States of Jersey
States Assembly

États de Jersey
Assemblée des États

Corporate Services Scrutiny Panel

Draft 2015 Budget

Presented to the States on 15th September 2014

S.R.12/2014

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1. EXECUTIVE SUMMARY

1.1 The Draft 2015 Budget contains the proposals of the Minister for Treasury and Resources in respect of taxation and the Capital Programme. In most years, it is those taxation proposals which prompt most reaction and discussion. This year much of the focus has instead been on income forecasts and the fact that the Draft Budget is based upon forecasts downgraded from those used in the 2014 Budget.

1.2 It is apparent that the income-forecasting process in 2013 was not ideal and measures were ultimately adopted in the 2014 Budget which should not have been proposed. Such circumstances should not be allowed to repeat themselves and we have recommended that the Minister introduce more formality into the forecasting process. Decisions of the States Assembly need to be based upon the most recent information and we have recommended that the Minister ensures that the most up-to-date forecasts are used as the foundation for the Budget-setting process. In that regard, we had anticipated that the Long-Term Revenue Plan would have been made available to Members earlier; it is of direct relevance to the debate on the Draft Budget and must be presented as soon as possible to the Assembly.

1.3 The downgraded forecasts have required the Minister to present a number of contingent measures to ensure the Consolidated Fund is not shown in deficit at the end of the year. Some of these measures are included in the Budget proposition itself, namely transfers from a number of funds to the Consolidated Fund. Other measures are described in the report accompanying the Draft Budget and include proposed dividends from the utilities and Departmental savings. The timing and character of these contingent measures undermine confidence in the States' financial strategy and it is vital that their deliverability is critically appraised. In respect of proposed base budget reductions we have recommended that the Minister confirm with Departments that there is sufficient management and financial information available to monitor and report upon the proposed reductions. The proposed reductions should also be subject to independent validation.

1.4 A Capital Programme for 2015 of approximately £75 million has been proposed. The Minister has advised that the Draft Budget is intended to help continue supporting the economy with the injection of capital expenditure. In order to ensure the efficacy of fiscal stimulus, measures proposed to support the economy in this way must meet the '3 Ts' test of being timely, temporary and targeted. Unfortunately, actual performance in capital expenditure in recent years does not instil confidence that forecasted profiles for future capital expenditure will be achieved. We have therefore recommended that the Minister review the legislative framework surrounding the capital allocation process to ensure it allows for realistic delivery of the Capital Programme and for appropriate performance management arrangements to be put in place.

1.5 The Capital Programme includes the latest updates in respect of the Hospital and Liquid Waste Projects. In terms of the Hospital Project, we have found that whole-life costing needs to be embedded within project-modelling and revenue budgets and that further work is required to ensure confidence in the expected spending envelope. We have recommended that the Minister take action to address these points. Furthermore, there are reservations about the anticipated investment returns on the Strategic Reserve (which are due to be used to fund the Hospital Project) and we have recommended that further testing of these anticipated returns should be undertaken. In terms of the Liquid Waste Project, the Draft Budget seeks the Assembly's approval of the spending envelope. The Project is in part due to be funded by expected savings from the Department of Transport and Technical Services. It remains unclear how those proposed savings will be achieved and we have therefore recommended that clarification of their delivery be provided.

1.6 Ultimately, this year's Draft Budget has raised significant questions in respect of the States' future financial management. It calls into question the current MTFP model and we have found that an urgent recalibration of the MTFP is required; its redesign needs to be on the basis of a robust economic model and not simply an accounting model.

1.7 The downgraded forecasts and the concerns identified over the contingent measures highlight the risk that deficit-financing may become the norm for the States. We have recommended that the Minister investigate the potential for the States to run a budget surplus of 0.5% or 1% of GVA over the economic cycle.

1.8 Given the risk that our income position might be deteriorating, the time has come for a full debate on States' expenditure and income. Further work is required in order to determine both the size of any structural deficit facing the Island and the strategy to be used to address it. In that regard, we recommend that the Minister ensure that Departments are requested to identify not only budget-reducing proposals but also measures to optimise income generation capability.

2. KEY FINDINGS AND RECOMMENDATIONS

Key Findings

1. Problems arose in the income-forecasting process in 2013 which meant that measures were proposed (and ultimately adopted) in the 2014 Budget which should not have been. These circumstances should not be allowed to repeat themselves.
2. Decisions of the Assembly need to take into account the most recent and up-to-date information.
3. The timing and character of the proposed remedial measures undermine confidence in the States' financial strategy. It is vital that the measures are critically appraised in relation to their propensity for delivery.
4. It remains unclear how proposed savings will be met to ensure the Liquid Waste Project can be funded in the way envisaged.
5. There are reservations about how much confidence can be attached to the Draft Budget's anticipated level of sustained investment return performance on the Strategic Reserve.
6. Further work is required to ensure confidence in the expected spending envelope for the Hospital Project.
7. Whole-life costing should be fully embedded within project modelling and revenue budgets for the Hospital Project.
8. In order to ensure the efficacy of the fiscal stimulus programme, measures to stimulate or support the economy must meet the '3 Ts' test of fiscal stimulus.
9. Actual performance in capital expenditure in recent years does not provide sufficient confidence that forecasted profiles for future capital expenditure will be achieved.
10. There is a risk that deficit-financing may become the norm for the States.
11. The Long-Term Revenue Plan will provide directions to both the Budget setting process and the foundation for the MTFP and is of direct relevance to the debate on the Draft Budget.
12. An urgent recalibration of the MTFP is required and its redesign needs to be on the basis of a robust economic model and not simply as an accounting model.
13. The time has come for a full debate on States' expenditure and taxation.
14. Further work is required in order to determine both the size of any structural deficit facing the Island and the strategy to be used to address it.

Recommendations

Our advisors from CIPFA and MJO Consultancy have both made a number of recommendations which we fully endorse and recommend should be implemented. In particular from our advisor's recommendations, we have identified the actions listed below, some of which need to be addressed immediately and others which should be addressed before the next MTFP is lodged.

We recommend that the Minister for Treasury and Resources should immediately take action:

1. To ensure that the most up-to-date forecasts are used as the foundation for informing the Budget Setting Process.
2. To ensure that proposed base budget reductions are subject to independent validation in order to ensure both their deliverability and their ability to be monitored.
3. To confirm with Departments that they have sufficient management and financial information to be able to monitor and report upon the proposed savings that the Draft Budget will require them to deliver.
4. To ensure that the capital cost of the Hospital Project is re-evaluated to ensure that there is appropriate precision within the expected spending envelope and that approved functionality synchronises with that expectation.
5. To review the legislative framework surrounding the capital allocation process to ensure it allows for the realistic delivery of the Capital Programme and for appropriate performance management arrangements to be put in place, with the outcome of this review to be reported to the States Assembly ahead of the lodging of the next MTFP.
6. To investigate the potential for the States to run a budget surplus of 0.5% or 1% of GVA over the economic cycle, with the outcome of this work to be reported to the States Assembly ahead of the lodging of the next MTFP.
7. To ensure that the Long-Term Revenue Plan is presented to the Assembly as promised prior to the Draft Budget debate.
8. To request that work begin immediately on the recalibration of the MTFP with a report on progress to be provided to the new Assembly by Christmas 2014.

We recommend that, prior to the lodging of the next MTFP, the Minister should take action:

9. To ensure that membership of the ITFG is formalised within a structured reporting framework and with formal minutes being made available to the Council of Ministers.
10. To ensure that an assessment is undertaken of the ability of the Department of Transport and Technical Services to identify savings in order to fund the Liquid Waste Project.

11. To ensure that the feasibility of proposed investment returns on the Strategic Reserve is subject to further testing.

12. To ensure that the full-life running costs of the Hospital Project are appropriately evaluated against the MTFP financing capability in respect of the Health and Social Services budget.

13. To ensure that Departments are requested to identify measures to optimise income generation capability, with service delivery benchmarking to be used as a means of identifying wider options.

14. To ensure that the economic drivers that influence tax yields are re-evaluated and that all sources of data (including Social Security and other contributions) are used to inform financial strategy and to determine the extent of any structural deficit.

3. CHAIRMAN'S FOREWORD

3.1 The original MTFP tied income to expenditure. Since 2013 the fall in income and the increase in expenditure have removed that link. Until the link is re-established there is a significant risk that the deficit will increase.

3.2 We have been particularly concerned about the income forecasts. The previous two Budgets, those for 2013 and 2014, used the forecasts from the MTFP. The Draft 2015 Budget used a lower set of forecasts produced by the Income Tax Forecasting Group. These are significantly lower for 2015 than those in the MTFP - £455 million as against £500 million. We understand that forecast for 2014 continues to drift downwards, a drift which is underlined by Social Security statistics. The total contributions and number of contributors is down by 1% in 2013 compared to 2012. The value of 2013 contributions in cash terms is now less than 2009, despite inflation over this period. The number of contributors is also down. This will have implications for income tax receipts for 2014.

3.3 The FPP has been warning of possible structural deficits since 2008. In 2008 it was merely a warning. By July 2011, the FPP commented that the Stabilisation Fund had been used to "*finance deficits arising for both cyclical and structural reasons*" and that "*if savings cannot ultimately be delivered then any shortfall may have to be made up through tax increases if there remains a structural deficit over the medium-term*." The FPP has also recently commented that it welcomes the property tax review as "*it could also help the States to find revenue raising measures in the event there is a structural deficit*."

3.4 Finally, in its most recent report, the FPP recognised that the next MTFP will have to contain measures to address the structural shortfall between States' income and expenditure and that "*the medium-term outlook, while uncertain, suggests that there are significant challenges in even maintaining a balanced budget*." In an interview for BBC Radio Jersey on 18th July 2014 the Chairman of the FPP remarked he was now far more certain a structural deficit existed.

3.5 The Panel has other significant concerns.

3.6 Although the fall in the forecasts was known in September 2013, the Budget for 2014 was not adjusted and contained the original MTFP forecasts. If the States of Jersey was a private company then a profits-warning would have been issued. The quantum of the change can be considered in the context of the balance on the Consolidated Fund in the 2014 Budget changing from a positive balance of £5.7 million to a projected deficit of some £40 million in the latest figures from the Treasury.

3.7 The measures to balance the Consolidated Fund are in effect reserves which are being used to fund core net spend. Using such reserves in this manner is a real wake-up call and is typically the product of a rapidly deteriorating fiscal position. It is disappointing that although the deterioration of the income figures was known in September 2013, the measures being taken to balance the Consolidated Fund for 2014, and to adjust the forecast Budget for 2015, were not commenced until July 2014.

3.8 In our review of the 2014 Budget we said that productivity is a fundamental part of economic growth and, given the comments by Standard & Poor's on our economic growth (*"the recovery is likely to be uneven and shallow*"), consideration of taxation measures in respect of productivity in the economy in the public and private sectors is an area demanding urgent work.

3.9 We also concluded that there is a risk that the injection of large amounts of capital funding over the next ten years could overheat the local economy. Forecasting the impact of such expenditure on the economy is difficult given the current challenges in measuring capacity within the construction industry.

3.10 We have been advised that work has progressed on these matters but we have seen no reports on them. In the meantime the income tax receipts have continued to fall short of the forecasts whilst expenditure has exceeded the levels forecast in the MTFP.

3.11 We are left with questions regarding the quality of the advice being given to the Minister for Treasury and Resources. Was there sufficient appreciation of the deteriorating financial situation and was the Council of Ministers fully aware of the overall situation at an early stage? It is not possible to reach conclusions as to whether the capital spend has fed through to the fiscal stimulus and whether that spend meets the '3Ts' or is recurring. We are also concerned that it is only now that the question of the existence of a structural deficit is being investigated and that apparently there is as yet no plan to deal with the deficit.

3.12 Our advisors have made a number of recommendations which are a more detailed reflection of those made by the FPP. We recommend that these are followed.

3.13 I would like to thank the Panel, our advisors and our Scrutiny Officers for their hard work and participation in this review, which has been achieved under considerable time pressures.

Senator Sarah Ferguson
Chairman
Corporate Services Scrutiny Panel

4. INTRODUCTION

4.1 The Draft 2015 Budget Statement (the 'Draft Budget') was lodged on 18th July 2014 as P.129/2014 and will be debated on 22nd September 2014. It contains the proposals of the Minister for Treasury and Resources (the 'Minister') in respect of taxation; capital expenditure; and, more generally, the Fiscal Framework. The Draft Budget has been prepared and lodged under Article 10 of the *Public Finances (Jersey) Law 2005* which dictates what the Minister must (or can) propose:

a. The amount of income to be raised by taxation. The Minister has proposed, under Part (a) of the proposition, estimated income for 2015 of £615,502,000. This estimate takes into account specific proposals in relation to Income Tax, the Goods and Services Tax (GST), Stamp Duty and Impôts.

b. A maximum amount, if any, that the States may borrow. No borrowing is proposed in the Draft Budget.

c. Amounts, if any, of growth expenditure to be allocated. All the 2015 growth allocations were agreed as part of the 2014 Budget. No provision for them is therefore included in the Draft Budget.

d. For each capital project to be started or continued for which no other approval exists, a capital head of expenditure. The Minister has proposed under Part (b) of the proposition a capital programme for 2015 totalling £76,382,000 (£75,144,000 if the Minister's amendment to the Draft Budget is adopted). In Part (c) the States Assembly is asked to approve the spending envelope for the Liquid Waste Project.

e. Details of each capital project to be undertaken by a States Trading Operation. Approval is sought for projects totalling £6,064,000 under Part (d) of the proposition.

f. Amounts, if any, to be transferred between the Strategic Reserve, Stabilisation Fund, Consolidated Fund or any other Specially Constituted Fund. A number of transfers to the Consolidated Fund are proposed under Parts (e), (g) and (h) of the proposition: £22.7 million from the Strategic Reserve; up to £6.12 million from the Housing Development Fund; up to £1.058 million from the Stabilisation Fund; and £2 million from the Dwelling-Houses Loan Fund (rising up to £6.5 million if the Minister's amendment to the Draft Budget is adopted).

4.2 There are other aspects to the Draft Budget beyond the above. In Part (f), the Assembly is asked to approve revised rules for the operation of the Housing Development Fund. In Part (i), the Minister seeks the Assembly's agreement in determining the capital limit of the Strategic Reserve whilst in Part (j) the Assembly is asked to approve rules for the future operation of the Stabilisation Fund. Finally, in Part (k), the Minister seeks the Assembly's backing for the proposed redemption of preference shares held by the States of Jersey in Jersey Water.

4.3 As in previous years, the Minister has also presented a number of reports alongside the Draft Budget. None of these reports seeks a decision from the Assembly at this time but they give an indication of future work that is to be undertaken or of decisions that might be required in due course.

4.4 We set out to explore all these various facets of the Draft Budget with a view to understanding not only the short-term implications of its proposed measures but also its long-term impact. To that latter end, we endeavoured to understand where the Draft Budget sits within the longer-term financial planning framework, building upon the work we had previously undertaken on the Medium Term Financial Plan (MTFP) and the Budgets of 2013 and 2014.

4.5 Our review had to be undertaken within a very short time frame and over the summer recess: Budget proposals remain strictly confidential until they are published and our review could not therefore begin in earnest until the Draft Budget had been lodged. We are grateful for the efforts of the Minister and his Department to brief us on draft proposals and to provide us with the information we required. We are also extremely grateful for the work of our expert advisors from the Chartered Institute of Public Finance and Accountancy (CIPFA) and MJO Consultancy whose reports may be read in Appendices 2 and 3.

5. INCOME FORECASTS

5.1 The most significant issue we explored during our review related to income forecasts and their use in the development and construction of the Draft Budget.

5.2 Under Article 10(3)(a) of the Public Finances Law, the Minister is obliged to seek the Assembly's approval of the amount of income intended to be raised by taxation during the year to which a draft budget relates. The Assembly's approval of intended amounts of income is also required in the MTFP (for each of the years to which the MTFP relates). This should be noted because each Budget fits within a context of longer-term financial planning established by the relevant MTFP. The Draft Budget is the last Budget relating to the current MTFP. These amounts of intended income provide the basis on which subsequent decisions can be taken in relation to taxation and expenditure. Whilst the amounts might be 'intentions' or estimates, they are therefore vital to the Assembly's decision-making.

5.3 The Minister stated in his testimony to us that, as a forecast, any statement of intended income would undoubtedly be proven to be incorrect by actual returns.[1] Whilst the generality of that argument may hold true, it is also the case that, for the sake of the Assembly's decision-making, there does need to be confidence that those stated intentions of income are realistic and that taxation and expenditure proposals brought to the Assembly are well-founded.

5.4 In the Draft Budget, the Minister seeks approval for estimated income from taxation in 2015 of £615,502,000. Questions were raised about income forecasts because the Draft Budget has been developed on the basis of lower income forecasts than either its two predecessors or the MTFP. This situation primarily stems from lower forecasts for Income Tax, which represents the greatest proportion of States income; major changes in forecasted Income Tax receipts therefore impact significantly upon forecasts for overall income.

5.5 The downgrading of Income Tax forecasts has been highlighted by both of our expert advisors in their reports and can be seen from the following table:

	2013	2014	2015	2016
MTFP Central	£450m	£470m	£500m	-
2013 Budget	£455m	£475m	-	-
2014 Budget	-	£475m	-	-
2015 Budget	-	£444m	£455m	-

5.6 We examined how Income Tax forecasts are developed and how decisions were taken on their use in the development of the Draft Budget.

[1] Minister for Treasury and Resources, 18th July 2014, Transcript Page 34

5.7 In terms of how income forecasts are constructed, we received the following advice from the Department of Treasury and Resources:

"*There is one future forecast, produced by means of a model, by the Income Tax Forecasting Group produced each year to inform the next year's Budget proposals. The forecast produced for the Budget 2015 predicts income tax for the years 2014 to 2017 and the current year's position is informed by the Taxes Office's in-house forecast. A similar forecast is performed by areas responsible for other income, for the same period to also inform the Budget e.g. Customs and Excise will produce their Impôt forecast.*"

We were advised that a full review of all States income is only carried out once a year to support the production of the Draft Budget. Work on sources of income is therefore undertaken by the sections with responsibility in those areas. There is also in-year monitoring of forecasts on a monthly basis (more comprehensively on a quarterly basis).

5.8 In relation to Income Tax forecasts, there are effectively two separate processes of which we were made aware: forecasts produced by the Income Tax Forecasting Group (ITFG) and in-year and in-house monitoring of Income Tax receipts by the Taxes Office.

5.9 In relation to the ITFG, it does what one would expect from its name: on an annual basis, it produces a forecast for Income Tax (recently in March 2012 and then May 2013 and May 2014). The ITFG's work is supported by the Economics Unit who make use of a model (based on a number of various economic assumptions) to forecast Income Tax receipts. Work is done annually on recalibrating the model by using actual Income Tax receipts to determine where the model may currently be mis-hitting. It is apparent that the ITFG is not obliged to follow the results of the model, however; rather the ITFG considers the outcome from the forecasting model used and "*reach[es] a consensus forecast using their judgement*."

5.10 Our advisor from CIPFA has stated that the "*the structure of the group is rarely stable and lacks formality*." We understand that at present the ITFG includes the following individuals: the Treasurer of the States; the Economic Advisor and one further officer from the Economics Unit; the International Advisor; the Director of Treasury Operations; the Head of Financial Planning; the Comptroller of Taxes; the Director of Tax Policy; and the Finance Director of the Taxes Office. We have also noted that there does not appear to be a formal report produced by the ITFG itself; the reports which we have received in the past (and which have been made available to the Assembly) appear to be the report prepared by the Economics Unit <u>for</u> the ITFG. We were advised that the Unit's final report reflects the consensus view of the ITFG after having considered a draft of the Unit's report over a series of meetings. In his testimony to us, the Minister underlined the independence of the ITFG (i.e. from political interference).[2]

5.11 Separately from the work of the ITFG, the Taxes Office monitors in-year Income Tax receipts and provides forecasts for the monthly and quarterly reports which go to the Corporate Management Board (CMB) and (in relation to the quarterly reports) to the Council of Ministers. We were informed by the Department that this work entails the following:

"*The approach that has been adopted by the Taxes Office is to identify the sub set of assessments in 2014 that can be compared to a 2013 equivalent assessment and therefore identify, on a comparable basis, the increase / decrease in revenue vs prior year for assessments that have been completed year to date. This result is then extrapolated over the full year and compared to budget.*

Adjustments are then made to take into account the following:

- *Payment on account taxpayers*
- *Refunds associated with dividends received from the States holdings in Jersey Utility Companies.*
- *Assessments that have been performed but not yet issued (Bulk Issue) - these are not yet loaded on the ledger (as assessments are only loaded to the ledger when issued). However it has been included in the year end forecast figure as by year end these values will have been loaded to the ledger and will therefore effect 2014 outturn.*
- *The value of the comparable assessments for last year has been calculated as a percentage of the total revenue for last year, and this percentage is then used to extrapolate forward the year to date position.*
- *The non-comparable value year to date is uplifted to give an expected outturn for full year.*
- *Adjustments made to prior year assessments.*
- *Non-collectible values expected to arise between now and the year end.*
- *Shareholder dividends that have been declared on returns but that we are awaiting vouchers for to confirm tax has already been deducted at source.*
- *The revenue raised from Penalty files.*

Comparable assessment values are then compared on a percentage basis to prior year to sense check any increase / decrease.

The forecast revenue is then compared to the MTFP forecast revenue."[3]

[2] Minister for Treasury and Resources, 18th July 2014, Transcript Page 8

5.12 Our advisor from CIPFA was given the opportunity to 'walk through' the Taxes Office's model on tax yield performance and forecasting. He has advised us that "*there is a considered approach to tracking and forecasting tax yields and [it] employs a 'bottom up' approach which aims to capture movements within all components of tax using Excel and Chrystal Report Writing Tools on top of the iTax Base system*." CIPFA's view is that "*the methodology appears to be robust and that the extent of variances experienced on forecasting reflects the volatility and complexity of tax impacts as well as prevailing economic conditions*."

5.13 It is these two separate processes which are seemingly used for the identification of Income Tax forecasts for inclusion in the MTFP and the Annual Budget and it is clear that the decision is not always simply to follow the forecasts produced by the ITFG. When we asked who was ultimately responsible for providing the forecast, we were informed that it is the Treasurer's responsibility to advise the Minister.[4]

5.14 If the ITFG's forecasts from recent years are considered alongside the table presented above, the following picture emerges in respect of Income Tax forecasts:

	2013	2014	2015	2016
MTFP (July 2012)	£450m	£470m	£500m	-
2013 Budget (October 2012)	£455m	£475m	-	-
ITFG 2013 (May 2013)	£446m	£462m	£479m	£497m
2014 Budget (October 2013)	-	£475m	-	-
ITFG 2014 (May 2014)	-	£444m	£455m	£475m
2015 Budget (July 2014)	-	£444m	£455m	-

5.15 As our advisor from MJO Consultancy has stated, "*every forecast since the publication of the MTFP has shown a deterioration*."

5.16 In light of this picture, we questioned the Minister on how, and why, decisions had been taken about the income forecasts included not only in the Draft Budget but also its predecessor, the 2014 Budget. From the advice and information we received, the following timetable can be constructed:

- In February and March 2012 a full review of all States income forecasts was undertaken. This included the work of the ITFG.
- In July 2012 the MTFP was lodged and used the mid-point of the ranges identified by the full review as the forecast. The MTFP was debated and approved in November 2012.

[3] Written advice, Department of Treasury and Resources, 18th August 2014
[4] Treasurer of the States, 31st July 2014, Transcript Page 11

- In October 2012 the 2013 Budget was lodged and used the same income forecasts as the MTFP. They were subsequently adjusted to take into account the measures approved in the 2013 Budget (which was approved in December 2012).
- In May 2013 the next full review of all income was undertaken (including the work of the ITFG). The Income Tax forecasts were lower as was the overall income forecast as a result.
- The 2014 Budget was lodged in October 2013. Notwithstanding the lower forecasts produced by the annual review, a decision was taken to base the 2014 Budget on the MTFP forecasts. A supplementary note was made available to Members at the time of the debate which explained the reasoning for this decision.[5] The Budget was approved in December 2013.
- In February 2014, the Minister answered a written question tabled by Deputy J.A.N. Le Fondré about income forecasts. The answer to this question confirmed that MTFP forecasts had been used for the 2014 Budget but that the May 2013 forecasts were being used as the basis for the Long-Term Revenue Plan.
- In May 2014 the latest full review of all income was produced including the ITFG forecasts, which revealed lower forecasts than both the MTFP and the May 2013 review.
- The Draft 2015 Budget was lodged in July 2014 and was based upon the forecasts produced in May 2014. Work on the Long-Term Revenue Plan was also updated to incorporate the May 2014 forecasts.

5.17 The Minister and his Department were aware of downgraded forecasts at the time of the 2014 Budget. However, a decision was taken to continue to use MTFP forecasts for the basis of the 2014 Budget. From our own consideration of this matter and from the reports of our advisors a number of questions arise: Why were the MTFP forecasts used for the 2014 Budget when the ITFG's latest report suggested those forecasts were optimistic? What were the implications of that decision? Is the forecasting process (including the decisions about which forecasts to use) sufficiently robust?

5.18 The Minister stated to us that that there was no reason for surprise at what had come to pass, advising us that "*we have known that the income line was going to be less than expected all the way through almost from the beginning of 2013 and it has become clearer and clearer what the numbers are*."[6] Indeed, the 'pressure' that had been felt on Income Tax

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[5] *Fiscal Policy Panel Report: Response of the Minister for Treasury and Resources* (R.149/2013), Presented on 3rd December 2013

[6] Minister for Treasury and Resources, 31st July 2014, Transcript Page 3

had led to steps to improve income through other sources, for example the investment of the Currency and Consolidated Funds.[7]

5.19 We were advised that MTFP forecasts were used for the 2014 Budget due to the results of the in-year and in-house monitoring by the Taxes Office during 2013. At the time the 2014 Budget came to be lodged, the actual Income Tax receipts from the first two quarters of 2013 were known. The Taxes Office's forecasts on the basis of its work suggested that receipts would not be as low as the ITFG's forecasts suggested. A decision was therefore taken to continue using the MTFP forecasts for the 2014 Budget but to use the ITFG May 2013 forecasts for development of the Long-Term Revenue Plan. The Plan, which we have been advised will be presented in due course, will look at financial planning out to 2020 and will form the platform for development of the next MTFP. As a further mitigating factor, we were informed that the actual receipts for 2013 had ultimately been close to the MTFP forecasts in that Income Tax receipts had amounted to £450 million (compared to the MTFP position of £452 million). However, within that context, personal Income Tax receipts had underperformed by £20 million whilst business Income Tax receipts had over-performed by £18 million.[8]

5.20 In terms of the implications of that decision, it would seem that some of the proposals included in the 2014 Budget might not have been put forward if lower forecasts had been used. In particular the proposal to reduce the Marginal Rate of Income Tax from 27% to 26% might not have been put forward. In that regard, we were informed by the Treasurer that the measure would not have been recommended if what is known now had been known then, on account of the lost revenue the measure would entail (although it was also stated that the measure might still have been included on economic grounds).[9]

5.21 Our advisor from MJO Consultancy has also suggested that a number of errors were made in the decision-making process over 2012 to 2014. First, there was in his view an apparent misunderstanding of the economic situation in 2012 when the initial forecasts were made. Economic factors affect the economic assumptions placed into the model used for the ITFG forecasts and our advisor has suggested some of the assumptions were optimistic. He has suggested that optimism also drove the decisions made on the basis of the forecasts and meant that the 2012 ITFG Income Tax forecasts (i.e. the MTFP forecasts) continued to be used for the 2014 Budget (even though the ITFG had itself revised the Income Tax forecasts downwards in May 2013). Our advisor has ultimately stated, "*it is very difficult to comprehend why the Treasury did not use the May 2013 forecasts for the 2014 Budget and to persist with forecasts which were out-dated even at the time of the publication of the*

7 Treasurer of the States, 31st July 2014, Transcript Page 4
8 Treasurer of the States, 18th July 2014, Transcript Page 9
9 Ibid, Transcript Pages 9 and 24

MTFP in July 2012." He has recommended that "*the process of economic forecasting should be re-examined*."

5.22 Our advisor from CIPFA has expressed similar reservations, advising us that "*we fear that this lack of transparency, coupled with the sub-optimal behavioural element of optimism bias, may be contributing factors behind what can now be seen as 'less than robust' income forecasting and a consequential failure to recalibrate expenditure*." He expresses concerns for the longer-term picture in relation to tax revenues, a matter we shall return to later in this report. He has also suggested that it might be a distraction to refer constantly back to the MTFP position and that, instead, reference should be made to the position on real income and expenditure.

5.23 The downgraded forecasts from May 2014 (or, more particularly, the decision to use those forecasts as a basis for the Draft Budget) have had immediate implications for the measures proposed in the Draft Budget. We shall explore those implications in subsequent chapters of this report. We have also considered, however, what this recent experience suggests in the longer term for forecasting income (in particular Income Tax) and the decision-making on the basis of that process. This is particularly pressing given one of the findings of our advisor from CIPFA. He was given the opportunity to consider the latest available corporate report (which at the time of this report was June 2014). Consideration of that report has led him to advise us that there may be a "*downward trend in income*" which raises the question of whether even the May 2014 ITFG forecasts will be realised. Indeed, our advisor has expressed some concern at the prospect that the Draft Budget, even with lower forecasts, is deliverable. He has stated that the Draft Budget should be considered on the basis of the most recent intelligence; as the Draft Budget stands (it was lodged in July 2014) it takes into account the May 2014 forecast produced by the ITFG and does not therefore take into account the in-year and in-house monitoring and forecasting undertaken by the Taxes Office. He has therefore recommended that "*latest forecasts MUST be used as the foundation for informing the Budget Setting Process, as far as reasonably practical to the point where Members are provided with the details within the States approval process*."

5.24 During our hearings, the Treasurer advised us of her own view that income would in fact prove to be more positive than the revised forecasts suggested. However, it had been prudent to plan for the longer-term on the basis of lower forecasts and hence the decision was made to move away from using MTFP forecasts;[10] it was therefore highlighted to us that the revised forecasts had been used for the Long-Term Revenue Plan, which will form the basis of the next MTFP. We were also advised that, in the longer run, income levels were

10 Treasurer of the States, 31st July 2014, Transcript Page 5

expected to return to previously anticipated levels; it was in 2014 and 2015 that there was particularly a problem.[11]

5.25 The Executive itself is considering changes to the forecasting process. One measure is proposed in *Updating Jersey's Fiscal Framework* (R.102/2014), in which it is suggested that income forecasts could be made the responsibility of the Fiscal Policy Panel (FPP). Our advisor from MJO Consultancy has considered that option and has suggested that this would need "*a thorough debate as it calls into question the purpose of the Income Tax Forecasting Group and the Economics Unit*." He asks whether this transfer of responsibility would weaken the FPP's independence and whether it would in fact allow for "*more credible and transparent fiscal and economic forecasts*."

5.26 Our advisor from CIFPA has recommended that "*Membership and attendance of [the ITFG] should be formalised within a structured reporting framework [and] with formal minutes being made available to the Council of Ministers*."

