

Annual Independent Fiscal Policy Review 2012



Prof. Geoffrey Wood

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Geoffrey Wood is Professor Emeritus of Economics at Cass Business School in London and Professor Emeritus of Monetary Economics at the University of Buckingham. A graduate of Aberdeen and Essex Universities, he has worked for the Federal Reserve System and the Bank of England. Overseas, he has advised several central banks and national treasuries. He is currently a director of an investment trust, an adviser to several financial institutions, a pension fund and the Treasury Select Committee of the House of Commons. He has authored, co-authored and edited over 20 books and has published over 100 academic papers. His fields of interest are monetary economics, monetary history, the government budget constraint and financial regulation.

1. Contents

2.	EXECUTIVE SUMMARY.....	4
3.	INTRODUCTION	6
4.	ECONOMIC OUTLOOK.....	7
5.	GUERNSEY'S PUBLIC FINANCES	15
6.	PERFORMANCE AGAINST THE FISCAL FRAMEWORK	28
7.	RISKS TO THE FISCAL STRATEGY	34
8.	FISCAL STRATEGY GOING FORWARD.....	38
9.	CONCLUSION.....	39
	APPENDIX 1. EXTRACT FROM THE FISCAL FRAMEWORK (BILLET D'ETAT XI, APRIL 2009).....	40
	APPENDIX 2. COMMENTARY ON THE FISCAL FRAMEWORK.....	42
	APPENDIX 3. INCOME AND EXPENDITURE PERFORMANCE AGAINST BUDGET IN DETAIL	43
	APPENDIX 4. FUNDING SOCIAL SECURITY.....	45
	APPENDIX 5. LONG-TERM PRESSURES ON EXPENDITURE	46
	APPENDIX 6. GLOSSARY OF TERMS AND ABBREVIATIONS	48

2. Executive Summary

Last year this report opened with the comment that *‘the States has wisely committed to a long-term policy of permanent balance’* together with the statement that *‘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.’* My views on this policy commitment remain the same. The key questions are how and when the States will return to budgetary balance and how soon it can consider measures to meet this policy commitment.

Since last year’s review, global growth has been weak with the UK and much of Europe experiencing recession or near recessionary conditions. Guernsey’s economic performance has continued to be affected by this global picture. The slowing of the local economy evident at the end of last year continued in 2012 and growth forecasts were revised down in September 2012. Current estimates report that 2012 will be the fourth consecutive year of recession or weak or zero growth. Economic output has fallen below its pre-recession trend level and has been at the lower end of previous forecasts. Any boost from the introduction of zero/10 appears to have been temporary, although this may reflect the international background. Whilst the States has based its projections for 2013 on a return of mild growth, it has wisely questioned whether historic growth rates will be sustainable in the post credit crunch era. It would be prudent not to presume a rapid return of output to pre credit crunch levels; a lower rate of growth would be a more reasonable basis on which to assess the sustainability of the States’ finances.

With economic growth weak, the critical component of the deficit reduction strategy is the Financial Transformation Programme (FTP). Without alternative revenue or spending measures, achieving budgetary balance is highly dependent on a successful outcome of the programme; failure would result in the deficit remaining stubbornly structural. In addition, addressing the short term deficit problem is only a partial solution to public finance imbalances. In the longer term, as was highlighted in last year’s review, a sustainable solution requires resolving the issue of long term funding of Social Security expenditure, a significant and growing component of public expenditures.

The States has demonstrated success in restraining total Revenue Budget expenditure (however, growth in Social Security spending continues as a result of controllable and what are known as “uncontrollable” forces). To achieve revenue budgetary balance the States needs to reduce, not merely restrain, expenditure on current services. Last year, this report outlined the view that this strategy was feasible but challenging. The updates on the FTP provided in the 2013 budget show signs of slippage (i.e. the reversal of HSSD and Education savings targets of 2013 and 2014) and the strategy now appears increasingly challenging.

The 2013 budget incorporates measures that should improve the underlying structural position of the States: namely extending the application of the 10% corporate tax rates. A desire to phase out mortgage interest relief is also signalled, subject to the results of a personal tax review in 2013. If progressed this could improve the underlying structural position of the States although the Budget states that the intent would be to redistribute through other aspects of the personal tax regime.

The mandate of this review is to measure fiscal performance against the parameters of the Fiscal Framework. The States’ levels of income, expenditure and borrowing (of which there is none) are well within

the boundaries prescribed by the Framework. However, the States are likely to fail to achieve the criterion which requires the removal of a deficit position within five years. Whilst it is arguable that economic conditions preclude more rapid measures (there is no allowance for economic conditions for this criterion in the framework) failure of the current FTP strategy to deliver within the current timeframe would only compound this problem. A realistic assessment of success is urgently required and alternative measures should be readied for the 2014 budget if the profile of savings to be achieved in 2013 is not on target.

The States level of capital expenditure remains below the 3% of GDP prescribed by the Framework. However, although the need for capital investment continues, increasing the capital allocation from General Revenue at this time would be in conflict with the need to eradicate the deficit position. It may be that the States will need to consider alternative methods of financing some elements of the capital programme long term.

Whilst Social Security expenditure is outside the scope of the Framework it is reassuring to see the States commit to a joint review of the personal tax and Social Security regime, recognising the need to view States' income and expenditure in its entirety. It would seem sensible for that review to test and challenge the assumptions of future expenditure levels, especially since the need to maintain international competitiveness implies an upper bound to aggregate public spending.

3. Introduction

This report is the third Annual Independent Review of Fiscal Policy published as part of the institutional arrangements to support the Fiscal Framework adopted by the States in April 2009¹. The role of this report is to provide an independent, external, assessment of the States' fiscal conduct against the criteria in the Framework. The 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**. A commentary on the framework is included in **Appendix 2**.

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 also provides an assessment of risks relating to the fiscal strategy and raises any general areas of concern that policymakers should be seeking to address. 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, by necessity, subjective in some respects. 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.

The planned delay in the publication of the next edition of the State Strategic Plan (SSP) means that no five year forecasts are available for review in this edition of the report. The report instead focuses on the fiscal performance in 2011 and the short term projections for 2012 and 2013 published in the 2013 budget.

¹ Fiscal Framework, Appendix 1, Billet D'Etat XI, April 2009.

4. Economic outlook

4.1. Global outlook

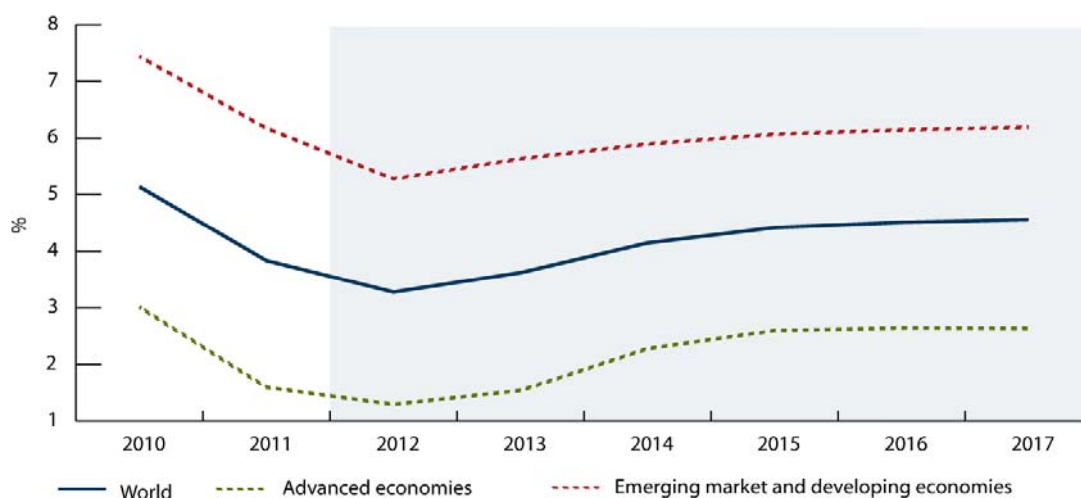
The World Economic Outlook (WEO) update, published by the International Monetary Fund (IMF) in October 2012, revised down projections of global economic growth in 2012 and 2013 for the second time this year. The IMF identifies the key reason for the setback in recovery as the failure of policies in advanced economies to rebuild confidence in medium term prospects. Unemployment continues to be a concern in many countries and the October 2012 Global Financial Stability Report highlighted that financial conditions are likely to remain fragile. As a result, although forecast output in emerging economies remains relatively solid, growth in advanced economies is expected to be slow.

The WEO forecasts assume that the European Stability Mechanism outlined by the European Central Bank will be successfully implemented by national policy makers and result in a gradual easing of financial conditions in economies on the periphery of the Euro area. It also assumes that US policy makers will be successful in avoiding the “fiscal cliff” implicit in their existing budget law and move towards a more comprehensive recovery plan. Failure on either account represents a significant downside risk.

Figure 4.1.1. Global GDP Growth

Annual percentage change, in real terms, as at October 2012

Source: International Monetary Fund, World Economic Outlook Update, October 2012



4.2. Domestic outlook

4.2.1. Recent economic performance

Guernsey does not, as noted last year, publish quarterly growth figures, nor does it collect data on quarterly business and consumer confidence or spending. Therefore, assessing recent economic conditions is dependent on a review of indirect measures. **Figures 4.2.1 to 4.2.4** present a range of such measures and clearly show the recent economic cycle. Taken together, signals from a weaker labour market, a softer property market and no evidence of significant underlying earnings growth points to an economy experiencing no growth at this point.

Figures 4.2.1 and 4.2.2 show aspects of the labour market over the course of the last three and a half years. Employment levels recovered in 2010 and early 2011, increasing to within 1% of their pre-crisis peak. However, employment levels began a second decline in mid 2011, but appear to have stabilised in the first half of 2012. The underlying trend in the number of people registered unemployed declined over the course of 2010 and remained fairly stable through the first half of 2011 but rose sharply in the later half. Unemployment peaked in the first quarter of 2012 and, on a seasonally adjusted basis, has fallen in the second quarter although it remains higher than at the same point the previous year.

Figure 4.2.1. Total employment

Actual and with SA trend, as at August 2012

Source: Policy and Research Unit

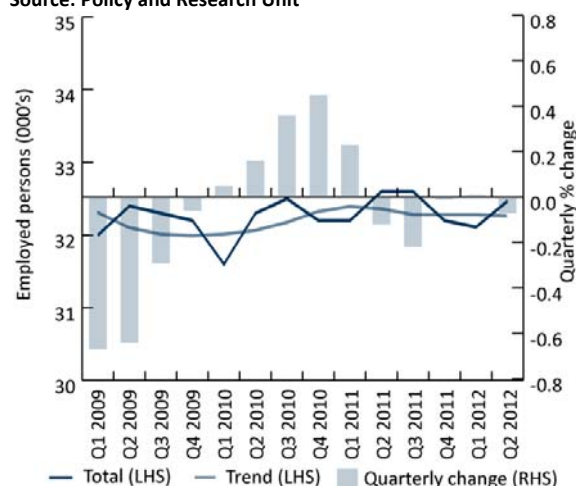
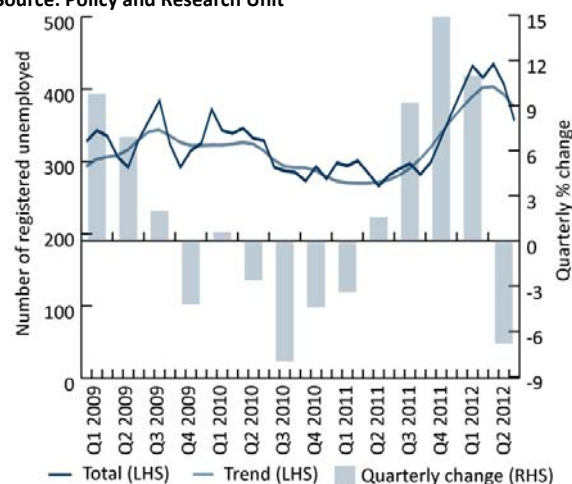


Figure 4.2.2. Total unemployment

By ILO definition, actual and with SA trend, as at August 2012

Source: Policy and Research Unit



In the absence of a goods and services tax and the impact increases in such taxes have had in the UK and Jersey, inflation in Guernsey has continued to be relatively benign, with RPIX remaining at around 3% (the States' target level of inflation) throughout much of the last three years (see **Figure 4.2.3**). Continued growth in house prices has added an additional upward pressure to RPI, in part no doubt due to the Bank of England keeping the base rate at 0.5%. Although this pressure subsided in the first and second quarters of 2012 it has resulted in annual changes in RPI slightly higher than RPIX.

Property prices have continued their rising trend throughout the last three years; with the annual change in prices remaining consistently above inflation until the end of 2011 (see **Figure 4.2.4**). During the first half of 2012 the rate of property price increases subsided to a level similar to retail price inflation pointing perhaps to an overall softening in prices: a period of lower rises could over time lead to property prices falling relative to earning and increasing levels of affordability, itself no bad thing after a decade-long rise. The volume of local market property transactions stabilised in 2010 and increased in the first half of 2011.

However, in contrast to the pattern observed in the price of houses, the number of properties sold decreased in the last two quarters of 2011 but has remained relatively stable in the first half of 2012.

Figure 4.2.3. Inflation

Annual percentage change, as at July 2012

Source: Policy and Research Unit

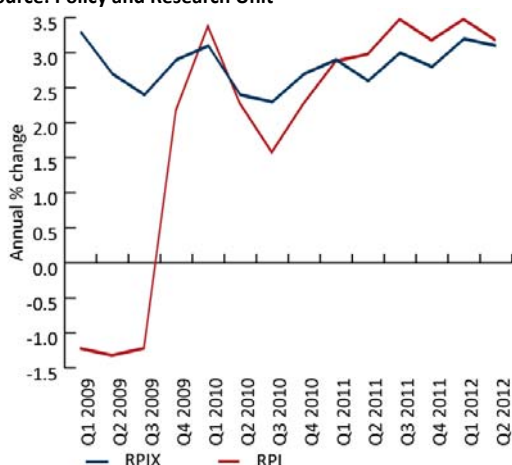
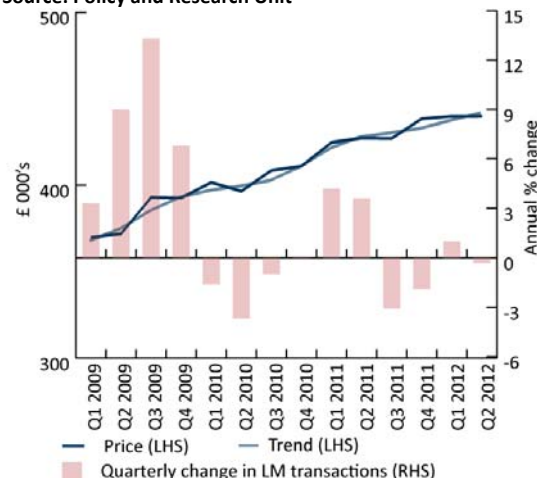


Figure 4.2.4. Local market property

LM mix adjusted purchase price with SA trend, as at August 2012

Source: Policy and Research Unit



Box 1. Inflation risks

Whilst the latest UK inflation figures show a slowing of inflation, the above-target levels experienced by the UK over the last three years have not been a completely unwelcome development for the UK Government. Whilst inflation has been above target and yields on bonds at abnormal and historic lows (many including 10 year gilts provide a negative real rate of return) due to risk aversion of international investors, UK borrowing costs have been reduced and total debt levels have been marginally eroded in real terms.

Given the near unprecedented levels of UK government debt there is an incentive for the UK Government to favour a continuance of this situation. The UK has few options to erode its deficit and borrowing position if the austerity programme fails or economic growth does not materialise in the coming years. Whilst it is not suggested that the current UK Government will or intends to pursue a pro-inflationary policy, given the incentives, the risk of a covert movement exists.

While higher levels of inflation might be considered tolerable to the UK with its levels of debt and deficit, Guernsey's inflation is anchored to the UK² and any movement upwards would likely be mirrored by local indices. Without debt and with significant assets, any pro-inflationary policy by the UK would pose one sided risks to Guernsey's balance sheet; the value of nominal government assets being eroded without any commensurate reduction in liabilities.

Both States' revenue income and expenditure are in some degree affected by inflation. Inflation increases the cost of procuring supplies and services (more than half of which are bought for the Health and Social Services Department). Increases in staff costs, meanwhile, are to an extent offset by increases in wages in the Island's workforce as a whole and consequently in personal tax receipts. However, should a situation occur where inflationary pressure is high but there is a real terms reduction in wages in the private sector, this could have a negative impact on the budget.

² Whilst recognising that Guernsey has no control over UK monetary policy, Guernsey did introduce an inflation target in 2009, to reduce inflationary expectations which had been anchored around a notion of UK 'plus'. The introduction of a nominal target (of RPIX of 3%) does seem to have been remarkably successful in this respect.

4.2.2. Finance sector conditions

Guernsey's finance sector can be divided into four major sub-sectors: banking, investments (funds), insurance, and fiduciaries (trusts). Total employment in the finance sector (including self-employed) declined by 1.3% in the year ending March 2012. This decline is a result of a contraction of approximately 4% in both the banking sector (which showed an annual decline for the third successive year) and fiduciaries. By contrast employment in investments and insurance increased by 4% and 5% respectively in the year ending March 2012.

As a result of the sustained contraction of the banking sector over the four year period for which data are available, there has been a slight shift in the distribution of employment in the finance sector away from banking and towards investments, which has proved the most resilient sub-sector during the period of economic stress.

