STATES OF JERSEY

PUBLIC SECTOR CUTS AND ALTERNATIVE TAXATION MEASURES (P.113/2010): COMMENTS

Presented to the States on 9th September 2010
by the Council of Ministers

STATES GREFFE

COMMENTS

The Council of Ministers urges States members to reject all parts of P.113/2010.

The Council has an achievable target for savings by 2013 of £50 million in real terms. This is a significant saving which can be achieved without serious detriment to the level and performance of front-line services. The highest priority for savings is through efficiency in existing practices and re-organisation of functions where this will reduce cost and improve performance. It is inevitable that some services will be cut but this will be done in a way that maintains the high standards of our key public services.

The Council of Ministers know that savings must be well planned and targeted if the result is to be a sustainable budget. That is why savings will be targeted over 3 years with the higher savings in 2012 and 2013. Public services are too valuable to just impose draconian cuts in one year which will have severe impacts on key front-line services and result in lower savings in the medium-term.

Savings will inevitably lead to job losses in the public sector. Phasing them properly with the significant reductions in 2012 and 2013 should allow expected economic growth to provide sufficient jobs to avoid an unwelcome increase in unemployment. In addition, where savings in 2012 and 2013 lead to public services being delivered with less States and more private sector involvement this could simply mean that employment is transferred to the private sector.

The Council of Ministers is adopting a pragmatic and realistic approach to savings, of which the 2011 business plan savings are a necessary first step. The current CSR review process will ensure that options that will be brought forward in October for savings in 2012 and 2013 are realistic and deliverable. Consultation has taken place with staff representatives and will continue throughout the process.

P.113 clearly fails to understand and recognise the financial situation the States is in and by advocating delay in both the CSR and FSR will have the drastic impact of the States becoming overdrawn on the Consolidated Fund by £44 million in 2013 as set out in table 1 of the attached report. P.113 does not present members with all the correct information and fails to explain what else would be required to bring the Consolidated Fund back into balance in 2012 and 2013. In contrast, the Council of Ministers' strategy aims to bring the deficit back to balance by 2013 and ensures that sufficient money is in the Consolidated Fund.

To bring in a 10% corporate tax rate for non-local non-finance companies without understanding the impact would be knee-jerk and irresponsible, particularly while the EU Code of Conduct group is assessing our business tax regime. The Minister for Treasury and Resources has already committed as part of the Business Tax Review to investigate ways of recouping the tax lost from these companies which effectively ceased to pay corporate tax in Jersey on the introduction of 0/10 without incurring unintended economic costs.

Preventing any rise in GST before 2013 would short circuit a wide ranging FSR consultation process and devalue the input of nearly 1,000 Islanders and the many representative organisations that have contributed to this consultation. It would be unwise to dismiss a legitimate tax raising option on such little evidence, particularly when it has a number of important characteristics relative to other taxes.

The Report to P.113 implies that the Council of Ministers does not have a strategy for dealing with the fiscal challenge the Island faces and that the proposals are rushed and not worked through. This is not correct: the Council's strategy is based on detailed analysis (much of which is summarised in the attached report) and is very clear. It is –

- To maximise savings, without inflicting unintended damage on front-line services, in order to minimise the need for tax rises.
- To boost economic growth in order to maximise jobs for Islanders and tax revenues.
- To increase taxes only as much as is necessary to fund important investment and in a way which is fair and supportive of economic growth.

By addressing the fiscal challenges we face in the manner proposed by the Council of Ministers we will lay solid foundations to build on our economic success and enhance the high quality of Island life we all enjoy.

The following report sets out the detailed analysis supporting the strategy proposed by the Council of Ministers.

