Fiscal Policy Framework

Update 2016

States of Guernsey

FINAL

Approved by the States on 16 November 2016

Glossary of Terms

Capital investment	The purchase or development of capital assets, e.g. buildings and infrastructure
Fiscal Policy	Government decisions governing tax rates and public spending
Medium-term	Between 5 and 15 years
Public sector	The governance, services and infrastructure provided by the government
Routine capital expenditure	The purchase of small capital goods such as police cars and IT infrastructure
Short-term	Up to five years
Zero-10 tax regime	Guernsey’s corporate tax regime

1. Executive summary

1.1. This appendix provides an update to the Fiscal Policy framework ('the framework') which guides all of the States' fiscal policy. It is intended to underline the credibility of fiscal policy and provide reassurance to taxpayers about the sustainability of future spending plans.

1.2. This update does not significantly change the spirit or practical application of the framework. The willingness and ability of the States to maintain consistent and stable fiscal objectives across multiple political terms, even when compliance with the rules of the framework is challenging, is an important measure of our firm commitment to long-term financial stability.

1.3. There are some recommended changes to the framework which clarify its application and which formally capture the extension made in 2015 in the Personal Tax, Pensions and Benefits Review (Billet d'État IV). Specifically this update:

- Formally includes the extension of the framework to set a limit on aggregate public revenue;
- Drops the superseded parameter on taxation within general revenue only;
- Extends the definition of the general revenue deficit used from the operating deficit to the overall deficit, formally capturing the allocation of money to the capital reserve within the fiscal rules; and
- Clarifies the definition of capital expenditure as requested in the capital prioritisation report in 2013 (Billet d'État XIX).

2. Background

2.1. The framework was introduced in 2009 (Billet d'État XI) and is based on the assumption that the following principles underpin good fiscal policy:

- stability is at the heart of sustainable economic prosperity;
- fiscal policy needs to be focused on the medium-term (five to 15 years); and
- economic and fiscal policy should be stable, transparent and predictable.

2.2. The framework set parameters on the States' fiscal policy. Broadly speaking these:

- Committed the States to a fiscal objective of long-term permanent balance i.e. that in the long term we should not spend more than we collect;
- Set a limitation on the level and durations of deficits within general revenue;
- Defined the size of the public sector (as applied to general revenue);
- Committed the States to sustained investment in infrastructure; and
- Defined the purpose of government borrowing and limited its extent.

2.3. The framework was extended in 2015 to capture the social security system and other revenue in the limits on the size of the public sector.

2.4. To provide greater transparency and oversight of the application of the fiscal rules, the States' performance against the framework parameters has been assessed on an annual basis in the Annual Independent Fiscal Policy Review, which is undertaken by independent reviewers.

3. Long term permanent balance

Fiscal rules: Guernsey's fiscal policy should operate on a principle of long-term permanent balance.

3.1. This requires that all government expenditure (capital and revenue) should be in balance with income in the long-term. We should not spend more than we receive. However, difficult economic conditions or a need to make substantial investments in infrastructure might make it necessary for us to run a temporary deficit in the short term.

3.2. The application of the permanent balance rule implies that if we use our reserves to support a temporary deficit we should restore these reserves with a period of budget surplus.

4. Clear limitations on acceptable temporary deficits

Fiscal rules: Annual overall deficits on general revenue may not exceed 3% of GDP

Identified deficits will be addressed within five years of their appearance through an appropriate combination of reductions in expenditure and revenue-raising measures

Measures to counter identified structural deficits will be agreed within two years of their identification

During any period of deficit, expenditure on public services must be limited so as not to grow in real terms at the aggregate level unless an appropriate combination of measures to remedy the deficit has been agreed and is being implemented

4.1. While larger economies can (and often do) run deficits for long periods, Guernsey, as a micro-jurisdiction dependent on international trade, is less able to run a deficit for an extended period without risking our long-term fiscal stability and credibility which is why time limits are set on running deficits.

4.2. Tackling any deficits will generally require a range of measures to limit expenditure and raise revenues. However, in this update the short-term fiscal restriction imposed in recent years is formalised to restrict the growth of expenditure on public services while a deficit persists.

4.3. In this update, the restriction on the size and duration of any deficit is placed on the overall size of the deficit (as opposed to the operating deficit), in order to tighten the fiscal parameters and provide greater clarity regarding the application of the framework. For clarity:

- Revenue income – routine expenditure = revenue surplus / (deficit)
- Revenue surplus – routine capital expenditure = operating surplus / (deficit)
- Operating surplus / (deficit) – transfers to reserves = overall surplus / (deficit)

4.4. As previously stated, the permanent balance rule implies that any period of deficit should be balanced by a period of surplus to repay the reserves depleted in running a short-term deficit. This is important for our fiscal stability. The exceptional circumstances of the transition to the zero-10 tax regime in 2008 and the almost simultaneous global financial crisis were much less difficult for the community than they might have been. Without reserves to enable us to smooth the transition, we may have needed to make more rapid and dramatic cuts in services or increases in taxes to bring the budget back into balance. If we are to be as well placed to meet any future crisis, we will need to restore the balance of the reserves.

5. A clearly defined public sector and commitment to limiting public sector growth

Fiscal rules: The aggregate amount of States' revenue, including all forms of taxation from within general revenue, social security contributions and the operating income of Committees should not exceed 28% of Gross Domestic Product ('GDP').