Figure 4.2.5. Annual change and distribution of employment in the finance sector in March each year

Annual percentage change and total employment, as at March 2012

Source: Social Security Department

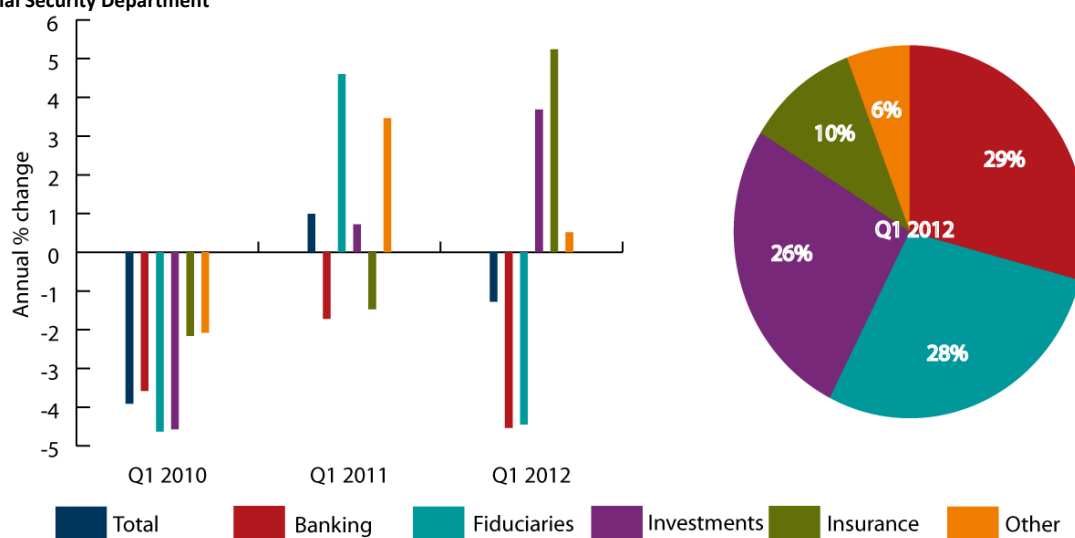


Figure 4.2.6 to 4.2.9 plot levels and quarterly changes of banking deposits and funds values alongside interest rates and stock market indices. Profits and economic output are not tightly correlated with these variables; there are leads and lags involved and the relationship is not linear.

The first half of 2012 saw a recovery in fund values but the value of banking deposits in the Island continued its steep decline until the second quarter. The Policy Council's recent economic overview stated that profits in the banking sector have fallen over the last two years; this will be in part driven by the low interest rate environment but also by the global decline in banking due to the changing economic and regulatory environment in the post-credit crunch era. Guernsey fund values (as illustrated in **Figure 4.2.8**) have experienced a modest decline over the last year, but viewing alongside global equity levels (as proxied by the FTSE in **Figure 4.2.9**) demonstrates that the funds sector has experienced genuine underlying growth in recent years.

The States' policy is to maintain Guernsey's status as a well regulated, tax transparent finance centre. Long term finance sector growth will be dependent on successfully negotiating a path through the twin pressures of the international regulation on tax transparency and the response to the 2008 crisis.

Figure 4.2.6. Banking deposits

At current prices, nominal change, as at August 2012

Source: Guernsey Financial Services Commission

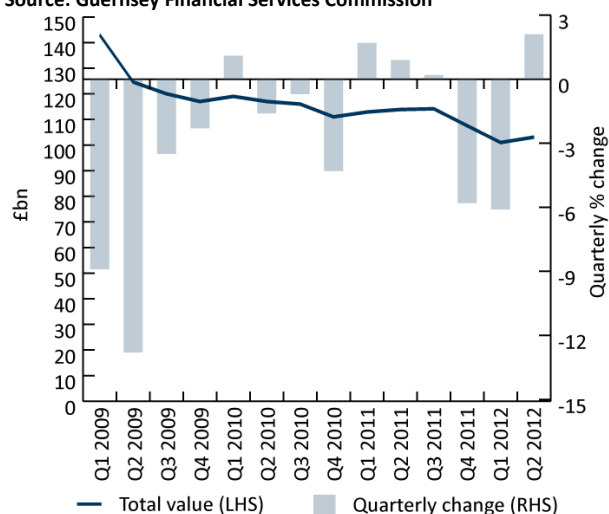


Figure 4.2.7. Bank of England base rate

As at November 2012

Source: Bank of England

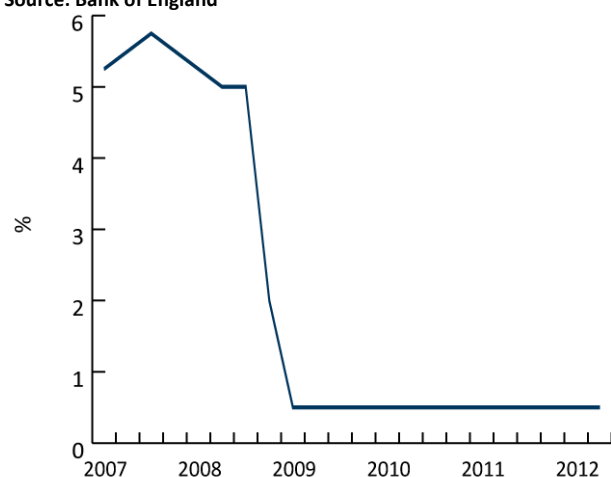


Figure 4.2.8. Fund assets

At current prices, nominal change, as at August 2012

Source: Guernsey Financial Services Commission

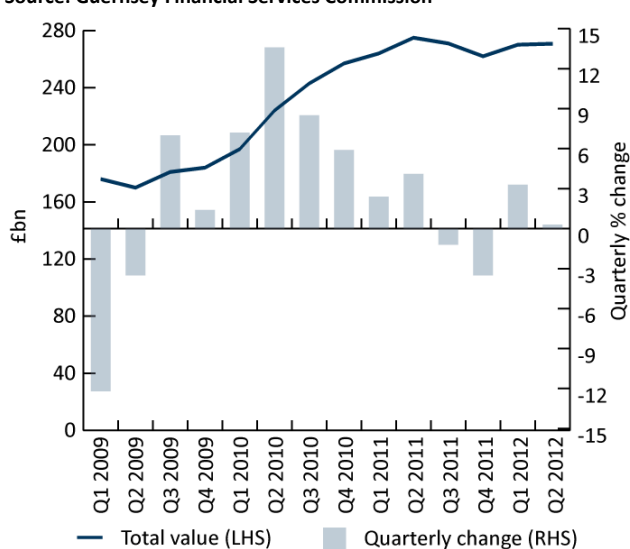
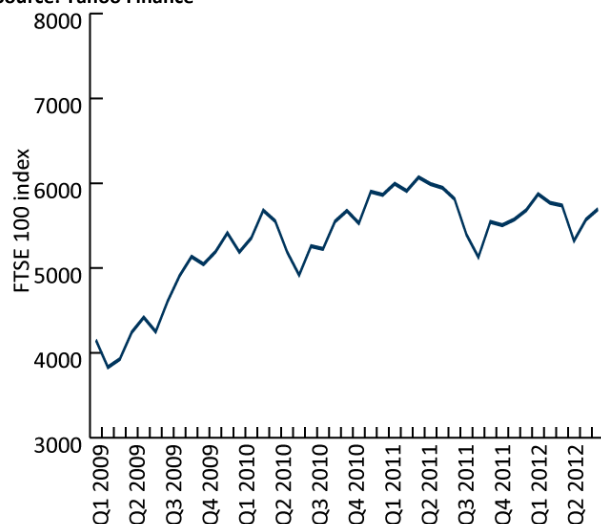


Figure 4.2.9. FTSE 100 index

Monthly adjusted closing price

Source: Yahoo Finance



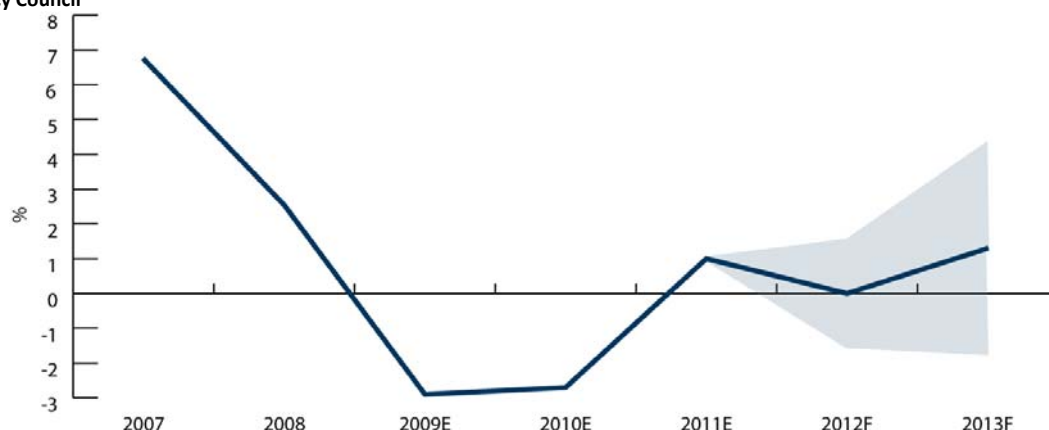
4.2.3. Outlook and forecasts

Current forecasts produced by the Policy Council suggest a weak 2012 with no real growth in GDP and a return to moderate growth in 2013. The current projection of zero growth in 2012 is underpinned by a weak labour market, a softening of property prices and anecdotal evidence from industry. The most recent published GDP figures (September 2012) revised estimates of 2010 growth down to a contraction of 2.7% as a result of revisions to banking profit estimates and a greater than previously reported fall in other (primarily investment) income of £20m. First estimates of GDP for 2011 reported moderate growth of 1.0%, however, this is less than the 1.4% growth forecast for 2011 in September 2011.

Figure 4.2.10. Annual growth in Gross Domestic Product

Real change, as at September 2011

Source: Policy Council



That forecasts have been revised down for 2012 by the Policy Council is no cause for great surprise. This report last year highlighted that most economic risks ‘remained on the downside’. A catastrophic Euro event has not materialised this year but its continued threat has impacted on confidence across continental Europe and the UK and its shadow has also fallen on the Guernsey economy.

However, the UK economy now seems to be (albeit weakly) emerging from recession and the corporate and financial sectors retain significant cash levels. Investment options are very limited in such a low interest rate environment, with negative yield on UK gilts in real terms. This has led some commentators to argue that a pickup in financial and investment activity ought to occur at some point soon in the cycle. This supports a central case of a resumption of (albeit modest) growth in 2013. Nevertheless the risks remain once again on the downside and while last year’s forecast at the same juncture did not look overly optimistic, it turned out to be so after the event. The States’ projection is a very reasonable central case on which to plan and base budgets but the States should be ready lest economic conditions worsen and the downside risks materialise.

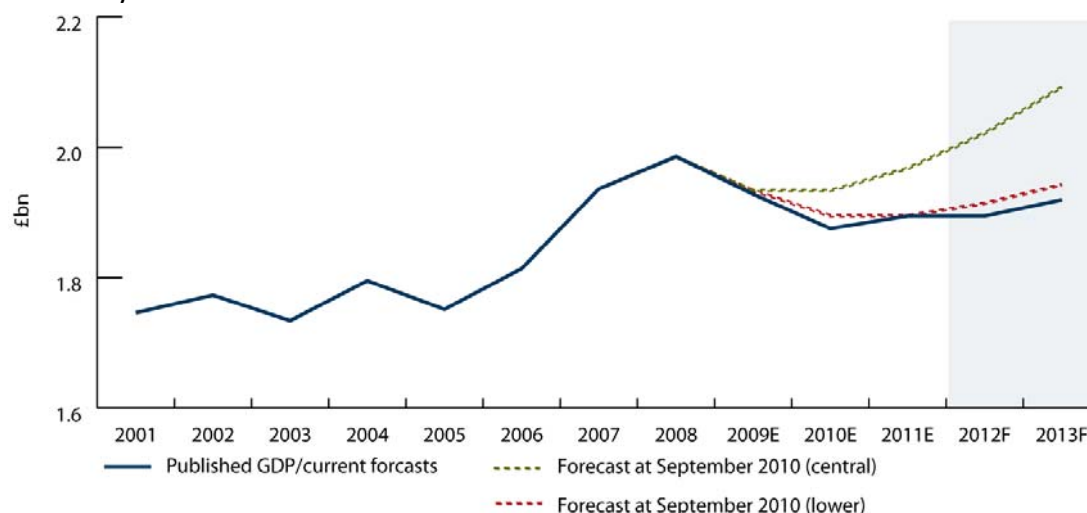
Box 2. Economic Risks

Figure 1 presents the Policy Councils' current estimates of GDP compared to the medium term GDP forecasts produced in 2010. What is evident is that events have proved much closer to the lower end of the forecast range than the central forecast, with the acknowledged down side risk materializing in the form of continued subdued global growth.

Figure 1. Gross Domestic Product compared to forecasts

At 2011 prices, as at September 2012

Source: Policy and Research Unit



These results may lead to a view that the early introduction of zero/10 in 2008 provided a one off temporary boost to the Guernsey economy rather than any change in the underlying growth rate. This does raise a question regarding the actual long-term growth rate of the Guernsey economy in the post-credit crunch era.

Prior to 2009, the historic 10 year growth rate had been around 2%, the chosen current expectation for average growth in the States Strategic Plan. This was a decline from the growth rates achieved in the '80s and 90s. For the period 1991 to 2010 the finance sector contributed for approximately 80% of that GDP growth, growing by around 10 percentage points of GDP. Irrespective of the changed, post-credit crunch world there would be a natural limit to how much greater a share of the economy the finance sector could occupy. In the slower global growth environment following the credit crunch, it is most likely that even an assumption of an average annual growth rate of 2% might be unrealistic (a point that was registered in the Policy Council's 2012 Economic Overview). A lower long-term rate of growth would mean that revenue growth would also be lower and that the States will need to factor this into their long-term planning.

The effects of population growth also need to be accounted for. Guernsey's population has grown by 7% over the last two decades. It is straightforward to provide a mechanical estimate of the impact on this population growth on output. The Policy and Research Unit's report on the long term pressures on public expenditure, published in March this year, estimated that GDP would be 17% lower by 2040 under a constant population model than against a model assuming net migration of 200 people per annum; a reduction of 0.6% in the average annual GDP growth rate.

The Guernsey Chamber of Commerce has conducted an annual survey of business conditions for the last six years. Carried out during January and February, the survey asks participating business to rate their year-on-year growth in profits and turnover for the year just ended and their expectations for the year ahead. The reported year on year growth in both turnover and profits demonstrate a correlation with estimates of real annual GDP growth. In 2011 turnover and profits each show less growth than that experienced in 2010 and that projected for 2011 at the beginning of the year.

Projections of for 2012 show that although, on balance, businesses expect moderate year-on-year growth, business confidence at the beginning of 2012 was weaker than a year earlier, in short supporting the current assumption of weaker economic conditions in 2012.

Figure 4.2.11. Overall survey scores for reported and projected year on year growth in turnover

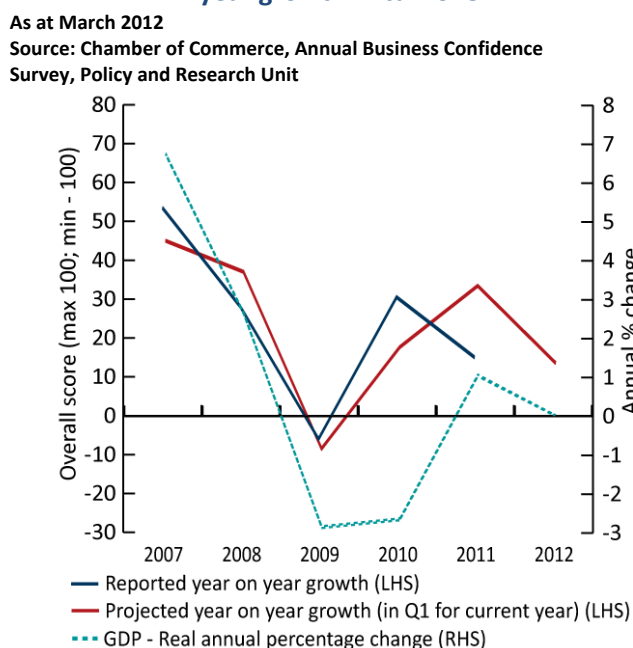
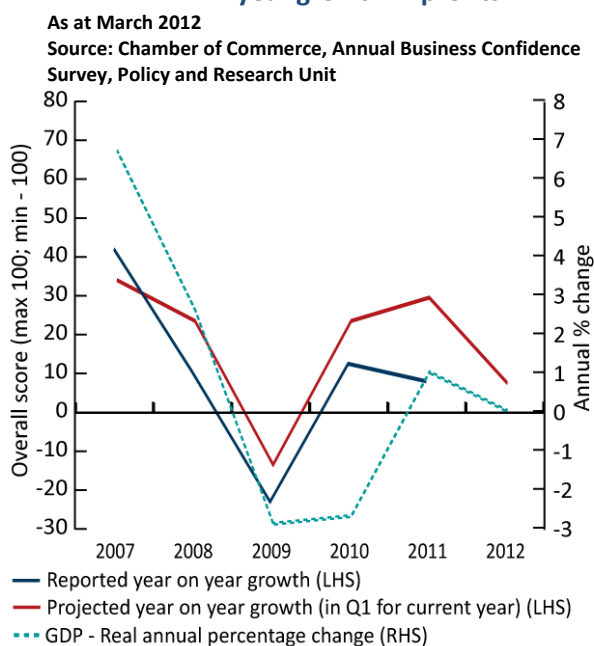


Figure 4.2.12. Overall survey scores for reported and projected year on year growth in profits



5. Guernsey's public finances

5.1. 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 November), paying for departmental and capital expenditure; and Social Security income, mainly derived from social insurance contributions (*'the Social Security Budget'*), although also having recourse to investment income and some revenue grants. The two are related by a complex series of interrelated accounts and transfers (see **Appendix 4**).

