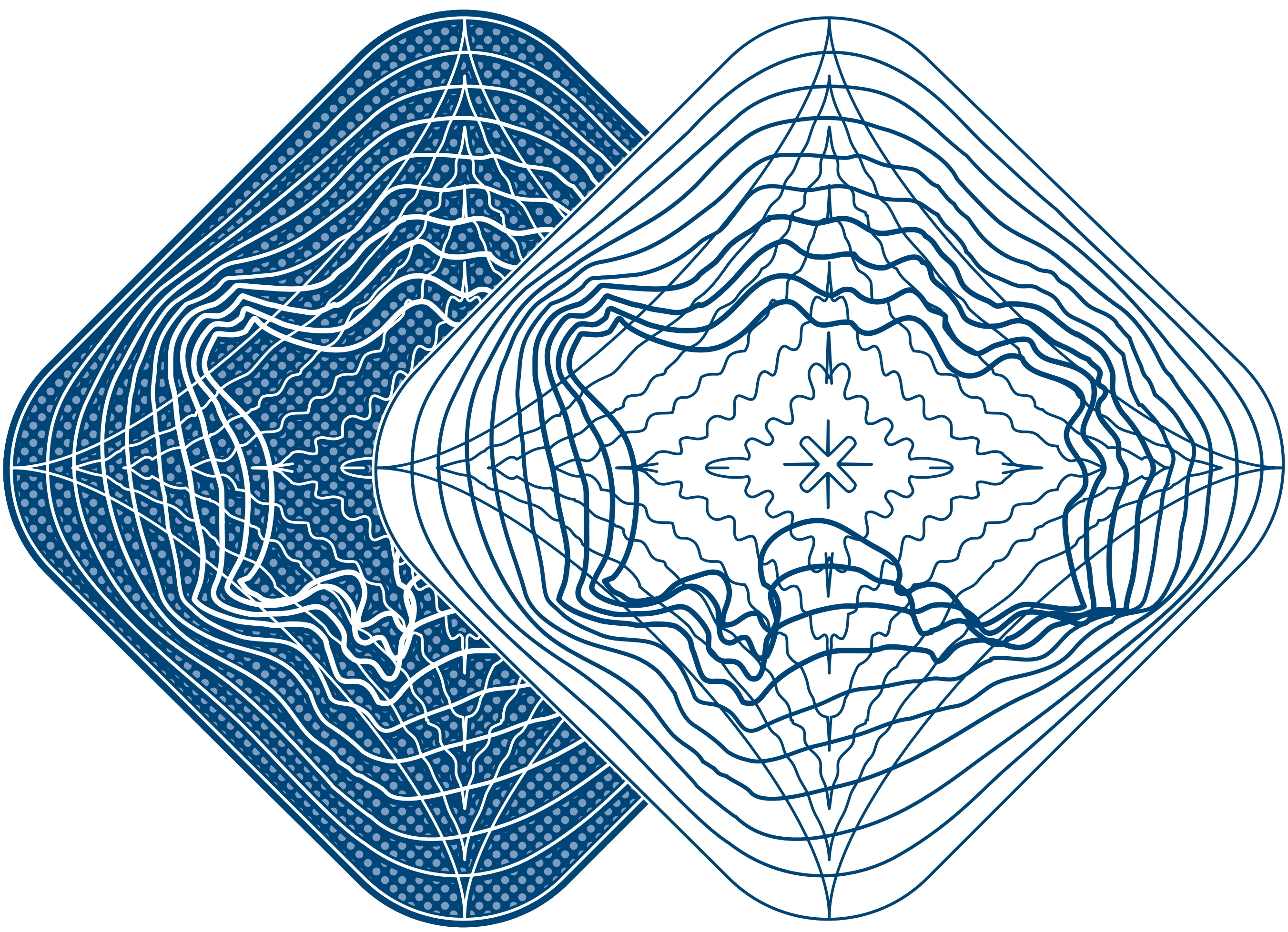
Jersey's Fiscal Policy Panel Annual Report

2009



Introduction

This is the second annual report of Jersey's 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 Consolidated Fund, the Stabilisation Fund and the Strategic Reserve. These recommendations are based on an assessment of the Jersey economy in the context of world economic developments and the risks and uncertainties faced. They are also informed by the Panel's five guiding principles, namely:

1. Economic stability is at the heart of sustainable prosperity;
2. Fiscal policy needs to be focused on the medium-term;
3. Policy should aim to be stable and predictable;
4. Supply in the economy is as important as demand; and
5. Low inflation is fundamental to the competitiveness of the economy.

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

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

Recommendations

- The Stabilisation Fund should be used to cover the deficits that will result from the expected contraction in the economy in 2009 and 2010.
- Given the likelihood of a significant downturn in 2009, continuing into 2010, stimulus should be applied to the economy now through some quick-acting, well-targeted and temporary measures. The proposal to use the Stabilisation Fund to fund discretionary policy this year is appropriate given the economic outlook.
- The extent of discretionary policy should not be defined by the balance in the Stabilisation Fund, but by the availability of suitable measures, the extent of the economic downturn and the scale of stimulus that is judged appropriate. However using the £44m that is estimated to remain in the Stabilisation Fund is consistent with the Panel's advice to implement a significant discretionary stimulus. It is important to make sure that specific discretionary projects represent value for money and are timely, targeted and temporary.
- No additions to or withdrawals from the States' Strategic Reserve should be made at this stage. However, in some circumstances it may be appropriate for the deficits that would arise on unchanged policy in recession, together with the cost of discretionary policy, to exceed the Stabilisation Fund – by borrowing either in the financial markets or from the Strategic Reserve. Especially in these circumstances, it is essential to ensure that the measures taken are temporary and that future fiscal discipline is strong enough to replenish the Funds.
- The Panel notes that its previous advice to transfer the majority (£63m) of the expected balance in the Consolidated Fund for 2009 to the Stabilisation Fund has been accepted. In future the working balance in the Consolidated Fund should not exceed £20m and any money accumulating above this level should, as a matter of course, be transferred to the Stabilisation Fund. If the current estimate of a Consolidated Fund balance of £31m in 2009 materialises, an additional transfer into the Stabilisation Fund from the Consolidated Fund will be required.
- The £60m per annum deficits forecast after the economy is assumed to have returned to trend suggests that a large part of the projected shortfall could be structural (i.e. permanent). There are also other pressures and uncertainties on the horizon that may adversely affect the financial position. Especially in the light of the longer-term risks to Jersey's finances that the Panel has previously identified, a strategy for dealing with this once the economy has recovered should be agreed during the current fiscal year.

- Recognising that the risks and uncertainties to States' finances in the future lie to the downside, the States should not approve measures that further undermine the tax base or commit to expenditure in the medium term.

These recommendations are based on the views of the domestic and international economic outlook outlined in section 1 and analysis of the underlying fiscal position in section 2 of this report.

Section 1 – The Economic Outlook

Key points

International economic outlook

- Since the Panel published the update to its 2008 annual report in November, the global outlook has continued to deteriorate. The world economy is expected to contract in 2009, for the first time in over 60 years.
- Actions taken by governments and central banks should reduce the length and depth of the global downturn, but some of the fiscal and monetary policy responses are unprecedented, so their impact is difficult to predict.

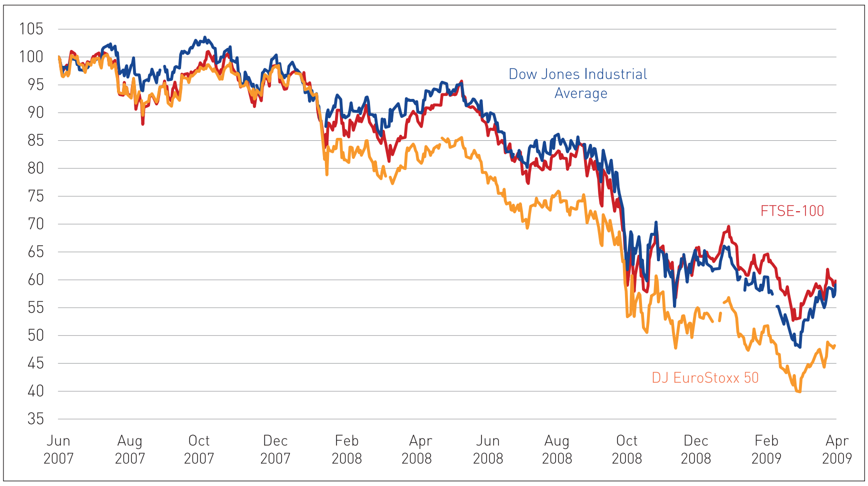
Jersey economic outlook

- Jersey has performed strongly in recent years, with rapid economic growth, rising employment and low inflation.
- This strong performance continued into 2008. The Panel estimates that growth over the year as a whole remained robust, albeit slower than recent years at around 3%. Inflation was higher, but much of the spike in June and September can be attributed to GST and global commodity price effects. RPIY, the best measure of underlying inflation at present, was 3.2% in December 2008 and 3.3% in March 2009.
- As a result of the dramatic deterioration in the global economy and financial sector, Jersey is expected to experience recession this year and next. The Panel's central expectation is for the economy to contract in real terms by 4% to 6% in 2009 and by 1% to 3% in 2010, on unchanged policies.
- Much of the steep measured decline in output will be the result of a sharp fall in finance sector profits and the downturn in the rest of the economy is unlikely to be commensurate. That said, the labour market is expected to slacken and unemployment is likely to rise as businesses seek to cut costs in response to falling turnover and profits.
- Inflation is expected to fall further over the course of 2009 as temporary effects, such as the introduction of GST and higher commodity prices, which were pushing inflation up, drop out of the annual rate. Furthermore, an increasing margin of spare capacity within firms and the labour market should contain underlying inflation. Headline inflation, measured by RPI, will fall further, and possibly turn negative for a period, driven by significantly lower mortgage interest payments.

1.1 International outlook

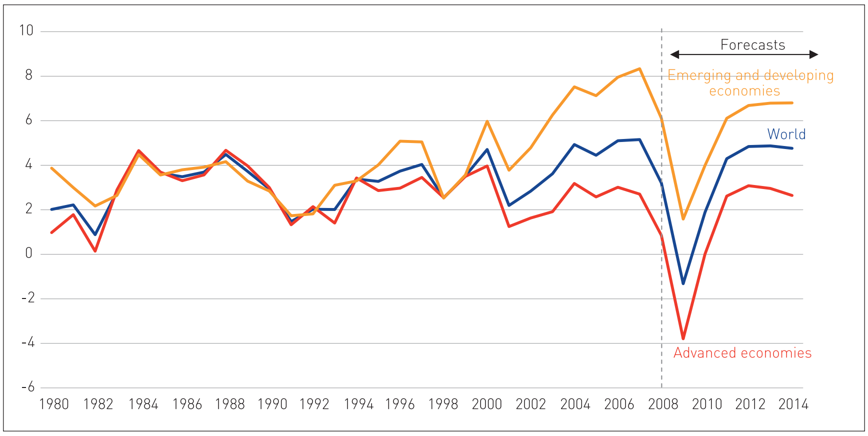
The state of the global economy is a key determinant of the performance of a small open economy like Jersey. Global economic conditions have continued to deteriorate rapidly over the past few months. Significant restructuring continues apace in the world's largest financial institutions, which has affected the availability of credit. Equity price indices in the UK and the US are around 40% below their level in June 2007, before the crisis began (Figure 1.1). Financial market difficulties are feeding through to the real economy. Global trade has contracted sharply, commodity prices have plummeted and consumers and businesses are cutting back on expenditure and investment.

