STATES OF JERSEY

ESTABLISHMENT OF A STABILISATION FUND AND POLICY FOR STRATEGIC RESERVE

Lodged au Greffe on 24th October 2006
by the Minister for Treasury and Resources

STATES GREFFE

PROPOSITION

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

to refer to their Act dated 20th April 2005 in which they approved the Economic Growth Plan and agreed, *inter alia*, that proposals for a counter-cyclical Stabilisation Fund should be brought forward, and to their Act dated 27th June 2006 in which they approved, in principle, the States Strategic Plan and agreed, *inter alia*, the establishment of a Stabilisation Fund and the need for a new policy for the Strategic Reserve; and

1. to agree, in accordance with Article 3(3) of the Public Finances (Jersey) Law 2005, that a special fund, to be known as the Stabilisation Fund, be established, with –

   (a) the purpose of the Fund being to make fiscal policy more countercyclical and create in the Island a more stable economic environment with low inflation;

   (b) the Minister for Treasury and Resources to be responsible for proposing to the States the transfers between the Consolidated Fund and the Stabilisation Fund having regard to the advice of a new independent Fiscal Policy Panel appointed by the States on the recommendation of the Minister and following advice from the States Economic Adviser; and

   (c) the fund to be set up with the transfer of the £32 million surplus funds currently available from the Dwelling House Loans Fund.

2. to agree that the Strategic Reserve Fund, established in accordance with the provisions of Article 4 of the Public Finances (Jersey) Law 2005, should be a permanent reserve, where the capital value is only to be used in exceptional circumstances to insulate the Island's economy from severe structural decline such as the sudden collapse of a major Island industry or from major natural disaster.

MINISTER FOR TREASURY AND RESOURCES

REPORT

A new fiscal framework for Jersey

Summary

This paper develops a new fiscal framework for Jersey as required by the Economic Growth Plan and following the States' decision to create a Stabilisation Fund earlier this year during the Strategic Plan debate.

The objectives in setting up this new framework are to –

- Contain inflation.
- Maximise the economic potential of the Island.
- Create an effective macroeconomic policy framework that can improve economic stability in a small island in a currency union.
- Put in place a transparent and credible framework that is both pragmatic and clear to all.
- Make fiscal policy overall more countercyclical and manage the revenue streams from the financial services industry in a manner that enhances economic performance.
- Make provision for review of the framework as experience is gained in its operation in order that it can be strengthened and improved.

The paper illustrates that to date States economic policy has not operated in such a manner and puts forward the following key recommendations to focus policy on meeting these objectives:

Strategic Reserve

1. The Strategic Reserve should be clearly put to one side and the capital value only used in exceptional circumstances to insulate the Island from severe structural decline (such as the sudden collapse of a major Island industry) or major natural disaster.

2. Over the medium and long-term continue to grow the Strategic Reserve (as a proportion of government spending and GDP) through reinvesting the return on the reserve and where possible paying in part or all of fiscal surpluses from the Consolidated Fund.

3. A suitable long-term aspiration is to grow the Strategic Reserve by another £100-£120 million, to a minimum level of around £600 million, so that it equates to about 20% of GDP.

Stabilisation Fund

4. The purpose of the Stabilisation Fund will be to make fiscal policy more countercyclical and create in the Island a more stable economic environment with low inflation.

5. The final decisions on what proposals are to be taken to the States for taxation and spending and withdrawals from/or payments into the Stabilisation Fund would continue to lie with the Treasury and Resources Minister. The Fiscal Policy Panel's report and advice would though be made public to ensure a transparent and credible process.

6. Establish an independent panel of leading economists to form the Fiscal Policy Panel and for them to publish an annual report in early September each year covering their views on economic conditions and

the States' finances. The report would comment on the need for running surpluses/deficits and whether funds could be withdrawn from/paid into the Stabilisation Fund.

7. The Treasury and Resources Minister would have the option of asking for an additional report/update at any point in the year should he/she feel that economic conditions have changed significantly to potentially merit a different approach.

