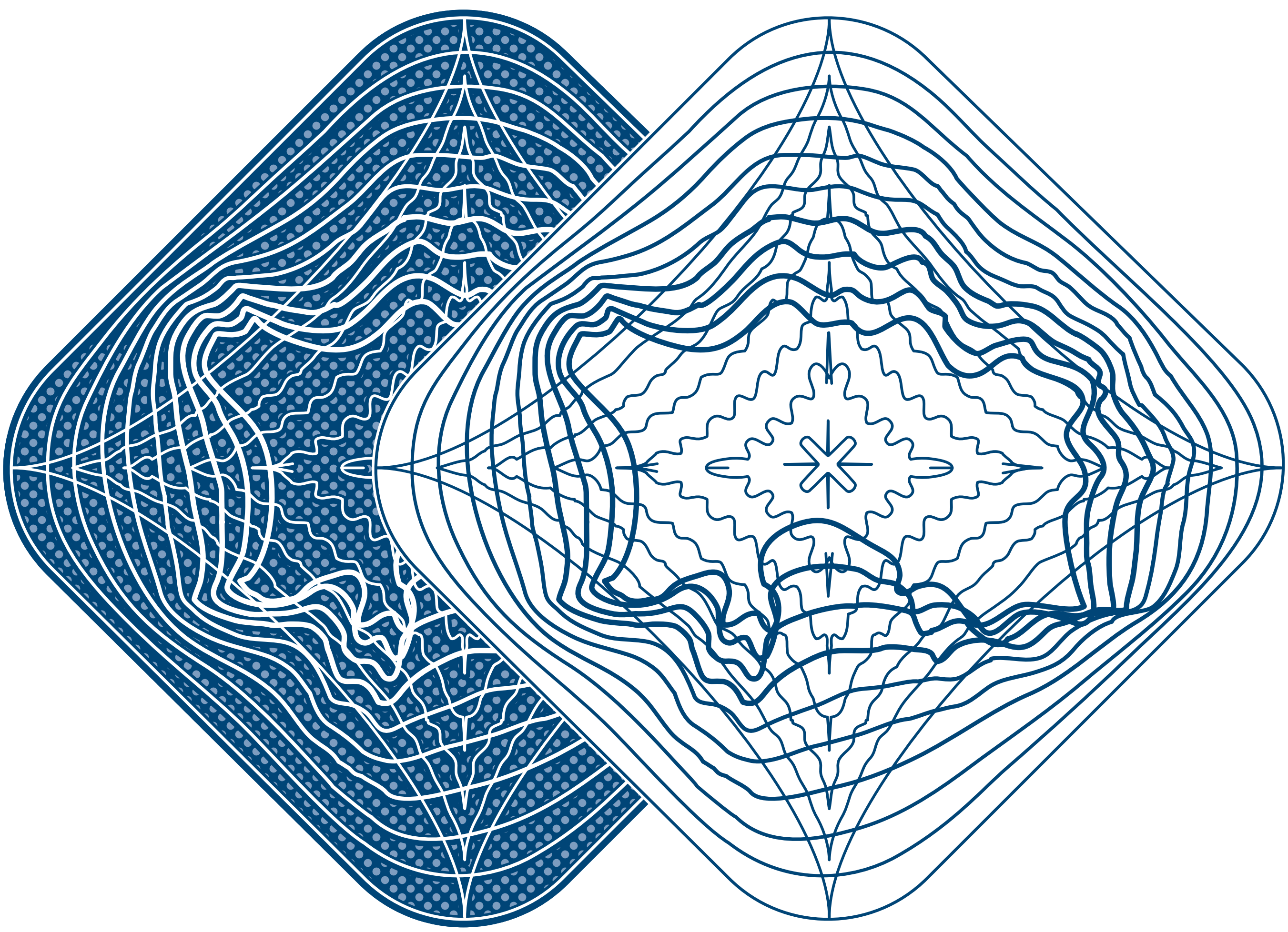
Jersey's Fiscal Policy Panel Annual Report

2008



Overview

As part of a fundamental reform to the fiscal policy framework, Jersey has created a Fiscal Policy Panel. This is its first annual report. As required by the framework, the report makes recommendations to the Minister of Treasury and Resources and the States on Jersey's fiscal policy and on additions to or subtractions from the Consolidated Fund, the Stabilisation Fund and the Strategic Reserve. These recommendations are based on an assessment of the combined effect of States' revenue and expenditure decisions on the Jersey economy in the context of overall economic developments and the risks and uncertainties faced.

In making its recommendations the Panel has been guided by its understanding of the preferences of Islanders. The Panel feels that Islanders want the States to be prudent, to 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 September 2007, the Panel has visited the Island on a number of occasions and has closely followed economic developments. It has greatly benefited from discussions with many people and institutions on and off the Island and has received invaluable help from the States of Jersey Economics Unit. The Panel considers that much remains to be done to improve the understanding of the factors that should guide Jersey's fiscal policy and will continue working to develop and refine its understanding of Jersey's economy.

Recommendations

- The Panel recommends that no further additions to or subtractions from the Stabilisation Fund or Strategic Reserve should be planned for this year or next.
- It considers that the modest financial surpluses contained in the current business plan for 2008 and 2009, once adjusted for the Energy from Waste (EfW) plant expenditure, are broadly appropriate given current economic prospects and the States' objectives of economic growth with low inflation.
- The Panel recommends that the States does not approve decisions either as part of the Business Plan or Budget that undermine the tax base or commit to expenditure growth greater than that currently forecast.
- In view of the risks to the economy, the States should not plan to allocate the expected additions to the Consolidated Fund at this stage.
- In the event of a sharper and more protracted slowdown than currently expected, the Panel recommends that the automatic stabilisers (the natural inclination in a slowing economy for tax revenues to fall and expenditure to increase) should first be allowed to work. If this is not enough, discretionary changes (plans to change tax revenues and/or spending) to loosen fiscal policy may be contemplated. Any discretionary changes should avoid policy measures that would permanently weaken the tax base or raise expenditure levels.
- There is a danger that the combination of the introduction of GST and higher food and fuel prices sets off a wage-price spiral. This is one of the principal near term risks to the Jersey economy. Should this happen, the Panel would recommend that fiscal policy is tightened as an aid to containing inflation and restoring competitiveness.

These recommendations are based on the following view of the economic outlook and the current and expected fiscal position.

Economic Outlook

The Jersey economy has performed impressively in the last few years with strong economic growth, significant employment growth, low unemployment and inflation close to target. Jersey has been able to build on its position as a successful economy that delivers a high standard of living for Islanders. The labour market is tight and there is little spare capacity in the economy.

However, growth is likely to slow as a result of three adverse shocks now hitting the economy: first, the loss of revenue as a consequence of the 0/10 fiscal changes; second, mounting global inflationary pressures, particularly rising food and energy prices; and third, the crisis in financial markets and world economic slowdown. The loss of revenue because of the 0/10 changes has necessitated the introduction of a goods and services tax (GST) which, like the rises in food and fuel prices, initially raises measured inflation as the impact feeds through.

Economic forecasts for the UK and global economies already factor in a significant slowdown and the Panel believes that the risks to these forecasts are on the downside. Trends in Jersey can lag behind those in the UK and global economies. However, an open economy like Jersey, highly dependent on financial services and other export industries such as other business services, tourism and agriculture is unlikely to escape the impact of a protracted downturn in global economic conditions and particularly in financial services. The 2008 Financial Institutions Survey showed that financial firms expected profits to continue to grow in 2008, though not as strongly as in 2007. The Panel expects that growth in the Jersey economy will slow, but likely remain above trend, this year, slowing further next year. The risks to growth are skewed to the downside.

The Panel sees one of the biggest risks to the economic outlook as the potential of a wage-price spiral. This could occur if Islanders respond to the squeeze on their incomes resulting from higher food and fuel prices together with the short-term price pressures of the introduction of GST by demanding and ultimately receiving higher wages than would otherwise have been the case.

Fiscal policy

The Panel concludes that the fiscal position in 2006 and 2007 was consistent with underlying economic objectives. In 2006 the surplus was £21m. Last year, the States ran a surplus of £37m which amounts to about 1% of GVA, at a time when the economy was growing strongly and approaching full capacity.

The capital allocation for the EfW plant distorts the budgetary picture going forward. If capital expenditure is adjusted for when EfW expenditure actually occurs and has its economic impact, then the planned financial position for 2008 and 2009 is one of modest surpluses.

Given the lack of spare capacity in the economy, the likelihood of continued above trend (albeit slower) growth in 2008 and emerging inflationary pressure, the Panel feels that the position of modest financial surpluses contained in the current business plan for 2008 and 2009 is broadly appropriate.

Should growth fail to slow as expected, or inflation rise further above target and a wage-price spiral threaten to develop, a tightening of fiscal policy (raising taxes and/or cutting spending) would be appropriate to withdraw demand from the economy and help curb inflationary pressure.

Conversely, if Jersey faces an economic slowdown that is larger than currently expected, a temporary loosening of fiscal policy (reducing taxation and/or increasing spending) would be appropriate to support demand in the economy – provided that inflationary wage increases are avoided. Money accumulated in the Consolidated Fund or Stabilisation Fund in better times could be used to replace the revenue lost due to the cyclical downturn and help support selected States' expenditure programmes. The automatic stabilisers (where tax revenue falls when the economy slows and expenditure increases) should be allowed to work before discretionary decisions are taken to loosen fiscal policy further. As the Panel is concerned about fiscal trends in the medium and longer-term any such decisions should make changes that are temporary in nature. They should not result in permanently lower tax rates or higher expenditure levels.

In the longer-term there are risks that could add to fiscal pressures. One is that the ageing of the population in the Island over the following decades will result in gradual demographic changes that will have large fiscal consequences. Another is that international pressure could require further changes to the 0/10 system or that there is more international competitive pressure on the 10% rate. A third is that if productivity growth in the economy is low, this will hold back economic growth and therefore improvements to the States' fiscal position.

The report is structured in the following way:

1. Introduction
2. Background to public finances and longer-term fiscal context
3. Economic outlook
4. Fiscal position and future pressures
5. Policy recommendations

Section 1 – Introduction

Fiscal framework

The States of Jersey's new fiscal framework (P133/2006) was agreed by the States in October 2006.

The objectives of the new fiscal framework are to:

- Create an effective macroeconomic policy framework that can improve economic stability by containing inflation and maximising the economic potential of the Island.
- Put in place a transparent and credible framework that is both pragmatic and understood by everybody in the Island.
- Make fiscal policy overall more counter-cyclical and manage the revenue streams in a manner that enhances economic performance.

The framework incorporates and defines the functions of the Stabilisation Fund and Strategic Reserve and defines the role of the Fiscal Policy Panel (FPP).

Role and principles of the Panel

The role of the Fiscal Policy Panel is to advise the Minister of Treasury and Resources and the States of Jersey on taxation and spending. The Minister for Treasury and Resources is responsible for the operation of the Strategic Reserve and Stabilisation Fund having regard to the Panel's advice.

The Panel is required to produce an annual report (of which this is the first) that:

- Examines the strength of the Jersey economy, the position in the economic cycle and the outlook for the Jersey and world economies.
- Comments on the appropriateness of the States' financial position and forecasts given the above and the States' economic objectives of economic growth and low inflation.
- Recommends policy regarding the overall balance between tax and spending and how fiscal policy should be set to ensure that it is counter cyclical (including use of the Stabilisation Fund).

The Panel set out in its Preliminary Report in April this year the five guiding principles that it will use in fulfilling its role:

(i) Economic stability is at the heart of sustainable prosperity.

(ii) Fiscal policy needs to be focused on the medium-term.

(iii) Policy should be stable and predictable.

(iv) The supply side of the economy is just as important as the demand side.

(v) Low inflation is fundamental to improving the competitiveness of the economy.

Context of this report

The development of 0/10 Fiscal Strategy and the personal and corporate tax changes that it incorporates has been an important step for the Island. The aim of the Strategy is to achieve medium-term stability both within the Island's fiscal policy and the wider economy.

