

Annual Independent Fiscal Policy Review 2014



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1. Summary

This year's Annual Independent Fiscal Review is set in a context of subdued economic conditions. The UK has confirmed its economic recovery of 2013 and 2014 has seen healthy growth in GDP and a steady fall in unemployment. Guernsey has lagged. According to first estimates of GDP, Guernsey achieved only a modest 0.5% of real annual growth in 2013, lower than the 1.3% forecast in mid-2013.

As with the UK, Guernsey's non-financial sectors have fared better than financial services, but Guernsey's high dependence on financial services means that the continuing slow recovery of this sector has had a larger impact on Guernsey's growth than it has had on its larger neighbour. The performance of Guernsey's finance sector has historically been closely linked to that in the UK and it is to be hoped that the growing strength of the UK financial system will feed into the local finance sector through the latter half of 2014.

Fiscally, 2013 appears to have been a difficult year. The economic weakness and, in particular, the weakness in the labour market have inevitably affected government finances and, in real terms, the ratio of income to general revenue was lower in 2013 than in 2012. As a result, the overall deficit grew to £25m, although budget projections show this falling to £14m in 2014.

Efforts to contain expenditure continue to bear fruit. Despite the challenging economic condition, the States has succeeded in achieving their target of no real terms growth in expenditure in 2013, even after the incorporation of a significantly higher transfer to the capital reserve than has been made in recent years. Overall, expenditure projections for 2014 show a real decrease in spending. The States are to be congratulated on this.

As the scheduled end of the States' Financial Transformation Programme [FTP] approaches, it is becoming increasingly clear that, despite some very notable success, the Programme is unlikely to meet its target on time. While not wholly unexpected, this is mildly disappointing. However, the 2015 budget does anticipate further savings from FTP initiatives beyond 2014 which may enable it to meet, or even beat its target. The Treasury and Resources Department have publically stated their intention to continue the drive for internal efficiency beyond the end of the Programme. An on-going scrutiny of States' expenditure to ensure its efficiency and, in some cases, its necessity is fiscally prudent and should be part of the States' core functions. However, it is impossible to provide public services without incurring cost and, as stated in previous reports, there is a natural limit to how much efficiency can reduce expenditure.

Capital expenditure, as measured by routine capital expenditure plus the allocation of money to the capital reserve, has, over the last few years, fallen short of the 3% of GDP target set out in the Fiscal Framework, although it did increase in 2013. Actual capital expenditure, including the money spent *from* the capital reserve, over the last ten years has been much closer to the 3% target, but the underinvestment in reserves means that the reserves held for the funding of large infrastructure projects is being depleted. This is unsustainable. The States need to save more and replenish the capital reserve; otherwise the reserve may be exhausted as soon as 2016.

The continuing deficit, reaching its sixth year in 2013, is of concern. Any deficit of more than five years is a breach of the criterion set out by the Fiscal Framework to address deficits within 5 years of their appearance. The 2015 budget makes a concerted effort to reduce the deficit in 2015, to the extent that recourse to the contingency reserve is no longer required, although it is anticipated that it will be necessary to draw down a small sum from the General Revenue Account Reserve to clear a small underlying balance until 2016.

To achieve this, the Budget has included some increases in indirect tax measures, and an extension of the intermediate rate of corporate tax. Combined, these measures are expected to raise an additional £9m, with the burden distributed fairly evenly between the corporate budgets and households.

The household measures appear relatively modest, rates of domestic TRP being low enough that a 15% increase equates to an average increase in household costs of less than £25 a year. While the freezing of personal tax allowances will widen the gap between those available in Guernsey and the UK, in the author's view, maintaining lower allowances (and a low tax rate) and thereby capturing a greater proportion of households within the income tax net, provides a greater proportion of the population with a clearer perception of a stake in government and should be supported.

The extension of the intermediate tax rate to incorporate fund administration activities (but not fund managers) has been signalled for some time and brings the Guernsey corporate tax regime into closer alignment with Jersey's.

Part of the States' policy surrounding the introduction of zero/10 in 2008 was to allow economic growth, in combination with expenditure restraint and increases in indirect taxes, to erode the deficit. The expected growth has not been forthcoming and the States have needed to rely on other aspects of the policy to address the deficit. It would be unwise to assume that Guernsey will consistently return to pre-crisis levels of growth any time soon, particularly in view of the increasing regulatory constraints on the finance sector. Economic growth can in any event never be guaranteed. The States will need to look to their own income and expenditure to find a real and sustainable solution to the way they manages their finances.

As expected, Social Security expenditure continues to grow faster than General Revenue, reflecting, predominantly, a steadily increasing number of pension claimants. This increase has been expected for some time and it will require careful planning if the reserves held by Social Security are to be sustained through the expected extended period of high demand. Also affected by the ageing of the population is the provision of health and social care services for older people. This provision will also need careful planning.

It is encouraging that not only are the States considering alternatives to increasing Social Security contributions to pay for the increase in expenditure, but that these considerations are being made alongside the consideration of the demands on the tax base as a whole, as part of the on-going Personal Tax, Pensions and Benefits Review. This is important. All money taken out of the private sector, whether by taxes or Social Security contributions, has an effect on the economy as a whole. Consideration of the combined impact is necessary for effective long-term planning.

The States should avoid relinquishing the ring-fencing of reserves for the provision of pensions and contributory benefits. However, any move to make co-ordination between the Treasury and Resources and Social Security Department in the setting of rates of tax and contributions more permanent, including any moves which might bring Social Security contributions within the boundaries of the Fiscal Framework, should be supported. These moves would increase both transparency and accountability.

2. Introduction

This report is the fifth Annual Independent Review of Fiscal Policy published as part of the institutional arrangements to support the Fiscal Framework that was adopted by the States in April 2009¹. The role of this review is to provide an independent, external assessment of the States' fiscal conduct against the criteria of the Framework. The Framework sets out clear numerical parameters and commits the States to long-term permanent balance. A summary extract of the framework is included in **Appendix 1**. A commentary on the framework is included in **Appendix 2**.

This report presents a review and analysis of current fiscal conduct and draws attention to any areas where actions are in conflict with the long-term objectives. It also provides an assessment of risks relating to the fiscal strategy and raises any general areas of concern that policymakers should be seeking to address. It is not a report which suggests actions; its remit is not to provide or recommend detailed solutions to those issues raised. However, where possible actions have been presented elsewhere comment may be offered on these.

In making the 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 and is subject to revision for up to three years, an assessment of present conditions is dependent on assessment of indirect variables such as levels of employment and unemployment; and of course, projections of future growth inevitably rely on judgement.

The report focuses on the fiscal performance in 2013 and the short-term projections for 2014 and 2015 published in the 2015 budget. The publication of indicative budgets for 2016 and 2017 in the 2015 budget is noted and encouraged, but the timing of publication has not permitted any detailed analysis of these in this year's publication. It is hoped that, if the States continue this practice, which would be welcome, it will be possible to incorporate these longer-term projections in subsequent reports.

Note that any reference to 'real' term figures throughout this report has been calculated using 2014 as the base year.

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

3. Economic outlook

3.1. Global outlook

The World Economic Outlook [WEO] update, published by the International Monetary Fund (IMF) in July 2014, reported that global growth projections for 2014 were marked down by 0.3% to 3.4% to reflect the weak first quarter, particularly in the United States. China, Russia and other emerging markets also experienced weaker than expected growth. Stronger growth was experienced in some advanced economies and Japan, Germany, Spain and the UK have all been highlighted as having a positive first quarter.

Some indicators point to a stronger second quarter. The United States is expected to bounce back in the second quarter with growth for 2014 projected at 1.7%, rising to 3% in 2015. Growth in the Euro area is expected to be 1.1% in 2014, increasing to 1.5% in 2015 but is uneven across the area, reflecting the continued financial fragmentation, impaired private and public sector balance sheets and high unemployment in some economies. Germany in particular seems to have experienced difficulties in the second and third quarters. Further, since the first quarter, current indicators suggest that both the Eurozone as a whole, and perhaps Japan, are weakening again. But it should never be forgotten that the more up-to-date economic data are, the more likely they are to be revised.

The downside continues to include the geopolitical risks arising in the Middle East and Ukraine. The U.S. is at risk of a rise in longer-term interest rates and the Euro area remains very vulnerable to both domestic and external shocks. The weaker global growth expected for the first half of the year emphasises that raising actual and potential growth must remain a priority in most economies.

Figure 3.1.1. Advanced Economies GDP Growth

Source: International Monetary Fund, World Economic Outlook, April 2014

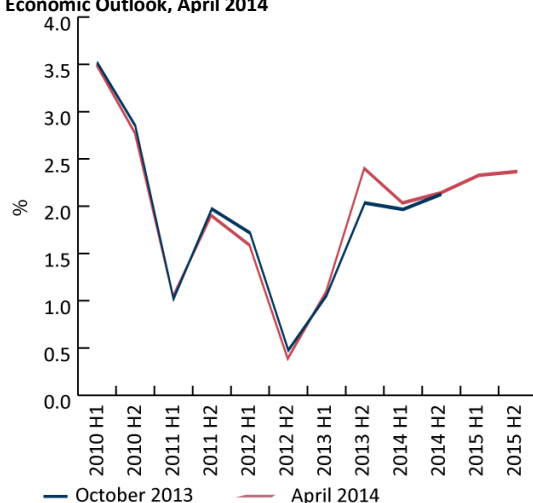
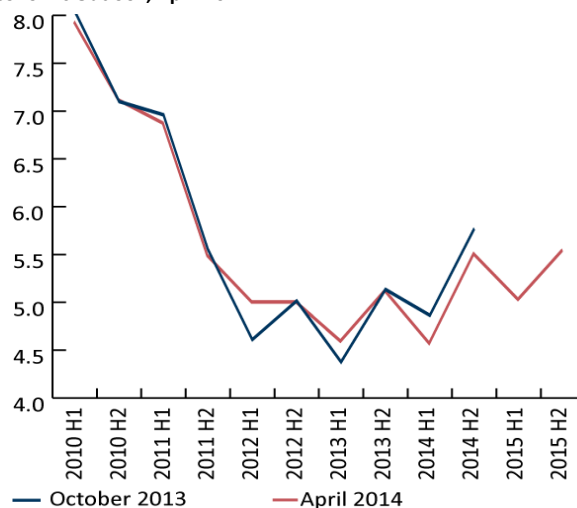


Figure 3.1.2 Emerging Market and Developing Economies GDP Growth

Annualised semiannual percentage change
Source: International Monetary Fund, World Economic Outlook, April 2014



It must be remarked that the IMF's forecasts change with great frequency, and indeed appear to be dominated by the most recent data. They are a little like weather forecasts. We report them here simply to show what has been said and to give an indication of the prevailing perspectives on the global outlook.

3.2. Domestic outlook

3.2.1. Economic growth

The first estimates of Guernsey's GDP for 2013 show very modest real growth of 0.5%, less than the 1.3% forecast in mid-2013.

Disappointingly, income from wages (less pensions) decreased by 0.8% in real terms from 2012, reflecting weak earnings growth and subdued levels of employment. However, combined company and self-employed profits grew by 0.8% with particularly strong growth in self-employment. Self-employment experienced 7.0% growth, the largest annual increase since 1998. In comparison, company profits grew by only 0.1%.

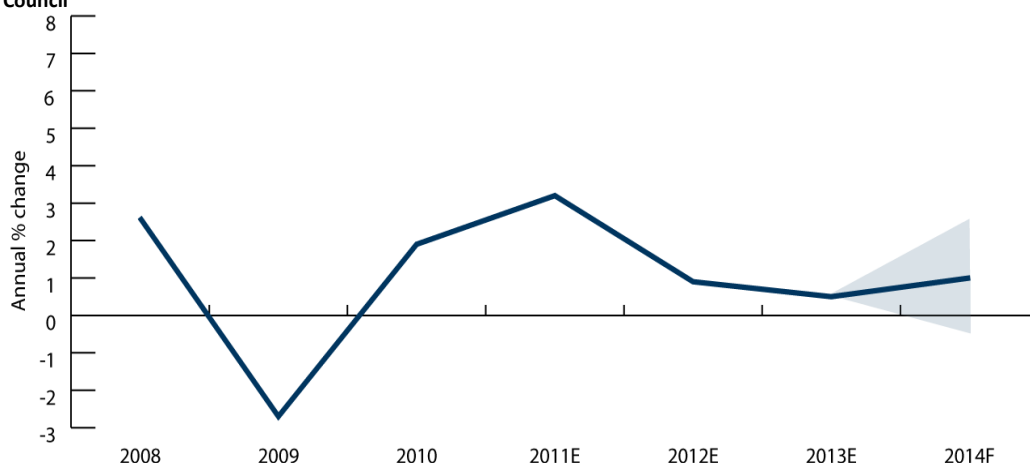
The finance sector continues to struggle, with output decreasing in real terms by 1.3%, a decline echoed in the employment statistics presented later in this report. However, activity outside the finance sector is stronger, mirroring recent experience in the UK. In total, non-finance sectors combined grew by 0.5%, with particularly strong growth in the legal and business services sectors, although the retail sector remains weak and declined by 7.2%.

The current GDP forecast for 2014 is for the very modest rate of growth to continue at around 0.6%.

Figure 3.2.1. Annual growth in Gross Domestic Product

Real change, as at September 2014

Source: Policy Council



3.2.2. Business projections

In May 2014, The Guernsey Chamber of Commerce published its annual survey of business conditions for the calendar year 2013. The survey asks local businesses for their turnover and profitability figures for 2013 and to indicate what they expect for 2014. The sample of businesses changes from year to year but the survey does give an indication of how local businesses are performing. To produce a general overview of overall economic conditions the responses collected are translated by the Policy Council into scores (e.g. a substantial increase in turnover is scored 1, a slight decrease in turnover is scored -0.5). The reported scores for year on year growth in turnover and in profits demonstrate a reasonable correlation with estimates of real annual GDP growth.

For the year 2013 there was a decrease in the turnover score, indicating a slower economy than 2012. This reflects the reduction in estimates of GDP growth for Guernsey's economy from 0.9% in 2012 to 0.5% growth in 2013. By contrast, overall scores for profitability showed a marked increase; there was an overall rise of 7% in the number of businesses reporting an increase in profits, although the percentage of businesses reporting a substantial increase in profits (> 5%) was lower than the previous year.

Profits growth projected for the current year tends to correlate with growth in the reported profits for the previous year. They were, as would therefore be expected, slightly more optimistic for 2014 than 2013.

Figure 3.2.2. Overall survey scores for reported and projected year on year growth in turnover

As at September 2014
Source: Chamber of Commerce, Annual Business Confidence Survey; Policy Council

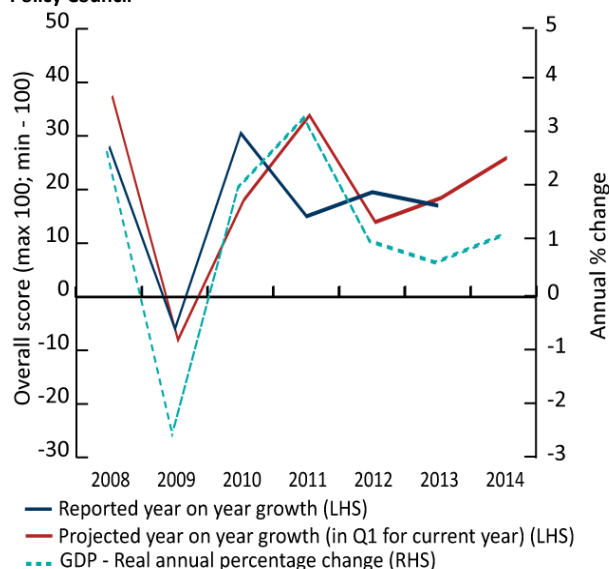
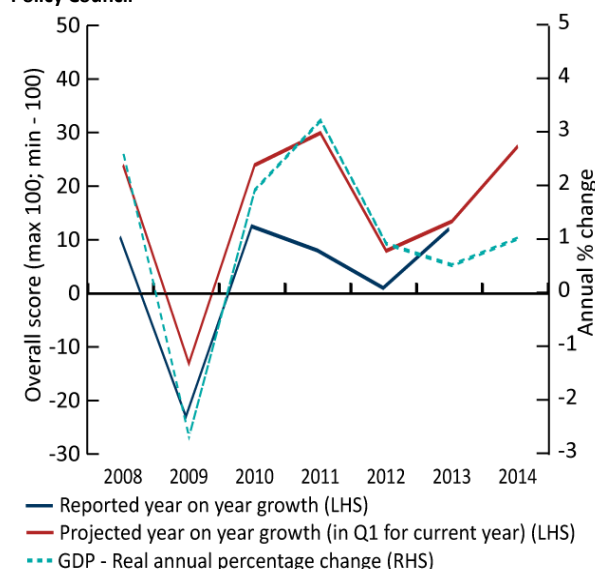


Figure 3.2.3. Overall survey scores for reported and projected year on year growth in profits

As at September 2014
Source: Chamber of Commerce, Annual Business Confidence Survey; Policy Council



Respondents generally had more confidence in the prospects for their own economic sector for the next 12 months than in the Island's economic prospects as a whole. This growing level of confidence is a positive sign for the local economy, suggesting that, although somewhat later than expected, the recovery of the local economy is beginning to find traction.

