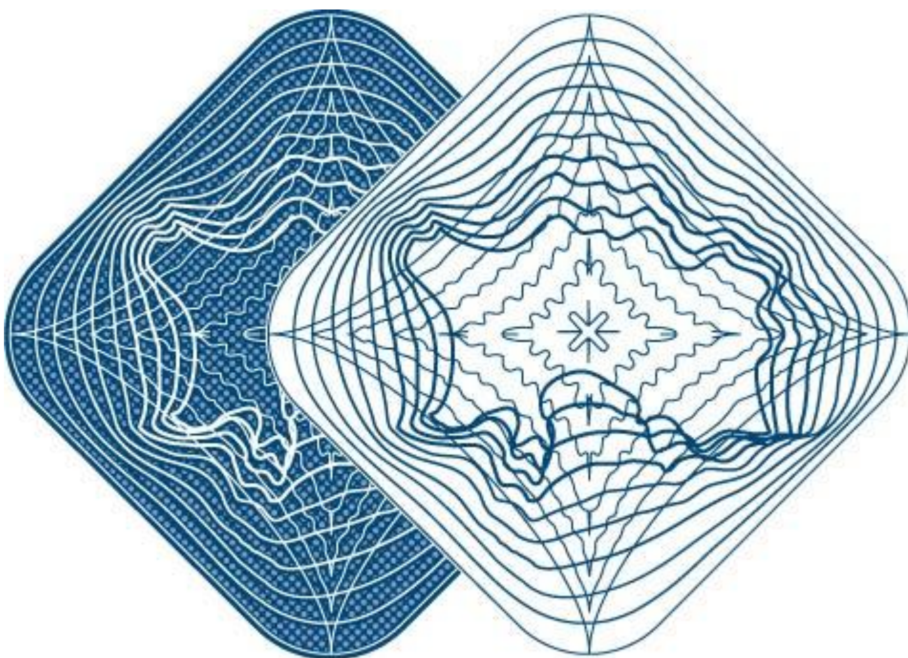
Jersey's
Fiscal Policy Panel
Annual Report
October 2012



Introduction

This is the fifth annual report of the Fiscal Policy Panel. As required by the States' Fiscal Framework, the report makes recommendations to the Minister for Treasury and Resources and the States on Jersey's fiscal policy and on additions to or subtractions from the Stabilisation Fund and the Strategic Reserve. These recommendations are based on an assessment of the Jersey economy in the context of overseas economic developments and the risks and uncertainties that the Island faces.

The Panel's work is guided by five key principles. These are:

1. Economic stability is at the heart of sustainable prosperity;
2. Fiscal policy needs to be focused on the medium-term;
3. Policy should aim to be stable and predictable;
4. Supply in the economy is as important as demand; and
5. Low inflation is fundamental to the competitiveness of the economy.

In making its recommendations, the Panel is guided by its understanding of the preferences of Islanders. The Panel feels that Islanders want the States to be prudent, avoid government borrowing and create the conditions for economic growth while respecting the Island's cultural heritage, maintaining the competitiveness of the economy and keeping inflation low.

Since it was formed in October 2007, the Panel has visited the Island on many occasions. Its work has benefited greatly from the discussions it has had with many people and institutions on and off the Island: its job would be much more difficult without their generosity. The Panel is also grateful for the invaluable support provided by the staff of the States of Jersey, in particular the States of Jersey Economics Unit.

More information about the Panel, including previous reports, can be found at www.gov.je/FiscalPolicyPanel.

Key points

International economic outlook

- Global economic growth remains below the levels seen immediately prior to the global financial crisis, but largely in line with the longer-run average.

- Growth forecasts have been revised down. The International Monetary Fund's July forecast is for global growth of 3½% in 2012 and 4% in 2013.

- For the advanced economies, downward revisions suggest that output will remain below the trend level in 2013. Growth in the advanced economies is forecast to remain well below that observed pre-2008.

- As a result of growth expectations being revised downwards, the pressure on commodity prices has eased somewhat since the spring.

- Risks to the downside have increased due to the ongoing sovereign debt crisis in the euro area, the resulting fiscal consolidation and financial market turmoil. Should policy action prove insufficient to address these threats, the global economy could be slowed further.

Jersey economic outlook

- Measured Gross Value Added (GVA) for the Jersey economy fell by 1% in 2011. The finance sector has stabilised, with GVA in real terms remaining flat over the year. The non-finance sector (excluding rental) declined by 2%.

- The Panel forecast GVA growth of between -3% and 1% in 2012, with similar performance in 2013.

- There remains significant uncertainty around these forecasts, with the risks primarily to the downside. The Bank of England Official Bank Rate is unlikely to increase during the forecast period and will potentially be reduced further. This would reduce bank profits, hence measured GVA, but have limited direct impact on real activity in Jersey. Heightened uncertainties at a global level also offer the potential to add a further drag to growth.

Public finances

- The Panel welcomes the move towards medium-term financial planning and the publication of the first Medium Term Financial Plan.

- Despite an apparent structural improvement in income tax receipts, there has been no material change in the forecast for States income as this has been offset by the weaker economic outlook. Total income is expected to be £7m lower, and income tax £1m lower, by 2014 than at the time of the 2012 Budget.

- Department net revenue expenditure is planned to be £31m higher in 2013 and £33m higher in 2014 than in the 2012 Budget.

- The amounts proposed to be put aside for provisions and contingencies are £13m lower in 2013 and £14m lower in 2014 compared to the 2012 Budget. As a result there will be less flexibility each year to deal with changing priorities and emerging pressures.

- The projected Consolidated Fund balances of £12m at the end of 2014 and £10m at the end of 2015 look tight. There appears to be little flexibility if income turns out to be lower or expenditure higher than expected.

- The gross capital allocation in the MTFP has significantly increased from £38m to £56m (£18m increase) in 2013 and £36m to £89m (£53m increase) in 2014 compared to the 2012 Budget. In 2015 the gross capital allocation is planned to be relatively high as well at £77m.

- It is planned to fund these increases in capital expenditure mainly from one-off receipts from utilities and other sources, property disposals, and anticipated carry forwards in future years. This may conceal a structural imbalance between expenditure and income.

- Adjusting the States financial position for the timing of expenditure, to better reflect its impact on the economy, suggests much higher deficits each year - £90m in 2012, £74m in 2013, £93m in 2014 and £62m in 2015. While fiscal stimulus in 2012 and 2013 is justified by the weak economy it is too early to say whether the large adjusted deficits in 2014 and 2015 will be warranted.

- The reliance on one-off receipts to fund capital expenditure in 2012 and 2013 is justified by the need to deliver additional fiscal stimulus in the

light of the weakening economy although there is little indication in the MTFP that this has been achieved by a discretionary stimulus which meets the 3Ts (timely, targeted and temporary). Adopting the same approach out to 2015 risks concealing the true underlying balance between expenditure and income.

- The MTFP has the flexibility to adjust the fiscal balance over the course of the next three years as economic conditions become more apparent. However, it is not clear how this process would be conducted and whether there would be the fiscal discipline required to do so.

- The medium-term sustainability of States' finances has weakened between Budget 2012 and the MTFP despite higher income tax receipts. This is because revenue expenditure plans have increased using the higher income tax receipts, allocating growth funding and reducing the amount put aside for contingencies. Although the current balance remains in surplus, gross capital allocations are planned to increase significantly (funded by one-off receipts) which means the capital balance is likely to be in significant deficit over the MTFP period.

- The short-term economic outlook has deteriorated which means that future income tax revenues may not grow as quickly as assumed in the MTFP. It is more likely now that income tax revenue will be in the lower part of the forecast range by 2015.

- Significant long-term pressures remain on States' finances which require a prudent approach now and in coming years to prevent adding to future fiscal challenges.

Recommendations

1. The Panel's assessment of the economic outlook for the Jersey economy has been downgraded for 2012 and 2013 and there are indications that significant spare capacity will remain in the economy over this period. This leads the Panel to advise that the States should act now to give discretionary fiscal support to the economy in 2012 and 2013 and if practical to a greater extent than set out in the MTFP.

2. While the consideration of additional discretionary stimulus should not be limited purely to capital expenditure it is clear that with such significant capital allocations over the life of the MTFP consideration could be given as to whether, in a timely, temporary and targeted manner:

   - Capital allocations in 2012 and 2013 can be spent in the year of allocation
   - Capital allocations from 2014 and 2015 can be brought forward to 2012 and 2013
   - Unspent allocations in 2012 from previous years can be spent as quickly as possible in late 2012 and 2013

3. The extent of stimulus should not be limited by the balances on the Consolidated or Stabilisation Funds. The States should give consideration as to the best way to fund needed stimulus if it is constrained by the availability of funding from these sources, not least because any constraint would be one of cash flow and funds could be repaid from future revenue.

4. It is too early to judge whether the stimulus that will be provided to the economy in 2014 and 2015 by capital expenditure financed by one-off receipts will be warranted but contingency plans should be made as to what measures could be implemented to reduce the extent of the stimulus if economic conditions merit such an approach.

5. No transfers into the Stabilisation Fund are recommended in 2012 or 2013. However, further consideration needs to be given as to how the Stabilisation Fund will be rebuilt through countercyclical fiscal policy, once the economy begins to recover. The Panel does not recommend a transfer into or out of the Strategic Reserve at this stage.

6. The Panel cannot rule out that there is an underlying structural imbalance between expenditure and revenue. The Panel's view is that further analysis is required by the Treasury and Resources Department to consider the nature of proposed capital expenditure, the way it is funded and what it implies for the underlying position of States' finances. If this analysis suggests there is a structural deficit then consideration should be given to its extent and nature, including a more detailed plan of action to rectify it.

7. The Panel have had to make significant adjustments to the financial forecasts presented in the MTFP to try to assess the underlying economic impact of the proposals. In future the presentation of States' finances would be more informative, leading to a better informed policy debate, if these types of adjustments were already included in the analysis accompanying any proposals in the MTFP or Budget.

Section 1 - The Economic Outlook

Key points

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- For the advanced economies, downward revisions suggest that output will remain below the trend level in 2013. Growth in the advanced economies is forecast to remain well below that observed pre-2008.
- As a result of growth expectations being revised downwards, the pressure on commodity prices has eased somewhat since the spring.
- Risks to the downside have increased due to the ongoing sovereign debt crisis in the euro area, the resulting fiscal consolidation and financial market turmoil. Should policy action prove insufficient to address these threats, the global economy could be slowed further.

Jersey economic outlook

- Measured Gross Value Added (GVA) for the Jersey economy fell by 1% in 2011. The finance sector has stabilised, with GVA in real terms remaining flat over the year. The non-finance sector (excluding rental) declined by 2%.
- The Panel forecast GVA growth of between -3% and 1% in 2012, with similar performance in 2013.
- There remains significant uncertainty around these forecasts, with the risks primarily to the downside. The Bank of England Official Bank Rate is unlikely to increase during the forecast period and will potentially be reduced further. This would reduce bank profits, hence measured GVA, but have limited direct impact on real activity in Jersey. Heightened uncertainties at a global level also offer the potential to add a further drag to growth.

1.1 International outlook

In its July Update the International Monetary Fund (IMF) forecast that the world economy will grow by 3.5% in 2012, increasing to 3.9% in 2013, largely in line with average growth rates over the last thirty years. The advanced economies, however, are expected to substantially undershoot long-term average growth rates in 2012 and 2013. The IMF's most recent (April) estimate of the output gap for the advanced economies suggested GDP would be 2.8% below potential in 2013.

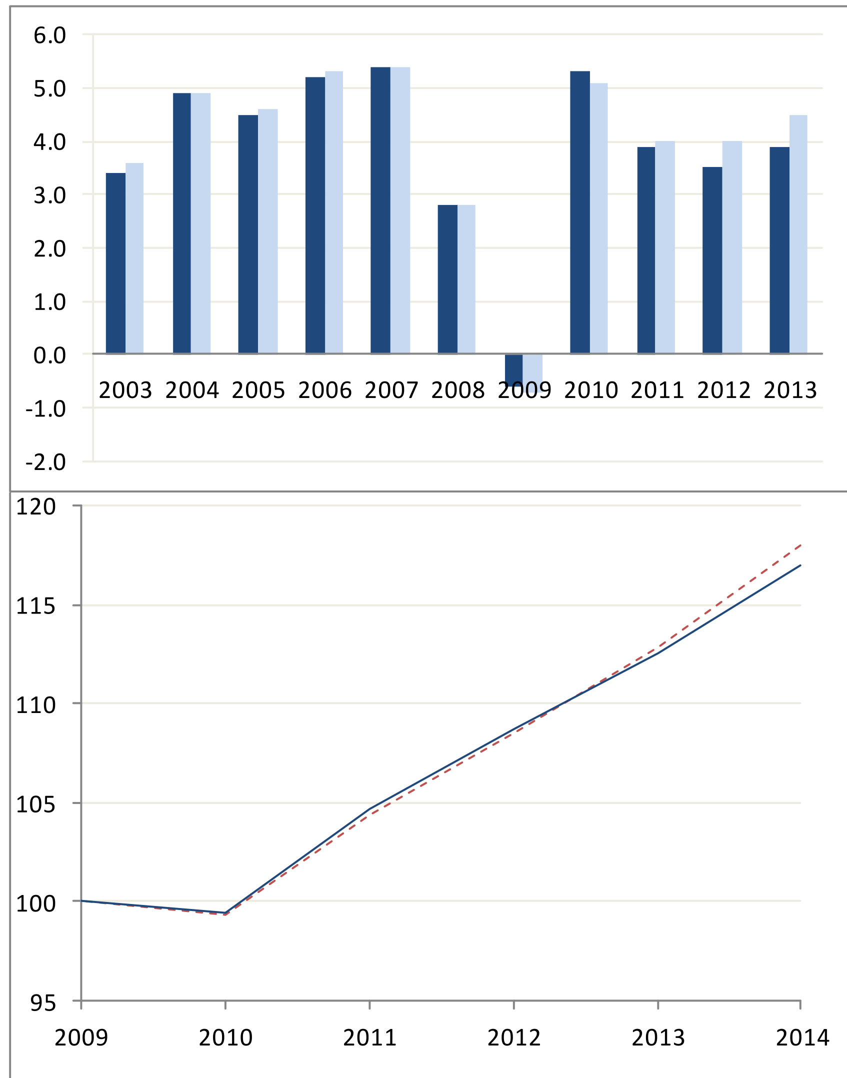
Figure 1.1

Global Growth

Top panel: % change in world GDP on previous year, pale bars are September 2011 estimates/forecast

Bottom panel: index of world GDP (2009 = 100), dashed line is September 2011 estimates/forecast

Source: IMF World Economic Outlook, September 2011 / July 2012 Update



Since our last report, the IMF's growth forecasts for both the advanced economies and emerging economies have been revised downwards by approximately 0.5 percentage points for 2012 and 2013. However, the outturn growth for both 2009 and 2010 has been revised upwards, so there is less than 1% difference in the forecast size of the global economy by 2014 (Figure 1.1). The Managing Director of the IMF, Christine Lagarde, has recently stated that global growth forecasts will be cut again when revised forecasts are published later this month.

This constrained growth is primarily a result of the ongoing sovereign debt crisis in the euro area, the resulting fiscal consolidation and the financial market turmoil associated with it. In the medium term, these factors are likely to persist and growth is likely to continue to be constrained.

The Organisation for Economic Co-Operation and Development (OECD) has also revised its growth projections downwards, particularly for the large European economies. The OECD's forecast is for the UK economy to contract by 0.7% in 2012, a considerable downward revision from the 0.5% growth they anticipated earlier in the year. The Bank of England's August Inflation Report has also revised the forecast down for UK growth in both 2012 and 2013, but to a much smaller extent. The OECD has made smaller downward revisions to the forecasts for Germany (revised from 1.2% growth to 0.8% growth), France (revised from 0.6% to 0.1%) and Italy (revised from -1.7% to -2.4%).

In the United States, the Congressional Budget Office estimate that if measures are not put in place to prevent (or otherwise mitigate the impacts of) proposed tax increases and spending cuts, it would lead to the United States returning to recession in 2013. There have been concerns too that growth in a number of emerging economies will continue to slow, after picking up in 2010. In particular, growth forecasts have been revised downwards for China, India and Brazil.

The forecasts from the IMF and OECD represent the central scenario, assuming that policy action is sufficient in the euro area and in the United States. What is of more concern is the increase in downside risks which intensified during the first half of 2012. In the event that policy action proves insufficient to tackle the issues of sovereign debt and financial market concerns, the global recovery could slow further. Whilst quarter 3 of 2012 has ended with some degree of optimism about policy both in the euro area and the US, the Panel would caution against assuming that the risks have fully subsided.

