States of Jersey
States Assembly

États de Jersey
Assemblée des États

Corporate Services Scrutiny Panel

Forecasting of Expenditure

Presented to the States on 16th April 2010

S.R.5/2010

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Chairman's Foreword

The Corporate Services Panel of 2005 to 2008, Chaired by the then Deputy P. Ryan, completed a number of important pieces of work. For example, it was that Panel that launched the idea of a fund for use in periods of a financial downturn, from which the Stabilisation Fund was created. It also undertook a review of the States of Jersey Financial Forecasting, producing a report (SR. 13.2008) dealing with the forecasting of income which the Minister for Treasury and Resources received favourably. Their legacy report suggested that the new Panel deal with forecasting of States' expenditure. My Panel undertook that task by creating a Sub-Panel.

It seemed appropriate to use the knowledge and understanding of Professor Michael Oliver to assist and advise the Sub-Panel. The task seemed innocuous enough at first and initial enquiries showed minor problems with the forecasting process. There was nothing that the Sub-Panel had not expected; such as the difficulties inherent in the requirement for departments to draw up forecasts of their expenditure in January of the year prior to the year concerned or the second and third year of forecasting being poor in some sectors.

However, the recognition that this did not get to the root of the problem caused the Sub-Panel to have a second tranche of hearings. Reasonable estimates were coming from the Departments and the process through the Council of Ministers seemed reasonable, resulting in an Annual Business Plan that sat broadly within expected income.

It was at the next stage in the process that the annihilation of the forecasting of expenditure for 2010 took place: the debate to approve the Annual Business Plan. In 2009, £13.1 million was added to the Business Plan almost at a stroke. No forecasting process or plan would be capable of incorporating that level of change.

It is very tempting to ask why this could happen. The second term of reference,

"To review the areas of responsibility for the operation of the forecasting process."

ensured the Sub-Panel did ask this question. The Sub-Panel asked the question at every one of the later hearings and it received a similar answer every time. "*The responsibility lies with the States Assembly*". Not one particular section of the Assembly but the Executive and non-Executive alike.

This in turn was found to be taking the Sub-Panel outside the terms of reference of this review because in order to deal with that conundrum, issues need to be looked at that are at the very heart of our cherished democracy. The fact that no one political position is responsible for getting this right seems, at the same time, to be both completely unacceptable in that there is nobody at the helm and yet highly desirable in order to maintain the democratic process. The problem had manifested itself clearly to the Sub-Panel. The answers have not. I am of the opinion that the answers may be buried within the structure and character of government. This is, however, beyond the remit of this report.

This took the Sub-Panel to the autumn of 2009, a time of significant activity for the main Panel with other reviews, all of which were constrained by time limits for the work to be undertaken and the reports published. In addition, the Sub-Panel noted that it was holding a view point which was highly political and needed careful consideration before moving forward. The review went on hold whilst the resources became available to deal with it.

Since that point, the Comprehensive Spending Review and the Fiscal Strategy Review have been launched. Both these reviews recognise the problems faced by the Island in respect of future financial planning. A restructure of the Treasury consolidates recognition that change is needed and the Comptroller and Auditor General has submitted reports in June 2009, December 2009 and February 2010, all recognising problems with discipline in expenditure control. I consider that, as the Sub-Panel's findings are now supported by so many other pieces of work, from so many different sources, it is time for the findings to be aired.

This must, therefore, be considered as an interim report. Doubtless, the Fiscal Strategy Review and the Comprehensive Spending Review will highlight particular issues. We will return to these once the relevant reports are published. It may also be necessary to report on the efficacy of the revised structure of the Treasury.

Most importantly, it is essential to highlight that this is a time for stringent financial discipline. More fundamentally, perhaps, it is necessary to consider what the role of the Island's Public Sector should be and how all States Members address their role in this. We can no longer afford to "muddle through".

Senator S. Ferguson
Chairman.

Executive Summary with Key Findings and Recommendations

The evidence obtained in the scrutiny process was not quite what the Sub-Panel had expected. Evidence shows that departments are, in the main, forecasting expenditure well, albeit that they are required to submit the estimate in the January of the year prior to the year being forecast and that perhaps the second and third years of forecasting have proved less reliable.

The forecasting of expenditure process then moves to the Council of Ministers and again, the Sub-Panel found, within the 2010 Annual Business Plan for example, evidence of forecast expenditure being restricted to the reasonably expected income of the Island.

All the work that had gone into formulating the Plan to that point then went to debate in the States Chamber. Looking at this raised serious questions for the Sub-Panel and the review was put on hold whilst it was decided how to deal with the issues.

Since that time, there is open recognition of a looming structural deficit, reviews are being undertaken by the executive in an attempt to staunch the upward spending spiral, the Comptroller and Auditor General has raised questions about financial responsibility and the States assembly added £13.1 million to the Annual Business Plan. All these aspects point to the same problem. A problem outside the terms of reference for this review and which the Sub-Panel has not attempted to answer. It does, however, raise the question:

> Where must the ultimate responsibility for the Islands' spending lie?

This Sub-Panel will not look into political discipline or the structure of Government within this review.

The following are the key findings and recommendations raised by the evidence gathered during the review (the detail may be found within the report):

KEY FINDING 1 The Sub-Panel notes and approves of the Treasury Department restructure.

KEY FINDING 2 There are no powers for the Treasurer to enforce compliance with Financial Directions issued by the Treasurer under the Law.

KEY FINDING 3 Forecasting of expenditure at department level is reasonably accurate.

KEY FINDING 4 January is very early to complete an accurate forecast and does not allow for changes within the year preceding the forecast year.

KEY FINDING 5 There is no position of overall responsibility for expenditure in the Island.

KEY FINDING 6 The Sub-Panel approved of the commissioning of the Fiscal Strategy Review and the Comprehensive Spending Review.

KEY FINDING 7 There is no individual political responsibility for States expenditure.

KEY FINDING 8 Discipline is required within States debates on expenditure.

The Sub-Panel makes the following recommendations:

I. **The Minister for Treasury and Resources should enable departments to produce forecasts for expenditure later than January of the year prior to the year forecast.**

II. **The Minister for Treasury and Resources should ensure that forecasts of the second and third years be tightened.**

III. **The Sub-Panel agrees with the reviews being undertaken and recommends that the Chief Minister ensures that the difficult choices likely to be exposed within the reviews be openly dealt with by the relevant Ministers.**

IV. **The Chief Minister must find a method of ensuring strict political discipline in dealing with expenditure, with an auditable line of responsibility.**

V. **The Minister for Treasury and Resources must find a method of ensuring that expenditure in Jersey is income driven.**

Panel Membership

The constitution of the Sub-Panel was as follows:

Senator S.C. Ferguson, Chairman
Connétable D.J. Murphy
Deputy R.G. Le Hérissier
Deputy T.A. Vallois

Officer support Mr M. Robbins

The Panel recognises the assistance given by Deputy S. Pitman during the early part of the review and regrets that she was unable to participate further due to pressure of work in other areas.

Independent Expert Advice

The Sub-Panel engaged the following advisor to assist with the review:

Professor Michael J. Oliver, BA, PhD, Professor of Economics, ESC Rennes School of Business, Lecturer, Highlands College Jersey, Senior Lecturer for the University of Plymouth, Associate of Lombard Street Research.

Professor Oliver submitted a report with background information to assist the Panel. See Appendix 1.

Terms of Reference

The Corporate Services Scrutiny Sub-Panel approved the following Terms of Reference:

1. **To review the policies, directions and practices driving the States of Jersey financial forecasting.**

2. **To review the areas of responsibility for the operation of the forecasting process.**

3. **To review the accuracy and timetabling of the forecasting process.**

4. **To submit a report to the States of Jersey on 9th July 2009 (the Thursday before the last sitting of the States prior to summer break).**

5. **To examine any further issues relating to the topic that may arise in the course of the Scrutiny review that the Panel considers relevant.**

Hearings

Public Hearings were held on 26th May 2009 and 9th October 2009. The witnesses included the Chief Minister and the Minister for Treasury and Resources on both occasions. A full transcript of the hearings may be found on the Scrutiny website.

Methodology

The Corporate Services Panel of 2005 to 2008, under the Chairmanship of then Deputy P. J. D. Ryan, submitted a report on 2nd December 2008, titled Review of States of Jersey Financial Forecasting (S.R.13/2008). That report dealt with aspects of financial forecasting, particularly related to the income side of States' finances. Examination of the expenditure side remained to be reviewed.

This Corporate Services Scrutiny Panel created a Sub-Panel to review forecasting of expenditure. The Sub-Panel recognised that there was much of a specialised financial nature to be investigated and considered the use of an advisor to assist. In recognising the wide range of people qualified in the field, it was decided that the personal knowledge gained by Professor Michael Oliver in his work in the role of advisor on the 2008 report and his knowledge of the requirements of the Sub-Panel made him the appropriate choice.

Following initial research by Professor Oliver, combined with the first tranche of hearings with the Chief Minister and the Minister for Treasury and Resources, the Sub-Panel requested a report from the advisor (Appendix 1). The report was submitted to the Sub-Panel on 7th July 2009 and outlined further questions that led to the second tranche of hearings with the Ministers. This in turn meant that the initial time line set by the Sub-Panel and laid out in the fourth Term of Reference became unrealistic. Further delays then occurred due to the workload of the main Corporate Services Panel during the autumn of 2009. During that period, the Sub-Panel became aware of the reorganisation within the Treasury, the intention by the Executive to launch the Comprehensive Spending Review and Fiscal Strategy Review. As many of the points contained in Professor Oliver's report and evidenced by the Sub-Panel in hearings were due to be addressed within these pieces of work, the decision was taken to place the review on hold pending the outcome.

