Jersey's Fiscal Policy Panel

Senator Alan Maclean
Minister for Treasury and Resources
Cyril Le Marquand House
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Dear Minister

Hospital Funding Strategy

Thank you for your letter dated 20 December 2016. We consider it appropriate that you have written to us asking for our comments on the proposals for funding the new hospital, given this has significant implications for the Strategic Reserve and important implications for wider fiscal policy. We also welcome the continued commitment to open and transparent fiscal policy decision making.

In line with the Fiscal Policy Panel's remit, your letter asks us to comment specifically on the funding proposals as set out in P.130/2016: *Future Hospital Funding Strategy,* rather than the hospital proposal itself, which is rightly a decision for the people of Jersey. We understand that this is an important and necessary investment for the well-being of the community. So our comments simply relate to the implications of this decision and the chosen financing method.

The Panel has discussed your proposals and we feel that at a high level the strategy of borrowing money through a bond issue, allowing the returns from the investment of the Strategic Reserve to pay for the interest and build up in the fund (to repay the capital borrowed) is sensible in view of the fiscal and economic outlook. We agree that the assumptions you have made about the likely returns and interest rates seem to be prudent and appropriate, although there is always considerable uncertainty around any such assumptions.

There are however a number of risks to the proposals that we would draw your attention to. These are not significant enough to require a different approach, but are issues that merit further consideration and where necessary further contingency planning.

Borrowing costs

The requirement to pay about £10.5m a year in interest payments (about 0.25% of GDP) on the new bond will put a small amount of additional pressure on States finances although clearly a potential income stream has been identified to fund this from the return on the Strategic Reserve. The FPP understand that this is a necessary consequence of this project and that the hospital is something that Islanders value and we consider that an efficient solution for financing has been identified. The funding pressure has been well known for some time and the fact it has been costed and a solution identified is welcome long-term planning.

The Strategic Reserve

The decision to use the Strategic Reserve Fund in this way has implications for the fund and also for other alternative uses of the real return. Given the existing policy to maintain the capital value of the Reserve in real terms at 2012 levels there is very little room left for manoeuvre over the next 10-15 years under your proposals which would suggest that within the existing rules there could be very few further calls on the fund. After this initial period, if returns are in line with modelling assumptions, there may be some surplus sufficient real returns to allow consideration of other uses of the remaining real return. From a wider fiscal policy perspective it does mean that future funding pressures - whether new or existing – may have to be more reliant on changes to revenue and expenditure.

The net asset position

The Council of Ministers’ fiscal framework looks to monitor the States net asset position over the economic cycle and relative to the size of the economy. In very broad terms the decision to fund the hospital in the way suggested does not significantly alter the net asset position of the States as it involves the acquisition of a new asset (the hospital) and a new liability (the bond) and they are broadly equal sizes.

However, this does involve the switching of assets from a liquid position (those invested in the Strategic Reserve) to more illiquid fixed assets (a new hospital). Given that one of the key purposes of the capital value of the Strategic Reserve is to insulate the Island should it face severe structural decline of a major industry, the size of the reserve and its liquidity is an important consideration. In addition, it is even more important under these circumstances that the funds in the Strategic Reserve are invested in a way that means their value is not closely correlated to the fortunes of the Jersey economy. This could mean, for example, ensuring investments are not heavily weighted in financial services that fluctuate in line with trends in the Jersey economy.

This effect is exacerbated somewhat by the use of debt finance (rather than simply running down the reserve directly from day one) since the debt creates a fixed claim which will have to be paid for out of the potentially volatile returns on the fund. The average expected rate of return on the fund relative to the debt may make this extra risk worth taking but again highlights that the risks implicit in the investment strategy of the strategic reserve need to be carefully judged.

Under the proposals the value of the Strategic Reserve will go from about 19% of GVA in 2015 to 24% of GVA by 2060 (although it would fall to about 17% in the early 2020s) assuming that the economy does not grow in real terms over the economic cycle in future. This raises a question about whether the Strategic Reserve would be large enough to respond to severe structural decline, which is its true purpose.

If real returns were allowed to accumulate in the Reserve it could reach nearly 45% of GVA by 2060, again assuming the economy does not grow in real terms in future, but this would imply a significant rise in general taxation to pay for the hospital, which could have adverse effects on the ongoing recovery of the Jersey economy from the financial crisis. However, if the hospital was funded entirely out of the Strategic Reserve in the initial years, without the use of a bond then it would clearly be lower as a share of GVA in the coming years and generate lower returns in the years ahead.

The Jersey economy faces continued challenges from competition and regulation in financial services and added uncertainty about the implications of Brexit on future economic performance, so there are more risks to the proposed approach than would be the case in a more benign environment. However, the FPP do not think this means a different approach would be better, rather we encourage further consideration as to how Jersey would respond if these threats crystallised.

Project risks

Experience in the UK suggests that large public sector capital projects often take longer and cost more than originally intended. It is recognised that this has been reflected to some degree by including contingency and risk in the plans. However, while it is not the FPP's role to comment on the details of the project it is appropriate that we draw attention to the fact that should the project turn out more costly than planned and is still financed in the same way, this will put added pressure on the value of the Strategic Reserve and increase the risks highlighted above. There is also the possibility that any cost overruns would only be become apparent once the bond had been issued and therefore would require a slightly different approach that could mean further drawing from the Strategic Reserve. This emphasises the need for strong project management and detailed contingency planning.

Local construction capacity

In our 2016 Annual Report we highlighted the significant degree of capital expenditure that is being planned by the States and that this will help support the economy in a period of increased economic uncertainty. However, we have advised previously that the States should plan how it will deliver large scale capital investment to reduce the risk of a build-up of inflationary pressure in Jersey's economy. Since the publication of our Annual Report it is clear that the construction sector is already growing strongly with GVA up 9% in 2015 and employment up 5% in the year to June 2016. The hospital alone will add a significant degree of construction activity particularly over 2019-21 – between 1-2% of GVA in each year. If there is further evidence that spare local construction capacity is limited in the run up to the hospital work getting underway then it will be important to consider how the hospital can be built without adding to capacity concerns in the local economy through use of off-island contractors and/or the ability to bring in temporary workers.

Structural pressures

We also highlighted in our Annual Report this year that while it remains important that the States supports the economy in the short term it is also important that progress is made in achieving a more sustainable fiscal position in the medium term, irrespective of the exact future relationship between the UK and the EU. We would argue that, given the issues we raise above about the implications of the proposed funding method for the hospital (in particular the reduced flexibility and liquidity of funding in the Strategic

Reserve) it amplifies the need to ensure that progress is made in addressing the existing structural pressures in States finances. This is particularly important in light of the future structural pressures that will arise from the ageing society and risks from Brexit.

In summary, we consider that this is the best and most cost effective way of funding a new hospital given current borrowing costs and expected returns on the Strategic Reserve. While there is some risk around investment returns, the Panel considers that the alternative funding method (higher taxation) would bring more certain economic costs. However, it is important that the Government of Jersey gives full consideration to the risks it poses which we have highlighted above. This would be the case whatever approach to funding was adopted as no approach is likely to be risk free.

I trust that you find these comments helpful and do let me know if you require anything further from the Fiscal Policy Panel on this issue.

Yours sincerely

Kate Barker (Chair)

Tera Allas and Francis Breedon