5.27 It is evident that questions can be asked about the preparation of the 2014 Budget. The Treasury itself advised us that the reduction in the Marginal Rate would not have been proposed if what is known now had been known then. However, it was known then: as the Minister has highlighted, the work of the ITFG in May 2013 had already downgraded the forecasts from the MTFP position and there was therefore awareness during preparation of the 2014 Budget that the position might have changed. The 2014 Budget was ultimately passed but it is paramount that a similar set of circumstances are not allowed to develop. This is particularly pressing given the findings of our advisor from CIPFA that the position on Income Tax receipts might in fact be worse than the current forecast from the ITFG (which is used within the Draft Budget).

5.28 Our advisor has considered the models used within the income-forecasting process and has concluded that the models themselves are robust. We acknowledge the work that has been undertaken on their development and on the efforts taken to improve them. The issue would not seem to be one of how forecasting numbers are produced but on how decisions are made on which numbers to use. In 2013, the problems appear to have occurred in the period between the production of the ITFG forecasts and the presentation of the 2014 Budget (which continued to use MTFP forecasts). In that regard, it is of some concern to hear that the work of the ITFG lacks the formality and we endorse the recommendation from CIPFA that greater formality should be introduced.

5.29 The current Draft Budget uses ITFG forecasts. However, from the work of our advisor there remain concerns that the ITFG forecast in itself may be too optimistic. The Assembly needs

[11] Treasurer of the States, 18th July 2014, Transcript Page 9

to be fully aware of the current situation when it comes to debate the proposition, as CIPFA has recommended.

KEY FINDING

5.30 Problems arose in the income-forecasting process in 2013 which meant that measures were proposed (and ultimately adopted) in the 2014 Budget which should not have been. These circumstances should not be allowed to repeat themselves.

5.31 Decisions of the Assembly need to take into account the most recent and up-to-date information.

RECOMMENDATION

5.32 Prior to the lodging of the next MTFP, the Minister for Treasury and Resources should ensure that membership of the ITFG is formalised within a structured reporting framework and with formal minutes being made available to the Council of Ministers.

5.33 The Minister for Treasury and Resources should ensure that the most up-to-date forecasts are used as the foundation for informing the Budget Setting Process.

6. BALANCING THE CONSOLIDATED FUND

6.1 The Minister's proposals in the Draft Budget (and indeed the MTFP) in respect of intended income may be based on forecasts (and therefore might well prove to be incorrect in the long run) but they are vital to subsequent decisions about taxation and expenditure. They also have a knock-on effect on the development and construction of the MTFP and the Annual Budget.

6.2 In that regard, under Article 10(8) of the Public Finances Law, the Minister "*must not lodge a draft budget that includes a report that shows a deficit in the Consolidated Fund at the end of the financial year to which the budget relates*." The revised income forecasts from May 2014 (which have been used as a basis for the Draft Budget) have impacted on the balance that was expected in the Consolidated Fund at the end of 2014 and 2015.

6.3 In the Draft Budget report as initially lodged, Summary Table F showed what the position of the Consolidated Fund would have been at the end of 2015 if all the measures proposed in the Draft Budget were approved. It indicated that if all the measures proposed in the Draft Budget were pursued (and if the income forecasts used as a basis for the Draft Budget were realised), the balance on the Consolidated Fund at the end of 2015 would have been £0. An amendment to the Draft Budget lodged by the Minister on 8th September 2014 changed the expected position slightly to show a final balance at the end of 2015 of £3,851,000.

6.4 That took into account measures which prepared specifically to ensure the Consolidated Fund does not go into deficit; measures which would not be required if higher income forecasts were used. This is not the first time the forecast balance of the Consolidated Fund has been downgraded: the 2014 Budget report showed that the Consolidated Fund would stand at £5.709 million at the end of 2014 – somewhat lower than the MTFP had foreseen; the MTFP had forecast a balance of £11.563 million in the Consolidated Fund at the end of 2014. Meanwhile,the 2014 Budget had forecast a balance on the Fund for the end of 2015 of £6.090 million.

6.5 Measures have therefore been developed and incorporated precisely because of the revised income forecasts and the need to ensure that the Consolidated Fund is not shown to be in deficit. Some of these measures appear explicitly in the proposition itself; they relate to three transfers to the Consolidated Fund:

a. Under Part (g)(i), a transfer of up to £6.12 million from the Housing Development Fund;

b. Under Part (g)(ii), a transfer of up to £1.058 million from the Stabilisation Fund; and

c. Under Part (h), a transfer of up to £6.5 million from the Dwelling Houses Loan Fund.[12]

6.6 Furthermore, the Minister is also seeking approval for a course of action whereby the Jersey New Waterworks Company Limited (i.e. Jersey Water) would reduce its share capital by removing the Fifth Preference Share class of share capital and would repay to the States a fair market value for the shares.

6.7 Further measures are described within the report accompanying the Draft Budget. They are described in Chapter 11 of the report and are shown in Figure 11.1 alongside those we have just described:

a. A proposed extraordinary dividend from Jersey Post;

b. A possible payment from JT (i.e. Jersey Telecom) in respect of the deferred Gigabit Dividend;

c. Transfers from Court and Case Costs Contingency and the Insurance Fund;

d. Utilisation of funds from the Drug Trafficking Confiscation Fund and the Criminal Offences Confiscation Fund;

e. Proposed savings from all Departments of 2% on pay budgets and 2% on gross non-pay budgets;

f. A reduction in the use of Departmental Carry Forwards from both 2014 and 2015;

g. Reduction in the Contingency allocation to Freedom of Information funding;

h. Proposed deferral or reduced contribution to the Long-Term Care Fund; and

i. Further rephasing of capital approvals, increased shareholder contributions and savings.

6.8 The Minister advised us that the measures proposed had been identified as a means of ensuring that proposed capital expenditure could still be funded. This was, he reported, in line with a recommendation from the FPP that such funding should be maintained and not be constrained by the balance of the Consolidated Fund.[13]

6.9 In its report on the Draft Budget, the FPP has indicated its support for the Draft Budget's "*proposed approach to mainly using savings and reserves to fund the potential shortfall in income because it limits the negative impact on the economy in the short term.*"[14]

6.10 Our advisors have commented upon the measures. Our advisor from CIPFA has highlighted that "*the utilisation of reserves to fund core spend is a real 'wake-up call' and is typically the product of a rapidly deteriorating fiscal position*." This relates to the various transfers from

12 Initially £2 million according to the Draft Budget as lodged.
13 Minister for Treasury and Resources, 18th July 2014, Transcript Page 2
14 *Jersey's Fiscal Policy Panel Annual Report – July 2014*, Page 7

other funds which appear amongst the measures and, indeed, our advisor from CIPFA has stated that the Department of Treasury and Resources was in fact intending to build up the Court and Case Smoothing Reserve at the beginning of the year. However, now it is being proposed that it be used to ensure the Consolidated Fund remain in balance. In its written submission, the Jersey Consumer Council raised concerns that the transfers of monies to the Consolidated Fund should not "*expose Islanders to a shortfall in funds in years to come*."

6.11 In relation to the proposed deferral or reduced contribution to the Long-Term Care Fund, our advisor from CIPFA suggests it is "*another indicator of the seriousness of the situation now faced*" given that the Fund was established to "*provide a necessary stream of finance to underwrite the expected demographic care demands of an ageing population and extent of progressively complex care costs*."

6.12 CIPFA has ultimately concluded that "*it is clear that the proposed remedial measures lack maturity and in some examples clearly contradict what was thought to be settled strategy*." Indeed, our advisor also concluded that "*it would be our considered view that the timing and the character of the remedial measures as now presented seriously undermines the confidence attached to the robustness of the States' Financial Strategy*."

6.13 Our primary question in relation to these measures concerned their deliverability. We understand that they will only be required in their entirety if actual income matches the May 2014 ITFG forecast. If actual income is higher, fewer measures will be required to ensure the Consolidated Fund remains in balance. By the same token, however, if income in 2015 turns out to be lower than forecast, further measures might be required to ensure the Consolidated Fund remains in balance.

6.14 The Chamber of Commerce stated to us:

"*Clearly they [the contingent measures] all need to be definites in order to achieve a zero position in 2015 if the tax forecasts are true and always if they come through*."

6.15 In respect of the savings, both of our advisors have indicated it may be difficult for Departments to realise savings of the magnitude identified if the experience of the Comprehensive Spending Review (CSR) were used as an example. Both acknowledge, however, that the level of Carry Forwards which are permitted each year suggests there might be sufficient slack for Departments to be able to accommodate the proposed savings. CIPFA has in fact stated that "*it is not understood why such a measure was not incorporated within the 2015 Budget proposals in the normal course*." Our advisor ultimately stated in respect of the proposed savings measures that:

"*It is critical that Departments are signed-up to delivering on Base Budget reductions. We would recommend that the ability of remedial measures designed to ameliorate expected Budget deficits are critically appraised in relation to their propensity for delivery. We believe* *that this 'savings' validation work is urgently required as delivery of such measures will be an important component of how Jersey deals with realigning deficits. In terms of independence it may be expedient if this work was conducted by the Comptroller and Auditor General*."

6.16 CIPFA has suggested that some of the measures, if not all of them, were identified fairly late in the development of the Draft Budget. This appeared to be the case from investigations we undertook ourselves. The Draft Budget provides for an extraordinary dividend from Jersey Post of £5 million in 2014 that would be used in 2015 to offset the balance in the Consolidated Fund. At our first public hearing with the Minister, however, we were advised that Jersey Post had indicated that a dividend of £2 million would potentially be feasible, but not the £5 million requested.[15] Given this advice, we approached Jersey Post about the situation. We also approached JT and Jersey Water about the measures included in the Draft Budget relating to them. The Jersey Electricity Company, we were advised, had not been approached by the Department of Treasury and Resources as the company was "*making heavy investment at the moment*."[16]

6.17 In its submission, Jersey Post confirmed that the board had decided to pay a dividend of £2 million in 2015 (i.e. not £5 million as described in the list of contingent measures in the Draft Budget). Jersey Post also advised us that it had been approached on 4th July 2014 about the prospect of paying a special dividend. We were ultimately advised that a decision about the dividend would not be made until May 2015 when the board would receive and approve the 2014 annual report and audited financial statements.[17]

6.18 In relation to the deferred Gigabit dividend (of £3 million in 2014 and £3 million in 2015) JT informed us that "*assuming the 2015 Budget is approved in its current state, JT would have to perform strongly during the course of 2014 and 2015 and the Board would have to assess at the appropriate time whether it is in the position to make the budgeted payments (as it is legally obliged to do for all dividend payments*)." JT subsequently advised us that it was possible the dividend could be paid through the re-phasing or slowing down of fibre deployment. The payment in question is referred to as the 'deferred Gigabit dividend'. This refers to the fact that, in December 2011, the Minister agreed that the dividend from JT could be reduced by £3 million (in each of the years 2013 to 2015) in order to ensure that JT had sufficient funds to undertake the Gigabit project.[18]

6.19 In relation to Jersey Water, we were informed that the company had first been approached about the redemption of the preference shares on 4th July 2014 and that it was discussed at a meeting on 8th July 2014. At the time of Jersey Water's submission to us, it was

15 Treasurer of the States, 18th July 2014, Transcript Page 22
16 Ibid, Page 24
17 Jersey Post, Written Submission, 5th August 2014
18 JT, Written Submission, 1st August 2014

investigating the options for redemption. However, we were informed that, if the Draft Budget were approved as it stood, the following would need to occur:

a. Jersey Water's board would need to consider whether the redemption was in the long-term interests of the company (with the decision to be based on professional advice);

b. A mutually agreeable price would need to be negotiated with the States;

c. Alternative funding for the redemption price would need to be identified; and

d. An Extraordinary General Meeting would need to be held for shareholders to vote on the resolutions.[19]

6.20 Figure 11.1 in the Draft Budget report shows a £5 million dividend from Jersey Post in 2014 to be used in 2015. It also initially showed a balance of £0 in the Consolidated Fund at the end of 2015 (if all proposed measures were adopted). If the dividend from Jersey Post were only £2 million (as we have been advised) this would have suggested a resulting negative balance for the Consolidated Fund at the end of 2015.[20] We have considered what this would mean in respect of the Minister's obligations under the Public Finances Law. We understand that, in a sense, he has met the requirements of Article 10(8) in that the Draft Budget has been lodged with a report that shows the Consolidated Fund will not be in deficit. The question is, however, whether any further action should be required of the Minister if the robustness of that report (and the calculated balance of the Consolidated Fund) can be challenged.

6.21 We had significant concerns about the deliverability of the proposed measures at the time the Draft Budget was lodged and from the Minister's amendment. This can be seen from the circumstances surrounding the proposed dividend from Jersey Post and, in terms of the proposed savings measures, from the fact that further discussion ont the proposals (including the savings) was required by the Council of Ministers at its meeting on 3rd September 2014. In terms of the remedial measures, we endorse the recommendation of our advisor from CIPFA that further appraisal of their deliverability is required and we would highlight the need for progress and outcomes on these measures to be monitored in order that their delivery might be measured in due course.

KEY FINDING

6.22 **The timing and character of the proposed remedial measures undermine confidence in the States' financial strategy. It is vital that the measures are critically appraised in relation to their propensity for delivery.**

[19] Jersey Water, Written Submission, 4th August 2014

[20] The anticipated balance on the Consolidated Fund would be affected slightly were the Minister's amendment (lodged on 8th September 2014) were adopted.

RECOMMENDATION

6.23 **The Minister for Treasury and Resources should ensure that proposed base budget reductions are subject to independent validation in order to ensure both their deliverability and their ability to be monitored.**

6.24 **The Minister for Treasury and Resources should confirm with Departments that they have sufficient management and financial information to be able to monitor and report upon the proposed savings that the Draft Budget will require them to deliver.**

7. TAXATION PROPOSALS

7.1 The estimated income which the Minister is proposing under Part (a) of the proposition is the income raised through Income Tax, GST, Impôts and Stamp Duty. The figure takes into account any proposed changes in respect of those sources which the Minister might make. Quite often it is these measures which prove to be the headline issues connected to the Budget. However, that has not been the case this year. Indeed, our advisor from CIPFA has highlighted that the specific taxation measures will collectively affect States income levels by £0.962 million. Nevertheless, we shall touch upon the Minister's specific proposals in this chapter. The impact of taxation measures are often described with reference to the MTFP benchmark; however, as we have previously stated our advisor from CIPFA has highlighted that references to the MTFP are potentially irrelevant given the shift there has been within the model in respect of income.

Income Tax

7.2 There are a number of measures proposed in respect of Income Tax, which have been examined by our advisor from CIPFA. These measures include:

a. Increasing Income Tax exemption thresholds by 1.7% in line with RPI (as of March 2014);

b. Stating that returnees to the Island who previously paid Income Tax on a prior-year basis will move to paying on a current-year basis;

c. Ensuring Marginal Rate taxpayers benefit from double tax credit; and

d. Capping mortgage interest tax relief at £15,000 from the 2015 year of assessment.

7.3 Our advisor has highlighted that these measures have "*a recurring structural change in the base line position for the Income Tax component of the States income model*." In addition to the measures listed above, there are proposals within the Draft Budget in respect of pensions and pension schemes.

7.4 The Minister advised us that the cap on mortgage interest tax relief would not affect a large number of taxpayers but that it would send a message of the direction of travel in respect of that area of taxation. The Minister referred us to research which suggested that the existence of such measures as mortgage interest tax relief could inflate the housing market and assist in keeping prices high. The Draft Budget report itself states that "*the more credit is extended to homebuyers, the higher prices become.*" It was therefore likely that in the long term the relief would be phased out, as had happened in other jurisdictions. The

Chamber of Commerce confirmed its own understanding that such relief had been phased out elsewhere. Chamber advised us, however, that "*capping mortgage interest will be difficult for plenty of people who are relying on some of that income. Whether it will have the effect on the housing market that is desired I am not quite so sure*."[21] The FPP has described the proposed cap as "*potentially a significant and welcome development*." There are questions as to whether the introduction of a second aspect of relief will make the tax system inherently more complex (when our understanding of the principles underlying the tax system is that it should be kept simple) given that there will be two aspects of relief to administer rather than one.

7.5 Perhaps the most significant Income Tax measure is one which has not been proposed. Last year, much of our focus was on the proposal (subsequently adopted by the Assembly) that the Marginal Rate be reduced from 27% to 26%. We understand that consideration was given to including a further reduction in the Draft Budget but the idea was ultimately not pursued. Nevertheless, we were advised that it remains the Minister's intention to lower the Marginal Rate to 25% in due course.[22] Indeed, further reductions were mooted in the report on the move to independent taxation, which was presented alongside the 2014 Budget, in which it was recommended that following the reduction in the 2014 Budget consideration be given to "*further reduction in future Budgets*." Such a reduction would have the same impact as last year's reduction in that it would lower Income Tax receipts by reducing the tax burden of all those taxpayers who pay at the Marginal Rate and by transferring a certain number of taxpayer from the Standard Rate to the Marginal Rate. Both of our advisors have remarked upon the fact that consideration was given to a further reduction of the Marginal Rate, given the income forecasts. We understand a further reduction was not proposed because it would essentially have been unaffordable: a reduction to 25% would have required further contingent measures to ensure the Consolidated Fund did not go into deficit as the reduction would have lowered States income still further.

Stamp Duty

7.6 The Minister has proposed that Stamp Duty on a property of not more than £400,000 will be charged at a rate of 0.25% between a mortgage threshold of £300,000 and £400,000. In addition, he has proposed increases in the Stamp Duty on properties worth more than £1 million. Our advisor from CIPFA has considered these proposals and has concluded that "*there is a lack of detail on expected volumes of transactions*." He has therefore recommended that there be "*more transparency on expected transaction volumes*." Furthermore, he has found that the additional revenue anticipated to be raised on higher

21 Chamber of Commerce, 24th July 2014, Transcript Page 13
22 Minister for Treasury and Resources, 31st July 2014, Transcript Page 12

worth properties would benefit "*from some empirical foundation within the Budget Statement notes*." We are concerned about the impact this measure may have on individual households. The Draft Budget also proposes that the temporary threshold for determining entitlement to reduced rates of Stamp Duty (and Land Transaction Tax) which are available to First-Time Buyers is not extended. This would see the threshold move from £450,000 to £400,000.

7.7 The proposal of having no Stamp Duty on properties up to £300,000 in value was welcomed by the Jersey Consumer Council who stated that "*it could encourage more movement at the bottom of the market and in turn may allow home owners who wish to move up the market to do so more easily, as their properties will become more marketable*."

Impôts

7.8 The Impôts on alcohol, tobacco and fuel often stimulate debate and have been subject to amendment in recent Budgets. In the Draft Budget, the Minister is proposing the following increases in Impôts:

- Tobacco 4.7%
- Strong beer 1.7%
- Strong cider 8.7%
- Spirits 1.7%
- Wine 1.7%
- Weak cider 6.9%
- Weak beer 0%
- Fuel 2.2%
- VED 1.7%

7.9 The Chamber of Commerce advised us of its view, in relation to Impôts on alcohol, that "*we would want to see a pause while a longer-term policy is agreed and it could be worked out exactly what we are trying to achieve with alcohol Impôts*."[23] Whilst acknowledging that this year's proposed increases were more "*measured*", Chamber advised that it would like to see "*a tax escalator over a period of time*."[24]

7.10 Again, our advisor from CIPFA has considered the proposals. He has advised us that "*forecasting and modelling on relevant assumptions / options appear to be sound for this*

[23] Chamber of Commerce, 24th July 2014, Transcript Page 18
[24] Ibid, Transcript Page 20

component of income." However, he also advised that "*the original MTFP position for 2015 of £53.111 million requires to be adjusted for changes in the assumptions related to specific elements*."

7.11 We approached industry representatives about the proposed changes. We received fewer representations than last year although the written submission from Randalls Limited suggested that the situation had not changed from the previous year and that the issues in respect of Impôts and potential increases remained the same. It must be noted in that regard that whilst the Impôts and taxation measures might not have been the headline issues of the Draft Budget, that does not diminish the impact and relevance that such measures have for certain individuals or sectors.

7.12 In our review of the 2014 Budget, there were two issues in particular which we highlighted and where we recommended that action be taken. In respect of tobacco Impôts, we explored the amount of duty-free consumption occurring in the Island. We found that an unhelpful situation existed, whereby claims from the industry (regarding the level of duty-free tobacco consumption in particular) could not be countered or verified. We recommended action be taken to address this situation. We were advised by the Minister of the measures which had been taken.

7.13 From our review of the 2014 Budget, we also recommended that the Minister should endeavour to reconcile differences with the industry in respect of price margins and comparisons for alcohol and tobacco. We asked him to update the Assembly on this work in July 2014. We were advised by the Chamber of Commerce, however, that there had been less consultation on this point than had been hoped for. The only meeting had taken place one week before the Draft Budget was presented to the Council of Ministers for consideration and the Chamber had hoped for greater communication.[25] It would therefore appear that our recommendation, though accepted, has not been pursued. This is unfortunate as it appears unlikely that the differences between Government and business which we identified last year will be resolved unless there is meaningful engagement.

Other Measures

7.14 When we reviewed the 2014 Budget, we received comments from witnesses that more could have been done to support the economy. We were advised of suggestions which had reportedly been put to the Department of Treasury and Resources in that regard, for example the development of a Seed Enterprise Investment Scheme.

[25] Chamber of Commerce, 24th July 2014, Transcript Page 3

7.15 Similar comments were made to us this year by the Chamber of Commerce, who intimated that the Draft Budget would do relatively little to support the economy[26] (beyond the injection of capital expenditure which we shall explore in the next chapter). Chamber advised us that whilst there had been some positive developments in the finance sector, there remained concerns within non-finance sector in relation to profitability and operating costs.[27] The Jersey Consumer Council also advised us of its desire to see efforts made to grow the economy. The Council suggested that measures could be taken to "*make it easier and more attractive for small businesses to start up by reducing red tape and offering incentives such as tax breaks to those businesses*." It added that the level of Social Security contributions for the self-employed could be revisited. The Council stated in its submission that "*regrettably, there appears to be little in the Draft Budget to help achieve [economic growth].*"[28] The Chamber of Commerce also suggested a review of Class 2 contributions "*to help people who have left employment and want to set up their own business*."[29]

7.16 The Minister refuted the Chamber's criticisms and described all the measures which had been taken to assist the economy. He also stated that it would be difficult to identify measures which could feasibly be taken given that Jersey's tax system:

"*We are struggling with finding evidence that an incentive programme or an incentive package on tax matters would be effective. We have zero tax, we have one of the lowest personal tax rates in the world, and we have provided fiscal stimulus in terms of the Innovation Fund and we stand ready to respond to economic developments, further proposals on finding opportunities to invest*."[30]

He had undertaken to consult stakeholders about what could potentially be done and we were informed that the work was ongoing; the Chamber of Commerce confirmed that one meeting had been held specifically in respect of an enterprise investment scheme.[31] The Minister also advised us of his awareness of the 'productivity challenge' and the need to address it.[32]

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26 Chamber of Commerce, 24th July 2014, Transcript Page 7
27 Ibid, Transcript Page 4
28 Jersey Consumer Council, Written Submission, 29th July 2014
29 Chamber of Commerce, 24th July 2014, Transcript Page 8
30 Minister for Treasury and Resources, 18th July 2014, Transcript Page 17
31 Chamber of Commerce, 24th July 2014, Transcript Page 7
32 Ibid, Page 20

8. CAPITAL EXPENDITURE

8.1 Under Article 10(3)(d) of the Public Finances Law, the Minister must seek the Assembly's approval of a capital head of expenditure "*for each capital project to be started or continued in the year by a States funded body (other than a States Trading Operation) and for which no other expenditure approval sufficient to complete the project exists*." Under Part (b) of the proposition the Minister has proposed a capital programme for 2015 of £75,144,000.[33]

8.2 Under Article 10(3)(e) of the Law, the Minister must also seek the Assembly's approval of details for each capital project to be undertaken by a States Trading Operation which is scheduled to start. The Trading Operations are Jersey Airport, Jersey Harbours, Jersey Fleet Management and Jersey Car Parking. In Part (d) of the proposition, the Minister seeks approval for £22.7 million of capital funding to be withdrawn from the trading funds for the Trading Operations' capital projects.

8.3 Provisions are included in the Draft Budget in respect of the three Major Capital Projects: Housing, Hospital and Liquid Waste. These three Projects were initially proposed or described in the 2014 Budget and we considered all three in our report on the 2014 Budget.

8.4 The Draft Budget sets out a (Departmental) Capital Programme for 2015 totalling £75,144,000. Under the Public Finances Law, the total amount for the Capital Programme must not exceed the envelope agreed for the year in the MTFP. In the MTFP, the Assembly approved capital spending of £77,341,000 for 2015 and that provision of the Law has thereby been respected. In terms of the projects contained within the Programme, there are differences from the provisional programme for the year which was initially included within the MTFP. These differences reflect developments in policy and priorities which have occurred since the MTFP was debated in 2012.

8.5 Summary Table C in the Draft Budget report describes how the 2015 Capital Programme will be funded. We will touch upon some of the funding sources below. However, those sources include the measures in respect of Jersey Post, JT and Jersey Water which we have covered in a previous chapter of this report. The income to be generated through those measures is therefore not only to be used to ensure the Consolidated Fund does not go into deficit but also to ensure that the 2015 Capital Programme can be funded. The Minister confirmed as much in his testimony to us, explaining that this had been done in order to meet recommendations from the FPP that capital expenditure should not be hampered or limited by the level of the Consolidated Fund.

[33] This figure takes into account the impact that adoption of the Minister's amendment (lodged on 8th September 2014) would have on the spending envelope of the 2015 Capital Programme.

Housing Project

8.6 One reason for the difference in the 2015 Capital Programme from what was provisionally indicated in the MTFP for the year is implementation of the Housing Project. In the 2014 Budget, the Assembly agreed to borrow £250 million through the issuance of a public rated bond in order that the sum could subsequently be loaned to Housing Trusts and Associations. The majority of the amount borrowed (£207 million) would be loaned to the publicly-owned company that would be established following the incorporation of the Department of Housing in line with the Housing Transformation Programme. That incorporation took place on 1st July 2014 when Andium Homes officially came into existence.

8.7 The MTFP, when debated in 2012, did not assume the incorporation of the Department of Housing and therefore included proposed capital expenditure on social housing within the spending envelopes for 2013, 2014 and 2015.[34] For 2015, that represented an allocation of £45,873,000 (out of the overall spending envelope mentioned above of some £77.3 million). With the incorporation of the Department, those capital programmes will now be undertaken by Andium Homes and will be funded through the borrowing referred to above. That part of the overall funding envelope for 2015 which had been attributed to the Department of Housing can therefore be used for other matters.

8.8 The Housing Project has essentially already been approved by the Assembly with the adoption of the 2014 Budget. The Draft Budget makes some provision for the Project, however, with Part (f) of the proposition, in which approval is sought for revised rules underpinning the operation of the Housing Development Fund (into which the borrowed £250 million has been deposited and from which loans will be made). The rules are contained in Appendix C to the Draft Budget. This aspect of the Draft Budget has been proposed in line with a recommendation of *Updating Jersey's Fiscal Framework* (R.102/2014) which suggested that the rules underlying the Housing Development Fund should make a distinction between its current uses and the uses to which it would be put for the Housing Project.

Liquid Waste Project

8.9 Part of the space within the capital spending envelope for 2015 created by the establishment of Andium Homes has been taken up by funding for the Liquid Waste Project. This effectively relates to the construction of a new sewage treatment works. Information on this Project was presented alongside the 2014 Budget (including the anticipated cost, the

[34] An amendment to the MTFP was therefore required as part of the Housing Transformation Programme and the establishment of Andium Homes.

proposed funding mechanisms and the nature of the works to be built) but the Project itself was not approved at that time (aside from the allocation of £10.1 million in the 2014 Capital Programme).

8.10 The Assembly approved the construction of a new sewage treatment works with the adoption of *Waste Water Strategy* (P.39/2014). In terms of the Draft Budget, approval is sought under Part (c) of the proposition for the overall spending envelope. Part (c) thereby asks the Assembly to approve a total capital allocation of £75 million for the new sewage treatment works, funding which is to be delivered through allocations "*in future Medium Term Financial Plans and Budget Statements respectively*." That envelope is consistent with the indications given in the 2014 Budget.

8.11 The Draft Budget itself includes an allocation towards the new works within the 2015 Capital Programme. In the 2014 Budget, it was proposed that the Liquid Waste Project would be funded through the following methods:

a. The annual Capital Programme would be used in part, with allocations in 2014, 2016, 2017, 2018 and 2019.

b. Some of the annual infrastructure capital vote to the Department of Transport and Technical Services would be used (in 2014, 2016 and 2017).

c. An investment from the Currency Fund would be made with the investment to be repaid by the Department of Transport and Technical Services.

8.12 The 2014 Budget reported that the first two methods would provide £45.5 million of funding with the investment of the Currency Fund due to make up the remaining £29 million. This is reflected in the Draft Budget where Part (b) of the proposition makes explicit reference to the fact that (if the Draft Budget is approved) the 2015 Capital Programme will in part be funded by an investment of £25,494,000 from the Currency Fund towards the Liquid Waste Project. This is one of the funding sources to which we referred in Paragraph 8.5 above.

8.13 Part (b) of the proposition also stipulates that the investment would be repayable over a period of 40 years according to a "*formula of investment return determined by the Minister for Treasury and Resources after taking advice from the States investment managers*."

8.14 At the time of the 2014 Budget, it was envisaged that repayments could be made with a 4% return and that those repayments would work out at £1.7 million per annum. That sum, it was reported at the time, would be funded through savings within the Department of Transport and Technical Services. £1 million of those savings would be achieved through the greater efficiency delivered by the new sewage treatment plant. Our advisor from CIPFA has highlighted that this would break down into £0.5 million through energy savings; £0.25

million on chemical pasteurisation savings; and £0.25 million of savings due to reduced maintenance costs (there no longer being outdated and customised equipment).

8.15 The remaining £700,000 per annum would be found in other ways by the Department of Transport and Technical Services. The level of savings required by the Department would be lowered if the new sewage treatment works could be delivered for less than £75 million.

8.16 In our report on the 2014 Budget, we highlighted the uncertainty regarding the deliverability of savings to repay the investment from the Currency Fund and we recommended that the Minister clarify how £1.7 million in savings each year would be delivered. Our advisor from CIPFA remains of the view this year that "*this will pose a formidable challenge for the Department especially against the backcloth of further revenue savings it may be obliged to make as a result of overall expenditure retrenchment*." We were advised by the Department of Treasury and Resources that there had been a commitment that the savings would be made. Nevertheless, our advisor from CIPFA has recommended that "*in the context of an additional 2% departmental savings requirement it is recommended that an assessment is undertaken of the ability of the Transport and Technical Services Department to fund the Liquid Waste Project as previously set out within the Budget setting process.*"

KEY FINDING

8.17 **It remains unclear how proposed savings will be met to ensure the Liquid Waste Project can be funded in the way envisaged.**

RECOMMENDATION

8.18 **The Minister for Treasury and Resources should ensure that, prior to the lodging of the next MTFP, an assessment is undertaken of the ability of the Department of Transport and Technical Services to identify savings in order to fund the Liquid Waste Project.**

Hospital Project

8.19 In the 2014 Budget, the Assembly agreed to the funding mechanism proposed for the Hospital Project (namely the planning and creation of new hospital services in Jersey). The Assembly thereby approved an amendment to the policy underlying use of the Strategic Reserve to allow the Reserve to be used towards the Project and also agreed to the first transfer from the Reserve (of £10.2 million) towards the Project. At the time the Assembly was advised that the spending envelope for the Hospital Project was £297 million although that figure was not explicitly agreed as part of the 2014 Budget.

