

## The role and guiding principles of the Fiscal Policy Panel

### Summary

After their initial meeting at the end of last year the members of the Fiscal Policy Panel (FPP) agreed that it was important to set out its views on the role of the Panel within the new Fiscal Framework before the first annual report is published in August. Based on what has already been agreed by the States in terms of the new Fiscal Framework, this preliminary report highlights the views of the FPP on its role within the framework and the basic principles that will guide its work. The key points are:

- There is a need to improve policy making in the Island so that fiscal policy contributes to stability by acting in a more counter-cyclical manner.
- The FPP is an independent advisory body. It does not make policy decisions. It is accountable to the Minister for Treasury and Resources, the States and the people of Jersey.
- The influence of the FPP will be indirect and depend on the professionalism, thoroughness and independence of its analysis and advice.
- All the FPP's advice, recommendations and reports will be in the public domain, to ensure a transparent and credible process.
- The Minister for Treasury and Resources and the FPP have agreed that the annual report will be published in August. An update may be published in October ahead of the Budget to cover any changes in the fiscal or economic outlook.
- In undertaking its work and writing its report the FPP recognises that it should be:
  - guided by an understanding of the preferences of Jersey society;
  - professional and build confidence in its work; and
  - fully transparent with regard to both its recommendations and methodology.
- Five principles will guide the FPP in its work:
  1. Economic stability is at the heart of sustainable prosperity;
  2. Fiscal policy needs to be focused on the medium-term;
  3. Policy should aim to be stable and predictable;
  4. Supply in the economy is as important as demand; and
  5. Low inflation is fundamental to the competitiveness of the economy.
- The Panel welcomes the commitment to review the framework after the first year, seeking advice from the FPP, as Jersey is still at an early stage in the development of its fiscal framework and experience may well identify further need for improvement.

## Introduction

Jersey is in the process of radical fiscal change with the move to a 0/10 corporation tax system (standard rate of 0% with a special rate of 10% for specified financial services companies) and the implementation of the States Fiscal Strategy to recover the associated loss in tax revenue. An important part of this strategy is to create the conditions for economic growth and low inflation to keep personal tax rates low while maintaining the quality of the Island's public services.

The States agreed to adopt a new Fiscal Framework proposed by the Minister for Treasury and Resources in October 2006. This included the establishment of a new Stabilisation Fund. The Minister for Treasury and Resources is responsible for the operation of the Stabilisation Fund, but with regard to the advice of the independent Fiscal Policy Panel.

This preliminary report highlights policy already agreed by the States in terms of the new Fiscal Framework and the views of the FPP on the role of the Panel and the basic principles that will guide its work.

## The new Fiscal Framework

The new Fiscal Framework was outlined in the report and proposition P133/2006: *Establishment of a Stabilisation Fund and Policy for the Strategic Reserve* agreed by the States in October 2006. It is worth recapping on what has already been agreed in terms of how this framework will operate. This section considers the objectives of the new framework, the purposes of the Stabilisation Fund and Strategic Reserve and the role of the FPP, as set out in P133/2006.

### **Objectives**

The objectives of the new Fiscal Framework are to:

- Create an effective macroeconomic policy framework that can improve economic stability by containing inflation and maximising the economic potential of the Island.
- Put in place a transparent and credible framework that is both pragmatic and understood by everybody in the Island.
- Make fiscal policy overall more counter-cyclical and manage the revenue streams in a manner that enhances economic performance.

### *The two funds*

The Framework also defines the functions of the Stabilisation Fund and Strategic Reserve:

- **The Strategic Reserve** should be clearly put to one side and the capital value only used in exceptional circumstances to insulate the Island from severe structural decline (such as the sudden collapse of a major Island industry) or major natural disaster.
- **The Stabilisation Fund** will be used to enable fiscal policy to be more counter-cyclical and to create a more stable economic environment with low inflation in the Island. The final decisions on what proposals are to be taken to the States for taxation and spending, and withdrawals from, or payments into the Stabilisation Fund continue to lie with the Treasury and Resources Minister.

