Jersey's Fiscal Policy Panel Annual Report

October 2017

Introduction

This is the tenth annual report of the Fiscal Policy Panel (FPP). The current members of the Panel are Dame Kate Barker (Chair) and Tera Allas, who were appointed in 2014, and Professor Francis Breedon, who was appointed in 2016. The Panel was placed on a statutory basis in 2014 and is required by the Public Finances Law to comment on Jersey's fiscal policy with reference to:

(a) the strength of the economy in Jersey;
(b) the outlook for the Jersey and world economies and financial markets;
(c) the economic cycle in Jersey;
(d) the medium and long-term sustainability of the States' finances
(e) transfers to/from the Strategic Reserve and Stabilisation Fund.

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 predictable, with flexibility to adapt to economic conditions to assist in creating a more stable economic environment;
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 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 and Treasury and Resources Department.

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

Key points

Economic Outlook

- The global economy has seen some improvement in 2017 and short-term forecasts have increased slightly over the last year, particularly for advanced economies. Considerable risks remain.
- 2016 saw only the third year of real growth in Jersey's economy since 2007, with the economy growing by 1%, slightly above the FPP assumption.
- Outlook for the finance sector is generally positive but uncertainties remain. The recovery in the non-finance sectors has continued, though the most recent survey data suggest some weakening in the second half of 2017 with profits under pressure.
- The labour market remains buoyant with employment at record levels, registered unemployment falling and earnings growing above inflation for the fifth consecutive year.
- Economic growth of around 1% is expected for 2017, falling back to around 0.5% in 2018. However, considerable uncertainty remains around these forecasts particularly with regards to Brexit and the challenges facing financial services.
- There are signs that spare capacity in the economy may be being used up more quickly than previously thought.

Public Finances

- The Panel considers that its four guiding principles have generally been followed during the MTFP Addition and Budget 2018 and the analysis in this section points out where further positive steps can be taken in keeping with these principles.
- Net revenue expenditure in 2016 was significantly below that anticipated at the time of the MTFP Addition, as departmental revenue expenditure was less than expected. Total States income in 2016 came in over £40m (6%) higher than expected at the time of the MTFP Addition. This left the operating position in surplus rather than in deficit and the current budget in balance rather than deficit as expected at the time of the MTFP Addition. As a result, in 2016 the States did not run countercyclical fiscal policy as advised by the Panel.
- Most of the developments in 2016 are one-off in nature which means overall States income is expected to be about £2m higher in 2019 than forecast a year ago. Current projections also suggest that net revenue expenditure will

be at the same level in 2019 as was expected in the MTFP Addition. This would leave income and expenditure in balance in 2019.

- The two main developments relating to the funding measures proposed in the MTFP Addition have been the decision not to implement the health charge and the deferral of the liquid waste charge until 2019. This means that Budget 2018 has had to propose a number of other revenue raising measures of just over £10m by 2019 in order to bring the budget to balance. It is noticeable that these measures are becoming more ad hoc in nature and that in the medium term a more strategic approach will be required.
- The FPP continues to believe that the profile and scale of the measures proposed in the MTFP Addition and Draft Budget 2018 are broadly appropriate and the remaining measures (or ones of equal value and economic impact) need to be implemented on time.
- The Panel is encouraged that the latest financial forecasts indicate that its previous advice will continue to be met and that the overall fiscal position returns to balance at around the time that the economy is expected to have returned to capacity.
- The Council of Ministers' proposal to hold back the allocation of any new growth expenditure for 2019 until Budget 2019 and subject to the agreement of waste charges (or equivalent expenditure measures) is in keeping with FPP advice to continue to implement the measures set out in the MTFP Addition or others of equal size. However, it is important to make sure that the potential for further efficiencies in States expenditure has been fully explored before cutting expenditure in priority areas.
- The adjusted fiscal position suggests the overall fiscal position is likely to have a less positive impact on the economy than expected at the time of the MTFP Addition for the 2017-19 period because the capital expenditure profiles are lower for these years. It is also noticeable that in 2016 the adjusted fiscal position has swung from one where the States was expected to be adding over £150m to the economy to an outturn where the position was broadly one of balance.
- Nonetheless, current plans mean the States would add about £170m in 2017 and between £200-£300m to the economy in each of the years 2018-21. This is equivalent to about 4% of GVA in 2017 rising to between 4-7% of GVA in 2018-21. The September Business Tendency Survey results highlight the need for this support in the short term but there is the risk that this could be pro-cyclical if the economy is above capacity in the later years.
- The recommendations from the FPP's 2016 Annual Report have been followed in general but the responses fall into two groups. Those where steps have been taken to meet the recommendation and those where more work is required to continue to make progress.

- There are several risks to successfully delivering the current plans for the 2017-19 years. These include uncertainty about future revenue, ability to control expenditure, political risks, the timing of capital expenditure and future population policy.
- In the longer term there are a number of challenges which are likely to lead to further structural pressure on States finances: the ageing population, weak productivity growth and continued economic volatility.

Recommendations

1. The FPP continues to believe that the profile and scale of the measures set out in the MTFP Addition and Draft Budget 2018 is broadly appropriate and advise that the remaining measures (or ones of equal value) for 2018 and 2019 need to be implemented on time.
2. The Council of Ministers is urged to ensure that a permanent programme for securing additional efficiencies in the public sector is fully embedded in all future States financial planning and in particular in time for the next MTFP. This process should identify ways in which the same services can be delivered but with fewer resources.
3. Progress has been made in meeting the Panel's previous advice regarding contingencies but there are two aspects worth giving further consideration to:
    - Ensuring that unspent contingencies that are returned to the Consolidated Fund are not used to weaken fiscal discipline and delay required permanent revenue or expenditure measures.
    - Further explanation on how the size of contingency allocations are determined and particularly so this is clearer ahead of the development of the next MTFP.
4. The Panel continues to highlight the need to prioritise delivering key capital projects on time and particularly those that will support the local economy in 2017 and 2018 (particularly in the light of the September 2017 Business Tendency Survey results) but there is the risk that this could be pro-cyclical if the economy is above capacity in the later years. However, it will be important as spare capacity continues to be used up across the economy also to be vigilant that these large capital projects do not put too much pressure on local resources and add to nascent cost pressures in the construction sector.
5. Given the scale of future capital expenditure there are a number of other risks that can be managed by:

- Prioritising projects that demonstrably add to future productivity growth, for example in areas such as skills and infrastructure.
- The States exerting tight control of costs to prevent projects over exceeding budgets.
- Providing more certainty on the funding and timing of the new hospital development.

6. The improved position on the Consolidated Fund should not at this stage lead to any changes in the proposed scales and timing of measures to balance the budget – either on the revenue and/or expenditure side.
7. If the current forecasts come to fruition the Panel would expect to advise in future reports to reduce the balance on the Consolidated Fund by either transferring funds to the Stabilisation Fund or making a further repayment to the Strategic Reserve.
8. The Panel continues to support the ongoing monitoring of trends in States assets and liabilities, as set out in Council of Ministers Fiscal Framework and this should include regular assessment of trends as a share of GVA.
9. Build on the work done by the Social Security Department looking at the sustainability of the Social Security Funds in the light of the ageing population and take a whole-of-government view for a strategy to deal with the ageing society.
10. The Economic and Productivity Growth Drawdown Provision (EPGDP) should continue to identify medium-term policies that help raise productivity and increase the underlying rate of economic growth. Consideration should be given as to how the EPGDP could facilitate the adoption of new technology across all sectors in Jersey and drive significant productivity growth.
11. When considering the longer-term challenges that the Jersey economy and public finances face, this gives some direction for the key issues that need to be developed and addressed in the next MTFP:

    - **Future structural pressures**: The longer-term challenges facing Jersey make it clear that further adjustment is likely to be required during the next MTFP period. A strategy to address this should be developed that looks at what is realistic in terms of further efficiency savings (as opposed to expenditure reductions) and whether revenue-raising measures will be required.
    - **Capital expenditure**: Identifying what capital expenditure is required that is conducive to economic growth and productivity improvements. Also, how it will be financed and managed to get the balance right between preventing capacity pressures and supporting the economy. The fact

fiscal policy in Jersey did not operate in a countercyclical way in 2016 is a timely reminder of how difficult this can be.

- **Planning for surpluses**: If economic conditions over the life of the next MTFP are such that the States runs budget surpluses in any year, these should be used to replenish reserves – either the Stabilisation Fund or Strategic Reserve.

Section 1 - The Economic Outlook

1.1 International outlook

The International Monetary Fund (IMF) estimates that the world economy grew by 3.2% in 2016, the lowest rate of growth seen since the immediate aftermath of the global financial crisis in 2009. This was due to a marked slowdown in growth in advanced economies – in particular the United States. The picture for emerging economies was mixed, with China and India slowing but Russia seeing some improvement. Both emerging and advanced economies have seen some improvement in 2017 and the IMF's short-term forecasts have improved slightly over the last year, particularly for advanced economies.

The most recent data on the global economy are mildly encouraging. The Manpower Global Employment Outlook surveys firms around the world in relation to their hiring intentions. In Q4 2017, of the 43 countries surveyed, 42 had a positive reading on an aggregate basis – suggesting increasing employment. The overall reading is at its highest level since early 2007. In addition, world trade in merchandise goods has been picking up in 2017.

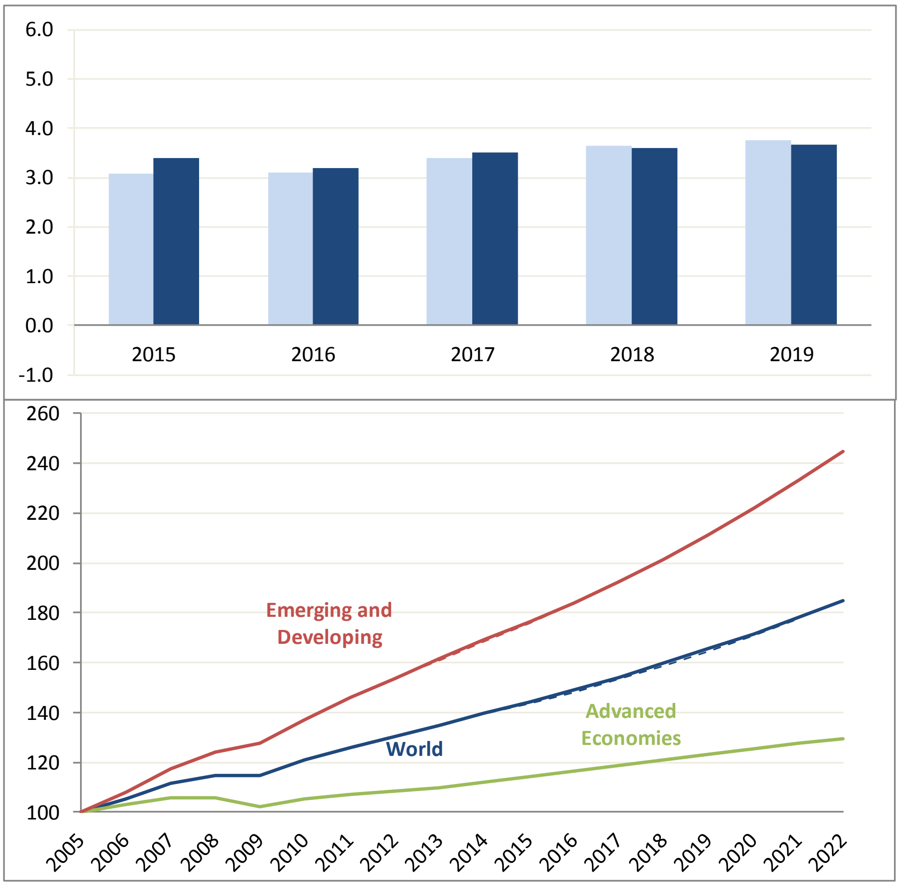
Figure 1.1

Global growth

Top panel: global GDP real growth – October 2017 estimates/forecasts; pale bars are July 2016 estimates/forecasts

Bottom panel: index (2005=100) of real-terms GDP - October 2017 estimates/forecasts; dashed lines are July 2016 estimates/forecasts

Source: International Monetary Fund (IMF) World Economic Outlook July 2016 update and October 2017 report



The EU has seen some momentum so far in 2017, with the IMF forecasting growth of 2.1% this year - the strongest for a decade. While this momentum is expected to be relatively short-lived, the balance of risks is on the upside. The United States is expected to accelerate in 2017 and 2018, though forecasts have been downgraded over the last year.

China has seen stronger performance this year to date, suggesting a more gradual slowdown than previously expected, though a hard landing is still a possibility. Among other large emerging economies, India is expected to continue its strong growth while Brazil and Russia have recovered from recent recessions but are not expected to see strong growth in the short term.

Considerable risks remain to the global economy – including concerns over United States fiscal policy and over China's ability to control financial sector risks. Within Europe, the potential for major political disruption appears to have subsided, but the impact of Brexit remains an uncertainty particularly for the UK. Heightened geopolitical tensions in recent months could also disrupt global momentum.

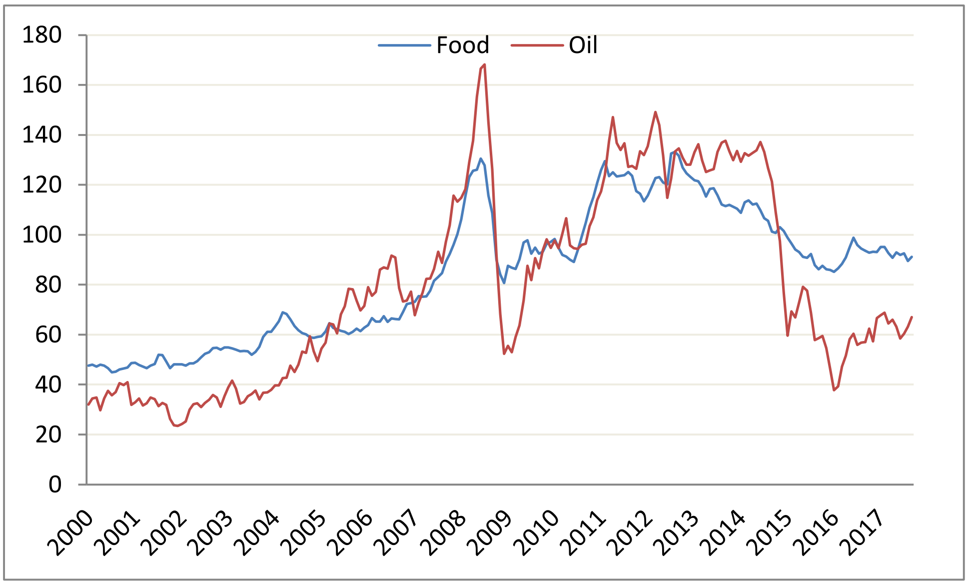
Oil prices continued to recover in the second half of 2016 and after falling again early in 2017 they have recovered to a similar price as one year ago. Recent data suggest that global supply remains strong and no significant price trends are forecast over the next eighteen months. Global food prices have seen little change over the last twelve months.

