
STATES OF JERSEY



UPDATING JERSEY'S FISCAL FRAMEWORK

**Presented to the States on 18th July 2014
by the Minister for Treasury and Resources**

STATES GREFFE

Treasury and Resources



Minister's Foreword

Updating Jersey's Fiscal Framework

Background

To assist in responding to the recommendations made by the Fiscal Policy Panel (FPP) in their 2013 Annual Report, the States of Jersey's Economic Adviser has produced a review of Jersey's existing fiscal framework and highlights a number of areas for potential improvement. That report is attached for members' information.

The fiscal framework provides the basis within which policy decisions are made on taxation and spending proposals. This includes:

- The rules governing decision-making, including resource principles, previous States decisions and legal requirements.
- The role and responsibilities of the FPP.
- Procedures and arrangements for the Medium Term Financial Plan (MTFP) and annual Budgets.

Jersey has already significantly improved its fiscal framework in the recent years. The work which has been done includes:

- The creation of the Stabilisation Fund and the FPP in 2006.
- Establishing a clearly defined purpose for the Strategic Reserve.
- Moving from annual business plans to longer term financial planning through the MTFP.
- Placing the FPP and their reporting procedures on a statutory basis.

As Jersey does not have control over interest rates, fiscal policy is a crucial part of our ability to influence our economic performance over the short and medium term. It is vital for future economic performance that we learn from international experience of fiscal frameworks and the experience in Jersey since 2006 to make sure we have the most robust and effective framework.

Some of the key recommendations made in the report are summarised below. The ones covering the Strategic Reserve, Housing Development Fund and Stabilisation Fund have informed the proposals in Draft Budget 2015. As reform should look at all aspects of the framework rather than individual component parts, the review covers proposals for improvements in a number of additional areas. However, the final recommendation is that the advice of the FPP should be sought before further proposals are taken forward to strengthen the framework for the next MTFP.

Key recommendations

The key recommendations set out in the review to strengthen Jersey's fiscal framework are:

1. The MTFP resource principles should be updated so that there is a clear fiscal rule to maintain balanced budgets over the economic cycle:

“The States will maintain balanced budgets over the economic cycle, through countercyclical fiscal policy and with regard to the advice of the FPP. Grounds for deviations from the rule over any period must be agreed by the FPP.”
2. To update and clarify the responsibilities of the FPP to ensure that they assess performance in maintaining balanced budgets against this rule. The review states that they should assess:

“Whether the States are likely to maintain balance budgets over the economic cycle and/or the next five years.

An assessment of whether counter cyclical policy is being operated and if not, the extent to which the fiscal balance should be adjusted to meet this requirement.

Include in their advice the potential impact on the above of the Social Security Funds and any other significant States funds the Panel feel are relevant.

Whether the long-term sustainability of States finances is improving or deteriorating and why.

Whether there are sound economic grounds for deviations from the fiscal rule.”
3. To remove existing confusion about the role of the Strategic Reserve by redefining that role as follows:

“The Strategic Reserve Fund should be a permanent reserve, where the value of the Fund at the end of 2012 is to be protected in real terms (as measured by Jersey RPI) and 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.

An exception can only be made to this rule for the provision of a new hospital, in line with the States agreement P.82/2012 “Health and Social Services: a new way forward”.

In addition, the Strategic Reserve can, if necessary, be used for the purposes of providing funding for the Bank Depositors Compensation Scheme, up to a maximum combined total not exceeding £100 million, if required to meet the States’ contribution to the Scheme and/or to meet any temporary cash flow funding requirements of the Scheme.”
4. To clearly state the rules governing the Housing Development Fund (HDF) to make the purpose of the fund explicit. This should make the distinction between current uses of the fund and the new uses relating to the bond issue, loans to housing trusts/associations and subsequent repayment. The potential flows into and out of the HDF need to be transparent.
5. To strengthen the fiscal framework could by updating and clarifying the role of the Stabilisation Fund as follows:

“The purpose of the Stabilisation Fund is to make fiscal policy more countercyclical and help create in the Island a more stable economic environment. The Minister for Treasury and Resources is responsible for proposing to the States the transfers between the Consolidated Fund and the Stabilisation Fund having regard to the advice of the Fiscal Policy Panel.

Money should be paid into the Stabilisation Fund from budget surpluses when the economy is above capacity and money withdrawn when the economy is below capacity. The Minister must seek advice from the FPP as to when these conditions are met and whether any deviations from this approach are merited by unusual economic or other circumstances.”
6. To improve Jersey’s budgetary framework by adopting FPP recommendations that Budgets should be clear and concise and that every Budget will include:
 - A financial forecast for the current and next 3 years including updated income projections taking into account the latest economic developments, expenditure forecasts and budget measures.
 - Proposed movements on the Consolidated Fund, Stabilisation Fund and Strategic Reserve for the current year and next 3 years.

- Data which shows what happened to these funds in the previous 3 years.
 - A financial forecast showing the surpluses and deficits as adjusted to recognise the economic impacts.
7. To consider further improvements to the way data on States finances is presented. The FPP have recommended that Budget and MTFP data is presented to show when income is received, when it is spent, and the impacts of the States position overall, including Social Security Funds.

The Chief Statistician should be asked to report to the FPP on the benefits, practicalities and resource implications of producing government finance data to an internationally recognised standard for economic accounts.

8. For the States of Jersey's Economic Adviser to seek FPP advice on formalising these proposals so that a robust and effective fiscal framework can be developed before the preparation of the next Council of Minister's Strategic Plan and MTFP begin.



Economics Unit

July 2014

Updating Jersey's fiscal framework

Summary

Introduction

In their 2013 Annual Report the Fiscal Policy Panel (FPP) recommended that the States clearly define the purpose and optimal size of the Strategic Reserve (SR) and set out conditions for its use. In response the Treasury and Resources Minister agreed before Budget 2015 to strengthen the definition of capital within the SR, confirm the role of the Stabilisation Fund (SF) and how it should be replenished and set out the arrangements for the Housing Development Fund (HDF).

All of the above changes would touch on key pillars of Jersey's fiscal framework which has evolved significantly since the inception of the SF and the FPP in 2006. It would be appropriate to also consider at the same time what other aspects of the current fiscal framework need updating, so that any reforms are undertaken within the context of the whole framework, not its individual constituent parts.

This paper uses the following structure to review Jersey's fiscal framework and arrive at recommendations for reform that the Minister can include in his response to the FPP as part of Budget 2015 but also to assist in future reform of the fiscal framework:

- Overview of the States economic objectives
- The experience of the fiscal framework in Jersey over the last 7 years
- International experience and guidance on fiscal frameworks
- Proposals for reform drawing on the above

Key points

1. The States' economic objectives set out in the current Strategic Plan focus on short-term policies of getting people back to work and the medium-term objective of a strong and sustainable economy. This requires economic growth that raises the standard of living and creates new employment opportunities and will need to

be supported by policies that contain inflation. The fiscal framework should be clearly aligned to these economic objectives. The ongoing work on establishing a long-term Island vision for Jersey (Preparing for our future) should help in developing further detail on the longer-term economic objectives.

2. Reviewing the performance of the fiscal framework in Jersey over the last 7 years points to a number of positive outcomes:

- The SF and FPP were both established and in advance of the global financial crisis
- SF was large enough to fund both automatic stabilisers and discretionary policy in the initial years following the global financial crisis.
- The value of the SR has been protected and grown significantly in real terms and as a share of GVA.
- The FPP have advised on key aspects of fiscal policy (including the 3Ts) and have grown in stature and credibility and are now on a statutory basis.
- The MTFP has established much greater focus on the medium-term and led the move away from annual business planning.

3. As would be expected with experience of any fiscal framework over time, reviewing how the framework has operated since its inception suggests there are a number of areas where greater clarification and improvement could be provided:

- Fiscal policy has not always been countercyclical and there has at times been problems delivering capital expenditure/fiscal stimulus.
- There is some uncertainty over how the States should implement counter cyclical fiscal policy when the SF is exhausted.
- Plans for the replenishment of the SF are not clear.
- The purpose and objectives of the SR needs clarification.
- FPP have expressed concerns about Budget transparency/completeness.
- Financial forecasts on a cash basis are not appropriate for assessing the economic impact of fiscal policy.

4. International experience suggests that strong and resilient fiscal frameworks have the following key components:

- 1) **Numerical fiscal rules:** provide a permanent constraint on fiscal policy in terms of a summary indicator of fiscal performance such as the government budget deficit or government debt but can also cover expenditure and revenue rules.
 - 2) **Independent fiscal institutions:** non-partisan public bodies have contributed positively to fiscal policy making through the provision of unbiased inputs for the annual budget, independent analysis on fiscal policy issues such as budgetary developments/compliance with rules and regular assessments and recommendations.
 - 3) **Medium-term budgetary frameworks:** where the horizon of fiscal planning is extended beyond the annual budgetary timetable and reflects the impact of past and new policy measures.
 - 4) **Budgetary procedures:** covers all the procedural rules laid down in law covering the planning, approval and execution of the budget.
5. The European Commission advises that:

The reform of these elements, namely numerical rules, independent fiscal institutions, medium-term budgetary frameworks and budgetary procedures should be regarded as a single process. All these fiscal arrangements are closely interconnected, and the functioning of one of them affects the working of the remaining elements. Partial or fragmented reforms usually fall short of providing the needed improvements.

6. Assessing Jersey's fiscal framework against these key components suggests a number of potential areas for reform.

Fiscal rules

7. The MTFP resource principle "Maintain balanced budgets over the medium term for current expenditure and achieve an appropriate balance between taxation and spending over the course of the economic cycle" is somewhat contradictory and should be clarified. The fiscal framework would benefit from an overarching fiscal rule that is its cornerstone, underpins every Budget/MTFP and against which performance was independently assessed. The following rule would give a clearer objective:

The States will maintain balanced budgets over the economic cycle, through countercyclical fiscal policy and with regard to the advice of the

FPP. Grounds for deviations from the rule over any period must be agreed by the FPP.

8. It is important that any fiscal rule is flexible, able to adapt to different economic circumstances and that it is linked to the role of the independent fiscal body. In addition, the FPP's role should be clarified so that in their annual report they assess performance against the overarching rule and must comment on (but not be limited to):

Whether the States are likely to maintain balance budgets over the economic cycle and/or the next five years.

An assessment of whether counter cyclical policy is being operated and if not, the extent to which the fiscal balance should be adjusted to meet this requirement.

Include in their advice the potential impact on the above of the Social Security Funds and any other significant States funds the Panel feel are relevant.

Whether the long-term sustainability of States finances is improving or deteriorating and why.

Whether there are sound economic grounds for deviations from the fiscal rule.

9. The Public Finances Law states that Council of Ministers cannot propose in an MTFP or Budget income and expenditure that leads to a deficit in the CF at the end of any financial year. This rule could be counterproductive and not necessarily consistent with medium-term sustainability. The FPP have continually advised that the States should not to be constrained by CF. Rather than change the law, the new framework should ensure that the CF rule does not constraint the States in meeting the overarching fiscal rule.
10. Once an MTFP is agreed by the States net States expenditure from the CF and capital expenditure are set in place for the MTFP period (3 or 4 years) which does limit the ability to adjust a key element of fiscal policy (although taxation and capital expenditure by project is still set in the annual Budget). This is helpful in terms of providing some constraint on expenditure in the medium-term but could also be unhelpful from an economic policy perspective if there was a need to adjust expenditure either way in response to unexpected economic conditions. Under such circumstances, it is important that the ability of the Council of Ministers to amend the MTFP be used in accordance with the law and that if an

economic downturn is not seen as a 'serious threat' then it would be advisable to change the Public Finances law to ensure that such flexibility could be included in the MTFP procedures.

