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1.0 Introduction

The Panel in considering the draft Strategic Plan at its meeting on 13th April 2006, decided to focus its attention on the Financial Framework as this was linked to its responsibility for scrutinising the States Business Plan and Budget.

1.1. Objectives

The Panel set out the following objectives for the review -

- To examine the original purpose for the establishment of the Dwelling House Loan Fund and to consider the options for the use of the balance in the Loan Fund.
- To examine the projected corporate and departmental efficiency savings for the years 2005 to 2009
- To clarify the potential extent of the revenue gap ('black hole').
- To investigate the proposed use of a Stabilisation Fund.
- To consider the Minister's enhanced anti-inflation strategy (Strategic Plan 1.2.2)

1.2. Sub Panel

The Panel decided to invite two additional members, Senators L. Norman and B. Shenton, to join them for the purpose of this review both being non-Executive members of the States. The Panel subsequently discovered that Scrutiny Panels did not have the power, under Standing Orders, to co-opt other members; however, Sub Panels did have that ability. The Panel, therefore, decided to form a Sub Panel to undertake this particular review. The Sub Panel was constituted as follows -

Deputy P.J. Ryan, Chairman
Senator L. Norman
Senator J. Perchard
Senator B. Shenton
Constable D. Murphy
Deputy J. Gallichan

Officer support: Mr. M. Haden and Miss S. Power

The Panel was of the opinion that a change to Standing Orders should be considered to allow for greater flexibility in respect of co-opting additional members to a Scrutiny Panel in the future.

1.3. Investigations

The Panel Chairman and Deputy Gallichan met the Head of Financial Planning, Treasury, and the Director, Property Holdings Department, to discuss the corporate and departmental capital and revenue efficiency savings.

The Panel received a Briefing Note from the Head of Corporate Capital, Treasury, on the Dwelling House Loan Fund, statistical information from the Head of the Statistics Unit and background economic information from the Economic Adviser, Chief Minister's Department.

Relevant papers are available for downloading from the Scrutiny website.

The Panel held a public hearing on 18th May 2006 with the Treasury and Resources Minister who was accompanied by the Treasurer of the States. The transcript is available on the Scrutiny website.

1.4. Sub Panel Findings

The Sub Panel considered its findings following the public meeting with the Minister and agreed on the following key points -

- the balance of the Dwelling House Loan Fund should not be used to fund initiatives in the Strategic Plan;
- the balance of the Dwelling House Loan Fund should be applied instead to the establishment of a Stabilisation Fund
- efficiency savings from the Change Programme should be applied to the Stabilisation Fund. This would prove to the public that the States was serious about reducing expenditure.
- it would be irresponsible to increase States expenditure above previously agreed levels at this stage when the Island is embarking on a high risk fiscal strategy, the accuracy of the future financial impact of which is still unclear;
- the purpose of the Stabilisation Fund should be clarified in the Strategic Plan as at present there was a blurring between (a) the concept of a Stabilisation Fund, as conceived in the Economic Growth Plan, to address cyclical periods of growth/inflation/recession/deflation in the economy, and (b) the requirement for a fund in which to deposit budget surpluses arising from the introduction of GST to address subsequent structural deficits arising from the introduction of Zero/ten.
- an inflation strategy which maintained a strong discipline over public spending should remain a key strategic aim for the Island.

1.5 Sub Panel recommendation

The Sub Panel agreed to recommend to the full Corporate Services Panel that it seek to amend P.40/2006 accordingly.

The full Panel unanimously accepted the recommendation of the Sub Panel and agreed to adopt, in principle, a draft report prepared by the Chairman, subject to further revision.

2.0 STATES OF JERSEY DRAFT STRATEGIC PLAN 2006 TO 2010 (P.40/2006) - **AMENDMENTS

The Panel's agreed amendment and accompanying report were lodged 'au Greffe' on 5th June 2006.

After the word 'Appendix' *insert the words* ", except that in Commitment One, Outcome 1.2 -

a) for Action 1.2.2 substitute the following action –

1.2.2. Retain any budget surpluses that occur before the introduction of the 0/10 tax changes (due in 2010) in the Consolidated Fund until the extent of any structural deficit as a result of the new fiscal strategy becomes clear with these surplus funds being be used to maintain revenue and capital spending in the short term whilst any structural deficit is addressed. (T&R)

(and renumber as appropriate)

1.2.3. Improve overall fiscal framework by the immediate establishment of a Stabilisation Fund, into which the following funds will be transferred –

i. The balance of excess funds over liabilities held currently in the Dwelling Houses Loans Fund as they become available. (T&R).

ii. The capital receipts from property sales identified in Action 6.2.3 of this Plan, estimated to reach at least £4 million per year by 2009 (being the capital element of the savings arising from the Change Programme) (T&R).

iii. The non-capital element of the Change Programme Efficiency Savings identified in 6.2 of the Strategic Plan (estimated to reach £6.64 million per year by 2009) (T&R).

1.2.4 Bring forward for approval by the States detailed proposals for the control of inflation to update the current inflation strategy, with the proposals to include details of the future use of the balance in the Stabilisation Fund created under 1.2.3 above and the operation and long term use of the Fund which will be broadly as described in the Economic Growth Plan (P38/2005) as adopted by the States. The proposals will also cover the role of fiscal measures, particularly GST rates, in this context. (T&R) (ED)

3.0 Report on Amendments – Executive Summary

New paragraph 1.2.2 *ensures that early GST receipts/budget surpluses do not go into Stabilisation Fund but are held instead to help address structural deficits post 2009.*

- *Forecasts post 2009 suggest structural deficits rising to £40m in 2013*
- *Re-appraisal of 'black hole' may reduce but unlikely to eliminate deficits*
- *Stabilisation Fund (SF) intended as counter-cyclical and counter-inflation tool*
- *Clarification of 2008/2009 forecast surpluses not appropriate for SF*

New paragraph 1.2.3 a*ccelerates the establishment of a Stabilisation Fund and places funds into it progressively via i) the balance of the DHLF, ii) the capital receipts element of the efficiency savings, and iii) the remaining un-allocated balance of the revenue efficiency savings.*

- *Numerous refs. to 2005 States decisions limiting public spending growth*
- *Recent success in control of inflation through limits to spending growth*
- *DHLF not 'income flow'*
- *Places balance of DHLF and efficiency savings into SF*
- *Property capital receipts once spent = slow erosion of property capital base*
- *Achievement or not of Efficiency Savings outside scope of amendment*

(i) Increases deficits by removal of Dwelling Houses Loans Fund (DHLF)
(ii) Increases deficits by removal of capital element of Efficiency Savings
(iii) Increases deficits by removal of non-capital element of Efficiency Savings (remaining unallocated £6.7m per annum)
i) ii) and iii) place increasing pressure on the Council of Ministers to reduce/delay spending

New paragraph 1.2.4 p*rovides for the early presentation by Treasury & Resources and Economic Development of a report on the usage, size etc of the Stabilisation Fund created in new paragraph 1.2.3 for a States debate.*

- *Closes off or converts funds in SF for other uses*
- *No allowance for next recession in forecasts*
- *Report and States decision on usage guidelines, size of fund, fiscal levers etc*
- *Where are we in the economic cycle*

Conclusion

- *Inflationary pressures*
  - *GST in 2008*
  - *2% real economic growth annually as per Economic Growth Plan*
  - *end of ITIS deflationary impact in 2007*
  - *proposed RUDL charges to non-Jersey owned businesses*
  - *public spending growth as per Strategic Plan?*
- *Balanced budgets over the full economic cycle rather than the next five years*

4.0 Addressing budget deficits post 2009

4.1 *Amendment: New paragraph 1.2.2*

This part of the amendment is designed to ensure that budget surpluses created largely as a result of the early introduction of GST in 2008 are held over to address budget deficits evident from 2010 and into the future after the introduction of 0/10 Corporation Tax and the loss of tax receipts from the business sector as a result.

