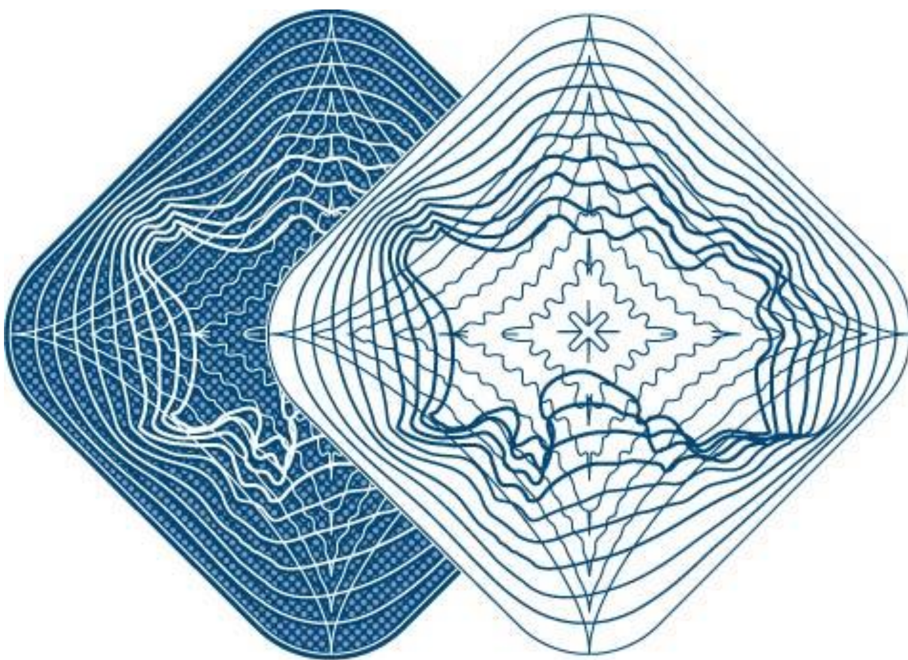
Jersey’s Fiscal Policy Panel Annual Report

November 2013



Introduction

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

Since it was formed in October 2007, the Panel has visited the Island on many occasions. Its work has benefited greatly from the discussions it has had with many people and institutions on and off the Island: its job would be much more difficult without their generosity. The Panel is also grateful for the invaluable support provided by the staff of the States of Jersey, in particular the States of Jersey Economics Unit.

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

Key points

International economic outlook

- Global growth slowed by more than forecast in 2012 and 2013 is expected to see the slowest growth in world output since 2009, below the long-run annual average.
- There has been a shift in the pattern of growth in the world economy as the advanced economies accelerate, albeit from a sluggish pace, and the slowdown in the emerging economies continues.
- Although growth is expected to accelerate next year, forecasts for 2014-2017 have been considerably downgraded. Primarily this relates to significant downward revisions to forecasts for the emerging and developing economies.
- Policy interest rates are at record lows in the UK, euro area and US and are likely to remain so throughout 2014. However there are some uncertainties around the timing of "tapering" of the US quantitative easing programme.
- A number of the previous major downside risks appear to have diminished but new risks have emerged around a prolonged slowdown in the emerging economies, policy uncertainties in advanced economies, capital withdrawal from emerging markets and falling prices of risk assets as the advanced economies tighten monetary policy.

Jersey economic outlook

- Gross Value Added (GVA) for the Jersey economy fell by 4% in 2012. The financial services sector saw GVA decline by 5% whilst the non-finance sectors declined by 4%.
- The fiscal stance was less accommodative in 2012 and it appears likely that at least part of the fall in GVA in 2012 will have been due to this less accommodative fiscal stance.
- Surveys have reported an improvement in local conditions this year compared to 2012 and Jersey is likely to benefit from the improving performance of the advanced economies, particularly the UK.

- The Panel forecast GVA growth of between -2% and 2% in 2013, and between -2% and 3% 2014.

- Local surveys and the persistently high level of unemployment suggest there is a significant degree of spare capacity in the economy and in the construction sector. Significant spare capacity will remain in the economy over 2013 and 2014 suggesting that additional fiscal stimulus could be effective in supporting businesses and employment.

- The longer-term outlook is clouded by the continued weak productivity performance across the economy; the continued regulatory and competitive pressures on financial services; and the future impact of the ageing society.

Public finances

- Fiscal policy was not counter cyclical in 2012, against the Panel's advice to increase capital expenditure to help support jobs and business activity during 2012.

- Capital expenditure totalled £36m in 2012 – half the £72m that was anticipated at the time of the Panel's last report and half the levels seen in 2010 and 2011. This seemed to be caused primarily by a lack of project management capacity which the Panel understands has now been addressed. The Panel reiterates that the extent of stimulus should not be limited by the balances on the Consolidated or Stabilisation Funds.

- Budget 2014 proposes to run a large budget deficit at a time when the economy is still expected to have significant spare capacity, implying that fiscal policy will be counter cyclical. Conditions in 2015 and beyond are less certain and the Panel should comment on whether deficits of the scale proposed are appropriate in future reports.

- The draft Budget proposes to make an exception to the Fiscal Framework for the new hospital project. It sets a worrying precedent for the States to make an exception to the Fiscal Framework in order to spend money from the Strategic Reserve. This exception would not be necessary if there were enough interest in the Strategic Reserve to leave the capital untouched, but the optimal size of the Strategic Reserve would have to be determined before this conclusion could be drawn.

- The Panel was encouraged by the Treasury Minister's progress update to the States in April, which stated that the Treasury and Resources Department will develop a consistent approach to the measurement and monitoring of structural surpluses and deficits. The Panel is not aware that this work has been finalised and would have liked to see this as supporting information for Budget 2014, especially as there are proposals for long-term changes to income tax and funding capital expenditure.

- Further information on the nature of the capital programme, distinguishing between renewal and enhancement, would help to determine whether there is an underlying structural deficit, as highlighted in the Panel's last report.

- Given the economic outlook for 2014, the Panel agree that it was advisable to delay the implementation of the Long-term Care charge until 2015. The Panel should keep a watching brief to see whether the plan to phase in the charge is appropriate given the economic outlook and fiscal balance in 2015 or 2016.

- Future risks and uncertainties remain more to the downside and include the impact of UK and US FATCA negotiations, lower long term productive potential, further risks to finance sector performance and the challenges of an ageing population.

Recommendations

1. The States should ensure that the planned fiscal stimulus is delivered in 2013 and 2014, and that where possible additional expenditure should be brought forward to compensate for likely delays in other expenditure.

2. The effectiveness of fiscal stimulus through capital spending depends on bringing forward capital projects and making sure the expenditure takes place on time. The Treasury and Resources department should be proactive in:

    - Identifying and resolving any bottlenecks and barriers in delivering capital projects
    - Ensuring there is flexibility to bring forward (and potentially delay) capital projects
    - Managing the capital programme in a similar way to the £44m fiscal stimulus programme in 2009.

3. The States should make contingency plans for an improvement in economic conditions and reduction in spare capacity from 2015. This would mean running counter cyclical fiscal policy and topping up the Stabilisation Fund. The plans could include:

    - Reducing departmental expenditure and/or raising revenue
    - Changing the profile of spending on the three significant projects or other projects in the capital programme
    - Changing how key capital projects are delivered to put less strain on local capacity.

4. The States should clearly define the purpose and optimal size of the Strategic Reserve and set out conditions for its use, including how borrowing from the Reserve would be dealt with. This should be done before deciding whether or not to use the Strategic Reserve to pay for the new hospital or any other capital expenditure.

5. In April 2013 the Treasury Minister provided a progress update on the Panel's seven main recommendations. This development is warmly welcomed by the Panel. It is recommended that a progress report should be published by the Minister every year.

6. Every Budget should include:

    - A financial forecast for the current and next 3 years including updated income projections

    - Proposed movements on the Consolidated Fund, Stabilisation Fund and Strategic Reserve for the current year and next 3 years.

    - Data which shows what happened to these Funds in the previous 3 years.

    - A financial forecast showing the surpluses and deficits adjusted to recognise the economic impacts.

7. The Treasury and Resources department should identify the maximum buffer that is required in the Consolidated Fund for remaining contingencies in a year. Any funds in excess of that buffer should be transferred to the Stabilisation Fund.

8. Further work should be undertaken on the nature of the capital programme, in particular distinguishing between spending to maintain and renew existing infrastructure and spending on new or enhanced infrastructure. This would help ascertain whether or not there is an underlying structural deficit.

Section 1 - The Economic Outlook

Key points

International economic outlook

- Global growth slowed by more than forecast in 2012 and 2013 is expected to see the slowest growth in world output since 2009, below the long-run annual average.
- There has been a shift in the pattern of growth in the world economy as the advanced economies accelerate, albeit from a sluggish pace, and the slowdown in the emerging economies continues.
- Although growth is expected to accelerate next year, forecasts for 2014-2017 have been considerably downgraded. Primarily this relates to significant downward revisions to forecasts for the emerging and developing economies.
- Policy interest rates are at record lows in the UK, euro area and US and are likely to remain so throughout 2014. However there are some uncertainties around the timing of "tapering" of the US quantitative easing programme.
- A number of the previous major downside risks appear to have diminished but new risks have emerged around a prolonged slowdown in the emerging economies, policy uncertainties in advanced economies, capital withdrawal from emerging markets and falling prices of risk assets as the advanced economies tighten monetary policy.

Jersey economic outlook

- Gross Value Added (GVA) for the Jersey economy fell by 4% in 2012. The financial services sector saw GVA decline by 5% whilst the non-finance sectors declined by 4%.
- The fiscal stance was less accommodative in 2012 and it appears likely that at least part of the fall in GVA in 2012 will have been due to this less accommodative fiscal stance.

- Surveys have reported an improvement in local conditions this year compared to 2012 and Jersey is likely to benefit from the improving performance of the advanced economies, particularly the UK.

- The Panel forecast GVA growth of between -2% and 2% in 2013, and between -2% and 3% 2014.

- Local surveys and the persistently high level of unemployment suggest there is a significant degree of spare capacity in the economy and in the construction sector. Significant spare capacity will remain in the economy over 2013 and 2014 suggesting that additional fiscal stimulus could be effective in supporting businesses and employment.

- The longer-term outlook is clouded by the continued weak productivity performance across the economy; the continued regulatory and competitive pressures on financial services; and the future impact of the ageing society.

1.1 International outlook

Global growth slowed in 2012 and by rather more than forecast at the time of the Panel's last report. As the slowdown continued into this year, forecasts for 2013 have been downgraded also. In the October 2013 World Economic Outlook, the International Monetary Fund (IMF) forecast that the world economy will grow by 2.9% in 2013, before accelerating to 3.6% in 2014, down from 3.9% and 4.4% at the time of the Panel's last report. This means the IMF now expects 2013 to see the slowest growth in world output since 2009, below the long-run annual average of approximately 3.4% since 1980.

The IMF has significantly downgraded its forecasts for 2013-2017 (Figure 1.1). The revised forecasts mean that by 2017 the IMF expects the world economy to be 3.3% smaller than they had forecast when the Panel last reported (bottom panel). Primarily this relates to significant downward revisions to forecasts for the emerging and developing economies.

Growth in world trade has slowed since the onset of the financial crisis, growing at an average of 2.8% in the last five years, including a significant fall in 2009. This is significantly less than the 6.7% average between 2000 and 2007 and the IMF do not forecast annual growth in trade to reach 6% in any of next five years.

2013 has seen a shift in the pattern of growth in the world economy as the advanced economies have accelerated, albeit from a sluggish pace, and the

slowdown in the emerging economies continues, with many seeing growth slowing further in 2013 after a disappointing year in 2012.

The United States saw a return to relatively strong growth in 2012 but has fallen back since, partly due to the considerable automatic cuts in government expenditure in 2013 resulting from the budget sequester – though a much larger fiscal consolidation (the fiscal cliff) was avoided. Ongoing uncertainties over fiscal policy and an anticipated tightening of monetary policy continue to act as a drag on growth but stronger growth is expected to return in 2014. The IMF forecast of 2.6% growth in 2014 was on the assumption of a swift resolution to the political standoff which had led to a shutdown of the federal government at the beginning of October. A deal reached by Congress on 16 October has temporarily resolved this standoff, but only until the early part of 2014.

The euro area emerged from recession in the second quarter of 2013, after 18 months of contraction. France, Germany and Portugal performed particularly strongly in the second quarter. However, the largest periphery economies of Italy and Spain remained in recession, as did the Netherlands in the core – representing the third, fourth and fifth largest economies in the euro area. The IMF expects the euro area to contract by approximately 0.5% over 2013 before growing by 1% in 2014, rising to 1.6% by 2018. The risk of a disorderly break-up of the currency union has diminished following policy action in 2012 such as the Outright Monetary Transactions framework (the purchase of sovereign debt by the European Central Bank). However, risks remain and a sustained recovery appears to remain a long way off – particularly for the southern periphery countries.

The UK has returned to growth in 2013, after a flat performance in 2012. The first three quarters have seen GDP grow by approximately 1.8%, though the economy remains approximately 2.5% smaller than it was at the peak in quarter 1 of 2008. Employment grew steadily in 2012 and the total number of hours worked has now increased above pre-crisis levels. The IMF has considerably upgraded its forecast for the UK since the summer, anticipating growth of approximately 1.5% this year and 2% in 2014 – well ahead of its forecast for the other large European economies. There have been positive indications from the Purchasing Managers' Index (PMI) surveys and prospects for trade have improved but for the moment the data only indicate a small upturn after a dire performance.