11. The public finance law also sets out that the total amount of borrowing by the States should not exceed an amount equal to the estimated income of the States derived from taxation during the previous financial year. In 2012 total income tax and GST revenue was nearly £510m or about 15% of GVA and it is not clear why this is deemed to be the appropriate limit for total borrowing and how it relates to the rules around accumulated assets such as the SR. While this clearly is not a constraint on fiscal policy for the foreseeable future it would be advisable to consider the suitability of this rule under different economic circumstances.
12. The current confusion around the role of the SR focuses on the lack of clarity around the definition of the 'capital value' from the original framework in 2006. If the intention is to maintain the SR in real terms relative to the total value at the time of the Health and Social Services White paper (end 2012) then this could be clarified and the purpose of the SR redefined as:

The Strategic Reserve Fund should be a permanent reserve, where the value of the Fund at the end of 2012 is to be protected in real terms (as measured by Jersey RPI) and 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.

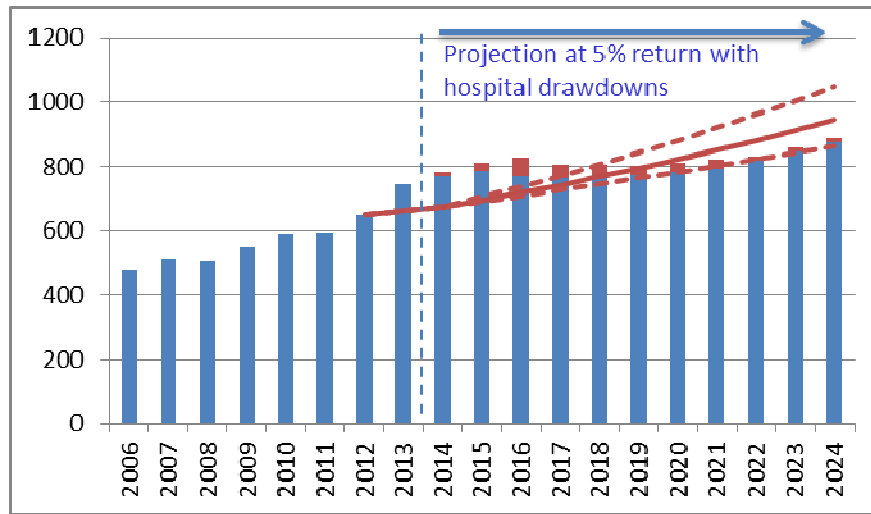
An exception can only be made to this rule for the provision of a new hospital, in line with the States agreement P.82/2012 "Health and Social Services: a new way forward".

In addition, the Strategic Reserve can, if necessary, be used for the purposes of providing funding for the Bank Depositors Compensation Scheme, up to a maximum combined total not exceeding £100 million, if required to meet the States' contribution to the Scheme and/or to meet any temporary cash flow funding requirements of the Scheme.

13. As the chart below shows the funding of the new hospital in the Island is likely to mean that the value of the fund falls below the 2012 value at times and that by 2024 the fund would be close to its 2012 value. This does depend on the return of the fund being in the region of 5% and consistently in excess of inflation.

Chart 1: Strategic Reserve in nominal terms

Red line = 2012 value uprated with RPI (dotted lines are inflation +/-1%), blue bar = nominal values at 5% return and with hospital drawdowns shown by red bar

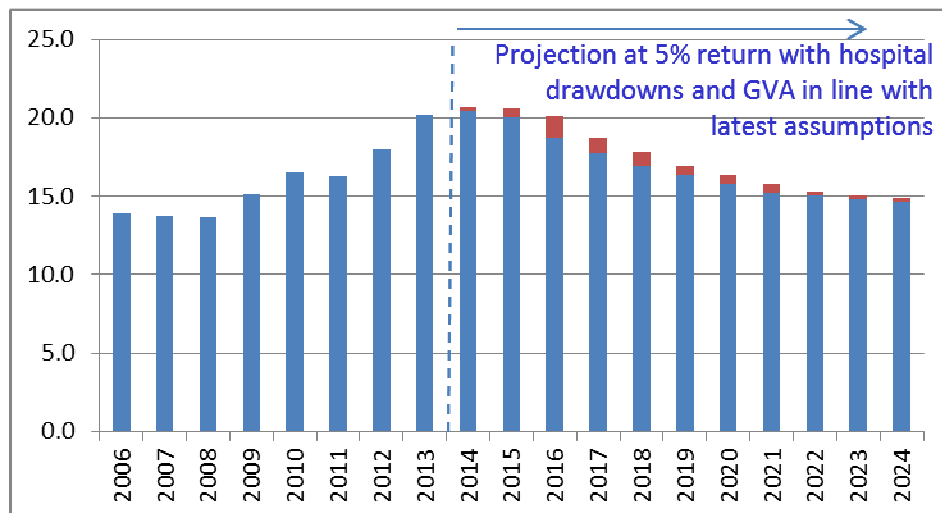


Source: Economics Unit calculations

14. Under this scenario the value of the SR would also fall to about 15% of GVA (assuming GVA grows in line with the latest economic assumptions). If the real return is spent in future then the SR as a share of GVA will continue to fall as nominal GVA growth should outpace inflation.

Chart 2: Strategic Reserve as a proportion of GVA

% GVA (assuming 5% investment return and GVA moves in line with assumptions), hospital drawdowns shown by red bar



Source: Economics Unit calculations

15. Defining the optimum size of the SR is extremely difficult and there is little that can be drawn from the rules governing sovereign wealth funds elsewhere. The definition above ensures that the value of the SR in 2012 is maintained in real

- terms, including the growth that was secured under the 2006 fiscal framework until that date.
16. However, the original purposes of the SR – severe structural decline and natural disaster – and their associated costs may not change in relation to Jersey RPI. These costs may be more associated with the size of the economy or the level of government expenditure both of which may increase in real terms and therefore at a sharper rate than RPI. Further consideration needs to be given to how the value of the SR may vary beyond 2024 and over the long-term and whether it is acceptable to see the SR continue to decline as a share of GVA and/or government expenditure.
 17. The rules governing the Housing Development Fund (HDF) should be clearly stated to make it more explicit what the intended purposes of the Fund are. This should make the distinction between current uses of the Fund and the new uses relating to the bond issue, loans to housing trusts/associations and subsequent repayment. The potential flows into and out of the HDF need to be transparent.
 18. When the SF was established as part of the 2006 Fiscal Framework, the States agreed that “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” and that transfer to/from it had to have regard to the advice of the FPP. The advantages of such a fund are that it facilitates counter cyclical fiscal policy which tries to delink revenues and expenditure and facilitate the ability to allow fiscal policy to support the economy during downturns without jeopardising long-term fiscal sustainability.
 19. However, a Stabilisation Fund is not sufficient by itself to run counter cyclical fiscal policy, not least as governments can use the non-fund fiscal position in other ways that could counteract the impact of the SF. As mentioned above, the experience in Jersey has been positive although there are a number of areas where the framework has worked less well.
 20. Jersey’s fiscal framework could be strengthened by better defining the role of the FPP in advising on counter cyclical policy (as set out above) and making clearer the role of the SF. The purpose of the SF should be set out as below to give further clarification to the existing purpose:

The purpose of the Stabilisation Fund is to make fiscal policy more countercyclical and help create in the Island a more stable economic environment. The Minister for Treasury and Resources is responsible for

proposing to the States the transfers between the Consolidated Fund and the Stabilisation Fund having regard to the advice of the Fiscal Policy Panel.

Money should be paid into the Stabilisation Fund from budget surpluses when the economy is above capacity and money withdrawn when the economy is below capacity. The Minister must seek advice from the FPP as to when these conditions are met and whether any deviations from this approach are merited by unusual economic or other circumstances.

Independent fiscal institutions

21. The FPP is Jersey's independent fiscal institution and a review of the FPP arrangements against experience locally and internationally also suggests a number of areas where improvements could be made. The clarification of their responsibilities set out above and the role of the SF go some way to doing this but there are other ways in which things could be improved:

- The FPP should be given responsibility for providing the financial forecasts used by the States.
- The public finances law does make explicit mention of the Panel's independence but should be strengthened by:
 - i. an appointment process that does not involve political input or the Treasury and Resources department and is agreed by the States;
 - ii. ring fencing the existing budget and economic resources for the Panel.

Medium-term budgetary frameworks/Budgetary procedures

22. Jersey has made significant steps forward in establishing its medium-term planning framework in recent years. It already has a number of underlying resource principles and the updated fiscal rules described above should be fully embedded in the MTFP and a framework in place for how compliance is monitored and evaluated.

23. Jersey's budgetary framework is set out in the public finances law and has many of the characteristics of the robust frameworks. Overall there is a clear process outlined in law and a requirement to provide some key budgetary data for the financial year covered by the Budget. The Budget is done on a centralised basis through Treasury and Resources and the budgetary impact of policies is set out for the financial year. The framework includes a Stabilisation Fund and

contingency funds, allowing significant flexibility for changing economic circumstances and unforeseen contingencies.

24. However, Budget 2014 was published in line with the law and the FPP concluded it “lacks a lot of basic and important information that is required to understand the overall impacts of proposed fiscal policy”. In addition their 2012 Annual report the FPP said the Panel had to make significant adjustments to the financial forecast in the MTFP to assess the underlying economic impact and that the future presentations of States finances would be more informative, leading to a better informed policy debate if these adjustments were already included in the MTFP and Budget.

25. Given these views the FPP recommended in their 2013 Annual Report that:

Budgets should be clear and concise, and the Panel recommends that every Budget should include:

- *A financial forecast for the current and next 3 years including updated income projections taking into account the latest economic developments, expenditure forecasts and budget measures.*
- *Proposed movements on the Consolidated Fund, Stabilisation Fund and Strategic Reserve for the current year and next 3 years.*
- *Data which shows what happened to these Funds in the previous 3 years.*
- *A financial forecast showing the surpluses and deficits as adjusted to recognise the economic impacts.*

The Jersey budgetary framework could be improved by adopting the FPP’s recommendations in full and formally made part of the Budget and MTFP process.

26. The guidance on both medium-term frameworks and budgetary procedures emphasises the need for cautious macroeconomic assumptions and realistic revenue forecasts. It also highlights that explicitly factoring alternative scenarios helps with budgetary priorities in unforeseen circumstances. The current framework is not explicit as to how and when financial forecasts are undertaken (beyond the requirements in the MTFP) and updated and there is currently no role for the FPP. The role and membership of the Income Tax Forecasting Group is not clearly set out and the degree of independence from Treasury unclear. Jersey’s fiscal framework could be enhanced by clearly defining frequency, role

and responsibilities around income forecasting and having a more explicit way of assessing alternative scenarios. If the FPP are given responsibility for financial forecasting, as set out above this would meet this requirement. It would also mean a greater role for top down budgeting, further strengthening the fiscal framework.

