1. Introduction

This is a response by David Phillips, a senior research economist at the Institute for Fiscal Studies (IFS). The views and opinions expressed here are those of the author only. The IFS has no corporate views.

David Phillips has led the IFS’s work on the fiscal future of Scotland, both in the run up to the Scottish Independence referendum, and as proposals for further devolution have been made following Scotland’s “No” Vote. In particular, he has recently analysed the workings of the Barnett formula, and examined the issues that need addressing in Scotland’s fiscal framework following the publication of the Smith Commission’s agreed proposals.

This earlier work may also be useful to the committee’s work. Please see the following publications:

http://www.ifs.org.uk/publications/7484

http://www.ifs.org.uk/publications/7442

Also please find a presentation attached. This was given at the Finance Committee’s Away Day in Stirling on March 30th, and summarises much of David’s latest thinking on the topic.

Please note this response focuses on the following areas:

- The “No Detriment Principles”
- The block grant adjustments

As a result, responses are not provided to all questions.

2 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?

Scotland’s new funding framework will need rules governing the main elements of the Scottish Government’s budget:

- The remaining Block Grant
- Deductions and additions to the block grant to account for revenue devolution/assignment and welfare devolution.
- Devolved/assigned tax receipts
- The Scottish Government cash reserve
- Scottish Government borrowing.
The Smith Commission (in paragraph 95) and subsequent UK Government Command Paper set out plans/principles that have relevance for these areas. These include that the Barnett formula should continue to determine the underlying block grant; that the UK government should bear the risk of shocks that face the UK as a whole; that Scotland should neither gain nor lose simply from the devolution of new powers to Scotland (No Detriment Principle 1); and, that neither Scotland nor the UK government should face detriment from the policy decisions of the other government (together, No Detriment Principle 2).

It is relevant to ask whether these principles are consistent with fairness, transparency, effectiveness and automaticity.

First, taking the Barnett Formula – there is clear political will to maintain this as the basis for calculating the block grant. It has the benefit of being relatively simple (in principle),and mechanical. However, it is arbitrary, and when introduced in the late 1970s, was never envisioned to still be in use almost 40 years later. Virtually every assessment of devolved funding arrangements has recommended it be replaced, generally with a needs-based block grant. There would clearly be real difficulties in implementing such a change, even over a period of several years. But it seems hard to deny such a system would be ‘fairer’ than the existing system, which involves a block grant that has no relation to current needs, and at least in principle, implies convergence in funding in the long run. It is also important to realise that the Barnett formula isn’t immutable and has been changed in the past to account for devolution – most notably with respect to the devolution of business rates. Analysis suggests that these changes were made in a flawed way and have led to the Barnett formula treating changes in spending at the UK Government’s Department for Communities and Local Government inappropriately. These flaws should be remedied (an approach to doing that has been set out in a recent IFS publication).

The idea that the UK government should bear the risks of shocks facing the UK as a whole makes sense from a practical point of view: the UK government has more flexibility to respond (it has more tax instruments under its control, for instance), and is likely to be able to borrow more easily than the

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1 See, for instance, the reports of the Calman Commission, the Smith Commission, and the House of Lords Committee (2009) on the Barnett formula.
2 Such a needs-based assessment would likely involve Scotland receiving substantially less than at present, however (the Holtham Commission suggested that identifiable spending would be around 105% of the English level if calculated on a needs basis, compared to more like 115% at present).
3 If Scotland’s population were to be growing at the same rate as England, convergence would occur when spending is growing. If Scotland’s population were growing less quickly than England’s, convergence may not occur (it depends on the rate of growth of spending and relative population growth).
4 http://www.ifs.org.uk/publications/7442
Scottish Government. As economic cycles are fairly well aligned across the UK, such an approach would significantly reduce the revenue risks facing Scotland, and thus, reduce the scale of additional borrowing powers Scotland would need to manage those risks.

The no detriment principles would seem sensible at first glance, but implementing them in practice will be difficult. This issue is addressed in more detail in the responses to subsequent questions.

