Jersey's
Fiscal Policy Panel
Annual Report
August 2016

Introduction

This is the ninth annual report of the Fiscal Policy Panel (FPP). The current members of the Panel are Dame Kate Barker (Chair) and Tera Allas, who were appointed in 2014, and Professor Francis Breedon, who was appointed in 2016. The Panel was placed on a statutory basis in 2014 and is required by the Public Finances Law to comment on Jersey's fiscal policy with reference to:

(a) the strength of the economy in Jersey;

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

(c) the economic cycle in Jersey;

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

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

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

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

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

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

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

Key points

Economic Outlook

- The global economy has continued to grow slowly relative to its long-term trend and recent expectations, primarily due to a further slowdown in emerging economies.
- The outcome of the UK referendum on EU membership has resulted in significant downgrades to forecasts for the UK economy. There has been some improvement in the euro area economies recently, but the UK referendum now presents some risks for Western Europe in particular. The US and Japan have slowed in 2016 but are not expected to be significantly affected by the UK leaving the EU.
- There was some improvement in a number of economic indicators for Jersey in 2015, with employment reaching record highs, and a generally positive sentiment in the first half of 2016. However, more recently there has been considerable uncertainty regarding the likely short- and long-term economic implications and the terms of the UK exit from the EU, and the impact these might have on Jersey.
- The Fiscal Policy Panel has lowered its economic growth forecasts for Jersey for 2016 and 2017. The economy is now expected to grow by just below 0.5% in real terms in 2016 and be largely flat in 2017 and 2018, although there is an even larger band of uncertainty around these forecasts than previously.
- There is some evidence that spare capacity was being used up somewhat faster than expected in the first half of 2016. However, the UK referendum result has the potential to impact on the level of capacity utilisation and it is not yet clear to what extent the impact will be primarily structural or primarily cyclical. The most likely outcome is that output will return to full capacity by 2019, but that this will be at a lower level than previously expected.

Public Finances

- The Panel considers that the four guiding principles from their Pre-MTFP Report have been followed during the development of the MTFP and the draft MTFP Addition.

- The overall approach in the draft MTFP Addition remains in line with the Panel's previous recommendations to withdraw fiscal support gradually from the economy as it recovers, and to use the States' reserves to pay for this whilst the planned measures to bring public finances closer to balance are phased in. The proposals in the draft MTFP Addition suggest that there is a further £10m adjustment required in the next MTFP period. The FPP recognises that it may not be appropriate to find measures to close this gap in the short term, especially given the weaker economic outlook, but also emphasise that the gap, together with any further adjustment which might be needed as a result of the UK leaving the EU, must be fully addressed in the next MTFP.
- Delivering capital expenditure on time relative to current plans is critical to delivering stimulus at the right time to the economy over the course of the MTFP Addition.
- The Panel has previously noted that the Council of Ministers' fiscal framework commits to monitoring the trends in States assets and liabilities and the Panel will continue to look at this in future reports.
- The distributional analysis of key measures considered for inclusion in the MTFP Addition is welcome and the FPP is encouraged to see that it was factored into decision making.
- There are a number of risks to delivering the fiscal plans over the 2016-19 period (covered in section 2.10), including future revenue trends, the ability to control expenditure, political risks, the timing of capital expenditure and population policy / immigration.
- The longer-term challenges to fiscal sustainability in Jersey remain, regarding the ageing population and the need to raise productivity in the medium-term. Changes in the UK's relationship with the EU may have adverse effects on Jersey and make these challenges more acute.

Recommendations

1. The Panel is encouraged by the approach to controlling expenditure outlined in the draft MTFP Addition and would urge the Council of Ministers to ensure that a permanent programme for securing additional efficiencies in the public sector is fully embedded in all future States financial planning. Progress in achieving efficiencies should be closely monitored, given their critical importance to the plan.

2. A key priority is to ensure that the planned capital projects are delivered on time and particularly during the period when economic growth is now forecast to be weaker and economic slack greater. More attention and urgency should be given to those projects which are likely to have the largest positive impacts on the local economy.

3. The FPP considers that the overall profile of the States' adjusted fiscal position and the significant stimulus it adds to the economy over the MTFP period is appropriate. Whilst the economic outlook is affected by the UK referendum result the Panel does not think it appropriate at this time to change the broad approach. It remains important that the States supports the economy in the short term and that progress is made in achieving a more sustainable position in the medium term, irrespective of the exact future relationship between the UK and the EU.

4. The work being undertaken by the Social Security Department looking at the sustainability of the Social Security Funds in the light of the ageing population is an important first step in meeting the FPP's recommendation to develop a strategy for the ageing society. However, this approach needs to be developed much further to take a whole-of-government view and the issues clearly communicated to the whole community.

5. The governance procedures in place for the Economic and Productivity Growth Drawdown Provision (EPGDP) meet the Panel's previous recommendation. However, given the scale of the productivity challenge facing the Island, which recent events mean is even more important to tackle, these funds should be focused on medium-term policies that help raise productivity and increase the underlying rate of economic growth.

6. The time to address any (as yet unidentified) structural impacts of the UK's decision to leave the EU on the local economy and States finances is the next MTFP period. However, this is contingent on the expectation that the current package of measures (or others of equivalent value) and capital expenditure are delivered as planned.

7. If the States needs to draw more from its reserves over the 2016-19 period the Panel believes that this is preferable at this stage to implementing additional fiscal tightening (above what is already planned) during what will be a period of continued external economic instability.

8. Given the economic conditions and general uncertainty facing the Island in coming years it is still vital to ensure that additional flexibility is built into plans over the 2016-19 period and in both directions. There may be a need to provide further support to the economy (in line with the 3Ts: timely, targeted and temporary) but it is also important to develop plans to implement measures to balance the budget in the next MTFP if necessary. If the economy performs better than expected in the short term there might even be a case for bringing these measures forward towards the end of this MTFP period.

Section 1 - The Economic Outlook

1.1 International outlook

The International Monetary Fund (IMF) July 2016 World Economic Outlook Update estimated that the global economy grew by 3.1% in 2015, the slowest year of growth since 2009. While advanced economies remained at the same pace as 2014, there was a further mild slowdown in emerging economies. A similar level of growth is expected in 2016 (3.1%), then a slight increase to 3.4% in 2017. Compared to forecasts from the same time a year ago, the IMF has downgraded its forecasts by 0.7 percentage points for 2016 and 0.4 percentage points for 2017.

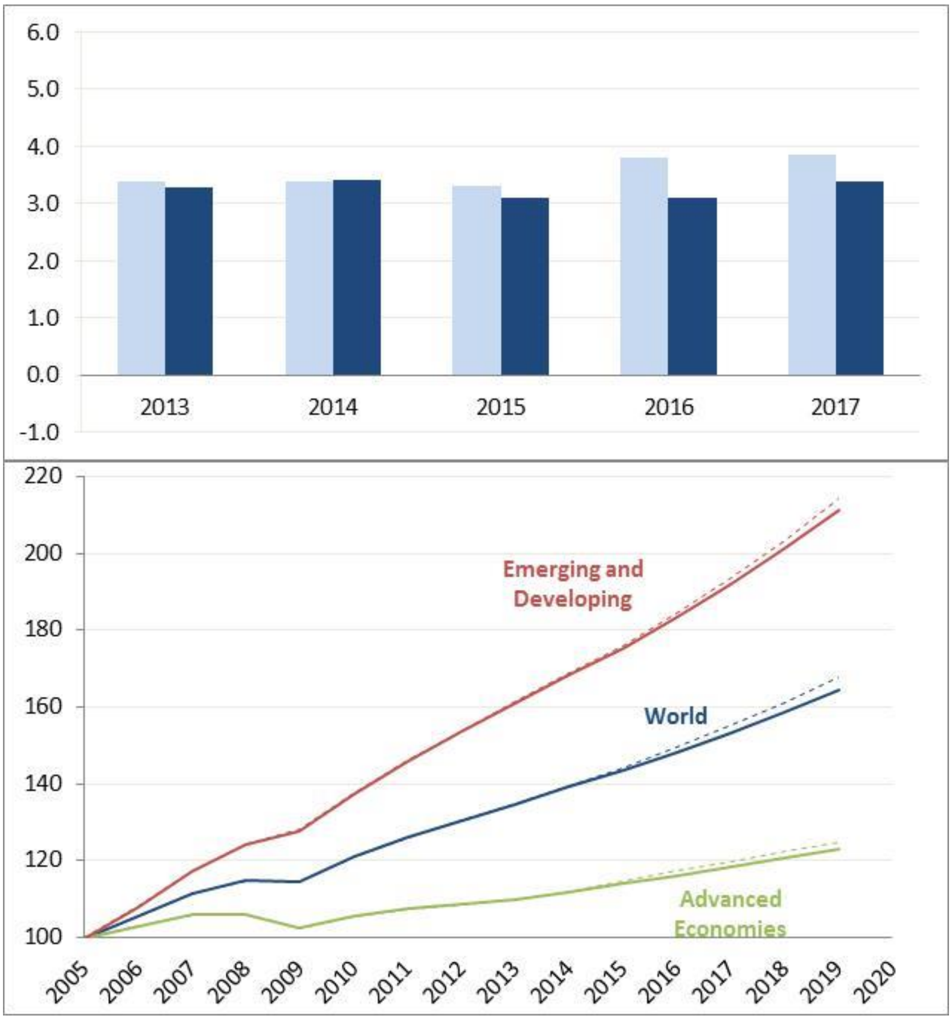
Figure 1.1

Global Growth

Top panel: global GDP real growth – July 2016 estimates/forecasts; pale bars are July 2015 estimates/forecasts

Bottom panel: Index (2005=100) of real-terms GDP - July 2016 estimates/forecasts; dashed lines are July 2015 estimates/forecasts

Source: International Monetary Fund (IMF) World Economic Outlook July 2015 update and July 2016 update.



Part of the reason for the downgrade is due to the uncertainty following the outcome of the UK's June 2016 referendum on membership of the European Union. The issue of 'Brexit' has resulted in significant downgrades to forecasts of the UK economy, in addition to smaller downgrades to forecasts for other advanced European economies.

In the July 2016 Update Report, the FPP stated that the average forecast for the UK had fallen by 0.5 percentage points for 2016 and 1.8 percentage points for 2017 since the referendum result. On the basis of developments since the July report, there is no reason to think that these forecasts would be significantly changed.

The Panel also considered likely long-term impacts in the July 2016 update, including an estimate by the Centre for Economic Performance that the UK's GDP could be reduced by between 6.3% and 9.5% in the long run as a result of leaving the European Union. Any such projection for the impact of leaving the EU remains highly uncertain, particularly as exit negotiations have yet to commence.

There was an initial fall in equity prices worldwide after the UK referendum, but these have since rebounded and the IMF does not forecast any significant impact on economic growth outside the EU. In the EU, the start of 2016 saw improving growth in a number of the larger euro area countries, only to slow again in the second quarter. The IMF has revised their forecast for the euro area up slightly (by 0.1%) for 2016 and down 0.2% for 2017. Among other advanced economies, the United States and Japan have seen forecasts downgraded, particularly for 2016, not least due to strengthening of their currencies which can potentially hurt the competitiveness of their exports.

Among emerging economies, China has performed largely in line with expectations, with any 'hard landing' so far having been avoided and growth forecasts being revised up slightly since last year - on the assumption that policy continues to be supportive of the economy. The situation has worsened considerably in other emerging markets, particularly Brazil and Russia which have seen sharp contractions last year and are expected to contract further over 2016 as a whole – though forecasts have improved somewhat over recent months.

The global economy continues to be subject to a number of risks. While the risk of an 'out' vote in the UK referendum has crystallised, the risk now is that the period of negotiations prolongs uncertainty and results in an outcome which has a significant negative impact on world growth. Such an outcome might include for example an intensification of UK financial stress, alongside a significant fall in business and consumer confidence sufficient to have an impact beyond the UK. The IMF's 'downside' scenario suggests that the combination of these and other factors could result in world growth being some 0.2 percentage points lower in 2016 and 0.3 percentage points in 2017.

The less probable 'severe' scenario suggests world growth could be 0.3 percentage points lower in 2016 and 0.6 percentage points lower in 2017.

Other risks remain, including the possibility of further difficulties in the euro area (heightened by the potential political contagion effects of the UK referendum result). Growth in China continues to be under pressure and the risk of a significant slowdown there could drag global growth down considerably. Geopolitical tensions have intensified further in 2016, and have the potential to act as a drag on growth.

