STATES OF JERSEY

ECONOMICS UNIT: DEVELOPING A NEW ECONOMIC GROWTH STRATEGY FOR JERSEY

Presented to the States on 20th September 2011
by the Minister for Economic Development

STATES GREFFE

States of Jersey
Economics Unit

Developing a new Economic Growth Strategy for Jersey

June 2011

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Introduction

Why have a growth strategy?

- Economic growth is about increasing the value of the goods and services that are provided locally for both the domestic and international market. It is not, as is often perceived, a goal in its own right, but instead a means to an end. The end is a higher standard of living for local residents through higher income, greater job opportunities, lower tax rates and better public services.
- Growth can, and should, be consistent with well-being, environmental sustainability and social cohesion. Inequality, discontent and negative environmental effects are not the consequences of growth per se, but the consequences of inappropriately managed growth. Government can and should use its capacity to intervene to ensure that growth is achieved in a sustainable and fair manner.
- The Council of Ministers has agreed a strategy to deal with the effects that the global recession has had on the Jersey economy. This consists of three key elements, one of which is maximising economic growth (the others are reducing and improving the focus of expenditure; and raising extra revenue from taxes and charges). Financial forecasts conducted after the global financial crisis suggested that the States faced a structural deficit in the public finances in the near term. In addition, there are a variety of spending pressures and challenges that could add to the problem in the medium to long-term, such as an ageing population.
- These fiscal pressures have been highlighted on several occasions by the Fiscal Policy Panel, which has urged the States to put in place a medium-term strategy to manage these pressures.
- Although the States has in place many policies which as the legacy of the previous Economic Growth Plan address many of the issues relevant for economic growth, there is no explicit economic growth strategy in place. It is therefore important to provide clarity for Islanders and their businesses in terms of what the framework will be for supporting growth in the Island going

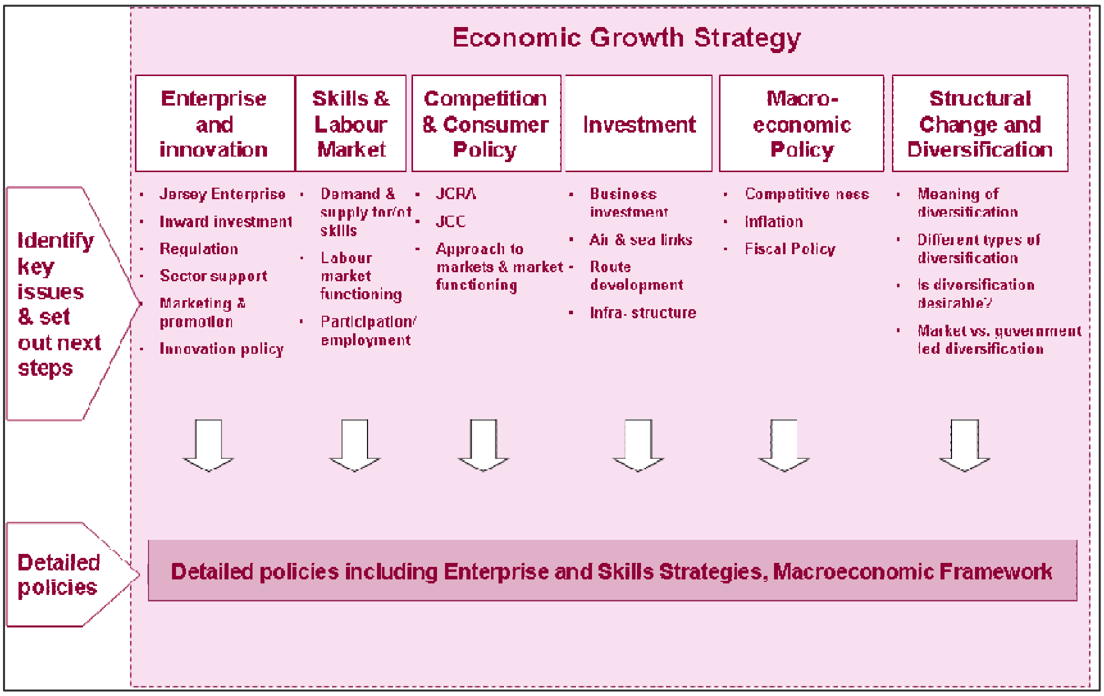
forward, setting out where the States can expect to make a difference and where it cannot.

- It is not necessary to set a target for economic growth, as there are reasons to believe that GVA growth alone may not be a good measure of success. Also the aim is not growth per se, but that of the type and nature that is complementary to wider economic and social objectives. Setting a target can therefore distract from the real objectives.

- Neither is there a need to set a time limit for a growth strategy, as the over-arching principles and strategy should remain relevant indefinitely and a successful strategy must be ongoing and self-reinforcing. However, the policies and programmes that are implemented to achieve economic growth need to be continuously reviewed and evaluated against their objectives, and where relevant, revised or stopped.

- Instead, the strategy should set out the over-arching principles and create a framework under which the policies for the new Economic Growth Strategy can be developed (see Figure 0.1 below). It is envisaged that a series of supporting strategies that cover issues such as enterprise and skills will follow. These will build on the principles set out here, and will set out more specific and detailed policies that will deliver sustainable economic growth. The new Economic Growth Strategy should also form the basis of the economic aspects of the 2012 Strategic Plan.

Figure 0.1 Economic Growth Strategy and policy development



- The key policy themes covered by the strategy should be:
    - The main drivers of productivity:
        - **Enterprise, Innovation and Business Development**,
        - **Skills and the Labour Market**,
        - **Competition and Consumer Policy**, and
        - **Investment and Physical Infrastructure**.
    - Important **cross-cutting policy areas (Planning and RUDL)**
    - **Demand: Macroeconomic stability and competitiveness**, and
    - **Structural Change and Diversification**.
- Policy development in each of these key areas should be done in a consistent and robust manner. Figure 1.11 (page 38) sets out the policy cycle that requires:
    - Development of clear rationale and objectives
    - Continued appraisal of policy alternatives
    - Monitoring of the impact during and after implementation
    - Evaluation against objectives
    - Discontinuation of policies that turn out to be ineffective.

These policy themes that should be covered by the new strategy are covered in more detail below.

Enterprise, Innovation and Business Development

Innovation is the implementation of a new or significantly improved product (a good or service), or process, a new marketing method, or a new organisational method in business practices, work-place organisation or external relations.[1] Enterprise is the process of capturing the outputs from the innovative process, developing them and taking them to market.

The combination of innovation and enterprise is a powerful one, and one that creates new economic value in two main ways. First, it can be a driver of technological

[1] OECD and Eurostat (2005) *Oslo Manual: Guidelines for Collecting and Interpreting Innovation Data*

progress and raise productivity directly. Second, it raises the level of competition and in doing so creates the incentive for innovation, efficiency and productivity across all firms.[2]

Significant progress has been made in the past few years in the areas of enterprise, innovation and business development in Jersey. Since 2007 Jersey Enterprise has provided support to hundreds of businesses through initiatives such as the small business support service and financial support through the Small Firms Loan Guarantee Scheme and grants for exports and innovation. However, it is important to take stock of what has been achieved, learn lessons from past experience, and set out a strategy for the future. The new strategy should therefore include a new Enterprise and Business Development Strategy to set out policies consistent with a number of over-arching principles, which in turn are based on evidence about what works. In particular:

- Government will not be able to determine which individual businesses will succeed and those that will fail. Instead the primary focus will be to create an environment conducive to enterprise and innovation of all shapes and sizes, achieved through a focus on addressing market failures, and particularly barriers to entry, growth and contraction. This may be supplemented by targeted, conditional support to emerging industries where it can be demonstrated that there is a convincing case of their value to the Island and that there is a role for government in assisting their establishment.
- Business development, enterprise and innovation are as much about survival and growth as start-ups and new ventures. The latter should receive special attention only where specific market failures can be identified.
- The ‘failure’ of some businesses and activities is acceptable, and even inevitable. The important thing is to ensure that support to businesses and activities that are not viable or successful, and which do not meet other objectives (for example social and environmental aims), is withdrawn at the right time and in the most appropriate manner. Equally, there is little consensus about ‘best practice’ in the area of enterprise and innovation, therefore policies should be continually evaluated and adapted to ensure they are as effective as possible.

[2] For a summary, see Nyström (2009) *Economic growth and the quantity and quality of entrepreneurship*

Next Steps

Innovation and enterprise policy has taken significant steps forward since the previous Economic Growth Plan in 2005. However, it is time to take stock and make any necessary adjustments to enterprise and innovation policies. To take forward these issues, a new Enterprise and Business Development Strategy should be developed based on an evaluation of activities in each of the following six key areas:

Support for new and emerging activities

Generic policies towards enterprise, combined with similar policies for competition and macroeconomic policy, should all serve to support the development of new and emerging activities that have the potential to provide high economic value – in the form of more job opportunities, better paid jobs and higher tax revenue for the same level of taxation – to the Island. Inward investment will also have a role to play here; by marketing the benefits that Jersey has to offer to prospective businesses and investors, Jersey will be able to attract them to the Island, and in turn generate job opportunities for local people and potentially diversify the economy.

In addition, there may be some cases where generic support is not sufficient, and there is a justification for dedicated support to be provided to a particular sector with promising characteristics. In essence the proposed approach involves targeted assistance to address barriers to the growth of sectors with the potential to be high-value and low footprint. Such support should be accompanied by strong conditionality (for example, automatic sunset clauses), and guided by a close and productive dialogue with industry.

The advantage of such an approach is that it will be supportive of new activities that could serve to diversify the economy, while at the same time ensuring that such diversification is consistent with economic growth and the continued prosperity of the Island.

Support for incumbent sectors

Although slightly different in nature, ongoing support for incumbent sectors should be appraised using a similar framework to that proposed for new and emerging activities. That is, support should be targeted at those areas where support can be justified by market failure, where it is likely to support innovation and enterprise and where high-value can be demonstrated.

The Rural Economy Strategy provides an example of this; in particular, the Rural Initiative Scheme is designed so that support goes to support approved business plans which demonstrate that new and existing businesses will:

- Develop new higher value markets and services
- Add value and reduce costs
- Improve productivity
- Enhance employment and improve skills
- Not displace existing Jersey businesses
- Not have an adverse impact on the environment

Ideally however, there may be advantages in moving towards a more general approach, and trying to incorporate existing sector approaches into generic support policies.

Business support

Existing business support policies should be evaluated to ensure that they are meeting their objectives in an effective and targeted manner. This should include:

- A review of the issues concerning access to finance, including loans, subsidies, grants and other forms of finance, with particular emphasis on identifying market failures;
- A review of the existing market development and export support such as the Export Development Initiative (JEDI). For example a review might explore the current barriers to exporting and the merits of using loans, export credits or guarantees either in addition to, or instead of, the current grant system;
- An assessment of the balance of current policies between those aimed at supporting growing businesses or start-ups, and determine whether there is scope or value in shifting this balance more towards facilitating growth in organisations of all sizes and away from encouraging start-ups per se; and,
- An evaluation of the business support services currently provided (including Jersey Enterprise) to determine whether they can be made more effective, in terms of focus, content or delivery.

Encouraging enterprise skills and culture

Encouraging enterprise skills and culture is an important role, so the development of enterprise skills should be covered by the new skills strategy, while fostering an enterprise culture should be covered by both a new skills strategy and the new Enterprise and Business Development Strategy.

Marketing and promotion

The two largest areas of focus for marketing and promotion are tourism and finance, with inward investment also receiving a small amount of resources for this purpose. Inward investment is likely to continue to play a significant role in the success of the Jersey economy. This should be based on a standard proposition to all potential businesses and investors (tailored to the requirements of individual sectors), although it may be supplemented in some cases with considered sector specific support for emerging industries where it is deemed appropriate under the framework set out in Section 8 of this report on Structural Change and Diversification.

Tourism-related marketing and promotion activities in this area will be examined to inform a new Tourism Strategy, however there may be scope to do more. In particular, there may be value in evaluating the effectiveness of other marketing and promotion activities, as well as looking at how such activities are managed and delivered, and whether there is scope for a more coordinated approach in certain areas.

Regulatory framework

There should be a commitment in the new Enterprise and Business Development Strategy to undertake a review of local regulatory requirements and their impact on current and future business operating in Jersey, with the aim of reducing any undesirable or unintended barriers to enterprise and competition. Of particular focus should be whether there is scope to improve the way in which regulations are administered: for example, through streamlining the process of submitting information to regulators and government departments.

Skills and the Labour Market

Substantial progress has been achieved since the previous Economic Growth Plan. Jersey's Skills Board and Skills Executive were established by the Council of Ministers in 2008. The Skills Executive comprises the Ministers for Education, Sport and Culture, Economic Development and Social Security and their respective Chief Officers. The Skills Board, which advises the Executive, and drives forward its policies and strategies is 'employer led'. Collectively they are referred to as 'Skills Jersey', and they cover 3 main areas of responsibility:

- Capturing employer and learner demand for skill development;

- Developing an all age Careers Information, Advice and Guidance Service; and
- Managing resources for the provision of vocational education and training opportunities.

In the short time since it was created Skills Jersey has already added significantly to the knowledge base about local skills, and the 2011 Business Plan contains a comprehensive set of objectives and key performance indicators relating to the development of skills at all levels.

The Jersey Early Years and Childcare Partnership (EYCP) has been established and 20 hours a week (term-time) free States-funded nursery education is available for children in the year before they are due to start primary school at a nursery provider which is committed to the work of the EYCP. This includes primary schools, day nurseries and pre-schools.

Other developments since the previous Economic Growth Plan include a significant increase in the offering by private sector education provides for further education and professional development. These organisations cater for the continuing professional development needs of employees in the financial sector and other businesses, and complement the suite of courses on offer at Highlands College well.

Skills Jersey requires three government departments (Education Sport and Culture, Social Security and Economic Development) to work together at both officer and Ministerial level. As is the case with the other elements aspects of economic growth, it would make sense to review and assess whether the current structure is the most effective and efficient way of meeting the Island's skills objectives. A review is already underway and any recommendations that could improve collaboration and delivery should be implemented.

There may be potential to strengthen the approach to skills and the labour market in a number of areas. Governance and incentives could be strengthened, for example, by making more use of cross-department budgets and objectives to align the incentives of different departments (Education, Social Security, Economic Development and Treasury). Further there should be a shift in emphasis with regards to labour market policy towards permanent active labour market policies for the young and 'hard-to-reach' groups.

Next Steps

Skills are an important driver of productivity improvements and there are clear circumstances under which market failure exists and government intervention can be justified. However, it will be important to determine where these circumstances exist in Jersey and critically what the most effective government interventions might be.

Skills framework

If the review of the structure and operation of Skills Jersey recommends ways that it can be improved to enhance delivery of the Island's skills objectives, they should be acted on quickly to enhance this aspect of the new Economic Growth Strategy.

A new Skills Strategy for Jersey

Much progress has been made in Jersey in addressing skills issues not least with the establishment of Skills Jersey and the research that it has undertaken. However, there is still a clear need to establish a holistic Skills Strategy for the Island that covers all the key issues including:

- Evaluating existing skills-related policies, identifying gaps and weaknesses and drawing on any lessons learned from local and international experience.
- Raising the skills levels across the population including reducing the proportion of the population with no formal qualifications.
- Identifying and addressing skills gaps within the existing workforce and providing a vehicle to identify current and new opportunities.
- An assessment of recent developments in early years care and education against the objectives and identification of strengths, weaknesses and opportunities for improvement of the existing approach.
- Continued development of a strategy to address literacy and numeracy skills across the population.
- A detailed response to the issues raised in the Green Paper on Primary, Secondary and Tertiary Education.
- Continued development and improvement in the vocational education offer in Jersey
- An expanded strategy for dealing with youth unemployment and drawing on the success of the New Deal for Young people in the UK to build on the strengths of Advance to Work.

- Assess the strengths and weaknesses of management skills in the Island and identify any issues that merit government policy.
- Identify whether more could be done to stimulate employers to network and collaborate with each other and government in skills development and investment.

The development of this strategy should be led by Skills Jersey seeking advice from the States Economics Unit where appropriate.

Employee involvement and commitment

Effective polices to improve employee involvement and commitment can bring benefits for employees and employers and there can be a number of barriers to their development. Further work should explore whether these barriers exist in Jersey and whether greater application of policies could bring benefits. For example, Jersey Enterprise should consider whether it might be of benefit to run a series of Master Classes on improving the skills and knowledge of employers on how to maximise the potential of their employees.

Support for Jobseekers

It will be important to act on the recommendations of the ongoing review of income support to ensure that policies towards the unemployed and those on low incomes minimise disincentives to work and are conducive to economic growth.

This should include an examination of the current strategy for dealing with youth unemployment, drawing on the success of the New Deal for Young people in the UK where necessary. This will include examining whether more information is needed on those young people not in employment, education or training (NEETs) in Jersey.

Further Active Labour Market Policies for job seekers of all ages should be considered in the context of the Jersey labour market and pursued where appropriate.

Minimum wage

During 2011, the Employment Forum will review the trainee rate and the associated code of practice with a view to making further recommendations to the Social Security Minister. Further consideration should also be given as to whether labour market conditions in the post global crisis world and the need to examine the current strategy for dealing with youth unemployment mentioned above, change the balance between the costs and benefits of youth minimum wage rate.

Participation and incentives to work longer

Even though Jersey has consistently high rates of participation in employment detailed consideration needs to given as to the barriers preventing those currently not participation in the labour force and whether government policy can address particular market failures. This should include but not be limited to older workers.

The States, as a major employer, should lead the way in human resources and employment policies designed to support and encourage the older worker.

The treatment of older workers under the current tax/benefit system should be reviewed to encourage individuals to remain in employment where appropriate.

The roles of social attitudes and access to lifelong learning also need to be considered.

Labour market information

Skills Jersey, the States Head Statistician and Economic Adviser will work together to identify any information gaps and whether they can be filled effectively.

Competition and Consumer Policy

In theory competition, or the threat of competition, can be beneficial for productivity and growth in three main ways. In particular:[3]

- Between-firm effects: Competition can increase aggregate productivity by encouraging firm turnover and the exit of less efficient firms.
- Within-firm effects: Competition increases the incentives for firms to increase their productivity in order to survive.
- Innovation: The relationship between innovation and competition is complex. While innovation and competition will usually be mutually beneficial, there may be cases in which ‘too much’ competition may harm innovation.

Significant advances have been made in this area since the last Economic Growth Plan. The Jersey Competition and Regulatory Authority (JCRA) is now well-established, and reforms to the Jersey Consumer Council have recently been announced that will build on its successes to date. However there may be scope to strengthen the current competition framework by keeping both under continual review

[3] This categorisation is taken from OFT (2007) *Productivity and Competition: An OFT Perspective on the Productivity Debate*

to ensure they are in line with best practice and by introducing competition assessments as a standard part of policy development.

Next Steps

In order to strengthen the existing competition framework, it is suggested that:

- The competition framework and competition law should continue to be reviewed at regular intervals to ensure that the JCRA can continue to take a pro-active approach to competition policy. Its powers and methodologies should be continually kept under review to ensure that they are in line with best practice around the world.
- Assessing policies for their impact on competition should be standard practice in all areas of government policy, for example in planning and RUDL decisions. How this can be done is set out in Section 6.
- Consumer policy should be kept under review to ensure that it is in line with best practice.

Investment and Physical Infrastructure

Investment in physical infrastructure or other forms of business investment can be key drivers of success, supporting productivity and economic growth. As a small island, Jersey does not have a large stock of physical infrastructure, however it is important that it is able to build and maintain the vital infrastructure it needs.

While business investment is important, it is not clear that there are market failures that justify government intervention. However, for physical infrastructure there are a number of such market failures that mean that there may be an active role for government. For example, transport infrastructure has many positive benefits to the Island that would not be considered in a narrow cost/benefit analysis.

The most important conclusion in this area is that strategic issues relating to important transport and communication links must be assessed on a regular basis, and where there is a case for government intervention or support, this is carefully considered.

Next Steps

- Infrastructure investment can have important economic benefits and regular and continued assessment is needed to identify and plan for future infrastructure needs.
- External transport links are strategically important in any economy but particularly an island economy and it will be important to:
  - Strengthen the process of evaluation and appraisal of new air routes
  - Investigate further 'critical mass' passenger issues at the airport and the implications for future funding
  - Review ferry services and freight markets as further experience is gained under existing policy and assess performance relative to other approaches such as a licensing regime.
- Review and assess at regular intervals future information technology and communications requirements and the ability of the current market arrangements to deliver the investment that will be required to meet industry demands to remain competitive in the future.

Cross-cutting policy areas: Planning & RUDL

While all policy areas are likely to be affected by the considerations set out above to a greater or lesser extent, the two that are likely to have the most significant impact on economic growth are policies and decisions relating to planning and Regulation of Undertakings and Development (RUDL).

Planning

Planning laws and regulations play an important role in addressing a variety of market failures in the form of externalities such as aesthetic appearance, durability and build quality and so on. But they can also have a significant impact on the success or otherwise of an economy; badly designed policies can raise the price of inputs across the economy and reduce productivity and growth.

While accepting that planning laws have benefits, the objective should be to implement them in a way that is least damaging to productivity. A high priority should be given to encouraging and facilitating productivity improvements across all sectors of the economy. This may occur by either attracting high productivity businesses from elsewhere, or encouraging the development of local businesses, existing and new. Planning policies can do this by ensuring that they facilitate the most productive use of land and do not act as a barrier to changes in the composition of the economy.

In turn this means that where possible market information such as prices (land values, rents and yields), vacancies and data on productivity should used to understand the relative demands for different land uses across different locations. While this information will only be one input into planning decisions, they should be taken seriously as an indication of the economic value of different land use permissions. The Island Plan includes a list of such indicators, and so appears to be sufficiently flexible to allow this to happen, but the critical factor will be in how it is implemented.

Next Steps

It is proposed that:

- Senior officers from the Planning Department, Economic Development Department and Economics Unit should meet on a regular (quarterly) basis to consider the economic implications of key planning decisions, including the likely impacts on productivity and competition.
- This group of officers should also discuss how the presumption against a change of use, particularly *within* employment land, is being interpreted and applied with respect to new and pending decisions. Full consideration should be given as to whether decisions are unnecessarily restricting productivity and growth.

RUDL

RUDL exists in order to manage inward migration to the Island (in tandem with the Housing Law). However, this comes at a cost. RUDL can act as a barrier to entry for new firms, and there is substantial evidence that higher barriers to entry are associated with lower productivity growth. There are two main mechanisms through which this can occur. Firstly, new firms may be more productive than incumbent firms, so their entry into the market may attract resources from less productive incumbents, and thus increase the average level of productivity. If entry is prevented or made more difficult, this will not occur to the same extent. Secondly, new firms provide the threat of competition to incumbent firms, which raises the incentive for them to innovate and raise their productivity in order to survive. In contrast, higher barriers to entry tend to be associated with higher mark-ups and lower productivity growth.

Given that RUDL is a barrier to entry, and accepting that it is a useful policy lever, the objective should be to use RUDL in such a way that its adverse effects as a barrier to entry are minimised. One way to do this would be to have explicit considerations to this effect in considerations of RUDL applications. For example, undertakings with the potential to be significantly innovative or the potential to shake up a concentrated or stagnant market (particularly where goods and services are consumed locally, but this applies to export businesses as well) – should be treated favourably in the RUDL process, if there are no conflicts with the other objectives of RUDL.

Next Steps

It is recommended that:

- RUDL and housing law application decisions continue to have regard to how they can affect economic growth. Advice could also continue to be sought from the Economics Unit by the Population Office and Housing Department about balancing the demand on resources and making efficient use of those resources.
- Evaluation of applications for (1)(i)(j) licenses should give weight to skills and potential for value-added, as well as competition while that for (1)(i)(k) licenses should give weight to potential contribution to innovation and entrepreneurship in the local economy.

Demand-Side and Competitiveness

An economy can be very productive and capable of producing high-value goods and services using minimal resources, but if there is no demand for these goods and services then the capacity on supply-side is largely irrelevant. The two major determinants of demand, particularly in small-island economies where businesses are highly mobile, are competitiveness and macroeconomic stability.

Competitiveness

Competitiveness is difficult to measure, because it includes a number of qualitative factors as well as quantitative factors, however a number of attempts have been made. One example is the Global Financial Centres Index (GFCI), which attempts to rank major financial centres according to competitiveness, using the following factors:

- **Business environment,** including ease of doing business, opacity, wage comparisons, corporate, employee and personal tax rates, bilateral tax information exchange agreements and country-risk assessments.
- **People,** including measures of intellectual capital, numbers of graduates, visa restrictions and quality of living.
- **Infrastructure,** including office occupancy costs, transport and office capacity.
- **General competitiveness,** including business confidence indices, investments and inflation indices.
- **Market access,** including measures of capital market access, credit ratings and volumes of financial trades.

While there is unlikely to be a measure that perfectly describes competitiveness, they do tend to be relatively volatile, suggesting that a competitive advantage can be lost fairly easily. Therefore while Jersey appears currently to be relatively competitive with respect to competing financial centres, it cannot afford to be complacent.

Macroeconomic Stability

Jersey has a good record of accomplishment of macroeconomic stability, with robust economic growth, low and stable inflation and prudent public finances. As in other areas though, a good record should still leave room for improvement.

One area that is particularly important, and which may require review is the Fiscal Framework. The Fiscal Framework refers to the overarching principles and structure of fiscal policy in Jersey. Specifically, this means the three main accounts and reserve funds (the Consolidated Fund, the Stabilisation Fund and the Strategic Reserve), the principles attached to their use, and the independent Fiscal Policy Panel that advises the States on the use of these accounts.

In keeping with the approach elsewhere in this strategy, policy should be reviewed and evaluated on an ongoing basis and the fiscal framework is no exception. Now would be a good time to review the existing fiscal framework and examine how it can best support the States fiscal and economic objectives going forward.

Next steps

Maintaining and improving competitiveness and macroeconomic stability are critical to future economic growth. Therefore it is proposed that:

- The Fiscal Framework should be reviewed and evaluated by the Economics Unit to examine how it can best support the States fiscal and economic objectives going forward.
- Low inflation is a key aspect of competitiveness and high inflation undermines economic growth. The focus of policy should continue to be on growth driven by productivity and supply side improvements, supported by counter-cyclical fiscal policy, which will be more conducive to low inflation.
- Jersey's competitive position should continue to be monitored on an ongoing basis so that any changes in its overall position can be addressed if necessary. Competitiveness will also be a primary consideration for all areas of government policy.

Structural Change and Diversification

Structural change involves a change in the sectors and activities that make up the economy. It can be beneficial when it involves an economy moving from low-value activity to activities that are able to generate high-value. This is because it means that businesses generate more profits and/or a greater number of better paid jobs. A local example is the move towards financial services and away from tourism and agriculture in the years since the Second World War. However, a move from high value activity to low value activity is undesirable because it will mean lower profits, employment and/or earnings which is more representative of economic decline than economic growth.

Diversification is not the same as structural change. As outlined above, the latter refers to any shift in the composition of the economy. In contrast, the former refers to a shift in economic activity in an economy that reduces the reliance of that economy on a particular sector or activity. In other words, all diversification will involve structural change, but not all structural change can be called diversification.

Although often suggested as a desirable objective for the Jersey economy, diversification does not appear to have a clear definition, nor has the justification for such a strategy been robustly set out or the potential trade-offs recognised.