The main provisions of the 0/10 Fiscal Strategy are now in place following the implementation of a Goods and Services Tax (GST) in May this year. Prior to this, the new Income Tax Instalment System (ITIS) and 20% means 20% had been introduced and they are already delivering additional revenues.

Since it was formed in September 2007, the Panel has visited the Island on a number of occasions and has closely followed economic developments. It has greatly benefited from discussions with many people and institutions on and off the island and has received invaluable help from the States of Jersey Economics Unit. The Panel considers that much remains to be done to improve the understanding of the factors that should guide Jersey's fiscal policy and will continue working to develop and refine its understanding of Jersey's economy.

As a result of recent reforms, the Panel believes that the States of Jersey is in a strong position to face the combined impact of the credit crunch and higher food and fuel prices. Many economies are not in such a fortunate position because their fiscal policies are in a much weaker state.

Section 2 – Background to the public finances and longer-term fiscal context

Key points

- An analysis of past behaviour suggests that although the States have been generally fiscally prudent, there has been a tendency for:

    1. Increases in revenue to feed through into increases in expenditure.

    2. Fiscal policy, including withdrawals from the Strategic Reserve, to be destabilising and pro-cyclical rather than stabilising and counter-cyclical.

- The States has built up significant funds in the Strategic Reserve and Stabilisation Fund.

- Changes in real revenues are highly dependent on receipts from the financial services sector which are difficult to forecast and do not seem to be well correlated with profitability in that sector

- In the longer-term there are key risks that could affect fiscal outcomes, namely:

    1. The ageing population.

    2. Future pressures on the financial services industry.

    3. Lower longer-term growth potential.

The States' finances

Composition of income and expenditure

The Consolidated Fund, governed by the Public Finances (Jersey) Law 2005, is the fund through which the majority of the States' income and expenditure is managed. General revenue income and departments' expenditure on public services (including capital expenditure) is all accounted for through this fund.

The largest slice - two-thirds - of States' income is taxation receipts from companies and individuals (Figure 2.1). Impôts, stamp duty and the island rate make up just under 15% of States' revenue. Department income (for example housing rents for the Housing department and the sale of services for Education, Sport and Culture) make up another 15% and other income (for example investment income and dividends from States' owned utility companies) makes up the remaining 6% of States' income.

States' expenditure (Figure 2.2) is focused mainly on the health and social care, social security and education, sport and culture departments.

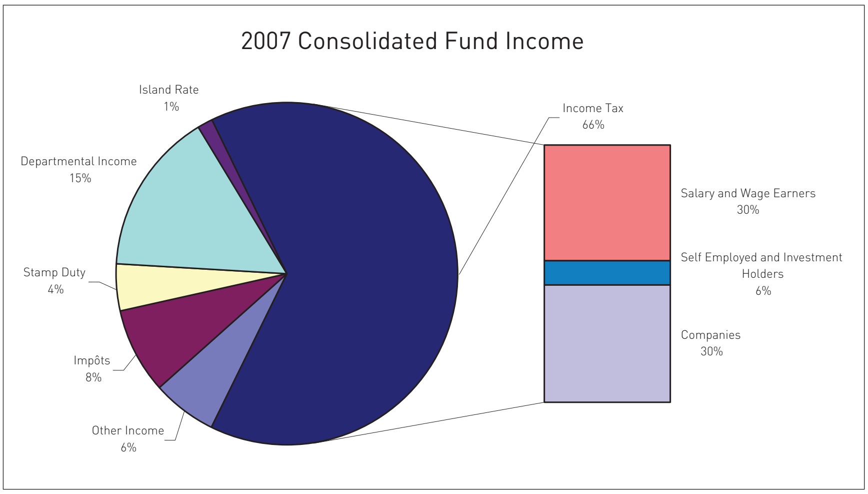


Figure 2.1: States' income consists mostly of income tax receipts
States' income by source (% of total)
Source: States of Jersey Financial Report and Accounts 2007

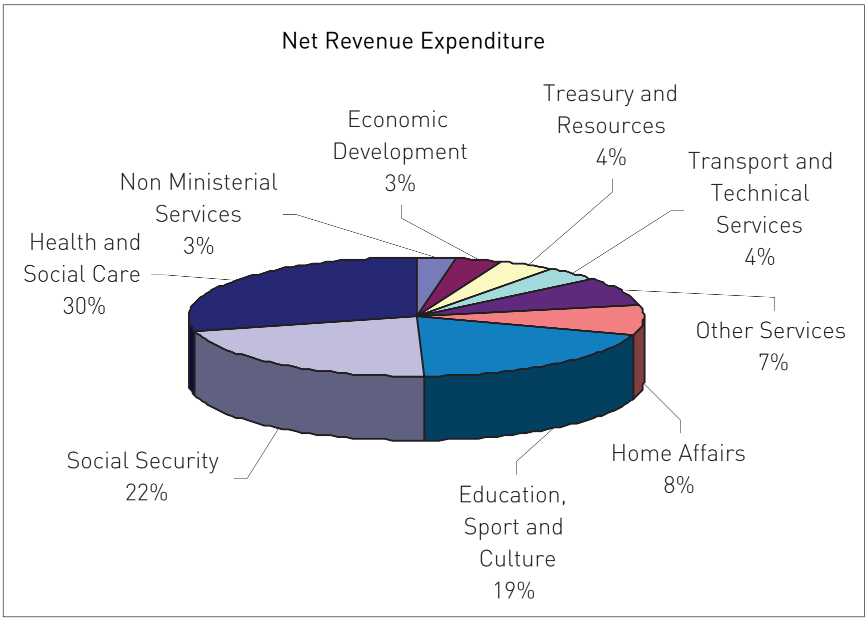


Figure 2.2: Spending is mostly on health, social security and education
States' net revenue expenditure by department (% of total)
Source: States of Jersey Financial Report and Accounts 2007

Trends in income and expenditure

States' income in real terms (i.e. removing the effects of inflation) has shown some variation over the years (Figure 2.3).

The main reason behind the variation in States' real income is the changing amounts of tax received from companies each year – particularly financial services companies. In some years, changes in corporate tax income correlate with changes in the profits of the finance industry (and therefore the economic cycle) although there is not a consistent relationship in every year.

In the mid to late 1990s there was strong growth in States' real income up to about £520m in today's (2007) prices and this was followed by a period of five years of no growth to 2003. In 2004 real income dipped to below £500m, before stabilising in 2005. It then grew strongly to around £560m in 2007.

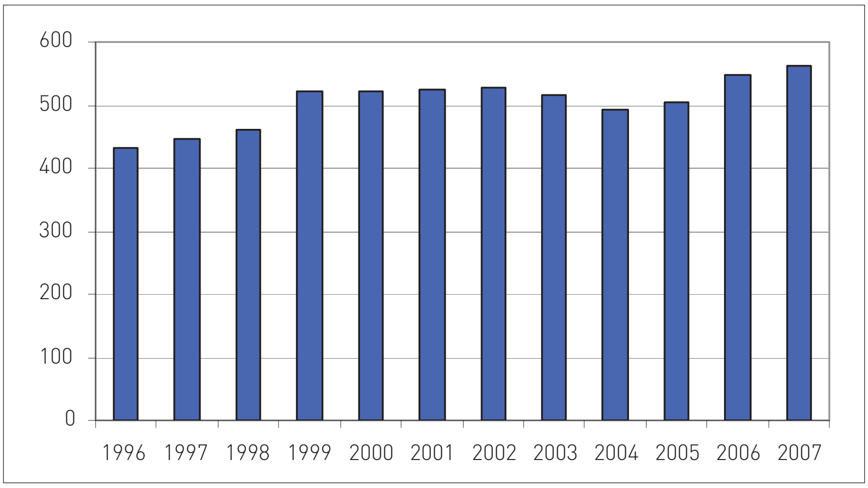


Figure 2.3: States' real income has varied in recent years
Total income (net general revenue income) - real terms (2007 prices), £m
Source: States of Jersey Economics Unit

Figure 2.4 shows the trend for States' real expenditure (revenue and capital). It does not include spending by separately constituted funds. During the mid to late 1990s there was strong growth in real expenditure of 4% per annum on average and this continued until 2001. This was a period of pro-cyclical fiscal policy, further boosting demand in the economy as strong growth in real expenditure took place during a period of strong economic growth. After 2001 though, real expenditure remained constant at about £520m per annum. That is, between 2001 and 2007 States' total expenditure on average increased at a similar rate to the rate of inflation. A more counter-cyclical policy might have involved temporarily increasing States' expenditure to support demand during the period of real economic decline from 2001 to 2004.

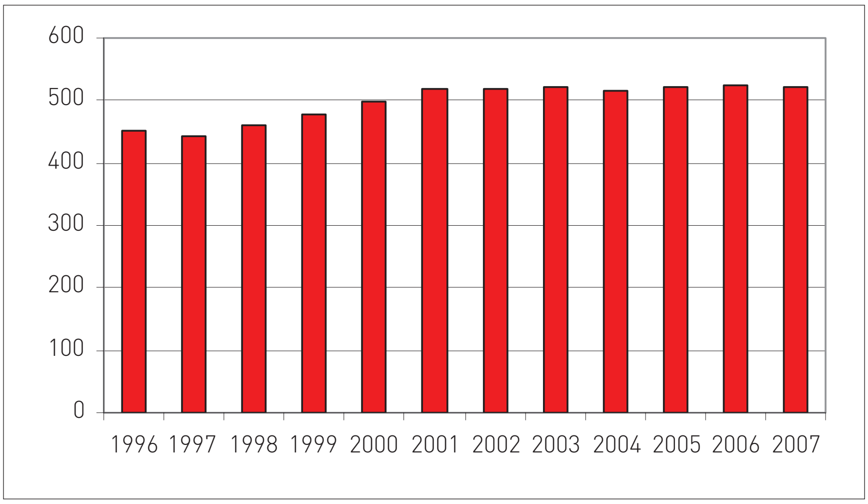


Figure 2.4: States' real expenditure steady in recent years
Total expenditure (net revenue expenditure plus capital spending approved) - real terms (2007 prices), £m
Source: States of Jersey Economics Unit

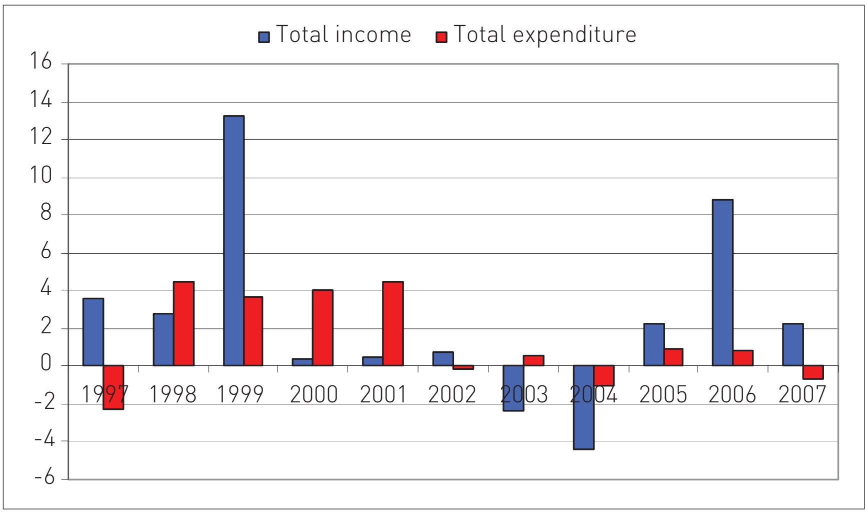


Figure 2.5: Changes in revenue have affected changes in expenditure
Real annual % changes in total income and total expenditure
Source: States of Jersey Economics Unit

Figure 2.5 shows how total real income increased strongly between 1997 and 1999 and was followed by an increase in total expenditure each year from 1998 to 2001. Real income barely grew or fell from 2000 to 2005, and total real expenditure stabilised in real terms after 2002.

Figure 2.6 below shows the balance of States' real income over expenditure. The more recent surpluses and deficits since 2001 were driven by changes in States' real income each year as real expenditure remained constant.

