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 require that no party is made better or worse off over time as a result of devolving a particular tax and that the ‘no detriment’ principle be applied whenever taxes are changed. More exactly, the devolved powers shall: i) “cause neither the UK nor the Scottish governments to gain or to lose financially simply as a consequence of devolving a specific power”; and ii) “cause no detriment to the UK or to any of its consistent parts”.

The application of the no detriment principle will require us to model counterfactual behaviour where the tax policies did or did not change. It is difficult to see how to model behavioural responses of this kind in a mechanical manner.

The no detriment restriction cannot be taken to mean literally no gains or losses for any party or it would never be possible to devolve any powers. The devolution process has to distinguish between the first and second round effects of the devolved powers and allow gains/losses from second round effects even if there are none from the first round effects. It should also permit devolution when it is not a zero-sum game; and when it is designed to correct imbalances of the past or to create gains outside government. Otherwise the process is meaningless.

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

General perspective: Economic research has brought together the analysis of public finances with that of macroeconomic disequilibria to describe how a benevolent policy maker can use fiscal policy to respond to economic shocks which also affect the level of government debt, directly or indirectly. \(^1\) It highlights the fact that the policy maker must trade-off the short-run costs and benefits of fiscal austerity or expansion, against the long-run benefits of lower or more stable debt. The striking result from this analysis is that this balance is rather fine – it is optimal to use fiscal policy to stabilise debt and the economy following shocks, or continue an existing fiscal agenda, but that returning debt to its pre-shock level should only be undertaken slowly.

However, it is important to emphasise that this result describes the policy that would be undertaken by a benevolent policymaker who is able to make credible promises.

about how they will behave in the future.\textsuperscript{2} In the real world, fiscal policy is typically implemented by governments who face the constraints of the political process. For a number of reasons this may result in a ‘deficit bias’ which can account for the rising government debt levels in many economies.\textsuperscript{3}

Recognising the costs of such biases, many politicians have sought to tie their own hands by adopting some form of fiscal rule which typically requires debt or deficits to be stabilised over relatively short time-horizons.\textsuperscript{4} However, since such rules clearly violate the gradual fiscal adjustments which define the best policy, and often violate the mandates which governments and electorates see as their responsibility to deliver, these rules have usually been broken whenever they start to bite. The result is that rules of this type are seen to have very little credibility. Some flexibility with measured (if not gradual) adjustments is needed.

**Specific Rules**: a number of different fiscal rules could be applied. For example:
- Balanced budget rules [which include the EU’s fiscal compact and the stability pact, and may be applied to nominal or to structural deficits]
- Debt rules and debt targets: they imply a primary deficit control rule needs to be agreed and applied to maintain fiscal sustainability
- Expenditure rules
- Revenue rules
- The golden rule of deficit financing [current revenues must match current spending; borrowing is only permitted to fund public investment].

The important point here is that deficits and debt are endogenous; that is, they are driven by the state of the economy as well as by policy decisions of the government. They therefore vary with the state of the economy and the government only has imperfect control. This has consequences. Strict deficit rules are often violated, even in the absence of irresponsibility or indiscipline by policymakers, and especially if current deficits are monitored at each point of time – a rule that is likely to violate the principle of gradual adjustments noted above.

To get around this by monitoring structural deficits instead [deficits averaged across the cycle as the EU now requires] has its own problems because of the difficulty of measuring potential output in the economy, and hence the cyclical budget deviations that need to be averaged out. There are many ways to do that. But, given the delays, errors and revisions in the underlying data, to do so in real time (as you need to if the monitoring is to be useful) introduces so many errors that in practice there are likely

\textsuperscript{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.

\textsuperscript{3}Demertzis, M. A Hughes Hallett and N. Viegi (2004) “An Independent Central Bank faced by Elected Governments”, European Journal of Political Economy, 20, 907-22, show the impact that political constraints are likely to have on the deficit and other performance indicators – all the more so when voters react to the state of the economy, and especially when monetary policy becomes ineffective or unavailable.

