total public expenditure has been greater, growing by 20% in nominal terms between 2007 and 2010 (14% in real terms), driven by the more rapid increase in Social Security expenditure (see **Figure 6.3.5**).

The proportion of aggregate expenditure paid for by contributions to Social Security has increased from 21% in 2007 to 26% in 2010, with a corresponding decrease in expenditure funded by general (taxation) revenues

<sup>22</sup> Although non-revenue funded expenditure is typically funded almost entirely by incoming contributions in any given year, it is acknowledge that SSD have recourse to investment income and the fund reserves to fund operating deficits when necessary (see **Appendix 4**)

(recognising that contribution rates increased twice over the time period). However, the proportion of total public expenditure spent on Social Security benefits (i.e. the grant to SSD from General Revenue plus expenditure funded by contributions) increased by only 1 percentage point from 34% in 2007 to 35% in 2010.

**Figure 6.3.5. Estimated aggregate expenditure by type, £m<sup>23</sup>**

At current prices, as at May 2011

Source: Treasury and Resources Department, Social Security Department

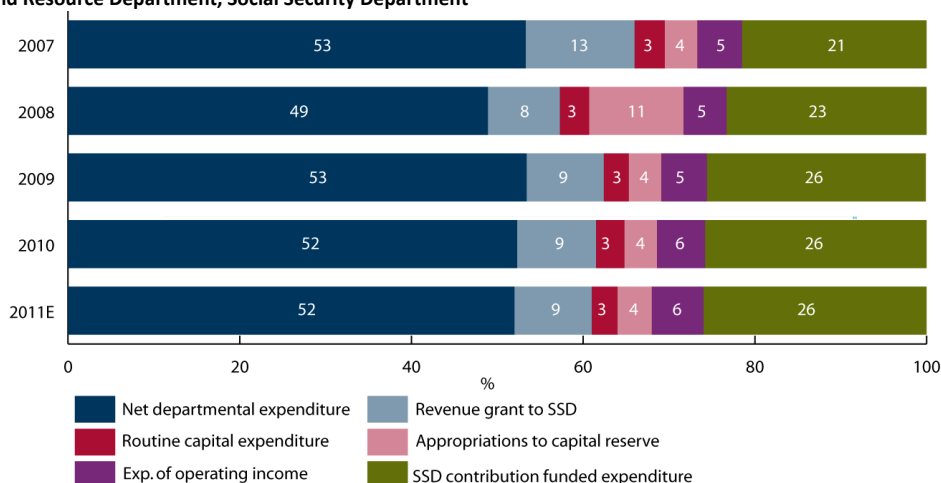


	2007	2008	2009	2010	2011E	Cumulative change 2007-2011
Estimated aggregate expenditure (£m nominal)	446	518	521	537	555	109
% Change (nominal)	6.4	16.1	0.7	2.9	3.5	24.9
% Change (real)	1.4	14.7	-1.5	0.7	0.4	14.2

**Figure 6.3.6. Estimated aggregate expenditure by type, percentage**

As at May 2011

Source: Treasury and Resource Department, Social Security Department



<sup>23</sup> These estimates include some degree of double counting between expenditure of departmental operating income and the SSD accounting (approx £7m in 2010), but it was not possible to eliminate this from the time series at the time of publication.

## Box 6. Uncontrollable costs

Expenditure can be broadly divided into two categories: that which can be directly controlled (e.g. the amount of money allocated for road resurfacing) and that which is dependent on factors beyond the States' control (e.g. the number of people eligible to claim a benefit).

### *General Revenue expenditure*

For the most part, expenditure areas relating to the provision of services are controllable, with budgeting set against the level of service provision. Other areas of expenditure are subject to factors beyond the States' control. Most notable of these are the formula-led expenditure paid from General Revenue to SSD and the inflation-linked pay awards for public sector employees. These latter items are usually described as uncontrollable because, once the formula determining them is set, they are determined by factors not controlled or controllable by the fiscal or other authorities.

The formula-led revenue grant to SSD is calculated as a fixed percentage of contributions (15% of contributions to the Guernsey Insurance Fund and 12% of contributions to the Guernsey Health Service Fund in 2010), plus the funds to cover expenditure on non-contributory benefits such as family allowance and supplementary benefit. This represents a significant portion of net revenue expenditure (£47m or 13% in 2010). The percentage of contributions on which the grants are based is under budgetary control; however, the value of contributions and therefore the grant is dependent on a range of uncontrollable factors including total employment and earnings. The annual increases in non-contributory benefits (which are funded from General Revenue - see **Appendix 3**) have historically been set as part of the SSD budgetary process, submitted to the States in September, two months earlier than the presentation of the General Revenue Budget.

In 2010, the States spent £188m on pay, more than half of the net revenue expenditure. Annual pay awards are typically linked to annual inflation rates, while additional funds are allocated in the budget for potential pay awards based on inflation forecasts. With such a large proportion of expenditure linked to inflation, and with no mechanisms by which the States can control local inflation, increases in inflation are a significant risk to States expenditure. At the current level of expenditure, each additional percentage point of inflation could cost the States almost £2m in additional pay costs. This is partially offset by an estimated £1.5m of additional ETI revenue.

Although current forecasts suggest that inflation will remain relatively benign in the coming year, unforeseen increases resulting from local or global inflation pressures or UK monetary policy are always a possibility.

### *Social Security expenditure*

A significant proportion of SSD expenditure is largely uncontrollable, as the States is committed to pay pensions and benefits but has little if any control over the numbers of people eligible to claim them.

Income support schemes such as unemployment and supplementary benefits are administered by SSD (with unemployment benefits paid from contributions income and supplementary benefits paid from General Revenue). Total expenditure in these areas is largely dependent on the business cycle, with unemployment (and therefore expenditure) increasing in times of economic stress. Movements in the number of claimants eligible for these benefits are difficult to predict and introduce a degree of volatility into Social Security expenditure (see **Figure 1**).

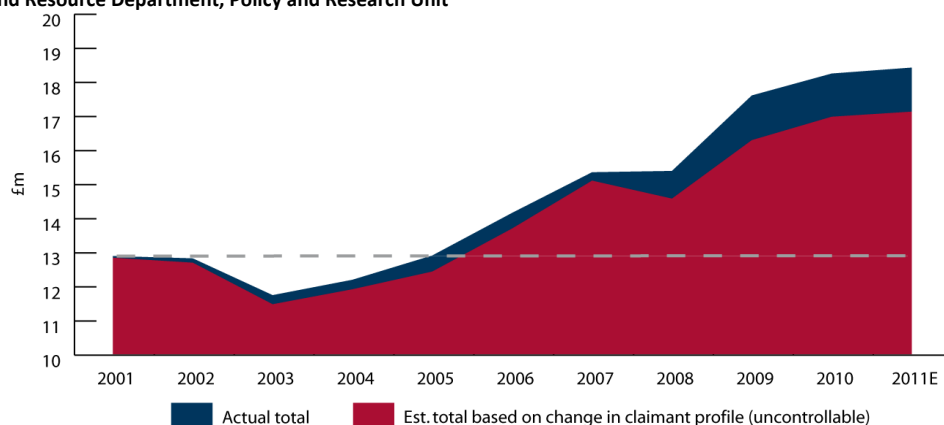
## Box 6. Uncontrollable costs (cont.)

The aging population (which is covered in more detail in **Box 7**) presents a significant financial problem in terms of pensions and long-term care. The increase in the number of people claiming a pension over the last decade has exerted an increasing upward pressure on pensions benefit expenditure, as represented by the red portion of **Figure 2**. When combined with the controllable increase in the amount of benefit payable to an individual, this has resulted in a real increase in expenditure on pensions of more than 40% between 2001 and 2010.

**Figure 1. Controllable and uncontrollable supplementary and unemployment benefit expenditure**

At 2010 prices, as at May 2011

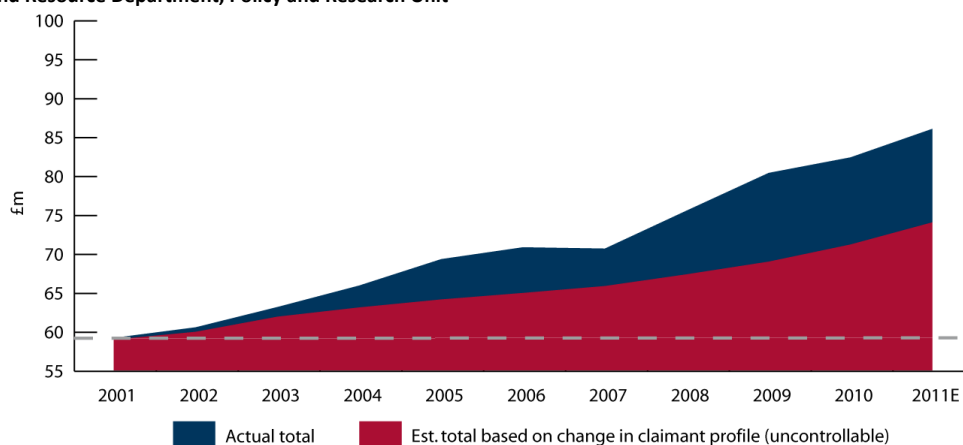
Source: Treasury and Resource Department, Policy and Research Unit



**Figure 2. Controllable and uncontrollable pensions benefit expenditure**

At 2010 prices, as at May 2011

Source: Treasury and Resource Department, Policy and Research Unit



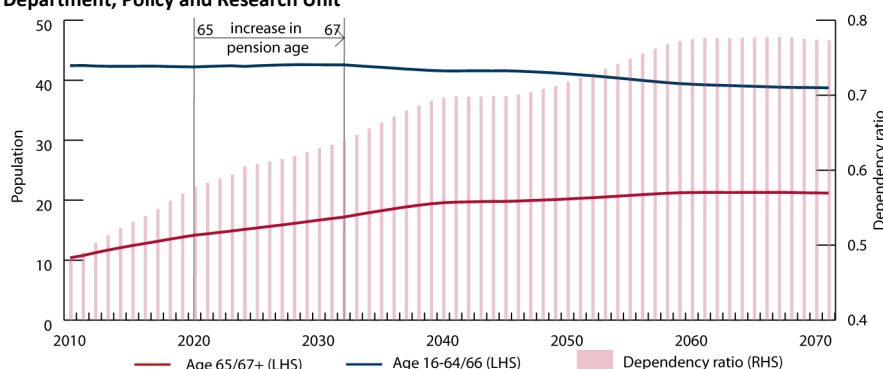
## Box 7. The impact of demographic change

Projections show that the age profile of Guernsey's population will change significantly over the next 60 years, with the number of people over 65 expected to double by 2040. Although the States has already taken some steps to mitigate the effects of this, by increasing the retirement age from 65 to 67, the impact of these changes on both the General Revenue and Social Security budgets are likely to be very significant. Even allowing for the retirement age increase, the working age population is projected to decrease and the number of pensioners to increase (see **Figure 1**). As a result the dependency ratio<sup>24</sup> is projected to increase from 0.48 in 2010 to 0.78 in 2070.

