STATES OF JERSEY

EXPENDITURE PROPOSALS FOR 2012 AND 2013 AND DRAFT BUDGET STATEMENT 2011 (P.157/2010): AMENDMENT (P.157/2010 Amd.) – COMMENTS

Presented to the States on 6th December 2010
by the Council of Ministers

STATES GREFFE

2010 Price code: B P.157 Amd.Com.

COMMENTS

The Council of Ministers opposes this amendment.

If accepted, this amendment would result in deficits increasing from £55 million to £71 million in 2011 and from £18 million to £31 million in 2012. These increases to deficits can only be achieved by reducing the Strategic Reserve by £28 million.

Members are urged to reject this amendment for the following reasons –

- The Fiscal Policy Panel (FPP) state in their 2010 annual report that the fiscal consolidation proposed in the draft Budget 2011 "is broadly appropriate given the Panel's latest assessment of the economic outlook".
- The package of measures proposed in the draft Budget 2011 have been specifically designed to be fair to all Islanders while minimising the impact on the economy. There is no evidence that the increase in GST will set back the recovery of Jersey's economy.
- Using the Strategic Reserve in the manner proposed by Deputy Southern is unsustainable and not consistent with States-agreed policy for the fiscal framework.
- By the end of 2011 the States will have invested £158 million of reserves in supporting the economy.
- The risks with taking such an approach to the use of the Strategic Reserve are that –
    - £28 million is never returned to the Strategic Reserve, leaving it permanently lower.
    - The Stabilisation Fund is not replenished, leaving Jersey in a much weaker position to support employment and business in the next economic downturn.
    - States finances are not returned to a sound footing and fiscal policy no longer operates in a counter-cyclical manner, posing risks to inflation in the future.
- One of the underlying justifications for this amendment is that GST is "intensely regressive". This is misleading and not borne out by the evidence. The Institute for Fiscal Studies in the UK conclude that "the current VAT system is seen to be mildly progressive". On the same basis, our GST system is closer to being proportional.

Supporting analysis

The States should not put off tax increases

The main argument put forward by Deputy Southern for delaying the increase in GST is to avoid tax increases at this stage in the economic cycle. This is inconsistent with his previous position P.154/2010 (that he decided to withdraw) in which he thought it perfectly acceptable to take £22.5 million out of the economy next year – more than the proposed £15 million from the increase in GST – in the form of higher social security contributions.

The reality is that it is proposed that GST does not increase until June 2011, by which time the economy is expected to be growing again. Further, even with the proposed rise in GST and the other proposals in the Budget, the States will continue to run a deficit of £55 million next year and the deficit will not be closed until 2013. Therefore, even if the recovery is slower than expected, fiscal policy is likely to support the economy right through the remainder of the downturn.

Fiscal Policy Panel advice

The advice from the Fiscal Policy Panel does not support the arguments put forward by the Deputy in his amendment. They were clear in terms of their advice in their Annual Report published on 30th November –

> *"Notwithstanding the fiscal consolidation planned over the next 3 years, the proposed fiscal stance is set to remain supportive of the economy until 2013. This is broadly appropriate given the Panel's latest assessment of the economic outlook."*

The proposals in the draft Budget 2011 have been developed with particular emphasis on ensuring minimal damage to the economy and our competitive position. The economic advice, including that of the FPP, is that GST has inherent benefits because it does not impact on the competitive position of the economy. So, rather than posing a risk to recovery, the package of measures chosen by the Council of Ministers has been designed and timed to allow recovery to take place.

Although the Consolidated Fund balance is unaffected by this amendment, the Strategic Reserve would be £28 million lower than it would have otherwise been by 2013 (see Figure 1).

Figure 1

2010		2011	2012	2013
£m		£m	£m	£m
53	Opening Consolidated Fund balance as in Draft budget	20	11	-7
-101	Surplus/Deficit as in Draft Budget	-55	-18	8
68	Transfer from Stabilisation Fund	46		
20	**Closing Consolidated Fund balance as in Draft Budget**	**11**	**-7**	**1**
	Amendment 1:			
	Delay GST by 12 months	-16	-14	
	Income support savings	1	1	
	Transfer from Strategic Reserve	15	13	
53	Opening Consolidated Fund balance if amendment approved	20	11	-8
-101	Surplus/Deficit if amendment approved	-71	-31	8
0	Transfer from Strategic Reserve	15	13	
68	Transfer from Stabilisation Fund	46		
20	**Closing Consolidated Fund balance if amendment approved**	**11**	**-8**	**1**

<u>Using reserves or borrowing</u>

The Council of Ministers has carefully considered borrowing and using reserves as a means of delaying dealing with the deficit, but neither is a sustainable option. Neither of these options addresses the underlying mismatch between expenditure and revenue, and instead simply avoids the difficult decisions.

The States agreed in 2006 the policy for the Strategic Reserve, and that the capital in the Reserve should be used only in exceptional circumstances; for example to insulate the Island's economy from the severe structural decline of a major industry. This is not what is happening now. The States should not confuse a structural gap in our finances, which is partly a result of past spending decisions, with that of structural decline in the economy. Jersey has to adjust to a new global environment, which means that some of the recent growth in tax revenues looks to have been only temporary. The forecast deficits until 2013 are manageable and much smaller than those faced by our larger neighbours, provided we manage our finances carefully and do not allow the position to get worse.