27. Further consideration should also be given to the way government accounts are calculated and presented in MTFP and Budget documents. The FPP have already requested that Budget and MTFP data is presented in a different way and fiscal data should be presented on the basis of when income is received and when it is spent, including the impacts of the States position as a whole including Social Security Funds and properly accounting for the economic impact of flows from other funds. The Chief Statistician should be asked to report to the FPP on the benefits, practicalities and resource implications of producing government finance data to an internationally recognised standard for economic accounts. This would provide back data in a consistent and recognised way and could form the basis on which States finances are presented in all Budget and MTFP reports.
28. It will be important to formalise any further changes to Jersey's fiscal framework ahead of the next Strategic Plan and MTFP so that both can be developed within an up to date, transparent and robust framework. There is no one-size fits all approach to fiscal frameworks and successful frameworks balance the use of fiscal rules and independent institutions to get the best results. The States' Economic Adviser should seek the advice of the FPP before formalising firm proposals that can be brought forward to update the framework in advance of the next Strategic Plan and MTFP.

Updating Jersey's Fiscal Framework

1. Introduction

In December 2006 the States agreed to the establishment of a new Fiscal Framework (in line with the requirements of the Economic Growth Plan) and that a Stabilisation Fund should be created with:

- 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;
- the Minister for Treasury and Resources 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
- the Fund set up by the transfer of the £32 million surplus funds currently available from the Dwelling House Loans Fund.

In addition it was agreed that the Strategic Reserve Fund 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.

The objectives in setting up this new framework were to:

- Contain inflation.
- Maximise the economic potential of the Island.
- Create an effective macroeconomic policy framework that can improve economic stability.
- Put in place a transparent and credible framework.
- Make fiscal policy overall more countercyclical and manage the revenue streams from financial services to enhance 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.

In November 2009 policy regarding the use of the Strategic Reserve was varied to enable it to also be used, if necessary, for the purposes of providing funding for the Bank Depositors Compensation Scheme. It was agreed that up to a maximum combined total not exceeding £100 million, should be made available if required to

meet the States' contribution to the Scheme and/or to meet any temporary cash flow funding requirements of the Scheme.

As part of Budget 2014 agreed by the States in December 2013 the States also decided with respect to the Strategic Reserve:

“to agree, as an exception to the approved policy for the use of the Fund, that the Fund may be used for the planning and creation of new hospital services in the Island, and to approve the transfer of an initial sum of £10.2 million from the Strategic Reserve Fund to the consolidated fund in 2014 so as to provide for these purposes, in accordance with the provisions of Article 4(3) and 10(3)(f) of the Public Finances (Jersey) Law 2005.”

In their 2013 Annual Report the independent Fiscal Policy Panel (FPP) stated that:

“The draft Budget proposes to make an exception to the Fiscal Framework for the new hospital project. It sets a worrying precedent for the States to make an exception to the Fiscal Framework in order to spend money from the Strategic Reserve. This exception would not be necessary if there were enough interest in the Strategic Reserve to leave the capital untouched, but the optimal size of the Strategic Reserve would have to be determined before this conclusion could be drawn.”

In conclusion they recommended that:

“The States should clearly define the purpose and optimal size of the Strategic Reserve and set out conditions for its use, including how borrowing from the Reserve would be dealt with. This should be done before deciding whether or not to use the Strategic Reserve to pay for the new hospital or any other capital expenditure.”

In response, the Minister proposed before Budget 2015 to set out:

- (a) A strengthened definition of capital within the Strategic Reserve;
- (b) Confirmation of the role of the Stabilisation Fund and how it should be replenished;
- (c) The arrangements for the repayment of the Housing Bond through the Housing Development Fund (HDF).

This paper provides advice to the Treasury and Resources Minister in meeting the FPP recommendation and at the same time reviewing the fiscal framework, with particular reference to:

- The States' current economic objectives.
- Experience in Jersey over the last 7 years from the operation of the framework and lessons for improvement.
- International experience from the operation of Fiscal Policy Councils and Fiscal Frameworks to ensure that the FPP operates in the most effective and independent manner and that the Fiscal Framework is best suited to meeting Jersey's economic objectives.
- Clarification about the role of the Stabilisation Fund and how it should be rebuilt in coming years and further explanation of how stabilisation policy should be conducted in Jersey (including when there is no money in the Stabilisation Fund).
- The role of the Housing Development Fund after the bond issue and how it should be operated to be consistent with the fiscal framework.

2. The States' current economic objectives

One of the five pillars of the existing States' Strategic Plan is "A strong and sustainable economy". That is an economy that generates economic growth that raises the standard of living and creates new employment opportunities. It allows tax rates to remain low and generates enough income to fund high quality public services and investment in our infrastructure.

The focus is on increasing the competitiveness of Island businesses, raising productivity across the economy and creating high value businesses that provide new jobs for Islanders. It was recognised that this would require a new Economic Growth Strategy that marries short-term job creation with sustainable medium-term economic growth that does not require excessive inward migration or development. It would also need to continue to support enterprise and innovation, with a greater focus on inward investment and development of a digital economy, facilitating diversification.

In addition, this would need to be supported by policies that help control inflation and keeps personal and corporate tax systems competitive with other finance centres and having regard to the advice of the independent Fiscal Policy Panel. States finances must be kept on a sound footing and provide stability and certainty around future tax and spending plans. It is also seen as essential to sustain a strong international profile.

The Strategic Plan recognised that the most urgent priority for the next three years was getting people into work and reducing the number of unemployed islanders by implementing Back to Work Schemes and the Economic Growth Strategy.

The ongoing work on establishing a long-term Island vision for Jersey (Preparing for our future) may help in setting out the long-term direction of economic policy. This would be very beneficial in helping to ensure that the fiscal framework is complementary to these objectives over the long-term.

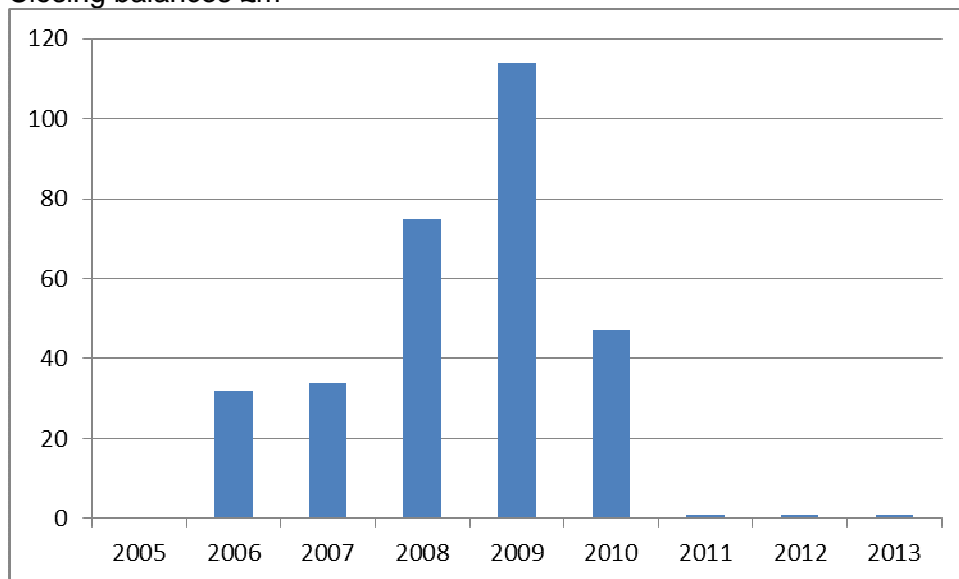
3. The experience in Jersey over the last 7 years

Reviewing the performance of the fiscal framework in Jersey over the last 7 years points to a number of positive outcomes:

- The Stabilisation Fund was established and significant resources built up in advance of the global financial crisis and with oversight from the independent FPP (see chart below).

Chart 3: The Stabilisation Fund

Closing balances £m



Source: States of Jersey Treasury and Resources

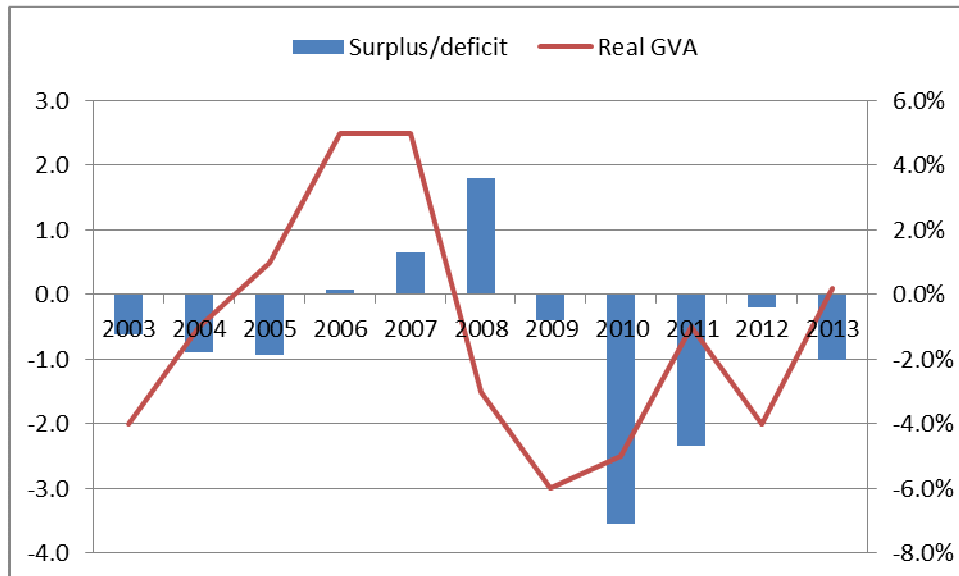
- SF was large enough to fund both automatic stabilisers and discretionary policy and offer significant support to the local economy in the initial years following the global financial crisis. Significant withdrawals from the SF totalling over £150m were made in 2009, 2010 and 2011.

- The value of the Strategic Reserve has been protected and grown significantly in real terms (see charts 5 and 6) and in 2013 amounted to about 20% of GVA, compared to less than 15% in 2006.
- The FPP have been successful and advised on number of key aspects of fiscal policy (including the 3Ts) and have grown in stature and credibility. They have published 6 annual reports, 5 update/interim reports and exchanged public letters with the Treasury and Resources Minister on additional fiscal stimulus for social housing in 2012. In addition, the FPP are now appointed on a statutory basis.
- The MTFP has established much greater focus on the medium-term and led to the move away from annual business planning.

As would be expected with experience of any fiscal framework over time, there are a number of areas where greater clarification and improvement could be provided:

- Fiscal policy has not always been countercyclical and there have at times been problems in delivering capital expenditure in line with expectations. The chart below shows that while deficits did support the economy in the early part of the downturn (by between 2-3% of GVA), fiscal policy became less accommodating (with the budget nearly balancing in 2012 despite a sharp fall in real GVA) before economic conditions improved.

