

Jersey's Fiscal Policy Panel Annual Report November 2008 Update

Overview

The Fiscal Policy Panel (FPP) published its first annual report in early September this year and presented its findings to States' members. This is the Panel's update to the annual report.

The Panel considers that an update ahead of the Budget is appropriate in the light of both the upheavals in the world economy that will inevitably have an effect on the Jersey economy and the amendments to the annual Business Plan.

Key findings

Recommendations

- The modest surplus expected for 2009 is broadly appropriate.
- There should be no further withdrawals from the Consolidated Fund to fund discretionary expenditure increases or tax reductions until the extent of the economic slowdown and the underlying strength of the fiscal position are clearer. The automatic stabilisers should be allowed to work first before any further discretionary loosening is contemplated.
- The Panel recommends that £63m should be transferred from the Consolidated Fund to the Stabilisation Fund to increase the potential for that fund to be used in the event of a severe or protracted slowdown in the economy and to prevent inappropriate use. This will bring the Stabilisation Fund balance to just above the guideline level of 15% - 20% percent of States' net expenditure which is appropriate in the current economic climate and in view of the downside risks to future economic growth.
- The Panel's previous recommendation that there should be no additions to, or withdrawals from, the Strategic Reserve remains.
- Given the uncertainties facing the economy and the public finances in the medium-term, the Treasury and Resources Minister and Council of Ministers should draw up contingency plans for each of the following eventualities:
 - a structural deficit in the medium-term; and
 - an economic slowdown that merits discretionary fiscal policy changes.
- When making decisions about permanent changes to taxation or spending the focus of the States should be on the medium-term fiscal position and competitiveness of the economy.

Economic outlook

- Recent data on the performance of the Jersey economy has been stronger than anticipated. Economic growth was 7% in real terms in 2007, a similar rate of increase to that recorded in 2006, while employment increased by 3% in the year to June 2008.

- However this has been overshadowed by the further significant deterioration in the external economic environment and the continuing financial market turmoil. This has reinforced the Panel's view that the Jersey economy will slow significantly in 2008 and 2009 and that the balance of risks for 2009 is firmly on the downside.
- Inflation has continued to rise in Jersey but with food and fuel prices having fallen sharply, inflation is less of a concern going forward. There are however still additional wage pressures in the economy and, should they influence wage settlements, it would be damaging to the Island's competitiveness, particularly with inflation falling elsewhere.

Fiscal policy

- The States agreed the following changes to the Business Plan:
 - additional expenditure of £11.4m in 2009 and about £10m in each future year;
 - To compensate for food and fuel prices, tax and benefits changes costing £3.4m in 2009 and about £6m annually over the rest of the forecast period; and
 - a new environmental tax that will raise about £4m in 2010 and about £5m each subsequent year.

Together these measures amount to £15m or around 0.4% of economic output in 2009 and between £11m and £12m (0.3% of output) in subsequent years. This reduces the scope for further discretionary fiscal easing should the economy slow dramatically.

- The Panel is concerned that these changes will lead to a permanent worsening of the fiscal position, while some of the recent improvements in the financial position will prove to have been cyclical (i.e. temporary).
- The amendments represent a structural deterioration in the ongoing fiscal position of approximately £10m (0.3% of economic output) a year in today's prices.
- After adjusting for the Energy from Waste (EfW) plant expenditure, the fiscal position forecast by the States' Treasury department is still of modest surpluses in 2008 and 2009, a deficit of a similar size in 2010 and near balance in 2011 and beyond.
- In the September report the Panel identified significant medium-term risks to the fiscal outlook. These risks have increased due to the structural nature of amendments made to the Business Plan. There is a real danger that the States could emerge from the economic slowdown and transition period to 0/10 with a significant structural deficit to address. There is also the added risk that the credit crunch will lead to long term changes to the financial services industries.

The next sections of the report consider in more detail recent developments in:

- The economic outlook
- Fiscal policy

Section 1: Economic outlook

Global economic environment

Since the publication of the Panel's first annual report in September, the economic outlook for the global economy, and in particular for many large developed economies, including the UK, has continued to deteriorate rapidly and beyond that previously expected by economic forecasters. In September the Panel had taken the view that the risk was that conditions would deteriorate at a faster rate than the consensus suggested. This risk has materialised.