**Figure 1. Projected demographic change and dependency ratios**

Assuming +200 net migration, as at April 2011

Source: Social Security Department, Policy and Research Unit

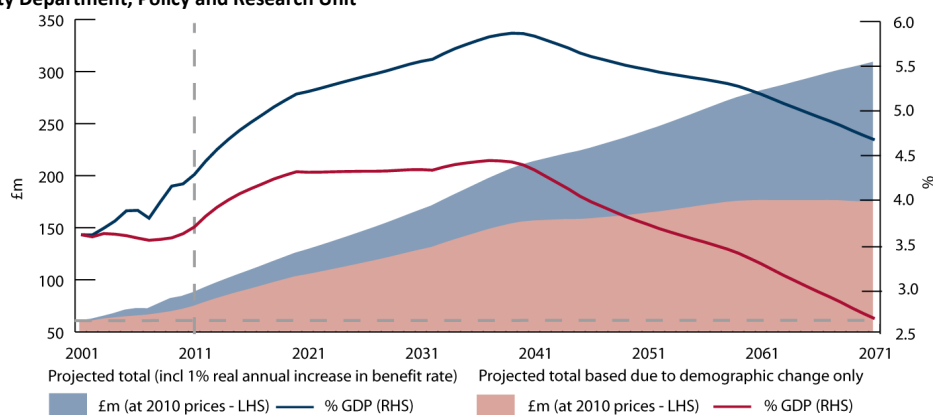


This represents a known but uncontrollable risk to both income (due to reduced personal tax and Social Security contributions) and expenditure (due to increased pensions and long-term care costs (see **Figure 2**)). As a result, the Guernsey Insurance Fund (from which pensions are paid) will almost certainly run an operating deficit for many years, depleting the reserves currently held in the fund, which have been prudently built and will help mitigate the cost of the demographic bulge for current contributors<sup>25</sup>. It should be noted that dependency ratios are projected to begin to decline after 2070 so, in the very long-term, this issue is temporary; but it is nonetheless significant, particularly if reserves should prove insufficient to cover the extended period of imbalance.

**Figure 2. Projected pensions expenditure**

At 2010 prices and as a percentage GDP, assuming 2% real annual growth in GDP and +200 net migration, as at May 2011

Source: Social Security Department, Policy and Research Unit



<sup>24</sup> The dependency ratio represents the proportion of those largely dependent on government support in the form of education, pensions or long-term care (i.e. those under 16 or above retirement age) to those likely to be making significant contributions to States revenues (i.e. of working age).

<sup>25</sup> See the actuarial reviews undertaken on behalf of SSD by the UK Government Actuary Service for more details.

## 6.4. Trends in income and expenditure

**Table 6.4.1. States revenue income and expenditure**

At current prices, as at May 2011

Source: Treasury and Resources Department

	2007 (£m)	2008 (£m)	2009 <sup>26</sup> (£m)	2010 (£m)	2011 budget estimates (£m)	2011 SSP estimates (£m)
Personal taxes	175	218	209	205	212	214
Company taxes	121	59	64	53	54	56
<b>Income taxes</b>	<b>296</b>	<b>277</b>	<b>273</b>	<b>258</b>	<b>267</b>	<b>270</b>
<b>Misc income</b>	<b>8</b>	<b>12</b>	<b>6</b>	<b>3</b>	<b>3</b>	<b>3</b>
Indirect taxes	61	60	62	70	75	75
<b>General Revenue income</b>	<b>366</b>	<b>349</b>	<b>341</b>	<b>331</b>	<b>345</b>	<b>347</b>
<b>Departmental operating income<sup>27</sup></b>	<b>23</b>	<b>26</b>	<b>28</b>	<b>30</b>	<b>32</b>	<b>32<sup>28</sup></b>
<b>Total revenue income</b>	<b>389</b>	<b>375</b>	<b>369</b>	<b>361</b>	<b>377</b>	<b>379</b>
<b>Gross departmental expenditure</b>	<b>(318)</b>	<b>(323)</b>	<b>(353)</b>	<b>(360)</b>	<b>(375)</b>	<b>(372)</b>
<b>Expenditure of Department operating income</b>	<b>(23)</b>	<b>(26)</b>	<b>(28)</b>	<b>(30)</b>	<b>(32)</b>	<b>(32)</b>
<b>Net departmental expenditure</b>	<b>(295)</b>	<b>(297)</b>	<b>(325)</b>	<b>(330)</b>	<b>(343)</b>	<b>(340)</b>
<b>Revenue surplus/(deficit)</b>	<b>71</b>	<b>52</b>	<b>16</b>	<b>1</b>	<b>2</b>	<b>8</b>
<b>Routine capital expenditure</b>	<b>(16)</b>	<b>(17)</b>	<b>(15)</b>	<b>(18)</b>	<b>(16)</b>	<b>(16)</b>
<b>Capital income</b>	<b>0</b>	<b>5</b>	<b>0</b>	<b>0</b>	<b>2</b>	<b>0</b>
<b>Operating surplus/(deficit)</b>	<b>55</b>	<b>40</b>	<b>1</b>	<b>(17)</b>	<b>(12)</b>	<b>(8)</b>
<b>Appropriation to capital reserve<sup>29</sup></b>	<b>(17)</b>	<b>(57)</b>	<b>(20)</b>	<b>(21)</b>	<b>(23)</b>	<b>(21)</b>
<b>Other transfers</b>		<b>9</b>				
<b>Overall surplus/ (deficit)</b>	<b>38</b>	<b>(8)</b>	<b>(19)</b>	<b>(37)</b>	<b>(35)</b>	<b>(30)</b>

The Fiscal Framework sets parameters for Revenue Budget funded expenditure in terms of shares of GDP, the rationale being to acknowledge that some real terms growth in public sector expenditure is to be expected as the economy grows. The numerical parameter set out in the Framework is for revenue income and expenditure (recurrent and capital) being constrained by an upper bound of 21% of GDP.

Data from 1991 to 2008<sup>30</sup> show that, prior to the introduction of zero/ten, General Revenue income and expenditure trended around the 21% mark. This was the rationale behind the adoption of the 21% limit on income and expenditure. From 2001 to 2003 inclusive, expenditure was slightly over this long-run 'norm' and the States ran mild overall deficits in those years. Capital spending (as measured by routine capital expenditure and the transfer of funds to the capital reserve) dropped significantly in 2006, leading to a widening of the overall surplus in that year. Conversely, capital expenditure was abnormally high in 2008, leading to a widening of the deficit in that year. Capital spending, particularly for a small economy, is

<sup>26</sup> Figures are presented consistent with the 2010 accounts, which did not include transfers from unspent balances in the calculation of the overall surplus/(deficit).

<sup>27</sup> Because of accounting modifications made in the 2010 accounts, operating income figures for 2007 to 2009 have been adjusted to provide a consistent series.

<sup>28</sup> The 2011 SSP does not provide an estimate of operating income; this figure is therefore assumed to be unchanged from the 2011 budget.

<sup>29</sup> Appropriations are presented consistent with the 2010 accounts and represent the appropriations as assigned to accounting years. This has been amended since the previous report, which presented data representing actual in year appropriations.

<sup>30</sup> Fiscal Framework, Appendix 1, Billet D'Etat XI, April 2009.

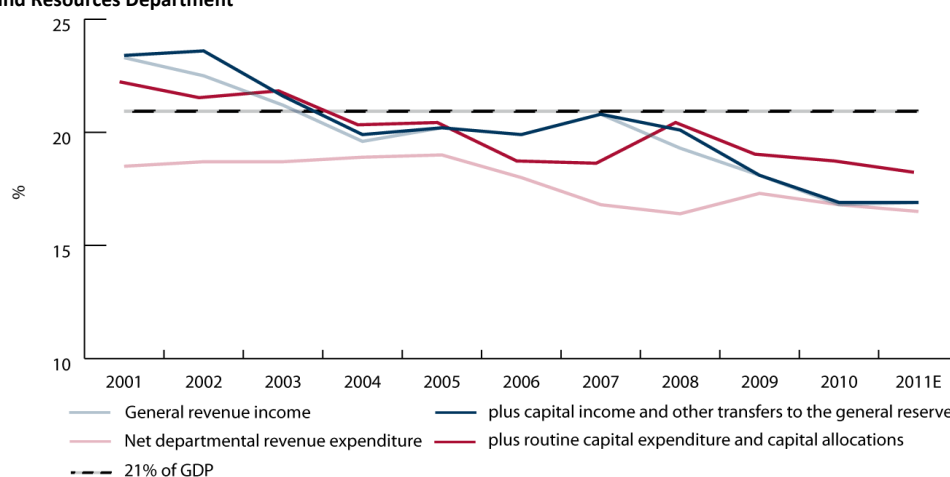


notoriously ‘lumpy’; this was the rationale for setting out a numerical target in the Fiscal Framework (thus smoothing the financing of expenditure and ensuring that sufficient funds were set aside in the medium term).

Total net revenue expenditure declined from 20.5% of trend GDP in 2005 to 18.8% in 2010 (the effect of the revenue grant reduction was, at the time, to remove around 0.8 percentage points (£17m) of expenditure from the General Revenue Budget). Revenue income declined post zero/ten from 20.8% in 2007 to 16.9% in 2010; between 2005 and 2010 total expenditure declined by 1.8 percentage points and total income by 3.4 percentage points of trend GDP. The overall General Revenue Budget deficit of £37m in 2010 corresponds to minus 1.9% of GDP against a deficit of 0.3% in 2005. The most recent estimates (published in the SSP) predict a moderate increase in income and a decrease in expenditure relative to trend GDP (to 16.9% and 18.3% respectively) in 2011, reducing the deficit to 1.5% of GDP.

**Figure 6.4.2. Revenue income and revenue and capital expenditure (Fiscal Framework)**

As a percentage GDP (trend), as at May 2011  
Source: Treasury and Resources Department



**Figure 6.4.3** provides a picture of the trend for total public income and expenditure (that is, including both departmental operating income and its subsequent expenditure by departments; and contributions income received by Social Security and its expenditure by SSD funds on contributory benefits<sup>31</sup>).

In 2010, departmental operating income and its related expenditure added an additional 1.6 percentage points to income and expenditure (see **Appendix 2**). Calculated on this basis, total expenditure is forecast to be 19.9% of trend GDP and total income 18.4% in 2011. As was explained in **Section 6.2**, as departmental expenditure and income is ‘netted off’, there was no effect on the surplus/deficit position.

Increased social insurance revenues partially offset the reduction in General Revenue income, with aggregate income decreasing by 1.8 percentage points of GDP between 2005 and 2010 compared to the 3.4 percentage points decline by General Revenue income.

