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Introduction

This paper is submitted on behalf of the Jimmy Reid Foundation, though the contents are the responsibility of the author. The bulk of this paper will consist of detailed comments on some of the specific questions in the Finance Committee’s call for evidence. However, it is worthwhile beginning by clarifying the nature of the points being made here, which fall into two categories.

First of all, at a fundamental level, it is extremely difficult to see how the Smith Commission proposals can be implemented in a fair and equitable way, and without adverse unintended consequences, unless deep-rooted reforms in the constitutional and funding arrangements for Westminster are also implemented. This is because of the implications of what will be referred to as the gearing problem, which arises if changes in income tax rates in the rest of the UK (rUK) are allowed to affect not just “devolved” services in rUK, but also reserved services for the whole of the UK. As will be shown, the proposed way in which the “no detriment” principles in Smith are to be implemented does not provide a satisfactory answer to the gearing problem: instead, it leads to a situation where, if Westminster decides to change rUK income tax to fund a reserved service like defence, then this will force the Scottish government to increase the Scottish rate of income tax, or to cut Scottish devolved services like health or education.

At another level, however, this note will also discuss a number of technical issues which will arise in the implementation of the current proposals: for example, problems with the operation of the proposed method for indexing the abatement to the Scottish Block Grant: and a separate range of problems which will be posed by the need to index the adjustments to the Block Grant which will be required in the light of decisions to change rUK income tax.

At first sight, it might appear that there is an inherent contradiction between these two approaches. If it is impossible to implement a satisfactory Scottish fiscal framework in the absence of fundamental UK changes, why should this note concern itself with technical points of implementation? But in fact, as will be seen, both approaches ultimately point in the same direction. The technical complexities of satisfactorily implementing the arrangements which are currently proposed are so great that it is likely to prove impossible to operate the resulting system in a fair, transparent, and acceptable manner. Solving the technical problems inexorably points to the same conclusion: that is, to the need for a fundamental reform of the UK framework, along some kind of properly federal lines.

To achieve this, there would need to be an rUK chamber responsible for taking the rUK Block Grant, setting the rUK income tax rate, and determining spending priorities on health, education, etc., from the resulting budget. And
there would need to an over-arching body setting the whole UK budget, and
determining the allocation of UK resources, (excluding income tax and other
devolved taxes), between reserved functions and the territorial Block Grants.

Specific Finance Committee questions.
(Note that the numbering in what follows refers to the ordering of the original
Finance Committee list of questions: not all questions are considered here.)

Question 1: 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?

1.1 Giving Scotland the ability to set its own income tax rates for the whole
of non-saving non-dividend income raises problems which are a good deal
more complex than those posed by the Calman tax proposals. One of the new
issues which arises relates to the gearing problem. This problem occurs if
changes in income tax in rUK are allowed to affect not just “devolved”
services in rUK, but also reserved services for the whole of the UK. Suppose,
for example, that Westminster decides to implement a significant cut in rUK
income tax rates, and to fund this it cuts public expenditure. Suppose, further,
that the cut in public expenditure is spread evenly over not just domestic
“devolved” services in rUK but also over “reserved” services like defence,
social security etc.

1.2 Now consider Scotland’s position. If the Scottish government does not
match the cut in income tax rates by the rest of the UK, then the Scottish
economy is likely to be at a chronic disadvantage: ultimately, any Scottish
Government operating under the Smith arrangements would have to follow
suit if the rest of the UK were pursuing an aggressive policy of cutting income
tax rates. But if the Scottish Government does adopt the same cut in tax rates
as the rest of the UK, then, the cut it would have to make in public expenditure
will be concentrated on devolved services in Scotland, rather than being
spread over devolved and reserved services as in the rest of the UK. As a
result, the cut in devolved services in Scotland would be significantly deeper
than in the rest of the UK.

1.3 This kind of arrangement would put Scotland in an intolerable situation.
The gearing effect would mean that an income tax cutting policy in the rest of
the UK would force upon Scotland either disproportionately higher tax rates or
disproportionately greater cuts in public expenditure: there would be no
escape.

1.4 The Smith Commission report does not specifically spell out this
gearing problem: but, on the other hand, one of the “no detriment” principles
in Smith would, if satisfactorily implemented, have the effect of solving the
problem. This is the principle set out in paragraph 95.4(b), relating to the
effect of decisions taken by the rUK or Scottish Governments post-devolution,
which states:
“Changes to taxes in the rest of the UK, for which responsibility in Scotland
has been devolved, should only affect public spending in the rest of the UK.
Changes to devolved taxes in Scotland should only affect public spending in Scotland.

