

Annual Independent Fiscal Policy Review 2013



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1. Executive summary

Over the course of 2013 both the short and long-term fiscal and economic challenges have been brought to the fore and the States finds itself at a critical juncture where decisions must be made on a number of issues to ensure the security of the States' fiscal future.

At present, the States' revenue budget, as captured by the Fiscal Framework, is well within the prescribed limit of 21% of GDP. However, after four years of negative or sub-par growth, the short-term imbalance in States' revenue budget remains. The 2012 accounts reported a deficit of £20m, £7m less than originally budgeted (and £11m less than the outrun forecast in the 2013 budget). However, the latest estimates for 2013, published in the 2014 budget forecast, that the deficit will increase to £27m in 2013 as a result of poorer revenues than had been expected. The budget shows the deficit falling to £14m in 2014. At the time of the publication of the 2012 accounts, Treasury and Resources stated that it is possible that the General Revenue budget will be in balance by 2015. However, given the stubborn nature of the deficit, there is a risk this may be a little optimistic.

The seventh successive year of deficit projected by the 2014 budget represents a breach of the Fiscal Framework [‘the Framework’] rule requiring that any deficit position be removed within five years. As stated in previous reports, this criterion in the Framework contains no allowance for economic conditions and it could be argued that recent conditions have precluded more rapid measures to remove the deficit.

As acknowledged in the 2012 accounts, if the States is to maintain the commitment to permanent balance in the medium-term, a period of surplus will be required to replenish the reserves spent supporting the sustained deficit position. In addition, allocations to the capital reserve have been routinely below that required to meet the Fiscal Framework [the Framework] target of 3% of GDP over the lifetime of the Framework. As highlighted in the Treasury and Resources Capital Prioritisation Report, in the future this will result in a shortfall in the funds for the planned capital investment programme. This suggests a situation where, irrespective of the success of the FTP, the States will not have sufficient revenues to meet its commitment to infrastructure investment without cutting other expenditure and will, therefore, continue to have a structural deficit.

Both the requirement to replenish reserves and the need to invest more funds in the capital programme imply that, unless the way in which the capital programme is financed is changed, clearing the deficit at the current level of spending is not enough to bring the States into long-term structural balance. Either additional revenues are required, both to repay the drawdown from reserves and increase the level of annual investment in the Island's infrastructure, or expenditure, capital or otherwise, will need to be cut.

The States faces two primary difficulties in achieving this. Firstly, in common with much of the Western world, economic growth in Guernsey remains weak and it is prudent to assume that it will continue below its pre-crisis average for the foreseeable future. This is likely to limit Guernsey's natural revenue growth in the medium-term given Guernsey's lack of consumption taxes and unusually high reliance on direct personal tax receipts (which are dependent on earnings and, therefore, more sensitive to economic conditions than some other forms of taxation). Planning should not be based on the expectation that Guernsey will be able to grow its way out of deficit within any reasonable time frame.

Secondly, the States faces problems in managing expenditure in both the short and long-term. The States of Guernsey has been operating a policy of expenditure restraint for a number of years now and, despite the

inherent difficulties in restraining government expenditure, Guernsey has been remarkably successful with very minimal growth or a reduction in net revenue and capital expenditure every year between 2009 and that forecast in 2013. However, welfare expenditure has continued to increase and is taking up an increasing share of total public expenditure.

However, as highlighted in previous reports, the Financial Transformation Programme [FTP], a key element of the deficit reduction approach, presents a significant challenge. The statement made to the States Assembly by the Treasury and Resources Minister in May 2013 contained the first official warning that the FTP may not achieve its stated objective:

“...the FTP forecast has, for the time being, dropped below £30 million. Within that portfolio, I believe that there are risks to delivery of some of our interdepartmental or cross-cutting projects due to the timeframes now remaining and the difficulties the States has faced in trying to deliver single-organisation projects which involve significant change, as evidenced recently with the SAP STSC...”

If, as the above caution suggests, the FTP may not generate sufficient savings to place the States’ finances in a position to achieve structural balance, a choice must be made. But the alternatives, be they either an increase in taxation or a real cut in service provision, are unlikely to be more palatable than the FTP.

The States is also in the process of reviewing the welfare benefits offered in Guernsey. The proposal to unify the current parallel supplementary benefit and rent rebate schemes is a sensible one, although there is a price tag attached. A fair and sustainable welfare system to support those less fortunate is a laudable goal. However, the problem of how to provide a system that adequately provides for low income households but does not unduly encourage long term dependency is a very difficult one. Controlling the costs of a welfare system are also difficult as, once eligibility criteria have been set, the government has very little control over how changing economic and social conditions may change the number of people who are eligible to claim. The proposals extend the current scope of eligibility and, whatever the apparent cost of that may be now, it is very difficult to predict or control how many households may be eligible to claim in the future.

The launch of the Personal Tax, Pensions and Benefits Review [PTR] has brought the issues of sustainable provision of public services in the long-term into the public domain. It is evident that there are choices to be made regarding the most appropriate balance between the level of taxation and the demand for public services; particularly healthcare, pensions and long-term care, in the context of an ageing population. It would be advisable for the States to make an early decision on whether (and how far) it is willing to increase the relative size of the state to cater for the increased demand; or whether a reduction or restructuring of long-term provision of pensions and healthcare services is preferable to the significant increase in taxation, which could be required to continue providing services under the current model.

There are many issues that the States of Guernsey faces. It seems the time for choices to be made is, if not now, certainly very imminent. Postponing such decisions might improve the situation, but it would be a little imprudent to rely on that.

2. Introduction

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

The role of the report is to provide independent analysis, review current fiscal conduct and draw attention to any areas where actions are in conflict with the long-term objectives. It also provides an assessment of risks relating to the fiscal strategy and raises any general areas of concern that policymakers should be seeking to address. It is not an advisory report; its remit is not to provide or recommend policy solutions to those issues raised.

In making these assessments, various judgements are required. Any assessment of the state of the economy, (and thus its position relative to its long-run 'norms' on which the Framework is based) is, by necessity, subjective in some respects. There has to be a reliance on official data provided by the States; but official data in all jurisdictions are prone to inaccuracy and subsequent revision, and Guernsey is no exception. As GDP is estimated with a nine-month lag, an assessment of present conditions is dependent on assessment of indirect variables such as levels of employment and unemployment.

As was the case last year, the four year projections of States' finances previously published in the States Strategic Plan [SSP] are not currently available. The report instead focuses on the fiscal performance in 2012 and the short-term projections for 2013 and 2014 published in the 2014 budget.

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

3. Economic outlook

3.1. Global outlook

The World Economic Outlook [WEO] update, published by the International Monetary Fund (IMF) in July 2013, reported forecasts of global growth revised down to slightly above 3% in 2013; the same growth as seen in 2012. This downwards revision was largely due to weaker domestic demand and slower growth in several key emerging market economies, together with a lingering recession in the euro area, with countries such as Greece, Spain and Ireland continuing to struggle with unsustainable levels of Sovereign debt.

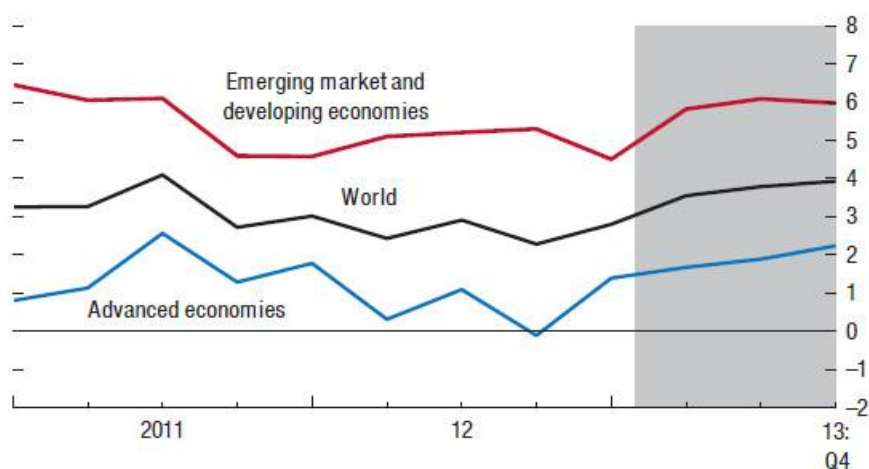
2014 forecasts show 4% growth in global GDP with improvements in both developing markets and advanced economies. The euro area is expected to come out of recession and recoveries in the US, UK and other advanced economies to gain a little strength.

The forecast assumes the increase in financial market volatility experienced in May and June and associated yield will partly reverse as it largely reflects a one-off reprising of risk due to the changing outlook of emerging market economies and the uncertainty surrounding the United States' exit from the monetary policy stimulus. Risks remain on the downside including the possibility of a longer growth slowdown in emerging market economies and possibly tighter financial conditions if the anticipated unwinding of monetary policy stimulus in the United States leads to sustained capital flow reversals.

Figure 3.1.1. Global GDP Growth

Percentage change, annualised quarter over quarter

Source: International Monetary Fund, World Economic Outlook Update, July 2013



It must be noted that the IMF's forecasts change with almost the same frequency as the headlines of the Guernsey Press. They are reported here simply to show what has been said, and to give an indication of the prevailing perspectives on the global outlook.

3.2. Domestic outlook

3.2.1. Economic growth

The first estimates of 2012 GDP report a slight decline of 0.2% (see **Figure 3.2.1**), compared to a forecast of no growth. Estimates echo the weakness in the labour market in 2012, incorporating declines in both profits and earnings, partially offset by a recovery in self-employed profits after three years of decline.

Like many developed countries, recovery from the financial crisis in Guernsey has been both slow and fragile. Conditions in Guernsey through the first half of 2013 were muted despite the developed world confirming its economic recovery - the US leading the way followed by accelerating growth in the UK and now parts of the Eurozone. Events of the summer, such as the withdrawal of the Co-operative bank and the difficulties of some well-established local firms such as Warry's Bakery and Huelin Renouf, will have dented consumer confidence and suggest that Guernsey is still experiencing fallout as a result of four consecutive years of sub-par or negative growth.

Financial market conditions appear to have improved in recent months. Confidence in the City seems to have increased and market developments such as AIFMD may justify a more positive outlook for the close of the year. However, the pressure of increased compliance costs in the face of numerous global regulatory initiatives and information exchange requirements has slowed the response of local finance firms. Long-term growth of the sector will be dependent on firms adapting to the higher cost environment.

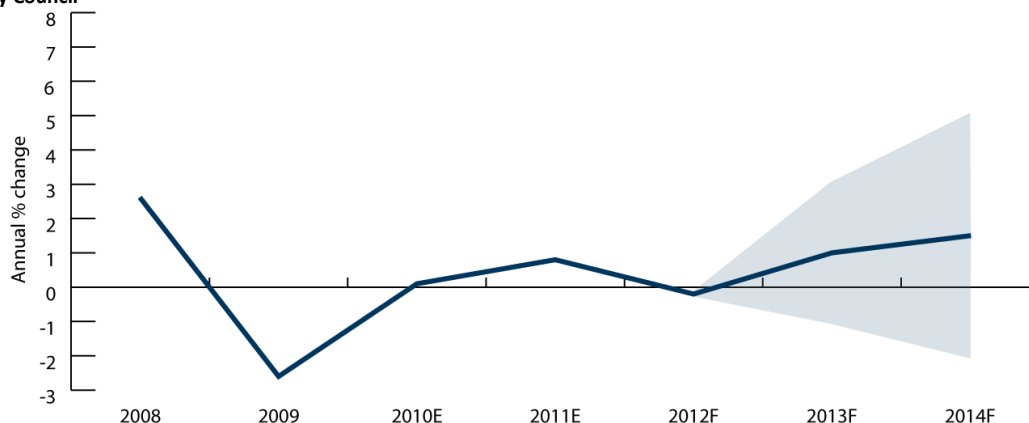
Early indications suggest that labour market conditions have also eased over the third quarter and Policy Council forecasts imply an expectation that economic conditions will improve sufficiently in the latter stages of the year to offset the earlier weakness. The Chamber of Commerce Annual Business Survey, which has proven a remarkably good forward indicator, also presents a picture of a better 2013 than 2012 (see **Figure 3.2.2**). The survey supports the view that 2013 will experience some economic growth, despite the various unfavourable announcements during the summer. Although these announcements were unwelcome, tough economic times lead to periods of restructuring of both the economy and individual firms. Going forward, there will be activities that were profitable in the past that will not be in future. Unwelcome announcements on the employment front may continue, irrespective of any general economic improvement.

The current central GDP forecast is for an overall resumption of growth at a moderate 0.9% in 2013; continuing at a slightly higher rate in 2014.

Figure 3.2.1. Annual growth in Gross Domestic Product

Real change, as at September 2013

Source: Policy Council



3.2.2. Business projections

The Guernsey Chamber of Commerce has conducted an annual survey of business conditions for the last six years. Carried out during January and February, the survey asks participating businesses to rate their year-on-year growth in profits and turnover for the year just ended and their expectations for the year ahead. The reported year on year growth in both turnover and profits demonstrates a correlation with estimates of real annual GDP growth.

The 2013 survey shows an increase in the reported turnover scores for 2012 but a decrease in the profit score suggesting that businesses experienced a reduction in profit margins over the year. The neutral profits score reported for 2012 is also consistent with first estimates of GDP, which show a slight contraction in the economy in 2012.

Profits projected for the year ahead have shown a fairly consistent optimism bias over the past 5 years, although the patterns exhibited tend to correlate well with reported profits. The projected year on year growth in profits for 2013 show a moderate increase, reflected in a forecast for a moderate level of GDP growth in 2013.

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

As at September 2013

Source: Chamber of Commerce, Annual Business Confidence Survey; Policy Council

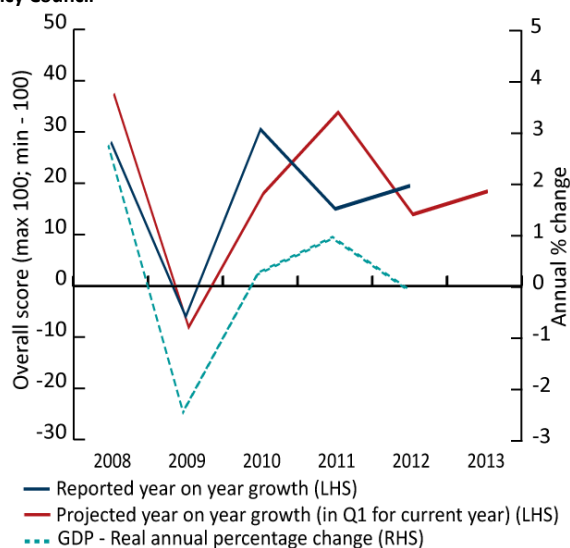
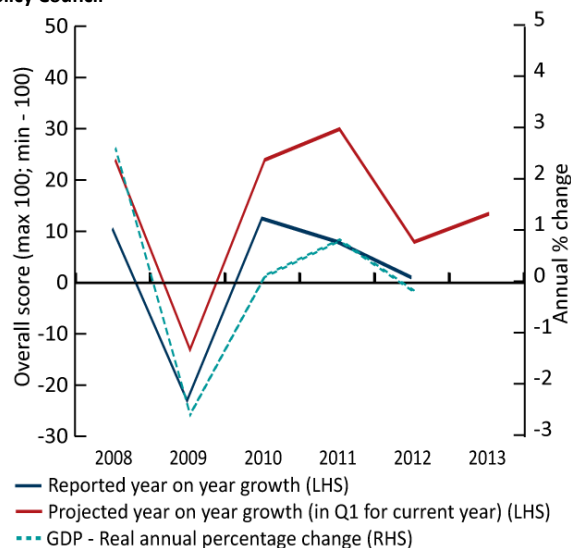


Figure 3.2.3. Overall survey scores for reported and projected year on year growth in profits

As at September 2013

Source: Chamber of Commerce, Annual Business Confidence Survey; Policy Council



Box 3.2. Long-term growth

There are several factors to suggest that growth rates are likely to be lower in the future.

