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REAL DEVOLUTION: THE POWER TO BORROW

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REAL DEVOLUTION: THE POWER TO BORROW

Two points are clear from the Scottish referendum debate. First, there are certain capabilities which the UK provides that are invaluable to all constituent nations. In particular, a successful currency union and a seat at the top table of the world's leading international forums, such as the European Union and NATO. There may be other centrally provided capabilities which are highly valued, such as security and diplomacy. Second, there is a clear wish for genuine power to be transferred away from central government to local decision making. This is not simply a matter of more discretion over how to spend resources allocated via budget transfers, but real responsibility for economic choices to meet local needs. This paper argues that devolution can only be meaningful if Scotland - and, crucially, Wales, Northern Ireland and regions in England - have the power to borrow. Contrary to received Whitehall and Westminster wisdom, such powers are feasible and desirable.

The referendum is a simple binary vote about whether Scotland should be an independent country. In the event of a 'No' vote, the three main political parties have committed to devolve further powers in a new Scotland Act by January 2015. All three parties are offering greater spending and tax revenue powers, but little, or nothing, on borrowing capacity.[1] Yet, without the power to borrow, these new arrangements risk throwing the last one hundred years of economic thought out of the window. Real devolution means that the Scottish state can succeed or fail – and if it fails, it must not count on the rest of the country to step in and rescue it. That must mean devolving borrowing power. Only then will local representatives be responsible for their actions and then held to account by the electorate. The difficulty for the UK is the deep-seated doubt about devolving borrowing powers away from the centre of government. Indeed, Parliamentary sovereignty is founded on a civil war fought precisely to gain control of fiscal powers.[2]

The aim of this Discussion Paper is to show why this doubt is unfounded and how borrowing powers can be devolved without putting sensible economic management at risk. We begin with borrowing and the 'inflation bias' problem. This follows a paper we wrote in May this year arguing that with two such different size states as Scotland and the rest of the UK the usual logic for fiscal constraints in a monetary union does not apply. Yet, even if that problem is solved, we then have the 'bail-out bias' problem, much feared in the Treasury and indeed Brussels and Frankfurt. The problem is that with two such different size states, there is both the incentive and the ability for the larger to bail out the smaller, whatever the political or legal constraints. The result is moral hazard (since Scotland would have an incentive to borrow imprudently).[3] This can only be tackled by addressing 'the elephant in the room' which is devolving more powers to other levels of government in the UK. These would be

[1] The Scotland Act has a ceiling on borrowing for capital projects at £240mn per year and a cumulative ceiling of £2.2bn plus some borrowing capacity to smooth-over budget shortfalls which arise from forecast errors.

[2] See North and Weingast (1989) on how the property and creditor rights which followed were perhaps the single most important reason why the industrial revolution happened in the UK and not elsewhere.

[3] Von Hagen and Eichengreen (1996) describe two similar ways by which a common currency could be undermined: accommodating inflation by keeping interest rates lower than otherwise and bailing-out a government which could also lead to a monetary accommodation. We use the terms 'inflation bias' and 'bail-out bias' for simplicity.

dramatic changes in UK constitutional arrangements indeed: but the current crisis of confidence in those arrangements revealed by the Scottish referendum could be the catalyst for real change.

1. Scottish independence and the fiscal 'red herring'

It is ironic that the one economic principle that both sides of the independence debate firmly agree on is not true. Both sides consider that fiscal constraints – limits on deficits and debt levels – are necessary for a successful monetary union between an independent Scotland and the rest of the UK. Note that fiscal constraints are not the same thing as fiscal risk sharing arrangements or a fiscal union, which Bank of England Governor Mr Mark Carney included in his preconditions for a successful monetary union.[4] Fiscal constraints are simply arbitrary limits on national spending and borrowing plans. The need for these constraints is taken as an article of faith in both camps. Here are two typical quotes.

"It is clear that appropriate fiscal constraints would be needed in a formal monetary union between an independent Scottish state and the continuing UK."
HM Treasury (2013), Scotland Analysis, Currency and Monetary Policy, p. 64.

