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Annual Independent Fiscal Policy Review 2016

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

He served for 6 years on CBI economics and tax committee. He is a member of the Oxford Business School Business Economics Programme and Chairman of the Prince's Trust Scotland Advisory Council and a member of its UK Advisory Council.

Professor Geoffrey Wood

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

A graduate of Aberdeen and Essex Universities, he has worked for the Federal Reserve System and the Bank of England. Overseas, he has advised several central banks and national treasuries. He is currently a director of an investment trust and an adviser to several financial institutions; a pension fund; and the Treasury Select Committee of the House of Commons. He also served as adviser to the Parliamentary Commission on Banking Standards. He has authored, co-authored and edited over 20 books and has published over 100 academic papers. His fields of interest are monetary economics, monetary history, the government budget constraint and financial regulation.

1. Executive summary

- The States of Guernsey has exercised notable fiscal control with revenue expenditure in 2015 and kept within budget. Despite that, Guernsey is running a deficit and not meeting her self-prescribed rules – this has continued for some time. The deficit has been long lasting and appears to be structural, affecting both expenditure and revenue. The States of Guernsey will need to respond accordingly.

- Guernsey's health and social care system continues to struggle to stay within budget. The Health and Social Services Department (now the Committee *for* Health & Social Care) exceeded its budget in 2015 despite a real increase in their cash limits and is expected to overspend again in 2016. However, controlling health and social care spending is a difficult challenge and, given the apparent lack of information and control mechanisms, the expenditure restraint is impressive.

- The fall in the working age population and continued pressure on the finance sector worldwide points to the possibility of further decline in revenues from personal and corporate taxation. The shortfall is being met by reductions in allocations to the capital fund. This is neither sustainable nor desirable.

- There has been an understandable public focus on the deficit created by current spend exceeding income but it is equally important to focus on the States' assets and liabilities. Although there have been a number of steps to limit liabilities in future, for example with a phased increase in the pension age, Guernsey needs to develop a long-term and sustainable solution to its fiscal problems.

- Two major liabilities of the States are discussed in depth in previous reports: the pension deficit and welfare provision. This report examines what assets are available to the States of Guernsey and how there may be an opportunity to manage these assets in a different way to create more value for the States as a whole. With a more commercial focus in the management of these assets, they could be geared to help close the current deficit, replenish the capital fund and yield an on-going return.

- Global growth is projected to continue at a sluggish pace over the next two years and the knock-on effects of UK's decision to leave the EU remain unclear. In order to be prudent, Brexit should be treated as a downside risk to Guernsey's economic growth between 2016 and 2019. The States may need to revisit its existing plans for fiscal tightening should revenues fall short as well as any actions designed to support economic activity if the downside risk materialises.

- The Public Service Reform agenda needs to reach beyond the focus on efficiency adopted within the previous Financial Transformation Programme and pursue true transformation of services if it is to be successful in the long-term. In other words, the States of Guernsey will need to make a fundamental review of both the type of services it provides and how they are supplied.

Contents

2. Introduction

This is the seventh annual independent review of the States of Guernsey's fiscal policy and is intended to support the Fiscal Framework adopted by the States in April 2009[1].

The primary purpose of this report is to review performance against the current Fiscal Framework. This report analyses the current and past fiscal position to see whether it is structural or temporary. A number of options for tackling the deficit are then explored in more detail.

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. This report does not provide, nor recommend, detailed solutions to the problems noted. Some existing proposals are appraised, and some possibilities reviewed.

In making assessments judgements are required. Any 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. Official data in all jurisdictions are prone to inaccuracy and to subsequent revision, and Guernsey is no exception. GDP is estimated with a nine-month lag, and is subject to revision for up to three years; an assessment of current conditions is therefore dependent on an assessment of indirect variables such as levels of employment and unemployment. And, of course, projections of future growth inevitably rely on judgement.

The authors note that, as part of the development of the Policy & Resource Plan, there will be an update to the Fiscal Framework and there will be some minor revisions to the parameters of the Framework.

Any reference to 'real' term figures throughout this report have been calculated using 2015 as the base year for prices.

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

3. Economic outlook

3.1 Global context

The IMF[2] and the OECD[3] have projected sluggish global market growth for 2016 and 2017 with global GDP growth continuing to be slow. They predict that most advanced economies are likely to experience slow growth. The outlook for emerging markets and developing economies is varied.

The euro zone will continue to remain at risk and the IMF continues to stress the need to address the long-standing structural issues of European banks. The difficulties experienced in the German banking system during the third quarter of this year have once again emphasised this.

The international tax agenda continues to gain momentum and the base erosion profit shifting (BEPS) programme led by the OECD is likely to increase the need for firms to justify their offshore business.

The vote in the UK to leave the EU has created uncertainty regarding the future shape of both the EU and the UK. The IMF has revised the global outlook for 2016 and 2017 downwards by 0.1% as a result of the political and economic uncertainty. A change of that size is not a serious change – it is gestural, symbolising disapproval of what was done. Ultimately though, the impact on EU and UK markets will remain unclear until negotiations commence on the future relationship. The main impact on Guernsey will be any knock-on effect of any trade barriers between the UK and the EU as the vast the majority of Guernsey's imports are from the UK. In addition, Guernsey's financial services may also be affected negatively if the City of London's financial markets become disadvantaged by the decision.

The authors believe that the continuing desire by regulators to increase banking sector capital combined with the uncertainty that Brexit brings should engender caution in tax revenue forecasting for the next couple of years at least. The States of Guernsey should therefore plan on the assumption that there will be a sustained downside risk due to the potential effect on industry sectors such as banking.

3.2 Domestic context

Following strong economic growth in 2011 and 2012, 4.5% in real terms, Guernsey's economy has seen somewhat muted growth, averaging real growth of just 0.3% per annum between 2013 and 2015. This is a significant downwards revision since the publication of first estimates for 2014 and perhaps more accurately reflects the fall in residential property prices, weakness in the labour market and net emigration experienced over the last two to three years.

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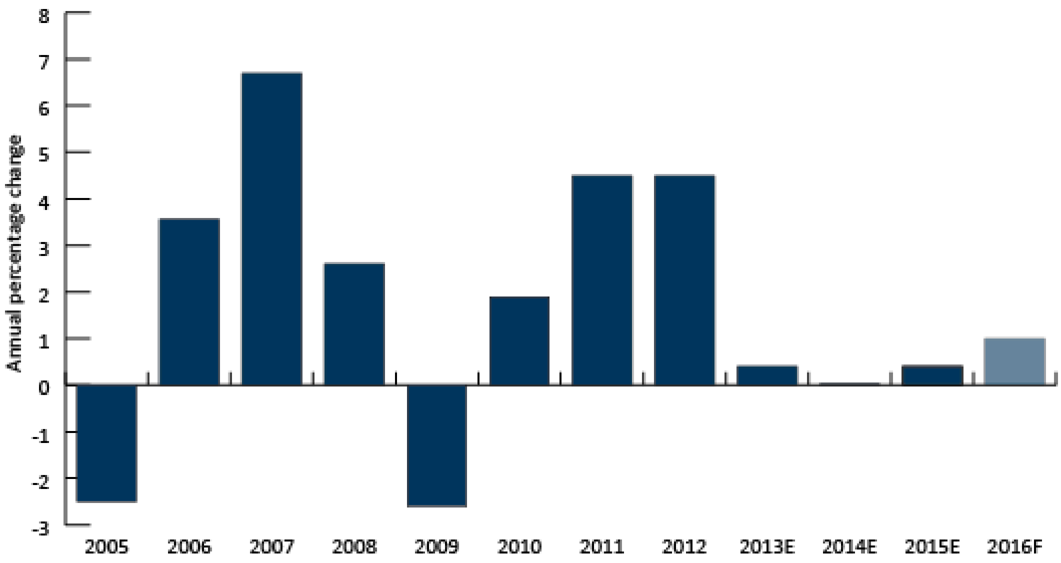
[2] International Monetary Fund (IMF), *World Economic Outlook – an update of the key WEO projections,* July 2016, http://www.imf.org/external/pubs/ft/weo/2016/update/02/pdf/0716.pdf

[3] Organisation for Economic Co-operation and Development (OECD), *Interim Economic Outlook*, September 2016 http://www.oecd.org/eco/outlook/economic-outlook/

Figure 1: Guernsey GDP – annual percentage change in real terms
Source: Data and Analysis Unit, States of Guernsey



During late 2015 and early 2016 labour market conditions have improved. Median earnings have grown in real terms year on year for three successive quarters and total employment numbers have stabilised. Unemployment in Guernsey remains low.