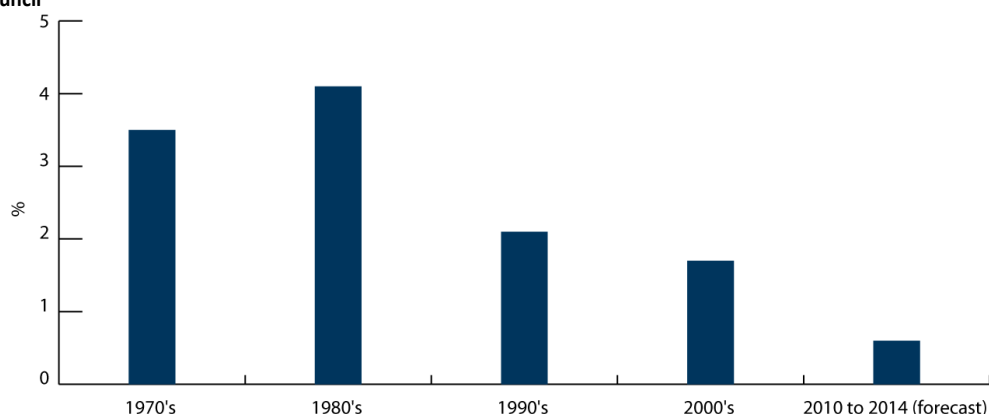
'Natural' mature economy factors

Guernsey's average growth rates have declined every decade since the eighties. This is not surprising; growth was rapid in the early days of financial sector development and the average rate has declined as the economy has matured and resources have become fully deployed. This trend would have been likely to continue irrespective of the events of 2008.

Figure B3.2a Average GDP Growth rate by decade

Geometric mean average annual percentage change in GDP, by decade, as at September 2013

Source: Policy Council



Global weakness

Recessions triggered by a financial crisis tend to last longer and recovery from them is slower. Developed Western economies are currently burdened with high levels of government debt. Guernsey, with its reliance for growth on exports from the finance sector, is dependent on global conditions despite having no debt of its own. Some economists suggest that the impact of the downturn on growth will continue to be felt for another 20 years. It is certainly highly likely that trend growth rates were unsustainably high in the past decade, as many organisations skimped on investment.

Difficult environment for offshore Finance centres

Guernsey's finance firms have to bear the pressure of responding to increased compliance costs in the face of numerous global regulatory initiatives together with the compliance costs of the numerous information exchange requirements. A reduction in the health of the finance sector would feed through directly into lower growth in the short-term as the sector has made the largest contribution to economic growth in recent times. As shown in **Figures B3.2b and B3.2c**, output of the finance sector has grown more over the last seven years than the economy as a whole, with the finance sector's cumulative contribution to growth of 8.6 percentage points between 2006 and 2012 being offset by a negative contribution from non-finance output. Within the employment market, the finance sector contributed 60% of cumulative employment growth between 2006 and 2013.

Figure B3.2b Cumulative contribution of finance and non-finance sectors to GDP growth, 2006-2012

Cumulative contribution to GDP growth, as at September 2013
Source: Policy Council

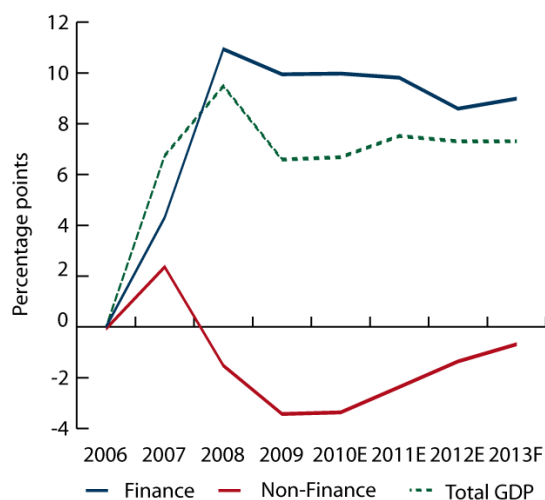
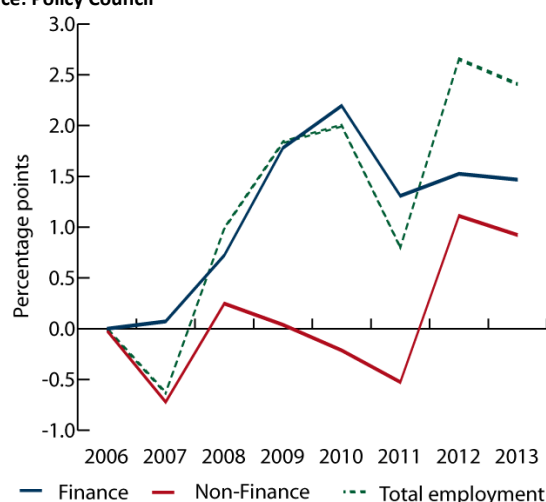


Figure B3.2c Cumulative contribution of finance sector to annual employment growth, 2006-2013

Cumulative percentage points contributed to total employment growth, as at September 2013
Source: Policy Council



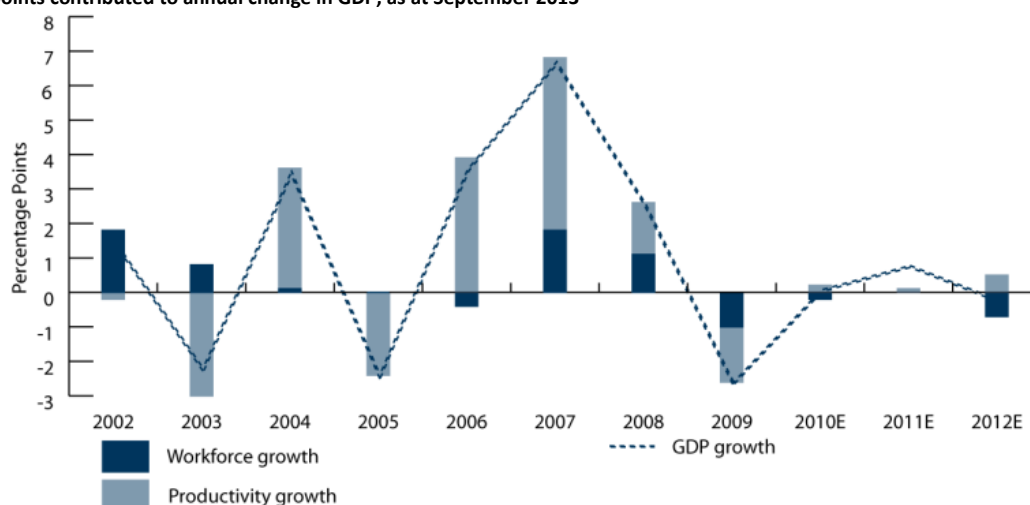
Demographics

Guernsey has an ageing population. To avoid a significant worsening of the dependency ratio and an increasing tax burden for those in work, various policy options could be reviewed – raising the retirement age, encouraging part-time work by the elderly and encouraging private pension provision are all possibilities. Some countries appear to consider increasing net immigration a solution, but long-term it is not, as immigrants themselves age. If net immigration is used to control the dependency ratio then it must increase at a faster rate every year. However, it should be noted that the licensing system, which restricts the amount of time many migrant workers are able to stay in Guernsey, means that many immigrants leave the Island before retirement to be replaced by other working age immigrants. This forms a “forever young” element within the population; boosting the working age population but with less impact on the dependent population in the longer term than would otherwise be the case.

Domestic solutions are the only true solutions; and it is, from many points of view, wrong to see an ageing population as a problem. Rather, as it is associated with increasing *healthy* life expectancy, it is a bonus which brings opportunities. Growth in the size of the workforce since 2002 has accounted for 34% of growth, whilst 66% can be attributed to productivity growth (see **Figure B3.2d**). A static or declining workforce would thus bring down average growth rates although there is no need for it to bring down the important measure, growth in income per head.

Figure B3.2d Contribution of growth in the workforce to GDP growth

Percentage points contributed to annual change in GDP, as at September 2013



Determining a trend growth rate in the future is a complicated task at the best of times and a very inexact science. However, the combination of the four factors above does suggest that trend growth will probably be less than the two per cent experienced over the last decade, and is more likely to be in the region of no more than one and a half per cent. The experience of other countries shows this effect is likely to increase the relative cost of public services, as was demonstrated in the Policy Council's review of long-term trends published in 2012, with the result that the focus on the need to restrain expenditure growth is likely to be a feature for many years to come.

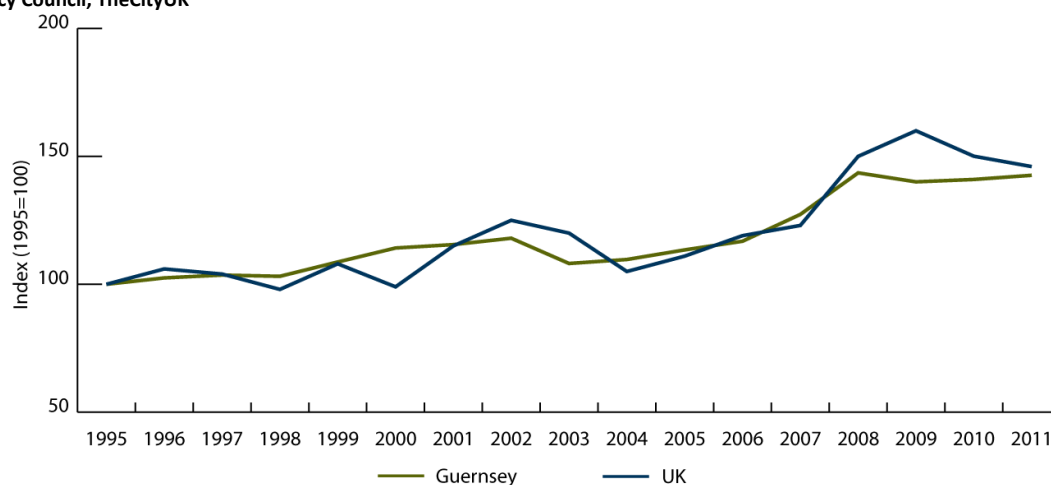
3.2.3. Finance sector: recent and future conditions

Finance sector activity in Guernsey closely mirrors that in the UK, with almost all captive insurance and most fiduciary business in Guernsey originating in the UK. Recent data published by the Office of Budget Responsibility implies that conditions for the UK finance sector have worsened over the last year with exports falling sharply during 2012 and early 2013. Prospects for financial services activity have been dampened by both general economic conditions in EU markets and the increase in regulation in the wake of the financial crisis. However, City confidence has improved and this, together with market developments such as the AIFMD, underpins the forecast of growth over the course of the latter part of 2013 and 2014.

Figure 3.2.4. Index of finance and business services share of the economy

Index 1995=100

Source: Policy Council, TheCityUK



Scenario modeling indicates that if finance sector growth in Guernsey stagnates over the next ten years, both GDP and total employment will be approximately 10% lower than the central forecasts by the end of the period. A knock on effect of this would be a 10% reduction in General Revenues against the central projections.

Within the finance sector, conditions vary between sub-sectors. The value of banking deposits in Guernsey continued its general downward trend in 2012, falling heavily at the end of the year. The first half of 2013 has seen a moderate recovery but deposit levels remain well below their pre-crisis peak. This has been mirrored by a decline in the number of registered banks in Guernsey which, through a series of amalgamations and surrenders, has been declining throughout the decade, falling from 69 in 2002 to 32 in 2013.

Few items of data are available on the fiduciaries sub-sector but a fall in the number of fiduciary licenses in late 2012 and early 2013 suggests that conditions continue to be difficult.

In contrast, investment activity continues to be buoyant with the total value of funds administered in Guernsey 6% higher in June 2013 than a year earlier. The upward trend in fund values has been accompanied by a significant shift in the types of funds administered, with a steady decrease in both the number and value of traditional open-ended funds and an increase in closed private equity funds and funds (particularly hedge funds) registered in other jurisdictions.

Figure 3.2.5. Banking deposits

At current prices, nominal change, as at September 2013
Source: Guernsey Financial Services Commission

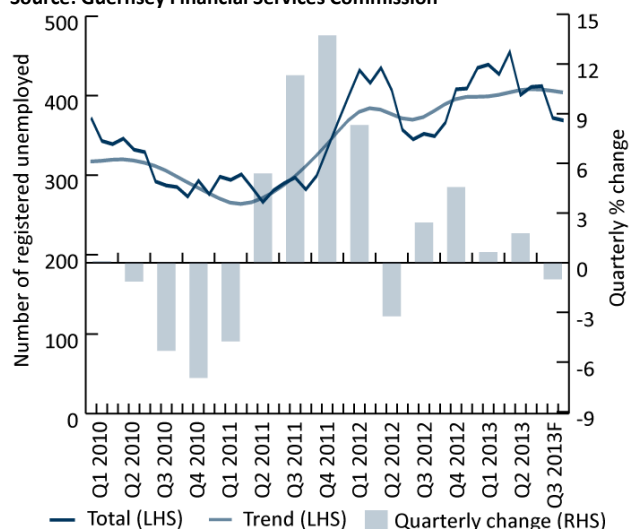
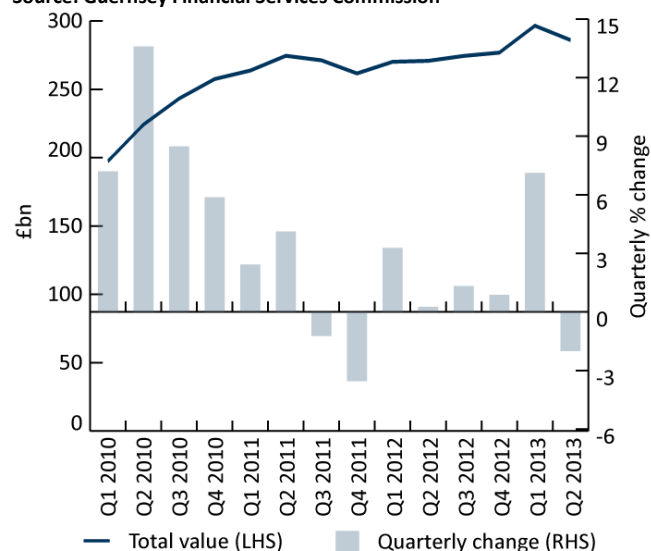


Figure 3.2.6. Fund assets

At current prices, nominal change, as at September 2013
Source: Guernsey Financial Services Commission



Within the insurance sub-sector, a steady increase the number of registered international cell companies suggest that the real increase in net worth recorded in 2009, 2010 and 2011 has continued in 2012 and the first half of 2013.