Three potential arguments for diversification can be identified; diversification may:

1. Reduce exposure to a dominant industry (i.e. the finance sector) in order to reduce year-to-year volatility in jobs, economic activity and tax revenue
2. Provide industries to 'fall-back on' if a dominant industry (the finance sector) were to leave
3. Provide a greater variety of job opportunities for local people

However, it is not clear that diversification would either reduce year-to-year economic volatility or provide a "fall-back" sector in the event that the finance sector leaves. Further, even if it could, this would be a necessary but not sufficient justification for diversification: it may be that there are better ways to achieve these objectives. For example, if the objective is economic stability, then an alternative to diversifying the economy is using the Fiscal Framework appropriately: building up the Stabilisation Fund during the good times to support the economy in the downturns. If the objective is to provide an insurance policy in case the finance sector leaves, a more effective policy response to diversification may also be a fiscal policy response – i.e. extracting as much value from the high-value sectors while they are here, and using this to build up the Strategic Reserve. If an external event caused the finance sector to diminish in size or leave the Island, then the Strategic Reserve could be used to ease the transition.

To the extent that diversification is able to achieve the objective of providing alternative job opportunities for local people, the costs and benefits of using diversification to achieve this objective would need to be carefully considered, along with whether there are any alternative approaches.

The ability of diversification to achieve these objectives is important because certain approaches to diversification would require giving up some of the value that could be obtained from high-value activities. Therefore achieving the objectives set out above requires making trade-offs, which may or may not be worthwhile.

Clearly it is desirable for the government's approach to diversification in the economy to be consistent with the strategy for growth. That is, it should be about creating the right environment for business to flourish and market forces to prevail. This involves creating an environment where the skills-base can meet business needs, enterprise can flourish and there is open competition across the economy. In other words, most of the policies to support economic growth will also encourage productive activities to locate in Jersey.

However, Jersey does have a range of sector specific industrial policies, whether or not they are explicitly acknowledged as industrial policy. For example, the government dedicates substantial resources to supporting the financial services, agriculture and tourism industries. Recently there have also been a variety of activities that have been considered for support in the form of expanded shipping and aircraft registries and intellectual property. Going forward, some of the support that is already in place is likely to continue in the future, and it is likely that requests for support from new industries and activities, such as renewable energy technologies, will emerge. All of this suggests that sector-specific support will continue to be an issue in Jersey, and the question is really about how to make it best support growth and diversification.

There is a growing economic literature on modern industrial policy which argues that industrial policy should recognise that the government cannot be certain which sectors will be successful and that there should a model of strategic collaboration between government and the private sector to identify the most significant bottlenecks and the most effective policy responses. Understanding and learning from mistakes is also a critical part of the process.

This approach relies on a willingness to experiment and building strong conditionality into government support to ensure that industries in receipt of support but that are not delivering their objectives do not continue to receive this support indefinitely.

Next steps

In essence, diversification can be thought of as being supported by general policies towards productivity and economic growth. Getting these policies right will create a level-playing field and thus will not prevent high-value activities from flourishing on the Island if the conditions are right. In addition, the process and principles set out above should ensure that the right type of diversification – into high-value activity – can take place without jeopardising the Island's economic success.

At the moment there is no clearly defined mechanism or process that could involve public/private collaboration and interaction, not least around the issues of identifying potential emerging industries and whether they merit government support.

Consideration should be given to developing a process that will ensure that government support for industries and sectors is conducive to both diversification and growth. Specifically:

- Jersey's objectives and approach to diversification should be clearly defined.

- Consideration should be given to further work on developing a process with clearly defined objectives that would ensure that government support for industries and sectors is conducive to both diversification and growth. This should include strengthening existing dialogues with industry, ensuring that candidates for new and emerging industries are identified early, and that information can be gathered on the barriers to their development and potential for government support.
- Any sector support should be carefully designed to address market failures or to provide 'pump-priming', and the latter should be time-limited. Strong conditionality should be built into any support. This means that support should not be given without some combination of clear objectives, sunset clauses and mandatory reviews. Support should be discontinued unless it can be demonstrated that these pre-agreed objectives are being achieved.

Developing a new Economic Growth Strategy for Jersey

1 Introduction

The previous Economic Growth Plan was written in 2005 (P.38/2005). It set out how the Economic Development Department (then Committee), would deliver the target of 2% real economic growth per year for the next 5 years (i.e. until 2009) that had been agreed by the States in July 2004. No further commitment to an explicit growth target has been made and no new strategy has been written to replace the Economic Growth Plan.

The need for a new strategy is clear. Financial forecasts conducted after the global financial crisis suggested that the States faced a structural deficit in the public finances in the near term. In addition, there are a variety of spending pressures that could add to the problem in the medium to long-term. This has been highlighted on several occasions by the Fiscal Policy Panel, which has urged the States to put in place a strategy to manage these pressures.

As a consequence, the Council of Ministers is implementing a three-part plan. First, it is proposed that expenditure is reviewed and reduced through the Comprehensive Spending Review. The objective is to save £65m a year by 2013. Second, revenues will need to increase, and the options have been examined as part of the Fiscal Strategy Review, and measures were agreed by the States in the 2011 Budget. Finally, the Council of Ministers has committed to doing what it can to maximise the contribution from economic growth.

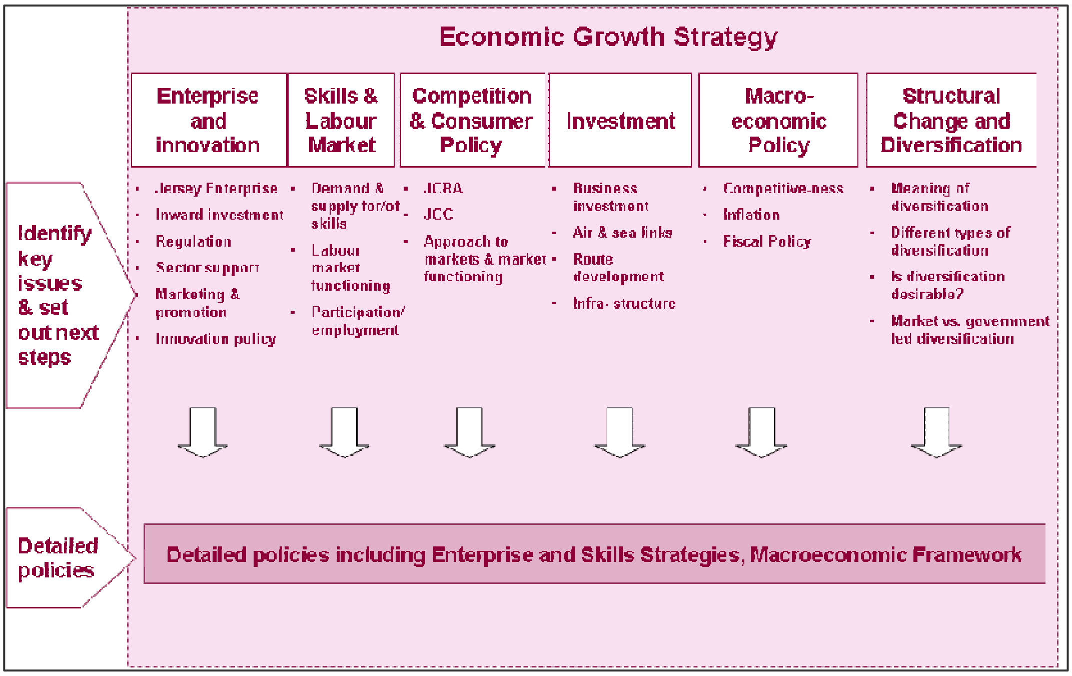
The purpose of this new growth strategy is to set out how economic growth, and therefore its contribution to public spending pressures, can be maximised, while at the same time taking into account constraints and existing commitments. For example, the Council of Ministers strategy to deal with the ageing population which makes assumptions about reasonable levels of productivity growth and inward migration. Only economic growth in excess of these assumptions can reasonably be earmarked for other purposes such as financing deficits, proving additional tax revenues or additional spending pressures. Further, the current States Strategic Plan contains a commitment to *'maintain a strong, environmentally sustainable and diverse economy'* and sets out to *"lay the foundations for a genuinely diverse economy".* How this is to be achieved, and what it means in practice for policy development and economic growth is less clear.

To this end, this report recommends ways in which policy needs to change in order to maximise Jersey's growth potential. It is based on a review of the most recent literature on economic growth and productivity from academics, think-tanks and other respected organisations and analysis of the situation in Jersey. It also looks at the links between policies to support economic growth and other policy objectives such as diversification.

This document is intended to set out the over-arching principles and create a framework under which the policies for the new Economic Growth Strategy can be developed. It is envisaged that a series of derivative strategies covering issues such as enterprise and skills will follow. These will build on the principles set out here, and will set out more specific and detailed policies that will deliver sustainable economic growth (Figure 1.1). The new Economic Growth Strategy will also form the basis of the economic aspects of the 2012 Strategic Plan.

There is no target set for economic growth, as there are reasons to believe that GVA growth alone may not be a good measure of success and that the nature and type of economic growth is as important as the rate. Under such circumstances a medium-term target could simply serve to confuse and distort economic growth policy. Neither is there a time limit set on the growth strategy, as the over-arching principles and strategy should remain relevant indefinitely and a successful strategy must be ongoing and self-reinforcing. However the policies and programmes that are implemented to achieve economic growth need to be continuously reviewed and evaluated against their objectives, and where relevant, revised or stopped.

Figure 1.1 Economic Growth Strategy and policy development



1.1 What is economic growth and why do we need it?

Economic growth is about increasing the value of the goods and services that are provided locally for both the domestic and international market. It is not, as is often perceived, a goal in its own right, but instead a means to an end. The end is a higher standard of living for local residents through higher incomes, greater job opportunities, lower tax rates and better public services – not just an increase in measured GVA.

Growth can, and should, be consistent with well-being, environmental sustainability and social cohesion. Inequality, discontent and negative environmental effects are not the consequences of growth per se, but the consequences of inappropriately managed growth. Government can and should use its capacity to intervene to ensure that growth is achieved in a sustainable and fair manner.

Economic growth is generally measured as the change in gross-value added (GVA), which measures the value of employment – the number of jobs and their rates of pay (i.e. total wages) – and the value of the profitability of businesses based in the Island. The change in GVA is a measure of the change in economic activity over time. It has to be accepted that while prudent macroeconomic management can reduce the extent of economic cycles (covered in Section 7 in Macroeconomic Stability), it is likely that there will always be periods of rapid growth and periods of falls in economic activity.

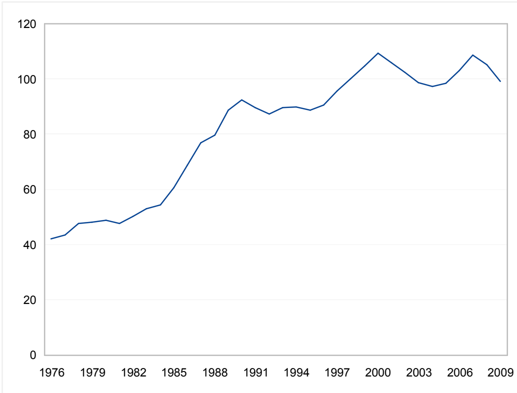
Notwithstanding inevitable cyclical fluctuations, the objective of economic policy should be for the general trend in economic activity to be upward in a manner that increases living standards as much as possible while also being sustainable. Sustainability in this context means that growth in economic activity now is not being achieved at the expense of future prosperity. For example, raising economic growth by increasing inward migration significantly or by using more natural resources could under certain circumstances simply result in more output being shared among more people or deplete the natural environment. Similarly, simply working longer hours would reduce leisure time and perhaps increase negative health impacts such as stress, and therefore growth driven by such a change will not be unambiguously beneficial.

This generally means that growth should be driven by improvements in productivity – i.e. achieving more outputs from the same inputs (labour, land and capital) – rather than by increases in the quantity resources used (discussed further in Section 1.2).

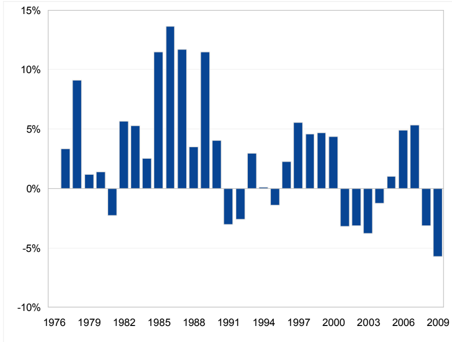
Figure 1.2 illustrates both the cyclical nature and the general upward trend in economic activity in Jersey.

Figure 1.2 Economic activity in Jersey (adjusted for Jersey inflation)

Real GVA, index, 1998=100



Annual change in real GVA, %

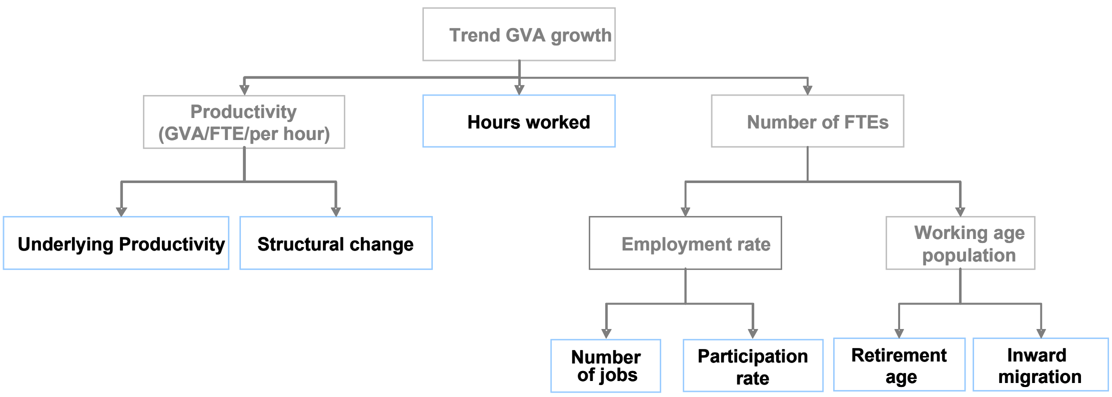


Source: Statistics Unit. Pre-1998 figures are indicative only.

1.2 What drives economic growth?

Economic growth is determined by a number of different factors. It is useful to distinguish between growth in the ability of an economy to create value – potential output – and growth in actual economic activity. The first of these is determined by **supply-side** factors. In essence, economic activity is determined by three things: the number of people that are working, the number of hours that they each work, and how much value each employee is able to generate. Each of these determinants can be further broken down into their components, as illustrated in Figure 1.3.

Figure 1.3 The determinants of potential economic growth for the economy



However, this is only one side of the story. Actual economic growth is determined by the interaction between demand and supply. For example, if the productive capacity of an economy is increasing significantly, but there is no demand for the goods or services it produces, then potential economic output will have grown, but actual economic output need not. Therefore policy to encourage growth should not neglect the **demand-side**. In particular, demand-side factors that influence economic growth are competitiveness and macro-economic stability.

An economic growth strategy needs to address both the demand and supply aspects of economic growth. A focus on the demand side would encourage demand for output without increasing the economy's capacity to supply, which would lead to inflation and other undesirable outcomes. On the other hand, a focus purely on the supply side would leave open the possibility that the economy is able to produce more at the same time that demand for the output is falling, which would be wasteful.

In order to raise economic growth in a sustainable manner, the government has to have policies in place that influence these determinants of growth. Each is covered in detail later in this paper.

1.3 The Jersey Economy

In 2009 the Jersey economy generated £3.6bn worth of profits and earnings (measured by gross value-added or GVA). Figure 1.4 (a) and (b) show the structure of the Jersey economy. As is well known, the economy relies heavily on financial services (in 2009 it was 43% of economic activity, and 27% of employment).

Figure 1.4 The composition of the Jersey economy

(a) Value-added by sector (2009) **(b) Employment by sector (2009)**

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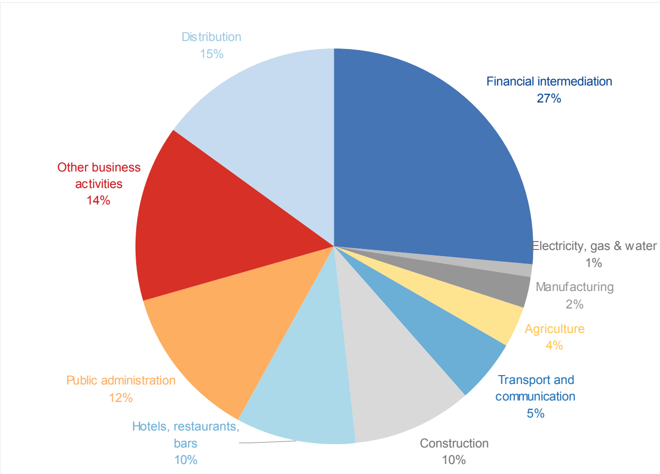


Source: States of Jersey Statistics Unit

Jersey is a small Island economy and, as such, is constrained in several dimensions. Business must compete for a limited number of resources, particularly in respect to employees and land, although capital may be scarce as well. The small size of many local markets for products and services means that local businesses aimed at the local market are unable to exploit economies of scale (although they may be able to take advantage of economies of scale available elsewhere). Due to the limited amount of capital available locally, they likely cannot raise large amounts of capital/finance on the home market (although this is probably less true in Jersey than in other small island jurisdictions given the expertise of the local finance industry). Transport costs are higher than they might be elsewhere and there is an inevitable dependency upon a limited number of transport links.

Because the local currency is pegged to UK pound and the economy is highly dependent on imports, it is likely that a significant proportion of inflation is imported, with local conditions and policies playing an important role in determining the wedge between UK and Jersey inflation. Further, since the exchange rate is pegged to the UK currency, monetary policy (i.e. the ability to influence/set the interest rates in the local economy) is not available as a policy lever to influence the Jersey economy.

As a consequence, while many of the drivers of economic growth will be the same, the approach to economic growth in Jersey will have to take these constraints into account more than might be the case in larger, less constrained, economies.

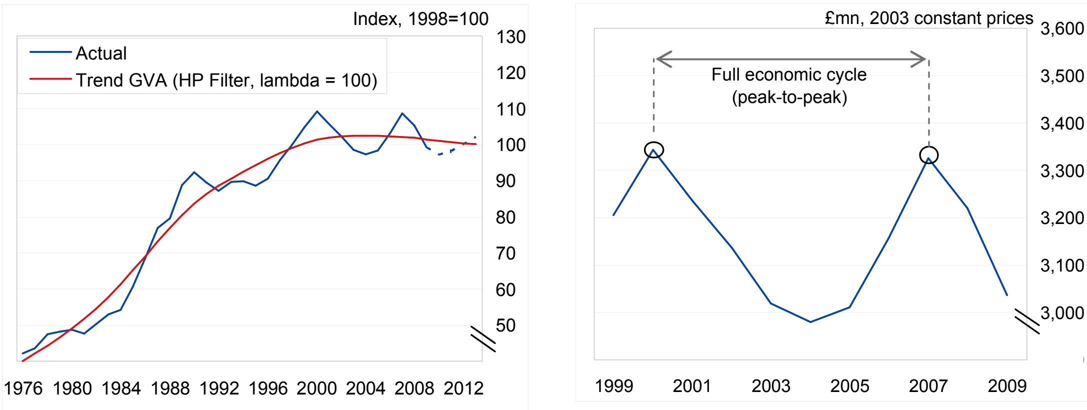
1.4 Recent economic growth performance and measures of success

In the post-war period, and particularly in the 1980s and 1990s, Jersey saw substantial growth in measured economic activity. Figure 1.5 (a) shows actual GVA (in blue) and the trend, or 'potential' GVA (in red) between 1976 and 2009. This growth was driven in no small part by the growth of the financial services industry in the Island. It is clear that the last ten or so years have not seen the same rates of growth as the Island previously experienced. In fact, over the last economic cycle, overall activity was broadly flat (Figure 1.5 (b)) and measured productivity actually fell.[4]

[4] The compound annual growth rate (CAGR) of GVA per FTE over the economic cycle 2000-2007 (both peak years) was slightly negative (-0.5%).

Figure 1.5 Recent economic performance in Jersey

(a) GVA since 1976 **(b) Most recent economic cycle**



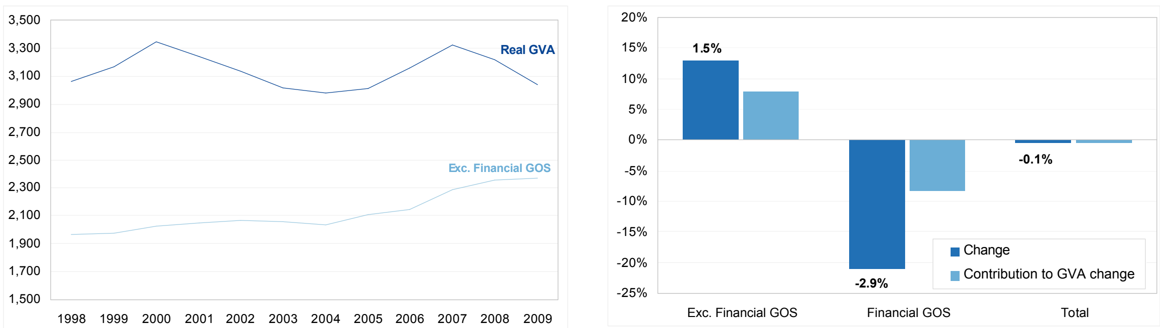
Source: States of Jersey Statistics Unit, Economics Unit calculations

However, measured economic activity in Jersey needs to be interpreted with care. A substantial proportion of GVA is made up of the profits of the financial services sector, which can be quite volatile and which fell nearly 30% over the past economic cycle. The trends in this component of GVA can be vulnerable to one-off factors which may or may not relate to changes in the 'real' economy in terms of employment and/or tax revenue. Excluding financial sector profits, the other components of GVA actually grew by around 13% or 1.5% p.a. over the economic cycle (Figure 1.6 (b)).

Figure 1.6 A more detailed look at GVA

(a) Real GVA
£m 2003 prices

(b) Change and contribution to GVA growth over last economic cycle
Total % change, 2000-2007. Figures over the bars are the compound annual growth rates



Note: GOS stands for *Gross Operating Surplus*, and is essentially the profits of companies. GOS, together with *Compensation of Employees* and the profit/income of sole traders, add up to total GVA.

Source: States of Jersey Statistics Unit, Economics Unit calculations

Further, the relatively small size of the economy and the large size of some financial services firms can mean that one-off events in certain organisations can affect the headline figures, whereas in larger economies they would get lost in the fluctuations of the rest of the economy.

All this suggests that a focus on measured GVA growth is perhaps not the right approach. Therefore, while it is a useful indicator, the approach taken by this growth strategy is *not* to specify a target rate of economic growth measured by GVA, as has been done in the past. In addition, it is suggested that a wider basket of indicators are taken into account when considering the success of this strategy, for example including, but not limited to:

- Employment
- Unemployment
- Average earnings and income distribution
- Economic participation
- Sustainable public finances
- Improved infrastructure
- Population
- Islanders' perceptions of quality of life
- Environmental objectives
- Highly valued public services
- Life expectancy
- Public safety and levels of crime

1.5 Existing strategies and commitments

The previous Economic Growth Plan was written in 2005 (P.38/2005). It set out how the Economic Development Department (then Committee), would deliver the target of 2% real economic growth per year for the next 5 years (i.e. until 2009) that had been agreed by the States in July 2004. This has guided and shaped a variety of policies that the States has implemented since, and continues to implement to this day, that are designed to encourage economic growth. However, now is an appropriate time to set out a new strategy to build on the successes of the Economic Growth Plan.

As outlined in the introduction, there are 2 other existing policies that are likely to interact with economic growth and its determinants. These are the strategy to deal with the ageing population and the 2009-2014 States Strategic Plan.

Strategic Plan

The 2009-2014 States Strategic Plan contains a commitment to *'maintain a strong, environmentally sustainable and diverse economy'*, and to *'continue work to diversify the economy, support new and existing businesses, attract low footprint / high value business from elsewhere and foster innovation.'* Other commitments that are relevant for economic growth are the commitment to *'maintain and develop the Islands' infrastructure'* and to *'maintain high quality education and skills.'* There is no explicit target within this document with respect to economic growth or any of its determinants, with the exception of the reiteration of inward migration target, discussed further below.

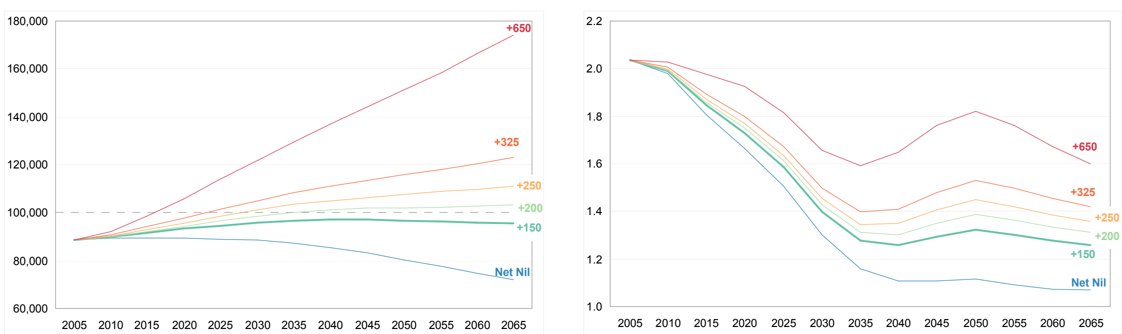
Ageing Population

Jersey, like many economies, is facing the prospect of an ageing population as fertility declines and longevity increases. Figure 1.7 illustrates what this is projected to look like in Jersey in the scenario without any net inward migration: not only would the total population be projected to fall, but the ratio of the number of people in the working population to those that are not of working age, or 'dependent' (i.e. those too young or old to work) will change substantially over the next 20 years. Specifically, in this scenario it is estimated that the Island would go from a situation where there are two people of working age for every dependent, to a situation where there was just 1.3. This has substantial implications for the ability of the government to provide public services as there are less people working to support a growing number of dependents and also the total level of economic activity that can be sustained by a shrinking working age population.

Figure 1.7: Projections of total population and the support ratio in Jersey

Support ratio is calculated as the working age population divided by number of those not of working age. It is also the inverse of the dependency ratio.

(a) Total Population **(b) Support Ratio**



Source: States of Jersey Statistics Unit

The previous Council of Ministers looked at this issue, and found that the net cost of the ageing population was likely to be in the region of £190m by 2035, under the assumption of no net inward migration (CoM Population Policy, 2009). The CoM proposed to deal with it in several ways, as set out in Imagine Jersey 2035 and the most recent Population Policy supporting the Strategic Plan. One of the ways in which the costs of an ageing society are to be met is by raising the level and growth rate of economic activity, through policies that affect its determinants. As set out above, these are productivity, structural change, hours worked, participation rate, the pension age and the level of inward migration.

Thus the Population Policy set out the key commitments concerning population size and inward migration, which are to:

- Maintain the absolute level of the working age population in the Island
- Ensure the total population does not exceed 100,000
- Ensure population levels do not increase continuously in the longer term
- Protect the countryside and green fields
- Maintain inward migration within a range between 150 and 200 heads of households per year in the long term
- In the short term, allow maximum inward migration at a rolling five-year average of 150 heads of household per year.

The net contribution to the cost of the ageing population (relative to net nil inward migration) of 150 heads of household per year has been estimated at approximately £11m per year by 2035 and £19m per year by 2065 (Figure 1.10).

Further proposals have been made which would see increases in the age at which the state pension was payable, increasing workforce participation, and new forms of public contributions to fund the costs of an ageing population such as residential care insurance and health insurance. The latter does not increase economic growth, but the former will do by increasing the number of people of working age who are in work or looking for work.

Figure 1.8 summarises the assumptions behind the determinants of economic growth that were used by the Population Policy and the most recent Strategic Plan.