Figure 1.1:
Equity prices have fallen sharply since June 2007
Daily stock market indices, June 2007 to April 2009 (index, 04/06/2007=100)
Source: Yahoo! Finance



Reflecting these developments, the global economic outlook for 2009 and 2010 has deteriorated markedly. The International Monetary Fund (IMF) forecasts that the advanced economies will experience a deep recession in 2009 and emerging economies will see growth slow to around 1.6% (Figure 1.2). The forecasts for both the UK and the EU are for a contraction of 4% in 2009 and a further contraction of 0.4% in 2010. Taking the forecasts for all economies together, the IMF expects the world economy to contract by over 1% in 2009, the first contraction for over 60 years.[1]

Figure 1.2:
The IMF expects a deep recession in advanced economies and a contraction in the world economy as a whole
% change in GDP on previous year
Source: IMF



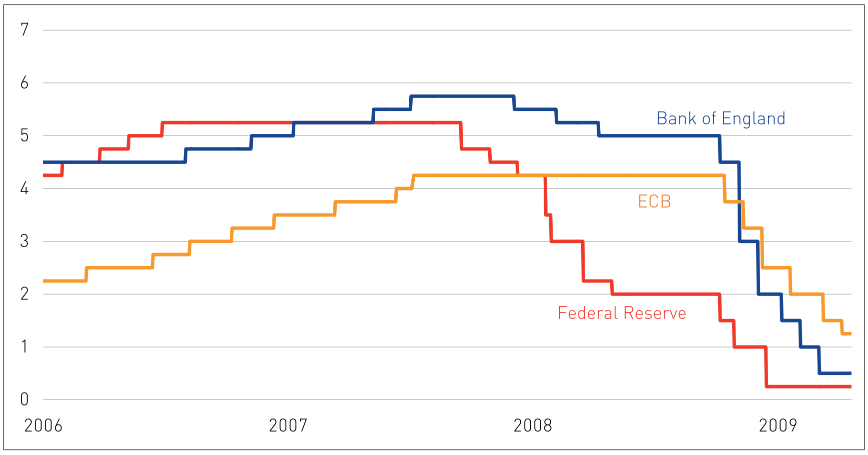
[1] IMF (2009), World Economic Outlook: Crisis and Recovery, April 2009, available at http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf.

These bleak projections already factor in some positive impact from the exceptional actions that are being taken by central banks and governments around the world.

Firstly, the authorities have taken unprecedented actions in order to try to stabilise the vulnerable financial sector. Deposit guarantee schemes, bank recapitalisations and loan guarantee facilities are among measures that have been used to address concerns about liquidity and capital adequacy, and to encourage lending.

Secondly, central banks have cut interest rates vigorously in an effort to stimulate borrowing and spending (Figure 1.3). As nominal interest rates reach their floor of zero, central banks have begun to undertake more unorthodox methods of stimulating economic activity. For example, at its March meeting, the Monetary Policy Committee (MPC) of the Bank of England agreed to begin the process of "quantitative easing" – that is, it would effectively create money to purchase medium- and long-term government bonds, or gilts, and corporate debt securities.[2]

Figure 1.3:
The US has been cutting interest rates vigorously since mid-2007, with the UK and ECB following in 2008
Official interest rates (per cent)
Source: Federal Reserve, Bank of England and European Central Bank



Thirdly, because monetary policy actions, plus passive fiscal policy in the form of automatic stabilisers together are unlikely to be sufficient to reduce the real consequences of the financial crisis, governments have been looking at ways of using substantial discretionary fiscal policy measures (Figure 1.4). These measures largely represent an injection of demand from the public sector into the world economy, to help offset materially weaker demand from the private sector.

Figure 1.4:
Discretionary fiscal stimulus measures announced around the world imply a large injection of demand
Discretionary fiscal measures announced for 2009-2010 as of January 2009
Source: IMF

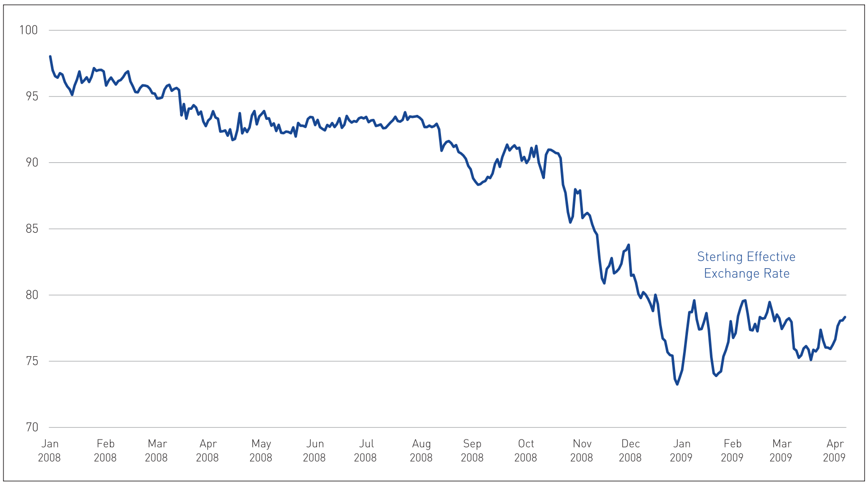
Note: The total G20 figures are weighted-averages of the individual G20 countries, where the weights assigned to each country reflect their relative GDP in purchasing-power parity terms

	Size as a % of GDP relative to 2007 baseline		
	2008	**2009**	**2010**
France	0.0	0.7	0.7
Germany	0.0	1.5	2.0
Japan	0.4	1.4	1.4
United Kingdom	0.2	1.4	-0.1
United States	1.1	2.0	1.8
Total G20	0.5	1.8	1.3

[2] Bank of England (2009), minutes of the MPC meeting held on 4-5 March, available at http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2009/mpc0903.pdf.

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

Figure 1.5:
The value of sterling has fallen dramatically relative to other currencies over the past 18 months
Daily sterling effective exchange rate (index, Jan 2005 = 100)
Source: Bank of England

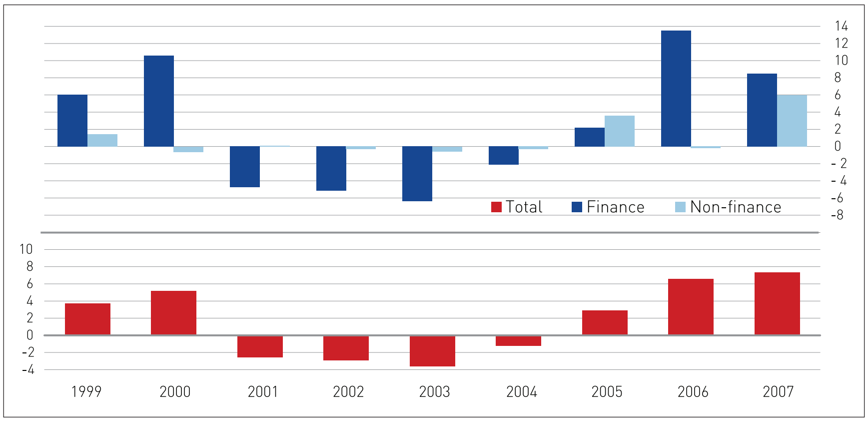


1.2 Jersey economic outlook

Economic growth

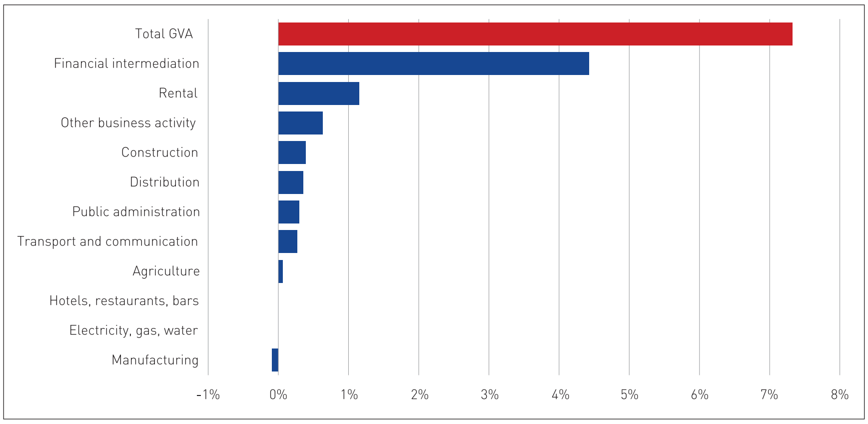
The Panel noted in its 2008 update in November that the most recent data available showed that economic growth remained rapid in 2007, continuing the robust performance seen in 2006 (Figure 1.6).

Figure 1.6:
Strong Jersey economic growth continued in 2007
% change in real GVA on previous year
Source: States of Jersey Statistics Unit



This strong growth was mainly driven by financial services, but most other sectors grew as well (Figure 1.7).

Figure 1.7:
Strong growth in 2007 was driven by financial services, but supported by growth in construction and distribution, among others
Contributions to real GVA growth in 2007 (percentage points)
Source: States of Jersey Statistics Unit



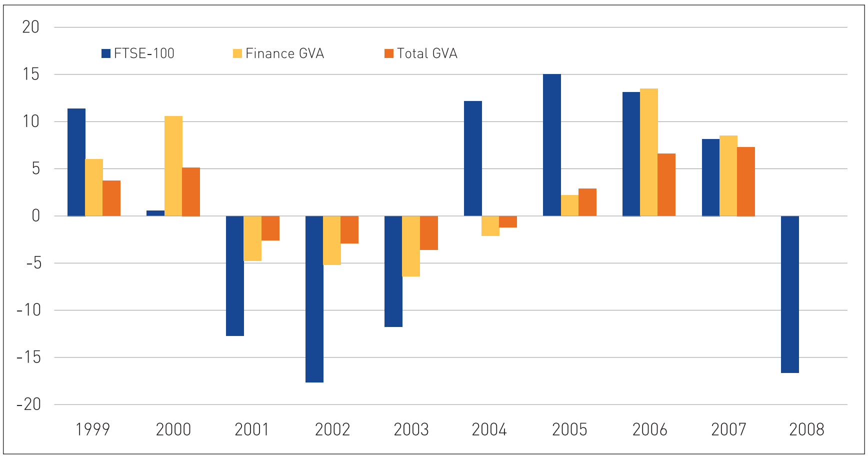
Data on GVA in 2008 will not be published until October 2009, but the information available suggests that the Jersey economy continued to grow strongly into 2008. The Panel estimates that GVA growth was 3% (in real terms) in 2008, a slowdown on previous years, but still above the likely sustainable trend rate of growth. The estimate is based on the manpower data showing a continued rise in employment in both the financial and non-financial sectors (see the Labour Market section below) and information that financial sector profits continued to rise. This is consistent with the picture presented by the businesses that the Panel met in March 2009. Anecdotal information suggests that although 2008 as a whole was strong, economic growth is likely to have slowed during the course of the year.

Turning to 2009, the Panel expects the economy to enter recession – a situation where the economy contracts rather than expands – and to remain in recession overall in 2010. The recession is the result of the global economic and financial crisis feeding through to the Jersey economy. The effect is likely to be felt most directly in the financial sector, but all parts of the economy will be affected to some extent.

Financial sector

As the Panel has noted in previous reports, economic performance in Jersey has been correlated with a short lag to the performance of equity markets (Figure 1.8), and global equity prices have fallen sharply in response to the financial crisis. Recent work by the Economics Unit has identified a number of other variables, beside equity prices, which have been correlated with financial sector GVA in Jersey in the past. These include conditions in the UK finance industry (such as its GVA, employment and bonuses) and conditions in the global economy (summarised by GDP growth in the US and euro area). Taken together, these indicators suggest that the financial services industry is likely to see a significant decline in value added, consistent with a likely drop in the demand for, and income from, Jersey financial services as the world experiences recession and wealth falls.

Figure 1.8:
Jersey growth has followed financial markets
Real GVA and FTSE-100 (% change on previous year)
Source: States of Jersey Statistics Unit and Economic Unit



The impact will vary by sub-sector of the finance industry. Trust and fund administration may see weaker incoming new business and reduced revenues on services priced on an ad valorem basis, but volumes should be shielded at least initially as these are mainly annuity businesses servicing an existing stock of assets. Wealth management services are likely to see less new business and lower income to the extent that they charge fees related to the performance of financial markets.

