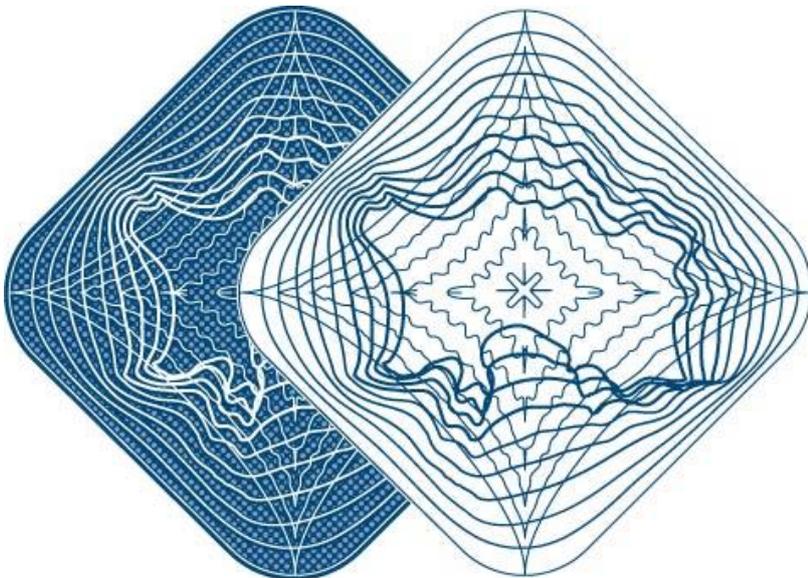


Jersey's
Fiscal Policy Panel
Annual Report
October 2019



Introduction

This is the twelfth annual report of the Fiscal Policy Panel (FPP). The current members of the Panel are:

Dame Kate Barker (Chair, appointed 2014),
Professor Francis Breedon (appointed 2016),
Richard Davies (appointed 2018).

The Panel was placed on a statutory basis in 2014. The Panel's statutory role was reiterated in the new Public Finances Law, which requires the Panel to comment on Jersey's fiscal policy with reference to:

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

In preparation of its reports the Panel visits the Island, meeting and talking to policymakers, business owners and managers, and representatives of public and private sector workers. The Panel is also grateful for the invaluable support provided by the staff of the Government of Jersey, in particular the Economics Unit and Treasury and Exchequer.

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

Key points

Economic Outlook

- This report is published at a time of heightened uncertainty, both with regard to the economic situation in the UK where the outcome of negotiation with the EU remains uncertain and more widely with the escalation of trade tensions between the US and its trading partners.
- Jersey's economy saw a fifth consecutive year of growth in 2018, with real-terms expansion of 1.4%. 2018 also saw a modest rise in GVA per person but since 2013 this measure is largely unchanged. This compares to growth of 7% in the UK over the same period.
- The finance sector was the largest driver of growth in 2018. The growth was seen in company profits and was due to strong net interest income results coming from higher interest rates. Whilst this is good news, economic prospects have weakened in industrialised economies and market expectations are for no further rise in UK interest rates across the next few years.
- 2018 saw the sixth consecutive of real GVA growth for the non-finance sectors. The latest survey evidence presents a mixed picture with future business activity strong, but current business activity becoming less positive than 2018 and business optimism becoming mildly negative.
- The latest data on the labour market show employment growing at 2% in the year to December 2018. More recent figures show registered job-seeker totals remaining quite low, however social security contributor numbers did not rise in the year to June.
- After peaking at 4.5% in the middle of last year, annual inflation fell to 2.8% in the year to June but housing costs remains the largest contributor to rising living costs. The risk of more serious price rises is present in the event of a disorderly Brexit, which is likely to lead to a substantial fall in the value of sterling and feed through to higher inflation via higher prices for imported goods and services.
- Average weekly earnings in June 2019 rose by 2.6% year-on-year, which represented a 0.2% fall in real earnings.
- Though GVA rose in 2018, the balance of recent indicators (in particular earnings, responses to the Business Tendency Survey and social security contributor numbers) suggests a cooling in the economy this year. Whereas the Panel's central assumption is for a continued expansion of 1% or higher for the next two years, this is highly dependent on a favourable outcome to Brexit negotiations.

Public Finances

- This report considers the draft Government Plan 2020-23 that was lodged in July 2019 and is the first Government Plan under the new framework set out in the Public Finances Law 2019.
- The Panel welcomes the enhanced role of the FPP in the new law and an extension to its role to include a responsibility to comment on the sustainability of the public finances in light of the States' financial assets and liabilities.
- In reviewing the end of the Medium-Term Financial Plan (MTFP) the Panel notes that, overall, efforts to eliminate the deficit were successful and that the Panel's guiding principles for the MTFP were broadly followed.
- In reviewing the Government Plan the Panel notes efficiency and revenue measures are key to delivering the fiscal surpluses over the period 2020-23. The Panel judges that surpluses are appropriate at this point in the economic cycle and given the economic outlook.
- Alongside the Government Plan is a new fiscal framework. The Panel was consulted on the guidelines for the framework and is content these are consistent with its advice. The guidelines provide criteria against which the Panel can assess the long-term fiscal sustainability of Government Plans.
- Income and expenditure plans mean that current surpluses seen over the MTFP continue over 2020-23. Additional revenue-raising measures include partial hypothecation of fuel duties but the Panel does not support hypothecation more generally.
- The Government Plan includes efficiency gains that could be challenging to deliver and so present a fiscal risk.
- The capital programme including subsidiaries is welcome for the investment it provides but the acceleration and scale of expenditure presents significant risks around delivery. Capital spending projections are a significant part of planned expenditure and will need robust and skilful management - if economic conditions are favourable they pose a risk of pressure on resources if off-island inputs are not utilised. On the other hand, if there is a downturn it will be desirable to advance the timing of projects where possible and use on-island resources.
- Two recommendations from the Panel's Advice for the Government Plan report have not been completed:
 - The draft Government Plan does not include a programme of additional contributions to the Strategic Reserve
 - No plan has been set out to deliver the proposed capital programme in a way that does not put excess pressure on the limited resources available on-island

Recommendations

1. The small surpluses over the Government Plan period are in line with the FPP's recommendation to run surpluses over the 2020-2023 period. The updated economic forecasts should not result in any significant deviation from the draft Government Plan, though the automatic stabilisers should be allowed to work.
2. In future years, each draft Government Plan should include more detail on the efficiencies to be achieved over the full four-year period. There is a risk that efficiencies will become harder to achieve.
3. Based on the latest forecasts for the output gap, the transfers to the Stabilisation Fund over 2021-23 should be more significant if the Fund is to be ready to address a significant downturn.
4. Government should make clear its intentions regarding the Strategic Reserve. If the Panel's previous recommendation to grow the Reserve is accepted, a plan should be set out for how to achieve this - over what time period and what size of structural surplus this will require.
5. The Panel continues to recommend that further work is undertaken to set out how the capital programme can be delivered without exacerbating capacity constraints in the local construction industry
6. Hypothecation should only be introduced where the revenue and spending are likely to be justifiably related. However, the wider use of hypothecation, as suggested in the Government Plan, would tend to make fiscal policy more complex and risk inefficient resource allocation and should be avoided if possible.
7. The Government should retain flexibility to respond to changes in the economic cycle, and the Panel supports the replenishment of the Stabilisation Fund throughout the Government Plan period.
8. In the event of a downturn the Government should firstly allow the automatic stabilisers to work with smaller contributions to the Stabilisation Fund, and secondly provide discretionary fiscal support if necessary. Some groundwork should be done now, to identify what revenue and expenditure measures can be introduced in good time - or the extent to which significant capital projects can be amended to have more of a positive and timely impact on the local economy.
9. The Panel looks forward to the development of the Economic Framework and recommends that funding should be made available in future Government Plans to support initiatives with genuine potential to raise private sector productivity.

Section 1 - The Economic Outlook

1.1 International outlook

This report is written at a time of heightened uncertainty, both globally and closer to Jersey with the lack of clarity about the direction of the UK economy. Starting with the global picture the International Monetary Fund's (IMF's) latest estimate is that the world economy growth slowed somewhat to 3.6% in 2018. The advanced economies presented a mixed picture, with growth rising in the United States (2.9%) whilst declining in Japan (0.8%) and the Euro Area (1.9%). Though slowing, the developing world grew at over twice the rate of industrialised countries, continuing a longer-term trend of convergence. Whilst growth in China (6.6%) and Brazil (1.1%) remained steady, Russia accelerated (2.3%) and there was a slight deceleration in India (6.8%).

More recent data on the global economy show a further slowdown across both advanced and developing economies, with global growth expected to be 3.2% this year. The IMF highlights the dampening effect of US trade sanctions threatening global technology supply chains, Brexit-related uncertainty and the rise in energy prices due to rising geopolitical tensions. In terms of employment projections, the Quarter 3 ManpowerGroup Global Employment Outlook survey of world firms showed a majority of the 44 countries surveyed expecting a reduction in employment before the end of the year.

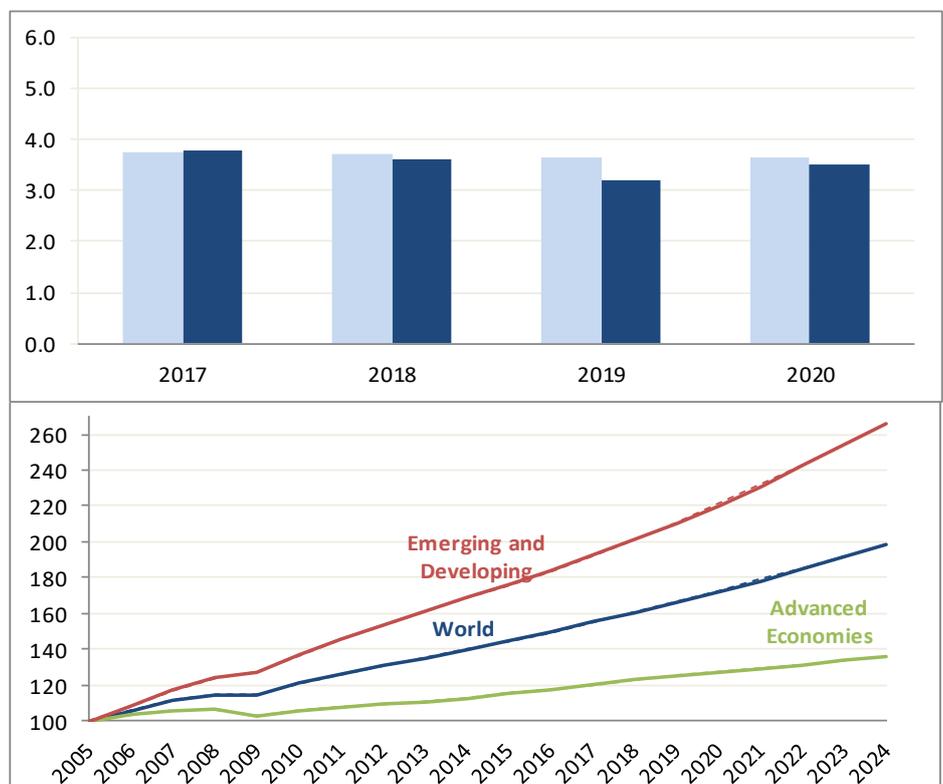
Figure 1.1

Global growth

Top panel: global GDP real growth - July 2019 estimates/forecasts; pale bars are October 2018 estimates/forecasts

Bottom panel: index (2005=100) of real-terms GDP - April 2019 estimates/forecasts; dashed lines are October 2018 estimates/forecasts

Source: International Monetary Fund (IMF) World Economic Outlook October 2018, April and July 2019.



Looking forward, the IMF forecasts a rise in growth to 3.5% in 2020. However, the scenario relies on a stabilisation in stressed markets and progress towards trade dispute resolution. Risks are mainly to the downside and include: further trade and technology tension dragging on sentiment and investment; an increase in risk aversion that exposes the financial vulnerabilities developed over years of low interest rates; and mounting disinflationary pressures that increase debt servicing difficulties, constrain monetary policy and make adverse shocks more persistent than normal.

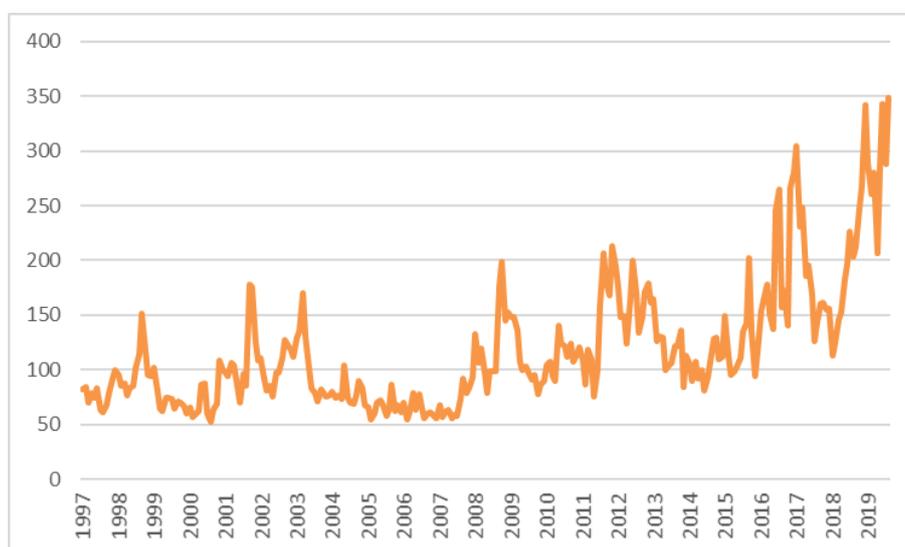
With a large part of the risk to global growth dependent on policy decisions, it is instructive to consider the Global Economic Policy Uncertainty index¹. This GDP-weighted measure of newspaper articles citing economic policy uncertainty shows implicit concern for policy developments as high as they have been in the last 30 years.

Figure 1.2

Global Economic Policy Uncertainty Index

A GDP-weighted index reflecting the relative frequency of newspaper articles that contain a trio of terms pertaining to the economy, policy and uncertainty.

