Annual Independent Fiscal Policy Review 2015

Dr Andrew McLaughlin

Prof. Geoffrey Wood

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Andrew McLaughlin

Andrew McLaughlin became CEO of Royal Bank of Scotland International in July 2015, having formally served as the groups Group Director of Communications and Chief Economist.

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

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

Professor Geoffrey Wood

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

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

1. Summary

Guernsey's economic and fiscal performance was satisfactory in 2014, particularly when considered against an international backdrop of continuing fiscal and economic difficulties. The deficit on the General Revenue accounts narrowed significantly in 2014, but the current forecast is for the deficit to increase in 2015. This is a result of a shortfall in income as opposed to any forecast overspend. The States should be commended for their continued tight expenditure control and the weakness of income growth should serve to highlight the difficulties inherent in forecasting and need for effective long-term policies to support economic growth.

The scale of the deficit anticipated in 2015 poses difficulties for the 2016 Budget, as it may require the use of almost all the funds dedicated to the purpose of supporting future short-term deficits. This has resulted in a tactical short-term response to restore the budget to balance in 2016, incorporating measures which may have otherwise been considered undesirable. This includes a reduction in the transfer of funds to the capital reserve for the support of the already under funded capital program. The short-term necessity is understandable, but a longer term solution is needed should the slow growth in revenues persist.

The Fiscal Framework commits the States to "long-run fiscal balance". Given that the General Revenue budget has been running at a deficit for some years now, the States will need to achieve a sustained period of surplus to meet this criterion. It is our view that in order to meet the spirit of this criterion, the States should be aiming to achieve surpluses in the region of 3% of GDP over the medium term (five to seven years in this context).

Externally, the uncertainty of the relationship between the UK and the EU and the general uncertainty of the future of the Eurozone creates a difficult trade environment. The drama surrounding the third Greek bailout has highlighted the consequences of a lack of fiscal prudence and discipline. We emphasize that a reputation for fiscal prudence, transparency and stability is important to Guernsey and in this context we make particular note of the State's decision to issue a Government Bond in 2014. The Bond, with a total value of £330m, was issued with the intention of consolidating the *indirect* liabilities of the States. While it is intended that this will allow the States to reduce the cost of borrowing for States associated entities such as Guernsey Electricity, it should be noted that, if this is achieved, it will be at the cost of increased risk to the taxpayer. The Bond, and the reissue of Bond money to third parties, will require careful management to minimise the risk to the tax payer and to protect Guernsey's reputation for fiscal discipline.

Looking at the challenges ahead, we commend the level of awareness in both communities of the long term fiscal challenges facing Guernsey and Alderney. This report details at length the impact of the projected demographic shift on the islands, highlighting the likely reduction in the working population and the ensuing fiscal and economic pressure. The projected demographic change has the potential triple effect of dampening GDP growth, reducing government revenue per capita and increasing public expenditure. It is a substantial risk to long-term sustainability.

Increasing (or at least maintaining) the size of the working age population could mitigate the GDP and income risk to some extent. However, the States have only limited control over the size of the population. With net migration closely linked to economic conditions, enhancing the productivity of the resident workforce and supporting economic growth should be key elements of any long-term planning. However, while the States should support growth and development wherever possible, in light of the demographic challenge and global economic conditions it would be unwise to rely on significant levels of economic growth for the purpose of long term fiscal planning.

The projected increase in service costs, particularly in health and social care, is difficult to quantify accurately, but there can be little doubt the pressure will be considerable. We note and support the decision taken in April 2015 to increase the pension age to help improve the sustainability of the old-age pension scheme and enhance revenues, but alone this will not be enough. As highlighted in the 2016 Budget, it is unlikely that the States of Guernsey can continue to provide services in the way it does if it is to achieve long-term sustainability. Structural change will be necessary.

Alderney is already suffering some of the problems which Guernsey may face in the future. These include a strongly aging population and the cost inherent to providing traditional services to a small and remote population. Solutions for Alderney's difficulties may provide the Bailiwick as a whole with examples of the type of structural changes to service provision that may be necessary if Guernsey is to meet these challenges on a larger scale.

The persistence of the deficit, underfunding of the capital account, and pressing sustainability issues in areas such as Health, which are a focus of this year's report, all point to the need for even tighter discipline on expenditure and an open and effective dialogue on longer term economic growth.

2. Introduction

This is the sixth Annual Independent Review of Fiscal Policy, published as part of the institutional arrangements to support the Fiscal Framework adopted by the States in April 2009[1]. The Framework sets clear numerical parameters and commits the States to long-term permanent balance and the role of this review is to provide an independent external assessment of the States' fiscal conduct against these criteria. This is the fifth report authored by Professor Geoffrey Wood, who has been joined by Dr Andrew McLaughlin as co-author this year.

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

In making 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 reliance on official data provided by the States; but official data in all jurisdictions are prone to inaccuracy and to subsequent revision, and Guernsey is no exception. As GDP is estimated with a nine-month lag, and is subject to revision for up to three years, an assessment of present conditions is dependent on an assessment of indirect variables such as levels of employment and unemployment. And, of course, projections of future growth inevitably rely on judgement.

The report focuses on the fiscal performance in 2014 and the short-term projections for 2015 and 2016 published in the 2016 budget. We also note and support the decision taken in April 2015 to incorporate Social Security contributions and operating income into the framework.

Note that in any reference to real terms figures throughout this report these have been calculated using 2014 as the base year.

[1] Fiscal Framework, Appendix 1, Billet D'État XI, April 2009.

3. Economic Outlook

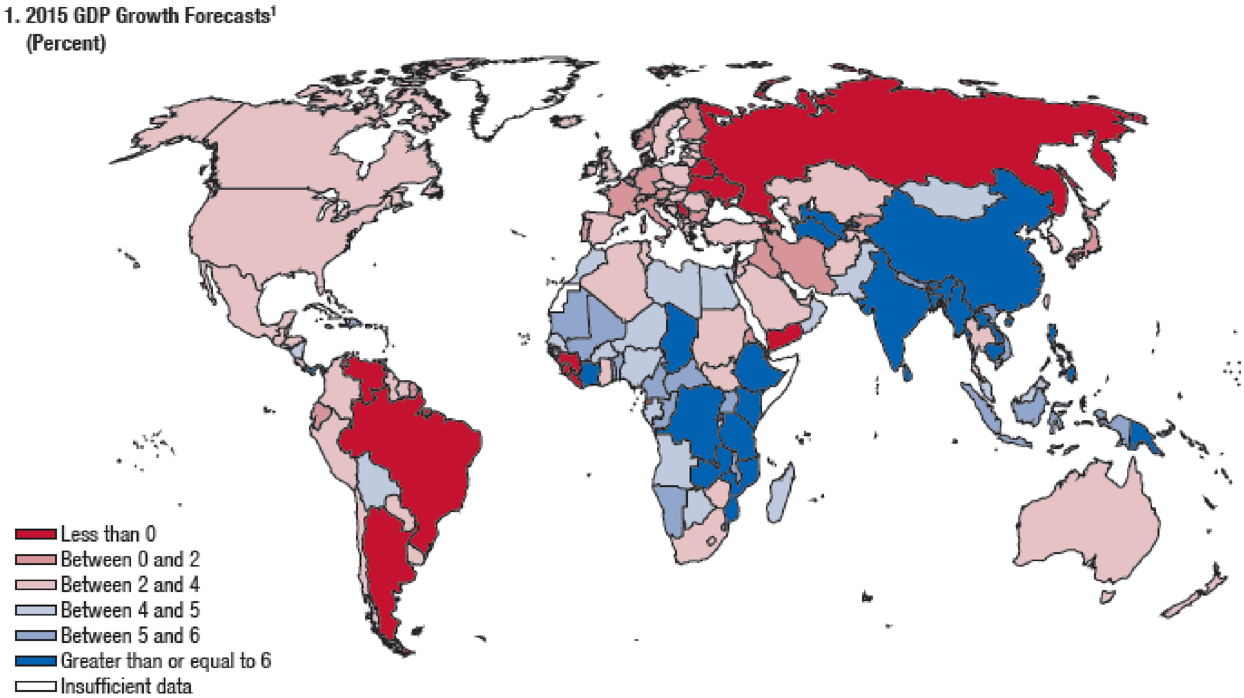
3.1. Global outlook

The OECD projects a slower rate of growth for emerging markets than previous forecasts, in part reflecting the impact of the drop in oil prices on major oil exporters. Emerging markets, however, still account for more than 70% of projected global growth (OECD, April 2015). Several central banks, most notably the US Federal Reserve, are signalling an intent to tighten monetary policy for the first time since the 2007-2009 financial crisis. Economic forecasters are as ever struggling to assess and understand the impact of rising interest rates on global demand and asset prices but on balance, most see risks tilted to the downside during the early phase of this adjustment.

UK growth is expected to average around 2.5% in 2015 easing to 2.3% in 2016. This growth is being led by London and the South East. Economic activity in Guernsey and in the finance sector in particular is closely correlated to activity in London. A steady recovery in the City should be beneficial for Guernsey.

The dramatic events within the Eurozone over the summer have pulled in to sharp focus the importance of maintaining fiscal prudence. The swings and uncertainty of the Greek crisis have done little to improve the stability of the Eurozone or the European Union and the Greek population are now paying a heavy price for the past lack of fiscal discipline. Greece is not alone in their continuing struggle with unsustainable level of government debt; both Italy and Portugal may face their own crises in the near future.

Figure 3.1.1 OECD 2015 GDP growth forecasts



(OECD, April 2015)

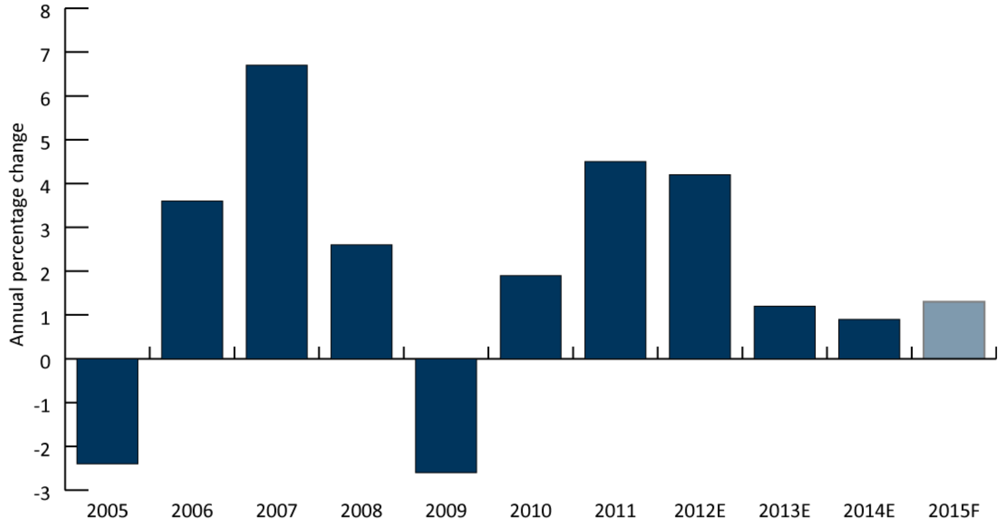
3.2. Domestic outlook

Economic growth and short term outlook

Guernsey's domestic outlook remains modest but, in the context of global conditions, satisfactory. First estimates of GDP show a modest growth of 0.9% in 2014 with business expectations of improvements in both turnover and profits (Chamber of Commerce & Young Business Group, 2015) underpinning a forecast for a faster rate of GDP growth for 2015.