Concerted action by central banks and governments in September and October has eased the extreme tensions on the financial markets. However it is now clear that there will be severe consequences for the real economy. The International Monetary Fund has recently revised down its forecasts significantly. Despite the falls in interest rates, it now thinks that the economies of the U.S., Europe and Japan will contract in 2009. It now predicts a fall of 0.3% for the developed economies as a whole and 1.7% for the UK. It does not expect a recovery until late 2009.

Inflation in many developed economies is probably close to peak given that global demand will now be much weaker and the prices of oil and other commodities have fallen significantly. There could be scope for further cuts in interest rates later this year and early next year in the UK and elsewhere.

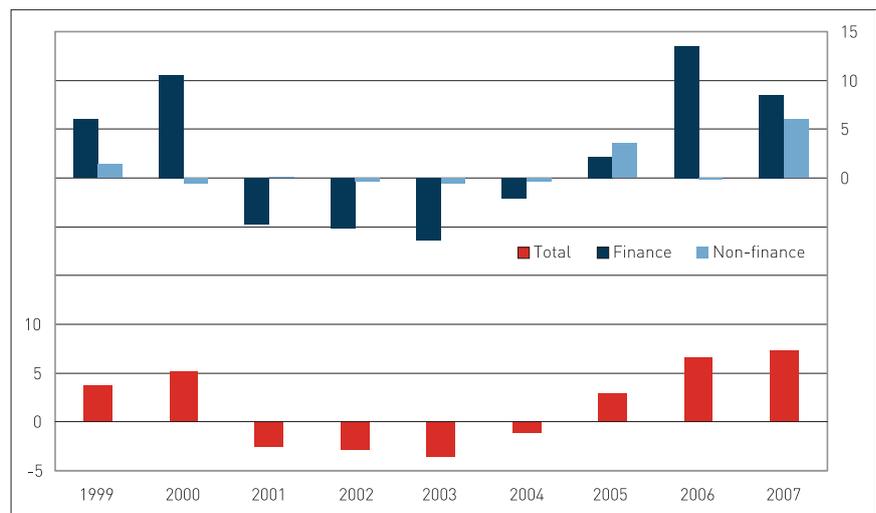
Jersey economic environment

New data has painted a more robust picture of the Jersey economy in 2007 and early 2008.

The level of economic activity in Jersey, as measured by gross value added (GVA), increased in real terms by 7% in 2007, which was a similar rate of growth to that seen in 2006 (figure 1.1) as a sharp acceleration in the output of the rest of the economy made up for a slowdown in the financial sector.

The rate of economic growth for 2007 turned out to be slightly stronger than the Panel had anticipated. This was mainly because the imputed owner-occupier rent adjustment included as part of other business activities was much larger than expected.

Figure 1.1:
The economy grew very strongly in 2007
Real GVA - percentage changes from previous year
Source: States of Jersey Statistics Unit



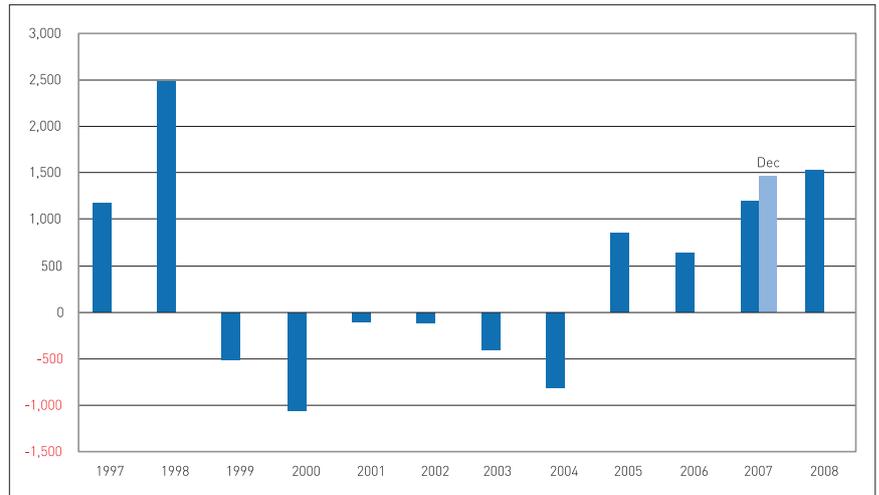
The latest employment data (figure 1.2) shows strong employment growth continued between June 2007 and June 2008 with an extra 1,500 people (just under 3%) becoming employed. This rate of growth was similar to that

recorded for the 2007 calendar year and indicates that the economy may well have still been growing strongly in the first half of 2008. It also means that the economy has even less spare capacity.