Since the last report Guernsey has changed the structure of its government. There is now an overarching committee, the Policy & Resources Committee, which is responsible for overall co-ordination of policies and resources. Six Principal Committees are responsible for developing policy, advising the parliament on policy, and overseeing and holding to account the delivery of services. The establishment of an overarching committee responsible for both policy co-ordination and resource allocation should provide an opportunity for the alignment of long-term policies with long-term policy objectives when setting the budget.

The development of an overarching plan for government, the Policy & Resource Plan, which aims to co-ordinate and, importantly, prioritise objectives over the next political term and beyond is to be welcomed. More effective prioritisation should be an important part of fiscal management in the future.

4. Performance against the Fiscal Framework

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

The parameters (outlined in **Box 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. In other words, not only is expenditure equal to total revenue on average, but any depletion of States' savings is restored.

Box 1. Parameters of the Fiscal Framework

The Fiscal Framework sets a number of parameters and commitments:

- Maintenance of long-run 'permanent balance'.
- Total general revenue 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.

In 2015, the States agreed to add a further criterion to the Framework stating:

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

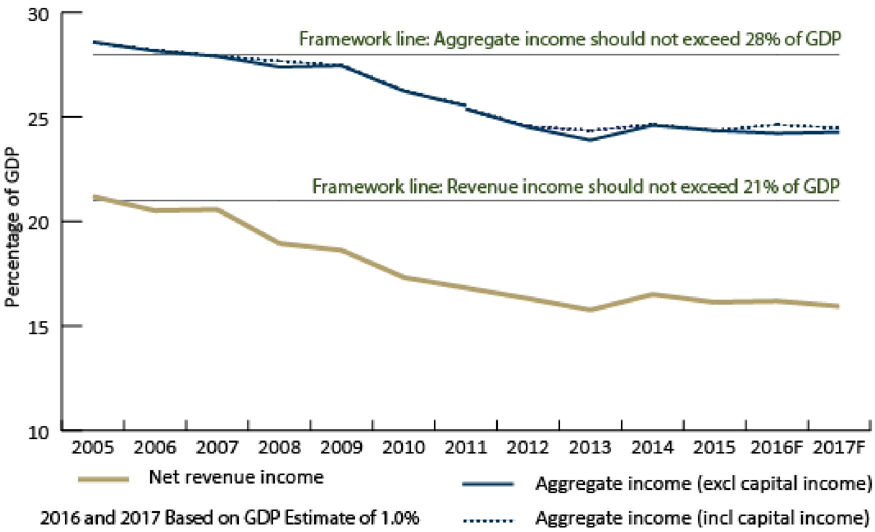
This section outlines the States of Guernsey's general performance against the Fiscal Framework. The Fiscal Framework rules are marked green if the rule is met and red if the rule is not met.

4.1 General revenue and income expenditure:

Fiscal Framework rules:

- **Total general revenue income averaging no more than 21% of GDP**
- **Total government income, incorporating general revenue, social security contributions and fees and charges, should not exceed 28% of Gross Domestic Product**

Figure 2: Net general revenue and aggregate government income[4]
Source: General Revenue Accounts, Misc. Accounts, Data and Analysis, States of Guernsey

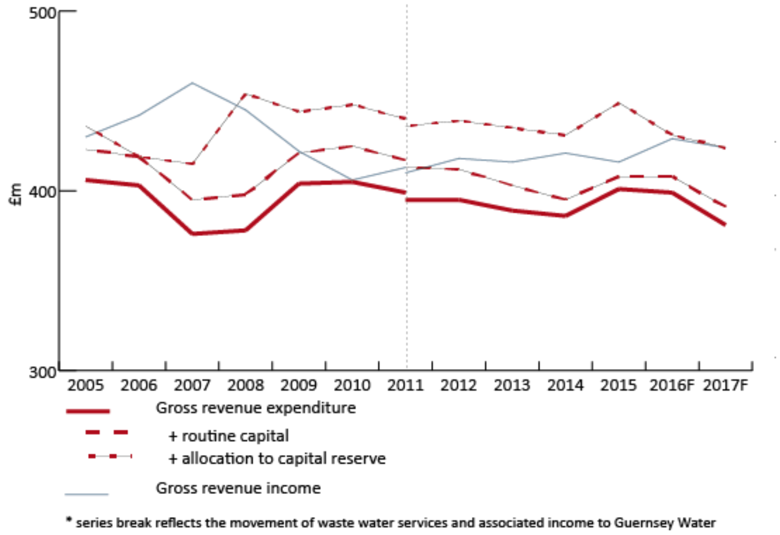


Net general revenue income represented 16.1% of GDP in 2015, based on estimated real GDP growth of 0.4%, well below the Fiscal Framework rule of no more than 21% of GDP[5]. Net general revenue totalled £380m in 2015. In real terms general revenue income fell by 1.8% between 2014 and 2015.

Aggregate income in 2015, which includes social security and net general revenue income, represented 24.3% of GDP, below the fiscal framework rule of no more than 28% of GDP. Aggregate income totalled £573m in 2015. Moreover, between 2014 and 2015, real aggregate income fell by 0.8%. The proposals laid by the Committee *for* Employment and Social Security in their report on benefit and contribution rates for 2017 to increase the contributions in 2017 (0.5% on all contributors other than employers to support the long term care system and 0.2% split between the employer and employee for the provision of parental benefits) is forecast to result in an increase in aggregate income. However, this will remain well within the limitation set.

[4] Net general revenue income incorporates all income sources (excluding capital) reported in the annual accounts available for distribution between departments. Aggregate income incorporates net general income plus Social Security contributions and departmental operating income.
[5] The proposed update to the Fiscal Policy Framework, scheduled for debate in November 2016, withdraws the parameter on general revenue income in favour of total government income introduced in 2015.

Figure 3: Gross revenue expenditure (at 2015 prices)
Source: General Revenue Accounts (October 2016), Data and Analysis, States of Guernsey



Gross revenue expenditure totalled £401m in 2015, a 3.7% increase in real terms from 2014. Furthermore, including routine capital expenditure and allocation to the capital reserve, gross revenue expenditure totalled £448m in 2015, equivalent to a 4% increase in real terms.

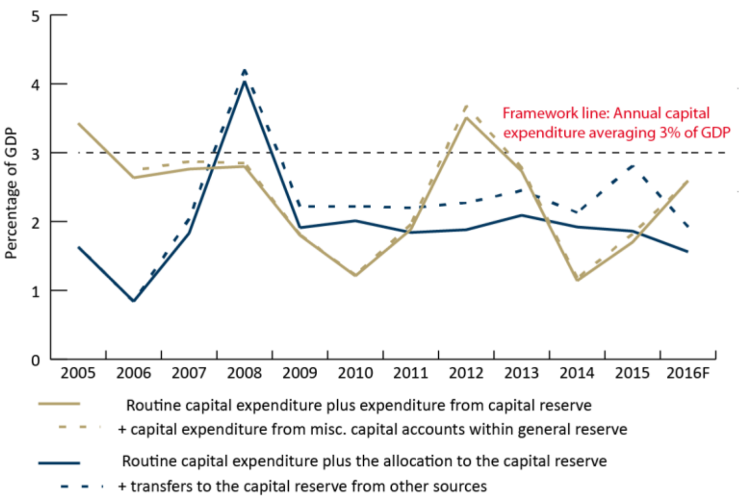
The authors note that the update to the Fiscal Policy Framework, due for debate as part of the States' Policy & Resource Plan, includes a criterion directing the States to adopt a policy of no real terms growth in expenditure during periods of deficit.