The addition of Social Security contributions added 7.1 percentage points to both income and expenditure in 2010. Forecasts for 2011 estimate aggregate income and expenditure at 25.5% and 27.0% of GDP respectively. Calculated on this basis, total expenditure was 0.5 percentage points higher in 2010 than in 2005, whilst total income fell by 1.8 percentage points over the same period. The total public sector shortfall

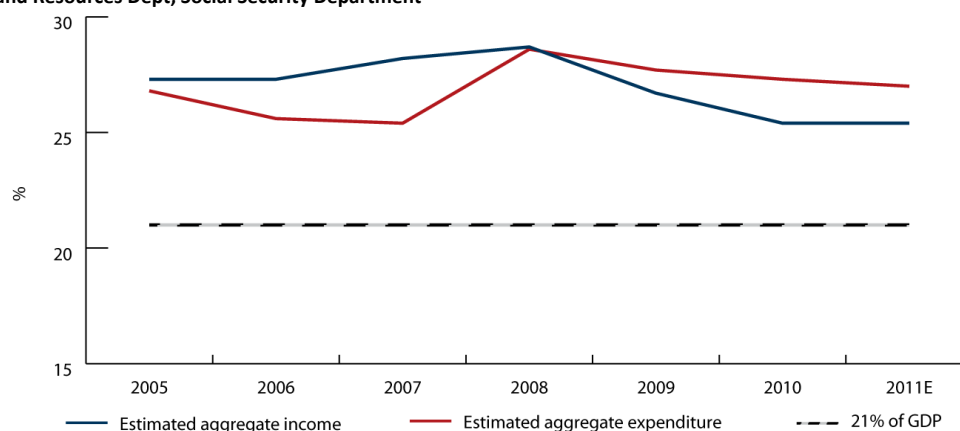
<sup>31</sup>It is acknowledged that total expenditure may in any one year be funded from investment income, in 2010; the Guernsey Insurance Fund had an operating deficit of £3.6m, the balance being funded from investment income of the Fund’s ‘reserve’ (see **Appendix 3**).

in income (against expenditure) is almost fully accounted for by the revenue in balance as rising SSD spending on contributory benefits has been almost fully funded by rising contributions (see **Appendix 3**).

**Figure 6.4.3. Estimated aggregate public sector income and expenditure<sup>32</sup>**

As a percentage GDP (trend), as at September 2011

Source: Treasury and Resources Dept, Social Security Department



Total public sector income and expenditure, although outside the scope of the Fiscal Framework, is of significance. Whilst, understandably, immediate focus is on addressing the present General Revenue Budget overall deficit (and the States' strategy to address this issue is discussed in **Section 7**), in the medium term the greatest pressures on public spending are likely to be from demands for Social Security spending on pensions and related benefits resulting from demographic change (see **Box 7**).

<sup>32</sup>These estimates include some degree of double counting between expenditure of departmental operating income and the SSD accounting (approx £7m in 2010), but it was not possible to eliminate this from the time series at the time of publication. These figures do not include income and expenditure of State's commercialised bodies (i.e. Harbours and Airports, States' Works and Guernsey Water, etc.)

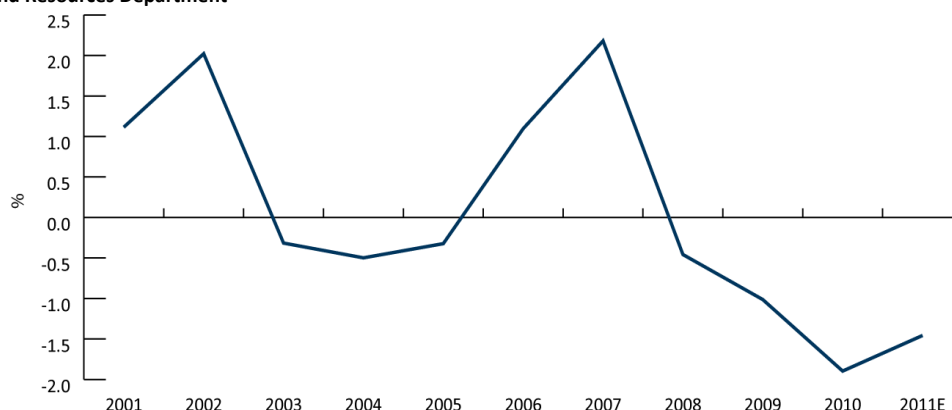
## 6.5. Permanent balance

*The States has wisely committed to a long-term policy of permanent balance. Whilst the current deficits are planned and funded through the Corporate Tax Contingency Reserve, the States will need to address replenishment of those reserves in the future once structural balance is attained a) to meet the long-run policy commitment and b) as a sensible precautionary move to ensure the States is as well-placed in the future to weather future external economic shocks as it was placed to meet the recent global downturn and the decision to introduce the zero/ten tax regime..*

**Figure 6.5.1. States' overall surplus/(deficit)**

As a percentage GDP (trend), as at September 2011

Source: Treasury and Resources Department



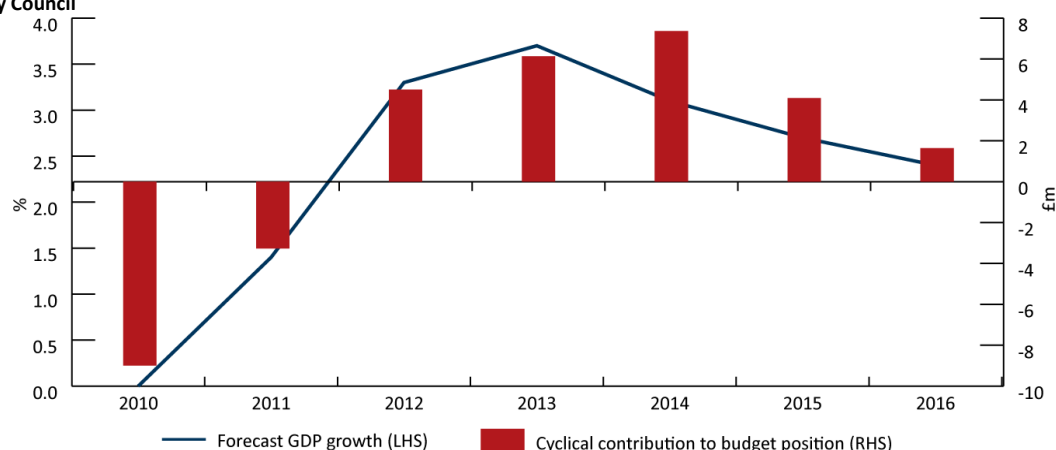
**Figure 6.5.1** presents the overall net position of the Revenue Budget. The deficit position since 2008 is apparent, as are the overall deficits between 2003 and 2005. The current deficit has been brought about by two separate factors: a planned (structural) reduction in the tax base through the introduction of the zero/ten tax regime in 2008, and an unplanned (cyclical) reduction due to the effects on the economy of the global downturn.

In a downturn, revenues are temporarily reduced. Conversely, revenues can be flattered by above trend levels of economic growth (as was partially evident during 2006 and 2007, which saw rapid economic and revenue growth). An attempt can be made to estimate the cyclical impact on revenues through the business cycle, though it should be cautioned that any such exercise can only be approximate.

**Figure 6.5.2. Cyclical contribution to fiscal position**

As a percentage GDP (trend), as at May 2011

Source: Policy Council



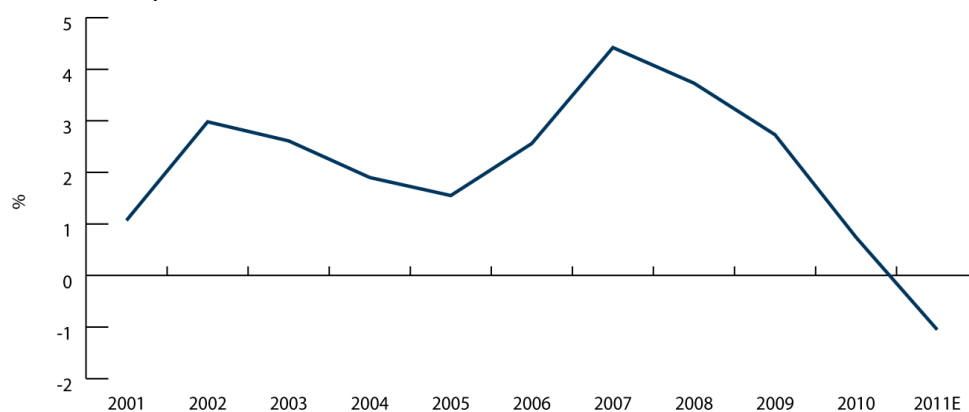
Based on current forecasts for GDP, the Policy Council's estimates of the 'cyclical' contribution to the fiscal position are presented in **Figure 6.5.2**. Based on this assessment, around a quarter (£10m) of the 2010 deficit was cyclical in nature. The cyclical contribution to the deficit is not as significant as in jurisdictions such as the UK or US. This is because the majority of Guernsey's tax base is composed of less cyclically volatile elements. Profits taxes, typically most volatile through the cycle, account for just 11% of government revenues, despite corporate profits composing a larger proportion of GDP (approximately 30%).

The **cumulative** surplus/(deficit) position of the States depends entirely on the starting point used in its determination. The deliberate movement to a deficit position as part of the movement to a zero/ten corporate tax regime also has to be recognised. The policy commitment to permanent balance was made after that movement and, as such, a prudent policy course would be to seek to address at least a partial replenishment of reserves once a balanced budget position has been re-attained.

**Figure 6.5.3. Cumulative States' overall surplus/(deficit)**

As a percentage GDP (trend), from 2001-2011, as at September 2011

Source: Treasury and Resources Department



The long period of overall surplus in the 1990s allowed the States to establish significant reserves in the form of the General Reserve<sup>33</sup> and the Contingency Reserve. Half of the Contingency Reserve was set aside in 2006 to fund the structural deficit expected as a result of the introduction of zero/ten in 2008 (see **Figure 6.5.4**). However, to date the majority of the overall deficit (85% in 2010) has been funded from the General Reserve, depleting the reserve in nominal terms by 40% between 2008 and 2010. The majority (81%) of the

<sup>33</sup> The General Reserve comprises the General Revenue Account Reserve, the Corporate Housing Programme account and various other minor capital accounts. It does not include the Capital Reserve, which is considered separately in **Section 8**.

funds remaining in the General Reserve at the end of 2010 were allocated to specific capital accounts (such as the Corporate Housing Programme) and cannot be used to finance future deficits.

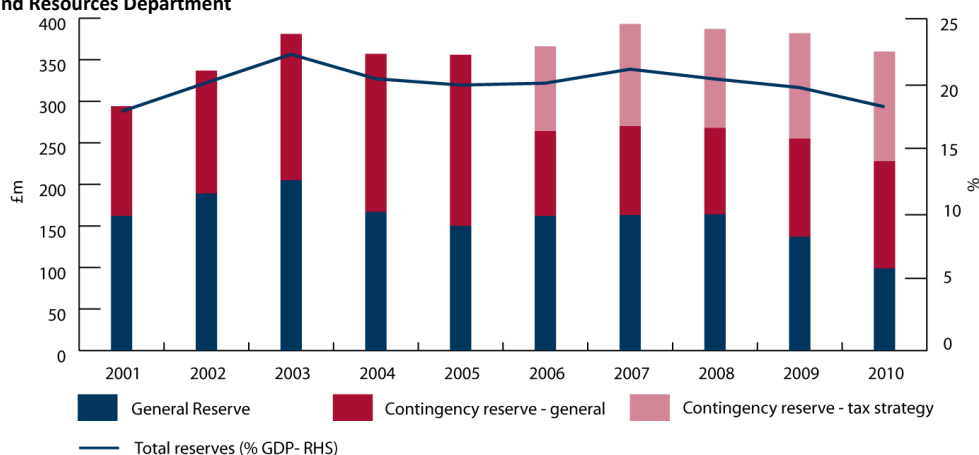
In both 2009 and 2010, the transfer from the tax strategy portion of the Contingency Reserve to General Revenue to fund the deficit was less than the realised and unrealised net gain on the invested capital. As a result, the balance of the capital set aside for funding the tax strategy increased from £119m in December 2008 to £132m (11%) in December 2010.

