Jersey's Fiscal Policy Panel Annual Report

October 2018

Introduction

This is the eleventh annual report of the Fiscal Policy Panel (FPP). The current members of the Panel are:

Dame Kate Barker (Chair, appointed 2014),
Professor Francis Breedon (appointed 2016),
Richard Davies (appointed 2018).

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 Exchequer.

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

Section 1 - **Key points**

Economic Outlook

- Growth improved in both emerging and advanced economies across 2017 and 2018, particularly in advanced economies. The IMF believes that recent levels of global growth will continue, with expansion in 2018-19 remaining at its 2017 level.
- However, downside risks to the global economy have increased. These include financial market instability in some developing countries, trade tensions, ongoing structural issues in the EU and geopolitical risks.
- After three years of real growth, Jersey's economy grew modestly in 2017 – recording a 0.4% expansion, slightly above the FPP's assumption of 0.1%. However, with the rise in population, GVA per person fell by close to 1% across the year.
- Finance sector output contracted for a third year running in 2017. Survey evidence suggests expectations for future business growth are high and sector representatives confirmed that the prospect of higher interest rates should boost bank profitability in Jersey. These developments are positive but the considerable uncertainty surrounding the political background (Brexit in particular) and the future path of interest rate rises in coming years is a risk to these sector forecasts.
- 2017 saw the recovery continue for non-finance sectors with a fifth consecutive year of real GVA growth. The latest survey evidence suggests a positive picture in 2018.
- The labour market has remained buoyant with employment in December 2017 reaching a new record high after 2.2% growth over the year. Registered job-seeker totals have fallen by over a half since the 2013 peak.
- Inflation has increased over the last twelve months, peaking at 4.5% in June before falling back a little in September. The main driver of high inflation has been increasing housing costs but household services, leisure services and motoring are also adding significantly to inflation.
- Average weekly earnings in June 2018 rose by 3.5% year-on-year, which represented a 1% fall in real earnings.
- Although total GVA expanded in 2017, a fall in GVA per head and weak earnings growth means that the Jersey economy saw a mixed performance last year. However, latest indicators suggest GVA growth of around 1.6% could be expected for 2018, with a similar 1.5% expected for 2019.

Public Finances

- The Panel is pleased to note that its four guiding principles have been generally followed during the MTFP Addition and subsequent Budgets, including the draft Budget 2019, and this report points out where further positive steps can be taken in keeping with these principles.
- Including depreciation, net revenue expenditure in 2017 was around £20m below that anticipated at the time of the MTFP Addition. On the income side, general revenue income in 2017 was £56m higher than expected at the time of the MTFP Addition. This resulted in a £23m current surplus.
- Income and expenditure trends indicate that the overall fiscal position is for a small current surplus in 2019 at an appropriate time (when the Panel anticipate the economy may be running above capacity).
- The FPP continues to believe that the profile and scale of the revenue and expenditure measures is broadly appropriate. While the total value of the deficit-reducing measures is less than envisaged at the time of MTFP Addition, revenue (and GVA growth) has been stronger than expected and therefore the States is still on track to balance the budget at the right time.
- Some new growth allocations have been proposed in Budget 2019, in particular £11m has been included to meet the shortfall in the Growth, Housing and Environment Department's budget due to the decision to defer the introduction of non-domestic waste charges. As a result of these changes there is a shortfall of approximately £7m which is to be met from unallocated reserves or departmental underspends, pending the delivery of anticipated savings from the implementation of the Target Operating Model. The first phase of implementation is anticipated to result in savings of £30m.
- The adjusted fiscal position provides less support to the economy during 2017-2019 than expected at the time of the MTFP Addition, because of higher income outturn/forecasts and lower than previously anticipated capital spending. However, the forecast suggests that government will still be adding significant amounts to the economy in the next medium-term planning period, peaking at around 3% of GVA in 2020 even if only half the planned capital spend is delivered. Generally it remains very difficult to use States' capital spending to manage the economic cycle and the Panel does not believe that this should be a reason to delay important capital projects, given that capital spending in the past has tended to be lower than forecast.
- The recommendations from the Panel's 2017 Annual Report have largely been followed but a number of the recommendations were more long-term in nature and these continue to be relevant moving into the next Government Plan period, including the need to carefully manage the significant capital spend envisaged in future years, continuing to monitor the trends in States assets

and liabilities, and addressing key issues regarding future structural pressures, future capital expenditure and planning for surpluses.

- A number of risks remain, including uncertainty about future revenue, ability to control States' expenditure, political risks, the timing of capital expenditure and future population policy.
- The longer term sees sustained challenges to public finances, including the impact of ageing population, challenges around productivity and continued economic volatility.

Recommendations

1. Further revenue or expenditure measures may be needed if the improved fiscal position proves more temporary than presently believed or if the economy hits capacity constraints. However, flexibility may also be needed in the opposite direction if economic conditions deteriorate.
2. Work should be undertaken as soon as possible to identify which of the expenditure and revenue measures have not been delivered and whether this relates to delays in realising the savings/revenue or whether some of the measures will prove impossible to implement so that alternatives will need to be sought.
3. The Panel is encouraged that the public sector modernisation programme launched this year is expected to lead to a more efficient public sector with Phase 1 anticipated to lead to £30m of savings identified in 2019. Detailed, realistic and time-bound targets should be developed as soon as possible for the delivery of the savings and these should be built into the four-year Government Plan.
4. Where measures are not implemented, the States should endeavour to find alternative measures of a similar size, rather than fund the shortfall through carry-forwards and unspent contingencies which may not be sustainable.
5. To the extent there is still a contingency allocation in the 2019 Government Plan, there should be a clear explanation for how the size of contingencies has been determined.
6. The new process for allocating contingency spend should continue to give due priority to those projects which have the potential to raise productivity, given disappointing recent trends in productivity. Going forward, it is important that productivity is a key focus of the new Government Plan.
7. There are a number of large capital projects coming in future years (including the hospital) which will need to be carefully managed to ensure that they do not put too much pressure on local resources during a period in which the economy may be running above capacity.

8. The improved position on the Consolidated Fund should not at this stage lead to any changes in the proposed measures to balance the budget – either on the revenue or expenditure side. Surplus funds should, in the first instance, be used to replenish the Stabilisation Fund. In the longer term, the States should set out a plan to bring the value of both funds to the optimal level to meet their objectives. The Panel will undertake analysis to establish the appropriate size of each fund early in 2019.
9. Further work will be required over the next Government Plan period to develop a whole-of-government strategy to meet the challenge of an ageing population.

Section 1 - **The Economic Outlook**

1.1 International outlook

The International Monetary Fund's (IMF's) latest estimate is that the world economy grew by 3.7% in 2017, the highest rate of growth since 2011. Growth was up across both the industrialised and the developing world, particularly in the former. The United States and Germany improved to around 2.5% growth and Japan saw its strongest growth since 2010. There was a mixed picture for emerging economies, with both China and India growing at approximately 7% on the year, but Russia and Brazil were much slower at 1.5% and 1.0% respectively.

More recent data on the global economy have been somewhat mixed. After growing at the fastest rate for six years in 2017, world trade in merchandise goods now shows signs of decelerating and would be threatened by any further escalation in trade tensions. More positively the ManpowerGroup Global Employment Outlook survey of firms around the world in Quarter 3 showed 43 of the 44 countries surveyed expecting an aggregate gain in employment in the final quarter of the year.

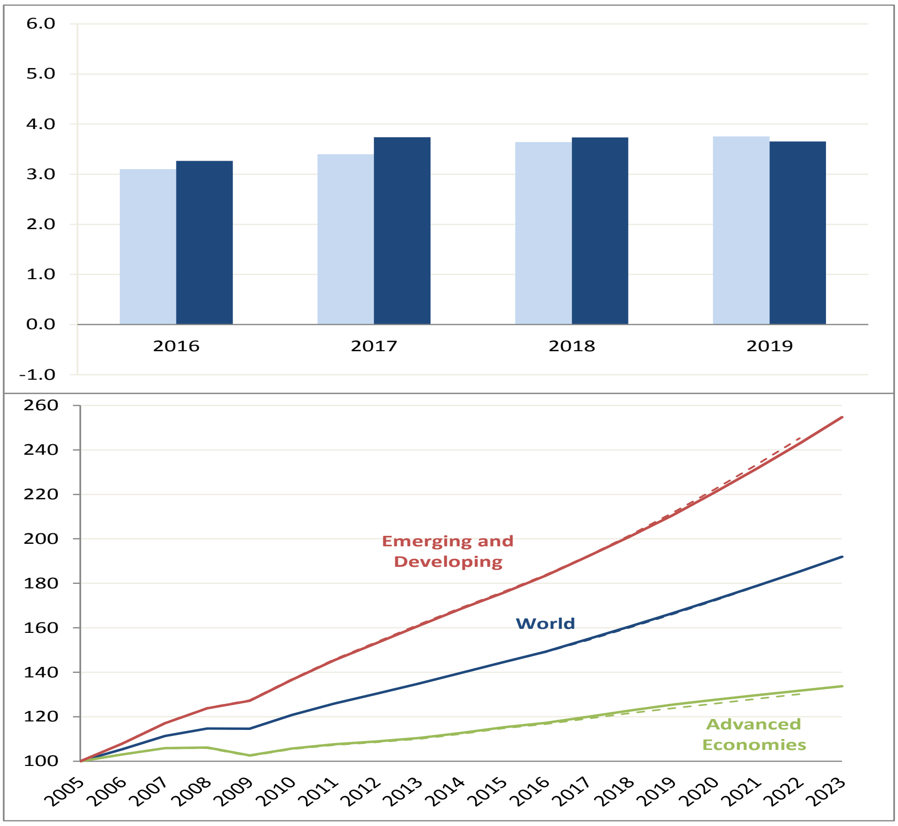
Figure 1.1

Global growth

Top panel: global GDP real growth - October 2018 estimates/forecasts; pale bars are October 2017 estimates/forecasts

Bottom panel: index (2005=100) of real-terms GDP - October 2018 estimates/forecasts; dashed lines are October 2017 estimates/forecasts

Source: International Monetary Fund (IMF) World Economic Outlook October 2017 and October 2018.



Looking forward, the IMF believes that recent global growth will continue, with expansion in 2018-19 remaining at its 2017 level. However, this growth is less even and downside risks have increased over the year. The outlook for the euro area is for slower growth falling to 1.9% in 2019. The United States is benefiting from a rising fiscal stimulus, but the forecast for 2019 growth has recently been revised downwards (to 2.5%) due to newly announced trade measures, such as £200bn of tariffs on Chinese imports.

Growth in China is expected to moderate to 6.2% in 2019 due to US trade measures and weaker credit growth. India faces similar threats from US trade policy but growth is expected to be 7.4% in 2019. Brazil and Russia are both forecast to continue their return to growth following recent recessions, albeit at a relatively sluggish pace.

The IMF view is that risks to this forecast have shifted to the downside. Recent and unexpected inflationary pressure and the consequent rise in expectations for US interest rates and capital outflow from emerging economies is an example of how changes in fundamentals can quickly result in financial market reassessments. Increasing trade tensions, ongoing structural weakness in the EU and geopolitical risks were also noted as potential threats to investment and economic activity.

There is still some potential that some of these risks may not come to pass and the global economic outlook may be more positive. The US and UK economies have both seen strong job growth which may lead to increasing wages and interest rates. Trade tensions, including those from Brexit, may be resolved relatively favourably and underlying productivity trends could improve in the euro area.

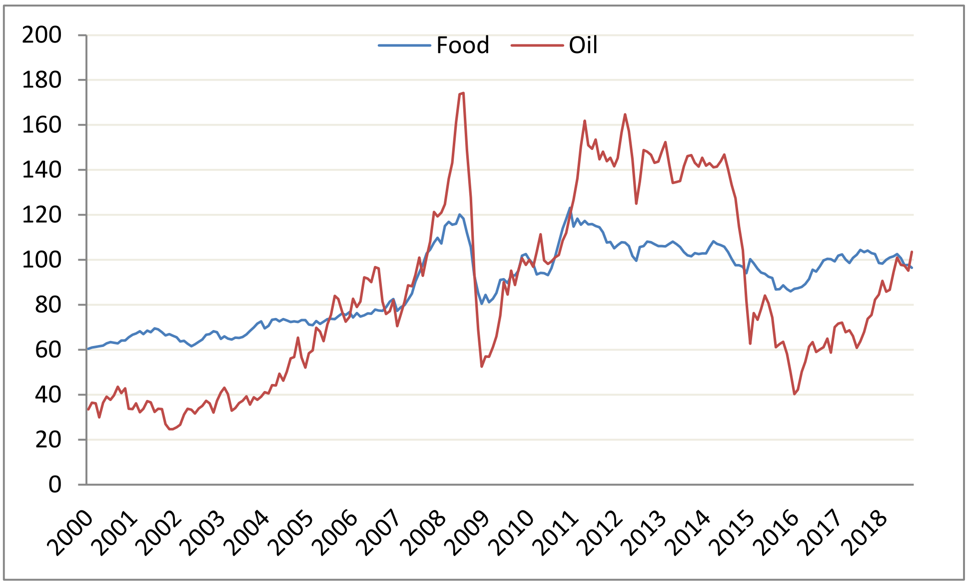
Oil prices increased by 40% in the year to September, lifting headline inflation in advanced and emerging market economies, but have fallen back somewhat since peaking in early October. Food prices have remained relatively stable in recent years.

Figure 1.2

Commodity prices

Index of nominal world food and USD oil prices, Jan 2010=100

Source: Food and Agriculture Organisation of the United Nations, Food Price Index and US Energy Information Administration Europe Brent Spot Price



The IMF's forecast for the UK is for a further slowdown in 2018 and beyond (1.6% in 2018 and 1.5% from 2019-2021). The Bank of England forecast is similar, averaging 1.75% over 2018-2021. This continues a gradual reduction from the 3% expansion seen in 2014.

The short and longer-term impacts of Brexit continue to be uncertain and depend on ongoing negotiations between the UK and the EU. With the deadline for withdrawal less than six months away, this uncertainty has intensified with agreement yet to be reached on a number of key issues.

Sterling fell by around 10% against both the euro and dollar in the months following the Brexit referendum. Whilst since staying generally stable against the euro, sterling saw a gradual rise against the dollar over the course of 2017 and early 2018 which has since been reversed.

UK Bank Rate has risen by 0.5 percentage points to 0.75% over the last year, but market expectations of further rises have reduced, with Bank Rate now expected to be barely above 1% by the end of 2021. The Monetary Policy Committee has become more pessimistic about the UK's supply capacity, now considering that very limited spare capacity remains in the economy and that supply will grow at only a moderate rate over the next two years.