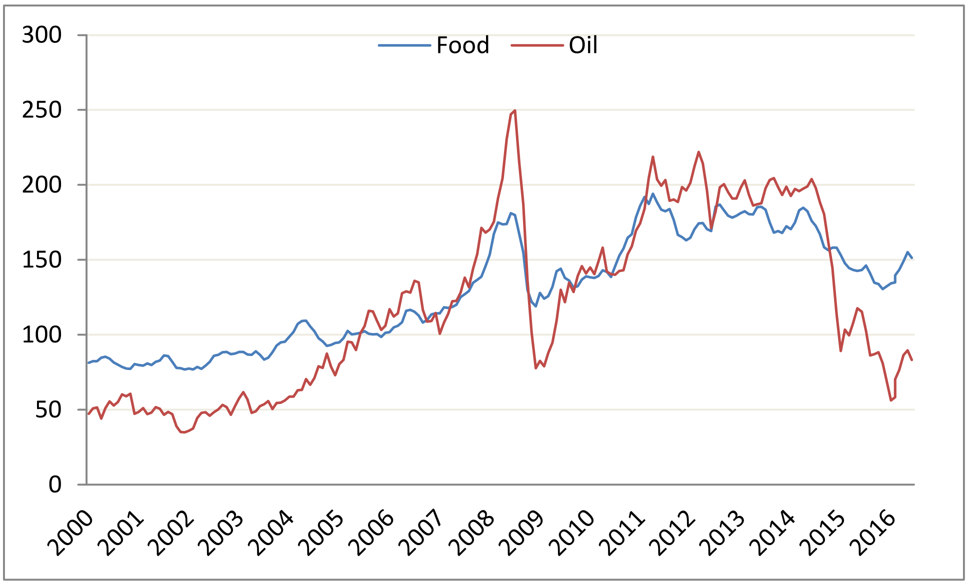
Global oil prices reached new lows at the beginning of 2016. Although there has been some recovery, prices remain around the same level as one year ago, much lower than their five-year average. Prices are expected to increase modestly over the next year, though the risk of a significant increase has fallen somewhat. Food prices fell over the course of 2015 but have seen increases in 2016 to date, such that prices are largely similar to one year ago.

Figure 1.2

Commodity Prices

Index of nominal US dollar food and oil prices indices, 2005=100

Source: International Monetary Fund, index of primary commodity prices - August 2016



The last twelve months have seen the first movements in both UK and US policy interest rates since both were cut to record lows in the aftermath of the global financial crisis. The US Federal Reserve took the long-awaited step to increase policy rates in December 2015, due to sustained strengthening of the labour market in particular. While the UK was at one stage expected to follow with a rate rise in 2016, Bank Rate was in fact cut from 0.5% to 0.25%, in the aftermath of the vote to leave the European Union, reaching a new record low. There is an expectation that the UK rate could be cut a little further.

Overall, the global economy has failed to gain the traction which was anticipated. While the euro area has seen some improvement in growth from a low base, other advanced economies have failed to accelerate as expected. Emerging economies continue to face pressure, though China continues to grow strongly – with only a mild deceleration. However, risks have increased over the last twelve months – primarily for the European Union and for the UK in particular, as a result of the outcome of the UK referendum on membership of the European Union.

1.2 Jersey economic developments

Gross value added (GVA) is the headline measure of economic activity in Jersey. 2014 saw the first year of real growth in Jersey's economy since 2007, with the economy growing by 5%, largely in line with the FPP estimate. This was led by a strong growth in financial services, growing by 9%, but non-finance (excluding rental) saw its second successive year of 2% real growth.

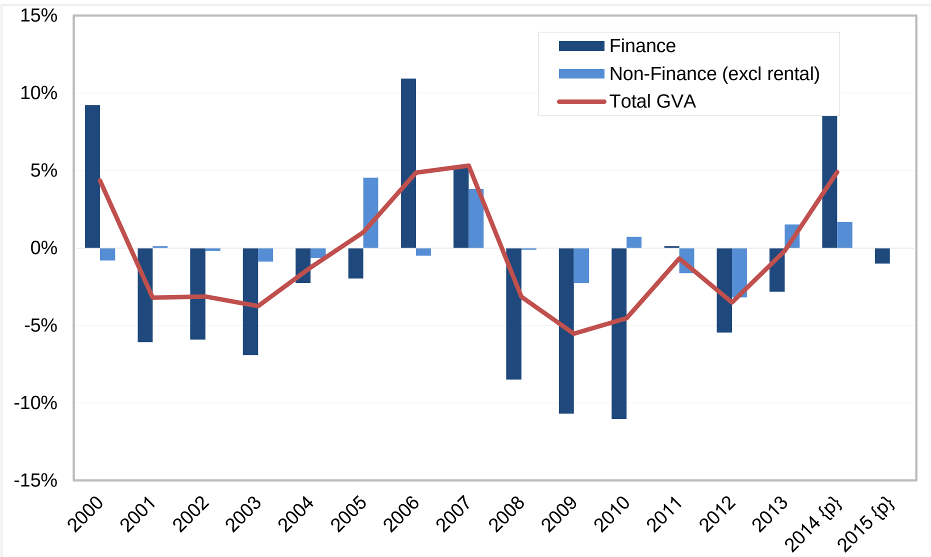
Estimates of whole economy GVA for 2015 will be published at the end of September, though the estimate for the financial services sector has recently been published in the Survey of Financial Institutions. This shows that the output of the financial services sector fell by 1% in 2015; which is covered in more detail in the next section.

Figure 1.3

A breakdown of Gross Value Added growth

Annual % real terms change
{r} = revised
{p} = provisional

Source: States of Jersey Statistics Unit



Financial services sector

The **Survey of Financial Institutions** (SFI) reported a small fall in the GVA of the financial services sector in 2015 in real terms. This was the result of an 8% real terms fall in profits for the sector, which followed 20% growth in profits the previous year. GVA of the banking sector fell by 5%, but there was strong growth in trust and company administration which grew by 3% in real terms, and in the legal sector which grew by 5%.

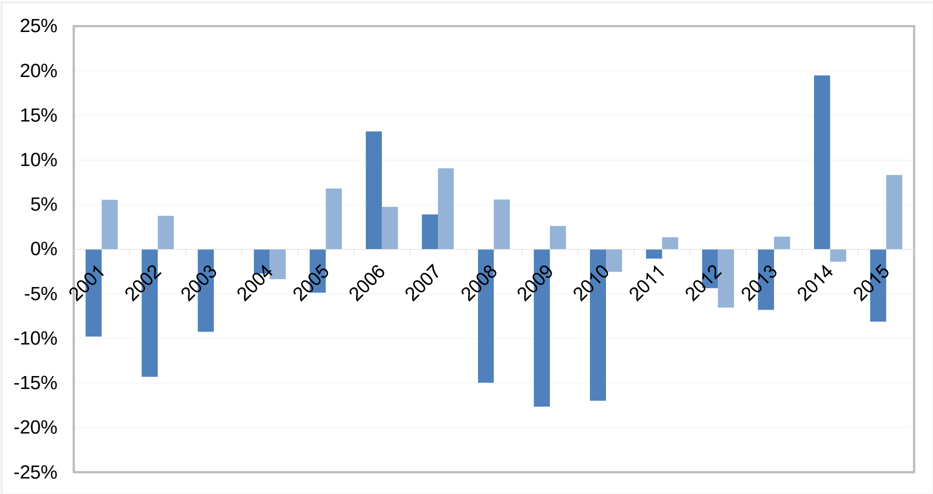
The salary element of financial services GVA grew strongly in 2015, returning to its (2009) peak level. The 8% annual real-terms increase followed five years in which total salaries and wages in the sector were either down or close to flat.

Figure 1.4

Financial services profit and employment costs

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

Source: States of Jersey Statistics Unit



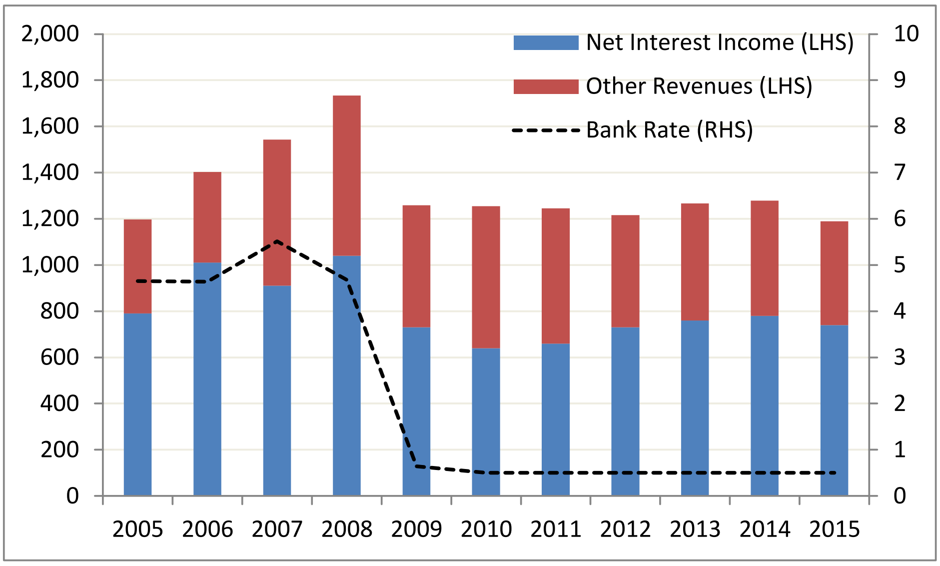
Revenues for the financial services sector were £2.38 billion in 2015, largely unchanged from the previous year. 50% of revenues came from the banking sector, with the majority of this from net interest income. Net interest income has been hit by the low interest rate environment, falling by 38% in nominal terms between 2008 and 2010. Although interest rates have remained low, net interest income has recovered somewhat, but by 2015 remained almost 30% below the 2008 peak. The further decrease in Bank Rate in August 2016 may put further downward pressure on net interest income for some Jersey banks.

Figure 1.5

Banking revenues

Source of revenue (£m, current prices - left hand scale) and annual average for Bank of England Official Bank Rate (% - right hand scale)

Source: States of Jersey Statistics Unit



Net interest income is also related to the level of deposits. The Jersey Financial Services Commission (JFSC) reports that the level of deposits held in Jersey has fallen each year since 2007, by an average of 6.3% per year. Over the last two years, these falls have been driven by falls in the sterling value of foreign currency deposits, with the level of sterling deposits falling much more slowly in 2014 and remaining flat in 2015. The majority of currency deposits are held in US dollars or euros and changes in the exchange rate will affect the sterling value of these deposits. Data for the first quarter of 2016 indicate that deposits were up by 1.5% over the quarter, but this data is very volatile from quarter-to-quarter so caution should be exercised in interpreting the trends.

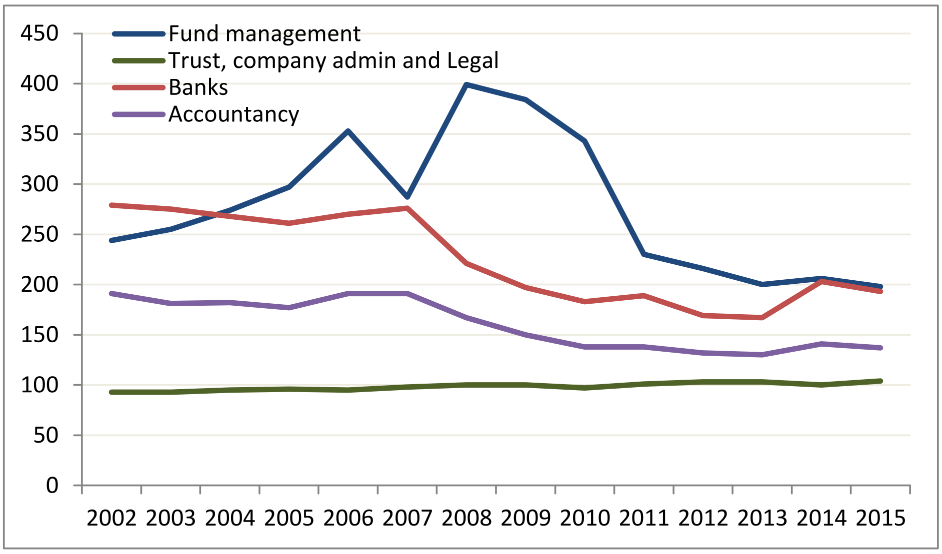
Productivity (as measured by GVA per full-time equivalent employee) fell somewhat for the sector overall, though Figure 1.6 shows that while productivity fell in the banking and fund management sectors in 2015, it grew by 4% for the trust, company administration and legal sector. The longer-term trend remains one of falling productivity in banking and in the (relatively small) fund management and accountancy sectors, with largely flat productivity in trust, company administration and legal.

Figure 1.6

Finance subsector performance

Gross value added per full-time equivalent employee by sector, constant 2013 values, (£000)

Source: States of Jersey Statistics Unit



The **Business Tendency Survey** provides more recent evidence on the performance of the sector, with the headline business activity indicator remaining strongly positive in the most recent quarter for which the survey was carried out (March 2016). This indicator has been positive in all but one quarter for the last four years. New business was at its highest level since March 2014. Profitability, employment and business optimism remained positive. Future business activity and future employment had fallen from high levels at the end of the year, but remained positive.