4.2 Capital expenditure:

Fiscal Framework rules:

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

Figure 4: Capital expenditure
Source: General Revenue Accounts, Misc. Accounts, Data and Analysis, States of Guernsey



Routine capital expenditure plus allocation to the capital reserve represented 1.9% of GDP in 2015. Total allocation to capital spending from general revenue has averaged 1.9% of GDP since the Fiscal Framework was introduced in 2009, whilst when transfers to the capital reserve from other sources are included this represents 2.8% of GDP in 2015. This figure includes transfers totalling £22m from the Corporate Housing Programme and the Core Investment Reserve. It should be emphasised that these transfers are a one off boost to capital spending, supplied by drawing down reserves.

Routine capital expenditure, plus expenditure from the capital reserve, represented 1.7% of GDP in 2015. Since the Fiscal Framework was introduced in 2009 actual capital expenditure has averaged 2% of GDP. When spending from miscellaneous accounts within the General Reserve are also included, actual capital expenditure represented 1.8% of GDP in 2015 and has averaged 2.1% of GDP since 2009[6].

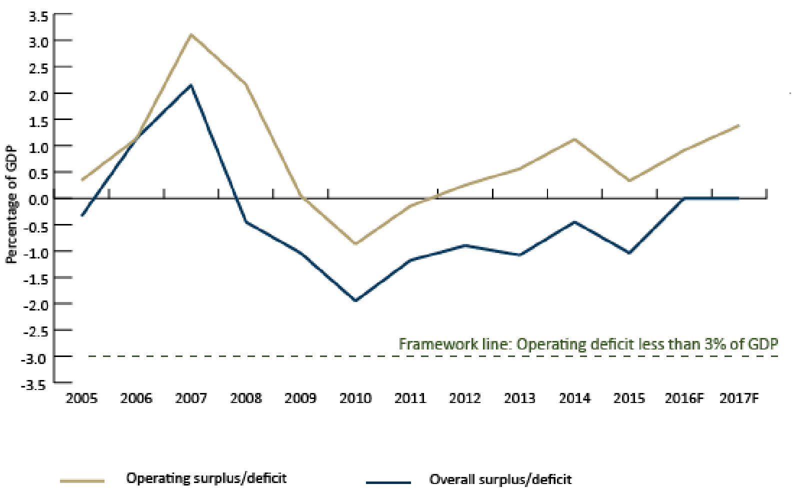
It is clear that the States continue to struggle to meet the 3% target for capital investment set by the Fiscal Framework. Given the deficit this is perhaps understandable, but this long-term underinvestment is not without long-term financial and economic risk.

4.3 General revenue and operating and overall 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**

Figure 5: General operating and overall revenue position
Source: General Revenue Accounts, Misc. Accounts, Data and Analysis, States of Guernsey



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

The operating position remains well within the Fiscal Framework rules to limit the size of the deficit to 3% of GDP. At the end of 2015 the operating surplus stood at 0.3% of GDP. That said, the operating surplus was considerably lower than had been forecast in the September 2015 budget due to a worsening revenue position, particularly with regard to corporate tax receipts[7].

The overall fiscal position, which takes into account allocations to the capital reserve and other transfers, is in deficit and one that has increased over the past year. The deficit represented 1% of GDP at the end of 2015 and totalled £24.5m, compared with 0.5% of GDP and £10.4m recorded at the end of 2014.

The overall deficit has persisted for eight years and it is now the fourth consecutive breach of the Fiscal Framework rule which states that the deficit should be addressed within five years of its appearance. The President of the Policy & Resources Committee, Gavin St Pier, formally recognised the existence of a possible structural deficit in his statement which accompanied the publication of the 2015 accounts:

> *"…it has become clear that there is more to the deficit in revenues than cyclical conditions and the inherent lags in some revenues. It is likely that there is a structural element to our deficit…"*

Short –term measures have balanced the in-year budget for 2016, primarily through reducing the money set aside for capital investment, but the underlying structural problem remains. The Fiscal Framework rule clearly applies and measures to counter the structural deficit are needed. The second part of this report examines the causes of the deficit in more detail and examines a number of options the States of Guernsey could take in order to address the deficit.

4.4 Borrowing

Fiscal Framework rules:

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

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

The States of Guernsey is now directly liable for debt which represents 14% of its GDP, with slow growth in GDP during 2015 this figure is unchanged from the previous year. No new debt has been issued in 2016.

During 2015, the Bond Management Sub-Committee approved applications totalling £121.9m to the following entities:

[7] The proposed update of the Fiscal Policy Framework applies this criteria at the level of the overall deficit, which will enable the inclusion of the allocation to the capital reserve within this parameter.

- Guernsey Housing Association LBG
- Cabernet Ltd
- Jamesco750 Ltd
- HSSD Accommodation Fund

To date in 2016 no further lending has been sought or approved.

The investment returns on the bond issues' proceeds, which have not yet been lent on, form part of the general revenue investment assets. During 2015 these were not sufficient to completely cover the coupon payment on this portion of the bond and led to a £5.7m deficit on the Bond Reserve. During the first half of 2016 this position has reversed and the investment return exceeded the amount necessary to pay the coupon thereby eliminating the 2015 shortfall.

5. The deficit

5.1 Causes of the deficit

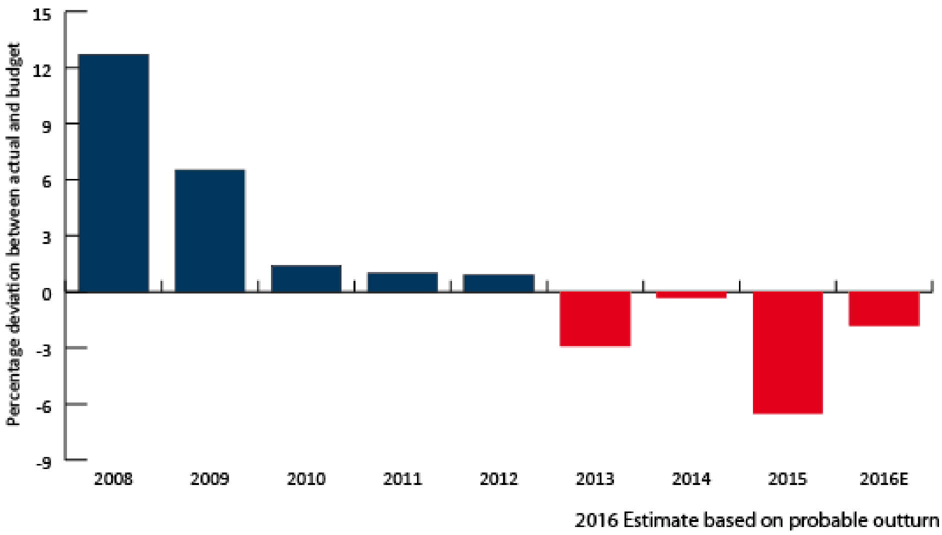
5.1.2 Revenue

Guernsey has a complex tax system and a narrow tax base. It is heavily dependent on income tax receipts and tax on company profits for general revenue income. Tax on company profits and income tax from individuals' together account for around three quarters of all general revenue.

The dependence on personal taxation is further compounded by the social security contributions system, which was expanded between 2006 and 2009 to recoup some of the income lost in the move to the zero ten tax regime in 2008. This increased Guernsey's reliance on direct personal taxation of earned income.

Over the last three years actual income has been lower than the budgeted income with 2015 recorded as the largest negative differential between budget and actual, a shortfall of 6.5%. Revenue for 2016 is also expected to fall short of the original budget by an estimated 1.8%.