The total value of reserves has decreased since the introduction of zero/ten, falling by 7% in nominal terms between 2008 and 2010. Reserves totalled £360m or 19% of GDP in December 2010, 2 percentage points less than in 2008.

**Figure 6.5.4. States Reserves**

At current prices and as a percentage of GDP, as at May 2011

Source: Treasury and Resources Department



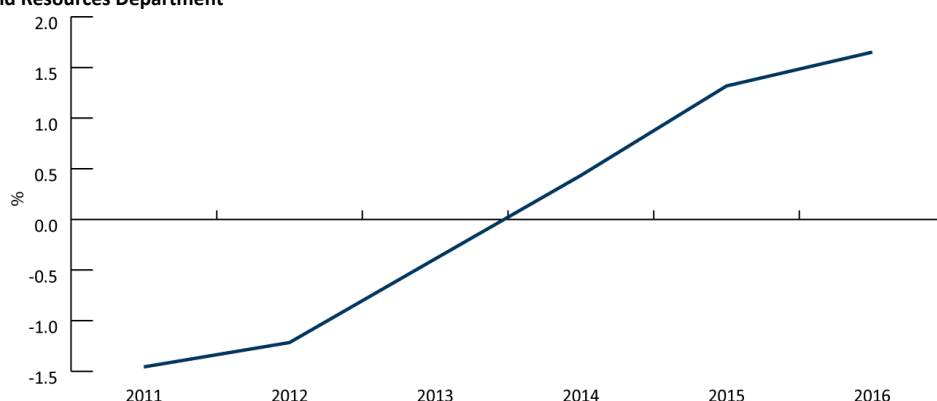
## 7. States fiscal strategy

The SSP sets out a strategy to eliminate the deficit on the Revenue Budget through a combination of expenditure restraint (by freezing aggregate spending in real terms for total revenue-funded expenditure) and delivering operational efficiencies through the FTP. **Figure 7.1.1** reproduces the projected 'central case' for the overall balance (surplus/deficit) for the General Revenue Budget from the SSP.

**Figure 7.1.1. Projected overall surplus/(deficit): central case**

As a percentage GDP (trend), as at September 2011

Source: Treasury and Resources Department



There are both harmful and helpful risks to this strategy; however, they are more prevalent and clearly biased towards the downside. As the impact of the downside risks are by their nature more severe, it is natural to focus on these. The downside risks to this strategy are threefold:

- Revenues are negatively impacted by lower than expected economic growth;
- Target savings through the FTP are not delivered, or are delayed;
- General expenditure restraint is unsuccessful.

Failure to a significant degree on any one of these points would have a significant adverse impact on the goal of achieving balance. **Figure 7.1.2** compares the central case to three different scenarios: one in which the FTP achieves just 50% of the projected savings; one in which departmental expenditure grows by 1% in real terms over the forecast horizon; and, finally, one in which economic growth is one percentage point per annum lower over the forecast horizon. As can be seen, in each scenario overall, budgetary balance is deferred and, in each case, revenues as a share of trend GDP are around 1% lower in 2016 than the central case. If all three downside risks were to materialise, the States would not return to budgetary balance within the forecast period and revenues would be £45m lower than the central projection in 2016.

**Box 8** illustrates that one year ahead budget forecasting has improved in recent years, although the projections of the path of future deficits are based on factors beyond straightforward accuracy of budget forecasts.

## Box 8. Budget forecasting

### *Net revenue income*

The States estimates both General Revenue income and expenditure for the current and subsequent year as part of their budgetary process. Since the introduction of the SSP in 2009, forecasts have been published over a five-year horizon.

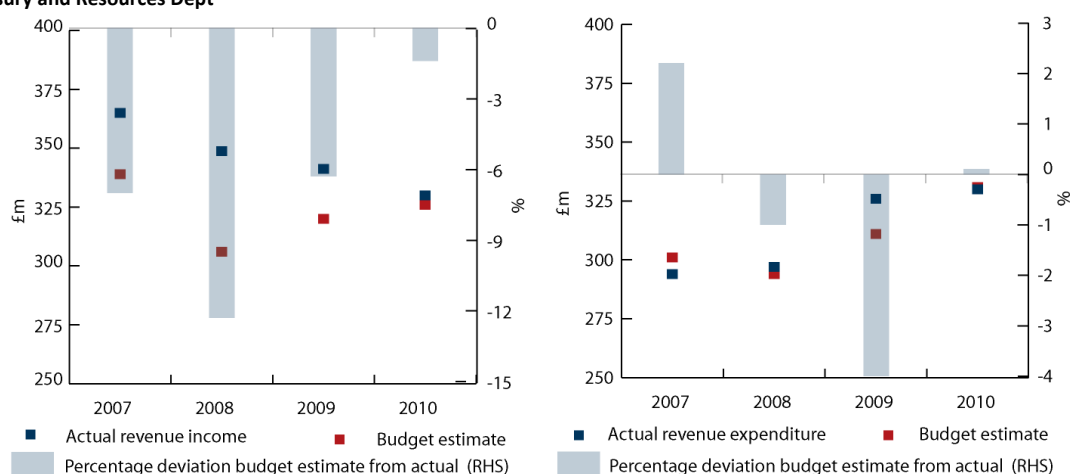
Revenue income forecasts have, to date, become progressively more accurate (see Figure 1). The budget estimate of revenue income in 2008 was £306m, an underestimate of £43m (12%). This reduced to an underestimate of £21m (6%) in 2009 and £4m (2%) in 2010.

The introduction of zero/ten in 2008 posed significant difficulties for forecasting revenues income, both because of the unknown impact its introduction was likely to have on local economic growth and by altering the historic relationship between corporate tax revenue and other economic indicators. In 2010, corporate income taxes were underestimated by only £2m, with personal income taxes overestimated by the same amount.

**Figure 1. Forecast and actual General Revenue income and expenditure**

At current prices, as at May 2011

Source: Treasury and Resources Dept



### *Net revenue expenditure*

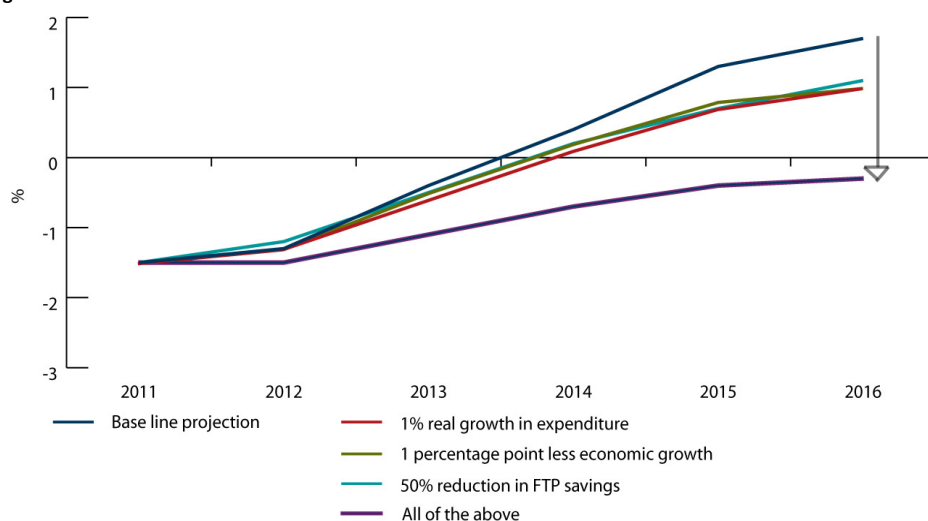
Budget forecasts of expenditure for 2008 underestimated revenue expenditure by £3m (1%). However the 2009 budget underestimated 2009 expenditure by £14m (4.3%), the most significant overspend occurring in the Health and Social Services Department (by £9m).

Incentives to restrain General Revenue expenditure in 2010 resulted in actual revenue expenditure in 2010 £1m below the 2010 budget estimates despite a £4m overspend by the Health and Social Services Department. However this was £1m above the expenditure forecast in the 2009 SSP.

**Figure 7.1.2. Implications of FTP failure and expenditure restraint on overall surplus/(deficit) projections**

Percentage GDP (trend), as at September 2011

Source: States Strategic Plan



The SSP includes an update to the FTP. It clearly illustrates that the savings from the FTP process are ‘back loaded’, that is the majority are expected to be achieved towards the latter stages of the programme. To date, £4m of ‘savings’ from the programme (approximately 13% of the projected total) can be accounted for by increases in fees and charges - a relatively easy process to implement. It is disconcerting that, given the present fiscal position, the States chose not to direct the savings to date as a contribution to reducing the deficit position, choosing instead to fund new services through the SSP prioritisation process. It would be more advisable to bank the savings first and spend later once balance has been achieved. The majority of the savings from the programme itself have yet to materialise and are dependent on the successful implementation of major projects, themselves subject to a high degree of risk and prone to potential slippage.

If the strategy of the States is unsuccessful it will need to either reduce expenditure further or increase revenues to make good any failure to achieve the forecast path for the deficit. The deficit is not projected to fall significantly until 2013; only a slight decrease is projected in 2012. The States must regularly monitor ‘progress against plan’ and realistically assess the prospects of success of the plan during 2012 to ensure that any remedial measures, if required, can be included in the 2013 budget. Remedial measures would include either revenue-raising measures or effecting real cuts in expenditure outside the FTP programme.

The SSP projections include total capital allocations insufficient to meet the target 3% of GDP level, as set out in the Fiscal Framework. The green line of **Figure 7.1.3** illustrates the impact on the deficit position if the 3% target was to be met over the SSP horizon met. **Figure 8.1.4** in the next section illustrates the consequent impact on the capital reserve. Even if the States successfully achieves its fiscal strategy, it will be prudent to replenish spent reserves and there is a need to raise the regular level of capital allocations to meet the 3% target at some point.

The FF also states that any deficit position should be eliminated within five years. It is clear from the current projections that, even with capital allocations at less than 3% of GDP, the current deficit (which first appeared in 2008) is very unlikely to be eliminated within this time frame.

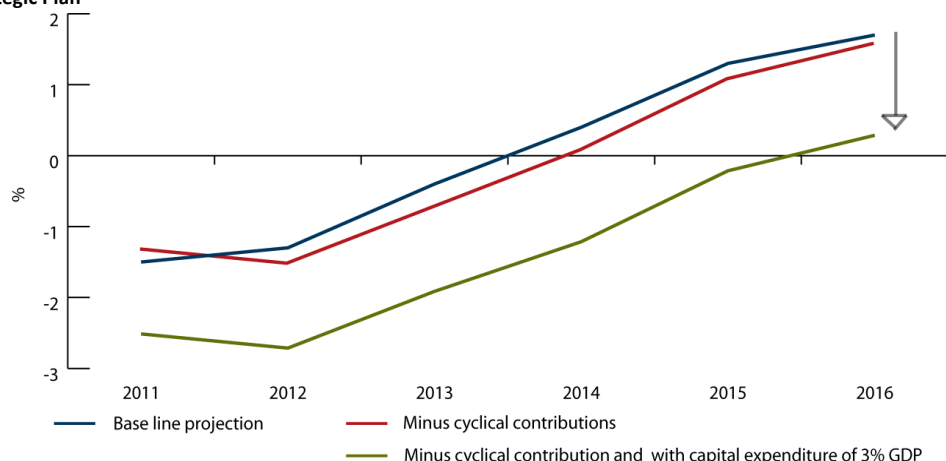


Returning the States to 'point' balance by 2014 overlooks the cyclical basis on which the revenues are projected. The central case is based on economic growth projections of 1.4%, 3.3%, 3.7%, 3.1% 2.7% and 2.6% in 2011, 2012, 2013, 2014, 2015 and 2016 respectively. These forecasts are for above trend growth in 2012 to 2015 (after three years of below trend growth). Thus, according to Policy Council estimates, in 2013 the cyclical contribution to revenues will be positive by around £6m. The red line of Figure 7.1.3 below illustrates the size of the deficit without the cyclical contribution to revenues. However, given that the States' tax base is less dependent on volatile revenue streams than it was prior to zero/ten, this is perhaps of less significance, particularly in view of the scale of impact of the identified downside risks.

