INQUIRY INTO SCOTLAND’S FISCAL FRAMEWORK

MEMORANDUM BY ALAN TRENCH

1. This memorandum is intended to assist the Committee in relation to my oral evidence on 27 May 2015. I have of course addressed some of these issues in previous evidence to the committee in June and November 2014.

2. The Committee may be aware that I have recently been involved with the constitutional review of devolution carried out by the Bingham Centre for the Rule of Law, which seeks to clarify some of the major issues that arise from making a decentralised Union work effectively. The report of that review was published on 20 May, entitled A Constitutional Crossroads: Ways Forward for the United Kingdom, and chapter 6 specifically addresses financial issues.¹ This develops earlier discussion in my work as part of the Institute for Public Policy Research’s ‘Devo More’ project, and particularly in Funding Devo More: Fiscal options for strengthening the Union published in January 2013.²

3. I shall seek to answer the questions raised by the Committee in its call for evidence, as best I can in brief.

4. What needs to be included within a revised funding framework for Scotland and how do we ensure that it is fair, transparent, effective and mechanical rather than requiring regular negotiations? In the two reports above, we have sought to identify the key elements of a revised funding framework for devolved governments generally. This comprises substantial fiscal devolution, a restructured block grant, and new machinery to administer the central elements of those arrangements.

5. The objective of ensuring that a revised framework – and particularly the reduction from the block grant that entails – is fair, transparent, effective and mechanical is one I would strongly endorse. There are questions about how to achieve that in the UK context, and the mechanisms proposed by the UK Government in the Command paper Scotland in the United Kingdom: An enduring settlement³ have significant shortcomings and are likely to rely on negotiations that will themselves be based on data of questionable accuracy. This system is unlikely to breed confidence in its fairness and unlikely to be stable. What is needed is higher-quality data, published regularly; an impartial

¹ The report is available at http://www.biicl.org/documents/595_a_constitutional_crossroads.pdf
² Available at http://www.ippr.org/assets/media/images/media/files/publication/2013/01/funding-devo-more_Jan2013_10210.pdf
³ Cm 8990, January 2015.
body to advise the UK Government on its decisions; and an independent body to help resolve disputes and disagreements should those arise.4

6. More broadly, it is hard to see how the existing arrangements – retention of the Barnett formula, with a discount from it – can be durable. The Barnett formula is essentially a ‘black box’ system; it works in an opaque way, which is simple to describe in principle but hard to examine empirically, and for which key decisions are made by HM Treasury alone.5 The mechanism for making a reduction from it adds a second black box to the first one. Moreover, it puts huge emphasis on the precise choice of mechanism for making a reduction from the block grant, for which the ‘indexed deduction’ approach may not always be right, particularly if there should be a divergence between the growth of UK-level and devolved tax revenues.6 Further difficulties will arise if the ‘no detriment’ principle is invoked, adding a third ‘black box’ of disputable data and intergovernmental negotiation to the system. This does not make for good governance of the fiscal arrangements of a decentralised union.

7. A better approach, involving not just impartial advisers, would involve a more rationally-constructed grant, a reduction made from that grant to allow for fiscal capacity, and periodic reviews of both the appropriate level of grant and the reduction. (This approach is outlined in chapter 7 of Funding Devo More).

8. What fiscal rules should be applied in order to ensure fiscal responsibility and debt sustainability? A significant virtue of the recommendations made by the Smith Commission, themselves drawing on the work in Funding Devo More, is these minimise the scope for spill-overs from the exercise of devolved tax powers. The need to apply rules externally to ensure fiscal responsibility is minimal. In relation to debt, there is more of an issue, discussed further below.

