# Jersey's Fiscal Policy Panel Annual Report

July 2014

## Introduction

This is the seventh annual report of the Fiscal Policy Panel (FPP). The current members of the Panel were appointed in April 2014 and are Joly Dixon CMG (Chairman), Christopher Allsopp CBE, Tera Allas and Dame Kate Barker. The Panel and its reporting structure were placed on a statutory basis in 2014 and as now required by the public finance law this report makes recommendations to the Minister for Treasury and Resources and the States on Jersey's fiscal policy with reference to:

(a) the strength of the economy in Jersey;

(b) the outlook for the Jersey and world economies and financial markets;

(c) the economic cycle in Jersey;

(d) the medium and long-term sustainability of the States' finances

(e) transfers to/from, the Strategic Reserve and Stabilisation Fund.

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

1. Economic stability is at the heart of sustainable prosperity;
2. Fiscal policy needs to be focused on the medium-term;
3. Policy should aim to be predictable, with flexibility to adapt to economic conditions to assist in creating a more stable economic environment;
4. Supply in the economy is as important as demand; and
5. Low inflation is fundamental to the competitiveness of the economy.

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

Since it was formed in October 2007, the Panel has visited the Island on many occasions. Its work has benefited greatly from the discussions it has had with many people and institutions on and off the Island: its job would be much more

difficult without their generosity. The Panel is also grateful for the invaluable support provided by the staff of the States of Jersey, in particular the States of Jersey Economics Unit and Treasury and Resources Department.

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

# Key points

## International economic outlook

- Global growth in 2013 was largely in line with 2012, with both emerging economies and advanced economies maintaining 2012 growth rates over the year as a whole.

- The advanced economies accelerated in the second half of 2013, with the UK and US economies strengthening and the euro area emerging from recession. However, most advanced economies remain below capacity, due to low rates of growth in the years following the global financial crisis.

- Inflation is relatively low in the advanced economies and is expected to remain so for some time. There are increasing risks of deflation, particularly in the euro area.

- Growth remains relatively slow in a number of the emerging economies when compared to the recent past, but this is expected to pick up pace. However, policy challenges remain.

- Policy interest rates in the advanced economies remain at record lows but rate rises are anticipated in both the UK and US over the next twelve months. However, policy rates are expected to remain relatively low into the medium term.

- There is a risk that the need to bring interest rates closer to a 'neutral' level will lead to some financial market volatility which could disrupt the recovery. There are also risks relating to ongoing political tensions in the Middle East and Eastern Europe.

## Jersey economic outlook

- No new economic growth (GVA) or employment data have been published since the last Annual Report in November 2013.

- The Survey of Financial Institutions showed profits fell by 6.5% in real terms in 2013, while employment costs saw a small increase. The Business Tendency Survey indicates that business activity has increased significantly for the finance sector and the majority of firms anticipate some increase in profits in 2014.

- Recent surveys suggest improving sentiment in the non-finance sectors, particularly with respect to future conditions. However, trading conditions remain challenging in a number of sectors.

- Survey data and the numbers of those actively seeking work are beginning to suggest that spare capacity in the labour market is falling but evidence indicates that significant spare capacity remains overall.

- The Panel has revised its forecast for 2013 and 2014 GVA downwards slightly. Some improvement is forecast for 2015.

- Some spare capacity is expected to remain at the aggregate level in the economy in both 2014 and 2015, suggesting that fiscal policy should continue to support the economy in both years. However, the structure of fiscal policy needs to remain alert to potential inflationary pressures in specific sectors or sub-sectors.

## Public finances

- The States has made good progress on many of our past recommendations, including those regarding managing capital expenditure, defining the purpose and rules of the Strategic Reserve, and including more useful information in the Budget.

- Draft Budget 2015 shows that States' income is now expected to grow less quickly in 2014 and 2015, compared to the forecast included in the Medium Term Financial Plan. In response to this, there are proposed measures of £43m in 2014 and £33m in 2015 to fund the expected shortfall in States' revenue. The majority of these measures do not impact on economic activity in 2014 or 2015 which is appropriate given economic conditions.

- The draft Budget 2015 proposals do not have a significant impact on the structural position of the States' finances. This is appropriate in light of the lower revenue forecasts, proposed fiscal stance and expected economic conditions for the next few years. The proposed cap on mortgage interest relief is potentially a significant and welcome development.

- The Treasury expects capital expenditure to be around £70m in 2014, £190m in 2015 and peak at around £230m in 2016 before gradually falling to around £100m by 2020. The amounts of capital expenditure planned in 2015 and 2016 are much higher than previously experienced in Jersey.

- Such a significant increase in capital expenditure in such a short time could put pressure on the capacity of the local construction industry and any specific bottlenecks within it. The Panel is encouraged that work is already underway within the States to assess public and private sector construction workflow and how this relates to construction industry capacity going forward.

- The small deficit of £31m in 2013 represents a loosening of fiscal policy which added further stimulus to Jersey's economy. However, our advice was to loosen fiscal policy to a greater extent last year by running a larger deficit, which would have added additional stimulus to Jersey's economy.

- Over the next few years, the States will need to make a transition from running significant deficits to support a recovering economy in 2014 and 2015, to withdrawing stimulus and returning to a balanced budget once the economy returns to more normal levels of activity in the years ahead.

- Delivering about £100m of fiscal stimulus is appropriate for 2014, given that economic growth is still expected to be weak and that there are no strong signs of capacity issues or inflationary pressures.

- Fiscal policy should be accommodating in 2015 as well because there is still likely to be aggregate spare capacity in the economy next year. The States plans to run a significant deficit of £190m for 2015.

- Nevertheless, forecast deficits for 2014 and particularly 2015 are at the top end of what is appropriate for these years.

- Determining what the appropriate fiscal balance should be from 2016 onwards is difficult because of the uncertainties around future economic growth, spare capacity in the economy, and whether or not there is a structural deficit in the public finances.

- There is a risk of an underlying structural shortfall between States' income and expenditure which would need to be addressed once the economy has recovered and over the course of the next Medium Term Financial Plan (MTFP). This is indicated by:

- The possibility of lost capacity and lower potential growth due to a structural change in the economy following the global financial crisis.
- The Stabilisation Fund has been exhausted and there are no clear plans to rebuild it.
- The current plans set out to balance budgets with no plans to run a surplus.
- The medium-term outlook, while uncertain, suggests that there are significant challenges in even maintaining a balanced budget.

- The property tax review is welcome because it could help the States to improve the efficiency of the current tax system. It could also help the States to find revenue raising measures in the event there is a structural deficit in public finances.
- Using the Strategic Reserve to pay for the hospital over the next ten years is expected to reduce the value of the Strategic Reserve as a proportion of GVA from about 20% of GVA in 2014 to about 15% of GVA by 2024.
- It is hard to say what the optimum size for the Strategic Reserve should be. However, 15% of GVA is not a very large buffer, given the likely large impact of any events that might warrant the use of the Strategic Reserve.
- To improve how we look at Jersey's long-term fiscal sustainability in the future, it will be important to look more closely at:

  1. The fiscal impact of past public sector activity - for example, the assets and liabilities on the States' balance sheet and how they change over time; and
  2. The potential impact of future public sector activity - projections for States' income and expenditure, and assets and liabilities over the long-term.

  We intend to cover these issues in more detail in our next report in advance of the next MTFP.

- The 2013 States' Accounts saw the five Social Security Funds consolidated into the States Accounts for the first time. The Panel welcome this development and the continued monitoring of the implications of trends in the Social Security Funds for the States' overall fiscal position.

- The Panel agrees with the £1m transfer out of the Stabilisation Fund, if it is required. If there was more money in the Stabilisation Fund, it would have been appropriate to transfer more out to fund the forecast shortfall in income.

## Recommendations

1. The focus in 2014 and 2015 should be on supporting the economy (by running deficits) while there is still spare capacity.

2. This focus should not be deflected in light of lower tax receipts (outturns or forecasts) especially where this is a result of a weaker than expected economic performance. The Panel supports the Budget's proposed approach to mainly use savings and reserves to fund the potential shortfall in income because it limits the negative impact on the economy in the short-term.

3. If there is a structural deficit in the public finances, the States should plan to address it once the economy has recovered. Structural changes in taxation, or expenditure programmes are easier to introduce once the economic recovery is fully established. This will be an important consideration for the next MTFP.

4. The States should bear in mind the following principles when forming the next MTFP:

    - Aim to balance the budget over the economic cycle - i.e. surpluses and deficits which broadly balance out over more than one MTFP period.

    - Adopt prudent assumptions for income and realistic assumptions for expenditure.

    - Include flexibility within a clear framework for expenditure.

5. It is very important that the States makes plans about how to deal with the expected improvement in economic conditions and reduction in spare capacity from 2016 onwards. It is even more important to consider how fiscal policy would need to change if growth turns out to be higher than expected, or if capacity constraints started to be felt. In either case, this

would mean running tighter fiscal policy and topping up the Stabilisation Fund. The plans could include:

- Reducing departmental expenditure and/or raising revenue to run surpluses (or at least smaller deficits).
- Managing how capital projects are delivered so as to put less strain on local capacity.
- Continuing with policies which will improve Jersey's economic potential, such as those which aim to increase productivity, innovation and reduce structural unemployment.

6. The Treasury should look at how budgeting for capital projects and the use of capital allocations can be improved because the current system may make it harder to adjust capital expenditure and therefore fiscal policy. During our fact finding visit, the Treasury confirmed that work is already underway and it will be important that this is finalised in time to influence the next Medium Term Financial Plan.

7. The delay to introducing the long term care charge was appropriate, but there is no need for further delays given the planned fiscal stance in 2015 and 2016.

8. The States should monitor the value of the Strategic Reserve relative to the size of Jersey's economy and States' expenditure. The States should give an indication of the desired size of the Strategic Reserve.

9. The States should produce projections for future States' income and expenditure for the next 20 years, adopting an approach similar to that used by the UK's Office for Budget Responsibility. This will complement the balance sheet information the States already publishes in its annual accounts.

10. The States should continue to monitor the outlook for the Social Security Funds through the planned three-yearly actuarial reviews and include the uncertainties and projections in its medium-term fiscal plans and long-term assessments of sustainability.

# Section 1 - The Economic Outlook

## Key points

## International economic outlook

- Global growth in 2013 was largely in line with 2012, with both emerging economies and advanced economies maintaining 2012 growth rates over the year as a whole.
- The advanced economies accelerated in the second half of 2013, with the UK and US economies strengthening and the euro area emerging from recession. However, most advanced economies remain below capacity, due to low rates of growth in the years following the global financial crisis.
- Inflation is low in the advanced economies and is expected to remain so for some time. There are increasing risks of deflation, particularly in the euro area.
- Growth remains relatively slow in a number of the emerging economies when compared to the recent past, but this is expected to pick up pace. However, policy challenges remain.
- Policy interest rates in the advanced economies remain at record lows but rate rises are anticipated in both the UK and US over the next twelve months. However, policy rates are expected to remain relatively low into the medium term.
- There is a risk that the need to bring interest rates closer to a 'neutral' level will lead to some financial market volatility which could disrupt the recovery. There are also risks relating to ongoing political tensions in the Middle East and Eastern Europe.

## Jersey economic outlook

- No new gross value added (GVA) or employment data have been published since the last Annual Report in November 2013.
- The Survey of Financial Institutions showed profits fell by 6.5% in real terms in 2013, while employment costs saw a small increase. The Business Tendency Survey indicates that business activity has

increased significantly for the finance sector and the majority of firms anticipate some increase in profits in 2014.

- Recent surveys suggest improving sentiment in the non-finance sectors, particularly with respect to future conditions. However, trading conditions remain challenging in a number of sectors.

- Survey data and the numbers of those actively seeking work are beginning to suggest that spare capacity in the labour market is falling but evidence indicates that significant spare capacity remains overall.

- The Panel has revised its forecast for 2013 and 2014 GVA downwards slightly. Some improvement is forecast for 2015.

- Some spare capacity is expected to remain at the aggregate level in the economy in both 2014 and 2015, suggesting that fiscal policy should continue to support the economy in both years. However, the structure of fiscal policy needs to remain alert to potential inflationary pressures in specific sectors or sub-sectors.

## 1.1 International outlook

The World Bank estimates that the global economy grew by 2.4% in 2013, largely in line with growth in 2012. Developing economies maintained growth of 4.8% while high income countries slowed slightly to 1.3%.

However, a number of the advanced economies began to accelerate in the second half of 2013, particularly the US and UK. The euro area as a whole emerged from recession in 2013 - after six successive quarters of decline – although there is continuing weakness in some of the periphery countries and also in core countries, particularly France and the Netherlands. The beginning of 2014 has seen a relative slow-down in some of the advanced economies, due to severe weather in the US and due to political tensions in Eastern Europe, but this is expected to be temporary, with reacceleration expected in the remainder of 2014.

In spite of the upturn in growth in late 2013, the advanced economies remain below their potential level of output as they have not yet recovered from the low rates of growth in the years following the global financial crisis. The IMF's most recent (April 2014) estimates of the "output gap" (i.e. the extent to which GDP differs from the estimate of potential GDP) suggest that almost all the advanced economies remain below their potential level and are expected to remain so in 2014 and 2015. Unemployment in most advanced economies remains at levels which indicate there is spare capacity in labour markets.

There have also been divergences in the growth path of the emerging economies. For example, the World Bank expects China to grow by 7.6% in 2014 (albeit this has been downgraded from earlier forecasts) and are expecting only 1.5% for Brazil. Emerging economies should benefit from improvement in the advanced economies but they continue to face significant policy challenges – not least in China where policy-makers are challenged with maintaining growth while managing risks which have built up in the country's financial system.

Looking forward, the World Bank forecasts global growth to increase to 2.8% this year, primarily due to stronger growth in the advanced economies. A further acceleration is forecast, to 3.4% in 2015 and 3.5% in 2016, as the advanced economies continue to improve and the developing economies pick up closer to their previous pace.

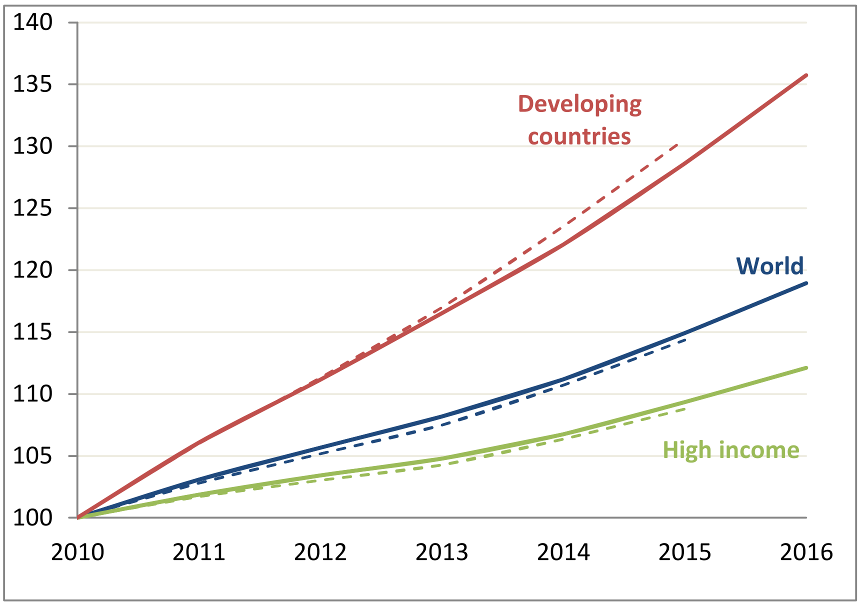
There are a number of risks to the global economy. Deflation has emerged as a key risk, particularly in the euro area, while the need for fiscal consolidation continues to hamper prospects for growth in many countries. Further, the recovery remains vulnerable to shocks such as the potential for political unrest in Iraq to lead to a sharp increase in oil prices, which may derail the current momentum. In the medium term, there are risks involved in the inevitable normalisation/tightening of monetary policy and the impact this may have on global financial markets and on economies with high levels of public and/or private debt or negative current account balances.