Source: policyuncertainty.com



The IMF's outlook for the euro area is for growth of 1.6% in 2020 with a recovery in external demand driving a return to investment in Germany. The United States is expected to slow to 1.9% with an unwinding of fiscal stimulus. Whilst problems in China – weakening foreign demand, escalating tariffs and the challenges of a structural slowdown – are expected to subdue growth, stimulus policy remains ready to counter an adverse external shock and ensure continued expansion (6.0%). The IMF forecasts moderate growth for the UK in 2020 (1.4%), based on the assumption of an orderly Brexit and a gradual transition to a new trade regime.

However, the outlook for the UK remains highly uncertain. There has been no clarification of the likely outcome of the ongoing Brexit negotiation, and both the short-term and longer-term impacts of the UK's new trading arrangements

¹ produced by Professors Steven Davis and Nick Bloom and Associate Professor Scott Baker.

are unclear. Though a deadline of 31 October remains for the two sides to agree upon a deal; unstable party politics, opposition to a 'no-deal' outcome and the possibility of an imminent general election all suggest the potential for further delay - although the EU would have to agree to this.

Having fallen by around 10% against the euro and dollar in the months following the Brexit referendum, sterling is now close to its 2009 trough and trades at an historically low level. The trade-weighted index presented in **Figure 1.3** shows the value of sterling in comparison to the currencies of its trading partners over the last 20 years. As can be seen, major depreciations have coincided with significant events (the global financial crisis of 2008, the Brexit referendum result in 2016) and the disturbances and uncertainty of a disorderly withdrawal from the EU could well prove just as significant.

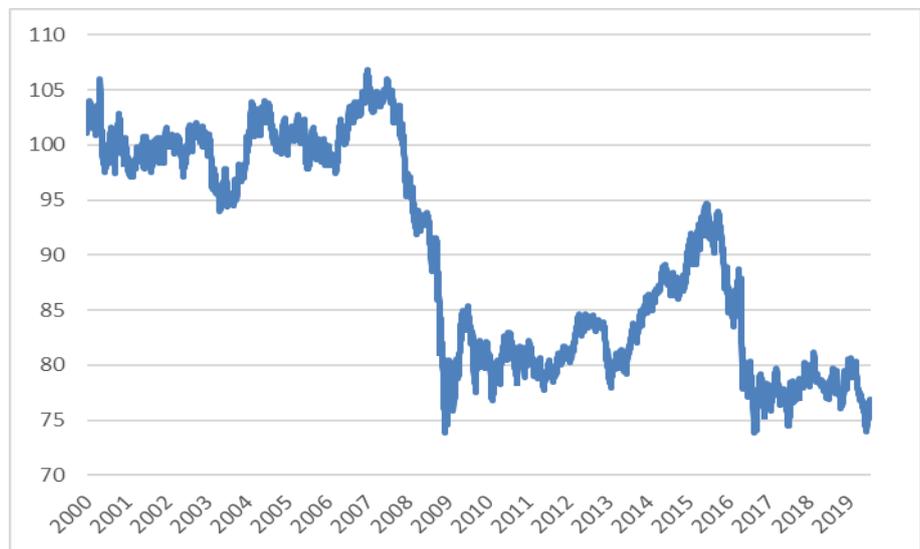
Figure 1.3

Sterling's trade-weighted index

The "Effective exchange rate index" shows movements in sterling's foreign exchange value.

Jan 2005=100

Source: The Bank of England (BoE) 2019.



Large depreciations, by making imported goods more expensive in local currency terms, are associated with inflation. One major channel through which these inflationary pressures may affect the local economy is through fuel prices. Statistical analysis shows this to be a major influence on Jersey inflation. Whilst crude oil prices remain lower than seen at the start of the decade, the recent trajectory is upwards and this, accompanied by any potential further fall in sterling with disturbed supply chains, could put significant upward pressure on fuel prices.

Figure 1.4

Crude oil prices

£, price of crude oil acquired by UK refineries, index (2010=100)

Source: Department for Business, Energy and Industrial Strategy (BEIS) 2019.



Whilst monetary policy was showing signs of tightening at the time of last year's report, this has since reversed and the central banks of the industrialised world are now tending to follow more accommodative policy. UK Bank Rate has remained at 0.75% for over a year and though a pickup in wage growth and full employment present a reason to consider a modest rise if a disruptive Brexit is avoided, market expectations, which represent an average across all outcomes, are for no further rise before the end of 2022. The only movement in the US Federal Funds Rate this year was down (to 2.00-2.25% in July). The European Central Bank drove its base interest rate further negative in September (-0.5%) marking five years since it was first negative.

In summary, the global economy has remained relatively resilient over the last year despite a rise in trade-related tensions and uncertainty. Conditions are right for continued expansion, however the pace of this depends on favourable political settlements between the UK and the EU as well as between the US and its major trading partners. Adverse developments in these negotiations could well lead to a fall in sentiment and investment, potentially feeding into financial vulnerabilities as identified by the IMF.

1.2 Jersey economic developments

Gross value added (GVA) is the headline measure of economic activity in Jersey. Real growth in Jersey's economy was 1.4% in 2018, marking five years of consecutive growth following six years of contraction. Output of the finance sector grew by 2.2% in real terms while non-finance (excluding the rental income of private households) grew by 0.8%. Growth was particularly

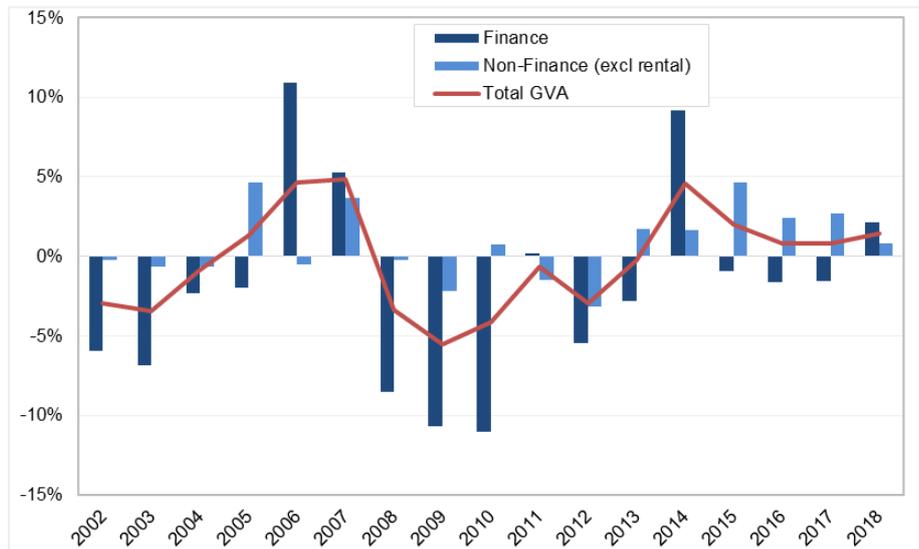
strong in the hotels, restaurants and bars sector (5.3%) with other business activities (1.8%) also expanding.

Figure 1.5

A breakdown of Gross Value Added growth

Annual % real terms change

Source: Statistics Jersey



1.2.1 Financial services sector

The financial services sector saw a 2.2% real-terms rise in GVA in 2018. Though employee compensation was unchanged in comparison to 2017, there was a 4.6% rise in sector profitability.

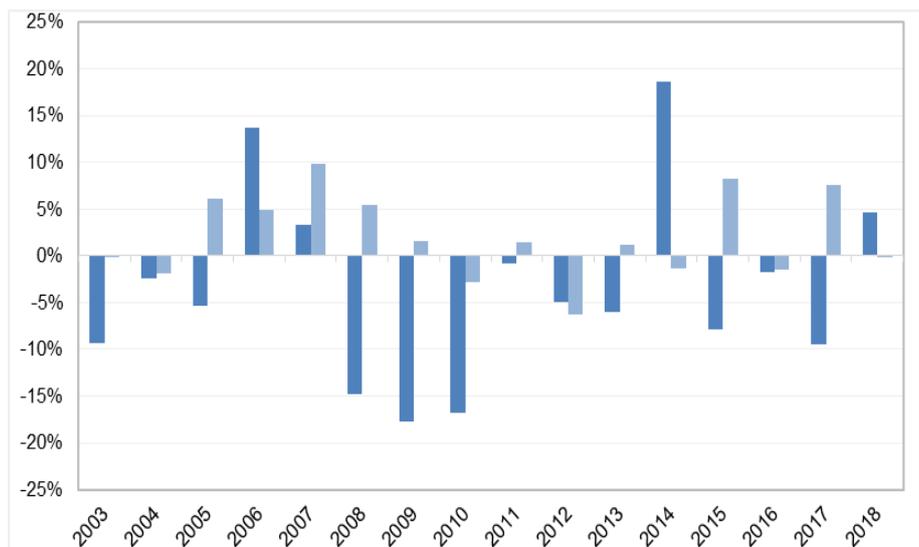
Trust and company administration was again the fastest growing sub-sector of the finance industry (4.4% annual growth in real terms), while banking also grew in real terms (2.2%).

Figure 1.6

Financial services profit and employment costs

Annual % change in gross operating surplus (dark bars) and compensation of employees (pale bars), constant prices

Source: Statistics Jersey



Revenues for the financial services sector were £2.7 billion in 2018, a 7% rise in comparison to the previous year driven by strong growth in banking activity revenue (9%) as well as revenues from trust and company administration

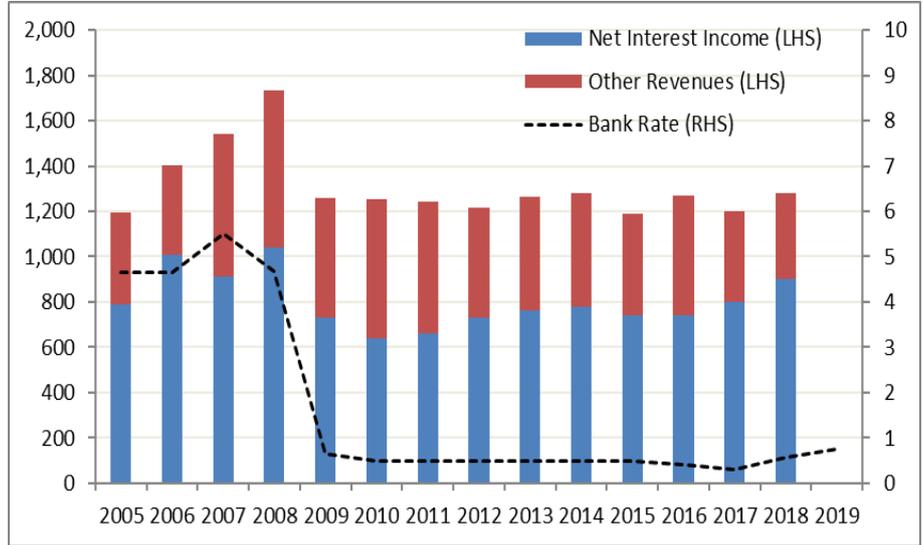
activity (5%) and investment advisory activity (20%). Net interest income (over a third of finance sector revenue) rose by 12.5% in nominal terms on the year. This represents a substantial improvement in a revenue source that fell by nearly 40% in the two years after 2008 and is still 13.5% below its 2008 peak.

Figure 1.7

Banking revenues

Source of revenue (£m, current prices - left hand scale) and annual average for Bank of England Official Bank Rate (% - right hand scale, 2019 until end Sept.)

Source: Statistics Jersey; Bank of England



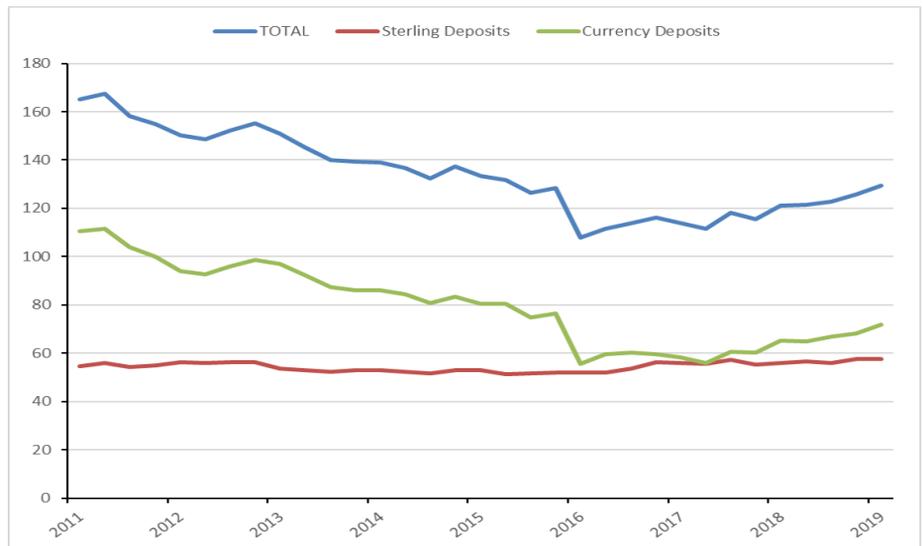
If UK Bank Rate remains flat in line with market expectations, net interest income is unlikely to continue growing unless driven by an expansion in deposits. The amount of foreign currency ('currency deposits', principally US dollars and euros) remains substantially below the levels it reached in 2007, but has grown reasonably steadily since 2016. Though foreign currency, these are measured in sterling, so this value also reflects changes in number of exchange rates. Sterling deposits have also grown slightly since 2016, but remain largely steady over the long term.

