Jersey's Fiscal Policy Panel Annual Report

November 2010

Introduction

This is the third annual report of the Fiscal Policy Panel. As required by the States' Fiscal Framework, the report makes recommendations to the Minister for Treasury and Resources and the States on Jersey's fiscal policy and on additions to or subtractions from the Stabilisation Fund and the Strategic Reserve. These recommendations are based on an assessment of the Jersey economy in the context of world economic developments and the risks and uncertainties that the Island faces.

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 stable and predictable;
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 continues to be guided by its understanding of the preferences of Islanders. The Panel feels that Islanders want the States to be prudent, avoid government borrowing 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 a number of occasions in order to keep up with local developments. In this it has greatly benefited 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. It is also grateful for the invaluable support provided by the staff of the States of Jersey, in particular the States of Jersey Economics Unit.

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

Recommendations

- Notwithstanding the fiscal consolidation planned over the next 3 years, the proposed fiscal stance is set to remain supportive of the economy until 2013. This is broadly appropriate given the Panel's latest assessment of the economic outlook.
- The economy appears to be continuing to operate below its potential capacity. It is therefore appropriate to use the Stabilisation Fund to cover the deficits in the near term. However the Stabilisation Fund is projected to be exhausted by the end of 2011.
- In view of the fiscal projections, no further transfers from the Consolidated Fund to either the Strategic Reserve or the Stabilisation Fund are possible at this stage.
- Although the States financial position is extremely tight, the Panel does not recommend using Strategic Reserve funds or borrowing at this stage.
- Propositions or amendments to the Budget that reduce revenues or increase expenditure without offsetting savings or revenue increases will worsen the fiscal position and should be avoided as they will undermine the credibility of the fiscal consolidation and make it more difficult to implement.
- It is important that the guiding principles set out in the Panel's interim report are followed. In particular:
    - Fiscal consolidation should have regard for the consequences for economic growth
    - Focus should be on a credible medium-term fiscal plan
    - Plan to run surpluses once the economy recovers to rebuild the Stabilisation Fund

Section 1 – The Economic Outlook

Key points

International economic outlook

- Significant uncertainty remains around the strength and durability of the global economic recovery.
- A 'double dip' world recession is not the most likely scenario, but there are significant downside risks to the global outlook.
- It would therefore be prudent for Jersey to continue to plan based on a fragile and drawn out global recovery.

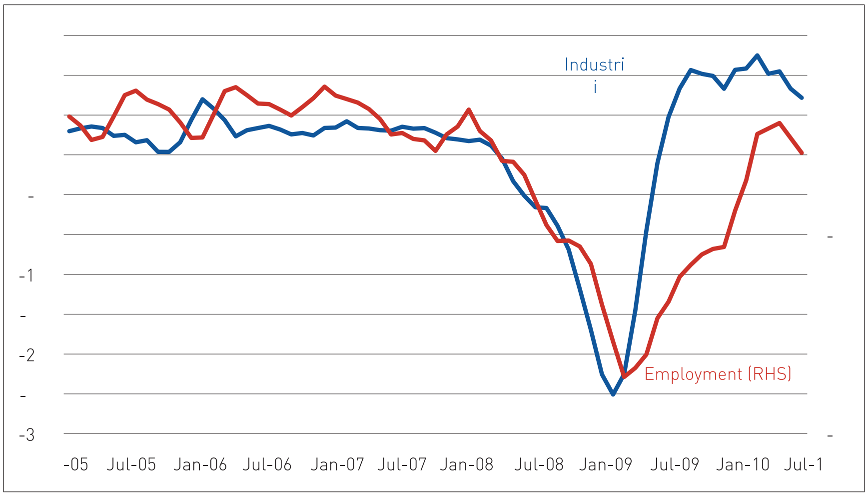
Jersey economic outlook

- When one-off factors are excluded, the sharp fall in financial services profitability in 2009 was largely as expected, leading to a fall in GVA in line with the Panel's forecast.
- The outlook for UK interest rates has softened significantly in the past 12 months, which suggests that the downward pressure on banking profitability in Jersey will be sustained for a longer period than previously expected.
- While there is some optimism in the finance sector for the rest of 2010 and 2011, and activity in the sector has improved, the non-finance sector continues to see significant pressure on business activity and margins, suggesting that 2010 has been another difficult year, and there is substantial uncertainty about 2011.
- The Panel expects a further fall in GVA in 2010, of -2% to -4%. It continues to believe that there is a good chance of moderate growth in 2011, with the central expectation being growth of 0 to 2%.

1.1 International outlook

Most of the major economies have returned to growth after the 'great recession'. Figure 1.1 shows how industrial production and employment have changed in the advanced economies since the onset of the crisis. Both of these indicators began to contract in mid-2008. Industrial production started to grow again in mid-2009, followed by employment at the beginning of 2010.

Figure 1.1
Signs of recovery
Advanced Economies, 3-month moving average (3mma) change on previous month's 3mma, annualised %
Source: IMF WEO, October 2010



However, the outlook for the global economy remains profoundly uncertain. Expectations about the strength of the global recovery have swung about since the beginning of 2010, reflecting fears of fiscal sustainability and contagion in the Euro area, disappointing performance in the United States, and worries over international imbalances and a lack of international coordination. The swings have also been visible both in financial markets and in commodity markets. Equity markets gave up earlier gains before recovering in the autumn. Oil prices – recently a good bell-weather of global trends - softened in mid-year to about $70 per barrel before rising back to over $80. Uncertainly and volatility is likely to continue.

Despite fears over a possible 'double dip', mainstream forecasts, such as those of the IMF,[1] suggest a continuation of recovery (Figure 1.2). Emerging economies, especially China and India, are expected to contribute most to global growth. Growth in advanced countries is expected to be lack-lustre, with downside risks. The recovery in the Euro area, though recently revised up, is expected to be particularly meagre. Year on year, the Euro area is forecast to grow by 1.7% this year and 1.5% in 2011. The IMF forecast for the United Kingdom is 1.7% for 2010 and 2.0% for 2011. The year on year figures are, however, somewhat misleading; the UK is expected to slow quite substantially during the course of 2011 as public expenditure cuts start to bite so that by Q4 2011 year on year growth is 1.6%.

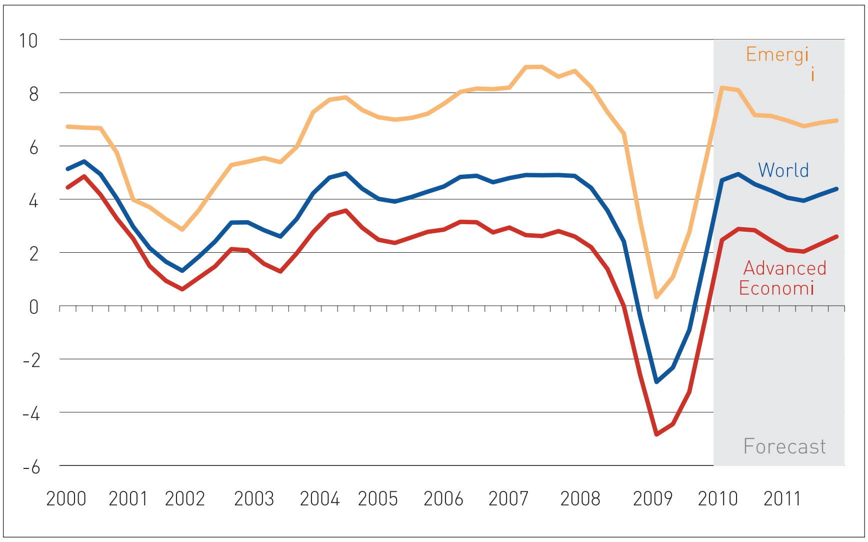
[1] World Economic Outlook, October 2010, International Monetary Fund

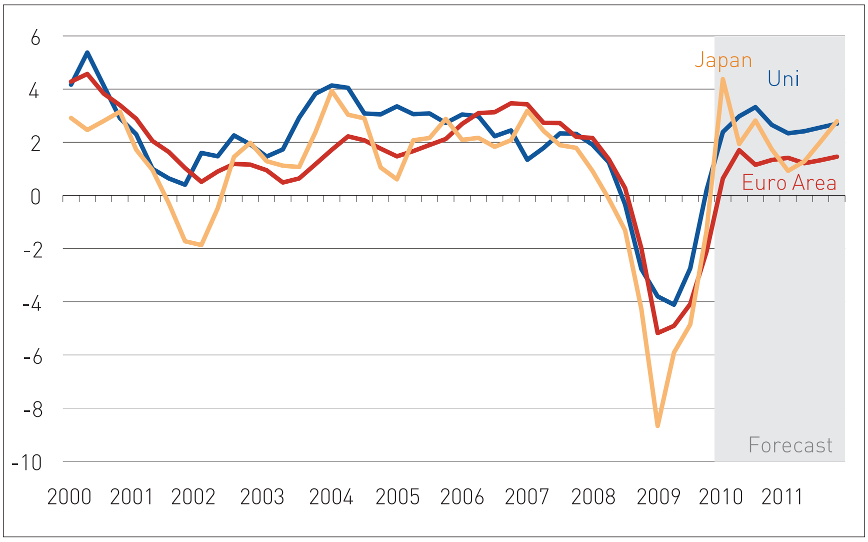
Reflecting the likely continuation of spare capacity, forecasts for inflation in advanced countries in 2011 remain extremely low – under 1½% according to the IMF.

The international background to fiscal policy decisions in Jersey remains highly uncertain and volatile. Though the Panel believes that a 'double-dip' recession is not the most likely outcome, there remain substantial downside risks to the global economic outlook. Caution suggests that Jersey should not be factoring a robust global recovery into its fiscal and economic forecasts.

