

Evidence to Scottish Parliament, April 2015

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The probable evil is that the general government will be too dependent on the state legislatures, too much governed by their prejudices, and too obsequious to their humours; that the states, with every power in their hands, will make encroachments on the national authority, till the union is weakened and dissolved.

Alexander Hamilton, 1778

The National Institute of Economic and Social Research (NIESR) continues to put public debt at the centre of its analysis on the constitutional options for devolving further powers within the UK. This was at the heart of our analysis of Scotland's currency options. We are concerned that the Smith Commission, the Treasury and emerging proposals for 'Full Fiscal Autonomy' (FFA) or 'Full Financial Responsibility' underestimate the importance of Scotland's borrowing capacity and the misalignment of incentives in the tiers of UK government.

We fully support First Minister's desire for responsible and accountable government. History suggests that successful constitutional change follows from aligning responsibility with liability. In particular, failure to align fiscal powers with full responsibility for borrowing in a clear and transparent manner within a sovereign state leads to over borrowing and irresponsible government. In our view, constitutional changes are best introduced after a clear and hard headed discussion of the full economic and borrowing consequences. The current state of the euro zone is an example of a politically process which ignored the warnings of economists over clear shortcomings in the institutional framework.¹

NIESR has argued that as more fiscal revenue powers are devolved to Scotland, it should be free to borrow but only under its own name from the capital markets. Only then will Scottish taxpayers be able to judge the benefit and the true cost of Scottish government policies. If the UK were to agree to FFA for Scotland this would represent an extreme form of devolution and require a number additional measures by the UK to credibly commit to no future bail-out. This note considers some of these measures. Those who say they are in favour of responsible and accountable government ought to welcome these measures as necessary conditions.

1. Fiscal decentralism and risk shifting

The classic justification to decentralise fiscal powers is given by Oates (1972): local decision making is optimal where local preferences are sufficiently different and where there are no cost savings from centralisation and where spill-overs from one locality to another can be contained. We do not seek to question just how different preferences are from the rest of the UK.² However, there will be important spill-overs because the UK is a closely integrated economy.

¹ For example, see Garber (1999).

² See and Paul Cairney's at <https://paulcairney.wordpress.com/> for work on British attitudes.

One of the most important and long lasting spill-overs from decentralising fiscal powers is fiscal indiscipline at sub-central government affecting the credit worthiness of central government. Perhaps the first evidence of this form of moral hazard is North and Weingast (1989) who show how the English Parliament gained control over fiscal powers from the monarchy in the Glorious Revolution of 1688 which led to a substantial decline in the cost of borrowing.³ Rodden (2006) and Sargent (2012) show that fiscal discipline over US states was hard fought but eventually won. Hamilton recognised that states would over extend themselves believing that the federal government would have no option but to provide support. Even after the debt assumption in 1790, by the 1830s state debts were five times greater than federal debt and eight states were bankrupt. Having learned the hard way, most states impose their own balanced budget requirements.

Similar cases can be found in Canada where Alberta defaulted in 1935 and there are now regional transfers if provinces are in distress. Argentina and Brazil have also had repeated defaults at the level of sub-central government.

There is recent carefully marshalled statistical evidence measuring the cost of this moral hazard. Germany has had to bail-out two Lander (states) and Danish municipalities receive payments from central government when in distress. Feld, Moessinger and Osterloh (2013) show how a court decision in Switzerland not to hold a canton responsible for its sub-entity's debt led to a substantial decline in borrowing costs which the authors interpret as the removal of moral hazard. Jenkner and Lu (2014) provide an empirical case study of Spanish 'autonomous' regions which when supported lead to a 70 basis point increase in federal borrowing costs.

2. Scottish borrowing

As Scotland gains more powers over taxation its borrowing capacity will have to increase. One reason is to incorporate budget forecast errors which can be considerable. A second reason is that as the Scottish Government keeps a greater share of its tax revenue it has less risk sharing through the Barnett Formula. Either the Scottish Government operates a balanced budget regime (excluding errors) with all of the pro-cyclical policy implications this implies (e.g., cutting spending in a downturn) or it shares risk temporally using capital markets. A third reason is borrowing for capital investment.