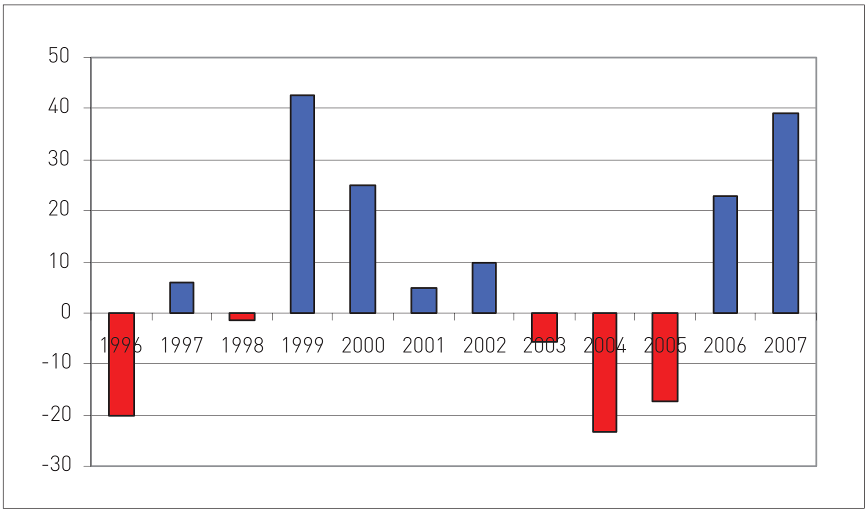


Figure 2.6: States' surpluses and deficits
Total income less total expenditure – real terms (2007 prices), £m
Source: States of Jersey Economics Unit

The Panel notes that past experience highlights a number of trends that should be avoided in the future if fiscal policy is to support the States' economic objectives of economic growth with low inflation:

- **the tendency for changes in revenue to feed through into changes in expenditure;**
- **that fiscal policy has at times acted in a destabilising, pro-cyclical way rather than in the counter-cyclical manner needed to support the States' economic objectives.**

Strategic Reserve

The Strategic Reserve was set up by the States in 1986 to provide the Island with some insulation from external shocks. In the late 1980s and early 1990s, Jersey transferred over £110m into the reserve and subsequently reinvested the return on its investments.

However, the Strategic Reserve has not always been used in the way it was originally intended. In the mid to late 1990s, at a time when both States' spending and the economy were growing rapidly, money from the Reserve was used to fund capital projects and economic development. Between 1994 and 2000, transfers totalling £60m were made from the Strategic Reserve to the capital, ICT and tourism investment funds and spent in subsequent years.

In contrast, since 2000 £40m has been transferred into the Strategic Reserve.

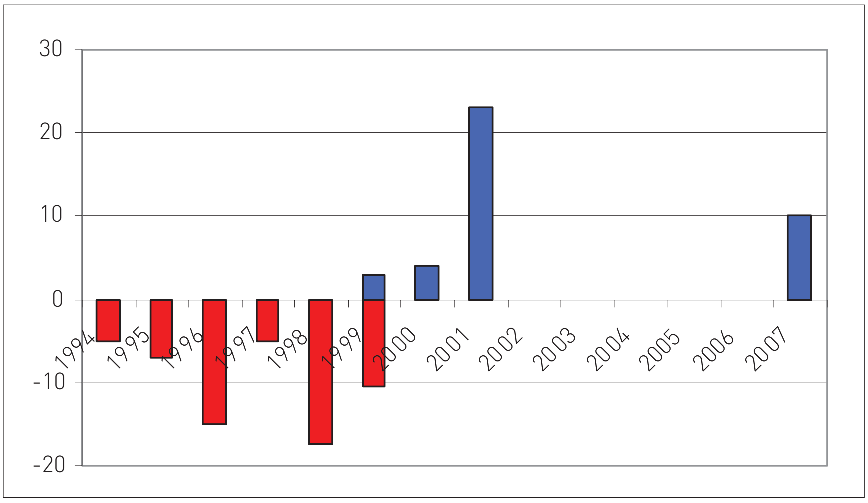


Figure 2.7: Transfers were made out of the Strategic Reserve in the late 1990s and into it more recently
Total transfers to and from the Strategic Reserve, £m
Source: States of Jersey Treasury and Resources Department

The Public Finances (Jersey) Law 2005 reiterates that the reserve should not be used for any purpose other than one specifically recommended by the Treasury and Resources Minister and approved by the States.

The purpose of the Reserve was further clarified by the States in December 2006 when it was agreed that the Strategic Reserve should be a permanent reserve, only to be used in exceptional circumstances to insulate the Island's economy from severe structural decline such as the sudden collapse of a major island industry or from major natural disaster.

At the end of 2007, the Strategic Reserve had accumulated net assets of £510m, which is about 13% of GVA. The following graph shows the market value of the Strategic Reserve since 2001. In real terms (2007 prices) the fund has grown by 10% - stable from 2001 to 2004 with modest growth thereafter.

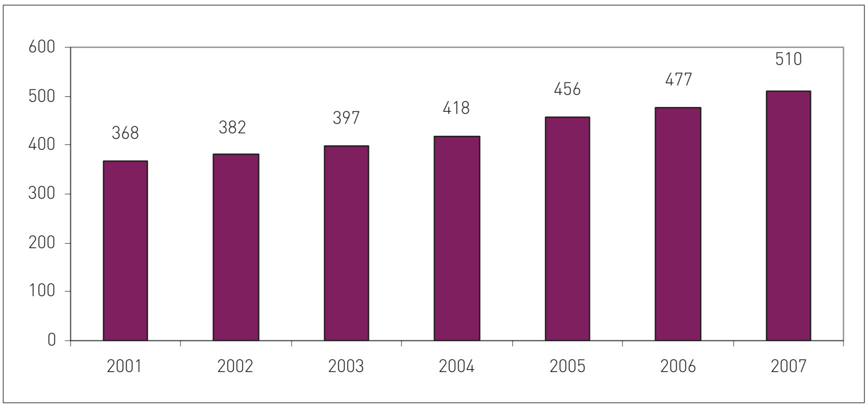


Figure 2.8: Strategic Reserve accumulating over the period
Strategic Reserve net assets £m, 2001-2007
Source: States of Jersey Financial Report and Accounts

The Strategic Reserve has at times been used in a manner that is pro-cyclical. This should be avoided in future.

Stabilisation Fund

Following the agreement of the States in December 2006, the Stabilisation Fund was established with a transfer of £32m of funds previously held in the Dwelling House Loans Fund.

The Stabilisation Fund was set up to allow fiscal policy to help create a more stable economic environment with low inflation in the Island. This will in general involve taking money out of the economy and paying it into the Fund when the economy is growing strongly and drawing money down from the fund to support the economy when it is performing less strongly.

Recognising this, the Treasury and Resources Minister committed to transfer a further £38m into the Stabilisation Fund from 2007 revenues, which will be transferred by the end of 2008.

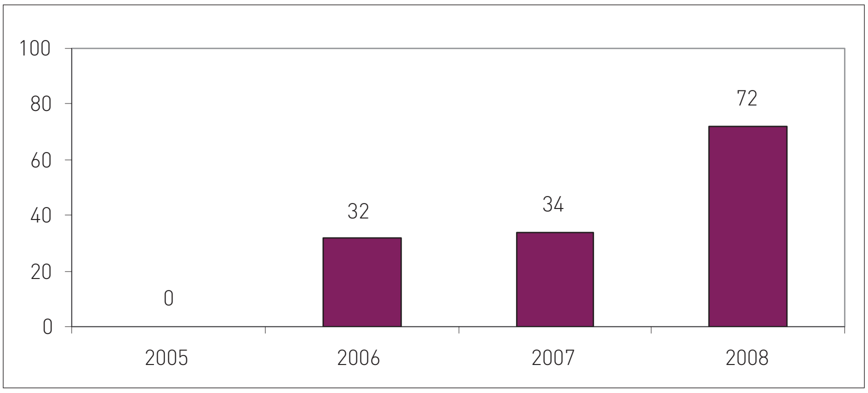


Figure 2.9: Two transfers into the Stabilisation Fund so far
Stabilisation Fund net assets £m, 2005 – 2008 (to date)
Source: States of Jersey Financial Report and Accounts

Tax change measures in recent years

The development of the 0/10 Fiscal Strategy and the personal and corporate tax changes that it incorporates have been an important step for the Island. The Strategy marks a significant step forward in trying to achieve medium-term stability both within the Island's fiscal policy and the wider economy.

On the 7th July 2004, the States agreed[1] to move to a new corporate system of taxation in order to keep the Island internationally competitive and meet EU and international rules on harmful tax practices. Committing to the system gave the certainty financial services businesses needed to continue to operate and develop in the Island. This in turn safeguarded the important contribution that the industry makes to the Island and to the States for the longer-term. The change to the 0/10 system will take place in 2009.

The new corporate system of taxation consists of a standard rate of corporate tax of zero per cent, together with a special rate of corporate tax of ten per cent for specified financial services companies. Other arrangements ensure that profits made by companies owned by Jersey residents are taxed at the personal tax level.

However, as a consequence of moving to this system, revenue is expected to decline £80m to £100m a year in tax revenue (equivalent to 2% to 2.5% of GVA) from 2010 onward as some financial services companies will pay less tax and some non-financial services companies, owned by non-residents, will pay tax elsewhere instead.

The latest States' Treasury and Resources Department estimate of lost revenue starts from £9m in 2009, rising to something between £89m and £104m a year by 2013 (this can be seen in Section 4, Figure 4.1).

This is a real loss to Islanders and the States each year, though necessary to keep the rest of the economic contribution that the financial services sector brings. The adverse effects are felt by the Island through the £60m increase in taxes that make up the £100m package of measures (see Figure 2.10) agreed by the States. Islanders are presently experiencing the most painful part of the compensatory package with the introduction of GST.

The initial impact of 0/10 falls on States' revenue. The form of the compensatory package was much discussed and debated. The package is displayed in the following table – with estimates of the contribution of the different components.

Measure:	**£m**
Grow the economy (2% per annum real growth)	20
Cut waste and improve efficiency in public services	20
Increase taxes (see below)	60
Total	100

Increase taxes:	**£m**
Introduce a broad based 3% Goods and Services Tax	45
Phase out tax allowances for tax payers on higher disposable incomes ('20 means 20') over five years	10
Introduce an Income Tax Instalment System (ITIS)	5
Total	60

Figure 2.10: Package of measures to address the expected fiscal deficit from introducing 0/10

[1] States Assembly Proposition number 106/2004.

The figures in the table are estimates. In practice, the measures are expected to meet the shortfall, because:

- Real economic growth has exceeded expectations if sustained.
- The public service waste cutting and efficiency improvements have been made. (However these savings were reallocated to public services expenditure and will not therefore help to reduce future deficits.)
- GST is expected to raise approximately £50m a year. However, about £5m of this will be used each year to zero-rate food.
- 20 means 20 is actually expected to raise £20m a year, but £10m of this has been used to increase personal tax exemptions.
- The Income Tax Instalment System (ITIS) is raising over £5m per year.

These States' revenues are being received now, but it is important to remember that they are intended to replace revenues expected to be lost in 2009 and beyond from the move to 0/10. Having reduced the income from these measures to the original estimated levels through several subsequent decisions, the States has less room to manoeuvre in future.

Longer-term fiscal context

The Panel must evaluate and consider the longer-term fiscal environment to advise the Treasury and Resources Minister on how to promote sound and stable fiscal policy over the medium and long-term.

It has established that there are several key risks or uncertainties to the Island's longer-term fiscal position and performance to be kept in mind.

The impact of an ageing population

Over the next twenty to thirty years lower birth rates and lower death rates will mean that Jersey's resident population will age, and as a consequence of this, there will be some noticeable demographic changes, albeit gradual at first:

- Fewer people of school age.
- Fewer people of working age.
- More people of retired age.

Under a scenario of no net inward migration, for example, Jersey's working age population would fall by 25% by 2035. In the absence of corrective policy action, there would be a significant impact on public services – mostly through increased healthcare and pension costs and also through lower income tax receipts.