<u>Supporting analysis</u>

Summary

This report sets out the key issues and the detailed analysis supporting the Council of Ministers' three part strategy for addressing the deficits forecast. The main points are –

- The impact of the worst global economic downturn since the 1930s has manifested itself in a significant loss of States revenue, particularly from income tax, which forecasts suggest will not quickly return.
- While 0/10 did lead to a loss of £80 million in tax revenue in 2010, this was expected and the States agreed the fiscal strategy to raise new and additional revenue from other sources to replace it. Therefore 0/10 is not responsible for the deficits forecast.
- Our fiscal situation has also been exacerbated by an inability to put States spending on a sound medium-term footing and the tendency for it to rise year after year relative to previous plans, resulting in a large rise in spending over a short period of time.
- An element of cost reduction in the delivery of public services is inevitable. The CSR has to be an integral part of the plan to address the forecast structural deficit and return to balanced budgets by 2013.
- If we do not proceed with the CSR as planned there will be two significant consequences:
  - the contribution to correcting future deficits made by personal taxes will **have** to rise;
  - **financial management will not improve** and the change in culture required to put States spending on a sound footing will not occur.
- The CSR must evolve into a strategic programme that lasts longer than 3 years and effects fundamental change to the way government works. This will require major investment to be successful.
- There has been (and will continue to be) consultation with staff representatives on the CSR.
- **Borrowing or using our reserves is not a sustainable option**. Either of these options brings with it significant risks and does not address the fundamental problem of an underlying mismatch between expenditure and revenue. Using the Strategic Reserve in the manner set out in P.113 would be imprudent for three reasons –
  - (i) the Strategic Reserve would be £100 million lower (on top of the £156 million that will have been drawn from the Stabilisation Fund) than would otherwise be the case putting us in a much weaker position to address any future major problem in the economy;
  - (ii) over the next 5 years we would not only run down the Strategic Reserve but we would not replenish the Stabilisation Fund leaving us in a much weaker position to support employment and business in the next economic downturn;

(iii) fiscal policy would not operate in a counter cyclical manner. That is, we would continue to run deficits once the economy has recovered at the risk of igniting inflation.

- Fiscal policy will continue to support the economy in what is hoped is the early stages of recovery next year. On current forecasts the States will run a deficit of £92 million this year and a deficit of £50 million in 2011. In line with the advice from the Fiscal Policy Panel the States has already agreed to use a significant sum from its reserves (most of the £156 million in the Stabilisation Fund) to support jobs and businesses through the downturn.
- Delaying the CSR means we run out of money and the States would effectively become overdrawn on the Consolidated Fund – something that is contrary to the Finance Law. The three point plan proposed by the Council of Ministers prevents this from happening.

Economic background

Severity of global downturn

The world economy has experienced the worst economic downturn since 1930s. This has manifested itself in the significant deterioration in government finances and the sharp rise in public debt in the leading economies across the globe. This has been accompanied by a sharp rise in unemployment which is currently 9.5% in the US, 7.8% in the UK and 10.0% in France.

The unprecedented scale and nature of the policy response from central banks and governments across the world has so far prevented a replay of the 1930s Great Depression. The larger economies have returned to growth this year but recovery remains fragile, not least because once the policy stimulus is withdrawn it is unclear how strong the underlying economies will be. A 'double dip' global recession is still a risk although it is not a central scenario for most economic forecasters.

From a Jersey perspective – as our economy is dependent on exports ranging from financial services to tourism and agriculture – this means that it would be imprudent to rely on a quick global rebound to repair the damage. We must plan for the fallout of what is now being called the 'great recession' to be long lasting.

Impact on the local economy

There is little doubt now that the local economy has been significantly affected by the global economic environment. The profitability of our financial services sector fell by almost half in 2009, although excluding any large one-off fluctuations the fall was lower, but still substantial, at 25%. Not surprisingly, employment in the finance fell by over 400 last year.

The impact has been felt more widely than in the financial services sector. Unemployment has reached 1,250, with younger people disproportionately affected. Retail sales, particularly in non-food items have fallen and the latest Business Tendency Survey shows that as recently as June this year, business activity was still falling, profitability was under pressure and employment was still being reduced across the local economy.

Under such circumstances it was right that the States agreed – on the advice of the Fiscal Policy Panel (FPP) – to support local employment and businesses through discretionary fiscal stimulus in a timely, targeted and temporary manner and invest in projects that had intrinsic value and were required anyway. However, the approach agreed by FPP was only to use the Stabilisation Fund in 2010 and 2011 for discretionary fiscal stimulus and to cover the deficits forecast. This still requires action thereafter to address the deficits forecast and the FPP advised we put in place an appropriate strategy.

