SPEECH: POLICY SCOTLAND BY DR ANGUS ARMSTRONG, NIESR[1]

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Good evening ladies and gentlemen. May I start by saying that it is wonderful to be back at Glasgow University. This is a great university in a magnificent city. I am very pleased to see Policy Scotland has gone from strength to strength since its launch just over a year ago.[2] It is important to have ideas openly debated by as many centres as possible so the best ideas are generated.

Tonight I would like to talk about the Smith Commission report. This is the first time I have commented on the Report: the reason being - I have not really known what to make of it. This is because the Commission has done almost pretty much the opposite of what I along with my co--- author, Dr Monique Ebell, suggested in our submission here. We argued that income tax should not be fully devolved; there are other taxes which could be better devolved instead. We also argued that Scotland should be allowed to borrow however much it likes, but that this must be under its own name and from the capital markets. Only then could a Scottish government succeed or fail and only then would be more responsive to the needs of the Scottish people.

Instead, the Smith Commission recommends effectively the full devolution of income tax and is vague about borrowing with no mention of capital markets. This is not a minor point. It is about giving real fiscal powers to a permanent institution but without being clear about where the final responsibility will be. This does not seem to be in any national interest as the devil really is in the detail. The Commission was, I think, cognizant of the concerns we had. It added some paragraphs in the text designed to balance these concerns but I doubt they will prove robust enough.

[1] Many of the points in this speech are the result of collaboration with my co---author Dr Monique Ebell at NIESR
[2] I had the pleasure of making a speech at the inaugural Policy Scotland seminar here

What is the objective?

It is always helpful to remind ourselves of what we're trying to achieve. In my view, the UK, and Scotland in particular, like many other countries around the world, are trying to come to terms with how to make sense of the profound economic forces unleashed by globalisation consistent with our traditional values of freedom, fairness and prosperity.

On a global scale, the old certainties of G7, the UN and NATO have competition in G20, APEC and the 'Coalition of the Willing'. The re---designing of spheres of influence can be seen across continents: most strikingly in Europe where nations are unsure whether security and prosperity are best achieved by joining nations together or breaking them up. We see the paradox of countries forming unions but also wanting de---centralised power. All this is to say that this is probably not exclusively a Scottish story.

So where does this leave us? In economic terms we are probably facing the most important constitutional changes since the Glorious Revolution of 1688. This separated the fiscal powers between the crown and state and fundamentally changed the incentives for citizens and promoted greater enterprise.[3] The shift in political power created the conditions for the industrial revolution. Of course, many other countries had similar shifts in power but the industrial revolution happened in the UK. There is nothing to say that changes must always be positive.

So the one thing I will confidently predict is that the Smith Commission is not the end of story on constitutional change in the UK. It is unlikely that a multinational union like the UK can reform its constitutional arrangements by considering each nation in isolation. Scotland has chosen, the Smith Commission has reported and the next move will probably be in England. The point I wish to make tonight is that we need to consider the whole picture rather than asking each nation in turn and then hoping that the sum of the parts turns out to be the right answer.

We have an opportunity to decide what the future arrangements of the UK might be. If the referendum showed us own thing, it is that the people are sovereign in our union. It is their voice which ultimately decides.

[3] See D.C. North and B.R. Weingast, Constitutions and Commitment, Journal of Economic History, 1989.

Fallacy of composition

Let me now turn my attention to the background to the Smith Commission. The Commission was announced only two hours after the Referendum result. It was immediately tied very clearly to something called ‘English votes for English laws’ – which has the fortunate or unfortunate acronym of EVEL – which I will return to. But there should be no mistake that the two issues were clearly tied together by Mr Cameron.

Fairly early in the process, it became clear that the Smith Commission was going to do something very different to what we at the National Institute had proposed. Now I am a fully paid up member of the economics cadre. As a professional group we don’t always cover ourselves in glory. In the UK the 2006 the economics profession was full of self---congratulation at the length of the economic upturn without causing inflation, only to miss the financial tsunami about to strike. That said, economists also have their moments: especially when it comes to economic arrangements. For example, many economists warned that the euro system was poorly designed and would eventually fail, but that advice was ignored.

While there were economists in the secretariat, there were no economists to answer what are some clearly economic questions. The Centre for Macroeconomics carried out its monthly survey of 46 independent economic experts for their views on devolving powers. The question was “do you agree that income tax should be fully devolved to the Scottish Parliament and Welsh Assembly?” Note the question is biased towards agreeing. Excluding those who did not reply and those who had no view either way, 85% disagreed or strongly disagreed. Now many people tell Truman’s joke about asking for a one handed economist, but this is pretty close to full agreement.

So why would economists and practical people see things in such different ways? This comes down to why macroeconomics is interesting. It is simply because the whole does not equal the sum of its parts. This is often called the ‘fallacy of composition’. It means that what seems like common sense is not always sensible for a whole economy.