The need for further borrowing is recognised in the Smith Commission. Paragraph 95 (5) (b) states: "borrowing powers should be set within an overall Scottish fiscal framework and subject to fiscal rules agreed by the Scottish and UK Governments based on clear economic principles, supporting evidence and thorough assessment of the relevant economic situation." On this critical issue on which history stands, the Commission is utterly vague. Indeed, a lack of clarity is a necessary requirement for moral hazard.

³ Here the monarchy would be performing the function of sub-central government in terms of the moral hazard. North and Weingast argue that this created the conditions for the industrial revolution to occur in the UK.

We accept that as more levers of fiscal policy may be devolved to the Scottish Government, the more likely it is to require a meaningful borrowing capacity.⁴ It is difficult to see why any government with fully devolved fiscal authority would insist on a balanced budget in a deep recession. FFA would almost end all risk sharing with the rest of the UK which means Scotland would have to manage its own risks. The exception is that FFA assumes that the UK still provides financial insurance. Armstrong and McCarthy (2014) show how this is very challenging to price fairly (on an actuarial basis) where the insurer cannot be certain of receiving payment.

Even side-stepping this critical omission, if further fiscal powers are to be devolved, perhaps leading to FFA then the Treasury will need to be clear about the status of Scottish borrowing. It would be anomalous for one government to control its tax and spending and another government to have ultimate responsibility for the debt that arose. At present the Scottish government can borrow from banks (backstopped by the UK government), the National Loans Fund of the Public Works Loan Board (the UK government) or the capital market. Given that the capital market is likely to reveal a higher borrowing cost, no Scottish bonds have been issued to date.⁵ Clearly if the UK government collects no taxes from Scotland under FFA then these arrangements would need to be changed.

3. Measures to minimise moral hazard

The problem is that central governments cannot easily credibly commit not to bail-out sub-central governments because it is in their gift to change the rules.⁶ Economists refer to this as an incomplete contracting environment. While the probability of a bail-out can never be reduced to zero, it can be minimised by taking measures which remove the incentive for the central government to bail out the sub-central government.

The analytical approach to this problem is to consider the final decision of the sub-central government on whether to take painful corrective fiscal action or gamble and not take this action on the assumption that the central government will eventually offer a bail-out. If the sub-central government is wrong, then the cost of eventual adjustment would be even higher. In this specific case, there are a number of possible reasons why a UK government would be tempted to bail-out the Scottish government. Since these reasons would all be understood by the Scottish government, this may delay and add to the cost of the final adjustment.

- Possible contagion from Scottish government debt to UK debt. If Scotland has not repaid its share of UK debt and if the Scottish government were to default then the expected tax burden on other UK taxpayers would raise its credit risk resulting in higher borrowing costs.

⁴ Even under Smith the UK government would have enough control to recoup any bail-out losses.

⁵ Without a clear no bail-out clause the bonds are likely to be perceived as having implicit support from the UK government.

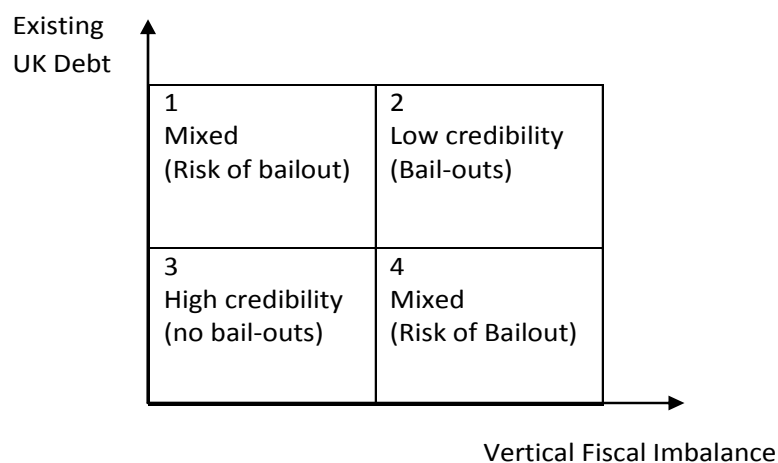
⁶ For example Article 125 of the Maastricht Treaty forbids the bail-out of member states. This has clearly been overlooked.