8. Panel members will be appointed by the States on the recommendation of the Minister and following advice from the States Economic Adviser. They will be appointed on a fixed 3 year basis with the contract being open for renewal by the States on the recommendation of the Minister for Treasury and Resources and following further advice from the States Economic Adviser.

9. A suitable target level (guideline rather than a cap) for the Fund would be 15-20% of total States net expenditure, equivalent in today's money of £75-£100 million. This would mean a further £40-£70 million will be needed on top of the £32 million transfer from the Dwelling House Loans Fund to meet this target level in coming years.

10. Once the framework has been established and is in operation its effectiveness should be reviewed by the Economic Adviser (seeking input from Fiscal Policy Panel members and the Treasury and Resources Minister). It is important that as experience is gained in the operation of the framework then where possible it is strengthened and improved. Developing the right macroeconomic policy framework for Jersey will be a process of evolution but implementing these recommendations will be a big step forward for the Island.

A new fiscal framework for Jersey

Introduction

The States Economic Growth Plan (EGP) sets out the importance that macroeconomic stability has in creating the conditions for economic growth and low inflation.

> *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.*

This paper builds on this recommendation in the EGP and sets out the details for such a framework.

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 in, and this involves getting the macroeconomic policy framework right. A volatile economic cycle of boom and bust 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 improving 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 it is the best and in fact only real alternative.

Why a new framework?

With the Island now focused on delivering sustainable economic growth, a prerequisite is that inflation must be kept on target. A new framework is needed to achieve this goal as the current one has failed to keep inflation on target over the economic cycle. In Jersey, the emphasis is on fiscal policy for two key reasons –

- In a currency union where interest rates are set relative to conditions in the U.K., fiscal policy is the only macroeconomic tool the Island has at its disposable. This means it must take into account the impact of interest rates on the economy and set fiscal policy relative to the economic conditions in Jersey.

- The specific nature of the Jersey economy which is dominated by the performance of the finance industry and the revenue it generates. This can mean that when the finance industry is performing

strongly, the higher taxation receipts this delivers can simply feed back into demand in the economy (through higher government expenditure) and create inflationary pressure. The impact is similar to spending windfall gains.

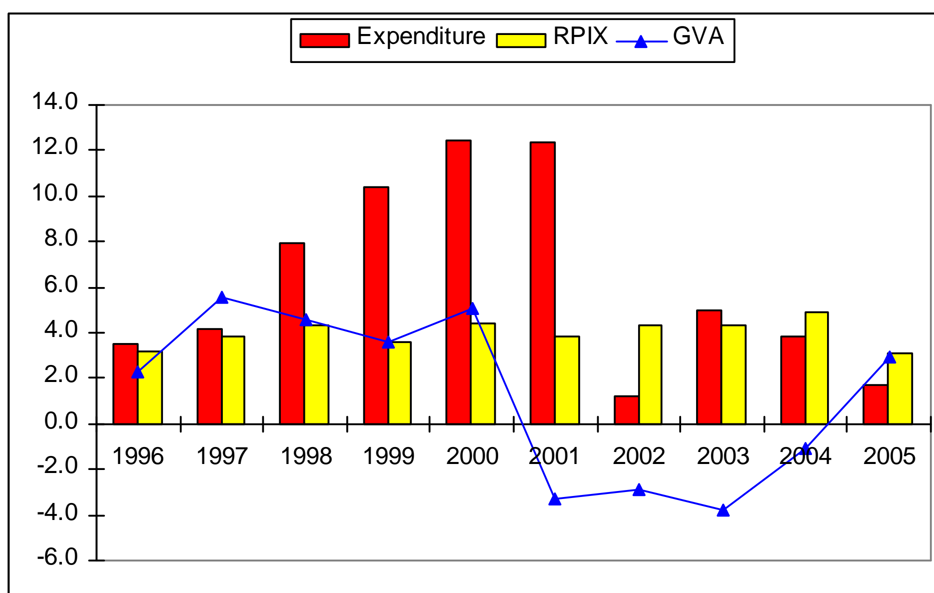
Putting a new framework in place is necessary but not sufficient. Further consideration needs to be given as to how the automatic stabilisers (where tax and expenditure naturally adjust to be counter cyclical) work in the Jersey economy and whether they could be strengthened. Also, how best to use discretionary 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 (SR). There would be little point in running fiscal surpluses if at the same time there were significant draw downs from the SR or vice versa. The other key components of fiscal policy in Jersey are the new Stabilisation Fund (SF) and the balance between States' taxation revenue and expenditure.

