Jersey's
Fiscal Policy Panel
Annual Report
July 2011

Introduction

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

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

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

In making its recommendations, the Panel is guided by its understanding of the preferences of Islanders. The Panel feels that Islanders want the States to be prudent, 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 many occasions. Its work has benefited greatly from the discussions it has had with many people and institutions on and off the Island: its job would be much more difficult without their generosity. The Panel is also grateful for the invaluable support provided by the staff of the States of Jersey, in particular the States of Jersey Economics Unit.

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

Recommendations

- Jersey should continue to plan on the basis of a fragile and drawn-out global recovery.
- The Panel is not recommending any transfers into or out of the Stabilisation Fund or Strategic Reserve at this stage.
- On current forecasts and policies, the financial position remains extremely tight. The decision not to progress all of the reductions in expenditure included in Budget 2011 should be reconsidered, or alternative measures of a similar magnitude should be found. Further decisions that reduce revenues or increase expenditure in the medium term without offsetting savings or revenue should be avoided.
- The pace and nature of fiscal consolidation in the near-term remains broadly appropriate given the current economic outlook. Looking further out, more ambitious plans will be needed to rebuild the Stabilisation Fund by running larger surpluses as the economy recovers. Should the economic outlook change, however, the Panel would need to reconsider this advice.
- The Panel continues to recommend that any unallocated funds in the Consolidated Fund in excess of £20m should be transferred into the Stabilisation Fund.
- The fiscal stimulus process has been conducted in an appropriate way, with a suitable process for ensuring that projects received funding in a timely, temporary and targeted manner. This should have increased the effectiveness of the programme from an economic perspective.
- The Panel recommends further measures to strengthen medium-term fiscal strategy. For example, there could be value in establishing a process that takes a strategic look at medium-term fiscal policy, involving a consideration of plausible future fiscal scenarios, the risks and opportunities to income and expenditure and the setting of strategic priorities.

Section 1 - The Economic Outlook

Key points

International economic outlook

- Global economic growth has returned to a rate of just over 4% a year – similar to pre-recession growth rates.
- However, growth in the advanced economies is forecast to remain well below that in developing and emerging economies, and to be insufficient to significantly reduce unemployment.
- Oil and other commodity prices continue to rise and act as a drag on global economic activity.
- A 'double dip' recession remains a relatively unlikely scenario, but risks remain on the downside, and have, if anything, increased. It would be prudent for Jersey to plan on the basis of a fragile and drawn-out global recovery.

Jersey economic outlook

- Measured Gross Value Added (GVA) for the Jersey economy is likely to have fallen more sharply than previously anticipated in 2010, but indicators for the finance sector suggest that the outlook for 2011 has improved slightly since the last annual report in November 2010.
- There are some signs of improvement in the non-finance sector, but the outlook remains subdued.
- Household finances will be squeezed in the short-term by a combination of the increase in Goods and Services Tax (GST) and increases in food and oil prices. In time, higher interest rates will be a factor too.
- The Panel judges that measured GVA fell by a further 6-8% in 2010, and forecasts growth of 0-3% in 2011 and 0-4% in 2012. Risks remain to the downside and to a greater extent than in November.
- Longer-term concerns have increased. There are still threats to the zero-ten corporate tax regime and changes to the international tax and regulatory environments pose challenges to Jersey's business models and are altering the relationships between Jersey banks and their parents.

1.1 International outlook

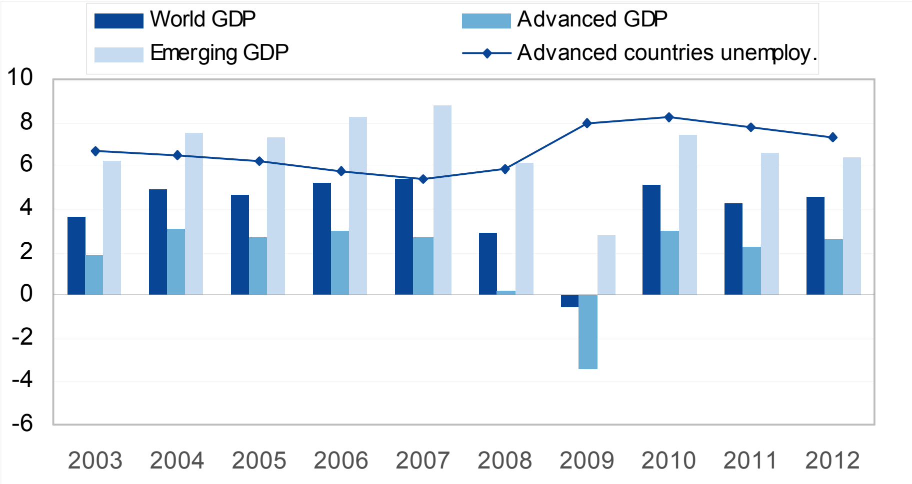
The latest IMF forecasts suggest that global economic growth will continue at a little over 4% a year – a similar growth rate to that seen before the recession, with growth in the emerging and developing countries far exceeding that in the advanced economies (Figure 1.1) .

Figure 1.1

Unemployment set to remain high despite growth

% change on previous year

Source: IMF World Economic Outlook, April 2011 and June 2011 Update



As has been noted by other commentators[1], what is so unusual about the recent recession in the advanced economies is not only its depth, but also the probable absence of a subsequent period of above trend growth to bring output back to its pre-crisis path.

This is illustrated by forecasts for the UK from sources such as the Bank of England which show that the level of activity will not have returned to the path anticipated before the onset of the global financial crisis by 2012. The effect of this is that a structural 'hole' – i.e. an ongoing deficit that is not likely to 'net out' over the economic cycle – has appeared in the public finances of many countries.

A further consequence is that the slow recovery of advanced economies will not be enough to make a major dent in their high unemployment rates, which are not expected to fall much below 8% by 2012.

The risks to the global outlook remain to the downside. The key risks, summarised in Figure 1.2, are that:

– Oil and other commodity prices continue to rise and act as a drag on global economic activity, and/or lead to higher nominal interest rates than would otherwise be suitable given general demand conditions.

[1] See for example *Monetary Policy in Extraordinary Times*, Speech given by David Miles, available at www.bankofengland.co.uk/publications/speeches

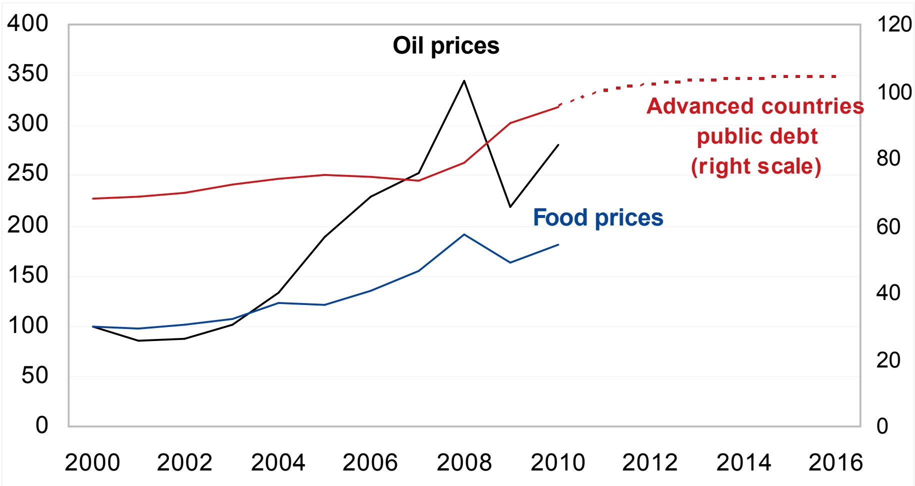
– Political uncertainties are adding to the difficulties in dealing with fiscal issues in both the U.S. and the euro area and global imbalances remain stubbornly high.

Figure 1.2

Key risks to the global economic outlook

Nominal food and oil prices index 2000=100, public debt % of GDP

Source: International Monetary Fund, WEO April 2011



Overall the Panel's assessment of the international economic outlook has not changed significantly since the November 2010 Annual Report. The Panel believes that a 'double-dip' recession is not the most likely outcome but any recovery in the developed economies will be slow and patchy. Substantial downside risks to the outlook remain. Given the linkages between the world and Jersey economies, this means that the States should not be setting fiscal policy on the basis that a robust global recovery is likely, especially as there is a significant probability that the global regulatory environment could have further negative consequences for Jersey's financial sector profitability.

1.2 Jersey economic outlook

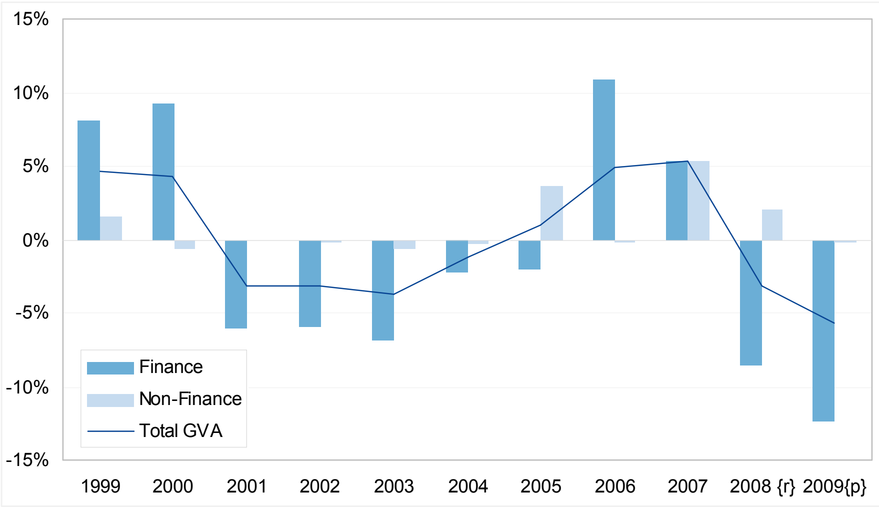
There have been no new data on GVA, a widely used measure of overall economic activity, since the last report. The latest data show GVA in Jersey in 2009 was 6% lower than in 2008, driven by a 12% fall in the output of the financial services sector (Figure 1.3), including a sharp fall in bank profits. This was broadly in line with the expectations of the Panel in previous reports, and with anecdotal and survey data.

Figure 1.3

A breakdown of Gross Value Added growth

Annual % change

Source: States of Jersey Statistics Unit



However, GVA data in Jersey need careful interpretation, largely because a significant component of the overall figure is banking sector profits, which can be volatile and loosely related to changes in the real economy as measured by variables such employment and tax revenue (Box 1). This is because Jersey banks' net interest income largely reflects movements in market interest rates and the relationship between Jersey-based banks and their parents (as described in Box 1 of the Panel's 2009 Annual Report), rather than the level of activity as measured, for example, by the value of deposits or volume of associated transactions.

Box 1: The Effect of Net Interest Income on GVA and the Economy

Banking activities make up 50% of the value of financial services activity and in 2009 financial services activity was worth £1.55 billion of the £3.62 billion total value of the Jersey economy. An important element of income for banks is net interest income; the difference between the interest it receives on its loans and the interest it pays to its depositors.

Before the financial crisis, net interest income made up almost two-thirds of the banking sectors' gross income^, so profits from net interest income are likely to be a notable part of all banking profits and therefore of financial services profits as a whole. Hence, changes in net interest income have a significant effect on overall changes in GVA.

Figure 1.4 shows net interest income since 2007. The falls in recent years are mainly due to lower interest margins as interest rates fell (see Box 1 Annual Report 2009) rather than a fall in banking activity or deposits. The first fall in net interest income in 2009 corresponds to the first fall in banking profits reported in the Financial Institutions Survey.

