Guernsey's Fiscal Policy Panel

1st Annual Report
1 December 2010

Preface

The Fiscal Policy Panel was set up by the States as part of the institutional arrangements supporting the Fiscal Framework. Its mandate is to provide an independent assessment of the States' fiscal conduct against the criteria set out in the Fiscal Framework adopted in April 2009.

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Main Points

- Guernsey seems to have suffered a moderate downturn as a result of the great recession that hit the global economy in 2008 and 2009. Although there are some signs that the worst is over, there is considerable uncertainty over the current economic position. The current evidence is mixed. It is far from certain that the economy is growing and 2010 could still turn out to be weaker than 2009, especially as significant uncertainty remains about the strength and durability of the global economic recovery.

- The Panel's mandate is to give an independent assessment of whether the States is respecting its own guidelines as laid down in the Fiscal Framework that was adopted in April 2009. Fulfilling this mandate is complicated by a number of factors including:

  - A particularly uncertain economic climate both globally and in Guernsey and regulatory uncertainty affecting the finance industry, Guernsey's largest industry.

  - The decision of the States to temporarily suspend its normal fiscal rules by deciding to partly finance the budget deficit resulting from the introduction of the zero/10 corporate tax system (zero/10) from reserves rather than immediately make full necessary adjustments to income and expenditure.

  - The continued uncertainty over the future of Guernsey's taxation structure.

  - The lack of consistent data and of unambiguous definitions of some of the key concepts in the Fiscal Framework.

- The Panel notes that a considerable adjustment has already been made to address the loss of revenue from the introduction of zero/10. Social Security contributions have been raised, allowing the Revenue Grant from the budget to the Social Security funds to be reduced, and indirect taxes have gone up. With an increase in direct personal tax revenues as well as personal contributions to the Social Security fund, the relative share of individuals in total taxation has increased significantly.

- Preliminary calculations suggest that both expenditure and revenue are currently significantly below their long term historical norms in relation to GDP. This is partly the result of moving some Social Security expenditure off budget, but spending is also lower because, insufficient funds have been allocated to meet the 3% target for capital expenditure set by the Fiscal Framework.

- The 2010 States Strategic Plan (SSP) reports optimistic, base and pessimistic scenarios of the projected fiscal position between 2011 and 2015. According to the projections updated by the 2011 Budget, balance would be achieved by 2014 under the base scenario and the Contingency Reserve Tax Strategy would still have a positive balance. The budget may not, however, be in permanent balance at that time as it is likely that the economy would be operating above potential at that point in the economic cycle.

1. Introduction

The Fiscal Policy Panel is part of the institutional arrangements supporting the Fiscal Framework that was adopted by the States in April 2009. Its mandate is to provide an independent assessment of the States' fiscal conduct against the criteria set out in that framework. The Panel set out its interpretation of the Framework, and of its own role, in a statement, published in September 2010, which is attached to this report as an appendix.

The Fiscal Framework states that the underlying guiding principle for fiscal policy is that the States' budget should be in "long run permanent balance". Ultimately the mandate of the Panel, which is an advisory body, is to give an opinion on whether this objective is being achieved; and, if not, to make recommendations on the actions that should be taken. The Fiscal Framework also gives some numerical criteria against which current policies should be assessed.

Such an assessment involves judgement as well as analysis. A planned surplus or deficit in any one year may, or may not, be consistent with the fundamental objective of long term balance depending on where the economy is in the cycle. In any economy this is an inherently difficult judgement, but it has been made harder by some apparent inconsistencies between the information received by the Panel in meetings with business and the official economic data. This report, therefore, makes some preliminary judgements about economic conditions in Guernsey in the light of global economic developments and uses the Policy Council's estimates of trend growth to assess the States' fiscal policy as set out in the States Strategic Plan and the 2011 Budget.

Assessment is made even more difficult at the moment because the States decided to temporally suspend normal fiscal discipline by planning to finance the budget deficits resulting from the introduction of the zero/10 corporate tax system partly from reserves rather than by immediately making the necessary adjustments to revenue and/or expenditure. Subsequently, the zero/10 system has itself come under pressure and Guernsey, along with the other Crown Dependencies, is presently reviewing its corporate tax regime.

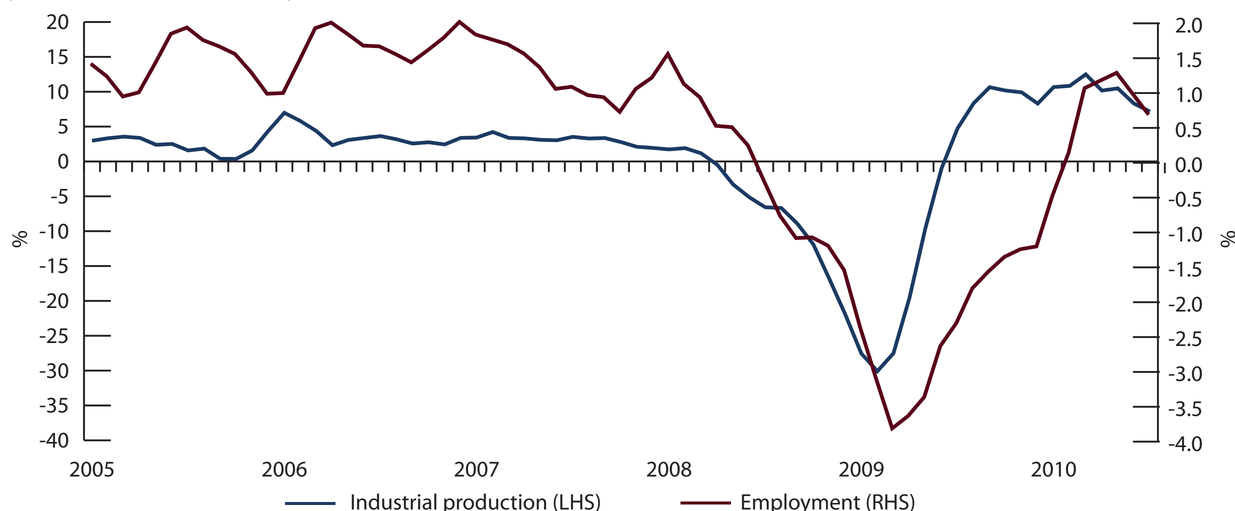
As published economic data can only give part of the picture of the state of the economy, the Panel considers it important to visit the Island and to talk with those involved in the economy. The Panel recently conducted its second fact-finding visit to the Island, meeting with representatives of most of the key economic sectors, in order to gain a firsthand view of the experience of local business during the recent downturn and their assessment of current and future conditions. It would like to thank those whom it met for their time and valuable opinions.

The Panel considers it important to take into account local circumstances and the preferences of Guernsey society in making its judgements and recommendations.

2. International Outlook

Most of the major economies have returned to growth after the 'great recession'. Figure 2.1 shows how industrial production and employment have changed in the advanced economies since the onset of the crisis. Both of these indicators began to contract in mid-2008. Industrial production started to grow again in mid-2009, followed by employment at the beginning of 2010.

Figure 2.1: Signs of recovery
(Advanced Economies, 3-month moving average (3mma) change on previous month's 3mma, annualised %)
(Source: IMF WEO, October 2010)



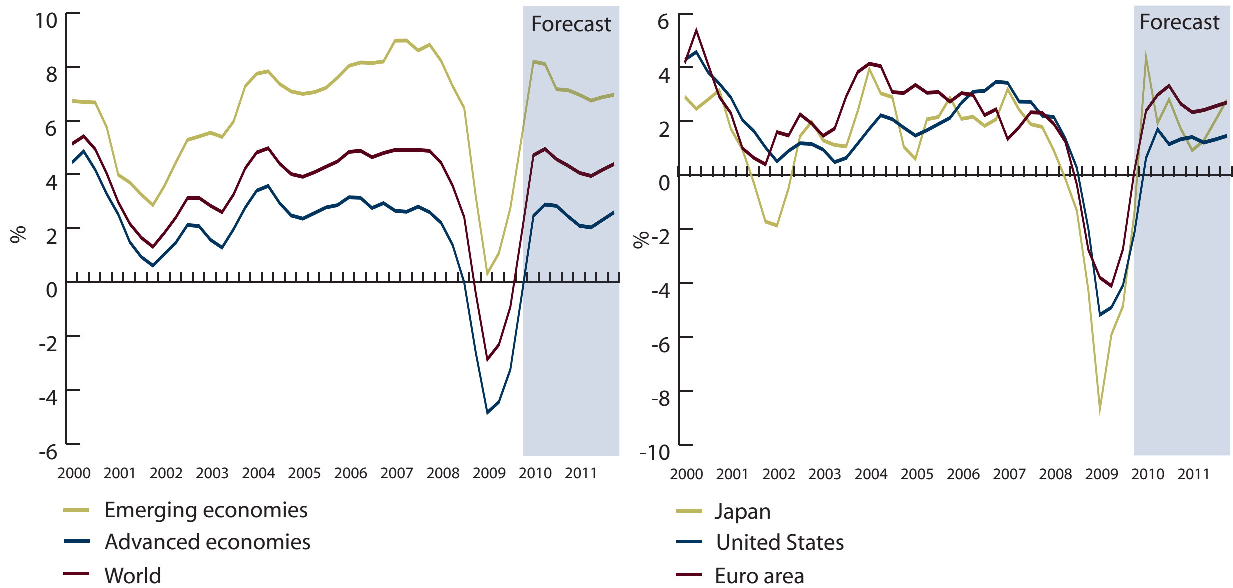
However, the outlook for the global economy remains profoundly uncertain. Expectations about the strength of the global recovery have swung about since the beginning of 2010, reflecting fears of fiscal sustainability and contagion in the Euro area, disappointing performance in the United States, and worries over international imbalances and a lack of international coordination. The swings have also been visible both in financial markets and in commodity markets. Equity markets gave up earlier gains before recovering in the autumn. Oil prices – recently a good bell-weather of global trends - softened in mid-year to about $70 per barrel before rising back to over $80. Uncertainty and volatility is likely to continue.

Despite fears over a possible 'double dip', mainstream forecasts, such as those of the International Monetary Fund (IMF) [1], suggest a continuation of recovery (Figure 2.2). Emerging economies, especially China and India, are expected to contribute most to global growth. Growth in advanced countries is expected to be lack-lustre, with downside risks. The recovery in the Euro area, though recently revised up, is expected to be particularly meagre. Year on year, the Euro area is forecast to grow by 1.7% this year and 1.5% in 2011. The IMF forecast for the United Kingdom is 1.7% for 2010 and 2.0% for 2011. The year on year figures are, however, somewhat misleading; the UK is expected to slow quite substantially during the course of 2011 as public expenditure cuts start to bite so that by Q4 2011 year on year growth is 1.6%.

Reflecting the likely continuation of spare capacity, forecasts for inflation in advanced countries in 2011 remain extremely low – under 1.5% according to the IMF.

[1] World Economic Outlook, October 2010, International Monetary Fund.

Figure 2.2: IMF forecasts of GDP growth
(% change on year before)
(Source: International Monetary Fund, WEO Oct 2010)



The international background to fiscal policy decisions in Guernsey remains highly uncertain and volatile. Though the Panel believes that a 'double-dip' recession is not the most likely outcome, there remain substantial downside risks to the global economic outlook. Caution suggests that Guernsey should not be factoring a robust global recovery into its fiscal and economic forecasts.

3. The Guernsey Economy

As this is the Panel's first annual report, this section begins by briefly describing the structure of the economy and issues related to measuring economic activity. It then looks at recent developments in the overall economy and in the finance and non-finance sectors. As Gross Domestic Product (GDP) and output data give only an imperfect and lagged view of economic activity, the section also briefly reviews recent developments in the labour and property markets and discusses recent data on tax receipts. It also discusses the inflation outlook. Finally it draws some tentative conclusions on the economic outlook.

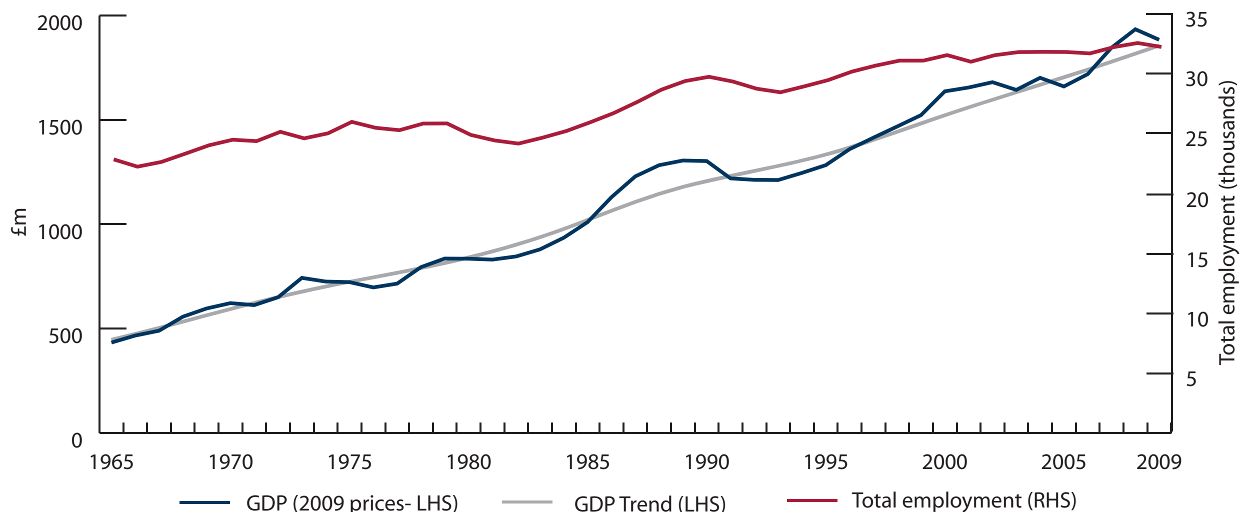
3.1. Measuring Economic Activity

As is normal for a small economy, there are far fewer economic data series available in Guernsey than in a large advanced economy. Furthermore, as the Island is highly dependent on financial services, the relationships between basic indicators such as GDP (see Box 3.1) and the variables of most interest to the Panel such as activity levels and tax revenues need to be treated with special caution. For these reasons, the Panel looks at a wide range of published data, including employment, unemployment, inflation, residential property prices and Employee Tax Receipts (ETI). It also relies on surveys and discussions with industry representatives.

GDP is a much used measure of economic activity. Guernsey has a long series of GDP estimates – going back, on a reasonably consistent basis, to the mid -1960s. Real GDP can be obtained from the nominal figures by allowing for inflation using the Retail Price Index, for which historic data also exist. Measured by real GDP, output has grown by about a factor of four since the mid-1960s (Figure 3.1). The more recent trend[2] rate of growth of real GDP since 2000 is about 2.2% per annum.

Employment, which is also an important measure of economic activity, has grown by over 40% since the 1960's. GDP has increased considerably more than employment as GDP per worker has more than trebled over this time. There is a cyclical relationship between the two series with the two periods of prolonged recession during the 1980s and 1990s coinciding with a reduction in employment.

Figure 3.1: Long run level of GDP and employment [2, 3]
(Source: Policy Council)



[2] Trend GDP has been estimated using a Hodrick-Prescott filter, a common econometric technique, to remove cyclical changes in output.
[3] Methodological changes in the collection of total employment statistics were made in 1980. The effect of these changes was to reduce total employment figures by approximately 300, accounting for about one third of the employment decrease observed between 1979 and 1980.

Box 3.1: Measuring the economy in Guernsey

Gross Domestic Product (GDP) is the traditional measure of a country's overall economic activity. Whilst imperfect, it provides a monetary value of the total amount of goods and services produced within an economy. It is often used to facilitate comparisons through time and internationally between countries and jurisdictions.

Gross Domestic Product can be measured by three approaches:

1. The Production Approach

Measures GDP as the sum of all the Gross Value Added (GVA) i.e. the difference between the value of goods and services produced in each industrial sector and the cost of raw materials and other inputs which are used in production.

2. The Income Approach

Measures GDP as the total of incomes of individuals, companies and other bodies earned from the production of goods and services.

3. The Expenditure Approach

Measures GDP as the total of all expenditure on finished goods and services, less spending on imports.

In many economies all three approaches are used, which allows them to be cross checked for consistency. However, data constraints preclude the use of either the production or expenditure approach in Guernsey. Thus GDP in Guernsey is calculated via the income approach, using data mainly sourced from income tax returns.

While tax data from employed individuals is known rapidly, there is a delay in the calculation of final tax liabilities for the profits of companies and the self employed. Initial estimates of Guernsey's GDP are normally calculated with a nine month lag. It should also be noted that the overall quality of the measure has decreased with the introduction of zero/ten as, whilst the statutory requirement to complete tax returns remains, companies have taken longer to file their returns as no tax is payable.

Guernsey thus calculates its GDP as the sum of the following:

- Individuals' Remuneration (i.e. wages, salaries and bonuses minus contributions to pension funds);
- Self employed profits;
- Company profits.

Plus so called "other income" which comprises:

- Public and private sector income arising from capital and the ownership of buildings;
- Public sector trading board profits;
- Other private income.

The sum of all these constitutes an estimate of GVA.

GDP is then arrived at by subtracting an allowance for Financial Intermediation Services Indirectly Measured (FISIM). Thus:

GDP = GVA - FISIM

The FISIM adjustment subtracts an amount to reflect the profits made by financial firms from interest rate spreads, i.e. profits derived from the difference between borrowing and lending rates. Unlike the profits from

(Box 3.1: Continued)

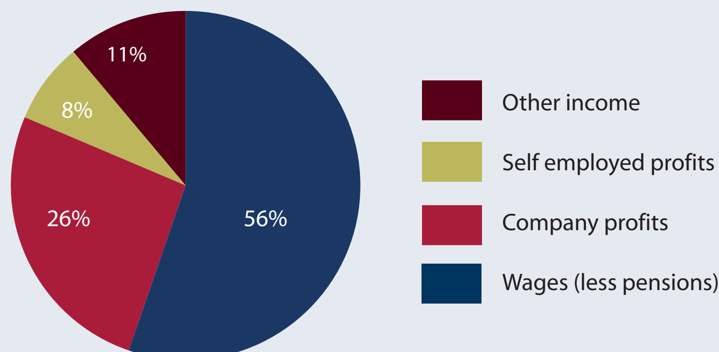
services for which a fee was charged, these profits were not traditionally counted as part of final production in widely used definitions of GDP. Under the income method used in Guernsey, profits from spreads would appear as part of the profits of the financial sector. Hence the need for an adjustment if the focus is on the (internationally comparable) concept of GDP[4] .

