13. APPENDIX 4: ADVISOR'S REPORT – MJO CONSULTING

Jersey's Medium Term Financial Plan[1]

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[1] The author would like to acknowledge all the help he has received from Ministerial Departments during the writing of this report. He would particularly like to thank the Economic Adviser and the Economics Unit, the States Statistician and the Treasury for their patience and hard work in clarifying and supplying various figures.

EXECUTIVE SUMMARY

ES1. The decision to publish a Medium Term Financial Plan (MTFP) is welcome, as it will in due course eliminate many of the problems associated with the annual budgeting process.

ES2. The deteriorating international economic situation and the on-going difficult conditions in Jersey suggests that there are further downside risks to the growth forecasts made in March 2011.

ES3. A reworking of the economic forecasts with new assumptions provided by the author suggests that income will be less than the central forecast but within the range of the income forecasts in the MTFP.

ES4. It appears that the MTFP already builds in a fiscal stimulus. A thorough debate needs to take place about the benefits of an additional fiscal stimulus (other than that already assumed in the MTFP) for the Jersey economy.

ES5. A more cautious approach to spending for 2014 and 2015 should be considered by policymakers. If revenues are better then expected then the Stabilisation Fund might be topped up.

ES6. If politicians wish to adopt the expenditure limits as set out in the draft MTFP and income forecasts are worse than expected then the policy implications (e.g. tax rises) need to be thoroughly explored and debated.

RECOMMENDATIONS

R1. In future, the MTFP should incorporate up to date economic forecasts. This might mean that economic forecasts need to be made more regularly but it would align the MTFP closer to recent economic circumstances.

R2. Work needs to be undertaken by Treasury and Resources to justify the size, nature and scope of any additional fiscal stimulus and in particular its economic impact.

R3. A thorough investigation needs to be conducted about the policy implications of funding an additional fiscal stimulus.

R4. The planned increases in revenue expenditure in 2014 and 2015 need to be revised as they leave little room for manoeuvre if the income forecasts are below the central assumption in the MTFP.

R5. In future, the MTFP might consider incorporating a more detailed macroeconomic overview (domestic and international).

R6. Consideration might be given to publishing specific targets in the MTFP which are linked in the first instance to the States Strategic Plan.

R7. The MFTP must be a five-year rolling plan which is published annually.

R8. Consideration should be given to whether there should be goals developed on public expenditure.

R9. Work should be undertaken to obtain an OECD compliant figure for total public expenditure as a percentage of GNI per capita.

1. INTRODUCTION

1.1 In 2008 and 2010, the Corporate Services Panel highlighted several problems with the annual budgeting process with two reports on forecasting. In the 2008 report the Treasurer of the States explained that the States tended to react to short term movements in the economy and to base decision-making too closely on spot forecast estimates of revenue income. He argued that long term spending commitments should not be based on short-term surpluses. One of the report's recommendations was that budget assumptions should be reviewed on a three-year rolling basis (Corporate Services Panel 2008). In 2010, this author echoed the view of the C&AG and advised the Panel that fiscal policy had to be made within a medium term framework. One of the Panel's key findings was that discipline is required in States debates on expenditure and a recommendation was added that the Minister for Treasury and Resources must find a method of ensuring that expenditure in Jersey is income driven (Corporate Services Panel 2010).

1.2 The Panel's investigations were timely and had occurred against the backdrop of the appointment of the Fiscal Policy Panel (FPP). In their August 2008 report, the FPP noted that the two main risks for the Jersey economy were that tax revenue does not increase as much as forecast and that expenditure turns out to be higher than forecast. They remarked:

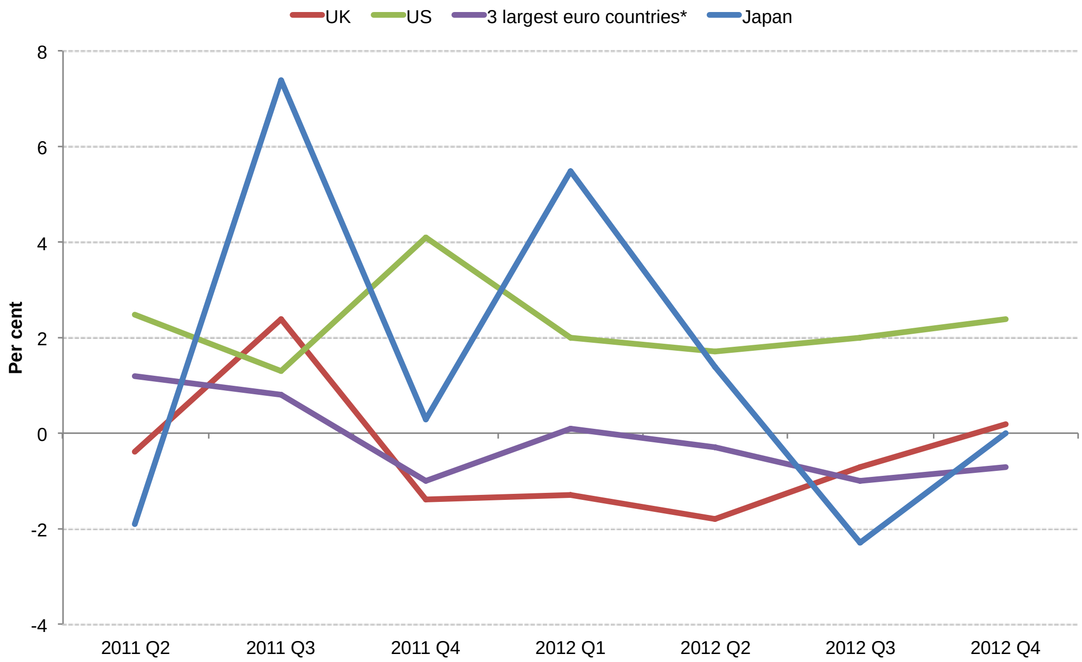
> The forecast fiscal stance for 2008 and 2009 is broadly right given the economic conditions, but there is a risk that States' finances could deteriorate significantly in the medium-term. Therefore this year's Business Plan and Budget should, if possible, avoid taking decisions that undermine the tax base or increase expenditure at a rate above that currently forecast.
>
> (Fiscal Policy Panel 2008, p. 36)

One month after the publication of this report, the States ignored the advice of the FPP during the debate on the 2009 Business Plan and revised net expenditure upwards by £10 million per annum. This illustrated clearly the difficulties associated with trying to control public expenditure in Jersey.

1.3 The formation of the Medium Term Financial Plan (MTFP) has been designed to address the problems associated with the annual budgeting process and other issues that have been raised in successive Scrutiny and C&AG reports. The decision to publish a MTFP is to be welcomed as it will in due course eliminate many of the problems associated with the annual budgeting process.

1.4 The publication of the MTFP has occurred against a background of a deteriorating international economic outlook. The anaemic recovery witnessed in the first quarter of 2012 petered out as the European slowdown appeared to spread to China, which is now in danger of a deflationary hard landing, and is in danger of threatening the rest of Asia. Economists point out that emerging market growth is unlikely to carry the rest of the world with it, whether this growth occurs in China, India or Brazil. Some economists have suggested that any hope of the US saving the rest of the world from anaemic growth appears fanciful. There has been some unease as to whether further bouts of quantitative easing can stimulate growth, but the unlimited policy support offered by the US Federal Reserve in QE3 is an important departure from previous rounds of monetary stimulus. Opinions are divided on the future of the euro but even with the ECB now prepared to buy unlimited quantities of bonds, there are few economic commentators who still do not expect either a cluster of sovereign defaults or widespread debt restructuring for countries in the Eurozone. Forecasts for the growth of real GDP for 2012 were revised downwards in early September 2012 (Figure 1) and the outlook for 2013 has turned more bearish.

Figure 1. Real GDP growth in selected economies (annualised quarter-on-quarter growth, Q2 2011–Q4 2012)



Source: OECD National Accounts
Note: * Germany, France, Italy

1.5 This report begins by examining Jersey's recent economic performance and what has been happening in the financial sector. Part two of the report considers the MTFP, first in relation to the Jersey context and then in a wider context. Part 4 examines the income forecasts in the MTFP, in particular the assumptions which are behind the income tax forecasts. It presents another forecast based on different assumptions. Part 5 turns to expenditure and the MTFP. First it raises some questions which need to be addressed if there is another fiscal stimulus before it turns to look at expenditure in Jersey since 2003. Finally, some conclusions are drawn.

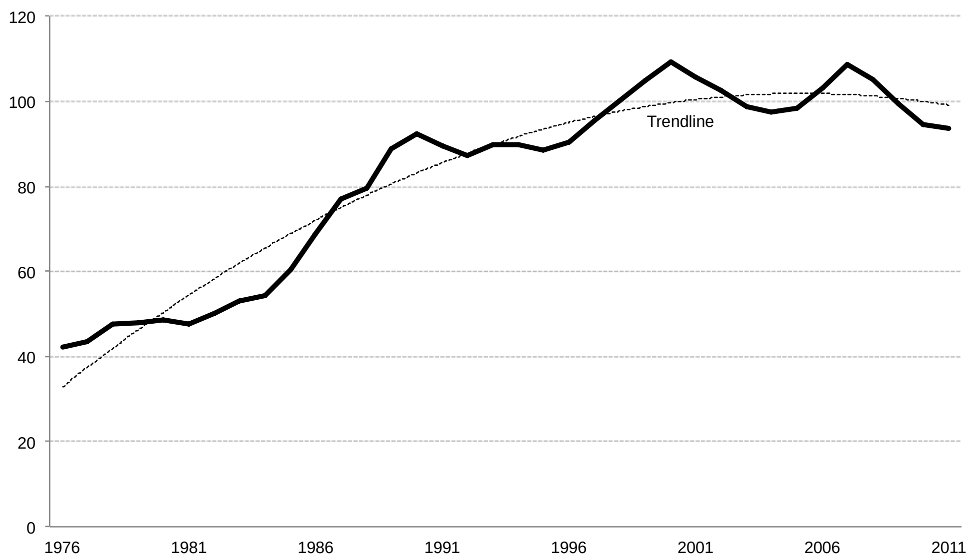
2. THE JERSEY ECONOMY

2.1 Economic performance

2.1.1 GVA

The growth of Jersey's real GVA is illustrated in Figure 2. Considerable caution should be attached to data points prior to 1998, but this graph is nevertheless useful to illustrate the pattern of economic growth in Jersey since the mid-1970s. Over this period, Jersey's economy has moved from what economists call 'low value added' activities (e.g. tourism and agriculture) to 'high value added' activities (financial services). As can been seen from the trendline, the impact of this transition has diminished over the last decade and in real terms, measured by GVA, the entire economy has not grown.