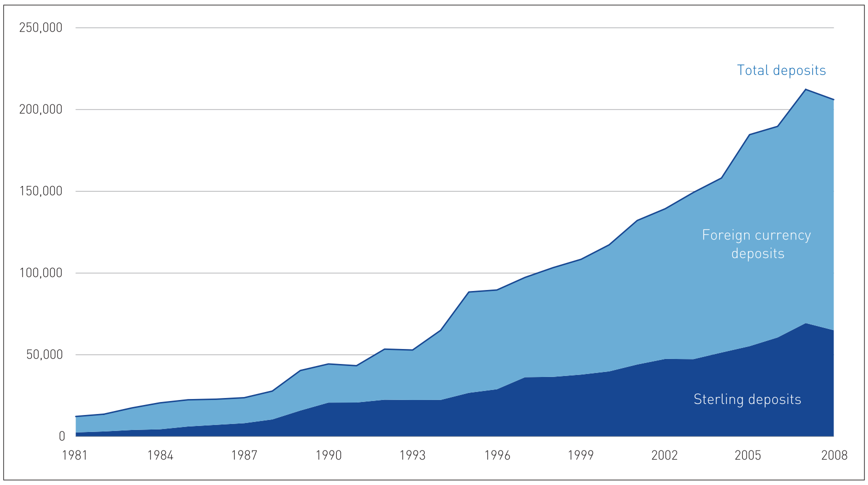
There is evidence to suggest that banks may already be suffering some reduction in the sterling value of deposits. Figure 1.9 shows that banking deposits fell slightly in 2008, the first fall in 15 years, and may fall further in 2009, although large movements in exchange rates make it difficult to discern the underlying trends. Furthermore, the profitability of banking in the Island will face an additional squeeze as a consequence of the effect of the low interest rate environment on deposit margins (see Box 1). It seems likely that deposit margins will remain low for some time since market expectations are for official interest rates to remain low until at least the end of the year (Figure 1.10 in Box 1).

These falls in profits will have two effects.

Firstly, a fall in financial sector profits will likely hit the amount of tax received by the States. Profits from financial sector firms are the source of around a third of total States' income, half of which comes from banks. The total contribution of the financial sector is greater, if one takes into account the tax revenue from employee income or the economic activity generated indirectly in other sectors such as hospitality and retail.

Secondly, a fall in financial sector profits will reduce measured economic growth (GVA). Profits earned by banks make a very significant contribution to the Jersey economy, accounting for nearly 30% of measured GVA in 2007. However, although these lower profits will be reflected by a fall in measured real GVA, unlike most falls in GVA, this fall may not imply an equivalent fall in the volume of economic activity undertaken in the Island. For example, banks in Jersey might be managing the same number of accounts for clients, suggesting that the services being provided and the number of staff required to provide them has not changed. The implication is that significant falls in GVA, particularly when driven by falls in banking profits, have to be interpreted with care.

Figure 1.9:
Bank deposits fell in 2008
Bank deposits held in Jersey (£ million)
Source: Jersey Financial Services Commission



Box 1: Banking profits in a low interest rate environment

The main job of banks is financial intermediation; that is, they take funds from those with spare money and lend it on to those in need of loans. Banks earn a profit by the spread between the interest rate charged on loans and the interest rate paid on deposits. This spread can be thought of as the sum of two implicit fees: a fee for deposit-taking services, and a fee for lending services.

The determination of the exact split of the overall margin between lending and deposit rates into a deposit fee and a lending fee requires the comparison of these two rates with a cost-of-funds rate, which will lie somewhere between the two. To see this, consider a bank that only provides the deposit-taking side of the intermediation; this bank raises funds from deposits, but rather than lending to final borrowers itself, it can charge other financial intermediaries for the use of these funds for lending.

Many banks in offshore financial centres do exactly this; they gather deposits and then 'up-stream' those funds to their parent bank. Intra-group loans to parent companies account for the vast majority of Jersey banks' total assets; i.e. they focus on the deposit-taking service (and not the lending service) and only earn the deposit margin. The parent bank, which does the lending services, collects the lending margin.

Since they want to attract funds to their bank, interest rates paid on deposits are determined by prevailing market conditions. However, since up-streamed funds will generally be an intra-group transfer, the rate paid on them will be set by the parent group. Different banking groups will set different transfer prices for these transactions. But all are subject to anti-tax avoidance rules that exist to ensure that profits are not being artificially allocated to a lower-tax offshore centre. In order to satisfy onshore tax authorities, transfer prices will typically be close to the relevant market price, such as the official Bank of England interest rate or an interbank lending rate such as Libid (London Interbank Bid Rate).

Figure 1.10:
The official Bank of England rate has fallen dramatically over the past year
Bank Rate and forward market interest rates (per cent)
Source: Bank of England

Note: The forward market interest rate series shown is as published in Bank of England (2009), Inflation Report, February, available at http://www.bankofengland.co.uk/publications/inflationreport/ir09feb.pdf

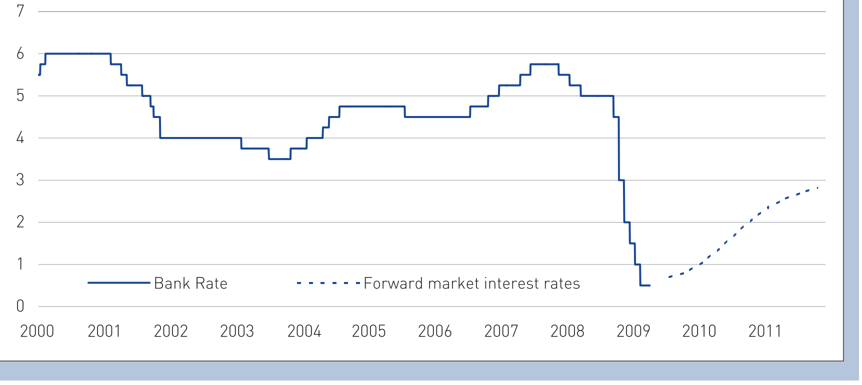
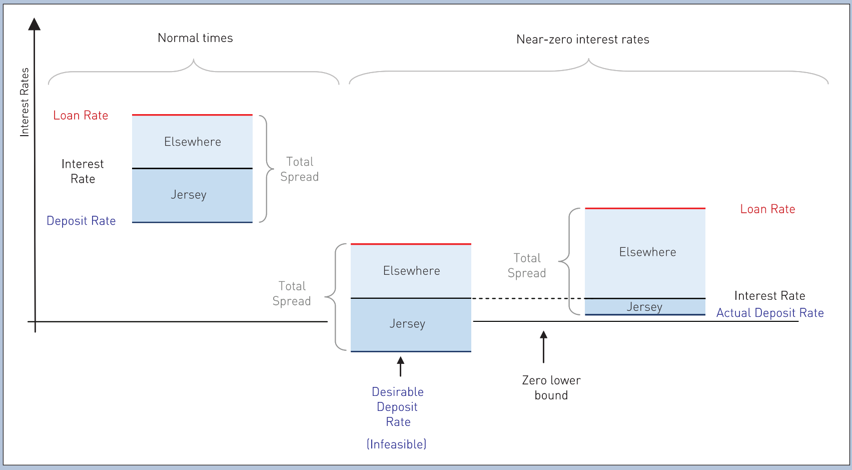


Figure 1.10 shows that the Bank Rate has fallen rapidly over the last year from 5.5% in January 2008 to 0.5% in March 2009, its lowest level in the Bank of England's 314-year history. Because interest rates paid on deposits cannot fall below zero in practice, a near-zero Bank Rate can reduce the deposit margin, even as the total intermediation margin remains the same (Figure 1.11).

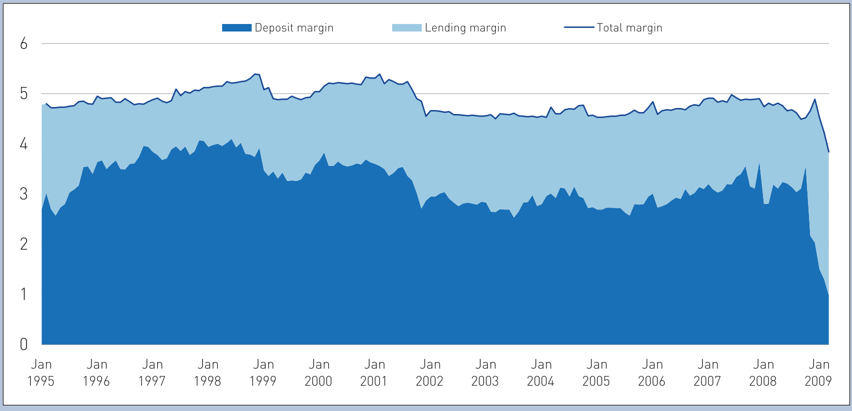
Figure 1.11:
Diagram showing the impact of low interest rates on banks margins
Source: States of Jersey Economics Unit



Data on margins for Jersey banks are not available but, as an illustration, margins for UK banks and building societies are shown in Figure 1.12. The slice of that margin attributed to deposit margin is the amount below the interbank rate that banks pay on deposits, and the lending margin is the amount above the interbank rate that banks charge on mortgages. It shows that the deposit margin has fallen very rapidly in recent months to around one-third of its average level. But there is much less change in the total margin because banks have simply increased the lending margin.

Figure 1.12:
UK banks' margins on deposits are exceptionally low
Margin between instant-access deposit accounts and the standard variable mortgage rate (SVR) with Libor/Libid average interbank rate (per cent)
Source: Bank of England

Note: Deposit margin = Libor/Libid average interbank rate – instant access deposit rate. Lending margin = SVR – Libor/Libid average interbank rate



Although banks in Jersey provide a range of other services – for example wealth management or foreign currency dealing – and not solely financial intermediation services, the bulk of profits earned by banks are earned from interest margins on intermediation.

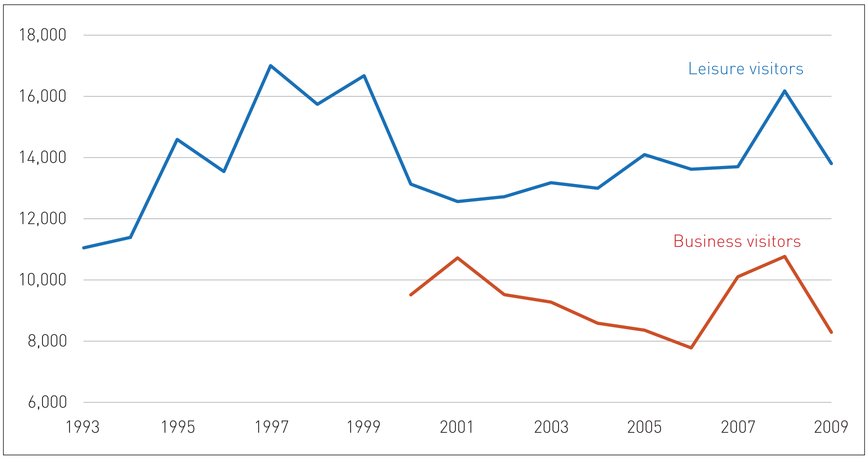
The rest of the economy

Although less directly exposed, the rest of the economy will suffer the second-round effects from the financial sector and is not itself immune from the effects of the financial crisis. Consumer confidence has fallen and Jersey households are likely to restrain their spending as the employment outlook worsens. This will have an impact on the retail sector but will also be felt more widely, for instance by hotels, restaurants and bars.

Investment spending is also likely to be reduced substantially. Increased uncertainty caused by the economic climate and, for some, difficulty in obtaining credit, is likely to reduce capital investment by the private sector. This is most apparent in the construction sector, where both residential and commercial property plans are being put on hold, but it might also affect non-construction investment; for example, companies may choose to delay investment projects such as replacing IT equipment.

The sales of services for export are likely to fall significantly, mainly reflecting weaker foreign demand for Jersey financial services. Spending by visitors to Jersey, both business and leisure, also counts as an export. This spending – concentrated mainly in the hotels, restaurants and retail sectors – is likely to be reduced as financial services retrench and consumers in the UK and other countries cut back on their spending, although this might be mitigated to an extent by the lower sterling exchange rate if it persists. Figure 1.13 shows that the number of staying business and leisure visitors in January and February 2009 was much lower than in 2008, but was similar to the level in 2002-2006.