However, following the report submitted by the Comptroller and Auditor General in February 2010, the Sub-Panel considered publication of the report was now essential due to the serious implications of failure to control Forecasting of Expenditure.

This report reflects the work undertaken by the Panel, its key findings, conclusions and recommendations.

Structural deficit?

1. In March 2009, the Panel received a briefing from the Comptroller and Auditor General who submitted figures relating to forecasting of expenditure in Jersey since 2001. The figures showed the steady increase in forecast expenditure not only year on year, as for example, may be the result of inflation but an escalation of the estimate for most years as the date approached. The actual spend for the year being, in most cases, in excess of even the inflated estimates.[1] The figures were updated in December 2009 to read as follows[2]

Comparison of expenditure forecasts published in annual budget statements 2001-2010 (£m)

Year of										*Budgets*
account	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
2001	343									
2002	363	375								
2003	381	394	394							
2004	398	414	414	408						
2005			435	424	423					
2006				438	433	441				
2007				450	444	454	474			
2008				462	455	457	492	505		
2009					466	480	507	525	546	
2010					478	490	518	546	563	586
2011							532	565	581	611
2012								583	598	620
2013									616	

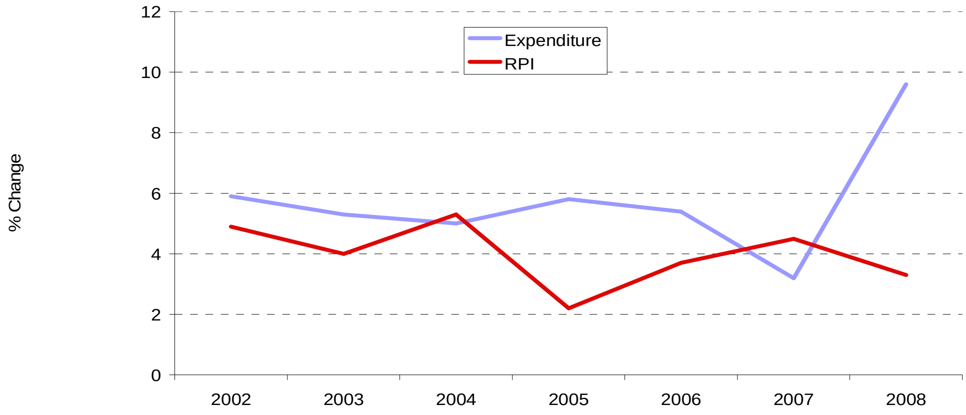
[1] Appendix A
[2] Appendix B

Net Revenue Expenditure – Actual and forecast rate of increase (%)

	Actual NRE	*Forecast NRE*	*Annual increase %*	
2001	356			
2002	377		*5.9*	
2003	397		*5.3*	
2004	417		*5.0*	
2005	441		*5.8*	
2006	465		*5.4*	
2007	480		*3.2*	
2008	526		*9.6*	
2009		542	*3.0*	*Estimate*
2010		586	*8.1*	*Forecast*
2011		611	*4.3*	*Forecast*
2012		620	*1.5*	*Forecast*

4. The Sub-Panel had serious concerns about the overall spending pattern. Particularly when the net revenue expenditure annual increase was placed alongside the listed retail prices index (RPI) figures[3]

Growth of expenditure and RPI, 2002–08



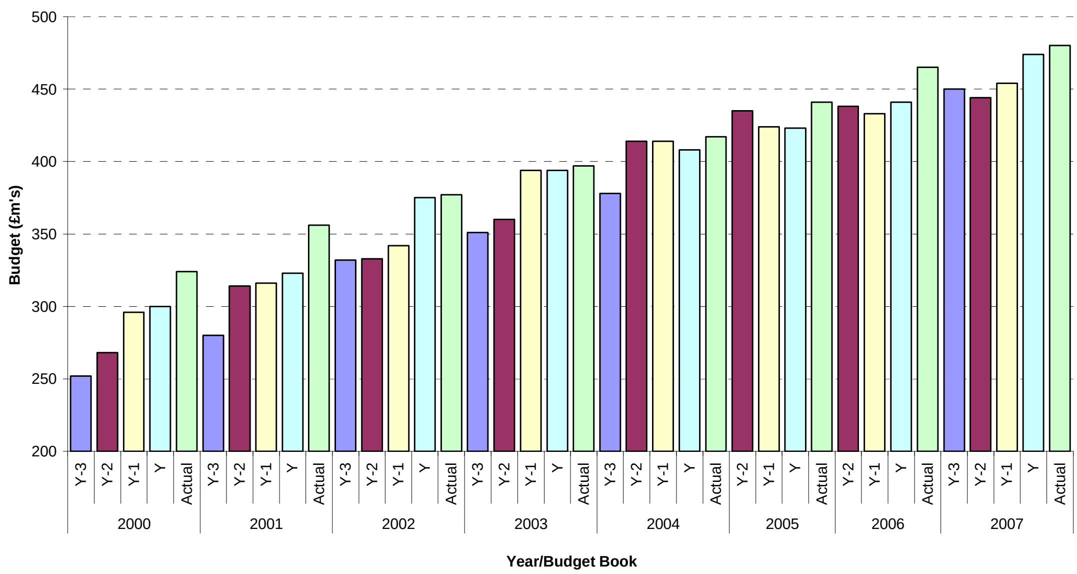
	2002	2003	2004	2005	2006	2007	2008
Expenditure	5.9	5.3	5	5.8	5.4	3.2	9.6
RPI	4.9	4	5.3	2.2	3.7	4.5	3.3

[3] RPI Figures from Jersey In Figures 2008. p10.

5. These figures clearly show that spending has been steadily outstripping the RPI almost year on year. The good years have been nothing like good enough to recover from the damage done in the bad. 2008 being particularly poignant as it marked the precipice to the recession. There was serious concern within the Panel that a structural deficit was likely and the reasons, it could be argued, may be contained within the above figures. Certainly, by May 2009, the Minister for Treasury and Resources was fully cognisant of the likelihood of a structural deficit of perhaps £50 or £60 million following the second annual report from the Jersey Fiscal Policy Panel.[4]

6. The urgency of the problem has been graphically outlined by the Comptroller and Auditor General in his various reports. The Stabilisation Fund will be used to contain the problem in 2010 and 2011, however, the £120 million being used over those two years to support the automatic stabilisers will only stretch so far and cannot be expected to offer assistance into 2012.

7. The situation is further highlighted in the graph on page 19 of Professor Oliver's report.



[4] Public Hearing 26th May 2009

Treasury role

8. The purpose of the Treasury Department, according to the executive summary of the Treasury and resources Draft Restructuring Plan, is to

   "support the delivery of sustainable, high quality, value for money public services."

   The Treasury's key objectives are listed as being:

- Maintaining sound and sustainable public finances
- Improving financial management to drive forward cost effectiveness of public services
- Promoting high standards of governance and accountability
- Maintaining a stable macroeconomic framework with low inflation
- Promoting a fair and efficient tax system with incentives to work, save and invest
- Maintaining the Island's reputation through the development and maintenance of international tax agreements
- Maximising the long term return on States investments
- Providing efficient and effective resource services, enabling improvements in the quality and cost effectiveness of public services

9. The Panel notes the significance of the challenges recognised by the Treasury. Not only will the looming structural deficit have to be faced and dealt with, but the following spending pressures seem unavoidable:

   - Implications of an ageing population
   - Rising cost of health care
   - Investment in sewage and solid waste infrastructure, and
   - Increasing the maintenance spend on States buildings (including schools and hospitals).

10. It is understood that the Treasury were intending to go to public consultation during the summer of 2010 to assist the deliberation in these areas.

11. The Treasury has also recognised that significant restructuring will assist in meeting some of its objectives in areas such as supporting service delivery, collecting taxes and supporting the economy. Some of these changes and projects are well underway.

> KEY FINDING 1
>
> The Sub-Panel notes and approves of the Treasury Department restructure.

12. The Sub-Panel recognises that these objectives have far-reaching implications in the management of the States finances. In view of the run-away figures shown previously, something clearly has to be done to gain control. The Treasury maintain that it will assist the finance officers throughout the States to achieve the required results through rigorous challenge of department spending and realisation of efficiencies.

13. The Public Finances (Jersey) Law 2005 is quite clear on the role of the Treasurer:

(Article) 28 Establishment of the office of Treasurer of the States

(1) There is established the office of Treasurer of the States.

(2) The Treasurer is the chief officer of the Treasury and as such is responsible to the Minister for the supervision of the administration of this Law and of the public finances of Jersey.

(3) It is the responsibility of the Treasurer to ensure the proper stewardship and administration of the public finances of Jersey and, in particular –

(a) to set financial management standards for their administration and for monitoring compliance with those standards;

(b) to ensure that professional practices are adhered to in their administration;

(c) to advise on the key strategic controls that are necessary to secure their sound financial management; and

(d) to ensure that financial information is available to enable accurate and timely monitoring of their administration,

and to advise on the appropriation and budget process for each financial year.

14. In his report dated February 2010 on the Public Finances (Jersey) Law 2005, the Comptroller and Auditor General is suggesting that the Law is not clear on the States wide control and responsibilities for expenditure control.[5] The report highlights numerous problems relating to the responsibilities of the Treasurer which the Sub-Panel has not investigated in this review, other than to recognise that there are no powers for the Treasurer to enforce compliance with Financial Directions issued by the Treasurer under the Law.

KEY FINDING 2

There are no powers for the Treasurer to enforce compliance of Financial Directives issued by the Treasurer under the Law.