For most countries the FISIM correction is small. In Guernsey, however, as in the other Crown Dependencies, the adjustment is substantial, due to the large weight of financial services in the activity of the Island. In 2009, FISIM was around 9% of GDP. The weight of financial services in GVA was 47% as opposed to 41% in GDP.

Given the importance of financial services in Guernsey, it may well be that GVA would be a better indicator of output and activity on the island. The Panel, however, is chiefly concerned, not with the level of GDP, but with indicators of activity that are well known and which have been produced in a reasonably consistent way over time. All indicators are imperfect and subject to interpretation. For the moment the best overall indicator of activity that is available is the annual time series of GDP.

There are other differences between the accounting concepts used in Guernsey and international practice. For example, Guernsey does not include the imputed rent on owner occupier housing, which is part of standard international definitions of GVA and of GDP. The inclusion of an estimate of this component would substantially raise measured GDP. Whilst the Panel notes that measurement issues, such as this, are under consideration, the Panel is most interested in indicators of trends and of changes from year to year.

Figure 1: Composition of Guernsey's GDP (2009)
(Source: Policy Council)



[4] International National Income accounting practice is however changing toward the inclusion of estimates of FISIM in the definition of GDP.

3.2. Structure of the Guernsey Economy

In 2009 Guernsey's GDP was approximately £1,900m. About 32,000 people were employed out of a total population of 62,000.

As Figure 3.2 shows, the financial services sector accounts for 41% of GDP (Figure 3.2)[5]. The figures presented include an adjustment for profits made by financial firms from interest rate spreads (see Box 3.1) Without this adjustment the measured share of financial services would be higher. The finance industry is also the largest employing sector accounting for 23% of total employment (Figure 3.3).

Figure 3.2: Economic output (GDP) by sector (2009)[6]
(Source: Policy Council)

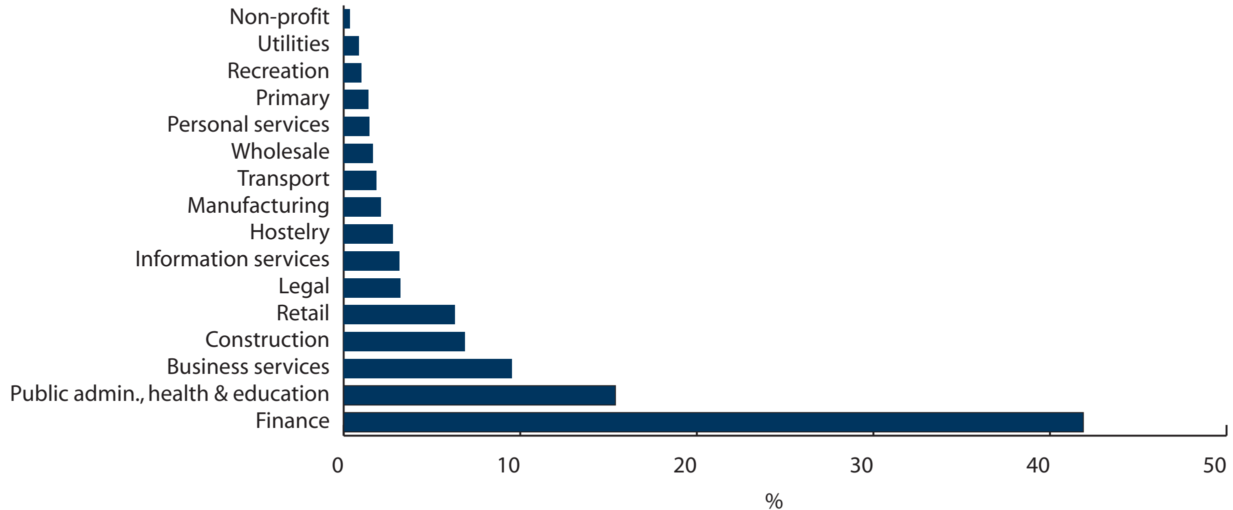
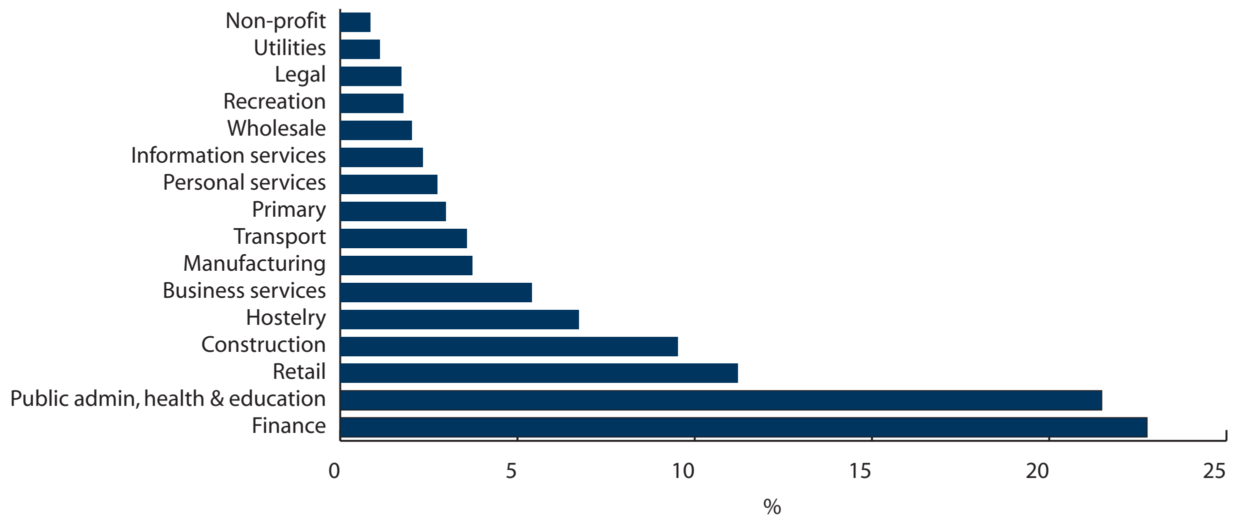


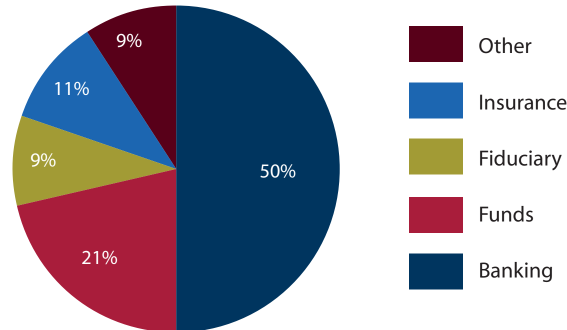
Figure 3.3: Employment by sector (2008)[7]
(Source: Policy Council)



[5] Output represents GDP components which can be allocated by sector i.e. wages (less pension contributions) plus company and self employed profits.
[6] Output represents GDP components which can be allocated by sector i.e. wages (less pension contributions) plus company and self employed profits.
[7] Employment figures presented refer to 2008. More recent employment data is categorised using the SIC classification system, and the sector structure is not directly comparable with the current output data. From 2011 onwards all data presented by sector will use the SIC classification system.

Guernsey's finance industry is quite diverse and comprises four main sub-sectors: banking, funds, insurance and fiduciary (Figure 3.4). Guernsey is also host to the Channel Islands Stock Exchange. Banking, the largest sub-sector, comprises approximately half of finance sector output in terms of GDP. These numbers are based on reported wages and profits of banking groups and the total will include profits from non-banking activities of some banking institutions (as many have their own fiduciary and funds businesses). The fund and investment sector comprise 21% of reported finance sector output. Fiduciaries (or trusts) comprise 9% of output. Guernsey is the largest European domicile for captive insurance, and insurance activities contribute 11% of finance sector activity.

Figure 3.4: Composition finance sector output (2009)
(Source: Policy Council)

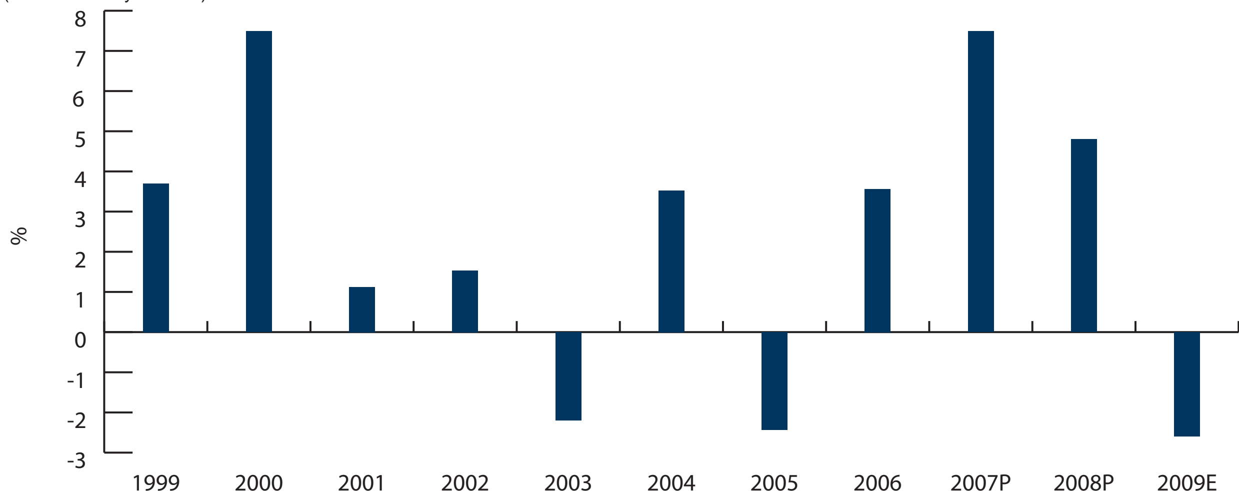


The public administration, health and education sector, which incorporates all the States' employing bodies, represents 14% of output allocated by sector and employs almost as many people as the finance sector. Of the remaining sectors, the largest contributors to output are: business services, which encompasses a wide range of business support activities including recruitment agencies, specialist consultants and technical and marketing services (12%); retail (6.5%) and construction (6.5%).

3.3. Recent Economic Performance

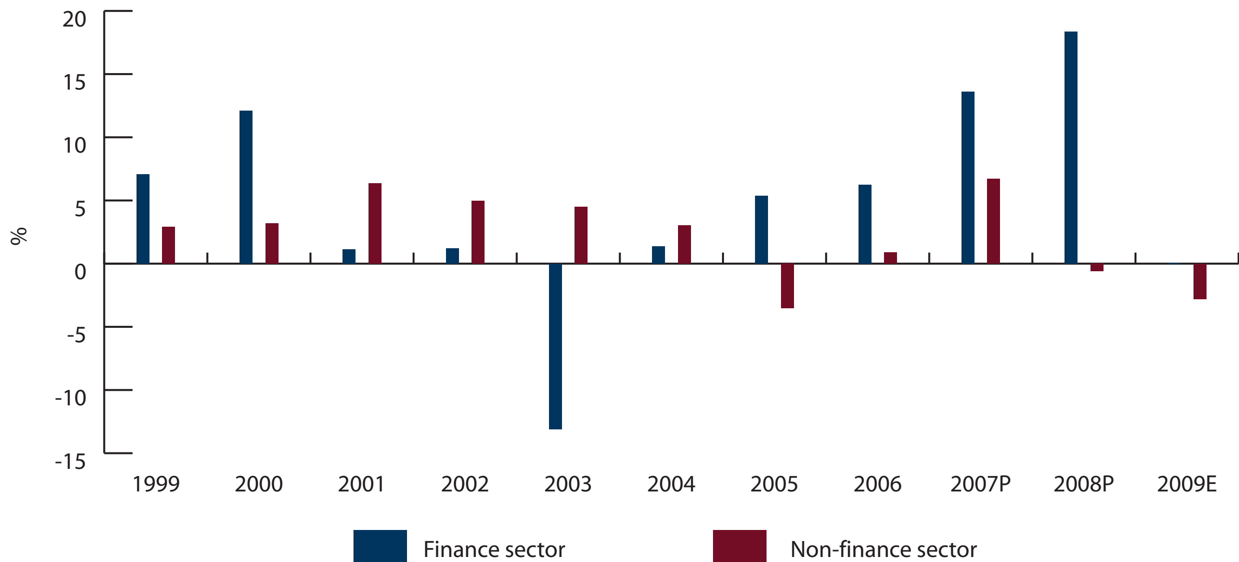
As measured by GDP, growth in the ten years to 2009 averaged 2.2% per annum in real terms. Following three consecutive years of growth, GDP declined by 2.6% during 2009 but remained 13% higher in real terms at the end of 2009 than at the end of 2005 (Figure 3.5).

Figure 3.5: Annual real GDP growth
(Percentage change)
(Source: Policy Council)



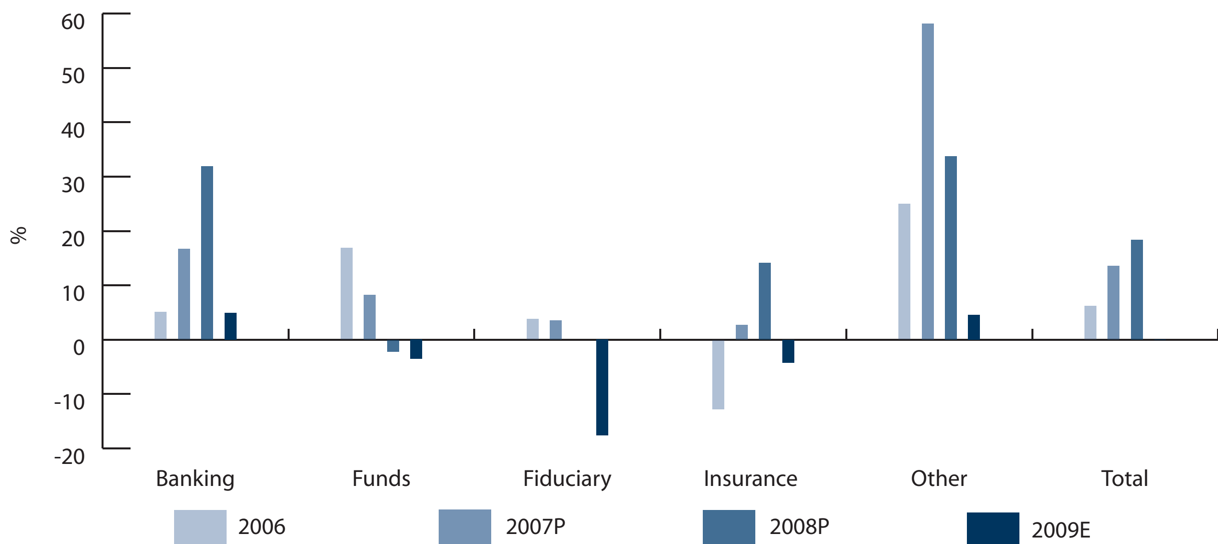
Over the ten year period to 2009 the finance sector as a whole grew at an average rate of 4.8% per annum in real terms with considerable volatility (Figure 3.6). A sharp contraction in 2003 was followed by five continuous years of increasingly rapid growth to 2008 then stagnation in 2009.

Figure 3.6: Annual change in real finance and non-finance sector output
(Percentage change)
(Source: Policy Council)



The sector is not homogenous as can be seen from Figure 3.7.

Figure 3.7: Annual change in real finance sub-sector output
(Percentage change)
(Source: Policy Council)

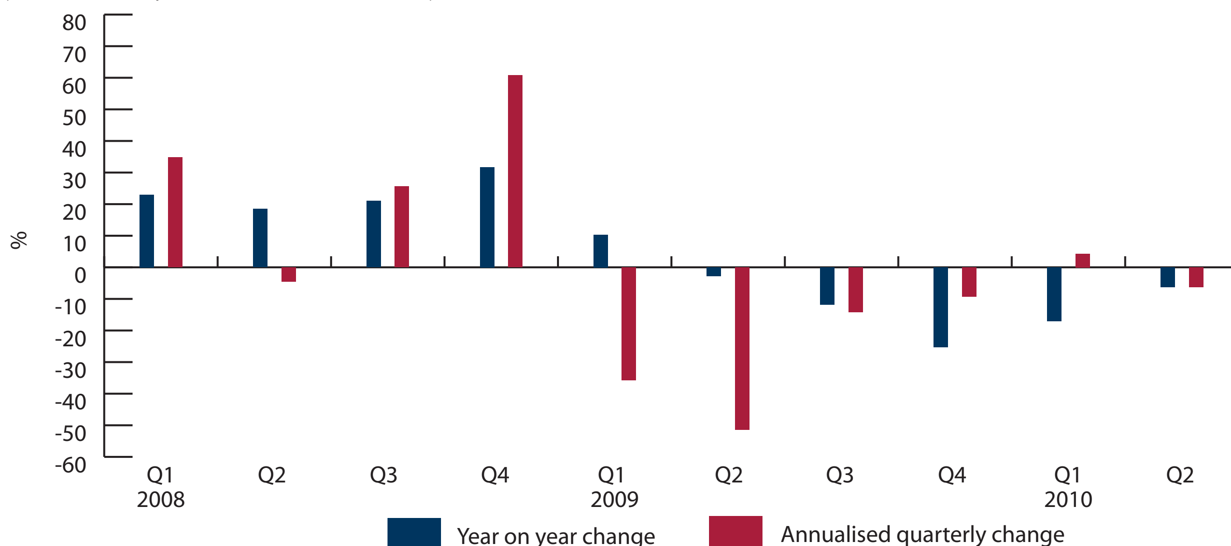


Non-finance sector growth over the ten year period to 2009 was much lower on average, just 2.3% per annum. This sector contracted a little in 2008 and is estimated to have contracted by 2.8% in 2009.