To understand why we face the deficits forecast it is necessary to look at trends in tax revenues and States spending.

Trends in tax revenues

Not surprisingly the trends in the global and local economies have had a significant adverse effect on States' revenue. By far the largest impact has been on income tax receipts.

This has happened at the same time as States income has been affected by the introduction of the new 0/10 corporate tax structure, which complicates understanding the cause of the ongoing deficits.

Actual income tax receipts in 2009 were £508 million. Probable income tax receipts in 2010 are £391 million. This is a fall between 2009 and 2010 of £117 million. This is a combination of the impact of 0/10 and the economic downturn.

The latest estimates of the impact of 0/10 indicate that of the £117 million difference between 2009 and 2010, £70 million was due to 0/10 (with 0/10 already having had an £11 million impact in 2009). These estimates are in line with the expected impact of £80-100 million of 0/10 to which the States agreed a fiscal strategy response to raise £80-100 million in revenue through –

- the introduction of 3% GST;
- States efficiency savings;
- income tax measures (20 means 20/ITIS);
- economic growth.

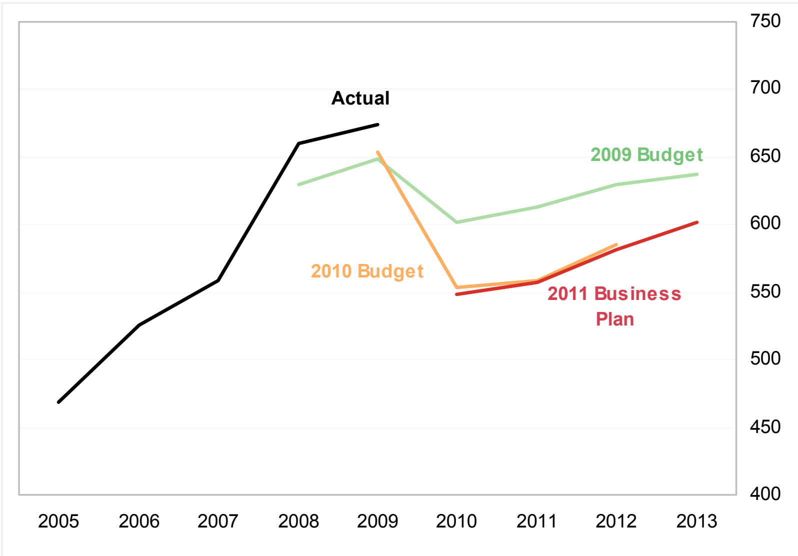
Overall there remains a deterioration of £50 million in income tax which is not explained by 0/10 and therefore there is no revenue stream in place to cover. This fall relates to the impact of the economic downturn on the income tax base. Of this fall of £50 million –

- £9 million was due to lower income tax from employees and £12 million from self-employed and investment holders;
- the remaining £29 million was from lower underlying taxable profits of companies.

Therefore there is a large drop in income tax revenue between 2009 and 2010, of which approximately 60% can be attributed to 0/10, and the remaining 40% to the economic downturn. This drop in income tax was the main contributor to the overall fall in States revenue, although falls in other income (EU Savings Directive, returns on investments) also contributed, some of which was also driven by the economic downturn.

The sharp fall in forecasts for income tax between 2009 and 2010/11 (Chart 1) cannot be due to 0/10, since in all forecasts a fall of £80 million as a consequence of 0/10 have been factored in. Further, since measures were already in place to raise at least £80 million, it should be clear that 0/10 cannot be a contributing factor to the deficits that we currently face.