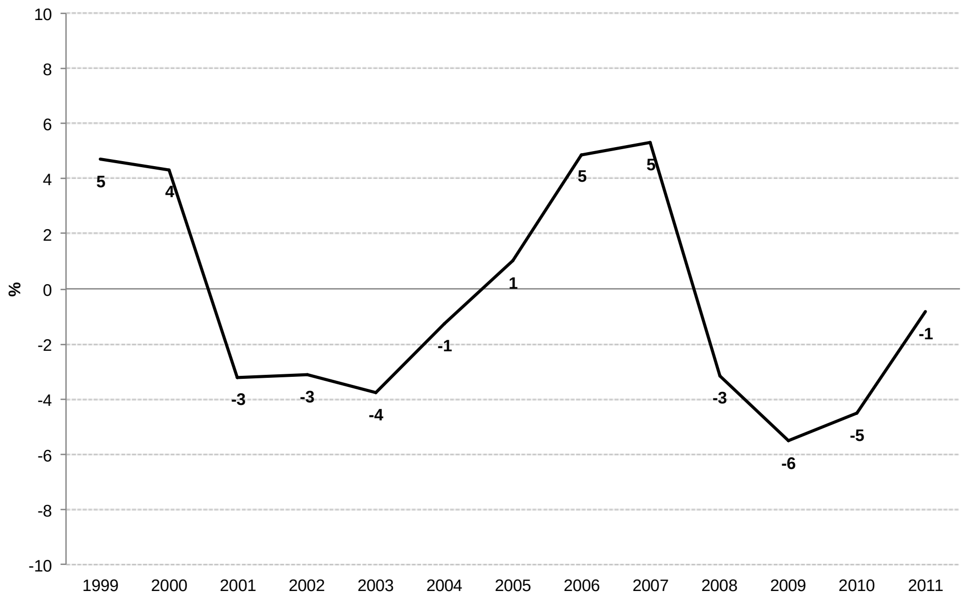
Figure 2. Real GVA index, 1976–2011 (1998 = 100)



Source: Economics Unit

The recent economic performance of Jersey's economy is illustrated more clearly in Figure 3. On the basis of real-term behaviour of GVA, the Jersey economy has spent more time with negative growth than positive growth since 1999. Between 2008–11, total GVA has fallen by 15 per cent in real terms.

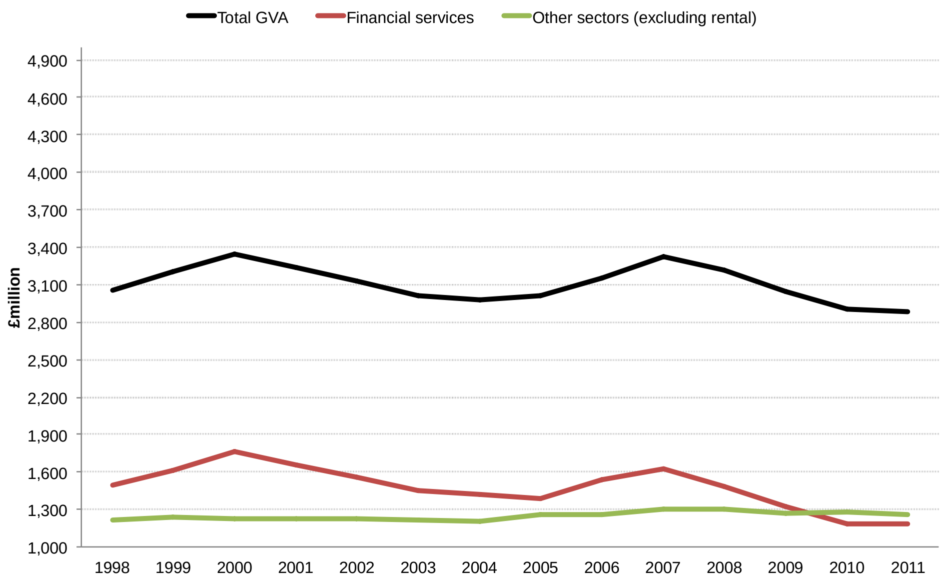
Figure 3. Annual percentage change of GVA in real terms, 1999-2011 (2003 = 100).



Source: Statistics Unit

Figure 4 bifurcates the components of GVA and illustrates clearly how the finance sector has driven the periods of growth and decline, with the growth of the non-finance sector remaining broadly constant. Although the finance sector has long dominated Jersey's economy, its share of GVA has fallen from a peak of 53% in 2000 and stood at 41% in 2011. In 2010, the combined non-finance sector of the economy overtook finance in its contribution to GVA for the first time in at least a generation.

Figure 4. GVA in constant (2003) values, 1999–2011



Source: Statistics Unit

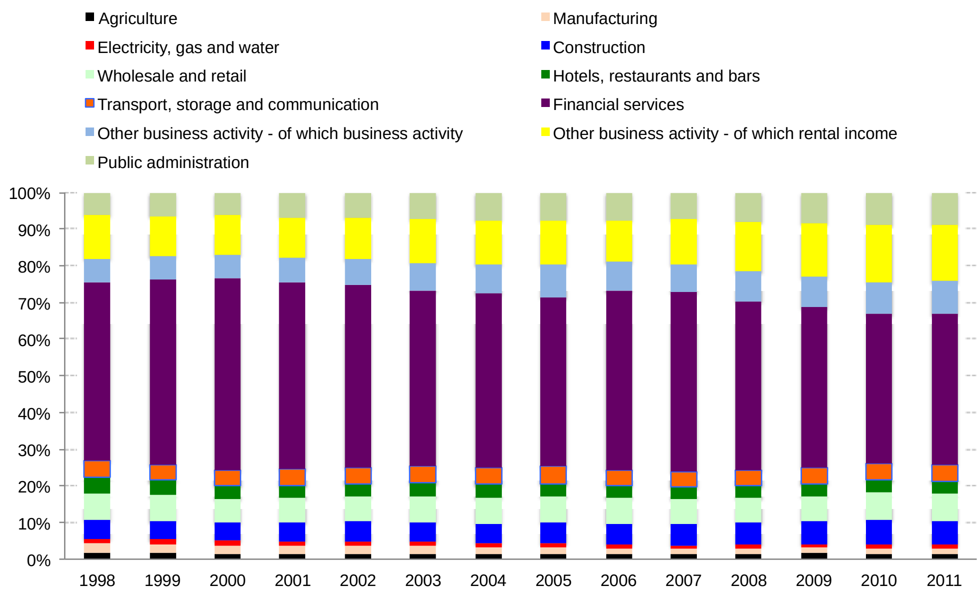
The contribution of each sector to GVA between 1999 and 2011 is illustrated in Figure 5. Although the dominance of finance is illustrated yet again in this figure, some important changes occurring in Jersey's economy are not highlighted:

- A calculation of real-term annual change in GVA by sector shows that whilst there was particularly strong growth in the finance sector during 2006 and 2007, this short period of growth followed a contraction of 23 per cent between 2001 and 2005. Between 2008 and 2011, the GVA of the finance sector decreased by almost 30 per cent.
- The sectors with the biggest falls in GVA since 1998 have been in agriculture; electricity, gas and water; hotels, restaurant and bars; and manufacturing.
- Despite the falls in GVA in the construction sector in 2003 and 2004 up until 2010 the sector saw real term growth over the period at an annual average rate of almost 2 per cent. However, there was a real term fall of 2 per cent in 2011.
- Rental income and other business activities (private sector

service industries which are businesses servicing other businesses and businesses servicing households) has seen steady real term rates of growth over the period.

- Until 2011, the only sector to show no negative real growth has been the public sector. The public sector's growth as a share of income has increased by over a third since 1999 (this is higher than any other sector). However, the real term growth in GVA for this sector is growth in the total earnings of all employees working in this sector as under the income approach to measuring GVA, the gross profit of public administration is defined to be zero.

Figure 5. Contribution of each sector to real GVA, 1998–2011 (2003 = 100)

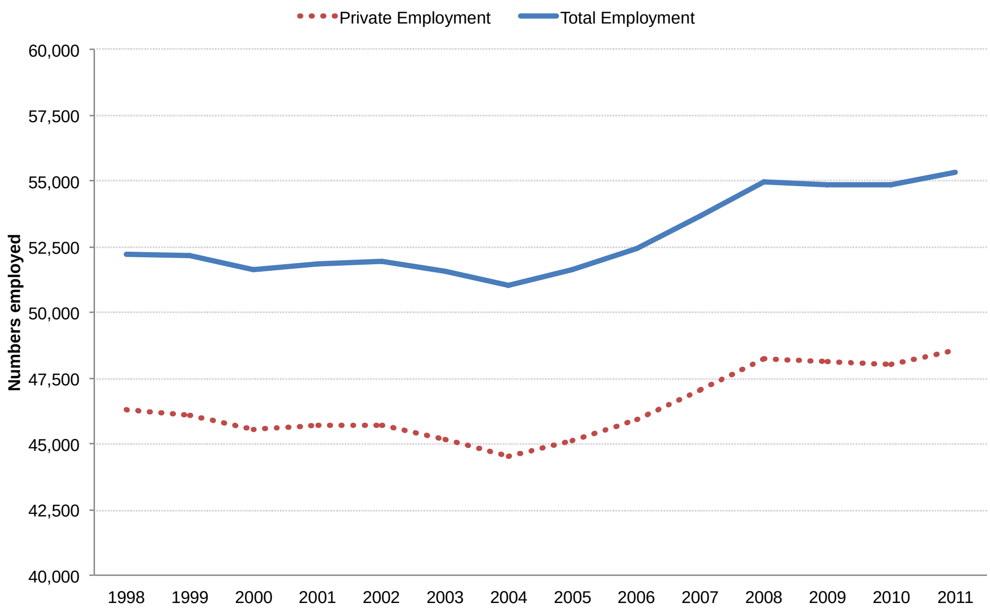


Source: Statistics Unit

2.1.2 Employment and unemployment

Employment growth since 1998 on a calendar year average is shown in Figure 6. During the recession in the early 2000s, total employment fell by around a thousand, but grew strongly after 2004. On the basis of these figure, the post-2008 recession does not appear to have had as dramatic an effect on total employment growth as the early 2000s recession.