Figure 1.1

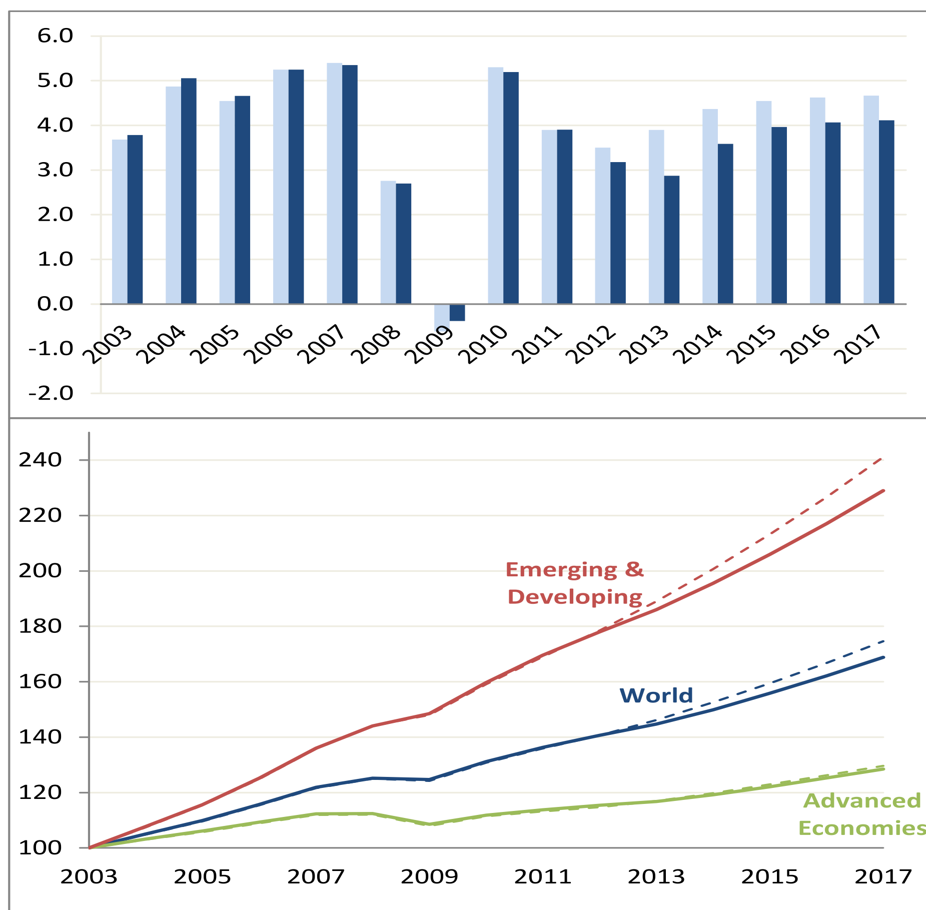
Global Growth

Top panel: % change in world GDP on previous year, dark bars are current (October 2013) estimates/forecasts, pale bars are July 2012

Bottom panel: index (2003=100) of GDP, dashed lines are July 2012 estimates/forecast

Source: Current estimates/forecasts from IMF World Economic Outlook, October 2013

Previous estimates/forecasts for 2010-2013 from July 2012 Update, other years from April 2012 Outlook



The IMF reports that three quarters of emerging markets are now experiencing slowdowns – a proportion only seen during previous crises. Subdued global demand has prevented emerging economies from returning to their pre-crisis growth rates and has dispelled any notion that they could rely on domestic demand or on short term capital inflows for significant growth. The recession in the European Union, the world's biggest economy, will have hit hard in this respect as it is the biggest market for China, India, Russia and Brazil amongst others.

The expectation of "tapering" of the US quantitative easing programme caused an increase in interest rate expectations in May 2013, resulting in a flow of capital out of some emerging and developing economies. Countries with large current account deficits, such as South Africa, Turkey, India and Brazil, have proved particularly vulnerable and have seen substantial depreciation of their currencies. There has also been a degree of overheating in many emerging economies necessitating corrective policy action and many are also now constrained by a lack of infrastructure following a long period of strong growth.

Commodity prices were relatively subdued over the twelve months to September 2013 with food prices declining by almost 8% and oil prices growing by only 2%. Oil prices have been largely range bound over the last

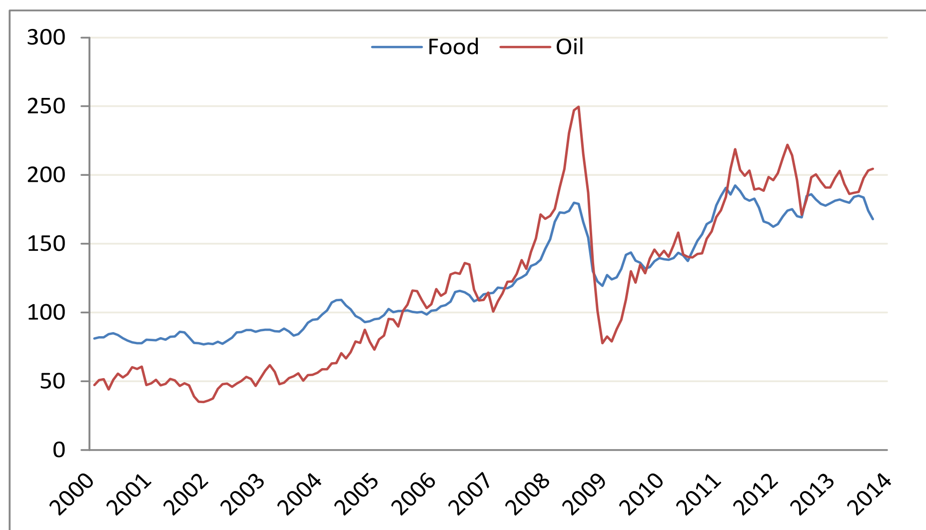
year, albeit at a high level, with the price rises of 10% over the summer cancelling out price falls in the early part of the year. The IMF's most recent quarterly forecasts (from September 2013) envisage oil prices falling 10% by the end of 2014.

Figure 1.2

Commodity Prices

Nominal food and oil prices index 2005=100

Source: International Monetary Fund, index of primary commodity prices – September 2013



Official interest rates have remained low in 2013 with the European Central Bank (ECB) cutting its benchmark rate further to a record low of 0.5% in May. UK and US official interest rates have been at record lows since late 2008 / early 2009.

Following the US Federal Reserve issuing forward guidance in December 2012, the Bank of England followed in August 2013 - stating that interest rates would remain at the current level at least until unemployment falls to 7%, which the Bank's central forecast did not expect before the end of 2015, "provided this does not entail material risks to price stability or financial stability". However market interest rates have nevertheless increased this year and sterling has strengthened reflecting improving growth in the economy and expectations that unemployment might fall to 7% earlier than the Bank expected.

The majority of forecasters expect short term interest rates in the UK to remain at their record low throughout 2014. The UK Treasury produce a monthly summary of published forecasts from a variety of city and non-city organisations. The October summary included twenty recent forecasts of the official bank rate. Only three of these forecasters anticipated any increase from the current rate by the final quarter of 2014. It is likely that rates could remain low even if unemployment falls below 7%, due to the scope for non-inflationary growth as productivity picks up.

Overall, the Panel's assessment is that the international economic outlook remains precarious. While many of the advanced economies, including the UK, are gaining momentum, the slow-down in emerging economies has been deeper and more protracted than previously envisaged. A number of the previous major downside risks appear to have diminished, particularly regarding disorderly break-up of the euro area, the US fiscal cliff and the risk of a hard landing in China. However, a full resolution has yet to be found to risks in relation to sovereign debt and US fiscal policy. In addition, a number of significant new risks have emerged around a prolonged slowdown in the emerging economies, policy uncertainties in advanced countries, capital withdrawal from emerging markets and falling prices of risk assets as the advanced economies tighten monetary policy.

1.2 Jersey economic outlook

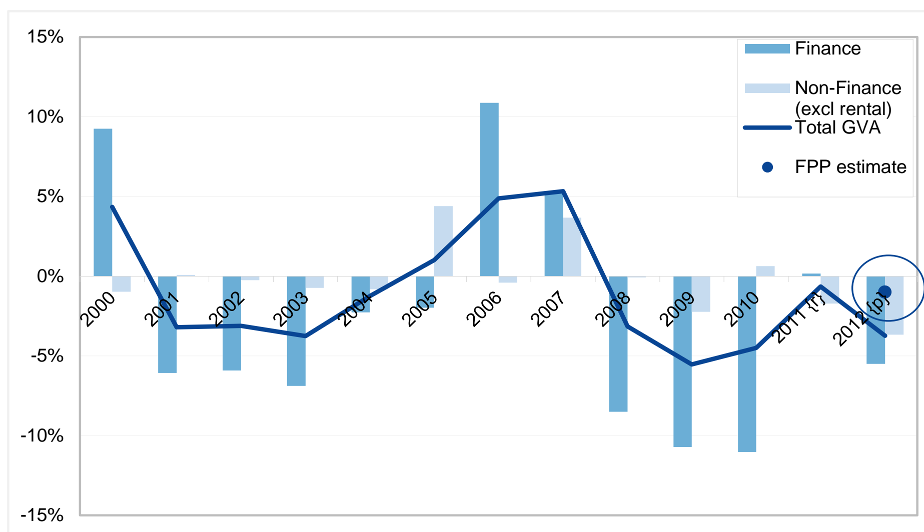
The level of economic activity in Jersey, as measured by Gross Value Added (GVA), is recorded to have fallen by 4% in real terms in 2012. This is slightly below the lower bound of the Panel's central forecast range of -3% to +1% and represents the fifth consecutive year of contraction. The financial services sector saw GVA decline by 5% whilst the non-finance sectors declined by 4% (Figure 1.3).

Figure 1.3

A breakdown of Gross Value Added growth

Annual % change

Source: States of Jersey Statistics Unit



The Panel's GVA forecasts were made on the basis that fiscal policy in 2012 and 2013 would remain as accommodating as in 2011. The impact of States net spending (i.e. spending minus revenues) in 2012 was approximately £70m less than in 2011. At the same time nominal GVA fell by approximately £33m. While only a proportion of States net spending will feed into Jersey's GVA (due to saving and leakage into imports), it appears likely that at least part of the fall in GVA will have been due to the less accommodative fiscal stance in 2012.

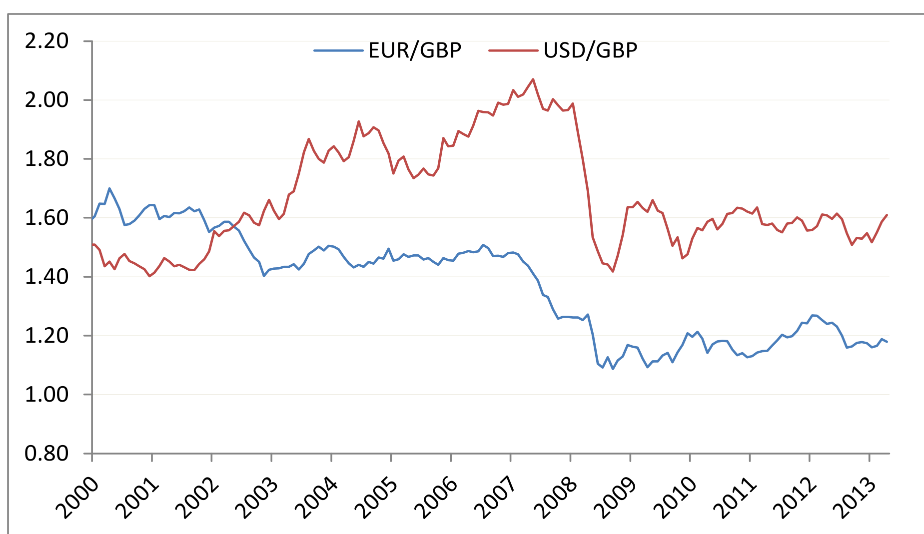
As a small export-orientated economy, economic growth in Jersey relies on external demand and this is dependent on remaining globally competitive. In the UK, unit labour cost competitiveness has improved since the financial crisis, returning to a level comparable to the early to mid-1990s. There is no available measure of unit labour cost competitiveness for Jersey. However, the Panel has considered the sterling exchange rate as this will influence the cost of Jersey exports to non-sterling markets. Sterling had reached a post-crisis high against the euro around the time of the Panel's October 2012 report but has since fallen by 5%. Sterling has made some recent gains against the dollar but these have simply cancelled out falls early in the year to leave the exchange rate largely at the same level as a year previous. Both exchange rates remain significantly below the pre-crisis levels, making Jersey exports relatively cheaper than they would otherwise have been.

Figure 1.4

Sterling exchange rates

Euros per pound
US dollars per pound

Source: Bank of England



Real wages have fallen in both Jersey and UK since the onset of the financial crisis. However, the fall in real wages in the UK since 2008 has been more significant than in Jersey.

Financial Services Sector

GVA in the finance sector is measured as having fallen by 5% in real terms in 2012 following a flat year in 2011. Over the last five years, measured GVA for the finance sector has fallen by almost a third, with the majority of this coming during 2008, 2009 and 2010.

Finance sector profits as measured by gross operating surplus (GOS) fell by 5% in real terms in 2012, and employee remuneration fell by 6%. This is the largest fall in financial sector employee remuneration since the 2008/2009 crisis. The previous falls in GVA in 2008, 2009 and 2010 were primarily driven by a fall in profits - mainly in the banking sector as a result of low interest rates,

which limit the margin that can be made on deposits in Jersey (as described in Box 1 of the Panel's 2009 Annual Report). A large part of the fall in GVA for the finance sector since 2008 has therefore been due to low interest rates, rather than being reflective of levels of activity.