Figure 1.13:
The number of staying visitors in January and February 2009 was much lower than in 2008
Staying business and leisure visitors (number) in January and February each year
Source: Jersey Tourism

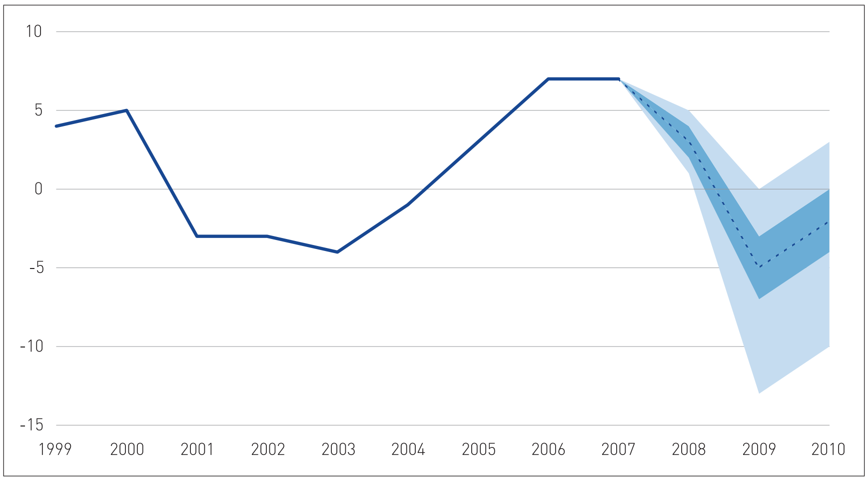


Overall economic growth

The reduction in interest rates and the depreciation of the sterling exchange rate should both serve to stimulate demand in Jersey to some extent, although the impact of low interest rates on measured GVA may be offset by their influence on the Jersey banking sector (described in Box 1). Taking these factors into account, together with information from meetings with a wide range of business contacts in the Island, the Panel believes that GVA will shrink by 4 to 6% in 2009 and shrink by a further 1 to 3% in 2010 (Figure 1.14). While these forecasts are based on the best available information, there remains considerable uncertainty around them, which is represented by the wide ranges around the central expectations in Figure 1.14.

The Panel considers that, given the significant uncertainty surrounding the severity and length of the global slowdown, the risks to economic growth in Jersey in 2010 are on the downside. In particular, there is a risk that global growth does not pick up as quickly as many are currently forecasting. Such a scenario would adversely affect a recovery in Jersey, so the bands of uncertainty in the Panel's forecast are wider below the central estimate (Figure 1.14).

Figure 1.14:
The economy is likely to contract in 2009 and 2010, but large uncertainties surround the outlook
% change in real GVA on previous year
Source: States of Jersey Statistics Unit and Economics Unit



The Panel has concluded that GVA likely grew overall in 2008, albeit less strongly than in recent years. It is expected to shrink substantially in 2009 and fall further in 2010. Given that the global outlook is the most uncertain in years, the Panel believes that there is a significant probability that the slowdown will last longer than two years.

Labour market

The most recent employment data available suggest that overall employment held up through 2008. Total employment was over 500 (1.1%) higher in December 2008 than 12 months earlier, and the average figure for the whole of 2008 was just over 1,200 (or 2.3%) higher than the corresponding figure for 2007.

Unfortunately, since Jersey employment data is only available every 6 months, the next scheduled release of official data will relate to June 2009 and will not be published until October. For information about what has been happening since December, the Panel must rely on anecdotal evidence and unemployment data.

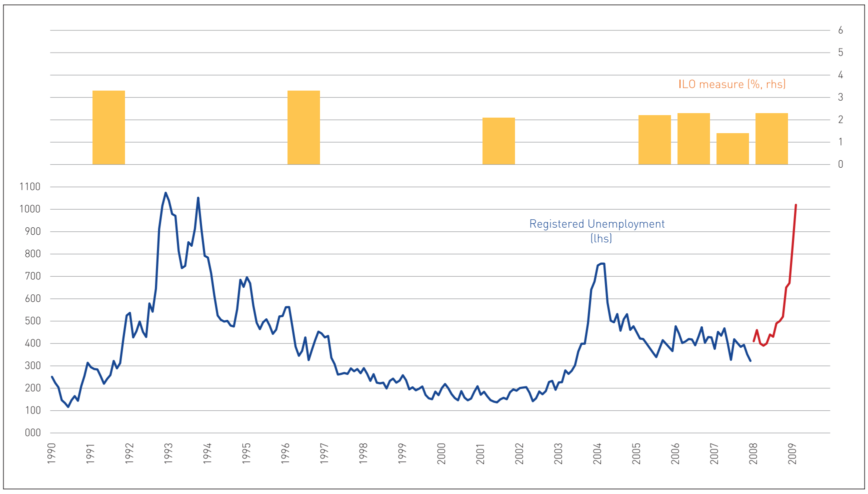
Anecdotal evidence suggests that there have been a number of job losses in recent months, and that the recession is likely to lead to further job cuts. While some of those made redundant will find jobs in other firms and some might choose to leave the Island, these effects are unlikely to be large enough to offset a rise in the unemployment rate.

The best gauge of unemployment is given by the internationally comparable UN International Labour Organization (ILO) measure. This information is collected annually in Jersey, with the most recent data showing an unemployment rate of 2.3% (approximately 1,000 people) in summer 2008. More timely information is available from the Social Security Department, which provides a measure of the number of individuals who register as unemployed. However because there is no statutory requirement for all unemployed residents to register as actively seeking work, the registered unemployment figures can at best be interpreted as an indicator of changes in unemployment.

In addition, the series has been subject to many definitional changes and improvements over the years; as a case in point there was a significant change to the income support system in 2008 that rendered recent figures incomparable with the historical series so that the red and blue lines in Figure 1.15 are not strictly comparable. Even taking into account these caveats, it is likely that some of the substantial increase in registered unemployment since December 2008 was driven by job losses, albeit not to the same degree as suggested by Figure 1.15.

Figure 1.15:
Registered unemployment has increased sharply in recent months
Number of people registered as actively seeking work and ILO measure of unemployment
Source: States of Jersey Social Security Department and Jersey Annual Social Survey

Note: There is a break in the registered unemployment series in 2008, as a consequence of the new Income Support system, where workers in receipt of Long-term Incapacity Allowance (LTIA) are now required to register as unemployed. The red line after 2007 shows figures revised to include long-term unemployment claimants, and does not join with the blue series, as pre-2008 figures were not revised



In its previous annual report, the Panel judged that the labour market had tightened significantly and that there was little spare capacity in the economy. The Panel believes that there has already been some slackening in the labour market and that this is likely to increase going forward as the weaker economic growth that is forecast feeds through the economy. However, the decline in employment may not be as significant as that suggested by the economic growth figures for the reasons given in Section 1.2 on the financial sector.

This in turn should reduce any pressure for wage increases, and prevent upward pressure on inflation. That said, the Panel is not suggesting that this increase in unemployment is benign; there could be both economic and social costs. In particular there is a danger that 'human capital' – the skills that workers have – will diminish if workers remain unemployed (and are not retrained) for an extended period or if highly skilled workers leave the Island.

Spare capacity

Spare capacity is the difference between potential economic activity – the level of output that is sustainable without higher inflation – and actual economic activity. When the economy is above its potential output there is a lot of demand chasing limited resources, which pushes up prices, and when it is below there is less pressure on prices.

It is not possible to directly measure potential economic activity, but it can be estimated using statistical techniques. The Panel considers that potential output growth is relatively low in Jersey at around 1-2% a year. Since actual economic output in recent years has grown much faster than potential output, the economy was likely to have been operating above its long-run sustainable capacity in 2008. In its previous reports, the Panel had been concerned that continued above-trend output growth would lead to a build-up of inflationary pressure, possibly sparking a wage-price spiral.

However it is predicted that the fall in actual economic activity will push the economy below its long-run sustainable level. Given this, a margin of spare capacity is likely to open up, which means that domestic inflationary pressures are no longer a primary concern at present.

Inflation

Inflation in Jersey has been relatively low and stable in recent years. A number of temporary factors pushed up inflation in 2008, including high energy and food prices and the impact of the introduction of GST. More recently, global commodity prices – such as oil and food – have plummeted, partly as a consequence of the global economic crisis, and these lower commodity prices have begun to feed through.

There are three main measures of inflation in Jersey: RPI, RPIX and RPIY (Figure 1.16). RPI is calculated using a broad basket of goods and services. The other two measures exclude certain items from the basket; in particular RPIX is RPI without mortgage interest payments (MIPs), while RPIY is RPIX without indirect taxes such as impôts and GST.

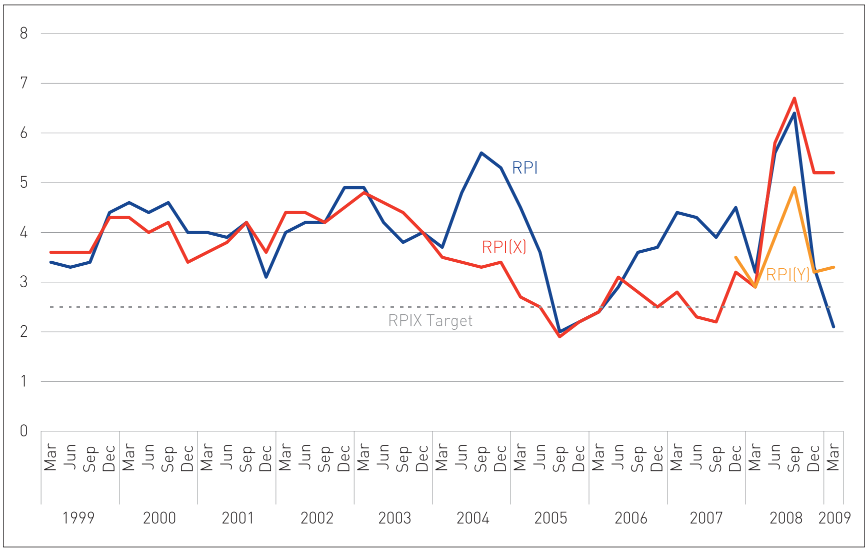
RPIY is probably the best indicator of underlying inflationary pressure – that is, the trend rise in prices driven by the structure of the economy – at present since it excludes the temporary impacts of both indirect taxes, such as GST, and MIPs. In the 12 months to March 2009, RPIY increased by 3.3%.

At 5.2%, RPIX was higher than RPIY, mainly because it includes the GST effect of around 2.1 percentage points. From June 2009 onwards the impact of GST drops out and RPIX is likely to follow a broadly similar path to RPIY.

The increase in RPI in the 12 months to March 2009 was 2.1%, down from 3.3% in December (Figure 1.16). This was lower than both RPIY and RPIX due to the significant cuts in the official Bank of England interest rate, which fed through to some extent to lower mortgage interest payments (MIPs).

Figure 1.16:
Inflation has fallen back from its September peak
RPI, RPIX and RPIY (annual % change)
Source: States of Jersey Statistics Unit

Note: RPIY figures are only available since December 2007



Given the economic outlook, underlying inflation can be expected to remain relatively stable, or even fall slightly. However, temporary factors will have a significant impact on the profile of the three inflation measures in 2009. In particular, the RPI measure is likely to fall rapidly, as not only does the GST effect drop out in June, but significantly lower MIPs will also continue to pull down this measure of inflation over the coming year.

It is possible that RPI inflation will turn negative for a time, as these exceptional factors work through, but it should be stressed that a temporary period of negative inflation – the most likely scenario in Jersey – is of little concern to macroeconomic policy, especially when it is primarily caused by lower interest rates, which typically serve to boost the economy. Much more serious would be the threat of deflation – a persistent period of general falling prices across the economy – as that can lead to an undesirable spiral, where consumers delay purchasing goods because they may be cheaper in the future, which dampens demand further, causing prices to fall further, and so on. The Panel does not anticipate such a situation developing in Jersey.