Figure 3.2.1 Real GDP Growth Rates

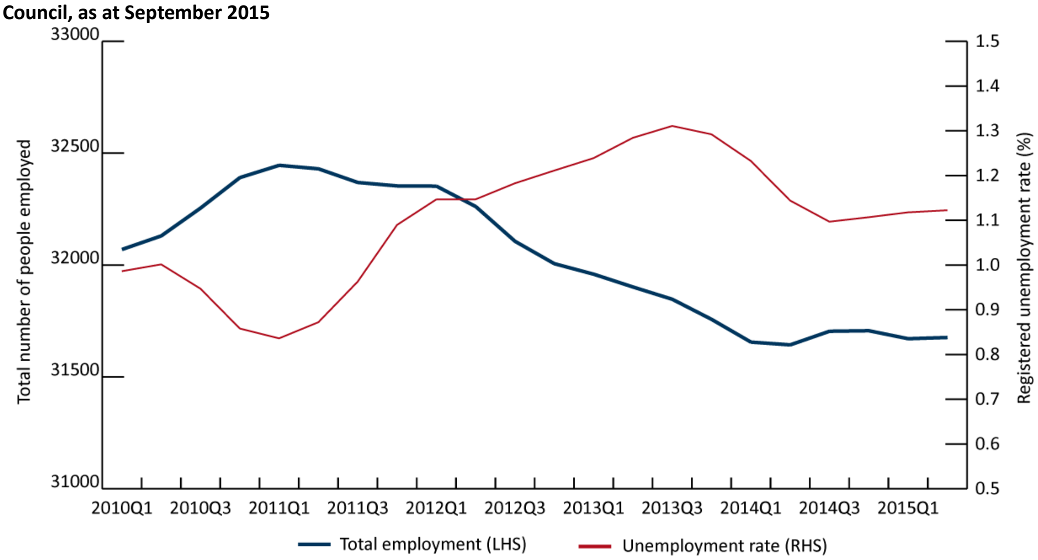
Source: Policy Council, as at September 2015



Guernsey's labour market strengthened over the latter part of 2014 and has plateaued in the first half of 2015. On a seasonally adjusted basis, total employment has stabilised at around 31,700 people, against the pressure of an increased number of people moving into retirement. Unemployment appears to have settled at 1.1%; higher than the pre-crisis average but, relative to other jurisdictions, still remarkably low. Median earnings also increased year on year in the course of 2014 and it is expected that this will feed into greater household consumption for 2015.

Figure 3.2.2 Employment and unemployment trends (seasonally adjusted)

Source: Policy Council, as at September 2015



Both the average real value of house prices and transaction volumes fell in late 2014 and early 2015.

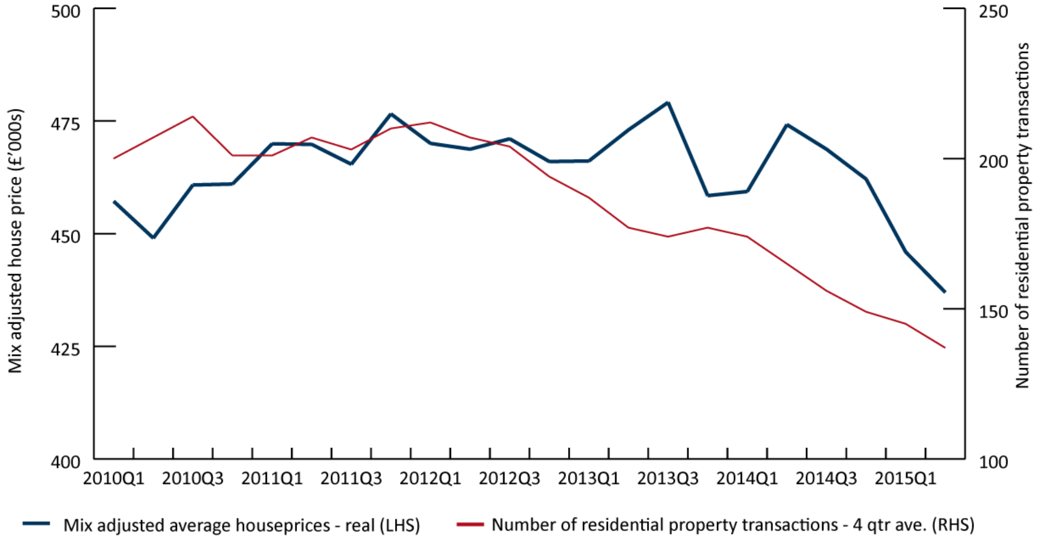
There are several possible factors contributing to this, including a time lag in the reaction of the housing market to the fall in real earnings between 2009 and 2013, the tighter controls on the availability of credit and the progression of the baby boom generation (who represent a significant proportion of aggregate purchasing power) to an age at which they are unlikely to move house or purchase new durable goods. Lower house prices can boost competitiveness over time but the authors are mindful that property remains the most tangible form of security for the Island's small businesses and is an important contributor to wider economic confidence.

While the downward pressure from the reduction in real earnings should ease if wages continue to rise, the other downward pressures may remain for some time. However, the housing booms of the 1980s and 2000s have resulted in house price to median earnings ratios in Guernsey of 15.3. This ratio is comparable to that of central London, and a period of readjustment may be welcome in many quarters.

Figure 3.2.3 Real average residential property prices and quarterly transactions

Local market only

Source: Policy Council, as at July 2015



Business confidence in growth prospects for the near future is good, but businesses have reported a slight loss of confidence in Guernsey's medium-term economic prospects compared to a year earlier (Chamber of Commerce & Young Business Group, 2015). Highest among the concerns raised was a need to review the current system of Government to improve efficiency and effectiveness. Plans for reform appear to have wide spread support both internally and externally, but they are not without political and economic risk, and require careful management.

Medium to long term economic prospects

A high GDP per capita is an indicator of high living standards and maintaining this is an important social and economic objective. Guernsey reports GDP per capita of about £37,000 per year. This is about 35% higher than GDP per capita in the UK and places Guernsey among the most productive societies in the world. There are several reasons for this: Guernsey specialises in very high value added industries with high median earnings; workforce participation is very high and unemployment is very low; and the nature of labour migration patterns in the islands means that when the demand for labour contracts or expands, so, to a limited extent, does the population. When one takes account of Guernsey's high housing costs, living standards may not be quite so high, but nonetheless Guernsey is one of the most prosperous societies in the world.

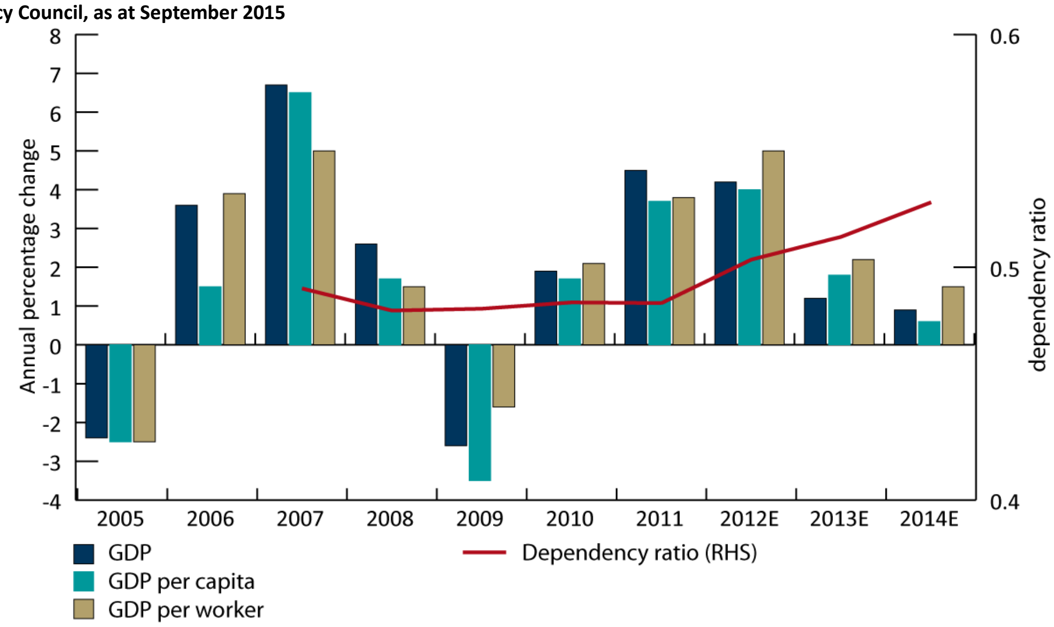
With population projections presenting a potential decrease in the working age population and an increase in the dependency ratio, the falling proportion of the population which is economically active is likely to result in downward pressure on growth in both GDP and GDP per capita.

Guernsey's dependency ratio is already increasing, driven by a combination of the retirement of the first of the baby boom generation and net emigration among the working age population over the last three years. As can be seen in Figure 3.2.4 below, while Guernsey has achieved a moderate to respectable increase in GDP per worker in 2012, 2013 and 2014, both GDP per capita and headline GDP growth rates have been significantly lower.

In order to maintain GDP and, perhaps more significantly, GDP per capita growth, Guernsey will need to either increase the size of its workforce or increase the output generated per employee – or both.

Figure 3.2.4 Real GDP growth rates per worker and per capita

Source: Policy Council, as at September 2015



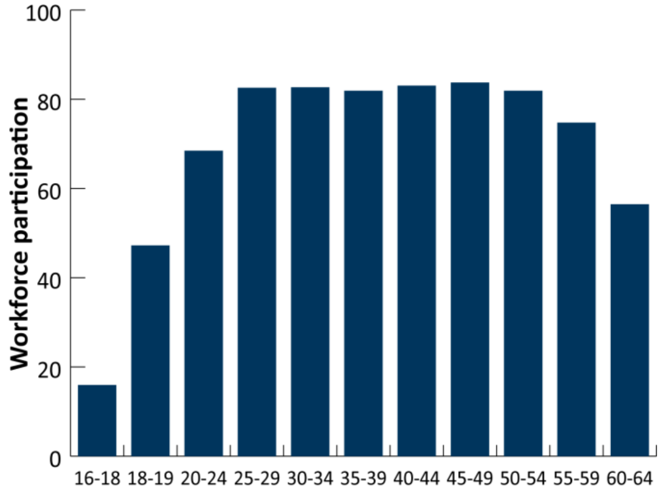
Maintaining or increasing the size of the workforce

Increasing pension age

Guernsey has already taken steps to combat the projected decline in the size of the workforce by agreeing to phase in an increase in the pension age to 70. However, current data show that workforce participation falls sharply as people approach retirement age (see figure 3.2.5). People will need to be supported to remain in the workforce for longer. This means adapting to the needs of the older worker. Whether this is achieved through improvements in the accessibility of work, more flexible working practices, or retraining, this is a challenge that will need to be met by both the public and private sectors.

Figure 3.2.5 Workforce participation by age

Percentage of population employed or self-employed
Source: Policy Council, as at March 2014



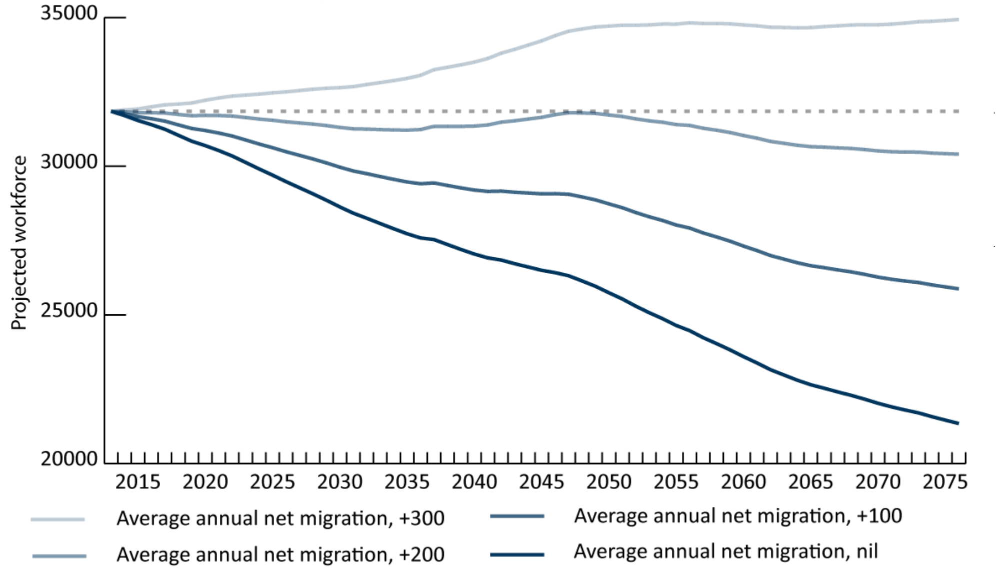
Immigration

Increasing the workforce by allowing an increase in immigration is one solution presented. Over the past seven year Guernsey has experienced an average net inward movement of approximately 100 people per year. Higher levels of net migration than have been achieved in the recent past would be required to maintain the size of the working population (see figure 3.2.6) and reduce the projected dependency ratio. Lower levels of immigration (or net emigration) would intensify the fiscal and economic consequences of an ageing population, placing the cost burden on a smaller number of economically active individuals.

As is typical of most societies, there is a level of public resistance to overall population growth. It may be difficult to strike a balance between meeting the demands of the business community to import skills so as to promote economic growth and the wish to protect the Islands cultural identity and natural environment.

Figure 3.2.6 Impact of migration levels on the projected workforce

Adjusted for age specific participation and increasing state pension age, based on fertility rate of 1.6
Source: UK Government Actuary's Department, Policy Council



Guernsey's licensing system limits the period of residence for many immigrants. While this presents difficulties for business, it has the advantage of limiting the number of immigrants who will, in later life, access pensions and care services in Guernsey. However, the licensing system restricts the movement of only a small proportion of the population, since those with a qualified residency status or who form part of a household of someone with a qualified status are largely free to come and go as they please. Inevitably a proportion of migrants will remain in Guernsey for their retirement and become dependent on Government services themselves. As a result increasing net migration could reduce the magnitude of the fiscal and economic challenges presented by the ageing population but could extend the duration of the period over which dependency ratios are high.