Figure 1.8: Existing commitments concerning economic growth and its determinants

	Ageing Population Measure	Fiscal Impact by 2035	Strategic Plan
Productivity	1% per year	£40-70m	
Structural Change	Shift 2-3k into high value	£10-15m	continue work to diversify the economy, support new and existing businesses, attract low footprint / high value business from elsewhere and foster innovation
Hours Worked			
Participation Rate	2-3k more people active in labour market	£10-15m	
Number of Jobs			
Pension Age	Increased by 3-6 years	£30-60m	reviewing pension provision, including a review of the age at which the Social Security pension is first payable
Inward Migration	+150 HH p.a	£10m	+150 HH p.a.
Islanders pay more in taxes/contributions		£30-50m	
TOTAL		**£140-235m**	

Source: Council of Ministers – Population Policy

It is important to note that realising the assumed economic growth of 1% per annum is going to be a crucial component ensuring that Jersey is able to meet the challenge of the ageing society. If these commitments to raise the level of economic activity cannot be achieved, it will be much harder to tackle the rising costs of an ageing population.

It also needs to be recognised that to some extent the economic growth that could be achieved within the constraints of these assumptions has already been earmarked to finance the costs of an ageing population. Only growth over and above this can be used to finance other policies or fiscal deficits, and it is important that potential growth is not "double-counted".

1.6 Can more be extracted from economic growth?

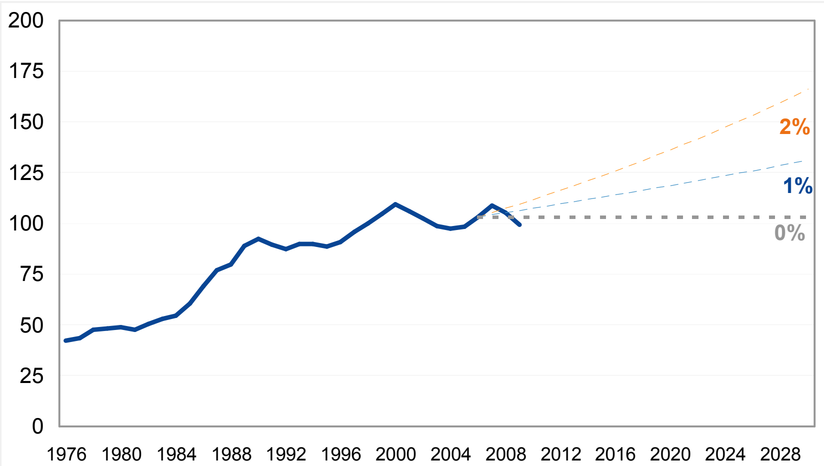
In order to use the proceeds of economic growth for anything over and above what has already been allocated to deal with the ageing population – for example, to raise money to close structural deficits in the public finances or to finance investment and improved public services – a higher level of economic growth would have to be achieved.

Work by the Economics Unit suggests that the economy was operating near sustainable level of economic activity in 2006 (Figure 1.5 (a)). This analysis was based on a combination of statistical and theoretical methods to determine trend growth in the past and then corroborated by data on other variables.

Taking 2006 as the most recent year when the economy was producing at a sustainable level, Figure 1.9 illustrates the path of potential output under three different scenarios of 0%, 1%, and 2% trend growth. Clearly small differences in growth rates can make a substantial difference in the level of potential output after only a few years, due to the compound nature of growth rates.

Figure 1.9 Illustration of different trend rates of growth

Real GVA, index 1998=100



Source: Statistics Unit. Economics Unit calculations

However, while small differences in growth rates make a large difference over the medium and long term, achieving even small increases in the growth rate can be very difficult. Governments of already highly developed economies have found it extremely difficult to identify a solution that leads to long-term increases in the rate of productivity growth.

Analysis by the Economics Unit suggests potential productivity growth per worker in the future in the region of 0.4% to 1.2%. As a consequence, even with active policies to encourage and promote economic growth, the 1% productivity growth assumed as part of the strategy to deal with the ageing population appears to be at the top end of the range of reasonable assumptions.

This is likely to be particularly the case when:

- The number of hours worked by those in work is not something that government has much influence over, and may not be a desirable or sustainable route to economic growth.
- The participation rate is already high, and the goal of getting an additional 2,000-3,000 more people active in the labour market is probably the most that could be relied upon.

- The number of jobs is not something that the States can influence directly. Further, it is already doing what it can in terms of keeping the Island competitive and attractive for businesses.
- The discussion about the age at which the Social Security pension is first payable is an ongoing one, but the assumption that 3-6 years could be added to it remains a reasonable one, and anything more, while possible, should not be relied upon.

Consequently, achieving a higher level of economic growth would require more radical approaches taken towards the determinants of economic growth that remain, particularly, inward migration and structural change.

There is unlikely to be much scope to change policy on inward migration in the near future. In the most recent restatement of the Population Policy the CoM stated that:

'Despite what could be argued is a more acute need to maintain the level of the working population in the Island, having listened to public opinion, the CoM has revised its policy proposal for inward migration from 200 heads of household (c.430 people) per annum to 150 heads of household (c.325 people).'

As Figure 1.10 shows, increasing the level of inward migration would have a positive impact on the fiscal position of £4m a year by 2035 and £6m a year by 2050. But inward migration is not simply important for the fiscal position. As pointed out above, an ageing population leads to a higher dependency ratio and a lower working age population. This in turn can lead to shortages of sufficient labour to maintain the success of the economy, and thus risk the prosperity of the Island. In contrast, allowing controlled inward migration can mitigate these risks and allow the economy to continue to prosper even in the face of challenges from an ageing population.

Figure 1.10: The net effect on the fiscal position of inward migration

£m, relative to nil net inward migration

	2035	2050
+150	11	19
+200	15	25
Difference	4	6

Source: Oxera calculations

With respect to structural change in the economy, again there is not a lot of scope to be more radical than that which has already been committed to i.e. shifting a total of 2,000-3,000 jobs into higher-value sectors. If it were possible to shift a further 2-3,000 jobs (making 4,000-6,000 relative to 2005) into higher value sectors, this could be expected to raise £20-30m in additional taxes.

Analysis for Imagine Jersey suggested that the absolute maximum proportion of the private sector that could be directly employed in financial services is around half. This would be equivalent to 40% of the working population (as the public sector is around 12%). Currently around 25% of the working population is employed by the financial sector, and the commitment to shift 2-3,000 more jobs across would bring this number to 30%. Shifting another 2-3,000 jobs would raise it further to around 35%, and approaching the maximum.

Two options are shifting jobs from relatively low value-added sectors into either (a) the finance sector, or (b) other, non-financial, but high-value, low footprint sectors.

The first option may be seen to contradict the existing commitment to *'maintain a strong, environmentally sustainable and diverse economy'*, since shifting a greater number of jobs into finance could be seen as the opposite of diversification. Although it is conceivable this could be achieved by diversification within finance as discussed in more detail in Section 8.

While the second option of diversifying into non-finance business that is high-value added and low-footprint would be consistent with a diversification agenda, it would also require new sectors of the economy that can deliver wages and value-added of a similar magnitude as the finance sector currently delivers. Very few candidate sectors currently exist. Should one emerge this would raise additional revenue, however relying on the emergence of such a sector would not be prudent. In addition, this is also exactly the type of employment that all economies (and in particular other small island economies) are looking for, so Jersey would need to be fleet of foot to ensure that it became the place where these new sectors located.

In summary, most of what is achievable in terms of economic growth has already been factored in to policy decisions concerning the ageing population, although clearly a new Economic Growth Strategy is still needed to set out how to achieve it. While it will still be important to encourage productivity growth, experience suggests that raising trend growth in this manner is very difficult. The only other plausible way to increase economic growth is through further structural change. Diversification into high footprint/low value industries would contradict the objective of maintaining a strong economy, and would not provide extra revenues for dealing with fiscal pressures. However, using structural change to boost economic growth could be consistent with a diversification objective provided that the commitment to diversify the economy and the commitment to attract low footprint/high value business from elsewhere are taken together, and that any diversification is achieved through encouraging low footprint/high value industries. This could include diversification within the finance industry into new markets and products. The issue of diversification is explored further in Section 8.

1.7 Justifying Government Intervention

There may be a number of different ways for a government to intervene to promote economic growth, whether it be through government providing certain goods and services, or by setting up rules and structures. Regardless how the government intervenes, it is important that is does so in a manner that is effective and leads to the most desirable outcomes.

When the issue is government expenditure, a key issue is to ensure that limited government funds (for any given level of taxation) are spent on the activities that provide the greatest benefits to society and that they are spent in the most efficient way. Similarly, when the government is intervening in other ways, for example by introducing new laws or regulations, it is important that are designed to minimise costs and maximise benefits.

This section provides a consistent framework for assessing potential government interventions and ensuring that the States of Jersey only implements policies, programmes and projects that will maximize improvements in efficiency.

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

- Improving economic efficiency by working with markets to achieve more desirable outcomes
- Achieving social objectives such as equity.

Satisfying one of these conditions is *necessary*, but *not sufficient* to justify government intervention; in addition, it is crucial that such intervention would *improve* the situation and to a greater extent than alternative options. In other words, the expected net benefit of a proposed government intervention needs to be compared against the alternative of doing nothing as well as against other policy options.

It should be noted that although the implication is that no government intervention is the default position, this is not necessarily because markets are generally to be trusted to deliver the right outcome and market failures are the exception. In contrast, the instances of market failure may well be in the majority. However, government intervention still needs to be justified on the basis of both (a) the existence of market failure, and (b) the likelihood that intervention will improve matters. This not only guards against distorting those markets that would otherwise function well, but it should, as part of the process, clarify the reasons for government involvement and therefore give an indication as to what the appropriate and most effective intervention may be.

Economic efficiency

Economic efficiency is reached when it is not possible to make anyone better off without reallocating resources from someone else, thus making them worse off by the same amount or more. If an economically efficient outcome is achieved, this ensures that total resources (inputs) are allocated in the most productive manner (i.e. maximising output).

In some cases the market mechanism is able to achieve an economically efficient outcome; however this is not always the case. Where the market mechanism cannot achieve economic efficiency it is referred to as a 'market failure', and can occur for the following 4 reasons:

1. **Externalities:** These occur when an activity produces benefits or costs for other activities that are not taken into account by market prices. For example, the private returns which an individual receives from a particular action (e.g. pay or profits) differ from the returns to society as a whole (e.g. the actions incur additional costs, such as pollution, which fall on others). The typical example is where a firm polluting a river does not take into account the costs it is imposing on those who have to clean the water for their use.

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

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

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

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

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

Equity

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

Additionality

To calculate the success of a government intervention (in terms of employment or output) it is necessary to calculate its additionality. That is, the net impact after taking into account what would have happened in the absence of the intervention. There are 3 specific ways in which the net benefits may not be as large as they first appear: deadweight, displacement and leakage.

In the context of public policy interventions, the term deadweight is used to refer to the costs of achieving outcomes which would have occurred without the intervention.[5] Displacement (or substitution) measures the extent to which benefits of a project are offset by costs elsewhere – for example, reductions of output or employment elsewhere in the economy.[6] Leakage refers to cases where the benefits of (Jersey government) expenditure accrue to those outside the Island. For example, expenditure by Islanders on imports sends money away from the Island and the benefits such as jobs will be found in the country of origin.

[5] This is slightly different from the other use of the term deadweight in economics, as in *deadweight loss*, which is the inefficiency or lost value that arises from a policy intervention such as a tax.

[6] The difference between displacement and substitution is a subtle one. If, for example, a public intervention increased employment in activity A in Town 1, this would be the gross benefit. To the extent that activity A falls in Town 2, there would be displacement. To the extent that there is less activity B (wherever it may take place), there would be substitution.

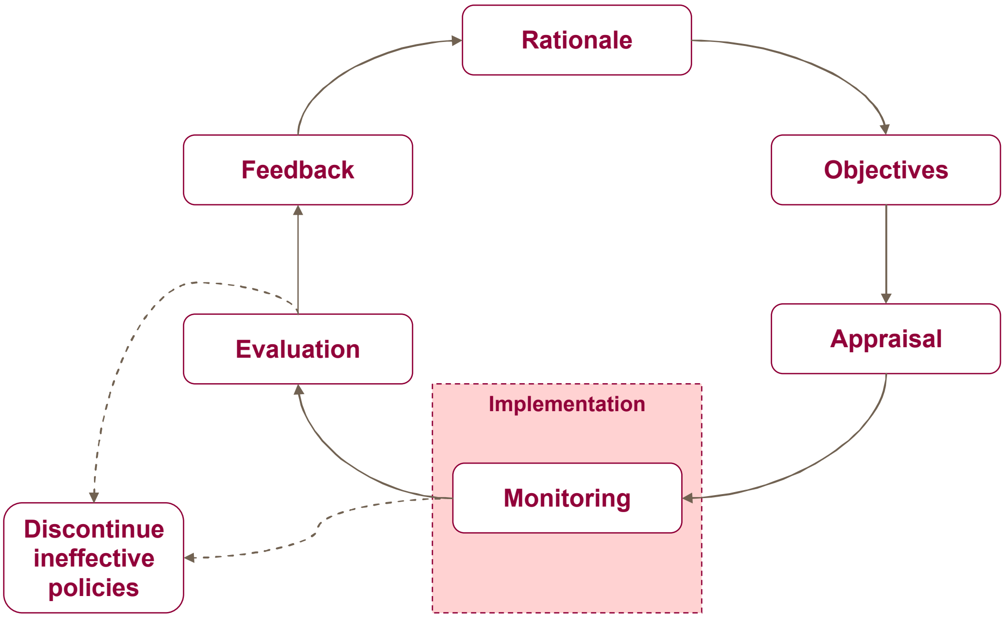
Implications for Policy

In order to ensure that limited public funds are being used to maximum effect, department policies relating to economic growth and development should be evaluated against the following questions in a comprehensive but proportionate manner:

- Can government intervention be justified?
    - Is there a market failure or a social objective that the market outcome will not achieve on its own?
    - Can government intervention improve the situation relative to the 'do nothing' alternative?
- Is the proposed intervention an effective use of public money? Have other options been examined and is the proposed intervention the most effective way of achieving the objectives?
- Does the proposed intervention encourage sustainable economic growth, or at the very least, is it consistent with it?

Government intervention can then be validated, objectives set and options reviewed by analysing their costs and benefits. In each case a range of possible approaches and policy options which may achieve similar results should be considered, where possible attributing monetary values to all impacts of any proposed policy and assessing the costs and benefits for relevant options. A good guide to undertaking analyses of this sort can be found in the Green Book produced by the UK Treasury, and Figure 1.11 illustrates how the policy process should work in theory. The advice of the Economics Unit could be sought at the key stages in the cycle, although clearly implementation is a matter for the States department concerned.

Figure 1.11 The Policy Cycle



Source: Adapted from HM Treasury – Green Book

The intention is that this growth strategy forms an overarching set of principles by which policies can be guided. While these principles are unlikely to change over the short- to medium-term, the policies that are intended to encourage economic growth should be developed within the policy cycle; that is, they should be continually assessed, evaluated and revised where appropriate to ensure that they are still consistent with these principles and that they are effective in achieving the objectives that they were designed for. There should be a standard policy development process across all the key elements of the economic growth strategy.

1.8 The Key Drivers of Economic Growth

The rest of the document examines each of the key drivers of economic growth in detail in order to identify the pertinent issues for Jersey and areas where further work is needed in order to develop and implement the right policies for growth. It is structured as follows. First, the factors that affect the supply capacity and productivity of the economy are covered; in particular, labour market and skills, innovation, competition, enterprise and investment. Second, those issues that affect the demand for the goods and services produced by the Island are looked at, including macroeconomic stability, competitiveness and the marketing and promotion of the Island and its goods and services to potential consumers abroad. Third, and final, the issues of structural change and diversification are examined, in the context of their relationship to economic growth.

Productivity

As pointed out in Section 1.1, improvements in productivity are the only way to increase economic growth in a sustainable manner. Productivity is a measure of the amount of value that can be created by a given amount of resources. There are two commonly used measures of productivity, which are:

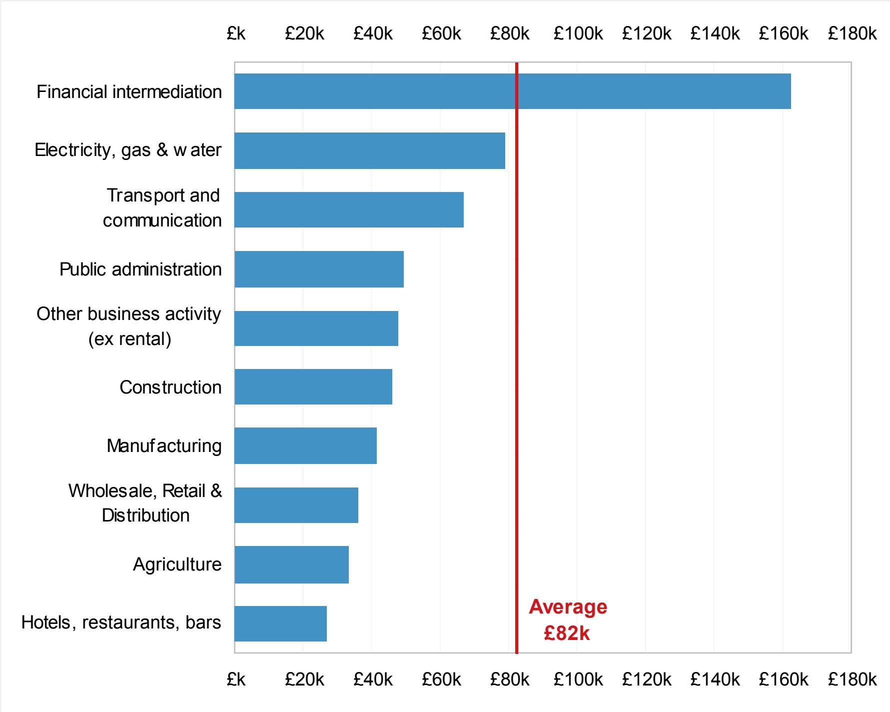
- **Total factor productivity (TFP)** or **Multi-factor productivity (MFP)** is the most comprehensive measure of productivity in theory. It measures how much output can be achieved for a given quantity of all inputs. While in practice changes in TFP can be estimated as the residual change in output after all changes in inputs have been taken into account, in practice it requires being able to measure all the inputs in the economy, including capital which is notoriously difficult to measure.
- **Labour productivity** is the easiest metric of productivity to measure in practice (although not without its own measurement difficulties) since it can be estimated by dividing the level of output (GVA) by the amount of labour (e.g. full time equivalent employees, or FTE)[7] in the economy, and it is the measured used in Jersey. The main drawback of labour productivity as a measure is that it will be influenced by 'capital deepening': if more capital is used in place of labour, it will appear as though labour productivity is increasing, when in fact it is just that capital is being substituted for labour as an input. This is not to say that the substitution of labour with capital is necessarily a bad thing – particularly in a labour constrained economy – just that focusing on labour productivity as a measure alone may not be that informative under certain circumstances.

Productivity performance can be split into two distinct but inter-related dimensions: levels and growth rates. In terms of the level of labour productivity, finance is by far the most productive sector in the Island. As Figure 1.12 shows, there is £160k of value-added for each full-time employee in finance, whereas the equivalent figure in the next most productive sector (the utilities) is around £80k.

[7] Strictly speaking, one should use the total number of hours worked; otherwise this measure will be influenced by employees working longer, which is an increase in inputs rather than an increase in productivity. However, since data on hours worked is not always readily available, GVA/FTE serves as a useful proxy.

Figure 1.12 Labour productivity by sector in Jersey

Value-added per full time equivalent employee, by industry. Average 2000-2007, 2009 prices

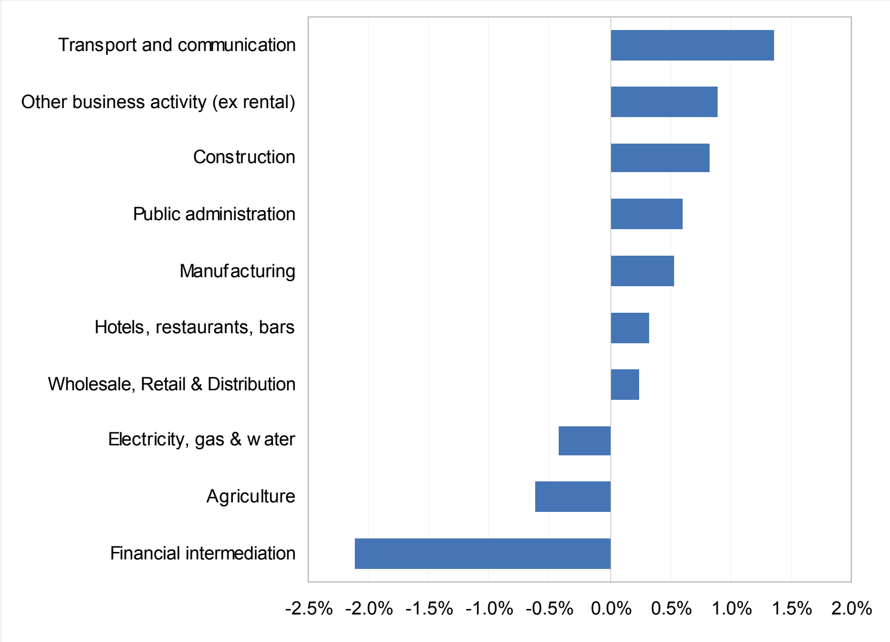


Source: States of Jersey Statistics Unit

While the level of productivity is a good approximation for the current standard of living, it is growth rates in productivity that determine the rate of economic growth and the rate at which the standard of living improves. Figure 1.13 shows labour productivity growth by sector in Jersey.

Figure 1.13 Average annual labour productivity growth by sector, 2000-2007

Compound annual growth rate of real GVA/FTE



Source: Jersey Statistics Unit, Economics Unit Calculations

Aggregate productivity growth can be driven through two different channels: (i) raising the growth rate of productivity in existing sectors, and (ii) shifting jobs and economic activity towards sectors with higher levels of productivity.

As noted above (Section 1.6) there is a limit to the extent to which there can be a further shift in the proportion of employment into finance. To the extent that there exist other high productivity sectors with greater scope to expand, average productivity growth through structural change may be possible. However no obvious candidates exist at the moment. For this reason the focus is on the first channel of raising productivity in all existing sectors.

With regard to raising productivity across existing sectors, there are five widely accepted drivers of productivity are:

- Skills;
- Innovation;
- Enterprise;
- Competition; and
- Investment in physical capital (including infrastructure)

These are all interdependent – for example greater skills will in turn lead to greater innovation and enterprise, and greater competition is likely to encourage innovation and enterprise. Existing policies in each of these areas are assessed in turn below against best practice and in light of identifiable market failures. In addition to these drivers, there are some overarching things that affect more than one of the above, including management quality, institutions, regulation and government support, which are covered where relevant below.

2 Enterprise, Innovation and Business Development

Innovation is the implementation of a new or significantly improved product (good or service), or process, a new marketing method, or a new organisational method in business practices, work-place organisation or external relations.[8]

Enterprise is the process of capturing the outputs from the innovative process, developing them and taking them to market. Entrepreneurship policy is not the same as the promotion of small and medium-sized enterprises (SMEs); instead entrepreneurship policy is broader, encompassing a variety of policies and constituency groups.

The combination of innovation and enterprise is a powerful one, and one that creates new economic value in two main ways. First, it can be a driver of technological progress and raise productivity directly. Second, it raises the level of competition and in doing so creates the incentive for innovation, efficiency and productivity across all firms.[9]

Market Failure and government intervention

There may be justification for the government to intervene in these areas because the social benefits of generation new ideas and bringing them to market may be greater than those considered by private individuals and businesses. For example, innovation often has positive benefits to wider society beyond those considered and captured by individual innovators. This suggests that without government intervention, the market would produce a lower level of innovation than is optimal. Similarly, the case for public intervention to encourage enterprise can be made based on market failures resulting from three types of externalities:[10]

- **network externalities:** the success of an enterprise may be influenced by the geographic proximity of complementary enterprises. In such cases there may be benefits from geographic clustering, sectoral linkages, or networks, and therefore a case for certain types of intervention that help bring these networks about.
- **knowledge externalities:** Similar to the externality involved in innovation, knowledge developed by a particular enterprise may be of benefit to others

[8] OECD and Eurostat (2005) *Oslo Manual: Guidelines for Collecting and Interpreting Innovation Data*
[9] For a summary, see Nyström (2009) *Economic growth and the quantity and quality of entrepreneurship*
[10] Adapted from the analysis in Audretsch (2004) *Sustaining Innovation and Growth: Public Policy Support for Entrepreneurship,* Industry and Innovation, vol 11; 167-191

and this benefit will not be factored into the decision of the individual entrepreneur; and

- **learning externalities:** entrepreneurs may be inspired by, or learn from, other entrepreneurs.

Although there is not a clear consensus, the literature appears to point to some tentative conclusions and implications for policy with respect to enterprise.

There is evidence that suggests that productivity growth is driven by entry and exit of firms rather than the improvement in productivity of existing firms.[11] However, in absence of an identified market failure, there is no reason to believe that people create too few or the wrong businesses in the absence of government intervention. If this is the case, encouraging start-ups in general will not be effective public policy because it will lead people to start marginal businesses that are likely to fail, have little economic impact, and generate little employment.[12] Similarly, indiscriminate support of small business is likely to lead to resources being used to support "lifestyle" businesses that have little or no potential or intention to grow.

Further, the evidence does not suggest that start-ups in general necessarily have higher productivity than older firms do: for example, a study by Haltiwanger, Lane and Spletzer (1999) looked at the relationship between firm productivity and firm age and found that firm productivity increases with firm age.[13] This conclusion is supported by recent research suggesting that differences in the growth of firms after entry, rather than entry rates, account for the main difference between US and European business dynamics.[14]

However, there is broad agreement that determining which businesses will be successful and which will be unsuccessful is notoriously difficult; not only are many business ventures unsuccessful, but it is very difficult to identify *ex ante* those that will succeed. Further, NESTA (2010) suggests that policies targeted at high-growth businesses are necessary, but not sufficient. They need to be combined with structural reforms that address barriers to entry, growth and contraction.[15]

[11] Disney, Haskell & Heden (2003) *Restructuring and Productivity Growth in UK Manufacturing*
Foster, Haltiwanger and Krizan 2002): *The link between aggregate and micro productivity growth: Evidence from retail trade*, NBER Working Paper August 2002.
[12] Shane (2009) *Why Encouraging More People to Become Entrepreneurs is Bad Public Policy*
[13] Haltiwanger, Lane and Spletzer (1999) *Productivity Differences Across Employers: The Roles of Employer Size, Age and Human Capital*
[14] Bartelsmann, Haltiwanger and Scarpetta (2004) *Microeconomic Evidence on Creative Destruction in Industrial and Developing Countries*, World Bank Policy Research Working Paper
[15] NESTA (2010) *Growth Dynamics: Exploring Business Growth and Contraction in Europe and the US*

Therefore, instead of either indiscriminate support of enterprise or determining ex ante which businesses are likely to be successful, the evidence seems to suggest that the appropriate policy response is not simply to give support to marginal entrepreneurs to start businesses such as loans, subsidies, regulatory exemptions, and tax benefits that encourage more and more people to start businesses. Policy should give targeted support to enterprise of all sizes – from start-ups to large organisations – where it can be demonstrated there is a market failure, and focus on addressing barriers to entry, growth and contraction.

The suggestion is that the role for policy should be in creating the right environment and institutional structures to support the flourishing of promising businesses and the contraction of those that are inefficient or not sufficiently innovative. Furthermore, it would appear that government intervention should be designed in a manner that does not encourage start-ups per se, but the exploitation of opportunities by, and growth of, businesses of all shapes and sizes, from start-ups through small businesses to large established ones.