"...a monetary framework will require a fiscal sustainability agreement between Scotland and the rest of the UK, which will apply to both governments and cover overall net borrowing and debt."
Scottish Government (2013), Scotland's Future, p. 117.

Both the 'Yes' and 'No' campaigns seem to have assumed that since the Euro-zone has fiscal constraints then all monetary unions must have fiscal constraints, even though this is, of course, not the case for the United States or say Switzerland. In Europe, or other monetary unions with many similar sized nations, fiscal constraints are needed to mimic or act as a replacement for political union. Because there is no political union (yet), there is a need for imposing "balanced budget" laws, modelled on the German "debt brake". Despite the clear failure of the old rules, the new Euro-zone fiscal compact requires members to enact national laws that require government finances are 'balanced or in surplus' (defined in practice as a "structural deficit" of less than 1% of GDP). This is both politically and economically very far from optimal, and is certainly a poor substitute for political union. Indeed, nations which do have a political union do not generally impose balanced budgets on regional governments. In the US, many states and municipalities chose to introduce balanced budget laws (usually allowing borrowing for investment spending); others do not. Similarly in Switzerland, where about half of taxation and spending is devolved to local and cantonal (regional) governments, those cantons which do have a 'debt brake' have imposed it upon themselves.

In our paper, Armstrong and Ebell (2014) we show that the case for fiscal constraints in a monetary union does not apply when countries are very different in size. This is a powerful result. To be clear, we argue that the necessity of fiscal constraints put forward by both sides of the independence debate (quoted above) is wrong. We show that the UK should have no interest in imposing any fiscal constraint on an independent Scotland in a monetary union.

[4] Indeed, the Canada and the US specifically leave borrowing limits to the provinces and states.

A seemingly counter-intuitive result is that Scotland might, however, benefit from putting a fiscal constraint on the UK. In the world of Realpolitik, however, we doubt the latter is going to happen. Indeed, we argue that introducing unnecessary fiscal constraints is more likely to invite moral hazard and a perception of joint bail-out responsibility.

2. 'Inflation bias' and fiscal constraints

The usual rationale for fiscal constraints on members of a monetary union is to impose fiscal discipline to prevent national over-borrowing that could pressure the central bank into easier monetary policy to accommodate the fiscal largesse. Excessive accommodation could undermine the value of the common currency. In Armstrong and Ebell we show that the logic of this argument, while valid when there are many similar sized countries who hold sway over monetary policy (e.g. the Euro area) does not in fact follow with two such different sized countries as an independent Scotland and the rest of the UK. We use the framework of Chari and Kehoe (2004) to show that while a monetary union of nations of equal size is sub-optimal without fiscal constraints, a monetary union of nations of very unequal size does not have the same inefficiency.

The inefficiency arises because members of a monetary union who vote on monetary policy have an incentive to over-borrow because they neglect the spill-over effects of their own decisions onto other nations which leads to higher inflation for all members of the monetary union. This is a standard externality argument. The case for fiscal constraints is to protect against excessive inflation due to over-borrowing. In our paper, we apply this model to the case of Scotland and the rest of the UK. This has two steps. First, we replicate Chari and Kehoe's results for a multi country setting to highlight the inefficiency which fiscal rules are meant to address. Second, we show that the case for fiscal constraints breaks down when there are two very unequally sized regions, such as the rest of the UK and Scotland. We believe it is the first time this counter-intuitive result has been shown.

The crucial difference between the multi-country Euro-zone-style setting and an asymmetrically sized (putative) sterling union is whether individual regions are able to influence monetary policy. In the Euro-zone, where regions have proportionate voice in setting monetary policy, they can expect to influence monetary policy. In a sterling union, however, the rest of the UK would be dominant in setting monetary policy, and that monetary policy would be likely to disregard Scotland's interests.[5] When the Scottish government chooses its borrowing, it would do so knowing that it cannot influence monetary policy for Scotland. So there would be no temptation to over-borrow, in the sense that Scotland could not expect any over-borrowing to be accommodated. It is worth remembering that it was the largest and most influential countries, France and Germany, which first violated the fiscal constraints in 2002, not the smaller countries.