Figure 1.2:
Strong employment growth continues into the first half of 2008

Annual change in June employment (headcount)

Source: States of Jersey Statistics Unit



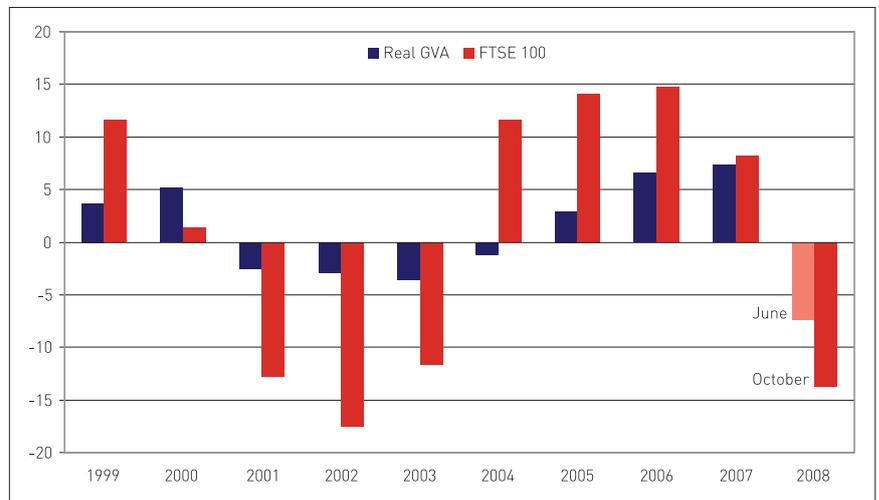
In line with the expectations in the Survey of Financial Institutions, the sentiment expressed recently by some financial services industry experts in Jersey suggests that 2008 should still see growth in profits, though there is significantly more uncertainty about 2009.

Figure 1.3 shows how the performance of financial markets, using the FTSE 100 index as an indicator, has deteriorated markedly through 2008 and in particular in recent months. Financial markets and the drivers behind them tend to affect Jersey's economic performance, particularly through the financial services industry.

Figure 1.3:
Jersey growth tends to follow financial markets and these have continued to deteriorate through 2008

Real GVA and FTSE 100, percentage change on previous year

Sources: States of Jersey Statistics Unit and Economics Unit calculations



The Panel's central expectation for growth (figure 1.4) remains at 3% in 2008 and 2% for 2009. There is, as yet, little evidence to suggest that growth is slowing more rapidly. Indeed, compared with the situation in September, prospects for growth have been boosted by the amendments to the Business Plan, lower interest rates, the recent sharp decline in sterling and the support to real incomes from lower expected inflation. Nevertheless, the Panel believes that the risks to the outlook are firmly on the downside for 2009 and even more so that at the time of the annual report. Despite the stronger than anticipated economic growth in 2007 and fairly resilient optimism of the financial services industry in these extraordinary times, the negative world economic outlook overshadows this.

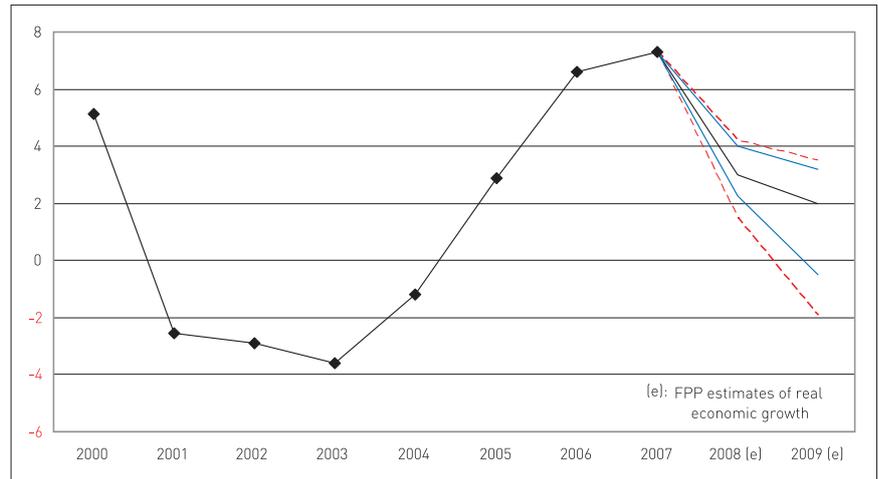
The risk that global economic conditions and the financial markets would deteriorate by more than independent forecasters then expected was factored in to the Panel's September estimate of future economic growth in Jersey. However, the extent of the recent deterioration in the global financial system has been greater than the Panel expected and there is still a substantial downside risk that the external economic environment will deteriorate by more than most external forecasters currently expect.