The Guernsey Chamber of Commerce annual business trends survey in February painted a picture of mildly improving business confidence: 46% of businesses were reported as expecting a rise in turnover in 2010 against 23% expecting a decline and 31% expecting unchanged conditions. By comparison, the previous year's report showed only 36% of businesses forecasting an increase in turnover for 2009 with 41% of businesses expecting a decline.

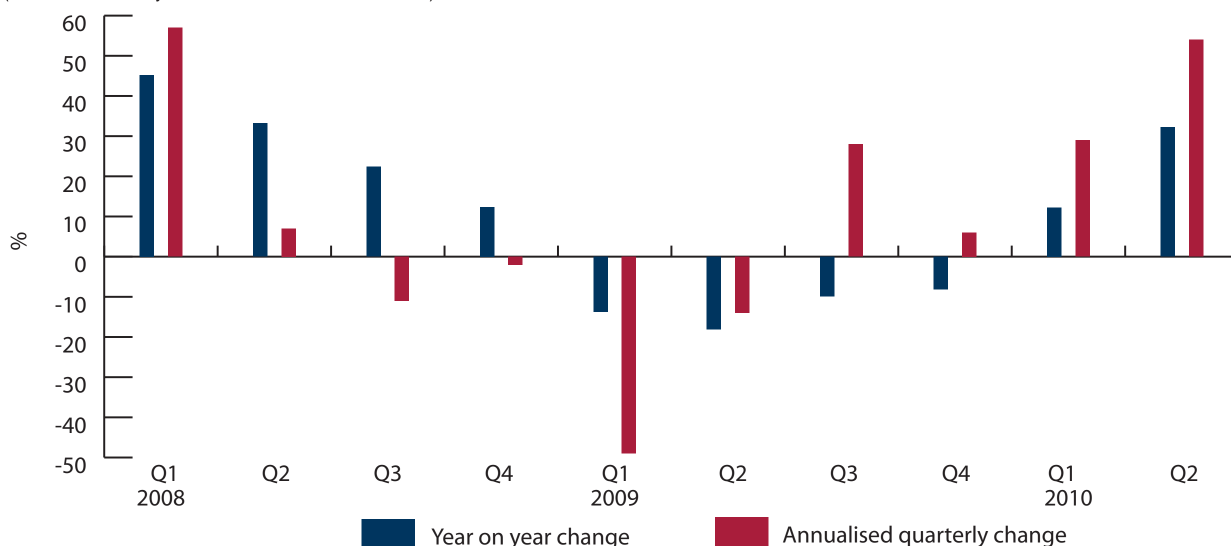
Recent quarterly data (Figure 3.8) show that bank deposits, which started falling in the first quarter of 2009, were still lower than a year earlier at the end of the second quarter of 2010, although the pace of decline had slowed. Lower deposits together with a decline in banks' net interest margin consequent on the fall in short term sterling interest rates might be expected to have depressed bank profits.

Figure 3.8: Change in banking deposits
(Percentage change, current prices)
(Source: Guernsey Financial Services Commission)



The value of investment funds administered in Guernsey declined between mid-2008 and mid-2009 but grew sharply in the first two quarters of 2010, to reach a level 32% higher than a year earlier (Figure 3.9). Some of this growth is likely to be attributable to rises in asset values but there has also been an increase in the number of fund administrators moving to the Island. The number of non-Guernsey[8] registered funds under administration in Guernsey increased from 324 at the end of the final quarter of 2009 to 349 at the end of the second quarter of 2010.

Figure 3.9: Change in the value of funds under administration
(Percentage change, current prices)
(Source: Guernsey Financial Services Commission)



[8] Non-Guernsey funds are those administered by local firms but not registered in the island. They represent about a third of the total number of funds administered in the Island and were the only fund type to see significant increase in the second quarter of 2010.

There are few reported data to assess current conditions in the fiduciary and insurance sub-sectors. Representatives of the finance sector reported to the Panel that the fiduciary sector had experienced tough conditions in 2009, consistent with the estimated 16% contraction, and that conditions in 2010 remained weak. The Guernsey Financial Services Commission (GFSC) reported that total insurance assets in the island increased from £21 billion at the end of 2008 to £23 billion in 2009.

Many businesses suggested that they had sought to reduce their cost base. It was suggested to the Panel that many in the finance sector had cut their training, recruitment and consultancy budgets. This is likely to have had a negative impact on demand for the services and products of the non-finance sector.

Retail output grew by an average of 2.5% a year in real terms between 1998 and 2002. However, between 2003 and 2008, it declined on average by just under one per cent per annum in real terms. 2009 GDP estimates indicate a contraction of 8.3% in the retail sector. More than half the decrease can be attributed to decreases in aggregate remuneration, consistent with testimony from retailers that they have reduced staffing levels. However, retailers told the Panel that 2009 had not been an especially difficult year and that whilst business had been slow at the beginning of 2010, it had picked up in recent months. They did report significant pressure on prices from competition from the internet, particularly for items such as clothing and electronics[9].

The construction industry grew rapidly between 1998 and 2003. This coincided with a period of numerous large commercial projects on the Island. With the completion of the majority of these projects, the level of work available has, reportedly, declined. Over the five year period ending in 2008, output from the construction industry declined by an average of 3% per annum. The published national accounts show a further 1.1% fall in 2009.

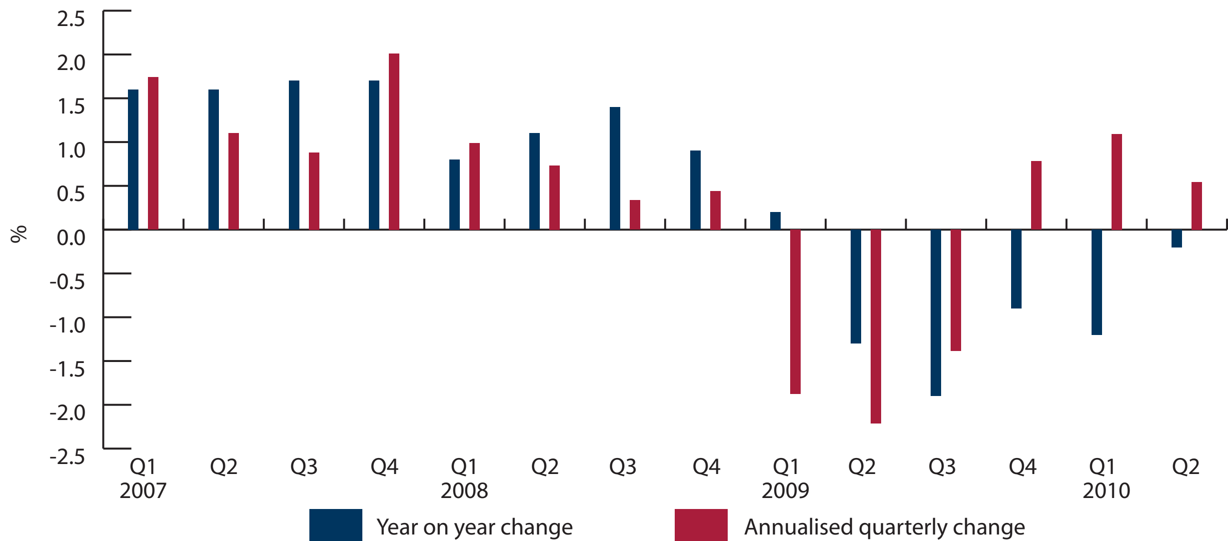
Tourism numbers have held up well during the global downturn. Tourist numbers, reported by the Commerce and Employment department (C&E) Tourism and Marketing division, were 306,000 in 2009, an increase of approximately 7% on 2008. C&E report that present indications are that numbers will show a further increase in 2010 and that the average length of stay has also increased. Hotel occupancy, collected by C&E from local hoteliers, increased in both 2009 and 2010: rates standing at 78% in June 2010 compared to 73% two years earlier. Economic activity relating to tourism is not captured in any single sector under the economic sector classification system, but will be reflected in the hostelry, recreation and retail sectors.

[9] A recent Commerce and Employment (C&E) survey reported that internet sales penetration in Guernsey is twice the level of the UK.

3.4. Labour Market

Total employment in Guernsey fell during the first three quarters of 2009 (Figure 3.10). Although it has subsequently expanded moderately, employment in the second quarter of 2010 remained 0.2% lower than a year earlier.

Figure 3.10: Quarterly and annual change in total employment
(Percentage change, seasonally adjusted)
(Source: Social Security)



Over the year ending in the second quarter 2010, employment in the professional, business, scientific and technical sector grew by 3%; but employment in finance, information and communications and wholesale and retail declined by 2.2%, 0.6% and 1.3% respectively.

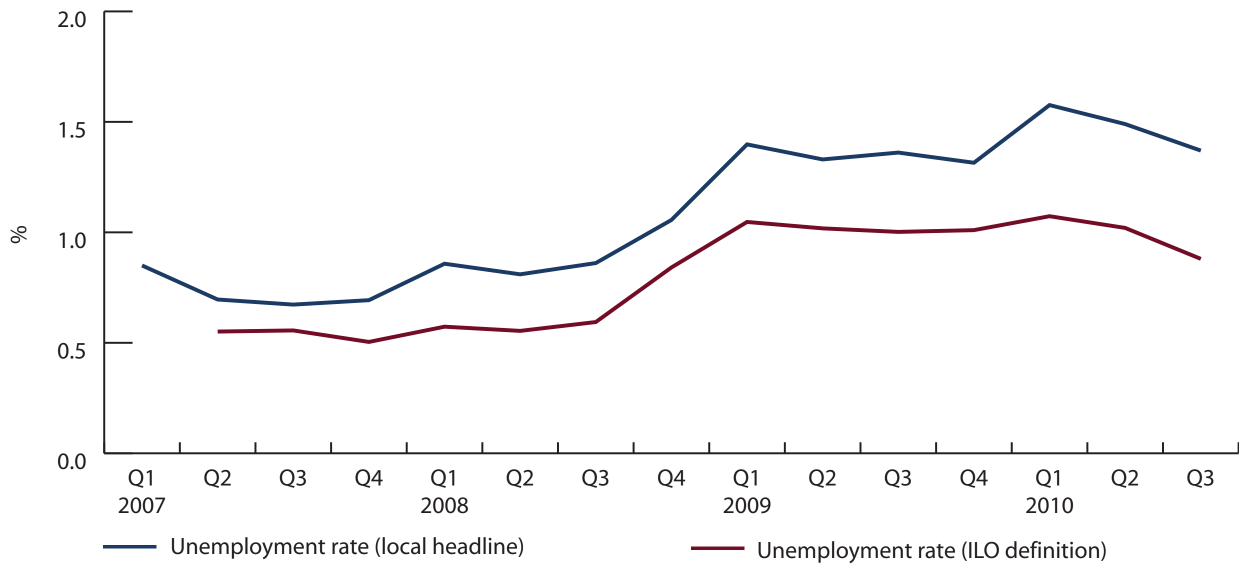
Unemployment

By international standards, unemployment in Guernsey is low. Measured on the International Labour Organisation (ILO) definition, unemployment peaked at 1.0% in the first quarter of 2010.

In the last 18 months unemployment, as measured by the number of people registered for unemployment or supplementary jobseekers' benefits, has risen. The unemployment rate peaked at 1.6% in the first quarter of 2010, well above the 0.7% average of the previous decade, before falling a little in the second and third quarters (Figure 3.11). The number of unemployed reached a peak of 510 people in April 2010 but has since declined to 435 in September 2010, little changed from a year earlier.

The chart also shows unemployment using International Labour Office definitions. It can be seen that on this measure, the rate is lower and appears to have stabilised.

Figure 3.11: Unemployment rate (non seasonally adjusted)
(Source: Social Security)

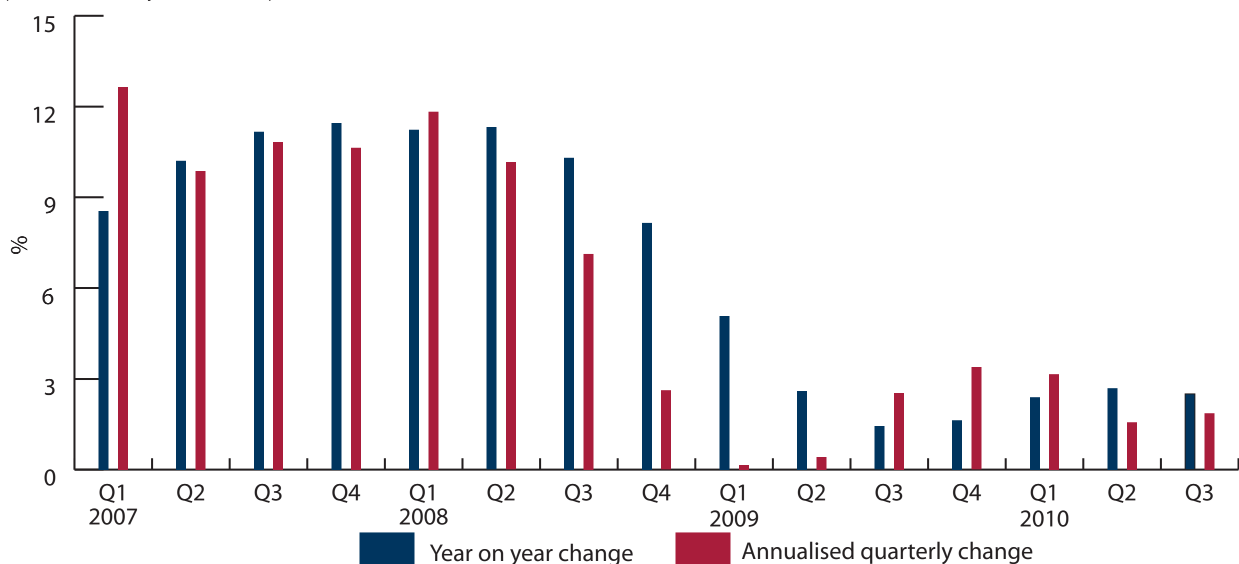


Tax Receipts

In Guernsey tax is collected at source from employees' incomes through an employee tax instalment (ETI) system which works like the UK's Pay As You Earn (PAYE) system. As employees' incomes account for around 54% of GDP and around 47% of total States' tax revenue, this is a useful indicator. It is also timely as it is available on a quarterly basis. The single person's tax allowance was increased from £8,250 in 2008 to £8,700 in 2009 and to £9,050 in 2010. Without wage or employment growth, rises in allowances would reduce the total tax collected.

ETI receipts showed strong growth throughout 2007 and 2008 tailing off rapidly at the end of 2009. The first half of 2009 saw little growth in receipts. Growth has resumed in 2010, albeit at rates little more than a third of the period 2007 to 2008 (Figure 3.12). Allowing for the effects of increased personal allowances (which without any earnings growth would have reduced revenues by around £2m) this is evidence of, underlying, if weak, real growth during 2010.

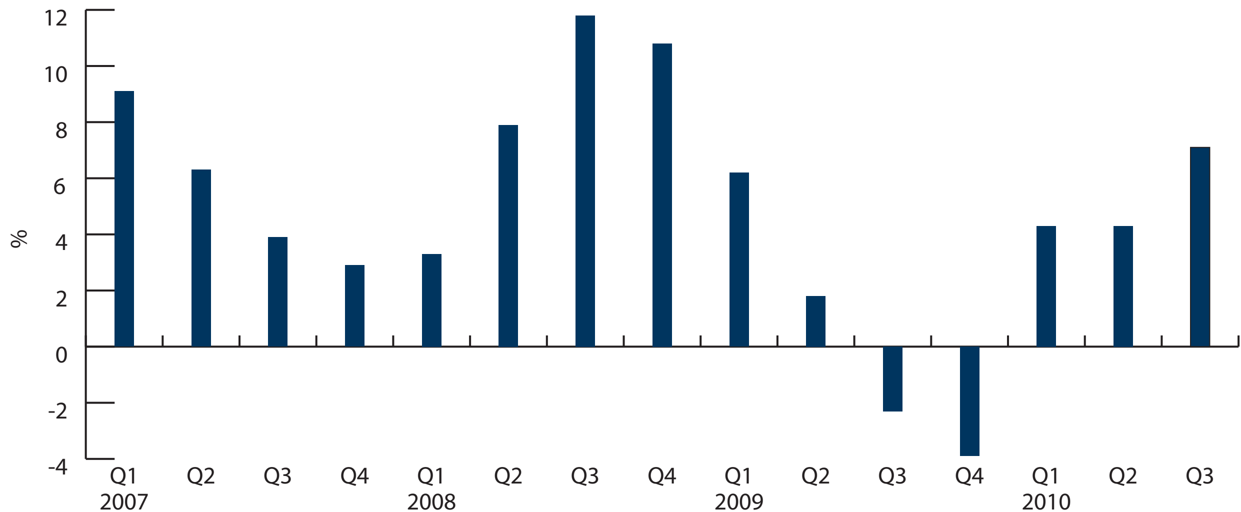
Figure 3.12: Quarterly and annual change in nominal employee tax income receipts
(Percentage change, seasonally adjusted)
(Source: Treasury & Resources)



3.5. The Property Market

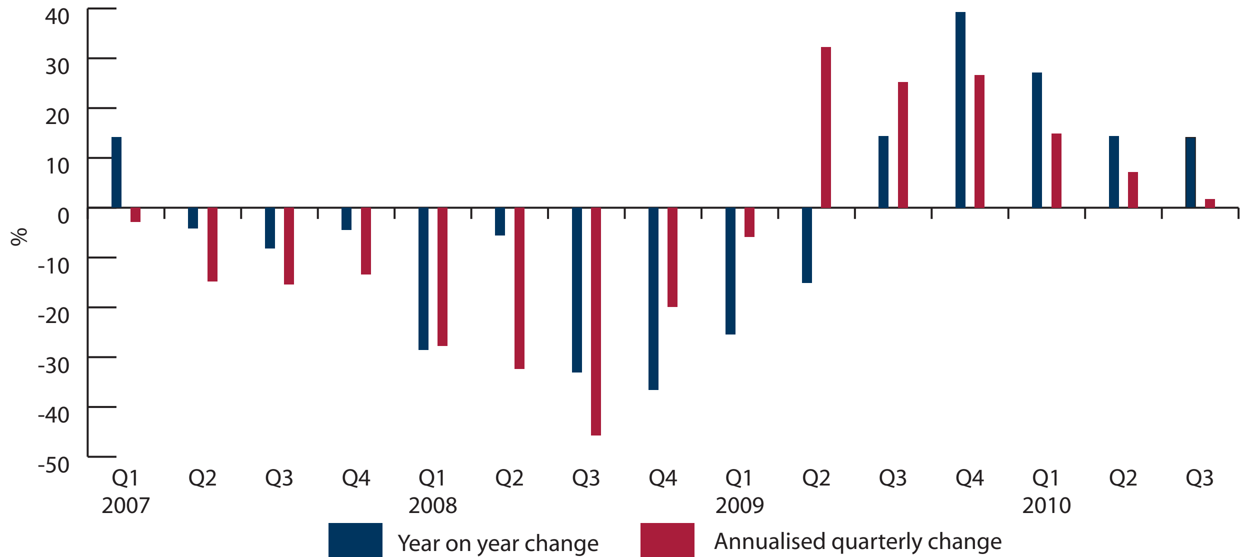
House prices on the local market rose strongly, as compared to a year earlier, from the second quarter of 2008 to the first quarter of 2009 (Figure 3.13). There was a small decline year on year in the third and fourth quarters of 2009 but since then prices have again been rising at a moderate rate.

