STATES OF JERSEY

ECONOMIC GROWTH PLAN

Lodged au Greffe on 1st March 2005
by the Economic Development Committee

STATES GREFFE

PROPOSITION

THE STATES are asked to decide whether they are of opinion −

to refer to their Act dated 7th July 2004 in which they approved the Fiscal Strategy and agreed that a target for economic growth of 2% per annum should be set for the period 2005 to 2009, and requested the Economic Development Committee, in conjunction with other Committees as necessary, to bring forward, for approval by the States, a strategy for delivery of this growth by February 2005, and –

(a) to receive the Economic Growth Plan entitled 'Growing Jersey's Economy', as set out in the report of the Economic Development Committee dated 1st March 2005 and, in order to give effect to recommendations made in the Plan –

(i) to agree that, in order to improve the skills base in Jersey and labour market performance –

(A) the Economic Development and Education, Sport and Culture Committees should bring forward a new skills strategy to address the issues raised in the Economic Growth Plan;

(B) the Education, Sport and Culture Committee should ensure that preparatory work begins on establishing an International Business School in the Island;

(C) all relevant Committees should give consideration to policies that can increase labour force participation in Jersey;

(D) the Economic Development Committee should help to promote and disseminate best practice in Jersey in the area of human resource management and other aspects of business performance;

(ii) to agree that, in order to create a more entrepreneurial society in Jersey, the Economic Development Committee should take the necessary steps to –

(A) establish a pilot Small Firms Loan Guarantee Scheme;

(B) establish a Jersey Business Angel Network;

(C) establish a pilot Venture Capital Fund;

(D) request the Education, Sport and Culture Committee to ensure that enterprise education is added to the curriculum for all young people in Jersey;

(E) put in place an expanded support service for small business development;

(F) request the Housing Committee, in consultation with other relevant Committees, to ensure that the current system of 1(1)(k) consents continues to facilitate the entry of entrepreneurs into Jersey;

(iii) to agree that, in order to encourage greater competition in Jersey and capture the benefits this can bring, the Economic Development Committee should ensure that –

(A) the legal powers of the Jersey Competition Regulatory Authority are kept under review and that it develops a high profile in the Island;

(B) further consideration is given to the best way to enhance the consumer voice in Jersey;

(iv) to charge the Economic Development Committee to produce and publish before the end of 2005 a review of external transport policy in Jersey; and

(v) to charge the Finance and Economics Committee to develop a new framework for the Strategic Reserve and Fiscal Policy that encapsulates the proposals in the Economic Growth Plan for a new counter-cyclical Stabilisation Fund, with the Strategic Reserve clearly reserved for use only if the Island faces a major shock to its economy;

(b) to approve, in principle, the additional funding required to implement the Plan and to charge the Finance and Economics Committee, in consultation with the Economic Development Committee, to assess the most appropriate source of funding.

ECONOMIC DEVELOPMENT COMMITTEE

REPORT

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Introduction

In July 2004, the States of Jersey agreed a target of 2% annual economic growth for the next 5 years. Based upon past performance, this target is eminently achievable. But to achieve it safely, Jersey will need carefully analysed strategies to enable it to happen so that we bring long-term benefits to the Island.

There were 3 key reasons for that States decision. First, carefully managed and sustainable economic growth will benefit the community by creating more job opportunities for local people. The second benefit is that controlled economic growth will minimise the tax burden Islanders face. The third benefit for Jersey lies in providing the opportunity to strengthen our existing industries and in laying down a framework for diversification.

We live in a changing world. To ensure that Jersey maintains its position in that world it is vital that we consolidate and build on our strengths. The States has already made the first significant decision to enable us to do that, by moving to the 0/10 corporate tax regime. That decision gives our key industry – finance – the certainty it needs to consolidate and build on its global position as a leading international financial centre.

But Jersey has other significant strengths. The people of the Island are one of our key assets, Jersey's ability to adapt and change is another. The Economic Growth Plan (EGP) examines how best to use all of Jersey's assets and build the foundations for a secure and prosperous future, which will benefit us all.

Executive summary

The Economic Growth Plan (EGP) sets out how the Economic Development Committee intends to deliver the 2% per annum real economic growth between 2005 and 2009.

Why growth?

In most of the industrialised world the need for economic growth is clear cut and undisputed.

For Jersey, economic growth is about increasing the value of the output of the economy in real terms. Put simply, this means that our economic cake will grow: our incomes will be higher and our job opportunities will be greater. Also, the tax base of our economy will be larger, so that tax rates (personal and corporate) will generally be lower to fund the level of public services that we all currently enjoy.

To put this into perspective, if we fail to achieve the economic growth identified by the States and if we want to continue with our current provision of benefits, services and pensions, then personal tax rises equivalent to 4% on the standard rate of income tax (with a higher marginal rate) could be required.

Economic growth with sustainable inflation is the first aim of the States Strategic Plan – agreed last May. Sustainable is a critical word, as it would be possible to rapidly deliver 2% economic growth which could damage the economic base in the Island, harm the economy's long term potential and have negative impacts on the natural environment. By ensuring that economic growth is well-managed and sustainable the EGP means that these risks are kept to an absolute minimum.

Sustainable economic growth in Jersey will therefore provide a better quality of life and more employment opportunities for people in the Island and at the same time minimise the impact in the Island of population growth and the effect on the environment. This reflects public opinion expressed during consultation on the Strategic Plan.

The approach

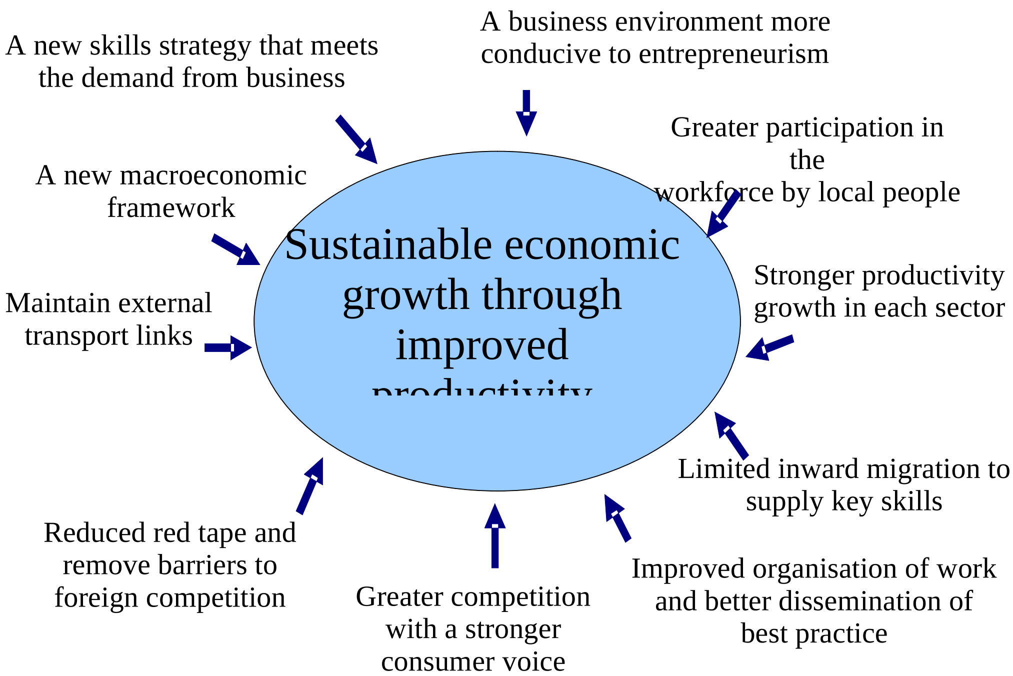
The focus of the Economic Growth Plan reflects the feedback from our consultation. Jersey's business community has asked for a 'light touch' approach from government. This Plan recognises that government intervention can only be justified in a limited number of areas, such as skills and innovation.

The emphasis is on allowing market forces to drive efficiency improvements in the Jersey economy and to support the international competitiveness of the Island. The framework provided in the Strategic Plan means that productivity (the amount produced per person in the Island) improvement across the economy must be the policy goal. This means improved productivity across financial services, retail, tourism, fulfilment and agriculture and every other sector of the economy currently with a presence in the Island and any that locates here in the future. By focusing on productivity improvements we can maximise the potential of the resources currently used in the Island. It may well be possible that new industries are attracted to the Island and this should be encouraged, but only so long as they leave a small footprint and their requirements for land and/or labour do not impinge on current activity in the Island. Such diversification should be market-led rather than a case of the government trying to pick winners.

It is also conceivable that there may be scope for marginal improvements in the participation rate and this could help to grow the size of Jersey's labour force. This might not bring productivity improvements in the short term but can clearly help to generate economic growth and lead to productivity improvements in the long term.

The overall approach of the Economic Growth Plan is summarised in the Chart below and explained in more detail in the rest of this summary.

Chart 1: The overall approach of the EGP



The 7 key strands

The overall approach of this Plan is summarised in the following 7 headings–

1. Government intervention
2. Boosting productivity and competitiveness
3. Skills and the labour market
4. Enterprise
5. Competition
6. Transport infrastructure
7. Macroeconomic stability

The report deals with each of these issues in turn with a chapter on each. The chapters are summarised in the following sections.

1. Government intervention

When, in economic terms, should government intervene? This question is critical for analysing the possible responses to particular problems and picking the right one.

The answer focuses upon market failure. This term is used to describe circumstances where the market mechanism fails to deliver economic efficiency. The fact that this failure exists does not automatically mean that government intervention is justified. It is a necessary but not sufficient condition for intervention – it is also necessary to show that adopting any new policy could be expected to bring net benefits to society and more so than other policy options or doing nothing.

All potential government intervention should be assessed on the basis of the same criteria. Even when these basic criteria are met, the next step is to show that the proposed policy will actually bring net benefits to society.

Part of government's role is to monitor what is happening in the world outside. It may well be that the Jersey economy could be knocked off course due to developments in the global economy. If this happens it must be recognised that the growth target may not be achieved in some years but that this does not mean the EGP should be abandoned. Rather that it will be more important that the Plan continues to be implemented so that the economy is better able to take advantage of the subsequent global recovery when it occurs. For every year where growth is below 2% there will be scope for stronger growth in subsequent years if the EGP continues to be implemented.

2. Boosting productivity and competitiveness

The most straightforward method to increase the output of the Jersey economy is to increase the productivity of the resources already in use. If the same quantity of land, labour and capital can be used more efficiently and produce more per unit then growth can be generated and competitiveness enhanced.

The 5 drivers of productivity are –

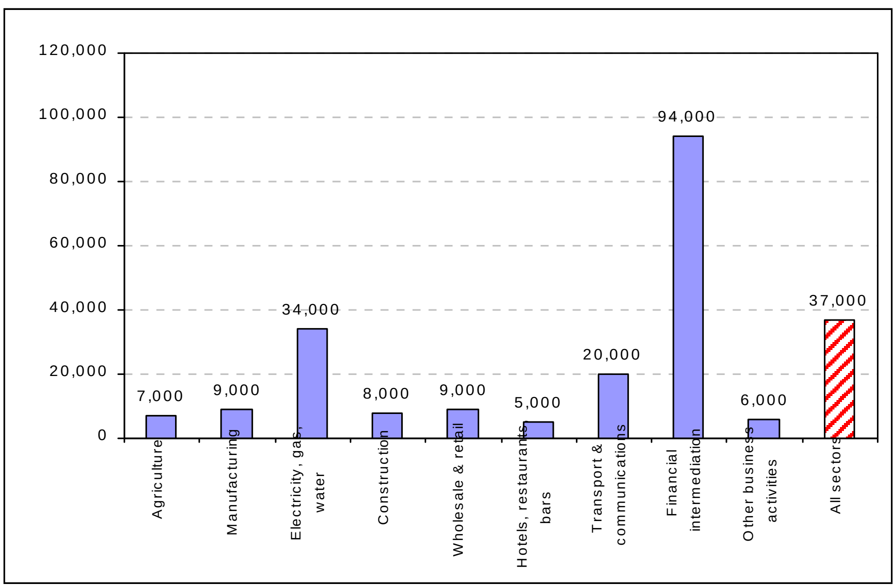
- Skills and human capital
- Investment in physical capital
- Innovation
- Competition
- Enterprise

The challenge for Jersey is to identify where these drivers are constrained due to market failure and whether government should respond with intervention. This should be done at the broad economy-wide level but can also be achieved by looking at different industry sectors. This requires an approach that looks at the performance of the key sectors of the economy in these areas and assesses whether there is market failure which can be addressed by government policy.

This means looking in detail at how each of these key sectors is working. A series of reports giving further analysis of the financial services, tourism, fulfilment and retail industries and the rural economy will be published shortly for further discussion, to build upon the Economic Growth Plan.

The performance and growth of the financial services sector is going to be vital to achieve the growth in the economy which the States require. Already, we know that it is by far the most profitable per person employed as the Chart below illustrates –

Chart 2: Profitability per employee
gross operating profit per full time equivalent, £, 2003



Source: States of Jersey Statistics Unit

The recommendations of the report on facilitating growth in the financial services industry will focus on a 6-point plan based on the key factors that will improve the industry's competitiveness and highlights –

1. Improved business education
2. Offshore product development
3. High value niche business
4. Raised industry profile
5. International initiatives/partnerships
6. Tax office liaison

The cost to the States of such a package of measures is estimated to be in the region of £1.2 million and is included in the overall costing of the package of measures included in the Economic Growth Plan.

While growth in the financial services industry will be the main driving force behind the additional £20 million of tax revenue that is required from economic growth, it is also important to recognise that it is unlikely to provide many additional job opportunities. This makes it critical that growth in the non-finance sectors of the economy is also generated to provide employment opportunities for local people, particularly the young and some additional tax revenue.

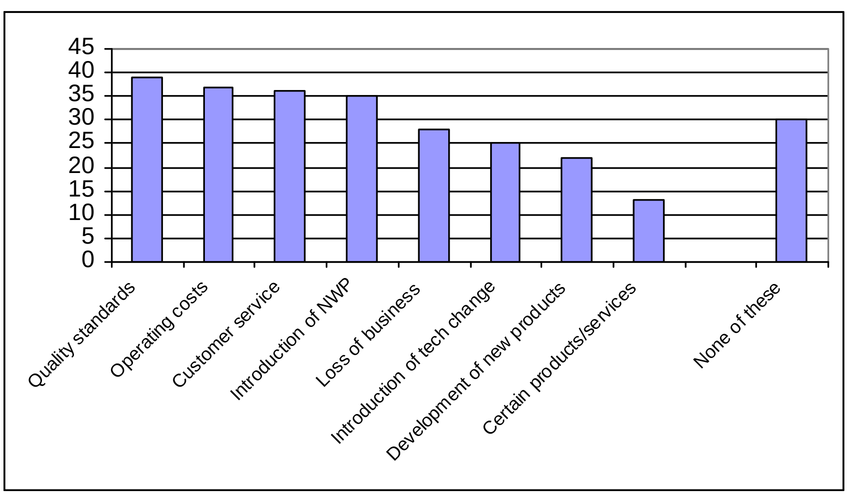
3. Skills and the labour market

Skills and human capital are at the heart of growing productivity and can be influenced by targeted education and training policies. That said, simply ensuring that people have higher skills and better education does not automatically lead to economic growth. The real issue is to ensure that the skills base in the economy is able to meet the needs of business both now and in the future.

The government has a vital role in improving the skills base and education levels. There is clear evidence that Jersey lacks some of the skills it requires and that the Island's international competitiveness is being hindered as a result (see the Chart below which shows how skills gaps are affecting businesses). Two recent reviews of education and training in Jersey highlight the type of actions required to address these problems and support the drive for real economic growth.

Chart 3: Implications of skills gaps

% of employers with skills gaps citing they have negative implications for the following –



Source: IFF Jersey Employers Survey 2004

The first of these reviews was by the Learning and Skills Development Agency (LSDA) and identified 3 priorities for a Skills Strategy for Jersey –

- Developing the enterprise and vocational curriculum for young people
- Developing the skills of the people in the workforce
- Developing higher level skills at work.

In addition, a review of Higher Education in Jersey has recommended that an International Business/Management School should be a priority for Jersey to aid the achievement of improved skills among the workforce. Specifically, the Island should improve the provision of generic degree programmes, encourage the take-up of Open University places and stimulate demand for junior/middle management training.

The Economic Development Committee and the Education, Sport and Culture Committee will soon publish a Skills Strategy for Jersey which will draw on this work and identify the priorities for action in Jersey. The implementation of a Skills Strategy is a top priority for the States and vital to achieving sustainable economic growth.

Given the high rates of labour force participation in Jersey it would be too much to expect a significant improvement and to be able to drive economic growth in this way. However, even marginal improvements in participation can help to reduce the requirement for inward migration and address skills shortages issues. For these reasons it is important that full consideration is given to any policies that can –

- Increase incentives/reduce disincentives to work
- Address barriers to work
- Ensure the unemployed receive the right training to re-enter employment.

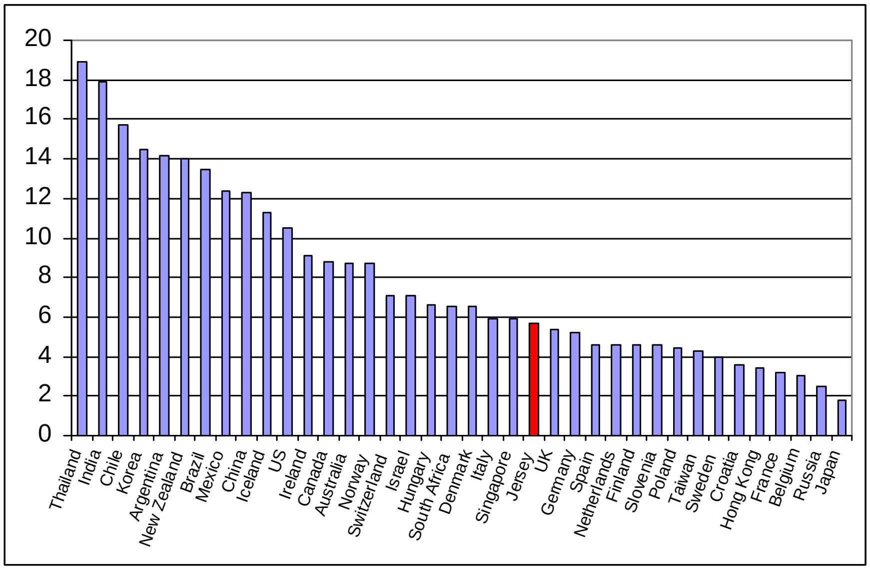
There is a role for government in terms of promoting and raising awareness of best practice in human resource management to ensure a better take-up of such practices and improved productivity in the Island. This role can be extended beyond human resource best practice and involve ensuring that information on best practice in all aspect of business operation is properly disseminated across the Island's business base.

While all efforts should focus on the above policy areas, there may still be a need for limited inward migration to address specific skills shortages. The new Migration Policy will ensure that it is possible to meet business needs and make the decisions about employing labour from outside the Island more transparent and business friendly within the boundaries deemed acceptable by the States to limit the impact on the environment and society. It is important to remember though the factors that can prevent labour mobility between other countries and Jersey and ensure that economic and other policy can deliver low inflation, high quality public services, a red-tape free environment and high quality of life.

4. Enterprise

Jersey's performance in enterprise is mediocre in the global context (see Chart 4), yet enterprise can play a vita role in driving productivity and economic growth as well as keeping inflation down.