Figure 1.8

Banking deposits

Total bank deposit values (£bn current prices) in sterling, foreign currencies ("Currency Deposits") and total values

Source: Jersey Financial Services Commission



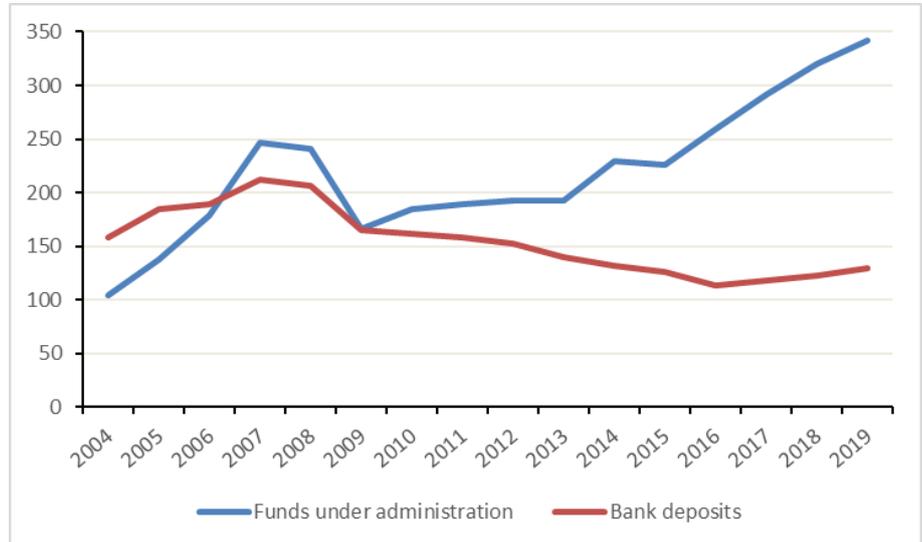
In contrast to the lower level of bank deposits than in 2011, funds administered from Jersey have experienced significant recent growth. After falling during the global financial crisis, the value of funds under administration has more than doubled in the last ten years to reach £342bn at the end of June.

Figure 1.9

Deposits and funds

£bn, total banking deposits held in Jersey (red line) and net asset value of regulated funds under administration (blue line).

Source: Jersey Finance



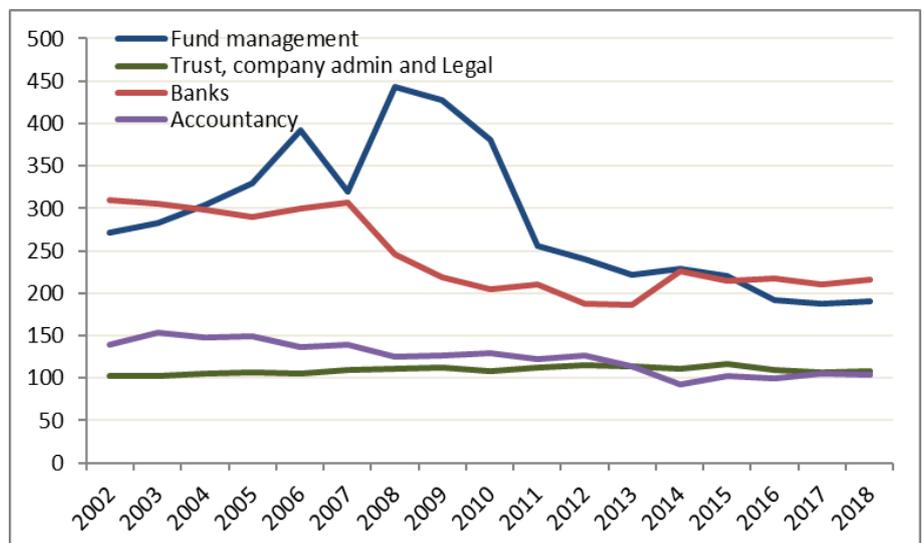
GVA per full-time equivalent employee (a measure of labour productivity) grew by 1% for the finance sector in real terms in 2018. On a sub-sector level, productivity grew by 2% in banking and also rebounded in every other subsector apart from accountancy (i.e. fund management, trust and company administration, legal) where a slight fall followed 2017's rise. Since 2002, productivity has fallen significantly (over 2% per year on average) in banking, and fund management. Productivity has also fallen in the accountancy subsector (1.8% annually) over the same period, whilst it has remained largely unchanged in the trust & company and legal subsector.

Figure 1.10

Finance subsector productivity

Gross value added per full-time equivalent employee by sector, constant 2018 values, (£000)

Source: Statistics Jersey



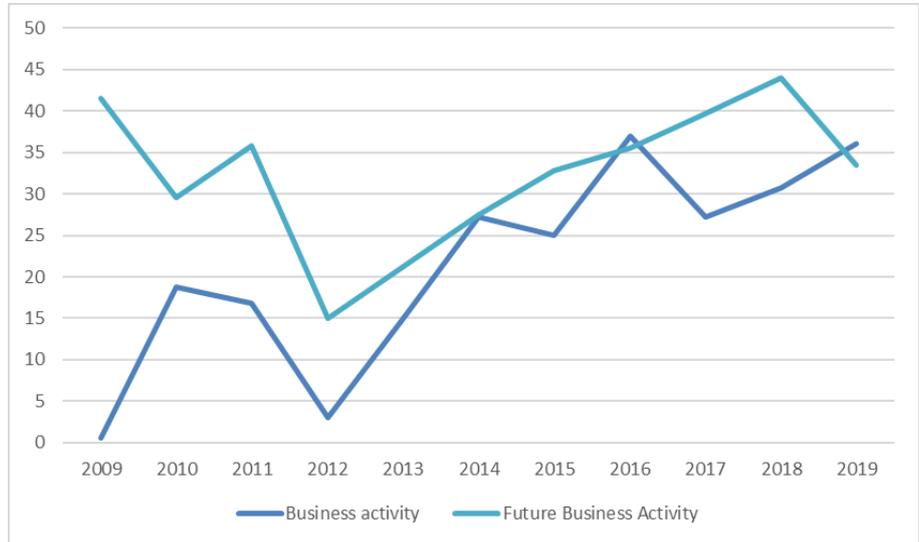
The business activity indicator from the **Business Tendency Survey** has continued to be strongly positive in 2019 for the finance sector. Expectations for future business activity also remain reasonably strong, despite a substantial drop compared to the average for 2018.

Figure 1.11

Finance business tendency

% net balance of respondents reporting an increase in business activity and future business activity (both weighted by employment). Annual average of quarterly results to June 2019.

Source: Statistics Jersey



The **outlook for the financial services sector** was positive overall in the June 2019 BTS, with the weighted proportion of firms expecting profits growth 56 percentage points higher than those expecting a decrease. Similarly with employment expectations, despite a dampening of sentiment since last year, firms planning to increase staff levels were 23 percentage points above those planning a reduction.

Figure 1.12

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: Statistics Jersey

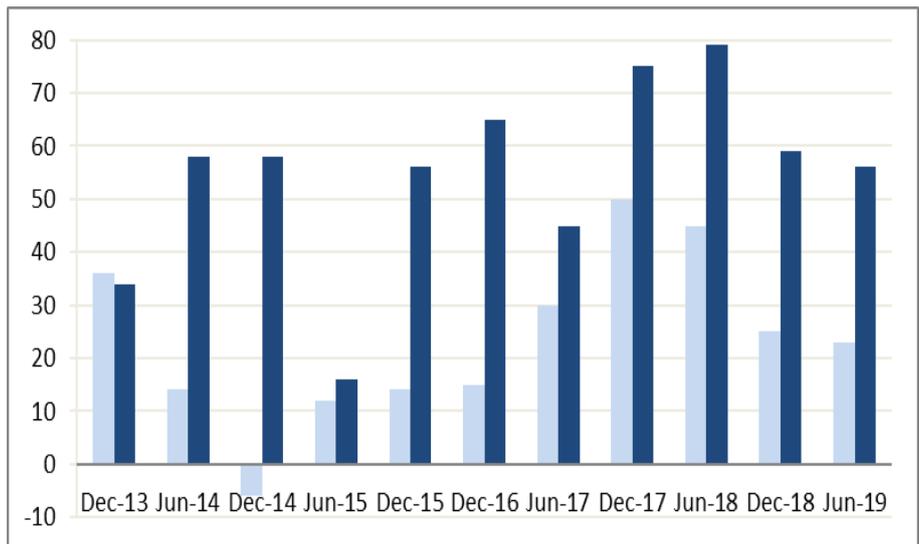


Figure 1.13 compares the responses to the BTS with the growth of financial services sector GVA. Whilst the BTS has improved strongly in the year to June, unfortunately this has proven a poor predictor of final outturns.

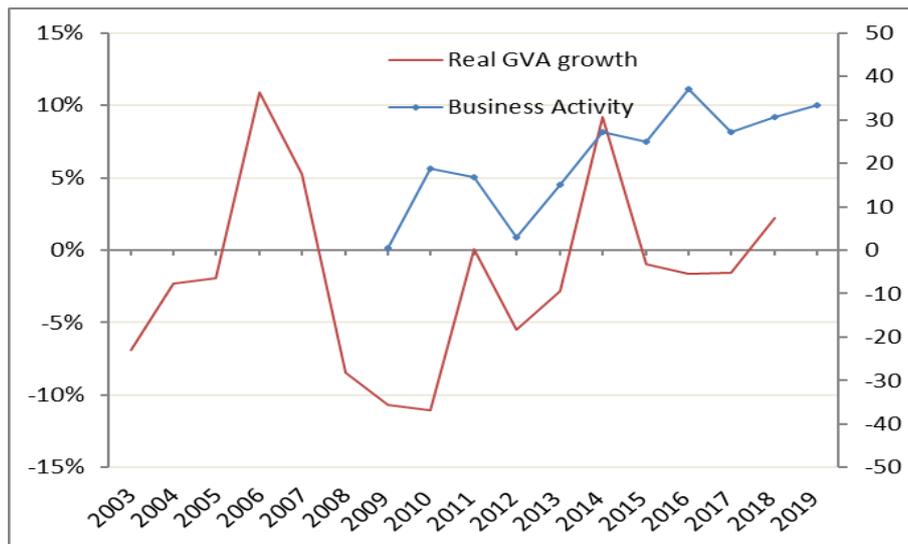
Figure 1.13

Finance GVA growth

Annual real GVA growth of financial services (left-hand scale)

Financial services responses to business activity question averaged over each year (right-hand scale). Note: 2019 based on average of responses to "business activity" in March and June plus "future business activity" from the June survey

Source: Statistics Jersey



During the Panel's recent fact-finding visit, the message from representatives of the financial services sector was positive in respect of short-term prospects for business opportunities and recruitment plans. Nevertheless, uncertainties and longer-term risks continue to mark the outlook for the industry.

Preparations for the short-term challenge of Brexit are in place and there was no immediate risk to short-term profitability. However, a situation where the UK would start directly competing for work currently undertaken in Jersey was a concern for the medium term. Despite the ongoing risk of unfavourable global regulatory decisions, industry welcomed the increased certainty on beneficial ownership due to Jersey's plans to follow the EU in their adoption of a new standard over the next three years.

Though plans to automate administrative tasks in the industry are underway, the importance of client relationships was stressed and it was argued that automation could have a larger effect on other jurisdictions that specialise in areas of finance where a personally tailored approach is less important. With the continued expansion of the trust and wealth management sectors, employment was expected to continue growing in the coming years.

Last year's interest rate rises in both the US and UK were welcomed by the banking sector for net interest income, but short-term prospects for interest rates were less promising. A continuation of loose monetary policy globally will likely be met with efforts at cost control in order to regain margins - which could reduce employment expansion and increase productivity.

1.2.2 Rest of the economy

2018 was another year of recovery for the non-finance sectors with aggregate GVA growing for the sixth consecutive year. Real output from these sectors is

now over 7% higher than its 2007 pre-crisis peak. Growth was particularly strong in the hotels, restaurants and bars sector (5%). The other business activities sector also saw significant growth (2%).

The Business Tendency Survey for the non-finance sectors has remained positive in 2019 with the headline business activity indicator still showing more companies reporting growth than those that reported a fall in business activity, though the results have not been as strong as in the previous two years. In terms of profitability, the majority of respondents have reported a reduction as they have since the survey began in 2009 (eleven years of GVA data suggest their gross operating surplus (profits) fell only twice over this period, in 2012 and 2018). Expectations for future business activity (for the following quarter) remain positive and have improved since last year.

Figure 1.14

Non-finance business tendency

% net balance of respondents reporting an increase (weighted by employment). Annual average of quarterly results to June 2019.

Source: Statistics Jersey

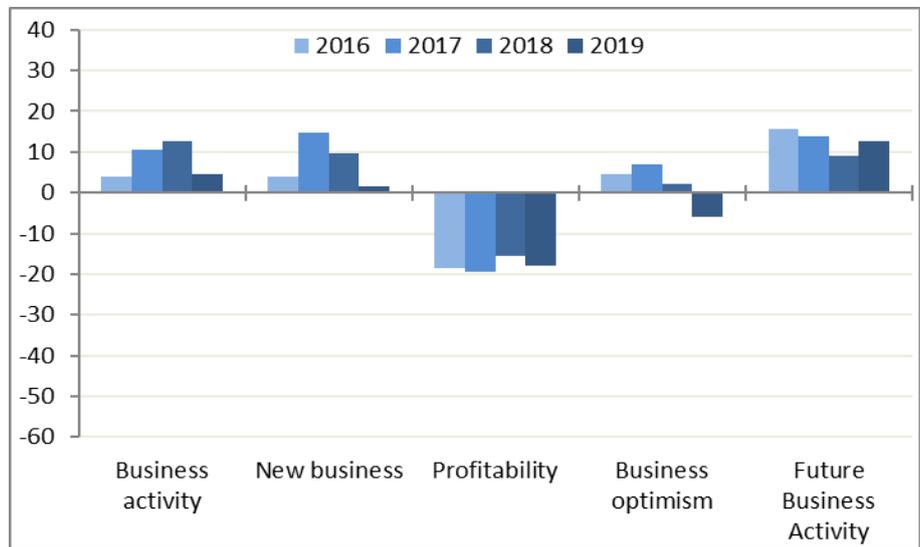


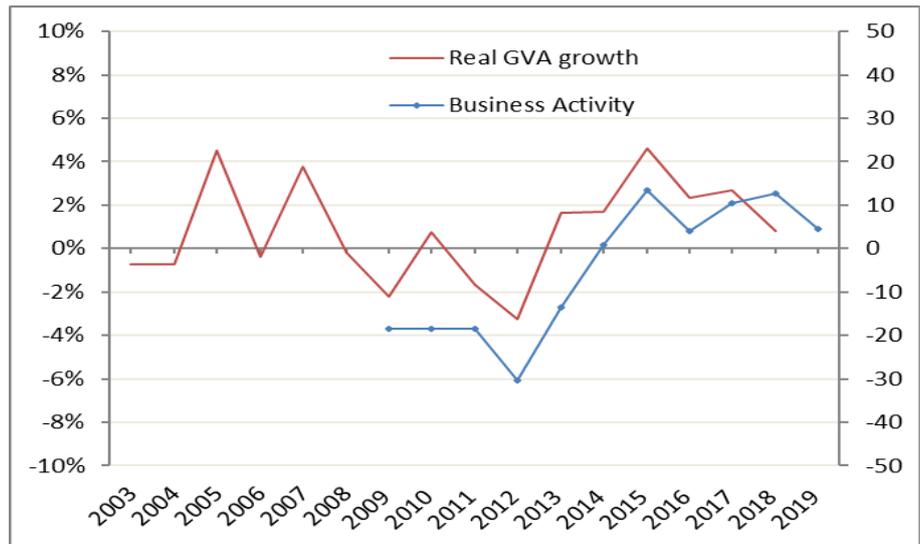
Figure 1.15 compares the responses to the BTS with the growth of non-finance sector GVA (excluding the rental income of private households). This shows that the business activity indicator has followed broadly similar trends to GVA growth in recent years - with both improving significantly in 2015, receding in 2016 and improving slightly together in 2017. The BTS showed an acceleration in business activity in 2018 despite GVA growth slowing but recent correlation suggests GVA growth may fall again given poorer BTS results so far for 2019.