**Figure 7.1.3. Fiscal position with capital allocations meeting the 3% target**

Percentage GDP (trend), as at 11<sup>th</sup> November 2011

Source: States Strategic Plan

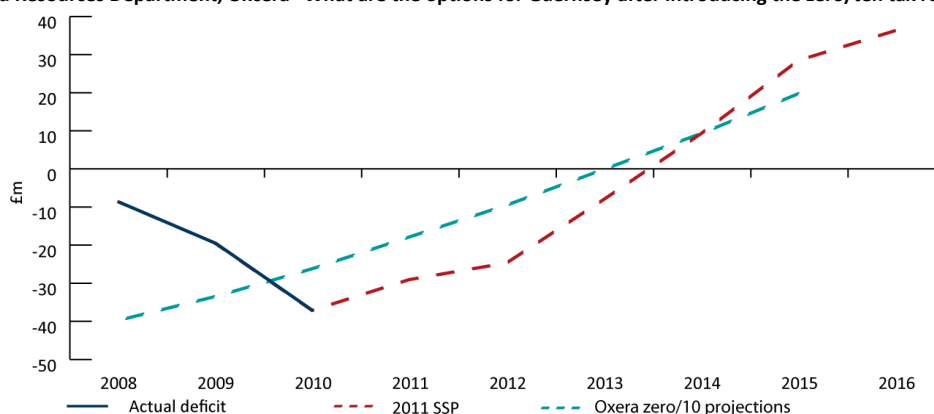


Comparing the actual outturn of the deficit with that produced by Oxera<sup>34</sup> in 2006 in the run-up to introducing zero/ten is quite informative. The deficit failed to materialise on the scale originally envisaged in 2008, due to the buoyancy of revenues from above trend growth in the period leading up to zero/ten (a period when the tax base derived a greater proportion of revenues from revenue streams more linked to the cycle). The size of the deficit is now around that originally envisaged (although Oxera's calculations assumed just 1% of GDP to be allocated to capital expenditure), but the assumed pace of reduction of the deficit is greater.

**Figure 7.1.4. SSP 2011 projections vs. original zero/ten projections**

At 2010 prices, as at September 2011

Source: Treasury and Resources Department, Oxera "What are the options for Guernsey after introducing the zero/ten tax regime?" April 2006



<sup>34</sup> What are the options for Guernsey after introducing the zero/ten tax regime? Oxera, April 2006

## 8. Assessment of performance against the Fiscal Framework

The key mandate of the report is to provide an independent assessment of States' current and projected fiscal performance against its pre-set objectives as outlined in the framework, together with an assessment of the economic forecasts on which those projections are based.

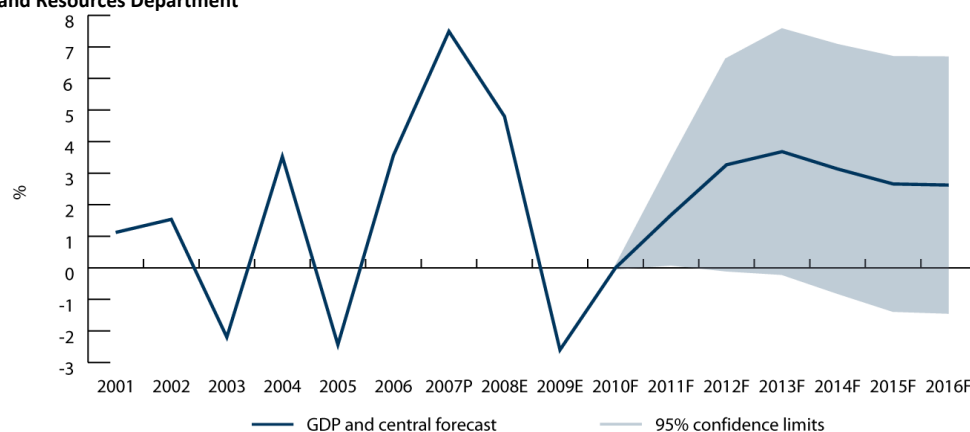
### 8.1.1. Economic assumptions

**Figure 8.1.1** sets out the path for economic growth as currently forecast by the Policy Council. The dark blue line provides an estimate of the probable central tendency of those forecasts based on past experience. As was noted in **Section 5**, growth estimates in Guernsey are subject to significant revision. Of course, all forecasts are subject to much uncertainty and, if the risks to global growth are 'on the downside', the same inevitably applies to Guernsey. These risks are compounded by the possibility that the European sovereign debt crisis may not be successfully managed. The impact of failure cannot be predicted at this stage, but will most likely be adverse in the short-run, whatever the long-run consequences. In these circumstances, assuming the central tendency as the most likely outcome could be viewed as optimistic, it is quite possible that growth and revenues turn out less than currently forecast.

#### Figure 8.1.1. Forecast GDP growth

In real terms, as at June 2011

Source: Treasury and Resources Department



### 8.1.2. Operating balance as a percentage of GDP

Throughout this report, reference is made to the overall deficit position, as this is the version of the deficit of most economic interest. However, the Fiscal Framework's numerical parameters include a constraint that the operating deficit (which differs from the overall deficit, as the operating deficit does not include the appropriation of funds to the capital reserve and other relevant transfers) cannot exceed 3% of GDP in any one year. This constraint has been met comfortably over the course of the last two years (in 2010, the operating position was in fact in balance) and is likely to be met, even under quite pessimistic downside cases, throughout the SSP forecast horizon.

### 8.1.3. Total revenue and capital expenditure as a percentage of GDP

The FF sets an upper bound on net revenue-funded income and expenditure of 21% of GDP. This limit was comfortably satisfied in 2009 and 2010 and is easily met in the central projections case of the SSP. However, it should be noted that the revisions to the revenue grant to Social Security transferred expenditure equal to approximately 0.8 percentage point of GDP from General Revenue to that funded by Social Security contributions. Capital allocations are also presently 1 percentage point of GDP lower than set out in the fiscal

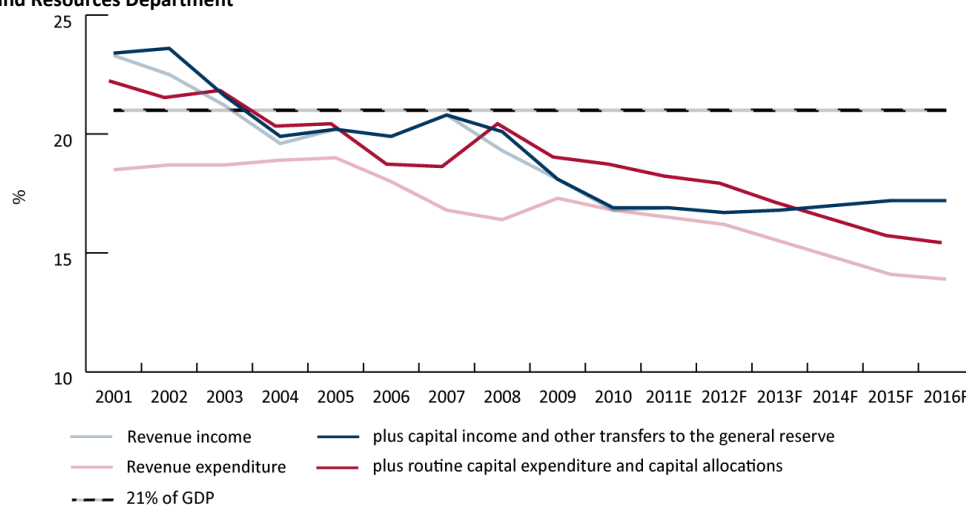
framework. This highlights that the area constrained by the upper bound is a far from complete definition of all States spending.

As was also demonstrated in **Sections 6.2** and **6.3**, including departmental operating income, which is currently netted off, both income and expenditure, would increase both totals by 1.6 percentage points.

Presenting the SSP projections in terms of the Fiscal Framework (see Figure 8.1.2) clearly demonstrates the strategy of the SSP. The illustration below demonstrates that, whilst the States has over the course of the last few years achieved admirable success in expenditure restraint, it makes it very clear that the strategy of the SSP has set some very challenging objectives for expenditure reduction.

**Figure 8.1.2. Projected revenue income and revenue and capital expenditure (Fiscal Framework) - Central case**

As a percentage GDP (trend), as at September 2011  
Source: Treasury and Resources Department



#### 8.1.4. Capital Expenditure as a share of GDP

The Fiscal Framework gives a norm for capital expenditure of 3% of GDP (close to £60m in today's prices). This, in light of historic and international experience, was deemed an appropriate rate for the maintenance and renewal of the Island's capital stock and infrastructure. **Figure 8.1.3** illustrates the historic and projected (within the horizon of the SSP) capital expenditure as accounted by the States<sup>35</sup>. According to the SSP projections, the States presently plans to set aside insufficient sums to fund capital spending at or above 3% of GDP. Around an additional £20m per annum in today's prices, close to 1% of GDP, would be required to meet the Fiscal Framework's 3% target.

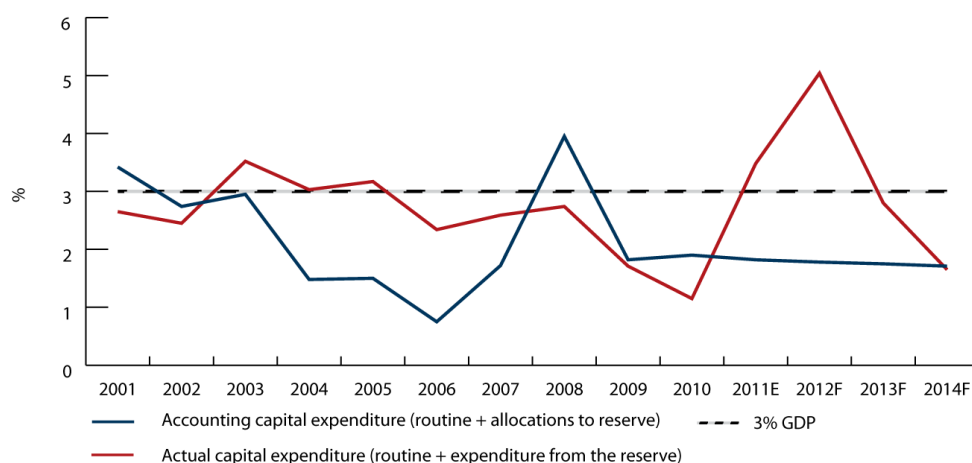
**Figure 8.1.3** also sets out the projections of actual capital expenditure against the projections of capital expenditure as accounted by the States. The discrepancy between the two, combined with projected allocations being lower than the Fiscal Framework target of 3%, have a direct impact on the capital reserve in future years, as is set out in **Figure 8.1.4**.