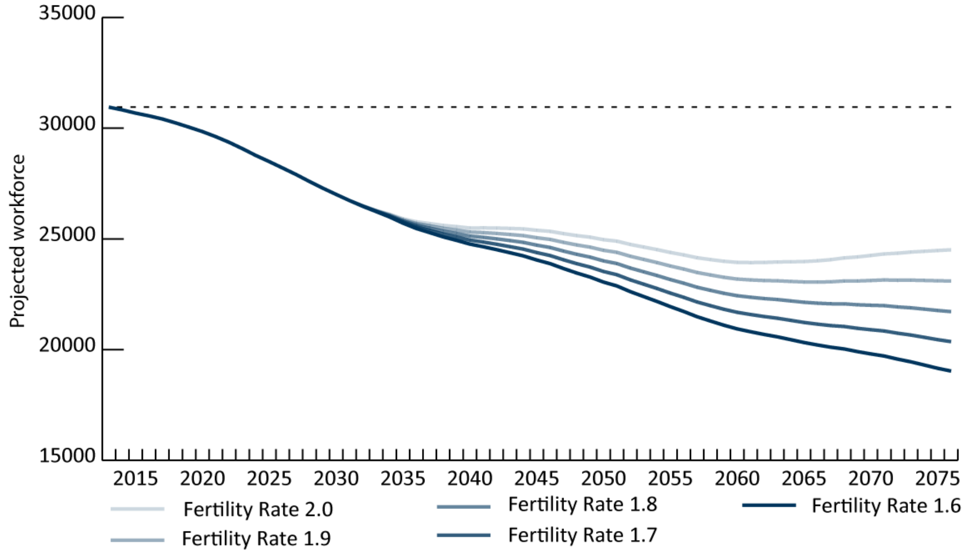
Fertility rates

The fertility rate in Guernsey, at 1.6 births per woman, is above the EU average but significantly lower than the 2.1 births per woman considered necessary to maintain a stable population. In the long-term an increase in fertility could increase the workforce, but it would take at least twenty years for this to have a significant effect (see figure 3.2.7). Furthermore, in the medium-term this would lead to an increase in dependency ratios, reflecting the need to support an increased number of children through their education and would not significantly lessen the magnitude of the peak in dependency ratios, although it could shorten the period over which dependency ratios are high.

However, it is unlikely that any policy decision by the States could result in any more than a marginal increase in fertility rates in Guernsey. Social attitudes favour smaller families and an increase in fertility rates to the 2.1 births per woman required for a long-term stable population in the absence of net migration is certainly not obviously on the horizon.

Figure 3.2.7 Impact of fertility rates on the projected workforce

Adjusted for age specific participation and increasing state pension age, based on nil net migration
Source: UK Government Actuary's Department, Policy Council



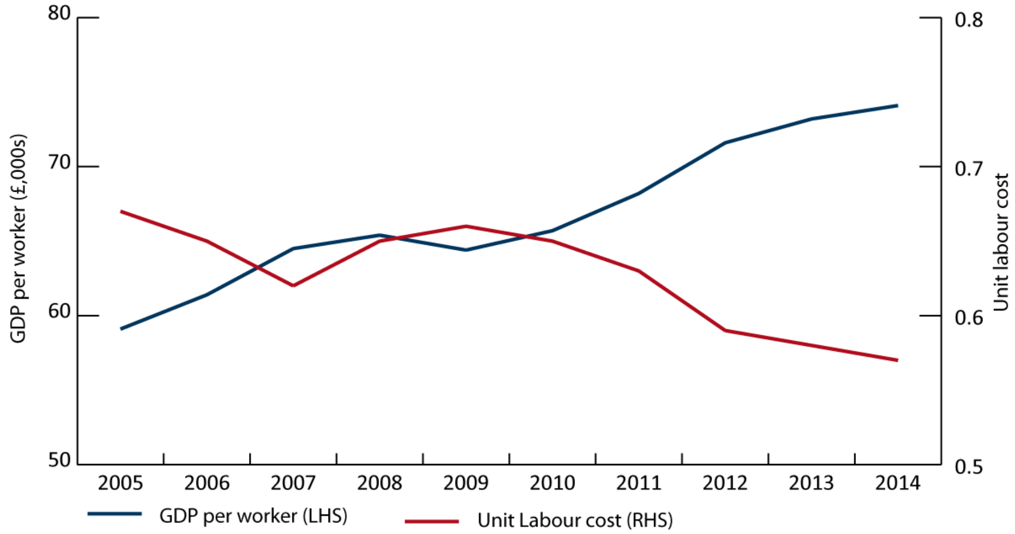
Increasing workforce productivity

Guernsey's workforce is already very productive in terms of output per head of population and per worker, but as the dependency ratio increases the rate of growth in output per capita could fall.

Guernsey does not have sufficient data on working hours to calculate official measures of labour productivity, but, assuming there has not been a significant increase in the average number of hours worked, the increase in GDP per worker suggests that productivity of the workforce (the amount of output produced per hour worked) has improved since the beginning of the financial crisis (see Figure 3.2.8).

Figure 3.2.8 GDP per worker and unit labour costs

At 2014 prices, as at September 2015
Source: Policy Council



Maintaining high labour productivity will become increasingly important, and much of the drive for productivity will come from the need for private sector business to remain competitive. As outlined in section 3.3, the role of Government policy should be to provide the right environment enablers to enhance private sector productivity. For example, a good education system with a focus on a broad knowledge base and transferable skills can provide the private sector with a flexible resident workforce, which can be trained to meet specific needs as they develop.

Public sector efficiency is also important to overall productivity. The private sector is the engine of economic growth, and inefficient use of staff and financial resources by the public sector will draw away from businesses resources which might be used to better economic effect in the private sector. To achieve this efficiency it is important that the States prioritise the effective provision of essential services and limit the amount of resources dedicated to non-essential activities.

3.3. Key economic policy considerations

Guernsey is a mature economy with an ageing population and a history of successful economic policy. The finance sector was attracted to Guernsey by good horizontal economic policy: a competitive tax system; a legal framework able to adapt to the needs of a growing industry; Guernsey's accessibility from London; and an English speaking, well educated workforce. All these factors still retain their importance, but much has changed since the finance industry first became established in Guernsey.

There has been an international move towards more competitive commercial taxation, and many jurisdictions have significantly increased their efforts to attract international finance business. The increase in the use of digital technology has reduced the need for physical proximity and increased the demand for digital connectivity and an effective communications infrastructure. As a result other jurisdictions are "catching up" while Guernsey's existing success makes enhancing growth further relatively challenging.

It is not possible to foresee which industries will be successful in the future. It is therefore important that a distinction is made between economic policy to support growth and development; and sector specific marketing activities. Most studies suggest that public sector intervention aimed at changing the distribution of resources across economic sectors and activities is damaging to growth. That same research points towards policies aimed at those things which boost competitiveness for all sectors and a pro-enterprise competition policy both as aids to growth.

We recognise of course that the politics of long run growth policies may often be politically unattractive in the short term; improving productivity typically means losers as well as winners, but bearing that in mind, where should the States focus?

Education and Skills

The importance of skills and education in economic development is well established. Cognitive skills are strongly correlated with individual earnings and economic growth[2], and are as important within the economic policy environment as they are in social policy.

It is important to note that the correlation is with cognitive skills and that this goes beyond attainment of exam targets. To be effective in enhancing growth, schooling and education must improve cognitive skills: the *quality* of education received is as important as the quantity. For example, Hanushek and Woessmann[3] demonstrated that an improvement in test scores for cognitive skills by one standard deviation is associated with approximately two percentage points higher annual growth in per capita GDP. International comparisons suggest that the UK, for example, could raise PISA[4] scores considerably by greater private operation and by having higher-quality exams (OECD, 2007).

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[2] Eric A. Hanushek and Ludger Woessmann, The Role of Cognitive Skills in Economic Development, *Journal of Economic Literature, V* 608 *ol. XLVI (September 2008)*

[3] Eric A. Hanushek and Ludger Woessmann, Do better schools lead to more growth? Cognitive skills, economic outcomes and causation, J Econ Growth (2012) 17:267–321

[4] Program for International Student Assessment

Businesses typically train for their own sector-specific skill needs and, industry being better placed to analyse their own requirements, policy emphasis is more effectively placed on ensuring the resident population has high quality core skills (such as literacy, numeracy, reasoning and leadership) and the capability and aspiration to develop, than on attempting to pre-empt the needs of specific sectors.

Competition and Regulation

Competition drives innovation, efficiency, and value for money. Crafts (2012) [5] showed that strengthening competition addressed Britain's 1970s productivity problem quite effectively where previous sector-focused industrial policy did not.

In a large economy, competition in most areas will happen naturally. However, the small scale of the Guernsey economy means that competition is apparently limited in many areas. For example, within the retail market, Guernsey does not have the critical mass to attract high volume, low cost stores such as Primark and Matalan, and given the high median earnings it is unsurprising that Guernsey tends to attract national chain stores focused on providing high end products and a good shopping experience.

It would seem likely that the gap this leaves, particularly at the lower end of the market, will be increasingly filled by online shopping. The growth of online shopping should increase competitive behaviours in local companies, requiring greater scrutiny of both prices and service quality in order to retain their market share. While this might be a challenge for local businesses, it is good for consumers in general.

The OECD states that *"An effective regulatory policy supports economic development as well as the rule of law, helping policy makers to reach informed decisions about what to regulate, whom to regulate and how to regulate"[6].*

Regulation can have both positive and negative impacts on economic growth and it is important that regulation is targeted only where needed and that it is applied in an effective manner. It is, of course, important that business not be made unviable by over regulation, but to be effective regulation policy must challenge the industries that are being regulated.

Some markets, such as the supply of utilities, will generally be monopolies or close to them, and where this is the case the role of regulation is to mimic the effects of competitive behaviour and ensure that standards are maintained and prices remain reasonable. The regulatory framework that the UK pioneered, of making prices of utilities move at a rate of "RPI minus X", where X represents an estimate of future growth in productivity in the utility in question, was and is widely regarded as a highly desirable approach.

Financial regulation is of particular importance in Guernsey, with the Island's reputation as an international finance sector being reliant on the maintenance of internationally accepted high standards. None the less, the increase in macro-prudential regulation and reporting requirements, which is largely beyond Guernsey's control, will have significantly increased the compliance cost for local companies, to the detriment of overall productivity. The introduction of FATCA, the U.S. act requiring the reporting of all financial accounts held by

[5] Nicholas Crafts, British relative economic decline revisited: the role of competition, Elsevier, Volume 49, January 2012

[6] Setting the scene: The importance of regulatory policy, Regulatory Policy and Governance: Supporting Economic Growth and Serving the Public Interest, OECD Publishing, 2011

all U.S. taxpayers, is of particular note. The benefit of the system rests entirely with the U.S. while the compliance costs fall on local companies and the local tax office and are significant.

Legal framework

The consistent, predictable, and transparent application of a sound legal framework is important to economic growth. It protects contract and property rights, provides security for businesses and their clients, and gives credibility on an international stage.

For a small and specialised jurisdiction such as Guernsey it is also important that the legal framework is able to adjust to the changing needs of industry in a way that is both timely and robust. Guernsey has a particularly strong history in this regard. Guernsey was, for example, the first jurisdiction to pass legislation enabling the formation of Protected Cell Companies[7], a legal innovation which placed Guernsey at the forefront of the captive insurance market. More recently, Guernsey introduced legislation on Image Rights[8], again showing a willingness to view the legal framework as a facilitator to economic activity. This type of innovation should be supported, provided of course it continues to be developed in a transparent, robust, and credible manor.

Access to technology

Access to technology is becoming increasingly important. The development of communication technology has reduced the need for physical proximity and increased the need for digital connectivity. Applied effectively, technology should enhance business productivity, which, in the context of the physical restriction on the growth of Guernsey's working population, should be a key objective for local policy makers.

Most productivity gains in advanced economies come from the diffusion and absorption of existing technologies, not from research and development. The role of Government policy should be to facilitate the adoption of technology by the private sector, by providing the necessary infrastructure to support technological integration and access to the skills and expertise to develop and use it. But it should never be forgotten that infrastructure spending is not a panacea.

The application of technology in the public sector can also bring significant financial and economic benefits, improving the access to education and health services from outside the island, improving public sector efficiency and reducing the per unit cost of service provision. As in the private sector, investment in technology should be subject to robust cost-benefit analysis, but may be a policy instrument useful in meeting some of the long term fiscal challenges Guernsey faces.