\textsuperscript{4}The most obvious examples are the EU’s Stability Pact, and its reformulated rules in the Fiscal Compact.
to be as many false alarms (false positives) and missed alarms (false negatives) as there are correct signals.\textsuperscript{5} Rules of this type again have little credibility.

Expenditure rules are usually defined in terms of limits on current public spending in aggregate, or limits to its growth, or a limit as a percentage of GDP, or in relation to the growth of productivity. Such rules may limit the size of government and its fiscal agenda, but will not necessarily achieve sustainable public finances unless a parallel rule also places a floor under revenues and a ceiling on debt. This risks short-term austerity and deflation. Revenue rules are less easy to use. The difficulty here is that revenues are both endogenous and considerably more sensitive to the state of the economy than spending. Revenues can therefore easily collapse just when they are needed most, for example when the budget comes under pressure in a recession or when tax rises would cause output to shrink yet further.

\textbf{Alternative rules:} Economic analysis provides an alternative strategy that preserves the principle of gradual adjustments at the same time. Taking the steady state level of debt out of a fiscal rule designed to maximize the rate of economic growth or consumption, subject to the golden rule of deficit financing above, supplies an optimal debt target. It depends on the marginal product of public capital; the higher the contribution of public capital to growth, the higher the level of debt warranted.\textsuperscript{6} Sustainability is then secured by applying a primary surplus rule in which the average primary surplus or deficit (before interest) is set larger than growth adjusted interest payments. The degree to which that primary surplus/deficit exceeds this threshold will determine the speed at which we return to the debt target, and hence also the debt ceiling that can be tolerated before collapse.

What makes this a suitable approach? Debt, unlike a deficit, represents a stock, not a flow. That introduces persistence in the target variable, especially in countries with high levels of public debt. Debt targets can therefore be used to pre-commit or anchor fiscal policies to a path with sustainable public finances.

A debt ceiling, with a debt target somewhat lower and a fiscal adjustment rule around the target value, has several advantages. First, such a set up introduces flexibility in to policymaking: the pro-cyclicality of hard targets that have to be achieved on an annual basis is removed together with the tendency of rigid targets to block structural reforms when the latter have short run fiscal costs.


Second, debt targets focus on the ultimate risk: unsustainable public finances. The space between the debt target and debt ceiling then allows policymakers to absorb shocks to fiscal balances; that is to trade off good years against bad. Also because the target is a stock not a flow, this produces a de facto structural balance rule without having to calculate cyclically adjusted deficit figures accurately. Space between the debt target and the highest permitted value will allow debt ratios to rise in bad years, but promote an automatic return in good years via a primary surplus rule, rather than a strict balanced budget rule. Fluctuations are therefore allowed.

Finally, again because the fiscal target is a stock and persistent, a debt rule may give policy makers some incentive to obey the rules: first, to preserve freedom of manoeuvre in the future; second, to save at the top of the cycle and remain below the ceiling in future periods; third because persistence in the target variable makes it possible to create the credibility and commitment to future policies that we need.

**Monitoring/enforcement:** In line with this thinking, economists have recommended that politicians place themselves under the scrutiny of some form of independent Fiscal Council.⁷ Such monitoring can remind policy makers of the need to take account of long-run fiscal sustainability; and the Fiscal Commission would highlight this whenever the policies being pursued endanger long-run fiscal sustainability. The key point is that this monitoring has to be forward looking and designed to head off insolvency problems before they become too large to fix at a reasonable cost. But, at the same time, the council could allow a government to run deficits when economic conditions imply that it is desirable or feasible to do so. In short, the aim is to allow short-run flexibility in a way that strict adherence to fiscal rules would rule out, but to ensure that this does not jeopardise long-run fiscal solvency.

*What mechanisms are required to ensure the transparency and effective scrutiny of how the block grant is calculated including the operation of the Barnett formula?*

How the block grant is calculated is, in principle, quite well known. Each spending heading is allocated the (change in) spending total given to the rest of the UK for that heading, multiplied by Scotland’s GDP share⁸ in UK national income and by the degree to which spending is deemed to be devolved under that heading. This covers about 60% of public spending in Scotland. But if a spending total is reserved (not devolved) the last factor is zero. Those elements supply the remaining public spending in Scotland and do not enter the block grant.