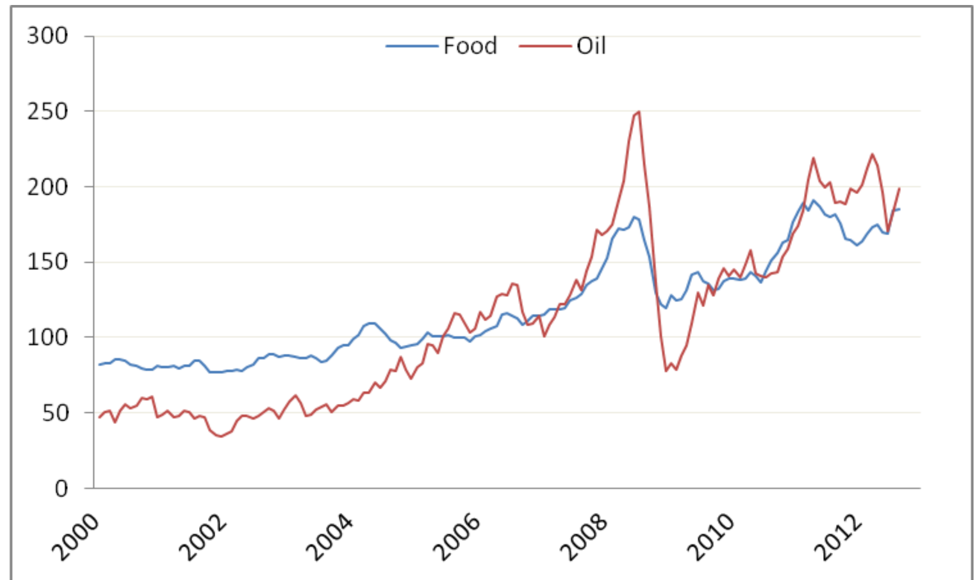
One consequence of the more pessimistic global economic outlook is that some commodity price pressures have begun to ease. Oil prices have fallen by over 10% since March 2012, reducing the annual rate of increase below 5%, which should provide some relief to measured inflation compared to recent years. Food prices have also shown subdued growth of around 2% over the last twelve months.

Figure 1.2

Commodity Prices

Nominal food and oil prices index 2005=100

Source: International Monetary Fund, index of primary commodity prices – September 2012



Interest rates in the euro area, UK and US are at historic record lows. The European Central Bank (ECB) cut rates from 1% to 0.75% in July, while US and UK rates have remained at record lows since the early months of the 2008/09 downturn. The Federal Reserve has stated that they anticipate the period of exceptionally low US rates to continue until at least mid 2015. Market expectations are that the UK Official Bank Rate will not rise above its current level in 2012 or 2013.

Overall, the Panel's assessment is that the international economic outlook has weakened somewhat since its October 2011 Update and that risks to the downside are highly significant.

1.2 Jersey economic outlook

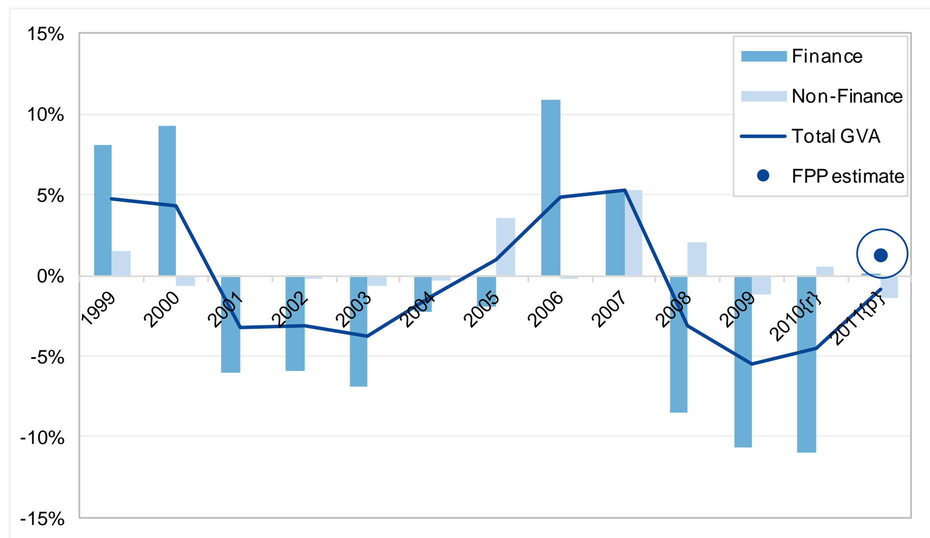
The level of economic activity in Jersey, as measured by Gross Value Added (GVA), fell by 1% in real terms in 2011. This is slightly below the Panel's previous forecast of 0 - 3% growth and represents the fourth consecutive year of contraction.

Figure 1.3

A breakdown of Gross Value Added growth

Annual % change

Source: States of Jersey Statistics Unit



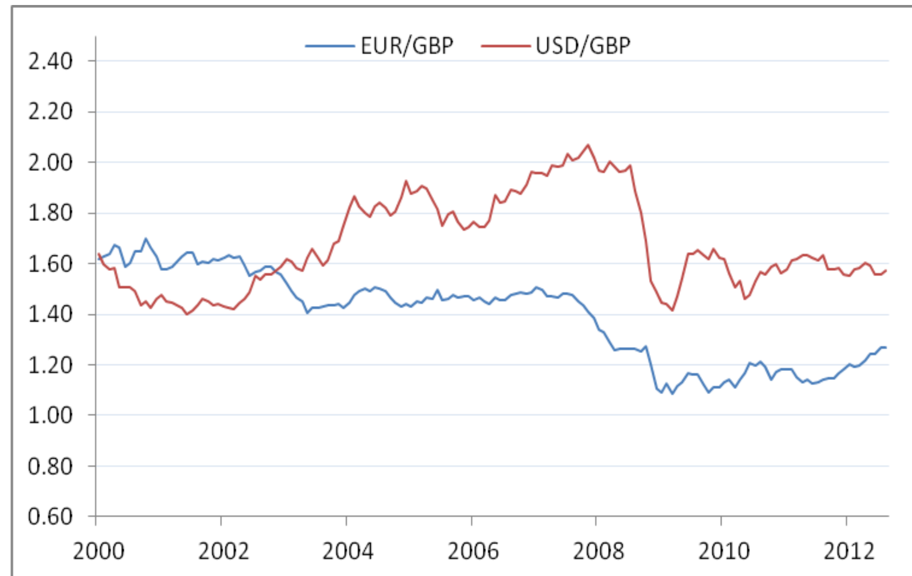
As an export economy, Jersey's competitiveness is influenced by the sterling exchange rate. In 2012, sterling has remained relatively steady against the dollar, with both currencies being seen as relative safe havens. The exchange rate has been within +/-5% of $1.60 for the last two years but remains well below the pre-crisis level of $2 seen in 2007 and early 2008. Similarly, while the value of sterling has appreciated almost 10% against the euro over the last twelve months, it remains significantly below the levels seen before 2008. The relatively low exchange rate should therefore be more favourable for Jersey's competitive position than was the case in the pre-crisis years.

Figure 1.4

Sterling exchange rates

Euros per pound
US dollars per pound

Source: Bank of England



Financial Services Sector

GVA in the finance sector stabilised in 2011, following three consecutive years of decline which saw sectoral GVA fall by an average of 10% per annum in real terms. Much of the decline has been a result of low profits in the banking sector which have been primarily a result of ongoing low interest rates, which limit the margin that can be made on deposits in Jersey (as described in Box 1 of the Panel's 2009 Annual Report). Since the Panel's October Update, market expectations for interest rates have fallen further and they are now considered unlikely to rise in either 2012 or 2013.

Her Majesty's Treasury (HMT) publish a summary of independent forecasts for the Official Bank Rate. Of the twenty one September forecasts included, none anticipate the rate to be higher by quarter 4 of this year, with only two of the forecasts suggesting it will be any higher by quarter 4 of 2013. At the time of the Panel's last report, the average rate of the September 2011 forecasts was 0.7% for quarter 4 of 2012 but in the most recent forecasts this has fallen to 0.4% for 2012 with an average of 0.5% for 2013.

Looking forward, the 2012 Survey of Financial Institutions (SFI) analysed future expectations for the finance sector, based on questions asked in the Business Tendency Survey (BTS) carried out in quarter 2 of 2012. This suggested that 54% of firms in the finance sector (weighted by employment) expected profits in 2012 to be higher than in 2011 in nominal terms, but the majority of those expected the increase to be less than 5%. Considering the net balance of companies responding in each range (e.g. the number expecting a 5%-10% increase minus those expecting a 5%-10% decrease),

the data in the Survey of Financial Institutions would suggest that profits might grow by approximately 2% in 2012 – a likely small fall in real terms.

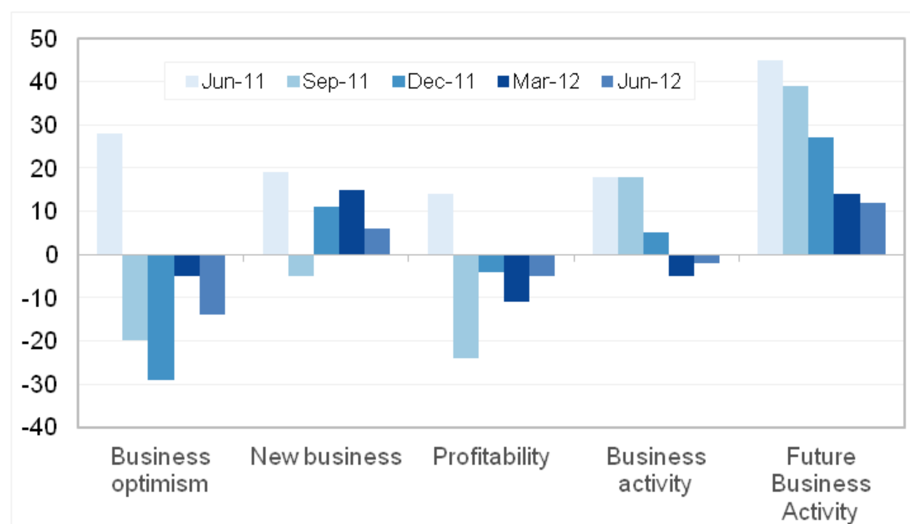
Figure 1.5 illustrates the responses by finance companies to the June 2012 BTS. Compared to a year earlier, respondents were more negative (or less positive) about business optimism, new business, profitability, business activity and future business activity. However, business optimism, new business and profitability were each more positive (or less negative) than the September 2011 BTS responses considered in the Panel's October update. The balance of financial services businesses (weighted by employment) reported declines in both profitability and business activity in quarter 2. Only new business and future business activity remain positive.

Figure 1.5

Financial services business tendency

% net balance of respondents reporting an increase (weighted by employment)

Source: States of Jersey Statistics Unit



The Panel met with representatives of the finance industry and key institutions locally in July and the data appear consistent with the views expressed to the Panel in these discussions - that firms expected little change in the current environment for the foreseeable future and that while risks and opportunities remained, profits were most likely to remain relatively flat over the next 1-2 years.

The Jersey Financial Services Commission (JFSC) data for the banking sector in the first half of 2012 show that on an annualised basis, net interest income, total income and net profits are lower than in 2011, though the level of bad debt provision appears to have fallen significantly. However, these data can be very volatile from quarter to quarter and affected by fluctuations in a small number of banks between quarters. It is therefore not possible to draw conclusions from these data about the performance of the banking sector as a

whole this year, although subsequent data will show whether these trends continue.

The JFSC data indicate that the value of bank deposits has also fallen but this decrease may be partly explained by currency movements, which have reduced the sterling value of non-sterling deposits. It is worth noting that the JFSC data are collected only from Jersey subsidiaries and include overseas branches of Jersey banks but do not include the Jersey branches of overseas banks and do not therefore cover the whole banking sector in Jersey.

JFSC data for fund management indicate a relatively flat picture, with the net asset value of funds increasing in quarter 1 before falling back to its December 2011 level during quarter 2. Investment business assets under management have remained relatively flat. In company administration, there were 1204 companies incorporated during quarters 1 and 2, resulting in a 1% increase in the number of live companies on the register. The JFSC does not collect data for trust company businesses.

Banking profits made up 77% of finance sector profits in 2011. With interest rates anticipated to remain low in the medium term, banking profits are likely to continue to be restricted. As a result, the finance sector is anticipated to remain relatively flat. However, there are a number of external factors which present both opportunities and threats.

The UK government's white paper on the proposals of the Independent Commission on Banking (Vickers report) envisages retail banks being ring-fenced by 2019. Most banks in Jersey are likely to be exempt from this requirement, due to a proposed de minimis threshold of £25 billion of deposits. However, those banks which are affected are likely to make up a considerable proportion of employment and profits in the Jersey banking sector. The proposals may result in some banks having to adapt their business models. Further, there is still some uncertainty about how the proposals will be applied. Banks also continue to be impacted by the Basel III banking regulations.

The Rest of the Economy

GVA for the non-finance sector (excluding the rental income of private households) declined by 2% in 2011. The majority of the decline was due to a 5% decline in construction GVA and a 16% decline in the output of the agriculture sector. Wholesale and retail was the only sector to exhibit any growth in 2011, with GVA increasing by 2%.

Figure 1.6 shows the responses of the non-finance sectors of the economy to the June 2012 Business Tendency Survey. The weighted net balance of

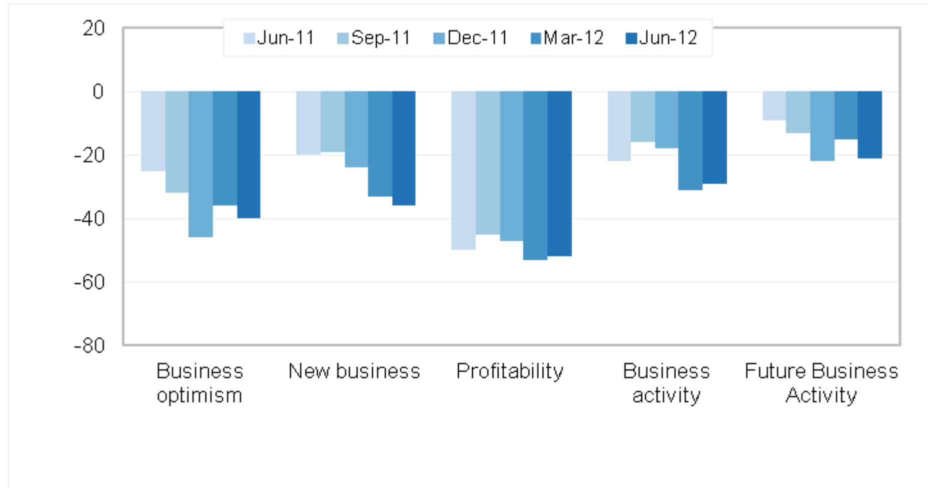
respondents remains negative for business optimism, new business, profitability, business activity and future business activity. Profitability, in particular, has remained strongly negative over the last year.

Figure 1.6

Non-Finance business tendency

% net balance of respondents reporting an increase (weighted by employment)

Source: Jersey Statistics Unit



In recent years, GVA in the non-finance sector (excluding rental) has experienced some individual years of strong growth in 2005 and 2007 and a significant decline in 2009 but in general has been less volatile than finance (Figure 1.3). After growth of 0.6% in 2010, real GVA fell by 1.7% in 2011. Figure 1.7 demonstrates that growth in 2010 occurred in spite of continuing negative sentiment demonstrated by the Business Tendency Survey but this negative sentiment has intensified in 2012.