Section 2: The Fiscal Outlook

Key points

- The Stabilisation Fund should be used to cover the deficits that will result from the expected contraction in the economy in 2009 and 2010.
- Given the likelihood of a significant downturn in 2009, continuing into 2010, stimulus should be applied to the economy now through some quick-acting, well-targeted and temporary measures. The proposal to use the Stabilisation Fund to fund discretionary policy this year is appropriate given the economic outlook.
- The extent of discretionary policy should not be defined by the balance in the Stabilisation Fund, but by the availability of suitable measures, the extent of the economic downturn and the scale of stimulus that is judged appropriate. However using the £44m that is estimated to remain in the Stabilisation Fund is consistent with the Panel's advice to implement a significant discretionary stimulus. It is important to make sure that specific discretionary projects represent value for money and are timely, targeted and temporary.
- No additions to or withdrawals from the States' Strategic Reserve should be made at this stage. However, in some circumstances it may be appropriate for the deficits that would arise on unchanged policy in recession, together with the cost of discretionary policy, to exceed the Stabilisation Fund – by borrowing either in the financial markets or from the Strategic Reserve. Especially in these circumstances, it is essential to ensure that the measures taken are temporary and that future fiscal discipline is strong enough to replenish the Funds.
- The Panel notes that its previous advice to transfer the majority (£63m) of the expected balance in the Consolidated Fund for 2009 to the Stabilisation Fund has been accepted. In future the working balance in the Consolidated Fund should not exceed £20m and any money accumulating above this level should, as a matter of course, be transferred to the Stabilisation Fund. If the current estimate of a Consolidated Fund balance of £31m in 2009 materialises, an additional transfer into the Stabilisation Fund from the Consolidated Fund will be required.
- The £60m per annum deficits forecast after the economy is assumed to have returned to trend suggests that a large part of the projected shortfall could be structural (i.e. permanent). There are also other pressures and uncertainties on the horizon that may adversely affect the financial position. Especially in the light of the longer-term risks to Jersey's finances that the Panel has identified, a strategy for dealing with this once the economy has recovered should be agreed during the current fiscal year.

- There remain significant uncertainties around the outlook for States finances in the medium-term, above and beyond those related to the current global economic turmoil. These include:

  i International pressure for further changes to the 0/10% corporate tax structure or to reduce offshore activity;

  ii Lower than expected productivity growth and therefore lower future economic growth;

  iii An ageing population; and

  iv Further health spending pressures such as New Directions.

- Recognising that the risks and uncertainties to States' finances in the future lie to the downside, the States should not approve measures that further undermine the tax base or commit to expenditure in the medium term.

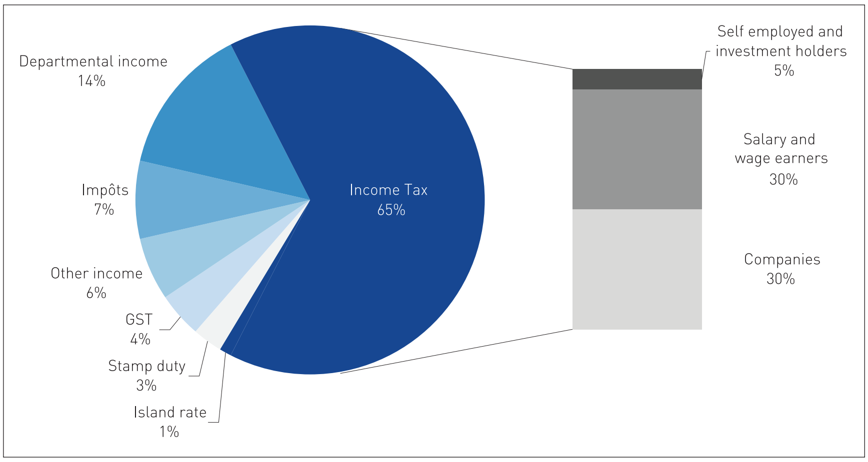
2.1 Background to public finances in recent years

Composition of income and expenditure

The largest slice – two-thirds – of States' income is taxation receipts from companies and individuals (Figure 2.1). Impôts, GST, stamp duty and the Island rate make up just under 15% of States' revenue. Departmental income (for example housing rents for the Housing Department) make up another 14% and other income (for example investment income and dividends from States-owned utility companies) makes up the remaining 6%.

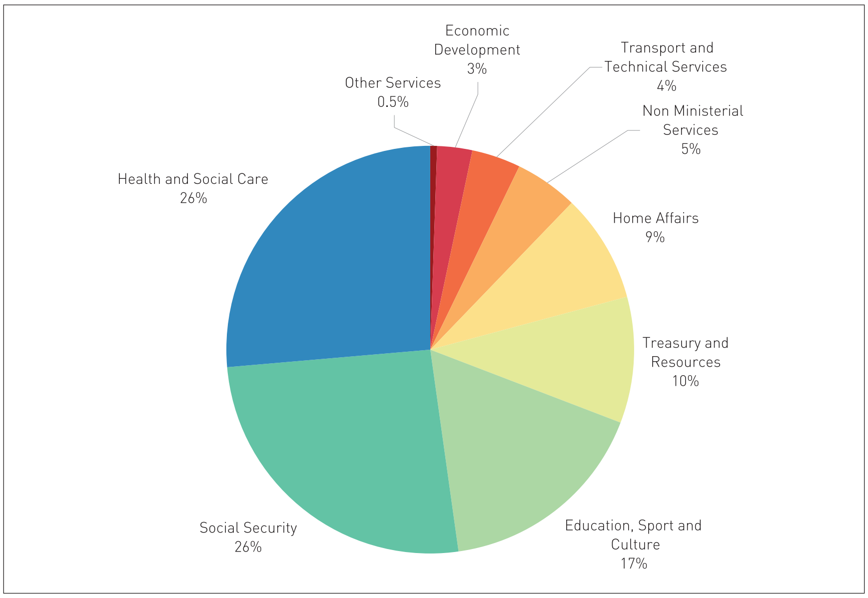
Figure 2.1:
States' income consists mostly of income tax receipts
States' income by source (% of total), 2008
Source: States of Jersey Treasury and Resources Department. Figures are provisional outturns, subject to audit

Note: Includes departmental income. Departmental income is not separately shown in the figures that follow, but is instead netted-off against departmental expenditure



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

Figure 2.2:
Spending is mostly on health, social security and education
States' net revenue expenditure by department, (% of total), 2008
Source: States of Jersey Treasury and Resources Department. Figures are provisional outturns, subject to audit



Trends in income and expenditure

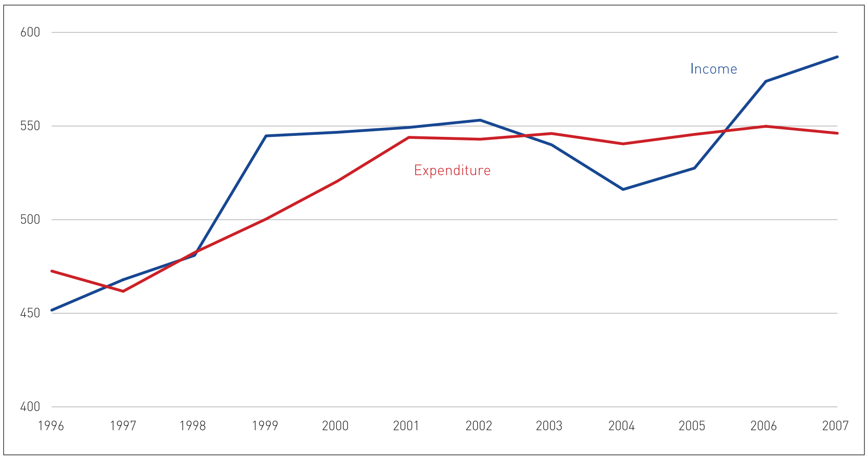
States' income and expenditure in real terms (i.e. removing the effects of inflation) have shown some variation over the years (Figure 2.3).

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

In the mid to late 1990s there was strong growth in States' real income up to about £550m in today's (2008) prices and this was followed by a period of five years of no growth to 2003. In 2004 real income dipped to £515m, before stabilising in 2005.

Figure 2.3:
States' real income and real expenditure
Total income and expenditure – real terms (2008 prices), £m
Source: States of Jersey Economics Unit

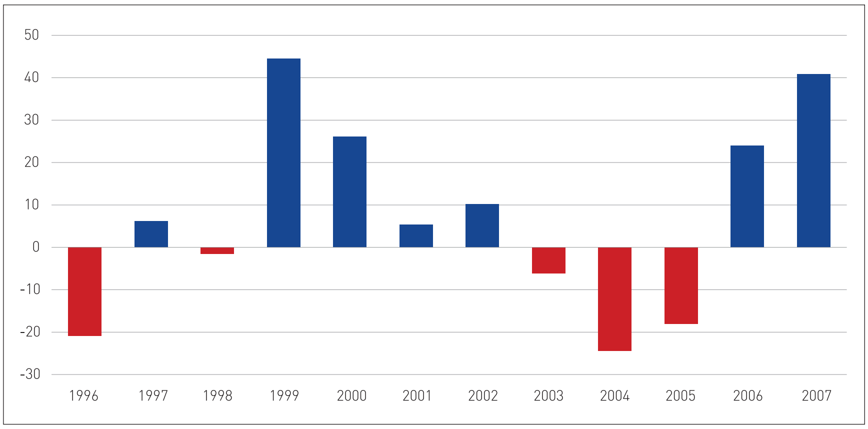
Note: Separately constituted funds are not included



In terms of expenditure (revenue and capital), during the mid to late 1990s there was strong growth in real expenditure of 4% per annum on average and this continued until 2001. This was a period in which fiscal policy was pro-cyclical – that is public sector demand was increasing during a period of already strong economic growth. After 2001 though, real expenditure remained constant at about £550m per annum in today's prices – that is, between 2001 and 2007 States' total expenditure on average increased at a similar rate to the rate of inflation. A more counter-cyclical policy might have involved temporarily increasing States' expenditure to support demand during the period of real economic decline from 2001 to 2004 and containing expenditure growth in 2007 when economic growth was strong.

Figure 2.4 shows the balance of States' real income over expenditure. The surpluses and deficits between 2001 and 2007 were driven by changes in States' real income each year as real expenditure remained constant.

Figure 2.4:
States' surpluses and deficits
Total income less total expenditure – real terms (£m, 2008 prices)
Source: States of Jersey Economics Unit



There have been periods when States' fiscal policy has been destabilising, in that it has added to demand at times when the economy has already been at capacity.

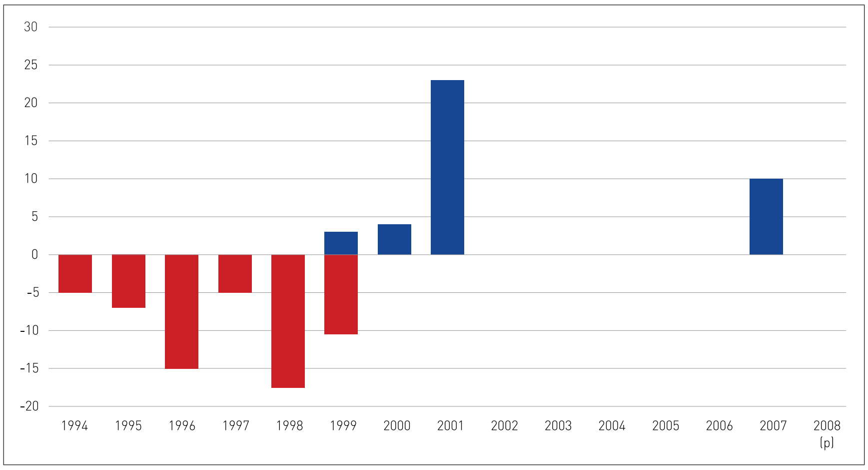
Strategic Reserve

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

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

In contrast, £40m has been transferred into the Strategic Reserve since 2000 (Figure 2.5).