1.5 The proposals for implementing Smith published on 21st January 2015 in Cm8990 accepted the principle of this clause, but proposed to implement it in the following way. If, for example, the Westminster government chose to use an increase in rUK income tax to fund reserved functions, then paragraph 2.4.14(ii) of Cm8990 explains what would happen: “... similarly, if the UK government spends this extra funding on reserved areas (such as pensions, benefits, defence, debt interest, etc.) then this would be spent UK wide, including Scotland, despite the “rest of UK” income tax not applying in Scotland. The tax deduction element of the funding model therefore needs to work alongside the Barnett Formula to ensure that increases in “rest of UK” tax do not fund higher spending in Scotland.”

1.6 To see what this means, consider the following. Suppose a UK government decided it was going to fund extra expenditure on say, Trident, by raising rUK income tax rates. Since defence is a reserved function, public expenditure on Trident is regarded as “benefiting” the whole of the UK. So public expenditure in Scotland will rise by Scotland’s population share of the extra spend on Trident. Since aggregate public expenditure in Scotland has now risen by this amount, the principle of Clause 95(4)(b) is in danger of being breached, so to avoid this happening, Westminster will reduce Scotland’s Block Grant correspondingly.

1.7 The implications of this are stark: if Westminster decides to use an increase of rUK income tax to fund a reserve service like Trident, (as it is perfectly entitled to do under the current proposals), then Scotland has the choice of either

a) Accepting a cut in Scotland’s devolved services equal to our population share of the increase in reserved expenditure: or

b) Raising our own income tax rates so as to recover an amount equal to our population share of the extra income tax revenue being raised in the rest of the UK.

1.8 This is profoundly unsatisfactory. Letting Westminster spend rUK income tax on reserved services means that Westminster can force on Scotland cuts in devolved services or changes in Scottish tax rates. This is absolutely counter to the popular conception of the scope of the extra powers promised under Smith. We thought we were getting control of income tax: well, it now turns out that this is only true to the extent that Westminster does not decide to use rUK income tax to fund reserved services.

1.9 But in fact, the actual situation is even worse than this. Previously, if Westminster chose to use a change in income tax to fund a reserved matter like Trident, what each part of the UK would contribute would be the sum yielded by the relevant change in income tax applied to that part of the UK. Now, when Westminster decides to increase rUK income tax to fund a reserved service, what Scotland will have to contribute (by cutting services or
1.10 The way in which it is proposed to implement Smith’s paragraph 95.4(b) principle is therefore unacceptable. The problem arises because, under the current implementation proposals, it will still be possible for the Westminster government to use changes to rUK income tax to fund changes in reserved services. Solving the problem would require hypothecation of rUK income tax receipts so that they could only fund rUK “devolved” services.

1.11 However, hypothecating rUK income tax receipts like this has very fundamental implications. What would be required is that there would have to be an rUK Block Grant, with expenditure on “devolved” services, like health and education, funded out of the aggregate of the Block Grant plus rUK income tax receipts. (In fact, this description simplifies in two respects, since it ignores funding from other own resource taxes like non-domestic rates and council tax, and also because it sweeps up the separate England, Wales and Northern Ireland into the composite rUK). Moreover, unless this change is to be purely cosmetic, the Block Grant for rUK has to be settled independently of the setting of the rUK income tax rate, and of determining spending priorities for rUK devolved services. If the same body is setting the Block Grant for rUK as is deciding the rUK income tax rate, then rUK Block Grant is just a residual and we are back with the kind of unacceptable results which have already been explored.

1.12 The conclusion is that, if the difficulties posed by the gearing problem are to be satisfactorily addressed, there would need to be an rUK chamber responsible for taking the rUK Block Grant, setting the rUK income tax rate, and determining spending priorities on health, education, etc., from the resulting budget. And there would need to an over-arching body setting the whole UK budget, and determining the allocation of UK resources, (excluding income tax and other devolved taxes), between reserved functions and the territorial Block Grants. That is, a proper federal system for the UK would be required. Westminster as currently constituted, or even after implementing proposals for English Votes for English Laws, (EVEL), could not fulfill this latter function, since most of the time it would be the same group of MPs who would control both Westminster, and whatever chamber is constituted to exercise EVEL.