3.2.4. Labour market

Overall, official statistics point to worsening conditions towards the end of 2012 and into early 2013. Following the brief recovery experienced during 2010 and early 2011, the level of total employment in Guernsey plateaued in 2011 before declining steadily over the course of 2012 and (to a slightly lesser extent) early 2013 (see **Figure 3.2.7**). The impact was partially off-set by a decrease in net immigration, with a slight decline in the working age population resulting in a slight increase in the employment rate (on a seasonally adjusted basis) in between March 2011 and March 2012 to 77.0% (see **Figure 3.2.8**). However, although population data for subsequent quarters are not yet available, Policy Council forecasts show a slight decline in the employment rate between March 2012 and March 2013.

Figure 3.2.7. Total employment

Total employed and self-employed people.
Actual and with SA trend, as at September 2013
Source: Policy Council

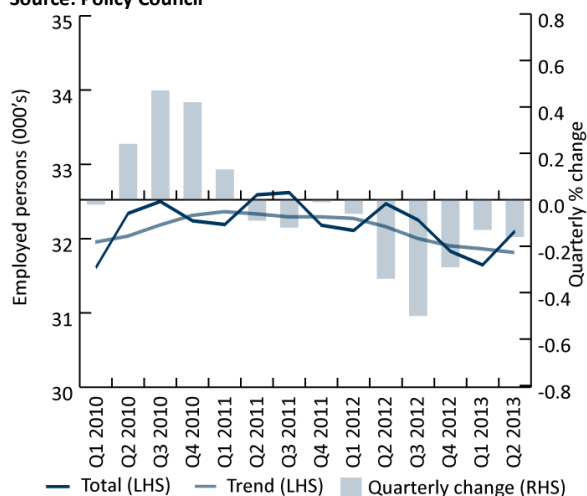


Figure 3.2.8. Employment rate

Total employment as a percentage of the working age population.
Actual and with SA trend, as at September 2013
Source: Policy Council

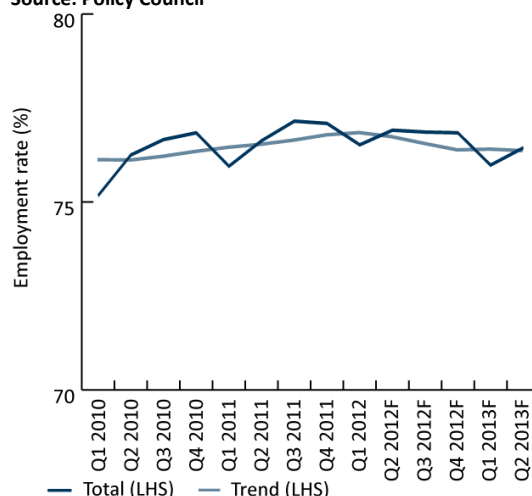


Figure 3.2.9. Total unemployment

Registered unemployment, actual and with SA trend,
as at September 2013
Source: Policy Council

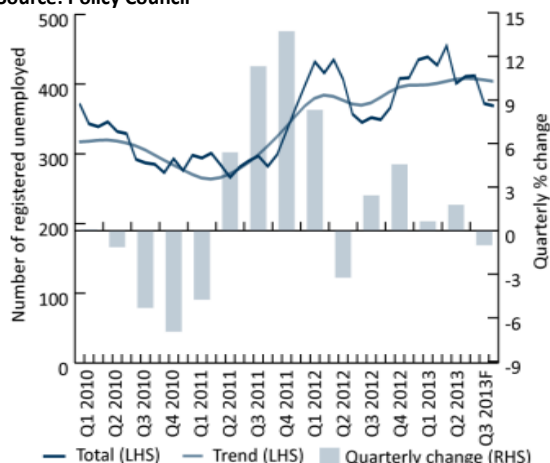
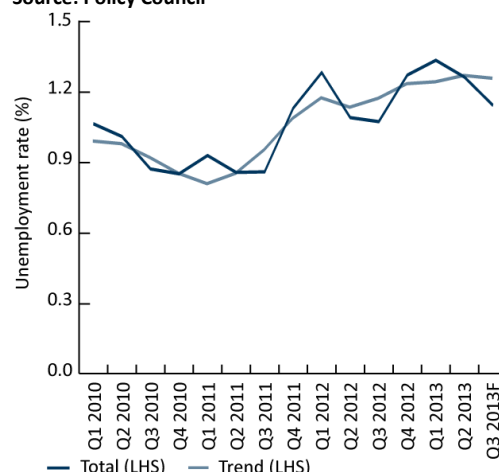


Figure 3.2.10. Unemployment rate

Registered unemployment rate, actual and with SA trend, as at
September 2013
Source: Policy Council



Registered unemployment, both in terms of the number of people registered unemployed and the unemployment rate, rose rapidly during 2011 (see **Figures 3.2.9** and **3.2.10**). Although this increase slowed in 2012 and early 2013, unemployment in Guernsey remains well above the pre-recession average and was higher in March 2013 than at any point since the early 1990s.

Unemployment forecasts for the third quarter, based on provisional unemployment figures for July and August, suggest that employment conditions may have started to improve a little, with a slight fall in unemployment expected by the end of the third quarter. This is supported by anecdotal evidence from industry representatives that the demand for labour increased slightly towards the end of the third quarter and an increase in the number of advertised vacancies both at the Job Centre and in the local media.

4. Performance against the Fiscal Framework

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

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

Box 4.1. Parameters of the Fiscal Framework

The Fiscal Framework sets a number of parameters and commitments:

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

Although total expenditure is within the parameters of the Fiscal Framework, 2012 marks the fifth year of deficit and deficits are projected to continue until 2014, in breach of the criteria set by the Framework. No projections beyond 2014 are included in this year's report (none have been published) but it is possible that the budget may return to balance by 2015. However, this possibility depends on capital expenditure remaining below the requirements outlined by the capital prioritisation report and the 3% of GDP required by the Framework. The States will need to examine capital spending and the replenishment of reserves used in financing the deficit if it is to meet the criterion of permanent balance in the long-term.

4.1. Income and expenditure

Fiscal Framework rules:

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

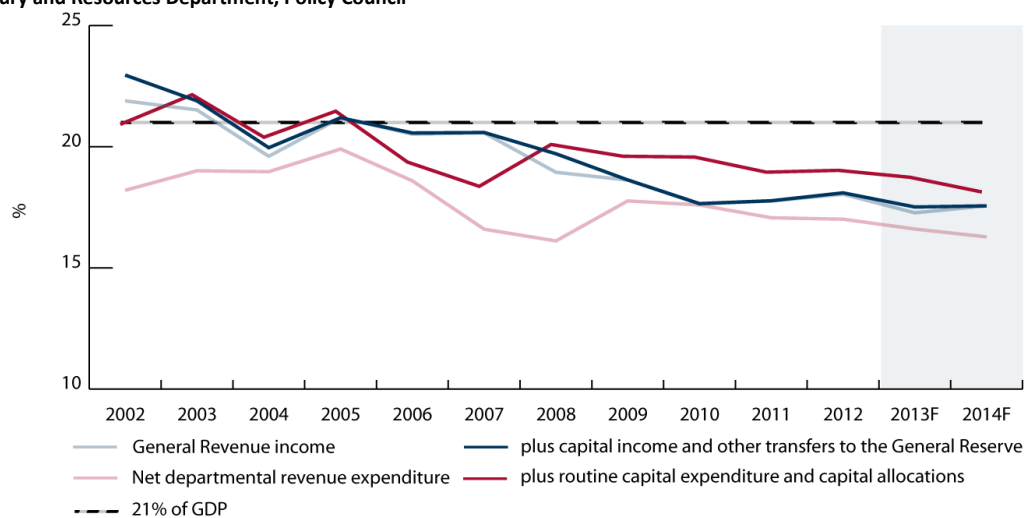
General Revenue and capital expenditure remains well within the 21% of GDP limit prescribed by the Framework and in general has fallen relative to GDP since 2008, with the general downward trend in expenditure relative to GDP becoming increasingly evident. In 2012, total revenue expenditure was equal to an estimated 19.1% of GDP and is expected to fall to 18.2% by 2014.

General Revenue income increased relative to GDP in 2012 from 17.8% to 18.1%. However, the latest estimates show this falling to 17.5% in 2013, reflecting poorer revenues from companies (specifically the fiduciary and insurance entities captured by the extension of zero/10) and duty on property sales than had been expected. Budget projections for 2014 show revenues continuing at this level.

Figure 4.1.1. Revenue income and revenue and capital expenditure (Fiscal Framework), 2002-2014

Net of departmental operating income, as a percentage GDP, as at October 2013

Source: Treasury and Resources Department, Policy Council



4.2. Fiscal position

Fiscal Framework rules:

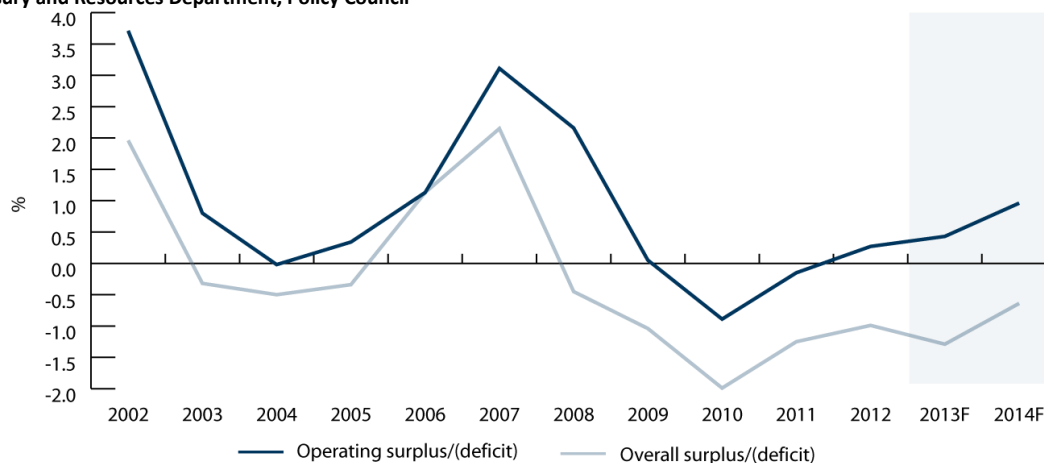
- **Restraint on any temporary operating deficit positions to less than 3% of GDP in any one year.**
- **Ensure that identified deficits will be addressed within 5 years of their appearance and that measures to counter identified structural deficits are agreed within two years of their identification.**

The operating (and, in fact, the overall) deficit position remains below 3% of GDP and the States has not, at any point within the current period of fiscal pressure, breached this criterion. However, the overall deficit reported in 2012 represents the fifth successive year of deficit, and the 2014 Budget projects that the deficit will continue into 2014; a clear breach of the criterion requiring the deficit be addressed within five years. It should be noted that the Framework makes no allowance for economic conditions. Removal of the deficit within the prescribed timeframe may not have been advisable, given the combined pressures of the deliberate reduction in corporate tax receipts and a sustained period of global economic stress.

Figure 4.2.1. Operating position, 2002-2014

As a percentage of GDP, as at October 2013

Source: Treasury and Resources Department, Policy Council



The Framework reflects the manner in which the States Accounts are reported; capital expenditure is reported as routine capital expenditure (small capital investments controlled by individual departments and incorporated into their annual budget) plus the transfer of funds from General Revenue to the Capital Reserve. The appropriated funds may not be representative of the actual amount of money spent on capital projects in any given year. The economic variable of interest is the actual in year expenditure compared to in year income. This issue is discussed in more detail in **Section 4.5**.

4.3. Permanent balance

Fiscal Framework rules:

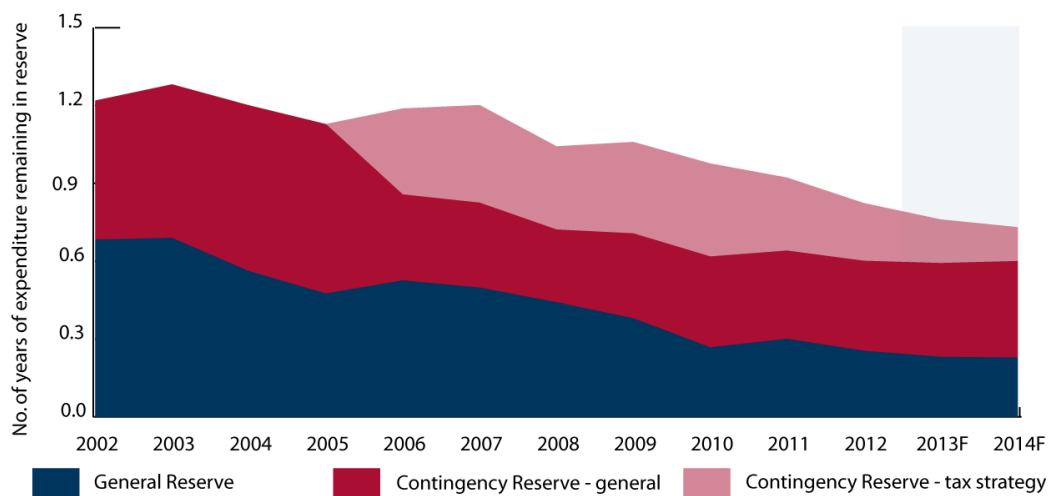
- **Maintenance of long-run 'permanent balance'.**

Throughout the current period of deficit the States has been fortunate in having significant financial reserves from which to draw. This has allowed the States to avoid borrowing to support the deficit position. However, as highlighted in the accounts, in order for the States to achieve the criterion of long-run balance, a period of surplus will be required to replenish the reserves used to support the current deficit position.

Figure 4.3.1. States' reserves, 2002-2014

Number of years of total revenue expenditure held in reserve, as at October 2013

Source: Treasury and Resources Department

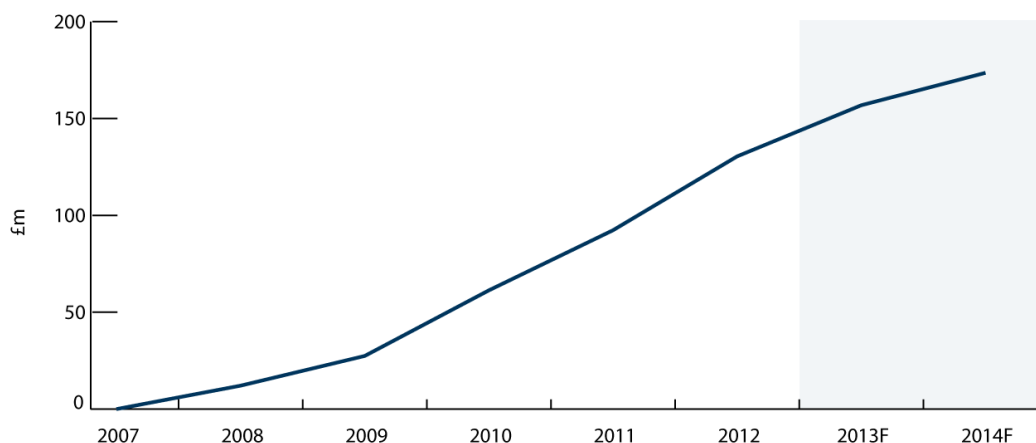


Between 2008 and 2012 the States has drawn a total of £109m from the General and Contingency Reserves and further drawdowns are anticipated for 2013 and 2014. Although this has been offset in part by the investment income received in relation to these reserves, the combined level of reserves in December 2012 was £77m less in nominal terms than in December 2007. In real terms, by the end of 2013, total reserves are expected to be only 66% of what they were at the end of 2007. The States will require a period of either significant or sustained (or both) surplus to rebuild these funds.