Chart 1: The change in income tax forecasts
£m, forecast at time of Budget in each year

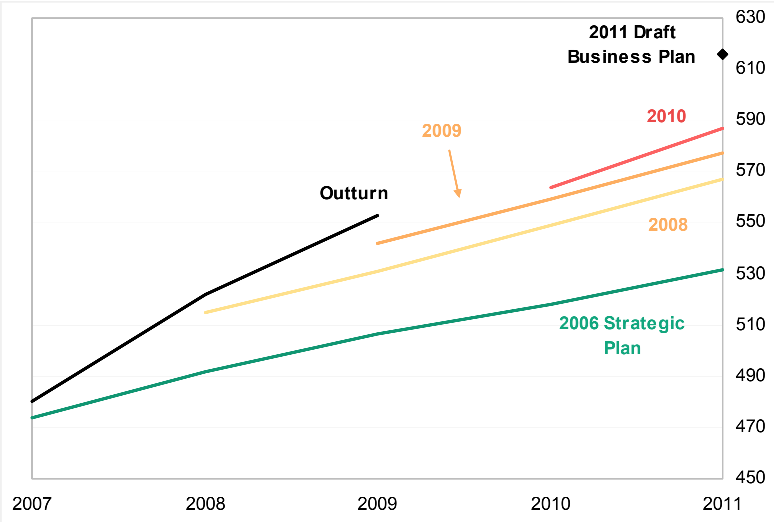


However, it is fair to say that because a large part of the growth in tax revenue during the economic upturn was temporary due to the cyclical nature of the economy, some of the increases in spending agreed by the States were not backed by the revenue to fund them. The lesson from this is not that 0/10 had a larger impact than expected, but rather that structural increases in States spending should be backed by structural increases in revenue – not ones accruing through the cyclical nature of the economy.

Expenditure trends

The chart below shows how our fiscal situation has been exacerbated by an inability to put States spending on a sound medium-term footing and the tendency for it to rise year after year relative to previous plans, resulting in a large rise in spending over a short period of time.

Chart 2: Changes in expenditure plans
£m net revenue expenditure in each Business Plan (unless otherwise stated)



A large proportion of the extra expenditure was allocated to important areas such as Health and Social Services, Education and Social Security benefits. However, this does not take away the fact that the current level of spending exceeds the tax revenue we can expect to receive.

This is why the CSR has to be an integral part of the plan to address the forecast structural deficit and return to balanced budgets by 2013. The CSR is about controlling public spending but it is also about introducing changes intended to extend the States planning horizons and give stability for departments to plan their services over a longer time scale.

The CSR has drawn on the experience of the UK, France and Canada in determining the principles under which the review should be governed. The purposes of the review have been to –

- control States spending by setting tough but achievable savings targets and realistic growth proposals;
- improve financial management across the States of Jersey by ensuring incentives are built in to the budgeting system to encourage improved decision-making;
- extend the States planning horizon so that clear three-year plans are made and adhered to;
- bring greater transparency to financial planning and provide more complete cost information for decision making; and
- deliver better value for money and good management of assets and investments.

The intention is to introduce a culture and framework of longer-term financial planning. The concept is of a major strategic or business review of objectives and priorities every three years at each change of Council of Ministers with annual reviews becoming part of business as usual.

The shortfall in our finances results from the impact of the economic downturn, the need to properly incorporate contingencies into our financial planning and to ensure we plan properly for unbudgeted costs and future investment that we know will be required. The FSR and CSR will combine to close the shortfall by 2013.

If we do not proceed with the CSR as planned there will be two significant consequences –

- the contribution to future deficits made by personal taxes will have to rise;
- financial management will not improve and the change in culture required to put States spending on a sound footing will not occur.

Change in States spending is likely to take longer than 3 years but this does not mean that we can delay the difficult decisions we need to take now. Rather, that the CSR must evolve into a strategic programme that effects fundamental change to the way government works and this will require major investment to be successful. Thus whilst the savings outlined in the CSR have to be achieved in 3 years the change programme may well run over 5 years and this has the potential to bring the States into surplus and create reserves to handle future recessions.

CSR consultation

Deputy Southern in P.113 implies that proper consultation has not taken place around the implications of the CSR for staff. The Employer has, and will, continue to consult staff representatives on a new policy on Voluntary Redundancy (VR).

For the current round of Voluntary Redundancies, the current terms and policy guidelines surrounding VR have existed for many years (since 1995) and Unions and Staff Associations were fully consulted on these at the time. For all practical purposes they have not changed.

