In my written submission to the Committee I have taken the liberty of going beyond the proposals for fiscal devolution contained in the Smith Commission and also considered the case of full fiscal autonomy which is now increasingly on the political agenda.

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 objectives of fairness, transparency and effectiveness are important objectives for the operation of a devolved taxation system, although they are clearly open to different interpretations. The Barnett formula is probably an example par excellence of a mechanical formula, but given our discussions below it is hard to see how a similarly simple mechanical formula could be devised if the Smith Commission’s proposals, with its no detriment clause, are used. Other forms of fiscal autonomy may be more amenable to the setting of mechanical rules such as debt to GDP ratios and/or deficit to GDP rules. I believe the rich experience in other countries should provide a very useful starting point for the design of a revised funding framework.

An important issue that seems to have been ignored so far in discussions of an appropriate devolved fiscal framework for the UK, is the issue of the significant inflation differentials that exist within all existing monetary unions (what I would call the sustainability issue). It is widely accepted that such differentials can be large and persistent for countries/regions within monetary unions and have important implications for competitiveness and sectoral imbalances, this being particular so in the case of divergent economic behaviour (for a recent discussion, see Darvas and Wolff (2014)). One important divergence is that caused by productivity differences, usually explained in the context of the Balassa-Samuelson hypothesis. The effects of such inflation differentials are non-trivial as they can affect the competitiveness of the country and its real interest rate and create significant imbalances which, without a separate exchange rate and monetary policy, may require painful and difficult adjustments. This issue is likely to be exacerbated in a Scottish context if oil revenues are fully devolved since this will introduce an important asymmetric price shock to the Scottish economy.

Given the high degree of both labour and capital mobility that exists within the UK, it is hoped that any new fiscal framework for Scotland would recognise the inflation differential effect and its potential importance and implications for the stability of the tax base. Of course a good starting point in this regard would be to have a good measure of inflation available in the Scottish context.

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

Discussion of fiscal rules were all the rage in the academic literature, and indeed by policy makers, in the run up to creation of the Euro, with debt to GDP ratios of 60% and fiscal deficits of 3% of GDP being the most oft cited mechanistic rules. Aside
from questions regarding the doubtful theoretical underpinnings of such numbers, economic history shows that they should not be enforced in a mechanistic way as some form of period-by-period rule but that they should be seen in the context of an adjustment process. This is perhaps seen most clearly in the Great Recession where such rules have had to be abandoned across the board.

This is clear in the current UK context where the fiscal deficit targets set by the Chancellor have not been met and there is now a focus on a budget surplus within the new parliament. In the context of the UK, I believe, as I have stated elsewhere, that there has been an overemphasis on deficit and debt level targets, which have very little, or any, theoretical justification, and an under emphasis on ensuring that the underlying growth in the economy is sustainable, since it is surely only if the latter is in place that the deficit can be brought into line in a credible way.

In moving from the position of a sovereign state to the devolution context there are clearly important differences that need to be recognised. First, in the Scottish context, and whatever form of devolution is granted, Scotland would remain part of the UK sterling zone. As the Governor of the Bank of England has noted (Carney 2014), the effective functioning of such a monetary union requires the ceding of some fiscal autonomy to the centre. He specifically notes that: ‘effective currency unions tend to have centralised fiscal authorities whose spending is a sizeable share of GDP – averaging over a quarter of GDP for advanced countries.’

Over and above this, there is the key issue in the context of devolution – either Smith Commission devolution or other forms of fiscal autonomy – of the concepts of moral hazard and the related issue of no bail out. Moral hazard arises when the sub-central level of government believes it can engage in ill-disciplined polices and ultimately has to be bailed out by the centre. A theoretical response may be to say that the centre should make a commitment not to bail out the sub-centre under any circumstances – a time-consistent commitment. However, it is always open to the centre to change its mind if the sub central level of government gets into difficulty and the spillovers from it threaten to jeopardise the fiscal credibility of the centre.

An appreciation of how other countries have addressed the moral hazard issue should offer a good basis on which to design a suitably robust fiscal framework.