Figure 1.15
Non-Finance GVA Growth

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

Non-finance responses to business activity question averaged over each year (right-hand scale). Note: 2019 based on average of responses to "business activity" in March to June, plus "future business activity" from the June survey

Source: Statistics Jersey



1.2.3 Sectoral performance

GVA of the **wholesale and retail sector** contracted by 1% in 2018 in real terms, bringing its fall since a 2007 peak to over 17%. There was a further ½% fall in labour productivity contributing to a 9% fall in real terms since 2007.

The sectors responses to the Business Tendency Survey have been strong, with the headline business activity stronger than 2018. Though future business activity has fallen back a little in the second quarter of 2019, having been strongly positive in the first quarter. The indicator for input costs has eased a little but remains strongly negative, suggesting continuing inflationary pressures.

The retail sector reported that business was relatively flat, with footfall unchanged from 2018. Representatives felt that a vibrant, clean and safe town centre was a strength for the sector and store vacancy rates are low - apart from a small number of large stores. There are continuing challenges with recruitment, however, and competition from online retailers continues to intensify, with competition now in the grocery sector as well as in non-food retail. The development of a retail strategy was welcomed by representatives.

The **hotels, restaurants and bars sector** expanded by 5% in 2018, recovering from a 2% fall in 2017. This was principally driven by productivity gains (4% annually) and takes output to a level 33% higher than its 2009 slump.

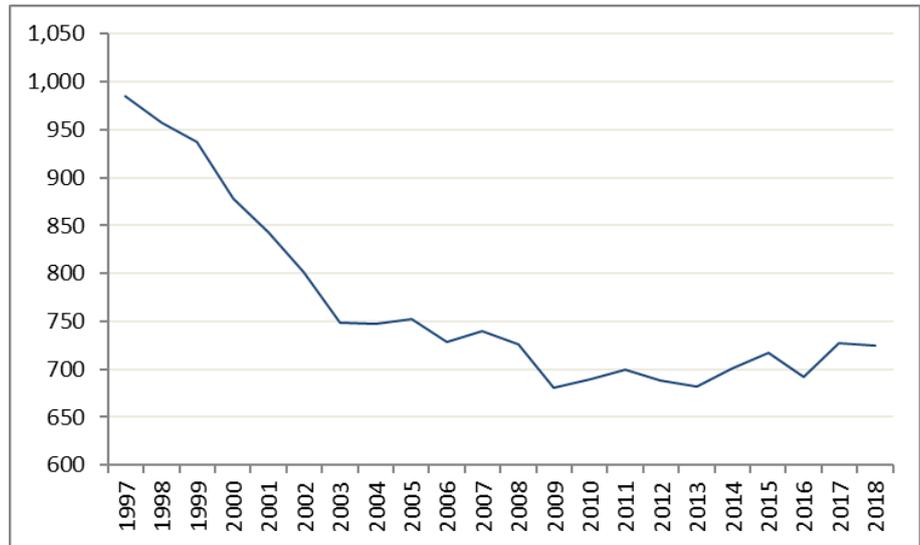
Overall visitor numbers in 2018 were effectively unchanged from 2017 (725,000) after a slow recovery from the low point of 681,000 visitors in 2009. Leisure visitor numbers increased, with 2018 seeing the highest number of leisure visitors since 2001. Visitor spend was up 10% compared to 2017.

Hospitality representatives reported that the sector was undergoing significant change, with a move to shorter visits and in particular day-trippers. There has been a longer-term trend to fewer advance bookings, and this was particularly pronounced in 2019. There is significant investment in refurbishment of tourist accommodation, but recruitment is difficult - particularly for chefs and housekeepers.

Figure 1.16
Visitor numbers

Annual number of visitors to Jersey, 000s

Source: Visit Jersey



GVA of the **construction sector** fell by 1% in 2018 after four consecutive years of growth. Output is still over 33% higher than it was in 2013 and productivity remains over 10% greater. Recent responses to the Business Tendency Survey have been less positive than in previous years and the most recent (June 2019) survey showed the headline business activity indicator at its lowest level since 2014.

Representatives of the sector reported challenges with planning future workloads, particularly as public sector projects were coming through more slowly than anticipated. Strong demand for small-scale residential work means that smaller firms remain very busy, but there are challenges for larger firms in ensuring a consistent pipeline of work. Programmes have been successful in encouraging young people to enter the sector, but some specific skill sets can be difficult to find locally. There are significant challenges with input costs and it is not always possible to pass this on to clients, which puts further pressure on profitability.

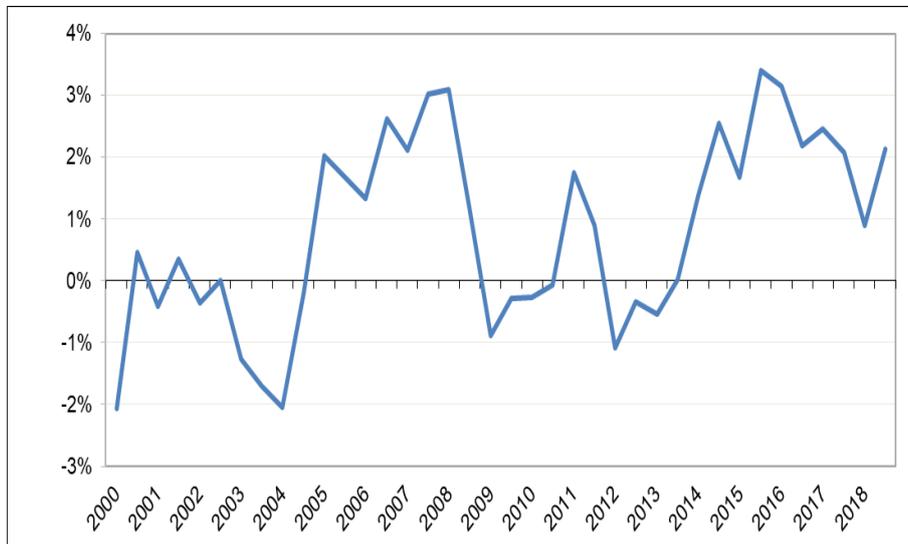
1.3 Labour Market

With total headcount reaching 60,900, representing growth of 1.9% from 2017, December 2018 saw the highest end-of-year employment on record. Employment has risen by almost 14% in the ten years to December 2018.

Figure 1.17
Employment

Annual change in total private sector employment

Source: Statistics Jersey



The two largest sectors of the economy, financial services and education, health and other services both grew at over 2% in terms of headcount over the year.

Figure 1.18

Employment changes by sector

Total headcount for each sector

Source: Statistics Jersey

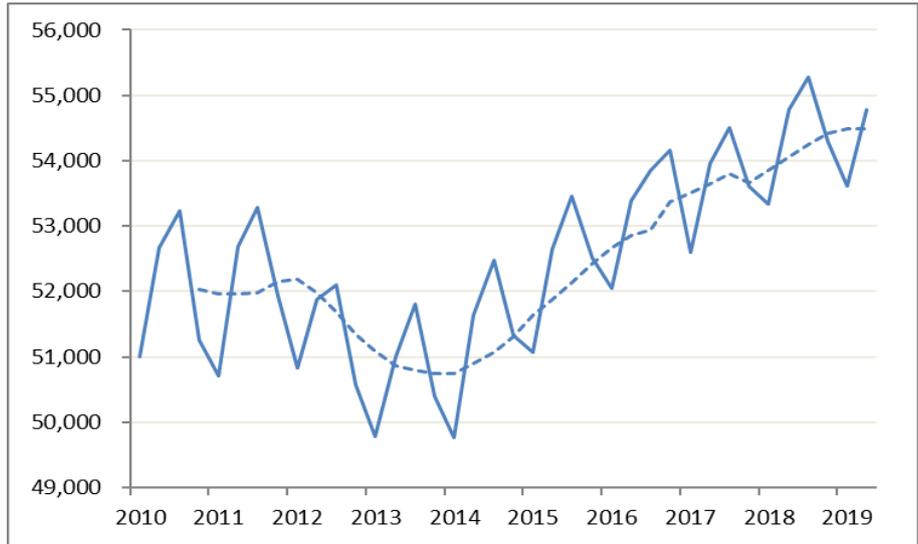
	Dec-17	Dec-18	Change	% Change
Agriculture and fishing	900	930	+30	3.3%
Manufacturing	910	930	+20	2.2%
Construction & quarrying	5,830	6,010	+180	3.1%
Electricity, gas & water	710	710	0	0.0%
Wholesale & retail trades	7,530	7,490	-40	-0.5%
Hotels, restaurants & bars	5,370	5,540	+170	3.2%
Transport, storage & communication	1,970	1,990	+20	1.0%
Computer & related activities	1,750	1,800	+50	2.9%
Financial & legal activities	13,460	13,760	+300	2.2%
Miscellaneous business activities	5,940	6,110	+170	2.9%
Education, health & other services	7,640	7,860	+220	2.9%
Public Sector	7,780	7,780	0	0.0%
Total	59,790	60,910	+1120	1.9%

Social Security contribution numbers provide monthly data on the total number of individuals paying class 1 (as employees) or class 2 (including the self-employed) contributions in that particular month. They can therefore be used to give some indication of recent trends in total employment. Data for the second quarter of 2019 showed average contributor numbers at the same level they were in the second quarter of 2018.

Figure 1.19
Social Security contributions

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

Source: Customer and Local Services

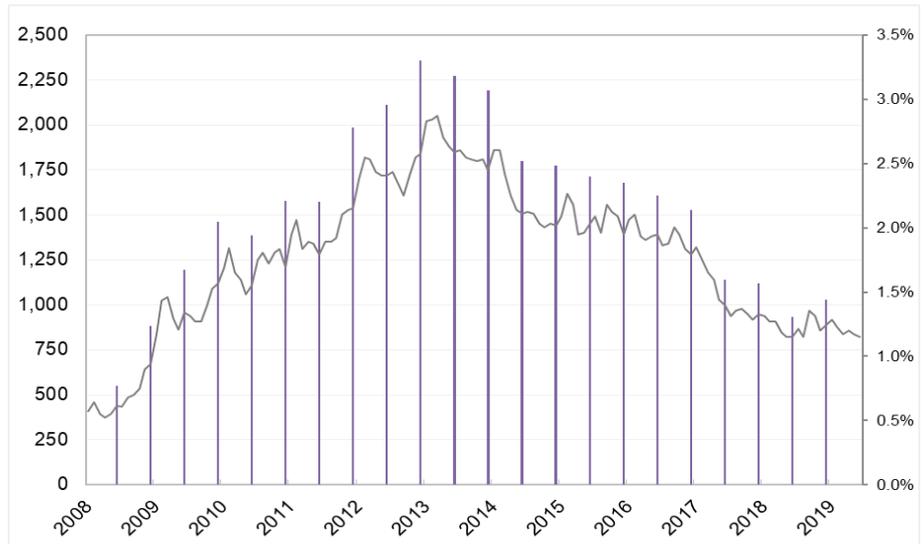


In the absence of ILO unemployment statistics, the number registered as **Actively Seeking Work (ASW)** can provide a reasonable proxy for labour market slack in the local economy. ASW numbers have fallen by over half since peaking at 2,050 in early 2013 and stood at 820 in June 2019.

Figure 1.20
Changes in ASW

Number registered as actively seeking work (LHS), not seasonally adjusted. Bars represent ASW as a percentage of the workforce (ASW plus employment; RHS).

Source: Statistics Jersey, Panel calculations

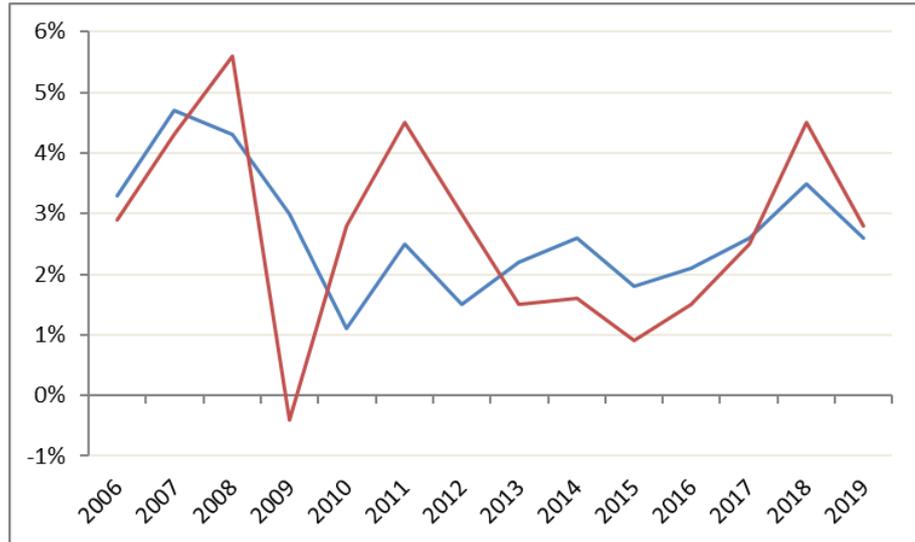


Average weekly earnings in June 2019 were 2.6% higher than at the same time in 2018, though they fell very slightly (0.2%) in real terms given the 2.8% rate of inflation over the same period. After strong growth through the 1990s, average earnings have stagnated and in real terms are now at the same level as in 2001.