The States has already agreed, in line with the advice from the Fiscal Policy Panel, to use up the £158 million in the Stabilisation Fund to support the economy through the downturn. This has sheltered the economy from the worst of the global recession, but we cannot continue doing this indefinitely. There is little economic justification in doing so. The FPP said in their Annual Report published on 30th November that –

> *"Although the States financial position is extremely tight, the Panel does not recommend using Strategic Reserve funds or borrowing at this stage."*

Deputy Southern's amendment would mean that the Strategic Reserve would be £28 million lower (on top of the £158 million that will have been drawn from the Stabilisation Fund) than would otherwise be the case, putting us in a weaker position to address any future major problem in the economy. It makes no attempt to explain how the States would repay the money and whether the funds would be found by increasing taxation in the future or cutting States spending over and above that set out in the CSR.

The risks with taking such an approach to the use of the Strategic Reserve are that:

– The money is never returned to the Strategic Reserve, leaving it permanently lower.

– The Stabilisation Fund is not replenished, leaving Jersey in a much weaker position to support employment and business in the next economic downturn.

– States finances are not returned to a sound footing and fiscal policy no longer operates in a counter-cyclical manner, posing risks to inflation in the future.

How GST affects Islanders

In P.154/2010, Deputy Southern argued that GST is 'intensely regressive'. In this amendment it is now the "most reviled and regressive tax". Deputy Southern continues to make these statements despite the evidence to the contrary.

As already pointed out in the draft Budget 2011 and the Council of Ministers' comment on P.154/2010, if the impact of GST on households across the income spectrum is considered as a proportion of income, then it does look like GST is regressive (as shown in the left-hand chart in Figure 2 below). The lowest quintile pays a significantly higher proportion of their income as GST.

However, this approach is now recognised to be misleading, as the Institute for Fiscal Studies (IFS; the independent authority on fiscal matters in the UK) points out –

> *"looking at a snapshot of the patterns of spending, VAT paid and income at any given moment is misleading because incomes are volatile and spending can be smoothed through borrowing and saving".*

This is because the low-income group can contain people whose current income is low, but whose lifetime earnings could be relatively high, for example, students that may be borrowing to finance expenditure, retirees running down savings, or those who are temporarily out of work.

This conclusion is supported by the UK national statistics agency, the Office for National Statistics (ONS). The ONS has said –

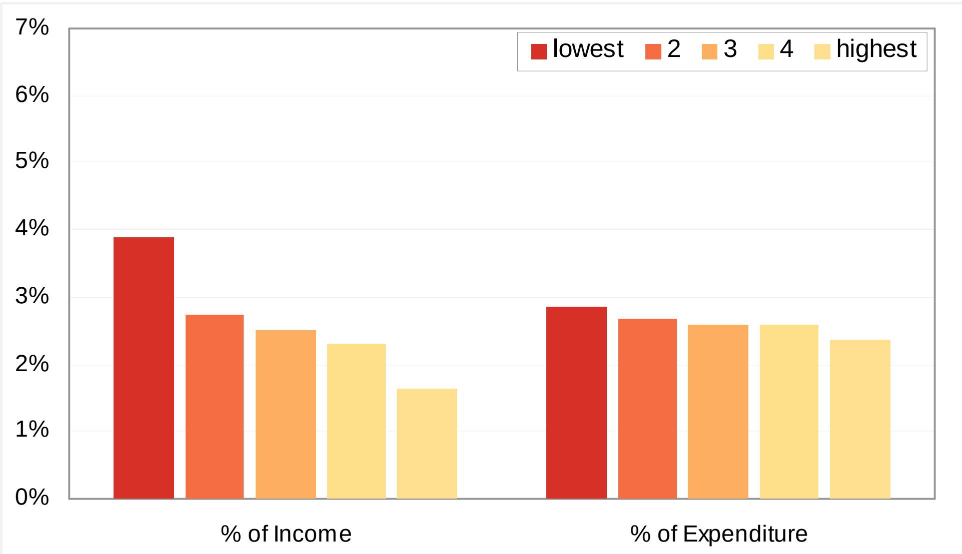
> *"While the payment of indirect taxes can be expressed as a percentage of gross income in the same way as for direct taxes, it should be remembered that for some households, particularly towards the bottom of the income distribution, annual expenditure exceeds annual income. For these households, expenditure is not being funded entirely from income. To express the payment of indirect taxes as a percentage of gross or disposable income is potentially misleading because for these households their expenditure will be a better indicator of standard of living than their income."*[1]

[1] ONS (2008) *The Effects of Taxes and Benefits on Household Income, 2006/07*

For these reasons, expenditure is a better measure of living standards and the impact of VAT should be looked at as a percentage of average household expenditure, with households ranked by household expenditure. When this is done for the UK, the IFS concludes that: “the current VAT system is seen to be mildly progressive”.

In Jersey, the data limitations only allow households to be ranked by income, but it is possible to calculate the expenditure of households in the different income quintiles and estimate the proportion that 5% GST would make up. The second chart in Figure 2 shows that GST looks much less regressive than in the first chart. GST at 5% would only account for about 2.9% of the amount a lower-income household spends, and this falls to just less than 2.5% for higher-income households. If it was possible to rank households by expenditure in Jersey and calculate GST as a proportion of their expenditure, this difference is likely to reduce further. <u>This evidence indicates that the impact of GST is not intensely regressive, but that it is in fact closer to being a proportional tax.</u>

Figure 2: Impact of 5% GST by income and spending
% of income/expenditure by quintile



Source: Economics Unit calculations

<u>Protecting those on lower incomes</u>

Nonetheless, the Council of Ministers accepts that people are concerned about the impact of GST on the less well-off, and for these reasons it is proposed to compensate the less well-off for the impact of the rise in GST. This will be done by increasing income support for those that receive it and maintaining an adequate GST bonus for those on low incomes but not receiving income support.