Chart 4: Jersey's entrepreneurial performance on an international scale
entrepreneurial activity prevalence rate (% of population that has taken some action to create a new business in past year and those in business less than 42 months), 2002



Source: Global Entrepreneurship Monitor 2002

To create an environment more conducive to the growth of enterprise in the Island, the Economic Growth Plan recommends –

- Establishing a pilot **Small Firms Loan Guarantee Scheme** to allow small firms with good, low risk business propositions but no collateral to access finance.

- Establishing a **Jersey Business Angel Network** to allow entrepreneurs access to business angels offering advice and potential investment.

- Establishing a pilot **Venture Capital Fund** to encourage investment. The Fund would only be allowed to invest in Jersey business start-ups and young businesses.

- Amending the educational **curriculum for all young people** to include the key skill of enterprise.

- Expanding the **support service for small business** development which builds upon and expands current support for business.

- Continuing to encourage **1(1)(k) residents** where they can contribute expertise and capital backing in the Island.

- Achieving a more entrepreneurial culture and greater business start-ups to generate the needed **diversification** in the Island backed by policies improving skills and education in the Island.

5. Competition

Ensuring vigorous competition between firms is critical to maximising productivity and economic growth. Competition encourages firms to innovate by improving efficiency and puts downward pressure on costs and improves the organisation of production. It should also result in a better deal for consumers.

The **Jersey Competition Regulatory Authority** (JCRA) has a key role to play. In particular –

- It should be pro-active and encouraged to develop a high profile in Jersey.

- Its legal powers should be kept under review and if necessary expanded to increase its potency.

- As a matter of priority it should investigate further some of the factors behind the price differences between Jersey and the U.K. on a number of goods and assess whether there are issues of lack of competition or collusion.

A **strong consumer voice** in Jersey is also vital for effective competition. The Jersey Consumer Council (JCC) therefore has a key role to play. It should be given additional support and consideration should be given as to whether its role can best be enhanced by –

- retaining the JCC as it currently stands but with additional funding,

- revamping and rebranding JCC under another name and with a more extensive remit, or

- retaining JCC in its current form, with another consumer body for the utility companies.

Jersey must be **open to foreign competition** and inward investment to help enhance competitive pressures and efficiency. Where there is no justification for barriers or impediments to open competition the States should ensure such barriers are removed.

Regulation should be reduced when it impedes market forces and imposes unnecessary costs on business. A Business Taskforce should be set up to keep a watching eye on new legislation to ensure that it has a minimum impact on business and to identify current regulations that impede market forces and which provide no real benefit to the community.

6. Transport infrastructure

The external transport infrastructure supporting economic growth should be allowed to operate where there is no clear indication of market failure or threat to required service levels. The Economic Development Committee will publish later in 2005 a review of external transport policy in Jersey. This will be vital for ensuring that transport links are maintained and that economic growth can take place. The EGP gives a clear indication of the appropriate policy guidelines.

The policy for the air routes –

- Continuation of open skies
- Resistance to subsidies to travellers or airlines
- Focus on maximising efficiency of airport.

In the case of the ferry services there may be greater risks in allowing market forces to prevail and a danger that this could lead to monopoly/price war cycles. The Economic Development Committee's review of transport policy and will give further consideration to a policy solution for the operation of the ferry services.

7. Macroeconomic stability

This means creating a stable economic environment in terms of economic growth, inflation and employment. Only against such a backdrop can businesses and individuals be expected to operate efficiently and take long-term decisions on such issues as investment.

The Economic Growth Plan highlights the need for a new macroeconomic framework for Jersey that represents a clear break with the past. If sustainable economic growth is to be achieved with low inflation then the States of Jersey must ensure that fiscal policy – the one macroeconomic tool available to it – is focused on delivering the stability and low inflation required.

The Economic Development Committee offers its full support to the Finance and Economics Committee in working towards a new framework for the Strategic Reserve and Fiscal Policy. This should include a new counter-cyclical Stabilisation Fund, with the Strategic Reserve clearly put to one side to be used in the manner that was originally intended, i.e. only if the Island faces a major shock to its economy.

Measurement

It will be important to monitor the progress of the Jersey economy over the course of the next 5 years to assess how it is progressing relative to the target. GVA (the total value of output in the economy) data is only produced once a year and with a significant lag so it will also be important to measure the performance of the economy through other intermediate economic indicators. These will be able to give an indication of how the economy is performing and it will require a certain degree of economic judgement to assess whether the economy is on course. The types of indicators that can be monitored closely and are either more frequent or timelier than GVA data are: financial services profitability, employment/unemployment trends, inflation, tax receipts, sectoral data such as that for tourism and agriculture and business surveys.

The way forward

To achieve the twin objectives of additional tax revenue and employment opportunities and undertake the actions that the Plan entails the States will have to make an investment – in the region of £2.5 million a year. Table illustrates rough estimates for the costs of the individual elements of the Plan.

But this is not the end of the matter. The focus in Jersey should now be on creating the right environment for enterprise and competition and the best approach to meet the skills needs of the Island. Focus groups will be organised to start the discussion on these issues and build upon the basic framework provided in this Plan.

In addition, a series of documents will soon be published assessing the potential role for government in maximising the productivity of the Island's key sectors: finance, retail, tourism, the rural economy and fulfilment.

The Economic Growth Plan is about getting the fundamentals in place. The focus of attention should now be on what else needs to be done to fully address the skills, enterprise and competition challenges which face the Island and to maximise productivity across all the sectors that make up the Jersey economy.

Manpower implications

Some of the actions required by the Economic Growth Plan will have manpower implications. It is estimated that the total requirements for additional staff would be approximately 9 persons on a fulltime equivalent basis (including the requirements of the Plan for Finance).

Table 1: The Economic Growth Plan for Jersey

Actions	**Objective**		**Timescale**	**Cost estimate p.a.**
Whole economy	**Employment**	**Tax**		
Implement a new skills strategy	√√	√	2005+	**0***
Improve higher education provision	√√	√	2006+	**£250k****
Increase labour force participation	√√	√	2005+	**0**
Facilitate the spread of Best Practice	√√	√√	2005+	**£50k**
Encourage enterprise	√√	√√		**£1.05m**
Small Firms Loan Guarantee Scheme			2005+	(£750k
Business Angels			2005+	£50k***
Venture Capital Fund			2005+	£50k
Enterprise education			2005+	0
Expand support service for SMEs			2005+	£200k)
Promote competition	√√	√		**£100k**
Consumer voice				(£50k
Business Taskforce on red tape				£50k)
Maintain external transport links			2005+	**0**

	√√	√√		
Macroeconomic framework	√√	√√	2006+	**0**
Revenue costs for whole economy (sum of above)	√√	√√	2005+	**£1.5m**
Sectoral actions				
A Plan for Finance (Current sector specific funding £0.6m p.a.)	√	√√	2005+	**£1.2m#**
A Rural Economy Strategy (Current sector specific funding £4.5m p.a.)	√√	√	2005+	**0**
Tourism Study (Current sector specific funding £7.5m p.a.)	√√	√	2005+	**?**
Retail Study (Current sector specific funding £0m p.a.)	√√	√	2005+	**?**
Fulfilment Study (Current sector specific funding £0m p.a)	√√	√	2005+	**?**
Revenue costs p.a. for sectoral initiatives	√√	√√	2005+	**£1.2m**
Total revenue costs p.a. for EGP	√√	√√		**£2.7m**

Key: √=will contribute to objective, √√=will make major contribution to objective

* To be financed through current budgets of TEP and Education, Sport and Culture.
**May be annual cost varies from £100k at start to £500k when close to start-up in 2010. Also revenue expenditure may be lower if some start-up costs covered through capital expenditure. A significant one-off capital investment is also likely to be needed outside of the Economic Growth Plan.
*** £50k in first year, £25k running costs thereafter.
\# May be up to £400K lower if additional funding for JFL is agreed under EDC's resource submission for 2006-2008.

Chapter 1: The criteria for government intervention

There may be a number of different ways for a government to intervene to promote economic growth but with limited government funds (for any given level of taxation) the real issue is to ensure that public funds are spent on the activities that provide the greatest benefits to society and that they are spent in the most efficient way. This Chapter provides a framework for assessing potential government interventions on the same grounds and ensuring that the States of Jersey only implements policies, programmes and projects that will maximize improvements in efficiency.

Departments requiring public funds to promote a particular policy must be able to answer the following 2 questions–

1. Are there better ways to achieve the objective?
2. Are there better uses for the resources?

This can be achieved by identifying other possible approaches which may achieve similar results, where possible attributing monetary values to all impacts of any proposed policy and assessing the costs and benefits for relevant options. Government intervention will be validated, objectives set and options reviewed by analysing their costs and benefits.

Justifying action

The first step is to make the case for action by identifying a clear need which is in the national interest for the government to address. The rationale for government intervention is essentially two-fold –

- Improving **economic efficiency** by allowing markets to operate more effectively.

- Achieving objectives of **equity**.

Even if either of these rationale is met, it is critical that the **additionality,** i.e. the net benefit of the intervention, is then calculated and compared against alternative polices and doing nothing.

Economic efficiency

Economic efficiency is generally said to be achieved when nobody can be made better off without someone else being made worse off. This enhances prosperity by ensuring that resources are allocated in the most productive manner. One cause of inefficiency is where the private returns which an individual receives from a particular action (e.g. pay or profits) differ from the returns to society as a whole (e.g. the actions incur costs such as pollution). Market failure is where the market mechanism cannot achieve economic efficiency and can occur for the following 4 reasons–

1. *Externalities:* These occur when an activity produces benefits or costs for other activities that are not taken into account by market prices. The typical example is where a firm polluting a river does not take into account the costs it is imposing on those who have to clean the water for their use.

2. *Public goods:* The market may have difficulty in supplying and allocating certain types of products and services that can be classed as public goods. Public goods exhibit 2 characteristics–

   (a) Non-rival – consumption of the good by one person does not prevent someone else using or consuming that good e.g. clean air.

   (b) Non excludable – means that if the good is made available to one consumer it is effectively made available to everyone e.g. national defence. This can give rise to free riding where some consumers fail to pay for the provision of the public good and let others do so.

3. *Imperfect information:* Buyers need to know the quality of a good or service to judge the benefit it can bring them and sellers need to know the reliability of a buyer. Where such information is not available to both sides of the market there is asymmetry of information and market failure can exist. This can lead to moral hazard (e.g. people with insurance taking less care) and adverse selection (e.g. those with the highest risks take out insurance).

4. *Market power:* This arises as a result of insufficient actual or potential competition to ensure that the market operates efficiently. This can occur where high start-up costs deter entry by competitors or through organisations acting strategically to protect their position.

Equity

The other key rationale for government intervention is to achieve equity objectives. Government can use policy to achieve distributional impacts through the way the different costs and benefits are distributed across different groups.

Additionality

To calculate the success of a government intervention (in terms of employment or output) it is necessary to calculate its additionality. That is, its net rather than gross impact after taking into account what would have happened in the absence of the intervention. Additionality can also be referred to as a ‘supply side’ or ‘structural’ impact which alters the productive capacity of the economy which might occur as a result because of an increase in the size of the workforce or increase productivity.

The net benefit or additionality of a policy can be calculated as follows –

Net benefit = gross benefits minus the deadweight minus displacement minus substitution minus leakage plus multiplier effects

Leakage effects benefit those outside the Island. For example, spending on imports where the benefits leak to the country of origin. Deadweight refers to outcomes which would have occurred without the intervention. Displacement and substitution measure the extent to which benefits of a project are offset by reductions of output or employment elsewhere.

Example

A publicly funded project in Jersey that costs £500k per annum might seem appealing because it is expected to generate 1,000 new visitors each year to the Island all spending £1,000 in the Island. At first glance, the benefit appears to be £500k extra spending in the Island above the cost of the project.

However, applying the formula above and taking into account all the relevant factors reveals a different answer. The benefit is the gross benefit with no account taken of factors such as deadweight and leakage. To calculate the real net benefit it is important to research these other factors.

It could be the case that 200 of the visits would have happened anyway for reasons nothing to do with the project, e.g. general growth in tourist numbers.

Another 100 of the visits simply substitute for those of other people, e.g. taking their seats on the plane.

The resources used (labour and land) mean that £100k of benefits cannot be generated elsewhere in the economy.

20% of the additional spending by tourists is directly on imports and of little benefit to the Island.

The multiplier effect of such spending is 1.1, meaning that an extra £100K of spending is created elsewhere in the economy.

Applying the formula above now means –

Net benefit = Gross benefit (£500k) – deadweight (£200k) – displacement (£100k) – substitution (£100k) – leakage (£200k) plus multiplier effects (£100k) = 0.

The end result is that what at first glance appears to be a project that would bring significant benefits to the Island is not the case when the net benefit is calculated.

Chapter summary

It is critical to examine all calls for government funds on the same basis and to apply a common approach to all. It is also important to bear in mind that just proving there is market failure and a net benefit to the economy is necessary but not sufficient in making the case for government intervention. Bearing in mind that government funds are limited, once the net benefit has been calculated it must then be compared with that of other projects to see which can generate the largest net benefit for the Island and which should receive greatest priority.

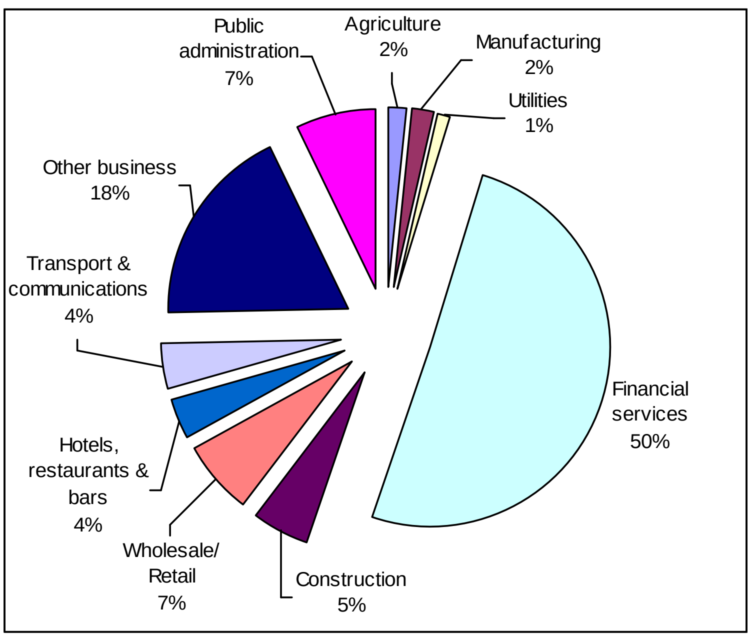
Chapter 2: Boosting productivity, growth and competitiveness

One way to bolster output in any economy and generate faster growth is to make more efficient use of the resources already in operation. Output is dependent on how many people are working and how much they produce. This latter point is basically referring to their productivity, which at the economy level is the main determinant of national living standards. Productivity is a measure of how well an economy uses the resources it has available by relating the quantity of inputs to outputs. Maximising productivity growth ensures that the potential of the resources in use is maximised something critical for every economy, but particularly for a small island economy.

All sectors

Maximising current potential involves maximising the productivity of every industry in the Island now and that may be present in the future. Enabling productivity growth in one sector of the economy would clearly help to spur productivity growth but without doing so in every sector, productivity growth will not be maximised. For example, the Chart below shows the importance of the finance industry to the Jersey economy as it contributes half of the total output. If productivity growth in finance could be achieved of 4% per year and if productivity growth elsewhere was flat the overall rate of productivity growth in the economy would be 2%. If 4% productivity growth can be achieved in finance and in every other sector of the economy then productivity growth in the economy overall would be 4% and twice that in the previous scenario. ***The implication for policy is clear – to maximise economic growth in the economy the aim must be to maximise productivity growth in every sector from financial services to retail to tourism to agriculture to fulfilment.***

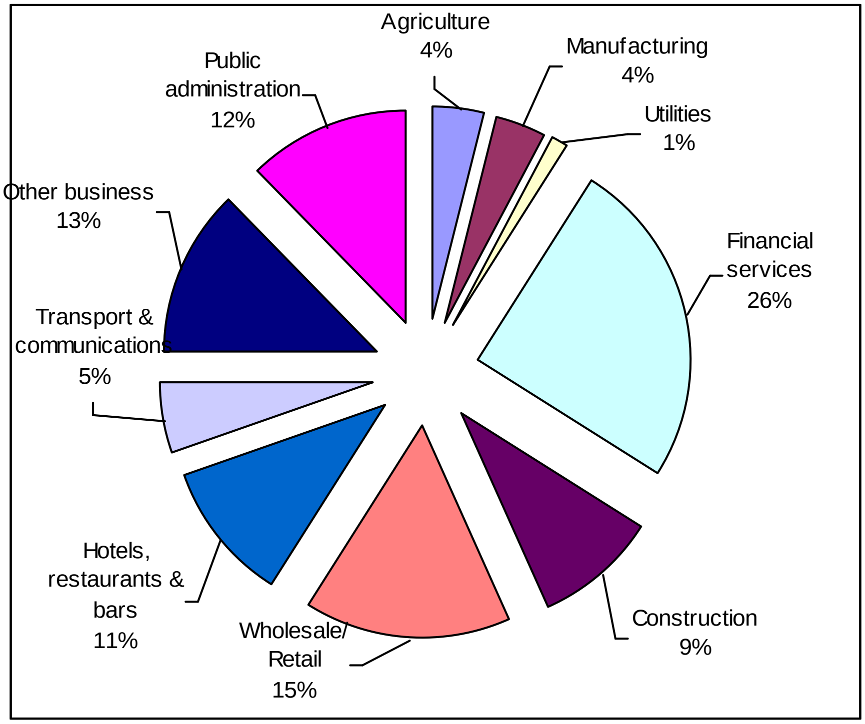
Chart 5: The Jersey economy by GVA
gross value added in 2003, current prices



Source: States of Jersey Statistics Unit

The target of 2% real economic growth in Jersey has been set for a number of reasons. The challenge is clearly to raise the living standards of everybody in Jersey but there are 2 additional underlying objectives. The first – laid down in the States' Strategic Plan – is to maximise employment opportunities for local people and the second – agreed by the States' as part of the Fiscal Strategy – is to generate £20 million additional tax revenue. The Char below shows the breakdown of employment in Jersey. While financial services is still the dominant employer in the Island it is by no means as dominant as it is in terms of output and employs a quarter of the workforce. **The need to maximise employment opportunities for local people therefore also clearly points to maximising productivity, competitiveness and growth in every sector of the economy including all the key sectors – financial services, retail, tourism, fulfilment and agriculture.**

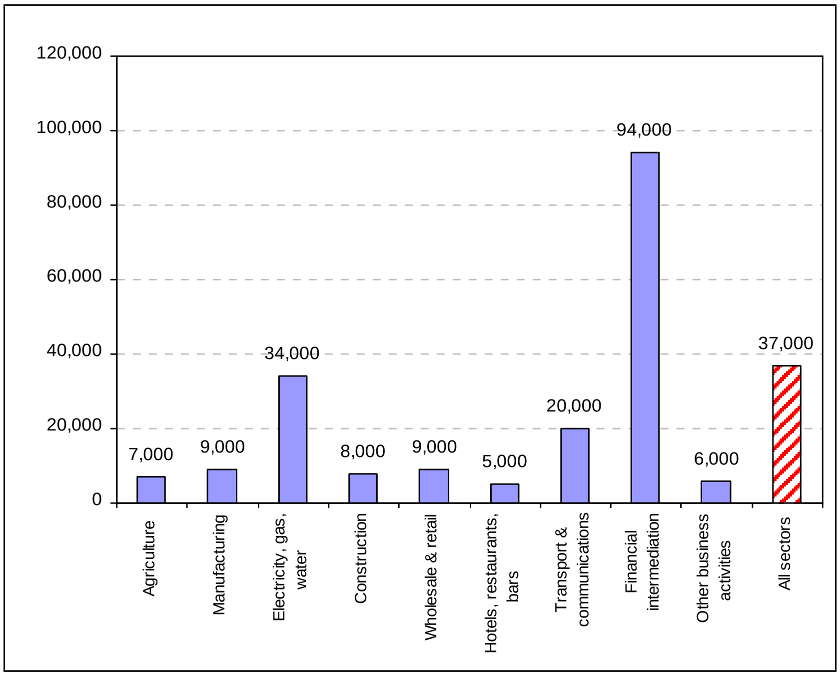
Chart 6: Employment in Jersey
employment in 2004, full-time equivalent basis



Source: States of Jersey Statistics Unit

When considering the need to generate additional tax revenue it is important to consider where the profits are generated in the economy, as it is profitability that generates tax receipts. The financial services industry in Jersey is by far the most profitable industry in the Island and generates two-thirds of the total profits. The Chart below shows that this translates into a quite startling level of profitability per employee relative to the rest of the Jersey economy. Profitability in the finance industry is nearly 3 times higher than the average for the economy as whole and than any other sector in Jersey. This analysis makes it abundantly clear that with one of the objectives of the growth plan being to generate additional tax revenues then everything must be done to maximise the potential of the finance industry as that will maximise the tax receipt content of economic growth. That is not to say that it should be the sole objective, as clearly growth and employment in other sectors of the economy will still deliver additional tax receipts.