Chart 4: The budget balance over the recent economic cycle
 Surplus/deficit as % GVA (left scale), real % change in GVA (right scale), 2013 GVA based on latest FPP forecast



Source: Treasury and Resources/Economics Unit calculations

- Recent experience suggests that under the current framework there is some uncertainty over how the States should implement counter cyclical fiscal policy when the SF is exhausted.
- Plans for the replenishment of SF are not clear. The purpose of the Fund is to make fiscal policy more countercyclical and this would require that if it has been exhausted during the economic downturn through financing deficits and fiscal stimulus that it should be replenished through running budget surpluses when the economy is performing more strongly (and operating above capacity).
- The FPP pointed out in their 2013 Annual Report that the purpose and objectives of the SR needs clarification. In particular, what is meant by the term 'capital value'.
- In both their 2012 and 2013 Annual reports the FPP have expressed concerns about Budget transparency/completeness and the way public finance data is presented in the Budget and MTFP.
- Financial forecasts on a cash basis and in particular the way capital expenditure is accounted for in terms of allocation rather than spend are not appropriate for illustrating the economic impact of proposals.

The fact that the framework has operated through a global financial crisis of massive proportions has tested the framework to the limits. Looking ahead, ongoing pressure on financial services may mean some of the volatility in the local economy/tax receipts has been removed. In addition, the move to 0/10 with the introduction of GST (and reduced reliance on corporate tax receipts) may also help in reducing volatility going forward.

4. International experience

The 2008 financial crisis and the aftermath have focused attention on fiscal policy and fiscal frameworks in particular. This is because of the associated fiscal problems in a number of countries both within Europe and outside, the greater emphasis on fiscal policy as a macroeconomic policy tool in a low interest rate environment and the need for medium-term fiscal consolidation in a number of countries given risks to fiscal sustainability.

The European Commission (EC) 2010 drawing on international experience and academic research has emphasised the need for strong and resilient fiscal frameworks and defines these as the elements of policy making that shape fiscal

policy. The four main components (also highlighted by the EC on their web database) are considered to be:

1. Numerical fiscal rules
2. Independent fiscal institutions
3. Medium-term budgetary frameworks
4. Budgetary procedures

Each of these components is discussed in more detail below.

4.1. Numerical fiscal rules

These cover rules that provide a permanent constraint on fiscal policy in terms of a summary indicator of fiscal performance such as the government budget deficit or government debt. Fiscal targets that may be revised frequently without any restriction are excluded. The EC advises that the key elements in the design of fiscal rules should be:

- **Statutory base:** backed by strong legal provisions, including requirements for amending the rule and enforcement procedures.
- **Multi-annual:** rules that are based over a number of years and embedded in a medium-term framework, with scope to adapt to specific economic circumstances.
- **Accounting system:** the use of an internationally recognised system of national accounting for public finance data such as the European System of National Accounts (ESA) 95 methodology that allows assessment on accruals basis (when the money is spent and received) and not cash terms.
- **Monitoring:** reliable data must be available and an independent monitoring body is helpful.
- **Enforcement mechanism:** corrective and enforcement mechanisms should be specified, such as ex-ante rules on non-compliance; monitoring and enforcement could be carried out by the same independent body.
- **Sanctions:** pre-established sanctions in the case of non-compliance can supplement the enforcement mechanism.
- **Escape clauses:** specify the circumstances under which departures from the rule are allowed such as natural disasters or acute economic recessions.

Rules can be set with respect to debt ceilings such as a percentage of GDP and balance budget rules. Effectiveness is dependent on the ambition of the target and monitoring and enforcement. Care has to be taken – for example by setting them within a medium-term framework – to ensure they can support stabilisation policy and limit any pro-cyclical bias.

Expenditure rules are also common across the EU (representing about one third of all fiscal rules) and tend to focus on central government and social security spending. They try to address frequent problems of recurrent spending overruns and pro-cyclical budgetary policy. They are not immune to pitfalls such as pro-cyclical risks with spending as share of GDP and incentives to use tax expenditures. Nonetheless the EC sees such rules as the cornerstones of some of the most resilient fiscal frameworks in the EU.

Research by the IMF (2014) also suggests that well designed expenditure rules can be a useful tool for sound fiscal policy, although there is a need to be aware of undesirable consequences such as the impact they may have on capital expenditure.

Revenue rules can cover ceilings on tax revenue or constraining specific tax revenue developments such as revenues that are unexpected and exceed forecasts. Such revenue rules are not common in national fiscal frameworks in the EU.

The IMF (2013) illustrate that between 1985 and August 2013, 87 countries have operated fiscal rules that fall into the four categories of budget balance rules, debt rules, expenditure rules and revenue rules.

4.2. Independent fiscal institutions

These institutions are non-partisan public bodies that are financed by public funds but functionally independent to the fiscal authorities. The EC believes that they have contributed positively to fiscal policy making through the provision of:

- Unbiased inputs for the annual budget such as macroeconomic forecasts.
- Independent analysis on fiscal policy issues such as budgetary developments and compliance with rules.
- Regular assessments and recommendations relating to such matters as long-term sustainability of public finances and fiscal targets.

The EC believes that experience to date gives useful guidance for the design of such institutions and that the important elements in the design are:

The mandate: should be clear and unambiguous specifying the tasks assigned and backed by strong legal provisions. Tasks should be carried out on a regular basis with the institution given access to all information necessary. Enforcement procedures and measures for specific rules/targets should be clearly specified and supported by legal provisions.

Independence: high degree of autonomy is important and can be ensured by public financing (preferably stipulated in law) and specific appointment procedures assuring independence.

Involvement in the budget process: is seen as crucial in determining influence and arrangements can help institutions to convey messages for example through regular hearings in parliament, consultation by government during budgetary process or obligation of authorities to justify departures from forecasts/recommendations. Delegation of macro forecasts is seen as an example of strong involvement that results in more realistic macroeconomic assumptions adopted for policy decisions and biases due to government optimism reduced.

4.3. Medium-term budgetary frameworks

Medium-term budgetary frameworks (MTBFs) are where the horizon of fiscal planning is extended beyond the annual budgetary timetable. A well designed framework is seen to reflect the impact of past and new policy measures. The EC draws on existing literature on MTBFs to provide guidance on their appropriate design:

Coverage: should cover the general government sector plus social security over a period of 3 or 4 years.

Expenditure projections: there is usually some binding expenditure target and the projected impact is broken down by main expenditure areas.

Revenue projections: plausible revenue projections based on cautious macroeconomic assumptions broken down by main types of revenue.

Departures from envisaged path: should be presented with clear analysis explaining differences.

Macroeconomic assumptions: baseline projections and corresponding macroeconomic assumptions should include alternative scenarios to help with budgetary priorities in unforeseen circumstances.

Accounting system: difference between projections based on cash and ESA 95 basis should be clearly specified, increasing transparency and consistency.

Input into budget law: the projections and objectives in the MTBF should form the basis on which the law is prepared.

Monitoring/corrective mechanisms: frequency of assessments should be specified with the body undertaking these assessments pre-defining actions in the circumstances when corrective actions are required.

The EC point out that common short comings in MTBFs include the non-binding nature of fiscal targets and their frequent revision, lack of political commitment, unrealistic macroeconomic assumptions underpinning fiscal projections and the absence of independent monitoring and corrective mechanisms in the case of deviation from the project path.

4.4. Budgetary procedures

These cover all the procedural rules laid down in law covering the planning, approval and execution of the budget. Drawing from the literature, seven budgetary dimensions are seen by the EC as conducive to the quality of the budget process:

1. **Transparency:** reliable and timely budgetary data, standard accounting practices supported by comprehensive coverage in law.
2. **Multiannual budgetary planning:** fiscal strategies go beyond the yearly budget cycle and provide commitment to a predefined path taking into account the multiannual budgetary impact of policies.
3. **Budget centralisation for planning/approval:** fragmented budget preparation by a large number of actors can result in deficit bias, so should be done centrally.
4. **Budgetary centralisation for implementation:** some decentralisation may be needed to allocate resources and some flexibility may be appropriate in the distribution of resources between spending programmes.
5. **Top-down budgeting:** budgetary planning started with a binding ceiling on the total amount of resources to be distributed among expenditure areas and is seen as more conducive to fiscal discipline than the traditional bottom-up approach where total spending is obtained as the sum of individual expenditure requests from departments.

6. **Realistic economic assumptions and reserves:** prudent and plausible macroeconomic assumptions should avoid systematically overly optimistic budgetary projections. Reserve funds provide the flexibility to deal with unexpected budgetary developments.
7. **Performance budgeting:** spending programmes are evaluated against their policy objectives and resource allocation in subsequent budgets is influenced by the efficiency of past spending.

In terms of strengthening domestic fiscal frameworks the EC point out that reform must address fiscal problems at the national level and that there is no one-size-fits-all solution. The EC believe that economic analysis and policy experience provide a number of insights into the design of domestic fiscal frameworks. They state:

“The reform of these elements, namely numerical rules, independent fiscal institutions, medium-term budgetary frameworks and budgetary procedures should be regarded as a single process. All these fiscal arrangements are closely interconnected, and the functioning of one of them affects the working of the remaining elements. Partial or fragmented reforms usually fall short of providing the needed improvements.”

5. Assessing the Jersey Fiscal Framework

This section examines the Jersey Fiscal Framework against the criteria set out by the European Commission as covered in the previous section.

5.1. Jersey’s fiscal rules

Rules governing the operation of Jersey fiscal policy are covered in a number of documents including the Public Finances Law, the reports and propositions outlined above and the 2013-15 Medium-term Financial Plan. Taking the main types of fiscal rule in turn:

Deficits/balanced budgets

The rules that relate to the matter of deficits are covered in the Public Finances Law and the R&Ps covering the States decisions explained above.

The Public Finances Law states that Council of Ministers cannot propose in an MTFP or Budget, income and expenditure that leads to a deficit in the Consolidated Fund (CF) at the end of any financial year. This does not prevent the States from operating a significant – and potentially unsustainable - economic deficit in any one year (for example by transferring money into the CF from other funds or through one-off

receipts). Neither does it constrain the ability to run unsustainable fiscal policy to the extent that rules about deficits and debt would normally attempt to do. It could also in certain circumstances prevent the operation of counter cyclical fiscal policy by limiting the ability to run deficits when the economy is in recession (even though these could be sustainable if financed through future surpluses when the economy is growing and above trend).

The 2013-15 MTFP sets out updated and expanded resource principles on a range of fiscal issues. There is one principle that relates directly to the need to maintain balanced budgets:

“Maintain balanced budgets over the medium term for current expenditure and achieve an appropriate balance between taxation and spending over the course of the economic cycle.”

Given the limitations of the Public Finances Law in constraining fiscal policy over the medium-term this is an important step to try and supplement the law and bring a measure of fiscal discipline. However, further clarification would be advisable particularly in terms of what budget is being balanced and what is meant by ‘over the medium-term’ and ‘appropriate balance’

The Public Finances Law states that the States may not borrow money except in accordance with a decision of the States made on a proposition lodged by the Minister. Also that the total amount of borrowing by the States should not exceed an amount equal to the estimated income of the States derived from taxation during the previous financial year. In 2012 total income tax and GST revenue was nearly £510m or about 15% of GVA. It is not clear why this is deemed to be the appropriate limit for total borrowing, provides quite a lot of latitude given the starting point and does not have any reference to accumulated savings such as the Strategic Reserve.

Expenditure

Once an MTFP is agreed by the States net States expenditure from the CF and capital expenditure are set in place for the MTFP period (3 or 4 years) and this is a type of expenditure rule that is already in operation in Jersey. This is helpful in terms of providing some constraint on expenditure in the medium-term, although to some extent it does depend on how the expenditure limits are set. A greater role for top down budgeting may help in ensuring that the MTFP constrains expenditure in a way that improves fiscal discipline. At times such a rule could also be unhelpful from an economic policy perspective if there was a need to adjust expenditure either way in response to unexpected economic conditions and the rule limits the ability to adjust a

key element of fiscal policy (although taxation and capital expenditure by project is still set in the annual Budget).

