Evidence to the Scottish Parliament Finance Committee Enquiry
on Scotland’s Fiscal Framework

IMF’s Fiscal Affairs Department¹
May 2015

Introduction

This note provides input into the Scottish Parliament Finance Committee’s enquiry into Scotland’s Fiscal Framework. Drawing on the Fund’s analytical work on designing fiscal frameworks and experience with fiscal decentralization in a broad range of countries, the note provides input on four key issues related to Scotland’s new fiscal framework, including the:

- assignment of additional revenues and expenditures to the Scottish Government;
- choice of fiscal rules for Scotland and their interaction with the UK Government’s own fiscal rules;
- role of the Scottish Fiscal Commission in providing independent scrutiny of the Scottish Government’s fiscal forecasts and performance; and
- coordination of fiscal policy between Scottish and UK Government, and the role of the Joint Exchequer Committee in facilitating that coordination.

The note’s evidence and recommendations are based on the analysis set out in Cottarelli and Guerguil eds. (2014) and data from the IMF’s Government Finance Statistics Yearbook unless otherwise stated.

Assignment of Revenue and Expenditures

By the standards of subnational governments in other advanced countries, Scotland has one of the largest discrepancies between its expenditure and revenue assignments.

- On the expenditure side, Scotland’s government is responsible for a broad array of public services (health, education, transport, policing, housing, and environmental protection). The expenditure of the Scottish government, local authorities, and public corporations on these services accounted for 61.5 percent of total public expenditure in Scotland in 2013-14. (GERS, 2013-14) By contrast, subnational governments account for an average of 27 percent of total general government expenditure among EU countries, 31 percent of total general government expenditure among OECD countries, and 44 percent among 13 federal countries surveyed in Cottarelli and Guerguil, 2014.²

¹ Views expressed in these comments are those of the IMF’s Fiscal Affairs Department and not necessarily of its management or Executive Board.

² Argentina, Australia, Austria, Belgium, Brazil, Canada, Germany, India, Mexico, South Africa, Spain, Switzerland, and the United States.
On the revenue side, by contrast, Scotland’s government is relatively heavily dependent on grants from the UK Government to fund their expenditure assignments. In 2013-14, the Scottish government and its local authorities’ own resources (council tax and non-domestic rates) accounted for 7.7 percent of total local revenues compared with an average of 53 percent in the EU, 59 percent in the OECD, and 50 percent in the federal countries surveyed in Cottarelli and Guerguil, 2014.

Scotland is therefore characterized by a significant “vertical” imbalance between its expenditure and revenue assignments which is addressed by a grant from the UK Government based on the Barnett Formula. With its Barnett formula grant accounting for over 90 percent of total revenue, Scotland is relatively heavily “grant dependent” compared with subnational governments in other countries. By contrast, transfers from the central government account for, on average, only 45 percent of subnational revenue in EU countries, 40 percent of revenue in OECD countries, and 43 percent among the federal countries surveyed in Cottarelli and Guerguil, 2014.

Large vertical imbalances of this nature tend to be associated with poor fiscal performance over time. Countries with large vertical fiscal imbalances tend to have larger general government deficits and higher levels of general government debt. (Aldasoro and Seiferling, 2014). The link between large fiscal imbalances and poor fiscal performance is generally explained with reference to (i) the lack of connection between local taxpayers and local spending; (ii) the soft budget constraint faced by the grant-dependent local government; and (iii) the local government’s ability to “externalize” part of the marginal cost of additional borrowing to the population of the country as a whole.

At the same time, even the most decentralized countries stop short of allowing subnational governments full control over all revenues collected locally. Revenue-sharing across regions provides insurance against region-specific shocks and cyclical variations. Such insurance is especially useful given that monetary policy cannot be tailored to each region's economic conditions. Consequently, central governments tend to retain control over the most cyclically-sensitive revenue and expenditure items (such as corporate income tax, capital gains taxes, and unemployment benefits), which act as automatic stabilizers for region-specific shocks and for the economy as a whole. Central governments also tend to retain control over universal contributory benefits (such as pensions), given the benefits that come from centralized administration and pooling of risk across society. Finally, even where some proportion of revenues from consumption and excise taxes are devolved, central governments often retain the powers to determine the base and rates for such taxes to avoid creating incentives for cross-border evasion.

Consistent with the above considerations, the Smith Commission’s proposals reduce Scotland’s vertical fiscal imbalance by devolving some, but not all, revenue. Under the Smith Commission proposals, Scotland’s own and assigned revenues would increase from 7.7 to 41.2 percent of total revenue. The choice and design of revenue instruments to be devolved to the Scottish Government (a variable 10 percent precept on Personal Income Tax,
around half of VAT, and all of Stamp Duty Land Tax, Landfill Tax, Air Passenger Duty, and Aggregates Levy) are generally consistent with international good practice. Specifically, they

- **are levied on relative immobile factors** such as land, consumption, employment, and environmental resources;

- **promote local fiscal responsibility** by allowing the Scotland government some local autonomy to alter rates and thresholds for income and environmental taxes;

- **limit scope for cross-border smuggling and tax evasion** by preventing the Scottish Government from altering the VAT rates or altering the tax base for VAT or income tax; and

- **take advantage of the economies of scale** that come from centralized collection and enforcement by HMRC.