As will be the case for many other economies, an ageing society will be a significant change to manage over the years that will put pressure on the fiscal position. Islanders will face some hard choices. The States' policy approach and how the Island adapts will determine the extent of future economic and fiscal consequences.

The importance of financial services to States' revenues

The significant presence of the finance industry in the Island, both in terms of economic activity (52% of GVA in 2006) and employment (25% of the workforce in December 2007), means that it, and its employees, make a very large direct contribution to States' revenues through corporation and personal taxes.

In addition there is an indirect contribution as many other businesses, such as hotels, restaurants, office cleaners and retailers supply the finance industry in Jersey, either by satisfying the demands of the finance businesses themselves or the consumption demands of its workers. These companies and their employees pay taxes as well.

Overall, it has been estimated that the financial services sector and its employees, combined with the second round effects on other businesses and employees, contribute to around 60%-70% of States' revenues each year. In 2007, this amounted to about £340m to £390m of the £559m of total income received.

The 0/10 regime addresses the medium-term risks to the finance industry and wider economic stability. It has provided the base from which the finance industry can build further success. However, there are other risks to be aware of in the longer-term.

Corporate tax competition between countries is becoming increasingly important and there is a tendency emerging for tax regimes to be simplified and offer lower rates of tax. One long-term risk for Jersey is that there is more downward pressure on the 10% rate from competing jurisdictions. This would erode the Island's fiscal position over time, unless counteracting measures were to be taken. There is also the risk that international pressure from outside the Island requires further changes to the 0/10 system.

Longer-term growth potential

Since the 1970s, growth in the Jersey economy and the increase in productivity have been boosted by the development of the financial services sector. Without this change in the composition of output, underlying growth in potential output would have been much more modest. As the scope for further restructuring of the economy in the future is likely to prove more limited, the challenge for the Jersey economy will be to raise productivity growth. Without such an improvement the risk is that Jersey's long-run rate of sustainable non-inflationary growth will be lower than it has been in the past.

Box: Fiscal policy in a monetary union

Jersey is in a currency union with the United Kingdom which means it shares the same currency and interest rate, which is set by the Monetary Policy Committee (MPC) of the Bank of England. The MPC sets interest rates relative to economic conditions on the mainland and with a view to achieving the UK's inflation target. Economic conditions in Jersey and the UK often differ which means the interest rates set by the MPC are not always appropriate for the Island.

The Island therefore has one less tool to achieve its economic objectives of economic growth with low inflation. With no control over its own interest rates, the main macroeconomic management tool available is fiscal policy, i.e. the combination of tax and spending.

Fiscal policy is less flexible than interest rate policy because fiscal decisions tend to be taken on an annual basis where as interest rates can be changed monthly. Interest rates also have an advantage in that they impact directly and relatively quickly on consumers and businesses, while tax and spending changes can often operate less directly and with significant time lags.

Given that fiscal policy is the sole macroeconomic policy instrument and it is less direct and lacks the flexibility of monetary policy, it would be difficult for Jersey to replicate UK economic management using fiscal policy. Rather, fiscal policy should be used to provide stability and underpin the overall objective of economic policy – improving the Island's underlying competitiveness.

The main way this can be done is to ensure that fiscal policy does not act in a pro-cyclical way. That is, when the economy is growing strongly it does not add to demand in the economy and lead to a build up of inflationary pressure (or vice versa when the economy weakens). The Panel believe that it is in this manner – by operating in a sound and predictable way – that fiscal policy can create the environment for improved competitiveness, economic growth and low inflation.

Section 3 – The economic outlook

Key points

International outlook

- The global economic and financial market outlook has deteriorated significantly over the last 12 months.
- A new policy challenge has arisen internationally from the combination of a significant slowdown in world growth and rising inflation as a result of higher oil and other commodity prices.
- The Panel is concerned that the risks to the current global outlook are stacked on the downside for growth and on the upside for inflation.

Jersey economic outlook

- Jersey has performed strongly in recent years with strong growth, rising employment and low inflation.
- The labour market is tight and there is little spare capacity in the economy. Inflation has risen, largely as a result of GST and higher fuel and food prices.
- Growth slowed in 2007, but remained well above its sustainable trend rate. Further slowing is likely in 2008 and 2009 as the Jersey economy is hit by a series of adverse shocks.
- Financial services companies are optimistic that profits will grow strongly again in 2008 and the Panel's central expectation is for real economic growth of 2% to 4% for 2008 and 1% to 3% for 2009 with inflation remaining above target.
- The risks to economic growth are to the downside. Financial services profitability could be less than expected and the rest of the economy may slow more rapidly.
- The risks to inflation are on the upside. The biggest threat to the inflation outlook in Jersey is a wage-price spiral whereby Islanders try to compensate for GST and higher food and fuel prices by demanding, and obtaining higher wages.
- To manage the adverse impact of these costs to Islanders the aim of policy should be to focus on keeping prices down - for example through increased competition - rather than adding to cost pressures by raising wages.

International outlook

After a number of years of strong global growth, low inflation and stable financial markets, the international situation has deteriorated rapidly in the last year.

This has been brought about by several major events:

- The turmoil in the US market for sub-prime mortgages quickly spreading into other financial and asset markets.
- Exposed banks seeking more capital from shareholders and tightening lending conditions, making borrowing harder and more expensive for businesses and consumers, affecting investment and consumption.
- Global inflation increasing, with much higher basic food and oil commodity prices playing a major role.

Growth in the US, UK, Euro zone and Japan is faltering. The current consensus view is that the global economy will slow modestly further in 2008 and 2009. Recent forecasts from the OECD are broadly in line with the consensus. The slowdown is set to affect virtually all OECD economies. Figure 3.1 shows that economic growth for this year is expected to be lower than previous years at 1¾ % real GDP growth for OECD countries as a whole, the UK and the Eurozone, and just over 1% for the US, while headline inflation is likely to remain high for some time.

Economic forecasts are prone to missing turning points in the economic cycle and it may be that consensus forecasts do so during this phase in the global cycle.

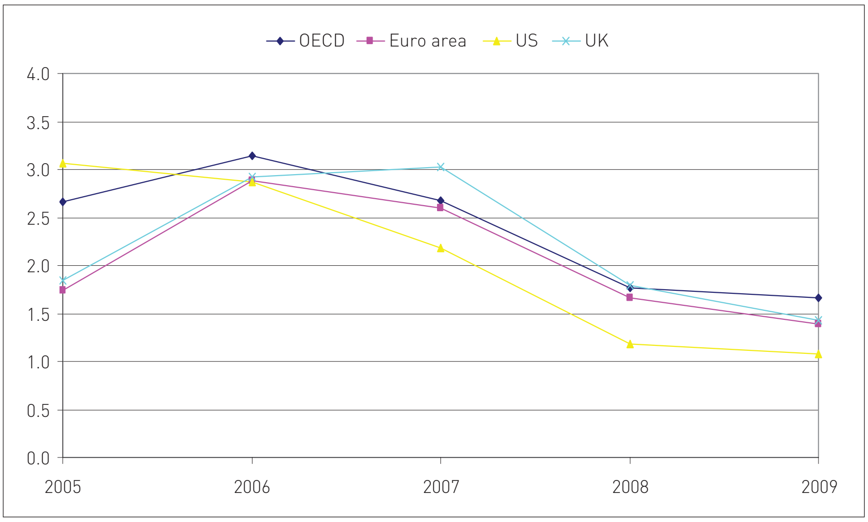


Figure 3.1: Expectations of lower real economic growth
Real GDP - percentage changes from previous year
Source: OECD Economic Outlook No. 83, June 2008

Risks to the outlook

There are two major risks to the global economic outlook; these come from financial markets and from inflation.

Financial markets and the credit crunch

Since August 2007 concerns over losses on US sub-prime mortgage loans have escalated into widespread financial stress. What initially appeared to be a contained problem quickly spread across other credit segments and broader financial markets to the point where sizeable parts of the financial system became largely dysfunctional.

Surging demand for liquidity, coupled with growing concerns about counterparty risk, has led to unprecedented pressures in major interbank markets, while bond yields in advanced economies have tumbled as investors have sought safe havens amid fears that economic growth would weaken. Equity markets in advanced industrial countries have also been weak, with financial sector shares falling off particularly sharply. Adjustment in financial markets is not yet complete and it is possible that there will be further periods of turbulence.

Inflation

A sharp rise in commodity prices, particularly food and fuel, since early 2007 has led to a large increase in headline inflation in advanced industrial economies. Inflation expectations are rising across the globe, particularly as prices have increased for frequently purchased goods. A major determinant of future inflation is likely to be the behaviour of wages, but in some countries (such as the UK and US) the effect of a depreciating exchange rate could also play an unwelcome role.

The recent Bank for International Settlements (BIS) annual report pointed out that these developments at the core of the global financial system have created great uncertainty about future economic prospects. These uncertainties centre on the following issues:

- Demand in many economies could contract by more than currently expected if a generalised squeeze in the availability of credit persists as banks restrict lending to repair balance sheets.
- The response of households facing such a climate of slowing growth, tighter credit conditions and higher inflation, is hard to predict and retrenchment may be greater than predicted. Falling demand from US households would weaken demand in the rest of the world.

In conclusion on the economic outlook the BIS says on the subject of these uncertainties that:

> "While difficult to predict, their interaction does appear to point to a deeper and more protracted global downturn than the consensus view seems to expect. At the same time, inflationary forces, particularly in

> emerging market economies, could also prove unexpectedly strong and persistent. A major factor in inflation prospects everywhere is likely to be the behaviour of wages..."

The Panel believes the risks to the consensus outlook for world growth are on the downside, and those to inflation on the upside. Jersey should therefore be readying itself to react should these risks materialise.

Jersey economic outlook

Economic growth

Economic activity in Jersey (as measured by real GVA) grew by 7% in 2006 following a year of more modest 3% growth in 2005 (Figure 3.2). Growth in 2006 was the fastest seen for at least eight years and was not surprising given the strong, 21%, growth (in real terms) in the profits of the financial services sector: growth in the finance sector has been a key determinant of the performance of the Jersey economy over the current economic cycle. However, the level of total GVA in 2006 in real terms was still slightly below the last peak recorded in 2000.

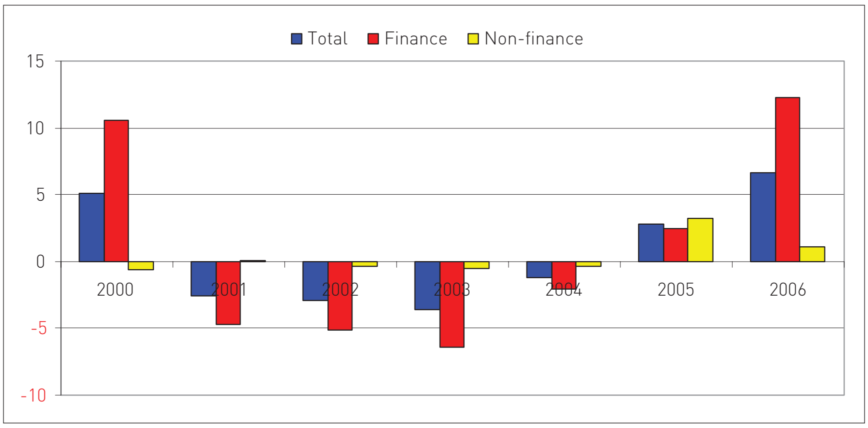


Figure 3.2: The economy showed very strong growth in 2006
Real GVA - percentage changes from previous year
Source: States of Jersey Statistics Unit

In the latest Survey of Financial Institutions, financial services firms reported profit increases in real terms of 9% for 2007. The optimism of the financial services sector for 2008 profit levels, recorded in April and May, remained high with 75% of firms expecting profits to increase (with just over 40% of these expecting profit growth to be greater than 10%). The expectation for the scale of the increase in profits is slightly lower however than last year (Figure 3.3).