The parameters of the Fiscal Framework currently cover only General Revenue income and expenditure. 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 financed from the General Revenue Budget, Social Security expenditure has an impact on the General Revenue balance.

In addition, total revenue and expenditure figures presented in the General Revenue Budget are also typically presented net of departmental operating income³ and expenditure financed from that source.

This chapter presents an overview of both the General Revenue and Social Security Budgets. It commences by examining the States' fiscal performance against the original 2011 Budget. It continues by looking at recent trends in income and expenditure and the expectations for 2012 and 2013 as presented in the 2013 Budget.

³Includes 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.

5.2. General Revenue

5.2.1. Overall fiscal position

Table 5.2.1. Budget forecasts for 2012 and 2013

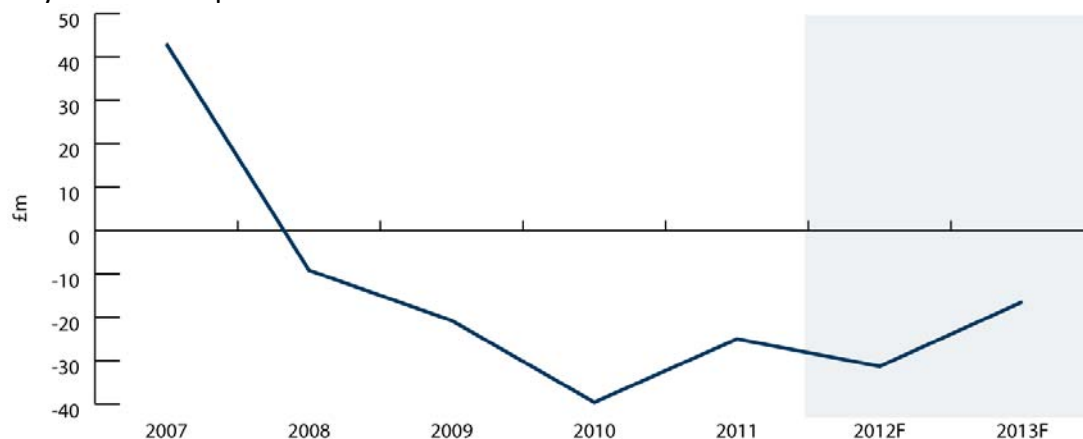
At current prices, as at November 2012

	2009 (£m)	2010 (£m)	2011 (£m)	2012F (£m)	2013F (£m)
Personal taxes	209	205	218	224	233
Company taxes	64	53	52	50	59
Income taxes	273	258	270	274	292
Misc income	6	3	2	2	1
Indirect taxes	62	70	74	78	79
General revenue income	341	331	346	354	372
Departmental operating income⁴	28	32	35	34⁵	35⁵
Total revenue income	369	363	381	388	407
Net departmental expenditure	(325)	(330)	(333)	(345)	(348)
Exp. of departmental operating income⁴	(28)	(32)	(35)	(34)⁴	(35)⁴
Gross departmental expenditure	(353)	(362)	(367)	(379)⁴	(383)⁴
Revenue surplus/(deficit)	16	1	13	9	24
Routine capital expenditure	(15)	(18)	(17)	(16)	(13)
Capital income	0	0	0	6	0
Operating surplus/(deficit)	1	(17)	(3)	(1)	11
Appropriation to capital reserve	(20)	(21)	(21)	(30)	(28)⁶
Overall surplus/(deficit)	(19)	(37)	(24)	(31)	(17)

Figure 5.2.1. Overall fiscal position, 2007-2013

At 2012 prices, as at November 2012

Source: Treasury and Resources Department



⁴ In the 2011 accounts Departmental Operating Income that was generated by the States of Alderney and its subsequent expenditure (£1.6m in 2011 and £1.8m in 2010) was included in the calculation of total Departmental Operating income for the first time. Prior to this net expenditure of the States of Alderney was included as a subsection of Treasury and Resources expenditure. 2010 figures have been amended since the previous report to be consistent with those restated in the 2011 accounts. Operating income of the States of Alderney is not included in these figures prior to 2010.

⁵ Departmental operating income figures for 2012 and 2013 from the 2013 budget were not available in time to be incorporated into this report. As such 2012 Departmental Operating income is assumed to be the same as that originally budgeted. 2013 Operating income is assumed to be the same in real terms (assuming 3% inflation) as that in 2012.

⁶ Includes £3m transfer to Strategic Policy Fund

The General Revenue accounts reported an overall deficit of £24m in 2011: a reduction of £13m on the previous year, more than the £10m budgeted but the first decrease in the deficit observed since the introduction of zero/10 in 2008. The reduction of the deficit resulted from an increase in income both from the General Revenue streams and departmental operating Income as well as restraint of expenditure growth in real terms (albeit the final position was improved by non-expenditure of the contingency “budget reserve” which is transparently incorporated into the budget to allow for possible variation in expenditure such as unsettled pay awards⁷).

Current estimates for 2012 predict a £7m increase in the size of the overall deficit, due to higher than planned expenditures, lower than planned income and a larger transfer to the capital reserve than in 2011.

The budget for 2013 projects a £14m reduction in the overall deficit position resulting from a projected increase in both personal and company tax receipts, the former as a result of projected growth, the latter as a result of the extension of the application of the 10% corporate tax rate as the corporate tax review is concluded.

This minor worsening of the fiscal position in 2012 comes after a better than projected 2011. Significantly, despite this slight reversal of the position, the deficit remains well within the boundary of the original projections of the SSP 2009 to 2013 (see **Box 3**). The improvement in 2013, given the contribution of improved corporate income, seems entirely plausible. However, there is a continued risk that economic growth (and thus income) will be worse than projected given the downside risks to the global economy and, perhaps more noteworthy, it does require real terms reductions in expenditure. Achieving the latter will be challenging: a subject returned to in **Section 7.2**.

⁷ If required, expenditure from the budget reserve is re-allocated to the relevant departments when presented in the annual accounts.

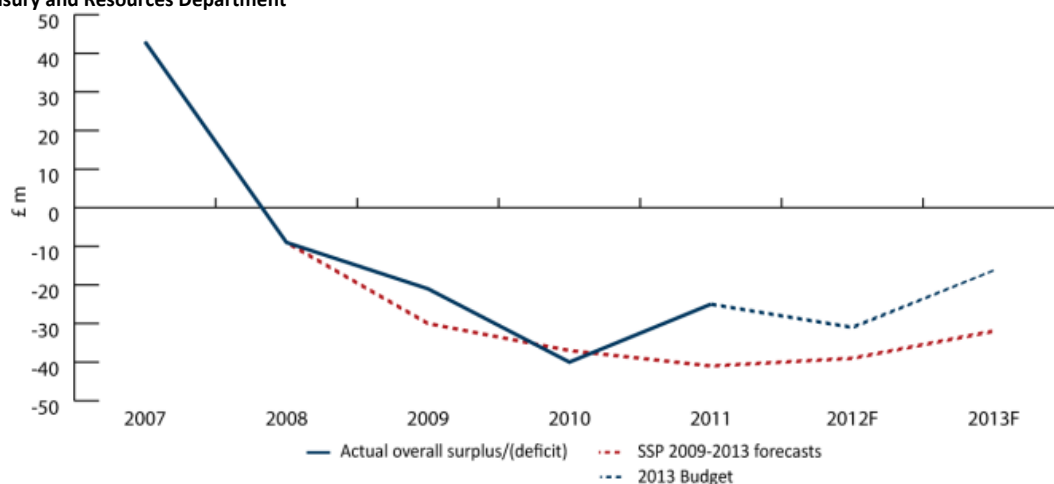
Box 3. Performance against five year forecasts

The States first published short- to mid-term forecasts of the revenue budget in the 2009 SSP (see **Figure 1**). When compared in real terms (adjusting for inflation in the intervening period) to the actual deficit and to that forecast in the 2013 Budget it can be seen that the actual (and currently forecast) deficit has been less than originally anticipated in four of the five years between 2009 and 2013.

Figure 1. Overall surplus/ (deficit) versus SSP forecasts

At 2012 prices, as at November 2012

Source: Treasury and Resources Department



Figures 2 and 3 show that after a £22m underestimate of General Revenue income in 2009, projections of income have typically been more accurate than those of expenditure. Projected income in 2011 was very close to that forecast in the 2009 SSP; however, current estimates of 2012 and 2013 income have fallen slightly below the position projected in 2009 (given global economic conditions in the period, an outcome of no real surprise).

Expenditure reported in 2011 was £14m lower than that projected in 2009; an overestimate which is expected to continue at the same level in 2012 and increase to £17m in 2013.

Figure 2. General Revenue income compared to SSP forecasts

At 2012 prices, as at November 2012

Source: Treasury and Resources Department

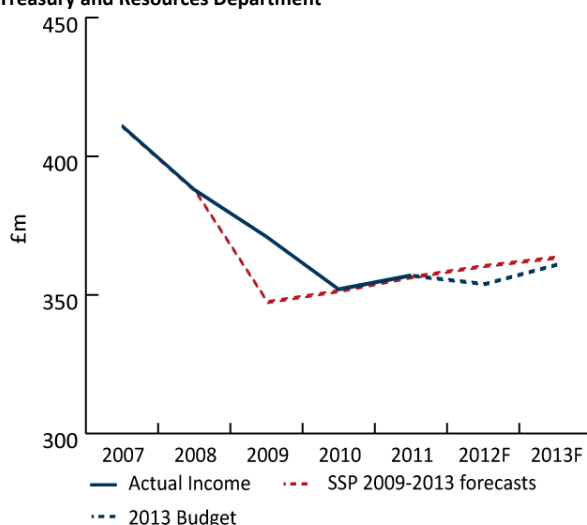
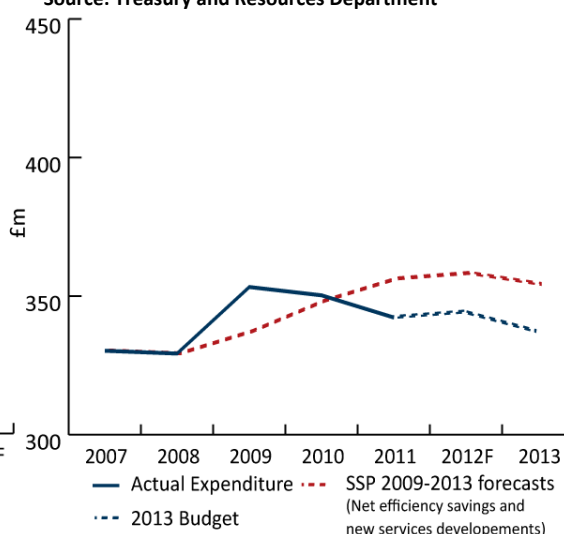


Figure 3. Net revenue expenditure compared to SSP forecasts

At 2012 prices, as at November 2012

Source: Treasury and Resources Department



5.2.2. Fiscal performance in 2011

Table 5.2.2. Fiscal position in 2011*

At current prices, as at May 2012

Source Treasury and Resources Department

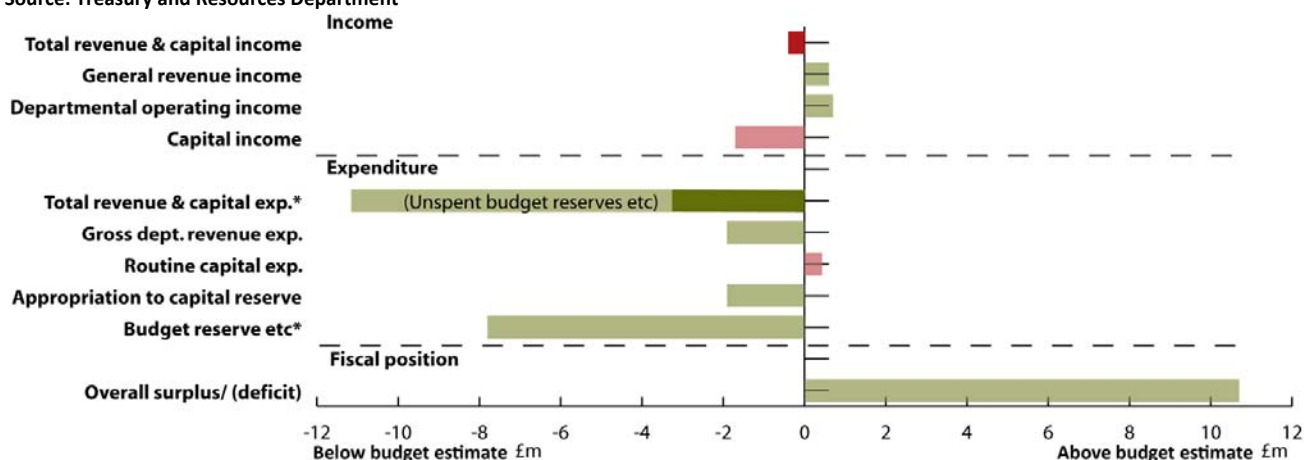
	2011 Accounts (£m)	2011 Budget (£m)	Contribution to deficit reduction (£m)
General Revenue income	346	346	+0
Departmental operating income	35	34	+1
Total revenue income	381	380	+1
Net departmental revenue expenditure	(333)	(335)	+3
Expenditure of department operating income	(35)	(34)	-1
Gross departmental revenue expenditure	(367)	(369)	+2
Budget reserve other unassigned allocations in the 2011 Budget	--	(8)	+8
Revenue surplus/(deficit)	13	3	+11
Routine capital expenditure	(17)	(16)	-0
Capital income	0	2	-2
Operating surplus/(deficit)	(3)	(12)	+9
Appropriation to capital reserve	(21)	(23)	+2
Overall surplus/ (deficit)	(24)	(35)	+11

*Because of the effect of rounding, numbers may not sum to totals.

Figure 5.2.2. Performance against Budget, 2011 income and expenditure

Variation of the 2011 accounts from the original budget, as at May 2012

Source: Treasury and Resources Department



*The 2011 Budget incorporates unassigned expenditure allocations for Service Developments (£1m), FTP savings (-£1m), and the Budget Reserve (£7m) which have been incorporated in total revenue and capital expenditure. The 2011 accounts do not state expenditure or savings made under these categories; all expenditure or savings made are incorporated within the standard reporting categories.

The 2011 accounts reported an overall deficit of £24m, £11m less than projected in the 2011 budget (see **Table 5.2.2** and **Figure 5.2.2**). Overall, the total amount of income reported in the General Revenue accounts was very close to that budgeted. A £2m short fall in capital income was almost entirely offset by slightly larger than anticipated receipts from both the General Revenue and departmental operating income streams.

Both gross departmental expenditure (including the expenditure of departmental operating income) and the appropriation to the capital reserve were £2m less than budgeted. Although this was partially offset by a small overspend on routine capital expenditure this resulted in a total underspend of £4m compared to that

assigned to specified expenditure areas in the budget. Including the unallocated budget for service developments, FTP savings and the budget reserve, which are incorporated into departmental revenue expenditure in the accounts (this can be viewed as a netting off of the 'gross departmental revenue expenditure' with the apparent under spend against the 'budget reserve' in **Figures 5.2.2 and 5.2.3**), the accounts reported an improvement in the overall balance of £11m (against original budget). More detail on income and expenditure performance in 2011 against the budget is provided in **Appendix 3**.

5.2.3. Current estimates of fiscal performance in 2012

Table 5.2.3. Current estimates of Fiscal Position in 2012*

At current prices, as at November 2012

Source: Treasury and Resources Department

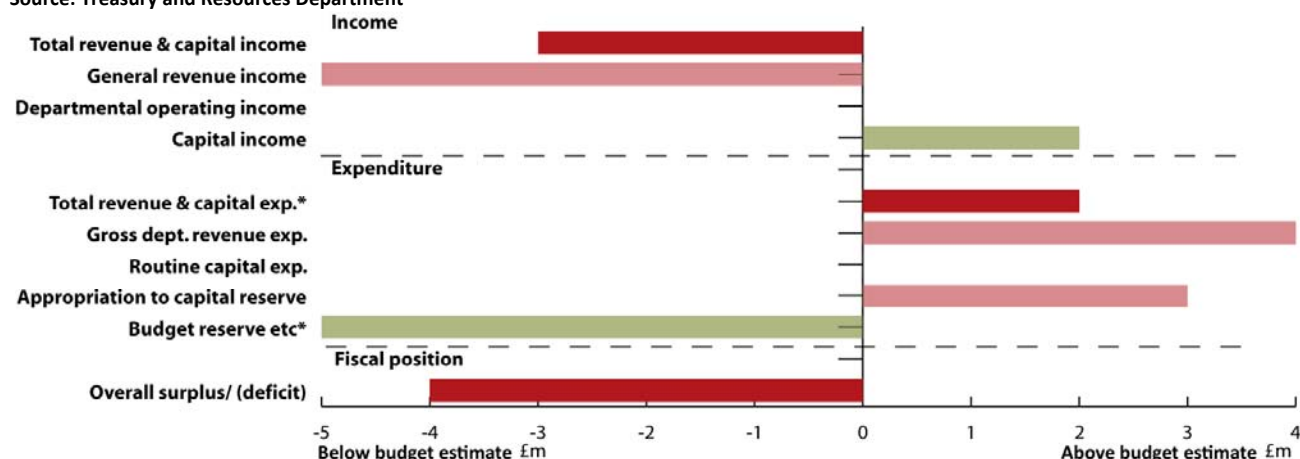
	2012 Current estimates (£m)	2012 Budget (£m)	Contribution to deficit reduction (£m)
General Revenue income	354	359	-5
Departmental operating income ⁸	34	34	0
Total revenue income	388	393	-5
Net departmental revenue expenditure	(342)	(338)	-4
Expenditure of department operating income ⁸	(34)	(34)	0
Gross departmental revenue expenditure	(376)	(372)	-4
Budget reserve other unassigned allocations in the 2012 Budget	(3) ⁹	(8)	+5
Revenue surplus/(deficit)	9	13	-4
Routine capital expenditure	(16)	(16)	0
Capital income	6	4	+2
Operating surplus/(deficit)	(1)	1	-2
Appropriation to capital reserve	(30)	(28)	-2
Overall surplus/ (deficit)	(31)	(27)	-4

*Because of the effect of rounding, numbers may not sum to totals.