Figure 3.13: Annual change in median average local market property price
(Percentage change)
(Source: Policy Council)



The volume of local market residential property transactions declined in both 2007 and 2008 (Figure 3.14). The annual rate of decline reached a trough of 37% in the fourth quarter of 2008 (for comparison the residential property sale volumes in the UK were 98% lower in August 2008 than a year earlier). Volumes however began to grow sharply in the second quarter of 2009 and this has continued into the first half of 2010, though growth has been slowing.

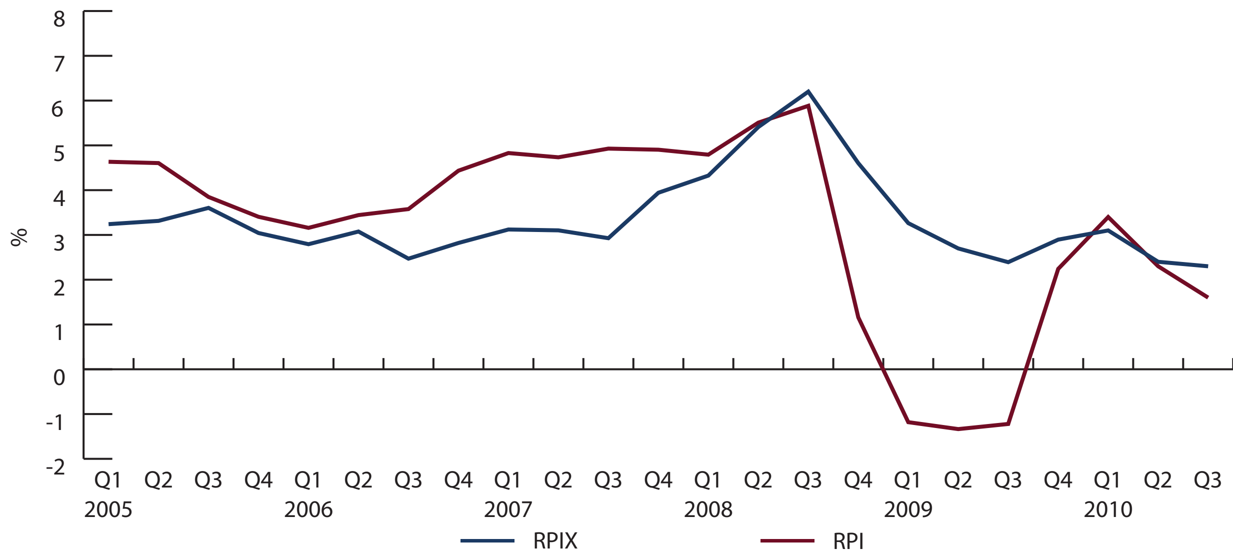
Figure: 3.14: Quarterly and annual change in local market residential property transactions
(Percentage change, seasonally adjusted)
(Source: Policy Council)



3.6. Inflation

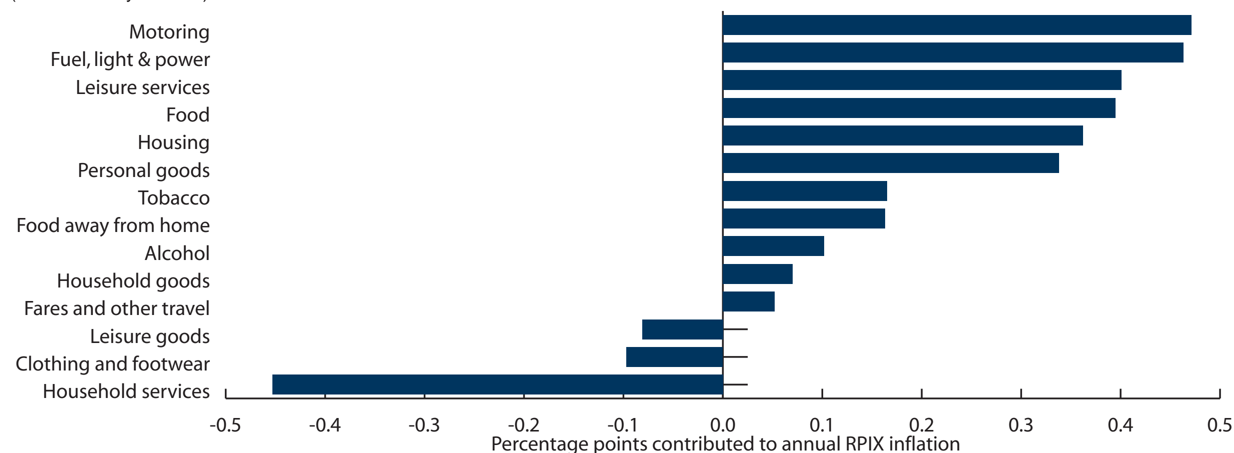
Inflation as measured by the annual change in the Retail Price Index excluding mortgage interest payments (RPIX), the States' preferred measure, was 2.3% at the end of September 2010 (Figure 3.15), below the 3% inflation target as set out in the Fiscal & Economic Plan, 2010. RPIX inflation declined from a peak of 6.2% in September 2008 to 2.4% in September 2009. Low levels of inflation could be a signal of weak local demand. Since then, RPIX inflation has remained stable. Inflation in Guernsey typically exhibits broadly the same trends as inflation in the UK. Recently, however, UK inflation has been affected by changes in the rate of VAT, which does not apply in Guernsey. RPIX inflation in Guernsey has, in recent quarters, been lower and less volatile than the equivalent measure in the UK, (which stood at 5.0% in June 2010). In Guernsey, as in the UK, the large fall, during 2008/9, in the RPI measure, as compared to RPIX, reflects the cut in interest rates.

Figure 3.15: Annual changes in retail price indices
(Source: Policy Council)



Principle drivers of RPIX inflation in the most recent quarter are those dependent on global fuel and oil prices; motoring and fuel, light and power, which each contributed approximately 0.5 percentage points to the annual increase (Figure 3.16). Food prices have also exerted an upward pressure on inflation, contributing an increase of 0.4 percentage points to the annual percentage change in the index. As observed by representatives from the retail sector, goods which are subject to competition from the internet, such as clothing and electrical goods have experienced a general decrease in price. Both clothing and footwear and leisure goods made a negative contribution to RPIX inflation of 0.1 percentage points. Household services made a negative contribution of 0.5 percentage points, in part as a result of decreases in telecoms charges resulting from increased competition. Inflation measured by the Retail Price Index (RPI) which includes a measure of mortgage interest was, as was the case in the UK, negative for the first three quarters of 2009 following the reduction of the Bank of England base rate to 0.5%.

Figure 3.16: Contributions to annual percentage change in RPIX (September 2010)
(Source: Policy Council)



3.7. Assessment

Recent data has been mixed:

- In the finance sector, bank deposits are still declining, albeit at a diminishing rate. The value of funds under administration has been growing over the first two quarters of 2010 and there is evidence to suggest that this is the result of increased activity as well as rising asset prices. There is also some evidence of increasing activity in the insurance sector.

- In the non-finance sector, construction, which accounts for 6.5% of total economic output, is expected to be flat; retail had a slow start to the year and is now reported to be improving; cost cutting in the financial sector is thought to have led to difficult conditions for the business services sector and only tourism is relatively confident.

- The housing market is showing some signs of growth after two slow years. Both prices and the number of transactions are increasing, but recent data has shown some softening.

- The data from the labour market is mixed. Unemployment has come down a little from its peak in Q1 2010, and employment has been rising moderately since Q4 2009, though quarterly growth has slowed.

- ETI tax receipts, after being flat over the previous three quarters, have picked up a little in the first three quarters of 2010, which could be consistent with a modest increase in earnings.

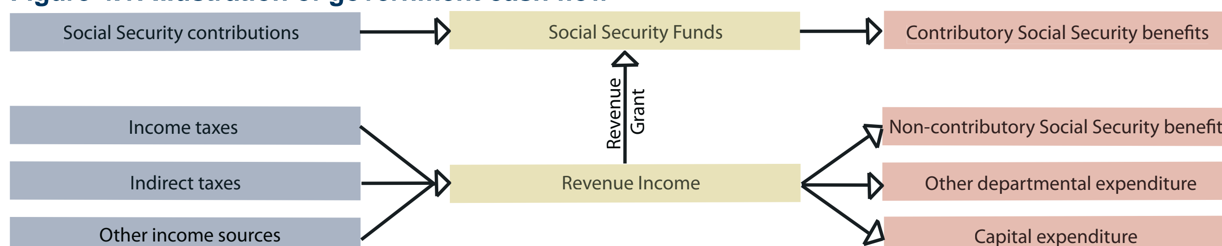
Overall, the Panel considers that much of the evidence currently available suggests that Guernsey weathered the global great recession without too much pain to the economy and that there are a number of signs that the worst may be over.

Looking forward, growth is likely to resume, albeit moderately, in 2011. The Guernsey economy should benefit from recovery in the UK, the continuing effects of the 2008 depreciation in the sterling exchange rate and the likely persistence of low sterling interest rates. The latter phenomenon will however continue to depress banks' net interest income. Furthermore considerable fragilities remain in the global economy and global and EU regulatory developments continue to create uncertainty for the finance sector.

4. Guernsey's Public Finances

Guernsey's public finances are managed through a series of interrelated accounts and reserves for general government, capital and Social Security purposes (Figure 4.1). Revenue income, predominantly from taxation, funds current departmental and capital spending as well as grants to the Social Security Department (SSD) which manages the Social Security system. In addition, SSD receives income in the form of Social Security contributions from employers and employees (see Box 4.1).

Figure 4.1: Illustration of government cash flow



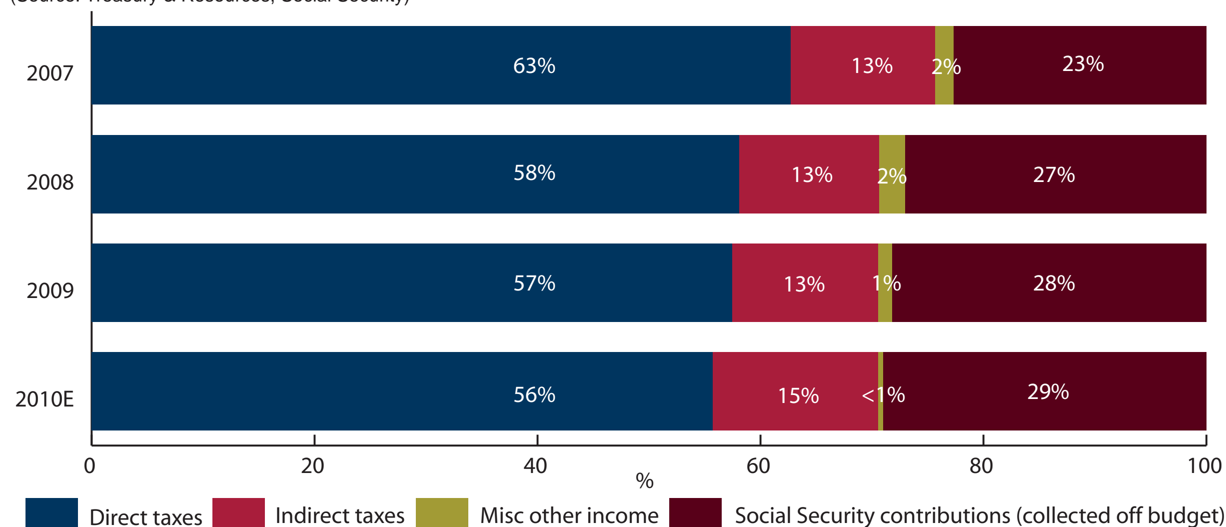
Whilst the Fiscal Framework sets numerical parameters to constrain the revenue, capital and operating accounts that comprise the States' budget, the Social Security system lies off budget and outside the Framework. Nevertheless, the interrelationship between the Social Security system and the other accounts means it is of legitimate interest to the Panel.

4.1. The Composition of States' Income and Expenditure

Income

Figure 4.2: Distribution of States' revenue income[10,11] and Social Security contributions

(Source: Treasury & Resources, Social Security)



Since the introduction of the zero/10 corporate tax regime, which cut corporate tax rates in 2008, total States' income (revenue income plus Social Security contributions) has increased, from £472m in 2007 to £475m in 2009 and an estimated £472m in 2010 (the first year in which the complete effect of the zero/10 changes will be felt on corporate tax receipts, due to the lags in tax collection). The contribution of revenue income to total States' income has fallen and that of Social Security contributions has risen (Figure 4.2). Tax revenues declined by £20m, or 6%, between 2007 and 2009, and are estimated to have fallen a little further in 2010, while Social Security contributions rose by £27m, around 25%, following increases in contribution rates for employers, employees, the self-employed and non-employed. Changes in tax and Social Security contributions between 2008 and 2010 are summarised in Table 4.1.

[10] Revenue income is presented net of departmental operating income.
[11] Miscellaneous other income includes net interest receivable on the general revenue account, unrealised profit on revaluation of investments, court fines, loan interest received, retention tax, dividends paid by States' trading entities and surplus notes and coins.

Table 4.1: Summary of recent tax and Social Security changes
(Source: Policy Council, Treasury & Resources)

	Year	Change	Estimated effect on 2010 revenues[12]
Direct taxes			
Tax on corporate profits	2008	Introduction of zero/10 tax regime reducing the standard rate of corporate tax to 0% with selected business activities, including banking activities, taxable at 10% and regulated utilities and company income from property taxed at 20%.	Tax revenues from corporate profits reduced by £75m. £10m generated by tax on distributions. (£65m)
Income Tax allowances	2008	Introduction of a ceiling mortgage value of £400,000 for tax relief on mortgage interest payments. Removal of interest relief on personal and business loans.	Combined additional income tax revenue of £5.5m. £5.5m
	2008-10	Successive increases in personal tax allowances with single persons allowance increasing from £8,250 in 2007 to £9,050 in 2010.	(£7m)
Indirect taxes			
Tax on property	2008	Tax on Rateable Value (TRV) replaced with Tax on Real Property (TRP) following an extensive reassessment of property.	Total increased revenue from property taxes of £7m.
	2009-10	Various increases in TRP dependent on property type. Increases were largely paid by business, particularly those in the finance industry.	£7m
Fuel and vehicle taxes	2008	Vehicle tax abolished and replaced with an additional tax on fuel sales. Tax on diesel introduced in line with taxes on petrol.	Motor tax revenues reduced to zero. Increased excise duty from fuel sales resulting in a net increase of £4m.
	2009-10	6.9% and 15% increases of duty on motor fuels introduced in 2009 and 2010 respectively.	£4m
Other customs and excise increases	2008-10	Duty charged on alcohol and tobacco increased.	Increased excise duties (excluding taxes on motor fuels) by £2m. £2m
Net effect on general revenue position			**(£53.5m)**
Social Security contributions (Outside central budget)			
Contribution payments	2008	Employer's contributions increased from 5.5% to 6.5%. Earnings limit for employee's contribution increased from £36,000 to £60,000.	Total contributions to Social Security increased by £22m by 2010.
	2009-14	The earnings limit for employee, self-employed and non-employed contributions set to increase further to £69,108 in 2009 and £115,128 (in 2009 terms) over a five year period.	
	2010	The upper earnings limit for employers increased from £115,128 to £117,468.	£22m
Net effect on total States' revenues			**(£31.5m)**

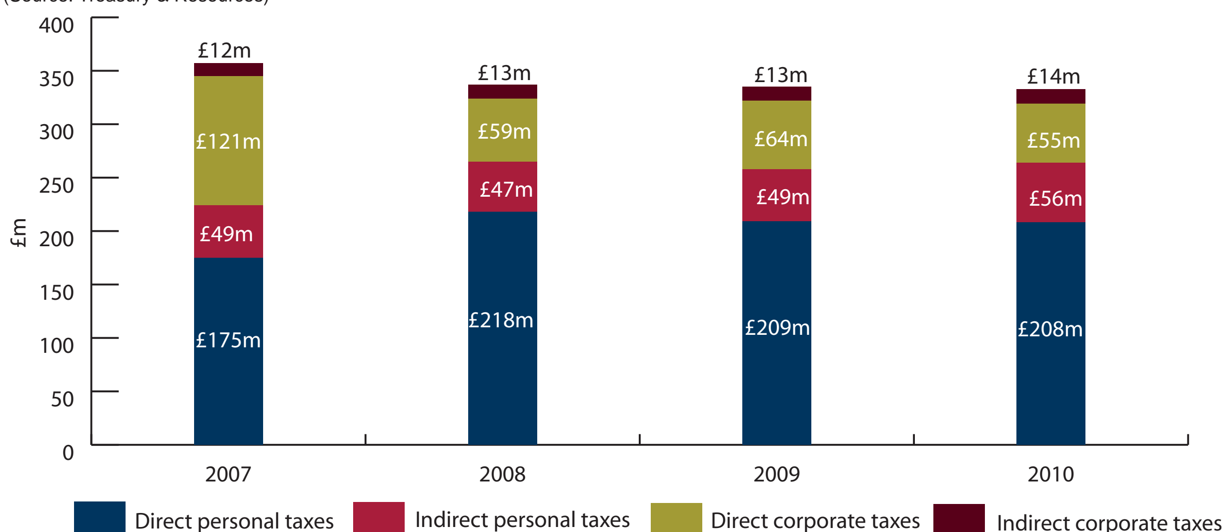
[12] These are Treasury and Resources projections calculated on a static equilibrium basis.