Past experience

The chart below shows that in recent times there has been little evidence of a counter cyclical approach being adopted by the States. In fact the opposite holds. When the economy was growing strongly in the late 1990s and inflation was above target the States allowed expenditure to increase strongly. This meant that when the economy slowed in the early 2000s expenditure also slowed and provided further pro-cyclical impact.

Chart 1: Trends in growth, inflation and government spending
% change in States expenditure, RPIX, real GVA



Source: States of Jersey Statistics Unit, Treasury and Resources

It is important to remember that balancing the books in Jersey does not necessarily equate to the government not adding to demand in the economy. For example in 1998, the economy was growing strongly and inflation was above target. This was at a time when the States withdrew £17 million from the SR, States spending grew by 8% but revenue actually grew by 11% allowing the States to run a small surplus of £13 million. The correct approach should have been to contain expenditure growth at a significantly lower rate allowing revenues to be put aside for harder times (which were only 3 years away) and at the same timing helping to contain inflation and sustain economic growth.

The new framework must be designed in such a way that it is able to prevent a repeat of the situation in the late

1990s and early 2000s and ensure that fiscal policy (including the SR) is implemented in a counter cyclical manner.

As already mentioned fiscal policy in Jersey terms should include the approach applied to both the SF and the SR. These are considered in turn below.

The Strategic Reserve

The Strategic Reserve was set up by the States in 1986 to provide the Island with some level of insulation from external shocks. The Public Finances (Jersey) Law 2005 reiterates that the reserve cannot be used for any purpose other than one specifically recommended by the Treasury and Resources Minister and approved by the States.

The SR has not always been used in the way it was originally intended and at different times has 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. Over the course of the 1994-2000 period transfers totalling £57 million were made from the SR to the capital and tourism investment funds. As already pointed out, this was during a period of sustained economic growth and above target inflation.

What is the Strategic Reserve?

In order to make sensible decisions about the use of the Strategic Reserve it is important to consider in a little more detail 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 repay 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 not be around to benefit from the future benefits.
- Strategic Reserve financing is generally *cheaper* than borrowing – by the difference between interest paid on debt and interest/return earned on assets [but can still have the same negative consequences such as increasing inflationary pressure and crowding out private sector activity as outlined below].

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.

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". More recently it has decided to spend at least half of its reserve in meeting the initial impact of their move to 0/10, which could seriously undermine its capability to meet its purpose.

Apart from our competitor offshore 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 State Petroleum Fund (SPF) in 1990 into which oil revenues are transferred. The stated purpose of the SPF 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". Drawdowns from the SPF are governed by long-term sustainability considerations and are approved by Parliament in the annual budget. Financial assets in the fund are expected to reach 120% of GDP 2010.

Another interesting example is Kiribati (a small island in the South Pacific with a population of 100,000). It possesses a sizeable stock of financial assets which are called the Revenue Equalization Reserve Fund (RERF) which was established in 1956 and into which were paid phosphate mining royalties. Although phosphate mining finished in 1979 a tradition of sound fiscal management has allowed Kiribati to increase the financial assets in the fund and by 2000 the fund was worth 800% (eight times) of GDP.