There is a substantial literature on how government can create a favourable environment for enterprise and innovation along these lines. For example, with respect to enterprise, the literature tends to categorise its determinants under the headings of; regulatory framework, research, development and technology, entrepreneurial capabilities, culture, access to finance and market conditions. Along similar lines, a previous UK government identified five 'enablers', which were culture, knowledge and skills, access to finance, regulatory framework and business innovation.[16]

With respect to innovation, the OECD recently published an Innovation Strategy[17], which is built on five policy principles for innovation:

1. Empowering people to innovate
2. Unleashing innovations
3. Creating and applying knowledge
4. Applying innovation to address global and social changes
5. Improving the governance and measurement of policies for innovation

[16] BERR (2008) *Enterprise: Unlocking the UK's Talent*
[17] OECD (2010) *OECD Innovation Strategy*, available at www.oecd.org/innovation/strategy. The OECD also plans to develop a policy handbook to provide operational advice and guidance for implementing an innovation strategy.

That said, there is evidence from the EU that most public innovation support actions seem to fall short of addressing the barriers to enterprise and innovation that organisations often cite – for example, have little impact on the capability of companies to innovate.[18] The same study concludes that there is very little known about 'best practice' in these areas, and that instead the focus should be on striving for 'better practice'. Therefore, within each of the determinants of innovation and enterprise, it is important that policy interventions are continually evaluated and adapted to improve their effectiveness and ensure they are addressing the undesirable and unintended barriers faced by business.

In addition to the 'microeconomic' determinants of enterprise and innovation outlined above, policy needs to be implemented in the context of sound 'framework' conditions, which means sound macroeconomic policy – fiscal discipline and low and stable inflation – competition, openness to trade and well-designed investment, tax and financial systems.

Enterprise, Innovation and Business Development Policies

Although there is no source of good, timely information on innovation and enterprise in Jersey - the last Household Survey of Entrepreneurship was published in 2002, and formed the basis of the previous Economic Growth Plan – it is clear that significant progress has been made in the past few years in the area of enterprise identified above. However, it is important to take stock of what has been achieved, learn lessons from past experience, and set out a strategy for the future. Economic Development will produce an Enterprise and Business Development Strategy to take forward the steps identified in this Growth Strategy.

The main channel through which enterprise and innovation are supported in Jersey is through Jersey Enterprise. It currently has a budget of around £1.6m out of the total £16m Economic Development budget (around 10% of the EDD budget and 2% of total States spending), and provides a 'one-stop-shop' that acts as a gateway to a range of business support services, including business advice, help to develop export markets (Jersey Export Development Initiative), finance for innovation and enterprise (Innovation Initiative), support for skills development and help with negotiating regulatory frameworks.

With regards to general business support, the Economic Development Department is committed to renewing its strategy, building on past experiences and successes and failures. As part of this it will evaluate the business support services it currently

[18] European Commission (2009) *Making Public Support for Innovation in the EU More Effective*

provides in order to determine whether they can be made more effective, in terms of focus, content or delivery, and whether the current balance of policies between those aimed at supporting growing businesses or start-ups is optimal.

Access to finance

Access to finance is one of the key ways in which government can support innovation and enterprise. In essence, firms looking for finance know significantly more about the activities they are looking to finance than any potential lender, and lenders need to be convinced that the risk of losing their money does not outweigh the potential returns. However, there are good reasons to believe that small firms find it harder than most to obtain finance, even for promising projects. This is because the availability of information tends to be negatively related to firm size, the cost of obtaining information positively related to a firm's size and smaller firms have less collateral to offer lenders. It follows that small and young firms are more exposed to information asymmetries and therefore to credit rationing.

The Small Firms Loan Guarantee Scheme (SFLGS) provides access to debt finance for small businesses that are unable to provide sufficient collateral to lenders, while the recently established Jersey Business Angels Network (JBAN) will provide access to equity finance to promising start-ups and growing small firms. To date the SFLGS has assisted 7 businesses and has not cost the States anything as the revenue from loans has so far covered any losses.

Both of these schemes are likely to be valuable to businesses, but they should be reviewed as a matter of course in the policy development cycle to ensure that they meet their objectives, are an effective use of funding and identify where improvements can be made where necessary. To inform the Enterprise Strategy, further work will build on existing knowledge in order to better understand the issues that local firms face with regard to access to finance, and to evaluate whether the existing policies address them all.

Export support

Another area that government gets involved in is market development and supporting exports. Given Jersey's status as a small island jurisdiction, export support can enable businesses to expand their client base abroad and access economies of scale not otherwise open to them. At present such activity is supported by Jersey Enterprise through working with business to go to trade fairs abroad, and advice and finance through the Jersey Export Development Initiative (JEDI): a grant of up to £10,000 is available to eligible local businesses to help to identify and exploit export opportunities. As part of a new Enterprise Strategy, it is proposed that the current support for exports and market development is evaluated to see whether objectives are being met, government funds are being used effectively and whether there are is scope for further improvements.

In summary, an Enterprise and Business Development Strategy is likely to:

- **review the issues concerning access to finance, including loans, subsidies, grants and other forms of finance across EDD, with particular emphasis on identifying market failures**
- **review the existing market development and export support across EDD such as the Export Development Initiative (JEDI). For example a review might explore the current barriers to exporting and the merits of using loans, export credits or guarantees either in addition to, or instead of, the current grant system**
- **assess the balance of current policies between those aimed at supporting start-ups and those aimed at encouraging growth in organisations of all sizes**
- **evaluate the business support services currently provided by EDD (including Jersey Enterprise) to determine whether they can be made more effective, either in terms of focus, content or delivery**

Enterprise education

It important to note that Jersey Enterprise is responsible for only a subset of all States policies with respect to enterprise. Skills Jersey and the Education, Sport and Culture Department are responsible for delivering enterprise education. The Economic Development Department is responsible for providing other support to business and enterprise through marketing and promotion exercises and the legal and regulatory framework. In addition sector-specific enterprise support exists, implemented through policies such as the Rural Initiative Scheme.

Fostering an enterprise culture involves tapping into potential entrepreneurs, and inspiring them to consider how they can turn their ideas into businesses. A focus on young people is likely to be particularly effective as they are more likely to be open to new ideas and have a lifetime of potential entrepreneurship ahead of them. In turn this means using schools and other youth organisations such as sports clubs in order to encourage entrepreneurship. A similar approach should be considered in order to raise the level of knowledge and skills relating to entrepreneurship. Skills Jersey has an aim to expand enterprise education initiatives in schools and colleges which should go some way to achieving this. **As part of the development of a skills strategy for Jersey, enterprise education initiatives will be examined to ensure that they are effective at increasing the skills and competencies associated with successful enterprise.**

New and emerging industries

The generic policies towards enterprise, competition and macroeconomic stability, if implemented effectively and consistently, will go a long way to supporting the development of new and emerging activities that have the potential to provide high economic value to the Island.

In addition, **there may be some cases where generic support is not sufficient, and there is a justification for dedicated support to be provided to a particular sector with promising characteristics. The proposed approach in these cases is covered in detail in Section 8, but in essence involves targeted assistance to sectors with the potential to be high-value and low footprint. Such support will be accompanied by strong conditionality (for example, automatic sunset clauses), and guided by a close and productive dialogue with industry.**

The advantage of such an approach is that it will be supportive of new activities that could serve to diversify the economy, while at the same time ensuring that such diversification is consistent with economic growth and the continued prosperity of the Island.

Marketing, promotion and inward investment

A substantial proportion of the resources controlled by the Economic Development Department are used for marketing & promotion activities. The two largest areas of focus for marketing and promotion are tourism and finance. Inward investment is also concerned with marketing and promotion, but the resources dedicated specifically to it are much smaller.

It is important that activities aimed at external businesses and customers – whether it is marketing or inward investment – are joined up across different areas of focus (such as finance, tourism and so on), and that the balance of expenditure between inward investment and other activities is appropriate. There may also be a role for those promoting inward investment to identify candidates for the emerging activities support set out in Section 8.

Inward investment will continue to play a significant role in the success of the Jersey economy. This will be based on a standard proposition to all potential businesses and investors, although it may be supplemented in some cases with considered sector specific support for emerging industries where it is deemed appropriate under the framework set out in Section 8.

The rationale for tourism promotion and grants to Jersey Finance is that there are wider benefits to the Island from such promotion that would not be considered by the private sector when making decisions about how much to spend on their own marketing and promotion. This is particularly the case with regards to the generic promotion of the benefits that the Island offers to businesses and tourists. Further, being a small Island means that it is harder for local businesses to develop links with significant numbers of potential suppliers and customers. However, it is important that resources used in this way are used effectively. **Tourism-related marketing and promotion activities in this area will be examined to inform a new Tourism strategy. In particular, work is being undertaken to examine the effectiveness of tourism marketing activities to understand better the best ways to support tourism. However there may be scope to do more. In particular, there may be value in evaluating the effectiveness of marketing and promotion activities in other areas, as well as looking at how such activities are managed and delivered, and whether there is scope for a more coordinated approach in certain areas.**

Regulation

The regulatory framework under which businesses operate is crucial.[19] The creation and protection of a 'level playing field' within the local economy is important for enterprise as well as for encouraging competition and efficiency. Regulations can be a barrier to firms entering the market, which can hamper competitive pressure and therefore the incentives to act in the best interest of customers. Taxation rules, labour and product market regulations and administrative burdens can all act in this way, and therefore regulations should be assessed for their impact on the market and the extent to which they may act as a barrier to entry, both locally and to international business (i.e. as an international competitiveness issue). **To this end, there will be a commitment in the Jersey Enterprise and Business Development Strategy to undertake a review of local regulatory requirements and their impact on current and future business operating in Jersey, with the aim of reducing any undesirable or unintended barriers to enterprise and competition. This will not**

[19] See, for example, Brandt (2004) Business Dynamics and Policies, OECD Economic Studies 38(I)

be a general review of 'red tape', but it will identify if any important issues exist. Of particular focus will be whether there is scope to improve the way in which regulations are administered: for example, through streamlining the process of submitting information to regulators and government departments.

To summarise, the policies relating to enterprise and innovation can be categorised into five key areas:

- Business support (including Jersey Enterprise, access to finance initiatives etc.)
- Encouraging enterprise skills and culture
- Support for new and emerging activities
- Support for incumbent activities
- Marketing & promotion (& inward investment)
- The regulatory framework

The next steps set out below should ensure that the policies in each of these areas are consistent with, and support, this economic growth strategy, and will be taken forward in a forthcoming Enterprise and Business Development Strategy.

Principles

All of the policies in this area should be guided by a number of over-arching principles that in turn are based on evidence about what works in enterprise and innovation. In particular:

- Government will not be able to determine which individual businesses will succeed and those that will fail. Instead the primary focus will be to create an environment conducive to enterprise and innovation of all shapes and sizes, achieved through a focus on addressing market failures. This may be supplemented by targeted, conditional support to emerging industries where it can be demonstrated that there is a convincing case of their value to the Island and that there is a role for government in assisting their establishment.
- Business development, enterprise and innovation are as much about survival and growth as start-ups and new ventures. The latter should receive special attention only where specific market failures can be identified.
- The 'failure' of some businesses and activities is acceptable, and even inevitable. The important thing is to ensure that support to businesses and activities that are not viable or successful is withdrawn at the right time. Equally, there is little consensus about 'best practice' in the area of enterprise and innovation, therefore policies should be continually evaluated and adapted to ensure they are as effective as possible.

Next Steps

Innovation and enterprise policy has taken significant steps forward since the previous Economic Growth Plan in 2005. However, it is time to take stock and make any necessary adjustments to enterprise and innovation policies. A new Enterprise Strategy should be developed based on an evaluation of existing activities in each of the following six key areas:

Support for new and emerging activities

The generic policies towards enterprise set out in this section, combined with similar policies to competition and macroeconomic policy should all serve to support the development of new and emerging activities that have the potential to provide high economic value to the Island. Inward investment will also have a role to play here. By marketing the benefits that Jersey has to offer to prospective businesses and investors, Jersey will be able to attract them to the Island, and in turn generate job opportunities for local people and potentially diversify the economy.

In addition, there may be some cases where generic support is not sufficient, and there is a justification for dedicated support to be provided to a particular sector with promising characteristics. The proposed approach in these cases is covered in detail in Section 8.

The advantage of such an approach is that it will be supportive of new activities that could serve to diversify the economy, while at the same time ensuring that such diversification is consistent with economic growth and the continued prosperity of the Island.

Support for incumbent activities

Although slightly different in nature, ongoing support for incumbent activities should be appraised using a similar framework to that proposed for new and emerging activities in Section 8. That is, support should be targeted at those areas where support can be justified by market failure, where it is likely to support innovation and enterprise and where high-value can be demonstrated.

The Rural Economy Strategy provides an example of this; in particular, the Rural Initiative Scheme is designed so that support goes to businesses demonstrating innovation and enterprise. Ideally however, there may be advantages in moving towards a more general approach, and trying to incorporate existing sector approaches into generic support policies.

Business support (including Jersey Enterprise, access to finance)

A new Enterprise and Business Development Strategy should be developed to guide the support delivered to businesses. As part of this strategy, existing policies should be evaluated to ensure that they are meeting the needs of local businesses in an effective and targeted manner. This should include:

- review the issues concerning access to finance, including loans, subsidies grants and other forms of finance across EDD, with particular emphasis on identifying market failures
- review the existing market development and export support across EDD such as the Export Development Initiative (JEDI). For example a review might explore the current barriers to exporting and the merits of using loans, export credits or guarantees either in addition to, or instead of, the current grant system

- assess the balance of current EDD policies between those aimed at supporting growing businesses or start-ups, and determine whether there is scope or value in shifting this balance more towards encouraging growth in organisations of all sizes
- evaluate the business support services currently provided by EDD (including Jersey Enterprise) to determine whether they can be made more effective, either in terms of focus, content or delivery

Encouraging enterprise skills and culture

Encouraging enterprise skills and culture is an important role, so the development of enterprise skills will be covered by the new skills strategy, while fostering an enterprise culture will be covered by both the skills strategy and the new Enterprise and Business Support Strategy.

Marketing and promotion

The two largest areas of focus for marketing and promotion are for tourism and finance, with inward investment receiving a small amount of resources for this purpose. Inward investment will continue to play a significant role in the success of the Jersey economy. This should be based on a standard proposition to all potential businesses and investors (tailored to the requirements of individual sectors), although it may be supplemented in some cases with considered sector specific support for emerging industries where it is deemed appropriate under the framework set out in Section 8.

Tourism-related marketing and promotion activities in this area will be examined to inform a new Tourism strategy, however there may be scope to do more. In particular, there may be value in evaluating the effectiveness of other marketing and promotion activities, as well as looking at how such activities are managed and delivered, and whether there is scope for a more coordinated approach.

Regulatory framework

The Jersey Enterprise and Business Development Strategy should review local regulatory requirements and their impact on current and future business operating in Jersey, with the aim of reducing any undesirable or unintended barriers to enterprise and competition. Of particular focus will be whether there is scope to improve the way in which regulations are administered: for example, through streamlining the process of submitting information to regulators and government departments.

3 Skills and the labour market

Supply of Skills

There is evidence that human capital and skills are an important driver of productivity,[20] whether it is through their direct effects on employee productivity or indirect effects through other channels such as management quality.[21] However the relationship is not as simple as higher skills leading to higher productivity. The skills acquired need to be linked to employer demands, employers have to be able to motivate and utilise the skills of employees effectively and individuals have to face the right incentives to participate in the workforce.

Market Failure

Clearly there are benefits to individuals from acquiring education and skills, whether this is in the form of monetary remuneration[22] or direct impacts on well-being[23]. However, education and skills also have positive externalities, that is, the social benefits of education and skills exceed the benefits to the individuals acquiring those skills. For example, greater education and learning are associated with lower crime levels, greater civic engagement and better health outcomes.[24]

There are wider economic benefits as well. There is evidence that the spoils of the productivity gains resulting from greater education and skills are shared between employees and employers.[25] Further, the evidence suggests that access to a qualified workforce is an important location determinant for many international companies, which is particularly important for jurisdictions like Jersey.[26]

Because wider benefits to society are not taken into account when an individual weighs up the costs and benefits of education and learning to them, the outcome that would result from the market mechanism will not be the desired outcome. In

[20] See for example Haskel, Hawkes & Pereira (2005) *Skills, Human Capital and the Plant Productivity Gap*; Haltiwanger, Lane and Spletzer (1999) *Wages Productivity and the Dynamic Interaction of businesses and workers*

[21] Bloom & van Reenan (2007) *Measuring and Explaining Management Practices Across Firms and Countries*

[22] J. van Reenen, H. Reed, L. Dearden, (2005) *The impact of training on productivity and wages: evidence from British panel data*, Institute of Fiscal Studies

[23] See for example Desjardins (2008) *Researching the Link between Education and Well-being;* Machin & Vujic (2006) *Crime and Education: New Evidence from Britain*

[24] Feinstein, Budge, Vorhaus and Duckworth (2008) *The Social and Personal Benefits of Learning: A Summary of Key Research Findings*

[25] J. van Reenen, H. Reed, L. Dearden, (2005) *The impact of training on productivity and wages: evidence from British panel data*, Institute of Fiscal Studies

[26] Booz Allen Hamilton and INSEAD (2006) Innovation: Is Global the Way Forward? and OECD (2008) The internationalisation of business R&D

particular, each individual is likely to acquire less education and skills than would be optimal for the economy and society.

In addition, individuals may have a higher discount rate than society as a whole – i.e. they place less value on the future benefits, even the private benefits, from education and training than is optimal – which would lead them to invest too little in acquiring skills. In the case of employer sponsored training, since there is a risk that not all of the benefits of that training is captured by that employer, they may also under-invest in training their staff.

As such the government often intervenes to encourage the provision of skills and education.

The UK Government has identified four broad areas where there are market failures and therefore where there may be a role for government to support skills. These are:[27]

- Subsidy of the training system
- Information on the benefits of courses
- Financial support for potential learners
- Appropriate regulatory environment for both education providers and employers

Further, evidence suggests that the wider social benefits and returns on investment are greatest in the early years of education. This implies that policy should be focussed on the provision of basic skills and early age education and early childhood interventions for vulnerable and disadvantaged children.[28]

The OECD in their 2006 publication "*Starting Strong II: Early childhood education and care*" highlight the international evidence in favour of public investment in Early Childhood Education and Care (ECEC). There has been much debate about the validity of the research methods used in many of these studies and in particular whether it is possible to separate out family effects from programme effects. However, the OECD concludes that the main findings from cost benefit studies "*make overwhelming case for strong government investment in early childhood services*". Some of the key findings from these studies are summarised below:

[27] The Department for Business, Innovation and Skills (2009) *The National Skills Strategy: An Analytical Paper*
[28] Heckman & Jacobs (2009) *Policies to Create and Destroy Human Capital in Europe*

- Children from a high quality pre-school programme in the US had better school records, improved labour market entry and higher incomes as a result and that the cost-benefit ratio for investment in the programme was 1:7.

- Zurich's CHF18m spend on childcare services create CHF29m of additional tax revenues and reduced public spending. Publicly funded childcare resulted in higher productivity and earnings, higher contributions to social security/savings and less dependency on social assistance.

- In North Carolina every dollar spent on its programme (for mainly disadvantaged children) of high quality, full-day, year round pre-school generated 4 dollar return to the children, their families and all tax payers. That is the lifetime earnings of the participants, their mothers and their children rise and less spending is needed on special or remedial education.

- Investing in pre-school in California is estimated to save government money and boost tax revenues to the extent that Californians get $4 benefits for very $2 spent.

- A cost-benefit analysis of establishing a national quality childcare system for Canada showed that benefits would exceed costs by about 2 to 1. About half the benefits related those to the children using the service and the benefits to mothers and families from continued employment.

- Studies from the UK, Norway and Canada show that increased female participation as a result of the provision ECEC services has boosted tax revenue.

- There are a range of studies showing the educational returns from early childhood investment in Sweden, France and the US.

- In the UK the Effective Provision of Pre-School Education (EPPE) project is a study that looks at young children's development between the ages of 3 and 7 and explores what constitutes effective practice. The key findings are:

  – Pre-school experience enhances children's development (an earlier start being related to better outcomes but full-time attendance led to no better outcomes than part-time attendance).

- Better quality programmes (such as those with better qualified staff) lead to better educational and social outcomes.
- Children make better progress in fully integrated centres and nursery schools.
- The importance of home learning – the quality of home learning environment was more important than social class – "*What parents do is more important than who they are*".

The OECD conclude that by establishing ECEC services "significant employment is generated, tax revenues increased, important savings made in later educational and social expenditure, if children – especially from at-risk backgrounds – are given appropriate development opportunities early enough in life, and careful academic programming is continued through primary and secondary schooling". They also point out that "the *quality* of the early childhood services provided is critical" and that the insufficient investment will lead to "increased numbers of children with special needs and learning difficulties; a lack of equity for poorer families; and overall poor quality of provision".

Key objectives

Putting all this together implies that strategic objectives in the area of skills should be to:

- Provide quality early childhood services, including support for those responsible for young people in providing a home environment that is conducive to learning and growth
- Ensure that all young people are equipped with a good foundation in literacy and numeracy, encouraged through both the formal education system and extra-curricular learning
- Ensure that education provision is responsive to the needs and desires of both learners and the employers that will be looking to employ them
- Remove any barriers individuals face to learning and skills development and achieving their full potential, be they financial – for example funding for university fees – cultural or any other barriers.

- Where there is reason to believe that the market may not deliver an optimal level of training and skills, the government should look at ways in which this can be addressed, whether it is through subsidies or through other means.

Skills Policies in Jersey

Substantial progress has been achieved since the previous Economic Growth Plan. Jersey's Skills Board and Skills Executive were established by the Council of Ministers in 2008. The Skills Executive comprises the Ministers for Education, Sport and Culture, Economic Development and Social Security and their respective Chief Officers. The Skills Board, which advises the Executive, and drives forward its policies and strategies is 'employer led'. Collectively they are referred to as 'Skills Jersey', and they cover 3 main areas of responsibility:

- Capturing employer and learner demand for skill development;
- developing an all age Careers Information, Advice and Guidance Service; and
- managing resources for the provision of vocational education and training opportunities.

Skills Jersey has already added significantly to the knowledge base about local skills, and the 2011 Business Plan contains a comprehensive set of objectives and key performance indicators relating to the development of skills at all levels. Skills Jersey's high-level objectives are:

- Full employment and the future diversification and development of the economy are supported by the development of skills from within the residential population.
- Employment and skills needs of organisations are met, as far as possible, from the resident population.
- All individuals have opportunities to maximise their occupational potential and life skills.
- The development of skills enables organisations to maximise their productivity and sustainability.

The Jersey Early Years and Childcare Partnership (EYCP) has been established and 20 hours a week (term-time) free States-funded nursery education is available for children in the year before they are due to start primary school at a nursery provider which is committed to the work of the EYCP. This includes primary schools, day nurseries and pre-schools.

Other developments since the previous Economic Growth Plan include the establishment of an International Business School on the Island, which caters for the continuing professional development needs of employees in the financial sector and other businesses and complements the suite of courses on offer at Highlands College.

Skills Jersey requires three government departments (Education Sport and Culture, Social Security and Economic Development) to work together at both officer and Ministerial level. As is the case with the other elements of the Economic Growth Strategy, it would make sense to review and assess whether the current structure is the most effective and efficient way of meeting the Island's skills objectives. A review is already underway and any recommendations that could improve collaboration and delivery should be implemented.

Jersey skills position

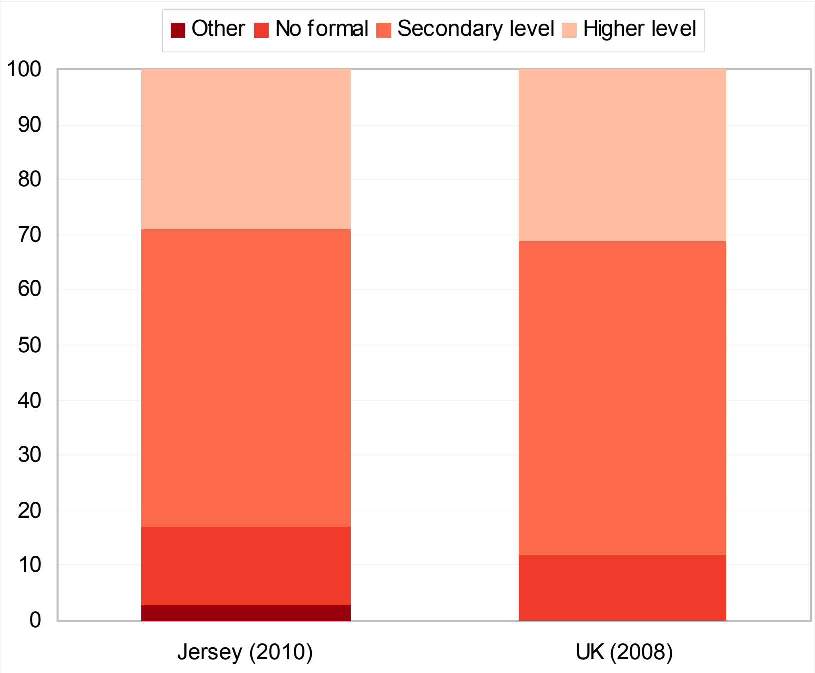
The Jersey Annual Social Survey (JASS) 2010 asked respondents to identify their highest level of academic achievement. Responses were grouped into higher level qualifications (e.g. higher national diplomas, first or higher degrees), secondary level qualifications (e.g. GCSEs, GNVQs, A-levels and O-levels) and no formal qualifications (those that do not possess any academic qualifications).

For the population as a whole it was found that a quarter (26%) of adults in Jersey had achieved higher level, 50% secondary level and 20% had no formal qualifications. These proportions have not a changed significantly since JASS 2008 and the distributions for men and women were similar. There was a significant difference by age however, with older generations more likely to have no formal qualifications. 55% of those over 65 years and 36% of those 55-64 years have no formal qualifications while the proportion was only 4% for those aged 16-34 years.

For people of working age (16-59/64 for women/men) the distribution of academic qualifications is very similar to that in the UK as shown in Figure 3.1. In Jersey 14% have no formal qualifications compared with 12% in the UK, 54% have secondary level qualifications compared with 57% in the UK and 29% have higher level qualifications compared with 31% in the UK.

Figure 3.1 Comparison of qualifications in the UK and Jersey

Highest academic qualifications for the working age population

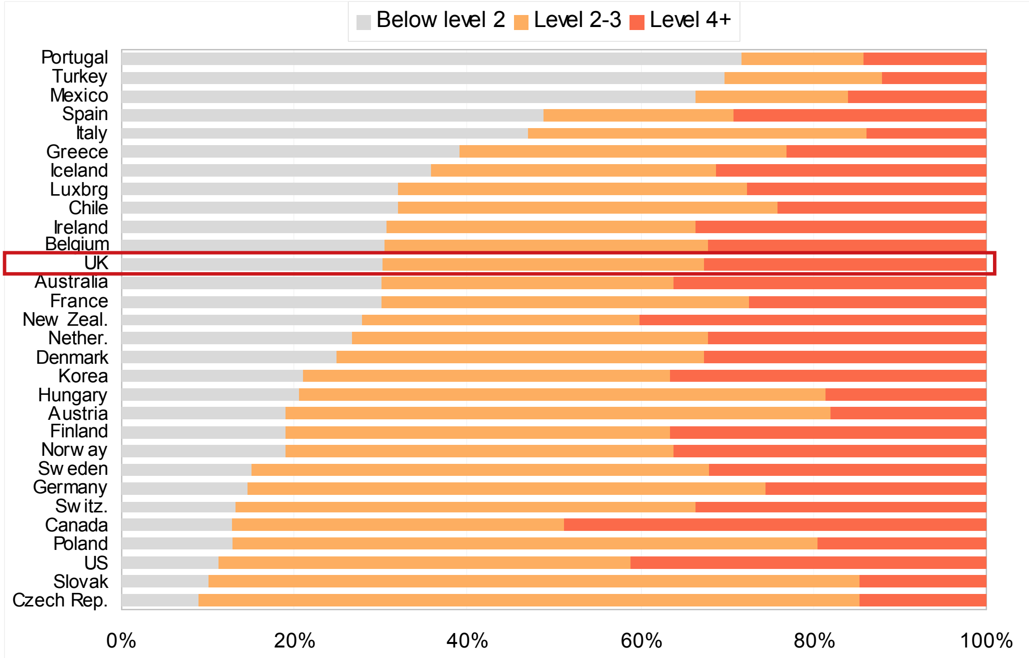


Source: JASS 2010 and 2008 labour Force Survey

While there seems to be no marked difference between the UK and Jersey in terms of academic qualifications it is important to put the UK position in international context. In terms of the proportion of the adult population that has below level 2 the UK ranks 19 out of the 30 countries shown (Figure 3.2). In terms of the proportion of the adult population that has level 2-3 the UK ranks 21 out of 30 and for those with level 4+ it ranks 10^{th}.