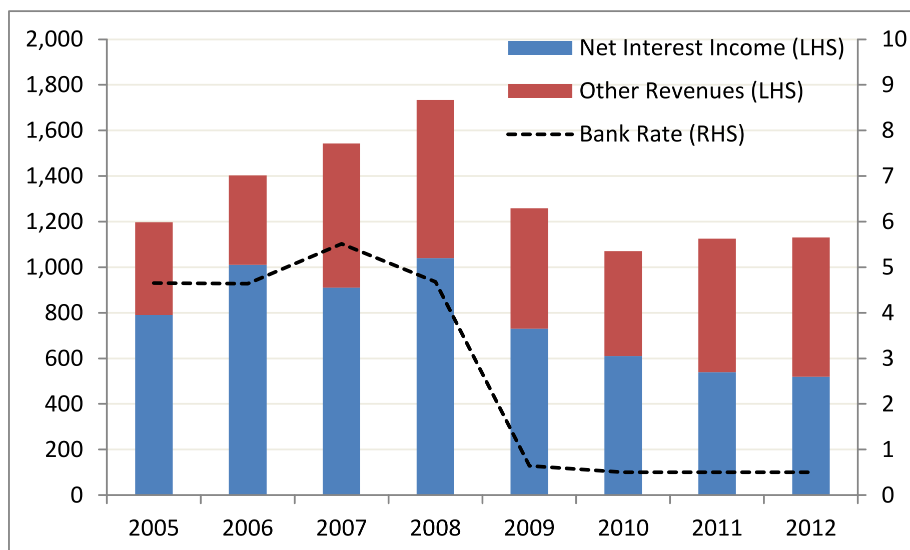
Figure 1.5 shows the significant fall in net interest income from the peak in 2008. In 2012 net interest income accounted for less than half of banking revenues, down from 72% in 2006. It is not clear whether banks have made progress in adapting to this change as non-interest revenues have not increased from pre-crisis levels.

Figure 1.5

Banking Revenues

Source of revenue (£m) and annual average of Bank of England Official Bank rate (%)

Source: States of Jersey Statistics Unit



Looking forward, more than half (55%) of finance sector firms surveyed expected profits to be higher in 2013 than they had been in 2012, with the majority of these expecting a small (less than 5%) increase. Almost a quarter expected profits to fall and the same proportion expected profits to be the same. Box 1 at the end of this section considers the accuracy of profit expectations from previous Surveys.

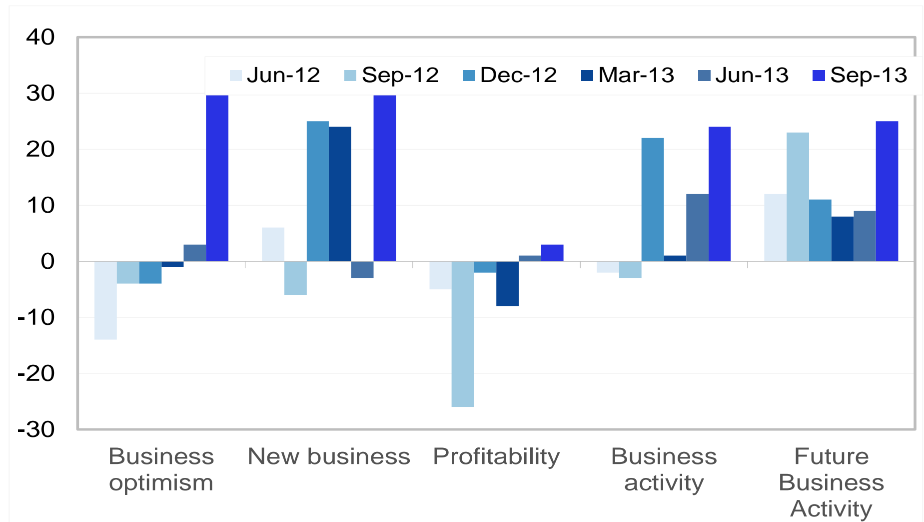
Figure 1.6 shows the results of the Business Tendency Survey for the financial services sector. All indicators have improved over the last year – with business optimism in particular moving from negative in 2012 to strongly positive in the most recent quarter. The headline business activity measure has also improved and stands at the highest level since early 2011.

Figure 1.6

Financial services business tendency

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

Source: States of Jersey Statistics Unit



The Panel met with representatives of the finance industry and key finance sector institutions in September. There were mixed views – both across the sector and within the sub-sectors - as to current performance and future prospects for the industry. On this basis the Panel remain cautious about the immediate prospects for the financial services sector as whole.

Banking profits made up more than three quarters of finance sector profits in 2012. Banking profits in Jersey are largely driven by interest income and interest rates are anticipated to remain low for some time. This suggests that the opportunity for significant growth in finance sector profits is limited in the short-term.

Box 1: Accuracy of Survey of Financial Institutions profit expectations

The 2011 SFI (published in 2012 and including the expectations for 2012) reported that 54% of firms in the finance sector (weighted by employment) expected profits in 2012 to be higher than in 2011 in nominal terms. Using the Panel's methodology for converting profit expectations to a forecast for gross operating surplus, the data in the SFI suggested that profits might grow by approximately 2% in nominal terms in 2012. The 2012 SFI (published in 2013 and including the outturns for 2012) reported that the profit element (gross operating surplus) of GVA actually fell by 1% in 2012.

The Panel consider the net balance of companies responding in each range (e.g. the number expecting a 5%-10% increase minus those expecting a 5%-10% decrease) to aggregate the profit expectations in each survey. Figure 1.7 demonstrates the difference between the growth in gross operating surplus thus implied by profit expectations and actual growth in gross operating surplus in recent years. This demonstrates that the Survey correctly estimated that gross operating surplus would be relatively flat in 2011 and 2012, and correctly estimated the strong growth in 2006 and 2007 but expectations for 2005 and for 2008-2010 were excessively optimistic and the difference of almost 3 percentage points for 2012 is not insignificant.

There are a number of caveats to this analysis. Finance profits are very volatile and the period over which expectations are available appears to be particularly volatile. Further, the surveys asked finance companies to report on profit expectations – not necessarily gross operating surplus. The Panel will continue to monitor how accurate the results of the SFI are in forecasting finance sector profits.

Figure 1.7

Financial services business tendency

Growth in Gross Operating Surplus compared to expectations in Survey of Financial Institutions (2004-2009) and Business Tendency Survey (2010-2013)

Source: States of Jersey Statistics Unit, Fiscal Policy Panel calculations

The Rest of the Economy

GVA for the non-finance sector (excluding the rental income of private households) declined by 4% in 2012. The majority of the decline was due to a 9% decline in wholesale and retail and an 8% decline in construction GVA. Some of the decline in wholesale and retail will reflect the closure of fulfilment industry businesses following changes to UK taxes. Hotels, bars and restaurants increased by 3% with other business activities excluding rental the only other sector to grow, by 1% in real terms.

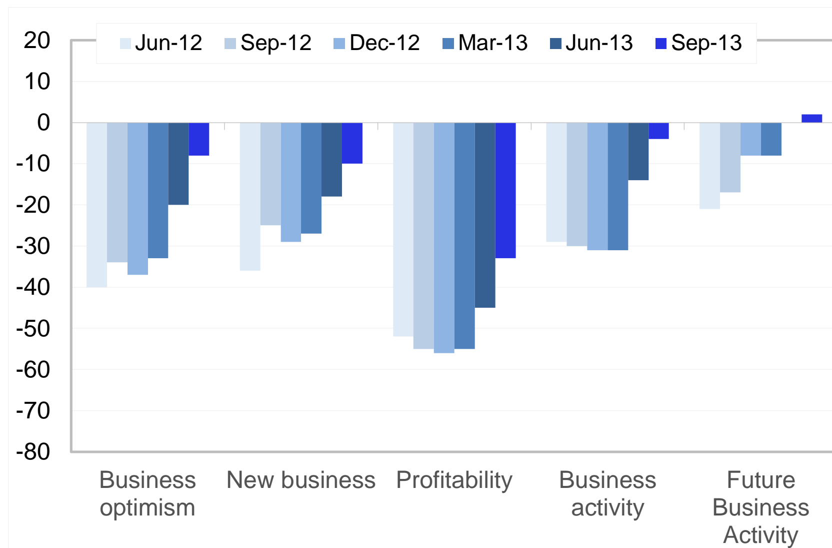
Figure 1.8 shows the responses of the non-finance sectors of the economy to the September 2013 Business Tendency Survey. All of the ten indicators have improved since June 2012 but future business activity is the only indicator to have become positive. A number of indicators, including business activity, profitability and business optimism are at their least negative level since the survey began in 2009.

Figure 1.8

Non-Finance business tendency

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

Source: Jersey Statistics Unit



In recent years, GVA in the non-finance sector (excluding rental) has experienced some individual years of strong growth, in 2005 and 2007, and a significant decline in 2009 and 2012 but in general has been less volatile than finance (Figure 1.3). The fall in the business activity and profitability indicators of the Business Tendency Survey in 2012 appears to be consistent with the poorer performance in GVA terms in the same year, as demonstrated in Figure 1.9.

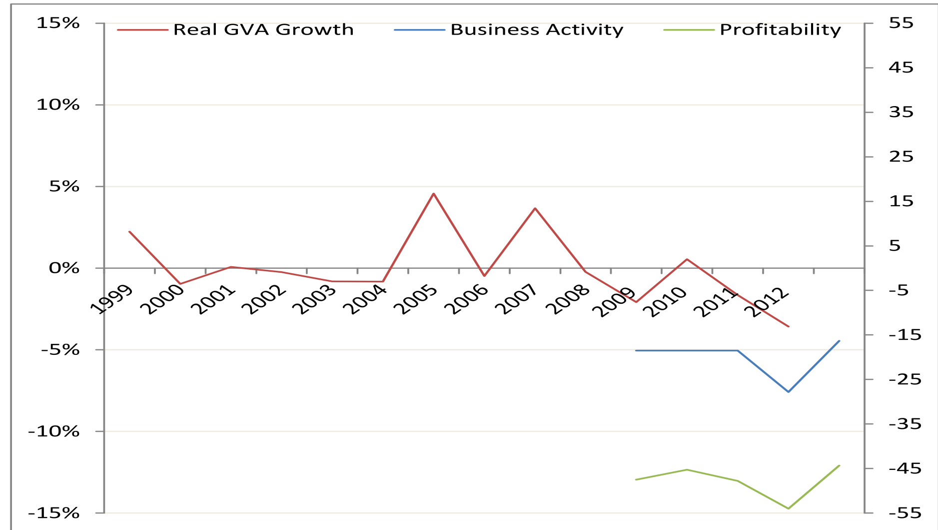
Figure 1.9

Non-Finance GVA Growth

Annual real GVA growth excluding financial intermediation and rental (LHS axis)

Response to business activity and profitability questions averaged over each year (RHS axis)

Source: Jersey Statistics Unit



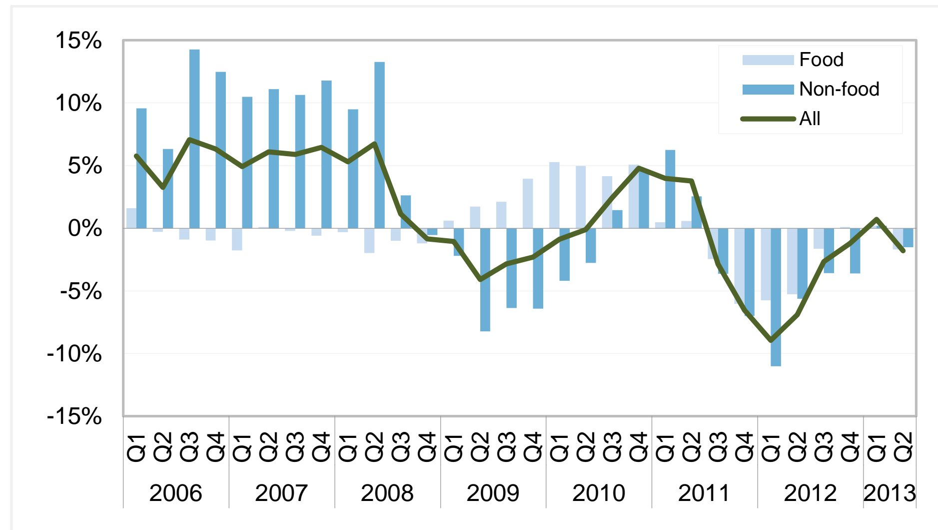
In the second quarter of 2013, retail sales volumes recorded their fourth consecutive quarterly fall to end 1.8% lower than the same quarter a year earlier. Both the predominantly food sector and the predominantly non-food sector declined by similar amounts. Footfall in St Helier (measured by a counter in King Street) in the year to date is largely in line with experience in 2012. When the Panel met with representatives of the retail sector in September there was general agreement that conditions remained challenging although trends were perhaps a little more mixed than headline retail sales numbers indicate.

Figure 1.10

Retail sales performance

Seasonally adjusted annual change in volume, %

Source: States of Jersey Statistics Unit



The total number of visitors to Jersey declined by 1.7% in 2012, falling back to a similar level as 2010. Staying business visitors increased, as did the number of day trippers, but the number of staying leisure visitors fell. Room occupancy rates fell back in 2012, to 60%, largely in line with the average over 2009-2011. Spend per visitor was unchanged in nominal terms - at £330 per visitor - representing a fall in real terms.

2013 statistics are available to August and show the number of staying leisure visitors has remained in line with 2012 while there has been a further increase in staying business visitors. Room occupancy is largely flat compared to the first eight months of 2012.

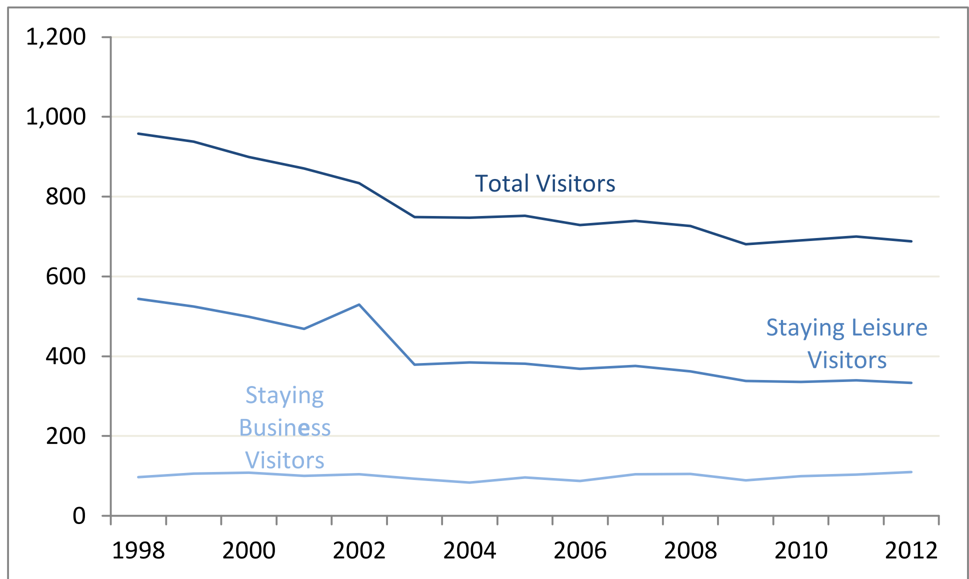
Overall the real GVA of hotels, restaurant and bars increased by 3% in 2012 - the third consecutive year of real growth. Employment in June 2013 was also 3% higher than 2012 reflecting growth in full and part-time jobs. Nonetheless, when the Panel met with representatives of the tourism industry in September conditions were still described as being weak with 2013 being slow so far.