However, an MTFP can be amended on the basis of a proposition lodged by the Council of Ministers and for specific purposes including if they “are satisfied that there is a serious threat to the economic, environmental or social wellbeing of Jersey which requires an immediate response”. This part of the law must have proper emphasis and be used if there is a need to alter the approach set out in the MTFP for economic reasons. If an unexpected downturn that could be exacerbated by the fiscal stance set out in the MTFP is not considered a ‘serious threat’ then it would be advisable to change the law to ensure that such flexibility could be included in the MTFP procedures.

Economic theory

The economic case for fiscal rules revolves around concerns about deficit bias and risks that governments will be fiscally undisciplined. Wyplosz (2012) cites two main reasons for deficit bias. First, the tendency for governments and/or the electorate to push the fiscal burden to future governments or generations. The second involves the democratic process and the role of interest groups and that politicians can enhance their election chances by catering to interest groups at the expense of future taxpayers. Wyplosz identifies both of these issues as relating to the common pool problem i.e. where the beneficiaries of public spending/tax advantages ignore the cost (in economic terms externality) they impose on other tax payers.

Wren-Lewis (2011) also mentions a number of other potential reasons for deficit bias. Mildly impatient governments might tend to favour tax cuts/higher spending now compared to higher taxes/lower spending later. The common pool problem is also seen to suggest that a fiscal council with no formal power might be effective at reducing deficit bias. In addition Wren-Lewis identifies another set of theories that explain deficit bias in terms of informational problems. An example being over optimism by the electorate and/or government on future growth and related tax receipts. He points out that “If this is the source of deficit bias, then delegating just the forecasting process to an independent agency would be appropriate”. Although where problems are associated with lack of information for the electorate the remedy could be to improve information available to them.

Frankel (2012) looks at why EU countries find it hard to get budget deficits under control. In doing so he reviews econometric studies over many countries that show government budget forecast in many countries are overly optimistic on average, often because official estimates of economic growth are optimistic. He concludes that

governments' budget forecasts are biased in the optimistic direction and that their real GDP forecasts are also overly-optimistic. He states that "national fiscal rules help counteract the wishful thinking that seems to come with euro membership" and that "the existence of an independent fiscal institution producing budget forecasts at the national level reduces the over-optimism bias".

Wyplosz concludes in his analysis that neither fiscal rules nor fiscal institutions alone are a panacea but there are benefits from combining rules and institutions. For Jersey this means clarifying the overarching rule for the States' budget and the role of the FPP in advising when the rule is met and quite importantly when deviations from the rule are acceptable.

A new overarching rule

To try and get the right balance between rules and use of independent advice the overarching rule could be that:

The States will maintain balanced budgets over the economic cycle, through countercyclical fiscal policy and unless there are strong grounds agreed by the FPP for deviating from this rule over any period.

In addition, the FPP's role could be clarified so that when they cover in their annual report "the medium and long-term sustainability of the States' finances" as set out in the public finances law they must comment on (but not be limited to):

- *Whether the States are likely to maintain balance budgets over the economic cycle and/or the next five years.*
- *An assessment of whether counter cyclical policy is being operated and if not, the extent to which the fiscal balance should be adjusted to meet this requirement.*
- *Include in their advice the potential impact on the above of the Social Security Funds and any other significant States funds the Panel feel are relevant.*
- *Whether the long-term sustainability of States finances is improving or deteriorating and why.*
- *Whether there are sound economic grounds for deviations from the fiscal rule.*

The FPP would have to comment on the basis of the information that is available to them but also make it clear what additional information should be provided/published to enable them to be in a better position to advise on all these matters.

Strategic Reserve

It is important to consider what the SR actually is in economic terms. As set out in the report to the 2006 Fiscal Framework, the SR represents consumption (in the widest sense) foregone in previous years by the residents of the Island. Adding to the SR reduces current consumption in the Island and increases the potential for consumption in the future. Spending the Strategic Reserve increases current consumption, but reduces the potential for increased consumption in the future.

Adding to the SR generally makes sense when the present value of consumption in the future is greater than that now and spending the SR makes sense if the opposite applies i.e. future consumption is valued less than current consumption. Such comparisons are complicated even further by the fact that those who consume/benefit may actually be different people/generations.

The SR is like 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. The SR and borrowing also have a number of similarities. Spending the SR and borrowing will both increase inflationary pressure in the economy as they will add to aggregate demand (although the impact on inflation will depend on the degree of spare capacity in the economy). Both can be used to finance counter-cyclical (or pro-cyclical) spending, to smooth the impact of external shocks and could ‘crowd out’ activity in the private sector (under certain conditions).

However, the Strategic Reserve differs from borrowing in a number of key 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 (although this is not currently the case in the aftermath of the global financial crisis and the low interest rate environment).

International experience of Sovereign Wealth Funds

The Strategic Reserve is one type of Sovereign Wealth Fund (SWF). The IMF (2013) define SWFs as special purpose investment funds that are owned by government that tend to have macroeconomic purposes and hold, manage or administer assets to achieve financial objectives with investment strategies that include investing in foreign financial assets. SWFs are normally distinguished on the basis of their objectives and asset allocation and generally fall into 5 categories:

- Stabilisation Funds – set up normally to insulate the budget and economy from commodity price volatility and external shocks.
- Savings funds – aim to share wealth across generations and transferring non-renewable assets into diversified financial assets.
- Development funds – allocate resources to priority projects such as infrastructure
- Pension reserve funds – set up to meet future pension liabilities pressures on government
- Reserve investment corporations – earn higher returns and/or reduce cost of holding reserves.

The Sovereign Wealth Fund Institute (SWFI) list about 75 different funds on their website. There is a clear link between SWFs and countries with oil and gas reserves. The Norwegian Government Pension Fund Global (previously The Norwegian Government Petroleum Fund) is one of the most well-known SWFs and was established in 1990s and is valued in excess of 100% of GDP. However, there are also well established and sizeable funds in Saudi Arabia, Kuwait, UAE, Oman, Singapore and Brunei. The number of funds has grown considerably since 2000 with the SWFI index showing that 28 commodity based funds have been established since 2000.

Position in other Crown Dependencies

The purpose of Guernsey's Contingency Reserve is "to provide some protection against major emergencies including significant economic downturns having a severe adverse effect on the Island". In 2006 the States agreed that "up to half of the Contingency Reserve (interest and capital) may be used to fund the shortfall in public sector expenditure during the first stage of the implementation of the Economic and Tax Strategy". At that time the balance was £200m with £100m plus interest and investment gain available to fund public services during the first phase. In 2013 £27m

was transferred from the Contingency Reserve (Tax Strategy) to fund the States deficit.

In 2012 the total Contingency Reserve was £218m (£133m general and £85m tax Strategy) which amounts to just over £10% of GDP for the total and nearly 7% for general purposes alone.

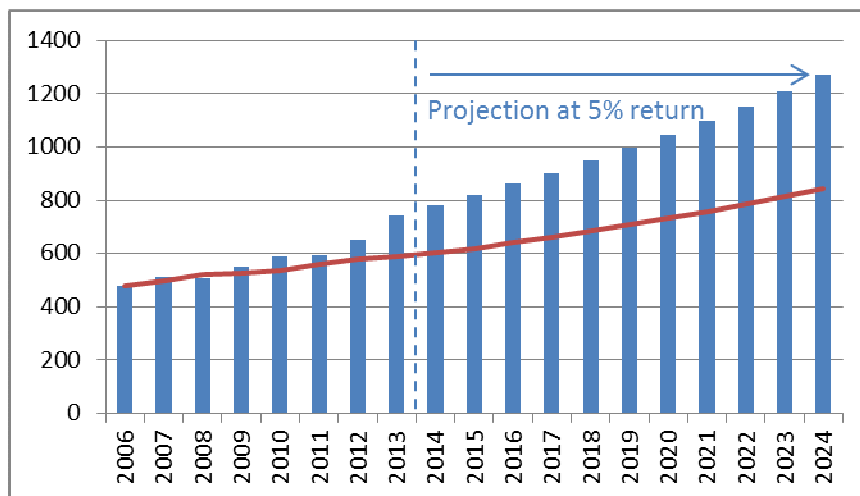
The Isle of Man has a Reserve Fund “set up to act as a buffer against the potential risks of increased expenditure to be charged to future years’ Accounts”. In March 2013 it totalled £386m – just over 10% of GDP. However, just under £100m has been allocated to rebalance public finances following the removal of the common purse VAT arrangement with the UK.

Jersey’s experience

Since 2006 the SR has grown in excess of inflation, with average returns of 6.5% p.a. If the return over the next 10 years was to be 5% p.a. then by 2024 the SR would amount to nearly £1.3bn and over £400m more than if it had been maintained in real terms at the 2006 level.

Chart 5: Strategic Reserve in nominal terms

Red line = 2006 value uprated with RPI, blue bar = nominal values at 5% return



Source: Economics Unit calculations

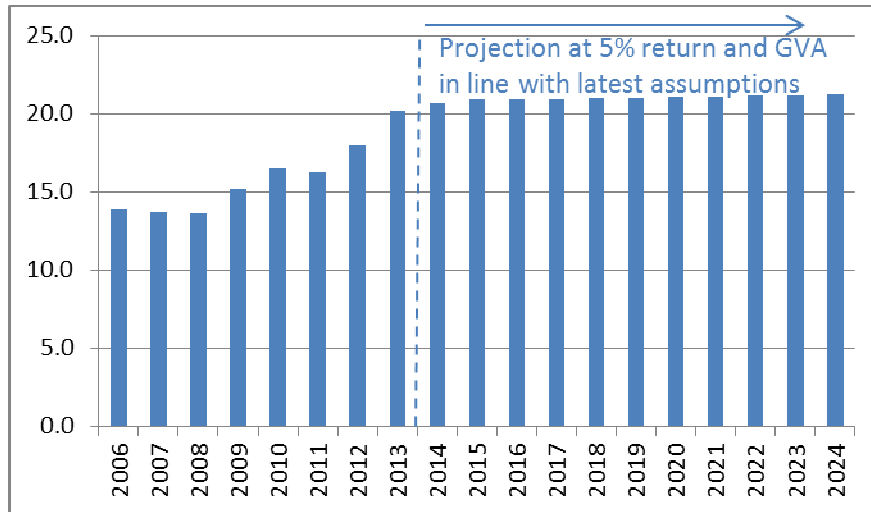
The report to the 2006 Fiscal Framework stated that the objective was:

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.

To date this objective has been achieved as shown in the chart below where the SR has grown from about 14% of GVA in 2006 to about 20% in 2013. If the SR was left untouched going forward with investment returns of 5% p.a. this would mean that by 2024 the Strategic Reserve would be 21% of GVA (assuming GVA grows in line with the latest economic assumptions).