4.2 ‘*The Black Hole’ in States Resources Forecast*

The Resources Forecast (Page 17 of the Strategic Plan) indicates significant budget deficits in 2010 and 2011 as a result of the introduction of the zero/ten fiscal changes, after the surpluses provided in 2008 and 2009 by the introduction of new Goods and Services taxes and revenue raising changes to existing taxes such as ‘20 means 20’.

The Minister told the Sub Panel reviewing the Financial Framework that his overall objective was ‘*to maintain balanced budgets over the longer term’*. However, even over the six year period covered by the Strategic Plan, the forecast is for an overall deficit by the end of the period of £12 million.

The Panel requested the Treasury to provide ‘indicative’ figures after 2011 using similar assumptions and growth patterns as used in 2010 and 2011 and any other assumptions such as the phasing out of tax receipts in 2012. The result is shown in ***Table 1***. The size of the continuing deficits forecast for 2012, 2013 and 2014 indicates that there remains a very strong likelihood of a serious structural problem that will need to be addressed from 2010 onwards.

Table 1: Extended Financial Forecast 2012 - 2015

	2012	**2013**	**2014**	**2015**
	£' m	**£' m**	**£' m**	**£' m**
States Revenues (2006 Budget)	480	485	500	516
Anticipated States Revenues - GST, 20/20	56	58	60	61
Potential States Revenues	**536**	**543**	**560**	**577**
Revenue Expenditure Forecasts	527	540	553	567
Capital Expenditure Forecasts	43	44	45	46
Total Net Expenditure Forecasts	**570**	**584**	**598**	**613**
Expenditure growth	***1.0%***	***2.5%***	***2.5%***	***2.5%***
Transfer of Parish welfare and residential care (May 06)	10	10	10	10
Total Net Expenditure Forecasts (incl Parish transfer)	580	594	608	623
Contribution from Dwelling Houses Loan Fund	-			
Funding from Island Rate for transfer of Parish Welfare	10	10	10	10
Total Net Expenditure Forecasts less contributions	570	584	598	613
Expenditure growth after DHLF	2.3%	2.5%	2.5%	2.5%

Draft Strategic Plan Surplus/(Deficit)	(33.3)	(40.9)	(38.5)	(35.8)

The Minister advised the Sub Panel that these figures should be taken with a health warning: '*they are almost academic; they are sort of a mathematical extension to where we are now, rather than a realistic position*.' Referring to the anticipated 'Black Hole' caused by the fiscal changes he said: '*Because there are a variety of contributing factors to the £80-£100 million deficit and we are taking a very prudent line, I do not think I will have any nasty shocks in terms of financial forecasts.'* When pressed to comment on the possibility that the indicative figures beyond 2011 contained a clear warning of a continual structural deficit, the Minister said: '*I think it is intended to indicate that we could live within our means within a 5 year period but yet at the end of it, if nothing else changed those figures, there could be difficulties thereafter. I have also said that, inevitably, things will change and those figures will alter. … What this is simply indicating is that the strategic policies within this plan over a five year period are capable of being delivered while we still achieve our budget.'*

The Sub Panel noted the encouraging out-turn figures for 2005 as reported in the Financial Report and Accounts and the assurance that the financial forecast would be revised on a regular twice-yearly basis. The Minister told the Sub Panel: '*Structural deficits do not happen overnight, and this plan says that over the next 5 years we can achieve balanced budgets. We will review the plan next year. It will not be in December 2010 that we suddenly say: "We have got a problem." We should be aware of that by 2008 and 2009 and plan it accordingly at that time. The whole idea is not to have sudden shocks to the economy but to plan on a rolling programme in advance*.'

The Sub Panel supports the Minister's insistence on the importance of delivering balanced budgets. Despite the assurances of the Minister, however, the Sub Panel was not convinced that the outlook indicated in the draft Strategic Plan Financial Forecast and beyond provided sufficient confidence for relaxing the tight spending controls of the last few years, as envisaged in the draft Strategic Plan. This is discussed further in the next section.

4.3 The Stabilisation Fund

Page 16 of the Strategic Plan (2nd paragraph of Financial Framework) refers to the creation of a stabilisation fund into which will be paid "…budget surpluses in times of economic growth…" It is not clear as to whether the Council of Ministers intends that the budget surpluses indicated for 2008 and 2009 will be paid into the stabilisation fund, but it is very clear that the surpluses are as a result principally of early GST receipts before 0/10 and not economic growth.

The Strategic Plan does not go into any detail about the proposed Stabilisation Fund; however, it appears to the Panel that what is being proposed is not the same form of Stabilisation Fund as proposed in the Economic Growth Plan (P.38/2005), as agreed by the States., which is designed to address cyclical movements in the economy rather than a structural deficit. For ease of reference the relevant section from the Economic Growth Plan (P38 2005) as approved by the States is included with this report at ***Appendix A***.

The effective control of inflation and the creation of a stabilisation fund are indeed crucial to our future economic well being and future economic competitiveness, but to help with the avoidance of doubt this amendment ensures that budget surpluses as a result of the early GST receipts are retained as a short term cushion to help to address any residual structural deficits

after 0/10 and not confused with the establishment of a true stabilisation fund which is addressed in section six of this report.

4.4 The proposed Regulation of Undertakings Licence Fees

The Sub Panel noted that one of the major proposals contained in the draft Zero/Ten tax changes to take effect in 2010 (currently out for public consultation), involved the charging of licence fees to businesses at a level of £500 per Regulation of Undertakings Manpower Licence (RUDL fees).

It was further noted that although the new locally owned Limited Trading Partnership (LTP) would be able to avoid the RUDL fees through offsetting against personal tax liabilities, non locally owned companies would not be able to follow this avoidance route.

The Treasury and Resources Minister was questioned about this at a private hearing on the 12th May 2006 by the sub Panel dealing with 'zero/ten' and 'look through'. The following points became apparent.

1. The RUDL fee proposal is deliberately targeted at non Jersey owned companies in order to recover an element of taxation from this sector that would migrate to other jurisdictions under the zero tax regime.
2. The size of the fees would be set at zero for the financial services sector so that they would escape increased costs, bearing in mind that they would be taxed at the 10% side of the 0/10.
3. The size of the fee for non finance sectors would be driven by the total 'tax' recovery target of approximately £5m.
4. The cost of the fees to non Jersey owned businesses would not be off-settable against any tax in another jurisdiction through a 'double tax' agreement, (unlike the present 20% Corporation Tax).
5. The fees will be irrecoverable by non Jersey owned companies and will represent real increased costs (not offset-able through double taxation agreements with the UK).
6. To the extent that these companies enjoy 'market power' they would be likely to pass on the extra costs to their customers. i.e. the RUDL fees will be inflationary.

5.0 Creation of a Stabilisation Fund

5.1 Amendment: New paragraph 1.2.3

This amendment addresses the 'contributions from savings and potential new income flows' in three parts represented by -

(i) the Dwelling Houses Loans Fund (DHLF),
(ii) the £4 million a year 'savings' from capital receipts; and
(iii) the remaining unallocated non-capital element of the efficiency savings

This amendment accelerates the establishment of a stabilisation fund, but additionally it has the effect of putting pressure on the Council of Ministers to take action in one of three ways -

1) **Continue spending plans with increased budget deficits;**
2) **Continue spending plans and increase taxation to reduce budget deficits; or**
3) **Reduce the growth in expenditure to the level foreseen in the 2006 Budget report to reduce budget deficits.**

For the sake of absolute clarity, the Panel does not advocate actions 1) or 2) but fully expects the Council of Ministers to review their spending plans as a matter of urgency in order to maintain their commitment to delivering balanced budgets and eliminating deficits over the period of the Strategic Plan. Only when it is clear that increased revenues will cover any future deficit should the Council of Ministers embark on its full spending programme.