The crisis has been accompanied by significant movements in exchange rates. For example, sterling has fallen significantly against a basket of currencies, shown as a trade-weighted index in Figure 1.5.

Figure 1.2
IMF forecasts of real GDP Growth
Quarterly % change on year before
Source: International Monetary Fund, WEO Oct 2010



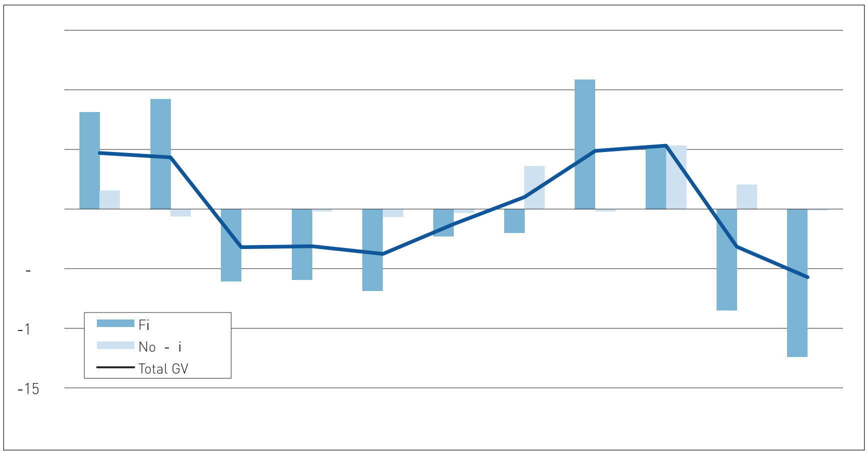


1.2 Jersey economic outlook

Jersey's Gross Value Added (GVA) data have recently been revised (see Box 1). The changes do not materially alter the Panel's perception of the economic situation in Jersey. Although the measured growth rate of economic activity between 2007 and 2008 was revised from +2% to -3%, this was driven by one-off factors which are not representative of the general performance of the economy as a whole. GVA in 2005 to 2007 was also revised, but only slightly.

In 2009 measured economic activity in Jersey was 6% lower than in 2008, driven by a significant, 12%, fall in the output of the financial services sector (Figure 1.3), including a sharp fall in bank profits. This was broadly in line with the expectations of the Panel in previous reports, and with anecdotal and survey data.

Figure 1.3
A breakdown of real Gross Value Added growth
Annual % change
Source: States of Jersey Statistics Unit



Box 1: GVA Revisions

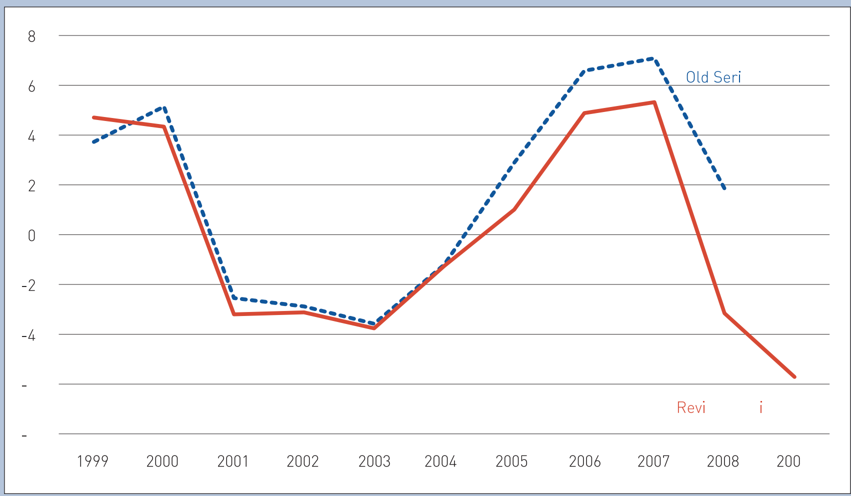
The States of Jersey Statistics Unit has recently revised one of its measures of economic activity. As explained in the 2009 GVA release:

"Following the guidelines of the SNA [System of National Accounts] framework, income transferred to resident parent companies in Jersey from non-resident units (branch-offices, subsidiaries, etc,) operating outside of the Island should not be included in the gross operating surplus (profits) element of GVA. In the 2009 round of the Survey of Financial Institutions, from which the profits element of GVA for the Finance sector is derived, more information as to the nature of the generation of profits was gathered, which indicated that a small number of such transfers of income had been included in all previously published estimates of GVA for Jersey, from 1998 to 2008."

Some profits that were not being generated on the Island had historically been included in measured GVA, when they should have been excluded. Now that these profits have been identified, they have been removed from the GVA figures to make them consistent with international standards and more representative of local economic activity. This income continues to be included in Gross National Income (GNI), which takes into account transfers of income in and out of the Island, so this measure has not been revised.

Figure 1.4 illustrates the effect that these revisions have had on the measured growth rate of economic activity between 1999 and 2009. The shape of the economic cycle has not changed significantly. The level has however shifted. In the old series growth peaked at over 6% in 2007 and remained positive in 2008. In the new series the figure for 2008 shows a significant fall in measured GVA.

Figure 1.4
Annual change in real GVA
1999-2009
Source: States of Jersey Statistics Unit

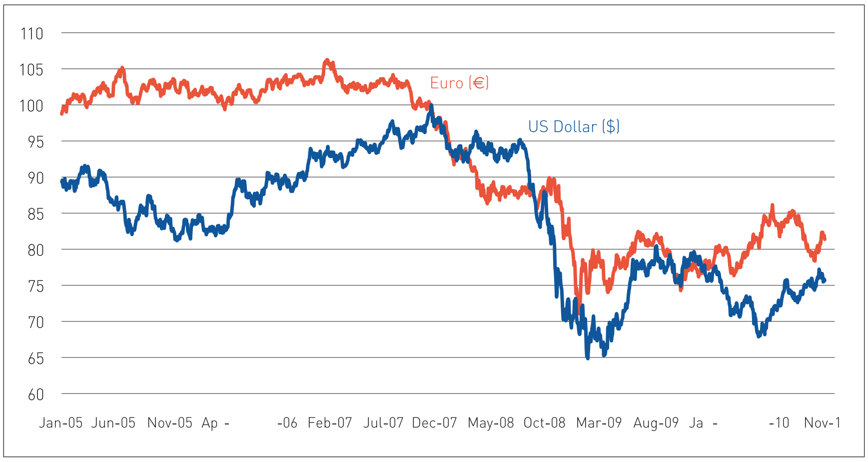


These revisions emphasise the fact that caution needs to be taken when interpreting any one particular economic indicator. This is particularly the case in a small Island economy such as Jersey where one-off events and idiosyncratic developments in a small number of organisations – events that would average out and get lost in the noise in larger economies – can affect the statistics significantly. The Panel has always used all the wide array of economic indicators available to it when forming its judgements and making its recommendations, and therefore these revisions do not change its outlook or any of its previous advice.

The significant depreciation of sterling against the euro and dollar in 2008 has only partially been reversed (Figure 1.5). As an export economy dependent on trade in financial services, tourism, agriculture and internet retailing, an exchange rate depreciation of this sort will have been positive for Jersey, making the Island's exports more competitive and offsetting in part the adverse trends in the wider global economy and financial markets.

Figure 1.5
Sterling exchange rate trends
Index 08/11/2007=100
Source: Bank of England

Note: Exchange rates expressed in terms of Euros or Dollars per Pound, therefore a lower number implies a depreciation of Sterling



The last twelve months have seen financial markets revise their expectations of the future path of UK interest rates significantly downward, as illustrated by Figure 1.6. The light blue line shows the expectations in the Bank of England's Inflation Report, around the time of the Panel's update in November 2009. The red line shows the market's view in the Bank of England's most recent Inflation Report, published this month (November 2010). Interest rates are not now expected to start rising until at least the middle of 2011. In part this reflects the risks to the global recovery and the potential exposure of UK banks to difficulties in the Euro zone. It also reflects fiscal tightening in the UK, which may require interest rates to be lower for longer.

Figure 1.6
Interest rate expectations
Market expectations of the Bank of England base rate, %
Source: Bank of England

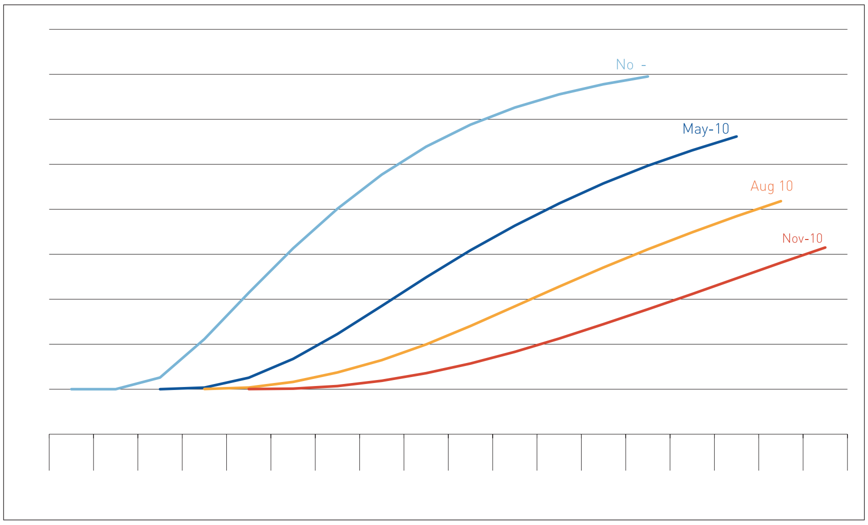
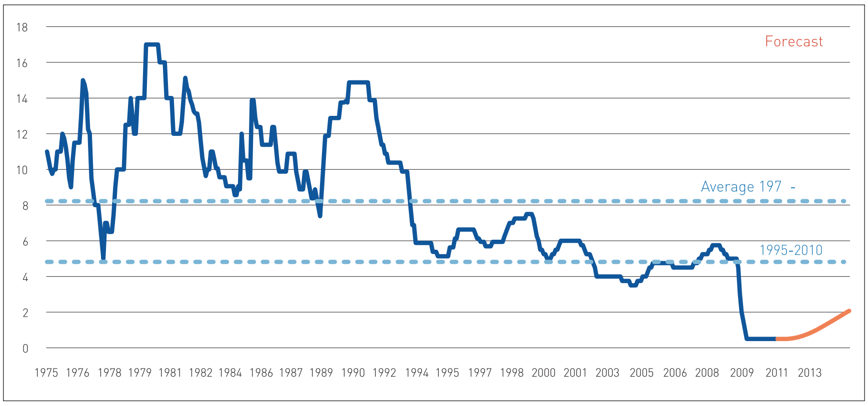