Chart 6: Strategic Reserve as a proportion of GVA

% GVA (assuming 5% investment return and GVA moves in line with forecasts)

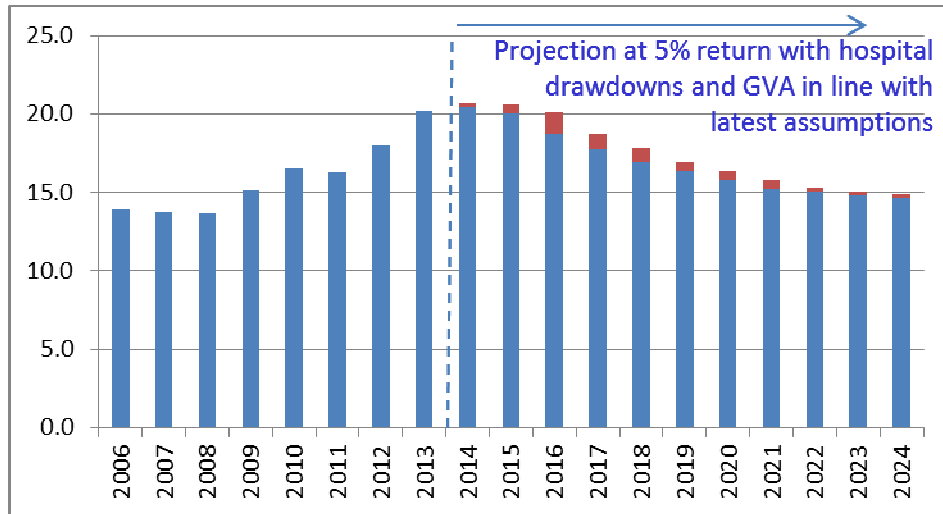


Source: Economics Unit calculations

Looking forward, the picture changes if the SR is used to fund the new hospital as set out in Budget 2014. Under the scenario of 5% return the value of the SR would also fall to about 15% of GVA (assuming GVA grows in line with the latest economic assumptions). If the real return is spent in future then the SR as a share of GVA will continue to fall as nominal GVA growth should outpace inflation.

Chart 7: Strategic Reserve as a proportion of GVA

% GVA (assuming 5% investment return and GVA moves in line with assumptions), red bars show hospital drawdowns

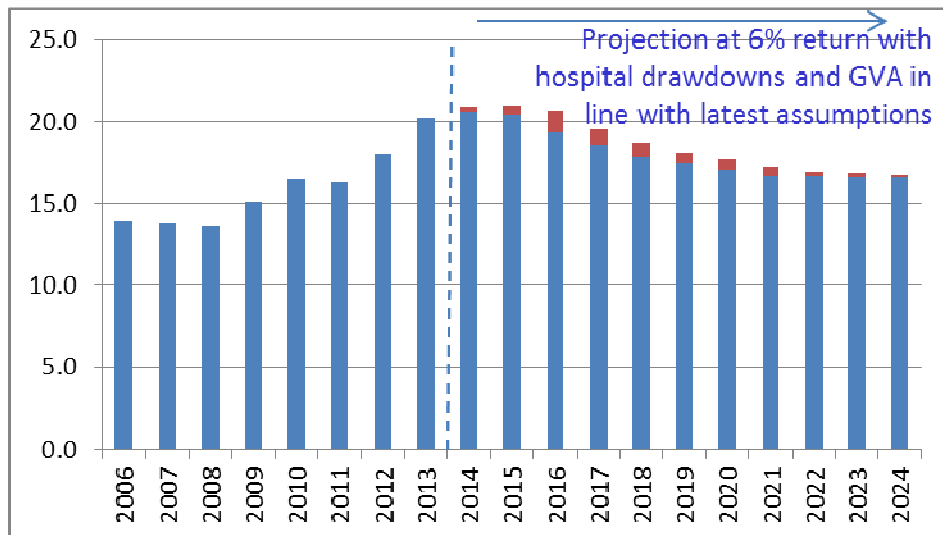


Source: Economics Unit calculations

The scenario above does depend on the level of return and growth in GVA. The chart below looks at the position when returns are higher at 6%. Under this scenario the SR would amount to about 17% of GVA in 2024.

Chart 8: Strategic Reserve as a proportion of GVA

% GVA (assuming 6% investment return and GVA moves in line with assumptions), red bars show hospital drawdowns

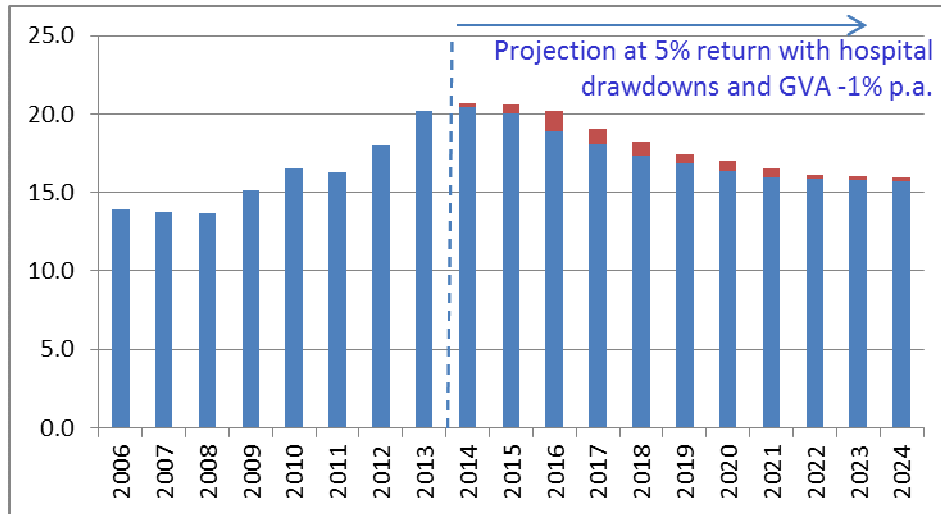


Source: Economics Unit calculations

The next scenario look at how the value changes if GVA growth is higher than assumed.

Chart 9: Strategic Reserve as a proportion of GVA

% GVA (assuming 5% investment return and GVA grows at 1% p.a. less each year than the current assumptions), red bars show hospital drawdowns

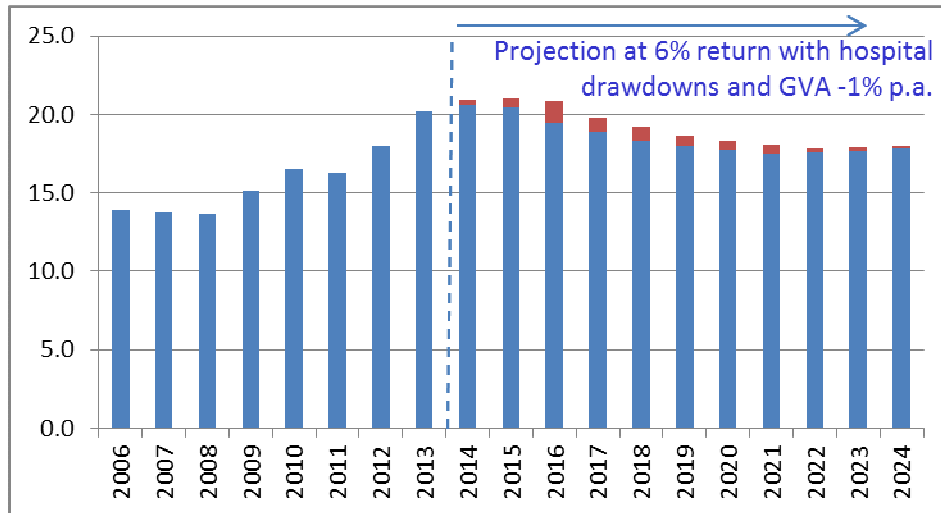


Source: Economics Unit calculations

The chart below combines both higher returns and lower GVA growth. Under this scenario the SR would amount to just over 17% of GVA by 2024.

Chart 10: Strategic Reserve as a proportion of GVA

% GVA (assuming 6% investment return and GVA grows at 1% p.a. less each year than the current assumptions), red bars show hospital drawdowns



Source: Economics Unit calculations

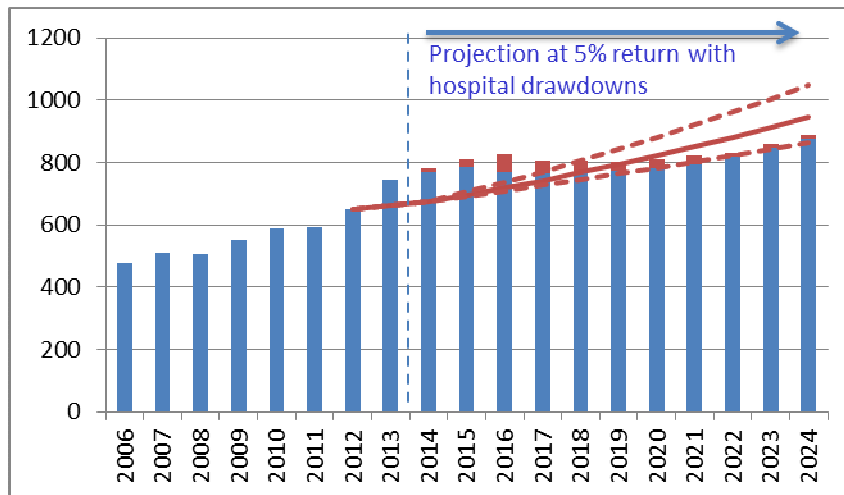
A similar picture is presented when the SR is considered as a proportion of States (net revenue) expenditure. That is, the SR started out in 2006 at slightly more than one year’s worth of expenditure, and although it declined slightly as a proportion of

expenditure by the end 2013 it was nearly 20% more than one year’s expenditure. Given the tendency for nominal GVA and expenditure to grow at similar rates this picture would remain unchanged out until 2024 if the SR grows at 5% p.a. However, when the hospital drawdowns are factored in it will be less than one-years expenditure by 2024.

Looking at the value of the SR in 2006 prices might be relevant given the reference to capital value in the original framework from 2006, it is still somewhat arbitrary and there could be valid reasons for using another year in which to base the value. The decision to improve health services and develop the hospital was taken in 2012 and this could be a suitable year in which to base the value of the SR. This would also recognise that the 2006 policy envisaged trying to build the SR further as there was no degree of certainty that its value in 2006 would be sufficient to meet the potential uses. The chart below shows that under this scenario the value of the SR would be below the 2012 value in real terms (at 5% return) by the time the hospital drawdowns are made (unless inflation is significantly below current assumptions).

Chart 11: Strategic Reserve in nominal terms

Red line = 2012 value uprated with RPI (dotted lines are inflation +/-1%), blue bar = nominal values at 5% return and with hospital drawdowns shown by red bar

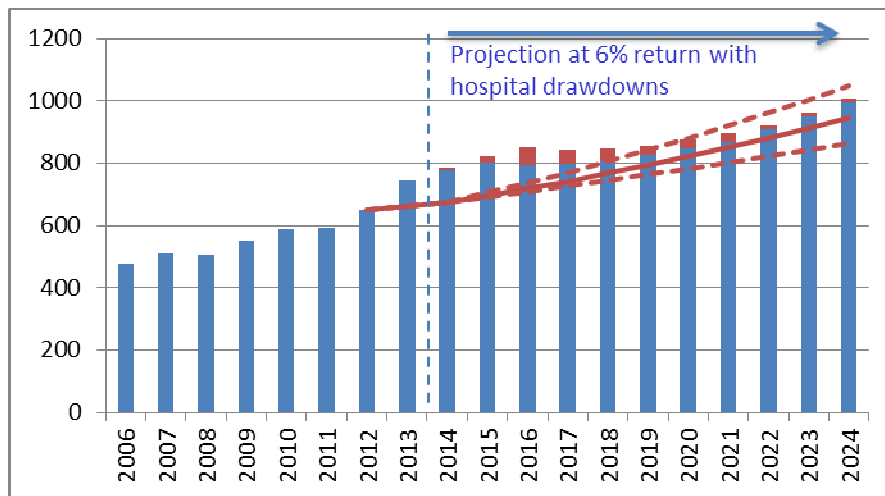


Source: Economics Unit calculations

The calculations are dependent on the level of return achieved on the SR investments. The chart below shows the same scenario but with a 6% return which means that by 2024 the value of the SR could be above the 2012 real value if inflation is in line with or below current assumptions.