5.2 Increased expenditure plans in the Strategic Plan

The Financial Forecast in the 2006 Budget Report, which was agreed by the States in December 2005 (only 6 months ago), shows a series of single figure budget deficits for the period 2006 to 2009 with a very large deficit of £70 million appearing in 2010 with the introduction of the new '0/10' corporate tax structure (see Table 2)

To address the immediate forecast deficits the agreed policy of the States in recent years, up to and including the 2006 Budget, has been to constrain public spending within strict limits. The following statements were made in 2006 Budget report -

"*These projections also assume that States expenditure increases remain within the modest levels set in the recent States Business Plan debate of an average of around 2.5% per annum over the next 5 years*." Page viii Para 1.4

"*The Committee's main objectives… for the period 2006 to 2010 are to: restrict increases in total States net expenditure to affordable levels, within the expenditure framework in the Fiscal Strategy and States Business Plan"* Page x Para 2.4 first bullet point.

"*The Committee is not able to control interest rates, however it will continue to endeavour to reduce inflationary pressures by constraining the growth in States spending to a level below*

the forecasts of inflation." Page xi 2.5 (last para)

Table 2: Financial Forecast 2006 to 2010 (2006 Budget)

	Estimates				
	2006	2007	2008	2009	2010
	£' 000	£' 000	£' 000	£' 000	£' 000
Income					
Income Tax	385	403	417	432	381
Impôts	46	44	43	41	40
Stamp Duty	17	17	17	17	17
Other Income	24	24	24	24	24
Total Income	472	488	501	514	462
Expenditure and Transfers to Reserves					
Total States Net Revenue Expenditure	441	454	467	480	490
Capital Allocation	39	39	39	39	42
Transfer to Strategic Reserve	-	-	-	-	-
Total States Net Expenditure	480	493	506	519	532
Deficit for the year	**(8)**	**(5)**	**(5)**	**(5)**	**(70)**

"*The States approved, in the Business Plan, an increase of 2.7% in total States spending…*" "*The revenue expenditure has increased by 3.8% in 2006*" …"*This increase has only been afforded due to the significant reduction in the capital allocation from £43m in 2005 to £39m in 2006*." Page xi 3.1

"*The planning of a five-year programme has been achieved despite a significant reduction in the annual capital allocation from £43m in 2005 and £45m per annum in the years 2006 to 2009 to a new allocation of £39 million per annum for 2006 to 2009, only increasing to £42 million in 2010*." Page xv 6.

In contrast to the above statements, the Resources Forecast in the draft Strategic Plan proposes expenditure growth in 2007 and 2008 of 4.3% and 3.8% respectively. The Plan proposes a year on year increase in States revenue and capital expenditure amounting to a total of approximately £57 million in additional spending over a five year period above that envisaged in the 2006 Budget financial forecast. (See Table 3)

The Strategic Plan financial forecast includes a contribution to income of £32 million over the period coming from the balance in the Dwelling House Loan Fund. Cosmetically this appears to reduce the expenditure growth in 2007 and 2008 to 3.5% and 3.2%, yet even this is still in excess of the growth in spending foreseen in the 2006 Budget.

In addition to the balance of the Dwelling House Loan Fund the £20 million of efficiency

savings, originally earmarked in the Fiscal Strategy to part fill the ‘Black Hole’ deficit caused by zero/ten corporate tax, is now to be ‘reinvested’ in new public spending initiatives.

Table 3: Financial Forecast 2006 - 2011 (Strategic Plan Resources Statement)

	2006 £' m	2007 £' m	2008 £' m	2009 £' m	2010 £' m	2011 £' m
States Revenues (2006 Budget)	472	488	501	514	462	471
Anticipated States Revenues - GST, 20/20	-	-	47	49	51	53
Potential States Revenues	**472**	**488**	**548**	**563**	**513**	**524**
Revenue Expenditure Forecasts	442	463	479	493	504	518
Capital Expenditure Forecasts	39	39	42	42	45	46
Total Net Expenditure Forecasts	**481**	**502**	**521**	**535**	**549**	**564**
Expenditure growth	***2.8%***	***4.4%***	***3.8%***	***2.7%***	***2.7%***	***2.7%***
Transfer of Parish welfare and residential care (May 06)	7	10	10	10	10	10
Total Net Expenditure Forecasts (incl Parish transfer)	488	512	531	545	559	574
Contribution from Dwelling Houses Loan Fund	-	4	7	7	7	7
Funding from Island Rate for transfer of Parish Welfare	7	10	10	10	10	10
Expenditure growth after DHLF and Island Rate income	***2.8%***	***3.5%***	***3.2%***	***2.7%***	***2.7%***	***2.7%***
Projected Surplus/(Deficit)	**(9)**	**(10)**	**34**	**35**	**(29)**	**(33)**

The difference between the spending plans in the 2006 Budget and the Strategic Plan can be seen clearly by placing the two Total Net Expenditure Forecast lines alongside each other. (See Table 4)

The Minister told the Sub Panel that the proposed increase in spending was consistent with his policy of a balanced budget: *I think we have to balance a variety of requirements that we have. My overall objective is to maintain balanced budgets over the longer term and if by spending some or all of the efficiency savings I was of the view that balanced budgets could not be maintained over the longer term, I would have concerns. I am still of the view that balanced budgets can and must be maintained over the longer term and if we choose to use some of those efficiency savings at the present to maintain our infrastructure, we have to accept the fact that we have at all times to look at the overall policy of those balanced budgets.*

Table 4: Comparison of expenditure forecasts

	2006 Budget	Strategic Plan	Difference
2006	480	481	[1]
2007	493	502	9
2008	506	521	15
2009	519	535	16
2010	532	549	17

2011		561	

The Council of Ministers claim that the draft Strategic Plan is '*fully funded from within existing spending limits*' but then goes on to qualify this statement "…***when the contributions from savings and potential new income flows are taken into account***".

The Panel believes that this statement should be subject to scrutiny. In the Panel's view, the draft States Strategic Plan represents a significant and premature shift away from the 2006 Budget policy of constrained States expenditure. The key questions are

- **Where are the 'new income flows' and savings coming from? and**
- **What effect might the proposed additional spending have on inflation?**

5.3 'New income flows'

5.3.1 The Dwelling Houses Loans Fund

£32 million of the surplus funds available in the DHLF (from a total balance at the end of 2005 of some £52.7 million) is identified as the key element in the 'new income flows' which will fund the proposed net increase in States expenditure through to 2011.

A briefing note on this Fund which was provided by the Head of Corporate Capital, Treasury, is attached at ***Appendix B***.

The Panel does not accept that this Fund can be accurately described as a 'new income flow'. Although it has grown larger over the years as loan capital with extra interest (over that charged to it) has flowed back into the fund from borrowers several times over since the 1950's, once spent there is no further 'income flow'. There have been very few (if any) new borrowers over the last few years from which continuing income flows through interest charges will derive once the balance of outstanding capital and interest has been returned. The figures for recent years show that the outstanding loans have been run down at a rate of about 15% a year.

A policy in the 1990's that made the interest charges un-competitive against traditional sources of mortgage capital, coupled with a much lower interest rate climate and competition amongst lenders, effectively led to a closing off of the fund to new borrowers. There is a legitimate argument that the fund should now be returned to its original source if it is no longer required. When the fund was created in the middle of the last century (the fund was created under the Building (Loans) Jersey Law 1950) the Strategic Reserve did not exist, however the argument goes that the fund should now be returned to the 'nearest fit' source i.e. the Strategic Reserve.

It is probable that had the original funds placed in the DHLF been placed instead in a 'strategic reserve', had one existed at the time, then over the years similar capital appreciation would have occurred through investment, as has occurred through the DHLF.

The Panel believes that the States' original intention was to **retain a strategic public asset** whilst at the same time assisting first time buyers of homes on lower incomes. In some ways it might have been better for the Finance and Economics Committee to have been responsible for the administration of the DHLF, with prospective recipients of the loans endorsed by the

Housing Committee. The Panel does not believe that the original intention was to convert these funds into future revenue or capital spending at some stage.

The Panel's amendment in sub paragraph (i) does not follow the 'return to Strategic Reserve' line but it does go some way towards it in that the funds would ebb and flow in the Stabilisation Fund (depending on the cyclical nature of the economy) without theoretically actually being irrevocably spent.