Figure 3.2 International comparison of workforce qualifications

Distribution of the 25-64 year-old population, by highest level of education attained



Source: OECD Education at a Glance 2010

While Jersey compares well with the UK, the UK has its strength and weaknesses when compared to other larger economies. If Jersey is to maximise growth going forward then policy should focus on reducing the numbers with low or no formal qualifications (beyond what will happen through demographics) and building on the relatively high rates of those moving into higher education. This will require identifying the Jersey specific issues and addressing them through skills policy.

Non-technical skills

The Literacy and Numeracy Review undertaken for the Skills Board identified the following issues:

- Clear indications of low levels of literacy and numeracy in the adult population in Jersey.
- The range of people affected by poor literacy and numeracy is broad from school leavers and young people to those in their forties, fifties and above.
- Employers identify inappropriate language, poor spelling, grammar and errors in formatting letters and emails as issues that may affect business performance.

A range of early actions and medium and long-term options were set out as to how Jersey could begin to address these issues, ranging from collecting additional data, extending 14-16 vocational training and job-related skills, to awareness campaigns and drawing on international experience.

Secondary schools

A review of the four 11-16 schools in Jersey identified the following key areas for development to achieve ‘high quality education and skills’:

- Despite an excellent overall performance there is a significant minority of pupils that perform well below their potential, particularly for 14-16 year olds.
- For many of the underperforming pupils the nature of the GCSE curriculum is a significant factor.
- The overall performance of a significant proportion of the pupils could be improved if more practical vocation subjects were offered.
- Some of the programmes of study offered to 11-16 year olds are not aligned to their interests
- The danger that a minority of pupils disengage from learning is very costly to the individuals and Jersey as a whole.

These issues will be addressed in more detail in the Green Paper on Primary, Secondary and Tertiary Education to be published later this year.

Skills gaps

Skills gaps – where employees may not be fully proficient at their jobs – can hinder business performance and therefore wider economic performance. Skills gaps can arise as a result of employees not acquiring the appropriate skills through their education but also through the introduction of new technology, working practices and/or products and processes. They are likely to be different in each industry sector and the sectoral reviews already undertaken in the construction, retail/wholesale, tourism/hospitality and rural economy sectors will have helped to identify sector specific issues. While sector specific strategies are currently being developed in collaboration with industry representatives under a common skills strategy framework it will be important to continue to monitor how gaps change/emerge over time and what the appropriate policy response should be. Responsibility for the delivery of the strategies will fall both on employers to ensure adequate training and development of their staff as well as promotion of opportunities for new entrants, while at the same time government may have a role too if employers responses are not adequate and market failure in addressing skills gaps is apparent.

Vocational education

The Wolf Report - *Review of Vocational Education* - in the UK was published in March 2011 and emphasises the importance of vocational education as a route to higher education and in offering different skills, content and forms of teaching to conventional academic study (which often does not provide all the skills the labour market values and demands). "Good vocational programmes are, therefore, respected, valuable and an important part of our, and any other country's educational provision. …….But many vocational students are not following courses of this type."

27 recommendations are made to extend the benefits of vocational education to more young people and offer better education, training and prospects.

Skills Jersey has already recognised the importance of the vocational route and has made progress in a number of areas:

- In Sept 2010 a partnership between the four 11-16 schools and Highlands College was formed to provide 14 – 16 vocational training.
- A new apprenticeship scheme will be piloted in Sept 2011, with the full roll out in Sept 2012. The scheme encompasses technical and vocational competence, key skills including literacy, numeracy, IT and softer skills and employer and employee responsibilities. The programme will be shorter with the apprentice of more value to the employer from an earlier stage.

Given the extensive overhaul that has been recommended in the UK it is clear that Jersey too must consider how it can build on these improvements and provide the right quality and form of vocational education for young people and employers.

The Demand Side and the Utilisation of Skills

Some have argued that there has been a global explosion in high-quality skills, and therefore that it is becoming increasingly difficult for economies to compete on skills alone. This has led them to argue that there should be more focus on labour demand and the effective utilisation of skills.[29]

One way of doing this is to improve employee involvement and commitment to business objectives and performance. One way of doing this is High Performance Working (HPW) which has been defined as a 'general approach to managing

[29] See for example Brown, Ashton & Lauder (2010) *Skills are not enough: the globalisation of knowledge and the future of the UK economy*

organisations that aims to stimulate more effective employee involvement and commitment to achieve high levels of performance.'[30] In contrast to the provision of education and training, which is at the heart about the supply of skills, HPW is about the effective utilisation and harnessing of those skills and turning them into higher productivity.

There is evidence that HPW has a variety of benefits for employees and employers[31], however to justify public policy interventions, market failures need to be identified. A number of barriers to the effective implementation of HPW have been postulated – including ignorance, inertia and doubt and inability[32] – which could be seen as market failures and therefore there may be a potential role for public policy in addressing them.

For example the UK Commission on Education and Skills (UKCES) suggests that there is a role for government in disseminating existing information about the benefits and best practices relating to HPW and funding more research into these areas

There is probably not a sufficient return to justify a substantial investment in primary research into HPW in Jersey; however there may be an argument that information provision and support from government to business concerning the benefits of improving employee involvement and commitment through policies such as HPW and how best to implement it would be a worthwhile investment. For example, HPW could be a subject for a Jersey Enterprise Masterclass.

Management Quality

The large discrepancies in productivity between firms even within the same industry are well documented[33], but the causes are less well explored. One explanation might be management quality. Bloom & van Reenen (2007, 2010)[34] explore firm-level productivity and management practices and find that poor management practices are more prevalent when (a) product market competition and labour market flexibility are weak and/or when (b) family-owned firms pass management control down to the eldest sons. They suggest that the first finding could be the result of two effects: (1) good practice spreads quickly in highly competitive environments and (2) poor

[30] UKCES (2009) High Performance Working: A Synthesis of the Key Literature
[31] UKCES (2009) High Performance Working: A Synthesis of the Key Literature
[32] Philpott (2007) *High Performance Working: The Utilisation of Skills*, in Skills and Economic Performance, SSDA
[33] For example, Foster, Haltiwanger and Syverson (2008) *Reallocation Firm Turnover and Efficiency: Selection on Productivity of Profitability?* notes that there are large productivity differences between very similar firms, even within narrowly defined industry classifications.
[34] Bloom & van Reenan (2007) Measuring and Explaining Management Practices Across Firms and Countries

practice is eliminated by natural selection as poorer performing companies are removed from the marketplace. The evidence also suggests that the level of education and skills of management and the wider workforce are important determinants of management quality. This work suggests that policymakers should focus on strengthening competition in product markets, improving the flexibility of labour markets and raising the educational/skills standards of the workforce (and management in particular).

Unemployment

An important question is whether there is a causal relationship between the underlying productive capacity of an economy and unemployment. There is little empirical support for the view that increasing productivity causes higher unemployment.[35] There is however, substantial evidence that causality runs the other way. In particular, higher unemployment has a significant negative impact on unobserved productivity by reducing the skills of those who are unemployed. While this will not necessarily show up in the measured labour productivity figures, it nonetheless has a negative impact on potential economic activity.

It is generally accepted that unemployment benefits should be considered holistically alongside training and other assistance to get individuals back into employment. This type of approach to unemployment policy is known as Active Labour Market Policy (ALMP) or '*welfare to work'* and usually involve one or more supply side measures such as job search assistance, job search monitoring, education and/or training placements and work placements in the public or voluntary sectors together with benefits sanctions for non-compliance - for example the Flexible New Deal programme in the UK. The consensus emerging from the economic literature is that there are positive benefits of these programmes.[36]

Substantial progress has been achieved since the previous Economic Growth Plan. The introduction of a statutory Income Support benefit has created a legal requirement (subject to certain exemptions) for adults to be in employment or be actively seeking work in order to claim income related benefits. This has led to a rise in the number of individuals registered as actively seeking work with the Social Security Department.

Further, the design of the Income Support benefit incorporates many Active Labour Market Policy features. Individuals drawing benefit are required to demonstrate that they are actively seeking work and benefit sanctions are applied if the claimant fails to undertake sufficient activities. This area of Income Support is currently under review and may be strengthened further.

Before the introduction of Income Support, there was no consistent approach to the provision of benefits for working age adults and jobseeking activities were not mandatory. Historically, the number of individuals registered as unemployed has substantially underreported the true figure.

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[35] For example Blanchard, Solow & Wilson (1995) *Productivity and Unemployment;* or Trehan (2003) *Productivity Shocks and the Unemployment Rate*

[36] See, for example, Brewer (2007) *Welfare Reform in the UK: 1997-2007*

Income Support was introduced in 2008, just before the impact of the current recession was felt in Jersey. With little time to bed the new system in, additional resources were quickly provided to support the increased number of jobseekers. Progress made in 2010 was consolidated with the introduction of an enhanced service to jobseekers in 2011.

The Enhanced Work Zone (EWZ) now provides specialist assistance to jobseekers, with the priority given to those aged under 25 and people who have been out of work for more than six months. The EWZ provides intensive, personalised help and support including job search assistance and job search monitoring, to help clients find a job.

Schemes such as Workwise, Jersey Employment Trust and Jobscope also provide assistance with gaining employment, but are aimed at those who have special needs or a disability and face additional barriers to employment.

Youth unemployment

The evidence not only suggests that the young, along with the low-skilled, are particularly vulnerable to unemployment, but also that youth unemployment is acutely damaging to the economy. There is evidence that those that have prolonged periods of unemployment in their youth are less likely to settle into stable, productive careers, will experience more unemployment in the future and will earn a lower wage on average than if they did not experience youth unemployment,[37] as they have many years of potential labour market participation ahead of them the costs of lower productivity and long spells of unemployment are high. Further, there are likely to be other indirect costs to society in terms of higher public expenditure on healthcare and policing.[38]

This implies that policy interventions designed to assist those in unemployment to return to work are an important component of policies to boost productivity, and those that deal with youth unemployment are particularly valuable.

The recent economic crisis hit young people disproportionately hard across a large number of countries, and in response many countries have had to reinforce existing

[37] Bell & Blanchard (2010) *Youth Unemployment: Déjà vu?*
[38] Controlling for other factors, the unemployed are less happy, suffer more from stress and have lower health outcomes than those in employment. Although there is no clear relationship between unemployment in general and crime, there is some evidence of a relationship between youth unemployment and criminal behaviour. See Bell & Blanchard (2010) *Youth Unemployment: Déjà vu?* and Fougere, Kramarz & Pouget (2009) *Youth Unemployment and Crime in France* for a summary of the literature.

youth labour market policies. In Jersey like anywhere the global great recession has lead to a rise in unemployment, particularly amongst young people (Figure 3.3).

The OECD have pointed out that "facilitating the school-to-work transition and improving labour market prospects for all youth" should remain top priorities in all OCED countries. In addition, particular focus should be given to "youth facing difficulties in getting a stable job after leaving school. If this is not the case, there is a high risk of durably increasing the hard-core group of youth left behind who would be likely to suffer long-term "scarring" in terms of their future earnings and employment prospects"

The group of young people identified as NEET (not in employment, education or training) is often seen as particularly problematic. A number of initiatives in Jersey specifically target this group.

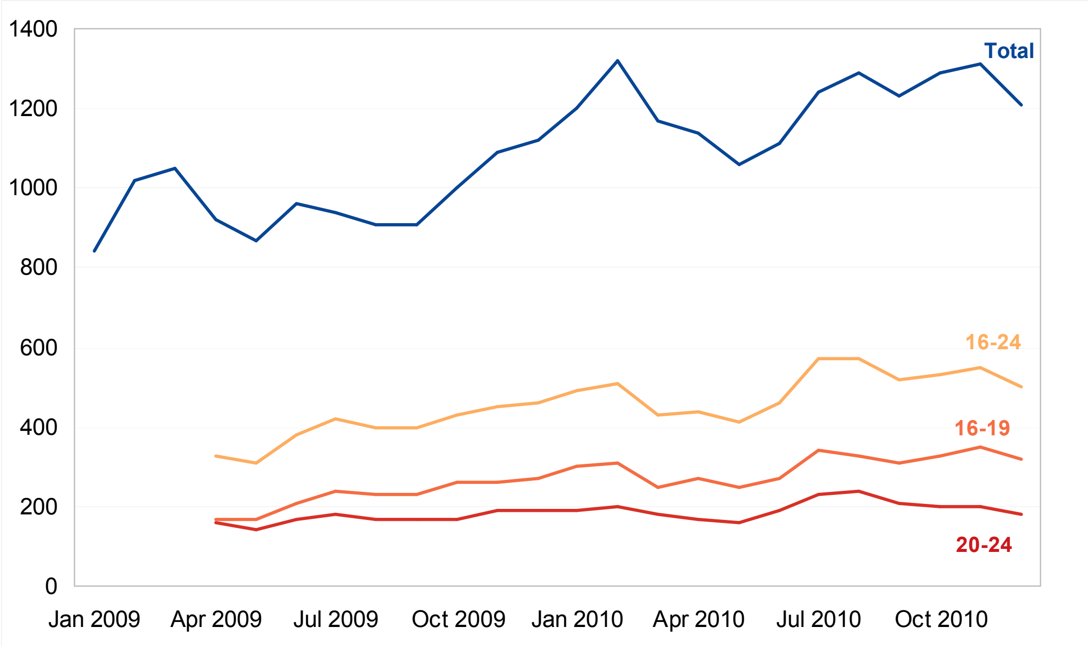
In addition to the resources now available through the Enhanced Work Zone to support younger jobseekers, the Advance to Work (ATW) scheme was established with funds from the Stabilisation Fund as part of the fiscal stimulus package agreed by the States in 2009. ATW was set up in order to assist young people between the ages of 16 and 19 who might otherwise have struggled to get into the labour market and obtain employment as a result of the economic downturn. The scheme has provided young people with a range of useful labour market skills and has been successful in placing participants in jobs. Although it was intended to be a temporary scheme under the fiscal stimulus package, there may be good arguments for continuing the scheme – perhaps in revised form – as business as usual but these will need to be based on evidence that the scheme is effective and addresses a structural and ongoing need.

The Prince's Trust is also active in Jersey, supporting young people with a range of employment-orientated courses and activities.

Although Jersey generally has lower unemployment than in the larger economies it has still been affected in a similar way. The chart below shows that in the course of 18 months the number of 16-24 year olds has increased from 330 in April 2009 to 500 in December 2010 and this is after additional places have been provided for young people at Highlands College (who are not actively seeking work and therefore not included in these numbers). Those young people however, who are on the Advance to Work scheme will be included in these numbers.

Figure 3.3 Unemployment in Jersey

Number actively seeking work, total and by age

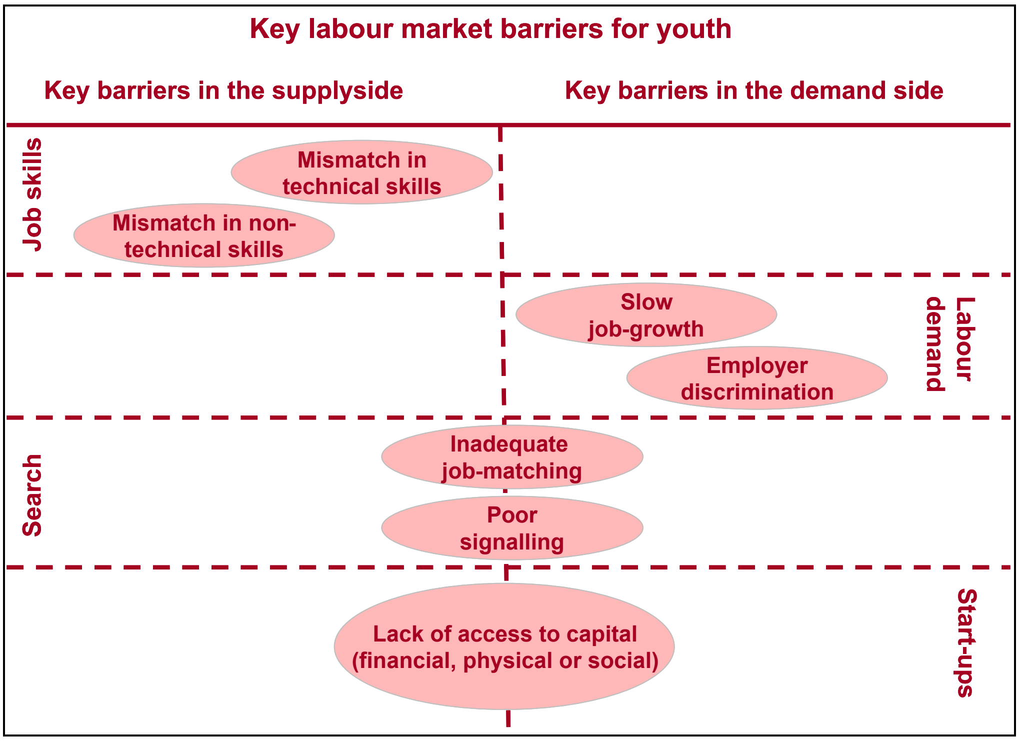


Source: States of Jersey Statistics Unit

The International Labour Organisation (ILO)[39] recently published its views on the lessons learned from youth unemployment programmes. In terms of lessons and best practices it focuses on the barriers set out in the diagram below and highlights the factors for success.

[39] Global employment trends for youth: ILO August 2010

Figure 3.4 Key labour market barriers for youth identified by the ILO



Source: ILO

The factors for success under each heading are set out below:

Technical skills mismatches

This entails facilitating access to vocational training, facilitating a competitive job-training sector, and providing effective labour market programmes for the youth unemployed. It may also involve workplace-training schemes, improving apprenticeships schemes, subsidised training programmes and entrepreneurship skills training.

Non-technical skills mismatches

This really refers to problems with numeracy and literacy which have already been mentioned as issues in Jersey and requires improving access for youth to general education and skills training within and outside the formal education system. It also focuses on soft and life skills and targeting disadvantaged youth.

Slow job-growth

Lack of labour demand is a by-product of insufficient growth and is a difficult barrier to address. While the overall macroeconomic and investment climate will be important factors there is some evidence that active labour market measures such as wage and training subsidies can motivate employers to take on young people.

Programmes providing training along with wage subsidies tend to have better impacts, although design is critical to minimise the risks of deadweight effects and potential substitution costs.

The OECD in their report *Off to a Good Start?: Jobs for Youth* (2010) identify many of the same issues as the ILO. They reiterate that apprenticeships and other vocational/educational training programmes appear to be efficient school to work pathways, particularly for secondary students, pointing out that:

"the school-to-work transition is easier in countries where combing study and work is frequent e.g. Austria, Germany and Switzerland, the so called 'apprenticeship countries'…combining study with work should be promoted to the extent that work is not harmful to studies."

And:

"Apprenticeships and other dual vocational education programmes appear to be efficient school-to-work pathways, particularly for secondary students. They can yield multiple dividends: securing the transition towards employment for the apprentice (stepping-stone effect) and lowering labour costs for the employer (cost effect), tied together by a training commitment from the employer, which yields a valued qualification on the labour market (skill effect)."

This suggests that local schemes such as the apprenticeship schemes and Trident are valuable. It also points out that:

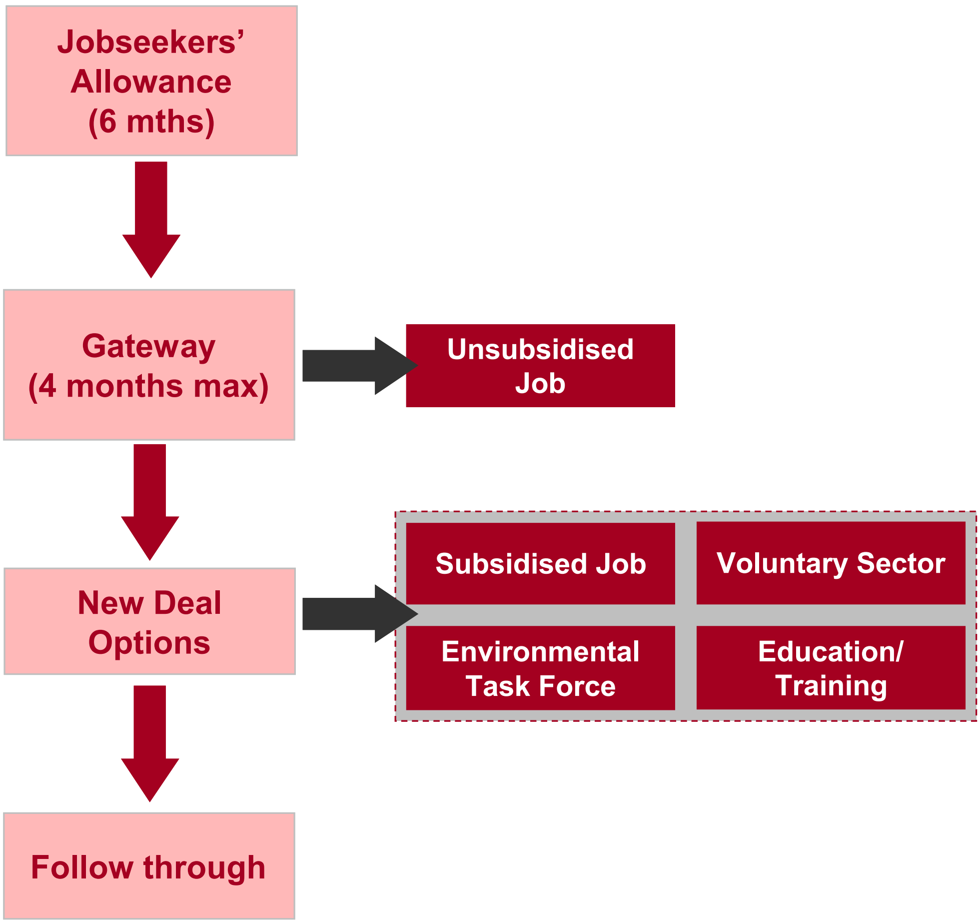
"Tackling the youth jobs crisis requires a strong commitment from all: the youth themselves, the government through well targeted and effective policy measures, social partners through their participation in the dialogue, and other key actors – such as teachers, practitioners and parents – who can really make a difference to investing in youth".

By 2015 the UK will increase the school leaving age (i.e. to 18) for those that haven't completed a certain level of education attainment after the current school leaving age of 16. Consideration could be given to the cost and benefits of a similar move in Jersey.

Another UK policy that Jersey could potentially learn from is the New Deal for Young People (NDYP). It was introduced in January 1998 with the aim to help the young unemployed into work and increase their employability. It focuses on 18-24 year-olds who have been claiming Jobseeker's Allowance for six months or more.

NDYP starts with a period called 'the Gateway' when participants receive up to four months of intensive, personalised help and support, initially designed to help them find a job. If this is not successful then participants are directed towards one of four New Deal Options – subsidised work, full-time education and training, work in the voluntary sector or work with the Environmental Task Force. The options last for about six months after which participants enter a period called the 'follow through' which provides similar support to the Gateway. NDYP is compulsory and at no point is there an option to not participate and continue claiming benefits. This is summarised in Figure 3.5 below.

Figure 3.5 The New Deal for Young People



Most of the research conducted on the UK NDYP points to positive outcomes, both in terms of helping young people find jobs and in terms of wider economic benefits. For example, the Institute for Fiscal Studies found that NDYP increased the probability of finding a job by 20% and the National Institute of Economic and Social Research found that NDYP benefited the economy by £500m a year, with over 200,000 young people leaving unemployment earlier than they would have done without the programme.

Recent developments in Jersey have introduced some services similar to the NDYP. For example, personal advisers within the Enhanced Work Zone offer a similar service to the Gateway, with intensive personal support aimed at finding a job. Advance to Work combines education with work placements. There may be further lessons for Jersey to learn from NDYP.

Finally there appears to be little monitoring of young people 'not in education, employment or training' (NEETs) in Jersey and more data on this group could help inform future policy.

Discrimination in the labour market

Where age discrimination towards youth has been deemed to be an issue, measures taken tend to fall into two areas. Firstly, affirmative action programmes to provide incentives for firms to hire young people, although evidence on effectiveness is mixed. Secondly, employee mentoring where more experienced workers mentor new employees helping to integrate and retain particular groups such as young people.

Inadequate job matching

Young people often lack relevant information and access to networks that can help them find the right job. Employment and intermediation services have been effective match-makers for example in the Gateway stage of the NDYP.

Poor signalling

Skills certification systems have been designed to act as a quality assurance bridge that recognises and highlights skills and competencies. They facilitate skills comparisons in the labour market and reduce asymmetric information between employers and potential employees.

Lack of access to start-up capital

Programmes that combine skills training, mentoring and financial support can significantly improve the chances of starting a successful business. There is clearly a link here to the issues raised and next steps set out in the enterprise section of this report.

Unemployment benefit

In addition to the Active Labour Market Policies included in the Income Support job seeking requirements, financial incentives encourage individuals to enter and remain in work. Two disregards in respect of gross earned income are applied to the wages of individuals receiving Income Support. A 6% disregard is applied in respect of Social Security contributions. A separate disregard, originally set at 6% in 2008 has now been increased to 16.5%, and will be further increased on 1 June 2011 to 20% of gross earnings. Individuals entering permanent work after a spell of unemployment, also receive additional support for the first four weeks of employment.

The Social Security Department is currently undertaking a thorough review of the Income Support system, with employment policies being one of the first areas to be considered. As part of this review the Statistics Unit has undertaken an Income Distribution Survey (2009/2010) and included material deprivation questions within the 2010 Annual Social survey.

The Health, Social Security and Housing Scrutiny Panel has recently published a review of benefits and income support in Jersey, which provides an independent review of the results of the Jersey Income Distribution Survey and the material deprivation questions included in the Jersey Annual Social Survey 2010.

Minimum Wage

Perhaps the main argument for the introduction or increase in a minimum wage is a moral rather than an economic one – it is thought to be fair and right that employees are able to earn a minimum amount for their labour to ensure that they can earn enough to live and are not being exploited. However there may be positive or negative economic effects as well.

There is a theoretical argument that minimum wages have the potential to raise productivity. By increasing the employment costs of certain employees, it increases the incentives for businesses to invest in training and other productivity enhancing measures in order to offset increased costs. McLaughan (2009), among others, have argued that simply increasing the minimum wage on its own will not be sufficient since low pay tends to be linked with other structural factors, and that institutional and structural reforms may be required alongside minimum wages.