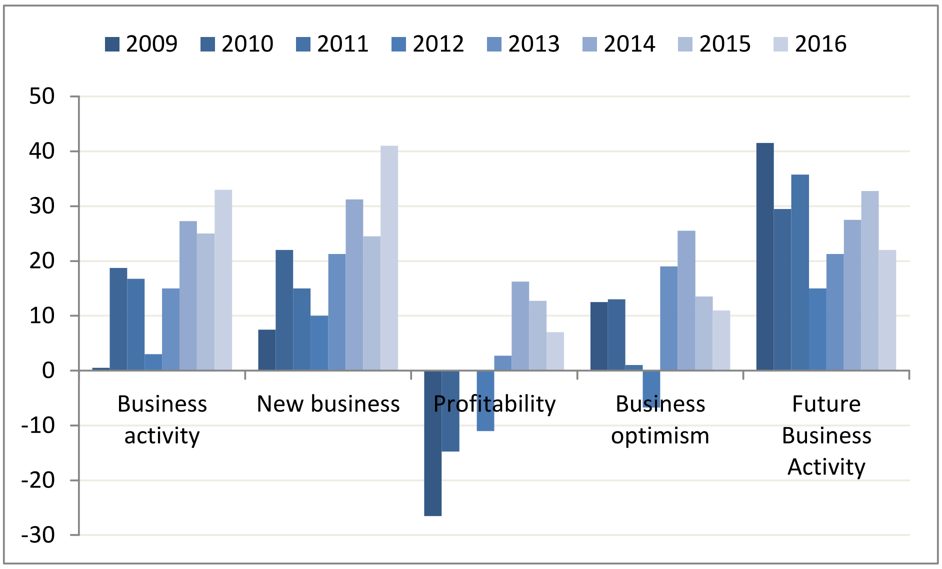
No Business Tendency Survey has been carried out in June 2016, and it is understood that none is planned for September 2016, so it will not be possible to see the impact of the UK referendum result on the results of the survey.

Figure 1.7

Finance business tendency

% net balance of respondents reporting an increase (weighted by employment). Annual average of quarterly results, September 2009 to March 2016 (2009 includes results from only two quarters, 2016 includes results from only one quarter).

Source: States of Jersey Statistics Unit



The **outlook for the financial services sector** was relatively positive in December 2015, when almost three quarters of finance firms (weighted by employment) expected profits in 2016 would increase compared to 2015, while less than a fifth thought profits would fall. 43% of firms also anticipated employment to increase, but 29% anticipated falls in employment. This was largely in line with views from the FPP's fact-finding visit in June which suggested a mixed but broadly-positive picture for the sector as a whole.

However, these expectations for 2016 predated both the result of the UK referendum on EU membership, and the decision to reduce the UK's Bank Rate from 0.5% to 0.25%. The uncertainty created in the aftermath of the referendum result has the potential to put pressure on the finance sector as investment into the UK may slow – but also could create opportunities if Jersey is seen as a safe haven in uncertain times. In the longer term, the changing nature of the UK relationship with the EU could have knock-on effects on Jersey in several ways:

- UK-based banks' strategies will be reviewed and they may change their stance, and business model, in Jersey.
- UK regulations themselves may change if they are no longer bound by the EU, but it is not clear if this will result in Jersey being more or less competitive in providing financial services to customers seeking off-shore jurisdictions.

The 25 basis point cut in Bank Rate is relatively small compared to the fall of 3 percentage points in just six months in 2008. The impact on financial services profits may therefore be limited. However, there is the potential for further cuts in the future and the prospect of a rate rise in the near future is now diminished. The prospect of UK Bank Rate remaining below 1% for a further 3-4 years will make further recovery in banking sector profits more difficult – though any resulting fall in sterling may provide a boost to sterling income from foreign currency business.

In addition, the sector continues to face ongoing regulatory changes. UK banking sector reform will require some adaptations to business models, but has the potential to present opportunities for Jersey as well as difficulties. Regulatory developments such as those to prevent base erosion and profit sharing (BEPS) and to introduce new rules for corporate taxation in the EU similarly present both threats and opportunities for businesses in Jersey.

In general, a constantly changing regulatory landscape presents challenges and may impact negatively on profitability. The loss of a UK influence in EU decision-making could further increase this risk. However, Jersey has in the past proved able to react to these changes, and now has a strong regulatory regime and a high level of compliance with international standards. This offers the opportunity to attract new business and the recent MONEYVAL report, which recognises that Jersey authorities have taken a proactive approach to international cooperation, provides an example of where Jersey can be a leading jurisdiction in complying with international regulation.

Representatives from the finance sector have also reported seeing some upward pressure in salaries in small pockets of the industry such as compliance, which could constrain growth and competitiveness in some businesses, if appropriate skills cannot be found or if the cost pressures in Jersey are greater than in competitors.

Rest of the economy

For non-finance sectors as a whole (excluding the rental income of private households), GVA increased by 2% in 2014 in real terms, a similar level of growth to the previous year. This represents the first time there has been two consecutive years of growth since at least 1998. There was particularly strong growth in the hotels, restaurants and bars sector (6%) and in construction (5%), though the wholesale and retail sector fell by 3%.

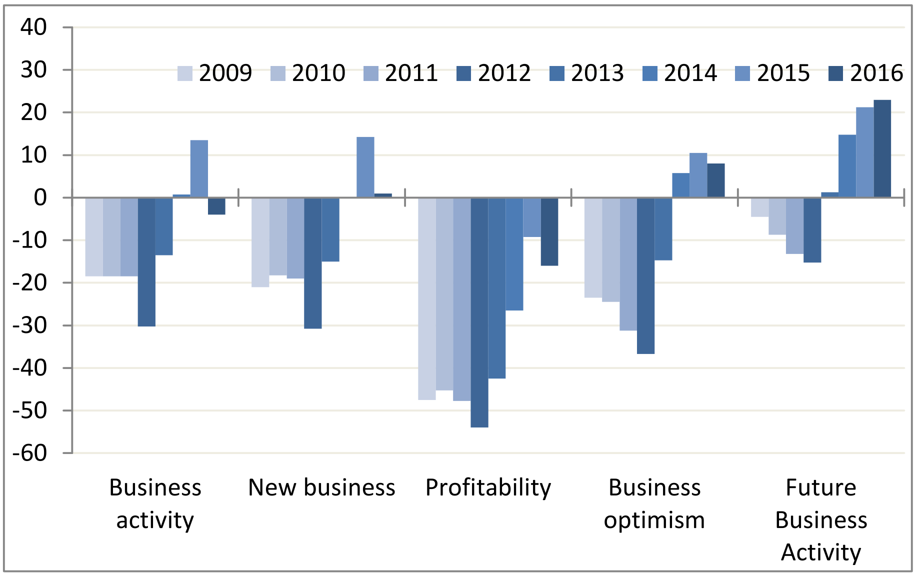
Over the course of 2015, the Business Tendency Survey indicated further improvement in non-finance sectors, with the headline business activity indicator remaining positive throughout the year. As with the finance sector, no Business Tendency Survey has been carried out in June 2016, and it is understood that none is planned for September 2016, so it is not possible to see the impact of the UK referendum result on this survey.

Figure 1.8

Non-finance business tendency

% net balance of respondents reporting an increase (weighted by employment). Annual average of quarterly results, September 2009 to March 2016 (2009 includes results from only two quarters, 2016 includes results from only one quarter).

Source: States of Jersey Statistics Unit



The BTS was first issued in 2009, shortly after the global financial crisis which significantly affected Jersey's economy. Therefore for the initial years of the survey it was difficult to say how the results of the survey might correlate with a growing economy.

Figure 1.9 compares the responses to the BTS with the growth of non-finance sector GVA (excluding the rental income of private households). This shows that the business activity indicator fell in 2012, in line with falling GVA growth, and saw some improvement in 2013 – but was negative on average - while GVA grew by 2%. The indicator improved further in 2014, to a neutral position; while GVA grew by a further 2%. On this basis, the BTS would suggest there was further growth in 2015 and that growth was expected in 2016 (though 2016 is based on only one quarter's survey responses and before the result of the UK referendum was known).

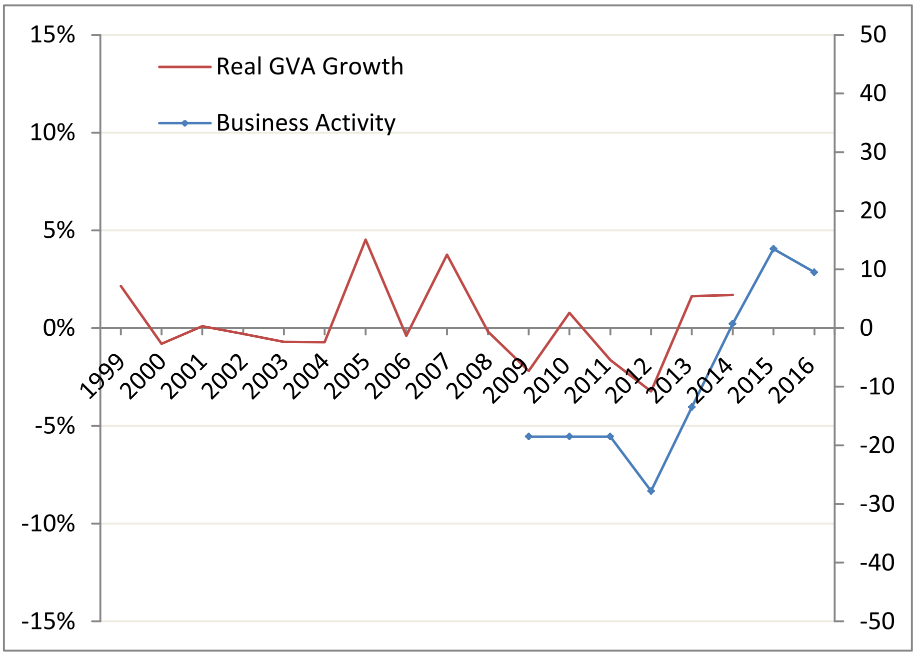
Figure 1.9

Non-Finance GVA Growth

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

Non-finance responses to business activity question averaged over each year. 2016 based on average of responses to "business activity" and "future business activity" in the March 2016 survey (right-hand scale)

Source: States of Jersey Statistics Unit



Sectoral performance

GVA of **the wholesale and retail** sector fell in 2014, and has not seen any annual growth since 2011. This included a significant fall in 2012 which was primarily due to difficulties faced by the fulfilment sector following the loss of low value consignment relief (LVCR). The business activity indicator of the Business Tendency Survey was positive throughout most of 2015, before falling to a negative position at the start of 2016.

The total volume of retail sales in 2015 was 1% higher than 2014; the second successive year of growth on a calendar year basis. Both food and non-food volumes were higher for the year, though non-food volumes have been on a generally downward trend in recent years. While retail sales figures have not been collected for 2016, footfall (as measured by a counter in King Street) has fallen by 3% in the first seven months of the year, when compared to the same period of 2015.

When the Panel met with representatives of the retail sector, the picture was of improving consumer confidence due to low interest rates and low levels of inflation. There was cautious optimism in most parts of the sector, though the increasing digitalisation of retail remained a challenge for some. The scale of impact of the UK referendum result on consumer confidence remains uncertain, although it is likely to be negative and bring further downward pressure on revenues over the next 2-3 years.

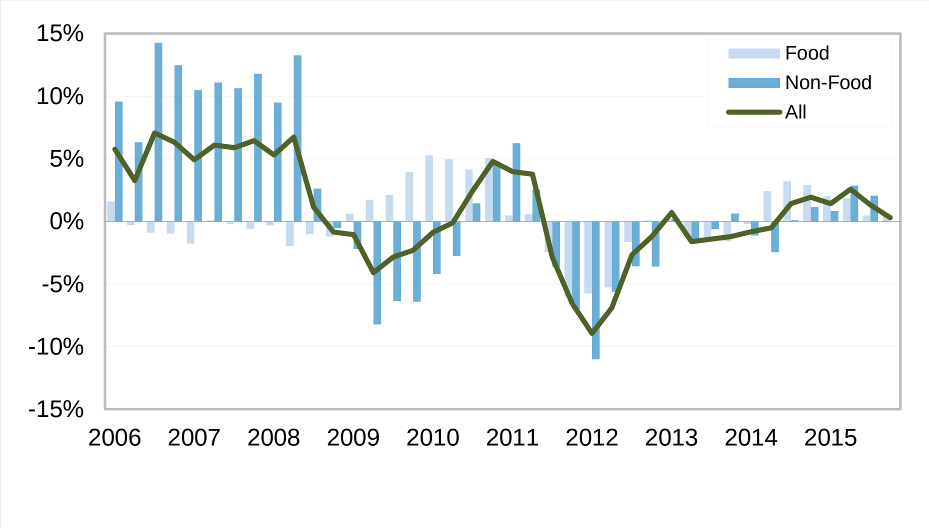
Figure 1.10

Retail sales

Seasonally adjusted annual change in volume, %

Quarter 1 2006 to quarter 4 2015.

Source: States of Jersey Statistics Unit



For the **hotels, restaurants and bars sector**, GVA increased strongly in 2014 – primarily as a result of improving productivity (GVA per FTE), with a relatively small increase in employment. This represents the fifth successive year of growth for the sector, and economic output is at its highest level since 2000.

A significant part of this sector is driven by the visitor economy, and the number of staying leisure visitors also increased strongly in 2014, by 3.7%. A further increase of 2.7% was seen in 2015. The first six months of 2016 also saw increases when compared to a year earlier, but it is too early to draw any robust conclusions on annual performance from this as the bulk of visitors arrive between June and September.