8.20 In the Draft Budget, the Minister seeks the Assembly’s approval of the second tranche of funding; under Part (e) of the proposition, approval is sought for the transfer of £22.7 million from the Strategic Reserve.

8.21 Under Part (i) of the proposition, the Minister is also seeking the Assembly’s agreement to the definition of the capital value of the Strategic Reserve. If agreed, this would reportedly clarify that only investment returns beyond the established capital limit could be used towards the Hospital Project. The Draft Budget explains the assumptions which underline this policy: over the ten years which the Hospital Project is expected to take to be delivered, investment returns are assumed to be 5.2% in 2014; 5.7% in 2015 and 2016; 5.5% in 2017; and then a constant 6.5% from 2018 to 2024. The Draft Budget shows that the actual investment return in 2013 was 14.1%. On this basis, the capital value of the Strategic Reserve would still grow and there would be sufficient investment returns to pay for the Hospital Project. Interestingly, we were advised during our review of the 2014 Budget that planning in respect of the Hospital Project had assumed average returns of 5% during the period of the Reserve’s use towards that Project. Returns of 10% had been experienced during the three previous years and the 2014 Budget presented scenarios to demonstrate what would happen to the Reserve if used for the Hospital Project and if there were returns of 2% and 10%.

8.22 Our advisor from CIPFA has indicated “*reservations on the confidence attached to the level of sustained investment return performance*” and stated that he would be more cautious about the general outlook. He refers in his report to the prospect in respect of interest rates and their link to potential investment returns and suggests that “*an inherently prudent approach be taken upon the incorporation within the Budget modelling*.” He has ultimately recommended that “*in light of current investment returns that the feasibility of delivering investment returns on the Strategic Fund of 5.7% in 2014, 5.7% in both 2015/2016 and 6.5% each year from 2018 to 2024 is further tested*.”

KEY FINDING

8.23 **There are reservations about how much confidence can be attached to the Draft Budget’s anticipated level of sustained investment return performance on the Strategic Reserve.**

RECOMMENDATION

8.24 **The Minister for Treasury and Resources should ensure that, prior to the lodging of the next MTFP, the feasibility of proposed investment returns on the Strategic Reserve is subject to further testing.**

8.25 The proposals in respect of the Strategic Reserve have wider implications in relation to the Fiscal Framework and we shall return to this subject in the next chapter.

8.26 The Hospital Project has been considered by the Health, Social Security and Housing (HSSH) Scrutiny Panel in its review of the redesign of Health and Social Services. A large part of that Panel's work has been to consider plans for future hospital services, including the choices made for the delivery of acute hospital services. That Panel has therefore considered the choices made in respect of siting services and has also looked at how the spending envelope for the project was established. For our part, we have focused on the funding mechanism chosen for the Hospital Project and the implications thereof and have not therefore considered questions regarding the two-site option which has been mooted.

8.27 Last year, we highlighted that there appeared to be at least some doubt regarding the spending envelope for the Hospital Project as although a sum of £297 million had been identified, it had not been 'agreed'. That would appear to remain the case, unlike the Housing Project (for which the spending envelope was agreed as part of the 2014 Budget) and the Liquid Waste Project (for which approval is sought in the Draft Budget). Indeed, our advisor from CIPFA has recommended that the "*capital costs are re-evaluated to ensure that there is appropriate precision within the expected £297m cost exposure and that approved functionality synchronises with these expected costs."*

KEY FINDING

8.28 **Further work is required to ensure confidence in the expected spending envelope for the Hospital Project.**

RECOMMENDATION

8.29 **The Minister for Treasury and Resources should ensure that the capital cost of the Hospital Project is re-evaluated to ensure that there is appropriate precision within the expected spending envelope and that approved functionality synchronises with that expectation.**

8.30 Furthermore, our advisor has repeated comments made to us in respect of the 2014 Budget "*regarding the lack of detailed recurring costs associated with running any new facility*" He has therefore recommended that "*the full life recurring running costs are appropriately evaluated against the MTFP financing capability in respect of the appropriate Health and Social Services Budgets. Whole Life Costing should be fully embedded within the Project Modelling and Revenue Budgets."*

KEY FINDING

8.31 **Whole-life costing should be fully embedded within project modelling and revenue budgets for the Hospital Project.**

RECOMMENDATION

8.32 **The Minister for Treasury and Resources should ensure that, prior to the lodging of the next MTFP, the full-life running costs of the Hospital Project are appropriately evaluated against the MTFP financing capability in respect of the Health and Social Services budget.**

Economic Impact and Deliverability of the Capital Programme

8.33 The following table indicates the anticipated level of capital expenditure over the next few years, as presented in the Draft Budget. This includes capital expenditure from both Departments and the States Trading Operations.

	2014	2015	2016	2017	2018	2019	2020
Total Capital Economic Input (Departmental) (£'000)	59,327	171,114	198,301	130,933	125,685	107,410	81,050
Total Capital Economic input (Trading Operations) (£'000)	13,952	21,435	29,913	13,812	20,871	23,480	23,859
Total Capital Economic Input (£'000)	73,280	192,548	228,213	144,745	146,556	130,890	104,909

[35]

8.34 The FPP has highlighted that "*the amounts of capital expenditure planned by the States between 2015 and 2019 are up to three times higher than previously experienced in Jersey*."

8.35 In recent years the capital programme has been used to help support the economy and that remains the intention. The Minister advised us of his desire to follow recommendations from the FPP that support continue to be delivered in 2015.

8.36 In its report on the Draft Budget, the FPP has downgraded its economic forecasts for 2013 and 2014 from those it produced last year but the FPP expects to see some GVA growth in 2015. The FPP has found that the outlook suggests "*that fiscal policy should continue to support the economy*" in 2014 and 2015. It has therefore recommended that "*the focus in 2014 and 2015 should be on supporting the economy (by running deficits) while there is still spare capacity*." The FPP stated that this support should not be deflected in light of lower tax receipts.

8.37 In its report, the FPP also provides information on the Draft Budget's economic impact by looking at actual anticipated expenditure within the financial year. The Draft Budget itself includes information which shows the economic impact its measures (including the Capital

[35] *Draft Budget Statement 2015* (P.129/2014), Figure 12.9, Page 65

Programme) has as well as the accounting impact it has on the balance sheet (e.g. in relation to the level of the Consolidated Fund.

8.38 The FPP has therefore advised that it would be acceptable to run deficit Budgets over 2014 and 2015 to ensure capital expenditure is delivered. If capital expenditure is to be used to stimulate or support the economy, our advisor from MJO Consultancy has indicated that it is necessary to be sure that the fiscal stimulus meets (and is seen to meet) the '3 Ts' test of the stimulus being 'timely, targeted and temporary'. He has found that this does not consistently appear to have been the case. He has recommended that "t*he fiscal stimulus needs to be re-appraised using all available evidence and international experience*."

KEY FINDING

8.39 **In order to ensure the efficacy of the fiscal stimulus programme, measures to stimulate or support the economy must meet the '3 Ts' test of fiscal stimulus.**

8.40 Planned expenditure is not the same as delivered expenditure, however, and in order for the Capital Programme to have the desired economic impact, the projects need to become reality. This was an issue which became apparent in 2013 when it was made known that, in 2012, capital expenditure had merely amounted to £36 million. We were informed last year that, from the FPP's perspective, capital expenditure was taken to have an economic impact when the tender for a project was awarded. In 2013, capital expenditure amounted to £43.2 million from an approved capital allocation of £62.9 million (£98.9 million in unspent approvals from previous years).

8.41 In terms of deliverability, we have considered whether there would be sufficient capacity within the local construction sector to accommodate capital plans. At the time of the 2014 Budget, we were informed that discussions had taken place with the construction industry about the matter. The FPP's own report on the 2014 Budget suggested that "*output [was then] 12% below the 2010 level, suggesting a significant level of spare capacity*." We ultimately highlighted in our report last year that there was a risk that the injection of large amounts of capital funding over the next ten years could overheat the local economy and we therefore recommended that the Minister should seek to improve the information available on capacity within the construction industry. We were also advised last year that a new reporting mechanism had been developed for the Council of Ministers on capital expenditure to show whether local contractors had been used for existing capital projects.

8.42 In its 2014 report, the FPP has highlighted the risk that significant levels of capital expenditure could put pressure on the capacity of the local construction industry although it acknowledged the work underway to assess construction sector workflow and capacity. We were also advised during our review by the Assistant Minister of the Draft Budget that work had been undertaken on this matter, with figures to be produced in September 2014. The

Minister also informed us of the work which had been undertaken with the Department of Social Security (through the Back to Work scheme) on developing local skills in order that the local construction sector could deliver as much as possible.

8.43 It has been acknowledged, however, that some external labour will be required, for example where specialist skills are required that do not exist within the local sector. The Chamber of Commerce acknowledged that this would sometimes be the case although it asked for consistent communication with the construction industry as a means of mitigating any potential ill-will that might arise. The Chamber President advised us:

"*I always find them [the construction industry] pretty reasonable and if they have gone for the piece and they have not got it because of the specialist requirement I usually find they are fairly accepting of that. What they do not like is that they did not know about it and then find out that it has gone outside the Island and they have perceived they could have done it. That is when you will get the contact just as much as we do and that is when they complain vociferously because of that*."[36]

8.44 Our advisor from MJO Consultancy has suggested that some 500 additional people within the construction industry will be required to deliver the planned capital programme. Consideration of the external resources required is important in light of the Island's migration policy. In 2014, the Assembly adopted an Interim Population Policy which established a planning assumption for use by Departments that 150 households (equating to 325 people) would be the level of net inward migration allowed to the Island for 2014 and 2015. Until further information is provided by the Minister, it is unclear how the proposed Capital Programme (and the resources it will require) will fit in with the Interim Population Policy. The Chamber of Commerce asked how the required capital programme would be resourced within the context of the Interim Population Policy.[37]

8.45 As well as the capacity of resources to undertake the planned capital expenditure, the question of whether the planned expenditure will be realised is affected by other factors (e.g. the receipt of planning approval). We asked the Minister what had been done to address any bottlenecks that might impact upon the delivery of capital expenditure. The Minister advised us of the improved quarterly monitoring process which had been introduced and of work undertaken to meet recommendations from the FPP in this regard.

8.46 Our advisor from CIPFA has highlighted concerns, stating that "*irrespective of further assurances obtained in 2013 and 2015 on better monitoring and a more 'hands on' performance management approach being applied to Capital Projects, the actual outturn performance does not provide sufficient confidence that forecasted profiles will be achieved*

[36] Chamber of Commerce, 24th July 2014, Transcript Page 26
[37] Ibid, Transcript Page 24

on the substantive projects." He has therefore concluded that "*given recent track record and the propensity for complex non-standard projects to be impacted by optimism bias, it would be our view that spend profiles should be treated with an appropriate degree of caution*."

8.47 Our advisor has therefore recommended that "*the legislative framework around the capital allocation process and incorporation within the Budget process be reviewed to allow for the realistic delivery of the Capital Programme and that appropriate performance management arrangements are put in place to ensure delivery.*"

KEY FINDING

8.48 **Actual performance in capital expenditure in recent years does not provide sufficient confidence that forecasted profiles for future capital expenditure will be achieved.**

RECOMMENDATION

8.49 **The Minister for Treasury and Resources should review the legislative framework surrounding the capital allocation process to ensure it allows for the realistic delivery of the Capital Programme and for appropriate performance management arrangements to be put in place, with the outcome of this review to be reported to the States Assembly ahead of the lodging of the next MTFP.**

9. THE LONGER-TERM PICTURE

9.1 We have considered the Draft Budget in the wider context of longer-term financial planning. The Draft Budget will be the last to be debated under the current MTFP. In 2015, the next Council of Ministers will propose a new MTFP and the next Assembly will debate and approve it. We therefore explored the implications of the Draft Budget for the decisions that the next Council and the next Assembly will be required to consider. This appeared to be something which the Minister had also considered; he advised us that a number of reports would be presented alongside the Draft Budget in order to ensure that future decisions about taxation and expenditure would be taken on an informed basis. Some had been presented in time for us to consider them in our review but others had not.

Strategic Reserve

9.2 There are elements within the Draft Budget proposition itself which impact on the longer-term picture and the overall Fiscal Framework. In Part (i) of the proposition, for instance, the Minister seeks the Assembly's agreement:

"*To note the future operation of the Strategic Reserve Fund ('The Fund'), as set out in Appendix D of the Budget Statement and to agree that the Strategic Reserve balance of £651,216,000 as at 31st December 2012 should be defined as the capital value of the Strategic Reserve and that, for future years, the capital value be maintained in real terms by increasing the capital value in line with increases in Jersey RPI(Y).*"

This is not a matter which the Minister is obliged to cover in the Draft Budget under the Public Finances Law but is something he has chosen to include.

9.3 As we have discussed, this measure has been proposed in part because of the use to be made of the Strategic Reserve for the Hospital Project. However, the measure has also been proposed in order to meet a recommendation from the FPP. In its report on the 2014 Budget, the proposed funding mechanism for the Hospital Project led the FPP to express some concerns and to recommend that, before any decision was taken on whether or not to use the Strategic Reserve, "*the States should clearly define the purpose of the Strategic Reserve and set out conditions for its use, including how borrowing from the Reserve would be dealt with*." The FPP also indicated that the use of the Reserve in this way might set a "*worrying precedent*."

9.4 We picked up on the FPP's concerns in our own report on the 2014 Budget and recommended that the Minister should ensure that the purpose and optimal size of the Strategic Reserve and the conditions for its use are clearly defined. Given that the policy that the Reserve may be used "*solely for the purpose of protecting the standard of living of future generations in the Island when the economy faces severe structural decline or a natural disaster*", there needs to be clarity about the capital level.

9.5 At the time of the 2014 Budget, we were advised that the capital level of the Strategic Reserve stood at £117,175,224. That effectively represented the balance of funds which had been transferred in and out of the Reserve by the Assembly over the lifetime of the Reserve.

9.6 We have considered the use of the words 'to note' and 'to agree' in Part (i) of the proposition. There was initially some doubt in our minds as to what the Assembly would agree to if that part of the proposition were adopted. We have concluded that the Assembly is simply being asked to approve the capital value of the Strategic Reserve and the mechanism by which that value will be uprated in future years. The Assembly is not being asked to approve Appendix D which describes the 'future operation' of the Strategic Reserve. We sought confirmation from the Minister that it remained the intention that transfers from the Reserve would only occur with the approval of the Assembly (as the Public Finances Law states). The Minister confirmed that was the case and we were advised that Part (i) of the proposition was intended to make it more, rather than less, difficult for the Strategic Reserve to be used.

9.7 In that vein, it will therefore remain the case that the Strategic Reserve can only be used in the following circumstances:

a. In accordance with P.133/2006, the capital value of the Strategic Reserve can only be used in exceptional circumstances to insulate the Island's economy from severe structural decline such as the sudden collapse of a major industry or from major natural disaster.

b. In accordance with P.84/2009, an exception can be made to enable the Reserve to also be used, if necessary, for the purposes of providing funding for the Bank Depositors Compensation Scheme up to a maximum combined total not exceeding £100 million.

c. In line with the 2014 Budget, a further exception can be made to fund the creation of a new hospital services.

9.8 In its report on the Draft Budget, the FPP has highlighted how the Strategic Reserve can be considered in a different light: as a proportion of GVA rather than simply a monetary value. The FPP has recommended that the aim should be for the Strategic Reserve to sit at a certain proportion of GVA and has shown what will happen in that regard as the Reserve is used for the Hospital Project. The FPP's work indicates that, whilst the monetary value of the Reserve might continue to increase during the undertaking of the Hospital Project (presuming investment returns are in line with assumptions), its value as a proportion of GVA will in fact be negatively affected. It has thereby found that the value is expected to reduce from 20% of GVA in 2014 to 15% of GVA in 2015. In its 2014 report, the FPP has recommended that the value of the Reserve in relation to Jersey's economy and States expenditure should be monitored and that an indication of the desired size should be given.

9.9 It does appear to be the case that the Strategic Reserve is often considered in terms of its monetary value. However, it is apparent from looking at the proposition through which the policy underlying the Reserve was agreed that this might not have been the original intention. The report accompanying *Establishment of a Stabilisation Fund and Policy for Strategic Reserve* (P.133/2006) stated that "*a suitable long-term aspiration is to grow the Strategic Reserve by another £100-£120 million, to a minimum level of around £600 million, so that it equates to about 20% of GDP*."

Stabilisation Fund

9.10 In Part (j) of the proposition, the Minister seeks the Assembly's approval of rules for the future operation of the Stabilisation Fund. Those rules are set out in Appendix E to the Draft Budget. The wording of Part (j) means that, if adopted, the wording of Appendix E would have received explicit approval from the Assembly. The provisions in respect of the Stabilisation Fund are therefore different from what the Assembly is asked to do in relation to the Strategic Reserve under Part (i) of the proposition.

9.11 As the Draft Budget states, the Stabilisation Fund was established on 5th December 2006 with the purpose of making fiscal policy more countercyclical and creating in the Island a more stable economic environment with low inflation.

9.12 We recall that, in its 2013 report, the Fiscal Policy Panel recommended that consideration be given to the maximum 'buffer' that is required in the Consolidated Fund "*for remaining contingencies in a year*", above which level funds should be transferred to the Stabilisation Fund. Given the anticipated levels of the Consolidated Fund described in the Draft Budget, it would not appear that there is a prospect of this mechanism being used to replenish the Stabilisation Fund in the short term.

9.13 Other indications have been given in the past that the Stabilisation Fund would be built up again. For example, when an advance was made to the Department of Housing of £27 million for social housing projects, the Minister indicated at the time that, upon repayment, £10 million from the returned funds would be placed in the Stabilisation Fund.[38] Similarly, last year, during our review of the 2014 Budget, he indicated he would give consideration to placing returns from the States of Jersey Development Company (SoJDC) in relation to the

[38] *Social Housing Schemes: Funding* (P.40/2012)

proposed Esplanade Square development in the Strategic Reserve or Stabilisation Fund.[39] Neither occurred. We were indeed advised during our review that the best course of action would be to put money back in the Stabilisation Fund which would resolve the conflict between an economic drive to run deficits and an accounting imperative for prudent financial management.[40]

9.14 Indeed, the Draft Budget proposes a transfer <u>from</u> the Stabilisation Fund to the Consolidated Fund (as part of the contingent measures). That would leave the balance of the Stabilisation Fund at £0 and it is unclear when the Fund will be used again. It is also apparent that use of the Stabilisation Fund alone may not be sufficient for the States to deliver a counter-cyclical economic policy.

The Fiscal Framework

9.15 The Minister has presented alongside the Draft Budget a number of reports which indicate (or foreshadow) the direction of travel in relation to taxation and expenditure. They have implications for the Fiscal Framework which provides the basis on which policy decisions about taxation and spending are made. Those reports are:

a. *Updating Jersey's Fiscal Framework* (R.102/2014);

b. *Property Tax Review Green Paper* (R.101/2014); and

c. *Property Rates and the States* (R.103/2014)

9.16 R.102/2014 is of particular pertinence. Indeed, the measures proposed in the Draft Budget in relation to the Strategic Reserve, Stabilisation Fund and Housing Development Fund in part stem from the recommendations made in the report. The report was produced in response to recommendations made by the FPP in 2013. MJO Consultancy has welcomed the report. He has highlighted the suggestion contained therein of "*a new rule to 'maintain balanced budgets over the economic cycle'.*" He has suggested that there would need to be a discussion as to what that would mean and whether, for instance, it would mean there no longer being a requirement to ensure the Consolidated Fund did not go into deficit within the financial year but, instead, that deficit financing may become the norm. That would require changes to the Public Finances Law. MJO Consultancy has concluded that an argument is being made for Jersey to follow the route of the United Kingdom and to enter the world of deficit-financing. Our advisor has instead recommended that Jersey should "*run a budget surplus of 0.5% or 1% of GVA over the economic cycle*."

KEY FINDING

39 Minister for Treasury and Resources, 24th October 2013, Transcript Page 35
40 Treasurer of the States, 31st July 2014, Transcript Page 49

9.17 **There is a risk that deficit-financing may become the norm for the States.**

RECOMMENDATION

9.18 **The Minister for Treasury and Resources should investigate the potential for the States to run a budget surplus of 0.5% or 1% of GVA over the economic cycle, with the outcome of this work to be reported to the States Assembly ahead of the lodging of the next MTFP.**

9.19 In addition, documents in respect of the Long-Term Tax Policy and Long-Term Revenue Plan were also due to be presented ahead of the debate on the Draft Budget but they were not presented before this report was completed. Their presentation indicates that the Draft Budget should indeed not only be viewed as the last Budget of the current MTFP but also as the precursor of subsequent financial decisions to be taken. The Minister confirmed that the Draft Budget was consistent with what would be mapped out in those documents. Our understanding during the review (taken from previous statements in respect of the Long-Term Revenue Plan) was that it would have been available earlier in the process and that it would provide a more comprehensive picture than we now expect to see (we understand that it will essentially provide a context in which the Plan can be developed). This is disappointing and we challenged the Minister on why the Long-Term Revenue Plan was not available earlier and highlighted its relevance to the debate on the Draft Budget. The Minister suggested that the Long-Term Revenue Plan was not directly relevant to the immediate provisions of the Draft Budget. However, we do not agree and we have noted the recommendation of our advisor from CIPFA that the Plan "*should be presented to Members as soon as possible for approval.*"

KEY FINDING

9.20 **The Long-Term Revenue Plan will provide directions to both the Budget setting process and the foundation for the MTFP and is of direct relevance to the debate on the Draft Budget.**

RECOMMENDATION

9.21 **The Minister for Treasury and Resources should ensure that the Long-Term Revenue Plan is presented as soon as possible to the Assembly for Members' approval.**

9.22 We have noted further comments made to us about the Draft Budget from stakeholders but also from our advisors. The views expressed have taken into account the issues and questions we have considered in this report, including income forecasts and the need for contingent measures. The advice we have received suggests that there are indeed some significant discussions to be had in the future about fiscal policy.

9.23 The Draft Budget was described to us by the Chamber of Commerce as a 'wake-up Budget'. Similar comments were made to us by both of our advisors. Our advisor from MJO Consultancy, for instance, has stated that the Draft Budget is the "*calm before the storm*" and "*signals the storms ahead*" whilst our advisor from CIPFA has described the Draft Budget as a "*wake-up call.*"

9.24 The reasoning behind these statements from our advisors is explained in their respective reports. Both have expressed concerns about the deliverability of a second CSR and the 'salami slicing' that such an approach would entail. They have both commented on the fact that the revised income forecasts suggest the current MTFP model requires recalibration. Our advisor from CIPFA, for instance, has recommended that "*the LTRP and, indeed, the 2015 Budget requires to be updated with the very latest forecasting rather than using components forged in May / June [2014] […] if more precise information is available as at August*." Indeed, in terms of income, CIPFA has raised the prospect that there has been a shift in the nature of income received by the States. In his report, our advisor shows how Income Tax receipts as a proportion of both total States income and of net revenue expenditure has fallen. He has highlighted the possibility that "*it may well be the case that Jersey's tax system is no longer easily generating tax revenues*" which would have implications for overall fiscal policy. MJO Consultancy has advised us that "*the next MTFP needs to be thoroughly redesigned on economic grounds, using proper economic forecasts and not constructed as if it is an accounting exercise*." Our advisor from CIPFA has therefore recommended that "*the MTFP requires urgent recalibration and Treasury should commence upon this work without delay. It is further recommended that the Council of Ministers should be given the opportunity to approve the changes needed to re-align the MTFP in a way that can provide stability for medium and longer term financial planning."* MJO Consultancy has recommended to us that "*the next MTFP needs to be thoroughly redesigned on economic grounds, using a more robust economic model and not constructed as if it is an accounting exercise*." He has also recommended that "*an investigation [be undertaken] into how the macroeconomic policymaking process can be improved and calibrated to the Economic Growth Plan*."

KEY FINDING

9.25 **An urgent recalibration of the MTFP is required and its redesign needs to be on the basis of a robust economic model and not simply as an accounting model.**

RECOMMENDATION

9.26 **The Minister for Treasury and Resources should request that work begin immediately on the recalibration of the MTFP with a report on progress to be provided to the new Assembly by Christmas 2014.**

9.27 CIPFA has also concluded that "*the income and capital assumptions underpinning the MTFP model are now so removed from the latest tracking that the 2013 – 15 MTFP model is no longer considered to be 'fit for purpose' and requires significant recalibration*." CIPFA has therefore "*strongly suggest[ed] that a framework is created which formally connects expenditure with income capability and is embodied within the Budget setting process in a way that expenditure is fully driven by income generating capability and not on the utilisation of reserves*." MJO Consultancy has has also advised us that expenditure appears to be the driver of the MTFP and has recommended that Sweden's fiscal policy be examined, particularly with regard to annual expenditure limits, as an example of how fiscal policy could be constructed.

9.28 This reflected the testimony of the Chamber of Commerce to us in which we were advised of their view that the time had come for decisions to be made about taxation and expenditure. In that regard, the Chamber President told us:

"*I would hope it would really focus States Members' minds on reform in terms of how expenditure is handled within the States, because I think that we are going to see a few years yet of difficult tax receipts because there is not a whole load of levers you can pull on the income side*."

9.29 Chamber also welcomed the moves towards longer-term planning, however, away from annual budgeting and advised that the 'next step' would be "*a long-term tax policy and [a] move towards some longer-term planning for expenditure and income. So, looking forward 15, 20 years, so a 2030-type plan: where are we going to be by 2030?*"[41]

9.30 The Jersey Consumer Council commented to us that it wished to see reduced government spending as opposed to increased revenues through more taxation. It also wished to see measures introduced to grow the economy which, in turn, would reduce unemployment and generate increased income through taxation. The Council advised us that its recent 'Money Matters' survey had highlighted that "*many consumers are now drawing significant amounts regularly from their savings to stay afloat and to supplement household income*."[42]

9.31 The FPP's report on the Draft Budget also touched upon the longer-term outlook. The FPP highlighted the possibility of a structural deficit within the Island's public finances. However, if there were such a deficit, the FPP recommended that it should be addressed once the economy has recovered (which it was expected would begin in 2016) and intimated that it would be an important consideration for the next MTFP. In particular, the FPP recommended that, in formulating the next MTFP, consideration should be given to balancing the budget over the economic cycle; adopting prudent assumptions for income

[41] Chamber of Commerce, 24th July 2014, Transcript Page 10
[42] Jersey Consumer Council, Written Submission

and realistic assumptions for expenditure; and including flexibility within a clear framework for expenditure. The FPP's report highlights the challenge facing the States in continuing a counter-cyclical fiscal policy at a time when economic conditions would improve. This would require consideration of reducing expenditure and / or raising revenue.

9.32 In his testimony to us, the Minister refuted the Chamber's description of it being a 'wake-up Budget' and claimed that the issues raised by the Draft Budget had not come as a surprise and had been known about well in advance. He advised us that the work surrounding the 2015 Budget was intended to assist with subsequent decision-making:

"*Whoever the Minister for Treasury and Resources is, is going to be before this Panel about a year today discussing the lodging of the next M.T.F.P. and that is the time that we will be debating what we are going to be doing. Do we hold back on expenditure? Do we continue to support a struggling economy? Do we hold back on further revenue investment in healthcare? These are very good legitimate debates and we hope that the issues paper that we publish in September is going to help inform those debates and I hope that they are informed in a way that has not been done in the past*."[43]

9.33 The time has therefore come for a significant debate on the States' finances to take place. The need for this debate is reflected in the advice we have received from our advisors. Our advisor from CIPFA, for instance, has recommended that "*the economic drivers that influence Tax yields are appropriately evaluated [including] the determination of the extent of any Structural Deficit and the likely impacts on Financial Strategy. All available sources of data including any correlation between Social Security contributions and Income Tax yields should be used to inform Financial Strategy. This should be a joint initiative between the Economics Unit and Treasury and Resources*." Finally, he has recommended that "*as well as concentration on expenditure reduction Departments should be encouraged to identify aspects of service provision or other opportunities that can optimise Income generation capability. Service delivery benchmarking should be used to identify wider options deployed by competitors and the UK where appropriate. Such efforts should be co-ordinated centrally by Treasury and that appropriate incentivisation measures should be deployed to encourage and concentrate efforts*." Our advisor from MJO Consultancy, for his part, has recommended that "*the process of economic forecasting should be re-examined*" and that "*an immediate strategy should be agreed for dealing with the structural deficit*." MJO Consultancy has recommended to us that there be "*a full public debate on government expenditure and taxation*."

KEY FINDING

9.34 **The time has come for a full debate on States' expenditure and taxation.**

[43] Minister for Treasury and Resources, 18th July 2014, Transcript Page 31

9.35 **Further work is required in order to determine both the size of any structural deficit facing the Island and the strategy to be used to address it.**

RECOMMENDATION

9.36 **The Minister for Treasury and Resources should ensure that, prior to the lodging of the next MTFP, Departments are requested to identify measures to optimise income generation capability, with service delivery benchmarking to be used as a means of identifying wider options.**

9.37 **The Minister for Treasury and Resources should ensure that, prior to the lodging of the next MTFP, the economic drivers that influence tax yields are re-evaluated and that all sources of data (including Social Security contributions) are used to inform financial strategy and to determine the extent of any structural deficit.**

10. CONCLUSION

10.1 The Draft Budget will be one of the last propositions debated by the current Assembly. However, the context in which the Draft Budget has been produced, and in which it will be debated, means that the Budget will have significant implications for debates and decisions of the next Assembly. Normally discussions about Draft Budgets centre on individual taxation proposals. That has not been the case this year and attention has been drawn to more fundamental issues regarding income forecasts; whether the Island's income profile is changing; and what implications that might have for expenditure plans. As we have noted, the time has come for a significant debate on States income and expenditure to take place.

10.2 It would be tempting to look back and focus on what could or should have happened in 2013 in relation to income forecasts. We have instead endeavoured to look ahead to the 2016 Budget and the next MTFP in order to identify constructive recommendations which, if implemented, will assist the next Assembly in debating those propositions and in addressing the issues which we have highlighted. It is apparent that a number of actions are required.

10.3 In the immediate term, there should be an independent review of income figures and the Department of Treasury and Resources should conduct an investigation into the size of the structural deficit. It may well be beneficial if the FPP were asked to review both of these actions and to advise on the economic options.

10.4 Looking further ahead to the lodging of the next MTFP, by that time there needs to have been a root-and-branch review of expenditure in all Departments. There needs to be a Fundamental Spending Review (FSR) to identify real and permanent savings (i.e. base budget reductions) with the Comptroller and Auditor General subsequently invited to review that FSR. Of particular significance, the Long-Term Revenue Plan needs to be produced.

10.5 If there is a shortfall in income (and if the balance of the Consolidated Fund is adversely affected in relation to the Public Finances Law's requirements), we anticipate that there might need to be a further Budget. This is feasible under the Law: the next Minister could lodge a further Budget in 2015 for the year if it became necessary. What also might need to be considered is the use of the Strategic Reserve (although we would hope to see any funds used replaced over the lifetime of the next MTFP). There also needs to be a review of economic forecasting and efforts made to top up the Stabilisation Fund.

10.6 Such measures are necessary to ensure that the next MTFP and the 2016 Budget can be developed in a context in which the financial picture is truly understood and in which the significant challenges which lie ahead can best be addressed.