Chart 12: Strategic Reserve in nominal terms

Red line = 2012 value updated with RPI (dotted lines are inflation +/-1%), blue bar = nominal values at 6% return and with hospital drawdowns shown by red bar



Source: Economics Unit calculations

Clarification of the purpose of the SR

The current purpose of the SR is that as agreed in Budget 2014 although the lack of clarity around the definition of the 'capital value' from the original framework in 2006 remains. If the intention is to maintain the 2012 value of the SR in real terms then this could be clarified and the purpose of the SR be redefined as:

The Strategic Reserve Fund should be a permanent reserve, where the value of the Fund at the end of 2012 is to be protected in real terms (as measured by Jersey RPI) and 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.

An exception can only be made to this rule for the provision of new hospital services, in line with the States agreement P.82/2012 "Health and Social Services: a new way forward".

In addition, the Strategic Reserve can, if necessary, be used for the purposes of providing funding for the Bank Depositors Compensation Scheme, up to a maximum combined total not exceeding £100 million, if required to meet the States' contribution to the Scheme and/or to meet any temporary cash flow funding requirements of the Scheme.

The original purposes of the SR – severe structural decline and natural disaster – and their associated costs may not change in relation to Jersey RPI. These costs may be more associated with the size of the economy or the level of government expenditure both of which may increase in real terms and therefore at a sharper rate than RPI. If the type of definition described above were adopted to clarify the purpose of the SR, further consideration should be given to how the value of the SR may vary beyond 2024 and over the long-term. In particular, whether it is acceptable to see the SR continue to decline as a share of GVA and/or government expenditure.

At times borrowing from SR could be cheaper than from markets, although this is currently not the case in the low interest rate environment and when investment returns to the Common Investment Fund have been high. Allowing borrowing from the fund could make financial and economic sense if it allows the States to minimise the cost of financing certain expenditure. However, there is a clear risk that the States could borrow under such conditions but actually renege on repayments. If this was the case the capital in the fund (as defined by the 2012 value in real terms), particularly while the hospital is being funded could be used for purposes not consistent with the purpose of the SR set out above.

The current framework does not explicitly mention the possibility of borrowing from the SR but it is clear if this was to be considered that there should be strict rules (e.g. repayment is clearly set out and defined with an identified revenue stream and appropriate interest rate) and that the FPP's remit should be extended to oversee such circumstances. Careful consideration would need to be given of how this might operate in practice before the framework could be extended in this manner.

It is very difficult to determine what the most appropriate size of the Strategic Reserve should be and the 2006 framework suggested an objective:

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.

Given the different type and purposes of SWFs across the globe there is little guidance from elsewhere in terms of what an appropriate size of the SR might be. Some of the largest are several hundred billion US\$ (Norway and UAE about \$800bn, Saudi Arabia \$700bn, Kuwait \$400bn and Hong Kong and Singapore about \$300bn). Aizenman and Glick (2008) show that they are also sizeable relative to GDP and range from 600%+ in UAE to 200%+ in Singapore and Kuwait, to 100%+ in Norway and >50% in Hong Kong and Saudi Arabia.

Another way to consider the size is to weigh up the benefits and costs of adding more funds to the SR. It would be beneficial to add to the SR if the forgone consumption/investment (and any associated returns) today is worth less than the present value of future consumption/investment by spending the money in the future and/or less than the present value of the consumption/investment from the flow of returns from that money.

In practice such a comparison will not be easy to make for a number of reasons. It may not be clear what the future consumption/investment may be relative to what might be forgone now, Islanders preference for spending money now versus later will not be clear and not the same across the population. The issue is even more complicated by the fact that the recipients of the future benefits may be different to those who forgo the benefits now both in terms of the actual individuals and generations.

The 2006 framework adopted an approach of trying to make additional payments into the SR where practical but without specifying the precise circumstances when this should happen. There has only been one payment into the SR of £10m in 2007 with the previous payment of £23m taking place in 2001. This would suggest that the current guidance would mean there is a real risk that the capital base is not added to in future years (above and beyond real investment returns). However, it is not clear that this will not be a suitable approach given the objectives of the SR or that there is a more appropriate approach. For example, if more money is paid into the SR in future years it could require a change in policy elsewhere such as increased taxation, lower spending, higher borrowing or disposal of other assets (or a combination of all four). Whether any of these would be appropriate would depend on the fiscal and economic situation at the time. Higher borrowing could bring potential benefits if the interest rate paid is below that gained on the SR.

Once the purpose of the SR has been clarified it would be appropriate to review the governance structure (including the investment strategy as part of CIF) to determine whether the current approach is consistent with the new objectives.

Housing Development Fund

The HDF was established in 1999 to assist in meeting the requirements for the development of social rented and first-time buyer homes by providing development and interest subsidies. The report to P.84/1999 said:

The HDF would extend the Housing Development Scheme to include funding for the development of social rented housing as well as for first-time buyer properties.

The HDF would provide a mechanism for funding housing developments undertaken by the States, as well as providing subsidies (where necessary) for developments undertaken by other providers of social rented housing (such as Housing Associations) and, if necessary, for certain private sector “first-time buyer schemes”.

The 2013 States Accounts summarises the HDF as:

Established under P.74/99 and P.84/99, the fund assists in meeting the requirements for the development of social rented and first-time buyer homes by providing development and interest subsidies.

Budget 2014 set out that a maximum of £250m would be borrowed in 2014 the amount transferred from the consolidated fund to the HDF. In addition, the purpose of the HDF was varied to enable the further provision and development of housing in Jersey and the HDF be permitted to lend up to a maximum of £250m to Housing Trusts/Associations/Companies so that they can provide housing on terms and conditions agreed with the Minister for Treasury and Resources (after consultation with the Minister for Housing). The HDF will be invested through the Common Investment Fund. All money due to the Fund, including loan repayments and interest will be credited to the Fund and money credited to the Fund does not form part of the annual income of the States.

The estimated housing transformation capital requirements set out in Budget 2014 suggest that there will be significant surplus capital within the fund for the initial years and to a lesser degree up to 2020 when it is expected that the entire fund will have been allocated for housing projects.

Given the States' high credit rating and current financial market conditions/low interest rate environment the money borrowed for the HDF is likely to pay interest rates that are below the returns on the CIF. As with the case of the SR, if this was to be considered there should be strict rules (e.g. repayment is clearly set out and defined with an identified revenue stream and appropriate interest rate and is

consistent with the requirement to not constrain future housing projects). The FPP's remit would need to be extended to oversee such circumstances and careful consideration would need to be given of how this might operate in practice before the framework could be extended in this manner.

The rules governing the Housing Development Fund (HDF) should be clearly stated to make it more explicit what the intended purposes of the Fund are. This should make the distinction between current uses of the Fund and the new uses relating to the bond issue, loans to housing trusts/associations and subsequent repayment. The potential flows into and out of the HDF need to be transparent.

Stabilisation Fund

When the SF was established as part of the 2006 Fiscal Framework, the States agreed that:

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

In addition it was agreed that:

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

The report to the 2006 Fiscal Framework set out that a target level/guideline for the SF was 15-20% of States net expenditure. The report also stated that given the difficulty in designing fixed rules 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 by an independent panel of at least three economists – The Fiscal Policy Panel (FPP).

The advantages of such a fund are that it facilitates counter cyclical fiscal policy which tries to delink revenues and expenditure (in Jersey terms this means trends in corporate/personal tax from financial services from immediate spending decisions) and the ability of fiscal policy to support the economy during downturns. In addition, by ensuring that deficits are not run year in and year out or that balanced budgets is the maximum achieved it supports long-term fiscal sustainability.

An independent Fiscal Commission Working Group of economic experts for the Scottish Government has advised that following independence the Scottish Government should establish a short-term stabilisation fund to manage year on year changes in oil and gas tax revenue immediately following independence and that its operation should be embedded into the wider management of the public finances.

However, a Stabilisation Fund is not sufficient by itself to run counter cyclical fiscal policy, not least as governments can use the non-fund fiscal position in other ways that counteract the impact of the SF.

As mentioned above, the experience in Jersey has been positive in that the accumulation of the SF allowed the States to run significant deficits in the aftermath of the global financial crisis, preventing the need to make painful adjustments at a time when the economy was weak, allowing swifter action in that the States did not have to agree/arrange borrowing and allowing for medium-term action through medium-term financial planning.

However, experience in Jersey also highlights a number of issues (as highlighted earlier) where the framework has worked less well and that needs further consideration and/or addressing directly:

- Fiscal policy has not always been countercyclical in Jersey since the financial crisis
- The FPP's remit focuses particularly on use of the Stabilisation Fund which may mean its mandate is unclear when the SF is extinguished.
- Future plans for rebuilding the SF are not clear

With respect to the first point, the FPP stated that fiscal policy “was not countercyclical in 2012, against the Panel’s advice to increase capital expenditure”. This suggests that lessons from 2012 can be learnt to ensure that in future years when fiscal stimulus is required the States is better able to deliver the levels of capital expenditure required. In addition, improved monitoring should be able to alert the States and ultimately the FPP when capital expenditure is not delivering the desired fiscal stance so that alternative approaches can be considered.

The FPP have advised in their annual reports that “the extent of fiscal stimulus should not be limited by the balance on the Consolidated or Stabilisation Funds”. However, greater clarity could be given within the fiscal framework to make it explicit that the FPP’s role is to advise on countercyclical fiscal policy not just use of the SF or SR.

The framework could also be clearer in explaining what the most likely outcome will be if the SF has no funds and it constrains the ability to run countercyclical fiscal policy (i.e. deficits to support the economy when conditions are weak). There are four potential solutions to such a situation:

- One-off payments into the Consolidated Fund from sales of assets/unexpected dividends etc
- Borrow from the SR (with repayments)
- Borrow from the HDF (or other funds - with repayments)
- Borrow externally/from the market

The FPP's advice could be important in determining which option is most cost effective for the States, whether it is consistent with medium-term sustainability and whether there is a viable policy approach where repayment is required.

If the SF is the valve that facilitates counter cyclical policy then its rebuilding after it has been exhausted during an economic downturn must be dependent on running budget surpluses when the economy is operating above capacity in subsequent years. This does require the ability to determine when the economy is operating above capacity and for how long it may do so, so that surpluses can be run to make sufficient payments into the SF. Given the data limitations and inherent uncertainty in a small island economy with a large international financial services sector, the expert judgement of the FPP on these matters will be instrumental in ensuring the right policies are in place.