However, whether there is a noticeable effect in practice is an empirical question, and there is little evidence of a strong relationship between a minimum wage and productivity. NIESR (2003) found no evidence of a positive effect on productivity of the introduction of the National Minimum Wage in the UK. Dickerson (2007) *Longer-term Implications of the NMW: A Re-Examination of the New Minimum Wage* and

Arulampalam, Booth and Bryan (2004) *Training and the New Minimum Wage* find no conclusive evidence that the minimum wage introduction reduced or increased the training of affected workers, although they find some evidence that in some cases it may have had a small positive impact.

Neumark and Wascher 2006[40] conclude in their review of the literature on the employment effects of minimum wages that a sizeable majority of the studies surveyed give a relatively consistent indication of negative employment effects of minimum wages. They also point out two further conclusions that there are very few studies that provide convincing evidence of positive employment effects of minimum wages and that there are stronger negative effects on employment for the least skilled groups. Even though the Jersey economy is markedly different to many of the larger industrial economies that the studies focus on, the introduction of the minimum wage is likely to have had a similar impact in Jersey. Increases in the minimum wage will have increased the wage bill for employers of low-paid workers, thus increasing their overall cost base. The incidence of the increased total wage bill in Jersey is not evenly distributed across all sectors of the economy. In particular, the sectors most likely to have experienced the greatest proportional increase in their wage costs are agriculture, tourism and retail. With the former two sectors competing in international markets the impact will have been greater.

There is evidence from studies in several major industrial countries – ranging from the US to Europe - that the negative employment effects of a minimum wage are felt especially among younger workers[41]. While there is little information on the situation in Jersey there is no reason to believe that the Jersey economy is any different in this respect, not least given the range of different economies with different institutional factors that the evidence base covers.

It is for these reasons that a number of countries only apply the full minimum wage above a certain age. For example, 18 years in France, 20 in Ireland and the US, 21 in Australia and Belgium, 22 in the UK and 23 in the Netherlands. In the UK there is a separate Youth Development Rate, 16-17 Year Old Rate and Apprentice Minimum Wage Rate.

Research commissioned for the Low Pay Commissions April 2011 Report[42] found that *"the youngest workers had lower productivity and lower earnings and suggested that young workers were overpaid relative to their productivity. This relationship was*

[40] Neumark and Wascher 2006; *Minimum wages and employment: A review of evidence from the new minimum wage research*; NBER Working Paper Series
[41] Neumark and Wascher (1999), Van Soest (1994) and Abowd et al (1997)
[42] www.lowpay.gov.uk/lowpay/rep_a_p_index.shtml

not exacerbated by the minimum wage. However, the research found evidence that, in difficult economic circumstances, the level of the minimum wage may have had an impact on the employment of young people. The evidence also suggested that these effects were mitigated to some extent where there were separate rates for younger workers."

The evidence of the impact of minimum wage rates on youth employment, the experience in other economies and the concerns about the rise in youth unemployment in Jersey over the course of global great recession would all suggest that detailed consideration should be given as to the potential benefits of introducing a more flexible minimum wage in terms of the way it is applied to young people in Jersey.

In Jersey the independent Employment Forum (similar to the UK's Low Pay Commission) has a statutory duty to make recommendations to the Social Security Minister about the level of the minimum wage and the trainee rate including any recommended changes to the classes of person who quality for the minimum wage. In doing so, the Forum must consult with representatives of employers and employees, as well as having regard to the effect on the economy and on competitiveness.

Since 2004, there have been repeated recommendations and proposals regarding lower minimum wage rate for young people in Jersey. When the minimum wage system was first presented to the States, the Social Security Minister had proposed that a youth rate should be available, at the same lower hourly rate as trainee rate. The youth rate was rejected by the States and was not implemented.

In its 2006 recommendation to the Minister, the Forum recommended that a lower minimum wage rate should be available for students, aged 16 to 18, in full time education. This was intended to avoid some of the possible negative consequences of the minimum wage on labour market opportunities for young people. The proposal was however rejected by the States of Jersey and was not implemented.

In 2008, a number of respondents asked the Forum to again consider a youth rate on the basis that valuable work experience opportunities were being lost. Some employers claimed to be discouraged from taking on younger employees for the same rate of pay as older employees as they often require greater levels of supervision due to their lack of 'work ethic' and experience in the work place.

The Forum consulted on a youth rate again in 2009; however the consultation did not reveal sufficient evidence to support the recommendation of a youth rate. The Forum was concerned that the introduction of a youth rate could have a detrimental effect on young people who already have a job, particularly students and young people who are supporting themselves.

The Social Security Minister again asked the Forum to review the need for a youth rate again during 2010. The Forum consulted on whether young people are missing out on work experience opportunities in any particular industries, whether young people are willing to work for a lower rate of pay (targeting young people on the Advance to Work Scheme), and whether employers would be more willing to employ younger people at a lower rate of pay.

There was some support for a youth rate, however the consultation had not revealed sufficient evidence that the minimum wage is a factor in youth unemployment, or that the availability of a lower rate would affect employers' or young employees' behaviour sufficiently. The Forum decided that specific evidence would be required to demonstrate whether a youth rate would improve opportunities for young people, and that it would be necessary to consider wider effects, such as the displacement of existing older staff.

This year, the Social Security Minister has asked the Forum to review the trainee rate and the "trainee rate code of practice"[43]. Employees who are undergoing an accredited course of training may be paid a lower hourly rate for up to one year in the first year of employment by an employer, in the particular job for which the employee is being trained. A code of practice sets out the criteria, including that the training should be provided at no cost to the employee and should be of relevance to the job for which the employee is being trained. As well as academic and vocational courses, the code was intended to be flexible to cover new training schemes in Jersey by including for example, any course that is included in the Economic Development 'Skills Strategy for Jersey'. The Forum will review whether the code is sufficiently flexible so that the trainee rate may be paid in appropriate circumstances.

Incentives to work at older ages

Jersey has a very high participation rate (particularly for women) among those of working age, and there is unlikely to be much scope to raise it further. However, one area where there might be room for improvement is participation among older people, at either the top end of the working age bracket, or just above what is currently considered as working age.

[43] www.jacs.org.je/content/38/index.html

As a way of dealing with the economic challenges posed by an ageing population, the OECD has recommended that its member states look to achieve a more sustainable balance between time spent in work and time spent in retirement. In particular, recent gains in average life expectancy have not been coupled with commensurate increases in the average age at which people retire from work. As a result, the average time pensioners receive pensions is increasing much faster than the time those pensioners were in work. In many countries this has resulted in governments trying to reduce policy-induced distortions to the working-retirement decision.

For example, many countries have committed to, or are at least considering, increasing the retirement age – perhaps by linking it to life expectancy – or changing the eligibility conditions or contributory requirements for claiming pensions.

In Jersey the Social Security Department has recently published a proposal to link state pension age to life expectancy. The initial proposal is to maintain average life expectancy at state pension age at that forecast for 2010. This equates to an increase of pension age of 2 years by 2031.

But there is a limit to the degree to which the pension age can be raised without becoming vulnerable to the charge that it is unfair to certain groups (i.e. those occupations and socio-economic groups with lower life expectancy than average or that cannot afford to retire as early as others).

Further, while increasing the age at which individuals are *entitled* to state pension schemes is necessary to address the increasing challenge in affording state pension schemes, it is neither necessary nor sufficient to make people work longer, and therefore address the other challenges that arise from an ageing population, such as the affordability of public healthcare. It also has no effect on the retirement age of those not dependent on public pension schemes – who tend to be those with more wealth, as many will continue to retire much earlier than the state pension age – or those that enter effective retirement through less usual channels such as special early retirement schemes, invalidity or unemployment.

Therefore it will also be necessary to take additional steps, including; assessing the role of the tax and benefit system, addressing social attitudes to older people, particularly in respect of age-discrimination in the labour market and supporting life-long learning across all age groups.

Some work is already underway. For example, tax and pension systems can interact to create an effective tax on additional years of working at older ages.[44] In Jersey, the current state pension allows an individual to draw a reduced pension up to 2 years before state pension age. In line with the importance of encouraging older workers to remain in the workforce, this flexibility will be extended to 2 years above state pension age. An individual choosing to delay drawing their pension until a later date will be able to receive an enhanced pension, based on the number of months by which the pension is delayed.

In addition, the Social Security Department has identified a number of other policy areas that must be actively pursued over the next 10 years. These include additional measures to protect the older worker in the labour force and improved benefits and rehabilitation services for those suffering ill health due to working conditions.

Labour Market Information

Good labour market information (LMI) has real value to the efficient functioning of the labour market. LMI helps individuals make decisions about careers and policy-makers make decisions about labour market and macroeconomic economic policy. Quality is important, rather than quantity.

There is a clear need for accurate, timely and insightful LMI on a range of issues such as: current and future employer skill needs; the existence, extent and nature of recruitment problems caused by skills shortages that may be holding back competitiveness; the existence, extent and nature of skills gaps amongst employees that may be stifling productivity.

Skills Jersey currently serves an important purpose in this respect, producing an annual survey of skills and employer skills needs, similar to the National Employer Skills Surveys in the UK. However, there may be scope to improve the information, and it is recommended that officers from Skills Jersey, the Head Statistician and Economic Adviser work together to identify any gaps and whether they can be filled effectively.

[44] For example, when an individual becomes eligible to collect a pension – even if it is not the full pension – each extra year worked means an extra year of pension contributions and foregoing a year of pension benefit, in addition to any disutility of labour. To the extent that these costs are not offset by additional pension benefits, there is an implicit tax on the extra year of working i.e. the change in pension wealth from the additional year of working is worth less than the extra contributions paid.

Collective Measures

The available evidence and analysis supports a strong case for stimulating employers to network and collaborate with each other and with government in skills development and investment. A number of recommendations along these lines from a UKCES report (UKCES, 2009) are worth considering for Jersey, including:

- Identifying, documenting and widely disseminating the economic and competitive benefits to employers of investing in skills, confirming – particularly on a sector-by-sector basis – the contribution that skills and other workforce development initiatives make to employer productivity and business performance;
- Championing the take-up of the 'new-look' Investors in People, and to explore the potential for developing new benchmarking tools on people practices that can stimulate greater employer commitment and investment;
- Piloting the development of new employer networks (spatial, sector-based and/or supply chain-based) to support collaborative skills development, joint investment approaches, enhanced leadership and management, improved skills utilisation, and other business needs. This could include Performance Working collectives, Best Practice Clubs, Leadership and Management groups and other mutual support and investment networks;
- Benchmarking high performance working practices, demonstrating their value and their take-up through existing and new employer networks, and exploring the potential for increasing the voluntary reporting of human capital in company reports; and
- Exploring whether it is possible to use public procurement to support employee development and skills provision.

Next Steps

Skills are an important driver of productivity improvements and there are clear circumstances under which market failure exists and government intervention can be justified. However, it will be important to determine where these circumstances exist in Jersey and critically what the most effective government interventions might be.

Skills framework

If the review of the structure and operation of Skills Jersey recommends ways that it can be improved to enhance delivery of the Island's skills objectives, they should be acted on quickly to enhance this aspect of the Economic Growth Strategy.

A new Skills Strategy for Jersey

Much progress has been made in Jersey in addressing skills issues not least with the establishment of Skills Jersey and the research that it has undertaken. However, there is still a clear need to establish a holistic Skills Strategy for the Island that covers all the key issues including:

- Evaluating existing skills-related policies, identifying gaps and weaknesses and drawing on any lessons learned from local and international experience.
- Raising the skills levels across the population including reducing the proportion of the population with no formal qualifications.
- Identifying and addressing skills gaps within the existing workforce and providing a vehicle to identify current and new opportunities.
- An assessment on recent developments in early years care and education against the objectives and identification of strengths, weaknesses and opportunities for improvement of existing approach.
- Continued development of a strategy to address literacy and numeracy skills across the population.
- A detailed response to the issues raised in the Green Paper on Primary, Secondary and Tertiary Education.
- Continued development and improvement in the vocational education offer in Jersey
- Assess the strengths and weaknesses of management skills in the Island and identify any issues that merit government policy.

- Identify whether more could be done to stimulate employers to network and collaborate with each other and government in skills development and investment.

The development of this strategy should be led by Skills Jersey seeking advice form the States Economics Unit where appropriate.

Employee involvement and commitment

HPW is an example of policies that can bring benefits for employees and employers and there can be a number of barriers to their development. Further work should explore whether these barriers exist in Jersey and whether greater application of policies such as HPW could bring benefits. For example, Jersey Enterprise should consider whether it might be of benefit to run a series of Master Classes on improving employee involvement and a commitment, including HPW.

Support for Jobseekers

It will be important to act on the recommendations of the ongoing review of income support to ensure that policies towards the unemployed and those on low incomes minimise disincentives to work and are conducive to economic growth.

This should include an examination of the current strategy for dealing with youth unemployment, drawing on the success of the New Deal for Young people in the UK where necessary. This will include examining whether more information is needed on NEETs in Jersey.

Further Active Labour Market Policies for job seekers of all ages should be considered in the context of the Jersey labour market and pursued where appropriate

Minimum wage

During 2011, the Employment Forum will review the trainee rate and the associated code of practice with a view to making further recommendations to the Social Security Minister. Further consideration should also be given as to whether labour market conditions in the post global crisis world and the need to examine the current strategy for dealing with youth unemployment mentioned above, change the balance between the costs and benefits of youth minimum wage rate.

Participation and incentives to work longer

Even though Jersey has consistently high rates of participation in employment detailed consideration needs to given as to the barriers preventing those currently not participation in the labour force and whether government policy can address particular market failures. This should include but not be limited to older workers.

The States, as a major employer, should lead the way in human resources and employment policies designed to support and encourage the older worker.

The treatment of older workers under the current tax/benefit system should be reviewed to encourage individuals to remain in employment where appropriate.

The roles of social attitudes and access to lifelong learning also need to be considered.

Labour market information

Skills Jersey, the States Head Statistician and Economic Adviser will work together to identify any information gaps and whether they can be filled effectively.

4 Competition and consumer policy

In theory competition, or the threat of competition, can be beneficial for productivity in three main ways. In particular:[45]

- Between-firm effects: Competition can increase aggregate productivity by encouraging firm turnover and the exit of less efficient firms.
- Within-firm effects: Competition increases the incentives for firms to increase their productivity in order to survive.
- Innovation: The relationship between innovation and competition is complex. While innovation and competition will usually be mutually beneficial, there may be cases in which 'too much' competition may harm innovation.

This competition may be local, or it may come from firms from outside the local area and the available empirical evidence supports the case that competition policy has significant positive effects on productivity growth.[46]

Competition should also have positive benefits for inflation; through putting pressure on firms to price in a way that attracts customers, competition should minimise price increases and mean that cost savings are passed on to consumers in the form of lower prices.

Market Failure

Government intervention to support competition must be justified on the basis that the level of competition in absence of such intervention is sub-optimal. A variety of market failures may exist that lead to suboptimal levels of competition – either too little or, in rare circumstances, too much. For example, small geographic markets or substantial economies of scale may mean that the number of firms that can be sustained is naturally low, and as a consequence the competitive threat to incumbent firms may be small. The fact that Jersey is a small island increases the likelihood that the degree of competition that is sustainable in certain industries is smaller than it would be elsewhere.

[45] This categorisation is taken from OFT (2007) *Productivity and Competition: An OFT Perspective on the Productivity Debate*
[46] For example, Buccirossi et al (2009) *Competition Policy and Productivity Growth: An Empirical Assessment*

Competition Law and the Jersey Competition Regulatory Authority (JCRA)

Jersey adopted a competition law around the time that the previous Economic Growth Plan was written. This saw the introduction of the Jersey Competition Regulatory Authority (JCRA). In the intervening five years the JCRA has undertaken a number of specific regulatory actions, and JCRA (2008) estimated that the financial benefits of these interventions are likely to have been significant. In addition, it cites work by the OFT in the UK[47] that suggests that the deterrent effect of competition policy is perhaps more significant than the effects of particular enforcement actions, suggesting the benefits of the competition law and the JCRA are even greater.

While the evidence suggests that the JCRA has had a significant positive impact, there is no room for complacency. The JCRA must continue to take a pro-active approach to competition policy, and its powers and methodologies should be continually kept under review to ensure that they are in line with best practice around the world, perhaps supplemented with regular reviews by independent external bodies.

Consumer policy and the Jersey Consumer Council (JCC)

It is generally accepted that competition policy and consumer protection are closely linked and complementary areas of policy. In Jersey there is no statutory authority equivalent to the OFT in the UK charged with consumer protection. However, the Jersey Consumer Council – which is analogous to Consumer Focus (formerly the National Consumer Council) in the UK – represents the consumer and has an important role in the competitive process by disseminating information relating to the conduct of firms, and thus providing consumers with the ability to make informed decisions and to vote with their feet. This provides extra discipline on businesses, as they are less likely to be able to act against the consumer interest and not lose substantial business as a result.

A recent review of the JCC conducted by PACT consulting produced a variety of recommendations that would strengthen the ability of the JCC to carry out its role in an effective manner, including putting it on a statutory footing and reforming its governance structure. This was supported by additional work by Colin Powell CBE[48] and resulted in a proposition (p.182/2010) – taken to the States in late 2010 and agreed in early 2011 – that sought to implement many of the suggested reforms.

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[47] OFT (2007) *The Deterrent Effect of Competition Enforcement by the OFT*

[48] *Jersey Consumer Council – Its Future Role*, available as Appendix to P.182/2010

Consumer policy more generally should be kept under review, and assessed against best practice – for example the OECD's Consumer Policy Toolkit, discussed further below – in order to ensure that competition is being supported by well-informed consumers and, where necessary, vulnerable consumers are being protected.

Competition in other policy areas

Competition considerations are important in many areas of policy, not just those directly relating to competition. Governments often use non-market levers to achieve policy goals, but these will often interact with competition. For example competition may be affected by planning restrictions and regulation of undertakings (RUDL). In cases like these, their effects on competition should be taken into consideration in the appraisal process. As the OECD notes, *"restrictions on competition – such as limitations on entry, price, output or production methods – are very costly ways to promote such public interests and have often been ineffective…There may be lower-cost approaches such as market incentives or approaches that are competition-neutral that work better within competitive markets."*[49] As far as it is practical, policies should be assessed as to their effect on competition in order to ensure that they are not having unnecessary or unintended negative impacts on competition.

In practice this could be done using a ready-made best-practice framework such as the OECD's Competition Assessment Toolkit.[50] This provides a general methodology for "identifying unnecessary restraints [on competition] and developing alternative, less restrictive, policies that still achieve government objectives." The toolkit has been consciously designed for use by officials with no economics training, and is versatile in that it can be used to conduct overall reviews of existing policies and regulations or to evaluate specific proposals of new policies and regulations.

It is proposed that departments in Jersey that are reviewing existing policies or proposing new ones should use the toolkit to assess whether they may have detrimental effects on competition. Figure 4.1 and Figure 4.2 set out how this might work in practice.

In essence, it is proposed that all policymakers ask the following questions of their policies as standard:

- Are there limits on the number or range of suppliers?

[49] OECD (1997) *The OECD Report on Regulatory Reform: Synthesis* cited in the OECD Competition Assessment Guidance
[50] Available at www.oecd.org/competition/toolkit

- Are there limits on the ability of suppliers to compete?
- Are there reductions in the incentives for suppliers to compete?
- Are there limits on the choices and information available to customers?

This should occur very early on in the policy development process, while options are still being developed. Should the answer to any of these questions be yes, policymakers would be encouraged to seek advice from the Economics Unit and potentially the JCRA on the potential impacts of policy options on competition. In this way, policies that have unnecessary or unintended negative impact on competition can be avoided.

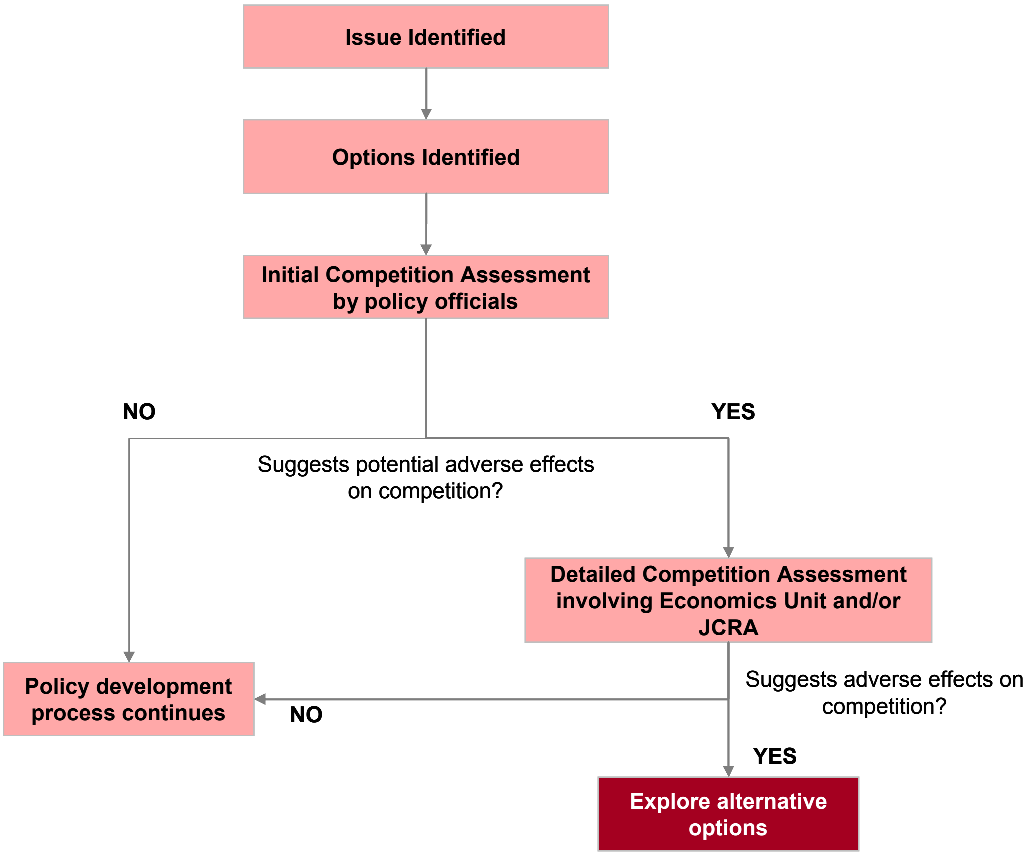
As there is not a requirement to complete a full regulatory impact assessment (RIA) or equivalent like there would be in the UK as part of the standard policy process, and which features a competition assessment, it will be more difficult to make this a standard and integral part of the policy development process in Jersey. However, hopefully with the support of senior officials and ministers, such an exercise could become standard practice.

Figure 4.1 How competition assessments might be done in practice

1.	**Which policies merit a competition assessment?**	In as far as possible, **all** new policies and regulations should be subject to a competition assessment. The depth of the assessment should be proportional to the potential negative effects.
2.	**When should a competition assessment be performed in the policy development process?**	For new policies: as **early** in the process as possible, before a policy or regulation has been decided on, as the point of a competition assessment is to try to identify alternative options when a potential policy is likely to have significant adverse effects on competition. Existing policies should be reviewed **periodically** as standard practice, although the natural time between reviews may vary between policy areas.
3.	**Who should be responsible for drafting and reviewing a competition assessment?**	The officers responsible for developing policy should be required to undertake a competition assessment as part of policy development. The Economics Unit will be able to assist in reviewing the assessments and in conducting them where appropriate. The JCRA may be requested by the ED Minister to look at particular policy issues in detail.
4.	**How can policymakers without responsibility for regulatory quality or competition be given incentives to prepare an appropriate assessment?**	If Ministers and senior officials can be persuaded to support competition assessment as a valuable stage in the policy development process, then other policy officials should have the incentive to undertake an assessment. This is particularly the case if it is accepted that policies that have not received economic advice, of which an element should be a competition assessment, are unlikely to receive Ministerial support.
5.	**What resources are required for competition assessment?**	Provided that a process for competition assessment receives support from Ministers and senior officials, the resources required for embedding competition assessments should not be significant.

A diagram of how this might work is shown in Figure 4.2.

Figure 4.2 Suggested process for competition assessments



Next Steps

In order to strengthen the existing competition framework, it is suggested that:

- The competition framework and competition law should continue to be reviewed at regular intervals to ensure that the JCRA can continue to take a pro-active approach to competition policy. Its powers and methodologies should be continually kept under review to ensure that they are in line with best practice around the world.
- Assessing policies for their impact on competition should be standard practice in all areas of government policy, for example in planning and RUDL decisions.
- Consumer policy should be kept under review to ensure that it is in line with best practice.

5 Investment and Physical Infrastructure

Investment in physical infrastructure or other forms of business investment can be key drivers of success, supporting productivity and economic growth. As a small island, Jersey does not have a large stock of physical infrastructure, however it is important that it is able to build and maintain the vital infrastructure it needs. To this extent that this has fiscal implication it will need to be supported by a flexible fiscal framework, which is covered in more detail in Section 7.

Market Failure

In many instances infrastructure has benefits beyond the benefits to the private individuals and organisations that use it. For example the infrastructure required for transport links and modern communications has benefits beyond those that use them directly, since they enable a thriving economy, which in turn supports jobs and public services.

While business investment is important for economic success, there is less of an economic case for government involvement in business investment, beyond the support from generic growth policies such as macroeconomic stability and competitiveness and the marketing and promotion activities that promote the Island as a place to invest. Should there be more specific areas in which particular market failures are identified – for example in the area of shared infrastructure - the States should assess what, if anything, it can do to address them.

Transport

Both internal and external transport links are important. In terms of internal transport links, the States needs to ensure that roads, footpaths and cycle routes are maintained and public transport services such as the bus services are run efficiently.

The main external transport links in Jersey are aviation services to and from the airport and shipping through the harbour. Both of these links are important to the success of the Island as they move passengers and goods in and out of the Island. The degree to which the Island is connected to other jurisdictions will be an important factor in the location decisions of employers and individuals, and as many goods are imported, these connections are even more important.

Any case for government intervention needs to be justified on the same basis as other policies – market failure or other defined social objective. There are arguments for careful government management of the both major transport links. With regard to aviation, the main justification is that there may be cases where the benefits to the

Island to having a flight route to a certain destination exceed the private benefits to that route, and therefore it may be justifiable for a public subsidy to support that route if it was not viable in absence of that money. However, alternative uses of that money would have to be considered as well. Each application for route development support must continue to be assessed on its merits for the Island as a whole. **Going forward the intention is to strengthen the process of evaluation and appraisal and the cooperation between States departments and the airport.**

Clearly air links are an important strategic asset for the Island, and need to be sustained and invested in to maintain them.

As part of work to inform a new Tourism strategy, the relationship between passenger numbers and financial viability will be explored, and in particular whether there is a 'critical mass' of passengers that would make the airport viable on an ongoing basis, which will provide an evidence base on which decisions about route development and the future of infrastructure can be based.

With regard to shipping, there may be a market failure in that direct competition is not sustainable in the market. This may mean that incumbent operators lack the incentive to operate efficiently and provide the best value service, which would provide the best outcomes for consumers. Therefore there may be a role for government intervention in this market in some form or another. A public consultation on the future of the ferry services to Jersey and Guernsey was recently undertaken, supported by detailed analysis undertaken by independent economic advisors. The economic advice concluded that there was a case for a licensing regime in which potential ferry operators would be required to contribute to a prescribed Universal Service Obligation (USO).[51] Ultimately however, in light of the consultation and other considerations, the Economic Development Department has decided to maintain the current system, while committing that policy towards shipping markets such as those for ferry services or freight will be kept under constant review to ensure that they are functioning properly and providing the maximum benefit for the Island.