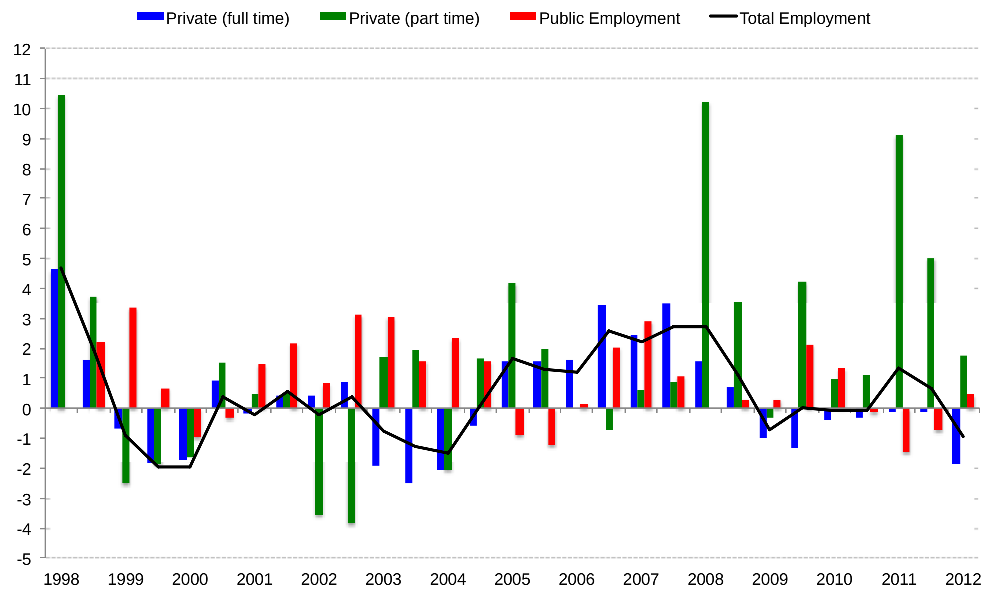
Figure 6. Total and private sector headcount (calendar year average), 1998–2011



Source: Statistics Unit

The annual percentage change in employment (Figure 7) plotted on a six monthly basis reveals some more interesting changes over time. After the recession of the early 2000s, total employment grew by between 1 per cent and 3 per cent per annum from 2005 to 2008. Employment growth was essentially flat between 2009 and 2010 before growing in 2011 and then falling again in the twelve months to June 2012. Growth in full time private employment has contracted since 2009 but there has been a significant growth in part-time private employment in recent years. By June 2012, the number of full-time staff employed in Jersey's private sector had fallen to its lowest June level since 2006 and by the same date, the number of part-time staff employment in the private sector was at the highest level for at least 15 years. Public sector employment growth fell in 2011 for the first time since 2005, but grew again in the year to June 2012.

Figure 7. Annual percentage change in employment, June 1998–June 2012

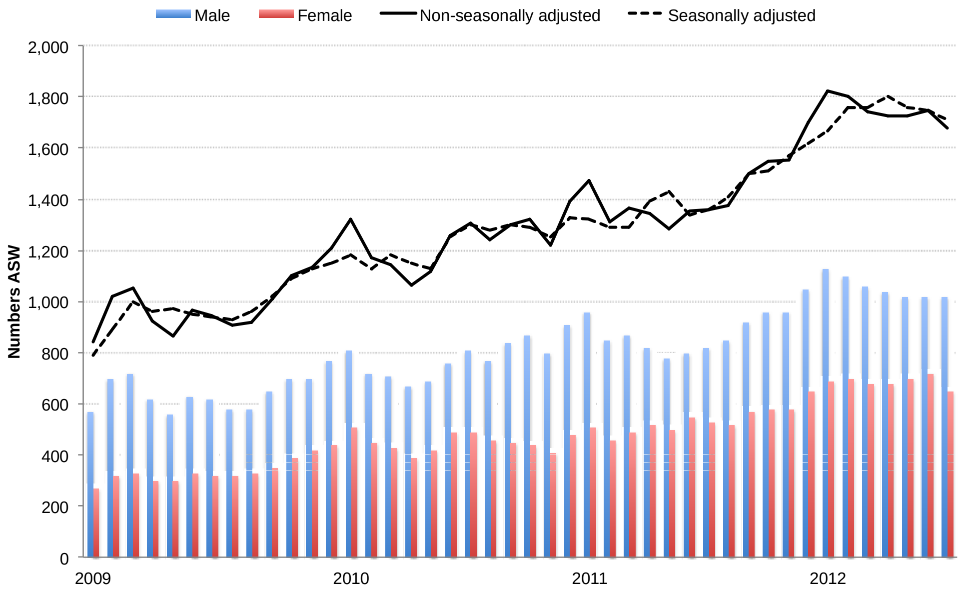


Source: Statistics Unit

Unemployment is at its highest level for a generation. Figure 8 shows the rise in unemployment since 2009. Although these numbers are high for Jersey in a macroeconomic context the unemployment rate might be just over 5 per cent which is still very low by international standards.[2]

[2] There is no legal requirement for all unemployed residents of Jersey to register as actively seeking work (ASW) with the Social Security Department. The unemployment rate on the ASW figures alone would be 3 percent; assuming an additional thousand people who do not appear on the ASW figures then the unemployment rate would be a little over 5 per cent.

Figure 8. Total number of individuals registered as Actively Seeking Work, Jan 2009 – August 2012



Source: Statistics Unit

2.2 The finance sector

2.2.1 The growth in financial services has been critical for the success of the Jersey economy over the last two decades. It has been estimated that financial services and its employees, combined with second round effects on other business and employees grew to contribute between 60% and 70% of States' revenues each year by the late-2000s (Fiscal Policy Panel 2008, p. 15). Given the dependence of Jersey's economy on finance, it is worth examining the recent performance of the finance sector in a little more detail.

2.2.2 The Statistics Unit publishes an annual Survey of Financial Institutions, which examines gross operating surplus, profits by sub-sector, the total number of staff employed in financial services, *inter alia*. Financial services is defined in the Survey as the activities of banks, fund managers, trust and company administrators and accountancy firms operating in Jersey. The survey does not analyse firms predominantly engaged in insurance and financial advisory services.[3]

2.2.3 A key measurement of economic performance in Jersey's financial services sector is gross operating surplus (GOS).[4] Data on this only goes back to 2009 and is illustrated in Table 1. This shows that although the total GOS increased in 2011 from 2010, it is below the 2009 level.

Table 1. Total GOS and average GOS per FTE employee 2009 – 2011

	2009	**2010**	**2011**
Total GOS (£ million)	870	720	730
Mean GOS per FTE employee (£ k)	70	61	62

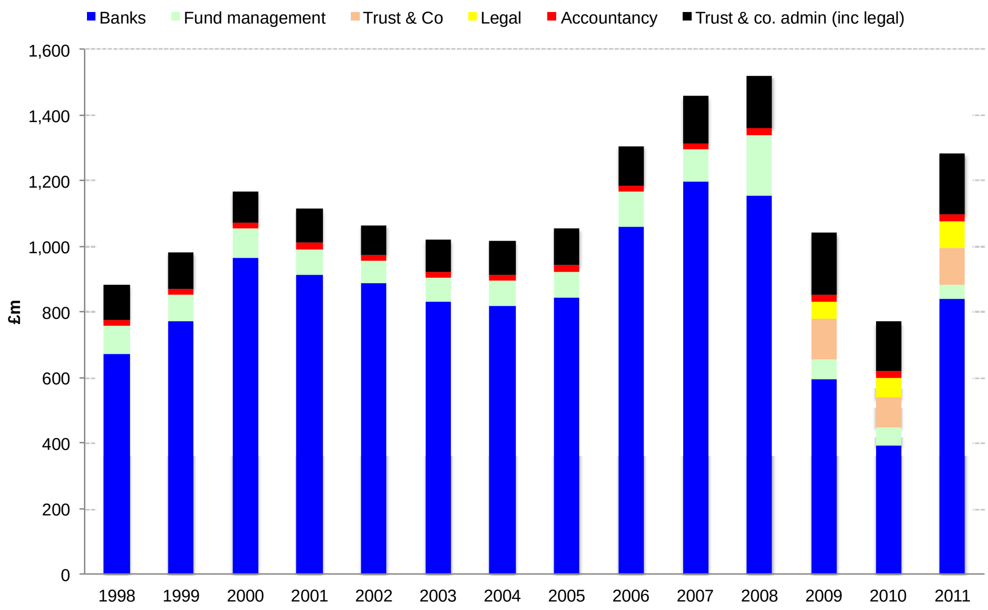
Source: Statistics Unit

2.2.4 Although figures for net profit can be susceptible to the volatility of such income transfers (and hence why GOS is the preferred measure of economic performance in financial services), they do provide data which goes back to 1998. Total net profit for the finance sector is illustrated in Figure 9.

[3] The 2011 Survey returned to the methodology which had been adopted prior to 2009 of allocating companies to sub-sectors according to their main area of business activity using the Standard Industrial Classification (SIC) of economic activity. In 2009 and 2010, companies were asked to report separate information for each business area. With the approach taken in 2009 and 2010, the total manpower in Banking reduced significantly because banks were involved in Fund management and Trust and company administration activities. In turn, the number of staff involved in Fund management increased by 400 full time employees (FTEs). The return to the SIC methodology in 2011 will lead to shifts between sub-sectors, particularly in manpower and profits.

[4] Gross operating surplus represents revenue minus operating costs, and excludes income transferred to resident parent companies in Jersey by non-resident units operating outside of the Island.

Figure 9. Total net profit for finance sector, 1998–2011

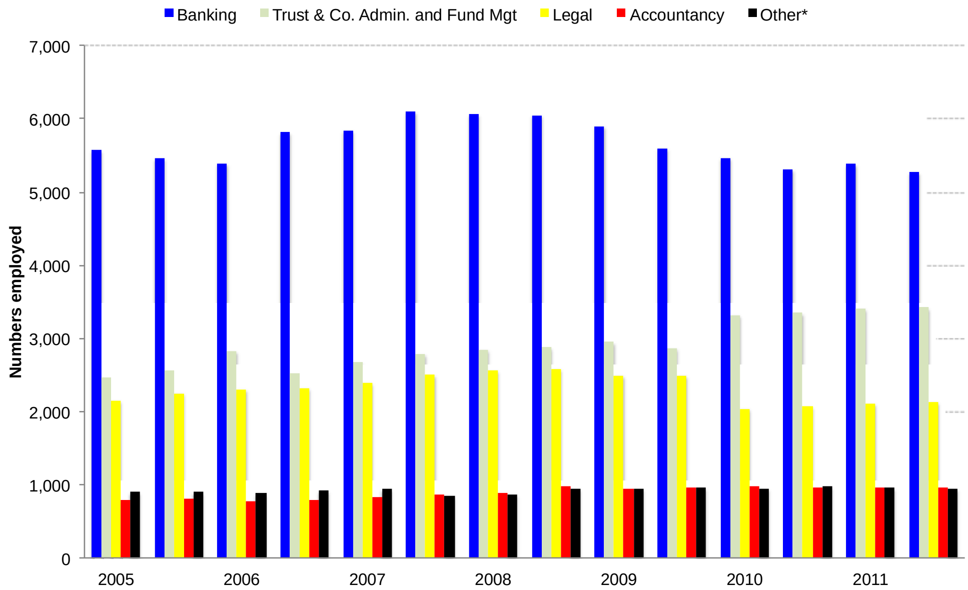


Source: Statistics Unit
Note: Trust and company administration and legal net profits have been separately recorded since 2009.

2.2.5 The importance of the Banking sub-sector for Jersey's economy is emphasised in Figure 10. Historically, it has had a strong influence on the movement of total net profits in the finance sector. In 2011, banking accounted for 77 per cent of the total net profits of Jersey's entire financial services sector. This was a similar proportion from the mid-1990s up until 2008. However, in 2009 and 2010, there was a collapse in total net banking profits. Over the period 2007 to 2010, net profits fell by 66%. In contrast, during the recession in the 2000s, total net profit in banking fell by just over 10%. An even more dramatic fall in net profits can be found in Fund management, where they have fallen by more than 75% since their peak in 2008. After a fall in 2009, the Legal sub-sector saw an increase in net profits between 2010 and 2011.