Figure 1.2

Commodity prices

Index of nominal US dollar food and oil prices, 2010=100

Source: World Bank Global Economic Monitor Commodities October 2017



The IMF's forecast for the UK has increased for 2017 but fallen for 2018, reflecting a more gradual slowdown than previously expected. However, the forecast for both years remains below expectations that were recorded before the EU referendum. IMF forecasts suggest some recovery beyond 2020 but the downgrades since the referendum imply the UK economy will be 2% smaller by 2021 than previously expected.

The long-term impacts are much more uncertain, as this will depend on the outcome of the ongoing negotiations between the UK and the EU, particularly in relation to the impact on trade and migration. The future prospects of the UK's financial services sector remain unclear.

Sterling fell by around 10% against both the euro and dollar in the months following the referendum. Further falls were seen in late 2016 and early 2017 but a recent recovery sees sterling 8% higher against the dollar and 1% higher against the euro than a year previous (as at 11 October). The longer-term falls are expected to impact on consumer spending as they continue to feed into higher prices.

UK Bank Rate has been at a record low level since being cut to 0.25% in August 2016 following the EU referendum but indications are that this may start to increase gradually in the near future. The Monetary Policy Committee has changed its judgement about supply capacity and now believes there is less spare capacity in the UK economy.

The US Federal Funds Rate has now increased by 1% from its record low since December 2015. Expectations are for one further increase this year, but the Federal Reserve has started to reverse its quantitative easing programmes by winding down its balance sheet. The benchmark interest rate in the euro area has remained unchanged at zero over the last year and European Central Bank indications are for no increase in the immediate future.

Overall, the global economy has remained relatively resilient over the last year, with growth improving from low levels in both the United States and Europe, and China having avoided further deceleration. While forecasters expect GDP growth to remain resilient outside the UK, there are risks from public policy especially in the US and concerns due to renewed geopolitical tensions. The main uncertainty for the UK remains the short-term and long-term implications of Brexit.

1.2 Jersey economic developments

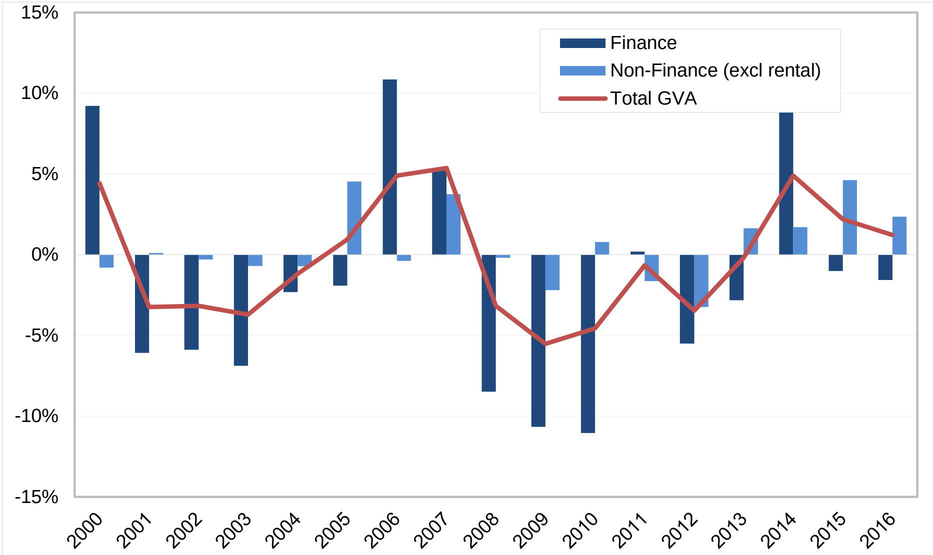
Gross value added (GVA) is the headline measure of economic activity in Jersey. 2016 saw only the third year of real growth in Jersey's economy since 2007, with the economy growing by 1%, slightly above the FPP assumption. Output of the finance sector fell by 2% in real terms while non-finance (excluding rental) grew by 2%. Several non-finance sectors reported strong growth in 2016, such as agriculture (12%); construction (8%); electricity, gas and water (8%); hotels, bars and restaurants (7%); and other business activities (6%).

Figure 1.3

A breakdown of Gross Value Added growth

Annual % real terms change

Source: States of Jersey Statistics Unit



Financial services sector

The **Survey of Financial Institutions** (SFI) reported a 2% fall in the GVA of the financial services sector in 2016 in real terms. This was the result of a 2% real terms fall in profits (following a sharp fall the previous year) and a 1% fall in total salaries (following strong growth in 2015). Over the last five years total employment costs have been largely flat, with profits falling by around 4%.

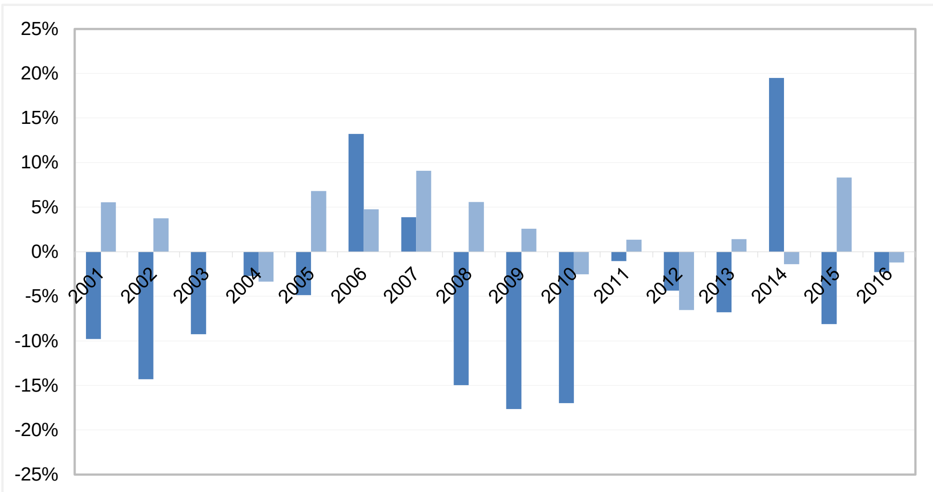
GVA of the banking sector fell by 6% but the combined Trust and company administration and Legal sub-sectors recorded a real-terms increase of 3%.

Figure 1.4

Financial services profit and employment costs

Annual % change in gross operating surplus (dark bars) and employment cost (pale bars), constant prices

Source: States of Jersey Statistics Unit



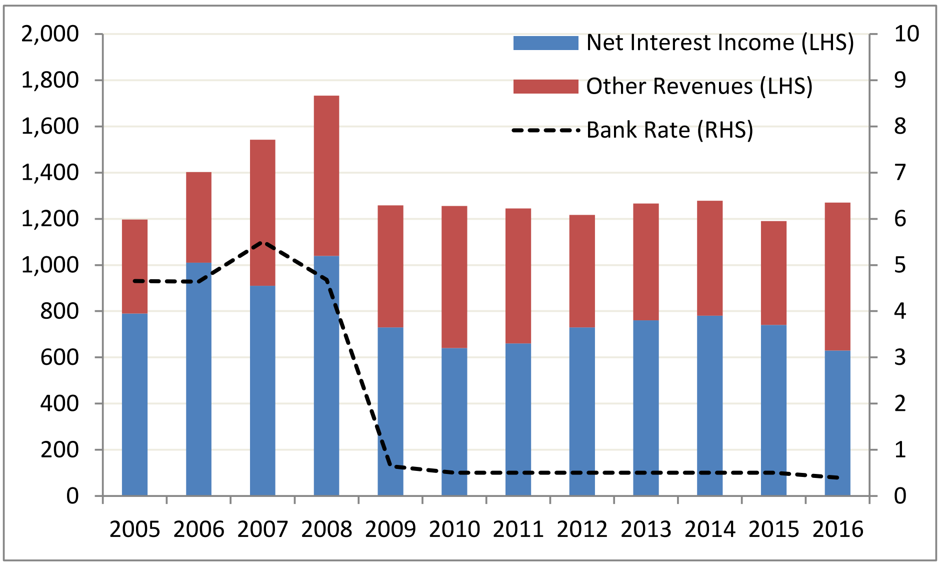
Revenues for the financial services sector were £2.5 billion in 2016, an increase of 6% from the previous year. 50% of revenues came from the banking sector (though only 38% from banking activity itself), with half of this from net interest income. As a result of the fall in interest rates in 2008 and 2009, net interest income fell by 38% over the course of two years but has since recovered somewhat. The further decrease in Bank Rate in August 2016 may have put further downward pressure on net interest income for some Jersey banks. However, prospects for a rate increase appear to have increased in recent months and this may support a modest reversal in the downward trend in net interest income. The interest rate on dollar deposits will have already begun to rise.

Figure 1.5

Banking revenues

Source of revenue (£m, current prices - left hand scale) and annual average for Bank of England Official Bank Rate (% - right hand scale)

Source: States of Jersey Statistics Unit; Bank of England



Net interest income is also related to the level of deposits. The Jersey Financial Services Commission (JFSC) reports that the level of deposits held in Jersey has fallen each year since 2007, by an average of 6.7% per year. Over the last three years, these falls have been driven by falls in the sterling value of foreign currency deposits, with the level of sterling deposits largely unchanged since 2013. The majority of currency deposits are held in US dollars or euros and changes in the exchange rate will affect the sterling value of these deposits. The fall in sterling in 2016 has not resulted in an increase in the total sterling value of currency deposits. The first quarter of 2017 shows a 2% increase in total banking deposits year-to-date, though quarterly movements can be volatile.

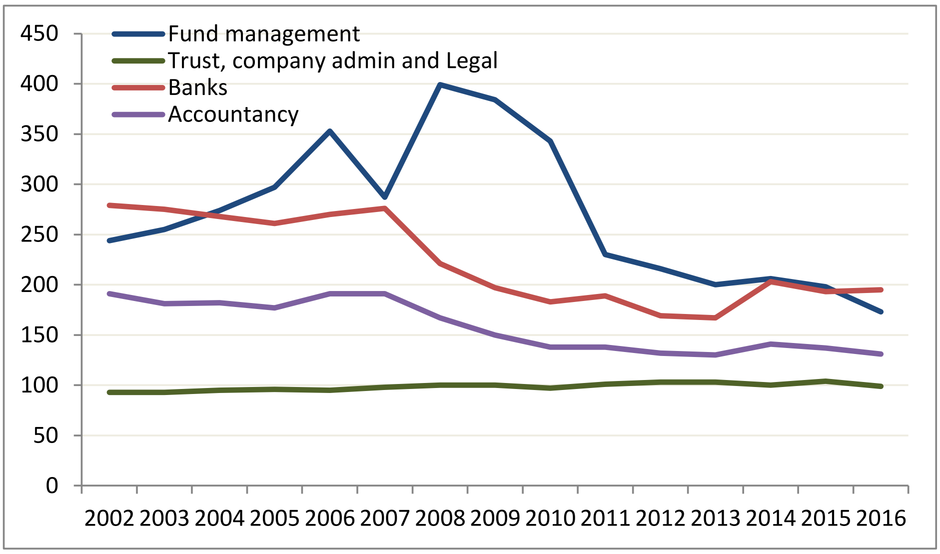
GVA per full-time equivalent employee (a measure of labour productivity) fell by 3% for the finance sector in real terms. On a subsector level, productivity grew by 1% in banking but fell in the trust, company administration and legal and fund management sectors. Since 2002, productivity has fallen significantly in both banking and fund management - by around 2.5% per year on average. Productivity for accountancy has seen a more gradual decline of 0.5% per year with trust, company administration and legal growing by around 0.5% per year.

Figure 1.6

Finance subsector productivity

Gross value added per full-time equivalent employee by sector, constant 2013 values, (£000)

Source: States of Jersey Statistics Unit



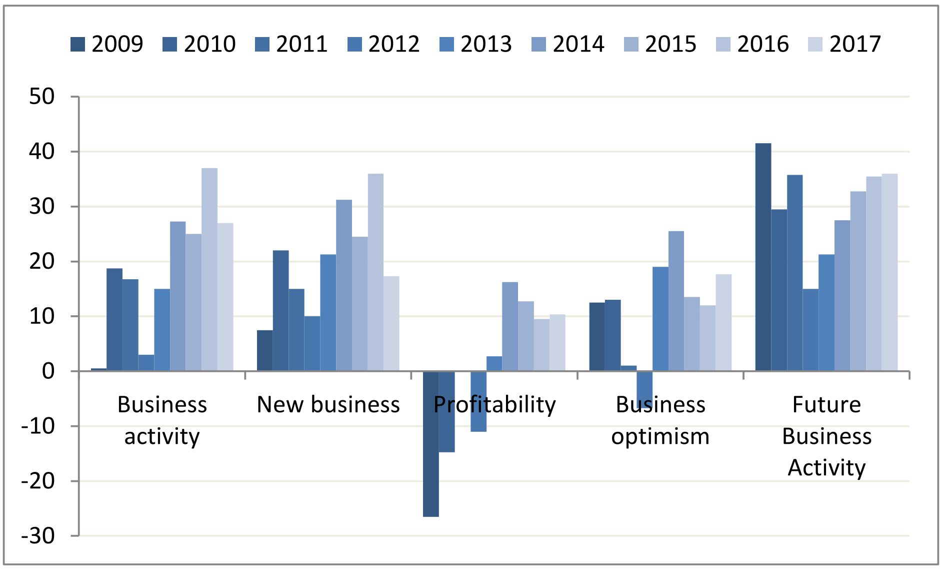
The **Business Tendency Survey** from September 2017 shows a reasonably positive picture for the finance sector, with the headline business activity indicator remaining positive but less so than recent months. Business optimism and profitability have improved in the most recent quarter.