3.2.3. Finance sector: recent and future conditions

Finance sector activity in Guernsey closely mirrors that in the UK, where almost all captive insurance and most fiduciary business in Guernsey originates. The UK Economic Outlook published by PwC in November 2013 reported the finance sector's contribution to output and employment in the UK as shrinking whilst non-financial services were growing—a situation mirrored in Guernsey.

However, PwC believe there is a lot of potential for the finance sector and that sustainable growth could add 2 to 3% to GDP growth in the UK over the next few years and create substantially more jobs by 2020. If this were to prove accurate, it is likely to be reflected in improved conditions for Guernsey's finance sector.

Conditions in Guernsey looked promising for the finance sector in the first quarter of 2013, with a rise of 7% in the total net asset value of funds administered in Guernsey and an increase of nearly 4% in the value of banking deposits. However, this was short-lived, with the total value of funds ending 3.9% lower and banking deposits 3.5% lower at the end of 2013 compared with the same time the previous year. In the first half of 2014, both bank deposits and fund values continued to decline.

As shown in **Figure 3.2.6**, employment within the finance sector was also strong in the first quarter of 2013 but, by the end of the year, had fallen by 2.1% compared to the end of the previous year. Over the six year period from the beginning of the crisis in late 2008 to the end of 2013, finance employment declined by nearly 11%. After a slight rally in the first quarter of 2014, this decline has continued.

The local finance sector plainly continues to struggle to stabilise and recover from the Global Financial Crisis. It is not being helped by successive waves of regulation imposed on the finance sector worldwide, purporting to ensure stability but in fact producing stasis.

Figure 3.2.4. Banking deposits

At current prices, nominal change, as at September 2014
Source: Guernsey Financial Services Commission

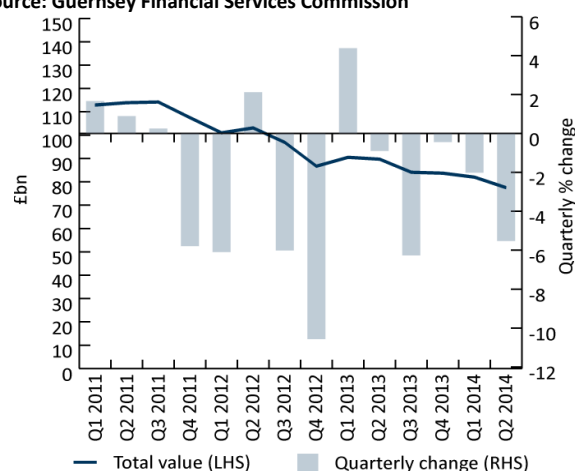


Figure 3.2.5. Fund assets

At current prices, nominal change, as at September 2014
Source: Guernsey Financial Services Commission

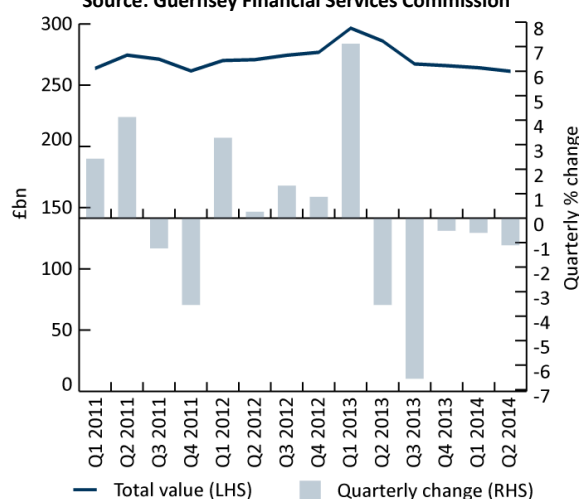
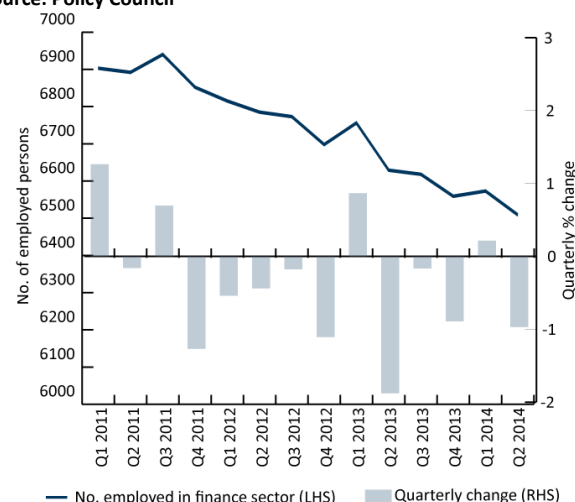


Figure 3.2.6. No. employed in Guernsey finance sector

Total employed and self-employed people, as at September 2014
Source: Policy Council



3.2.4. Labour market

Official statistics show continued weakness in the labour market through the first half of 2014. The total number of people employed continues its downward trend but, as shown in **Figure 3.2.8**, the latest figures available for the employment rate, adjusted for seasonal variations, indicate recovery in the first quarter of 2013, albeit they remain lower than the same time the previous year.

The unemployment rate (**Figure 3.2.10**) appears to have improved from the third quarter of 2013, falling to 1.1% in the second quarter of 2014. Unemployment rates in an economy as small as Guernsey can change very quickly and the seasonal nature of Guernsey's labour market means that it is perhaps a little early to declare a definite turning point. Although still remarkably low by international standards, unemployment in Guernsey remains well above the pre-crisis level; but it seems to be heading in the right direction.

The statistics would appear to contradict each other; falling unemployment and falling employment seem an unlikely combination. But in a population as small and mobile as Guernsey's, these figures must be viewed in the context of the total population. The number of people resident in Guernsey decreased by 0.6% in the year ending 31st March 2013 and, of more concern, the working age population decreased by 1.2% in the same period. This is a result of a net emigration of about 460 people over the course of the year, counter to recent trends of net immigration over the last six years and the first period of net emigration since annual data collection began in 2007 (**Figure 3.2.12**).

There is not enough information available to do more than speculate about the cause but it could be conjectured that, given Guernsey's links with the UK, this may reflect the comparative improvement in the UK economy relative to Guernsey's, causing a reverse in the typical flow of migration between the two jurisdictions (see **Box 3.2**).

The decline in the working age population also reflects the steady progression of the first and largest age cohorts of the baby-boom generation out of the working age population. The number of people over the pension age increased by 2.4% in 2013. Actuarial projections show the population of those age 65 or more continuing to increase well beyond the middle of the century.

Figure 3.2.7. Total employment

Total employed and self-employed people.
Actual and with SA trend, as at September 2014
Source: Policy Council

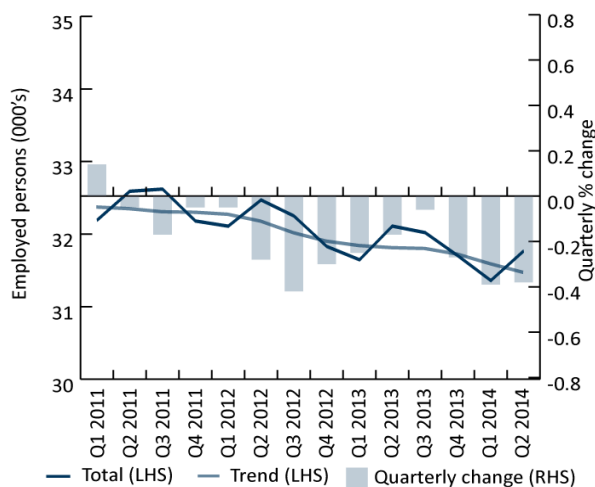


Figure 3.2.8. Employment rate

Total employment as a percentage of the working age population.
Actual and with SA trend, as at March 2014
Source: Policy Council

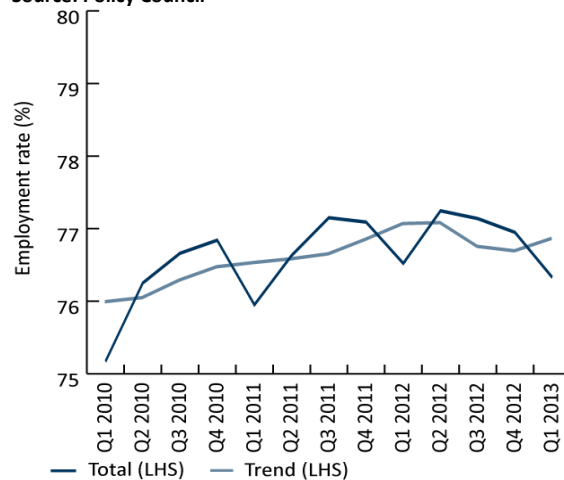


Figure 3.2.9. Total unemployment

Registered unemployment, actual and with SA trend,
as at September 2014.
Source: Policy Council

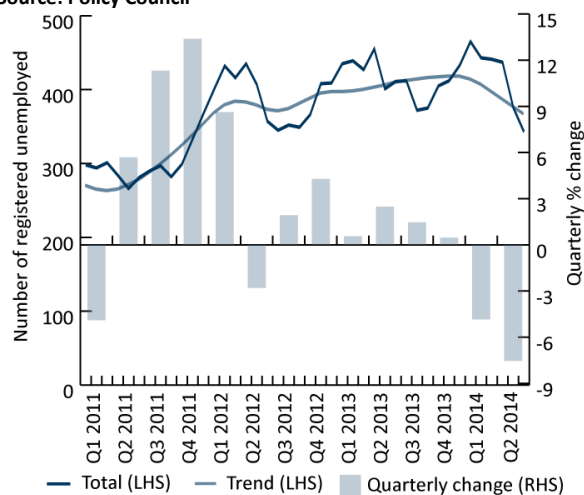


Figure 3.2.10. Unemployment rate

Registered unemployment rate, actual and with SA trend, as at
September 2014.
Source: Policy Council

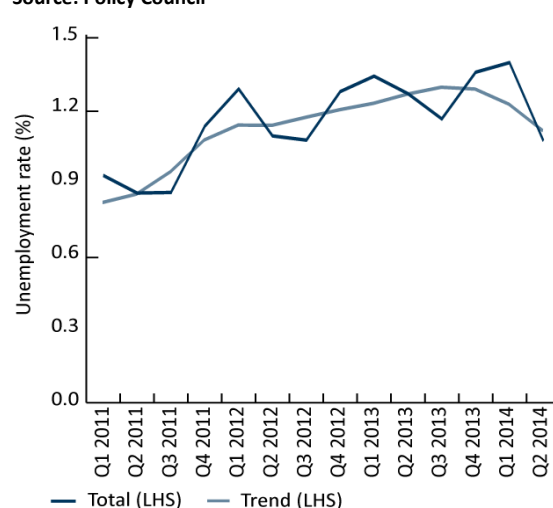


Figure 3.2.11. Proportion of working age population

As at March 2014
Source: Policy Council Population data

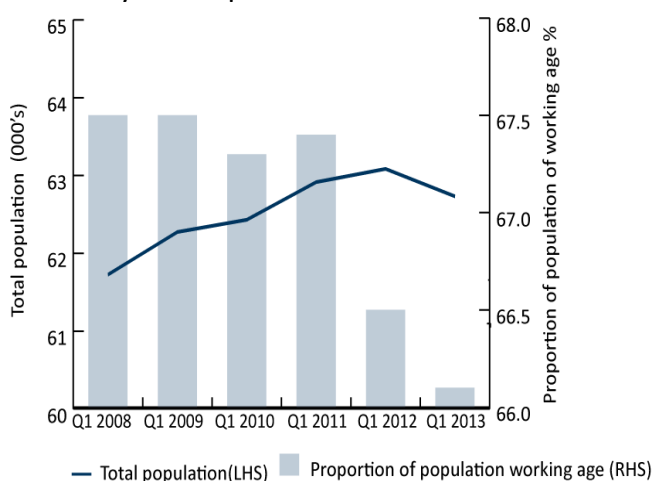
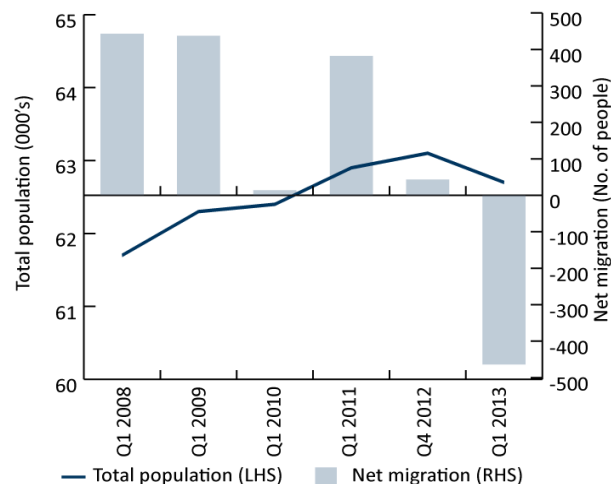


Figure 3.2.12. Net migration

As at March 2014
Source: Policy Council Population data



Box 3.2. Comparison of Guernsey vs UK recovery from the recession

The economic recovery is underway in the UK and would appear to be gaining ground. GDP growth is predicted to rise above pre-recession levels for the first time in 2014. The UK has also reported falling rates of unemployment for more than two years, with the rate dropping below 7% in early 2014, a significant recovery from its highest point at the end of 2011 when it reached a decade high of 8.4%. Employment rates (the percentage of the working age population who are economically active) in the UK have been increasing for more than two years and by the end of 2013 had recovered to almost pre-crisis levels.

By comparison, while Guernsey, as remarked in previous reports, experienced a more gentle recession in the early years, the Island now appears to be lagging behind in the recovery. Unemployment continued to increase well into 2013 and it is only very recently, as noted above, that unemployment has shown any real signs of improvement. Average employment rates for the year rallied in 2011 and 2012 but fell in 2013 despite a decrease in the working age population.

Figure 3.2.13. Comparison of UK and Guernsey employment rates

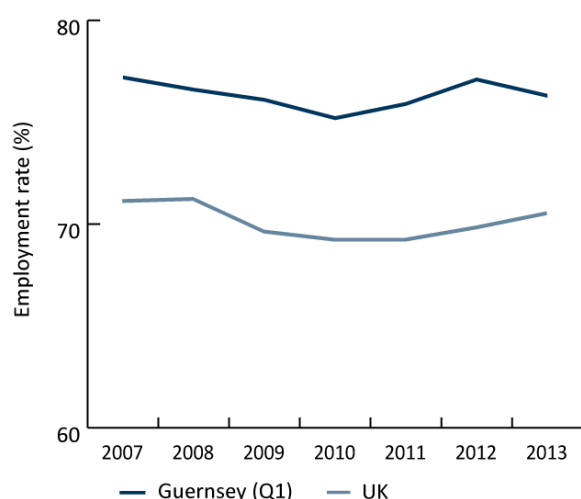
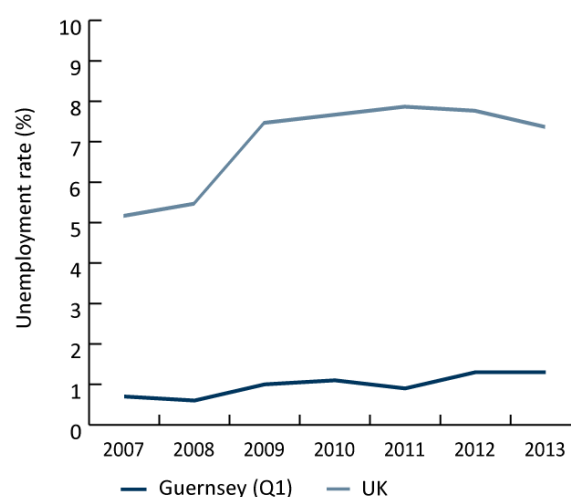


Figure 3.2.14. Comparison of UK and Guernsey unemployment rates



However, the picture is not uniform across the economy. As with the UK, the recovery is being led by non-finance sectors. In Guernsey, hospitality (which captures much of the activity from the tourist industry), construction and ICT have shown consistent year on year growth in employment over the last twelve months. However, with the finance sector comprising such a large part of Guernsey's economy, it is unsurprising that the impact of its slower recovery has had a much more significant impact than in the UK.