Figure 5.2.3. Performance against Budget, 2012 income and expenditure (current estimates)

Variation of the current estimates (2013 budget) from the original budget, as at November 2012

Source: Treasury and Resources Department



*Incorporates a 2012 budget reserve of £6.6m, unallocated budget for service developments of £1.2m minus £2.3m of expenditure provisionally allocated for the non recovery of monies fraudulently obtained from the States in July 2012. As referred to in 5.2.2 above expenditure of funds from the budget reserve are incorporated into departmental revenue expenditure in the accounts – this can be viewed as a netting off of the 'gross departmental revenue expenditure budget' and the apparent under spend against the 'budget reserve'.

⁸ Current estimates of Departmental operating income for 2012 from the 2013 budget were not available in time to be incorporated into this report. As such 2012 Departmental Operating income is assumed to be the same as that originally budgeted.

⁹ Includes a provisional allowance of £2.3m for exceptional expenditure.

The current estimate of the overall deficit for 2012 (as published in the 2013 Budget) is £4m larger than originally budgeted. This is a result of a combination of factors, including a £6m shortfall in company tax receipts and a £4m overspend on gross departmental revenue expenditure (although this overspend will be absorbed by the budget reserve).

On a more detailed level, current estimates report that most departmental outturns are expected to be within authorised budget limits. However, there is a £1.5m anticipated overspend in the Health and Social Services Department and a £2.1m overspend in formula led General Revenue expenditure on Social Security¹⁰.

An additional £2.3m of unbudgeted expenditure has been provisionally allocated as an allowance for the non-recovery of the balance of monies defrauded from the States in the summer of 2012.

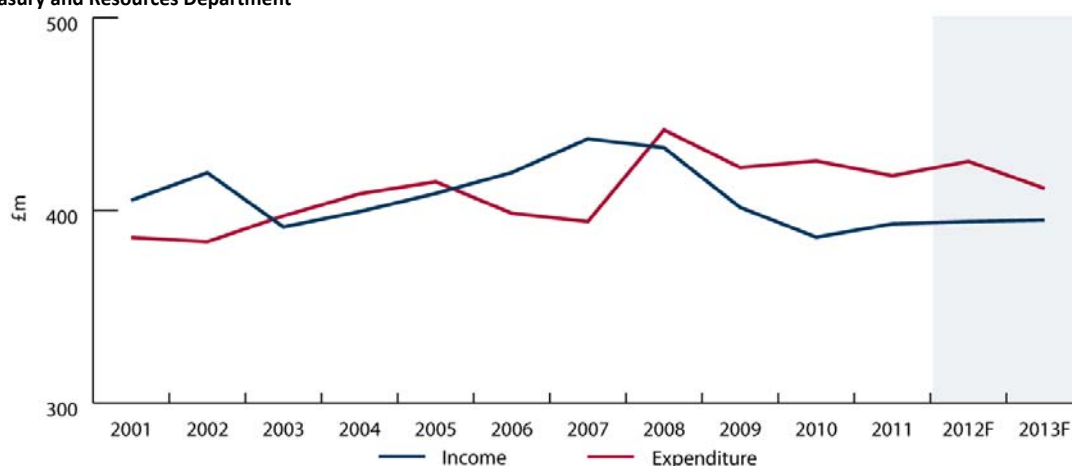
5.2.4. Income and expenditure in detail

In 2011 total revenue income (including capital and departmental operating income) increased year on year by 1.8% in real terms. This was predominantly a result of an increase in personal tax receipts with an additional £7m of tax revenue generated via the Employee Tax Instalment scheme and a further £6m from tax on other (predominantly non-earned) personal income. This is the first increase in revenues, in both nominal and real terms, recorded since before the introduction of zero/10 in 2008 which, combined with difficult economic conditions, produced a general decline in income between 2007 and 2010.

Current estimates for 2012 (as published in the 2013 budget) show a 0.3% real increase in total revenue income. However, this includes £5m of capital income generated by the buyback of shares by Guernsey Post Ltd. Absent this effect, income reduced in real terms by 1.0%.

Figure 5.2.4. Total revenue income and expenditure, 2001 – 2013

Total revenue income and expenditure (incl. Dept. operating income and capital income and expenditure), at 2012 prices, as at November 2012
Source: Treasury and Resources Department



The 2013 Budget forecasts an increase in total revenue income of 0.2% in 2013 with the reduction in capital income offset by increases in both personal and company tax receipts.

The anticipated £9m increase in company tax is largely a result of an estimated £12m of additional revenue generated by the extension of the 10% intermediate corporate tax rate to cover licensed insurance intermediaries and managers and regulated fiduciary and domestic insurance activities, offset by an

¹⁰ Formula led expenditure on Social Security, which includes supplementary benefit and the Revenue Grant to the Social Security funds, are (once benefit levels are set) demand led areas of expenditure and as such beyond the States' control (see Section 7.1.1).

estimated £4m of lost revenue as a result of the removal of the tax on deemed distributions. This should improve the structural position of States finances.

Total revenue and capital expenditure fell year on year by 1.8% in real terms in 2011 to £405m, continuing a period of successful expenditure restraint. The 2013 budget estimates that expenditure will increase by 1.8% in real terms in 2012 (an increase assumed to be temporary) before falling by 3.3% in 2013.

The net effect of all these movements is illustrated in **Figure 5.2.4**. The one off effect on 2012 revenues from capital income masks the underlying increase in revenues between 2012 and 2013 but the projected real terms decrease in expenditures is evident. This demonstrates the dependence of the deficit reduction strategy on the FTP programme; without savings generated by the programme, irrespective of the improvement in income noted above, the deficit position risks remaining stubbornly structural.

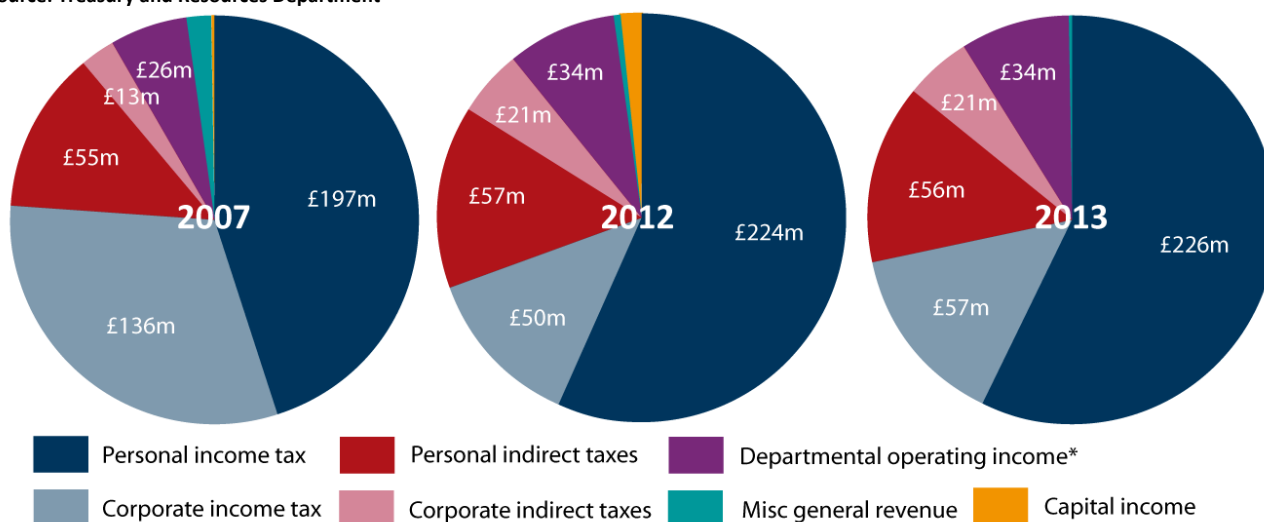
There has been a shift in the distribution of States income between 2007 and that projected for 2013 away from corporate taxes and toward personal taxes. The significant reduction in corporate tax which resulted from the introduction of zero/10 reduced this proportion of income from 33% in 2007 to a minimum of an estimated 14% in 2012. However, the net effect of the changes to the zero/10 regime to be introduced in 2013 (i.e. the loss of deemed distributions and the extension of the 10% tax rate) will increase the proportion of revenue generated from corporate tax to 16%.

It is estimated that personal income tax receipts will comprise more than 57% of States income in 2013 compared to 45% in 2007.

Figure 5.2.5. Total revenue income by source, 2007, 2012 and 2013

At 2012 prices, as at November 2012

Source: Treasury and Resources Department



*Current estimates of Departmental Operating income for 2012 and 2013 were not available for inclusion in this report. Departmental operating income in 2012 is assumed to be equal to the original budget. 2013 Departmental operating income is assumed to show no annual increase in real terms.

The distribution of expenditure in 2013 is expected to be broadly similar to that of 2007 with a moderate increase (1 percentage point) in the proportion of expenditure spent on Health and Social Services and a slight decrease (0.5 percentage points) in the proportion of expenditure spent on Education. The proportion of revenue expenditure spent on Social Security decreased from 16% to 11% between 2007 and 2008 as a result of the second of two reductions in the grant paid from General Revenues. However, as a result of

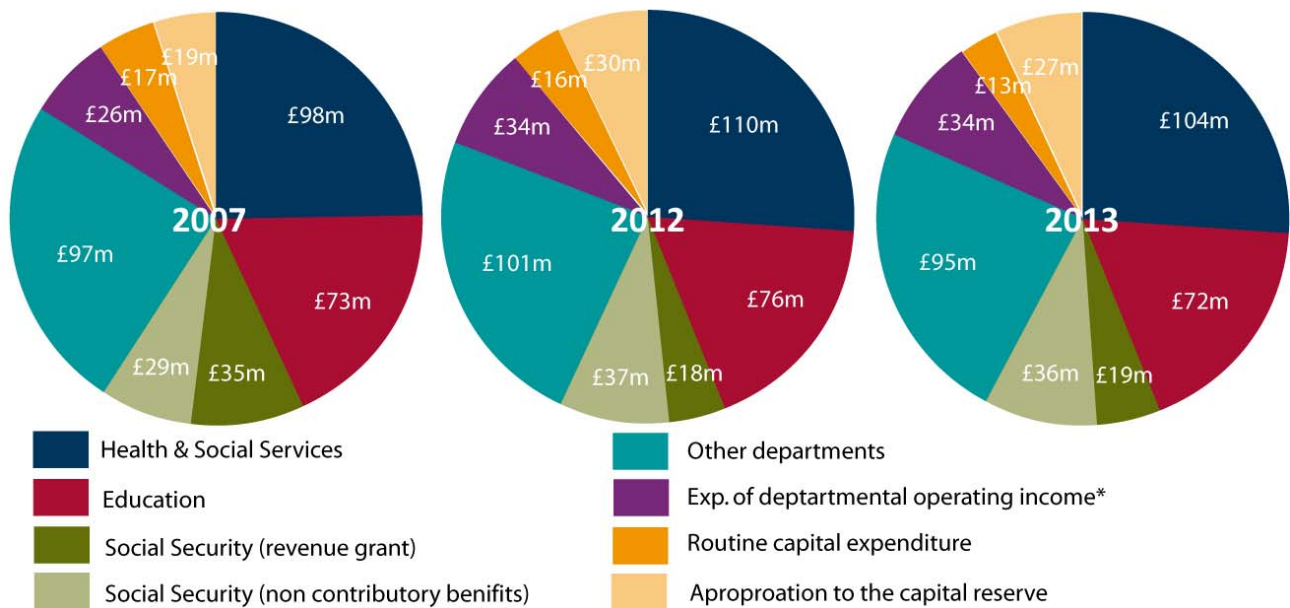
increases in both the revenue grant¹¹ and payment of non-contributory benefits the proportion of revenue expenditure spent on Social Security has subsequently increased to 14%.

The proportion of expenditure financed by departmental operating income increased from 6% to 9% between 2007 and 2011, indicating that a period of successful revenue budget restraint has been accompanied in some areas by increased income from fees and charges (see **Section 7.1.1**).

Figure 5.2.6. Total revenue expenditure by area, 2007, 2012 and 2013

At 2012 prices, as at November 2012

Source: Treasury and Resources Department



*Current estimates of Departmental operating income for 2012 and 2013 were not available for inclusion in this report. Departmental operating income in 2012 is assumed to be equal to the original budget. 2013 Departmental operating income is assumed to show no annual increase in real terms.

¹¹ Resulting from an increase in the value of Social Insurance contributions received by Social Security on which the formula for the revenue grant is based.

Box 4. Net expenditure and departmental operating income

The accounting practice in Guernsey is to present departmental expenditure net of the expenditure from departmental operating income. This income, which includes revenue generated by fees and charges for the provision of services, is available only to the department by which it was generated and is offset against the department's expenditure. As a result, what may appear to be a reduction in a department's expenditure may actually be due to an increase in operating income.

Between 2007 and 2011, departmental operating income increased by 29% in real terms and the proportion of total revenue income generated in this way increased from 6% in 2007 to 9% in 2011. In 2011 the increase in operating income (£2.7m) accounted for approximately 20% of the reported reduction in the deficit.

Figure 1. Departmental operating income, 2007 - 2011*

At 2012 prices, as at May 2012

Source: Treasury and Resources Department

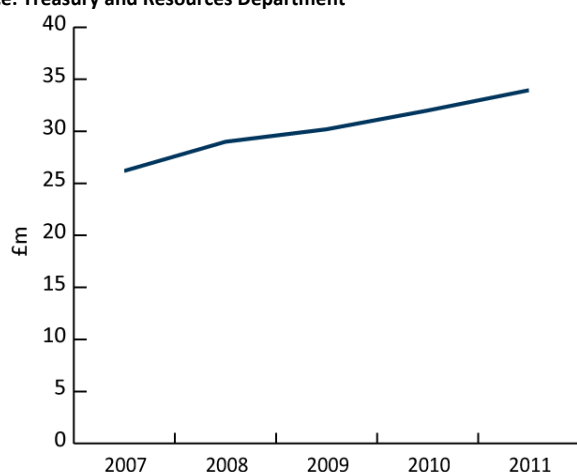
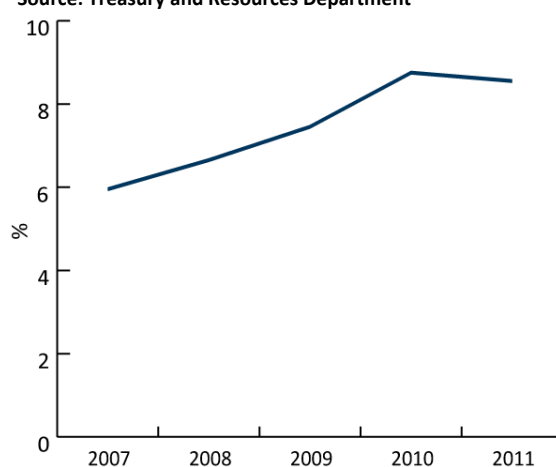


Figure 2. Departmental operating income, as a percentage of revenue income*

As a percentage of total revenue income, as at May 2012

Source: Treasury and Resources Department



*In order to provide a consistent series this data excludes operating income generated by the States of Alderney which was not incorporated in total departmental operating income prior to the publication of the 2011 accounts.

Fees and charges are an appropriate mechanism for financing certain services and their adoption has increased in many jurisdictions in the last 20 years. However, careful consideration is needed in their application and definition. A narrow definition is that they are 'prices charged for voluntarily purchased publicly provided services that, while benefiting specific individuals, are closely associated with pure public goods'. This would exclude permits and licences as these are generally not avoidable and relate to privileges granted by government. A broader definition is that they are payments made by consumers in direct exchange for government services. However they are defined, an important principle is that rates should not be set higher than costs plus a return on capital, as they then become another tax levied in the form of a monopoly profit.

The States has a current policy on the setting of fees and charges (Billet d'Etat III, January 2007) but this policy leaves a large degree of discretion with departments and thus potentially lacking consistency across the States. Particularly given the need to remove the budget deficit, the temptation exists to generate revenues to make up shortfalls in savings or to substitute for General Revenues. The task of developing a revised, States wide, fees and charges policy forms part of the FTP. This is a sensible move. The current review must ensure that the States does not inadvertently stray across the boundary between financing a service and levying another tax. That said given current practices, a consistent, evenly applied policy could readily result in an increase in revenues. This in itself would not be of concern so long as changes are determined by a consistent policy which mimics how a competitive supplier of the service would behave.

5.3. Social Security

5.3.1. Operating surplus/deficit

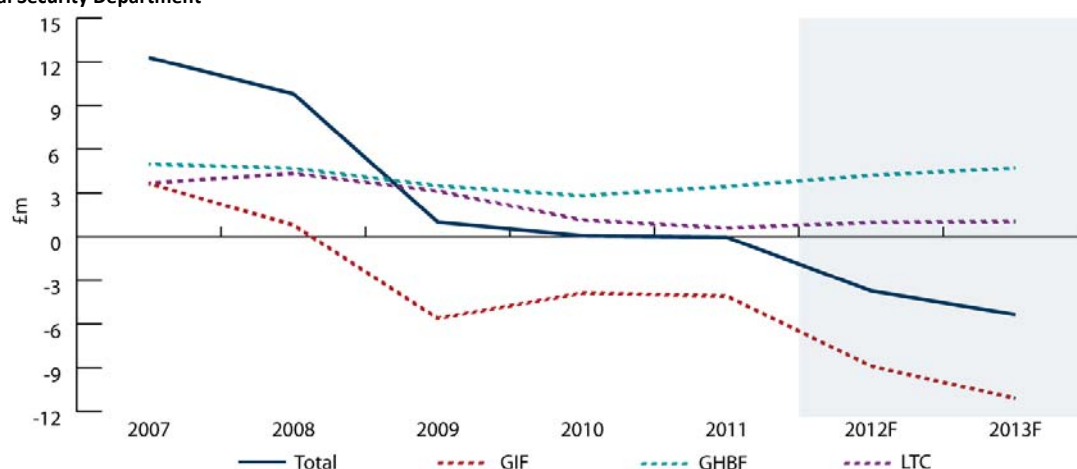
Because the growth in Social Security expenditure has been greater than the growth in income, the combined operating surplus (excluding income from investments) made by the funds has declined over the last five years. In 2011, the funds reported a combined operating deficit of £44,000, (including the £4m deficit in the Guernsey Insurance Fund (GIF)) and this deficit is projected to grow to £6m by 2013, driven by the growing deficit in the GIF.