**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?**

Clearly if the Smith proposals are adopted there will continue to be an important block grant component and it would seem that if a more radical form of fiscal devolution were to be adopted, such as full fiscal autonomy, there would still need to be a block grant in the adjustment to FFA. If the block grant is to be recalculated then country experience gives various examples of how this may be done and perhaps the Australian Grants Commission is the most high profile example of this (see Hallwood and MacDonald (2009)). Once the block grant has been decided, and absent a no detriment clause, it may be possible to use a method of indexation to adjust the block grant moving forward.
What mechanisms are required to ensure the effective working of the “no detriment” principle?

It is hard to see how a mechanistic approach could be adopted to ensure the effective working of the no detriment principle since this relates to spillovers between Scotland the rest of the UK and these are unlikely to be instantaneous but spread over time.

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

What fiscal rules should be applied to these additional borrowing powers? [taken together]

The extent of additional borrowing powers will be determined by how far along the line we move from the initial risk pooling/sharing position to full fiscal autonomy. Clearly, since Smith offers greater devolution than Calman, its proposals will require greater borrowing powers on both current and capital spending. In the case of full fiscal autonomy, the required latitude on borrowing would be considerable since any insurance/risk pooling function of the current fiscal arrangement would have gone. It is difficult to see how such levels of borrowing, which would effectively have to be akin to an independent state, could be made consistent with the overall UK macroeconomic position.

A second order reason for enhanced borrowing powers is that as we move to a fiscal framework where macroeconomic forecasts are important, a not insignificant allowance would have to be made for this since macroeconomic forecast errors can be large as the UK experience has demonstrated. I believe the rich experience of rule setting in other countries would be a good a starting point as any for the second question.

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

I have no expertise to offer on this question.

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

I have no expertise to offer on this question.

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 Scottish Fiscal Commission should be politically independent and oversee the relevant economic and fiscal forecasts necessary for its work. The economic and fiscal forecasts could be produced by an independent body affiliated to the Commission, and led by a macroeconomic forecaster with considerable and
successful experience in forecasting. Alternatively, the forecasts could be produced in house as in the case of the OBR.

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

There is a wide array of experiences of fiscal devolution around the world, ranging from the limited devolution of powers in the Netherlands to the Basque experience that is often taken as an example of full fiscal autonomy within the confines of the Spanish state. (See, for example, chapter 9 of Hallwood and MacDonald (2009) for an extensive discussion of the experience of fiscal devolution in other countries; see also Hallwood and MacDonald (2004)).

The full fiscal autonomy option currently being discussed for Scotland does not exist anywhere in the world and so seeking guidance as to how this may implemented with the above-noted objectives is difficult. Although the Basque arrangement is often taken as a comparator, a reading of the documents underpinning the agreement very rapidly indicates that this is full fiscal autonomy in name only since, for example, adjustment of taxes, such as corporation tax, are confined to relatively narrow bands, much as in the case of the US. Such confinement reduces the need to have a complex set of rules for borrowing. Clearly what is being proposed in the Scottish context is much more challenging than this and moves us into unchartered territory. In the context of our discussions above, it is I believe worth noting the nature of the Basque agreement in more and summarizing how borrowing at the sub central government is achieved.

The specific status public financing systems are codified in the Economic Accord (1981 and 1997) between the State and the Basque Country. “Specific status” allows the Basque Country government to establish and regulate its own tax system, defined as ‘concerted taxes’, but to coordinate and harmonize them with the general Spanish system. These conditions mean that specific status regional governments cannot have a lower tax burden than in the rest of Spain, tax rules governed by international treaties must be respected and free movement of capital and people within Spain must not be hindered.

As concerted tax covers almost all taxes raised by the State (except customs duties), the specific status regional governments are required to make payments to the State for services rendered – such as national defence and diplomatic services. This payment is called the “Cupo” and it is calculated as a geometric weighted average of each special status areas relative (to national) population and GDP. Social security payments are sent to the Spanish treasury and ‘returned’ to the specific status areas – in fact, the monetary flows are netted out in the Cupo. The regional governments also share in any EU funds directed to Spain – these are passed on by the State to the specific status areas. The Basque Country (which has 5% of the population) pays for 6.24 percent of central government spending on non-devolved matters.