Given that the reporting firms would have been fully aware of the credit crunch, its subsequent effects and other global price pressures when

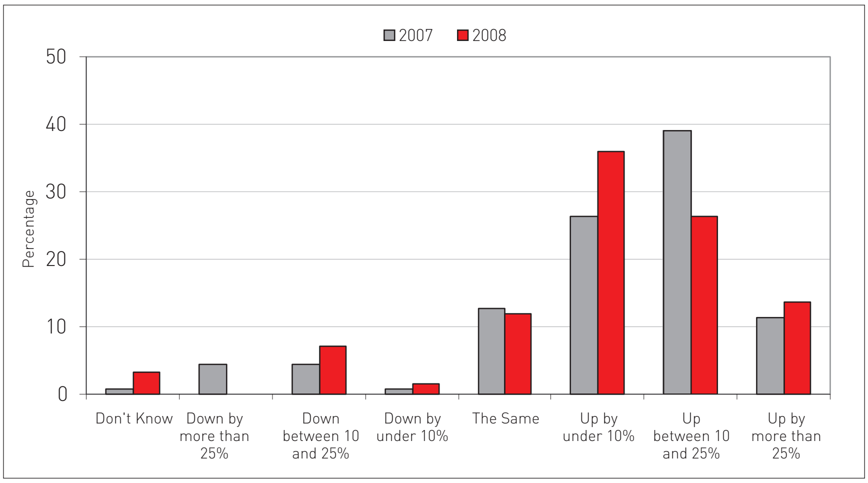


Figure 3.3: Financial services firms profit expectations
% of firms (by count of firms)
Source: States of Jersey Statistics Unit

responding to the survey, this is a very promising outlook for the finance industry and, therefore, the rest of the economy for this year – provided their expectations are met. In the few years that profit expectations have been recorded, financial services firms have shown that they are good at predicting the direction of their profits and to some extent their size as well. However, there is not a long enough series of data to examine whether expectations fully reflect a turning point in the finance industry's fortunes.

For 2007, the trends in financial services profits suggest that, if other sectors of the economy performed largely as they did in 2006, real economic growth could be in the region of 4% to 6%. That is, growth in 2007 will be slower than in 2006 but still strong, and well above estimates of the rate of sustainable non-inflationary trend growth. The more modest profit expectations of financial firms for 2008, should they come to pass, would suggest a lower rate of real economic growth this year.

The Panel expects economic growth to be strong but slower in 2008 (between 2% and 4% in real terms) and slower still in 2009 (1% to 3% in real terms). This will be a result of weaker global growth, the continuing problems in financial markets, higher inflation and the squeeze on Islander's incomes outweighing the effects of a sharp increase in government spending in 2008 and low real short term interest rates.

Two other factors should help support growth in 2008. Section 4 shows that States' net revenue expenditure is expected to increase by 6% in real terms in 2008. This will add to demand in the economy. Real interest rates are expected to be very low over the next year as well, which will also help to support demand.

Figure 3.4 shows real economic growth in recent years and the Panel's expectations for real economic growth to 2009. This is shown by the two dark blue lines and the black line shows the middle of this range. However, there is a risk, mostly to the downside, that future economic growth may be outside these central expectations. The light blue lines

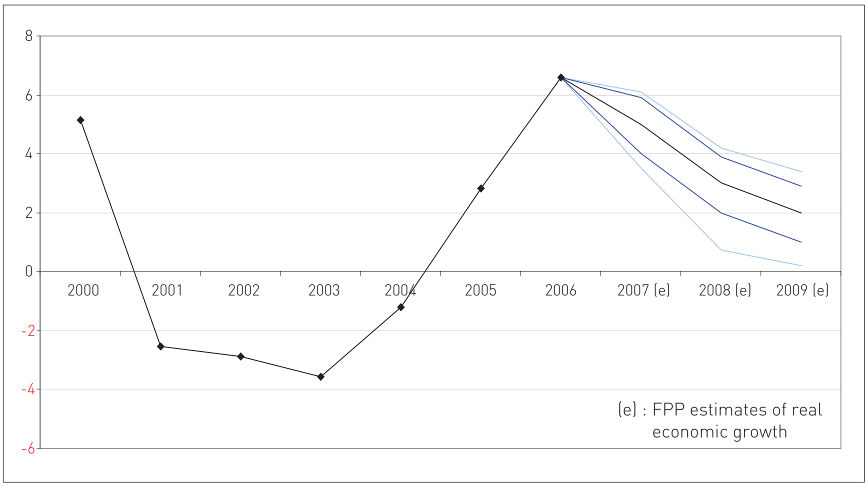


Figure 3.4: Growth in the economy is expected to slow this year
Real GVA - percentage changes from previous year
Sources: States of Jersey Statistics Unit and FPP estimates

capture this element of risk to the central expectation of future economic growth.

The squeeze on real incomes

The increases in food and petrol prices, as well as heating oil and electricity prices have put pressure on Islander's incomes. The combined impact of GST and higher food and fuel prices is estimated to be about 3.9% of personal income, representing a significant burden for Islanders.

From the start of 2007 to June 2008 for a household in the middle quintile of income, it is estimated that:

- Food expenditure took up about 0.9% more income;
- Heating oil and electricity expenditure together took up about 0.7% more income; and
- Petrol and other motor oil expenditure took up about 0.6% more income.

The main assumption behind these estimates is that the recent increase in prices has not affected the amount or quality of these goods consumed. If Islanders have reacted by reducing consumption or switching their consumption to alternatives then the impact could be less than the total 2¼% of income estimated.

GST is estimated to have had an effect equivalent to 1.6% of income at most given other States' initiatives to reduce this burden on less well-off households. This is somewhat less than the combined effect of the other impacts (about 2¼% of income) detailed above.

Risks to the outlook

Figure 3.5 shows that economic performance in Jersey has been correlated (with a short lag) to the performance of financial markets, using the FTSE 100 index as an indicator.

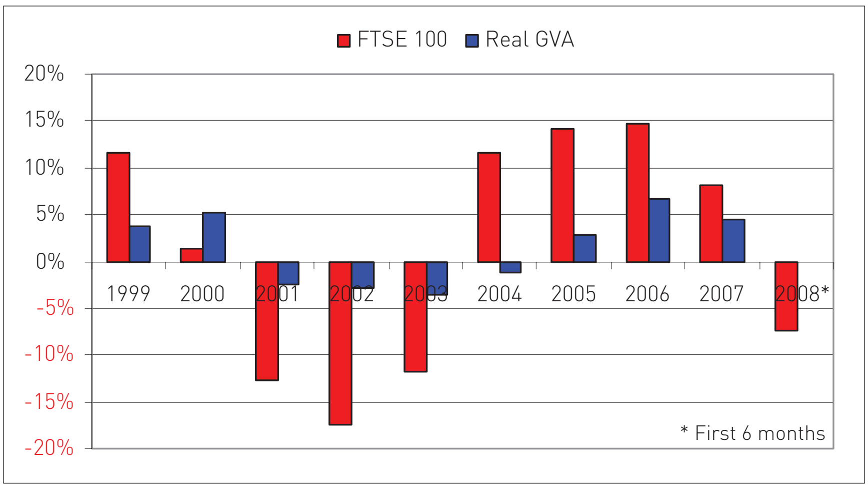


Figure 3.5: Jersey growth has followed financial markets
Real GVA and FTSE 100, % change on previous year
Sources: States of Jersey Statistics Unit and Economics Unit calculations

The poor performance of financial markets so far this year and the many uncertainties outlined by the BIS and others suggest that growth may well slow more sharply than the Panel expects in 2008. Past experience suggests that a protracted downturn in the global economy and financial markets will eventually have an impact in Jersey and that the economy may weaken further. The Jersey economy cannot remain immune to persistent world economic and financial market trends.

Looking beyond 2008, there is a risk of a prolonged global downturn combined with high inflation and a slow subsequent recovery. This, especially if combined with weaker financial markets, would have a negative and possibly drawn out effect on the Island's economy.

There is also however, the possibility that the world economy and financial markets recover more quickly than forecast and there is a return to the sustained growth and financial market performance seen in recent years.

The Panel has concluded that the economy grew strongly in 2007 at a rate well above its sustainable trend (although slower than 2006) and is likely to slow to a rate closer to trend in 2008 and 2009. Given the external economic environment the biggest risk appears to be that the economy will slow more sharply than the Panel currently expects.

Inflation

The Island has had some success in reducing inflation in recent years, helped partly by favourable global inflation trends. RPIX (RPI excluding the cost of house purchase) has remained at or near to the States' Strategic Plan inflation target of 2.5% per annum and since 2005 RPI(X) has been within 0.5 percentage points of the target level for 11 of the 14 quarters (Figure 3.6).

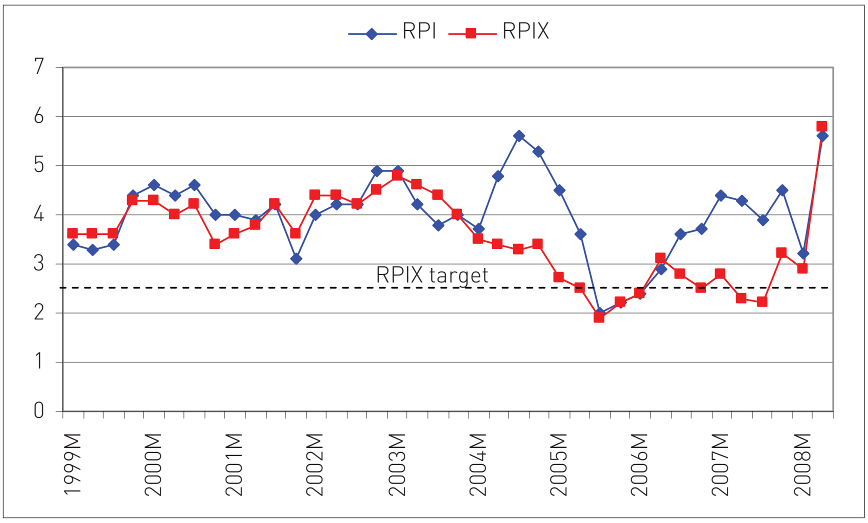


Figure 3.6: Inflation in Jersey
annual percentage changes in RPI and RPIX
Source: States of Jersey Statistics Unit

More recently, inflation trends in Jersey have reflected global trends. The risks to the inflation outlook are similar to those in other countries but complicated further by the introduction of GST. In June 2008, underlying inflation on the RPIX measure was 5.8%. This was much higher than previous quarter's RPIX inflation of 2.9%, largely because of the effect of the introduction of GST (adding about 2.1 percentage points) and sharply increasing prices for food, for housing, fuel and light, and for motoring.

Until the recent introduction of GST, trends for food and fuel prices in Jersey have been very similar to those in the UK (Figure 3.7). Since the start of 2007 food prices in Jersey and the UK have increased at a similar rate (6% in 2007). Over the same time period, oil and petrol prices in Jersey have also increased at a similar rate (15% in 2007) to the UK. The annual rates of increase for food and fuel and petrol prices so far in 2008 are much higher than 2007 at 10% and 25% respectively.

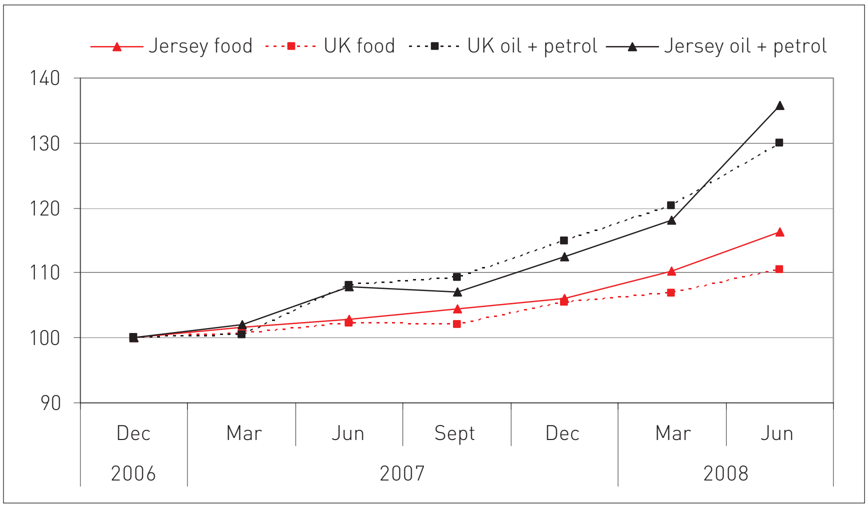


Figure 3.7: Trends in food and fuel prices
Index of food and fuel prices 2006Q4=100
Source: States of Jersey Statistics Unit, Economics Unit calculations

The impact of GST

The overall impact of GST (as with any other tax increase) is contractionary to the extent it reduces demand in the economy by taking money out of consumers' pockets. However, because it has had the effect of increasing the prices of many goods and services, it will initially feed through into the measured rate of inflation. The effect on the rate of inflation drops out again after a year.