15. The Comptroller and Auditor General also deals with the problems of controlling the departmental budgets. The Sub-Panel considers that, in the main, the evidence provided to it during the review suggested that the forecasting of expenditure at departmental levels was reasonably accurate and professional. Therefore, the problem with the forecasting of States expenditure appears to lie elsewhere.

KEY FINDING 3

Forecasting of expenditure at department level is reasonably accurate.

[5] Paragraph 27 of C&AG Report

Where is the problem?

16. It seems only too easy for everyone to suggest that the blame for States spending lies with someone else.

17. The Chief Minister explained the system by which the forecasting arrives at the States.

> *"…so it starts from the department itself and the forecast - if it is a forecast - is put together by the finance team working with the officers in the department, signed off with the Chief Officer and the Minister and then that is put forward to the Treasurer on behalf of the Treasury Minister. It is then aggregated and the Council of Ministers process is very much a political process to determine within the, what they regard as, acceptable limits of spending the relevant priorities that they will then put forward to the States."*[6]

It was explained further that departments were required to complete their forecasting by January of the year preceding that which the forecast was relating to. There is no one public office or politician responsible by legislation for the forecasting of expenditure in Jersey.

KEY FINDING 4
January is very early to complete an accurate forecast and does not allow for changes within the year preceding the forecast year.

18. The following question was asked in the Public hearings

> "Who holds responsibility (Political and Officer) for the forecasting of expenditure process?"

[6] Public Hearing 26th May 2009.

19. The Minister for Treasury and Resources stated:

> *"Ultimately the States hold responsibility for making the decisions on expenditure but obviously it is a proposition that is taken to the States Assembly by the Chief Minister."*

The Chief Minister echoed this clearly when he commented that responsibility rests with politicians who may decide they want to spend more.[7]

KEY FINDING 5
There is no position of overall responsibility for expenditure in the Island.

20. Professor Oliver made numerous enquiries when researching the issues to advise the Sub-Panel. The overarching message, which is reflected in his report to the Sub-Panel of July 2009 (Appendix 1), shows that the lack of responsibility for the overall process has resulted in the recognition that although forecasts are put together responsibly by the individual departments, there is a general sense of foreboding to the effect that;

> *unless something awful happens, they will do nothing. If they do nothing, something awful will happen.*[8]

21. The professor's report discusses the reasoning behind this so it will not be considered in depth here. The recommendations to the Panel contained within his report are summarised as follows[9]:

    1. *There should be a proper debate now about the future growth of public expenditure, which should address questions such as 'do we want a low tax economy', or 'do we want higher public expenditure?'*

[7] Stated in the Public Hearing of 26th May 2009. However, problems experienced with the recording of the proceedings resulted in an incomplete record. This comment is taken from scrutiny officer notes made at the time and is not a verbatim quote.
[8] Page 5 Report by Professor Oliver, July 2009.
[9] Page 28 Report by Professor Oliver, July 2009.

2. *Efficiency savings alone will not deliver structural change to the public finances.*
3. *There should be specific goals set on public expenditure.*
4. *Fiscal policy has to be made in a more meaningful medium-term framework (3 years).*
5. *The Treasury needs restructuring.*
6. *The Strategic Plan needs to have a firmer link to the annual Business Plan.*
7. *There should be a contingency budget introduced for unforeseen emergencies*

22. The above recommendations caused the Sub-Panel to review the evidence it had gathered to date and it called further Public Hearings with the Chief Minister and Minister for Treasury and Resources on 9th October 2009. In following protocol laid out within the Codes of Practice for Scrutiny Panels and the Public Accounts Committee, the Panel advised the witnesses of the areas intended to be discussed at the hearings. The Minister for Treasury and resources responded by sending a letter to the Sub-Panel. The letter explained that two separate and significant pieces of work were to be undertaken. The Fiscal Strategy Review and the Comprehensive Spending Review.

23. Review of Fiscal Strategy. (FSR)

    Intention:

    To evaluate current tax and fiscal structures to determine how to ensure they are and remain sustainable into the future. The review will develop, consult on and then bring to the States a fiscal strategy in time for the 2011 budget that will:

    - *ensure sustainable public finances and support economic objectives;*
    - *plan for potential future changes in global fiscal norms and the possible impact on Jersey;*
    - *address the potential structural deficit once the economy has recovered;*
    - *fund essential public services;*

- *take account of funding sources for the future spending pressures*[10]*.*

24. Comprehensive Spending Review.(CSR)

    Intention:

    > *Consideration of whether and if so how improvements could be made to the expenditure and business planning process. The CSR will be asked to seek savings of £50 million from the 2011-2013 business plans. Some of these savings would be used to create a contingency fund for unforeseen expenses, to fund any changes needed to make savings and to fund some growth in essential services. Targeting this level of savings will break the historical cycle of annual spending increases above previous forecasts. The CSR will be complemented by a new 3 year spending control process, which will not only limit unforeseen increases, but encourage greater efficiency and reward those services which are most successful at controlling costs.*[11]

25. Suddenly the concerns of the Sub-Panel which had been uncovered during the process of the review were apparently recognised within the two reviews to be undertaken by the Ministers. This information was very encouraging for the Sub-Panel in October 2009. The details were given in confidence at that time although the reviews are now in the public domain. The Sub-Panel thanks the Chief Minister and Minister for Treasury and Resources for their openness at that early stage. The high level of co-operation prevented duplication of effort for both the Sub-Panel and the Departments.

26. The Sub-Panel fully endorses the undertaking of the reviews and the apparent determination shown by the Chief Minister and the Minister for Treasury and Resources to progress them.

KEY FINDING 6
The Sub-Panel approve of the commission of the Fiscal Strategy Review and the Comprehensive Spending Review.

[10] Details supplied by Treasury Dpt.
[11] Details supplied by Chief Minister's Department.

What Lies Ahead?

27. However, despite many of the Sub-Panels' concerns being looked at, the area of responsibility for the finances of the Island has not been resolved. Neither the Chief Minister nor the Minister for Treasury and Resources has any power to control what takes place in the States Chamber. Of course, there can be no guarantee of support from other Members either. Therefore, regardless of the quality, accuracy or appropriateness of the forecasting of expenditure work done by numerous officers and Ministers prior to the Business Plan reaching the States, the ability to remain 'in budget or not' rests with the States Assembly.

28. Despite recognition of problems of short term forecasting, to meet one year budgets, and having to prepare budgets in the January of the previous year, the Sub-Panel considers the departments are producing accurate assessments of the financial needs of the future, given the services they are required to provide. The Council of Ministers in 2009 brought forward a Business Plan to the States (P117/2009) which curtailed the estimated expenditure at an amount, which, it could reasonably be argued, would be met by expected income, given the recession, and cyclical problems associated with the period.

29. The next step was to have the matter debated in the States. At that point, amendments to the Annual Business Plan agreed in the debate, being £1.6million Net Revenue Expenditure and £11.5 million Capital Expenditure[12], meant an additional £13.1 million pounds on top of the forecasting proposed by the carefully conceived plans created at department level.

£13.1 million over budget with no direct political responsibility!

> KEY FINDING 7
>
> There is no individual political responsibility for States expenditure.

[12] Figures from Annual Business Plan 2010 (as amended 05.10.09) Addendum.

30. The Sub-Panel wishes to make it clear that this is in no manner a comment on the content of the amendments to the Business Plan.

31. This is a multi-million pound problem, yet the departments appear, in the main, to be attempting to cut their cloth according to the requirements of their Ministers and the financial climate. This direction stems from the difficult decision-making done at the Council of Ministers level, with the assistance of the Corporate Management Board. It is accepted that these are difficult times and the balance of the forecasting process, between the services to be provided and the amount of money available, is going to fluctuate, particularly during a recession. Any lack of discipline at the point of the States debate could turn a difficult financial time for Jersey into a dangerous downward spiral. Unchanged, the process can only be a recipe for serious financial difficulties in the future.

KEY FINDING 8
Discipline is required within States debates on expenditure.

32. The February 2010 report 'States' Expenditure Forecasts' published by the Comptroller and Auditor General in response to questions from the Sub-Panel sends a clear picture of the consequences of failure to control expenditure.

GST at 12%.

Or

A structural deficit of £170 million.

That may be a worst-case scenario, or is it?

Decisions to be made

33. The questions about how the States deals with business clearly took the Panel outside the terms of reference of this review. However, in order to deal with that enigma, issues need to be looked at that may challenge the democratic procedures of the Island. The Sub-Panel therefore raises the following question

Where must the ultimate responsibility for the Islands' spending lie?

34. The answer to this question will require brave and difficult decisions relating to democracy, power and responsibility, the Sub-Panel would implore the Chief Minister to deal with the problem.

Recommendations

35. The Sub-Panel makes the following recommendations:

i) The Minister for Treasury and Resources should enable departments to produce forecasts for expenditure later than January of the year prior to the year forecast.

ii) The Minister for Treasury and Resources should ensure that forecasts of the second and third years be tightened.

iii) The Sub-Panel agrees with the reviews being undertaken and recommends that the Chief Minister ensures that the difficult choices likely to be exposed within the reviews be openly dealt with by the relevant Ministers.

iv) The Chief Minister must find a method of ensuring strict political discipline in dealing with expenditure, with an auditable line of responsibility.

v) The Minister for Treasury and Resources must find a method of ensuring that expenditure in Jersey is income driven.

Appendix 1 - Report into the forecasting of expenditure

Professor Michael J. Oliver,

Contents

1. Introduction

From the vantage point of 2009, Reg Jeune's infamous words from the 1980s that Jersey has 'got money coming out of our ears' are a distant memory. The credit crunch has been slow to arrive in Jersey, but economic activity is the Island is beginning to decelerate. The implications of this for States revenue and expenditure over the next few years appear to be bleak.