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[7] The Protected Cell Companies Ordinance, 1997

[8] The Image Rights (Bailiwick of Guernsey) Ordinance, 2012

4. Performance against Fiscal Framework

Monitoring performance against the Fiscal Framework is the primary purpose of this report. The Framework provides numerical parameters on General Revenue expenditure to help guide States' finances towards long-term fiscal stability. This year for the first time income gathered in the form of Social Security contributions and fees and charges also falls within the parameters of the Fiscal Framework, which has been extended to capture all government income.

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

Box 4.1. Parameters of the Fiscal Framework

The Fiscal Framework sets a number of parameters and commitments:

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

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

- Total government income, incorporating General Revenue, Social Security contributions and fees and charges, should not exceed 28% of Gross Domestic Product

Summary

Guernsey's short term fiscal performance continues to be generally satisfactory and control of expenditure remains tight. However, the shortfall in income now expected in 2015 means the deficit is likely to continue for an eighth year, in ongoing breach of the fiscal framework. The persistence of the deficit, underfunding of the capital account, and pressing sustainability issues in areas such as health which are a focus of this year's report, all point to the need for even tighter discipline on expenditure and an open and effective dialogue on longer term economic growth. We also highlight the decision to undertake a significant amount of borrowing and would emphasise the need for careful management of the borrowed funds to ensure the continued integrity of the State's Finances and to protect its international reputation for fiscal prudence.

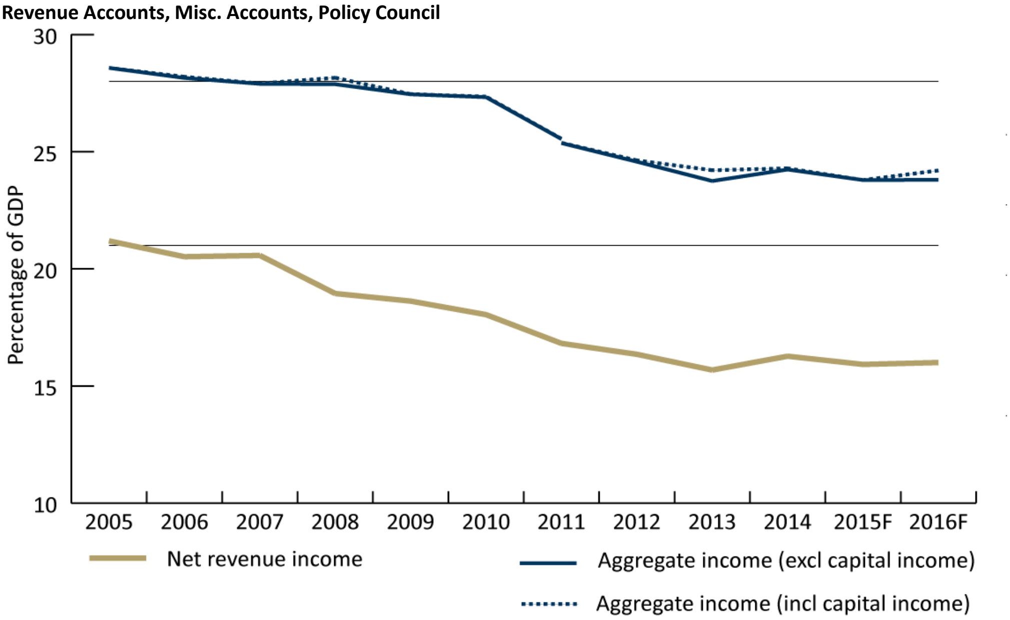
4.1. Income and expenditure

Fiscal Framework rules:

- **Total General Revenue income averaging no more than 21% of GDP.**
- **Total government income, incorporating General Revenue, Social Security contributions and fees and charges, should not exceed 28% of Gross Domestic Product**

Figure 4.1.1 Net general revenue and aggregate government income

Net general revenue income incorporates all income sources (excluding capital) reported in the annual accounts available for distribution between departments.
Aggregate income incorporates the above, plus Social Security contributions and Departmental operating income
Source: General Revenue Accounts, Misc. Accounts, Policy Council



Both these measures are well within the parameters set by the Framework. Some increases in taxation have been applied, including increases in both domestic and commercial TRP rates and the extension of the 10% intermediate rate to capture a greater portion of the Finance Sector and, if recommendations in the 2016 budget are accepted, to large retail businesses and hydrocarbon importers. These extensions and underlying income growth have sufficed to maintain income as a percentage of GDP; they have not significantly increased it. The States have resisted a structural change to the tax system and continue to run a deficit in 2014 (see figure 4.2.1). However, given that income within the general revenue budget has reduced relative to GDP by 5 percentage points over the last decade, the deficit is not large.

It should also be noted that a significant portion of the income lost through the change in the corporate tax regime in 2008 was recouped by increases in Social Security contributions from both employers and individuals. This is shown by the smaller reduction in aggregate income between 2006 and 2009 than can be seen when looking at General Revenue in isolation, and highlights the importance of considering both revenue streams when looking at the impact of taxation on the economy.

The spare capacity within the aggregate income limitation was an intentional policy decision, made when this level was set earlier in 2015. It recognises the known underfunding of the Long Term Care system (which is still under review) alongside the provision of other supported living services. Further considerations highlighted in the report "Planning a Sustainable Future" (Billet D'Etat IV, 2015) include the mounting pressure on the health system as the population ages and the current under funding of the capital programme.

However the report stated that:

"To fund all known and estimable short- and long-term pressures on expenditure … … using current service models would require an increase in income to an estimated 29% of GDP. Beyond this there is a known but inestimable increase in healthcare, which will add further pressure.

A limit of 28% of GDP will therefore require the States to manage and restrain expenditure pressures if it is to provide public services in a sustainable way within this level. As such the States will need to maintain the culture of expenditure restraint and prioritise both short and long-term funding needs if it is to avoid the need to increase income to a level at which this would be breached to retain fiscal balance."

Some decisions, such as increasing the pension age, have already been taken to address this but much more will be required. The long term fiscal pressures are examined in more detail in section 5 but what is evident is that meeting these challenges will need more than reductions in expenditure at the margins. Long-term sustainability within the limitation set will require structural change in service provision.

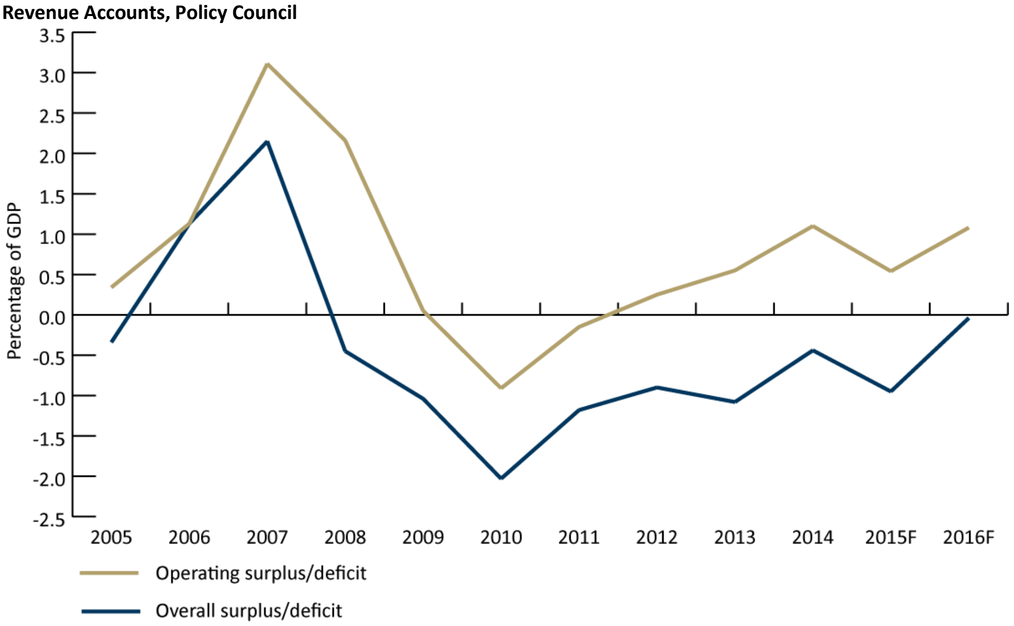
4.2. The Fiscal Position

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.**

Figure 4.2.1 General revenue operating and overall position

Source: General Revenue Accounts, Policy Council



The operating position is well within the framework criteria limiting the size of the deficit to 3% of GDP, as is the overall position although this remained in deficit in 2014 and is expected to increase in 2015.

The overall deficit has now persisted for seven years, with 2015 expected to be the eighth in a continued breach of the Framework. The deficit fell to less than 0.5% of GDP in 2014, the current expectation is that it will increase to approximately 0.8% of GDP in 2015. While the expected worsening of the 2015 position is a result of a weakness in income growth and, as such, largely beyond the State’s direct control, the stubborn persistence of the deficit is of concern. After eight years it is difficult to argue that this is temporary.

The revenue shortfall and the increased scale of the deficit now projected in 2015 is expected to largely exhaust the funds allocated to support short term deficits (see figure 4.2.2). The 2016 budget presents a tactical short-term response to restore the budget to balance in 2016. While this may restore in-year balance to the budget, this has been achieved through a significant reduction in the allocation of funding from general revenue to the capital reserve and if the problem persists a more long-term solution is needed.

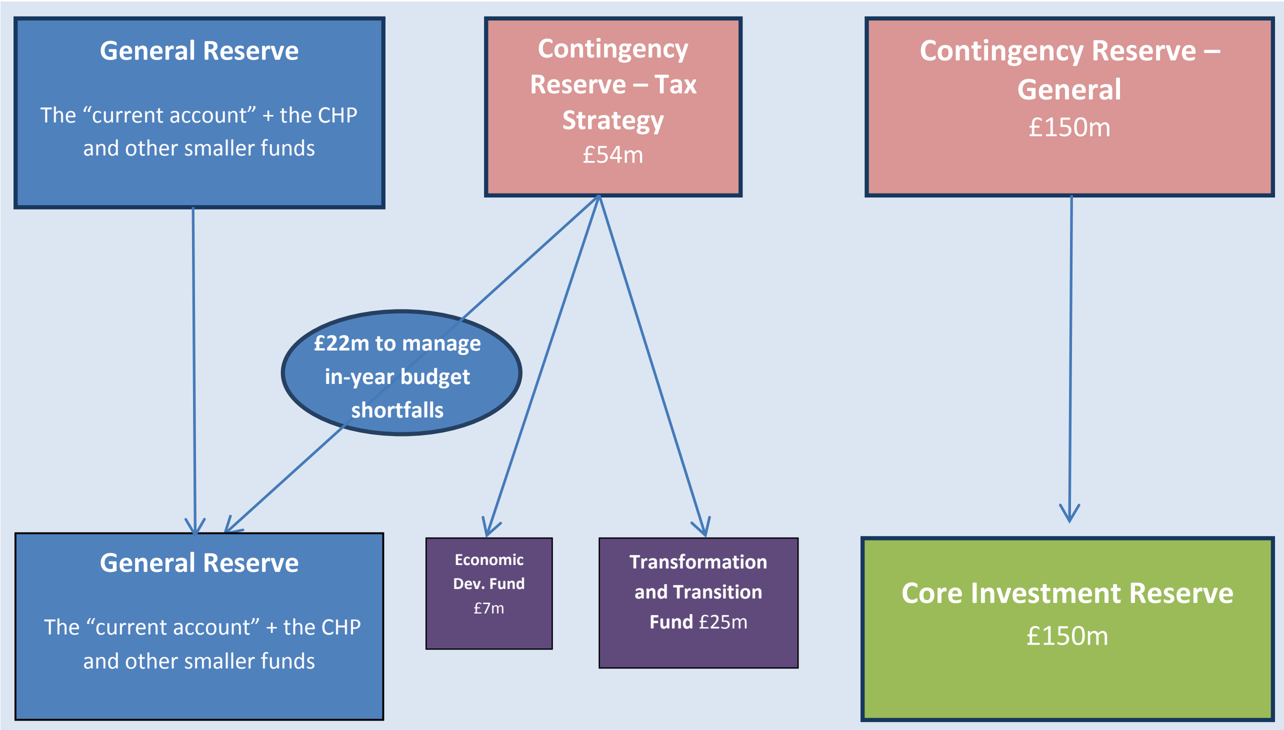
Fiscal Framework rules:

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

General revenue

In past years this has been monitored with reference to the level of reserves held by the States in the General Revenue and Contingency Reserves, based on the assumption that in order to meet the requirement for permanent balance these reserves would need to be rebuilt during periods of surplus. In total the General Revenue and Contingency Reserves had been depleted by £97m (or 9% of GDP) between their nominal peak in 2007 and the restructuring of these funds towards the end of 2014.