Might an independent Scotland accept bilateral constraints as the two camps suggest anyway? The problem is that the UK should have no incentive to engage as they know the constraints on Scotland would be worthless (as they

[5] The Fiscal Commission proposes that the Bank of England could be structured on a shareholder basis reflecting relative populations.[4] This suggests that one member of the Monetary Policy Committee (MPC) might represent Scottish interests and the eight other members represent the rest of the UK. The MPC would have a permanent majority of eight to one in favour of setting monetary policy in the interests of the rest of the UK. The Scottish representative would lose every vote.

cannot influence monetary policy). Moreover, agreeing to a (worthless) constraint may invite the perception of culpability and therefore an expectation of a bail-out if necessary. This perception may lower borrowing costs and undermine the very market discipline designed to prevent over-borrowing by Scotland. Even a perception of possible support might therefore be counter-productive (see Lane, 1991).

3. 'Bail-out bias' and fiscal constraints

While the 'inflation bias' problem is solved, another one is created. Because Scotland is a relatively small part of the UK economy (less than 10%), the rest of the UK could always bail out an independent Scotland. And because there is at least the potential of support, this creates moral hazard and the second problem - a 'bail-out' bias. Indeed, because Scotland has little influence on monetary policy then it is possible that it could find itself taking on too much risk. This is far from hypothetical as regards existing debt: in recent weeks the Scottish Government has threatened to renege on its fair share of existing UK debt if it becomes an independent nation, and the UK government has indeed committed to pay the debt regardless, rather than allow default. In Armstrong and Ebell (2013) we show how Scotland will inherit a high level of debt if it becomes independent and, under certain conditions, why there is a risk of a self-fulfilling withdrawal of funding. We show how a high domestic debt burden combined with using a currency another nation controls creates a vulnerable currency and financial arrangement.[6] Where the debt came from is immaterial. The result is the same regardless of whether the debt was inherited from the UK or accrued under the ability to borrow under devolution. As with the case of Europe, external support would be required if the debt became unsustainable. In a political union after devolution, there would be a strong presumption that this support would come from the UK, hence the need for fiscal constraints.

The standard answer to this problem is to make it explicit at the outset that the UK government has no responsibility for Scottish debt. The UK government may also ask the Bank of England to either not recognise or limit its exposure to Scottish government debt in standard liquidity operations only to demonstrate that there are no direct contagion channels. However, there is a clear time inconsistency problem here. In the event of over-borrowing and a withdrawal of funding the UK would consider the costs and benefits of providing support to Scotland, irrespective of what it had said earlier. To be simply unwilling to countenance even reviewing the situation would be inefficient no matter what was said before. In Europe they have even ignored the Maastricht Treaty and provided direct support to governments.

The only credible way to reduce the moral hazard problem is to address the 'elephant in the room' of devolving powers to regional or even local authorities in England as well as Wales and Northern Ireland. From a size point of view, the English regions would be a sensible starting point – with eleven roughly similar size regions and a much less powerful central government there is less of a moral hazard problem. So one possibility would be to revive

[6] This is particularly the case with a volatile tax revenue stream as there may be a budget shorfall just when capital markets are closed to government borrowing.

the idea of regional assemblies which was rejected in 2004 in the North of England.[7] . But while regional assemblies would be an ideal size, regions currently have no administrative functions and so would take some time to establish.[8] A less disruptive approach might be to consider alternative levels of local government. As in the US, entities vary widely in size - from London's 8 million people and 22% of UK output to small district councils with only a few tens of thousands of residents. For some cities, like London or Birmingham, access to capital markets would be relatively straightforward; for others, it would make far more sense to come together at a regional or sub-regional level via the new Local Enterprise Partnerships; this is of course precisely what more successful LEPs like Greater Manchester have been demanding for some time.