Figure 1.21
Average earnings and inflation

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

Source: Statistics Jersey



1.4 Inflation

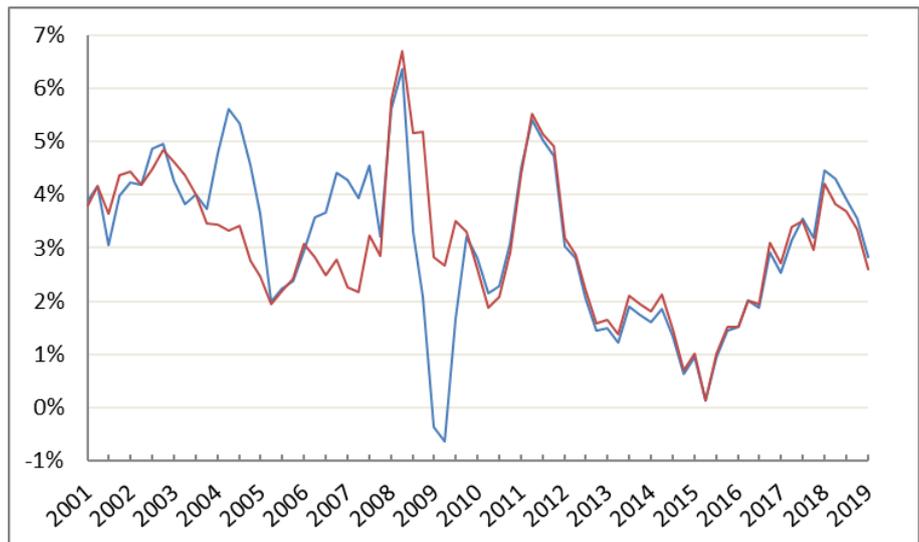
The Retail Price Index (RPI) increased by 2.8% in the year to June 2019, slowing from a six-year inflation peak of 4.5% in June 2018. Figure 1.21 shows recent inflation at higher levels than earlier in the decade, with the initial surge largely due to the fall in the value of sterling after the Brexit referendum.

However, the main contributor to inflation over the past year has been increasing housing costs, driven by strong recent growth in house prices and increases in interest rates. Household services and leisure services also added significantly to inflation.

Figure 1.22
Inflation in Jersey

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

Source: Statistics Jersey



1.5 The output gap

The trend rate of growth is the rate of growth once cyclical factors are removed i.e. the underlying rate of growth over the business cycle. The trend *rate* of growth is closely related to the concept of 'potential output' (trend GVA); that is the *level* of economic output associated with full non-inflationary use of resources. When the economy is above potential output this implies demand is above the non-inflationary capacity of the economy and there is upward pressure on inflation with a positive 'output gap'. Conversely, when the economy is below potential output this implies under-utilisation of capacity and resources e.g. unemployment above its sustainable rate, and downward pressure on inflation.

Neither the trend rate of growth nor the output gap can be measured or observed directly: they can only be estimated. One approach of particular value with this challenge is Principal Component Analysis (PCA) that assigns a separate weight to each of a set of indicators. Beyond earnings data, data on vacancies and unemployment, the BTS offers detailed quarterly data on business sentiment with direct relevance to capacity utilisation. The PCA method supposes a common, unobserved factor that drives changes amongst these variables. These factors are then derived as weighted averages of the variables to account for as much of the variance in the dataset as possible.

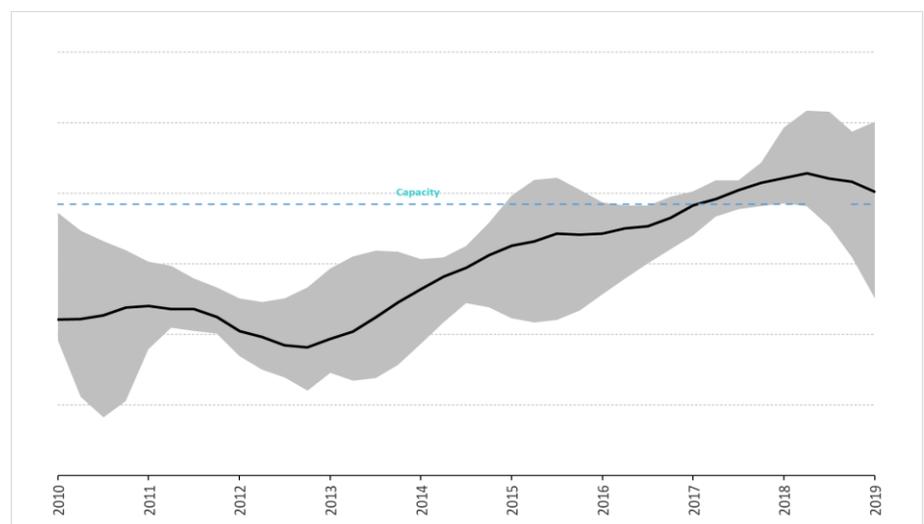
The results for the PCA method shows a peak was reached in the latter half of last year and a slowing has occurred since then. Though the point at which the economy can be said to be at capacity involves arbitrary choice, the inflationary pressure of the business cycle appears to be in retreat. Indeed, last year's peak in RPI inflation coincides with the peak in the PCA factor. Though observing the economy as close to capacity is not in itself a cause for concern, the output gap analysis suggests the economy is slowing.

Figure 1.23

Output Gap estimate based on PCA

Thick line is Principal Component; swathe is minimum and maximum of scaled series used in PCA

Sources: Statistics Jersey, Government of Jersey, Panel calculations



1.6 Economic growth forecast

In 2018, profits in the finance industry grew and aggregate output per head rose a little. However, the GVA figures present a mixed story with profits falling in the second largest sector (other business services) and construction along with no growth in employee compensation in the financial services sector. Furthermore, recent social security contributor numbers, BTS results and falls in real average earnings are further evidence of a potential slowdown in the local economy.

Though Jersey's position is strong, with economic performance markedly better than at the start of the decade, robust public finances and a strong net asset position, Jersey remains vulnerable to external risks, notably at present the slowdown in the global economy and the economic uncertainty in the largest trading partner, the UK.

The UK economy has already slowed. In the latest quarter, UK GDP contracted by 0.2% - the first fall in output since 2012. Much of this slowdown can be attributed to ongoing uncertainty around Brexit. The prospect of the UK leaving the EU without a negotiated agreement ('no-deal') has risen significantly since March.

Further, the prospect for interest rate rises now appears more limited than earlier in the year. Policy rates have been cut in both the US and euro area in recent months and markets are not expecting any significant increase in the UK's Bank Rate over the next five years. All else equal this limits the potential for profit growth in Jersey's banking sector over the medium term as most deposits are held in sterling, dollars and euros.

The Panel forecast real GVA growth of around 0.9% for 2019, rising to 1.0% in 2020. As indicated by Figure 1.24, there is considerable uncertainty around these forecasts. Beyond 2022, the chart shows the Panel's long-term trend growth assumption of 0.6%.

Figure 1.24

Economic growth forecast

% change in real GVA on year before

Sources: Panel judgment; Statistics Jersey

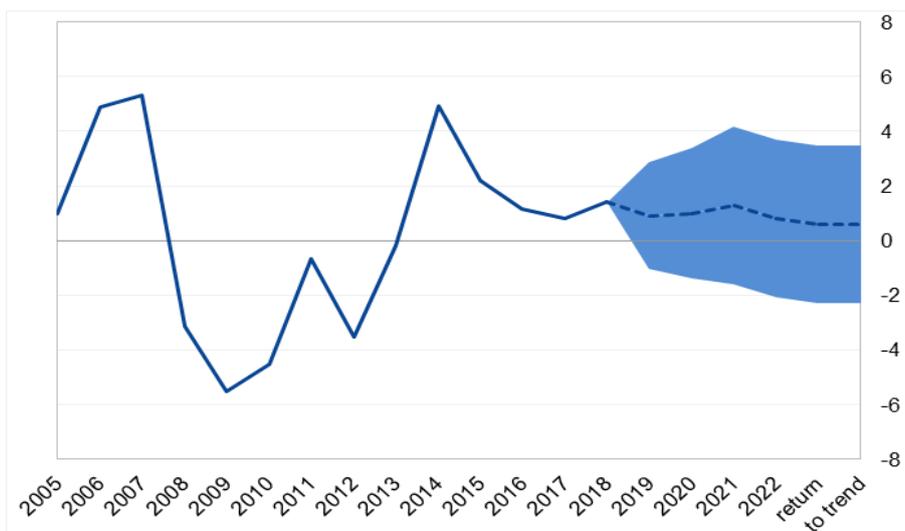


Figure 1.25 shows the Panel's most recent economic assumptions which were included in its letter to the Treasury Minister in September 2019².

Figure 1.25

Central economic assumptions

% 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: Panel judgement

% change unless otherwise specified	2017	2018	2019	2020	2021	2022	Trend 2023+
Real GVA	0.8	1.4	0.9	1.0	1.3	0.8	0.6
RPI	3.1	3.9	2.8	2.4	2.6	2.7	2.6
RPIY	3.2	3.5	2.6	2.3	2.5	2.6	2.5
Nominal GVA	4.1	5.9	3.5	3.3	3.8	3.4	3.1
GOS (including rental)	-0.3	7.5	3.3	3.0	3.5	3.2	3.2
Financial services profits	-6.4	9.6	2.0	2.0	3.1	3.3	3.4
Compensation of employees	8.1	4.6	3.6	3.5	4.0	3.5	3.1
Employment	2.3	1.4	1.0	0.2	0.8	0.5	0.4
Average earnings	2.6	3.5	2.6	3.3	3.2	3.0	2.7
Interest rates (%)	0.3	0.6	0.7	0.6	0.5	0.5	0.5*
House prices	2.9	7.1	6.3	5.4	4.5	3.6	2.7
Housing transactions	6.7	7.2	7.0	3.0	3.2	2.3	1.5

*Interest rate assumption for 2023 only

Since the September assumptions, data have been released on GVA in 2018. GVA growth was recorded as 1.4% in real terms, lower than the FPP assumption of 2.5%. Figure 1.25 has been updated with the 2018 outturn but is otherwise unchanged from the September assumptions. While the real-terms growth rate in 2018 was lower than the FPP's estimate, this was due to a change in the deflator used for the rental income of private households. In nominal terms, GVA growth was largely in line with the FPP's estimate. Therefore, this new data point does not change the Panel's view of the level of spare capacity.

² [Fiscal Policy Panel Update September 2019](#)

Section 2 - The Fiscal Outlook

3.1 Introduction

This section considers the draft Government Plan for 2020-23 ('the Government Plan'), which was lodged in July. This represents the first Government Plan under the new framework set out in the Public Finances Law 2019³. The requirement to produce a Government Plan replaces the Medium-Term Financial Plan (MTFP) required under the previous law. The MTFP was a four-year expenditure plan whereas the Government Plan will be debated annually, setting expenditure for a single year - with forecasts for the following three years.

New Public Finances Law

The new law makes a number of further changes. In particular, the Panel welcomes the changes in the way that capital expenditure is approved in the new law. Previously the entire cost of each project needed to be 'allocated' before work could start. The new law introduces the concept of 'major projects', for which expenditure can be allocated in the year in which it is to be spent. This should make it easier for the government to ensure Jersey has the infrastructure needed to deliver public services and support the economy. This change will mean that appropriate rigour is needed to ensure that sufficient funding is available to complete multi-year capital projects.

The Public Finances Law also reiterates and extends the role of the FPP. In particular, the FPP is now required to comment on the sustainability of public finances in light of the States' financial assets and liabilities.

MTFP 2016-2019

This draft Government Plan also represents the end of the 2016-2019 MTFP period. Jersey's public finances are in a much stronger position now (with a largely balanced budget forecast for 2019) than at the beginning of the MTFP period. The forecast in 2015 was for a £145m structural deficit by 2019 and the MTFP set out a suite of measures to resolve this. Some were more successful than others but, overall, efforts to eliminate the deficit appear to have been successful and the FPP's guiding principles for the MTFP were broadly followed:

³ [Public Finances \(Jersey\) Law 2019](#)

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

Draft Government Plan 2020-23

This first Government Plan has a number of key features:

- The Council of Ministers' six priorities. The Plan is based around strong themes and outcomes. This makes it clear where Government will focus its attention over the four years.
- Budget 2019 set out spending pressures which had the potential to result in an annual deficit of £40m, before new funding for priorities. The draft Government Plan aims to close this deficit, with a small surplus each year even after funding the new priorities. Part of this is achieved through £100m of efficiencies, with the first £40m to be delivered in 2020 and the remainder by 2023.
- There are some measures to increase revenues, but these amount to less than was planned (but not fully achieved) under the last MTFP. The main changes are an increase in the long-term care charge to allow the Long-Term Care Fund to meet the increasing costs in the future; and above-inflation increases in impôts (duties).
- The capital pipeline over the four years is significant, and includes feasibility works for several potentially large major projects to come.

New fiscal framework

Alongside the Government Plan, there is also a new fiscal framework. The main features of the fiscal framework are summarised in the Government Plan, including the following guidelines:

- seek to increase the Strategic Reserve and public sector net worth, while following the advice of the Fiscal Policy Panel on borrowing and net financial assets.
- run a primary structural current balance or surplus in the long term until the Strategic Reserve is judged large enough to meet its mandate.

- borrow only to finance investment (or refinance liabilities), except under times of economic duress, and monitor the impact on net financial assets.

The Panel was consulted on the development of these guidelines and is content that they are consistent with the Panel's advice. They provide a set of criteria against which the Panel can assess how each Government Plan contributes to longer-term fiscal sustainability.