The wider economic recovery in the UK has been followed by the finance sector in recent months. If this continues, and if the historic correlation between the UK and Guernsey finance sectors also continues, there should be an improvement in local economic conditions.

4. Performance against the Fiscal Framework

Monitoring performance against the Fiscal Framework is the central purpose of this report. The Framework provides numerical parameters on General Revenue expenditure to help guide States' finances towards long-term fiscal stability. Expenditure from the Social Insurance funds is not currently within the parameters of the Framework.

The parameters (outlined in **Box 4.1**) set limits on various aspects of income and expenditure and outline a long-term objective of 'permanent balance': that the States should not in the long-term spend more than they receive from taxation (and profits) and that periods of deficit should be balanced by periods of surplus. Further commentary on the Framework itself is provided in **Appendix 1**.

Box 4.1. Parameters of the Fiscal Framework

The Fiscal Framework sets a number of parameters and commitments:

- Maintenance of long-run 'permanent balance'.
- Total General Revenue income averaging no more than 21% of GDP.
- Restraint on any temporary operating deficit positions to less than 3% of GDP in any one year.
- Ensure that identified deficits will be addressed within five years of their appearance and that measures to counter identified structural deficits are agreed within two years of their identification.
- Annual capital expenditure averaging 3% of GDP.
- Total borrowing never to exceed 15% of GDP (and only to fund capital expenditure).
- The level of new borrowing in any one year not to exceed 3% of GDP.

Although total expenditure is within the parameters of the Fiscal Framework, 2013 marks the sixth year of deficit and 2014 is likely to become the seventh. If the 2015 budget is successful, the underlying deficit will be greatly reduced in 2015, with balance to be restored once the outstanding savings to be achieved by the Financial Transformation Programme are realised in 2017. A delay such as this is understandable given the world economic background, but even so any larger deficit than currently expected for 2015, or any further extension of the time to balance, would be a serious concern.

The increase in the amount allocated to capital spending in 2013 (and that budgeted for 2014 and 2015 and beyond), to a level closer to the 3% of GDP target reflects acknowledgement of the need for continuing investment in infrastructure, and is very welcome.

4.1. Income and expenditure

Fiscal Framework rules:

- **Total General Revenue income averaging no more than 21% of GDP.**

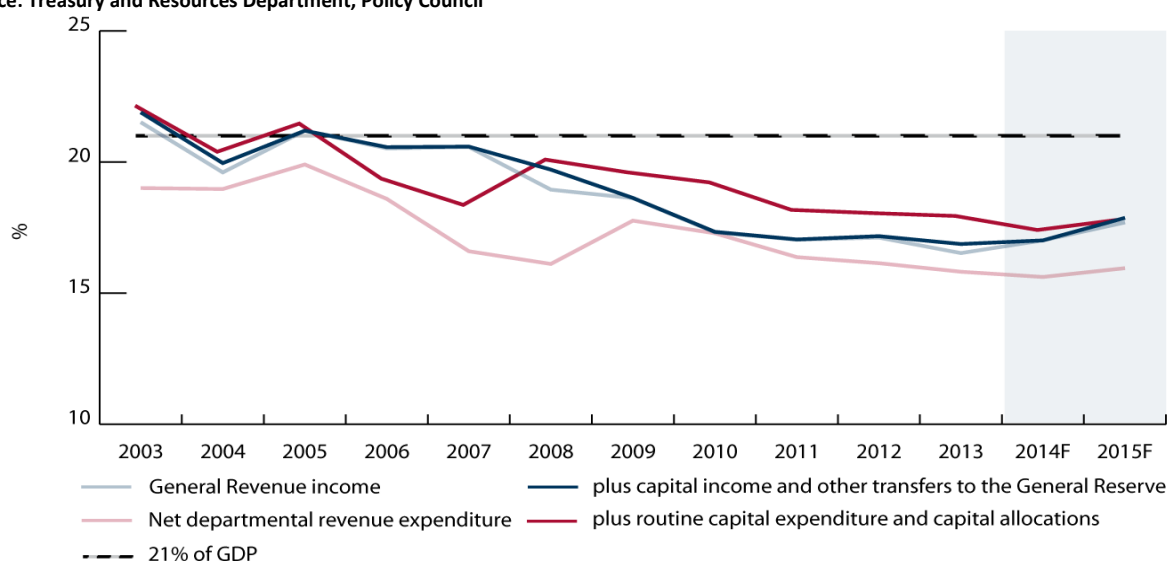
Combined General Revenue and capital expenditure remains well within the 21% of GDP limit set by the Fiscal Framework, having fallen to 18.0% in 2013, the lowest level recorded in the last ten years. The forecast for 2015 is for a small decline, to 17.9%.

General Revenue income decreased relative to GDP in 2013 from 17.2% to 16.9%. The latest estimates for 2014 show income continuing at this level before increasing in 2015. This reflects the budget measures which will see a slight increase in revenues from taxes on corporate income and indirect taxes.

Figure 4.1.1. Revenue income and revenue and capital expenditure (Fiscal Framework), 2003-2015

Net of departmental operating income, as a percentage GDP, as at October 2014

Source: Treasury and Resources Department, Policy Council



It may be worth noting that this parameter of the fiscal framework was set with reference to historic norms. As can be seen from **Figure 4.1.1**, the levels chosen were fairly representative of the level of expenditure typical ten years ago. The introduction of zero/10 in 2008 and the successful efforts to restrain and reduce expenditure from the General Revenue budget have brought about a structural change which reduced income and expenditure from the General Revenue Budget relative both to GDP and the criteria imposed. Given the structural change, the relevance of the historical norm has lessened.

With a full five years of accounting data now available since the introduction of zero/10, a new picture is developing. The new norms for both income and expenditure appear to have re-established at a significantly lower level. At least as far as expenditure from general revenue is concerned, the States have reduced public spending in Guernsey by 2% of GDP, establishing a new apparent norm at 18% to 19% of GDP.

4.2. Fiscal position

Fiscal Framework rules:

- **Restraint on any temporary operating deficit positions to less than 3% of GDP in any one year.**
- **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.**

The first of these criteria is applied to the operating position - that is the fiscal position before any transfer of funds to the capital reserve. At this incomplete level of reporting, the deficit was cleared in 2012 and the States have achieved an operating surplus for the second year running in 2013. The operating surplus is expected to grow in 2014 and 2015. It must however be noted that this computation excludes transfers to the capital reserve.

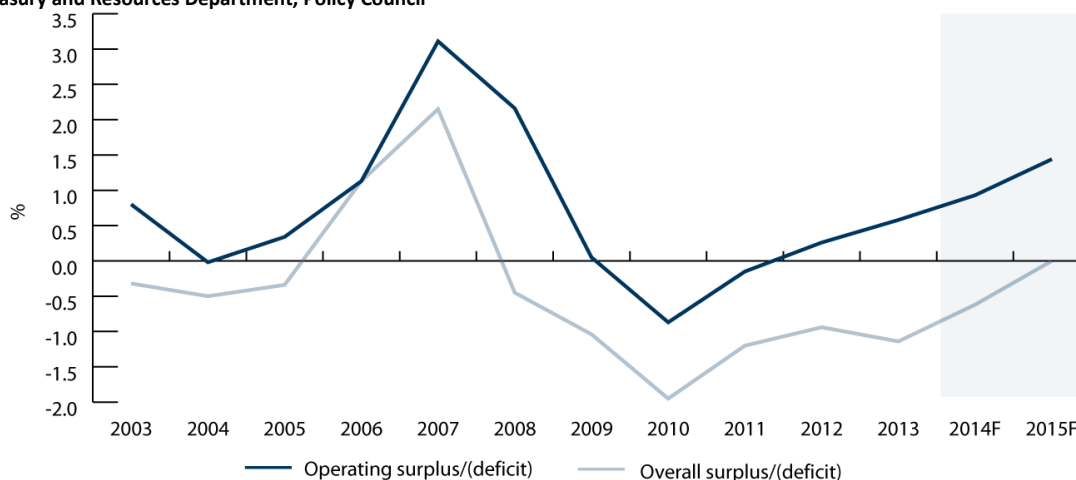
The overall deficit position (which includes the appropriation of funds to the capital reserve) remained below 3% of GDP in 2013. However, this represents a sixth successive year of deficit and the second year of breaching the criterion requiring the deficit to be addressed within five years.

The 2015 Budget projects the overall deficit continuing through 2014 with a return towards balance forecast for 2015. As outlined in the 2015 Budget, it is expected that a true balance (without recourse to any reserves) should be achieved by 2017.

Figure 4.2.1. Operating position, 2003-2015

As a percentage of GDP, as at October 2014

Source: Treasury and Resources Department, Policy Council



The Framework and the calculation of the reported overall fiscal position reflect the manner in which the States' Accounts are reported; capital expenditure is reported as routine capital expenditure (small capital investments controlled by individual departments and incorporated into their annual budget) plus the transfer of funds from General Revenue to the Capital Reserve – i.e. the money set aside for spending on larger capital projects. The appropriated funds are used as the measure of capital expenditure because they are far less volatile than actual capital spending, which can vary considerably from year to year; inevitable in a small jurisdiction. There can, therefore, be a considerable difference in value between the appropriated funds and the actual amount of money spent on capital projects in any given year. This issue is discussed in more detail in **Section 4.4**.

4.3. Permanent balance

Fiscal Framework rules:

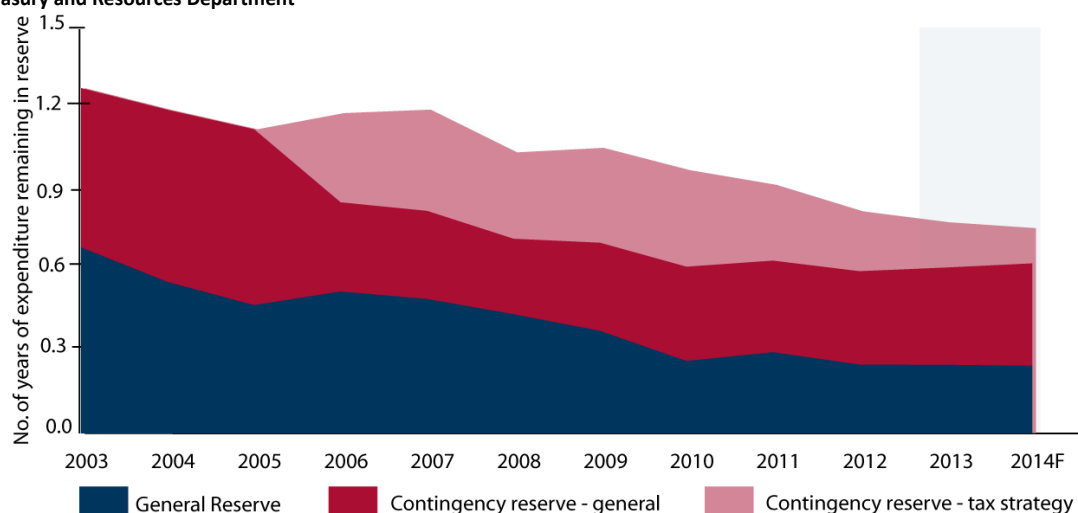
- **Maintenance of long-run ‘permanent balance’.**

Throughout the current period of deficit the States have been fortunate in having significant financial reserves on which to draw. This has allowed the States to avoid borrowing to support the deficit². Six years of deficit has reduced the amount held in reserve from 1.04 years of expenditure at the end of 2008, to 0.78 years five years on.

Figure 4.3.1. States’ reserves, 2003-2014

Number of years of total revenue expenditure held in reserve, as at October 2014

Source: Treasury and Resources Department



At present the States hold reserves for managing fluctuations in expenditure in two separate accounts.

The General Reserve: this incorporates the General Revenue Account Reserve (which could be considered the States’ current account), the money allocated to the corporate housing programme and various small funds; and

The Contingency reserve: this is divided into two portions: the tax strategy allocation, which was hypothecated to support the deficit resulting from the change in the corporate tax strategy when zero/10 was introduced; and the general contingency reserve, which is generally considered to be the States’ “rainy day” fund.

The combined level of reserves in both the General and Contingency reserves in December 2013 was £8m less in nominal terms than the previous year. In real terms, by the end of 2014, total reserves are expected to be only 65% of what they were at the end of 2007. The States will require a period of either significant or sustained surplus (or both) to rebuild these funds.

² The Fiscal Framework limits the States’ ability to borrow to fund a deficit, allowing borrowing only to pay for capital investment.

The 2015 budget outlines an improvement in the fiscal position which would no longer require recourse to the tax strategy portion of the contingency reserve to support a deficit in 2015 and beyond and proposes the contingency reserve be redefined and restructured.

The general section of contingency reserve (i.e. that section not hypothecated to supporting the transition to the new corporate tax regime) is to be restructured into a core investment reserve, the capital value of which is *“only to be available to be used in the exceptional and specific circumstances of severe and structural decline or major emergencies”*. The Treasury and Resources Department proposes establishing the fund’s current real value as an effective minimum for the reserve and set a medium-term objective to increase the reserves value from 40% of annual expenditure to 64%, returning the fund to its relative value in 2006. The intention is that these funds will be invested on a more long-term basis than has been possible under the current structure and the liquidity requirements.

The balance of the section of the contingency reserve currently hypothecated to supporting the change in the tax strategy is to be divided.

- £7m is to be used to establish an economic development fund to support the objectives of the Economic Development Strategy.
- £25m is to establish a Transformational and Transition fund to support continued investment in the transformation of public services begun by the FTP
- £22m to be transferred to the General Revenue Account to establish a reserve from which short-term imbalances and cyclical variations can be managed (including £10m to fund the delayed delivery of the remaining FTP savings)

4.4. Capital expenditure

Fiscal Framework rules:

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

The States of Guernsey Policy Council Fiscal Framework (Billet d'Etat XI, 2009) sets 3% of GDP as an appropriate annual average level of capital expenditure for Guernsey. It made reference to historic and international norms as a guide in determining this 'target'. However, the Framework expresses the target as an '*assumed norm for capital expenditure*' due to the risks involved in setting targets for capital expenditure, namely that unnecessary and unproductive investments could be made just to meet targets³.

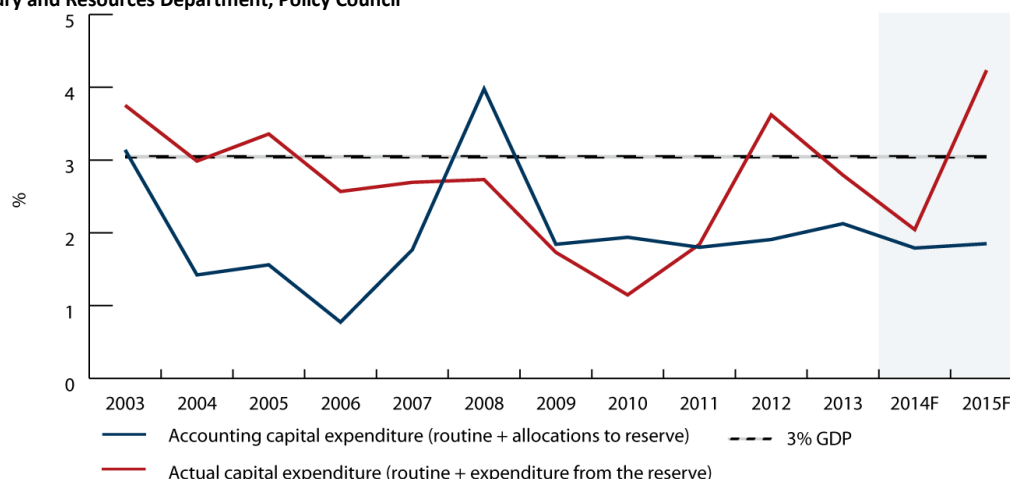
Capital expenditure is essentially tax payers' money invested in public infrastructure. The rationale behind setting an appropriate level for capital expenditure is to ensure that the States generate sufficient General Revenue to cover its capital expenditure requirements so as to safeguard against having insufficient monies to fund the capital programme. Whilst acknowledging that capital expenditure, particularly for a small economy such as Guernsey, can be variable, generating revenues of 3% of GDP year in, year out would ensure that long-term capital expenditure could be financed without recourse to external borrowing.