Figure 1.7

Finance business tendency

% net balance of respondents reporting an increase (weighted by employment). Annual average of quarterly results, September 2009 to September 2017 (2009 and 2016 include results from only two quarters)

Source: States of Jersey Statistics Unit



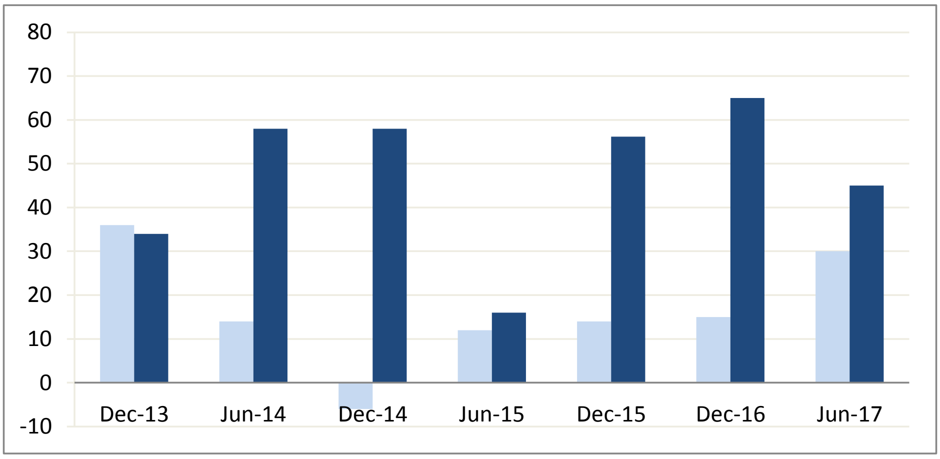
The **outlook for the financial services sector** was relatively positive in June 2017, with 58% of firms expecting profits to be higher than last year; compared to 13% expecting a decrease.. When asked about employment, 52% of firms anticipated an increase, with 22% expecting a fall. Figure 1.8 shows how the net balance has gradually improved for employment expectations since 2014, whereas for the last two years for which two surveys were carried out (there was no June 2016 survey), the profit expectation has been more volatile and has tended to be lower in June (which are in-year expectations) than in December (which are expectations for the following year).

Figure 1.8

Finance employment and profit expectations

% net balance of respondents (weighted by employment) expecting an increase in employment (pale bars) and profits (dark bars). Results from June are in-year expectation and results from December are expectations for the following year.

Source: States of Jersey Statistics Unit



During the Panel's recent fact-finding visit, the short-term outlook for the finance sector appeared stable with some signs of optimism. The commercial environment was reported to be positive but with significant challenges and external risks.

Brexit is clearly still a major worry, with uncertainty around the likely result of ongoing negotiations between the UK and EU, and about the implications for business in Jersey. However, the impact has been limited to date and considerable progress has been made in generating business from new markets which may help to offset some of this uncertainty.

The sector reported the potential for job growth, particularly in a number of specialist roles such as credit control. There were however some difficulties recruiting – particularly with compliance roles and experienced trust administrators, and some signs of wage inflation, but no indication of an industry overall working above capacity.

Progress has been made in planning for the ring-fencing of banking operations, and this presents both opportunities and difficulties. In addition, future regulatory and political risks unrelated to Brexit cannot be ruled out. As banks continue to consolidate their global operations this could lead to pressure on some non-core Jersey operations – though the consolidation trend can also have positive outcomes for Jersey.

Technology is becoming a key theme for the industry. A nascent Fintech sector is starting to emerge, but expectations are that technology will completely change a number of activities currently undertaken in Jersey. Automation may provide some opportunities to improve productivity; but this requires investment and could come with some reductions in employment in some areas. Cybersecurity is a key risk in Jersey just as it is elsewhere.

The monetary policy environment has potential for policy rate increases in a number of large developed economies. This could help to improve profits for banks, as could the fall in sterling which may boost the local currency value of deposits held in euros or US dollars.

Rest of the economy

2016 saw the recovery continue for non-finance sectors with aggregate GVA for non-finance as a whole seeing a fourth consecutive year of growth, the longest consecutive period of growth since at least 1998. However, output of the sectors is now only 4% above its pre-crisis peak in 2007 in real terms. A number of the non-finance sectors saw strong growth of more than 5%, including construction; hotels, bars and restaurants; and other business activities. Wholesale and retail fell by 3% and public administration fell by 4%.

Since the end of 2016, the Business Tendency Survey has been largely positive for non-finance as a whole, with the headline business activity indicator being positive for four successive quarters though having fallen in the most recent quarter (September 2017). The balance of respondents reporting a reduction in profitability remains higher than those reporting an increase and this is at its worst level since 2014.

Figure 1.9

Non-finance business tendency

% net balance of respondents reporting an increase (weighted by employment). Annual average of quarterly results, September 2009 to September 2017 (2009 and 2016 include results from only two quarters).

Source: States of Jersey Statistics Unit

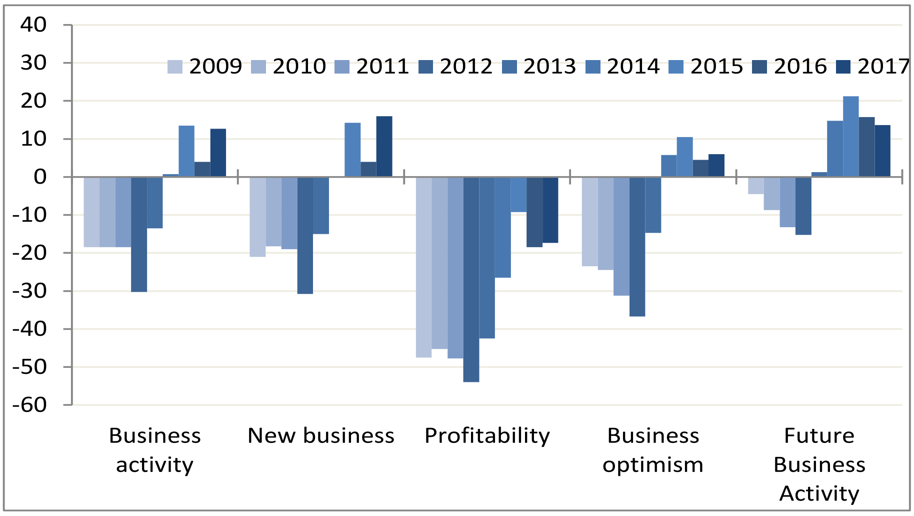


Figure 1.10 compares the responses to the BTS with the growth of non-finance sector GVA (excluding the rental income of private households). This shows that the business activity indicator has followed a similar trend to GVA for non-finance in recent years – with both indicating strong growth in 2015 before falling back slightly in 2016, but remaining positive. On this basis, the BTS results for the first half of 2017 would indicate potential for a further year of growth this year, though it is not yet clear whether this sentiment will be carried into the final quarter of the year.

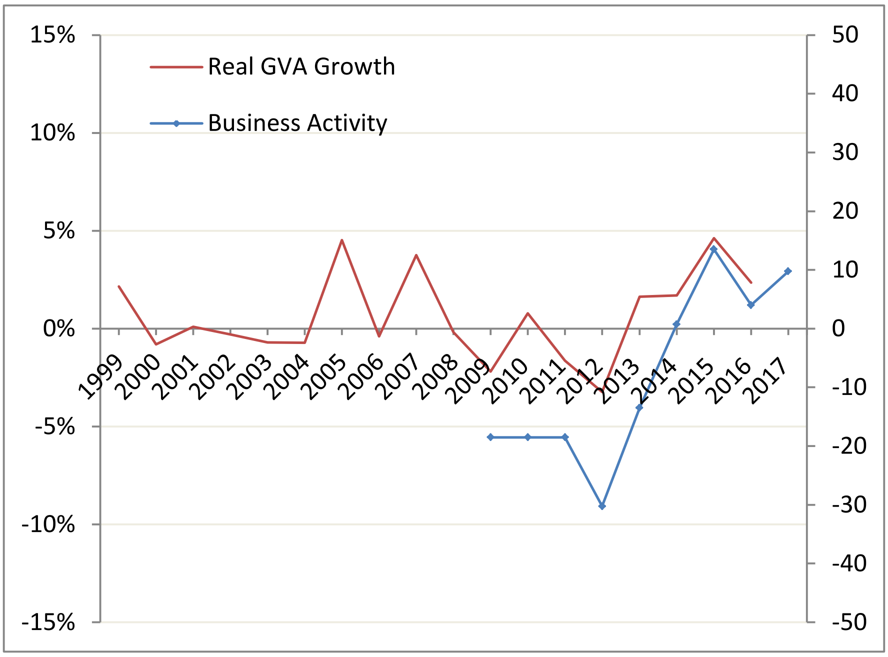
Figure 1.10

Non-finance GVA Growth

Annual real GVA growth excluding financial intermediation and rental (left-hand scale)

Non-finance responses to business activity question averaged over each year. 2017 based on average of responses to "business activity" in March, June and September plus "future business activity" from the September survey (right-hand scale)

Source: States of Jersey Statistics Unit



Sectoral performance

GVA of the **wholesale and retail sector** declined by 3% in 2016 in real terms, largely reversing the strong growth in the previous year. There was a 1% fall in labour productivity and a 2% fall in FTE employment. GVA of the sector has fallen significantly in recent years, due to the loss of much of the fulfilment sector as a result of the end of low value consignment relief (LVCR) and due to increased online competition for the retail sector.

The most recent (September 2017) Business Tendency Survey remains positive though a number of indicators have fallen from record highs in the previous quarter. Only input costs and profitability are negative (implying rising costs and falling profitability) in the most recent quarter.

During the Panel's fact-finding visit, the retail sector reported a mixed picture – with larger firms seeing growth but with business remaining relatively flat for a number of smaller retailers. Food volumes are generally increasing, but non-food continues to face competition from online retailers. There are some difficulties with recruitment, as unemployment falls, but the main challenge is rising costs – particularly in relation to food and energy prices and the potential for increased user pays charges and minimum wage rises.

The **hotels, restaurants and bars sector** grew strongly in 2017, with GVA up 7%. This was the combination of 5% growth in productivity and 2% increase in employment. Productivity is at its highest level since at least 1998, having grown by 8% over the last ten years.

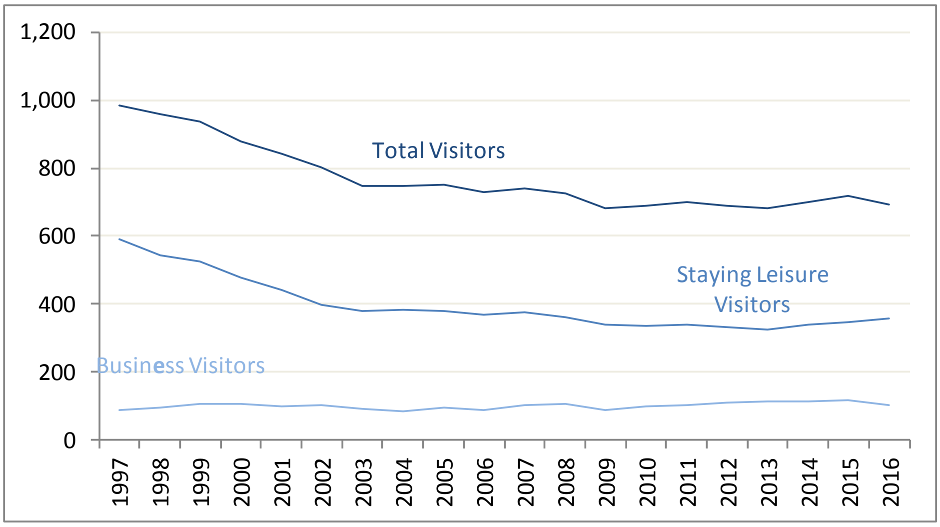
Following two years of growth, overall visitor numbers fell by 4% in 2016. Staying leisure visitors continued to grow but other categories of visitor saw falls. The first six months of 2017 followed a similar pattern, but this may not be indicative of the year as a whole as the majority of visits occur during the summer period.

Tourism sector representatives expressed some uncertainty about likely visitor numbers for 2017 as there was a general trend towards bookings being made later each year. Increasing input costs were a growing concern, as passing price increases on risks losing market share to other jurisdictions. The sector reported continued difficulty in recruiting staff locally.

Figure 1.11
Visitor numbers

Annual number of visitors to Jersey, 000s

Source: States of Jersey Statistics Unit



GVA of the **construction sector** grew by 8% in 2016, its third consecutive year of growth. The sector has increased by 24% since 2013 and output is now larger than the previous (2010) peak – with productivity and employment now at the highest levels since at least 1998. Responses to the Business Tendency Survey have been largely positive in recent years and the most recent (September 2017) survey showed strong business optimism but continued pressures on input costs.

Representatives of the construction sector remained positive when the Panel met with them in June 2017. They reported increasing workloads, employment increasing and a general increase in salaries. However, while wage pressures have yet to become significant, there are some difficulties with recruiting – particularly from the EU. Some uncertainties remain though, particularly with smaller contractors who are reluctant to scale up their operations in case the current strong pipeline begins to dry up.

1.3 Labour Market

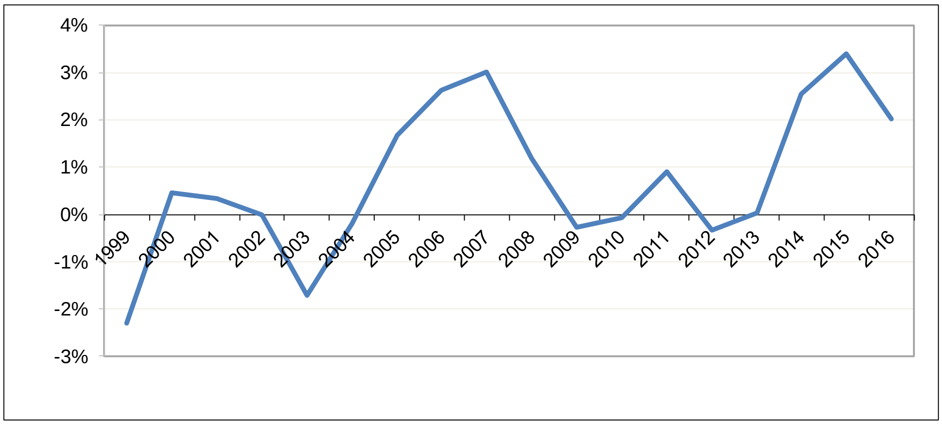
Employment in December 2016 was over 58,000 – 1.3% higher than a year before. This was a record high for December, and June 2016 was also a record high. Employment has grown a total of 13% in the ten years to December 2016.

Figure 1.12

Employment

Annual change in total private sector employment for December of each year

Source: States of Jersey Statistics Unit



The largest increase over the course of 2016 was in education, health and other services which grew by 500 (7%) on a headcount basis. The other large increase was in construction and quarrying which added 290 employees (5%) over the year. All other private sectors saw a small number of additional jobs, with the exception of wholesale and retail which was flat. The public sector declined by 270 (3%).