It is not correct for Deputy Southern to say that the "6-week window for applications over August means that by the time that the States next meet, voluntary redundancies will be in place before the provision of those services under threat can be decided by the States." First, the central VR pot is not directly linked to the 2% service cuts and second, responses for VR applications will not be determined until after the States debate on the 2011 Business Plan. Final decisions will not be made by the Corporate Panel until early October.

It is true that nobody has yet seen the proposals for possible new VR terms. This is because these are currently being worked on and initial proposals are scheduled for discussion at SEB on 20th September prior to staff consultation. The Deputy has been reassured by the Chief Minister on at least two occasions in the States that staff representatives will be consulted on any proposals for new terms.

Further information that shows there has not been a lack of consultation include –

- Specific proposals for achieving 2% savings have identified 67 posts that could be removed which will affect 30 individuals. Consultation at both local and corporate level has taken place on these 2% savings measures.
- Ideas for making the next level of savings are still being discussed and so far no specific proposals have been identified on which meaningful consultation could take place. However, a commitment has been given to hold consultative meetings once that detail is available. A commitment has been made to have full discussions with staff affected by changes and to work with trade unions and other staff representatives to mitigate job losses and, where this is not possible, to enable staff to find other work either inside States of Jersey or outside.
- On 2nd August 2010, Senior Officers met with senior staff representatives to inform them of the details surrounding the new VR launch from 2nd August until 17th September. The meeting was well attended and constructive. Unfortunately, the Regional Industrial Organiser of Unite chose not to attend the meeting. (Representatives had been notified of the launch the previous week before staff and the media were informed.)
- On 6th August 2010, HR Director and Head of Employment Relations met with senior representatives of Unite and the Civil Service Association to discuss the VR programme, job reductions, redeployment, etc. The Regional Industrial Organiser of Unite was in attendance. It was a good meeting with all parties agreeing to meet again in late September to discuss the response to the call for Voluntary Redundancies.
- On 20th August 2010, a presentation on the VR scheme was made to all manual worker shop stewards at TTS, with senior HR staff available to answer questions, which was deemed very successful by the attendees.
- The HR Director and Head of Employment Relations have met the Civil Service Staff Side's executive committee, including Prospect's National Officer, twice to discuss the VR and redeployment schemes.

Use of the Strategic Reserve/borrowing

Borrowing or using our reserves is not a sustainable option. Either of these options does not address the underlying mismatch between expenditure and revenue and simply involves burying our heads in the sand and hoping that the problem goes away.

The States agreed in 2006 the policy for the Strategic Reserve and that the capital in the reserve should be used only in exceptional circumstances, for example to insulate the Island's economy from the severe structural decline of a major industry. This is not what is happening now – we like everyone else have to adjust to a new global environment which means that some of the recent growth in tax revenues looks to have been only temporary. We are in a fortunate position that the forecast deficits are manageable and much smaller than those faced by our larger neighbours. However, this is only true if we manage our finances carefully and do not allow the position to get worse.

The States has already agreed, in line with the advice from the Fiscal Policy Panel to use up the £156 million in the Stabilisation Fund to support the economy through the downturn. This year the States will run a deficit of £92 million and in 2011, even after the first phases of the CSR and FSR are implemented, the deficit will still be

£50 million. So fiscal policy will continue to support the economy in what is hoped is the early stages of recovery next year.

P.113 suggests that we delay the moderate fiscal tightening by using up a £100 million from the Strategic Reserve. States finances will not return to balance by 2015 (and there is no explanation as to how we should cover the £20-30 million hole after 2015). Such an approach would be imprudent for three reasons –

(i) The Strategic Reserve would be £100 million lower (on top of the £156 million that will have been drawn from the Stabilisation Fund) than would otherwise be the case putting us in a much weaker position to address any future major problem in the economy.

(ii) Over the next 5 years we would not only run down the Strategic Reserve but we would not replenish the Stabilisation Fund leaving us in a much weaker position to support employment and business in the next economic downturn.