<sup>35</sup>The States funds capital expenditure through the capital reserve, transferring allocations from General Revenue into the reserve. This means that actual physical in year expenditure may differ from allocations. See **Appendix 4**

### Figure 8.1.3. Capital expenditure profile<sup>36</sup>

As a percentage of GDP (trend), as at September 2011

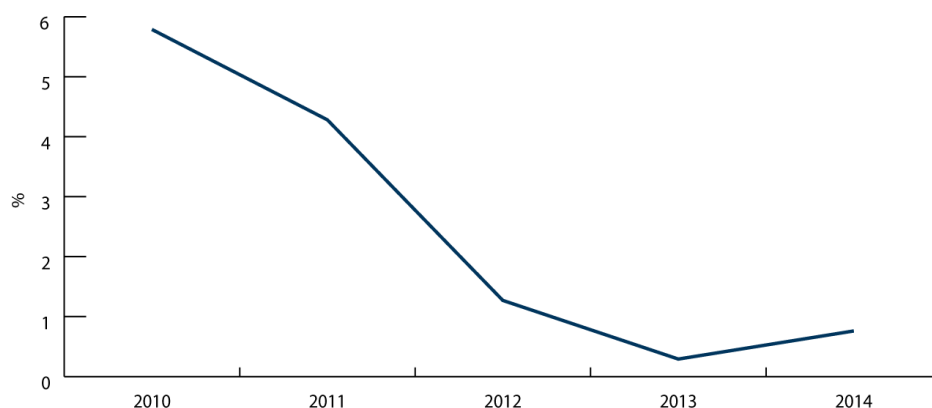
Source: Treasury and Resources Department



### Figure 8.1.4. Projected Capital reserve balance<sup>37</sup>

As a percentage of GDP (trend), as at November 2010

Source: Treasury and Resources Department



#### 8.1.5. Sustainability and permanent balance

The projected cumulative deficit over the period of fiscal deficits is some £129m against the £132m currently set aside in the Corporate Tax Contingency Reserve. As **Figure 8.1.5** illustrates, the States returns to a cumulative balance over the period from 2005 to 2016 on the central SSP case, but this is assuming that projected surpluses generated post-2014 are saved not spent. The effect on that balance of just one of the risks outlined in **Section 7** materialising is not insignificant.

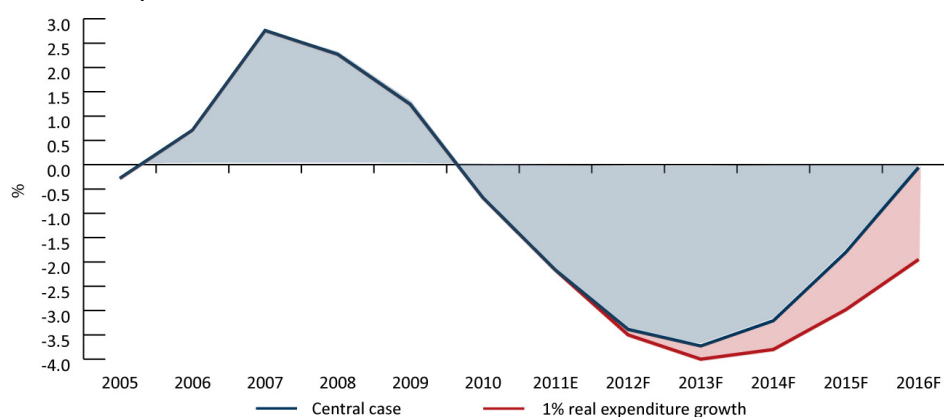
<sup>36</sup> This does include the transfer of funds to the capital reserve from the ports holding account (~£1m per annum)

<sup>37</sup> The current capital programme only extends to 2014.

### Figure 8.1.5. Projected cumulative surplus/(deficit) (2005-2016)

As a percentage of GDP (trend), as at September 2011

Source: Treasury and Resources Department

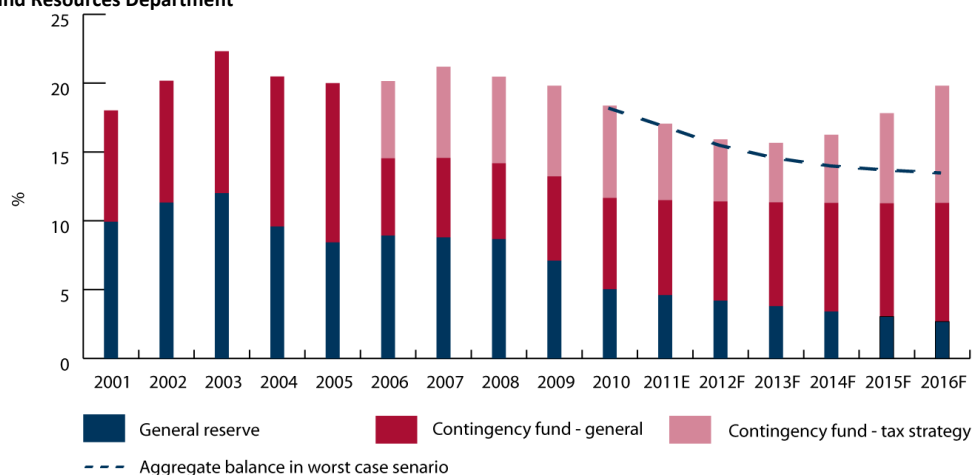


**Figure 8.1.6** illustrates the decline in total reserves over the course of the last decade. In terms of share of GDP, reserves will fall from their peak of 22% of GDP in 2003 to a trough of 15% in 2013 on current projections. The 2010 budget deficit was partially funded by recourse to the General Reserve. This lacked transparency as it gives a false impression of the remaining reserves that were earmarked specifically for the purpose of funding the deficits post zero/ten (i.e. the tax strategy portion of the contingency reserve); this is particularly important as, as was explained in **Section 7**, the majority of the General Reserve is earmarked for specific uses.

### Figure 8.1.6. Projected reserves

As a percentage of GDP (trend), as at September 2011

Source: Treasury and Resources Department



## 9. Conclusion

The States has had considerable success in restraining expenditure growth in recent years and that success is more apparent when expenditure is referenced relative to GDP. However, the exclusion of growth in expenditures funded by revenues from fees and charges from the area encompassed by the Fiscal Framework has slightly flattered that success.

The States has set out a challenging strategy to close its fiscal deficit. In international terms, the deficit is relatively small and is clearly manageable. However, progress will need to be closely monitored to ensure revenue growth, expenditure restraint and the projected savings from the FTP are delivered; otherwise, remedial action will be required. In these circumstances, it is not advisable to continue to spend the savings achieved until the deficit has been closed.

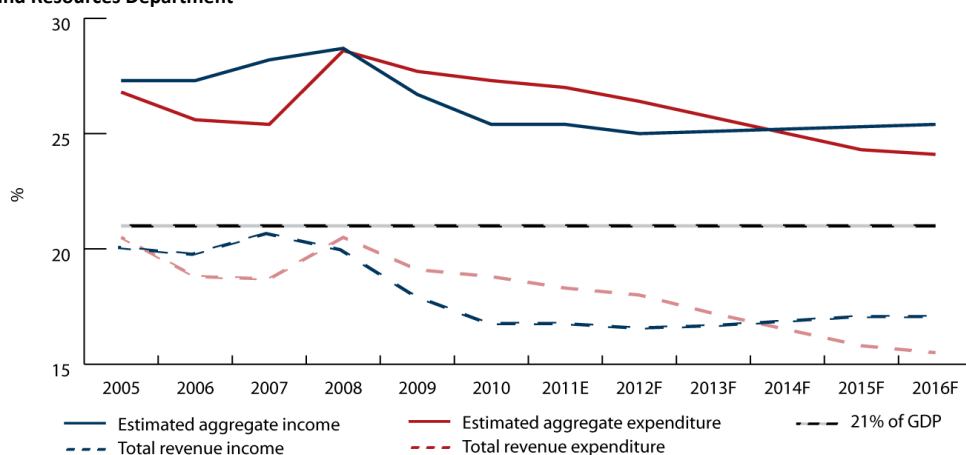
To meet the criteria of sustainability and permanent balance, the States will need a period of surplus beyond the SSP horizon to replenish the General and Contingency Reserves that it has already and will continue to draw down over the next few years. It would perhaps be imprudent to consider measures for achieving this today (over and above the current strategy) given the weakness and risks to the global and local economy. However, it would be similarly imprudent not to register that need over the longer horizon. It would be wise to consider what might be done when economic circumstances are calmer. To meet the permanent balance criteria, projected surpluses generated post-2014 must be saved not spent.

The States is presently not setting aside sufficient funds for capital expenditure to meet the Fiscal Framework target of 3% of GDP, and that, combined with an above average level of actual capital expenditure over the SSP forecast horizon, will result in depletion of the capital reserve. The States will need to address this shortfall at some point.

**Figure 9.1.1. Projected estimated aggregate income and expenditure**

As a percentage of GDP (trend), as at September 2011

Source: Treasury and Resources Department



Finally, nearly a third of public sector expenditure is outside the scope of the Fiscal Framework. The most significant medium-term pressures on public finances are to be found in the Social Security system and relate to the problem of funding of pensions as the demographic bulge works its way through the system. The States needs to address how best to manage the tension between affordability and fairness against the constraint of it being imperative to retain the internationally competitive fiscal position on which Guernsey's successful economic model is based. The States might wish to give consideration to introducing a framework that encompasses all areas of public sector expenditure, be they funded by general taxation, fees or social insurance contributions to help it manage this issue in the long-run.

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## Appendix 1. Extract from the Fiscal Framework (Billet D'etat XI, April 2009)

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### The proposed fiscal policy framework

#### Principles

The principles underlying fiscal policy in Guernsey are that:

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

#### Objective

Consistent to these underlying principles the overarching objective of the fiscal framework is that fiscal policy should achieve the economic position of **'long-run permanent balance'** ie that income and expenditure should match over the medium term to ensure continued conservative fiscal policies of the States of Guernsey.

#### Framework

1. Assuming a long-run **permanent balance** position implies the acceptance of long-run 'permanent', ie normal, levels for taxation and public spending including public sector capital investment: these long-run levels provide 'norms' for future plans and are calculated with reference to historic or international empirical experience.
2. Deviations, and hence any fiscal deficits, from these long-run norms are only acceptable if they are of a temporary nature, i.e. in the instances of a mistiming of income and increased capital expenditure requirements or those caused by severe swings of the economic cycle.
3. To ensure that balance is achieved in the medium term forecasts of all future revenue and expenditures will be continually generated to ensure that any revenue shortfalls are matched by future surpluses.
4. Any borrowing to fund temporary mismatches between expenditure requirements and revenue income will be restricted by strict conservative limits to ensure the sustainability of Guernsey's long term finances and the international credit rating of the States. **Gross debt can only be accumulated to fund capital investment.**
5. Any use of the contingency reserve as an alternative to borrowing will require the replenishment of the reserve in subsequent years to maintain reserves to an agreed level.