Figure 2.5:
Transfers were made out of the Strategic Reserve in the late 1990s and into it more recently
Total transfers to and from the Strategic Reserve, £m (current prices)
Source: States of Jersey Treasury and Resources Department



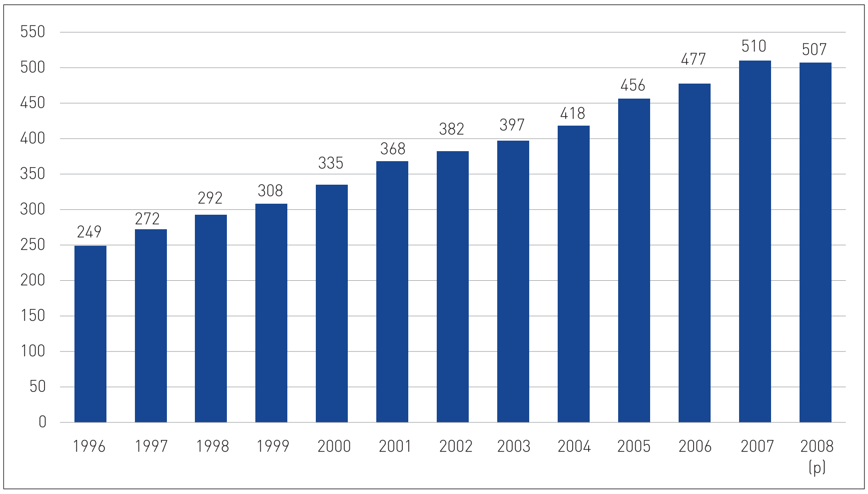
The Public Finances (Jersey) Law 2005 reiterates that the Reserve should not be used for any purpose other than one specifically recommended by the Treasury and Resources Minister and approved by the States.

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

At the end of 2008, the Strategic Reserve had accumulated net assets of £507m, which is about 12% of GVA. Figure 2.6 shows the market value of the Strategic Reserve since 1996.

Figure 2.6:
Strategic Reserve accumulating over the period
Strategic Reserve net assets, £m, 1996-2008 (current prices)
Source: States of Jersey Treasury and Resources Department

Note: (p) = provisional figure



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

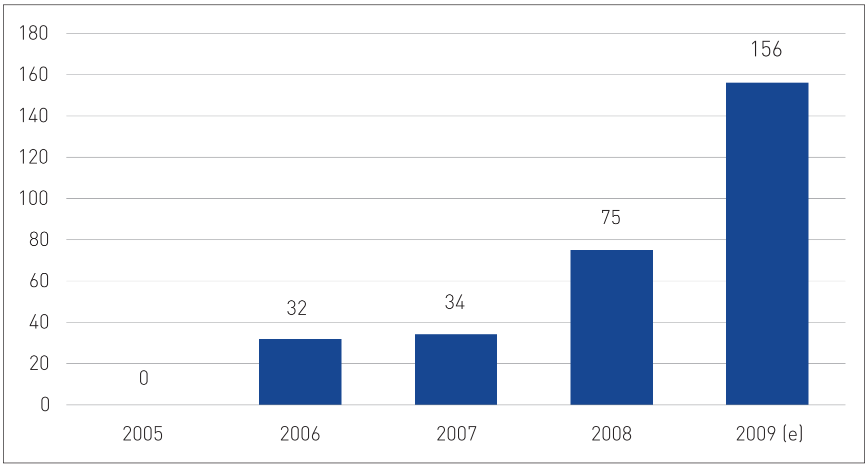
Stabilisation Fund

The Stabilisation Fund was established in 2006 using £32m from the Dwelling Houses Loans Fund. The objective was to encourage greater fiscal discipline and counter-cyclical fiscal policy. Broadly speaking this means taking money out of the economy and paying it into the Fund when the economy is growing strongly and drawing money down from the Fund to support the economy when it is performing less strongly. In turn this should serve to create a more stable economic environment in the Island.

There have been significant transfers into this Fund recently. In 2008 £38m was added to the Stabilisation Fund from 2007 revenues. Furthermore, given the projected surpluses for 2008, the States followed the Panel's advice and decided in the Budget 2009 to transfer the majority of the Consolidated Fund balance (£63m) into the Stabilisation Fund, leaving an expected working balance of about £20m. Figure 2.7 shows how the Stabilisation Fund balance has grown since its creation.

Figure 2.7:
The Stabilisation Fund has grown to £156m
Stabilisation Fund net assets £m, (current prices) 2005 – 2009 (to date)
Source: States of Jersey Treasury and Resources Department

Note: (e) = expected after the transfers currently proposed by the Treasury and Resources Minister



The Dwelling Houses Loans Fund has accumulated a balance of £18m since the last transfer made in 2006. The Treasury and Resources Minister is proposing to transfer this amount in to the Stabilisation Fund this year which would leave an expected balance of £156m.

Consolidated Fund

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

The States approved a number of amendments to the 2009 Business Plan which permanently reduced income and increased expenditure by approximately £10m a year. In addition a couple of smaller amendments were made to the 2009 Budget that also permanently weakened the States financial position (see the Panel's November 2008 update).

Building on the recommendation in its November 2008 update, the Panel believes it is appropriate to keep a working balance of no more than £20m in the Consolidated Fund. This is in order to reduce the temptation to commit to spending these funds during the business plan and budgetary process and to avoid introducing measures that might be pro-cyclical or might weaken the structural budget position. The level of working balance required should be reviewed on an ongoing basis.

The Panel recommends that the working balance in the Consolidated Fund should not exceed £20m during any year and any money accumulating above this level should, as a matter of course, be transferred to the Stabilisation Fund.

2.2 Current position and short-term outlook

The Panel included probable figures for 2008 income, expenditure and deficits in its November update. Since then, provisional outturn figures for 2008 have become available. These are the best available estimates, but have not yet been audited. Figure 2.8 shows both sets of numbers for 2008. The provisional outturn for States' income in 2008 was £30m higher than the probable estimate, mainly reflecting higher income tax receipts. The provisional outturn for States' expenditure in 2008 was £23m lower than the previous estimate, reflecting a shift in the timing of the Energy from Waste (EfW) plant expenditure (less of the costs fell in 2008 and more will fall in the coming years). As a result, the provisional budget surplus for 2008 was £77m (including the EfW timing adjustment), £53m higher than the previous estimate.

Figure 2.8:
States' financial forecasts (assuming unchanged policy)
Financial forecast from 2009 Budget (as amended) with a revised EfW timing adjustment, current estimate of net capital expenditure allocation and economic downturn adjustment scenarios
Sources: States of Jersey Budget 2009 (as amended) and provisional figures from the unaudited States of Jersey Financial Report and Accounts 2008

Actual outturn	Probable estimate	Provisional outturn		Forecast				
2007 £m	2008 £m	2008 £m		2009 £m	2010 £m	2011 £m	2012 £m	2013 £m
			States Income					
559	630	660	Total States Income	650	596	614	630	638
			States Expenditure					
480	526	522	Net Revenue Expenditure	546	563	581	598	616
42	143	143	Net Capital Expenditure Allocation	38	32	32	32	32
	(63)	(81)	EfW plant adjustment	38	33	8	2	-
-	-	-	Additional unbudgeted 2009 spending pressures	10	-	-	-	-
522	606	583	**Total States Net Expenditure**	632	628	621	632	648
-	-	-	Economic downturn adjustment, central scenario	(13)	(50)	(62)	(54)	(55)
-	-	-	Economic downturn adjustment, pessemistic scenario	(22)	(62)	(81)	(81)	(82)
-	-	-	Economic downturn adjustment, optimistic scenario	(11)	(39)	(43)	(26)	(21)
37	**24**	**77**	**Forecast Surplus/(Deficit) central scenario**	**5**	**(82)**	**(69)**	**(56)**	**(65)**
-	-	-	Forecast Surplus/(Deficit), pessimistic scenario	(4)	(95)	(88)	(83)	(92)
-	-	-	Forecast Surplus/(Deficit), optimistic scenario	7	(71)	(49)	(28)	(31)
(10)	-	-	Transfer to Strategic Reserve	-	-	-	-	-
-	(38)	(38)	Transfer to Stabilisation Fund	(63)	50	62	-	-
93	**16**	**51**	**Estimated Consolidated Fund balance***	**31**	**32**	**33**	**(21)**	**(86)**

*without the EfW adjustment

Figure 2.8 also shows the latest forecast of States' income and expenditure over 2009-2013, as revised by the Treasury and Resources Department in March. States' income and net revenue expenditure are unchanged from the final amended 2009 Budget that was approved by the States in December 2008. But the forecasts also take into account the revision to the EfW timing adjustment, the current estimate of the net capital expenditure allocation and adjustments to take account of the economic downturn using the Economics Unit's economic growth forecast, as well as factoring in the low-interest rate environment (see Box 1). These forecasts show a rise in real GVA of 2% in 2008, followed by falls of 4% in 2009 and 2% in 2010, with optimistic and pessimistic scenarios around the central case. Using the Panel's forecasts shown in Figure 1.14 above instead would not materially change the picture.

Estimating the impact of the economic downturn on States finances is not straightforward and there is considerable uncertainty about the estimates shown, illustrated by the range given in Figure 2.8.

The largest change expected as a result of the economic downturn is on the income side. Most of this is due to income tax from company profits and income tax on investment income falling over the forecast period. States' investment income, stamp duty and GST also fall slightly, but income tax on earnings is expected to be the most robust source and change very little. The relatively small change expected on the expenditure side is due to higher income support and supplementation costs.

The changes to the budget position and the forecast are shown in Figure 2.9. The blue line shows the forecast for surpluses and deficits in the 2009 Budget, based on information available at the time – a surplus declining to a balanced budget by 2011. The green line shows the central updated forecast for public finances and the green area shows optimistic and pessimistic scenarios around that. Each scenario attempts to capture the effects of what a downturn in economic activity would do to States income and expenditure. Under each scenario the story is broadly the same – a balanced budget in 2009 turning into large deficits in 2010 and beyond. It is important to note the wide range of uncertainty surrounding the current forecasts, shown by the wide green area.

Figure 2.9:
Changes in the forecast for public finances
Financial forecasts – budget surpluses and deficits, £m (with EfW timing adjustment)
Sources: States of Jersey Treasury and Resources Department and Economics Unit

Note: Budget 2009 forecast shows 2008 probable estimate and the original EfW adjustment. Current forecast shows 2008 provisional outturn, the revised EfW timing adjustment, the current estimate of the net capital expenditure allocation adjustment and the impact of the economic downturn

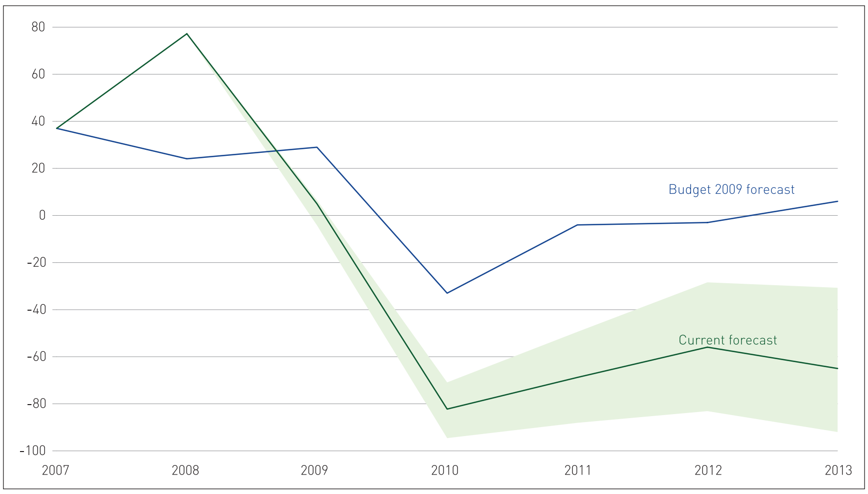


Figure 2.8 shows that the current estimate is for a Consolidated Fund balance of £31m in 2009, above the £20m working balance recommended by the Panel. If and when this materialises, it would require an additional transfer into the Stabilisation Fund from the Consolidated Fund.

The Panel considers that the Stabilisation Fund should be used to cover the deficits now thought likely to arise in 2010 and 2011 as a result of the expected contraction in the economy in 2009 and 2010. These deficits will occur because as the economy slows, tax revenue will fall to a much lower level and at the same time expenditure is also likely to rise slightly.