Figure 1.7 puts recent interest rate expectations in a historical perspective. It shows that interest rates in 2009 and 2010 are the lowest for at least thirty-five years. Although the chart does not go back that far, the current level of interest rates is also unprecedented in the 316-year history of the Bank of England. Even by 2013, interest rates are not expected to have reached a level comparable to recent long-run averages (Figure 1.7).

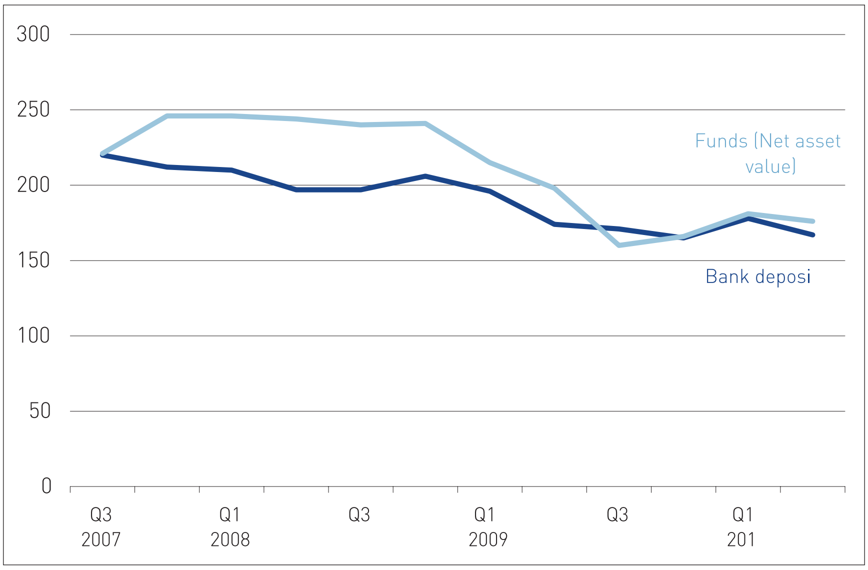
Figure 1.7
Interest rates since 1975
Source: Bank of England



Financial Sector

Indicators of all of the key areas of the financial services sector appear to have stabilised. Data from Jersey Finance (Figure 1.8) show that over the course of the downturn there was a fall in bank deposits and the value of funds under administration, but the sterling value of bank deposits has stabilised since the end of 2009, while the value of assets under management in funds has increased.[2] However, as discussed in previous reports,[3] near-zero interest rates may have a significant adverse effect on the profitability of some banks in the Island – particularly those that rely heavily on net interest income (NII) – due to the effect on interest rate margins.

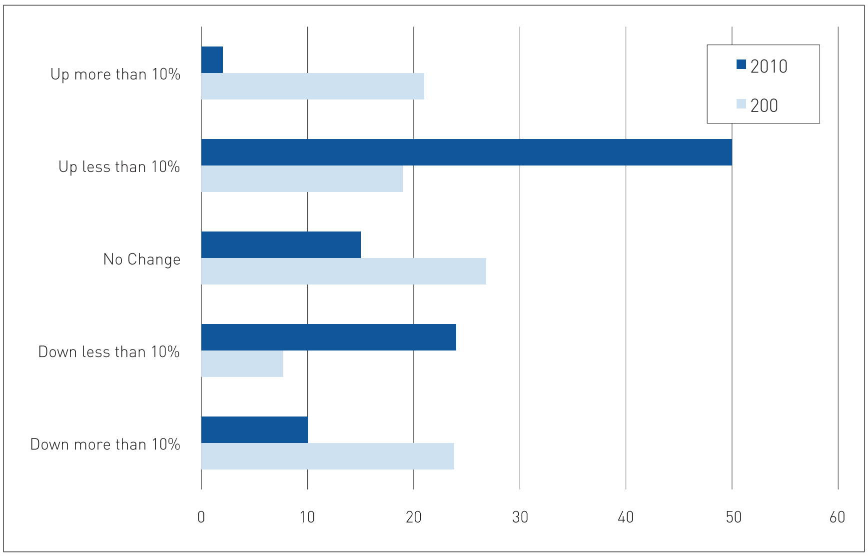
Figure 1.8
Financial services trends
Funds under management and total bank deposits, £bn
Source: Jersey Finance



[2] Jersey Finance Quarterly Report June 2010 available at http://www.jerseyfinance.je/Technical/Statistics
[3] For example, see the box on p11 of the Panel's 2009 Annual Report

Figure 1.9 shows how financial sector firms in the 2010 Survey of Financial Institutions (SFI) expected profits to change between 2009 and 2010. It presents a mixed outlook: nearly half of firms expected profits to increase a little in 2010, but a significant minority (28%) expected falls of more than 5%. Banks were slightly less optimistic than the average firm in the financial sector, perhaps reflecting the difficulties that the low interest rate environment and fierce competition for deposits still posed for them.

Figure 1.9
Financial services profits expectations for 2010
% of respondents (weighted by employment)
Source: States of Jersey Statistics Unit



The most up-to-date information about the economic environment in Jersey comes from the quarterly Business Tendency Survey (BTS). Like any other economic indicator, business surveys have to be interpreted with care. In particular, small movements in the indicators do not usually contain much significant information, and even large movements in either direction can provide false signals of expansions and contractions. However, provided this caveat is borne in mind, the BTS provides some indication of sentiment in the local economy.

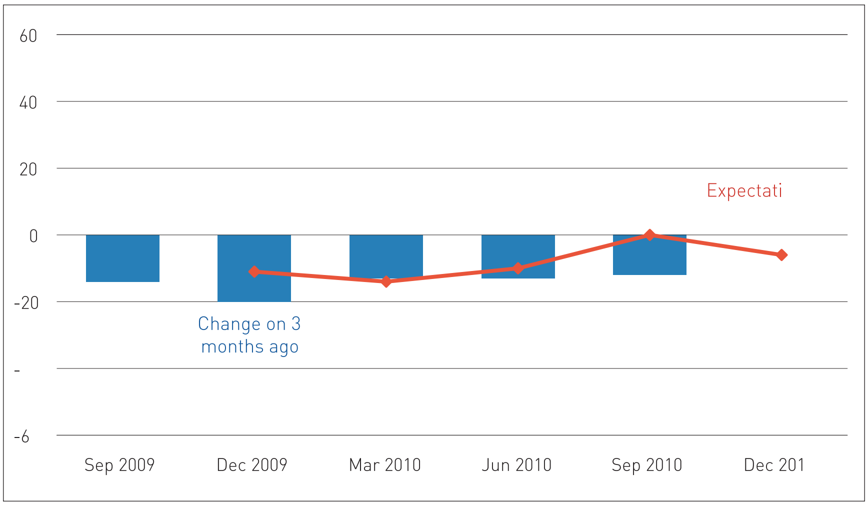
The BTS suggests that on balance financial sector firms continue to see quarter on quarter falls in profitability, but the balance of business activity and expectations of business activity have both picked up and have been positive for several quarters.

The Rest of the Economy

The Business Tendency Survey suggests that the non-finance sector is still seeing falls in economic activity quarter-on-quarter, although the rate of decline appears to have slowed in the past two quarters (Figure 1.10).