Figure 1.13

Employment changes by sector

Total headcount for each sector

Source: States of Jersey Statistics Unit

	Dec-15	Dec-16	Change
Agriculture and fishing	1,390	1,410	+20
Manufacturing	1,070	1,110	+40
Construction & quarrying	5,310	5,600	+290
Electricity, gas & water	480	500	+20
Wholesale & retail trades	7,820	7,820	0
Hotels, restaurants & bars	5,230	5,290	+60
Transport, storage & communication	2,700	2,730	+30
Computer & related activities	750	760	+10
Financial & legal activities	13,070	13,080	+10
Miscellaneous business activities	4,800	4,830	+30
Education, health & other services	7,240	7,740	+500
Public Sector	7,960	7,690	-270
Total	**57,820**	**58,560**	**+740**

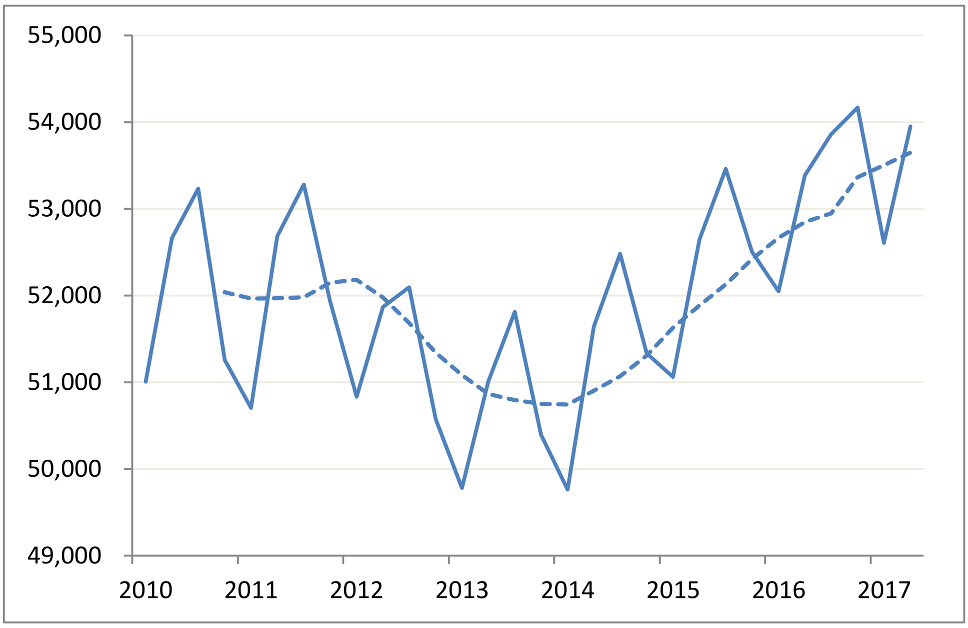
Social Security contribution numbers provide monthly data on the total number of individuals paying class 1 or class 2 contributions in that particular month. They can therefore be used to give some indication of recent trends in employment. Data for the first half of 2017 show average contributor numbers around 1% higher than the first half of 2016. This suggests continued growth in employment, though slowing somewhat from strong growth in the last two years.

Figure 1.14

Social Security contributions

Number of Class 1 and Class 2 contributions, quarterly average (solid line) and four quarter moving average (dotted line)

Source: Social Security Department



Unemployment, as measured by the internationally comparable ILO rate, was estimated to be 4% in 2014/15. The previous figure was 4.6% in June 2014, though as the collection method differed the two figures are not entirely comparable.

The number registered as **actively seeking work** (ASW) is a useful indicator of trends in unemployment, though it is not a comprehensive measure of unemployment as only around half of the people unemployed had registered as ASW at the time of the Census in 2011. ASW has halved since its peak in early 2013 and in September 2017 stood at 980. However, on a like-for-like basis the fall is likely to be more significant as a number of changes have been made to the Income Support criteria in recent years which have increased the number of individuals counted as ASW.

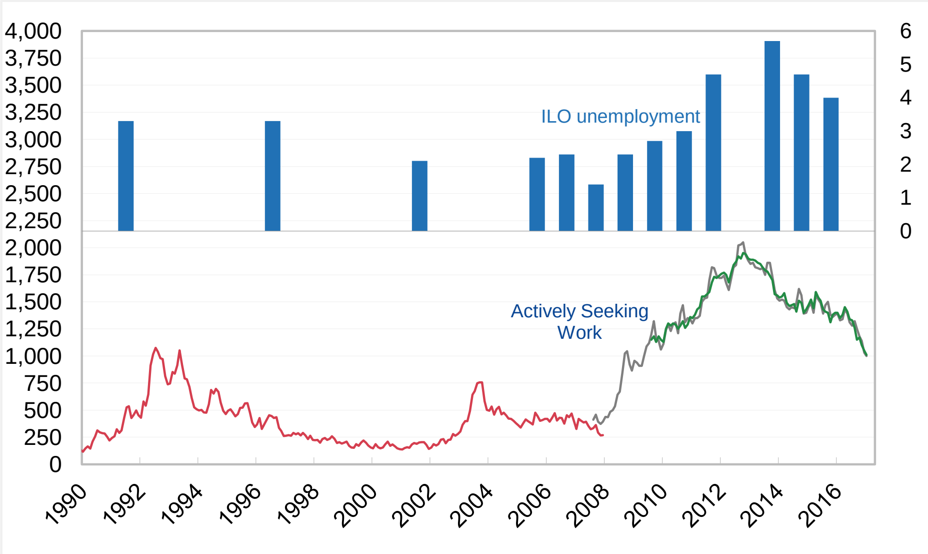
Figure 1.15

Changes in unemployment

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

Lower Panel: number registered as 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



32% of firms in the finance sector (weighted by employment) reported an increase in employment in the three months to September 2017 in the most recent round of the Business Tendency Survey, with 14% reporting a decrease. The same survey reported that 39% of finance firms anticipate increasing employment over the following three months, with only 11% anticipating a decrease.

The vast majority of non-finance firms (68%) reported no change in employment in the third quarter of 2017, with roughly equal numbers reporting increases as decreases. Looking forward, 14% anticipate increases with 13% anticipating falls in employment to September 2017.

Figure 1.16 demonstrates that the employment indicator has improved considerably in recent years for both finance and non-finance and there is some optimism for future employment. While the broad trends are consistent, optimism has not always resulted in the employment indicator being positive the following quarter.

Figure 1.16
Employment trends from BTS

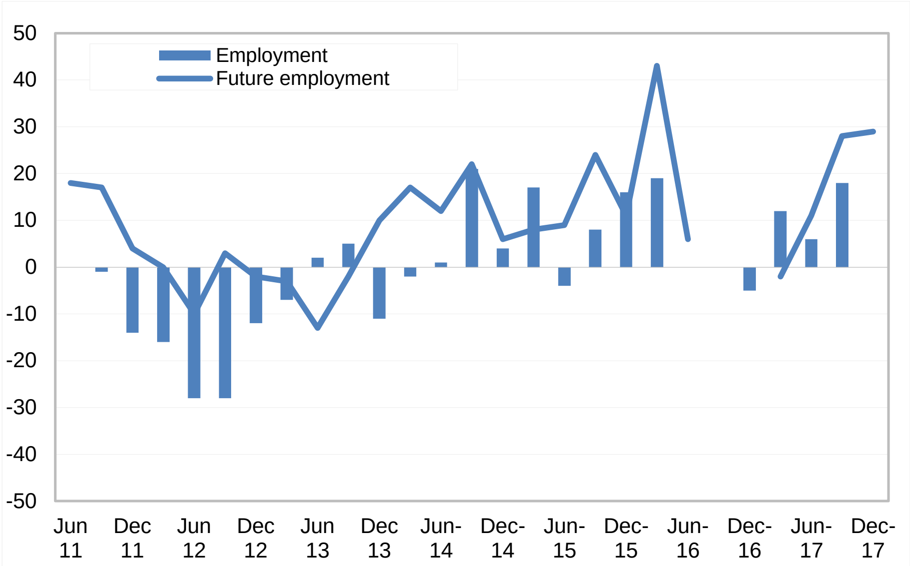
Weighted net balance reporting increase in employment, compared to weighted net balance reporting an increase in future employment one quarter earlier.

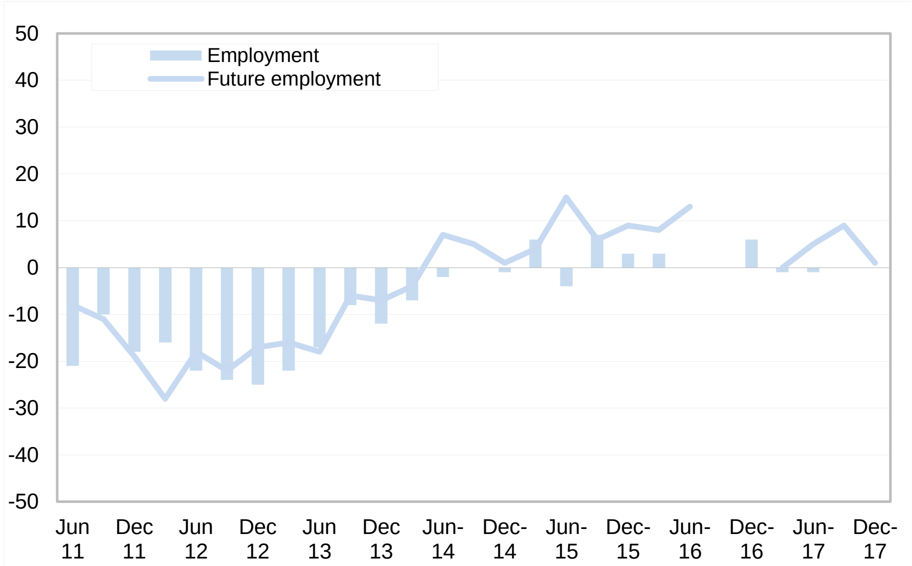
The break in both series is due to no survey having been conducted in June or September 2016

Top panel = finance

Bottom panel = non-finance

Source: States of Jersey Statistics Unit





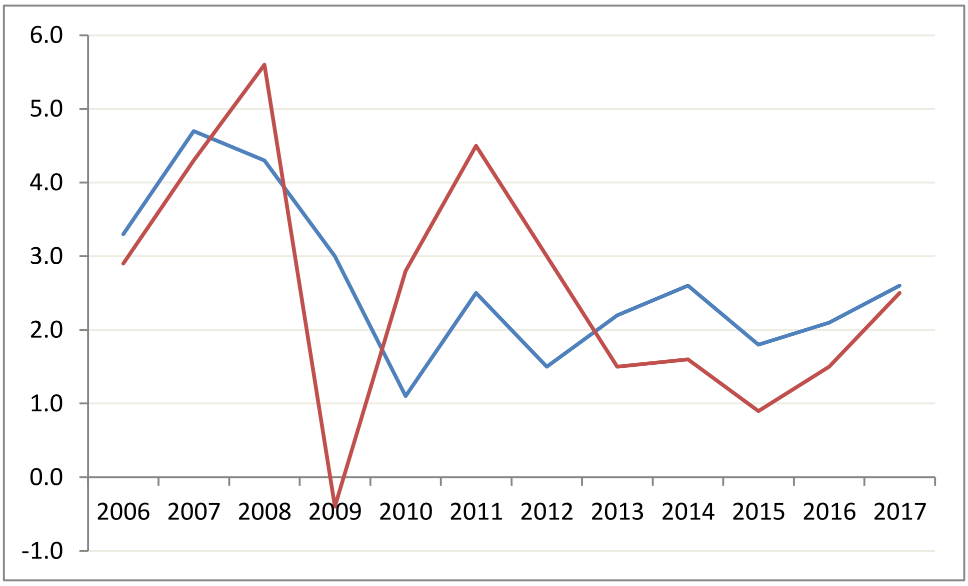
Average weekly earnings in June 2017 were 2.6% higher than a year previous. This was the fifth consecutive year in which earnings grew more quickly than inflation, but the most recent increase was only 0.1% above inflation. Real earnings are now at their highest level on record – though only 0.1% above 2007.

Private sector earnings grew by 0.3% in real terms (with finance growing by 0.4% and non-finance by 0.2%), while public sector earnings fell by 0.9%. The hotels, restaurants and bars sector saw the largest increase, of 1% in real terms, but construction and agriculture also grew by around 0.5% above inflation.

Figure 1.17
Average earnings and inflation

% increase in average earnings (blue line) and retail price index (red line) - June each year.

Source: States of Jersey Statistics Unit



1.4 Inflation

The Retail Price Index (RPI) increased by 2.5% in the 12 months to June 2017, with RPI inflation falling back from 2.9% the previous quarter. RPI inflation has started to pick up closer to long-term averages, following four years at 2% or below. RPIX inflation (excluding the impact of mortgage interest payments) has also picked up following a number of years of low inflation, hitting 3.1% in March 2017 before falling back to 2.7%.

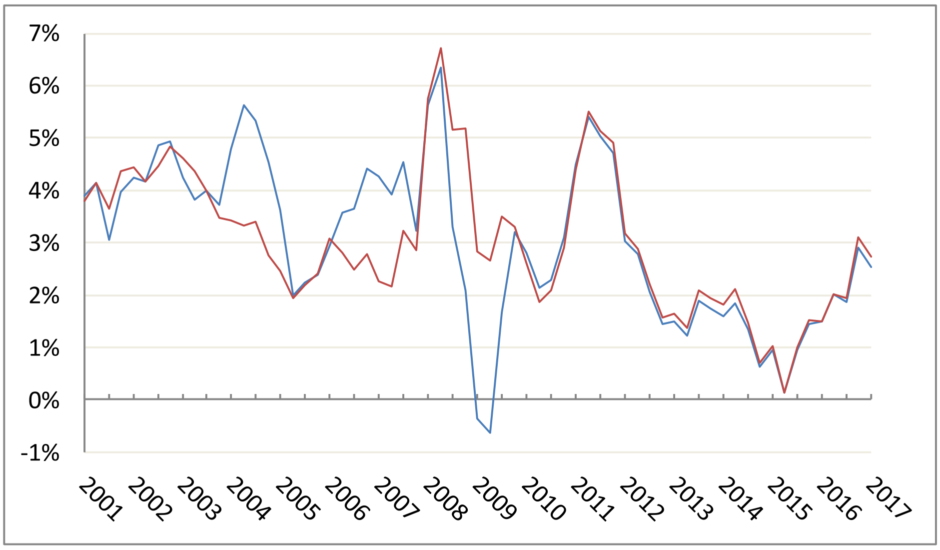
The increase in inflation in 2017 was not unexpected, as it was largely caused by the significant depreciation of sterling following the UK vote to leave the EU, effectively making imports more expensive. A similar pattern has been observed in the UK, while inflation in the euro area has picked up much more slowly with consumer price growth remaining below 2%.

Figure 1.18

Inflation in Jersey

Annual % change in retail prices index (blue line) and retail prices index excluding mortgage interest payments (red line)

Source: States of Jersey Statistics Unit



1.5 Economic growth forecast

Overall, indications are that the economy has performed strongly over the last twelve months. There has been continued growth in employment, and earnings have been growing faster than inflation in recent years. Sentiment in the BTS remains relatively strong and non-finance sectors have seen growth in GVA, with finance sector GVA volatile due to the impact of banking profits. GVA per head has been essentially flat over 2014-16.

The overall outlook is largely unchanged from the Panel's August 2017 letter. Uncertainty around Brexit remains the biggest challenge in the immediate future. The financial services sector has come through a period of significant change but there are likely to be further challenges in the medium-to-long term. It is important that recent productivity growth in non-finance is maintained, and does not prove to be only a cyclical adjustment.