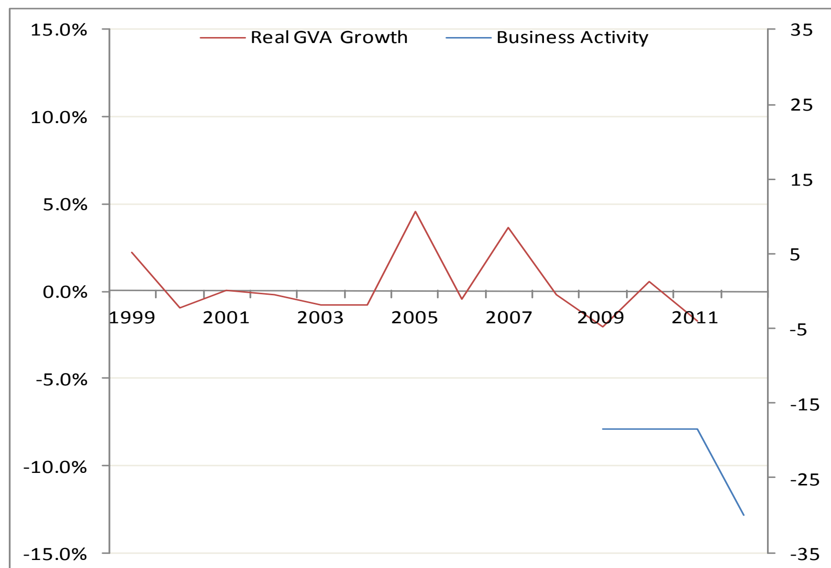
Figure 1.7

Non-Finance GVA Growth

Real GVA growth excluding financial intermediation and rental, year on year growth (LHS axis)

Response to Business Activity question on Business Tendency Survey (averaged over each year) (RHS axis)

Source: Jersey Statistics Unit



In the second quarter of 2012, retail sales volumes decreased by 7% compared to the same quarter a year earlier, but showed a 2% increase on the previous quarter, on a seasonally adjusted basis. On an annual basis, the

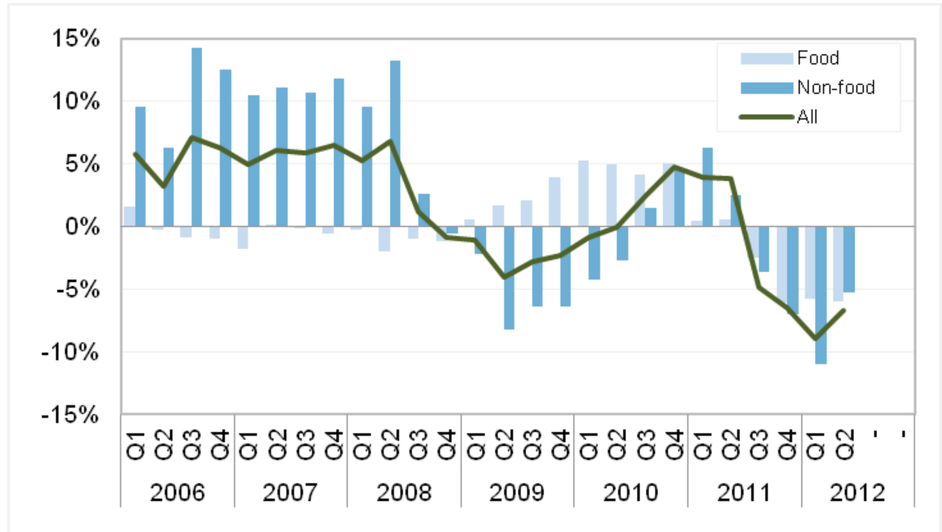
predominantly food sector declined by 6% and the predominantly non-food sector by 5%. Footfall in St. Helier (measured by a counter in King Street) has also declined over the last year. When the Panel met with representatives of the retail sector in July it was clear that these trends were born out by their experience and that the weak local labour market and wider economic conditions had impacted on spending in the local economy, combined with ongoing competition over the internet from off island retailers.

Figure 1.8

Retail sales performance

Seasonally adjusted annual change in volume, %

Source: States of Jersey Statistics Unit



The total number of visitors to Jersey increased by 1% to 689,000 in 2011, following a 0.3% increase in 2010. 2011 saw increases in staying leisure visitors, those visiting friends and relatives, business visitors and day trippers. Data for the first seven months of 2012 suggest that the volume of staying business visitors has remained relatively stable compared to 2011 but there has been a fall in the number of staying leisure visitors.

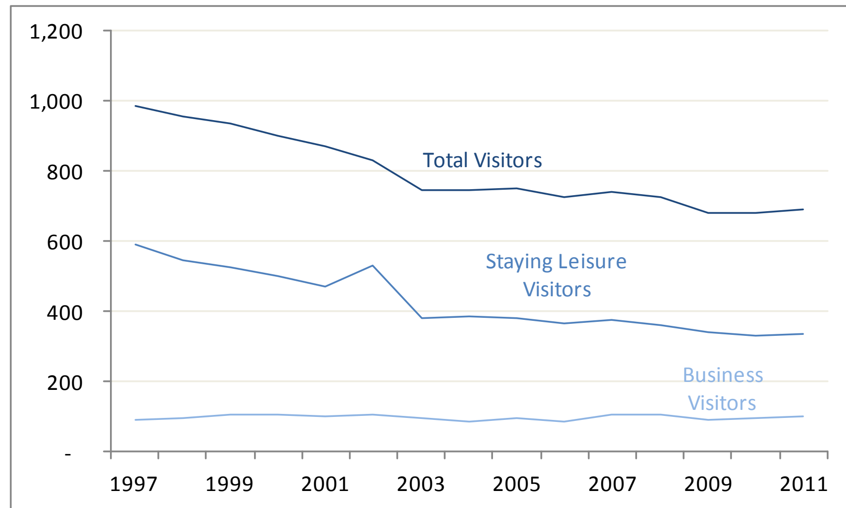
Room occupancy rates also increased slightly to 62% in 2011. However, when the Panel met with representatives of the tourist industry, it was suggested that high discounting of room rates was leading to pressure on yields.

Figure 1.9

Tourism trends

Number of visitors, 000s

Source: Jersey Tourism



The construction industry in 2011 made up 6.5% of the economy, making it one of the largest non-finance sectors of the economy. The Business Tendency Survey from June 2012 shows that business activity, new business and profitability are falling for the majority of firms. The Panel met with representatives from the construction industry who confirmed that the industry is going through a significant slowdown with order books emptying, less new business and a real risk of job losses. Whilst the States have allocated £27.1m to construction work on social housing, the full impact of this has not yet fed through to construction firms.

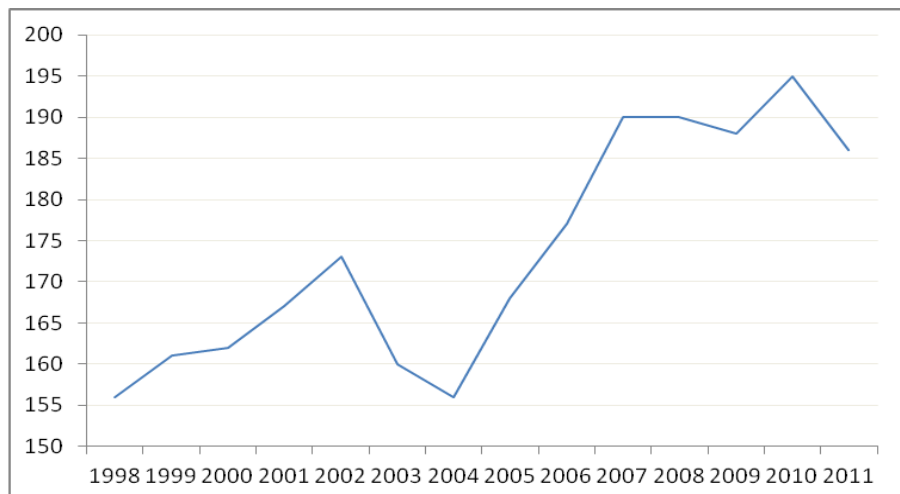
The GVA data available to date suggests that the construction industry had not had any significant downturn by 2010, but saw output shrink in 2011. Whilst GVA has fallen by 2.1% since 2008, this has not been as steep as the downturn experienced in 2002-2004 where real GVA in the sector fell by almost 10% over two years.

Figure 1.10

Construction GVA

Real GVA (£ million)

Source: States of Jersey Statistics Unit



1.3 Labour Market

The economic downturn has continued to impact on unemployment levels in 2012. The number Actively Seeking Work (ASW) had increased to 1,670 by August 2012, the last available data, 320 higher than a year. However, recent months have seen something of a reversal of previous increases with the August total representing the third successive monthly fall, on a seasonally adjusted basis. The internationally comparable International Labour Organisation (ILO) rate of unemployment was last measured in March 2011 and stood at 4.7%, an increase from 3.0% in the summer of 2010. Since March 2011 the seasonally adjusted ASW measure of unemployment has risen by 36% but it will not be apparent how much the ILO rate has increased over the same period until the Annual Social Survey is released in December.

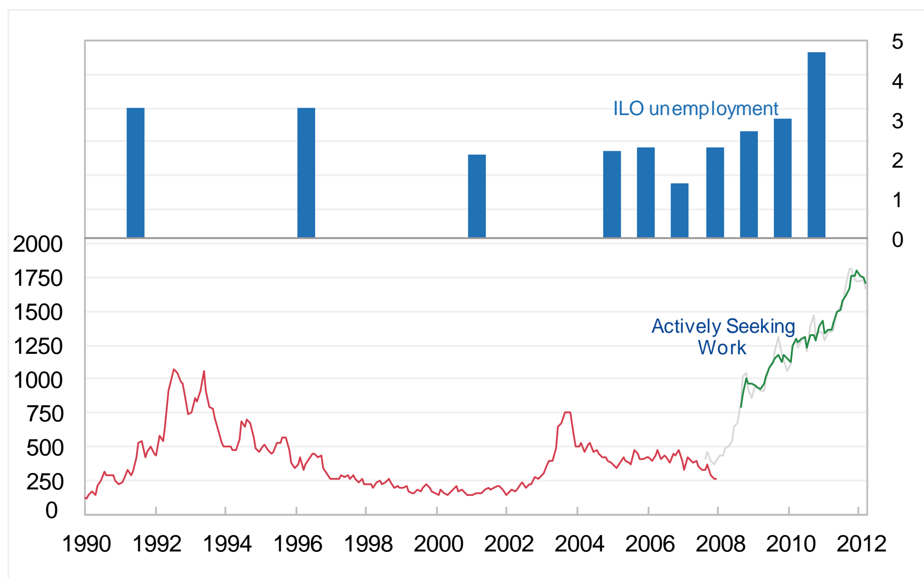
Figure 1.11

Changes in unemployment

Upper Panel: ILO unemployment (% of working age population)

Lower Panel: Number registered as unemployed and actively seeking work. Red line is historic series. Grey line is new series, not seasonally adjusted. Green line is new series, seasonally adjusted

Source: States of Jersey Statistics Unit



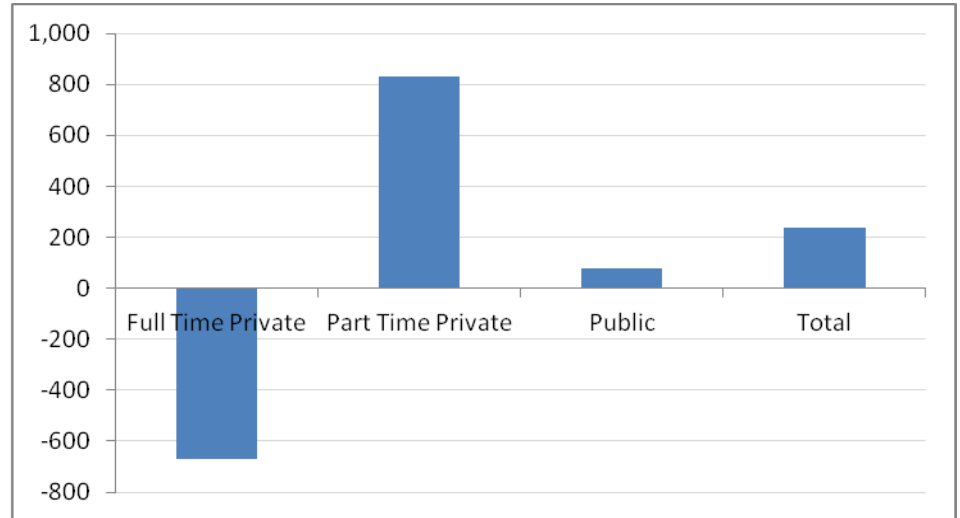
Overall employment, however, grew by almost 1% during 2011. Total employment in 2011 was the highest for at least fifteen years, the period over which comprehensive figures have been available. However, this masks a fall in the proportion of full time workers which made up only 80% of the private sector workforce in December 2011, compared to 82% in December 2008. Full time private sector employment has declined since December 2008, but there has been a larger increase in part time employment (Figure 1.12).

Figure 1.12

Changes in employment

Changes in headcount in the public and private sectors between December 2008 and December 2011

Source: States of Jersey Statistics Unit



There has also been a sectoral shift in employment, with 670 fewer employees in financial and legal activities over the three years to December 2011, representing a 5% reduction. The biggest absolute increase in private sector employment has been in education, health and other services. However, the largest increase in part-time employment has been in retail occupations, which have made up over half of the increase in part-time employment since December 2008 - a period in which full-time retail employment has fallen.

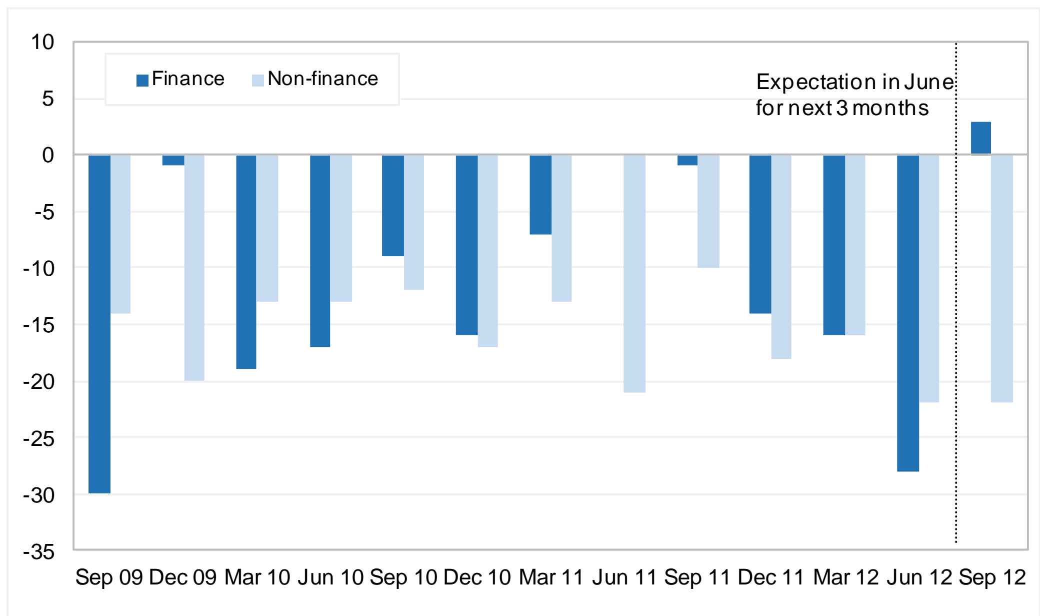
In the BTS 41% of finance firms reported a reduction in employment in the second quarter of 2012, with only 13% reporting an increase. Similarly, 29% of non-finance respondents reported a reduction in employment, with only 7% reporting an increase. However, while non-finance firms remained negative about future employment prospects, finance sector respondents were relatively neutral. This should be seen in the context of the consistently negative responses over recent years, particularly for non-finance, in spite of the relatively flat overall employment levels in 2009 and 2010 and growth in 2011.

Figure 1.13

Employment trends in key sectors

Weighted net balance reporting increase in employment

Source: States of Jersey Statistics Unit



1.4 Inflation

Retail Price Index (RPI) inflation fell significantly to 3% in June from 4.7% in March 2012. The primary reason for this was the effect of the increase in GST in June 2011 falling out of the annual calculations. However, RPI inflation remained slightly above the UK rate of 2.8% in June.

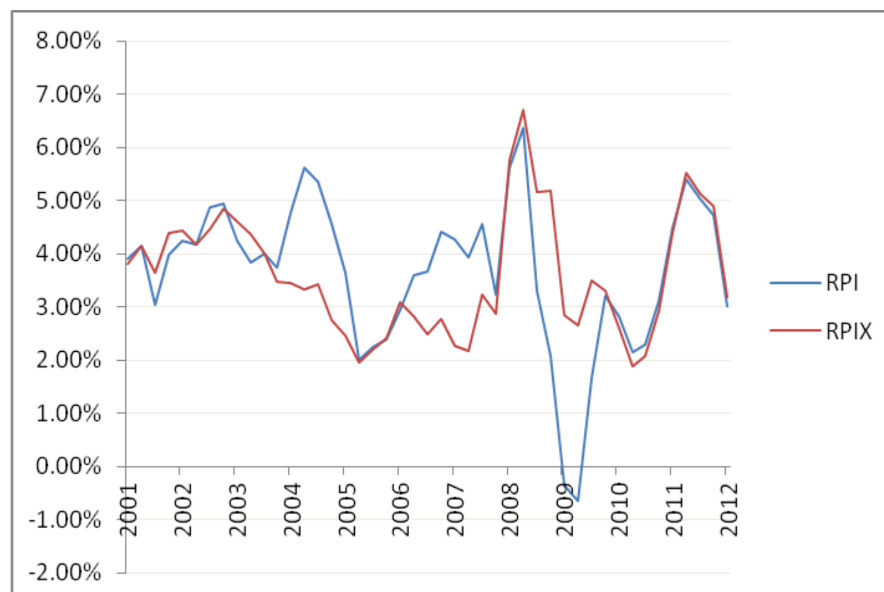
RPI(X) excludes the impact of mortgage interest payments. This measure of inflation was running at 3.2% in June 2012, significantly down from 4.9% in the previous quarterly report. This rate is also slightly above the UK level of 2.8%.