A key element of satisfying the criteria of fairness is to determine an appropriate block grant adjustment. This involves setting an initial adjustment, and then indexing that adjustment in subsequent years. Further detail on this will be provided in the answer to the question addressing the block grant adjustment. The key point is that it is not possible to design a system that meets both no detriment principles, and is at the same time “transparent, effective and mechanical”. But it is possible to design such a system that is broadly “fair” if one is more flexible about the no detriment principles. Such flexibility will be key to implementing a workable system.

3 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?

The House of Lords Committee on the Barnett Formula recommended in 2009 that full information on the calculations undertaken to determine the block grant (including the operation of the Barnett formula) should be published. This recommendation has not been acted upon in a comprehensive manner. To ensure transparency and effective scrutiny, such information should be published in full at every fiscal event which affects the devolved governments’ block grants.

Two sorts of information should be published:

- Information on what changes in spending by Whitehall Departments have been deemed ‘comparable’, and from which a Barnett consequential therefore arises, and what changes have been deemed ‘non comparable’, and therefore lead to no Barnett consequentials. This should include a justification for such decisions, as well as information on whether the decision required negotiation between the UK and devolved governments.

- HM Treasury officials produce spreadsheets to calculate the changes to block grants, based on spending changes and the decisions about whether they should lead to Barnett consequentials. These spreadsheets should be published at the time of each fiscal event, and an archive should be made available.
4 What mechanisms are required to ensure the transparency and effective scrutiny of adjustments to the block grant to reflect the tax revenues foregone by the UK Government?

In principle at least, the first year adjustments to the block grant are relatively straightforward to implement, although the calculations involved may be complex. When devolving a tax, the block grant is reduced by the amount of revenue being transferred. When devolving responsibility for an additional area of spending, the block grant is increased by the amount the UK would have spent in Scotland on that area.

Given the complex calculations that may be required in order to estimate these quantities, it would be preferable if the UK Government and Scottish Government agree on a methodology, and publish detailed information on the calculations. This will allow proper external scrutiny. If agreement on a single method cannot be reached, then both parties should publish detailed information on their methods, and resulting calculations. The OBR and Scottish Fiscal Commission should continue to assess and, if appropriate, sign off these calculations. Information should also be published on the mechanism by which ultimate agreement is reached (and what that agreement entailed). Consideration should be given for an independent institution to act as an arbiter.

Calculating the adjustment to the block grant in subsequent years is more conceptually complex. One cannot simply continue to deduct or add an amount equal to the revenues or spending devolved. Doing this would remove any incentive for the Scottish Government to boost tax revenues or limit expenditure growth (including through discretionary tax rises, or spending cuts): any change in revenue or spending would simply be cancelled out by an offsetting change to the block grant adjustment.

There are a number of methods for adjusting the block grant, and each has different properties. None will meet all the principles set out by the Smith Commission, however, meaning that the UK and Scottish Governments will have to prioritise which principles they think are more important to be met. The attached presentation sets out three possible mechanisms, and their advantages and disadvantages (including worked examples of how they perform under different scenarios). The following summarises the findings:

- Fixed % adjustment to block grant (i.e. block grant reduced by the same % in each year as in 1st year)
  - Easy to understand and can be implemented using Barnett formula
  - But Scotland bears risk of UK-wide shocks it is ill-equipped
to bear

- Index to % change in rUK revenues
  - Insulates Scotland from UK-wide shocks but still growth incentive
  - In spirit of “no detriment simply from devolution” as Scotland is left no better off or worse off in the long term if revenues grow at the same % rate as in rUK
  - Scotland affected (a bit) by rUK decisions on taxes that in Scotland are the responsibility of the Scottish Government

- Index to £s p.p change in rUK revenues
  - Also insulates Scotland from UK-wide shocks while still proving growth incentive
  - Scotland unaffected by rUK decisions on taxes that in Scotland are the responsibility of the Scottish Government
  - But Scotland loses out unless its revenues grow more quickly in % terms than rUK – not in spirit of 1st “no detriment” principle

(Note it refers to ‘revenues’ and taxes but the same approaches would be feasible for devolved welfare spending too).

If the Scottish Government wanted to ensure “no detriment” from further devolution, it seems that there would be clear benefits to indexing the block grant adjustments to the % change in rUK revenues:

- Taxes in rUK go up and down and the (relatively small) increases and reductions in Scotland’s budget this method causes would balance out
- Problems under other methods larger & likely to grow over time.