Figure 4.3.2. Cumulative depletion of reserves, 2007 - 2014

Cumulative real value, at 2013 prices, as at October 2013

Source: Treasury and Resources Department



4.4. External borrowing

Fiscal Framework rules:

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

Although part of the original function of the Fiscal Framework was to provide limits to proposals to borrow in order to finance the capital expenditure programme put forward in 2009, a subsequent decision was taken not to borrow at that time. As a result, the States currently has no external debt².

4.5. Capital expenditure

Fiscal Framework rules:

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

The Fiscal Framework sets a target of 3% of GDP for capital expenditure. The original States report setting out the Fiscal Framework (Billet d'Etat XI, 2009) makes clear that this was intended as a rule of thumb/steady state for an appropriate level of capital expenditure for Guernsey. It made reference to historic and international norms as a guide in determining the 3%. It also explained the risks in setting targets for capital expenditure, namely that unnecessary and unproductive investments could be made just so as to meet targets³.

The rationale behind the rule was to ensure that the States generated sufficient General Revenue to cover its capital expenditure requirements so as to safeguard against running into the situation where there were insufficient monies to fund the capital programme. That is, whilst acknowledging that capital expenditure, particularly for a small economy such as Guernsey, can be 'lumpy', generating revenues of 3% of GDP year in, year out would ensure that long term capital expenditure was financed without recourse to external borrowing.

There is a complication in the way the States accounts for capital expenditure. The overall deficit is reported after the appropriation of funds from General Revenue to the Capital Reserve. In 2012 the reported deficit was £20m after transfers of £25.4m. However, actual spending from the Capital Reserve in 2012 was £61.7m⁴, £36m more than the fund transferred into it from General Revenue. If calculated using actual expenditure on capital the deficit in 2012 would stand at £56m. This is the difference between income and expenditure in that year.

² Whilst strictly speaking true, the States does act as Guarantor, underwriting loans to some States-owned or States-backed entities. These include two loans relating to the Aurigny Group (£22.7m) and one to a wholly owned Guernsey incorporation formed for the purchase of two fuel tank ships (£16.7m). The total outstanding balance on these three loans was £39.4m at the end of Dec 2012. The States also has "Step In" rights for the assets and liabilities of the GHA and on this basis have provided letters of conform in respect of the GHA's four borrowing facilities totalling up to £80.5m.

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

⁴ Actual capital expenditure in 2012 was high due to the runway development (an example of the point that capital expenditure is 'lumpy').

Figure 4.5.1. Capital expenditure, 2002-2014⁵

As a percentage of GDP, as at October 2013

Source: Treasury and Resources Department, Policy Council

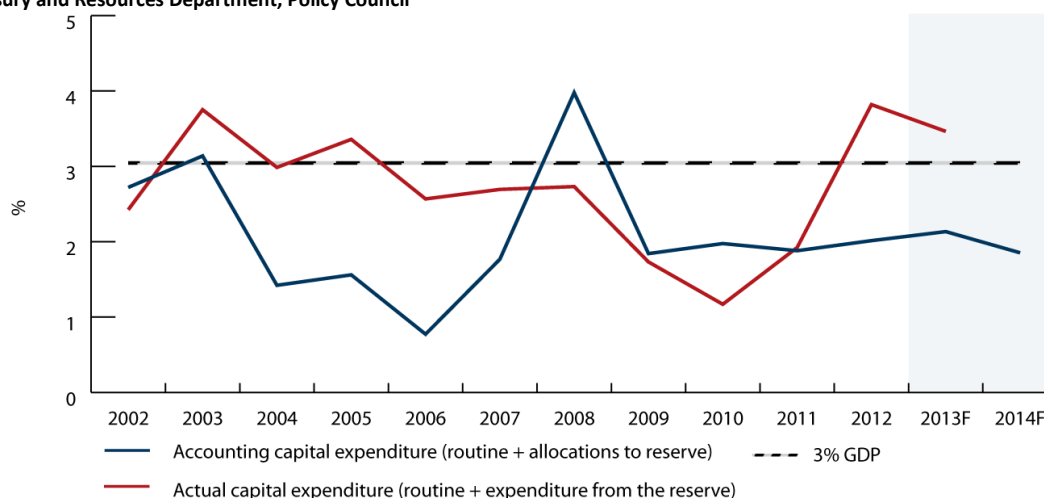


Figure 4.5.1 shows the difference between the two ways of measuring capital expenditure, showing how they have differed year in, year out. It conveniently illustrates the rationale of the capital expenditure target. The red line is actual expenditure. The dotted line is the Fiscal Framework target funding. The blue line is what has been transferred into the Capital Reserves. Actual annual capital expenditure has averaged 2.7% of GDP over the past 10 years; capital expenditure *as reported* has averaged 2.1% of GDP. In effect, although as reported capital expenditure is one percentage point below 3% of GDP target, the actual expenditure on capital projects over the past decade has been, on average, not far short of the 3% target. However, this does show a shortfall of approximately £15m per annum in the money allocated from General Revenue- the primary (but not the only) source of funds.

This is not an esoteric point, although the accounting presentation may make it seem so at first glance. The effects on the Capital Reserve are shown in **Figure 4.5.2**. The Treasury and Resources Department Capital Prioritisation report has identified that, assuming appropriations to the Capital Reserve continue at their current level, the Capital Reserve is now £70m short of the funds necessary for the recommended capital programme from 2014 to 2017.

The recommended programme will cost around 2.8% of GDP per annum and, combined with the £7m of routine capital expenditure budgeted for 2014, should meet the 3% of GDP criteria. However, assuming this expenditure is distributed evenly across the four year time period (which is unlikely), at the current rate of allocations the capital reserve will be exhausted by 2016.

⁵ Figures for actual capital expenditure for 2014 were not available at the time of publication.

Figure 4.5.2. Capital Reserve balance

At December each year, at current prices, as at October 2013

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

Source: Treasury and Resources Department

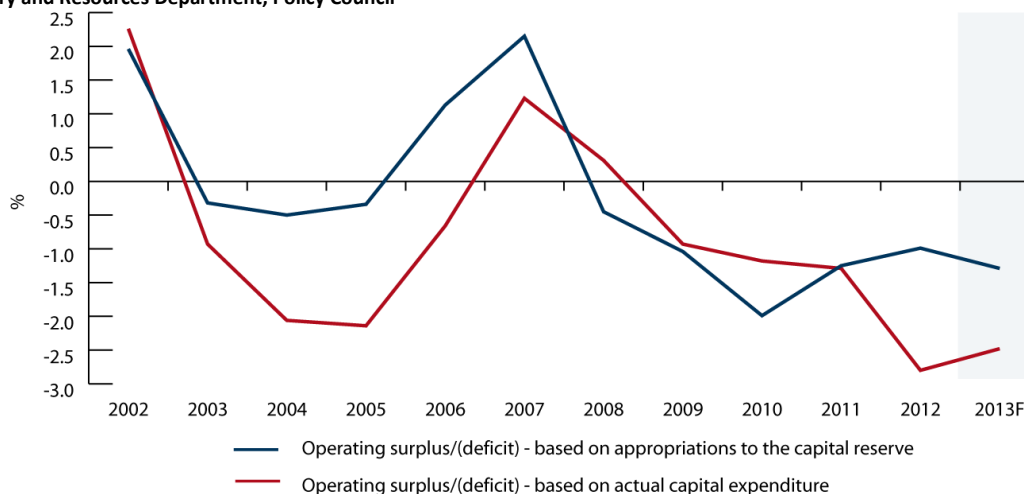


In short, the time has now come where a choice has to be made: the States need either to generate sufficient revenues to cover all revenue and capital expenditure (without recourse to transfers from reserves) or reduce capital (or other) spending. Alternative means of financing the necessary investment include borrowing; however, this is not a viable option in the long-term. Financing the shortfall through borrowing will require the same amount of revenues to cover interest and repayments.

Figure 4.5.3. Overall deficit, 2002-2013⁶

Comparing the use of appropriations to Capital Reserve and actual capital expenditure, as a percentage GDP, as at October 2013

Source Treasury and Resources Department, Policy Council



⁶ Forecasts for actual capital expenditure for 2014 were not available at the time of publication.

5. Guernsey's public finances in detail

5.1. Introduction

Guernsey's public finances can, broadly speaking, be divided into two distinct revenue streams: General Revenue income, mainly derived from taxation (as presented in the States' Annual Budget (*'the General Revenue Budget'*) in November), which pays for departmental and capital expenditure; and Social Security income, mainly derived from Social Insurance contributions (*'the Social Security Budget'*), although also receiving investment income and some revenue grants. The two revenue streams are related by a complex series of interrelated accounts and transfers (see **Appendix 4**).

The parameters of the Fiscal Framework currently cover only General Revenue income and expenditure. The Framework does not affect the expenditure and income of the Social Security Budget. However, as non-contributory benefits rates are set in the Social Security Budget but financed from the General Revenue Budget, Social Security expenditure has an impact on the General Revenue balance.

In addition, total revenue and expenditure figures presented in the General Revenue Budget are also typically presented net of departmental operating income⁷ and expenditure financed from that source.

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

⁷Includes income from fees and charges levied by individual departments for certain services and the subsidies paid from the Social Security funds to other States Departments.

5.2. Aggregate income and expenditure

Aggregate expenditure, capturing both General Revenue and expenditure from the Social Insurance funds totalled £569m in 2012, up by £23m, a real increase of 1% on the previous year. Approximately a third of this increase is due to the increase in expenditure on old-age pensions. Although expenditure restraint within the revenue budget has kept aggregate expenditure growth at minimal levels since 2008, over the last decade aggregate expenditure has gently trended upwards, increasing in real terms by 18% between 2002 and 2012.

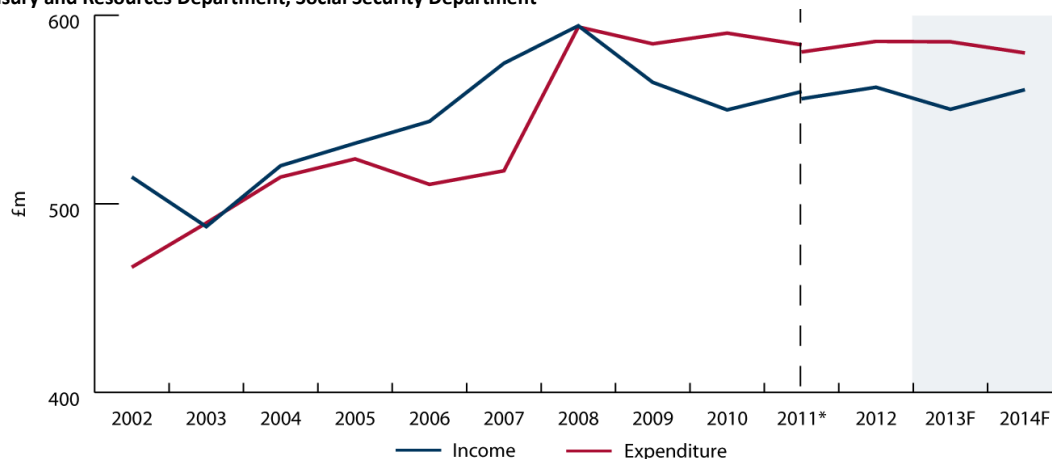
Aggregate income, capturing General Revenue income and Social Insurance contributions, also increased year on year by 1% in real terms in 2012, totalling £545m.

At the aggregate level, the shortfall between income and expenditure in 2012 (excluding the investment income from the Common Investment Fund) is almost unchanged from the previous year, despite the improvement in the General Revenue position. As mentioned above, this is largely due to increased expenditure from the Social Insurance funds. The budget projections show an aggregate shortfall of approximately £20m in 2014.

Figure 5.2.1. Aggregate income and expenditure, 2002-2014

At 2013 prices, as at October 2013

Source: Treasury and Resources Department, Social Security Department



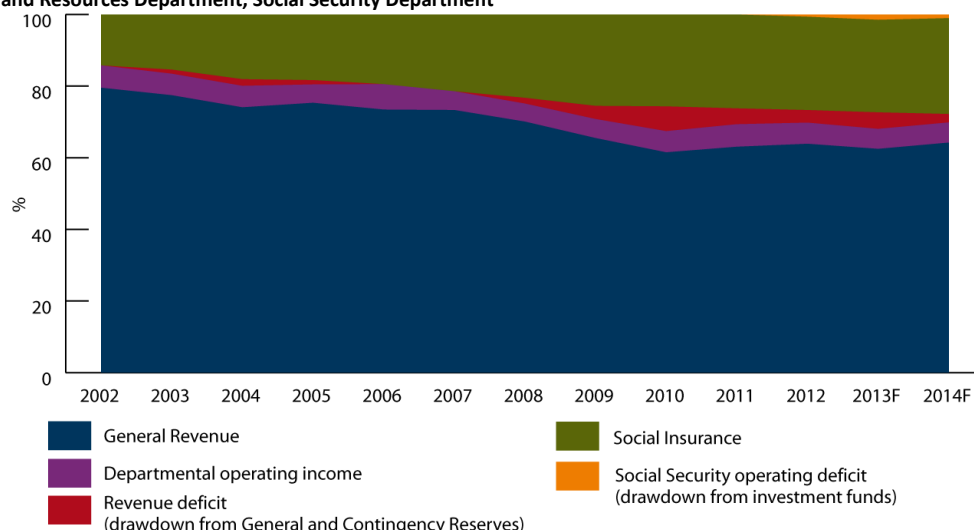
*Series break reflects the transfer of waste water services and associated operating income and expenditure to Guernsey Water thereby removing it from the revenue budget on an ongoing basis

As a result of increases in expenditure by the Social Insurance funds, the reduction in the revenue grant between 2006 and 2008 and the policy of expenditure restraint within the General Revenue budget, the distribution of aggregate expenditure has shifted toward expenditures financed by Social Insurance contributions over the last decade (see **Figure 5.2.2**).

Figure 5.2.2. Distribution of aggregate expenditure by funding source, 2002-2014

As at October 2013

Source: Treasury and Resources Department, Social Security Department



Figures 5.2.3 to 5.2.6 show the change in the proportion of aggregate expenditure on various service types. Expenditure on benefits, pensions and long-term care has increased substantially over the last 6 years and, as a result the proportion of aggregate expenditure spent in these areas has increased from 27% of aggregate expenditure in 2007 to 30% in 2012, with an additional increase anticipated in 2013. The increase to date has been driven primarily by an increase in expenditure on pensions and this has outweighed increases in expenditure in other areas of Social Security expenditure, such as unemployment benefits. However, if the proposals for the modernisation of supplementary benefit are accepted, this will add a further upward pressure from 2015.

Despite a 15% growth in spending by Health and Social Services between 2007 and 2012 (a total increase of £17m at 2013 prices) the proportion of aggregate expenditure consumed by healthcare has not changed very little over this period. The proportion of expenditure consumed by education and all other revenue expenditures have each decreased by 3 percentage points. The proportion of spending on capital remains largely unchanged.