The Kiribati government now faces one of the most volatile revenue bases in the world as it is largely dependent on fishing licence fees and donor grants. As a result since 2000 there have been significant drawdowns from the RERF and as a result the advice of the IMF was sought on a sustainable fiscal framework. The conclusions included a rule that seeks to preserve the real per capita value of the RERF (and therefore permits the use of the real per capita return to smooth Kiribati's extreme revenue volatility) and a smoothing mechanism that requires the budget to build up savings by running surpluses in good times and enabling fiscal policy to offset the bad times.

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 performing strongly (and is close to/above full capacity).
- An unclear framework which allows continual calls for the use of the reserve which waste time and distract attention from other issues.
- Using the reserve but never making repayments.
- Trying to use the SR to meet structural (ongoing) expenditure.
- Funding inappropriate government intervention.
- Inadequate provision for future generations that could face a different life in Jersey.

The Strategic Reserve in Jersey

In 2005 the SR amounted to £456 million which equated to 97% of total States expenditure (the highest it has been since 1998) or about 13% of GVA (14% of GNI and 16% of GDP). The Strategic Plan in 1998 set a broad target of one year's tax receipts but until now payments into it have largely been at the discretion of the Finance and Economics Committee (now the Treasury and Resources Minister) and to some extent by the residual of each years' spending and taxation decisions.

If the SR is to meet its objectives of insulating the Island from a major external shock or downturn then it is important to consider exactly what such an external shock could be. There are two potential causes of such a major external shock: a major natural disaster and severe structural economic decline. Given that the SR is consumption forgone by Jersey residents in the past, care should be taken as to when and how it is used. However, it would be hard to argue that circumstances of natural disaster or severe structural decline would not be an appropriate use of such revenues. If the SR is to really be effective in insulating against such shocks then how large should it be?

Natural disasters

Work done by the IMF shows that natural disasters are becoming much more common. There are two reasons for this: an increased concentration of population in high risk areas and an increase in the frequency and intensity of extreme weather. Small island economies are seen as particularly vulnerable but this largely reflects the incidence of hurricanes in the Caribbean. Developing countries are also much more prone to natural disasters.

Studies have shown that natural disasters tend to be associated with an immediate contraction in economic output, a worsening of external balances, deterioration in public finances and an increase in poverty. From 1970-2002 there were 6,480 incidents of natural disaster. For 2,036 of those there are estimates of cumulative damage which range from 1-132% of GDP but with an average of 21%.

Although there is no reason to think that Jersey will ever face a natural disaster and that even if it did to what extent GDP would fall, if the SR is to really provide some re-assurance and insulation against any such disaster whether it be from weather or bird-flu, then a figure of 20% of GDP would offer some guidance. There are a number of caveats around such a figure (not least that the States may not have to offset the total fall in GDP) but there is always going to be a great deal of uncertainty around trying to determine what funds might be required should a natural disaster hit the Island.

For Jersey to build up its SR to around 20% of GDP would require additional funds in the region of £100-£120 million.

Severe structural decline

A major shock that could emanate in the Island is if one or more of its key industries were no longer competitive and that as a result there was going to be a significant reduction in States revenue, public services and the standard of living. It must be recognised that the SR could only help smooth the transition from the period of structural strength to weakness and is unlikely to be able to alleviate the problem permanently (it would be unsustainable for a fund of a fixed value to meet ongoing commitments from anything other than the real return).

It is important to recognise that the SR would not be used to meet any revenue shortfall brought about by a cyclical downturn (that is the role of the SF). Also that it would not simply be used to meet any form of structural decline – it would have to be significant in nature to the extent that it will manifest itself in a significant fall in States revenue/employment/living standards in the Island.

What would severe structural decline look like? The easy example to consider is what would happen if the financial services industry became uncompetitive for what ever reason and it left the Island? A rough estimate is that it would lead to an initial loss of between £100-£200 million in government tax revenue (depending on whether that was before or after introduction of 0/10). This is before the impact on the wider economy of the loss in financial services is considered, which would be significant and could amount to another £100-150 million loss in tax revenue (and excludes any second round effects from the development of new or existing businesses outside finance). For the Island to have to deal with that and to try to smooth the process out, £450 million is

clearly only a few years worth of insulation against the loss of tax.

