Is Independence Possible in an Interdependent World?

Scotland vs. the UK in the European Economy

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A macroeconomic overview

- Three view points:

a) Institutions before particular policies/policy rules

Accounting identities link financing gaps, pass them between sectors; Fiscal rules and the enforcement problem; Debt targets and sustainable fiscal policies; Fiscal policy councils in a banking union, to review financing imbalances; The separation principle and resolution process in a banking union.

b) Fiscal arrangements in a currency union

Fiscal federalism; decentralisation theorem; allocating responsibilities to different levels; institutional support; fiscal discipline and debt control; pressures for fiscal autonomy or independence; spending vs revenue devolution

c) Size and break-up of unions: Scotland in the UK vs UK in the EU

Natural disagreements over policy; Alesina's two decentralisation theorems

General evidence: net gains, mobility vs "distance" (C-instability)

Specific cases: drivers for Scotland's exit from the UK; and for a UK exit from EU

National accounting identities link the major macro-imbalances

- Financial imbalances affect, and are affected by, fiscal imbalances:

$$S - I = (G - T) + (X - M)$$

or

$$(S - I) - (X - M) = (G - T)$$

- So if $(S - I) \rightarrow 0$, $(X - M) \rightarrow 0$, then $(G - T) \rightarrow 0$. And vice versa; the causality can flow either way.
- Ex-ante vs. ex-post
- Examples: recessions, trade deficits, low interest rates, cheap credit, asset bubbles, fiscal irresponsibility, capital reversals or financing stops (a liquidity crisis)
- Spain, Ireland, Portugal, Greece, Portugal vs Netherlands, UK
- Timing of deleveraging; the German CA surplus
- Private debt becomes public; or maybe public debt becomes privately held

Fiscal Rules

- ***Need*****:** link between target values and final objective (sustainable debt); short term flexibility (absorb shocks); mechanisms to relate deviations to corrections; monitoring; enforcement; punishment
- ***Design:***