**Figure 1.1**

**Global Growth**

Index (2010=100) of GDP, dashed lines are June 2013 estimates/forecasts

Source: World Bank Global Economic Prospects June 2014



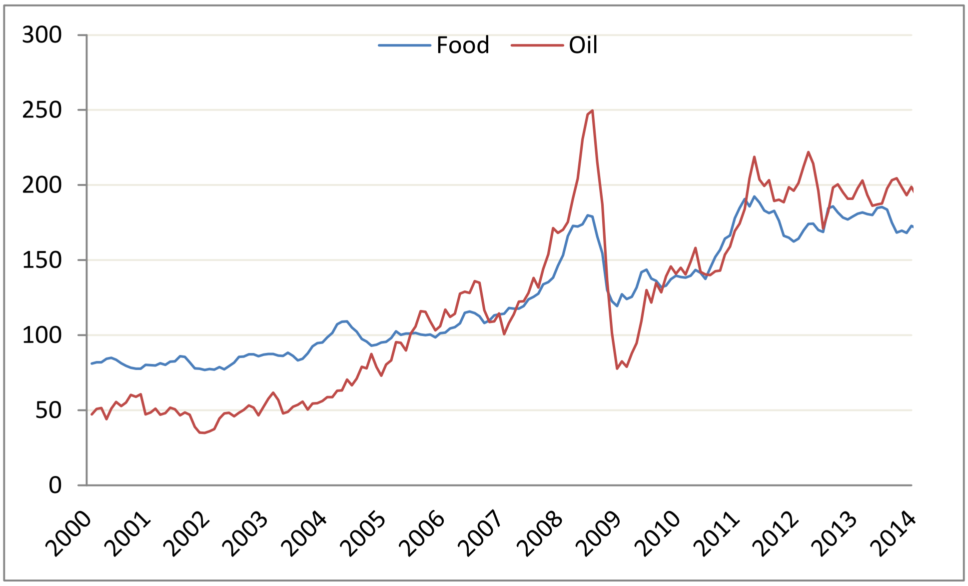

Commodity prices have been relatively subdued in recent years. At the time the Panel's last Annual Report was published, in November 2013, global food prices were at their lowest level for almost two years but have since grown to return to levels previously seen in early 2012. While food prices have been volatile from month to month, there has been no clear trend since 2011. Oil prices have remained largely range bound, with average prices in June showing only a 5% increase since November last year, despite recent political tensions. The IMF anticipates most commodity prices remaining relatively flat or declining over the next twelve months.

**Figure 1.2**

**Commodity Prices**

Nominal US dollar food and oil prices indices, 2005=100

Source: International Monetary Fund, index of primary commodity prices – June 2014




Official interest rates in the US and UK have remained at record lows while rates in the euro area were cut further in June this year. Inflation remains low in the advanced economies and is not expected to increase significantly for some time. The IMF has urged the European Central Bank (ECB) to commit to a programme of quantitative easing in order to combat the risk of deflation in the euro area.

A recent statement from Bank of England Governor Mark Carney led markets to expect that the UK Bank Rate will start to increase in the latter part of this year, though Bank Rate is expected to remain well below the pre-crisis levels in the medium term. A US rate increase is also expected, but this is not generally anticipated until mid-2015.

Overall, the global economy appears to be gaining some traction, though this remains uneven. Political tensions in both the Middle East and Eastern Europe could threaten the recovery and it remains to be seen whether the return of policy interest rates toward a (probably lower than pre-crisis) neutral level can be achieved without disrupting the current momentum.

## 1.2 Jersey economic outlook

Given the short time since the Panel's November 2013 Annual Report, the amount of new economic data is limited, with no new data for economic growth (GVA) or employment. Therefore, an updated assessment of the economy needs to draw heavily on data from the quarterly Business Tendency Survey, and on information gathered from meeting with key stakeholders.

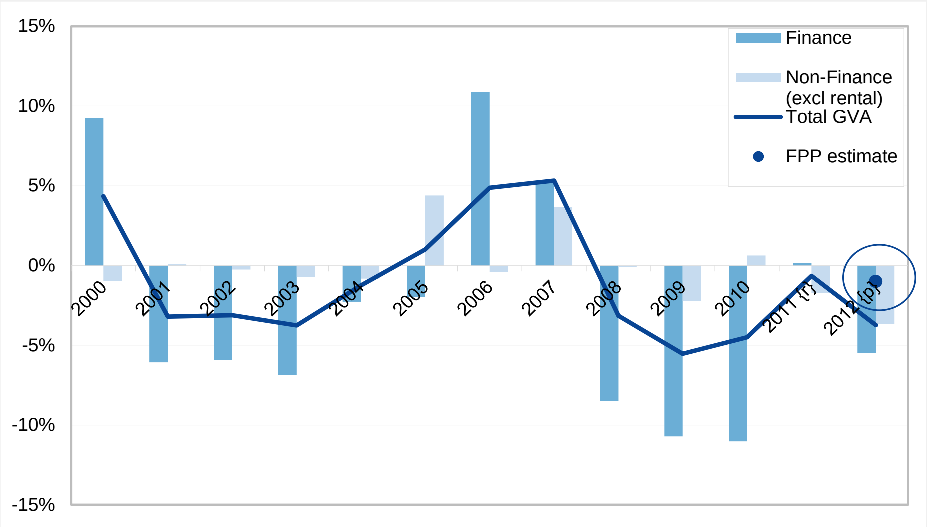
Gross Value Added (GVA) is the headline measure of economic activity in Jersey. The most recent estimate of GVA relates to 2012 and showed GVA to have fallen by 4% in real terms, slightly below the lower bound of the Panel's central forecast range (from October 2012) of -3% to +1%.

**Figure 1.3**

**A breakdown of Gross Value Added growth**

Annual % change

Source: States of Jersey Statistics Unit



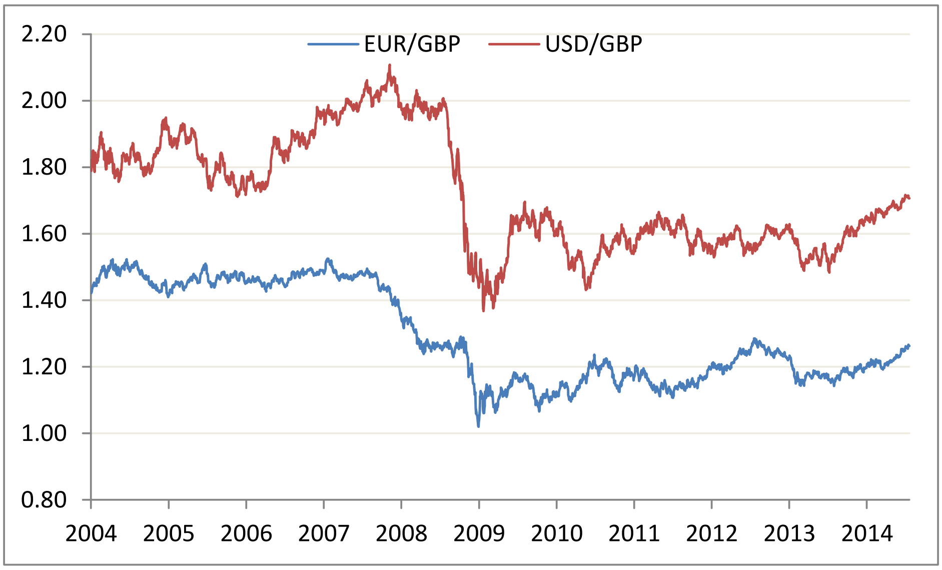

As a small, export-orientated economy, Jersey's economic performance relies on remaining globally competitive. While Jersey does not have a measure of unit labour cost competitiveness, there are other factors which will influence the competitiveness of goods and services in the global market. One example, particularly for non-finance firms who rely on export markets (or compete with imports), is the sterling exchange rate which will influence the cost of Jersey exports to non-sterling markets and the cost of exports to sterling markets relative to imports from elsewhere. A strengthening of the exchange rate can, for example, directly increase the cost of tourist visits to Jersey, relative to other non-sterling destinations; or increase the relative cost of agricultural produce. Sterling has strengthened since the Panel's November report - as at 21 July 2014, sterling had gained 6% against the euro and 6% against the US dollar. Market expectations for an interest rate rise in the UK have moved to an earlier date in recent months and have put further upward pressure on sterling. The exchange rate remains significantly lower than in the years before the financial crisis, against both the dollar and euro.

Figure 1.4

**Sterling exchange rates**

Euros per pound
US dollars per pound

Source: Bank of England data, as at 21 July 2014



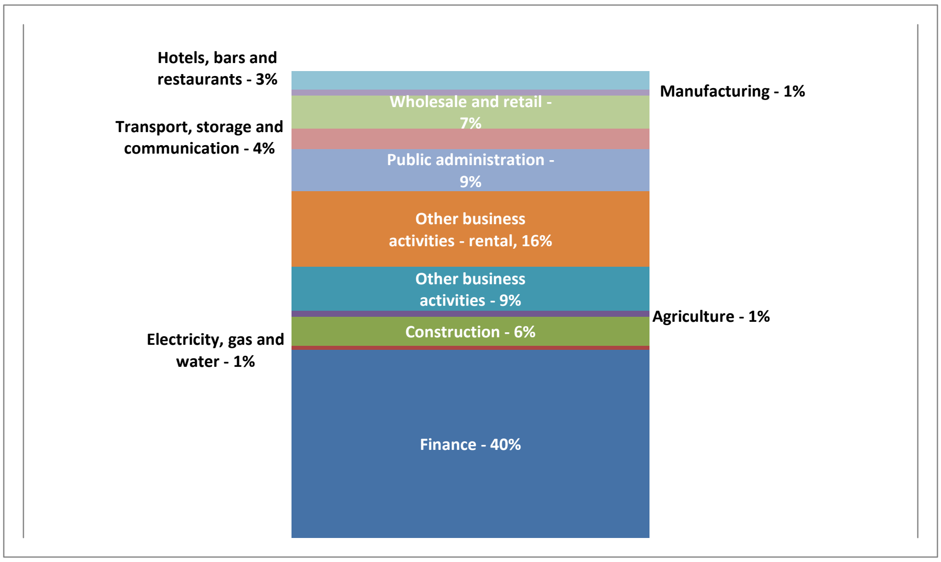

The following sections consider the performance and prospects of each of the main sectors of the economy, including a particular focus on financial services, retail, hospitality and construction. Figure 1.5 shows that these sectors combined represent almost 60% of Jersey GVA.

Figure 1.5

**Sectoral share of GVA**

% 2012 GVA, may not sum to 100% due to rounding

Source: Statistics Unit




### Financial Services Sector

The Survey of Financial Institutions (SFI) reported that net profit for the finance sector was flat in nominal terms in 2013, and largely unchanged since 2011. Net profit has been influenced in the last three years by large transfers of income from non-resident units to resident parent companies based in Jersey, but in nominal terms it remains more than 20% lower than the 2008 level. The banking sector (which accounts for four fifths of finance sector profits) saw a small fall in profits in 2013 while the fund management sector saw profits increase by more than a third.

Gross operating surplus is an alternative measure of profit which considers the economic activity of only the Jersey operations of businesses in the Island and as such is not influenced by the large transfers from non-resident units. This is the measure of profits used to calculate GVA. In 2013, gross operating surplus declined by 5% in nominal terms – equivalent to a decline of approximately 6.5% in real terms.

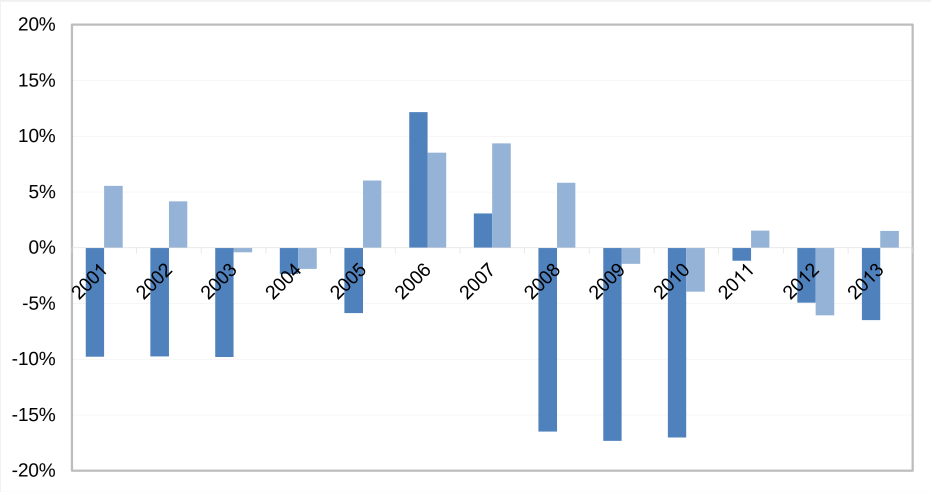
The SFI states that total expenditure on employment increased by 3% in 2013, returning to the level seen in 2011. In real terms this represents a small increase in 2013 but this is not big enough to offset the more significant real terms fall in 2012.

**Figure 1.6**

**Financial Services gross operating surplus and employment costs**

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

Source: Statistics Unit



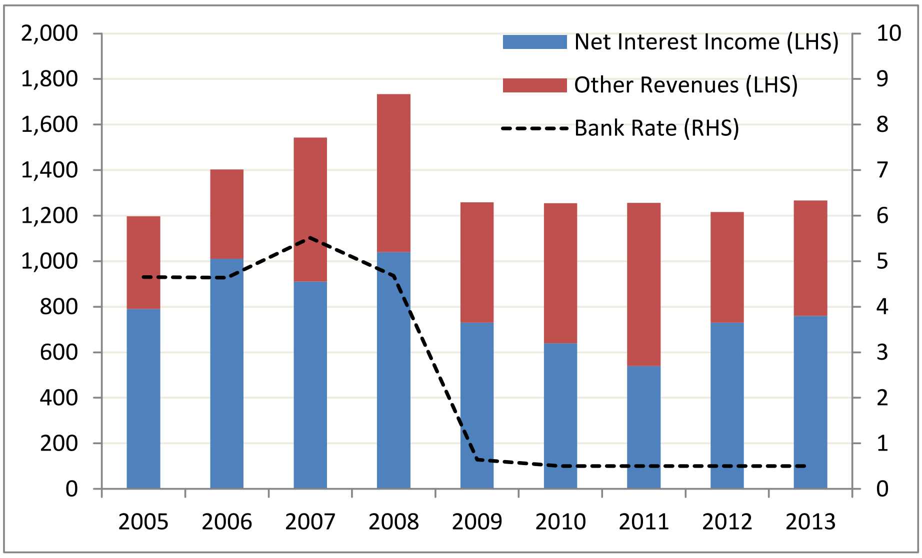

Net interest income, which makes up almost one third of finance sector revenues, has declined significantly since the peak in 2008 with a key factor being the low interest rate environment. Figure 1.7 shows that net interest income fell by almost 30% in 2009 and continued to fall to a little over half its peak by 2011, even after interest rates reached their record low of 0.5% in March 2009. The longer than expected period over which interest income fell may have been, at least partially, due to banks being cushioned from some of the adverse impacts in the short-term, e.g. due to fixed rate loans or hedging strategies. Some of the decline in net interest income has since been reversed, which may reflect banks changing their approach in response to competitive dynamics and liquidity requirements and adapting to the new low interest rate environment.

**Figure 1.7**

**Banking Revenues**

Source of revenue (£m - left-hand scale) and annual average of Bank of England Official Bank rate (% - right-hand scale)

Source: States of Jersey Statistics Unit




Net interest income is a factor of both profit margins and the level of deposits. Data from Jersey Financial Services Commission (JFSC) show that the sterling value of deposits has declined by approximately 30% between 2008 and 2013. The first quarter of 2014 was largely unchanged from 2013 but caution should be used when drawing any conclusions from the quarter-to-quarter data as it has the potential to be quite volatile.

Figure 1.8 shows that net profit for the trust, company administration and legal sector have continued on a largely upward trend in recent years, whilst the 38% increase in fund management profits in 2013 did little to reverse the very large declines of the previous four years.