Figure 5.2.3. Proportion of aggregate expenditure spent on Health

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

As percentage of aggregate expenditure, as at October 2013

Source: Treasury and Resources Department

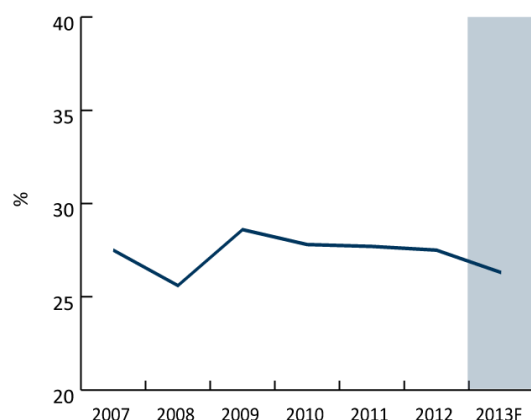


Figure 5.2.5. Proportion of aggregate expenditure spent on Capital

Including routine capital expenditure and the allocation to the Capital Reserve

As percentage of aggregate expenditure, as at October 2013

Source: Treasury and Resources Department

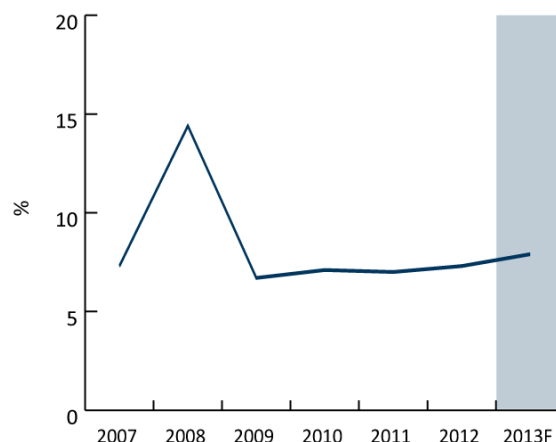


Figure 5.2.4. Proportion of aggregate expenditure spent on benefits, pensions and long term care

Including Non-contributory benefits, GIF, and LTCF

As percentage of aggregate expenditure, as at October 2013

Source: Treasury and Resources Department

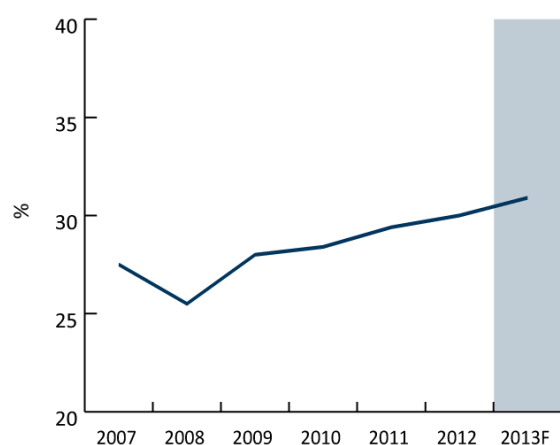
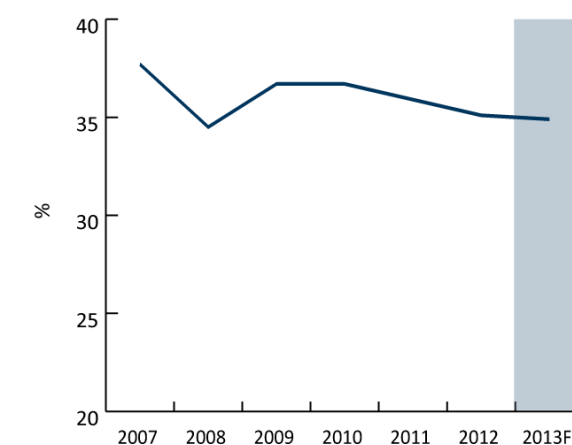


Figure 5.2.6. Proportion of aggregate expenditure spent on all other public services

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

As percentage of aggregate expenditure, as at October 2013

Source: Treasury and Resources Department



5.3. General Revenue

Table 5.3.1. Budget forecasts for 2013 and 2014

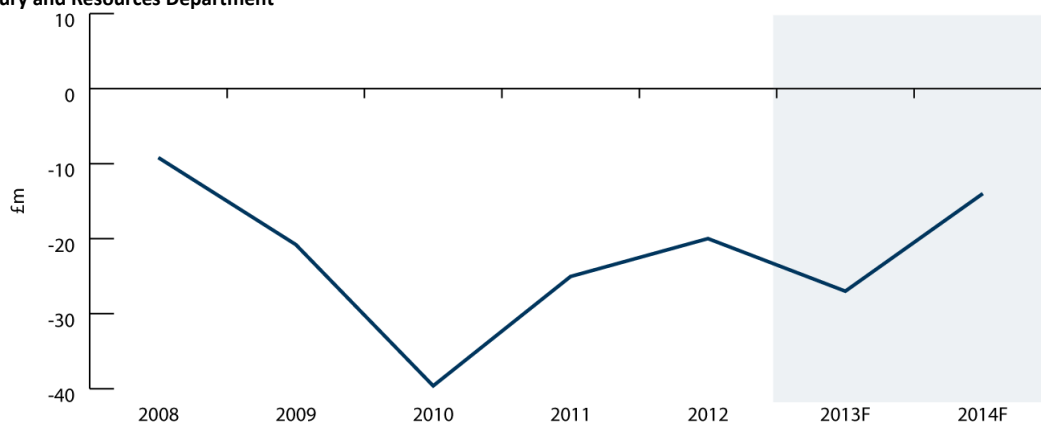
At current prices, as at October 2013

	2010 (£m)	2011 (£m)	2012 (£m)	2013F (£m)	2014F ⁸ (£m)
Personal taxes	205	218	227	231	239
Company taxes (incl. distributions)	53	52	53	54	60
Income taxes	258	270	281	292	299
Misc. income	3	2	4	2	3
Indirect taxes	70	74	77	74	82
General Revenue income	331	346	362	361	384
Departmental operating income	32	31	34	33⁹	34
Total revenue income	363	377	396	394	418
Net departmental expenditure	(330)	(333)	(342)	(349)	(356)
Exp. of departmental operating income	(32)	(31)	(34)	(33)⁹	(34)
Gross departmental expenditure	(362)	(364)	(375)	(382)	(390)
Revenue surplus/(deficit)	1	13	21	12	28
Routine capital expenditure	(18)	(17)	(16)	(13)	(7)
Capital income	0	0	1	8	0
Operating surplus/(deficit)	(17)	(3)	5	9	21
Appropriation to capital reserve	(21)	(21)	(25)	(36)¹⁰	(35)
Overall surplus/(deficit)	(37)	(24)	(20)	(27)	(14)

Figure 5.3.2. Overall Fiscal Position 2008-2014

At 2013 prices, as at October 2013

Source: Treasury and Resources Department



⁸ Incorporates changes to the funding arrangements for the Corporate Housing Programme, the net impact of which was to improve the overall deficit position by £3.9m.

⁹ Revised estimates of operating income were not available at the time of publication. Figures reflect those published in the 2013 budget.

¹⁰ Includes £3m transfer to the Strategic Development Fund and a £1m transfer to the General Reserve.

The 2012 General Revenue accounts reported the fifth successive year of deficit and the second successive year in which the deficit has been reduced. The most recent out-turn for 2013 published in the 2014 budget projects an increase in the deficit in 2013 to £27m, £10m more than budgeted. The downward revision of the overall position is largely a result of a reduction in income from document duty as a result of the weak property market and the overestimation of initial receipts from the extension of the 10% tax rate to capture fiduciaries, domestic insurance and insurance management activities. However, it should be noted that over the last four budgets, the size of the deficit for both the current year and the budget year has been overestimated by an average of £7m due to slight under estimates of income and over estimates of expenditure and the current out-turn estimates for 2013 may prove similarly conservative.

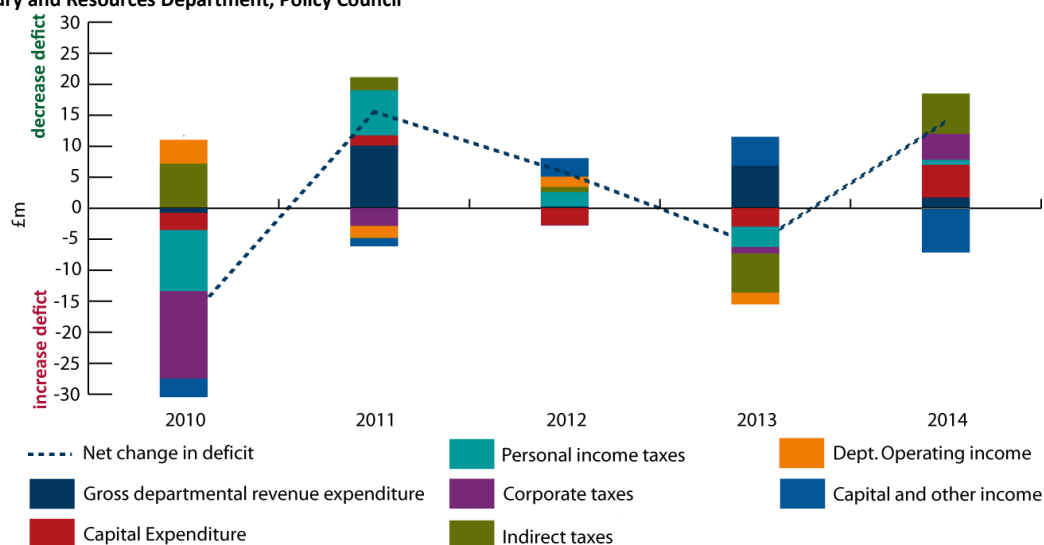
The budget projects a reduction of the deficit in 2014 to £14m and there is a possibility that the budget may return to balance in 2015. But it should be noted that even if balance is achieved in 2015, it is based on the assumption of a continuation of capital allocations at their current level, approximately 1% of GDP below the target stated in the Fiscal Framework.

As shown in **Figure 5.3.3**, the improvement in the current overall position in 2011 and 2012 was a result of a combination of factors. The most significant contributions were the real reduction in expenditure in 2011 and the increase in personal tax receipts in both 2011 and 2012. The 2014 budget projects an increase in the deficit in 2013 despite further real reductions in revenue expenditure.

Figure 5.3.3. Contribution to real annual change in fiscal position 2010-2014

At 2013 prices, as at October 2013

Source: Treasury and Resources Department, Policy Council



In 2012, total revenue income (including capital and departmental operating income) increased by 1.9% in real terms, the second successive increase in revenues and a further signal that States revenues are recovering from the combined impact of the introduction of zero/10 and the global financial crisis. However, in real terms they remain 9% below the level before the introduction of zero/10 and the financial crisis and the current estimates suggests they may fall again in 2013.

Net revenue expenditure by departments (excluding that funded by operating income such as fees and charges) fell in real terms by 0.5% in 2012, the third successive year that a decrease has been achieved. Despite this, total revenue expenditure (including expenditure of operating income and capital spending) increased in real terms in 2012 (although by less than 1%), largely due to a 5% increase in expenditure supported by operating income and a 6% increase in capital expenditure.

Figure 5.3.4. Total revenue income and expenditure, 2002 – 2014

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



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

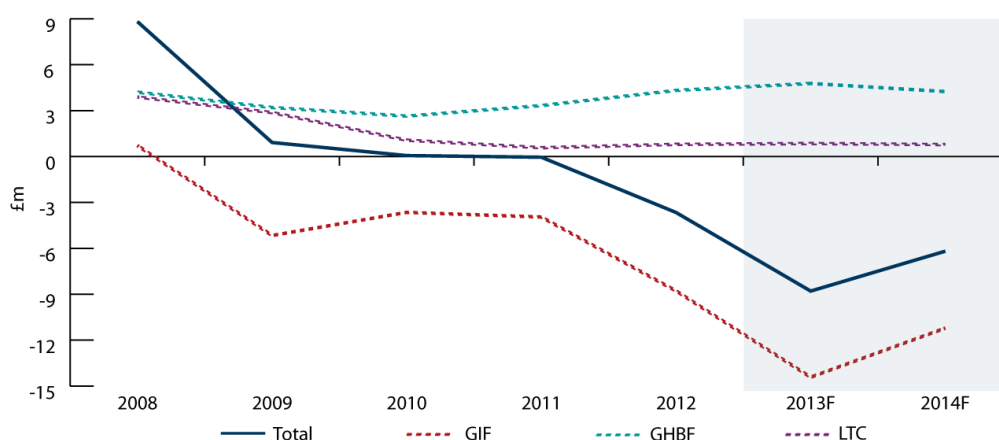
The 2014 Budget presents the latest estimates for 2013. These show a real year on year reduction in both income (by 2.5%) and expenditure (by 0.9%). The fall in document duty receipts is expected to make the largest contribution to the fall in income for 2013, and is directly attributable to the weakness in the property market, particularly in terms of sale volumes, in the first two quarters.

5.4. Social Security

Because the growth in Social Security expenditure has been greater than the growth in income from Social Insurance contributions, the combined operating surplus (excluding income from investments) made by the funds has declined over the last five years. In 2012, the funds reported a combined operating deficit of £4m. The continuing pressure from increasing levels of expenditure, driven by increasing numbers of pension claimants, would be partially offset in 2014 should the proposed 0.5% increase in employers' contributions be approved¹¹.

Figure 5.4.1. Operating surplus/(deficit), 2008-2014

Operating deficit of SSD administered funds, at 2013 prices, as at October 2013
Source: Social Security Department



¹¹ This proposal is still subject to the October States' Debate and is by no means a foregone conclusion.

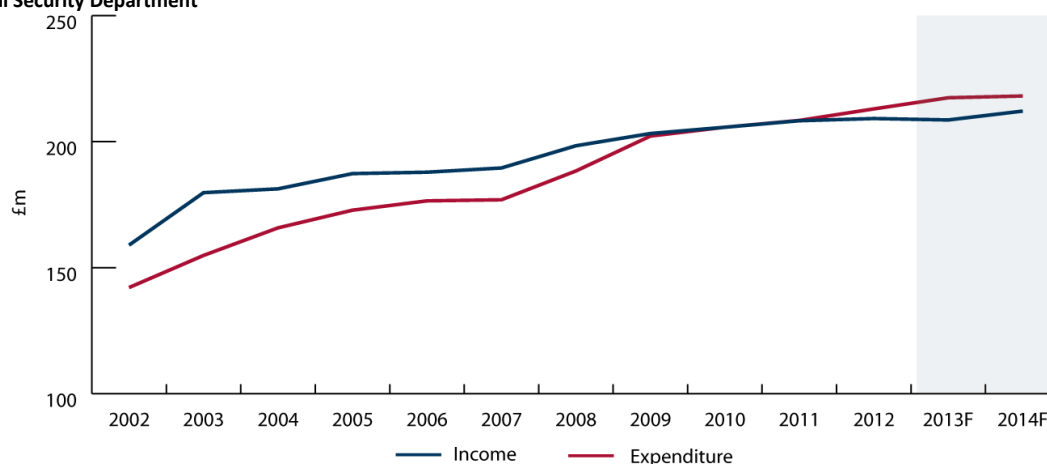
Despite the reduction of the Revenue Grant paid to the funds between 2006 and 2008, total funding for the Department has increased in real terms year-on-year throughout the last decade, largely as a result of the increase in employers' contribution rates introduced in 2008 and the increase in the upper earnings limit for the payment of employees' Social Insurance contributions between 2006 and 2008.