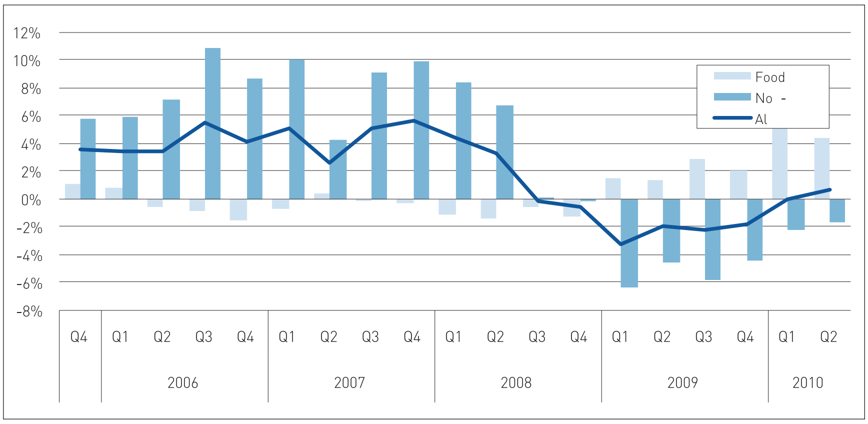
Looking more closely at some of the different industries in the non-finance sector, there are important variations across sectors. In the second quarter of 2010 overall retail sales volumes grew on a year-on-year comparison for the first time since the beginning of 2008. Figure 1.11 shows that this was made up of growth in food sales combined with

Figure 1.10
Business activity in the non-finance sector
Weighted net balance
Source: Jersey Statistics Unit



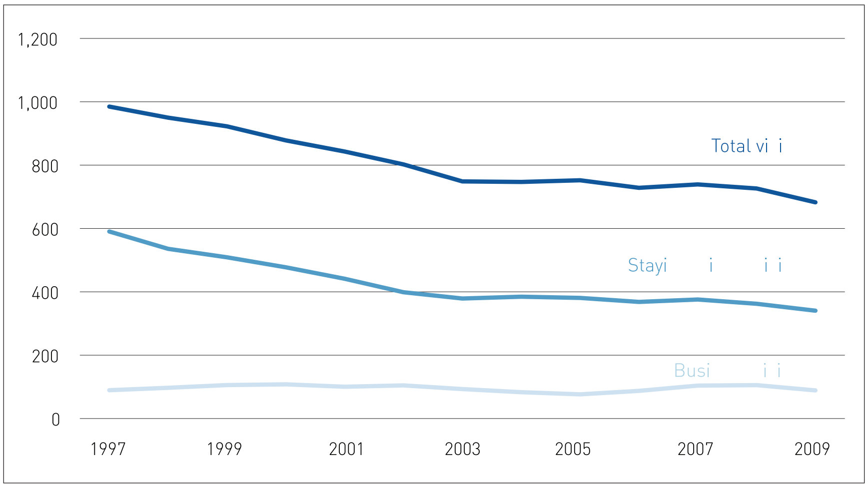
slowing decline in the non-food sector - which has been the area most affected during the downturn. However, the BTS for September 2010 indicated that for the combined wholesale and retail sector activity and profitability continued to fall. Firms reported that they were still reducing employment and were pessimistic about the general business situation. When the Panel met representatives of local retailers in July their views largely resonated with these trends, with some differences at the individual firm level.

Figure 1.11
Retail sales performance
Seasonally adjusted annual change in volume, %
Source: States of Jersey Statistics Unit



Earlier in the year the Panel also met with representatives of the tourism industry and heard that 2010 was turning out to be a difficult year and that the timely allocation of fiscal stimulus funding to support additional advertising was greatly appreciated. Figure 1.12 shows that the number of visitors to Jersey has been on a downward path for a long period of time, driven largely by falling staying leisure visitor numbers. The anecdotal information from the industry was that trading was very difficult this year, especially after the volcanic ash travel disruption. This is reflected in the latest data for 2010 which show that total arrivals in the first nine months of this year were similar to the levels in the same period of 2009.

Figure 1.12
Tourism trends
Number of visitors, 000s
Source: Jersey Tourism



The construction sector is one of the largest non-finance sectors and appears to be faring better than the retail and tourism sectors. When the Panel met representatives from the industry, these encouraging signs were attributed to two key factors – the impact of the fiscal stimulus and signs that private sector activity was beginning to pick up. However, the latest Business Trends Survey shows some deterioration of sentiment in September compared to June.

1.3 Labour Market

The local labour market has been significantly weakened by the downturn. Private sector employment was stable between June 2009 and June 2010, after several years of robust growth. This stability in the headline figure masks a shift in employment from full-time to part-time jobs and a shift from finance to other sectors: the finance sector employed nearly 500 fewer people during this period, while the number of jobs in the construction and wholesale and retail sectors increased.

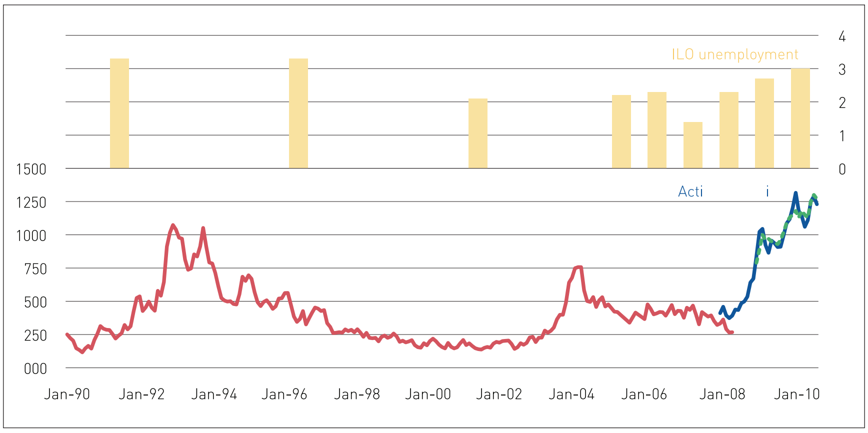
Unemployment measured by the number of individuals registered as actively seeking work with the Social Security department has risen significantly over the past two years and now stands at historically high levels (Figure 1.13). The internationally comparable measure of unemployment – the ILO measure – had risen slightly in summer 2010 compared to 2008 (up from 2.3% to 3.0%), but was still substantially lower than in many other jurisdictions, including the UK where the most recent figure is 7.7%[4].

According to the SFI, nearly 60% of fund managers and over 40% of banks expected to reduce staffing levels in 2010, while the legal sector was relatively optimistic - around 65% of legal firms expected employment to increase. Overall 40% of firms (weighted by employment) expected no change in employment over 2010. Of the remaining 60%, around half expected employment to increase, half expected a decrease, but the predicted falls tended to be larger than the predicted increases.

[4] September 2010

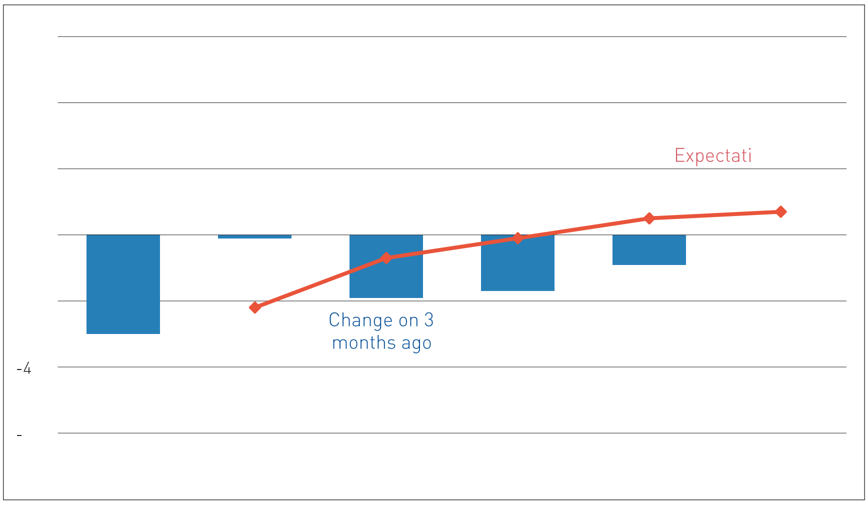
Figure 1.13
Unemployment in Jersey
Number of individuals actively seeking work and ILO unemployment rate (%)
Source: States of Jersey Statistics Unit

Note: There was a break in the ASW series in 2008 as a consequence of the new Income Support System. Broken green line is seasonally adjusted series.



Although 2010 as a whole will have been a difficult year, firms in the finance sector in particular are beginning to be more positive about the outlook for employment in the coming months. Information from the BTS suggests that, although the net balance with respect to employment relative to three months ago was still negative in September, expectations of employment in three months' time has been positive for two quarters in a row (Figure 1.14).

Figure 1.14
Employment expectations of finance sector firms
Weighted net balance
Source: States of Jersey Statistics Unit

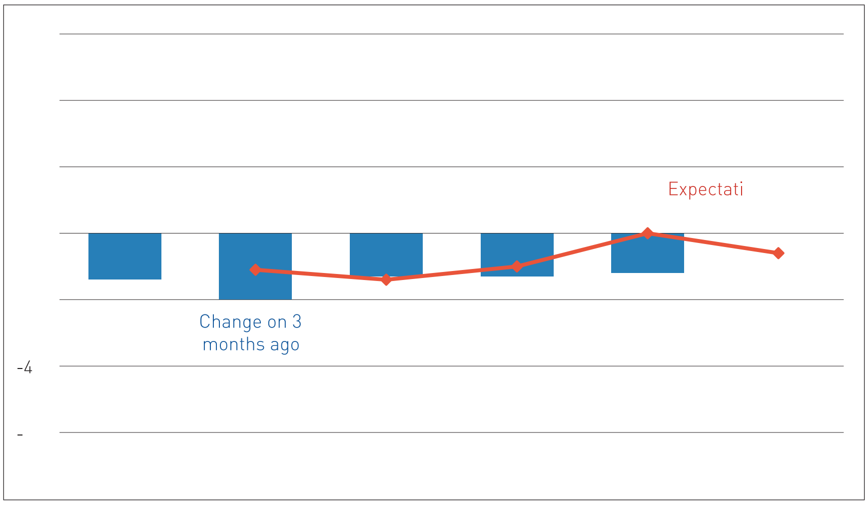


Businesses in the rest of the economy are still seeing quarter-on-quarter falls in employment and expectations remain negative (Figure 1.15).

In summary, there are some positive developments in the outlook. However, it is too early to expect a significant improvement in labour market conditions. The most likely scenario is that the labour market will remain weak for the next 12 months.