Communications

A large part of Jersey's economy is built on knowledge and service-based industries such as finance, law and information technology. In an increasingly competitive and globalised world, the ability to communicate quickly, easily and cheaply is paramount

[51] Oxera (2009) The Supply of Ferry Services: A Policy Assessment

to the success of such industries, and will play a significant part in the decision of businesses to locate on the Island.

For this reason it is important that the Island has sufficient investment in information and communications infrastructure in order to enable the economy to be successful. In terms of government policy, this implies that the States should keep the functioning of the market under review to ensure that it is able to deliver the optimal level of investment, and where there are identifiable market failures that may lead to under-investment, the appropriate form of government intervention should be considered.

It is possible that the future success of new industries such as e-gaming and e-commerce may support the development and maintenance of world-class communications infrastructure on the Island.

Next Steps

- Infrastructure investment can have important economic benefits and regular and continued assessment is needed to identify and plan for future infrastructure needs.
- External transport links are strategically important in any economy but particularly an island economy and it will be important to:
  - Strengthen the process of evaluation and appraisal of new air routes
  - Investigate further ‘critical mass’ passenger issues at the airport and the implications for future funding
  - Review ferry services and freight markets as further experience is gained under existing policy and assess performance relative to other approaches such as a licensing regime.
- Review and assess at regular intervals future information technology and communications requirements and the ability of the current market arrangements to deliver the investment that will be required to meet industry demands to remain competitive in the future.

6 Cross-cutting policy areas: Planning & RUDL

While all policy areas are likely to be affected by the considerations set out above to a greater or lesser extent, the two that are likely to have the most significant impact on economic growth are policies and decisions relating to planning and Regulation of Undertakings and Development (RUDL). These two areas are examined in more detail in this section.

6.1 Planning

Planning laws and regulations play an important role in addressing a variety of market failures in the form of externalities such as aesthetic appearance, durability and build quality and so on. But they can also have a significant impact on the success or otherwise of an economy; badly designed policies can raise the price of inputs across the economy and reduce productivity and growth.

For example, planning policies can exacerbate problems of land scarcity and raise the price of land or controls might make it difficult for undertakings to purchase land of a required size or with the necessary permissions for use. Further, beyond the direct effects on the availability and price of housing and commercial property, there is an indirect effect on prices throughout the rest of the economy: measures that raise the price of land affect costs for the majority of commercial activities in the economy. The empirical evidence lends some support to this view, although there is no consensus on the importance of planning regulations in determining productivity.[52]

Jersey, like many island economies, only has a limited amount of land and labour, and it is therefore even more important that we make the best use of the resources we have if the Island is to continue to provide a good standard of living and deliver high quality public services for Islanders.

Accepting that planning laws have benefits, the objective should be to implement them in a way that is least damaging to productivity. A high priority should be given to encouraging and facilitating productivity improvements across all sectors of the economy. This may occur by either attracting high productivity businesses from elsewhere, or encouraging the development of local businesses, existing and new. Planning policies can do this by ensuring that they facilitate the most productive use of land within the policy objectives that underpin the planning system, and do not act as a barrier to desirable changes in the composition of economy.

[52] See Griffith & Harmgart (2008) Supermarkets and Planning Regulation and Haskel & Sadun (2008) *Regulation and UK Retail Productivity* for examples relating to the retail sector.

In turn this means that where possible market information such as prices (land values, rents and yields), vacancies and data on productivity should used to understand the relative demands for different land uses across different locations. While this information will only be one input into planning decisions, they should be taken seriously as an indication of the economic value of different land use permissions. The Island Plan includes a list of such indicators, and so appears to be sufficiently flexible to allow this to happen, but the key will be in how it is implemented. In particular, if the result is simply to keep current land uses then the outcome is unlikely to be optimal and will hinder economic efficiency and economic growth.

Box 1: Indicators E 1 (Island Plan)

"Economic indicators:

- *Freehold Land values, rental values & yields*
- *Average earnings by sector*
- *Unemployment rate*
- *Employment by sector*
- *Number of rural diversification schemes*
- *Demand across all sectors*
- *Vacancy Rates*
- *Amount of employment land lost to other forms of development*
- *Amount of land developed for employment/land supply by type"*

One example where there is a risk that the Island Plan might not be consistent with maximising productivity is SP5 (supplementary policy) in the Draft Island Plan, which states that:

> *"A high priority will be given to the maintenance and diversification of the economy and support for new and existing businesses, particularly where development can attract low footprint/high value business from elsewhere and foster innovation, in the following ways:*
>
> 1. *the protection and maintenance of existing employment land and floorspace for employment-related use;*

2. *the redevelopment of vacant and underused existing employment land and floorspace for new employment uses;*
3. *the provision of sufficient land and development opportunities for new and existing employment use."*

If interpreted to the letter, this is not necessarily the best way to encourage economic growth and diversification. It implies a presumption against change of use from employment land to other uses such as housing. However, the Plan goes on to say that there are circumstances in which this presumption could be overturned, and these are set out in Policy E1. Again, this is sufficiently flexible to be conducive to economic growth and productivity, provided it is implemented in the right way.

Box 2: Policy E1 (Island Plan)

"Protection of Employment Land

There will be a presumption against development which results in the loss of land for employment use as supported by the Strategic Policy SP 5 Policy SP 5 'Economic Growth and Diversification', unless;

1. *It is demonstrated that the site is inappropriate for any employment use to continue, having regard to market demand. Applications will need to be accompanied by documentary evidence that the size, configuration, access arrangements or other characteristics of the site make it unsuitable and financially unviable for any employment use and confirmation by full and proper marketing of the site for 12 months on terms that reflect the lawful use and condition of the premises; or*
2. *The overall benefit to the community of the proposal outweighs any adverse effect on employment opportunities and the range of available employment land and premises; or*
3. *The existing use is generating environmental problems such as noise, pollution, or unacceptable levels of traffic and any alternative employment use would continue to generate similar environmental problems."*

Next Steps

It is proposed that:

- Senior officers from the Planning Department, Economic Development Department and Economics Unit meet on a regularly (quarterly) basis to consider the economic implications of key planning decisions, including the likely impacts on productivity and competition.
- The group of officers should also discuss how the presumption against a change of use, particularly *within* employment land, is being interpreted and applied with respect to new and pending decisions. Full consideration should be given as to whether decisions are unnecessarily restricting productivity and growth.

6.2 Regulation of Undertakings and Development Law (RUDL)

RUDL exists in order to manage inward migration to the Island (in tandem with the Housing Law) and is simply a tool by which the desire to constrain the population (and to some extent economic activity) is implemented.[53] RUDL is a distinctly non-market way of managing the labour market in Jersey. In essence RUDL decisions involve the States making a cost-benefit analysis on each application for licenses, bearing in mind the overall constraint on resources. The justification for such an intervention is the existence of market failure. Specifically, not all the costs of job creation are borne by the individual business, so individual firms may want to hire more labour than is desirable from the perspective of the Island. For example, while the hiring firm will take into account the labour costs of employment, they will not take into account the demands that an extra person may place on infrastructure and public services or the effect on the level of demand in the housing market.

However, this comes at a cost. RUDL (or in fact the desire to limit population and inward migration) can act as a barrier to entry for new firms, and there is substantial evidence that higher barriers to entry are associated with lower productivity growth. There are two main mechanisms through which this can occur. Firstly, new firms may be more productive than incumbent firms, so their entry into the market may attract resources from less productive incumbents, and thus increase the average level of productivity. If entry is prevented or made more difficult, this will not occur to the

[53] Both RUDL and the Housing Law are set to be replaced by new legislation, should the Draft Control of Housing and Work Law 201- be passed when it to comes before the States.

same extent. Secondly, new firms provide the threat of competition to incumbent firms, which raises the incentive for them to innovate and raise their productivity in order to survive. In contrast, higher barriers to entry tend to be associated with higher mark-ups and lower productivity growth.

Given that RUDL is a barrier to entry, and accepting that it is a useful policy lever, the objective should be to use RUDL in such a way that its adverse effects as a barrier to entry are minimised. One way to do this would be to have explicit considerations to this effect in considerations of RUDL applications. For example, undertakings with the potential to be significantly innovative or the potential to shake up a concentrated or stagnant market (particularly where goods and services are consumed locally, but this applies to export businesses as well) – should be treated favourably in the RUDL process.

Such judgements will not be easy, but it would be possible to look at existing market concentration or the threat of competition, business plans etc. to determine whether a prospective firm could be expected to raise the incentives for incumbent firms to be as efficient and productive as possible and therefore be good for the economy as a whole.

A slightly different argument applies to the granting of licenses to existing businesses and housing consents for individuals – i.e. (1)(i)(j)s and (1)(i)(k)s – than to granting licenses to new businesses. In the case of existing businesses and housing consents for individuals it is less to do with barriers to entry and competition, and more to do with skills and economic contribution.

A higher level of net inward migration will not increase average productivity per worker per se and, although it can help generate economic growth, it is a not a panacea for sustainable economic growth. However, if managed properly there are several ways in which inward migration can be used in order to raise labour productivity. For example:

- Inward migration of skilled workers can increase human capital levels, and/or offset human capital losses from emigration of skilled residents;
- Inward migration can affect capital flows and investment – as migrants bring investment capital with them, and as they send remittances back to their country of origin. Migrants can enable firms to invest and adapt new technologies by overcoming shortages or lags in the supply of specialist skills;
- Migrants can bring new ideas, technologies and processes that can be adapted and applied in local firms;

- Migrants can help to establish new connections with international markets and supply chains that enable firms to invest and grow.

This suggests that these factors should be taken into account when deciding policy in relation to inward migration (and in particular, 1(1)(j)s and (1)(i)(k)s). Where possible, evaluation of applications for (1)(i)(j) licenses should give weight to skills and potential for value-added, while that for (1)(i)(k) licenses should give weight to potential contribution to innovation and entrepreneurship in the local economy.

It is important that the Population Office and the Housing Department should have regard to how RUDL and housing law application decisions can affect economic growth. In addition, the effect on skills or innovation/entrepreneurship of granting a 1(i)(j) or 1(i)(k) could also be considered.

Next Steps

It is recommended that:

- The Population Office and the Housing Department continue to have regard to how RUDL and housing law application decisions can affect economic growth. Advice could also be sought from the Economics Unit about balancing the demand on resources and making efficient use of those resources.
- Evaluation of applications for (1)(i)(j) licenses should give weight to skills and potential for value-added, as well as competition while that for (1)(i)(k) licenses should give weight to potential contribution to innovation and entrepreneurship in the local economy.

7 Demand: Macroeconomic Stability and Competitiveness

An economy can be very productive and capable of producing high-value goods and services using minimal resources, but if that economy is not sufficiently competitive internationally such that it is more attractive for these goods and services to be produced and bought and sold elsewhere, then its capacity on supply-side is largely irrelevant.

The two major determinants of demand for local resources and locally produced goods and services, particularly in small-island economies where businesses are highly mobile, are international competitiveness and macroeconomic stability.

7.1 Competitiveness

Competitiveness concerns how attractive a jurisdiction is to do business in and with. It encapsulates all the costs of doing business and hence determines the price that suppliers can charge on the international market and still recover their full costs. So the key drivers of competitiveness are productivity, taxation (rates and mix), wages, rents and red tape, as they all affect the cost of doing business in a particular place, and therefore the location decisions of firms. It can also include less tangible factors such as political and economic stability. These factors combine to have a knock-on effect on how many jobs there are in the local (Jersey) economy and how successful businesses are and so competitiveness is crucial for economic prosperity.

Competitiveness is difficult to measure directly, because it includes a number of qualitative factors as well as quantitative factors; however a number of attempts have been made. One example is the Global Financial Centres Index (GFCI), which attempts to rank major financial centres according to competitiveness, using the following factors:

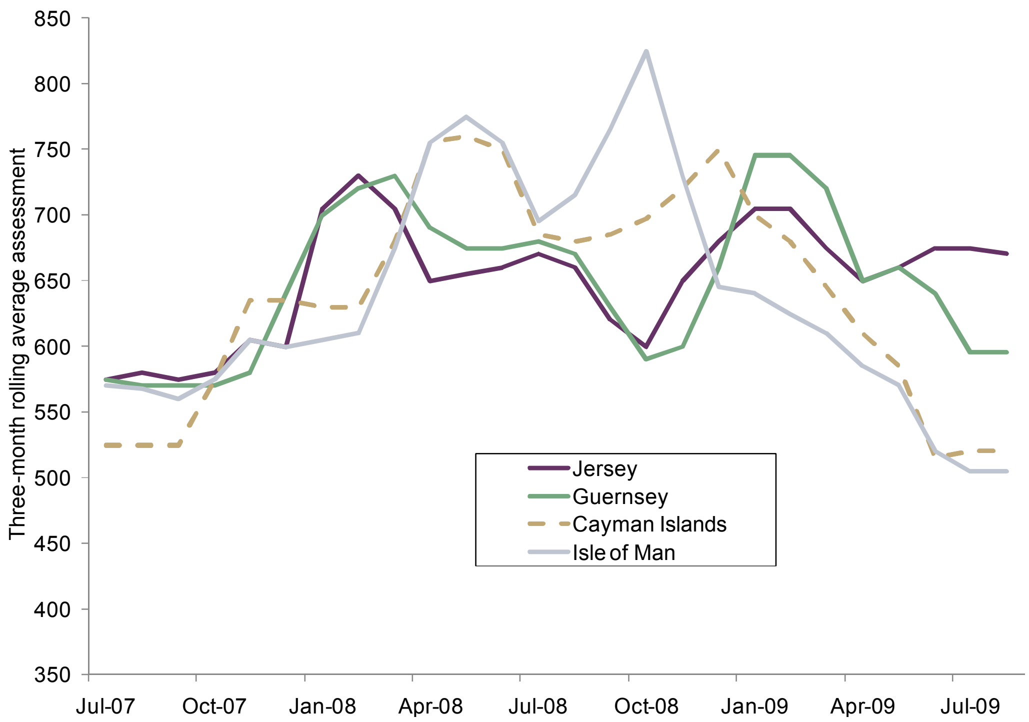
- **Business environment,** including ease of doing business, opacity, wage comparisons, corporate, employee and personal tax rates, bilateral tax information exchange agreements and country-risk assessments.
- **People,** including measures of intellectual capital, numbers of graduates, visa restrictions and quality of living.
- **Infrastructure,** including office occupancy costs, transport and office capacity.

- **General competitiveness,** including business confidence indices, investments and inflation indices.
- **Market access,** including measures of capital market access, credit ratings and volumes of financial trades.

Figure 7.1 illustrates how Jersey has compared recently on this measure to 3 selected competitor jurisdictions – Guernsey, Cayman Islands and the Isle of Man.

Figure 7.1 How Jersey compares to its competitors on one measure of competitiveness

A higher number implies greater competitiveness



Source: Global Financial Centres Index (GFCI), City of London. Cited from work by Oxera

Two things are apparent from an analysis of Jersey's competitiveness. First, measures of competitiveness are relatively volatile, and while measures like this are unlikely to be perfect measures of competitiveness, they do suggest that a competitive advantage can be lost fairly easily. Second, Jersey is relatively competitive with respect to competing financial centres, but cannot afford to be complacent.

The implication for policy is that the assessment of new policies should, in as far as possible, include a consideration of their impact on competitiveness. For example, a key objective in the Fiscal Strategy Review (FSR) of domestic taxes was to ensure that decisions concerning fiscal policy do not jeopardise the Island's international competitiveness. For that reason, along with fairness and efficiency, competitiveness was the other key consideration. Taxes on consumption and immovable property tended to score well on this measure because the evidence suggests that they are least damaging to competitiveness.[54] Competitiveness should continue to be a significant consideration in any changes to the business tax regime that might fall out of the review of business taxes. But competitiveness goes wider than just taxes, and it is important to ensure that the competitiveness implications of all policies are given due consideration, for example in terms of telecommunications infrastructure and reliable energy supplies.

7.2 Macroeconomic Stability

In the past few years significant advances in the quality and quantity of available data from the Statistics Unit and economic analysis from the Economics Unit have been achieved. The results of a new quarterly Retail Sales Survey were published for the first time in 2009, with data back to 2005, and a new Business Tendency Survey was started in 2009, which provides useful and timely data on trends in all sectors of the local economy.

Using this information, as well as data from a wide range of other sources the Economics Unit has begun to produce forecasts of economic activity 1-2 years in advance, which are published in official documents such as the Budget and Business Plan. The independent Fiscal Policy Panel also produces its own forecasts at least once a year in its annual report, but often more frequently, and advises the States on using fiscal policy to achieve macroeconomic stability.

All of these developments mean that economic policy can be made from a more informed position, and as a consequence, macroeconomic stability should be enhanced.

Fiscal Framework

The Fiscal Framework refers to the overarching principles and structure of fiscal policy in Jersey. Specifically, this means the three main accounts and reserve funds (the Consolidated Fund, the Stabilisation Fund and the Strategic Reserve), the principles attached to their use, and the independent Fiscal Policy Panel set up to advise the States on their use.

[54] For more detailed analysis see the Fiscal Strategy Review: Supporting Research paper available at http://www.gov.je/Government/Consultations/Current/Pages/FiscalStrategyReview.aspx

The Fiscal Framework has been in place for nearly five years[55], with the Fiscal Policy Panel having been in place since 2007 and reappointed for another 3 years.

The role of the FPP is to publish an annual report each year that:

- Examines the strength of the Jersey economy, the position in the economic cycle and the economic outlook
- Comments on the appropriateness of the States financial position
- Recommends policy regarding the Stabilisation Fund and Strategic Reserve and whether economic conditions justify payments in or out of these reserves

To date the FPP has produced 7 reports (1 initial report, 3 annual reports, 3 interim updates) and provided ad hoc advice to the Treasury and Resources Minister on one occasion.[56] In this time they have recommended transfers into and out of both the SF and SR, cautioned against unfunded spending increases and provided advice concerning a fiscal stimulus package implemented by the States.

The introduction of a Comprehensive Spending Review (CSR) process and other changes to strengthen the budgeting and spending process, while not strictly speaking referred to as part of the Fiscal Framework, are developments that will add to the robustness of the Fiscal Framework.

In keeping with the approach elsewhere in this strategy, policy should be reviewed and evaluated on an ongoing basis and the fiscal framework is no exception. Now would be a good time to review the existing fiscal framework and examine how it can best support the States fiscal and economic objectives going forward.

Inflation

Jersey has a relatively good performance record with regard to inflation. On both the RPI and RPIX measures, inflation has been relatively low (between 2-5%) and stable although there have been sustained periods when inflation has increased at a higher rate than that in the UK e.g. the late 1990s to 2005. Since 2005 it has tended to track UK inflation, with the exception of temporary periods where local factors may have pushed it slightly higher or lower (Figure 7.2 and Figure 7.3).

The recent divergence of RPIX in the UK and Jersey can be explained by the introduction of GST in May 2008, which raised the Jersey RPI and RPIX inflation rate between June 2008 and May 2009, and the UK VAT cut in December 2008, which

[55] P.133/2006 setting out the new Fiscal Framework was agreed by the States in October 2006.
[56] FPP reports and publications can be accessed at www.gov.je/FiscalPolicyPanel

cut the UK rate of inflation for 12 months. In addition the patterns of housing and motoring prices in Jersey and the UK diverged from the end of 2008. The UK has recently seen the temporary VAT cut end and a further increase in VAT, which has pushed up inflation in the UK. GST in Jersey is set to increase in June 2011, which will have a temporary effect on inflation for 12 months – adding about 1.3% to RPI and 1.4% to RPIX.

Figure 7.2 RPI Inflation

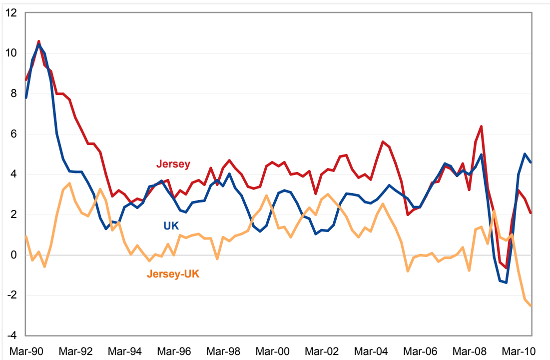
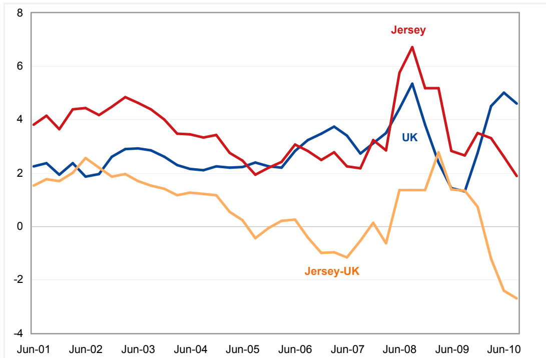


Figure 7.3 RPIX Inflation



Source: Statistics Unit

Economic Activity

Measured economic activity (GVA) is more volatile in Jersey than in many other jurisdictions. This is largely due to the large concentration in one particular sector – financial services. The Fiscal Framework outlined earlier in this section should help to manage this volatility going forward by allowing fiscal policy to work against the economic cycle rather than exacerbating it. Section 8 discusses the options in relation to diversification in more detail.

Next steps

Maintaining and improving competitiveness and macroeconomic stability are critical to future economic growth. Therefore it is proposed that:

- The Fiscal Framework should be reviewed and evaluated by the Economics Unit to examine how it can best support the States fiscal and economic objectives going forward.
- Low inflation is a key aspect of competitiveness and high inflation undermines economic growth. The focus of policy should continue to be on growth driven by productivity and supply side improvements, supported by counter-cyclical fiscal policy, which will be more conducive to low inflation.

- Jersey's competitive position should continue to be monitored on an ongoing basis so that any changes in its overall position can be addressed if necessary. Competitiveness should also be a primary consideration for all areas of government policy.

8 Structural change and diversification

8.1 Structural Change

Structural change involves a change in the sectors and activities that make up the economy. It can be beneficial when it involves an economy moving from low-value activity to activities that are able to generate high-value. This is because it means that businesses generate more profits and/or a greater number of well-paid jobs. A local example is the move towards financial services and away from tourism and agriculture in the years since the Second World War. Had Jersey not shifted away from tourism and agriculture and towards finance, average earnings would be around 45% lower than they are today, tax rates would have had to have been much higher and/or public services would be of a lower quality.

However, structural change need not be benign. If an economy where to shift in the other direction, from high-value activity to low-value activity, such structural change would have the effect of *lowering* average productivity, and have a knock-on effect on profits, job opportunities, wages and tax revenues, and ultimately on the prosperity and standard of living in that economy.

There may be a role for government in facilitating and potentially even encouraging structural change where it is beneficial and where it would not happen – or not occur smoothly – without government support.

8.2 Diversification

8.2.1 What is meant by diversification?

Diversification is not the same as structural change. As outlined above, the latter refers to any shift in the composition of the economy. In contrast, the former refers to a shift in economic activity in an economy that reduces the reliance of that economy on a particular sector or activity. In other words, all diversification will involve structural change, but not all structural change is diversification.

It is well known that Jersey is highly dependent on financial services, and this has brought many benefits to the Island including low personal tax rates, high quality public services, well paid jobs, high levels of employment and a high standard of living. It is believed by some that such specialisation causes problems, to the extent that the current Strategic Plan contains an objective to *'maintain a strong, environmentally sustainable and diverse economy'* and an action to *"lay the foundations for a genuinely diverse economy"*. However it is not clear that a comprehensive analysis has ever been conducted in order to establish whether a more active approach to diversification is desirable, what it would look like or how it could be achieved. The purpose of this section is to shed some light on these questions.

8.2.2 Is diversification desirable?

Economic theory suggests that economies should specialise in those activities in which they are relatively more efficient. By doing so they are able to get the most value from the limited resources they have at their disposal and they can trade what they are able to produce with other countries (who also specialise in activities they are efficient at) in return for the things that they wish to consume — in order to maximise their standard of living.

Jersey has a comparative advantage in the financial services industry due to a number of factors, particularly the tax and legal structure, the skills and experience of the local labour force, its geographical location and national language. Therefore the specialisation in the financial services sector is a way for Jersey to maximise its standard of living. By producing high-value financial services efficiently, individuals and businesses bring income and wealth to the Island which can in turn be used to buy goods and services both locally and from abroad, raising living standards for the Island.

Such specialisation can, in certain circumstances, have disadvantages that are not captured in the basic models of comparative advantage: exposure to the fortunes of a particular industry for example may bring with it a higher level of volatility of the local economy, even if on average the value of the economy is higher. In extremis, that one industry could disappear completely, so exposing the economy to a very rapid and radical change. Diversification means spreading resources more widely, or not keeping all the eggs in one basket, and is thought by some to be one way to mitigate these risks.

For example, it is generally accepted that countries that depend on selling primary commodities to a global market such as oil or agriculture would do well to diversify their economic activity in order to reduce their vulnerability to external demand and supply shocks that have a knock-on impact on global prices and therefore the real economy of that country, particularly income and employment. By doing so they tend to shift their economies towards higher-value industries while at the same time reducing the instability inherent in the market for such primary commodities.

However in contrast, there is no consensus about whether developed economies that mainly produce high-value goods and services should specialise or diversify. While in less developed countries there tends not be a trade-off between diversification and growth, such a trade-off usually does exist for more developed countries. The goods and services that developed countries produce and sell tend to be heterogeneous and sold into mature markets therefore are a lot less vulnerable to global demand and supply shocks. Further, the goods and services that these countries tend to specialise in tend to be of high-value, and therefore unless other suitable industries can be found that are of equally high-value or greater, diversification will often mean sacrificing some degree of income and standard of living.

Therefore, to the extent that there is a trade-off between diversification and living standards, to establish that Jersey's dependence on the financial services sector leaves it exposed to that sector is a necessary, but not a sufficient, justification for diversification. In other words, even if specialisation of this sort in developed economies does have its disadvantages, it is not clear prima facie that any benefits from diversification outweigh the costs or would leave the economy in a stronger position. To determine whether diversification is the appropriate policy response, the costs and benefits of diversification have to be weighed up, along with an analysis of the alternatives.

8.2.3 Costs of diversification

To understand the costs of diversification it is important to understand the concept of opportunity cost. That is, the cost of diversifying into different economic activities is the foregone benefits that would have accrued from alternative uses of the same resources (land, labour and capital).

If an economy has spare resources that are not, and could not, be used in other activities, those resources could be employed in activities that diversify the overall economic activity in the Island at little cost. However, if an economy is using all of its resources, diversifying into new economic activities must mean that resources are diverted from existing uses, so there may be costs to diversification.

The costs would still be negligible if the economy is able to diversify into similarly high-value, low footprint activities. However, there would be significant opportunity costs if diversify into low-value activities. To quantify – in 2009 every job moved from finance sector (£160k GVA/FTE) to a sector with average labour productivity (£80k GVA/FTE) would have reduced overall GVA by £80k. Therefore, every 500 jobs shifted from finance to an activity with a GVA of £80k would mean £40m lost value-added (around 1% of total GVA). This would have an impact on tax revenues, the number of well paid jobs and the overall standard of living.

By changing the composition of sectors, diversification will have an effect on both the level of productivity and, in the short-run while the shift is taking place, the growth rate of productivity. For example, if more jobs were created in a high-value sector and fewer in a low-value sector, then this would raise the average productivity in the economy and the rate of growth of productivity as jobs were shifted between the two. When the transition has taken place, the growth rate of productivity is determined by the underlying rate of productivity growth, but the level of average productivity is higher.

It could also have an effect on the aggregate rate of productivity growth if different sectors experience different rates of productivity growth. For example, if jobs were created in a sector that saw productivity growth of 2% and there were fewer jobs in a sector that had trend productivity growth of 1%, then the trend rate of productivity in the economy would rise as a consequence.