**Figure 1.8**

**Finance subsector performance**

net profit by sector (£m)

Source: Jersey Statistics Unit

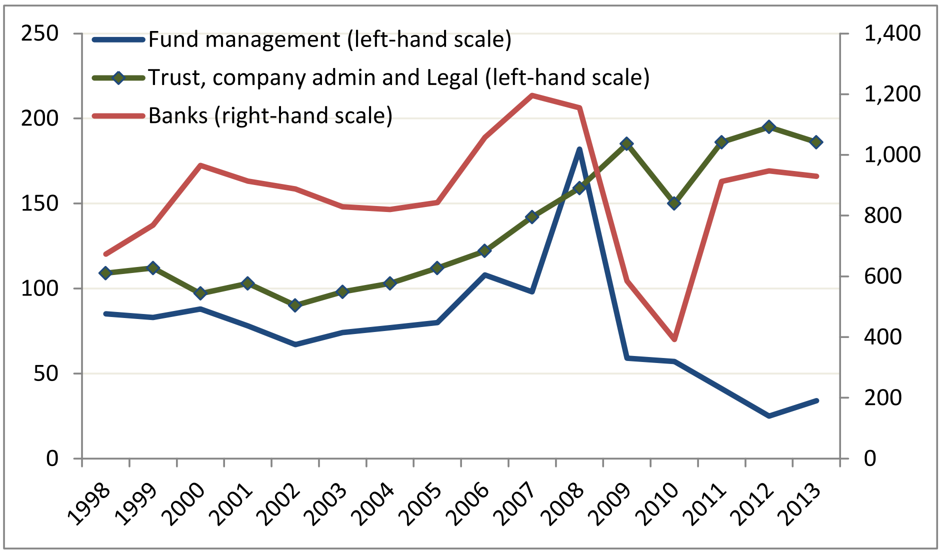


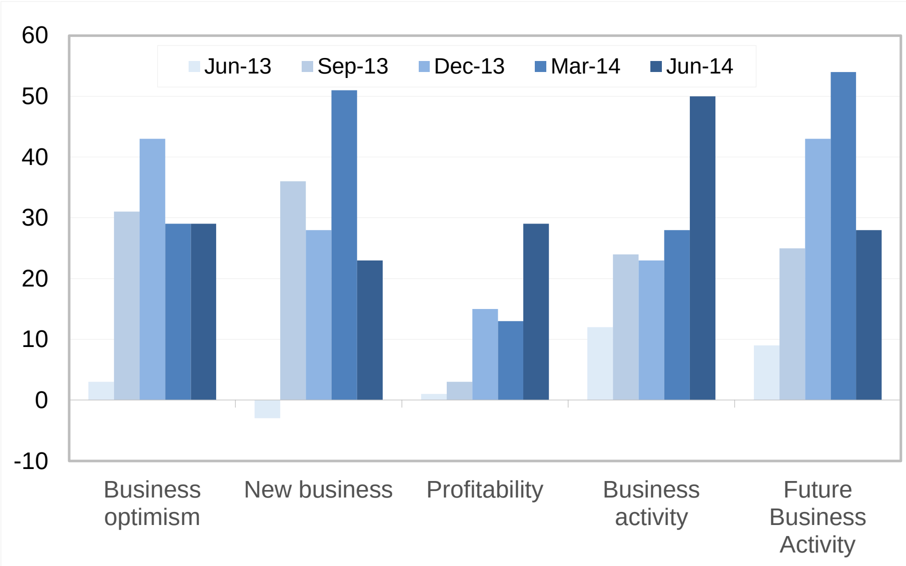
Figure 1.9 shows that the key indicators of the Business Tendency Survey have improved for the finance industry over the last twelve months. The headline business activity indicator is at its highest level since the survey began in 2009.

**Figure 1.9**

**Finance business tendency**

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

Source: Jersey Statistics Unit




Looking forward, more than two-thirds of finance companies (weighted by employment) anticipate an increase in profits in 2014, with the majority of these expecting a small (less than 5%) increase. Only 12% of finance firms expected profits to decline this year – the lowest proportion since the Business Tendency Survey began to collect these data, in 2010.

There are a number of potential threats and opportunities currently facing the finance sector. The Panel welcomes the Financial Services Industry Policy Framework which was published earlier this year. The framework document outlines a number of key objectives to enable further growth in the financial services sector. The framework focuses on four priorities – sustain the core; enhance enablers; capture adjacent growth opportunities; and reposition and build capabilities.

The prospect of an increase in the Bank of England's Bank Rate presents a further opportunity for growth in finance sector profits, particularly in the banking sector. The relationship between interest rates and profit margins was described in Box 1 of the 2009 Annual Report. The Panel met with representatives of the finance industry in June, who confirmed that increasing interest rates will improve profitability over time but there are several offsetting factors which suggest caution over the benefits of Bank Rate increases. As Figure 1.7 demonstrates, the fall in profits was more gradual than the reduction in interest rates which suggests that there may be some timing lag.

However, even in the medium term, net interest income looks unlikely to return to previous levels, due to changes in the global regulatory environment. Further, when the interest rate does rise it is expected to be more gradual and rates are not expected to reach their previous levels in the medium term.

Finance companies continue to rationalise globally and Jersey will see further reorganisation as firms focus more on business which is in line with their strategic fit. There is a drive to become more cost-effective and while this will improve efficiency, it will lead to further job reductions which may only be partially offset by increasing business from new opportunities, for example expanded business in the Middle East.

At the Panel's meetings with finance industry representatives, it was clear that the sector is constantly evolving and adapting to the changing environment. The banking sub-sector now has more certainty on the implications of the Independent Commission on Banking (Vickers) recommendations and this will require a change in the business models of some of the banks. Some uncertainty remains regarding the response of local regulators and of parent banks. A similar review has been carried out for The European Commission, by the High-level Expert Group on Bank Structural Reform (known as the Liikanen Report) which will also have implications for the finance industry in Jersey.

The trust company sector is also evolving as firms are re-focusing their efforts and regulation is constantly changing, both locally and internationally. The prospects for the trust sector are dependent on Jersey continuing to keep legislation up to date and competitive. The funds sector has been successful in winning new business and the most recent (March 2014) data from the JFSC suggest a total net asset value of £195bn is serviced by Funds in Jersey.

Overall, finance sector revenues and profitability were mixed in 2013, with many firms expecting a small increase in profits in 2014.

**The Rest of the Economy**

As stated above, there have been no new GVA data since the 2012 figures which showed that GVA for the non-finance sector (excluding the rental income of private households) declined by 4% in 2012.

The Business Tendency Survey (BTS) gives a more up to date picture of the sentiment within the non-finance sectors. Figure 1.10 demonstrates that a number of the key indicators for non-finance have improved over the twelve months to June 2014. Overall, nine of the ten indicators improved since the

June 2013 survey. Business activity has become marginally positive for the first time since at least September 2009, and future business activity has remained positive for the last four quarters.

**Figure 1.10**

**Non-Finance business tendency**

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

Source: Jersey Statistics Unit

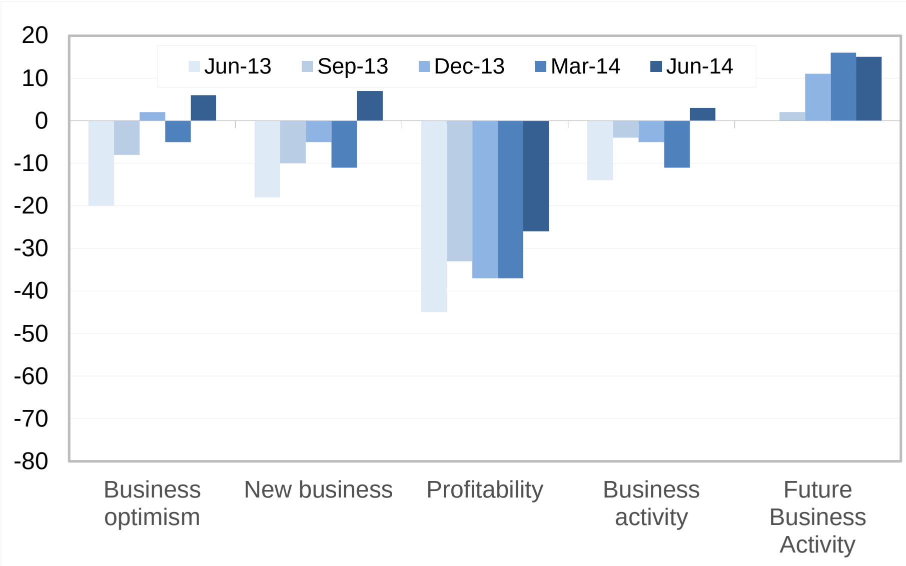



Figure 1.11 compares the responses to the BTS with the growth of non-finance sector GVA (excluding the rental income of private households). This demonstrates that the fall in GVA in 2012 was associated with more negative responses to the profitability and business activity indicators on the BTS. The BTS responses have improved over 2013 and 2014 but, as the survey has only been running since 2009, it is not yet possible to identify any clear correlation between non-finance GVA and the responses to the BTS.

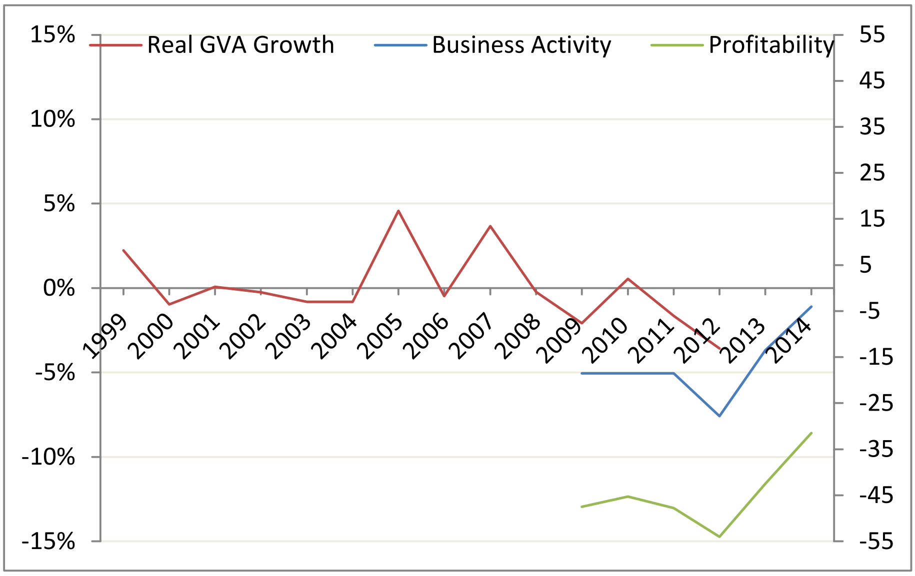
**Figure 1.11**

**Non-Finance GVA Growth**

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

Non-finance responses to business activity and profitability questions averaged over each year (right-hand scale)

Source: Jersey Statistics Unit



**Retail** sales volumes remained flat over the first quarter of 2014, on a seasonally adjusted basis, following a 1% fall in 2013. Both the predominantly food sector and the predominantly non-food sectors are at largely the same volumes as in the first quarter of 2012. Footfall in St Helier (measured by a counter in King Street) was relatively flat in 2013, compared to 2012. The first six months of 2014 have seen footfall up by less than 1% on the similar period in 2013.

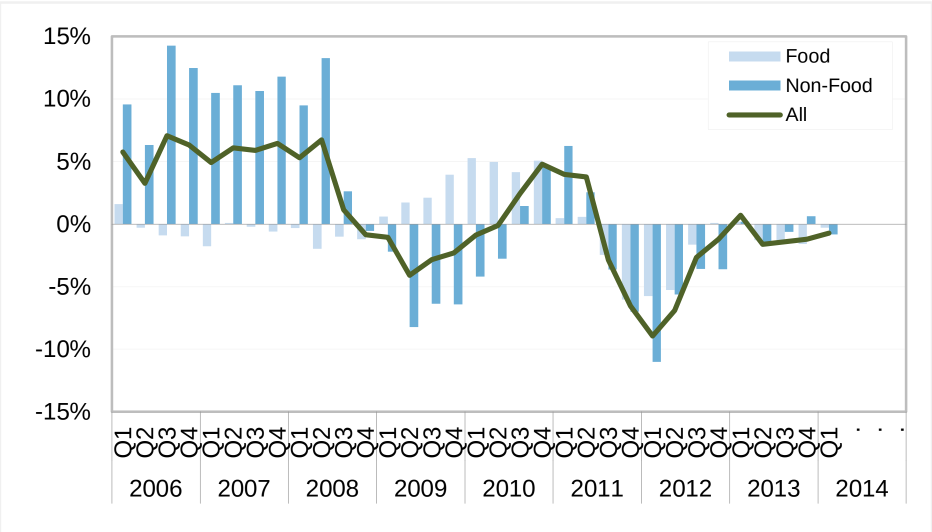
The business activity indicator of the Business Tendency Survey turned positive for the wholesale and retail sector for the first time in 2013. The profitability indicator has also improved since 2012 but remains strongly negative. When the Panel met with representatives of the retail sector in June, indications were that the sector remained largely flat with significant continuing pressures on prices and volumes. Retailers are keen to explore ways in which they can improve competitiveness relative to online retailers, for example by developing their own online offering or through supporting increased events and festivals in the core retail area.

**Figure 1.12**

**Retail sales performance**

Seasonally adjusted annual change in volume, %

Source: States of Jersey Statistics Unit




For the **hospitality** sector, 2013 saw a 2.2% decline in the number of staying leisure visitors but this was partially offset by a 2.6% increase in business visitors. The first five months of 2014 have seen a further slight fall in staying leisure visitors, compared to the same period in 2013 but it is too early to draw any conclusions, given that the majority of leisure visits are recorded during the summer season. Room occupancy rates remained at 60% in 2013, largely in line with the average since 2009.

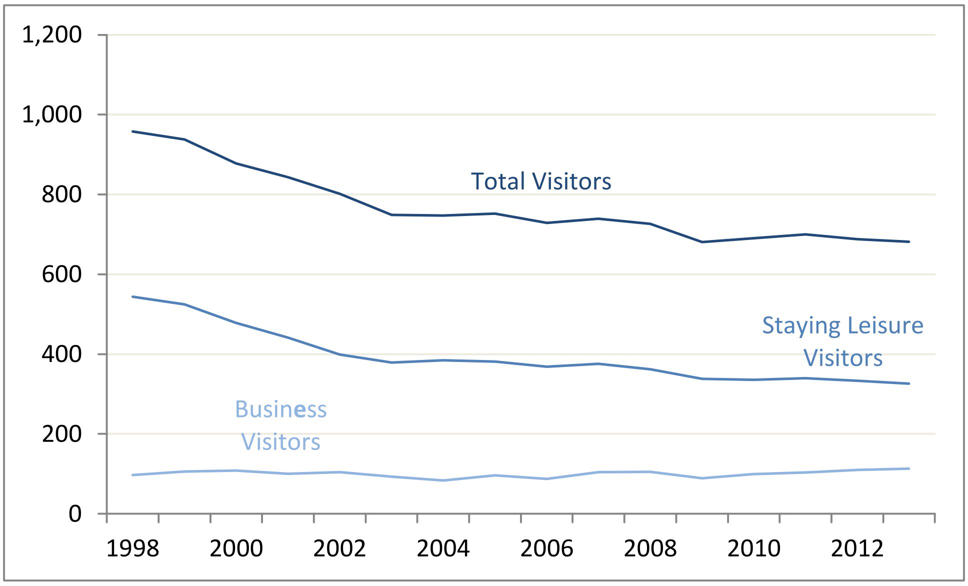
No new GVA or employment figures have been published for the hotels, restaurants and bars sector. When the Panel met with representatives of the tourist industry in June, they were optimistic about occupancy levels in 2014, on the basis of an increase in advance bookings, but the industry has seen no firm evidence of a sustained improvement. The industry is keen that the recommendations of the Tourism Shadow Board are implemented in order to address the structural decline in visitor numbers.

**Figure 1.13**

**Tourism trends**

Number of visitors, 000s

Source: Jersey Tourism




While no new data is available for GVA of the **construction** industry, the Business Tendency Survey shows that sentiment in the industry remained negative throughout most of 2013 before seeing an improvement in 2014. Nine of the ten indicators have improved significantly over the last twelve months, with six of the ten indicators turning positive.

The business optimism indicator in particular has increased, with a net balance of 23% of respondents now saying business optimism has improved. Business activity is positive for the first time since 2010. While profitability remains negative, it is at its least negative level for almost three years.

