SUBMISSION FROM JOHN MCLAREN, FISCAL AFFAIRS SCOTLAND

Finance Committee - pre attendance written submission with regards to the questions outlined in the Committee’s call for written evidence on Chapter 2 of the Command Paper ‘Scotland in the United Kingdom: An enduring settlement’.

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?

Detailed points on the proposed framework are outlined below. Whether the current proposal is what should be included in any revised framework is a very different question and not one that is addressed here.

However, it is worth commenting on the “fair, transparent, effective and mechanical rather than requiring regular negotiations” aspect of the question above.

First, in order to know whether these requirements are being met, each one needs to be clearly defined. Having done so, it is debatable whether each can be met at the same time, or at least to the same degree. It seems inevitable that there will be some degree of trade off involved. Consequently some degree of prioritisation across the requirements may be needed.

Second, there is the question of whether each requirement is actually desirable, in particular with respect to the frameworks being mechanical. Barnett is highly mechanical in nature but this has brought its own problems. It may be better to accept that a degree of adaptability and an element of negotiation (which occurs even with Barnett) is probably inevitable, and welcome. If not, then introducing a funding mechanism that is transparent and mechanical may require softening the requirement for being fair (or at least what is considered ‘fair’ by one or other of the two government’s).

What fiscal rules should be applied in order to ensure fiscal responsibility and debt sustainability?

As the last recession showed, no fiscal rules are bullet proof and the consequences of their being broken are not automatic. For example, with regards to debt positions, Japan, Greece and Ireland each started the recession with debt as a share of GDP ratios of 180%, 118% and 29% respectively, but now find themselves in very different places. Hence, fiscal rules need to be adaptable to local conditions.

Nevertheless there appears to be a growing consensus across OECD countries that ‘good’ fiscal rules should incorporate (i) an annual borrowing limit or date-related target for reaching some form of ‘balanced budget’, and (ii) a limit or date-related target for debt as a % of GDP. However, it should be noted that any such ‘benchmarks’ are not rooted in any well evidenced research or in any widely accepted theory of optimal debt.
It is also interesting to note that, pre recession, such rules tended to apply to maximums for annual borrowing limits (e.g. the EU’s 3% of GDP) and for debt as a % of GDP (e.g. the UK’s 40% limit).

However, post recession, with such rules largely abandoned, the ‘new’ rules apply to turning round the current, unsustainable positions. So we get the UK’s current debt target as simply that it is falling, but with no sign as to what level it should fall to. On balancing the budget the target relates to the timing of reaching such a balance, but with little indication of the longer term desired position.

Inevitably the current UK fiscal rules will change in the medium term to take into account the current targets having been reached, but it remains unclear what these future targets might be. Furthermore, changes over time are also likely to occur, in line with the changing UK political discourse. It may well be that, due to the relative sizes involved, any such UK changes will take the lead on this, with Scotland being expected to follow suit.

Despite the somewhat random nature of these targets, setting fiscal rules may still prove to be a worthwhile exercise. Academic research (1) suggests that such rules, along with supporting institutions, can help to achieve greater fiscal discipline, as the combination tends to force governments to better address unsustainable fiscal positions. Equally it gives markets confidence in the direction of travel and so allows for market borrowing without penalising costs.

In general terms, and regardless of the actual targets, consistency of fiscal rules across the UK would be beneficial in terms of transparency and coherency and in terms of improving the likelihood of a mood of co-operation over effective management between government’s.

**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?**

**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?**

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

(Taken together)

On the assumption that the system outlined by the Smith Commission and in the Command Paper is what is going to be put in place then the key questions concern how the actual workings of the Barnett formula will be revised and, in particular, how it is adjusted over time.

The original Barnett system is very simple, contrary to popular belief, and that is one of the reasons it was introduced and has lasted so long. As soon as you move away from this simplicity (including to the 2012 Act) then anomalies and difficulties start to emerge.
The Command Paper offers two worked examples (see para 2.4.14) of how the adjustment process will work. However, these examples are somewhat opaque and less than comprehensive. As an alternative Annex 1, here, expands on how the adjustment process works in practice and, hopefully, clarifies the outcomes.