The Panel forecasts GVA growth of around 1% for 2017, falling back to around 0.5% in 2018. In both cases the growth is largely driven by continued increases in employment. As indicated by Figure 1.19, there is considerable uncertainty around these forecasts. Beyond 2018, the chart shows the Panel's long-term trend growth assumption of 0%.

Figure 1.19

Economic growth forecast

% change in real GVA on year before

Sources: Panel judgement; States of Jersey Statistics Unit

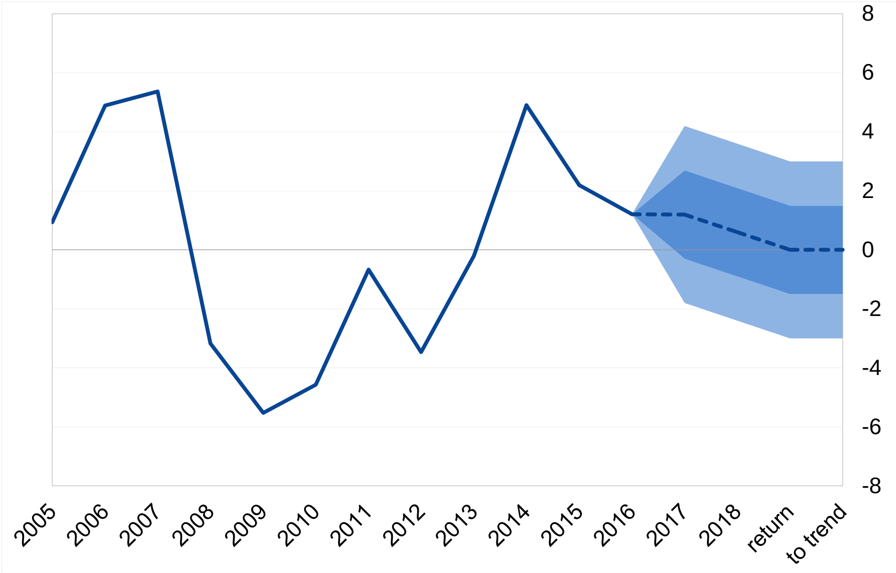


Figure 1.20 shows the Panel's most recent economic assumptions which were included in its letter to the Treasury Minister in August 2017. GVA for 2016 has turned out higher than anticipated (1%), but this is mainly due to strong growth in the rental income of private households which is a significant proportion of GVA. Both the finance sector and non-finance sectors as a whole performed largely in line with the Panel's August assumptions. Average earnings figures have also since been published for June 2017, with the outturn of 2.6% being below the FPP assumption of 3.0% but this does not significantly affect the forecast.

The main changes since the last Annual Report are that employment growth is now expected to continue into 2017 and 2018, resulting in a positive expectation for GVA growth.

Figure 1.20

Central economic assumptions August 2017

% change year on year unless otherwise stated, bordered numbers indicate outturns.

Note: Changes in profits, earnings, employment costs and house prices are in nominal terms

Sources: Economics Unit calculations and Panel judgement

	2014	2015	2016	2017	2018	Return to trend 2019	2020
Real GVA	4.9	*2.2*	0.2	1.2	0.6	0.0	0.0
RPI	1.6	0.6	1.7	2.8	2.4	3.3	3.3
RPIY	1.6	0.6	1.7	2.8	2.4	3.0	3.0
Nominal GVA	6.6	2.9	1.9	4.0	3.0	3.0	3.0
Company profits	12.3	-0.7	0.9	3.9	2.9	3.0	3.0
Financial services profits	19.4	-7.6	*-0.6*	4.0	2.4	3.0	3.0
Compensation of employees	2.1	5.9	2.8	4.0	3.0	3.0	3.0
Employment	2.3	2.0	**2.0**	1.0	0.5	0.0	0.0
Average earnings	2.6	1.8	2.1	3.0	2.5	3.0	3.0
Interest rates (%)	0.5	0.5	0.4	0.2	0.3	0.4	0.5
House prices	3.0	4.0	4.0	3.0	3.0	3.0	3.0

1.6 Spare capacity and trend GVA

While outturn GVA in 2016 was slightly higher than expected, this was due to a significant increase in the rental income of private households – driven by both an increase in occupied housing and an increase in rental values. This does not therefore change the Panel's view on the level of spare capacity.

However, during the Panel's fact-finding visit in June 2017 there were some indications that spare capacity in the economy is being used up. This was resulting in some tightening in the labour market – with some difficulties in finding the right skills and early signs of earnings inflation. This is an issue which needs to be carefully monitored going forward.

Figure 1.21 looks at the balance between growth in labour productivity and growth in earnings for the economy as a whole, as this may provide an indicator of whether inflationary pressure is building in the economy. This indicates that while earnings have been relatively flat in real terms since 2006, there has been a fall in labour productivity. However, there are a number of reasons why this might not be indicative of inflationary pay increases. Firstly, much of the fall in labour productivity has been due to falls in financial services profits over 2008 to 2013. Secondly, while the productivity figures may include some element of change within individual sectors (e.g. it will reflect the fall in banking employment and increase in trust and company administration), this is not explicitly captured in the average earnings index which looks at increases in earnings on a 'matched pair' basis within individual companies to provide a growth figure for each sector.

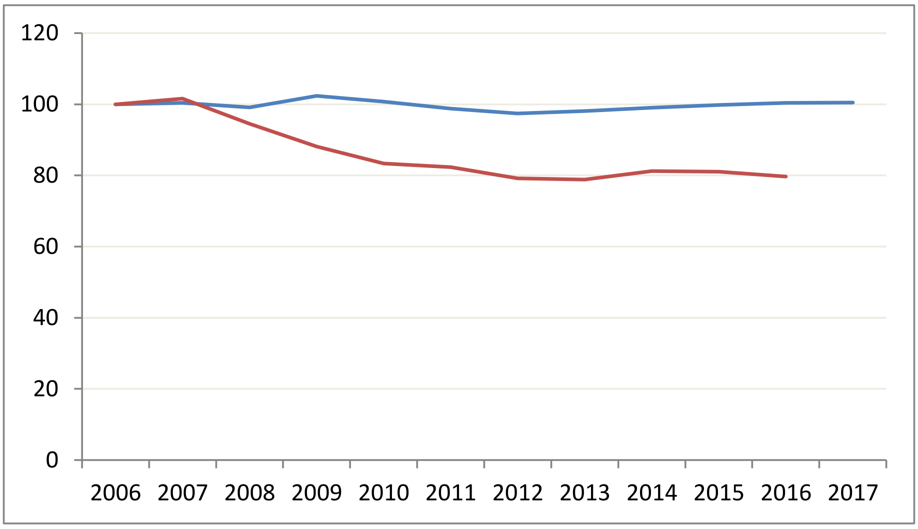
Figure 1.21

Comparison of earnings growth and productivity growth

GVA/FTE in real terms (red line) and the average earnings index in real terms (blue line)

2006=100

Sources: States of Jersey Statistics Unit



The Panel has in the past looked at Jersey's level of 'trend GVA' – i.e. the level of output consistent with full non-inflationary utilisation of resources. Figure 1.22 illustrates that, based on the Panel's current economic assumptions, Jersey's GVA might come into balance with the path of trend GVA (which is very uncertain, as indicated by the arrows either side) in 2018. This assumes no growth in trend GVA, in line with the analysis carried out by the Panel in their pre-MTFP report in January 2015. The Panel will continue to review this in future reports to see if there is evidence of a positive trend after the impact of the global financial crisis and Brexit become clearer. The flat trend is appropriate for a current planning assumption but this could change in future reports.

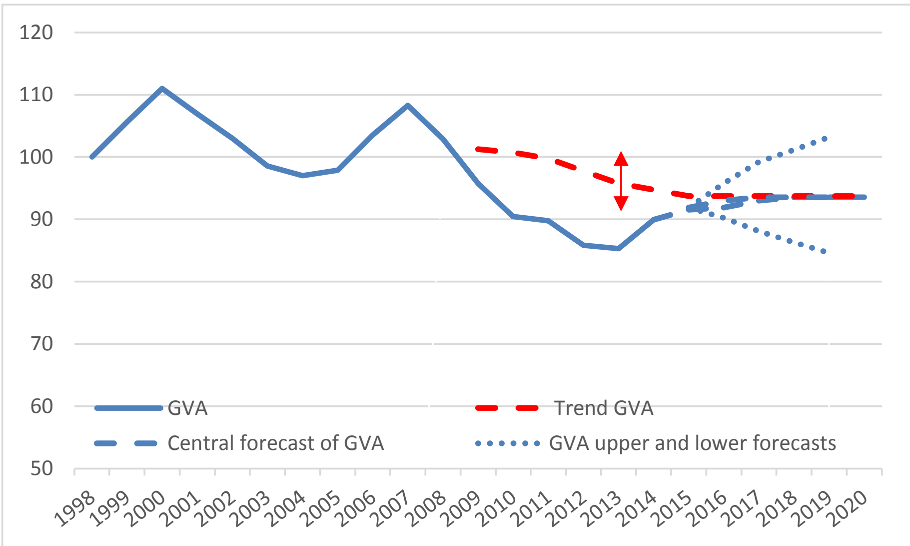
Figure 1.22

Trend GVA

GVA levels (solid line) and updated assumptions (dashed lines) and Panel estimate of trend GVA (red dashed line).

Index, 1998=100

Sources: States of Jersey Statistics Unit and FPP calculations



Section 2 – The Fiscal Outlook

2.1 Introduction

In this section, the Panel discusses whether the latest fiscal plans, including the proposals set out in Budget 2018 follow its four guiding principles and the eight recommendations as described in the 2016 Annual Report (see Appendix 1). It concludes with recommendations for this report, including some preliminary ones for the development of the next MTFP in 2018.

This section is set out as follows:

- Guiding principles for the MTFP
- Developments since the MTFP Addition
- Timing of proposed measures
- Allocation of growth
- Contingencies
- The adjusted fiscal position
- Funding the shortfall until 2019
- Trends in key States assets
- Panel's previous recommendations
- Risks to achieving current plans
- Longer-term challenges
- Guidance for the next MTFP
- Recommendations

2.2 Guiding principles for the MTFP

The Panel described four guiding principles for fiscal policy in its 2015 Pre-MTFP report:

1. Aim to balance the budget over the economic cycle.
2. Aim to ensure long-term fiscal sustainability.
3. Adopt practical and realistic assumptions for future trends in income and expenditure.
4. Include flexibility within a clear framework for expenditure.

The Panel considers that its four guiding principles have been generally followed during the MTFP Addition and Budget 2018 and the analysis below points out where further positive steps can be taken in keeping with these principles.

2.3 Developments since the MTFP Addition

Figure 2.1 shows the central Budget 2018 forecasts for total States income (blue bars) and States net revenue expenditure (red bars) between 2016 and 2019 and how it compares with the same data at the time of the MTFP Addition. Net revenue expenditure in 2016 was significantly below that anticipated at the time of the MTFP Addition. Departmental revenue expenditure was less than expected due to a number of underspends in key areas such as Social Security, Health, Education and Department for Infrastructure. However, for the period 2017-19 net revenue expenditure is expected to remain at similar levels to that expected at the time of the MTFP Addition.

Total States income in 2016 came in over £40m higher than expected at the time of the MTFP Addition. The main reasons for the increase were a one-off adjustment for Current Year Basis personal tax and stronger than expected investment income and stamp duty revenues (neither of which is expected to be repeated). The other key changes to income forecasts for 2017-2019 have been a reduction in corporate tax revenues, partly offset by improvements in personal income tax and GST. Lower inflation and interest rate assumptions have also led to lower expected revenue for impôts and other income. Overall these developments leave States income about £2m higher in 2019 than forecast a year ago.

Current projections also suggest that although net revenue expenditure in 2016 was over £40m below that expected at the time of the MTFP Addition it will increase by 13% between 2016 and 2019 to be at the same level in 2019 as was expected in the MTFP Addition. Total income will grow by just over 7% over the same period so that by 2019 income and expenditure are in balance.

Figure 2.1

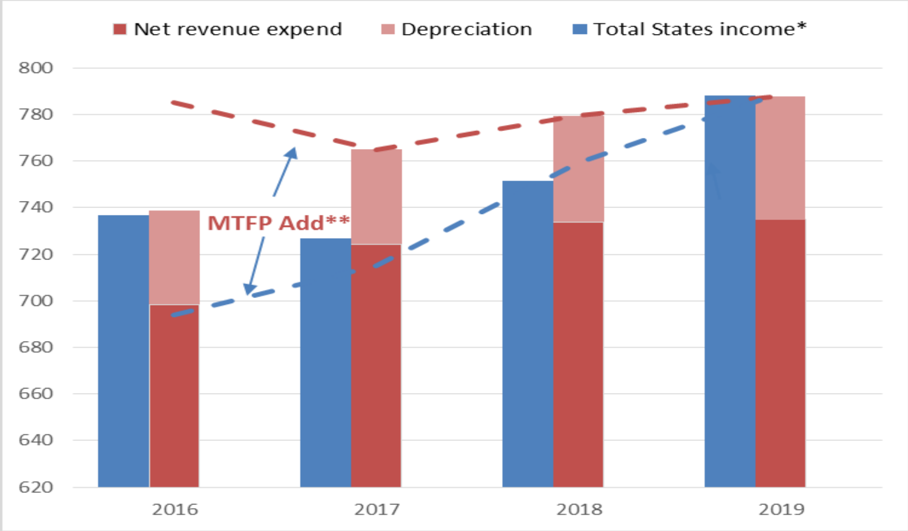
States income and expenditure at Budget 2018 (bars) compared with that in MTFP Addition (dotted lines)

£m (current prices)

Source: States Treasury.

*Includes funding measures

**MTFP Addition expenditure includes depreciation



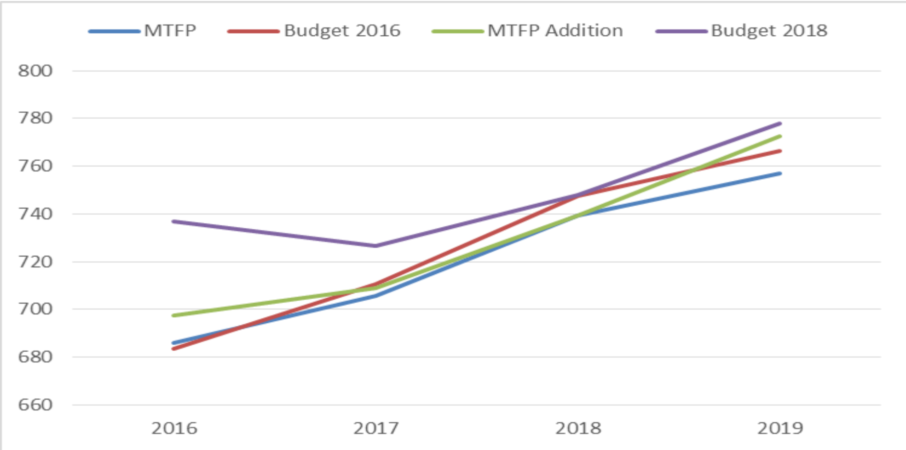
Although States income was significantly higher in 2016 than expected at the time of the MTFP Addition, by 2019 it is forecast to be back in line with the forecast made at that time. States income before measures is now expected to total £778m in 2019, compared with £772m at the time of the MTFP Addition.