Experience elsewhere illustrates well the temporary nature of the impact of GST on inflation. A study done in 1988 for the IMF looked at the price effects of introducing Value Added Tax (VAT) in 35 countries. The results showed that in 83 per cent of the cases the introduction of VAT did not alter the rate of price change. In 17% of cases VAT could have contributed to acceleration in the rate of inflation, although this was associated in each case with expansionary wage and credit policies. The conclusion was that there was 'nothing inherently inflationary about the use of VAT'.

Australia introduced a 10% GST in July 2000 and at the same time removed its wholesale tax. The chart below is another example of how the introduction of GST had a one-off impact on the price level and was not inflationary.

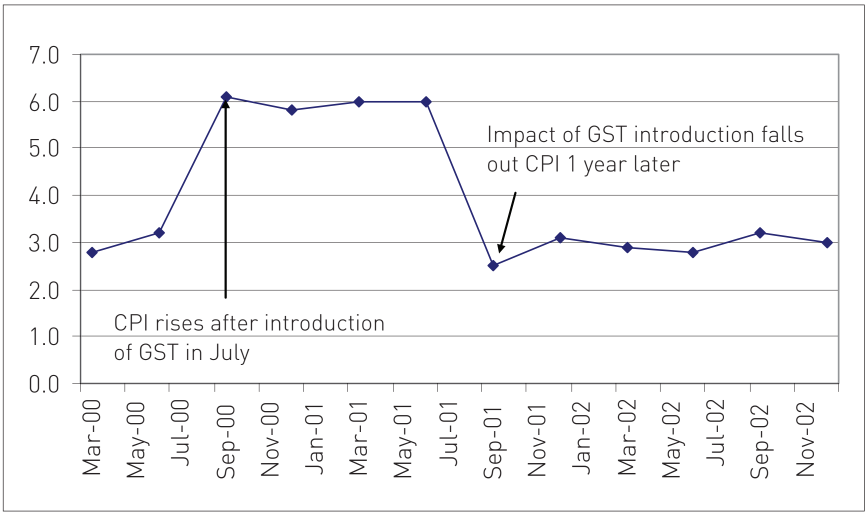


Figure 3.8: The introduction of GST in Australia
% increase in CPI
Source: Australian Statistics Office

The Panel sees the possibility of the Island getting sucked into a wage-price spiral (as a result of price increases leading to higher wages) as a key risk at this juncture. This is a concern for policy makers in most economies that are experiencing the rapid rise in food and fuel prices, and is amplified in Jersey by the introduction of GST. Put simply, this is a vicious circle as outlined in Figure 3.9. Higher wages lead to higher prices which lead to even higher wages. As a result, Islanders not only have to meet the costs of GST and higher food and fuel prices, but also the loss of competitiveness that such a spiral would bring to an open economy like Jersey. For Islanders, this would manifest itself in job losses and/or wages in the future being lower than would otherwise have been the case in order to regain the lost competitiveness. As Jersey is in a currency union with

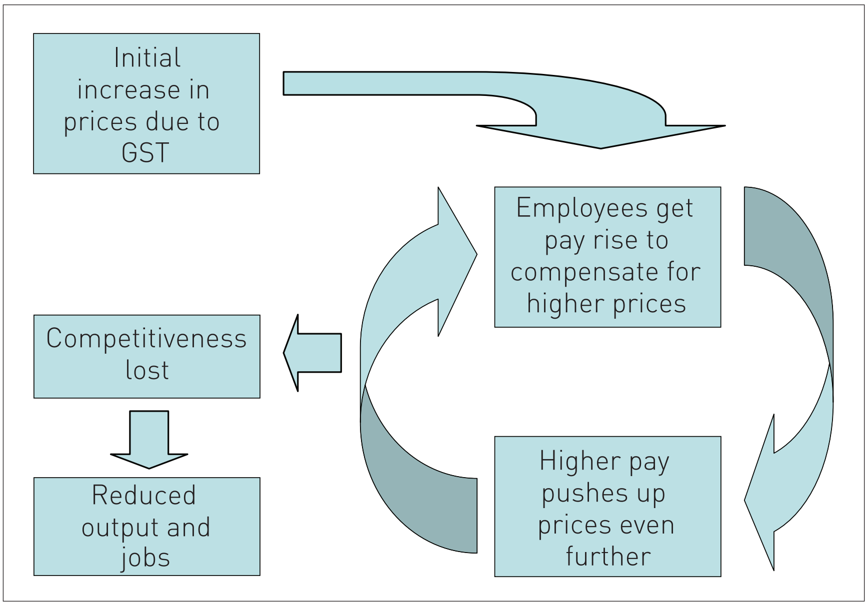


Figure 3.9: A wage-price spiral

the UK, there is not the possibility of exchange rate depreciation to regain competitiveness vis-à-vis the UK.

The Panel sees the biggest threat to the inflation outlook in Jersey and to the improved economic performance of recent years as being the onset of a wage-price spiral precipitated by the combined impact of the introduction of GST and higher food and fuel prices. Islanders should not think that by seeking compensation for these factors in their wage packet that they will escape these costs. A wage-price spiral would increase the costs Islanders ultimately have to bear, not reduce them.

Should a wage-price spiral develop in Jersey the Panel's recommendation would be that fiscal policy be tightened relative to current plans: that is that tax revenue would have to rise and/or spending decrease relative to the current plans. This would reduce demand in the economy and lower output and employment, helping to remove inflationary wage and price pressure.

The Panel will watch trends in pay settlements and earnings closely this year and next to assess whether the risk of a wage-price spiral is becoming a reality and whether it needs to adjust its recommendations accordingly.

To minimise and even reduce the additional burden Islanders are facing at the moment, it is important that the focus of policy is on applying downward pressure to prices, through competition for example, rather than upward pressure on wages. Consumers, businesses and the States all have a part to play in this.

Labour market

The number of people employed grew by 3% last year to approximately 53,040 workers in December 2007, representing the highest December figure for at least a decade (Figure 3.10). This consisted of a net increase of 1,390 in the private sector and 70 in the public sector.

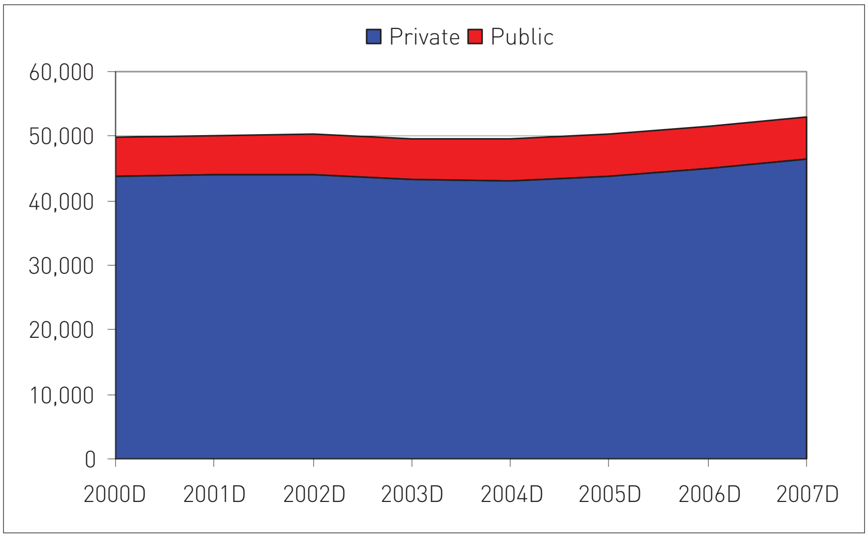


Figure 3.10: Employment continues to increase in the private sector
Private and public sector employment in December of each year
Source: States of Jersey Statistics Unit

The finance sector accounted for 730 and miscellaneous business activities another 300 (up 10%) of the total increase in private sector employment. Total employment in the finance sector of over 13,000 was the highest recorded since the inception of the Manpower Survey in 1996.

Much of the growth in the employed workforce over the last five years has been through increased participation and reduced unemployment. The participation rate – the proportion of working aged people in work (or looking for work) – has increased from 82% to 85% over this period and the unemployment rate has fallen from 2.1% to a record low of 1.4% at the same time.

Inward migration has also supported employment growth in the last couple of years with net increases of 800 and 1,100 people in 2006 and 2007 respectively.

Average earnings in the year to June 2008 were 4.3% higher than in the previous twelve month period - a similar rate of increase to that seen over the last five years. In real terms, this represents a 0.2 percentage points increase in average earnings for the year.

Real GVA/FTE has increased over the last few years (Figure 3.11), returning to a level last seen at the peak of the last economic cycle in 2000. This could indicate that average productivity in the Island has increased, although much of the improvement could be cyclical. It is very important that productivity improvements are made in the economy in future so that Islanders can benefit from higher wages that do not contribute to inflation and therefore genuinely help to ease the burden of higher taxes and basic commodity prices at the moment. The Panel emphasised in its preliminary report that supply-side developments are as important as demand-side developments.

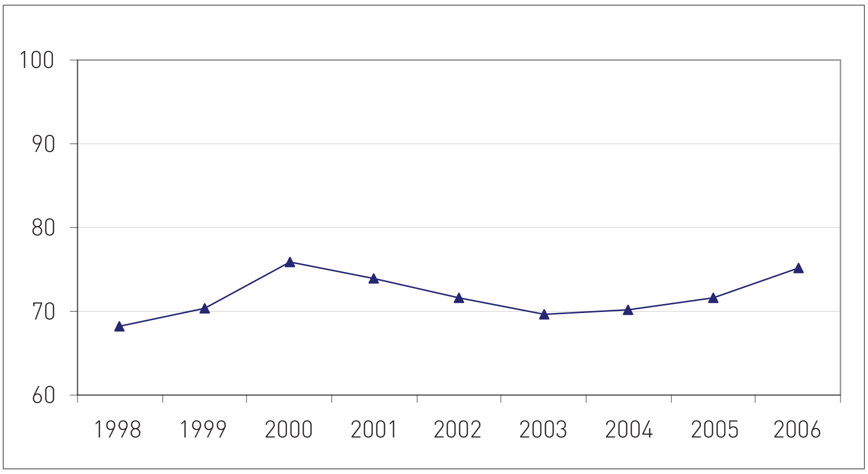


Figure 3.11: Productivity has increased over the last few years
Real GVA per FTE for the economy (£'000)
Source: States of Jersey Statistics Unit

The Panel believes that the labour market has tightened significantly and that there is little spare capacity left in the economy.

It has based its recommendations on the assumption that the economy was approaching full capacity in 2007 and that if growth had continued to grow as rapidly in 2008 and 2009 tighter fiscal policy would have been required. However, the deteriorating external economic environment, the squeeze that Islanders face in terms of GST, food and fuel prices and the fact that the Panel expects the economy to continue to slow means that tightening fiscal policy is not appropriate at this juncture.

Section 4 – The fiscal position and future pressures

Key points

- The States ran a surplus of £37m last year which represented some modest fiscal tightening over 2006. The Panel's view is that the fiscal position last year was broadly right given economic conditions at the time.

- If capital expenditure is adjusted for when the Energy from Waste (EfW) plant expenditure actually occurs then the financial position for 2008 and 2009 is one of continued modest surpluses. Given the Panel's central expectation for slowing growth, modest surpluses of this scale are appropriate, despite that the economy has little spare capacity. The deteriorating external environment and slowing economy have removed the need for tighter fiscal policy which would have been the case if growth had continued at previous rates.