What level?

The analysis above shows that at nearly 100% of government expenditure the current level of the SR is significant but there is a great deal of uncertainty as to whether it is sufficient to insulate the Island from structural decline and natural disasters, particularly if both were to occur close to each other, or indeed one was to precipitate the other. Jersey is not alone in having a fund of this nature and a number of countries have built up funds of far greater value (relative to the size of the economy) while there are many others that have squandered such funds (with little to show for it).

But what does this mean for policy for the SR in Jersey? The pragmatic and prudent approach should be to build up the SR further where returns on the fund allow and where economic conditions allow further payments into the fund. This will reduce (but not remove) the probability that the SR is too small to meet its aims. The overarching aim is to continue to build the fund as a proportion of annual expenditure and GDP. The opportunity to make withdrawals such as those made in the second half of the 1990s should be removed.

Until the SF meets its required level (or at times when it needs replenishing) there may be a tension between making payments into the SR and/or SF. To some extent the Treasury and Resources Minister will have to decide which has the political priority. However, where surpluses are the result of cyclical improvement and have been planned to meet payments into the SF then this could take priority. Where surpluses are above those needed to replenish the SF then there would be scope to pay into the SR. The FPP (as discussed below) should also be able to provide guidance as to when is the right time to contribute to the SF.

Policy for the Strategic Reserve in Jersey

It is recommended that the guiding principles for the SR under the new fiscal framework are –

1. The overall aim of the SR is to provide the Island with some insulation from an external shock such as severe structural decline (such as the collapse of a major Island industry) or a major natural disaster.

2. The aim in the medium and long-term should be to continue to grow the SR (as a proportion of government expenditure) through re-investing the return in the reserve and paying in part or all of surpluses from the Consolidated Fund when the economy is performing strongly.

3. A suitable long-term aspiration is to grow the SR by another £100-£120 million, to a minimum level of around £600 million, to equate to about 20% of GDP.

It is possible that the States may decide to sell assets currently outside the SR e.g. privatisation and add the revenue received to the SR. In some cases the income stream from the assets e.g. past dividends may have funded States expenditure. The Treasury and Resources Minister could use this as an opportunity to curtail expenditure (e.g invest the income stream back in the SR). Where the Minister deems that it is not appropriate to do this then it should be possible to transfer the return (preferably in real terms) into the Consolidated Fund (CF). This is the only payment possible (outside conditions being met to use the SR) from the SR to CF. It could be monitored on a strict basis e.g. a privatisation receipts = £10 million, return on SR=5%, either £500k (nominal) or £300k (real approx) can be transferred from the SR to CF to meet expenditure commitments.

Stabilisation Fund

The SF was alluded to in the EGP and is in the process of being set up with an initial payment of £32 million from the Dwelling House Loan Fund (DHLF). This Report and Proposition, presented alongside this year's Budget, will set the rules and principles governing its use. It is worth considering whether there are things to learn from the use of such funds elsewhere.

The international experience

During the 1990s U.S. States created budget stabilization funds to help provide countercyclical 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 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.

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.

The U.K. Treasury has identified the need for a more flexible fiscal regime if the U.K. entered EMU 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 the approach outlined below would give to Jersey.

The IMF's advice to Kiribati stated that the island needed to build up savings in good times to provide a buffer for fiscal policy in bad times so that the government can sustain its expenditures without having to resort to procyclical cuts. Such an approach would allow fiscal balances to expand and contract (breathe) around the long-run sustainable level. They recommend that the mechanism is simple and involves having a benchmark for actual revenue and where revenue exceeds that benchmark the additional revenue should be saved. In years of poor revenue collection the government could draw on the surpluses that it accumulated in earlier years to bring revenues back up to the benchmark.