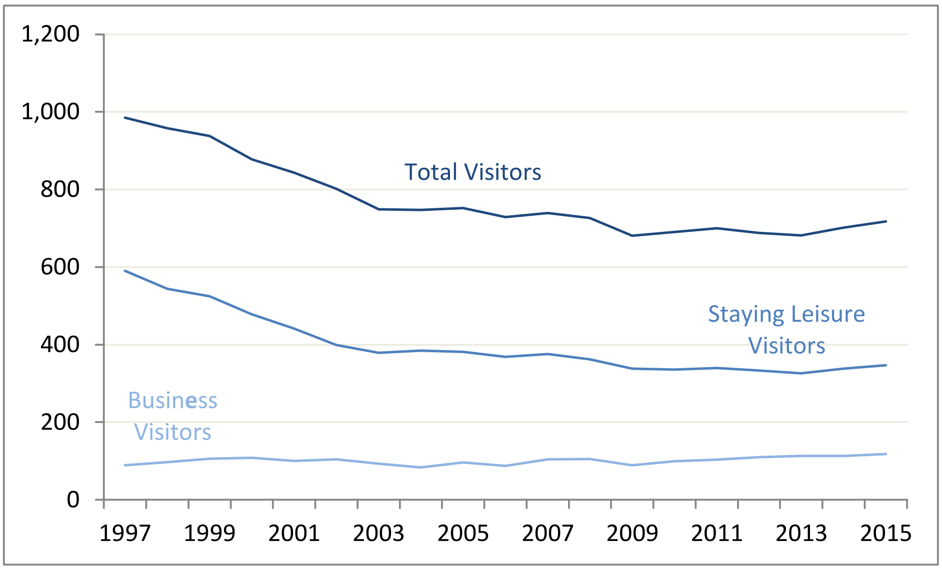
When the Panel met with representatives of the sector in June 2016, there was some cautious optimism but also a perception of continued fragility. The industry is continuing to report some labour constraints for specific skill sets. The impact of the UK referendum on EU membership is not yet clear: the fall in the value of sterling may make Jersey a more attractive destination when compared to non-sterling destinations; but if consumer confidence in the UK is reduced then it could reduce the total number of visits by UK tourists.

Figure 1.11

Visitor numbers

Annual number of visitors to Jersey, 000s

Source: States of Jersey Statistics Unit



GVA of the **construction sector** increased by 5% in 2014, following three years of declining output. The Business Tendency Survey was positive throughout most of 2015, with a slightly negative response on business activity in the final quarter. This indicator improved to be largely flat in the first quarter of 2016, though a number of other indicators saw significant falls, including profitability, employment, business optimism, future business activity and future employment.

Representatives of the construction sector spoke of a buoyant market when the Panel met with them in June 2016. However they indicated that spare capacity had increased compared to a year earlier. The capital programmes for social housing and for ports and airports gave the industry some confidence in the future pipeline. But there is concern that the present uncertainties could depress the pipeline from the private sector.

1.3 Labour Market

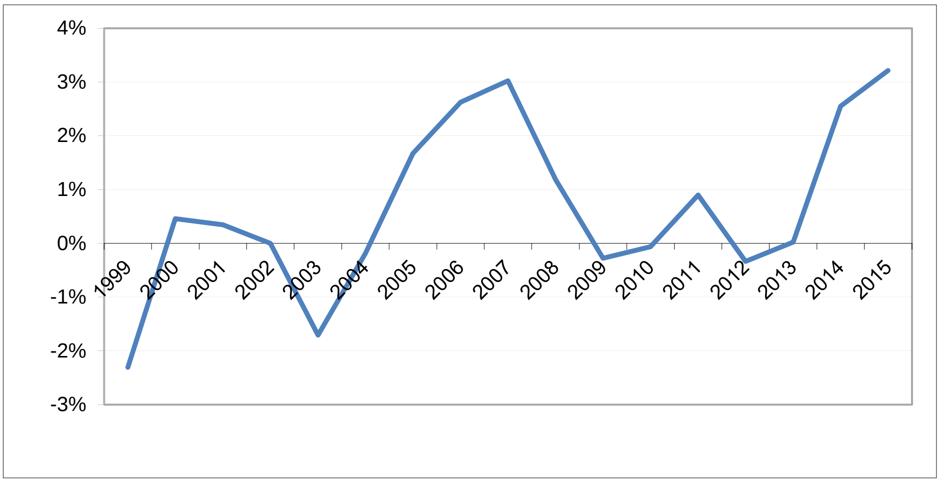
2015 saw record levels of employment, with the highest June and highest December numbers recorded. There were over 57,000 people employed in December 2015 – an increase of over 3% over twelve months.

Figure 1.12

Employment

Annual change in total private sector employment for December of each year

Source: States of Jersey Statistics Unit



On a sectoral basis, employment in the finance sector increased by 420 (3%), driven by trust and company administration and legal. There were also significant increases in employment in education, health and other services (8%); construction and quarrying (6%); miscellaneous business activities (4%); and hotels, restaurants and bars (3%).

Figure 1.13

Employment changes by sector

Total headcount for each sector

Source: States of Jersey Statistics Unit

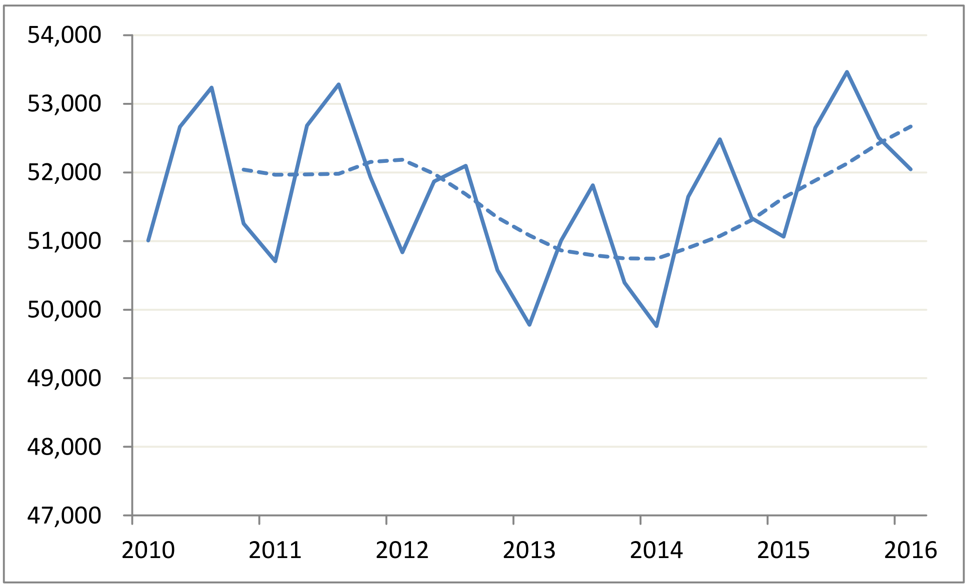
	Dec-14	Dec-15	Change
Agriculture and fishing	1,440	1,390	-50
Manufacturing	1,040	1,060	+20
Construction & quarrying	4,980	5,300	+320
Electricity, gas & water	500	480	-20
Wholesale & retail trades	8,010	7,800	-210
Hotels, restaurants & bars	5,060	5,230	+170
Transport, storage & communication	2,600	2,700	+100
Computer & related activities	690	750	+60
Financial & legal activities	12,590	13,010	+420
Miscellaneous business activities	4,640	4,810	+170
Education, health & other services	6,680	7,240	+410
Public Sector	8,320	7,960	-360
Total	**56,540**	**57,720**	**+1,180**

Social Security contribution numbers provide monthly data on the total number of individuals paying class 1 or class 2 contributions in that particular month. It can therefore be used to give some indication of recent trends in employment. Figure 1.14 shows an increase over the course of 2015 and the first quarter of 2016 shows a 2% increase on the same quarter a year previous. Contribution numbers in February 2016 were approximately 5% higher than the low point three years previously.

Figure 1.14
Social Security contributions

Number of Class 1 and Class 2 contributions, quarterly average (solid line) and four quarter moving average (dotted line)

Source: Social Security Department



Unemployment, as measured by the internationally comparable ILO rate, was estimated to be 4% in 2014/15. The previous figure was 4.6% in June 2014, though as the collection method differed the two figures are not entirely comparable.

The number of people registered as **actively seeking work** (ASW) can be seen as an indicator of the trend in unemployment (it is not however, a comprehensive measure of unemployment as there is no statutory requirement for unemployed residents to register). ASW peaked in early 2013 and by July 2016 had fallen by a third (seasonally adjusted) since then. A number of changes have been made to the Income Support criteria in recent years which have increased the number of individuals counted as ASW, so these figures also need to be read with care.

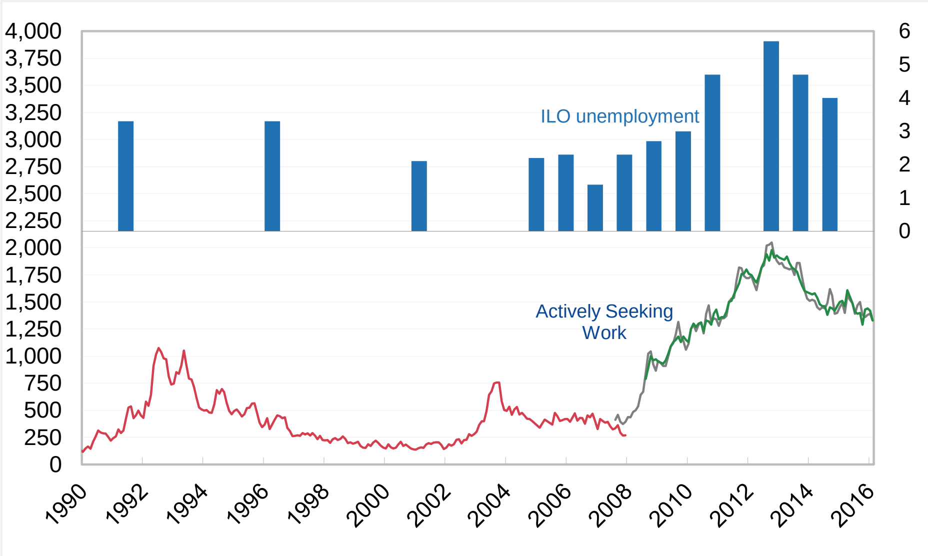
Figure 1.15

Changes in unemployment

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

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

Source: States of Jersey Statistics Unit



In the most recent Business Tendency Survey from March 2016, 36% of finance firms (weighted by employment) were increasing employment whilst 17% were reporting a fall in employment. This was the most positive net balance since 2014. Looking forward though, the balance for future employment had fallen significantly after hitting a record high in December 2015.

Similarly, the employment indicator was positive for non-finance, though with a much smaller weighted net balance of +3%. More than three quarters (78%) of firms reported no change in employment, with only 12% reporting an increase but around 9% reporting a fall.

Figure 1.16 demonstrates that the employment indicator has improved considerably in recent years for both finance and non-finance and there is some optimism for future employment. While the broad trends are consistent, optimism has not always resulted in the employment indicator being positive the following quarter. Nevertheless, the combination of record high employment levels in 2015, a recovery in Social Security contributor numbers, falling numbers of Actively Seeking Work and the Business Tendency Survey data suggest a relatively positive picture for employment trends.

Figure 1.16a
Employment trends in finance sector

Weighted net balance reporting increase in employment, compared to weighted net balance reporting an increase in future employment one quarter earlier

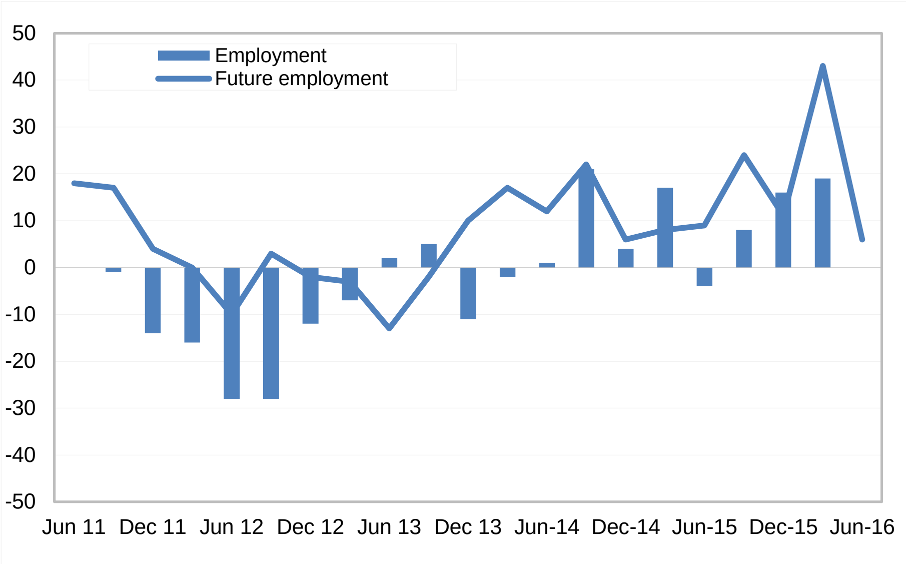
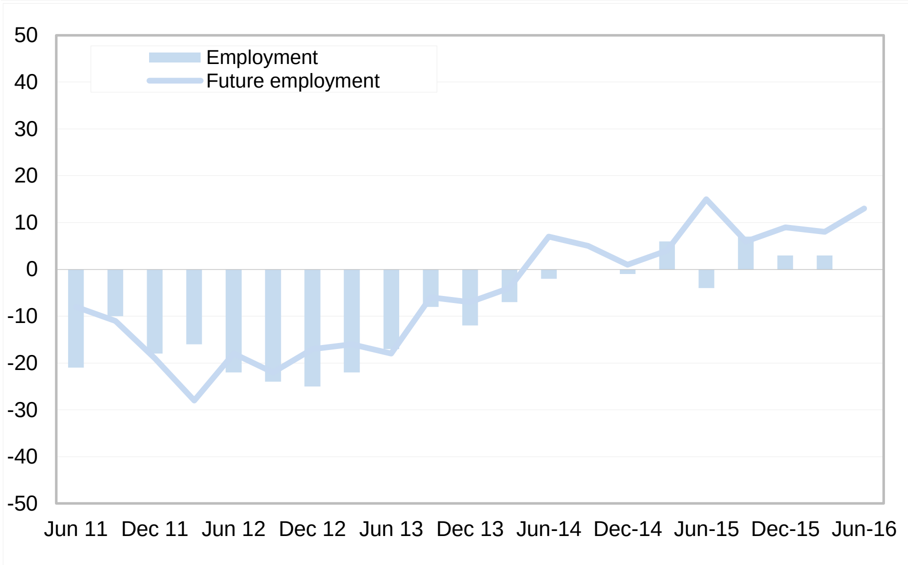