Chart 7: Profitability per employee
gross operating profit per full-time equivalent, 2003



Source: States of Jersey Statistics Unit

Achieving higher productivity

Productivity can be measured in a number of different ways. Labour productivity looks at the output produced per unit of labour input and can be measured in terms of output per worker or output per hour worked. Neither measure actually takes into account the amount of capital used. However, Total Factor Productivity (TFP) attempts to measure output per unit of inputs – both labour and capital. Measuring TFP requires an estimate of the capital stock which is notoriously difficult to measure and means that most governments tend to focus on labour productivity.

The key components of labour productivity are physical capital, human capital and innovation and technological progress. That means that there are 3 broad routes through which to improve productivity –

- Investment in physical capital to augment the productivity of labour – the amount and quality of physical capital that an employee has available to them to do their job will impact directly on their productivity.

- Maximise the contribution of labour through increasing the proportion of the population that is working (quantity of labour) and increase the skills of the workforce (quality of labour) through education and training. This includes entrepreneurial and managerial ability. Improving the proportion of the population that are working will improve output per person but not necessarily output per person employed.

- Innovation and technological progress – productivity growth is underpinned by inventions and innovations of both new technologies and improved working practices.

These 3 factors are essential components of productivity growth but they are not the only drivers. Other factors and in particular the level of competition and the degree of entrepreneurial activity are also essential to productivity.

At the firm level there are 2 main kinds of factors that account for productivity differences –

- differences in the inputs firms use (physical capital, human capital, managerial and entrepreneurial ability and technology);

- differences in the competitive environment firms face.

Competition can be a key enabler. It encourages firms to innovate, putting downward pressure on costs and providing incentives for the efficient organisation of production. It can reorganise market structures, by reallocating resources away from inefficient firms to more productive competitors and new entrants. Studies have tended to show that measures of competitive pressure in a sector have a positive impact on firm efficiency and productivity growth rates. Such factors as increases in the size of market shares and the size of supernormal profits earned by firms which are associated with market power have a negative impact on future productivity growth. Entrepreneurial ability in creating new businesses is an important source of competitive pressure – measures of enterprise and entrepreneurship e.g. new business start-ups are highly correlated with growth. New entrants and the threat of entry are also critical components of effective competition and a source of innovation.

All these factors which largely relate to the microeconomic level must be backed by a stable macroeconomic environment. For firms and individuals to respond to market signals and make efficient decisions they clearly must be able to do so against a backdrop of sustained economic growth and low inflation with stable and high employment. A volatile economic cycle of boom and boost imposes costs on the economy which is likely to undermine efficiency and economic growth in the medium and long-term.

Taking this analysis towards its policy conclusion the general consensus is that the appropriate framework for maximising productivity and economic growth is –

- To provide a **stable macroeconomic environment** and greater certainty for firms to make critical decisions.

- **Microeconomic reform** to make markets work.

This second point is worth considering in more detail as it refers to all markets in the economy – whether those for products, capital or labour.

- **Product markets**: Efficiently functioning product markets create the competitive pressures that increase the economy's output in 3 ways: keeping prices down causing firms to increase output to satisfy demand, ensuring that firms innovate and that firms minimise costs of production by combining factor inputs in the most efficient way.

- **Labour markets**: Can generate growth through 3 routes: increased labour supply allows employment to rise to meet the demands of a growing economy, flexible labour markets ensure that the economy is able to adjust rapidly to take advantage of new growth opportunities and well functioning labour markets reward employees according to their performance and skill. In a small Island economy with a limit on the amount of labour that can be utilised it is even more important to maximise the contribution of every person in employment to limit the constraint it can place on output growth. This could mean that labour resources are freed from one part of the economy to facilitate growth in another.

- **Capital markets**: Economic growth can be supported by ensuring that firms are able to finance investments to enable them to expand operations to meet demand, providing funds for firms to innovate, enabling shareholders to incentivise firms and allowing people to borrow to acquire skills/training.

Government intervention in the market place is normally justified on the grounds of market failure (as set out in Chapter 1) and this normally exists when the competitive outcome of markets is not efficient from the point of view of the economy as a whole.

A sectoral approach

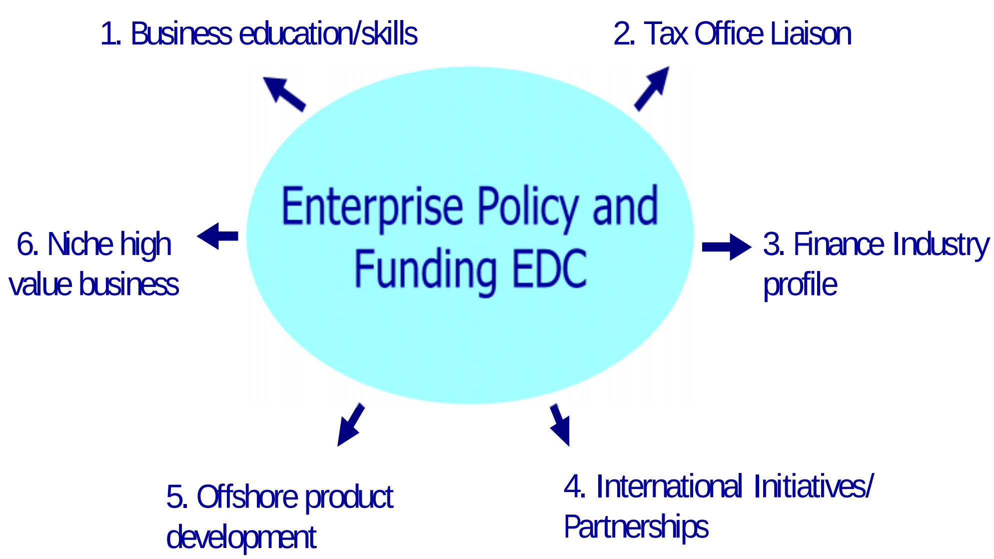
If the productivity of the Jersey economy is to be maximised then this will involve maximising the productivity of every sector in the Island. This will involve the same approach at the sectoral level as that at the broad macroeconomic level. That is assessing the performance of each sector on the grounds of the 5 drivers of productivity summarised below –

1. Investment in physical capital
2. Skills and human capital
3. Innovation
4. Competition
5. Enterprise.

Once the performance of each sector on each of these criteria is assessed in detail it will be critical to identify if there are any barriers to the development of the industry in any of these aspects and in particular if there is a case of market failure. Only if this can be proven will it be appropriate to start to consider whether there are government policies that can rectify the market failure.

The way forward is to assess each industry in Jersey on the same basis and consider whether government intervention is merited and can achieve desired outcomes. Work has already begun on assessing Financial Services in this way. The Chart below summarises the approach recommended in creating the right environment for growth in financial services.

Chart 8: A 6-point plan to improve the competitiveness of the financial services industry



By extending this approach to all the key industries in the Island it will ensure that productivity and competitiveness are maximised across the whole economy. This requires each industry such as tourism, agriculture, retail and fulfilment to be looked at in this way. A series of reports – *Meeting the productivity challenge at the sectoral level* – have been commissioned. These reports will focus on identifying barriers to productivity growth that result from market failure or inappropriate government intervention and should consider whether there is a suitable government policy response. If this results in numerous possible policy options and potential costs to the States then the policy responses should be selected on the basis of the size of the net benefits they will bring to Jersey.

Chapter summary and actions

The focus of the Economic Growth Plan needs to be on boosting productivity in every *sector of the economy. The approach taken should be to focus on the 5 drivers of productivity growth (summarised below, ensuring that they are assessed for every sector in the Island. The challenge is to take the same approach and assess the constraints on the 5 drivers for the key industries in Jersey and consider whether there is an indication of market failure and if there are appropriate policy responses that the States can implement.*

The next steps are for the Economic Development Committee to ensure that work is undertaken to look at the 5 drivers below for every key sector in Jersey– finance, retail, tourism, agriculture and fulfilment – and assess whether there is need for government intervention to correct market failures. A separate series of reports – Meeting the productivity challenge at the sectoral level – will ensure that the productivity challenge is met in each of the key sectors in the Jersey economy and is critical to ensure that the target for economic growth can be met. These reports are a top priority and the assessments should be published by end of 2005.

1. *Investment in physical capital.*
2. *Skills and human capital.*
3. *Innovation.*
4. *Competition*
5. *Enterprise*

These 5 drivers do focus on the microeconomic issues and it must be remembered that these factors must be against a background of ***macroeconomic stability*** *(covered in Chapter 7).*

Chapter 3: Skills and the labour market

Skills and human capital

There is now a large body of literature that puts human capital as a key determinant of productivity. The level of skills within the population can be influenced through formal and informal education and training. Higher-skilled workers are better at innovating, researching and developing and they also tend to adapt more easily to change and are better at implementing and getting the most from new technologies.

The Jersey Employers Survey 2004 gives detailed information on the suitability of the Jersey labour force to meet the demands placed on it by business. The data looks at both internal and external skills issues and the key findings are summarised below, while the following sections look at the results in more detail.

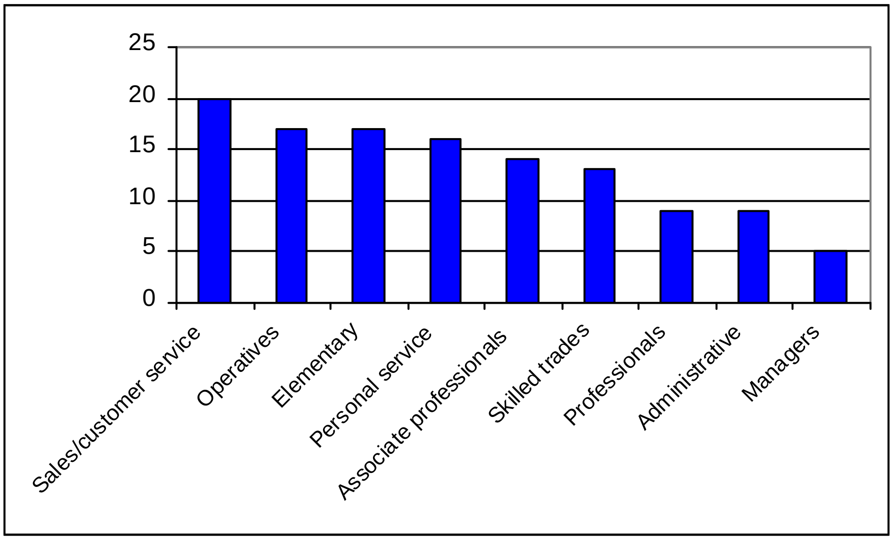
- Nearly one in 5 (18%) employers have skills gaps in at least one sector of their workforce.
- Nearly half of all skills gaps are attributable to the inability of the workforce to keep up with change.
- Despite the high proportion of Jersey firms (90%) that offer some form of training, 28% of skills gaps relate to a failure to train/develop staff.
- Skills gaps have clear implications for business and are hindering current and future performance.
- About a third of employers recruiting either school-leavers or FE college-leavers believed them to be poorly or very poorly prepared for work.
- A fifth of employers had a vacancy at the time of interview and one in 10 considered that they had a vacancy that was proving difficult to fill.
- Overall, almost half of all vacancies (46%) and three-quarters of hard-to-fill vacancies (77%) are skill-shortage related and this latter figure compares to 40% in the U.K.
- The proportion of employers reporting that at least some of their staff lack the skills needed to fulfil their job role fully has increased from 11% in 2001 to 19% in 2004. (Compares to 7% in the U.K. in 2001.)

Internal skills issues

Nearly one in 5 (18%) employers have skills gaps in at least one sector of their workforce, approximately the same proportion as in the U.K. (22%). The level of proficiency of the various categories of employment in the Jersey workforce is summarised in the Chart below. It shows the percentage of employees in each occupational group that were thought by their employers to be not fully proficient at their current job. It is clear from this Chart that skills gaps are most prevalent amongst sales/customer service, machine operatives and elementary staff. Additional data also shows that skills gaps are highest amongst larger companies and in public services, construction/manufacturing and retail sectors.

Chart 9: Proficiency of employees by occupation

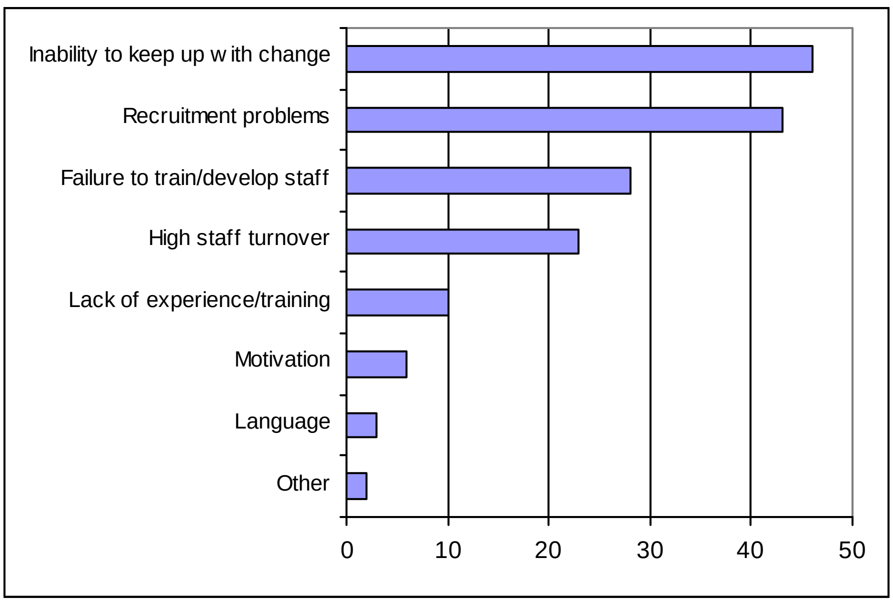
% of employees not fully proficient at their job



Source: IFF Jersey Employers Survey 2004

Nearly half of all skills gaps are attributable to the inability of the workforce to keep up with change. This is a large increase from 2001 suggesting that there is more change for employers to cope with. Another serious issue is that 43% of skills gaps are attributable to recruitment problems, suggesting that employers are obliged to recruit below the calibre of recruit that they need. Despite the high proportion of Jersey firms (90%) that offer some form of training 28% of skills gaps relate to a failure to train/develop staff.

Chart 10: Causes of skills gaps
% of employees with skills gaps

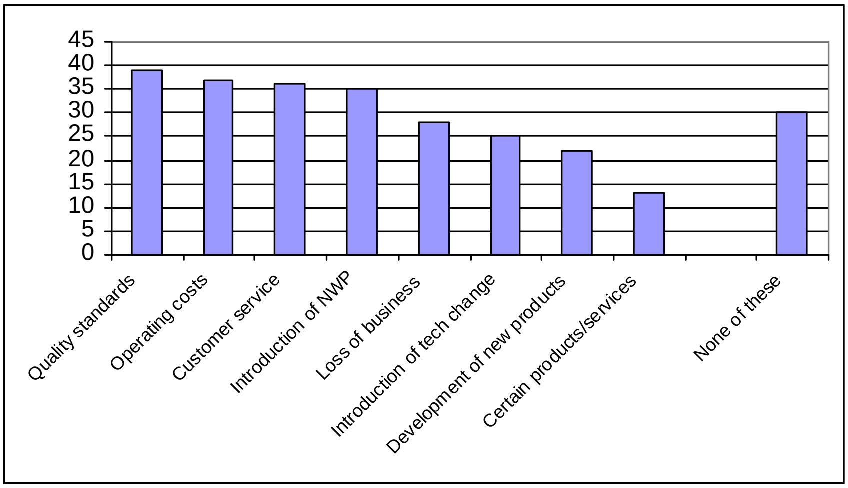


Source: IFF Jersey Employers Survey 2004

The key skills lacking where there are skill gaps to some extent reflect the occupations where skills gaps are most prominent. Shortcomings in terms of communications and customer-handling reflect the high number of gaps for sales and customer service. However, both lack of team working and management skills are also significant contributors to skills gaps as are the lack of technical/practical skills and problem solving skills.

Skills gaps have clear implications for business. The Chart below shows that they have significant implications for quality, increased operating costs, customer service and the introduction of new working practices. Such factors will impact on the bottom line, as will loss of business to competitors, which was another significant implication of skills gaps. Skills gaps also undermine future performance due to the impact on new working practices, technological change and delays in new products and services.

Chart 11: Implications of skills gaps
% of employers with skills gaps citing following as implications

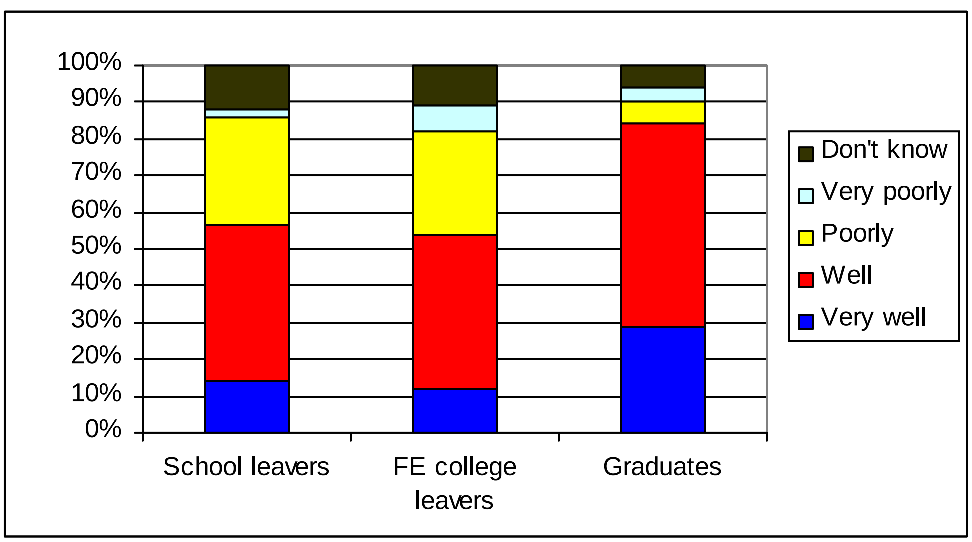


Source: IFF Jersey Employers Survey 2004

The principal response of employers to having skills gaps is to provide more training (66%) and a further 30% have increased/expanded existing trainee programmes. In addition, 42% of employers with gaps have changed working practices.