The US Federal Funds Rate has now increased by 1.75 percentage points since December 2015 from its record low and expectations are for another two increases before year end. In contrast, the benchmark interest rate in the euro area has remained unchanged at zero since March 2016 and, whilst announcing an end to its programme of quantitative easing by year end, European Central Bank indications are for no interest rate increase in the immediate future.

Overall, the global economy has remained relatively resilient over the last year, with growth accelerating in the United States and Europe, while China has managed to moderate its deceleration. Though projecting 3.9% world growth for 2018 and 2019, the IMF believe risks to this outlook are mounting and have expressed concern about potential disturbance from financial markets, from trade tensions and from other political and environmental events. The main uncertainty for the UK remains the short-term and long-term implications of Brexit.

1.2 Jersey economic developments

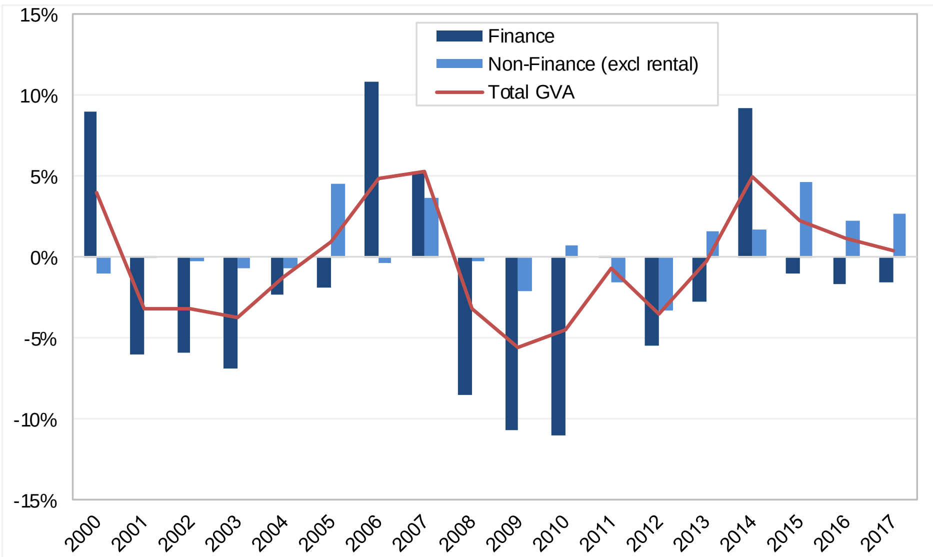
Gross value added (GVA) is the headline measure of economic activity in Jersey. Real growth in Jersey's economy was very modest in 2017 (0.4%), following three years of recovery from a major and extended downturn after 2007. Output of the finance sector fell by 2% in real terms while non-finance (excluding the rental income of private households) grew by 3%. Growth was particularly strong in the construction sector (9%) as well as in other business activities (4%) and transport, storage and communication (4%).

Figure 1.3

A breakdown of Gross Value Added growth

Annual % real terms change

Source: Statistics Jersey



1.2.1 Financial services sector

The **Survey of Financial Institutions** (SFI) reported a 2% fall in the GVA of the financial services sector in 2017 in real terms, the sharpest fall since 2013. Though employee compensation rose 6% (both through higher employment numbers and average earnings and bonuses), there was a 9% reduction in sector profitability detracting from overall output.

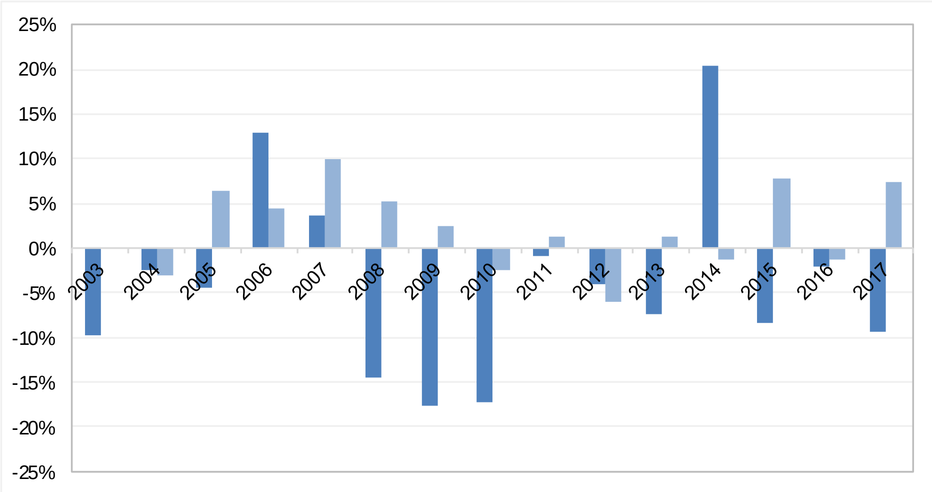
Strong growth in real output from the trust and company administration sub-sector (5% year on year) was not enough to compensate for a 5% fall in banking. The fall in banking was driven by smaller banks (<100 FTE), with the larger banks relatively flat. This result comes despite an 8% rise in net interest income.

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: Statistics Jersey



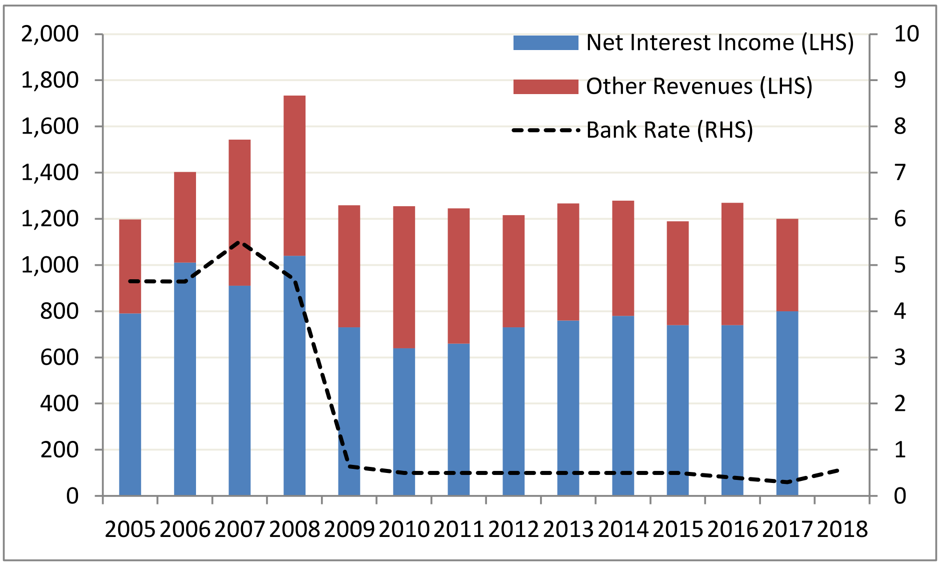
Revenues for the financial services sector were £2.5 billion in 2017, a decrease of 1% from the previous year due to a large fall in banking non-interest revenues, and suggesting a further recovery in net interest income might not be sufficient to support revenues in the banking sector. Net interest income (nearly a third of finance sector revenue) rose strongly to reach its highest level since 2008. Another 0.5 percentage point rise in US rates this year, along with the two 0.25 percentage point increases from the Bank of England since last November should give interest revenues another lift this year.

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, 2018 until end Sept.)

Source: Statistics Jersey; Bank of England



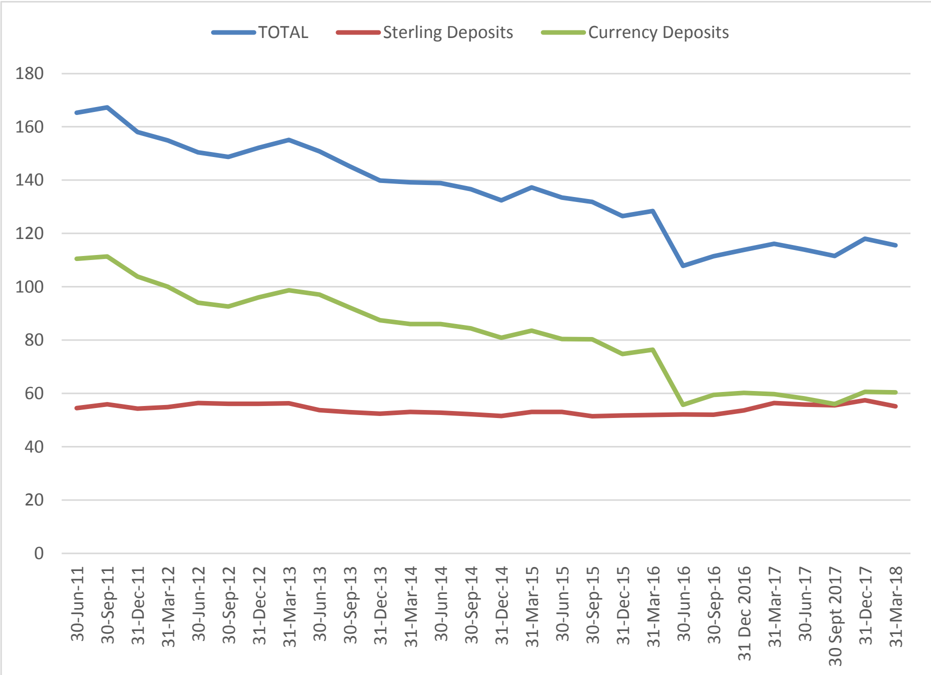
However, net interest income is also related to the level of deposits. The amount of foreign currency ("Currency Deposits", principally USD and euros) has fallen since 2007, including a significant fall in 2016 (which was largely related to the departure of a small number of banks with significant non-sterling deposits). Foreign currency deposits have stabilised since then, just above sterling deposits which have remained relatively stable.

Figure 1.6

Banking deposits

Total bank deposit values (£b, current prices) in Sterling, foreign currencies ("Currency Deposits") and total values

Source: Jersey Financial Services Commission



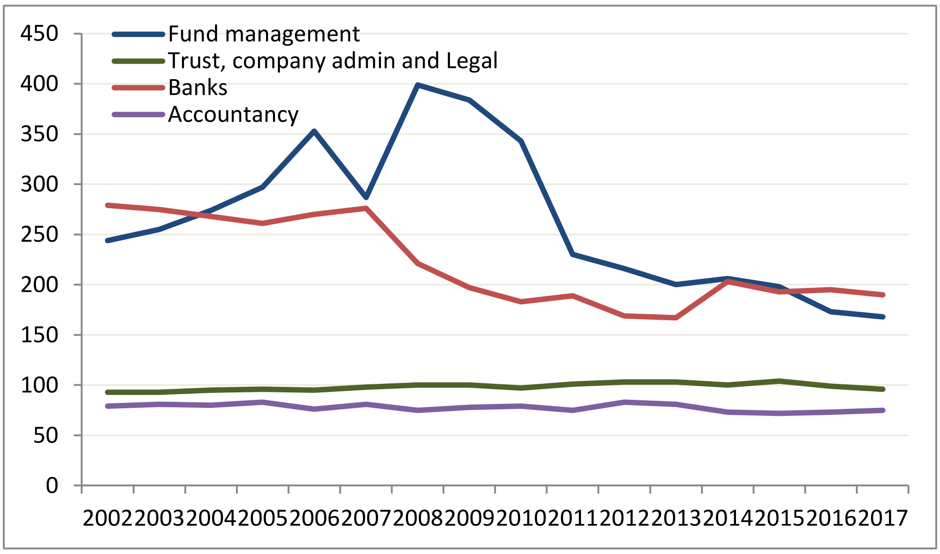
GVA per full-time equivalent employee (a measure of labour productivity) fell by 4% for the finance sector in real terms over the year. On a subsector level, productivity fell by 3% in banking and also fell in every other sub-sector apart from accountancy (i.e. fund management, trust and company administration, legal). Since 2002, productivity has fallen significantly in both banking and fund management – by around 2.5% per year on average. Productivity for the trust and company administration and legal sub-sectors has been largely flat on this basis since 2002.

Figure 1.7

Finance subsector productivity

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

Source: Statistics Jersey



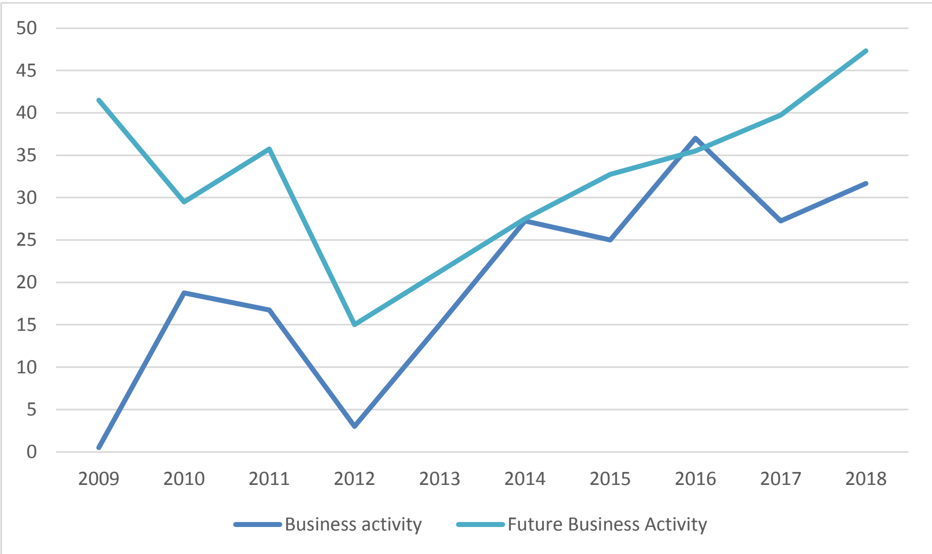
The **Business Tendency Survey** from September 2018 shows a positive picture for the finance sector, with business activity remaining strong. All indicators have been positive since mid-2017, with the exception of input costs. Expectations for future business activity have been particularly strong.

Figure 1.8

Finance business tendency

% net balance of respondents reporting an increase in business activity and future business activity (both weighted by employment). Annual average of quarterly results to September 2018.

Source: Statistics Jersey



The **outlook for the financial services sector** remained positive in the June 2018 BTS, with 85% of firms expecting profits to be higher than last year; compared to 6% expecting a decrease. This is the strongest result from the survey since it began in 2009. When asked about employment, 64% of firms anticipated an increase, with 19% expecting a fall. This is an improvement on expectations at the same time last year, but slightly less optimistic than in December 2017. Figure 1.9 shows a gradual improvement in the net balance of employment expectations since 2014. Profit expectations have recently tended to be higher in December (expectations for the following year) than in June (in-year expectations). The result from this June was contrary to this trend, reaching the highest point for eight years.