The Panel proposes that, instead of using the Dwelling House Loan Fund to fund additional spending, the balance of excess funds over liabilities should be retained as a strategic asset and transferred to a Stabilisation Fund, as described in section six below.

The effect of the Panel's amendment on the Financial Forecast, as shown in Table 5, is to increase the projected deficits. It should, however, be noted that this is entirely due to the proposed increased spending plans of the Council of Ministers. The inclusion of the Dwelling House Loan Fund in the Strategic Plan masks the impact of the additional spending. Diverting the use of these funds will oblige the Council of Ministers to review their spending increases.

Without increases to spending this table would be roughly equivalent to that presented to the States in the 2006 Budget.

Table 5: Financial Forecast excluding DHLF contribution

	2006 £' m	2007 £' m	2008 £' m	2009 £' m	2010 £' m	2011 £' m
States Revenues (2006 Budget)	472	488	501	514	462	471
Anticipated States Revenues - GST, 20/20	-	-	47	49	51	53
Potential States Revenues	**472**	**488**	**548**	**563**	**513**	**524**
Revenue Expenditure Forecasts	442	463	479	493	504	518
Capital Expenditure Forecasts	39	39	42	42	45	46
Total Net Expenditure Forecasts	**481**	**502**	**521**	**535**	**549**	**564**
Expenditure growth	***2.8%***	***4.4%***	***3.8%***	***2.7%***	***2.7%***	***2.7%***
Transfer of Parish welfare and residential care (May 06)	7	10	10	10	10	10
Total Net Expenditure Forecasts (incl Parish transfer)	488	512	531	545	559	574
Contribution from Dwelling Houses Loan Fund	-	4	7	7	7	7
Remove Contribution from DHLF	**0**	**(4)**	**(7)**	**(7)**	**(7)**	**(7)**
Funding from Island Rate for transfer of Parish Welfare	7	10	10	10	10	10
Revised Surplus/(Deficit) after Scrutiny adjustments	**(9)**	**(14)**	**27**	**29**	**(36)**	**(40)**
Draft Strategic Plan Surplus/(Deficit)	**(9)**	**(10)**	**34**	**35**	**(29)**	**(33)**

5.3.2 The Change Programme Efficiency Savings

The Change Programme targeted £20m per annum to be achieved by 2009 mainly through corporate and departmental efficiencies but also with a capital contribution through the Property Plan.

Appendix C details the latest sources and estimates of the efficiency savings. From its discussions with the Head of Financial Planning and the Director, Property Holding Department, the Panel has seen no reason to suspect that this target is not achievable. The focus of its review has been on how it is proposed to use these savings.

It is clear that the £20m savings were originally intended to part fill the structural deficit as a result of 0/10 (the 'black hole'). However, the Minister told the Sub Panel that the Council of Ministers now believed that '*we can live within that range, still spend that £20 million, and still achieve balanced budgets over the period*. *We will do that by making sure by way of prudence on our revenue expenditure and our capital expenditure.*'

The efficiency savings are not clearly identified as a separate line in the Resources Forecast table on Page 17. The Panel requested therefore that an amended Forecast be prepared by the Treasury to show the effect of removing these savings from the calculation. Removing the efficiency savings from the Financial Forecast is shown in two parts: (a) the capital receipts and (b) the non-capital element.

(a) Capital receipts

The Property Plan targets net capital rising from £0.7 million in 2007 to £4 million per annum from 2009 onward. Although there was always an element of the £20m that would come from ‘capital receipts’ in the proposition (P.58?2004) agreed by the States on Public Sector Reorganisation, this was originally to be £5 million and not the latest figure of £4 million, so in fact an extra £1m is to be saved from revenue expenditure over P58/2004.

These capital receipts will very slowly erode the capital base of the States property portfolio and if spent will slowly erode the overall level of States Capital Assets. Technically they should not really be described as ‘efficiency’ savings, although they do result in an improving cash position for the States through better use and perhaps disposal and/or alternative purchase of property. This can be described as running the property portfolio more ‘efficiently’. However the public perception of ‘efficiency savings’ is - ‘efficiency’ improvements result in a like for like lower cost of running the public administration and services every year (revenue expenditure) once they have been made.

By placing these capital receipts into the Stabilisation Fund as per amendment sub paragraph ii) we maintain the overall capital base of the States. The effect of this amendment on the Financial Forecast is shown in Table 6.

Table 6: Financial Forecast excluding DHLF contribution and capital receipts

	2006 **£' m**	**2007** **£' m**	**2008** **£' m**	**2009** **£' m**	**2010** **£' m**	**2011** **£' m**
States Revenues (2006 Budget)	472	488	501	514	462	471
Anticipated States Revenues - GST, 20/20	-	-	47	49	51	53
Potential States Revenues	**472**	**488**	**548**	**563**	**513**	**524**
Revenue Expenditure Forecasts	442	463	479	493	504	518
Remove Property Capital Receipts		**1**	**2**	**4**	**4**	**4**
Capital Expenditure Forecasts	39	39	42	42	45	46
Total Net Expenditure Forecasts	**481**	**503**	**523**	**539**	**553**	**568**
Expenditure growth	***2.8%***	***4.4%***	***3.8%***	***2.7%***	***2.7%***	***2.7%***
Transfer of Parish welfare and residential care (May 06)	7	10	10	10	10	10
Total Net Expenditure Forecasts (incl Parish transfer)	488	513	533	549	563	578
Contribution from Dwelling Houses Loan Fund	-	4	7	7	7	7
Remove Contribution from DHLF	**0**	**(4)**	**(7)**	**(7)**	**(7)**	**(7)**
Funding from Island Rate for transfer of Parish Welfare	7	10	10	10	10	10
Expenditure growth after Island Rate income	***2.8%***	***4.6%***	***4.0%***	***3.0%***	***2.7%***	***2.7%***
Revised Surplus/(Deficit) after Scrutiny adjustments	**(9)**	**(15)**	**25**	**25**	**(40)**	**(44)**
Draft Strategic Plan Surplus/(Deficit)	**(9)**	**(10)**	**34**	**35**	**(29)**	**(33)**

(b) Non-capital element of the efficiency savings

The non capital element of the efficiency savings amounts to £16m revenue savings each year by 2009. These savings fall into a different category to the £4m per year of capital receipts.

The Panel acknowledges that £10 million of the non-capital efficiency savings has already been reallocated by the States in the 2005 and 2006 Budgets. The remaining efficiencies targeted in the section 6.2 of the draft Strategic Plan amount to £6.64m and are composed of -

- £1.3 million through the implementation by 2008 of the Head of Profession model for the finance function within the States (6.2.1);
- £1.6 million through transformation of HR and IT functions by 2008 (6.2.2)
- £1.5 million revenue savings from property by 2009 (6.2.3)
- £0.510 million by centralising customer facing services by 2009 (6.2.5)
- £1.9 million through improved procurement arrangements for goods and services by 2009 (6.2.6)

The Panel proposes that, instead of immediately 're-investing' these sums into new forms of expenditure from 2007 onwards, the remaining efficiency savings are retained in a stabilisation fund, as explained in section six below. The effect of this amendment on the Financial Forecast is shown in Table 7.