The issue of long term pressures on Social Security was discussed at length in last year's report and was subject of a detailed report by the Policy Council in March 2012¹². That report (and numerous reports from the Department itself) explains that the GIF has buffer reserves of the equivalent of five years of annual payments. This puts the fund in a position where it can maintain an annual mismatch between income and expenditure for some time, using reserves as a buffer to help mitigate the impact of an ageing population. However, depending on the base assumptions used, maintaining a certain level of reserves and above inflation increases in pensions would still require increased contributions at some juncture. Given both income sources effectively utilise the same tax base and the overall burden of tax and social insurance is the variable of economic interest to individuals and companies on the island, doing so ought only to be done in conjunction with any revenue measures required to address the revenue budget deficit.

Figure 5.3.1. Operating surplus/deficit, 2007-2013

Operating deficit of SSD administered funds, at 2012 prices, as at September 2012

Source: Social Security Department



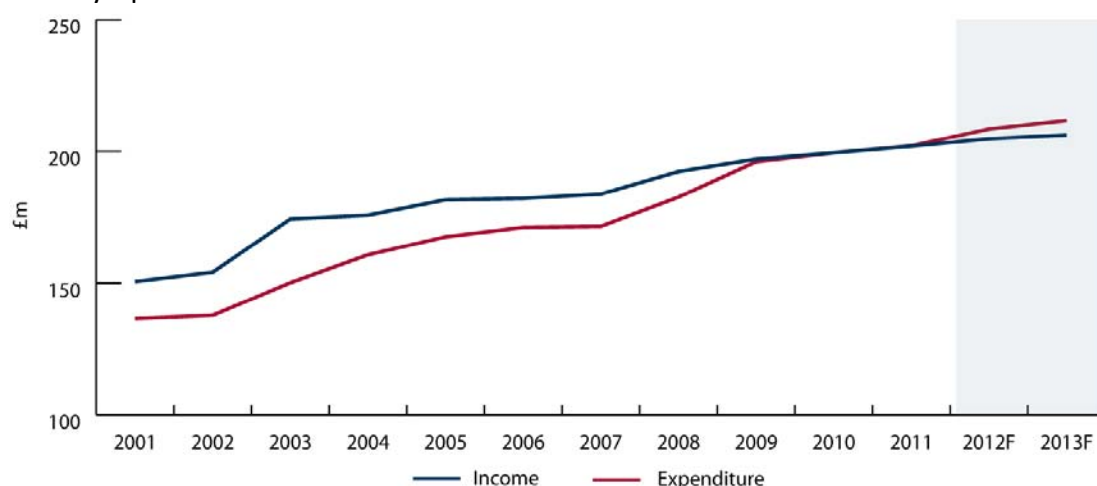
5.3.2. Income and expenditure in detail

Despite the reduction of the Revenue Grant paid to the funds between 2006 and 2008 total funding for the Department has increased in real terms year-on-year throughout the decade. Despite the various increases to contributions rates and limits resulting in a cumulative increase in income of 34% in real terms between 2001 and 2011, Social Security income (excluding investment income) in 2011 was less than expenditure.

¹² For more information please see: "Potential long term implications of demographic and population change on the demand for and costs of public services", Policy and Research Unit, Policy Council, March 2012.

Figure 5.3.2. Total Social Security income and expenditure

Including contributions, revenue grant and payment of non-contributory benefits from General Revenue, at 2012 prices, as at November 2012
Source: Social Security Department

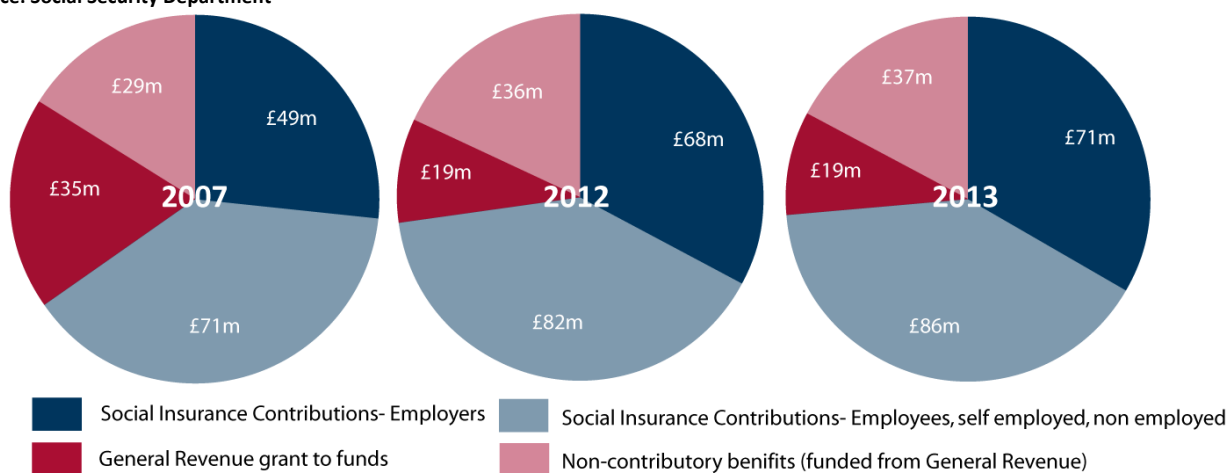


The reduction of the Revenue Grant and the changes to the contribution rates and limits made to compensate for the reduction of income has had a significant impact on the distribution of Social Security income. Increased employers' contributions comprise almost 60% of the increase in revenue between 2007 and that forecast for 2013, increasing their share of total Social Security income from 27% in 2007 to a forecast 33% in 2013 (see **Figure 5.3.3**).

Figure 5.3.3. Total Social Security income by source, 2007, 2012 and 2013

At 2012 prices, as at September 2012

Source: Social Security Department



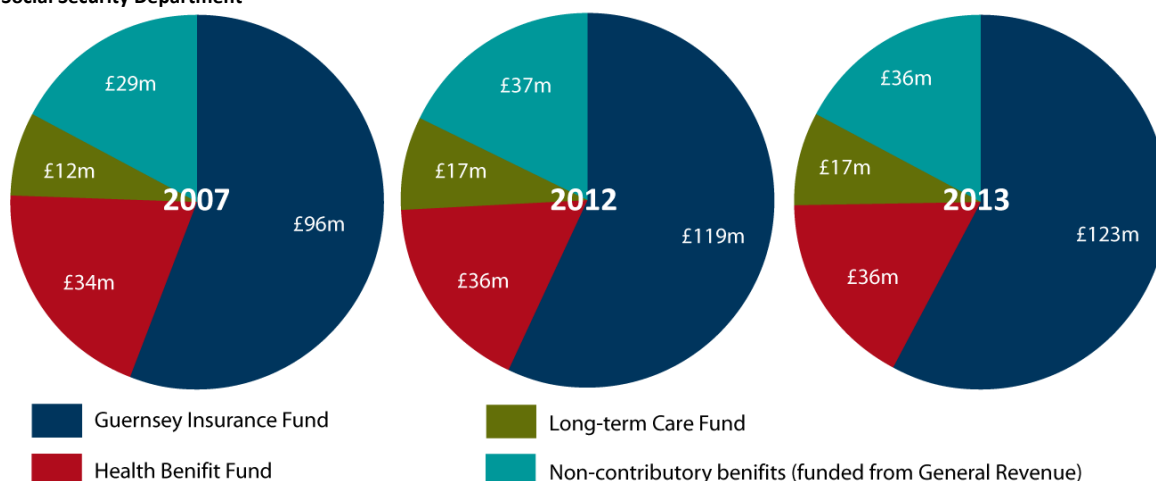
Total expenditure on Social Security was £196m in 2011. Between 2001 and 2011 Social Security expenditure has increased in real terms each year, a cumulative increase of 48% in real terms over this period, with a further increase of 5% anticipated by 2013.

Although the expenditure on all four main areas financed by Social Security has increased in real terms since 2007 the *distribution* of expenditure has changed only marginally in recent years. The GIF remains the largest expenditure area comprising 56% of Social Security spending in 2007 and an expected 58% in 2013 (the majority of this increase is expected to occur in 2012 and 2013 as the number of people retiring grows. See **Appendix 5**). The proportion of total expenditure on Social Security spent by the Guernsey Health Benefit Fund (GHBF) is projected to decline by 2 percentage points in this period in total while the expenditure on Long Term Care (LTC) is expected to increase by 1 percentage point.

Figure 5.3.4. Total Social Security expenditure by area, 2007, 2012 and 2013

At 2012 prices, as at September 2012

Source: Social Security Department



5.4. Aggregate income and expenditure

Aggregate public sector income, including both General Revenue and Social Security income totalled an estimated £525m in 2011 and is estimated to increase in real terms by 0.4% in both 2012 and 2013.

Aggregate public expenditure is expected to total an estimated £567m in 2012. Upward pressure from both General Revenue and Social Security expenditure is estimated to result in a real increase of 2.1% in 2012. Projections for 2013 report a decrease in aggregate expenditure of 1.8% in 2013 driven by the budgeted decrease in revenue expenditure.

Figure 5.4.1. Aggregate income and expenditure

At 2012 prices, as at September 2012

Source: Treasury and Resources, Social Security Department

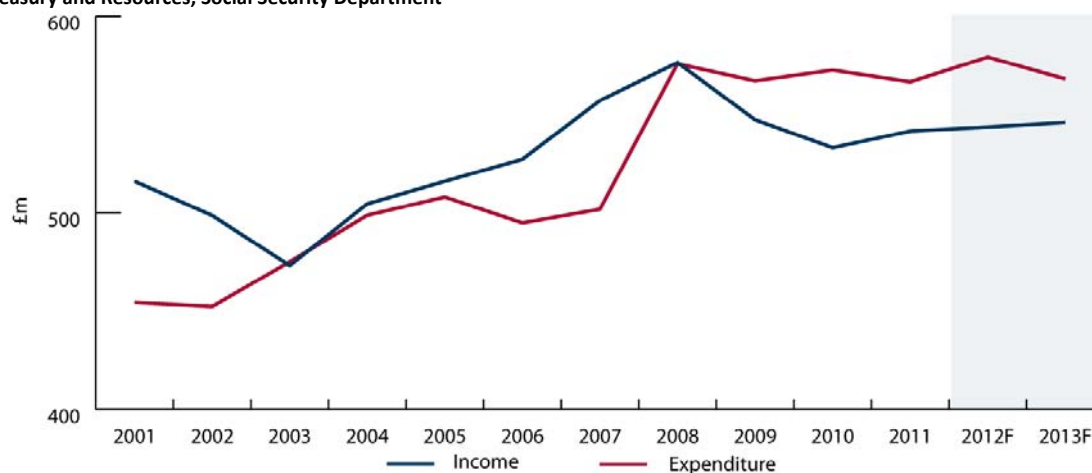


Figure 5.4.1 perhaps most aptly provides a narrative for the overall position of public finances. Both income and expenditure rose rapidly in the period up to 2008. After 2008 the introduction of zero/10 lead to a fall in total public sector income (despite the increases in Social Security contributions). Despite the demand led growth of Social Security, total expenditure has generally been held in check since 2008. Total income after 2010 has gradually risen, but insufficiently to return the States' budget to overall balance. As income growth is unlikely to accelerate much beyond the rate expected in 2013 given global conditions, to return to balance, a reduction in total expenditure on a scale of that promised by the FTP is clearly required.

6. Performance against the Fiscal Framework

Although total spending is within the parameters of the Fiscal Framework, the current continuing fiscal deficit and the speed of its planned reduction are inconsistent with the Framework. No projections beyond 2013 are included in this year's report (none have been generated since there is to be no SSP publication this year) but it is questionable whether the structural fiscal position of the States will be sufficient to generate funds to replenish reserves utilised in the post-2008 period.

6.1. Income and expenditure

Fiscal Framework rules:

- **Total General Revenue and capital expenditure averaging no more than 21% of GDP.**

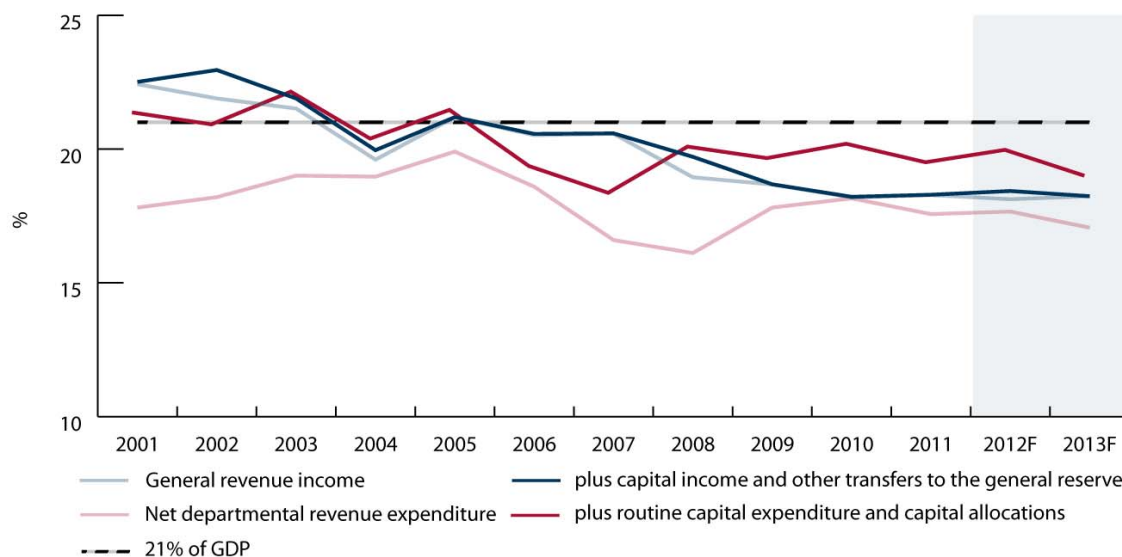
The States continues to meet this rule. When considered as a percentage of Guernsey's GDP, expenditure has remained fairly stable since 2008. In 2011 General Revenue and capital expenditure equalled 19.6% of GDP, well below the 21% parameter set by the Fiscal Framework. Revenue income fell relative to GDP between 2007 and 2010, but showed a very slight increase relative to GDP in 2011.

The most recent published estimates for 2012 report a moderate increase in both income and expenditure relative to GDP (by 0.1% and 0.4% respectively). The 2013 Budget forecasts both income and expenditure falling relative to GDP in 2013 (by 0.2% and 1.0% respectively).

Figure 6.1.1. Revenue income and revenue and capital expenditure (Fiscal Framework), 2001-2013

Net of departmental operating income, as a percentage GDP, as at November 2012

Source: Treasury and Resources Department, Policy Council



6.2. Fiscal position

Fiscal Framework rules:

- **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 of a deficit appearing.**
- **Removal of a deficit within five years of it first appearing.**

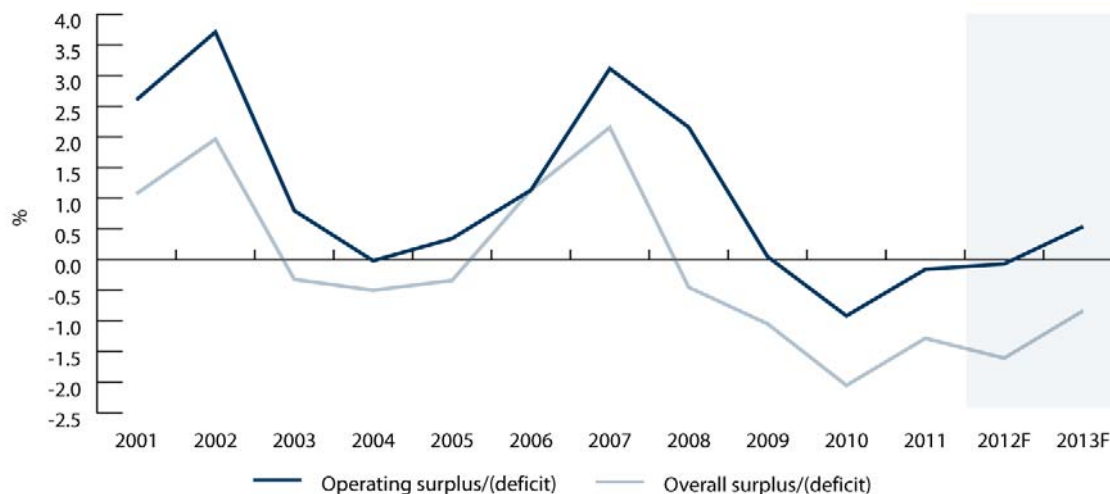
2011 was the second successive year that the General Revenue Budget showed an operating deficit (of 0.1% of GDP), however the 2011 deficit was smaller relative to GDP than that of 2010 (see **Figure 6.2.1**). Although negative, these amounts are in themselves negligible. In 2011, the overall deficit, which incorporates the allocation of funds to the capital reserve, stood at -1.3% of GDP, the fourth successive year of deficit recorded in the States' accounts.