There is a risk that the UK, US and other major developed economies move into a deeper, longer recession than currently expected and that financial markets deteriorate even further.

Figure 1.4:
Growth in the economy is expected to slow this year and in 2009

Real GVA - percentage changes from previous year

Sources: States of Jersey Statistics Unit and FPP estimates



Inflation as measured by the annual increase in the Retail Price Index excluding mortgage interest payments, RPI(X), was 6.7% in September, and that as measured by the RPI 6.4% (figure 1.5). Inflation remained elevated mainly due to high food and fuel prices and the introduction of GST. The temporary impact of GST on these measures of inflation (just less than 2 percentage points) will drop out in June 2009.

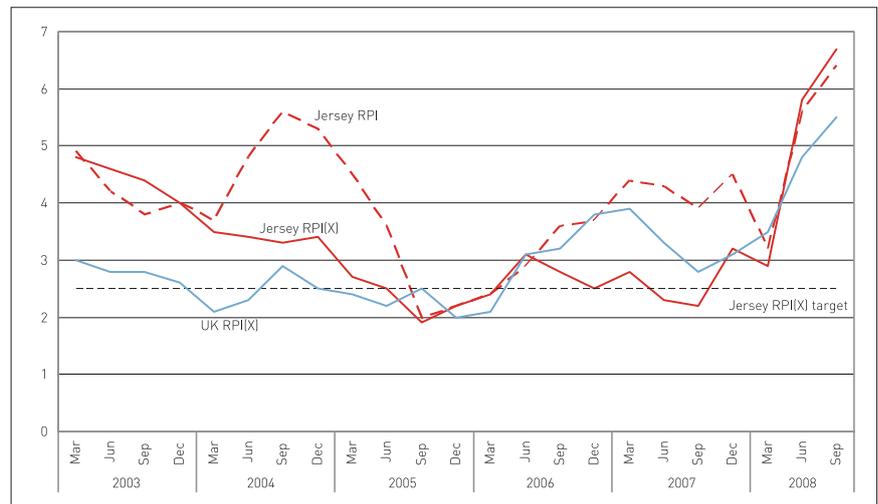
Inflationary pressure should ease over the next year or so. The slowdown in economic activity that is expected in the Island over the next 12 to 18 months will mean that the inflationary pressure of demand relative to supply will no longer be building. The slowdown in global economic activity and easing of commodity prices will also combine to lower inflation.

The recent reduction in the UK's base rates will also feed directly into a lower rate of inflation as measured by RPI, but weighing against this in the medium-term will be the effect lower rates (and any more cuts that may follow) have on stimulating expenditure in the Island.

Figure 1.5:
Inflation in Jersey

Annual percentage changes in RPI and RPI(X)

Source: States of Jersey Statistics Unit



The Panel sees the possibility of the Island getting sucked into a wage-price spiral as a risk but a less likely one now given the changed economic environment.

Although food and fuel prices have started to fall and the effects of the introduction of GST are already working through the system, wage pressure persists. The Panel repeats its message on the need to resist these pressures.

Assistance has already been given through the fiscal system to help with higher food and fuel prices, including the impact of GST, and so to do so again in wages would only reduce the Island's competitiveness.

Section 2: Fiscal policy

Shortly after the Panel's report was published, the States' Business Plan for 2009 and a number of proposals to amend it were debated by the States. In addition, the financial forecasts underpinning the Business Plan were updated to reflect the latest information available.

Business Plan amendments

The States approved some changes to the Business Plan that will affect the fiscal situation of the Island in the future (figure 2.1).