Figure 1.9

Finance employment and profit expectations

% net balance of respondents (weighted by employment) expecting an increase in employment (pale bars) and profits (dark bars). Results from June are in-year expectation and results from December are expectations for the following year.

Source: Statistics Jersey

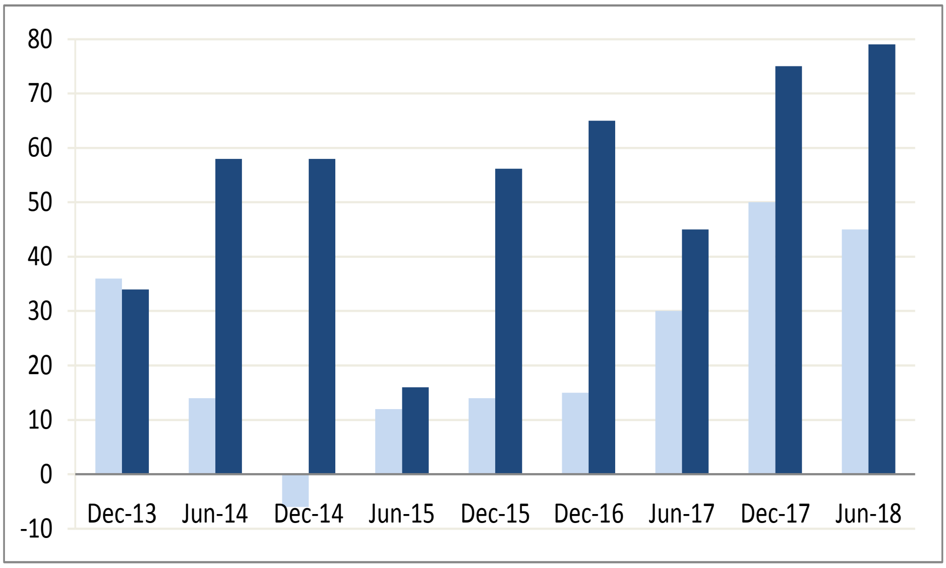


Figure 1.10 compares the responses to the BTS with the growth of financial services sector GVA. The BTS has improved strongly in 2018 to date and while this optimism is encouraging, the historical relationship with GVA outturns has not been strong.

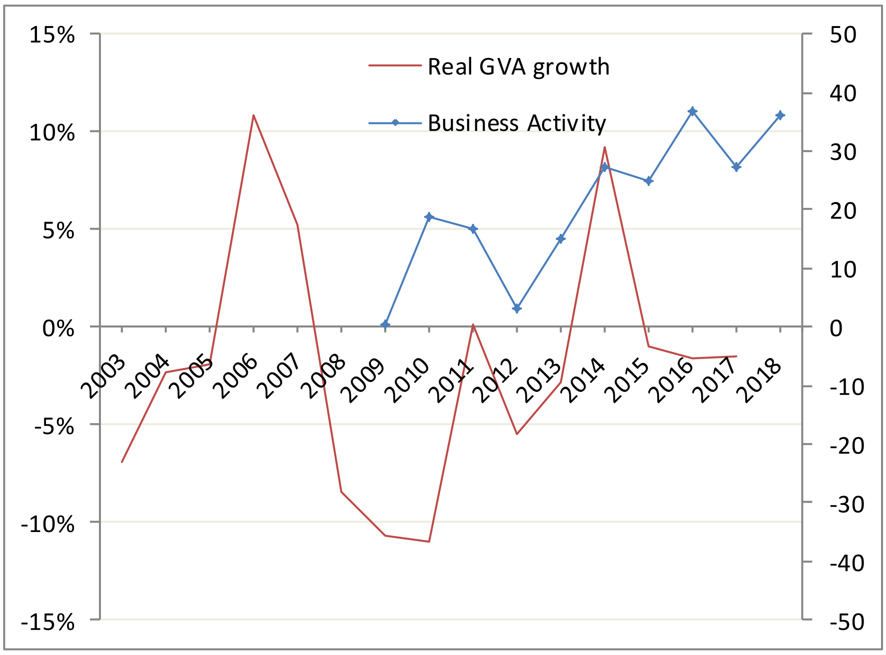
Figure 1.10

Finance GVA growth

Annual real GVA growth of financial services (left-hand scale)

Financial services responses to business activity question averaged over each year (right-hand scale). Note: 2018 based on average of responses to "business activity" in March, June and September plus "future business activity" from the September survey

Source: Statistics Jersey



During the Panel's recent fact-finding visit, representatives of the financial services sector were positive in regards to short-term business prospects and employment intentions. However, considerable uncertainties continue for the medium-term outlook.

Brexit remains a key risk, with the uncertainty about the eventual relationship between the UK and EU having potential knock-on effects. There is a chance that regulatory pressure coming from the EU will increase without a UK voice in Brussels. The potential for unfavourable international regulatory pressure remains in the medium term despite recent positive developments.

Recruiting specialist skills for the sector can be challenging with reports of difficulties in finding particularly leadership skills and investment expertise. Some growth in employment is anticipated in coming years but the move towards greater automation will subdue demand for labour in the medium term. A commitment to re-training staff to take on the more high-skilled roles that will come from this transition will dampen the effects of job-shedding and potentially raise productivity.

Recent interest rate rises in both the US and UK bode well for banking sector revenues and any further rise will again improve profit margins on deposits, though the Bank of England has stated that any future increases in UK rates are likely to be implemented at a gradual pace and to a limited extent. Any rate rises may also take some time to impact on profits due the need for banks' hedging positions to unwind.

On other regulatory matters, Jersey banking operations have largely completed the process of ring-fencing required by the UK's Independent Commission on Banking. Jersey is a key part of some of the 'non-ringfenced' banking operations of large banking groups and this strategic importance and influence may lead to more investment. The EU Code of Conduct Group on Business Taxation has determined that Jersey is a cooperative tax jurisdiction and work is ongoing to ensure that the legal framework provides reassurance over any potential substance concerns.

On the whole, the message was one of optimism in the sector, reflecting the strong results in the immediate forward-looking indicators in the Business Tendency Survey, but with significant risks in the medium-to-long term.

1.2.2 Rest of the economy

2017 was another year of recovery for the non-finance sectors with aggregate GVA growing for the fifth straight year. Real output from these sectors is now 6% higher than its 2007 pre-crisis peak. The majority of sectors saw growth, with the exception of hotels, restaurants and bars and the small manufacturing sector.

The Business Tendency Survey for the non-finance sectors has remained largely positive in 2018, with the headline business activity indicator continuing a run of positive readings to reach its highest level in a decade in June 2018 before falling back slightly in September 2018. The balance of respondents reporting a reduction in profitability, though still outweighing those reporting expansion, has fallen since the end of 2017. Expectations for future business activity (for the following quarter) remain positive but have been fallen gradually over the last four years, though this has yet to lead to a fall in the business activity indicator.

Figure 1.11

Non-finance business tendency

% net balance of respondents reporting an increase (weighted by employment). Annual average of quarterly results to September 2018.

Source: Statistics Jersey

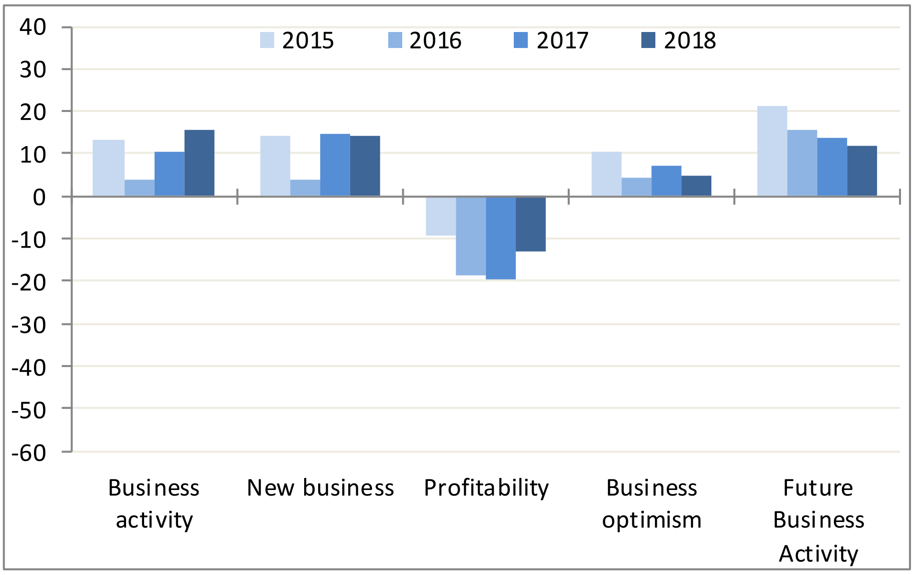


Figure 1.12 compares the responses to the BTS with the growth of non-finance sector GVA (excluding the rental income of private households). This shows that the business activity indicator has followed similar trends to GVA growth in recent years – with both improving significantly in 2015, before falling back in 2016 and then improving slightly in 2017. The BTS has further improved in 2018 and while this is a positive sign for the sector it is not clear that it necessarily presages a further acceleration in GVA growth.

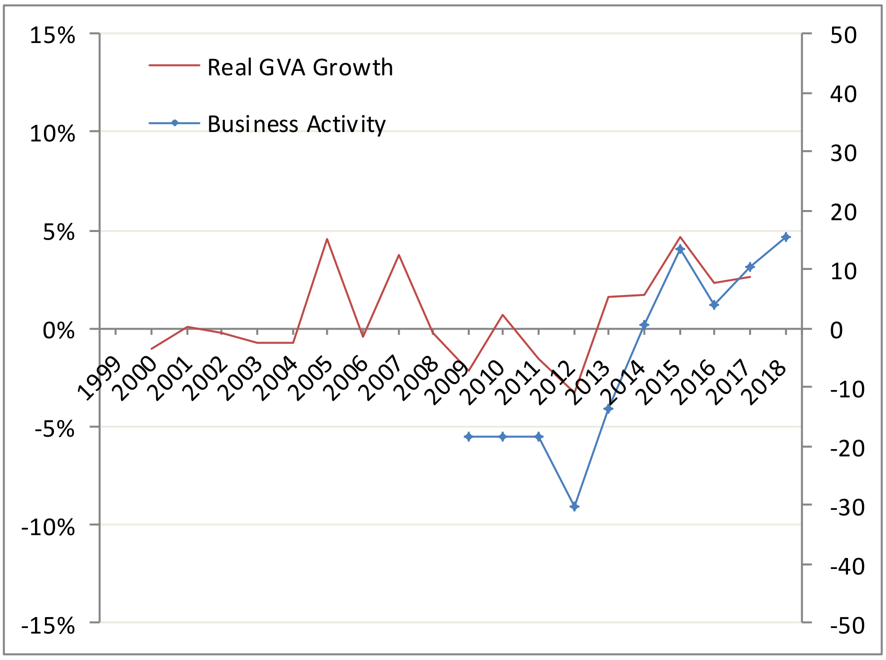
Figure 1.12

Non-Finance GVA Growth

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

Non-finance responses to business activity question averaged over each year (right-hand scale). Note: 2018 based on average of responses to "business activity" in March to September, plus "future business activity" from the September survey

Source: Statistics Jersey



1.2.3 Sectoral performance

GVA of the **wholesale and retail sector** rose by 1% in 2017 in real terms, though it has fallen 17% since its 2007 peak. There was a ½% fall in labour productivity; GVA growth was driven by a 2% rise in FTE employment. The sector remains significantly smaller than in the early part of the decade, due to the loss of much of the fulfilment sector as a result of the end of low value consignment relief (LVCR) and due to increased online competition for the retail sector.

The most recent (September 2018) Business Tendency Survey was mixed with the lead indicator, business activity, falling back significantly from the previous quarter's record high and is now relatively flat, suggesting neither a contraction nor expansion in business activity over the quarter. The indicator for input costs, however, has remained strongly negative, suggesting continuing inflationary pressures.

Representatives of the retail sector reported a challenging environment when they met with the Panel in July. While food retail was seeing growth, there was less optimism on non-food. This reflects a more general trend for declining high street retail in the face of the challenge of online shopping. While this has resulted in reports of falling occupancy rates on the high street, the situation does not appear to be as acute as in the UK. The sector has reported a number of other challenges to margins including continuing high property costs / rent and the extension of a positive rate of corporate tax to large corporate retailers. The sector also continues to struggle with recruitment, with the situation having worsened over the last twelve months.

The **hotels, restaurants and bars sector** contracted by 2% in 2017, after a 7% real growth rate recorded in 2016. Employment growth was strong with 2% full-time equivalent workers but productivity fell by 3½ %, reversing much of the large gains of 2016.

Overall visitor numbers in 2017 recovered from their modest fall in 2016 and the estimated total was the highest in a decade. The rise is due to a lift in leisure visitors as business visits have suffered from the decline of inter-island air capacity and increased air fares. Visitor numbers have largely held up in 2018 to date, though the number of visitor nights was down 7% in January to August compared to the same period a year earlier.

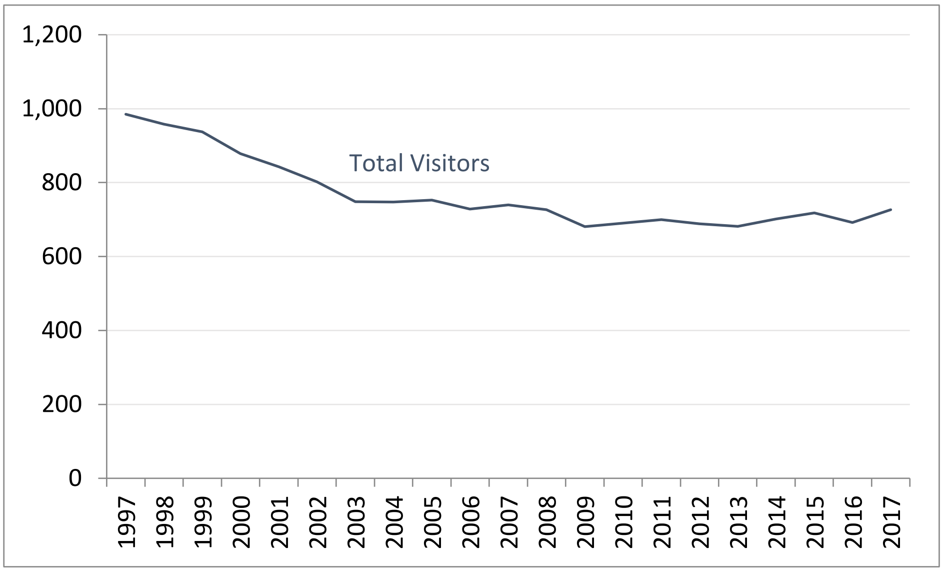
When the Panel met with sector representatives, they pointed to benefits coming from changes in the hospitality products and services Jersey offers. While the core season (May to August) remains the foundation, companies are successfully marketing the 'shoulder months' April and September.