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⁸ In fact modified to reflect population shifts, changing needs assessments, the influence of special interests and an imposed process of convergence (the Barnett squeeze). From time to time arbitrary amounts are added to compensate for adverse shocks to the economy (Barnett bypass). They are not explained in a formal sense.
The question then is, where do these numbers come from? The rUK spending totals reflect English needs and circumstances without any input from Scotland. They are set by UK spending departments, by a process that is not revealed and which might be very different if calculated to fit Scottish circumstances. The other two factors are rules of thumb, based on implicit assumptions or rudimentary calculations thought to be plausible but in fact open to interpretation.

To make the process transparent and open to scrutiny, it would be necessary for the UK government departments involved to share their data and assumptions; and to reveal exactly how they make up their spending totals (and, where applicable, how the “Star Chamber” modifies those totals). Similarly HMT would have to reveal how, and on what assumptions, it reached the figures used for Scotland’s GDP share and devolution proportions, and any bypass figures. None of these calculations are likely to be revealed, perhaps not even to the OBR. In a sense it is correct not to do so: the OBR’s function is to check that the UK government will likely raise enough revenues to cover the spending plans it has set itself – whereas as our responsibility is to check that the Scottish government’s spending plans fit the revenues it can expect to get from the UK government (in this instance). We therefore need to know what Scotland should expect to get and that the numbers were calculated correctly.

The last concern is how the conditions for transparency and outside scrutiny will change under the Smith proposals. Not much. The Scottish income tax forecasts will be generated by the OBR. At present, those forecasts are obtained by multiplying HMRC’s forecasts for UK-wide income tax receipts by the Scottish share of UK income tax receipts taken from surveys of income tax payments published a few years after the actual payments. The errors caused by this information lag are likely to be numerically small. So the main problem is to get sight of how HMRC forecasts the UK income tax receipts, and on what assumptions. At present, the OBR has no access to the HMRC’s income tax model or forecasting process. So while conditions for transparency or external scrutiny are clear enough, they are unlikely to be met. It is possible for the OBR to have its own assumptions or data fed through the HMRC model, and we might be able to get them to do the same for us. But that is not the same as knowing how the forecasts were generated, and being able to explain why certain changes have occurred.

The other two innovations under Smith will be the assignment of a portion of VAT revenues, and revenues to pay for certain parts of welfare spending. But since, in both cases, this exactly how the elements of the block grant are determined now, the conditions for transparency and scrutiny remain exactly as before.
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 aside (it is not part of the revenue forecasting or grant adjustment process, but of the decision to use certain taxes or tax rates), 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 exercise in forecasting hypothetical counterfactuals as each 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 to make crude mechanical adjustments. 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 subject to greater scrutiny and dispute.

To make the adjustment process transparent and open to scrutiny we need to be able to see exactly how the net amount of what should be taken out and put back into the grant has been calculated by those whose forecasts are actually used in that operation, and why. This would give the outsider the ability to verify the calculations and to understand and explain the differences with any alternative projections which the fiscal commission (or others) might have access to. To do that requires four things: full access to the model, methodology, data and assumptions used to generate those projections; access to alternative forecasts that might explain any differences; an agreed method for reconciling the forecasts used and actual outturns; and (for shared taxes) an agreed way to compensate any losses imposed by an outside authority (through changes in tax thresholds or rates, or in the definition of the tax base), not by the Scottish Parliament.

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 behavioural responses from households comparing the UK’s Stamp Duty rates to those scheduled to appear under Scotland’s LBTT regime resulted in tax revenues rising in the UK, but falling in Scotland. To correct this in line with the no detriment principle, will require modelling the behavioural responses to tax changes in detail.