Any discussion on revenue and expenditure in Jersey cannot be fully understood without reference to the Island's unique economic and political context. Finance had established itself as an important industry in the Island's economy from the 1960s and by the mid-1970s, Jersey was well on the way to becoming a global level Offshore Financial Centre. Soon after, finance became the Island's main driver of economic growth. At the start of the 21st century, Jersey had bank deposits of over $249 billion, $500 billion was held in offshore trusts, and around $153 billion was managed in offshore funds. By the beginning of this decade, however, a whole series of overspends, a perception that the public service was overstaffed or at least inefficient in how it operated and growing expectations of public service provision was putting considerable pressure on the exchequer. Added to this, there was evidence the political structure was unable to assert itself over the bureaucracy and this led to a growing disillusionment with government.

Just over five years ago, the States of Jersey began broader reform on a number of fronts. There were major changes to the political structure when the States accepted the principles of ministerial government. For the first time, under a Chief Executive with clear powers, it was possible to run the civil service as a coherent organisation and not one that was fragmented to reflect a myriad of political committees. Matters like intelligence and statistical gathering and monitoring were also given more attention through the establishment of functions in the Chief Minister's Office such as International Relations and Statistics.

On the economic side, the States agreed to balance government income and expenditure and improve the delivery of public services (States of Jersey 2005). In June 2004, the States agreed to double the annual rate of economic growth to 2% for the next 5 years and in March 2005, it published an economic growth plan (Economic Development Committee 2005). This was followed by a series of measures which aimed to diversify the economy, increase productivity and uplift the skills of the workforce (e.g. Economic Development 2007). A new Fiscal Framework was agreed by the States in October 2006 and outlined the purpose of a Stabilisation Fund and the Strategic Reserve (States of Jersey 2006). Concomitantly, the introduction of a Fiscal Policy Panel in 2007 allowed three outside independent experts to provide comments on the appropriateness of the States financial position and forecasts.

Changes to the tax system included an Income Tax Instalment System (IT IS) to replace the existing arrangement where employees would pay income tax in one lump sum at the end of the financial year to a system similar to the UK's Pay As You Go (PAYE) arrangements. Under IT IS, it was estimated that the payment method would raise additional sums each year. In addition, a number of income tax allowances for higher income groups over a five year period were phased out in a piece of legislation known as ‘20% means 20%’ (the implication being that Jersey’s income tax rate of 20 per cent would be non-negotiable for higher earners who had previously been offered a number of allowances and had reduced their top rate of tax below 20 percent). Finally, a goods and services tax (GST) was introduced at 3 per cent in 2008, and the rate was fixed for three years and would apply it to all goods and services expect for medical supplies, prescriptions, charities, residential rents, postage and businesses with a taxable turnover of less than £300,000.

Given the difficulties in a small society to enforce any public expenditure cuts and to make far-reaching changes to the economy, these reforms would have been unthinkable in earlier times. Policymakers have noted that in past economic cycles, whenever the Jersey economy underwent a moderate pace of economic expansion there was a tendency to put off reforms and to assume that economic growth would continue unabated. The reforms that have been introduced over the last five years have been packaged somewhat differently. This time it is different, policymakers argue, and complacency will not set in at the expansionary phase in the economic cycle. They argue that the formidable challenges that have to be met in the foreseeable future encompass the expansion of new European Union economies, greater aspirations of long established competitors and demographic changes.

Despite this, these reforms do not seem to have completely quelled the escalation of tension between each of the stakeholders in the Island insofar as public expenditure is concerned. As I noted in my last report, this unease can be characterised as follows. The Treasury will announce that there is an improved outturn to a forecast, as income receipts are higher than the initial forecast. The politicians will respond to this news by blaming civil servants for not being accurate enough in their initial revenue forecasts and accuse the Treasury of under forecasting income to constrain States expenditure. The politicians will then spend some, if not all, of the extra income. Finally, the general public's reaction to all of this, after reading in the *Jersey Evening Post* that 'extra money' has been found, is a mixture of bemusement and anger. Some will question why new taxes have been introduced in the first place; others will get angry as the States approve additional expenditure and yet others will lobby politicians to spend the extra income. Invariably public expenditure continues to rise, and in recent times, 'extra money' appears like Manna from heaven as Jersey's economy continues to grow at rates faster than that predicted by official forecasts. Some of the interviewees summarised this situation thus: 'unless something awful happens, they will do nothing. If they do nothing, something awful will happen'.

It is probably fair to say that all sides are culpable in this 'blame game', but it clearly do not help that the political situation in Jersey is unique. There are no official political parties but 53 individual parties (each member of the States assembly). One of the advantages of political parties is that they assert discipline on their members, which leads to consistency of purpose. Unfortunately, politics in Jersey (more so than the UK!) is marked by disconnects, the law of unintended consequences and occasional rapid policy reversals (e.g. one day a debate can occur with members arguing that health expenditure should be controlled and the following week Members will just as passionately argue that extra resources need to be found to save a children's home). Those members not sitting on the Council of Ministers (CoM) have a relatively easy time because they can support propositions for extra spending and do not feel that they are responsible for the financial position that the States ends up with. Last year, the CoM brought amendments to their own Business Plan and spent more than agreed because of an impending election and this went against the advice of the Fiscal Policy Panel (usually lauded by senior politicians for the quality of their advice). To emphasize, these observations are made not to denigrate the politicians (politicians need to get re-elected, unlike academics!) but merely to highlight a system which is perhaps best not suited for rational, long-term policymaking.

To examine the issues around the forecasting of expenditure, this report is divided into three parts. First I turn to provide an overview of forecasting expenditure and relate this to some academic literature. Secondly, I turn to examine the forecasting of expenditure in Jersey. Finally, I make some recommendations.

2. An overview of forecasting expenditure

2.1 Introduction: expenditure planning and forecasting

As Western governments became more accountable for the use of public funds post-1945, there was a concomitant growth in budgetary procedures and institutions which led to the development of more advanced fiscal forecasting and monitoring techniques. A quarter of a century ago, Zarnowitz (1985) claimed that there was no more empirical exercise in public financial management than forecasting revenue and expenditures. By the 1980s, the developed world, with its plethora of econometric models which were used by local, federal and state governments to garnish their empiricism, were urging developing countries to become more rigorous with their forecasting procedures (e.g. Feenberg et al. 1989). The spread of scientific budgetary procedures, however, was tempered by some academics who subscribed to the view of the late John Kenneth Galbraith that 'the only function of economic forecasting is to make astrology look respectable'. As practical experience confirmed that forecasting was more of an art than a science, over the last fifteen years a more nuanced view has emerged which stresses that budget forecasts of revenues and expenditures should utilise very sophisticated econometric or other empirically driven approaches, but recognises that the political environment can undermine that rigour which underpins this approach (Bunn and Wright 1991).

Clearly, expenditure forecasting is a highly complex exercise and requires many forms of input which include historical data, experience, incremental approaches, judgement, hierarchical bargaining, game-playing, unit cost, trend analysis and econometric modelling. Forecasting is not a wholly technical and professional exercise that is objective and nonpartisan: each set of actors which participates in the process will have normative considerations which influence the budget process. Due to this, the need to design a procedure flexible enough to accommodate the day-to-day requirements of fiscal policy decision-making tends to create tensions with the use of appropriate tools. The main topics in the literature pick up on how practitioners and scholars have approached which procedure would best fit policy requirements and formal correctness, and these are discussed below.

2.2 Academic views on fiscal forecasting

In a recent European Central Bank working paper, Leal et al. (2007) reviewed the fiscal forecasting literature and some of the challenges in the field of fiscal forecasting from a practitioner's perspective. They note that generally speaking, the academic papers can be grouped into two: (i) some discuss the appropriate procedure for fiscal forecasting, in many cases by means of accuracy comparisons and (ii) others discuss the properties of the produced forecasts, in terms of (systematic) biases and violation of the rationality. Several things should be noted:

- It is not clear from a study of the literature which method fiscal and monetary authorities, international economic organisations, financial market analysts, rating agencies or research institutes should be adopting when preparing their forecasts. Some authors (Bretschneider et al. 1989) compare the forecasting accuracy of different forecasting methods and favour a combination of judgement and simple econometric equations, against time series and complex econometric models. They argue that the main reason for this is the knowledge of special events state revenue forecasters might have. Others, such as Grizzle and Klay (1994) also show evidence for combining judgement and simple methods on the basis of transprancy against more complicated or automated techniques.

- Pike and Savage (1998), Sentance et al. (1998), Giles and Hall (1998) and Willman et al. (2000) have explored the fiscal side of structural macroeconomic models. Macroeconomic models as iteration tools for preparing the budgetary forecasts allow for estimating the effects of fiscal policy on economic activity; however, it is often the case that such models are too aggregated to produce sufficiently detailed government revenue and expenditure projections, which are necessary for a thorough assessment of public finances.
- A number of authors have analysed the potential bias the political and institutional process might have on revenue and spending forecasts (Auerbach 1995 and 1996; Plesko 1988; Feenberg et al. 1989; Bretschneider et al. 1989; Shkurti and Winefordner 1989; Cassidy et al. 1989; Bruck and Stephan 2006; Jonung and Larch 2006), and the nature and properties of forecast errors within national states (Campbell and Ghysels 1995; Jennes and Arabackyj 1998; Auerbach 1999; Gentry et al. 1989; Fullerton 1989; Melliss 1996; Melliss and Whittaker 1998; Baguestani and McNown 1992; Mühleisen et al. 2005; Moulin and Wierts 2006; Strauch et al. 2004) and international

organisations (Artis and Marcellino 1998 and 2001; Pons 2000; Keereman 1999 or Golosov and King 2002).