Figure 1.14

Inflation in Jersey

Annual % change

Source: States of Jersey Statistics Unit



Given the recent trends in commodity prices and likely level of spare capacity in the economy (see next section) inflation is forecast by the Economics Unit to fall slightly over the remainder of 2012.

1.5 Spare capacity

An important element of the Panel's remit is to assess economic conditions and determine what the appropriate fiscal stance should be, given those conditions. This requires assessing the degree of spare capacity in the economy as periods of excess capacity are ones where the Panel is more likely to advise that deficits are run to support the economy and in some cases even that discretionary stimulus is required. However, assessing the degree of spare capacity can prove difficult even in larger economies and one of the important policy questions they presently face is the extent to which the 2008 financial crisis has destroyed capacity in the economy, meaning that there is less spare capacity than would have been estimated on pre-crisis assumptions.

Whilst other jurisdictions have attempted to calculate the output gap using econometric analysis (e.g. the Congressional Budget Office in the USA) or using a statistical approach (e.g. the European Commission), there are limitations to how much insight such analysis can provide on the likely level of spare capacity. Further, the nature of the Jersey economy limits the usefulness of these approaches further – primarily due to finance sector profits making up a large part of measured GVA.

The Panel assess the degree of spare capacity in the Jersey economy qualitatively by looking at a range of information. For example, the persistently high level of unemployment suggests that the economy is not currently

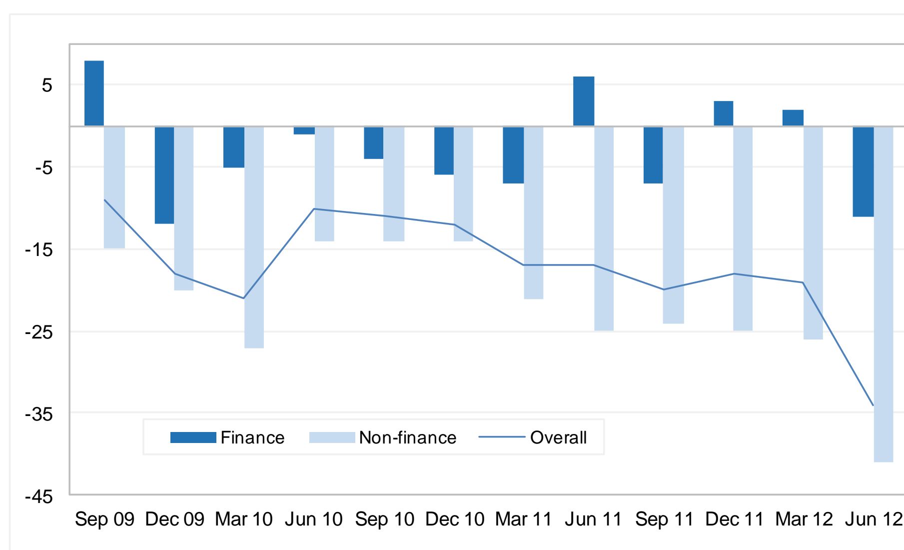
operating at full capacity, especially when this is combined with the shift towards part-time employment in the economy.

Survey evidence is another useful source of information on spare capacity and the Business Tendency Survey includes a question as to whether a firm's current business activity is above / at normal / below capacity. This information supports the labour market data and shows that both finance and non-finance respondents were operating at below capacity in quarter 2 of 2012, though this is markedly more negative for the non-finance respondents where nearly 50% of businesses indicate they are working below capacity (compared to just less than 25% in finance).

Figure 1.15
Capacity utilisation

Net balance of firms reporting activity above/below normal capacity (weighted by employment)

Source: States of Jersey Statistics Unit



1.6 Outlook

To arrive at its best estimates of the path of the economy, the Panel has combined the economic data available with the qualitative information from the key surveys and the information it received when meeting with representatives of the key industry sectors (Figure 1.16). On the basis of the continued deterioration in the economic situation within the Island and externally, and the fiscal constraints in many of the advanced economies, the Panel has revised down its forecasts for 2012 and sees little scope for improvement in 2013.

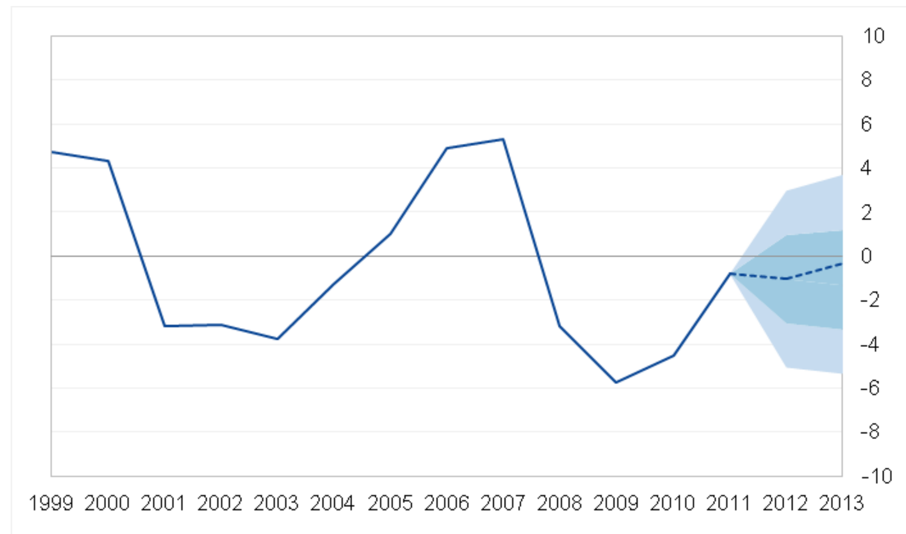
There remains significant uncertainty around these forecasts, not least because of the continued uncertainty at the global level given the predicament of the euro area. The Panel has revised its central forecast growth in GVA for 2012 down to -3% to 1% and forecast a similar performance in 2013, with risks to the downside. The MTFP should be set against a backdrop of very weak economic conditions with continued high unemployment. These forecasts are made on the basis that fiscal policy in 2012 and 2013 remains as accommodating as in 2011.

Figure 1.16

Economic Forecasts

% change in GVA on year before

Source: Panel judgement; States of Jersey Statistics Unit



Whilst the BTS responses and level of unemployment suggest that the economy is currently operating beneath full capacity, and is likely to remain so into 2013, the outlook beyond that is less clear. Considerable downside risks to the global outlook make it difficult to predict when the Jersey economy will again be operating at its potential. This means that it is difficult for the Panel to advise on the critical questions as to what year the Jersey economy is likely to return to capacity. As more information becomes available about Jersey's economic performance in subsequent years the Panel will be able to give greater assurance to trends in spare capacity.

Section 2 - The Fiscal Outlook

Key points

- The Panel welcomes the move towards medium-term financial planning and the publication of the first Medium Term Financial Plan.
- Despite an apparent structural improvement in income tax receipts, there has been no material change in the forecast for States income as this has been offset by the weaker economic outlook. Total income is expected to be £7m lower, and income tax £1m lower, by 2014 than at the time of the 2012 Budget.
- Department net revenue expenditure is planned to be £31m higher in 2013 and £33m higher in 2014 than in the 2012 Budget.
- The amounts proposed to be put aside for provisions and contingencies are £13m lower in 2013 and £14m lower in 2014 compared to the 2012 Budget. As a result there will be less flexibility each year to deal with changing priorities and emerging pressures.
- The projected Consolidated Fund balances of £12m at the end of 2014 and £10m at the end of 2015 look tight. There appears to be little flexibility if income turns out to be lower or expenditure higher than expected.
- The gross capital allocation in the MTFP has significantly increased from £38m to £56m (£18m increase) in 2013 and £36m to £89m (£53m increase) in 2014 compared to the 2012 Budget. In 2015 the gross capital allocation is planned to be relatively high as well at £77m.
- It is planned to fund these increases in capital expenditure mainly from one-off receipts from utilities and other sources, property disposals, and anticipated carry forwards in future years. This may conceal a structural imbalance between expenditure and income.
- Adjusting the States financial position for the timing of expenditure, to better reflect its impact on the economy, suggests much higher deficits each year - £90m in 2012, £74m in 2013, £93m in 2014 and £62m in 2015. While fiscal stimulus in 2012 and 2013 is justified by the weak economy it is too early to say whether the large adjusted deficits in 2014 and 2015 will be warranted.

- The reliance on one-off receipts to fund capital expenditure in 2012 and 2013 is justified by the need to deliver additional fiscal stimulus in the light of the weakening economy although there is little indication in the MTFP that this has been achieved by a discretionary stimulus which meets the 3Ts (timely, targeted and temporary). Adopting the same approach out to 2015 risks concealing the true underlying balance between expenditure and income.

- The MTFP has the flexibility to adjust the fiscal balance over the course of the next three years as economic conditions become more apparent. However, it is not clear how this process would be conducted and whether there would be the fiscal discipline required to do so.

- The medium-term sustainability of States' finances has weakened between Budget 2012 and the MTFP despite higher income tax receipts. This is because revenue expenditure plans have increased using the higher income tax receipts, allocating growth funding and reducing the amount put aside for contingencies. Although the current balance remains in surplus, gross capital allocations are planned to increase significantly (funded by one-off receipts) which means the capital balance is likely to be in significant deficit over the MTFP period.

- The short-term economic outlook has deteriorated which means that future income tax revenues may not grow as quickly as assumed in the MTFP. It is more likely now that income tax revenue will be in the lower part of the forecast range by 2015.

- Significant long-term pressures remain on States' finances which require a prudent approach now and in coming years to prevent adding to future fiscal challenges.

This chapter will first consider the background to public finances (section 1.1) before analysing the current situation and outturn in 2011 (section 1.2). The MTFP is considered in detail in section 1.3 and in particular what is proposed relative to what was included in Budget 2012 in terms of central reserves, contingencies and capital allocations. Consideration is then given to the Panel's assessment of the appropriate balance of fiscal policy (section 1.4) given the latest analysis of the economic outlook in chapter 1. The MTFP proposals are then analysed in terms of their economic impact (section 1.5) in the light of this assessment.

Section 1.6 gives consideration to what the analysis in the previous sections has highlighted in terms of what the MTFP means for the medium-term

sustainability and the structural position of States' finances. Section 1.7 then goes on to highlight the key risks and uncertainties going forward.

2.1 Background to the public finances

Income and Expenditure

In 2011 the States received £712m gross revenue income, up from £663m in 2010[1]. The £50m increase was mainly due to an increase in GST receipts (up £22m as a result of the change in the GST rate from 3% to 5%), an increase in net income tax receipts (up £15m) and an increase in departmental income (up £9m) with smaller increases in stamp duty and impôts making up the balance.

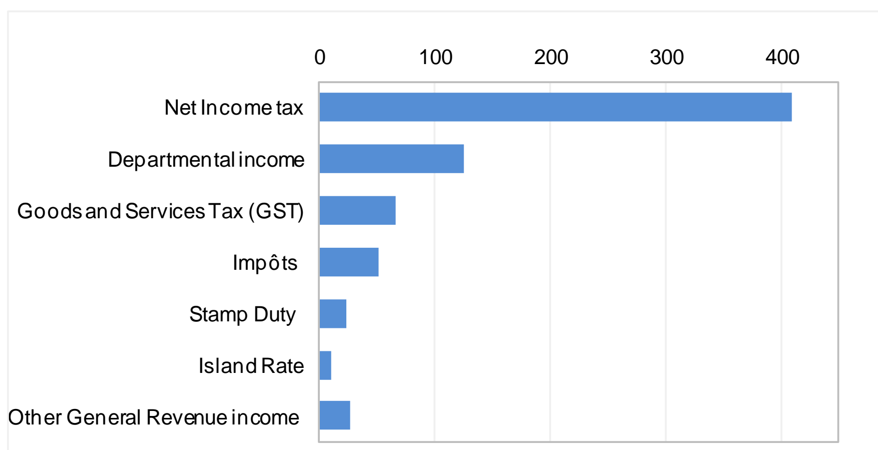
Income tax continued to be by far the largest source of revenue, contributing £409m, or 57% of the total, departmental income brought in £126m, GST brought in around £66m, while impôts brought in £51m (18%, 9% and 7% of total revenue respectively). The remaining 10% comes from the Island Rate, stamp duty and other income (Figure 2.1).

Figure 2.1

States income by source

2011, £m

Source: States of Jersey Treasury



Gross revenue expenditure (which does not include departmental income and capital expenditure) was £725m in 2011.

Net revenue expenditure (NRE), which is gross revenue expenditure plus departmental income, was £599m. Around 73% of this – £438m – went to the three largest departments: Social Security, Health and Social Services and Education Sport and Culture. The remaining 27% was divided among the other ministerial and non-ministerial departments (Figure 2.2).

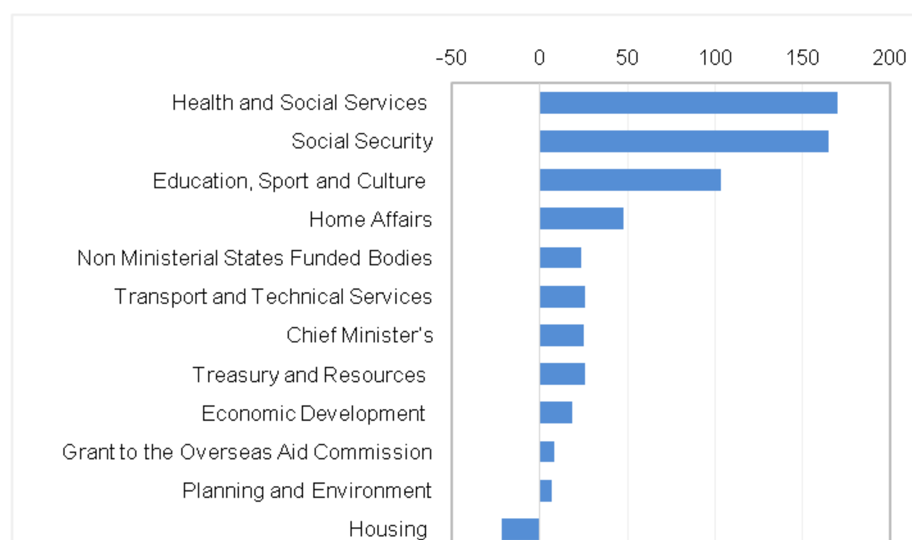
[1] The Panel defines gross revenue income as "States income" as presented in the MTFP plus departmental income which is netted off against revenue expenditure in the MTFP. From an economic perspective it is important to think about revenue and expenditure in gross terms without any netting off against one another.

Figure 2.2

Net revenue expenditure by department

2011, £m

Source: States of Jersey Treasury



Gross capital allocations are the commitments to future capital expenditure made each year. Net capital allocations are the extent to which these commitments are funded by general tax revenues. The remainder may be funded by capital receipts such as property disposals, or other sources of income. For significant capital projects a capital allocation may be made in one year, but the capital expenditure may take place over two or more years. It is the capital expenditure that impacts on economic activity when the money is spent on goods, services and wages, not the original commitment through the capital allocation. Capital expenditure totalled £73m in 2011 – a similar amount was spent in 2010. From 2003 to 2007 an average of £60m a year was spent, while in 2009 capital expenditure peaked at over £120m (the extra in part due to the new Energy from Waste plant and fiscal stimulus).

Figure 2.3 shows the gross capital allocation and capital expenditure trends in recent years. Gross capital allocations are made up of ongoing tax revenues (the net capital allocation) and other capital receipts, such as property disposals. The 2008 gross capital allocation includes the £103m allocation for the Energy from Waste plant, while capital expenditure in 2009 includes a large amount of the expenditure for it. For the last couple of years, the gross capital allocations for capital expenditure have been lower at around £40m a year. In addition, the extent to which these have been funded by tax revenues has decreased.

