The Smith Report recommendations and the UK Government’s draft clauses would provide for a marked increase in the powers and responsibilities of the Scottish Parliament, including in areas of finance. Both emphasised the need to develop a new Scottish fiscal framework, consistent with the UK fiscal framework, setting out fiscal rules, the funding of devolved competences, and tools to manage volatility.

This paper takes as its particular focus the relationship between the new devolution ‘settlement’, including a new fiscal framework, and intergovernmental relations. Managing the new fiscal framework will require more effective and institutionalised intergovernmental relations than currently exist. The paper focuses upon the proposed settlement set out in Smith, the UK Command Paper and the draft clauses, but it should be acknowledged that the Scotland bill to be tabled after the UK General Election may move beyond these proposals, in light of the changing positions of the parties, the election result and its consequences.

1. Devolution and Financial Interdependence

1.1 All multi-level systems combine elements of self-rule and shared rule. Self-rule refers to the extent to which regional governments are independent of central government, for example, in their scope for policy-making, legislation and revenue-raising. Shared rule, by contrast, refers to the capacity of a regional government to influence central decision making. In Scotland, a relatively high degree of self-rule has coincided with a comparatively very low level of shared rule. This is problematic in light of the new complexities and responsibilities provided for by Smith and the draft clauses.

1.2 The Scotland Act 2012, and especially the Smith proposals once implemented, will increase the self-rule of the Scottish Parliament, particularly as a result of the devolution of 100% income tax on earned income, including almost all rates and thresholds, as well as the devolution of air passenger duty and the aggregates levy, and an assigned share of VAT revenues. However, these provisions also increase the interdependence of devolved and reserved competence, without (currently) any increase in shared rule.

1.3 The Smith report noted that income tax will remain a ‘shared tax’, under the shared control of the UK and Scottish Parliaments. In practice, the Scottish Government will determine tax rates and thresholds for Scottish taxpayers; the UK Government will remain responsible for all other areas of income tax, including the personal allowance, taxes on savings, tax credits and the framework for determining the rules underpinning income tax policy, including definition of taxpayers and rules on tax avoidance and tax relief. The UK Government will thus determine the framework within which the new Scottish powers will be exercised, and its policies will have a direct impact on those aspects of income tax policy which are to become the responsibility of the Scottish Government and Parliament. The two governments will also share a bureaucracy - HMRC will continue to collect and administer Scottish income tax as well as income tax from the rest of the UK.

1.4 The Smith provisions and the draft clauses also create new policy interdependencies in other policy spheres with implications for devolved finance. Most notably, around 14% of social security spend would fall under the control of the Scottish Parliament, including Disability Living Allowance/Personal Independence Payments, Attendance Allowance, and Carer’s Allowance. These benefits interact with many other benefits, tax credits and tax/VAT exemptions, all of which remain reserved to the UK Government. Interdependencies are also apparent in relation to the flexibilities in the administration of
the Universal Credit (UC), including the power (thus far ill-defined) to ‘vary’ its housing cost elements of UC, including ‘varying’ the under-occupancy charge and local housing allowance rates, eligible rent and deductions for non-payment, subject to the consent of the Secretary of State on the practicability and timing of proposed changes. These housing elements are not only closely related to other areas of the Universal Credit, but also to other aspects of housing policy which remain reserved, including housing taxes and tax relief, and policies which shape both the mortgage market and the capacity for the Scottish Government to borrow to invest in social housing. In addition, the Scottish Government is to assume responsibility for at least some employment support programmes for the unemployed, but it will have no formal role in Job Centre Plus, or in relation to the development or oversight of rules making benefit entitlement conditional upon take-up and completion of employment support schemes. Decisions taken by UK ministers will affect in fundamental ways the new areas of devolved responsibility in social security. These interdependencies will create more spill-over effects, ensuring that the decisions taken by one level of government will have repercussions for the other.

1.5 Social security finance adds further complications. Most social security spending is calculated in the basis of demand, through Annually Managed Expenditure rather than Departmental Expenditure Limits. It is therefore not subject to the Barnett formula. An agreement will have to be reached between the UK and Scottish Government to determine how annual block grant adjustments are to be determined – a process likely to be more complicated in the context of welfare policy divergence.

1.6 Both the Smith Report and the UK Government Command Paper recognise the need for intergovernmental collaboration toward agreement on a new Scottish fiscal framework, consistent with the UK fiscal framework. This would include, among other things, agreements on: Block Grant Adjustment to reflect new tax-raising powers and welfare responsibilities ‘to reflect tax revenues foregone… and spending no longer undertaken by the UK Government’; agreement on the extension and limit of borrowing powers; the operation of the ‘no detriment’ principle, and some form of balanced budget rule. The UK Command Paper goes further than Smith by insisting that as “Scotland’s fiscal position contributes to the overall UK fiscal position and has important consequences for UK fiscal policy… the fiscal framework must require Scotland to contribute proportionally to fiscal consolidation at the pace set out by the UK Government across devolved and reserved areas”.

1.7 The emerging devolution settlement is thus more complex and interdependent than that set out in the Scotland Act 1998. The Smith Commission recognised this increased complexity in its call for the reform and “scaling up” of intergovernmental machinery “as a matter of urgency”, including new bilateral arrangements. A meeting of the Joint Ministerial Committee in December kick-started a re-evaluation existing intergovernmental arrangements within the Cabinet Office and the Devolved Governments.