Figure 1.16b
Employment trends in non-finance sector

Weighted net balance reporting increase in employment, compared to weighted net balance reporting an increase in future employment one quarter earlier

Source: States of Jersey Statistics Unit



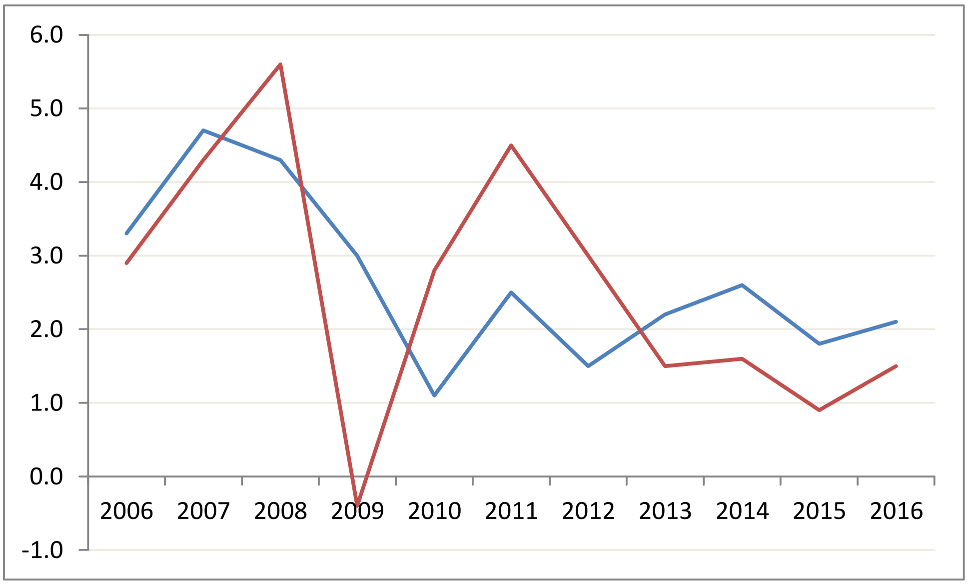
Average earnings increased by 2.1% in the year to June 2016, representing the fourth successive year in which earnings increased faster than inflation. Real earnings have now returned to the same level as 2007, before the global financial crisis, after which earnings fell in real terms for four out of the next five years.

While private sector wages saw further real growth in the twelve months to June 2016, public sector wages fell in real terms for the second successive year. The largest increases were in construction and hospitality sectors – though this followed two years of construction earnings growing lower than the private sector average, and five years for hospitality.

Figure 1.17
Average earnings and inflation

% increase in average earnings (blue line) and retail price index (red line) - June each year.

Source: States of Jersey Statistics Unit



1.4 Inflation

Inflation has remained relatively low (below 2%) since the beginning of 2013. The last year has seen inflation pick up somewhat from 0.1% in September 2015 to stand at 1.5% in June 2016. RPIX inflation (excluding mortgage interest payments) also sits at 1.5%, having been below 2% for twelve of the last fourteen quarters (compared to two times in the previous 52 quarters since the measure was introduced in 2000).

Jersey is not alone in having enjoyed relatively low inflation in recent years. The European Union as a whole has seen inflation (as measured by CPI) averaging less than ½% over the last three years, compared to closer to 2½% during 2011-2013.

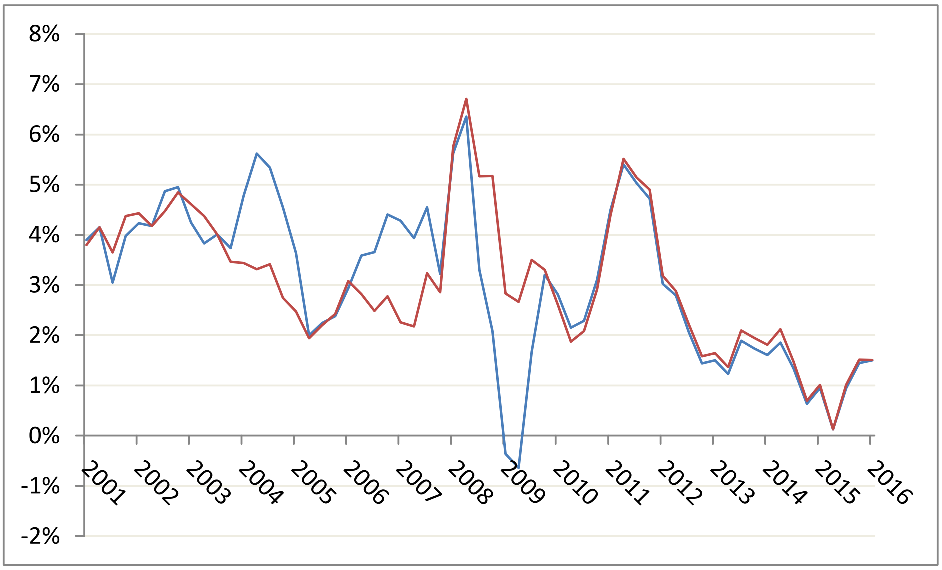
The significant fall in the value of sterling since the UK referendum result is likely to see some additional upward pressure being put on prices from the third quarter of 2016. The initial extent of this will become apparent when price data are published for September 2016.

Figure 1.18

Inflation in Jersey

Annual % change in retail prices index (blue line) and retail prices index excluding mortgage interest payments (red line)

Source: States of Jersey Statistics Unit



1.5 Economic growth forecast

As a result of new data, it appears likely that economic output will have grown somewhat slower in 2015 than previously expected; with GVA estimated to have grown by just less than 1%, a significant slowdown from the 5% growth seen a year earlier. However, this is at least partly due to the volatility of profits of the financial services sector, which grew by 20% in 2014 but fell by 8% in 2015.

Looking forward, the result of the UK referendum on membership of the EU is likely to have a negative impact on growth in both 2016 and 2017. However, the economy appears to have been relatively buoyant in the first half of 2016 and the impact of the vote may take some time to be felt in full; therefore the 2016 forecast has been downgraded by around 1% - meaning the rate of growth in 2016 is expected to be slightly lower than 2015. This is due to expected slower growth in financial services profits and somewhat higher inflation, plus average earnings growth being lower than previously expected.

The Panel has forecast growth to be largely flat in 2017 and 2018, as the impact of the referendum result starts to be more fully felt. The forecast for 2017 represents a downgrade of around 1½% from the previous forecast, due to somewhat lower growth in employment and company profits and inflation averaging around 1% higher over the year due to the recent falls in the value of sterling. However, the impact of the referendum on the Jersey economy is still very uncertain and likely to remain so at least until negotiations are complete. Therefore, there is a wide range of possible outcomes around this central projection – even wider than before, due to increased uncertainty.

Figure 1.19

Economic growth forecast

% change in real GVA on year before

Sources: Panel judgement; States of Jersey Statistics Unit

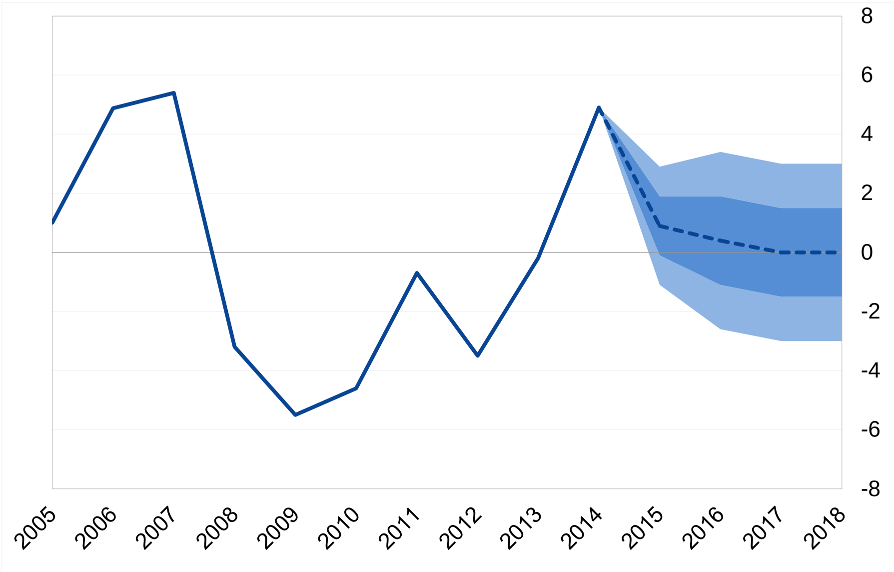


Figure 1.20

Central economic assumptions

% change year on year unless otherwise stated, bordered numbers indicate outturns.

Note: Changes in profits, earnings, employment costs and house prices are in nominal terms

Sources: Economics Unit calculations and Panel judgement

						Return to trend	
	2014	2015	2016	2017	2018	2019	2020
Real GVA	4.9	0.9	0.4	0.0	0.0	0.0	0.0
RPI	1.6	0.6	2.2	3.3	3.0	3.3	3.3
RPIY	1.6	0.6	2.3	3.4	3.0	3.0	3.0
Nominal GVA	6.6	1.5	2.7	3.4	3.0	3.0	3.0
Company profits	12.3	-2.7	2.8	2.9	3.0	3.0	3.0
Financial services profits	19.4	-7.5	2.6	2.8	3.0	3.0	3.0
Compensation of employees	2.1	5.3	2.6	3.8	3.0	3.0	3.0
Employment	2.3	1.9	0.5	0.0	0.0	0.0	0.0
Average earnings	2.6	1.8	2.1	3.8	3.0	3.0	3.0
Interest rates (%)	0.5	0.5	0.4	0.1	0.1	0.2	0.4
House prices	3.0	4.0	4.0	3.0	3.0	3.0	3.0

1.6 Spare capacity and trend GVA

While GVA in 2015 now looks likely to be somewhat less than previously expected, the Panel does not believe this has significantly increased the level of spare capacity. Similar to the increase in GVA in 2014, this is driven by the volatility of financial services profits largely as a result of one-off factors and may not have had significant impacts on the level of remaining capacity. The Panel understands that a fall in financial services profits in 2015 has already been taken into account in the income forecasts used in the MTFP.

While meetings with local business representatives suggested that capacity was being used up somewhat faster than expected in the first half of 2016, this may have slowed somewhat since the result of the UK's EU referendum. The Panel's July 2016 Update Report set out three possible scenarios for the impact of the UK decision – a cyclical downturn in output, a structural loss in potential/trend output or a combination of the two. At this stage it is not yet clear which of these will most accurately represent the outcome for Jersey's economy.

Figure 1.21 sets out one potential outcome, that the UK decision results in a loss of potential output over the next three years; such that the economy returns to balance by 2019, but at lower level of output than previously anticipated.

Figure 1.21

Impact on trend GVA

GVA levels (solid line) and updated assumptions (dashed lines).

Updated estimate of trend GVA (dark red dashed line) and September 2015 estimate (pale red dashed line)

£m, constant 2013 prices

Sources: States of Jersey Statistics Unit and FPP calculations

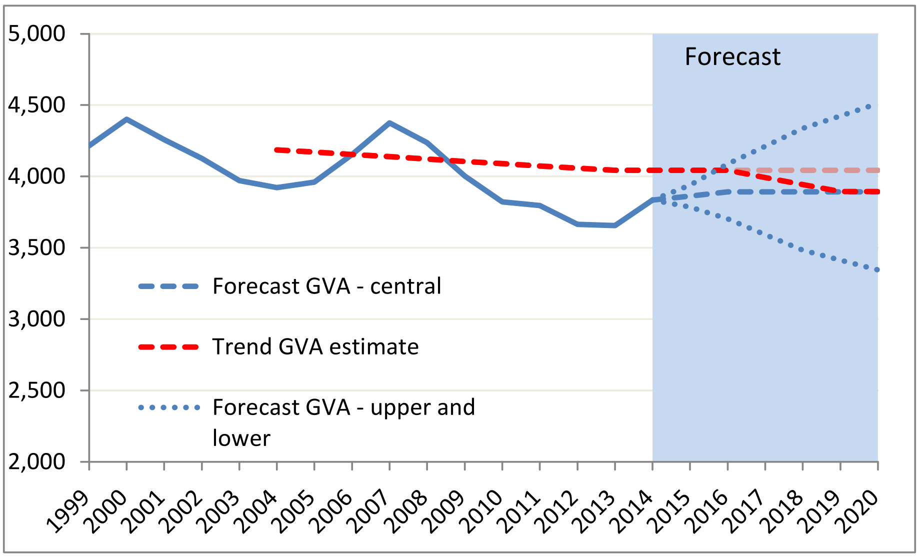


Figure 1.21 assumes that the impact is largely structural. However, there may also be some cyclical impact – the timing of which is not yet clear. This might see the economy dip further in 2017 or 2018 due to the uncertainty during negotiations; before seeing some cyclical recovery – possibly in 2019 or 2020. However, there is the potential that the cyclical recovery could be delayed until after 2020; in which case some spare capacity would remain beyond the forecast period.