What level for Jersey?

For the SF to be effective it will need to have sufficient funds to be able to offer some real insulation against an economic down turn. That is not to say that the SF will prevent an economic downturn, just that it would allow funds to be used to either maintain valuable expenditure programmes or reduce taxes that might partly offset some of the negative consequences of a downturn.

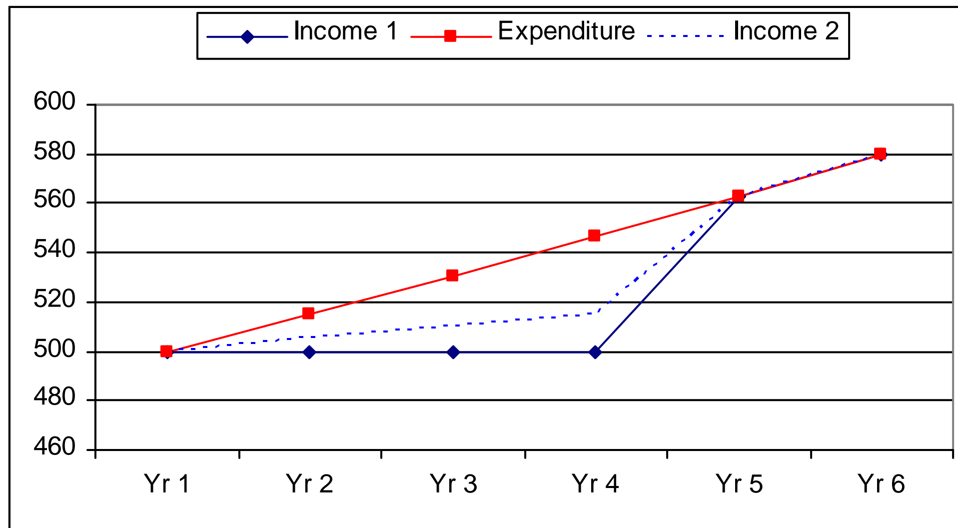
The real question is what is the most suitable level for the SF? The exact same question has been asked in the U.S. where States have their own 'Rainy Day' funds that are in place for this purpose. Research there has tended to point to a suitable level being in the region of 15-20% of annual government expenditure. Is this relevant for Jersey?

It is worth considering what the implications might be of an economic slowdown in Jersey for government income. In 2003 and 2004 States income grew by 1.8% and -0.2% respectively. It is therefore not beyond the realms of possibility that the States could experience for a number of years very weak or in fact no growth in income. Where this was attributable to a cyclical economic downturn there would a case for the States to use the SF to smooth out expenditure and prevent expenditure cuts or tax increases.

It would be useful to consider how this might impact on government finances in Jersey. Take the hypothetical example below looking at an initial scenario where Jersey balances the books in year 1 through to year 6 as

expenditure and income rise in line at 3% per year. Assume that the Island then faces an economic downturn which either keeps income flat in nominal terms (income 1) for 3 years or sees it grow at only 1% for 3 years (income 2) between year 1 and year 4. Assuming that expenditure growth is unchanged and that revenue returns to previously forecast levels in year 5 (see next paragraph) then a deficit opens up of between £60-£90 million or 12-18% of annual expenditure. This coincides with the recommendation in the U.S. that Rainy Day funds amount to between 15% and 20% of annual expenditure.

Chart 2: How a slowdown might impact on government finances
States income and expenditure, £m



Source: Economics Unit calculations

The example above could be considered in certain circumstances to be an under estimate of the deterioration in government finances because it assumes that expenditure grows at the same rate as that expected before the slowdown took hold. It may well be the case that expenditure actually rises at a faster rate during the slowdown e.g. outlays on benefits increase and that the SF would need to have more funds in place to meet these requirements. Similarly it assumes that in Year 5 States income recovers to the previously forecast level. It could well be that in reality income does not return to this level and there is larger deficit to address.