2.2.6 The banking sub-sector has traditionally been a large employer, accounting for almost half of total employment within financial services. Following the financial crisis, the fall in employment in banking over the last four years has been quite dramatic (Figure 10). In June 2012, employment levels in banking were almost 1,000 lower than late 2007.[5] The Legal and Administrative sub-sectors have seen employment growth more recently but this has not compensated for the loss in employment in Banking, whilst employment growth in Accountancy and 'Other' has shown small declines.

Figure 10. Employment in Financial Services by sub-sector, June 2005 to December 2011



Source: Statistics Unit
Note: 'Other' includes insurance (general, life and non-life), pension funding and investment and unit trusts

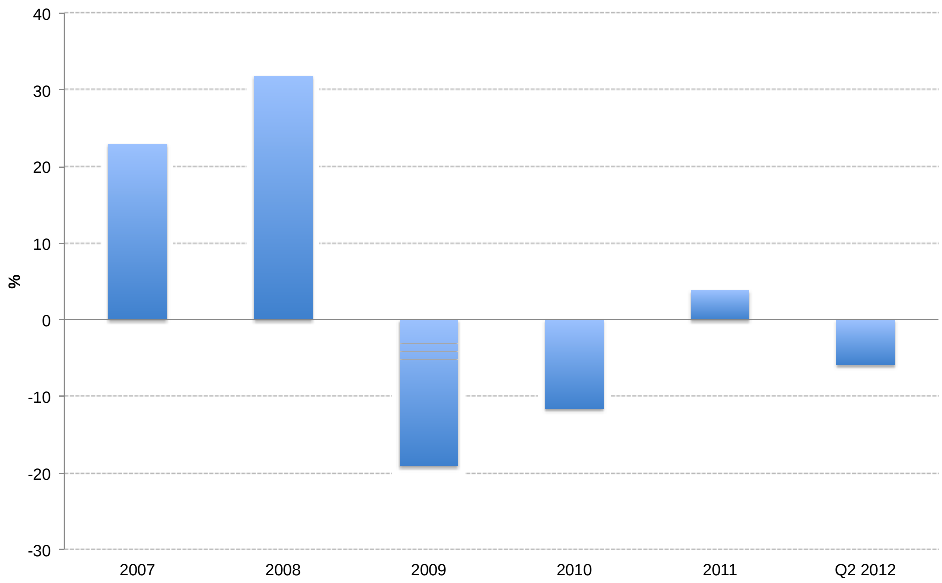
2.2.7 At an early stage it was recognised that the effects of the global financial crisis were going to cause some dislocation to Jersey's finance industry. In their 2009 report, the FPP noted that the impact of the crisis would vary by sub-sector in financial services. The FPP suggested that trust and fund administration could see weaker new business and reduced revenues and that in a low interest rate environment, banking profitability would be squeezed. In addition, it was expected that bank deposits would fall. The FPP warned of the

[5] This figure is taken from the June 2012 Labour Market Survey. As footnote 2 explained, this figure is overstated.

effects falling profits would have on the States finances and the GVA figures. As discussed above, these warnings have proved prescient.

2.2.8 Looking ahead, there are some on-going worries for the finance industry. For the Banking sub-sector, one major concern is the future path of net interest income, which is largely driven by interest rates.[6] Prior to the crisis, net interest income accounted for nearly two thirds of the banking sectors' gross income, so profits from net interest income are vital part of all banking profits (and financial services as a whole). Figure 11 illustrates the changes in net interest income between 2007 and the second quarter of 2012. In a low interest rate environment, net interest income will continue to grow slowly.

Figure 11. Trends in net interest income, 2007–Q2 2012 (percentage change)



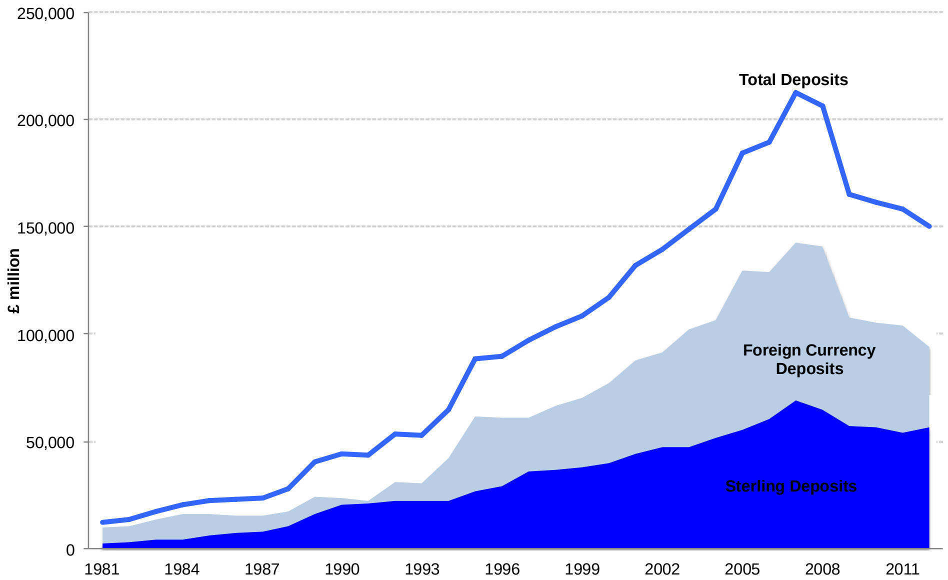
Source: Jersey Financial Services Commission

2.2.9 Figure 12 illustrates that until 2008, there had been no significant falls in sterling deposits. There was a fall in total banking deposits in 2008 and a steeper fall in 2009. Foreign currency deposits have fallen faster than sterling deposits since 2008. It is difficult to analyze the

[6] The difference between the interest a bank receives on its loans and the interest the banks pays to its depositors.

trends in the movements in bank deposits because of exchange rate movements, but one observation would be that any falls in non-sterling deposits before the current financial crisis have quickly reversed. In the past, there has not been a period when total bank deposits have contracted for four successive years. Another observation (not illustrated on the graph) is that the number of banks in the Island is at its lowest level in over thirty years.

Figure 12. Bank deposits held in Jersey, 1981–Q2 2012 (£ million)



Source: Jersey Financial Services Commission

2.2.10 The growth of the financial services industry down to 2008 provided Jersey with an outstanding source of income and employment. No one can predict the future but it would be difficult to believe that financial services will disappear from Jersey. However, there are three reasons which suggest that the next few years will not be entirely propitious for the growth of financial services. First, interest rates are currently predicted to remain low for some time. Secondly, onshore parents of banks are ever more cost conscious and will continue to question whether funding bank subsidiaries offshore is profitable. Finally, the operating environment for financial services has become more difficult in the wake of the financial crisis particularly with extra legislation.

3. THE MEDIUM TERM FINANCIAL PLAN

3.1 The Jersey context

3.1.1 The argument that an expenditure framework for Jersey should be placed into a medium term context is hardly controversial and is standard practice in many English county councils. When this author investigated income and expenditure forecasting in Jersey several years ago, policymakers were eager to share their frustrations about the one-year budgeting process. The arguments made – that the process was short-term in nature and made no provision for unforeseen expenditure – were reinforced by Departments who were calling for longer-term planning horizons and greater flexibility to plan ahead. The additional (unplanned) calls on the public purse in the last eight years have also frustrated States members who have argued that a proper budgeting process should allocate contingencies for the unforeseen. In short, a medium term financial plan (MTFP) is sensible.

3.1.2 What a MTFP should look like is considered in greater depth by the second adviser's report and it is not the intention of this report to offer prescriptions about the format and so on of the plan. From a wider perspective, however, there are several observations which need to be made about the scope and content of Jersey's MTFP.

3.1.3Apart from the rationale that the States budgeting period should be extended from one to three years (and preferably to five years), what other reasons are there for the introduction of a MTFP? The MTFP explicitly recognises that the purpose of the MTFP 'is to direct resources towards the delivery of the objectives set out in the States' Strategic Plan' (MTFP 2012, p. 35). The seven priorities of the States Strategic Plan ('Inspiring confidence in Jersey's future') are to get people into work; manage population growth and migration; house our community; promote family and community values; reform Health and Social Services; reform government and the public sector and develop sustainable long term planning. This is an essentially aspirational manifesto from the Council of Ministers for 2013 to 2015 and the intention is to use the MTFP to explain how the priorities will be financed.

3.1.4 In the 2009 States Strategic Plan, four resources principles were introduced and a further three have been added to the new States Strategic Plan. These become particularly important in any evaluation of the MTFP. The resource principles are as follows:

- Be prudent, taking account of the uncertain economic and financial outlook.
- Identify and implement all possible savings and efficiencies. (For 2013 and beyond we will optimise methods of service delivery and provide value for money).
- No additional spend unless matched by savings or income.
- The Stabilisation Fund will only be used during an economic downturn, as advised by the Fiscal Policy Panel, to fund the effects of reductions in States revenues or increased demand for States services, and to provide appropriate stimulus to the economy.
- Maintain balanced budgets over the medium term for current expenditure and achieve an appropriate balance between taxation and spending over the course of the economic cycle [added in the 2012 States Strategic Plan].
- Actively manage the Balance Sheet as well as the Budget by maximising investment returns within agreed levels of risk [added in the 2012 States Strategic Plan].
- Plan our expenditure on capital and infrastructure over the long term and consider carefully the appropriate sources of funding for major projects, including borrowing [added in the 2012 States Strategic Plan].

3.1.5 The States Strategic Plan has been approved by the States Assembly so it would be pointless to critique the Plan; however, it is important to raise the question of whether the MTFP does provide the financial underpinning for these priorities and more importantly, whether Departments can deliver the priorities once they have been given the resources.

3.2 The wider context

3.2.1 Several English county councils produce annual rolling medium term plans, but Jersey is not a county council and so whilst comparisons with the numerous plans produced by local authorities in England are useful, they are not entirely satisfactory. Indeed, the MTFPs of county councils read like a series of Excel spreadsheets, but they have become common accounting practice along with the annual budget (Schick 2009).

3.2.2 In the UK central government context, the spending review provides the medium-term framework to manage strategic reform of public expenditure control over a three to four year period and the annual budgeting process deals with the politics and resource allocations as part of the overall spending review framework (Hyndman *et al*. 2006; Ferry and Eckersley 2012; Rhodes 2011).

3.2.3 It is of course possible to have a MTFP or a medium term financial strategy which might provide a statement of a government's economic strategy in a framework which both demonstrates a vision and articulates medium-term guidelines which eschew short-termism. One of the best-known examples of a plan for the medium term was the Medium Term Financial Strategy (MTFS) introduced by Chancellor Howe for the UK in 1980. The origins of the MTFS were two-fold.