Let's consider an example. Today was the Autumn Statement and the Chancellor had to explain why he has missed his deficit reduction targets despite stronger economic growth. The Chancellor approaches the problem as a businessman – the UK government has too much debt and a large deficit. So, like any good businessman, Mr Osborne recommends cutting costs – cutting the wage bill – to make firms more productive so they can sell more and start growing again. This makes perfect sense for a businessman. But what happens if the goods are sold to the very workers that accepted lower wages? Now this is more like an economy. Demand falls. And when demand gradually improves revert to saving less again, there is no tax buoyancy because staff are on flexible hours and have no bargaining power.

The issue is of course that the economist considers the impact of one unit of the economy on all of the others. We are not the atomistic components like a business. The example I have just given is one instance of the fallacy of composition called the 'paradox of thrift'. The key point is that our actions affect other people. In this case, our spending is someone else's income. And unless this is taken into consideration, this can lead to inferior social outcomes.

The same is true when considering the devolution of powers. Walter Oates (1972) in his ground---breaking work argued that choices should be at the lowest level of government, i.e., decentralise as much as possible, as long as there are no cost differences AND as long as there are no spill---overs. This condition is often not met in the case where economies are so closely integrated as Scotland and the rest of the UK. My key point is not to look at each part in isolation, but instead focus on the whole.

Smith Commission

So let us no turn to the Smith Commission and I will raise four areas where spill---overs appear to be an important issue.

First, paragraph 21 on the Scottish Parliament to be permanent. This is a very important change and it means that powers devolved to this parliament, really are for Scotland. This inevitably means less power for the Westminster parliament. As more taxes are devolved it inevitably means that the UK Parliament has less ability to raise tax revenues --- perhaps for a controversial war or some other disaster – but where there may be differences in views. The Commission clearly recognised this issue and inserted the paragraph 95 (8) which states that the UK Parliament has reserved powers to introduce an additional UK wide tax, if it was felt to be in the UK's national interest.

I think that after a decade or so of increasingly strong and hopefully successful management by the Scottish Parliament, the idea of the Westminster 'imposing' a new tax on Scotland, and against the interests of the Parliament, would be the equivalent of the British introducing the tax on tea in the US and lead to the Boston Tea Party. Hopefully there would be no risk of a Scottish whiskey party. The serious point is only to suggest that the fiscal consequences for the UK and its creditors must be considered as more and more taxes are devolved. Simply inserting a paragraph to allow the introduction of a new tax is probably not good enough.

Second, let's now turn to income tax. According to the Smith Commission this is still a shared tax, presumably because Scotland will have powers on earned income and not income on savings. PAYE income tax is 86% of all income tax. The powers on earned income exclude lowering the threshold (raising the threshold can be achieved by introducing a zero tax) but include tax rates and bands. In my view, this is effectively full control over income tax on earnings and almost full control over total income tax. This is an exceptional measure as this is the most visible and by far the largest form of tax paid in the UK. Other than Spain, which has its own inefficiencies and separation issues, no other OECD country fully devolves income tax on earnings.

The crucial issue is whether this power can reasonably be devolved to one nation but not other nations within a multination state. Can it be considered as reasonable that only the Scottish Parliament votes on income tax in Scotland and yet Scottish representatives also vote on income taxes elsewhere in the UK? This of course brings back the issue of EVEL – English votes for English laws. Now, this issue was not hidden, the Prime Minister made it absolutely clear when the Smith Commission was announced.

On one level the idea of EVEL sounds perfectly fair and sensible and not a matter of concern for Scotland. It is a symmetrical response to devolution of income tax in Scotland. But the UK is not a symmetric union: the English make up 84%, Scots 8% and Welsh and Northern Irish the remaining 8%.

The point is that there are spill---overs to consider. Scotland's trade with the rest of the UK is equivalent to 70% of its GDP. But the rest of the UK's trade with Scotland is equivalent to only 7% of its GDP. That is because the size of cross border trade (between Scotland and the rest of the UK) is the same but the rest of the UK is ten times bigger than Scotland. It means that decisions taken in the rest of the UK really matter for Scotland.

So now we could have a situation where tax policy is taken in the rest of the UK, or perhaps England, which matters for the UK economy and matters for Scotland. Moreover, the fiscal decisions taken in the rest of the UK, because they are so big, may influence monetary policy and so interest rates in Scotland. Yet with EVEL, the symmetric response to devolving full income tax powers to Scotland, results in a transfer of economic power but without Scots having an influence on the decision. This is why I suggested to the Treasury Select Committee that the result could be undemocratic.

What about the other way? Scotland is 8% of the UK population and trade accounts for only 7% of the rest of the UK. Therefore, much smaller impact.

Now lets suppose that the EVEL happens and all devolved taxes to Scotland are similarly devolved to the rest of the UK. This means that the UK parliament loses control over one third of its tax base! This probably doesn't matter too much to gilt holders in the good times, but in the bad times it is issues such as this that become important.