  - balanced budget rules, incl. fiscal compact: nominal vs. structural

  - debt rules, incl. debt targeting

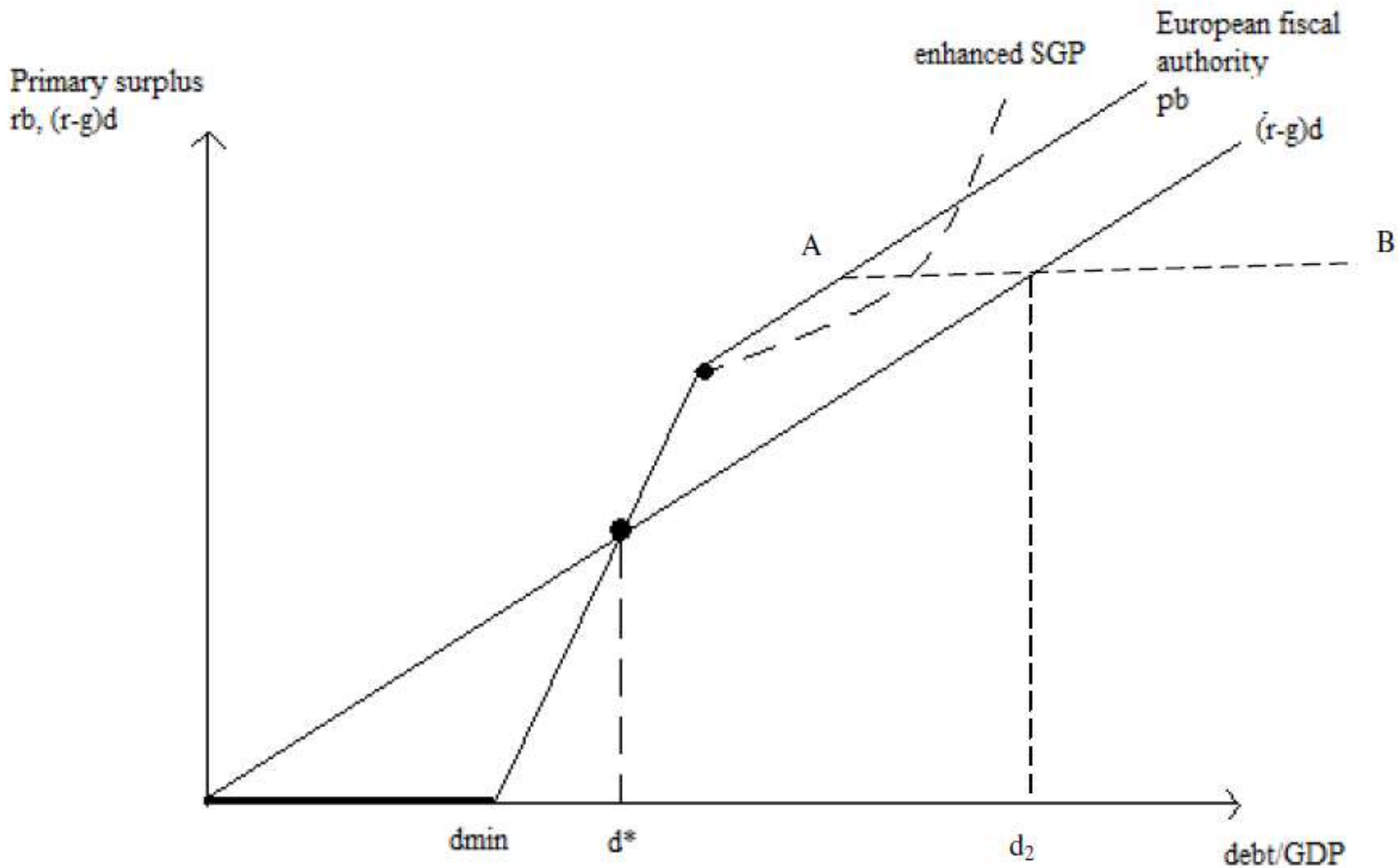
  - expenditure rules

  - revenue rules

  - Golden rule of deficit financing
- Independent monitoring (moral hazard); *forward* looking
- Effective enforcement
- Credible sanctions (ex-ante, not ex-post)

Sustainable fiscal rules: example

The debt ratio will stabilise when *pb=(r-g)d*: where *pb* = *primary* surplus, *r* the interest rate payable on debt *d*, and *g* the growth rate in revenues. So fiscal compact not sustainable: too lax in bad times, too tight in good.



A Fiscal Policy Council and the Banking Union

- FPC: a) reviews fiscal outlook for the government and public, incl. b) future revenues/spending; c) estimates current and future *structural* imbalances (ie debt); d) estimates consequences of current spending and taxation plans; e) gives advice on how to correct any imbalances.
- Forward looking monitoring, not (as now) backward looking
- i) the FPC has no executive authority; ii) may not engage in policy advocacy; and iii) must restrict its analysis to be within the targets and priorities set by government.
- Independent (politically, physically; and in use of models, forecasts, and information)
- Wider remit (other targets, alternative policies, lower costs)
- Accountable to parliament, not government.

Separation and the Banking Union

- Private sector monitoring and resolution in the BU and ECB
- Public sector monitoring by FPC; resolution in IMF, Council of Ministers (possibly)
- Independent actors; implies separation of private from public risk
- Private resolution discretionary under BU; currently national regulators and local incorporation of subsidiaries (req. by EU systemic risk board, Vickers, conduct regulation, parts of Basel III)
- Jointly owned and managed private sector rescue vehicle
- insurance based levies?
- Public bail-outs not allowed; substitute a graduated debt protocol and “chapter 11” process under FPC administration instead
- Cuts links between private and public imbalances. FPC can reduce latter, but not the former. Hence needs to be able to monitor the financial regulation process
- ESM has changed function; now extends IMF, but should change back

Fiscal arrangements in currency unions

- Grants/tax sharing schemes for partial fiscal autonomy generate additional pressures for greater autonomy
- Risk sharing and accountability likewise require decentralisation
- **Fiscal federalism**: Oates decentralisation theorem, *in multilevel governments, each level of government (including the central government) will maximise social and economic welfare within its own jurisdiction*.
- That will necessarily provide a higher level of welfare than in a regime where central government provides a uniform set of policies and public goods – since, having additional choices, regional policymakers can always choose to replicate the central government's common policies if they wish to do so.
- Decentralisation will ***always*** produce better outcomes for all – subject to not devolving by so much as to create diseconomies of scale or excessive spillovers in the delivery of public services/policies

Allocation of responsibilities

- By comparative advantage:
- ***Regional governments***: income, sales, corporate, business taxes, social security taxes that affect mobile factors, production costs and competitiveness; health, education, justice, infrastructure, R&D, innovation, and development spending.
- The latter are all instruments that affect productivity growth in the short and long run; and unit labour costs (cost of business)
- ***Central government***: framework policies affecting financial stability, price stability, taxes/spending for risk sharing, competition and regulation policy, coordination, and commercial policy
- Size of government does not increase if it is tax rather than spending decentralisation, covering rates and (most important) tax bases
- Fiscal discipline: rents to/from the centre, debt targets, free riding monitored by (network of) fiscal councils
- Enforcement by graduated “chapter 11” process

What kind of decentralisation?

- No evidence of permanently higher *rates of GDP*, but fiscal decentralisation does increase the level of GDP per head.
- Permanent growth rate changes depend on other factors: increases in the growth of productivity, technical progress, or labour force.
- Greater fiscal autonomy is associated with higher output levels and possibly higher short run growth rates ***if*** tax decentralisation moves to support spending devolution.
- This result continues to hold if tax competition is allowed between regions or vertically, but not if taxes are shared
- "*Revenue decentralisation has the expected positive effect on productivity, and is consistently highly significant. Expenditure decentralisation, however, has a robust and highly significant* ***negative*** *effect on productivity ….*"
- Best to devolve both spending and tax raising powers

On the number, size and break-up of nations - I

- Not everyone agrees on the balance of policies or priorities for national objectives (inflation, growth, employment, financial stability)
- Not everyone agrees on best debt target; or on preferences for social support, health, or defence vs. education vs. infrastructure.
- Not everyone agrees on income distribution and hence the best *means* of increasing *pb* (e.g. tax rises vs spending cuts).
- Not everyone agrees on *speed* of consolidation, hence on the *size* of pb increases per period.
- Ability to lower r varies with reputation, inherited debt. No opportunity to exploit that if no monetary policy (in EMU, within UK).
- Tolerance and opportunity for real devaluation (via prices, wages, non-wage costs) varies; similarly scope for creating productivity gains varies with economic structure and availability of levers.
- What to do if real exchange rate adjustments or primary surpluses are too large (competitiveness or fiscal "fatigue") or take too long?