Tourism sector representatives also reported increases in average spend per visitor. Difficulties in recruiting and retaining staff have not abated however, and problems with the recruitment of local staff have been exacerbated by high housing costs making attracting labour from off island more challenging. Recruitment of skilled staff, particularly chefs, remains especially difficult. The sector reported pressures to profitability due to increasing input costs and rising wages with the cost of premises remaining high.

Figure 1.13
Visitor numbers

Annual number of visitors to Jersey, 000s

Source: Visit Jersey



GVA of the **construction sector** grew by 9% in 2017, its fourth consecutive year of growth. The sector has grown by 35% since 2013; productivity and employment are both now at the highest levels since at least 1998. Responses to the Business Tendency Survey have been largely positive in recent years and the most recent (September 2018) survey showed strong business optimism and employment growth but continued upward pressure on input costs.

The outlook for construction is mixed, with the sector reporting high levels of activity but also concerns that the pipeline may be drying up. The sector's perceived uncertainty surrounding large public capital works programs has qualified previous expectations of future demand from the public sector. The future business indicator of the Business Tendency Survey has fallen in the latest quarter, though it has been positive since the beginning of 2015.

1.3 Labour Market

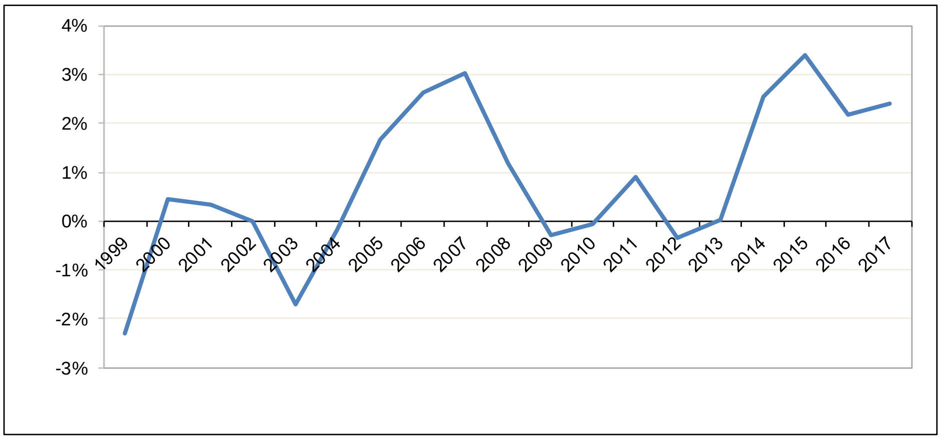
Employment in December 2017 was over 59,950, the highest December headcount figure recorded to date and 2.2% higher than in 2016. Employment has grown by a total of 12.5% in the ten years to December 2017.

Figure 1.14

Employment

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

Source: Statistics Jersey



The largest increase over the course of 2017 was, as with 2016, in education, health and other services which saw headcount grow by 470 (6.1%). Other sectors that saw increases in headcount include financial & legal (230, 1.8%), miscellaneous business activities (190, 3.9%), construction and quarrying (150, 2.7%) and hotels, restaurants and bars (110, 2.1%). The only sectors to lose jobs were agriculture and fishing, with a drop in headcount of 80 (5.6%) and electricity, gas and water with a fall of 20 (4%). The public sector added 60 jobs (0.9%).

Figure 1.15

Employment changes by sector

Total headcount for each sector

Source: Statistics Jersey

	Dec-16	Dec-17	Change
Agriculture and fishing	1,440	1,360	-80
Manufacturing	1,110	1,120	+10
Construction & quarrying	5,600	5,750	+150
Electricity, gas & water	500	480	-20
Wholesale & retail trades	7,830	7,890	+60
Hotels, restaurants & bars	5,290	5,400	+110
Transport, storage & communication	2,740	2,800	+60
Computer & related activities	760	810	+50
Financial & legal activities	13,100	13,330	+230
Miscellaneous business activities	4,830	5,020	+190
Education, health & other services	7,740	8,210	+470
Public Sector	7,690	7,780	+90
Total	**58,640**	**59,950**	**+1,310**

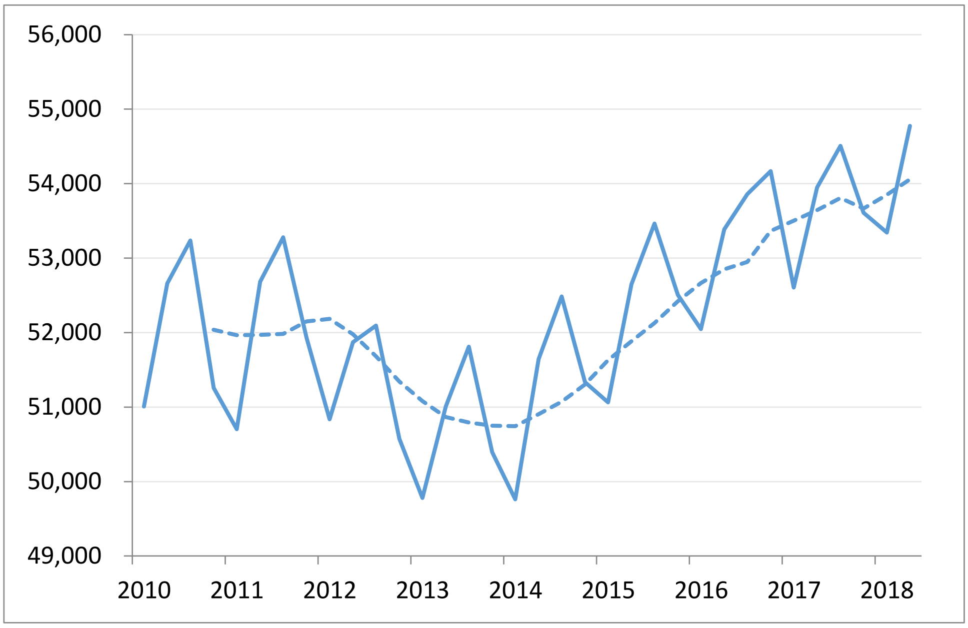
Social Security contribution numbers provide monthly data on the total number of individuals paying class 1 or class 2 contributions in that particular month. They can therefore be used to give some indication of recent trends in employment. Data for the first half of 2018 show average contributor numbers continuing to grow at over 1% annually.

Figure 1.16

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% from April 2014 to May 2015 – the most recent data for this measure. The previous figure was 4.6% in June 2014, though as the collection method differed the two figures are not entirely comparable.

The number registered as **actively seeking work** (ASW) is a useful and more timely indicator of trends in unemployment, though it is not a comprehensive measure of unemployment as only around half of those unemployed had registered as ASW at the time of the Census in 2011. ASW has fallen by over half since peaking at 2,050 in early 2013 to 970 in September 2018.

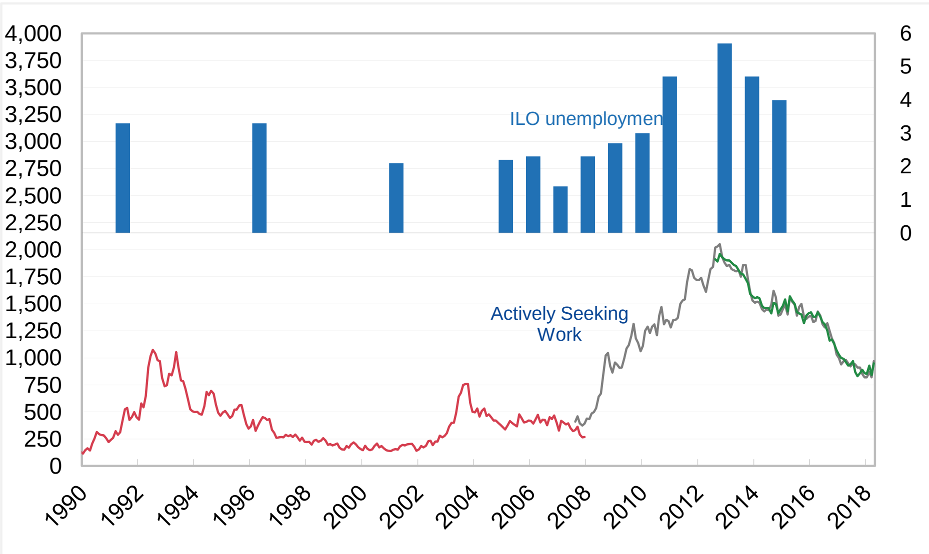
Figure 1.17

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: Statistics Jersey



Through the Business Tendency Survey, 36% of firms in the finance sector (weighted by employment) reported an increase in employment in the three months to September 2018 whilst 11% reported a decrease. The same survey reported that 34% of finance firms anticipate increasing employment over the following three months, with only 10% anticipating a decrease.

Trends were more balanced in non-finance firms, where a majority (66%) reported no change in employment, whilst 22% reported an increase and 12% a decrease. 25% anticipated an increase and 11% a decrease in employment in the three months to September 2018.

Figure 1.18 demonstrates that the employment indicator has improved considerably in recent years for both finance and non-finance, though there has been some recent softening in finance. Both sectors are strongly optimistic for future employment. Optimism has proven a useful forward indicator for employment.

Figure 1.18

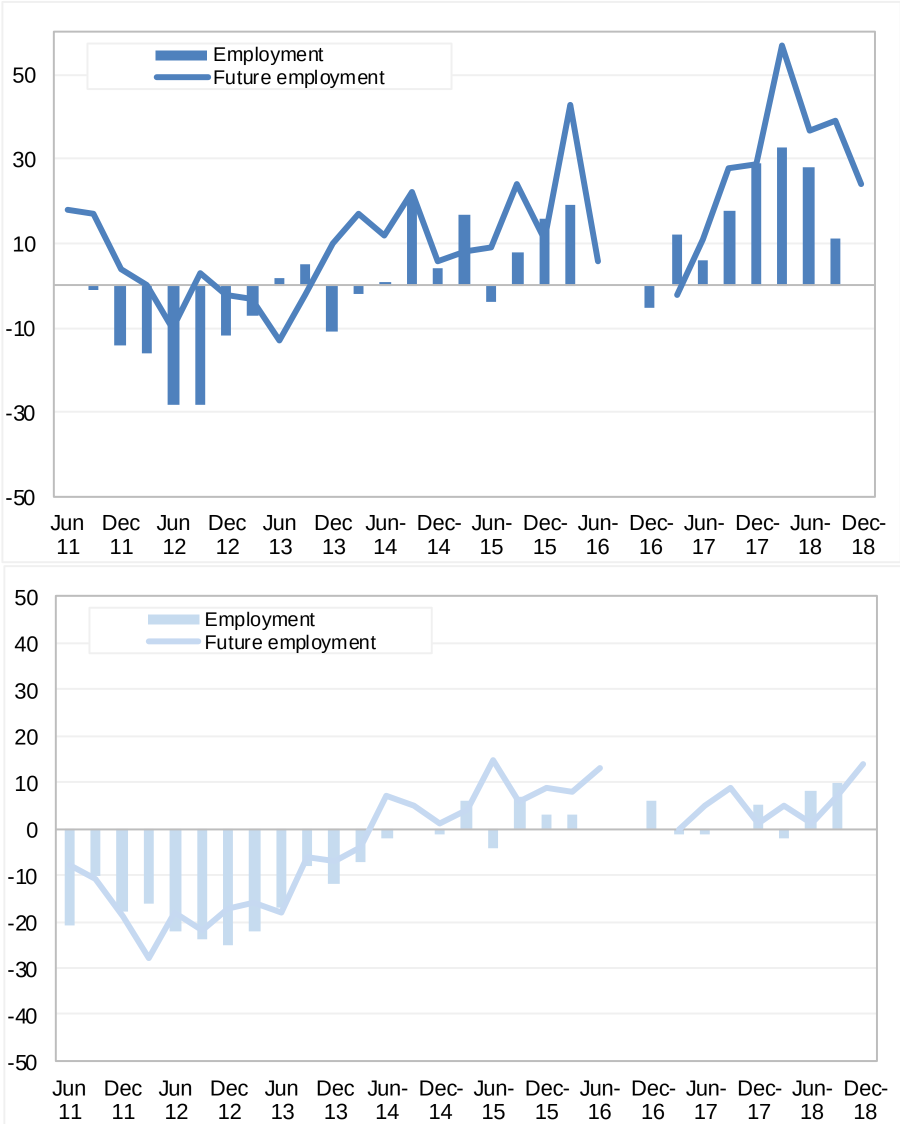
Employment trends from BTS

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

The break in both series is due to no survey having been conducted in June or September 2016

Top panel = finance; bottom panel = non-finance

Source: Statistics Jersey



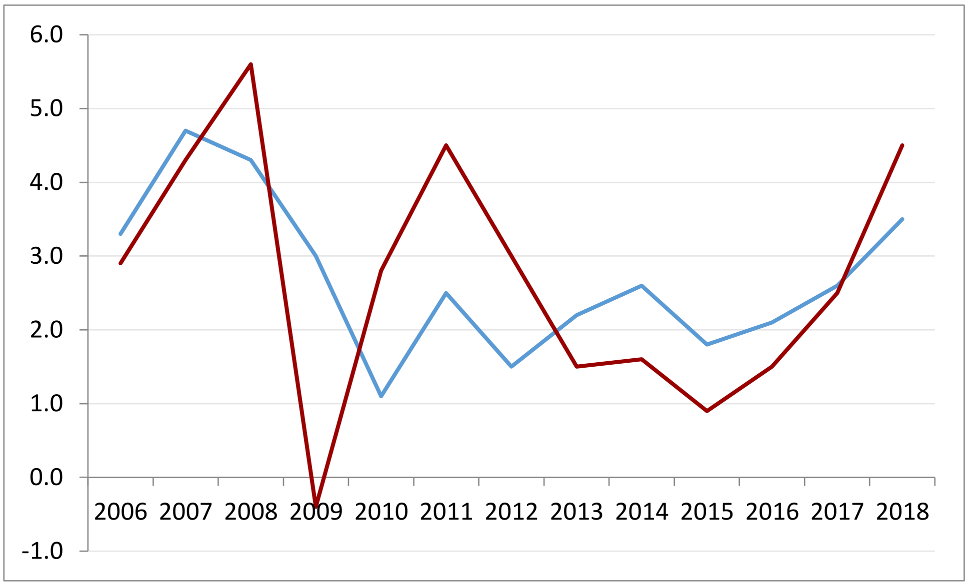
Average weekly earnings in June 2018 were 3.5% higher than at the same time in 2017, though they fell by around 1% in real terms given the 4.5% rate of inflation. This followed a four-year run of real-terms earnings increases. Over ten years, earnings have grown by less than ½% in real terms

The highest rise in average earnings was seen in the construction industry (6.7%) with a 4.5% increase in the minimum wage also seeing agriculture (5.7%) and hotels, restaurants and bars (4.3%) reporting above average rises. The public sector saw a 3.1% rise in average earnings.