11. APPENDIX 1: PANEL MEMBERSHIP, TERMS OF REFERENCE AND EVIDENCE CONSIDERED

Panel Membership and Terms of Reference

11.1 The Corporate Services Scrutiny Panel comprises the following Members:

Senator S.C. Ferguson, Chairman

Deputy J.G. Reed, Vice-Chairman

Connétable D.W. Mezbourian

Deputy R.J. Rondel

Deputy T.A. Vallois [Co-opted to the Panel for the purposes of the review under Standing Order 138(5A)]

The Panel appointed MJO Consultancy, represented by Professor M. Oliver, and the Chartered Institute of Public Finance and Accountancy (CIPFA), represented by Mr. S. Fair, to act as expert advisors during the review.

11.2 The following Terms of Reference were agreed for the review:

1. To consider the proposals of the Minister for Treasury and Resources in the Draft 2015 Budget Statement in respect of:
   a) Income Tax;
   b) Goods and Services Tax (GST);
   c) Impôts;
   d) Stamp Duty; and
   e) Other tax proposals;
2. To consider the Capital Programme for 2015 as presented in the Draft 2015 Budget Statement;
3. To consider any transfers which the Minister may propose in the Draft 2015 Budget Statement between the Consolidated Fund and other Funds;
4. To consider how the Draft 2015 Budget Statement fits within long-term tax policy;
5. To consider the economic implications of the Minister's proposals in the Draft 2015 Budget Statement;
6. To consider the current status of the financing of the Housing, Hospital and Liquid Waste Projects;

7. To consider how the Key Findings and Recommendations of *Medium Term Financial Plan* (SR18/2012) have been addressed by the Minister; and

8. To assess the implications of the Long-Term Revenue Plan for the 2016 – 2018 Medium Term Financial Plan.

Evidence Gathered

11.3 The following documents were considered by the Panel and its expert advisors during the review:

1. *Review of States of Jersey Financial Forecasting* (SR13/2008), Corporate Services Scrutiny Panel, 2nd December 2008
2. *Strategic Reserve Fund Investment Strategy*
3. *Fiscal Policy Panel Report: Response of the Minister for Treasury and Resources* (R.149/2013), Minister for Treasury and Resources, 3rd December 2013
4. Written Question to the Minister for Treasury and Resources tabled by Deputy J.A.N. Le Fondré, 18th February 2014
5. *Ratings on States of Jersey Affirmed at 'AA+ / A-1+'; Outlook Stable*, Standard and Poor's Ratings Services, 23rd May 2014
6. *Income Tax Forecast Note for Income Tax Forecasting Group*, May 2014
7. *2013 Carry Forward Report*, Department of Treasury and Resources
8. *Monthly Budget Monitoring Report – May*, Department of Treasury and Resources
9. *Long-Term Tax Policy Programme* [Draft], Department of Treasury and Resources, 4th June 2014
10. Act B2, Council of Ministers, 11th June 2014
11. *Budget 2015 Pre-Budget Briefing*, Department of Treasury and Resources, 13th June 2014
12. *Tax Revenues Report for the period ending 30 June 2014* [Extract], Taxes Office
13. *Quarterly Corporate Revenue Report – June 2014*, Department of Treasury and Resources
14. *Jersey's Fiscal Policy Panel Annual Report – June 2014*
15. *Budget 2015 Pre-Budget Briefing*, Department of Treasury and Resources, 10th July 2014

16. *Budget 2015 – Council of Ministers 11th July 2014*, Department of Treasury and Resources, 11th July 2014

17. *Budget 2015 Pre-Budget Briefing*, Department of Treasury and Resources, 17th July 2014

18. *Draft Budget Statement 2015* (P.129/2014), Minister for Treasury and Resources, 18th July 2014

19. *Draft Income Tax (Amendment No.44) (Jersey) Law 201-* (P.130/2014), Minister for Treasury and Resources, 18th July 2014

20. *Property Tax Review Green Paper – July 2014*, Minister for Treasury and Resources, 18th July 2014

21. *Updating Jersey's Fiscal Framework* (R.102/2014), Minister for Treasury and Resources, 18th July 2014

22. *Property Rates and the States* (R.103/2014), Minister for Treasury and Resources, 18th July 2014

23. *MTFP Financial Forecasts – Timeline*, Department of Treasury and Resources

24. Social Security Contributions Data 2007 – 2014, Department of Social Security

25. *Budget 2015 – Plan of Proposed Measures to Manage the Consolidated Fund*, Council of Ministers, 3rd September 2014

26. *Draft Budget Statement 2015 (P.129/2014): Fourth Amendment* (P.129/2014(Amd4)), Minister for Treasury and Resources, 8th September 2014

11.4 The Panel wrote directly to a number of key stakeholders, from which the following written submissions were received:

1.	Randalls Limited	16th July 2014
2.	Chartered Institute of Taxation	25th July 2014
3.	Jersey Consumer Council	29th July 2014
4.	JT	1st August 2014
5.	Jersey Water	4th August 2014
6.	Jersey Post	5th August 2014

11.5 The Panel received two briefings from the Minister for Treasury and Resources and his Department during the development of the Draft Budget: on 13th June and 10th July 2014. In addition, the following Public Hearings were held:

18th July 2014	Senator P.F.C. Ozouf, Minister for Treasury and Resources, accompanied by Ms. L. Rowley, Treasurer of the States
23rd July 2014	Mr J. Filleul, President, Mr I. Taylor, Chief Executive, and Mr R. Kirkby, Finance Committee Chair, from the Chamber of Commerce
31st July 2014	Senator P.F.C. Ozouf, Minister for Treasury and Resources, accompanied by Deputy E.J. Noel, Assistant Minister for Treasury and Resources, and Ms. L. Rowley, Treasurer of the States

11.6 The transcripts of the Public Hearings, as well as those written submissions not received in confidence, are available to read on the Scrutiny website: www.scrutiny.gov.je

12. APPENDIX 2: REPORT FROM CIPFA

CORPORATE SERVICES SCRUTINY PANEL

BUDGET 2015

REPORT
September 2014

CIPFA
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London WC 2N 6RL
Phone: 0207 543 5600
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CIPFA FINANCE ADVISORY

Certificate No. 5631/06

Contents

1. Executive Summary

1.1 In July 2014, the States of Jersey commissioned CIPFA Business - Finance Advisory (the commercial arm of the Chartered Institute of Public Finance and Accountancy) to support the work of the Corporate Services Scrutiny Panel in its assessment of the States of Jersey Budget Proposals 2015. This draft report outlines CIPFA's preliminary position on this work to 5 September 2014.

Our Approach

1.2 Our approach to this independent review has sought to draw together a wide range of evidence together as a foundation for our analysis and assessment of the Budget Proposals 2015. Our scope of work included for the assessment of the Financial Management attributes of good practice in respect of the main components of the Budget Proposition as outlined within the Draft Budget Statement 2015.

2015 Budget Statement

1.3 The largest movement between the 2014 and 2015 Budget Compilation processes have undoubtedly been Income related and the consequential emergence of potential budget deficits which challenge the balancing of the Consolidated Fund. The differential from a positive closing balance of £5.7m to a projected deficit for 2014 of £34.5m - a net movement on forecasts of some £40.2m, is extremely significant within a 12 month period between Budget Statement compilation. The latest projected 2015 deficit on the Consolidated Fund before Budget proposals is estimated to be £50.0m.

1.4 Initial remedial measures of some £47.797m for 2014 and £28.137m for 2015 appear to have been injected fairly late within the 2015 Budget strategy work as we understand that a further Income Tax base rate reduction of 1% was being actively contemplated as recently as June. This was before the requirement to urgently recalibrate the short term financial forecasting model as a result of a significant downward revision of 2014 Income becoming evident. The remedial measures had been initially applied to the budget process in order to bring the Consolidated Fund back to surplus from a projected £34.453m deficit to a surplus £13.344m by the end of 2014 and a break even position by the end of 2015. Such measures included a mix of generating additional unbudgeted income from States Strategic Investments, utilising balances on other reserves and funds, delivery of Departmental Revenue expenditure savings of 2% and deferment of contributions and re-phasing of capital etc. It is a requirement of Jersey Law that measures are taken by the Minister to ensure that any deficit Consolidated Fund is negated. Subsequent modifications to these measures were agreed by the Council of Ministers on 3 September 2014 (including a 1% reduction in the Pay Award Contingency for 2015) culminating in revised projected surplus balances on the Consolidated Fund of £14.844m in 2014 and £3.851m in 2015 respectively.

1.5 On the base forecasting model the Net Revenue Expenditure Deficits before Budget Measures were estimated as £31.2m for 2014 and £39.2m for 2015. However, as we understand that as there is a continuing deterioration in 2014 income (which is now estimated at approximately £40m below budget within 2014), we would take the view that such positions may be optimistic given the downward trend in income. Additionally, the States do not have a strong track record on delivering savings (previous CSR difficulties) and the expected £12m of departmental savings introduced through remedial measures to be achieved in 2015 is considered to be extremely challenging.

1.6 Within our previous scrutiny work on the 2014 Budget we provided a cautionary note on the affordability of the previous marginal Income Tax reduction/other Budget proposals and advised that the baseline assumptions on the critical economic assumptions required further testing. It is obvious looking back that there were no plans to recalibrate core spend in direct relationship with reducing Tax yields and there is now a disconnect between expenditure profiles and related funding. A real indicator of this can be seen in a shift in the proportion of Income Tax to Net Revenue expenditure from a relationship of 71% of Income tax to Net Revenue Expenditure in 2013 and 70.9% for Budget 2014 to a 65.8% comparative position for Budget 2015 – down 5%. The fact that a further 1% cut in the marginal rate of Income Tax was in recent contemplation when Income Tax Forecasts produced by the ITFG showed a significant downturn on Tax yields further suggests a lack of clear direction in the setting of Financial Strategy.

Funding Core Spend from Specific Reserves

1.7 The need to fund core net spend from specific reserves/funds, together with the apparent speed by which the remedial measures have been put together does not inspire confidence that the 2015 Budget has been founded on sound principles and good financial management practice. The utilisation of <u>specific reserves to fund core spend</u> is a "real wake-up call" and is typically the product of a rapidly deteriorating fiscal position. It is clear that the proposed remedial measures lack maturity and in some examples clearly contradict what was thought to be settled strategy.

1.8 A key factor in the timeline of events appears to be the need to do something to rebalance the impact, on the latest intelligence, of falling income streams as well as the inability to influence core mainstream expenditure. The main assumptions underpinning the MTFP model are now so removed from the latest tracking that the 2013-15 MTFP model is no longer considered to be 'fit for purpose' and requires significant recalibration.

1.9 Given the continuing deteriorating position on Income Tax forecasts it is critical that the latest income forecasts are used in determining the 2014 Outturn and setting the base for 2015. The available information from the Tax Office is considered to be comprehensive and robust. Given the complete 'turn around' in the tenor of the 2015 Budget, it is essential that Members are provided with objective, comprehensive and contemporaneous Budget information that will allow an appropriate level of assurance and facilitate informed decision making.

Summary

1.10 If the causal misalignment of Expenditure with Income is not adequately addressed the States will face even larger Deficits moving forward on 2016 and 2017 and less flexibility in the utilisation of Reserves. In order to allow for the setting of a robust financial strategy there needs to be a cultural acceptance within the States of the underlying factors that have had a negative impact upon the 2015 Budget Setting process and there is an urgent need to pursue a strategy of recovery and stability. Whilst the option of raising Taxes may be counterintuitive and may be adversely affect the potential competitiveness of Jersey, such is the States' current financial position in the context of the uncertainty of the current and future economic landscape that the concept of raising additional revenue generation should not be ruled out.

Recommendations – Moving Forward

1.11 Should the Corporate Services Scrutiny Panel be minded to approve the 2015 Budget proposition, as now constituted, we would recommend that such approval be given subject to a range of measures designed to improve the effectiveness of the Budget Strategy process being implemented - our twelve recommendations are outlined below:-

Remedial Measures impacting Financial Forecasts – it is critical that Departments are signed-up to delivering on Base Budget reductions. We would recommend that the ability of remedial measures designed to ameliorate expected Budget deficits are critically appraised in relation to their propensity for delivery. We believe that this 'savings' validation work is urgently required as delivery of such measures will be an important component of how Jersey deals with realigning deficits. In terms of independence it may be expedient if this work was conducted by the Comptroller and Auditor General;

Capital Programme Performance – it is recommended that the legislative framework around the Capital Allocation process and incorporation within the Budget process be reviewed to allow for the realistic delivery of the Capital Programme and that appropriate performance management arrangements are put in place to ensure delivery;

Replacement Hospital - Capital Programme – it is recommended that Capital Costs are re-evaluated to ensure that there is appropriate precision within the expected £297m cost exposure and that approved functionality synchronises with these expected costs;

Replacement Hospital – Recurring Revenue Costs – it is recommend that the full life recurring running costs are appropriately evaluated against the MTFP financing capability in respect of the appropriate Health and Social Services Budgets. Whole Life Costing should be fully embedded within the Project Modelling and Revenue Budgets;

Funding the Replacement Hospital – Strategic Reserve – it is recommended that in light of current investment returns that the feasibility of delivering investment returns on the Strategic Fund of 5.7% in 2014, 5.7% in both 2015/2016 and 6.5% each year from 2018 to 2024 is further tested;

Funding the Liquid Waste Project – in the context of an additional 2% departmental savings requirement it is recommended that an assessment is undertaken of the ability of the Transport and Technical Services Department to fund the Liquid Waste Project as previously set out within the Budget setting process;

Income Tax Forecasting Group - ITFG – Membership and attendance of this group should be formalised within a structured reporting framework – quarterly outwith Budget setting –

Monthly with Budget setting quarter with formal minutes being made available to the Council of Ministers;

Base Budget Setting - latest Forecasts MUST be used as the foundation for informing the Budget Setting Process, as far as reasonably practical to the point where Members are provided with the details within the States approval process;

Long Term Revenue Plan (LTRP) – this promised analysis which should provide direction to both the Budget Setting Process and a foundation for the MTFP should be presented to Members as soon as possible for approval;

Economy and Financial Strategy – it is recommended that the economic drivers that influence Tax yields are appropriately evaluated. This will include the determination of the extent of any Structural Deficit and the likely impacts on Financial Strategy. All available sources of data including any correlation between Social Security contributions and Income Tax yields should be used to inform Financial Strategy. This should be a joint initiative between the Economics Unit and Treasury and Resources;

Medium Term Financial Plan (MTFP) – the MTFP requires urgent recalibration and Treasury should commence upon this work without delay. It is further recommended that the Council of Ministers should be given the opportunity to approve the changes needed to re-align the MTFP in a way that can provide stability for Medium and Longer Term Financial Planning; and

Optimising Income Generation Capability – as well as concentration on expenditure reduction Departments should be encouraged to identify aspects of service provision or other opportunities that can optimise Income generation capability. Service delivery benchmarking should be used to identify wider options deployed by competitors and the UK where appropriate. Such efforts should be co-ordinated centrally by Treasury and that appropriate incentivisation measures should be deployed to encourage and concentrate efforts.

2. Introduction

2.1 In July 2014, the States of Jersey commissioned CIPFA Business - Finance Advisory (the commercial arm of the Chartered Institute of Public Finance and Accountancy) to support the work of the Corporate Services Scrutiny Panel in an assessment of the States of Jersey Budget Proposals 2015. This draft report outlines CIPFA's preliminary position on this work to 19 August 2014.

Our Approach

2.2 Our approach to this independent review has sought to draw together a wide range of evidence together as a foundation for our analysis and assessment of the Budget Proposals 2015.

2.3 The majority of the conclusions and recommendations contained within this draft Report are based on informal and formal interviews with Officers within the States of Jersey and Document Review. Evidential sources also included prevailing best practice on Budget setting and wider Financial Management practice as encapsulated within the CIPFA Financial Management Model.

Scope

2.4 Our scope of work included for the assessment of the Financial Management attributes of good practice in respect of the main components of the Budget Proposition outlined within the Draft Budget Statement 2015 covering the following:-

- Budget Deficit Modelling
- Remedial Measures
- Income Tax Yield Forecasts and the MTFP
- Impots and Stamp Duty Changes
- Capital Programme

Focus – Emerging Deficits

2.5 One of the most significant aspects of the 2015 Budget Proposition and supporting statements is the recognition of a significant deterioration in Income Tax yield. This deterioration has only recently come to light and consequential emergency remedial measures have been introduced to mitigate projected Consolidated Fund Balance deficit positions which have now emerged as being forecasted as £34.5m for 2014 and £41.5m for 2015. These remedial measures are over and above the basic 2015 Budget proposal measures.

2.6 Traditionally, Budget scrutiny predominately relates to basic adjustments to Income tax, Impots, Stamp Duty and other income and expenditure proposals which are typically associated with setting the States Budget. Given the forecasted deficits for 2014 and 2015 that are now embodied within the 2015 Budget Statement, the basic proposals outwith the remedial measures for 2015 are of relatively minor significance. These 2015 'traditional' budget type proposals amount to only some £0.962m of net addition 'Duty' revenue to be generated in 2015 onwards with a recurring net reduction of £3.3m per annum on Income Tax yield base expected to kick in from 2016 onwards. Accordingly our primary attention has been focussed upon:-

- The efficacy of the remedial measures now proposed to mitigate such emerging deficits;
- The ability to reduce expenditure;
- The robustness of forecasting; and
- The relevancy of the MTFP in such a context.

3. Budget Deficit Modelling

3.1 The largest movement between the 2014 and 2015 Budget Compilation processes have undoubtedly been Income related and the consequential emergence of potential budget deficits which challenge the balancing of the Consolidated Fund.

3.2 It is interesting to note that the projected closing balance on the Consolidated Fund Balance for 2014 within the 2014 Draft Budget Statement1 was £5.7m after a proposed transfer of the Strategic Reserve of £10.2m and the transfer from the Currency Fund of £3m. The differential from a positive closing balance of £5.7m to a projected deficit for 2014 of £34.5m - a net movement on forecasts of some £40.2m (in addition to these two 2014 transfers), is extremely significant within a 12 month period between Budget Statement compilation.

3.3 The following table is an extract from Page 56 – Figure 11.1 of the 2015 Draft Budget Statement highlight the projected Consolidated Fund balances after the basic Budget proposals-

	2014	2015
	£'000	£'000
Consolidated Fund balance from 2013 Outturn	**316**	**985**
Income Tax (ITFG) forecast (May 2014)	**(30,965)**	**(44,475)**
GST forecast (May 2014)	(2,848)	(3,858)
Impots forecast (May 2014)	710	-
Stamp Duty forecast (May 2014)	(4,672)	(5,083)
Other Income (May 2014)	3,006	2,705
Total Other income potential forecast	**(3,804)**	**(6,236)**
Total Projected Income Shortfall (excluding Budget 2015 measures)	**(34,769)**	**(50,711)**
Projected Consolidated Fund balance - pre Budget proposals	**(34,453)**	**(49,726)**
Impact of proposed 2015 Budget measures included in financial forecast		
Income Tax - amend double tax credit provision		
Income Tax - reduce MITR cap to £15,000		
Income Tax - increase exemption thresholds by 1.7%		
Impôts duty increases		637
Reduce Stamp Duty on borrowing to £400k		(532)
Increase Stamp Duty rates > £1 million		857
Total 2015 Budget measures	-	**962**
Changes to Capital Programme included in financial forecast		
Increased Consolidated Fund allocation		**(1,297)**
Proposed measures to balance Consolidated Fund included in Financial Forecast		
Apply Jersey Post and Jersey Water to reduce Consolidated Fund Captal Allocation		11,800
Rephasing of unspent capital approvals - reallocated in 2015		(3,220)
Projected Consolidated Fund balance - after Budget proposals	**(34,453)**	**(41,481)**

3.4 Initial remedial measures of some £47.797m for 2014 and £28.137m for 2015 appear to have been injected fairly late within the 2015 Budget strategy work as we understand that a further Income Tax base rate reduction of 1% was being actively contemplated as recently as June 2014 before the requirement to urgently recalibrate the short term financial modelling as a result of a significant downward revision of 2014 Income had become evident.

[1] Draft Budget Statement - Summary Table F – Consolidated Fund Forecast for 2014 – page 164

3.5 The proposed 2015 remedial 'emergency' measures have been applied to the budget process in order to bring the Consolidated Fund back to surplus from a projected £34.453m deficit to a surplus £13.344m by the end of 2015. Such measures, as contained within Page 56 – Figure 11 of the 2015 Budget Statement include a mix of receiving additional unbudgeted income from States Strategic Investments, utilising balances on other reserves and funds, delivery of Departmental Revenue expenditure savings and deferment of contributions and re-phasing of capital etc. It is a requirement of Jersey Law that measures are taken by the Minister to ensure that any deficit Consolidated Fund is negated. Article 10(8) of the Public Finances (Jersey) Law 2005 states:

"The Minister must not lodge a draft budget that includes a report that shows a deficit in the consolidated fund at the end of the financial year to which the budget relates."

3.6 Indeed, we further understand that Article 10(8) of the Public Finances (Jersey) Law 2005 requires the Minister to take steps to ensure that decisions and related financial impacts will not create a deficit in the Consolidated Fund to be established at the point in time of the end of the financial year. The remedial measures have obviously been put together, as far as reasonably be practical to ensure a positive balance is achieved at financial year end. The following is an extract from Figure 11.1 of the 2015 Budget Statement:-

Proposed measures that would affect the Financial Forecast		
Contributions from States Strategic investments		
Proposed Jersey Post Extraordinary Dividend	5,000	
Possible Jersey Telecom Payment of deferred Gigabit Dividend	3,000	3,000
Utilising available balances on Funds and Reserves		
Transfer from Court and Case Costs Contingency	3,600	
Transfer from Insurance Fund	2,500	
Utilisation of available Drug Trafficking Confiscation Funds		1,100
Utilisation of available Criminal Offences Confiscation Funds	6,400	
Proposed savings		
Proposed savings from ALL departments 1% pay budgets		3,640
Proposed savings from ALL departments 1% on gross non pay budgets		2,395
Proposed reduction in 2014 carry forwards of ALL departments	5,000	
Reduce Contingency allocation to FoI funding by £1m		1,000
Further savings		
PECRS - delay increased repayment of pre 1987 debt	1,000	2,000
Proposed savings from ALL departments of a further 1% pay budgets		3,640
Proposed savings from ALL departments of a further 1% on gross non pay budgets		2,395
Proposed reduction in 2015 carry forwards of ALL departments		5,000
Other measures if required		
Proposed deferral/reduced contribution to Long Term Care Fund (LTCF)	5,000	5,000
Further rephasing of capital, increased shareholder contributions and savings		3,967
Proposed Measures that would affect the Consolidated Fund balance		
Contributions from States Strategic investments		
Proposed redemption of Jersey Water preference share		6,800
Apply Redemption of Jersey Water preference share		(6,800)
Apply Jersey Post Extraordinary Dividend		(5,000)
Utilising available balances on Funds and Reserves		
Proposed transfer from Housing Development Fund (HDF) to Consolidated Fund	6,120	
Proposed transfer from Dwelling Houses Loans Fund (DHLF) to Consolidated Fund	2,000	
Proposed transfer from Stabilisation Fund to Consolidated Fund	1,058	
Rephasing of Unspent capital approvals - return to Consolidated Fund	7,119	
Consolidated Fund c/fwd		**13,344**
Projected Consolidated Fund balance after Proposed Measures	**13,344**	-

CIPFA The Chartered Institute of Public Finance & Accountancy

3.7 Subsequent to consideration of the Budget Proposition measures the Council of Ministers have approved and published on 3 September a revised "Plan of measures to manage the Consolidated Fund". The revisions effectively reduce some initial measures and introduce compensating measures, the aim of which is to restore the Consolidated Fund to a surplus of £3.851m by 31 December 2015.

3.8 An extract to the revisions to the proposed changes for 2015 are set out below:-

	2015
	£'000
End position per Figure 11.1 of Draft Budget Statement 2015 - "Proposed Measures to Balance the Consolidated Fund"	-
Necessary reductions to proposed measures:	
Reduce Proposed Jersey Post Extraordinary Dividend	**(3,000)**
Remove Shortfall in available COCF funding	**(1,100)**
Remove Further rephasing of capital, increased shareholder contributions and savings (this was a balancing figure with no specific measures developed in the original plan)	**(3,967)**
Total reductions to proposed measures by 2015	**(8,067)**
Compensating measures identified:	
Rephasing of JDE capital project - reallocated in 2016	**1,238**
Increase DHLF Transfer	**4,500**
Utilisation of unspent balance on Restructuring Provision 2015	**2,700**
Reduce Contingency allocation to 2015 Pay Award by 1%	**3,480**
Total Compensating measures by 2015	**11,918**
Projected 2015 Consolidated Fund balance after proposed changes	**3,851**

3.9 The revised changes for both 2014 and 2015 are laid out in the extract from the Council of Minsters Report of 3 September 2014 - Appendix B – Page 7 below:-

	2014	2015	
	£'000	£'000	
Consolidated Fund balance from 2013 Outturn	**316**	**985**	
		(316)	
Income Tax (ITFG) forecast (May 2014)	**(30,965)**	**(44,475)**	
GST forecast (May 2014)	(2,848)	(3,858)	
Impots forecast (May 2014)	710	-	
Stamp Duty forecast (May 2014)	(4,672)	(5,083)	
Other Income (May 2014)	3,006	2,705	
Total Other income potential forecast	**(3,804)**	**(6,236)**	
Total Projected Income Shortfall (excluding Budget 2015 measures)	**(34,769)**	**(50,711)**	
			2016
Projected Consolidated Fund balance - pre Budget proposals	**(34,453)**	**(50,042)**	**£000**
<u>Impact of proposed 2015 Budget measures included in financial forecast</u>			
Income Tax - amend double tax credit provision			(500)
Income Tax - reduce MITR cap to £15,000			100
Income Tax - increase exemption thresholds by 1.7%			2,100
Impôts duty increases		637	637
Reduce Stamp Duty on borrowing to £400k		(532)	(532)
Increase Stamp Duty rates > £1 million		857	857
Total 2015 Budget measures	-	**962**	**2,662**
<u>Changes to Capital Programme included in financial forecast</u>			
Increased Consolidated Fund allocation		**(981)**	
Projected Consolidated Fund balance - after Budget proposals	**(34,453)**	**(50,061)**	
<u>Proposed measures to balance Consolidated Fund included in Financial Forecast</u>			
Apply Jersey Post and Jersey Water to reduce Consolidated Fund Captal Allocation		8,800	
Rephasing of unspent capital approvals - reallocated in 2015		(1,982)	
	(34,453)	**(43,243)**	
<u>Proposed measures that would affect the Financial Forecast</u>			
<u>Contributions from States Strategic investments</u>			
Proposed Jersey Post Extraordinary Dividend	2,000		
Possible Jersey Telecom Payment of deferred Gigabit Dividend	3,000	3,000	
<u>Utilising available balances on Funds and Reserves</u>			
Transfer from Court and Case Costs Contingency	3,600		
Transfer from Insurance Fund	2,500		
Utilisation of available Criminal Offences Confiscation Funds	6,400		
<u>Proposed savings</u>			
Proposed savings from ALL departments 2% budgets		12,070	
Proposed reductions carry forwards of ALL departments	5,000	5,000	
Reduce Contingency allocation to FoI funding by £1m		1,000	
PECRS - delay increased repayment of pre 1987 debt	1,000	2,000	
<u>Other measures if required</u>			
Proposed deferral/reduced contribution to Long Term Care Fund (LTCF)	5,000	5,000	
Utilisation of unspent balances on Restructuring Provision 2015		2,700	
Reduce Contingency allocation to 2015 Pay Award by 1%		3,480	
<u>Proposed Measures that would affect the Consolidated Fund balance</u>			
<u>Contributions from States Strategic investments</u>			
Proposed redemption of Jersey Water preference share		6,800	
Apply Redemption of Jersey Water preference share		(6,800)	
Apply Jersey Post Extraordinary Dividend		(2,000)	
<u>Utilising available balances on Funds and Reserves</u>			
Proposed transfer from Housing Development Fund (HDF) to Consolidated Fund	6,120		
Proposed transfer from Dwelling Houses Loans Fund (DHLF) to Consolidated Fund	6,500		
Proposed transfer from Stabilisation Fund to Consolidated Fund	1,058		
<u>Rephasing of Unspent capital approvals - return to Consolidated Fund</u>	7,119		
Consolidated Fund c/fwd		**14,844**	
Projected Consolidated Fund balance after Proposed Measures	**14,844**	**3,851**	

3.10 In respect of 2014 it is interesting to note that the revised measures includes for an additional £4m of a transfer from the Dwelling Homes Loans Fund to the Consolidated Fund which makes the transfer of now £6.5m. As a consequence, the Council of Ministers Report of 3 September states – "Any monies required for future starter home deposit schemes would need to be requested from the Consolidated Fund." We would now assume that future access for funding this activity is now going to be tied to the 'financial health' of the Consolidated Fund.

3.11 Outside of the impact on the Consolidated Fund and the relevant legal parameters relative to Budget setting, the Financial Forecast position highlights Deficits of £33.234m for 2014 and £39.196m for 2015 before any remedial measures as follows:-

Outturn	Financial Forecast (incl. budget measures)	Budget 2014 (Dec 2013)			Budget 2015 (Jul 2014)	
2013 £'000		2013 £'000	2014 £'000	2015 £'000	2014 £'000	2015 £'000
	States Income					
451,661	Income Tax	454,965	474,965	499,475	444,000	455,000
77,603	Goods and Services Tax	79,761	81,955	84,508	79,107	80,650
54,320	Impôts Duty	54,534	54,903	55,012	55,613	55,649
17,370	Stamp Duty	24,529	27,402	28,961	22,730	24,203
24,093	Other Income	20,545	21,926	24,764	38,842	57,175
11,641	Island Rate	11,670	12,032	12,453	11,956	12,219
636,688	**States Income**	**646,004**	**673,183**	**705,173**	**652,248**	**684,896**
	States Expenditure					
636,186	Departmental Net Revenue Expenditure	626,224	661,966	673,194	675,800	702,666
	Central Allocations	7,547	7,633	17,963	7,633	17,963
636,186	**Total Net Revenue Expenditure (excl: Depn)**	**633,771**	**669,599**	**691,157**	**683,433**	**720,629**
502	**Forecast Surplus/(Deficit) for the year**	**12,233**	**3,584**	**14,016**	**(31,185)**	**(35,733)**
12,566	Net Capital Expenditure Allocation	12,566	2,049	11,062	2,049	3,463
(12,064)	**Forecast Surplus/(Deficit) for the year after Capital**	**(333)**	**1,535**	**2,954**	**(33,234)**	**(39,196)**
Proposed measures:						
	Contributions from States strategic investments				8,000	3,000
	Available balances on other funds to offset expenditure				12,500	1,100
	Proposed savings				6,000	20,070
	Other measures if required				5,000	8,967
Total Proposed Measures					31,500	33,137
Forecast Surplus/(Deficit) after proposed measures		**(333)**	1,535	2,954	**(1,734)**	**(6,059)**

Remedial Measures

3.12 The proposed remedial measures are £31.5m for 2014 and £33.1m respectively. Forecasted deficits of £1.7m relate to 2014 and £6.1m relate to 2015. These measures exclude some of the utilisation and transfer of other reserves - £16.397m in respect of this financial year to help stabilise the Consolidated Fund in accordance with relevant legal parameters outlined above. Essentially the Financial Forecast model tries to capture total movement in Income and Spend including changes to Capital Allocations and illuminates activity levels, in financial terms of the basic spend and income components.