Figure 4.2.2 Restructuring of reserves, as agreed in 2015 Budget



On the assumption that the deficit would be much reduced in 2015 and balance would be achieved by 2016, these reserves were restructured in the 2015 Budget. The portion of the Contingency Reserve which had been previously allocated to underpin the deficit position (the Contingency Reserve - Tax Strategy) was divided into a number of funds dedicated to different purposes. In effect the Budget decision allowed £32m of the £54m remaining in the Contingency Reserve - Tax Strategy to be spent with the stated objective to "*stimulate economic growth and transform the operation of the States in order to move the overall financial position onto a more sustainable footing*." [9]

[9] Quote extracted from 2015 Budget

The remaining £22m was transferred to the general reserve with the intention of providing an accessible pool of capital which could be used to support any moderate and temporary deficit positions which might occur in the future.

If the funds dedicated to transformational objectives are used effectively to improve long term economic and fiscal stability the investment is of merit, since the long term structural change needed to place States expenditure on a sustainable footing is unlikely to be achieved without initial outlay. As previously highlighted, investment in economic development is best focused on policy and infrastructure that will benefit all sectors than on attempts to enhance specific sectors. However, the larger than anticipated deficit now forecast for 2015 may exhaust the funds allocated for supporting cyclical deficits. The premature commitment of these reserves has reduced the States' ability to manage short term fluctuations in the financial position in the future.

The position in which the States finds itself in the setting of the 2016 budget serves to highlight the difficulty inherent in forecasting, even in the relatively short term, and the caution that should be used when relying on such forecasts. There is a three year time lag before final GDP data are available and similar lags are apparent in the production of final assessments for taxes on corporate profits, reflecting the time needed for submission and assessment of company accounts. These lags make accurate forecasting challenging. The States should routinely review the source of such forecasting errors and seek to shorten the time lag on the availability of accurate data to improve forecasts, but some level of inaccuracy is unavoidable. Policy based on a reaction to fluctuations in short term forecasts is unlikely to improve fiscal stability or achieve long term balance.

The 2015 budget stated a medium term objective of restoring the remaining Contingency Reserve (General), now renamed the Core Investment Reserve, to the same level, relative to expenditure, as it was in 2006. To achieve this, the States will need to appropriate £90m from revenue surpluses. This is a challenging objective given that the return to a surplus has not yet been achieved, the underfunding of the capital program has yet to be dealt with and that the 2016 Budget proposes using the real return on investment in 2016 to subsidise the reduced allocation to the capital reserve (see section 4.3).

In order to meet the requirement for permanent balance, and to achieve this medium-term objective of building the Core Investment Reserve, the States will need to achieve a sustained period of surplus. We believe that in order to satisfy the permanent balance criterion and build the reserve, the States should be aiming to achieve revenue surpluses in the region of 3% of GDP (about £65m per annum at current prices) over the medium term, that being some five to ten years.

Social Security

With the formal incorporation of Social Security contributions within the Framework, extension of the permanent balance principle should be extended to the Social Security Funds, albeit over a longer time period in recognition of the long-term nature of fiscal planning these funds support.

Both the Guernsey Insurance Fund [GIF] and the Long Term Care Fund [LTCF] have funding problems, with both, under current assumptions of future income and expenditure, projected to become exhausted. The positions of the GIF and, to a far lesser extent, the LTCF have been improved by the decision to increase the pension age in Guernsey to 70 by 2049, but further action is required on both if the funds are to be sustainable in the long term.

The analysis presented in figure 4.2.3 suggests that it is possible to stabilise the GIF without increasing contribution rates, albeit at the cost of a less generous up-rating policy, and thus a more rapid reduction in the relative value of the old age pension in comparison to median earnings in the community. Given the universal nature of the old age pension and the policy decision to limit aggregate income, this would seem fiscally prudent, accepting that a less generous uprating policy may require some increase in spending on means tested benefits.

Review of the LTCF is still continuing, but based on the information available it seems unlikely that it will be possible to achieve stability of this fund without substantial action (see figure 4.2.4). Provisional analysis suggests that this fund will need either a significant structural change in the way services are provided or a significant increase in funding (or more likely a combination of the two) to achieve long-term sustainability.

A decision to increase revenue for both or either of these funds to ensure sustainability, either through an increase in contributions or by some other means, will need to be borne by the economy as a whole. It is also important to remember that both will need to be made sustainable within the limitation placed on States aggregate income. These issues are covered in more detail in section 5.2.

Figure 4.2.3 Projections of Guernsey Insurance Fund

Source: Policy Council, internal modelling of Social Security funds based on actuarial projections of the population, mid estimates only. Assuming an increase in pension age to 70 by 2049, average real increase in earnings of 1.5%, average investment return of 3.5%.

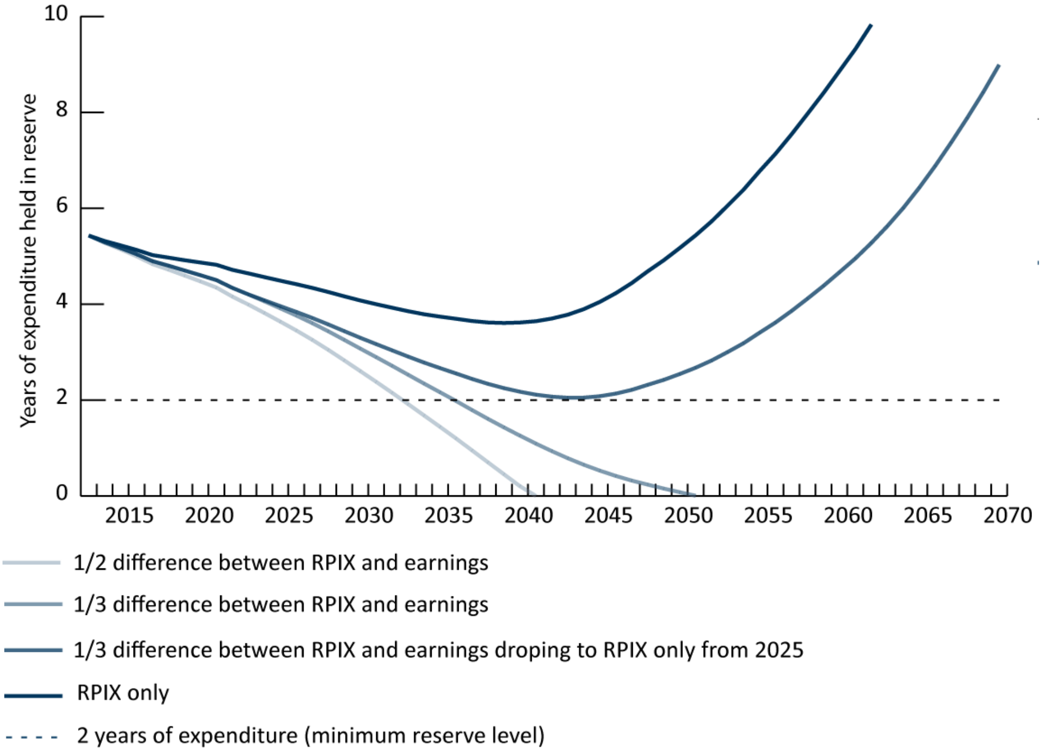
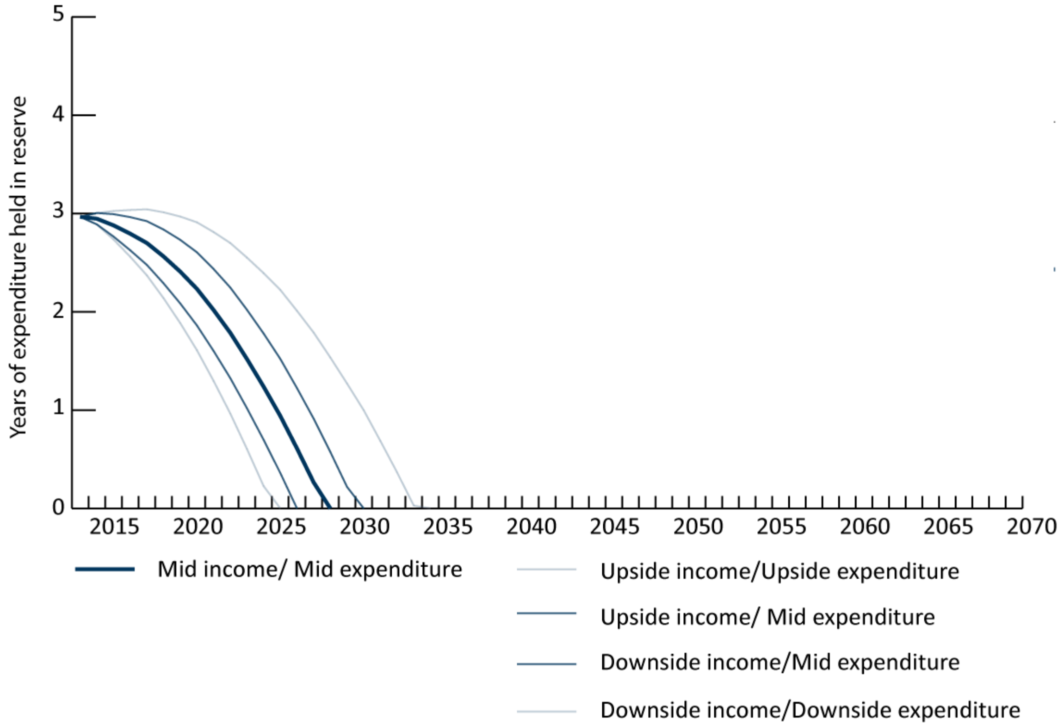


Figure 4.2.4 Projections of Guernsey Long Term Care Fund

Source: Policy Council, internal modelling of Social Security funds based on actuarial projections of the population. Assuming an increase in pension age to 70 by 2049, average real increase in earnings of 1.5%, average investment return of 3.5%.



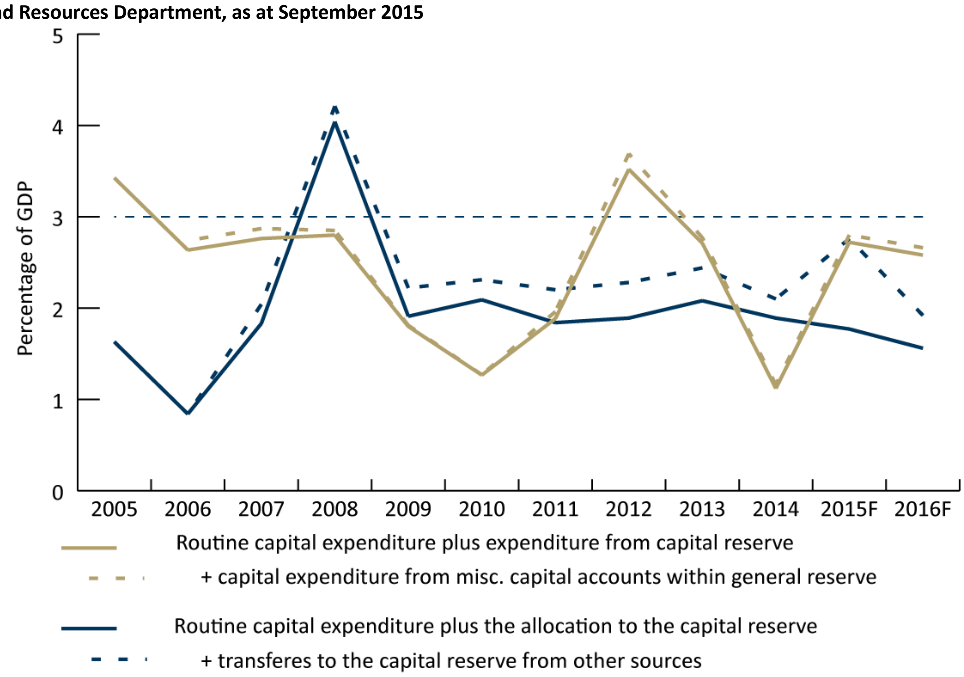
4.3. Capital Expenditure and Borrowing

Fiscal Framework rules:

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

Figure 4.3.1 Capital expenditure

Source: Treasury and Resources Department, as at September 2015



The States continue to under invest in capital expenditure according to its own criterion. Total allocation to capital spending from general revenue (including routine capital) has averaged 1.9% of GDP since the framework was introduced in 2009, supplemented by additional allocations from other sources averaging of 0.3% of GDP. These supplementary sources include capital returns on the Capital Reserve and the Core Investment Fund and transfers from sources such as the Ports Holding Accounts and the Corporate Housing Programme reserve. These are typically one-off or volatile in nature.