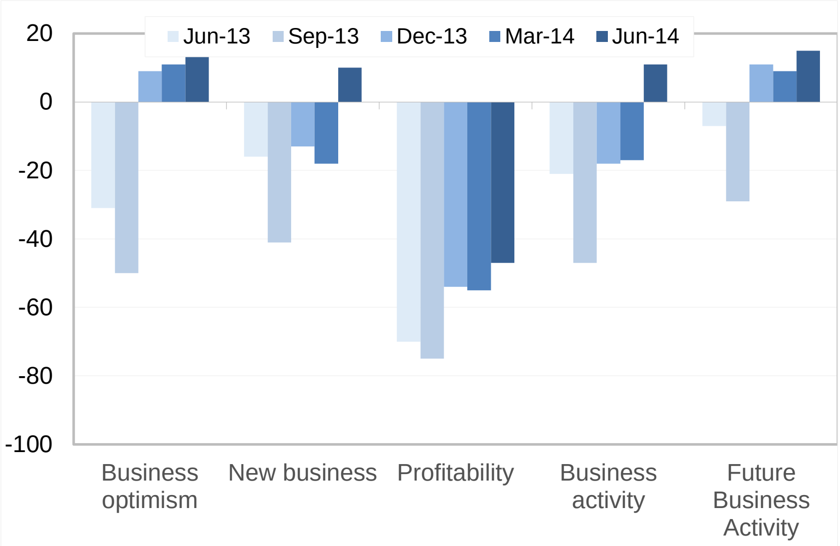
The construction sector has seen considerable change in recent years. The sector avoided any significant contraction over 2008-2010 when it was supported by the States' Fiscal Stimulus Programme. However, GVA contracted significantly in 2011 and 2012 as activity appeared to be affected by the struggling economy. When the Panel met with representatives from the construction industry in June, they were optimistic about the future after experiencing a lack of demand in recent years. While the sector has reduced employment in 2011 and 2012, they now expect activity to ramp up over the next twelve months in response to the States capital expenditure plan and a potential upturn in private sector projects.

**Figure 1.14**

**Construction business tendency**

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

Source: Jersey Statistics Unit




In June 2014, 34% of construction firms reported being above capacity, with 27% reporting they were below capacity. This indicator has significantly improved over 2013 and 2014 and is positive for the first time since 2010. Figure 1.15 shows how this indicator has changed since the survey began in 2009.

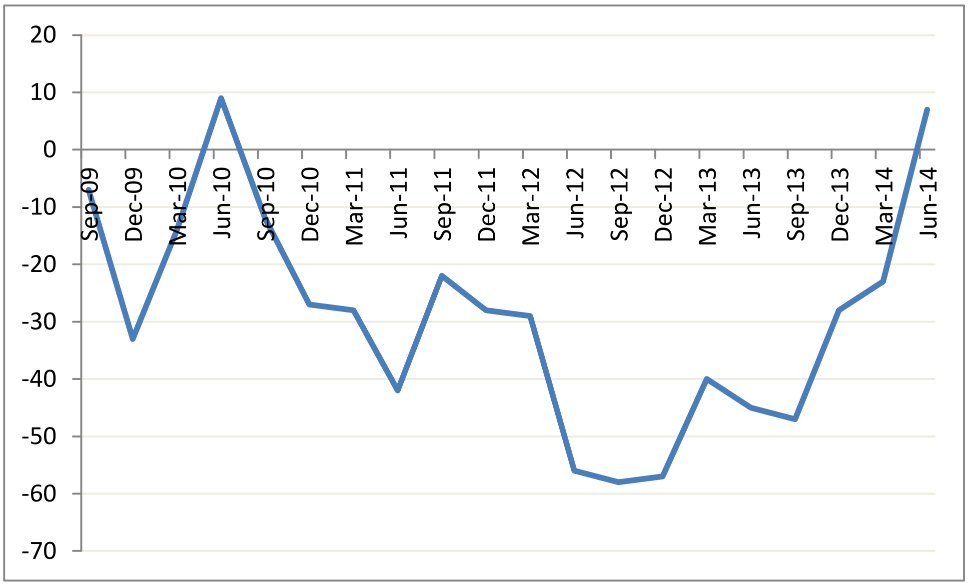
It will continue to be important to monitor construction capacity, particularly considering the significant increase in States capital expenditure anticipated over the next five years. The Panel is encouraged that the States is taking steps to carry this out in more detail, including considering the different types of construction activities (and their impact on the local economy) which will be required to deliver the proposed capital expenditure.

**Figure 1.15**

**Construction Capacity**

% net balance of respondents reporting current business activity above capacity (weighted by employment)

Source: States of Jersey Statistics Unit



## 1.3 Labour Market

No new figures have been published for employment, average earnings, or the International Labour Organisation (ILO) rate of unemployment. Therefore, the Panel has considered indicators such as the numbers registered as actively seeking work, the responses to the Business Tendency Survey and Social Security contribution records.

The number of people registered as **actively seeking work** (ASW) can be seen as an indicator of the trend in unemployment, although it cannot be seen as a comprehensive measure of unemployment as there is no statutory requirement for unemployed residents to register. ASW peaked in early 2013 and has fallen since, with a net fall of 340 (18%) in the twelve months to June 2014. The number of long-term (>12 months) ASW has fallen back to 2011 levels and the number of young people (<25 years old) ASW has fallen back to 2009 levels. However, Figure 1.16 shows that the total ASW number remains historically high, though part of the increase is likely to be due to the introduction of Income Support in 2008 which means that the current series is not strictly comparable with the previous series.

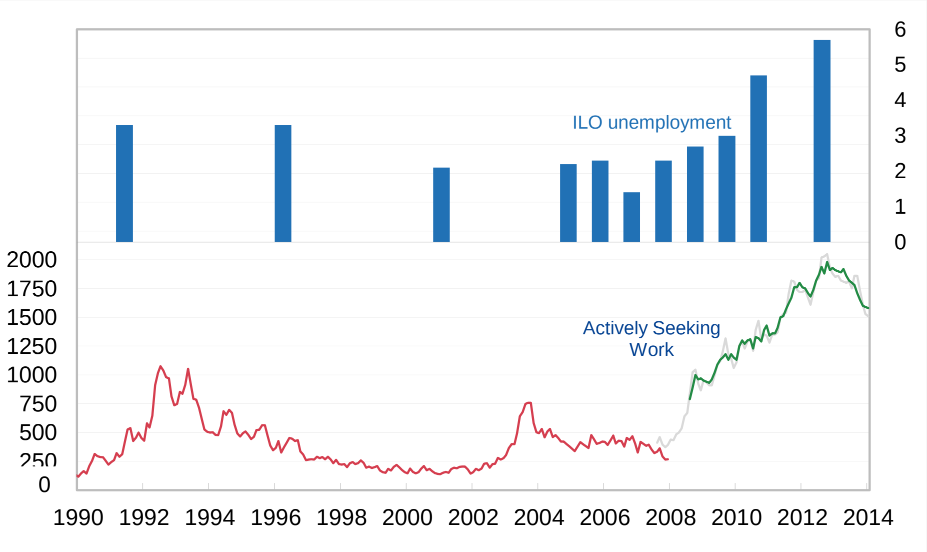
**Figure 1.16**

**Changes in unemployment**

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

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

Source: States of Jersey Statistics Unit




The most recent **Business Tendency Survey** which was carried out in June 2014 showed that 58% of finance firms reported no change in employment, with 21% reporting an increase and 21% reporting a fall in employment. The net balance is at largely the same level as at the time of the Panel's last Annual Report. The net balance for future employment was positive at +22, the highest level since the survey began in 2009.

For the non-finance sector, 67% reported no change in employment with 15% reporting an increase and 18% reporting a fall in employment. The net balance remains negative but at its least negative level since at least 2009. However, expectations of future employment are now positive.

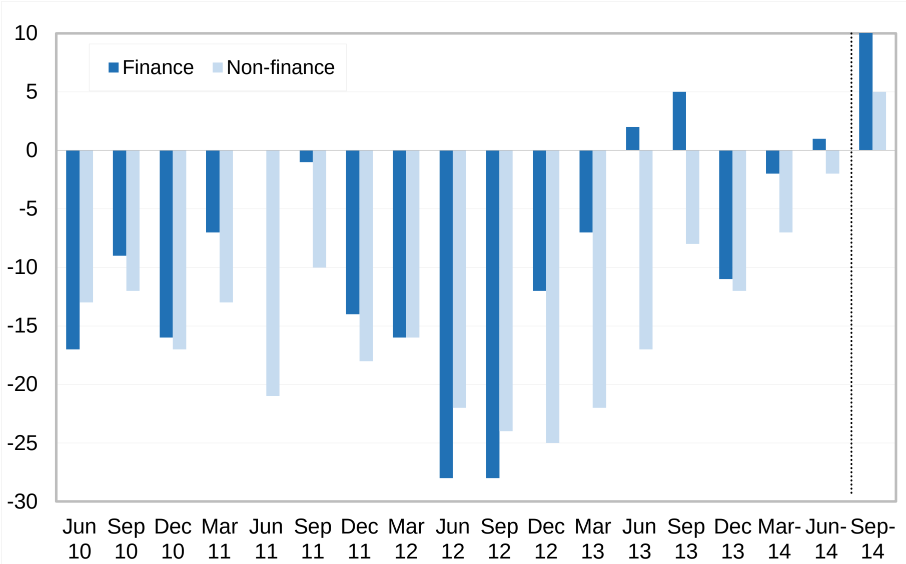
Figure 1.17 demonstrates that the employment indicator has improved considerably over the course of 2013 for both finance and non-finance but it remains negative for non-finance and largely neutral for finance, indicating that neither sector was expanding employment at the time of the survey.

**Figure 1.17**

**Employment trends in key sectors**

Weighted net balance reporting increase in employment, September 14 figure is based on expectations in June 2014 survey.

Source: States of Jersey Statistics Unit



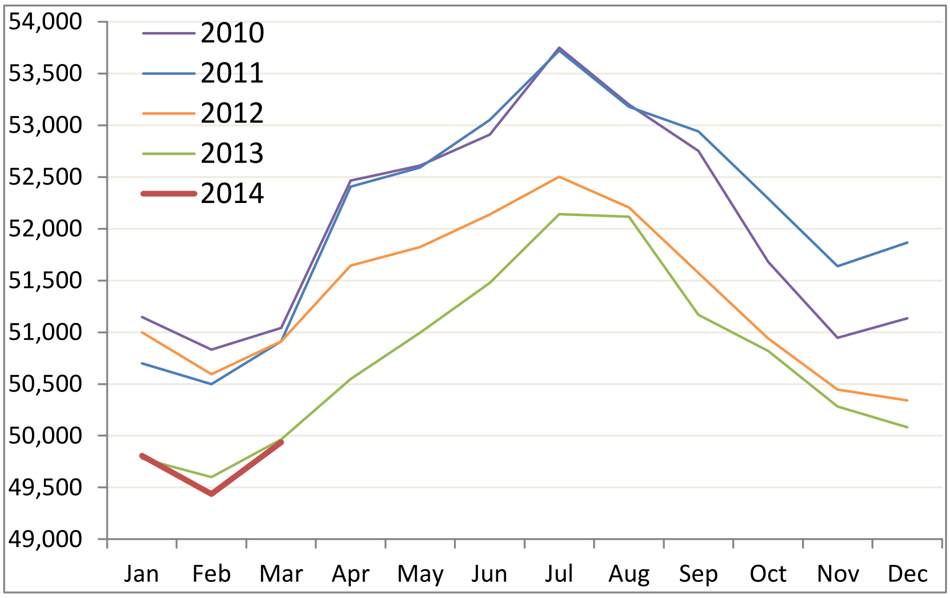

The Panel has also considered **Social Security contribution records** for 2013 and 2014, which show that over the most recent twelve months of data (April 2013 - March 2014), an average of 50,700 individuals contributed each month. This represents a small (0.7%) decline from the same period a year earlier. Figure 1.18 looks at a longer-term view of contributions and demonstrates that there has been a significant decline in the number of individual contributions over the last five years.

**Figure 1.18**

**Social Security contributions**

Number of Class 1 and Class 2 contributions in each month

Source: Social Security Department




Average earnings data for 2014 will not be published until August 2014. As stated in the 2013 Annual Report, average earnings in June 2013 were 2.2% higher than a year earlier which represented the first time in four years that earnings have risen faster than prices as measured by the retail price index (RPI), which increased by 1.5% in the 12 months to June 2013.

Overall, the different indicators paint a mixed picture, but on balance suggest that while expectations are positive, there has not yet been a strong pick-up in the labour market.

## 1.4 Inflation

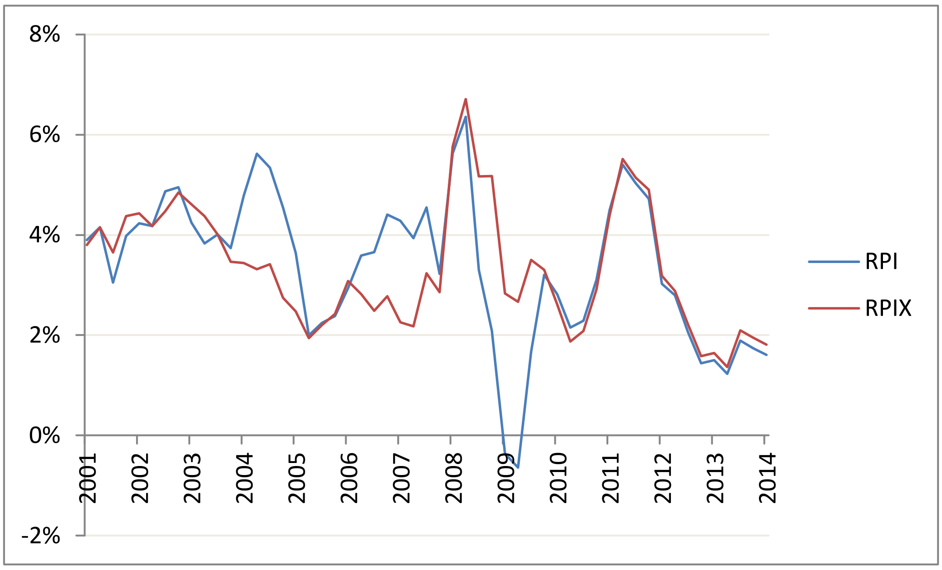
2013 saw significant falls in inflation, with RPI inflation reaching a low of 1.2% in September 2013. Inflation rose to 1.9% in December 2013 but has since fallen to 1.6% in June 2014 - remaining significantly below the levels seen in the previous four years. RPIX inflation (which excludes mortgage interest payments) stood at 1.8% in June 2014.

**Figure 1.19**

**Inflation in Jersey**

Annual % change in retail prices index and retail prices index excluding mortgage interest payments

Source: States of Jersey Statistics Unit




## 1.5 Spare capacity and potential output

The Panel's remit requires making an assessment of the degree of spare capacity in the economy to inform any recommendations on the appropriate balance of fiscal policy. This involves an assessment of where the economy is in relation to its 'potential output' - the level of output consistent with full utilisation of resources. The (percentage) deviation of actual output (GVA) from potential output is usually termed the 'output gap'. An output gap exists if output is below potential and there is spare capacity. Alternatively, the economy could be operating above capacity, suggesting excess pressure on resources, and damaging inflationary pressure.

There is a presumption that if the economy is (or is expected to be) below potential, fiscal policy (as measured by the surplus or deficit position of the budget) should be 'expansionary' – taking the economy back towards potential – and if output is excessive it should be contractionary. The Stabilisation Fund was set up to help enable the States' fiscal policy to be stabilising and counter-cyclical in this way. The concept of potential output is also very important in allowing the Panel to separate out structural from 'cyclical' factors in assessing the medium and longer term sustainability of the public finances. Looking forward, this would mean that States finances could be balanced over the economic cycle, along the future path of potential output.

Though central to the policy framework, the concept of 'potential output' is, clearly, extremely hard to assess and subject to uncertainty - especially given the shocks experienced by all economies since the financial crisis. In particular, past trends may be a poor guide to the future. Potential output may have been destroyed during the recession and its aftermath, meaning that the degree of slack in the economy (output gap) may be substantially lower than would have been expected on the basis of pre-crisis trends. In Jersey, assessments are particularly difficult, due both to a lack of data and due to the large weight of financial sector profits in GVA.

The issues can be illustrated for Jersey in Figure 1.20. This shows developments in GVA, excluding financial sector profits and owner occupied imputed rent, together with an estimate of the 'trend' of potential output. (If financial sector profits were included, the trend between 2000 and 2007 would have been negative).