Figure 2.2

States income (before funding measures)

£m (current prices)

Source: States Treasury.



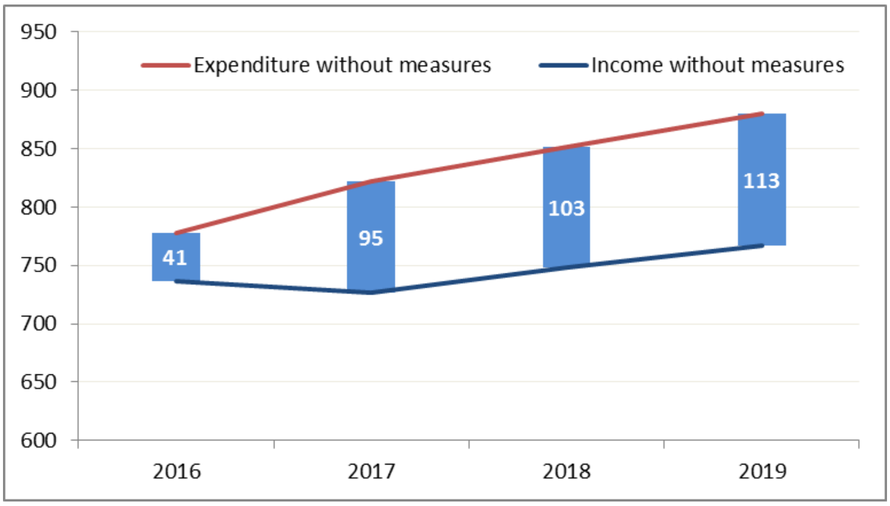
When the trends in income are compared with the expected trends in expenditure (including depreciation) before funding measures the chart below shows that the gap would now be £113m by 2019. At the time of the MTFP Addition the difference was expected to be £123m, with the majority of the difference down to the slightly improved outlook for income described above.

Figure 2.3
Adjusted current budget before funding measures

Blue bars are funding measures

£m (current prices)

Source: States Treasury.



The two main developments relating to the funding measures proposed since the MTFP Addition have been:

- The decision not to implement the health charge; worth £15m by 2019
- Deferral of the liquid waste charge until 2019

This means that Budget 2018 has had to propose a number of other revenue raising measures that equal just over £10m by 2019 as set out in figure 2.4 below. The main measures are:

- Second earner's allowance to be increased by £850 to £5,850
- Income tax exemption thresholds to be increased by 2.5%
- Changes to the tax regime applied to high value residents
- Taxing the profits of larger corporate retailers at 20%
- Bring more finance companies within the scope of the 10% company income tax rate
- Increasing some International Services Entities ("ISE") fees paid by businesses
- Disallowing the deduction of rates by landlords renting property in Jersey
- Impôts duties on alcohol and road fuels increased by RPI
- Impôts duties on tobacco increased by RPI +5%
- Vehicle Excise Duty increased by RPI (plus a change to incentivise the purchase of the least polluting vehicles)

It is noticeable that the measures required are becoming more ad hoc in nature and that in the medium term a more strategic approach will be required.

Figure 2.4

Budget 2018 revenue-raising measures

£m

Source: States Treasury.

Proposed Measures		Est. 2018 revenue (£'000)	Est. 2019 revenue (£'000)
Personal Tax	Increase 2nd earners allowance	-	-2,600
	High Value Residency changes	-	300
	Increase exemption thresholds at RPI		500
	Disallowance of deduction of rates by landlords		600
Corporate Tax	Tax profits of large corporate retailers	-	5,700
	Extend Financial Services corporate tax	-	3,000
Income Tax sub-total		-	7,500
GST - ISE Fees		1,000	1,000
Impôt Duties:			
	Tobacco duty increases (RPI + 5%)	800	800
	Fuel duty increases (RPI)	500	500
	VED duty increases	600	400
Impôt Duties sub-total		1,900	1,700
Total Financial Implications		2,900	10,200

Overall the package of measures set out in MTFP Addition has been replaced with different revenue raising measures. The chart below shows that at the moment the Treasury and Resources Department expect the same amount of efficiencies/savings/other user pays charges to be delivered by 2019, as was the case at the time of the MTFP Addition. The main differences from what was proposed at the time of the MTFP by 2019 are:

- The health charge is no longer included in the plans as it was not agreed by the States
- The £5m transfer from the Health Insurance Fund is no longer planned and this will be met by underspends
- Budget 2018 is expected to raise £10.2m from the range of measures set out above.

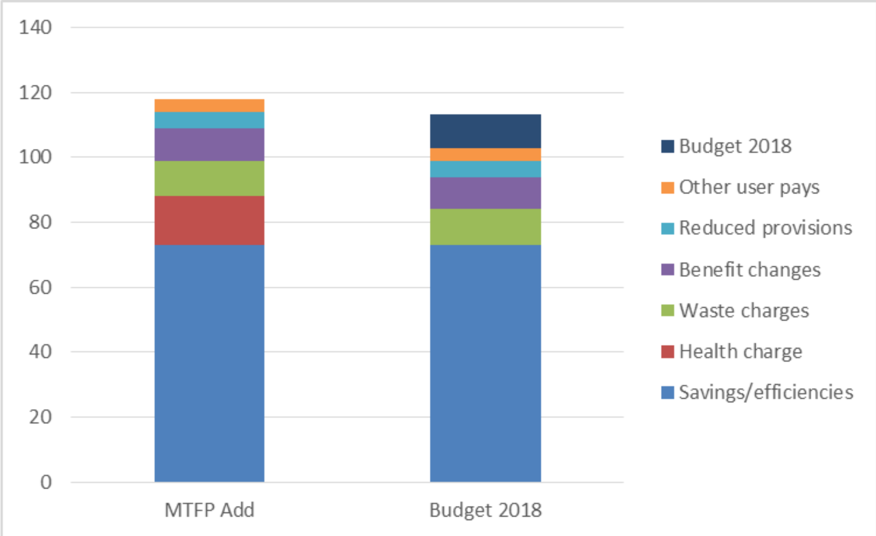
Waste charges are still expected to raise £11m by 2019 although the delay in the introduction of the liquid waste charge does reduce revenue raised in 2018 by £3m which is being met largely from growth allocations. The total package of measures is now expected to raise £113m by 2019 compared with £123m at the time of the MTFP Addition. Within the total, only the £5m which will be raised by reducing expenditure provisions is not a recurring measure. Although expenditure provisions could be reduced to the same degree in the next MTFP period there is no certainty about this.

Figure 2.5

Measures proposed in MTFP Addition and Budget 2018

£ million (current prices), per year by 2019

Source: States Treasury



2.4 Timing of proposed measures

The chart below shows the timing of the measures as currently proposed, including those in Budget 2018. It is clear that delivering the expenditure savings, efficiencies and user pays charges is the largest part of the measures proposed and that by 2017 nearly three quarters of the total is expected to be achieved. A better understanding of progress in these areas will be apparent in December 2017 when the Update to the MTFP Department Annex for 2018 is published.

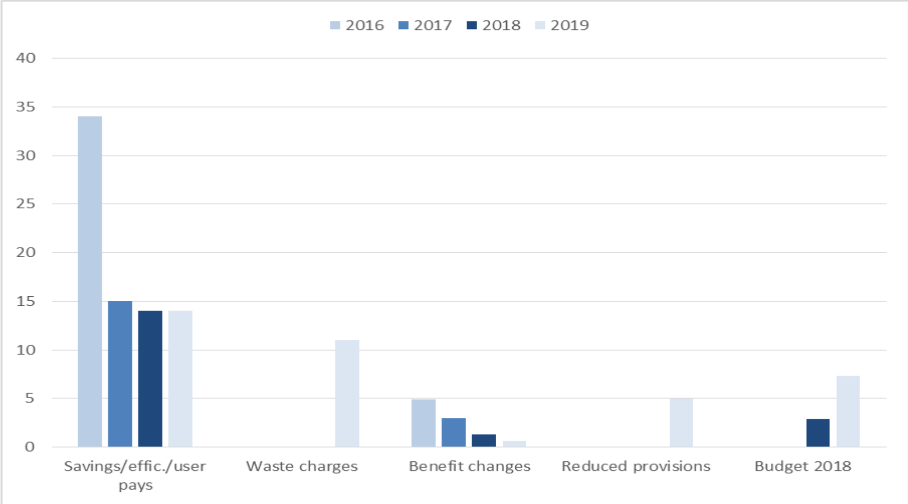
There are still £28m of savings, efficiencies and user pays that are required in 2018 and 2019. In addition, there is £11m from waste charges and the £10m of Budget measures that still have to be approved. **The FPP continues to believe that the profile and scale of these measures is broadly appropriate and advise that the remaining measures (or ones of equal value) need to be implemented on time. Delay in implementing the remaining measures could still mean that the States fails to balance the current budget at the right time in line with FPP advice.**

Figure 2.6

Timing of measures proposed as at Budget 2018

£ million (current prices)

Source: States Treasury



The FPP has previously pointed out that making savings based on efficiencies in the public sector was highly desirable irrespective of the economic conditions the Island faced. Given the continued uncertainty regarding the long-term outlook for the economy this is now critical. The Panel is encouraged by the approach outlined in the MTFP Addition and further developed in Budget 2018. **However, the Panel continues to urge the Council of Ministers to ensure that a permanent programme for securing additional efficiencies in the public sector is fully embedded in all future States financial planning and in particular in time for the next MTFP. To be clear this process should identify ways in which the same services can be delivered but with fewer resources – rather than simply cutting services or relying on pay restraint. This will lead to improvements in public sector productivity that can support wider productivity growth across the whole economy.**

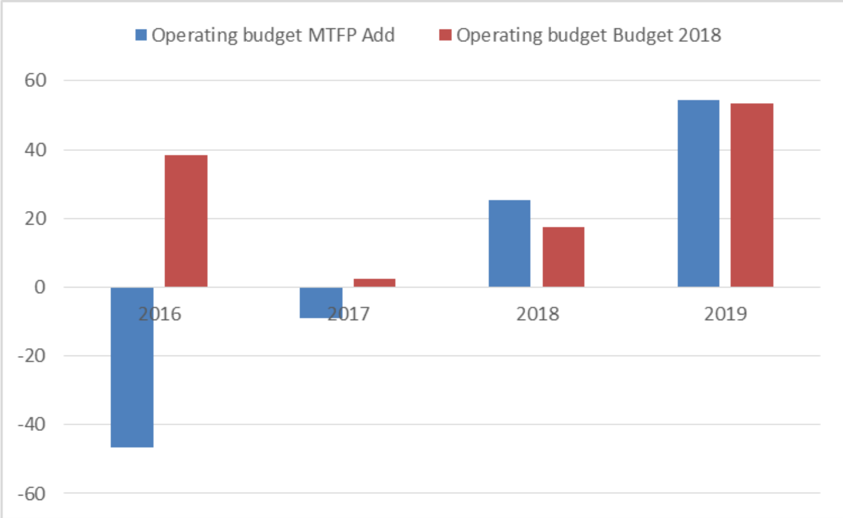
The chart below shows that the combination of all these income and expenditure trends means that the States operating position is largely unchanged in 2019 relative to where it was expected to be at the time of the MTFP Addition.

Figure 2.7
States projected operating budget position 2016-2019

The difference between States income and net revenue expenditure (operating position)

£ million (current prices)

Source: States Treasury



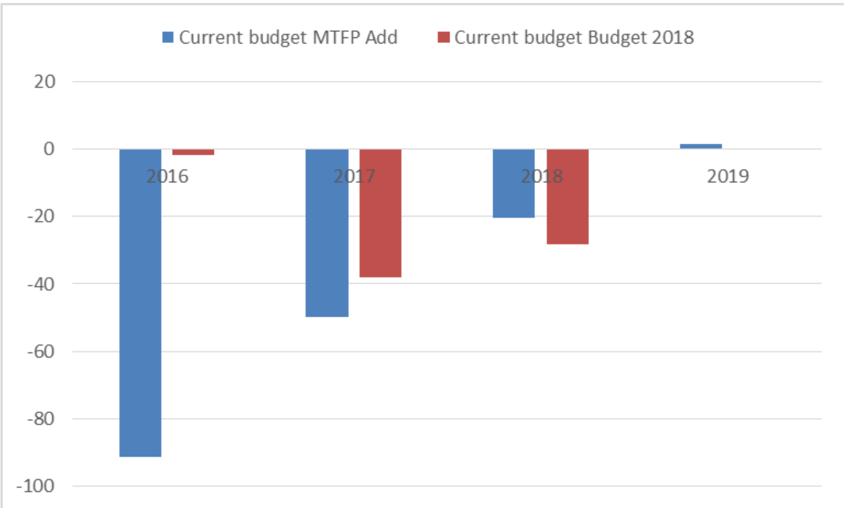
With estimates of depreciation unchanged this also leaves the current budget in balance in 2019 and to a similar degree to that expected at the time of the MTFP Addition. **The Panel is encouraged that these forecasts indicate that its previous advice will continue to be met and that the overall fiscal position returns to balance at the right time (which is when the economy is expected to be back at capacity).**

Figure 2.8
States projected current budget position 2016-2019

The difference between States income and net revenue expenditure including depreciation

£ million (current prices)

Source: States Treasury



2.5 Allocation of growth funding

The main development in Draft Budget 2018 with regards to revenue expenditure is the allocation of growth funding. In the debate of the Medium Term Financial Plan Addition the States agreed a central growth allocation in 2018 and 2019 of £10.4m and £20.5m respectively. The Treasury has worked with departments to review the allocations for 2018 and a number of changes mean that funding of £2.1 million has been identified to reallocate to DfI to offset the net shortfall in the department's 2018 expenditure due to the delay of the Liquid Waste Charge.

