Thank you for inviting me to give evidence. I am sorry that I could not make either of the two dates available for oral evidence. You have already amassed some impressive written submissions. Where I simply adopt the answer of one or more of those to your questions, I just say so, to save everybody’s time.

I suggest the overriding principle that *fiscal autonomy (responsibility) implies equal responsibility for downside risks and upside rewards, and equal responsibility on the revenue and the expenditure side of the budget*. I agree with other commentators that the ‘no detriment’ principle is easy to implement in the year that a tax and/or a spending area is handed over, but difficult thereafter. I agree with the Cabinet Secretary for Finance, in his letter to you of 30.04.2015, that this is the central issue.

I agree with several of your witnesses (e.g., Royal Society of Edinburgh; Andrew Hughes Hallett; Charlie Jeffery, David Phillips) that the ‘no detriment’ principles have been put forward in a great hurry; are far from fully defined; may conflict with one another; and if fully applied would in any case defeat the point of fiscal autonomy. Furthermore, even since your consultation was launched, parties have shifted their positions towards the Smith proposals; and there has been a UK General Election.

Therefore, there will need to be an institution, not owned by either the Scottish Government or the UK Government, where these issues can be discussed as far as possible in a non-partisan and collegiate way.

I therefore group some of your questions and my answers as below:

- 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?
- What mechanisms should there be for reviewing the Statement of Funding Policy?
- How should inter-governmental machinery including the Joint Exchequer Committee be strengthened and made more transparent?
- 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?
- 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?

In this area there are already institutions that belong to one of the two governments (e.g., HM Treasury, HMT, which at present issues the Statement of Funding Policy...
without reference to any outside body); scrutiny bodies that are designed to keep their governments honest (OBR and the Scottish Fiscal Commission); and intergovernmental bodies (e.g., Joint Exchequer Committee as part of the intergovernmental arrangements created under the Scotland Act 1998).

Responsibilities are not correctly aligned. For instance, only the UK Government can ensure that UK-wide debt and deficit levels meet international and prudential requirements (see Cm 8990 and evidence from Angus Armstrong), so it is appropriate that HMT continues to control the UK’s fiscal balances.

However, it is less appropriate for HMT to remain the sole proprietor of the Statement of Funding Policy. That should be the responsibility of an intergovernmental body, with scope for appeal to a non-departmental body that is not ‘owned’ by either government. It is appropriate for an initial draft to come from HMT, with data in a form that others can check (David Phillips), but for the draft to be signed off by the Joint Exchequer Committee, with an appeal lying to the sort of body I have proposed elsewhere, for which the closest model would be the Commonwealth Grants Commission of the Commonwealth of Australia. I have written about the CGC model in my Fiscal Crisis of the United Kingdom (Palgrave 2005) and would be happy to send supplementary evidence on this.

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

As Andrew Hughes Hallett of the Scottish Fiscal Commission has said in written evidence, to seek to adopt both ‘no detriment’ principles in full is to negate the point of devolution, let alone of fiscal autonomy. In the light of that, I have one comment on each of the two no-detriment principles.

**The first no-detriment principle** is that ‘the Scottish Government and UK Government budgets should be unchanged as a result of the decision to devolve further powers to the Scottish Parliament’ (Cm 8990 2.4.6). The fairest way to implement ‘no detriment’ after year 1 of a transfer is that labelled the ‘Levels Deduction Method’ by Bell and Eiser: see [http://scotfes.com/2014/11/20/how-should-the-barnett-formula-be-adjusted-to-reflect-devolved-taxes-a-question-of-allocating-risk-wonkish/](http://scotfes.com/2014/11/20/how-should-the-barnett-formula-be-adjusted-to-reflect-devolved-taxes-a-question-of-allocating-risk-wonkish/)

Professor Bell is giving oral evidence and will be able to say more about this.

Under the Levels Deduction method,

- In future years, Scotland’s grant is equal to its grant the previous year, plus a population share of the change in comparable spending, minus a population share of the change in comparable revenues. (ibid)

Unlike the Index Deduction method proposed for the Scottish Rate of Income tax under the Scotland Act 2012, the Levels Deduction method does not produce perverse feedbacks from the decisions of one government to those of the other. This is the only method I have seen that is fair as between upside and downside risks, and that treats the revenue and expenditure sides of the budget in the same way.
The second Smith no-detriment principle is that there should be ‘no detriment as a result of UK Government or Scottish Government policy decisions post-devolution’ (Cm 8990 2.4.13). If interpreted broadly, this is absurd, because it would mean that every policy decision by one government would have to be mirrored by the other. I propose therefore that it should be treated very narrowly, to cover only these cases where

- A policy change by one government directly affects the tax receipts of the other (e.g., by one government making a change in disability benefits that has a knock-on effect on VED receipts); or
- A policy change by one government that will bring both tax competition and deadweight loss for the UK as whole (e.g., by a subnational government reducing Corporation Tax in a way that causes companies to change their tax domicile and arrange inter-company transfers purely to minimise their tax liability).

- What fiscal rules should be applied in order to ensure fiscal responsibility and debt sustainability?
- 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 Scottish Government should have free access to capital markets for its borrowing over and above the limits currently set in the Scotland Act 2012. However, within a continuing UK, the UK Government retains responsibility for overall UK public debt and deficit. Furthermore, however strongly the UK Government might insist that Scottish borrowing was entirely a matter between the Scottish Government and its creditors, the markets would probably believe that, if necessary, the UK Government would always bail out the Scottish Government. Such beliefs have underlain several debt crises in the last ten years. They are an example of what is called ‘moral hazard’. For both Scotland and the rest of the UK to be satisfied that moral hazard had been avoided, new Scottish debt must be issued with a guarantee that repayments will be a first charge on Scottish tax receipts. This has to take the form of legislation by either the Scottish or the UK Government. It would be more credible in the latter case. This would also reduce the likely premium over UK gilts that Scottish Government debt might otherwise have to offer.

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