The above framework implies the following **limits to fiscal expenditure** of the States

- that the level of gross borrowing by the States may not exceed 15% of Guernsey gross domestic product;
- that the maximum annual operating deficit of the States may not exceed 3% of gross domestic product;



- that the maximum additional borrowing sanctioned in any one States term may not exceed one times the level of 'permanent' capital expenditure over that time period;

*and that the assumed 'norms' for permanent capital expenditure and taxation to be 3.0% and 21% of gross domestic product respectively.*

- To **ensure adherence** to this framework the undertaking is made to ensure that identified deficits will be addressed within 5 years of their appearance and that measures to counter identified structural deficits are agreed within two years of their identification.
- To **provide credibility** to this framework, and a degree of objectivity to the likely path of States finances, each year the Policy Council will publish a report to the States, separate to Treasury and Resources annual budgetary process, to provide an objective analysis on the conduct of fiscal policy.

## Appendix 2. Departmental operating income

Departmental operating income includes revenue from rents, fees and charges for services, recoveries of funds (such as the reimbursement of expenses) and transfers of funds between departments and from the Social Security<sup>38</sup> system. It is added directly to the gross budget of each Department and is typically not considered as “general” revenue.

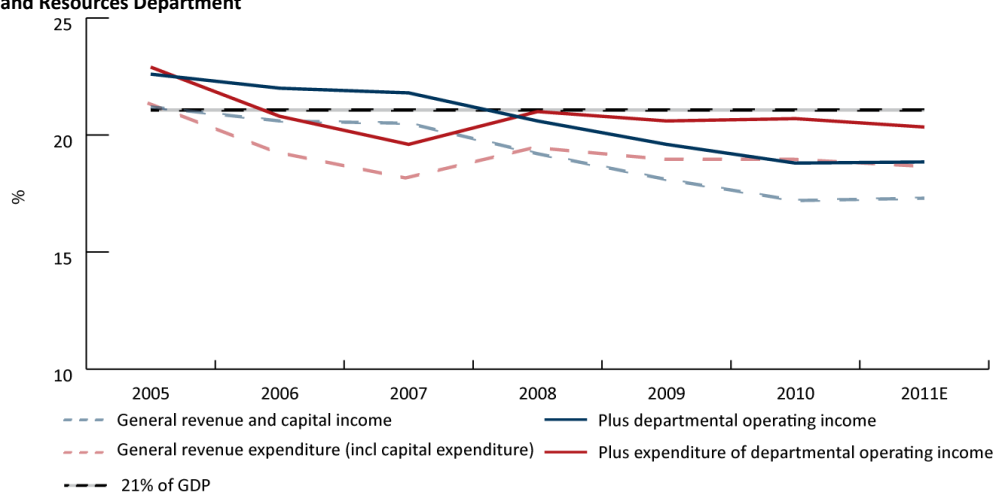
General Revenue income and expenditure, as presented in the executive summary of the General Revenue Budget and States Accounts, is presented after departmental operating income and operating income expenditure is ‘netted off’ (see **Figures 1** and **Table 6.4.1**). This creates a distinction between expenditure funded from “general” income sources (i.e. direct and indirect taxes) that are paid into the central accounting stream and allocated to departments in the Budget, and expenditure funded by revenues from departmental fees and charges, which is only available to the department by which the revenue is generated.

Departmental operating income grew in nominal terms by 9% in 2010 to £30m and grew in real terms by 22% between 2007 and 2010. In 2010, departmental operating income and its related expenditure added an additional 1.6 percentage points to income and expenditure. Calculated on this basis, total expenditure is forecast to be 19.9% of trend GDP and total income 18.4% in 2011. As departmental expenditure and income is ‘netted off’, there is no effect on the surplus/(deficit) positions.

**Figure 1. Revenue income and revenue and capital expenditure incl. departmental operating income**

As a percentage GDP (trend), as at September 2011

Source: Treasury and Resources Department



Almost all States departments have some departmental operating income, although the level varies from department to department. For some departments, this represents a significant proportion of the gross budget; for example, both the Culture and Leisure and Housing Departments finance more than half their gross expenditure from departmental operating income (see **Table 1**). As such, for some departments, the net expenditure presented in the departmental summary of the Annual States’ Accounts and Budget significantly understates their actual level of expenditure.

<sup>38</sup> The inclusion of payments from Social Security as operating income in departmental budgets results in the double counting of income and expenditure in the SSD and central accounts. Whilst these accounts are considered separately, this does not pose a problem but it does make the issues of presenting an accurate aggregated figure more complex than it would otherwise appear.

**Table 1 Departmental operating Income**

At current prices, as at May 2011

Source: Treasury and Resources Department

	2007		2008		2009		2010		2011 (budget est)	
	£'000s	% of gross expenditure	£'000s	% of gross expenditure	£'000s	% of gross expenditure	£'000s	% of gross expenditure	£'000s	% of gross expenditure
Policy Council	4	0.1	1	0.0	1	0.0	1	0.0	1	0
Treasury & Resources	2,366	12.1	2,854	13.9	2,915	13.7	3,068	14.0	2,931	13.4
Courts & Law Officers	2,312	32.1	1,535	20.0	1,708	20.9	1,753	19.0	1,645	17.2
Commerce & Employment	540	4.9	619	5.4	572	4.8	653	5.3	659	5.3
Culture & Leisure	3,640	53.2	3,930	54.8	4,013	52.7	3,905	51.3	3,914	52.1
Education	1,094	1.7	1,315	1.9	1,444	2.0	1,397	1.9	1,308	1.7
Environment	905	11.0	1,264	13.7	1,631	16.5	2,213	21.6	2,226	21.2
Health & Social Services	5,986	6.5	6,263	6.2	7,452	6.5	7,190	6.3	8,669	7.5
Home	496	1.9	1,152	4.0	979	3.2	992	3.1	1,049	3.2
Housing	767	30.6	809	29.9	1,041	37.1	1,587	53.7	1,600	49.6
Public Services	5,525	41.5	6,658	46.1	6,260	39.1	7,332	46.8	8,473	53.4
Social Security	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
Public Accounts Committee	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
Scrutiny Committee	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
States Assembly & Constitution Committee	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
Gross Revenue Expenditure	23,335	7.4	26,100	9.0	27,721	7.9	30,091	8.4	32,474	8.8

## Appendix 3. Funding Social Security

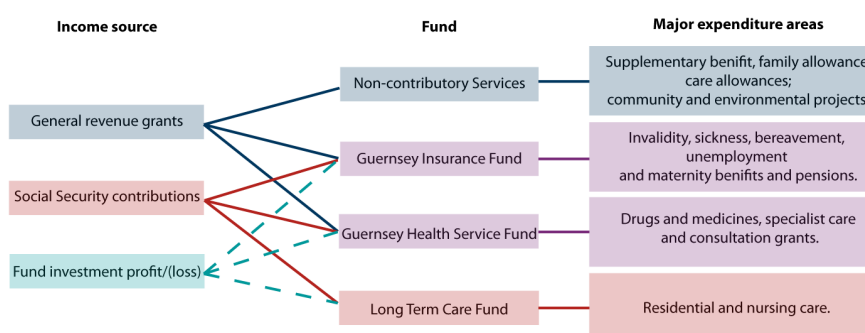
The Social Security Department is responsible for the payment of social benefits in Guernsey. The departmental expenditure is funded by a mix of grants from General Revenue and Social Security contributions (see **Figure 1**).

The revenue grant to Social Security funds was reduced between 2006 and 2009. In order to replace the lost revenue (approx. £22m), the contribution rates for employers and the earnings limit for employees' contributions were increased (from 5.5% to 6.5% and from £30,000 to £60,000 respectively) in 2008. Further incremental increases in the earnings limit for employees have been and will continue to be introduced until 2014, in order to bring the earnings limit for employees' contributions to the same level as the earnings limit for contributions paid by employers and self-employed individuals.

Income is channelled into four distinct areas:

- **Non-contributory services** – funded entirely from General Revenue, non-contributory services include the majority of benefits which residents are entitled to claim regardless of the level of contributions paid (such as supplementary benefit), as well as general administrative expenditure entailed by the department.
- **The Guernsey Insurance Fund (GIF)** – funded predominantly from Social Security contributions but with an additional revenue grant. This fund pays for the majority of contributory benefits, including pensions and unemployment benefit.
- **The Guernsey Health Service Fund (GHSF)** – funded predominantly from contributions but with an additional revenue grant. This fund pays for health benefits and specialist care, most of which are available to registered residents on a non-contributory basis.
- **The Long-term Care Insurance Fund (LTCF)** – entirely funded by contributions and finances nursing and residential care for the elderly. The benefits are available to anyone who has been permanently resident in Guernsey or Alderney for a continuous period of at least five years.

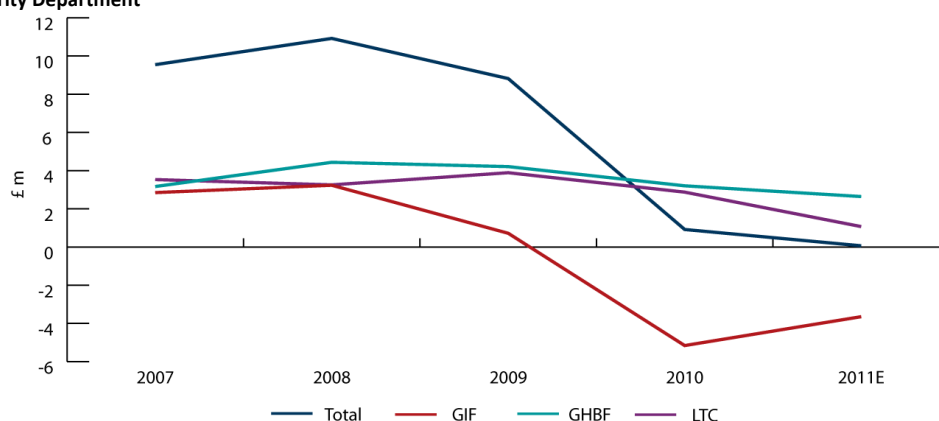
**Figure 1. Funding Social Security expenditure**



**Figure 2. Operating surplus/(deficit) of SSD funds**

At current prices, as at May 2011

Source: Social Security Department



Spending on contributory benefits has historically been fully-funded by contributions and revenue grant income over the course of each year. The GHSF and LTCF showed operating surpluses of £2.6m and £1.1m respectively in 2010 (see **Figure 2**). Although expenditure of the GIF has been fully-funded from revenue and grant income in previous years, it showed operating deficits of £5.2m in 2009 and £3.6m in 2010.

Given previous excess income over expenditure, reserves for each fund have built up over time. The GIF 'reserves' presently total around £550m,<sup>39</sup> despite the GIF being originally designed as a pay-as-you-go scheme. This enables a shortfall in any given year (between income and expenditure) to be funded either from the capital of the fund or from interest or investment gains of the fund in any one year. The size of the reserve provides a buffer to help mitigate the funding pressures caused by increasing pension payments caused by an aging population, particularly as the demographic 'bulge' works through the system. How much and how quickly this is used is clearly a political decision of the States.

The assets of the three funds (GIF, GHSF and LTCF) are combined to form the Common Investment Fund which, at 31 December 2010, was valued at £722m (an increase of 12.4% on the previous year); this is the equivalent of four to five years of aggregate expenditure by the three underlying funds at their current level.

<sup>39</sup> See actuarial reviews undertaken on behalf of SSD by the UK Government Actuary Service.