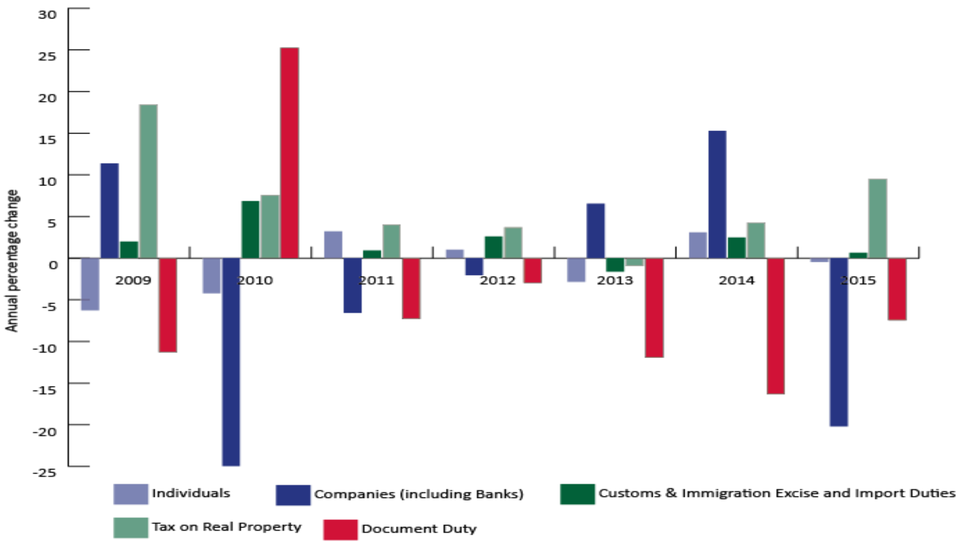
Figure 6: Percentage deviation in actual income from budgeted income
Source: General Revenue Accounts, Data and Analysis, States of Guernsey



A more in depth examination of the five largest components of general revenue income reveals there was a sharp drop in company tax revenues in 2015; a result of overpayment of taxes by companies in the previous year, which had to be repaid in 2015. The overpayment was due to overestimated interim assessments issued by income tax during 2014 and reflects the pressure on profit margins, particularly in banking, over the last few years. It is likely these shortfalls will continue in the banking sector due to capital regulation and the tightening of other rules. Combined with a downward revision of 2015 in response to the lower than forecast profits for 2014 this has had a substantial impact on the budgeting process and illustrates the need for robust forecasting.

Furthermore, general revenue income has been affected by the lack of transaction activity within the housing market which has affected document duty receipts.

Figure 7: Annual % change in income at constant prices from 5 largest tax contributors
Source: General Revenue Accounts, Data and Analysis, States of Guernsey



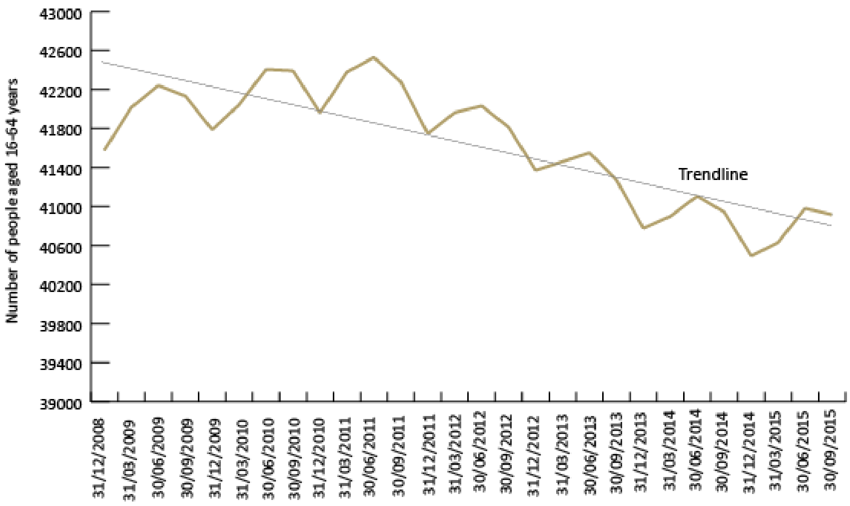
5.1.3 Decline in working age population

There has been a clear downward trend in the working age population over the last five years due to a combination of the natural progression of a large number of people entering retirement and net emigration from the island. The lack of growth in tax collected from individuals is undoubtedly linked to this decline.

The rising dependency ratio and increasing numbers of older people is also having an impact on the demand for health and social care services provided by the government. As noted in the sixth Annual Independent Review of Fiscal Policy[8], the authors support the decision taken in 2015 to make a phased increase the pension age, however this change alone is not enough. The evidence is that without further policy changes, the States of Guernsey will be unable to achieve long-term sustainability.

[8] McLaughlin, Dr Andrew; Professor Wood, Geoffrey. Annual Independent Fiscal Policy Review 2015: https://gov.gg/CHttpHandler.ashx?id=98211&p=0

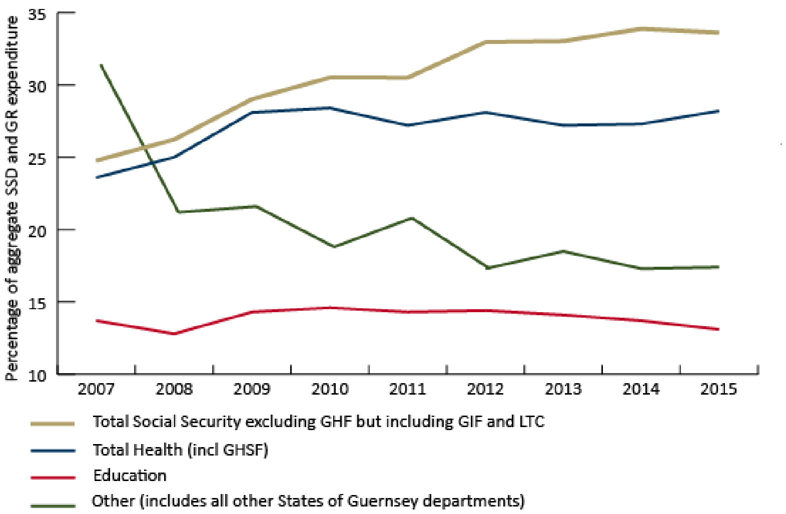
Figure 8: Working age population
Source: Data and Analysis, States of Guernsey



5.1.4 Expenditure

Generally, States of Guernsey Departments, including Education, the second largest general revenue spending department (prior to restructuring), have continued to show impressive restraint in expenditure and their share of total expenditure has fallen. However spending on health and social care (which includes spending from the Guernsey Health Service Fund) and social security (which includes the long-term care fund and Guernsey Insurance Fund) expenditure continues to show significant growth and their share of total spending is growing.

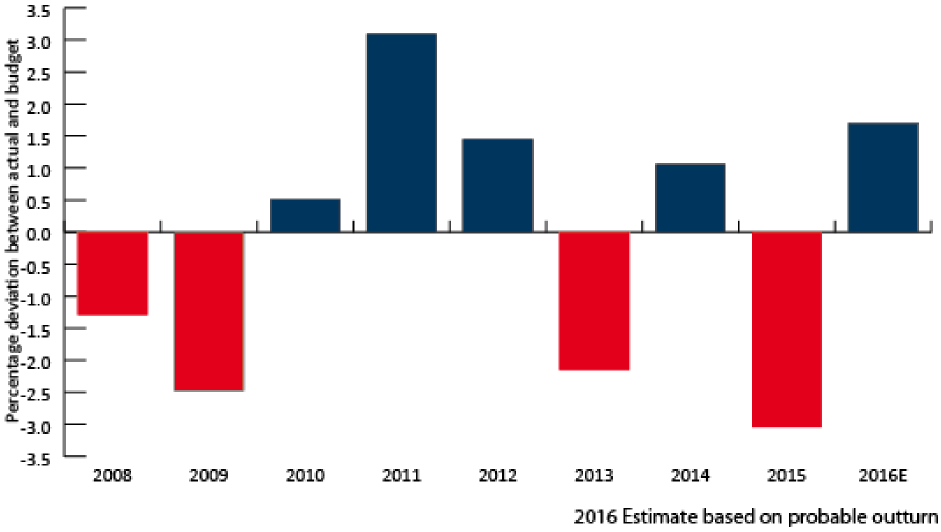
Figure 9: Principal areas of expenditure
Source: General Revenue Accounts, Misc. Accounts, Data and Analysis, States of Guernsey



Spending controls relative to budget have been, broadly speaking, good within the States of Guernsey. Overall, general revenue expenditure over the last 8 years has been at, or very close to, levels set within the budget, with less than 5% deviation between budget and actual.