9. What mechanisms are required to ensure the transparency and effective scrutiny of how the block grant is calculated including the operation of the Barnett formula? I have already touched on this issue. Both more accurate published

4 On dispute resolution, see also my recent paper published by the UK’s Changing Union project based at Cardiff University: Intergovernmental Relations and Better Devolution (December 2014), available at http://sites.cardiff.ac.uk/wgc/files/2014/12/INTERGOVERNMENTAL-RELATIONS-AND-BETTER-DEVOLUTION-FINAL-Dec-2014.pdf
6 The Holtham Commission was careful to analyse this issue in its report, and identify the key issue as the nature of the risks borne by the UK and devolved governments. See Independent Commission on Funding and Finance for Wales Final report – Fairness and Accountability: A New Funding Settlement for Wales, (Cardiff, 2010), particularly chapter 5.
data are needed, along with an external review of how the grant and changes to it are calculated.

10. **What mechanisms are required to ensure the effective working of the “no detriment” principle?** As noted above, it is hard to see what mechanisms could make this principle work effectively, so extensive is its likely use.

11. **What additional borrowing powers for current spending and for capital spending should the Scottish Government have? What fiscal rules should be applied to these additional borrowing powers?** The Smith Commission and Cm 8990 *Scotland in the United Kingdom* propose increases in these, and rightly so. Borrowing powers are the other side of the coin of fiscal devolution, both ‘prudentially’ and to manage the volatility of devolved tax revenues. The question is how to manage these so that devolved borrowing does not undermine the functioning of the UK as a whole. *Scotland in the United Kingdom*, in particular, suggests a highly constrained approach, most notably in paragraph 2.2.6 (p. 23) which says—

> A relatively higher level of borrowing in Scotland would mean that borrowing in the rest of the UK would need to be lower in order to meet a particular borrowing target and maintain market confidence (and sustain a given level of interest rates). This would force a fiscal choice on the rest of the UK, either to lower spending or increase taxes.

Treating devolved borrowing choices as a zero-sum game, in which devolved decisions count against UK ones, is an inappropriate way to ensure fiscal devolution works. A better approach would be to disentangle devolved and non-devolved decisions, and ensure that the Scottish Government is free to make such decisions as it wishes within the devolved sphere of competence. Indeed, this approach could be usefully adopted more generally rather than the emphasis that *Scotland in the United Kingdom* places on the impact devolved decisions might have on non-devolved ones.

12. **How should inter-governmental machinery including the Joint Exchequer Committee be strengthened and made more transparent?** The Bingham Centre’s review has a number of suggestions to make about this (see particularly chapter 2, section 2.1.) More helpful communiqués and reporting to each government’s respective parliament about what has transpired is key.

13. **What mechanisms should there be for reviewing the Statement of Funding Policy?** It is plain that the Statement of Funding Policy needs to be fundamentally recast, in much the same way as the *Memorandum of Understanding* for intergovernmental relations is being. Not only does it need to be more capable of periodic review and to include independent machinery as discussed above, its
legal foundation needs to be more firmly established. It needs to be underpinned by and recognised in statute, rather than being simply a statement of Treasury policy for the time being.

14. What lessons can we learn from the experience of other fiscal federations? Both the Bingham Centre review and Funding Devo More discuss and draw on the lessons that can usefully be learned from other systems. In particular:

a. There is no inherent difficulty in operating systems that combine devolved/sub-state taxation and grant systems, subject to

b. Having appropriate institutional architecture for doing so and

c. Keeping systems under regular review, rather than believing that system can be introduced and then simply left to work.

d. Tax collection arrangements will merit particular attention, the more so as UK Government seems intent on charging the marginal cost of collecting devolved taxes to the recipient governments. (This contrasts markedly with practice in Canada, for example).

That said, the UK faces particular difficulties arising from the facts that a) it is seeking to decentralise an existing, centralised state and b) it is doing so highly asymmetrically, seeking to carve out a limited tax space for Scotland (and Northern Ireland and potentially Wales) while leaving the existing system in place otherwise. Fiscal devolution will entail significant changes and disruption for the central government as well if it is to be introduced and work effectively.