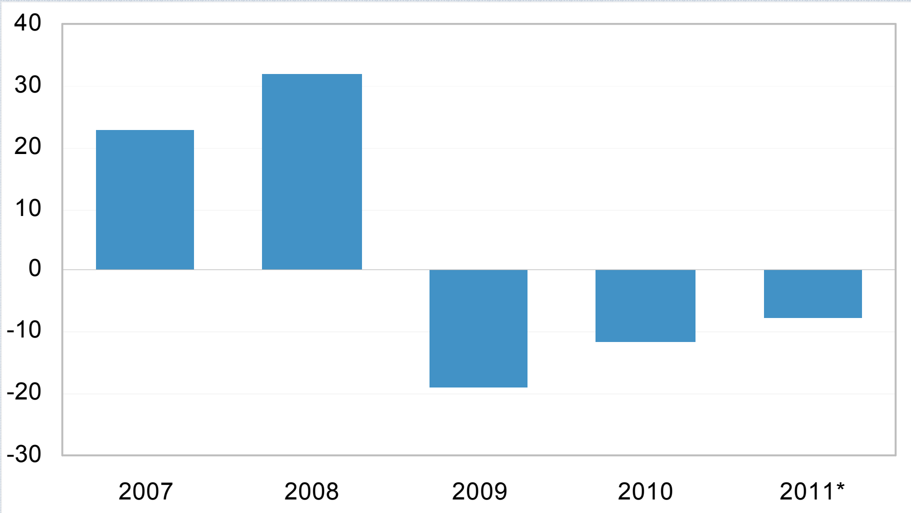
Figure 1.4

Trends in net interest income

Annual % change

Source: Jersey Financial Services Commission

*Annualised based on first quarter



It is possible to look at GVA excluding the profit from financial services, of which banking profits from net interest income is a very large part. Unfortunately current statistics do not distinguish net interest income profits from other banking profits.

Figure 1.5 shows that GVA excluding financial services profits has been less volatile and has shown markedly different movements compared to total measured GVA. The falls in GVA in 2001, 2002, 2008 and 2009 were not apparent in GVA excluding financial services profits. In other words,

Box 1 continued: The Effect of Net Interest Income on GVA and the Economy

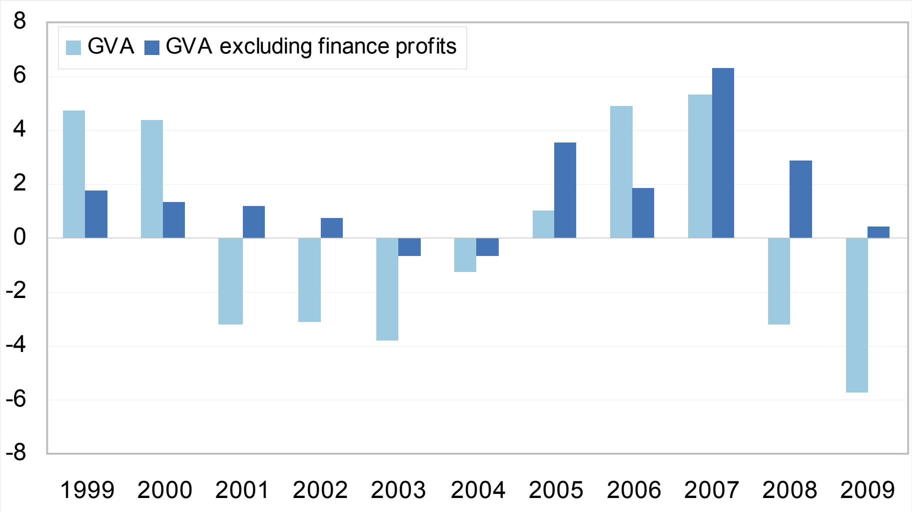
the total value of compensation for employees (wages, salaries other employment costs) and profits of the other sectors continued to rise. This emphasises that looking at GVA alone may give a misleading picture of activity and economic conditions across the whole economy. Excluding financial service profits, GVA grew by 1.5% per annum in real terms over the economic cycle (2000-2007).

Figure 1.5

Trends in GVA and its components

Annual % change in real GVA

Source: States of Jersey Statistics Unit



^ IMF country report no. 09/282, Table 7 page 26

The significant depreciation of the pound sterling against the euro and dollar in 2008 has only partially been reversed and the pound is still some 20% below its 2007 peak (Figure 1.6) making Jersey produced goods and services more competitive. As an open economy that trades in a wide range of goods and services - financial services, tourism, agriculture and internet retailing - the exchange rate depreciation will have been some (albeit moderate) compensation for businesses for the adverse trends in the wider global economy and financial markets in recent years. Nevertheless, there is a downside because buying imports or travelling abroad becomes more expensive.

However, Jersey's competitive position cannot be measured by exchange rates alone and trends in the costs of locally produced goods and services are just as important. Unfavourable trends in unit labour costs (wages), for example, can be just as damaging for exports as those in exchange rates.

Figure 1.6

Sterling exchange rate trends

Index: 08/11/2007=100

Source: Bank of England

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

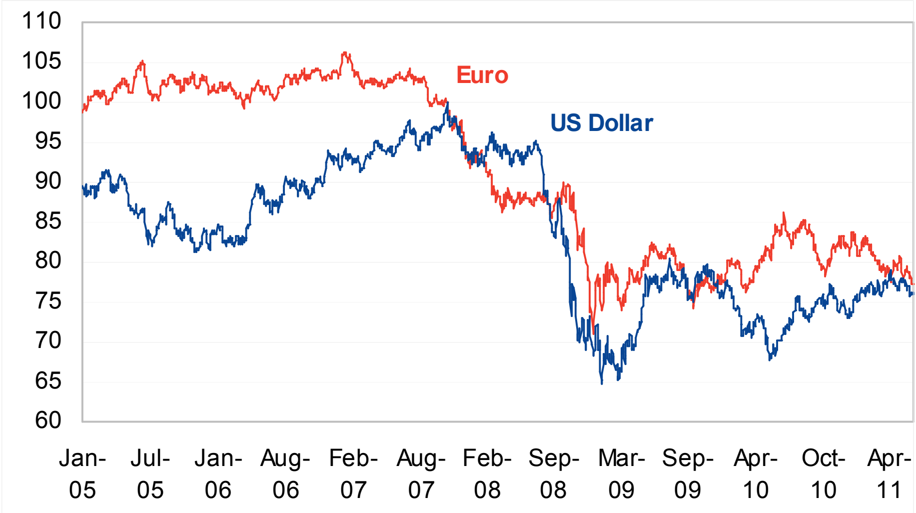


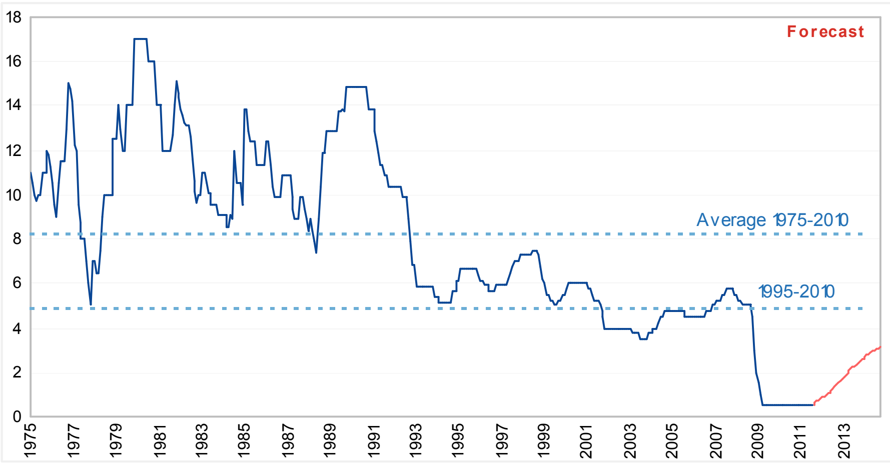
Figure 1.7 shows historic interest rates and financial market interest rates expectations at the time of the last Bank of England Inflation Report in May 2011. Current interest rates are far below those seen in recent decades. There is a large degree of uncertainty about when interest rates will rise as new information becomes available about the speed of the UK's recovery and global financial conditions, but Bank Rate is not expected to regain its 1995-2010 average for some years.

Figure 1.7

Interest rates since 1975

% bank base rate, red line indicates market expectations for Bank Rate as at May 2011

Source: Bank of England



Financial Services Sector

Figure 1.8.shows the recent results of the Business Tendency Survey for the financial services sector. For a sustained period a positive balance of firms has reported that business activity and new business have increased. In addition, for the second time since the Survey started in September 2009, a positive balance of financial services businesses reported an increase in profit

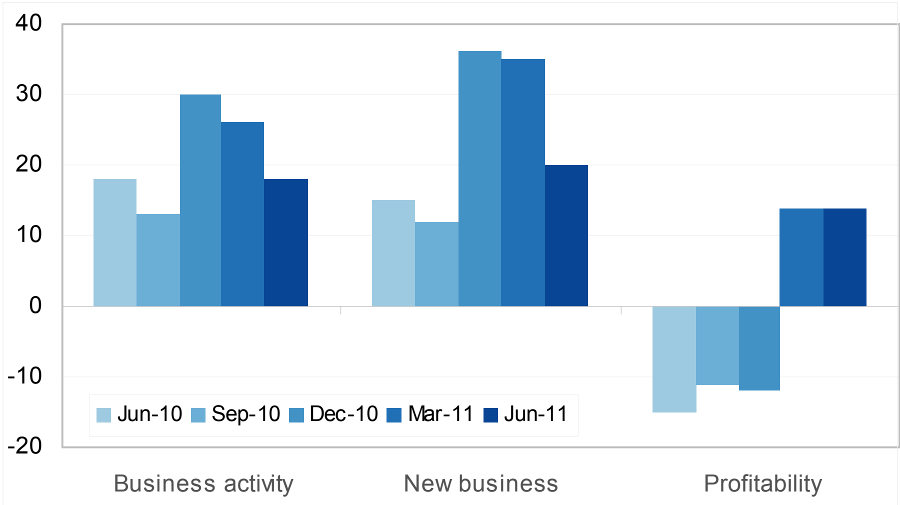
in the second quarter of 2011. The Financial Institutions Survey also showed fairly positive profit expectations for June to September with many finance companies (63%) anticipating an increase. This general picture of improved conditions, including the increase in profits, was supported when the Panel held discussions with representatives of the finance industry.

Figure 1.8

Financial services business tendency

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

Source: States of Jersey Statistics Unit



The recent Financial Institutions Survey revealed a 25% fall in financial services profits in 2010. Financial services businesses were a little more optimistic about current year profits in 2011 than in 2010. Almost two-thirds (63%) expected a rise in profits in 2011 (compared to 50% in 2010) and a similar number expected to increase employment. Only 14% expected profits to decline (compared to 34% in 2010). The Panel interprets this with some caution as the profit expectations for 2010 included in the previous round of the survey proved a poor guide to the outturn.

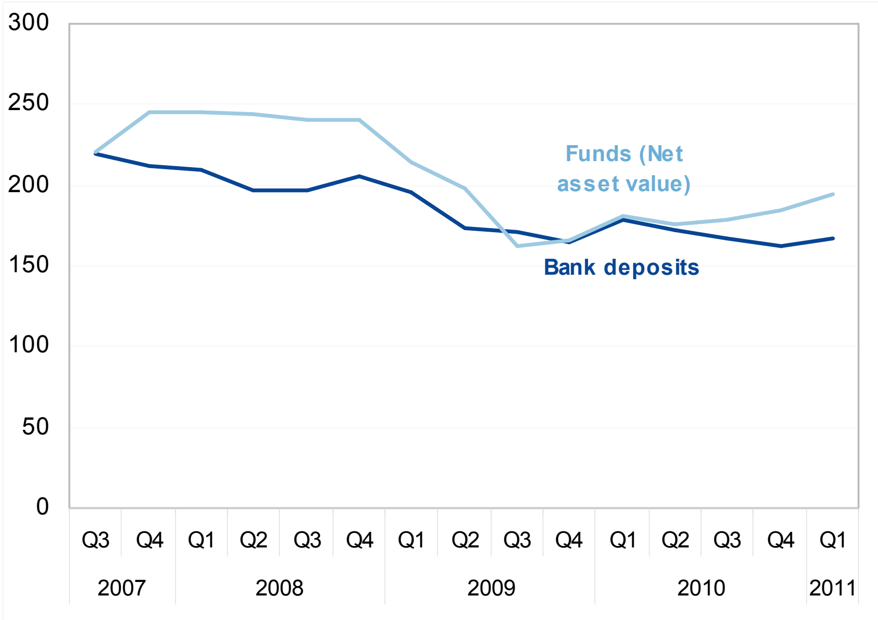
Activity in the financial services sector has increased in the first half of this year. Data from Jersey Finance (Figure 1.9) show that bank deposits, which fell over the course of the downturn, appear to have stabilised and in the first quarter were 3% higher than in the previous three months. In addition, the net asset value of funds under administration increased by 5.4% in the first quarter, to 20% above the 2009 trough.