Figure 1.19
Average earnings and inflation

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

Source: Statistics Jersey



1.4 Inflation

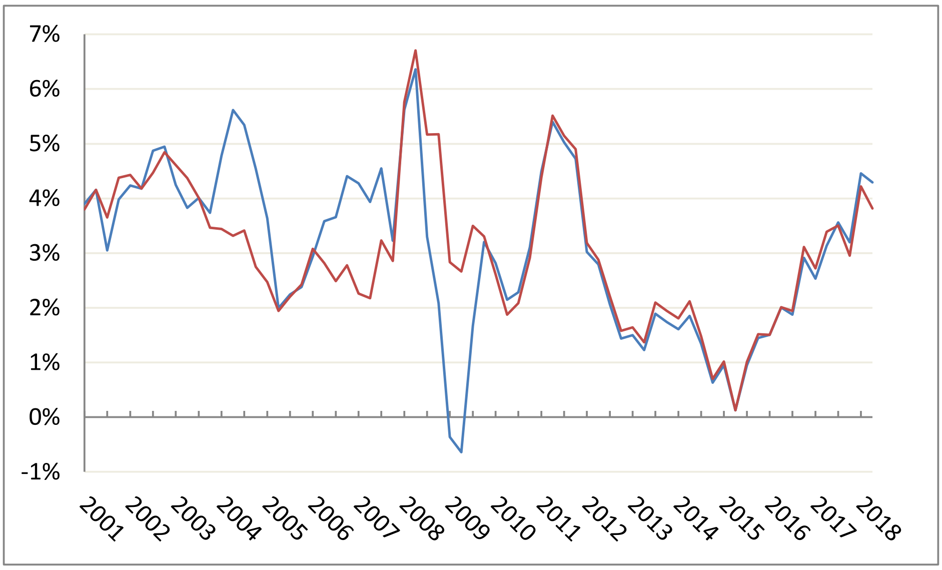
The Retail Price Index (RPI) increased by 4.2% in the year to September 2018, falling slightly from the six-year peak of 4.5% in June. Figure 1.19 shows that inflation has been above 3% for the last year with the initial acceleration linked to falls in the value of sterling following the Brexit referendum.

The main driver of the high rate of high inflation has been increasing housing costs, driven by strong recent growth in house prices and increases in interest rates. Household services, leisure services and motoring are also adding significantly to inflation.

Figure 1.20
Inflation in Jersey

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

Source: Statistics Jersey



1.5 Economic growth forecast

In 2017, profits in the finance industry fell and GVA per head declined a little. However, this reflected some one-off factors and there were also a number of positive signs which appear to have continued into 2018. Employment has continued to rise and business activity has been reported as rising across most sectors. Though last year's GVA readings could suggest a stalling in the economy, it is important to note that this was largely driven by losses in a small number of companies in the banking sector and the non-financial sector grew by 3%. BTS results have remained strong into 2018 in both finance and non-finance.

The overall outlook is largely unchanged from the Panel's August 2018 letter. Uncertainty around Brexit remains the biggest challenge in the immediate future. The financial services sector has come through a period of significant change but there are likely to be further challenges in the medium to long term. Though recent Bank Rate increases and the rise in the US Fed Funds rate is welcome news for the financial sector, in the near term the Bank of England may not increase Bank Rate significantly. Also, net interest income may not increase as quickly with rising rates as it declined with falling rates (due partly to early rises being passed on to customers, and also due to gradual unwinding of hedging positions taken by deposit receivers). A fall in the level of deposits is a further dampening factor.

The Panel forecast real GVA growth of around 1.6% for 2018, falling to 1.5% in 2019. The growth this year will be driven by continued growth in employment and profits with average wages having fallen in real terms. As indicated by Figure 1.21, there is considerable uncertainty around these forecasts. Beyond 2019, the chart shows the Panel's long-term trend growth assumption of 0%.

Figure 1.21

Economic growth forecast

% change in real GVA on year before

Sources: Panel judgement; Statistics Jersey

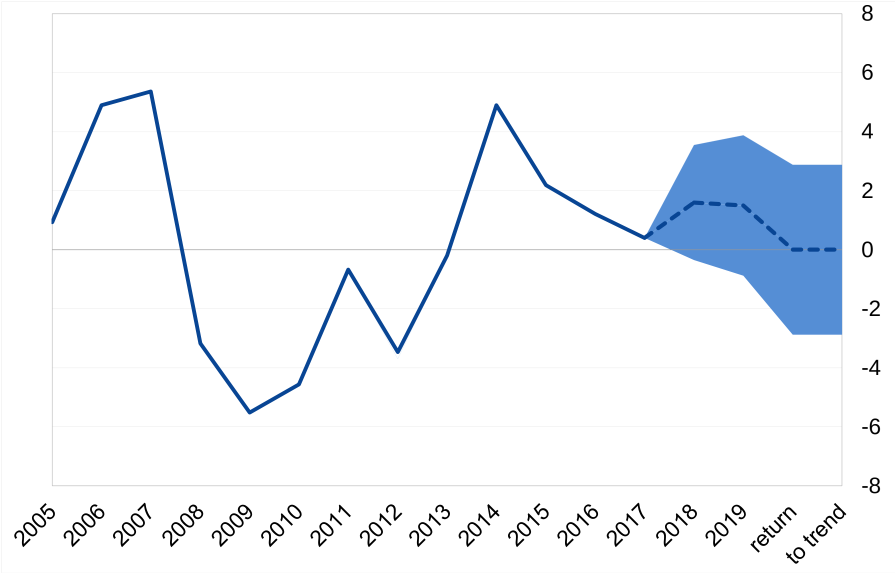


Figure 1.22 shows the Panel's most recent economic assumptions which were included in its letter to the Treasury Minister in August 2018.

Figure 1.22

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: Panel judgement

% change unless otherwise specified	2015	2016	2017	2018	2019	Return to trend 2020+
Real GVA	2.2	1.2	0.1	1.6	1.5	0.0
RPI	0.6	1.7	3.1	4.2	3.4	3.3
RPIY	0.6	1.7	3.2	3.8	3.0	3.0
Nominal GVA	2.9	1.9	3.3	5.4	4.5	3.0
Company profits	-0.7	0.9	-0.8	5.0	4.0	3.0
Financial services profits	-7.6	-0.6	-6.2	4.3	3.5	3.0
Compensation of employees	5.9	2.7	6.9	5.8	4.9	3.0
Employment	2.0	2.1	2.3	1.5	1.0	0.0
Average earnings	1.8	2.1	2.6	4.2	3.9	3.0
Interest rates (%)	0.5	0.4	0.3	0.6	0.8	1.0*
House prices	4.0	4.0	3.0	5.0	4.0	3.0

*Interest rate assumption for 2020 only

Since the August assumptions, data have been released on average earnings in June 2018 and GVA in 2017.

- GVA growth was recorded as 0.4% in real terms, slightly higher than the FPP assumption of 0.1%.
- Average earnings rose by 3.5%, somewhat below the FPP assumption of 4.2%, and below the rate of inflation, leaving a real average earnings loss of 0.9%. The recently announced plans to significantly increase the minimum wage next year, earnings might increase more than the 3.9% FPP assumption.

1.6 Spare capacity and trend GVA

During the Panel's fact-finding visit in July 2018, there were indications that

Jersey's spare capacity continued to be used up. Industry representatives spoke of increasing difficulties in acquiring the appropriate skill sets and tightening across many areas of the labour market contributing to pay pressure. All sectors saw nominal earnings grow faster than their five year average in 2018 (and all but one grew faster than the ten year average) but earnings largely failed to keep up with inflation.

Figure 1.23 shows the balance between growth in labour productivity and growth in earnings for the economy as a whole. A widening gap between these may indicate a rise in inflationary pressures as it suggests labour costs per unit of output are rising. Much of the divergence between productivity and earnings occurred in 2007-2012, a period over which productivity was falling primarily due to the low interest rate environment. However, the gap has continued to widen in the last five years with further falls in labour productivity alongside increases in real earnings.

There are some differences to the way in which earnings and productivity growth are measured however, which limit the conclusions which can be drawn from this analysis. Given recent minimum wage increases have not coincided with productivity gains in lower paid sectors, next year's proposed rise may result in some further inflationary pressures. Weak productivity remains a major issue for the economy and this is covered in more detail in section 2.13.

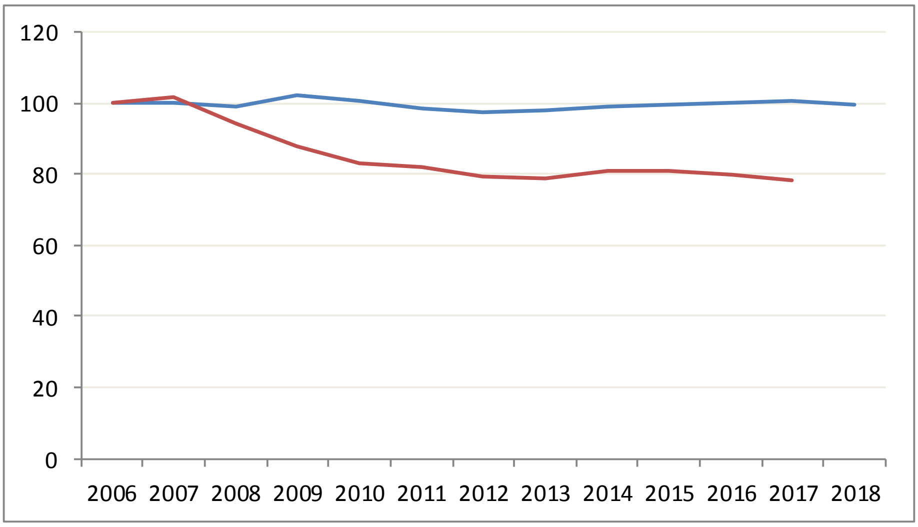
Figure 1.23

Comparison of average earnings growth and productivity growth

GVA/FTE in real terms (red line) and the average earnings index in real terms (blue line)

2006=100

Sources: Statistics Jersey



The Panel has in the past looked at Jersey's level of 'trend GVA' – i.e. the level of output consistent with full non-inflationary utilisation of resources. Figure 1.24 illustrates that, based on the Panel's current economic assumptions, Jersey's GVA will exceed trend next year (this is, however, subject to a large degree of uncertainty). From 2016 onward the chart assumes no growth in trend GVA, in line with the analysis carried out by the Panel in their pre-MTFP report in January 2015. The Panel will update this analysis as part of the advice in early 2019 to inform the next medium-term planning cycle. At present the flat trend is still considered appropriate for a planning assumption.

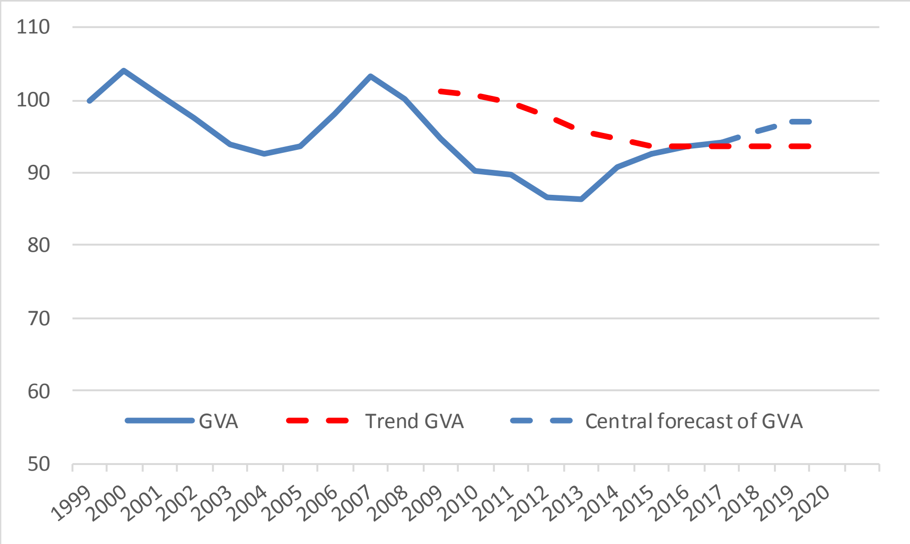
Figure 1.24

GVA relative to trend

GVA levels (solid line) and updated assumptions (dashed lines) and Panel estimate of trend GVA (red dashed line).

Index, 1999=100

Sources: Statistics Jersey and FPP calculations



Section 2 - **The Fiscal Outlook**

2.1 Introduction

In this section, the Panel discusses whether the latest fiscal plans, including the proposals set out in Budget 2019, follow its four guiding principles and the recommendations as described in the 2017 Annual Report (see Appendix 1).A number of recommendations are set out in this section, including some preliminary ones looking ahead to the development of the Government Plan.

This section is set out as follows:

- Guiding principles for the 2016-19 MTFP
- Developments since the MTFP Addition in September 2016
- Timing of proposed measures
- Allocation of growth
- Contingencies
- The adjusted fiscal position
- Funding the shortfall up to 2019
- Funding pressures in next medium-term planning period
- Trends in key States assets
- Panel's previous recommendations
- Risks to achieving current plans
- Longer-term challenges
- Guidance for the Government Plan

2.2 Guiding principles for the 2016-2019 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 is pleased to note that its four guiding principles have been generally followed during the MTFP Addition and subsequent Budgets,

including the draft Budget 2019, and the analysis below points out where further positive steps can be taken in keeping with these principles.

2.3 Developments since the MTFP Addition

Figure 2.1 shows the central Budget 2019 forecasts for total States income (blue bars) and States net revenue expenditure (red bars) between 2016 and 2019 and how it compares with the forecasts at the time of the MTFP Addition (approved September 2016).

Including depreciation, net revenue expenditure in 2017 was around £20m below that anticipated at the time of the MTFP Addition. Expenditure was less than expected due to a variety of reasons including lower welfare payments.

On the income side, general revenue income in 2017 was £56m higher than expected at the time of the MTFP Addition. Around half of the difference was due to personal income tax being higher as a result of increasing average effective tax rates and due to a larger than expected impact from the change in accounting rules to recognise personal tax from Current-Year-Basis (CYB) taxpayers one year earlier. The latter is forecast to contribute less to revenue in 2018. Some elements of taxable income grew more quickly than expected, particularly employment income, personal business profits and distributions.