One set of changes that were agreed will result in additional expenditure of £11.4m in 2009 and about £10m in each subsequent year of the forecast period. About £5m of this £10m each year is proposed to be spent on environmental initiatives and is dependent on introducing a new environmental tax that would raise £3.8m in 2010 and about £5m in the subsequent years to fund them.

An amendment was also approved for tax and benefits changes totalling about £6m annually from 2009 onwards (similar to the hypothetical cost of excluding food and domestic fuel from GST) aimed to help compensate less well-off islanders for the recent food and fuel price increases.

Together, the consequences of these amendments will be to worsen the fiscal position of the Island by £15m in 2009 and between £11m and £12m in each subsequent year to 2013.

Figure 2.1:
A summary of the approved Business Plan amendments

Source: States of Jersey Economics Unit calculations

	2009	2010	2011	2012	2013
	£m	£m	£m	£m	£m
States Income					
Environmental Tax	-	3.8	5.0	5.2	5.2
Allowances change re food/fuel	-	(2.4)	(2.4)	(2.4)	(2.4)
	-	1.4	2.6	2.8	2.8
States Expenditure					
Changes under amendment no. 4	11.4	9.7	10.2	10.0	9.8
Benefits change re food/fuel	3.4	3.5	3.6	3.8	3.9
	14.8	13.2	13.8	13.8	13.7
Net decline in fiscal position	(14.8)	(11.8)	(11.2)	(11.1)	(11.0)

Note: Numbers have been rounded independently and so they may not add up to the total

Focusing on the medium-term, it is the structural changes to States' finances that are particularly important to consider. The amendments mostly result in structural changes (for example increasing tax allowances and new recurring expenditure on early years education) to the States' finances in future, rather than one-off or cyclical changes (for example income support transitional relief).

The ongoing fiscal position will see a structural decline of approximately £8m in 2009 and £10m (0.3% of economic output) in subsequent years (figure 2.2).

Figure 2.2:
A summary of the Business Plan amendments that are structural in nature

Source: States of Jersey Economics Unit calculations

	2009	2010	2011	2012	2013
	£m	£m	£m	£m	£m
States Income					
Environmental Tax	-	3.8	5.0	5.2	5.2
Allowances change re food/fuel	-	(2.4)	(2.4)	(2.4)	(2.4)
	-	1.4	2.6	2.8	2.8
States Expenditure					
Changes under amendment no. 4	4.8	7.8	9.3	9.5	9.6
Benefits change re food/fuel	3.4	3.5	3.6	3.8	3.9
	8.2	11.3	12.9	13.3	13.5
Net decline in fiscal position	(8.2)	(9.9)	(10.3)	(10.6)	(10.8)

Note: Numbers have been rounded independently and so they may not add up to the total

Updated Business Plan forecast

The financial forecast underlying the Business Plan has been updated by the States' Treasury department on the basis of more recent economic and tax data and the Panel's economic growth forecast in its annual report.

It has built into the forecast structural increases in income tax receipts, GST and other income, and a structural decrease in stamp duty receipts (figure 2.3).

Figure 2.3:
Summary of changes to the Treasury's forecast assumptions since the Business Plan

Source: States of Jersey Treasury department

Probable 2008 £m	Forecast				
	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m
States Income					
10 Income Tax	15	17	17	22	22
- 0/10% Corporate Tax Structure	(3)	(3)	(6)	(9)	(12)
3 Goods and Services Tax	5	5	5	5	6
(7) Stamp Duty	(11)	(12)	(12)	(12)	(13)
- Other Income	8	13	14	12	11
6 Total States Income	14	20	18	18	14

However, it is not possible to know at this stage in the economic cycle how much of the higher than expected income from recent tax measures reflect an earlier underestimate of their effect, and how much is the result of stronger economic growth. There is a risk that rather more proves to be cyclical as a result of recent strong economic growth, and rather less proves to be structural and thus sustainable, than the Treasury department has assumed.

Overall change to the forecast

The combination of Business Plan amendments and updating the income forecast assumptions (figure 2.4) results in an expectation that the fiscal position will improve slightly more than that expected a few months ago.