Capital expenditure has been higher recently despite the lower capital allocations because capital projects relating to past capital allocations have been accelerated to provide additional stimulus to the economy. This is shown by the large gaps between the expenditure line and allocation bars, particularly from 2009 onwards. At the end of 2011, the amount of past capital allocations remaining unspent was £72m (2010: £106m).

Figure 2.3

Capital expenditure and gross capital allocations

£m (current prices)

Note: The fiscal stimulus allocation is the £17m capital element of the £44m total

Source: States of Jersey Treasury data. Panel calculations

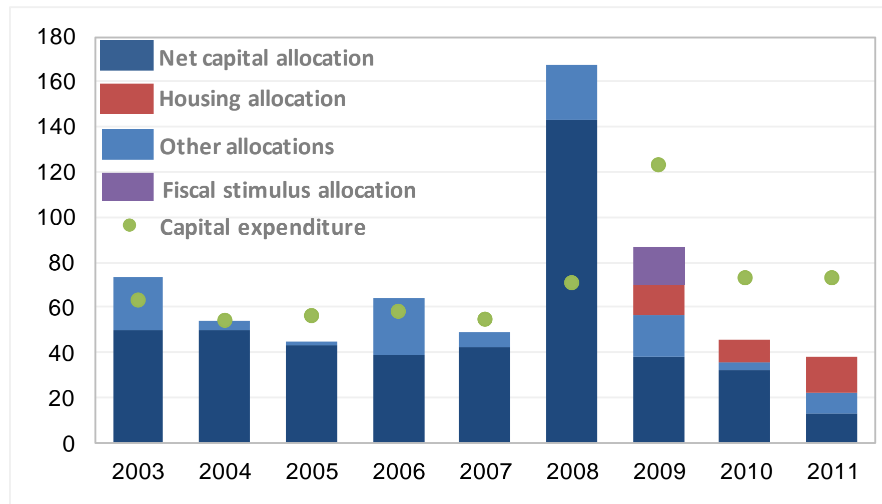


Figure 2.4 shows States' total income and expenditure (revenue and capital) in real, inflation adjusted, terms between 2003 and 2011. Between 2003 and 2007, total expenditure increased from £700m to £723m - less than 1% a year in real terms, while income exhibited greater fluctuations.

During 2008 and 2009 expenditure grew more rapidly at around 8.5% a year in real terms. Expenditure in 2009 increased particularly sharply because of capital expenditure on the new Energy from Waste plant. In 2010 and 2011 nominal expenditure was similar, but slightly lower than for 2009. Prevailing inflation reduced the value of this expenditure in real terms resulting in the downward sloping line.

Between 2005 and 2008 income grew sharply in real terms. Some of this income growth is likely to have been due to early actions to replace lost zero-ten revenue (for example GST, introduced in 2008), and some of it will have been cyclical, a result of the buoyant economy, rather than structural (i.e. ongoing). In addition, the loss of income tax following the global financial crisis may not be all cyclical - some of it could be permanent.

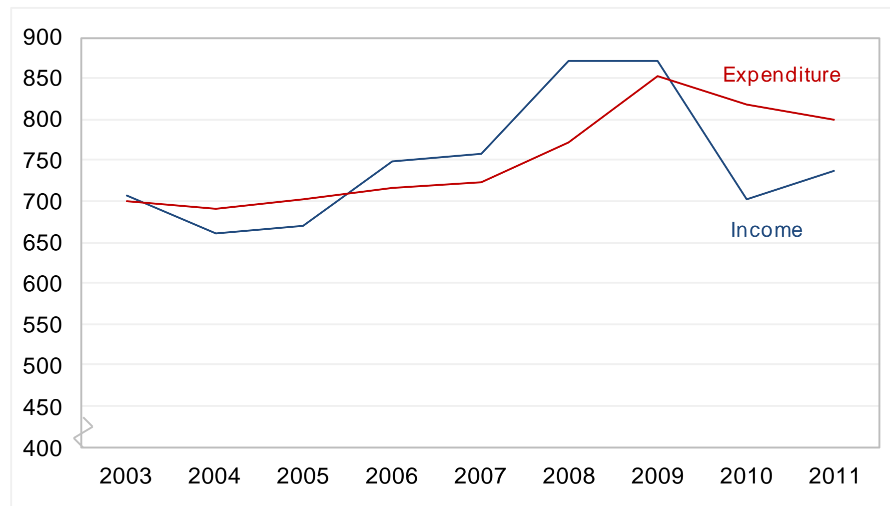
Figure 2.4

Real income and expenditure

£m , 2011 prices

(RPIX deflator used up to 2007, RPIY used from 2008)

Source: States of Jersey Treasury



Note: Income is gross revenue income plus departmental income plus capital proceeds. Expenditure is gross revenue expenditure (excluding capital/servicing depreciation) plus gross capital expenditure.

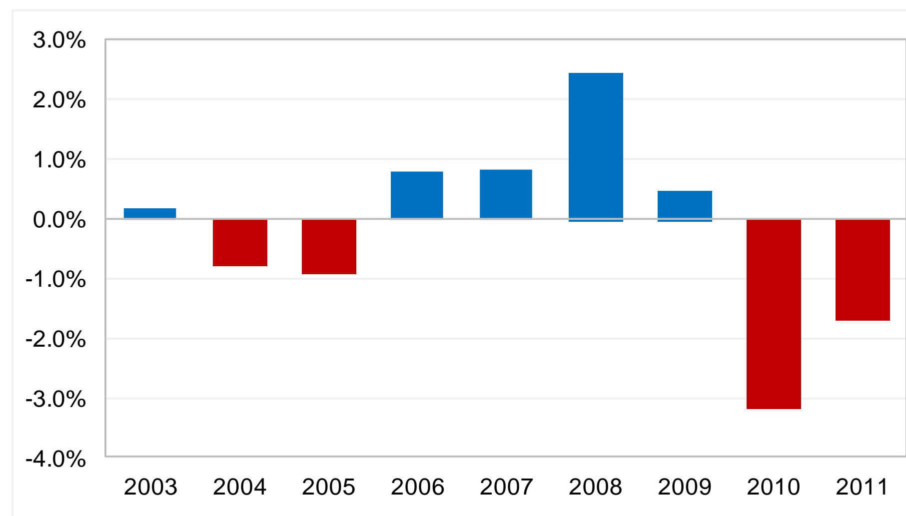
The annual surpluses and deficits (on a Business Plan accounting basis) run by the States between 2003 and 2011 as a proportion of the economy are shown in Figure 2.5. Surpluses have tended to occur after years when the economy has done well – reflecting lags in tax collection – and deficits after the economy has been weaker. The largest annual surplus over this period was 2.5% of GVA (2008), while the largest deficit was nearly 3.2% of GVA (2010).

Figure 2.5

Annual surplus/deficit as a % of GVA

Source: States of Jersey Treasury, Statistics Unit and Panel calculations

Note: Total income and total expenditure in real terms (2011 £) is used.



Strategic Reserve

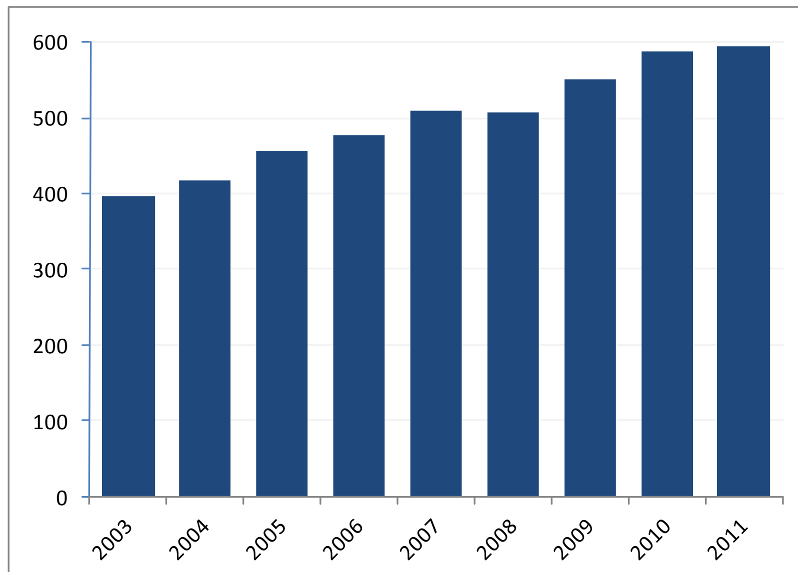
The Strategic Reserve has existed since 1986, and is intended to be used in exceptional circumstances such as a natural disaster or a significant, permanent or long-lasting economic change. Figure 2.6 shows how the balance in the Strategic Reserve has grown steadily – only falling slightly in

value in 2008 as a consequence of the fall in asset valuations during the financial crisis – and now stands at £594m.

Figure 2.6 Strategic Reserve net assets

£m, current prices

Source: States of Jersey Treasury



Stabilisation Fund

The Stabilisation Fund was created in 2006. It is intended to be used over the course of the economic cycle for facilitating counter-cyclical fiscal policy. This means that when the economy is strong, money is transferred to the Stabilisation Fund and when the economy is weak, the money is used to finance either the budget deficits arising from unchanged fiscal policies (called the "automatic stabilisers"), discretionary fiscal measures (such as a policy change which would reduce tax revenue or increase expenditure) or both.

Figure 2.7 shows the balance of the Stabilisation Fund since its inception in 2006 up until 2013. Between 2006 and 2009 the balance increased as money was put aside when the economy was doing well, and it reached £156m during 2009. From 2009 onwards the balance dropped as funds were used to pay for the discretionary fiscal stimulus package agreed by the States in 2009 and to go towards the budget deficits that were expected to arise during the downturn. At the time of the 2012 Business Plan, the balance at the end of 2011 was expected to be £10m. However, now it is proposed to use the money to pay for part of the social housing capital programme, leaving a balance of £1m.

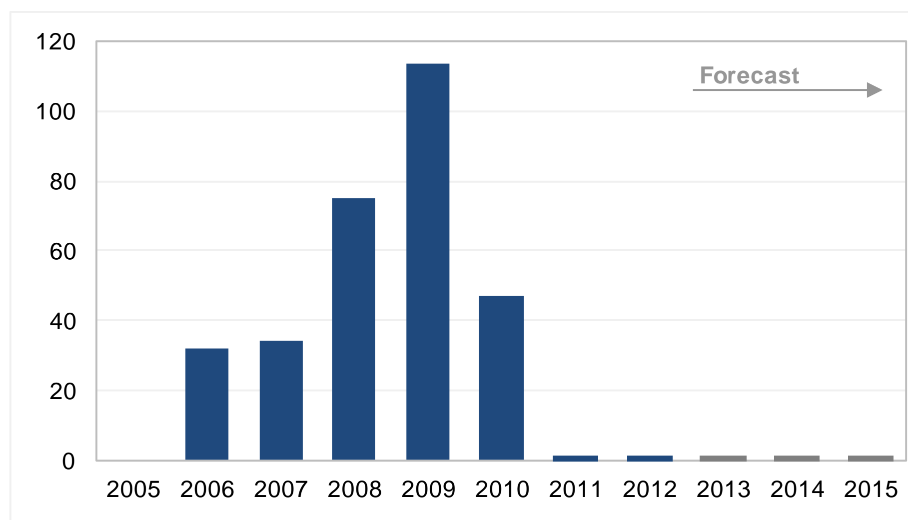
Figure 2.7

Stabilisation Fund net assets

£m, current prices

Source: States of Jersey Treasury

Note: Figures refer to year end, so for 2009 include a transfer out of £44m for fiscal stimulus



2.2 Current situation

2011 Outturn

The States of Jersey Annual Report and Accounts 2011 show a deficit of £11m. This number is not directly comparable to the figures from previous Business Plans, Budgets or Fiscal Policy Panel reports. In order to achieve comparability, two adjustments need to be made. The first is to remove the financial balance of the States' Trading Operations, as these are not included in the financial forecasts. The second is to add back in capital allocation as this is included in the financial forecasts, but treated differently in the accounts.[2]

After these two adjustments are made, the figure to use when comparing the financial forecasts (i.e. in Business Plans and Budgets) to the outturn is a deficit of £25m (Figure 2.8).

[2] The accounts are now produced on a UK Generally Accepted Accounting Principles (GAAP) basis, under which capital expenditure is accounted for using concepts of depreciation and impairments. In contrast, the financial planning process uses an amount of capital allocated to specific projects each year, although it could be spent at any time in the future and which, under GAAP, would eventually be fully accounted for through depreciation and impairments.

Figure 2.8 Public Finances in 2011 : Reconciliation of outturn and accounts

Source: States of Jersey Treasury

	Accounts* £m	Outturn Planning basis £m
General Revenue Income	587	587
Net Revenue Expenditure	-599	-599
Trading Operations	1	
Capital Allocation		-13
Budgeting Surplus/Deficit	**-11**	**-25**

* Pre-GAAP Adjustments and Other Income and Adjustments

A deficit in 2011 of £25m is £41m lower than the £66m estimated in Budget 2012 (Figure 2.9) (and 2012 Business Plan) and £30m lower than the £55m forecast in Budget 2011. The following factors account for the difference between the Budget 2012 estimate and the final figures in the accounts.

Figure 2.9 Public Finances in 2011 : Difference from 2012 Budget

Source: States of Jersey Treasury

	Budget 2012 Estimate £m	Outturn Planning basis £m	Difference £m
General Revenue Income	567	587	+20
Total Net Revenue Expenditure	-620	-599	+21
Trading Operations	-	-	-
Capital Allocation	-13	-13	-
Budgeting Surplus/Deficit	**-66**	**-25**	**41**

General revenue income increased by £20m, due to higher than expected income tax revenue (£29m) (mainly the impact of the '20 means 20' regime and lower mortgage interest relief), while other income was around £6m lower and impôts £3m lower.

Total approved expenditure was £20m higher due to additional expenditure approvals made in 2011 (total £11m) and a savings target (£9m) that was met through higher department underspends. Nevertheless, total net revenue expenditure was £21 million less than was expected in the 2012 Budget because department underspends and unused central contingencies amounted to £41m for 2011 (Figure 2.10).

Figure 2.10

Public Finances in 2011: Net Revenue Expenditure - Breakdown of difference from 2012 Budget

£m

Source: States of Jersey Treasury

	Budget 2012	Now	Difference
Department NRE	601	601	0
Savings target	-9		9
Central Provision			
- Central reserve/contingency	*9*	*9*	0
- Restructuring provision	*6*	*6*	0
Additional approvals			
- Carry-forwards from 2010	*13*	*16*	3
- Other		*8*	8
Total Approved	**620**	**640**	**20**
Underspend			
- Department underspends		*-27*	-27
- Central contingency unused		*-14*	-14
Total NRE	**620**	**599**	**-21**

The Consolidated Fund balance increased from £41m to £47m during 2011 (Figure 2.11). The unallocated Consolidated Fund balance at the end of 2011 was £23m higher than was previously forecast because of higher income tax receipts, carry forward adjustments and a £10m higher transfer from the Stabilisation Fund to the Consolidated Fund.

Figure 2.11

Public Finances: Consolidated Fund 2011

Source: States of Jersey Treasury

	2011 £m
Opening balance	**41**
Deficit for the year	-25
Transfer from the Stabilisation Fund	46
Other Fund Adjustments	26
Carry Forward to Fund Expenditure in 2012	-41
Closing balance	**47**

2012

Compared to the 2012 Budget, income is now expected to be £12m higher in 2012 due to higher forecasts for income tax revenue partly offset by lower GST, impôts and stamp duty receipts (in part due to weaker economic conditions). Department net revenue expenditure is expected to be slightly higher (by £3m) but this is balanced by a smaller net capital allocation (£2m) and a smaller central reserve (£1m). The overall position is now expected to be a deficit for the year of £7m rather than a deficit for the year of £19m.

The Consolidated Fund balance is expected to fall from £47m to £33m this year, largely due to the £7m deficit and a £27m allocation for the social housing project and the £5m allocation to the proposed Innovation Fund, partly offset by the repayment of Jersey Telecom preference shares and use of expected carry forwards to fund capital projects in later years.

Figure 2.12

Public Finances: Consolidated Fund 2012

Source: States of Jersey Treasury

	2012 £m
Opening balance	**47**
Deficit for the year	-7
Other Fund Adjustments	-2
Capital Expenditure Allocation - Housing	-27
Repayment of JT Preference Shares	20
Allocation to Innovation Fund	-5
Carry Forward to Fund Capital	7
Closing balance	**33**

The outcome compared to past FPP advice

The Panel made a number of recommendations in their last report. The key ones are repeated here in summary:

- Jersey should plan on the basis of a fragile and drawn out global recovery.
- Increased downside risks to the public finances reinforce the need to remain focused on fiscal consolidation and financial stability in the medium term.
- The States should avoid making decisions in Budget 2012 that permanently reduce revenue or increase expenditure.
- No Strategic Reserve or Stabilisation Fund transfers. The Stabilisation Fund balance should be increased wherever possible.
- Any excess in the Consolidated Fund over £20m should be transferred to the Stabilisation Fund.
- If economic conditions continue to deteriorate the States should be ready to support economic activity without weakening finances.
- In the event of further significant deterioration additional discretionary stimulus should be considered.