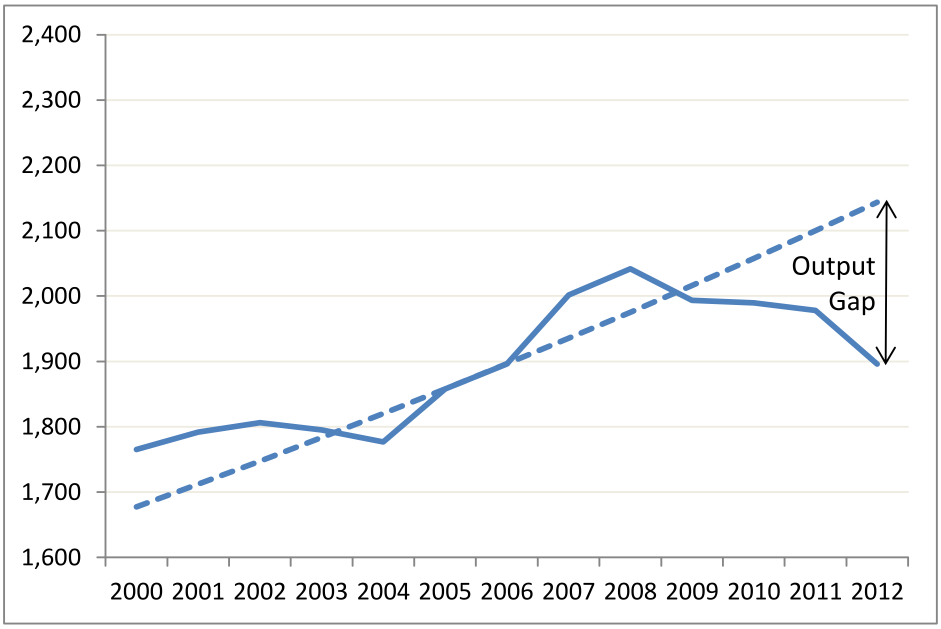
For illustrative purposes, the Panel has assumed that the economy was at full capacity in 2005 - a year which saw significant growth after several years of decline, suggesting that the economy was using up spare capacity to return to its potential level of output. Assuming that the full business cycle is represented by 2002 to 2008 (peak to peak), the trend growth rate would be approximately 2%. Using these assumptions would result in an estimated output gap for 2012 of approximately 12% (i.e. output is 12% below potential output).

**Figure 1.20**

**Illustration of output gap**

GVA (£m, constant 2003 prices) excluding finance profits and OOIR; dashed line is estimate of potential output

Source: Fiscal Policy Panel calculations




The difficulties are obvious from the figure. Recent data, for example the number actively seeking work, would not appear to support such a significant output gap, suggesting that it is likely the global financial crisis reduced the growth of potential output at least for a period and it is unclear whether and how far the growth rate will recover. This would suggest that the trend line should be moved down from 2008 onwards but also that the future growth rate may be different from that seen in the last economic cycle.

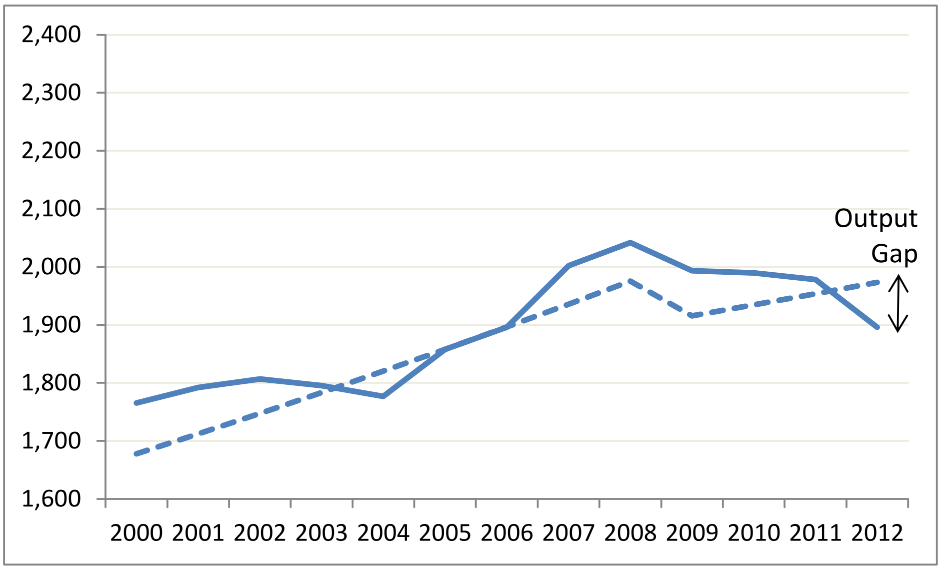
Figure 1.21, which is purely illustrative, combines an initial shift downwards in the potential output trend, followed by a reduction in the growth rate to 1%. It illustrates that, if this were the case, the estimated output gap would be significantly smaller, at 4%, in 2012.

**Figure 1.21**

**Alternative illustration of output gap**

GVA (£m, constant 2003 prices) excluding finance profits and OOIR; dashed line is estimate of potential output

Source: Fiscal Policy Panel calculations




Based on the economic assumptions which underpin the 2015 Budget, this trend line would result in an output gap of 5% in 2015, falling to 2% by 2019.

Figure 1.20 and Figure 1.21 illustrate the uncertainties involved in trying to estimate current and forecast output gaps on the basis of previous trends. Relatively small changes in assumptions can have a large effect on estimates of the output gap. Moreover, the estimates do not take account of any changes in population, employment rate or productivity – all of which will all have an impact on the future path of potential GVA. Public finances will therefore need to continue to remain flexible to respond to changes in the level of spare capacity. This is discussed further in section 2.2 [in the public finances section].

Ahead of the next MTFP, the Panel will undertake further work to consider whether a different quantitative approach could be taken to estimating the output gap.

However, in assessing the likely level of spare capacity in the short term, there are other, more direct methods that rely on a range of other information - including data on employment, unemployment and evidence from surveys.

Moreover, in the absence of big external influences, if inflation is decelerating this is an indicator that there may be spare capacity. This has broadly been the case in Jersey recently, though the effect is not strong.

The Business Tendency Survey collects data on capacity utilisation. The all sectors indicator was marginally positive for the first time in June 2014, suggesting that more firms are reporting that they are above capacity than those which are below. This is the first time the indicator has been positive, having been negative since the survey was launched in 2009. However, a net balance of firms indicating they are above capacity does not necessarily indicate that the economy is operating above capacity in aggregate terms. The non-finance sector was slightly negative whilst the finance sector has indicated that the finance sector has been operating above current capacity for the last five quarters.

However, outside the finance and construction sectors, few firms report being above capacity – with 26% of wholesale and retail firms reporting spare capacity and 20% of firms in all other sectors.

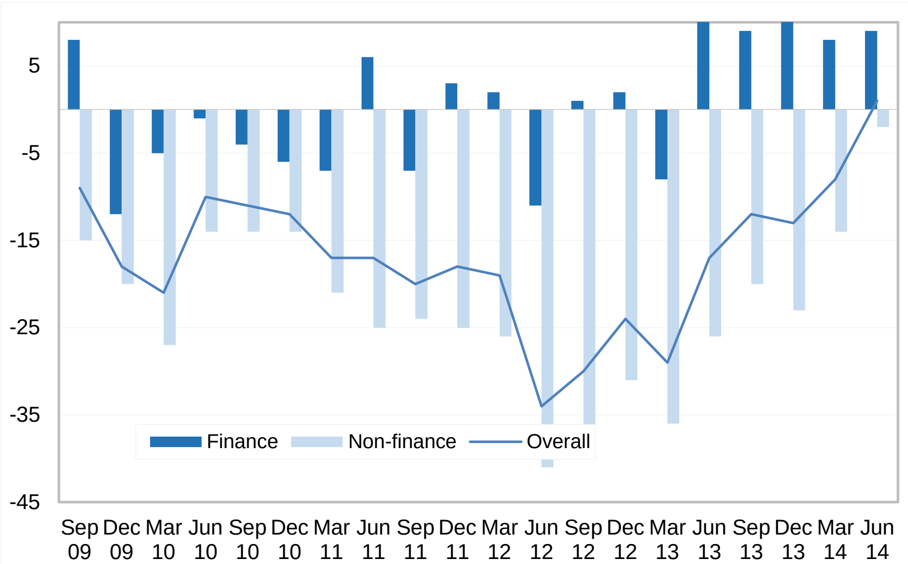
On balance, the Panel therefore concludes that some spare capacity is likely to remain into 2015.

**Figure 1.22**

**Capacity utilisation**

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

Source: States of Jersey Statistics Unit




## 1.6 Outlook

The Panel has forecast the performance of the economy for 2013, 2014 and 2015. This is based on the quantitative data available to date, but also on surveys and on the information gathered in meetings with key industry representatives.

The Panel's previous forecast for 2013 has been revised slightly downwards, with a central range of -2% to +1%. This is primarily due to a further fall in finance sector profits in 2013 and continuing negative responses to the BTS in the non-finance sector. Our central range for 2014 has also been revised slightly downwards to -2% to +2%. While 2014 has seen a significant improvement in survey data, industry representatives continued to be cautious about the prospects for any significant upturn in activity or profit margins this year.

The Panel have extended their forecast range to cover 2015. Uncertainty about economic conditions next year, both locally and globally, necessitates a larger central range for 2015. The Panel expect GVA growth of between -1% and +4% next year.

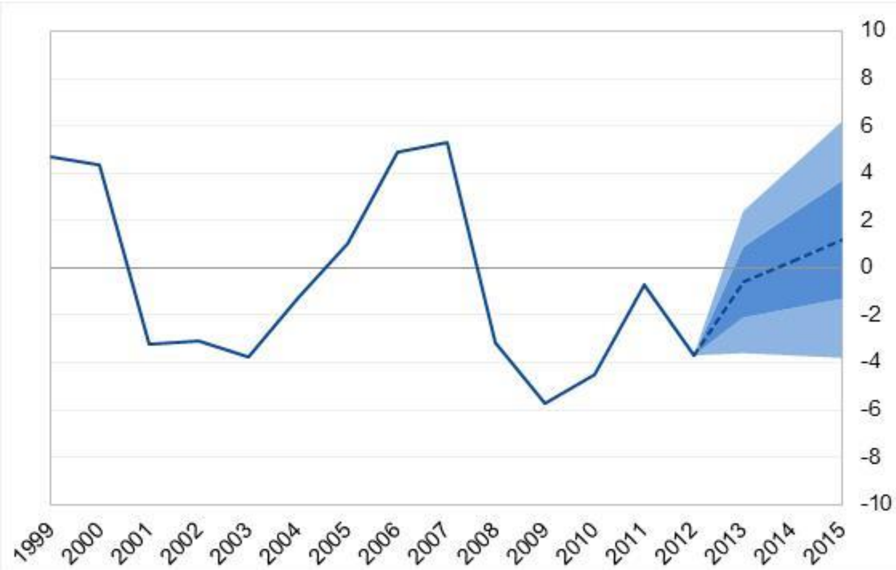
There remains significant uncertainty around these forecasts given the limitations of the data available and the uncertainty surrounding the global economic, financial and regulatory situation and how it will feed through into the local economy.

**Figure 1.23**

**Economic Forecasts**

% change in GVA on year before

Source: Panel judgement; States of Jersey Statistics Unit




Based on this, the Panel expect some spare capacity to remain at the aggregate level in the economy in both 2014 and 2015, suggesting that fiscal policy should continue to support the economy in both years. However, the structure of fiscal policy needs to remain alert to potential inflationary pressures in specific sectors or sub-sectors.

# Section 2 – The Fiscal Outlook

## Key points

- The States has made good progress on many of our past recommendations, including those regarding managing capital expenditure, defining the purpose and rules of the Strategic Reserve, and including more useful information in the Budget.

- Draft Budget 2015 shows that States' income is now expected to grow less quickly in 2014 and 2015, compared to the forecast included in the Medium Term Financial Plan. In response to this, there are proposed measures of £43m in 2014 and £33m in 2015 to fund the expected shortfall in States' revenue. The majority of these measures do not impact on economic activity in 2014 or 2015 which is appropriate given economic conditions.

- The draft Budget 2015 proposals do not have a significant impact on the structural position of the States' finances. This is appropriate in light of the lower revenue forecasts, proposed fiscal stance and expected economic conditions for the next few years. The proposed cap on mortgage interest relief is potentially a significant and welcome development.

- The Treasury expects capital expenditure to be around £70m in 2014, £190m in 2015 and peak at around £230m in 2016 before gradually falling to around £100m by 2020. The amounts of capital expenditure planned in 2015 and 2016 are much higher than previously experienced in Jersey.

- Such a significant increase in capital expenditure in such a short time could put pressure on the capacity of the local construction industry and any specific bottlenecks within it. The Panel is encouraged that work is already underway within the States to assess public and private sector construction workflow and how this relates to construction industry capacity going forward.

- The small deficit of £31m in 2013 represents a loosening of fiscal policy which added further stimulus to Jersey's economy. However, our advice was to loosen fiscal policy to a greater extent last year by running a larger deficit, which would have added additional stimulus to Jersey's economy.

- Over the next few years, the States will need to make a transition from running significant deficits to support a recovering economy in 2014 and 2015, to withdrawing stimulus and returning to a balanced budget once the economy returns to more normal levels of activity in the years ahead.

- Delivering about £100m of fiscal stimulus is appropriate for 2014, given that economic growth is still expected to be weak and that there are no strong signs of capacity issues or inflationary pressures.

- Fiscal policy should be accommodating in 2015 as well because there is still likely to be aggregate spare capacity in the economy next year. The States plans to run a significant deficit of £190m for 2015.

- Nevertheless, forecast deficits for 2014 and particularly 2015 are at the top end of what is appropriate for these years.

- Determining what the appropriate fiscal balance should be from 2016 onwards is difficult because of the uncertainties around future economic growth, spare capacity in the economy, and whether or not there is a structural deficit in the public finances.

- There is a risk of an underlying structural shortfall between States' income and expenditure which would need to be addressed once the economy has recovered and over the course of the next Medium Term Financial Plan (MTFP). This is indicated by:

    - The possibility of lost capacity and lower potential growth due to a structural change in the economy following the global financial crisis.

    - The Stabilisation Fund has been exhausted and there are no clear plans to rebuild it.

    - The current plans set out to balance budgets with no plans to run a surplus.

    - The medium-term outlook, while uncertain, suggests that there are significant challenges in even maintaining a balanced budget.

- The property tax review is welcome because it could help the States to improve the efficiency of the current tax system. It could also help the States to find revenue raising measures in the event there is a structural deficit in public finances.

- Using the Strategic Reserve to pay for the hospital over the next ten years is expected to reduce the value of the Strategic Reserve as a proportion of GVA from about 20% of GVA in 2014 to about 15% of GVA by 2024.

- It is hard to say what the optimum size for the Strategic Reserve should be. However, 15% of GVA is not a very large buffer, given the likely large impact of any events that might warrant the use of the Strategic Reserve.

- To improve how we look at Jersey's long-term fiscal sustainability in the future, it will be important to look more closely at:

  1. The fiscal impact of past public sector activity - for example, the assets and liabilities on the States' balance sheet and how they change over time; and

  2. The potential impact of future public sector activity - projections for States' income and expenditure, and assets and liabilities over the long-term.

  We intend to cover these issues in more detail in our next report in advance of the next MTFP.

- The 2013 States' Accounts saw the five Social Security Funds consolidated into the States Accounts for the first time. The Panel welcome this development and the continued monitoring of the implications of trends in the Social Security Funds for the States' overall fiscal position.

- The Panel agrees with the £1m transfer out of the Stabilisation Fund, if it is required. If there was more money in the Stabilisation Fund, it would have been appropriate to transfer more out to fund the forecast shortfall in income.

## Recommendations

1. The focus in 2014 and 2015 should be on supporting the economy (by running deficits) while there is still spare capacity.

2. This focus should not be deflected in light of lower tax receipts (outturns or forecasts) especially where this is a result of a weaker than expected economic performance. The Panel supports the Budget's proposed approach to mainly use savings and reserves to fund the potential shortfall in income because it limits the negative impact on the economy in the short-term.

3. If there is a structural deficit in the public finances, the States should plan to address it once the economy has recovered. Structural changes in taxation, or expenditure programmes are easier to introduce once the economic recovery is fully established. This will be an important consideration for the next MTFP.

4. The States should bear in mind the following principles when forming the next MTFP:

    - Aim to balance the budget over the economic cycle - i.e. surpluses and deficits which broadly balance out over more than one MTFP period.

    - Adopt prudent assumptions for income and realistic assumptions for expenditure.