Figure 2.4:
Summary of changes to public finances and future expectations since 2008 annual report

Source: States of Jersey Treasury department

Probable 2008 £m	Forecast				
	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m
States Income					
10 Income Tax	15	17	17	22	22
Increased tax allowances	-	(2)	(2)	(2)	(2)
- 0/10% Corporate Tax Structure	(3)	(3)	(6)	(9)	(12)
3 Goods and Services Tax	5	5	5	5	6
- Proposed environment tax	-	4	5	5	5
(7) Stamp Duty	(11)	(12)	(12)	(12)	(13)
- Other Income	8	13	14	12	11
6 Total States Income	14	22	21	21	17
2 Total States Net Expenditure	15	13	14	14	14
4 Forecast Surplus/(Deficit) for the year	(1)	9	7	7	3

Overall, after adjusting for EfW expenditure (as the Panel did in its annual report) the fiscal position is still one of modest surpluses in 2008 and 2009 and a deficit in 2010 (figure 2.5). The surpluses expected (0.7% - 0.8% of GVA now and 0.5% - 0.8% before) are still broadly appropriate given the current economic environment.

Figure 2.5:
Public finances including EfW timing adjustment

Revised financial forecast including 2007 actual figures – abbreviated

Sources: States of Jersey Draft Budget 2009 and States of Jersey Financial Report and Accounts 2007

Actual 2007	Probable 2008		Forecast				
			2009	2010	2011	2012	2013
£m	£m		£m	£m	£m	£m	£m
559	630	States Income	650	602	614	631	638
		States Expenditure					
480	526	Net Revenue Expenditure	546	563	581	598	616
42	143	Net Capital Expenditure Allocation	38	40	37	35	16
	(63)	EfW plant adjustment	37	26			
522	606	Total States Net Expenditure	621	629	618	633	632
37	24	Forecast Surplus/(Deficit) for the year	29	(27)	(4)	(2)	6
(10)	-	Transfer to Strategic Reserve	-	-	-	-	-
-	(38)	Transfer to Stabilisation Fund	-	-	-	-	-
94	17	Estimated Consolidated Fund balance*	83	82	78	76	82

*without the EfW adjustment

Although the combined effects of the amendments to the 2009 Business Plan and the revisions to the financial forecast result in a small improvement in the fiscal situation, the Panel recommends caution. Whereas most of the increases in expenditure and tax concessions are permanent, the revenue increases in the financial forecasts may well prove to be very short lived. Furthermore, uncertainties have increased.

The Panel is concerned that the Business Plan changes were largely structural in nature. Some of the recent improvements in the fiscal outlook will have been cyclical suggesting that these changes increase the risk of a medium-term deterioration in States' finances.

Medium-term risks

The medium-term risks to the fiscal outlook were identified and discussed in the Panel's annual report. A summary of these are:

- The extent to which recent tax revenue growth is cyclical (i.e. temporary).
- Some tax revenue that will be lost from 0/10.
- Tax revenue is difficult to forecast and may change unexpectedly from year to year.
- Future service and initiative pressures on spending.
- The New Directions Policy to address the rising cost of health care and consequences of an ageing population.
- Public sector annual pay awards (as a guide each additional 1% not already factored into the forecast adds £3.5m to expenditure).

The three risks to income remain. They have increased given the deterioration of the external economic environment over the last few months.

However, the risk of the future pressures on spending has partly materialised through amendments made to the Business Plan. £9.3m of the £29.25m services and initiatives pressures identified were approved by the States and are now factored into the Draft Budget. The remaining pressures are shown in figure 2.6. The other risks to expenditure including New Directions and wage settlements above those budgeted for, identified in the Panel's annual report, remain.

Figure 2.6:
Service pressures and initiatives not included in cash limits and their estimated recurring costs

Source: States of Jersey Treasury department

Revenue expenditure	Dept	2010+ £'000
Increased costs of Residential Care placements	SS	550
Customs and Immigration (increased activity)	HA	400
Property Maintenance underfunding	T&R(PH)	13,000
Infrastructure Maintenance underfunding	TTS	3,800
Paying rates on States Properties	T&R(PH)	1,600
ICT Strategy	ESC	600
		19,950

The annual report examined a few alternative scenarios to illustrate what the possible impact of different pressures and uncertainties could be on States' finances over the forecast horizon.

