WRITTEN RESPONSE FROM PROFESSOR CAMPBELL LEITH

What needs to be included within a revised funding framework for Scotland and how do we ensure that it is fair, transparent, effective and mechanical rather than requiring regular negotiations?

The principles underpinning the Smith Commission’s recommendations include ensuring, over time, that no party is made better or worse off solely as a result of devolving a particular tax and that the ‘no detriment’ principle be applied when taxes are changed. While certain forms of indexation may offer a mechanical means of approximating the first principle, applications of the no detriment principle implicitly require the modelling of counterfactual scenarios where the tax policies did or did not change. It is difficult to see how this can be done in a mechanical manner.

What fiscal rules should be applied in order to ensure fiscal responsibility and debt sustainability?

Economists have brought together the analysis of public finances with that of Keynesian disequilibria to describe how a benevolent policy maker should use fiscal policy to respond to economic shocks which affect the level of government debt.1 They highlight that the policy maker needs to trade-off the short-run costs of fiscal austerity against the long-run benefits of lower debt. The striking result from this analysis is that this balance is very fine – it is optimal to use fiscal policy to stabilise debt following shocks, but that returning debt to its pre-shock level should only be undertaken very slowly.

However, it is important to note that this result describes the policy that would be undertaken by a benevolent policy maker who is able to make credible promises about how they will behave in the future. In the real world, fiscal policy is typically implemented by governments subject to the constraints of the political process. For numerous reasons this may result in a ‘deficit bias’ which can account for the rising government debt levels in many advanced economies over recent decades. Recognising the costs of such biases, many politicians have sought to tie their own hands by adopting some form of fiscal rule, which often requires debt and deficits to be stabilised over relatively short time-horizons.2 However, possibly since such rules clearly violate the gradual fiscal adjustment implied by economists’ descriptions of

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2 Leith, C. and S. Wren-Lewis (2013), “Fiscal Sustainability in a New Keynesian Model”, Journal of Money, Credit and Banking, forthcoming, show that the costs to society of not being able to credibly promise to stabilise debt levels gradually are very large.
optimal policy, these rules have often been broken whenever they start to bite. This has happened so often, that it is difficult to see that such rules have any credibility anymore.

In response to this economists have recommended that politicians place themselves under the scrutiny of some form of Fiscal Council.³ The idea is that such monitoring can remind policy makers of the need to take account of long-run fiscal sustainability, such that the Fiscal Council would highlight, in periodic reports, whenever policies were being pursued which endangered that long-run fiscal sustainability. At the same time, the council could also allow a government to run deficits when the economic conditions implied that it was desirable to do so. In short the aim is to allow for short-run flexibility in a way that strict adherence to fiscal rules may not allow, but to ensure that this does not jeopardise long-run fiscal solvency.

Designing Fiscal Targets to Achieve these Goals:⁴

Mervyn King, the former governor of the Bank of England, famously described those who advocate strict adherence to an inflation target as being “inflation nutters”. Strict adherence to a deficit/debt target is the fiscal equivalent. Just as monetary policy should flexibly target inflation, fiscal targets should facilitate the use of debt as a shock absorber. To achieve this without compromising fiscal sustainability requires the appropriate design of fiscal targets combined with effective monitoring of progress towards these targets by the Scottish Fiscal Commission.

Desirable properties of these fiscal targets/rules include:
1. They should apply over a sufficiently long time horizon to allow gradual adjustment to the target. For example, “the government should achieve a deficit of x% within 5 years”.
2. The time horizon over which the target is to be achieved should be rolling to avoid the policy maker being forced to make undesirably large fiscal adjustments towards the end of the horizon date in order to achieve the target. This obviously creates the possibility of policymakers continually delaying fiscal adjustments. The Scottish Fiscal Commission publically monitoring any failure to meet past plans is therefore crucial in highlighting and discouraging such behaviour.
3. The targets should be set in terms of deficits and not debt. There are several reasons for this,
   i. We are unsure what the long-run debt target should be.⁵

⁵ Standard macroeconomic models where parents care about their children as much as themselves often leave the optimal debt level indeterminate. When we consider different generations explicitly the optimal long-run
ii. Even if we knew the ideal long-run debt target, optimal policy analysis suggests we should move towards it very slowly. Such slow progress towards the debt target, regardless of how desirable it was, may not be politically feasible.

iii. Any unforeseen shocks which move us away from the debt target are likely to result either in the rule being abandoned or in undesirable fiscal adjustments to achieve the debt target. The coalition government’s effective dropping of its target that debt should be falling in 2015-16 is an example of this.