Figure 1.9

Financial services trends

Funds under management and total bank deposits, £bn

Source: Jersey Finance



Other things being equal, increased interest rates should help alleviate some of the pressure on banks' net interest income. However, other factors may partially offset any improvement in net interest income from higher interest rates and the margin banks get at any given interest rate could be lower in future. In particular, Basel III banking regulations, enhanced liquidity rules applied by the UK Financial Services Authority and proposals by the Independent Commission on Banking are likely to mean that Jersey banks will have to adapt their business models.

The Rest of the Economy

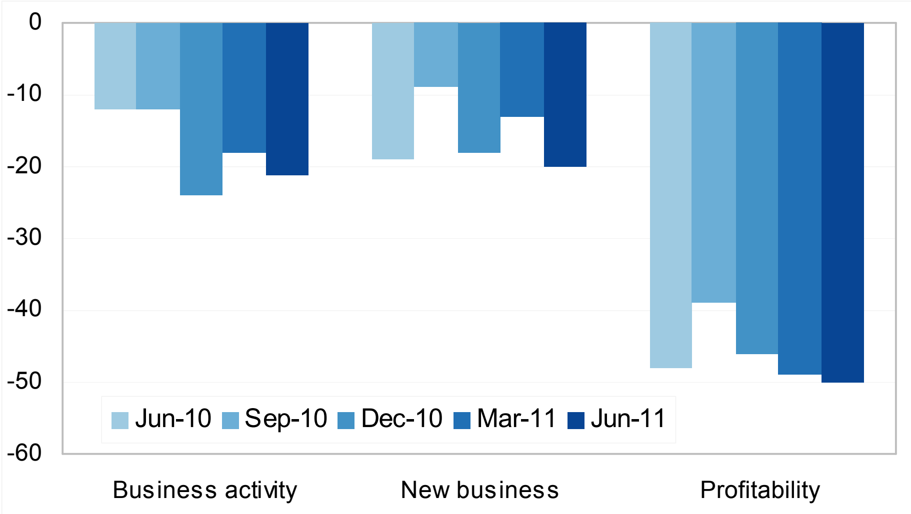
In contrast to the finance industry, non-finance businesses report that business activity, new business and profitability have continued to fall this year (Figure 1.10). In addition, in June, a net balance of 22% of businesses reported a decrease in optimism about the overall business situation. These results need careful interpretation and need to be considered alongside other indicators discussed in more detail below.

Figure 1.10

Non-financial services business tendency

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

Source: States of Jersey Statistics Unit



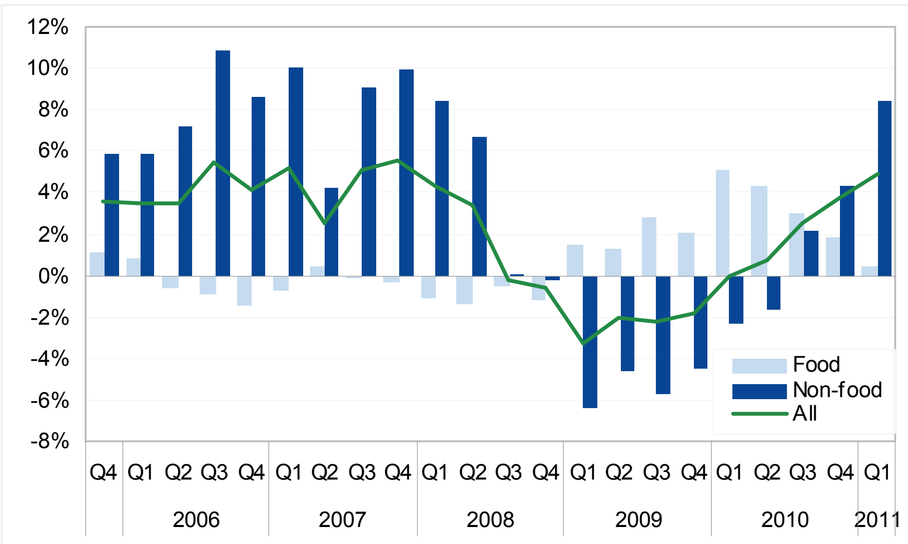
In the first quarter of 2011 retail sales volumes increased by 5% compared with the same quarter a year ago (Figure 1.11). This growth was made up of a 1% increase for food stores and a 7% increase for non-food stores, representing the third quarter in a row when retail sales have increased for both types of retail. This is in contrast to the period from the second half of 2008 when food stores saw continued growth but overall sales growth in the retail sector was negative as a result of large falls in non-food sales volumes. When the Panel met with retailers to discuss trading conditions their views were that although footfall on the high street in the year to date was up on a year ago, the picture was more mixed than either footfall or retail sales figures might suggest.

Figure 1.11

Retail sales performance

Seasonally adjusted annual change in volume, %

Source: States of Jersey Statistics Unit



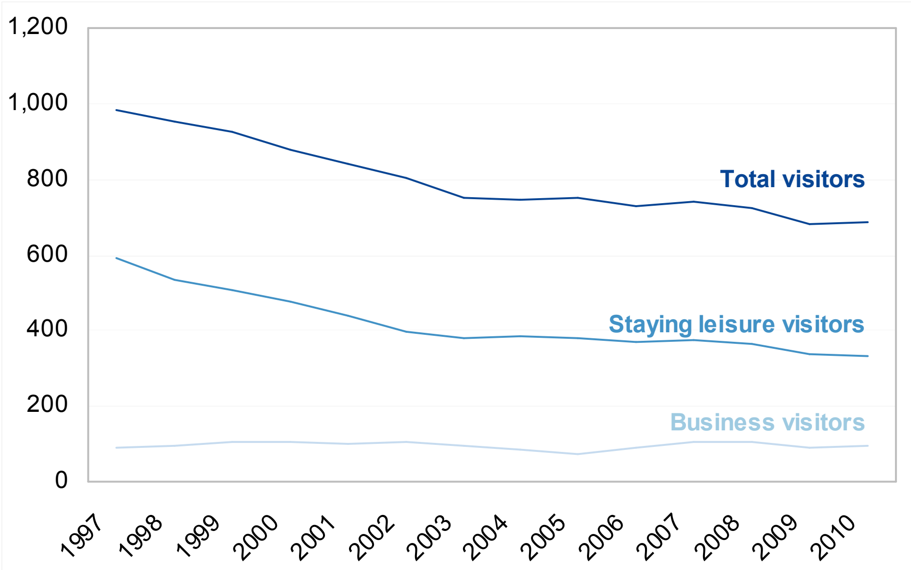
The total number of visitors to Jersey stabilised in 2010 and was 0.7% higher than in 2009, after a long period of decline Figure 1.12. Overall a slight fall of 1% in staying leisure visitors and of 2.4% in those visiting friends and relatives was offset by increases in business visitors and day trippers. In the first five months of this year total arrivals were 4.6% higher than in the same period of 2010 and forward booking data for accommodation in 2011 are better than last year. A more detailed breakdown of data for January to April this year shows that staying leisure visitors were down 3.7% but business visitors were up 11.2% on the same period a year earlier. The Panel met with representatives of the tourism industry and heard that while optimism was returning to the sector, yields were still under pressure and overcapacity remained in certain segments of the market.

Figure 1.12

Tourism trends

Number of visitors, 000s

Source: Jersey Tourism



The Business Tendency Survey suggests that activity and new business are still falling in the construction sector, one of the largest non-finance sectors in terms of GVA and employment. When the Panel met representatives from the industry, the mood in the sector was more upbeat than the Survey results suggest. There was some confidence that while the impact of the fiscal stimulus would wane as the program came to an end, there was scope for the private sector demand to pick up. However, this was very much dependent on the outcomes from the draft Island Plan.

1.3 Labour Market

There are clear indications that the local labour market has been significantly weakened by the downturn, most notably with the rise in those unemployed and actively seeking work (Figure 1.13). Registered unemployment was at about 1,200 in the first half of 2010 and about 1,300 in the second half of 2010 and into 2011. In April and May 2011 registered unemployment reached 1,400. The International Labour Organisation (ILO) measure of unemployment (the percentage of economically active people who are unemployed) is a better indicator of the level of unemployment as not all of those looking for work will register as unemployed. In the summer of 2010 the ILO unemployment rate was 3% which corresponds to about 1,700 people.

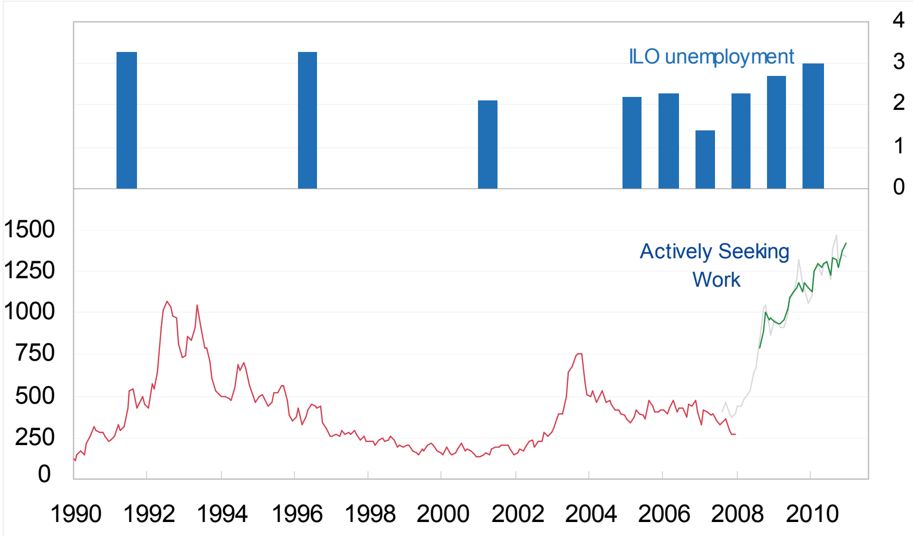
Figure 1.13

Changes in unemployment

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

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

Source: States of Jersey Statistics Unit



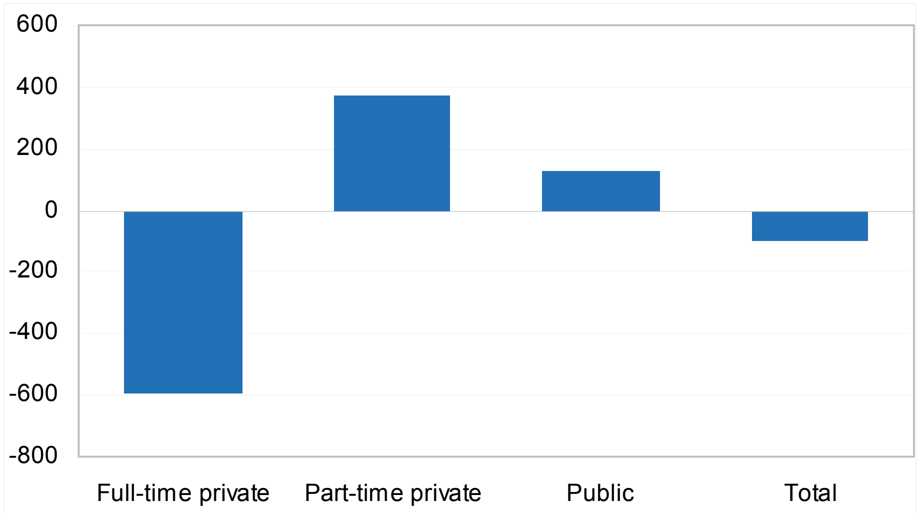
Overall employment in the Island in December 2010, the latest period for which data are available, was only 100 lower than at the peak in December 2008. This stability in headline employment hides a shift in employment from full-time to part-time jobs (Figure 1.14) and a shift from finance to other sectors. Finance employment in December 2010 was 12,680 - 750 below that at the peak in December 2008 - and over 200 of the growth in part-time jobs since then has been concentrated in retail and wholesale.