The results are not always intuitively obvious. For this reason it may take some time for government’s and the public to become comfortable with such adjustments. This means that there may be, initially at least, considerable scope for discontent over the adjustment process, from either side.

With regards to the ‘no detriment’ principle, one key issue relates to the position where the raising of existing taxes is not equally spread across the UK. For example, Scotland’s share of Income Tax (IT) is notably lower than its population share (7.3% vs 8.3%) and this is largely down to fewer tax payers in the higher rate bracket. This has two major implications. First, any adjustment to the UK higher tax rate could disproportionately benefit or cost Scotland, depending on which share is used.

Second, it means that, based on recent experience, Scottish IT revenues are likely to grow more slowly than the UK’s.

Furthermore, if the UK population continues to rise faster than that of Scotland then IT is also likely to rise faster and so Scotland could, again, lose out. To compensate for this, any adjustment process may want to move in line with changes in UK IT per capita. The downside to this is that it does not allow Scotland to benefit from any net migration rise through being seen as a more attractive place to live and work. Although, as the Smith recommendations do not include powers over immigration, the scope to achieve this may be limited.

Furthermore, the IT tax base will alter over time as a result of different demographics, either through ageing or through net migration patterns. This could affect what is seen as ‘fair’ in terms of the ‘no detriment’ principle.

**Complexity over time** - Individual taxes may come and go, specific benefits are even more likely to come and go. As a result, over time it will be very difficult to follow what is the ‘correct’ adjustment is for a change in Scottish or UK policy.

Even without the introduction of new taxes and benefits, over time the complexity will inevitably grow as rates and thresholds change and the calculation of the ‘no detriment’ compensation amount will become less precise. On the assumption that such imprecision will not be biased one way or the other it may be easiest to simply accept that this will be the case and that the swings and roundabouts will balance out.

**Second round impacts** - While Scotland will keep any ‘above UK trend’ increase in IT, such an outcome suggests higher economic growth which should also result in higher growth in VAT (and other) receipts. At present, Scotland would receive a share of this increase, but not its full, higher than UK growth, share. Whether any attempt will be made to incorporate such second round effects into the adjustment process is not clear at present.
A revised Barnett formula will also heighten awareness of the existing ‘faults’ within the formula. The IFS have already highlighted one such issue, with regards to the treatment of business rates income. Another relates to the fact that the formula was originally designed to reduce the spending per head advantage seen for Scotland (and Wales and NI) over time. This convergence feature will remain as part of a revised Barnett formula, with no lower limit over how close the spending per head levels can get. A third concern relates to how differential population growth rates affect the ‘fairness’ of Barnett, as historical spending levels are maintained but new funds are allotted purely on an, annually updated, population basis.

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?

(Taken together)

A number of basic issues arise in relation to the correct approach to borrowing powers.

- First, whether any limit applies and if it does whether it is fixed or variable. Some degree of adjustment to the economic and fiscal conditions that apply at the time is likely to be warranted, but it is difficult to be precise in such matters. The comments made above re fiscal rules in general are again relevant here.

With regards to the borrowing for current versus capital spending issue, it is unclear whether such limits can be strictly applied in practice. This also brings up the issue of whether it is still necessary for Barnett to distinguish between current and capital consequentials. Given the extra responsibility being given to the Scottish government in a number of new areas, it seems odd that this restriction on the Scottish Parliament is still in place.

- Second, whether borrowing is undertaken indirectly via the UK government or directly, or both. This is likely to have a bearing on the cost of future borrowing.

- Third, how any borrowing responsibility/limits are split between local and central government in Scotland. What is the role that should be played by elected Scottish local authorities in agreeing borrowing limits and rules?

- Fourth, the ability of the Scottish government to top up any existing UK benefit brings into question what borrowing limit applies as it could, in practice, put an effective ceiling on the scope for such adjustments.

There is much scope for further discussion of each of these points although the final decisions are likely to result from political negotiation rather than from reference to academic research findings, such as they are.
How should inter-governmental machinery including the Joint Exchequer Committee be strengthened and made more transparent?

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

What should be the role and remit of an enhanced Scottish Fiscal Commission and who should be responsible for generating the economic and fiscal forecasts?