Actual capital expenditure is, as one might expect, significantly more volatile than the planned average. While still, on average, falling below the 3% target set out by the Framework, the actual capital spend has been approximately 0.4% of GDP higher over the past 10 years than that allocated from General Revenue.

It should be noted that the anticipated shortfall in 2015 and the lack of reserves to support a deficit in 2016 have resulted in the reduction of the allocation of funds from General Revenue in 2016. The Budget highlights that this will result in a funding shortfall of £52m by 2017 against the current portfolio of capital works due to be undertaken over this period and suggests a delay in a number of projects (with a total value of £120m) until the subsequent capital prioritisation round.

While the desirability of balancing the 2016 Budget is very clear and, this move is highlighted as a one-off, this is not a sustainable solution if the weakness in revenue growth persists. Further consideration should be given to the sustainability of the capital programme. For example, continued underinvestment in infrastructure, such as sea defences, could lead to critical failure, necessitating expensive emergency repairs.

As highlighted in previous reports, the States need to find a long-term solution which enables them to meet their commitments to achieve long term balance and to make adequate investment in infrastructure.

However, while infrastructure investment in Guernsey needs strengthening, this criterion is not intended to encourage spending for spending's sake. Like any government expenditure, capital investment should be made only after robust cost-benefit analysis.

Fiscal Framework rules:

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

In December 2014 the States of Guernsey successfully completed a £330m bond issue. The States of Guernsey were able to secure a 3.375% pa interest rate with a final maturity of 2046. This is the lowest ever coupon for a long-term fixed rate sterling bond issued without a guarantee from the UK government.

The primary purpose of the loan was to consolidate the existing liabilities of States associated entities, allowing these entities to reduce the cost of their borrowing by taking advantage of the better credit rating available to the States of Guernsey. In effect this money will be re-lent at a slightly higher interest rate with the repayments made by the benefiting entities used to accumulate sufficient reserves to make the repayment on the bond when it becomes due.

Should everything proceed as planned this is at first glance an attractive scheme, reducing the cost of borrowing to the States associated entities, potentially reducing the cost to the consumer, and presenting the States with the opportunity to generate some revenues by acting as an intermediary.

However, the bond is hypothecated against States revenues and if, for whatever reason, one or more of these entities should be unable to meet their repayments or the capital accumulation is not sufficient to meet the repayment when it becomes due, the taxpayer will be *directly* liable for the debt.

Arguably, the States were already *indirectly* liable for much of this debt (although this is far from clear), but the result of the decision is that the States are now directly liable for debt equivalent to 14% of its GDP. **This is close to the maximum amount of borrowing allowable within the Fiscal Framework and well in excess of the 3% of GDP allowable in any one year. Ultimately, the decision to transfer this debt to the States has increased the risk to the taxpayer.**

It is to be expected that inflation and economic growth will, over time, reduce both the real and relative (to Guernsey's income) value of this debt. But, as recent experience has shown, both prices and GDP can go down as well as up. These risks are intensified for Guernsey as it does not have its own monetary policy which could otherwise aid the management of the debt. Guernsey must, as ever, accept the economic consequences of the Bank of England's actions, but now in addition has to accept the consequences for the management of Guernsey's debt. Guernsey is, in one respect, now like a developing country borrowing in a foreign currency.

Recent global and European events have brought the importance of a reputation for fiscal prudence in to sharp focus. This is particularly true of a jurisdiction such as Guernsey, dependent as it is on attracting and retaining international finance business. The States would be wise to take particular care to ensure that the debt is carefully managed to avoid reputational damage.

5. Fiscal and economic future

5.1. Current Fiscal Position

Figure 5.1.1 Consolidated budget forecasts for 2015 and 2016

Source: Treasury and Resources Department, Social Security Department, as at September 2015

		2012 (£m)	2013 (£m)	2014 (£m)	2015F (£m)	2016F (£m)
General Revenue	Personal taxes	227	227	237	n/a	n/a
	Company taxes (incl. distributions)	53	55	61	n/a	n/a
	Income taxes	**281**	**282**	**298**	**292**	**306**
	Misc. income	4	4	8	24	18
	Indirect taxes	77	76	77	70	76
	General Revenue income	**362**	**361**	**383**	**385**	**400**
	Departmental operating income	34	35	32	34	35
	Total revenue income	**396**	**396**	**415**	**419**	**435**
	Net departmental expenditure	**(342)**	**(346)**	**(350)**	**(366)**	**(372)**
	Exp. of departmental operating income	(34)	(35)	(32)	(34)	(35)
	Gross departmental expenditure	**(375)**	**(381)**	**(382)**	**(398)**	**(406)**
	Revenue surplus/(deficit)	**21**	**15**	33	19	28
	Routine capital expenditure	(16)	(13)	(8)	(7)	(11)
	Capital income	1	10	1	0	10
	Operating surplus/(deficit)	**5**	**13**	**26**	**12**	**27**
	Appropriation to Capital Reserve	(25)	(35)	(36)	(36)	(28)
	Other transfers		(3)		4*	1*
	Overall surplus/(deficit)	**(20)**	**(25)**	**(10)**	**(20)**	**-**
Social Security Funds	Income: Social Security Contributions	148	151	155	158	161
	Income: Grant	18	18	19	20	20
	Total Income	**167**	**170**	**175**	**178**	**181**
	Expenditure: GIF	(119)	(125)	(129)	(135)	(140)
	Expenditure: GHBF	(36)	(36)	(38)	(39)	(44)
	Expenditure: LTCF	(17)	(17)	(18)	(19)	(19)
	Depreciation charge	(1)	(1)	-	-	-
	Total Expenditure	**(173)**	**(179)**	**(186)**	**(193)**	**(203)**
	Social Security Funds: Operating surplus/(deficit)	**(5)**	**(9)**	**(11)**	**(15)**	**(21)**
	Aggregate: surplus/(deficit) before investment return	**(25)**	**(33)**	**(22)**	**(35)**	**(21)**

*Transfers from General Revenue Account Reserve to reflect a timing difference in the delivery of FTP savings

Guernsey's medium term history has shown remarkable discipline in restraining General Revenue expenditure. Before capital spending, projected revenue expenditure in 2016 is £10m (or 2.5%) lower at 2014 prices than in 2009. While the Health and Social Services (HSSD) and Education Departments might be criticised for overspending their original budgets for 2014, it should be noted that, even before adjustment for inflation, both Departments spent less than they did the previous year.

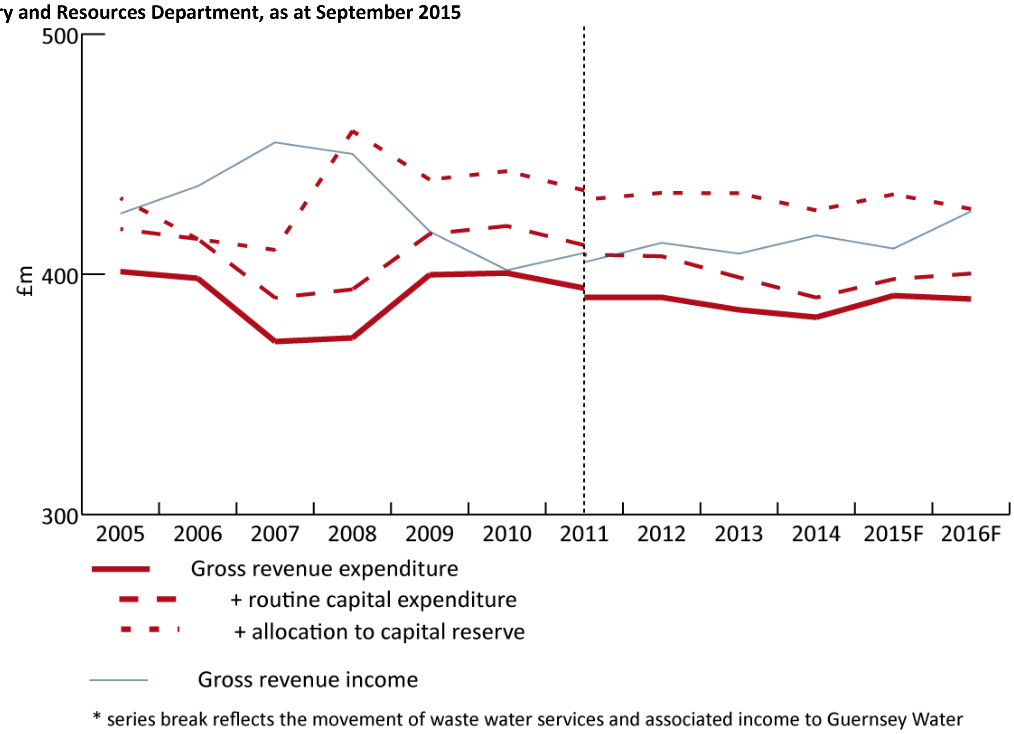
It is encouraging that the legacy of the Financial Transformation Programme appears to be a continuing culture of expenditure restraint and encouragement of efficiency. This is important: a balanced budget (if it is achieved in 2016) must not breed complacency; there are financial challenges to be met in both the short and long term.

It is evident that the HSSD in particular have struggled to meet their budget restrictions. Following external assessment of the HSSD budget, the Budget recommends an increase in the cash limits by £8.2m in order to ensure adequate funding to support the *existing* services. The review, conducted by BDO with the assistance of HSSD staff, highlights the high unit cost of providing services in Guernsey relative to other regions. The potential for both demand led and inflationary growth in health and social care costs is a significant financial risk in both the medium and long term.

The authors support the position adopted in the 2016 Budget that any increase in funding to support existing service models should be temporary. If services are to be sustainable in the long term and the expenditure pressures are to be managed the States should consider structural changes in the way services are delivered.

Figure 5.1.2 General Revenue Expenditure (at 2014 prices)

Source: Treasury and Resources Department, as at September 2015



As observed earlier in the report, the shortfall in income now anticipated in 2015 is not inconsiderable and highlights the difficulty in forecasting, even within a short time horizon. It is to be noted that, according to the 2016 Budget, current forecasts for those income streams which are typically considered less volatile, such as Tax on Real Property and income tax receipts on employed income, have changed very little. The current difficulty is a result of the forecasting of more volatile revenue streams such as company and distributed profits, personal income which is not related to employment, and document duties. Given the extent of the discrepancy in some areas (the original forecast for income tax on company profits overstated revenues by more than 10% against current expectations) it would be advisable to review the source of these errors and how to manage such discrepancies in the future.

As expected, expenditure managed through the Social Security system continues to grow in real terms, driven by a continued upward pressure from the increasing number of people claiming Old Age Pensions. As a result, the total operating deficit on the Social Security Funds is increasing and will continue to do so for the foreseeable future.

To date the investment performance of the reserves, which has averaged 5.97% per annum over the last 5 years, has been sufficient to cover the operating deficit, and the value of the reserves is still increasing. However, the pressure developing on these funds is such that expenditure growth will very likely outpace any reasonable expectations of investment return in the not too distant future.

5.2. Fiscal Pressures

Short term pressures

There can be any number of short-term expenditure pressures on the States' finances at any given time. Among those to be met in the immediate future is the still unresolved reform of the benefit system so as to combine the currently parallel Supplementary Benefit and Rent Rebate systems. If previous work is any indication, tackling the inequalities between individuals and families produced by the dual system is likely to come at significant additional cost to the annual general revenue budget. The States are also committed to providing improved parental leave benefits and subsidised pre-school education, but the source of funds for these has not yet been agreed.

As previously noted the States are still not allocating sufficient money to the capital reserve to meet the medium term capital expenditure commitment, and a sustainable solution to this is still needed.

The resolution of these problems risks changing what might still be a temporary deficit into a structural one unless expenditure can be diverted from other areas or income can be increased to meet these needs. This risk is intensified since, should current forecasts for 2015 prove accurate, the reserves made available for the purpose of supporting a short term deficit may be exhausted in 2015, reducing the States capacity to absorb short-term fluctuations in income.

Given the limitation placed on aggregate States income and the potential scale of long term pressures it would be prudent to explore alternatives thoroughly before raising additional income to meet short term expenditure demands. There is substantial evidence that opening up a new source of finance to resolve a particular problem often leads to the emerging of new demands for spending. Reducing universal benefits, and in particular the provision of a universal family allowance, has previously been highlighted as a possible means of financing the change in the welfare system. While certainly feasible it raises the intractable matter of choosing between universal and means tested benefits. Both have their advantages and their problems, and it would not be wise to take a decision as a cost saving measure without considering the basic issues.