Figure 1.11

Tourism trends

Number of visitors, 000s

Source: Jersey Tourism



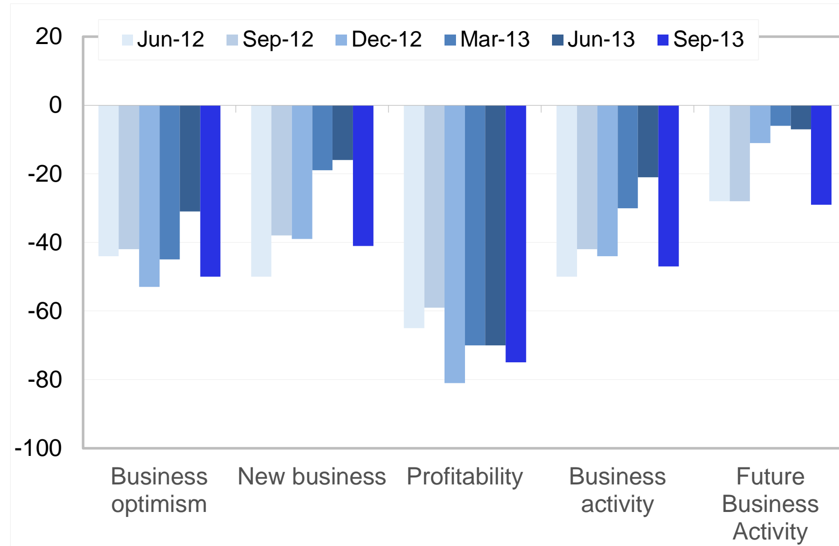
The construction industry in 2012 made up approximately 6% of the economy, making it one of the largest non-finance sectors. The Business Tendency Survey from September 2013 shows that all indicators remain strongly negative, with 75% of businesses (weighted by employment) reporting a decline in profitability. When the Panel met with representatives from the construction industry in September, sentiment was consistent with the results of the Survey and they expressed concerns about the speed with which the States capital programme was being delivered.

Figure 1.12

Construction business tendency

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

Source: Jersey Statistics Unit



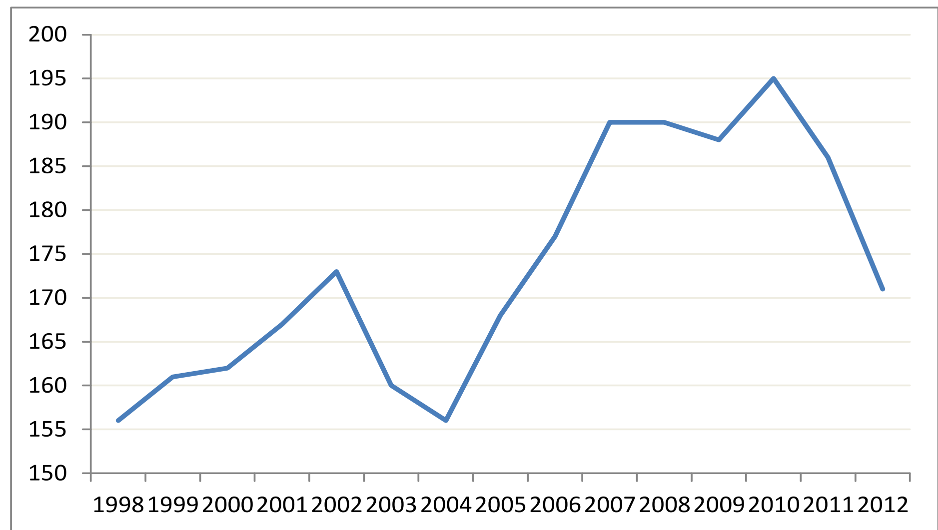
The 8% fall in GVA in 2012 is the largest annual fall the construction industry has experienced since at least 1998 – the period over which comparable data are available (Figure 1.13). Part of this fall in GVA will be due to the reduction in States capital expenditure of nearly £30m compared to 2011. While the years 2007-2009 were relatively flat, the most recent fall means the industry's output has contracted, in real terms, to around its 2005 level. The output of the industry has fallen by over 12% in the last two years, larger than the previous slump seen in 2003-2004.

Figure 1.13

Construction GVA

Real GVA (£ million)

Source: States of Jersey Statistics Unit



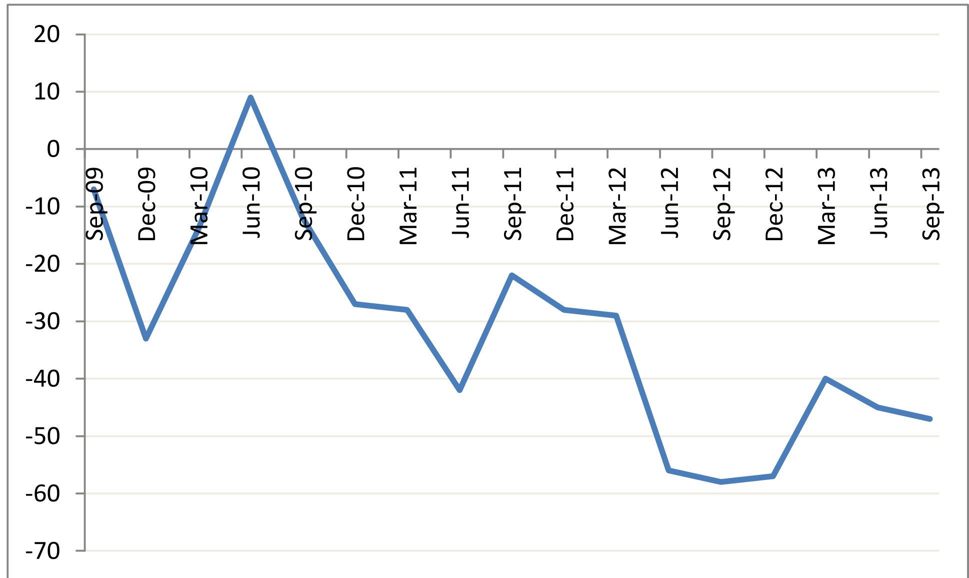
The Business Tendency Survey for quarter 3 of 2013 suggests that there is still a degree of spare capacity in the construction sector, with a weighted net balance of 47% of respondents stating that current business activity was below capacity. Figure 1.14 shows how this indicator has changed since the survey began in 2009.

Figure 1.14

Construction Capacity

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

Source: States of Jersey Statistics Unit



The industry reported it was operating close to capacity in 2010. Output is now 12% below the 2010 level, suggesting a significant level of spare capacity.

1.3 Labour Market

On a seasonally adjusted basis, the number of people actively seeking work (ASW) peaked in March 2013 and appears to have stabilised since then. Over the 12 months since September 2012, the number of ASW has increased by 200 – approximately 12%. Further, the number of long-term ASW (seeking work for more than 12 months) has increased by 25% and now makes up one fifth of the total.

The internationally comparable International Labour Organisation (ILO) rate of unemployment in June 2013 was 5.7%, an increase from 4.7% in March 2011.

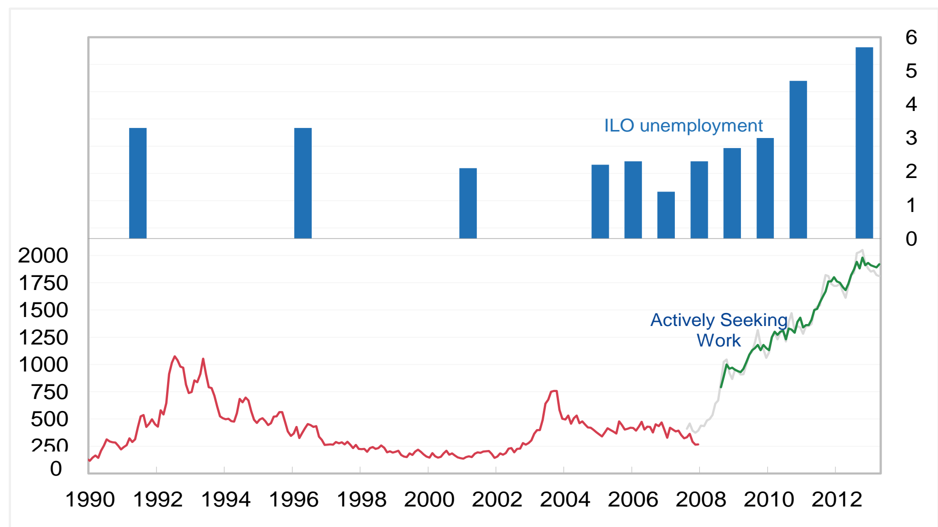
Figure 1.15

Changes in unemployment

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

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

Source: States of Jersey Statistics Unit



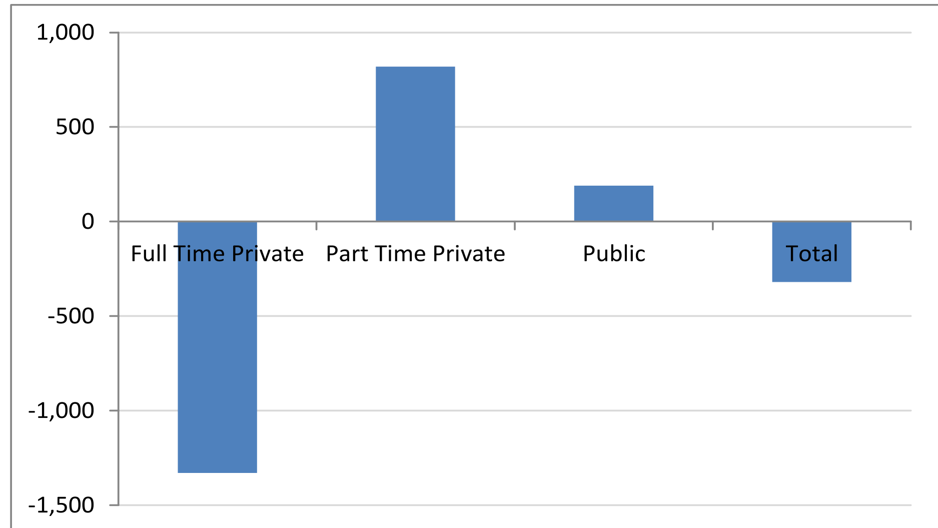
The most recent figures for employment relate to June 2013 and show that employment has been relatively flat on an annual basis. Total employment has fallen approximately 1% from the record high reached in June 2011. Total private sector employment stands at 49,370, with 6,920 public sector employees. Over the five years from June 2008, total private sector employment has fallen by approximately 500 (1%) – but an increase of 820 part-time posts masks a fall in full-time employment of 1,330.

Figure 1.16

Changes in employment

Changes in headcount in the public and private sectors between June 2008 and June 2013

Source: States of Jersey Statistics Unit



There has also been a sectoral shift in employment, with 820 fewer employees in financial and legal activities over the five years to June 2013, a 6% reduction. The biggest absolute increase in private sector employment has been in the private education, health and other services sector which has added 960 new jobs over the last five years, including 480 full time jobs. However, the largest increase in part-time employment since 2008 has been in hospitality occupations, which has added 590 part-time jobs but this has been at the expense of 150 full-time jobs.

In the September 2013 Business Tendency Survey, 53% of finance companies reported no change in employment – with 26% reporting an increase and 21% reporting a fall in employment. In terms of future expectations, 17% of finance firms expected increases, against only 7% expecting decreases. As Figure 1.17 shows, this is an improvement on the same quarter in 2012 and the last two surveys have given the first positive numbers for employment growth since the Survey began in 2009.

Conversely the indicator for non-finance was negative – with 67% of respondents reporting no change, 13% reporting an increase and 21% reporting a decrease. Expectations were also more negative in the non-finance sectors, with 13% anticipating an increase and 19% anticipating a reduction in employment. However, Figure 1.17 demonstrates that the

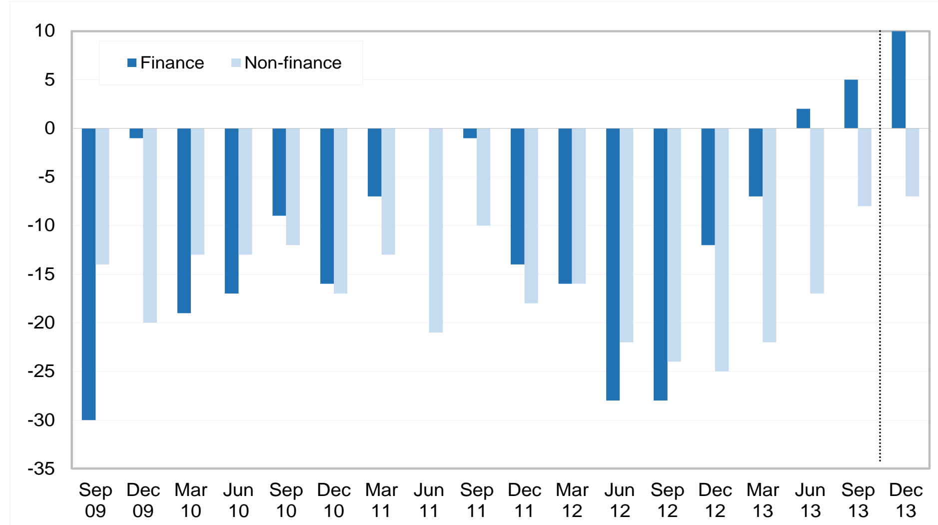
employment indicator has improved considerably over the course of 2013 for both finance and non-finance.