Table 4.2: Accounts 2007 - 2010
(Source: Treasury & Resources)

	2007 (£m)	2008 (£m)	2009 (£m)	2010 estimate (£m)
Income taxes	**296**	**277**	**273**	**263**
Personal taxes	175	218	209	208
Company taxes	121	59	64	55
Misc income	8	11	6	2
Indirect taxes [13]	61	60	62	70
Total revenue income	**365**	**349**	**341**	**335**
Revenue expenditure	**(294)**	**(297)**	**(325)**	**(336)**
Revenue surplus/(deficit)	**71**	**52**	**16**	**(1)**
Routine capital expenditure	(16)	(17)	(15)	(16)
Capital income	0	5	0	0
Operating surplus/(deficit)	**55**	**40**	**1**	**(17)**
Appropriation to capital reserve	(5)	(47)	(42)[14]	(21)
Overall surplus/ (deficit)	**50**	**(7)**	**(41)**	**(38)**
Transfer from unspent balances			5	3
Overall surplus/ (deficit) after transfer	**50**	**(7)**	**(36)**	**(35)**

Despite some large, above inflation, increases in duties and property taxes, the split between direct and indirect taxation has remained fairly static with 80% of tax revenue derived from direct taxation (Table 4.2). However the distribution of direct taxation between personal and corporate tax has changed significantly. Total direct corporate tax revenues almost halved, from £121m in 2007 to £64m in 2009, despite around £10m of 'transitional' tax revenues, and are expected to fall further to £55m this year (Figure 4.3). Personal direct taxes rose by £34m to £209m between 2007 and 2009, reflecting strong growth in personal incomes[15]. In 2009 personal taxation accounted for 77% of direct tax revenues, up from 59% in 2007. As personal contributions to the Social Security fund have also been increased, the relative share of individuals in total taxation has increased significantly.

Figure 4.3: Composition of taxation revenue by source
(Source: Treasury & Resources)



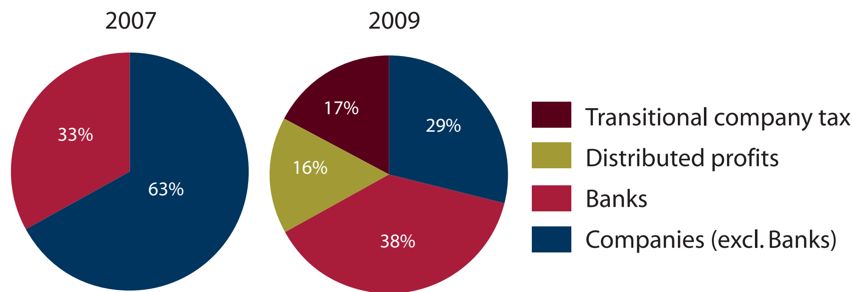
[13] Overall document duty (tax on property sales) declined from £24.0m to £15.3m in 2008 following an exceptional year in 2007 and a reduction in the volume of house sales during 2008. Document duty decreased again in 2009 (~£1.5m) which has offset the additional revenue from indirect taxes outlined in the Table 4.1.

[14] The 2011 budget redistributes previously accounted capital expenditure of £22m from 2009 to 2008 and £12m from 2008 to 2007. The figures in this table are consistent with previously published accounts.

[15] Personal tax rates were unchanged and tax allowances were increased. The single person's tax allowance remained at £8,250 between 2007 and 2008 and was increased to £8,700 in 2009. Without wage growth, rises in allowances would reduce the total tax collected.

The single most important source of direct corporate tax revenues is the banking sector providing nearly 38% of revenues in 2009 (Figure 4.4).

Figure 4.4: Source of direct corporate tax revenues 2007 and 2009
(Source: Treasury & Resources)

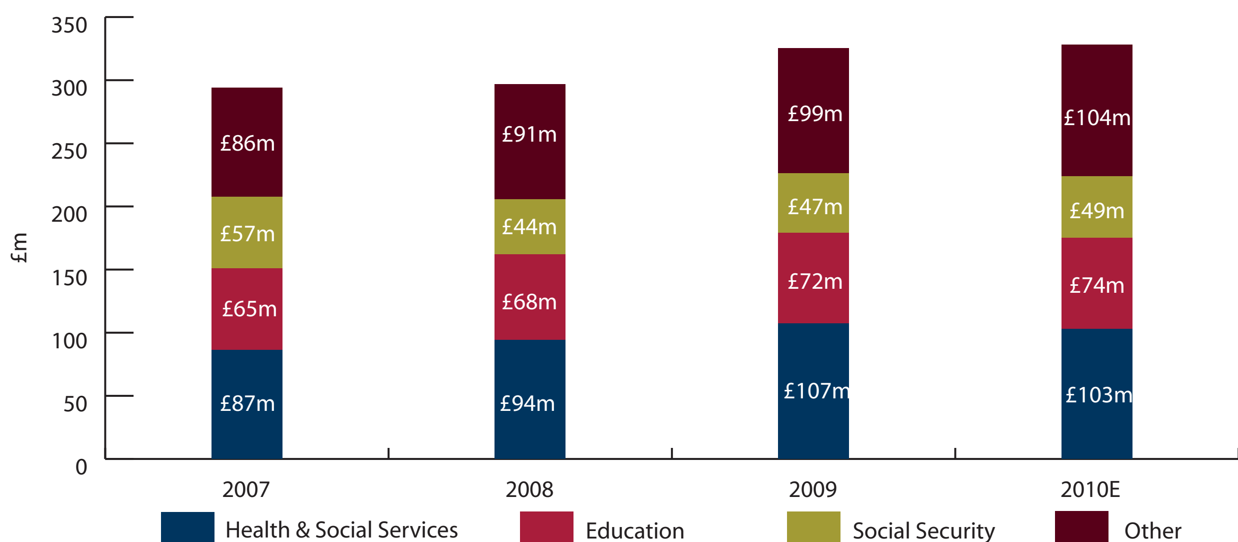


Expenditure

Total government spending in Guernsey comprises revenue expenditure (including the Revenue Grant to SSD and non-contributory Social Security benefits) and capital expenditure within the States' budget, together with additional spending on contributory benefits by SSD, which is off budget (Box 4.1).

Net revenue expenditure[16] was £325m in 2009, up over 10% (or 5% in real terms) from 2007. Around 70% of States' revenue expenditure is accounted for by just three departments: Health and Social Services; Education; and Social Security. This share has remained broadly constant in recent years, although individual departmental expenditure growth has varied significantly. Health expenditure grew particularly rapidly, rising by £20.4m, or 24%, between 2007 and 2009 (an increase of 19.5% in real terms). On budget 'formula led expenditure' by SSD includes payments from general revenues for both contributory and non-contributory benefits. In 2009 this totalled £44.8m or 13.8% of the total revenue expenditure budget. This expenditure is set ahead of the annual States' Budget when the States approves the annual Social Security benefits and contributions report earlier in the year. As part of the zero/10 changes, the States changed the formula for calculating the Revenue Grant to Social Security which had the effect of reducing it by around £22m between 2007 and 2009 (see Box 4.1). Excluding the transfers to SSD, departmental expenditure grew by £40.7m, or 17%, between 2007 and 2009, an increase of 12.7% in real terms.

Figure 4.5: States' net revenue expenditure by department[17]
(Source Treasury & Resources)



[16] Expenditure is presented net of operating income.
[17] Expected expenditure outrun for 2010 by department was not available at the time of publication. 2010 figures presented represent budgeted expenditure. It should be noted that the expected outrun of revenue expenditure for 2010 as presented in the 2011 budget (table 4.2) is expected to be £4m higher than that the budgeted expenditure for 2010 presented in Figure 4.5.

Capital spending comprises routine capital expenditure, financed within the operating budget, and transfers to the Capital Reserve, from which the capital programme is funded. Routine capital expenditure, £15m in 2009, has been steady in recent years, but transfers to the Capital Reserve have fluctuated considerably (Table 4.2). The States' present policy is to routinely transfer at least £20m per annum into the Capital Reserve and supplement with additional extraordinary transfers when possible.

Off budget expenditure by SSD was £132m in 2009, up from £93m in 2007, an increase of 30%, as more Social Security spending was moved off budget. The underlying increase, excluding the effects of the changes to Social Security funding, was 19%, with total expenditure on contributory benefits having increased to £149m in 2009 from £125m in 2007. The projected 2010 figure is £137m.

Box 4.1: Social Security

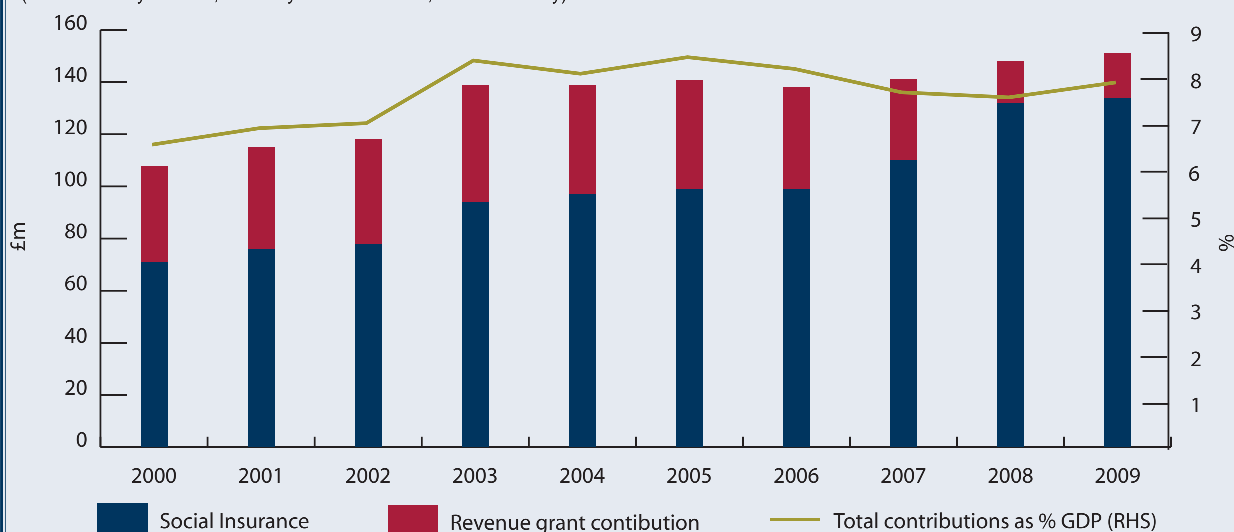
Two types of benefits are administered by the Social Security Department (SSD), contributory and non-contributory. Contributory benefits are those where the receipt of the benefit and the amount paid is dependent on the number of contributions paid into the scheme by the recipient. These include unemployment and sickness benefits. Non-contributory benefits are those which are available to all residents regardless of the number or amount of contributions paid. Included in this category are family allowance and supplementary benefit.

Contributory Social Security benefits in Guernsey are paid from three separate funds: the Guernsey Insurance Fund; the Guernsey Health Fund; and the Guernsey Long Term Care Insurance Fund. These funds are financed primarily from the Social Security contributions of employees and employers. The States also makes a contribution from general revenue income in the form of the Revenue Grant. The funding formula for the Revenue Grant was changed as part of the move to the zero/ten corporate tax regime, with the consequent reduction in the Revenue Grant phased in over 2006 to 2009. This resulted in the level of the grant declining from £38.5m in 2006 to £16.5m in 2009. Contributions from employers and employees were commensurately raised.

Non-contributory benefits are paid for directly from general taxation revenues and administered separately by SSD. These totalled £27.7m in 2009. The rates are approved by the States on recommendation from SSD separate to the States' annual budgetary process.

Figure 1: Financing of Social Security contributory funds (2009 prices)

(Source: Policy Council, Treasury and Resources, Social Security)

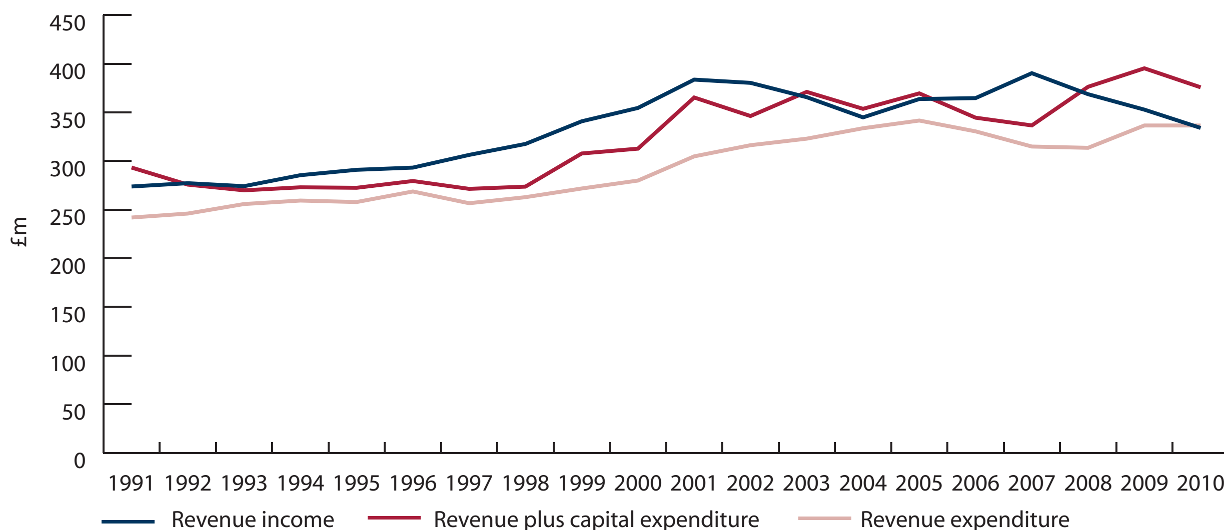


At the end of 2008, SSD published a green paper discussing the issues surrounding the long term sustainability of the Social Security funds. It used as the example the Guernsey Insurance Fund, the value of which at that time was approximately £500m, some five times the then annual payments from the fund. SSD's calculations demonstrated that if contribution limits and rates remained steady and were up-rated only in line with the average of prices and wage inflation, the balance of the Guernsey Insurance Fund would be depleted in around thirty years which would result in all payments needing to be made from current contributions. Subsequently, the States approved in part the measures proposed by SSD to increase contributions. SSD has stated its intent to revisit the issue in the near future, but has agreed with the Fiscal and Economic Policy Group to await the development of proposals resulting from the Corporate Tax Review.

4.2. Trends in Income and Expenditure

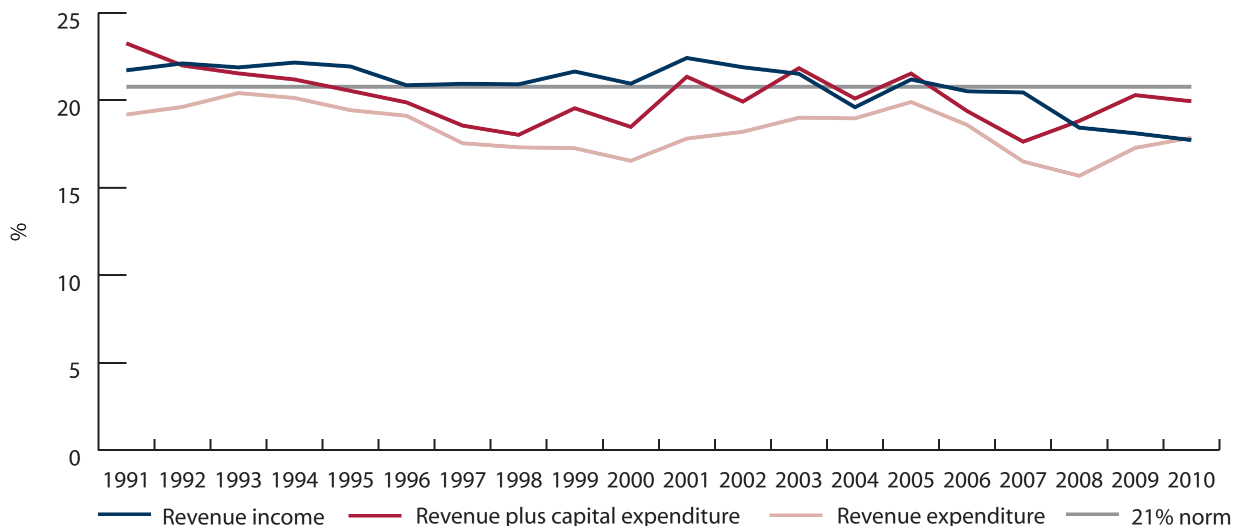
Excluding Social Security contributions, States' income grew steadily in real terms from 1991 to 2001 before dipping during the period of weak economic growth and reduced financial services profitability of the early 2000s. Although it subsequently recovered, income fell again in 2008 and 2009 with the move to zero/10 and is expected to have declined further this year to a level below that of 2000 in real terms (Figure 4.6). Meanwhile on-budget expenditure remained steady in real terms during much of the 1990s, only to grow rapidly from 1999 to 2001, stabilising at the higher level before growing again in the last two years.