Figure 1.14

Changes in employment

Change in headcount in the public and private sectors between December 2008 and December 2010

Source: States of Jersey Statistics Unit



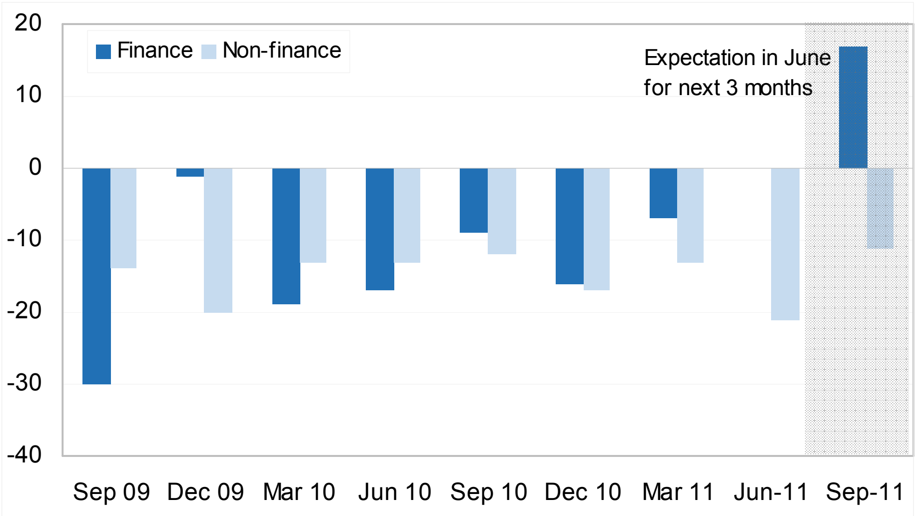
Information from the BTS suggests that firms - in both finance and non-finance - were not increasing employment in the first half of this year. However, expectations for the third quarter show that finance firms expect to increase employment for only the second time since the survey began in September

2009. In contrast, non-finance firms expect further reductions in employment (Figure 1.15).

Figure 1.15
Employment trends in key sectors

Weighted net balance reporting increase in employment

Source: States of Jersey Statistics Unit



Labour market conditions tend to lag behind economic activity and it is therefore not surprising that apart from some increase in expectations in the finance industry there has not been much improvement in Jersey since the last report. It is too early to expect a significant improvement in labour market conditions this year. The Panel expect the labour market to remain weak for the next 12 months, until recovery in activity is more assured.

1.4 Spare capacity

Given the current local and global economic environment, it is likely that spare capacity remains in the Jersey economy, not least because the labour market remains weak and unemployment has not fallen.

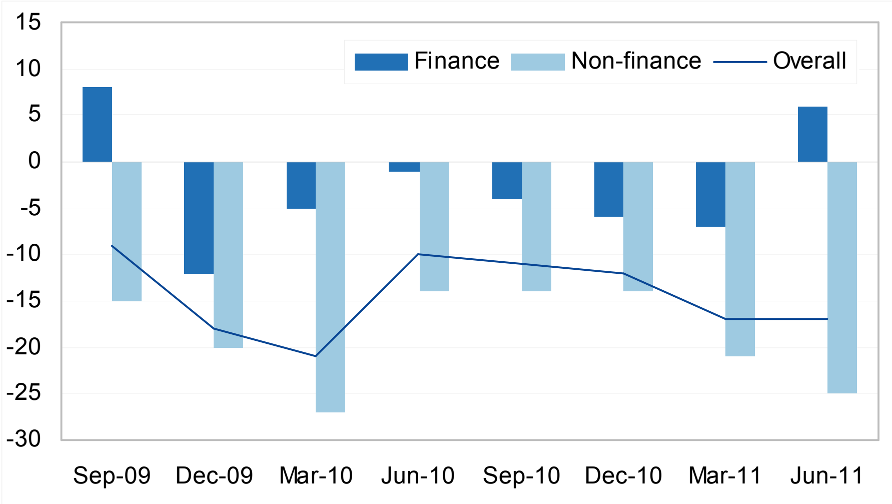
While it is not possible to determine absolute levels of spare capacity, the results of the Business Tendency Survey suggest that the degree of slack in the economy may have increased in the first half of this year. However, there is a dichotomy between the key sectors in the economy. A net balance of +6% of finance firms state that they are above capacity, while a net balance of -25% of non-finance businesses state they are below capacity Figure 1.16.

Figure 1.16

Capacity utilisation

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

Source: States of Jersey Statistics Unit



1.5 Inflation

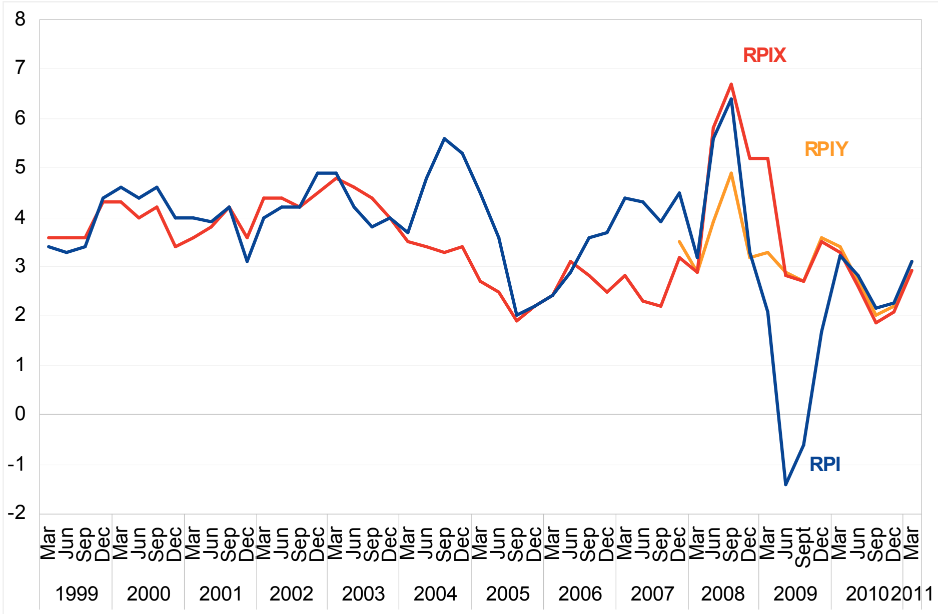
Inflation in Jersey is below that in the UK on all three measures (Figure 1.17). RPI inflation in Jersey in March 2011 was 3.1% compared to 5.3% in the UK. The majority of this difference was due to higher price increases in the UK for motoring costs, clothing and footwear, household goods and food. However, the rise in VAT in the UK in January from 17.5% to 20% will also have been a contributing factor. At times of significant changes in indirect taxation it is important to look at underlying inflation excluding these impacts. RPIY inflation (which excludes mortgage interest payments and indirect taxes) was 3.1% in Jersey compared to 4.0% in the UK. With the rise in GST in June 2011, RPIY will be the best measure of underlying inflation in Jersey. RPIY inflation is expected to rise only slightly as spare capacity in the economy reduces the impact of imported inflation.

Figure 1.17

Inflation in Jersey

Annual % change

Source: States of Jersey Statistics Unit



Temporary factors will push up the headline measure of inflation in Jersey this year. The rise in GST from 3% to 5% in June will add about 1.3 percentage points to the headline rate, higher food and oil prices may still have to feed through into the local economy and, if they rise, interest rates will add to headline inflation through increases in mortgage interest payments. Given the likely spare capacity in the local economy, the outlook for inflation next year looks more benign provided that salaries and wages do not increase to compensate for the temporary rise in RPI. This does, however, mean that there will be a number of factors adversely affecting Island household finances over the next 12 months. These are discussed in more detail in Box 2.

Box 2: The Impact of Shocks on Disposable Income

Disposable income is the amount of income a household has to spend or save after it has paid direct taxes.

Changes to the income tax system in Jersey have affected disposable incomes. For the 2007 to 2011 years of assessment, the withdrawal of personal allowances due to "20 means 20" have increased the tax burden of better off households by 0.4%-0.5% of their income (at most) each year. The 2011 year of assessment (mainly affecting individuals in 2012) is the last year of withdrawal of personal allowances for these tax payers. In 2011 for example, a single person household with income over £50,000 would pay an extra £240 in tax and a household with a mortgage of £300,000 and 2 young children with an income over £110,000 would pay an extra £525 in tax. Households on incomes lower than these are not affected as much (or in many cases at all) by 20 means 20. In addition, these households have, or will, benefit from exemption threshold increases taking effect in 2011 and 2012 (scale of impact 0.1%-0.2% of income) which will slightly increase their disposable income.

Average earnings growth is an indicator of disposable income growth, particularly where unearned income and income tax rules do not change much over time. Over the medium term, average earnings increases in Jersey tend to be about 1% higher than price increases which means that households have become better off over time. However, since 2009 sharp price increases in housing, motoring, food, fuel and light costs have put pressure on household disposable income.

From the fourth quarter of 2009 to the first quarter of 2011 the average household income before tax increased by £700 from £53,700 to £54,400. The average household annual expenditure increased by £1,900 from £44,000 to £45,900 over the same period. Food, fuel and light costs increased sharply adding £360 (0.8%) to the total annual spend of an average household, or 0.6% of total annual income. However housing and motoring costs were the most important contributing factors to the squeeze on income.

Figure 1.18

Expenditure and income

Change for period Q4 2009 to Q1 2011

Source: Statistics Unit and Panel calculations

Change in:		% of total annual spend	% of total annual income
Food	£223.79	0.5%	0.4%
Fuel and light	£133.60	0.3%	0.2%
Housing, motoring and other	£1,560.79	3.4%	2.9%
Total spend	£1,918.19	4.2%	3.5%

Box 2 continued: The Impact of Shocks on Disposable Income

Prices are expected to continue to increase faster than average earnings in 2011 and 2012 (Figure 1.19). The average earnings increase for 2011 is an estimate at this stage based on information provided by businesses in the most recent Business Tendency Survey. The difference between this and the expected change in RPI for 2011 of just under 2% (marked 'A') indicates the possible squeeze on income for the year. Although it is not possible to forecast the change in average earnings for 2012, estimates for RPI suggest a further 1.5% squeeze (marked 'B') mainly due to the 2% increase in GST Eventually, higher interest rates will add additional pressure to some households, increasing borrowing costs for those with mortgages.

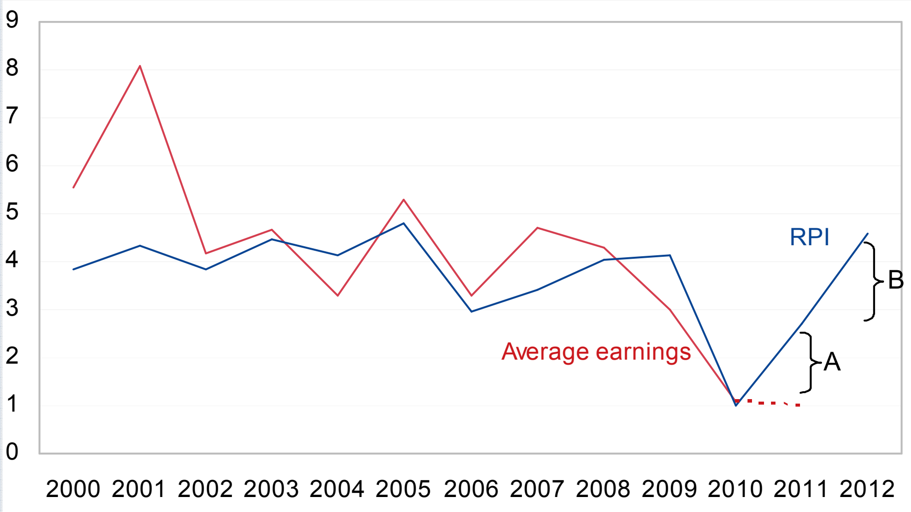
Figure 1.19

Cost increases outpace average earnings increases

Annual RPI * and average earnings increases (%)

Source: Statistics Unit and Panel calculations

* five quarter moving average



1.6 Growth forecasts

To arrive at its best estimates of the path of the economy, the Panel has combined the economic data available with the qualitative information it received when meeting with representatives of the key industry sectors (Figure 1.20).