Each year, the sum of money set aside for capital expenditure, based on the Fiscal Framework rule, is appropriated from General Revenue to the Capital Reserve (i.e. the amount set aside for capital spending). Comparing the appropriation to the capital reserve to the actual capital spend reveals that over the last decade, the States have typically allocated less to the Capital Reserve than they have spent from it. **Figure 4.4.1** shows the difference between the two ways of measuring capital expenditure, showing how they have differed year by year. It also illustrates capital expenditure in relation to the Fiscal Framework target (the dotted line). The red line is the States' actual capital expenditure. The blue line represents routine capital expenditure plus the transfer into Capital Reserves.

Figure 4.4.1. Capital expenditure, 2002-2015

As a percentage of GDP, as at October 2014

Source: Treasury and Resources Department, Policy Council



³ The Island Infrastructure Plan highlighted a need for between £1.5bn and £1.9bn of expenditure on infrastructure over the next 20 years. The lower figure is broadly equivalent to the 3% of GDP outlined by the Framework.

Capital programmes are spread out over a number of years and expenditure varies significantly year to year. Therefore, considering the amount transferred to the capital account, rather than the actual capital expenditure, presents a smoother, more consistent and informative picture. However, this is only useful if it is assumed that, over the long-term, the money allocated and money spent will average broadly the same amount. This has not been the case in recent years.

Actual annual capital expenditure (defined as routine capital expenditure plus non-routine capital expenditure) has averaged 2.6% of GDP over the past 10 years; capital expenditure *as reported* (routine capital expenditure plus appropriation from General Reserve) has averaged 2.0% of GDP. In effect, although as reported capital expenditure is one percentage point below the 3% of GDP target, the actual expenditure on capital projects over the past decade has been, on average, not far short of the 3% target. The issue is, therefore, more how the States can afford to maintain this level of expenditure than whether it is actually investing enough money in maintaining and developing its infrastructure. The expenditure has been around the norm, but the fund intended to allow this to continue is being gradually run down. The States need to save more to replenish the fund.

For the past 2 years, after a 6-year period of underinvestment, actual capital expenditure has exceeded or met the 3% target. An additional £9m has been transferred to the capital reserve in 2013 compared to the previous year, a step in the right direction but not sufficient to sustain historic levels of expenditure, or meet the full 3% of GDP benchmark.

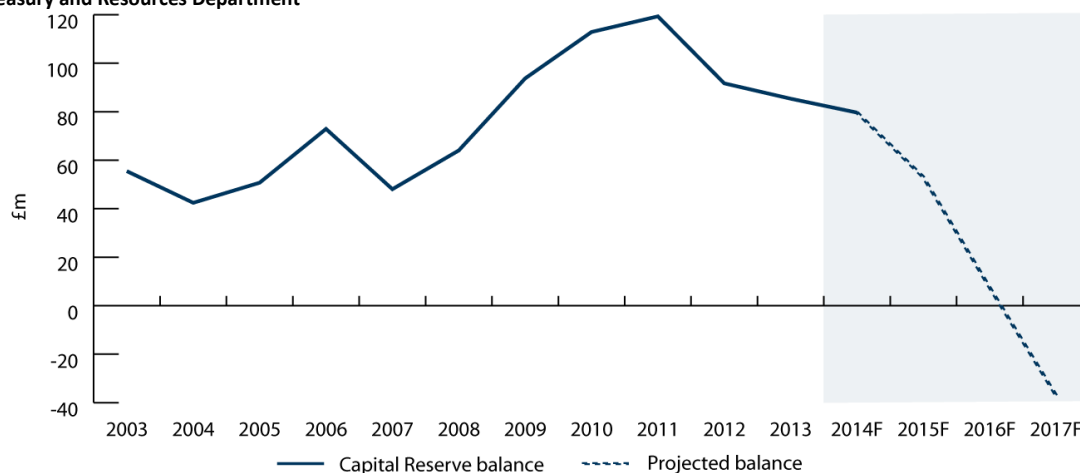
The effects on the Capital Reserve are shown in **Figure 4.4.2**. The updated projected cost of the recommended capital programme for 2015-2017 is £275m, around 3% of GDP per annum, though the actual capital expenditure for 2014 is expected to fall significantly short of the 3% target. The Treasury and Resources Department Capital Prioritisation report has identified that, assuming appropriations to the Capital Reserve continue at approximately the current level (£36-£38m per annum), the Capital Reserve will fall £57m short of the funds necessary for the recommended capital programme for the period 2014 to 2017. The 2015 Budget recommends the transfer of £20m from the Corporate Housing Programme which will reduce this shortfall to £36m. Assuming the £275m expenditure is distributed evenly across the period 2015-2017 at the expected level of allocations, the Capital Reserve will be exhausted by 2016 or 2017.

Figure 4.4.2. Capital Reserve balance

At December each year, at current prices, as at October 2014

Projected to 2017, assuming expenditure on capital at a constant rate in line with recommendations of Capital Prioritisation report at projected rate of capital allocations

Source: Treasury and Resources Department

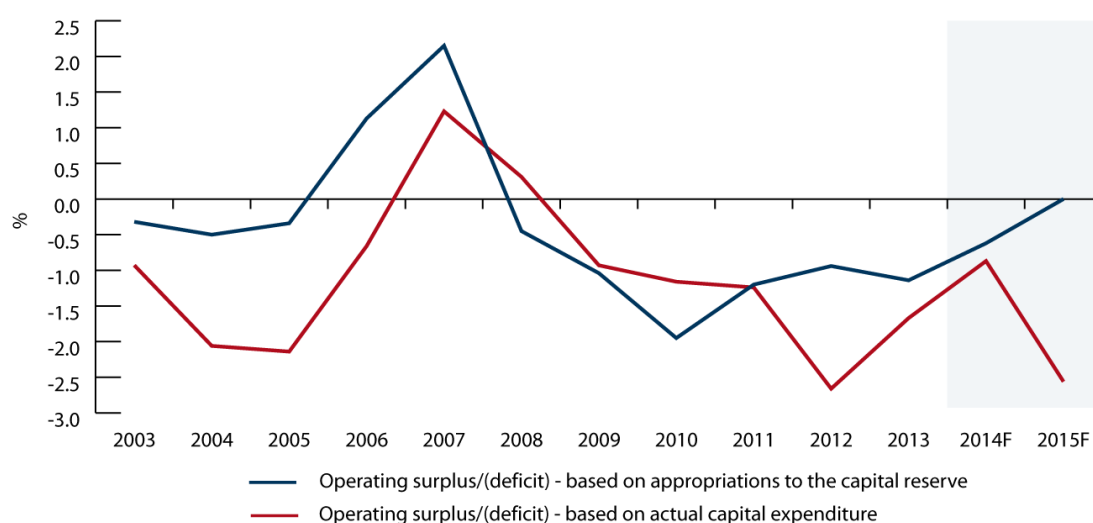


As highlighted previously, a choice must be made: the States needs either to generate sufficient revenues to cover all revenue and capital expenditure (without recourse to transfers from reserves) or reduce capital (or other) spending and accept any consequences this may have. Alternative means of financing the necessary investment include borrowing; however, this is not a viable option in the long-term unless the capital projects themselves are reliably capable of generating sufficient revenue to service the debt. Financing the shortfall through borrowing in the absence of a discreet and reliable revenue stream will require some other source of repayment; and the only one available is taxation. Enough would need to be raised to cover interest and repayments.

Figure 4.4.3. Overall deficit, 2003-2015

Comparing the use of appropriations to Capital Reserve and actual capital expenditure, as a percentage GDP, as at October 2014

Source: Treasury and Resources Department, Policy Council



4.5. External borrowing

Fiscal Framework rules:

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

Although part of the original function of the Fiscal Framework was to provide limits to proposals to borrow in order to finance the capital expenditure programme put forward in 2009, a subsequent decision was taken not to borrow at that time. As a result, the States currently has no external debt on its balance sheet.

There is, however, some off balance sheet contingent debt. The States act as Guarantor of loans or provides internal loans to some States-owned or States-backed entities to a total value of £251m, details of which are provided in the table overleaf. The more transparent reporting of these liabilities used in the 2013 accounts and 2015 budget are to be supported.

The 2015 budget outlines a proposal to issue a public bond at a minimum of £250m over a period of at least 20 years maturity. The intention of this bond is to consolidate the existing debt on the basis that the States' credit rating and greater borrowing power offer better value to taxpayers and customers than individually

negotiated loans. This would also enable the States to take advantage of the current low interest rate environment. The Treasury and Resources Department suggests that this bond could be extended to fund other further projects, provided these projects could demonstrate a secure income stream.

The appeal of this at current interest rate levels is clear. But there is a downside. All debt is at the moment hypothecated against particular revenue streams from enterprises- the States would be liable only if these enterprises should fail, and only to the extent to which the sale of assets failed to cover these liabilities. Consolidating and bringing it onto the books of the States essentially hypothecates the debt against the general revenue of the States (although it is of course planned that repayment would be made from the revenues of the entities themselves). Thus, apart from the argument against setting a precedent for borrowing, which should not be understated, there is a risk in future years should either revenue or expenditure growth not be as benign as expected. Guernsey would then face the problems of any country not borrowing in its own currency. The recent example of, for example, Spain when faced with this gives one pause.

Box 4.2. States of Guernsey as banker/guarantor

The table below provides detail of the debt held by various States-associated entities and the role the States hold in relation to that debt.

Recipient	Arrangement Type	Amount £m
Guernsey Housing Association ⁴	Guarantee	80.5
Alderney Housing Association ⁵	Guarantee	5.0
Guernsey Electricity Limited	Guarantee	20.0
JamesCo750 Limited	Internal Loan	13.8
Cabernet Limited ⁶	Guarantee	22.0
Cabernet Limited ⁷	Overdraft	3.0
Cabernet Limited	Internal Loan	26.0
Waste Strategy Fund	Pending	29.5
Ladies' College	Pending	4.0
Guernsey Electricity Limited	Guarantee	45.0
Health & Social Services Department (Accommodation Fund)	Internal Loan	2.2
Total		251.0

⁴ Market value of assets £141m

⁵ Market value of assets £6.7m

⁶ The States Capital Investment Portfolio contains a project to recapitalise Cabernet Limited. When this project proceeds, a total of £11million of the existing Cabernet Limited debt will be removed.

5. Guernsey's public finances in detail

5.1. Introduction

Guernsey's public finances can, broadly speaking, be divided into two distinct revenue streams, with in turn two distinct uses for these streams:

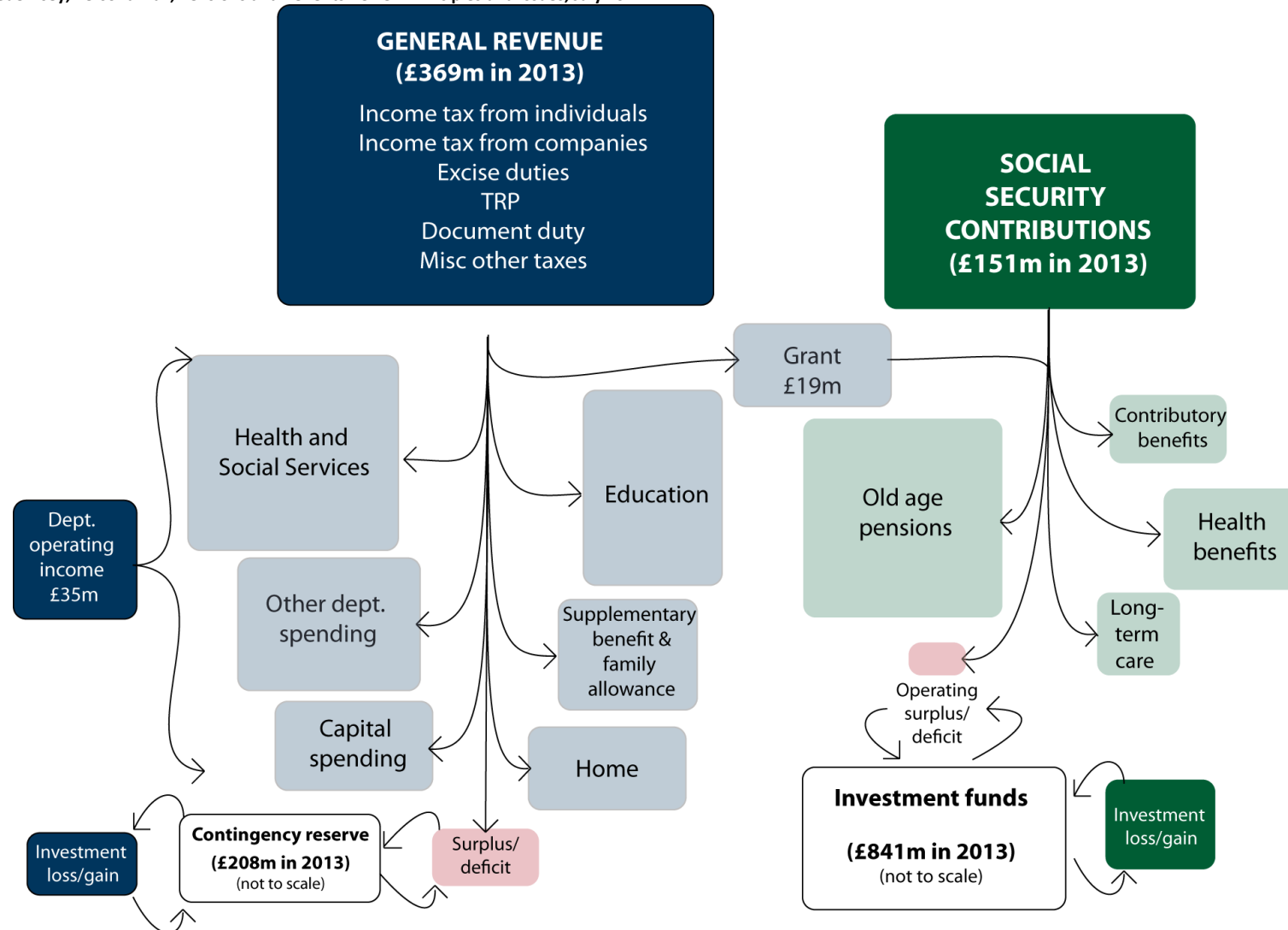
- General Revenue income, derived primarily from taxation (as presented in the States' Annual Budget in November) is used to meet the year on year expenses of most public services such as healthcare and education. It is also the primary source of funds to support capital expenditure
 - In addition to this, a small proportion (about 8%) of total revenue, described as departmental operating income, is raised within departments (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). This income is available to the department to use and the expenditure financed by it is netted off the budget requirements for expenditure from General Revenue income. Total revenue and expenditure figures presented in the General Revenue Budget are typically presented net of departmental operating income and expenditure financed from that source. (Fees and charges are discussed in detail in Box 6.1.)
- Social Security income, derived primarily from Social Security contributions (*'the Social Security Budget'*) is used to pay for insurance-based benefits such as pensions, unemployment benefit and primary and specialist medical care subsidies.

The two budgets are interconnected. A grant is paid from General Revenue to support the Social Security Funds and the Social Security Funds pay a small number of grants to States Departments for particular functions (see **Figure 5.1.1** and **Appendix 3**).

The parameters of the Fiscal Framework currently cover only General Revenue income and expenditure. The Framework captures neither the majority of expenditure and income of the Social Security Funds nor departmental operating income. However, as non-contributory benefit rates are set in the Social Security Budget but financed from the General Revenue Budget and the payment of the grant from General Revenue to Social Security is calculated as a percentage of contribution receipts, the recommendations of the Social Security Budget can impact on the General Revenue balance. Changes in Social Security expenditure which reflect changes to the proportion of the population that are entitled to benefit, for example an increase in unemployment or the aging of the population, also affect the General Revenue balance, but are much less readily controlled than are benefit rates.