1.13 On a separate point, question 1 implies that it is a desirable property that the fiscal arrangements should be largely mechanical. It is by no means clear that being largely mechanical is actually desirable. After all, Barnett is often referred to as a well-functioning mechanical arrangement. However, it
was the mechanical nature of the arrangements surrounding Barnett, whereby Scottish tax revenues were automatically transferred to Westminster, which allowed subsidies worth approximately £150 billion, (over and above the relatively higher spending levels funded by Barnett), to be transferred from Scotland to the rest of the UK, largely without any comment. Furthermore, as the implementation of Smith weakens the (admittedly imperfect) arrangements for fiscal transfers within the UK monetary union, the case for regular high-level oversight of the effects of the arrangements will become even stronger. In this context, arrangements that are largely mechanical are not necessarily desirable, since they represent an attempt to depoliticise and managerialise what should inherently be a political and democratic issue.

**Question 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.**

3.1 The overall funding which a Scottish government will receive from Westminster will consist of the Scottish government’s block grant as determined by the Barnett formula, with two different types of abatement or adjustment:

a) abatements relating to tax revenues foregone by the UK government:
b) adjustments compensating for the effects of rUK decisions to change rUK controlled tax rates.

(Para 2.4.2 of Cm 8990, which sets out how the Barnett based block grant will be adjusted, does not specifically mention this second type of adjustment. However, as already noted, the existence of these adjustments is clearly spelled out in para 2.4.14, which explains how Smith’s second no detriment principle will be applied.)

The difficulties posed by these two different types of abatement/adjustment will be discussed under Questions 4 and 5 respectively. However, the complexity of this overall arrangement has an important implication for the setting of the original block grant by means of the Barnett formula. Namely, it will be essential that the Barnett formula itself should operate in a very clear and transparent fashion.

3.2 Unfortunately, to date the Treasury has signally failed to operate the Barnett formula transparently. In particular, there has been a major failing on the part of the Treasury to align two key information sources. One is the Treasury Funding Statement (TFS) which indicates at a fairly detailed level which items of expenditure are reserved or devolved, (for Scotland, Wales, and Northern Ireland): the TFS is the source which drives the operation of Barnett. The other key data source is the Public Expenditure Statistical Analyses (PESA) which records the outturn of public expenditure, including a territorial analyses of identifiable expenditure. Because the TFS and PESA databases are not aligned, it is not possible to calculate, other than by fairly crude estimates, what the outturn expenditure for England has been on those services which are devolved respectively to Scotland, Wales, or Northern Ireland. These, however, are key pieces of information, because they are required in order to monitor whether or to what extent, the operation of the Barnett formula is bringing about convergence of per capita spending levels.
3.3 It will be of even greater importance in future that the Treasury align the TFS and PESA databases, and that it produces, and publishes, clear statements on public expenditure per head in England on the aggregate of services devolved to Scotland.

**Question 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?**

4.1 It is understood that the final details of this type of adjustment to the block grant are yet to be determined: but the current proposal is that the adjustment to the block grant for income tax receipts foregone should be indexed from year to year in line with the so-called Holtham method – that is, in line with the overall growth in the UK income tax base. (This approach was originally suggested in relation to the Calman tax proposals by the Holtham Commission in Wales.) This raises a number of important issues.

4.2 First, there is the question of equity. It is interesting that Question 4 as posed mentions transparency and effective scrutiny, but does not mention equity. Equity is, however, clearly of great importance. As Professor Holtham himself said, in giving evidence to the Finance Committee at an earlier stage, the Holtham method “might not be in Scotland’s interest if [the Scottish] tax base grows more slowly than that of the UK”. The Holtham indexation approach has been justified on a number of grounds, including the desirability of giving the Scottish government an appropriate incentive to grow its income tax base. This neglects, however,

a) the fact that the Scottish income tax base is very different from that of the UK as a whole, with Scotland having materially fewer, in proportionate terms, of the very high incomes associated with the City of London. The implication is that there are naturally going to be extended periods when the income tax base in Scotland grows more slowly than that of the UK as whole.

b) the fact that the Scottish government lacks many of the economic powers it would need in order to take effective action to grow the income tax base.