The recommendation is that the target level for the SF should be 15-20% of government expenditure (measured as total States net expenditure). The most appropriate level for the SF is somewhat uncertain and the 15-20% target level should be interpreted as a guideline. It is not a cap and should be seen more as the lower level for the amount of money in the SF and for it to have some real potency in the event of a cyclical economic slowdown. This would suggest that the SF should be built up to level of £75-£100 million.

Operation of the fund

If the target level for the SF is set at 15-20% of expenditure then what would determine whether money should be paid into or withdrawn from the SF? The overall guiding principle should be the prevailing economic conditions. When the economy is performing strongly money should be paid into the SF (and SR) and when the economy is performing more weakly then money should be withdrawn.

There are two ways in which this could happen. The first would be based on fixed rules that indicate when the economy is performing strongly and when it is performing weakly e.g. when States income falls/rises by a certain % or reaches a certain benchmark, employment falls/rises by a certain % or economic growth falls below/above certain rates. The second is that independent economic advisers assess the performance of the economy and advise whether economic conditions justify payments into or from the SF. This could be done through an annual report published at Budget time and which the Treasury Minister could draw on to make his budget decisions and those surrounding the SF.

The nature of the Jersey economy and the information available on it means that it is very hard to devise one or two rules that could be used to govern policy for the SF. While the quality and depth of statistical information is greater than in many small island economies, it is nowhere near as great as in most advanced economies and there is no detailed economic model for forecasting economic performance. It is therefore harder to determine the economic performance of the economy than it is in most advanced countries at any point in time. This suggests that it therefore requires a significant degree of experience and sound judgement to analyse the economic performance of the Jersey economy, its likely direction and the underlying state of government finances.

Experience across the globe has shown that bringing some independence into macroeconomic policy making can improve credibility and effectiveness. Given that in Jersey the only macroeconomic tool available is fiscal policy there is a fine line to tread in terms of bringing more independence into decision making. A balance is needed between giving more weight to independent economic advice (to act as a check on political objectives) but at the same time allowing elected politicians to take the decisions on taxation and spending.

It is for these reasons that it is recommended that the mechanism for determining the circumstances for making payments from and to the SF is through an objective assessment of the economic climate at the time. An independent panel of at least three economists – The Fiscal Policy Panel (FPP) - should be appointed by the States on the recommendation of the Treasury and Resources Minister and following advice from the States Economic Adviser to ensure an independent and transparent appointment process.

How the FPP would operate

The FPP would be commissioned to publish an annual report in early September each year which will set out advice and recommendations for the Treasury and Resources Minister. An Interim Report would be prepared by the end of July each year for the Treasury and Resources Minister which the Minister could use for making decisions concerning the annual Business Plan. The Minister would have the option of asking for an additional report/update at any point in the year should they feel that economic conditions have changed significantly to potentially merit a different approach.

The FPP will be made up of independent economists that the Economic Adviser and Treasury and Resources Minister feel can bring together the right mix of experience and skills. They could be current or ex-Monetary Policy Committee of the Bank of England members, public or private sector economists or academic economists. Panel members will be appointed by the States on the recommendation of the Minister and following advice from the States Economic Adviser. They will be appointed on a fixed 3 year basis with the contract being open for renewal by the States on the recommendation of the Minister for Treasury and Resources and following further advice from the States Economic Adviser.

The FPP's reports should cover such issues as –

- The strength of the Jersey economy.
- Position in the economic cycle.
- The outlook for the Jersey and world economies and financial markets.
- The appropriateness of the States financial position/forecasts given the above.
- A recommendation as to whether this translates into conditions which merit withdrawals from/payments into the SF or if conditions are broadly neutral and there is no need for payments. Where payments are needed the FPP will be expected to give some indication of the scale of payments.
- If withdrawals are to be made what would be the best way to mitigate the economic slowdown – tax cuts v spending increases or indirect v direct tax cuts.

- When the SF may be at sufficient levels and therefore payments made into the SR.