    - Include flexibility within a clear framework for expenditure.

5. It is very important that the States makes plans about how to deal with the expected improvement in economic conditions and reduction in spare capacity from 2016 onwards. It is even more important to consider how fiscal policy would need to change if growth turns out to be higher than expected, or if capacity constraints started to be felt. In either case, this would mean running tighter fiscal policy and topping up the Stabilisation Fund. The plans could include:

    - Reducing departmental expenditure and/or raising revenue to run surpluses (or at least smaller deficits).

    - Managing how capital projects are delivered so as to put less strain on local capacity.

- Continuing with policies which will improve Jersey's economic potential, such as those which aim to increase productivity, innovation and reduce structural unemployment.

6. The Treasury should look at how budgeting for capital projects and the use of capital allocations can be improved because the current system may make it harder to adjust capital expenditure and therefore fiscal policy. During our fact finding visit, the Treasury confirmed that work is already underway and it will be important that this is finalised in time to influence the next Medium Term Financial Plan.

7. The delay to introducing the long term care charge was appropriate, but there is no need for further delays given the planned fiscal stance in 2015 and 2016.

8. The States should monitor the value of the Strategic Reserve relative to the size of Jersey's economy and States' expenditure. The States should give an indication of the desired size of the Strategic Reserve.

9. The States should produce projections for future States' income and expenditure for the next 20 years, adopting an approach similar to that used by the UK's Office for Budget Responsibility. This will complement the balance sheet information the States already publishes in its annual accounts.

10. The States should continue to monitor the outlook for the Social Security Funds through the planned three-yearly actuarial reviews and include the uncertainties and projections in its medium-term fiscal plans and long-term assessments of sustainability.

## 2.1 Public finances update

This section summarises developments in public finances since the publication of the Panel's 2013 Annual Report and the extent to which these were consistent with our previous advice and recommendations.

**Previous recommendations**

We made eight recommendations to the States in our last report published in November 2013. **The States has made good progress on many of our recommendations including those regarding managing capital expenditure, defining the purpose and rules of the Strategic Reserve, and including more useful information in the Budget.**

**Budget 2014**

The Treasury Minister proposed measures in the draft Budget 2014 which were expected to cost between £5m and £6m a year from 2015, compared to the MTFP forecast. The main proposals were to decrease the marginal income tax rate from 27% to 26%, increase income tax exemption thresholds by 1.5% and increase impôts duty on alcohol, tobacco and fuels.

The States approved the Budget after amending the proposed increases in impôts duty - reducing future revenue by another £0.3m a year.

The States also agreed the proposed capital programme for 2014 and the proposed plans and funding sources for the three major capital projects: the hospital project, the liquid waste project and the social housing project.

These projects will be funded from a mix of internal and external sources ranging from the investment income from the Strategic Reserve (£297m), investing from the Currency Fund (£29m) and external borrowing (£250m).

In June 2014, the States very successfully issued a bond to borrow £250m at a rate of 3.75% for 40 years to fund the social housing project. This is likely to increase international scrutiny on Jersey, and its fiscal outlook and sustainability.

**Annual update to the MTFP**

In January 2014, the Treasury and Resources Minister presented an annual update to the Medium Term Financial Plan (MTFP) for 2014[1] to the States. The two key findings were:

1. All the changes in expenditure allocations approved by the States since the MTFP have been accommodated within the MTFP's original total expenditure limits.

2. £56m of the £65m Comprehensive Spending Review savings target was delivered by the end of 2013, and it is expected a further £5m of savings will be made by the end of 2016.

**2013 States' Accounts**

The published accounts this year included the activities of the Social Security Funds for the first time. We welcome this development. Their inclusion was in response to a recommendation by the Comptroller and Auditor General (C&AG) and will provide a more complete picture of the state of government finances and the balance of income and expenditure. In turn, this helps us to assess the overall impact of States' activities on Jersey's economy in 2013 and how this should be taken into consideration for future fiscal policy setting.

*Income and expenditure*

States' income was £765m and States' revenue expenditure (not including capital expenditure) was £764m in 2013. States' income and expenditure was slightly lower than forecast in the MTFP, being £3m and £4m (or 0.4%) lower respectively.

Within total States' income, personal income tax receipts were £20m lower than forecast - mainly due to weaker average earnings and employment growth, and changes in the deemed distribution rules. However, this was mostly offset by one-off company income tax receipts and extra dividends from utilities. Company income tax has tended to be more volatile than personal income tax, reflecting the volatility of the profits of finance sector companies.

[1] Medium Term Financial Plan Department Annex for 2014 (R8/2014), accessed at the States Assembly website: (http://www.statesassembly.gov.je/AssemblyReports/2014/R.008-2014.pdf)

*The balance of income and expenditure*

The balance of spending and revenue in relation to economic performance helps us to understand whether or not, and to what degree, fiscal policy has been counter-cyclical.

The States ran a small accounting deficit of £12m (0.3% of GVA) in 2013. However, this measure of the surplus/deficit takes into account capital allocations rather than actual capital expenditure, and it is the latter that impacts on the economy. Including capital expenditure instead, and the impact of States' Traders and other Funds (such as the Social Security Fund) results in a slightly larger economic deficit of £31m (0.9% of GVA) in 2013 (Figure 2.1).

This compares to an expected economic deficit of £42m (1.2% of GVA) in November last year, and an economic surplus of £26m in 2012. One of the key reasons for the smaller deficit than expected is that the States spent £52m on capital projects instead of the £75m that was previously expected.

**The small deficit of £31m in 2013 represents a loosening of fiscal policy which added further stimulus to Jersey's economy. However, our advice was to loosen fiscal policy to a greater extent last year by running a larger deficit, which would have added additional stimulus to Jersey's economy.**

Figure 2.1

Actual adjusted deficit for 2013 and the previous estimate

£m (current prices)

Source: States of Jersey Treasury data.

| | Actual 2013 £m | Previous estimate 2013 £m | Difference 2013 £m |
|---|---|---|---|
| **Surplus/(Deficit) - accounting** | **-12** | **0** | **-12** |
| Add back: Capital allocation | 13 | 13 | 0 |
| Add: Surplus of traders | 14 | 14 | 0 |
| Add: Surplus from other Funds | 6 | 6 | 0 |
| Capital expenditure | -52 | -75 | 23 |
| **Surplus/(Deficit) - economic** | **-31** | **-42** | **11** |
| **% of GVA** | 0.9 | 1.2 | |

*The States' balance sheet*

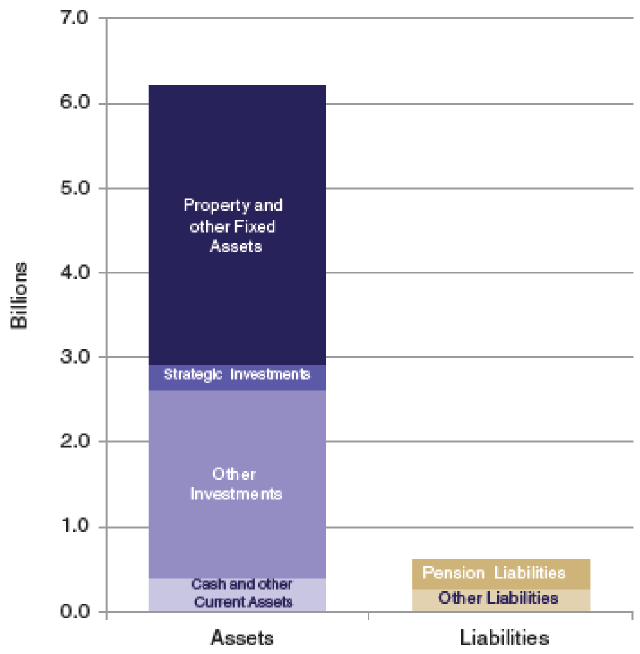
The States' balance sheet from the States' Accounts is shown in Figure 2.2. It shows a snapshot of the States' financial position at the end of 2013. This includes the assets – what the States owns and what is owed to the States, and the liabilities – what the States owes at that the end of the year.

Figure 2.2

**States' assets and liabilities, 2013**

£billions

Source: States of Jersey 2013 Accounts




The assets on the balance sheet include:

- Property and other fixed assets, £3,280m - such as land, buildings, social housing and various networks including the road network, the foul and surface water network and sea defence network.
- Strategic investments, £316m - The States owns controlling investments in the following utility companies: Jersey Electricity plc, Jersey New Waterworks Company Limited, JT Group Limited and Jersey Post International Limited.
- Other investments, £2,230m - for example in the Strategic Reserve (£743m) and Social Security Funds (£1,320m).
- Cash and other current assets, £406m.

The liabilities on the balance sheet include public sector pension liabilities (£348m) and other liabilities (£271m), including the value of currency in circulation and amounts owed to other people and businesses.

Jersey has a strong public sector balance sheet because, unlike many other governments, the value of its assets far outweighs its liabilities. However, care is required when interpreting what the balance sheet really means for fiscal sustainability and flexibility. This is discussed in more detail in Section 2.6.

**Draft Budget 2015**

*Overall*

Draft Budget 2015 includes more information explaining the overall impacts of proposed fiscal policy and the latest outlook for States' finances.

**We are pleased that our recommendation to include more financial information in the draft Budget has been adopted.**

*Proposals*

The main draft Budget 2015 proposals are:

- **Income tax**: Increase exemption thresholds by 1.7%, amend the double tax credit provisions so that marginal rate taxpayers can benefit and cap mortgage interest relief at £15,000.
- **Impôts**: Increase the duty for alcohol, tobacco and fuel
- **Stamp duty**: Increase in the duty for properties costing over £1m and decrease the duty on borrowing up to £400,000.

Altogether, the draft Budget 2015 proposals would result in an estimated £1m increase in revenue in 2015 and £2.6m a year from 2016, compared to the revenue forecast included in the Medium Term Financial Plan and Budget 2014.**The draft Budget 2015 proposals do not have a significant impact on the structural position of the States' finances. This is appropriate in light of the lower revenue forecasts and proposed fiscal stance for the next few years. The proposed cap on mortgage interest relief is potentially a significant and welcome development.**

The implications of this for the medium term depend on the extent to which the lower revenue forecasts are cyclical or structural, which is discussed further in section 2.2.

*Review of property tax*

Draft Budget 2015 also sets out the main aims for the Treasury's review and public consultation on Jersey's property tax system.

**We are supportive of the property tax review because it could help the States to improve the efficiency of the current tax system. It could also help the States to find revenue raising measures in the event there is a structural deficit in public finances which needs to be addressed once the economy recovers.**

*Long term care charge*

The States is now planning to introduce the long term care charge in two steps in 2015 and 2016, after delaying it by a year.

**The delay to introducing the long term care charge was appropriate, but there is no need for further delays, given the planned fiscal stance in 2015 and 2016.**

## 2.2 Medium term outlook for public finances (2014-2017)

### Income and current expenditure

The draft 2015 Budget includes a revised financial forecast which shows that States' income, particularly income tax revenue, is now expected to grow less quickly in 2014 and 2015, compared to the forecast included in the Medium Term Financial Plan. The forecast shortfall is £36m in 2014 and £55m in 2015 (equivalent to about 5% and 8% of States' income in the two years).

Overall, the Treasury now forecasts an accounting deficit of £33m in 2014 and £39m in 2015, after offsetting some of the expected fall in revenue through lower central and capital allocations (Figure 2.3). There are proposed measures in the 2015 Budget which would reduce these deficits, if they occur, which are covered later in the report.

The income, expenditure and surplus/deficit figures for 2016 and 2017 are indicative until the next Medium Term Financial Plan is developed.

Figure 2.3

Forecast and indicative public finances 2014-2017

Source: States of Jersey Treasury

| | Forecast 2014 £m | Forecast 2015 £m | Indicative 2016 £m | Indicative 2017 £m |
|---|---|---|---|---|
| **States Income** | **768** | **789** | **814** | **851** |
| Department Expenditure | 791 | 807 | 794 | 831 |
| Central Allocations | 8 | 18 | | |
| Net Capital Allocation | 2 | 3 | 20 | 20 |
| **States Revenue Expenditure** | **801** | **828** | **814** | **851** |
| **Surplus/(Deficit) - accounting** | **(33)** | **(39)** | **-** | **-** |

### Capital expenditure

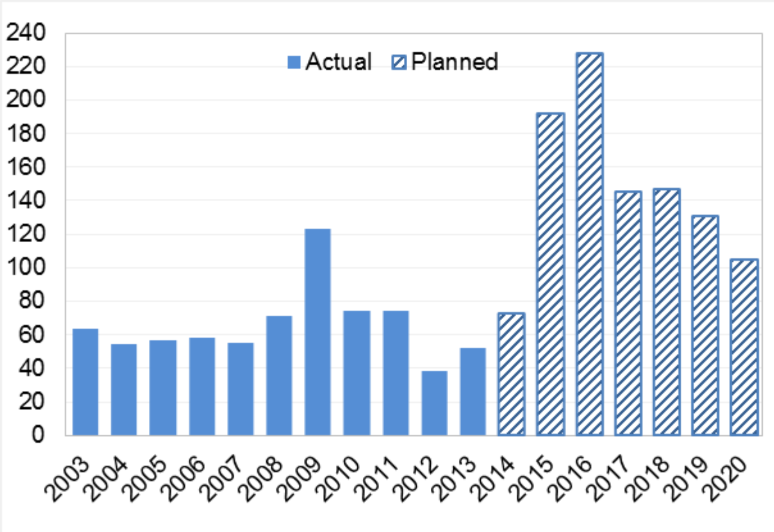
The States has spent £21m on capital projects up until the end of May 2014. The Treasury expects capital expenditure to be around £70m in 2014, £190m in 2015 and to peak at around £230m in 2016 before then gradually falling to around £100m by 2020 (Figure 2.4).

**Figure 2.4**

**Capital expenditure projections, £m**

Source: States of Jersey Treasury

Note: Capital expenditure includes the Trading Funds.




**The amounts of capital expenditure planned by the States between 2015 and 2019 are up to three times higher than previously experienced in Jersey.**

The hospital and social housing projects will be mostly paid for by using savings (Strategic Reserve), borrowing, and selling assets (such as properties) rather than by increasing income (through higher charges or taxation) or reducing expenditure.

However, the impact on the local economy will depend on the degree to which such spending puts pressure on local businesses (particularly in terms of labour requirements) relative to how much may be spent on imported raw materials and other goods and services.

**Such a significant increase in capital expenditure in such a short time could put pressure on the capacity of the local construction industry and any specific bottlenecks within it. The Panel is encouraged that work is already underway within the States to assess public and private sector construction workflow and how this relates to construction industry capacity going forward.**

### The balance of income and expenditure

*Overview*

Figure 2.5 shows Treasury's latest estimates of what the accounting balance and economic balance of income and expenditure will be over the next few years. The necessary adjustments to arrive at the economic balance include:

- **Estimated capital expenditure** rather than a budget allocation for future capital expenditure;
- **States' activities** such as the Traders, which includes for example, the airport and harbours.
- **States' other Funds** such as the Social Security Funds; and
- **Timing differences** for when the States will receive and spend money.
- **Proposed measures** which would impact on the economy if States' income in 2014 and 2015 is in line with the latest forecast. This is explained further in the next section.