- First, from the mid-1970s several economists began to argue for a published set of medium-term guidelines which would avoid 'piecemeal adjustments aimed at correcting the unemployment figures without any satisfactory concept of the tolerable limits of policy' (Budd and Bums 1977, p. 10). Such economists called for a plan which would include estimates of public revenue, expenditure borrowing and monetary targets. The idea was that the plan would act as a constraint on discretionary economic policy, first by discussing the appropriate targets for monetary and fiscal policy and second, by discussing whether spending and taxation proposals and forecasts for inflation and GDP were consistent with those guidelines.
- Secondly, the dissatisfaction with making economic policymaking in the short-term and the belief that Keynesian economic policies had contributed to Britain's problems led some to argue that discretionary fiscal policy should be abolished as the prime instrument for regulating aggregate demand (Congdon 1978, p. 33). For Congdon, the medium-term plan needed to be based on a gradual deceleration of money supply growth and a declining profile for expenditure borrowing. Congdon's proposals chimed in closely with economic philosophy of Margaret Thatcher and her close associates (including Geoffrey Howe and Nigel Lawson).

3.2.4 Some economists were highly critical of the MTFP. Writing in 1985, Christopher Allsopp (1985, p. 18) noted that:

> …the MTFS is a poor basis for policy…it is badly designed to cope with the realities of the economy. Its theoretical basis is seriously incomplete and muddled. The underlying empirical assumptions are untested and implausible. Not surprisingly, the MTFS has led to serious errors in the past. Its rigid framework is destabilising and the government has found itself boxed in by expectations engendered by the policy itself.

Despite this, the MTFS remained the basis for macroeconomic policymaking in the UK until Gordon Brown became Chancellor in 1997.

3.3 The MTFP v the MTFS

There are some interesting contrasts to be made between Jersey's MTFP and the UK's MTFS of the 1980s and 1990s:

3.3.1 The MTFS was a five-year plan, but the MTFP is only a three-year plan which is not rolled over from year to year.

3.3.2 The intention of the MTFS was more focused and more strategic. In contrast, Jersey's MTFP intends to provide a fiscal stimulus, balance budgets, improve services and maintain the current system of taxation.

3.3.3 The MTFS promised 'jam tomorrow'. Jersey's MTFP intends to deliver immediate 'jam' with additional money for public services.

3.3.4 Unlike the early incarnations of the MTFS, the emphasis in the MTFP is on increasing government expenditure and hence the MTFP is not ideologically driven in a Thatcherite sense. In the early 1980s, the plan was to reduce the share of public expenditure in GDP. Public expenditure cuts became less ambitious as the MTFS evolved as even the Thatcher government found it difficult to rein in expenditure. The links to the States Strategic Plan in the MTFP illustrate that the Council of Ministers believe that the role of government is to create jobs and hence increase the role of government and government expenditure.

3.3.5 Like the MTFS, the MTFP is not a National Plan, despite its links to the States Strategic Plan and the Economic Growth and Diversification Strategy.

3.3.6 The MTFS was designed to influence the attitude and expectations of the public, particularly with regard to controlling inflation through a tight monetary and fiscal policy. The MTFP goes some way in doing this, for example, by agreeing on expenditure limits for public sector pay. However, the Council of Ministers and in particular the Treasury and Resources Minister have not yet had their '1981 moment' when the appearance of a draconian budget was intended to show the public that MTFS would not be derailed by short-termism.

3.3.7 The success of the MTFS was judged on whether pre-announced targets for the money supply and the growth of public expenditure were achieved. The success of the MTFP will be gauged on whether it can finance the goals of the States Strategic Plan over the next three years.

3.3.8 Over the course of the MTFS, critics pointed out that the Treasury massaged the public sector borrowing requirement (budget deficit) by selling public assets through the privatisation programme (e.g. British Telecom, British Gas, etc). It is worth noting that one of the new resource principles of the Strategic Plan is to 'actively manage the Balance Sheet as well as the Budget by maximising investment returns within agreed levels of risk' which raises the question of how asset sales will play a role in the evolution of Jersey's MTFP.

4. THE INCOME FORECASTS IN THE MTFP

4.1 Assumptions and forecasts in the MTFP

4.1.1 The economic assumptions behind the MTFP for budget years 2012–15 (i.e. with the year of assessment being the prior year) are shown in Table 2 and the income forecast are shown in Table 3. The central income forecast is produced in a range with an upper figure (optimistic) and a lower figure (pessimistic). The range of the upper and lower figures is put at +/- 5% which allows for the uncertainties associated with forecasting total tax take. Although the emphasis is on the range and not the estimated points, the central income forecast is used in the MTFP.

Table 2. Assumptions behind the MTFP forecasts, 2012–15 (budget years)

% change	**2012**	**2013**	**2014**	**2015**
Real GVA	1.4	2.0	2.5	2.5
RPI	3.8	3.0	3.1	3.5
Employment	0.5	1.0	1.0	0.5
Average Earnings	3.5	3.8	4.1	4.8
Interest rates (%)	0.5	0.6	0.9	1.4

Table 3. Income tax forecasts in the MTFP, 2012-15 (budget years)

	2012	**2013**	**2014**	**2015**
	£m	£m	£m	£m
Upper	450	470	495	525
Central	**430**	**450**	**470**	**500**
Lower	410	425	450	475

4.2 A revised forecast

4.2.1 The forecasts were prepared by the Economics Unit in March 2012. By the time the MTFP was published towards the end of July 2012 it was clear that the international economic situation had deteriorated. Earlier in July, the author had expressed his unease to the Corporate Services Panel about the assumptions and the forecasts in the MTFP. By August, many international forecasting agencies were preparing to downgrade their economic forecasts. On 22nd August, Jersey's Statistics Unit reported sluggish growth in the annual earnings figures in the year to June 2012. This coincided with the latest quarterly publication of the Economic Outlook from the Economics Unit, which noted that a vast majority of indicators were suggesting that the local economy was continuing to weaken.

4.2.2 Following a discussion with the Economics Unit in late August 2012, the author queried what the income forecasts would look like with changed economic assumptions. The States Economic Adviser and his team kindly agreed to run some economic assumptions through the States model. These assumptions were given to them by the author. *It should be stressed that the Economic Unit and the States Economic Adviser did not endorse the economic assumptions used to remodel the Income Tax Forecasts*. The results are reported in Table 4. The figures in bold in Table 4 have been downgraded from those in Table 2.

Table 4. Revised assumptions, 2012–15

% change	**2012**	**2013**	**2014**	**2015**
Real GVA	**0.0**	**0.5**	**1.5**	**1.5**
RPI	3.8	3.0	3.1	3.5
Employment	0.5	**0.5**	1.0	0.5
Average Earnings	**1.5**	**1.5**	**1.75**	**2.5**
Interest rates (%)	0.5	0.6	0.9	1.4

The rationale for the revised assumptions included:

- Continued uncertainty with the Eurozone, which even in the absence of 'eurogeddon' (total implosion of the euro zone) suggests that future growth will be very sluggish to poor;
- Weaker global conditions and an absence of confidence;

- Continued weakness in large parts of the global financial services sector and further global banking dislocation;
- The June 2012 Business Tendency Survey suggesting significant challenges for the Jersey economy remain and that any significant (prior 2008 crisis) recovery in financial services remained distant;
- The less sanguine tenor of the Economic Outlook in August 2012.

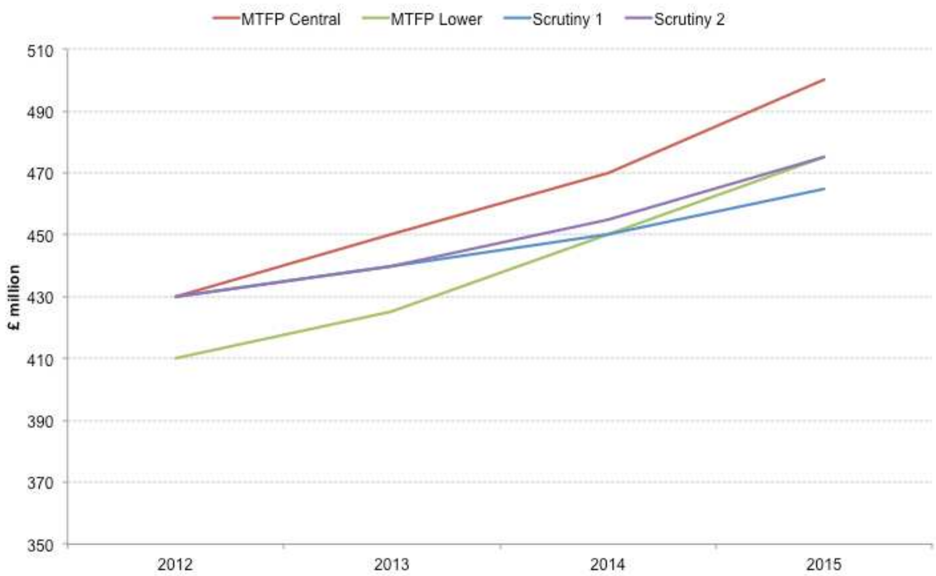
4.2.3 Even as the calculations were being undertaken by the Economics Unit, two further pieces of news suggested that a downgrade to Jersey's forecast might be in order. On the 5th September Guernsey's Policy Unit reported that it had provisionally estimated its economic growth for 2011 as 1 per cent and it had downgraded its GDP forecasts to zero growth for 2012. Guernsey's Policy Unit also forecast that GDP growth in 2013 would be 1.3 per cent. On the 6th September, the OECD announced a further downgraded (from its July 2012 forecasts) to UK economic growth for 2012 (shown in Figure 1).

4.2.4 From these assumptions, the revised income tax forecasts (Scrutiny 1 and Scrutiny 2) are given in Table 5 along with the lower, central and upper MTFP forecasts for comparative purposes. Figure 13 plots the lower and central forecasts for income tax given in the MTFP and the Scrutiny 1 and Scrutiny 2 forecasts.

Table 5. Revised income tax forecasts, 2012-15 (budget years)

	2012	**2013**	**2014**	**2015**
	£m	£m	£m	£m
MTFP Upper	450	470	495	525
MTFP Central	**430**	**450**	**470**	**500**
MTFP Lower	410	425	450	475
Scrutiny 1	430	440	450	465
Scrutiny 2	430	440	455	475

Figure 13. Income tax revenue, new forecast



Source: calculated from data provided by Economics Unit.