Figure 4.6: Revenue income and revenue and capital expenditure (2010 prices)[18]
(Source: Policy Council, Treasury & Resources)



In relation to the size of the economy, the picture is rather different (Figure 4.7). As a share of GDP, income remained pretty static close to its 21% long run average until 2007 before steadily declining to stand at an estimated 17.7% in 2010. Revenue expenditure declined throughout the 1990s, to a trough of 16.5% of GDP in 2000, from which it rose steadily to peak at 19.9% in 2005 before falling back sharply. It has since risen from a low of 15.7% of GDP in 2008 to 17.3% in 2009 and an estimated 17.9% in 2010.

Figure 4.7: Revenue income and revenue and capital expenditure (% of GDP)[18]
(Source: Policy Council, Treasury & Resources)

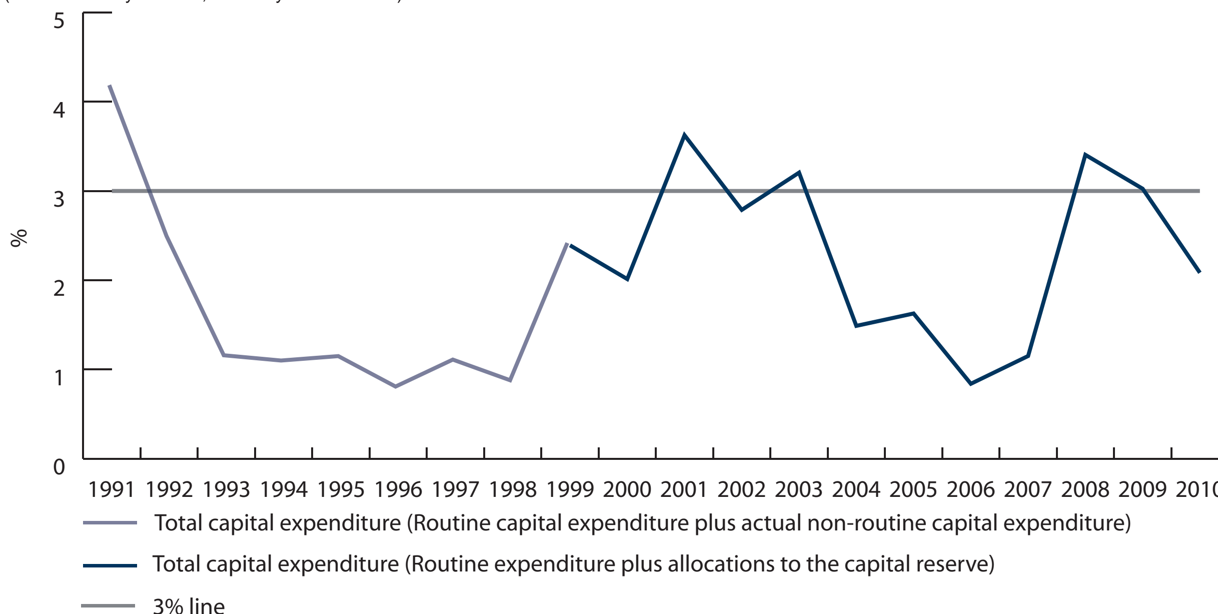


[18] From 1999 total capital expenditure is presented as routine capital expenditure plus the allocation (transfer) to the capital reserve. Due to changes in the presentation of the accounts, prior to 1999 capital expenditure is presented by committee and not disaggregated into routine and non-routine expenditure. As a result inclusion of the transfers to capital reserve would result in an effective double counting of non routine capital expenditure. Therefore actual "in-year" capital expenditure is presented for 1991 to 1998.

With the inclusion of capital expenditure[19], expenditure shows rather less variation. Capital expenditure averaged 1% of GDP from 1993 to 1999 (Figure 4.8), its subsequent rise contributing to a rise in total spending. In the early 2000s total expenditure oscillated around 21% of GDP. As both revenue and capital expenditure subsequently fell, total expenditure decreased reaching a trough of 17.6% in 2007 before recovering. The most recent estimates project combined revenue and capital expenditure at 19.3% of GDP in 2010.

Figure 4.8: Capital expenditure (as a percentage of GDP)[19]

(Source: Policy Council, Treasury & Resources)

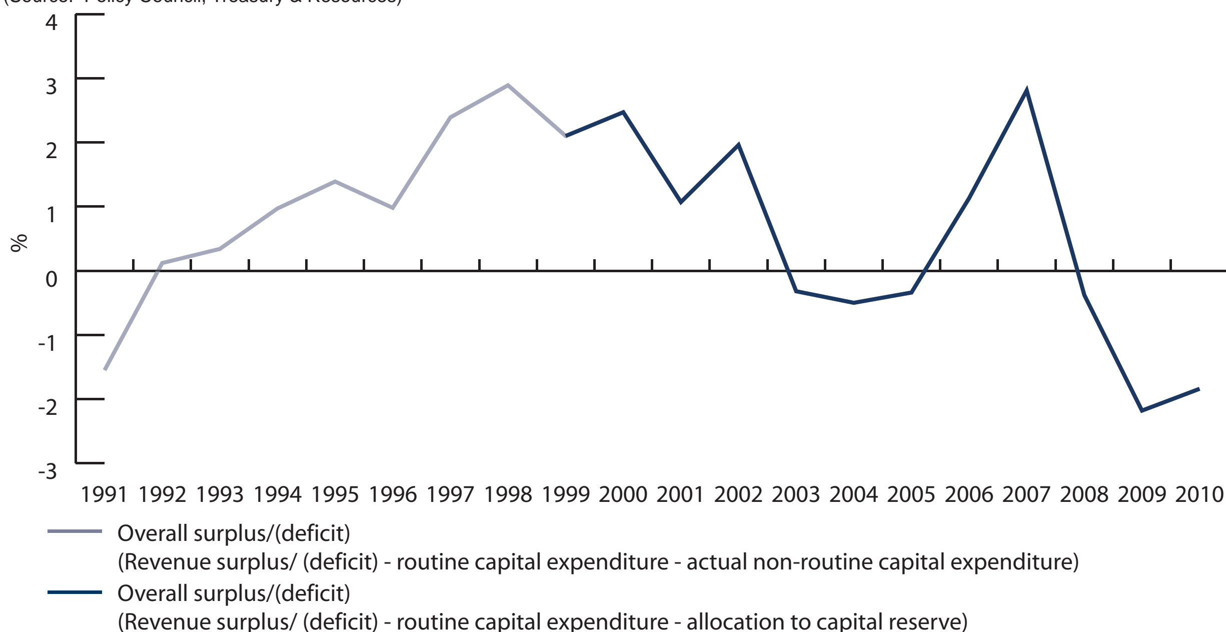


Whilst income exceeded expenditure and overall budget surpluses were usual for most of the 1990s during the last decade the position has been much more variable (Figure 4.9). Guernsey recorded deficits in the mid- 2000's, following the sharp contraction of the finance sector in 2003. Although the budget returned to surplus in 2006 and 2007, overall deficits of £7m (0.4% of GDP) and £41m (2.2% of GDP)[20] were recorded in 2008 and 2009 respectively. A £35m deficit (1.8% of GDP) is currently projected for 2010 after transfer of unspent balances.

[19] See footnote 18.

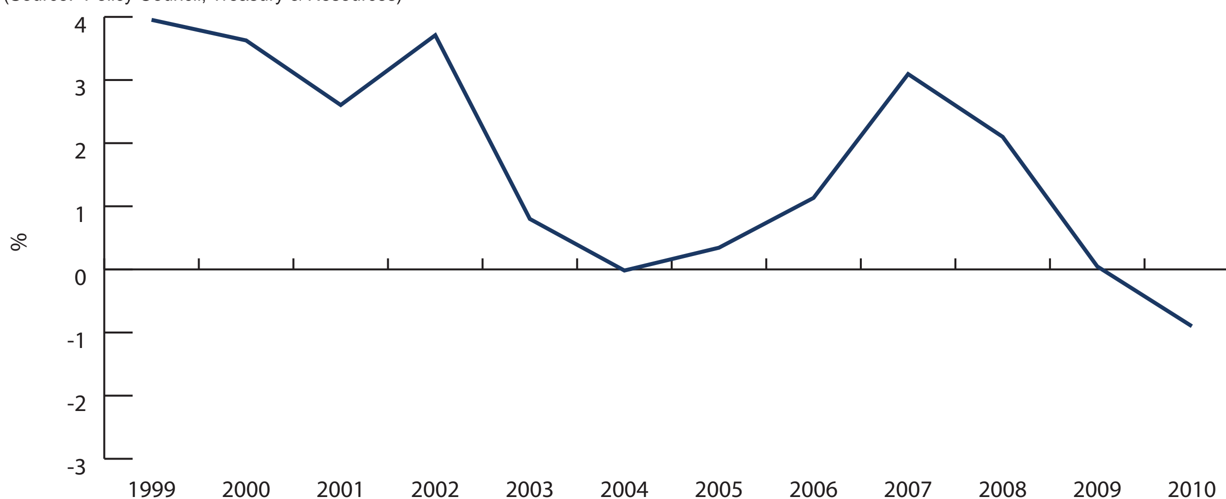
[20] As per footnote 17, this deficit figure is consistent with those contained in previous States' accounts and not that as represented, following the reallocations between years of the transfers to reserves as per the 2011 Budget.

Figure 4.9: States' overall surplus/(deficit)[21] (as a percentage of GDP) 1991 – 2010[22,23]
(Source: Policy Council, Treasury & Resources)



The operating budget, which excludes transfers to the capital reserve, showed a surplus of £40m (2.1% GDP) and £0.9m (less than 0.1% GDP) in 2008 and 2009 respectively, however an operating deficit of £17m (0.9% GDP) is expected in 2010 (Figure 4.10).

Figure 4.10: States' operating surplus/(deficit)[21] (as a percentage of GDP) 1999 – 2010[22]
(Source: Policy Council, Treasury & Resources)



[21] States' budgets have historically used the following surplus/(deficit) definitions:
1. Routine revenue income – routine expenditure = revenue surplus / (deficit)
2. Revenue surplus – routine capital expenditure = operating surplus / (deficit)
3. Operating surplus / (deficit) – allocations (ie transfers to reserves) = overall surplus /(deficit)

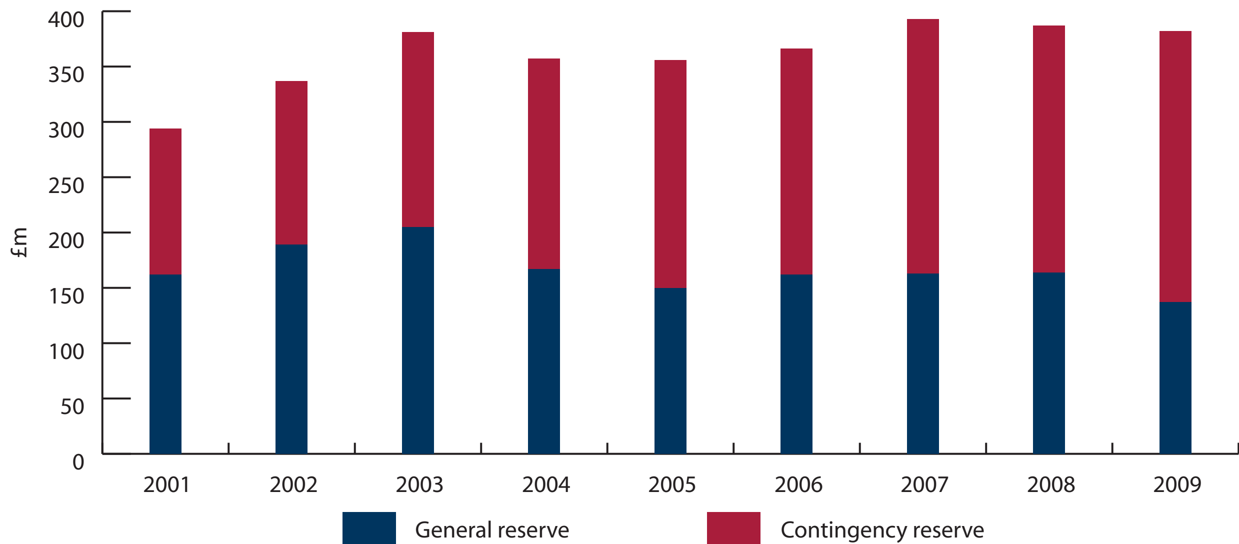
[22] 2010 figures are based on Treasury & Resources projected outrun presented in the 2011 budget.

[23] See Footnote 18.

4.3. Reserves

As well as the Capital Reserve, the primary purpose of which is to smooth capital expenditure, the States maintain two reserves, the General Revenue and the Contingency Reserves. These are in addition to the Funds held within the Social Security system[24]. At the end of 2009 the balances of the General and Contingency Reserves were £137m and £245m respectively (Figure 4.11). The aggregate balance stood at £382m at the end of 2009, around 20% of GDP.

Figure 4.11: Reserves 2001 – 2009 (nominal)
(Source: Policy Council, Treasury & Resources)



The Contingency Reserve was established in 1986 with the purpose of providing protection against major emergencies, including significant economic downturns. It had an original target of 50% of annual revenue expenditure (around £180m in terms of today's expenditure). The current balance is well in excess of this. In June 2006 the States decided that up to half of this reserve could be used to fund any budgetary shortfall that resulted from the introduction of zero/10 up to 2014. The Fiscal Framework stipulates that "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." Although no such level has been agreed, the Framework document proposed that "the States should commit to maintenance of the contingency reserve at its post zero ten level in the long run". Within the Contingency Reserve, the balance of the reserves set aside to fund shortfalls following zero/10 stood at £126m (or 7.7% of GDP) at the end of 2009.

The General Reserve contains the non specific reserves of the States. The Reserve contains within it various capital accounts including, the Corporate Housing Program, the Wilfred Carey Purchase Fund and the Restructuring and Reorganisation Fund.

[24] Separately, the States also has a Superannuation Fund (separate to SSD's funding of the States' general pension) which exists to fund the pension liability of the States as employer. The Superannuation fund stood at £828m at the end of 2009: a level close to a 'fully funded' match of assets to liabilities.

5. The States' Fiscal Strategy

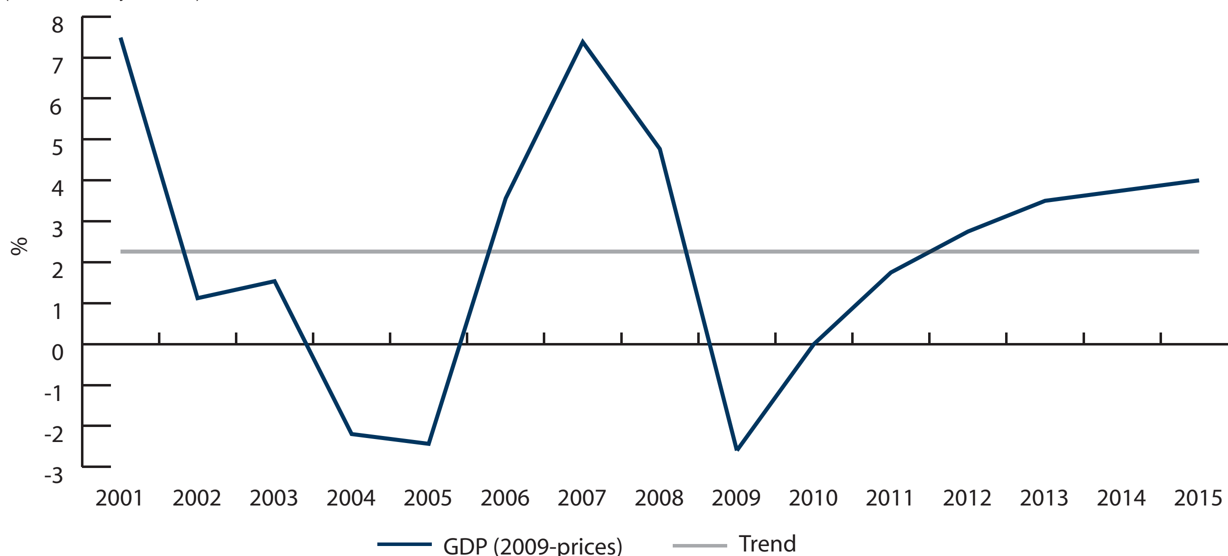
The States acknowledged that the introduction of zero/10 would result in a considerable loss of revenue from corporate taxes. It was however decided not to immediately introduce measures to replace all the lost revenue, but instead to: reduce the Revenue Grant from the budget to the Social Security funds; increase a number of excise duties and property taxes; and set aside half of the Contingency Reserve to cover the deficits, the Contingency Reserve Tax Strategy (CRTS). At the same time, contributions from individuals and employers to the Social Security fund were increased commensurately with a decrease in the Revenue Grant. As a result around £35m of the £65m of lost revenue was replaced by 2010 (Table 4.1) with an additional £3m in indirect taxes proposed in the 2011 Budget and a freezing of personal allowances for 2011.

The strategy to maintain the deficits within the limits set by the CRTS and to bring the budget back into permanent balance in line with the Fiscal Framework is based on:

- A freeze in public sector revenue expenditure in real terms. It is agreed that this freeze covers formula based expenditure as well as departmental expenditure, reinforcing the need for the Panel to examine Social Security expenditure and revenues.
- Improvements to the budgetary process so as to better prioritise new service developments.
- A corporate tax review, the fundamental purpose of which is not to raise revenue but to find a new and stable corporate tax base that preserves Guernsey's competitive position.

On the assumptions that total on-budget revenue expenditure is frozen in real terms and that the economy grows by 1.75% in 2011, 2.75% in 2012 and 3.5% thereafter (Figure 5.1), the SSP as amended by Budget 2011[25], estimates that the budget will return to balance in 2014 (Figure 5.2). At that point the balance of the CRTS would be £68m[26]. In a pessimistic scenario in which expenditure grows by 1% in real terms and the economy does not grow until 2012 and is weak thereafter, the CRTS could be exhausted by 2013 and the budget remain in deficit beyond 2015.