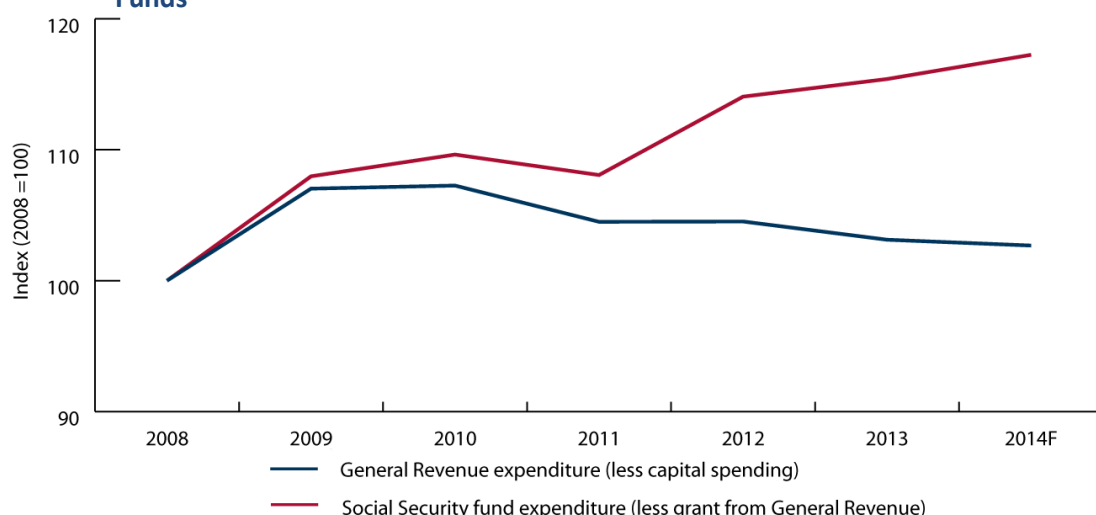
Figure 5.1.1. Illustration of States income and expenditure streams

Source: States of Guernsey, Personal Tax, Pensions and Benefits Review Principles and Issues, July 2014



Over the last decade, expenditure from the Social Security Budget has consistently grown at a faster rate than that from General Revenue. Since the revenue grant was restructured between 2006 and 2008, general revenue expenditure, excluding appropriations to the Capital Reserve, has grown in real terms by only 3%. By contrast, expenditure from the Social Security Funds (excluding the grant from General Revenue) has grown by 17% (see **figure 5.1.2**). As a result, the Social Security Budget comprises an increasingly large proportion of total public expenditure.

Figure 5.1.2. Comparison of real growth in expenditure from General Revenue and the Social Security Funds



This chapter presents an overview of both the General Revenue and Social Security Budgets. It commences by examining the States' expenditure in aggregate, combining the income and expenditure of both revenue streams to outline total public expenditure. It continues by examining expenditure in more detail, identifying the sources of pressure within the States' finances.

5.2. Aggregate income and expenditure

Table 5.2.1 below shows the consolidated budget forecasts of General Revenue and Social Security for 2014 and 2015 and the actual figures for the years 2011-2013 inclusive.

Table 5.2.1. Consolidated budget forecasts for 2014 and 2015

At current prices, as at October 2014

		2011 (£m)	2012 (£m)	2013 (£m)	2014F (£m)	2015F (£m)
General revenue	Personal taxes	218	227	227	236	244
	Company taxes (incl. distributions)	52	53	55	58	64
	Income taxes	270	281	282	294	308
	Misc. income	2	4	4	19 ⁷	23
	Indirect taxes	74	77	76	68	75
	General Revenue income	346	362	361	381	406
	Departmental operating income	31	34	35	34	34⁸
	Total revenue income	377	396	396	415	440
	Net departmental expenditure	(333)	(342)	(346)	(353)	(366)
	Exp. of departmental operating income	(31)	(34)	(35)	(34)	(34)
	Gross departmental expenditure	(364)	(375)	(381)	(387)	(400)
	Revenue surplus/(deficit)	13	21	15	28	40
	Routine capital expenditure	(17)	(16)	(13)	(7)	(7)
	Capital income	0	1	10	0	0
	Operating surplus/(deficit)	(3)	5	13	21	33
	Appropriation to Capital Reserve	(21)	(25)	(35)	(35)	(37)
	Other transfers			(3)		4
	Overall surplus/(deficit)	(24)	(20)	(25)	(14)	0
Social Security Funds	Income: Social Insurance Contributions	144	148	151	160	158
	Income: Grant	18	18	18	19	20
	Total Income	162	167	170	179	178
	Expenditure: GIF	(110)	(119)	(125)	(130)	(135)
	Expenditure: GHBF	(36)	(36)	(36)	(38)	(39)
	Expenditure: LTC	(16)	(17)	(17)	(18)	(19)
	Depreciation charge	(1)	(1)	(1)	-	-
	Total Expenditure	(163)	(173)	(179)	(185)	(193)
	Social Security Funds: Operating surplus/(deficit)	(1)	(5)	(9)	(6)	(15)
	Aggregate: surplus/(deficit) before investment return	(25)	(25)	(34)	(20)	(15)

⁷ The 2015 Budget presents a redistribution of income between misc. income and indirect taxes.

⁸ Estimates of operating income for 2015 were not available at the time of publication. These are assumed to be unchanged in 2015.

Aggregate expenditure, capturing both General Revenue expenditure and expenditure from the Social Security funds, totalled £588m in 2013; a money terms increase of £18m from 2012. In real terms, this is a 0.3% increase in expenditure; a smaller increase than 2012 due to continuing expenditure restraint within the revenue budget.

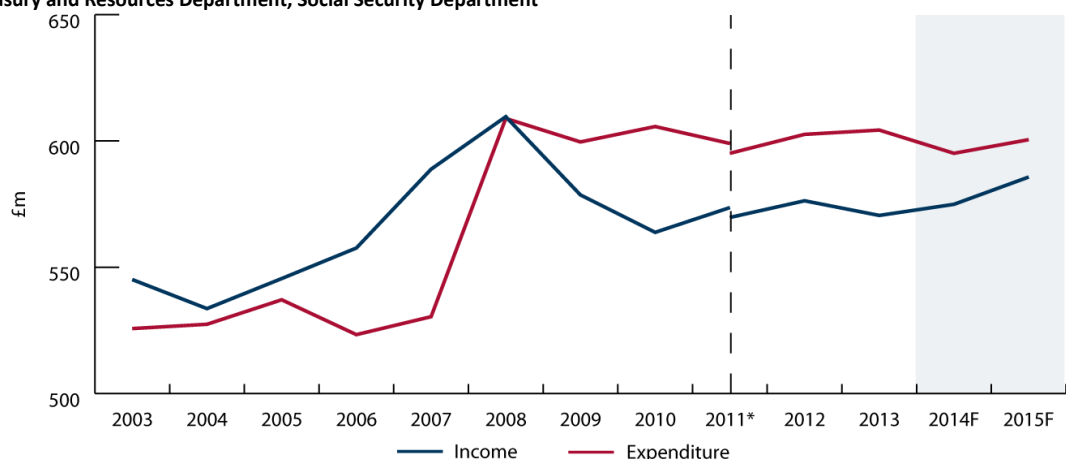
In 2012, approximately a third of the increase in aggregate spending was due to the increase in old age pension expenditure, a consequence of an increase in the number of claimants rather than an increase to the amount of pension benefit paid to individuals. Since 2012, pension expenditure has increased at a slower rate, with a smaller number of new claimants entering the system compared with 2012. This supports evidence that the peak of the baby-boomers reaching retirement has been reached. However, the annual average number of new claimants expected to begin claiming their pension between 2013 and 2015 is expected to be more than 25% higher than the 3-year average over 2008 to 2010. This increased level of new claims each year is expected to continue for an extended period of time. Best available estimates suggest this could last 30-40 years.

Aggregate income in 2013, capturing both General Revenue and Social Security contributions, totalled £9m more than the previous year, but in real terms this represented a decrease of 1%. Weak government income, which is reflected in both the General Revenue and Social Security Accounts, is a manifestation of the weak labour market, which has led to both lower levels of employment and a real decrease in median earnings. Income is expected to increase in real terms in 2014 and 2015, in part reflecting the income measures outlined in the 2015 budget.

Figure 5.2.1. Aggregate income and expenditure, 2003-2015

At 2013 prices, as at October 2014

Source: Treasury and Resources Department, Social Security Department



*Series break reflects the transfer of waste water services and associated operating income and expenditure to Guernsey Water thereby removing it from the revenue budget on an ongoing basis

Despite General Revenue expenditure being held in check once again, aggregate expenditure increased slightly (by 0.3%) in real terms in 2013. As in previous years, the upward push from pensions is the largest contributing factor. However, the expected contraction in General Revenue expenditure in 2014 is expected to result in aggregate expenditure in 2014 and 2015 being lower than in 2013 in real terms.

Figure 5.2.2 illustrates the continuing growth expenditure by the Social Security Department relative to total spending and the growing operating deficit on the Social Security budget. This deficit has increased to an anticipated £15m in 2015 due largely, as stated above, to increasing expenditure on pensions (and, to a lesser extent, other benefits). The number of pension claims increased from 16,188 in 2012 to 16,575 in

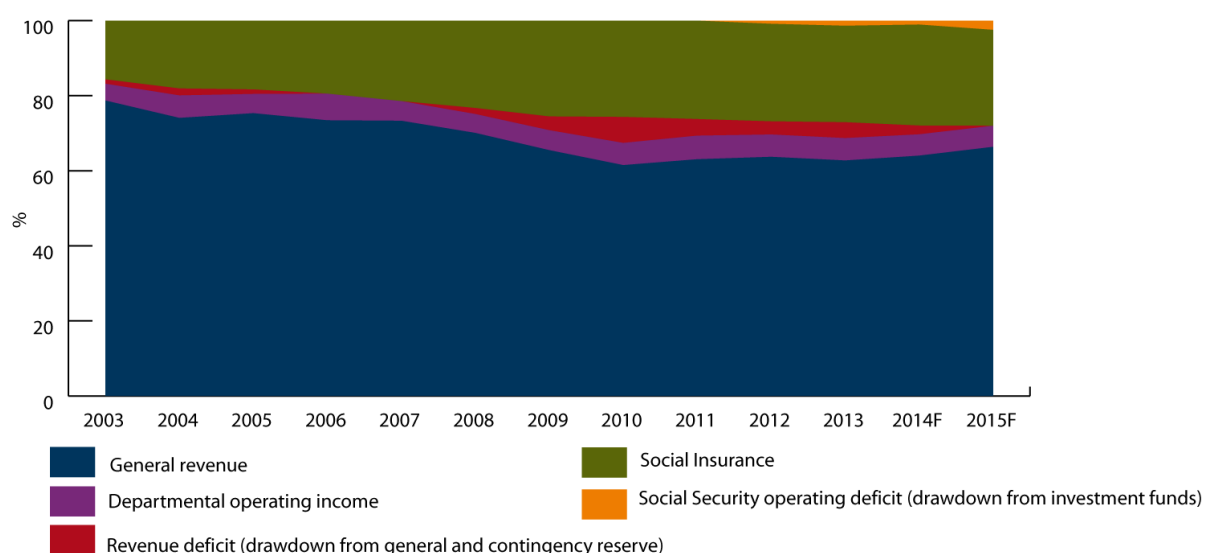
2013, increasing expenditure from £94.7m to £101.0m. Further increases in spending on pensions are anticipated in 2014 and 2015. The rate of the old-age pension increased by 3.6% (0.5 percentage points above the RPIX rate for June 2012). However, pension increases for 2014 have been restrained to the RPIX rate of 2.1%, bringing the maximum benefit payable to £196.90 per week. Proposals presented by the Social Security Department recommend restraining the increase in pension payments to RPIX again in 2015.

The operating deficit on Social Security funds is growing. While at the moment the shortfall is more than compensated by the investment return on the consolidated funds, further draw-downs from reserves over an extended period of time are planned, so the investment return will not keep pace with growing expenditure. Social Security spending will need to be carefully managed to prevent exhaustion of these reserves and to allow the reserves to be rebuilt in the future.

Figure 5.2.2. Distribution of aggregate expenditure by funding source 2003-2015

As at October 2014

Source: Treasury and Resources Department, Social Security Department



The proportion of aggregate expenditure on health decreased in 2013, 2014 and 2015 (**Figure 5.2.3**) despite the Health and Social Services Department (HSSD) having exceeded their annual budget in 2013 and the expectation that they will do so again in 2014. This is a reflection of real reductions in expenditure by both HSSD and the Guernsey Health Service Fund (GHSF) in both 2013 and 2014.

Although actual capital expenditure did not increase in 2013, the amount appropriated to the capital reserve increased and is reflected in **Figure 5.2.4**.

The proportion of spending on pensions and benefits continues to increase (**Figure 5.2.5**), primarily due to increased pension claims but also to small real increases in other contributory benefits including long-term care and Supplementary Benefit. The number of claimants for lower level long-term care grants increased and expenditure in this area increased by 1.2%; expenditure for more intensive long-term care increased by 4.2%;

“The increase is due mainly to the general rate of benefit increasing by 3.6% with demand remaining fairly static” (States of Guernsey-Consolidated Contributory Funds Report and Financial Statements 2013).

The 4.4% increase in Supplementary Benefit spending was partly due to the 3.1% increase in the benefit rate with the remainder due to other factors, probably related to the weak employment market.

The proportion of expenditure on all other public services decreased in 2013 (**Figure 5.2.6**), the result of increased expenditure in the areas already highlighted being offset by a real reduction in expenditure on the remaining public services (excluding HSSD and Social Security, which are outside the scope of the Fiscal Framework and this review).

Figure 5.2.3. Proportion of aggregate expenditure spent on Health

Including expenditure by Health and Social Services (gross) and the Guernsey Health Service Fund

As percentage of aggregate expenditure, as at October 2014

Source: Treasury and Resources Department

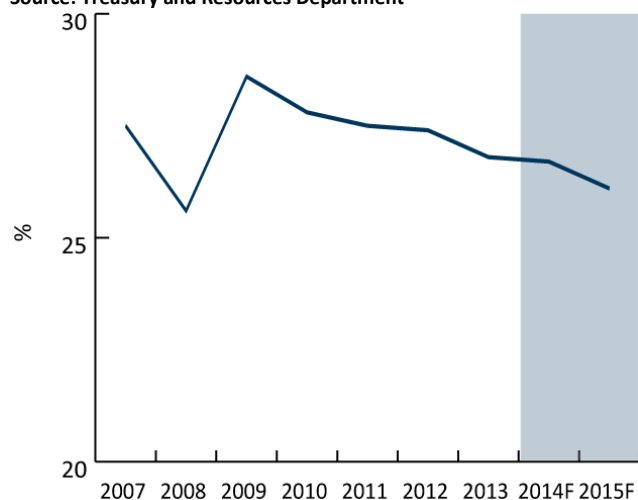


Figure 5.2.4. Proportion of aggregate expenditure spent on Capital

Including routine capital expenditure and the allocation to the Capital Reserve

As percentage of aggregate expenditure, as at October 2014

Source: Treasury and Resources Department

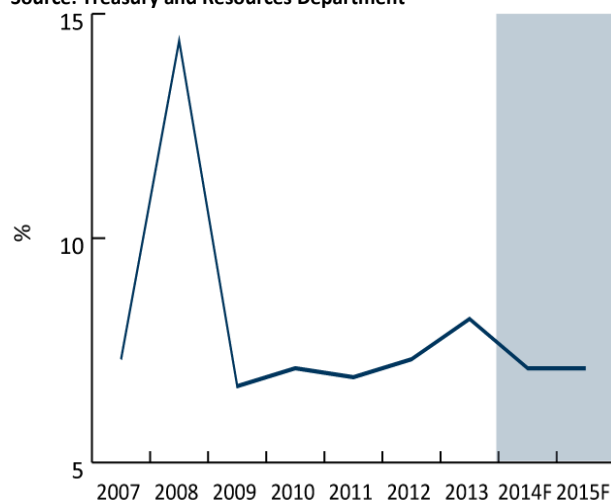


Figure 5.2.5. Proportion of aggregate expenditure spent on benefits, pensions and long-term care