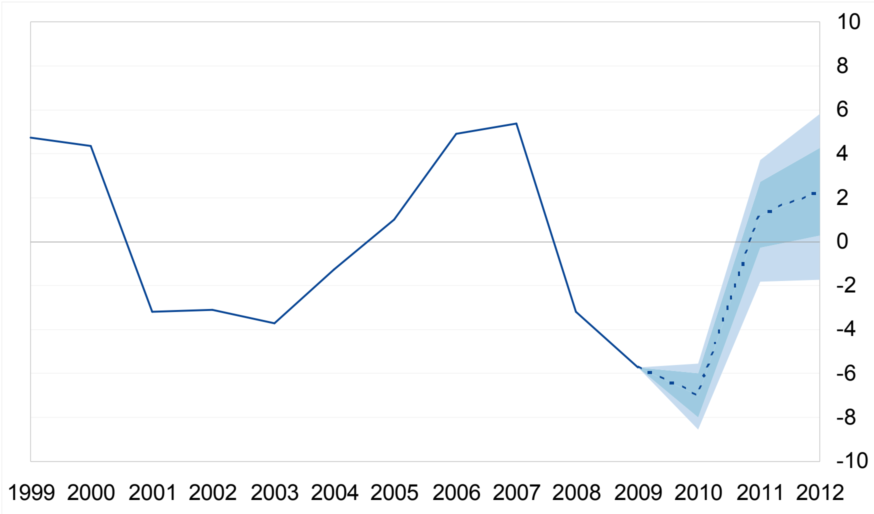
There remains significant uncertainty around these forecasts given the limitations of the data available and the uncertainty surrounding the global economic, financial and regulatory situation and how it will feed through into the local economy. The Panel has factored into the forecasts some of the expected improvement in financial services profits but is cautious given that, as explained earlier, past experience shows these businesses do not always achieve their expectations. The Panel estimates that GVA contracted by around 6-8% in 2010, which is rather weaker than the Panel's previous forecast. Under the central scenario, which includes the effect on real incomes of the rise in GST, subdued growth of 0 to 3% is likely this year with slightly stronger growth of 0-4% possible in 2012. This is very dependent on the future path of interest rates, future regulatory changes and global financial market and economic conditions. Significant risks therefore remain to the downside and to a greater extent than at the time of the previous report.

Figure 1.20

Economic Forecasts

% change in GVA on year before

Source: States of Jersey Statistics Unit; Panel forecasts



Section 2 - The Fiscal Outlook

Key points

- Due to higher income tax receipts, the budget deficit in 2010 was lower than anticipated. However, for future years the overall fiscal outlook is slightly worse than in Budget 2011, as higher income has been more than offset by decisions that increase expenditure.
- The financial position remains very tight, with only small surpluses projected in 2013 and 2014. Given the substantial uncertainty and downside risks, the decisions not to progress all of the reductions in expenditure included in Budget 2011 should be reconsidered, or alternative measures of a similar magnitude should be found. Further decisions that reduce revenues or increase expenditure in the medium term without offsetting savings or revenue should be avoided.
- The Panel notes that the Stabilisation Fund has been used to finance deficits arising for both cyclical and structural reasons. Now that the Stabilisation Fund has been mostly exhausted, more ambitious plans will be needed for its replenishment as the economy recovers.
- The risks around achieving the necessary fiscal consolidation proposed in Budget 2011 appear to have increased. In particular the proposal to defer part of the increase in Social Security contributions (at a cost of £9m a year) and an initial vote against a significant savings proposal in the Comprehensive Spending Review (CSR) in relation to grants to fee paying schools (costing around £5-6m a year) is of concern.
- The fiscal stimulus programme has come to an end, and the Panel is broadly satisfied that it was conducted in an appropriate manner, with the governance process ensuring that the projects receiving funding were timely, temporary and targeted.
- The proposal to use the £4m unspent funds from the fiscal stimulus allocation to finance a necessary capital project is, in the view of the Panel, an inappropriate use of funds from the Stabilisation Fund.
- Developments to strengthen financial planning and management appear to be making good progress with the proposals for a medium-term budgeting framework. The Panel recommends further measures to strengthen medium-term fiscal strategy. For example, there could be value in establishing a process that takes a strategic look at medium-term fiscal policy, involving a consideration of plausible future fiscal scenarios, the risks and opportunities to income and expenditure and the setting of strategic priorities.

2.1 Background to the public finances

Income and Expenditure

In 2010 the States received £546m in income, down from £674m in 2009. The drop in income of £128m was due both to the economic downturn (which is estimated to have cost approximately £50m) and to the change in the local corporate tax system to 'zero-ten' (the effect of which has been estimated at around £80m between 2009 and 2010).

Income tax continued to be by far the largest source of revenue, contributing nearly £394m, or 72% of the total. Of this, income tax on salary and wages made up around 69%, tax on companies 22% and self-employed and investment income the remaining 9%.

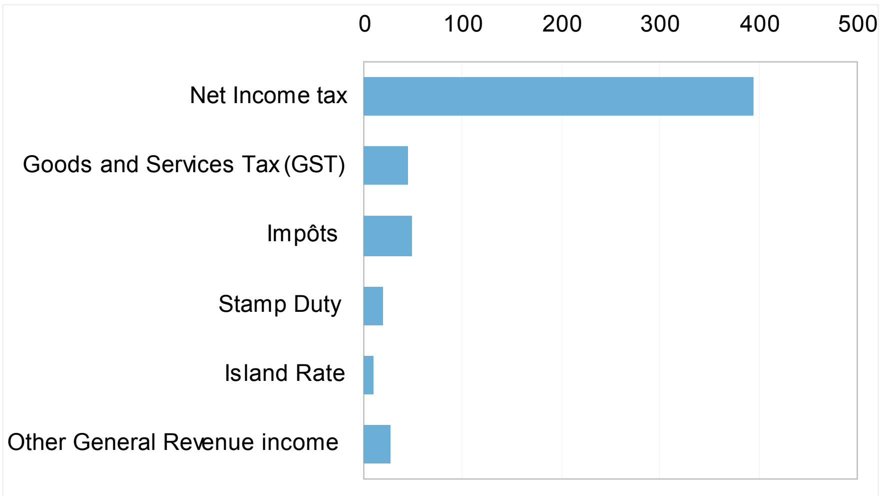
Impôts brought in £50m, while GST brought in around £44m (9% and 8% of total revenue respectively). The remaining 10% comes from the Island Rate, stamp duty and other income (Figure 2.1).

Figure 2.1

States income by source

2010, £m

Source: States of Jersey Treasury



Total net revenue expenditure (NRE) in 2010 was £599m.[2] Around 72% of this – £434m – went to the three largest departments: Social Security, Health and Social Services and Education Sport and Culture. The remaining 28% was divided among the other ministerial and non-ministerial departments (Figure 2.2).

[2] Net revenue expenditure is current expenditure (i.e. excludes capital expenditure or depreciation) and offsets income received by departments against their expenditure.

Figure 2.2

Net revenue expenditure by department

2010, £m

Source: States of Jersey Treasury

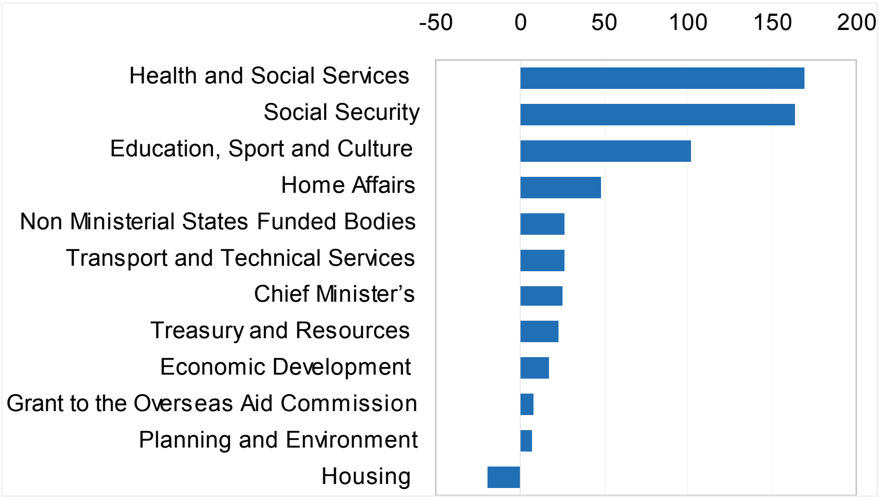


Figure 2.3 shows States' income and expenditure between 1998 and 2010. Between 2001 and 2007 expenditure increased by less than 1% a year in real terms, while income exhibited cyclical fluctuations. Since 2007 expenditure has grown more rapidly, even excluding Energy from Waste, rising at around 3.3% a year in real terms between 2007 and 2010.

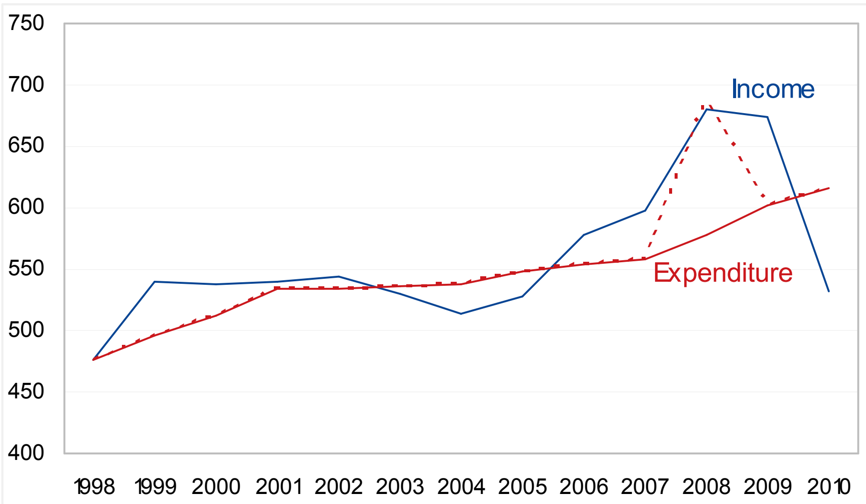
Between 2005 and 2008 income grew sharply in real terms. Much of this income growth is likely to have been due to early actions to replace lost zero-ten revenue (for example GST, introduced in 2008), and some of it will have been cyclical, a result of the buoyant economy, rather than structural (i.e. ongoing).

Figure 2.3

Real income and expenditure

£m , 2009 prices

Source: States of Jersey Treasury



Note: Expenditure is net revenue expenditure (excluding capital/servicing depreciation) plus capital allocations. Broken red line includes EfW expenditure (as allocated). Solid red line excludes it.