Figure 5.1: Forecast real GDP Growth
(Percentage change)
(Source: Policy Council)



[25] The 2011 States' Budget report contains revised projections for the final outturns for 2010 revenues and expenditures and also provides an updated projection for 2011. The projections for 2012 to 2015 have not been revised by Treasury and Resources. However, on page 11 of the report it is acknowledged that there will be a 'cumulative effect of a £9m improvement in the States' financial position'. This assumption has been incorporated into the 2012 to 2015 projections shown here (Source: Policy Council).
[26] Including investment income.

Figure 5.2: Fiscal position 2010 to 2015 SSP projections adjusted for the 2011 Budget
(Source: Policy Council)

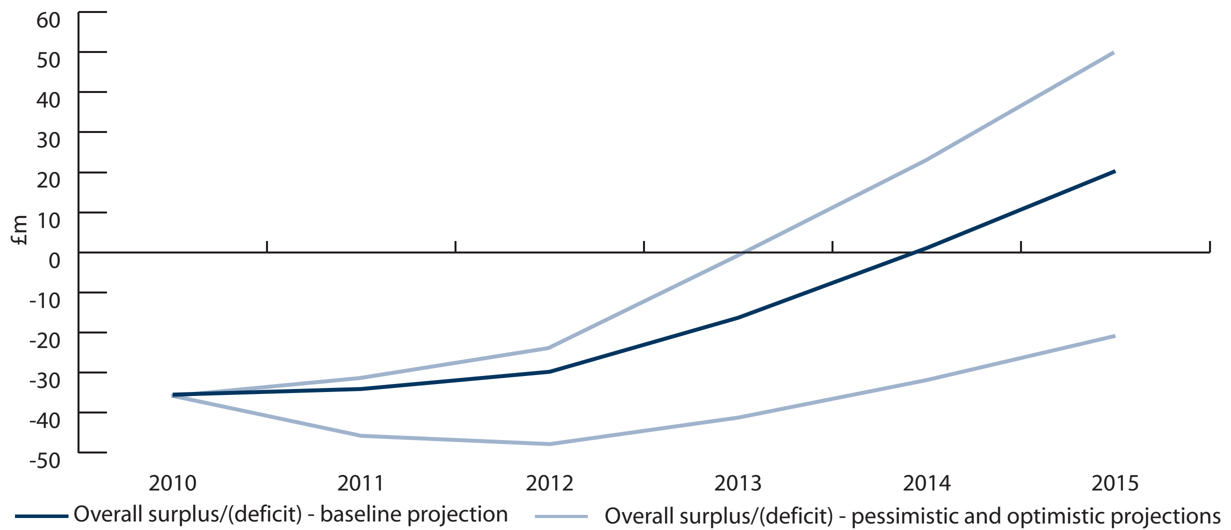
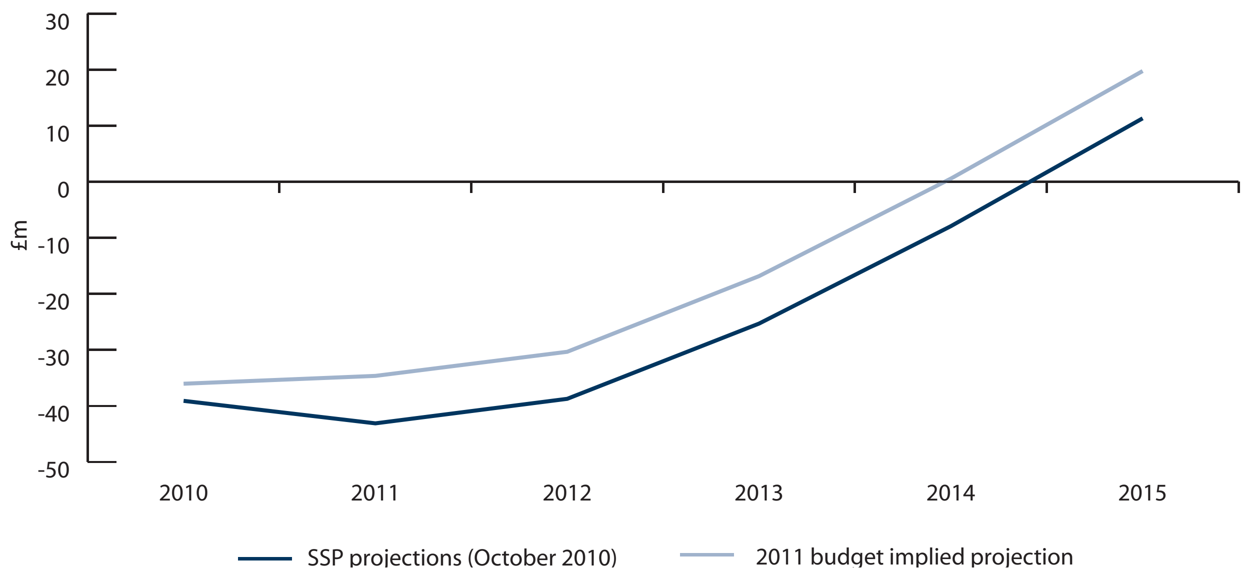


Figure 5.3: Implications of the 2011 Budget on the SSP projections of the fiscal position 2010 to 2015 - baseline case
(Source: Policy Council)



The States' recent track record in controlling expenditure has been mixed. The decision to change the formula for calculating the Revenue Grant, reducing the size of the grant by £22 million between 2006 and 2009 put on-budget Social Security expenditure on a permanently lower path. In contrast, other departmental expenditure rose nearly 13% in real terms in the two years to 2009. Health expenditure in particular has been growing at a rapid rate. Although some savings can be found, holding health expenditure constant in real terms will be difficult, especially with an ageing population. There will also be difficulties in controlling formula led expenditure, which is set outside the States' annual budget process. Keeping total expenditure 'frozen' in real terms will therefore be more challenging if the underlying growth in the formula led element is greater than inflation.

The States recognises these risks. The SSP says:

" There are several key financial risks to the States' fiscal position which have not been factored in to the modelling undertaken but which may have a significant impact on the overall position. These include the ability of the Health and Social Services Department to constrain its expenditure, particularly on the demand led off Island care, given recent results and the forecast overspend in 2010. There is also a risk of formula led expenditure increasing at a faster real term rate than illustrated in the models due to the demand led nature of the expenditure and the difficulty this places on controlling spend in these areas. Finally, the triennial valuation of the Superannuation Fund is due to be carried out at the end of 2010, the outcome of which is uncertain. However, this could increase financial pressure if the funding level is found to be inadequate."

The Financial Transformation Programme (FTP) is making progress in identifying sustainable efficiency savings. Over the five years from November 2009 it aims to reduce the States' baseline revenue expenditure by at least £31 million or 10%. Since October 2009 work has begun on 27 projects within a prioritised programme. These are expected ultimately to deliver net reductions in annual revenue expenditure of over £20 million when completed between 2011 and 2013. Realising the potential savings that have been identified will however not be easy. Furthermore in accordance with a Resolution in the 2009 SSP, savings generated through FTP will not be used to reduce the deficit until after 2012. In the interim, they will all be used to fund new service developments and may actually increase the deficit in the short run. After 2012 half of the savings achieved through FTP can be used for deficit reduction in either the base or pessimistic scenario. In the optimistic scenario, 25% could be used for deficit reduction.

6. The Panel's Assessment of Fiscal Policy Against the Fiscal Framework

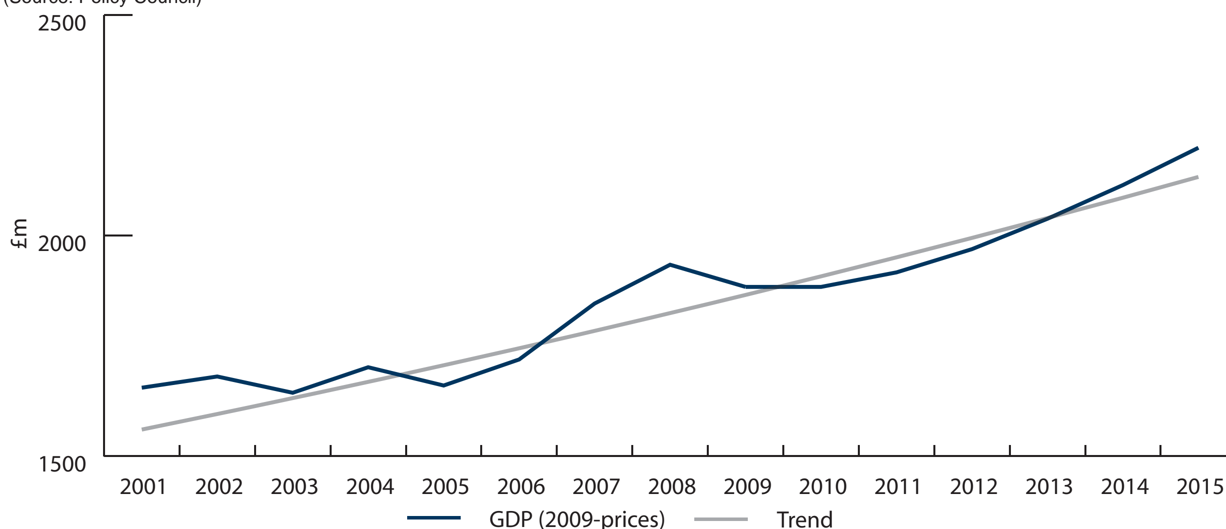
The Panel's mandate is to assess the States' fiscal conduct against the criteria as set out in the Fiscal Framework (FF) and the economic assumptions on which the projections are made.

6.1 Economic Assumptions

Figure 6.1 shows the path of GDP projected by the Policy Council under the central, or base, scenario. GDP growth (year on year) in 2010 is projected at zero, followed by 1.75% in 2011, 2.75% in 2012 and 3.5% thereafter. Essentially, sub-trend growth is assumed for 2010 and 2011, with above trend growth thereafter. There is, of course, enormous uncertainty over these projections. The assumptions for 2010 and 2011 are relatively cautious. On the other hand, there is a serious risk that the assumptions for 2012 and beyond are optimistic (and especially the assumption of 3.5% growth for 2013 and beyond, which is well above the historical trend).

The pessimistic scenario, with no growth until 2012 and slow growth thereafter, is suitably cautious. As discussed above, however, the likely consequences for the public finances, are extremely worrying, and would indicate the need for fiscal adjustment. The optimistic scenario – with growth rebounding to 3.5% in 2011 and being maintained at well above trend levels for the next four years seems very unlikely. It would be very unwise to base budgetary policy on such a scenario.

Figure 6.1: Forecast level GDP (2009 prices) - baseline case
(Percentage change)
(Source: Policy Council)



6.2. Operating Balance as a Percentage of GDP

The most straightforward of the FF's numerical constraints is that the annual operating deficit should not exceed 3% of GDP. Table 6.1 shows that this is unlikely to happen, even under the pessimistic scenario.

Table 6.1: Operating balance (%of GDP)
(SSP projections adjusted for the 2011 Budget)
(Source: Policy Council, Treasury & Resources)

	Baseline case		Pessimistic case	
	£m	% GDP	£m	% GDP
2010	(17.5)	(0.9)	(17.5)	(0.9)
2011	(6.2)	(0.3)	(17.6)	(0.9)
2012	(1.8)	(0.1)	(19.6)	(1.0)
2013	8.0	0.6	(13.1)	(0.6)
2014	30.0	1.4	(2.7)	(0.1)
2015	45.6	2.1	5.2	0.2

6.3. Total Revenue and Expenditure as a Percentage of GDP

The FF stipulates that public expenditure and revenue, expressed as a percentage of GDP, should be below the level set by the historical norm, which is 21%. Figure 6.2a would appear to suggest that, on the face of it, this is very likely to be the case. Taxation revenue has been well below the historic norm since the introduction of the zero/10 corporate tax regime while expenditure has been reduced by the cut in the Revenue Grant, which has effectively moved around £22 million off budget, which is more than 1% of GDP.

Were it not for the reduction in the Revenue Grant and the shortfall in transfers to the Capital Reserve (see next section), total expenditure would have been running at or above the 21% norm since 2008, but will be brought back within the limit by the SSP, amended by the 2011 budget, by 2012, if the projections are achieved.

Figure 6.2a: Trend, actual and projected (1991-2015) total income and expenditure [27,28] (% GDP) – baseline base

(SSP projections, adjusted for the 2011 Budget)
(Source: Policy Council)

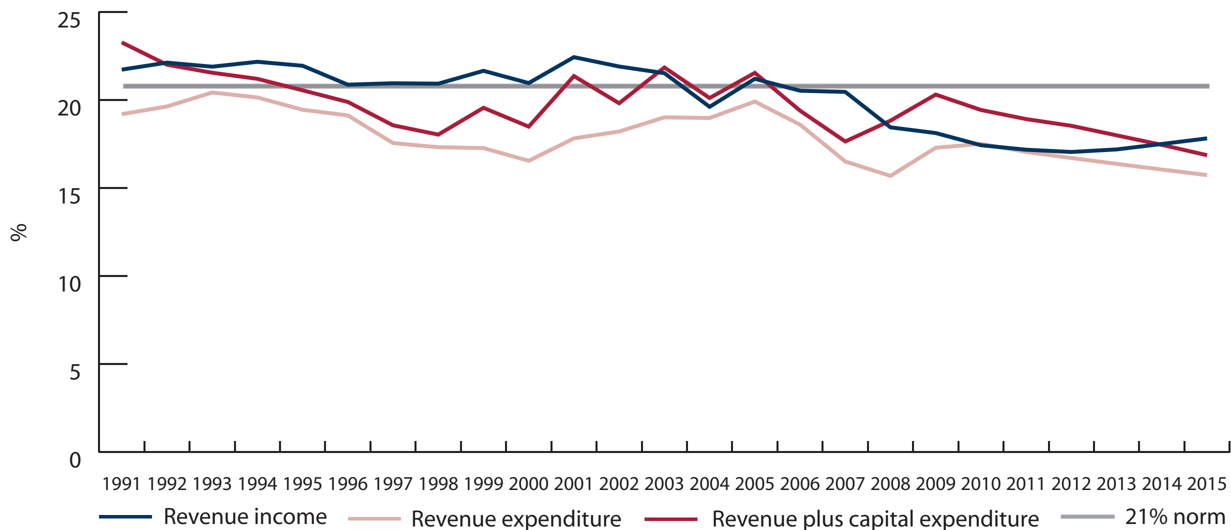
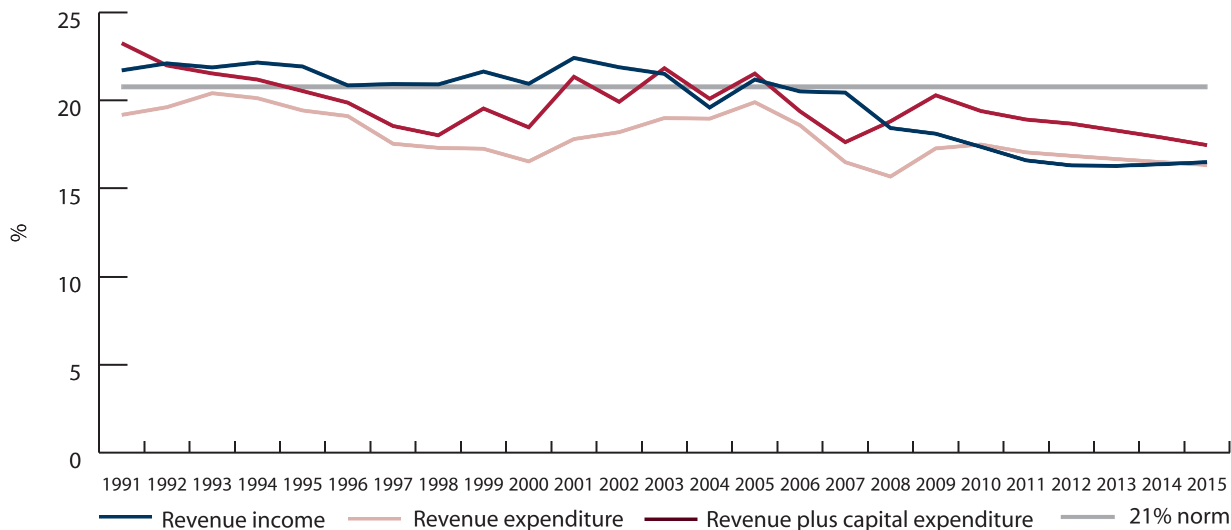


Figure 6.2b: Trend, actual and projected (1991-2015) total income and expenditure[27,28,] (% GDP) – pessimistic case

(SSP projections, adjusted for the 2011 Budget)
(Source: Policy Council)

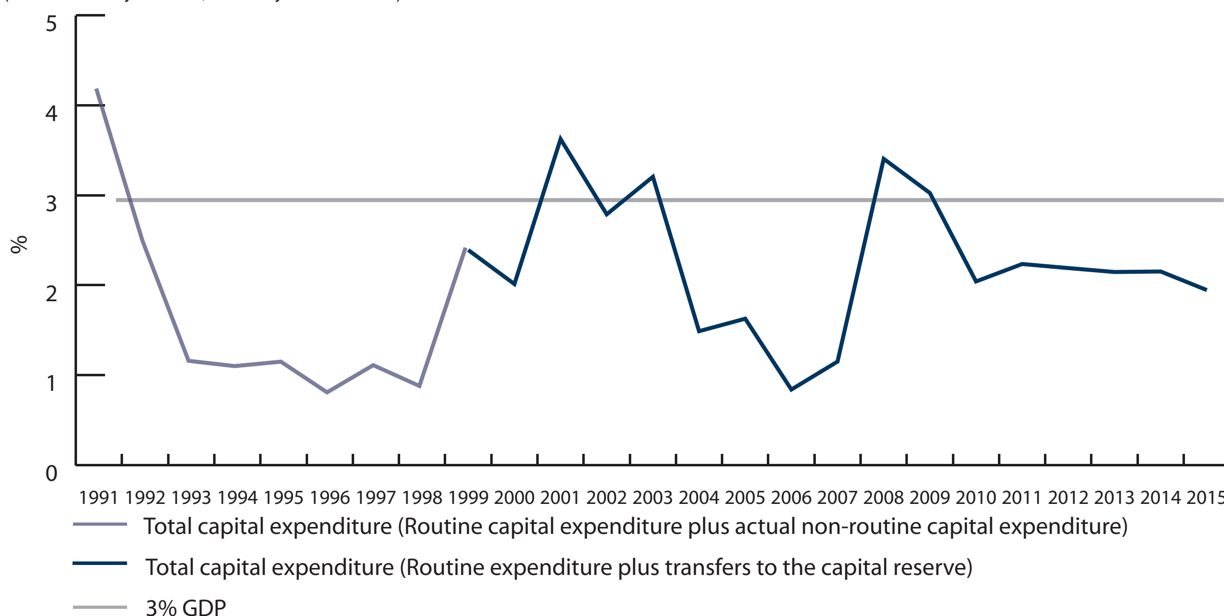


[27] See footnote 18.
[28] Data for 2010 - 2015 is presented as a percentage of trend GDP.