- The main lessons which Leal et al. (2007) draw from this strand of literature, some of which relate to the current study, are:
  - there is evidence of the existence of systematic political and institutional bias in revenue forecasting in the case of European countries, while the evidence for the US is mixed;
  - forecast quality deteriorates with the length of the forecasting horizon;
  - forecasts from independent, competing agencies tend to increase forecast accuracy;
  - nevertheless information matters, as outside forecasts (from independent forecasters) tend to be less accurate than inside forecasts (from staff of the relevant organisation);
  - unforeseeable policy decisions and institutional changes have a significant impact on forecast error patterns across time.

2.3 The performance of fiscal forecasters and the appropriate procedures for fiscal forecasting

The academic literature is proliferated with papers evaluating forecast records (albeit more often for the macroeconomic side of the economy than for the fiscal side). As Leal et al. (2007) remind us, when considering accuracy comparisons over time, two things should be borne in mind. First, the information set available when generating real-time forecasts tends to be much smaller than that available when performing *ex post* comparisons (e.g.

GDP revisions, lags or frequent revisions in the availability of fiscal data and changes in announced policy). Secondly, evaluating point forecasts of certain variables does not permit a comprehensive assessment of a set of projections where all economic and fiscal variables are jointly determined. Nevertheless, evaluating forecast accuracy is an important element of forecasting procedures. Policymakers might learn from past errors and improve their forecasts: sizeable, systematic or biased forecast errors should allow fiscal analysts to identify weakenesses in their forecasting procedures, in terms of methods, discussions or decision-making processes.

The evidence on forecast errors is illuminating. Leal et al. (2007) examined the distribution of government budget balance forecast errors for 15 European countries, taken from spring and autumn projections. They found that the distribution of projection errors appears to be slightly twisted to under-prediction of budget balances (which might be evidence for the presence of bias), particularly for current year autumn projections. In terms of bias, Bretschneider et al. (1989) have shown that a government would tend to overestimate a deficit when the loss of an underestimation is greater. Keereman (1999) and Jonung and Larch (2006) have demonstrated how public authorities may have an interest in presenting a pessimistic forecast to build in a safety margin that would allow them to meet budgetary targets, also in case of revenue or expenditure slippages. Another source of bias occurs when relevant economic variables are systematically omitted, or from errors in fiscal variables induced by systematic errors in economic variables (output gap, price variables, GDP volatility) through estimated tax/spending elasticities (see Feenberg et al. 1989; Cassidy et al. 1989; Keereman 1999; Melander et al. 2007; Artis and Marcellino 2001; Strauch et al. 2004).

In short, there are three types of errors: policy errors, economic errors and technical (behavioural) errors (Auerbach 1995). Policy errors are due to errors on the course of fiscal policy, owing to the implementation of new, not yet announced by the forecast cut-off date, fiscal policy measures or cancellation of the previously announced measures. Economic errors are those that can be explained by wrong forecasts of macroeconomic variables that are used in the budget projections (GDP, interest rates, inflation). Finally, technical errors would be due to other factors.

2.4 The fiscal time frame

The forecasting horizon is divided into short-term, medium-term and long-term forecasts. Short-term budgetary forecasts normally cover a time period of up to one year. Medium-term budgetary forecasts cover a time period of 2 to 5 years. Long-term budgetary forecasts covering a period beyond 5 years and up to several decades aim to estimate the budgetary pressures stemming from population ageing particularly in the areas of pension related expenditure and healthcare.

The need for placing the annual budget process in a medium- and long-term perspective goes back at least to the 1950s literature on development planning. In more recent times, medium-term expenditure forecasting was pioneered by the United Kingdom, particularly with the Thatcher

Government's Medium Term Financial Strategy. Australia was another pioneer who led developed countries in reforms to control expenditure growth. Australia's 'forward estimates' approach aimed at strengthening the link between government policy and expenditure programs and improving the affordability of policies, by combining projections methods with institutional arrangements to enforce outcomes.

3. Forecasting of expenditure in Jersey

3.1 The Jersey context

The majority of the academic literature has been concerned about fiscal forecasting in the developed world and there is less written on small island states, and next to nothing on developed small island states.[13] Although some academics acknowledge that income and expenditure forecasting in developed small island states shows similarities to their larger mainland counterparts, there are clearly additional issues, particularly in relation to the formulation of fiscal policy, which policymakers have to consider.

In relation to Jersey, the Comptroller and Auditor General (2008a, p. 16) has highlighted a number of issues which are worth noting because they form a backdrop to the wider debate about fiscal forecasting:

- The States of Jersey is both a central and local government authority and its range of activities is much broader than those which would be attempted by a local authority in a larger developed country.
- The Island's population is relatively small. As such, for many services the population is smaller than would be considered necessary elsewhere to maximise the efficiency of services or justify the creation of separate infrastructure and administrative structures.

[13] The literature has examined developing small island states, for example Smith (1987), McKee and Tisdell (1990) and Purfield (1995).

- The small population have to bear the overhead cost of creating a government structure which in many developed countries would be borne by a much larger population.
- The Island is more remote than a mainland authority. As such, the Island is not able to depend upon the provision of timely support from neighbouring authorities. The result of this is that the Island has to consider maintaining reserves of equipment and material in order to deal with exceptional emergencies. In turn, this will have the effect of increasing the cost of the service involved.
- Although the Island uses the same currency as the mainland of the United Kingdom, there is evidence that the purchasing power of sterling on the Island is lower than on the mainland because supply costs and mark-up is higher. The result of this is that unless allowance is made for the difference in purchasing power, the Island's services will appear more expensive than similar services provided by a mainland authority in the same manner.
- The geographical separation of the Island makes recruitment of staff more problematic and potentially more expensive than for a mainland developed economy.
- The limited recruitment market in the Island tends to lead to rapid inflation in earnings so that remuneration levels in the Island exceed those in many developed economies.

3.2 Is the growth of public expenditure really 'out of control'?

On the 25th June 2008, one longstanding critic of States' spending, Kevin Keen, wrote a letter to the *Jersey Evening Post* in which he noted that 'the States seem to have as much chance of controlling their expenditure as getting Paris Hilton to give up partying. Why? In my opinion, the reason is pretty much the same for both Miss Hilton and our government. They both have too much money'.

As noted in the introduction, even with the reforms which have been undertaken since the early-2000s, this sentiment is frequently expressed, not only in the pages of the local newspaper, but in any number of conversations across the Island. However, there are two issues here which need separating. The first is the *amount* of expenditure by the States and how this has grown over time and secondly, the ability to *control* expenditure, of which forecasting plays an important role.

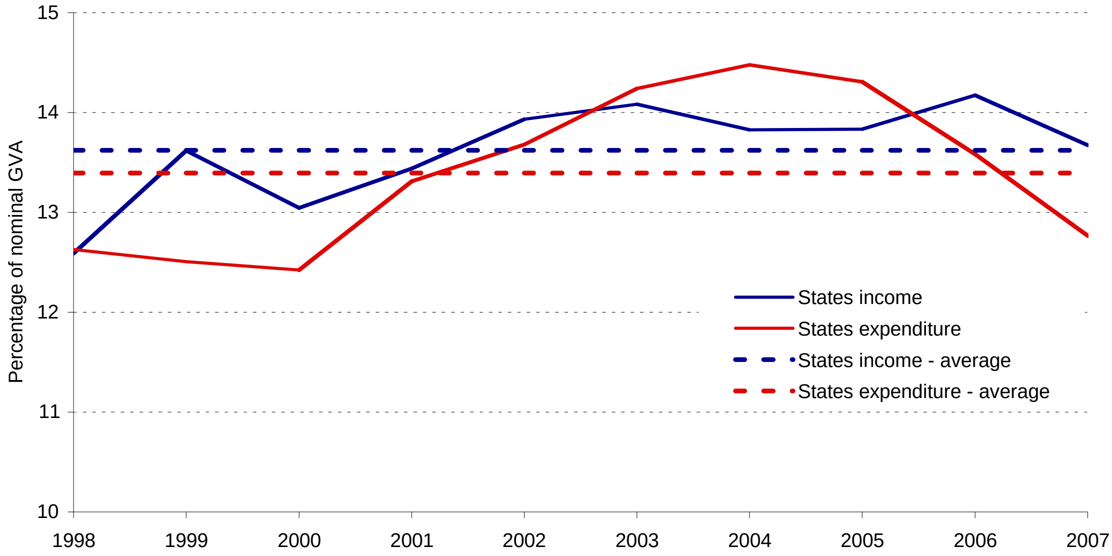
The points made above by the Comptroller and Auditor General are prescient, because they reflect the commonly held view that expenditure forecasts have grown to absorb unexpected revenue income and the largesse of States expenditure means that it is also poorly targeted, which includes, *inter alia*:

- There are too many public employees.
- Public employees enjoying salaries which are around 40% higher than their UK counterparts.
- Money is wasted on administration.

How is it possible to quantify this perception? Moreover, how does expenditure in Jersey compare to other small island states? As noted in section 3.1, it is difficult to find comparable data on small island states, but a 2008 IMF working paper, which examined big government, high debt, and fiscal adjustment in small states, is illuminating (Medina Cas and Ota 2008). Their study employed the definition of a small state as countries that have a population of about two million or less and of their 42 country sample, 26 were islands. These countries represented a range of income levels (from low income to high income), external indebtedness (low to severe) and as Appendix A shows, had public debt ranging from 5.3% of GDP to 385.4% of GDP and total government expenditure ranging from 19.5% of GDP to 68.4% of GDP.