After the allocation of growth expenditure to departments in 2018 and the full year effect for 2019, there remains £11.1m of the £20.5m budget in the MTFP Addition to be allocated in Budget 2019. The Council of Ministers is recommending that the allocation of any new growth expenditure for 2019 should be deferred until the Budget 2019 and be subject to the prior approval of at least £11.85m of non-domestic waste charges (or equivalent expenditure measures). **This is in keeping with FPP advice to continue to implement the measures set out in the MTFP Addition or others of equal size. However, it is important to make sure that the potential for further efficiencies in States expenditure has been fully explored before cutting expenditure in priority areas.**

2.6 Contingencies

In the 2016 Annual Report the Panel felt that it would be beneficial in future to have clearer rules around the quantum of contingencies that are required and what they can be used for, to allow for more transparent financial planning. The Panel welcomes the publication by the Treasury and Resources Minister of R110/2017 Contingency Allocation: Revised Policy. Its sets out how payments to the Allocation for Contingency can be made, types of expenditure that can come out of it, what can happen to unspent contingencies and the allocation process for contingencies. **This goes some way to meeting the Panel's recommendation but there are two aspects that it would be worth giving further consideration to:**

- **Ensuring that unspent contingencies that are returned to the Consolidated Fund are not used to weaken fiscal discipline and delay required permanent revenue or expenditure measures.**
- **Further explanation on how the size of contingency allocations is determined and particularly so this is clearer ahead of the development of the next MTFP.**

2.7 The adjusted fiscal position

The analysis of the operating and current budget excludes capital expenditure. It is possible to adjust this picture to include all the States funds and the timing of capital spending in cash flow terms (i.e. when the money will be spent) to give an indication of whether the States as a whole is planning to spend more in the Jersey economy than it takes out by raising revenue, and to what extent.

The key steps to such a calculation are:

- **Calculate operating surplus/deficit** (total consolidated fund income less expenditure) excluding capital allocations (as money is not always spent when it is allocated)
- **Add capital expenditure profile** to operating surplus/deficit (including that of traders and subsidiary companies such as Andium Homes and States of Jersey Development Company - SOJDC)
- **Add flows into and out of additional funds** including trading funds, social security fund, health insurance fund, long-term care fund
- **Equals adjusted fiscal position**

The chart below shows the outcome of this analysis at the time of the MTFP Addition and as today assuming that the proposals in Budget 2018 are implemented. Current plans mean the States would add about £170m in 2017 and between £200-£300m to the economy in each of the years 2018-21. This is equivalent to about 4% of GVA in 2017 rising to between 4-7% of GVA in 2018-21.

The adjusted fiscal position is lower than at the time of the MTFP Addition for the 2017-19 period because the general and large project capital expenditure profiles are lower for these years. It is also noticeable that in 2016 the adjusted fiscal position has swung from one where the States was expected to be adding over £150m to the economy (the blue bar in the chart below) to an outturn where the position was broadly one of balance (the red bar in the chart below). This means that in 2016 the States did not run countercyclical fiscal policy as advised by the Panel. This is considered in more detail below.

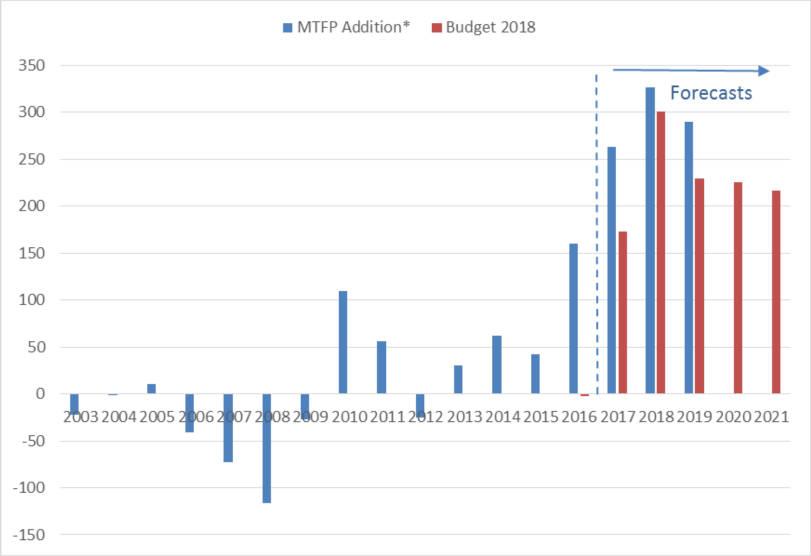
Figure 2.9

Estimates of adjusted fiscal position (States spending relative to revenue)

£ million (current prices) including States trading departments, Andium and SOJDC

*MTFP Addition forecast to 2019 only

Source: States Treasury



In 2016 the operating position turned out significantly different to that expected at the time of the MTFP Addition as explained above – an operating deficit of £43m turned into an operating surplus of £38m. This therefore explains about £81m of the £160m variation in the adjusted fiscal position between the MTFP Addition and the actual outturn for 2016. The other major contributor to the difference was that capital expenditure (excluding that of the hospital) turned out lower than expected with less capital expenditure by departments, traders and subsidiary companies Andium and Ports of Jersey.

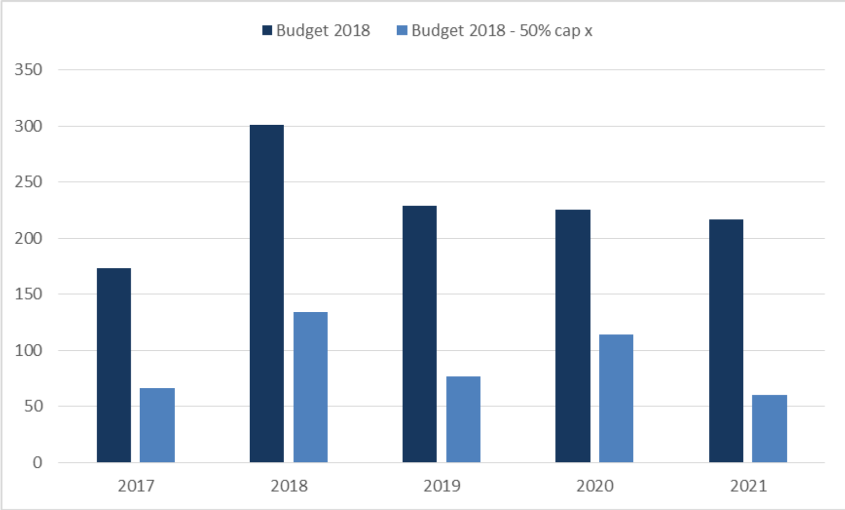
These recent trends are a reminder of how dependent the position in future years is on whether the planned capital expenditure takes place in line with the expected timeframe. Experience in recent years suggests that the outturn for capital expenditure has generally been well below the level now planned and below the past plans for capital spending. However, if only half of the projected capital expenditure is delivered in coming years the chart below shows that the States would still be putting more into the economy than it takes out at around between £50-£150m each year in the 2017-21 period. This is equivalent to between 1-3.5% of GVA and would not be out of line with the actual experience in recent years, as shown in figure 2.9 above.

Figure 2.10

Estimates of adjusted fiscal position (States spending relative to revenue). Budget 2018 plans and position if only 50% of capital expenditure is delivered

£ million (current prices)

Source: States Treasury



The Panel advised in the 2016 Annual Report that the period of uncertainty triggered by the UK's decision to leave the EU required a change of focus on capital expenditure. The Panel stated that the key priority was to ensure that the planned capital projects were delivered on time and particularly during the period when economic growth was forecast to be weaker and economic slack greater. More attention and urgency was to be given to those projects which are likely to have the largest positive impacts on the local economy. The actual experience in 2016 was that lower than expected capital expenditure was a key reason why the overall adjusted fiscal position was not as supportive to the economy as was planned, and economic growth slowed. **This leads the Panel to highlight again the need to prioritise delivering key capital projects on time and particularly those that will support the local economy in 2017 and 2018. During this period it is still expected that it would be advantageous for the States to be supporting the economy in what is likely to remain a continued period of economic uncertainty. However, it will be important as spare capacity continues to be used up across the economy also to be vigilant that these large capital projects do not put too much pressure on local resources and add to nascent cost pressures in the construction sector.**

Irrespective of the exact economic conditions, those capital projects should be prioritised that demonstrably add to future productivity growth.

Such a large-scale capital programme also brings other risks and uncertainty. In such an environment there is a risk that costs could be difficult to contain suggesting that tight control of costs will be essential to prevent projects exceeding budgets.

In addition, with future funding of the new hospital yet to be agreed it makes it very difficult to manage such a large programme, given the uncertainty over the timing of this very significant component.

2.8 Funding the shortfall until 2019

Whilst the measures previously agreed in the MTFP Addition and those that may be agreed in Budget 2018 are phased in, there will be a need to finance the shortfall between income and expenditure each year until 2019.

The table below shows that despite the better than expected outturn in 2016 there is still a need to make the planned further withdrawal from the Strategic Reserve to prevent the Consolidated Fund balance turning negative over the forecast period. Although the withdrawal of £55m is planned for 2017 it will not actually be needed until 2018 when the Consolidated Fund balance would turn negative (only to the tune of £0.5m) without the funding from the Strategic Reserve. The improved position on the Consolidated Fund does mean that the £16m withdrawal in 2018 that was considered at the time of the MTFP Addition and Budget 2017 will not be required. In line with previous plans, two repayments will still effectively be made to the Strategic Reserve in 2017 and 2019 of £5m and £20m respectively (although in 2017 this will be negated by the withdrawal of the £55m).

Overall this approach remains in line with the Panel's previous advice to use the States' reserves to balance the Consolidated Fund whilst the planned measures to bring the States' finances closer to balance are phased in. However, it is noticeable that despite the improvement in the States financial position in 2016, the amount planned to be withdrawn from the Strategic Reserve is unchanged (relative to that at the time of the MTFP Addition) and this means that the Consolidated Fund is over £30m better off by 2019 compared to the position in the MTFP Addition. The Budget statement explains that this is because it will provide a level of flexibility against variations in the income forecasts during what is expected to be a period of continued uncertainty.

The Panel recommend that this improved position on the Consolidated Fund does not at this stage lead to any changes in the proposed measures to balance the budget – either on the revenue and/or expenditure side.

If the current forecasts come to fruition the Panel would expect to advise in future reports to reduce the balance on the Consolidated Fund by either transferring funds to the Stabilisation Fund or making a further repayment to the Strategic Reserve. Given the 'one-off' nature of the fiscal improvement in

2016 this should be treated as a 'windfall' that could help rebuild reserves after they have been run down in the aftermath of the global financial crisis.

Figure 2.11

Consolidated fund changes

£ million (current prices)

Source: States Treasury

	2017 £ m	2018 £ m	2019 £ m
Consolidated Fund opening balance	91	80	55
Forecast operating surplus/(deficit)	3	18	53
Capital programme funding	(65)	(50)	(33)
Proposed transfers from Strategic Reserve	55		
Proposed transfers to Strategic Reserve	(5)		(20)
Proposed asset disposals	1	1	1
Proposed transfer from COCF		7	
Consolidated Fund closing balance	79	55	56
[closing balance at MTFP Addition	28	19	22]

2.9 Trends in key States assets

Figure 2.12 shows the projected net asset positions for the States' largest funds - an indicator of States reserves - from the end of 2014 through to the end of 2019 in real terms. The projection includes the Strategic Reserve, the Social Security Funds, the Consolidated Fund, the Health Insurance Fund, the Stabilisation Fund and the Long Term Care Fund.

It shows that in real terms the value of these reserves has risen in recent years by about 8% a year between 2014 and 2016. However, the value of these reserves will grow more slowly in coming years and by an average of between 1.5-2.0% a year in real terms between 2016 and 2019 as returns are expected to perform closer to the longer-term average rather than the high rates of recent years. Within the various other Funds the main underlying trend is expected to be further real growth in the value of the Social Security Reserve Fund. By 2019 the value of these reserves will be just over £3.0bn in nominal terms which equates to just under 60% of GVA. The value of the reserves is expected to fall slightly as share of GVA over 2016-19 but still be higher than in 2014. **The Panel has previously noted that the Council of Ministers fiscal framework commits to monitoring the trends in States assets and liabilities and this is something the Panel continues to support. Monitoring how the value changes as a share of GVA is good practice.**

Figure 2.12

States reserves projections in real terms

Total year end net assets, £ million (constant 2014 values) projections for the States' largest Funds

	2014 £m	2015 £m	2016 £m	2017 £m	2018 £m	2019 £m
Consolidated Fund	5	64	89	76	51	50
Strategic Reserve	787	766	801	768	783	815
Stabilisation Fund	6	6	6	6	6	5
Social Security Funds	1323	1369	1607	1681	1730	1761
Health Insurance Fund	85	80	84	88	90	89
Long-term Care	12	11	20	24	24	22
Total	2217	2296	2607	2642	2683	2743
Total % of GVA	*56*	*56*	*62*	*61*	*60*	*59*

Source: States Treasury / Social Security

2.10 Panel's previous recommendations

The recommendations from the FPP's 2016 Annual Report are repeated in Appendix 1 of this report. In general the advice has been followed but the responses fall into two groups. Those where steps have been taken to meet the recommendation and those where more work is required to continue to make progress. Those that fall into the first category are:

- The Panel has been briefed by Treasury Officers and progress appears to be being made in delivering the efficiencies set out in the MTFP Addition. However, continued close monitoring is required to ensure that the remaining measures are implemented and that work continues to identify further efficiencies.
- Current plans include significant fiscal support in the immediate years while also returning the current budget to balance by 2019. This profile is in keeping with FPP advice to support the economy in the short term and achieving a more sustainable position in the medium term. However, experience last year where the planned degree of support to the economy was not delivered is a timely reminder that a clear focus on delivering capital expenditure in line with current plans is an essential part of these plans.
- The intention to make further withdrawal from the Strategic Reserve this year is consistent with FPP advice to draw from reserves rather than implementing additional fiscal tightening (above what is already planned) during uncertain economic conditions.
- The improved balance on the Consolidated Fund provides greater flexibility going forward (provided that current forecasts are met) and increases the ability to provide further support to the economy if necessary. However, the previous recommendations highlighted that flexibility was also required in the other direction to ensure there were

sufficient measures to return the budget to balance. With the decision not to implement the health charge and the delay in introducing waste charges this has reduced flexibility in this direction.

Recommendations where more progress is required are:

- Ensuring that the planned capital projects are delivered on time and particularly during the period when economic growth is forecast to be weaker and economic slack greater.
- Taking a whole-of-government view for a strategy to deal with the ageing society and other long-term structural challenges.
- The Economic and Productivity Growth Drawdown Provision (EPGDP) should continue to identify medium-term policies that help raise productivity and increase the underlying rate of economic growth. There is an opportunity to accelerate the adoption of new technology across all sectors in Jersey and drive significant productivity growth and consideration should be given as to how the EPGDP could facilitate this.
- Addressing the (as yet unidentified) structural impacts of the UK's decision to leave the EU on the local economy and States finances in the next MTFP period. This is contingent on the current package of measures (or others of equivalent value) and capital expenditure being delivered as set out in the MTFP Addition.

The Panel is encouraged that the proposals in Budget 2018 and the latest financial forecasts together suggest that plans remain on course to meeting FPP advice for the 2016-19 MTFP period. However, given the continued economic and fiscal uncertainties it is important that flexibility to adjust plans is retained and further consideration is given as to whether this can be enhanced.