## Appendix 4. Capital expenditure accounting

Under the States accounting policy, for the purpose of calculating the overall deficit, capital expenditure is considered to be routine capital expenditure (included at the level of the operating surplus/(deficit)) plus the appropriation of funds from General Revenue to the capital reserve.

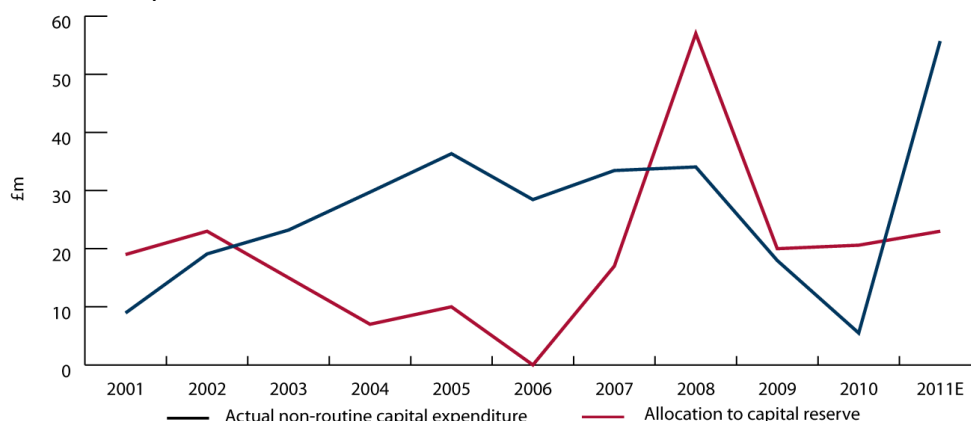
This represents the amount of money set aside for funding non-routine<sup>40</sup> capital projects and not the actual level of expenditure. The level of expenditure in any given year can differ significantly from the amount of money appropriated to the capital reserve from General Revenue (see **Figure 1**).

The appropriation from General Revenue represents by far the largest source of income to the capital reserve, but it should be noted that funds are also transferred to the capital reserve from the Ports Holding Account (£2.6m in 2010) and that the reserve also earns a significant amount of interest on its balance (£1.3m in 2010).

**Figure 1. Appropriations to the capital reserve from General Revenue and expenditure on non-routine capital projects**

At current prices, as at May 2011

Source: Treasury and Resources Department



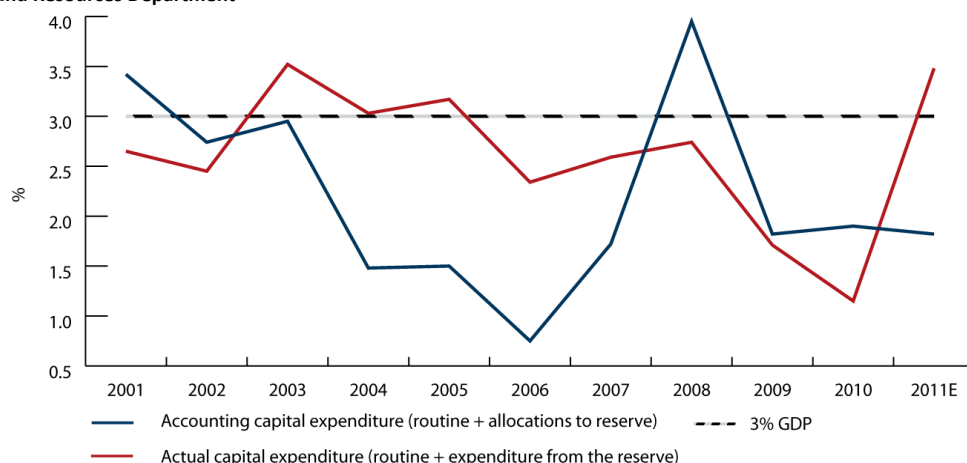
In six of the eleven years shown in **Figure 1**, expenditure from the capital reserve has been greater than the funds appropriated to the reserve from General Revenue (by a significant margin between 2004 and 2006 and in 2011) resulting in a depletion account balance. The projected capital spending profile (shown in **Figure 8.1.3**) shows the States continuing to spend more on capital projects than allocated to the reserve in 2012 and 2013 (**Figure 8.1.4**), depleting the capital reserve balance to less than 1% of GDP by 2013.

<sup>40</sup> Routine capital expenditure is funded directly from General Revenue, while non-routine capital expenditure refers to that funded from the Capital Reserve.

**Figure 2. Total capital expenditure**

As a percentage GDP (trend), as at May 2011

Source: Treasury and Resources Department



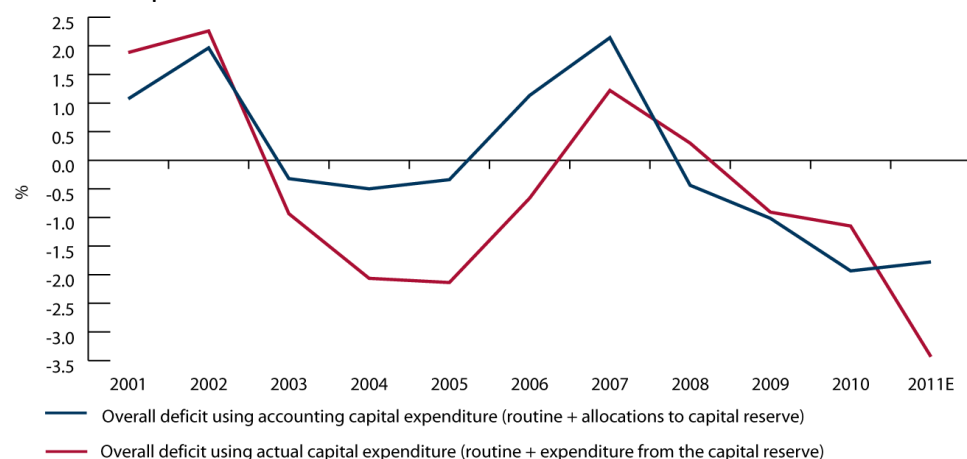
**Figure 2** shows the total capital expenditure using accounting policy (routine capital expenditure plus the allocations to the capital reserve). Under the framework, the States are committed to investing 3% of GDP in capital expenditure each year. However, using the accounting definition of capital expenditure, this has only been achieved three times over the past ten years.

**Figure 3** shows the effect on the overall deficit of replacing the allocation to the capital reserve, with expenditure from the reserve on non-routine capital projects.

**Figure 3. Overall surplus/(deficit) using actual capital expenditure**

As a percentage GDP (trend), as at May 2011

Source: Treasury and Resources Department



## Appendix 5. Glossary of Terms and Abbreviations

Term	Abb.	Description
Capital appropriation		Annual transfer of funds from General Revenue to the Capital Reserve to fund future capital expenditure.
Capital expenditure, non-routine		Expenditure on large capital projects funded from the Capital Reserve.
Capital expenditure, routine		Expenditure on small capital investments, IT projects, equipment, machinery and vehicles funded directly from General Revenue.
Common Investment Fund	CIF	Central investment fund managed by SSD comprising the combined reserves of the GIF, GHSE and LTCF.
Contingency Reserve		Reserve of funds set aside to cover large-scale unforeseen expenditure. In 2006, half of this reserve was set aside to fund the deficit resulting from the introduction of zero/ten, referred to as the Tax Strategy reserve.
Contributory benefits		For the purpose of this report, contributory benefits are considered to be all benefits (incl. administration costs) funded by the three SSD funds (GIF, GHSE and LTC). Typically, payment of these benefits is dependent on the contributions record of the claimant.
Employee Tax Instalments system	ETI	System by which income tax from employees is paid directly to income tax by their employers on a "pay-as-you-earn" basis.
Expenditure, net departmental revenue		Non-capital expenditure by States Departments presented net of expenditure funded by departmental operating income.
Expenditure, total revenue		All expenditure presented in the General Revenue Accounts used to calculate the Overall surplus/(deficit); i.e. Revenue expenditure plus routine capital expenditure and the allocation of funds to the capital reserve.
Fiscal and Economic Plan		Sub-section of the SSP outlining current fiscal and economic policy objectives in line with the Fiscal Framework.
Fiscal Framework	FF	Policy Council document outlining core fiscal policy and defining parameters for the General Revenue Budget.
Fiscal Transformation Programme	FTP	A series of projects designed to identify and deliver savings to the Revenue Budget. The programme is scheduled for completion in 2015.
General Revenue Accounts/Budget		Central budget/accounts produced by Treasury and Resources, which cover the majority of public sector expenditure excluding that funded by Social Security contributions.
Gross Domestic Product	GDP	Macro-economic indicator measuring the size of the economy. In Guernsey, this is the sum of all remunerations, company and self-employed profits and other income, such as income from property and profits of public sector trading boards.
Guernsey Health Service Fund	GHSE	Fund managed by the Social Security Department with income sourced predominately from Social Security contributions, but also receiving a revenue grant. This fund covers expenditure on health benefits.
Guernsey Insurance Fund	GIF	Fund managed by the Social Security Department with income sourced predominately from Social Security contributions, but also receiving a revenue grant. This fund covers expenditure on contributory benefits such as pensions and unemployment.
Income, departmental operating		Any income paid directly to a States department which is not incorporated as General Revenue income. This includes fees and charges for service, rents received, recoveries and funds received from SSD in payment for services. Totals for departmental expenditure are typically presented net of departmental operation income.



Income, revenue		Income from direct and indirect taxes and miscellaneous income sources included in the calculation of the revenue surplus/(deficit). Revenue income does not include income from capital or appropriations to the General Reserve. It is typically presented net of departmental operating income.
Income, total revenue		All income presented in the General Revenue Accounts used to calculate the Overall surplus/(deficit); i.e. Revenue income plus capital income and appropriations to the General Revenue.
International Labour Office	ILO	The UN specialised agency, which seeks the promotion of social justice and internationally recognised human and labour rights. It also produces international guidelines for calculation of labour market statistics.
Long Term Care Fund	LTCF	Fund managed by the Social Security Department with income sourced entirely from Social Security contributions. This fund covers expenditure on long-term care for older people.
Non-contributory benefits		For the purpose of this report, non-contributory benefits are considered to be any benefits (incl. administration costs) administered by SSD but funded directly from General Revenue. Payment of non-contributory benefits is independent of the contributions record of the claimant.
Organisation for Economic Co-operation and Development	OECD	International organisation promoting co-ordinated economic development and international co-operation.
Revenue Grant		A grant paid from General Revenue to SSD to supplement the GIF and GHSE, calculated as a fixed percentage of contributions received.
Social Security Accounts/Budget		Accounts/ budget produced by SSD covering expenditure on contributory and non-contributor benefits. Because of the revenue grant made to the GIF and GHSE, and the funding of non-contributory benefits from General Revenue, there is some overlap between the SSD and General Revenue accounting systems.
Social Security Department	SSD	Department responsible for the collection of Social Security contributions and the payment of contributory and non-contributory social benefits.
States Strategic Plan	SSP	Annual central policy document outlining States Fiscal and Economic, Social and Environmental policy.
Surplus/(deficit), operating		Revenue surplus deficit plus capital income minus routine capital expenditure.
Surplus/(deficit), overall		Operating surplus/deficit plus appropriations to General Revenue minus the appropriation of funds to the capital appropriation.
Surplus/(deficit), revenue		Revenue income minus net departmental expenditure.