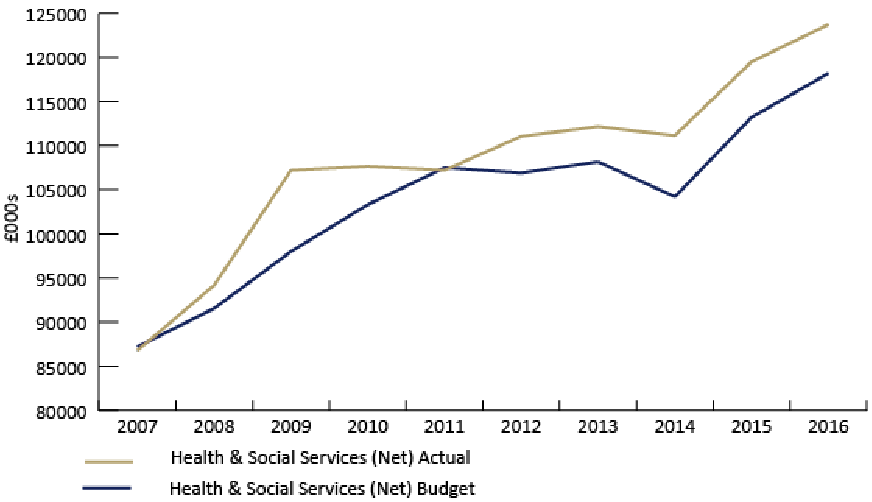
That said, there is still sustained and continued pressure on the budget. That is clear when looking at expenditure by service area.

Figure 10: Budgeted net general revenue expenditure vs actual
Source: General Revenue Accounts, Data and Analysis, States of Guernsey



In 2015, with the exception of Health and Social Services, *all* departments underspent their budget. However, Health and Social Services exceeded their original budget by 5.6%, despite a real terms increase in their cash limits. Figure 11 shows that the health overspend in 2015 was not an isolated case. In seven of the past nine years expenditure by the Health and Social Services Department has exceeded its budget. In 2016 the probable outturn is for health and social care expenditure to once again exceed budget (by between 4.5 to 5%).

Figure 11: Health and social services expenditure: actual vs budget
Source: General Revenue Accounts, 2017 Budget, Data and Analysis, States of Guernsey

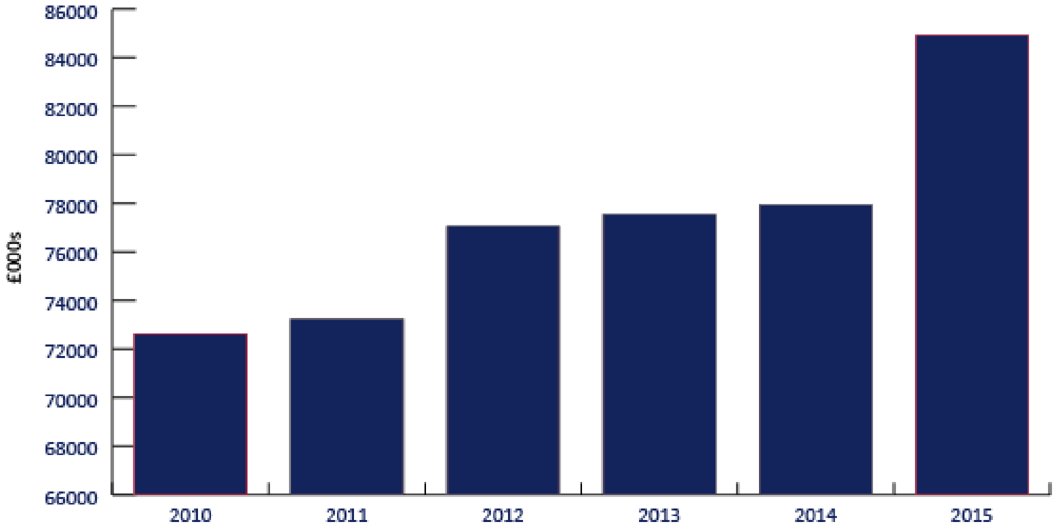


When health expenditure is broken down further[9], the main area for concern is the significant increase in the cost of acute hospital services, which saw growth of 150% in real terms between 2011 and 2015. The most significant components of the increase in costs of acute hospital services in 2015 were attributed to:

- recruitment difficulties
- an increase in demand for services
- an increase in the number of complex (and therefore expensive) cases

Increased staffing costs as a result of a shortage of frontline nursing and midwifery staff, is a problem in many European countries. The well-documented difficulties in recruiting staff and the lack of the information available to allow well-informed and well-timed decisions has meant that Guernsey has experienced a substantial increase in spending on agency staff in 2015 (see figure 12 below). It is clear that the current arrangement is both expensive and unsustainable.

Figure 12: Health expenditure - pay costs
Source: General Revenue Accounts, Data and Analysis, States of Guernsey



It is the view of the authors of this report that health expenditure within the States of Guernsey is difficult to control under the current model of service provision and that this should be reviewed as a matter of priority. The contracts that are in place appear not to provide sufficient rigour or flexibility in the provision of services. For example, contracts that are currently in place with the Medical Specialist Group to provide specialist medical care and specialist services, saw annualised growth of 3.9% and 3.6% per annum in real terms between 2011 and 2015. This growth is far in excess of inflation, furthermore revenue incomes to fund this expenditure have not changed substantially, such growth places additional pressure on an already stretched budget.

[9] There are some areas of health expenditure which are not covered within the health and social services budget including the Guernsey Health Service Fund which includes Medical Specialist Group expenditure, Guernsey Physiotherapy Group and Drugs and Medicines.

There is a clear need for a major reform of the health system. The authors would suggest that to find a long-term solution the States of Guernsey should review: what services it should provide; to whom; and how these services can be most effectively delivered, in order to find a long-term solution. That said, in spite of issues with financial control in Health and Social Services (now the Committee *for* Health & Social Care), and given the constraints in the area in which they are working, the expenditure restraint is impressive.

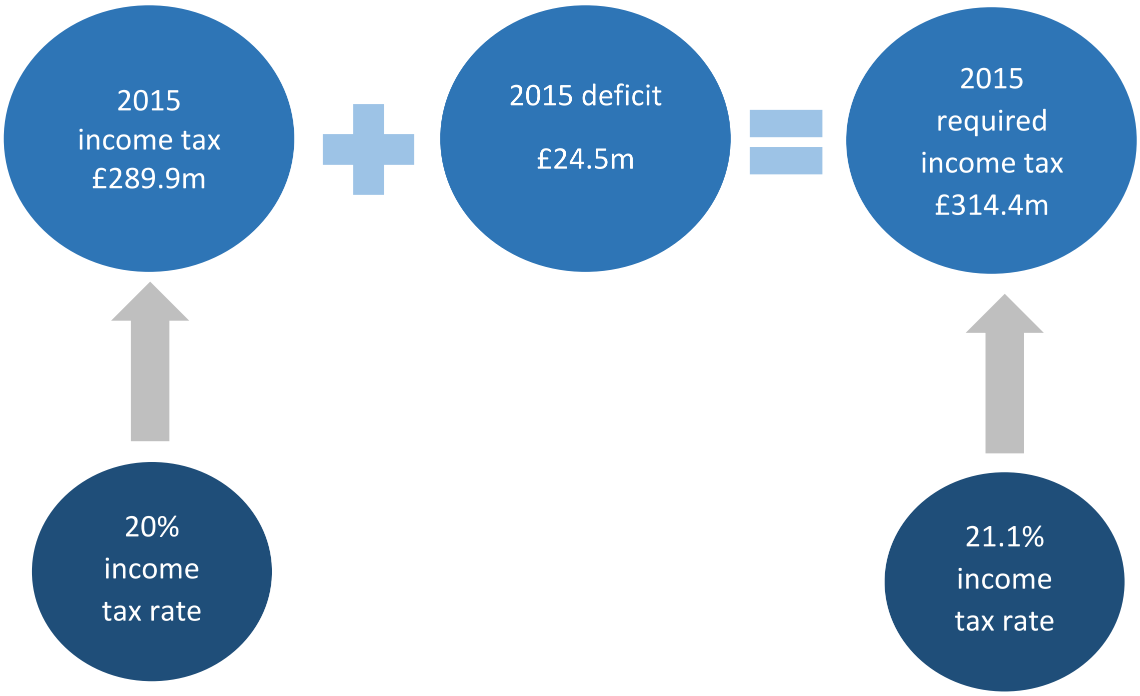
5.2 Deficit reduction options

Clearly the States of Guernsey needs to tackle the sustained structural deficit. Some options for how the States might approach this are examined more closely below. **This is neither a comprehensive nor recommended list; rather the options are meant simply to illustrate some of the routes to tackling the deficit and the relative scale of action required based on the size of deficit reported in 2015.**

5.2.1 Raising income

Changes to income tax

Increasing the level of income tax would be a simple way to combat the deficit *in the short-term.* As demonstrated below, if income tax rates were raised by 1.1% the deficit could be controlled fairly quickly.