Given the above, there must be serious doubts about the equity of Holtham indexation. In effect, the Scottish government is being forced to fight on ground which would probably not be of its own choosing, (i.e., the income tax base), without adequate weapons, (in the form of economic powers).

4.3 Leaving aside these general doubts about the equity of what is proposed, there are specific concerns about the effects of Holtham indexation, relating to the effects of relative population growth. It is a long standing feature that population growth in England has been relatively faster than that in Scotland: moreover, population in Wales and Northern Ireland has also tended to grow relative to that in Scotland. In fact, over the last ten years, the rate of population growth in the UK as a whole has been higher than the rate of population growth in Scotland by an average of 0.22% annually. Suppose that Holtham indexation is applied at the level of growth in the overall UK income tax base, as currently appears to be proposed: (see, for example,
SPICE Financial Scrutiny Unit Briefing: “Scotland act 2012: Financial Provisions”, p18.) Then Scotland will be penalised unless the per capita income tax base in Scotland grows as fast as the per capita tax base in the UK as a whole, multiplied by the relative rate of population growth of the UK compared to Scotland. (The algebra demonstrating this is given in Annex 1). Since UK population has been growing relative to Scotland’s, the effect is that Scotland has to grow its per capita tax base faster than the UK, if it is not to be penalised by Holtham indexation. This anomaly would be corrected if Holtham indexation were based, not on the overall growth in the UK tax base, but on growth in the per capita UK tax base. There appear to be strong grounds for making, at least, this change.

4.4 In addition to the abatement to the Scottish block grant for UK income tax receipts, there will also need to be abatements for the other taxes which the Scottish government will control (like LBTT), or which are hypothecated to Scotland, (like approximately half of Scottish VAT receipts). These abatements will need to be appropriately indexed as well. Again, similar issues of principle and technicality are likely to arise as with Holtham indexation.

**Question 5: What mechanisms are required to ensure the effective working of the “no detriment” principle.**

5.1 As noted above in the answer to question 1, the specific version of the operation of the no detriment principle envisaged in paragraph 2.4.14 of Cm8990 is very problematic, if decisions to change rUK income tax are allowed to impact on expenditure on reserved functions. Leaving this difficulty aside, and assuming that appropriate arrangements for hypothecating rUK income tax receipts to “devolved” services have been put in place, operation of the no detriment principle will still lead to significant difficulties.

5.2 The implication of paragraph 2.4.14 is that, every time there was a decision to change an rUK controlled tax, (like income tax), there would need to be an adjustment to the Scottish block grant, to cancel out the Barnett implications of the change in rUK public expenditure. One difficulty with this approach is that there would be plenty of scope for argument about whether a given change in rUK income tax was a decision related change or not. Consider, for example, a change in tax thresholds. If the change is merely to uprate thresholds in line with inflation, so as to avoid fiscal drag, then this could be regarded as a housekeeping measure, rather than a tax change. But what if thresholds were not uprated in a given year: is this a specific decision, or would it just be overlooked? If some threshold changes are treated as tax changes for the purposes of 2.4.14, and others are not, how would the danger be avoided of consistent ratchet effects being built in on the adjustments being made to the Scottish block grant?

5.3 Furthermore, the adjustments to the Scottish block grant for rUK tax changes will need to be indexed in some way. But it is not at all clear how this should be done. There is a real danger that the Treasury might argue that the
adjustments should be aggregated with the tax foregone abatements discussed under Question 4, and indexed by the Holtham method. However, a) an rUK tax change which took the form of, say, introducing or abolishing a basic 10p tax rate on a given band would have revenue consequences which would primarily grow in line with the number of taxpayers, not in line with the growth in taxable earnings. So Holtham indexation would be inappropriate for this, or similar, changes. b) ideally, whatever form of indexation is used should be self-cancelling, in the sense that, if a given rUK tax change is made at one point in time, and then reversed a few years later, the resulting net adjustment to the Scottish block grant should be zero. Holtham indexation of the initial adjustment would only achieve this by accident.

5.4 For these reasons, the question of how to index the adjustments to the Scottish block grant arising from rUK tax changes looks fraught with difficulty. Another possible approach would be to take the year zero UK tax structure as a fixed reference point, and to ask HMRC to conduct an annual exercise to assess, at rUK level, the revenue consequences of the difference between the current rUK structure, and the reference structure. This would solve the indexation and self-cancelling problems: but would have the significant downside of enshrining an increasingly irrelevant year zero tax structure as a fixed reference point.