Measures to reduce the deficit have been in place since 2008 and are expected to eliminate the *operating deficit* in 2013. However, the *overall deficit* (which includes the appropriation of funds to the capital reserve) ought to be removed by 2012 to meet the criterion requiring the removal of the deficit within five years. The latest estimates, presented in the 2013 Budget, project an increased overall deficit in 2012 and it is therefore unlikely that the deficit position will be cleared in time to comply with this criterion. Although the budget shows this deficit falling to an estimated 0.8% of GDP it is not expected that overall fiscal balance will be achieved in 2013.

Figure 6.2.1. Operating position, 2007-2011

As a percentage of GDP, as at November 2012

Source: Treasury and Resources Department, Policy Council



6.3. Permanent balance

Fiscal Framework rules:

- **Maintenance of long-run 'permanent balance'.**

Given the cyclical movement of the business cycle and the dependence of revenues on economic conditions it is inevitable that the balance of the States Accounts will fluctuate with the boom and recession movements of the wider economy. A state of permanent balance accepts that a government is likely to experience periods of surplus and periods of deficit but requires that, on average, the budget should remain in balance.

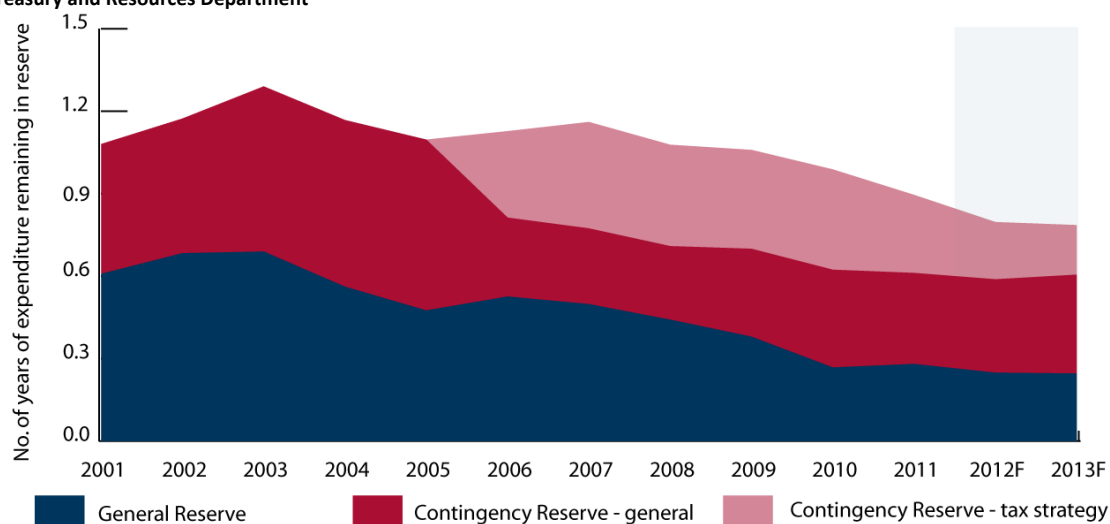
Because the States has no external borrowing and the current deficit position is being financed from reserves, the effect of successive deficit years is to deplete the funds held in the various reserves (see **Figure 6.3.1**). The combined balance of the General and Contingency Reserves, from which the deficit position is being financed, has been declining since 2007 and at the end of 2011 had fallen to the equivalent of approximately seven months of revenue expenditure.

The increase in the deficit in 2012 and its expected continuation in 2013, albeit at a reduced level, will continue to erode States' reserves. These are expected to fall further in 2012 and 2013. The implication of the permanent balance criterion is that a period of surplus will be required; during which the reserves can be replenished. Any increase in the length or depth of the period of deficit will require a longer and/or greater period of surplus to raise the reserves to their previous level. It is debatable whether on current strategy the trajectory of the States' finances will generate funds to replenish reserves given the current policy commitment on long run capital expenditure targets (see **Section 6.5**).

Figure 6.3.1. States' reserves

Number of years of total revenue expenditure held in reserve, as at November 2012

Source: Treasury and Resources Department



6.4. External Borrowing

Fiscal Framework rules:

- **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.**

Although part of the original function of the Fiscal Framework was to provide limits to proposals put forward in 2009 to borrowing money to finance the capital expenditure programme, a subsequent decision was taken not to borrow money at this time. As a result the States currently has no external debt¹³.

¹³ Whilst strictly speaking true, the States does underwrite external borrowing of some States-owned or States-backed entities including Guernsey Electricity and the Guernsey Housing Association.

6.5. Capital Expenditure

Fiscal Framework rules:

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

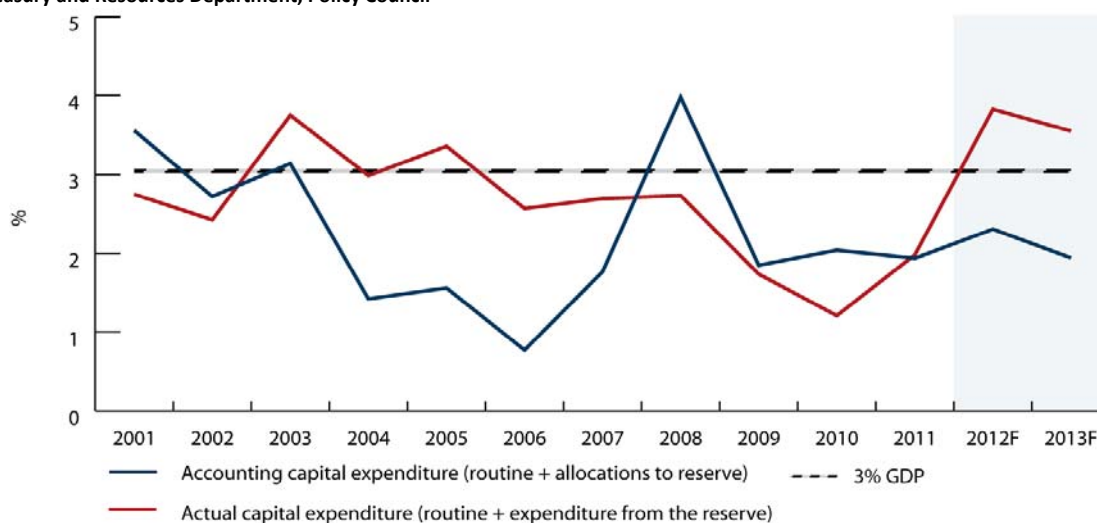
As explained in the Framework (Billet D'Etat XI, April 2009), this level was chosen to reflect a steady state level of capital allocations deemed to be required to ensure sufficient funds were available to finance the assumed appropriate level of capital expenditure. The report states that the appropriateness of that level was based on reference to historic and international norms. The financing arrangement for capital is such that actual expenditure (which is inevitably lumpy) is financed from the capital reserve into which funds are appropriated from General Revenue on an annual basis. The framework is designed to ensure a steady state level of funding for capital expenditure; it is therefore the level of funds appropriated to the reserve that is judged against the criterion, not in-year expenditure.

Over the five years ending 2011, capital expenditure covered by the Fiscal Framework (as measured by routine capital expenditure and the allocation to the capital reserve) averaged 2.4% of GDP. In only one of these years did capital expenditure exceed the 3% target of the Framework. The 2013 Budget projects capital expenditure in 2012 to increase as a result of the additional funds contributed by the buyback of Guernsey Post Ltd shares¹⁴ and the sale of other capital assets. The budget shows capital expenditure returning to its previous level of 2.0% of GDP in 2013.

Figure 6.5.1. Capital expenditure, 2007-2011

As a percentage of GDP, as at November 2012

Source: Treasury and Resources Department, Policy Council



The Fiscal Framework sets a target level of capital expenditure equal to 3% of GDP. Since the Fiscal Framework was approved, allocations have been consistently below this level (they have however been higher than the level presumed in the original zero/10 tax strategy, which assumed capital expenditure equivalent to 1% of GDP – see **Box 5**). This was noted in last year's report and it was acknowledged that, at the time, economic conditions and the States' finances were inconsistent with attempting to remedy the situation.

¹⁴Guernsey Post Ltd, in which the States of Guernsey are the principle shareholder, recently undertook a review of its asset portfolio and capital requirements concluding that it would be appropriate to return £5m to the States in the form of a buyback of shares.

The capital reserve remains positive and the projections for its balance are better than two years ago because the capital programme (i.e. expenditure) has slipped. In 2010, before the slippage, the capital reserve was projected to be almost exhausted by 2013.

Current reserves are sufficient to pay for the current programme, although in 2012 and 2013 expenditure from the capital reserve is expected to surpass funds allocated to it from General Revenue. However, if the capital programme were to continue on a similar scale to that currently under way, it raises the question of whether it will be possible to replenish reserves to the level needed for contingencies such as breakwater repairs and other emergencies.

Given the potential demand for capital expenditure, it may be that the States will need to consider alternative methods of financing some elements of the capital programme in the long term if a change in the level of States revenues does not materialise. It is appreciated that the States decided against 'external' borrowing in its capital prioritisation debate in 2009; however, for those projects associated with the States of Guernsey trading entities in particular, appropriate alternatives might be found. For example, it might be useful to consider the issuing of utility backed bonds.

The States' 2012 budget made reference to the need to review what capital expenditure was part of the target, questioning whether the commercialised utilities or other States enterprises should be included (see **Box 5**). These are important and inevitably related matters. A review of both these matters is strongly recommended.

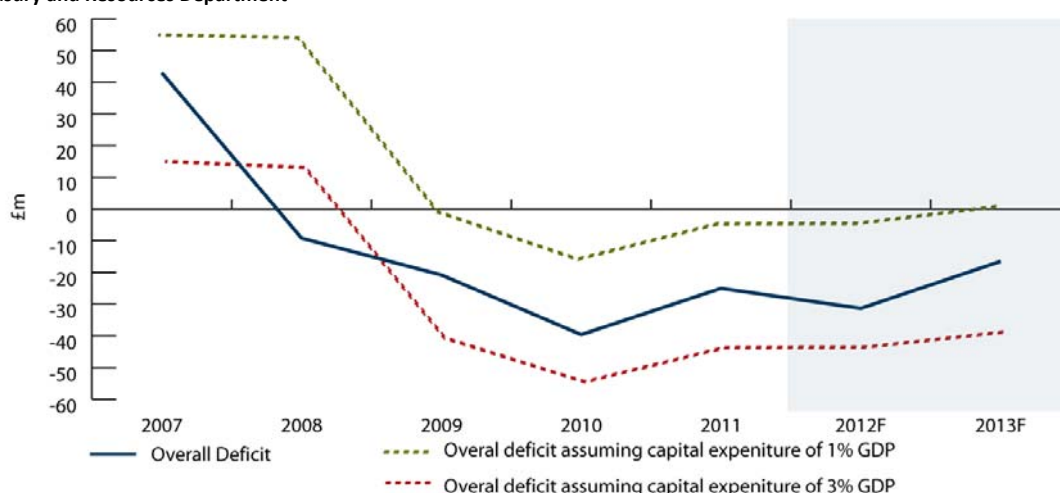
Box 5. Capital Expenditure effect on overall fiscal position

In 2011, £21.3m of the General Revenue budget was allocated to the capital reserve and £16.7m was spent on routine capital expenditure; a total capital expenditure to £38.0m or 2.0% of GDP. The original fiscal projections made by Oxera when zero/10 was first proposed assumed capital expenditure of 1% of GDP per annum. The basis for the original deficit calculations therefore differs from today's practice. The Fiscal Framework outlines a requirement for capital expenditure of 3% of GDP per annum. **Figure 1** shows the impact on the overall revenue position of an assumed rate of capital expenditure of both 1% and 3% of GDP.

Figure 1. The impact of capital spending on the overall fiscal position, 2007-2013

At 2012 prices, as at November 2012

Source: Treasury and Resources Department

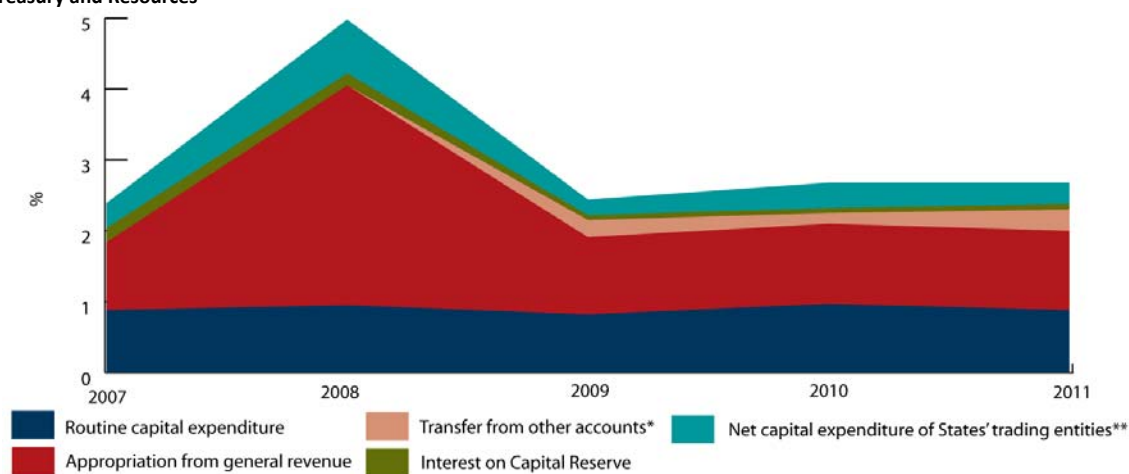


It should be noted that, in addition to the capital expenditure made from General Revenue, additional investment in capital projects is made from outside the General Revenue Budget (see **Figure 2**). In 2011 £5.6m was transferred to the capital reserve from the Ports Holding account. The States' trading entities¹⁵ also invested a combined total of £5.7m in capital projects. Combined with the interest earned on the capital reserve, this brings the total investment by public entities in capital projects to £50.5m or 2.6% of GDP.

Figure 2. Total funds from General Revenue and States' trading entities allocated to capital expenditure

At 2011 prices, as at May 2012

Source: Treasury and Resources



*Ports Holding Account and States of Alderney

**Harbours, Airports, Guernsey Water, Guernsey Dairy and States Works

¹⁵Guernsey Harbours and Airports, Guernsey Water, Guernsey Dairy and States Works. These entities are operated on a commercialised basis

7. Risks to the fiscal strategy

Last year's report identified three risks to the States' current deficit reduction strategy: a failure to restrain expenditure growth; failure of the FTP to deliver its projected savings; and weak economic growth resulting in an adverse effect on States' revenues.

7.1. Expenditure restraint

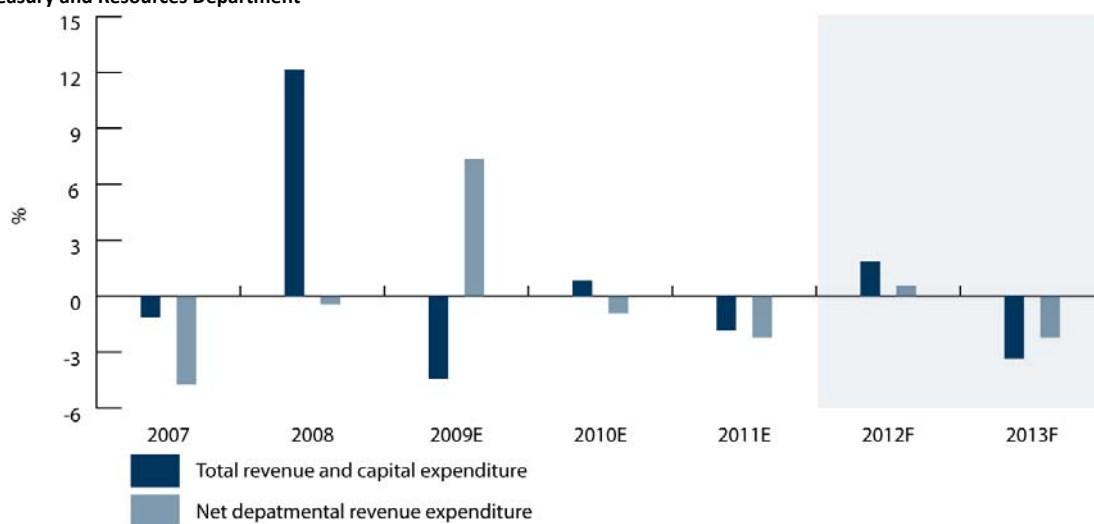
In recent years the States have demonstrated success in restraining expenditure growth in real terms. In 2008 a larger than normal appropriation to the capital reserve (£57m) resulted in a significant annual increase in total revenue and capital expenditure; however in four of the five years ending 2011 total revenue and capital expenditure has either been reduced in real terms or growth has been minimal. Current estimates for 2012 report a 1.8% increase largely driven by a one-off increase in capital expenditure.