Stamp duty receipts in 2017 were around £6m higher than expected at the time of the MTFP Addition while impôt duties, corporate tax and GST were each around £4m higher. The outturn for other income was £11m higher, largely driven by high investment returns on the Consolidated Fund balance.

There have been significant increases in the income forecast since last year's Budget. This reflects the higher outturn in 2017 but also improved economic assumptions for 2018 and 2019 with expectations for continued employment growth and above-average inflation. Income is forecast to grow to £784m this year and £826m next year, both around £35m above the MTFP Addition forecast.

The forecasts for expenditure for 2018 and 2019 are up by £39m and £28m respectively, when compared to the MTFP Addition forecast, due to significant carry-forwards from 2017 and from previous years.

Figure 2.1

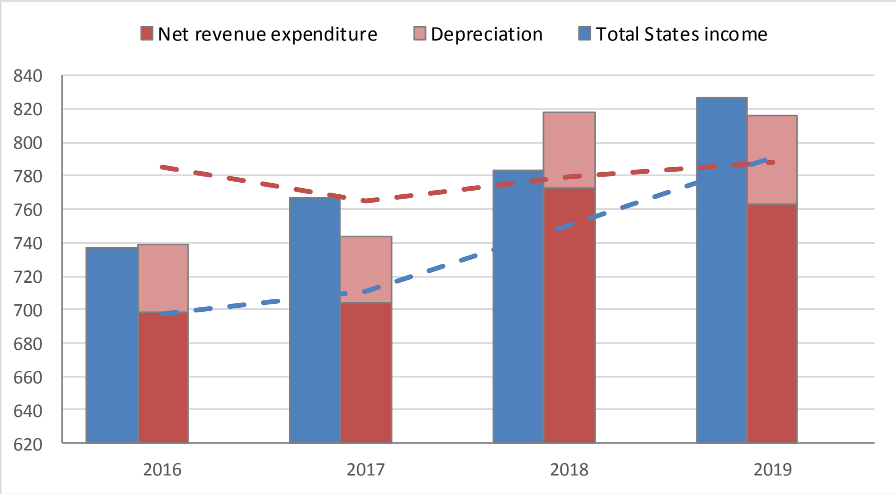
States income and expenditure at Budget 2019 (bars) compared with that in MTFP Addition (dashed lines)

£m (current prices)

Source: States Treasury and Exchequer

Includes funding measures

MTFP Addition expenditure includes depreciation



2017 was the second consecutive year in which income was higher than expected at the time of the MTFP Addition (as shown by the blue bar being higher than the dashed blue line) and this is expected to continue into 2018 and 2019. Figure 2.2 shows that States income before measures is now expected to total £812m in 2019, compared with £772m at the time of the MTFP Addition.

Figure 2.2

States income (before funding measures)

£m (current prices)

Source: States Treasury and Exchequer

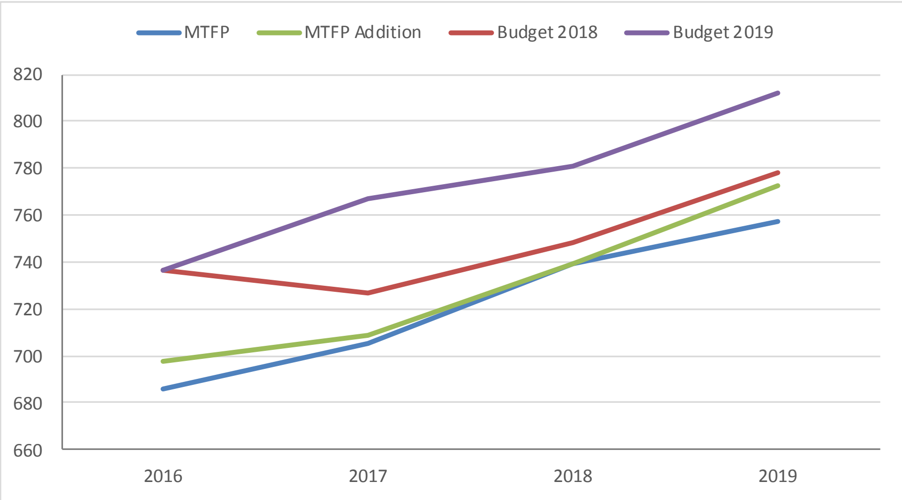


Figure 2.3 shows that expenditure (including depreciation) before measures is now expected to be £96m more than income before measures in 2019. This is a significant improvement on the £123m estimated at the time of the MTFP Addition.

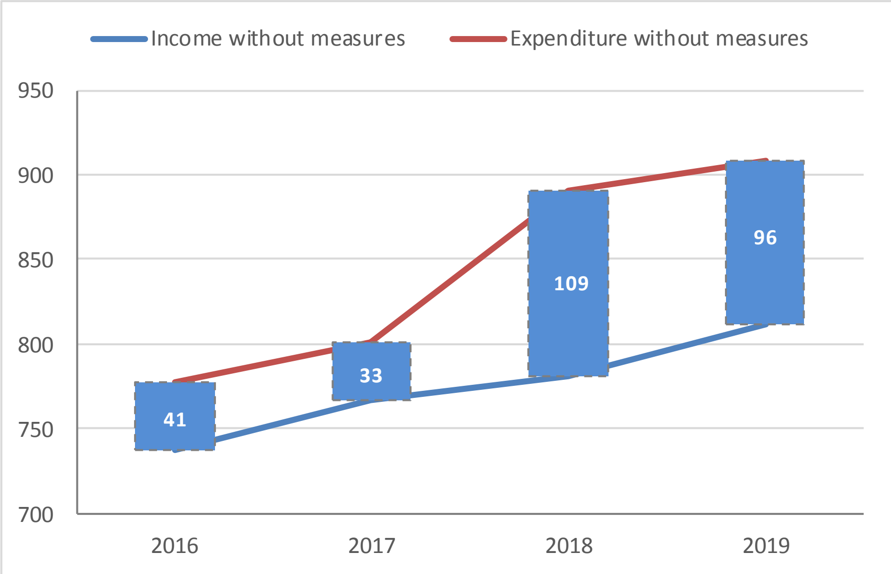
Figure 2.3

Adjusted current budget before funding measures

Blue bars are deficit without funding measures

£m (current prices)

Source: States Treasury and Exchequer



While some of the funding measures proposed in the MTFP Addition have not been delivered (primarily the £15m health charge and waste charges), other revenue-raising measures have been implemented such as the extension of corporate tax in Budget 2018. A further £1m of measures have been proposed in the draft 2019 Budget.

Figure 2.4

Budget 2019 revenue-raising measures

Source: States Treasury and Exchequer

Proposed Measures		Est. 2019 revenue (£'000)	Est. 2020 revenue (£'000)
Personal Tax:			
	Non-Resident's Relief	0	-100
Income Tax total		0	-100
GST:			
	Extend exemption to domiciliary	-203	-203
GST total		-203	-203
Impôts:			
	Alcohol	-214	-217
	Tobacoo	765	750
	Road fuel	916	907
Impôt Duties sub-total		1,467	1,440
Stamp Duty:			
	Abolish stamp duty on mortgages for properties below £600k	-989	-989
	Extend the First Time Buyers threshold to £500k	-268	-268
	Raise all standard rates by 0.5% on residential property valued above £500,000	1296	1296
Impôt Duties sub-total		39	39
Total Financial Implications		1,303	1,176

Overall some of the package of measures set out in the MTFP Addition has been replaced with different measures. Figure 2.5 shows that in Budget 2019 the States Treasury and Exchequer expect a total of £106m of efficiencies/savings, taxes and charges to be delivered by 2019, lower than the £123m estimated at the time of the MTFP Addition. The main differences from what was proposed at the time of the MTFP by 2019 are:

- The £15m annual health charge is no longer included in the plans as it was not agreed by the States Assembly.
- Waste charges of £11m are no longer expected to be delivered in 2019.
- The £5m transfer from the Health Insurance Fund is no longer planned and this will be met by underspends.
- New measures implemented in Budget 2018 and Budget 2019 are expected to raise £14.4m.

Within the £106m total set out in Figure 2.5, only the £5m which will be raised by reducing expenditure provisions is not a recurring measure. Although expenditure provisions could be reduced to the same degree in the next medium-term planning period, clearly this is uncertain. Further, Budget 2019 identifies that, whilst hard-wired into cash limits, it is known that not all measures have been delivered and work continues to identify efficiencies not delivered on a sustainable basis.

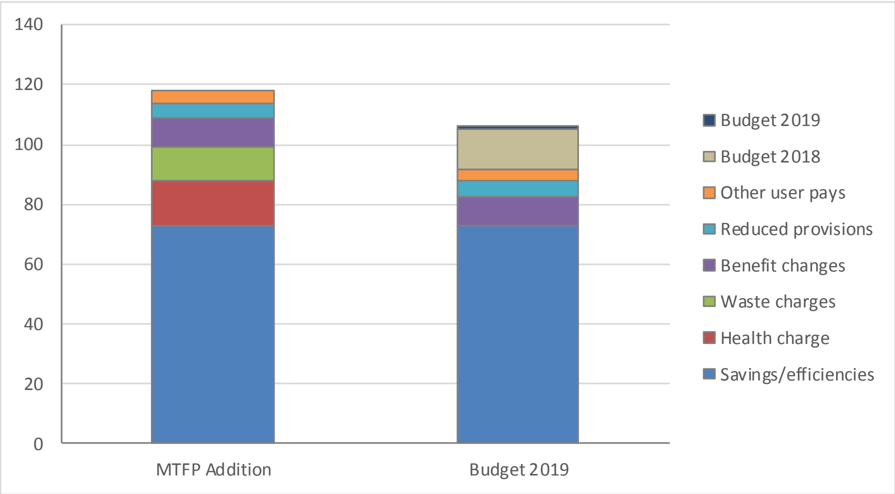
The Panel recommends that work should be undertaken as soon as possible to identify which of the measures have not been delivered and whether this relates to delays in realising the savings/revenue or whether some of the measures will prove impossible to implement so that alternatives will need to be sought.

Figure 2.5

Measures proposed in MTFP Addition and Budget 2019

£ million (current prices), per year by 2019

Source: States Treasury and Exchequer



2.4 Timing of proposed measures

Figure 2.6 shows the timing of the measures as currently proposed, including those in Budget 2019. It is clear that delivering the expenditure savings, efficiencies and user pays charges is the largest part of the measures proposed and that over 80% of these are expected to have been achieved by 2018.

£31m of measures still need to be realised in 2019 but a large proportion of these relate to the delayed impact of decisions made in Budget 2018 (such as the extension of corporate tax to additional firms in financial services and to large corporate retailers).

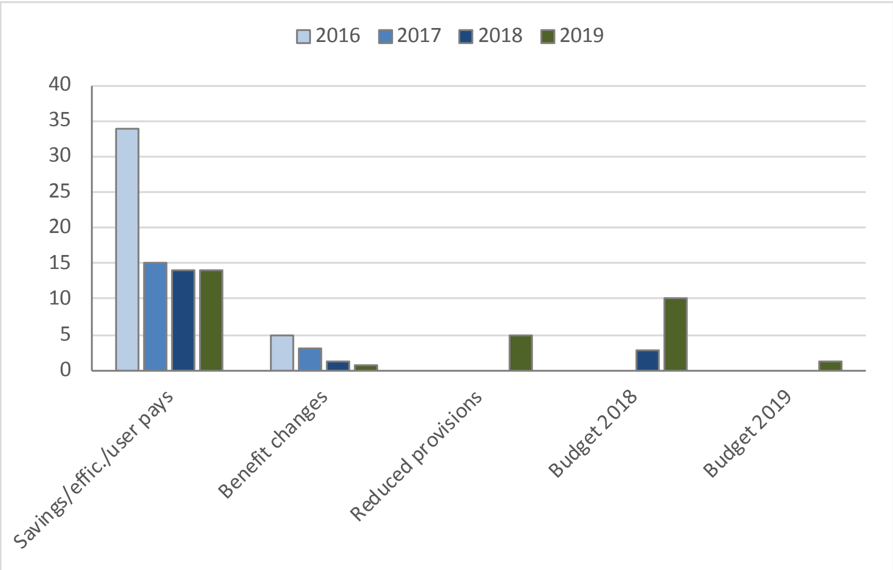
The FPP continues to believe that the profile and scale of the revenue and expenditure measures is broadly appropriate. While the total value of the deficit-reducing measures is less than envisaged at the time of MTFP Addition, revenue (and GVA growth) has been stronger than expected and therefore the States is still on track to balance the budget at the right time. However, further revenue or expenditure measures may be needed if the improved fiscal position proves more temporary than presently believed or if the economy hits significant capacity constraints. However, flexibility may also be needed in the opposite direction if economic conditions deteriorate.

Further, given that some of the measures proposed in the MTFP Addition were not achieved, these or measures of a similar size may need to be considered for the next medium-term planning period.

Figure 2.6
Timing of measures proposed as at Budget 2019

£ million (current prices)

Source: States Treasury and Exchequer



The Panel previously recommended that a permanent programme for securing additional efficiencies in the public sector is fully embedded in all future States financial planning and in particular in time for the next medium-term planning period. The Panel is encouraged that the public sector modernisation programme launched this year is expected to lead to a more efficient public sector with Phase 1 anticipated to lead to £30m of savings identified in 2019. **The Panel recommends that detailed, realistic and time-bound targets are**

developed for the delivery of these savings as soon as possible and built into the four-year Government Plan.

Figure 2.7 shows that the combination of all these income and expenditure trends means that the States operating position is significantly more positive in 2019 relative to where it was expected to be at the time of the MTFP Addition.