However, the potential decline in the working population and the increased pressure and demand for public services as less of the population is working will exert continuing pressure on both revenue and expenditure. Raising the level of income tax (or any other revenue raising measure) on its own can therefore only be a short-term solution. And of course one should never forget that tax increases generally bring in less revenue than forecast, just as tax cuts usually cost less.

Goods and service tax

A goods and services tax is another option for raising revenue. The authors acknowledge this is not currently on the political agenda for Guernsey given decisions made in the last political term, but it is included here to give an illustration of what is available.

A goods and service tax of 2% on all purchases by households would be sufficient to eliminate the £24.5m deficit reported in 2015 if applied as an additional tax alongside the current income tax rate of 20%.

In some respects the introduction of a goods and services tax might present a more efficient means of revenue generation than income tax as it draws income from a wider tax base and creates less of a disincentive to employment. At its most radical, a goods and services tax could be applied as a complete replacement for income tax (again the authors acknowledge this is not something the States is currently considering). It is difficult to determine the level at which a goods and service tax would need to be set if it were to be a complete replacement for income tax, since doing so could substantially change behaviour. However, it is broadly estimated that if a goods and services tax were applied comprehensively to the sale of all goods and services (on a basis comparable to Jersey's GST regime) the rate would need to be set at 27% in order to raise both the current level of revenue generated from income tax and eliminate the deficit. Again, however, given the nature of cost pressures on health and social security, the authors would emphasise that, as with a higher income tax, this would not be a long-term solution to Guernsey's fiscal problem.

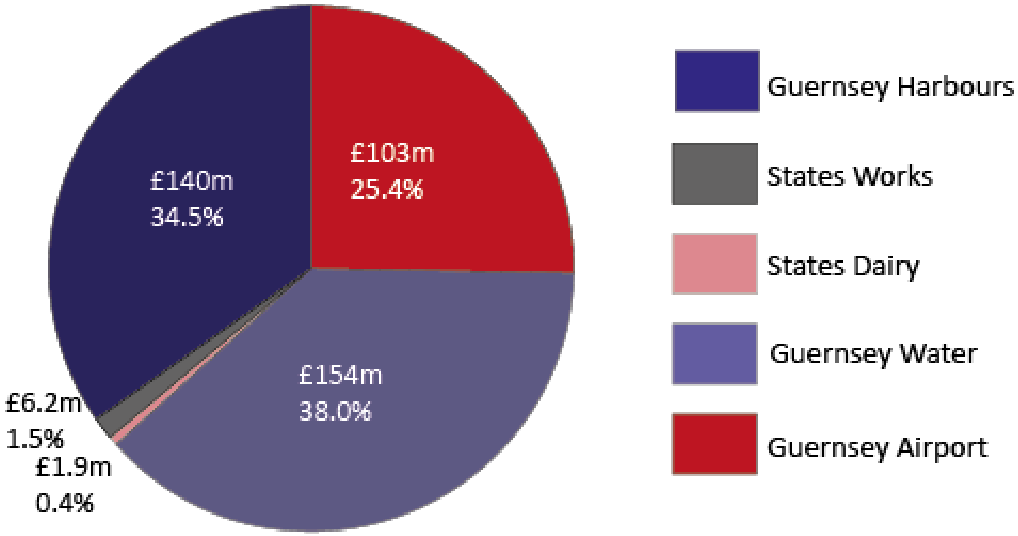
Social security contributions

The Committee *for* Employment & Social Security have proposed to increase the States' aggregate revenues in 2017 in their report on benefit and contribution rates for 2017. These proposals, if approved, will increase the States' aggregate income by an estimated £9.5m but will not reduce the deficit on general revenue. Instead, these additional funds will reduce the operating deficit on the social security funds and provide additional funding for parental benefits. However, the authors note that, as reported in the actuarial review of the Long Term Care Fund, while this will extend the life of the fund by 13 years, it is not sufficient to ensure stability and that further action will be needed. Once again, the increase in revenues is not a long-term solution.

Using States' assets

The States of Guernsey has a number of trading assets, both incorporated and non-incorporated. The fixed assets for non-incorporated trading assets stand at £405 million. With a more commercial focus in the management of these assets, it is possible that they could contribute towards the reduction in the deficit through a higher on-going return.

Figure 13: 2015 fixed asset value for unincorporated trading entities
Source: Miscellaneous Accounts, Data and Analysis, States of Guernsey



The change in the machinery of government to bring together non-incorporated and incorporated assets under the States' Trading and Supervisory Board has provided an opportunity to apply a more commercial mind-set to the management of these assets.

> **Box 2: Debt financing capital assets**
>
> In the same way that people may borrow against the value of their house and their future earnings in order to purchase a property, a company debt financing implies that a company could borrow against its own assets and future revenues so it can invest in its infrastructure or in improving services. The larger these assets and the more secure their future revenues, the easier it is to borrow. The amount of debt versus the total value of the asset would be the level of gearing for that company similar to the loan to value for somebody purchasing a house.
>
> For example, as outlined in the 2017 Budget, the Belle Greve Wastewater Outfalls project was funded initially from the Capital Reserve and proposals are being put forward for Guernsey Water to re-finance the project through a loan from the proceeds of the States of Guernsey bond issue. This would be an example for using debt to finance a large capital expenditure.

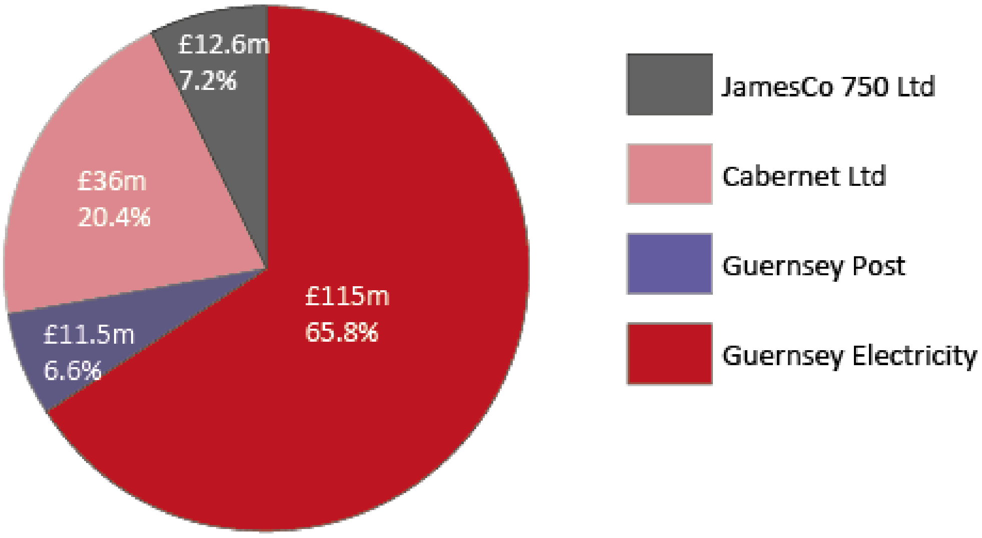
The non-incorporated assets are not currently making a significant return to the States of Guernsey in the way you would expect a commercialised entity to provide to its shareholders. They also currently carry little or no debt. However, they hold significant capital assets and will need to continue to invest in large capital expenditures. In the past non-incorporated entities have used monies in the capital reserve to fund large projects. This means that the States carry the full cost of the depreciation of these assets over time and the commercialised or semi-commercialised entities have little incentive to manage their services in a way that reflects the true capital costs. By tying up the capital reserve in this way, there is also less money available to fund non-commercial capital infrastructure.

There is an opportunity to release equity to the States from the States' trading assets and, potentially, to improve performance of those assets. The States' trading assets have a certain amount of guaranteed income and therefore the risk of a trading asset defaulting on any debt is low. Moreover, there is some evidence from other jurisdictions and larger states that a mix of debt and equity, and the greater scrutiny that comes with it, can increase financial disciplines and embed a commercial mind-set. It may be worth investigating whether this is a possibility in Guernsey.