- We have seen from the euro zone (e.g. Spain) how banks are often large buyers of sub-central government debt. If the sub-central government were to default, then this can lead to the bank becoming impaired. Since the rest of the UK would stand behind the banking system, this would undermine the credit of the UK government.
- If Scotland borrows directly from the UK government (perhaps through the National Loans Fund of the Public Works Loan Board) any decision to default would impact on the net worth of the rest of the UK and its cost of borrowing.

For the UK to minimise a no bail-out commitment several steps would be necessary. First, the commitment would be written into law to at least raise the cost of back-tracking. Second, Scotland's share of public debt (approximately £126bn) would need to be repaid before debt issuance powers are granted. Third, all existing loans from the UK are repaid. Fourth, the UK bank capital risk weights for Scottish government debt are placed above zero.⁷

Of course, the exact measures a UK government would seek depend on the fiscal powers being devolved. Figure 2 shows the possibilities along two dimensions. Vertical fiscal imbalance is the difference between devolved spending and devolved revenue powers. The difference is the degree to which the Scottish government is dependent on the block grant relative to spending control. With a high degree of vertical fiscal imbalance, central government cannot credibly commit to a no bail-out scenario. In Hamilton's words, the state must have the means to extinguish its debt. This is particularly the case if the UK continues to have a high debt burden shared among all UK citizens including in Scotland. The risk and cost of contagion from allowing a default to happen would tempt the central government to provide support.

Figure 1: Credible commitment and existing debt and block grant options



⁷ Current Prudential Regulatory Authority guidelines have Scottish government debt at zero risk weight.

Under the devolved fiscal powers in the Scotland Act (2012), the Scottish Government would have a large vertical fiscal imbalance. The government would control 69% of spending and revenue of 15% of total identified spending (see Armstrong and Ebell, 2014). This implies limited fiscal autonomy, and almost full dependence on the block grant from Westminster. With this share of spending funded by a block grant and the high debt burden it would be difficult to commit to a no bail-out environment or that this is consistent with the expected level of devolved power. Best judgement is we are in cell 2.

However, Bell and Eiser (2014) show that under the Smith Proposals the vertical fiscal imbalance becomes much smaller as revenue and spending shares are almost equal. Scotland would be in line with Canada, Switzerland and Germany, to name three federal nations. Scotland would move from cell 2 to cell 1. However, because of the high degree of outstanding UK debt, we would argue that it would still be difficult for the UK government to make a no bail out commitment for fear of contagion.

If Scotland were to seek FFA then the UK would have almost no method of address. This idea that the UK government could introduce a new tax if conditions required as proposed in the Smith Agreement would be likely to trigger a twenty first century Boston Tea Party. Rodden (2006) suggests that if a political party is in power in the sub-central government and a contender at central government then voters could punish default by voting them out of power in central government elections. This would not be the case in the UK. Therefore, for FFA the UK government would require the measures listed above if it is to credibly commit to no bail-out and protect the interests of the rest of the UK.

4. Capital flight

If a UK Government seek the sort of measures outlined above, this would not necessarily rule out FFA. A Scottish government could raise the funds on capital markets to repay its share of existing UK debt. However, the cost of raising the funds would depend on the policies of the government as well as a fixed liquidity cost associated with being a small issuer (see Armstrong and Ebell, 2013). The cost of issuance would fall if investors were confident of a disciplined approach to repayment through future fiscal surpluses.

Because Scotland is 8.5% of the UK economy it has relatively little weight in the setting of UK overall monetary policy. With FFA it would be operating an independent fiscal policy with initially a high debt burden but with marginal influence on monetary policy. Moreover, with FFA there would be no fiscal risk sharing across the border meaning that the Scottish government would be responsible for dealing with all positive and negative shocks. This is the same economic framework as countries in Southern Europe. Armstrong and Ebell (2014) describe how this arrangement leaves a country vulnerable to economic shocks.

One could argue that this analysis ignores the possible growth dividend from operating an independent fiscal policy. However, we have seen no clear indication of

how these productivity gains will be achieved. The economies of Scotland and the rest of the UK are of course very closely integrated. This makes the risk of capital flight (financial and human capital) greater than in Europe. This could create a negative feedback loop of lower fiscal revenues perhaps undermining the budget and incentivising more capital flight.

End.

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