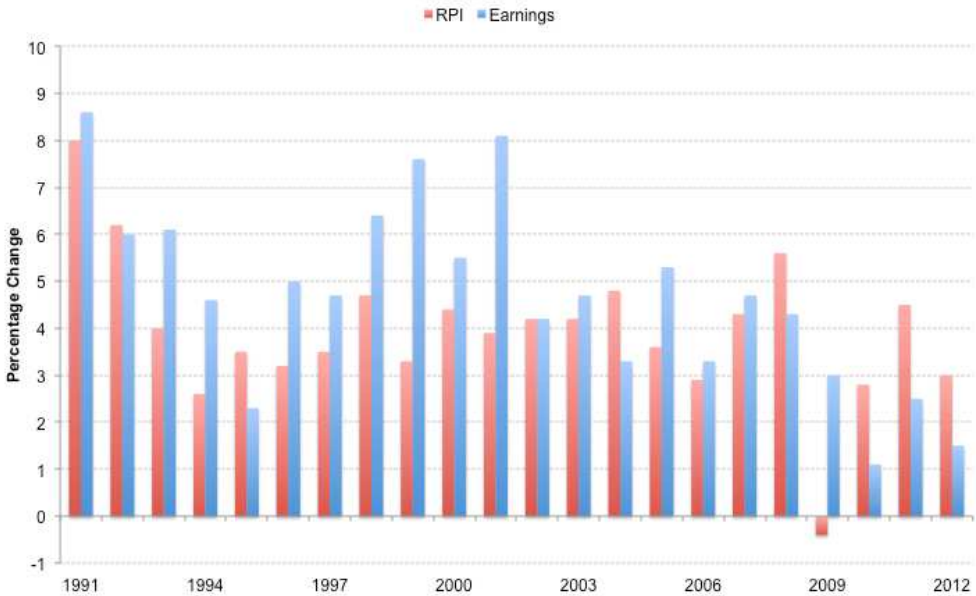
As the discussion on sensitivity analysis on page 177 of the MTFP notes:

> In modelling taxable income, the assumptions about future employment and average earnings growth are particularly important for employees (Schedule E) and self employed and investment holders (Schedule BD), where as the forecast for economic growth (GVA) is particularly important for companies (Schedule C). Future employment, average earnings and economic growth are themselves linked, but they are varied independently for the sake of this analysis.

4.2.5 Scrutiny 1 is the forecast from the assumptions in Table 4 alone. Taking the 2008–15 period as a whole, this assumption assumes average growth of minus 1 per cent. This might appear a very pessimistic assumption but it needs to be remembered that during the years of negative real GVA growth between 2001 and 2005, average annual real GVA growth was minus 2 per cent per. Although there was a rapid growth in real GVA during 2006 and 2007, even if this is included in a calculation of growth over a seven-year period from 2001–07, average growth was zero. Moreover, the source of this significant growth in 2006 and 2007, the Banking sub-sector, is highly unlikely to contribute as much as it did growth prior to 2008 with low interest rates forecast for the foreseeable future. The fall out from the global financial crisis probably still has some way to run and as this report has argued, there is every indication that the financial services sector will continue to see sluggish growth over the next few years.

4.2.6 Perhaps a more robust criticism of the assumptions behind Scrutiny 1 is that average earnings growth is significantly below inflation down to 2015. Figure 14 shows that over a twenty-year period, this has happened just seven times. However, post-2003 the relative behaviour of prices and earnings seems to have been changing so that the latter has lagged the former on five occasions. In short, aside from 2005 and 2009, there has either been a significant squeeze on earnings growth or a very low differential in favour of earnings over prices for the last decade. Moreover, the average earnings figures given in the MTFP have been downgraded since the 2012 Budget, when it was assumed that they would be 5.6%, 5.4% and 5.2% in 2012, 2013 and 2014 respectively. The forecasts in the MTFP suggest that the earnings growth between 2013 and 2015 will be higher than inflation by a margin which apart from 2005 and 2009, has not occurred since 2001.

Figure 14. Annual percentage changes in average earnings and the RPI at June each year, 1991 to 2012



Source: States of Jersey Statistics Unit

4.2.7 The Economics Unit suggested that another forecast might be made on the basis of the revised assumptions but proposed that rather than increasing exemptions in line with inflation they might increase in line with earnings. In essence, this would improve the tax yield and improve the income forecasts. Scrutiny 2 in Figure 13 illustrates the implication of this assumption on the forecast. Both Scrutiny 1 and Scrutiny 2 are below the MTFP central forecast, but only Scrutiny 1 brings the forecast below the lower MTFP forecast in 2015. Scrutiny 2 is the same as the lower MTFP forecast in 2015. Given the inherent difficulties with forecasting so far in advance, the figures for 2015 come with a significant health warning.

4.2.8 The risks attached to the income forecasts made in March 2012 have increased in recent months and updated assumptions suggest that the future income tax outturn is more likely to be to the right of the central line in Figure 13. If such an outturn were to occur this would still be within the range assumed by the Economics Unit. The reworked forecast therefore does not suggest that the economic calculations behind the MTFP are wrong nor does it imply that the entire economic forecast needs to be revised downwards (i.e. the range needs to be shifted down). What it does suggest, however, is that there is potentially a very interesting policy discussion to be had over what happens if the income forecasts are on the downside because the Jersey economy continues to struggle. For instance:

- At what point should a fiscal stimulus be undertaken?
- What form should a fiscal stimulus take?
- How will the fiscal stimulus be funded?

5. EXPENDITURE AND THE MTFP

5.1 A new fiscal stimulus?

5.1.1 As discussed above, the purpose of the MTFP is to fund the seven priorities given in the States Strategic Plan between 2013 and 2015. In addition, the Council of Ministers also intends to deliver a further fiscal stimulus to the economy through advancing capital schemes. An earlier fiscal stimulus was approved by the States on 19^{th} May 2009 and permitted the transfer of up to £44 million from the Stabilisation Fund to the Consolidated Fund to provide funding for discretionary initiatives in order to support employment and business in Jersey through the economic downturn. On 31 May 2011, the Treasury and Resources Minister closed the fiscal stimulus programme to new bids after a net allocation of £37.9 million. Shortly afterwards a report was published which noted that 'the Programme has been very successful, with a package of initiatives which have provided an extra stimulus to the economy and supported individuals, employment and businesses in Jersey through the downturn' (States of Jersey 2011).

5.1.2 In their October 2012 report, the FPP recommended accelerated fiscal support. However, there are some important questions which arise from this:

- In the MTFP, it is noted that 'more economic stimulus is need in ways that will deliver cost effective service for the Island and sustain jobs' (p. 108). It is unclear why a new fiscal stimulus was considered in the MTFP in light of the growth assumptions on page 164 (i.e. real GVA increases of 1.4%, 2%, 2.5% and 2.5% for the years 2012 to 2015, respectively).
- It is unclear what parts of the MTFP have already been designed to provide a stimulus and whether the same criteria

used in the last stimulus (e.g. that it should be temporary, timed and targeted – the ‘3Ts’) have been applied in the growth bids.

- Despite listing all the items where money was spent (States of Jersey 2011), there has been no proper economic analysis done on the success or otherwise of the 2009 stimulus. The previous Chief Minister suggested that the success of that fiscal stimulus should be evaluated on whether unemployment was reduced or continued to rise. Should the 2009 stimulus be judged as a failure because unemployment has continued to rise?
- On balance, international criticism about the efficacy of fiscal stimuli has grown. For example, the distinguished economist John B. Taylor from Stanford University found that the size of multipliers was much lower in the US (which is a far more closed economy than Jersey’s open economy) than pro-stimulus economists had initially predicted.
- The ‘3 Ts’ sounded like a robust theoretical concept and the Corporate Services Panel was instrumental in persuading the Treasury Minister that the ‘Red, Amber, Green’ (RAG) should also be used as part of the evaluation process. In practice, however, there was always the possibility that stimulus items would begin to appear permanently in Departments’ Business Plans. The Annex to the MTFP suggests this is the case:
  - ESC have made a commitment in the 2012 Annual Business Plan that the initiatives started through Fiscal Stimulus (Advance to Work, Advance Plus and Careers Strengthening) would continue beyond 2012.
  - The Chief Minister’s Department intends to place External Relations on a ‘sound financial footing following its development over the last 4 years from Fiscal Stimulus and other non-recurring funding’.

  There might well be other such examples from Departments, but without a detailed analysis, it is not possible to provide a list of these. This is *not* to suggest that the two examples cited above are a waste of money (both are laudable): the point is that even with the best intentions and well designed systems, 'fiscal stimulus creep' can occur.

- Finally, through prudent planning, Jersey did not have to resort to deficit financing and made use of a Stabilisation Fund to finance the stimulus. The Stabilisation Fund is empty. Would the States Assembly be prepared to vote for deficit financing to provide for a fiscal stimulus without really understanding how successful the last stimulus was?

5.2 Expenditure

5.2.1 It is frequently remarked how Jersey is a 'low spend, low tax jurisdiction' and that it does not run a budget deficit which needs to be financed in the money markets.[7] In 2007, as part of the Statistics Unit's assessment of GVA for 2006, figures were published which showed general government expenditure as a percentage of GNI. At the time, total government expenditure as a percentage of GNI in Jersey was about three-fifths of the OECD average. It would be very interesting to re-run this exercise for the lifetime of the first MTFP to see in particular what this looks like on a per capita basis.

5.2.2 Since its publication on 23rd July 2012, there has been a lot of discussion and public comment about the expenditure commitments in the MTFP, particularly from the Chamber of Commerce. The concerns about the growth of expenditure in Jersey are neither new nor confined to the private sector who fear higher tax rises in the future in order to fund future expenditure commitments. In his remarks which prefaced the report on the States Accounts in 2003, the President of the Finance and Economics Committee noted that net revenue expenditure had grown by 95% in the previous decade.

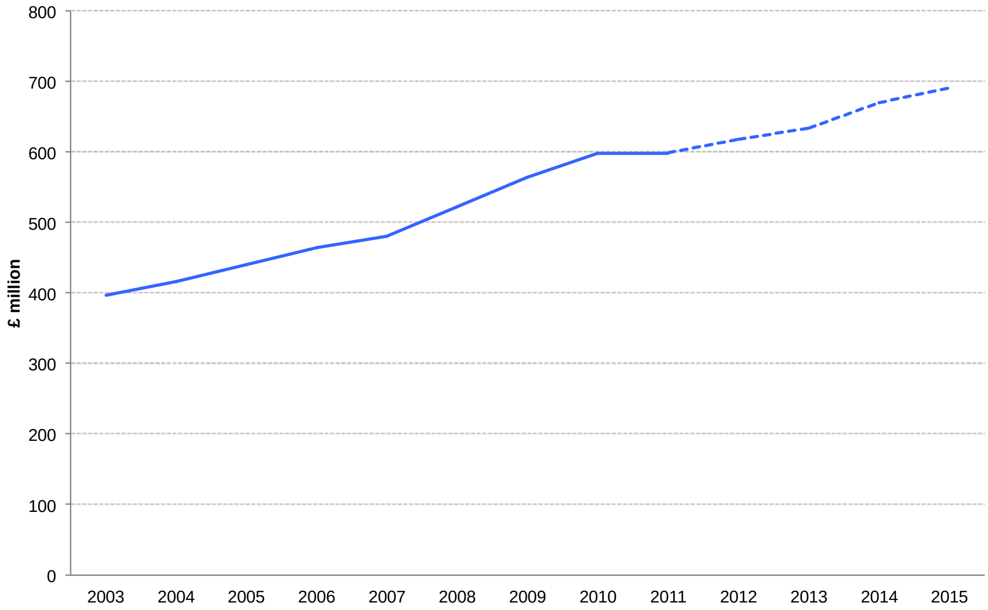
[7] A significant amount of future capital expenditure (e.g. a new hospital) could not be financed out of the Consolidated Fund as it is incurred. Innovative ways will have to be found to fund future infrastructure projects.