Of course, the Smith Commission understood this. Paragraph 75 says that "MPs representing constituencies across the whole of the UK will continue to decide the UK's budget, including income tax." It is far from clear that is what the Prime Minister had in mind in his statement or that it is for the Smith Commission to decide what EVEL will mean. Survey evidence suggests that EVEL now has around twice the rate of public support as any other constitutional arrangement.[4]

Third, now let's look at how the Budget Formula would be amended with the devolution of greater tax powers. The bloc grant for Westminster is the essentially the difference between the amount of devolved spending to the Scottish Parliament and the amount of taxes raised by the Scottish Parliament. Clearly, the more that taxes raised by the Scottish Parliament, the smaller the block grant.

The infamous Barnett formula looks at the changes in the bloc grant. This takes account of changes in the Spending Review times the comparable spend and population of the devolved area. The Smith Commission acknowledges that this must be adjusted. First, of all this must be the only formula to be adjusted and then for all parties to say it is unchanged. As Prof David Bell has pointed out, just how the formula is to be changed and where the risks will fall is a complex issue which really matters. Once the size of the block grant is reduced, there will be less risk sharing and therefore more risk for one or the other or both sides of the border. The key is to know the risks in advance.

More substantively, the Commission recognises that decisions taken in one jurisdiction should only have consequences for that jurisdiction (whether they be positive or negative). This we can all sign---up to. As I've argued above, where decisions taken in one area can have a material impact on decisions taken in another area is likely to cause problems. We have seen that there will be economic spill---overs from decisions taken in one nation onto others.

The Smith Commission again recognises this, and in paragraph 95 (4a) states "where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision---making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving." If only life were so simple! How could the affects of policy in one nation on the budget of another nation really be measured with accuracy? While we can measure budgets very well because it is

[4] Taking England Seriously: The Future of England Survey 2014

largely a matter of cash, making a clear causal argument from the policy in quite a different matter. Suppose England introduced a penal tax rate that lead to beneficial migration north of the border. Would it be reasonable to expect Scotland to reimburse England for its mistake?

My fourth and final example of spill---overs involves borrowing powers. Here the Smith Commission is simply vague. In our submission and evidence to Parliamentary Committees we have gone to great lengths to stress the importance of being clear.

Under the Scotland Act 2012, Scotland can borrow a modest £200mn for current borrowing needs (or forecast errors in the estimate of taxes) and around £240mn for capital spending per year. The cumulative limits are £500mn and £2.2bn per year respectively. The borrowing can be from the National Loans Fund or a commercial loan and the Scottish Government can issue bonds for capital spending subject to the limit. The National Loans Fund is in effect the UK government and would be the cheapest and therefore most likely source of borrowing.

One of the biggest buyers of government and sub---government debt is the banking sector. And here the Bank of England (more precisely, the Prudential Regulatory Authority) plays an important judgement in deciding how much capital a bank should hold against the assets reflecting the riskiness of the assets. EU Capital Requirements Regulation stipulates that domestic currency central government debt has a zero risk weight. But the PRA has also ruled that Scottish Government debt would also have a zero risk weight. And since it is the UK government that stands behind the banking sector, this means the borrowing pretty much comes from the UK.

Given that the Scottish Parliament has new fiscal powers it will need to have the capacity to borrow beyond the current limits. We have stressed that if Scotland is to have fiscal powers and be allowed to borrow then the only way to avoid moral hazard and to inject some market discipline is for Scotland to borrow from the markets in its own name and not indirectly from the UK Government. The Smith Commission seems to realise there is a difficulty and paragraph 95 (5) simply says that any borrowing must be “consistent with a sustainable overall UK fiscal framework.” Best guess is that this means more of the same but with bigger limits.

Here we have fiscal powers being devolved but any adverse consequences on borrowing being controlled and ultimately the risk being borne by the UK. Lord Smith said in his oral evidence that it is simply inconceivable that the rest of the UK would ever allow Scotland to default. In which case the right answer is not that the UK underwrites the debt of another parliament. It is that a resolution procedure is established whereby excessive borrowing can be resolved but at a cost to the Scottish Parliament. Only then can one expect responsibility and real freedom for the Scottish Parliament to make decisions. We have seen many times before the consequences when someone else carries the consequences of borrowing.

So what is our overall conclusion?

Setting policy for a nation is very different to setting policy for a business. There are externalities or spill---overs which for a business may not matter but within a country or union they do matter. Of course there are always trade---offs, but this is very different from simply ruling them out from occurring. But if they are not thought about and taken into account before deciding the transfer of powers, then the whole may well be less than the sum of the parts. The Prime Minister made clear, the next move is likely to come from south of the border with some clearer definition of what English votes for English laws means. Proceeding sequentially is probably not an optimal approach.

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