Box 2: Fiscal policy, the automatic stabilisers and discretionary fiscal measures

The FPP, as part of the Fiscal Framework, is mandated to comment and advise on Jersey's fiscal policy, including recommendations on additions to, or withdrawals from, the Stabilisation Fund. In doing so, the Panel's focus is on:

a) The longer-term sustainability of the fiscal position as measured by the balance of the States revenue and expenditure position (in the medium term). This means aiming for budget balance or (small) surplus over the economic cycle.

b) Subject to that, the use of fiscal policy in the short run to stabilise Jersey's economy in a counter-cyclical way.

Sustainability

The objective of sustainability means setting expenditure programmes and tax rates so as to ensure that over the medium term expenditures are covered by tax revenues. Put another way, sustainability requires the avoidance of structural deficits in the medium term. Sustainability is a forward-looking goal which may require changes in expenditure plans and in the tax system as the anticipated conditions facing the economy change.

Stabilisation

Although the deficit (or surplus) in any one year is a useful policy indicator, it is not a policy goal except in the medium term. The stabilisation objective requires tolerating temporary, reversible, fluctuations in the fiscal balance – since changes in taxes or expenditures to prevent short-term deficits or surpluses would unnecessarily destabilise the economy. Over the economic cycle, deficits should be tolerated in the down-phase, to be repaid by surpluses in the up-phase – without changes in expenditure programmes or tax rates.

Passive stabilisation

A policy of not changing fiscal policy in response to the economic cycle and keeping the policy settings that are appropriate for the medium term is often described as allowing the automatic stabilisers to work. The automatic stabilisers are essentially the changes in tax revenues and expenditure that occur with movements in the economic cycle without any policy changes.

These stabilisers work mainly through their effect on tax revenues; for given tax rates, tax revenues will rise and fall with economic activity. Thus revenues rise above their trend level when GVA is above trend and fall below when GVA is below trend.[1]

Most of States expenditure is relatively unaffected by the economic cycle, however for given rates of benefit, expenditure on unemployment and on social security falls in the boom and rises in recessions. This element of expenditure is cyclical and adds to the power of the automatic stabilisers.

To see why they can be thought of as automatic stabilisers, consider what would happen if a government actively tried to adjust fiscal policy in order to keep the fiscal balance unchanged over the economic cycle. This would involve increasing expenditures and/or cutting tax rates in an upturn, and cutting expenditure and/or raising tax rates in downturns. These actions would be pro-cyclical; that is, they would exacerbate the swings in the economic cycle. If, instead, the automatic stabilisers are allowed to work, these fluctuations are not as large.

In tranquil times, a policy of allowing the automatic stabilisers to operate – which means setting expenditure programmes and tax rates to be appropriate for the medium term and not adjusting policy over the cycle – may be judged to deliver enough 'stabilisation'. The Stabilisation Fund would rise and fall in a passive way as deficits and surpluses emerged over the cycle. For larger fluctuations, however, discretionary fiscal policy may be used to deliver a greater degree of stabilisation.

Active stabilisation

Discretionary fiscal stabilisation policy involves the active use of the fiscal instruments to offset booms or slumps. This means departing from the medium term basis for fiscal policy to alter its short term impact in a counter-cyclical way – raising taxes or cutting expenditure to prevent the States from adding to a boom, or cutting taxes and raising expenditure to support demand during recession.

With discretionary stabilisation policy, the most significant challenge lies in ensuring that policies are successful in achieving their purpose – the stabilisation of the economy – while not jeopardising the sustainability of the public finances. This is why the Panel stresses that discretionary stabilisation measures should be timely, targeted, and temporary (see Section 2.3).

[1] The size of this effect depends on the details of the tax system and on what shocks are being experienced. A very rough estimate of its size is to assume that the tax take is simply proportional to the size of GVA. Using this logic, and given that in Jersey States' income is around 1/8 of GVA , a 1% fall in GVA (relative to trend) would lower States income by 1/8% of GVA (and the income itself would fall by 1%). For a typical, more heavily taxed, European country, the corresponding figure for state income as a proportion of GVA would be much larger – about 1/2 of GDP.

2.3 Fiscal stimulus package proposal

Background

On 13 March 2009, the Treasury and Resources Minister wrote to the Panel (Appendix 1) to ask for an update on the advice given in November 2008. The Minister asked whether economic conditions justify the use of the Stabilisation Fund this year to support the Island's economy and if so, whether the proposed policy options meet the criteria the Panel introduced at the time of the update, namely that they be timely, targeted and temporary.

The Panel responded on 26 March 2009 (Appendix 2) concluding that, given the information and data available, it would be appropriate to draw down from the Stabilisation Fund this year and next and that discretionary policy would be desirable to help mitigate the adverse effects on the economy. The Panel also commented on the appropriateness of the six broad policy options – supporting people on low incomes, direct tax cuts, indirect tax cuts, spending on skills and training, additional infrastructure and maintenance expenditure and expanding small business support – put forward by the Minister in his letter.

On 9 April 2009, the Minister's fiscal stimulus package was lodged for debate by the States.

Size of the proposed stimulus

The extent of discretionary policy should not be defined by the balance in the Stabilisation Fund, but by the availability of suitable measures, the extent of the economic downturn and the scale of stimulus that is judged appropriate. However, the proposal to use the £44m that is estimated to remain in the Stabilisation Fund is consistent with the Panel's advice to implement a significant discretionary stimulus (set out in its letter to the Treasury and Resources Minister in Appendix 2).

In some circumstances it may be appropriate for the deficits that would arise on unchanged policy in recession together with the cost of discretionary policy to exceed the Stabilisation Fund – by borrowing either in the financial markets or from the Strategic Reserve. Especially in these circumstances, it is essential to ensure that the measures taken are temporary and that future fiscal discipline is strong enough to replenish the Funds.

Nature and timing of the proposed stimulus

The more effective any discretionary action is, the smaller will be the effect of the automatic stabilisers on the fiscal deficit (see Box 2). If the discretionary policy achieves its objective of stabilising economic activity and employment, then the automatic stabilisers will be triggered to a lesser extent. The nature of the proposed stimulus is therefore crucial.

Discretionary fiscal policy should, as far as possible, be:

- **Timely.** Action should start immediately to have an impact as quickly as possible and ideally within the next 6 to 9 months – especially as the bulk of the automatic stabilisers will only start to be felt in 2010, due to the lags in Jersey's tax system.

- **Targeted.** Policy should hit the intended target whether it is to support activity and employment in the Island, support those most adversely affected by the downturn or implement projects which have intrinsic benefit.

- **Temporary.** Policy should last only until demand in the economy picks up again. Therefore there should be no long term implications for public finances – that is no long term damage to the tax base and no long term spending commitments.

If any of these principles are not met then the policy will not be effective. Poorly timed policies that affect the economy too late to mitigate the downturn will be of little use, and could even be damaging if they add to demand once the economy is growing strongly again. Poorly targeted policies will have little or no impact on the local economy. Policies that are not temporary will either permanently reduce tax revenue or permanently add to spending. They will increase the risk that public finances will be out of balance and reduce the ability to build up a healthy sized Stabilisation Fund in the future. Discretionary projects should also represent value for money and be intrinsically valuable.

It is proposed by the Council of Ministers that the stimulus should be largely focused on the following priorities:

- maintenance and infrastructure spending;

- supporting people most affected by the downturn; and

- business and skills support.

The Panel supports these priorities in general terms. If policy is developed and implemented in a timely, targeted and temporary manner, it should go some way to meeting the Council of Ministers' objectives of mitigating some of the impacts of the downturn. It is very important to make sure that the specific projects for each area represent value for money and are of intrinsic benefit. The Panel's detailed comment can be found in Box 3.

Box 3: The Panel's reply to the Treasury and Resources Minister

In its letter to the Treasury and Resources Minister the Panel made the following points about the policy options outlined in the economic stimulus package.

Maintenance and infrastructure spending

For maintenance or infrastructure projects to be timely, it is vital that they are ready to go in the next few months. Maintenance projects should be timely and also meet the targeted criterion because they are likely to use local labour effectively. The scale should be dependent on the amount of spare capacity in the local construction sector and it is important to avoid excess demand pushing up prices. Making sure maintenance of the infrastructure (including public housing stock, schools and hospitals for example) is up to date and bringing forward maintenance scheduled for the near future does not increase the overall cost to public finances, and so meets the temporary criterion.

Large infrastructure projects may struggle to be timely. For the targeted criterion it should be possible to target such spending on supporting local employment in the Island and the scale of the intervention should consider the amount of spare capacity in the local construction sector. Any such interventions should be designed to be temporary, and each policy should be assessed for any future expenditure commitments such as ongoing maintenance or further investment.

As maintenance and infrastructure investment leads to improvements in the stock of States assets, it can be considered as an investment in the supply-side of the economy that will bring returns beyond the life of this downturn. The key issue is whether the projects have intrinsic merit.

Supporting people most affected by the downturn

This can be timely, provided that the income support system can be altered quickly. It is by definition targeted on the least well off and therefore those who are most likely to spend. However, it is difficult to see how such a measure would be temporary as it would be hard to reverse unless it was directed only to the newly unemployed.

Business and skills support

Business and skills support may be timely especially if it only requires changes to existing policies.

For businesses, policy could be targeted on those particularly affected by the downturn, for example, by focusing on those that are not able to obtain or maintain credit solely as a result of problems in the financial sector. Policy would have to be designed carefully to be temporary and not stand in the way of inevitable structural change.

Spending on a skills programme has immediate benefits. It can be targeted on Jersey residents, those losing their jobs or low income groups. If measures also included support payments to participants, these could be targeted towards those most likely to spend. Care would have to be exercised to ensure that those elements of such schemes that do not bring lasting benefits could be made credibly temporary. Investment in skills – if done effectively – should bring lasting economic benefits beyond the life of this downturn. Improving the skills base is important for supporting future productivity and economic growth. However, there will be permanent budgetary implications.

2.4 Medium to long term outlook

There are a number of uncertainties and pressures that may affect the Island and its public finances in the medium to long term.

Firstly, the revised financial forecasts suggest deficits of around £60m per annum for 2012 and beyond in the central scenario (Figure 2.9), after the economy is assumed to have returned to trend. This would suggest that a large part of the projected shortfall could be structural (i.e. permanent in the absence of changes to taxation or expenditure).

A structural deficit of this scale would require the States to take corrective action once the economy has recovered and is performing more robustly. This action would require tough decisions on cutting spending or increasing taxation and so a strategy should be developed for how this would be achieved.

The risk of a structural deficit is increased when the list of emerging spending pressures is considered. This gives an added imperative that plans to balance the States finances in the medium term are given full and proper consideration. The Panel would not advise that new additions to expenditure or reductions in the tax base are made unless offsetting savings can be implemented. The decision not to exempt food and domestic fuel from GST was in keeping with such an approach.

In the longer term, there is a risk that the intensification of international pressure on offshore financial centres could require changes to the 0/10% system or result in action to reduce offshore activity.

The other key risks that could add to fiscal pressures highlighted in the previous annual report remain and include:

- A lower than expected long-term rate of productivity growth which would mean lower rates of economic growth and smaller improvements in the States fiscal position.
- An ageing population.
- The New Directions policy to address the rising cost of health care and consequences of an ageing population.

A large part of the forecast deficits for could be structural (i.e. permanent). There are also other pressures and uncertainties on the horizon that may adversely affect the financial position.

Recognising that the risks and uncertainties to States' finances in the future lie to the downside, the States should not approve decisions that further undermine the tax base or commit to medium term expenditure greater than that currently forecast, either as part of the Strategic Plan, Business Plan, 2010 Budget, or at any other time. Furthermore, during the current fiscal year a strategy should be agreed for dealing with any structural deficits once the economy has recovered.

Appendix 1: Letter from the Treasury and Resources Minister to the FPP

13 March 2009

Dear Chairman

Fiscal Stimulus

Since your last report in November, developments in the global economy have unravelled at a pace not seen in recent history. The global economic outlook is now seen by many as being the worst in the post-war period. I note that in the last few days both the World Bank and the IMF have said they expect the world economy to shrink this year, in what the IMF describes as "the worst performance in most of our lifetimes".