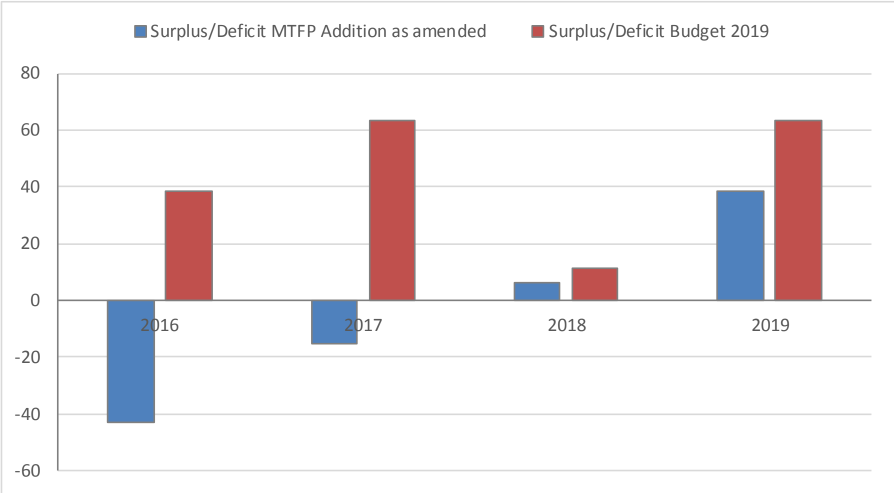
Figure 2.7

States projected operating budget position 2016-2019

The difference between States income and net revenue expenditure (operating position)

£ million (current prices)

Source: States Treasury and Exchequer



With estimates of depreciation unchanged this also leaves the current budget projected to be in surplus in 2019, a more positive position than that expected at the time of the MTFP Addition. **The Panel is encouraged that these forecasts indicate that the overall fiscal position is for a small current surplus in 2019 at an appropriate time (when the Panel anticipate the economy may be running above capacity).**

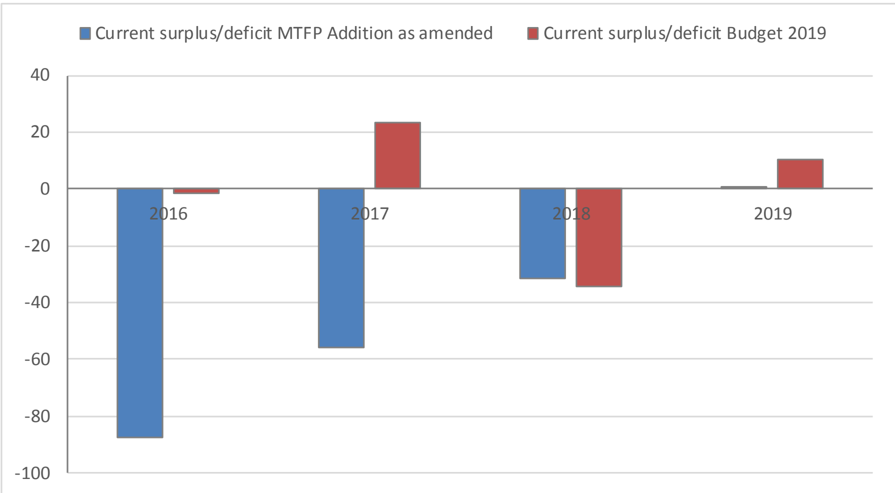
Figure 2.8

States projected current budget position 2016-2019

The difference between States income and net revenue expenditure including depreciation

£ million (current prices)

Source: States Treasury and Exchequer



2.5 Allocation of growth funding

The MTFP Addition set out a central growth allocation of £20.5m for 2019, of which £9.4m was agreed in Budget 2018 for the recurring element of new growth awarded in respect of 2018. This left £11m remaining to be allocated in Budget 2019. Some of the growth allocations have since been reduced/removed (particularly a £4m reduction to the funding for the P82/2012 redesign of health and social care services) and some new growth allocations have been proposed in Budget 2019, in particular £11m has been included to meet the shortfall in the Growth, Housing and Environment Department's budget due to the decision to defer the introduction of non-domestic waste charges.

As a result of these changes there is £7m of expenditure which is not met from within the growth allocations for 2019 at the time of the MTFP Addition. This appears to differ from the Budget 2018 position where the previous Council of Ministers recommended that the allocation of any new growth expenditure for 2019 should be subject to the prior approval of at least £11.85 million of non-domestic waste charges or equivalent expenditure measures to be consistent with the overall MTFP strategy and objective of broadly balanced budgets by 2019.

The £7m shortfall is to be met from unallocated reserves or departmental underspends, pending the delivery of anticipated savings from the implementation of the Target Operating Model

While the revised income forecasts suggest that the budget is likely to be in surplus in 2019, this should not be used to allow a relaxation of the fiscal discipline which was set out in the MTFP. **The Panel recommends that where measures are not implemented, the States should endeavour to find alternative measures of a similar size, rather than fund the shortfall through carry-forwards and unspent contingencies which may not be sustainable**.

2.6 Contingencies

The Panel made two recommendations regarding contingencies in its 2017 Annual Report – ensuring that unspent contingencies returned to the Consolidated Fund are not used to weaken fiscal discipline and that there is further explanation on how the size of contingency allocations is determined.

The Panel is encouraged by the development of the new process for allocating contingencies and understands that more clarity will be possible as the new Government Plan will allow more flexibility from year-to-year which may negate the need for significant contingencies.

The Panel recommends that to the extent there is still a contingency allocation in the 2019 Government Plan, there should be a clear explanation for how the size of contingencies has been determined.

2.7 The adjusted fiscal position

The analysis of the operating and current budget excludes capital expenditure. 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 (including subsidiary companies) is planning to spend more in the Jersey economy than it takes out by raising revenue, and to what extent.

The key steps to such a calculation are:

- **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 and subsidiary companies such as Andium Homes, Ports of Jersey and Jersey Development Company - JDC)
- **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**

Figure 2.9 shows the outcome of this analysis at the time of the MTFP Addition and as today assuming that the proposals in Budget 2019 are implemented. In 2017, the States added approximately £18m to the economy, against an estimated £263m at the time of the MTFP Addition. The amounts added to the economy in 2018 and 2019 are also now forecast to be significantly smaller than previously anticipated – a total of £324m, compared to the £617m expected in the MTFP Addition.

The adjusted fiscal position adds less to the economy than at the time of the MTFP Addition for the 2017-19 period because of higher income outturn/forecasts and lower than previously anticipated capital spending.

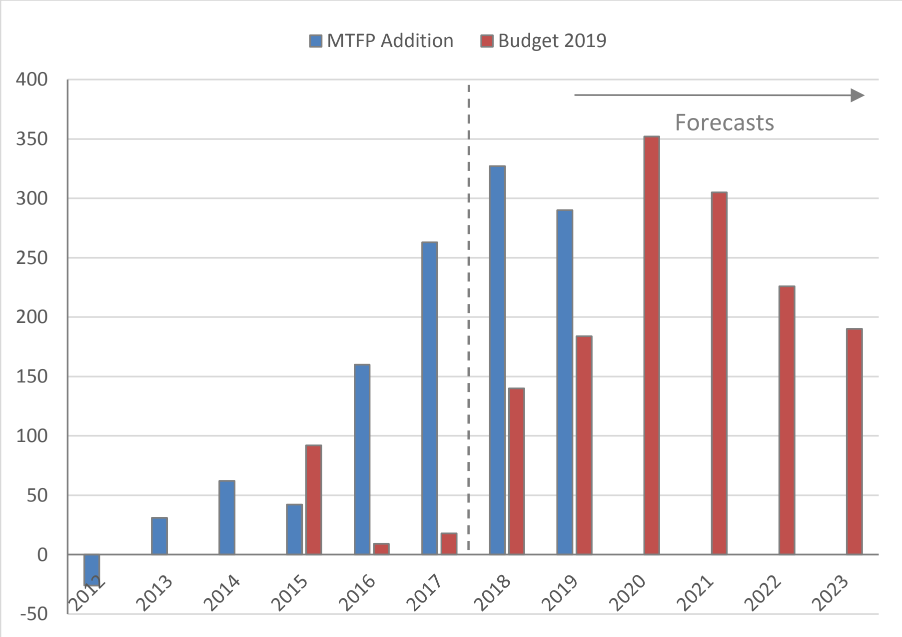
Figure 2.9

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

£ million (current prices) including States trading departments, Andium; Ports of Jersey and JDC

*MTFP Addition forecast to 2019 only

Source: States Treasury and Exchequer



In 2017 the operating position turned out to be significantly different to that expected at the time of the MTFP Addition as explained above – a projected operating deficit of £15m turned into an operating surplus of £63m. This therefore explains about £80m of the £245m variation in the adjusted fiscal position between the MTFP Addition and the actual outturn for 2017. The other major contributor to the difference was that capital expenditure turned out lower than expected with less capital expenditure by departments; on the new hospital; and by subsidiary companies, in particular Andium Homes. Given the strong performance of the construction sector in 2017, as outlined in Section 1, this may suggest that there was considerable demand from the private sector which at least partially offset the lower-than-expected capital spend from government.

These recent trends are a reminder of how dependent the fiscal stance in future years is on whether the planned capital expenditure takes place in line with the expected timeframe. Experience over the past few 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. If only half of the projected capital expenditure is delivered in coming years Figure 2.10 shows that the States would be putting around £50m into the economy in both 2018 and 2019. Beyond the current MTFP period current plans suggest that around £120m-£150m would be put into the economy in 2020 and 2021, falling back to less than £100m per year in 2022 and 2023. As a proportion of GVA, this is significant – peaking at around 3% in 2020.

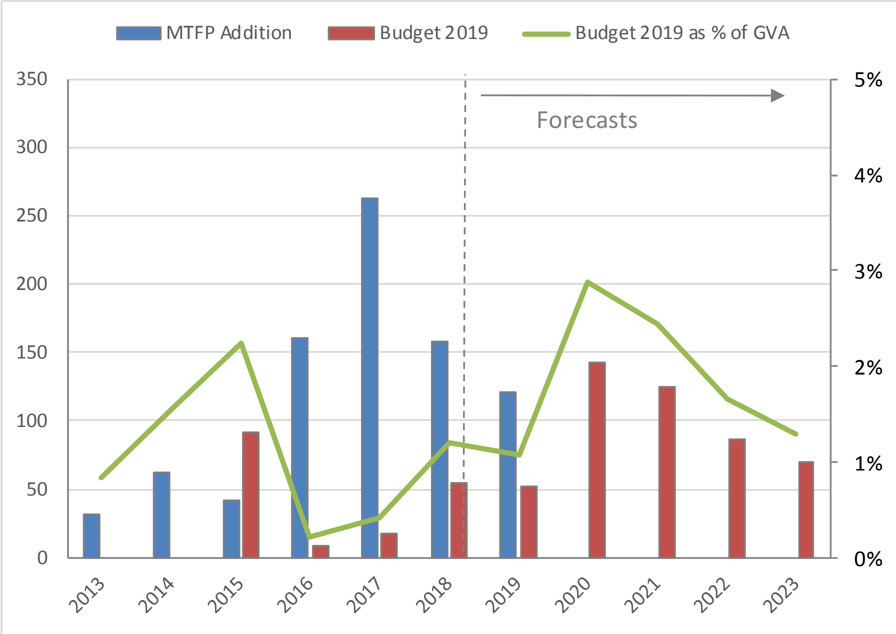
Figure 2.10

Estimates of adjusted fiscal position (States spending relative to revenue) if only 50% of capital expenditure is delivered

£ million, current prices (LHS axis)

Green line is latest estimate as % of GVA (RHS axis)

Source: States Treasury and Exchequer; Panel calculations



The Panel has in recent years advised that it would be advantageous for the States to continue to support the local economy during the period of uncertainty following the UK's decision to leave the EU. In 2017, as in 2016, this did not occur to the extent to which it was planned. While this has coincided with a period in which the economy has slowed (from above 2% growth in 2015 to around ½% in 2017), this slowdown was largely due to the performance of the financial services sector, particularly the profit of the sector in 2017, which is unlikely to be significantly affected by the adjusted fiscal position. However, capital expenditure has not been as supportive to the economy as planned.

The adjusted fiscal position has not been as supportive as planned in recent years. In addition, there are a number of large capital projects coming in future years (including the hospital) which will need to be carefully managed to ensure that they do not put too much pressure on local resources during a period in which the economy may be running above capacity. Generally it remains very difficult to use States' capital spending to manage the economic cycle and the Panel does not believe that this should be a reason to delay important capital projects, given that capital spending in the past has tended to be lower than forecast.

2.8 Funding the shortfall until 2019

It was planned to transfer £50m from the Strategic Reserve to meet the shortfall expected in 2017. However, the outturn reflected a surplus of £43m which means that the balance on the Consolidated Fund at the end of 2017 was £120m, significantly higher than the £25m expected at the time of the MTFP Addition.

The Panel's previous advice was that reserves should be used to balance the Consolidated Fund while the measures were brought in to bring the States' finances back to balance. However, the transfers from the Strategic Reserve of £57m in 2016 and £50m in 2017 have resulted in a significant balance building up in the Consolidated Fund. The further surpluses forecast for 2018 and 2019 will mean that the balance on the Consolidated Fund will continue to grow. This has allowed Budget 2019 to propose a transfer of £50m to the Stabilisation Fund. This is instead of the £50m transfer to the Strategic Reserve in 2019 which was originally planned, and is intended to act as a buffer against any consequences that may arise from the short-term uncertainties that face the global and local economies

The transfer of £50m to the Stabilisation Fund is in line with the Panel's advice in its August 2018 letter. However, as Figure 2.11 shows, the forecast balance on the Consolidated Fund remains significant. Budget 2019 indicates that this is designed to meet the need for flexibility as the Government Plan is progressed, not least because of the considerable capital investment required. Box 1 sets out the provisional results of the Panel's analysis of the size of Jersey's automatic stabilisers which shows that they are relatively limited – putting greater emphasis on active use of the Stabilisation Fund.

The Panel recommend that this improved position on the Consolidated Fund should not at this stage lead to any changes in the proposed measures to balance the budget – either on the revenue or expenditure side. Surplus funds should, in the first instance, be used to replenish the Stabilisation Fund. In the longer term, the States should set out a plan to bring the value of both funds to the optimal level to meet their objectives. The Panel will undertake analysis to establish the appropriate size of each fund early in 2019.

Figure 2.11
Consolidated fund changes

£ million (current prices)

Source: States Treasury and Exchequer

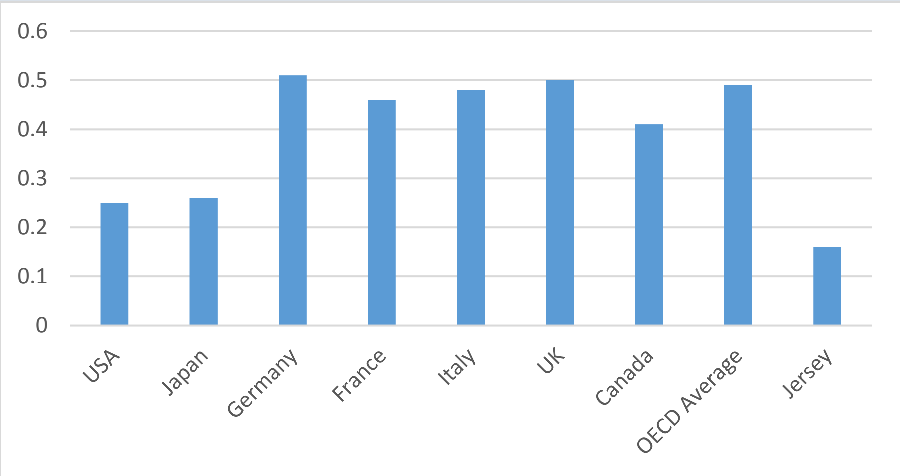
	2017 £ m	2018 £ m	2019 £ m
Consolidated Fund opening balance	91	120	127
Forecast operating surplus/(deficit)	43	50	91
Capital programme funding	(65)	(50)	(33)
Proposed transfers from Strategic Reserve	50	-	-
Proposed transfers to Stabilisation Fund		-	(50)
Proposed asset disposals	1	1	-
Proposed transfer from COCF	-	7	-
Consolidated Fund closing balance	**120**	**127**	**135**
Closing balance at MTFP Addition	**25**	**21**	**22**

Box 1: Jersey's automatic stabilisers

Given the structure of government revenue and expenditure, the government budget position tends to dampen the economic cycle even without policy changes. For example, in a boom tax revenues tend to rise whilst expenditure (particularly welfare spending such as unemployment benefit) tends to fall – leading to a budget surplus that helps dampen the boom. This feature – termed automatic stabilisers – is a useful side effect of the government budget position.