Question 8: How should inter-governmental machinery including the Joint Exchequer Committee be strengthened and made more transparent.

8.1 In line with the comment made at 1.13, it is not desirable for the operation of the funding mechanism to be too mechanistic. There is a need for a high level body to take a view on how the arrangements are working, and to make adjustments, (to powers, and to fiscal transfers), as appropriate. This is a role which would most naturally be played by the federal government in a proper federal system. It goes well beyond what the currently constituted Joint Exchequer Committee (JEC) is appropriate for.

8.2 In addition, there is a need for a different kind of forum in which day-to-day issues on the running of the fiscal framework can be raised and ironed out. The existing JEC seems appropriate for this role, provided it does not simply impose Westminster decisions in those cases where agreement cannot be reached.

Conclusion
1. A satisfactory solution to the gearing problem – that is, the problem that arises if changes in rUK tax rates are allowed to affect both “devolved” and reserved services – is of fundamental importance. It has been argued here that the implementation of the Smith Commission’s no detriment principle as currently proposed does not provide an acceptable solution. A full solution of the gearing problem would involve meaningful hypothecation of rUK income tax receipts to rUK “devolved” expenditure. It is difficult to see how this could
be achieved without introducing an rUK block grant, and along with this some form of properly functioning federal organisation for the UK.

2. Separately, the note has looked at a number of technical issues which will arise relative to the current proposals, particularly relating to the proposed method of Holtham indexation of the abatement to the Scottish block grant for tax revenues foregone by the UK: and in relation to the adjustments required to the Scottish block grant for rUK tax changes. A specific proposal has been made here to improve the equity of Holtham indexation – namely, that the abatement for income tax receipts foregone should be indexed in relation to the movement in the per capita UK tax base rather than the overall tax base. Apart from this, however, it is clear that:
   a) there are technical problems on how the different abatement and adjustment elements should be indexed.
   b) there is scope for a good deal of argument about what elements of future rUK tax changes are decision related, (so requiring block grant adjustment), and which are just housekeeping changes.
   c) the resulting system will be so complex that it will be difficult to open up the whole process for scrutiny.

3. On technical grounds, therefore, (and quite separately from the difficulties posed by the gearing problem), it is doubtful if the proposals to implement Smith set out in Cm 8990 can be put into operation in a way which is open, fair, and not subject to argument. The technical difficulties with the current Smith implementation proposals would, however, be avoided under a proper federal system, under which there were separate block grants for rUK and Scotland, (or, more accurately, for England, Scotland, Wales and Northern Ireland), and where each country’s budget for devolved services was then determined as its block grant plus designated own resources. Implementing such a system would, of course, require fundamental change to UK constitutional arrangements.
Annex 1. Holtham indexation and relative population growth.

Let $p^k_{UK}$ and $p^k_S$ denote respectively populations in UK and Scotland in year $k$, and let $T^k_{UK}$ and $T^k_S$ denote the tax bases in UK and Scotland in year $k$. Holtham indexation is neutral for Scotland between year $k$ and year $(k+1)$ if the tax base in Scotland grows at the same rate as that of the UK:

That is, if

$$\frac{T^{S}_{k+1}}{T^S_k} = \frac{T^{UK}_{k+1}}{T^{UK}_k}$$

(1)

Let $\overline{T}^k_{UK}$ denote the per capita UK tax base in year $k$: so that $\overline{T}^k_{UK} = \frac{T^k_{UK}}{p^k_{UK}}$, and so on.

Then equation (1) is equivalent to

$$\frac{p^S_{k+1}}{p^S_k} \frac{\overline{T}^{S}_{k+1}}{\overline{T}^S_k} = \frac{p^k_{UK}}{p^k_S} \frac{\overline{T}^{UK}_{k+1}}{\overline{T}^{UK}_k},$$

i.e.

$$\frac{\overline{T}^{S}_{k+1}}{\overline{T}^S_k} = \left[ \frac{p^k_{UK}}{p^k_S} \frac{\overline{T}^{UK}_{k+1}}{\overline{T}^{UK}_k} \right] \frac{p^S_{k+1}}{p^S_k}.$$

In other words, for conventional Holtham indexation to be neutral, the per capita tax base in Scotland must grow at the same rate as the per capita tax base for the UK as a whole, multiplied by the relative rate of population growth for the UK as compared with Scotland.