Figure 2.5

**Public finances forecast for 2014 - 2017 adjusted for economic impact**

Source: States of Jersey Treasury

*Proposed measures adjusted to take account of the impact on the economy

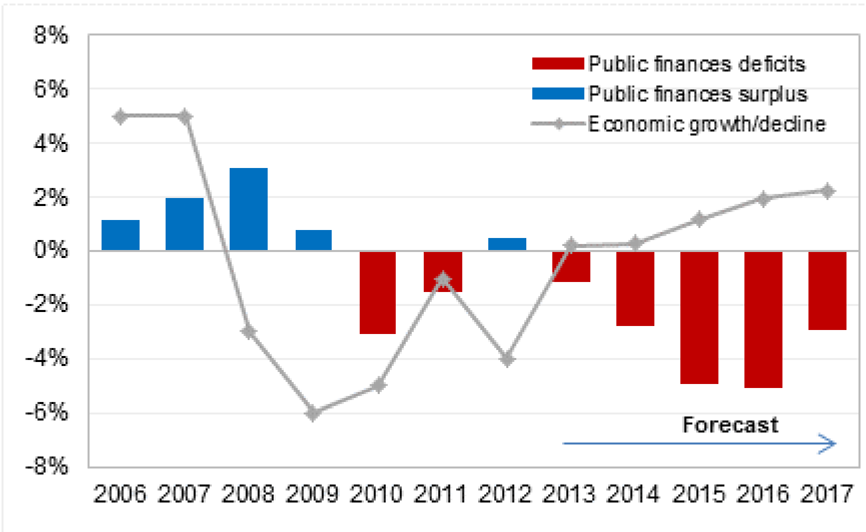
| | Forecast 2014 £m | Forecast 2015 £m | Indicative 2016 £m | Indicative 2017 £m |
|---|---|---|---|---|
| **Surplus/(Deficit) - accounting** | **(33)** | **(39)** | **0** | **0** |
| Proposed measures* | 5 | 17 | | |
| Add back: Capital allocation | 2 | 3 | 20 | 20 |
| Add: Surplus from Traders | 14 | 14 | | |
| Add: Surplus from other Funds | 9 | 7 | 2 | |
| Expenditure outturn adjustment | (27) | | | |
| Capital expenditure estimate | (73) | (192) | (228) | (145) |
| **Surplus/(Deficit) - economic** | **(103)** | **(190)** | **(206)** | **(125)** |
| **As a % of GVA (forecast)** | 2.8 | 4.9 | 5.1 | 2.9 |

Figure 2.6 shows these deficits in the context of the recent balance of fiscal policy and the expected return to economic growth over the next few years.

Figure 2.6

**Annual surplus/deficit as a % of GVA, and real economic growth %**

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



*Proposed measures*

**The financial forecast in the draft 2015 Budget shows that States' income is now expected to grow less quickly in 2014 and 2015, compared to the forecast included in the Medium Term Financial Plan. In response to this, there are proposed measures of £43m in 2014 and £33m in 2015 to fund the expected shortfall in States' revenue.**

£32m of the proposed measures in 2014 and the £33m of the proposed measures in 2015 would affect the forecast income and expenditure in those years. The remaining £11m of the proposed measures in 2014 use available balances on Funds and Reserves.

These proposed measures fall into two categories, based on their economic substance:

1. Measures which impact on the economy immediately, such as by reducing expenditure or increasing tax revenue from the economy in these years. About £5m and £17m of these measures in 2014 and 2015 would do this ("Proposed measures" in Figure 2.5).

2. Measures which do not impact on the economy immediately, but which may have implications for future years such as using savings or other reserves. Most of the proposed measures in 2014 and about half in 2015 would not impact on the economy immediately (£38m and £16m in 2014 and 2015 respectively).

**The focus of supporting the economy in 2014 and 2015 should not be deflected in light of lower tax receipts (outturns or forecasts) especially where this is a result of a weaker than expected economic performance. Given the weak economic recovery that is expected for 2014 and 2015, the Panel supports the Budget's proposed approach to mainly use savings and reserves to fund this shortfall in revenue, if it occurs.**

*Fiscal policy implications*

**Over the next few years, the States will need to make a transition from running significant deficits to support a recovering economy in 2014 and 2015, to withdrawing stimulus and returning to a balanced budget once the economy returns to more normal levels of activity in the years ahead.**

The large expected future economic deficits are mainly driven by the States plans for significant amounts of capital expenditure. Care needs to be taken in interpreting what this means for the economy – the impact of these will not be as large as the value of the projects, because there will be a degree of leakage outside Jersey's economy.

These major capital projects should go ahead because they been approved by the States on the basis of the long-term benefits they are expected to bring. Managing the impact of them on the wider economy during the transition is going to be very important.

For 2014 and 2015, where support and stimulus is recommended, our previous advice regarding capital expenditure has been very clear. If projects that were going to take place anyway, can be brought forward and have intrinsic economic value in their own right - policy should be timely, targeted and temporary (the 3 T's):

- Timely: Start immediately and impact as soon as possible
- Targeted: Carry out measures which will have the most impact in supporting economic activity and employment in the island
- Temporary: The measures should have no negative long-term implications for public finances.

The States expects to run an economic deficit of about £100m (equivalent to almost 3% of GVA) this year and a significantly larger economic deficit of about £190m (about 5% of GVA) in 2015.

**Delivering about £100m of fiscal stimulus is appropriate this year, given that economic growth is still expected to be weak and that there are no strong signs of capacity issues or inflationary pressures.**

**Fiscal policy should be accommodating in 2015 as well because there is still likely to be aggregate spare capacity in the economy next year. The States plans to run a significant economic deficit of £190m for 2015.**

**The forecast deficits for 2014 and particularly 2015 are at the top end of what is appropriate for these years.**

The States is indicating that it anticipates another large deficit of about £200m in 2016 and a smaller deficit of £130m in 2017.

The analysis in the economic outlook section showed that it is very difficult to estimate the current degree of spare capacity in Jersey. It is even more difficult to make forecasts for several years ahead, since that depends also on what happens to growth – which is also highly uncertain, especially some years in advance. The overall picture presented in this Report is of a moderate pick-up in growth, to about the previous trend rate (see Figure 1.23), taking into account the likely impacts of the capital programme, and the large deficits that are anticipated. It is too early to be confident that the large economic deficits expected in 2016 and 2017 will appear appropriate from a fiscal policy perspective. But there are clear risks that they will not. For example, if recovery were faster than expected, or if the amount of spare capacity in 2016 or 2017 turns out to be lower than we are implicitly assuming, then policy would need to adjust.

In any case, if the economy recovers in line with the forecast, the States will have to manage the capital projects so that they do not have adverse effects on the wider economy – for example through increasing inflationary pressure and reducing competitiveness.

**It is very important that the States makes plans about how to deal with the expected improvement in economic conditions and reduction in spare capacity from 2016 onwards.**

**It is even more important to consider how fiscal policy would need to change if growth turns out to be higher than expected, or if capacity constraints started to be felt. In either case, this would mean running tighter fiscal policy and topping up the Stabilisation Fund. The plans could include:**

- **Reducing departmental expenditure and/or raising revenue to run surpluses (or at least smaller deficits).**
- **Managing how capital projects are delivered so as to put less strain on local capacity.**
- **Continuing with policies which will improve Jersey's economic potential, such as those which aim to increase productivity and innovation, and to reduce structural unemployment.**

**Structural position**

One of the Panel's key principles is that fiscal policy needs to be focused on the medium term. Aiming to balance the budget over the economic cycle is an important step towards a sustainable medium-term fiscal policy.

During the last economic cycle between 2000 and 2007, the States ran a small surplus overall[2], indicating that the public finances were broadly in balance and that there was not a structural deficit over the period. However, since then, there may have been structural changes in the economy and in States' expenditure which could have changed this.

[2] After including capital expenditure instead of capital allocations.

**The picture of surpluses and deficits after 2008 (Figure 2.6) suggests that there is a risk of an underlying structural shortfall between States' income and expenditure which would need to be addressed once the economy has recovered. This is indicated by:**

- **The possibility of lost capacity and lower potential growth due to a structural change in the economy following the global financial crisis.**
- **The Stabilisation Fund has been exhausted and there are no clear plans to rebuild it.**
- **The current plans set out to balance budgets with no plans to run a surplus.**
- **The medium-term outlook, while uncertain, suggests that there are significant challenges in even maintaining a balanced budget.**

The income tax rate cut in the 2014 Budget which permanently reduced States' income from 2015 has increased this risk slightly.

Another way of looking at medium term fiscal sustainability is to look at the trends in States' revenue and expenditure as a proportion of GVA in the past and projections for the future. We can see whether or not the projected changes in income and expenditure (as a proportion of GVA) look reasonable and how they compare with the past.

Figure 2.7 shows States' income, which includes income tax, GST, stamp duty etc and States' expenditure which includes departments' net revenue expenditure and capital expenditure (but not States' Traders or other Funds). The difference between the lines show whether the States ran a surplus or deficit in each year.

Over the last economic cycle, 2000 to 2007, States' income and expenditure (current and capital expenditure) were relatively balanced, both growing by 2% as a share of GVA. From 2008 to 2012, income and expenditure grew sharply as a share of GVA, particularly as Jersey's economy declined each year in real terms. The spike in States' income in 2008 was partly due to the introduction of GST followed by the loss of revenue due to the move to the 0/10 regime in 2010. States' expenditure peaked above States' income in 2010 and 2011 due to the large deficits and fiscal stimulus expenditure which supported the economy at the time.

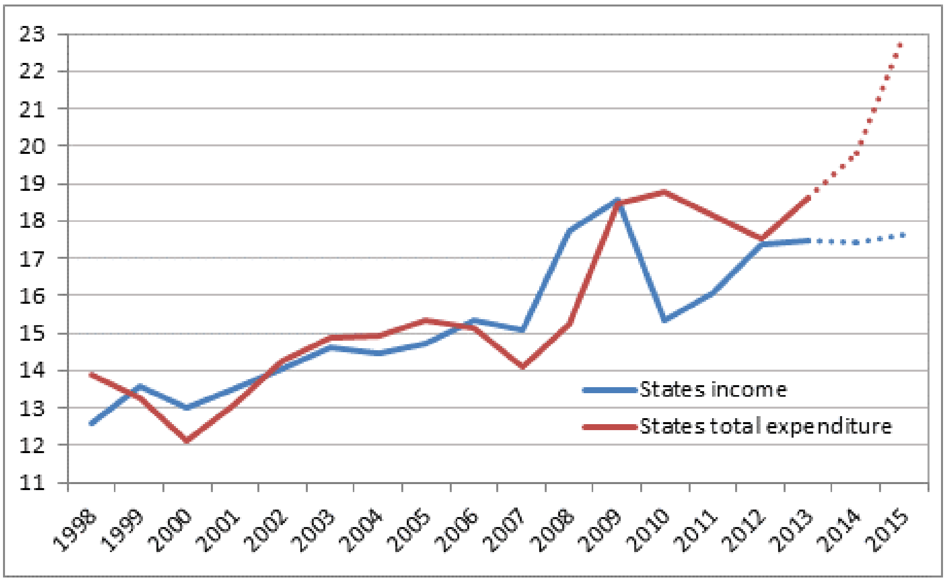
**Figure 2.7**

**Total States' income and expenditure as a % of GVA**

Dotted lines based on the forecast for income, expenditure and GVA growth.

Note: Excludes Traders and Social Security

Source: States of Jersey accounts and Panel calculations




In 2014 and 2015, income is expected to remain stable at 17% of GVA, whilst expenditure is expected to grow sharply to 23% of GVA mainly as a consequence of the major capital projects that are planned.

Removing capital expenditure from the picture shows States' income compared to States' current expenditure and the difference between them ("current" surpluses or deficits) over the same period (Figure 2.8).

From 1998 to 2009, total States' income more than covered current expenditure (resulting in current surpluses), with income increasing from about 13% of GVA to 18% of GVA, and expenditure from 11% of GVA to 16% of GVA.

From 2010 to 2013, total States' income and expenditure were broadly balanced overall, with small current deficits at first and small current surpluses after. Both increased slightly as a share of the economy to about 17% of GVA.

For 2014 and 2015, the latest forecasts suggest that States' current expenditure will continue to grow slightly as a share of the economy whilst revenues are, roughly, flat. The divergence is small in comparison to the impression given by the picture including capital expenditure. The divergence between the structural budget position, as indicated by trends in the current budget and that indicated by the total position (including capital expenditure) indicates the crucial importance of managing the economic impact of the surge in capital expenditure over the next few years.

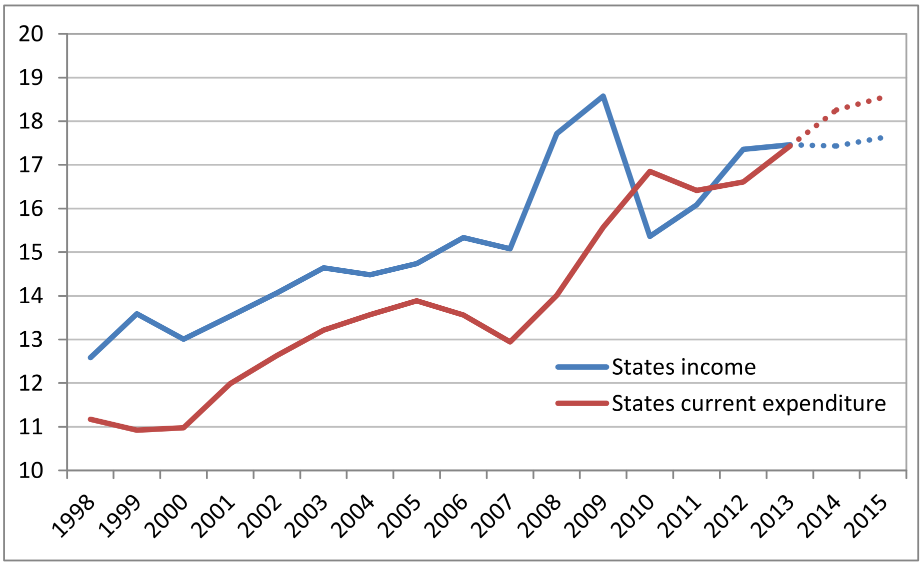
Figure 2.8

**Total States' income and current expenditure as a % of GVA**

Dotted lines based on the forecast for income, current expenditure and GVA growth.

Note: Excludes Traders and Social Security

Source: States of Jersey accounts and Panel calculations




**The Panel intends to undertake additional analysis ahead of its report next year to help the States better understand the underlying structural position of the States' finances.**

**Flexibility to adjust fiscal policy**

It is important that the States ensures it has enough flexibility in its expenditure and tax programmes to be able to run deficits and surpluses of appropriate size over the economic cycle, and, in the event there is a structural deficit, to be able to fund it until corrective action can be taken when the economy recovers.

The lack of available money, whether in the Consolidated Fund, the Stabilisation Fund, the Strategic Reserve, or any other Fund, should not be a barrier to carrying out counter-cyclical fiscal policy.

The Public Finance Law requires the full amount of funding for a capital budget to be set aside at the time that the project is agreed as a "capital allocation". This may reduce the flexibility of fiscal policy and have unintended consequences for the ways in which the Treasury and other departments manage capital projects and capital expenditure. For example, the use of capital allocations appears to make it more difficult to change plans for capital projects and capital expenditure – particularly the ability to bring new projects forward in place of other projects which already have money allocated, but are not making progress.

**The Treasury should look at how budgeting for capital projects and the use of capital allocations can be improved because the current system may make it harder to adjust the timing of capital expenditure and, therefore, fiscal policy. During our fact finding visit, the Treasury confirmed that work to increase**

**flexibility is already underway and it will be important that this it is finalised in time to influence the next Medium Term Financial Plan.**

**Medium Term Financial Plan 2016-2019**

The next Medium Term Financial Plan (MTFP) for 2016-2019 will be developed and agreed next year.

**The focus in 2014 and 2015 should be on supporting the economy (by running deficits) while there is still spare capacity.**

**Determining what the appropriate fiscal balance from 2016 onwards should be, is, as noted, difficult because of the uncertainties around future economic growth, spare capacity in the economy and whether or not there is a structural deficit in the public finances.**

This should become slightly easier later this year and next year when the Treasury publishes its Long Term Capital and Revenue Plans.

For now, developing the MTFP with three principles in mind will increase the chances of setting up an appropriate framework within which counter-cyclical policy can be combined with sustainability in the medium term:

1. **Aim to balance the budget over the economic cycle**

This means running surpluses while the economy is at full capacity and growing strongly, and running deficits when the economy is weak, such that over the whole economic cycle the surpluses and deficits broadly cancel each other out.

Jersey's last complete economic cycle (2000-2007, peak to peak) lasted about seven years. Economic cycles tend to last longer than a single MTFP period; and the most recent recession has been different to any other, making it hard to assess where the economy is in the current cycle. This means that it may not be appropriate to aim for structural balance over a single MTFP period.

**If there is a structural deficit in the public finances, the States should plan to address it once the economy has recovered. Structural changes in taxation, or expenditure programmes are easier to introduce once the economic recovery is fully established. This will be an important consideration for the next MTFP.**

2. **Adopt prudent assumptions for income and realistic assumptions for expenditure**

Using a prudent estimate of the tax base and future revenue growth, and realistic assumptions for expenditure will increase the likelihood that the States will be able to carry out countercyclical fiscal policy - run surpluses in the good times (putting money into the Stabilisation Fund) and deficits in the bad times (paid for by the money in the Stabilisation Fund).