However, the pressure on expenditure exerted by the Guernsey Insurance Fund [GIF], primarily from the payment of pensions, which grew by 9%, in 2012, has increased the rate of expenditure growth beyond that of income. As demographic change continues, the operational deficit, which first appeared in 2011, is likely to continue to expand in the absence of policy and behavioural responses.

Figure 5.4.2. Total Social Security income and expenditure, 2002-2014

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

Source: Social Security Department



The Social Security Common Investment Fund, which supports the payment of insurance benefits in Guernsey, held £750m in 2012, the majority of which is hypothecated to the GIF. The investment income generated by these funds has traditionally helped support the payment of benefits; however, the growing deficit is forecast to erode the capital of the funds over time. Projections show that, without any mitigation action, the funds allocated to the GIF will be exhausted by the middle of this century.

6. A time for choices

The States are facing key fiscal decisions on two fronts with pressure from both short- and long-term matters.

6.1. Short-term fiscal pressures

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

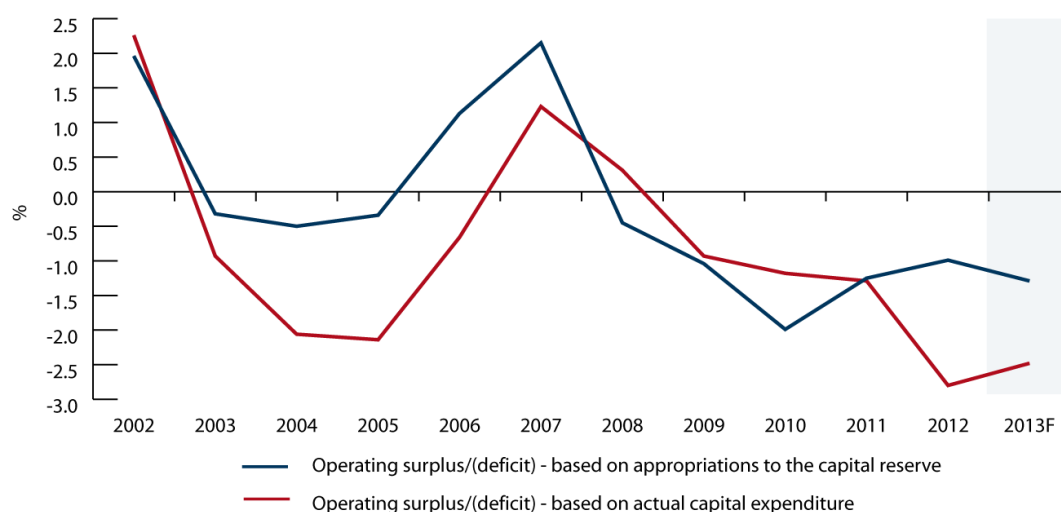
In the short-term, the overall deficit position remains. Although initially a result of the change to the corporate tax regime, the subsequent weakness in economic conditions has exacerbated the problem. As has been previously remarked, expenditure restraint has been remarkably successful. However, revenue growth has been slower than may have been expected in the pre-crisis environment in which the change to zero/10 was planned.

At various times attempts have been made to assess the “structural” nature of the States’ deficit. Estimating “structural” deficits is inexact, as the Office of Budget Responsibility in the UK will testify. Some approaches require estimating the potential output of the economy (i.e. the level that the economy could be operating at given better economic circumstances) and attempting to judge the actual stage of the economic cycle, and then calculating the effects on revenue and expenditure of the gap.

A more simple and straightforward approach, and one not necessarily less accurate, would be to take the current deficit position, allow for a small additional amount in revenues (to reflect that, irrespective of the point we are at in the business cycle, that they are likely to be slightly depressed presently) and adjust this for the impact of the capital expenditure shortfall.

Figure 6.1.1. Overall deficit, 2002-2013¹²

Comparing the use of appropriations to the Capital Reserve and actual capital expenditure, as a percentage GDP, as at October 2013
Source Treasury and Resources Department, Policy Council



¹² Figures for actual capital expenditure for 2014 were not available at the time of publication.

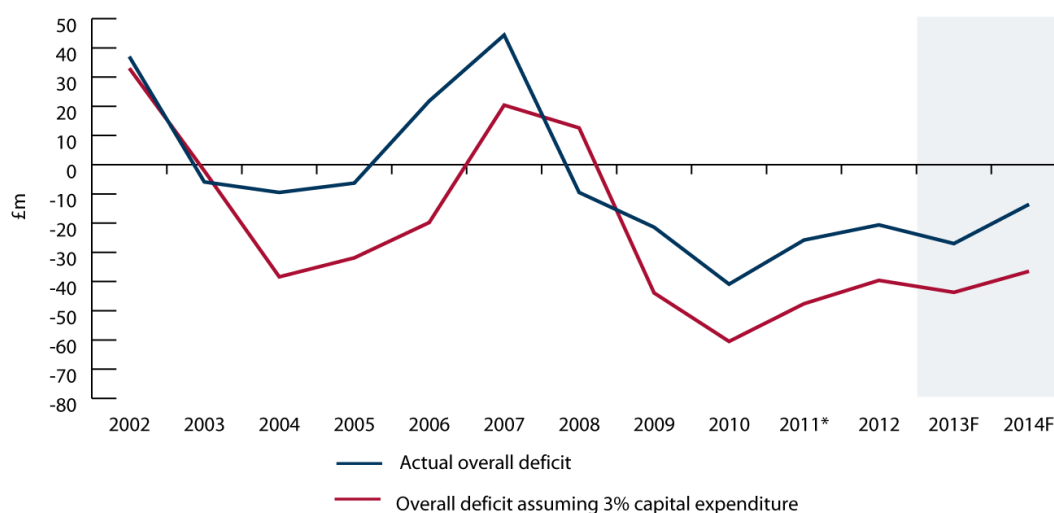
The 2014 budget projects a revenue surplus (before the inclusion of any capital income or spending) of £28m. Allowing for an additional 1.5%¹³ of revenues to reflect the weakness in the economy over the last five years and less capital expenditure of 2.7% of GDP (the average level of actual expenditure on capital over the last decade), an approximate conservative estimate of the structural deficit in 2014 would be £21m. This provides a reasonable assessment of the relative scale of the underlying issue but as mentioned above such an estimate is inevitably inexact.

If the States is to meet its objective of long-term permanent balance then in addition to clearing the accumulated deficit, it must generate a period of surplus to replenish the reserves drawn down over the deficit period.

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

As a percentage of GDP, as at October 2013

Source Treasury and Resources Department, Policy Council



The two previous reports identified three risks to the States' current deficit reduction strategy: a failure to restrain expenditure growth; failure of the Financial Transformation Programme [FTP] to deliver its projected savings; and weak economic growth resulting in an adverse effect on States' revenues.

A year later, the most recent estimates of economic growth published by the Policy Council show that there was little or no real growth in the economy in 2012 and that 2013 and 2014 growth rates are likely to be comparatively weak (see **Section 3.2**). As highlighted in **Section 1**, because of the high dependence on direct personal taxes, public revenues in Guernsey are closely tied to economic conditions, albeit with a lag associated with the collection of certain taxes. This vulnerability is suitably illustrated by the lower than budgeted personal tax receipts now anticipated in 2013, reflecting the weakness in the labour market in the first half of the year. This is further reinforced by a downward revision, in the region of 20% (£4m), of receipts from document duty, directly reflecting the weakness in the property market. If economic growth continues to be slow, natural revenue growth (i.e. that not due to increases in direct or indirect tax rates) is likely to continue to be weak.

¹³ This amount is an arbitrary allowance for the current economic weakness.

The importance of expenditure restraint and the FTP was highlighted in the 2012 Accounts:

“...the current regime of expenditure restraint and delivery of the Financial Transformation Programme targets remain absolutely essential in order to enable the States’ financial position to, in the short-term, return to a balanced budget position and, in the medium-term, to generate modest surpluses to build up our reserves again and fund capital projects.”

Despite overspends in some areas, expenditure restraint has been maintained for another year. Gross departmental expenditure showed no real growth in 2012 and the 2014 budget projects a reduction in 2013 and 2014. However, the risk that the FTP will not deliver its projected savings appears to have increased. A statement made to the States Assembly by the Treasury and Resources Minister in May 2013 contained the first official warning that the FTP may not achieve its stated objective:

“...the FTP forecast has, for the time being, dropped below £30 million. Within that portfolio, I believe that there are risks to delivery of some of our interdepartmental or cross-cutting projects due to the timeframes now remaining and the difficulties the States has faced in trying to deliver single-organisation projects which involve significant change, as evidenced recently with the SAP STSC...”

Since the above statement was made, forecasts of total savings from the programme have increased to just above the £31m target. However, in August 2012, £21m of savings were forecast for 2013; by July 2013 this forecast had been reduced to £10m without a commensurate increase in the savings forecast for 2014. In July 2013 £8.8m of savings to be achieved by the end of 2014 (more than a quarter of the £31m target) were from projects which had not yet commenced.

Figure 6.1.3. FTP forecast savings by year of delivery

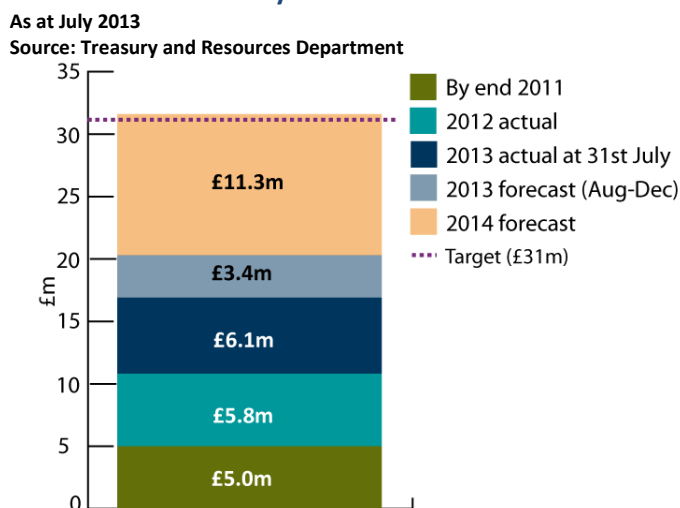
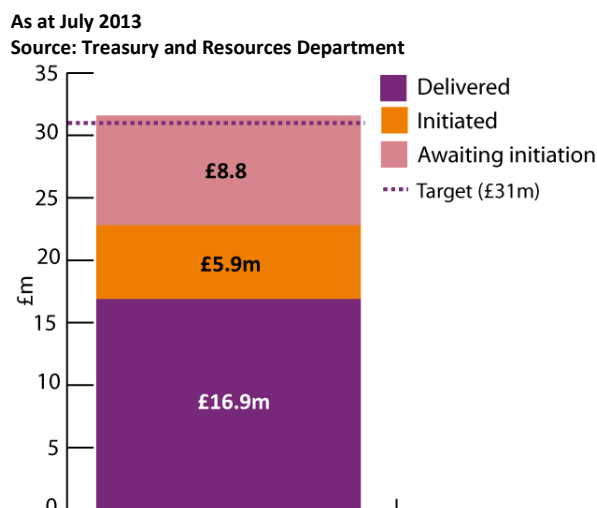


Figure 6.1.4. FTP forecast savings delivery by current status



The States must also consider the demand for new expenditure and how to balance new spending desires against the need to rebalance the budget. Requests for new expenditure include proposals for the “modernisation of supplementary benefit”, to be discussed in the October States debate. The proposals include an integration of the existing scheme of rent rebates for social housing tenants with the supplementary benefit system. If properly managed, this would appear to be a sensible move in the long-term. However, the recommendations come with a significant cost implication and, given the current fiscal conditions, the States will need to consider carefully whether the proposal to fund the changes by reducing other benefit expenditure is both feasible and appropriate.

6.1.2. Available options

As stated in previous reports, alternative methods of closing the deficit are unlikely to be more palatable than the FTP. However, if that programme is not likely to achieve sufficient savings to meet the States’ objectives, the assembly would be wise to consider these alternatives.

If the combination of reducing expenditure through efficiency and natural revenue growth proves insufficient, there are only two broad options available: increase revenues by changing tax rates or the tax regime (or both), or decrease expenditure by cuts in service and social security provision.

6.2. Personal Tax, Pensions and Benefits Review

The States is in the process of undertaking a review of its personal tax and benefits regime.

It has very laudably highlighted the long-term pressures on future spending – primarily pensions, health and long-term care. As explained in **Section 5.4**, spending on welfare benefits including pensions has grown in real terms by 20% between 2007 and the forecast for 2013. The States has undertaken actuarial reviews and calculated the increased funding requirements of the pensions funds if there were no change in the historic rate setting practice and no change in the retirement age (over and above what is already planned). Varying either of these– i.e. reducing the rate by which the old-age pension is increased or further increases in the retirement age would reduce the funding pressures.

However, one area that remains unaddressed by the review is the need to resolve the current revenue deficit situation. As explained in **Section 6.1.1**, the underlying (structural) deficit is probably in the region of £30m. It seems hard to justify deferring the addressing of this. Either expenditure must be cut, the capital programme must be scaled back (to a level lower than the previously determined steady state level of capital expenditure as set out in the Fiscal Framework), or the States needs to acknowledge that it needs to raise additional revenues.

The charts overleaf (**Figure 6.2.1 to 6.2.3**) show what revenues may have looked like under the pre zero/10 tax base. As demonstrated, the structural deficit appears to be a result of a structural decrease in revenues between 2008 and 2010. Within the revenue budget, these structural changes include the loss of income from corporate profit taxes following the introduction of zero/10 and the reduction in expenditure resulting from the reduction in the revenue grant paid to the Social Insurance funds in between 2006 and 2008. Within the Social Security budget, structural changes include the reduction in income resulting from the reduction in the revenue grant previously mentioned, the increase in revenues resulting from the extension of the upper limit on Social Insurance contributions made by employed people and the increase in the employers' rate by 1% in 2008.

Since 2006 (when the first of the changes to the tax regime was introduced) aggregate expenditure (incorporating both General Revenue and Social Security) has increased by 14%, driven largely by increased health and welfare expenditure. However, since the deficit position arose in 2008, aggregate expenditure has remained in check; the upward trend in Social Security expenditure, driven by increasing expenditure on old-age pensions, being offset by a decreasing trend in General Revenue expenditure.

These models show that General Revenue income in 2013 was £44m lower than it may have been had there been no structural change in revenues resulting from zero/10. This has been partially offset by a £31m decrease in expenditure as a result of the decrease in the revenue grant reduction¹⁴ but the overall General Revenue position is an estimated £13m poorer in 2013 than it would be had no structural changes been made; increasing the deficit from an estimated £14m to the £27m overrun presented in the 2014 budget.

Structural changes to Social Security income, both from the reduction in the revenue grant and the increase in contributions, have also impacted the aggregate position. The reduction in the revenue grant has reduced the income of the Social Security funds by £31m. However, when considered with the net gain in income resulting from the increase in employers' Social Insurance contributions (an estimated £19m per annum in 2013) and the extension of the upper earnings limit (an estimated £14m in 2013), overall Social Security income is estimated to be approximately £2m per annum more than it would have been had no changes taken place.