Figure 2.7 shows a plausible scenario that could occur given the medium-term risks to income and expenditure. The assumptions are that:

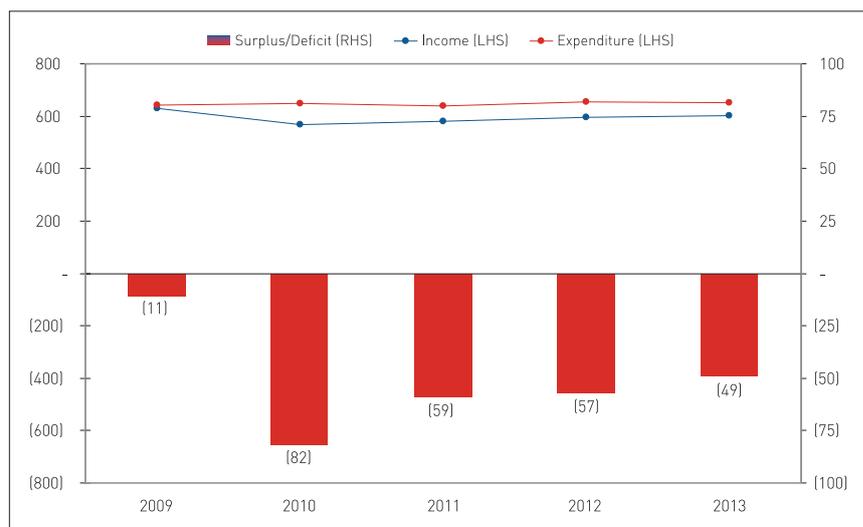
- Income tax receipts remain flat in 2009 and 2010 before increasing once more; and
- The level of expenditure increases by £20m from 2009 onward.

The result is a worse fiscal outlook where there is a small fiscal deficit in 2009 instead of a moderate surplus, and large deficits from 2010 instead of a fiscal balance.

Figure 2.7:
Public finances (including EfW adjustment) – flat income tax and higher expenditure scenario

Income, expenditure, surplus and deficits for 2009-2013

Sources: States of Jersey Draft Budget 2009 and Economics Unit calculations



The current financial market turmoil is expected to diminish over time. However, it is possible that policy decisions by governments to reshape the financial system will result in a different climate for the financial services industry in general and for small jurisdictions like Jersey in particular. This has also added to the medium-term risks.

Consolidated fund

The Panel's recommendation in its annual report to not transfer any money into the Stabilisation Fund or Strategic Reserve and to leave a significant balance build up in the Consolidated Fund did not work as well as hoped, because a number structural changes to income and expenditure were approved by the States that has worsened the Island's fiscal outlook.

Offsetting these changes is the expectation that States' income will be higher over the forecast period.

Bearing this and the increased risks in mind, the Panel recommends that £63m is transferred in to the Stabilisation Fund.

This leaves an expected £20m in the Consolidated Fund by the end of 2009, in case the economy's automatic stabilisers affect revenue or expenditure, or unforeseen emergencies arise during the year.

Conclusion

The States has loosened fiscal policy through its Business Plan amendments in advance of the risk of a greater than expected economic slowdown in the Island materialising. These amendments will support economic growth in the near term but permanently weaken the tax base and permanently increase expenditure by around £10m from now on. The scope for any further discretionary fiscal policy easing in 2009 and 2010 if growth surprises on the downside has been reduced.

There should be no further withdrawals from the Consolidated Fund until the extent of the slowdown in 2009 and 2010 and the strength of the underlying fiscal position are clearer.

The weaker economic outlook, the structural changes to reduce tax revenue and increase expenditure and the possibility of lasting changes from the repercussions on the financial sector of the credit crunch means the medium-term risks to the future fiscal balance have increased.

Should income tax receipts turn out to be weaker than forecast and/or further structural increases in expenditure occur then the States could be left to face a significant fiscal deficit from 2010 onwards.

£63m should be transferred from the Consolidated Fund to the Stabilisation Fund to increase the potential for that fund to be used in the event of a severe or protracted slowdown in the economy. Doing so will bring the Stabilisation Fund balance to just above the guideline level of 15% - 20% of States' net expenditure and around 3 percent of total economic activity.

In line with the Panel's previous recommendation there should be no withdrawals from the Strategic Reserve.

Given the significant uncertainties in the medium-term it would make sense for the States to consider contingency plans in terms of how fiscal policy could be tightened in future years if a structural deficit materialises.

Similarly, with the threat of a significant deterioration in economic prospects in the Island it would be worth considering what the contingency plans would be for discretionary fiscal policy intervention. Identifying the political priorities under such circumstances would allow the Panel to make more informed comment in their full report next year.

