

Additional written evidence to Devolution (Further Powers) Committee

1. This paper provides some additional points to my oral evidence to the Committee as a witness on 5 February 2015. On the day due to time pressures in the session, I wasn't able to address some important issues in terms of borrowing powers covered in the Command paper Cm 8990 'Scotland in the United Kingdom'.
2. This evidence is presented in a personal capacity as an economist, and not as the Principal of the University of Glasgow.
3. During my evidence session I focused on the application of the no-detriment clauses in pars. 95(3) and 95(4) of the Smith Commission. Both of these will require very close scrutiny when legislation is brought forward. In the case of par 95(3) evaluating the administrative costs of devolving additional spending powers needs to be done on an appropriate and fair basis to take account of the full cost of delivery of the additional programmes. In addition, future block grant indexation has to be implemented fairly, and none of this is set out in full in the Command paper.
4. In the case of devolved tax adjustment (box 1 on p. 29 and p 31 in the Command paper) the examples given are the most straightforward ones of decreases or increases in rest of UK income tax. However, as I pointed out during my evidence session, with multiple changes to income tax and National Insurance policies over time, and given the dynamic impact of these tax changes over time it may be difficult to judge how dynamic effects to the tax base impact on Scotland, and hence applying the no-detriment clause may lead to some disputes without independent modes of assessment. The block grant adjustment approach (Box 1) could also create issues in relation to the devolution of welfare spending powers, as again changing benefit structures could impact on the tax base through behavioural effects in the labour market.
5. Indeed this is one reason (in addition to the observation that there seemed much greater appetite for greater fiscal autonomy amongst the Scottish electorate) why I suggested that devolving all of income taxation (including the personal allowance) and NI powers might be better than the Smith Commission proposals. Because sharing a greater proportion of the income and NI tax base between the UK and Scotland will create disputes over the calculation of the residual block grant.
6. In the evidence session I also suggested that to avoid disputes there might be scope for the OBR and the Scottish Fiscal Commission to arbitrate where the two jurisdictions cannot agree on an interpretation of the no-detriment clause. I noted that given the power usually exercised by HM Treasury in spending allocations, a movement towards a more 'Federal' structure would require a move towards a more shared/distributed model of decision-making on fiscal and tax matters between UK and Scottish Parliaments. This is not the approach taken in the Command Paper.
7. On the fiscal framework and borrowing, one of the difficulties is that the UK's fiscal framework is in a period of transition. Prior to 2008 and the financial crisis, there were a number of fiscal rules, which were abandoned as the UK dealt with the recessionary aftermath of the banking and financial crisis. Under the current coalition government, rather than a return to a fiscal rule which would

apply for the foreseeable future, there has been in essence a fiscal retrenchment rule which states that the UK government in three years time would like to eliminate the cyclically adjusted deficit. The OBR has a role in assessing this fiscal stance. In addition, public sector net debt as a share of GDP should be falling by 2016-17. We don't know if this temporary rule will be replaced by a different fiscal rule or framework which will then guide policy after 2018-19. I have a general concern that legislation on devolution will need to be framed in such a way that it recognises that fiscal consolidation will not go on for ever. How would one frame the borrowing powers which a Scottish Parliament will undoubtedly need, if as the paper suggests Scotland retains 40% of Scottish tax to fund spending? So, whilst one might expect at a time of fiscal consolidation for that action to be shared across the UK, it also follows that the borrowing powers should increase when that period of consolidation is over.

8. This illustrates a major issue in how this legislation should be framed. Suppose we wind forward to 2018-19, and suppose a future UK government might decide then that a fiscal framework might involve running a deficit no greater than, say, 2-3% of GDP and an associated debt-GDP rule. One would expect a shared fiscal framework with Scotland to echo this new rule. And so at the moment the Command paper is not very clear on how any of this will work, and no clauses have been drafted for the borrowing powers, which are related to the fiscal framework. It highlights to me that when this legislation is finally presented in the UK Parliament, there needs to be:

- (a) A clear understanding of how a UK fiscal framework will operate, not only in the first part of the next UK parliamentary term, but indeed for the future in more 'normal' economic times, when austerity policies are not being implemented at UK level, and there should be a shared agreement between UK and Scottish governments on how a shared fiscal framework would operate.

- (b) A clear understanding that the shared fiscal framework will have implications for any clauses which will be developed around borrowing powers.

9. Indeed, one may wish to use the provisions around Joint Ministerial Committees to deal with what will be a thorny issue. If borrowing power limits are enshrined in the legislation, as opposed to, say, the operation of an internal fiscal pact between the governments, the advantage will be that the borrowing powers will be guaranteed by statute. The disadvantage is that the level of borrowing might be set independently of the fiscal rule, which as I said might change over time at UK level.

10. I have concerns about the description of borrowing for current spending on p.33, because of the links with the as-yet-to-be-determined fiscal framework, but also because the additional tax powers will require the Scottish government to have the appropriate tools to manage tax revenue risks over the economic cycle. There are some phrases on p.33 which are vague and the implementation has to be monitored. A 'rainy day' fund, for instance, would be wholly inadequate to deal with revenue-smoothing. The danger is that we empower the Scottish Parliament to take on additional spending and a higher proportion of its own taxation, but we don't give it the borrowing tools which many federal governments have to smooth tax revenues and revenue spending. Clearly this has to happen within the

framework of an overall agreement between the UK and Scottish Parliaments, cascading the UK fiscal framework to devolved authorities in proportion to the tax revenue risks incurred by the latter.

11. I also have concerns regarding the text in the Command paper around capital borrowing (pp. 33-34) which suggests that the prudential regime could replace all DEL capital which is not in the spirit of the Smith Commission agreement. Borrowing limits for capital spending would need to be agreed between the two governments based on the capacity to service debt at devolved level, given the devolved tax base.

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