Cautious assumptions about States' revenue would seem sensible in that it is easier to adjust fiscal policy if revenue turns out to be higher than expected over an economic cycle, as compared to a situation where there is a shortfall.

Projections of expenditure should also be cautious, bearing in mind that the structural level of unemployment may have risen and that increasingly, the ageing population will impact on public services and expenditure.

**3. Include flexibility within a clear framework for expenditure**

It is not clear yet when, or if, spare capacity in the economy will be used up between 2016 and 2019. Uncertainty means that flexibility should be built in. For example, this could include flexibility so that the timing of some expenditures (for example, capital expenditure) could be adjusted in response to economic conditions as they become clearer.

## 2.3 Strategic Reserve

Draft Budget 2015 sets out the purpose and rules for using the Strategic Reserve including:

- The capital value of the Reserve is only to be used in exceptional circumstances to insulate Jersey's economy from severe structural decline or natural disaster.
- The capital value is £651m, the value of the Reserve at the end of 2012. From 2013, the capital value will be maintained in real terms by uprating by Jersey annual RPI(Y).
- That the Fund may be used if necessary to provide funding for the Bank Depositors Compensation Scheme (not exceeding £100m)
- That real investment returns will be used to pay for the cost of the new hospital (up to £297m) over the next ten years.

If the Strategic Reserve only grows at the rate of inflation in the future, its value will probably fall relative to the size of the economy and States' expenditure, both of which tend to increase in real terms. In this case the Strategic Reserve would become less effective, should it be required to help in the type of exceptional circumstances it is intended for.

Figure 2.9 demonstrates this by showing a projection for the net asset value of the Strategic Reserve as a % of GVA over the next ten years, assuming that investment returns are 5% a year and Jersey's economy grows at 5% a year in nominal terms (consistent with our economic growth forecast and the economic assumptions used in Budget 2015). In this scenario, the value of the Strategic Reserve remains at just over 20% of GVA.

**Figure 2.9**

**Strategic Reserve net asset value as a % of GVA (before hospital cost)**

Source: States of Jersey Treasury, and Panel calculations

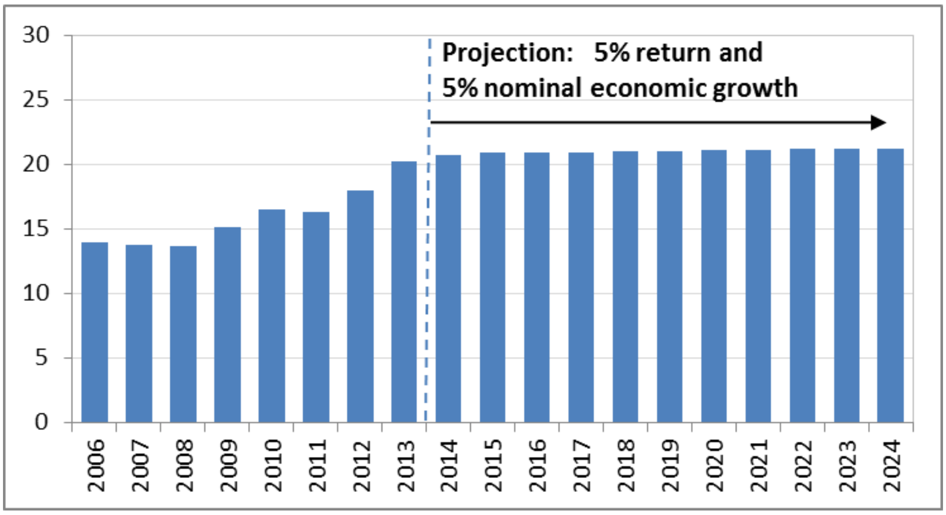



Figure 2.10 shows a similar scenario for investment returns and economic growth but includes the impact of the cost of the new hospital (red bars) and the associated foregone investment returns.

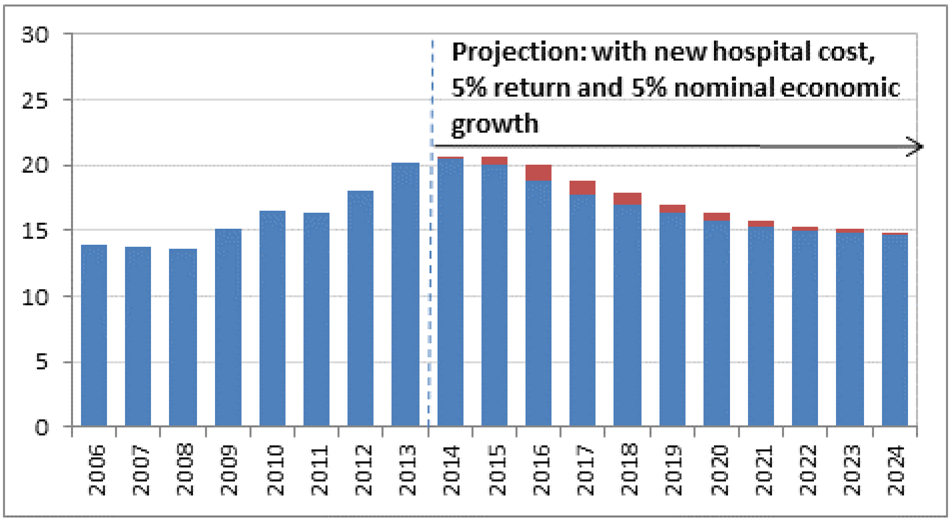
**Using the Strategic Reserve to pay for the hospital over the next ten years is expected to reduce the value of the Strategic Reserve as a % of GVA from about 20% of GVA in 2014 to about 15% of GVA by 2024.**

**Figure 2.10**

**Strategic Reserve net asset value as a % of GVA (after hospital cost)**

Red area shows the expected cost of the new hospital

Source: States of Jersey Treasury, Panel calculations




The future size of the Strategic Reserve is sensitive to the investment return each year. A nominal return of 6% a year on average, for example, would leave the value of the Strategic Reserve at about 16.5% of GVA by 2024, whilst a much higher (and less likely) return of around 8% a year on average would maintain the value at about 20% of GVA.

**It is hard to say what the optimum size for the Strategic Reserve should be. However, 15% of GVA is not a very large buffer, given the likely large impact of any events that might warrant the use of the Strategic Reserve.**

**The States should monitor the value of the Strategic Reserve in future relative to the size of Jersey's economy and States' expenditure. The States should give an indication of the desired size of the Strategic Reserve.**

### 2.4 Stabilisation Fund

At the end of 2013 the Stabilisation Fund had £1m left in it. There is a proposal in draft Budget 2015 to use this money to help fund the shortfall in States' income in 2014 or 2015, if it occurs.

**The Panel agrees with the £1m transfer out of the Stabilisation Fund, if it is required. If there was more money in the Stabilisation Fund, it would have been appropriate to transfer more out to fund the forecast shortfall in income.**

Box 1 discusses some of the issues around replenishing the Stabilisation Fund.

### Box 1: The Stabilisation Fund and how it could be replenished

Over the course of an economic cycle, parts of States income and expenditure which are sensitive to the economic conditions will adjust. For example, during a downturn, personal income and/or company profits will fall or grow more slowly reducing tax revenue growth, whilst spending on managing and reducing unemployment will increase. Likewise in an upturn, the opposite occurs.

One use of the Stabilisation Fund is to help these "automatic stabilisers" in the economy to work, by building up the Fund in the good times and using the money to fund them in the bad times. Another use is to fund extra stimulus spending in the economy during more severe downturns, which is what happened in 2008.

As Jersey's economy is expected to return to growth, the States should develop plans for replenishing the Stabilisation Fund again, so that it can help during the next downturn.

Given that the purpose of the Stabilisation Fund is to allow fiscal policy to be more countercyclical, the main way in which the States should achieve this is by adjusting fiscal policy so that the States runs surpluses when the economy returns to growth, which can be paid into the Stabilisation Fund.

This approach could be complemented by saving any unexpected windfall revenues, for example one-off tax receipts, or unexpected savings. In addition, department underspends could be returned to the Stabilisation Fund.

## 2.5 Social Security Funds

The 2013 Accounts saw the five Social Security Funds consolidated into the States Accounts for the first time. This includes the Social Security Fund, Social Security (Reserve) Fund, Health Insurance Fund, Jersey Dental Scheme and Long Term Care Fund.

The five funds between them held assets of over £1.3billion as at the end of 2013. Figure 2.2 shows how this compares to total States assets and liabilities. While the Social Security Funds make up a significant portion of the States balance sheet, the balances in each fund are not generally available to fund Departmental expenditure but are ring-fenced for specific purposes. For example, balances held in the Social Security (Reserve) Fund have been set aside for the future provision of pension benefits, to reduce the impact of pensions in future generations and smooth contributions for Social Security benefits over time.

The Social Security Fund and Social Security (Reserve) Fund are subject to review every three years. The most recent of these was carried out by the UK's Government Actuary's Department (GAD) in 2014, looking at the financial condition of the Fund at the end of 2012 and projections out to 2072.

**GAD concluded that the financial outlook for the Fund remains healthy in the short to medium term. However, expenditure would exceed the income of the Fund within five years under GAD's assumptions and the current contribution rate.** The balance on the Reserve Fund would allow benefits to continue to be paid after this but this would be extinguished by 2046 under the central scenario of net migration of 325 people per year. However, this would occur by 2041 with net nil migration or 2066 with net inward migration of 700 people per year.

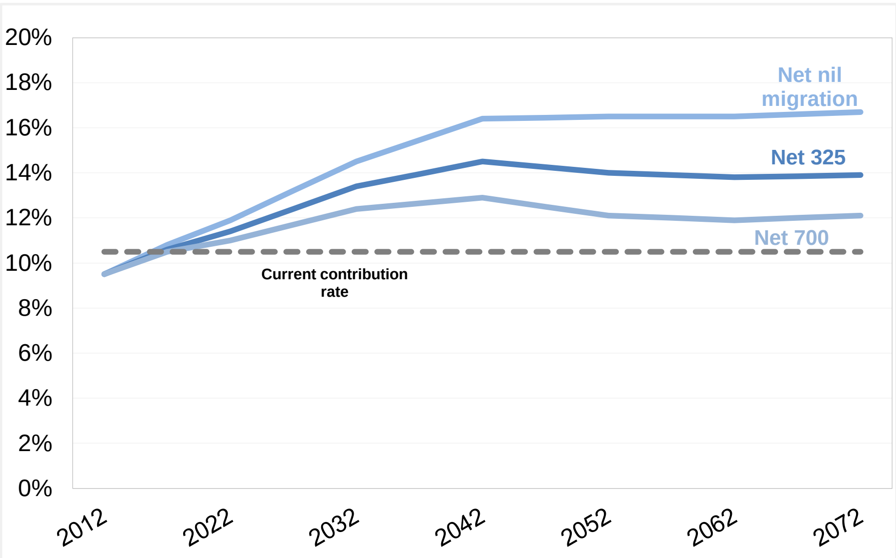
GAD has set out the break-even rate which would be required out to 2072 to ensure that the income for the Fund is sufficient to meet their projections for expenditure. Figure 2.11 demonstrates that break-even rates by 2072 will vary from 12.1% to 16.7%, depending on the migration assumption used. Increasing contributions could be delayed, however, if changes were made to benefits such as increasing the pension age, or if assets were drawn down from the Social Security (Reserve) Fund.

**Figure 2.11**

**Break-even rate projections for Social Security Fund**

Break-even rate (% of earnings) required for income to meet expenditure; based on varying assumptions for migration

Source: Government Actuary's Department




These calculations are sensitive to changes in the key assumptions. Any variations to demographic assumptions, economic assumptions or future pension arrangements could all have a significant impact on the date at which the Social Security Reserve Fund would be exhausted at current contribution rates. For example, assuming investment returns are 4% higher than earnings (rather than 2% higher in the central case) would mean that the Fund would not be exhausted within the sixty year forecast horizon, under either the net 325 or net 700 migration scenarios.

**The long term outlook for the Fund is sensitive to a range of assumptions including demographic, migration, economic, pension arrangements and contribution rates. Therefore it is important that the States continue to monitor the outlook for the Fund through the planned three-yearly actuarial reviews and include the uncertainties and projections in its medium-term fiscal plans and long-term assessments of sustainability.**

## 2.6 Long term fiscal sustainability

Fiscal policy needs to be sustainable over the long term as well as the medium term. The OBR looks at the UK's public sector fiscal sustainability over the long term in two steps:

1. The **fiscal impact of past public sector activity**, as reflected in the assets and liabilities on its balance sheet; and

2. The **potential impact of future public sector activity**, by examining how spending and revenues may evolve in the future – and the impact this would have on public sector borrowing.

The OBR assesses the potential fiscal impact of future government activity by constructing long-term projections of government revenue, spending and financial transactions on an assumption of 'unchanged policy'. A similar approach is taken by a number of other fiscal bodies around the world. The OBR factors in relevant expected future changes, such as demographic changes and expected productivity increases.

The States' balance sheet provides a starting point for assessing Jersey's long term fiscal sustainability (step 1 above). The assets and liabilities that have built up on the States' balance sheet over time show the overall impact of past fiscal policy.

However, care is required when interpreting what the balance sheet means for fiscal sustainability. For example, the States Funds' investments and cash are important for fiscal sustainability, while property and other fixed assets (although being the most valuable group of assets on the States' balance sheet) do not contribute to fiscal sustainability in the same way. They have to be properly maintained and replaced over time to provide public services and could not be readily sold externally.

Also, the balance sheet does not include the impact of future government activity. For example, the States expect the Social Security Funds' assets to grow and help cover future public pension payments. These future assets and liabilities are not included on the balance sheet. It is not always possible to include potential liabilities either.

Importantly, fiscal sustainability is also affected by another future asset – the States' ability to raise taxes in the future.

The next Medium Term Financial Plan, and supporting Long Term Revenue and Capital Plans will provide more useful information to help the States to plan sustainable fiscal policy. Our next annual report will look at long term fiscal sustainability in more detail.

**We would like to improve how we look at Jersey's long term fiscal sustainability in the future. In order to do this we need to look at:**

1. **The fiscal impact of past public sector activity - for example, the assets and liabilities on the States' balance sheet and how they change over time; and**

2. **The potential impact of future public sector activity - projections for States' income and expenditure, and assets and liabilities over the long-term.**

**The States should produce projections for future States income and expenditure for the next 20 years, adopting an approach similar to that used by the UK's Office of Budget Responsibility. This will complement the balance sheet information the States already publishes in its annual accounts.**

### 2.7 Future risks and uncertainties

The future risks and uncertainties to Jersey's fiscal outlook are largely to the downside.

**International financial services environment**

There are uncertainties about how the international financial services environment will develop in the future and there are risks and opportunities for Jersey. These are explored further in the economic outlook section. The opportunities include for example, higher UK interest rates and new markets, while the risks include changes to international regulations and financial services business rationalisation. The States of Jersey has published a Financial Services Industry Policy Framework which sets out a joint strategy for the financial services industry which will require government, the regulator and industry to work together closely in the future.

**Lower long term productive potential**

Jersey's future economic growth potential could be reduced as a result of structural changes that may have taken place in the economy in recent years.

Productivity in the finance sector (as measured by GVA per full time equivalent employee) has fallen significantly. A consistent series is available over the last fifteen years and shows that measured productivity has fallen by almost 3% per year on average over this period.

Within financial services it is the banking sub-sector which has seen the largest fall in productivity – with real GVA per full time equivalent falling at an annual average rate of 6% since 2000. However, measured productivity largely reflects the fall in output of the banking sector which in turn has been driven by low interest rates – rather than being reflective of underlying activity. Were interest rates to recover, a rise in measured finance sector output and productivity could be expected – though this is likely to be a gentle increase over time both. However, external political and regulatory challenges continue to pose risks for the long-term prospects of the finance industry.

GVA for the non-finance sector has been much less volatile but the past trend suggests weak growth in measured productivity.

**The challenges of a population living longer**

In common with many other developed countries, Jersey people are living longer and are expected to live longer in the future.

While this is a good thing, it means there will be fewer people of working age and more people above working age which means that workforce participation (either within working age or above) must increase and/or productivity of those working must increase for the economy to even stay the same size. This could add further fiscal pressures, particularly if it reduces how quickly States income will grow in the future.

At the same time expenditure will inevitably rise in areas such as health care and pension provision. The impact of this will peak as a result of the demographic profile during the mid-2020s to 2030s and the States will need to prepare in advance for the changes this will bring.