Departmental revenue expenditure has also been successfully restrained. Only in 2009 was there significant growth in revenue expenditure, primarily as a result of overspends on Health and Social Services. In 2012, the currently estimated overspends in Health and Social Services and Social Security are expected to be largely absorbed by the budget reserve and by under-spends in other areas. Budget forecasts for 2013 show a real reduction in both total and net departmental expenditure of 3.3% and 2.2% respectively. This is a more challenging target than has been achieved in the last four years and is only achievable through the success of the FTP (see **Section 7.2.**)

Figure 7.1.1. Annual percentage change in revenue and capital expenditure

Real annual percentage change, as at November 2012

Source: Treasury and Resources Department



7.1.1. “Uncontrollable” expenditure

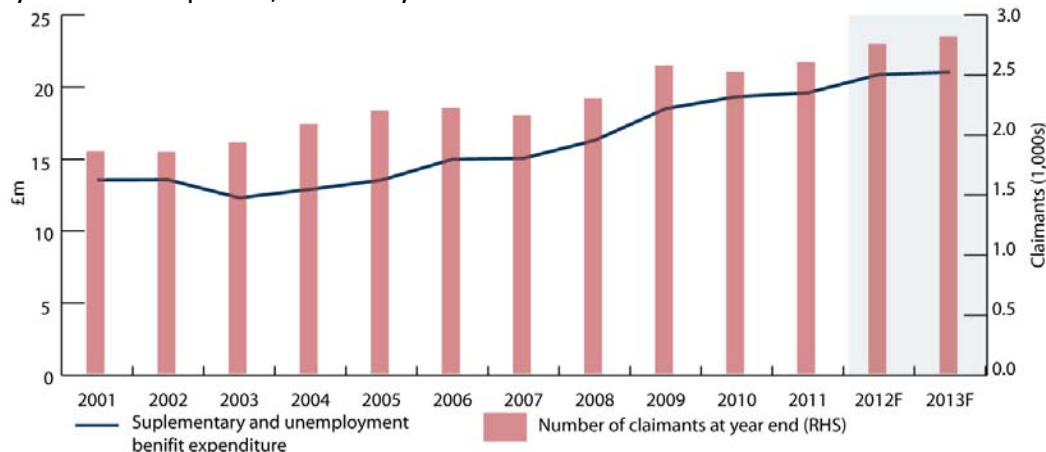
Some elements of public expenditure are, by their nature, very difficult for governments to control. These include demand led services and benefits such as pensions, supplementary benefit and legal aid. Although the government can to control the rates at which such benefits are set, once these and the eligibility criteria have been decided the States have little or no direct control over the number of people eligible and the total value of their claims. For illustration, **Figure 7.1.2** shows the co-movement of numbers of people claiming supplementary and unemployment benefits, and total expenditure in these area.

The current 2013 budget appears to presume no further increase in formula led welfare expenditure in real terms. This could prove optimistic, for even if the economy resumes growth it could well be that improvements (i.e. reductions) in the numbers of unemployed and supplementary benefit claimants comes only with a lag. The number of part time workers claiming unemployment benefits¹⁶, has increased from 27 in March 2007 to 165 in March 2012. This could indicate a lack of full time work but, given the continued demand for short term licence holders it is also consistent with the view that the benefits system unintentionally encourages welfare dependence.

Figure 7.1.2. Unemployment and supplementary benefit expenditure

At 2012 prices, as at September 2012

Source: Treasury and Resources Department, Social Security



Particularly with the (in many respects, but not all, uncontrollable) increases in supplementary benefit expenditures in recent years, proposals to increase Social Security further by significant amounts can only be accommodated by reduced expenditures elsewhere or by increased taxation. It is already widely understood that sustaining long term expenditures on pensions, health and long term care through the social insurance funds is likely to require increased contributions (unless there are changes to current spending models, i.e. to benefit criteria). It may well be that revenue raising measures are required to return the revenue budget to balance. Given these circumstances the States will need to assess very carefully what additional benefits it believes can be paid for by recourse to additional taxation.

Longer term issues, such as pensions and the long term care of older people, are very closely tied to demographic trends and, as the population ages at a predictable rate and the relative use of services is fairly constant, these can be and are projected with some degree of accuracy. The Social Security Department commissioned the UK Government Actuary's Department to produce demographic projections for Guernsey and to provide an actuarial review of the GIF and LTC funds based on the projected population changes and highlighting the pressures exerted by the aging population. The principles used in the actuarial review were then used to provide estimates of the impact on total public expenditure in a Policy Council Report ¹⁷ (see Appendix 5).

¹⁶ Which they may be eligible to do if they are earning less than they would be entitled to claim on unemployment and would be able to work additional hours if they were available.

¹⁷ "Potential long term implications of demographic and population change on the demand for and costs of public services", Policy and Research Unit, Policy Council, March 2012

7.2. The Financial Transformation Programme

The FTP was set up in 2008 to identify, develop and oversee projects designed to make significant savings in public expenditure. These savings would then be used to reduce the deficit caused by the introduction of the zero-10 tax regime. The stated target at the programme outset was to save £31m of net revenue expenditure by 2014.

In the latest update (August 2012) £10.5m of savings had already been delivered by the FTP, with a further £1.3m scheduled for completion by the end of 2012¹⁸. The States has, as a sensible precaution and in recognition of the fact that in such a wide reaching programme one or more elements may not perform as well as expected, over-programmed the savings and increased the profile of savings beyond the original target. The current total programmed savings for the FTP are, in real terms, £13m (41%) higher than the target¹⁹. However, detailed proposals for projects representing 63% of the total projected savings are still in development.

Figure 7.2.1 FTP forecast savings by delivery year*

As at August 2012

Source: Treasury and Resources Department

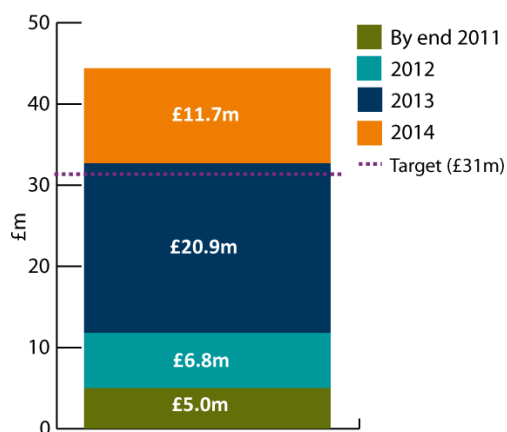
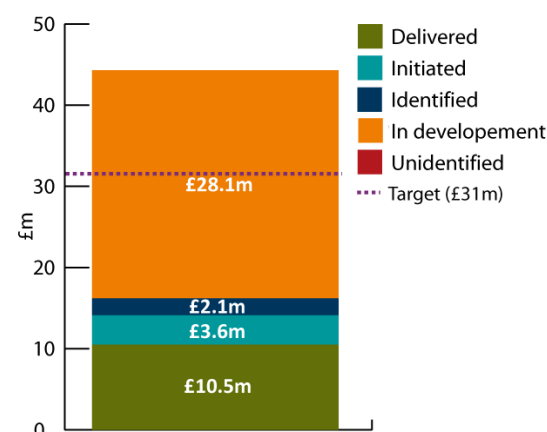


Figure 7.2.2 FTP forecast savings delivery by current status

As at August 2012

Source: Treasury and Resources Department



*Note that, since the publication of the last FTP update in August 2012, shown above, the savings targets for Health and Social Services and Education Departments for 2013 have been revised downwards, delaying the target delivery of these savings until 2014. As a result the total savings to be delivered in 2013 has been revised down from £20.9m to £9.2m and 2014 targets adjusted to compensate accordingly²⁰.

The programme is moving in to a more challenging period; the savings required in 2013 and 2014 combined to meet the overall target for the programme total just over twice that delivered in total by the programme to date. The success or failure of the FTP led projects in 2013 is likely to have a significant impact on the ability of the States to meet its deficit reduction strategy. Last year's report noted that the majority of

¹⁸ Savings made to date include some increases in fees and charges which are included in departmental operating income and subsequently netted off gross departmental expenditure (see **Box 5**).

¹⁹ Deliberate 'overprogramming' (to reflect that some projects will not be developed beyond development stages or will not deliver the amount of savings initially expected) involves expanding the scope of the programme beyond the stated target to ensure that that target is achieved. In this instance the scope of the programme has been extended by £13m; more than 60% of the savings still required to meet the target. .

²⁰ The 2013 budget states: "The 2013 and 2014 FTP targets will represent a significant challenge for the Health and Social Services and Education Departments and both departments have worked with the Policy Council to derive the most appropriate and realistic targets that are capable of delivery. It is recognised that it is imperative that the FTP targets do not imperil the delivery of front line services."

"Therefore the original targets for Health and Social Services and Education Departments have been adjusted to allow for a greater level of benefits to be delivered in 2014 in recognition of the longer term transformation programmes being developed by both Departments and the need for these to be completely integrated with plans for the delivery of the FTP benefits."

savings were ‘back loaded’ and commented that ‘the States must regularly monitor ‘progress against plan’ and realistically assess the prospects of success of the plan’. There has been some slippage, i.e. the reversal of savings targets between 2013 and 2014 for both Education and Health and Social Services Departments.

Given the crucial nature of the FTP savings to deficit reduction the States would be wise to reassess the likelihood of realising the current programme savings, fully, and plan accordingly.

7.3. Weak growth

Last year’s report highlighted various significant risks to the economy and suggested that they were all on the downside. Forecasts for 2012 (published by the Policy Council earlier this year) reduced the then forecast rate of growth from 1.9% to 0%.

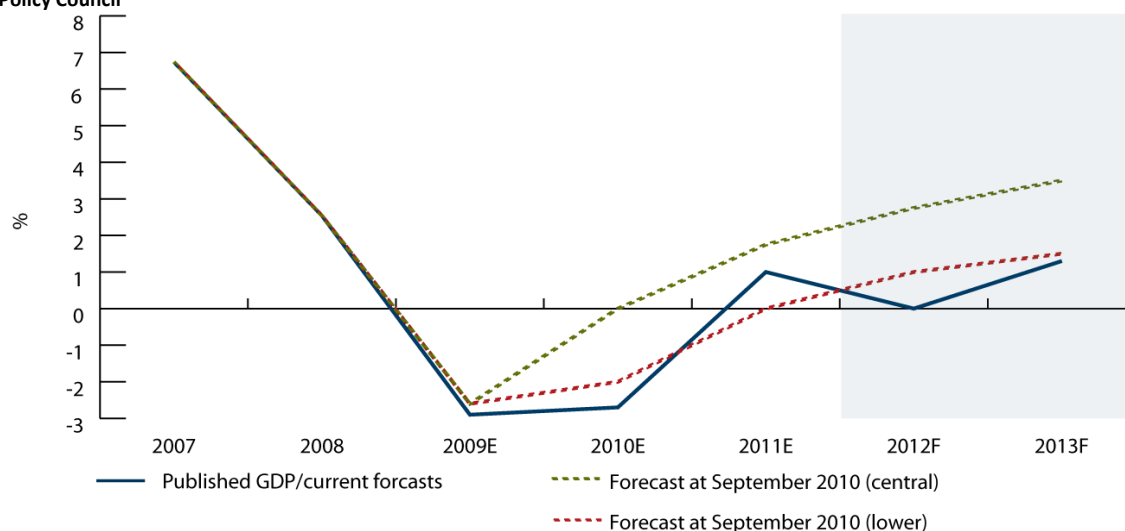
Earlier estimates of 2010 growth were also revised down (as explained in **Section 4**) with the cumulative effect being that the growth trajectory of the Guernsey economy now appears to have bumped along the lower bound of forecasts first published in 2010²¹. The result is that income is lower than then anticipated. The lack of growth in 2012 is likely to have cost around £6m in revenue, with benefits payments being £2m higher than anticipated. The net effect is to add around £8m to the deficit.

Given the weakness of growth since 2008 and the acknowledgement that growth rates in the post-credit crunch era are likely to be lower than in the past it would be imprudent to build in expectations of rapid recovery of this lost revenue to the structural fiscal position. It would be preferable to treat current levels of income as the base from which to project future (lower rates of) income growth.

Figure 7.3.1. GDP growth versus forecasts

Real annual percentage change, as at September 2012

Source: Policy Council



²¹ In 2010, the Policy Council published five year forecasts of GDP including both optimistic and pessimistic alternatives to the central forecast. **Figure 7.3.1** reproduces the central and pessimistic case below showing that the recovery has been slower than was expected two year ago (in line with the experience in the UK and Europe) and current estimates of GDP growth are closer to the pessimistic case than the central case.

8. Deficit reduction strategy going forward

The reduction in the deficit between 2010 and 2011 was primarily a result of increased revenues from personal income tax, although increases in indirect tax receipts and departmental operating income also contributed to reducing the deficit. Real terms expenditure restraint meant that the pressure from increased departmental expenditure was comparatively small.

The latest estimates for 2012 show that increases in personal and indirect tax and capital income are unlikely to be sufficient to offset completely increases in departmental and capital expenditure and the decrease in corporate taxes. As a result, a net increase in the deficit is expected. Nonetheless, as shown in **Section 5**, the overall deficit position still remains within the envelope forecast in SSP 2009-2013 projections (2011 being better than projected).

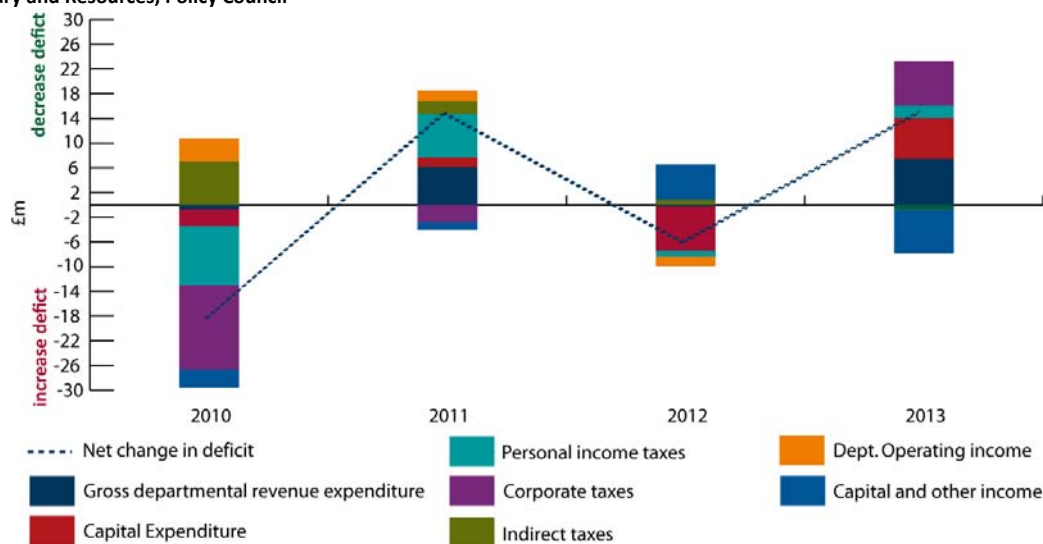
The projected deficit decrease in 2013 is due to increased income combined with real terms cuts in revenue budget expenditure. Excluding the one off impact of the additional capital income and expenditure in 2012, in real terms the £8m net increase in tax receipts expected from the proposed changes to the corporate tax system (the removal of tax on deemed distributions and the extension of the 10% rate to fiduciary and insurance activities) is expected to account for approximately 45% of the reduction in the deficit in 2013. Expenditure cuts account for a further 47% of the decrease. Success in achieving the planned reduction in the deficit is thus highly dependent on the success of the FTP.

As was observed in **Section 5.2.4** if 2013 projections for this are met, the deficit reduction strategy would appear to be on track. However, if not, then the current overall deficit is more persistent and would require additional measures to complete its removal.

Figure 8.1.1. Contribution to real annual change in fiscal position

At 2012 prices, as at September 2012

Source: Treasury and Resources, Policy Council



9. Conclusion

In the current difficult economic circumstances, the States' fiscal performance is impressive although there are some signs that the deficit reduction strategy is proving as challenging as was suggested in last year's report. Revenue expenditure has been restrained and is well within the parameters set out in the Fiscal Framework. Moves to improve the structural income position of the States which have been set out in the Budget, such as the extension of the 10% corporate tax rate to cover regulated insurance and fiduciary activities, are to be welcomed.

Failure to achieve the full savings of the FTP is the key risk to deficit reduction. There are signs of slippage, so a realistic appraisal of success must be made no later than early 2013. There is a risk that the strategy will need to be revised and alternative measures considered. These are unlikely to be more palatable than the current strategy and so the States should strive to secure the success of that current approach. Given the contribution and profile of the FTP any alternative measures, if needed, will be required by the 2014 Budget; otherwise there is a risk of the deficit becoming persistent. Further, the planned speed of deficit removal remains inconsistent with the parameters of the Framework, as there is no allowance in the Framework for the effects of economic conditions on the timing of deficit reduction.

As was stated in last year's report, insufficient revenues are being set aside to meet the capital target of the Framework, although (again as last year) economic conditions and the current fiscal position make it imprudent to attempt to rectify this matter at this juncture.

Longer term demand pressures continue to be exerted on Social Security spending and short term uncontrollable factors have caused it to rise. In view of the budget interlinkages between the two expenditure areas it is most welcome that the States are going to conduct a joint review of personal tax and social insurance contributions.

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

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**' i.e. 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. Commentary on the Fiscal Framework

As a small, very open economy, Guernsey is very susceptible to external events and conditions. It also has few policy levers available to it 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, in other words, 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 financing 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 A2. 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 of a deficit appearing
- Removal of a deficit within five years of it first appearing.
- 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.

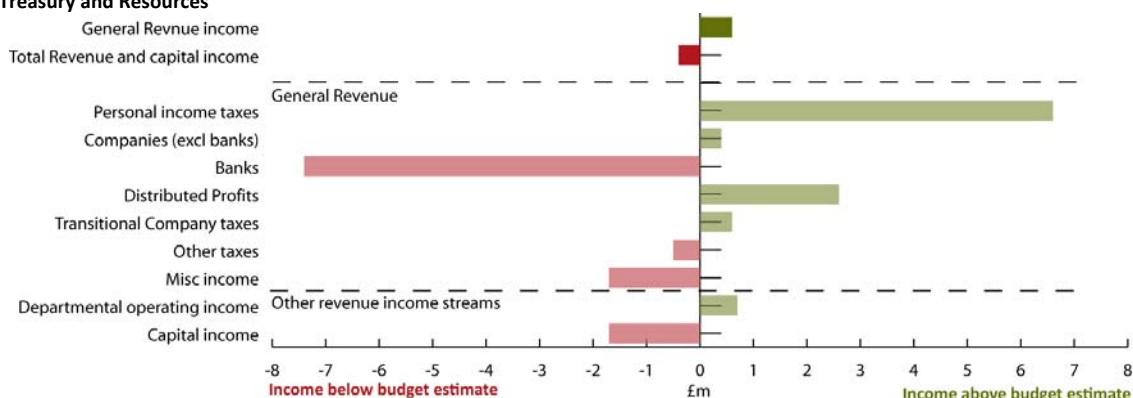
Appendix 3. Income and expenditure performance against budget in detail

Income from personal taxes contributed more to General Revenue income than had been budgeted for, adding an additional £7m to revenue income above the budget estimate. Distributed profits also contributed significantly more than expected with the actual income generated coming in 27% (£3m) above the budgeted figure. However this was almost entirely offset by a £7m shortfall in the receipt of taxes from banking activity, 23% below the expected figure. There were additional £2m shortfalls in both miscellaneous and capital income resulting in a slight shortfall (£0.4m) in the total income cover by the central accounts.