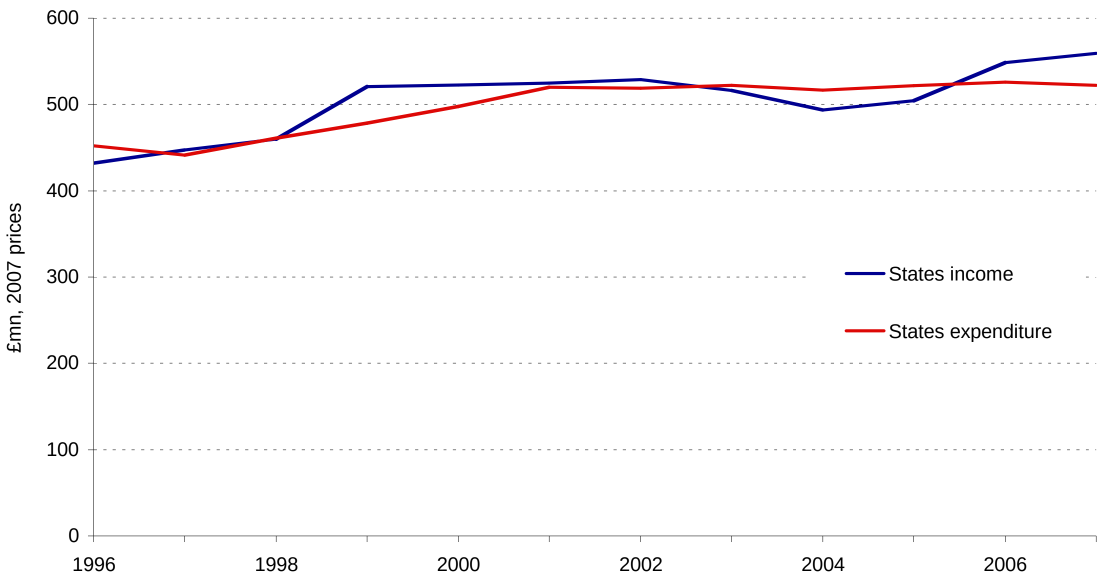
On the basis of these figures, Jersey is a paradise. There is no external indebtedness and there is currently no public debt. In terms of the amount of expenditure in Jersey, Figures 1 and 2 highlight the fact that (i) the average level of States expenditure is a little over 13.5% of GVA; (ii) that although it did grow particularly fast between 2000 and 2005, expenditure has now fallen back to the 2000 level (as a percentage of nominal GVA) and (iii) in real terms, States expenditure has been better managed over the last three years.

Figure 1. States income and expenditure as share of GVA, 1998-2007



Source: Treasury and Resources, FPP Annual Report and Statistics Unit.

Figure 2. States income and expenditure in real terms, 1996-2007



Source: Treasury and Resources, FPP Annual Report and Statistics Unit.

All of this begs the question as to why it is perceived that expenditure in Jersey is too high and is often described as ‘out of control’. As White (2007) has observed, the more general usage of the term implies that public expenditure has grown too rapidly with the experience in the private sector and as a proportion of GVA. If it could be shown that the CoM are powerless to arrest the growth, then it would be correct to describe public expenditure as ‘out of control’. In a stricter sense, ‘out of control’ can be used to describe the phenomenon where the level of expenditure outlined in the annual Business Plan exceeds what was planned. In this sense, public expenditure would be ‘out of control’ if it could be shown that where outturn exceeds, or is less than planned expenditure, this was not the result of explicit policy changes approved by Ministers, whether announced or not.

On this basis, Figure 3 is instructive as it illustrates actual versus forecast Gross Revenue Expenditure (GRE) between 2000 and 2007 and shows how budgets were revised, as the relevant financial year drew closer. For example, for the year 2000, numbers represented on the graph were taken from the following documents:

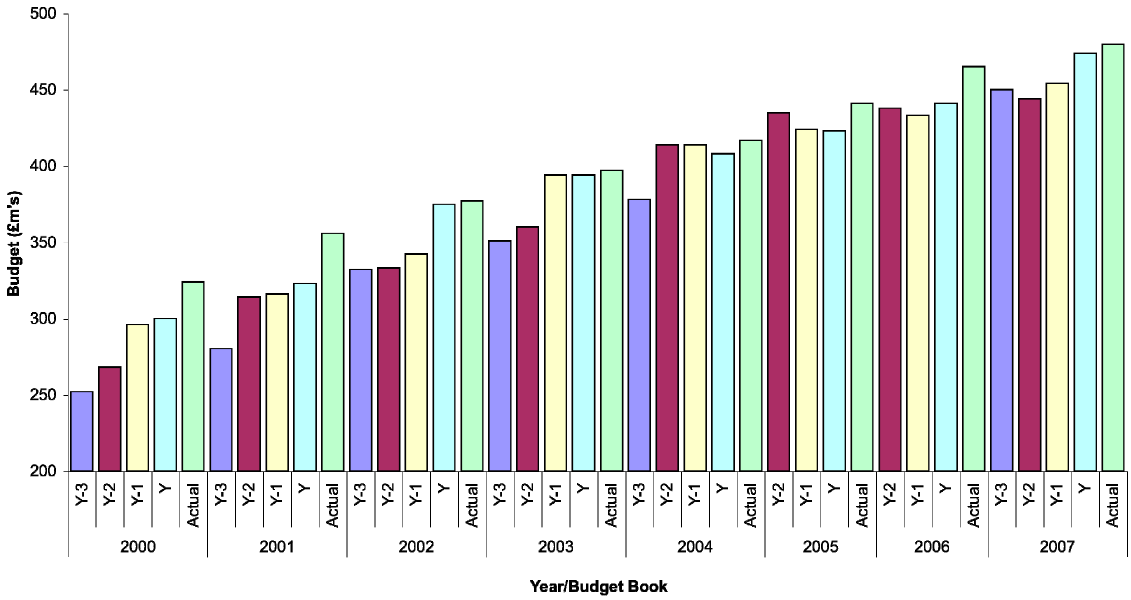
Y-3 = budgeted amount for 2000 GRE, as found in the 1997 Budget,

Y-2 = budgeted amount for 2000 GRE, as found in the 1998 Budget,

Y-1 = budgeted amount for 2000 GRE, as found in the 1999 Budget,

Y = budgeted amount for 2000 GRE, as found in the year 2000 Budget.

Figure 3. Actual versus forecast Gross Revenue Expenditure, 1997–2007



Although Figure 3 illustrates the enormous increase in expenditure over this period, there has been a considerable progress in adhering to spending plans in recent years.

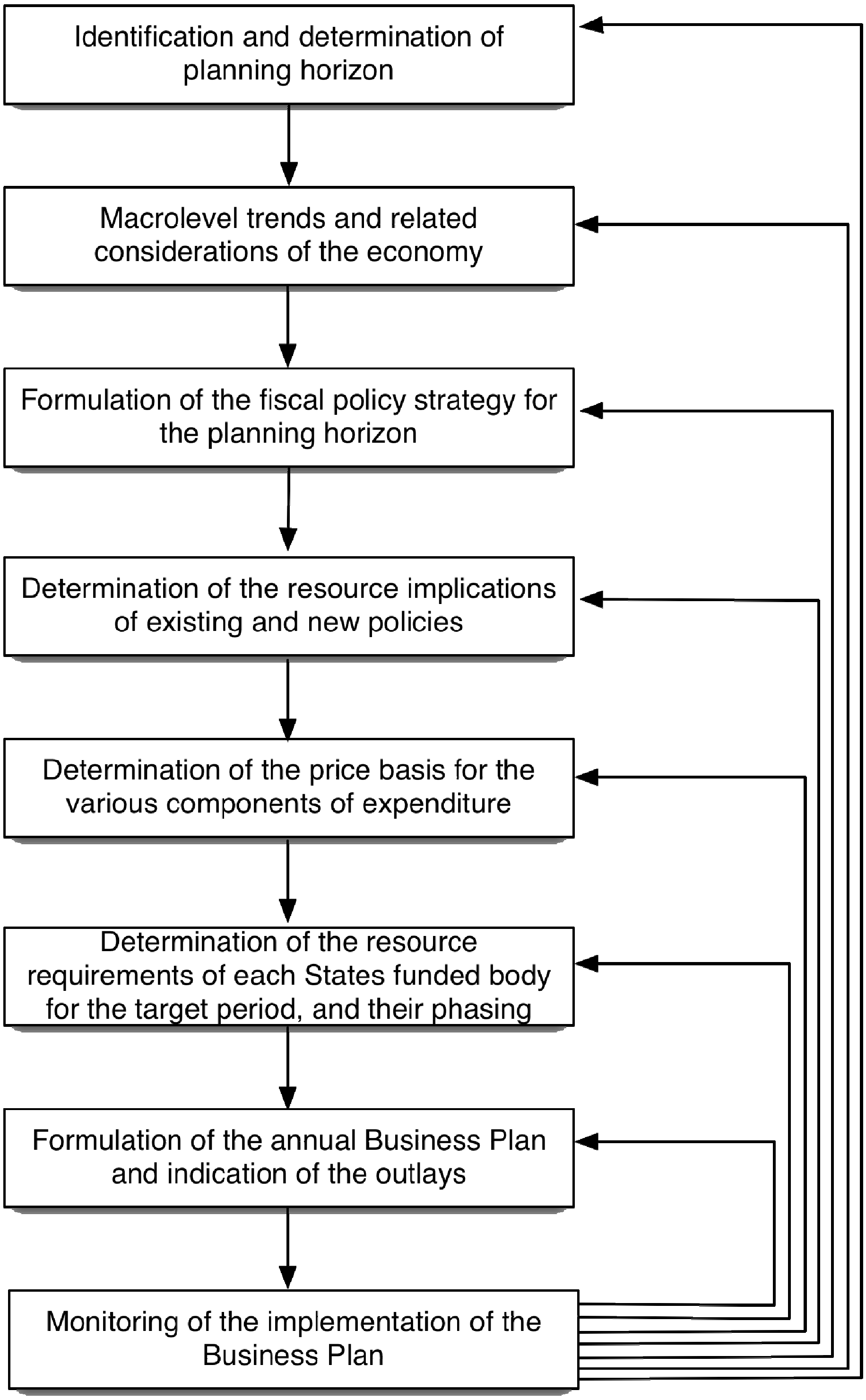
Where poor forecasting or underestimating leads to unanticipated increases in the price of materials or labour costs and departments have not been apprised of that fact early enough for them to decide whether or not to approve the additional cost of financing a planned volume of service, then in those circumstances there may be a 'loss of control' in the stricter sense. As witnesses have attested, it is not easy to distinguish changes which should be counted as policy changes and those changes due to under-estimating.