Figure 1.17

Employment trends in key sectors

Weighted net balance reporting increase in employment, December 13 figure is based on expectations in September 2013 survey.

Source: States of Jersey Statistics Unit



Average earnings in June 2013 were 2.2% higher than a year earlier. This is the first time in four years that earnings have risen faster than prices as measured by the retail price index (RPI). However, while the 0.7% real increase is an improvement on recent years, it does not reverse the declines over 2010-2012 and real earnings remain approximately 5 per cent below their 2009 peak.

1.4 Inflation

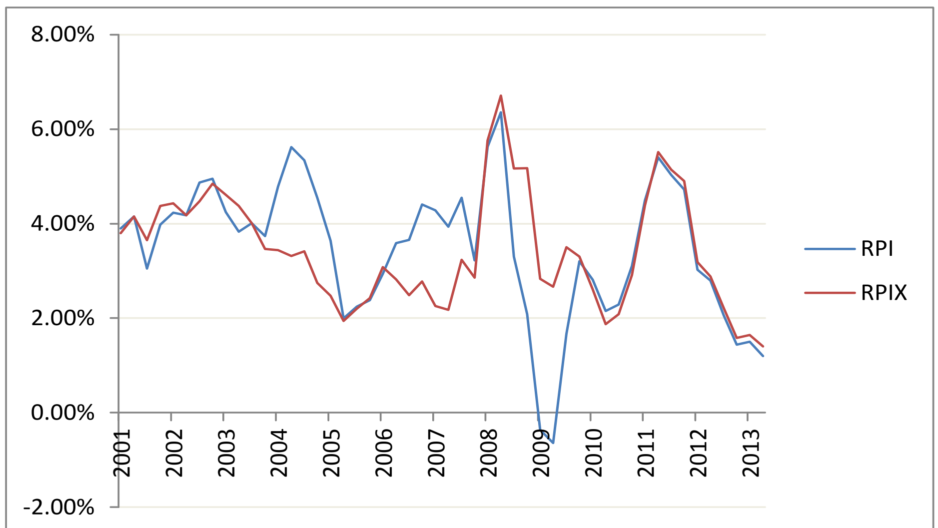
Inflation has fallen sharply in 2013, with RPI inflation falling to 1.2% in September 2013 and RPIX inflation (which excludes mortgage interest payments) reaching 1.4% - its lowest level since at least 1999. This is well below comparable measures in the UK where RPIJ (comparable to Jersey's RPI) increased by 2.5% and RPIX increased by 3.2%.

Figure 1.18

Inflation in Jersey

Annual % change

Source: States of Jersey Statistics Unit



1.5 Spare capacity

The Panel's remit requires making an assessment of the degree of spare capacity in the economy to inform any recommendations on the appropriate balance of fiscal policy.

Where the economy appears to be operating above capacity it is likely to be prudent for the States to run a budget surplus to seek to withdraw demand from the economy. Conversely, when the economy is below potential and there may be spare capacity in the economy the government should consider whether to run deficits to support the economy.

As outlined in the Panel's October 2012 report, accurately measuring the degree of spare capacity in the economy is challenging. Even in larger economies it is at best an uncertain science, and one of the important policy questions presently faced is the extent to which the 2008 financial crisis has destroyed capacity in the economy, meaning that there is less spare capacity than would have been estimated on pre-crisis assumptions.

Whilst other jurisdictions have attempted to calculate the output gap using econometric analysis (e.g. the Congressional Budget Office in the USA) or using a statistical approach (e.g. the European Commission), there are limitations to how much insight such analysis can provide on the likely level of spare capacity. Further, the nature of the Jersey economy limits the usefulness of these approaches further – primarily due to finance sector profits making up a large part of measured GVA.

The Panel use a range of information to assess the likely level of spare capacity in the economy including data on inflation, employment, unemployment and evidence from surveys undertaken by the Statistics Unit. Unemployment remains historically high, suggesting that there is some degree of spare capacity in the economy. The Business Tendency Surveys throughout 2013 have suggested that non-finance respondents feel that activity is currently below capacity. Figure 1.13 suggests that the output of the construction industry may be below trend.

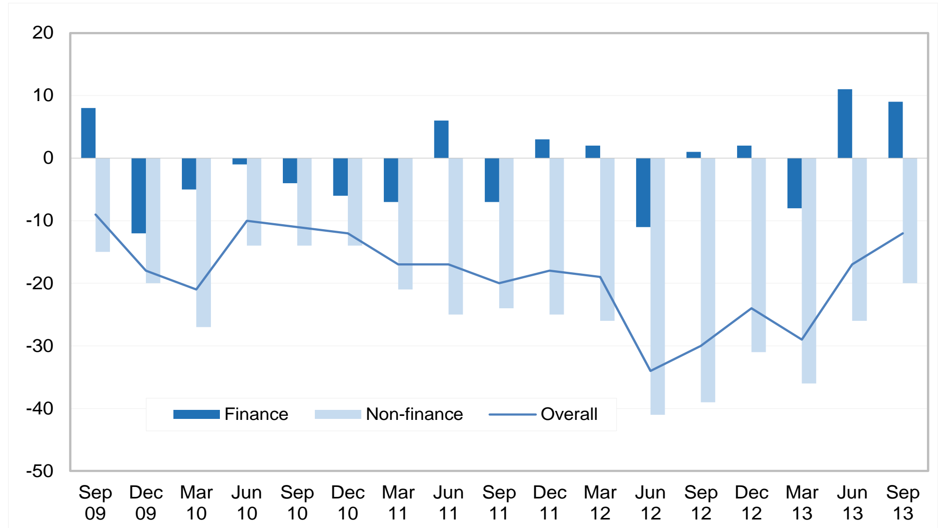
While Figure 1.19 illustrates that there has been some improvement in capacity utilisation in 2013, the capacity utilisation indicator in the September 2013 Business Tendency survey suggested that a weighted net balance of 20% of non-finance firms reported spare capacity. In addition the persistently high level of unemployment suggests further spare capacity outside these firms.

Figure 1.19

Capacity utilisation

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

Source: States of Jersey Statistics Unit



1.6 Outlook

The Panel have forecast the performance of the Jersey economy for 2013 and 2014. This is based on a number of factors – drawing on both the quantitative data available and the qualitative information available from the various surveys and from meetings with representatives of the key industry sectors.

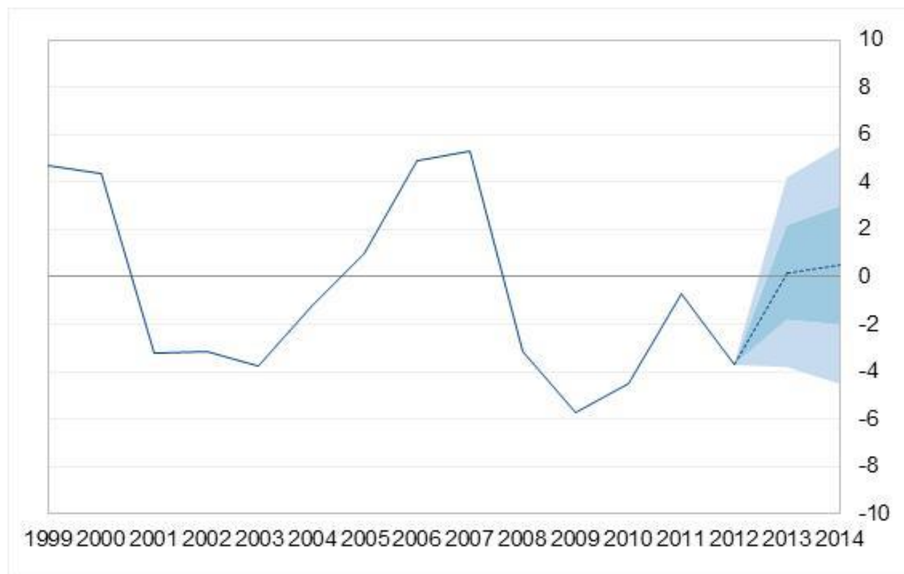
The Panel have revised its forecast for 2013 upwards, based on surveys reporting an improvement in local conditions compared to 2012, real earnings growth in 2013 and on the improving performance of the advanced economies. A similar performance is forecast for 2014, with the potential for more upside if the global recovery gains traction.

Figure 1.20

Economic Forecasts

% change in GVA on year before

Source: Panel judgement; States of Jersey Statistics Unit



The Panel's central forecast is for GVA growth of between -2% and +2% in 2013 and -2% to +3% in 2014. These forecasts are made on the basis that

fiscal policy is used to support the economy, to a greater extent than in 2012 i.e. that the economic deficits as set out in section 2 of this report are realised.

The 4% fall in GVA in 2012 was below the central range of the forecast included in the Panel's October 2012 annual report. The fall in financial services GVA was greater than the Panel anticipated, primarily due to a significant fall in compensation of employees, while the fall in non-finance sectors was also greater than anticipated. The Panel's previous forecast also assumed that capital expenditure in 2012 would be of a similar magnitude to that set out in the MTFP. This demonstrates that there is a considerable degree of uncertainty around the Panel's forecasts.

However, the Panel believe that significant spare capacity will remain in the economy over 2013 and 2014 suggesting that additional fiscal stimulus could be effective in supporting businesses and employment.

1.7 Longer-term outlook

Since 2000, GVA has fallen by 17% - equivalent to an annual average of 1.5%. However, excluding finance sector gross operating surplus - the profit element of GVA - and owner occupied imputed rent (OOIR) - an estimate of the rental value of owner occupied homes - GVA has been much less volatile (Figure 1.21). Finance GOS is influenced by the interest rate environment, while OOIR is a notional calculation – so excluding these might be seen as an accurate reflection of the underlying economic conditions. GVA excluding finance GOS and OOIR has seen average growth of approximately 0.5% per year since 2000. Figure 1.21 also shows that the non-finance sector excluding rental has been largely flat since 2000,

Figure 1.21

Gross Value Added

Constant (2003) values (£m)

Total GVA; GVA excluding finance gross operating surplus and owner occupied imputed rent; non-finance GVA excluding the rental component of other business services

Source: States of Jersey Statistics Unit

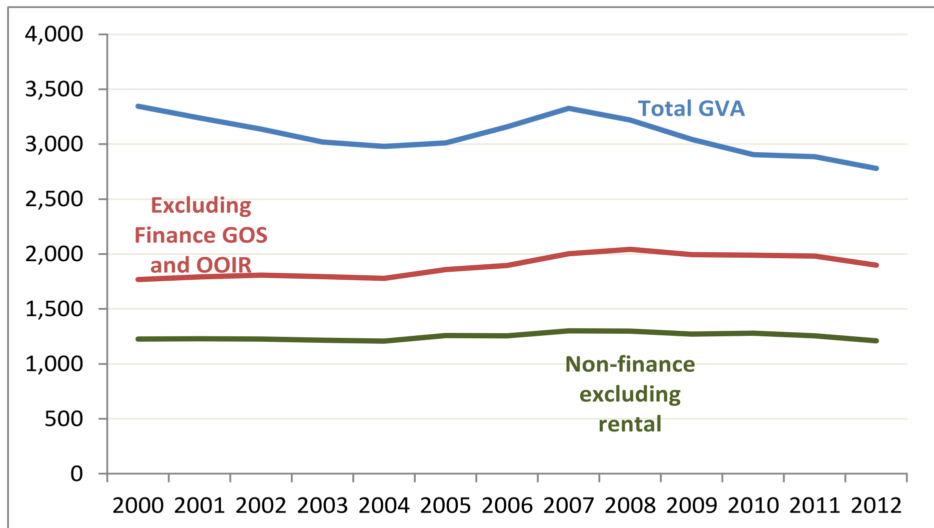


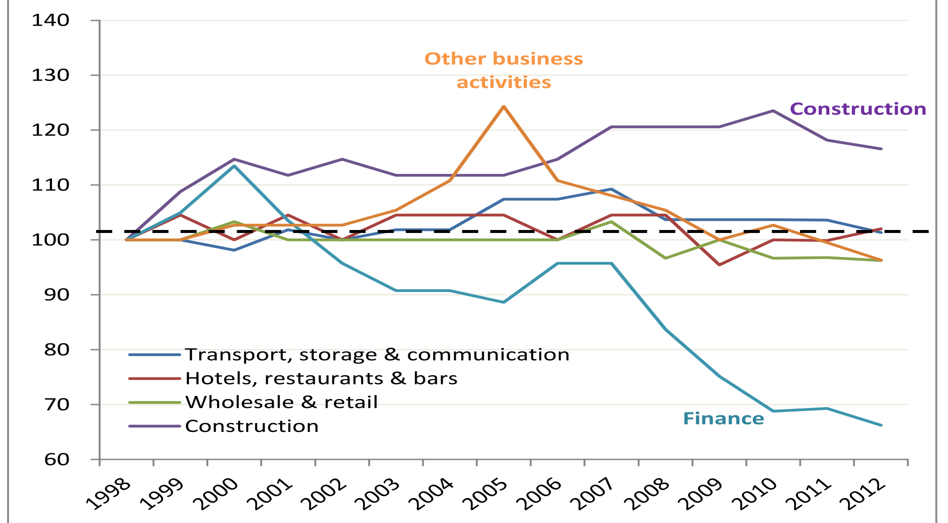
Figure 1.22 looks at the change in productivity (as measured by GVA per full-time equivalent employee) since 1998 (the period over which comparable data are available) for the largest six (private) sectors. It demonstrates that only the construction sector has seen any sustained growth in productivity over the period, growing at an average of 1% per year (in compound annual average growth rate terms). Measured productivity in the finance sector has fallen significantly, falling by almost 3% per year on average.