Table 7 *Financial Forecast excluding DHLF contribution and capital receipts and non capital revenue savings*

	2006 £' m	2007 £' m	2008 £' m	2009 £' m	2010 £' m	2011 £' m
States Revenues (2006 Budget)	472	488	501	514	462	471
Potential States Revenues	472	488	548	563	513	524
Revenue Expenditure Forecasts	442	463	479	493	504	518
Remove Property Capital Receipts		**1**	**2**	**4**	**4**	**4**
Capital Expenditure Forecasts	39	39	42	42	45	46
Total Net Expenditure Forecasts	481	503	523	539	553	568
Expenditure growth	***2.8%***	***4.4%***	***3.8%***	***2.7%***	***2.7%***	***2.7%***
Transfer of Parish welfare and residential care (May 06)	7	10	10	10	10	10
Total Net Expenditure Forecasts (incl Parish transfer)	488	513	533	549	563	578
Contribution from Dwelling Houses Loan Fund	-	4	7	7	7	7
Remove Contribution from DHLF	**0**	**(4)**	**(7)**	**(7)**	**(7)**	**(7)**
Funding from Island Rate for transfer of Parish Welfare [3]	7	10	10	10	10	10
Transfer efficiency savings to Stabilisation Fund		**3**	**6**	**6**	**6**	**6**
Expenditure growth after Island Rate income	***2.8%***	***4.6%***	***4.0%***	***3.0%***	***2.7%***	***2.7%***
Revised Surplus/(Deficit) after Scrutiny adjustments	**(9)**	**(18)**	**19**	**19**	**(46)**	**(50)**
Draft Strategic Plan Surplus/(Deficit)	**(9)**	**(10)**	**34**	**35**	**(29)**	**(33)**

5.4 *Panel's views*

Clearly, if the Panel's amendments regarding the capital receipts and/or revenue efficiency

savings are accepted, in addition to the amendment regarding the Dwelling House Loan Fund, the forecast deficits will increase significantly compared to the Forecast shown in the draft Strategic Plan.

The Panel believes that this cumulative revised forecast position reveals starkly the potentially precarious nature of the Island's financial position in 2010 and 2011 as the scale of corporate tax changes take effect.

The Council of Ministers insists in their Strategic Plan that the forecasts for 2010 and beyond must be considered 'indicative' at this stage and that early action would be taken by the Council of Ministers to address a structural deficit. The Panel accepts that this will be the case and that the Council of Ministers may have legitimate grounds for believing that the future financial position will be much healthier as the full effects of the Fiscal Strategy unfold.

Nevertheless, the Panel does not believe that now is the right time to relax the tight spending controls which have been central to recent States Budgets. The existing spending controls as approved in the 2006 Budget should be maintained until the future position is much clearer with regard to the 'Black Hole' and any structural deficits remaining after 2011. New paragraph 1.2.3 i) is designed to achieve this position.

Additionally, the Panel believes that the significant new information in the Resources Forecast of the Strategic Plan which extends a further year's projections over that presented to the States during the 2006 Budget, and also particularly the information illustrated in the extended forecast to 2015 in Table 1 above, suggests that the States would be well advised to reconsider some of the 'reinvestment' of the Efficiency Savings agreed by the States in the 2006 Budget, certainly until the eventual position after 2011 becomes clearer. It is for this reason that the Panel has proposed parts ii) and iii) of the new paragraph 1.2.3.

As a consequence of the Panel's amendments, it will be necessary for the Council of Ministers to review the extent and the timing of their spending plans. The revenue and capital items identified in the draft Strategic Plan list a series of important new initiatives: '*the improvement of social housing, home ownership, the income support system, law and order, the need to care for the growing number of elderly people in our population and anti-discrimination measures'*

The Panel acknowledges that it may be easy for the Council of Ministers to criticise amendments which will oblige them to rethink their spending plans. They may say that these are the very initiatives which will be threatened by the Panel's amendments.

The Panel does not accept, however, that these social priorities need be abandoned by the Council as it is certain that there are other expenditure projects, for example in the capital programme, which could be re-prioritised

The Panel does not believe it is within its remit to identify specific changes which will be necessary to the draft Strategic Plan spending initiatives should its amendments be approved. It has not undertaken any such exercise. Indeed, the lack of financial detail in the Plan prevents any detailed analysis. It is for the Council of Ministers to undertake this review and bring forward suitably revised proposals in the States Business Plan.

6.0 Inflation Strategy

6.1 Amendment: New paragraph 1.2.4

This amendment makes the policy guidelines of the Stabilisation Fund an urgent priority for the Council of Ministers. The amendment does not attempt to pre-empt due consideration of its purpose, terms of usage, and ideal size, simply to accelerate provision for the initial establishment (in 1.2.3) and thereafter accelerate policy formulation on its use (in 1.2.4). The Panel believes that detailed work on a Stabilisation Fund long before the next recessionary cyclical downturn should be a top strategic aim.

6.2 Reducing inflation

Appendix D shows Jersey's performance in controlling inflation as compared to the UK (with which we are in currency union) tracked against our levels of increases in public spending over the last decade. Statistics with the large anomaly of increases in local housing costs removed (RPIx) are interesting as well as the normal RPI.

Without the ability to alter interest rates to suit the levels of inflation in our local economy the only (albeit less than perfect) tools we have at our disposal are the control of public spending and fiscal strategy. Both affect the level of money supply in the economy, the former because the States is by far the major single employer and procurer of goods and services, and the latter by reducing or increasing real disposable incomes.

It is true to say that reductions in public spending or increases in taxation take a while to feed through into reducing inflationary pressure. This is especially true for the latter because most of our tax revenue is from direct taxes paid a long time in arrears of the income upon which it is based. N.B. the introduction of GST may change this.

Nevertheless our recent success in controlling inflation (whilst controlling mainly public spending) is in stark contrast to our performance prior to this period. We have only recently begun to reverse the trend of deteriorating economic competitiveness versus our international competitors.

A central tenet of the Economic Growth Plan involves the achievement of 2% real growth. This means 2% above whatever the rate of inflation is in any year; thus, in the current year when the RPI stands at 2.4%, economic growth of 4.4% is required to meet the target. Clearly the higher our inflation rate actually is the more difficult or unsustainable attaining 2% real growth will become.

In the Panel's view, the control of inflation must remain a key strategic aim of this or any Jersey Council of Ministers. The review of the inflation strategy, however, does not receive a mention in the list of top priorities provided on page 14 of the draft Strategic Plan.

6.3 *Stabilisation Fund*

It would be wrong to anticipate the contents and recommendations of a properly researched report on the merits of a Stabilisation Fund. It is quite possible that the report's findings might not concur with the setting up of such a fund or the practicalities of using such a fund to help promote economic stability. If that were to be the case then it would be up to the Council of Ministers through the Treasury to make recommendations to the States at that point to close off the fund and return the balance in it created with this amendment to general revenues or into the Strategic Reserve or indeed for any other purpose e.g. the creation of a fund to be used for further assistance for low income first time home buyers through 'shared equity', as they see fit. The point is that the States will have ultimate control on the use of these funds (the DHLF balances and part efficiency savings) through a future debate specifically for this purpose.

The 'indicative' forecasts for 2010 onwards show structural deficits. A further recommendation from the Treasury regarding how they intend to fill this residual structural deficit after the fiscal changes envisaged in the new 'Fiscal Strategy' are complete, will be very important. It is possible that some of the balances placed in the Stabilisation Fund with this amendment might need to be transferred into the Consolidated Fund in due course to help fill the black hole in the medium term.

It should be emphasised that this is not the purpose of the Stabilisation Fund as envisaged in the Economic Growth Plan (P.38/2005), as agreed by the States, and the establishment and use of the Stabilisation Fund, if agreed by the States, to fill structural deficits as opposed to the filling of cyclical deficits should be clearly understood and any longer term temptation to do this resisted.

Our enquiries lead us to believe that there is no provision included for any cyclical recessionary downturn in the figures included in the Strategic Plan Resources Forecast on page 17, and that might add weight to the need to establish the Stabilisation Fund and inform ourselves of its appropriate usage in early course.

No one can predict when and if there will be a next recession in our economy with much accuracy. Suffice to say that statistically it has happened in the UK economy once every 7 to 12 years. Most commentators also agree that monetary control of inflation has had some success in the UK over the last decade in mitigating some of the negatives of economic cycles by smoothing out peaks and troughs.

This should be contrasted with Jersey's past performance in the context of the control of economic cycles. The panel has observed through its research that in times of economic growth and consequent economic confidence, the tendency at the political level has been to spend more, whether through pressure from the public for better infrastructure or services, or a desire to be popular.

This extra spending has undoubtedly in itself driven further economic growth and in turn, population to feed that growth, in some ways producing a self defeating cycle by driving the demand to provide extra infrastructure and services for the increase in population.