Including non-contributory benefits, GIF, and LTCF

As percentage of aggregate expenditure, as at October 2014

Source: Treasury and Resources Department

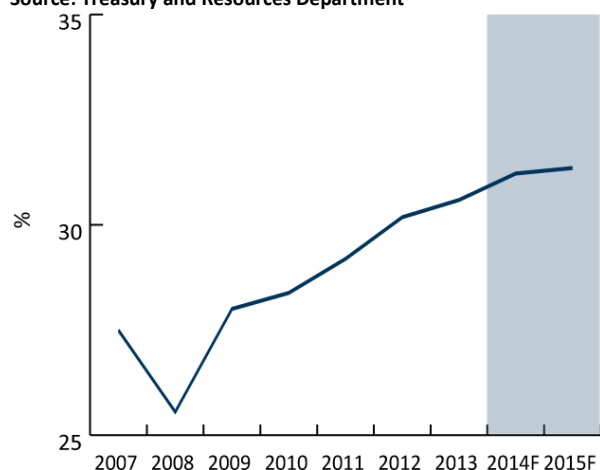
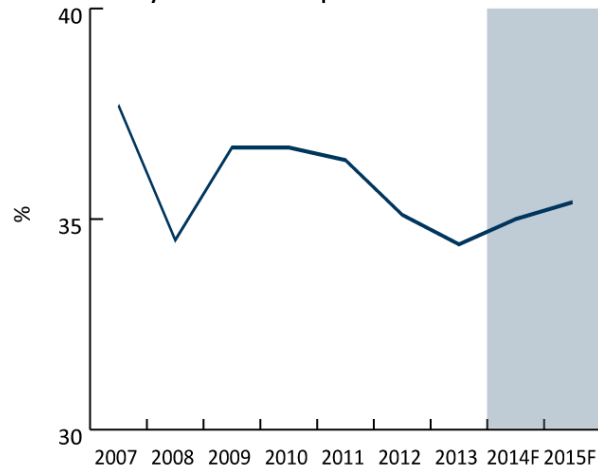


Figure 5.2.6. Proportion of aggregate expenditure spent on all other public services

Including education and all other expenditure not captured by figures 5.2.2 to 5.2.4

As percentage of aggregate expenditure, as at October 2014

Source: Treasury and Resources Department

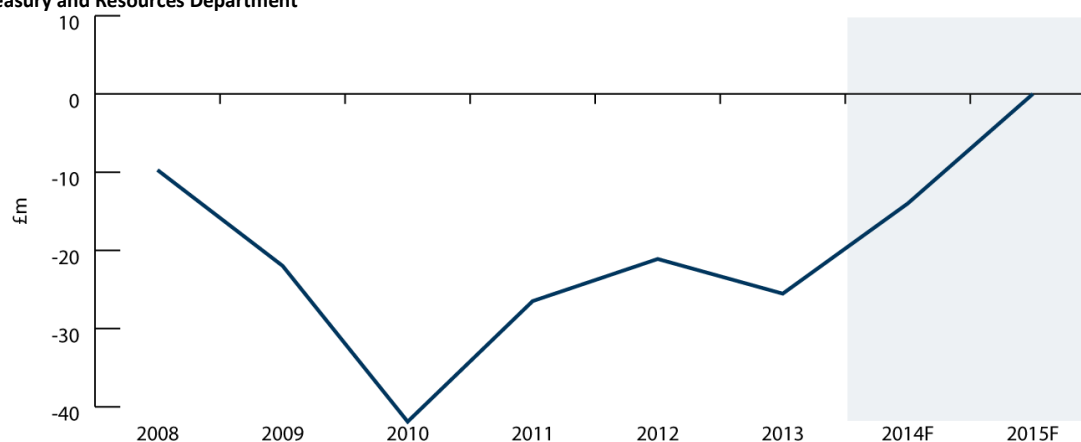


5.3. General Revenue

Figure 5.3.1. Overall Fiscal Position 2008-2015

At 2014 prices, as at October 2014

Source: Treasury and Resources Department



The 2013 General Revenue accounts reported the sixth successive year of deficit. This deficit increased by approximately £4m in real terms following two successive years in which the deficit had been reduced. The increase in the deficit was in line with, though lower than, the 2013 Budget prediction of a £27m overall deficit in nominal terms.

The 2015 budget projects a reduction of the deficit in 2014 to £14m in line with original budget estimates and a return to balance in 2015, albeit that this balance includes the transfer of £4m from the General Revenue Reserve Account to clear a comparatively small underlying balance.

At the inception of zero/10, the States' had hoped that economic growth would aid the closing of the deficit. Given the turn of events the global economy took in 2009, it is unsurprising that this did not happen. However, the continuing lack of economic and revenue growth has exacerbated the situation.

As shown in **Figure 5.3.2**, the worsening in real terms of the current overall position in 2013 is due to a real terms decrease in income. Total revenue income (including capital and departmental operating income) decreased by 1.1% in real terms, following two years of increases. Both corporate and personal income taxes fell in real terms, as did indirect taxes. These falls reflect the continuing weakness in the labour market during 2013 and, perhaps, the decline in the overall population. To a lesser extent, the continuing weakness in the property market has also impacted States' revenues with receipts from document duty well under budget.

General Revenue in real terms is now approximately 10% below the level before the introduction of zero/10 and the financial crisis. However, the current estimate suggests revenue income should rise in 2014 and 2015.

The weakness in income receipts in 2013 was offset by the States' continuing success in achieving real-term reductions in expenditure. While the annual decreases themselves may seem individually small, to have not only held expenditure in check, but to have reduced revenue expenditure by a total of 5.7% over a five year period with no real cuts in public services is an achievement which fully deserves to be commended.

Net revenue expenditure by departments (excluding that funded by operating income such as fees and charges) fell only slightly in real terms by 0.1% in 2013. Encouraging is the fact that overall, departmental

spending was kept within the original budget. However, this has been achieved with recourse to the Budget reserve and a number of departments spent more than their original budget, although all but two managed to stay within authorised limits.

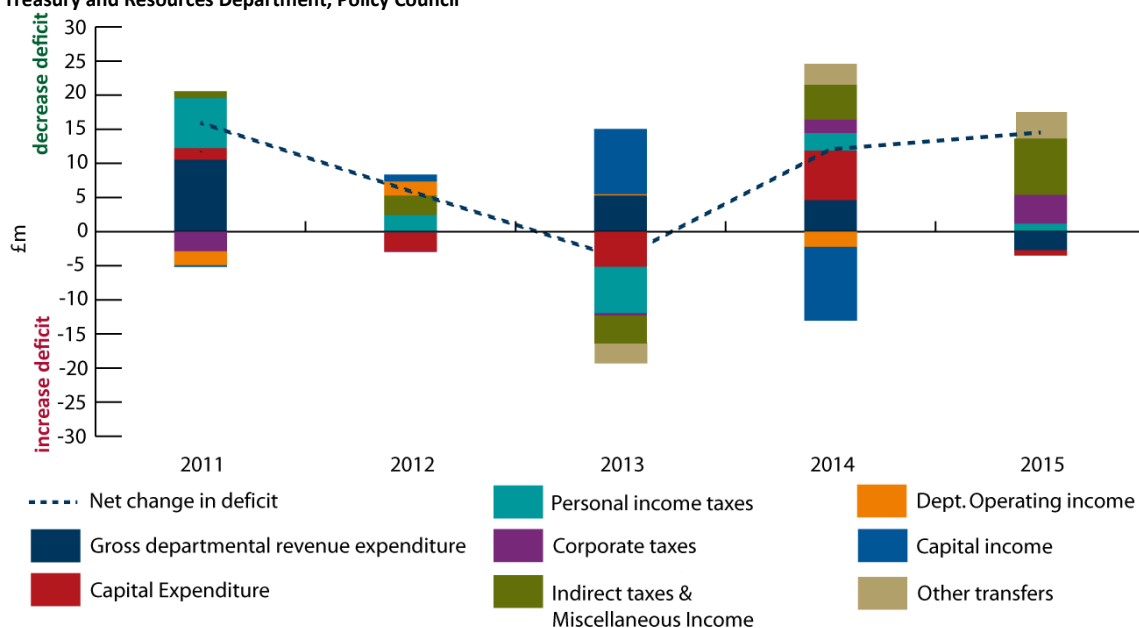
Once again, HSSD did not meet their authorised budget and overspent by approximately £300,000 (£4m when compared with the original budget of £108.2m) in 2013. However, the Department did reduce gross expenditure in real terms by nearly 2% in 2013. It is expected that HSSD will once again exceed their budget in 2014. However, if current outrun estimates prove correct, the Department will have achieved a decrease in spending in both real and nominal terms. While the Department may not have achieved its target, the reduction it has achieved should be commended, particularly given the demand-led nature of much of its expenditure and high inflation associated with medical costs.

Total revenue expenditure (including expenditure of operating income, and allocation of funds to the Capital Reserve) in 2013 equalled, in real terms, the figure reported in 2012. This expenditure includes the transfer of an additional £10m of one-off capital income to the Capital Reserve, raised from a share repurchase by Guernsey Post Ltd⁹ and the sale of a property. The estimates of spending for 2014 show a further reduction in spending contributing to the reduction in the deficit, together with an improvement in both personal and corporate tax receipts in real terms.

Figure 5.3.2. Contribution to real annual change in fiscal position 2011-2015

At 2013 prices, as at October 2014

Source: Treasury and Resources Department, Policy Council



⁹ Return of capital to the States of Guernsey as sole Shareholder of Guernsey Post Ltd.

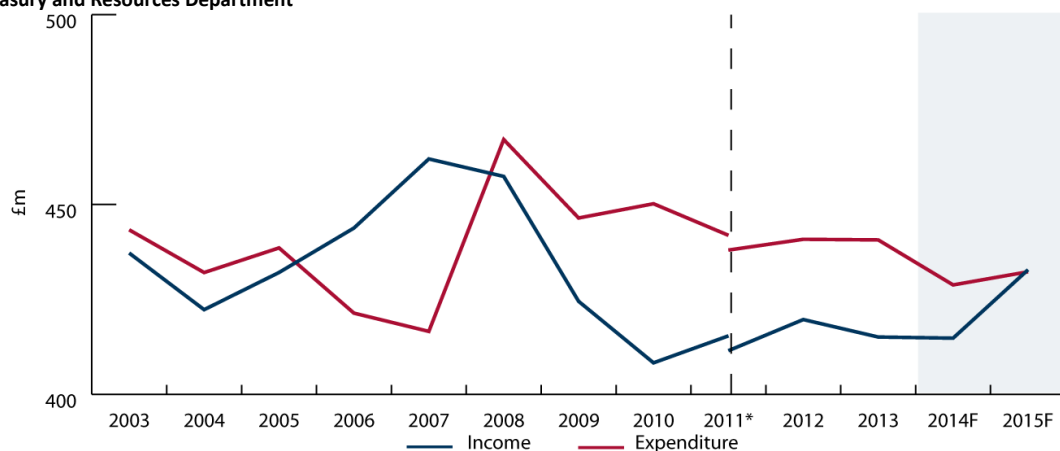
Looking forward, proposals to extend the 10% rate of income tax on corporate entities to include fund administration activities may go some way to reducing the deficit in 2015, although estimates suggest that the additional revenue raised will be modest. It should be emphasised that the extension to capture insurance and fiduciary business in 2013 did not raise as much revenue as expected; ***it is a widespread finding that tax increases do not bring in the amount of revenue forecast when they are proposed.*** Other tax measures, including the increases in both domestic and commercial TRP rate should also improve the fiscal position. However, when considering indirect taxes on corporations, it is important to ensure that these taxes do not become a barrier to businesses.

It is to be hoped that improving economic conditions will feed through to government revenue but, particularly in light of the continuing weak economic conditions and slow growth, this should not be depended upon.

The Financial Transformation Programme is scheduled to end in December 2014 and the States must start looking beyond the end of this programme. The Treasury and Resources Department has stated that, in addition to continuing efforts to achieve the savings identified within the FTP but not achieved by the target date, it intends to continue its commitment to achieving internal efficiencies beyond the end of the current programme, with further projects such as the Strategic Asset Management Plan. There may well be significant savings to be had through such projects, but they are likely to be more long-term in achievement, with most of the “easy wins” having been made during the life-span of the FTP.

Figure 5.3.3. Total revenue income and expenditure, 2003 – 2015

Total revenue income and expenditure (incl. Dept. operating income and capital income and expenditure), at 2013 prices, as at October 2014
Source: Treasury and Resources Department



*Series break reflects the transfer of waste water services and associated operating income and expenditure to Guernsey Water thereby removing it from the revenue budget on an ongoing basis

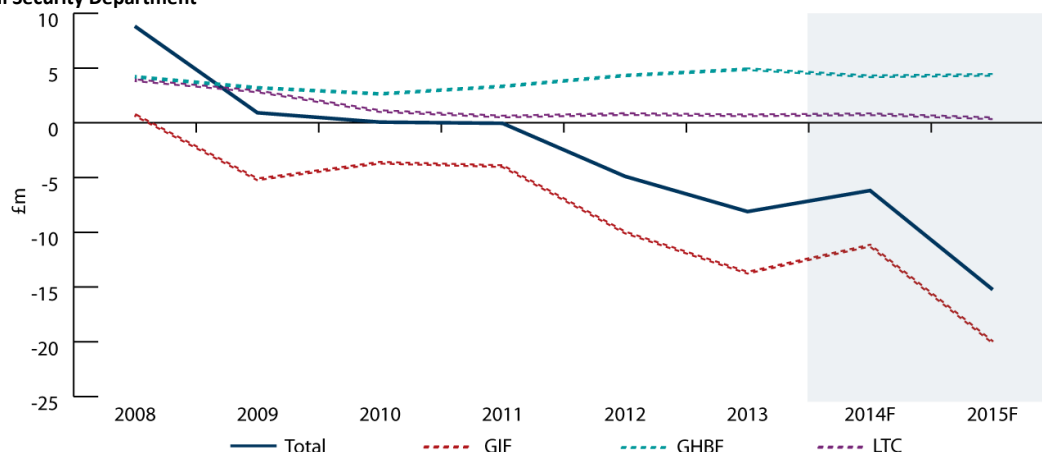
5.4. Social Security

Because the growth in Social Security expenditure has been greater than the growth in income from Social Security contributions, the combined operating surplus (excluding income from investments) made by the funds has declined over the last five years. In 2013, the funds reported an increasing combined operating deficit of £8m, driven primarily by the £14m deficit on the Guernsey Insurance Fund [GIF]. While both the Guernsey Health Benefit Fund and the Long-Term Care Fund are expected to make small operating surpluses in 2014 and 2015, the deficit on the GIF is expected to grow to £20m in 2015.

Figure 5.4.1. Operating surplus/(deficit), 2008-2015

Operating deficit of SSD administered funds, at 2013 prices, as at October 2014

Source: Social Security Department



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 every year throughout the last decade. This is largely a result of the increase in employers' contribution rates introduced in 2008 and the increase in the upper earnings limit for the payment of employees' Social Security contributions phased between 2006 and 2014.

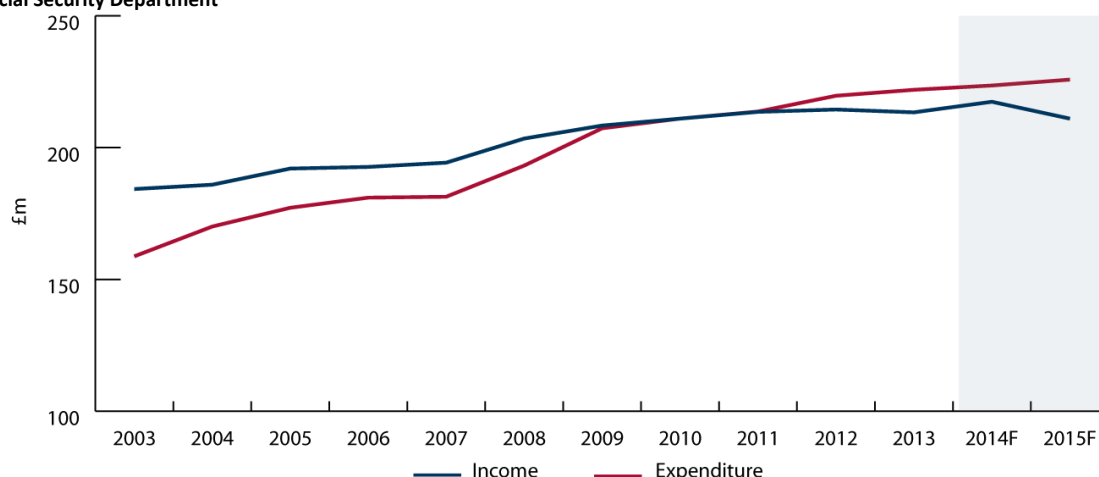
The rate of increase in expenditure from the GIF has slowed down considerably with real increases falling from 4.8% in 2012¹⁰ to less than 2% in 2013, 2014 and 2015. Expenditure from both the GIF and LTCF has increased in real terms by 24% over the five year period ending 2013 and this steady increase is expected to continue. In contrast, real expenditure from the Health Service Fund has fallen by 6.6% over the same period and is expected to fall further by 2015.