Equally, in the past there have also been concerns expressed about the ability of the States to forecast expenditure requirements coupled to worries that income forecasting is not robust enough to enable future expenditure to be planned.

5.2.3 Over the last few years there has been some excellent work done by the Economics Unit in improving its income forecasting process in conjunction with the Forecasting Group. Unfortunately, the on-going ramifications of the financial crisis coupled to the changes in Jersey's tax system in recent years have brought new difficulties and uncertainties to the forecasting process. Forecasting is an inexact science and there is always the danger of the familiar pattern developing (which has been remarked upon by the author before in previous reports), that the Treasury will announce that there is an improved outturn to a forecast, as income receipts are higher than the initial forecast. The politicians will then spend some, if not all, of the extra income. Finally, the general public's reaction to all of this, after learning that 'extra money' has been found, is a mixture of bemusement and anger. Some will question why new taxes have been introduced in the first place; others will get angry as the States approve additional expenditure and yet others will lobby politicians to spend the extra income and invariably public expenditure continues to rise. It is to be hoped that with the arrival of the MTFP, this process of short-termism will gradually disappear.

5.2.4 Assuming that the expenditure plans in the MTFP are enacted, the growth of total net revenue expenditure between 2003 and 2015 will have been 74% on a nominal basis. Figure 15 illustrates the growth of actual total net revenue expenditure since 2003.

Figure 15. Growth of net revenue expenditure, actual and forecast, 2003–2015 (£ million, current prices)

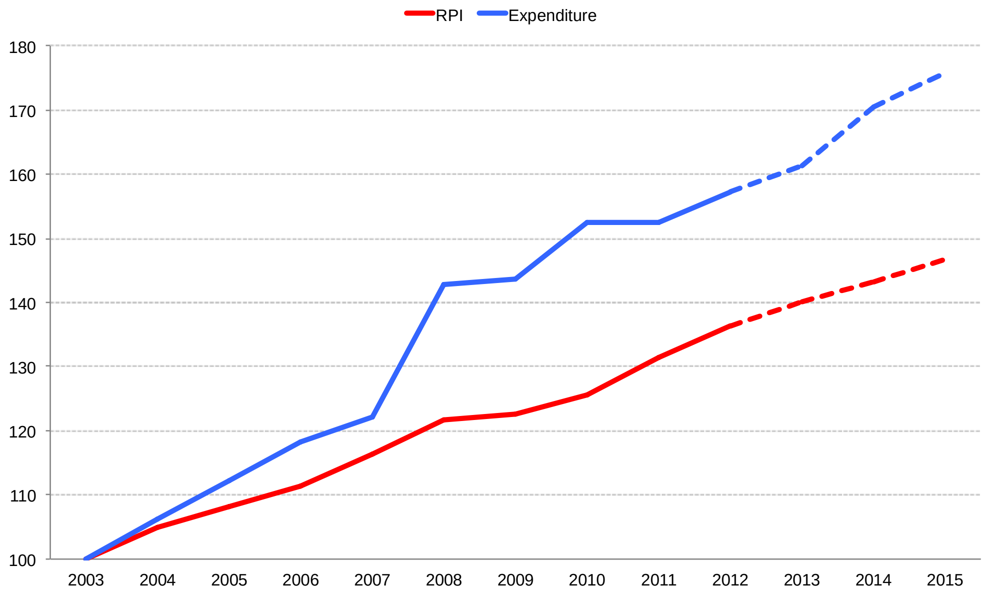


Source: States of Jersey Accounts and MTFP
Note: NRE figures exclude capital servicing, depreciation and impairments of fixed assets. The NRE figures only cover the Consolidated fund, and not Trading Funds, the Strategic Reserve, Stabilisation Fund, Special Funds or States of Jersey Development Company. It also excludes any public sector body outside of the group boundary such as the Social Security Funds.

5.2.5 Net revenue expenditure increased considerably in 2008 as a result of additional funding approvals which were granted by the States to meet the costs of the Historical Child Abuse Enquiry, the loss of the Reciprocal Health Agreement income, the cost of preparing for a flu epidemic and the additional funds approved for Income Support because of the downturn in the economy. Expenditure remained high in 2009 as the result of the economic stimulus, but even if some of the Comprehensive Spending Review is included, net revenue expenditure will have increased by almost £140 million in the five years after 2007. Between 2012 and 2015, total net revenue expenditure (excluding deprecation) will have increased by an additional £73 million.

5.2.6 Figure 16 illustrates the growth in net revenue expenditure compared with the growth in RPI over the years 2003 to 2015 (amounts rebased to 2003).

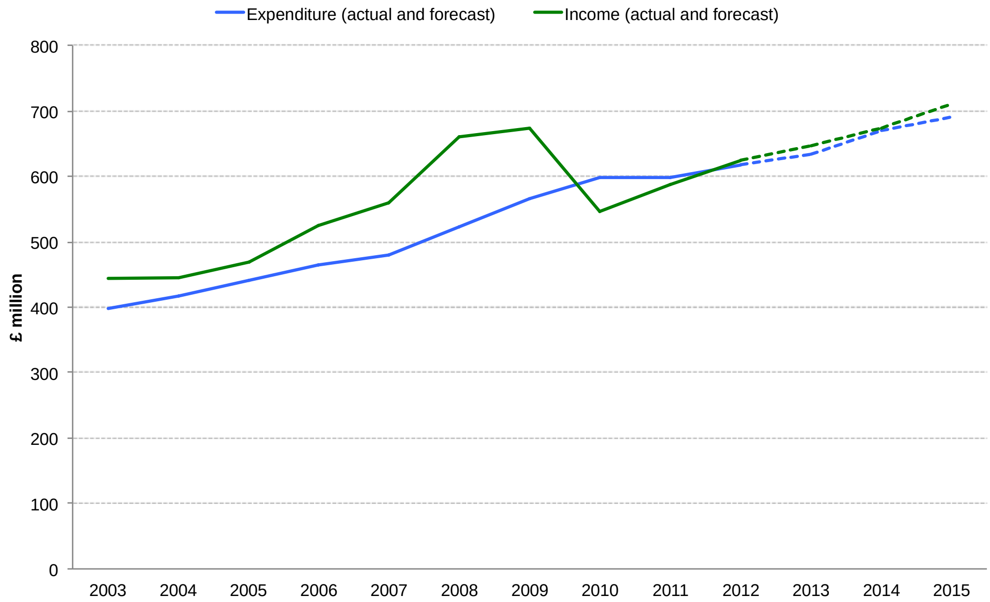
Figure 16. Net revenue expenditure and RPI, actual and forecast, 2003–2015 (2003 = 100)



Source: States of Jersey Accounts and Statistics Unit

5.2.7 Figure 17 illustrates that on the basis of the current forecasts, the gap between income and expenditure is the tightest it has been since the early 2000s and there appear to be few possibilities that the Stabilisation Fund will be replenished over the lifetime of the first MTFP.

Figure 17. Growth of actual net revenue expenditure allocation and income, actual and forecast, 2003–2015 (£ million, current prices)



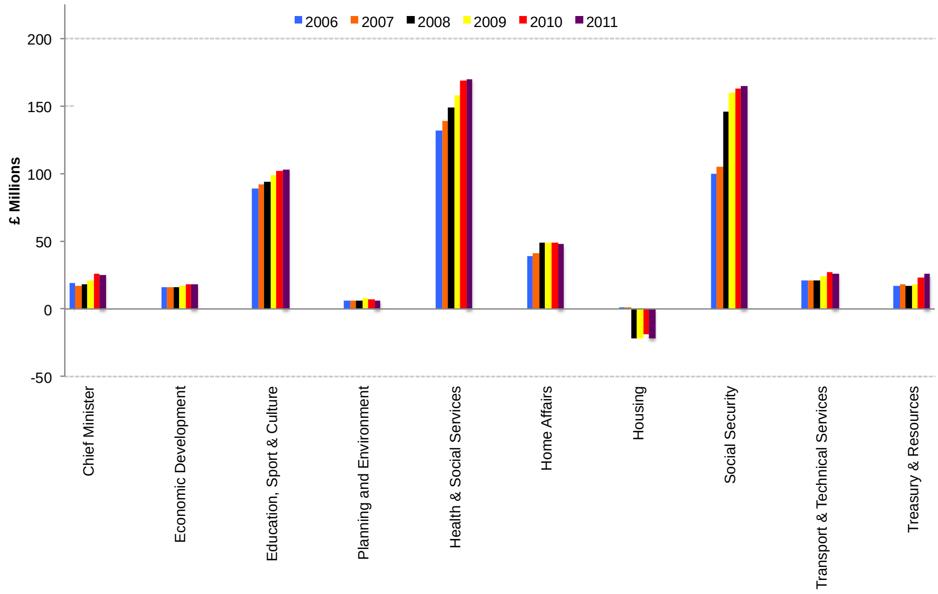
Source: States Accounts and MTFP

This report does not comment on the detailed composition of expenditure commitments but it is instructive to see which Ministerial Departments have benefited from increases in net revenue expenditure since the onset of Ministerial Government.[8]

5.2.8 Turning first to expenditure patterns between 2006 and 2011. As is well known, the biggest spending departments are Health and Social Services, Education Sport and Culture and Social Security (Figure 18).

[8] This analysis ignores Non Ministerial States funded bodies such as the Law Officers' Department, C&AG, the States Assembly and its services and so on.

Figure 18. Total Net Expenditure by individual Departments, 2006–2011 (£m, current prices)



Source: States of Jersey Accounts

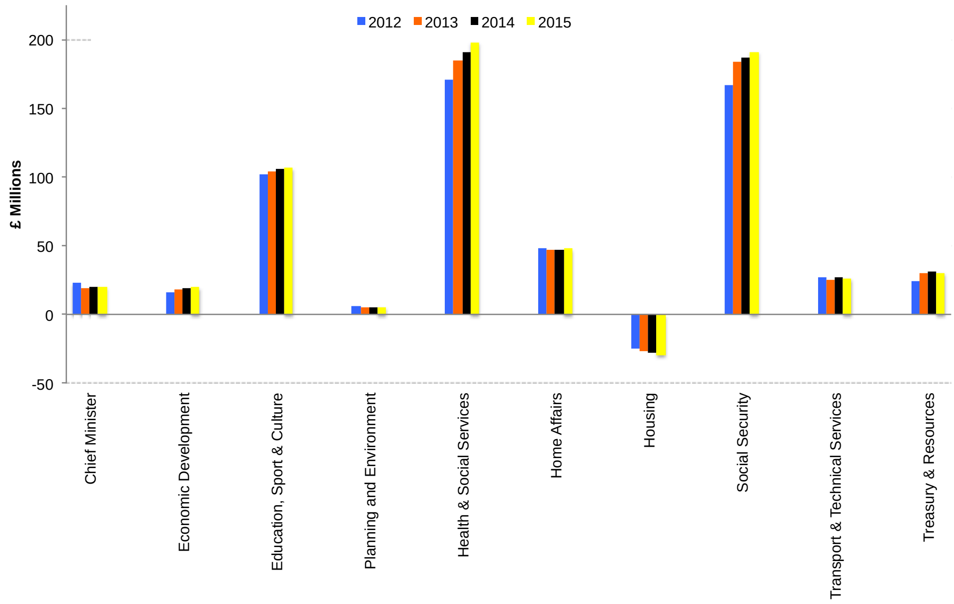
The change in the growth of Departmental net revenue expenditure over the same period is shown in Table 6.

