

Fiscal autonomy for Scotland? - A rejoinder

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In their paper 'A restatement of the case for fiscal autonomy' Hallwood and MacDonald (2006b) claim that Barnett is a formula for a rake's progress and that fiscal autonomy, as outlined in their previous paper 'The economic case for Scottish fiscal autonomy: with or without independence' (Hallwood and MacDonald, 2006a), offers a superior financial settlement for Scotland. We here restate our continued disagreements with their argument. We start with corrections of their interpretation of our paper 'Flaws and myths in the case for Scottish fiscal autonomy' (Ashcroft, Christie and Swales, 2006) before highlighting where we believe their latest paper fails to provide answers to important questions we posed.

The first disagreement that we have with Hallwood and MacDonald's interpretation of our argument is that they imply that it is a politically motivated defence of the Barnett formula. This is false. It is important to state from the start that we do not defend Barnett against all other possible financing systems: rather we compare it to the system of fiscal autonomy proposed by Hallwood and MacDonald. Further, Ashcroft, Christie and Swales individually have differing political views and have different judgements concerning both the general desirability and potential longevity of the Barnett formula. We do, however, agree that the adoption of fiscal autonomy would be a dangerous and risky step for the Scottish economy.

Second, Hallwood and MacDonald maintain that our claim that the Barnett formula offers a hard budget constraint 'is based on a serious misconception of its economic consequences.' We disagree. It is the mechanism that sets the budget that determines whether it is hard or not, and the current system - with no bail-out facility and no scope for borrowing - sets a hard budget constraint for the Scottish Executive. Hallwood and MacDonald (2006b, p. 3) implicitly accept this, though it is tucked away in a footnote, when they state that under the present mechanism "... in principle the Scottish Executive and Parliament should be able to get the balance between different types of public spending right."

Third, Hallwood and MacDonald also accuse us of emphasising 'the down side, or costs, of having the ability to have freedom over tax raising powers' and further that for a small open economy like Scotland that the spill-over

effects of lowering taxation are likely to be positive. We do not deny that tax cutting *can* have positive effects in certain circumstances, but we think that it is unlikely that these impacts would be positive for Scotland in the manner suggested by Hallwood and MacDonald. In order to have a positive outcome any reduction in taxation must generate economic activity with sufficient taxable value to exceed previous tax income. We doubt that would be the case and believe it necessary to make clear the downside of any potential change. It should also be noted the proposed oil fund requires a level of taxable income above the existing level otherwise expenditure would require to be cut to make payments into this fund. The example of Luxemburg, while interesting, draws an unlikely analogy with Scotland.

Fourth, Hallwood and MacDonald state that we make a case for the status quo when we argue that 'Hallwood and MacDonald's proposals are likely to increase the pressure on Scottish MPs at Westminster.' We do not set out to ease the lives of representatives at Westminster. However we do believe that any change to the system of financing the devolved administrations would have repercussions well beyond those introduced in Hallwood and MacDonald's initial paper and that these cannot be ignored. The issue of representation at Westminster is one of these concerns. In their first paper, Hallwood and MacDonald abstracted from the constitutional problems inherent in their proposals. They pay more heed to these concerns in their latest paper, now asserting that the political implications of fiscal autonomy within the Union are infeasible and opt instead for independence. Of course it is quite legitimate to argue for or against Scottish independence on economic grounds but this is quite different from arguing about the most appropriate way to finance devolved government.

In terms of their restatement of their own argument, we do not believe that the case for fiscal autonomy is more forcibly made than it was previously. We stand by our earlier representation of the comparison of fiscal autonomy as against the present arrangements. These are that under the present funding system to Scotland, the benefits are an automatic macroeconomic stabilisation level and a public expenditure per capita substantially above the UK average. This is to be compared with the potential for retaining North Sea oil revenues and the supposed growth potential unlocked by fiscal autonomy.

In our view the theoretical arguments for the improvement in growth are weak. However, Hallwood and MacDonald seem to base their support for fiscal autonomy more squarely on empirical grounds: they believe that there is "accumulating empirical evidence" in favour of their position. Roy (2006) reviews the empirical evidence elsewhere in this issue and finds conflicting support for this view.

However, from our perspective the bottom line is simply that no other country in the world operates a system of

fiscal autonomy, as proposed by Hallwood and MacDonald, so that there is simply no evidence as to how effective it would be. We think that, in itself, is significant. Adopting such a system of fiscal autonomy would be an extremely risky step. Hallwood and MacDonald (2006a, p. 32) assert that "... the incentive generating effects of fiscal autonomy could be so great that the potential returns from fiscal autonomy could outweigh the potential risks". Using terminology from the finance literature, they state that: in moving to fiscal autonomy, Scotland would accept a "risk- return trade off", presumably partially bolstered by North Sea oil revenues. Recall that in Hogarth's engravings of the Rake's Progress, the rake ends up in Bedlam via debtors' prison after gambling away his inheritance. Is it the present system or fiscal autonomy that is more likely to lead Scotland along this rocky road?

References

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Roy, G.D. (2006) 'Fiscal Decentralisation and Economic Growth: is there a Link?' Quarterly Economic Commentary 31/2, October 2006.