Section 2 – The Fiscal Outlook

2.1 Introduction

In this section, the Panel discusses whether the draft MTFP Addition follows its four guiding principles and eight recommendations as described in the 2015 Annual Report.

This section is set out as follows:

- Guiding principles
- Developments since the MTFP
- The adjusted fiscal position
- Timing of proposed measures
- Funding the shortfall until 2019
- Trends in key States assets
- Panel's previous recommendations
- Flexibility post UK referendum
- Risks to achieving the MTFP Addition
- Longer-term challenges

2.2 Principles and recommendations for the MTFP

The Panel described four guiding principles for fiscal policy in its 2015 Pre-MTFP report:

1. Aim to balance the budget over the economic cycle.
2. Aim to ensure long-term fiscal sustainability.
3. Adopt practical and realistic assumptions for future trends in income and expenditure.
4. Include flexibility within a clear framework for expenditure.

The Panel considers that its four guiding principles have been followed during the development of the MTFP and the MTFP Addition.

2.3 Developments since the MTFP

The MTFP set out the States' overall tax and spending envelope for the next four years and departmental expenditure limits for 2016. The MTFP Addition proposes the remaining details for departmental expenditure limits between

2017 and 2019 that fit within the overall spending limits that were agreed in the MTFP. In addition it updates the forecast for States income.

Figure 2.1 shows the central MTFP Addition forecast for total States income (blue bars) and States net revenue expenditure (red bars) between 2016 and 2019 and how it compares with the same data at the time of the MTFP. As has already been explained, total expenditure is unchanged relative to that agreed in the MTFP. However, States income is slightly higher in 2016-18 and about £4m lower in 2019.

Total States income (including the funding mechanism to offset the States payment of rates and for the health charge) is projected to increase from £694 million in 2016 to £789 million in 2019 (a 14% increase). States net revenue expenditure (excluding depreciation) is expected to fall slightly from £740 million in 2016 to £735 million in 2019. In real terms (after taking account of inflation) this means that States income is expected to rise by about 6% but States expenditure is set to fall by 8%.

Figure 2.1

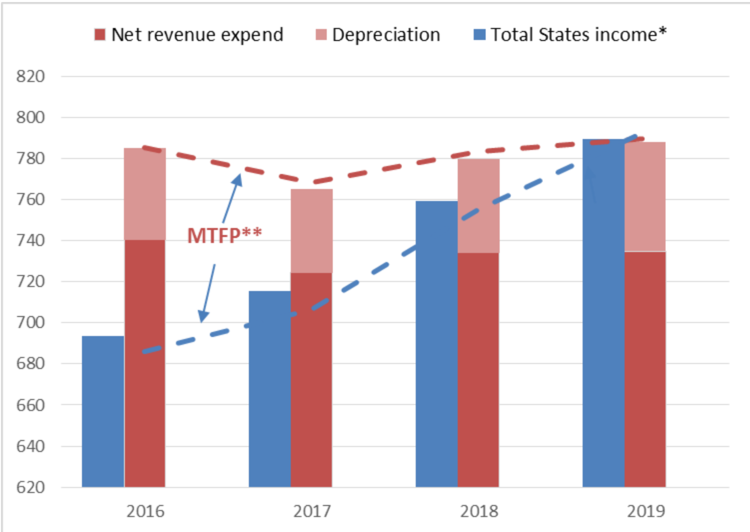
States income and expenditure in MTFP Addition (bars) compared with that in MTFP (dotted lines)

£m (current prices)

Source: States Treasury.

*Includes funding mechanisms

**MTFP expenditure includes depreciation



The variations in States income are the result of changes to the underlying forecast and also the revenue that will be raised from the proposed health charge. There have been two new forecasts for States income since the MTFP - one for Budget 2016 and the latest one in the MTFP Addition. The forecast for Budget 2016 led to a number of small variations compared to the MTFP 2016-19 position which generally reflects an improvement in the 2015 position, a reduction in 2016 and small net changes in the position over the remaining forecast years.

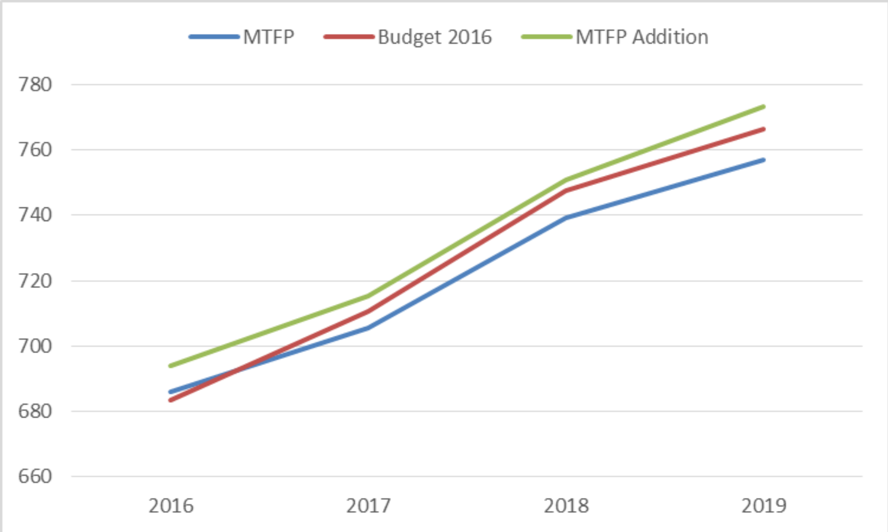
The forecast for States income in the MTFP Addition included a number of further variations as a result of improvements in personal tax revenue and a small net reduction in corporate tax (there were also slight variations in impots duty and stamp duty forecasts). The chart below shows that the net impact of all these changes is that States income (before including the proposed funding mechanisms to offset States payment of rates and for health) was expected to be £16m higher in 2019 in the MTFP addition than at the time of the MTFP.

Figure 2.2

States income (before funding mechanisms)

£m (current prices)

Source: States Treasury.



The improvement in the underlying forecast of States income between the MTFP and the MTFP Addition means that the proposed mechanism for the sustainable funding of health has been altered, and is now calibrated to raise £7.5m in 2018 and £15m in 2019, compared with £15m and £35m respectively at the time of the MTFP.

The chart below shows that the combination of all these income and expenditure trends means that the States operating position (States income less net revenue expenditure) was projected to move from being £46m in deficit in 2016 to a surplus of £55m by 2019. Once depreciation is included the current balance moves from a deficit of £91m (just over 2% of GVA) in 2016 to near balance in 2019.

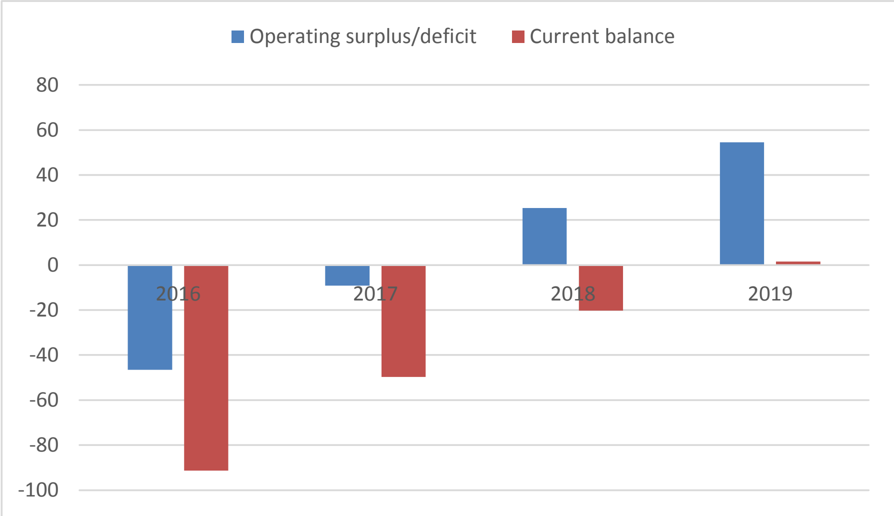
Figure 2.3

States projected fiscal position 2016-2019

The difference between States income and net revenue expenditure (operating position) and including depreciation (current balance):

£ million (current prices)

Source: States Treasury



The FPP's advice in previous reports was to balance the current budget by 2018/19 as that was the point when the economy was expected to be back to capacity. However, the revisions to the economic assumptions set out in section 1 and the accompanying analysis suggest there are two different potential implications of the UK's withdrawal from the EU for the economic outlook:

- That GVA trends are weaker in the 2016-19 period meaning that the economy returns to capacity later than previously expected (the impact is largely cyclical).
- That GVA trends are weaker but there is also a reduction in the capacity of the economy which means that the economy is still likely to be close to balance in 2018/19 (both a structural and cyclical impact).

It is not yet clear to what extent the impact will be primarily structural or primarily cyclical, but the most likely outcome is that the economy will return to capacity by 2019, but at a lower level than before. The implications of these trends for the overall approach to fiscal policy are considered in more detail in the following sections of this report.

The ability to balance the books by 2019 (on the basis of the forecasts in the MTFP Addition and before the implications of the UK referendum were considered) is dependent on successfully implementing a range of measures. These measures total £123m and are a package of expenditure savings, efficiencies, benefits changes and user pays charges (including a new health charge). At the time of the MTFP it was thought this package of measures would need to total £145m but changes since then have allowed that total to be revised to £123m mainly due to improved income forecasts (£16m by 2019).

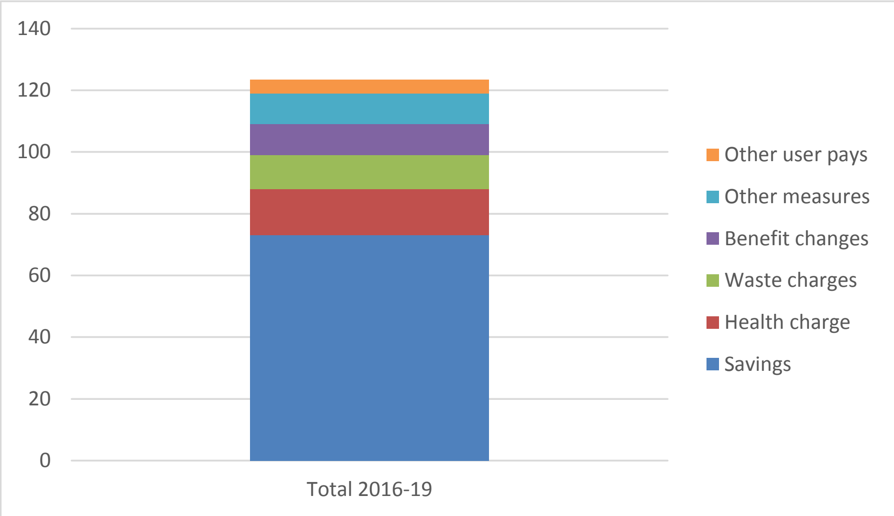
The chart below shows that the largest component of the £123m package is expenditure savings (£73m) which includes those already agreed for 2016 (£32m) and proposed for 2017-19 (£41m). The other key components are a £15m health charge, £11m waste charges, £10m benefit changes (including £5m agreed for 2016), £10m of other measures and £4.5m of other user pays measures (which are included as expenditure savings in the MTFP Addition).

Of the £73m of expenditure savings there are £71m that the Council of Ministers considers to be efficiencies that will have little or no impact on the level of service provision experienced by the public. £24m of this will be achieved through pay restraint. The remaining £1.8m of savings are considered more likely to impact on the level of service provision, with the largest of these savings being in Community and Constitutional Affairs, Economic Development, Tourism, Sport and Culture and Health departments.

Figure 2.4
Measures proposed in MTFP Addition by 2019

£ million

Source: States Treasury



The £10m of other measures is made up of a £5m per year transfer from the health insurance fund for the 2016-19 period and adjustments to the 2016 contingency provisions over the period of the MTFP. The analysis in section 10 of the MTFP Addition sets out the measures that are sustainable and excludes the £10m of these other measures. If forecasts are achieved this would suggest that there is a further £10m adjustment required in the next MTFP period to fully address the funding pressures currently identified. **The FPP recognise that this approach may be appropriate in the short-term especially given the weaker economic outlook but also emphasise the need to make sure this funding gap is fully addressed in the next MTFP.**

However, the Panel also feels that it would be beneficial in future to have clearer rules around the quantum of contingencies that are required and what they can be used for. This would allow for more transparent financial planning.

Comparing the measures in the MTFP with those in the draft MTFP Addition also highlights that the target for savings/efficiencies/user pays has fallen from £90m to £77m. The Council of Ministers has explained in the MTFP Addition that this target was reduced as it became clear that it "would have a disproportionate impact on the community". Also, the timeframe for departments to find efficiencies had been extended to allow them to continue to restructure and reduce costs over a longer period. It is recognised that the next MTFP will require further efficiency savings to meet the cost of the ageing society and that departments must therefore continue to:

- focus on priority services
- provide services more efficiently and cost effectively
- simplify processes
- restructure and merge departments
- remove unnecessary regulations
- maintain pay restraint
- invest in e-Government.