2. Intergovernmental Relations and Finance under the current settlement

2.1 By design, intergovernmental relations (IGR) in the UK are mainly informal, underpinned by good communication, goodwill and mutual trust. The Memorandum of Understanding (MoU), the concordats between the Scottish Government and Whitehall departments, and the Devolution Guidance Notes were intended to embody and nurture a co-operative working culture among civil servants on a day-to-day basis.
2.2 The Joint Ministerial Committee (JMC), which brings together all of the devolved administrations with the UK Government, is the centrepiece of UK intergovernmental machinery. The JMC is a consultative not an executive body – it facilitates communication, not co-decision. It meets annually in plenary format and when required (usually annually) in its domestic format, as well as the more regular and routinized meetings of the JMC (Europe). The Calman Commission had recommended that a JMC (Finance) be established, but this was not pursued. The JMC has discussed financial issues and disputes. Using the JMC's Dispute Avoidance and Resolution Protocol, invoked as a last resort for those issues ‘where a dispute cannot be resolved bilaterally or through the good offices of the relevant territorial Secretary of State’, the three devolved administrations pursued and resolved a dispute with the UK Government over Barnett consequentials arising from the 2012 Olympics.

2.3 A number of other forums have been created to discuss intergovernmental finance. The ‘Finance Quadrilaterals’ bring together the devolved Finance secretaries and Treasury ministers to discuss ongoing fiscal issues, usually meeting twice per year. The Joint Exchequer Committee, composed of three UK ministers (the Chief Secretary to the Treasury, the Exchequer Secretary, and the Secretary of State for Scotland) and two Scottish Government ministers (the Cabinet Secretary for Finance, Employment and Sustainable Growth and the Cabinet Secretary for Parliamentary Business and Government Strategy) was established in September 2011 as a forum for high level discussions on the implementation of the financial provisions of the Scotland Act 2012. Although the Scottish Government regarded it as a forum for developing a longer-term relationship to discuss fiscal issues, its terms of reference were never agreed and it has not met for at least two years.

2.4 At operational level, a Scotland Act 2012 implementation programme board, including representatives from HMRC, HM Treasury, the Scotland Office and the Scottish Government, has been overseeing the delivery work carried out by HMRC with respect to the implementation of the Scottish rate of income tax as well as the devolution and, hence, the disapplication of Stamp Duty Land Tax and Landfill Tax in Scotland. However, the focus of these forums, to date, has been on implementing new powers. We can expect them and similar intergovernmental forums in social security to extend their work to incorporate implementation of the Smith powers. It is not at all certain that they will have a permanent role in managing policy interdependence or in providing an avenue for Scottish influence over those areas of reserved policy which will directly impact upon Scottish competences.

2.5 Most intergovernmental exchange continues to take place below the radar, between officials of varying ranks working in similar or overlapping policy issues on a (vertical and horizontal) bilateral basis and ultimately in ad hoc meetings between ministers. This raises questions about the capacity of both the Scottish Parliament and the Westminster Parliament to give effective scrutiny to intergovernmental relations.

3. No Detriment

3.1 Intergovernmental working will be central to the application of the principle of ‘no detriment’. This principle, set out within the financial section of the Smith Report, indicated that neither government should be adversely affected as either a result of the devolution of further powers or of the policy decisions taken post-devolution. The implication is that policy decisions of one government which are considered to have a detrimental impact on the other would require financial compensation.
3.2 We can illustrate some examples of where the ‘no detriment’ principle as a result of policy decisions could emerge. The Work Programme, for example, is largely financed by savings in social security spending. If, this programme (or its equivalent), designed and delivered by the Scottish Government, failed to meet DWP expectations and targets for getting the long-term unemployed back to work, the Scottish Government may be expected to compensate the UK Government for higher than expected benefit costs. An oft-cited example is in relation to the devolution of Air Passenger Duty. If, as expected, the Scottish Government was to use its new powers to cut APD and this was considered to have a detrimental impact on air transport and associated revenue in the north of England, a strict application of the ‘no detriment’ principle suggests that the Scottish Government would be required to pay financial compensation to the UK Government as a consequence.

3.3 The ‘no detriment’ principle is clearly open to interpretation, with some interpreting it more narrowly than others. In his evidence to the Treasury Select Committee, George Osborne, gave his view that “the no detriment principle is principally about adjustments to the block grant” stressing several times his belief that “that authorities live with the consequences of their own actions”. Asked specifically about the detrimental effects of a cut in APD, he indicated that “tax competition is something we should allow… (A Scottish cut in APD would be) a responsibility for the government here… it’s not necessarily something the people of Scotland should pay for” (Chancellor’s Evidence to Treasury Select Committee, 20 January 2015). A Labour Government may have a different, broader view of ‘no detriment’, given its unease over tax competition, its emphasis upon inter-regional solidarity, and the pressure it may face from its own MPs and party in the north of England, where the impact of policy divergence may be more clearly felt.

3.4 The ‘no detriment’ principle is intended to work both ways: if the tax receipts or the spending of the Scottish Government is adversely affected in its new areas of policy competence by the policy decisions of the UK Government, it should be compensated accordingly. It is not clear how this could be implemented. Neither is it clear which authority would be entrusted to determine when detriment had occurred, the precise cost incurred as a result of policy decisions, and the level of compensation which should be paid.

3.5 A strict and extensive application of the ‘no detriment’ principle could result in an increase in intergovernmental disputes without prior intergovernmental agreement and ongoing intergovernmental cooperation over the operation of the principles. One possible consequence of the ‘no detriment’ principle is that it may present a disincentive to develop divergent policies likely to have cross-border effects.

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