Average earnings growth slowed from 3.0% in 2009 to 1.1% in the year to June 2010, another sign that the labour market was weaker than it has been in the recent past. The slowdown was evident in both the public and the private sectors.

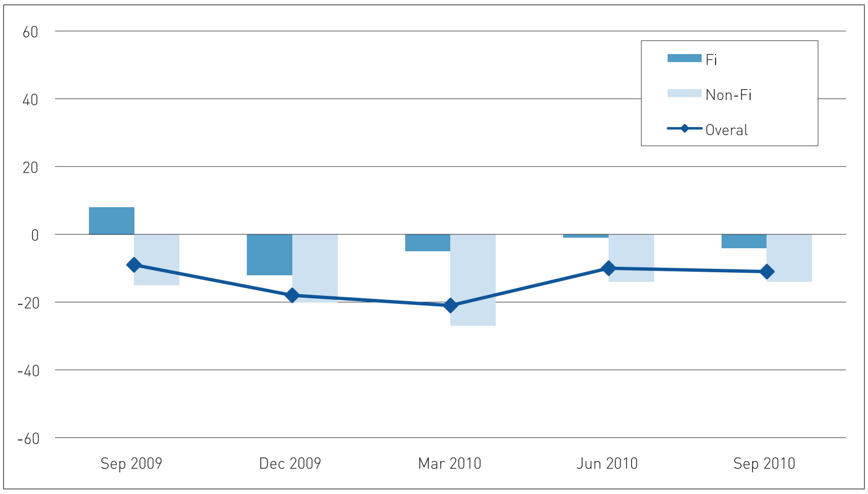
Figure 1.15
Employment expectations of non-financial firms
Weighted net balance
Source: States of Jersey Statistics Unit



1.4 Spare capacity

Given the current economic climate, there is likely to be a degree of spare capacity in the Jersey economy. Unemployment is historically high. Further, it seems plausible that underemployment – defined as those willing and able to work longer hours – has also risen as a consequence of the downturn. Although there are no data on underemployment in Jersey, there are two reasons to believe it may have risen recently: Firstly, the degree to which it has occurred in the UK;[5] and secondly, the shift between full-time and part-time jobs that occurred between 2008 and 2009. Both of these developments would support the view that underemployment has risen, although it is not possible to confirm this with the available data.

Figure 1.16
Capacity utilisation
Weighted net balance of firms reporting activity above/below normal capacity
Source: States of Jersey Statistics Unit



While it is not possible to determine absolute levels of spare capacity from the Business Tendency Survey, it does give an indication of how capacity utilisation is changing over time. Figure 1.16 illustrates the net balance of

[5] Office for National Statistics (2010) Characteristics of the underemployed and overemployed in the UK, in Economic and Labour Market Review, Vol 4 No 7, July 2010

firms in the finance and non-finance sectors responding to the question about the level of capacity utilisation relative to normal. The balance for financial sector firms remains marginally negative, and while the balance for firms in the other sectors is still substantially negative, it is less negative than it was in March.

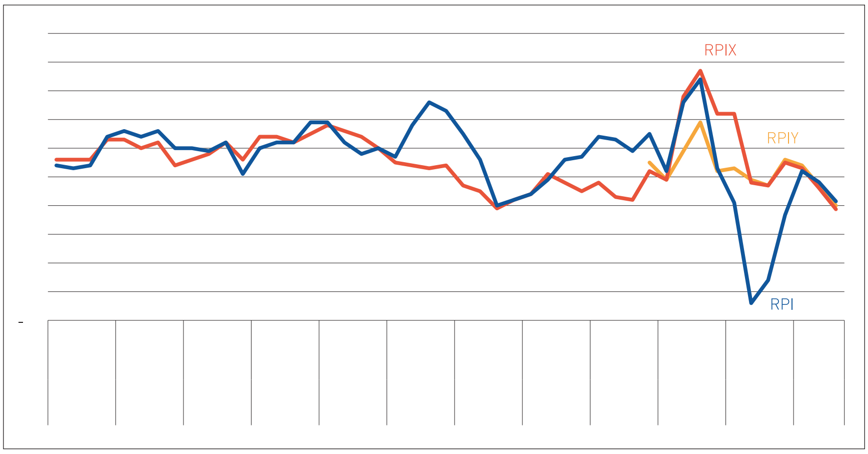
1.5 Inflation

With the exception of a temporary increase in 2008 due to the introduction of Goods and Services Tax (GST) and high global food and fuel prices, inflation in Jersey has been low and stable in recent years, and on the RPIX measure inflation has been relatively close to the 2.5% target (Figure 1.17).

Retail Price Index (RPI) inflation, which includes the effect of mortgage interest rates, fell dramatically from over 6% in September 2008 to -1.4% in June 2009 due to a large fall in interest rates and mortgage interest payments (MIPS).

Inflation as measured by RPIX, which excludes MIPS, and RPIY, which excludes MIPS and indirect taxes, was lower in 2009 and 2010 than in 2008 as food and fuel prices did not increase as quickly. The GST effect also dropped out of RPI and RPIX inflation in March 2009. RPIY is the most appropriate measure of underlying inflation, however as interest rates (and indirect taxes) have not changed over the past year, inflation on all three measures is similar at around 2%.

Figure 1.17
Inflation in Jersey
Annual % change
Source: States of Jersey Statistics Unit



Given the likely spare capacity in the local economy, together with subdued core inflation in the UK and internationally, the inflation outlook remains relatively benign. While there are potential risks to both the upside and the downside, it is expected that local RPIX and RPIY inflation will continue at 1.5-3% for the near future. Should the proposal to increase GST be approved, this would raise RPI and RPIX inflation for a year from June 2011. However, provided salaries and wages do not increase to compensate, this effect should be temporary and not inflationary. RPI inflation will depend crucially on the path of interest rates set by the Bank of England's

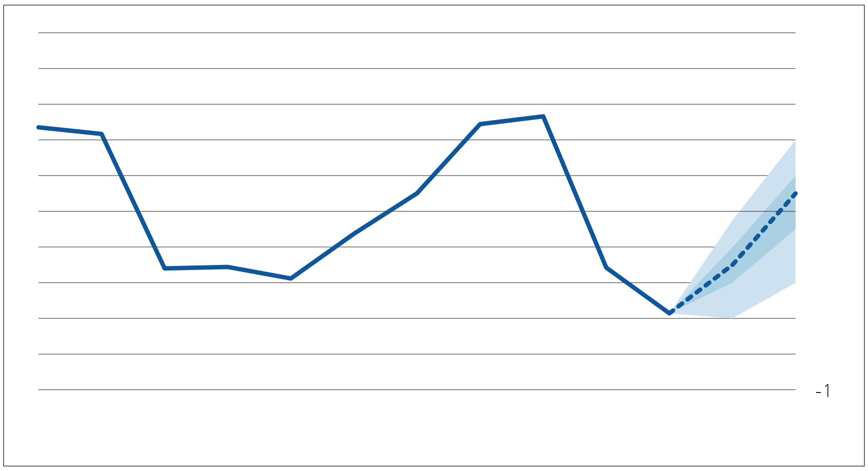
Monetary Policy Committee (MPC); RPI inflation will follow RPIX and RPIY closely until such time as the MPC decides to raise rates.

Should unexpected increases in commodity prices or a more robust economic recovery emerge, prices may increase faster than in this central scenario. Similarly, weaker global demand and economic growth than expected may put greater downward pressure on local prices than the Panel foresees in its central outlook.

1.6 Growth forecasts

To arrive at the best estimates of the path of the economy overall the Panel has combined all the economic data available with the qualitative information it received when meeting with representatives of all the key industry sectors (Figure 1.18). There remains significant uncertainty around these forecasts given the limitations of the data available and the unpredictable nature of the global economic situation and how it will feed through into the local economy. The Panel expects that GVA will contract by around 2-4% in 2010, which is a little weaker than the Panel's previous forecast. Under the central scenario, which includes the effect on real incomes of a rise in GST next year, subdued growth of 0 to 2% is likely in 2011, although this is very dependent on the future path of interest rates and global financial market and economic conditions. Significant downside risks therefore remain.

Figure 1.18
Economic Forecasts
% change in GVA on year before
Source: Panel judgement; States of Jersey Statistics Unit



Section 2: The Fiscal Outlook

Key points

- The developments since the Panel's September interim report do not change the Panel's judgement or previous recommendations. The proposed fiscal consolidation is broadly appropriate given the Panel's latest assessment of the economic outlook.
- The Panel notes that the proposed measures are broadly in line with the guiding principles it set out in its interim report. The Panel welcomes the plan to restore the budget to balance. However, the plan relies on some ambitious savings, and the States does not have a strong record of accomplishment on expenditure control. Efficiency savings and expenditure cuts have to be fully realised if the current plans are to be sufficient. While the references to improved financial management are encouraging, the Panel continues to stress that a change in culture is required if efforts to control expenditure are to be successful.
- Despite the measures proposed, there could still be difficult decisions for future budgets. The Consolidated Fund is forecast to be in deficit in 2012 and there is the potential for revenues to turn out lower, or expenditure higher, than expected in any of the forecast years.
- Although the States financial position is extremely tight, the Panel does not recommend using Strategic Reserve funds or borrowing at this stage. However, should the States go down either of these routes for whatever reason, it would require further consolidation measures in future in order to run sufficient surpluses to pay back any borrowed funds.
- The Panel accepts that the small surplus projected for 2013 is reasonable at this point in time. However, especially as the Stabilisation Fund is projected to be exhausted by the end of next year, it will continue to monitor the situation closely as the economy recovers.