From an rUK perspective, indexing to £s p.p change in rUK revenues has the attraction that it would lead to the Scottish Government’s budget increasing less quickly than the % change mechanism (at least while Scottish revenues per person from devolved taxes are less than the equivalent revenues in rUK). This would help address concerns in England and Wales that Scotland is ‘over-funded’ at present under the Barnett formula.

5 What mechanisms are required to ensure the effective working of the “no detriment” principle?

The ideas behind the two ‘no detriment’ principles seem sensible at first
glance:

- Neither government should gain nor lose simply as a result of the decision to devolve revenues or spending responsibilities (1st no detriment principle);
- Each government should bear the risks and reap the benefits of their own policies, and not win or lose from knock on effects from the other government’s policies. Related to this, it seems reasonable that changes in taxes in rUK for which the Scottish Government has responsibility in Scotland, should not impact the amount spent for the benefit of Scotland (together, the 2nd no detriment principle).

The difficulty arises in practice, when considering how to implement the principles.

As discussed above, it does not seem possible to design a block grant adjustment mechanism that satisfies the need for transparency and ‘automaticity’, and at the same time, satisfies both of these no detriment principles.

For instance, indexing the block grant to the % change in equivalent revenues/spending in rUK seems to satisfy the spirit of the 1st no detriment principle, but does not fully satisfy the 2nd no detriment principle. Conversely, indexing the block grant the £s p.p change in equivalent revenues/spending in rUK satisfies this aspect of the 2nd no detriment principle, but does not seem in the spirit of the 1st. See the response to the previous questions for reasons why Scotland may have an incentive to choose the former option, and prioritise satisfying the 1st no detriment principle.

There is a further issue with the 2nd no detriment principle: taken at face value, it implies that where there are knock-on effects from one government's decisions on the revenues or spending of the other, compensating transfers should take place. The calculation of such transfers would be difficult, however, involving complex calculations and modelling; seemingly minor and technical differences in assumptions may lead to very different answers. This aspect of the no detriment principles therefore leaves much scope for disagreement – which could cause difficulties for inter-governmental relations. Difficult negotiations would likely be required in such circumstances, which would mean the system was not “mechanical”, and may lead to a lack of transparency.

This would suggest restricting the circumstances in which such transfers take place to the most significant and obvious examples of “knock on” effects; and requiring full information to be published by both the UK government and Scottish government on assumptions and modelling undertaken during negotiations about what compensating transfers should take place. Again,
assessment and sign off of costings by the OBR and SFC seems worthwhile; as does investigation of whether an independent body can act as an arbiter.

6 What additional borrowing powers for current spending and for capital spending should the Scottish Government have?

The scale of borrowing powers for current spending available to the Scottish Government should be commensurate with the additional spending and revenue risks faced by the Scottish Government following further devolution. They should be kept under review if the devolution settlement moves beyond that envisioned by the Smith Commission.

Note, that the way in which the block grant mechanism is indexed will have major implications for the scale of current borrowing powers required. If indexed to equivalent revenues/spending in the rest of the UK, then the block grant adjustment would bear the burden of shocks that hit the whole UK. For instance, if a recession were to reduce income tax revenues in Scotland and the UK by 10%, the block grant adjustment would be reduced by 10%, in effect sheltering the Scottish budget from the shock to its tax revenues. Scotland would though face the risk of shocks affecting Scotland differentially compared to the rest of the UK. This would mean some current borrowing powers would be required. Far larger borrowing powers would be required if Scotland were expected to bear the full risk of economic shocks (which would be the case, for instance, if the block grant adjustment was set as a fixed fraction of the block grant, or implemented via changes to the Barnett formula comparability factors).

At present, current borrowing is available only to cover forecast errors. Given the additional revenue risk Scotland will face (associated with shocks that affect it differently to the UK as a whole), it seems sensible for Scotland to have the ability to borrow to smooth its budget more generally (e.g. so that it can borrow temporarily to cope with a shock that is forecast to hit Scotland harder than the rest of the UK).