When employers were asked how their new recruits were prepared for employment there were some stark results, as the Chart below shows. Not surprisingly, the majority of employers taking on new labour market entrants judged them to be well prepared. However, approximately a third of employers recruiting either school-leavers or FE college-leavers believed them to be poorly or very poorly prepared for work – but took them on anyway. Graduates fair better but still 10% of employers taking on new graduates stated that they were poorly or very poorly prepared.

Chart 12: Basic skills of graduates and school leavers
% of employers (who have recruited school leavers/FE college leavers/graduates) citing they were considered the following in terms of preparedness for work

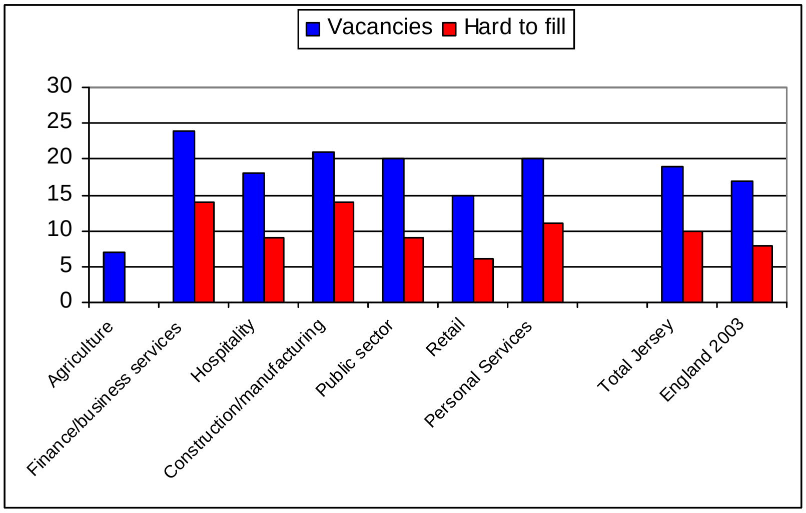


Source: IFF Jersey Employers Survey 2004

External skills issues

A fifth of employers had a vacancy at the time of interview and one in 10 considered that they had a vacancy that was proving difficult to fill. Both these figures are slightly higher than the equivalent figures for the U.K., as the Chart below shows. Hard to fill vacancies are more prevalent in the finance/business services and construction/ manufacturing sectors.

Chart 13: Employers with vacancies and hard-to-fill vacancies
% of employers



Source: IFF Jersey Employers Survey 2004

The 2 key reasons given for hard-to-fill vacancies are skills-related in the broad sense – a lack of work experience and a lack of skills. Overall, almost half of all vacancies (46%) and three-quarters of hard-to-fill vacancies (77%) are skill-shortage related. When asked to consider the impact of hard-to-fill vacancies on their organisation, a majority of employers stated they had a direct effect on the bottom line, with significant proportions of employers also stating they had a negative impact on other aspects of their business.

The proportion of Jersey employers offering training increased slightly in 2004 relative to that in 2001, returning to levels seen in 1998. With two-thirds of employers delivering training in Jersey this is slightly higher than the equivalent figure for the U.K. Although samples are small, the main barriers to training in Jersey appear to be a lack of local provision alongside the direct and indirect costs of training.

Two-thirds of organisations that have offered training have made use of external specialist trainers. More than a third of employers that provide training only use Jersey-based trainers; while one in 5 uses only off-Island providers (the remainder use both).

The case for government action

As already discussed (in Chapter 1) the case for government intervention requires there to be a case of marke failure. There is a general consensus that there is market failure in the case of education and training because private and social returns to education diverge. That is, employees and employers look at the returns to a particular piece of training from their particular perspective rather than from that of the economy as a whole. Employees will consider what benefits they are likely to get in terms of higher pay or future higher pay, responsibility and job satisfaction etc. relative to the costs. Employers will consider the impact that the training will have on their costs, productivity and efficiency. Neither will really take into account the benefits it might bring to the economy overall in terms of greater efficiency and capacity to innovate. Under such circumstances the market would under provide the right level of education/training for the economy as a whole.

The Employers Skills Survey 2004 has clearly shown that the Jersey economy is skills constrained and outlines the areas of weakness. The issue then is the best way for government to address these skills constraints, given that the market cannot be expected to do so.

The skills solutions

The Learning and Skills Development Agency (LSDA) was tasked with assessing the training and education infrastructure in Jersey and making recommendations for its improvement, given the needs in Jersey highlighted above. In particular, a Skills Strategy that could meet the needs of the Strategic Plan and ‘develop a skilled and qualified workforce which meets the Island’s needs’.

The recommendations of the LSDA fall into 3 distinct priority categories –

1. **Developing the enterprise and vocational curriculum for young people**, which includes –

   - the need to develop a vocational provision for young people which offers clear pathways for progression into work and further study;
   - ensuring the curriculum for all young people includes the key skill of enterprise education;
   - promoting greater awareness of the worlds of work, such as careers education and work experience etc.

2. **Developing the skills of people in the workforce**, which includes –

   - stimulating demand for skills performance from employers and employees in order to develop better performance in the workplace;
   - further developing flexible, responsive and coherent support for workforce development;
   - development of better informal learning and take-up of more formal learning should be promoted within companies, especially SMEs.

3. **Developing higher level skills at work**, which includes –

   - developing higher level skills in Finance and in other key sectors such as retail, hospitality and health care, including gathering more information on precise needs;
   - a support service for small business development should be put in place, which builds upon and expands current support for business to secure a comprehensive service for small businesses.

If the Economic Growth Plan is to have a chance of success it is clear that 3 priorities and related actions must be part of a comprehensive Skills Strategy for Jersey. The Economic Development Department in conjunction with Education, Sport and Culture will publish shortly such a Strategy and its implementation will be a critical part of the EGP and a top priority for the States of Jersey.

Higher education

Just like the case for government intervention in training, there is a similar one for government intervention in higher education. A higher education institution (HEI) can impact on economic growth through a number of channels –

- bringing additional spending to Jersey through purchases made by the university in its process of operation and through the additional spending of students/staff;
- improving the level of human capital;

- the possibility of greater innovation in the economy through industry working closely with academia and technology transfer.

On the first bullet it is easy to see how this benefit would be encapsulated. Students and staff would be in the Island and would therefore add to spending already taking place in the Island. Given the Island's dependency on imports of many goods, it would not be the case that all the additional spending adds to growth in the Jersey economy.

It is quite conceivable that under one set of assumptions a HEI could add significantly to the stock of human capital in the Island and under another set of assumptions that it adds very little to the stock of human capital. For a HEI to add to the stock of human capital it would have to either educate members of the resident population or people from outside the Island that then stayed on to work in the Island. If it largely educated people from outside the Island who then subsequently left the Island to work in another country, there would be little impact on the stock of human capital in Jersey.

HEIs clearly facilitate new thinking and ideas and can therefore increase the rate of innovation in an economy. However, this requires the HEI and industry to work closely together and for technology transfer to take place. An isolated university with little contact with and expertise of little relevance to local industry clearly provide little opportunity for such positive spillovers. However, a university closely integrated with say the financial services industry and with academic expertise in key areas of interest e.g. financial derivatives would provide maximum opportunity for such positive spillovers and would be most likely to have a positive impact on economic growth.

A Review of States of Jersey Higher Education by Dr. Michael Goldstein considered a number of potential options for a HEI in Jersey. It concluded that there was likely to be insufficient demand to justify a full-blown University in the Island but that development of an International Business/Management School is a high priority. This would be crucial for the financial services sector and for senior, top-level managers from a range of other sectors. Its conclusions also focused on other areas of weakness in higher education in Jersey and some of its key recommendations included –

- Highlands College should be encouraged and facilitated further to develop generic degree programmes at both Honours and Foundation levels, with appropriate U.K. universities.

- Robust funding arrangements for people to undertake Open University courses.

- A feasibility study to identify the best way to coordinate, develop, promote and stimulate demand for junior/middle management training to meet the needs of employers in the Island.

- The provision of support for start-up businesses and their after-care should be reviewed.

When these recommendations are combined with the LSDA skills strategy recommendations and the 14-19 year review there is clearly much scope for government intervention to improve the skills base and level of human capital in the Island. The next step is clearly to pinpoint the key priorities and ensure that all 3 approaches are properly coordinated.

Labour market participation

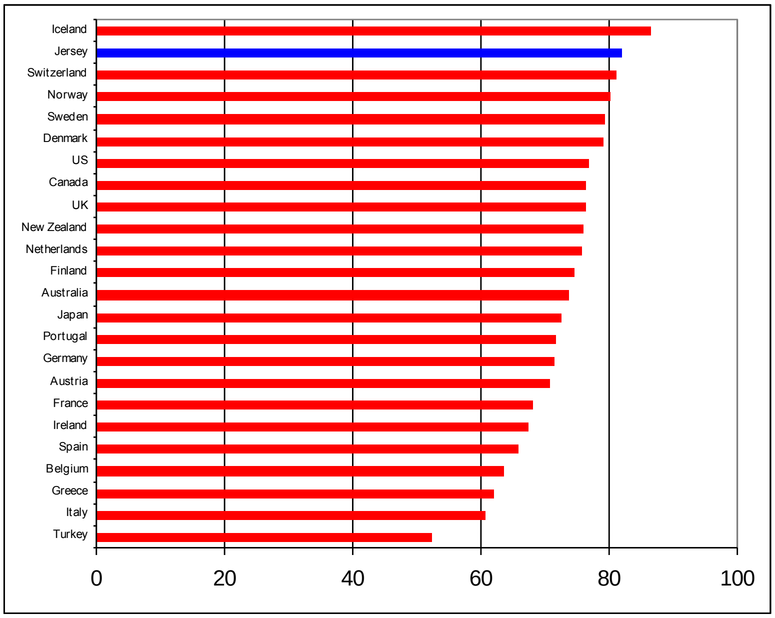
Increasing productivity is not the only way to increase output and generate economic growth – increasing employment will also have the effect of raising aggregate output. As employment grows the level of output per head of the population is increased as people go from being economically inactive to active. However, this might actually lead to a one-off reduction in the level of productivity as measured in terms of output per worker. This will happen because people drawn back into the labour force may have lower productivity than those already in it.

Calculations by the U.K. Treasury suggest that new entrants into employment are on average between one-half and two-thirds as productive as existing workers. Overall the addition of such people to the workforce will mean that the economy will have become more productive as aggregate output will have increased. As a result economic growth will also have been generated.

This does not mean that the long-term trend growth in output per worker has been affected. Rather that productivity in the long term will be affected by the extent to which the skills levels of the new entrants to the labour force increase over time. Another reason to ensure that the right training infrastructure is in place to meet business needs and that it is also able to meet the requirements of such new entrants to the workforce.

The overall level of participation in Jersey already seems high relative to that in the U.K. and elsewhere. The Chart below shows that for the OECD countries shown, the only country with a higher activity rate than Jersey is Iceland.

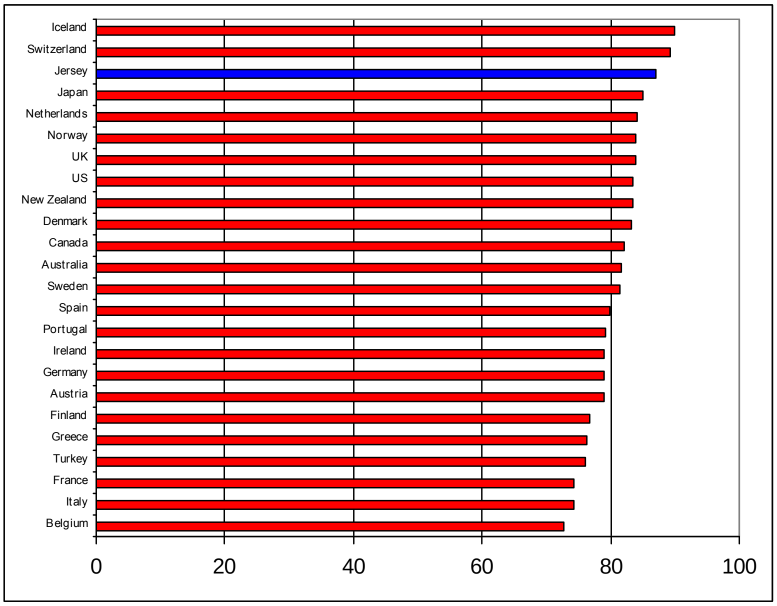
Chart 14: Overall participation rates
economically active as a % of 15-64, 2001



Source: OECD/Jersey Census

It is worth considering how activity rates compare by gender to see if Jersey's high overall participation rate is reflected in the level of participation amongst males and females. The next Chart shows that male activity rates are similarly high in Jersey and are only higher in Iceland and Switzerland.

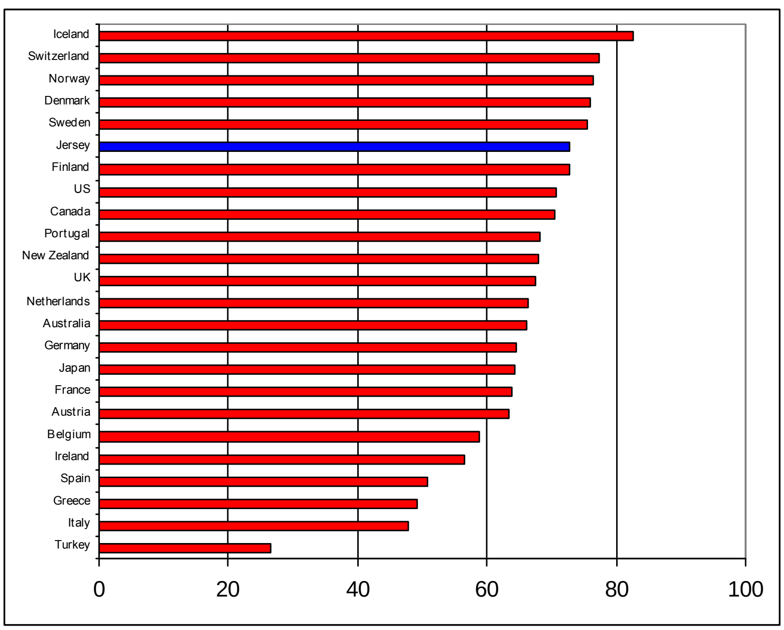
Chart 15: Male participation rates
economically active as a % of 15-64, 2001



Source: OECD/Jersey Census

Rising female participation has been a factor in many industrialised countries which has been repeated in Jersey. However, the Chart below shows that female participation in Jersey is also among the highest in the OECD countries. Only Iceland, Switzerland and the Scandinavian countries have higher female participation rates.

Chart 16: Female participation rates
economically active as a % of 15-64



Source: OECD/Jersey Census

Given the high levels of economic activity amongst the population overall and males and females, it is not realistic to expect a massive boost to growth through encouraging much higher participation in the labour force. However, that does not mean that some improvement in participation is not possible and could not bring benefits.

The Strategic Plan sets out that the working population should not be allowed to grow by more than 1% per annum over the next 5 years. This puts added emphasis on ensuring that participation is maximised as it wil reduce the need for inward migration to expand the working population.

For every 1% that the overall participation rate in Jersey can be raised, that adds another 4-500 people to the workforce. So while it is not realistic to expect a massive improvement in the participation rate in Jersey, marginal improvements can make a difference and reduce the requirement for inward migration. This means that full consideration should be given to policies that will –

- Increase incentives to work (e.g. effectiveness of minimum wage).
- Address barriers to work such as cost of childcare for those on low incomes.
- Reduce any disincentives to work created by interaction of benefits/income support system.
- Ensure those unemployed for long periods receive the right training needed to re-enter work.

Organisation of work

The way in which labour is organised can also be a driver of productivity growth. People working together in a way which enhances team work and communication are going to be more productive than those that work as individuals and with little communication. This actually puts effective human resources management at the centre of improving productivity.

This means ensuring that there are no barriers preventing best practice in human resource management permeating through the economy and spurring productivity growth in businesses. A good example of such best practice is High Performance Working (HPW). It is worth considering in more detail what HPW, how it delivers results and what constrains its take up to see if there are any implications for what can be done in Jersey to encourage a greater take up of such best practice.

What is High Performance Working?

While HPW clearly involves using human resource practices and policies to boost company performance, there is not a definitive list of practices that it involves. However, HPW practices tend to focus on employee autonomy and involvement in decision making, support for employee performance, rewards for performance and the sharing of knowledge and information. Part of HPW's strength derives from its flexibility to incorporate different practices to meet the varying needs of individual organisations. Examples of the types of practices used are: sophisticated and wide coverage of training, coherent performance management systems, flexibility of workforce skills, job variety and responsibility, teamworking, frequent/comprehensive communication to employees and use of performance related rewards.

Does HPW improve business performance?

The majority of evidence suggests that HPW can improve company performance. A significant body of research has looked into the link between HPW and company performance and the findings show that companies that use HPW tend to have higher productivity. The introduction of HPW can bring benefits for employees in terms of increased job satisfaction and motivation. The environment of trust and intrinsic rewards that HPW creates also brings higher organisational commitment, as well as increased job satisfaction. Where such practices lead to higher productivity and higher skills levels they can also generate higher earnings for employees.

The research shows that the success of HPW relies on finding ways to induce or encourage employees to contribute more effectively by triggering discretionary behaviour that makes the difference in a job being done well. This happens when people find their job satisfying, they feel motivated and they are committed to their employer. HR policies and practices must fit with and be tailored to the business strategy, while at the same time being flexible enough to help organisations adapt to changing circumstances. Successful firms are able to meet people's needs both for a good job and to work in 'a great place'. They create good work and a conducive working environment thereby becoming both 'an employer of choice' and high performing.

What limits the take-up of HPW?

The Jersey Employers Skills Survey 2004 shows that in response to business challenges only 27% of employers are looking at new working practices. This suggests that widespread use of HPW and other human resource practices could bring productivity gains to Jersey businesses and the economy in general.

Research from elsewhere tells us that the key barriers to the introduction of HPW are –

- Resistance to change within organisations where the existing culture has become inflexible.

- Existence of mistrust between management and employees can mean it is difficult to introduce HPW and the main barrier seen by firms to the introduction of HPW is the attitude of management and employees.

If the benefits and nature of HPW are communicated well and better understood by managers and employees then one of the key barriers to HPW can be removed, or at least substantially reduced.

There is no 'one size fits all' approach and that maximum benefit from HPW can best be achieved by an organisation finding the best fit for itself, that is, the combination of practices that are best suited to the environment and strategy of the firm. In most instances the best results can also be achieved by introducing practices in self-reinforcing bundles rather than isolated single initiatives.