6.4. Capital Expenditure as a Percentage of GDP

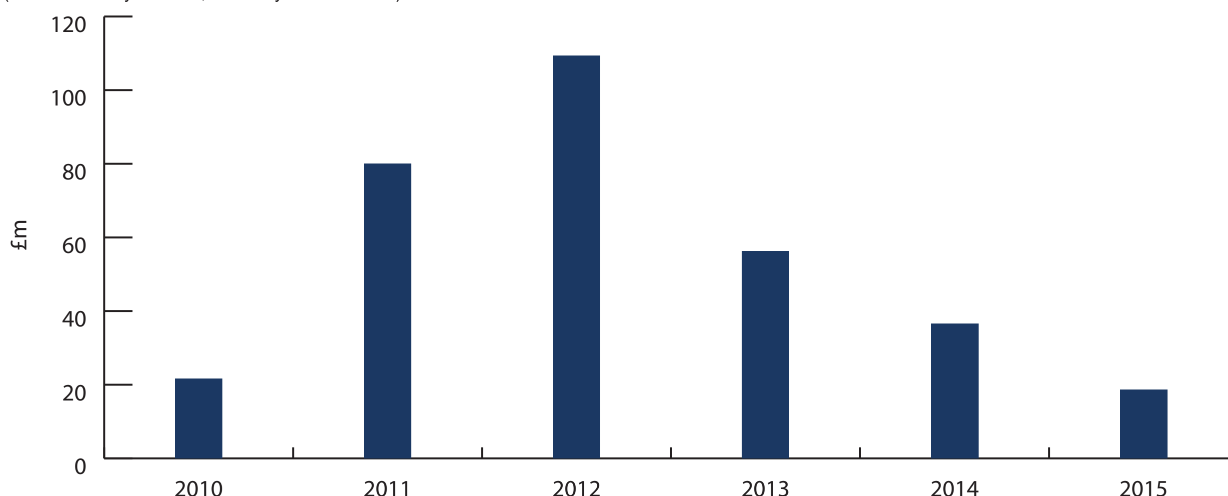
The FF gives a norm for capital expenditure of 3% of GDP (close to £60m in today's prices), which, in the light of historic and international experience, was deemed an appropriate rate for the maintenance and renewal of the Island's capital stock and infrastructure. As Figure 6.3 demonstrates the States' budget has rarely put aside sufficient to fund capital spending at or above 3% of GDP, nor are future plans sufficient. An additional £10 to £15m per annum in today's prices, close to 1% of GDP, would be required to meet the FF's 3% norm.

Figure 6.3: Capital expenditure (as a percentage of GDP)
(Source: Policy Council, Treasury & Resources)



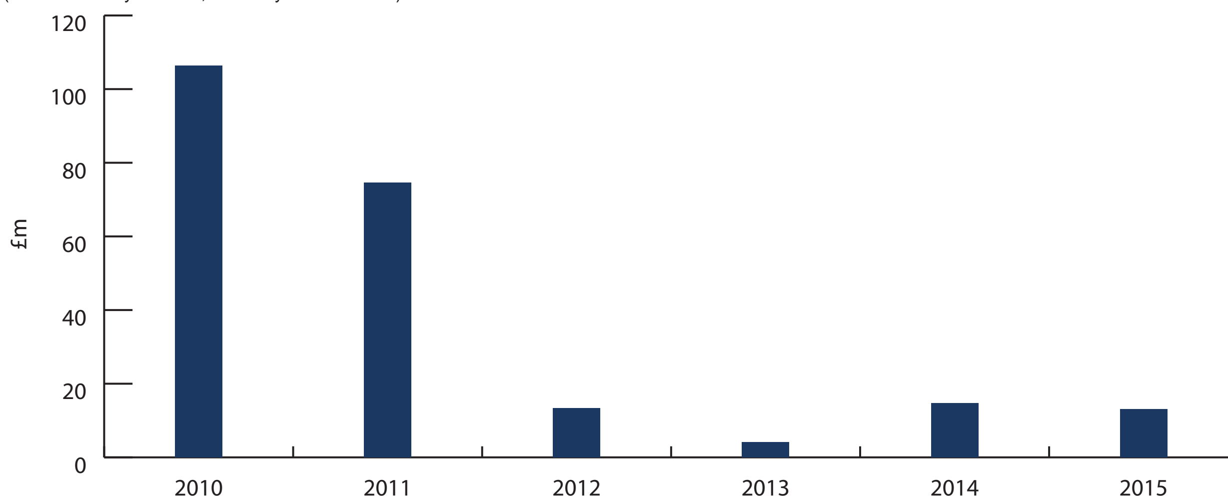
The profile for planned total capital expenditure up to 2015 is presented in Figure 6.4: the size of the airport runway project results in a lumpy profile for overall capital expenditure, peaking at 5.3% of GDP in 2012 but averaging 2.9% over the period.

Figure 6.4: Capital programme expenditure profile, 2010 – 2015 (2010 Prices)
(Source: Policy Council, Treasury & Resources)



As a result of the inadequate transfers, the Capital Reserve is barely sufficient to fund the capital programme and is virtually depleted by 2012 (Figure 6.5). Capital spending close to 3% of GDP over the forecast period is only achieved by running down the Capital Reserve. This is an unsustainable strategy over the medium term.

Figure 6.5: Capital reserve balance, 2010 – 2015 (2010 prices)
(Source: Policy Council, Treasury & Resources)



6.5. Sustainability

The FF requires that revenue and expenditure should be within the historic norm on a sustainable basis. In its first report the Panel has not been able to assess the sustainability of income or expenditure other than looking at the adequacy of capital allocations and the effects of the economic cycle. In particular, it has not assessed the appropriateness of the capital expenditure target, nor the adequacy of provisions to fund future Social Security benefits. The provision of both contributory and non-contributory benefits is an obligation of the States. Although funds exist for the payment of contributory benefits, were these to prove inadequate the States would become liable.

The overarching objective of the FF is to achieve long term permanent balance. This implies that the budget should be in balance when economic output is at its trend or sustainable level, consistent with stable inflation. At this point the economy's productive resources will be neither under- nor over-utilised. To assess the strategy in the SPP against the objective of permanent balance would require a view on where the economy is in relation to trend. The Panel does not have much information on this. However, even though Guernsey seems to have been only relatively mildly affected by the global recession, it seems likely that the economy is currently operating below trend. The States' own estimate is that it will not return to trend until 2013 (Figure 6.1). Permanent balance would imply that the budget should be in balance at that level of economic activity. It would therefore seem likely that the current fiscal strategy entails a significant structural deficit, of the order of £20m, that will not go away as the economy recovers, as well as a cyclical one, resulting from below trend output. The surpluses shown in the projections from 2014 are the result of unsustainable levels of above trend output. This is inconsistent with the FF's permanent balance rule.

6.6. Summary

In summary, the Panel's tentative assessment is that the States is making commendable efforts to meet the targets of the FF. Ambitious expenditure restraint and efficiency gain measures have been proposed and considerable efforts have already been made to make up for the revenue lost by the introduction of zero/10. However, more remains to be done and many questions however remain about sustainability. Furthermore, there are substantial risks because of the uncertainty of the global economic situation and the potential threats to Guernsey's main industry, the financial services sector, and because of questions related to capital expenditure and possible contingent liabilities in the Social Security system. With these caveats, the score card looks as follows:

- The budget deficit as a percentage of GDP is well within the limit, even on the pessimistic scenario.
- On-budget expenditure and revenue are well within the historic norm. Including off budget expenditure and Social Security contributions, total public expenditure and revenue remains within the historic norm provided that the 2011 budget measures are adopted.
- Allocations to fund capital expenditure seem to be significantly below the 3 percent of GDP norm.
- As it seems very likely that there is a structural deficit (around 1% of GDP) as well as the cyclical deficit, the current strategy is not compatible with permanent balance.
- It seems likely that the current measures will meet the target of limiting the cumulative deficits to the size of the Contingency Tax Reserve.

Appendix 1:

THE ROLE AND GUIDING PRINCIPLES OF THE FISCAL POLICY PANEL

Preliminary statement from the Fiscal Policy Panel

The Fiscal Policy Panel of the States of Guernsey ('the Panel') was established in February 2010. The Panel's composition was agreed by the Fiscal and Economic Policy Group with the endorsement and approval of the Policy Council. Its three members are Christopher Allsopp CBE, Marian Bell CBE and Joly Dixon CMG (Chairman).

The role of the Panel is to provide an independent assessment of the conduct of States' fiscal policy against the criteria laid out in the Fiscal Framework, as set out and agreed by the States of Guernsey ('the States') in 2009. Its assessment will be published in an annual report.

The Panel is an independent advisory body and does not make policy decisions. The Panel has full editorial responsibility for its reports, which are made public.

After its initial meeting on the Island in March 2010, the Panel decided that it would be useful to outline its understanding of the Fiscal Framework and of the role that the Panel should play within it, in advance of the publication of its inaugural annual report later in the year.

1. The Fiscal Framework

In April 2009, in the context of a proposal from the Treasury and Resources Department to utilise external borrowing facilities to fund States' capital spending[35], the States decided to adopt a Fiscal Framework to set parameters and constraints on such borrowing, and on the total levels of States' revenue and expenditure.

The Fiscal and Economic Plan, approved in July 2009, endorsed the principles and parameters of the Fiscal Framework and reiterated the States' commitment to the maintenance of a competitive corporate tax regime as being fundamental to the long term success of the Guernsey economy.

The key points of the Fiscal Framework are set out at the end of this statement.

The Panel notes that the numerical parameters contained in the Fiscal Framework are as much a reflection of political preferences to control public expenditure and the associated tax burden as they are an economic consideration.

The numerical limit on the deficit in any one year is fairly common practice. The limit of 3% of gross domestic product ('GDP') is the same as one of the fiscal criteria in the Maastricht Treaty.

The most important numerical limit is the ceiling on public expenditure and taxation as a share of GDP, which has been set as equal to the average over the past twenty years. Combined with the objective of budget balance over the medium term, this criterion implies that public expenditure should grow in line with GDP whilst tax rates should be set to match public expenditure over the medium term.

Stability of the trend of public expenditure and of tax rates implies that budget deficits and surpluses are likely to arise over the economic cycle as fluctuations in GDP occur. That is, the criteria imply that the 'automatic stabilisers' should be allowed to operate, which is a reflection of the focus on medium term stability and the sustainability of the fiscal system.

The Panel notes that the Fiscal Framework does not seek to answer other important fiscal questions such as the ways in which revenue is raised, how the burden is shared across different members of society or the degree of income redistribution practised through the tax and benefit system. Nor does it have anything to say on the role of government, such as the extent of provision of public goods. Though economic issues do arise, these questions have to be resolved through the political process. Similarly, the Panel's role is to focus on the overall coherence of the tax and expenditure system.

The introduction of the zero/10 corporate tax regime on January 1st, 2008, reduced potential tax revenues. Whilst fiscal balance was more or less maintained in both 2008 and 2009, a deficit of £40 million is currently being projected for 2010, a significant proportion of which might be structural, not cyclical, in nature. This deficit is a result of a decision to defer any alternative revenue raising measures until the post zero/10 fiscal position is clearer[36] . As the States is presently reviewing the corporate tax regime, it has again chosen to defer consideration of this issue until there is greater clarity on the 'permanent' fiscal position. Whilst this approach is deliberate, the Panel notes that there is already a tension between the Fiscal Framework and the current position.

[35] The States subsequently chose to reject the use of external debt financing to fund its capital programme.
[36] By contrast Jersey chose to introduce a Goods and Services Tax ahead of the implementation of zero/10.

2. The Fiscal Policy Panel

The Panel sees its role as assessing and commenting on fiscal issues in Guernsey against the principles, objectives and constraints set out in the Fiscal Framework. That is, the Panel's role is to comment on fiscal issues in the light of the States' own published criteria.

The Panel is an advisory body. It does not make policy decisions.

Its main responsibilities are:

- to provide to the public and States' Members an independent view on the conduct of States' fiscal policy;
- to set out an independent judgement on the discipline of the States in adhering to its own criteria;
- to indicate, in appropriate circumstances, specific fiscal decisions which it believes are inconsistent with the Fiscal Framework;
- to challenge, if necessary, the assumptions behind, and forecasts for, the future trajectory of the fiscal position.

The Panel will publish an annual report which:

- discusses the current and prospective economic conditions for Guernsey;
- assesses States' fiscal conduct against its own criteria;
- gives an opinion on whether current and probable future spending and revenues are likely to remain within prescribed limits and whether in its opinion sufficient measures have been taken to rectify any current, or potential future, deviations.

The intention is that the Panel's independent and external views, analysis and commentary will provide greater transparency and understanding of the States' finances and fiscal position.

The Panel is appointed by the Policy Council, through the Fiscal and Economic Policy Group. The Panel is an independent body and has complete responsibility for and editorial control of its reports.

The Panel recognises that its influence will be indirect and reliant on the perceived professionalism, integrity and independence of its work. It must also be sympathetic to local circumstances and take into account the preferences of Guernsey society. To be effective it must fully understand the policy making process. Equally, its own role must also be understood and appreciated by States' Members and the general public.

The Panel will seek to build an understanding of the Island's economy and of the underlying values and preferences of the population. For this it will follow economic developments closely and will visit the Island from time to time so as to build and maintain relationships with local bodies and with industry and their representative groups.

It is anticipated that the influence of its reports will increase over time as the Panel builds up a track record and as its framework for analysis becomes better known and understood. Ideally, in future years, policy making will be guided as much by what the Panel is likely to say in future reports as by what is said in a current report.

The Panel recognises that there may be times when it draws conclusions that conflict with or differ from a course of action decided by the States. The frequency of such occurrences is likely to diminish over time once the Framework and the Panel are established and the likely response of the Panel to proposed policy measures is anticipated by policymakers.

The Panel recognises that it must build confidence in its analysis and should be seen to be using all the data that is available and to have an extensive understanding of the mechanisms of the Guernsey economy and States' fiscal and budget setting processes. As part of its role, the Panel may make suggestions for improved data and analysis, but this will be done within limits, recognising that there will never be complete data or total certainty. To fulfil its role, the Panel needs to be fully transparent, its commentary, analysis and conclusions should be made public and the methodology that the Panel adopts is as important as its conclusions themselves. This will make the Panel's

conclusions more predictable and allow others to anticipate its views.

The States' Economist will organise the drafting and publication of the annual report and act as secretary and administrator to the Panel. The Panel will be supported by staff from the Policy and Research Unit of the Policy Council. These staff will provide the Panel with access to internal States' forecasts, and the resultant budget forecasts prepared by the Treasury and Resources Department, and act as a liaison for other departments. The Panel will also draw on any other sources of information as it sees fit and may require.

3. Concluding comments

The Panel recognises that its work will develop over time with experience. It also recognises that many of the States' processes, such as the Fiscal Framework itself, are recent introductions and will themselves be adapted from time to time in the light of experience. The Panel's first report will be published in the autumn. The Panel anticipates that its work and the influence of its reports will mature and develop over time alongside the experience of the Fiscal Framework.

8th September, 2010

The Fiscal Framework

Principles

The Fiscal Framework sets out a number of key principles underlying fiscal policy in Guernsey. These 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.

The Fiscal Framework states that the underlying guiding rule is that fiscal policy should achieve 'long run permanent balance' – i.e. that income and expenditure should match over the medium term.

Assumptions

The Fiscal Framework also sets out certain assumptions underpinning the States' fiscal and economic policy:

- The key objective of economic policy is to promote long term economic growth;
- The private sector is the engine of growth and that the Government's primary economic objective is to provide a stable, competitive environment for the private sector to thrive;
- Given that Guernsey is a small island economy and that monetary policy is not under its control, there is only a limited role for fiscal policy in active stabilisation.

Numerical Parameters

The Framework also provides some numerical parameters to guide the achievement of long run balance of the fiscal position:

- The maximum annual operating public deficit may not exceed 3% of gross domestic product ('GDP');
- The level of gross borrowing by the States may not exceed 15% of Guernsey GDP ;
- The 'normal' levels of overall expenditure and revenue as a share of GDP should be held at their long term historical average.

[37] This numerical parameter is currently redundant as it was decided that there should be no borrowing by the public sector. During the course of the debate, the ceiling was amended. The original recommendation was for a maximum level of 20%.

Appendix 2:

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

The proposed fiscal policy framework

Principles

The principles underlying fiscal policy in Guernsey are that:

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

Objective

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

Framework

1. Assuming a long run permanent balance position implies the acceptance of long run 'permanent', ie normal, levels for taxation and public spending including public sector capital investment: these long run levels provide 'norms' for future plans and are calculated with reference to historic or international empirical experience.

2. Deviations, and hence any fiscal deficits, from these long run norms are only acceptable if they are of a temporary nature, ie 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.