3.3 The expenditure planning and forecasting process

For the revenue forecasting process there is a Forecasting Group which comprises seven officials: the Comptroller of Income Tax, the International Affairs Adviser, the Treasurer of the States, the Director of International Finance, the IS/Finance Director, the Economic Advisor to the States and the Head of Financial Planning. There is no similar group for expenditure forecasting and the Treasury drives this process. There are only 10 staff in the Treasury which deal with all States investments, States accounts, the annual Business Plan, the Strategic Plan, answering all States questions, all the comments on propositions, States financial standards and States financial directions.

The Panel was briefed by the Head of Financial Planning on the issues surrounding financial planning and reporting (Appendix B summarises this process). Figure 4 captures the iterative nature of the expenditure planning process. Each of the elements reflects a group of complex activities, and their apparent simplicity is deceptive. As has been discussed in Section 2, the quantification of each aspect and the choices faced at each juncture gives rise to several technical issue, not all of which lend themselves to quick, easy or durable solutions.

Figure 4. Schematic Presentation of Expenditure Planning Process



Section 3.4 describes what can go wrong with this process, but attention should be drawn at this stage to the annual Business Plan in box 7. The annual Business Plan outlines the ultimate level of spending in terms of cash

limits. However, there are three problems with the Business Plan process. First, each States funded body prepares its resource requirement for the next financial year at the beginning of the previous financial year. This opens up the possibility of departments revising their budgets to match administrative changes over the course of a year and invariably encourages some degree of 'horse trading' as departments take advantage of budgets transfers to debate the true cost to be transferred.

Secondly, the Business Plan includes expenditure forecasts for a four or five-year period, which gives the impression that there is a medium-term framework for policymaking. This is simply not the case. For example, an estimate of an expenditure outturn for December 2008 is based on initial forecasts written in July 2003 but over that five-year period a number of events will disrupt that prediction. As the Treasury and Resources Minister noted in testimony to the Panel, the future forecasts reflect 'the Treasury's desirable expenditure cap' and 'the fact that they have always been breached indicates that there is a disconnect between what the Treasury would like public expenditure to be capped at in years going forward and the political realities of the year before and the pressures that then weigh on the shoulders of the Council of Ministers … that then decide to spend more money, of which we have absolutely no power apart from the power of persuasion'.

To be sure, the choice of the appropriate period for expenditure planning does present a big dilemma for policymakers. Although the next fiscal year might be the ideal choice, purely because of the limited time between the forecast and the actual occurrence, it might be too short to control the endogenous factors of expenditure growth.[14] Five-year forecasting periods may, in fact, be considered too short (e.g. energy, retirement and education policies) and perhaps it would be appropriate to forecast over period that synchronize with the long-term activities of the States.

Finally, according to the analysis of the Comptroller and Auditor General submitted to the Panel, the annual percentage increase of net revenue expenditure shown in the 2009 Budget's forecasts for the years 2009-2013 appear to have assumed a common rate of annual increase with relatively little variation (which he describes as 'normal practice'). It is unclear why a general percentage increase is assumed year on year.

3.4 What goes wrong with forecasts of expenditure?

Clearly, there is enormous pressure within the Treasury to get the expenditure forecast right. So what goes wrong, if anything, with the process? In a briefing to the Panel, Chris Haws noted that there were six factors which caused expenditure forecasts to deviate:

1. Economic assumptions are wrong (e.g. rates of pay/ levels of benefits);
2. Departments identify additional spending pressures without offsetting savings;
3. New priorities are identified and agreed without offsetting savings;
4. 'In principle' propositions from Members approved by the States which are later included in Business Plans (e.g. winter fuel).

[14] This point echoes that made by the Comptroller and Auditor General in his June 2009 report 'Financial management in the States', page 6.

5. Urgent unforeseen expenditure (e.g. Historic Child Abuse Enquiry).

6. Amendments to proposed Business Plan (e.g. nursery education).

The formulation of the fiscal policy strategy (box 3 of Figure 4) needs to take into account the outlook for the economy and its implication for expenditure, as well as the autonomous factors contributing to the growth of expenditure and their impact on the economy. The determination of the outlook for the economy involves assessment of developments in the domestic and external economies, the rate of inflation, the growth of the economy, productivity, developments in wage rates, and overall domestic economic activity. The purpose of the economic outlook in a narrow context is to ensure that the overall implications of fiscal policy in general, and expenditures in particular, are consistent with the macroeconomic plan of the economy. The projections for the economy would establish the broad framework within which to determine the policy guidelines of expenditure forecasts. However, by their very nature, projections for the economy may not be precise and need modification; depending on the seriousness of the error, it is then likely that a number of modifications will have to be made to expenditures.

As the previous report on the forecasting of income made clear, there have been concerns about how the economic forecast for Jersey is put together and how the economic outlook is formulated. Currently, the Economic Adviser primarily feeds inflation assumptions going forward into the overall expenditure process. Although there is more optimism in the Treasury over the past year that the macroeconomic trends in terms of GVA are better understood, more work needs to be done on exploring the relationship between the components of expenditure and the overall economy. For example, it became clear from testimonials during the Fiscal Stimulus Package that factoring in employment and unemployment trends (and the linkage to income support claims) was not well developed.

The problems with the collective bargaining process in Jersey are well known. A great deal of uncertainty exist around wage bargaining, primarily because the cash limits include pay at the Retail Price Index (RPI) and if both sides settle above RPI than there is a need to find additional money. The bargaining process and the outcome depends on political factors: invariably there is tough talking from both the unions and the States of Jersey but frequently, the States' commitment to hold down pay awards has been surpassed by the unions.

Items (2) and (3) on the above list suggests that something might be wrong with the anatomy of original expenditure plans. Ideally, expenditure forecasts could by formulated to show (i) the present level of expenditure; (ii) additional expenditure to provide the same service in future, e.g. to maintain a pupil/teacher ratio in educational institutions and (iii) additional expenditure if the service is to be changed. Whereas elements (i) and (ii) can be described as existing policy, (iii) can be defined as a new policy. There is a danger in Jersey that distinctions between existing and new policies is often not clear and may be blurred depending on the nature of the sector and the degree of political expediency. Indeed, items (4) and (6) are entirely political and cannot be accounted for in the expenditure forecast. One senior official went so far as to admit that the forecasting process:

> … is more about factoring in political decisions, what the political trends are, and then if anybody can guess what the political decisions are over the course of 12 months that are going to impact on spending then they are going to be better than any sort of economic relationship you can find.

Item (5) urgently needs addressing, and a recommendation will be made to address this in the next section.

There is one further item which perhaps should also be listed, namely on the capital side, where estimates of how much a project can cost can be under-estimated. In the past, the States frequently failed to estimate the cost of capital projects sufficiently accurately (e.g. the Airport). In recent years, the Treasury has become more risk averse and capital expenditure does appear to have been better managed.

4. Recommendations

Clearly, expenditure planning and forecasting are intertwined. Planning implies the formation of the goals and policies, and forecasting is a prediction of the future:

> Forecasting does not automatically produce a plan, but the process of forecasting provides an opportunity for decision-making. Forecasts are sometimes more than mechanical projects, as they reflect a design. Both planning and forecasting, therefore, are parts of the budget and generally take the form of rule-of-thumb projections.
>
> (Premchand 1983, pp. 204-5)

Current processes are inherently incapable of planning public finances effectively, because whilst Treasury officials have the responsibility for producing adequate information and advice on which spending decisions are made, and the CoM has responsibility for bringing spending proposals to the States, under the system of government in Jersey sole responsibility for approving expenditure lies with the States, so it is only the States that can ensure financial plans are adhered to. Under the present system, not only is accountability diffuse, but there is no single point at which priorities are determined, which makes expenditure prioritisation impossible. Moreover, whilst the CoM are required to assess the full resource implications of their proposals, individual States members can bring forward, and gain approval to, uncosted initiatives.

While the strengthening of the business planning process has been a welcome development of recent years, it does appear that the Business Plan tend to overlook some pressures which could reasonably have been foreseen.

There is a failure to identify the full resource implications of initiatives and whilst there has been considerable progress made in integrating legislation and capital projects into the business planning process, the failure to undertake proper cost benefit analysis on legislation, capital and other projects needs to be addressed.