### *The FPP*

The Panel is a group of three independent and professional economists with extensive experience in policy-making. Its task is to give advice on taxation and spending and on withdrawals from, or payments to, the Stabilisation Fund (and ultimately the Strategic Reserve). The Panel's main formal output is an annual report for the Treasury and Resources Minister that:

- Examines the strength of the Jersey economy, the position in the economic cycle and the outlook for the Jersey and world economies.
- Comments on the appropriateness of the States financial position and forecasts given the above.
- Recommends policy regarding the Stabilisation Fund and whether economic conditions justify payments to or from the Fund and gives guidance on their size.
- Considers if payments are to be made and what would be the best way to achieve them.
- Outlines when the Stabilisation Fund may be at sufficient levels and therefore when payments should be made into the Strategic Reserve.

## The views of the FPP

The appointment of the members of the FPP was agreed by the States in September last year. The three members are Joly Dixon CMG (Chairman), Marian Bell CBE and Christopher Allsopp CBE. Following an initial meeting in early November the FPP agreed that it was important that they should publish this paper to make it clear what their role is and how they see the framework operating in practice.

The Panel's thoughts on the fiscal framework, their role, the annual report, the principles that will guide them and the continued development of the framework are set out below.

### **1. Fiscal Framework**

Jersey has a very successful economy. The standard of living is high, with per capita income amongst the highest in the world. However, there has also been a volatile economic cycle and sustained periods when inflation has been above target.

Past experience in Jersey shows the need to improve fiscal policy to ensure that it acts in a more counter-cyclical manner. When the economy was growing rapidly and inflation was above target in the late 1990's, the States allowed expenditure to increase strongly, adding to demand in a pro-cyclical and inflationary way. When the economy slowed in the early 2000's, government expenditure also slowed thereby deepening, rather than lessening, the downturn. Furthermore, funds from the Strategic Reserve have also been used pro-cyclically, with draw downs at times when the economy was already growing strongly and inflationary pressures were rising.

Maintaining a low inflation environment is fundamental to the Island's competitiveness and a key element in the Island's prosperity. In all economies, fiscal policy has an important role to play in ensuring stable economic conditions. In Jersey, as in other economies within currency unions, fiscal policy has to carry a greater burden. It, and supply side policies, are the only policy instruments available.

In general terms the Strategic Reserve can be seen as an insurance policy. It should only be used in very exceptional circumstances to insulate the Island from a severe and sudden adverse event like a major natural disaster or the sudden collapse of a major industry.

The Stabilisation Fund can be seen as a savings account. It should be used to smooth expenditure and promote growth through stability. It should allow fiscal policy to be more counter-cyclical and help to promote a healthier economic environment in the Island with low and stable inflation. In general the size of the fund should increase when the economy is already growing above potential and the public sector should be withdrawing demand from the economy. The size of the Stabilisation Fund should decrease when the public sector should be increasing demand which otherwise would be below potential.

The nature of the Jersey economy and the information available means that it would be impossible to devise a rule or a set of rules that could determine use of the Stabilisation Fund. While Jersey has a very good range and high quality of statistical information, the amount of information available is considerably less than in many other larger economies. Furthermore there is no advanced model of the economy and its constraints. Especially in these circumstances, decision making is better made by discretion within a clear and transparent medium term framework rather than by rules.

## ***2. The role of the FPP***

The FPP is an advisory body. It advises the Minister for Treasury and Resources, who has the responsibility to propose fiscal policy measures for decisions to be made by the States. The FPP does not make policy decisions. The operation of fiscal policy should not be delegated to a non-political body. The power to tax and the decisions over the priorities for public expenditure are too political to be handed over to an independent body.

However, an independent advisory panel like the FPP can be a useful addition to the policy making process. Provided that the institutional structure is well designed and the working methods are sound, the FPP will be able to play a much greater role in policy-making than for example a think-tank or a lobby group.

The influence of the FPP will be indirect and depend on professionalism, thoroughness and independence.

To be effective, the FPP must fully understand the policy making process, because although it is not a policy making body it must be well integrated into the policy-making process. It is equally important that the role of the FPP, the principles by which it operates and its procedures should be understood by politicians, officials and the general public.

It is important that all the FPP's reports, advice and recommendations be made public to ensure a transparent and credible process.