(Taken together)

It is likely that the current nature of the JEC meetings, which are occasional and involve senior politicians, makes them unsuitable for a leading role in the future. Although such a body will no doubt need to continue, in order to give final approval to negotiations taking place at a lower level.

The existing Scottish Fiscal Commission will need to be expanded in terms of its funding and staffing levels to undertake the work it will need to do. It’s remit is likely to be similar to that for the OBR, as, like the OBR, its most important role will be to bring ‘neutral’ information and analysis to the table, in order to enhance clarity and minimise the room for dispute.

Similarly the Finance Department of the Scottish government will need to be expanded and better staffed. The overall result should be something akin to a Scottish Treasury and OBR, though on smaller in scale. As at the UK level, these two bodies will need to work closely with each other in order to fulfil their new roles.

A better model of the Scottish economy and its finances is essential. It should be provided by either the OBR or its Scottish equivalent. This will not be easy as the current quality and breadth of economic and fiscal data available for Scotland is relatively poor.

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

There are always inconsistencies and quirks with regards to any regional or federal funding system but many other countries manage to survive them. Nevertheless, the UK’s asymmetry of powers in the existing quasi federal system is almost unique, Spain may be the closest to it (2). This makes the ability to attain a ‘fair, transparent, effective and mechanical’ system all the more difficult.

In Scotland’s case it will also be highly devolved in the sense of full autonomy over setting of some taxes, as opposed to the use of assigned tax revenues. No other country has fully devolved IT to a region (save the Basque region of Spain), usually it is assigned rather than fully devolved e.g. Germany. Hence, it may well be that few international lessons are available, as all systems are different.

Notes

Annex 1 - Mechanics of (Rest of) UK Income Tax change example.

If the UK government raises the Income Tax (IT) rate post Smith, then more IT is raised in the RUK but the amount raised in Scotland is unchanged.

This extra revenue could be used a number of ways:

- to offset reductions in other taxes, keeping overall (R)UK revenues the same
- to be spent on services that are devolved (like the NHS)
- to be spent on services that are not devolved (like Defence)
- to be spent on reducing borrowing (and so debt levels and future debt interest related payments)

If the extra RUK IT revenues were spent on devolved services then Scotland’s block budget would rise, through the continued use of the Barnett formula, even though Scots were not paying any more in tax.

To adjust for this, it is assumed there would be a further, offsetting, cut in the Scottish block to return it to its previous position. Hence, if Scotland wanted the extra spending seen in the RUK then it too would need to raise the IT rate in order to access this extra funding.

In each of the other cases outlined above the argument is slightly different but the appropriate outcome is the same.

For example, if the rise in UK IT was spent on reserved areas like Defence or Pensions then Scotland also benefits from increased expenditure on these shared resources. Hence, a cut in the Scottish block might be considered appropriate, with Scotland then also having to raise the IT rate in order to ‘pay for’ its share of this extra spend on shared services. Otherwise it could be seen as a ‘free lunch’ scenario.

Clearly a similar situation would happen if the reverse were true. If RUK reduced the rate of IT, this would feed through to lower spending in Scotland, either directly via the Barnett formula working, or indirectly through lower spend on public services in relation to Scotland. This in turn implies an increase in the Scottish block to adjust for this i.e. Scotland is still paying at the higher rate of income tax but is receiving less of a service (of some kind) and so needs to be compensated, i.e. it is neither receiving the new benefit of a lower tax rate nor the old benefit of the higher spend on the NHS/Defence/Pensions etc.

Scotland could then choose whether to reduce the IT rate by a similar amount in order to benefit from a similar tax cut (and cut in its budget) or to continue to spend the extra, transferred, money on services.

If this impact were in relation to devolved spending, like the NHS, then the increase in the Block grant would be to offset the Barnett related cut to the Block.
If it was in relation to reserved spending, like Pensions, then the increase would be to allow for higher pensions in Scotland, although this may need to be done indirectly e.g. through a huge increase in pensioner winter allowance or the introduction of a new benefit. Effectively the higher rate of Scottish IT (than in the RUK) would be paying for this.