The authors note that in the 2017 Budget, the Belle Greve Wastewater Outfalls project was funded initially from the Capital Reserve and proposals are being put forward for Guernsey Water to re-finance the project through a loan from the proceeds of the States of Guernsey bond issue. This proposal indicates there is already an emerging shift in policy to encourage non-incorporated States assets to become more commercial by paying for their own capital projects through debt financing.

One issue that may need to be managed for the States' trading assets is the combination of policy objectives which could compete and conflict with any attempt to commercialise them. The States will need to review the impact of existing legislation and historical policy objectives on the operational freedom of these entities – for example the existence of price controls. The authors would therefore suggest the States explore the potential for changes in the capital structures of these assets to establish a regular return. A cautious gearing, for example of up to 20% in non-incorporated assets, would maintain financial flexibility and could release sufficient equity to cover the current under-investment in the capital programme and reduce the deficit.

Figure 14: tangible fixed asset value for incorporated trading entities
Source: Incorporated Assets Accounts, Data and Analysis, States of Guernsey



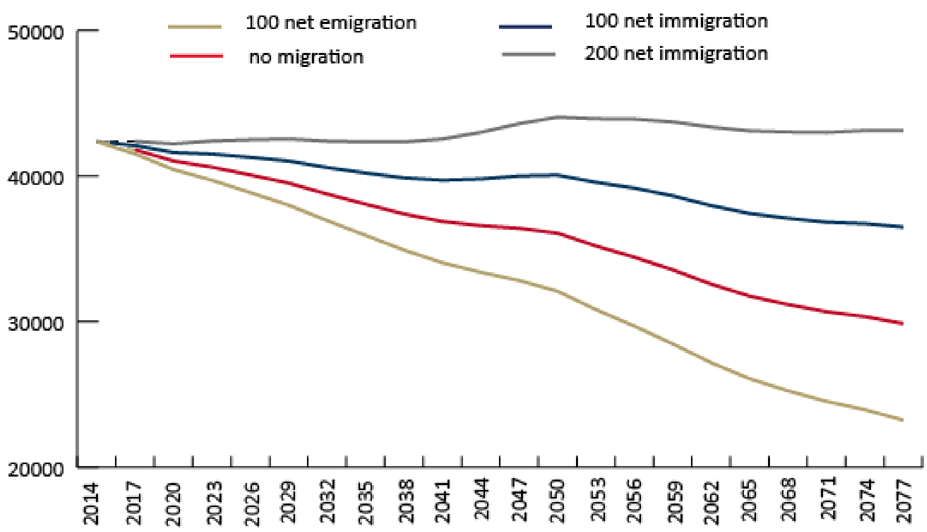
Details on the States of Guernsey property portfolio are not currently available but there may also be an opportunity to rationalise the property portfolio and consider selling assets or using them more efficiently by charging for the use of services. The Public Service Reform programme indicates that this work is ongoing and the authors consider this may well be another efficient way of releasing equity[10].

Increase in the working age population

Even with an increasing retirement age, Guernsey's working age population will need a higher level of net migration than experienced in recent years (approximately 100 people per year since 2009) to reach a stable equilibrium. Projections indicate that a sustained level of net migration of 100 people per year or fewer will result in a long term decline in the working age population. Acknowledging that such projections do of course need to be treated with great caution, a long term decline of this nature would pose a risk to revenues and to economic growth.

These projections suggest that the States of Guernsey may need to consider a much more pro-active approach to encouraging people to move and to work in Guernsey if maintaining the working age population is a fundamental economic policy objective.

Figure 15: working age population projections (including transition of retirement age)
Source: UK Government Actuary's Department



5.2.2 Reduce Expenditure

To date, the States' principal approach to deficit reduction has been one of expenditure restraint and reduction. This was achieved in the first instance through the Financial Transformation Programme[11]. The Public Service Reform programme, adopted in 2015 represents an opportunity for a more wholesale and radical approach to reducing expenditure.

A budget of £25m has been allocated to spend on the transformation programme. It is unclear, at this stage, what scale of benefits there are or what the benefits could be for the

[10] States of Guernsey. *A Framework for Public Service Reform.* https://www.gov.gg/change
[11] Treasury and Resources Department. *Fundamental Spending Review.* Billet d'État XXV 2009: https://www.gov.gg/CHttpHandler.ashx?id=3897&p=0

overall States of Guernsey budget. The reform programme is currently working on the assumption that, without reformation, there is the potential for a £50m to £70m deficit on general revenue by 2040 and the long-term aim of the programme is to prevent this from happening. A benchmarking exercise carried out by BDO has identified £7m of savings in health and social care services within the current structure but with more fundamental reform there is the potential to increase these savings up to £24m[12].

It is important that this programme reaches beyond the focus on efficiency adopted within the Financial Transformation Programme and pursues true transformation of services if it is to be successful in the long-term. In other words, the States of Guernsey will need to make a fundamental review of both the type of services it provides and how they are supplied.

During 2016 the States announced the intention to cut 3% from the budget for 2017 and thereafter 5% in 2018 and 5% in 2019. While there may be scope to reduce expenditure for 2016 to meet these targets under the existing model, departmental expenditure control is generally good and meeting the longer term targets is likely to require the restructuring of services.

Figure 16: Public sector employment as a percentage of the labour force (2009 and 2013)
Source: OECD, Government at a Glance 2015[13]

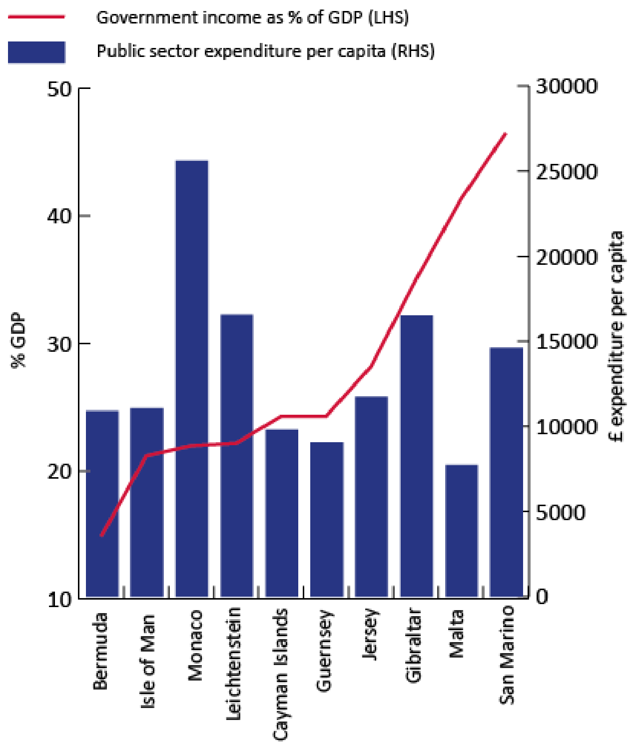
There has inevitably been a call for the reduction in the number of public service employees which, given that staff costs represented 53.3% of general revenue expenditure in 2015 and the increase in full time employees (FTE) in 2015 compared with 2014 (an increase entirely attributable to the Health and Social Services Department, where staff numbers increased in order to address the recommendations of the Nursing and Midwifery Council Review and the Recruitment and Retention Taskforce), is unsurprising.

[12] BDO Limited. *Costing, Benchmarking & Prioritisation Project at the Health & Social Services Department*. Billet d'État XIX 2015, Appendix II: https://gov.gg/CHttpHandler.ashx?id=98324&p=0
[13]OECD. 2015. *Government at a glance 2015*. http://www.oecd-ilibrary.org [Accessed September 2016]

Realistically, given the proportion that staff costs represent of the total budget any reduction in overall budget must include savings on pay costs. That said, Guernsey's public sector comparatively speaking is not overly large, comprising 17.3% of the total labour force compared to the OECD average of 19.3%.

Furthermore when aggregate expenditure is compared with similar sized jurisdictions, many of whom face the same challenges in terms of delivering high quality services paid for by a shrinking working age population and unable to benefit from the economies of scale found within larger jurisdictions, the size of Guernsey's public sector, in terms of aggregate income as a percentage of GDP ranks around average and expenditure per head of population appears relatively low.