Figure A.3.1 Performance against Budget, 2011 income

Variation of the 2011 accounts from the original budget, as at May 2012

Source: Treasury and Resources



Income area	above/below budget	
	£m	%
Personal income taxes	+6.6	+3.1
Companies (excl banks)	+0.4	+2.7
Banks	-7.4	-23.4
Distributed profits	+2.6	+27.0
Transitional company taxes	+0.6	n/a
Other taxes	-0.5	-0.6
Misc income	-1.7	-46.2
General Revenue income	+0.6	+0.2
Departmental operating income	+0.7	+1.9
Capital income	-1.7	-89.2
Total revenue and capital income	-0.4	-0.1

On a departmental basis comparison between the 2011 budget and accounts shows a general success in restraining expenditure to the budget. In all but four departments, net revenue expenditure was kept within the allocated budget and in the Policy Council, States of Alderney, Home Department and the parliamentary committees expenditure was more than 10% below the allocated budget.

The largest departmental over spend (£0.8m) was made by the Social Security Department, predominantly in the formula led costs such as payment of supplementary benefit, over which the department has only a limited amount of control.

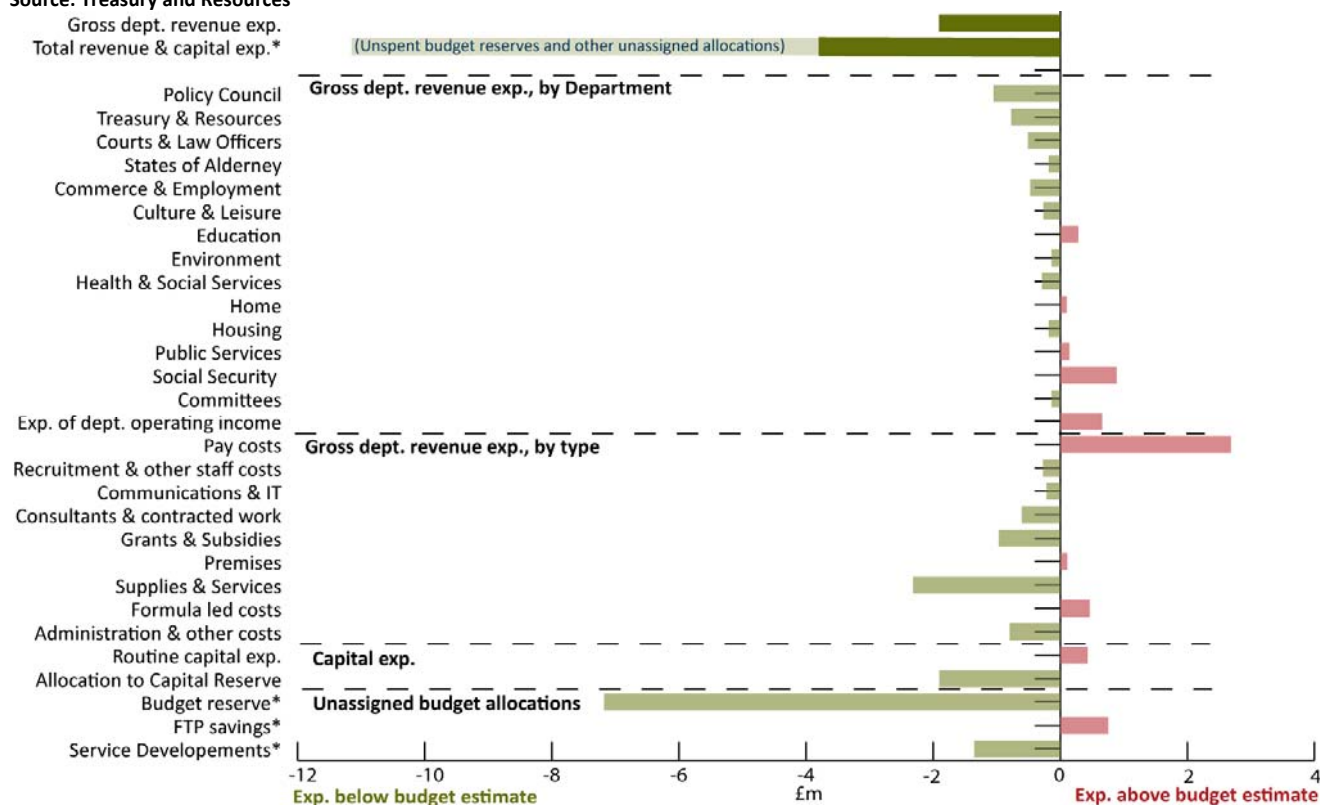
When viewed by type of area the most significant savings were made in the purchasing of supplies and servicing. However pay costs²², which comprise more than 50% of gross departmental revenue expenditure amounted to £2.6m (1.4%) more than budgeted.

²²Pay costs incorporates wages, salaries and all related costs (e.g. pensions and Social Security contributions) for all public sector staff including established staff, public service employees, medical, teaching, fire police and prison staff.

Figure A.3.2 Performance against Budget, 2011 expenditure

Variation of the 2011 accounts from the original budget, as at May 2012

Source: Treasury and Resources



Expenditure (by Department)	above/below budget £m	%	Expenditure (by type)	above/below budget £m	%
Policy Council	-1.0	-10.7	Pay Costs	+2.7	+1.4
Treasury & Resources	-0.8	-4.5	Other staff costs	-0.3	-5.7
Courts & Law Officers	-0.5	-6.4	Communications & IT	-0.2	-2.1
States of Alderney	-0.2	-10.0	Consultants & contractors	-0.6	-1.9
Commerce & Employment	-0.5	-4.0	Grants & Subsidies	-1.0	-3.3
Culture & Leisure	-0.3	-7.3	Premises	+0.1	+0.6
Education	+0.3	+0.4	Supplies & Services	-2.3	-9.8
Environment	-0.1	-1.6	Formula led costs	+0.5	+0.9
Health & Social Services	-0.3	-0.3	Administration & other	-0.8	-7.8
Home	+0.1	+0.3			
Housing	-0.2	-11.0			
Public Services	+0.1	+1.9			
Social Security	+0.9	+1.7			
Committees	-0.1	-19.3			
Exp. of dept. operating income	+0.7	+1.9			
Gross dept. revenue expenditure	-1.9	-0.5	Gross dept. revenue expenditure	-1.9	-0.5
Routine Capital Expenditure	+0.4	+2.7	Routine Capital Expenditure	+0.4	+2.7
Allocation to Capital Reserve	-1.9	-8.2	Allocation to Capital Reserve	-1.9	-8.2
Service Developments*	-1.4	n/a	Service Developments*	-1.4	n/a
FTP Savings*	+0.8	n/a	FTP Savings*	+0.8	n/a
Budget reserve*	-7.2	n/a	Budget reserve*	-7.2	n/a
Total revenue & capital expenditure	-11.2	-2.7	Total revenue & capital expenditure	-11.2	-2.7

Appendix 4. Funding Social Security

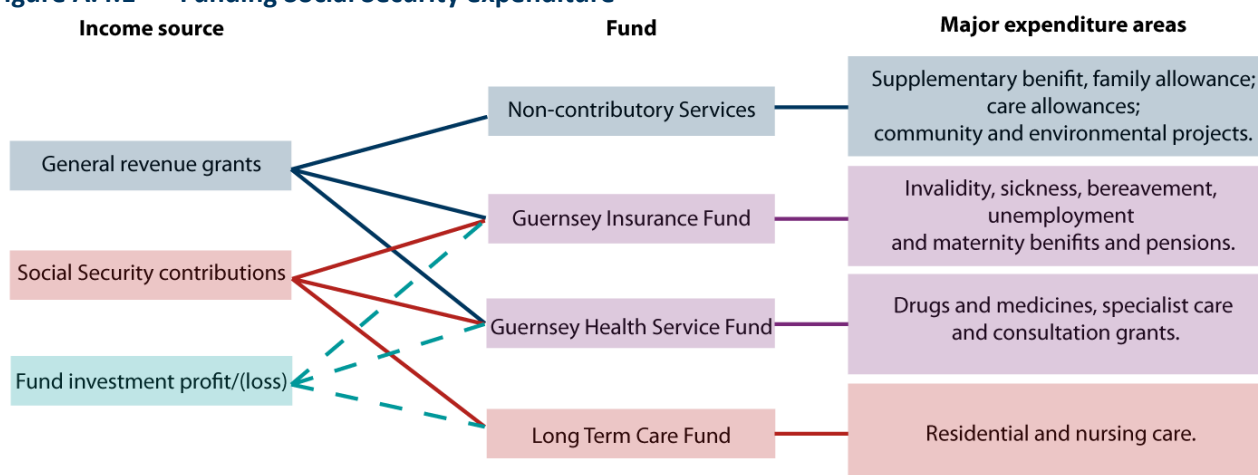
The Social Security Department is responsible for the payment of social benefits in Guernsey. The departmental expenditure is funded by a mix of grants from General Revenue and Social Security contributions (see **Figure A.4.1**).

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 Fund (LTC) – 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 A.4.1 Funding Social Security expenditure



Appendix 5. Long-term pressures on expenditure

In 2011 the first of the “baby boom” generation reached the official retirement age and, going forward, the number of pensioners in the Island is expected to rise considerably. Building on population and GIF and LTC expenditure projections produced by the UK Government Actuary’s Department, the Policy Council produced a report outlining long-term pressures on States expenditure in March 2012²³. The report models the potential impact on both the General Revenue and Social Security budgets of increasing cost of pensions, health and long-term residential and nursing care to an aging population when combined with a decreasing working age population and associated tax revenues.

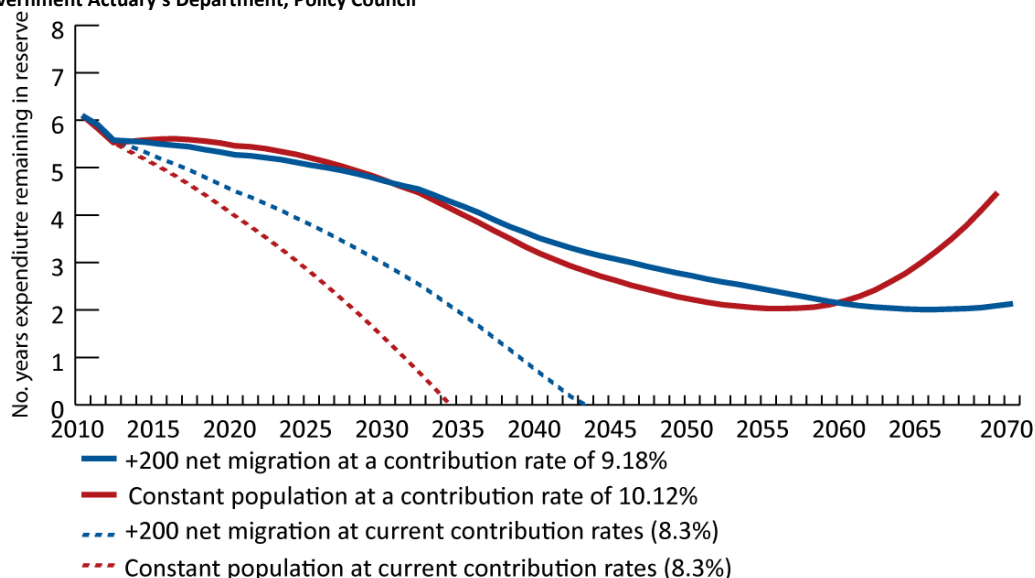
Although the problems outlined have wide spread implications in a number of expenditure areas, much of the burden will be carried by Social Security’s GIF which covers the payment of States’ pensions. Although the fund currently holds reserves equivalent to more than five years expenditure, projections made by the UK Government Actuary’s Department show that, at the current rate of contributions and assuming a 1% real growth in the rate of pension payments, the reserves currently held by the fund will be exhausted between 2034 and 2045, depending on the model of population growth used.

In a report entitled “Challenge of sustainability - the pensions puzzle” SSD proposed that contribution rates be increased in the very near future in order to ensure the sustainability of the reserve. **Figure A.5.1** below show that an immediate (2013) increase in the combined rate of contributions made by employers and employees to the GIF fund by less than 1 percentage point could maintain the reserve above the equivalent of two years of expenditure throughout the period over which the demographic bulge poses an issue. However, it should be noted that the timing of the increase in contributions is important, since delaying the increase will likely mean a larger increase in contributions is required to maintain the integrity of the reserve.

Figure A.5.1 Projected reserves of GIF at current contribution rates and at a rate sufficient to maintain two years of expenditure in reserve

Assuming net migration of +200 people per annum or maintenance of a constant population at the March 2007 level, and real growth in benefits of 1% per annum

Source: UK Government Actuary’s Department, Policy Council



²³ For more information please see: “Potential long term implications of demographic and population change on the demand for and costs of public services”, Policy and Research Unit, Policy Council, March 2012.

The report also highlights potential for significant increases in healthcare expenditure to cater for the larger demand for services posed by the aging population. The issue is compounded by incorporating an assumption of a growth in health care costs per capita above the assumed growth in average earnings which has been typical in most western economies in recent history.

Figure A.5.2 Total public expenditure on Healthcare: The effect of varying real annual growth in healthcare expenditure per capita, +200 net migration

Assuming net migration of +200 people per annum
Source: Policy Council

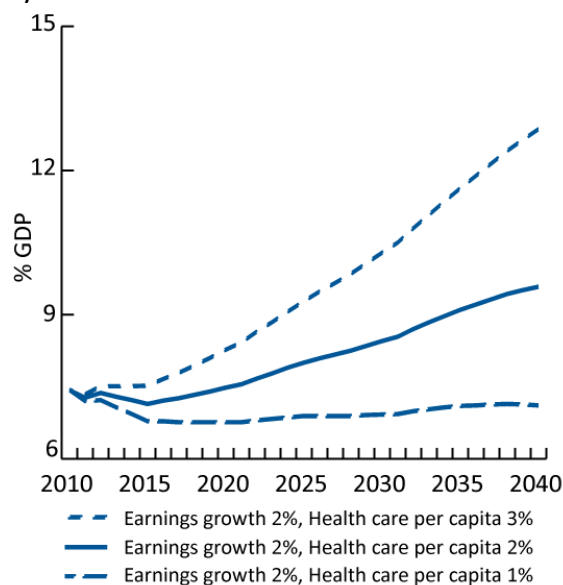
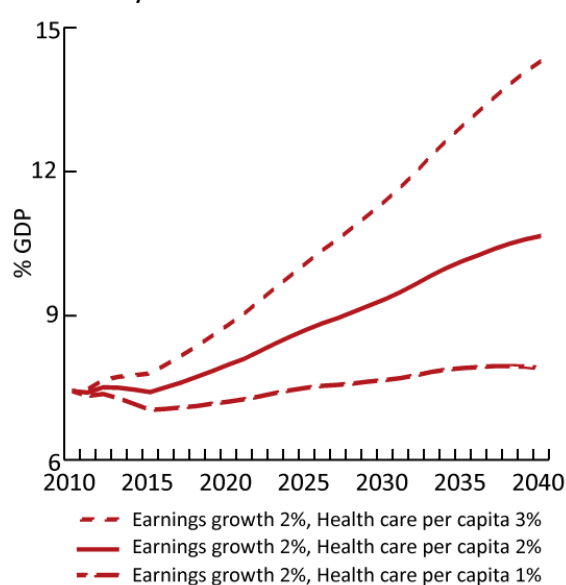


Figure A.5.3 Total public expenditure on Healthcare: The effect of varying real annual growth in healthcare expenditure per capita, constant population

Assuming maintenance of constant population (March 2007 level)
Source: Policy Council



Appendix 6. 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, GHSF and LTC.
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, GHSF 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, gross departmental revenue		Non-capital expenditure by States Departments including expenditure funded by departmental operating income.
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.
Financial 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.
Formula led expenditure		Expenditure areas dependent on a pre-defined formula and/or number of claims such as payment of the revenue grant to social security (calculated as a percentage of SSD contributions income), legal aid and supplementary benefit
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	GHSF	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		Any income paid directly to a States department which is not incorporated as General Revenue income. This includes fees and charges for service, rents

operating		received recoveries and funds received from SSD in payment for services. Totals for departmental expenditure are typically presented net of departmental operation income.
Income, General Revenue		Income from direct and indirect taxes and miscellaneous income sources included in the calculation of the revenue surplus/(deficit) which is available to all departments and allocated in the annual budget. It does not include capital income
Income, total revenue		All income presented in the General Revenue Accounts used to calculate the Overall surplus/(deficit); i.e. General Revenue income plus departmental operating income and capital income.
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	LTC	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-contributory 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		General Revenue income minus net departmental expenditure.
Uncontrollable expenditure		Expenditure which is, at least in part, dependent on factors which are beyond the States' direct control, including unemployment, supplementary and pensions benefits.