Figure 1.22

Sectoral productivity

GVA per FTE
Index, 1998=100
Constant prices

Source: Jersey Statistics Unit



Despite the significant fall in measured productivity, the GVA per full-time equivalent of Jersey's finance sector remains considerably higher than any other sector.

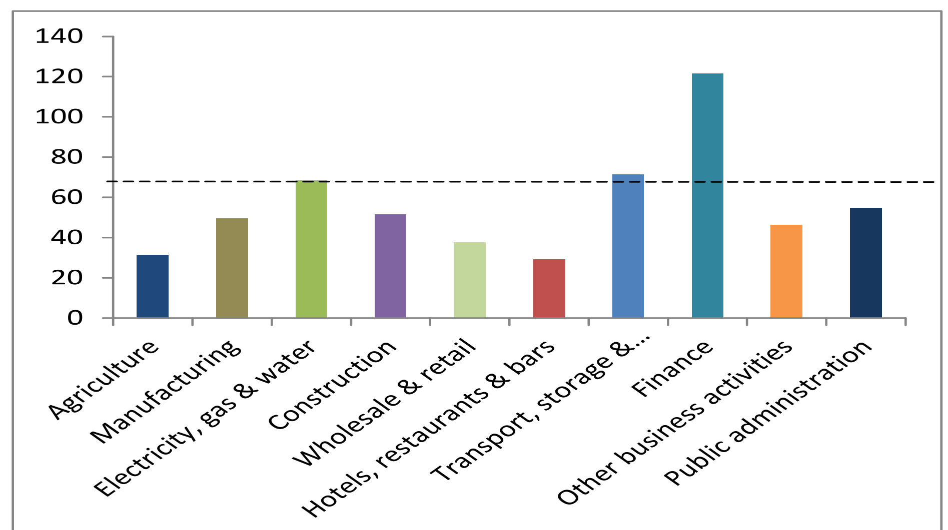
Figure 1.23 demonstrates that GVA per employee in the finance sector is almost double the average across all sectors. Two other sectors - electricity, gas and water and transport, storage and communication - also have GVA per employee higher than the economy average.

Figure 1.23

Sectoral productivity

2011 GVA per FTE (£000s)
Dotted line is all sectors, excluding the rental component of other business activities

Source: Jersey Statistics Unit



Within financial services it is the banking sub-sector which has seen the largest fall in productivity – with real GVA per full time equivalent falling at an annual average rate of 6% since 2000. However, measured productivity largely reflects the fall in output of the banking sector which in turn has been driven by low interest rates – rather than being reflective of underlying activity. Were interest rates to recover, a sharp rise in measured finance sector output and productivity could be expected.

In real terms the fund management sector has fallen at an annual average of 3% over the same period. The fund management sector had seen some productivity growth up to 2008 but productivity has almost halved since then. Trust and legal has remained relatively steady over the period, with productivity increasing by an average of 0.3% per year.

The McKinsey report for Jersey Finance ("Securing Jersey's future as a leading international finance centre") stated that continuing adverse market trends posed a risk to the finance sector while external political and regulatory challenges may result in a further fall in output and employment for the sector. However the report also outlined opportunities for the finance sector and emphasises the need for Jersey to set its finance industry upon a stable, long-term growth path.

While the States needs to work towards resolving the above issues, they are only made more acute by future demographic change. Figure 1.24 shows that by 2040 the 65 or over population will double under net nil migration (i.e. the same number of people arriving and departing each year) and this will be largely the case across any of the migration scenarios considered by the Statistics Unit. Under net nil this will also be combined with a decline in the numbers of working age population, from approximately 66,000 in 2015 to 61,000 by 2030 and 50,000 by 2070.

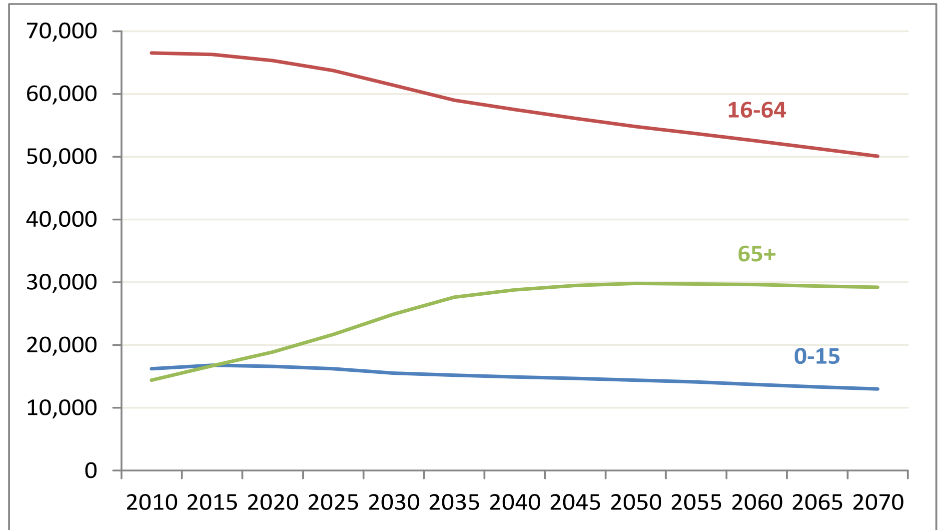
As the working age population declines as a proportion of the total population this means that workforce participation (either within working age or above) must increase and/or productivity of those working must increase for the economy to even maintain the current size. This issue is not unique to Jersey and is faced by the majority of the advanced economies but this does not detract from the risk that the ageing population could lead to a fall in output across the economy.

Figure 1.24

Population Projections

Change in age of population under net nil migration scenario

Source: Statistics Unit



Section 2 – The Fiscal Outlook

Key points

- Fiscal policy was not counter cyclical in 2012, against the Panel's advice to increase capital expenditure to help support jobs and business activity during 2012.

- Capital expenditure totalled £36m in 2012 – half the £72m that was anticipated at the time of the Panel's last report and half the levels seen in 2010 and 2011. This seemed to be caused primarily by a lack of project management capacity which the Panel understands has now been addressed. The Panel reiterates that the extent of stimulus should not be limited by the balances on the Consolidated or Stabilisation Funds.

- Budget 2014 proposes to run a large budget deficit at a time when the economy is still expected to have significant spare capacity, implying that fiscal policy will be counter cyclical. Conditions in 2015 and beyond are less certain and the Panel should comment on whether deficits of the scale proposed are appropriate in future reports.

- The draft Budget proposes to make an exception to the Fiscal Framework for the new hospital project. It sets a worrying precedent for the States to make an exception to the Fiscal Framework in order to spend money from the Strategic Reserve. This exception would not be necessary if there were enough interest in the Strategic Reserve to leave the capital untouched, but the optimal size of the Strategic Reserve would have to be determined before this conclusion could be drawn.

- The Panel was encouraged by the Treasury Minister's progress update to the States in April, which stated that the Treasury and Resources Department will develop a consistent approach to the measurement and monitoring of structural surpluses and deficits. The Panel is not aware that this work has been finalised and would have liked to see this as supporting information for Budget 2014, especially as there are proposals for long-term changes to income tax and funding capital expenditure.

- Further information on the nature of the capital programme, distinguishing between renewal and enhancement, would help to

determine whether there is an underlying structural deficit, as highlighted in the Panel's last report.

- Given the economic outlook for 2014, the Panel agree that it was advisable to delay the implementation of the Long-term Care charge until 2015. The Panel should keep a watching brief to see whether the plan to phase in the charge is appropriate given the economic outlook and fiscal balance in 2015 or 2016.

- Future risks and uncertainties remain more to the downside and include the impact of UK and US FATCA negotiations, lower long term productive potential, further risks to finance sector performance and the challenges of an ageing population.

Recommendations

1. The States should ensure that the planned fiscal stimulus is delivered in 2013 and 2014, and that where possible additional expenditure should be brought forward to compensate for likely delays in other expenditure.

2. The effectiveness of fiscal stimulus through capital spending depends on bringing forward capital projects and making sure the expenditure takes place on time. The Treasury and Resources department should be proactive in:

    - Identifying and resolving any bottlenecks and barriers in delivering capital projects

    - Ensuring there is flexibility to bring forward (and potentially delay) capital projects

    - Managing the capital programme in a similar way to the £44m fiscal stimulus programme in 2009.

3. The States should make contingency plans for an improvement in economic conditions and reduction in spare capacity from 2015. This would mean running counter cyclical fiscal policy and topping up the Stabilisation Fund. The plans could include:

    - Reducing departmental expenditure and/or raising revenue

    - Changing the profile of spending on the three significant projects or other projects in the capital programme

   - Changing how key capital projects are delivered to put less strain on local capacity.

4. The States should clearly define the purpose and optimal size of the Strategic Reserve and set out conditions for its use, including how borrowing from the Reserve would be dealt with. This should be done before deciding whether or not to use the Strategic Reserve to pay for the new hospital or any other capital expenditure.

5. In April 2013 the Treasury Minister provided a progress update on the Panel's seven main recommendations. This development is warmly welcomed by the Panel. It is recommended that a progress report should be published by the Minister every year.

6. Every budget should include:

   - A financial forecast for the current and next 3 years including updated income projections
   - Proposed movements on the Consolidated Fund, Stabilisation Fund and Strategic Reserve for the current year and next 3 years.
   - Data which shows what happened to these Funds in the previous 3 years.
   - A financial forecast showing the surpluses and deficits adjusted to recognise the economic impacts.

7. The Treasury and Resources department should identify the maximum buffer that is required in the Consolidated Fund for remaining contingencies in a year. Any funds in excess of that buffer should be transferred to the Stabilisation Fund.

8. Further work should be undertaken on the nature of the capital programme, in particular distinguishing between spending to maintain and renew existing infrastructure and spending on new or enhanced infrastructure. This would help ascertain whether or not there is an underlying structural deficit.

2.1 Public finances update

This section summarises the updated picture of public finances in 2012 and looks at the extent to which the Panel's previous advice and recommendations have been followed.

Previous FPP recommendations

The Panel's last report, published in early October 2012, was based on the draft Medium Term Financial Plan (MTFP) 2013-2015. In the context of a downgraded short term economic outlook for Jersey, the Panel made seven recommendations that the States should:

1. Give discretionary fiscal support to the economy in 2012 and 2013 and if practical to a greater extent than set out in the MTFP.
2. Increase capital spending in 2012 and 2013, and bring forward spending on capital projects planned for 2014 and 2015.
3. Not limit the extent of stimulus to the balances on the Consolidated or Stabilisation Funds.
4. Be flexible with spending plans in 2014 and 2015, so that they can be adjusted according to how well the economy is likely to perform in those years.
5. Leave the Stabilisation Fund and Strategic Reserve as they are for 2013 and 2014, and develop a plan to rebuild the Stabilisation Fund when the economy begins to recover.
6. Analyse capital expenditure requirements and how they will be funded to determine whether or not there is a structural deficit. If there is, a plan should be developed to rectify it.
7. Include forecasts of income and expenditure which show the economic impacts in future MTFPs and Budgets.

MTFP 2013-2015

The States approved the MTFP with some minor amendments which, together with the accompanying Council of Ministers' compromises[1], did not affect the planned level of expenditure or overall balance between income and expenditure for 2013 to 2015.

Budget 2013

The Treasury Minister's tax proposals in the draft Budget 2013 did not significantly change the outlook for future States income.

[1] "MEDIUM TERM FINANCIAL PLAN COMPROMISES AND CENTRAL GROWTH ALLOCATION 2014" at: http://www.statesassembly.gov.je/AssemblyReports/2013/R.114-2013.pdf

The main proposals were to:

- increase income tax exemption thresholds in line with inflation of 3% and add some anti-avoidance measures.
- Increase impôts duty on alcohol, tobacco and fuels, and increase Vehicle Emissions Duty.
- Extend stamp duty relief for first time buyers.

In line with the capital allocation in the MTFP, the Budget 2013 set out the main capital projects planned for 2013 by department: £37m across mainly Health, Education, and Transport and Technical Services, £19m for social housing projects and £3m for States Trading operations.

The States agreed the draft Budget 2013 with amendments to the proposed impôts duty increases on tobacco and fuels. These amendments reduced future States income by about £1m a year compared to the Treasury Minister's original proposals.

Long-term care charge

The new long-term care scheme that will help Jersey people to pay for care, either in their own home or in a care home, will start in July 2014 if agreed by the States. While it is not the Panel's role to comment on the detail of the scheme, it is welcome that such plans take account of the Panel's previous advice to plan for the medium-term. Originally, the plan was to introduce a 1% long-term care charge from the start of 2014 raising up to £16m a year. Now, the proposal is to delay the introduction until 2015 and introduce it gradually – 0.5% raising up to £8m in 2015 and 1% raising up to £16m in 2016 and beyond.

Given the economic outlook for 2014, the Panel agree that it was advisable to delay the implementation of the charge until 2015. The Panel should keep a watching brief to see whether this plan to phase in the charge is appropriate, given the economic outlook and fiscal balance in 2015 or 2016, and report back on this in the next annual report.

Financial Report and Accounts 2012 Outturn

Income and expenditure

States income for 2012 was £10m (1.3%) higher than forecast in the MTFP and States revenue expenditure (not including capital expenditure) was £10m (1.3%) lower than forecast. This meant that in 2012 there was a £13m

accounting surplus compared to the £7m accounting deficit expected at the time of the MTFP (Figure 2.1).

Figure 2.1

States income and expenditure for 2012, actual and MTFP forecast

£m (current prices)

Source: States of Jersey Treasury data.

	Actual 2012 £m	MTFP 2012 £m	Change £m
States Income	758	748	10
Department Expenditure	731	719	12
Central Reserve (Contingencies and growth etc)		22	-22
Net Capital Allocation	14	14	0
Total Net Expenditure Allocation	745	755	-10
Surplus/deficit	13	-7	20

Note: States income includes departmental income. Department expenditure does not include departmental income.