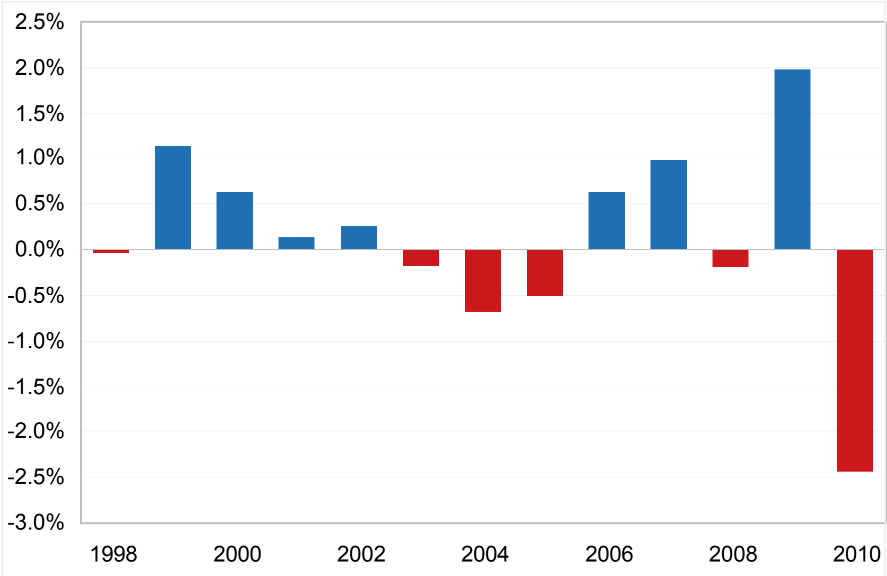
Figure 2.4 depicts the annual surpluses and deficits run by the States between 1998 and 2010 as a proportion of the economy. Surpluses have tended to occur after years when the economy has done well – reflecting lags in tax collection – and deficits after the economy has been weaker. The largest annual surplus over this period was 2.0% of GVA (2009), while the largest deficit was nearly 2.5% of GVA (2010).

Figure 2.4

Annual surplus/deficit as a % of GVA

Source: States of Jersey Treasury

Note: Expenditure is net revenue expenditure (excluding capital/servicing depreciation) plus capital allocations. Assumes a fall in GVA in 2010 of 3% in nominal terms, consistent with the forecast in Figure 1.20. 2008 includes an allocation for a large, one-off capital project (Energy from Waste) of £103m.



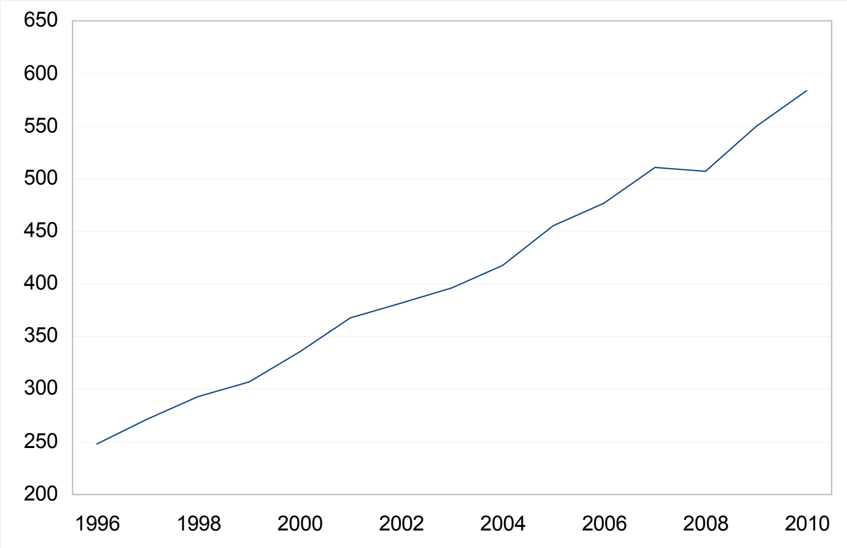
Strategic Reserve

The Strategic Reserve has existed since 1986, and is intended to be used in exceptional circumstances such as a natural disaster or a significant, permanent or long-lasting economic change. Figure 2.5 shows how the balance in the Strategic Reserve has grown steadily since 1996 – only falling slightly in value in 2008 as a consequence of the fall in asset valuations during the financial crisis – and now stands at £585m.

Figure 2.5 Strategic Reserve net assets

£m, current prices

Source: States of Jersey Treasury



Stabilisation Fund

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

Figure 2.6 shows the balance of the Stabilisation Fund since its inception in 2006 up until 2013. Between 2006 and 2009 the balance increased as money was put aside when the economy was doing well, and it reached £156m during 2009. From 2009 onwards the balance dropped as funds were used to pay for the discretionary fiscal stimulus package agreed by the States in 2009 and to go towards the budget deficits that were expected to arise during the downturn. The result is that by the end of 2011 the balance is expected to be £10m (see Section 2.2). This balance is higher than the zero previously expected, as the 2010 deficit was slightly lower than previously forecast, so fewer funds are needed from the Stabilisation Fund.

In order that the Stabilisation Fund can continue to play a role in counter-cyclical fiscal policy it will be necessary to rebuild the Stabilisation Fund as and when the economy begins to grow again. The States should start planning for this.

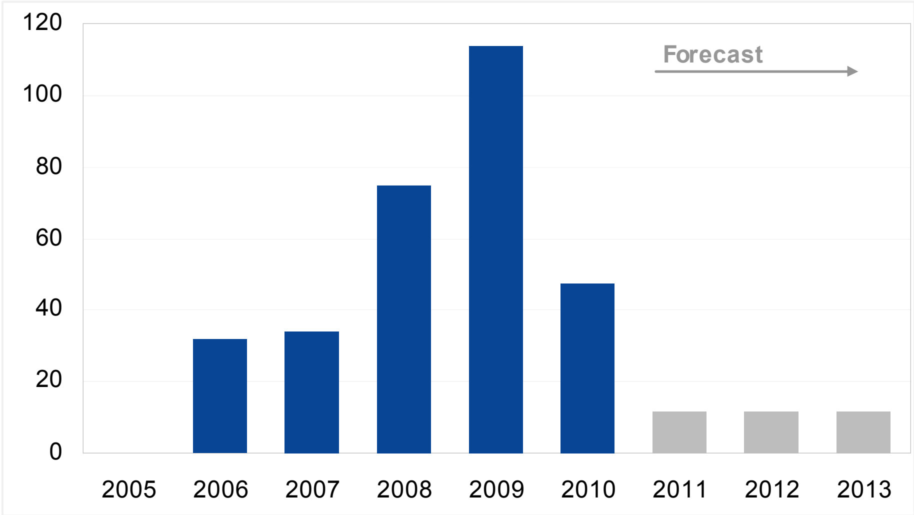
Figure 2.6

Stabilisation Fund net assets

£m, current prices

Source: States of Jersey Treasury

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



2.2 Current situation and short-term outlook

2010 Outturn

The States of Jersey Annual Report and Accounts 2010 show a deficit of £70m. This number is not directly comparable to the figures from previous Business Plans, Budgets or Fiscal Policy Panel reports. In order to improve comparability, two adjustments need to be made. The first is to remove the financial balance of the States' Trading Operations, as these are not included in the financial forecasts. The second is to add back in capital allocation as this is included in the financial forecasts, but treated differently in the accounts.[3]

After these two adjustments are made, the figure to use when comparing the financial forecasts (i.e. in Business Plans and Budgets) to the outturn is a deficit of £85m (Figure 2.7).

[3] The accounts are now produced on a UK Generally Accepted Accounting Principles (GAAP) basis, under which capital expenditure is accounted for using concepts of depreciation and impairments. In contrast, the financial planning process uses an amount of capital allocated to specific projects each year, although it could be spent at any time in the future and which, under GAAP, would eventually be fully accounted for through depreciation and impairments.

Figure 2.7 Public Finances in 2010 : Reconciliation of outturn and accounts

Source: States of Jersey Treasury

	Accounts* £m	Outturn Planning basis £m
General Revenue Income	546	546
Net Revenue Expenditure	-599	-599
Trading Operations	-17	-
Capital Allocation	-	-32
Budgeting Surplus/Deficit	**-70**	**-85**

* Pre-GAAP Adjustments and Other Income and Adjustments

A deficit in 2010 of £85m is £16m less than the £101m forecast in Budget 2011 (Figure 2.8).The following factors account for this difference.

Figure 2.8 Public Finances in 2010 : Difference from 2011 Budget

Source: States of Jersey Treasury

	Budget 2011 Estimate £m	Outturn Planning basis £m	Difference £m
General Revenue Income	532	546	+14
Net Revenue Expenditure	-601	-599	+2
Trading Operations	-	-	-
Capital Allocation	-32	-32	-
Budgeting Surplus/Deficit	**-101**	**-85**	**+16**

On the income side, income tax revenue was £15m higher than forecast. This was mainly due to higher than expected revenue from salary and wage earners. Taken together, other elements of General Revenue Income were around £1m lower.

Total net revenue expenditure in 2010 was £2 million less than was projected in the 2011 Budget. As Figure 2.9 shows, this was largely the result of higher total approvals being largely offset by an underspend from departments (£13 million) and of the fiscal stimulus programme (£3 million). In total, there was a significant underspend of £24m in 2010, £16m greater than expected at the time of Budget 2011; the £8m underspend expected at the time of Budget 2011 was due to a foreseeable Social Security underspend.

Additional Budget Approvals totalled £32m[4] - £17m more than anticipated in the 2011 Budget. It should be noted that this was not due to new expenditure decisions – these were mainly items of expenditure approved in previous years, but which were not budgeted for as they did not have a specific year of expenditure associated with them. Of the £17m, £14m was fiscal stimulus expenditure approved in 2009 but spent in 2010, £2m was related to CSR

[4] Additional Budget Approvals covers expenditure voted and allocated within the current year or within previous years but which has been spent this year. As an example, £44m was approved and allocated in 2009 (P55/2009) for discretionary fiscal stimulus, however this was to be spent over 2-3 years. Therefore, while it was allocated from the Consolidated Fund in 2009, it is only included in the accounts as an Additional Budget Approval in the year in which it is spent.

provisions and the remainder was the consequence of a number of small expenditures relating to past allocations such as those relating to preparing for and dealing with a flu pandemic.

Figure 2.9

Public Finances in 2010: Net Revenue Expenditure - Breakdown of difference from 2011 Budget

£m

Source: States of Jersey Treasury

	Budget 2011	Now	Difference
Department NRE	586.0	586.0	0.0
Additional Central Provision	22.6	20.8	-1.8
of which			
- Carry-forwards from 2009	*7.6*	*5.8*	*-1.8*
- Voluntary Redundancy	*6.0*	*6.0*	*0.0*
- Court and Case Costs	*8.5*	*8.5*	*0.0*
- Procurement Initiatives	*0.5*	*0.5*	*0.0*
Other Additional Approvals		17.2	+17.2
Capital to Revenue Transfers		-1.5	-1.5
Total Approved	**609**	**623**	**+14**
Underspend	-8	-24	-16
of which			
- Social Security	*-8*	*-8*	*0*
- Other Department underspend		*-13*	*-13*
- Fiscal Stimulus underspend		*-3*	*-3*
Total NRE	**601**	**599**	**-2**

On balance therefore, although lower expenditure contributed to a lower deficit in 2010, this does not indicate an improvement in the underlying fiscal position as a large proportion of the underspend (£13m) has been granted to Departments to roll forward into 2011.[5] This expenditure has therefore not been cut; its timing has been shifted.

2011 Onward

Looking forward, in Business Plan 2012 the Treasury has identified additional spending that was not included in Budget 2011. First, it is proposed to use up to £4m a year to increase the central contingency fund to cover a number of spending pressures that are likely to need financing, but for which the magnitudes are currently unknown (for example Freedom of Information and legal aid). In the Draft 2011 Budget the Council of Ministers originally proposed contingency reserves that were £4m and £8m larger in 2012 and 2013 respectively than was passed by the States Assembly. Therefore although this change increases expenditure relative to the final 2011 Budget, it does not increase expenditure relative to the draft budget.

[5] The remaining £8m was an underspend of £8m by Social Security, which was expected at the time of Budget 2011, and which has not been granted as carry-forward.

Second, as part of the proposed Medium Term Financial Plan (MTFP)[6], a growth allocation has been proposed to allow for the fact that priorities may change over the 3-4 year term of the MTFP and that emerging pressures may need to be addressed. This allocation provides the flexibility for the Minister for Treasury and Resources, after consultation with the Council of Ministers, and the States, to consider and address such challenges annually, but still remain within overall spending limits. The growth allocation also provides an annual opportunity for States members to influence the allocation of funding to address emerging pressures or priorities within the overall States spending limits. The amount proposed for this allocation is £6m in 2013 and £16m in 2014. The Panel understands that these amounts are indicative at this stage and subject to change as the MTFP is developed further.