The types of issues covered in the report would be trends in GVA, financial services profitability (and expectations), non-finance business conditions, employment/unemployment, inflation, interest rates and government revenue/expenditure. The Statistics Unit are already planning to expand the amount of information available by producing a quarterly retail sales release and an annual business enquiry.

The States Economic Adviser would not sit on the Panel but would act as Secretary to the Panel acting as its Jersey support – arranging/preparing for meetings, providing the information needed to write the report and arrive at a conclusion. The FPP could draw on any other sources of information that it sees fit and may require. The Economic Adviser would continue to work with the Head of Statistics to improve (where feasible) the amount of economic data available and to meet the data requirements of the FPP.

The current level of the SF

The current level of the stabilisation fund with the initial transfer from the housing loan fund is £32 million which equates to about 7% of 2006 expenditure. If the projected balance in the Consolidated Fund at the end of 2006 was transferred to the SF that would amount to another £43 million which would take the SF upto 15% of 2006 expenditure.

If the CF is transferred to the SF then this would require the States to run a tighter fiscal policy in subsequent years as the CF would be lacking the funds to balance the financial position over the 2007-2011 period. Without such a transfer the SF is insufficient to meet its intended purpose and payments into it would be required. When this is combined with the fact that the latest GVA data shows that the economy was performing strongly in 2005 with real economic growth of 3% (and inflation above target in 2006) it is clear that the current financial forecasts need to be adjusted to take into account payments into the SF, at least for 2006 and 2007.

Policy for the SF

Drawing this analysis together the key principles governing the SF should be –

1. The purpose of the Stabilisation Fund will be to make fiscal policy more countercyclical and create in the Island a more stable economic environment with low inflation.

2. The final decisions on what proposals are to be taken to the States for taxation and spending and withdrawals from/or payments into the Stabilisation Fund would continue to lie with the Treasury and Resources Minister. The Fiscal Policy Panel's report and advice would though be made public to ensure a transparent and credible process.

3. Establish an independent panel of leading economists to form the Fiscal Policy Panel and for them to publish an annual report in early September each year covering their views on economic conditions and the States' finances. The report would comment on the need for running surpluses/deficits and whether funds could be withdrawn from/paid into the Stabilisation Fund.

4. The Treasury and Resources Minister would have the option of asking for an additional report/update at any point in the year should he/she feel that economic conditions have changed significantly to potentially merit a different approach.

5. Panel members will be appointed by the States on the recommendation of the Minister and following advice from the States Economic Adviser. They will be appointed on a fixed 3 year basis with the contract being open for renewal by the States on the recommendation of the Minister for Treasury and Resources and following further advice from the States Economic Adviser.

6. A target level (guideline rather than a cap) of 15-20% of total States net expenditure, equivalent in today's money of £75-£100 million. This would mean a further £40-70 million will be needed on top of the £32 million transfer from the Dwelling House Loans Fund to meet this target level in coming years.

7. Once the framework has been established and in operation its effectiveness should be reviewed by the Economic Adviser (seeking input from Fiscal Policy Panel members and the Treasury and Resources Minister). It is important that as experience is gained in the operation of the framework then where possible it is strengthened and improved. Developing the right macroeconomic policy framework for Jersey will be a process of evolution but implementing these recommendations will be a big step forward for the Island.

The framework in practice

It is necessary to consider in a little more detail how the framework would operate in practice and in particular what the relationship would be between the SF, SR and the Consolidated Fund (CF).

In general terms the CF would operate like a current account being the day to day fund for operating the government's finances. The SF would be the savings account and payments would go to and from the CF under specific circumstances and based upon advice from the FPP. The SR would effectively be the long-term savings account (akin to a pension fund) and would accumulate any surplus from the CF and SF.

Financial and manpower implications

There are no manpower implications of this proposal and the intention is that the costs of the proposed Fiscal Policy Panel will be absorbed within the existing budgets of the Treasury and Resources and Chief Minister's departments.