5.1. In the original framework the parameter establishing the size of the public sector was set with reference to general revenue taxation only. However, to ensure that the framework is comprehensive, the States added an additional parameter in 2015 which captures contributions to social security and income from operational activities. The new, more comprehensive parameter is included in this update in formal recognition of the prior decision. This supersedes the original parameter, relating to general revenue income.

5.2. This parameter allows revenue to be increased up to the pre-zero-10 norm if necessary. The limit, which sits approximately 2.5% of GDP above current aggregate income, is not a target or intended to encourage profligate spending. It has been set acknowledging the current financial constraints and the cost pressures on health and social care services in the medium to long-term as a result of demographic change, but not sufficiently high that these challenges can be met without restraining expenditure.

6. Sustainable investment in public infrastructure.

Fiscal Rules: Actual capital expenditure averaging 3% of GDP per annum in the medium-term.

6.1. Capital investment in public infrastructure is necessary to facilitate economic growth and under investment now poses a risk to both our economy and finances in the medium-term.

6.2. The 3% of GDP level set in the framework was set with reference to European Union (EU) averages and is consistent with medium-term projection of levels of investment required to replace, maintain and develop Guernsey's infrastructure to meet the needs of the community.

6.3. Capital expenditure is by its nature quite volatile, increasing and decreasing as large scale projects are commenced and completed. It is therefore impractical to expect that actual capital spend will equal 3% of GDP in any given year. The overall fiscal position must also be considered. The States have not met this criteria in recent years, in part because the persistence of the deficit has limited the amount of money available to dedicate to capital investment.

6.4. While it may be necessary to spend less than 3% of GDP in any given year, this does not remove the economic and fiscal risk of not making sufficient investment in the medium-term. In order to better reflect this the criteria is applied as a medium-term average.

6.5. It should be noted that both the limitation on the size of the overall deficit and the restriction on the amount of public sector debt which can be incurred in any term are linked to the assumption that the States should be investing in infrastructure at this level.

6.6. In the capital prioritisation report of 2013 (Billet d'État XIX) the Treasury and Resources Department requested clarification on whether this should include activities of the Corporate Housing Programme and the States' incorporated and unincorporated trading entities. Capital expenditure will be defined as encompassing:

- Routine capital expenditure from within general revenue
- Expenditure on capital projects from the capital reserve and other reserves held within general revenue or the social security funds, including, but not limited to, the Corporate Housing Programme Fund and the Guernsey Insurance Fund.

6.7. It should not encompass capital spending made by the States' incorporated and unincorporated trading entities, given that these should operate like commercial entities.

7. Limited and clearly defined government borrowing

Fiscal Rules: Gross debt can only be accumulated to fund capital investment with an identified revenue stream

The level of gross borrowing by the States may not exceed 15% of Guernsey's gross domestic product

The maximum additional borrowing sanctioned in any one States' term may not exceed the level of capital expenditure (3% per annum) over that time period

7.1. Placing clearly defined limits on how much public sector debt the States are allowed to accrue is one of the core functions of the framework. The limitations are designed to restrict the amount of liability the States can impose, in total or in any one term, on future taxpayers and ensure that by limiting the access to debt, its uses are properly scrutinised and prioritised.

7.2. The framework's limit on borrowing is significantly lower than those imposed by the EU and the UK reflecting the smaller, more vulnerable nature of Guernsey's economy. The framework also restricts borrowing to the funding of capital expenditure with the additional restriction that projects funded by borrowing should generate a revenue stream to facilitate the repayment of that debt.

7.3. The resolution to issue a bond in 2014 was made with the intention of lending the money on to States owned entities trading accounts and funds "subject to each recipient repaying such borrowing in full from a secure income stream and without direct recourse to general revenue". Each recipient is required to demonstrate how they will repay the borrowed money from a secure income stream in order that repayment of the debt should not become a liability on general revenue in the future.

8. Conclusion

8.1. The framework serves an important role in establishing a clear set of parameters in which the States should operate. It also provides a commitment to stability and transparency to reassure the public and the business community that Guernsey will retain a prudent, conservative fiscal policy.

8.2. The framework commits government to the following fiscal rules:

- Guernsey's fiscal policy should operate on a principle of long-term permanent balance
- Annual overall deficits on general revenue may not exceed 3% of GDP
- Identified deficits will be addressed within five years of their appearance through an appropriate combination of reductions in expenditure and revenue-raising measures
- Measures to counter identified structural deficits will be agreed within two years of their identification
- During any period of deficit, expenditure on public services must be limited so as not to grow in real terms at the aggregate level unless an appropriate combination of measures to remedy the deficit has been agreed and is being implemented
- The aggregate amount of States' revenue, including all forms of taxation from within general revenue, social security contributions and the operating income of Committees should not exceed 28% of GDP
- Actual capital expenditure averaging 3% of GDP per annum in the medium-term
- Gross debt can only be accumulated to fund capital investment with an identified revenue stream
- The level of gross borrowing by the States may not exceed 15% of Guernsey GDP
- The maximum additional borrowing sanctioned in any one States' term may not exceed the level of capital expenditure (3% per annum) over that time period

8.3. The above rules are an important part of Guernsey's fiscal management and the States are asked to accept the amended framework as detailed in this appendix.

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