However, this measure of the surplus/deficit takes into account capital allocations rather than actual capital expenditure. It is actual capital expenditure, rather than allocations, that will have an impact on the economy.

Capital expenditure totalled £36m in 2012 – half the £72m that was anticipated at the time of the Panel's last report and half the levels seen in 2010 and 2011 (Figure 2.2), the period immediately after the onset of the financial crisis when the Stabilisation Fund was used for discretionary stimulus spending. This decrease occurred despite the Panel's advice to increase capital expenditure to help support jobs and business activity during 2012.

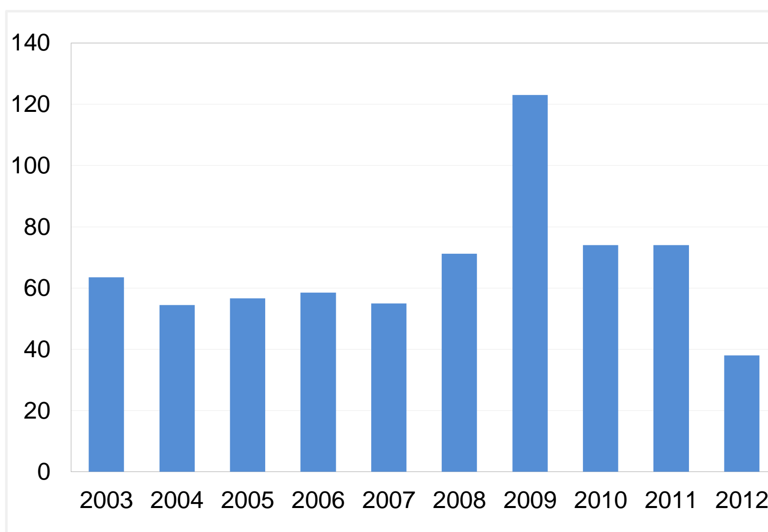
Figure 2.2

Capital expenditure

£m (current prices)

Source: States of Jersey Treasury data. Panel calculations

Note: This includes the capital expenditure of the Trading Funds



Fiscal stimulus - social housing expenditure

In April 2012, the Treasury Minister wrote a letter[2] to the Panel stating:

> "I am writing to seek the advice of the Fiscal Policy Panel on a proposal I wish to take to the States shortly which changes the proposal in the 2012 Budget document not to withdraw the full amount from the Stabilisation Fund and makes temporary use of those funds to support housing capital projects.
>
> I have given full consideration to your advice …… to bring forward capital projects. Following discussions with the Housing Minister it has been identified that there are a number of projects that are being progressed by the Department that will be ready to tender during 2012. These projects together will provide a total of £27.1 m of work for the construction industry, boost wider economic activity and provide 121 new homes that are very much needed."

On the basis of evidence of a weaker economic outlook for Jersey, the Panel supported the Treasury Minister's proposal provided the housing projects met the conditions for fiscal stimulus – namely that they be timely, targeted and temporary (the three "T"'s).

In this instance, timely meant that the spending should take place as soon as possible in 2012 and at the latest early 2013. As £1m was spent in 2012 and £12m is expected to be spent in 2013, very little of the proposed fiscal stimulus appears to have been timely in the sense of supporting the economy in 2012 as advised by the Panel. This highlights the difficulties in altering the timing of States expenditure.

The States should ensure that the planned fiscal stimulus is delivered in 2014.

Balance of income and expenditure

As set out in the Panel's last report it is important the States consider the economic impact of spending and revenue measures by taking into account the timing of the impact on the economy. This adjusted position (Figure 2.3) shows that the low level of capital expenditure in 2012, combined with the higher accounting balance, meant the adjusted economic deficit was £7m (0.2% of GVA) in 2012 rather than a £65m (1.8% of GVA) deficit which the

[2] May be found at: http://www.gov.je/SiteCollectionDocuments/Government%20and%20administration/L%20TreasuryMinister%20FiscalPolicyPanelStablisationFund%2020120412%20JN.pdf

Panel expected at the time of its last report (based on the forecasts in the draft MTFP).

The adjusted deficit in 2012 was not only much less than the Panel was anticipating at the time of the last annual report it was also a significant tightening of fiscal policy from the deficit of £76m (2% GVA) run in 2011.

This is disappointing given the Panel's advice to bring forward capital expenditure where possible in 2012 and 2013, which would have increased the deficit and added stimulus to Jersey's economy.

Figure 2.3

Adjusted surplus/deficit for 2011, 2012 and MTFP forecast

£m (current prices)

Source: States of Jersey Treasury data.

	Actual 2011	Actual 2012	MTFP 2012	Change 2012
Surplus/(Deficit) - accounting, £m	**-25**	**13**	**-7**	**20**
Add back: Capital allocation, £m	13	14	14	0
Capital expenditure, £m	-64	-34	-72	38
Surplus/(Deficit) - economic, £m	**-76**	**-7**	**-65**	**58**
As a % of GVA, %	**2.0**	**0.2**	**1.8**	

Fiscal policy was counter cyclical in 2011 because the States ran larger adjusted deficits whilst real GVA fell.

Fiscal policy was not counter cyclical in 2012 because the States only ran a small adjusted deficit of £7m (equivalent to 0.2% of GVA) whilst the level of economic activity (GVA) fell by 4% in real terms. This is contrary to the Panel's advice.

Fund movements

The unallocated Consolidated Fund (CF) balance was £31m at the end of 2012, which was £1m less than expected. There were no transfers in or out of the Stabilisation Fund or Strategic Reserve.

However, the Panel have frequently advised that CF balances that exceed £20m should be transferred to the Stabilisation Fund. This is sound practice even if the funds are to be reallocated from the Stabilisation Fund in the same year as it will encourage consideration of whether such funds should be used for stabilisation purposes rather than just changing priorities or pressures within year. The Panel have also stated previously that with the introduction of the Medium-term Financial Plan and provision for expenditure contingencies the £20m limit needs to be lowered.

The Treasury and Resources department should identify the maximum buffer that is required in the Consolidated Fund for remaining contingencies in a

year. Subsequently, any funds in excess of that buffer should be transferred to the Stabilisation Fund.

2.2 Public finances 2013

Treasury Minister's progress update

In April 2013 the Treasury Minister provided a progress update[3] on the Panel's seven main recommendations. **This development is warmly welcomed by the Panel. It is recommended that a progress report should be published by the Minister every year.**

The Panel also warmly welcome the publication within that report of quarter by quarter analysis of capital spend by the key departments.

Given the low level of capital expenditure delivered in 2012 the Panel was encouraged to be told that key departments have taken steps to build up project management capacity so that more schemes could be brought forward and tendered successfully. However, the success of these initiatives should ultimately be judged on the end result in terms of the amount of capital expenditure that is delivered on time to support the economy.

The Panel was encouraged by the Treasury and Resources Department's statement that it would develop a consistent approach to the measurement and monitoring of structural surpluses and deficits. The Panel is not aware that this work has been finalised and would have liked to see this as supporting information for Budget 2014, especially as there are proposals for long-term changes to income tax and funding capital expenditure.

Further work should be undertaken on the nature of the capital programme, in particular distinguishing between spending to maintain and renew existing infrastructure and spending on new or enhanced infrastructure. This would help ascertain whether or not there is an underlying structural deficit, as highlighted in the Panel's last report.

2013 In-year Treasury estimates

Income is expected to be £2m lower than budget in 2013 and expenditure is expected to be £19m lower (Figure 2.4).

[3] R32/2013 "PROGRESS REPORT BY THE MINISTER FOR TREASURY AND RESOURCES ON THE RESPONSE TO THE FISCAL POLICY PANEL ANNUAL REPORT APRIL 2013". May be found at: http://www.statesassembly.gov.je/AssemblyReports/2013/R.032-2013.pdf

Figure 2.4

Public finances position and previous expectations for 2013

Source: States of Jersey Treasury

	Probable 2013 £m	MTFP/FPP 2013 £m	Change £m
States Income	**766**	**768**	**(2)**
Department Expenditure	728	747	(19)
Central Reserve	8	8	0
Net Capital Allocation	13	13	0
Total Net Expenditure Allocation	**749**	**768**	**(19)**
Surplus/(Deficit) - accounting	**17**	**1**	**16**

The most recent quarterly report on capital expenditure (June 2013) shows that capital expenditure was £16m in the first half of this year and that the Treasury expects a further £68m will be spent this year to bring the total spend to £84m[4]. The Panel are concerned that capital expenditure in 2012 and the first half of 2013 was lower than required to provide enough fiscal stimulus. It is recognised that capital expenditure can be lumpy and not spread evenly throughout the year and that the remaining capital expenditure of £68m could be delivered on time in the second half of the year.

When the Panel were briefed in September by the Treasurer on recent developments it was positive that a number of steps had been to taken to learn from the experience in the last 18 months. In particular there is now a capital project status report that covers each current capital project line by line. Analysis was also being undertaken of unspent capital identifying that which might be 'stuck' and when projects might be tendered. The main capital programme is also being set out to 2020.

These recent developments on capital monitoring are welcome. The Panel recommend that the Treasury and Resources Department are pro-active in:

- **Identifying and resolving any bottlenecks and barriers in delivering the capital programme and**
- **Ensuring there is flexibility in the capital programme to bring forward (and potentially delay) capital projects**
- **Managing the capital programme as a fiscal stimulus programme in a similar manner to that established for the initial £44m of discretionary fiscal stimulus in 2009.**

[4] Excluding Trading Funds capital expenditure.

Balance of income and expenditure

In the MTFP, the States planned to run a balanced budget in accounting terms this year (Figure 2.5). However, adjusting for in-year information, timing adjustments and anticipated capital expenditure provides a revised deficit of £79m for 2013. This is £5m higher than the deficit the Panel estimated that the States was planning to run in 2013, mainly because more expenditure was carried forward from 2012 to 2013 than expected.

Figure 2.5

Public finances position and previous expectations for 2013 - adjusted for economic impact

Source: States of Jersey Treasury

	Probable 2013 £m	MTFP/FPP 2013 £m	Change £m
Surplus/(Deficit) - accounting	**17**	**1**	**16**
Add back: Capital allocation	13	13	-
Carry forward adjustment	(25)	7	(32)
Capital expenditure estimate	(84)	(95)	11
Surplus/(Deficit) - economic	**(79)**	**(74)**	**(5)**

The movements on the Consolidated Fund in 2013 are shown in Figure 2.6. The £5m allocation to the Innovation Fund is proposed for 2013 as it did not take place last year as planned at the time of the MTFP.

Figure 2.6

Consolidated Fund movements for 2013, MTFP and draft Budget 2014

Source: States of Jersey Treasury

	Proposed 2013 £m	MTFP 2013 £m
Opening balance	**31**	**33**
Forecast Surplus/deficit for the year	0	1
Other Fund Adjustments	-10	-10
Allocation to Innovation Fund	-5	
Carry Forward to Fund Capital	-4	-4
Closing balance	**12**	**20**

2.3 Draft Budget 2014

Overall

Draft Budget 2014 lacks a lot of basic and important information that is required to understand the overall impacts of proposed fiscal policy and the latest position of States finances. It is disappointing that, in this regard, the draft Budget 2014 is a step back from previous Budgets in terms of completeness and transparency, rather than the steps forward which the Panel recommended a year ago.

Budgets should be clear and concise, and the Panel recommends that every Budget should include:

- **A financial forecast for the current and next 3 years including updated income projections taking into account the latest economic developments, expenditure forecasts and budget measures.**
- **Proposed movements on the Consolidated Fund, Stabilisation Fund and Strategic Reserve for the current year and next 3 years.**
- **Data which shows what happened to these Funds in the previous 3 years.**
- **A financial forecast showing the surpluses and deficits as adjusted to recognise the economic impacts.**

Proposals

The main draft Budget 2014 proposals are:

- To reduce the marginal rate of income tax from 27% to 26% and to increase income tax exemption thresholds by 1.5%.
- To increase the income tax relief available to parents with children in full-time higher education who pay the marginal rate of tax.
- To increase the age entitlement to the higher exemption income tax threshold from 63 to 65 years.
- To remove the restriction of a child's earned income on the income tax child allowance.
- To increase impôts duty for alcohol, tobacco and fuel
- To extend first time buyer stamp duty relief

Overall, the draft Budget 2014 proposals would result in the Consolidated Fund balance remaining tight over the course of 2014, falling from £12m to £6m.

Perhaps the most significant measure in the draft Budget 2014 is the proposed reduction in the marginal rate of income tax. This is a structural change in taxation policy that will reduce revenue in future years by nearly £8m a year on a recurring basis. As a fiscal stimulus measure it does not score well as it is neither timely (it will impact largely in 2015) nor temporary. To ensure such a decision can be afforded, careful consideration of the structural position of States finances is required although it is not clear from the Budget 2014 report that this has been undertaken.

Although the distributional impact of the tax cut is not a matter for the FPP, it is noted that it will mainly benefit those who pay the marginal rate of tax (the vast majority of income tax payers). Those who benefit the most (both in % and £ terms) are those at the high income end of the 27% rate and at the margin of the 20% rate (see Appendix page 51). The desirability, or otherwise, of this distributional change is a matter for the States.

States income

Altogether these measures reduce total revenue by about £5m a year from 2015 when compared to the MTFP forecast. Total revenue increases by less than £1m in 2014.

The forecast for States income for 2014 in the draft Budget remains the same as the forecast in the MTFP and last Budget, before adjusting for the effect of the proposed measures above. There is no updated forecast presented for States income for 2015 or 2016 which means it is difficult to assess future trends in States finances.

States revenue expenditure

There is no States revenue expenditure forecast presented in Budget 2014, although it is assumed it is the same as the revenue expenditure forecast presented in the MTFP.

Balance of income and expenditure

Figure 2.7 adjusts the forecast figures using the most up to date plans for capital expenditure and shows that the proposed plan is to run larger adjusted deficits than in 2013.