With either a regional or local approach, the result would be different borrowing authorities, of varying size and creditworthiness, and a much less powerful central government. Consequently, there would be far less risk of moral hazard. Markets would have an incentive to monitor and discipline excessive borrowing; and more successful and prudent authorities would be unsympathetic to the idea of bailing out failure. Bail-out bias would not be eliminated, but it would be mitigated and manageable. Famously, when New York experienced a fiscal crisis in the mid-1970s, the message from Washington was 'Drop Dead', but in practice some temporary and conditional assistance was provided. More recently, the state of Michigan has proposed a transfer of approximately $200mn to support the bankrupt city of Detroit, but this pales in comparison to Detroit's debts of £18-20bn.

Another question often raised as an objection to devolving borrowing powers is the relative size of local versus central government for overall macroeconomic management purposes. This of course is particularly important in those rare times when economies are unresponsive to monetary policy. However, the scope for fiscal policy does not just depend on the share of tax revenues raised by central government. The ability to change tax revenues and spending depends also on the starting point in terms of the amount of debt. The trade-off is the size of central government against creating real devolved powers and possibly more dynamism outside of the South of England economy. However, as in the eurozone, by creating borrowing authorities, none of which is dominant economically, we have opened back up the possibility of the 'inflation bias' problem we had originally solved.

4. Borrowing powers in a monetary and political union

The inflation bias in the Chari and Kehoe (2004) model of several similar sized regions or nations can be resolved if the monetary union committee can credibly commit to take decisions only in the interests of the whole union, or if it was run by a benevolent dictator, known to economists as the social planner. The committee could be constructed such that it would not respond to over-borrowing. This is straightforward in a political union as the Parliament can select a committee of monetary policy experts to act on behalf of the government to achieve a clear national target. While there may be regional representation at the decision making level, perhaps to

[7] Since the global financial crisis, much has changed, and the idea of regional assemblies in the North of England is again being discussed; and of course borrowing powers were not on the agenda at the time

[8] Outside of Scotland the remaining 58 million people are represented in 11 regions, meaning the average population is very close to 5.4 million people in Scotland.

influence at the margin, a permanent majority of those acting in the interests of the whole nation can be imposed. In the UK the MPC has operational independence to achieve an inflation target which the Chancellor sets on behalf of the government. Regional agents play an important role in the information process but the MPC is an expert panel rather than representing any regional interests.

Other central banks allow for some regional voting interest but this is usually a minority to ensure that the national objectives of monetary policy are put ahead of regional concerns. Another way to see this is that the externalities which may be created from acting on a regional basis do not adversely impact on national policy. Monetary policy committees are often dominated by serving the national interest, but often with an explicit consideration or even vote by regional representation. The US Federal Reserve is the most obvious example where the voting composition is seven members of the Federal Reserve Board and five regional Federal Reserve Bank Presidents on a rotating basis (with the exception of New York).

In the Euro-zone the national central bank governors are supposed to make decisions in the interests of the union rather than their nation to avoid the externality outcome. This is another attempt to avoid the 'inflation bias' problem which arises from acting in line with national interests. However, whether this can be achieved without a political union and across different nations with different national objectives remains to be seen. Members of the Euro-zone have chosen to significantly tighten national fiscal constraints in light of the crisis. Most important is whether the national fiscal authorities believe that there would eventually be monetary accommodation for over borrowing.

5. Conclusion: borrowing powers for real devolution

The aim of this paper is to show that real devolution, by which we mean the devolution of responsibility for economic outcomes, including the ability to borrow and to take full responsibility for the resulting debt, is possible. Successful devolution must address the 'inflation bias' and 'bail-out bias' problems. Both can be solved. Monetary decision making powers should be maintained at the UK level, dominated by national priorities; but fiscal decision-making, including the power to tax, spend and borrow freely, can and should safely be devolved in part to the nations, regions and local governments of the UK; not just Scotland (and Wales and Northern Ireland) but English regions and local authorities. This would not just devolve power and responsibility, but would also minimise the risk of moral hazard. This would be a huge constitutional change from current fiscal arrangements, but the rewards would be greater regional and local accountability and possibly greater economic dynamism in the regions, cities and towns of the UK.