Third, some of the proposed increases to social security contributions have been modified. In particular, the proposal that has been lodged in the States now includes a cap on employer contributions at £150,000 and no longer includes an additional 2% above the existing ceiling for employees. Increasing Social Security contributions reduces the need for the supplementation of the Social Security Fund from general revenues, and therefore reduces States expenditure. While this new proposal would still achieve a reduction in expenditure, it would reduce it by less than previously proposed. These two changes together have been estimated by the States of Jersey to cost approximately £9m a year relative to the original proposition.

Finally, capital allocations have increased by £2m a year from 2012 onwards, however this is due to a revenue-to-capital transfer, so does not contribute towards the overall change in expenditure.

The combined effect of the above proposals is to increase overall expenditure by in the region of £15-20m a year.

Moreover, the Panel understands that in 2011 a transfer of £6.1 million from the Health Insurance Fund will be used to offset expenditure by the Health and Social Services department, and that a similar transfer may be required in 2012 as well. This will result in lower overall net revenue expenditure in both years than would have been the case if this had been made clear as a transfer from the HIF. The Panel recommend that such transfers are made more explicit in the future.

Income is also now forecast to be slightly higher than it was forecast to be in Budget 2011 – in the region of £10m a year from 2012 onwards – due to higher forecasts for income tax revenue and £3m from additional Budget measures.

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[6] P97/2011

The overall result is the projected budget balance has worsened by £11 million in 2011, £5 million in 2012 and £10 million in 2013 (Figure 2.10).

Figure 2.10

2012 Business Plan: Change in financial forecasts since Budget 2011

Source: States of Jersey Treasury

	2011 £m	2012 £m	2013 £m
Income	2	9	10
- Income Tax	*10*	*7*	*7*
- GST	*-2*	*-2*	*-2*
- Impôts	*-1*		
- StampDuty			
- Other Income	*-6*		
- Island Rate			
*- Additional Measures**		*3*	*3*
- CIF Asset Value	*1*	*1*	*2*
Expenditure	13	14	20
- Capital Allocation	*0*	*2*	*2*
- Carry-forward	*13*		
- Additional Central Reserves/Contingency		*4*	*4*
- Revised FSR Proposal (Social Security)		*9*	*9*
- Growth Provision (P97/2011)			*6*
- Other		*-1*	*-1*
Surplus/Deficit	-11	-5	-10

* Additional measures refer to funds raised from higher ISE fees and income tax provisions that were announced in Budget 2011 but not included in the financial forecasts at that time.

Nevertheless, as Figure 2.11 shows, the deficit is still forecast to improve over three years from an estimated deficit of £66m in 2011 to a £9m surplus in 2014.

Figure 2.11

Public Finances: 2012 Business Plan

Source: States of Jersey Treasury

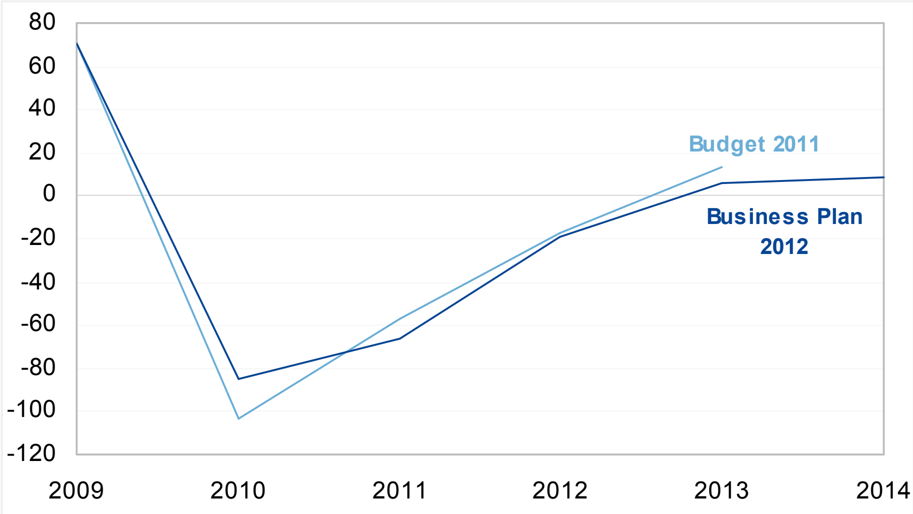
				<-- Forecast -->		
Outturn 2009 £m	Outturn 2010 £m	Estimate 2011 £m		2012 £m	2013 £m	2014 £m
674	546	567	Income	613	642	681
603	631	633	Expenditure	632	636	672
71	-85	-66	Surplus/Deficit	-19	6	9

Figure 2.12

Financial Balance: Comparison of 2011 Budget with 2012 Business Plan

£m

Source: States of Jersey Treasury



The States financial position remains extremely tight and, while the additional revenue means that decisions on the expenditure side will not change the projected path of consolidation significantly, it does lower the projected balance by around £10m a year from 2013 (Figure 2.12), and there remain significant risks to the central outlook (see Section 1). In previous reports the Panel has recommended that decisions that permanently reduce revenues or increase expenditure without offsetting savings or revenue increases will worsen the fiscal position and should be avoided – unless a view can be taken that the structural balance between income and expenditure has improved. This remains the Panel's view. The Panel would therefore recommend that, unless the projected fiscal situation improves, either the decisions not to progress all of the reductions in expenditure included in Budget 2011 be reconsidered, or that alternative measures be sought that would increase revenue or reduce expenditure in the medium term.

As emphasised in the previous report it is important that the Panel's guiding principles are followed. Namely:

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

Box 3: How the fiscal situation in Jersey has evolved

It is useful to consider the current fiscal situation in context. In the recent past Jersey has benefited significantly from a large and vibrant financial services sector presence on the Island. This has provided a significant number of well-paid jobs, raised demand for other support and auxiliary services and provided a large and lucrative tax base that the States of Jersey could tap into to finance public services at relatively low tax rates; not only corporate tax, but individual income and sales taxes as well.

However, in recent years there have been some changes. Jersey agreed to change its corporate tax system in order to ensure that it was in line with the principles being agreed internationally by organisations such as the Organisation for Economic Cooperation and Development (OECD) and the European Union (EU). As a consequence Jersey moved to a 'zero-ten' model of corporate tax whereby it introduced a main rate of 0% corporate tax, with a higher rate of 10% for certain financial institutions regulated by the Jersey Financial Services Commission.

This change in the tax regime caused a loss in tax revenue - estimated at around £90m a year (£10m in 2009 and an additional £80m from in 2010) – that needed to be replaced if expenditure was not to be reduced significantly. The States of Jersey agreed a package of measures to fill the gap, which included the introduction of a sales tax (Goods and Services Tax, or GST) and the tightening of income tax allowances ('20 means 20').

This has caused a shift away from corporate tax that is ultimately paid by shareholders, many of whom will be overseas, towards indirect and direct taxes on local individuals. Further, this may well not be the end of this trend. Risks remain about future corporate tax revenues and if they materialise it may require further adjustment to personal taxes to continue to generate a sustainable stream of revenues to pay for public services. Jersey is likely to face difficult choices, especially at a time when personal disposable incomes are already being squeezed by slow growth in average earnings and higher inflation.

The Funds

As Figure 2.13 shows, the Consolidated Fund balance is expected to be £24m at the end of 2011, falling to £5m at the end of 2012 as a consequence of a £19m budget deficit in that year. After that the balance is expected to rise to £11m and then £20m as the budget deficit becomes a surplus in 2013 and 2014. The Stabilisation Fund balance is forecast to be run down from £114m at the end of 2009 to £10m in 2011 (Figure 2.6).

Figure 2.13

Business Plan 2012 Financial forecasts

£m

Source: States of Jersey Treasury

Outturn	Outturn	Estimate		<-- Forecast -->		
2009 £m	**2010 £m**	**2011 £m**		**2012 £m**	**2013 £m**	**2014 £m**
674	546	567	Income	613	642	681
603	631	633	Expenditure	632	636	672
71	**-85**	**-66**	**Surplus/Deficit**	**-19**	**6**	**9**
			Consolidated Fund			
51	**51**	**54**	**Opening Balance**	**24**	**5**	**11**
71	-85	-66	Surplus/Deficit	-19	6	9
-63			Transfer to Stabilisation Fund			
44	68	36	Transfer from Stabilisation Fund			
-44			Fiscal Stimulus Allocation			
-8	20		Other Adjustments*			
51	**54**	**24**	**Estimated Consolidated Fund balance**	**5**	**11**	**20**
			Stabilisation Fund			
75	**114**	**46**	**Opening Balance**	**10**	**10**	**10**
19	-68	-36	Transfer to/from Consolidated Fund			
20			**Other income/transfers**			
114	**46**	**10**	**Estimated Stabilisation Fund balance**	**10**	**10**	**10**

* Other adjustments are necessary because the effect of the surplus//deficit on the Consolidated Fund balance is not straightforward. For example, expenditure included in the overall balance may have been previously allocated, and therefore will not affect the unallocated Consolidated Fund balance.

The unallocated Consolidated Fund balance was £34m higher at the end of 2010 than was previously forecast (£54m rather than £20m) (Figure 2.14). This was due to higher income (£14m), additional underspend (£13m) and some other minor technical adjustments[7] (£6m). Of this additional balance, £11m will be used to pay for a higher deficit in 2011 (due to £13m of carry forward expenditure being offset by £2m additional income) and the transfer from the Stabilisation Fund is reduced by £10m. The remaining £13m is left in the Consolidated Fund. As a result the Consolidated Fund balance is now forecast to be higher in 2012 and 2013 than previously anticipated, despite larger projected deficits.,

Figure 2.14

Change in financial forecasts since Budget 2011

£m

Source: States of Jersey Treasury

* Other adjustments are necessary because the effect of the surplus//deficit on the Consolidated Fund balance is not straightforward. For example, expenditure included in the overall balance may have been previously allocated, and therefore will not affect the unallocated Consolidated Fund balance

Outturn	Estimate		<-- Forecast -->		
2010 £m	2011 £m		2012 £m	2013 £m	2014 £m
+14	+2	Income	+9	+10	
-2	+13	Expenditure	+14	+20	
+16	**-11**	**Surplus/Deficit**	**-5**	**-10**	
		Consolidated Fund			
-2	**+34**	**Opening Balance**	**+13**	**+8**	
+16	-11	Surplus/Deficit	-5	-10	
		Transfer to Stabilisation Fund			
	-10	Transfer from Stabilisation Fund			
		Fiscal Stimulus Allocation			
+20		Other Adjustments*			
+34	**+13**	**Estimated Consolidated Fund balance**	**+8**	**-2**	
		Stabilisation Fund			
		Opening Balance	**+10**	**+10**	
	+10	Transfer to/from Consolidated Fund			
		Other income/transfers			
	+10	**Estimated Stabilisation Fund balance**	**+10**	**+10**	

The Panel has previously recommended that any unallocated funds in the Consolidated Fund in excess of £20m should be transferred into the Stabilisation Fund. No transfers into the Stabilisation Fund are recommended at this point, but should surpluses materialise in the Consolidated Fund the most appropriate use of these funds would be a transfer into the Stabilisation Fund, especially as the Stabilisation Fund will need to be replenished if it is to be useful in the future. The Panel does not recommend a transfer into the

[7] Because the Operating Cost Statement and surplus/deficit figure includes some items that are not included in the Consolidated Fund calculation, adjustments have to be made for these.

Strategic Reserve until such time as the Stabilisation Fund has been replenished.

The Stabilisation Fund balance is forecast to be run down from £114m at the end of 2009 to £10m in 2011 (Figure 2.6).. Although difficult to quantify, it is possible that the Stabilisation Fund has been used in part to temporarily finance some of the structural component of the deficit, as well as the cyclical component and the discretionary fiscal stimulus measures. While it would not have been advisable to raise taxes or reduce expenditure to address a structural deficit in the midst of a downturn, it is important that surpluses are run when the economy picks up in order to pay these funds back into the Stabilisation Fund.