3.13 Whilst we can see the necessity for measures to be introduced, the timing is considered to be problematic and undermines confidence in the formulation of Financial Strategy and the Budget process. For example, the ability to crystallise some of the measures at this point in the financial year requires considerable agility – particularly at the point in time relative to the date within which the States Members are asked to vote on the 2015 Budget Proposition. Our comments on each category of remedial measure are outlined below.

Contributions from States Strategic Investments

3.14 We understand that recent requests were made by Treasury and Resources for cash injections from strategic investments. These were £5m from Jersey Post and £3m from Jersey Telecom by way of an extraordinary/deferred dividend. It has subsequently transpired that the certainty and timing regarding agreement with Jersey Post has not been fully established and that a revised figure of £2m in respect of Jersey Post has been now agreed relative to representations of affordability within Jersey Post's own Financial Strategy. Effectively this has been a call of some £5m to contribute towards anticipated Budget balancing requirements.

3.15 For 2015 it is proposed that redemption of Jersey Water Preference Shares - £6.8m be made and that this is used to reduce Capital Allocations. The difficulty with Share redemptions is that connected recurring income streams can be adversely impacted or indeed terminated. The £2m Extraordinary Dividend from Jersey Post is also going to be applied to Capital Allocation. The revised measures also includes for a reduction in the planned rephrasing of unspent capital allocations from £3.220m to £1.982m as well as a reduction in the adjustment for increased Consolidated Fund Allocation from £1.297m to £0.982m.

Utilising available balances on Funds and Reserves

3.16 The application of specific reserves and funds to offset core expenditure signals a revised strategy that was not in contemplation at the start of 2014 financial year. Indeed, Treasury and Resources were seeking to build up the Court and Case Smoothing Reserve by approximately £0.2m to £3.6m at the start of the financial year. Notwithstanding this position, five months later it is now proposed that the entire Court and Case Smoothing Reserve is allocated to assist with meeting core States expenditure. The application of specific funds in 2014 such as the Insurance Fund (£2.5m) and Criminal Offences Confiscation Funds - £6.4m further portrays the extent of the necessity of the situation on even the basic deficit position as illuminated by the financial forecast. For 2015 the revised measures include for the utilisation of balances on the Restructuring Provision - £ 2.7m and reducing the Contingency Allocation to the 2015 Staff Pay Award by 1% from 2.5% achieving some £3.48m.

3.17 The utilisation of reserves to fund core spend is a "real wakeup call" and is typically the product of a rapidly deteriorating fiscal position. Reliance on specific key funds does not come without some risks. We note that the closing balance on the Stabilisation Fund as at 2013 was only £1.059m. Undue reliance upon reserves to provide a 'bail out' is clearly not a best practice approach to Financial Strategy. Indeed we would reiterate our position highlighted within our 2014 Budget Report which is extremely relevant in this context:-

"Through our experience of supporting public bodies we have noted that some organisations have struggled to effectively utilise significant reserves and incorporate a strategy for using reserves within a Medium and Longer term approach. Indeed, we have seen organisations start out to use investment performance to fund recurring expenditure which has, through the twin pressures of funding retrenchment and service growth expectation, led to the organisation utilising the capital component of such reserves and significantly diminishing the value of the reserve. As such reserves were ostensibly created with the intention of preserving funds for the use by future Tax payers or as a contingency against unforeseen disaster the loss of such a resource has been especially difficult for decision makers as within the current climate the capability of building such funds back up to previous levels is considered to be almost an impossibility as "when it is gone – it is gone"."[1]

Proposed Savings and Further Savings

3.18 The 2013 outturn underspend was £22.8m of which £20.1m or 3% of total Revenue Budget was requested to be carried forward. This comprised of £16.9m agreed as departmental carry forwards, £3m allocated to restructuring carry forwards and £0.2m of Court & Case Cost carry forward transferred to Smoothing Reserve. The proposed 2014 reduction of £5m is assumed to be readily achievable, however, it is not understood why such a measure was not incorporated within the 2015 Budget proposals in the normal course rather than a response to the emerging deficit positions. In respect of the 2015 remedial proposals a 1% saving on all departmental pay budgets and gross non pay budgets is designed to achieve some £6.035m on savings.

3.19 Some Departments have previously struggled to demonstrate a strong track record of achieving savings as directed by the previous CSR exercise although we do note that approximately £54.9m of savings has been reported to have been achieved from a £55,7m target for the period 2011 – 2013 although a further £6.478m is still required by 2016. Within the £54.9m that has been suggested to have been achieved is a Terms and Conditions Review Savings of £10.7m - £7m for 2012 and £3.7m for 2013. Within our experience we believe that it is extremely difficult to generate this type of saving and the figures presented are extremely precise. We would require further evidence to suggest that real cashable savings of this magnitude have been fully achieved as a result of direct management intervention. In the absence of such evidence we cannot be fully confident as to the efficacy attached to this level of savings as reported.

3.20 The degree to which 'salami sliced' base budget remedial reductions can be delivered without impacting service delivery is unknown. However within our 2014 Report we did express our reservations on the lack of precision within the budget process:-

[1] CIPFA Report for the Corporate Services Scrutiny Panel – Budget 2014 – para 1.31

"A recurring theme within our work has been the relative lack of precision in the Departmental Budget build-up as well as issues over the required performance management levers and motivation that will enable the delivery of budgets to outturn."

3.21 The consistency for at least 3% of carry forwards to be generated on an annual basis may provide some comfort that 1% savings on pay and non-pay Budgets can be delivered without undue impact on service delivery being achieved. We note that the revised remedial measures clarified a required 2% Base Budget Saving across all Departments save some aspects of Social Security core spend and the Council of Ministers decided that there should be no differentiation between Pay and Non Pay in the application of the 2% Base Budget Saving requirement. We understand that the required 2% saving will impact Departments as follows:-

	Gross Revenue Expenditure	
	2015	
	Revised	
Department	**Base Budget***	**2% saving**
	£'000	**£'000**
Chief Minister	23,544.5	486.0
Economic Development	20,349.0	420.0
Education, Sport and Culture	128,343.4	2,649.0
Department of the Environment	9,922.9	204.8
Health and Social Services	227,808.5	4,702.0
Home Affairs	50,058.8	1,033.2
Social Security	16,033.3	330.9
Transport and Technical Services	39,609.5	817.5
Treasury and Resources	37,731.4	778.8
Non Ministerial States Funded Bodies	26,559.4	548.2
States Assembly and its services	4,749.7	98.0
	584,710.3	**12,068.5**
	*Departmental recharges have been eliminated	[1]

3.22 Given the proximity to the start of the financial year it may well be the case that delivery of such a 2% baseline cut in budgets will represent a degree of challenge. Indeed, Transport and Technical Services are also required to find the appropriate financing costs to service the funding mechanism associated with the Liquid Waste Project.

3.23 The proposal to delay PECRS repayment on pre 1987 debt is a matter of timing – although an obvious departure from planned scheduling on debt repayment. This demonstrates that restructuring may be a necessary measure as a result of the gravity of the situation.

Other Measures if required

3.24 The £5m proposal to defer/reduce scheduled contributions to the Long Term Care Fund (LTFC) in both 2014 and 2015 provides another indicator of the seriousness of the situation now faced. The Long Term Care Fund was established to provide a necessary stream of

[1] Council of Ministers - Budget 2015 – 3 September 2014 – Appendix C

finance to underwrite the expected demographic care demands in Jersey of an ageing population and extent of progressively complex care costs. The 2015 proposal to re-phase capital and shareholder contributions of £3.967m is another unplanned departure from core strategy. The very phrase “Other measures if required” suggests an inherent lack of certainty and confidence in the Financial Modelling even by those involved in promulgating such proposals.

3.25 It is clear that the proposed remedial measures lack maturity and in some examples clearly contradict what was thought to be settled strategy. The need to fund core net spend from specific funds, together with the apparent speed by which these measures have been put together does not inspire confidence that the 2015 Budget has been founded on sound principles and good financial management practice. We note that within the draft Ministerial briefing held on 6 June 2014 that it was within contemplation to reduce the marginal rate of tax by 1% on top of last year’s 1% tax reduction to 26%. The remedial measures highlighted above were clearly not within the scope of the 2015 Budget process at that point in time.

3.26 It would be our considered view that the timing and the character of the remedial measures, as now presented, seriously undermines the confidence attached to the robustness of the States’ Financial Strategy. A key factor in the timeline of events appears to be significantly affected by the need to introduce the latest intelligence on falling income streams as well as the inability to influence core mainstream expenditure.

4. Income Tax Yield Forecasts and the MTFP

4.1 The 2015 Budget proposals includes for three Income Tax proposals – the impact from which will not be derived until 2016. These are:-

- Increasing thresholds for marginal relief by 1.7% in line with the March RPI figure – total full year cost and permanent tax base reduction in income of - £2.9m;

- Amend the legislation to ensure marginal rate taxpayers benefit from double tax credit - total full year recurring cost £0.5 m; and

- Capping Mortgage Interest Tax Relief at £15,000 from 2015 year of assessment – total additional recurring revenue of £0.1m.

Relevancy of the MTFP as a benchmark

4.2 The total reported impact of these Income Tax proposals announced within the 2015 Budget Statement for lower Income Tax yields from 2016 onwards are approximately a recurring net reduction of some £3.3m. As with the 2014 Budget proposals the total impacts of these Income Tax proposals have a recurring structural change in the base line position for the Income Tax component of the States Income model.

4.3 The Figure 7.1 Estimated Financial Implications of the 2015 Budget implications on Page 37 of the 2015 Budget Statement is as follows:-

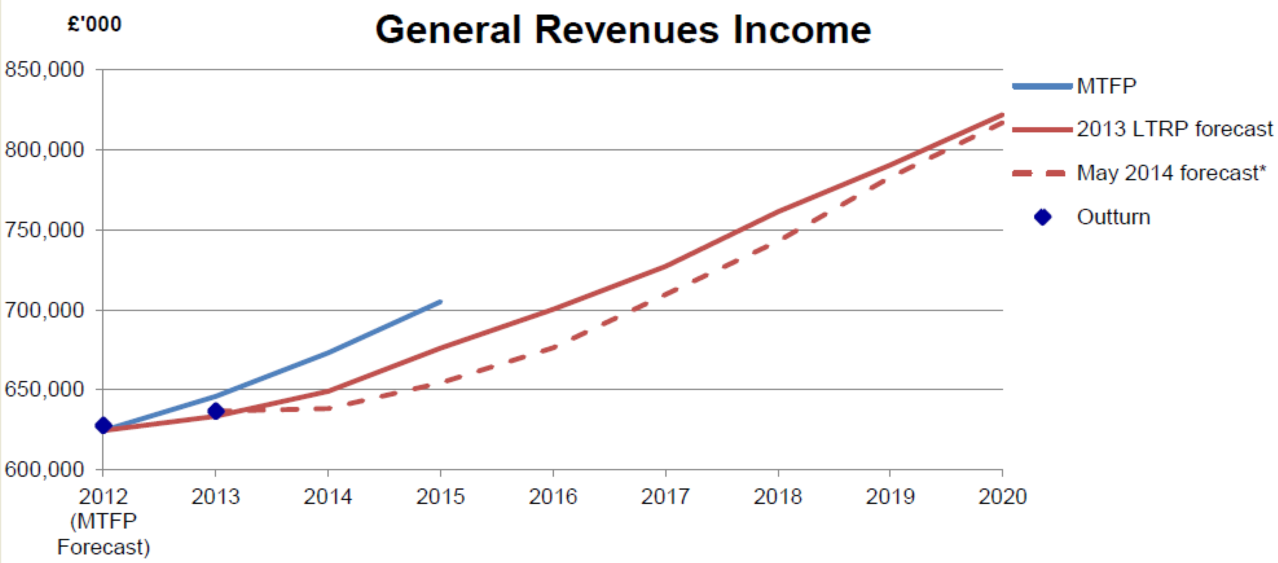
Financial Implications for 2016

Measure	Estimated Impact on 2016 Taxation Revenue £m
Income Tax	
Maintain the marginal rate of tax at 26%	Neutral
Increase tax exemption thresholds by 1.7%	2,100,000
Amend the double tax credit provisions	(500,000)
Cap mortgage interest tax relief at £15,000	100,000
Sub Total – additional 2016 financial implications	**1,700,000**
Financial implications from 2015 brought forward	**962,000**
Total – Financial implications 2016	**2,662,000**

4.4 On Page 17 reference is made to the net saving of the impact of the Income Tax proposal in increasing the Exemption threshold by 1.7% of £2.1m and this is reflected within the above table. However, this is only a saving when compared to the previous provision of 3% as contained within the MTFP. This does not reflect the actual impact on income received and is not relevant in the context of actual deficit financing. Given what we now see as a significant lack of correlation between the current 2014 and 2015 Financial Projections and the MTFP, we would form the view that such a benchmark outlined in page 17 and page 37 highlighted as Financial Implications lacks relevancy and it is the recalibrated income trajectory which has illuminated the significant 2014 and 2015 deficits that require to be addressed.

Long Term Revenue Plan

4.5 We have been advised that the Long Term Revenue Plan (LTRP) informs the Medium Term Financial Planning but have yet to have sight of the detail. What we do know however is that whilst the purpose of the LTRP is to provide an accurate tracking of Income trajectories based on the latest information even that is becoming detached from the latest forecasting information available. This can be illustrated from an extract of the Council of Ministers Briefing on the 2015 Budget – 11 July 2014:-



	2012 (MTFP Forecast)	2013	2014	2015	2016	2017	2018	2019	2020
	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
Outturn	627,733	636,668							
MTFP	624,602	646,004	673,183	705,173					
2013 LTRP forecast	624,602	633,573	649,186	676,228	700,415	727,270	761,333	790,582	822,048
Variance 2013 LTRP to MTFP	0	(12,431)	(23,997)	(28,945)					
May 2014 forecast*		636,668	638,414	654,462	676,399	709,666	742,976	782,870	817,122
Variance to 2013 LTRP		3,095	(10,772)	(21,766)	(24,016)	(17,604)	(18,357)	(7,712)	(4,926)
Variance to MTFP		(9,336)	(34,769)	(50,711)					

4.6 At the Corporate Services Scrutiny Panel meeting with the Minister of Treasury and Resources on 31 July 2014 the Minister advised that the LTRP will be available in early September 2014. Given the lack of precision demonstrated on income forecasting to date we believe that the LTRP and, indeed the 2015 Budget requires to be updated with the very latest forecasting rather than using components forged in May/June – for example the May 2014 ITFG position – if more precise information is available. We have recently been availed on the 2014 - June and July actuals and forecasted income outturn positions. These show further downward pressures and it is critical that the Budget 2015 is modified to incorporate the latest intelligence accordingly.

4.7 Far from providing the stability for the development of Financial Strategy the 2016 Income and Capital assumptions underpinning the MTFP model are now so removed from the latest tracking on Income that the 2013-15 MTFP model is no longer considered to be 'fit for purpose' and requires significant recalibration. We understand that such recalibration will begin in 2015 and we fully welcome recent Treasury proposals outlined by the Minister to extend the MTFP cycle to four years – 2016 to 2020. The cumulative differential positions on 2014 and 2015 between the MTFP position and the latest Budget proposals on Income Tax is some £70m. A concern is that tracked expenditure differentials has not moved in response to this contraction in income – indeed in some areas the baseline position has exceeded the MTFP position. We would strongly suggest that a framework is created which formally connects expenditure with income capability and is embodied within the Budget setting process in a way that <u>Expenditure is fully driven by Income</u> generating capability and <u>not on the utilisation of reserves.</u>

4.8 On Income Tax projections, within our Report on the 2014 Budget we previously made the point that despite a downward projection from Jersey's internal Income Tax Forecasting Group (ITFG) by some £13m for 2014, the MTFP figure of £475m was used within the 2014 Budget Process rather than the £462m ITFG figure. We were advised that more accurate internal projections pointed to a more positive outturn projection. The latest outturn projection within the Financial Forecast 2013-2015 for 2014 is £444m - well down on the £475m MTFP assumption and the £462m ITFG assumption. Indeed the latest projections of £444m for 2014 and £455,000 for 2015 are significantly adrift from the baseline positons highlighted within our 2015 Budget Report:-

YOA	**2011**	**2012**	**2013**	**2014**	**2015**
Budget Year	**2012**	**2013**	**2014**	**2015**	**2016**
	£m	**£m**	**£m**	**£m**	**£m**
Personal	356	362	371	386	401
Companies	79	86	93	96	99
Bad debts	-3	-2	-3	-3	-3
March 2013 income tax forecast	433	**446**	**462**	**479**	**497**
March 2012 income tax forecast (used in MTFP)		455	475	505	
Total change		-9	-13	-26	

4.9 We understand that the ITFG is made up of a number of individuals including the Treasurer to the States and the Economic Adviser to the States although the structure of the group is rarely stable and lacks formality. Even if we exclude MTFP tracking, the shift within the ITFG's projections from March 2013 to May 2014 is significant on Income Tax:-

2014 - £462 (March 2013) – to £444m (May 2014) – 3.7% Change 2015 - £479 (March 2013) – to £455m (May 2014) – 5.0% Change 2016 - £497m (March 2013 – to £475m (May 2014) -4.4% Change

4.10 Given the differentials between the revised 2014 and 2015 projections and the MTFP figures - £31m for 2014 and £50m for 2015, it is extremely surprising that a further marginal rate reduction was in contemplation in June 2014. The States employs a monthly performance monitoring regime on Tax Yields and a more granular Quarterly reporting process which is circulated to the Council of Ministers. The most up to date Monthly Report that was made available to Scrutiny is May. Within the May Performance Report the following extract is reported:-

Summary of States financial position as at May 2014
General Revenues
Full year forecast ~ £34.8 million adverse

- Income Tax of £31 million adverse (Personal Tax)
- GST of £2.8 million adverse
- Island Rate of £0.1 million adverse and
- Stamp Duty of £4.7 million adverse; offset by
- Impôts £0.7 million favourable
- Other Income of £3.1 million favourable (EUSD and RLAM returns).

Year to date budget ~ £23.2 million adverse

- Income Tax (Personal) of £21.1 million adverse
- GST of £0.5 million adverse
- Impôts of £2.8 million adverse and
- Stamp Duty of £1.4 million adverse;

4.11 We understand that the actual 2013 Income tax yield outturned at £451,661 including a "one off £10m receipt. The forecast of Income from the May monitoring Report highlights an Income Tax forecast of some £444m for 2014:-

States of Jersey Variance Report by Entity Figures exclude IFRS Revenue Expenditure such as depreciation, impairments and any loss or gain on the sale of assets									
Prior YTD		**Year To Date (May)**				**Full Year**			
Actual (£'000)	Entity	Actual (£'000)	Budget (£'000)	Budget Variance (Adv)/Fav	Var %	Forecast (£'000)	Budget (£'000)	Forecast Variance (Adv)/Fav	Var %
221,973	Income Tax	212,915	234,066	(21,151)	9%	444,000	474,965	(30,965)	7%
37,151	GST	36,860	37,344	(484)	1%	79,107	81,955	(2,848)	3%
16,820	Impots	16,191	19,001	(2,810)	15%	55,613	54,903	710	(1%)
6,074	Stamp Duty	9,869	11,292	(1,423)	13%	22,730	27,402	(4,672)	17%
4,784	Island Rate	5,740	5,013	727	(15%)	11,956	12,032	(76)	1%
10,065	Other Income	8,633	6,741	1,892	(28%)	25,007	21,926	3,081	(14%)
296,867		290,208	313,457	(23,249)	7%	638,413	673,183	(34,770)	5%

4.12 The corresponding June Monitoring Report highlights that a revised forecast of £439,000 in respect of Income Tax with the adverse Income Tax forecast variance increasing to some £36m up from £31m which demonstrates a further deteriorating position on Income Tax :-

States of Jersey Variance Report by Entity Figures exclude IFRS Revenue Expenditure such as depreciation, impairments and any loss or gain on the sale of assets										
Prior YTD	**Prior Yr**		**Year To Date (June)**				**Full Year**			
Actual (£'000)	Actual (£'000)	Entity	Actual (£'000)	Budget (£'000)	Budget Variance (Adv)/Fav	Var %	Forecast (£'000)	Budget (£'000)	Forecast Variance (Adv)/Fav	Var %
259,655	451,660	Income Tax	245,744	282,748	(37,004)	13%	438,865	474,965	(36,100)	8%
42,773	77,603	GST	42,727	43,728	(1,001)	2%	79,107	81,955	(2,848)	3%
24,091	54,320	Impots	22,682	26,222	(3,540)	14%	55,773	54,903	870	(2%)
7,146	17,370	Stamp Duty	11,828	13,648	(1,820)	13%	22,670	27,402	(4,732)	17%
4,784	11,641	Island Rate	5,740	6,016	(276)	5%	12,032	12,032	0	0%
12,704	24,093	Other Income	13,839	8,895	4,944	(56%)	38,831	35,760	3,071	(9%)
351,153	636,687		342,560	381,257	(38,697)	10%	647,278	687,017	(39,739)	6%

4.13 During the Scrutiny Process we were able to meet with the Controller of Tax and his staff on 1 August. The Controller confirmed that the latest view on Tax yield was even worse that the established forecasted position for 2014 but could not confirm by how much. Despite some difficulties in gaining access to information on how Tax yield performance and forecasting is achieved, we were able to have a "walk through" from the Finance Director of the Tax Office and have sight of the written procedures used to compile these figures and report via Treasury.

4.14 Our session with the Finance Director of the Tax Office revealed that there is a considered approach to tracking and forecasting Tax yields and employs a 'bottom up' approach which aims to capture movements within all components of tax using Excel and Chrystal Report Writing Tools on top of the iTax Base system. It would be our view that the methodology appears to be robust and that the extent of variances experienced on forecasting reflect the volatility and complexity of tax impacts as well as prevailing economic conditions rather than any explicit weakness in the work of the Tax Office. The Monthly Report on Income yields from the Tax Office to the Treasury is considered to be comprehensive and robust.

4.15 Given the continuing deteriorating position on Income Tax forecasts it is critical that the latest forecasts are used in determining the 2014 Outturn and setting the base for 2015. A worst case scenario could be that failure to adjust projections in line with the latest intelligence could mean that Members could be voting on a Budget that senior officers know is unlikely to be achieved.

4.16 Within our 2014 Budget Report we were critical on a lack of transparency behind modelling and key assumptions used and highlighted a number of risks within the 2014 process including:-

- Lack of clarity on overall affordability of all options and lack of sensitivity analysis at a macro level – e.g. significant changes to GVA, Employment and base interest rates
- Marginal Income Tax rate reduction impact and affordability is highly questionable as an effective stimulus measure
- Inconsistent messages on Income Tax yield forecasting (e.g. States Economics Unit Forecasts with Budget Baseline positions) - difficulty in tracking the annual recurring £12.4m reduction in base yield re Income Tax

4.17 We fear that this lack of transparency, coupled with the sub optimal behavioural element of optimism bias within the construction of the Budget, may be contributing factors behind what can now been seen as 'less than robust' Income forecasting and a consequential failure to recalibrate expenditure. This failure to account for the most accurate Income position within the 2014 Budget was exacerbated by the decision taken to apply a 1% reduction in the marginal tax rate from 27% to 26%. Clearly, the underpinning economic stimulus argument used to promote the previous rate cut has been unfounded.

4.18 Looking at the relationship between the positioning of Income Tax to overall Income and Net Revenue Expenditure (as extracted from Figure 10.1 – p55) we derive the following position:-

	Outturn Actual 2013	Budget 2014	Outturn Probable 2014	Proposed Budget 2015
	£000	£000	£000	£000
Income Tax	£451,661	£474,965	£444,000	£455,000
States Income	£636,688	£673,183	£652,248	£684,896
Less Andium Homes Return			-£13,800	-£29,400
Adjusted States Income	£636,688	£673,183	£638,448	£655,496
% Income tax to States Income	70.9%	70.6%	69.5%	69.4%
Net Revenue Expenditure	£636,186	£669,599	£683,433	£720,629
Add back Housing Income			-£13,800	-£29,400
Adjusted Net Revenue Expenditure	£636,186	£669,599	£669,633	£691,229
% Income Tax to Adjusted Net Revenue Expenditure	**71.0%**	**70.9%**	**66.3%**	**65.8%**

4.19 On a % change basis, the 2014 probable Income Tax figure is 6.5% down on the 2014 Budget figure (MTFP £475m) used and set last year and we understand that the latest intelligence places Income Tax around £439m – down £5m on the Probable Outturn. The above table shows that there is a downward shift in the dependency on Income Tax relatively to overall States Income from approximately 71% as an actual in 2013 to 69.4% in the 2015 proposal. However, if we compare Income Tax to overall Net Revenue Expenditure we get a potentially worrying position.

4.20 Whilst the 2013 % Income Tax to overall Income and 2014 % Income Tax to Net Revenue Expenditure is broadly similar 71%, the proposed position for 2015 illuminates an approximate reduction of some 5% to 65.8%. On the evidence presented to us it is obvious that there was no plans to recalibrate core spend outwith the remedial measures in direct relationship with reducing Tax yields. Even maintenance of the reduced overall income requires delivery of the other income streams such as Stamp Duty, Impots and GST. Such dependencies are not without risk, for example we note that the 2014 Probable Outturn for Stamp duty of £22.7m is approximately 31% higher than the 2013 Outturn of £17.4m. It is clear that maintaining States Income streams at least at projected levels will be fundamental to the options available to maintain current activity. Summary Table A highlights the various components of States Income analysed within the 2015 Budget Statement:-

Outturn	States Income	Budget 2014 (Dec 2013)			Budget 2015 (Jul 2014)	
2013 £'000		2013 £'000	2014 £'000	2015 £'000	2014 £'000	2015 £'000
	Income Tax					
356,663	Personal Income Tax	377,000	394,000	414,510	364,000	373,000
98,472	Companies	79,965	82,965	86,965	83,000	85,000
(3,475)	Provision for Bad Debt	(2,000)	(2,000)	(2,000)	(3,000)	(3,000)
451,660		454,965	474,965	499,475	444,000	455,000
77,603	**Goods and Services Tax (GST)**	79,761	81,955	84,508	79,107	80,650
	Impôts Duties					
4,510	Impôts Duties Spirits	4,161	4,747	4,724	4,924	4,858
7,231	Impôts Duties Wine	7,256	7,626	7,891	7,549	7,677
986	Impôts Duties Cider	1,040	829	902	1,005	1,113
5,087	Impôts Duties Beer	5,738	5,575	5,601	5,334	5,194
15,048	Impôts Duties Tobacco	14,004	14,789	14,236	15,563	15,316
20,385	Impôts Duties Fuel	21,135	20,263	20,584	20,157	20,395
234	Impôts Duties Goods (Customs)	150	150	150	200	200
839	Vehicle Emissions Duty (VED)	1,050	924	924	881	896
54,320		54,534	54,903	55,012	55,613	55,649
	Stamp Duty					
14,019	Stamp Duty	20,478	23,127	24,598	18,837	20,499
2,390	Probate	2,500	2,500	2,500	2,488	2,200
961	Stamp Duty on Share Transfer (LTT)	1,551	1,775	1,863	1,405	1,504
17,370		24,529	27,402	28,961	22,730	24,203
600,953	**TotalTaxation Revenue**	613,789	639,225	667,956	601,450	615,502
	Other States Income					
3,341	Net Investment Income	3,721	3,679	4,356	8,135	9,107
11,127	Dividends and Returns	8,319	11,186	13,287	8,284	10,503
3,792	Jersey Financial Services Commission Fees	3,700	3,700	3,700	3,700	3,700
2,468	Returns from States Trading Operations	1,691	1,731	1,771	1,691	1,671
	Return from Andium Homes				13,834	29,472
1,939	EUSD Retention Tax	1,500	-	-	1,712	1,200
749	Income Tax Penalties	1,071	1,071	1,071	1,043	1,071
677	Fines and Other Income	543	559	579	443	451
24,093		20,545	21,926	24,764	38,842	57,175
11,641	**Island Rate Income from Parishes**	11,670	12,032	12,453	11,956	12,219
636,687	**Total States Income**	646,004	673,183	705,173	652,248	684,896

4.21 Outwith the Economic factors that significantly impact Tax yields it may well be the case that Jersey's tax system no longer easily generating tax revenues. This can be partially recognised looking at the UK as an example where Tax yields have consistently failed to meet expectations suggesting leakage in recovery or a restructuring within the shape of the tax paying population (albeit that there is significant differences in the predominate method of assessment). As an example, in 2010 the UK Office for Budget Responsibility (OBR) predicted that the Tax system should collect some 38.7% of national income however the 2014 UK Budget position demonstrates that this yield to income ratio has fallen to 37% - the equivalent of some £30bn or 1.7% of GDP. In terms of growth, the UK economy grew by 4.7% in 2013/14 against Tax revenue growth of only 3.5% which bucks a trend whereby revenues should grow faster than GDP.

5 Impots and Stamp Duty Changes

5.1 The 2015 Budget Proposals cover three specific activities totalling net additional revenue for 2015 of £962,000. This is split between the following components:-

- Impots Duty Increases – additional £637,000 in revenue;
- Reduction in Stamp Duty on borrowing to £400,000 – (reduction in revenue £532,000); and
- Increase Stamp Duty rates with transaction> £1m – addition to revenue of £857,000.

5.2 In terms of actual revenue implications it is estimated by Treasury & Resources that restriction on "First time Buyers Relief" will improve income from this source. It has been estimated that purchasers have benefited by an annualised sum of £287,0001.

Impots

5.3 Although the proposals are expressed as raising additional revenue of approximately £1.451m the actual anticipated income is expressed as £637,000 based on key changes to volume assumptions:-

- Alcohol duties - £310,000
- Tobacco duties - £687,000
- Fuel duties - £439,000
- Vehicle Emissions Duty - £15,000

5.4 The actual additional revenue is broken down as highlighted by Figure 4.6 – summary of Duty Revenue:-

[1] 2015 Budget Statement – Page 31

	MTFP (July 2012) 2015 £'000	Budget 2014 (October 2013) 2015 £'000	Budget 2015 (July 2014) 2015 £'000	Contribution to Budget measures 2015 2015 £'000
Impôts on Spirits	4,110	4,724	4,858	134
Impôts on Wine	7,769	7,891	7,677	(214)
Impôts on Cider	1,180	902	1,113	211
Impôts on Beer	5,784	5,601	5,194	(407)
Impôts on Tobacco	11,260	14,236	15,316	1,080
Impôts on Motor Fuel including Fuel Duty Rebate	21,858	20,584	20,395	(189)
Impôts on Goods Imported	150	150	200	50
Vehicle Emissions Duty	1,000	924	896	(28)
TOTAL IMPÔTS DUTY	**53,111**	**55,012**	**55,649**	**637**

5.5 The 2014 Forecast suggests that a marginal 1% positive surplus on 2014 Base Estimate. Forecasting and modelling on relevant assumptions/options appear to be sound for this Impot component of income and that the 2015 baseline is uprated for recent trends etc. However the original MTFP position for 2015 of £53.111m requires to be adjusted for changes in the assumptions related to specific components such as Spirits, Tobacco and Motor Fuel impots as there are significant differentials between MTFP and Budget 2015 (the differentials are widening) positions relative to most components save imported Goods.