What would this mean for borrowing costs for Scotland? We have argued in Armstrong and Ebell (2013) that Scotland within the existing UK currency union would face higher borrowing costs that the UK due to the size of its bond market and volatility of tax revenues. Neither factor can be easily changed. However, the borrowing costs outside of the existing currency union would be higher due to the presence of additional currency risk premium.

The context of this paper and this debate is of course the Scottish independence referendum. But this is not justabout Scotland. A 'No' vote will open up the opportunity for a significant reconsideration of the UK's 'fiscal constitution' – and to remove the dead hand of Whitehall and Westminster control by devolving borrowing capacity in the rest of the UK as well as Scotland. While dealing with the rest of the UK may take some time, because of the unclear level and size of regional or local authority, the final end point should be clear at the start. If the vote is "No", these changes could be introduced almost immediately in Scotland, with expansion to the rest of the UK as the appropriate arrangements are put in place. But the UK as a whole, not just Scotland, should not miss this opportunity for real and radical change.

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ANNEX

Fiscal Rules and Inflation Externalities, based on Chari and Kehoe (2004)

The argument for fiscal rules is based on a model in which each government agrees a period 0 debt level b_i and a period 1 repayment x_i with lenders. The monetary authority then chooses inflation in period 1 to maximize union-wide welfare from consumption9. The monetary authority solves:

$$\max_{\pi} \frac{1}{I}\sum_{i=1}^{I} U(c_{i,1}) = \max_{\pi} \frac{1}{I}\sum_{i=1}^{I} U\left[y(\pi) - \frac{x_i}{\pi}\right]$$

Inflation π reduces real output ($y_\pi < 0$), but also reduces the real burden of repayments $\frac{x_i}{\pi}$. The monetary authority sets inflation to satisfy its first order condition:

$$\frac{1}{I}\sum_{i=1}^{I} U'(c_{i,1}) \cdot \left[y_\pi + \frac{x_i}{\pi^2}\right] = 0$$

As inflation is assumed to reduce real output, the monetary authority's optimal inflation level is increasing in the debt level of each of the identically sized countries. This also means that the monetary authority's optimal inflation choice will be increasing in the debt levels of all countries, formally $\pi = \pi(x_1, x_2, \dots x_I) = \pi(\bar{x})$, with $\frac{\partial \pi(\bar{x})}{\partial x_i} > 0$.

Now consider an individual member country's debt choice at date 0. Lenders will agree to any debt contract that guarantees zero profits: $b_i = \beta \frac{x_i}{\pi(\bar{x})}$, where b_i is country i's date 0 borrowing, x_i is its nominal repayment at date 1, and $\pi(\bar{x})$ is the monetary authority's inflation policy. Each government will choose the debt level which maximizes its own country's utility from consumption at dates 0 and 1.

$$\max_{x_i} U(c_{i,0}) + \beta U(c_{i,1})$$

subject to its budget constraints

$$c_{i,0} = \omega_i + b_i = \omega_i + \beta \frac{x_i}{\pi(\bar{x})}$$

$$c_{i,1} = y(\pi(\bar{x})) - \frac{x_i}{\pi(\bar{x})}$$

where consumption in period 0 is the sum of country i's endowment ω_i and its borrowing b_i, and consumption in period 1 is production $y(\pi(\bar{x}))$ net of debt repayments $\frac{x_i}{\pi(\bar{x})}$. Each government understands that the monetary authority is setting inflation as a function of the debt levels of all countries, so that inflation is a function of $\bar{x} = (x_1, x_2, \dots x_i, \dots x_I)$. The government of country i chooses debt to satisfy its first order condition:

[9] The monetary authority maximizes an equally weighted sum of utilities across all member states. This equal-weighting is appropriate either if all countries are similarly sized, or if each member country has equal weight in the monetary policy decision-making process.

$$U'(c_{i,0}) - U'(c_{i,1}) = \frac{x_i}{\pi(\bar{x})} U'(c_{i,0}) \frac{\partial \pi(\bar{x})}{\partial x_i}$$

The smaller is the difference in marginal utilities $'(c_{i,0}) - U'(c_{i,1})$, the larger is consumption at date 0 relative to date 1, and hence the greater is the borrowing at date 0.