Since the Panel's October update the States has broadly followed FPP advice with regard to 2012. The 2012 Budget used the FPP economic forecast at the time which factored in the likelihood of a fragile and drawn out global recovery. During the Budget debate the States did not pass any amendments which significantly reduced revenue or increased expenditure on a permanent basis. Since then the States has considered how local economic conditions have changed in order to gauge whether further economic stimulus would be necessary.

FPP fiscal stimulus letter

In April 2012, the Treasury Minister contacted the Panel to ask for advice regarding the use of £10m which had been planned to be returned to the Stabilisation Fund to help fund £27m of housing capital projects. (See the appendix for the letters between the Treasury Minister and FPP).

Given that there was increasing evidence that economic conditions had deteriorated the Panel supported the proposal subject to it meeting the conditions and principles for fiscal stimulus, namely that the project is already planned to take place, could be brought forward, has economic value and meets the 3 T's timely, targeted and temporary.

However, the Panel also advised that this stimulus project alone may not be sufficient if economic conditions continue to worsen and that the MTFP should include enough flexibility to allow for extra fiscal stimulus this year and next if necessary.

This advice was consistent with the Panel's recommendations in the FPP October 2011 update.

2.3 The Medium Term Financial Plan 2013-2015

Introduction

The Panel welcomes the move towards medium-term financial planning and the publication of the first Medium Term Financial Plan.

The objectives of the MTFP are as follows[3]:

- provide greater control of States' spending
- provide certainty for departments with overall States' spending limits and minimum department spending limits set for a period of years
- provide flexibility within these spending limits by identifying a specific allocation for growth in spending, distinct from central contingencies, that may address emerging pressures and changes in priorities during the period of the Medium Term Financial Plan

In particular, the MTFP looks at longer term financial planning for public services provision and capital spending requirements, and sets out a long term tax policy for Jersey (MTFP appendix 11).

Comparison to the 2012 Budget

In the MTFP 2013-2015 income is forecast to be £5m higher in 2013 and £7m lower in 2014 compared to the 2012 Budget. This is due to higher forecasts for income tax revenue offset by lower GST, impôts and stamp duty receipts (in part due to weaker economic conditions) (Figure 2.13).

Figure 2.13

MTFP 2013-2015: Change in financial forecasts since Budget 2012

£m

Source: States of Jersey Treasury data

	2012 £m	2013 £m	2014 £m
Income Tax	14	9	-1
GST	-2	-2	-2
Impôts	-4	-3	-4
Stamp Duty	-1	-2	-2
Other Income	5	-5	-6
Island Rate	0	0	0
Budget Measures	0	8	8
Income	**12**	**5**	**-7**

The Treasury has proposed additional net revenue expenditure and capital expenditure for 2013 and 2014 that was not included in Budget 2012.

Department net revenue expenditure is expected to be £626m in 2013 and £643m in 2014, which is, respectively, £31m higher and £33m higher than in the 2012 Budget.

[3] P97/2011: Draft Public Finances (amendment no. 3) (Jersey) Law 201-

Figure 2.14

Public Finances 2012-2015: MTFP, the 2012 Budget and differences

£m

Source: States of Jersey Treasury data

Actual 2011 £m	Probable 2012 £m	MTFP 2013-2015	Forecast 2013 £m	Forecast 2014 £m	Forecast 2015 £m
587	625	States Income	647	674	711
584	596	Department Net Revenue Expenditure	625	643	654
15	22	Central Reserve (Contingencies and growth etc)	8	26	37
38	38	Gross Capital Allocation	56	89	77
-25	-24	Funded By Other Sources	-43	-84	-57
13	14	Net Capital Allocation	13	5	20
612	632	Total Net Expenditure Allocation	646	674	711
-25	-7	Surplus/deficit	1	0	0

2011 £m	2012 £m	Budget 2012	2013 £m	2014 £m	2015 £m
567	613	States Income	642	681	
605	597	Department Net Revenue Expenditure	594	610	
15	19	Central Reserve (Contingencies and growth etc)	21	40	
38	38	Gross Capital Allocation	38	36	
-25	-22	Funded By Other Sources	-17	-14	
13	16	Net Capital Allocation	21	22	
633	632	Total Net Expenditure Allocation	636	672	
-66	-19	Surplus/deficit	6	9	

2011 £m	2012 £m	Difference	2013 £m	2014 £m	2015 £m
20	12	States Income	5	-7	
-21	-1	Department Net Revenue Expenditure	31	33	
0	3	Central Reserve (Contingencies and growth etc)	-13	-14	
0	0	Gross Capital Allocation	18	53	
0	-2	Funded By Other Sources	-26	-70	
0	-2	Net Capital Allocation	-8	-17	
-21	0	Total Net Expenditure Allocation	10	2	
41	12	Surplus/deficit	-5	-9	

Central reserves and contingencies

The amounts proposed to be put aside for provisions and contingencies are shown in Figure 2.15 and are £13m lower in 2013 and £14m lower in 2014 compared to the 2012 Budget. There are several reasons which explain this. First, the MTFP includes a provision for staff pay awards of £6m in 2013 and £17m in 2014 which the 2012 Budget does not, reflecting the progress made so far in negotiations. Second, the initial growth allocations of £6m in 2013, £16m in 2014 and £26m from 2015 have now been allocated to departments.

Finally, the contingency allocations (to cope with unexpected one-off emergency items for example) have been reduced by £13m in 2013 and £14m 2014. Although no money has been proposed to be allocated for contingencies during 2013, there are expected to be £6m of unused contingencies in 2012 which are earmarked to be carried forward to 2013. The combined effect of this is that the contingency amounts are now £7m lower in 2014 than proposed at the time of the 2012 Budget.

The MTFP proposes using some of the central reserves and contingencies that were put aside in the 2012 Budget to fund additional revenue expenditure and to make a provision for the most recent States employees pay award offer. However, the resulting lower reserves and contingencies means there will be less flexibility each year to deal with changing priorities and emerging pressures.

Figure 2.15

Public finances: Central reserves

£m

Source: States of Jersey Treasury data

	MTFP				2012 Budget			Difference		
	2012	2013	2014	2015	2012	2013	2014	2012	2013	2014
	£m	£m	£m	£m	£m	£m	£m	£m	£m	£m
Pay Provision (net)	3	6	17	26	0	0	9	3	6	8
Restructuring Provision (net)	7	2	3	4	7	2	2	0	0	1
Allocation to Contingencies	12	0	6	7	12	13	13	0	-13	-7
Allocation to Growth	0	0	0	0	0	6	16	0	-6	-16
	22	8	26	37	19	21	40	3	-13	-14

Gross revenue income and expenditure

Figure 2.16 shows gross department revenue expenditure (which includes the central reserves above) and gross department revenue income, after adjusting for inflation, in real terms. Real gross revenue expenditure is expected to remain at around £730m throughout the MTFP period, falling in real terms in 2012 and 2013 before slowly increasing again in 2014 and 2015, whereas real revenue income is expected to grow from around £730m to £750m (by 1.3% a year). By 2015 there is expected to be a small surplus of about £20m.

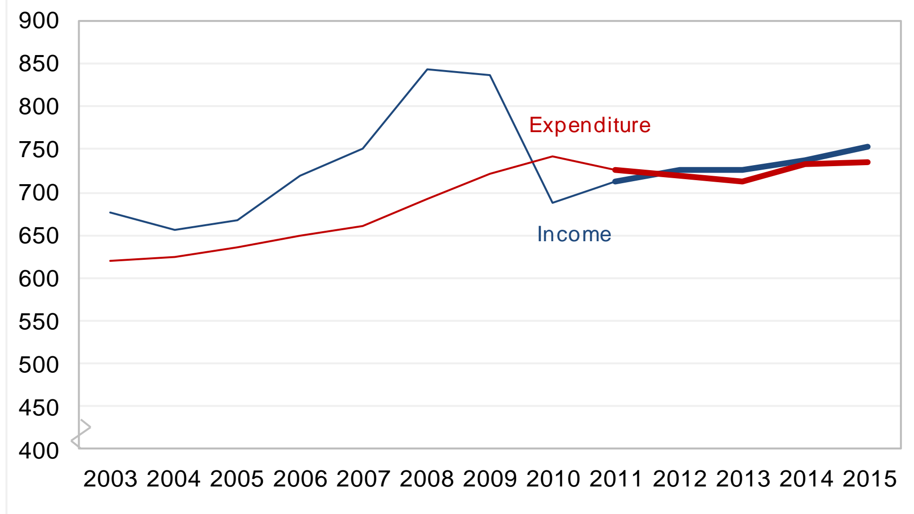
Figure 2.16

Public finances: Revenue - income and expenditure, adjusted for inflation

£m (2011 prices)

Note: Income is gross revenue income (so includes departmental income) and expenditure is gross revenue expenditure

Source: States of Jersey Treasury, Panel calculations



Capital allocations

The gross capital allocation (Figure 2.14), in the MTFP has significantly increased from £38m to £56m (an £18m increase) in 2013 and £36m to £89m (a £53m increase) in 2014 compared to the 2012 Budget. In 2015 the gross capital allocation is planned to be relatively high as well at £77m (Figure 2.17).

Figure 2.17

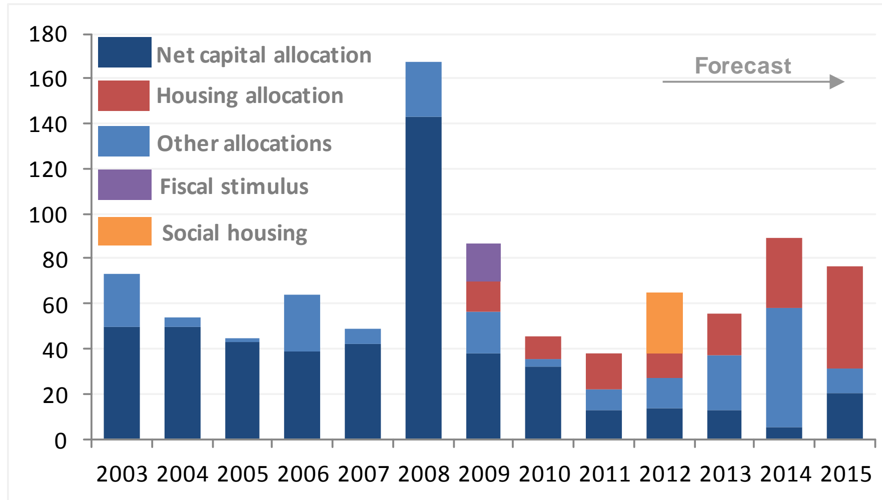
Capital allocations

£m (current prices)

Note: The fiscal stimulus allocation is the £17m capital element of the £44m total.

Net capital allocation + housing allocation + other allocations = gross capital allocation

Source: States of Jersey Treasury data. Panel calculations.



It is planned is to fund these capital allocations mainly from a repayment of an advance to departments, housing funding sources, one-off receipts from utilities and anticipated carry forwards of current expenditure in future years. The greater emphasis on funding the allocations in this way has meant less is expected to be funded from annual tax revenue (the net capital allocation) - £8m less in 2013 and £17m less in 2014 (Figure 2.18). The impact on Jersey's economy of funding more capital expenditure through the use of one-off capital and other receipts is different to the economic impact of funding

capital expenditure through higher tax receipts. This is looked at in more detail later (section 2.6).

Figure 2.18

MTFP 2013-2015: Change in financial forecasts since Budget 2012

Source: States of Jersey Treasury data. Panel calculations.

	2012 £m	2013 £m	2014 £m
Gross Capital Allocation	0	18	53
Housing Funding Sources	0	-5	-17
Repayment of Advances to Departments	0	0	-38
Utility Receipts	-2	-10	-5
Other	0	-11	-10
Net Capital Allocation	-2	-8	-17

Although there is little overall change in the total net expenditure proposed, underlying this are significant changes to departmental net revenue expenditure, which is now higher, and to central allocations, such as for contingencies and future growth, which are now lower. Capital expenditure has also increased substantially

The deficit presented in the MTFP is forecast to decline slightly over the period from an estimated deficit of £7m in 2012 to balance in 2014 (Figure 2.19).

Figure 2.19

Public Finances: MTFP 2013-2015

Source: States of Jersey Treasury

Outturn 2009 £m	Outturn 2010 £m	Outturn 2011 £m	Estimate 2012 £m		<-- Forecast --> 2013 £m	2014 £m	2015 £m
674	546	587	625	Income	647	674	711
603	631	612	632	Expenditure	646	674	711
71	-85	-25	-7	Surplus/Deficit	1	0	0

Carry forwards

The carry forward process allows departments to manage their spending across financial years, gives them a greater sense of certainty and helps to avoid the incentive to spend any money left over before the year end.

At the end of 2011 £41m of departments' budgets remained unspent. £28m of this has been agreed to be carried forward to 2012 to be spent by departments and £13m carried forward for contingencies.

Spending the carry forward money in 2012 as opposed to saving it (for example by putting it in the Stabilisation Fund) will provide some stimulus to Jersey's economy this year. However, it is possible that a higher proportion of the carry forward money could have been spent differently to provide further economic stimulus as conditions weaken locally.

Allocating money to the Stabilisation Fund (in order to build up the balance in good times and fund stimulus during the bad times) should be a competing objective for any carry forward amounts each year. It is unclear whether this consideration was part of the carry forward process.

Comprehensive Spending Review

The savings target of £65m for the Comprehensive Spending Review originally set out at the end of 2010 is an important requirement that underpins the MTFP. The Council of Ministers states its commitment to deliver the savings targets in the MTFP. It is expected that almost £56m of the £65m savings will be delivered by 2013 with a further £4m being delivered through additional savings by 2015. This leaves an expected shortfall of £5m by the end of the MTFP period (Figure 2.20). In 2016, through additional savings, the shortfall is expected to be £3.6m.

Figure 2.20

Comprehensive Spending Review: Expected profile of savings to be made

	2011 £m	2012 £m	2013 £m	2014-2015 £m	Shortfall £m	Total £m
Original plan 2010	12	23	30	0	0	65
Current plan MTFP	13	20	23	4	5	65

Source: States of Jersey Treasury

How the savings are achieved are a political decision rather than an economic decision. However, if the savings are not made over the medium term then any shortfall may have to be made up through other measures if there remains a structural deficit in public finances over the medium term. This is discussed in more detail later.

The Consolidated Fund

The Consolidated Fund is the fund through which the majority of the States' income and expenditure is managed, including general revenue income and departmental income and expenditure.

The projected financial position of a £12m Consolidated Fund balance at the end of 2014 and £10m at the end of 2015 looks very tight (Figure 2.21). There appears to be very little flexibility in the plan if income turns out to be lower than expected or expenditure higher than expected. For example, the planning range of 5% of income tax revenue is £25m either way, suggesting that if income tax receipts turn out to be in the lower part of the range, the Consolidated Fund balance may not be sufficient.

Figure 2.21

Public Finances: Consolidated Fund 2011-2015

Source: MTFP

	2011 £m	2012 £m	2013 £m	2014 £m	2015 £m
Opening balance	**41**	**47**	**33**	**20**	**12**
Forecast Surplus/deficit for the year	-25	-7	1		
Transfer from the Stabilisation Fund	46				
Other Fund Adjustments	26	-2	-10	-32	-2
Capital Expenditure Allocation and Return		-27		27	
Repayment of JT Preference Shares		20			
Allocation to Innovation Fund		-5			
Carry Forward to Fund Expenditure in 2012	-41				
Carry Forward to Fund Capital		7	-4	-3	
Closing balance	**47**	**33**	**20**	**12**	**10**

The Panel has recommended before that any unallocated funds in the Consolidated Fund in excess of £20m should be transferred into the Stabilisation Fund.

As a consequence of introducing contingency funds into the budgeting process, the Panel have been considering whether the guideline balance should be reduced. The contingency amounts have however been reduced in this MTFP compared to those outlined in the 2012 Budget and so the Panel maintains its original recommendation.