The Panel has undertaken some work to assess the extent to which these stabilisers operate in Jersey. Using a methodology developed by the OECD (Van Den Noord, 2000), this allows us to compare Jersey's performance with that of other OECD economies

Figure 2.12: Automatic stabilisers in OECD economies
Change in net lending as a % of GDP for a 1% change in GDP



As Figure 2.12 indicates, Jersey's automatic stabilisers are far weaker than the OECD average. This is mainly due to two key factors. First, Jersey's government sector is far smaller (as a share of GDP) than the OECD average so the influence of the government sector on overall activity is weaker. Second, personal taxes are not very responsive to the economic cycle partly because Jersey does not tend to see significant falls in wages or employment during downturns (and vice versa in upturns) and partly because taxes are not very progressive at higher incomes.

Overall, these results show that there is a significant potential role for active stabilisation policy in Jersey reinforcing the need to consider boosting the Stabilisation Fund during upturns and vice versa during downturns.

2.9 Funding pressures for next medium-term planning period

While Budget 2019 forecasts a surplus next year, in line with the Panel's recommendations, there are a number of structural pressures from 2020 onward which lead to a risk that this surplus will be reversed. Based on the latest income forecast and on expenditure forecasts as predicted by Departments at the end of August 2018, a current deficit of £28m is forecast for 2020, rising to £41m in 2023. There are a number of pressures causing these projected deficits:

- The £11m shortfall from non-domestic waste charges;
- The impact of inflation which includes provision for pay and provision for uprating benefits;
- The additional employers' costs of the new CARE pension scheme;
- Repayments of the pre-1987 PECRS debt;
- 2% investment in Health - service standards and healthcare inflation;
- Education demographics;
- The States Grant to the Social Security Fund returning to formula after being frozen in the MTFP 2016-2019;
- Health Insurance Fund replacement funding (£5m);
- Higher Education (partly offset by increased tax income from the removal of the Higher Child Allowance from 2019 onwards);
- the Children's Change Programme and Children's Plan;
- Health P.82 investment including reinstating the £3.6m of funding which was reallocated in 2019;
- £3m per annum for investment in initiatives to grow the economy;
- additional recurring expenditure during the MTFP 2016-2019 period for existing commitments including cyber-security measures, the International Taxes team and funding for our response and preparation in respect of Brexit

The indicative deficits over the Government Plan period are before investment in the Common Strategic Policy priorities but also before taking account of the savings which are anticipated as a result of implementing the new Target Operating Model.

It is clear, therefore, that some significant challenges lie ahead in meeting these structural pressures and ensuring that budgets can be balanced over the economic cycle. In early 2019 the Panel will set out some of the key considerations which should be taken into account in developing the Government Plan, including how the States should seek to deal with the considerable risks in the economic outlook and the impact this might have on government finances.

2.10 Trends in key States assets

Figure 2.13 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 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 has risen by 25% between 2015 and 2017. However, the value of these reserves is expected to grow more slowly in coming years and to remain relatively flat as a proportion of GVA. As stated in section 2.8, the Panel will undertake some analysis to establish the appropriate size of the Strategic Reserve and Stabilisation Fund, as part of their report to inform the Government Plan which will be published early next year.

Figure 2.13

States reserves projections in real terms

Total year end net assets, £ million (constant 2015 values) projections for the States' largest Funds

Source: States Treasury and Exchequer / Social Security

	2015 £ m	2016 £ m	2017 £ m	2018 £ m	2019 £ m
Consolidated Fund	65	90	117	121	123
Strategic Reserve	771	815	821	843	849
Stabilisation Fund	-	-	-	-	46
Social Security Reserve Fund	1,289	1,562	1,742	1,751	1,763
Social Security Fund	88	72	70	68	66
Health Insurance Fund	76	85	92	91	90
Long Term Care	11	20	24	23	20
Total	**2,300**	**2,644**	**2,867**	**2,897**	**2,956**
Total % GVA	*56*	*63*	*67*	*66*	*67*

2.11 Panel's previous recommendations

The recommendations from the FPP's 2017 Annual Report are repeated in Appendix 1 of this report. Progress has been made in some areas:

1. While the scale of budgetary measures is likely to be less than planned in the MTFP (with the notable element being the failure to implement non-domestic waste charges or an alternative sustainable measure of a similar size), the States is now on track to deliver a small current budget surplus in 2019, which is appropriate at a time when the economy seems likely to be above capacity.

2. Progress has been made in securing a programme for further efficiencies as the implementation of the Target Operating Model is expected to deliver significant savings, with Phase 1 expected to identify £30m of savings in 2019.
3. The Panel welcomes the formation of the Investment Appraisal Board which is intended to bring a more robust process to the allocation of contingencies. However, further work will be needed in the Government Plan to clearly explain how the size of contingencies has been determined, as set out in section 2.6.
4. Some of the surplus balance on the Consolidated Fund is expected to be transferred to the Stabilisation Fund in 2019. However, continued caution is required to ensure that this significant balance does not deter difficult decisions around expenditure cuts or revenue-raising measures.
5. The Common Strategic Policy identifies preparing for Islanders living longer as a cross-cutting theme. **However, further work is required over the next Government Plan period to develop a whole-of-government strategy to meet this challenge.**
6. The Economic and Productivity Growth Drawdown Provision (EPGDP) has been used to invest in projects focussed on skills and digital infrastructure. The Panel welcomes the new Investment Appraisal Board which will consider all contingency requests, including those for EPGDP funding. **The Panel urges that the new process continues to give due priority to those projects which have the potential to raise private sector productivity, given disappointing recent trends. It is important that productivity is a key focus of the new Government Plan.**

A number of the recommendations were more long-term in nature and these continue to be relevant moving into the next Government Plan period, including the need to carefully manage the significant capital spend envisaged in future years, continuing to monitor the trends in States assets and liabilities, and addressing key issues regarding future structural pressures, future capital expenditure and planning for surpluses.

2.12 Risks to achieving current plans

There are several risks to successfully delivering the last phase of the plans for 2017-19 as originally set out in the MTFP Addition and developed further in Budget 2018 and the proposals for Budget 2019:

- **Future revenue**: There is always significant uncertainty in forecasting future trends in revenue and the external economic volatility has clearly exacerbated these risks such that the range of possible outcomes is wider even than normal.

- **Controlling expenditure**: Risks remain that current savings and efficiencies may not be delivered in a sustainable way.

- **Political risks**: Political pressures may mean that proposed measures prove more difficult to implement than initially expected, and alternative measures may take time to develop. This has been demonstrated by the challenges in implementing either the Health Charge or non-domestic waste charges.

- **Timing of capital expenditure**: As discussed above, delays to capital projects can prevent fiscal support reaching the economy when it is needed. On the other hand, there is the risk that large projects could come on stream at times when the economy is short of capacity - adding to inflationary pressure and reducing value for money.

- **Population policy**: Immigration is a key element of the supply side of the economy and migration policy should be implemented in a pragmatic way that does not constrain it. A weakened supply side would only serve to exacerbate the structural pressures the economy already faces. A related risk is that recruitment difficulties referred to in Section 1 may be exacerbated by high housing costs which make attracting labour from off island more challenging.

2.13 Longer-term challenges

Current plans are to run a small budget surplus in 2019, broadly in line with previous FPP advice. The Panel has put so much emphasis on addressing the imbalance between States revenue and expenditure over this period because in the longer term there are a number of challenges which are likely to lead to further structural pressure on States finances. These are in addition to the medium-term pressures identified in the draft 2019 Budget. We will look at these again in our advice to the Government Plan. Below we reiterate the key points on these challenges, as set out in our 2017 report:

Ageing population – While many other economies face challenges from demographic change, the problem may be particularly acute in Jersey. While there is some uncertainty around the future demographic structure of Jersey, the ageing of the population is something that will happen under any level of migration. As the population ages, demands on public services will increase, particularly health and social care, but less revenue is likely to be generated from older people which will lead to increasing pressure on public finances.

Productivity - Jersey's poor productivity performance has been highlighted in Section 1 and has been highlighted by the Panel in previous reports. While part of this trend is due to falling profitability in the finance sector due to the low interest rate environment, there are clearly challenges in all sectors. The Panel welcomes the priority placed on creating a vibrant and sustainable economy in the Common Strategic Policy but continues to emphasise that productivity-led growth is key to improving Jersey's economic performance and competitiveness, improving public finances and raising the standard of living.

Economic uncertainty - Section 1 points to a number of areas of significant uncertainty in the short-to-medium term, surrounding Brexit and the potential regulatory challenges facing the financial services sector. In addition, the Panel has previously pointed to the fact that smaller economies tend to face more economic volatility than their larger equivalents. This serves to highlight the importance of keeping public finances on a sound footing and with enough flexibility to manage further potential negative shocks to the economy. This is particularly important for Jersey where automatic stabilisers are weak and so a more activist policy is needed to mitigate volatility.

2.14 Guidance for the Government Plan

The 2017 Annual Report set out some key themes which will need to be considered for the next medium-term planning period. These are reiterated below and will be further developed when the Panel undertakes its report to inform the Government Plan in early 2019.

- **Future structural pressures**: The longer-term challenges highlighted above make it clear that further fiscal adjustment is likely to be required during the next medium-term planning period. A strategy to address this should be developed that looks at what is realistic in terms of further efficiency savings (as opposed to expenditure reductions) and whether revenue-raising measures will be required. If the latter is required then consideration needs to be given as to how it can be done in the least damaging way to economic growth and what the key equity considerations are. It may be important to allow sufficient time for consultation on different ways forward.
- **Capital expenditure**: Identifying what capital expenditure is required that is conducive to economic growth and productivity improvements. Also, how it will be financed and managed to get the balance right between avoiding undue capacity pressures and supporting the economy. It is

not possible to use capital spending to offset the impact of the economic cycle at all times, but large projects in a small economy will tend to risk inflation pressure.

- **Planning for surpluses**: If economic conditions over the life of the next medium-term planning period are such that the States runs budget surpluses in any year (which is what we presently expect given the economic cycle), that these are used to replenish reserves – either the Stabilisation Fund or Strategic Reserve.

Appendix 1: FPP's 2017 Annual Report recommendations

1. The FPP continues to believe that the profile and scale of the measures set out in the MTFP Addition and Draft Budget 2018 is broadly appropriate and advise that the remaining measures (or ones of equal value) for 2018 and 2019 need to be implemented on time.
2. The Council of Ministers is urged to ensure that a permanent programme for securing additional efficiencies in the public sector is fully embedded in all future States financial planning and in particular in time for the next MTFP. This process should identify ways in which the same services can be delivered but with fewer resources.
3. Progress has been made in meeting the Panel's previous advice regarding contingencies but there are two aspects worth giving further consideration to:
    - Ensuring that unspent contingencies that are returned to the Consolidated Fund are not used to weaken fiscal discipline and delay required permanent revenue or expenditure measures.
    - Further explanation on how the size of contingency allocations are determined and particularly so this is clearer ahead of the development of the next MTFP.
4. The Panel continues to highlight the need to prioritise delivering key capital projects on time and particularly those that will support the local economy in 2017 and 2018 (particularly in the light of the September 2017 Business Tendency Survey results) but there is the risk that this could be pro-cyclical if the economy is above capacity in the later years. However, it will be important as spare capacity continues to be used up across the economy also to be vigilant that these large capital projects do not put too much pressure on local resources and add to nascent cost pressures in the construction sector.
5. Given the scale of future capital expenditure there are a number of other risks that can be managed by:
    - Prioritising projects that demonstrably add to future productivity growth, for example in areas such as skills and infrastructure.
    - The States exerting tight control of costs to prevent projects over exceeding budgets.
    - Providing more certainty on the funding and timing of the new hospital development.
6. The improved position on the Consolidated Fund should not at this stage lead to any changes in the proposed scales and timing of measures to balance the budget – either on the revenue and/or expenditure side.

7. If the current forecasts come to fruition the Panel would expect to advise in future reports to reduce the balance on the Consolidated Fund by either transferring funds to the Stabilisation Fund or making a further repayment to the Strategic Reserve.
8. The Panel continues to support the ongoing monitoring of trends in States assets and liabilities, as set out in Council of Ministers Fiscal Framework and this should include regular assessment of trends as a share of GVA.
9. Build on the work done by the Social Security Department looking at the sustainability of the Social Security Funds in the light of the ageing population and take a whole-of-government view for a strategy to deal with the ageing society.
10. The Economic and Productivity Growth Drawdown Provision (EPGDP) should continue to identify medium-term policies that help raise productivity and increase the underlying rate of economic growth. Consideration should be given as to how the EPGDP could facilitate the adoption of new technology across all sectors in Jersey and drive significant productivity growth.
11. When considering the longer-term challenges that the Jersey economy and public finances face, this gives some direction for the key issues that need to be developed and addressed in the next MTFP:

    - **Future structural pressures**: The longer-term challenges facing Jersey make it clear that further adjustment is likely to be required during the next MTFP period. A strategy to address this should be developed that looks at what is realistic in terms of further efficiency savings (as opposed to expenditure reductions) and whether revenue-raising measures will be required.
    - **Capital expenditure**: Identifying what capital expenditure is required that is conducive to economic growth and productivity improvements. Also, how it will be financed and managed to get the balance right between preventing capacity pressures and supporting the economy. The fact fiscal policy in Jersey did not operate in a countercyclical way in 2016 is a timely reminder of how difficult this can be.
    - **Planning for surpluses**: If economic conditions over the life of the next MTFP are such that the States runs budget surpluses in any year, these should be used to replenish reserves – either the Stabilisation Fund or Strategic Reserve.