Long term pressures

Marginal reductions in existing expenditure are unlikely to be sufficient to meet long term expenditure challenges Guernsey faces. Achieving a sustainable budget surplus in the medium to long-term is highly likely to require wholesale structural change, which should include consideration of what the States and the population consider essential functions and whether there are services that could be more expediently delivered in a different way.

In common with most of the developed world, Guernsey has an ageing population. The increase in the number of people claiming pensions has already begun, with the first of the baby boom generation reaching pension age in 2011. In 2015 Guernsey took what was a relatively early decision to agree an increase in the pension age to 70 by 2049. While Guernsey is among the earliest jurisdictions to confirm this move, others are likely to follow suit in the near future. In fact it is likely that many jurisdictions will choose to increase their pension ages at a faster rate than Guernsey has.

Given the reduction in the projected working age population, increasing life expectancy and the growing pressure on expenditure, this decision was plainly prudent. However, alone it will not resolve the sustainability of the States' public pension system. Even allowing for the increase in pension age, at the current assumed rate of pensions uprating of halfway between the increase in prices and the increase in earnings, the GIF could well still be exhausted before the middle of the century.

The question of establishing an appropriate rate of uprating, both in terms of ensuring the sustainability of the system and to protect the income of the Guernsey pensioner population, remains unresolved. The original proposition, as recommended by the Personal Tax, Pensions and Benefits Review (Billet D'Etat IV , March 2015), was to allow a limited increase above the increase in prices for a period of ten years, with a view to reducing this rate once further work to enhance personal provision could be implemented. Central projections show that this could ensure the sustainability of the GIF without the need to increase Social Security contributions.

The States deferred this decision to enable investigation of other, more generous, options. As set out in Billet D'État XVIII, October 2015, the Social Security Department have now reiterated the original recommendation.

We highlight the risk of committing to a policy of uprating which could prove unsustainable in the long term, particularly as economic conditions may prove less favourable than projected. While the assumptions used in the projection of the GIF are less optimistic than those applied in the previous actuarial assessment[10], the downside risk should nevertheless not be ignored.

Neither should this decision be made in isolation from the other known funding demands which are on the horizon, particularly since the States apply an aggregate limit to income.

[10] 2014 actuarial reviews and analysis have been based on a less optimistic assumption of earnings growth (1.5%) than that used in 2009 (2.0%). In addition, on advice from the UK Government Actuaries, the projections presented include a further downward revision of income projections to reflect the weak growth in contributions since 2009.

Figure 5.2.1 Projections of Guernsey Insurance Fund - central projections based on different uprating assumptions

Source: Policy Council, internal modelling of Social Security funds based on actuarial projections of the population, mid estimates only. Assuming an increase in pension age to 70 by 2049, average real increase in earnings of 1.5%, average investment return of 3.5%.

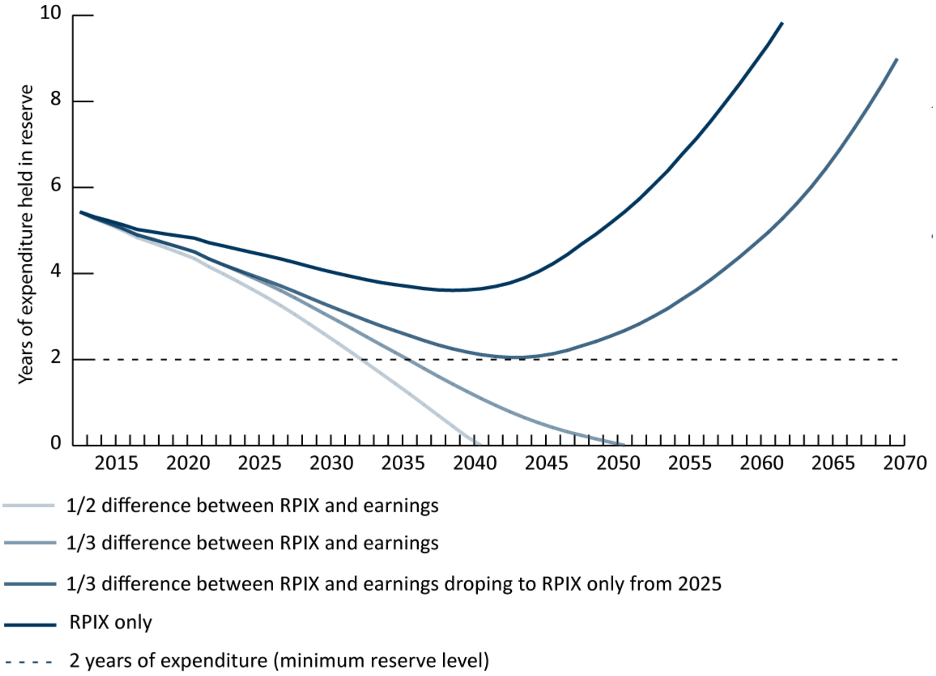


Figure 5.2.2 Estimated increase in contribution rates required to ensure the sustainability of the GIF

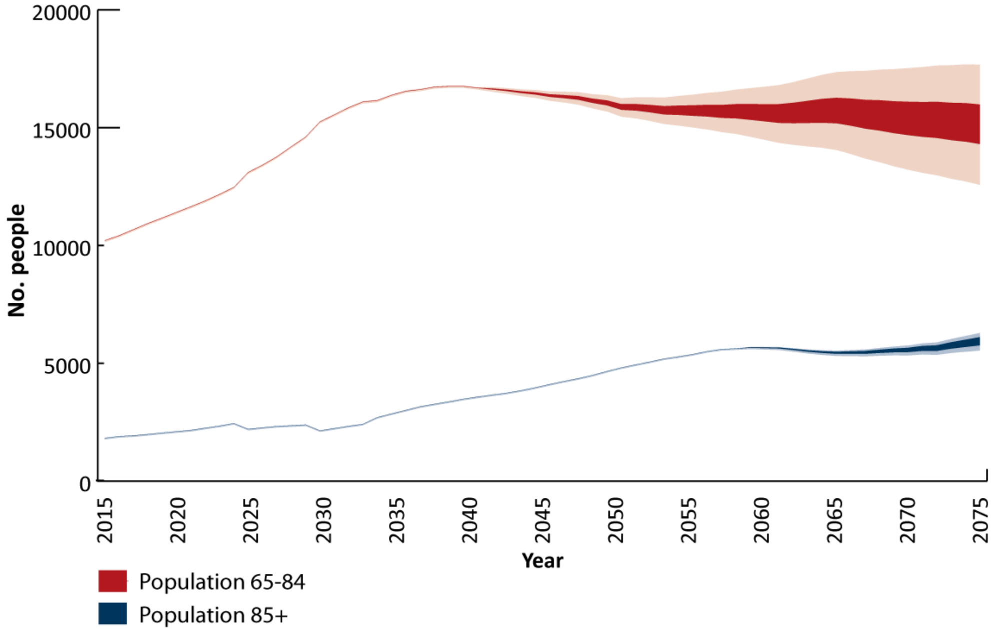
Source: Policy Council, internal modelling of Social Security funds based on actuarial projections of the population. Assuming an increase in pension age to 70 by 2049, average real increase in earnings of 1.5%, average investment return of 3.5%

Uprating Policy	Downside	Mid	Upside
1/2 difference between RPIX and earnings	1.4%	0.8%	0.3%
1/3 difference between RPIX and earnings	0.9%	0.3%	-0.2%
1/3 difference between RPIX and earnings dropping to RPIX only from 2025	0.6%	0.0%	-0.5%
RPIX only	0.1%	-0.5%	-0.9%

The States of Guernsey face a very significant long term increase in the number of people likely to be highly dependent on health and social care, with the number of people aged 85 or over expected to quadruple over the next 50 years (see Figure 5.2.3), from 1700 in 2014 to more than 6500 by 2065. The cost of providing this care is currently divided, for the most part, between the Social Security LTCF and the Health and Social Services Department. A resolution passed in April 2015 as part of the Personal Tax, Pensions and Benefits Review (Billet D'Etat IV , March 2015) has already acknowledged that the LTCF is unsustainable under the current model of funding and service provision.

Figure 5.2.3 Projection of older population

Source: UK Government Actuary's Department, as at March 2014



Decision makers should be conscious that they will face successive decisions on the old age pension scheme, other costs relating to the GIF, the future of the LTCF and other expenditure (currently carried by the general revenue budget) associated with providing support services for an increasing number of older people.

The decision on whether to increase contributions for the purpose of stabilising the pension system with a more generous uprating policy could rapidly be followed by a decision on whether to increase contributions again to support the future of the LTCF[11]. The Policy Council has already provided an early indication that *"the SLAWS Working Party has advised the Policy Council that it is minded to recommend an increase in contributions of 0.5% from 1st January 2017 to address the worsening position of the Long-term Care Insurance Fund."*[12] **It is important that the States remain aware of the potential combined cost these decisions may place on the economy and the tax payer.**

These decisions must also take into consideration the long-term pressure ageing and other factors will exert on the portion of health and social care costs which will need to be met year-on-year from general revenue. In addition to the cost of providing health care to an increasing number of older people, factors such as higher levels of obesity, increasing public expectation and a trend towards increasing medical specialisation could exert an unsustainable cost pressure on Health Services. While accurately predicting how large these might be is difficult it is likely that these costs will be significant and it is therefore likely that a structural reform of the way health care is provided in Guernsey will be necessary to provide long-term stability.

Alongside the consideration of the provision of public services, the authors note the intention of the States to investigate further the enhancement of private pension provision in Guernsey. A survey conducted in 2012 (Pensions Survey, States of Guernsey, 2012) showed that less than 50% of working age people (excluding public

[11] To be presented as part of the work that is being carried out by the Supported Living and Ageing Well Working Party, demonstrating the financial demands of the adult social care system.

[12] Extract from Policy Council comment made to Billet D'État XVIII, October 2015

sector employees) were contributing to a private or workplace pension. Uptake appears to be particularly weak among younger workers and those on modest incomes.

This weakness in private pension provision is a significant risk to the States long term finances, implying as it does an increasing demand on the welfare system by people who will not have sufficient income to make them financially independent in retirement. Moves to enhance provision should be supported, albeit that a mandatory or “opt-out” workplace pension system similar to that introduce in the UK could result in a short-term reduction in consumption. The potential cost of any future private pension schemes for employers also needs to be borne in mind when considering any proposals to increase employer’s contributions to the Social Security System.

5.3. Alderney and the fiscal union

Alderney has some very significant fiscal and economic challenges to face. The population is highly sensitive to economic activity; a shortage of employment opportunities combined with a rapidly ageing population has resulted in a fall in the number of Alderney residents of working age of 15% in just 5 years. Over the same period, the population under 16 has fallen by 24%, the dependency ratio has rocketed from 0.59 to 0.72 and the median age of the population has risen to 55.[13]

With Alderney in fiscal, but not political, union with Guernsey these changes produce increasing fiscal dependence on the larger island. There is a trilemma - between the fiscal union and economic and democratic sovereignty. This is, globally, not a new issue, and at a regional level this problem is being highlighted currently in the European Union. Alderney’s reliance on service provision from Guernsey means that Alderney’s self-determination in policy making is limited, and ultimately is at the behest of Guernsey’s fiscal policies. The politics and economics are so intertwined that it will take the utmost cooperation and coordination between the islands to create a sustainable solution. For the respective governments to approach this challenge in a frank and constructive manner is commendable.

Provision of services to a small and isolated population is inevitably more expensive and, per capita, providing services to Alderney’s population will cost more than providing similar services in Guernsey. The smaller the population in Alderney becomes the more marked this difference will be. While the review of the financial relationship between the islands is not yet complete, it is unlikely that Alderney’s economy generates enough tax revenues to meet the additional unit cost.

It is not unusual for small island economies to be directly or indirectly subsidised by a larger economy. Many of the Scottish Islands for example face similar problems, but the relative size of the Scottish Islands in comparison to the UK economy is very different. Even so, remoter locations, which lack economies of scale to make the provision of a full range of government services financially viable, rarely receive the same breadth or structure of services as are provided to larger mainland communities. In some places, such as the Scottish

[13]For comparison, over the same period in Guernsey the population has increased by 1%; the working age population has decreased by 3%; the population under 16 has fallen by 1% and the dependency ration has increased from 0.48 to 0.53.

Islands, a generally long-established population continues to live there in full recognition and acceptance of these differences in provision. But the unhappy history of Alderney means that this is not the case there.

Structural changes to the way services are provided is required if the per unit cost of providing services to Alderney is to be sustained. Technological solutions to health and education services, which would provide Alderney residents with remote access to services on Guernsey or elsewhere, could provide a way both to improve access to services and to reduce the unit cost, provided the infrastructure is available to support the technology.