The most difficult political task facing us may be to convince Jersey's population that restricting the money supply in the economy is in the long term interests of the community in times of growth and confidence. This means taking the difficult political decision to adopt a measured deflationary policy that restricts money supply through constrained public spending and fiscal

measures during growth and rising inflation, and vice versa in times of recession. In other words the opposite to what Jersey's politicians have done in the past.

To what extent fiscal measures (as well as the control of public spending) can or should be used to adjust money supply in our local economy and therefore act as a lever to control inflationary pressures, is an interesting concept and one that the Panel would expect to be addressed carefully in the report.

7.0 Conclusion

To return to the central question – what will be the effect of the significant increases in spending envisaged in the Strategic Plan as presented?

- The Strategic Plan proposals are a clear departure from the successful policies of the last 3 years in containing inflation. They represent a return to previous higher levels of expenditure growth. Higher inflationary pressures fed by this expenditure growth will undermine our ability to attain or sustain the Economic Growth Plan's 2% real growth target.

- The Treasury and Resources Minister was confident that the balanced budgets could be maintained over the five year period of the Strategic Plan while at the same time increasing public spending. The Panel urges a more cautious approach and makes the following comments -

  (a) The Resources Forecast on Page 17 of the Strategic Plan clearly indicates that balancing the books over the next five years will only be possible if the large surpluses as a result of the early GST receipts are used to cover the 2010 and 2011 structural deficits. What happens after that?

  (b) 'Balancing the books over a five year cycle' is in any case an extremely suspect policy from an economic theory perspective. More correct would be 'Balancing the books over the full economic cycle' (inflation/growth through deflation/recession and back again, regardless of the time frame). At what position is Jersey currently in the full economic cycle? Amendment 1.2.4 may help our knowledge in this respect.

- 2008 will see the introduction of a 3% GST. The Treasury accepts that this will lead to price increases of about 3% probably leading to a one-off inflationary hit approaching that level spread over 2008 and 2009 and this is unavoidable.

- Any deflationary effect of the introduction of ITIS in 2006 will dissipate through 2007.

- The proposed imposition of Regulation of Undertakings licence fees on businesses as part of the 0/10 proposals is likely to be in part inflationary.

- The Economic Growth Plan 2% real growth will of itself generate inflationary pressure. The higher our inflation rate is the more difficult or unsustainable attaining 2% real growth will become.

What will be the likely inflation level if we combine these inflationary pressures? Some factors may be unavoidable - but an increase in public spending is not.

Financial and manpower implications

There are no additional manpower costs and no additional financial costs to these amendments. The Panel recognises that the implications of the amendments are to reduce total States net revenue and capital expenditure and that, as a consequence, the Council of Ministers will be required to re-assess its overall programme. This will probably mean a delay in enacting certain initiatives. The Panel is not in a position to identify specific initiatives and believes that this is the responsibility of the Council of Ministers.

Appendix A

Extract from Economic Growth Plan (P.38/2005)

Chapter 7: Macroeconomic stability

The need for stability

One key requirement for economic growth is the need to provide a stable economy for businesses and consumers to make decisions and this involves getting the macroeconomic policy framework right. A volatile economic cycle of boom and bust imposes costs on the economy which is likely to undermine efficiency and economic growth in the medium and long-term.

While it may be tempting in the short-term to allow the economy to grow rapidly there are real risks to doing so in the long-term, especially if there is limited or no spare capacity in the economy. A sustainable growth policy will focus on consistent growth close to trend (only allowing above trend growth when there is significant spare capacity in the economy) and ensuring that attention is paid to the supply-side of the economy and not just the demand-side.

The danger of not pursuing such a policy is clearly that excessive growth will lead to accelerating inflation and that the only way for the economy to adjust is through a recession. Inflation is therefore bad for economic growth and a sustainable economic growth plan must also include maintaining low and stable inflation.

Many years of experience across different economies have shown that one of the main consequences of high inflation has been greater instability in economic conditions. Periods when demand has been growing more rapidly than output and inflation has risen have been followed by periods when demand and output (and employment) have fallen sharply (the boom and bust cycle). These falls were probably greater than would have been the case had demand and output grown at a steadier and more balanced pace.

In the Jersey sense (and in fact for any economy in a currency union) this implies an important role for fiscal policy in providing stabilisation and controlling inflation. There may be some questions about the efficacy of fiscal policy but when you have no control over interest rates there is little else left in the macroeconomic policy locker.

A critical element could be ensuring that the automatic stabilisers in the economy work as well as possible and where possible actually strengthening them. There could also be a case for increasing the role of discretionary fiscal policy to help smooth out cyclical variations in the economy. Work by the UK Treasury as part of the 5 EMU tests has shown that expenditure taxes can be one of the most effective discretionary tools because of their direct impact on consumption and the fact that in the UK legislation is such that VAT and excise duties can be changed at any point in the year.

In Jersey any consideration of fiscal policy must also take into account policy for the Strategic Reserve. There would be little point in running fiscal surpluses if at the same time there were significant draw downs from the Strategic Reserve or vice versa.

Policy for the Strategic Reserve

It is worth considering first what the purpose of the Strategic Reserve (SR) is. One of the main problems with the debate surrounding the potential use of the SR is that it represents different things to different people. The original intention, however, was it should be used to provide the Island with some level of insulation from external shocks. The SR has not always been used in this way and at different times funded capital projects when the Island was in recession but has also been used to fund tax cuts and/or expenditure increases at times when the economy was growing strongly.
At other times it has been used for investment in economic development.

With the potential for fiscal surpluses now reduced and 0/10 on the horizon it would be a sensible time to clarify the role of the SR. The original amendment to public finance law constitutes that the reserve cannot be used for any purpose other than one specifically recommended by the Finance and Economics Committee and approved by the States. It is therefore possible for F&E to clearly highlight the circumstances under which they are likely to come forward with such a recommendation.

The international experience

Both Guernsey and the Isle of Man have Strategic Reserves. The Isle of Man has been making substantial contributions to its Strategic Reserve in recent years. It currently has a stated policy of planning for annual budget surpluses of at least 5% of net spending, though there appear to be no explicit policies on the use of the Strategic Reserve.

Guernsey has a Contingency Reserve Fund of £176m, the purpose of which "is to provide protection against major emergencies including economic downturns having a severe adverse effect on the Island".

Apart from our competitor off-shore finance centres the other countries identified as possessing Strategic Reserves are mainly those which benefit from significant oil revenues. Norway is often cited as the best example of a country which has used its windfall oil revenues wisely. It created the Government Petroleum Fund (GPF) in 1990 into which oil revenues are transferred. The stated purpose of the GPF is to "serve as a tool for coping with the financial challenges from the ageing population and the expected decline in oil revenues by transferring wealth to future generations".

During the 1990s US States created budget stabilization (rainy day) funds to help provide countercyclical support. Today 46 states have such rainy day funds although many have failed to adopt either contribution or expenditure rules that would create significant balances in the funds. Such funds have some general properties:

- They are designed to accumulate revenues during periods of strong economic performance
- They can improve a state's credit rating by demonstrating that a State has significant reserves to weather a moderate recession
- They are designed to be counter cyclical but not to address a structural budget deficit.

- They sometimes have contribution rules
- Withdrawals are often part of the political process and only sometimes based on specific rules.
- Suitable levels for such rainy day funds to be able to provide counter cyclical aid is estimated by some analysts to be in the region of 15-20% of state spending.

What is the Strategic Reserve?

In order to make sensible decisions about the use of the Strategic Reserve it is important to understand exactly what – economically – it is.

Fundamentally the Strategic Reserve represents consumption foregone in previous years by the residents of the Island. Adding to the Strategic Reserve *reduces* current consumption in the Island and *increases* the potential for consumption in the future. Spending the Strategic Reserve *increases* current consumption, but removes the potential for increased consumption in the future.