If the role of the FPP is expanded as above to give specific advice on running countercyclical policy then this will clarify that their role is not limited to use of the Stabilisation Fund. To address the remaining issues the role of the Stabilisation Fund could be restated as:

The purpose of the Stabilisation Fund is to make fiscal policy more countercyclical and help create in the Island a more stable economic environment. The Minister for Treasury and Resources is responsible for proposing to the States the transfers between the Consolidated Fund and the Stabilisation Fund having regard to the advice of the Fiscal Policy Panel.

Money should be paid into the Stabilisation Fund from budget surpluses when the economy is above capacity and money withdrawn when the economy is below capacity. The Minister must seek advice from the FPP as to when

these conditions are met and whether any deviations from this approach are merited by unusual economic or other circumstances.

5.2. Jersey's independent fiscal institutions

The FPP is Jersey's key independent fiscal institution and was established as part of the 2006 Fiscal Framework. The States agreed as set out above that the FPP would advise on use of the SF. The report to the decision set out that the FPP would be commissioned to publish an annual report each year which set out advice and recommendations for the Treasury and Resources Minister. The Minister would have the option of asking for an additional report/update at any point in the year should economic conditions change significantly. The FPP would be made up of independent economists appointed by the States on a fixed 3 year basis with the contract being open for renewal by the States.

The FPP's reports would 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 States' financial position/forecasts given the above.
- A recommendation on withdrawals from/payments into the SF and their scale.
- What way to best mitigate the effects of any economic slowdown.
- When the SF may be at sufficient levels and payments made into the SR.

The States' Economic Adviser would not sit on the Panel but would act as Secretary to the Panel and its Jersey support – arranging/preparing for meetings, providing the information needed to write the report and arrive at a conclusion.

In 2013 the States agreed to put the FPP onto a statutory basis. The intention was to put the existing arrangements onto a more permanent footing by enshrining their responsibilities and reporting structure in law. The law also updated the reporting timetable of the Panel to include the changes made to the fiscal framework with the introduction of the MTFP. The key changes/elements of the law are summarised below:

- The Minister shall appoint the members of the Panel (after seeking the views of the Appointments Commission) and must notify the States at least 2 weeks before appointment.
- The Minister shall appoint a member of the Panel for a period not exceeding 5 years and may appoint a person more than once.
- The Minister must ensure that the Panel is provided with appropriate and sufficient resources to discharge its functions and provide the Panel with such information as it reasonably requires to discharge its functions.
- The Panel may not be directed on the advice given or the comments and recommendations made by it in any report.
- The Panel must prepare an annual report upon the state of the economy in Jersey and States finances including:
 - (a) the strength of the economy in Jersey;
 - (b) the outlook for the Jersey economy/ world economy/financial markets;
 - (c) the economic cycle in Jersey;
 - (d) the medium and long-term sustainability of the States finances
 - (e) transfers to/from, the Strategic Reserve and Stabilisation Fund.
- The Panel must publish its annual report in a year in which a draft medium term financial plan must be lodged – no later than 2 weeks before the date by which an amendment to the draft medium term financial plan must be lodged. In any other year – no later than 2 weeks before the date by which an amendment to the draft budget must be lodged.
- The Council of Ministers and the Minister must have regard to the Panel's annual report.
- The Panel must prepare a report, in a year in which a draft medium term financial plan must be lodged, for the purposes of the preparation of that draft plan and sufficiently early in the year that regard may be had to it in the preparation of that draft plan. The report must provide advice and recommendations on the prevailing economic conditions and on the medium and long-term sustainability of the States finances.
- The Minister must request that the Panel prepare a report, and the Panel must comply with the request, if the Council of Ministers is preparing a proposition to amend a medium term financial plan.

- The Council of Ministers, when preparing a draft medium term financial plan or a proposition to amend a medium term financial plan, must have regard to the relevant report published by the FPP.
- Other reports can be prepared on the request of the Minister and the Council of Ministers must have regard to such reports.

Comparing the arrangements for the FPP with the international guidance outlined above provides a number of encouraging points:

- The FPP's role and purpose was set out in 2006 and clarified further in 2013 with the changes to the Public Finances Law.
- The Panel operates with autonomy and has a good track record of publishing clear and independent recommendations.
- There have been two appointment (and one reappointment) processes that have been open and transparent.
- The Panel have built up a good reputation both within and outside the States and have enhanced their credibility with decision makers.
- The FPP are established as a key part of MTFP/Budget process.

Such a comparison also suggests a number of areas where improvements could be made:

- Objectives could be clearer particularly in terms of the States desire to run counter cyclical policy and the FPP's role in advising on it. Also what role the FPP has in oversight of any fiscal rules.
- The FPP could be given responsibility for providing the macroeconomic assumptions used by the States and undertaking income tax forecasts.
- The public finances law does make explicit mention of the Panel's independence but this could be strengthened further by:
 - an appointment process that does not involve political input or the Treasury and Resources department and is agreed by the States;
 - ring fencing the existing budget and economic resources for the Panel.

5.3. Jersey's medium-term budgetary frameworks

The move from annual business plans to 3 or 4 year Medium-term Financial Plans takes a big step towards putting in place in Jersey a medium-term framework in line with guidance.

The first MTFP included revenue and expenditure projections over a three year horizon with additional analysis on longer term trends in tax revenue and capital expenditure.

The MTFP has a sound basis in the public finances law. However, what is actually required by the law is set out largely in terms of the financial planning cycle and details around the preparation and lodging of the Plan. An MTFP for example, has to include for each financial year an intended total amount of States income and a total amount of net States expenditure from the consolidated fund.

The report accompanying an MTFP must contain estimates of the Consolidated Fund, a statement of expected purposes for contingency expenditure and 'such information as the Council of Ministers believes that the States may reasonably be expected to need in order to consider the amounts proposed'.

The MTFP does set out a number of resource principles:

Existing Resource Principles

- Be prudent, taking account of the uncertain economic and financial outlook.
- Identify and implement all possible savings and efficiencies. (For 2013 and beyond we will optimise methods of service delivery and provide value for money).
- No additional spend unless matched by savings or income.
- The Stabilisation Fund will only be used during an economic downturn, as advised by the Fiscal Policy Panel, to fund the effects of reductions in States revenues or increased demand for States services, and to provide appropriate stimulus to the economy.

Additional Resource Principles

- Maintain balanced budgets over the medium term for current expenditure and achieve an appropriate balance between taxation and spending over the course of the economic cycle.
- Actively manage the Balance Sheet as well as the Budget by maximising investment returns within agreed levels of risk.

- Plan our expenditure on capital and infrastructure over the long term and consider carefully the appropriate sources of funding for major projects, including borrowing.

Taxation Resource Principles

- Taxation must be necessary, justifiable and sustainable.
- Taxes should be low, broad and simple.
- Everyone should make an appropriate contribution to the cost of providing services, while those on the lowest incomes are protected.
- Taxes must be internationally competitive.
- Taxation should support economic development and social policy, where possible.

It is less clear how these principles have been derived and how they are applied. In addition, if the fiscal framework is to be updated with new and clearer fiscal rules it would be good for these principles to be updated and a framework in place to make them more prominent and that makes it clear how success is monitored and evaluated.

5.4. Jersey's budgetary procedures

The preparation and lodging of a draft budget is set out in the public finances law. It must seek approval of the States for the following financial year:

- Income to be raised through taxation
- A maximum amount of borrowing
- The amounts of growth expenditure
- A capital head of expenditure for each capital project
- Details of capital projects for each States trading operation
- Amounts to be transferred between the Consolidated Fund and any other fund.

The report accompanying a draft budget must contain for the financial year:

- An estimate of the amount to be paid into the CF by way of tax receipts (if proposals in budget are approved) and income
- Summary of the amount in respect of growth expenditure

- Summary of amounts to be withdrawn/paid into CF
- The nature and cost of each capital project
- An estimate of amount in CF at beginning/end of year
- Comments if any of CAG on any estimate of a capital project
- Such other information as the Minister believes that the States may reasonably be expected to need to make the decisions

Overall there is a clear process outlined in law and a requirement to provide some key budgetary data for the financial year covered by the Budget. The Budget is done on a centralised basis through the Treasury and Resources Department and the budgetary impact of policies is set out for the financial year. The framework includes a Stabilisation Fund and contingency funds, allowing significant flexibility for changing economic circumstances and unforeseen contingencies.

However, Budget 2014 was published in line with the law and the FPP concluded:

Draft Budget 2014 lacks a lot of basic and important information that is required to understand the overall impacts of proposed fiscal policy and the latest position of States finances. It is disappointing that, in this regard, the draft Budget 2014 is a step back from previous Budgets in terms of completeness and transparency, rather than the steps forward which the Panel recommended a year ago.

In their 2012 Annual report the FPP said:

The Panel have had to make significant adjustments to the financial forecasts presented in the MTFP to try to assess the underlying economic impact of the proposals. In future the presentation of States' finances would be more informative, leading to a better informed policy debate, if these types of adjustments were already included in the analysis accompanying any proposals in the MTFP or Budget.

Given these views the FPP recommended in their 2013 Annual Report that:

Budgets should be clear and concise, and the Panel recommends that every Budget should include:

- *A financial forecast for the current and next 3 years including updated income projections taking into account the latest economic developments, expenditure forecasts and budget measures.*

- *Proposed movements on the Consolidated Fund, Stabilisation Fund and Strategic Reserve for the current year and next 3 years.*
- *Data which shows what happened to these Funds in the previous 3 years.*
- *A financial forecast showing the surpluses and deficits as adjusted to recognise the economic impacts.*

The Jersey budgetary framework could be improved by adopting the FPP's recommendations in full and ensuring that it is formally part of the budget process (this could require amendment to the public finances law).

The guidance on both medium-term frameworks and budgetary procedures both emphasise the need for cautious macroeconomic assumptions and realistic revenue forecasts. It also highlights that explicitly factoring alternative scenarios helps with budgetary priorities in unforeseen circumstances.

The current framework is not explicit as to how and when financial forecasts are undertaken (beyond the requirements in the MTFP) and updated and there is currently no role for the FPP. The role and membership of the Income Tax Forecasting Group is not clearly set out and the degree of independence from Treasury unclear. Jersey's fiscal framework could be enhanced by clearly defining frequency, role and responsibilities around income forecasting and having a more explicit way of assessing alternative scenarios. If the FPP are given responsibility for financial forecasting, as set out above this would meet this requirement. It would also mean a greater role for top down budgeting, further strengthening the fiscal framework.

Further consideration should also be given to the way government accounts are calculated and presented in MTFP and Budget documents. The FPP have already requested that Budget and MTFP data is presented in a different way and fiscal data should be presented on the basis of when income is received and when it is spent, including the impacts of the States position as a whole including Social Security Funds and properly accounting for the economic impact of flows from other funds. The Chief Statistician should be asked to report to the FPP on the benefits, practicalities and resource implications of producing government finance data to an internationally recognised standard for economic accounts. This would provide back data in a consistent and recognised way and could form the basis on which States finances are presented in all Budget and MTFP reports.

It will be important to formalise any further changes to Jersey's fiscal framework ahead of the next Strategic Plan and MTFP so that both can be developed within an up to date, transparent and robust framework. There is no one-size fits all approach to fiscal frameworks and successful frameworks balance the use of fiscal rules and independent institutions to get the best results. The States' Economic Adviser should seek the advice of the FPP before formalising firm proposals that can be brought forward to update the framework in advance of the next Strategic Plan and MTFP.

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