Figure 2.7

Public finances forecast for 2013 – 2015 adjusted for economic impact

Source: States of Jersey Treasury

	Probable 2013 £m	Forecast 2014 £m	Forecast 2015 £m
Surplus/(Deficit) - accounting	**17**	**0**	**0**
Add back: Capital allocation	13	5	20
Carry forward adjustment	(25)	(6)	-
Capital expenditure estimate	(84)	(110)	(138)
Surplus/(Deficit) - economic	**(79)**	**(111)**	**(118)**

These large adjusted deficits are expected to come about because most of the capital expenditure is planned to be funded from savings (including the Strategic Reserve) and borrowing.

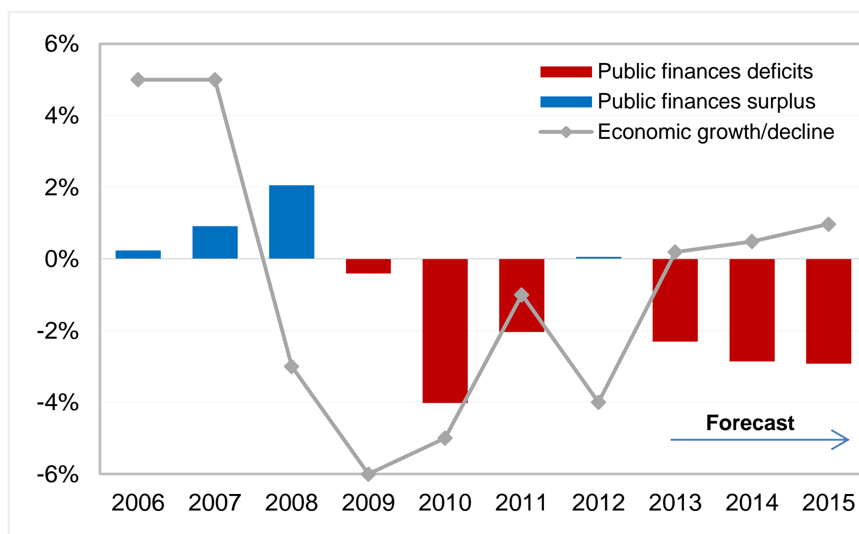
Figure 2.8 shows this in the context of expected economic growth over the next couple of years. **Budget 2014 proposes to run large deficits when the economy is expected have significant spare capacity in 2013 and 2014 and this suggests that fiscal policy will be counter cyclical for this period. Conditions in 2015 are less certain and the Panel should comment on whether deficits of the scale proposed are appropriate in future reports.**

Figure 2.8

Annual surplus/deficit as a % of GVA

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

Note: Total income and total expenditure in real terms (2012 £) is used. Income and expenditure includes the Trading Funds.



Note: the adjusted deficits do not include the economic impact of the activities of the Social Security Fund which predominantly receives social security contributions to pay for the public pension. Including these has a minor impact which would make the deficits smaller and surpluses larger each year.

States capital expenditure

Draft Budget 2014 sets out the proposed capital programme for 2014 which is based on the £89m allocations in the MTFP.

As shown in Figure 2.7, capital expenditure is expected to be £110m in 2014 and £138m in 2015, compared to £34m in 2012 and an estimated £72m in 2013. The main reason for this increase in 2014 and 2015 is the proposed start of the new hospital and liquid waste projects.

The MTFP sets out an indicative Long Term Capital Plan for 2012 to 2032 which identified a broad estimate of £1,646m of capital expenditure (2012 prices) over the next 20 years, together with ideas about funding possibilities. Three large projects did not have funding sources identified but the 2014 Budget goes into more detail about these.

2.4 Three significant capital projects

The Budget 2014 includes proposals to fund three significant areas of capital expenditure over the next 10 years – a new hospital (estimated £297m), a new sewage treatment works system (estimated £75m) and social housing (refurbishment, land acquisition and new buildings – estimated £250m).

Funding options for large capital projects

A mix of internal and external funding options is proposed for the three large capital projects ranging from spending the Strategic Reserve (£297m), investing from the Currency Fund (£29m) and external borrowing (up to £250m).

Large capital projects can be funded either from saving by current taxpayers, or by borrowing which is to be repaid by future tax payers. The first is most appropriate for projects which are a renewal or replacement of existing infrastructure, the second for new or improved infrastructure where future taxpayers will benefit from the stream of services from the project. Jersey does not have a pot of savings designated for capital expenditure (beyond existing capital allocations) to cover capital projects of the scale now being envisaged. Borrowing can either be internal, from existing funds, or external. It is not within the remit of the FPP to advise on the most advantageous funding solution.

Use of the Strategic Reserve

Budget 2014 proposes using an "excess" in the Strategic Reserve to fund capital projects. The Fiscal Framework for Jersey was agreed by the States in 2006[5]. The proposition sets out that the Strategic Reserve:

"…should be a permanent reserve, where the capital value is 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."

The proposition does not specify what the capital value is, how it should be calculated and how large it should be.

The box illustrates alternative ways of determining the capital value of the Strategic Reserve and what the appropriate balance in the Reserve should be. The Panel is not suggesting that one approach is more appropriate than another. **The States should clearly define the purpose of the Strategic Reserve and set out conditions for its use, including how borrowing from the Reserve would be dealt with. This should be done before deciding whether or not to use the Strategic Reserve to pay for any capital expenditure.**

[5] "ESTABLISHMENT OF A STABILISATION FUND AND POLICY FOR STRATEGIC RESERVE" P133/2006. May be found at: http://www.statesassembly.gov.je/AssemblyPropositions/2006/223-48242-24102006.pdf

Box 2: Determining the capital value and appropriate balance - discussion

The draft Budget is based on one of the ways to calculate the value of the capital and interest in the Strategic Reserve. This approach involves taking the value of the money transferred in and out, and inflating it to 2012 prices to get a capital value of £230m at the end of 2012.

Another way involves taking the value of the Strategic Reserve when the Fiscal Framework was agreed (£477m at the end of 2006) and inflating this to 2012 prices using the RPI. This gives a higher capital value of £580m at the end of 2012.

The report to the Fiscal Framework proposition also discussed an aspiration to grow the Strategic Reserve to 20% of the economy (in terms of GDP which broadly equates to GVA). The value of the Strategic Reserve was £651m at the end of 2012, which is equivalent to 18% of GVA in that year. Using the Treasury's investment return and economic assumptions, the value of the Strategic Reserve is expected to be £830m (in 2012 prices) by 2024, which would be 20% of GVA in that year.

Whether or not there is a surplus over the capital value depends on the calculation used. If the policy was to grow the Strategic Reserve to 20% of GVA there would be little scope to pay for capital expenditure from the Reserve over the next ten years or so, unless the funding was repaid with interest.

Hospital project

This project involves improving and replacing the hospital in order to help meet the challenges facing the Island's future Health and Social Services.

The work is expected to finish by 2024. Most of the spending, and therefore the economic impact of this spending, is expected to take place between 2016 and 2021. However, some initial work and spending is proposed to take place in 2014 and 2015.

The Treasury Minister's proposal for funding the new hospital is to draw this money out of the Strategic Reserve in instalments over the next ten years or so. The money is not being borrowed from the Strategic Reserve as it is not proposed that the money (or the forgone investment returns) will be repaid.

In the Budget 2014, there is a statement that "there would be no new cost to the taxpayer". The Panel do not see how this can be the case - there is no such thing as free money. By using the Strategic Reserve and not paying the

money back, Islanders are foregoing investment returns which would have increased the size of the Strategic Reserve and its ability to be used for other purposes. Islanders will enjoy the benefits of the new hospital in future years instead but it is not clear from the information in Budget 2014 how these compare to forgone returns from the Strategic Reserve or indeed any other investments for which the funding could be used.

In considering whether the Treasury Minister's proposal is in line with the Fiscal Framework it is necessary to consider whether the capital value remains to one side and only the interest is being spent on the new hospital.

There are many ways the capital balance, and therefore the interest balance can be estimated and it is only the report to the proposition which provides guideline aspirations for the size of the Strategic Reserve. Therefore it could be argued either way whether this proposal is consistent with the Fiscal Framework proposition and guidelines.

The draft Budget proposition proposes to make an exception to the Fiscal Framework for the new hospital project. It sets a worrying precedent for the States to make an exception to the Fiscal Framework in order to spend money in the Strategic Reserve. This exception is not necessary if there is enough interest in the Strategic Reserve to leave the capital untouched, but the optimal size of the Strategic Reserve will have to be determined before this conclusion can be drawn.

Liquid waste project

This project involves replacing the sewage treatment works at Bellozanne and a programme of repair and replacement of the network of drains costing an estimated £75m by 2020. Most of the spending is expected to take place between 2014 and 2018, and in particular 2015 and 2016.

Figure 2.9 shows the proposed sources of funding which are expected to match the spending profile.

Figure 2.9

Proposed sources of funding for the liquid waste project (2013 prices)

Source: States of Jersey Treasury

	2013 £m	2014 £m	2015 £m	2016 £m	2017 £m	2018 £m	2019 £m	Total £m
Main capital programme		3		7	7	12	1	30
Investment from currency fund			21	8				29
TTS rolling vote		4		4	4			12
Other	1	3						4
Total	**1**	**10**	**21**	**19**	**11**	**12**	**1**	**75**

The draft Budget proposes that the investment from the Currency Fund will be repaid with interest from the Transport and Technical Services (TTS)

Department's existing budget and operational cost savings from the new sewage treatment works.

Using the currency fund will provide a boost to economic activity in 2015 and 2016, followed by a drag on activity beyond this as the investment is repaid.

Social housing

This is a series of refurbishments and new build projects which is expected to cost about £207m by 2020. There is a further estimated £43m which depends on there being sites released for development in the Island Plan, or from other sources.

The Housing Department expects to spend £45m in 2014 (£23m funded separately and £22m in the capital programme).

The proposed funding for this is £250m of external borrowing which will be repaid over the next 20 – 30 years. The extra revenue to repay the loan and interest, which is expected to be between 3% and 4% a year in the Budget, is scheduled to come from the following sources:

- Increased social rent levels from 70% of market value to 90% of market value
- Sales of social housing stock
- Rental income from the newly built social housing stock

Economic impact of the large capital projects

The estimated capital spending profile for all three projects together with the future programme for departmental capital spending (based on allocations) is shown in Figure 2.10.

Figure 2.10

Estimated capital expenditure 2013-2020

Source: States of Jersey Treasury

	2013 £m	2014 £m	2015 £m	2016 £m	2017 £m	2018 £m	2019 £m	2020 £m
Estimated capital expenditure	84	110	138	166	140	120	89	70

The draft Budget 2014 proposes that the hospital and social housing projects are mostly paid for by using savings (Strategic Reserve) and selling assets (such as properties) rather than by increasing income (through higher charges or taxation) or reducing expenditure.

Some of the borrowing to pay for the social housing project will be repaid by selling property and some by increasing income, through increasing the social rent level from 70% of market rate to 90% of market rate.

The draft Budget 2014 proposes the liquid waste project is mostly paid for within current expenditure plans or, beyond 2017, reducing future expenditure in order to repay the Currency Fund.

This means that most of the spending in the table above from 2016 onwards will be additional to Jersey's economy. It is clear that the scale of expenditure is unprecedented: Estimated capital expenditure in 2016 is about five times that in 2012 (when it was clear that the economy was weak and merited fiscal stimulus)

The Panel cannot at this stage know whether the economic conditions in 2016 and beyond will mean that such high levels of capital spending will be appropriate. If the economy recovers, there is a risk that this spending could be pro cyclical, unless other adjustments were made. Moreover, the spending could create capacity concerns in the construction sector and wider economy.

The Panel recommends that the States should make contingency plans for an improvement in economic conditions and reduction in spare capacity from 2015. This would mean running counter cyclical fiscal policy and topping up the Stabilisation Fund. The plans could include:

- Reducing departmental expenditure and/or raising revenue
- Changing the profile of spending on the three significant projects or other projects in the capital programme
- Changing how key capital projects are delivered to put less strain on local capacity.

2.5 Future risks and uncertainties

Future risks and uncertainties remain more to the downside and can be summarised as:

A structural deficit in the public finances – There is a risk that there is an underlying shortfall between States income and expenditure which needs to be addressed. This may be indicated by the extent to which capital expenditure is being funded by borrowing, both internal and external, and running down funds established for other purposes.

UK and US FATCA negotiations – Jersey's commitment to co-operate internationally on tax matters is important for the integrity of the Island and

future success of its finance industry. In October, Jersey signed an agreement with the UK and is close to signing an agreement with the United States. These commitments improve tax transparency through the automatic exchange of tax information between Jersey and these countries in order to help tackle tax evasion.

The US agreement is not expected to harm Jersey's competitive position because it will apply equally to all financial services centres. The UK agreement is also not expected to have a significant impact on Jersey's competitive position internationally, as it is solely concerned with reducing tax evasion on the part of UK residents. The G20 is also pressing for similar agreements to be adopted globally which will help to level the playing field. However, there is a risk that some UK residents who qualify for special tax treatment as 'resident non-domiciled' and who presently hold their foreign source earnings in Jersey will decide not to do so and move their business to another financial centre. If this occurs this could have a significant impact on the profits of individual financial institutions that are most dependent on this business.

Lower long term productive potential and further risks to finance sector performance (as highlighted by McKinsey) are covered in section 1 and highlight that economic growth potential in future years could have been reduced by structural changes in the economy that have occurred over the last 10 years.

The challenges of a population living longer: In common with many other developed countries, Jersey people are living longer and are expected to live longer in the future. While this is a good thing, it means there will be less people of working age and more people above working age which could reduce how quickly States income will grow in the future. At the same time expenditure will rise in areas such as health care and pension provision. The impact of this will peak as a result of the demographic profile during the mid-2020s to 2030s and the States will need to prepare in advance for the changes this will bring. The introduction of the Long-term Care Scheme is a welcome development on this front. Figure 1.24 in Section 1 shows the demographic changes.

Appendix - Distributional impact of the proposed income tax rate cut

27% marginal income tax rate cut to 26%