It is similar to the opposite of borrowing – which has the effect of *increasing* current consumption but requires future taxpayers to pay interest on the loan, and to repay the capital, thus *reducing* future consumption. However, the Strategic Reserve differs from borrowing in the following ways:

- It reverses the intergenerational payment pattern. Those who have "paid" for it may well be not around to benefit from the future benefits (because they have left the Island).
- Strategic Reserve financing is *cheaper* than borrowing – by the difference between interest paid on debt and interest/return earned on assets

The Strategic Reserve and borrowing also have a number of similar traits

- Spending the SR and borrowing will both increase inflationary pressure in the economy
- Both can be used to finance counter-cyclical spending
- Both can be used to smooth the impact of external shocks
- Both can be used to finance direct current consumption, or real economic investments
- Both can lead to a larger public sector than would otherwise have been the case and 'crowd out' activity in the private sector.

Problems to avoid

The above analysis of what the SR is, past experience with the reserve and the experience of other countries spells out lessons for its future operation. There are a number of pitfalls to avoid:

- Using the reserve to boost spending at times when the economy is close to/above full

capacity

- Continual calls for the use of the reserve which waste time and distract attention from the real issues
- Using the reserve but never making repayments
- Funding inappropriate government intervention
- Inadequate provision for future generations that could face a different life in Jersey.

A new framework

Drawing this analysis together suggests that the two most important objectives are to:

1. Maintain the Strategic Reserve at close to current levels to maximise the potential cushion/benefit for future generations in times of severe structural decline/natural disasters. This implies that a greater value is placed on maintaining future consumption (under specific circumstances) rather than consumption today or tomorrow in general terms.
2. Provide some flexibility to tackle short-term cyclical pressures brought about by a cyclical downturn in the economy (from external or internal factors).

The first point actually requires the SR to be put tightly under lock and key so that it is untouchable by the current generation (unless the Island is hit by a major shock). The second point actually requires some flexibility and resources to be available at times of cyclical downturn. Is it possible to reconcile these conflicting objectives?

The only pragmatic way to reconcile these conflicting objectives would be to have two separate funds, with strict rules governing both, say the Strategic Reserve and a new Stabilisation Fund (SF). The real question is how would they operate?

Strategic Reserve

The SR would be **maintained at or above current levels** (say 90% of government expenditure) in much the same way, with fiscal surpluses invested in the fund or used to replenish the Stabilisation Fund (discussed below). Similarly, the real return from the reserve would be added to the reserve, although it could at times be used to replenish the Stabilisation Fund.

The Strategic Reserve would solely be 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. It would be off limits for all other purposes and this could be made clear from the outset. The circumstances in which the SR could be accessed would be set out clearly in advance.

The only other call on the Strategic Reserve would be an initial payment to capitalise the SF.

Stabilisation Fund

The new SF would be governed by **strict but transparent rules** that only allow it to be used at times of a cyclical downturn. There would be a set trigger mechanism before which the SF

would be off limits. The trigger mechanism could be one or more of the following examples:

Government revenue/expenditure falls by 10 or 20% below expected trends

Unemployment rises above an agreed level

GVA declines significantly in any calendar year (or if data allowed in two consecutive quarters).

Profitability of the financial services industry falls by more than 10% in any one year.

There could be pitfalls with any of the above measures e.g. the first one could lead to incentives to be over optimistic with revenue/expenditure trends, issues of data timeliness and frequency, so it might well be the case that the **trigger mechanism would be need to be based on at least two different indicators**. It is also apparent that such trends would have to be precipitated by cyclical factors and this might be difficult to assess. However, it might also be justified to allow significant structural factors to be addressed for the first year with the SF while full consideration is given to the right policy response to address the structural change.

A decision would have to be made as to whether a trigger mechanism would be needed to make payments to the SF (or SR) at times when the economy was growing quickly. If there was a requirement to do so and it meant that the fiscal stance had to be tightened there would be a countercyclical effect. The alternative would be to leave such payments to the discretion of F&E/The Jersey Chancellor at the risk they would not be made a sufficient rate to be truly countercyclical.

The SF could have a **target level** e.g. 15% of government expenditure. When it falls below the target rate it would be expected that in times of cyclical upturn payments would be made into the SF – through fiscal surpluses (and/or possibly the real return on the SR) and these could be based on fixed rules.

The experience from the US is that States will not draw on such funds if the rules are too mechanical i.e. they will not draw down funds in year 1 if there is an immediate requirement to repay them in year 2. It could be the case that firmer rules are required in Jersey similar to those set out for drawing down the SF or that exact decisions about repayments are made by the Jersey Chancellor.

The **initial capitalisation** of the SF would be an issue. However, this could be done by an initial (one off) payment from the SR and by absorbing other funds. The SF could be built up further if needed over several years if the real return on the SR/fiscal surpluses allowed. The aim could be to have it operational by 2006 for the first Jersey Chancellor. Currently projections for the SR suggest that it could amount to £445m or 94% of government revenue in 2006 based on a 3.89% annual return. This would allow an initial and one-off payment of £20m into the SF and still keep the SR at 90% of government revenue. Additional payments could be made from any real return in these years.

Such a framework would be drawing on the international experience from such funds and tailoring it to meet the specific requirements and circumstances of Jersey. It would draw on the experience with oil funds in countries like Norway and the 'Rainy Day Funds' used by US States. The UK Treasury has identified the need for a more flexible fiscal regime if the UK entered EMU and while they are not in favour of a stabilisation fund as such they do recognise

the need to strengthen automatic stabilisers and discretionary fiscal policy. Their fiscal rules are already based over the economic cycle and therefore allow the flexibility that this approach would give to Jersey.

Clearly for a Jersey Chancellor to make the right decisions at times of cyclical slow down and with a SF at their disposal further research would be needed in Jersey on the role played by automatic stabilisers and how best to use discretionary fiscal policy. In particular how funds released from the SF could best be used to mitigate a cyclical downturn e.g. tax cuts (direct or indirect) versus maintaining expenditure (capital or current).

Chapter summary and actions

A critical part of the Economic Growth Plan is to provide a new macroeconomic framework for Jersey that represents a clear break with the past. If sustainable economic growth is to be achieved with low inflation then the States of Jersey must ensure that fiscal policy - the one macroeconomic tool available - is focused on delivering the stability required. A transparent and credible framework is required to support stability and control inflation.

The Economic Development Committee offers its full support to the Finance and Economics Committee in working towards a new framework for the Strategic Reserve and Fiscal Policy that encapsulates the proposals in this report for a new counter cyclical Stabilisation Fund, with the Strategic Reserve clearly put to one side to be used only if the Island faces a major shock to its economy.

Appendix B - Briefing Note: Dwelling House Loan Fund

States of Jersey Treasury

To:	**Julian Morris**	**From:**	Ray Foster
Cc:		**Date:**	2/5/06

Financial Framework - Draft Strategic Plan: Dwelling Houses Loans Fund

Further to the Panel's request, the following background information is provided:

i) The Dwelling Houses Loans Fund (DHLF) is administered under the Buildings (Loans) Jersey Law 1950 (last revised 31/8/2004).

ii) The DHLF was established in order to lend money to individuals (as identified in the relevant Law) to acquire a house. In the initial years the Fund received cash injections totalling £3.753 million from States general revenues. Over the years the rate of interest charged on loans to borrowers has exceeded the rate of interest charged to the Fund and a surplus has accrued.

iii) The intention of the States Loan scheme is to provide financial subsidy to those who need support in acquiring a property and repaying a mortgage, those who are able to pay more do so. Once an individual's income is sufficient to pay a commercial rate under the current rules they do so.

The current commercial rate is higher than a borrower would normally pay in the private sector, which is an incentive to individuals to leave the States scheme when they are able.

iv) At 31/12/2005, the DHLF had an accumulated fund balance of some £52.7 million - of this, £13.5 million relates to loans and interest outstanding.

The remaining £39.2 million represents a temporary advance from the DHLF to the (then) Capital Fund. Under the Public Finances (Jersey) Law 2005, the Capital Fund has been superseded by the Consolidated Fund.