¹⁰ This increase reflects the movement of Guernsey's largest age cohort, those born in 1946/7 into pensionable age.

Figure 5.4.2. Total Social Security income and expenditure, 2003-2015

Including contributions, revenue grant and payment of non-contributory benefits from General Revenue, at 2013 prices, as at October 2014

Source: Social Security Department



Despite the operating deficit on the Social Security funds, the continuing good investment performance of the Social Security Common Investment Fund (which supports the payment of insurance benefits in Guernsey) means that total reserves held by Social Security increased by £50m to £810m at the close of 2013. The investment income generated by these funds has traditionally helped support the payment of benefits. However, the growing deficit is forecast to erode the capital held over time.

This deficit is not unexpected. It has been acknowledged that it will be necessary to utilise the GIF's investment income and reserves to support expenditure from the fund through an extended period of imbalance. However, actuarial projections show that the funds allocated to the GIF will be exhausted by the middle of this century unless action is taken. A long-term solution to the sustainable provision of old-age pensions in particular is still required if these funds are to be made sustainable in the long-term (see **section 6** for more detail).

While currently showing an operating surplus, the projected position on the LTC fund is worse; central projections indicate that with no change, this fund would be exhausted in about 10 years. Again, a long-term solution is needed.

The Personal Tax, Pensions, and Benefits Review will continue into 2015. The Review is expected to include proposals to manage the projected increase in the expenditure from the Guernsey Insurance Fund, particularly with regards to pensions. Separately, the Policy Council's Supported Living and Ageing Well project is to consider, among other things, how long term-care in Guernsey is structured and financed.

6. Fiscal demands: old and new

Decisions on the States' fiscal future in both the short- and long-term remain outstanding. It is important that the States consider short- and long-term problems together. To resolve short-term issues to the detriment of long-term stability would be imprudent, as would losing sight of the current imbalance when considering long-term fiscal pressures.

6.1.1. The deficit, capital expenditure and estimating the structural position

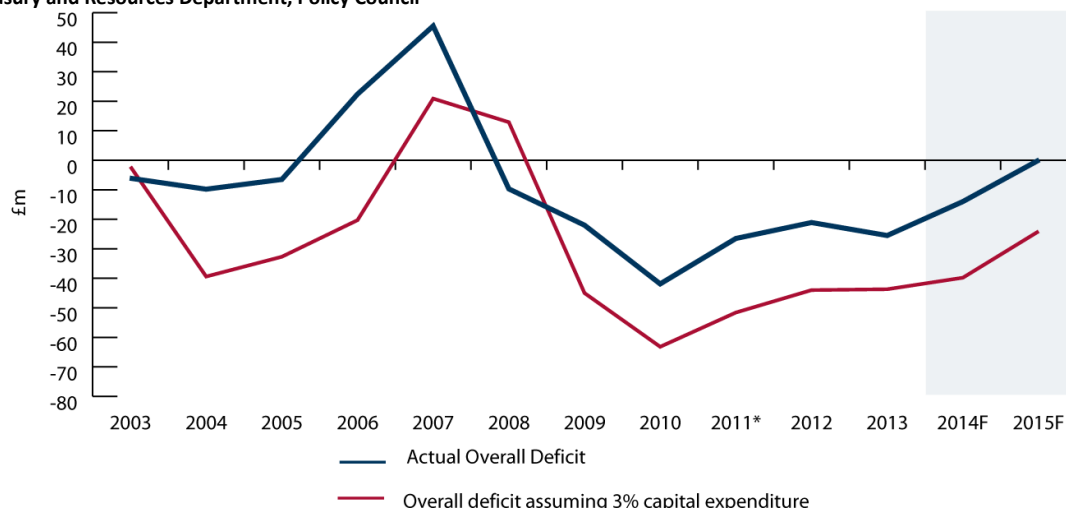
In the short-term there remains a small deficit. While the deficit remains small in relation to total expenditure, it has increased in 2013 due to weaker than anticipated tax receipts. The 2015 Budget presents an expected reduction in the deficit to £14m, with a return to balance (albeit with recourse to a relatively small drawdown from the General Revenue Reserve Account to cover the delay in realisation of the final savings from the FTP), with a true balance anticipated in 2016 or 2017.

However, as previously stated the States are not allocating sufficient reserves to capital spending and were £15m short of this target in 2013. If it were assumed that the States met this target, the overall deficit in 2013 would have stood at £40m, 1.8% of GDP. Projected forward to 2015, this implies a continuing underlying deficit in 2015.

Figure 6.1.2. Reported overall deficit adjusted for under investment in capital expenditure

As a percentage of GDP, as at October 2014

Source: Treasury and Resources Department, Policy Council



There is undoubtedly a cyclical component to this but, as stated in previous reports, the extent of this is difficult to assess with any accuracy.

As previously remarked, proposals to extend the 10% rate of income tax on corporate entities to include fund administration activities may go some way to reducing the deficit, adding an estimated £3m a year to revenue according to the Treasury and Resources Department. If this can be achieved without damaging Guernsey's competitive position, it should help reduce the deficit but alone it is not enough to restore fiscal balance, and we would repeat our caution that forecasts of revenue from tax increases almost universally turn out to be too high.

Other proposals in the 2015 budget include increases in indirect taxes on both households and corporate bodies. Combined with a freeze on personal tax allowances, these proposals are expected to add £6m to

States' income. While this expected return to balance may make it easier for the States to disentangle short- and long-term issues in the forthcoming Personal Tax, Pensions and Benefit Review, the need to balance short- and long-term objectives remains.

6.1.2. Financial Transformation Programme

The States' Financial Transformation Programme (FTP) is now approaching its scheduled close. We remarked in previous reports that the targets set for the FTP have become increasingly challenging as the programme has progressed. Overall it has been successful; however, concerns that the programme would not make its targets are realised in the latest progress report which shows the FTP may fall short of its £31.1m target by the end of 2014 by £1.8m. Although the achievements to date are considerable, and it is expected that these planned savings will eventually be realised, it is mildly disappointing that the programme has not been able to deliver these savings on time. Nevertheless, if current forecasts prove accurate, to have reduced annual net revenue expenditure by some 8% in five years is no small accomplishment. This is despite some departments, such as Health and Social Services and Education, struggling to meet their goals.

However, in the update delivered to the States in February 2014 it was reported that various departments achieved total "savings" of £810,000 through increasing rental income and charges. These rents and charges are incorporated into departmental operating income and are offset against expenditure and therefore reduce the *net* expenditure requirement of the department (i.e. the need for funding from the general taxation revenues).

While this is only a relatively small portion of the total savings made, the principle matters. If these charges reflect an appropriate charge – that is to say, what would be charged by an efficient private sector provider in a competitive market – they are justified (the original scope of the programme reviewed whether fees and charges were applied at an appropriate level but whether they are charged at a competitive price for the service was not extensively discussed).

However, accounting practices aside, they are an increase in income not a reduction in resources used by the States and the latter was the objective of the FTP. The charge increases may be sensible, but it is doubtful that they are a genuine saving

Figure 6.1.3. FTP forecast savings by year of delivery

Source: Treasury and Resources Department
As at: October 2014



The Treasury and Resources Department has signalled its intention to continue the drive for internal efficiency; this is, of course, to be commended. Further projects to increase efficiency, such as better use of States' properties, can be achieved in the long-term through careful planning but it must be recognised that there is a natural limit to how much cost saving can be achieved without cutting public services.

The States spend approximately 50% of their budget on staff costs and this is therefore an inevitable target for reducing expenditure. The Voluntary Severance Programme adopted in 2013 is estimated to have reduced annual staff costs by £1.5m, albeit that the programme entailed a one-off cost in the region of £4m.

Box 6.1. Fees and Charges

The States of Guernsey *Fees and Charges Policy Guidance* was produced to ensure fees and charges were set according to a transparent and predictable set of guidelines. Prior to introducing a charge, a number of questions need to be answered to establish how the charge will be categorised and how the cost will be calculated, which depends on whether the service is of more benefit to the public or to the individual.

The table below shows the categories of charges. Fees and charges falling into categories F-I are based on the calculation method set out in the States of Guernsey *Fees and Charges Policy Guidance*.

	Category	Description	Examples
A	Charges set by commercialised and independent entities	Not bound by calculation method in SoG Policy Guidance	Guernsey Post, Guernsey Airport
B	Profit making charges	Commercial enterprise in competition with other private sector organisations	Leasing publically owned buildings
C	Charges regulated as part of Social Security welfare provision	Not bound by calculation method in SoG Policy Guidance providing there is a standard method of calculation used and the cost and rate of subsidy is known by the Board and justified	Prescription charges
D	Charges defined by law	Not bound by calculation method in SoG Policy Guidance	
E	Fines	Fines for criminal offences are not bound by the calculation method in SoG Policy Guidance	
F	Civil penalties	Treated as category G or I depending on nature of penalty	
G	Charges which act as a disincentive	Calculated as per SoG Policy Guidance	
H	Permits and license fees	Calculated as per SoG Policy Guidance	
I	Cost recovery charges for service provision	Charge for which purpose is simply to recover cost - calculated as per SoG Policy Guidance	

Although policy guidance exists to encourage standardisation in the way fees and charges are levied, the principles for levying the charges are not clear. It is perfectly appropriate for the States to charge for certain services provided it does so in a transparent manner which reflects the cost to the States of providing the service and the value to the individual of such services, including consideration of what a user may expect to pay for such a service if it were available in the private sector. This principle is very important.

6.2. Long-term fiscal pressures

6.2.1. Personal Tax, Pensions and Benefits Review

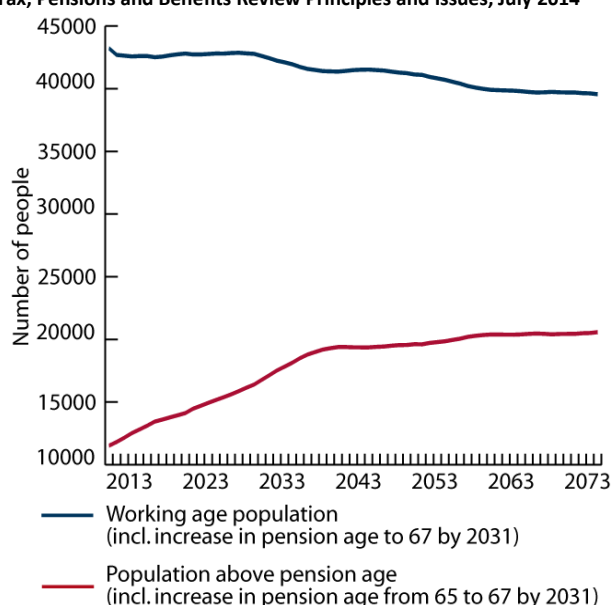
The States are continuing the process of reviewing its personal tax, pensions and benefits regime and recently released a document outlining the fiscal pressures ahead for Guernsey and Alderney. The document aims to inform the public on the main issues and outline possible solutions.

The main area of concern is the changing demographic structure of Guernsey - fewer working age adults and increasing numbers of retirees, both phenomena largely a product of the 'baby boom'. Previously, the States has balanced its income, the majority of which is taken from the working age population, with expenditure on services, much of which is provided to those not of working age. The balance between these groups is starting to tilt and problems and risks have been identified on both income and expenditure.

The review highlights matters which have been outlined in this report in previous years. Among these is the growing operational deficit in the Social Security accounts, which is primarily a result of the increasing amount required to be paid out in pensions each year.

Figure 6.2.1. Projected population: Working age and those above pension age

Source: States of Guernsey, Personal Tax, Pensions and Benefits Review Principles and Issues, July 2014



Action to mitigate the position commenced in 2009 when it was announced that the State pension age would be raised from 65 to 67, but this alone is unlikely to resolve the problem. Increasing the revenue to the GIF, either through increased Social Security contributions or an increase in the grant from General Revenue, is an option. However, given the other pressures on the States' expenditure in the long-term, it may be more prudent to consider other measures. These include a further increase in the pension age or reducing the level at which pensions are uprated on an annual basis, rather than increasing the overall tax burden.

It is important to remember that today's 65 year olds are likely to be fitter, healthier and more active than the average 65 year old when the current pension law was introduced in the 1960s. Encouraging people to remain active and engaged in the community and perhaps in work for longer, in general helps them remain

healthy for longer. It may also help mitigate some of the problems associated with the decline in the working age population.

Private pension provision and making such provision more accessible for the public is also under investigation. This is an important piece of work if the States is to avoid supporting an increasingly large proportion of the retired population on welfare benefits, as a result of what could prove to be a significant gap in the private provision of the local community.

In addition, as previously highlighted, the States must resolve the issue of how to sustain their capital programme in the long-term if it is to maintain its infrastructure.

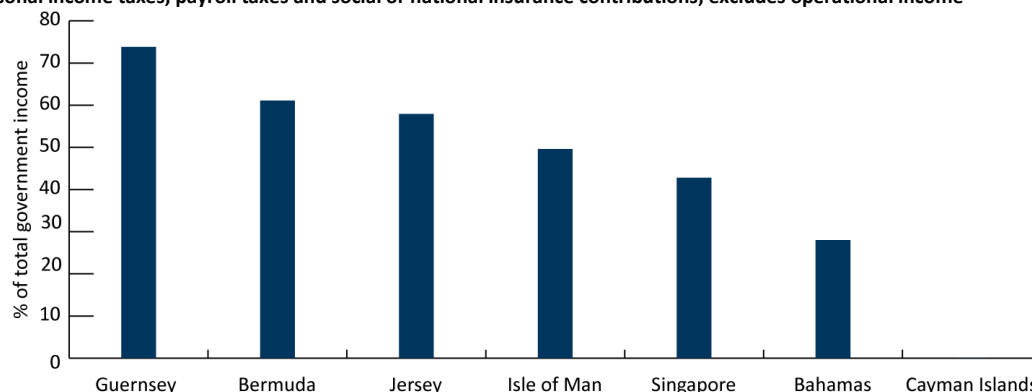
On the income side, Guernsey's current system is heavily reliant on personal income tax and Social Security contributions (**Figure 6.2.4**), a situation which is a direct result of the reduction in income tax on corporate profits resultant from the introduction of zero/10.

Broadening the tax base is on the discussion agenda. Guernsey's reliance on direct personal taxes relative to other jurisdictions is fairly high and a move to a broader range of income sources would bring Guernsey closer into alignment with practices elsewhere. Given Guernsey's economic structure, which rules out the use of capital taxes, and the need to retain a corporate tax regime which is competitive in comparison to other jurisdictions, particularly the other crown dependencies, the options available to do this are limited.

Figure 6.2.4: Comparison of reliance of direct taxes on income in island Jurisdictions as a percentage of total funding

Source: States of Guernsey, Personal Tax, Pensions and Benefits Review Principles and Issues, July 2014

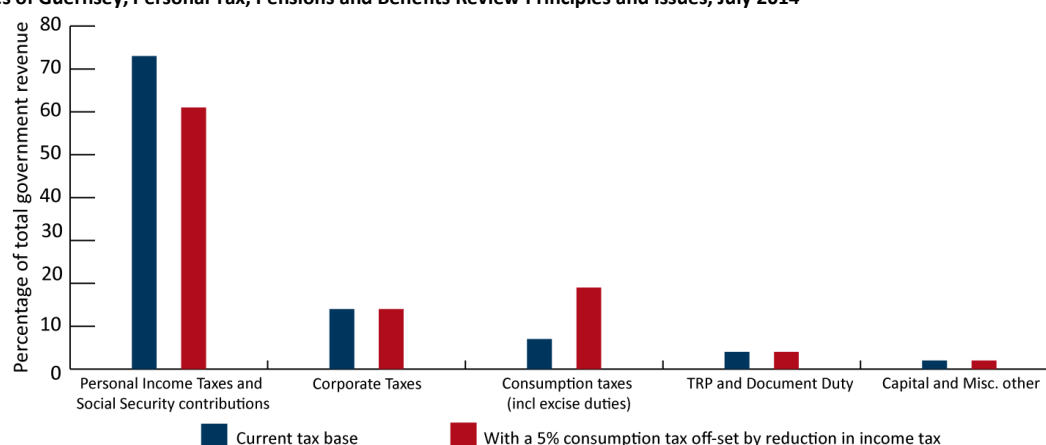
Includes: Personal income taxes, payroll taxes and social or national insurance contributions; excludes operational income



There are a number of proposals for consideration, including increased income tax or Social Security contributions, increased or special higher earners' rates, withdrawing personal allowances for higher earners (although if this were done, care would have to be taken to avoid the kind of bizarre and distorting structure of income tax rates applied in the UK) and introduction of a consumption tax. To protect lower income earners, increases in certain taxes could be partially offset by a reduction in income tax or an increase in personal allowances. **Figure 6.2.5** illustrates the broadening of the tax base assuming the introduction of 5% consumption tax.