The remainder of this section is set out as follows:

- Income and expenditure
- Adjusted fiscal position
- Flexibility
- Assets and reserves
- Panel's previous recommendations
- Longer-term challenges

3.2 Income and expenditure

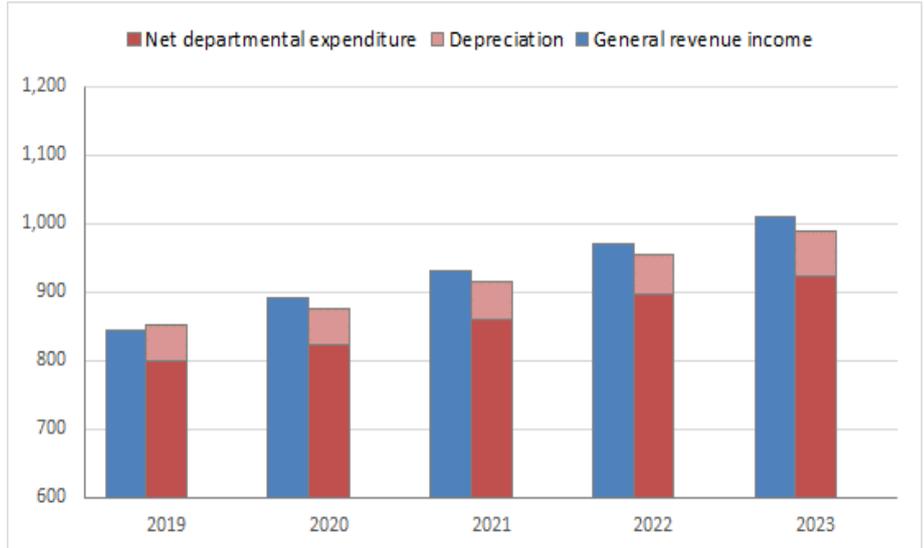
The measure of the surplus/deficit position used in the fiscal framework and in the Government Plan is the 'current balance'. This measure includes current spending and income but excludes capital spending, rather including depreciation to represent the portion of the capital stock that is 'used up' to deliver services. The Panel is supportive of this definition as it removes the incentive to cut capital budgets in order to achieve a balanced budget.

Figure 2.1 sets out forecasts of current expenditure, income and depreciation over 2019-2023. Both income and expenditure are forecast to see strong growth in 2020, before slowing to around 4% annual growth in the following three years. This means that current surpluses are expected to continue over the Government Plan period.

Figure 2.1
Income and expenditure
forecasts

£m (current prices)

Source: Treasury and Exchequer



The small surpluses over the Government Plan period are in line with the FPP's recommendation to run surpluses over the 2020-2023 period. The Panel's analysis in March 2019 suggested that the economy was likely to remain a little above trend over the 2020-23 period and therefore it is appropriate to run surpluses in order to replenish the Stabilisation Fund.

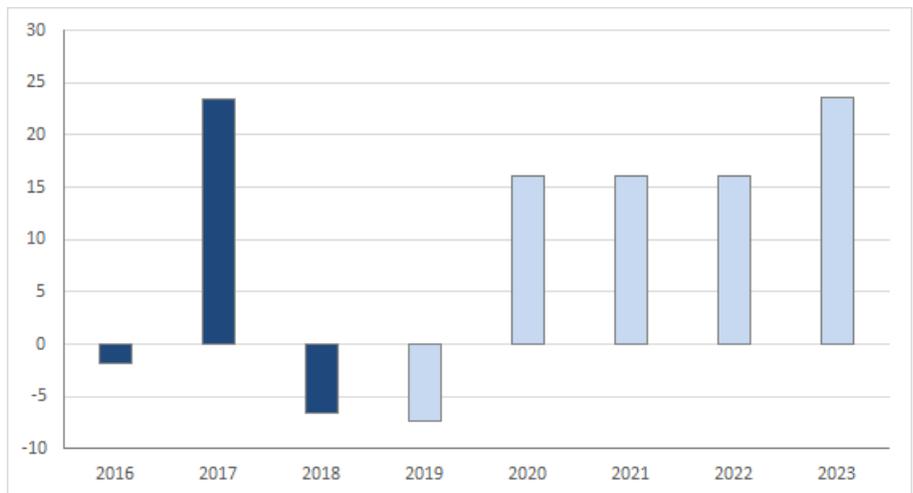
Figure 2.2

Surplus/deficit

Current budget surplus - £m
 (current prices)

Outturn (dark blue bars) and
 forecast (light blue bars)

Source: Treasury and Exchequer



As set out in section 1, the outlook for the local economy has deteriorated a little since the Panel's March 2019 analysis. The economy is still likely to remain above trend over the forecast period, but less so than was expected in March. This may result in a modest reduction in government revenues and an increase in expenditure, relative to the outlook based on the March projections, as the automatic fiscal stabilisers take effect.

The Panel has provided updated economic forecasts in September 2019 and it is understood these will be used to produce revised fiscal forecasts. Should these fiscal forecasts be weaker than those underpinning the draft Government Plan, it may be appropriate to run slightly smaller surpluses to respond to the weaker economic conditions and make a smaller contribution to the Stabilisation Fund.

The updated economic forecasts should not result in any significant deviation from the draft Government Plan, though the automatic stabilisers should be allowed to work. This would be preferable to cutting expenditure to account for a cyclical reduction in income forecasts - which could lead to government reducing its positive impact on demand at a greater rate than is appropriate to the economic conditions. It would be pro-cyclical and weaken growth further to cut spending when the economic outlook is slightly weaker.

3.2.1 Efficiencies programme

Part of the approach to achieving these budget surpluses is to undertake a further round of efficiencies, building on those achieved in the last Medium-Term Financial Plan (MTFP). In total, £100m of annual efficiency savings are forecast to be achieved by 2023. This is broadly expected to be achieved by:

- reducing duplication
- streamlining processes and cutting waste
- integrating services and functions
- taking a smarter and more commercial approach to contract awards and management
- reducing non-essential spend and developing lower-cost alternatives
- improving compliance in revenue collection

The Panel continues to support the pursuit of efficiency savings. Genuine efficiency savings will help the Government to continue to invest in the six priorities while keeping public finances on a sustainable footing. It is important that any change in Jersey's cyclical position (for example in the event of a disorderly Brexit) does not result in easing up on the pursuit of genuine efficiencies. **The Panel recommends that efficiencies should be sought regardless of the stage of the economic cycle.**

At the time the draft Government Plan was lodged, plans had been developed to achieve half of the £40m efficiencies for 2020. These are set out in Figure 2.3. It is understood that further detail on the remaining £20m of efficiencies will be set out later in October. The Panel has previously recommended that

detailed, realistic and time-bound targets should be built into the four-year Government Plan. This recommendation has not been completely followed, but the Panel accepts that some of these are expected to result from the significant public sector modernisation programme, which is still underway. **In future years, each draft Government Plan should include more detail on the efficiencies to be achieved over the full four-year period.**

Figure 2.3

Efficiencies proposed for 2020

£m

Source: Treasury and Exchequer

Activity	
Bringing key back-office support services together to streamline processes and reduce duplication	0.3
Reviewing the contracts that the Government has with its suppliers, to make savings through smarter purchasing, by achieving economies of scale, and through tougher negotiation on price	3.0
Identifying options for the more efficient collection of taxes income, and reducing non-compliance among taxpayers	7.0
Identifying options for the better establishment of charges, subsidies and cost allocation	1.2
First phase transformation of services within departments, achieving efficiency savings through more cost-effective structures, integration of services, and driving improvements in productivity.	8.2
Total	19.7

Efficiency gains are often more difficult to achieve than hoped. **The £100m efficiency target looks ambitious, at around 10% of forecast departmental expenditure by 2023.** Achievement of this target should be considered as a fiscal risk, amongst those covered in section 3.7.

3.2.2 Revenue

The Panel's March report included a recommendation to consider implementing revenue-raising measures or expenditure cuts now, when the economy is above trend, to increase the ability of the public finances to support the economy in a future period of below trend output. The draft Government Plan sets out an additional £5m of tax revenues and £27m of additional Social Security contributions in 2020 - Figure 2.4.

Figure 2.4
Government Plan revenue-raising measures in 2020
 Estimated additional revenue compared to forecast

Source: Treasury and Exchequer

Proposed Measures	Est. 2020 revenue (£'000)
GST:	
Reduction in the GST de minimis	400
GST sub-total	400
Impôts:	
Alcohol	962
Tobacco	888
Road fuel	925
Earmarked road fuel duty increases - Climate Emergency Fund	1,849
Impôt Duties sub-total	4,624
Total Financial Implications (General Revenue Income)	5,024
Social Security Contributions	
Long-Term Care charge	23,700
Social Security Contribution rates - family friendly benefits	3,350
Total Financial Implications (contributions)	27,050

Some of this increase in revenues is hypothecated (which means that there is an additional identified expenditure that will be funded from it). However, in the case of the Long-Term Care (LTC) charge, the full increase in the contribution will not be spent in 2020 but will contribute to the longer-term sustainability of the LTC Fund. Raising this additional revenue now is appropriate, and likely to be less harmful than doing so at a time when the economy is below trend.

The earmarked (hypothecated) increase in road fuel duties relates to the decision of the States Assembly in May 2019 to declare a 'climate emergency' and set a target to achieve carbon neutrality by 2030. In response to this, the Government Plan has proposed the establishment of the Climate Emergency Fund, initially funded by £5m from general revenues and by a proposed 4 pence per litre increase in fuel duties in 2020 (in addition to the 2 pence increase for inflation), with plans for a further 2 pence in 2021 and again in 2022.

Raising additional revenue to fund this ambitious policy target means that the response to the climate change challenge does not significantly weaken fiscal sustainability. However, the use of hypothecation is not without risk.

More generally, the Government Plan goes further than this, by setting out a principle that promotes hypothecation:

“For new areas of significant investment, such as initiatives designed to respond to the climate emergency declared by the States Assembly, investment should be tied to a funding mechanism, such as a hypothecated tax.” (p. 132)

This principle appears overly cumbersome and will be difficult to implement in practice. Indeed, it is not clear that the Government Plan follows this principle as there is significant new spending in priority areas that is not tied to a matched income stream.

The key risk with hypothecation is that it may not always be desirable to align the expenditure with the revenue. For example, if carbon taxes aimed at changing behaviour prove a successful revenue-raising policy it may well be the case that the revenue generated is more than is required to fund appropriate environmental projects and so that revenue may be more effectively used elsewhere. Conversely higher taxes may prompt a change in behaviour that leads to a revenue shortfall relative to the hypothecated expenditure.

The Panel recommends that the use of hypothecation only be introduced where the revenue and spending are likely to be justifiably related, and that any new important areas of investment should not be constrained by the ability to find a new method of funding.

Strict implementation of the principle stated in the Government Plan could well lead to the creation of a plethora of new funding mechanisms, which could add excessive complication to Jersey's tax code - and constrain the ability of the States to prioritise resources to where they are needed most.

Although hypothecation can be a useful way to present the reason for new revenue-raising measures to the public, it is poor public finance practice and introduces unnecessary constraints into the budget process that lead to the inefficient allocation of resources.

3.2.3 Capital

The Government Plan sets out a plan for £350m of capital spending over the four-year period, with approximately £90m per year for 2020-22 and £80m in 2023. This is in addition to any unspent allocations in the Consolidated Fund carried forward from the MTFP in to the Government Plan period, projected to be at least £100m. The largest element of the capital programme is the rolling vote, which totals £53m over four years and relates to the maintenance of existing assets. There is also a further £33m for replacement of assets and £20m for replacement of IT assets.

Given the significant amounts spent on maintenance and replacement of assets (totalling around £25m/year), it would be prudent for Government to consider what impact this maintenance and replacement programme has on aggregate demand in the Jersey economy. It may be that much of this expenditure is spent on imports (e.g. on purchasing off-the-shelf IT) but if a significant element is likely to feed into the domestic economy, this may require careful planning to ensure it does not exacerbate any domestic capacity constraints. While it would not be appropriate to delay urgent maintenance where this would impact on public services, it may be possible to seek to plan the maintenance and replacement of assets more carefully to

help to smooth the economic cycle. Such expenditure was a large part of the previous Fiscal Stimulus programme following the global financial crisis - with £29m allocated to construction, maintenance and civil infrastructure.

Other significant projects include an integrated technology solution for HR, payroll, finance and procurement (£28m over 2020-23), health services improvements (£20m), public realm enhancements (£14m), the Rouge Bouillon site (£14m), cyber-security (£14m), the completion of the sewage treatment works started under the previous MTFP (£12m) and costs relating to Discrimination Law, safeguarding and the regulation of care (£10m).

Figure 2.5
Capital spending

£m

Source: Treasury and Exchequer

Capital programme area	2020	2021	2022	2023	Total
Pre-feasibility Vote	11,200	1,700	250	0	13,150
Discrimination law, safeguarding and	2,500	2,600	2,600	2,000	9,700
Schools extensions and Improvements	2,000	5,701	5,650	1,750	15,101
Infrastructure including the Rolling Vote	24,050	22,370	20,650	23,150	90,220
Information Technology	25,461	31,393	23,871	10,100	90,825
Replacement Assets	10,085	8,360	5,884	8,627	32,956
Estates including new Schools	14,344	18,177	26,773	31,241	90,535
Central Risk and Inflation Funding	1,000	1,500	1,800	2,000	6,300
Total	90,640	91,801	87,478	78,868	348,787

The Panel previously recommended that the Government Plan should consider and set out how the proposed capital programme can be delivered in a way that does not put excess pressure on the limited resources available on-island. This is not clearly set out in the draft Government Plan and therefore the Panel continues to recommend that further work is undertaken to set out how the capital programme can be delivered without exacerbating capacity constraints in the local construction industry.

Additional significant capital expenditure is undertaken by the subsidiary companies including Andium Homes, Ports of Jersey and the Jersey Development Corporation (JDC). The Government Plan includes a large projected increase in their capital expenditure that peaks at just under £200m in 2021, with Andium accounting for around half the total. So, a better measure of total public demand for capital projects includes these bodies as well as Government departments.

To assess the scale of this demand in the Government Plan it is useful to compare it against the output of the construction industry in Jersey. It should be noted that the measure of output used here, nominal Gross Value Added (GVA), is not a measure of turnover or sales but an estimate that nets off purchases of materials, goods and services consumed in producing finished work. This means the turnover of the construction industry is much larger, but that total could also double-count sub-contracting between firms in the construction sector.

Figure 2.6 shows total outturn and forecast capital cashflows across Government Departments, trading operations, subsidiary companies (e.g. Andium) and confirmed major projects but excluding capital projects that are likely to be deemed major projects in future Government Plans, such as Fort Regent.