A copy of the accounts is attached.

v) The surplus currently accruing on the Fund has no particular purpose under the administering law. The terms of Article 2 of the Building Loans (Jersey) Law, 1950 states *"…there shall be established a fund, to be called the "Dwelling-Houses Loan Fund" (in this Law referred to as "the Fund"), into which the States may pay, and from which the States may withdraw, such sums as they shall from time to time determine."*

vi) It is proposed that £12 million of the current surplus be allocated to increase the funding available to the 2007 - 2011 Capital Programme - principally to provide for refurbishment and redevelopment of States social housing. This proposal will be considered by the Council of Ministers on 11 May 2006 and, if adopted, will be included in the States Annual Business Plan to be discussed in September 2006.

vii) When considering how the accumulated surplus should be appropriated, the States will need to consider a number of factors including:

the need to agree a Strategic Reserve policy (Strategic Plan aim 9.1.7);

the impact on the economy of a potential significant ‘one off’ increase in government expenditure (inflation and impact on construction sector capacity);

the need to ensure that a funding requirement is not created that will remain once the surplus has been exhausted;

the impact on the States general revenues cash flow.

Ray Foster
Head of Corporate Capital

Dwelling House Loan Fund

Income and Expenditure account for the year ended 2005

	2005		2004	
	£	£	£	£
INCOME				
Interest charged to borrowers		1,394,829		1,630,954
Interest from advances to Capital Fund		1,634,493		1,346,953
Opening Balance Interest Adjustment		0		0
		3,029,322		2,977,907
EXPENDITURE				
Administrative expenses	117,892		122,486	
Bad debt	0		0	
		(117,892)		(122,486)
Surplus/(deficit) for the year		2,911,429.32		2,855,422

Balance Sheet as at 31 December 2005

	2005		2004	
	£	£	£	£
FUNDS EMPLOYED				
Accumulated Fund				
Balance at start of year	49,804,500		46,949,078	
Surplus/(loss) for the year	2,911,429		2,855,422	
		52,715,929		49,804,500
		52,715,929		49,804,500
REPRESENTED BY:				
Loans and interest outstanding		13,457,869		15,611,931
Current assets				
Debtors	5,911		0	
Debtor - Temporary advance to Capital Fund	39,276,522		34,192,569	
		39,282,434		34,192,569
Current Liabilities				
Creditors	24,373		0	
		(24,373)		0

	52,715,929	49,804,500

Appendix C- Projected Profile of Corporate and Departmental Efficiency Savings

	2005 £' 000	2006 £' 000	2007 £' 000	2008 £' 000	2009 £' 000	Total £' 000	
Corporate Efficiencies							
HR	300	400				700	
IT	500	440				940	
Finance	206	494	427			1,127	
Procurement	150	300	750	700		1,900	
Total Support Services	1,156	1,634	1,177	700	0	4,667	
Cross-Departmental	120	120	120	120		480	
Executive Overheads			330	330		660	
Property							
-Revenue		400	500	600		1,500	
-Capital			700	1,600	1,700	4,000	
Total Corporate Efficiencies	1,276	2,154	2,827	3,350	1,700	11,307	**57%**
Departmental Efficiencies	4,724	1,846	1,173	650	300	8,693	**43%**
Target	**6,000**	**4,000**	**4,000**	**4,000**	**2,000**	**2,000**	

Notes; This new Allocation schedule was presented to the Finance and Economics Committee and CMB in December 2005 by the Change Team.

Appendix D - States Net Revenue Expenditure and Capital Expenditure 1990 to 2005 compared against inflation

Figure 1 Jersey Inflation 1990 to 2005

Jersey Retail Prices Index, Annual Averages June 2000 = 100

Jersey (June 2000 = 100)					
All items RPI		***% change***		**RPI (X)**	**% change**
1990	65.7				
1991	71.0	*8.1*			
1992	75.3	*6.1*			
1993	78.2	*3.9*			
1994	80.3	*2.7*			
1995	83.2	*3.6*			
1996	85.8	*3.1*			
1997	89.0	*3.7*			
1998	92.9	*4.4*			
1999	96.2	*3.6*	1999	96.6	
2000	100.4	*4.4*	2000	100.4	3.9
2001	104.2	*3.8*	2001	104.3	3.9
2002	108.7	*4.3*	2002	108.8	4.3
2003	113.4	*4.3*	2003	113.7	4.5
2004	118.9	*4.9*	2004	117.5	3.3
2005	122.6	*3.1*	2005	120.3	2.4

Source: Jersey Statistics Unit

Figure 2 UK Inflation 1990 to 2005

United Kingdom (January 1987 = 100)						United Kingdom CPI (2005=100 = 100)		
All items RPI		***% change***		**RPI (X)**	***% change***			***% change***
1990	126.1		1990	122.1		*1990*	71.5	
1991	133.5	*5.9*	1991	130.3	*6.7*	*1991*	76.8	*7.4*
1992	138.5	*3.7*	1992	136.4	*4.7*	*1992*	80.1	*4.3*
1993	140.7	*1.6*	1993	140.5	*3.0*	*1993*	82.1	*2.5*
1994	144.1	*2.4*	1994	143.8	*2.3*	*1994*	83.8	*2.1*
1995	149.1	*3.5*	1995	147.9	*2.9*	*1995*	86	*2.6*
1996	152.7	*2.4*	1996	152.3	*3.0*	*1996*	88.1	*2.4*
1997	157.5	*3.1*	1997	156.5	*2.8*	*1997*	89.7	*1.8*
1998	162.9	*3.4*	1998	160.6	*2.6*	*1998*	91.1	*1.6*
1999	165.4	*1.5*	1999	164.3	*2.3*	*1999*	92.3	*1.3*
2000	170.3	*3.0*	2000	167.7	*2.1*	*2000*	93.1	*0.9*
2001	173.3	*1.8*	2001	171.3	*2.1*	*2001*	94.2	*1.2*
2002	176.2	*1.7*	2002	175.1	*2.2*	*2002*	95.4	*1.3*
2003	181.3	*2.9*	2003	180.0	*2.8*	*2003*	96.7	*1.4*
2004	186.7	*3.0*	2004	184.0	*2.2*	*2004*	98	*1.3*
2005	192.0	*2.8*	2005	188.2	*2.3*	*2005*	100	*2.0*

Source: Office for National Statistics	Source: Office for National Statistics

Figure 3 - States Net Revenue Expenditure and Capital Expenditure 1990 to 2005

Revenue				Capital		Combined Revenue + Capital			
Non-Trading Committees Net Revenue Expenditure				Expenditure from Capital Fund		Total Expenditure			
	£m	Annual Increase %	Index (1990 = 100)		£m		£m	Annual Increase %	Index (1990 = 100)
1990	158	14.5	100.0	***1990***	61	***1990***	219	23.8	100.0
1991	181	14.6	114.6	***1991***	63	***1991***	244	11.4	111.4
1992	199	9.9	125.9	***1992***	51	***1992***	250	2.6	114.4
1993	209	5.0	132.3	***1993***	49	***1993***	258	3.0	117.7
1994	219	4.8	138.6	***1994***	75	***1994***	294	14.1	134.3
1995	227	3.7	143.7	***1995***	68	***1995***	295	0.4	134.8
1996	237	4.4	150.0	***1996***	72	***1996***	309	4.8	141.4
1997	255	7.6	161.4	***1997***	70	***1997***	325	5.0	148.5
1998	278	9.0	175.9	***1998***	67	***1998***	345	6.3	157.8
1999	294	5.8	186.1	***1999***	61	***1999***	355	2.8	162.1
2000	324	10.2	205.1	***2000***	31	***2000***	355	0.1	162.3
2001	356	9.9	225.3	***2001***	42	***2001***	398	12.1	182.0
2002	377	5.9	238.6	***2002***	44	***2002***	421	5.8	192.6
2003	397	5.3	251.3	***2003***	50	***2003***	447	6.1	204.4
2004	417	5.0	263.9	***2004***	42	***2004***	459	2.6	209.7
2005	423	1.4	267.7	***2005***	47	***2005***	470	2.4	214.7

[1] The difference in this case between £480m and £481m is accounted for by the States decision to increase expenditure by £300k to fund television licences for the elderly. This tipped the rounding to £442k and £455k.