- The Panel is concerned that in the medium-term the combination of spending pressures, including public sector pay, and the threat of slower growth in tax receipts could create structural problems within the States' finances. The Panel therefore recommends that this year's Business Plan and Budget should avoid taking decisions that undermine the tax base or permanently increase expenditure above that currently forecast.

- If the Jersey economy slows more significantly than expected in the second half of 2008 or in 2009 then the automatic stabilisers should be allowed to operate and relax fiscal policy. If such a loosening was not sufficient to counteract the downturn in the economy then discretionary loosening could be appropriate.

- A public sector pay settlement higher than that already factored into the business plan will increase the risk of starting a wage-price spiral. If wage and prices should accelerate, there would be a need to tighten fiscal policy to reduce the risk of sustained inflationary pressure building up.

Current state of public finances

The States ran a surplus of £37m last year (Figure 4.1), £10m of which was transferred into the Strategic Reserve and the rest added to the Consolidated Fund balance. This compares to a surplus of £21m in 2006, after continuing growth in real States' revenues combined with stable real expenditure levels. The size of the 2007 surplus amounts to about 1% of GVA and compared to 2006 represents some modest further fiscal tightening, withdrawing demand from the economy, at a time when the economy was growing strongly and close to full capacity.

The squeeze on Islanders' incomes this year outlined in the previous section and the expected slowdown in the economy mean a further tightening of fiscal policy this year and next is not necessary, despite recent strong growth and a continued shortage of spare capacity.

Tax revenue is forecast to grow further in real terms following the strong growth in revenues in 2006 and 2007. Total income for 2008 is expected to be £624m - almost 12% higher (9% in real terms) than 2007. This reflects further growth in income tax receipts of 7% and the introduction of GST which is expected to raise £30m in the eight months of 2008 that it will have been in operation. Net revenue expenditure is expected to increase in 2008 by 9% (6% in real terms) to £524m.

The financial forecast for 2009 to 2013 is based on the latest estimates of States' revenues and proposed levels of States' expenditure as a result of the business planning process earlier in the year.

Actual	Probable		Forecast				
2007	2008		2009	2010	2011	2012	2013
£m	£m		£m	£m	£m	£m	£m
		States Income					
430	460	Income Tax	475	490	510	530	550
-	-	0/10% Corporate Tax Structure	(9)	(77)	(82)	(87)	(96)
-	30	Goods and Services Tax	45	46	47	48	50
54	50	Impôts Duty	50	49	49	49	49
29	30	Stamp Duty	31	32	33	34	34
-	-	Tax/Stamp Duty on Share Transfer	1	1	1	1	1
36	44	Other Income	33	27	25	24	23
10	10	Island Rate	10	11	11	11	12
559	624	**States Income**	636	579	594	610	623
		States Expenditure					
480	524	Net Revenue Expenditure	531	549	567	584	602
42	143	Net Capital Expenditure Allocation	38	40	37	35	16
522	604	**Total States Net Expenditure**	569	589	604	619	618
37	**(43)**	**Forecast Surplus/(Deficit) for the year**	**67**	**(10)**	**(10)**	**(9)**	**5**
(10)	-	Transfer to Strategic Reserve	-	-	-	-	-
-	(38)	Transfer to Stabilisation Fund	-	-	-	-	-
94	**13**	**Estimated Consolidated Fund balance**	**80**	**70**	**60**	**51**	**56**

Figure 4.1: Summary of recent public finances and future expectations
Revised financial forecast (July 2008) including 2007 actual figures
Sources: States of Jersey Draft Annual Business Plan 2009 and States of Jersey Financial Report and Accounts 2007

Income tax receipts for the period are forecast to grow between 3% to 4% each year (or about 1% in real terms), while net revenue expenditure is forecast to increase 1% to 3% each year (or falling/staying level in real terms).

A significant element in the financial forecast is the Energy from Waste (EfW) plant. Using the usual conventions for capital expenditure, the whole cost of £100m falls in the year in which the decision is made which results in a large fiscal deficit in 2008 and surpluses in subsequent years. Without this approved funding, there would have been a large surplus of £57m in 2008.

The capital allocation for the EfW plant distorts the picture going forward because in general the amount spent on capital projects by the States each year is in the region of £40m. The expenditure for the EfW plant will actually be incurred over the next three years: £36.9m in 2008, £36.4m in 2009 and £26.4m in 2010.

If capital expenditure is adjusted for when the EfW expenditure actually occurs and has an impact on the economy then the financial position for 2008 and 2009 is one of continued modest surpluses with a Consolidated Fund balance falling to £50m through the forecast period as 0/10 is introduced (Figure 4.2). However, in 2010 the fact that capital expenditure will be higher than the £40m originally included in the forecasts (because there will also be £26m expenditure on the EfW plant) what was previously estimated as a minor deficit becomes much larger.

Figure 4.2: Public finances including EfW timing adjustment
Revised financial forecast including 2007 actual figures – abbreviated
Sources: States of Jersey Draft Annual Business Plan 2009 and States of Jersey Financial Report and Accounts 2007

Actual 2007 £m	Probable 2008 £m		Forecast 2009 £m	2010 £m	2011 £m	2012 £m	2013 £m
559	624	**States Income**	636	579	594	610	623
		States Expenditure					
480	524	Net Revenue Expenditure	531	549	567	584	602
42	143	Net Capital Expenditure Allocation	38	40	37	35	16
	(63)	EfW plant adjustment	37	26			
522	604	**Total States Net Expenditure**	605	616	604	619	618
37	**20**	**Forecast Surplus/(Deficit) for the year**	**31**	**(37)**	**(10)**	**(9)**	**5**
		Estimated Consolidated Fund balance	**80**	**70**	**60**	**51**	**56**

The Panel considers the modest surpluses planned for 2008 and 2009, adjusting for the EfW plant expenditure, are broadly appropriate given current economic prospects.

It is too early to accurately assess what the economic conditions are likely to be in 2010 but the Panel notes that should the economy be growing strongly in 2010 and/or the expected slowdown in 2009 does not materialise, then running a significant deficit of this nature would be pro-cyclical and unlikely to be conducive to meeting the States' economic objectives. However, a protracted slowdown in 2009 and 2010 could also mean that such a deficit would be counter-cyclical and appropriate. The

Panel will discuss this further in its next report when Jersey's economic performance in 2008 and into 2009 is clearer.

Risks and uncertainties

Recent tax revenue growth

Some of the recent growth in tax revenue will be structural (for example due to changes to the tax system ahead of 0/10 and permanent growth in Island industries) and some will be cyclical (for example, higher employment, bonuses or profits purely because the economy is doing well).

Structural growth in tax revenue does not change as the economy speeds up or slows down and so can be built in to the tax base in forecasts. However, cyclical growth in tax revenue will disappear as the economy slows down. To the extent that recent increases in tax revenue have been cyclical, there is a risk that future tax revenues could be weaker than forecast.

The loss of income from 0/10 is expected to be between £89m and £104m a year by 2013. The best estimate of £96m (the middle of the range) included in the forecast but there is of course the possibility that the actual loss turns out to be at the high end or low end of expectations.

Tax revenue (particularly the part that comes from companies) is difficult to forecast beyond a year and may change unexpectedly from year to year as well.

Future pressures on spending

The Draft Annual Business Plan 2009 highlights that there are a number of pressures on States' expenditure this year and in coming years.

There are £29.25m of service pressures and initiatives that have not been accommodated within the approved spending limits for 2009 (Figure 4.3). While spending limits are not expected to increase, the Council of Ministers have made it clear that they will continue to seek other options of funding and ensure they are considered in future business plans. The most significant pressures are property and infrastructure maintenance work totalling £13m and £3.8m respectively.

In addition, a 'New Directions' policy is being developed to address the rising cost of health care and consequences of an ageing population. The cost is expected to be significant and will be considered for future business plans.

Annual pay awards

There is also the outcome of the annual pay awards to consider. The civil servants, police and prison officers groups are in their final year of a three-year agreement and a number of other employee groups, including the manual workers group are still to negotiate their pay awards for this year.

Other service pressures/initiatives	Dept	2009	2010	2011	Total
		Additional recurring funding			
		£'000	**£'000**	**£'000**	**£'000**
Increased Early Years provision	ESC	600	900		1,500
Introduce inclusive vocational day services and employment for people with special needs	SS	600	200	-	800
Increased costs of Residential Care placements	SS	550	-	-	550
Provision for strategic fiscal advice	Corporate	200	-	-	200
Chief Minister's department	CMD	650	-	-	650
Law Officers (additional resources)	Non Min	650	-	-	650
Customs and Immigration (increased activity)	HA	400	-	-	400
Discrimination Legislation	HA	500	-	-	500
Environment - Energy/efficiency initiatives	P&E	1,000	1,000	500	2,500
Environment - Recycling	TTS	500	250	750	1,500
Environment - Sustainable transport Initiatives	TTS	500	500		1,000
Infrastructure Maintenance underfunding	TTS	3,300	500	-	3,800
Property Maintenance underfunding	T&R(PH)	12,500	500	-	13,000
Paying rates on States Properties	T&R(PH)	-	1,600	-	1,600
ICT Strategy	ESC	-	-	600	600
		21,950	**5,450**	**1,850**	**29,250**

Figure 4.3: Service pressures and initiatives not included in cash limits
Source: States of Jersey Draft Annual Business Plan 2009

A higher public sector pay settlement than that already factored into the business plan would increase future expenditure (as a guide, every extra 1% would add £3.5m to expenditure) and could influence private sector wage settlements.

The Panel set out in Section 3 that if wages in the public and private sector simply rise to reflect the rising costs of commodities and GST the economy will enter a wage-price spiral that will be very damaging for the economy. If wage and prices should accelerate, there would be a need to tighten fiscal policy to reduce the risk of sustained inflationary pressure building up.

Alternative scenarios

This section looks at some alternative scenarios based on different assumptions about trends in revenue and expenditure.

Figure 4.4 illustrates the current financial forecasts adjusted for the projected occurrence of the EfW spending.

In order to appreciate the possible impact of these pressures, risks and uncertainties over the forecast horizon on States' finances, the Panel has set out three scenarios:

1. Growth in income tax receipts (2% real growth)
2. Declines in income tax receipts (2% real falls)
3. Growth in expenditure (3% real growth)

1. Growth in income tax receipts

The Annual Business Plan 2009 forecast includes 3% to 4% growth per annum in income tax in nominal terms, or about 0% to 1% per annum in

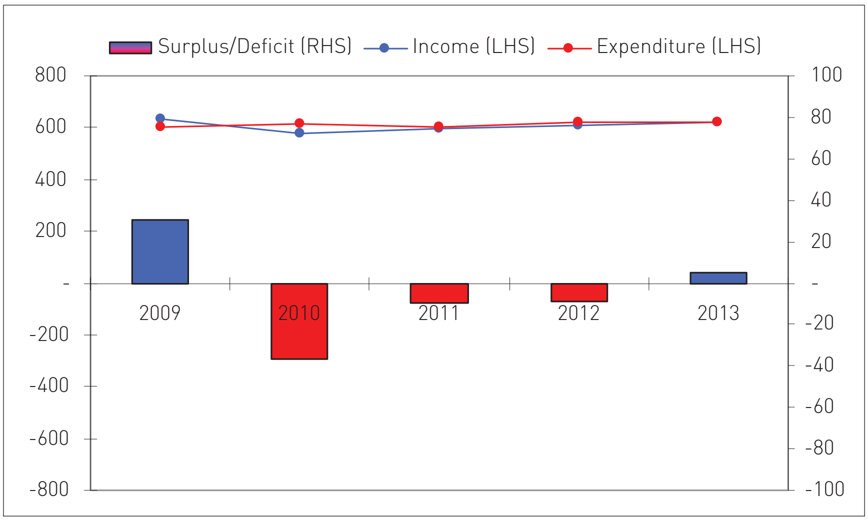


Figure 4.4: Public finances – current forecasts adjusted for EfW
Income, expenditure, surplus and deficits for 2009-2013
Sources: States of Jersey Draft Annual Business Plan 2009 and States of Jersey Financial Report and Accounts 2007

real terms. Supposing that income tax receipts were to increase by an additional 2% per annum (representing 2% real growth) through greater tax paid by financial services companies, for example, then the situation would look like that in Figure 4.5. That is, the outturns in States' finances would be much better than forecast and surpluses would occur 2011-2013.