Reduction in Stamp Duty on borrowing to £400,000

5.6 Outwith first-time buyers, Stamp duty/LTT is currently payable on mortgages secured on Jersey property at the rate of 0.5%. It is proposed that Stamp Duty/LTT on mortgages will be paid on a property worth not more than £400,000 at the rate of only 0.25% between a mortgage threshold of £300,000 and £400,000. It is expected that this proposal will cost approximately £532,000 per annum.

5.7 Behind this proposal there is a lack of detail on expected volumes of transactions although it is assumed that current activity has been extrapolated to achieve the forecast impact for 2015. We would recommend more transparency on expected transaction volumes.

Increase Stamp Duty rates with transaction> £1m – addition to revenue of £857,000

5.8 A new base value and banded duty rate is proposed for properties costing more than £3 million. The current and proposed rates of duty/LTT for properties costing more than £1 million are extracted from Figure 5.1 within the 2015 Budget Statement, viz:-

Property Cost	Current Rate	Proposed Rate
£1 million - £1.5 million	£22,000 plus 3.5% on the difference between the cost and £1 million	£22,000 plus 4% on the difference between the cost and £1 million
£1.5 million - £2 million	£39,500 plus 4% on the difference between the cost and £1.5 million	£42,000 plus 5% on the difference between the cost and £1.5 million
£2 million - £3 million	£59,500 plus 5% on the difference between the cost and £2 million	£67,000 plus 6% on the difference between the cost and £2 million
Properties costing more than £3 million	£59,500 plus 5% on the difference between the cost and £2 million	£127,000 plus 7% on the difference between the cost and £3 million

5.9 The 2015 additional revenue forecast is based upon an expectation that a set volume of transactions are achieved although it is admitted that the "number of transactions affected by these proposals is likely to be low, with fewer than 100 properties sold for more than £1 million in each of the last three years."1

5.10 An analysis highlighted in Figure 5.3 outlines the number of properties costing more than £1 million sold in Jersey between 1 July 2011 and 30 June 2014 as :-

Year	Cost of between £1 million and £1.5 million	Cost of between £1.5 million and £2 million	Cost of between £2 million and £3 million	Cost of more than £3 million	Total
2011/12	53	13	6	11	83
2012/13	39	12	15	5	71
2013/14	46	21	15	12	94

5.11 Inherent within the proposal is the assumption that "as the property market picks up, there will be the potential for increased stamp duty and LTT revenues." In calculating the additional revenue we are unsighted on the volume of expected transactions falling within each category. Additionally, the assumption that the property market will improve would benefit from some empirical foundation within the Budget Statement notes.

5.12 We understand that Property Tax Review work is on-going and a number of options are being considered including the potential abolition and replacement of Parish Rates and Island-Wide Rates with a Domestic Property Tax. We await with interest what impact this may have within future Budgets.

5.13 In summary, we believe that more transparency is required in relation to the base assumptions underpinning the relevant Impots and Stamp Duty and the proposals would benefit from more detail on the key assumptions – particularly expected volumes in relation to Stamp Duty transactions.

[1] 2015 Budget Statement - Page 32

6 Capital Programme

6.1 The proposed Capital Programme allocation for 2015 equates to some £76.382m including the major infrastructure Projects introduced into the 2014 Budget – Replacement Hospital and Liquid Waste Strategy - split by Department as follows:-

	£'000 2015 Budget
Chief Minister's	
E Government	320
JDE Development and Upgrade	1,238
Payroll Replacement	1,000
Chief Minister's total	**2,558**
Education, Sport and Culture	
School ICT	1,000
Additional Primary School Accommodation (Phase 2)	2,134
Sports Strategy Infrastructure (Phase 2)	1,450
Education, Sport and Culture total	**4,584**
Health & Social Services	
Future Hospital (Phase 2)	22,700
Replacement of MRI Scanner	2,277
Replacement of RIS/PACS	1,567
Refurbishment of Limes	1,662
Health & Social Services total	**28,206**
Transport and Technical Services	
Infrastructure Rolling Vote	11,097
Liquid Waste Strategy (Phase 1)	25,494
EFW Plant La Collette Replacement Assets	681
Road Saftey Improvements	635
Transport and Technical Services total	**37,907**
Vehicle Replacement (additional from consolidated fund)	**300**
Replacement Assets	**2,827**
Total Projects - Capital Allocation	**76,382**
Housing	
Social Housing Programme *	-
Total Programme	**76,382**

6.2 Funding sources for this proposed programme is laid out in Summary Table C:-

	£'000 2015
Departmental Capital Programme	**76,382**
Funding Sources	
Consolidated Fund	(3,463)
Strategic Reserve	(22,700)
Contribution from Currency Fund	(25,494)
JPH receipts	(9,140)
Housing Repayment	(528)
Repayment of JT Preference Shares	(1,757)
Repayment of Jersey Water Preference Shares	(6,800)
Jersey Post Extraordinary Dividend	(5,000)
Funded from the Central Planning Vote	(1,500)
Funding Available	**(76,382)**
Social Housing Programme*	-
Housing Funding Sources*	-
TOTAL CAPITAL EXPENDITURE	**76,382**
Funding from Consolidated Fund (Main allocation)	**3,463**
Funding from Other Sources (Income to Consolidated Fund etc)	**72,919**
Housing Funding	**-**
TOTAL FUNDING	**76,382**

Funding Sources

6.3 As can be seen from the above table the major contributing sources are the Currency Fund and the Strategic Reserve and these map directly to the Liquid Waste Strategy (Phase 1) and Future Hospital (Phase 2) projects respectively. The Social Housing Capital Programme has been excluded given the incorporation of Andium Homes Ltd on 1 July 2014. The remaining programme of £28.188m (£46.392m equivalent for 2014) is spread across the Departments – of significance is the Infrastructure Rolling Vote of £11.097m within Transport and Technical Services which makes up approximately 39% of the remaining programme. The comparative downward shift in the overall programme (excluding the Infrastructure Projects) appears to be a natural movement in line with affordability with the utilisation of Strategic Investment sources signalling the progressive difficulties in funding projects. The 'ring fencing' of the Strategic Reserve' primarily for the replacement Hospital and the establishment of a baseline position with a 'floor' balance of £651.216m (proposition (i) 2015 Budget) with future years requiring this capital to be maintained in real terms "by increasing the capital value in line with increases in Jersey (RPI (Y)"[1], will largely minimise or eliminate the availability of capital Funding for other projects from this source.

6.4 It is understood that future Real Investment Returns on the Strategic Reserve will be used to fund the previously approved capital costs of some £297m associated with the replacement Hospital Project and the States have agreed such a draw down up to that level. Within our

[1] 2015 Budget Draft Budget Submission – Page 3 – (i)

2014 Budget Report we were positive on the way that the States had researched a number of alternative funding options for the Hospital Project, the Waste Strategy and arrangements involving the Housing Stock. However, we do now have concerns related to the future Investment returns assumptions used within the current model.

Replacement Hospital

6.5 In respect of the replacement Hospital Project we understand that project remains (as per the Draft Budget Statement) forecast to spend over 10 years from 2014 to 2024 and that the following assumptions first cast within the Budget 2014 are still live:-

- The Hospital costs can be fully met over the 10 years of development from the Strategic Reserve;
- There will be no debt for future generations;
- There will be no new cost to the taxpayer;
- The cost of the Hospital will be funded from the Investment Returns of the Strategic Reserve Fund; and
- The funding remains in the Strategic Reserve until it is needed and is fully invested so as to maximise investment return and minimise cost.[1]

6.6 As can be seen above and together with the required baseline position highlighted within the Proposition item (i), Investment returns on the Strategic Reserve are required to meet a minimum level of performance to ensure that the 'core' balance of reserve is preserved. Expectations on investment performance are highlighted within tables aligned with paragraph 2.54 – page13 of the Draft Budget Statement 2015. Basic assumptions are highlighted below:-

£'million	2013 Actuals	2014 F'cast	2015 F'cast	2016 F'cast	2017 F'cast	2018 F'cast	2019 F'cast	2020 F'cast	2021 F'cast	2022 F'cast	2023 F'cast	2024 F'cast
Total Fund Value Actual / Forecast - opening	651.0	743.1	771.3	791.9	779.5	779.8	787.8	809.2	832.0	856.2	898.3	943.2
Estimated Growth @ 3% p.a above RPI(Y)	92.1	38.4	43.3	43.5	41.7	49.3	50.3	51.7	53.1	55.2	58	60.9
Net Growth - Hospital Allocation (2013 onwards)		-10.2	-22.7	-55.9	-41.4	-41.3	-28.9	-28.9	-28.9	-13.1	-13.1	-12.6
Total Fund Value Actual / Forecast - closing	**743.1**	**771.3**	**791.9**	**779.5**	**779.8**	**787.8**	**809.2**	**832.0**	**856.2**	**898.3**	**943.2**	**991.5**
Inflation - RPI(Y)	-13.0	-14.5	-18.0	-18.1	-17.3	-24.9	-26.0	-26.9	-27.8	-29.1	-30.1	-31.2
Net Growth after inflation	79.1	23.9	25.3	25.4	24.4	24.4	24.3	24.8	25.3	26.1	27.9	29.7
Net Growth Cumulative	*79.1*	*103.0*	*128.3*	*153.7*	*178.1*	*202.5*	*226.8*	*251.6*	*276.9*	*303.0*	*330.9*	*360.6*
Net Cumulative Growth - Hospital Allocation	0.0	-10.2	-32.9	-88.8	-130.2	-171.5	-200.4	-229.3	-258.2	-271.3	-284.4	-297.0
Cumulative Net Growth left not allocated to Hospital	**79.1**	**92.8**	**95.4**	**64.9**	**47.9**	**31.0**	**26.4**	**22.3**	**18.7**	**31.7**	**46.5**	**63.6**
Forecast Investment Return assumptions (p.a)	14.1%	5.2%	5.7%	5.7%	5.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%
Forecast RPI(Y) assumptions (p.a)	2.0%	2.2%	2.7%	2.7%	2.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%

6.7 The Forecast Investment Return assumptions moving forward are critical to modelling as is Forecast RPI (Y). We understand that Investment return assumptions were provided by advisers to the States - AON Hewitt. Whilst there appears to be robust controls in place over the transfer of funds from the Strategic Reserve including oversight by the Comptroller and Auditor General, we would have reservations on the confidence attached to the level of

[1] Draft Budget Statement – Page 84

sustained Investment Return performance which is assumed to achieve a consistent 6.5% per annum from 2018 through 2024 with 5.2% achieved within 2014 rising to 5.7% in 2015.

6.8 Irrespective of the stellar 14.1% achieved in 2013 we would be more cautious about the general outlook. Indeed, the Minister for Treasury and Resources, in the Foreword to the Budget Statement 2015 suggests that "interest rates are expected to increase at a moderate rate next year which will start to alleviate some of the pressure on States income." If there is a positive level of correlation between base interest rates and investment returns then we would have some difficulty with base Investment Return assumptions as there are now indications that interest rates may not start to rise in a manner that was expected and even recently predicted. At the point of writing this report there are indications that rates will not rise until into 2015 and at a slower rate that envisaged through to 2017. Indeed, there are signs that economic growth trajectories within the Eurozone have now been re-evaluated with some significant countries including Germany now expected to record some negative growth within reporting quarters in 2014.

6.9 An extract from the June 2014 Revenue Monitoring Quarterly Performance Report highlights annualised Performance Year to date as well as an average annualised 3 year position.:-

Performance of Key States Funds	Value of investment assets	Performance Year to Date (Net)	Performance 3 Years (Net)	Benchmark 3 Years (Net)	Performance traffic light
Strategic Reserve Fund	£757m	1.9%	8.0%	6.8%	OK
Social Security Reserve Fund	£1185m	2.3%	9.5%	8.3%	OK
Health Insurance Fund	£81m	2.7%	9%	7.4%	OK
Jersey Currency Notes Fund & Coinage	£94m	0.8%	4.0%	2.7%	OK
Consolidated Fund	£417m	1.2%	1.3%	0.9%	OK
Jersey Teachers Superannuation Fund	£397m	4.1%	8.8%	7.9%	OK
Total Value of core funds	**£2534m**				
Other funds	£4m				
Total invested assets	**£2538m**				

3 Years performance annualised

6.10 Whilst the 3 year position appears to be reasonable the annualised Year to Date position does not provide the level of performance that would match expectations on investment at a level required to meet the proposed performance levels for generating the returns to meet the Hospital funding requirement.

6.11 There are also signs that UK economic confidence may be misplaced as an imbalance on Manufacturing and Exports together with a strong pound, and weaker than anticipated profits generated by the Service Sector, (including Financial Services) may effectively stall or at best put the brakes on expected economic growth at the point when 'slack' within the UK economy is fully consumed. Unexpected additional borrowing has been required as a result of further deterioration in Tax yields. In respect of the Investment Return assumptions, critical to operation of the Strategic Reserve, we would recommend that further advice is obtained on the accuracy of maintaining such forecasts and an inherently prudent approach be taken upon the incorporation within the Budget modelling.

Hospital Project Recurring Revenue Costs

6.12 We would reiterate our comments made within our 2014 Budget Report regarding the lack of detailed recurring costs associated with running any new facility and again recommend that the full life recurring running costs are appropriately evaluated against the MTFP financing capability in respect of the appropriate Health and Social Services Budgets. Whole Life Costing should be fully embedded within the Project Modelling and Revenue Budgets. This may well change as service requirements are re-evaluated in the course of the project.

Programme Capability

6.13 We understand that overall states capital expenditure outturned at approximately £51m in 2013 and £38m in 2012. Within our 2014 Budget Report we highlighted our "significant concerns, based on recent track record of spending on the prospectivity for Departments to deliver the approved total allocation of £88.892m in 2014." In respect of the Hospital spend profile we understand that the following pattern of cash flow is envisaged:-

	Dec 2014	Dec 2015	Dec 2016	Dec 2017	Dec 2018	Dec 2019	Dec 2020	Dec 2021	Dec 2022	Dec 2023	Dec 2024	Total
£'m	10.2	22.7	55.9	41.4	41.3	28.9	28.9	28.9	13.1	13.1	12.6	297

6.14 Despite assurances received on this project the States has not got a good track record of delivering on Capital Programmes. Irrespective of further assurances obtained in 2013 and 2014 on better monitoring and a more "hands on" performance management approach being applied to Capital Projects, the actual outturn performance does not provide sufficient confidence that forecasted profiles will be achieved on the substantive projects. Industry capacity within Jersey is a key driver of delivery and we understand that capacity issues are being currently researched especially in the context of economic stimulus – particularly with the need to assess investment implication that spread off-island. Project complexity is another factor that can adversely impact on expectations as is the behavioural aspects of Optimism Bias.

6.15 In respect of Optimism Bias we commented upon this factor within our 2014 Budget Report – specifically in relation to the Hospital Project with HM Treasury 'Green Book' experience of extremely high rates overspending and significantly elongated timescales experienced within complex non-standard projects. An extract of our comments is as follows :-

"Overall construction costs equate to a quantum of some £210m including a 5% contingency. A provision for Optimism Bias of 10% or £21m is provided and inflation factor of some £43.9m makes up a total of £274.9m. Whilst the HM Treasury Green Book methodology has been substantially followed, the HMT Supplemental "Green Book" Guidance points to high level Optimism Bias factors for Non-Standard Construction Projects such as Specialised Hospitals of 51% and a duration timeline excess of 39% on original forecasts for completion."[1]

[1] CIPFA Report to the Corporate Scrutiny Panel – 2014 Budget - Paragraph 1.26

6.16 Given recent track record and the propensity for complex non-standard projects to be impacted by optimism bias, it would be our view that spend profiles should be treated with an appropriate degree of caution.

Liquid Waste Strategy

6.17 Our understanding within the 2014 Budget Statement was that the new Liquid Waste Sewerage Treatment Works system would have an estimated total capital costs of £75m and be funded from £12m of existing TTS Infrastructure Budget with the balance of funding met from £30.5m main Capital Programme funding over the duration and an investment of the Currency Fund - £29m and contributions from the Consolidated Fund of £3m with existing resources funding - £0.5m. It is further understood that such sources outlined in the 2014 process remain within the 2015 Budget Model.

6.18 In respect of projects costs we understand that the overall exposure of £75m remains but the costs are re-profiled as follows:-

Item Description	**Funding £m**							
Year	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**Total**
STW site works incl. construction, and TTS & professional fees for prelim. works	0.5	9.44	12.564	31.446	0.0	0.0	0.0	53.950
Effluent outfall	0.0	0.16	2.590	0.0	0.0	0.0	0.0	2.750
Contingencies	0.0	0.0	5.135	6.295	0.005	0.005	0.005	11.445
Professional Fees (for STW)	0.0	0.0	4.80	0.0	0.0	0.0	0.0	4.800
TTS Costs	0.0	0.0	0.411	0.411	0.411	0.411	0.411	2.055
TOTAL	**0.5**	**9.6**	**25.5**	**38.152**	**0.416**	**0.416**	**0.416**	**75.000**

6.19 As outlined within our 2014 Budget Report we had reservations about the precision on the costs and the ability of TTS to meet the estimated £1.7 million per annum for principal and interest payments to finance the £29m borrowed from the Currency Fund. £1m of this Financing Payment is proposed to be generated from internal TTS operating savings:-

- Energy Savings on £1m annual exposure - £0.5m
- Chemical – Pasteurisation savings - £0.25m
- Annual site maintenance on outdated and customised equipment - £0.25m

6.20 The remaining £0.7m was proposed to be financed from additional internal departmental efficiencies. We envisage that this will pose a formidable challenge for the Department especially against the backcloth of further revenue savings it may be obliged to make as a result of overall expenditure retrenchment in Jersey. Indeed we previously summarised our position on this project as follows and would not seek – a year on - to change this:-

"..This significant and wholly necessary project lacks maturity in terms of the lack of overall cost exposure information as well as lacking precision in the sourcing of a significant component of annual financing costs."[1]

6.21 As highlighted above, the latest adjustment to the remedial measures announced on 3 September 2014 requiring 2% Base Budget reduction on departmental net revenue spend will make it even harder for TTS to meet its funding obligations regarding this project.

[1] CIPFA Report to the Budget Scrutiny Panel – 2014 Budget - Para 1.46

7 Concluding Comments and Recommendations

7.1 Within our concluding comments within our 2014 Budget Report for the Corporate Services Scrutiny Panel we noted that:-

"Economic forecasting necessarily impacts the financial modelling used within the Budget Proposals and there is a need for optimal accuracy within assumptions used and clarity/transparency in the tracking of such impacts. In this respect it is of some concern that the forecasts of Income Tax yields differ from the baseline position used within the Budget 2014 Statement."[1]

2014 Budget Risks Highlighted

7.2 Within our list of Risks associated with the 2014 Budget, amongst other things, we also suggested that the "Marginal Income Tax rate reduction impact and affordability is highly questionable as an effective stimulus measure".2 and on 'Affordability' we concluded that the "revised economic forecasts on GVA, Employment, Interest Rates etc. consistently provide a cautionary note on the economic foundations to the critical assumptions that are contained within the Budget and consequential adjusting of the MTFP. Affordability testing on the 2014 Budget proposals against this cautionary background needs to be more explicitly demonstrated."3

7.3 Unfortunately, one year on such comments appear to have gone unheeded. A significant deterioration in income appears to have caught the Treasury and Resources Team "off guard" and has necessitated a list of remedial measures that are neither considered nor potentially fully realisable. Even the labelling of "Other measures if required" suggests an inherent lack of certainty and confidence in the Financial Modelling. It is obvious looking back that there were no plans to recalibrate core spend in direct relationship with reducing Tax yields. There is a disconnect between expenditure profiles and related funding.

Remedial Measures

7.4 The timing and the character of the remedial measures seriously undermines the confidence attached to the robustness of the States' Financial Strategy. A key factor in the timeline of events appears to be the need to do something to rebalance the impact on the latest intelligence on falling income streams as well as the inability to influence core mainstream expenditure – presumably due to a lack of time.

7.5 The need to fund core net spend from specific funds, together with the apparent speed by which these measures have been put together does not inspire confidence that the 2015 Budget has been founded on sound principles and good financial management practice. The utilisation of reserves to fund core spend is a "real wake-up call" and is typically the product of a rapidly deteriorating fiscal position.

[1] CIPFA Report to the Corporate Services Scrutiny Panel – Concluding Comments Para 1.49
[2] CIPFA Report to the Corporate Services Scrutiny Panel – Concluding Comments Para 1.49
[3] CIPFA Report to the Corporate Services Scrutiny Panel – Concluding Comments Para 1.58

Deteriorating Income Position

7.6 The fact that a further 1% cut in the marginal rate of Income Tax was in contemplation when Income Tax Forecasts produced by the ITFG showed significant downturn further suggests a lack of clear direction in the setting of Financial Strategy. We note that there appears to be a number of references in the 2015 Budget Material to the Fiscal Policy Panel (FPP) endorsement of the current Financial Strategy of running deficits "while conditions remain weak"1. We do not believe that running of the planned deficits will have a significant impact as a form of economic stimulus. However, the propensity to deliver on Capital Programmes and the potential for future Tax increases if reserves become depleted will inevitably have appreciable economic impacts. Some of the recent Tax and Social Security trends resemble underlying patterns that may well point to a structural deficit although it is clear that a realignment of expenditure with income is now a fundamental requirement as deficits financed from reserves cannot be considered to be a responsible financial strategy beyond the short term.

7.7 Given the serious lack of precision demonstrated on income forecasting we believe that the LTRP and, indeed the 2015 Budget requires to be updated with the very latest forecasting. In relation to forecasting we have been made aware that the latest projections on Income Tax yield may be even worse than the projections underpinning the current 2014 Outturn position within the 2015 Budget submission. There is a real danger that forecasting and the determination of assumptions are deemed to be a hypothetical exercise - the consequences of which can be addressed in the future and does not attract immediate risk, indeed *"Good forecasting helps managers identify risks, but they need to take into account that data and assumptions can themselves be part of that risk."*2. The latest Income Forecasts point to Income being approximately £40 below Budget.

7.8 In relation to the system and processes used by the Tax Office and Treasury in compiling In Year Monitoring and Forecasting, we are satisfied that the methodology used, as directed by the Finance Director at the Tax Office, is sound and that the downward trajectory on Income Tax yields relates to the impacts of previous decision son tax and the prevailing economic conditions. During the 2014 and 2015 Budget setting process we have been critical of the lack of formality around the operation of the Income Tax Forecasting Group (ITFG). In this respect the role of the organisation's Chief Financial Officer is critical. An extract from CIPFA's Guidance on the Role of the Chief Financial Officer outlines relevant responsibilities in this context:-

"CFOs must act in the public interest, even if necessary against a perceived organisational interest. In some types of public service organisation this professional obligation is given statutory backing, and a fiduciary duty is established in case law. As holders of the 'red card', the CFO must exercise a professional responsibility to intervene in spending plans in order to maintain the balance of resources so that the organisation remains a going concern."[3]

[1] Council of Ministers Budget 2015 Plan of proposed measures to manage the Consolidated Fund – Page 1 – Para 2
[2] NAO – Forecasting in Government to achieve Value for Money – January 2014 - Para 3.11 – Page 29
[3] CIPFA – The Role of the Chief Financial Officer in Public Organisations – Principle 1 – Page 7

Aspirational Capital Programme

7.9 On the Capital Programme we believe that the States face challenges in improving the precision of key assumptions as well as capacity including performance management capability and ultimately, affordability. The appropriate legislative allocation approval process has created a dysfunctional impact upon Financial Performance and Strategy as it is driven largely by aspirational/expectation rather than reality. Continuation of the existing position will act as a significant impediment to the formulation of a robust financial strategy that informs both the annual Budget Setting process and the MTFP.

Financial Strategy and the MTFP

7.10 In previous work for the States we envisaged that the MTFP would provide the appropriate stability for the development of Financial Strategy. However, main assumptions underpinning the MTFP model are now so removed from the latest tracking that the 2013-15 MTFP model is no longer considered to be ‘fit for purpose’ and requires significant recalibration. Within our work we detected elements of optimism bias in the formulation of basic assumptions. This may be caused by a variety of factors including prevailing operating culture and political influence.

7.11 Perhaps the most critical element is the apparent failure to adjust Financial Strategy in line with the very latest intelligence. Given the continuing deteriorating position on Income Tax forecasts it is critical that the latest forecasts are used in determining the 2014 Outturn and setting the base for 2015. A worst case scenario could be that failure to adjust projections in line with the latest intelligence could mean that Members could be voting on a Budget that senior officers know is unlikely to be achieved.

7.12 Given the complete ‘turn around’ in the tenor of the 2015 Budget, it is essential that Members are provided with objective, comprehensive and contemporaneous Budget information that will allow an appropriate level of assurance that will aid informed decision making. Whilst we appreciate that the 2015 Budget setting process differs due to the timing of the States elections we would still be of the view that the incorporation of information set in May for the forthcoming financial year does not meet good practice. It is not the materiality (or lack of) of the movement between May and August but the overall movement that has driven expected bottom line deficits that should drive the requirement for constant modification.

2016 and Beyond

7.13 Moving on one year - we believe that if the causal misalignment of Expenditure with Income is not adequately addressed the States will face even larger Deficits moving forward on 2016 and 2017 and less flexibility in the utilisation of Reserves. In order to fully deal with the issues highlighted within this report and allow for the setting of a robust financial strategy there needs to be a cultural acceptance within the States of the underlying factors that have had a negative impact upon the 2015 Budget Setting process and the need to pursue a strategy of recovery and stability. Whilst the option of raising Taxes may be counterintuitive and may be adversely affect the potential competitiveness of Jersey, such is the States current financial position in the context of the uncertainty of the current and future economic landscape that the concept of raising additional revenue generation should not be ruled out

Recommendations – Moving Forward

7.14 Should the Corporate Services Scrutiny Panel be minded to approve the 2015 Budget proposition as now constituted we would recommend that such approval be given subject to a range of measures designed to improve the effectiveness of the Budget Strategy process be implemented. Based upon our foregoing analysis our twelve recommendations are outlined below:-

Remedial Measures impacting Financial Forecasts – it is critical that Departments are signed-up to delivering on Base Budget reductions. We would recommend that the ability of remedial measures designed to ameliorate expected Budget deficits are critically appraised in relation to their propensity for delivery. We believe that this 'savings' validation work is urgently required as delivery of such measures will be an important component of how Jersey deals with realigning deficits. In terms of independence it may be expedient if this work was conducted by the Comptroller and Auditor General;

Capital Programme Performance – it is recommended that the legislative framework around the Capital Allocation process and incorporation within the Budget process be reviewed to allow for the realistic delivery of the Capital Programme and that appropriate performance management arrangements are put in place to ensure delivery;

Replacement Hospital - Capital Programme – it is recommended that Capital Costs are re-evaluated to ensure that there is appropriate precision within the expected £297m cost exposure and that approved functionality synchronises with these expected costs;

Replacement Hospital – Recurring Revenue Costs – it is recommend that the full life recurring running costs are appropriately evaluated against the MTFP financing capability in respect of the appropriate Health and Social Services Budgets. Whole Life Costing should be fully embedded within the Project Modelling and Revenue Budgets;

Funding the Replacement Hospital – Strategic Reserve – it is recommended that in light of current investment returns that the feasibility of delivering investment returns on the Strategic Fund of 5.7% in 2014, 5.7% in both 2015 and 2016 and 6.5% each year from 2018 to 2024 is further investigated;

Funding the Liquid Waste Project – in the context of an additional 2% departmental savings requirement it is recommended that an assessment is undertaken of the ability of the Transport and Technical Services Department to fund the Liquid Waste Project as previously set out within the Budget setting process;

Income Tax Forecasting Group - ITFG – Membership and attendance of this group should be formalised within a structured reporting framework – quarterly outwith Budget setting – Monthly with Budget setting quarter with formal minutes being made available to the Council of Ministers;

Base Budget Setting - latest Forecasts MUST be used as the foundation for informing the Budget Setting Process, as far as reasonably practical to the point where Members are provided with the details within the States approval process;

Long Term Revenue Plan (LTRP) – this promised analysis which should provide direction to both the Budget Setting Process and a foundation for the MTFP should be presented to Members as soon as possible for approval;

Economy and Financial Strategy – it is recommended that the economic drivers that influence Tax yields are appropriately evaluated. This will include the determination of the extent of any Structural Deficit and the likely impacts on Financial Strategy. All available sources of data including any correlation between Social Security contributions and Income Tax yields should be used to inform Financial Strategy. This should be a joint initiative between the Economics Unit and Treasury and Resources;

Medium Term Financial Plan (MTFP) – the MTFP requires urgent recalibration and Treasury should commence upon this work without delay. It is further recommended that the Council of Ministers should be given the opportunity to approve the changes needed to re-align the MTFP in a way that can provide stability for Medium and Longer Term Financial Planning; and

Optimising Income Generation Capability – as well as concentration on expenditure reduction Departments should be encouraged to identify aspects of service provision or other opportunities that can optimise Income generation capability. Service delivery benchmarking should be used to identify wider options deployed by competitors and the UK where appropriate. Such efforts should be co-ordinated centrally by Treasury and that appropriate incentivisation measures should be deployed to encourage and concentrate efforts.

13. APPENDIX 3: REPORT FROM MJO CONSULTANCY

Jersey's 2015 Budget

Michael J. Oliver

1. INTRODUCTION

1.1 Since the start of the 2014 there have been signs that economic activity in Jersey is picking up. The Business Tendency Survey for June 2014 shows that a number of key indicators for non-finance have improved over the last twelve months and business activity is the most positive since September 2009. Future business activity has now remained positive for a year. In parts of the finance sector firms are expecting a small increase in profits in 2014. The latest data on average earnings suggests some modest relief for workers in the year to June 2014 with average weekly earnings 2.6% higher than June 2013.

1.2 Whilst all of this news is positive, it has to be set against one crucial statistical measures of public welfare, which is that GVA per capita has fallen by 21% since 2008. Thus although the latest increase in average earnings is higher than the five-year average of 2.1% per annum, it is far below the long-term annual average of 4.5% since 1990. Until there are sustained increases in GVA – which in the past has depended on the profitability of the finance sector – the Jersey economy cannot begin to hope for ‘escape velocity’ from the most savage recession in living memory.

1.3 One of the biggest challenges for Jersey is how to return the finance sector to its former profitability. While there will be some who might welcome the demise of the finance industry, it needs to be remembered that the sector has delivered an outstanding period of prosperity to the Island. The contraction in financial services did not begin with the financial crisis of 2008-9 and the new Policy Framework for finance highlights the work now required to sustain Jersey’s reputation as a leading international finance sector in the aftermath of the Global Financial Crisis. The optimism of the late-2000s, when some policymakers thought that a return to higher interest would rescue the sector, has been replaced by realism that the future for offshore finance is now very different to a decade ago.

1.4 Like its predecessor a year ago, the foreword to the Budget is strong on rhetoric and weak on recognising reality. The reality is that key aspects of the Government's macroeconomic strategy have significant problems, and although these are not insurmountable they have to be addressed to provide stability, prudence and coherence for the economic challenges which lie ahead. This report takes the opportunity to consider the Budget by drawing on certain key themes which have dominated economic policymaking over the past few years including income forecasts, the fiscal stimulus and the MTFP.

1.5 The publication of the 2015 Budget coincided with the resignation of the Treasurer. This author does not know of any other cases in the developed world where a Treasurer has resigned around the time a Budget has been published. This adds to serious questions about the conduct of economic policy which much be addressed going forward.