In general, to identify the magnitude of behavioural responses, and consequent second round effects on economic performance, from policy changes in either the rUK or Scotland requires extensive modelling work which goes well beyond the kind of analysis and analytic capacity being used to underpin the Scottish Government and OBR forecasts of devolved taxes.
Four points are relevant:

i) To estimate the potential for detriment from any particular policy initiative, using the definition given to the Smith commission, counterfactual calculations will have to be made of what the revenues and impacts would be without the change and then with the change – for responses by producers and consumers in Scotland, in the UK and in the regions of rUK;

ii) This has to be done both ways: for changes contemplated in Scotland, and for any changes in the devolved or partly devolved taxes made by the UK;

iii) These calculations can only be made in advance, to determine the expected detriments and the adjustments needed to eliminate them. In practice there will inevitably be unexpected shocks/events, revisions to the data, errors due to mis-estimating the responses to the policy change. The question is how to treat the detriments that appear ex-post but were not expected ex-ante? Both sides have to agree on this in the interests of greater transparency. There are three options: ignore this problem; include the ex-post detriments in the reconciliation process; or set tolerance limits, below which actual or expected detriments are ignored, but above which actual detriments would be included in the final reconciliation.

iv) All of this has to be done for Scotland and for the constituent parts of rUK. It seems unlikely that any of us have the capacity or the data to do this with an acceptable degree of accuracy.

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

The arrangements prior to the devolution of additional powers implied a significant degree of risk sharing between Scotland and the rUK 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 affect the Scottish economy and Scottish fiscal balances. 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 a Scottish recession caused by such shocks would lead to policy makers having to cut spending or raise taxes to balance Scotland’s budget – and make the recession worse as a result.

However, it is possible to calculate a rough outline of what borrowing capacity might be needed. The golden rule of deficit financing is a good place to start because it separates borrowing for current spending from that for capital spending. The determinants of what is sensible or beneficial to borrow in each case are likely to be different. A convenient way to treat capital borrowing is then to set a debt target as a
function of the return on public capital as discussed above, and set a primary surplus rule to bring the current debt back to that target value when there are deviations to preserve sustainability.

Current spending should balance current revenues on average. That implies setting a borrowing limit from the distribution of unexpected uncovered spending (deviations from zero net revenues) such that 95%, say, of those unexpected deviations are covered by borrowing. The deviations will be from the distribution of forecast errors in devolved taxes since the block grant components are set and known in advance.

Existing borrowing limits are inadequate. Capital borrowing is limited to £2.2bn over 10 years, and £240m in any one year. Borrowing for current spending is limited to £500m over 4 years and £200m in one year. These limits amount to 1.6% of GDP over 10 years and 0.1% of GDP per year, respectively. Recent data shows that three-quarters of the borrowing limit for current spending was used by the shortfall in just one devolved tax. In addition, Scottish borrowing has to be done through the Treasury at 5%, where the 10 year rate for guaranteed loans is 1.8%. Even with a risk premium of 1% point, the level suggested by market analysts, this means borrowing costs are 80% higher than they need to be.

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

The discussion of suitable fiscal rules above has largely answered this question: a debt targeting rule, with a primary surplus rule to ensure sustainability and golden rule to cover public investment and infrastructure. However, the experience of the Euro-zone has taught us is that it is not so much the form of rule that matters, but whether they are enforced. Once Germany and France refused to keep to the rules in 2005, and the European Court of Justice upheld that judgement, the credibility of the regime was lost – however well chosen the rules may have been. There are lessons here: the sanctions need to be ex-ante (imposed on what you would like but do not have), not ex-post; the judgement of whether enforcement should be applied or not, must be independent and have no ties to the political sphere.

One way in which the rules can be enforced more effectively is to have intermediate targets where governments need to take predefined actions prior to breaching the debt ceiling. For example, Slovakia, in addition to having a debt ceiling of 60% of GDP, has introduced other debt thresholds at which action much be taken. When debt reaches 53% of GDP, the government must pass a package of measures to reduce debt and freeze wages; at 55%, expenditures are automatically cut by 3 per cent\(^9\); and beyond a ceiling of 60%, fiscal policy could be given to an independent administrator beyond the reach of government till a debt level of 55% is regained.

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How should inter-governmental machinery including the Joint Exchequer Committee be strengthened and made more transparent?