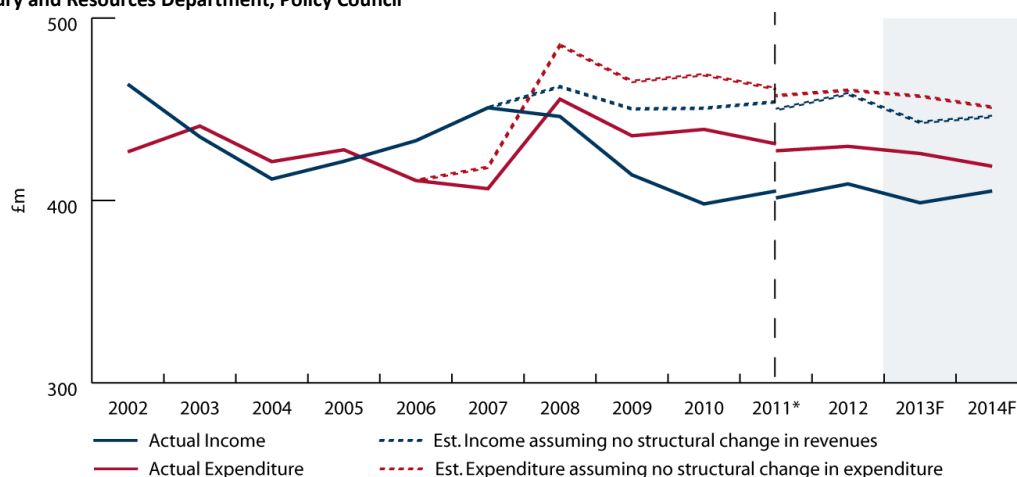
The net effect on aggregate incomes resulting from these changes is to worsen the current aggregate position in 2013 (incorporating both General Revenue and Social Security) by approximately £11m, increasing the deficit from £16m to £27m. If approved, the proposed increase in Social Insurance contributions could close this gap to an estimated £4m.

¹⁴ This structural change in expenditure represents an internal shift of expenditure from General Revenue to that supported by Social Insurance contributions (i.e. it represents a decrease in the income of the Social Insurance funds) and as such it has no impact on aggregate expenditure levels.

Figure 6.2.1. Estimated General Revenue income and expenditure assuming no structural changes

General Revenue income and expenditure (including capital income and expenditure), at 2013 prices, as at October 2013.

Source: Treasury and Resources Department, Policy Council



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

Figure 6.2.2. Estimated Social Insurance income and expenditure assuming no structural changes

Social Security income and expenditure (including the revenue grant and non-contributory expenditure), at 2013 prices, as at October 2013.

Source: Treasury and Resources Department, Policy Council

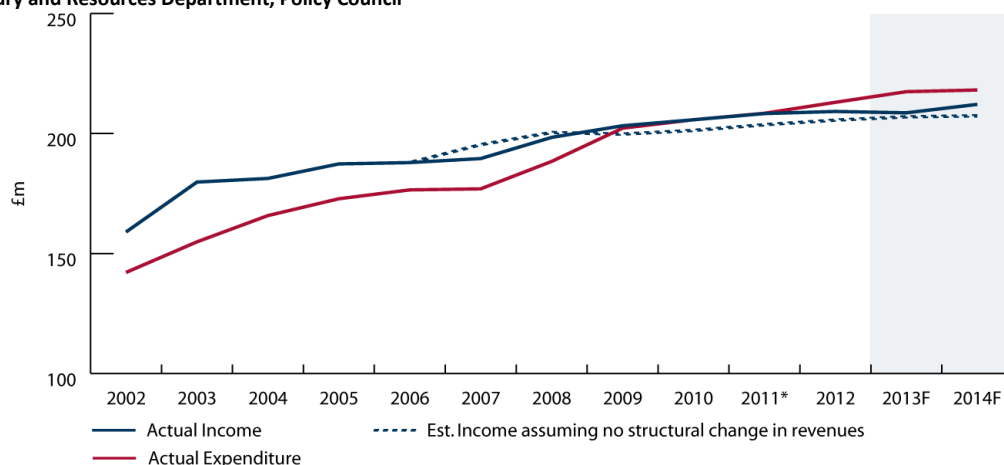
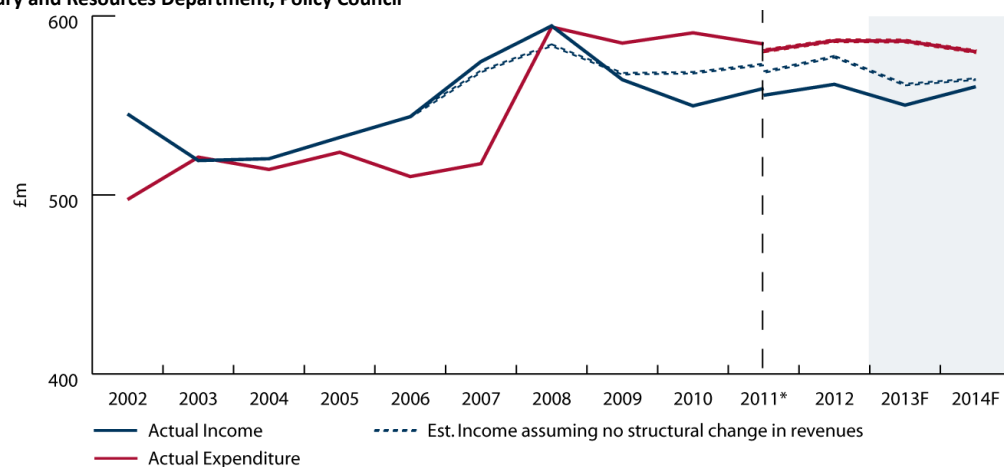


Figure 6.2.3. Estimated aggregate income and expenditure assuming no structural changes, 2002-2014

Aggregate income and expenditure, at 2013 prices, as at October 2013.

Source: Treasury and Resources Department, Policy Council



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

7. Conclusion

The States has achieved a good deal with respect to restraining expenditure; the general downward trend of revenue expenditure in real terms since 2008 is a testament to this. But despite this success, the overall revenue deficit seems set to continue into its sixth and seventh years; this is in breach of the Fiscal Framework criteria requiring its removal within five years. The allocation of funds to capital expenditure also remains insufficient to meet the demands of the recommended capital programme; a second position inconsistent with the parameters of the Fiscal Framework.

There is a limit to how far a policy of efficiency and expenditure restraint can reduce the structural revenue deficit. The revenue deficit has resulted from reduced revenues not uncontrolled expenditure growth. If the FTP alone is not sufficient, the States must consider cuts in services, deferral of capital spending or increasing revenues in order to close this structural deficit.

This is my third annual report and the third year in which I have made similar comments. Further deferral of resolution of this problem would be ill advised. Aside from any other considerations, the sooner action is taken; the smaller it need be, as there will be less to make up in allocations to the capital budget. It seems hard to argue that now is not the time for choice.

The increase in the proportion of total public expenditure on the provision of old-age pensions and welfare benefits must also be understood. Taking public spending in totality, this increase in expenditure on Social Security has effectively offset the progress made in restraining revenue expenditure.

Barring any structural change to the way these services are provided in Guernsey, this trend is likely to continue for the foreseeable future. Although this may be driven principally by the ageing population, the States should nevertheless be aware that the cost of providing income support type benefits can rise significantly beyond expectations, as it has in many developed economies. Many of these are facing substantial current or future budgetary problems as a result of the growth of such expenditures.

Against the background of a slower average rate of economic growth than in the previous decade, and mounting demographic pressures, the States is unlikely to find itself in a position where it is able to support all future demand for services without changes to either the level or structure of services it provides or the amount of revenue it raises. Again, this necessitates tough choices but deferral merely delays and risks exacerbating the problem.

Growth in Guernsey may return to its previous trend. That is always possible. But if it does, it will prove easier to lower taxes or increase spending than it has been to contain them. Given the world economic situation, it would not be wise to count on higher trend growth in Guernsey over the next few years.

Appendix 1. Extract from the Fiscal Framework

Source: Billet D'Etat XI, April 2009

The proposed fiscal policy framework

Principles

The principles underlying fiscal policy in Guernsey are that:

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

Objective

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

Framework

1. Assuming a long-run **permanent balance** position implies the acceptance of long-run 'permanent', ie normal, levels for taxation and public spending including public sector capital investment: these long-run levels provide 'norms' for future plans and are calculated with reference to historic or international empirical experience.
2. Deviations, and hence any fiscal deficits, from these long-run norms are only acceptable if they are of a temporary nature, i.e. in the instances of a mistiming of income and increased capital expenditure requirements or those caused by severe swings of the economic cycle.
3. To ensure that balance is achieved in the medium term forecasts of all future revenue and expenditures will be continually generated to ensure that any revenue shortfalls are matched by future surpluses.
4. Any borrowing to fund temporary mismatches between expenditure requirements and revenue income will be restricted by strict conservative limits to ensure the sustainability of Guernsey's long term finances and the international credit rating of the States. **Gross debt can only be accumulated to fund capital investment.**
5. Any use of the contingency reserve as an alternative to borrowing will require the replenishment of the reserve in subsequent years to maintain reserves to an agreed level.

The above framework implies the following **limits to fiscal expenditure** of the States

- that the level of gross borrowing by the States may not exceed 15% of Guernsey gross domestic product;

- that the maximum annual operating deficit of the States may not exceed 3% of gross domestic product;
- that the maximum additional borrowing sanctioned in any one States term may not exceed one times the level of 'permanent' capital expenditure over that time period;

and that the assumed 'norms' for permanent capital expenditure and taxation to be 3.0% and 21% of gross domestic product respectively.

- To **ensure adherence** to this framework the undertaking is made to ensure that identified deficits will be addressed within 5 years of their appearance and that measures to counter identified structural deficits are agreed within two years of their identification.
- To **provide credibility** to this framework, and a degree of objectivity to the likely path of States finances, each year the Policy Council will publish a report to the States, separate to Treasury and Resources annual budgetary process, to provide an objective analysis on the conduct of fiscal policy.

Appendix 2. Commentary on the Fiscal Framework

Source: Annual Independent Fiscal Review 2011

As a small, very open economy, Guernsey is very susceptible to external events and conditions. It also has few policy levers available to it which could be considered traditional economic management tools. In terms of general demand, conditions and prospects for the finance sector (Guernsey's dominant industry) are almost wholly driven by the state of global financial markets and the health of the City of London. Monetary policy is set by the Bank of England and any inflationary consequences of current UK monetary or fiscal policy typically feed straight through to Guernsey. This is despite the current differential between local and mainland inflation rates due to VAT rises.

Recognising that there are limits to what the States can control, the prudent and conservative policy set out by the States is principally to commit to achieving 'permanent balance'. This recognises what is known in economists' circles as the 'intertemporal budget constraint', or, in other words, acknowledging that, in the long-run, the States cannot spend more than it generates in revenues. It will, therefore, be necessary at some time to replenish reserves that are to be spent financing the deficit projected over the course of the next few years.

To help achieve this objective, the Fiscal Framework also sets strict numerical parameters for States' revenue funded expenditure, setting an upper bound for revenue income and expenditure of 21% of GDP. The purpose of these limits is to guard against unforeseen and unintended rises in public sector expenditure. It is for this reason that this report not only provides an assessment of current and future States' fiscal conduct against the Fiscal Framework, but also seeks to develop the theme of 'controllable' and 'uncontrollable' costs to help improve understanding of the pressures on public sector expenditure.

The States' Fiscal and Economic Plan recognises the private sector as the driver of the economy and fiscal competitiveness as a key factor supporting the economy. The size (and cost) of the public sector in its entirety is therefore of keen economic interest. The majority of Social Security income and expenditure relating to contributory benefits is 'off budget', administered and reported through accounts and budgets separate from the States' Revenue Budget. Although such expenditure is outside of the current scope of the Fiscal Framework, it is of economic relevance. In the medium term, there are likely to be significant pressures on Social Security expenditure as a result of demographic change; consideration is, therefore, given at times in the report to looking at public sector expenditure and income 'in totality'.

Box 7.1. Parameters of the Fiscal Framework

The Fiscal Framework sets a number of parameters and commitments:

- Maintenance of long-run 'permanent balance'.
- Total General Revenue and capital expenditure averaging no more than 21% of GDP.
- Restraint on any temporary operating deficit positions to less than 3% of GDP in any one year.
- Agreement to measures to remove any temporary deficit position within two years of a deficit appearing
- Removal of a deficit within five years of it first appearing.
- Annual capital expenditure averaging 3% of GDP.
- Total borrowing never to exceed 15% of GDP (and only to fund capital expenditure).
- The level of borrowing in any one year not to exceed 3% of GDP.

Appendix 3. Income and expenditure performance against budget

Table A3.1 Fiscal position in 2012*

At current prices, as at May 2012

Source Treasury and Resources Department

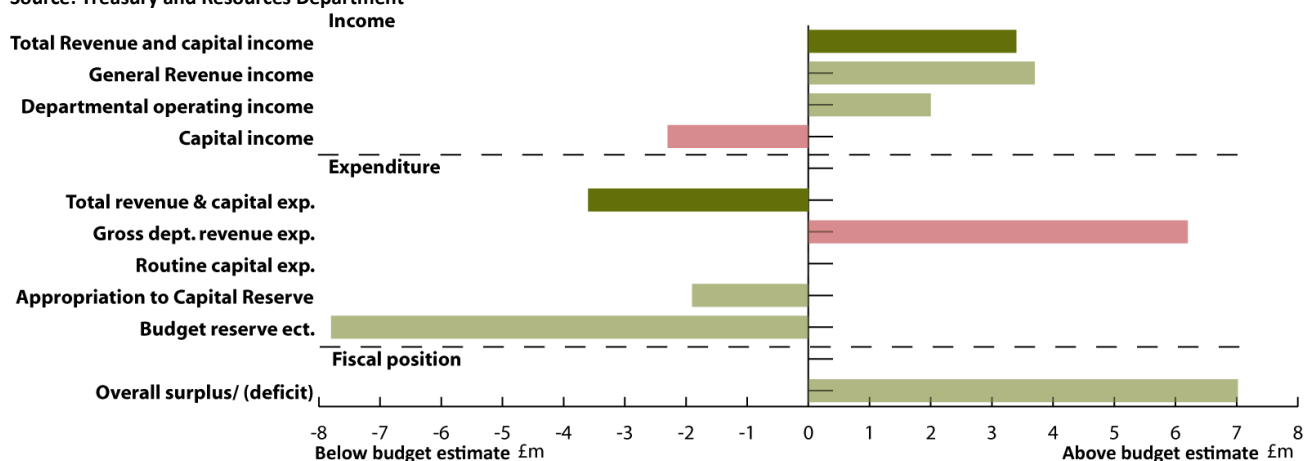
	2012 Accounts (£m)	2012 Budget (£m)	Contribution to deficit reduction (£m)
General Revenue income	362	359	+4
Departmental operating income	34	32	+2
Total revenue income	396	390	+6
Net departmental revenue expenditure	(342)	(346)	-4
Expenditure of department operating income	(34)	(32)	-1
Gross departmental revenue expenditure	(375)	(369)	-6
Budget reserve other unassigned allocations in the 2011 Budget	-	(8)	+8
Revenue surplus/(deficit)	21	13	+7
Routine capital expenditure	(16)	(16)	-0
Capital income	1	4	-2
Operating surplus/(deficit)	5	0	+5
Appropriation to capital reserve	(25)	(27)	+2
Overall surplus/ (deficit)	(20)	(27)	+7

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

Figure A3.1 Performance against Budget, 2012 income and expenditure

Variation of the 2012 accounts from the original budget, as at July 2013

Source: Treasury and Resources Department



*The 2012 Budget incorporates unassigned expenditure allocations for Service Developments (£1m), and the Budget Reserve (£7m) which have been incorporated in total revenue and capital expenditure. The 2011 accounts do not state expenditure or savings made under these categories; all expenditure being incorporated within the standard reporting categories.