Figure 6.2.5: Broadening the tax base with a 5% consumption tax

Source: States of Guernsey, Personal Tax, Pensions and Benefits Review Principles and Issues, July 2014



While introducing a consumption tax would broaden the tax base, it should be approached with caution. If not well designed, consumption taxes can become an administrative burden for business and government alike. Guernsey would be better to follow a simple, broad based GST model such as applied in New Zealand than to attempt to follow the far more complex VAT model applied in the UK. A consumption tax at a low rate and with a broad base is easier to administer, less of a burden to business and less distorting to behaviour. If the States choose to follow this path they should avoid the temptation to make a large number of exemptions and other complications. The danger of this route is that it introduces a very efficient revenue raiser.

The Treasury and Resources and Social Security Departments indicated their intention partially to offset any increases in indirect taxes (such as GST) with a reduction in direct taxes, i.e. income tax. Should the aim be to provide a revenue neutral solution (as has been indicated) there are two methods of achieving this; increasing the personal allowance or decreasing the headline rate. The distributional impact of these would be somewhat different.

The former would result in a marginally more progressive system benefiting lower middle income households. However, it would also remove a not insignificant number of households from the need to pay income taxes at all. While this may seem appealing at first glance, indirect taxes are usually not perceived by individuals in the same way as direct taxes. Removing a large portion of tax payers from the need to pay income tax (albeit that they would be liable for indirect taxes) risks a portion of the population losing their perception of a stake in the government.

Reducing the headline tax rate would be a less progressive option and higher income households would receive more benefit from this than those on lower income. However, reducing the headline tax rate is more likely to create a competitive advantage in attracting high value employment to Guernsey than would be increasing allowances. It should also be noted that such rate reductions have a history of increasing revenue.

Neither option will benefit those who are already below the tax threshold. If they are to be compensated for the increase in their costs, it will need to be achieved by other means.

While outside the remit of the Personal Tax Pensions and Benefits Review, the possibilities of what might be achieved within the corporate tax area are inevitably of interest. Maintaining a stable and competitive corporate tax system is critical to Guernsey's economic model.

With effect from January 2013, although the standard rate for corporate Income Tax will remain at 0%, the company intermediate income tax rate (10%) is extended to banking activity, licensed fiduciaries (in respect of regulated activities), licensed insurers (in respect of domestic business) and licensed insurance intermediaries and licensed insurance managers (in respect of the carrying on of business and acting as such). Budget recommendations are to extend this further to capture fund administrators (but not fund managers) in 2015.

Companies do not pay tax; corporate tax is a cost passed on to individuals such as shareholders, customers, suppliers and employees, many of whom are already taxpayers. The benefit of extending the field of corporate taxes in Guernsey would mainly be achieved by taxing companies with non-resident shareholders and the benefit, in terms of additional income, may well be less than expected, particularly given the competitive risk.

6.2.1 Social Welfare Benefits Investigation Committee (SWBIC) and Supported Living and Ageing Well Strategy (SLAWS)

Related to the Personal Tax, Pensions and Benefits Review, there are two major on-going States projects which will affect Social Security funding in the near future. The Social Welfare Benefits Investigation Committee (SWBIC) has been set up to reform the Social Welfare system and make it more equitable to all users, and The Supported Living and Ageing Well Strategy (SLAWS) is set to review the long-term care needs of the Bailiwick of Guernsey's population.

SWBIC has also been formed to tackle the complexity currently present in the provision of supplementary benefit and rent rebates. The two systems apply different requirements for assessing whether a household is eligible to claim the benefits they respectively offer and how much the household will then receive. This creates inconsistencies in the system. Removing these inconsistencies is a sensible objective. However, previous reports on the issues indicate the solution is likely to require a significant additional increase in spending on means tested welfare benefits, an area in which the costs can prove difficult to control.

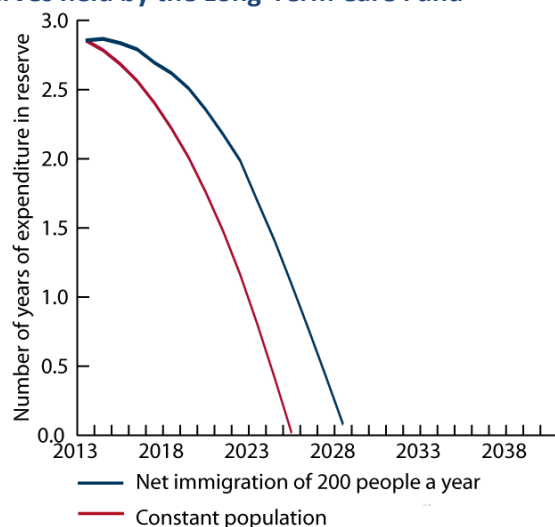
The Supported Living and Ageing Well Strategy (SLAWS) seeks to address the care, support and supported accommodation needs of the Island's older people and other adults (18+) who require long-term care services, by reviewing how housing and health and social care services are provided for them (see **Appendix 4** for the Objectives and Principles of SLAWS).

Continuation of the current systems of provision is considered financially unsustainable due to the ageing population and the forecast consequent reduction in the Long-term Care Insurance Fund reserves (See **Figure 6.2.3**). There are also significant implications for services funded from General Revenue such as social services provided by the HSSD and accommodation provided by the Housing Department. It is intended that SLAWS will set out actions necessary to address these issues. If approved by the States, these are likely to need to be implemented over an extended period of time.

The evidence suggests that doing nothing is an expensive option. Projections indicate that the Long Term Care Fund, which supports a significant proportion (but not all) of the services under review by the working party, will be exhausted within the next 10-15 years if action is not taken. To continue the provision of long term care under the current model would require a significant increase in Social Security contributions to stabilise the fund. Estimates suggest the increase in the contribution rate needed to support the current

scheme could in exceed 1 percentage point, bringing in approximately £18m at the current level of contributions. This does not factor in the potential increase in the cost of care services currently provided by the Health and Social Services and Housing Departments. Given the scale of potential costs involved it would be advisable to take action sooner rather than later.

Figure 6.2.3. Projected reserves held by the Long-Term Care Fund



6.2.2 Alderney: population and problems

Alderney is governed separately from Guernsey but the two islands are in fiscal union and, as a result, difficulties facing Alderney will impact both Islands.

The 2013 Alderney Census Report reported a decrease of 17% in the population of Alderney since 2001, taking the total population to 1,903. The population was at a peak in the decade 1991-2001. Like Guernsey, Alderney is faced with an ageing population, albeit that the statistics from Alderney suggest that this is a much more significant and current problem than in Guernsey. Despite the decrease in the total population, there has been an increase of 31% in the number of people aged between 60 and 69 between 2001 and 2013, while the number of young working age people (age 20-39) decreased by 47% over the same period. Approximately 50% of the Island's population is already aged 55 or over and the average age is nearly ten years older than the average age of the population in Guernsey.

A lack of employment opportunities has been identified as the major contributory factor in the decrease in the population. Alderney has become a home to some of the large online gambling operators, a strong contributor to the economy, together with a modest finance sector. Other employment sectors have suffered over the last few years and, in general, total employment has declined.

Unemployment is low but this can be attributed to the transient population. The known shortage of employment opportunities means that many who become unemployed relocate rather than attempt to seek alternative employment in Alderney. As a result, the proportion of economically active people remains relatively unchanged (down by 1%), but there were 202 fewer people employed on the Island in 2013 than in 2001.

However, for some, migration to the Island is still appealing; especially to retirement age individuals from the UK, due to the Open Market housing and low taxation. Some 747 new residents migrated to Alderney between 2001 and 2013 to offset the departure of 1,138 former residents.

Alderney, a region of the Bailiwick of Guernsey, is now faced with the challenge of increasing its working population and needs to identify new employment opportunities to attract economically active individuals.

Currently on the agenda in Alderney is whether it would be cost effective to develop Alderney's airport runway to accommodate larger aircraft in an effort to encourage further employment opportunities. Given its small size and relatively remote location, accessibility (or lack of it) is likely to be a key factor for the location of business in Alderney and providing links to a greater range of destinations could be beneficial to the economy. However, such work comes at a cost in terms of both building and maintenance. Careful cost benefit analysis is needed, as well as an analysis of what other measures would allow Alderney to capitalise on the improved accessibility.

Adding to Alderney's economic problems are the costs of sustaining services, such as health and education, in such a small area, and one separated from Guernsey by a sometimes rather turbulent sea. Newcomers to the Island often expect to receive the same level of services experienced when living in larger jurisdictions, but this is just not cost effective, or in some cases even possible, for such a small population. There is, for example, no formal post-16 education and the functions of the Island's hospital are limited.

Those services which are provided are expensive. While no detailed data are available on the relative cost of services in Alderney, it is generally understood that the per capita cost is significantly higher than the cost of providing these services in Guernsey. Meeting Alderney's needs in a sustainable way is a difficult challenge requiring a careful balance between the high cost of providing services and the social and economic benefit they may have.

It is clear that the States of Alderney and Guernsey need to work together to solve Alderney's economic and demographic problems. Given the projections of Guernsey's own aging population, working on the problems of Alderney may prove valuable when faced with similar demographic problems in Guernsey in the future.

7. Conclusion

The States' finances are in a better position than they have been for some time. The 2015 Budget shows not only continuing success in restraining overall expenditure levels, but also a clear path for returning the Budget to balance. While the FTP is not expected to meet its target on time, much has been achieved. It is expected that the required remaining savings will be achieved, or even exceeded, by the end of 2017. Reducing government expenditure is no easy task and the States are to be congratulated on what has been achieved.

Adopting the proposal to establish a Transformational and Transition Fund, to support the continuation of the work begun by the FTP in transforming public services, would be a very wise move. Having made such a promising beginning, the States should capitalise on it.

Despite Guernsey's economy still being weak from the global crisis, the short-term deficit problem is being tackled. The States must now, on the sound foundation provided by that achievement, turn its attention to long-term pressures if it is to secure long-term balance in the future.

The aging of the population is not a problem unique to Guernsey. But it is one that could exert a considerable amount of pressure to both the General Revenue and Social Security Budgets, and it is highly commendable that Guernsey is addressing this matter before many other countries have given it more than token consideration. Expenditure in areas such as old-age pensions and health and social care will need careful management if the States are to keep their aggregate income and expenditure in check. While it is tempting to hope that economic growth will ease this problem, the experience of the last five or six years demonstrates that this cannot be relied on.

The Personal Tax, Pensions and Benefits Review has asked "How big should our government be?" and has extended this question to both the General Revenue and the Social Security budgets. Given how much of the long-term expenditure pressure will fall on the Social Security budget, the suggested limit on *aggregate* income is a sensible move. Bringing the Social Security Budget within the boundaries of the Fiscal Framework could provide greater transparency, control, and accountability over total spending and should be fully supported.

Alderney and its struggling economy and declining population present a further challenge the States will have to face. Developing a strategic approach to adapting to Guernsey's own aging population in a fiscally sustainable way will undoubtedly help in this.

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Appendix 1. Extract from the Fiscal Framework

Source: 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

Source: Annual Independent Fiscal Review 2011

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', administered 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'.

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. Funding Social Security

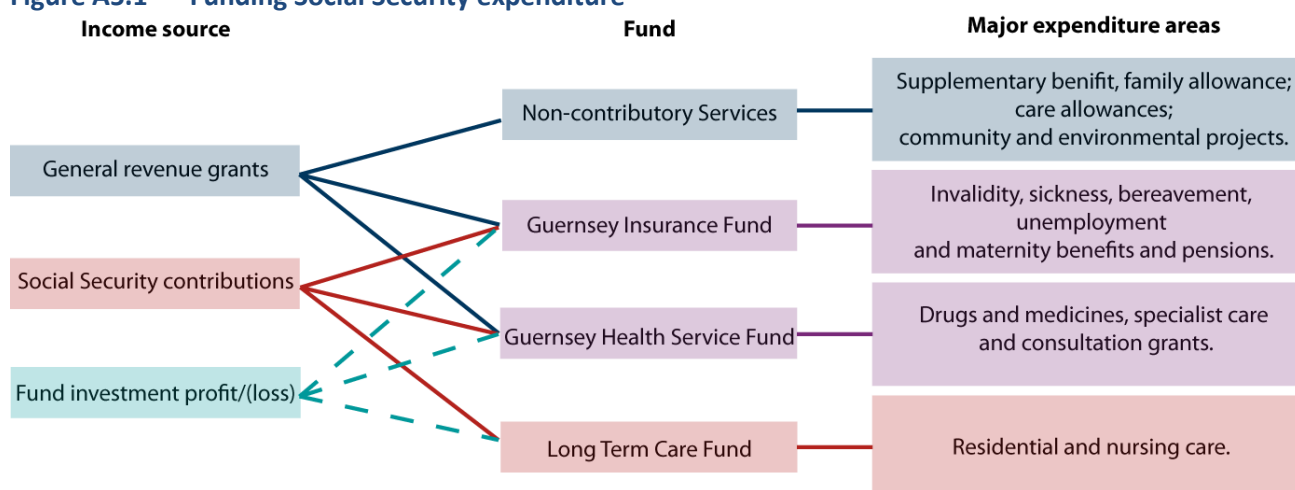
The Social Security Department is responsible for the payment of social benefits in Guernsey. The departmental expenditure is funded by a mix of grants from General Revenue and Social Security contributions (see **Figure A.5.1**).

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, this 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 A5.1 Funding Social Security expenditure



Appendix 4. Objectives and Principles of The Supported Living and Ageing Well Strategy

The Supported Living and Ageing Well Strategy Working Party has agreed a set of objectives and principles.

Objectives

- Reduce, where possible the incidence of adults (18+) having enduring care, support or supported accommodation needs.
- Improve outcomes for all adults (18+) with enduring care, support or supported accommodation needs.
- Protect the health and well-being of the carers of those with care and support needs.

Principles

- Promote improve and protect individuals' health, well-being and dignity.
- Ensure there are opportunities for independence and choice.
- Enable fair access to appropriate care and support and suitable housing.
- To establish a partnership culture whereby the public, private and third sectors, service users and their carers can each contribute to service delivery and development, and share information appropriately.
- To have regard to affordability and financial viability for the funders, providers and recipients of care and support services.
- To ensure that service provision and funding options are sustainable in the medium to long-term.
- To ensure safe, quality care and ensure standards through appropriate regulation.

Appendix 5. Glossary of Terms and Abbreviations

Term	Abb.	Description
Capital appropriation		Annual transfer of funds from General Revenue to the Capital Reserve to fund future capital expenditure.
Capital expenditure, non-routine		Expenditure on large capital projects funded from the Capital Reserve and controlled centrally.
Capital expenditure, routine		Expenditure on small capital investments, IT projects, equipment, machinery and vehicles funded directly from General Revenue and controlled by departments.
Capital Prioritisation		
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/10, 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 predominantly 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 predominantly from Social Security contributions, but also receiving a revenue grant. This fund covers expenditure on contributory benefits such as pensions and unemployment.
Income, departmental operating		Any income paid directly to a States department which is not incorporated as General Revenue income. This includes fees and charges for service, rents received recoveries and funds received from SSD in payment for services. Totals for departmental expenditure are typically presented net of departmental operation income.
Income, 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.
Personal Tax, Pensions and Benefits Review	PTR	An on-going holistic review of the personal tax pensions and benefits regimes in the context of long-term pressures on expenditure.
Revenue Grant		A grant paid from General Revenue to SSD to supplement the GIF and GHSF, 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 GHSF, 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.
Social Welfare Benefits Investigation Committee	SWBIC	
Supported Living and Ageing Well	SLAWS	An on-going review of support and long-term care services for older people.
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.