It has been suggested that Scotland’s borrowing for the purposes of capital investment should be managed under the “prudential code” that applies to local government capital borrowing. It is worthwhile investigating this option, as it is a regime that seems to have worked well for local government. However, it is worth noting the differences in the political relations between local and central government, and the Scottish and UK government. It seems that there is more political space for central government to either (a) overrule autonomy of a local authority if it felt that the level of borrowing was not in fact

5 Note that if prior to the shock, Scotland’s revenues grew slower (faster) than those of the rest of the UK, the mechanism would somewhat more than (less than) compensate Scotland for the decline in its revenues, if such a shock hit.

6 See the CIPFA submission to the Devolution (Further Powers) committee.
‘prudent’, or (b) bail out a local authority that got in to such trouble, than might be the case for the UK government acting in such a manner with respect to the Scottish government. This means that while for local government borrowing, there are effective means for central government to deal with any problems that may arise is a particular authority borrows what is felt to be an imprudent amount, such means may not be politically feasible if such a regime applied to Scotland. The political fallout from either the UK government overruling the Scottish Government’s decisions on what was ‘prudent’, or from having to bail out the Scottish Government, could be substantial. Thus a prudential regime seems to carry greater risk when applied to Scotland, than when applied to local government. In the absence of such a prudential regime, the Scottish and UK governments should agree a limit on capital borrowing powers.

7 What fiscal rules should be applied to these additional borrowing powers?

Please see response to the previous question for thoughts on the rules for capital borrowing. In the context of the Smith Commission proposals, it is important that the rules for current borrowing and the UK’s broad fiscal framework are consistent with each other, and to ensure that Scottish Government borrowing does not have a significant impact on the UK’s overall fiscal position. This would likely require some limits on the total amount of current borrowing that Scotland is able to undertake (perhaps determined on the basis of limiting the fraction of Scotland’s budget that is taken up by current borrowing interest costs). This would give flexibility for the Scottish government to determine borrowing on a year-to-year basis, but ensure the long run sustainability of the Scottish budget.

8 What mechanisms should there be for reviewing the Statement of Funding Policy?

The Statement of Funding Policy should be regularly reviewed, at each Spending Review, and at the time at which proposals for changes to the devolution settlement are agreed. Furthermore, there should be an opportunity for external independent scrutiny during this review period. This may, in future, prevent problems of the kind that have arisen in the past when the “Barnett Formula Comparability Factors” contained in the Statement of Funding Policy have been amended (e.g. when Business Rates were devolved to Scotland, the change made was somewhat ill-conceived and led to an ongoing flaw in the Barnett formula).

9 What lessons can we learn from the experience of other fiscal federations?

Two kinds of lessons can be drawn from other countries’ experiences of
operating systems of substantial sub-national fiscal autonomy.

In the broad sense, there is a substantial literature on fiscal federalism. This includes a recent study examining the lessons that can be learned from 13 fiscal federations for the European Union’s moves towards greater fiscal coordination and integration: there may also be lessons for the journey of the UK and Scotland in the opposite direction.\textsuperscript{7} It may be particularly worthwhile examining the experience of Australia and Canada which have well-defined rules and institutions for governing the fiscal relations between national and sub-national governments.

But one can also learn lessons from what other countries do not do: the approach taken to tax devolution by the UK and Scotland, and the “no detriment” principles suggested by the Smith Commission seem almost without precedent in other countries.

For instance, it is unusual to devolve income tax fully to the sub-national government: most fiscal federations with devolved income taxes have a “local”/“state” tax, and a “federal” income tax. This allows both levels of government access to what is often the single largest (and most salient tax), one of the most flexible (in terms of rate structure), and one that is buoyant. In a UK context it would also avoid difficulties related to whether Scots MPs should have a vote on income tax in the UK parliament (as under such a system changes to the UK-wide tax would continue to apply in Scotland, so the answer would clearly be “Yes”). With full devolution of income tax, the situation is more complex (see the attached presentation).

In addition, while the “no detriment” principles may seem intuitively appealing, they are not a central feature of the fiscal frameworks of other countries, perhaps because of the difficulties of implementing such principles in practice. This may provide further evidence that the compensating transfers required under the “no detriment” principles should only be used in limited circumstances, in order to avoid the system becoming unworkable.