Jersey has close ties with the UK. The latest evidence shows that the UK economy is now in recession with GDP falling by 1.5% in the fourth quarter of 2008 – the sharpest fall since the 1980s. Of all the main industrial economies, the IMF forecasts for the UK are among the worst, with the economy expected to shrink by a further 2.8% in 2009. The UK Government and the Bank of England have taken unprecedented fiscal and monetary action to support the domestic economy.

The latest research from the States of Jersey Economics Unit indicates that Jersey is likely to enter a period of significant contraction in 2009 and could weaken further in 2010. Our prospects to a large extent are dependent on the fortunes of the global economy and policy makers steering the world economy back on course. However, thanks to a prudent fiscal policy operated over the last three years and more, we have the means to support employment and businesses in the meantime through the Stabilisation Fund.

Last week you visited the Island to prepare for your next annual report and met with many businesses and organisations from all sectors of the economy. I hope you found these discussions informative and it is a great credit to the Panel that I have received excellent feedback from those who participated in the meetings.

Under the States' new Fiscal Framework, as Minister for Treasury and Resources, I have the ability to ask for an update to your most recent report at any time should economic conditions change. Based on all the available information, I feel that economic conditions have changed markedly since your November report and, as a consequence, I am writing to ask whether you could update your previous advice? Specifically, I would like you to advise as to whether, in your opinion, economic conditions now justify use of the Stabilisation Fund to support the local economy?

Based on information available to the Council of Ministers, the downturn now appears to be beginning to put local jobs and businesses at risk. Whilst accepting that we cannot prevent the downturn in Jersey we want to consider what action should be taken to mitigate the impact on the worst affected individuals and businesses.

Initial forecasts prepared by Treasury and Resources officials suggest that in the face of a sharp economic slowdown in Jersey, a large proportion of the Stabilisation Fund could be used to cover for the automatic stabilisers i.e. the fall in tax revenue and rise in expenditure associated with economic contraction.

Given the nature of the automatic stabilisers in Jersey – they operate largely through lower tax receipts and can therefore take time to feed through into the economy – there may be a need to implement discretionary policy and introduce a number of new initiatives to support our economy. Work is underway in both the Treasury and Resources and Economic Development Departments to determine the most suitable policies to achieve this objective.

Your previous advice has been that in the face of a sharp economic slowdown the automatic stabilisers should be allowed to work first before contemplating discretionary changes. I would appreciate your advice as to whether you agree that, given the extent of the economic downturn in Jersey, the States should be doing more than just allowing the automatic stabilisers to work and implementing discretionary policy to support the economy this year?

The work already in train will identify what we think is achievable in Jersey in terms of discretionary policy. However, it would be extremely helpful if you could give me some further guidance on how some of the options may comply with your 3Ts criteria (that policy should be Temporary, Targeted and Timely) and expand your advice to cover general advantages and disadvantages of particular policy options. Options that I may consider or those that may be suggested by other States members include:

1. Supporting people on low incomes

2. Direct tax cuts

3. Indirect tax cuts

4. Spending on skills/training

5. Additional infrastructure/maintenance expenditure

6. Expanding small business support

I appreciate that you are not due to publish this year's annual report until May, by which time you will have been able consider the issues in more detail. However, I would appreciate any initial advice and guidance you could give in the meantime.

I believe it is imperative that we act quickly and decisively to support demand in the local economy and therefore help mitigate some of the effects of the downturn in Jersey.

It would be most helpful if any advice could be given publicly, by the end of March. If this timetable can be achieved, your advice would assist me in finalising the fiscal stimulus package that, subject to your advice, I intend to lodge for debate by the States alongside the Strategic Plan on 8 April. States members would also have the benefit of some initial advice from you at the time of lodging but also more detailed advice in your annual report ahead of the debate.

I look forward to hearing from you.

Yours sincerely

Senator Philip Ozouf
Minister for Treasury and Resources

Appendix 2: Reply from the FPP to the Treasury and Resources Minister

26 March 2009

Dear Minister

Thank you for your letter dated March 13 2009. The Fiscal Policy Panel's role is to give you and States members independent economic advice on matters relating to tax and spending policy and in particular on the use of the Stabilisation Fund. Your questions are both appropriate under the terms of the new Fiscal Framework and justified given the rapid changes in the global economy since our last report in November. In these extraordinary economic times, it makes sense that we should update that advice.

We address the key issues you raise below but would first point out that we operate within the confines of the limited data that is available on both the economic performance and the fiscal outlook, compounded by the back drop of the most uncertain economic times in recent history.

Economic Conditions

During our visit to the Island earlier this month we met with many businesses and their representatives. We also had the opportunity to discuss the new economic forecasts produced by the Economics Unit. Our preliminary findings are that economic growth in 2008 is likely to have been close to our forecast of 3% year on year. More importantly, the outlook for 2009 has deteriorated more sharply than we had expected previously. The key points are:

- IMF forecasts have been further revised down and now predict that the world economy will shrink in 2009.
- Financial market turmoil continues.
- With the prospects for the global economy and financial markets bleak, the performance of the financial services industry in Jersey is likely to be weaker than previously thought and this is compounded by the impact of low interest rates on the profitability of the banking sector.
- The discussions we had with Jersey businesses to complement the information provided by Economic Development suggest that key sectors such as retail, construction and tourism will see a fall in activity this year.
- Consumer confidence is likely to have fallen.
- There are recent signs that housing market activity has stalled.

The Panel's best judgement, on the basis of the limited data that is available, is that Jersey will experience a significant cyclical downturn this year which will put Island jobs at risk. There is real likelihood that the economy will decline further in 2010. There is of course significant uncertainty around the Jersey economic outlook, particularly in such uncharted waters.

Fiscal Policy

If our assessment of the economic outlook is correct, such conditions merit offsetting policy action, which the Stabilisation Fund, as part of the new Fiscal Framework, is designed to facilitate.

Discretionary Policy

You asked for advice on whether use of discretionary policy is appropriate, given the economic conditions facing the Island. We consider that discretionary policy is necessary, if your intention is to mitigate the adverse effects of the international crisis on the Jersey economy in the near term.

Discretionary fiscal policy action has already been put in train across the globe. The packages range in size considerably. The IMF has recently estimated that the measures announced in the US amount to nearly 5% of GDP. Those in the UK and France amount to around 1.5% over a two year period.

Given the lack of economic data and the uncertainties related to the effects on the Jersey economy of any given fiscal stimulus, the Panel is not in a position to quantify the size of the stimulus that is appropriate for Jersey. It would however note that measures amounting to 4% of GVA over a two to three year period would amount to £160 million which is about the amount currently in the Stabilisation Fund. It is also worth bearing in mind that in a small open economy like Jersey there will be a risk that any stimulus put into the economy by the States will quickly leak out of the economy through spending on imports. This is primarily a result of the nature of the Jersey economy and may mean that any given policy is less effective than would be the case in larger economies.

The Panel cautions that any discretionary policy action should not allow the States to be distracted from its longer term strategy. The short-term impact of the downturn on States finances will be exacerbated by lower profitability in the banking sector due to lower spreads as a result of extremely low interest rates. Meanwhile the longer-term picture is clouded by the added uncertainty resulting from the unknown length of the downturn and the risk that a new financial world may be less conducive to offshore business. The preliminary forecasts that we have seen from the Treasury and Resources Department show not only a significant deterioration in the States finances going forward as a result of the economic cycle but also a risk that once the economy recovers the States could be running a structural (i.e. underlying) deficit. This reinforces the necessity to ensure that any policy actions are truly counter cyclical and meet the "3Ts" outlined below. Priority should be given to ensuring that they do not aggravate medium-term fiscal problems either by narrowing the tax base or widening the expenditure base.

It is important to get the timing and content of any discretionary policy right. Although the cyclical impact of the downturn on the States finances will fall mainly in 2010 and 2011, the time to act is now.

Policy Options

The key criteria that should be applied in determining discretionary actions are, as you mentioned in your letter, the 3Ts. That is, policy should be:

- **Timely.** Action should start immediately to have an impact as quickly as possible and ideally within the next 6 to 9 months.
- **Targeted.** Policy should hit the intended target whether it is to support activity and employment in the Island, support those most adversely affected by the downturn or implement projects which have intrinsic benefit.
- **Temporary.** There should be no negative long term implications for the public finances, i.e. no long term damage to the tax base and no long term spending commitments.

You asked for further advice on six policy options that either you might be considering or might be put forward by other States members. Each of the policy options you put forward is considered in turn below.

1. Supporting people on low incomes

This type of policy can be timely, provided that the income support system can be altered quickly. It is by definition targeted on the least well off and therefore those who are most likely to spend. However, it is difficult to see how such a measure would be temporary as it would be hard to reverse such a decision unless it was directed only to the newly unemployed.

2. Direct tax cuts

Given the lags in the Jersey tax system it is hard to see how such a policy could be timely and impact in 2009, without being complex. It may also be harder to target the less well off or those worst affected by the downturn because quite simply they may not pay tax. It would then be less effective at holding up demand in the economy than direct support for the less well off. A pre-announced commitment to reverse the cut would be essential to meet the temporary criterion, but this is unlikely to be credible, and without a credible commitment, this proposal carries a serious risk of aggravating medium term budget problems.

3. Indirect tax cuts

This type of tax change could be timelier than a direct tax change. But such a tax change would not be well targeted as it would benefit everybody, rather than those most likely to spend on the Island. It would be less effective at holding up demand in the economy than direct support for the less well off. Furthermore a pre-announced commitment to reverse the cut would be essential to meet the temporary criterion, but is unlikely to be credible.

Like direct tax cuts, this option carries a serious risk of aggravating medium term budget problems and a real risk of undermining the tax base. Changes to GST so soon after introduction should be avoided.

4. Spending on skills/training

This option may be timely, especially if it only requires changes to existing policies. Spending on the programme itself has immediate benefits. It can be targeted on Jersey residents, those losing their jobs or low income groups. If measures also included support payments to participants, these could be targeted towards those most likely to spend. Care would have to be exercised to ensure that those elements of such schemes that do not bring lasting benefits could be made credibly temporary.

Investment in skills – if done effectively - should bring lasting economic benefits beyond the life of this downturn. Improving the skills base is important for supporting future productivity and economic growth. However, there will be permanent budgetary implications.

5. Additional infrastructure/maintenance expenditure

If these options are to meet the timely criteria, then it is vital that projects are identified that are ready to go in the next few months i.e. are 'shovel ready'.

The most likely projects to meet this requirement are maintenance expenditure. Such measures should also meet the targeting criterion since maintenance projects are likely to utilise local labour. The scale is dependent on the amount of spare capacity in the local construction sector. It is important to avoid excess demand pushing up prices. Making sure maintenance of the infrastructure (including public housing stock, schools, and hospitals) is up to date and bringing forward maintenance scheduled for the near future does not increase the overall cost to public finances, and so meets the temporary criterion.

Large infrastructure projects may struggle to be timely. They score better on the targeting criterion as it should be possible to target such spending on supporting local employment in the Island and the scale of the intervention should consider the amount of spare capacity in the local construction sector. Any such interventions should be designed to be temporary, and each policy should be assessed for any future expenditure commitments such as ongoing maintenance or further investment.

As maintenance and infrastructure investment leads to improvements in the stock of States assets, it can be considered as an investment in the supply-side of the economy that will bring returns beyond the life of this downturn. The basic question to address is do the projects have intrinsic merit?

6. Small business support

This option may be timely especially if it only requires changes to existing policies. Policy could be targeted on businesses particularly affected by this downturn for example by focusing on those that are not able to obtain or maintain credit solely as a result of problems in the financial sector. Policy would have to be designed carefully to be temporary and not stand in the way of inevitable structural change.

We hope that these answers to the questions you pose are informative and assist you in developing your proposals for a fiscal stimulus package for Jersey. We will of course expand on many of the issues we raise in this letter in our annual report when it is published on May 5 2009. We hope that too will assist you and other States members in agreeing the policies that are in the best interests of the Jersey economy and Islanders.

Yours sincerely

Joly Dixon
Chairman of the Fiscal Policy Panel