Stabilisation Fund and Strategic Reserve

The MTFP states that "During the period 2013 to 2015, the Council of Ministers would wish to take opportunities that arise to rebuild the Stabilisation Fund. Funds will be placed in the Stabilisation Fund either from a Consolidated Fund transfer in the period or from additional income generated during the period." There are no plans to make additions to or withdrawals from the Strategic Reserve.

No transfers into the Stabilisation Fund are recommended by the Panel in 2012 or 2013. However, further consideration needs to be given as to how the Stabilisation Fund will be rebuilt through countercyclical fiscal policy, once the economy begins to recover.

The Panel does not recommend a transfer into the Strategic Reserve at this stage.

2.4 Setting the balance of fiscal policy

In deciding what the appropriate balance should be between taxation and spending it is important to assess economic conditions in the local economy including the degree of spare capacity. As discussed on page 23 in Section 1.6 it is difficult to predict when the Jersey economy might return to full capacity. Therefore it is important to keep some flexibility in the States' finances over the life of the MTFP, to be able to adjust the fiscal stance and ensure that the States' finances continue to act in a counter-cyclical manner. However, it is the Panel's judgement that there is significant spare capacity in the economy this year that will persist at least until 2013. There is much more uncertainty about whether such trends will continue in 2014 and 2015.

In past reports the Panel has set out some guiding principles including:

- Fiscal consolidation should have regard for the consequences for economic growth
- Focus should be on a credible medium-term plan
- Plan to run surpluses once the economy recovers to rebuild the Stabilisation Fund.

It is important for sound fiscal policy that the proposals in the MTFP 2013-2015 follow these principles. In addition, given the deterioration in the economic outlook for 2012 and 2013 it is important to assess the degree to which fiscal policy will support economic activity and whether additional stimulus is required.

Firstly, the automatic stabilisers should be allowed to work. This means that in 2012 and 2013 falls in tax revenue and increases in expenditure that occur naturally (because of the downturn and without any policy changes) should be allowed to take place. To try to reverse these cyclical impacts (for example by increasing tax rates or reducing expenditure) during 2012 and 2013 would be pro-cyclical and only act to exacerbate the situation. Any deterioration in the fiscal position expected as a result should be allowed to take place as by its nature it should correct itself as the economy.

The next step is to assess whether this automatic adjustment in the fiscal stance is sufficient given the extent of the economic slowdown. In Jersey, such adjustment tends to be somewhat delayed because of the lags in the taxation system and experience suggests that the automatic stabilisers in Jersey are not that strong.

If it is judged that the automatic stabilisers alone will not give sufficient support to the economy then (as previously recommended by the Panel and undertaken in recent years) the States should consider bringing forward any previously agreed and funded capital projects it can to 2012 and 2013 to help support the economy. This will inject more money into the economy at the time when it is most needed.

Only if the combination of automatic stabilisers and bringing forward already funded capital projects does not add sufficient support to the economy should consideration be given to additional discretionary fiscal stimulus projects. The amount of discretionary stimulus should be determined by the degree of additional support that is required in the economy, not the size of the Stabilisation Fund or the balance on the Consolidated Fund.

It should be noted that having an empty Stabilisation Fund should not stop the States from pursuing counter-cyclical fiscal policy – in particular running a deficit when the economy is doing badly. In this situation the States should consider using other sources of savings or borrowing the money to help support the economy and then repay this when the economy is performing well again.

The source of any transfers to the Stabilisation Fund over the MTFP period will be important. If surpluses are run as the economy recovers and are used to rebuild the Stabilisation Fund then this is an example of good countercyclical fiscal policy which will put Jersey in a better position to deal with the next downturn when it arises. If however, the Stabilisation Fund is rebuilt as the economy recovers by using savings (for example, money from the Strategic Reserve) and not annual surpluses ahead of the next downturn, then this could suggest a pro-cyclical fiscal policy is being pursued (exacerbating the economic cycle) and that there could be a structural deficit that needs to be addressed.

In the following sections, the Panel will therefore assess the proposals in the MTFP on the basis of whether the balance of fiscal policy is appropriate given the economic outlook and in particular whether it meets the following criteria:

1. It demonstrates that the decision making process above has been followed giving due regard to impact of the automatic stabilisers, ability to bring forward capital projects and the need for additional discretionary stimulus.
2. Additional measures (discretionary stimulus) and support for the economy are required and delivered in 2012 and 2013 and any

discretionary stimulus meets the 3 "T's" (targeted, temporary and timely).

3. Medium-term flexibility is sufficient to protect the medium-term sustainability of States finances and to return them to balance once the economy is operating at full capacity.

2.5 The economic impact of the proposals

The first step is to assess the economic impact of the MTFP proposals in terms of the combined impact of tax and spending on the economy. The Panel refers to the annual surplus or deficit each year and makes any necessary adjustments to smooth the timing of receipts and expenditure to better reflect the impact on the economy.

Summary table A for income and expenditure in the MTFP shows an overall position of an expected small deficit of £7m in 2012 with essentially a balanced position each year from 2013 to 2015.

However, there are some adjustments which need to be made to these projected balances to see more clearly what the impact on the economy will be. These are:

1. *The sale of assets and use of savings or reserves.* Most of the one-off capital receipts such as property disposals and preference dividend repayments from utilities are shown as receipts offset against capital allocations, but unlike the annual receipts of tax revenues, do not take money out of the economy in the same way. Therefore the overall effect of using them to fund capital expenditure is to add more money into the economy than the headline surplus/deficit figure suggests.

2. *The timing difference between committing to a capital project and the expenditure.* The timing of capital expenditure does not always coincide with the years in which funding is allocated to the capital programmes, especially for larger projects if they are unexpectedly delayed or take a few years to complete. There are two points here. First, the planned programme over 2012 – 2015 should be adjusted for when expenditure is expected. Second, the rate at which capital projects, approved in the past, become capital expenditure should be adjusted. In recent years actual capital expenditure has increased as previously approved capital projects have been accelerated.

3. *Unspent amounts carried over each year.* Each year there are unspent amounts that are carried over which tend to be spent in the following

year. The Panel understands that in the past the 'carry forwards' have tended to be relatively small and a similar size from year to year (which means any adjustments would broadly cancel each other out). However, with the inclusion more recently of contingency amounts in the budget, the size of the 'carry forwards' has tended to be larger and more variable in size. These 'carry forwards' may be presented in different ways, but for the Panel's purposes the adjustment should be such that expenditure is lower in the year the money is allocated but not spent and higher when it is spent. The Panel's adjustments are based on proposed carry forward figures in the MTFP and an assumption from Treasury that from 2013 carry forwards will be of a similar size each year of around £20m.

4. *Expenditure requests outside of the Business Plan.* Certain decisions by the Treasury Minister or the States allocate funding without a specific year of expenditure – for example, the discretionary fiscal stimulus programme agreed by the States in 2009 and more recently the decision to build £27m of social housing. Adjustments should be made to reflect the likely timing of actual expenditure.

Figure 2.22 shows these adjustments to the MTFP surplus/deficit.

Figure 2.22

Projected fiscal balance, adjusted for the timing of expenditure and capital expenditure rather than capital allocation

Source: States of Jersey Treasury; Panel calculations

	2011 £m	2012 £m	2013 £m	2014 £m	2015 £m
MTFP surplus/deficit	**-25**	**-7**	**1**	**0**	**0**
Add: net capital allocation	13	14	13	5	20
Less: capital expenditure	-73	-72	-95	-95	-82
Carry forward adjustment	0	-25	7	-3	0
Adjusted surplus/deficit	**-85**	**-90**	**-74**	**-93**	**-62**
% of GVA	-2.3%	-2.5%	-2.1%	-2.6%	-1.7%

The capital expenditure estimates relate to the timing of the implementation of projects, rather than the year of approval. The capital expenditure for 2012 is based on departmental forecasts supplied to the Treasury but these are subject to change based on timing of projects. For 2013, 2014 and 2015 the capital expenditure amounts provided by the Treasury are only indicative as they use high level assumptions based on the gross capital allocation proposed and the expected rate of spending them based on past experience. As such, final capital expenditure in these years may be somewhat higher or lower.

It should also be noted that the Jersey Telecom "Gigabit Jersey" infrastructure project is not included in the above adjustments but will add further stimulus to the economy particularly in 2012 (£10m) and 2013 (£8m).

The adjustments for 2011 result in an adjusted deficit for the year of £85m which is £60m higher than the £25m MTFP deficit because capital expenditure for the year was much higher than the net capital allocation from revenue income in the Consolidated Fund.

Looking at 2012 shows a slightly higher adjusted deficit of £90m for the year, once account is taken of the capital expenditure adjustments - which includes the social housing scheme stimulus measure.

Setting the fiscal balance

The adjusted deficit in 2013 of £74m is slightly smaller than 2012, but still significantly (£73m) higher than indicated in the MTFP. These adjustments would suggest that fiscal policy is supportive of the economy, as set out in assessment criterion 2 in section 2.10. There is little indication, however, in the MTFP that this has been achieved by a discretionary stimulus which meets the 3Ts.

The £27m of investment in social housing in 2012 is consistent with our advice in the letter to the Treasury and Resources Minister in March but it is difficult to see how the remainder of the fiscal support meets these requirements from the information in the MTFP.

The profile of the fiscal support for the economy also raises some questions. The immediate requirement is to support the economy in 2012 and 2013. It is not clear that larger or similar sized adjusted deficits in 2014 and 2015 will be warranted.

For the end of MTFP period, the relatively large deficits planned for 2014 and 2015 (2.6% of GVA in 2014 and 1.7% of GVA in 2015) are largely due to the increased levels of planned capital expenditure that are expected to be funded by one-off capital receipts rather than ongoing tax revenues.

If economic conditions require tighter fiscal policy in 2014 and 2015, then the planned (adjusted) deficits set out above for those years would have to be reduced, meaning that capital, or other expenditures would have to be decreased, or revenues increased.

There may be some flexibility to reduce capital expenditure below the levels assumed in Figure 2.2 which would adjust the fiscal balance over the course

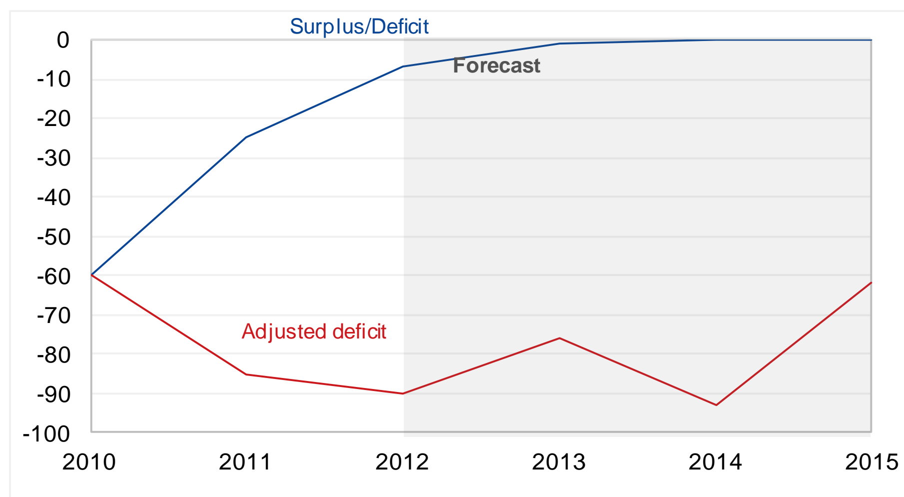
of the next three years, as economic conditions become more apparent. However, it is not clear how much flexibility there is in practice, how this process would be conducted and whether there is the fiscal discipline required to prioritise the capital projects allocated in 2014 and 2015.

Figure 2.23

Projected fiscal balance, before and after adjustments

£m

Source: MTFP, Panel calculations



2.6 Medium-term sustainability

Assessment of what the proposals in the MTFP means for the sustainability of States' finances in the medium-term is one of the key considerations of the Panel. Another way to look at the fiscal position is the extent to which the States is expected to meet its current, as opposed to capital, commitments over the economic cycle (Box 1). In 2010 and 2011 "current" deficits were being run, while over the MTFP period it is encouraging that the plan is to cover the current costs of public service provision with tax revenue each year (Figure 2.4). In view of the likely spare capacity in the economy, this might imply that the cyclically adjusted current budget is in broad balance. However, this also shows that the money expected to be put into the economy in 2013-2015 is through the planned capital programme (paid for through other means than 'normal taxation' receipts).

Figure 2.24

Projected "current" balance, adjusted for the timing of expenditure

Source: States of Jersey Treasury; Panel calculations

Note: adjustments for carry forwards relate to revenue expenditure only

2011 MTFP/2011 Accounts £m		2012 £m	2013 £m	2014 £m	2015 £m
713	States Income (gross)	748	768	803	844
725	States Expenditure before Capital (gross)	741	754	798	824
-12	Current balance - before adjustments	7	14	5	20
0	Carry forward adjustments	-32	11	0	0
-12	Current balance - adjusted	-25	25	5	20

Deficits that result from capital expenditure which will be of future benefit can be less of a concern than those that arise through an imbalance on the current account, provided that the funding is repaid in the future as benefits accrue. The critical question is whether the capital expenditure brings future benefits. However, it is not clear from the information provided in the MTFP that all of the £220m capital investment proposed meets this requirement or that there is a commitment to repay the one-off funding sources. The Panel therefore cannot rule out that there is a risk of an underlying structural imbalance between expenditure and revenue.

The Panel's view is that further analysis is required by the Treasury and Resources Department that will consider the nature of the capital expenditure, the way it is being funded and what it implies for the underlying position of States' finances. If this analysis suggests there is a structural deficit then consideration should be given to its extent and nature, including a more detailed plan of action to rectify it.

There have been a number of recent developments that point to a worsening of the structural position:

- Income tax revenue was £29m higher than estimated in 2011 and is now expected to be£8m higher in 2012 than previously expected. Revenue expenditure plans have been increased on the basis that all the expected increase is structural.

- Revenue expenditure plans have also been increased by reducing the amounts put aside for contingencies. This substitutes expenditure that is uncertain in size or timing for ongoing expenditure and so potentially worsens the structural position. It also increases the chance that contingencies that require additional expenditure will have to be met from resources not currently included in the MTFP.

- The amount of gross capital expenditure is planned to increase significantly during the life of the MTFP and is expected to remain high in the long-term. In the short-term this is being funded by one-off receipts but in the long-term this will require additional funding measures as yet unspecified and to be determined in the future. This increases the likelihood that the underlying structural position is not in balance.

- There are some smaller factors which could all worsen the structural position - such as the £5m shortfall on the original CSR savings target by 2015, the need to find a replacement for HIF funding of around £6m a year and the possibility that States employee pay awards end up being higher than provided for.

Over the course of the long-term capital plan (2012 – 2032) it is estimated that there is a capital spend requirement of around £80m on average a year. This is similar to the level of actual capital expenditure seen in 2011 and expected for 2012. It is also similar to the level that might be expected at this stage for 2013, 2014 and 2015 planned in the MTFP (Figure 2.22).

The long-term capital plan is proposed to be funded by £20m a year from the Consolidated Fund[4] with the remainder coming from: policy changes (average £20m a year); the Trading Funds (airport, harbours and car parks, average £13m a year); capital receipts (average £7m a year); and other identified sources (average £4m a year) which leaves a "new funding" gap of around £16m a year (required for the new hospital).

[4] MTFP figure 36, page 141for more detail.

The fact that the level of capital expenditure suggested by the MTFP will require the measures mentioned above to fund it in the longer-term highlights to the Panel that for the period of the MTFP a structural deficit could be opening up (even before funding of the hospital is accounted for) which will require future measures to address it, which are, to some extent, uncertain and unspecified.

Box 1: What is a structural deficit?

A budget deficit occurs when government expenditure is higher than government revenue. Surpluses and deficits are made up of a structural part and a cyclical part.

The structural part of a budget deficit (or surplus) occurs every year regardless of the position of the economy in the economic cycle.

The cyclical part occurs automatically over the economic cycle without any government policy changes. So over the part of the cycle when economic activity falls, tax revenues fall (due to lower profits and wages) and expenditure increases (due to higher benefits) resulting in a budget deficit. Over the part of the cycle when economic activity increases, tax revenues increase and expenditure decreases resulting in a budget surplus. These cyclical surpluses and deficits cancel each other out over the economic cycle and so do not require changes in government policy to address them.

It is easier to see what the structural position is when an economy is running close to its productive potential or capacity which is where an economy is producing as much as it can while keeping inflation stable. So if, bearing in mind any lags in the tax system, there is a deficit being run when employment is close to full levels for example, then it is likely that the deficit is entirely structural.

When an economy is running far above or below its potential capacity, it is harder to determine the underlying structural position of public finances.