The role for government is therefore one of improving information and communicating the potential benefits of HPW to both employers and employees. There is not a case for prescriptive centralised policy in this area but rather a case for facilitating the spread of human resources best practice. This approach can be extended beyond just human resource best practice and applied to the application of business best practice in general. Where the information flow on such best practice is limited in Jersey and clearly hampering the spread of best practice whatever the sector then the States role should be try and improve the information flow.

The way forward is to ensure that the Economic Development department fulfils this role in monitoring best practice for the key industries in the Island and facilitating a better understanding of the benefits it can bring. The aim is to generate a wider spread of best practice in the Island and improved productivity across the economy.

Inward migration

There are potentially 2 routes by which inward migration could help to boost economic growth in Jersey. Firstly the Jersey economy is constrained by the availability of skills and there can be significant lags in putting the right training/education infrastructure in place and delivering improvements in the skills base. It is also not feasible to plan for every skill need such as that for surgeons. This suggests that there might be scope to boost economic growth by allowing inward migration of people with the required skills.

Secondly, the economy of Jersey is also constrained by the availability of at least 2 resources: land and labour Additional labour supply through inward migration would provide more of one of these resources and provided that there is sufficient demand to generate use of these resources would initially generate growth (further growth would have to be generated through improved productivity, investment or innovation).

Any requirement for inward migration on these grounds can be minimised by ensuring that the productivity of those already in the Island is as high as possible and continues to grow. The previous sections of this Chapter have illustrated how this can be achieved through training and education and using HR best practice such as HPW. In addition any improvements in the participation rate, even minor ones can help to reduce any requirement for inward migration.

It would be unrealistic to think that Jersey could maximise its growth potential without some inward migration. Over the course of the 2005-09 period that requirement may well change and could decline if improvements in training and education are bring productivity improvements and participation rates rise.

It will be vitally important to allow any decisions to be made quickly and in response to business needs. The new Migration Policy will be a vital part of the Growth Plan allowing government to be more responsive to business needs and enabling businesses to operate with a greater degree of certainty in knowing whether they can employ people from outside the Island, within the boundaries deemed acceptable by the States to limit the impact on the environment and society.

Mobility of labour

Having the right framework in place to allow inward migration is a necessary but not sufficient condition for such flows to take place. It will also be vital to ensure that there is sufficient demand to utilise the labour supply and that will require growth of the current industrial base and diversification. In addition it will be important to remove/reduce any barriers to labour mobility between Jersey and the intended source country, particularly the U.K. given its important role in supply inward migrants. This will include –

1. Ensuring that inflation is kept to a minimum so Jersey does not become a more expensive place to live relative to source countries.

2. Ensuring that high house prices do not act as a deterrent to people moving to Jersey.

3. The perception that moving to Jersey is difficult and involves reams of red tape (at least for those people that are in demand in the Island).

4. Public services such as health and education remain of an international high standard and other factors that affect the quality of life.

Chapter summary and actions

Skills and higher education

The government has a vital role in improving the skills base and education levels, primarily because of market failure. There is clear evidence that Jersey is skills constrained and that its international competitiveness is being hindered as a result. Two reviews of education and training policy in Jersey provide the actions required to start to address these problems and underpin the drive for economic growth.

The LSDA has identified the 3 priorities for a Skills Strategy for Jersey –

- *Developing the enterprise and vocational curriculum for young people*
- *Developing the skills of the people in the workforce*
- *Developing higher level skills at work.*

In addition a review of Higher Education in Jersey has come forward with the following key recommendations –

- *Development of an International Business/Management School is a high priority.*
- *Highlands College should be encouraged and facilitated further to develop generic degree programmes at both Honours and Foundation levels, with appropriate U.K. universities.*
- *Robust funding arrangements for people to undertake Open University courses.*
- *A feasibility study to identify the best way to coordinate, develop, promote and stimulate demand for junior/middle management training to meet the needs of employers in the Island.*
- *The provision of support for start-up businesses and their after-care should be reviewed.*

The Economic Development and Education, Sport and Culture Committees will

publish shortly their Skills Strategy for Jersey which will draw on this work and identify the priorities for action in Jersey. The implementation of this Skills Strategy is a top priority for the States and vital to achieving sustainable economic growth.

Improving participation

Given the high rates of labour force participation in Jersey it would be too much to expect a significant improvement in them and to be able to drive economic growth in this way. However, even marginal improvements in participation can help to reduce the requirement for inward migration and address skills shortages issues. For these reasons it is important that full consideration is given to any policy changes that can –

- *Increase incentives/reduce disincentives to work*
- *Address barriers to work*
- *Ensure the unemployed receive the right training to re-enter employment.*

Work organisation/best practice

There is a role for government in terms of promoting and raising awareness of best practice in human resource management to ensure a better take-up of such practices and improved productivity in the Island.

This role can be extended beyond human resource best practice and involve ensuring that information on best practice in all aspect of business operation is properly disseminated across the Island's business base.

Inward migration

While all efforts should focus on the above policy areas, there may still be a need for limited inward migration to address specific skills shortages. The new Migration Policy will ensure that it is possible to meet business needs and make the decisions about employing labour from outside the Island more transparent and business friendly within the boundaries deemed acceptable by the States to limit the impact on the environment and society. It is important to remember though the factors that can prevent labour mobility between other countries and Jersey and ensure that economic and other policy can deliver low inflation, high quality public services, a red-tape free environment and a high quality of life.

Chapter 4: Enterprise

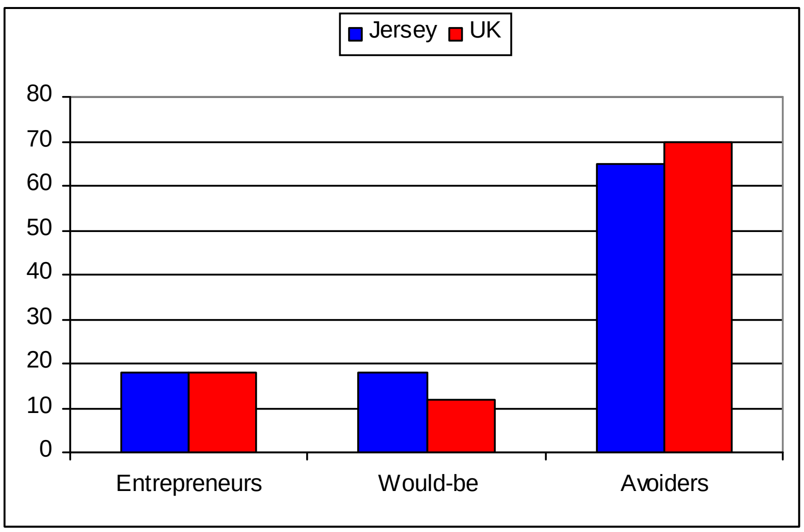
As already mentioned in Chapter 2, creating the right environment for enterprise and entrepreneurial activity is another critical factor for improving productivity performance. Entrepreneurial ability in creating new businesses is an important source of competitive pressure – measures of enterprise and entrepreneurship, e.g. new business start-ups, are highly correlated with growth. New entrants and the threat of entry are also critical components of effective competition and a source of innovation.

Entrepreneurship in Jersey

The Jersey Household Survey of Entrepreneurship 2002 provides valuable evidence on the current state of entrepreneurship in Jersey and some of the key barriers. The main findings are –

- One in 5 of the Jersey working-age population are entrepreneurial in their activity, the same proportions as the U.K. (Chart 10). Another 18% have entrepreneurial ambitions, compared to only 12% in the U.K Men are more likely than women to be both entrepreneurs and would be entrepreneurs. Older people are more likely to be entrepreneurs and younger people more likely to be would-be entrepreneurs.

Chart 17: Entrepreneur status
% of working age population

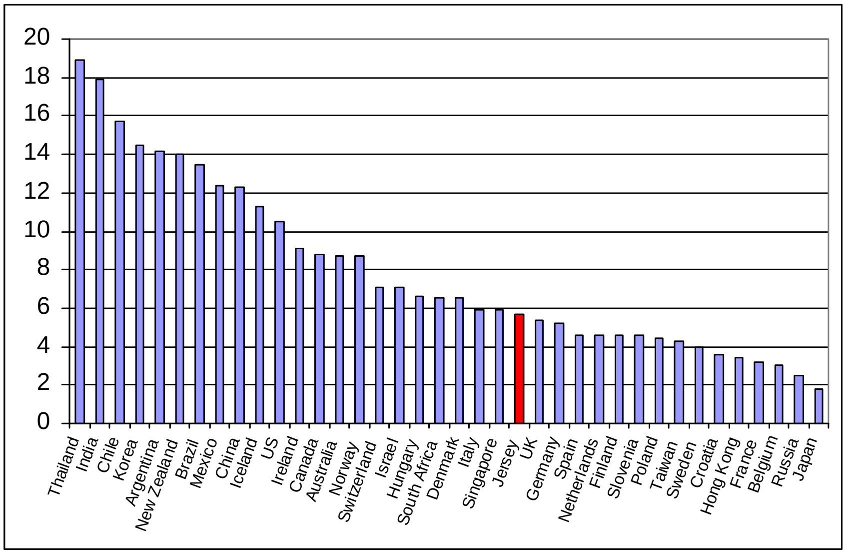


Source: Jersey Household Survey of Entrepreneurship 2002

- In terms of would-be-entrepreneurs, while they are more prevalent in Jersey than in the U.K., they are less likely to be giving serious thought to their potential venture.

- Overall, Jersey seems broadly comparable with the U.K. in terms of the overall entrepreneurial activity rate. However, as the Chart below shows, the Global Entrepreneurship Monitor puts the U.K. 24th, leaving Jersey only 23rd out of the 38 countries considered. At best, Jersey's entrepreneurial performance on an international scale is mediocre.

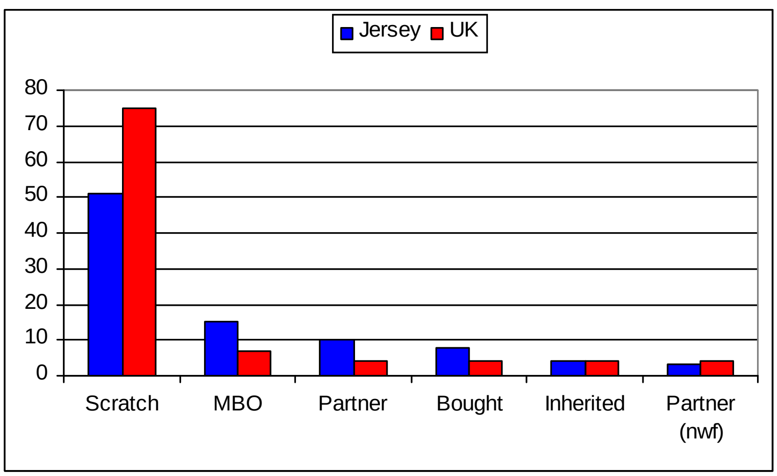
Chart 18: Jersey's entrepreneurial performance on an international scale
entrepreneurial activity prevalence rate (% of population that has taken some action to create a new business in the past year and those in business less than 42 months), 2002



Source: Global Entrepreneurship Monitor 2002

- About half of Jersey business owners started their business from scratch, compared to nearly three-quarters in the U.K. This could suggest that U.K. business owners are more entrepreneurial than those in Jersey, but also that businesses owned by Jersey entrepreneurs are more stable, or it could simply reflect cultural factors and other barriers to start-ups such as legislation.

Chart 19: Source of business
% of business owners

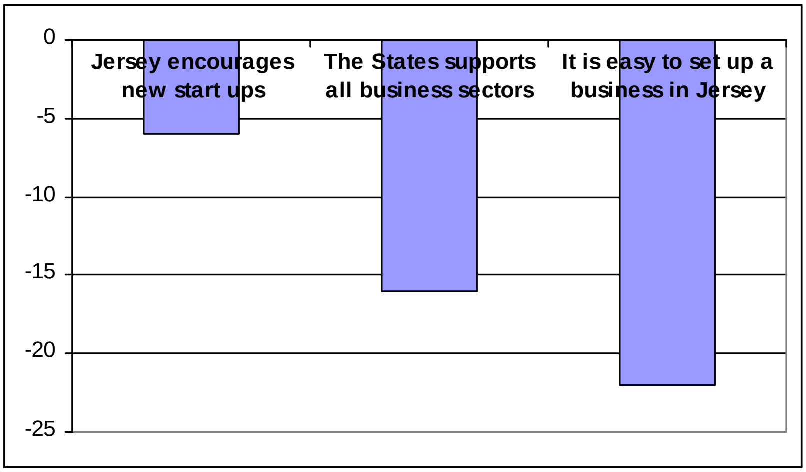


Source: Jersey Household Survey of Entrepreneurship 2002

- 57% of entrepreneurs stated that they had used a bank for business purposes, significantly below the 72% in the U.K. 51% had used an accountant, compared to 58% in the U.K. As many as 26% have not used any organisation for business support over the last year, compared to only 14% in the U.K.

- There are negative perceptions about Jersey as a place to do business. The Chart below shows that on balance respondents feel that Jersey does not encourage new start-ups, that the States does not support all business sectors, and that it is not easy to set up a business in Jersey.

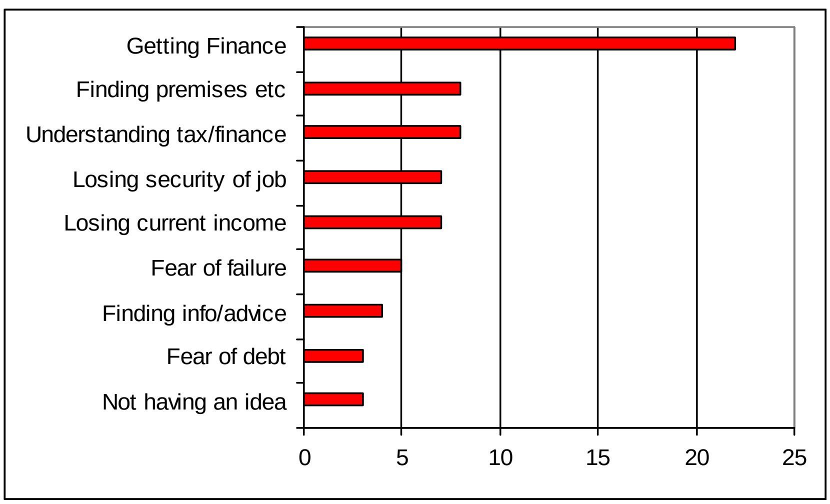
Chart 20: Attitudes to business in Jersey
% balance (% saying agree minus % saying disagree) of all respondents



Source: Jersey Household Survey of Entrepreneurship 2002

- The main barrier that would-be entrepreneurs need to overcome if they are to be converted to entrepreneur status is getting finance. Two in 5 would-be entrepreneurs perceive no real barriers to realising their venture (but this begs the question: why they have not gone into business themselves?). A relatively high proportion of would-be entrepreneurs refer to financial issues such as losing current income, job security and fear of debt, showing that financial issues are the main barrier to entrepreneurial activity.

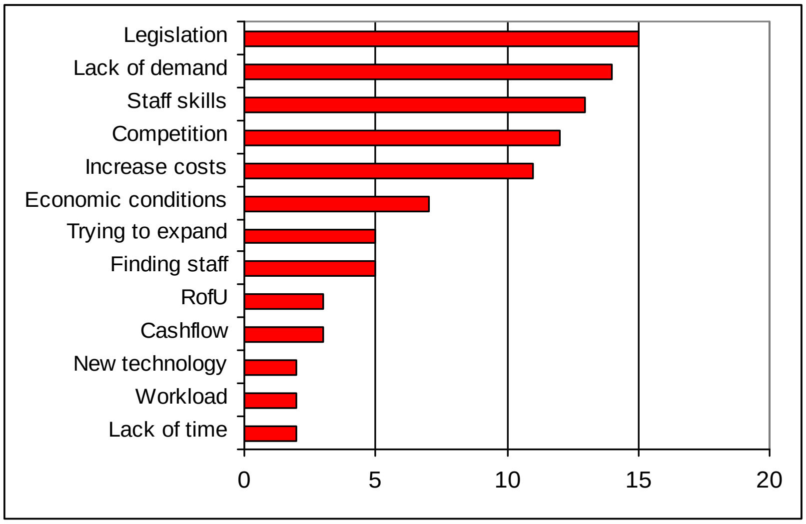
Chart 21: Barriers to entrepreneurial activity
% of would be entrepreneurs



Source: Jersey Household Survey of Entrepreneurship 2002

- The most commonly mentioned challenge facing entrepreneurs in their business is legislation, which is mentioned by one in 7 entrepreneurs. A number of factors also relate to the economic environment in which firms operate, namely – lack of demand, competition, increase costs, economic conditions and cashflow. Staff recruitment is also a major challenge facing entrepreneurs, with 13% citing finding staff with relevant expertise or skills a challenge and 5% stating finding any staff as a problem.

Chart 22: Challenges to entrepreneurs
% of entrepreneurs



Source: Jersey Household Survey of Entrepreneurship 2002

Summary of key issues

To summarise the key findings from the survey in terms of the main issues –

- There is significant room for improvement in the entrepreneurial activity rate in Jersey.
- One weakness in Jersey appears to be the inability of entrepreneurs to start a business from scratch.
- A lower proportion of entrepreneurs in Jersey use a bank for business purposes than in the U.K.
- There are negative perceptions across the population in general in terms of Jersey as a place to do business.
- The main barrier to would be entrepreneurs is getting finance.
- The most commonly cited challenge facing current entrepreneurs is legislation, with many of the other challenges related to the economic situation.

The policy response

Given the entrepreneurial situation in Jersey and the clear need to boost Jersey's performance in this area if economic growth is to be achieved there are a number of areas for policy to focus on –

- Improving access to finance for would be entrepreneurs.
- Changing perceptions of Jersey as a place to do business.
- Reducing legislation that impedes business and prevent market forces from operating.
- Providing macroeconomic stability for business.
- Creating a culture more conductive to risk-taking.
- Ensure entrepreneurs with experience, capital and a sound business proposals can enter the Island.

The next sections look at policies that might be appropriate for Jersey.

Improving access to finance

The economic case

Before considering ways to improve access to finance for small firms it is important to set out on what grounds the case for government intervention is being made (as discussed in Chapter 1). It is not sufficient to say tha some small firms have difficulty in raising external finance therefore the government must intervene to help them. If such firms are inherently more risky than other firms then the market could be acting efficiently and simply allocating funds to the uses with the lowest risk/highest potential returns.

Economic theory, however, tells us that there can be market imperfections in the financing of small firms. They arise because of information asymmetries between banks and small businesses. Basically, the owner of a small business generally has much better information than the bank on their firm's performance and has more control of the outcome. This is not the case with large companies because their shares may be publicly traded and their performance assessed by market analysis. They are also more likely to have a track record that banks can examine and draw comfort from.

Under such circumstances, lenders may increase interest rates to offset their inability to accurately calculate the risk profile of borrowers and the lender may ration credit to avoid lending to high risk ventures. The end result is that viable business opportunities at normal market interest rates will not take place, and this is likely to impact on the creation and/or survival of small businesses.

In such a climate collateral may be used as a sorting device. Good borrowers are considered more likely to put their own or their businesses assets at risk, and those with greater risk attached will be less likely to put their own assets at risk. However, if firms do not have access to collateral but still have good, low risk ventures they may be denied access to credit.