Ultimately, many of the issues of sustainable service provision do, or will in the future, apply to Guernsey. But they are more pressing in Alderney because of the acute lack of scale, remoter location, and older population. This combination of factors has brought it to an earlier crisis. Finding solutions to Alderney's difficulties may have the added benefit of providing some guidance for Guernsey in dealing with growing cost pressures from the ageing of Guernsey's population and the increasing tendency towards specialisation in medical services.

6. Conclusion

Guernsey's recent fiscal and economic performance has been satisfactory. While the General Revenue deficit continued for a seventh year in 2014 and is expected to continue for an eighth, the States continue to demonstrate a tight control on expenditure. While economic growth forecasts for the immediate future are not buoyant, conditions appear to be stable. However, we note that the lack of revenue growth anticipated for 2015 has led to a further reduction in the already under resourced capital programme. While this may be an expedient measure in the face of a temporary and short term lack of revenue, if subdued revenue growth persists this is not a sustainable solution.

We make particular note of the States' decision to issue a Government Bond in December 2014 and highlight the importance of a reputation for fiscal prudence, transparency and stability, especially in a jurisdiction such as Guernsey, where the economy is reliant on attracting and retaining international business. Having taken the decision to consolidate the indirect liabilities held by the States into formal and direct debt secured against tax revenues, this debt must be carefully managed if Guernsey is to protect its international reputation.

This review highlights the importance of long term public expenditure control if the States are to meet the "long-run permanent balance" objective of the Fiscal Framework. While the States have been remarkably successful at restraining expenditure growth in recent years, given the potential scale of the long term cost pressures marginal or incremental cost savings in existing services are unlikely to be sufficient. Meeting a long term expenditure challenge of this magnitude may well require structural changes to service provision. Particular attention should be given to Health and Social Care services.

The States continue to discuss and prioritise issues of long-term sustainability against the back-drop of an ageing population and the continued and open discussion of these issues is to be supported. The States have already taken the decision to increase the pension age to 70 by 2049 and this should be commended as a sign of the willingness of local policy makers to take action to tackle long-term issues. However, this change alone will not be sufficient to deal with the problems presented by long term changes. There are still considerable challenges in the short, medium and long term. It is important that policymakers continue to review fiscal policy and implement changes for both the short and long term health and prosperity of Guernsey.

Appendix 1. Extract from the Fiscal Framework

Source: Billet D'État 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', i.e. 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's 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 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. An Overview of States Financing

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

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

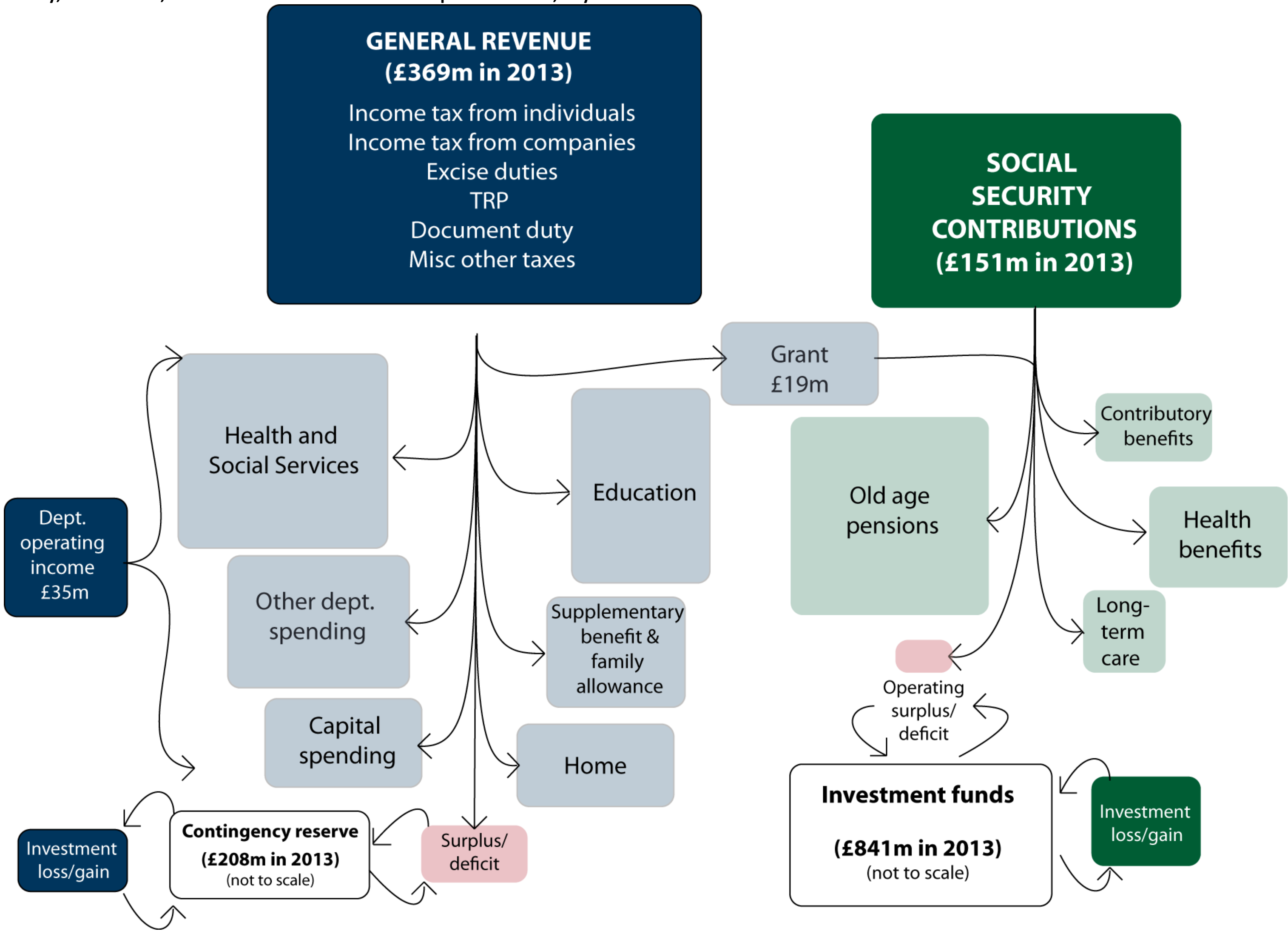
- Social Security income, derived primarily from Social Security contributions (*'the Social Security Budget'*) is used to pay for insurance-based benefits such as pensions, unemployment benefit and primary and specialist medical care subsidies.

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

The parameters of the Fiscal Framework originally covered only General Revenue income and expenditure, but this has subsequently been amended to cover the expenditure and income of the Social Security Funds and departmental operating income.

Figure B1.1b Illustration of States income and expenditure streams

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



Appendix 3. Funding Social Security

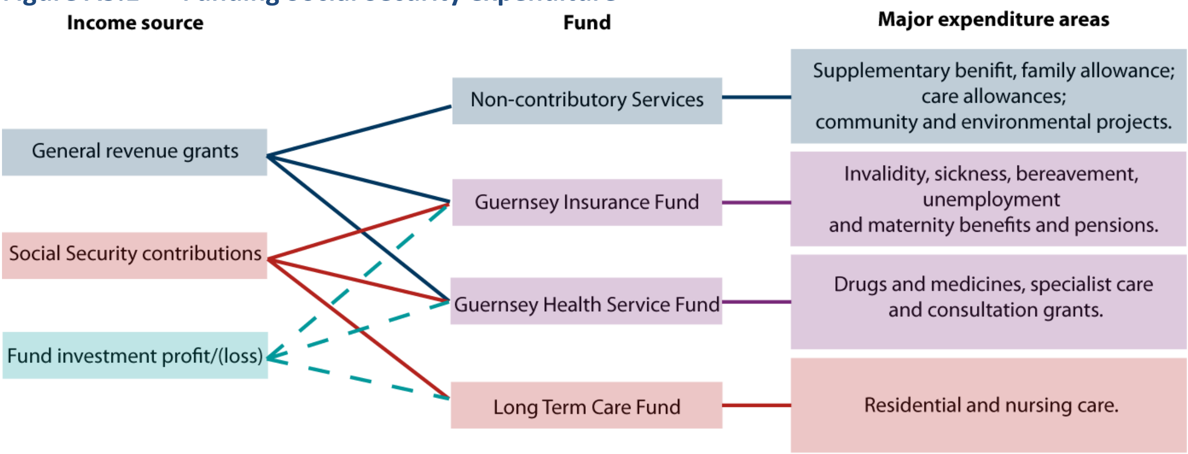
The Social Security Department is responsible for the payment of social benefits in Guernsey. The departmental expenditure is funded by a mix of grants from General Revenue and Social Security contributions (see **Figure A.5.1**).

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

Income is channelled into four distinct areas:

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

Figure A5.1 Funding Social Security expenditure



Appendix 4. 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		Process adopted for prioritising projects within the capital investment program
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 LTCF). Typically, payment of these benefits is dependent on the contributions record of the claimant.
Employee Tax Instalments system	ETI	System by which income tax from employees is paid directly to income tax by their employers on a “pay-as-you-earn” basis.
Expenditure, gross departmental revenue		Non-capital expenditure by States Departments including expenditure funded by departmental operating income.
Expenditure, net departmental revenue		Non-capital expenditure by States Departments presented net of expenditure funded by departmental operating income.
Expenditure, total revenue		All expenditure presented in the General Revenue Accounts used to calculate the overall surplus/ (deficit); i.e. revenue expenditure plus routine capital expenditure and the allocation of funds to the capital reserve.
Fiscal and Economic Plan		Sub-section of the SSP outlining current fiscal and economic policy objectives in line with the Fiscal Framework.
Fiscal Framework	FF	Policy Council document outlining core fiscal policy and defining parameters for the General Revenue Budget.
Financial Transformation Programme	FTP	A series of projects designed to identify and deliver savings to the Revenue Budget. The programme is scheduled for completion in 2015.
Formula led expenditure		Expenditure areas dependent on a pre-defined formula and/or number of claims such as payment of the revenue grant to Social Security (calculated as a percentage of SSD contributions income), legal aid and supplementary benefit.
General Revenue Accounts/Budget		Central budget/accounts produced by Treasury and Resources, which cover the majority of public sector expenditure excluding that funded by Social Security contributions.
Gross Domestic Product	GDP	Macro-economic indicator measuring the size of the economy. In Guernsey, this is the sum of all remunerations, company and self-employed profits and other income, such as income from property and profits of public sector trading boards.
Guernsey Health Service Fund	GHSF	Fund managed by the Social Security Department with income sourced predominantly from Social Security contributions, but also receiving a revenue grant. This fund covers expenditure on health benefits.

Guernsey Insurance Fund	GIF	Fund managed by the Social Security Department with income sourced predominantly from Social Security contributions, but also receiving a revenue grant. This fund covers expenditure on contributory benefits such as pensions and unemployment.
Income, departmental operating		Any income paid directly to a States department which is not incorporated as General Revenue income. This includes fees and charges for service, rents received, recoveries and funds received from SSD in payment for services. Totals for departmental expenditure are typically presented net of departmental operation income.
Income, net 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, gross general 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.
Long Term Care Fund	LTCF	Fund managed by the Social Security Department with income sourced entirely from Social Security contributions. This fund covers expenditure on long-term care for older people.
Non-contributory benefits		For the purpose of this report, non-contributory benefits are considered to be any benefits (incl. administration costs) administered by SSD but funded directly from General Revenue. Payment of non-contributory benefits is independent of the contributions record of the claimant.
Organisation for Economic Co-operation and Development	OECD	International organisation promoting co-ordinated economic development and international co-operation.
Personal Tax, Pensions and Benefits Review	PTR	An on-going holistic review of the personal tax, pensions and benefits regimes in the context of long-term pressures on expenditure.
Revenue Grant		A grant paid from General Revenue to SSD to supplement the GIF and GHSF, calculated as a fixed percentage of contributions received.
Social Security Accounts/Budget		Accounts/ budget produced by SSD covering expenditure on contributory and non-contributory benefits. Because of the revenue grant made to the GIF and GHSF, and the funding of non-contributory benefits from General Revenue, there is some overlap between the SSD and General Revenue accounting systems.
Social Security Department	SSD	Department responsible for the collection of Social Security contributions and the payment of contributory and non-contributory social benefits.
States Strategic Plan	SSP	Annual central policy document outlining States Fiscal and Economic, Social and Environmental policy.
Social Welfare Benefits Investigation Committee	SWBIC	Working Party formed to investigate and present recommendation on the future of welfare benefits in Guernsey. This work is focus on efforts to combine the current rent rebate and supplementary benefit systems (which operate in tandem) into a single means-tested system.
Supported Living and Ageing Well Strategy	SLAWS	An on-going review of support and long-term care services for adults.
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.