On the last point, it is important to make sure this investment is productive and that it actually delivers improvements in efficiency and effectiveness.

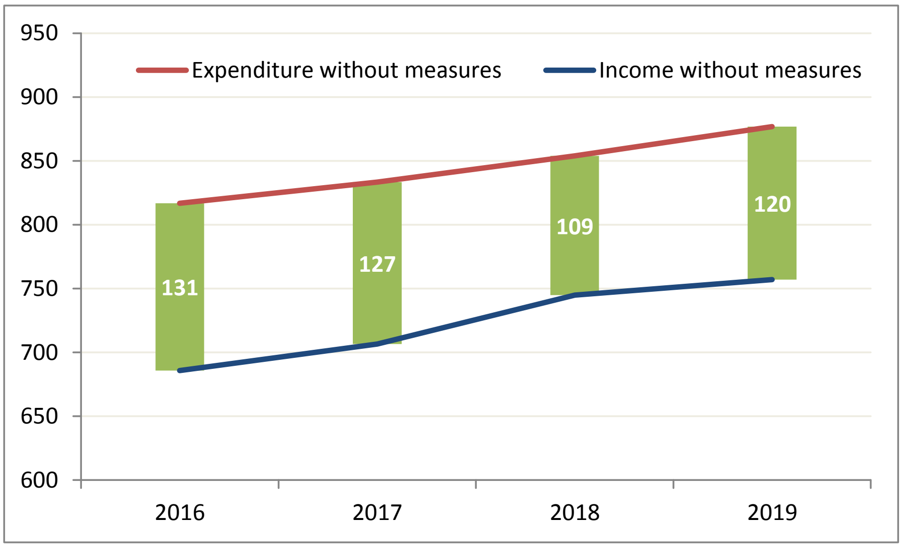
The FPP have previously pointed out that making savings and efficiencies in the public sector was highly desirable irrespective of the economic conditions the Island faced. Given the weaker long-term outlook for the economy this process is now critical. **The Panel is encouraged by the approach outlined in the MTFP Addition and would urge the Council of Ministers to ensure that a permanent programme for securing additional efficiencies in the public sector is fully embedded in all future States financial planning. Progress in achieving efficiencies should be closely monitored, given their critical importance to the plan.**

Figure 2.5 shows that without the extra measures, the adjusted deficit would fall somewhat over 2016-2018 but would grow again in 2019 to end at £120m - just £11m lower than the projection for 2016.

Figure 2.5
Adjusted deficit without measures

£ million

Source: States Treasury



2.4 The adjusted fiscal position

As described above, the MTFP Addition proposes that the States will run deficits in 2016 -18 on the current budget, before the public finances are brought back in to balance by 2019. It is possible to adjust this picture to include all the States funds and the timing of capital spending in cash flow terms (i.e. when the money will be spent) to give an indication of whether the States as a whole is planning to spend more in the Jersey economy than it takes out by raising revenue, and to what extent.

Figure 70 on page 186 of the draft MTFP Addition sets out how this calculation is done in detail. However, the key steps are as follows:

- **Calculate operating surplus/deficit** (total consolidated fund income less expenditure) excluding capital allocations (as money is not always spent when it is allocated)
- **Add capital expenditure profile** to operating surplus/deficit (including that of traders such as Andium Homes and States of Jersey Development Company - SOJDC)
- **Add flows into and out of additional funds** including trading funds, social security fund, health insurance fund, long-term care fund
- **Equals adjusted fiscal position**

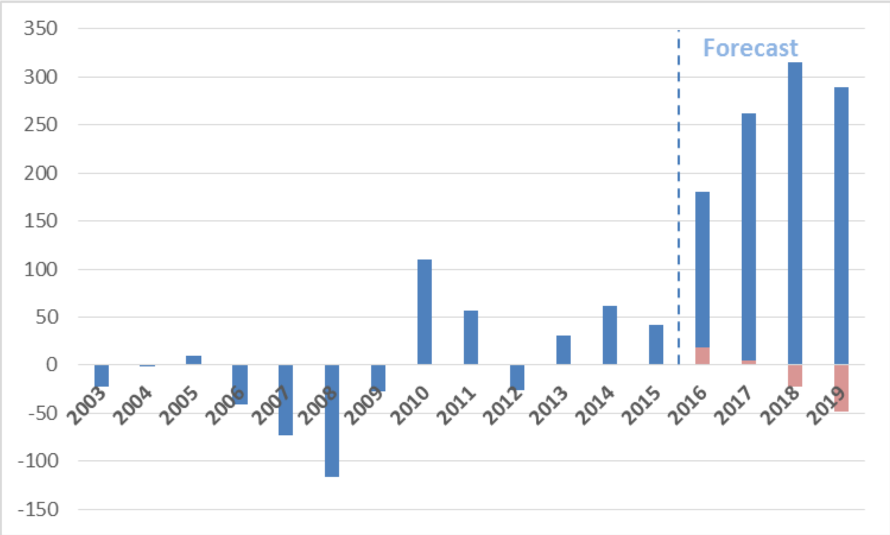
The chart below shows the outcome of this analysis. The States will add in excess of £250m to the economy in each of the years 2017-19. This is equivalent to more than 6% of GVA each year, although this is highly dependent on how much of the planned capital expenditure over the next few years takes place in line with the expected timeframe. The red bars in the chart below show that excluding the impact of capital expenditure the adjusted fiscal position is much more neutral over 2016-19. Without capital expenditure, the adjusted position would be one of very small deficits moving to small surpluses by the end of the period. **This highlights that delivering capital expenditure on time relative to current plans is critical to delivering stimulus to the economy over the course of the MTFP Addition.**

Figure 2.6

Estimates of adjusted fiscal position (States spending relative to revenue)

£ million (current prices) including States trading departments, Andium and SOJDC, red bars show position for 2016-19 excluding capital expenditure

Source: States Treasury



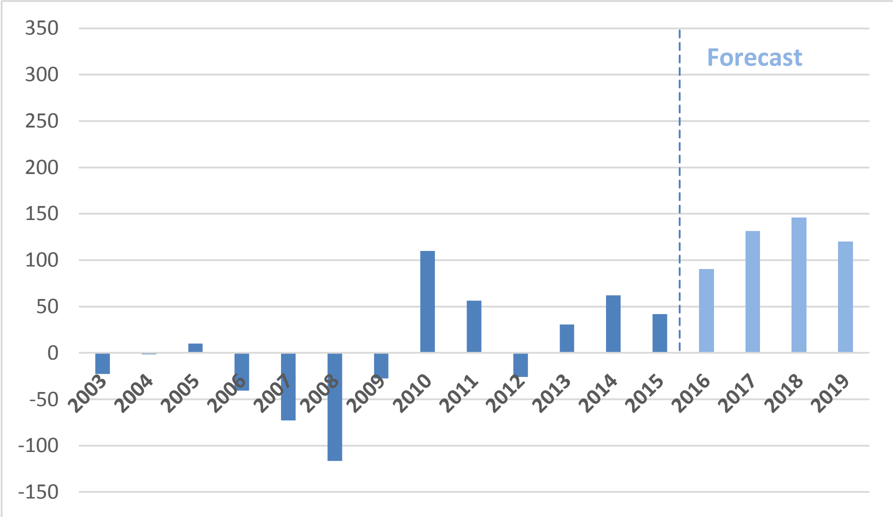
Experience in recent years suggests that the outturn for capital expenditure has generally been well below the level now planned and below the past plans for capital spending. However, even if only half of the projected capital expenditure is delivered in coming years the States would still be putting significantly more into the economy than it takes out at around between £120m-£150m each year in the 2017-19 period. This is equivalent to between 3-4% of GVA and significantly exceeds the level in recent years.

Figure 2.7

Estimates of adjusted fiscal position (States spending relative to revenue). Lower estimate 2016-2019.

£ million (current prices)

Source: States Treasury



The Panel advised previously that the States should plan how it will deliver such large scale capital investment to reduce the risk of a build-up of inflationary pressure in Jersey's economy. However, the period of uncertainty triggered by the UK's decision to leave the EU may require a change of focus. Given the scale of capital expenditure spread over a number of years there will still be a need to ensure the States could reduce the impacts on the local economy should capacity constraints emerge. Nonetheless, these concerns about the degree of spare capacity in the local economy in future are somewhat alleviated by the change in the economic outlook highlighted in section 1 of this report. **The Panel now believes that a key priority is to ensure that the planned capital projects are delivered on time and particularly during the period when economic growth is now forecast to be weaker and economic slack greater. More attention and urgency should be given to those projects which are likely to have the largest positive impacts on the local economy.**

2.5 Timing of proposed measures

The £113m of sustainable measures (excluding the £10m of other measures) proposed in the draft MTFP Addition by 2019 is gradually phased in over the period. The net impact rises from £39m in 2016 to £56m in 2017 and to £83m in 2018. The chart below shows how much is raised in total each year through the key measures. All show a similar profile of gradually increasing impact over the period. By far the biggest contribution (£46m in 2019) comes from efficiencies in government spending which the Panel has already highlighted should be pursued whatever the economic conditions.

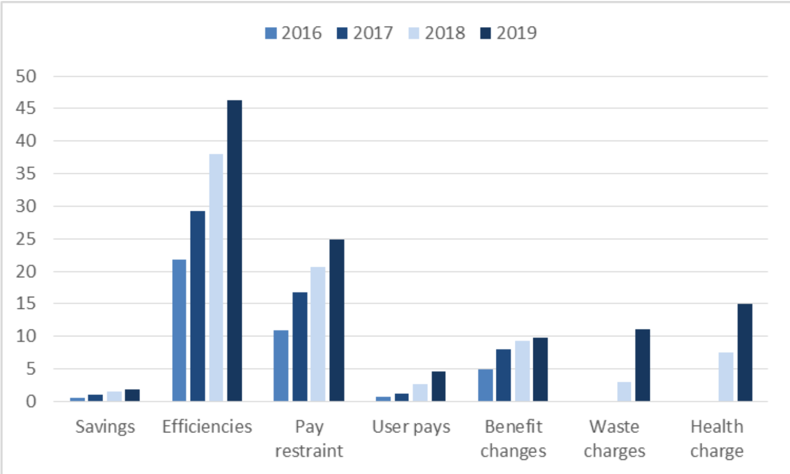
Given the overall profile of the States' adjusted fiscal position and the fact that it adds significant stimulus to the economy over the MTFP period, the FPP does not recommend at this time changing the profile of the package of measures aimed at addressing the funding shortfall. This will be kept under review in future reports as economic conditions develop.

Figure 2.8

Timing of the planned measures in the MTFP Addition

£ million (current prices), cumulative

Source: States Treasury



2.6 Funding the shortfall until 2019

Whilst these planned measures are being phased in, the States will still need to finance the shortfall between income and expenditure each year until 2019.

The draft MTFP Addition proposes to do this mainly by using the Strategic Reserve with £107m being withdrawn in 2016 and 2017 and £20m being repaid in 2019. This results in a net drawdown over the 2016-19 period of £87m. This is in addition to the withdrawal of £14m already agreed in the MTFP for 2015 (to cover Committee of Inquiry costs and the redundancy provision). At the time the MTFP was agreed last year the drawdown from the Strategic Reserve in 2016-19 was expected to total £127m although £30m was expected to be repaid in 2019 leaving a net drawdown of £97m. In addition there was also expected to be a £30m withdrawal from the Health Insurance Fund (HIF) in 2016 and 2017 which is no longer required (although three payments of £5m from the HIF are now included in the other measures described above). The £8m payment from the Criminal Offences Confiscations Fund is unchanged since the MTFP.

Overall this approach remains in line with the Panel's previous recommendations to gradually withdraw fiscal support from the economy as it recovers, and to use the States' reserves to pay for this whilst the planned measures to bring the States' finances closer to balance are phased in. **Whilst**

the economic outlook is affected by the UK referendum result, the Panel does not think it necessary at this time to change the broad approach. It remains important that the States supports the economy in the short-term and that progress is made in achieving a more sustainable position in the medium-term irrespective of the exact future relationship between the UK and the EU.