(iii) Fiscal policy would not operate in a counter cyclical manner. That is, we would continue to run deficits once the economy has recovered at the risk of igniting inflation.

Borrowing carries exactly the same risks as using the Strategic Reserve, but with the additional problem that the States would have to pay interest on any money borrowed. This additional cost that we would burden Islanders with in the future would add to future deficits and divert money away from our public services.

Business tax

The Minister for Treasury and Resources is consulting on possible changes to the business tax regime and a full review is currently underway. Jersey's business tax regime is also being assessed by the EU Code of Conduct group. It would be imprudent to make any changes to our business tax regime until the outcomes of these reviews are known.

The Minister for Treasury and Resources has committed, as stated in the Business Tax Review consultation document, to investigate ways of recouping the tax lost from companies which effectively ceased to pay corporate tax in Jersey on the introduction of 0/10. The Minister has already stated that if he can increase business tax revenues, while retaining competitiveness, protecting the economy and not placing an additional burden on businesses, he will do so.

To bring in a 10% corporate tax rate for non-local non-finance companies without understanding the impact would be knee-jerk and irresponsible.

Profligate to delay

P.113 clearly fails to recognise the financial situation the States is in and by advocating delay in both the CSR and FSR will have the drastic impact of meaning the States will become overdrawn on the Consolidated Fund in 2012. So the reality is that P.113 does not present members with all the correct information and fails to explain what else would be required to bring the Consolidated Fund back to balance in 2012.

Table 1: The impact of adopting P.1132010 on the Consolidated Fund

Probable 2010 £m	Consolidated Fund	2011 £m	Forecasts 2012 £m	2013 £m
53	Opening Balance	20	20	(13)
(92)	Forecast Surplus/(Deficit) for the year	(50)	(20)	-
59	Transfer from Stabilisation Fund	50	-	-
-	Effect of delaying CSR	(2)	(5)	(20)
-	Effect of Business Tax proposals	-	10	10
-	Effect of using Interest on Strat Reserve	19	20	20
-	Effect of adopting modified FSR	(17)	(38)	(41)
20	**Projected Closing Balance after P113**	**20**	**(13)**	**(44)**

We cannot even delay the CSR as suggested by Deputy Southern in P.113. Delay means we still run out of money and the States would effectively become overdrawn on the Consolidated Fund – something that is contrary to the Finance Law. The only way the Council of Ministers can see to rectify such a situation and put States finances back on a sustainable footing would be to raise personal taxes to a greater extent than set out in the Draft Annual Business Plan.

Table 2: The impact of delaying the CSR as set out in P.113/2010

Probable 2010 £m	Consolidated Fund	2011 £m	Forecasts 2012 £m	2013 £m
53	Opening Balance	20	18	(7)
(92)	Forecast Surplus/(Deficit) for the year	(50)	(20)	-
59	Transfer from Stabilisation Fund	50	-	-
-	Effect of delaying CSR	(2)	(5)	(20)
20	**Projected Closing Balance if CSR Delayed**	**18**	**(7)**	**(27)**

Public services are vital

The Council of Ministers recognises the importance of our public services to Island life and the wider economy. However, it does not believe that implementing the CSR as currently planned will undermine public services. Rather, while helping to control public spending it will also bring about changes intended to extend the States planning horizons and give stability for departments to plan their services over a longer time scale. By supporting the CSR States members will be starting the process that is required to ensure we can properly manage States spending and provide future investment in public services. This process will need to be supported by a change in culture and attitude of States members, officers and departments and this process cannot be stalled.

GST should not be ruled out

The consultation on the Fiscal Strategy only finished on the 30th August and the summary of responses will be later in September. To try and tie the Minister's hands preventing any rise in GST before 2013 would short circuit a wide ranging consultation process and devalue the input of nearly 1,000 Islanders and the many representative organisations that have contributed to this consultation.

Whilst the Council of Ministers recognises that GST may not be popular, few taxes are. However, the Fiscal Strategy Green Paper makes it clear that it has a number of important characteristics – not least in terms of the economic impact relative to other taxes – which means that dismissing this as an option at such an early stage and on the basis of very little evidence would be foolish.