Recommendation 1

To end the 'blame culture' which was outlined at the beginning of this paper, there should be a proper debate *now* about the future growth of public expenditure (i.e. before the next election cycle) in Jersey. Politicians should instigate an immediate dialogue with the electorate and raise questions such as 'do we want a low tax economy?' or 'do we want higher public expenditure?' The implications of these questions should be clearly spelt out (i.e. less expenditure will result in less taxes; more expenditure will result in higher tax which in turn is formed by projections of economic growth, etc). This debate needs to be undertaken at a States assembly level and not at CoM level, although in the first instance it should be instigated by the CoM. Politicians need to be transparent with the electorate about their ambitions: this is not a technical exercise although to do it would require some important long-term projections about the future state of the public finances.

Recommendation 2

It is the easiest thing in the world for a government to spend money, but far more difficult to cut back on expenditure. The forecast structural deficit presents an opportunity to cut public spending and not increase it. Given the backdrop to the structural deficit, it is fanciful to hope that efficiency savings alone will deliver structural change to the public finances. Instead, efficiency savings will only offset savings to deliver what the CoM want to do in the Strategic Plan (in other words, expenditure increases). It is important to recall the Comptroller and Auditor General's (2008b, p. 7) report on the last round of efficiency savings, where 'at the same time as reductions in expenditure were being targeted, substantial increases in expenditure were also being approved. In other words, a major re-direction of resources was being planned'.

Recommendation 3

If Recommendation two is a recommendation too far, it would be worth considering having specific goals on public expenditure, e.g. a constant revenue/GDP and expenditure/GDP ratios or constant expenditure in real terms.

Recommendation 4

<u>Fiscal policy has to be made in a more meaningful medium-term framework</u>. This would imply setting tough three-year cash limits and the States should formally approve the Business Plan spending totals which would then be adhered to by everyone. If an emergency comes up, then a department has to absorb it within existing spending totals. Once the States has agreed that level of spending, the CoM must keep within it, making difficult decisions to reprioritise where necessary. On this basis, the only time the CoM should propose spending in excess of agreed limits is when recommended by the Fiscal Policy Panel as a counter cyclical measure. The Comptroller and Auditor General (2009, p. 9) has also urged the development of medium term

financial planning centrally, which would allocate responsibility for overall expenditure control. This leads to Recommendation 5.

Recommendation 5

<u>The Treasury is currently woefully understaffed and this should be addressed as a matter of urgency</u>. In order to increase the accuracy of forecasting revenue and expenditure and to encourage long-term thinking (which is currently lacking), there should also be a discussion on whether a Corporate Centre Intelligence Unit would facilitate improved strategic thinking.

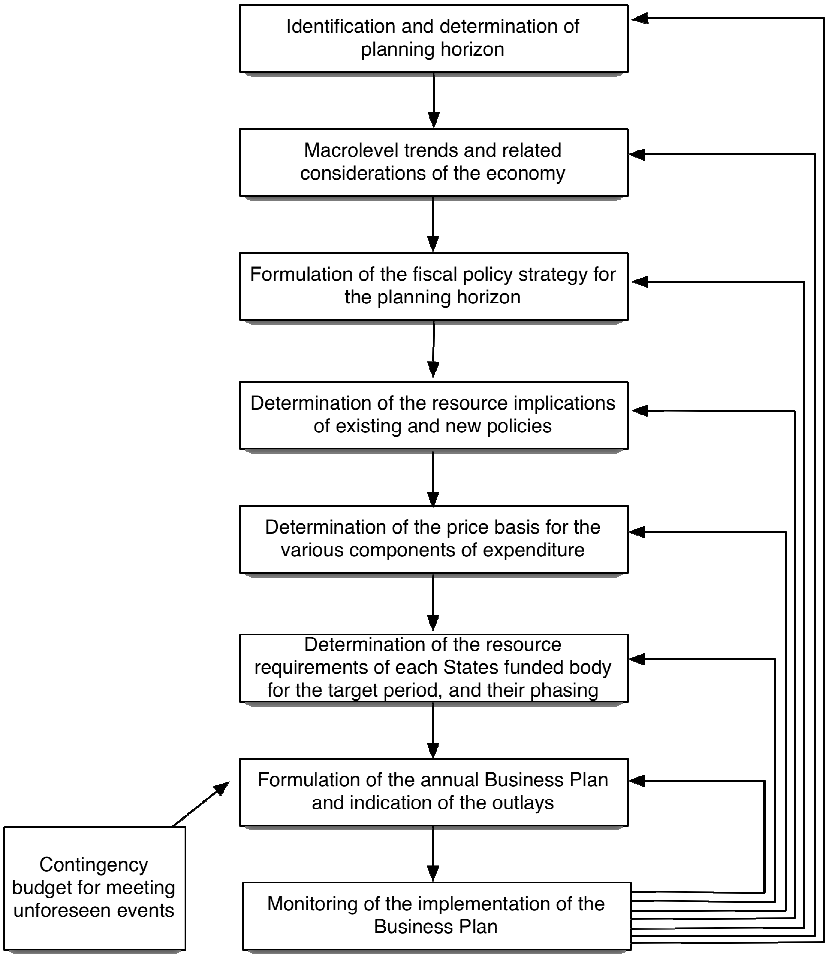
Recommendation 6

<u>The Strategic Plan needs to have a firmer link to the annual Business Plan</u>. It was noted above that there are problems with the Business Plan process, but it would also be fair to say that in the past, there have been problems with the aspiration in the Strategic Plan. The first Strategic Plan in 2006 was not fully costed and arguably, after it was approved it became a device to lever-up expenditure. The Strategic Plan should show up in the annual Business Plan with harder assumptions about economic variables.

Recommendation 7

<u>There should be a contingency budget introduced for unforeseen emergencies</u> (see Figure 5). This would avoid returning to the States every time the unforeseen happens with the likelihood the States will overspend its budget and run unplanned deficits.

Figure 5 . Schematic Presentation of Expenditure Planning Process with contingency budget added



Recommendation 8

It appears that a very small number of material budget items (e.g. supplementation and major demand led benefits, such as income support) cannot be controlled by departments, and <u>a debate needs to take place whether material demand led spend be placed outside cash limits</u>.

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Appendix A. Fiscal Indicators and Vulnerability in Small States

Table A3 . The Size of Government and Public Debt in Small States
(Percent of GDP; average 2000-2004)

		Expenditure subcategories				
	Total Expenditure	Capital	Wages & Salaries	Goods & Services	Transfers & Subsidies	Public Debt[1]
Antigua and Barbuda	29.4	3.7	11.9	6.0	3.4	129.7
Bahamas, The	19.5	2.4	9.3	4.1	1.8	33.5
Bahrain, Kingdom of	28.6	6.3	13.8	4.4	2.7	32.8
Barbados	37.3	5.5	12.3	3.9	10.8	83.4
Belize	32.1	11.6	9.4	3.6	1.5	90.6
Bhutan	43.5	23.9	7.3	9.0	2.3	67.0
Botswana	38.3	10.2	9.6	n.a.	n.a.	7.0
Cape Verde	35.5	11.8	10.6	1.0	6.6	89.7
Comoros	21.2	4.8	7.8	4.9	1.2	95.5
Cyprus	38.0	3.7	9.8	3.0	7.8	102.9
Djibouti	30.4	4.8	14.3	7.0	3.9	84.9
Dominica	41.3	9.3	15.6	5.2	5.7	112.7
Equatorial Guinea	19.4	9.4	1.5	1.4	1.4	19.1
Estonia	35.9	3.1	7.5	13.5	11.5	5.3
Fiji	30.3	5.2	11.8	4.3	4.5	47.4
Gabon	25.1	3.9	6.2	4.0	3.8	65.5
Gambia	27.6	9.7	5.1	4.2	2.5	226.9
Grenada	36.6	13.6	10.7	3.9	4.5	87.6
Guinea Bissau	41.6	13.5	8.6	4.7	4.2	385.4
Guyana	45.6	12.5	11.3	7.3	7.1	185.4
Jamaica	35.7	2.1	11.8	n.a.	n.a.	127.2
Lesotho	45.0	9.0	14.3	19.3	6.9	87.7
Maldives	37.1	12.2	6.5	17.4	0.4	44.0
Malta	45.9	5.6	n.a.	n.a.	n.a.	85.5
Mauritius	25.1	4.0	6.5	2.1	8.4	72.5
Micronesia	68.4	11.5	24.8	27.4	3.7	32.6
Namibia	35.0	4.4	15.1	6.2	8.0	26.9
Papua New Guinea	31.9	9.7	9.3	5.3	1.8	66.5
Qatar	30.2	5.5	7.5	n.a.	n.a.	46.6
Samoa	37.2	13.5	8.6	n.a.	n.a.	59.8
São Tomé & Principe	68.0	31.1	8.3	7.4	6.1	297.6
Seychelles	51.3	7.1	14.5	9.9	12.5	181.7
Slovenia	43.8	2.5	9.4	7.7	19.1	28.5
Solomon Island	35.2	10.0	10.1	5.7	2.2	99.4
St. Kitts and Nevis	44.9	10.8	15.1	8.8	3.7	160.3
St. Lucia	29.3	7.7	11.0	3.9	4.4	55.7
St. Vincent & Grens.	33.2	6.2	13.9	6.0	4.5	71.1
Suriname	36.6	3.3	13.9	10.5	6.5	59.5
Swaziland	32.2	7.1	11.5	7.6	4.8	21.7
Tonga	28.0	1.7	12.3	8.4	2.2	67.4
Trinidad and tobago	25.0	1.8	7.1	3.0	9.0	31.8
Vanuatu	24.1	4.0	11.5	4.6	2.4	38.6

[1] In Botswana, Comoros, Equatorial Guinea, Guinea Bissau, and São Tomé, there was no domestic debt data, so total public debt equals total external public debt.

Sources: National authorities, and IMF staff estimates

Appendix B. Financial Planning Cycle