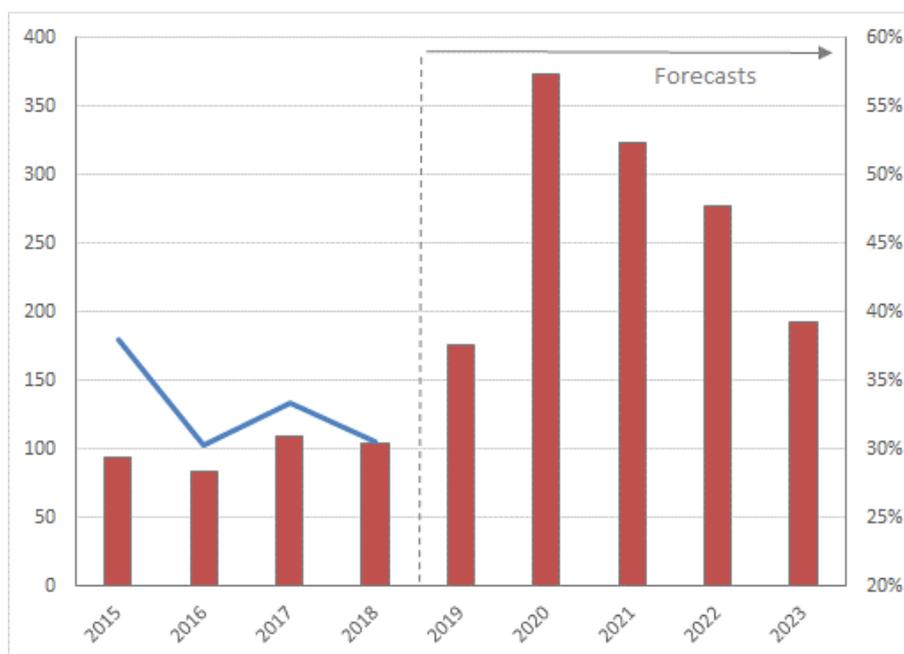
Figure 2.6

Capital spending, outturn and forecast cashflow

£ million (current prices) including trading operations and subsidiary companies: Andium, Ports of Jersey and JDC (LHS).

% construction GVA (RHS)

Source: Treasury and Exchequer



The capital programme set out in the Government plan is diverse, and in addition it comes at a time when the private sector within the island is also investing in large scale housing and office projects. The Panel understands that to manage demand in Jersey the plan includes a strategy to bring off-island companies and resources in to build major projects. There are also opportunities for the construction industry to innovate with prefabrication that can help manage demand on-island and reduce construction times. The Panel welcomes the investment by Government in considering the capital programme across the broader public sector, but the scale of the expansion is clearly a significant risk within the Government Plan.

The Government Plan also commits to further consideration of the need for an Infrastructure Fund, with the intention that this could reduce the dependency on short-term public sector finances and drive efficiencies through collaboration with third-party investors. Funding is proposed to work towards the establishment of a Fund and set out how it could operate, ahead of a potential Assembly debate in 2020. It will be important to ensure that establishment of a Fund is compared to other options, e.g. government borrowing or use of reserves. The approach to choosing projects to be funded

will also be key, consideration should be given to including a role for independent assessment of projects. The Panel looks forward to receiving further information about this proposal as it develops.

3.3 The adjusted fiscal position

In previous Annual Reports, the Panel has sought to understand and clarify the aggregate impact of government finances on the economy. This involves making several adjustments to the operating surplus/deficit (total Consolidated Fund income less expenditure) excluding capital allocations:

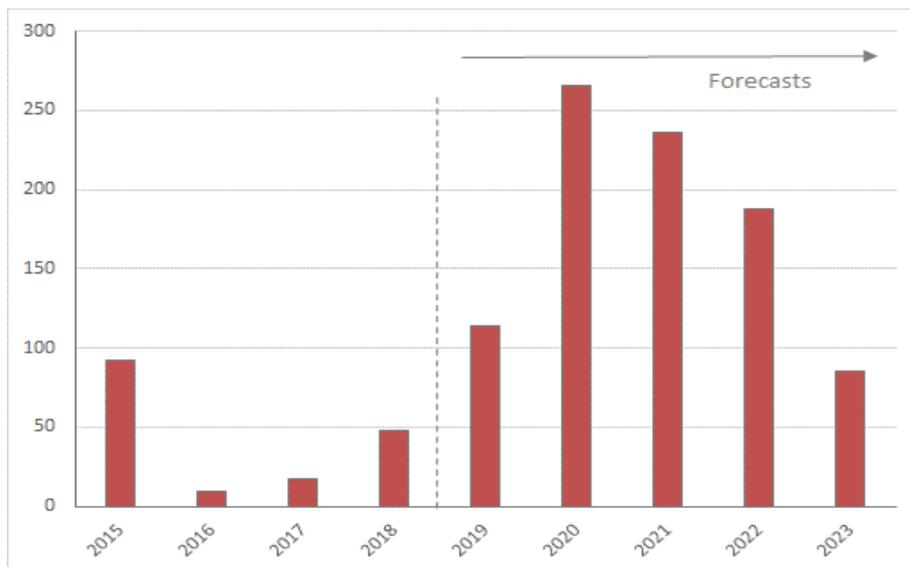
- **Add capital expenditure profile** to operating surplus/deficit (including that of trading operations and subsidiary companies such as Andium Homes, Ports of Jersey and Jersey Development Company - JDC)
- **Add flows into and out of additional funds** including trading funds, Social Security Fund, Health Insurance Fund, Long-Term Care Fund

Figure 2.7 sets out the results of this calculation over 2019-2023.

Figure 2.7
Estimates of adjusted fiscal position (spending relative to revenue)

£ million (current prices)
 including trading operations and subsidiaries: Andium, Ports of Jersey and JDC.

Source: Treasury and Exchequer



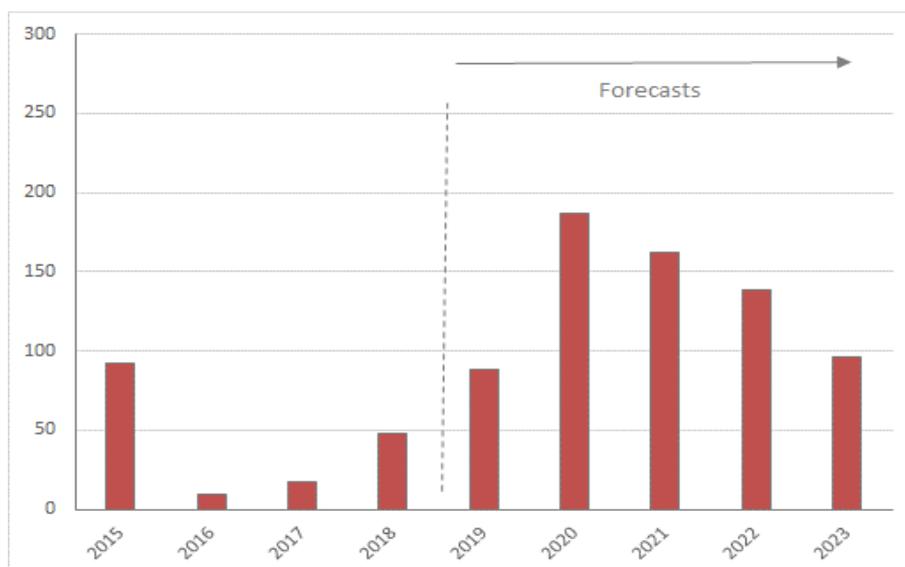
The Panel has also produced an illustrative example of how the adjusted fiscal position would look if only half the capital expenditure were achieved. This reflects the recent history of capital expenditure failing to be delivered on time (an issue not by any means unique to Jersey).

Figure 2.8

Estimates of adjusted fiscal position (spending relative to revenue) if only 50% of capital expenditure is delivered

£ million (current prices) including States trading funds and subsidiaries: Andium, Ports of Jersey and JDC.

Source: Treasury and Exchequer; Panel calculations



3.4 Flexibility

As outlined in section 1, output of the economy is now expected to be somewhat less above potential over the period of the 2020-23 Government Plan than was expected in March. The FPP will review its judgement on the output gap on request in response to significant new developments both locally and internationally. For example, the optimal stance of public finances may change considerably should Jersey suffer a major downturn from a disorderly 'no-deal' Brexit scenario as the Panel set out in the September 2019 economic assumptions letter⁴.

The Panel previously recommended that the Government of Jersey should retain the flexibility to respond to changes in the cyclical position. The draft Government Plan goes some way to facilitating this flexibility, with the Stabilisation Fund forecast to reach £138m by 2023. This would provide funding to support the economy in a downturn, by first allowing the automatic stabilisers to work, and second through discretionary fiscal support if necessary.

Figure 2.9 sets out the forecast balance on the Consolidated Fund over 2019-2023. This demonstrates that there is some flexibility in early years, over and above the balance on the Stabilisation Fund. However, the significant capital expenditure over the Government Plan means that the balance on the Consolidated Fund is forecast to be reduced to £25m by the end of 2023.

⁴ [Fiscal Policy Panel Update September 2019](#)

The Public Finances Law states that a Government Plan cannot forecast a negative closing balance on the Fund in any of the four years covered by a Plan. While a positive balance £25m is sufficient to meet the requirement of the Law, a small reduction to revenues of £7m per year (less than 1% of the revenue forecast) in each of the four years, or an added expenditure pressure, could result in an amendment needing to be made to the Government Plan to either:

1. Raise additional revenue.
2. Reduce expenditure.
3. Transfer from reserves or borrow.

Figure 2.9
Consolidated fund changes
 £ million (current prices)

Source: Treasury and Exchequer

	2019	2020	2021	2022	2023
Consolidated Fund opening balance	143	161	100	60	33
Forecast operating surplus/(deficit)	101	69	73	76	87
Capital programme funding	(33)	(91)	(92)	(87)	(79)
Proposed transfers to Stabilisation Fund	(50)	(36)	(16)	(16)	(16)
Consolidated Fund to Climate Emergency Fund		(5)			
Transfer from Loans Fund			6		
Allocation for Assisted Home Ownership Scheme			(10)		
Transfer from Criminal Offences Confiscation Fund		2			
Consolidated Fund closing balance	161	100	60	33	25

In the event that such an amendment is required in future, the appropriate approach would depend on the nature of any change to revenue and expenditure forecasts. If it were to represent a structural deterioration of Jersey's public finances, then it would be appropriate to act through either increasing revenues or reducing expenditure, or a combination of both. If it were a cyclical deterioration, it would not be optimal for Government to take a more contractionary fiscal stance as this could exacerbate the cyclical downturn.

Given the size of existing reserves, it should not be difficult to make a small adjustment in the event of a cyclical downturn, either by reducing/cancelling the transfers to the Stabilisation Fund or by transferring some of the existing balance on the Stabilisation Fund (£50m). If a more significant adjustment were needed, further transfers could also be made from the Strategic Reserve, as was proposed in the last MTFP.

In the case of a disorderly no-deal Brexit, along the lines of the scenario set out in the September 2019 economic assumptions letter, the impact is likely to be partly cyclical and partly structural.

In this eventuality, the Panel will provide further advice on request, based on the specific circumstances that unfold, but broadly the approach should be to provide support to the economy during the initial cyclical downturn but seek to tighten over the subsequent years in order to close any structural deficit and ensure the long-term sustainability of public finances. This would help to smooth the adverse impact of the economic adjustment.

If there is a significant change in the cyclical position, the Government of Jersey should seek to move relatively quickly to develop a suite of interventions appropriate to the specific situation. **The Panel recommends that some groundwork be done now, to identify what revenue and expenditure measures can be introduced in good time - or the extent to which significant capital projects can be amended to have more of a positive and timely impact on the local economy.**

3.5 Net asset position

The new Public Finances Law and the new fiscal framework both put considerable additional emphasis on the monitoring of the net asset position and the FPP now has a statutory duty to comment on the sustainability of public finances in light of the States' financial assets and liabilities.

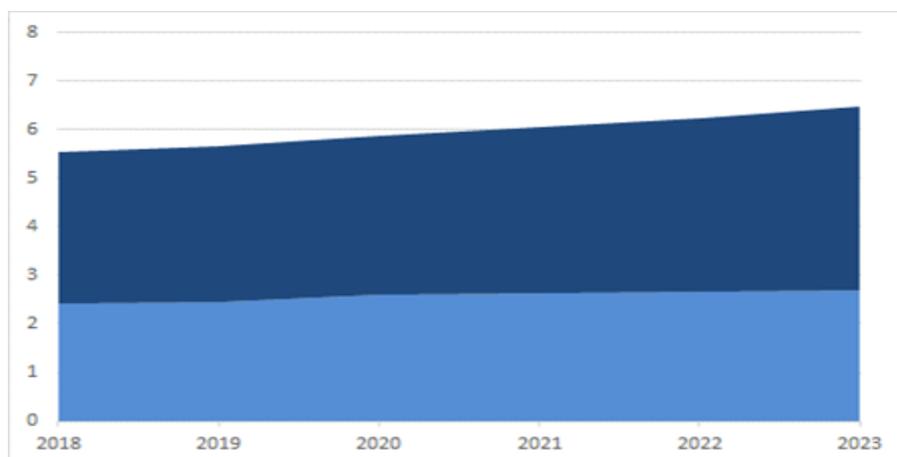
The Panel welcomes the additional information provided on the net asset position in the draft Government Plan, in particular the detailed forecasts of assets and liabilities. Figure 2.10 sets out the forecast for the net asset position over the 2020-23 Government Plan period. This excludes the net assets position of subsidiary companies (Andium Homes, Ports of Jersey and States of Jersey Development Company), and therefore differs from the asset position set out in the States of Jersey Annual Report and Accounts. Given the significant physical assets held by the subsidiaries, the Panel recommends that they should be included in improved balance sheet forecasts in future Government Plans.

Figure 2.10
Net asset position

£ billion (current prices)

Dark blue area is net financial assets, light blue area is physical assets, whole area is overall net asset position

Source: Treasury and Exchequer



Overall, the net asset position of Government remains strong throughout the Government plan period and is forecast to increase remain broadly stable relative to the size of the economy as a share of GVA. Although, as noted above, this measure excludes the large planned capital expenditure by subsidiary companies.