In contrast, to achieve the first best, all governments would need to set policy cooperatively, maximizing their welfare jointly, as would be the case with full political union. In this first best case, the impact of each country's borrowing on the inflation rate faced by all other countries is taken into account.

$$\max_{(x_1, x_2, \ldots x_i, \ldots x_I)} \frac{1}{I} \sum_{i=1}^{I} U(c_{i,0}) + \beta U(c_{i,1})$$

If all countries are equally sized and symmetric, then the joint first best choice of debt satisfies:

$$U'(c_{i,0}) - U'(c_{i,1}) = I \frac{x_i}{\pi(\bar{x})} U'(c_{i,0}) \frac{\partial \pi(\bar{x})}{\partial x_i}$$

Comparing the two optimality conditions makes it clear that in the non-cooperative fiscal policy case, date 0 consumption – and hence the representative country's debt - will be larger than the first best, as the gap between marginal utilities will be larger in the cooperative case.

The model with symmetric countries implies that monetary union together with fiscal disunion is suboptimal, as it leads to excessive borrowing. Fiscal limits are a way of forcing the members of a fiscally disjoint monetary union to behave in line with the first best, as the borrowing limits can be set so that each country's borrowing is not allowed to exceed the first best optimal level.

Fiscal Rules in a Sterling Zone

The argument begins to break down, however, when the countries are asymmetrically sized. If monetary policy is exclusively determined by the economic imperatives of the larger country, the inflation externality of the small country onto the large country is eliminated, as the small country has no impact on the large country at all. However, this also amplifies the inflation externality of the large country onto the smaller country.

To show this formally, we adapt Chari and Kehoe's (2004) model to the Sterling Zone, assuming that the rest of the UK monetary authority would not take Scotland's welfare into account when setting monetary policy. In the model, the Bank of England would solve:

$$\max_{\pi_{UK}} U(c_{UK,1}) = \max_{\pi_{UK}} U\left[y_{UK}(\pi_{UK}) - \frac{x_{UK}}{\pi_{UK}}\right]$$

That is, in the model the BoE would only consider the impact of the inflation rate in lowering the real debt repayments $\frac{x_{UK}}{\pi}$ for the UK, and would ignore its impact on Scotland.

Scotland might, however, wish to impose fiscal constraints on the rUK. Scotland would be subject to the inflation rate set by the rUK. If the Scottish government has the same objective as the governments in our model, it would solve

$$\max_{x_S} U(c_{S,0}) + \beta U(c_{S,1}) = \max_{x_S} U\left(\omega_S + \beta\frac{x_S}{\pi_{UK}}\right) + \beta U\left(y(\pi_{UK}) - \frac{x_S}{\pi_{UK}}\right)$$

Would the UK's monetary policy be appropriate for Scotland? Formally, Scotland's optimal choice of inflation (were it allowed to choose) would satisfy:

$$U'(c_{S,1}) \cdot y_{\pi_{UK}} \frac{(\pi_{UK})^2}{x_S} = U'(c_{S,0}) - U'(c_{S,1})$$

This is the first order condition of the Scottish government for UK inflation, and characterizes its preferred inflation rate. Recall that $y_{\pi_{UK}}$ is negative (output is decreasing in inflation). As a result, Scotland's preferred inflation rate is decreasing in the gap between marginal utilities at dates 0 and 1, and hence increasing in its own borrowing. This echoes the logic of the previous section's model on monetary union among equals. However, there is no reason for the rUK to set debt and therefore inflation levels which match Scotland's debt choice, so Scotland might have an interest in imposing fiscal constraints.