### *The annual report*

In agreement with the Minister for Treasury and Resources the FPP have decided that it will publish its annual report in August. An update may be published in October ahead of the Budget to cover any changes in the fiscal or economic outlook in the preceding months. This will ensure the most effective and transparent process.

The annual report will carry significant weight and as it will be published, good reasons will have to be given for rejecting its recommendations. The advisory process should however be seen as interactive rather than one-way. The FPP should influence and constrain policy making. As it builds a track record and as its framework for analysis becomes known, its very existence should affect the policy-making process. Ideally, decision makers and the political system will be guided as much by what they know that the FPP is likely to say in a future report as by what is said in a current report.

There will inevitably be occasions when the FPP issues a report that makes recommendations that differ to some extent from the proposals in a draft budget, but it would be undesirable for this to happen too often once the framework has established itself and the likely FPP response is anticipated by policymakers.

### *Key ingredients*

To make the system work well, there are three key ingredients:

First, the FPP should be guided by an understanding of the preferences of Jersey society. The FPP must therefore discuss the issues widely with the community and try to build up an understanding of the societal context in which their economic recommendations are being made.

Second, the FPP should be professional. The FPP must build confidence in its analysis and should be seen to be using all the data that is available and to have an extensive understanding of the mechanisms of the Jersey economy.

Third, the FPP should be fully transparent. All its advice should be made public and the methodology the FPP adopts is as important as the recommendations themselves. This will make the FPP's advice more predictable and allow others to anticipate its views.

### **3. Guiding principles**

The work of the FPP will be based on the following five guiding principles:

- (i) *Economic stability is at the heart of sustainable prosperity.* Low inflation and steady growth provide the ideal conditions for high investment and growing productivity by reducing uncertainty and increasing efficiency. Jersey cannot fully insulate itself from developments in the global economy. But policy makers should try to stabilise inflationary expectations as far as possible through an inflation target, fully supported by a prudent fiscal policy.
- (ii) *Fiscal policy needs to be focused on the medium-term.* The annual business plan and the annual budget should be firmly anchored within a medium term framework.
- (iii) *Policy should be stable and predictable.* Economic decision makers and especially investors, on whom long term prosperity depends, need certainty. Mervyn King, the Governor of the Bank of England, has said that monetary policy should be boring. Fiscal policy should also be boring in the sense that it is predictable and gives few surprises. Experience has shown that attempts at fine-tuning are often counter-productive and that policy-makers can best add to stability by concentrating on the medium term. They should make their decision-making processes known; have clear objectives and transparent methods.

- (iv) *The supply side of the economy is just as important as the demand side.* Fiscal policy must be set with reference to the degree of spare capacity in the economy and the level of real interest rates. The degree of spare capacity is a function both of demand and supply. Jersey has a number of important resource constraints affecting both the product and especially labour markets.
  
- (v) *Low inflation is fundamental to improving the competitiveness of the economy.* Jersey is a small, open, island economy in a currency union. It has only a limited degree of control over its own economic development, especially in the short term. Its long term prosperity rests on maintaining low inflation and enhancing the competitiveness of the economy.

The FPP will have to make judgements based on the best available information and a sound understanding of the underlying economy. There is no magic formula. Its advice will be as precise as possible and will relate directly to decisions about fiscal policy variables like the size of the deficit or surplus and the resulting transfers to or from the Stabilisation Fund.

#### **4. Further development**

The Panel are pleased to see that the new Anti-inflation Strategy launched by the Council of Ministers in February gives due attention to the need to understand the economic cycle better in Jersey and in particular how the degree of spare capacity in the economy varies. It is also pleased to see that the Strategy recognises the importance of the supply side of the economy in managing inflation.

Both the new Fiscal Framework and the Anti-inflation Strategy make provisions to review the new Fiscal Framework after its first year in place, drawing on advice from the FPP. The FPP looks forward to playing its full part in this process.

The Panel will produce its first annual report in August. This will be another important step in a reform process that is still at an early stage. Both the Panel and the Fiscal Framework of which it is a part can be expected to develop further over the coming years.

**Joly Dixon CMG (Chairman)**  
**Christopher Allsopp CBE**  
**Marian Bell CBE**

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