2.11 Risks to achieving current plans

There are several risks to successfully delivering the current plans for the 2017-19 years as originally set out in the MTFP Addition and developed further with the proposals for Budget 2018:

- **Future revenue:** There is always significant uncertainty in forecasting future trends in revenue and the external economic volatility has clearly exacerbated these risks such that the range of possible outcomes is much wider than normal.

- **Controlling expenditure:** Risks remain that current savings and efficiencies may not be delivered or that spending is reduced by means such as pay restraint only which prove unsustainable in the longer term.

- **Political risks:** That there is not sufficient buy-in to the proposals so that some of them are delayed or postponed without any additional proposals being implemented in their place. Or that ad hoc policy adjustments in response to changing economic and/or fiscal conditions are made that undermine the sustainability of States finances.
- **Timing of capital expenditure:** As discussed above delays to capital projects can prevent fiscal support reaching the economy when it is needed. On the other hand there is the risk that large projects could come on stream at times when the economy is short of capacity - adding to inflationary pressure and reducing value for money. This will not be easy to manage and in future years economic growth will have to be generated without such large scale impetus from public sector capital projects.
- **Population policy:** Immigration is a key element of the supply side of the economy and migration policy should be implemented in a pragmatic way that does not constrain it. A weakened supply side would only serve to exacerbate the structural pressures the economy already faces.

2.12 Longer-term challenges

Current plans are to balance the current budget by 2019, in line with previous FPP advice. The Panel has put so much emphasis on addressing the imbalance between States revenue and expenditure over this period because in the longer term there are a number of challenges which are likely to lead to further structural pressure on States finances.

The ageing population

As is the case with many other economies across the globe, demographic pressures are likely to put further structural pressure on public finances in the longer term. The fact that people are now living longer combined with lower birth rates will have significant consequences for Jersey and for the States' public finances.

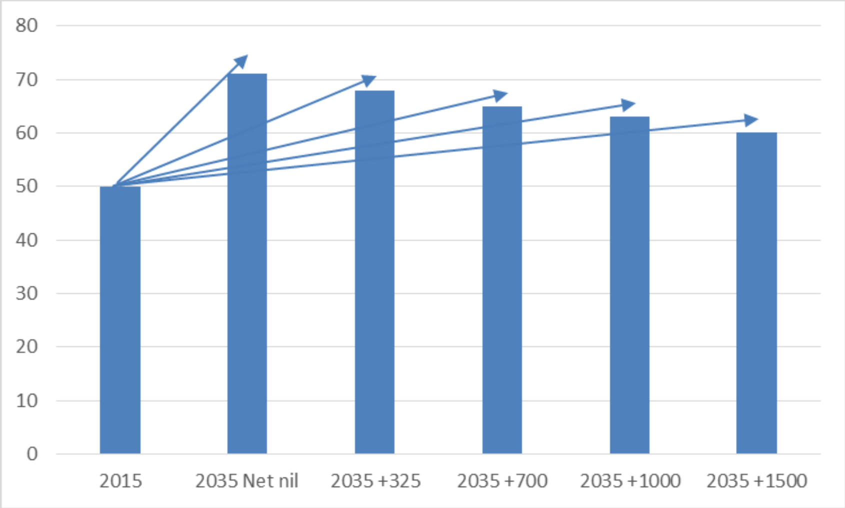
The impacts of an ageing population will be gradual and to some extent dependent on the level of inward migration. As figure 2.13 below shows the dependency ratio rises under all migration scenarios and to a greater extent the lower the level of migration. From a public finance perspective this means the number of people in the age groups that tend to consume significant levels of public services such as health and social care increases relative to those that are key for generating States revenue.

Figure 2.13

Dependency ratios in Jersey

the no. of children aged under 16, plus the no. of persons aged 65+ divided by the no. of people aged 16 to 64 years, % at different levels of migration of people

Source: Statistics Unit



While there are many uncertainties that will impact on States finances in the future, the ageing of the population is something that will happen and under any level of migration. This requires forward planning to make sure the States makes any necessary policy changes at the right time to address the pressures that will emerge. The consultation on future changes to the Social Security Fund is a good example of forward planning. Likewise, the *Shaping Our Future* public consultation to create a shared, long-term community vision for Jersey is also an encouraging development. However, this progress will ultimately need to translate into firm proposals that set the direction of future policy if it is to have a positive impact.

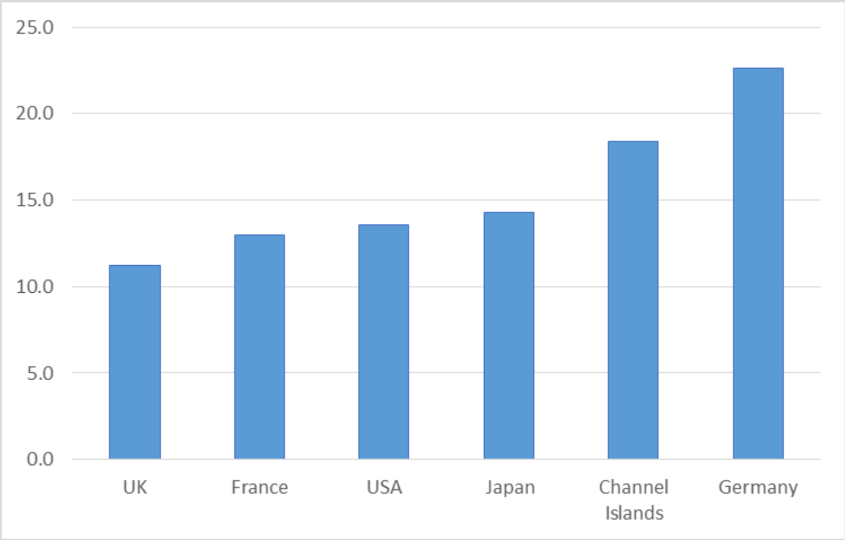
Jersey may also face a larger impact from the ageing society than some of larger economies. The chart below shows that for the Channel Islands as a whole the rise in the dependency ratio could be one of largest when compared with expected trends in the G7.

Figure 2.14

Change in international dependency ratios

Difference 2015-35, the no. of children aged less than 14, plus the no. of persons aged 65+ divided by the no. of people aged 15 to 64 years, per 100

Source: United Nations



Increasing productivity

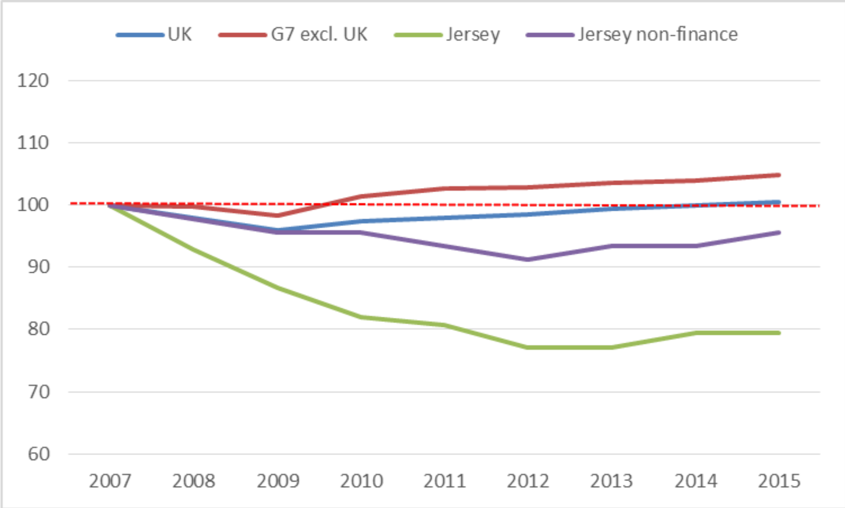
Jersey's recent productivity performance has been a constant concern of the Panel and referred to in previous reports. Figure 2.15 below compares trends in Jersey with those in the UK and the rest of the G7. The poor performance of productivity in most industrial countries has been well documented although the causes have not been fully established. Trends in the UK do not compare well with the rest of the G7 and in turn the trend in Jersey's performance does not compare well with that of the UK. Although productivity levels in Jersey are higher than those in the UK, GVA per FTE has fallen much further since 2007 than is the case in the UK. Part of this trend is due to the impact of low interest rates on the profitability and productivity of Jersey's banking sector which has not had the same impact in the UK. However, as the chart shows, the productivity performance of the non-finance sector in Jersey still looks weak relative to that of the UK as whole.

Figure 2.15

Productivity trends

Jersey=GVA per FTE, other countries = GDP per worker, real terms 2007=100

Source: Statistics Unit, OECD, ONS



Improving Jersey's underlying rate of productivity growth is vital to raising Jersey's economic performance and competitiveness, improving public finances and ultimately raising the standard of living. This is particularly the case as the underlying demographic changes highlighted above start to have more of an effect.

The Panel has previously welcomed the setting up of the Economic and Productivity Growth Drawdown Provision. However, this funding and existing budgets must combine to deliver effective policies in education and skills, enterprise, inward investment and innovation all supported by continued investment in key areas of infrastructure.

The future performance of the financial services sector in Jersey is also critical to the Island's future productivity and economic performance given that it has been a key contributory factor to Jersey's weak productivity growth. Continued progress will need to be made in meeting the external political and regulatory challenges to the long-term prospects of the finance industry.

Economic uncertainty

Although Brexit is one of the key uncertainties facing the Jersey economy at the moment, small economies always face more economic volatility than their larger equivalents. The chart below shows that the standard deviation of GDP in large high income economies is lower than that in small high income economies. This serves to highlight the importance of keeping public finances on a sound footing and with enough flexibility to manage further potential negative shocks to the economy.

Figure 2.16

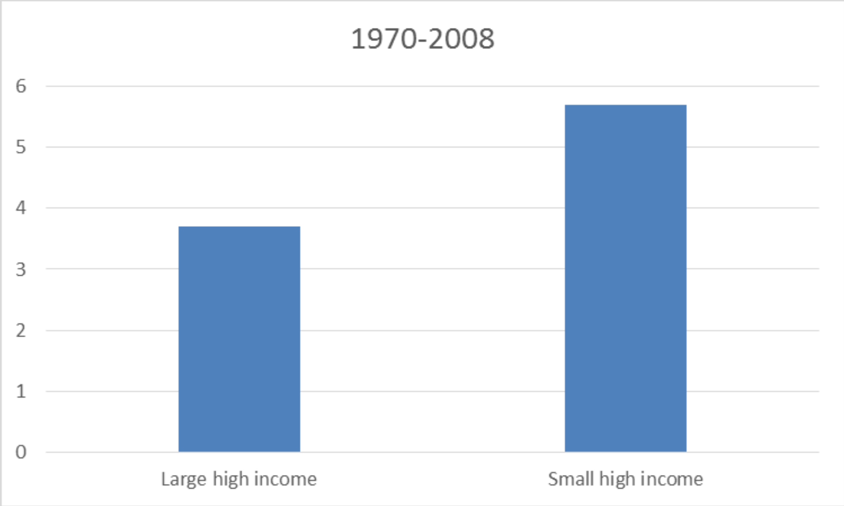
Volatility in large and small economies

Standard deviation in GDP, %

Small economies = 37 economies with a population between 30,000 and 3,000,000 and GDP per capita above $11,500 in 2007

Large economies = all economies with population above 3,000,000 and GDP per capita above $11,500 in 2007

Source: Breedon, Petursson and Rose (2011)



2.13 Guidance for the next MTFP

When considering the longer-term challenges that the Jersey economy and public finances face, the Panel considers this gives some indication of the key issues that need to be developed and addressed in the next MTFP:

- **Future structural pressures**: The longer-term challenges highlighted above make it clear that further fiscal adjustment is likely to be required during the next MTFP period. A strategy to address this should be developed that looks at what is realistic in terms of further efficiency savings (as opposed to expenditure reductions) and whether revenue-raising measures will be required. If the latter is required then consideration needs to be given as to how it can be done in the least damaging way to economic growth and what the key equity considerations are. It may be important to allow sufficient time for consultation on different ways forward.
- **Capital expenditure**: Identifying what capital expenditure is required that is conducive to economic growth and productivity improvements. Also, how it will be financed and managed to get the balance right between preventing capacity pressures and supporting the economy. The fact fiscal policy in Jersey did not operate in a countercyclical way in 2016 is a timely reminder of how difficult this can be.
- **Planning for surpluses**: If economic conditions over the life of the next MTFP are such that the States runs budget surpluses in any year, that these are used to replenish reserves – either the Stabilisation Fund or Strategic Reserve.

Appendix 1: FPP's 2016 Annual Report recommendations

1. The Panel is encouraged by the approach to controlling expenditure outlined in the draft MTFP Addition and would urge the Council of Ministers to ensure that a permanent programme for securing additional efficiencies in the public sector is fully embedded in all future States financial planning. Progress in achieving efficiencies should be closely monitored, given their critical importance to the plan.

2. A key priority is to ensure that the planned capital projects are delivered on time and particularly during the period when economic growth is now forecast to be weaker and economic slack greater. More attention and urgency should be given to those projects which are likely to have the largest positive impacts on the local economy.

3. The FPP considers that the overall profile of the States' adjusted fiscal position and the significant stimulus it adds to the economy over the MTFP period is appropriate. Whilst the economic outlook is affected by the UK referendum result the Panel does not think it appropriate at this time to change the broad approach. It remains important that the States supports the economy in the short term and that progress is made in achieving a more sustainable position in the medium term, irrespective of the exact future relationship between the UK and the EU.

4. The work being undertaken by the Social Security Department looking at the sustainability of the Social Security Funds in the light of the ageing population is an important first step in meeting the FPP's recommendation to develop a strategy for the ageing society. However, this approach needs to be developed much further to take a whole-of-government view and the issues clearly communicated to the whole community.

5. The governance procedures in place for the Economic and Productivity Growth Drawdown Provision (EPGDP) meet the Panel's previous recommendation. However, given the scale of the productivity challenge facing the Island, which recent events mean is even more important to tackle, these funds should be focused on medium-term policies that help raise productivity and increase the underlying rate of economic growth.

6. The time to address any (as yet unidentified) structural impacts of the UK's decision to leave the EU on the local economy and States finances

is the next MTFP period. However, this is contingent on the expectation that the current package of measures (or others of equivalent value) and capital expenditure are delivered as planned.

7. If the States needs to draw more from its reserves over the 2016-19 period the Panel believes that this is preferable at this stage to implementing additional fiscal tightening (above what is already planned) during what will be a period of continued external economic instability.

8. Given the economic conditions and general uncertainty facing the Island in coming years it is still vital to ensure that additional flexibility is built into plans over the 2016-19 period and in both directions. There may be a need to provide further support to the economy (in line with the 3Ts: timely, targeted and temporary) but it is also important to develop plans to implement measures to balance the budget in the next MTFP if necessary. If the economy performs better than expected in the short term there might even be a case for bringing these measures forward towards the end of this MTFP period.