Running a structural deficit over an extended period causes a government's savings and other assets to be run down or alternatively to borrow money. Eventually action would have to be taken to correct the structural deficit by increasing the productive capacity of the economy and/or increase tax revenue or reduce expenditure.

In the UK, HM Treasury have researched how they can adjust their public finances figures for the estimated effect of economic cycles. The Office for Budget Responsibility (OBR) in their annual "Economic and Fiscal Outlook" carry out a fiscal forecast showing cyclically-adjusted public finances.

In particular, one of the medium-term fiscal target measures for the UK government is that the cyclically-adjusted current budget should be in balance by the end of a rolling five-year forecast period. This measure, which excludes net investment spending, estimates the structural current surplus/deficit position in any year. Therefore the target is to ensure that current revenues should cover current expenditure on average over five years after allowing for the impact of economic conditions.

Source: OBR Economic and Fiscal Outlook March 2012

2.7 Holistic assessment of States' fiscal position

One of the Panel's aims is to look at the States overall fiscal position from the point of view of all its major funds and entities. The Consolidated Fund, Social Security Fund and Health Insurance Fund are the main funds run by the States of Jersey which receive money from and pay money to Islanders each year, thereby interacting with the local economy. The Strategic Reserve and Stabilisation Fund which in normal years mainly receive investment income from investments abroad do not have significant and direct interactions with the local economy (although clearly where transfers are made to and from the Consolidated Fund they can).

When bearing in mind these other Funds it is clear that the States is currently taking out around £25m more out of the economy through social security contributions than it is putting in through pension payments and other benefits. However, these surpluses may decline over the next few years although there is some uncertainty around the precise path.

Figure 2.25

Projected "total funds" balance, after previous adjustments

Source: States of Jersey Treasury; Panel calculations using 2009 Government Actuary report

Note: The HIF surplus/deficit includes the proposed transfers to the Consolidated Fund for health expenditure .

	2011	2012	2013	2014	2015
	£m	£m	£m	£m	£m
Consolidated Fund surplus/deficit	-25	-7	1	0	0
Consolidated Fund adjustments	-60	-83	-75	-93	-62
	-85	-90	-74	-93	-62
Social Security Fund surplus/deficit	30	26	23	19	15
Health Insurance Fund surplus/deficit	6	-1	2	-4	-5
Total Funds surplus/deficit	-49	-65	-49	-78	-52

Looking at the fiscal position holistically (Figure 2.25) changes the size of the deficits in the earlier years more than the later years, but the overall profile of the fiscal position between years is still that of large deficits each year. This serves to reinforce the points made earlier that the profile of the fiscal stance over the course of the MTFP may not fit with the requirements of the economic conditions in 2014 and 2015.

2.8 Risks and sustainability

The move towards medium term financial planning is a welcome improvement which amongst other things helps to reduce the risks of an inappropriate and/or unsustainable fiscal policy being pursued.

However, relative to where we were at the time of the 2012 Budget, the risks to the fiscal outlook have increased for a number of reasons.

Need for flexibility in 2014 and 2015

Planning to run deficits in 2014 and 2015 carries the risk that there will not be enough flexibility to amend the plans in future years to return the budget to balance by 2014/15 and prepare to run surpluses if the economy continues to recover. The risk is that decisions may be required to reduce capital expenditure by prioritising projects and that it will be too late or difficult to make these decisions. Without such adjustment the outcome would be larger deficits than necessary at a time when the economy was performing more strongly, suggesting that fiscal policy had moved from being countercyclical to pro-cyclical over the life of the MTFP.

In addition the fact that the balance on the Consolidated Fund is very tight by 2015 (£10m) there would appear to be limited flexibility should revenue or spending trends differ from those set out in the MTFP.

Risks to income tax revenue

Although there has been an improvement in the income tax revenue base in 2011 and 2012 which is expected to recur through the MTFP period, the economic outlook has deteriorated which means that future income tax revenues are not going to grow as quickly as previously thought. It is more likely now that income tax revenue will be in the lower part of the range by 2014 and 2015.

The Panel is also aware that the estimate of the fiscal impact of the end of the deemed distribution aspect of zero-ten is uncertain, so will continue to monitor this closely.

2.9 Long-term pressures

There are a number of long-term pressures that need to be considered.

The States should be cautious about its longer term expectations for future economic growth and the contribution it can make towards spending pressures through higher tax revenue as it is not clear what the sources of future productivity growth will be. One factor which will affect future productivity growth is the way the States decides to approach its future population and migration policy from next year.

It is also more likely that economic recovery in Jersey (and elsewhere particularly in the UK and the euro area) will take longer than previously

expected and the long and drawn out nature of this may also have reduced the longer term potential for economic growth rates.

The new population projections published by the States' Statistics Unit show that like many other countries Jersey continues to face an ageing population which will add to the demands on public services. Without any associated improvement in revenues the ageing population will add to the structural pressures on States' finances in the long-term.

It is welcome news that the Treasury are actively looking at the States long term capital requirements. The proposed plan to fund the long term capital programme is ambitious and requires future policy changes to increase income and introduce user pays charges. In addition there is the prospect of £330m future investment in the hospital which even if it is financed by borrowing will place additional structural strains on the financial position as it will require repayment of capital and interest over many years.

Risks from potential changes to financial regulation either unilaterally from the UK, or from a wider international agreement remain and could threaten the existing business models of some of the Jersey financial sector.

Taken together, all these longer-tem pressures emphasise that it is important for the States to be prudent when making decisions relating to ongoing income and expenditure, not least because decisions taken now and in the coming years could lead to even tougher fiscal challenges in the future.

Section 3 - Recommendations

This section draws on the previous two sections and sets out what recommendations the Panel are making given the latest assessment of the economic outlook and the analysis of the proposals set out in the MTFP.

1. The Panel's assessment of the economic outlook for the Jersey economy has been downgraded for 2012 and 2013 and there are indications that significant spare capacity will remain in the economy over this period. This leads the Panel to advise that the States should act now to give discretionary fiscal support to the economy in 2012 and 2013 and if practical to a greater extent than set out in the MTFP.

2. While the consideration of additional discretionary stimulus should not be limited purely to capital expenditure it is clear that with such significant capital allocations over the life of the MTFP consideration could be given as to whether in a timely, temporary and targeted manner:

    - Capital allocations in 2012 and 2013 can be spent in the year of allocation

    - Capital allocations from 2014 and 2015 can be brought forward to 2012 and 2013

    - Unspent allocations in 2012 from previous years can be spent as quickly as possible in late 2012 and 2013

3. The extent of stimulus should not be limited by the balances on the Consolidated or Stabilisation Funds. The States should give consideration as to the best way to fund needed stimulus if it is constrained by the availability of funding from these sources, not least because any constraint would be one of cash flow and funds could be repaid from future revenue.

4. It is too early to judge whether the stimulus that will be provided to the economy in 2014 and 2015 by capital expenditure financed by one-off receipts will be warranted but contingency plans should be made as to what measures could be implemented to reduce the extent of the stimulus if economic conditions merit such an approach.

5. No transfers into the Stabilisation Fund are recommended in 2012 or 2013. However, further consideration needs to be given as to how the Stabilisation Fund will be rebuilt through countercyclical fiscal policy,

once the economy begins to recover. The Panel does not recommend a transfer into or out of the Strategic Reserve at this stage.

6. The Panel cannot rule out that there is an underlying structural imbalance between expenditure and revenue. The Panel's view is that further analysis is required by the Treasury and Resources Department to consider the nature of proposed capital expenditure, the way it is funded and what it implies for the underlying position of States' finances. If this analysis suggests there is a structural deficit then consideration should be given to its extent and nature, including a more detailed plan of action to rectify it.

7. The Panel have had to make significant adjustments to the financial forecasts presented in the MTFP to try to assess the underlying economic impact of the proposals. In future the presentation of States' finances would be more informative, leading to a better informed policy debate if these types of adjustments were already included in the analysis accompanying any proposals in the MTFP or Budget.

Appendix – Correspondence between Treasury Minister and FPP

Minister for Treasury and Resources
P O Box 353, Cyril Le Marquand House, The Parade
St Helier, Jersey, JE4 8UL
Tel: +44 (0)1534 445502
Fax: +44 (0)1534 445522

Private and Confidential 12th April 2012
Mr Joly Dixon, CMG
70 rue Notre Dame
1200 Brussels
Belgium

Dear Joly

Advice on use of Stabilisation Fund

I am writing to seek the advice of the Fiscal Policy Panel on a proposal I wish to take to the States shortly which changes the proposal in the 2012 Budget document not to withdraw the full amount from the Stabilisation Fund and makes temporary use of those funds to support housing capital projects.

In your October 2011 update you made it clear that:

> *"should the economic situation deteriorate, the States should be ready to support economic activity without weakening States' finances. For example:*
> - *bringing forward already funded capital projects in the capital programme, or redistributing past capital project allocations to projects that are able to take place sooner.*
> - *speeding up the planning process for private sector projects already in the pipeline."*

Since that report we have seen a number of developments which represent a further weakening of the local economy:

- The confirmation that from 1 April 2012 Low Value Consignment Relief into the UK will no longer be available from the Channel Islands, significantly impacting on our Fulfilment Industry which employees 700 people directly and many more indirectly.
- Unemployment is the highest on record. The recent Census results show that in March 2011 unemployment had risen to 4.7% and that the numbers actively seeking work have risen by nearly 30% since then.
- The December 2011 results of the Business Tendency Survey showed that business activity and optimism across the Island had fallen further.
- Retail sales volumes fell significantly in the second half of last year and there have been few signs since of conditions improving.
- Anecdotal evidence (consistent with the picture in the Business Tendency Survey) is that construction order books are not being replenished and that this could be putting further jobs at risk.

In response to this new economic data I have given full consideration to your advice above and what can be done to bring forward capital projects. Following discussions with the Housing Minister it has been identified that there are a number of projects that are being progressed by the Department that will be ready to tender during 2012. These projects together will provide a total of £27.1m of work for the construction industry, boost wider economic activity and provide 121 new homes that are very much needed (please see the details in the attached papers).

I am in a position to be able to secure funding for these vital social housing projects because the unaudited States Accounts for 2011 identify a balance in the Consolidated Fund which is £27 million higher than expected, primarily as a result of improved taxation revenues and carrying out the full approved transfer from the Stabilisation Fund. Approval of the States is sought to increase the expenditure approval in 2012 for the Social Housing Programme expenditure from £10.8m to £37.9m.

The funding of £27.1 million will be repayable by Housing upon incorporation on 1st January 2014 when an investment will be made by the Currency Fund in the new organisation. Of this repayment £10 million will be reimbursed to the Stabilisation Fund.

At the time of your October update forecasts showed that the balance on the Stabilisation Fund would be £10m in 2011 through to 2014. If the States agrees to the above the balance would effectively be 0 in 2011 through 2013 but return to £10m as forecast when the £27.1m investment will be made by the Currency Fund, allowing the £10m to be repaid to the Stabilisation Fund on 1 January 2014.

I think that in this case the Stabilisation Fund would be used to facilitate short-term increases in capital expenditure at a time of continued economic weakness, without any impact in the medium-term on the balance in the Stabilisation Fund. My commitment would remain to rebuild the Stabilisation Fund in due course as economic conditions and States finances allow.

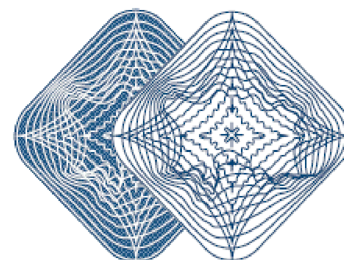
I still believe that our economic prospects remain favourable in the medium-term – especially as we have taken the key decisions to keep our finances on a sound footing – but I am also acutely aware that we should be doing what we can to support local employment and businesses until conditions improve. If the States agree to this proposal I think we will be bringing forward capital projects, supporting the economy and without weakening States finances.

Given the implications of this decision for both the projected balances on the Consolidated and Stabilisation Funds I thought it important that the States was aware of your advice on this matter before being asked to take the decision. I would therefore be grateful if you could respond in time for members to be aware of your views in advance of the States debate on this proposition.

Yours sincerely

Senator Philip Ozouf
Minister for Treasury and Resources

direct dial: +44 (0)1534 440287
email: p.ozouf@gov.je
www.gov.je



Jersey's Fiscal Policy Panel

Senator Philip Ozouf
Minister for Treasury and Resources
Cyril Le Marquand House
PO Box 140
St Helier
Jersey JE4 8QT

4 May 2012

Dear Minister

Use of Stabilisation Fund

Thank you for your letter dated April 12 2012. You asked for advice on your proposals to use money that might otherwise have been allocated to the Stabilisation Fund in line with our recommendation that balances in excess of £20m in the Consolidated Fund be transferred to the Stabilisation Fund, to support housing capital projects. This is entirely consistent with our remit to give you and States members independent economic advice on matters relating to overall tax and spending policy relative to economic conditions and in particular on use of the Stabilisation Fund.

We address the key economic issues relating to your proposal below, considering in turn:

- the current economic situation
- the need for fiscal stimulus
- better than expected tax receipts in 2011
- key principles for fiscal stimulus
- medium-term sustainability.

However, we remind you that as ever we operate within the confines of the limited data that are available on both the current economic performance and the medium-term fiscal outlook and against the back drop of volatile and uncertain global economic trends, particular

surrounding the Eurozone. We will cover these issues in more detail and on the basis of more up to date and complete information when we report on the Medium-term Financial Plan (MTFP) ahead of the debate.

Current economic situation

We have been following developments locally and globally with interest and have noted that since our October 2011 Update Report when we stated that risks to the economic outlook this year were weighted to the downside, these risks have to some extent materialised. JFSC figures suggest that profitability in the banking sector improved in 2011 as net interest income increased for the first time since the onset of the financial crisis. However, the March 2012 Business Tendency Survey showed a small net balance of finance sector firms reporting a fall in business activity compared with three months previously for the first time and the balance expecting an increase in future business activity the least positive to date, while profitability remained negative, though less so than in September at the time of our last report.

The same survey showed that for the non-finance sector as a whole all ten indicators were negative and those for business activity and new business the most negative to date. These data are consistent with the other data you refer to in your letter, in particular falling retail sales volumes, record unemployment, the likely impact of the removal of LVCR on the fulfillment industry from 1 April and continued negative trends in the construction sector.

In summary we feel that these trends in the local economy are more in line with the downside of our previous forecast of growth between 2 and -2% this year.

Fiscal Stimulus

In view of the worsening economy it would be appropriate to follow our advice from October that "should the economic situation deteriorate, the States should be ready to support economic activity without weakening States' finances". We support your proposal to fund £27m of additional housing projects in 2011, subject to it meeting the conditions for fiscal stimulus outlined below. However, at only 0.5-1.0% of GVA this additional expenditure may not provide sufficient stimulus if economic conditions deteriorate further. As the States considers the Island's first MTFP it will be important to include sufficient flexibility in States'

finances to undertake additional fiscal stimulus this year and next if necessary. We will comment more on this issue when we report later in the year.

Better than expected tax receipts in 2011

You mentioned that you are in the position to be able secure funding for these projects because the consolidated fund is £27m higher than expected largely as a result of improved taxation revenues and carrying out the full transfer into the Consolidated Fund from the Stabilisation Fund. Our advice has been consistent over the years that better than expected revenues in one year do not in themselves merit a change in fiscal policy (expenditure or tax) either in the short or medium-term. If economic conditions had not deteriorated since our last report our advice would have been to transfer all these funds into the Stabilisation Fund.

Key principles for fiscal stimulus

We have previously advised about the key principles that should be applied in determining discretionary fiscal stimulus actions – the now familiar 3Ts. If projects can be identified that were going to take place anyway, can be brought forward and that have intrinsic economic value in their own right policy should be:

- **Timely**. Start immediately to have an impact within the next 12 months and preferably as soon as possible.
- **Targeted**. Policy should be targeted toward measures that will have the most impact in terms of supporting economic activity and employment in the Island.
- **Temporary.** The measures chosen should have no negative long-term implications for the public finances either in terms of the tax base or spending commitments.

Medium-term sustainability

The latest trends in the economy should not distract attention from our concern that the States' finances be on a sustainable basis in the medium-term so that when economic conditions improve deficits close and return to surplus when economic activity is performing strongly allowing the Stabilisation Fund to be replenished. Latest developments only

intensify the need to look at the States' fiscal position on a consolidated basis. These are issues we will cover in more detail when we report later this year.

We hope these comments are sufficient at this stage and we look forward to receiving all the information on the new MTFP in due course. We have copied this letter to all States members.

Yours sincerely

Joly Dixon (Chairman)
Christopher Allsopp
Marian Bell