Figure 2.9

Consolidated fund changes

£ million (current prices)

Source: States Treasury

	2016 £ m	2017 £ m	2018 £ m	2019 £ m
Consolidated Fund opening balance	65	51	28	19
Forecast operating surplus/(deficit)	(47)	(9)	25	55
Capital programme funding	(27)	(65)	(43)	(33)
Proposed transfers from Strategic Reserve	57	50		(20)
Proposed asset disposals	3	1	1	1
Proposed transfer from COCF			8	
Consolidated Fund closing balance	51	28	19	22

2.7 Trends in key States assets

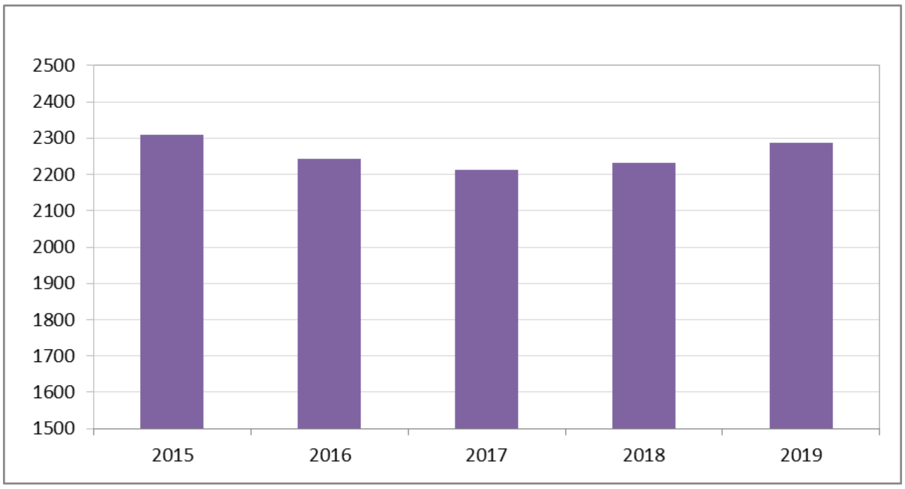
Figure 2.10 shows the projected net asset positions for the States' largest funds - an indicator of States reserves - from the end of 2015 through to the end of 2019 in real terms. The projection includes the income and expenditure of the Strategic Reserve, the Social Security Funds, the Consolidated Fund, the Health Insurance Fund, the Stabilisation Fund and the Long Term Care Fund.

It shows that in real terms the value of these reserves will decline slightly before returning to a similar level in 2019 to that in 2015. These trends are made up of an increase in the value of the Social Security Reserve Fund with the other funds all tending to fall slightly in real terms. By 2019 the value of these reserves will be about £2.5bn in nominal terms which equates to just slightly less than 60% of GVA. **The Panel has previously noted that the Council of Ministers fiscal framework commits to monitoring the trends in States assets and liabilities and this is something the Panel will continue to monitor in future reports.**

Figure 2.10

States reserves projections in real terms

Total year end net assets, £ million (constant 2015 values) projections for the States' largest Funds (Strategic Reserve, Social Security, Social Security Reserve, Consolidated, Health Insurance, Stabilisation and Long-Term Care Funds)



Source: States Treasury

2.8 Panel's previous recommendations

The recommendations from the FPP's 2015 Annual Report are repeated in Appendix 1 of this report. The Panel is encouraged that overall the draft MTFP Addition appears to be responding to these recommendations and that further progress has been made since the MTFP was agreed.

With respect to these recommendations, the FPP continues to advise that:

- The analysis of the States' overall fiscal position (including all funds) has progressed in the MTFP Addition and needs to continue to develop to include contingent liabilities such as those related to the ageing population and the position on public sector and social security pensions (previous recommendation 1).
- Given the economic uncertainty created by the UK referendum result, it is important to maintain the focus on ensuring the MTFP Addition is sufficiently flexible to adapt to changing economic conditions. This is covered in more detail in the next section (previous recommendations 3 and 6).
- The draft MTFP Addition does set out the level of efficiencies that are required to address the funding shortfall but it will be important to explain how this and the other savings measures will impact on public services and the scale of the proposed changes relative to the total spending on these services (previous recommendation 4).

- The distributional analysis is welcome and the FPP are encouraged to see that it was factored into decision making (previous recommendation 5).
- The work being undertaken by Social Security looking at the sustainability of the Social Security Funds in the light of the ageing population is an important first step in meeting the FPP's recommendation to develop a strategy for the ageing society. However, this approach needs to be developed much further to take a whole-of-government view and the issues clearly communicated to the whole community (previous recommendation 7).
- The governance procedures in place for the Economic and Productivity Growth Drawdown Provision (EPGDP) meet the Panel's previous recommendation 8. However, given the scale of the productivity challenge facing the Island, which recent events mean is even more important to tackle, these funds should be focused on medium-term policies that help raise productivity and increase the underlying rate of economic growth.

2.9 Flexibility post UK referendum

In its July 2016 update report the Panel advised that "the MTFP sets a clear path for fiscal policy for the next few years and ad hoc adjustments to that path should not be made while the impacts of the UK's referendum remain so uncertain". In the light of the analysis in section 1 assessing the economic outlook, the Panel continues to recommend that the initial response should be for the States to allow the automatic stabilisers to work (i.e. allowing spending on some benefits to naturally increase and tax revenue on earnings and profits to naturally fall to offer some initial support to the economy without making any explicit policy changes). The States should focus on ensuring that the measures proposed in the MTFP Addition are delivered and in particular that:

- The intention to support the economy in the short-term through significant capital investment is actually achieved and that capital projects that benefit the local economy are delivered on time in line with existing timescales.
- The package of measures identified to raise £123m by 2019 are implemented (or alternatives put in place) and phased in as currently planned.
- **The time to address any (as yet unidentified) structural impacts of the UK's decision to leave the EU on the local economy and States finances is the next MTFP period. However, this is contingent on the**

expectation that the current package of measures (or others of equivalent value) are delivered.

- **If there is a short-term adverse impact on the Jersey economy, as suggested in the updated economic assumptions, the States may need to draw more from its reserves over the 2016-19 period. The Panel believes that this is preferable at this stage to implementing additional fiscal adjustment (above what is already planned) during what will be a period of continued external economic instability.**

Given the economic conditions and general uncertainty facing the Island in coming years it is however vital to ensure that additional flexibility is built into plans over the 2016-19 period. As explained in the FPP's July 2016 Update Report, this flexibility is needed in both directions:

- Firstly, the ability to add further support to the economy if the Island economy performs well below what is currently expected and employment is materially affected and/or some of the fiscal support in existing plans is delayed or postponed. Any further support should be implemented in line with the principles of the 3Ts: timely, targeted and temporary (see Box 1 overleaf).
- Secondly, recognising that there is likely to be some structural impact on the future performance of the economy and that this will require further reductions in expenditure and/or increases in revenues to bring the budget back to balance in the next MTFP period. It is important to start developing plans for this especially given the fiscal challenges of future demographic trends. If the economy performs better than expected in the short term there might even be a case for bringing these measures forward towards the end of this MTFP period. The July Update report highlighted the key considerations under each of these scenarios and this is repeated in Box 1.

Given that section 1 concluded that a structural loss of output is the most likely impact of the UK referendum, it is therefore likely that further tightening will be required.

Box 1: Summary of policy options from the July 2016 FPP Update Report

Further fiscal support

Should short-term fiscal support be appropriate, it will be important to ensure that any proposals are consistent with the 3Ts i.e. are timely, targeted and temporary. In the past the FPP have advised to look first at capital expenditure that is necessary at some time, and brings economic benefit in its own right. This still applies today but given the significant amount of capital expenditure already planned in the MTFP it may be that it is hard to find suitable projects that satisfy the 3Ts and/or can be delivered from local capacity. Given the risks of delay in capital projects, however, it would be important to ensure that current projects are delivered on time to ensure that the planned stimulus is actually delivered.

Capital expenditure of this type helps to mitigate concerns about leakage which is inevitable in a small open economy like Jersey. Alternative fiscal measures to support the economy all have some risk of benefits leaking outside the local economy (for example through spending on imports) and have other risks associated with them. Looking at some of the main options in turn:

- **A reduction in GST** may not be passed on fully to consumers and is not well targeted as it benefits everyone – those on low and high incomes and residents/visitors alike. Further, it may prove politically difficult to increase the rate of GST back to its previous level, putting fiscal consolidation at risk.
- **Income tax changes** do not benefit those who do not pay tax and are difficult to make timely because of the lags in the tax system.
- **Employee social security contributions** only impact on those who have employment income and could have implications for the Social Security Fund.

Another way of looking at how to support the economy would be to consider whether any of the tightening measures already set out in the MTFP could be slowed or introduced with a slight delay in a way that is consistent with the 3Ts and which would mean they are more effective than any of the options considered above. It will be important to fully assess the fiscal situation and the specific nature of the economic shock hitting the economy before determining what, if any, is the most appropriate response.

Further fiscal tightening

As this would be required to address a permanent impact on States finances, there will need to be consideration of measures that deliver a lasting change to fiscal policy. This will require assessing what can be achieved and in the timescales required both in terms of additional revenue raising and/or reductions in government spending. Consideration could be given to measures in the MTFP that could be increased or introduced more quickly. Preparing the groundwork and understanding what needs to be done to implement specific measures should be done in advance.

2.10 Risks to achieving the MTFP Addition

There are several risks to successfully delivering the fiscal plans over the 2016-19 period.

Future revenue trends

There is always significant uncertainty in forecasting future trends in revenue: neither economic trends nor their precise implications for public finances are readily forecastable, which is why the FPP chooses to show ranges around the central projections. However, external economic volatility has clearly been exacerbated by the UK's decision to leave the EU, and the range of possible outcomes is much wider than normal. As previously highlighted, an important part of the economic stabilisers is to allow tax revenue to adjust to economic conditions and this should not lead to knee-jerk changes to fiscal policy. However, the longer-term and structural impacts of these trends are difficult to predict today and it is difficult to gauge the appropriate structural adjustment.

Controlling expenditure

Although the draft MTFP Addition now sets out the detail of the spending plans for 2016-19 there is still a risk that current savings and efficiencies may not be delivered. This risk has been reduced as a result of the detailed proposals in the MTFP Addition but that does not mean it has been totally removed.

Political risks

A number of political risks remain. Firstly, a risk that there is not sufficient buy-in to the proposals so that some of them are delayed or postponed without any additional proposals being implemented in their place. This risk has been reduced by publishing the detailed distributional analysis of the measures proposed in the MTFP Addition.

Secondly, there is the possibility that in the light of changing economic and fiscal conditions as a result of the UK's withdrawal from the EU, ad hoc policy adjustments are made that undermine the sustainability of States finances. The Panel hopes that FPP advice would be sought in advance of any significant adjustments, to reduce this risk.

The timing of capital expenditure

As already discussed, delays to capital projects can prevent fiscal support reaching the economy when it is relatively weak. Conversely, there is the risk that large projects could come on stream at times when the economy and/or construction sector is short of capacity - adding to inflationary pressure and reducing value for money for the States.

Population policy and immigration

Immigration is an important element of the supply side of the economy. If it is too constrained, or does not prioritise the skills and occupations that are most important for growth and productivity, it will have a detrimental impact on the economy and public finances, particularly in the longer term. How population policy is implemented will be very important to the success of the draft MTFP Addition. **Migration policy should be implemented in a pragmatic way that does not constrain the supply side of the economy and in particular the ability for businesses to attract key skills. A failure to get this right would exacerbate the structural pressures the economy already faces.**

2.11 Longer-term challenges

The ageing population

The draft MTFP Addition aims to balance the public finances by 2019. However, demographic pressures are likely to put further structural pressure on public finances in the longer term. The fact that people are now living longer will have significant consequences for Jersey (and many other economies) and for the States' public finances.

The impacts of an ageing population will be gradual - taking place over the next twenty years or so. The States will need to make sure that it can make any necessary policy changes in time to address the pressures that will emerge. The review of the Social Security Fund is an important first step but is not in itself sufficient to deliver the policy changes required. The Panel has previously welcomed the Council of Ministers' commitments to develop a rolling long-term plan and see this as important to achieving the longer-term strategy for addressing the implications of the ageing society.

Increasing productivity

Improving Jersey's underlying rate of productivity growth is vital to raising Jersey's economic performance and competitiveness, improving public finances and ultimately raising the standard of living particularly as the underlying demographic changes start to have more of an effect.

The Panel welcomed the setting up of the Economic and Productivity Growth Drawdown Provision but also emphasises that with an ongoing programme of public sector efficiencies and savings that it is important to ensure investment is not cut in areas critical for sustainable growth and continued expansion of productive capacity. This includes areas such as education and skills and key areas of infrastructure but also requires effective policies in other areas such as enterprise, inward investment and innovation.

The future performance of the financial services sector in Jersey is critical to the Island's future economic performance and it is important that continued progress is made in meeting the external political and regulatory challenges that pose risks for the long-term prospects of the finance industry.

Appendix 1: FPP's 2015 Annual Report recommendations

1. The analysis of the States' overall fiscal position (including all funds) needs to continue to develop and the 2016 MTFP Addition will be a good opportunity to expand this analysis further.

2. The States should plan how it will deliver capital projects to reduce the risk of a build-up of inflationary pressure in Jersey's economy. To avoid the need to change the timing of important projects or make adjustments to other spending or income, the States should consider whether resources could be imported cost-effectively from outside the island to reduce any bottlenecks within the local economy.

3. The States should also maintain other flexibilities, such as the timing of tax changes or other States expenditure, which could be used to ensure fiscal policy remains counter-cyclical.

4. The draft MTFP and 2016 MTFP Addition should be clearer about how much of the £90 million savings will be due to improving efficiency.

5. As details of the proposed package of measures for the 2016 MTFP Addition are developed attention should be given to ensure that they are sustainable, including their potential distributional impacts.

6. Given the risks to delivering the scale of savings required, the planning around flexibility to address the overall structural position must continue. The States should ensure these measures can be implemented in practice if necessary, and also take care that any short-term flexibility measures carried out do not compromise long-term sustainability or efficiency.

7. A strategy for managing the fiscal consequences of an ageing population should be progressed and take a whole-of-government view, considering the long term sustainability of all States' income, expenditure and their supporting Funds together.

8. The Panel welcomes the additional funding for the economic and productivity growth provision but stresses that strong governance measures should be put in place to control how the £20 million is allocated.