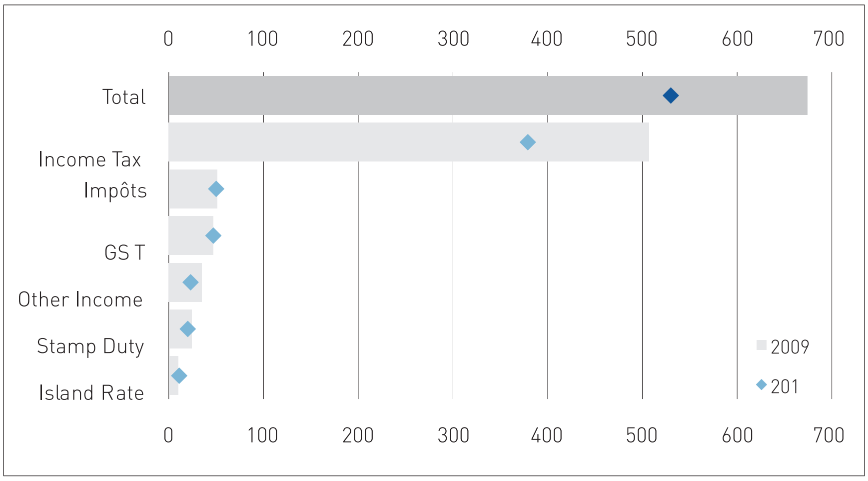
2.1 Background to the public finances

In its Interim Report in September 2010, the Panel reported on the background to the public finances, including the composition of and trends in income and expenditure, the Strategic Reserve and the Stabilisation Fund. The position has not materially changed since then.

Income and Expenditure

In 2009 the States received £674m in income. Income tax continued to be by far the largest source of revenue, contributing nearly £507m, or 75% of the total. Of this, income tax on salary and wages made up around 49%, on companies 43% and self-employed and investment income the remaining 8%. Impôts and GST both brought in around £50m (around 8% of total revenue) each. The remaining 10% came from the Island Rate, stamp duty and other income. In 2010, total income is expected to be £142m lower at £532m. Income tax is expected to fall by £128m to £379m (72% of the total) as a consequence of the economic downturn and the introduction in 2009 of the zero-ten corporate tax system taking effect (Figure 2.1).[6] The effect of zero-ten in 2010 has been estimated at around £80m, with the remaining £50m being due to the economic downturn.

Figure 2.1
States income by source
2009, 2010, £m
Source: States of Jersey Treasury Department



Total net revenue expenditure (NRE) in 2009 was £603m.[7] Nearly 70% of this – around £415m – went to three departments: Social Security, Health and Social Services and Education Sport and Culture. The remaining 30% was divided among the other ministerial and non-ministerial departments (Figure 2.2).

Figure 2.2
Net revenue expenditure
2009, 2010, £m
Source: States of Jersey Treasury Department

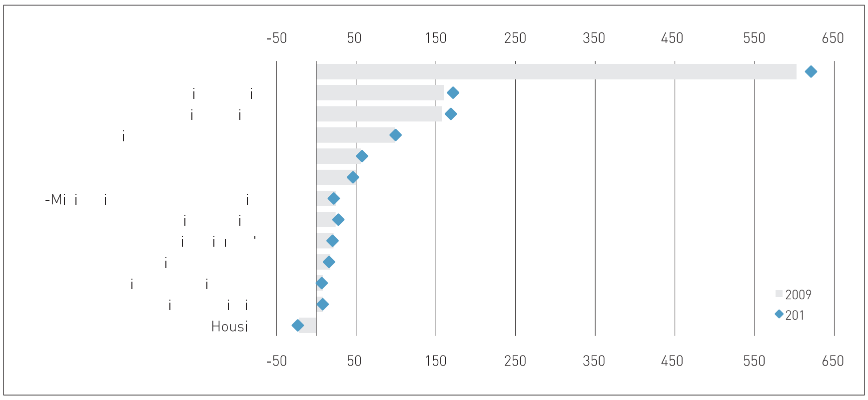


Figure 2.3 shows States' income and expenditure[8] between 1999 and 2009. Between 2001 and 2007 expenditure increased by less than 1% a year in real terms, while income exhibited cyclical fluctuations. Since 2007 both income and expenditure have grown sharply in real terms. Much of this income growth is likely to have been due to early actions to replace lost

[6] Corporate income tax is paid in the year after the year in which the liability is raised. For example, income tax for activity in 2009 is received by the States in 2010.
[7] Net revenue expenditure is current expenditure plus capital depreciation and offsets any income received by departments against their expenditure.
[8] Current expenditure (net revenue expenditure excluding capital depreciation) plus capital allocations

zero-ten revenue (for example GST, introduced in 2008), and some of it will have been cyclical, a result of the buoyant economy, rather than structural. It is also likely that some of the rise in expenditure was driven by the perceived availability of this additional income for spending.

Figure 2.3
Real income and expenditure [8]
£m in 2009 prices (deflated using RPIX)
Broken red line includes EfW expenditure as allocated. Solid red line adjusts to represent spending profile
Source: States of Jersey Treasury Department

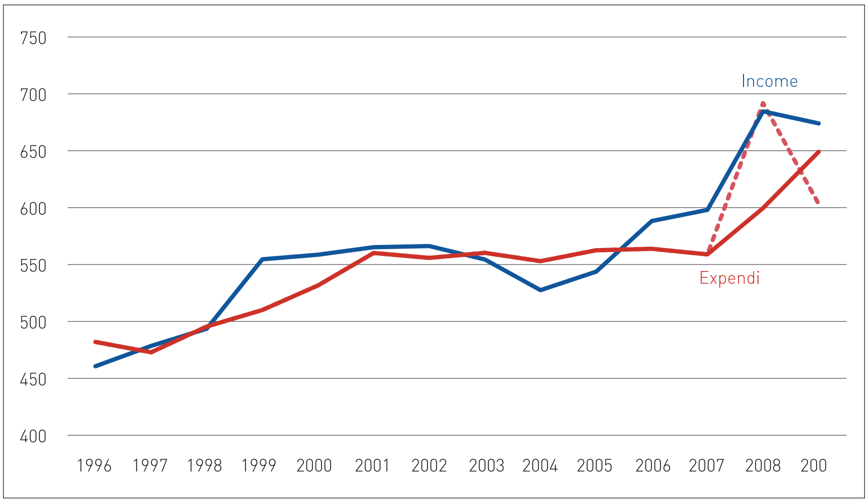
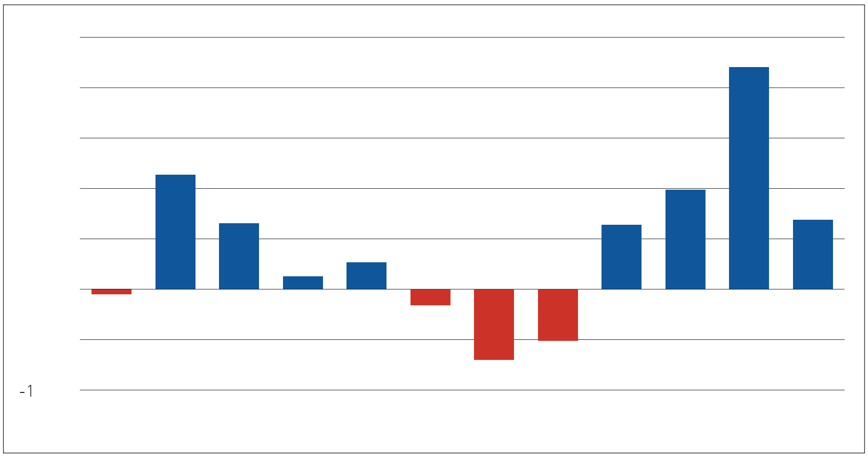


Figure 2.4 depicts the annual surpluses and deficits run by the States between 1996 and 2009 as a proportion of the economy (after the timing adjustments discussed below). Surpluses have tended to occur after years when the economy has done well – reflecting lags in tax collection – and deficits after the economy has been weaker. After the relevant adjustments (see footnote to Figure 2.4), the largest annual surplus over this period was 2.2% of GVA (2008), while the largest annual deficit was 0.7% of GVA (2004).

Figure 2.4
Annual surplus/deficit as a % of GVA
Source: States of Jersey Treasury Department

Note: Based on net revenue expenditure (excluding capital depreciation) plus capital allocations. An adjustment has been made for the large one-off capital expenditure allocation in 2008 for Energy from Waste



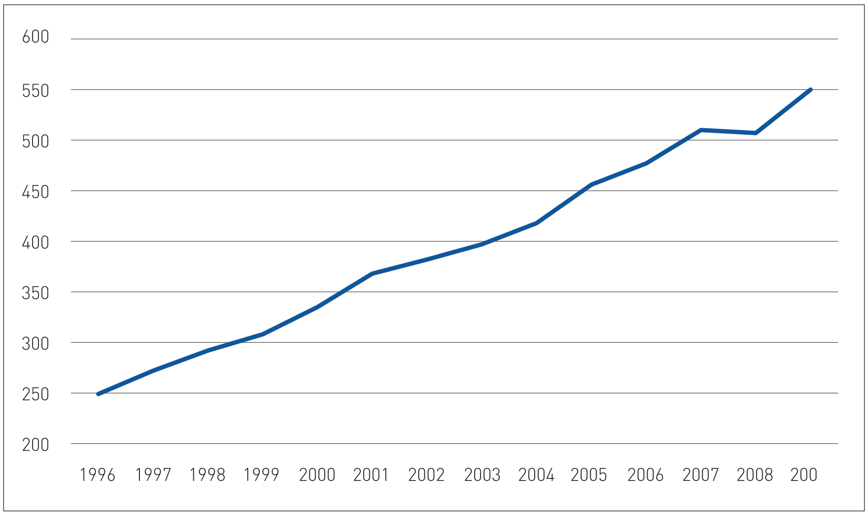
In the light of the anticipated decline in income, the 2010 Budget forecast deficits in the region of £50m over the period 2011-2013 (Figure 2.5). In its 2009 report the Panel judged that a large part of the deficit could be structural and reiterated its recommendation that the States make plans to address the structural deficit once economic conditions improved. Since then the Comprehensive Spending Review has identified additional spending pressures that need to be financed, so the problem faced in the absence of any corrective action is slightly larger and more likely to include a significant structural element.