The 2012 accounts reported an overall deficit of £20m, £7m less than projected in the 2012 budget (see **Table A3.1** and **Figure A3.1**). Overall, the general revenue income reported was £3.7m above that budgeted primarily due to better than anticipated personal tax receipts (see **Table A3.2**). Expenditure was £3.6 below budget; however this did include expenditure of approximately half of the budget reserve.

Table A3.2 Performance against Budget, 2012 income

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

Source: Treasury and Resources Department

Income area	above/below budget	
	£m	%
Personal income taxes	+4.6	+2.0
Companies (incl. banks)	-2.9	-6.7
Distributed profits	+0.2	+1.2
Other taxes	-0.7	-1.2
Misc. income	+2.6	+185.4
General Revenue income	+3.7	+1.0
Departmental operating income	+2.0	+6.4
Capital income	-2.3	-65.9
Total revenue and capital income	+3.4	+0.9

At a more detailed level (see **Table A3.2**) almost all States departments managed to stay within their budget for the year, with the only significant overspends occurring in Health and Social Services (£4.5m beyond the original budget and £2.2m beyond the increased budget approved in December 2012¹⁵) and Social Security (£1.8m beyond the original budget). Looking more deeply, both departments succeeded in keeping general administration costs within budget, with overspend arising in more demand led areas.

Table A3.3 Performance against Budget, 2012 expenditure

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

Source: Treasury and Resources Department

Expenditure (by Department)	above/below budget		Expenditure (by type)	above/below budget	
	£m	%		£m	%
Policy Council	-0.6	-6.0	Pay Costs	1.9	0.9
Treasury & Resources	-0.6	-3.3	Other staff costs	-0.9	-17.7
Courts & Law Officers	-0.5	-6.3	Communications & IT	-1.1	-10.7
States of Alderney	0.1	4.7	Consultants & contractors	-1.0	-3.4
Commerce & Employment	-0.7	-6.3	Grants & Subsidies	-1.5	-4.7
Culture & Leisure	-0.6	-15.1	Premises	-0.5	-2.9
Education	0.0	0.0	Supplies & Services	-0.4	-1.9
Environment	-0.3	-3.8	Formula led costs	1.9	3.5
Health & Social Services	4.2	3.9	Administration & other	-1.1	-10.8
Home	-0.5	-1.4			
Housing	0.0	2.2			
Public Services	-0.3	-4.2			
Social Security (Revenue funded only)	1.8	3.3			
Committees	-0.2	-27.8			
Exp. of dept. operating income	2.0	6.4			
Gross dept. revenue expenditure	6.2	1.7	Gross dept. revenue expenditure	6.2	1.7
Routine Capital Expenditure	0.0	0.1	Routine Capital Expenditure	0.0	0.1
Allocation to Capital Reserve	-1.9	-7.0	Allocation to Capital Reserve	-1.9	-7.0
Service Developments*	-1.3	n/a	Service Developments*	-1.3	n/a
FTP Savings*	6.5	n/a	FTP Savings*	6.5	n/a
Budget reserve*	-6.6	n/a	Budget reserve*	-6.6	n/a
Total revenue & capital expenditure	-3.6	-0.9	Total revenue & capital expenditure	-3.6	-0.9

¹⁵ Following approval of the original 2013 budget, a resolution was made in December 2012 to increase the authorised Health and Social Services Departmental budget by a maximum of £2.5m.

For Health and Social Services this centred on provision of on-Island Health and Social Care Services, with the overspend attributed to an increase in the number of patients and the clinical workload. By contrast, off-Island treatment, which in the past has been the source of significant overspends, was within budget despite a slight increase in the number of placement days. This underspend was attributed to improved contracts and an increase in the number and complexity of cases treated on-Island.

In Social Security the overspend is entirely attributable to formula led expenditure and principally to Supplementary Benefit. Weak economic conditions and a stagnant labour market are undoubtedly contributing factors.

The demand led nature of these overspends is suggestive. Although the States appears to have been relatively successful at limiting growth in administrative and so-called “controllable” costs, restraining expenditure which is largely demand led or “uncontrollable” has proved much more challenging.

Appendix 4. Current estimates of fiscal performance in 2013

Table A3.4 Current estimates of Fiscal Position in 2013*

At current prices, as at November 2012

Source Treasury and Resources Department

	2013 Current estimates (£m)	2013 Budget (£m)	Contribution to deficit reduction (£m)
General Revenue income	361	372	-9
Departmental operating income ¹⁶	33	33	0
Total revenue income	394	404	-9
Net departmental revenue expenditure	(349)	(338)	-11
Expenditure of department operating income ⁸	(33)	(33)	0
Gross departmental revenue expenditure	(382)	(381)	-1
Budget reserve other unassigned allocations in the 2012 Budget	-	(10)	+10
Revenue surplus/(deficit)	12	24	-10
Routine capital expenditure	(13)	(13)	0
Capital income	8	0	+8
Operating surplus/(deficit)	9	11	-2
Appropriation to Capital Reserve and other transfers ¹⁷	(36)	(28)	-8
Overall surplus/ (deficit)	(27)	(17)	-10

The current estimate of the overall deficit for 2013 (as published in the 2014 Budget) is £10m larger than originally budgeted, primarily as a result of lower than anticipated income from the extension of the 10% intermediate tax rate to capture fiduciaries domestic insurance and insurance management activities together with a £4m anticipated shortfall in receipts from document duty due to a weak housing market.

¹⁶ Current estimates of Departmental Operating Income for 2013 from the 2014 budget were not available in time to be incorporated into this report. As such 2013 Departmental Operating income is assumed to be the same as that originally budgeted.

¹⁷ Includes £3m transfer to the Strategic Development Fund and a £1m transfer to the General Reserve.

Appendix 5. Funding Social Security

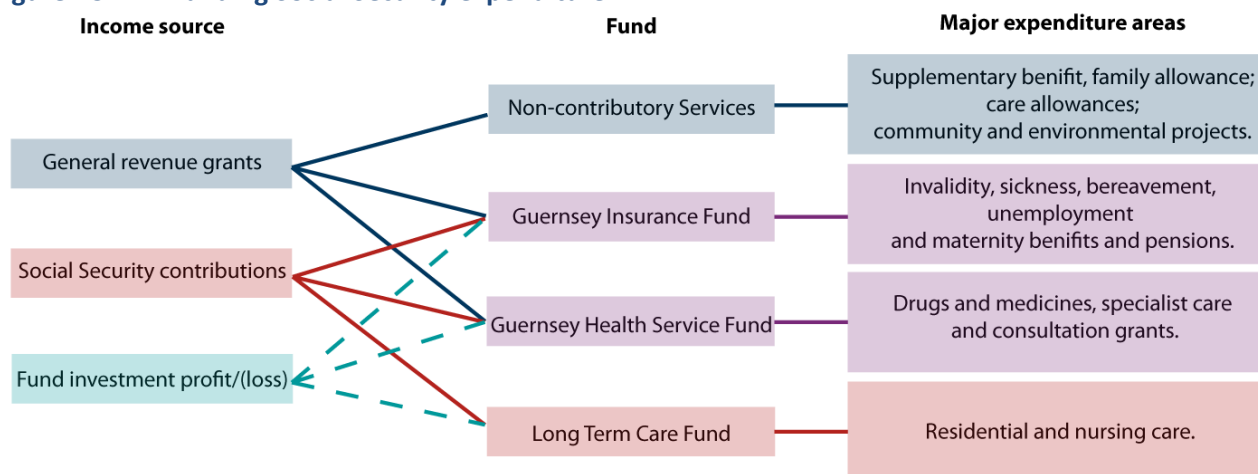
The Social Security Department is responsible for the payment of social benefits in Guernsey. The departmental expenditure is funded by a mix of grants from General Revenue and Social Security contributions (see **Figure A.5.1**).

The revenue grant to Social Security funds was reduced between 2006 and 2009. In order to replace the lost revenue (approx. £22m), the contribution rates for employers and the earnings limit for employees' contributions were increased (from 5.5% to 6.5% and from £30,000 to £60,000 respectively) in 2008. Further incremental increases in the earnings limit for employees have been and will continue to be introduced until 2014, in order to bring the earnings limit for employees' contributions to the same level as the earnings limit for contributions paid by employers and self-employed individuals.

Income is channelled into four distinct areas:

- Non-contributory services – funded entirely from General Revenue, non-contributory services include the majority of benefits which residents are entitled to claim regardless of the level of contributions paid (such as supplementary benefit), as well as general administrative expenditure entailed by the Department.
- The Guernsey Insurance Fund [GIF] – funded predominantly from Social Security contributions but with an additional revenue grant. This fund pays for the majority of contributory benefits, including pensions and unemployment benefit.
- The Guernsey Health Service Fund [GHSF] – funded predominantly from contributions but with an additional revenue grant. This fund pays for health benefits and specialist care, most of which are available to registered residents on a non-contributory basis.
- The Long-term Care Fund [LTC] – entirely funded by contributions, this finances nursing and residential care for the elderly. The benefits are available to anyone who has been permanently resident in Guernsey or Alderney for a continuous period of at least five years.

Figure A5.1 Funding Social Security expenditure



Appendix 6. Glossary of Terms and Abbreviations

Term	Abb.	Description
Capital appropriation		Annual transfer of funds from General Revenue to the Capital Reserve to fund future capital expenditure.
Capital expenditure, non-routine		Expenditure on large capital projects funded from the Capital Reserve and controlled centrally.
Capital expenditure, routine		Expenditure on small capital investments, IT projects, equipment, machinery and vehicles funded directly from General Revenue and controlled by departments.
Capital Prioritisation		
Common Investment Fund	CIF	Central investment fund managed by SSD comprising the combined reserves of the GIF, GHSF and LTC.
Contingency Reserve		Reserve of funds set aside to cover large-scale unforeseen expenditure. In 2006, half of this reserve was set aside to fund the deficit resulting from the introduction of zero/10, referred to as the Tax Strategy Reserve.
Contributory benefits		For the purpose of this report, contributory benefits are considered to be all benefits (incl. administration costs) funded by the three SSD funds (GIF, GHSF and LTC). Typically, payment of these benefits is dependent on the contributions record of the claimant.
Employee Tax Instalments system	ETI	System by which income tax from employees is paid directly to income tax by their employers on a “pay-as-you-earn” basis.
Expenditure, gross departmental revenue		Non-capital expenditure by States Departments including expenditure funded by departmental operating income.
Expenditure, net departmental revenue		Non-capital expenditure by States Departments presented net of expenditure funded by departmental operating income.
Expenditure, total revenue		All expenditure presented in the General Revenue Accounts used to calculate the Overall surplus/(deficit); i.e. Revenue expenditure plus routine capital expenditure and the allocation of funds to the capital reserve.
Fiscal and Economic Plan		Sub-section of the SSP outlining current fiscal and economic policy objectives in line with the Fiscal Framework.
Fiscal Framework	FF	Policy Council document outlining core fiscal policy and defining parameters for the General Revenue Budget.
Financial Transformation Programme	FTP	A series of projects designed to identify and deliver savings to the Revenue Budget. The programme is scheduled for completion in 2015.
Formula led expenditure		Expenditure areas dependent on a pre-defined formula and/or number of claims such as payment of the revenue grant to Social Security (calculated as a percentage of SSD contributions income), legal aid and supplementary benefit.
General Revenue Accounts/Budget		Central budget/accounts produced by Treasury and Resources, which cover the majority of public sector expenditure excluding that funded by Social Security contributions.
Gross Domestic Product	GDP	Macro-economic indicator measuring the size of the economy. In Guernsey, this is the sum of all remunerations, company and self-employed profits and other income, such as income from property and profits of public sector trading boards.
Guernsey Health Service Fund	GHSF	Fund managed by the Social Security Department with income sourced predominately from Social Security contributions, but also receiving a revenue grant. This fund covers expenditure on health benefits.

Guernsey Insurance Fund	GIF	Fund managed by the Social Security Department with income sourced predominantly from Social Security contributions, but also receiving a revenue grant. This fund covers expenditure on contributory benefits such as pensions and unemployment.
Income, departmental operating		Any income paid directly to a States department which is not incorporated as General Revenue income. This includes fees and charges for service, rents received recoveries and funds received from SSD in payment for services. Totals for departmental expenditure are typically presented net of departmental operation income.
Income, General Revenue		Income from direct and indirect taxes and miscellaneous income sources included in the calculation of the revenue surplus/(deficit) which is available to all departments and allocated in the annual budget. It does not include capital income
Income, total revenue		All income presented in the General Revenue Accounts used to calculate the Overall surplus/(deficit); i.e. General Revenue income plus departmental operating income and capital income.
International Labour Office	ILO	The UN specialised agency, which seeks the promotion of social justice and internationally recognised human and labour rights. It also produces international guidelines for calculation of labour market statistics.
Long Term Care Fund	LTC	Fund managed by the Social Security Department with income sourced entirely from Social Security contributions. This fund covers expenditure on long-term care for older people.
Non-contributory benefits		For the purpose of this report, non-contributory benefits are considered to be any benefits (incl. administration costs) administered by SSD but funded directly from General Revenue. Payment of non-contributory benefits is independent of the contributions record of the claimant.
Organisation for Economic Co-operation and Development	OECD	International organisation promoting co-ordinated economic development and international co-operation.
Personal Tax, Pensions and Benefits Review	PTR	An on-going holistic review of the personal tax pensions and benefits regimes in the context of long-term pressures on expenditure.
Revenue Grant		A grant paid from General Revenue to SSD to supplement the GIF and GHSE, calculated as a fixed percentage of contributions received.
Social Security Accounts/Budget		Accounts/ budget produced by SSD covering expenditure on contributory and non-contributory benefits. Because of the revenue grant made to the GIF and GHSE, and the funding of non-contributory benefits from General Revenue, there is some overlap between the SSD and General Revenue accounting systems.
Social Security Department	SSD	Department responsible for the collection of Social Security contributions and the payment of contributory and non-contributory social benefits.
States Strategic Plan	SSP	Annual central policy document outlining States Fiscal and Economic, Social and Environmental policy.
Supported Living and Ageing Well	SLAWS	An on-going review of support and long-term care services for older people.
Surplus/(deficit), operating		Revenue surplus deficit plus capital income minus routine capital expenditure.
Surplus/(deficit), overall		Operating surplus/deficit plus appropriations to General Revenue minus the appropriation of funds to the capital appropriation.
Surplus/(deficit), revenue		General Revenue income minus net departmental expenditure.
Uncontrollable expenditure		Expenditure which is, at least in part, dependent on factors which are beyond the States' direct control, including unemployment, supplementary and pensions benefits.