Table 6. Change in growth of Departmental Net Revenue Expenditure between 2006 and 2011

Department	(£m, current prices)
Social Security	£64,666,006
Health & Social Services	£38,662,853
Education, Sport & Culture	£14,701,195
Home Affairs	£8,459,551
Treasury & Resources	£8,434,488
Chief Minister	£5,907,771
Transport & Technical Services	£4,956,932
Economic Development	£2,407,536
Planning and Environment	£305,012
Housing	- £22,436,675
Total change	£126,064,669.00

5.2.9 Projected net revenue expenditure allocation for Ministerial Departments between 2012–15 is shown in Figure 19. This captures the same pattern as Figure 18, but Table 7 shows that the composition of the 'winners' has changed slightly.

Figure 19. Total Net Expenditure by Departments, 2012–2015 (£m, current prices)



Source: States of Jersey Accounts

Table 7. Change in growth of Departmental Net Revenue Expenditure between 2012 and 2015*

Department	(£m, current prices)
Health & Social Services	£27,844,100
Social Security	£26,603,000
Treasury & Resources	£4,469,000
Education, Sport & Culture	£3,327,100
Economic Development	£1,722,000
Transport and Technical Services	£454,000
Home Affairs	£156,000
Planning and Environment	- £1,045,000
Chief Minister	- £5,073,400
Housing	- £7,864,000
Total change	£50,592,800

Note: *These changes do not include the Central Contingency Allocations and carry forwards into 2012.

The Departments who are going to receive the biggest increase in expenditure between 2012 and 2015, aside from Health and Social Services and Social Security are Education, Sport and Culture, Treasury and Resources and Economic Development. Table 7 should raise the question of whether this pattern of expenditure is correctly aligned to the States Strategic Plan; the answer to which lies outside the scope of this report.

6. CONCLUSIONS

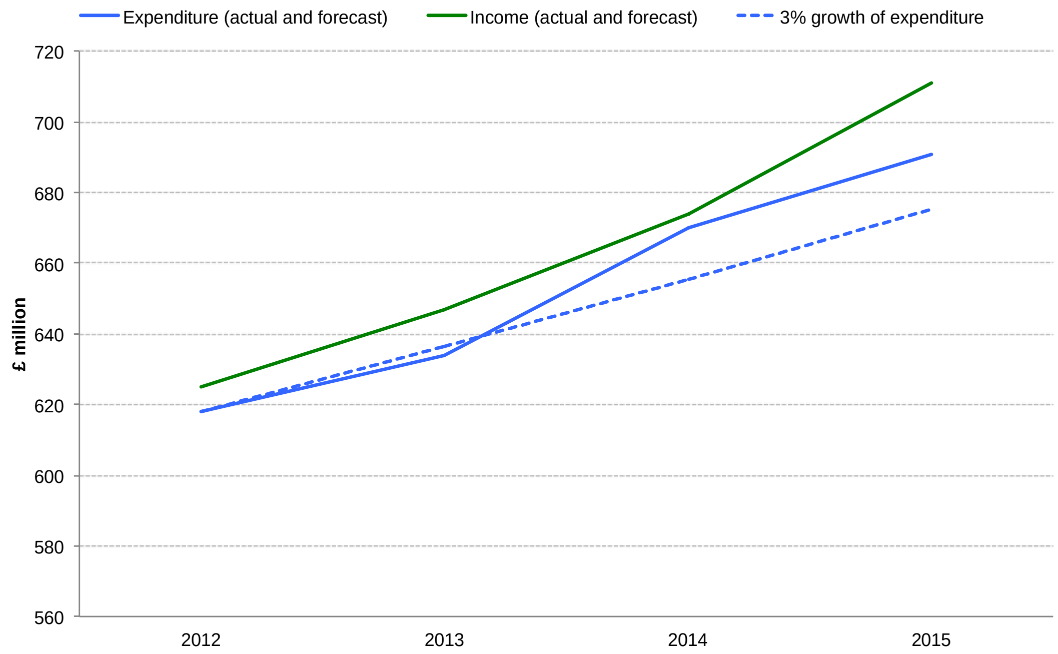
6.1 Due to the continuing global uncertainty and volatility, it is only to be expected that the Channel Islands' economies will continue to underperform in the near term. Guernsey has recognised this and has downgraded its forecasts of growth as well as questioning whether its long-term growth rate of 2 per cent is sustainable in what it calls the 'new normal' economic environment. In Jersey, GVA fell for 4 consecutive years in the early 2000s. It would be surprising if the levels of GVA assumed in the MTFP for 2012 and 2013 will be achieved.

6.2 Jersey's finance sector has provided the bulk of national income for at least two decades. In the short run, finance will probably continue to see slower growth. In the medium run, there is a question whether finance will be able to provide the levels of income which it has done in the past. The plan to diversify the economy has the potential to provide additional income in the medium to long run, but whether it is sufficient to replace any lost income from finance remains to be seen.

6.3 Jersey's adoption of a medium term financial plan is to be welcomed not least because spending programmes have a longer gestation than one year. However, if the income forecasts are too optimistic (so leading to a higher level of spending than would be justified by actual revenue), and spending programmes are approved too far ahead, medium term planning can lead to imprudent spending. The way to deal with this is to ensure that the MTFP has sufficient room to manoeuvre to take account of the degree of uncertainty in the revenue forecasts. As Figure 17 has shown, there appears little room for error.

6.4 A more cautious approach to expenditure, merely for illustrative purposes, is provided in Figure 20. Assuming nominal growth of 3 per cent per annum, by 2015 net revenue expenditure allocation would be £28 million lower than is currently planned. If greater prudence on the growth of public expenditure was followed over the next few years and actual income turns out to be more buoyant than some of the assumptions discussed in this report, then the Stabilisation Fund could quickly be topped up again.

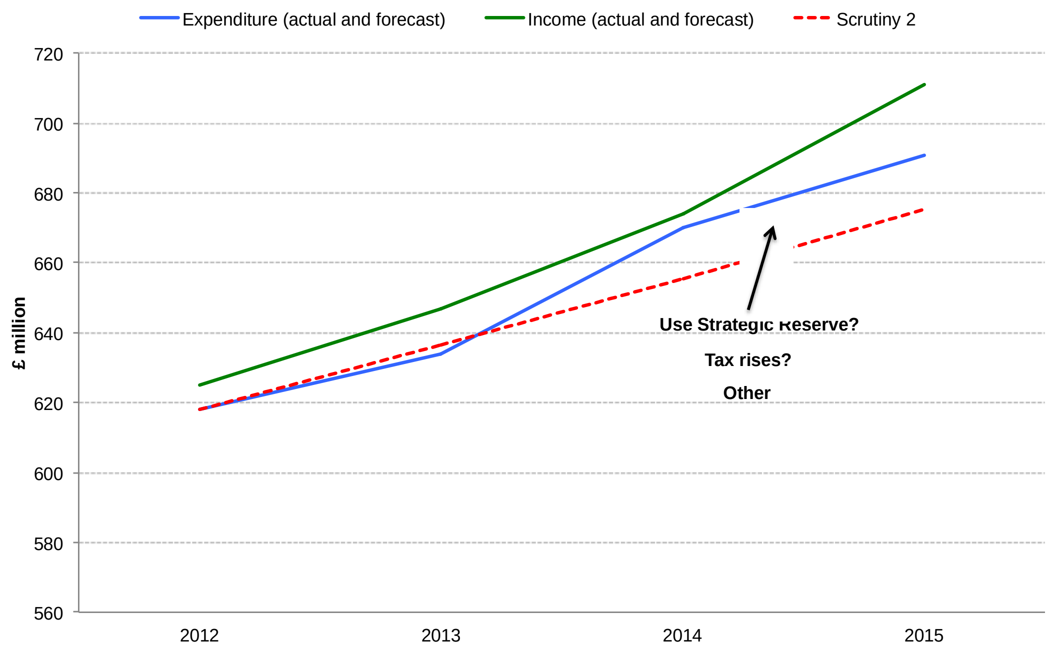
Figure 20. Growth of net revenue expenditure allocation as forecast and with 3% growth, 2012–2015 (current prices)



Source: MTFP and author's calculations

6.5 The economic consequences of additional expenditure without the income to pay for it needs to be emphasised. Figure 21 plots the income and net revenue expenditure allocation forecasts for 2012–2015 and also includes the revised income forecasts from Table 5 (Scrutiny 2 only). This illustrates that if income did fall to Scrutiny 2 levels (the dashed red line) as discussed earlier in this paper, then policymakers would have a number of choices. If they wished to keep expenditure to the levels discussed in the MTFP (the blue line) then this would have to be funded either by tax rises; use of the Strategic Reserve; or another option. The policy implications of each option need to be thoroughly explored and debated.

Figure 21. Growth of income and net revenue expenditure allocation with Scrutiny 2 forecast, 2012–2015 (current prices)



Source: States Accounts, MTFP and calculations from the author's assumptions

6.6 There should also be a debate about whether goals could be developed on public expenditure, e.g. a constant revenue/GNI and expenditure/GNI ratios or constant expenditure in real terms. Net revenue expenditure is not a satisfactory basis for international comparisons of expenditure and work needs to be done on assessing whether the Island really is a low spend jurisdiction, particularly on a per capita basis.

6.7 Between 1979 and 1997, successive UK Chancellors struggled to constrain government expenditure but made strenuous effort to put fiscal policy on a firmer foundation. After 1997, aside from his first two years as Chancellor, Gordon Brown then relaxed fiscal policy. Between 1999 and 2007, fiscal policy became far too lose and led to a significant rise in debt. The reason for this fiscal loosening was the desire to spend more money on public services. During the 2000s, Jersey made vigorous efforts to improve the design of fiscal policy and appointed an independent Fiscal Policy Panel.

These were bold and decisive moves. It would be a pity if after all the hard work Jersey's enviable fiscal position was quickly lost. The UK's experience with populist approaches should provide cautionary lessons for Jersey politicians.

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