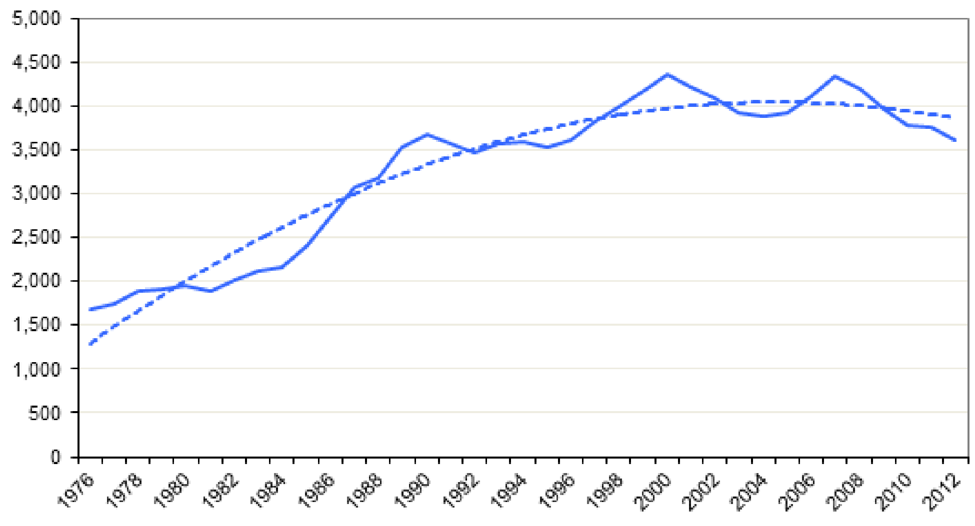
2. THE JERSEY ECONOMY

2.1 Economic performance

2.1.1 GVA

Since Scrutiny examined the 2014 Budget last year, there has been no new data on Jersey's GVA. It is worth stressing the picture as it stood then (Figure 1) accompanied by the usual 'health warnings' about data points prior to 1998. The transition from low value economic activities to high value added activities (predominately financial services) and the diminishing impact of this for GVA is captured in the graph. Coupled to the duration of the recession, this adds to the likelihood that parts of the economy are in structural decline.

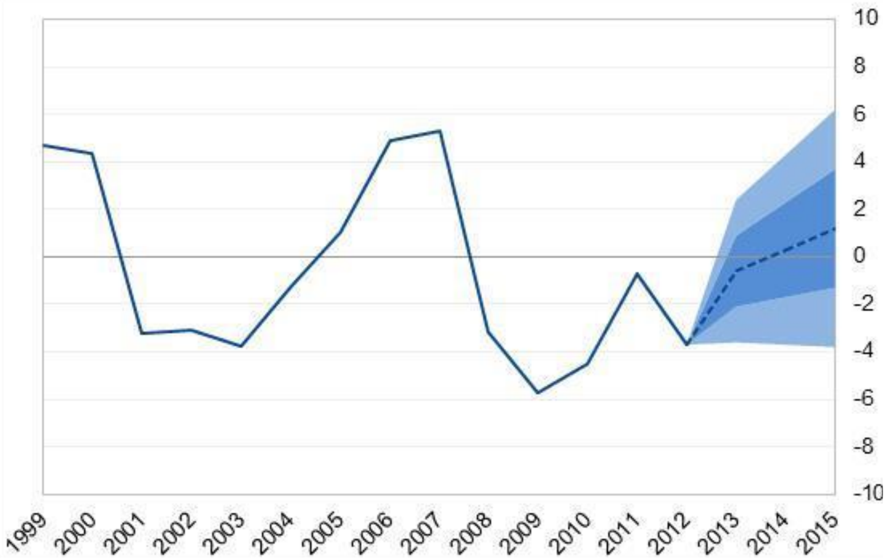
Figure 1. Real GVA, 1976–2012 (£m, current prices)



Source: States of Jersey Economics Unit

The Fiscal Policy Panel's (FPP) forecast for GVA in 2012 was in the central forecast range of –3% to +1% but the provisional outturn was –4%. Data for GVA in 2013 will be available in mid-September although in their July 2014 report, the FPP revised their central forecast for 2013 and 2014 downwards to –2% to +1% and –2% to +2%, respectively. For 2015, they have selected a larger central range for 2015 of between -1% and +4% (Figure 2).

Figure 2.   Actual and forecast GVA, 1999–2015



Source: Fiscal Policy Panel (2014, p. 30)

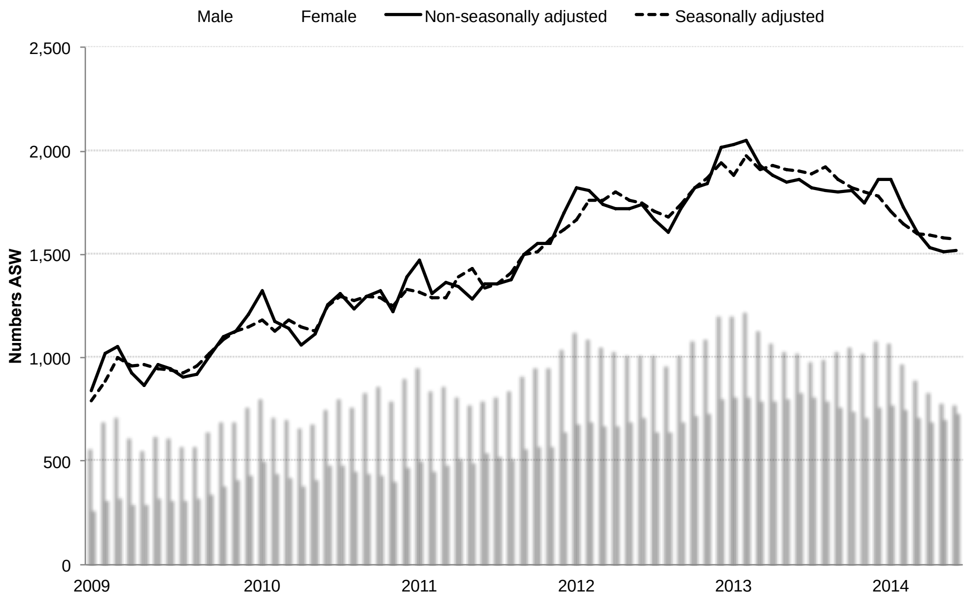
2.1.2 Employment and unemployment

It is very unfortunate that the delay in the compilation of data from the manpower survey run by the Population Office in December 2013 has resulted in the postponement of the Jersey's Labour Market survey for December 2013 and Jersey Resident Population report for 2013.

It has been remarked before that the post-2008 recession has not had as dramatic an effect on total employment growth as the early 2000s recession; however, one notable difference this time is the growth in part-time private employment. Part-time work brings with it lower salaries and reduced benefits and this will be reflected in a lower standard of living for Jersey's employees (and lower income tax receipts for the Treasury).

The number of those who are 'actively seeking work' is illustrated in Figure 3. Unemployment doubled between 2009 and 2013 (Figure 6).[59] Since May 2013 there been a reduction in those actively seeking work and although the latest figure is historically very high, it seems to be on a downward trend. Unfortunately, there has been a simultaneous increase in the number of people who are classified as underemployed (that is they were working less than 35 hours per week and were actively seeking more work): in July 2014 almost a quarter of all people registered as ASW were underemployed.

Figure 3. Total number of individuals registered as Actively Seeking Work, Jan 2009 – July 2014



Source: States of Jersey Statistics Unit

The FPP have also included a useful figure in their July 2014 report which shows the number of Social Security contributions over the past five years (Figure 4). Figure 4 demonstrates that there has been a significant decline in the number of individual contributions over this period.

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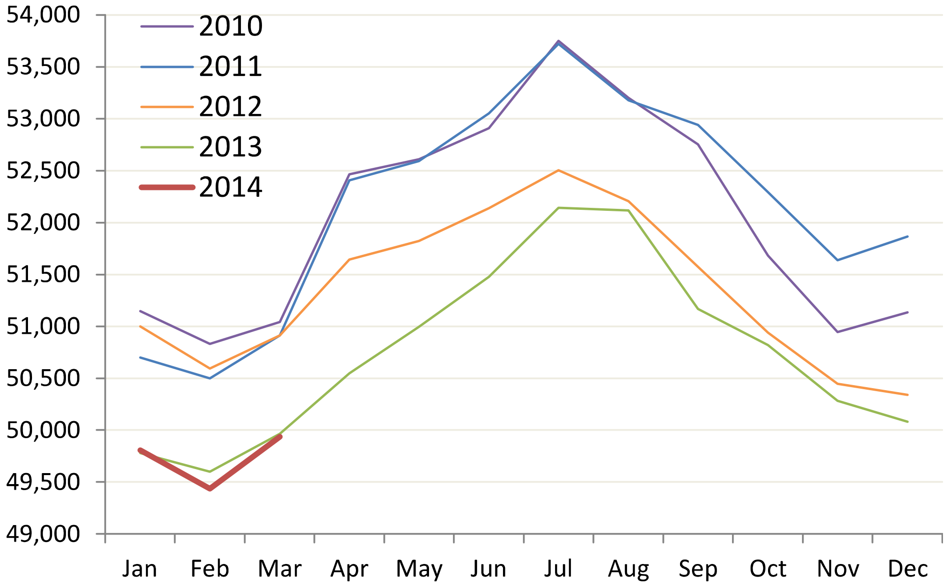
[59] There is no legal requirement for all unemployed residents of Jersey to register as actively seeking work (ASW) with the Social Security Department. It is widely accepted that there is a lot of hidden unemployment in Jersey which might, in the worst case, add an additional one to two thousand to the ASW figures. This would then produce an unemployment rate more akin to rates in some other developed economies.

Figure 4. Number of Class 1 and Class 2 contributions in each month, January 2010 – March 2014



Source: States of Jersey Statistics Unit

With a lag, social security data can provide a good indicator of what has recently happened in the economy in terms of employment and will indicate future income tax streams. Table 1 shows that the total contributions and number of contributors is down by 1% in 2103 compared to 2012. The value of 2013 contributions in cash terms is now less than 2009, despite inflation over this period. The number of contributors is also down. This will have implications for income tax receipts for 2014.

Table 1. Contributors and contributions to social security, 2009–2013

	2009	2010	2011	2012	2013
Total of Class 1 contributions below SEL (£000)	163,206	161,463	161,187	164,253	162,719
Total of Class 1 contributions above SEL (£000)				5,121	5,163
Total of Class 2 contributions below SEL (£000)	17,493	17,659	16,169	15,544	14,971
Total of Class 2 contributions above SEL (£000)				1,974	2,136
Total Value of contributions (£000)	180,699	179,121	177,356	186,893	184,988
Average No of Class 1 contributors during year	48,618	48,275	48,359	47,620	47,091
Average No of Class 2 contributors during year	4,291	4,176	3,877	3,783	3,751
Average Class 1 contribution per annum (£)	3,357	3,345	3,333	3,557	3,565
Average Class 2 contribution per annum (£)	4,077	4,229	4,170	4,631	4,561

Source: Social Security Annual Report 2013, p. 17

2.2 The finance sector

2.2.1 The annual Survey of Financial Institutions published by the Statistics Unit provides data on Jersey's biggest industry including gross operating surplus, profits by sub-sector and the total number of staff employed in financial services.[60]

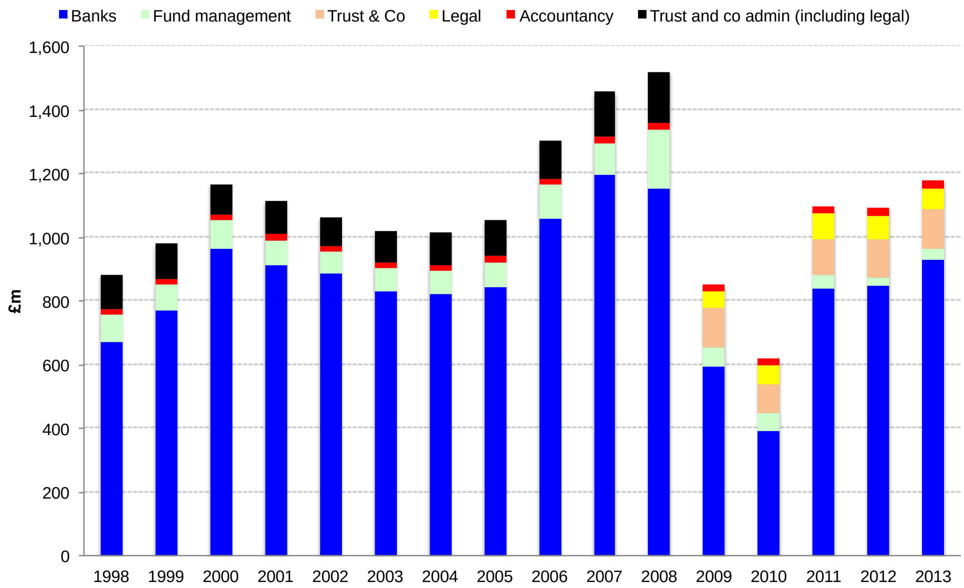
2.2.2 A key measurement of economic performance in Jersey's financial services sector is gross operating surplus (GOS).[61] Data on this only goes back to 2009. In 2009, GOS was £870 million but fell in 2010 to £720 million. It has hovered around this figure for three years but fell by a further 5 per cent in 2013.

2.2.3 Although figures for net profit can be susceptible to the volatility of income transfers (and hence why GOS is the preferred measure of economic performance in financial services), they do provide data which goes back to 1998. Total net profit for the finance sector is illustrated in Figure 5.

[60] Financial services is defined in the Survey as the activities of banks, fund managers, trust and company administrators and accountancy firms operating in Jersey. The survey does not analyse firms predominantly engaged in insurance and financial advisory services

[61] Gross operating surplus represents revenue minus operating costs, and excludes income transferred to resident parent companies in Jersey by non-resident units operating outside of the Island.

Figure 5. Total net profit for finance sector, 1998–2013



Source: States of Jersey Statistics Unit
Note: Trust and company administration and legal net profits have been separately recorded since 2009.

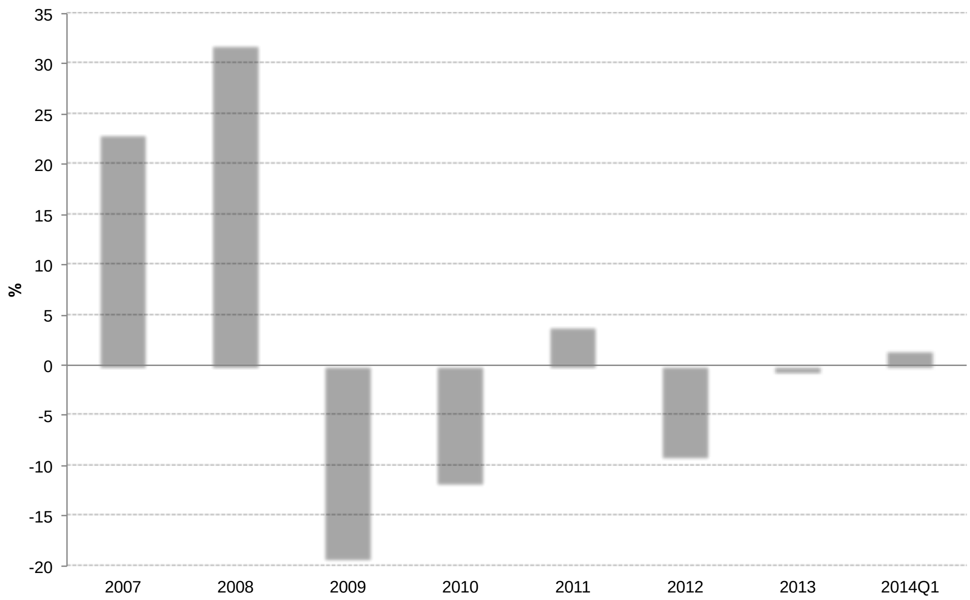
2.2.5 The importance of the banking sub-sector for Jersey's economy is well known. In 2013, banking accounted for 79% of the total net profits of Jersey's entire financial services sector. This was a similar proportion from the mid-1990s up until 2008. However, in 2009 and 2010, there was a collapse in total net banking profits. Over the period 2007 to 2010, net profits fell by 66%. In contrast, during the recession in the 2000s, total net profit in banking fell by just over 10%. The banking sub-sector has traditionally been a large employer, accounting for almost half of total employment within financial services. The fall-out in employment from financial services since 2008 has been dramatic with a decrease in employment of over 1,000.

2.2.6 The banking sub-sector has seen significant falls in net interest income since 2008.[62] Prior to the crisis, net interest income

[62] Net interest income is driven by interest rates and is the difference between the interest a bank receives on its loans and the interest the banks pays to its depositors.

accounted for nearly two thirds of the banking sectors' gross income, so profits from net interest income are a vital part of all banking profits (and financial services as a whole). Figure 6 illustrates the changes in net interest income between 2007 and the first quarter of 2014.

Figure 6. Trends in net interest income, 2007–Q1 2014 (percentage change)

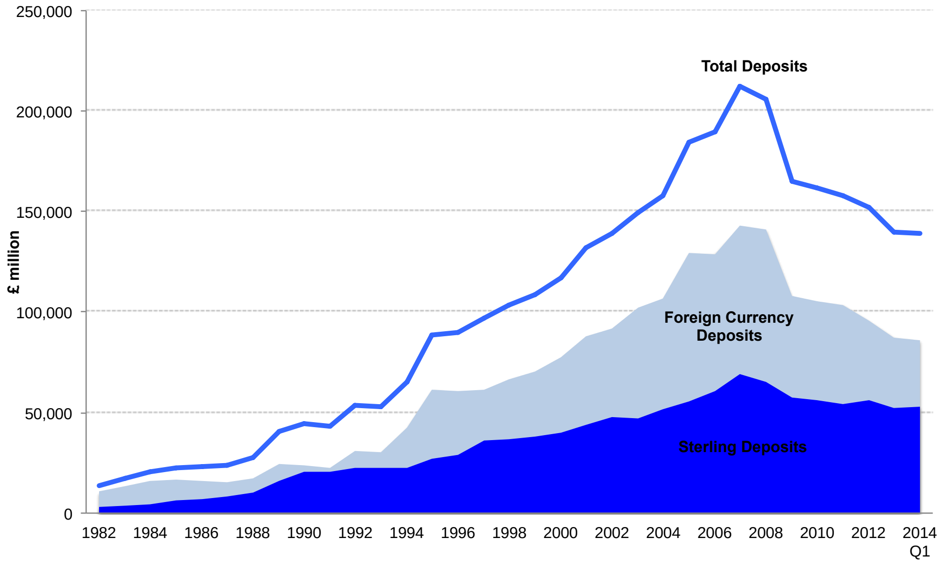


Source: Jersey Financial Services Commission

2.2.7 Many economists are expecting an increase in interest rates during the next twelve months and normalization of rates over the economic cycle to 3% (the Governor of the Bank of England expects the base rate to be 3% by 2017). Some economists are unsure how quickly interest rates will rise, for example, the fund manager Neil Woodford expects far slower increases in rates. If the upward movement in interest rates is 3% by 2017 then this 'new normal' is lower than the historical average (Jersey's Economic Adviser has assumed in his latest forecast that interest rates will be at 2.5% by 2017). Moreover, it needs to be remembered that net interest income is a factor of both profit margins and the level of deposits. The sterling value of deposits in Jersey declined by over a third between 2007 and 2013 (Figure 7). The authorities hope that the new Financial Services Industry Policy

Framework will encourage a range of new banks to deposit funds in Jersey which might counter this contraction.

Figure 7. Bank deposits held in Jersey, 1982–Q1 2014 (£ million)



Source: Jersey Financial Services Commission

In their 2014 report, the FPP have drawn attention to the latest Business Tendency Survey which suggests that only 12% of finance firms expected profits to decline this year – the lowest proportion since the Business Tendency Survey began to collect these data in 2010. A number of people in the financial services sector have told this author that the profit squeeze in the sector is in part explained by increased compliance and regulation. This can be illustrated with reference to the Survey of Financial Institutions which shows that there was an increase of 160 FTEs engaged in compliance in 2013 compared with 2012. Considerable uncertainties and risks still remain for the finance industry largely because of the unknown impact of UK and US FATCA negotiations.

3. INCOME TAX FORECASTS, EXPENDITURE PLANS AND ECONOMIC FORECASTS

3.1 Table 2 provides a summary of the income tax forecasts over the last three years. This table is grouped into five. First, in rows 1-3 there are the forecasts prepared by the Economics Unit in March 2012 which were used in the MTFP published at the end of July 2012. Second, in rows 4 and 5 there are the forecasts which were prepared by this author with the assistance of the Economics Unit in the summer of 2012. Third, in rows 6 to 8 there are the forecasts prepared in March 2013, which fed into the long-term revenue projections for 2020. Fourth, in rows 9 to 11 there are the income forecasts produced in April 2014 which have been used for the basis of the 2015 Budget. Finally, rows 12 to 17 are a series of basic calculations showing the differences between the various forecasts.

3.2 A discussion about the income tax forecasts will be included in Section 4 but the following should be noted:

- Every forecast since the publication of the MTFP has shown a deterioration;
- The 2014 forecast is now worse than that Scrutiny 1 forecast in 2012 which was criticised at the time for being very negative;
- The cumulative difference between the MTFP income tax forecast for 2014 and 2015 and the figure now given in Budget 2015 is £70m.

3.3 In its report on forecasting expenditure in 2010, one of the Corporate Services Panel’s key findings was that discipline is required in States debates on expenditure and a recommendation was added that the Minister for Treasury and Resources must find a method of ensuring that expenditure in Jersey is income driven (Corporate Services Panel 2010). In 2012, the MTFP provided spending plans for three years and closely matched income to expenditure. This is shown in Figure 8. Re-plotting total income and expenditure outturns for 2013 and the forecasts for 2014 and 2015 shows a badly deteriorating picture (Figure 9).

Table 2. Income tax forecasts, 2013–20 (budget years)

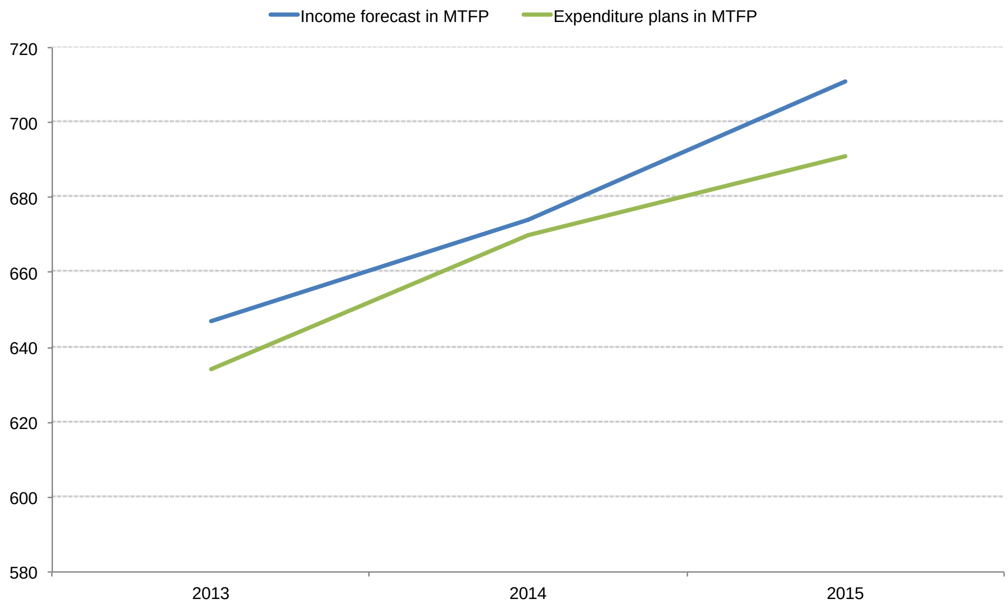
	2013	2014	2015	2016	2017	2018	2019	2020
	£m	£m	£m	n.a				
(1) MTFP Upper	470	495	525	n.a				
(2) MTFP Central	**450**	**470**	**500**	**n.a**				
(3) MTFP Lower	425	450	475	n.a				
(4) Scrutiny 1	**440**	**450**	**465**	n.a				
(5) Scrutiny 2	**440**	**455**	**475**	n.a				
(6) ITFG 2013 Upper	460	480	500	525				
(7) ITFG 2013 Central	**445**	**460**	**480**	**495**	**519**	**546**	**570**	**596**
(8) ITFG 2013 Lower	435	440	455	465				
(9) ITFG 2014 Upper		465	475	500	520			
(10) ITFG 2014 Central		**445**	**455**	**475**	**500**			
(11) ITFG 2014 Lower		420	430	450	470			
(12) Difference between (2) and (4)	10	20	35					
(13) Difference between (2) and (5)	10	15	25					
(14) Difference between (2) and (7)	5	10	20					
(15) Difference between (2) and (10)		25	45					
(16) Difference between (7) and (10)		15	25	20	19			
(17) Difference between (4) and (10)		5	10					
(17) Difference between (5) and (10)		10	20					

Source: MTFP, ITFG 2013 and ITFG 2014

The following should be noted:

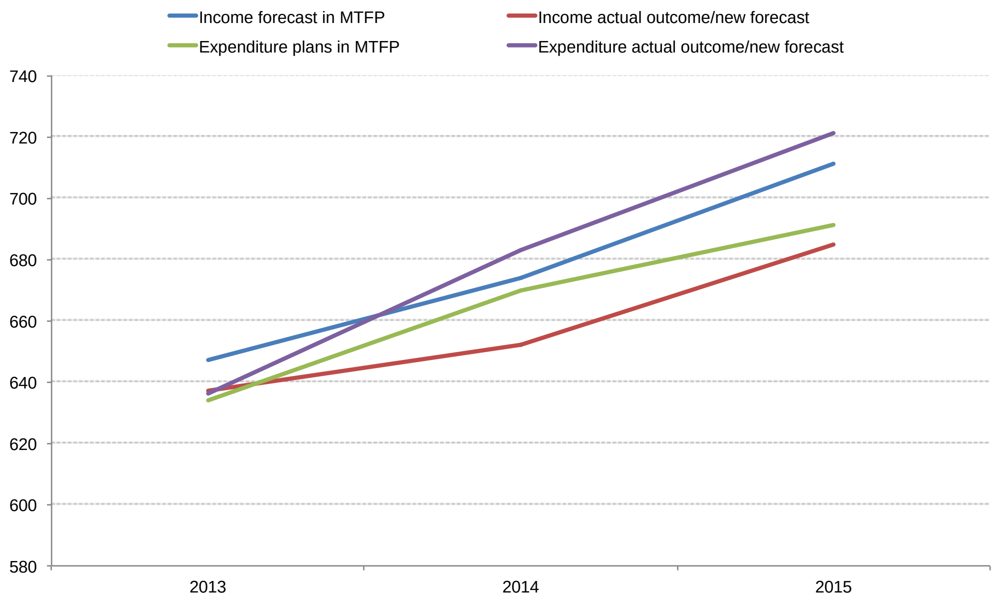
- The actual outturn for total income in 2013 was £10m worse than forecast in the MTFP;
- The cumulative difference between the original MTFP forecasts and the May 2014 forecasts for the period 2013–15 totals £94m;
- Total expenditure plans for the period 2013–2015 are now £45m higher than at the time of the MTFP.

Figure 8. Forecast of income and expenditure in the MTFP, 2013-2015



Source: MTFP

Figure 9. Forecast of income and expenditure in the 2015 Budget, 2013-2015 compared to MTFP



Source: MTFP and 2015 Budget

3.4 Turning to the economic forecasts since 2012, Table 3 recalls the initial economic assumptions that were in the MTFP in 2012. These forecasts are set against subsequent forecasts made in 2013 and 2014 (Tables 4 and 5).

Table 3. Economic assumptions behind the MTFP forecasts, 2012–15 (budget years), outturns in grey

% change	**2011**	**2012**	**2013**	**2014**	**2015**
Real GVA	1.2	1.4	2.0	2.5	2.5
RPIX/RPIY	3.7	3.3	3.0	2.9	3.0
Nominal GVA	4.9	4.8	5.0	5.6	5.6
Company profits	5.2	5.6	5.5	6.0	6.0
Compensation of employees	3.5	4.0	4.8	5.1	5.3
Employment	1.0	0.5	1.0	1.0	0.5
Average earnings	2.5	3.5	3.8	4.1	4.8
Interest rates (%)	0.5	0.5	0.6	0.9	1.4
Inters rates (pp change)	0.0	0.0	0.1	0.3	0.6
House prices	-1.0	1.0	3.0	4.0	5.0

Source: MTFP

Table 4. Economic assumptions and outturns made in the 2014 Budget (budget years), outturns in grey

% change	2011	2012	2013	2014	2015	2016	2017
Real GVA	–0.8	-1.0	-0.5	1.0	1.0	1.5	1.5
RPIX/RPIY	3.4	3.0	2.8	2.8	3.0	3.0	3.5
Nominal GVA	2.6	1.9	2.3	3.8	4.0	4.5	5.1
Company profits	2.0	2.4	3.0	3.5	4.0	4.5	5.0
Compensation of employees	2.8	1.0	2.0	3.5	4.0	4.7	4.7
Employment	0.8	-0.5	0.0	0.5	0.5	1.0	0.5
Average Earnings	2.5	1.5	2.0	3.0	3.8	3.7	4.2
Interest rates (%)	0.5	0.5	0.5	0.5	0.7	1.1	5.0
Interest rates (pp change)	0.0	0.0	0.0	0.0	0.2	0.6	4.4
House prices	-0.8	-1.0	-1.0	1.0	2.0	3.0	5.0

Source: ITFG 2013

Table 5. Economic assumptions and outturns in the 2015 Budget (budget years), outturns in grey

% change	2012	2013	2014	2015	2016	2017
Real GVA	-3.9	0.2	0.3	1.3	2.0	2.3
RPIY	3.0	1.5	2.2	3.0	3.3	3.3
Nominal GVA	-0.9	1.7	2.5	4.0	4.7	5.0
Company profits	-0.7	1.8	2.6	4.6	4.6	4.9
Financial services profits	-2.1	1.0	2.0	6.0	6.0	6.0
Compensation of employees	-1.1	1.6	2.5	3.5	4.7	5.0
Employment	-0.4	-0.5	0.0	0.5	1.0	1.0
Average Earnings	1.5	2.2	2.5	3.0	3.7	4.0
Interest rates (%)	0.5	0.5	0.5	0.9	1.7	2.5
House prices	-1.4	-1.3	0.0	2.0	3.0	4.0

Source: ITFG 2014

The following should be noted:

- There are some big differences between the forecasts of economic aggregates in 2012 and 2013 and eventual outcomes, particularly in terms of compensation of employees and GVA;
- The latest forecast suggest that financial services profits will be growing at 6 per cent per annum from 2015 (a similar figure to the forecast for all company profits made in 2012). This would be very welcome but might be unduly optimistic;
- The latest forecast suggests that the growth of real GVA will be higher in 2016 and 2017 than was forecast last year.