8.2.4 Benefits of diversification

In Jersey the term diversification is often used to refer to the desire to shift the focus of the economy away from financial services and toward other industries. Given that there could be costs of such a strategy, it is important to be clear about the benefits and the rationale for diversification. In particular there are three potential justifications for diversification:

1. Reducing exposure to finance sector in order to reduce year-to-year volatility in jobs, economic activity and tax revenue
2. Provide industries to ‘fall-back on’ if the finance sector were to leave
3. Provide alternative jobs for local people

Each of these justifications is explored in detail below.

1. **Reducing exposure to finance sector in order to reduce year-to-year volatility**

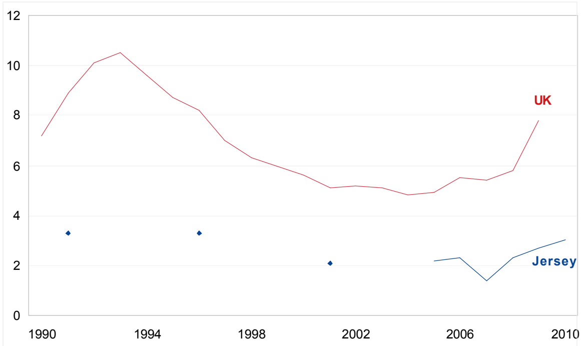
Economic diversification is most commonly advocated as a way to achieve both economic growth and stability simultaneously. According to portfolio theory in finance, diversifying a portfolio of assets helps to spread risk – across countries, currencies or markets – to reduce the probability that all the assets in the portfolio perform badly at the same time. The act of moving from a concentrated portfolio to a diversified one can sometimes provide an investor with the same returns for less risk.

It is widely accepted that indiscriminate diversification or diversification for the sake of it will not necessarily be good for growth or stability. The key to reducing risks for the same return is that the more diversified portfolio contains assets that do not behave exactly alike – in technical terms, assets that have uncorrelated returns – and so when the returns from some assets fall, the returns of others can offset it, and the overall return of the portfolio is not as volatile as it might otherwise be. There is little point spreading your eggs between two baskets rather than one if the probabilities of the eggs in each of those baskets breaking are closely related. The question is whether this analogy can be applied to the structure of the Jersey economy. That is, whether it is possible to achieve the same level of living standards with a lower level of risk.

It is certainly true that the finance sector is more volatile than other sectors. The standard deviation – a common measure of volatility - of the annual change in financial intermediation GVA between 1999 and 2009 was nearly twice as large as that of the economy as a whole (Figure 8.2). This is largely due to the volatility of finance sector profits, and particularly bank profits. This is likely to feed through into the volatility of tax revenues and potentially also the non-finance sector to some extent, although these effects are more difficult to quantify. There is little evidence that employment or unemployment in Jersey are particularly volatile relative to jurisdictions with less reliance on finance, even given the volatility of the finance sector (Figure 8.1 illustrates this for the case of the UK).

Figure 8.1 Comparison of employment and unemployment between Jersey and the UK

(a) Annual change in employment **(b) ILO unemployment rate, %**



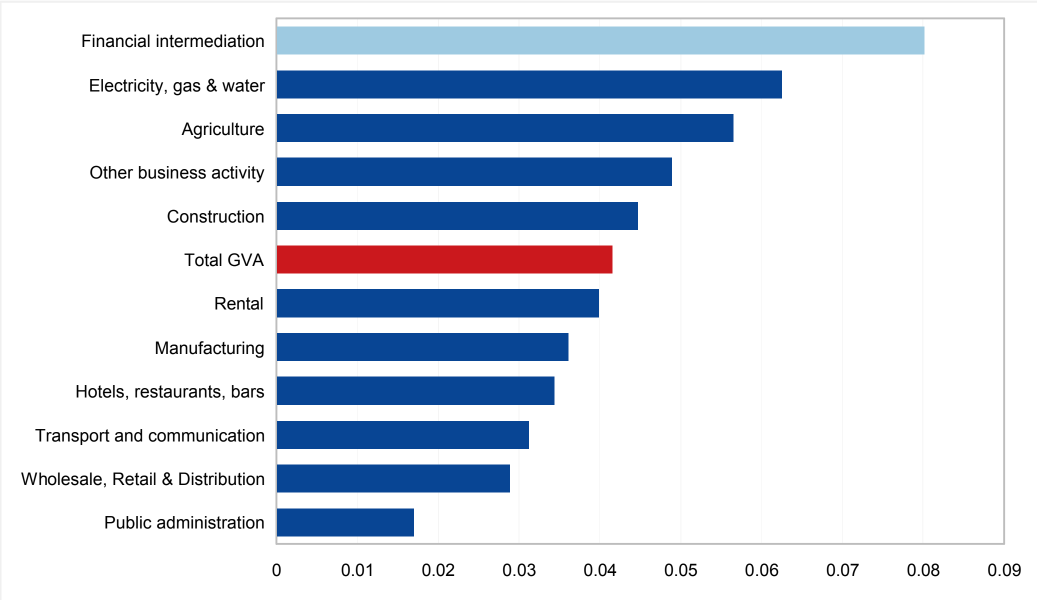
Source: National statistics offices

It is worth noting as well that the finance sector in Jersey is actually a relatively diverse collection of services, with different clients in different geographical locations. While the activities will still be correlated to some extent, it might be true that the Jersey economy is more diverse than the headline figures suggest.

Further, if the concern is volatility of finance – rather than finance per se - then reducing exposure to that volatility (perceived or real) could also be done through diversification within finance i.e. by developing new financial products and services that are uncorrelated with current activity and selling both current and new products and services to diverse geographical markets.

Figure 8.2 Volatility of economic growth by sector

Standard deviation of real GVA growth, 1999-2009



Source: Statistics Unit; Economics Unit calculations

Diversification in theory could reduce the volatility of economic growth in two ways. Firstly, diversification into sectors that are uncorrelated with existing economic activity would reduce overall volatility by offsetting current fluctuations. Secondly, if the new industry is less volatile then its growth will reduce the proportion of the economy that the volatile sector makes up. In this way diversification could reduce the volatility of overall economic activity, even if the economic cycles across these sectors are correlated.

However, in both cases there is likely to be a trade off between stability and the standard of living: greater stability of economic growth will come at the expense of lower income per capita. Therefore neither example is directly comparable to the ‘do not put all your eggs in one basket’ argument whereby it is possible to achieve the same return with a lower degree of risk.

If there was a higher value sector that was less volatile than finance and uncorrelated with finance, it could bring benefits to the economy in terms of jobs and tax revenues rather than provide diversification from financial services. One candidate might be diversification within finance. If there are particular niches within the finance industry that are high-value added and that are not necessarily correlated with the rest of the industry, then encouraging these sectors may reduce the volatility of the finance sector and hence the overall economy without a significant cost. A similar argument might apply to diversification within finance by the development of client bases in different geographic markets that are not highly correlated with existing markets or each other.

Perhaps more importantly, putting aside the fact that there may be a trade off between volatility and trend growth, it is not clear that a reduction in the year-to-year volatility of economic growth is desirable. Specifically, if the volatility of economic growth does not cause significant problems due to fluctuations in tax revenues, employment or unemployment, it is not immediately obvious what the problem with year-to-year volatility in economic growth is. As already noted, there is little evidence that it does cause problems with respect to employment and unemployment, and to the extent that it causes problems for the management of the public finances, other policy levers such as the Stabilisation Fund might be a more effective policy lever than diversification to manage it since it does not involve the same trade-offs.

Therefore there are questions about (a) whether this objective is a desirable one, and (b) if so, whether diversification is a good way to achieve it.

2. Reducing exposure to finance sector to provide 'fall-back' if finance sector leaves

If a large proportion of the finance sector were to leave the Island, there would be a significant fall in jobs and tax revenues. Directly the finance sector makes up around 43% of the economy (value-added) and 27% of local employment. The sector is also a large contributor to tax revenues, although the exact contribution is difficult to quantify. Ballpark estimates put the income tax revenue on individuals employed in the finance sector at around £80-90m, and the corporate income tax revenue from financial services companies of around £60m.[57]

The indirect contribution to the economy and jobs is likely also to be significant. Finance industry employees will spend a significant amount of income locally, which sustains income and jobs in non-financial sectors as well.

Should the finance sector leave the Island suddenly, the shock to the Island would be substantial. Having a small 'fall-back' sector is unlikely to provide much of a cushion. To be any consolation, these 'fall-back' sectors would have to be significant. But to reach any scale, resources would have to be diverted away from the finance industry and towards these new sectors, which could come at a cost in terms of standard of living, depending on the relative value-added of the 'fall-back' sectors. In either case

[57] Estimates relate to 2009 and are based on work by Oxera.

there is likely to be a difficult transition period as the structure of the economy has to change in a relatively short period of time.

An alternative policy could be to capitalise on the finance sector while it is here, prudently saving tax revenues in the Strategic Reserve, to be used to cushion the blow in the event that the finance sector does leave the Island, either suddenly or gradually. The funds could then be spent on supporting jobs and other industries and smoothing the transition process. In this sense the Strategic Reserve acts a bit like an insurance policy, and mitigates the trade-off between the benefits of specialisation and the costs, including volatility.

3. Provide alternative job opportunities for local people

The objective of economic policy and government policy more widely should be to enable local people to maximise their standard of living, and it may be that some local people would choose to work in industries other than financial services. A more diverse economy could provide a different range of jobs in the Island but it is not clear that the types of diversification that could realistically be expected to occur would provide the sort of jobs that some Islanders might prefer. There is also the case that many of those employed in the finance and related industries might really value the jobs they have and that diversifying away from finance might jeopardise their opportunities. Where the balance lies is difficult to determine and there are potential costs and benefits that are hard to quantify but need to be balanced to determine whether diversification for this purpose would achieve what is intended.

8.2.5 Even if diversification is desirable, is it achievable?

To a large extent it is individuals and business that determine the structure of the economy. While the government does get involved in a few areas – for example tourism, finance and agriculture all receive funding in one guise or another – the general approach is to create a level-playing field in which efficient and productive businesses can thrive regardless of the industry in which they operate. Using government intervention to encourage structural change in the economy has a very mixed history.

It is perhaps helpful to distinguish between an ‘active’ and a ‘passive’ diversification strategy. The former would involve government intervention to promote particular industries and encourage either (a) a rebalancing away from the financial services sector, or (b) further diversification within the finance sector. In contrast, a passive diversification strategy would involve creating an economic environment that is conducive to efficient and effective businesses thriving regardless of the sector in which they are active, and therefore is unlikely to look any different from the current policy.

Active diversification strategies have well documented problems. Ahrend (2006) notes that there is no miracle recipe to achieve diversification and further that *"there is no shortage of examples of failed diversification policies, and economists know fairly well on the basis of international experience what does not work. Fiscal irresponsibility as well as large-scale state investment in pet industrial projects ranks at the top of the list of what should be avoided."*

But while there is broad agreement on the policies that do not work, there is less agreement among economists about what does work. In the words of Ahrend (2006), *"failures have been so common (and sometimes so spectacular) that, in recent years, economists have often preferred not to give any advice at all with respect to diversification policies."*[58]

With regard to Luxembourg – another jurisdiction with a significant finance sector – a recent OECD report (OECD, 2009) noted that while *"the high reliance on the financial sector is a concern as it makes the economy vulnerable to external shocks and eventually international competition may remove the comparative advantages of placing financial institutions in Luxembourg…implementing a diversification strategy is not easy for a small economy, for obvious reasons of demand (limited home market size), but also because of limited resource."* It goes on to suggest that "intra-industry" diversification (i.e. within the finance sector) could offer the economy some protection against external shocks, and which has the advantage of requiring fewer resources and carries a lower risk.

That said, Luxembourg is supportive of diversification, and is actively encouraging certain high-value sectors – including ICT, healthcare, and other technologies – to set up in the country, mainly by using attractive tax offers in relation to investment and intellectual property. It has also exploited its natural comparative advantage of being at the geographical centre of Europe to become one of the leading logistics centres for the region. This diversification is not seen as a way to reduce the importance of the financial services sector in Luxembourg however, instead it is seen

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[58] Ahrend (2006) *How to Sustain Growth in a Resource Based Economy?: The Main Concepts and their Application to the Russian Case*

as a continuation of a process of industrial evolution that began with the decline of the steel industry in the country around 40 years ago.

Trying to pick winners and encourage particular industries to locate in the Island is not an efficient government intervention, unless it is purely facilitating industry that wants to locate to the Island and exploit a comparative advantage that is not viable elsewhere. The end result of such intervention is likely to be higher costs imposed on the economy and greater inefficiency and therefore lower economic growth. This suggests that while there may be benefits to Jersey in supporting and facilitating certain high-value industries that want to locate on the Island, it is not clear that a diversification strategy should go much beyond this.

8.2.6 Examples of Diversification

1. Diversification away from finance and into tourism

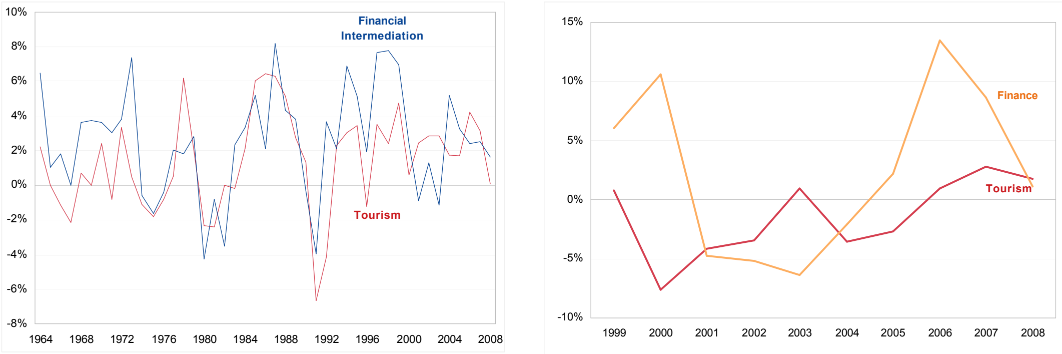
Every job moved from the finance sector, which generates approximately £160k of value-added per FTE, into the tourism sector, with a value-added per FTE of £27,000, would directly reduce GVA by £133,000.Therefore, every 500 jobs shifted from finance to tourism would mean £67m lost value-added (nearly 2% of total GVA). That is, other things being equal such a shift would cause economic decline rather than economic growth.

Tourism tends to be correlated with the finance industry, and it is likely that in Jersey a significant proportion of tourism activity is actually related to the finance industry as a large proportion of visitors and expenditure is due to business rather than leisure visitors. Figure 8.3 (a) compares the annual growth rates in the finance sector and the tourism sector in the UK, and Figure 8.3 (b), which does the same for Jersey. In Jersey at least, tourism does tend to be less volatile. This suggests that diversification into tourism in Jersey might be able to reduce year-to-year volatility in jobs, economic activity or tax revenue to some degree.

Figure 8.3 The correlation between tourism and finance

Annual growth in GVA

(a) UK **(b) Jersey**



Source: Office of National Statistics, States of Jersey Statistics Unit

This type of diversification, if extensively pursued, could potentially provide a “fall-back” industry to insure against the loss of the financial sector, however this would be at the expense of the value-added lost in replacing a high-value industry such as finance with a low value one (tourism). In doing so the States would receive significantly lower tax revenues, average wages and profits would fall and the standard of living in the Island would likely fall.

Diversification into tourism would provide alternative jobs for local people, however these jobs would, on average, be less well paid. The decision would have to be made as to whether the loss of high-value added jobs and the associated loss in tax revenue would be worth the gains from alternative job opportunities. It is also not clear as to whether Islanders value tourism jobs.

A sustained decline in visitor numbers, particularly those coming to the Island for leisure purposes, in recent years also adds another note of caution. It is not apparent that government can or should have the foresight to identify what industry might have potential in the future to expand and grow in the Island. An industry that might locate here now could lose competitiveness in the future for reasons outside government control and rather than act as a fallback could face structural issues in its own right.

2. Diversification away from finance and into an average industry

Every job moved from finance sector (£160k GVA/FTE) to a sector with average labour productivity (£80k GVA/FTE) reduces overall GVA by £80k.Therefore, every 500 jobs shifted from finance to an activity with a GVA of £80k would mean £40m lost value-added (around 1% of total GVA). This would have an impact on tax revenues and standard of living. That is, other things being equal such a shift would cause economic decline rather than economic growth.

Depending on the nature of this average industry, it may or may not be correlated with financial services, and therefore may or may not reduce year-to-year volatility in jobs, economic activity or tax revenue.

As with diversification into tourism, this type of diversification could potentially provide a "fall-back" industry to insure against the loss of the financial sector. While the opportunity cost would not be quite as high (average GVA/FTE is higher than in tourism), this would still be at the expense of the value-added lost in replacing a high-value industry such as finance with a lower value one. As such, tax revenues would be reduced, average wages and profits would fall and the standard of living in the Island would likely fall.

As with tourism, diversification into an 'average' industry may provide alternative jobs for local people, however these jobs would, on average, be less well paid. The decision would have to be made as to whether the loss of high-value added jobs and the associated loss in tax revenue would be worth the gains from alternative job opportunities. Also whether the industry offered a long-term comparative advantage that could make maintain its competitive position in the future.

3. *Diversification away from finance and into a high-value, non-finance industry*

This approach is probably the most attractive option in theory because it has the potential to achieve all the benefits of diversification with little cost in terms of lost value-added. However, in practise there are very few industries that have such high value added as finance and even fewer that might be suited to a small island economy. In addition, given that this would have to be an export industry to replace the export of financial services, Jersey also has to be internationally competitive (see discussion on competitiveness above) in order for this new industry to locate in Jersey.

This approach would reduce year-to-year volatility in economic activity, tax revenues and jobs only to the extent that the fortunes of new activities or the demands of new customers are not closely related to existing economic activity in the finance sector.

To the extent that the new industry is not closely tied in to the fortunes of the financial services sector, then if it was able to achieve sufficient size, this approach could provide a fall-back industry in the event that the financial services sector should leave the Island.

With regard to providing new job opportunities, it could, depending on the industry, create a variety of different careers and professions for local people.

4. Diversification within finance

As with diversification into high-value, non-finance industries, diversification into new products and services and expanding the customer base into new geographical locations may help to diversify the economy while retaining the high-value nature of the economic activities conducted here. Diversification in both these dimensions is already being pursued by many financial firms with support from the States and Jersey Finance. For example, the Survey of Financial Institutions suggests that many financial services firms are already looking to diversify their client base across geographical locations.

This approach would reduce year-to-year volatility in economic activity, tax revenues and jobs only to the extent that the fortunes of new activities or the demands of new customers are not closely related to existing economic activity in the finance sector. It is plausible that diversifying the customer-base across jurisdictions will reduce exposure to localised economic shocks, although it will likely do little to mitigate the consequence of global crises such as the one recently experienced.

Diversification within the finance sector and closely related industries may not be an effective way to mitigate the consequences of the Island becoming a less attractive jurisdiction for financial activities. To the extent that financial services might be expected to be related to some degree and if a large proportion of the financial services sector leaves, there is little reason to expect that others will stick around, diversification within the finance sector might be less appropriate as a policy response to this threat than in reducing year to year fluctuations. That said, it may still provide some benefits, if the activities into which diversification occurs are sufficiently differentiated from the finance sector as a whole.

With regard to providing new job opportunities, this option may not be so attractive. Diversifying the client base would likely result in more jobs in similar areas to those that already exist. Diversification into new products and services may create new job opportunities, but these are likely to be very similar in nature and require similar skills and qualifications to existing job opportunities. However, as already discussed above it is not clear that Islanders in general would not prefer more jobs in finance relative to other sectors that might grow in the Island.

5. *Diversification within non-finance activities*

For example, suppose there was a fall in activity in a non-finance sector, with a consequent rise in a new sector. In most cases this would be structural change but not diversification, as it would not affect the reliance of the economy on the finance sector. Only in the specific case where the change involved a shift towards a sector that then became significant in its own right, and would provide a significant number of jobs and tax revenue would this begin to reduce the reliance on the finance sector, and only then if the fortunes of this new sector were largely independent of those of the finance sector.

Even if this is not the case, it may be desirable, not as diversification, but as positive structural change, particularly if it involves a move from a low productivity sector to one with significantly higher productivity.

8.3 Conclusions and Implications for Policy

The objective of diversification does not have a clear definition, nor has the justification for such a strategy been made explicitly and robustly. Certain approaches to diversification would require giving up some of the value that could be obtained from high-value activities in order to achieve one or a combination of the objectives set out above.

However, it is not clear that diversification would either reduces year-to-year economic volatility or provide a “fall-back” sector in the event that the finance sector leaves. Further, even if it could, this would be a necessary but not sufficient justification for diversification: it may be that there are better ways to achieve these objectives. For example, if the objective is economic stability, then an alternative to diversifying the economy is using the Fiscal Framework appropriately: building up the Stabilisation Fund during the good times to support the economy in the downturns. If the objective is to provide an insurance policy in case the finance sector leaves, a more effective policy response to diversification may also be a fiscal policy response – i.e. extracting as much value from the high-value sectors while they are here, and using this to build up the Strategic Reserve. If an external event caused the finance sector to diminish in size or leave the Island, then the Strategic Reserve could be used to ease the transition.

To the extent that diversification is able to achieve objective of providing alternative job opportunities for local people, the costs and benefits of using diversification to achieve this objective would need to be carefully considered, along with whether there are any alternative approaches.

Clearly it is desirable for the government's approach to diversification in the economy to be consistent with the strategy for growth. That is, it should be about creating the right environment for business to flourish and market forces to prevail. This involves creating an environment where the skills-base can meet business needs, enterprise can flourish and there is open competition across the economy. In other words, most of the policies to support economic growth will also encourage productive activities to locate in Jersey.

However, Jersey does have a range of sector specific industrial policies, whether it is acknowledged explicitly or not as an industrial policy. The government dedicates substantial resources to supporting the financial services, agriculture and tourism industries. Recently there have been a variety of activities that have been considered for support in the form of expanded shipping and aircraft registries and intellectual property. Going forward, some of the support that is already in place is likely to continue in the future, and it is likely that requests for support from new industries and activities, such as renewable energy technologies, will emerge. All of this suggests that sector-specific support will continue to be important in Jersey, and the question is really about how to make it best support growth and diversification.

There is a growing economic literature on modern industrial policy. For example, Rodrik (2008)[59] argues that industrial policy should recognise that the government cannot be certain which sectors will be successful, but that this is a question of design rather than whether government should get involved or not. The argument is that modern industrial policy should be:

> *"[a] model of strategic collaboration and coordination between the private sector and the government with the aim of uncovering where the most significant bottlenecks are, designing the most effective interventions, periodically evaluating outcomes, and learning from the mistakes being made in the process."*

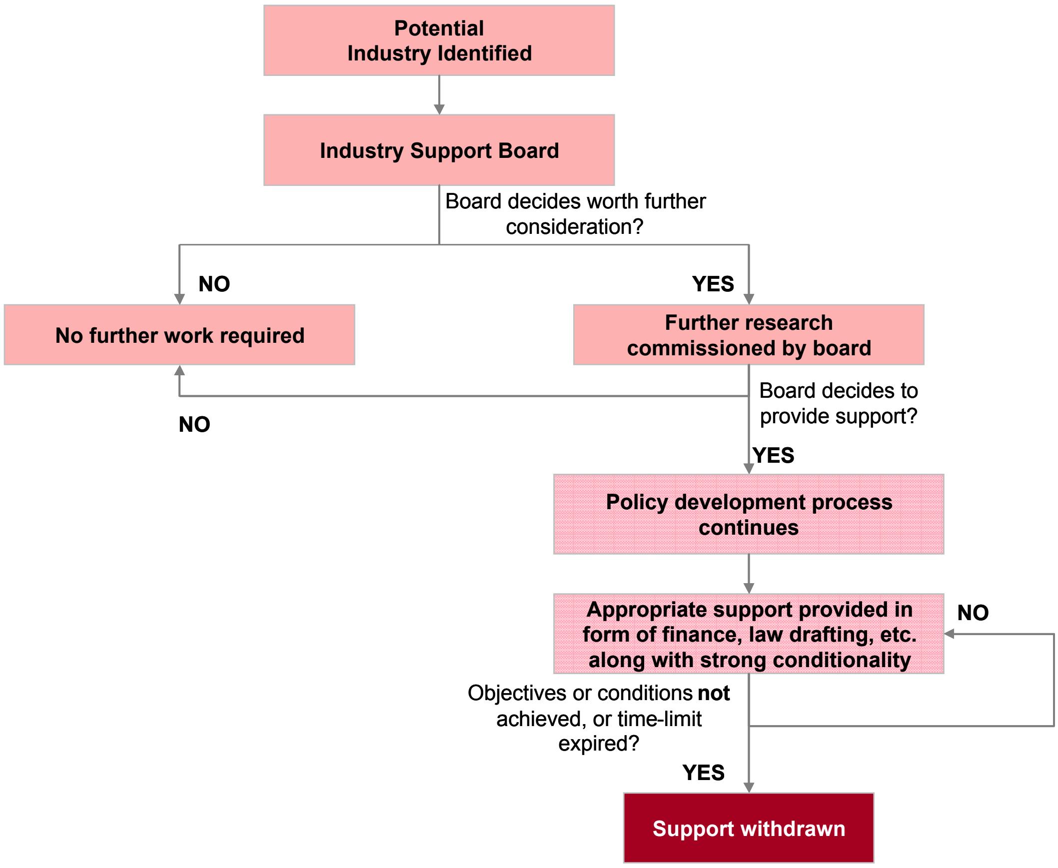
[59] Rodrik (2008) *Normalising Industrial Policy*, Commission on Growth and Development, WP No. 3

This approach relies on a willingness to experiment and strong conditionality built into government support to ensure that industries in receipt of support but that are not delivering do not continue to receive this support indefinitely.

The potential costs and benefits of each candidate would need to be weighed up carefully, taking into account factors such as the benefits of such developments would be captured locally or flow to other jurisdictions.

It is clear that Jersey needs clearly define objectives for diversification and a consistent framework for assessing potential opportunities. An example of a process through which this could happen in practice is illustrated in Figure 8.4**Error! Reference source not found.**. A specific board could be set up with a clearly defined remit for the purpose of acting as a gateway for government support to emerging industries. The board could be constituted by senior government officials and members form the private sector. The board could receive proposals for support and consider them, taking advice from the Economics Unit where relevant.

Figure 8.4 Potential process for supporting emerging industries



In essence, diversification can be thought of as being supported by general policies towards productivity and economic growth. Getting these policies right will create a level-playing field and thus will not prevent high-value activities from flourishing on the Island if the conditions are right. In addition, clearly defined objectives and process should ensure that the right type of diversification – that into high-value activity – can take place without jeopardising the Island's economic success.

While a more active strategy for diversification whereby the dominance of finance is actively discouraged and alternative candidates are encouraged could be an alternative approach, the analysis above suggests that the costs to such a strategy need to be acknowledged and weighed up against any benefits. Such an approach would likely undermine an economic growth strategy, reduce future tax revenues and living standards, and in turn make dealing with challenges such as an ageing population even more difficult.

Next Steps

- Jersey's objectives and approach to diversification should be clearly defined.
- Consideration should be given to further work on developing a process with clearly defined objectives that would ensure that government support for industries and sectors is conducive to both diversification and growth. This should include strengthening existing dialogues with industry, ensuring that candidates for new and emerging industries are identified early, and that information can be gathered on the barriers to their development and potential for government support.
- Any sector support should be carefully designed to address market failures or to provide 'pump-priming', and the latter should be time-limited. Strong conditionality should be built into any support. This means that support should not be given without some combination of clear objectives, sunset clauses and mandatory reviews. Support should be discontinued unless it can be demonstrated that these pre-agreed objectives are being achieved.