Decentralisation theorems (Alesina)

- **Theorem 1**: *more efficient for local governments to provide Pareto-optimal output than a central government to provide a uniform level*. Implication: *decentralisation increases with variability in the demand for public goods.*
- Decentralisation reduces mobility and information costs; but it increases administrative, coordination, and economies of scale costs.
- Benefits of competition: horizontal (Tiebout) and vertical (Breton). The UK focuses on horizontal in EU, Scotland on vertical in UK. Different initial positions.
- Assume government chooses degree of centralisation, then people choose amount/type of public good.
- **Theorem 2:** *Centralisation then falls with increasing taste differences; with increasing democracy; with the level of income; and with country size.*
- **Example:** Scotland more social democratic leaning (vs England's natural Tory majority); democracy increases with new Parliament and devolution in 1997; economy has recovered, relative to UK, since 70s; UK is not small, but has a "celtic fringe". Result: separatist movement, referendum in 2014

Size and break-up: general evidence

- Largest drivers in data: democracy, then fractionalisation
- Decentralisation not static (Jefferson's speech....)
- Predictable adjustments to decentralisation over time in Belgium, France, Italy, Spain, UK. Opposite in Canada.
- Secession: ***net*** benefits under secession > utility under union? Undecided in Scotland.
- If not, then fiscal autonomy or "devolution max" next best.
- No mobility assumption is important: mobility decreases the need for decentralisation, people go elsewhere [American colonies in the 1600s; contrast France in 1700s, Spain 1800s].
- C- instability: MA produces RI (early colonies),then stabilises; likewise Yugoslavia in 1990s. Dissent until the political distance between insiders is smaller than b/t them and those outside

Drivers of Scotland’s separatism - I

- Self-determination: more countries are formed than is efficient. A natural result: non-cooperative vs. cooperative games, countries internalise the costs imposed on others by separating, but relieve any costs imposed on them. Depends on the distribution of (***net***) costs across countries in the union.
- Internal coalitions: countries capture gains from outside to pay for losses in efficiency when they separate.
  - Scotland wants corporation tax to redress the cost advantages, scale economies, unfair competition from the agglomeration of south-east England; independence may depends on Green votes.
- The number of countries increases with economic integration: globalisation goes with localisation. Scotland’s separatism starts as the EU becomes a reality (single market membership). Oil makes Scotland part of world market, less a component of UK economy

Drivers of Scotland’s separatism - II

- Number of countries rises if utility from public spending increases and government is efficient/cheap (as in Scotland, Scandinavia), as well as with rising preference differences.
- Compensation schemes to preserve the union invites time inconsistency (“sunk costs sink the transfers”)
  a) Scotland believes the original union treaty between equals, with exit rights, has not been upheld
  b) threat to withdraw what is offered after “no” vote; eg Tatarstan
  c) Close “no” votes have led to further extensions of autonomy in Quebec, Flanders, South Tyrol etc.
- Either way, pressure for independence as best defence against time inconsistency
- Compensation for those who would secede (social payments rise after 1997); the UK government’s offers of extra powers have increased with referendum threat

Drivers of a UK exit from the EU

- The UK's gains from EU membership are from single market, the costs from single currency, fiscal/political union, forms of market regulation
- Lack of identity with progress to more Europe
- Distance from Europe, but good mobility to ROW, and good economic performance (to 2007), lower the costs of leaving. So decentralisation from ROW not needed – pressure to decentralise from EU rises.
- Time inconsistency: many thought the UK was getting an unfettered single market, but now it is compromised
- Increased fractionalisation of political life in all political parties; greater scope for pressures to separate
- Underlying taste differences: lower taxes, deregulation, tolerance for inequalities
- Size matters: frustration at not getting her point of view across, but less risk in letting that frustration show b/c UK derives less trade or investment income from the EU than others.

Conclusion

- Breaking up is not hard to do. Far from being abstract, the conditions for when it becomes a possibility are easily satisfied
- Europe needs institutions rather than policies: a) to give the sense of owning a framework that members own and operate; b) to introduce a structure which reflects the interests of those a succession would leave behind as well as those who wish to separate; and c) to create a broader, more flexible set of institutions so economies with different aspirations and structures can perform successfully without finding themselves so restricted that they could do better outside.
- Europe and the UK need to recognise that, to preserve their unions, they need to make it positively worthwhile for their members to remain in terms of their own goals and priorities.