4. DISCUSSION

4.1 The 2014 income tax cut in retrospect

In the author's report for Scrutiny on the 2014 Budget he wrote this about the proposed reduction in the marginal rate of income tax, which is worth quoting in full:

> On balance, from an economic perspective, there seems to be significant dangers associated with reducing the marginal rate of income tax, which has recurring costs, largely because of the state of the public finances. The continuing poor performance of the Jersey economy and the subsequent downward deterioration of the income forecasts suggest that the optimistic income forecasts made in the MTFP are misplaced. If the reduction in the marginal rate of tax was part of a fiscal stimulus there could be some merit in what is being proposed; however, the delay in the impact of the changes for the bulk of taxpayers until 2015, when the Long Term Health Charge begins, suggests that what is being proposed is a very weak fiscal weapon. As the Fiscal Policy Panel (2013, p. 42) have noted, the tax cut is neither timely nor temporary. This criticism could be extended to the Budget generally: where is the mapping of any stimulus against the 3Ts (temporary, timed and targeted) or an explicit discussion on how it will create jobs?

There was no discussion in the 2014 Budget about whether the public finances allowed for a reduction in the marginal rate of tax. This reduction was economically imprudent although remarkably, it seems that a further reduction was planned for inclusion in the 2015 Budget. In the draft briefing on the 2015 Budget prepared for Ministers on 6 June, the intention was to cut the marginal rate of tax by another percentage point. It is difficult to comprehend why the case for further reducing the marginal rate of tax was even considered in the light of the forecasts from the Income Tax Forecast Group which had been produced in May 2014.

If the outturn for income is as low as the latest forecasts suggest then the 2015 Budget is the calm before the storm. It is a Budget which signals the storms ahead, as can be seen in the emergency remedial measures outlined on pages 56-58 and which are discussed by the advisor from CIPFA. The FPP are right to note that these measures do not have any impact on economic growth, but another reading shows how quickly the public finances have deteriorated in Jersey when funds are being raided to balance the books. It will be interesting to see how easily Departments will be able to make savings. The 'salami slicing' approach to expenditure from the last Comprehensive Spending Review caused problems for many and suggests Departments might struggle to make these cuts. On the other hand, in the light of the publicity earlier in the year about Departmental underspends there might be financial slack which could be taken-up fairly painlessly.

4.2 The structural deficit

The issue of whether or not Jersey has a structural deficit – as opposed to a cyclical deficit - has been the focus of numerous comments by the FPP over the years. It is important to highlight these.

In their 2008 report the FPP noted:

> there is also a significant risk that States' revenue and expenditure levels turn out to be worse than that currently forecast revealing a structural deficit in States' finances in the medium-term
>
> (Fiscal Policy Panel 2008a, p. 39)

In their November 2008 update, the FPP noted:

> There is a real danger that the States could emerge from the economic slowdown and transition period to 0/10 with a significant structural deficit to address.
>
> (Fiscal Policy Panel 2008b, p. 2)

and recommended that:

> Given the significant uncertainties in the medium-term it would make sense for the States to consider contingency plans in terms of how fiscal policy could be tightened in future years if a structural deficit materialises.
>
> (Fiscal Policy Panel 2008b, p. 11)

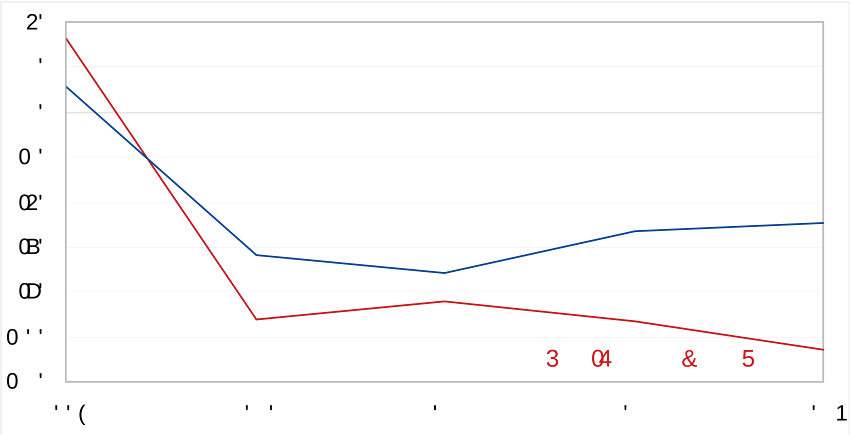
In their annual report published in May 2009, the FPP made a further warning about the structural deficit:

> the revised financial forecasts suggest deficits of around £60m per annum for 2012 and beyond in the central scenario …after the economy is assumed to have returned to trend. This would suggest that a large part of the projected shortfall could be structural …A structural deficit of this scale would require the States to take corrective action once the economy has recovered and is performing more robustly. This action would require tough decisions on cutting spending or increasing taxation and so a strategy should be developed for how this would be achieved. The risk of a structural deficit is increased when the list of emerging spending pressures is considered. This gives an added imperative that plans to balance the States finances in the medium term are given full and proper consideration. The Panel would not advise that new additions to expenditure or reductions in the tax base are made unless offsetting savings can be implemented… during the current fiscal year a strategy should be agreed for dealing with any structural deficits once the economy has recovered.
>
> (Fiscal Policy Panel 2009a, p. 33)

In an update published five months later, the Fiscal Policy Panel (2009b, p. 12) reiterated that ‘in order to avoid the running down of reserves or resorting to borrowing, the Panel continues to recommend that a strategy be put in place by the end of the year for addressing a structural deficit should one arise’ and expressed concerns ‘that consistent upward drift [spending] potentially creates structural problems in the medium term where these increases are not matched by commensurate structural increases in revenues’. The FPP also voiced its concern about expenditure which was not resourced from structural increases in revenue as ‘it is likely to be storing up problems further down the line, regardless of the cause of the drift’.

By September 2010 the FPP made its most explicit warnings so far and noted that ‘a significant structural deficit is increasingly likely unless action is taken’ (Fiscal Policy Panel 2010a, p. 9). They also produced a figure showing the deterioration in the public finances (reproduced as Figure 10 below).

Figure 10. Forecast surpluses and deficits, £m (current prices) 2009–2013



Source: Fiscal Policy Panel (2010a, p. 9)

The FPP stressed again its desire to see how policymakers were going to address the structural deficit:

> The Panel believes it is important to set out some guiding principles for Jersey as it faces up to the structural deficit and a post crisis world. In particular:
>
> - Fiscal consolidation should have regard for the consequences for economic growth;
> - Focus now should be on a credible medium-term fiscal plan
> - Balancing the books will not be enough and the plan should be to run surpluses once the economy recovers to rebuild the Stabilisation Fund.
>
> (Fiscal Policy Panel 2010a, pp. 3-4)

In their annual report for 2010 produced two months later, the Panel reflected that the Comprehensive Spending Review had 'identified additional spending pressures that need to be financed, so the problem faced in the absence of any corrective action is slightly larger and more likely to include a significant structural element' (Fiscal Policy Panel 2010b, p. 19).

By July 2011, the Panel commented that the Stabilisation Fund had been used to 'finance deficits arising for both cyclical and structural reasons' (Fiscal Policy Panel 2011, p.22) and that 'if savings cannot ultimately be delivered then any shortfall may have to be made up through tax increases if there remains a structural deficit over the medium-term' (Fiscal Policy Panel 2011, p. 38). By October 2012:

> The Panel cannot rule out that there is an underlying structural imbalance between expenditure and revenue. The Panel's view is that further analysis is required by the Treasury and Resources Department to consider the nature of proposed capital expenditure, the way it is funded and what it implies for the underlying position of States' finances. If this analysis suggests there is a structural deficit then consideration should be given to its extent and nature, including a more detailed plan of action to rectify it.
>
> (Fiscal Policy Panel 2012, p. 6)

The October 2012 Annual review expressed a number of concerns that pointed to a worsening of the structural position including:

> revenue expenditure plans have been increased on the basis that all the expected increase is structural…gross capital expenditure in the short term…funded by one-off receipts but in the long-term this will require additional funding measures as yet unspecified and to be determined in the future. This increases the likelihood that the underlying structural position is not in balance...There are some smaller factors which could all worsen the structural position - such as the £5m shortfall on the original CSR savings target by 2015, the need to find a replacement for HIF funding of around £6m a year and the possibility that States employee pay awards end up being higher than provided for.
>
> (Fiscal Policy Panel 2012, p. 50)

In their Annual Report in 2013, the Panel noted that it still had not seen any work on the measurement and monitoring of structural surpluses and deficits and 'would have liked to see this as supporting information for Budget 2014, especially as there are proposals for long-term changes to income tax and funding capital expenditure' (Fiscal Policy Panel 2013, p. 31).

Finally, in its most recent report, the Panel recognised that the next Medium Term Financial Plan will have to contain measures to address the structural shortfall between States' income and expenditure and that 'the medium-term outlook, while uncertain, suggests that there are significant challenges in even maintaining a balanced budget (Fiscal Policy Panel 2014, p. 32). In an interview for BBC Radio Jersey on 18 July 2014 the chairman of the FPP, Joly Dixon, remarked he was far more certain a structural deficit existed.

4.3 The Property Tax Review

If there is a structural deficit it will probably be unlikely that expenditure cuts alone will be able to address this. The announcement of a Property Tax Review is therefore a potential source of future revenue.

The Property Tax Review (Green Paper) and the report by PwC makes interesting reading. The Fiscal Strategy Review in July 2010 showed that the revenues from domestic and non-domestic property were £22 million (£14 million from domestic rates and £8 million from non-domestic rates). One suggestion in the July 2010 review was to triple the domestic rate (it was an average of £350 in 2010) so that it was more akin to the UK average. PwC estimate that if this were to happen, it would generate an extra £32.5 million based on 2013 figures. As PwC recognize, the cost of living in Jersey is significantly above the UK and it would be an increased financial burden if this suggestion were to be implemented. Nevertheless, the *economic* rationale to abolish both the Parish Rates and the Island Wide Rate and replace it with a Domestic Property Tax (PwC suggestion) and increase it by between 25% and 50% of the existing charge over a 10-year time scale (the author's suggestion) is compelling. Given the enormous increase in home building on the Island which is being undertaken over the next five years, this will add an additional 2,600 rateable properties.

The reality, however, is that the introduction of a domestic property tax will likely to be very difficult to implement for various reasons including the tribulations associated with introducing any new tax in a jurisdiction where issues of affordability are of huge concern; the laudable principle that everyone should pay something will most likely be set against the memories of the unpopular 'poll tax' in the UK in the 1980s by some critics; and the efficient and cost-effective rates system will have to replaced by a more costly system of centralised administration. None of these difficulties is insurmountable, but it is doubtful that significant revenues with obtainable from a Domestic Property Tax before the 2020s.

4.4 The Fiscal Stimulus

There have been further references since the publication of the draft 2015 Budget to fiscal stimulus. It needs to be recalled that one of the recommendations by the Corporate Services Scrutiny Panel about the MTFP was that Treasury and Resources should undertake work to justify the size, nature and scope of any additional fiscal stimulus and in particular its economic impact. This was not undertaken and the effect of the entire fiscal stimulus exercise in Jersey has not been well understood. Four years on, it would probably be hard to make a case other than the initial stimulus had a very limited impact on the economy. When the economy has been at it weakest over the past two years, the Stabilisation Fund was exhausted. The view of the FPP has always been that if authorities were going to undertake a meaningful fiscal stimulus then they should not be constrained by the size of the balance in the Consolidated Fund.

Policymakers seemed to have adopted a rather schizophrenic approach to the fiscal stimulus. On the one hand, the Treasury has been keen to publicize the amount of stimulus undertaken but it is not clear from an economic perspective, as opposed to an accounting perspective, how the economy has benefited. It would be more accurate to say that aside from 2009 and 2010, there has been a lot of lip-service paid to the 3Ts (temporary, timely and targeted). On the other hand, there have been blockages with getting approved capital expenditure into ‘shovel ready’ projects as witnesses to Scrutiny have attested. The FPP has also criticized the size of the injections in the economy during 2013 which suggests that not enough had been done.

It appears that the Treasury is going to undertake more detailed work about on island and off-island spend which will be useful for any future stimulus but as will be discussed in Section 4.7, it remains vague when the Stablisation Fund will be able to be used again. In addition, as Section 4.9 notes there appears to be an enormous amount of stimulus to come when it is expected that the economy will recover.

4.5 Economic forecasts

It is well known that over the last few years economic forecasters at the IMF, the OECD and many respected private sector organizations have been heavily criticised for the accuracy of their economic forecasts. The usual explanation given for inaccurate forecasts is that economies are very complicated and economists do not fully understand how they work.

In a survey of economic forecasts for the 1990s, Loungani (2001) concluded that many forecasts made during this time were much the same and that the record of economists to predict recessions was very poor. This conclusion was based on the finding that forecasters predicted only two of the recessions that occurred around the world in the 1990s a year in advance. 40 of the 60 recessions remained undetected seven months before they occurred. In an update to this work, Ahir and Loungani (2014) considered 88 recessions over the period 2008-12 and found that none of the 62 recessions in 2008-09 was predicted even as the previous year was drawing to a close. Although forecasters did a good job of predicting by September 2009 that many countries would be in recession in 2010, the period 2011-12 witnessed just one exception of an accurate forecast of a recession. They summarise:

> … forecasters continue to have only a limited ability to forecast recessions, particularly by September of the year before the recessions begin. Why is this the case? To fail to forecast a few recessions may be misfortune, to fail to forecast nearly all of them seems like carelessness. Do forecasters simply not update their forecasts often enough to be alert to the onset of recessions? That simple possible explanation turns out not to be true. Other work carried out by one of us shows that individual forecasters do update their forecasts quite often. So the explanation for why recessions are not forecast sufficiently ahead of time lies in two other classes of theories, one that forecasters do not have enough information to make a reliable call of a recession and the other that they do not have the incentives to do so.

In 2008, the author was asked by the Corporate Services Scrutiny Panel to examine economic forecasting. At that time, there was dissatisfaction with fluctuations in the forecasts and concern that outcomes of States finances were undermining the confidence in the forecasting process. The Panel uncovered that there was not a formal economic model for Jersey's economy and that forecasting was conducted predominately by using qualitative methods which rely heavily on the experience of several individuals who have had many years observing how economic issues affected the island. Such an approach involved 'gauging the temperature' on what was going on in industry by meeting with people from different sectors on a regular basis (e.g. banks, Chamber of Commerce, tourism and agriculture). This approach eschewed econometric modelling and it did not rely on full-blown measures of national accounting which are more appropriate for larger economies.

In 2009, a Bank of England employee on secondment to the Economics Unit developed a model using econometric analysis. The aim was to improve the understanding of the underlying relationships between economic variables and the tax base of the key schedules. One of the big problems in the 1999 to 2007 period was that forecasts tended to overestimate income in times of recession and underestimate income in periods of growth. However, the aim in the past had been to produce a forecast which was plus or minus 3% in terms of the actual.

Section 3 reproduced Jersey's economic forecasts for the last few years and highlighted how these assumptions were used by the ITFG to produce income forecasts which have since been revised heavily downwards. The deterioration in the income forecasts illustrated in Table 2 certainly suggests that the economic assumptions used in successive forecasts until Budget 2015 (Tables 3 and 4) were unduly optimistic. At the time, the author noted that the original forecasts used in the MTFP were predicated on economic assumptions which made little sense in the light of what was happening in the international economic arena and in the finance sector in Jersey going forward. Thus the first error made by policymakers was to misunderstand what was currently happening in the economy *at the time the forecasts were made* in March 2012 and what this would mean for future income. Once committed to using the income forecasts as the basis for the MTFP in July 2012, policymakers refused to consider that their forecasts were too optimistic. In the terminology of behavioural finance, there was overconfidence. This was the second error.

The third error was to use the same forecasts from March 2012 in the 2014 Budget. In March 2013, the Economics Unit updated their economic assumptions from March 2012 to assist the ITFG in forming their judgement for their forecasts for

Budget 2014 and the Long Term Revenue Plan. The final draft on the income tax forecast by the Economics Unit for the ITFG was dated September 2013. The only information about this forecast that was placed in the public domain in 2013 was by this author in his report to the Corporate Services Scrutiny Panel for their review of 2014 Budget. This showed the revised income tax forecast in 2013 (reproduced in rows 6 to 8 of Table 2). The Panel raised concerns about the lack of information on the latest forecasts in the 2014 Budget but the Ministerial response to the Panel's report on 29 November 2013 noted that the 'intention remains to work within the MTFP framework' and to just use the ITFG forecasts for the Long Term Revenue Plan. A further justification for this was given in the draft 2015 Budget which said that the 'in-year forecasts in 2013 were more encouraging and as a result the 2014 Budget was prepared using the MTFP forecasts, adjusted only for the impact of budget measures'. Perhaps the Treasury was relying on further one-off payments of company tax, but as was pointed out by the FPP, these were one-off payments and not a reliable new income stream. The third error compounded the other two. It is very difficult to comprehend why the Treasury did not use the May 2013 forecasts for the 2014 Budget and to persist with forecasts which were out-dated even at the time of the publication of the MTFP in July 2012.

It is important to stress that the art of forecasting is not confined to purely technical or economic assessments and ultimately they have to be acted upon; that is a political decision is required. Referring back to the quotation from Ahir and Lougan, it seems that in 2012 the forecasters in Jersey could not update their forecast in time for the MTFP and that although they did have information in 2013 which suggested a more negative outturn, for some reason there was no incentive to use the updated forecasts. In turn, this raises some very important questions which will doubtless attract the attention of future economic historians:

- Did the Treasurer fully understand the implications of what the different economic forecasts were suggesting?
- Did the Treasurer provide advice to the Treasury Minister which was based on more optimistic scenarios rather than those which were prudent and if so, why?
- When were the Council of Ministers aware of the deterioration in the income forecasts? Did they express their disquiet about the forecasts?

- Were the 2013 forecasts not published in the 2014 Budget because policymakers were concerned that this would have called into question the wisdom of the marginal rate tax cut and drawn attention to the potentially deteriorating fiscal position in Jersey when the authorities were seeking to obtain a favourable review from the credit rating agency, S&P?

Recent international press coverage (e.g. *Wall Street Journal*, *Financial Times*) on the 'Good Judgment Project' might provide some advice for how to improve forecasting performance in Jersey (https://www.goodjudgmentproject.com/). The advice from this project can be has the acronym CHAMP:

- Comparisons are important: use relevant comparisons as a starting point;
- Historical trends can help: look at history unless you have a strong reason to expect change;
- Average opinions: experts disagree, so find out what they think and pick a midpoint;
- Mathematical models: when model-based predictions are available, you should take them into account;
- Predictable biases exist and can be allowed for. Don't let your hopes influence your forecasts, for example; don't stubbornly cling to old forecasts in the face of news.

4.6 The current status of the MTFP

The creation of the MTFP was designed to address the problems associated with the annual budgeting process and other issues that have been raised in successive Scrutiny and C&AG reports. This author welcomed the introduction of the MTFP as it signalled a decisive movement away from short-term views to medium-term strategic thinking and enhanced prudent planning. Unfortunately, the author now has grave concerns about the robustness of the current MTFP for the following reasons:

- It was noted last year that the draft 2014 Budget had not included any public update on the financial forecast contained in the MTFP and that from a macroeconomic perspective, it had been difficult to understand what was being proposed in the Budget and to calculate the impact of the fiscal changes on the economy. These criticisms were also shared by the FPP who observed that the draft 2014 Budget was a 'step back from previous Budgets in terms of completeness and transparency, rather than the steps forward which the Panel recommended a year ago' (Fiscal Policy Panel 2013, p. 41). Although the financial forecasts have been updated in the 2015 Budget there is still a muddled and unclear discussion about what is happening in the real economy;
- There has been a move back to operating on a year-to-year timescale, illustrated by the inappropriate marginal tax cut last year, the late decision not to reduce the marginal rate further and the introduction of emergency remedial measures into the draft Budget 2015 to replace potentially lost income;
- Prudence has been lost. As remarked above, it is difficult to understand why the revised forecasts to the MTFP made in the first half of 2013 were not included in the 2014 Budget;
- The MTFP has not been strategic and has attempted to provide a fiscal stimulus, balance budgets, improve government services and maintain the current system of taxation;
- Continuous expenditure is *the* driver of the MTFP. It would be very interesting to see if expenditure could be permanently cut in the absence of fiscal stimulus and a recession, but it seems highly unlikely at present that this can be done;
- The significance of the Fiscal Policy Panel's (2014, p. 6) comment that 'the medium-term outlook, while uncertain, suggests that there are significant challenges in even maintaining a balanced budget' should not be underplayed. The assessment would have to be that the emergency measures which have been introduced to raise income in the short-run are sticking plaster for an MTFP which is now not fit for purpose.

4.7 Updating Jersey's Fiscal Framework

In the recent past, income revenue was buoyed by the growth of the finance industry. Even though the Jersey economy experienced recessions in the early 1990s and early-2000s, the post-2008 economic downturn has been particularly intense because of the severe contraction in the finance industry. Another key feature in the past was that policymakers frequently ran pro-cyclical fiscal policy: that is spending was increased in booms and was reduced in downturns. To be fair, the retrenchment was not particularly severe because income streams returned, but the fiscal expansionism exacerbated the economic upswings.

One of the major reasons for establishing a FPP was to have independent specialists who could warn if fiscal policy was pro-cyclical. The tension between the FPP's recommendations and the decisions of the States Assembly was quickly tested, however. In August 2008 the FPP pointed out that:

> the two main risks [are] that tax revenue does not increase as much as forecast and that expenditure growth turns out to be higher than forecast. The forecast fiscal stance for 2008 and 2009 is broadly right given the economic conditions, but there is a risk that States' finances could deteriorate significantly in the medium-term. Therefore this year's Business Plan and Budget should, if possible, avoid taking decisions that undermine the tax base or increase expenditure at a rate above that currently forecast.
>
> (Fiscal Policy Panel 2008a, p. 36)

One month after the publication of this report, the States ignored the advice of the FPP during the debate on the 2009 Business Plan and revised net expenditure upwards by £10 million per annum. However, unlike the US, the UK and euro countries who had forgotten how to run counter-cyclical policies, Jersey was learning.

How much policymakers have learnt over the past eight years about Jersey current fiscal framework can be gleaned from 'Updating Jersey's Fiscal Framework' which has been published alongside the draft 2015 Budget. This report is welcome as it highlights a number of areas which need improvement. Indeed, some of these the author has recommended in past reports for Scrutiny, for example how the financial forecasts need to be more closely tied to an economic impact; the importance of improving the finance data for internationally recognised standards for economic accounts and always including current and financial forecasts for the current and subsequent three years in each Budget.

The ‘Updating Jersey’s Fiscal Framework’ document has been produced now that Jersey finds itself in deficit waters. How deep those waters are currently or how deep Jersey might be required to go in the future are not discussed in the report. Some of the issues are profoundly political economy in nature and will be informed by the forthcoming publication of the Long Term Revenue Plan and Long Term Tax Policy. There are some significant suggestions in the report which as they are formulated into new policies will require a thorough debate. Three things can be highlighted:

First, there is a suggestion of a new rule to ‘maintain balanced budgets over the economic cycle’. As is well known, the Public Finance Law does not allow the Consolidated Fund (CF) to go into deficit but this new rule would allow greater flexibility which could mean a deficit in the CF in a financial year but not over the cycle. It is not surprising that it has taken a while for this suggestion to be made given the positive fiscal balances in the past but with the deteriorating fiscal position, new ways of thinking are required to assist deficit financing. The suggestion that the annual balanced budget rule might become an annual unbalanced budget rule will perhaps sit uneasily with some members of the States Assembly but needs to be considered alongside the arguments for allowing the States to run a deficit during a recession and a budget surplus in good times. Although it is not suggested in the paper, this might be reformulated so that Jersey is required to have a budget surplus of, for example, 0.5% or 1% of GVA on average over the business cycle (as has been the case in Sweden since 2000). This would establish a long-term fiscal policy rule and in turn would provide funds for the Stabilisation Fund to be used in an economic downturn. As the paper recalls, when the Stabilisation Fund was established it was hoped that this would make fiscal policy more countercyclical but the evidence has been that this is not sufficient by itself to enforce countercyclical fiscal policy. Introducing a budget surplus rule over the economic cycle (rather than merely balancing the budget) would also act as a greater constraint on government expenditure.

Secondly, there are several suggestions that the FPP should be made more responsible for providing financial forecasts used by the States. This needs a thorough debate as it calls into question the purpose of the Income Tax and Forecasting Group and the Economics Unit particularly as at the time of the publication of the MTFP it was stressed how the forecasting procedures had been strengthened in the Treasury. Would the States Assembly be happy about this sub-contracting of responsibility? Does this strengthen or weaken the FPP's independence and will it allow for more credible and transparent fiscal and economic forecasts? Why could the FPP do this better than in-house expertise in Jersey?

Finally, the report acknowledges that there is some constraint on expenditure in the medium-term in the current MTFP but it calls for greater flexibility for expenditure decisions. The word 'flexibility' invariably equates to 'spend more' in Jersey rather than 'spend less' and if there is going to be a thorough discussion about rules for expenditure within the MTFP there should be further moves away from discretion.

4.8 Public Expenditure

In 2010, the Corporate Services Scrutiny Panel undertook a review on the forecasting of public expenditure. Concerns had been expressed about the amount of expenditure by the States over time and the ability to control expenditure, of which forecasting plays an important role. At the time of the review it was noted that over the period 1998 to 2007, the average level of States expenditure was a little over 13.5% of GVA and that whilst it had grown particularly fast between 2000 and 2005, it had fallen back to the 2000 level (as a percentage of nominal GVA).

In recent years, the level of States expenditure has increased for the reasons discussed earlier in the report so that expenditure by 2013 was probably around 20% of GVA. As figure 9 showed, total expenditure plans for the period 2013–2015 are now £45m higher than at the time of the MTFP. The constraint of the MTFP has been breached and because of this alone it is difficult not to come to the conclusion that States expenditure is out of control. Moreover, expenditure no longer seems to be linked to income as it has been in the past. Although the counter argument will doubtless be made that this level of expenditure is necessary, given the structural changes to Jersey's economy, this author is firmly of the view that the point has been reached where the debate about the future direction and growth of public expenditure can no longer be put off (in some quarters it is assumed to have taken place which is not true). It is hoped that the 2015 Budget will provide the catalyst for this and the forthcoming Long Term Revenue Plan and Long Term Tax Policy will add succour to the debate.

4.9 General reflections

Over the past eight years this author has written numerous reports for the Corporate Services Scrutiny Panel and in so doing he has spent a considerable amount of time examining Jersey's economy. He has met with policymakers, politicians and current and former advisers in the public sector and many individuals in the private sector both in Jersey and elsewhere. In all his reports, the author has frequently tried to avoid sounding like a scratched record. Over time, his concerns about the future direction of Jersey's economy have grown, largely because of the inherent contradictions in economic policymaking. These contradictions need to be viewed from a political economy perspective (simply put, that is the political management of the economy) by stakeholders when all too frequently they are scrutinised and critiqued from a narrow financial and accounting perspective without considering the wider social and economic context.

A good example of a contradiction in economic policy is the decision to increase capital expenditure by around £100m annually for the next decade. This will require an additional 500 people to be employed in construction (assuming retirements and people leaving the industry). There was no work undertaken on the economic implications of this before the decision was made to spend the money. It will be very difficult to find additional workers without increasing immigration, which will run up against the immigration cap that the States has imposed. While there will be numerous solutions proposed (e.g. fixed term employment licenses), the reality is that the solutions will be porous and difficult to police. In turn, the increased immigration will place extra pressures on existing resources with mixed economic and social benefits.

Figure 1 can be re-stated starkly. Jersey is an economy which has been in relative decline since the early 2000s. Despite a fillip to the economy in the mid-2000s, the global financial crisis of the late-2000s and the repercussions of this (a prolonged period of low interest rates, tighter international regulation and a more hostile approach to offshore financial centres) has served to make the situation worse. Whilst there might be some excellent initiatives to boost financial services and plans to diversify the economy and even return tourism to its former glory, the likelihood of this making any significant positive impact on States income in the short- to medium-run will be handicapped by long-standing problems in the supply side of the economy. As has been discussed in this report, under the current direction of travel the 2015 Budget and its supporting documents have significant ramifications which should serve as a very loud wake-up call.

Finally, this report has shown that there have been weaknesses in the policymaking process over the last few years and a significant cause for concern is that the Treasury seems to have lost its ability to provide independent policy advice to its Minister. In a quote that resonates with what has happened in Jersey, Thomas Whitaker, a former senior civil servant in the Department of Finance in Ireland, remarked:

> You gave your views on any new proposals fearlessly, critically, honestly. You did not care whether your views were likely to commend themselves to the minister, whether for their own sake or politically. Once a decision was taken by minister or government, however, you carried it out as loyally and efficiently as you could. That was my understanding of the function of senior civil servants but I'm afraid it has been undermined. The young men who are preoccupied about this generate deep disappointment in me by telling me that that was an old world that has vanished. In the new world, the civil servant is all the time trying to please the minister, over-conscious of what might be politically acceptable, arranging the options so that they will appeal, rather than in strict order of eligibility.
>
> (Kenny 1987)

The danger is that in turn, this encourages 'group think', an unwillingness or failure on the part of institutions to critically challenge each other 'and an attitude of "deference and diffidence" on the part of the institutions, both towards the political establishment and towards challenging public opinion' (Barry 2013, p. 2). For the sake of good public policymaking, this should not be allowed to happen and measures need to be implemented to prevent its recurrence.

5. OVERALL CONCLUSIONS AND RECOMMENDATIONS

5.1 The draft 2015 budget shows future income forecasts which are significantly lower than those expected in the MTFP and expenditure which is higher. There should be an opportunity for the public to question and debate the implications of what this means in terms of future public expenditure and whether the burden and incidence of taxation might shift. <u>Recommendation: A full public debate on government expenditure and taxation.</u>

5.2 There should be serious concerns about some of the assumptions which have underpinned the economic forecasts in recent years. However, any suggestion that economic forecasting should be sub-contracted out to the FPP should be considered carefully. <u>Recommendation: The process of economic forecasting should be re-examined.</u>

5.3 Expenditure has been higher than was planned for in the 2012 MTFP and it is unclear that it has been spent effectively as part of the fiscal stimulus. Serious questions need to be asked about the efficacy of the fiscal stimulus programme and work undertaken on how this could be improved in future. <u>Recommendation: The fiscal stimulus needs to be re-appraised using all available evidence and international experience.</u>

5.4 The MTFP promised a framework through which the States of Jersey had the financial ability to achieve the goals of the Strategic Plan 'Inspiring Confidence in Jersey's Future'. The MTFP is currently not fit for purpose. <u>Recommendation: The next MTFP needs to be thoroughly redesigned on economic grounds, using a more robust economic model and not constructed as if it is an accounting exercise.</u>

5.5 Should Jersey follow the route of the UK and enter a world of deficit financing? This needs to be debate thoroughly and the implications discussed. There needs to be a significant tightening of the fiscal rules. <u>Recommendation: Jersey should not balance budgets over the economic cycle but run a budget surplus of 0.5% or 1% of GVA over the economic cycle.</u> <u>Recommendation: There needs to be an examination of the design of fiscal policy drawing on, for example Sweden, particularly with regard to annual expenditure limits.</u>

5.6 In almost every report, the Fiscal Policy Panel has drawn attention to the dangers of a significant structural deficit in Jersey's public finances. On a number of occasions it has also requested contingency plans by Treasury and Resources for dealing with the structural deficit when the economy is out of recession. Recommendation: An immediate strategy should be agreed for dealing with the structural deficit.

5.7 There are serious reservations about how macroeconomic policy has been made in Jersey over the last few years. Recommendation: An investigation into how the macroeconomic policymaking process can be improved and calibrated to the Economic Growth Plan.

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