Nevertheless, even although the rule should not be specified in terms of a debt target, it is essential that there is effective independent scrutiny of long-term debt projections which will depend on the deficit target, growth rates, demographic trends, and changes in real interest rates among other factors. The deficit target should then be periodically adjusted to ensure ongoing fiscal sustainability. This will be particularly important in the Scottish context given that the fiscal framework is likely to contain a maximum borrowing constraint so that the deficit target will need to be adjusted to avoid breaching this constraint. To the extent that this borrowing limit is too low, the effective use of government debt as a shock absorber will be compromised.

What mechanisms are required to ensure the transparency and effective scrutiny of adjustments to the block grant to reflect the tax revenues foregone by the UK Government?

The ‘no detriment’ principle is discussed below. However, beyond the application of this principle, the devolution of revenue raising powers requires the block grant be adjusted to reflect the tax revenues that would have been raised had the previous tax system remained in place. This becomes an increasingly hypothetical exercise as any new tax system replaces the current one. Simple indexation measures, such as indexing the block grant adjustment to the growth in the UK tax base, may offer a means of making such adjustments mechanical. However, to the extent that the indexation measure for the UK drifts away from the equivalent measure in Scotland such adjustments are likely to come under greater scrutiny over time.

What mechanisms are required to ensure the effective working of the “no detriment” principle?

The first application of the ‘no detriment’ principle was around the forestalling of tax revenues from the Land and Buildings Transactions Tax (LBTT) where it was argued that the behavioural response from households comparing the UK’s Stamp Duty rates to those anticipated to apply under Scotland’s LBTT regime resulted in tax revenues rising in the UK, but falling in Scotland. Therefore in order for the no debt level may even be negative, but is highly sensitive to assumptions about factors such life expectancy, growth rates and household and policy maker rates of time preference – see Moldovan, I., C. Leith and S. Wren-Lewis (2015), “Debt Stabilization in a Non-Ricardian Economy”, mimeograph, University of Glasgow.

detriment principle to be applied, effective modelling of the behavioural response to tax changes was required.

In general, identifying the magnitude of the spillovers from policy changes in either the rUK or Scotland requires extensive structural modelling work which goes well beyond the kind of analysis currently underpinning the Scottish Government’s forecasts.

**What additional borrowing powers for current spending and for capital spending should the Scottish Government have?**

The arrangements prior to the devolution of the additional powers envisaged by the Smith Commission implied a significant degree of risk sharing between Scotland and the Rest of the UK in that all tax revenues were pooled and then used to finance borrowing costs and government expenditure. A stated aim of devolution is to ensure that Scotland bears the costs and receives the benefits of policy decisions made by its representatives.

However, there are shocks beyond policy successes and failures which also affect the economy (e.g. oil price shocks, severe weather shocks, shifts in global demand for Scottish products etc) which do not immediately stem from policy decisions but which also affect the Scottish economy. Where these idiosyncratic risks to Scotland were pooled with the rest of the UK previously, they will now be borne by Scotland alone. This would mean, in the absence of borrowing, that a Scottish recession caused by such shocks would lead to policy makers having to cut spending or raise taxes to balance Scotland’s budget.

Analysis of optimal policy discussed above suggests that such balanced budget policies are undesirable and that it is preferable to use government debt to smooth the fiscal response to such shocks i.e. to act as a shock absorber. The additional borrowing powers required to mimic the risk sharing achieved under the previous arrangements are not likely to be trivial.

**What fiscal rules should be applied to these additional borrowing powers?**

While monetary policy rules can be effective in achieving the kinds of policy outcomes suggested by optimal policy exercises, the same is not true of many of the fiscal rules which have been adopted in the past. As noted above, overly restrictive fiscal rules are often made to be broken and do not produce the gradual adjustment following shocks that standard ‘tax smoothing’ policies would encourage. In this respect one of the advantages of having a properly functioning Fiscal Council is that that body can provide an evaluation of the sustainability of public finances and sound the alarm bell when fiscal policies are not consistent with that objective without hindering the policy maker’s ability to respond to shocks.
What should be the role and remit of an enhanced Scottish Fiscal Commission and who should be responsible for generating the economic and fiscal forecasts?

Aside from assessing the forecasts of the newly devolved taxes, the need to issue government debt to smooth the fluctuations in spending and revenues caused by shocks to the economy gives the Scottish Fiscal Commission a key role in assessing the sustainability of the public finances. As noted above, this requires a combination of flexible fiscal rules and monitoring from the SFC. Of key importance is the role the SFC has in evaluating the extent to which past plans have been implemented when the fiscal targets roll forwards in time. Without the effective monitoring of slippage in progress towards a fiscal target the policy maker is always able to promise adjustment tomorrow.

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