It is on these grounds that loan guarantee schemes are often put forward. That is, **to specifically allow small firms with good, low risk business propositions but no collateral to obtain access to finance**.

This market failure is perceived to exist in the U.K. and many other industrialised countries which operate loan guarantee schemes e.g. U.S., Netherlands, Denmark, Belgium, France and Germany. Bearing this in mind and the fact that Jersey has many of the same lending institutions as those in the U.K., there can be little reason to think that the failures inherent in the U.K. and elsewhere do not exist in Jersey. The business community and banking sector certainly feel that such a scheme would bring significant benefits to Jersey and the Entrepreneurship Survey shows that access to finance is a barrier to entrepreneurship in Jersey.

A scheme for Jersey

It is possible to draw on the experience of the Small Firms Loan Guarantee Scheme (SFLGS) in the U.K. and the recommendations of the recent Graham Review to design an appropriate guarantee scheme for Jersey that could be run by the Economic Development Department. The key components of a scheme designed explicitly to allow small firms with good, low risk business propositions but no collateral to obtain access to finance would be –

- To focus on Jersey start-ups and young businesses (up to 4 years old) with a defined turnover limit.
- Loans available from £5,000 to £250,000 and from 2 to 10 years.
- 75% of the loan would be guaranteed by the States and the States would receive a fee of 2% of the outstanding loan per year for acting as guarantor. The level of guarantee could be reviewed on an annual basis to see if there is any need to reduce/increase it.
- The commercial aspects of the loan are decided between the borrower and lender, with the States playing no part in the discussions.

- A cap should be set for the total amount of loans available under the scheme to limit the exposure of the States.

- The Scheme could initially be piloted for one year to test the extent of demand in Jersey for such a scheme and the rules could be reviewed after this initial period.

The obvious question is how much will such a pilot cost the States to fund? The cost will be determined by the cap set on the amount of loans available (assuming full take-up) and the default rate on those loans. The States will have to budget to meet these costs and therefore is a need to have an estimate of it. A rough calculation can be set out as follows –

> If the cap is set at a total value of £5 million loans in year one, with the States guaranteeing 75% and a bad debt rate of 20% (similar to that in the U.K. in 2004) then the cost to the States will be only about £750,000 (excluding the 2% fee received on outstanding balances). If the bad debt rate turns out to be lower then clearly the cost will be less.

The Jersey Chamber of Commerce has suggested that such a scheme would need to offer £25 million which would allow 100 participants or more. The overall requirement of the scheme could be assessed after the initial pilot to assess likely demand and the extent of such a cap.

Business angels

Business angels can play a crucial part in aiding business start-ups and early development through a number of routes –

- Advice and mentoring
- Contacts with other entrepreneurs
- Investing small amounts of their own capital in the business.

Given the relatively high numbers of high-wealth individuals in the Island, many with successful business careers behind them, there should be more scope for harnessing their abilities and the contribution they can make to the economy.

At the very least a Jersey Business Angel Network should be set up to allow entrepreneurs in Jersey to come into contact with potential business angels. Future 1(1)(k)s could even be questioned on whether they would be willing to register for the network as part of the application process.

There would be a minimal cost to the States largely to cover the administration required to cover such a scheme, and a very rough estimate of this would be in the region of £50,000 for the first year to cover marketing and setting the scheme up with subsequent annual costs of £25,000 per annum.

A Jersey Venture Capital Fund

If there is market failure in the provision of funds to start-up and young businesses – for reasons of lack of information or inability to assess risk – with the end result that viable business opportunities are being constrained by lack of finance, then it could be argued that, if the return to such investment could be improved, it might encourage more of such investment. One way to do this would be to lower the tax paid on the income from such investment. A vehicle could be set up that means that anybody investing through a Venture Capital Fund will pay less tax on the returns from such investment. The Fund would only be allowed to invest in Jersey business start-ups and young businesses.

Such a fund would only incur a cost to the States if the money invested would have been invested elsewhere and generating an income that would have been taxed at 20%. It is likely that in one form or another the funds would have been generating an income – whether from savings in Jersey/abroad or investments in Jersey or abroad so there will be a cost to the States in terms of forgone tax revenue. However, it is fair to say that the scope for venture capital investment in Jersey is limited and that any tax forgone is not likely to have a significant impact on the public finances. In addition, if the venture capital achieves results and growth in businesses that would not otherwise have happened, it will also generate higher tax receipts in the future.

Similar to the loan guarantee scheme, the Fund could be piloted for the first year to assess demand. A rough estimate of costs involved would be to assume the Fund initially has a capital base of £2.5 million per annum. If the Fund generates 10% returns per year this would suggest that the tax forgone if returns are taxed at 10% rather than 20% would be £25,000 per annum.

As well as the costs of foregone tax revenue there would also be annual running costs. This could involve somebody running the scheme from within the Economic Development Department or could be contracted out to a private sector organisation. Either way, running costs of £50,000 per annum should be budgeted for.

Creating an entrepreneurial culture

Both the LSDA recommendations for a Skills Strategy and the review of higher education in Jersey point the way to generating a more entrepreneurial culture in Jersey. In particular the LSDA suggest that the curriculum for all young people in Highlands College, school sixth-forms and work-based training should include the key skill of enterprise education. This would include –

- Modules of enterprise for 16-19 year olds.
- Links with sector representatives and individual employers to ensure reflects working practice.
- Secondments into workplace for staff and reciprocal arrangements.

The cost of such changes would be included in the overall cost of the Skills Strategy.

Support for SMEs

Both reports suggest that some form of support service for small business development should be put in place, which builds upon and expands current support for business (such as that provided by Jersey Business Venture) to secure a comprehensive service for small businesses. The focus of such support should be on helping people that are interested in starting their own business acquire the skills and understanding of how to draw up business plans, make the case for acquiring loans, tapping into other people’s knowledge, e.g. business angels, and growing a business rather than direct financial support.

An additional £200,000 per annum should be made available to expand the services of Jersey Business Venture either under its current name or as a new service.

1(1)(k) arrangements

It will also be important to ensure that entrepreneurs with experience, capital and a sound business proposal can enter the Island. The benefits for Jersey can be assessed in terms of additional employment opportunities and/or tax revenues. Where the expertise and capital backing is lacking in the Island, the current system of 1(1)(k) arrangements should continue to facilitate the entry of such individuals into the Island.

Diversification

The need for diversification

The need for diversification in the Jersey economy (and any economy in a similar position) is based on the need to maximise the use of the Island’s resources, create employment opportunities, generate additional tax revenues and to reduce the drawbacks of specialising in a particular industry. Before considering these drawbacks, it is worth considering the advantages that such specialisation can bring.

A country which specialises in the area/s where it has a comparative advantage is likely to benefit from a higher standard of living (assuming open free trade) because it will effectively be able to generate higher income by focusing on using its resources to produce the good/service that it can produce most of and derive the highest income. With free trade it is then in a position to benefit from trade with other countries that focus on their area of specialisation.

This does require the ability to identify where a country has a comparative advantage. In Jersey's case it is clear that the comparative advantage relating to the financial services industry is based around a number of factors: the tax structure, legal structure, skills/experience, integrity, geographical location and language.

Such specialisation can bring drawbacks. With a large part of the economy dependent on the area of specialisation (in Jersey's case 50% of GVA is generated by the financial services industry) the economy is very vulnerable to any global downturn in that industry or to the industry moving elsewhere. In particular, tax revenues and employment are very dependent on the success/competitiveness of the industry.

One way to mitigate against such problems is to try to identify any other areas where the country might have a comparative advantage. Provided the cycle of such an industry is not tied to that of the original area of specialisation this would allow diversification and provide greater stability in the economic cycle (and employment/tax revenues) which in itself would provide advantages in terms of stability and certainty for businesses and consumers.

If the economy has unused resources or can free up or acquire additional resources it is also likely that if diversification leads to specialisation in another industry where a country has a comparative advantage that it will also mean that the size of the economic pie that the economy can produce to divide amongst its citizens will be larger. In short, diversification can lead not only to a more stable national output but a larger national output. This latter point is very important for Jersey given that growth is required to drive additional tax receipts and employment opportunities.

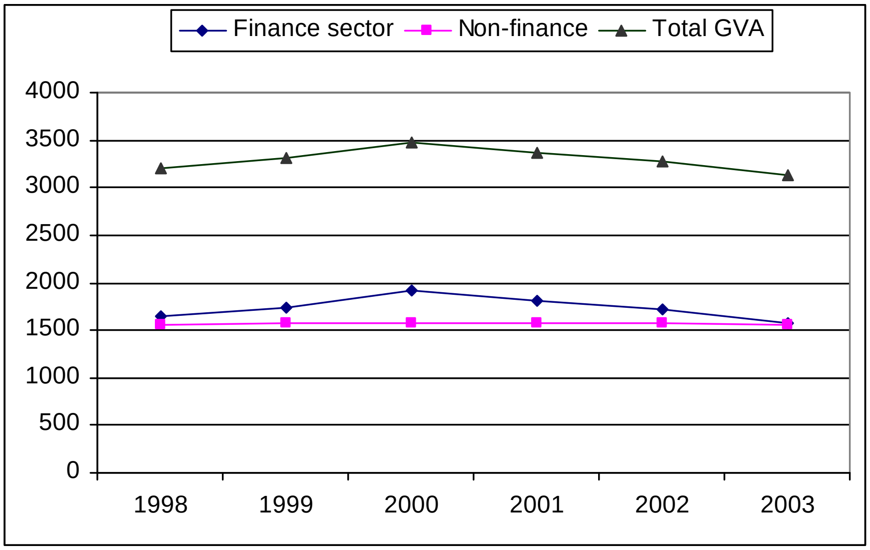
The danger is that if the economy is operating at full potential further production diversification will mean diverting resources from existing uses and impede their efficiency. In the Jersey context this means that if diversification is pursued at a time when the economy is working close to full capacity and resources of land or labour cannot be freed up or acquired, then resources will be diverted away from the financial services industry, undermining its competitiveness (and future tax revenues). The end result is that growth in the economy overall is actually undermined rather than supported. Annex 2 points out that this is not currently the case in Jersey but there can be little doubt that it is vital that growth is based on productivity and supply side improvements to limit the chances of this happening in future years.

Diversification can be both horizontal and vertical. Moving into new sectors of economic activity is largely horizontal diversification, but it is also possible to pursue vertical diversification by adopting polices that lead to diversification within existing sectors. Vertical diversification can build on the current strengths and exploit synergies and may be easier and less costly to implement.

The Jersey context

The fact that 50% of Jersey GVA is generated by the Financial Services industry does leave it exposed to the trends in that sector. The Chart below shows that between 1998 and 2000 the economy grew by 9% and this was totally due to a 16% increase in output from the finance sector (the non-finance sector declined by 0.6% over the same period). In contrast, between 2000 and 2003 the economy declined by 10%, with financial services output falling by 17.5% and that of the non-finance sector by 1%. These trends over the last 5 years show clearly the dangers of having one sector particularly dominant in the economy – the fortunes of the economy are driven by that sector and when it does not perform well, neither does the economy overall. If the non-finance sector could have grown over the period, then this would have reduced the negative impact of the decline in the financial services industry.

Chart 23: Breakdown of Jersey GVA
£ million, constant 2003 prices



Source: States of Jersey Statistics Unit

The fact that Jersey has a low level of unemployment and a fixed land mass that it can use for economic development suggest that if diversification is not only to achieve a more stable base but also to deliver growth, then this will require productivity improvements to free up resources currently in use, and potentially some inward migration of workers with the right skills to meet some of the additional demand. This will prevent such diversification simply diverting resources away from current activity and particularly the financial services industry.

Diversification leading to growth in the Jersey economy could be achieved through both horizontal and vertical diversification. In fact, given that it is imperative that both 2% real growth and £20 million additional tax revenues are achieved between 2005 and 2009, this would imply that both types of diversification will be necessary. If this is not to simply transfer activity between sectors then it is also vital that productivity improvements are achieved across the economy to free up the needed resources. The next Chapter considers how vertical diversification can be achieved in the 50% of the economy that is Financial Services.

Given that Jersey is a small Island economy, it is clear that such diversification would need to meet other requirements and in Jersey's case there are additional requirements laid out in the Strategic Plan. Taken together this would suggest that diversification in Jersey should have the following characteristics –

- High value added/profitability but small in terms of space/resources used.
- Creates high value employment (particularly for young people) with minimum requirement for additional low skilled labour.
- Low levels of pollution/emissions.
- Would create permanent establishment in the Island with either Jersey shareholders or Jersey-based owners.
- Preferably its business cycle detached from that of financial services (something which realistically will be difficult to achieve).
- It does not divert resources away from more profitable and/or local employment-intensive business in the Island.

The role for government

The government's role in generating growth and diversification in the economy elsewhere should be about creating the right environment for business to flourish and market forces to prevail. This involves creating an environment where the skills base can meet business needs, enterprise can flourish and there is open competition across the economy. Trying to pick winners and encourage particular industries to locate in the Island is not an efficient government intervention, unless it is purely facilitating industry that wants to locate to the Island and exploit a comparative advantage that is not viable elsewhere. The end result of such intervention is likely to be higher costs imposed on the economy and greater inefficiency and therefore lower economic growth.

Chapter summary and actions

To create a better environment for enterprise and improve the rate of entrepreneurial activity in Jersey the following recommendations are made –

- *A pilot small firms loan guarantee scheme similar to that in the U.K. should be established to specifically allow small firms with good, low risk business propositions but no collateral to obtain access to finance. Initially the scheme should be piloted to assess demand and suitability of such a scheme for Jersey and this will cost the States in the region of £750,000 per annum.*

- *A Jersey Business Angel Network should be set up to allow entrepreneurs in Jersey to come into contact with potential business angels that can offer advice and potential investments. Such a network would cost £50,000 in the first year and £25,000 a year thereafter.*

- *A pilot Venture Capital Fund should be set up that means that anybody investing through such a vehicle will pay less tax on the returns from such investment. The Fund would only be allowed to invest in Jersey business start-ups and young businesses and would impose a cost to the States in the region of £50,000 per annum in running costs.*

- *To create a more entrepreneurial culture the curriculum for all young people in Jersey should include the key skill of enterprise education.*

- *An expanded support service for small business development should be put in place, which builds upon and expands current support for business (such as that provided by Jersey Business Venture) to secure a comprehensive service for small businesses. An additional £200,000 per annum should be made available in this area.*

- *It will also be important to ensure that entrepreneurs with experience, capital and a sound business proposal can enter the Island. Where the expertise and capital backing is lacking in the Island the current system of 1(1)(k) arrangements should continue to facilitate the entry of such individuals into the Island.*

- *Achieving a more entrepreneurial culture and greater business start-ups will help generate the needed diversification in the Island. Such a market-led approach backed by polices improving skills and education in the Island and promoting competition is a much better way to achieve diversification than the government attempting to pick winners.*

Chapter 5: Competition

Ensuring there is vigorous competition between firms is also critical to maximising productivity and economic growth. Competition encourages firms to innovate by improving efficiency and reducing slack, puts downward pressure on costs and improves the organisation of production. The end result is a better deal for consumers.

There has been a stream of research looking at the benefits of competition and shows that it is closely linked to dynamic and efficient markets. Research has shown that –

- Market power tends to reduce the rate of innovation and productivity growth.
- Increased market concentration is associated with reduced technical efficiency.
- Entry (of high productivity) and exit (of low productivity) firms is key factor in U.K. and U.S. productivity growth.
- New entrants tend to bring higher rates of productivity.
- Firms that face strong domestic competition perform better in international markets.

There are 2 broad approaches to ensuring competition prevails –

- A strong domestic competition framework.
- Domestic markets that are open to trade and investment by overseas firms.

The first point clearly requires a strong competition authority. The DTI in its 2000 White paper sets out the criteria for a world class competition regime. It sets out 6 clear principles–

1. Competition decisions should be taken by a strong, proactive and independent competition authority.
2. The regime should root out all forms of anti-competitive behaviour.
3. There should be a strong deterrent effect.
4. Harmed parties should be able to get real address.
5. Government and the competition authorities should work for greater international consistency and co-operation.
6. Competition policy deserves a high profile because of its importance for economic performance.

Jersey has already moved in the right direction in this area with a new Jersey Competition Law in 2004. However, it is worth considering how this weighs up against the 6 criteria outlined above that represent a structure for a world class competition regime.

1. Clearly the legislation outlines a framework for an independent and strong competition authority. Whether the JCRA proves to be pro-active will be largely down to the way it operates within the legislation. There is clearly scope to be pro-active as it can investigate on its own volition or in response to a complaint. Key determining factors could be the leadership of JCRA and the resources they have at their disposal.
2. The JCRA is charged with prohibiting practises that distort or restrict competition and abuse of a dominant position. The JCRA is also able to grant or refuse approval for proposed mergers and acquisitions.
3. The new Law allows the JCRA to impose financial penalties on firms up to a maximum of 10% of

turnover. It does not, however, provide for criminal penalty for breach of the prohibitions (on the grounds that it would not be right, at least at present, to criminalise anti-competitive behaviour that until recently was considered legitimate). This does leave questions as to whether the current framework can deliver the required deterrent effect. Particularly in hard-core cartels (price-fixing, market sharing and bid-rigging) where such activities carry sentences of up to 5 years in Canada and Japan, and 3 years in the U.S.

4. There are provisions under the Jersey law for harmed parties to get real redress. Article 51 of the Competition Law provides that an aggrieved person may sue a party who has breached the Law, and the Court may award damages to cover not only any loss sustained by the aggrieved person, but also punitive or exemplary damages.

5. Under the fifth principle it will be necessary that the JCRA will be able to co-operate with French and U.K. authorities where necessary.

6. The new Jersey legislation does place considerable emphasis on the JCRA but ensuring that competition policy has a high profile will require the attention of both the relevant Committees of the States of Jersey and the JCRA itself. A conscious effort will be required on both sides to ensure that businesses and the population in general know that priority that will be given to competition policy and that JCRA will be able to back this up with action against any parties breaking the new Law.

This suggests ensuring that a framework is in place to give the right priority to competition policy and maximise growth potential there are several areas for attention and possible improvement –

- JCRA must have the leadership and resources to be pro-active, simply waiting for complaints will not be enough.
- If the deterrent effect under the new legislation is not deemed to be enough then serious consideration should be given to custodial sentences for severe offenders such as hard-core cartels.
- Consideration should be given as to how Article 51 works in practice and whether harmed parties are using it to claim compensation.
- JCRA and the States must work together to ensure that competition policy has a high profile in Jersey.

