WRITTEN SUBMISSION FROM PROFESSOR GERALD HOLTHAM

Replies to questions in the call for written evidence of Finance Committee of the Scottish Parliament

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?

Currently the UK government sets a Departmental Expenditure Limit (DEL) for the Scottish government, subtracts from that some assessment of the tax resources available to the Scottish government and provides a block grant for the remainder.

Certain borrowing powers have been devolved to Scotland and they would permit expenditure over and above the DEL. If the assessment of tax resources is done properly, the Scottish government could also raise taxes to increase spending above the DEL. However, we note that current policy announcements are generally vague on how tax resources are to be assessed. The deduction from the Northern Ireland grant for devolving corporation tax, for example, is very small and cannot have been derived from any respectable, reproducible formula. Devolved territories may benefit from that kind of ad hoc horse trading but it sets a dangerous precedent and is best avoided.

The tax resources must be assessed assuming a standard rate of tax. One possibility is to make that the same rate as applying in England. In that case, however, any talk of confining voting on “English” tax rates to English MPs falls away since those rates would affect deductions from DELs and the size of block grants. Note there has been no discussion or proposals for any other means of fixing standard rates.

The idea of the DEL is to allow the UK government to exercise macroeconomic control and to limit spending, especially deficit spending. However there are two difficulties. Firstly the DELs of the devolved territories are the result of historical accident and have no particular justification. If Scotland’s tax resources were sufficient to finance the DEL, that would be one situation. Where they are not, part of the block grant at least must be viewed as the sort of equalization payment common in federal systems to support parts of the federation with lower tax resources and or higher expenditure needs.

Scotland and the UK as a whole have to decide how much weight they put on social solidarity across the union and how far they favour fiscal autonomy for the constituent countries. Devomax with no equalization flows emphasises autonomy at the expense of social solidarity. A system which reserves some taxes to the centre and makes equalization payments compromises full autonomy to preserve some social solidarity. At present the UK system has that second form but if that is maintained then the equalization payments require reform to reflect relative need. A formula to do this need not be much more complicated than the Barnett one and could be mechanical, reflecting a few key factors like demographics, incidence of poverty and chronic ill health, population sparsity and the cost of service provision.
What fiscal rules should be applied in order to ensure fiscal responsibility and debt sustainability?

The DEL approach is designed to ensure overall expenditure control. The Scottish government can borrow but that will also be subject to limits. At present the borrowing limits are arbitrary. It would be better if long-term borrowing were confined to supporting investment spending but the limits were set with explicit regard to targets for government debt/GDP ratios and to a rationing system that allocated borrowing powers among devolved territories in proportion to their capital budgets.

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 formula for block grants should be given some statutory basis and administered by a body independent of any arm of government, like the OBR or some newly-created body. The present situation is opaque and unsatisfactory.

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?

The adjustment should themselves by as mechanical as possible and subject to a formula. It is unlikely that exactly the same formula would be appropriate for all taxes since tax bases may evolve differently from each other and differently in different parts of the UK. In any case, it is sure that any formula will result in the accretion of anomalies over time. Moreover a balance must be struck between assigning risks and responsibilities appropriately and ensuring that potential provision of social services does not become too different in different parts of the Union. Periodic reviews, say once a decade, would be required and a possible recalibration of the system. Note that we speak of “potential” provision. Actual levels of social services may differ in different parts of the Union, reflecting local preferences and decisions on priorities and tax levels. The ideal, however, is that at standard tax rates each territory should have the same potential to provide social services, reflecting relative need.

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

I do not think that there is any possibility of this principle being made operational. It is simply a mistaken approach. If applied rigorously it could eliminate any fiscal autonomy since most measures have spill-over effects. Moreover there is no objective way to assess the “detriment” since counter-factuals cannot be observed. It would be better if the governments of the UK agreed among themselves what acceptable levels of tax competition were in areas like higher-rate income tax, corporation tax and APD and reflected these agreements in concordats which limited how far devolved taxes could be reduced. No doubt getting agreement would be difficult and complicated but the negotiations would be one-off and once concordats were agreed that would be the end of the matter. Action within agreed limits would not result in any further discussion. The “no detriment” approach implies continuing,
indeed endless discussions. There is no need to limit tax increases since these would engender positive spill-overs if anything. It is absurd to worry about “negative detriment”.

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

I have not studied this issue so as to be able to offer opinion on quantities. Short-term borrowing for cash management purposes should be related to the size of cyclical movements in the economy and the anticipated effect of those on revenues. Longer-term borrowing should be assessed as indicated above. The objection to present arrangements is that they proceed from totals that are handed down and appear arbitrary. It is not impossible to agree principles from which the borrowing limits should flow.

Gerald Holtham
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