As a Fiscal Commission, we don’t have experience of the exact remit and limits of the Joint Exchequer Committee, or other intergovernmental committees.

What mechanisms should there be for reviewing the Statement of Funding Policy?

We have no expertise to offer here.

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?

The purpose of any fiscal council is to increase credibility and commitment to a set of sustainable fiscal policies, and to provide a politically neutral monitoring service which is available to the economy as a whole. At one end of the scale the Swedish Fiscal Council has a mandate to comment on and recommend improvements to existing policies, especially where there is a risk of unsustainable levels of public debt or extreme tax liabilities; or where there is a chance to reach those targets better or faster. The Swedish council is also asked to examine the prospects for growth, employment, income distribution and structural reform programmes; and to comment on the effectiveness of the Government’s communications.

At the other end of the scale, the Office of Budget Responsibility is asked to provide independent forecasts of future fiscal revenues and budget position, including the implications for growth and employment that may affect the fiscal position. It may use their own data and assumptions, but only in the Treasury/HMRC models. It may not examine or comment on the other targets of economic policy, or the merits of other policies that could be used. The accent here is on forecasting rather than assessing policy efficiency. Neither agency is, or is allowed to be involved in policy advocacy.

A fiscal policy commission needs to be politically and functionally independent in order to: a) review the fiscal outlook (and major influences on that outlook) for the government and public; b) assess likely future revenues; c) estimate current structural imbalances; d) estimate the likely consequences of current spending and taxation plans, including those implied by changing demography, pensions or foreign factors; e) give advice on correcting any imbalances; f) raise the alarm, publically, if the fiscal position is likely to become unsustainable.

More specific tasks, such as those asked of the Swedish council, may well become desirable given pressures to expand the OBR and Commission remits, and certainly should be assessed seriously. For the same reason, control over what forecasts are
used and how they are best obtained is best left to the Commission itself. But it would be politic to leave final decisions on these matters until what emerges from the Smith process and progress towards fiscal autonomy becomes clear.

Looking ahead, the Fiscal Commission will need to have an observer role in the monitoring of financial services or banks, and in the resolution of financial institutions in trouble. This role stems from the inevitable but unavoidable link between private financial imbalances, internal and external, and public sector fiscal imbalances.

This may appear irrelevant to a discussion of sustainability issues in fiscal policy. But a) establishing a feasible public debt management and financial resolution scheme requires us to separate private risk from public risk (we may wish to bail out the former as a liquidity problem, but not the latter as a solvency problem); and b) the governance arrangements have to recognise that sovereign debt problems are often caused by financing stops and trade imbalances that arise in the private sector, rather than fiscal irresponsibility in the public sector per se. (Consider Spain or Ireland as members of the Euro zone, or certain regions within Spain or Italy).

**What lessons can we learn from the experience of other fiscal federations?**

The key feature of all fiscal federations is the existence of a central budget, with flows to/from regional economies. Virtually all fiscal federations have local revenue collecting agencies and remit an agreed proportion of those revenues to the central budget. And in nearly all, regional governments have the power to set the tax rates, tax bands and thresholds for “their” taxes (Australia is an exception). The number of taxes that are devolved varies substantially, from just natural resource taxes in Australia, to virtually all of them in the US or parts of Spain (income, sales, corporation, property, excise, business and some welfare taxes for example). But nowhere are there shared taxes like the Scottish Income tax. Double taxation on a common tax base, such as Federal and State income taxes for example, is common. Similarly, the balance between federal and regional revenues can vary a lot: from regional revenues at 20% in Sweden, to 40% in the US, 50% in Canada and 70% in Switzerland and more in parts of Spain.

The UK, ironically by this definition, is already a fiscal federation because there is a central budget and local revenues. But because there have been no powers to set taxes locally and because regional taxes are not collected locally, it has been a fiscal federation by default – not by design. Interestingly, there are parts of the UK that act like a full fiscal federation (Guernsey, Jersey, Isle of Man). They have rules similar to those described here already: debt limits, a deficit rule, monitoring by a fiscal commission, borrowing but a contingency reserve, the use of taxes as a policy lever, and so on.