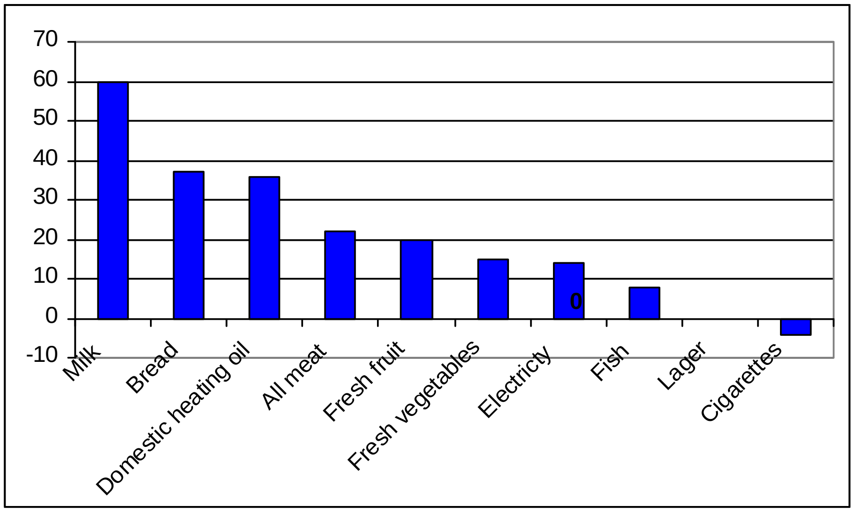
Price differentials

The June 2004 comparison of Jersey and U.K. retail prices shows that are a number of key areas where prices in Jersey are significantly higher than those in Jersey. Chart 23 shows that prices are significantly higher in Jersey for milk, bread, heating oil and meat. Another study has also shown that prices of petrol excluding impôts are significantly higher in Jersey. There could be a number of reasons for this with only some of them relevant to JCRA. These factors include –

- Differences in costs (wages/rents)
- Transports costs
- Supplier cost pressures
- Lack of competition in particular markets
- Protection from foreign competition
- Price collusion such as cartels.

It should be a matter of priority for JCRA to investigate further some of the factors behind these differences and examine where there are issues of lack of competition or collusion.

Chart 24: Differences in retail prices between Jersey and the U.K.
% difference average prices of matched items June 2003 and 2004



Source: States of Jersey Statistics Unit

A consumer voice

The voice of consumers can have a key role to play in promoting competition and helping to prevent excessive price increases. By using publicity to draw attention to price differentials and suspiciously high prices, a strong consumer voice can help to keep prices down and put consumers on a more even keel with businesses. It can also interact closely with a competition authority and draw their attention to certain issues when necessary. Similarly, consumer representatives can attract the attention of consumers to good deals and value for money.

Jersey already has a consumer voice in the Jersey Consumer Council (JCC). Given the information on price differentials with the U.K. and other concerns about the levels of competition in certain sectors in the Island, it would make sense to ensure that the consumer voice in Jersey can be heard loud and clear.

There are probably 3 alternative ways of increasing the volume of the consumer voice in Jersey –

- Give additional support to the JCC.
- Revamp the JCC and rebrand it under another name with a more extensive remit.
- Keep the JCC as it is and have another Consumer body for the utilities.

It is vital that further consideration is given to all 3 options and that a decision is made as to the best way to ensure that the Consumer Voice in Jersey has a bigger and more effective role than to date.

Open to foreign competition

Ensuring that domestic markets are open to foreign competition and inward investment is another way of reaping the benefits of competitive pressures. Competition from abroad can have the same impact as competition from other domestic firms in terms of driving efficiency and innovation and keeping prices down. The threat of potential competition from abroad is also an important factor, because this too can encourage incumbent firms to improve efficiency and to innovate in order to ensure that foreign firms do not enter the market on the grounds that they have a competitive advantage.

Keeping markets open to inward investment can also bring advantages in terms of extra investment that can drive growth and encourage the spread of best practice and new working practices through the economy.

The challenge is to identify where there are barriers to open competition and where there is no reason for the government to allow them to remain they should be removed.

Reducing regulation

Allowing markets to work efficiently is a key theme of the EGP. It is the best way to achieve efficiency across the economy and generate economic growth. This should also include ensuring that government regulation and bureaucracy does not impede markets forces and impose unnecessary costs on business.

To identify regulations that impede business and to keep a watching eye on new legislation to ensure that it has a minimum impact on business a Business Taskforce should be set up to identify current regulations that impede market forces and assess the impact of new regulation on Jersey businesses.

Chapter summary and actions

To ensure that the right priority is given to competition policy in Jersey the JCRA must be pro-active and encouraged to develop a high profile in Jersey. JRCA's legal powers should be kept under review and if necessary expanded to increase its potency.

It should be a matter of urgent priority for JCRA to investigate further some of the factors behind the price differences between Jersey and the U.K. on a number of goods and assess whether there are issues of lack of competition or collusion.

A strong consumer voice in Jersey is also vital for effective competition. There are probably 3 alternative ways of increasing the volume of the consumer voice in Jersey and further consideration should be given as to which is the way forward –

- *Give additional support to the JCC.*
- *Revamp the JCC and rebrand it under another name with a more extensive remit.*
- *Keep the JCC as it is and have another Consumer body for the utilities.*

The Jersey market must be open to foreign competition and inward investment to help enhance competitive pressures and efficiency. Where there is no justification for barriers or impediments to open competition, the States should ensure such barriers are removed.

To identify regulations that impede business and to keep a watching eye on new legislation to ensure that it has a minimum impact on business, a Business Taskforce should be set up to identify current regulations that impede market forces and assess the impact of new regulation on Jersey businesses.

In general these recommendations should incur no additional costs to the States and are largely about prioritising current work. Ensuring that there is a strong consumer voice in Jersey will require additional funding, however, in the region of £50,000 per annum.

Chapter 6: Transport infrastructure

In a small Island economy like Jersey there can be little doubt about the importance of the external transport links to the Island. They are vital for just about every aspect of the economy – the financial services industry, agriculture, tourism, retailers and the population as a whole. The importance of external transport links justifies close scrutiny of all transport policies but does not mean that government intervention should be advocated unless it is on the grounds outlined in 1. That is, its importance does not mean it is a special case and just like in other circumstances inappropriate or poorly appraised government intervention will not have the desired effect.

Transport links and growth

Traditionally, transport was thought of purely in terms of derived demand, implying that it is driven by the level of activity in the economy rather than the other way round. This approach is now considered too simple however, as changing the cost and nature of transport provision can change the extent to which it is used.

Given that output growth is a function of the capital and labour inputs used in the economy and the efficiency with which these inputs are used, it is clear that transport can have an impact on growth in the economy. Transport can have an impact directly through investment in the transport infrastructure increasing the amount of capital and through contributing to a more efficient use of resources.

However, the real issue is whether investment in transport infrastructure is likely to offer better returns than putting resources into education and training. There is no right answer to this question, but generally evidence suggests that although infrastructure investments have a modest positive effect on economic activity, education and training tends to offer better returns. Such generalisations however, are not particularly helpful in the Jersey context given that certain investments/policy decisions could have a direct impact on ferry and airport services which are vital for virtually every aspect of the economy.

The nature of the Jersey economy – that 50% of activity is dependent on exports and that as it cannot produce many goods itself the Island is very dependent on imports does give transport and in particular the external transport links added importance.

Strategic assets

There can be little doubt that the harbour and airport are Strategic Assets for the Island. The thought of the Jersey economy operating efficiently without regular air and sea services is hardly worth entertaining. However, this in itself does not justify public funding for such facilities and could actually make a stronger case for both the harbour and airport to operate as commercial operations that are self-funding with minimal (if any) call on the public purse. The greater efficiency and cost savings that this should deliver would help to drive economic activity in the way described above.

It is vital to remember that public funding of either the airport or the harbour does have a cost in terms of the knock-on effects in the Island economy. That is, public funding will require additional tax revenue to be raised or public expenditure cut elsewhere in the economy. Calls for government intervention to support external transport links should be treated on the same merits as other policy proposals. If not then a good intentioned intervention could impose more costs on the economy than benefits and actually constrain economic activity.

When should the government intervene?

Chapter 1 sets out the clear criteria for government intervention in the Island. Firstly, there must be a clear case of market failure and even then it must then be proven that any intervention can actually bring net benefits to the Island.

In the case of external transport links the market failure is often seen to be that the market will not sustain the volumes/business profitability required to sustain vital transport links. As a result, ferry operators or airlines will leave the market on key routes, causing significant economic damage through its impact on the different sectors of the economy, from finance through to tourism and retail.

This may be a valid case (but still its existence needs to be proven) but the real issue is will government intervention rectify the situation. An often quoted example is to subsidise the cost of travel to the Island to increase the number of people travelling and therefore maintaining the volumes required on the intended route. However, there is a need to be able to illustrate that such journeys are price sensitive (have elastic demand) and to the degree that any change in price will have a significant impact on demand. The issue here is that the price of an airline/ferry ticket is only a small proportion of the overall cost of a trip to the Island which includes accommodation costs, car hire and other expenditure on goods/services. That would imply that a significant change in price and large government subsidy would be required to make a significant change in the number of visitors to the Island.

Even if it was believed that a subsidised reduction in the price of a ferry journey/flight would lead to an increase in the number of travellers the exact net benefit must also be calculated. For example, many of the people receiving the lower fare would have travelled in any case, some of them may simply transfer from one mode of transport to the other, they may take the seats of travellers that can no longer come (e.g. on full flights) and some of their spending may simply leak out of the economy (e.g. on imports).

If once all these factors are taken into account there is no net benefit and/or a net cost then all the government intervention is doing is undermining efficiency in the Island and constraining economic activity (through higher taxes or lower expenditure elsewhere). Even where there is only a modest net benefit then the government intervention should be questioned as a similar intervention elsewhere – such as training or education – could bring greater benefits and a have a positive impact on economic activity.

A variation on this argument concerning the airport is that a government subsidy that reduces landing charges is not intended to attract more travellers but will simply act as a subsidy to the airline involved and make it more profitable on the Jersey route. This will reduce the likelihood that it will pull aircraft off the Jersey route to a more profitable route. While this is a slightly different argument, it is difficult for the government to assess when the situation is arising. It not only needs to be able to assess the profitability of the airline's Jersey route but also how it compares with the all the airline's other routes. There is clearly a situation of asymmetry of information with the airline holding most of the vital data. It is not enough to demonstrate that there are more profitable routes than the Jersey one – but a need to show that the Jersey one is the least profitable of all the routes, that the aircraft are suitable for the other routes and that additional aircraft on the other route will not simply lead to lower profitability on that route.

There is also the question as to when does the government draw the line in supporting the profitability of the airlines. One year a certain amount may be required then the next year, additional support could be requested. If the airline has all the relevant information how can the government ensure that the money it is spending is bringing net benefits to the Island?

The other danger with these types of policies is that they could simply be addressing the symptoms rather than the cause of the problem. Before any such intervention is considered the government must be sure that the airport or harbours are operating efficiently. If they are not, then lower landing charges or harbour dues could be delivered through a more efficiently run airport or harbour, without the need for government financial support and with the desired results.

An alternative way of dealing with the issue of route profitability could be to wait and see if an airline is genuine about pulling out of the route and then allow an auction between airlines in terms of the subsidy required to operate the route. This would limit the likelihood that incumbents would pursue subsidies when they were not actually needed and would also give a better indication of the size of subsidy required to keep the route open without adding to the profitability of the airline unnecessarily (and the cost imposed on the Jersey economy).

Chapter summary and actions

The overarching policy to ensure that the external transport infrastructure supports economic growth is that market forces should be allowed to operate where there is no clear indication of market failure or threat to required service levels. The Economic

Development Committee will publish later in 2005 a review of external transport policy in Jersey. This will be vital for ensuring that transport links are maintained and that economic growth can take place. The EGP gives a clear indication of the appropriate policy guidelines but it will be for this review to determine the way forward. The EGP would suggest that the high level approach should be in terms of the policy for the ***air routes*** *–*

- *Continuation of open skies*
- *Resistance to subsidies to travellers or airlines*
- *Focus on maximising efficiency of airport.*

In the case of ***ferry services*** *to and from Jersey, there may be greater risks in allowing market forces to prevail in the provision of ferry services, not least in the danger of monopoly/price war cycles and the breakdown of the winter service. EDC's review of external transport policy will have to consider the policy options for the ferry services and whether the appropriate response is to allow a licensed monopoly to operate or whether there are other viable alternatives.*

Chapter 7: Macroeconomic stability

The need for stability

One key requirement for economic growth is the need to provide a stable economy for businesses and consumers to make decisions, and this involves getting the macroeconomic policy framework right. A volatile economic cycle of boom and boost imposes costs on the economy which is likely to undermine efficiency and economic growth in the medium and long term.

While it may be tempting in the short term to allow the economy to grow rapidly, there are real risks to doing so in the long term, especially if there is limited or no spare capacity in the economy. A sustainable growth policy will focus on consistent growth close to trend (only allowing above trend growth when there is significant spare capacity in the economy) and ensuring that attention is paid to the supply side of the economy and not just the demand side.

The danger of not pursuing such a policy is clearly that excessive growth will lead to accelerating inflation and that the only way for the economy to adjust is through a recession. Inflation is therefore bad for economic growth and a sustainable economic growth plan must also include maintaining low and stable inflation.

Many years of experience across different economies have shown that one of the main consequences of high inflation has been greater instability in economic conditions. Periods when demand has been growing more rapidly than output and inflation has risen have been followed by periods when demand and output (and employment) have fallen sharply (the boom and bust cycle). These falls were probably greater than would have been the case had demand and output grown at a steadier and more balanced pace.

In the Jersey sense (and in fact for any economy in a currency union) this implies an important role for fiscal policy in providing stabilisation and controlling inflation. There may be some questions about the efficacy of fiscal policy but when you have no control over interest rates there is little else left in the macroeconomic policy locker.

A critical element could be ensuring that the automatic stabilisers in the economy work as well as possible, and where possible actually strengthening them. There could also be a case for increasing the role of discretionary fiscal policy to help smooth out cyclical variations in the economy. Work by the U.K. Treasury as part of the 5 EMU tests has shown that expenditure taxes can be one of the most effective discretionary tools because of their direct impact on consumption and the fact that in the U.K. legislation is such that VAT and excise duties can be changed at any point in the year.

In Jersey any consideration of fiscal policy must also take into account policy for the Strategic Reserve. There would be little point in running fiscal surpluses if at the same time there were significant draw-downs from the Strategic Reserve or vice versa.

Policy for the Strategic Reserve

It is worth considering first what the purpose of the Strategic Reserve (SR) is. One of the main problems with the debate surrounding the potential use of the SR is that it represents different things to different people. The original intention, however, was it should be used to provide the Island with some level of insulation from external shocks. The SR has not always been used in this way and at different times funded capital projects when the Island was in recession but has also been used to fund tax cuts and/or expenditure increases at times when the economy was growing strongly. At other times it has been used for investment in economic development.

With the potential for fiscal surpluses now reduced and 0/10 on the horizon it would be a sensible time to clarify the role of the SR. The original amendment to public finance law constitutes that the reserve cannot be used for any purpose other than one specifically recommended by the Finance and Economics Committee and approved by the States. It is therefore possible for the Finance and Economics Committee to clearly highlight the circumstances under which they are likely to come forward with such a recommendation.

The international experience

Both Guernsey and the Isle of Man have Strategic Reserves. The Isle of Man has been making substantial contributions to its Strategic Reserve in recent years. It currently has a stated policy of planning for annual budget surpluses of at least 5% of net spending, though there appear to be no explicit policies on the use of the Strategic Reserve.

Guernsey has a Contingency Reserve Fund of £176 million, the purpose of which"is to provide protection against major emergencies including economic downturns having a severe adverse effect on the Island".

Apart from our competitor off-shore finance centres the other countries identified as possessing Strategic Reserves are mainly those which benefit from significant oil revenues. Norway is often cited as the best example of a country which has used its windfall oil revenues wisely. It created the Government Petroleum Fund (GPF) in 1990 into which oil revenues are transferred. The stated purpose of the GPF is to "serve as a tool for coping with the financial challenges from the ageing population and the expected decline in oil revenues by transferring wealth to future generations".

During the 1990s, U.S. States created budget stabilization (rainy day) funds to help provide counter-cyclical support. Today 46 States have such rainy day funds, although many have failed to adopt either contribution or expenditure rules that would create significant balances in the funds. Such funds have some general properties –

- They are designed to accumulate revenues during periods of strong economic performance.
- They can improve a State's credit rating by demonstrating that a State has significant reserves to weather a moderate recession.
- They are designed to be counter-cyclical but not to address a structural budget deficit.
- They sometimes have contribution rules.
- Withdrawals are often part of the political process and only sometimes based on specific rules.
- Suitable levels for such rainy day funds to be able to provide counter-cyclical aid is estimated by some

analysts to be in the region of 15-20% of state spending.

What is the Strategic Reserve?

In order to make sensible decisions about the use of the Strategic Reserve it is important to understand exactly what – economically – it is.

Fundamentally the Strategic Reserve represents consumption foregone in previous years by the residents of the Island. Adding to the Strategic Reserve reduces current consumption in the Island and increases the potential for consumption in the future. Spending the Strategic Reserve increases current consumption, but removes the potential for increased consumption in the future.

It is similar to the opposite of borrowing – which has the effect of increasing current consumption but requires future taxpayers to pay interest on the loan, and to replay the capital, thus reducing future consumption. However, the Strategic Reserve differs from borrowing in the following ways –

- It reverses the intergenerational payment pattern. Those who have "paid" for it may well be not around to benefit from the future benefits (because they have left the Island).
- Strategic Reserve financing is cheaper than borrowing – by the difference between interest paid on debt and interest/return earned on assets.

The Strategic Reserve and borrowing also have a number of similar traits –

- Spending the SR and borrowing will both increase inflationary pressure in the economy.
- Both can be used to finance counter-cyclical spending.
- Both can be used to smooth the impact of external shocks.
- Both can be used to finance direct current consumption, or real economic investments.
- Both can lead to a larger public sector than would otherwise have been the case and 'crowd out' activity in the private sector.

Problems to avoid

The above analysis of what the SR is, past experience with the reserve and the experience of other countries spells out lessons for its future operation. There are a number of pitfalls to avoid –

- Using the reserve to boost spending at times when the economy is close to/above full capacity.
- Continual calls for the use of the reserve which waste time and distract attention from the real issues.
- Using the reserve but never making repayments.
- Funding inappropriate government intervention.
- Inadequate provision for future generations that could face a different life in Jersey.

A new framework

Drawing this analysis together suggests that the 2 most important objectives are to –

1. Maintain the Strategic Reserve at close to current levels to maximise the potential cushion/benefit for future generations in times of severe structural decline/natural disasters. This implies that a greater value is placed on maintaining future consumption (under specific circumstances) rather than consumption today or tomorrow in general terms.

2. Provide some flexibility to tackle short-term cyclical pressures brought about by a cyclical downturn in the economy (from external or internal factors).

The first point actually requires the SR to be put tightly under lock and key so that it is untouchable by the current generation (unless the Island is hit by a major shock). The second point actually requires some flexibility and resources to be available at times of cyclical downturn. Is it possible to reconcile these conflicting objectives?

The only pragmatic way to reconcile these conflicting objectives would be to have 2 separate funds, with strict rules governing both, say the Strategic Reserve and a new Stabilisation Fund (SF). The real question is how would they operate?

Strategic Reserve

The SR would be **maintained at or above current levels** (say 90% of government expenditure) in much the same way, with fiscal surpluses invested in the fund or used to replenish the Stabilisation Fund (discussed below). Similarly, the real return from the reserve would be added to the reserve, although it could at times be used to replenish the Stabilisation Fund.

The Strategic Reserve would be solely for the purpose of protecting the standard of living of future generations in the Island when the economy faces severe structural decline or a natural disaster. It would be off-limits for all other purposes and this could be made clear from the outset. The circumstances in which the SR could be accessed would be set out clearly in advance.

The only other call on the Strategic Reserve would be an initial payment to capitalise the SF.