A large proportion of the net financial assets are held in 'special funds', with the largest of these being the Strategic Reserve and the combined Social Security funds. Figure 2.11 shows the closing balance of some of these main funds, and the Consolidated Fund, over 2019-23. While the Consolidated Fund balance falls over the course of the Government Plan, there is growth in all the other funds. The Social Security Reserve and Strategic Reserve grow due to investment returns on the significant balances already held in these funds, with returns of around 4½% per year forecast for the Strategic Reserve and around 5½% on the Social Security Reserve. These different assumptions for the rate of return for each fund reflect the different investment mandates each fund has been set. The Stabilisation Fund is boosted by transfers each year from the Consolidated Fund; and the Long-Term Care Fund grows each year as a result of the proposal to increase contribution rates from 1% to 2%.

Figure 2.11

Reserves

Size of selected funds

Source: Treasury and Exchequer

	2018 £m	2019 £m	2020 £m	2021 £m	2022 £m	2023 £m
Consolidated Fund	143	161	100	60	33	25
Strategic Reserve	807	848	887	927	970	1,014
Stabilisation Fund	-	50	87	103	121	138
Social Security Reserve Fund	1,716	1,821	1,923	2,029	2,143	2,263
Social Security Fund	85	96	101	100	103	114
Health Insurance Fund	94	98	107	117	126	135
Long Term Care Fund	25	28	44	63	80	94
Total	2,870	3,102	3,250	3,400	3,574	3,783
<i>Total as % of GVA</i>	<i>61</i>	<i>64</i>	<i>65</i>	<i>65</i>	<i>66</i>	<i>68</i>

The Panel's Advice for the Government Plan looked at some of these funds in detail and made recommendations around the Stabilisation Fund and Strategic Reserve in particular.

Stabilisation Fund

The Panel recommended that government should build up the Stabilisation Fund while the economy is above capacity. Further, the Panel stated that the contribution should include both the automatic stabilisers and a further transfer to reinforce the impact of those stabilisers.

Previous analysis by the Panel suggests that the automatic stabilisers in Jersey are around 0.16% of the output gap. Figure 2.12 sets out an estimate

of the output gap, based on the FPP's September economic forecasts and the appropriate size of the automatic stabilisers implied by these forecasts:

Figure 2.12
Estimate of automatic stabilisers and proposed transfers to Stabilisation Fund

Source: Panel calculations

	2020 £ m	2021 £ m	2022 £ m	2023 £ m
Output gap (%)	1.0	1.7	1.9	1.9
Output gap (£m)	52	88	102	107
Automatic stabilisers (£m)	8	14	16	17
Transfers proposed in draft Government Plan	36	16	16	16
Note: £20m of the £36m transfer in 2020 is from reserves, not from surpluses.				

The additional transfer of £20m in 2020 can be viewed as partly making up for missed contributions in 2017-2019. In addition to the amounts above, the automatic stabilisers in Jersey are relatively weak (see Box 1 of the Panel's 2018 Annual Report⁵) so there should be some further additions to the Stabilisation Fund to support the potential future use of active fiscal policy. This means that the contributions to the Fund in line with the automatic stabilisers in later years should be viewed as a lower bound.

It is harder to quantify the amount of active fiscal policy that may be needed but the Panel's previous analysis suggested around £300m of reserves were used following the global financial crisis. Therefore, the Panel recommends that **a transfer of up to £36m to the Stabilisation Fund in 2020 appears to be broadly appropriate. If a smaller structural surplus is warranted the additional transfer in 2020 could be lower but based on the latest forecasts for the output gap, the transfers over 2021-23 should be more significant if the Fund is to be ready to address a significant downturn. In the event of a no-deal Brexit it is likely that transfers to the Fund would have to be halted and possibly reversed.**

Strategic Reserve

In the March report, the Panel undertook analysis to determine what size the Strategic Reserve might need to be if it was required to meet its objective to insulate the economy from the sudden collapse of a major island industry. This analysis concluded that the current Strategic Reserve was not sufficient, at 17% of GVA, and that a range of 30%-60% of GVA may be required to fulfil this function.

⁵ [Jersey's Fiscal Policy Panel Annual Report October 2018](#)

While it is a political decision how far and how fast the Reserve should be built up, the Panel recommended that government should consider working towards a larger Strategic Reserve through a long-term programme of contributions and retaining the returns from investment. The Panel is pleased to see that the second half of this recommendation has been met, as the draft Government Plan does not propose any drawdown from the Strategic Reserve and therefore investment returns would be retained in the Reserve. However, no plan has been set out to contribute further to the Reserve over the 2020-23 period. The Government Plan states

“we will review the appropriate balance to be held in the Strategic Reserve, and when this has been completed, the Government can consider transfers to the Strategic Reserve in future plans.” (p. 173)

It is acknowledged that the draft Government Plan includes significant capital expenditure and increased spending in priority areas. However, if a plan is to be developed to build up the Reserve, this would appear to be most achievable now, when the economy is above trend. This will require running a structural surplus, in addition to the cyclical surplus needed to replenish the Stabilisation Fund.

Government should make clear its intentions regarding the Strategic Reserve and if the Panel's recommendation to grow the Reserve is accepted, a plan should be set out for how to achieve this - over what time period and what size of structural surplus this will require.

The 'structural balance' is defined in the fiscal framework summary set out in the Government Plan. A structural surplus will still enable counter-cyclical policy, for example in a downturn it may be desirable for the overall budget position to be a deficit, funded by reserves.

3.6 Panel's previous recommendations

The recommendations from the FPP's Advice for the Government Plan report are repeated in Appendix 1 of this report. A number of these have already been considered in this section, but progress against each is considered below:

- The recommendation to run surpluses over 2020-23 has been included in the draft Government Plan.
- The Panel recommended that consideration is given to implementing revenue-raising measure or expenditure cuts now, when the economy is above trend. The Government Plan includes some new revenue and targets for efficiency savings of £100m over the four-year period.

- The transfer to the Stabilisation Fund in 2020 is in line with the Panel's recommendation. However, the transfers in 2021 to 2023 do not appear to be sufficient to meet the recommendation - based on the current economic forecasts.
- The recommendation to grow the Strategic Reserve has been partially met. The Government Plan proposes to retain the investment returns in the Reserve but does not set out a programme of additional contributions.
- The proposed increase in the long-term care contribution is in line with recommendation 7 of the Panel's Advice for the Government Plan.
- Recommendation 8 has not been met - to set out how the proposed capital programme can be delivered in a way that does not put excess pressure on the limited resources available on-island.

Three of the recommendations from the report were more long-term in nature and it is not yet possible to judge the extent to which they have been implemented. The Panel will continue to monitor these:

- The Government should assess potential uses of the Stabilisation Fund according to the 'three Ts' - that active fiscal policies should be timely, targeted and temporary.
- Any policy decisions related to the Social Security Funds should consider a range of different scenarios and the impact these may have on the ability to pay deferred pensions.
- It is important that the forthcoming Economic Framework focuses policy on measures that will enable improvements in private sector productivity. These should be aimed at addressing the five key drivers of productivity growth: investment, infrastructure, innovation and enterprise, skills and competition.

3.7 Risks to achieving current plans

The greatest risks to the Government Plan in the near term are driven by economic prospects. Notably the outcome of Brexit negotiations where the outcomes and hence consequences are very broad in their impact. Under a 'no-deal' outcome with a worst case set of assumptions it is highly likely that the economy would face a deep and prolonged recession. The challenge to the public finances would be both cyclical with a recession and structural in that revenues could be permanently lower than anticipated in the Government Plan. With or without Brexit, the UK and global economies are slowing. As economic growth in Jersey is likely to be weaker than the FPP's March forecast, this will make it more challenging to maintain a surplus to replenish the Stabilisation Fund and build up the Strategic Reserve.

Given this significant uncertainty, the Panel would continue to urge that flexibility should be built into any plans. Whilst the overall fiscal stance set out in the draft Government Plan (that of continued small surpluses) seems broadly appropriate, fiscal policy should be ready to adapt to changing conditions.

The Government Plan and its fiscal sustainability is underpinned by large and uncertain efficiency gains in government expenditure and also revenue. If these gains prove harder to realise or take longer to implement this would put pressure on the public finances, but also present a risk in displacing the funding for government priorities. With a weaker economic outlook, it would, all else equal, be appropriate to run smaller surpluses than those in the Plan. However, it will be important to distinguish between any cyclical adjustment to spending priorities as compared with simply making smaller efficiency gains. Efficiencies should always be pursued as a structural improvement to public finances.

It is likely that efficiency gains will become increasingly more difficult to secure and it will require a strong political commitment to ensure they are delivered. If these gains are not delivered this would present a structural deterioration in the budget balance that might need to be addressed by revenue or expenditure measures.

The Government Plan includes an ambitious programme of investment with a sustained high level of capital expenditure throughout 2020-23. However, past experience demonstrates that it has been very difficult to deliver large capital programmes as intended. The improved approach to capital allocation is welcome, but there is a risk that it will not by itself deliver the significant improvement in delivery that is required in the Government Plan.

The size of the planned capital expenditure programme, including funding already allocated but unspent, is large relative to the capacity of the domestic construction industry on-island. This presents a risk that either there will not be sufficient capacity to deliver the capital expenditure or that public investment could crowd out private demand. More broadly the balance of demand will influence the cost of capital expenditure with a risk that the planned budgets for projects overrun. This is a significant risk with capital and infrastructure projects generally but it is heightened in the current conjuncture for Jersey.

The no-deal Brexit scenario presented by the Panel does not include any significant shock to the financial services industry with the recession driven by the supply-side shock of a sterling depreciation and markedly higher inflation. This reflects the fact that Jersey financial services remain a '3rd-country' for the EU with or without Brexit, but the position of UK financial services would

change markedly with Brexit. This means there may be a risk with this change in status for the UK even with an orderly Brexit e.g. increased competition for some financial services, or perhaps an unanticipated disruption in financial services more broadly.

3.8 Longer-term challenges

The key longer-term challenges remain as set out in previous reports i.e. financial services, productivity and the ageing society.

Financial services

The risks to financial services were set out in detail in the advice from the Panel for Government Plan 2020-23 published in March. Since then the likelihood of a 'no-deal' or a more disorderly Brexit has risen, and the prospects of a higher interest rates has receded. A disorderly Brexit with a UK recession and any downturn in UK financial services would impact on Jersey financial services. While it is very difficult to identify and evaluate the impact of specific risks any impact would most likely be manifest in weaker productivity growth. This presents a risk to the assumption of modest productivity growth in financial services supported by automation and process improvement.

Productivity

The Jersey economy is challenged by low productivity growth in both the finance and non-finance sectors. Productivity growth is generally pro-cyclical, falling in downturns and rising in booms. In the event of a downturn with domestic demand, output and employment falling firms in the non-finance sector will come under pressure. It will be important that any cyclical intervention in the short term does not undermine any structural adjustment required and the prospects for productivity growth in the long term.

As set out previously it is important that the forthcoming Economic Framework focuses policy on measures that will enable improvements in private sector productivity. These should be aimed at addressing the five key drivers of productivity growth: investment, infrastructure, innovation and enterprise, skills and competition. While there may be some costs in the short term of implementing these policies, they have the potential to improve future government revenue and therefore to improve the sustainability of public finances in the long term. **The Panel looks forward to the development of the Economic Framework and recommends that funding should be made available in future Government Plans to support initiatives with genuine potential to raise private sector productivity.**

Ageing society

As stressed in previous reports the demographic changes presented by an ageing society entail both an economic and a fiscal challenge. The implications of such changes have always been relatively clear, but the economic and financial crisis from 2008 consumed much of the fiscal headroom that many countries had available to meet them.

Jersey has been prudent in budgeting for these challenges with the Social Security Fund and the Long-Term Care Fund. Both funds sit alongside the Strategic Reserve providing Jersey with a very strong balance sheet in terms of net financial assets. The Panel has already explored the appropriate size of the Strategic Reserve, given its mandate, in the March 2019 report.

In light of the new Public Finances Law, the Fiscal Framework and the long-term sustainability of the public finances it will be important for the Panel to consider the sustainability of the Social Security Reserve Fund and its contribution to public sector net worth. This will entail consideration of the liabilities the fund is mandated to meet alongside its financial assets and the net impact on fiscal sustainability in the longer term.

Appendix: Recommendations from FPP Advice for Government Plan

1. The Government of Jersey should plan to run surpluses over the 2020-2023 period - though retaining the flexibility to respond to changes in the cyclical position.
2. The Government should consider implementing revenue-raising measures or expenditure cuts now, when the economy is above trend, to increase the ability of the public finances to support the economy in a future period of below trend output.
3. In any year, the contributions to or withdrawals from the Stabilisation Fund should mirror that part of the current Budget position driven by the economic cycle and the automatic fiscal stabilisers. The Panel's forecast implies that the economy will be running around 2% above capacity next year, meaning that the addition to the Stabilisation Fund should include 0.32% of GVA in 2020 (about £16m). A further transfer is also needed to replenish the past use of the Fund for active fiscal policy through the last downturn, and ensure that the Fund is ready to provide additional fiscal support in the event of any future downturn.
4. The Government should assess potential uses of the Stabilisation Fund according to the 'three Ts' - i.e. that active fiscal policies should be timely, targeted and temporary. Should it be required over the next medium-term planning period, the Panel would advise that any active counter-cyclical support to the economy (using the Stabilisation Fund or elsewhere) should be assessed against these three criteria.
5. The Government should consider working towards a larger Strategic Reserve through a long-term programme of contributions and retaining the returns from investment, given that its objectives include insulating the economy from the sudden collapse of a major island industry.
6. The Government should ensure that any policy decisions related to the Social Security Funds consider a range of different scenarios and the impact these may have on the ability to pay deferred pensions.
7. The FPP's view is that the early part of the forthcoming Government Plan period is an appropriate time to plan an increase in the long-term care contribution, while the economy is running above trend. Consideration should also be given to whether a larger increase could be appropriate in order to provide additional flexibility regarding future increases in the rate.
8. The Government Plan will need to consider and set out how the proposed capital programme can be delivered in a way that does not put excess pressure on the limited resources available on-island.
9. It is important that the forthcoming Economic Framework focuses policy on measures that will enable improvements in private sector productivity. These should be aimed at addressing the five key drivers of productivity growth: investment, infrastructure, innovation and enterprise, skills and competition.