Borrowing by the regional governments in Spain is regulated and coordinated by the State – an aspect of harmonization aimed at both maintaining prudence at the regional government level as well as ensuring consistency with the central government’s targeted fiscal balance. Borrowing with maturities of greater than one year is restricted to financing capital projects; amortization payments (interest plus
principal) should not be greater than twenty-five percent of a regional government’s current revenue, and the issue of any public debt requires authorization by the state.

Moreover, regional governments have to submit to the Fiscal Policy and Financial Council (CPFF) – a central government organ, an annual debt schedule that has to be agreed between the two parties. Any changes therein must be agreed with the CPFF.

Since we have seen that borrowing is going to be a central aspect of any fiscally devolved settlement for Scotland, it is worth providing a summary of the experience in other countries (the following text in “” is from Hallwood and MacDonald (2009)). “There are essentially four models of how SCG debt accumulation is disciplined: market discipline, ‘collegiate’ administrative discipline, rules based discipline and borrowing targets set by CG. None of these is perfect.

A few high-income countries allow sub-central government borrowing disciplined by-and-large by capital markets. These include Canada, Finland, Portugal and Sweden. Four conditions are necessary for effective market discipline. Markets must not be required to treat governments as privileged borrowers, there should be adequate information flow to lenders on sub-central government financial and economic conditions, bailout should be excluded – to prevent moral hazard, and borrowers should have in place institutional arrangements that promote adequate response to deteriorating credit ratings should these occur. Given the high level of development of UK financial markets, one might think that such a system could work here. But there are dangers: even in such a highly developed market economy as Canada, market discipline has not been tight when judged by the rapid increase in provincial indebtedness and deterioration in provincial credit ratings. Only with a lag of more than a decade have the most indebted provinces acted meaningfully to contain growth in their indebtedness.

Rules based systems – where the rules are specified in laws - are in place in the USA, Spain and Japan. Thus, borrowing at some levels of sub-central government is limited to the estimated debt service capacity of a sub-central government or to some other indicator of creditworthiness. A rules based system also has the advantages of transparency and evenhandedness. The main disadvantage of this system is that sub-central government may attempt to circumvent the rules by, for example, reclassifying current spending as capital spending or moving some spending off balance sheet.

In a collegiate administrative system the centre and the region agree what is thought to be reasonable borrowing limits within dimensions such as the perceived needs of SCG, the overall fiscal balance and macroeconomic condition. There is an obvious political dimension in the bargaining process that may promote short-term political interests at the expense of excessive borrowing by sub-central government. Indeed, the Australian system of administrative controls – whereby the federal and state governments agree borrowing limits in the Loan Council, has been supplemented with efforts to introduce some market-type discipline.

A fourth debt management arrangement is that of direct control of sub-central government borrowing by central government. This is the system in effect in the UK
whereby central government annually approves borrowing limits for local authorities and restriction may be placed on the loan characteristics including the term and type of loan. Inflexibility is a possible disadvantage of this method of control, especially given informational advantages on local needs that sub-central government may possess in comparison with central government.”

The lesson that we learn from other fiscal federations is the importance of appropriate rules being in place to ensure the stability of governance at the centre and at the sub level. And I believe this experience can offer important guidance for the implementation of the Smith Commission’s, and other, variants of fiscal autonomy.

**Summary**

It should be possible to design a suitable overall fiscal and macroeconomic framework that allows the Smith Commission’s form of devolution to operate effectively in the context of a devolved UK settlement. I do not believe the same can be said for full fiscal autonomy, which only exists in countries that are politically independent. If Scotland were to go down that road it would need its own central bank and exchange rate policy. A system of fiscal autonomy, such as that existing in the Basque country, could I believe be made to work in the UK context especially if it were recognized that such a system relies on marginal tax changes for its effectiveness. Key to the success of such a system would be the recognition of economic divergences with their consequent implications for competitiveness between Scotland and the rest of the UK, and the knock on implications this may have for the tax base.

**References**