Stabilisation Fund

The new SF would be governed by **strict but transparent rules** that only allow it to be used at times of a cyclical downturn. There would be a set trigger mechanism before which the SF would be off limits. The trigger mechanism could be one or more of the following examples –

- Government revenue/expenditure falls by 10 or 20% below expected trends.
- Unemployment rises above an agreed level.
- GVA declines significantly in any calendar year (or if data allowed in 2 consecutive quarters).
- Profitability of the financial services industry falls by more than 10% in any one year.

There could be pitfalls with any of the above measures, e.g. the first one could lead to incentives to be over optimistic with revenue/expenditure trends, issues of data timeliness and frequency, so it might well be the case that the **trigger mechanism would need to be based on at least 2 different indicators**. It is also apparent that such trends would have to be precipitated by cyclical factors and this might be difficult to assess. However, it might also be justified to allow significant structural factors to be addressed for the first year with the SF while full consideration is given to the right policy response to address the structural change.

A decision would have to be made as to whether a trigger mechanism would be needed to make payments to the SF (or SR) at times when the economy was growing quickly. If there was a requirement to do so and it meant that the fiscal stance had to be tightened there would be a counter-cyclical effect. The alternative would be to leave such payments to the discretion of the Finance and Economics Committee/The Jersey Chancellor at the risk they would not be made a sufficient rate to be truly counter-cyclical.

The SF could have a **target level**, e.g. 15% of government expenditure. When it falls below the target rate it would be expected that in times of cyclical upturn payments would be made into the SF – through fiscal surpluses (and/or possibly the real return on the SR) and these could be based on fixed rules.

The experience from the U.S. is that States will not draw on such funds if the rules are too mechanical, i.e. they will not draw down funds in year 1 if there is an immediate requirement to repay them in year 2. It could be th case that firmer rules are required in Jersey similar to those set out for drawing down the SF or that exact decisions about repayments are made by the Jersey Chancellor.

The **initial capitalisation** of the SF would be an issue. However, this could be done by an initial (one-off) payment from the SR and by absorbing other funds. The SF could be built up further if needed over several years if the real return on the SR/fiscal surpluses allowed. The aim could be to have it operational by 2006 for the first Jersey Chancellor. Currently projections for the SR suggest that it could amount to £445 million or 94% o government revenue in 2006 based on a 3.89% annual return. This would allow an initial and one-off payment of £20 million into the SF and still keep the SR at 90% of government revenue. Additional payments could be made from any real return in these years.

Such a framework would be drawing on the international experience from such funds and tailoring it to meet the specific requirements and circumstances of Jersey. It would draw on the experience with oil funds in countries like Norway and the ‘Rainy Day Funds’ used by U.S. States. The U.K. Treasury has identified the need for a more flexible fiscal regime if the U.K. entered E.M.U. and while they are not in favour of a stabilisation fund as such they do recognise the need to strengthen automatic stabilisers and discretionary fiscal policy. Their fiscal rules are already based over the economic cycle and therefore allow the flexibility that this approach would give to Jersey.

Clearly for a Jersey Chancellor to make the right decisions at times of cyclical slow down and with a SF at their disposal further research would be needed in Jersey on the role played by automatic stabilisers and how best to use discretionary fiscal policy. In particular how funds released from the SF could best be used to mitigate a cyclical downturn e.g. tax cuts (direct or indirect) versus maintaining expenditure (capital or current).

Chapter summary and actions

A critical part of the Economic Growth Plan is to provide a new macroeconomic framework for Jersey that represents a clear break with the past. If sustainable economic growth is to be achieved with low inflation then the States of Jersey must ensure that fiscal policy – the one macroeconomic tool available – is focused on delivering the stability required. A transparent and credible framework is required to support stability and control inflation.

The Economic Development Committee offers its full support to the Finance and Economics Committee in working towards a new framework for the Strategic Reserve and Fiscal Policy that encapsulates the proposals in this report for a new counter-cyclical Stabilisation Fund, with the Strategic Reserve clearly put to one side to be used only if the Island faces a major shock to its economy.

APPENDIX 1

THE ECONOMIC THEORY OF GROWTH

What does economic theory tell us about growth?

There are 2 main strands of economic theory that try to explain how economic growth is generated. The older of the 2 theories, Neoclassical Growth Theory, uses an aggregate production function to relate changes in output to changes in inputs (labour and capital) and their share of output. This theory does allow a role for government intervention but in the long-run growth is driven by the amount of factors of production available, while technological change is seen as determined by external factors outside the government's control and is beyond the scope of economic policy.

The more recent theory is Endogenous Growth Theory, which emerged in the late 1980s, putting knowledge and innovation as factors of production and their spillover consequences at the heart of economic growth. It gives a clear role for government in terms of changing incentive structures to encourage the growth of knowledge and innovation. Education is seen as a key driver as it can affect both the supply and demand for knowledge creating activities. If the spillovers that are important exist in the form of network economies (benefits from firms being in one location or in close communication), there may be scope for a type of industrial policy that involves sectoral or technology targeting.

While both Endogenous and Neoclassical analyses of growth stress the importance of incentives (to encourage participation and risk taking), there is no set formula that can be applied. The case for government intervention still comes down to the aspects covered in Chapter 1 which largely come down to–

- Identifying market failure (where private and social returns diverge).

- Whether the desired behavioural response of the economic actors (e.g. businesses and consumers) can be affected by policy.

Growth promotion can have an impact on economic equality and/or environmental protection but if the aim is to maximise economic growth there are several clear instances where government intervention would be deemed appropriate i.e. instances of market failure or provision of public goods. In the case of accumulation of human capital, private rates of return ignore a social component where society in general can also benefit from one person's education. Innovation is another case because innovators fail to capture the full social returns to what they produce.

The components of growth

Given that in most economies the amount of land available for use is fixed (beyond reclamation), then the 2 key components of growth that have been the focus of most attention are physical and human capital.

Physical capital

Capital accumulation is central to explaining economic performance and there are a number of angles for public policy: the supply of savings, incentives for firms to invest in different assets and the relationship between public and private capital.

If government policy can affect the user cost of capital then it can influence the level of **investment** in the economy. Recent research has shown that the user cost of capital is an important determinant of investment. However, whether this is relevant really depends on whether the social and private returns diverge and that there is an argument for subsidising particular types of investment. Evidence seems to suggest this is the case for **R&D and innovation**, although the jury is still out as to whether this is the case for capital investment in general.

A critical role for government is to ensure that there are adequate levels of infrastructure needed to support economic activity. This can range from the obvious examples such as roads and bridges to institutions for the enforcement of contracts and property rights.

Labour

Labour and growth interact through 2 main channels; the supply of labour or quality improvements – investment in human capital. In addition there is the possibility of benefits from labour organisation – more flexible labour practices.

Labour supply can be influenced at the extensive margin (participation in the labour force) and the intensive margin (effort or hours worked). The evidence suggests that the responsiveness to taxes/income transfers is mainly on the former, with the latter being relatively inelastic.

As mentioned above human capital formation is placed as a key driver of long-run growth by endogenous growth models. The case for government intervention in subsidising human capital on a wide scale rests on there being significant divergences between private and social returns. There are plenty of theoretical reasons to expect social and private returns to diverge, for example due to technology spillovers, but the evidence is more limited.

The case for large aggregate responses to influence labour supply and savings is weak because of the absence of externalities that need to be fixed. There is a more widespread view that private and social returns diverge in the case of technology and human capital formation, although the evidence base is less clear cut.

Appendix summary

This overview of economic theory sets out the framework in which governments can consider how they can influence economic growth. The common ground is that policy should focus on skills, labour supply, capital accumulation and innovation (including R&D) to maximise the chances of governments achieving an economic growth objective but only where there is clear evidence of externalities and market failure. It is in these areas that Jersey should look for the right policies to stimulate economic growth.

APPENDIX 2

THE TARGET AND SCOPE FOR GROWTH

Jersey economic growth – the experience so far

When considering how to generate economic growth in an economy, it is important to consider the current economic circumstances to see what stage the economy is at in the economic cycle and therefore the room the economy has to grow. For example, if the economy has already been growing strongly for a number of years then there is a danger that it could be operating above capacity, and that even growth in line with the estimated trend rate of growth (say 2-2.5%) could lead to a continuum of price pressures that have already built up in the economy, and higher inflation and the associated risks that come with it.

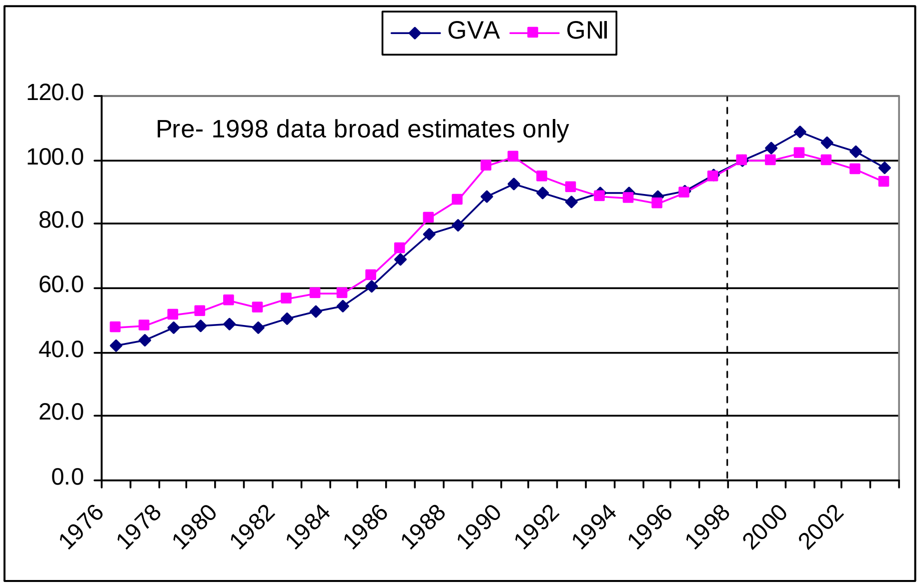
Under such circumstances, the right prescription for the economy would be a period of below trend growth (or perhaps to boost the supply side of the economy) so that demand and supply could move back towards a better balance. To pursue an economic growth target of 2% (if that was not sufficiently below trend) under such circumstances would risk higher inflation and a more severe downturn in the future.

The Jersey Statistics Unit recently published GVA and GNI data for the period 1998 to 2003. This data can be considered to be an accurate reflection of the performance of the economy over that period and the levels of GVA and GNI generated. To get an idea of the economic cycle in Jersey over the long run it is necessary to consider data over a longer period. Unfortunately there is no data available of a similar quality to that recently published by the Statistics Unit. However, there are GDP and GNI data which at best can be seen as broad estimates of the trend in the economy from 1976 to 2001.

It is possible to combine the 2 sets of data to get a better understanding of the economic cycle over the 1976-2003 period. However, doing so must come with a significant health warning that data used for 1976-1998 are estimates only and are not as reliable as the more recent data published by the Statistics Unit.

Bearing this health warning in mind, it is possible to look at the economic cycle in Jersey from 1976 to 2003 in index terms, which is summarised in the Chart below. Over the course of 1976-1990, the Jersey economy experienced GVA growth in every year except 1981, and 1990 represents a clear peak in the economic cycle (on the basis of this data). There then followed several years when real GNI and GVA declined, with growth resuming in the second half of the 1990s. Estimates for 1998 onwards suggest that the economy peaked again in 2000.

Chart 25: Jersey GVA and GNI 1976-2003
1998=100 and in constant prices



Source: States of Jersey

The real issue is whether 2% growth per annum from 2005 onwards is both feasible and appropriate for the Jersey economy given the past performance of the Jersey economy, its position in the economic cycle and the requirement that the working population grows by 1% per annum. The normal way to assess the potential for growth in an economy is to try to gauge whether there is the extent of spare capacity in the economy and what is the trend rate of growth in the economy overall (normally taken as the long-term average growth rate and representative of the sustainable rate at which the economy can grow in line with potential output).

In Jersey over the course of the 1976-2003 period, real GVA growth averaged 3.3%. However, this takes into account the period of strong growth in the second half of the 1980s. Growth between 1995-2003 has been more subdued, averaging 1.0%. Given this significant difference between the short-term and the long-term average, it would suggest that it is best not to rely too much on any one estimate of trend growth, in case it has changed (moved down) over time. This would suggest that the rate should be considered within the range 1-3%, the mid-point of which is 2%.

The States' Strategic Plan sets a maximum increase in the working population of 1% per annum and it is important to bear in mind what this might mean for economic growth over that period. Over the course of the last upturn in the Jersey economy between 1996 and 2000, the economy expanded at a rate of just over 4% a year. Between the 1996 and 2001 Censuses, data shows the working population in Jersey (as measured by the number of economically active adults) expanded at a rate of 0.5% per annum. This would suggest that the States' requirement for a maximum 1% growth in the working population will not constrain the ability of the economy to grow by 2%.

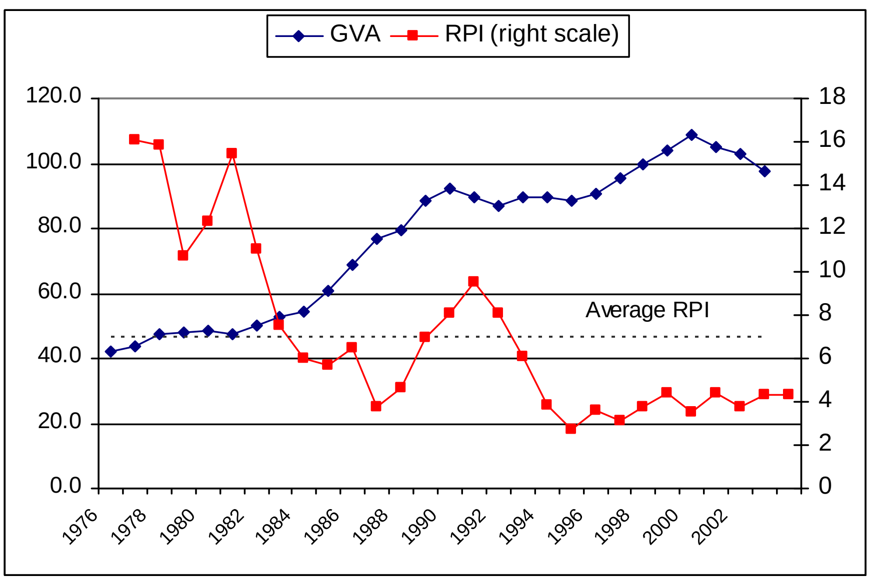
[It should be noted that 1% growth in working population does not imply that the population will necessarily have to grow at the same rate or at all – growth in the working population could be achieved by growth in the working age population with a constant participation rate or simply a higher participation rate with a similar working age population. In reality there may be a need for some inward migration to meet specialist skills requirements but this could be limited by ensuring that the right education and training infrastructure is in place for local people and that growth is based on productivity improvements.]

The trend rate of growth is most useful for trying to work out the degree of spare capacity in the economy. This can be done by estimating a point in the cycle where the economy is believed to have been at trend and extrapolating trend growth from that point to outline the economy's potential. This can be compared with actual growth to see at what points the economy was above potential (with likely inflationary pressure) or below potential (with spare capacity).

For further verification of when the economy is close to capacity, it is useful also to bear in mind trends in unemployment and inflation. When the economy is close to trend, the level of unemployment should be close to the long-run average. If it were significantly below the average, it would suggest that the economy might actually be above trend, and similarly if it were above the average, it would imply there was spare capacity in the economy and that it might be below trend. Examination of the trends in Jersey suggest that between 1980 and 2003 unemployment was close to the long-run average in the early 1980s, 1991 and 2003.

It is also possible to look at inflation trends to see how they compare at different points in the cycle. The inflation rate in 1991 and 1992 was either side of the long-run average again, suggesting that his was a period when the economy was close to trend. All the data on GNI, unemployment and inflation, point to this being a likely period when the economy was close to its potential.

Chart 26: Jersey GVA and inflation
GVA index 1998=100 at constant prices, % change in RPI (right axis)



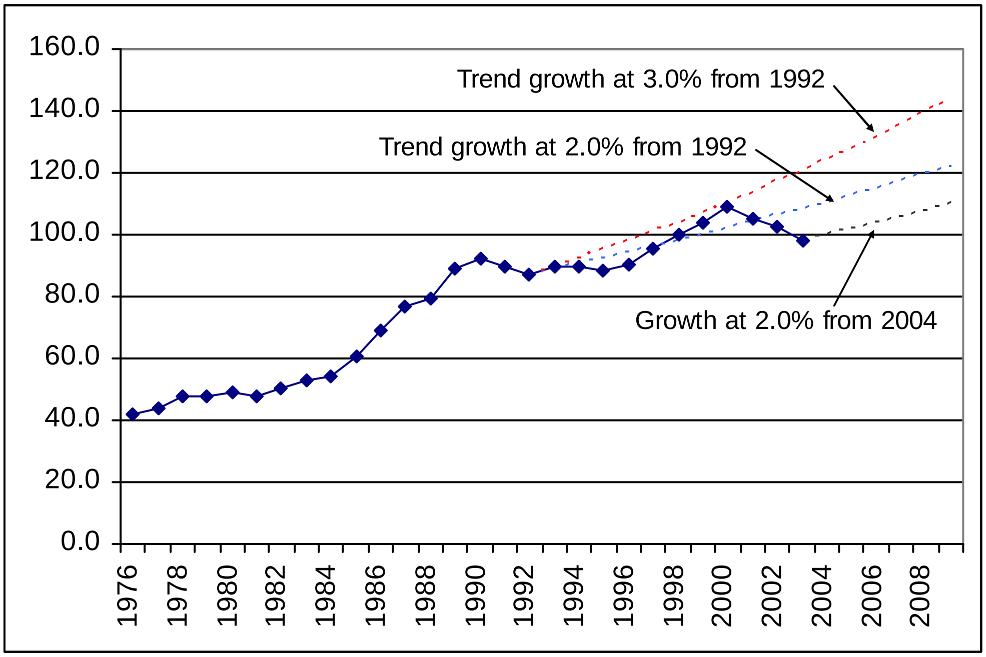
Source: States of Jersey

Taking all this information together it would suggest that a fair assumption would be that the Jersey economy was at trend/potential output in 1992. It is possible to use this point in combination with the estimate (or range) for trend growth to get an idea where the economy is currently relative to potential. The Chart below projects forward the path of potential output from 1992 if the trend rate of growth was either 3.0% or 2%. It shows that whichever measure of trend output is used, there would still be room for the economy to grow at 2% over the next 5 years without it using up all the spare capacity in the economy.

However, given the concerns about the reliability of data and that there must be significant margin for error, there is a possibility that spare capacity could be less than the Chart shows, particularly if the projected trend rate of growth is too high. This puts added emphasis on ensuring that polices are in place, not only to boost the rate of growth in the economy, but also the trend rate of growth, i.e. improved productivity, greater investment, etc.

Chart 27: Jersey GVA and trend rates of growth

GVA index 1998=100 at constant prices and trend growth projected forward from 1992



Source: States of Jersey

Appendix summary

Examination of the past trends in the Jersey economy points to the 2% real growth target as suitable for Jersey in the 2005-09 timeframe. It is in line with past performance and there also appears to be sufficient spare capacity to absorb the rate of growth required. A maximum rate of growth of 1% per annum in the working population over 2005-09, as set out in the States' Strategic Plan, is also consistent with allowing real growth of 2% per annum.