Figure 2.5
Budget 2010 forecast of fiscal balance
£m
Source: States of Jersey Treasury

Strategic Reserve

The Strategic Reserve has existed since 1986, and is intended to be used in exceptional circumstances such as a natural disaster or a significant, permanent or long-lasting economic change. Figure 2.6 shows how the balance in the Strategic Reserve has grown steadily since 1996, and now stands at £550m.

Figure 2.6
Strategic Reserve net assets
£m, current prices
Source: States of Jersey Treasury Department



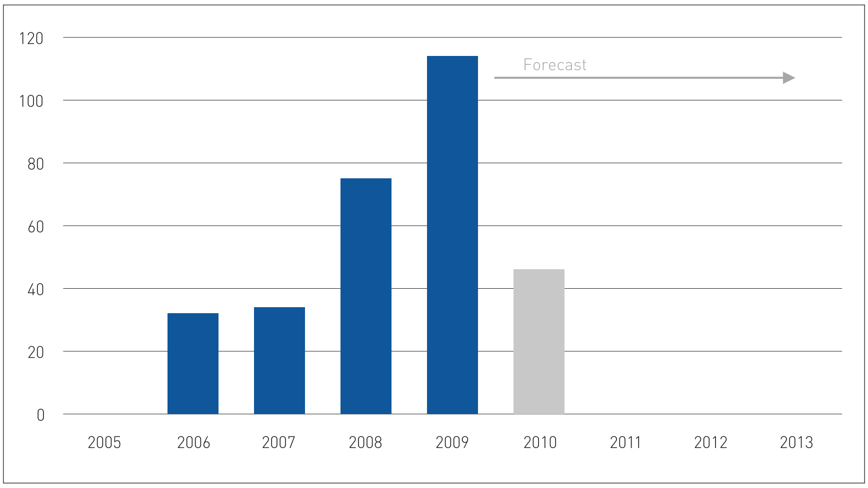
Stabilisation Fund

The Stabilisation Fund was created in 2006. It is intended to be used over the course of the economic cycle for facilitating counter-cyclical fiscal policy so that, when the economy is strong, excess revenues are transferred to the Stabilisation Fund and when the economy is weak, the money in the Stabilisation Fund is used to finance either budget deficits arising from unchanged fiscal policies (the automatic stabilisers), discretionary fiscal measures, or both.

Figure 2.7 shows the balance of the Stabilisation Fund since its inception in 2006 up until 2012. Between 2006 and 2009 the balance increased as money was put aside when the economy was doing well. From 2009 onwards the balance dropped as funds were used to pay for the £44m fiscal stimulus package agreed by the States in 2009 and budget deficits during the downturn (estimated at £101m in 2010[9] and £55m in 2011, after the measures proposed in the draft 2011 Budget). The result is that by the end of 2011 the balance is expected to be zero. In order that the Stabilisation Fund can continue to play a role in counter-cyclical fiscal policy it will be necessary to rebuild the Stabilisation Fund as and when the economy begins to grow again.

Figure 2.7
Stabilisation Fund net assets
£m, current prices
Source: States of Jersey Treasury Department

Note: Figures refer to year end, so for 2009 include a transfer out of £44m for fiscal stimulus



[9] £68m of the £101m deficit will be taken from the Stabilisation Fund. £33m will be funded from the excess balance of over £20m in the Consolidated Fund at the beginning of 2010.

2.2 Current situation and short-term outlook

Figure 2.8 shows the financial forecasts from the draft 2011 Budget. After all the proposals have been taken into account, the deficit is forecast to improve over three years from an estimated £101m in 2010 to an £8m surplus in 2013.

Figure 2.8
Public Finances: Draft 2011 Budget
Source: States of Jersey Treasury

Outturn 2009 £m	Estimate 2010 £m		Forecast 2011 £m	2012 £m	2013 £m
674	532	Income	564	618	646
559	630	Expenditure	619	636	638
71	**-101**	**Surplus/Deficit**	**-55**	**-18**	**8**
		Consolidated Fund			
51	**53**	**Opening Balance**	**20**	**11**	**-7**
71	-101	Surplus/Deficit	-55	-18	8
-63		Transfer to Stabilisation Fund			
44	68	Transfer from Stabilisation Fund	46		
-44		Fiscal Stimulus Allocation			
-6		Other Adjustments*			
53	**20**	**Estimated Consolidated Fund balance**	**11**	**-7**	**1**
		Stabilisation Fund	**11**	**-7**	**1**
95	**114**	**Opening Balance**	**46**	**0**	**0**
19	-68	Transfer to/from Consolidated Fund	-46	0	0
114	**46**	**Estimated Stabilisation Fund balance**	**0**	**0**	**0**

* Other adjustments are necessary for a number of reasons, including that the outturn surplus/deficit is calculated on a different basis to the unallocated Consolidated Fund balance.

Figure 2.9 sets out how projected income, expenditure and deficits have changed since the Panel issued its interim report in September. These differences have been driven by changes in three areas. Firstly, the financial forecasts have been updated to take into account the latest tax and economic information. Secondly, more ambitious savings targets have been agreed by the States as part of the Comprehensive Spending Review (CSR) process. Finally, the draft Budget has announced the Treasury Ministers' intentions concerning the Fiscal Strategy Review (FSR) proposals and other budget measures.

Figure 2.9
Change in financial forecasts since September
£m
Source: Panel analysis based on figures from States of Jersey Treasury

	2010			2011			2012			2013		
	Sept-10	Now	Change	Sept-10	Now	Change	Sept-10	Now	Change	Sept-10	Now	Change
Income												
Baseline	549	532		557	542		581	564		601	591	-10
FSR	0	0		22	19		48	32		56	33	-23
CSR	0	0		0	0		0	0		0	0	0
Budget	0	0		0	4		0	8		0	8	8
TOTAL	**549**	**532**		**579**	**565**		**629**	**604**		**657**	**632**	**-25**
Expenditure												
Baseline	641	633		641	631		674	671		707	703	-4
FSR	0	0		0	1		0	-14		0	-14	-14
CSR	0	0		-12	-12		-25	-35		-50	-65	-15
Budget	0	0		0	0		0	0		0	0	0
TOTAL	**641**	**633**		**629**	**620**		**649**	**622**		**657**	**624**	**-33**

The forecasts of revenues have been revised downward for a variety of reasons, not least because the latest information from the Taxes Office suggests that tax revenues for 2010 will be lower than previously forecast. Additional CSR savings of £10m and £15m were agreed by the States for 2012 and 2013 respectively. Expenditure has also been revised down slightly between 2011 and 2013 due to revised forecasts of expenditure on Social Security and Income Support. Revenue from proposed tax changes – whether through FSR or budget measures – have not changed significantly, although the composition has shifted slightly from FSR measures to budget measures. Overall, the deficit is projected to be around £9m worse in 2010 than expected in September, gradually moving to an £8m improvement by 2013.

On the revenue side, the proposals for tax increases included in the draft Budget are worth £22m in 2011, rising to £55m by 2013 (Figure 2.10). The majority of this will be raised by putting in place FSR measures. An additional 2 percentage points on GST from June 2011, raising it to 5%, contributes £30m by 2013. Introducing a new rate of social security contributions of 2% for employers and employees will raise around £16m by allowing the States to reduce the amount by which it supplements the Social Security Fund. Increases in International Service Entities (ISE) fees (the fee that certain companies pay instead of GST), impôts and stamp duty raise the remainder.

Figure 2.10
Summary of proposed FSR and Budget revenue measures
Source: States of Jersey Treasury

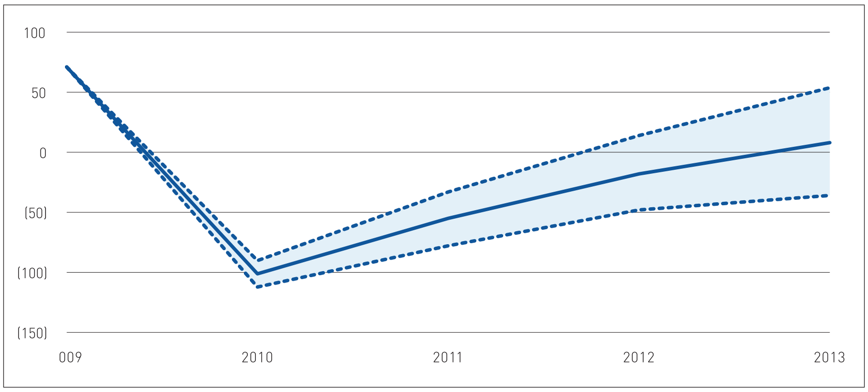
Measures (£m)	2011	2012	2013
FSR measures			
2% on GST to 5% from 1 June 2011	16	29	30
2.0% employee soc sec above ceiling Jan 2012	0	8	8
GST compensation	-1	-2	-2
ISE fees increase £100 to £200	3	3	3
2.0% employers soc sec above ceiling Jan 2012	0	7.5	7.5
Total FSR	**18**	**46**	**47**
Other budget measures			
Impôts	3	3	3
Stamp duty/LTT (1 June 2011)	1	2	2
Exemptions uprated by 1.1% in 2011 for 2012		2.5	2.5
Budget 2011 measures		0.5	0.5
Total other budget measures	**4**	**8**	**8**
Total FSR + Budget	**22**	**54**	**55**

The Budget document also refers to work under way to develop improved financial management. The Panel are supportive of progress in this area, but feel it appropriate to reiterate that changes to processes are necessary but not sufficient, and will need to be combined with a change in culture and attitude across all parties in the decision process.