2.3 Fiscal Stimulus

The discretionary fiscal stimulus programme was formally closed to new projects at the end of April 2011, in line with the Panel's previous advice that no further discretionary stimulus should take place in 2011, other than that previously authorised. The Panel continues to believe that additional discretionary stimulus is not merited at this point, although a marked deterioration in the global or local economic outlook in the future would clearly be cause to reconsider this judgement.

In a statement in February the Minister for Treasury and Resources announced that £2.2m of fiscal stimulus funds would be used for skills and training programmes, despite this not necessarily meeting the criteria for stimulus – particularly timeliness. Given the relatively weak state of the local labour market, using these funds for additional expenditure on skills and training is not a significant concern to the Panel.

Figure 2.15 provides a breakdown of the expenditure on discretionary fiscal stimulus projects by type of programme and by year. It can be seen that for the most part expenditure was timely in that it was spent between 2009 and 2011. The largest proportion of the funds went to construction and maintenance projects as these were thought to be projects that needed to be undertaken anyway, would involve on-island expenditure, and would provide greatest support to the local economy. A significant amount of money was also spent on programmes to enhance skills and training for those looking for employment, and in supporting businesses through the downturn.

The economic impact of the £40m that has been spent on fiscal stimulus is very difficult to quantify. However, overall the Panel is satisfied that the process has been conducted in an appropriate way. In particular the projects that received funding were for the most part timely, temporary and targeted –

which should have increased the effectiveness of the programme from an economic perspective.

Figure 2.15

Fiscal stimulus spending by programme area

Source: States of Jersey Treasury

	2009 Actual £m	2010 Actual £m	2011 Forecast £m	2012 Forecast £m	Total Forecast £m
Civil Infrastructure	0.8	4.9	0.2	0.0	**5.9**
Construction & Maintenance	0.2	9.6	13.6	0.0	**23.5**
Programme Manager	0.1	0.2	0.0	0.0	**0.3**
Skills and Training	0.5	1.8	2.7	1.8	**6.7**
Support for Business	0.0	2.3	1.3	0.0	**3.6**
Support for Individuals	0.0	0.0	0.0	0.0	**0.0**
Total	**1.7**	**18.8**	**17.8**	**1.8**	**40.0**

It appears that £4m of the £44m originally allocated will remain unspent. The Panel understands that it is being proposed that this money is allocated to fund a capital project that is thought to be necessary and for which other funds cannot be found. This would not be consistent with the original decision on the use of £44m for discretionary fiscal stimulus, as in the Panel's view further stimulus at this point is not justified and would not be timely. The funds should be returned to the Stabilisation Fund.

2.4 Comprehensive Spending Review

In previous reports the Panel has noted that the fiscal consolidation proposed by the States of Jersey relies on some ambitious Comprehensive Spending Review (CSR) targets to reduce expenditure. Having had discussions with officials concerning the progress of the CSR, the Panel is reasonably confident that the £65m savings should be achievable, although there would appear to be a lot of work still to be done to finalise the details. The main risk to not achieving the desired level of savings is that the suitable areas for savings will not be agreed – whether by the Council of Ministers, the States Assembly or the public. One prominent example of outstanding disagreement is the ongoing debate on Education savings, and school grants in particular. Significant issues like this need to be debated fully; however it is also important to note that to reduce spending, difficult decisions have to be taken. Furthermore, effectively ring-fencing large areas of expenditure means that larger savings will have to be made in the other unprotected areas if overall savings targets are to be achieved.

As a temporary measure, the Business Plan proposes to fund the shortfall resulting from these decisions in other ways. For 2012 it has been proposed that growth provisions previously allocated to the Education department be used to offset the shortfall from lower CSR savings. For 2013 and 2014 it has been provisionally proposed, as a fallback position, to use a significant proportion of the original £10m set aside for CSR restructuring. These proposals reduce the States room for manoeuvre should additional needs arise, with a risk that the fiscal position could deteriorate.

It is not the role of the Panel to comment on how the savings are achieved, since these are ultimately political rather than technical economic decisions. However it is worth noting that if savings cannot ultimately be delivered then any shortfall may have to be made up through tax increases if there remains a structural deficit over the medium-term.

2.5 The economic impact of the proposals

A key element of the Panel's remit is to assess the degree to which fiscal policy is acting in a stabilising manner – supporting the economy in tough times, and dampening overheating in better times.

In order to assess the economic impact of the overall balance of income and expenditure, it is necessary to adjust the timing of expenditure set out in the budget so that it better reflects when funds are put into the economy, rather than when they are allocated for budgeting purposes. There are two main cases where this is relevant.

- As capital is included as an allocation for budgeting purposes, large one-off capital expenditures, such as the Energy from Waste plant, will tend to show up in the balance in one year, even if spending takes place over several years. In these cases an adjustment can be made to spread the allocation over several years to more accurately reflect the spending profile.
- Certain decisions by the Treasury Minister or the States allocate funding without a specific year of expenditure – for example, the discretionary fiscal stimulus programme agreed by the States in 2009. These funds are budgeted for when the funds are allocated, and the *revenue element* of this expenditure shows up in the accounts in the surplus/deficit when it is spent, while the capital element does not. This means that the surplus/deficit has to be adjusted for the *capital* element in past years and both the capital and revenue elements in future years.

These adjustments are inevitably approximate, but should provide a better illustration of the net flow of funds from the States in a given year. Figure 2.16 shows the results of these adjustments.

Figure 2.16

Projected fiscal balance, adjusted for the timing of expenditure

Source: States of Jersey Treasury; Panel calculations

Note: adjustments for past years are for *capital* elements only, as revenue expenditure already included in budgeting surplus/deficit

				Forecast			
	2008 £m	2009 £m	2010 £m	2011 £m	2012 £m	2013 £m	2014 £m
Surplus/ Deficit	-7	71	-85	-66	-19	6	9
Adjustments							
Energy from Waste	89	-46	-27	-11	-1		
Fiscal Stimulus		-1	-15	-18	-2		
Adjusted Surplus/ Deficit	82	24	-126	-95	-22	6	9
Adjusted Surplus/ Deficit as % GVA	2.2%	0.7%	-3.6%	-3%	-0.6%		

It should be noted that this analysis does not include some other elements of States income and expenditure such as the transfer from the Health Insurance Fund discussed on page 29. This makes net revenue expenditure look less than it would otherwise have been if it had been set out as a transfer in the same manner as transfers from the Stabilisation Fund for example. This in turn means that this additional expenditure between 2010 and 2011 does not show up as having an additional economic impact, even though expenditure has increased without an offsetting increase in revenue.

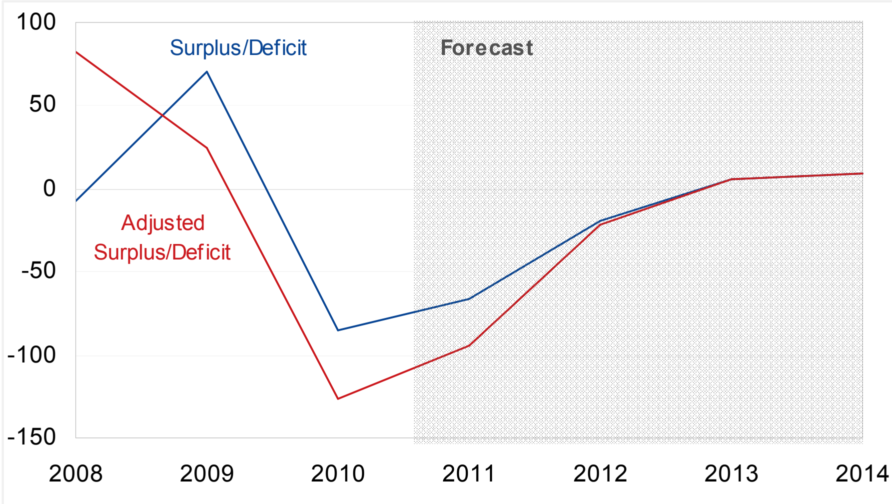
Nonetheless, on the basis of Figure 2.16 the States put around £126m (equivalent to around 3.6% of GVA) more into the economy in expenditure than it took out in taxes and duties in 2010. In 2011 and 2012 the equivalent figures are £95m and £22m, around 3.0% and 0.6% of GVA respectively (Figure 2.17). It is not until 2013 that the States is projected to be running a fiscal surplus; of £6m, or 0.2% of GVA. The Panel continues to believe that it is broadly appropriate, given the current economic outlook, for fiscal policy to continue to support the economy, albeit to a diminishing extent, until 2012, and for the budget to be broadly in balance in 2013. Once the economic recovery is assured the Panel will be looking to the Sates to run larger surpluses to rebuild the Stabilisation Fund. Should the economic outlook change, however, the Panel would need to reconsider its advice.

Figure 2.17

Projected fiscal balance, before and after timing adjustments

£m

Source: States of Jersey Treasury, Panel calculations



2.6 Medium-term financial Planning

Given these challenges, a robust approach to fiscal planning is crucial. As noted above, progress continues to be made with respect to the longer-term sustainability of the public finances. Expenditure forecasts are likely to be more realistic and financial control stronger as a result of the CSR process and the proposed medium-term budgeting framework.

The creation of additional contingency funds for specific variable expenditure – as is being proposed to better cope with fluctuations in court and case costs, for example - is a welcome development, and will continue to strengthen expenditure management and therefore financial planning. However, the early signs are that it might be difficult to ensure that contingency funds are of a sufficient size to finance contingencies and to ensure that these funds are used in an appropriate manner. It is possible that these are simply teething issues, and the Panel will watch this area closely in the future.

The Panel also welcomes the progress that has been made on strengthening medium-term financial planning and budgeting. The detailed proposals for 3-4 year spending limits set out in Public Finances (Amendment No.3) (Jersey) Law 201X are encouraging.[8]

The Panel recommends further measures to strengthen medium-term fiscal strategy. For example, there could be value in establishing a process that takes a strategic look at medium-term fiscal policy. As well as detailed estimates of income to be considered alongside the expenditure estimates from the MTFP on a regular and ongoing basis by Ministers and senior officials, this would involve a consideration of plausible future fiscal scenarios,

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the risks and opportunities to income and expenditure and the setting of strategic priorities for revenue generation and expenditure.

A process of this sort would enhance strategic thinking and planning with respect to fiscal policy, allowing for the better design, phasing and implementation of new policies and measures on both the income and expenditure side of the accounts. Given the high degree of uncertainty about the future, there is a need to assess likely evolution of income and expenditure, plus the relevant risks, out beyond the 3-4 year horizon of Business Plans and Budgets.

Finally, the Panel understands that the Fiscal Framework may be reviewed in the near future to assess how well it has performed to date, and to evaluate whether any changes are required to ensure that it is well placed to meet future challenges. This is would be another positive development, and the Panel would welcome the opportunity to input into this process.

2.7 Long-term pressures

In all of its reports to date the Panel has stressed that there are a number of long-term pressures that need to be considered. This time is no different.

First, an emphasis on caution with regards to future economic growth is required. While economic growth could potentially help to deal with future pressures, it is not yet clear what the sources of future productivity growth might be.

Indeed, there are threats that could be significant. Potential changes to financial regulation either unilaterally from the UK, or from a wider international agreement could threaten the existing business models of some of the Jersey financial sector. The examples of the potential impacts of the Basel III accord, the UK Financial Services Authority liquidity rules and any final decision by the Independent Commission on Banking set out in Section 1 are the "known unknowns", but there are likely to be other "unknown unknowns".

The assessment of the zero-ten regime by the EU Code of Conduct Group has still to be completed, but it would appear that it has meant the end of the deemed distribution aspect of zero-ten, although the rest of the corporate tax regime will remain in place. The Panel is aware that the estimate of the fiscal impact of this change is uncertain, so will continue to monitor this closely.

Taken together, the effect of an ageing population, low productivity growth and risks to the profitability of, and the potential tax take from, the finance sector, the potential challenges could be significant. It is therefore important to be prudent, and take this into account when making decisions relating to ongoing income and expenditure.