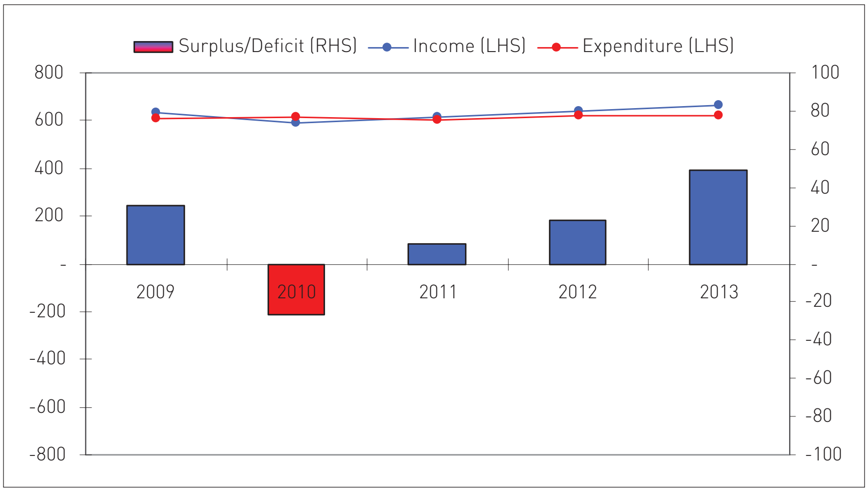


Figure 4.5: Public finances – increased income tax scenario
Income, expenditure, surplus and deficits for 2009-2013
Sources: States of Jersey Draft Annual Business Plan 2009 and States of Jersey Financial Report and Accounts 2007

2. Declines in income tax receipts

Given the significant economic uncertainty going forward, and the possibility that some recent rises in revenue have been cyclical, it is appropriate to model a scenario where income tax receipts do not increase in nominal terms for a number of years. If income tax receipts were to decrease in real terms by 2% per annum (no change in nominal terms) through lower taxes paid by financial services companies, for example, then the situation would look like that in Figure 4.6. This is what happened to States' income from 2000 to 2002 before it declined in real terms in 2003 and 2004. The result is that significant deficits occur in 2010-2013 and that at least part of such deficits could be structural and therefore would need to be rectified.

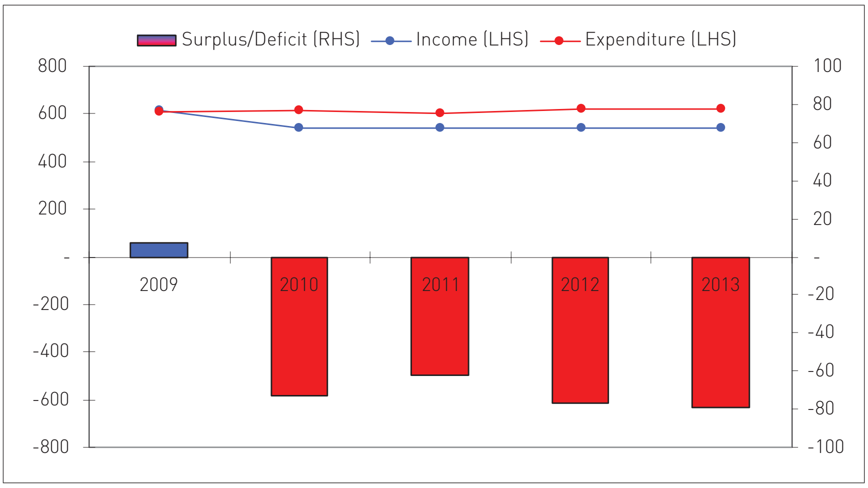


Figure 4.6: Public finances – decreased income tax scenario
Income, expenditure, surplus and deficits for 2009-2013
Sources: States of Jersey Draft Annual Business Plan 2009 and States of Jersey Financial Report and Accounts 2007

3. Growth in expenditure

If instead of no real increases in States' expenditure, expenditure were to increase by 3% per annum in real terms, the fiscal position would look like that in Figure 4.7. Again significant deficits occur in 2010-2013 that are likely to be at least partly structural and require policies to address them.

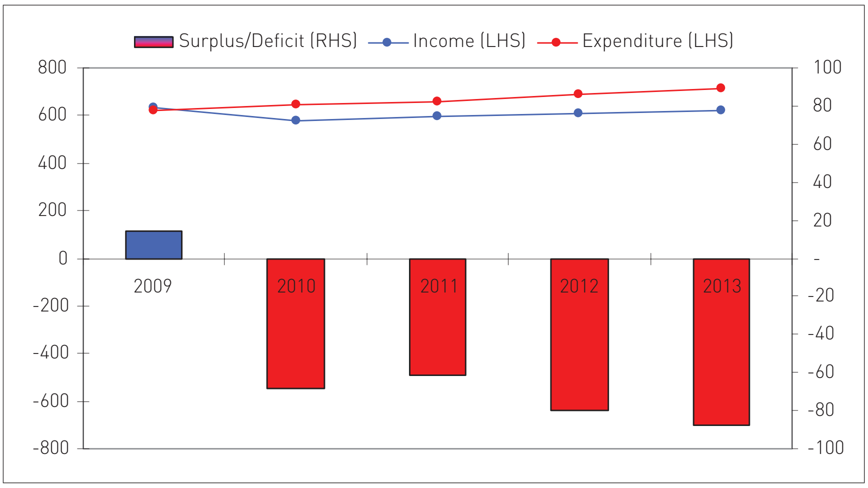


Figure 4.7: Public finances – increased expenditure scenario
Income, expenditure, surplus and deficits for 2009-2013
Sources: States of Jersey Draft Annual Business Plan 2009 and States of Jersey Financial Report and Accounts 2007

The Panel sees the two main risks being that tax revenue does not increase as much as forecast and that expenditure growth turns out to be higher than forecast. The forecast fiscal stance for 2008 and 2009 is broadly right given the economic conditions, but there is a risk that States' finances could deteriorate significantly in the medium-term. Therefore this year's Business Plan and Budget should, if possible, avoid taking decisions that undermine the tax base or increase expenditure at a rate above that currently forecast.

What if the economy weakens?

The Panel has highlighted that there is a significant risk that the global economy will slow more than current forecasts suggest and that continued financial markets weakness will mean that Jersey could face a significant economic slowdown. In the face of a significant economic slowdown in Jersey a temporary loosening of fiscal policy (temporarily reducing taxation and/or increasing spending) would be appropriate.

The Panel does not believe however, that economic conditions currently merit a further loosening of fiscal policy in 2008 or 2009. The automatic stabilisers (where tax revenue falls when the economy slows and expenditure increases) should be allowed to work before discretionary decisions are taken to loosen fiscal policy further. Any discretionary loosening must be temporary so that it does not impair the long-term fiscal position.

Scenario 2 above shows how the automatic stabilisers might work in Jersey – that is income tax receipts might not increase and actually fall in real terms. This would open up a significant deficit which would also represent counter-cyclical policy.

If such a loosening was not sufficient to counteract the downturn in the economy then discretionary loosening could be appropriate. However, it is critical that any loosening should not be based on permanently lower tax rates or an increase in expenditure that builds into base budgets. Money from the Consolidated or Stabilisation funds could be used to replace revenue lost due to the cyclical downturn and therefore help support government expenditure programmes. It could also be used to fund expenditure programmes that were temporary.

Section 5 – Policy recommendations

Key points

- These recommendations are based on the Panel's assessment of the economic outlook and the current and expected fiscal position.

Recommendations

- The Panel recommends that no further additions to or subtractions from the Stabilisation Fund or Strategic Reserve should be planned for this year or next.
- It considers that the modest financial surpluses contained in the current business plan for 2008 and 2009, once adjusted for EfW expenditure, are broadly appropriate given current economic prospects and the States' objectives of economic growth with low inflation.
- The Panel recommends that the States does not approve decisions either as part of the Business Plan or Budget that undermine the tax base or commit to expenditure growth greater than that currently forecast.
- In view of the risks to the economy, the States should not plan to allocate the expected additions to the Consolidated Fund at this stage.
- In the event of a sharper and more protracted slowdown than currently expected, the Panel recommends that the automatic stabilisers should first be allowed to work before discretionary changes to fiscal policy are contemplated. Any discretionary changes should avoid policy measures that would permanently weaken the tax base or raise expenditure levels.
- There is a danger that the combination of the introduction of GST and higher food and fuel prices sets off a wage-price spiral. This is one of the principal near term risks to the Jersey economy. Should this happen, the Panel would recommend that fiscal policy is tightened as an aid to containing inflation and restoring competitiveness.

Recommendations

Given the current economic situation and prospects, and the likelihood that Jersey will feel the force of the global economic slowdown in the next couple of years (examined in Section 3), the Panel feels that the position of modest financial surpluses forecast for 2008 and 2009, once adjusted for EfW expenditure, is broadly appropriate. The squeeze on Islanders' incomes this year from higher commodity prices and GST means a tightening of fiscal policy is not proposed.

The Panel is concerned about the extent to which the expected slowdown in the global economy and continued weakness of financial markets will affect the economic performance and fiscal outlook of Jersey. It expects the economy to slow significantly over the course of the next 12 to 18 months and the Island should be preparing for this by budgeting for surpluses now and building up a balance in the Consolidated Fund.

In addition, there is also a significant risk that States' revenue and expenditure levels turn out to be worse than that currently forecast revealing a structural deficit in States' finances in the medium-term. The Panel recommends that the Business Plan and Budget do not include decisions that weaken the tax base or commit to greater expenditure growth.

By maintaining current tax and spending profiles, significant funds will accumulate in the Consolidated Fund in addition to those already in the Stabilisation Fund. The States should take care to ensure that this additional money is not allocated unless the economy starts to slow more sharply. This will provide scope to allow the automatic stabilisers to operate and to implement a discretionary relaxation of fiscal policy should future economic conditions merit such an approach.

Contingent recommendations

Prolonged global economic and financial market downturn

There is a risk that the global economic slowdown and financial market downturn are sharper and more prolonged than forecasters currently expect.

If this becomes apparent then some fiscal loosening would be appropriate next year. The automatic stabilisers within fiscal policy should be allowed to work first, i.e. the natural inclination in a slowing economy for tax revenues to fall and expenditure to increase. Then, discretionary loosening (i.e. plans to reduce tax revenues and/or increase spending) is an option if there is a need to reinforce the automatic stabilisers. Depending on the balance in the Consolidated Fund this could involve money being transferred out of the Stabilisation Fund. Any discretionary loosening would have to be designed so that it was clearly cyclical and not structural.

Economic growth in Jersey does not slow

Should growth in the economy not slow down as expected next year there would be a need to tighten fiscal policy to reduce the risk of inflationary pressure building up if the economy moved above full capacity.

Wage-price spiral

There is a danger that the combination of the introduction of GST and higher food and fuel prices sets off a wage-price spiral. Should this happen, the Panel would recommend that fiscal policy is tightened relative to the current plans – that is tax revenue would have to rise or spending would have to fall (or a combination of both). This would help to contain the additional inflationary pressure and restore the Island's competitiveness.

Appendix 1: List of contributors

The Panel is very interested to hear the views and opinions of people on fiscal policy and related economic matters.

On 18 June 2008 the JEP published an article inviting written submissions to be made by the public. The following groups were also invited meet the Panel during its visit to the Island in July:

Business representatives:

- Chamber of Commerce
- Institute of Directors
- Jersey Finance Limited
- Jersey Financial Services Commission

States of Jersey representatives:

- Economic Development Department
- Economics Unit
- States Business Plan Scrutiny Sub Panel
- Statistics Unit
- Treasury and Resources Department

Union representatives:

- Amicus
- Communication Workers Union
- Jersey Civil Service Association
- National Union of Teachers
- Royal College of Nursing
- Transport & General Workers Union
- Unite Union 2/300 Branch

The Panel would like to thank all of those who met them in July and those who submitted their views in writing.