The proposed tax increases, combined with the savings from the CSR, should they be fully realised, would result in the deficit profile illustrated in Figure 2.11.

Figure 2.11
Projected surplus/deficit
£m
Source: States of Jersey Treasury

Note: The blue bands illustrate the judgement of the Treasury about the degree of uncertainty around the central projection



The Consolidated Fund balance will be run down from £53m at the end of 2009 to £11m in 2011 (Figure 2.8). In 2012 it is forecast to be £7m in deficit, before returning to a positive balance in 2013. The Stabilisation Fund is depleted in 2011. Although the States financial position is extremely tight, with no margin for error, the Panel does not recommend using Strategic Reserve funds or borrowing at this stage. However, should the States go down either of these routes, for whatever reason, it would require tighter policy and further fiscal consolidation in future in order to run sufficient surpluses that the borrowed funds could be paid back. If the States is to stay within the letter of the Fiscal Framework, any money withdrawn from the Strategic Reserve should be considered 'borrowing', just as funds from the financial markets would be, and the intention should be that this is paid back in future years.

2.3 The economic impact of the proposals

A key element of the Panel's remit is to assess the degree to which fiscal policy is acting in a stabilising manner – supporting the economy in tough times, and dampening overheating in better times. In order to assess the impact of the proposals, it is necessary to adjust the timing of expenditure set out in the budget so that the deficit better reflects when funds are being put into the economy, rather than when they are allocated for budgeting purposes. This is done in Figure 2.12.

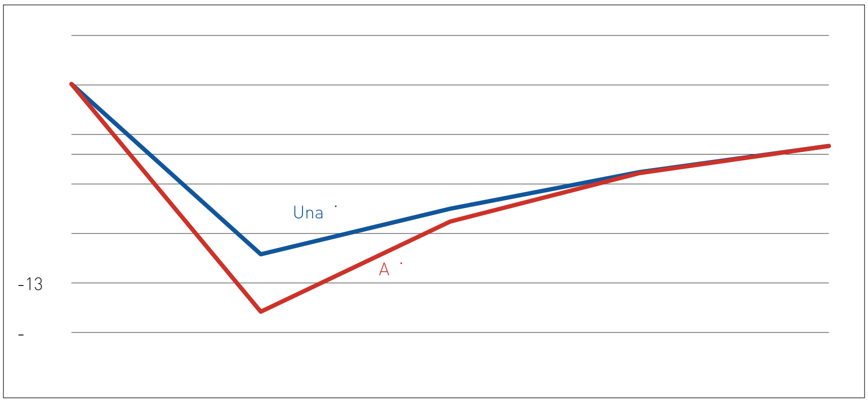
Figure 2.12
Projected fiscal balance, adjusted for the timing of expenditure
Source: States of Jersey Treasury, Panel calculations

Outturn 2009 £m	Estimate 2010 £m		Forecast 2011 £m	2012 £m	2013 £m
71	**-101**	**Deficit**	**-55**	**-18**	**8**
		Timed Adjustments			
	27	Energy from Waste	11	1	
	31	Fiscal Stimulus	2		
71	**-159**	**Adjusted Surplus/Deficit**	**-68**	**-19**	**8**

The States will be putting around £160m (equivalent to around 4.5% of GVA) more into the economy in expenditure than it is taking out in taxes and duties in 2010. In 2011 and 2012 the equivalent figures are £68m and £19m, 1.9% and 0.6% of GVA respectively (Figure 2.13). It is not until

2013 that the States is projected to be running a fiscal surplus, and even then of only £8m, or 0.2% of GVA. The Panel continues to believe that it is broadly appropriate, given the current economic outlook, for fiscal policy to continue to support the economy, albeit to a diminishing extent, until 2012, and for the budget to be broadly in balance in 2013. Should the economic outlook change, however, the Panel would need to reconsider its advice.

Figure 2.13
Projected fiscal balance, before and after timing adjustments
£m
Source: States of Jersey Treasury, Panel calculations



In previous reports, the Panel has recommended that, given the severity of the economic downturn, the Stabilisation Fund be used to finance the temporary deficits that arise from a discretionary fiscal stimulus package and from allowing the automatic stabilisers to operate. This continues to be the Panel's advice, but it notes that the Stabilisation Fund will be depleted in 2011 (Figure 2.8).

2.4 Evaluation of overall strategy against guiding principles

In its Interim Report, the Panel set out three guiding principles that it believes the States should consider when designing an overall fiscal strategy. These are:

1. Fiscal consolidation should have regard for the consequences for economic growth
2. Focus should be on a credible medium-term fiscal plan
3. Plan to run surpluses once the economy recovers to rebuild the Stabilisation Fund

The Panel has assessed the plans set out in the Budget against these three principles, and each is discussed in turn below:

1. Regard for economic growth

The Panel has stressed the need to consider the supply side of the economy as well as the demand side. The budget and FSR proposals appear to have been developed with regard to the impact on economic growth. The Panel appreciates the political difficulties in deciding on the balance of measures used to raise revenues. It notes that a large part of the tax increases will come from GST, which meets the requirement of being a relatively growth-neutral tax and which is unlikely to have a harmful effect on the supply side of the economy provided that the broad base is fully maintained. However, increases in employer social security contributions may inhibit employment.

The CSR proposals do not appear to involve any major cuts to key services which might have impeded growth. Rather they aim to achieve significant efficiency savings. If achieved, this can be expected to be positive for the economy, especially in an island economy with limited resources.

2. Credible medium-term fiscal plan

Realistic and specific proposals have been put forward with regards to raising revenue and the Panel welcomes the measures proposed to improve expenditure control. However, there are some areas that the Panel would highlight as potential issues.

First, while the Panel welcome the plan to restore the budget to balance by 2013, the planned consolidation relies on some ambitious savings, and the States does not have a strong record of accomplishment on expenditure control. Combined with the limited margin for error built into the consolidation plan, the Panel feel it important to emphasise that efficiency savings and expenditure cuts have to be fully realised if the current plans are to be sufficient. If the expenditure savings targets are not achieved then it will likely require further action on the revenue side to realise the desired fiscal outcome.

Second, the Panel, while not against amendments to the budget per se, believes it is important to emphasise that unfunded amendments – i.e. amendments that reduce revenues or increase expenditure without offsetting savings or revenue increases – will not only worsen the fiscal position but will also undermine the credibility of the consolidation strategy and make it more difficult to implement. This is particularly important when forecast income and expenditure are already finely balanced.

Third, the Budget as proposed potentially leaves some difficult decisions until future budgets. In particular, it projects a negative balance of the Consolidated Fund at the end of 2012, and small balances in each of the other forecast years. Under the Finance Law it is not permitted for the Treasury Minister to propose a budget that is forecast to lead to a negative Consolidated Fund balance at the end of the forthcoming year. Given the potential for revenues to turn out lower than expected in any of the forecast years and uncertainty about whether savings will be achieved, it is far from assured that the current measures will be sufficient. In addition, it remains possible that changes may be required to the corporate tax regime and these uncertainties are compounded by the other pressures on States finances outlined in section 2.5.On the other hand, the Panel notes that the growth assumptions behind the financial forecasts are cautious,[10] so there may be room for flexibility to reconsider tax increases or expenditure decisions should circumstances be better than expected. The focus should remain on providing stability and a credible strategy should circumstances change.

3. Run surpluses once the economy recovers to rebuild the Stabilisation Fund

After the FSR, CSR and Budget changes, a small surplus is projected for 2013. The Panel accepts that this is reasonable at this point in time, but will continue to monitor the situation to see whether there will be sufficient revenue when the economy recovers to rebuild the Stabilisation Fund, given that it is projected to be exhausted by next year.

2.5 Long-term pressures

Several of the concerns about the longer-term sustainability of the public finances that the Panel have highlighted in previous reports have begun to be addressed to some extent as part of the CSR and FSR processes. Expenditure forecasts are likely to be more realistic and financial control stronger as a result of the CSR process, which should put the States in a better position to plan for future spending. Equally, raising revenues to balance the budget will put the States in a stronger position going forward.

However, there remain challenges on the horizon that are likely to put further pressure on the public finances. As mentioned in previous reports, the impact of an ageing population on tax revenues and public expenditure is likely to continue to pose challenges going forward. It is therefore important to be prudent, and take this into account when making decisions relating to ongoing income and expenditure.

The assessment of the 0/10 regime by the EU Code of Conduct Group has still to be completed and there is still some uncertainty about what the outcomes will mean for the corporate tax structure and revenues in Jersey. In addition, attention is likely to remain on offshore centres in the post financial crisis world.

Finally, while economic growth could potentially help to deal with some of these pressures, it is not yet clear what the sources of productivity growth might be. Low productivity growth could mean slower growth in the economy and the tax base, and therefore make raising revenue to finance expenditure more difficult in the future.

[10] The central financial forecasts are based on assumptions for GVA growth of 1% in 2011, and 2% in each of the following years.