**Given Scotland’s already relatively extensive expenditure responsibilities, the Smith Commission’s relatively modest proposals for devolution of additional expenditures are appropriate.** The targeted welfare benefits for carers, the sick and disabled, and the elderly to be devolved to the Scottish Parliament accounted for around £2.5 billion in 2013-14, or around 6 percent of total devolved expenditure. The proposal to retain policy and administrative responsibility for universal and cyclically-sensitive benefits (such as pensions and unemployment benefit) is also in line with international good practice given their role in pooling risk, ensuring intergenerational fairness, and stabilizing the macroeconomy across the UK.

**Choice of Sub-national Fiscal Rules**

The additional borrowing powers granted to Scotland under the 2012 Scotland Act and Smith Commission proposals need to be subject to transparent and binding fiscal rules. As at the national level, fiscal discipline at the subnational level is enhanced if fiscal policy is conducted within a transparent rules-based framework. Amongst the various fiscal rules that operate at the subnational level in the EU and OECD, the most common are some combination of:

- **a budget balance rule**, which is at times expressed in terms of the current or operating balance (the “golden rule”) and thereby allows the local government some ability to borrow for investment purposes. 11 of the 13 federations reviewed in Cottarelli and Guerguil, 2014 (8 of the 9 OECD members in that sample) had some form of restriction on local government balance, with 4 expressed in terms of the current or operating balance (3 in the OECD group). To provide subnational governments with some flexibility to absorb cyclical variations in their revenues, these rules are sometimes expressed as a requirement to run an average overall or operating balance over a number of years; and

- **a limit on the overall accumulation of debt** to ensure overall levels of borrowing remain sustainable. 10 of 13 federations surveyed in Cottarelli and Guerguil has some debt limit in place (4 of the 9 OECD members in the sample.) This limit is typically expressed either in terms of the ratio of total debt/total revenue (with 80 or 120 percent being typical values) or the ratio of total debt service/revenue (with 10 to 15
percent being typical values). However, the volatility of debt ratios can complicate their use as a hard limit on year-to-year fiscal policy.

**Expenditure rules** are less common at the subnational level (being in place in only 6 of the 13 federations mentioned above (5 of the 9 OECD members) given the interdependence between subnational expenditure levels and levels of own resources and grants. **Structural balance rules** are relatively uncommon at subnational level given the difficulties in calculating both subnational output and potential growth.

**Symmetry between national and subnational fiscal rules is important to ensuring effective coordination of fiscal policy across levels of government.** Given that the national fiscal rules in UK Government’s Charter of Budget Responsibility are expressed in terms of the current balance and net debt of the public sector (including those of Scotland), the use of similar aggregates would facilitate fiscal policy dialogue between the UK and Scotland governments.

**Role of the Scottish Fiscal Commission**

The credibility of fiscal rules and fiscal policy, at either national or subnational level, can be enhanced if they are scrutinized by an independent fiscal council. The Scottish Fiscal Commission could contribute to the credibility of the government’s fiscal policy by:

- assessing the realism of the Scottish government’s forecasts for devolved revenues and expenditures;
- evaluating whether those forecasts are consistent with meeting the government’s stated fiscal rules *ex ante*;
- assessing the government has adhered to its fiscal rules *ex post*; and
- identifying potential threats or risks to the government meeting its fiscal rules.

The Scottish Fiscal Commission should avoid duplicating work done by the independent Office for Budget Responsibility (OBR) and ensure consistency with it.

Many inputs required for assessing the realism of budget forecasts will be available from the OBR. In particular, the OBR already produces economic and fiscal forecasts for the UK as a whole. Moreover, most of Scotland’s revenues under the new funding arrangement will be in the form of shares of UK-wide taxes which are already forecast by the OBR. Finally, the alternative approach of having two independent fiscal institutions producing separate forecasts, using potentially different methodologies, would create a risk that fiscal discussions between UK and Scotland governments are not based on a common understanding of economic and fiscal prospects.

**Ensuring the fiscal council’s independence is critical to enabling it to perform its tasks effectively.** In the case of fiscal councils independence can be safeguarded by:

- being established by legislation which clearly defined the mandate of the council and protects it from political interference;
- having its members appointed in a manner which ensures they are professionally qualified and have the confidence of the government and all major parties in the legislature; and

- being given resources commensurate with their remit and multi-year certainty of funding (IMF 2013).

**Coordination between UK and Scottish Fiscal Policy**

**Effective coordination of fiscal policy across levels of government requires regular interaction between national and subnational governments at key stages of the fiscal policymaking process.** Such interaction required dedicated intergovernmental fora which bring together ministers and senior officials to discuss:

- **setting fiscal objectives or rules** which apply to the national and subnational budgets;

- **sharing information** about national and local economic developments and prospects;

- **coordinating the preparation of medium-term plans and annual budgets** between the national and subnational governments;

- **managing new burdens** being placed on local authorities and ensuring they are fully funded through adjustments to grants or funding formulae;

- **discussing major investment projects** before they are committed and agreeing national and subnational contributions to their cost;

- **monitoring the execution** of national and subnational budgets and compliance with local fiscal rules;

- **discussing and agreeing corrective actions** in case of slippage against national or subnational fiscal targets; and

- **sanctioning those authorities** that fail to take agreed corrective actions or adhere to other provisions of the central-local fiscal coordination framework.

The remit of the Joint Exchequer Committee should be reviewed in light of the above objectives.