Figure 17: Public sector expenditure and income in smaller jurisdictions[14]
Source: Data and Analysis, States of Guernsey



[14] Care should be taking when making comparisons across smaller jurisdictions, methodological, timing and currency differences may apply to GDP, income and expenditure calculations. Any currency conversion to pound sterling based on October 2016 exchange rates. Cayman Islands, San Marino, Liechtenstein, Gibraltar and Monaco based on 2014 GDP data, all other locations based on 2015 GDP. Expenditure and income figures based on 2014 data for San Marino and Liechtenstein, 2014/15 data for Gibraltar, Bermuda and Cayman Islands, 2015/16 data for Isle of Man, all other locations based on 2015 expenditure and income data.

6. Risks

6.1 Fiscal stability

As observed in previous reports the social security funds, including the Guernsey Insurance Fund, are running an operating deficit in order to meet the demand for services. This draw down is planned and the States has policies in place to manage them but these policies should remain under continuous review as the financial position changes. For example, lower than expected levels of migration and economic growth, as experienced over the last five years, will make a material difference to the projected positions of these funds.

It is clear from the evidence set out in section 5 of this report that health expenditure in particular is putting pressure on the budget and this pressure will continue to mount if not properly managed. Historically, the provision of health and social care has been clinically led and the authors consider that the States should review whether there is oversupply of services in health which is creating additional demand. The community expectation for the health service is high. There may be a need to manage expectations to prevent expenditure by the States on health services becoming unsustainable and threatening all other areas of public service and overall fiscal stability. The immediate tasks facing the Committee *for* Health & Social Care will include the need to review the necessary or appropriate levels of health service that can be provided on-island with a view to investigating the option of using healthcare services off-island. If the Policy & Resource Plan is to achieve its goal, it will need to prioritise and manage expectations with regard to health and social care in Guernsey.

As highlighted earlier, there has been an overall lack of capital expenditure. While this restraint has helped the States to manage the deficit, continuing underinvestment poses a fiscal and economic risk. Critical failures in infrastructure due to a lack of maintenance and new investment could be very expensive in the long-term. Additionally, the general lack of investment in infrastructure in order to enable economic development could become a long-term barrier to growth.

As noted in section 5.1, Guernsey's narrow and complex tax base, allied with the complexity of international tax relations, is putting considerable pressure on the administration of the corporate tax regime. The complexity of the work, and thus the resources required, for the States to meet international standards are increasing. There is an inevitable fiscal cost to this.

6.2 Economic efficiency and stability

Transaction costs are high in Guernsey. In particular, the comparatively high cost of professional services such as lawyers, dentists, doctors and conveyancers places pressure on businesses and households in the island. These costs, as shown in the table below, are typically (but not in every case) higher than equivalent figures for the UK. If the ratio of these costs in Guernsey is higher relative to average wages than in the UK, this could well suggest that lack of competition may be contributing to these higher costs.

Table 1: Average cost of selected professional services In Guernsey and the UK
Source: Data and Analysis, Which UK, NHS

	Guernsey	UK
Lawyers fee for drafting a will	£350	£225
Surveyors fee for house valuation	£456	£500
Conveyancing fee	£1,315	£1,000
Dentist Check-up	£36.83	£19.70

As mentioned in this and previous reports, the ageing of the population and the continuing decline in the working age population risks downward pressure on economic activity. Businesses require continued access to sufficient skills and staff resources to be effective. There is also the inevitable increase in demand for services for older people requiring additional financial and staff resources in both the private and the public sector.

Following the decision by the UK to leave the EU, the States of Guernsey will need to monitor UK negotiations with the EU closely to minimise any risks to Guernsey's economy and to capitalise on any opportunities. As a priority, the States will need to ensure there is suitable market access for industry.

As well as a fiscal risk, the increase in international regulatory demands has an impact on the private sector. Business resources dedicated to compliance are typically non-profit generating; however, compliance is necessary and only a competitive issue if the requirements are out of step with the requirements of competing jurisdictions, although it does depress income and thus ultimately tax revenue. A problem arises where the level of compliance makes a particular business model unsustainable or where the compliance burden is lower in competing jurisdictions. Guernsey needs to strike an appropriate balance between credible and robust regulation and the need to maintain its competitive position. It should also never be forgotten that all regulation or compliance which would not be enacted in the interests of the islanders alone inevitably reduces welfare on the island.

In the past, the States has faced criticism from industry for the lack of information and perceived silo mentality. A lack of confidence in the States could be a barrier to economic growth and investment. There is also a fear among industry that the government is not as enterprising in its outlook as it was in the past, and not as nimble. The proposals in both the Public Service Reform framework and the Policy & Resource Plan aim to address this criticism and to ensure there is better engagement with both the private sector and the third sector, particularly in the development of future policy and strategy. Better engagement, improved flow of information, and more effective decision-making could improve levels of confidence in Guernsey and have a wider economic benefit.

7. Alderney

The States of Alderney faces similar pressures to Guernsey as a result of a declining working age population and increasing numbers of older people. As noted in the Annual Independent Fiscal Policy Review 2015, the threat is much more immediate in Alderney due to its more remote location, small and declining population and high dependency ratio.

The proposals to develop a Medium Term Financial Plan for Alderney are to be welcomed. While the major elements of revenue in Alderney (i.e. income tax and social insurance contributions) will continue to be collected by the States of Guernsey, the States of Alderney and States of Guernsey have agreed in principle to allow Alderney greater independence in the collection and use of some smaller revenue streams. The authors note this development and the greater flexibility it could allow Alderney in the management of its own affairs.

However, the issue of sustainable provision of transferred services to Alderney continues to be a significant issue for both islands. As in Guernsey, service level expectations are beyond what is sustainable for a very small population. Projects that both reduce the unit cost of providing services to Alderney and improve services should be supported. The authors note the introduction of video teleconferencing technology for remote medical consultations earlier this year which has reduced the need for travel off island to consultations.

8. Conclusion

The States of Guernsey has demonstrated impressive fiscal restraint and control in 2015. However, despite the tight control on expenditure, there is still overall deficit, and one which has persisted for eight years. Short–term measures have balanced the budget for 2016 but the underlying deficit remains. While it is always possible to find special factors to suggest the deficit is not structural, it has continued for a long period of time, and the evidence set out in this report suggests it is a structural deficit. The authors suggest the States should respond accordingly as a matter of priority.

The decline in the working age population and continued pressure on finance worldwide suggests the decline in revenues from personal and corporate taxation will persist. Concurrently, despite the overall restraint in expenditure, spending on health and social care and social security continues to show significant growth and there will be continued pressures on those budgets from an aging population. These combined factors indicate the deficit is structural. This review has focused on setting out potential options to tackle expenditure and revenue.

Broadening and simplifying Guernsey's tax base would generate a more stable revenue stream. This review has illustrated what level of increase in income tax or a goods and services tax would be necessary to eliminate the deficit by raising revenue. It is recognised however that raising income tax will not resolve the long-term pressure on expenditure or the erosion of the tax base if the working age population continues to decline. On its own, raising additional revenues is only a short-term measure and is not a long-term solution.

The commercialisation of the States' trading assets could provide a longer term contribution to closing the current deficit by generating on-going returns. The authors note the shift in policy suggested by the proposals in the budget for trading assets to pay for their own capital projects through debt financing rather than paying for those projects through the capital reserve. The States should carry out a detailed review of current and historic policy objectives that affects its trading assets so as to understand their commercial capability and operational freedom.

The Public Service Reform agenda provides an opportunity for radical reform, but it will need to go beyond the financial savings of the Financial Transformation Programme and pursue true reform. As referenced in the 2017 Budget, "salami slicing" of budgets is not a long-term solution. A more fundamental change in the way that services are provided by the States will be needed if the States are to manage their long-term spending responsibilities successfully. The authors welcome the move towards the States working more closely with the private and third sectors. More effectively engaging them in policy and strategy development will surely increase confidence in government.

But with a declining working age population and an aging population, for fiscal control to be restored and maintained, Guernsey will have to develop policies to control *over the long-term* the components of its expenditure which are currently set to grow faster in perpetuity than income can reasonably be expected of income.